



Institutional rural finance: lessons from the past and reforms for the future

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Since their inception, the rural finance institutions have been unable to meet the expectations of planners and beneficiaries, and concerns have been raised about a lack of credit facilities for the rural sector. In spite of three decades of experience in rural financing, Papua New Guinea has not been able to establish a viable rural financial institution. Reforms to the Rural Development Bank to improve its performance are suggested here.

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Institutional rural finance has a long history in Papua New Guinea. The Papua New Guinea Development Bank was established in 1967 to provide funds for primary production, to establish and develop industrial and commercial undertakings, and to provide management services. Legislative changes redirected the Bank's emphasis towards agricultural development and accordingly changed its name to the Rural Development Bank of Papua New Guinea.

But the Rural Development Bank has not succeeded in adequately meeting its mandate to provide finance to agriculture. Failure of institutional rural finance has resulted in the exploration of other possibilities. The Department of Agriculture and Livestock has recently introduced the idea of commodity based credit through the existing banking system. The commodity industries have proposed

the establishment of tree crop or farmers banks, but such a proposal requires thorough appraisal before experimentation.

The Rural Development Bank

The Rural Development Bank is the major player among rural financial institutions in Papua New Guinea, followed by the public and private sector commercial banks and other non-banking financial intermediaries. Over the last three decades the Bank has struggled with agricultural financing. As stated by the then Chairman of the Rural Development Bank, Sir Frederick Reiher, 'the bank requires changes and if the bank is left behind as it is, not only will it become ineffective, it is bound to face its natural death in due course' (Reiher 1991).

There have been several studies and reports on restructuring and improving the

performance of the Rural Development Bank, including reports by the World Bank and Asian Development Bank. Donor agency experience and the results of their impact assessment studies showed that the Bank's failure to reduce costs and other evidence of political interference with the objectives agreed to in the 1985 Action Program persuaded the World Bank to drop further lending to the bank.

- The personnel costs of the Rural Development Bank rose from 2.7 million kina in 1985 to 5.2 million kina in 1990, while administrative overhead costs exceeded the agreed level of 5 million kina—reaching 10 million kina.
- The mounting losses due to loan default pertained to agriculture loans, but reflected a trend across all commercial and industrial portfolios of the Bank.
- Data on recovery were not available and the donor agencies were not able to evaluate the loan recovery performance.
- The 1990 Annual Report of the Rural Development Bank showed that the share of agriculture lending was only 49 per cent against an agreed 75 per cent. The Bank ignored the criticism that it was abandoning its mandate in agriculture.

The donor agencies expected a firm resolution to seek critical changes in policy and the institutional framework of the Rural Development Bank, including interest rate reforms and financial independence and viability. Although donor studies have been criticised by the Bank, the regulators and decision makers must sort out the problems and redeem the institution.

Current status of the Rural Development Bank

The Annual Report and Financial Statements 1992 are the latest available audited reports of the Rural Development Bank. The report was presented attractively

but with alarming and inconsistent information. Two examples will illustrate the point.

- The pie chart on the loan portfolio of 1992 shows agriculture advances of 89 million kina (75 per cent) of the total lending. The report also shows that the total net lending portfolio of the Bank was 44 million kina. The explanation is that bad debts have been mixed with the loan portfolio. Loan approvals by sector from 1983 to 1992 reveal that approvals for agriculture were less than 50 per cent of the total lending.
- The interest earned (the major income), including commission and other items, is about 12 million kina according to the accounts. Given an average lending rate of 10 per cent, earned interest cannot exceed 5 million kina for a loan portfolio of 44 million kina. The provision of interest on bad debts must be verified.

The Auditor-General's report on the Rural Development Bank's 1992 financial statements revealed a deteriorating situation.

- There has not been an adequate review of the recoverability of each loan.
- Auditors were unable to obtain sufficient evidence to form an opinion on the adequacy of the provisions for bad debts.
- The Auditor General was unable to obtain evidence to form an opinion on the level of mis-statement of interest income due to the accrual of interest on non-performing loans.
- The Auditor General was unable to form an opinion on the realisable value and provisions against the loans, advances and investments totalling 6.5 million kina of the Bank's subsidiaries—these companies were showing net liability.

