microREPORT

COSTS AND BENEFITS OF LIQUIDATING PERU'S AGRICULTURAL BANK

Robert C. Vogel

January 2005

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Accelerated Microenterprise Advancement Project

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IMCC is a small firm specializing in financial reform in developing and transitional economies.

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1 Introduction

The Banco Agrario del Peru (BAP) was a large agricultural development bank working throughout Peru's rural and agricultural regions. Because of its poor performance, fiscal pressures, and new macroeconomic policies aimed at controlling inflation, BAP was closed in 1992. This summary case describes and explains some of the forces that led to the bank's demise and, more importantly, the implicit as well as explicit costs and benefits of liquidating BAP, many of which became apparent only after its closure. Lessons about the value of rural financial infrastructure, in particular, may be useful when considering the liquidation of other agricultural development banks.

2 The Establishment and Evolution of BAP

The progenitor of BAP was formed in 1931 to provide loans to cotton, sugar, and rice producers in the coastal region. Over time the range of products financed by BAP broadened and the bank was also allowed to accept deposits and transfer payments through letters of credit. After the mid-1950s, the bank increasingly attracted donor support; the World Bank made its first loan to BAP in 1954, followed by a series of five additional loans, with a total of US$148.3 million disbursed through 1987. The United States Agency for International Development (USAID) also gave or lent resources to BAP, sometimes through the Ministry of Agriculture and mostly for supervised credit programs, which amounted to $43 million. The Inter-American Development Bank (IDB) likewise lent a substantial amount to BAP from 1971 through 1983 in the form of seven projects totaling about $226 million. In addition to loans made directly to BAP, the bank was responsible for distributing loans funded by other agencies such as the Ministry of Agriculture, which in turn used donor funding. The acceptance of these external funds subjected BAP to donor fads and practices, including reporting and evaluation requirements that boosted BAP's administrative costs. The ebbs and flows in donor funding also increased the bank's liquidity management problems, and the access to relatively cheap donor funds deflected BAP from aggressively seeking deposits.

In the late 1960s and early 1970s, BAP's activities were reoriented to support land reform and central planning. In addition to providing subsidized credit, the bank softened its collateral requirements and attempted, with little success, to make more longer-term loans with donor funds. This was reinforced by laws that required BAP to make at least half of its loans to poor farmers. Through numerous laws and decrees, BAP was increasingly subjected to political whims throughout the 1970s and 1980s. These shifts in mission were most pronounced when the political party in power changed. To its long-run detriment, neither donors nor politicians paid much attention to BAP's financial health or to reinforcing an information system that provided a timely and accurate record of its solvency. BAP's transparency was clouded by the actions of donors and government, the very parties that should have been most concerned about tracking its performance.

Both the number of employees and the number of BAP offices rapidly increased during the 1980s to provide increasingly subsidized loans in remote areas. The adverse effects of this expansion on administrative costs were paralleled by higher rates of inflation that substantially exceeded the nominal interest rates charged on BAP loans. In the later 1980s, BAP was required to make loans in disadvantaged areas at zero nominal rates of interest, with the promise that the government would reimburse BAP for the interest rate subsidy—a promise that was not kept.[1] High administrative costs, sticky interest rate policies, and accelerating inflation evaporated the purchasing power of BAP's loan portfolio and converted the bank into a dependant of the

[1] The loans made during the late 1980s at zero interest rates made up 10 to 15 percent of BAP's portfolio and, at the time of closure, the government's debt to BAP for the interest rate subsidy amounted to something between $150 million and $380 million, depending on what exchange rate (official or black market) is used to convert local currency to dollars.

Central Bank by 1990. Between 1987 and 1988, for example, the purchasing power of BAP's loan portfolio was virtually cut in half and the bank was forced to suspend term lending.

At least three notable trends stand out in BAP's history. First, over the period 1970 to 1989, BAP steadily increased its loan coverage from less than 4 percent of all farmers to about a quarter of them in 1989, a substantial achievement. In the late 1980s, BAP extended loans to farmers who cultivated about half the farmland in the country. The ratio of new BAP loans to gross domestic product from agriculture grew steadily from 1970 to 1980 and then fluctuated substantially over the 1980s until plummeting below early 1970s levels in 1987. In large part, the fluctuations in this ratio were due to ebbs and flows in the real value of BAP's new lending.