- The interest accrued on loans from the government, pending approval of conversion of the loan into equity, may increase the net loss for 1992 to 20 million kina.

- The Bank has a deficiency of share capital and reserves amounting to 3 million kina. In spite of this, the Bank presumes it can meet its debts and commitments and prepares its accounts as if it were a 'going concern'.

The Bank's accounts give misleading information to the bank regulator, the public and the donor agencies. The equity base is totally eroded and the bank is over-trading on the capital. Yet the Bank assumes, despite the current budget crisis, that the government will provide sufficient financial support to meet all its commitments.

Hard decisions are necessary, and must be carried out without any compromise. Some decisions may not be favourable to all concerned, and there may be resistance to change, especially among bank personnel. Change must be managed in keeping with main objective of long-term sustainability of the institution. In addition, the Bank has a key role to play in Papua New Guinea's rural economy and the provision of services to the rural community.

Experimenting with new models

Any attempt to replicate the achievements of other successful rural financial institutions should be carried out with great caution. A solution that works in one socioeconomic environment will not necessarily work in another, where social values are different (Yaron 1994). The much-acclaimed Bangladesh Grameen Bank's (BGB) ideas of generating self-employment for the poor through credit without collateral should work in other countries with widespread poverty and underemployment. But we must not lose sight of the implicit and explicit subsidies available to banks perceived as successful. The BGB's operations are subsidised to the extent of 40 per cent (Hossain 1988). Furthermore, elements like taking the bank

to the people and intensive interaction of bank staff with borrowers may be inappropriate and highly expensive for sparsely settled areas with an under-developed transport system (Hossain 1988).

Despite a multitude of non-banking investment financing institutions like the Public Officers Superannuation Fund, National Provident Funds, Credit Corporation, Investment Corporation and others, rural sector investment financing in Papua New Guinea continues to be very low. It would make sense to assess the various ways of increasing the involvement of these institutions in rural financing instead of establishing other specialised institutions, including a Rural Development Corporation, thereby duplicating roles and responsibilities and leading to increased public sector expenditure to finance these institutions when there is no guarantee that the new institutions will not meet the same set of problems and failures as existing institutions.

Some of the generic characteristics of most of the failed rural banks include

- initial low-cost and cost-effective administrative structures becoming high-cost and non-profitable systems unable to sustain their operations
- deviation from the main role of financing agriculture and the rural sector and diverting the lending portfolio from agriculture to other highly profitable areas
- investing funds on interest-bearing deposits with other banks because this is more profitable than lending to agriculture
- poor credit recovery and accumulation of bad and doubtful debts
- hiding the bad and doubtful debts
- failure to make provision for bad debts
- furnishing misleading book profit by adding interest to bad and doubtful debts

- poor resource mobilisation including rural savings and failure to attract capital from the market
- unethical mobilisation of deposits by retaining part of the loans as deposits
- recovering the earlier loans by withholding the current loan in the name of repetitive loans and showing an improved performance in recovery and loan disbursement
- seeking government subsidies to sustain operations without proper expenditure control
- using the implicit subsidy as low interest-bearing funds provided by donor agencies
- a top-heavy structure with weak branch networks and central administrative offices draining most of the income
- rural sector failure or downturn losses transferred to rural banks as bad debts, without credit guarantee and insurance against failures.

Careful evaluation needed

In addition to responding to the generic problems listed above, the issues must be properly identified and addressed before venturing into new ideas and models of agricultural financing, including the proposed tree crop or farmers bank.

Financial policy

The first and foremost prerequisite for a successful rural financial system is an appropriate financial policy on

- interest rates to allow adequate spread and earning a reasonable return on a par with the opportunity cost of capital
- credit decisions based on financial return
- the term nature of lending (short and long term)

- resource mobilisation
- accounting of bad debts and profitability
- expenditure control based on costing studies
- cost recovery including service charges.

Any rural finance program is bound to fail without appropriate policies in these areas.

Institutional policies

A rural bank must have appropriate and cost-effective structures and management systems. Rural financial institutions must be financially sustainable. Financial and economic viability, institutional cost effectiveness and a reasonable return on investment to recycle funds must be established.

Viability of the credit operation

The viability of the credit operation, particularly smallholder credit to thousands of farming units stretched across the country, is the crux of the problem. The affordability and profitability of smallholder lending must be properly evaluated before embarking on new banking ideas. Failure to do so will lead to a situation similar to that of the Rural Development Bank, namely another subsidised credit operation draining and diverting the financial resources of sponsoring agencies.

Resources for lending

Adequate resources must be available or mobilised to lend to the various activities of the rural sector. Lack of resources for lending is a critical issue. If the new banking proposals, including the tree crop banks, are going to depend on funding assistance from the government, then they are going to repeat the mistakes of the Rural Development Bank. Under the current financial crisis the idea will be

viewed as a transfer of funding from one ailing institution to another experimental institution.

It may be possible for the tree crop banks, proposed by the Industry Corporation, to provide the short-term credit with loan recovery tied to sale proceeds of the commodities. It may not be possible, however, to provide the long-term investment credit that is crucial for the rehabilitation and renovation of the tree crop sector. New banking ideas must provide the best alternate system to convince the external donors to provide loans.

The failure of the Agricultural Bank Bonds to attract investors in Papua New Guinea is an indication of the difficulty of mobilising long-term funds for investment credit. Borrowing at a commercial interest rate of 11–13 per cent from elsewhere for lending to long and medium-term investments may not be an option when the current market rate of lending is around 15 per cent.

Managerial capacity

The Industry Corporation must also assess its managerial capacity to take up the responsibility of financing the agricultural sector. It can hire the expertise to manage the banking activities, but the cost of hiring specialist workers may affect viability and erode cost effectiveness, though not profitability, of the new approach, as in the present system. Alternatively, if it chooses to manage the lending portfolio, there may be other problems. Considering the track record of management style in Papua New Guinea (and elsewhere), too many and diversified management roles may lead to role conflict, confusion and ultimately management failure.

Viability of the rural sector

Having satisfied the above conditions, the viability of the rural sector must be ensured

to enable loan repayment. Rural services delivery and technology transfer must fully address the problems of the rural sector. It must be ensured that any failures or losses of the rural sector are not transferred to the rural bank.

Moral ethics and willingness to repay bank loans

Above all, the willingness and moral ethics of the rural society to save and repay loans, without a handout mentality, are of paramount importance.

Need for reforms

Two problems in particular confront rural financial institutions (Yaron 1994)

- ensuring efficient and relatively low-cost operational procedures for screening borrowers, processing and monitoring loans, mobilising and servicing voluntary savings
- achieving adequate loan collection so that continued operations are feasible without constant reliance on state concessional funds or bail-outs.

Reforms must try to liberalise the financial market and remove all financial repression so that both cost and price are decided by the market. During the period 1990–94, the weighted average interest rate (price / interest charged on loan) was between 15 and 10 per cent (for commercial banks), and the weighted average interest rate on deposits was between 11.5 and 5 per cent (cost / interest paid to mobilise funds by commercial banks). The interest spread (the difference between the interest cost and interest income) was about 5 per cent—just sufficient to cover the bad debts. At this spread, the administrative and other costs remain as losses, showing the extremely narrow margin in rural banking.

Given the current level of administrative costs and interest rates, rural banks cannot hope to break even, even if their lending portfolio increases to

200 million kina. Therefore it is vital that banks reduce administrative costs and that interest rates are reformed.

A viable and efficient rural financing institution for Papua New Guinea can only be achieved by appropriate and timely institutional and policy reforms to the Rural Development Bank. The implementation of these reforms must be carried out within a reasonable time frame, and be true to the spirit of the reform, without compromise.

Institutional reforms

The Rural Development Bank must be restructured. The central administrative office—the centre of expenditure—must be lean and responsive to the needs and expected roles of the bank. Branches must be adequately strengthened by transferring excess staff from the central office to enable them to perform a more dynamic role in the preparation of lending projects and programs, delivery and monitoring of credit, recovery and rural savings mobilisation. The reduction in staff strength and retrenchment must be carried out without delay. Salary and wage costs must not exceed 2–3 per cent of the lending portfolio.