A second trend was the crowding-out of commercial banks by BAP. In 1950, BAP provided a third of all formal agricultural credit in the country, with commercial banks supplying the rest. Over the next three decades, BAP increasingly extended a larger percentage of total agricultural loans, until it captured more than 90 percent of the formal agricultural loan market in 1976 and more than 80 percent thereafter. Commercial banks were pushed out of the rural financial market by BAP's subsidized loans and were further discouraged from making agricultural loans in the 1970s and after by land reform.

Third, the mix of money used by BAP to fund its loans changed dramatically during the latter part of the 1980s. The importance of additional deposits and loans repaid declined in real and relative terms, and BAP was driven to the Central Bank for funds. Despite being allowed to offer slightly higher interest rates on deposits than commercial banks, and receiving preferential treatment on reserve requirements, BAP was unable to attract many deposits from rural households. The real value of deposits in BAP fluctuated widely from year to year because of inflation and changes in exchange rates, but fell sharply after 1986. Shortly before the bank was liquidated, most of BAP's deposits were comprised of quasi-compensatory balances deposited by merchants who sold inputs to BAP clients and frozen deposits made by farm organizations such as the coffee producers. From 1986 through 1989, the increase in nominal deposits provided less than 3 percent of the funds used in BAP lending.

3 A Review of the Situation after BAP's Closure

BAP's liquidation was based on the assumption that the private sector would fill most of the void in the rural financial market left by BAP's closure and the collapse of other rural financial institutions, especially the credit unions and mutuals. Although there was some recognition that rural finance problems might persist, this was considered something that could be put on the back burner for several years by policy makers. International Monetary Fund (IMF) and IDB staff applied substantial pressure to close BAP, reinforcing similar sentiments in the Ministry of Economy and Finance, the World Bank, and the Central Bank.

As a bridge between the liquidation of BAP and the hoped-for voluntary expansion of private sector lending to farmers, the government implemented several measures soon after BAP was closed in May 1992. The first measure imposed an agricultural loan quota of 15 percent on the loan portfolios of commercial banks. A second measure liberalized restrictions on the sale of farmlands in the hope that this would enhance their use as loan collateral. The government also initiated a third measure that provided about $200 million as funding for farm inputs through a program called FONDEAGROS, which was managed by the Ministry of Agriculture and provided loans in kind. From 1992 to 1995, the government committed about $230 million to these programs. A companion program called Fondos Rotatorios was the fourth measure implemented and involved government expenditures of about $92 million from 1992 to 1995. The program was managed by the Ministry of Agriculture and provided loans in areas outside the coast at concessionary interest rates. The fifth measure was to promote, through the Ministry of Agriculture, the formation of private cajas rurales (rural savings and loan institutions) to replace part of the financial infrastructure that BAP had formerly provided in rural areas. In early 1997 there were 17 of these cajas, with a loan portfolio of about $44 million, mostly funded by the second-story COFIDE (Corporación Financiera de Desarrollo).

4 Costs and Benefits of Liquidation

The costs and benefits of closing the Banco Agrario del Peru are easier to qualify than to quantify. Some of the most important costs are implicit rather than explicit, and some costs are still being incurred years after the bank's liquidation. The hyperinflation during the final few years of BAP's existence also makes it difficult to convert nominal values to real values.

4.1 Costs

The most prominent cost of liquidating BAP was the loss of virtually all of its loan portfolio, which, on paper, had a book value of about $200 million in 1990. If the bank had continued to operate it likely would have recovered substantially more of this portfolio—possibly as much as a third or more—rather than the less than 1 percent recovered by the commission responsible for liquidating BAP. At least some of BAP's borrowers would have repaid their loans if they knew the bank would persist and provide loans in the future, even though these new loans lacked subsidies. The announcement in 1991 that BAP was to be liquidated destroyed the perceived value of borrowers maintaining a good credit rating with the bank through loan repayment and undermined the morale of BAP employees.

Another sizeable, but unmeasurable, cost of closing BAP was the loss of nonmoney "financial capital." Financial intermediation is based on the knowledge (nonmoney financial capital) assembled about one another by intermediaries and their clients. Borrowers and depositors develop a working relationship by collecting information about how to do business with a bank, while bankers assemble knowledge to screen loan applicants for creditworthiness. It is much easier and less costly to borrow and lend among people who know each other than it is to conduct these transactions among strangers. The liquidation of BAP terminated working relationships between banks and clients amounting to about one-quarter million rural households, relationships that will be costly and time consuming to rebuild. It will cost hundreds of millions of dollars and many years to rebuild similar numbers of working relationship in rural areas—witness the slow and costly expansion of the cajas rurales. The cajas rurales that were operating in 1997 provided only a small fraction of the financial services provided by the more than 500 offices—about 170 of them full-time facilities—that BAP had at its zenith.

Liquidation also sharply decreased the value of most of BAP's physical assets; the use value of these assets was much higher than their salvage value. At closing, about half of the offices owned by BAP were in relatively new buildings (about 80). The ownership of some of these buildings was transferred to commercial banks at "fire sale" prices to clear BAP debts, other offices were sold for modest prices, and still others remain vacant. BAP vehicles were given to various government agencies, including the military, and most of BAP's computers (old laptops) were scrapped along with BAP's sophisticated radio communication system. It is fortunate that donors have short memories; otherwise, there would have been much gnashing of teeth among them when the physical assets they helped BAP purchase were so ignominiously scrapped or used for other purposes.

BAP had an inordinately large number of employees, down from something near 5,500 to about 4,500 at closing. The initial cost to terminate these employees was about $8 million. Court cases were still pending in 1997, however, that involved some unknown quantity of additional payments to these ex-employees. The costs involved in lawyers and courts haggling over BAP's assets and liabilities were also still ongoing five years after BAP was liquidated. Inefficiencies in the judicial system are a major reason the liquidating commission gave up on collecting many debts owed to BAP.[2]

After BAP was liquidated, the government was forced to use alternative—even less efficient—channels to provide agricultural credit. In 1997, when this paper was initially written, it was anticipated that a significant portion of the funds provided by COFIDE to the cajas rurales, for example, would not be recovered. Likewise, the periodic funding of temporary credit programs administered by the Ministry of Agriculture—FONDEAGROS and various Fondos Rotatorios—have cost the government hundreds of millions of dollars since the closure of BAP, and many of these loans, the authors predicted, would not be recovered.[3] The costs of these stop-gap programs and the costs of reconstructing new financial infrastructure to fill the gap in rural financial markets—especially in deposit services and microlending—left by the closure of BAP will likely continue for some time, including the private costs of building new banking facilities in rural areas.

For good or ill, the BAP was the primary source of medium- and long-term credit in Peru for farm investments. The private sector has filled little of this important market niche since BAP was liquidated. The lack of these longer-term loans will impose costs on the economy, especially where farm units and agro-industries must make substantial investments that are usually supported by borrowings before competing in international markets. Commercial banks have been more successful in expanding short-term lending for agricultural purposes, especially in coastal areas. In 1996, commercial banks lent about $350 million for these purposes. The cajas municipales (municipal savings and loan institutions) and a few nongovernmental organizations also lent minor amounts, possibly as much as $12 million, for agriculture in 1996.

4.2 Benefits

BAP was liquidated because dominant policy makers, including donor employees, concluded that the benefits of closing the bank exceeded perceived costs. With the aid of hindsight, one can speculate on whether or not costs were estimated accurately by decision makers. Would they have closed the bank if they had known that few of BAP's loans would be collected later, that most of the bank's physical assets would have little salvage value, that employee compensation litigation would drag on for years, that five years later commercial banks would fill only about half the breach, that term lending for agriculture would disappear,

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[2] In some cases debts were uncollectible because BAP records disappeared or were left in disarray at closing.
[3] In August 1997, for example, the government directed $31 million in ad hoc funding through the Ministry of Agriculture for in-kind loans for fertilizer, farm chemicals, and seed.

that the government would be forced to do substantial ad hoc financing of agriculture after BAP's liquidation, and that replacement rural financial infrastructure would take so long to build? In fairness to those who weighed the costs and benefits of closing BAP, it was likely easier for them to see the substantial near-term benefits of their actions than it was to predict accurately the ultimate costs, many of which occurred years later.