Cost control measures must be introduced along with specific ceilings on various expenditure and performance indicators. Loan recovery must be assigned top priority while loan defaults are appropriately classified and provision for bad debts monitored. Performance must be scrutinised carefully to conform to the standards concerning lending decisions, cost control, credit management and savings mobilisation. Manipulation of accounts to paint 'rosy pictures' must be stopped. Improving the capacity to monitor and audit the financial institution, its profitability, cost controls, assets and liability management must be accorded high priority.

The appointment of the top executive positions and board of directors must be processed without much political interference, preferably by the central bank, keeping in mind the banking management expertise of the applicants. Similarly, political interference in lending decisions must be eliminated. The role of management, the board and professional advisors must be clearly recognised.

Restrictions on bank branching and closure of loss-incurring branches or other remedial measures, including financial discipline and reduction of overhead costs, must be evaluated and carried out. Transaction costs for smallholder and less developed areas must be kept at a minimum by implementing various systems and procedures including mobile banking. Any operating costs exceeding what the smallholder can pay must be subsidised. Using informal groups including non-government organisations to deliver and recover credit to smallholder and less developed areas must be assessed.

Policy reforms

Interest rate policy. Interest rates must be liberalised and market rates charged on loans and deposits. This policy is key to maintaining the financial viability of the lender, enabling it to pay sufficient interest on deposit. The interest spread must remain as profit and it must cover the opportunity cost of capital in the long run. Bank regulators must monitor interest rates and the interest rate spread along with service charges to ensure that there is no imperfection, including excessive charges.

Service charges. Service charges must be properly costed to recover all administrative costs from customers. Interest rates need not be inflated across the board to cover service charges. Similarly, other charges (to recover bad debts, exchange risks, indexation for inflation) must be carefully estimated and

charged to the loan accounts. Service costs on credit programs for special projects for development of smallholder, remote areas and less developed areas may be subsidised, if they are really beyond the repayment capacity of the target farmers.

Non-directed finance. The market must be allowed to decide the credit flow. Forced credit flow, through political or administrative means, may misdirect the flow to non-viable projects and lead to failure of the credit program and heavy loan default.

Smallholder credit and credit for less developed areas. The market approach may adversely affect the delivery of credit to this vulnerable, but most important rural segment. There must be specialised credit programs specifically designed on a project or program basis, and supported with the delivery of services.

Resources mobilisation. A rural bank must make efforts to mobilise savings for further on-lending and introduce attractive and cost-effective savings instruments.

Policy on credit decisions. Credit decisions must be based on financial returns on investment and the repayment capacity of the borrowers.

Policy on the term nature of lending. A rural bank must be encouraged to lend on both a short and medium or long-term investment basis, with an appropriate mix of deposits to ensure liquidity and profitability.

Policy on loan recovery. Proper records on loan recovery / recoverability must be maintained and close follow-up with marketing agencies must be undertaken to recover as income is realised by the farmers.

Accounting of bad debts. Bad and doubtful debts must be carefully classified and provision made periodically for irrecoverable debts. Strict expenditure control must be ensured and subsidy should not be provided on an *ad hoc* basis.

Banking regulation policy

A Rural Banking Division should be established in the central bank and in the Department of Finance and Planning to regulate rural bank operations and to monitor its restructuring. The regulator must form a task force to carry out the various policies to restructure and revamp the Bank.

The idea of promoting other rural banking institutions, including the proposed tree crop banks and the Rural Development Corporation need not be pursued until after detailed evaluation. Specialised credit programs and projects addressing the tree crop sector and other development projects should be transferred to the Rural Development Bank and re-financed.

Finally, the Rural Development Bank must lend only to agriculture and other rural sector activities with an appropriate credit-mix for smallholder and less developed areas. Commercial and Industrial finance must be restricted to projects with linkages with the rural sector or as part of the rural project.

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