Perhaps the most clearly perceived benefits of closing BAP were extracting the government from subsidized credit, insulating the Central Bank from politics, disentangling fiscal from monetary policies, and stabilizing the economy. On a practical level, government and donor officials felt that BAP, with its Central Bank funding, was a major cause of inflation. Policy makers believed that BAP's demise would cool inflation and constrain government spending. The decision to close BAP was driven primarily by stabilization policy, supported by a philosophical shift in favor of private enterprise.

Understandably, commercial bankers supported liquidating BAP, although few of them rushed in later to fill the breach left by BAP's closure. Although undocumented, informal finance likely filled part of this breach, and some of this informal finance undoubtedly relied on loans from commercial banks.

5 Lessons

Each country is different. One must be cautious, therefore, in drawing lessons from a case in one country and applying them where conditions may be substantially different. Nevertheless, the lessons learned from this Peruvian case might provide a checklist of what may happen when government-owned agricultural development banks elsewhere are liquidated.

It is probably unrealistic to expect that the private sector will build all of the financial infrastructure necessary to support rural development. In most countries governments play some role in laying or in maintaining such infrastructure. At a minimum, this includes prudential regulation and supervision, especially of institutions handling deposits. It may also include providing seed capital to start up new institutions and limited subsidies to strengthen existing financial institutions. The gap that persists in Peru's rural financial market five years after the liquidation of BAP is an indication of the reticence of commercial banks to jump into making small loans in rural areas, into term lending, and into rural deposit mobilization, especially after a country has passed through severe economic stress.

When new financial organizations are created to fill part of the void left by liquidated agricultural development banks, they will likely use some of the rubble left from the liquidated bank: buildings, employees, and old banking practices and habits. The new organization must also deal with clients' banking habits and perceptions and must sink or swim in the economic and political environment that may or may not favor its survival. Changing habits and the economic environment requires time, changes in incentives, and patience. This includes changes in the role assigned to new and existing organizations. If these systemic problems are not resolved, the performance of new financial institutions may echo that of liquidated institutions.

Financial institutions are vulnerable to political intrusions when they are dependent on donor or government funding or are integrated with a government ministry. Some measure of independence comes from mobilizing deposits. Rural banks may also have more independence from the whims of donors and politicians if their governance is dominated by central banks, ministries of finance, and superintendents of banks, rather than by non-bank agencies.

Rural finance is costly, but experience in several countries shows that it can be done profitably, if done correctly—even by government-owned development banks. It was not done correctly in Peru, and the costs helped strangle BAP and force it into dependency on outside subsidies. Correct policies include allowing lenders to charge rates of interest that cover their costs and maintenance of value, plus allowing a margin for profit. In real terms this may involve charging as much as 3 to 4 percent per month on small loans. With this, the intermediary should be encouraged to reduce transaction costs and realize economies of scale and scope. Inflation combined with concessionary interest rate policies sapped the vitality of BAP.

The perceived benefits of liquidating a development bank are apparent more readily and earlier than the costs of the action. Many of these costs are impossible to assess accurately in advance because they include the time and effort involved in building new financial infrastructure to replace the old. A minister of finance and an IMF country representative may cure some of their short-term headaches in reforming and stabilizing an economy by closing the agricultural bank, but other, even more persistent headaches may appear later in the office of the President, in the Ministry of Agriculture, and in donor offices when they try to rebuild rural financial infrastructure.

Especially in the case of agricultural development banks, the practice in the past of providing highly subsidized credit discouraged alternative sources of finance from expanding in rural areas. Thus, when these types of banks are liquidated, they leave a larger void in rural financial systems than might have been the case if nonsubsidized lenders had not been driven out by unfair competition. The time and costs involved in filling this void can be substantial.

In part, development banks encounter problems because their operations are not transparent enough. In private banks, transparency allows depositors and shareholders to participate in the regulation of bank behavior. In government-owned banks, it is the responsibility of donors and the government to assist in regulating bank behavior by withholding funds from banks that perform poorly. This requires governments and donors to care about the solvency of the bank and to insist on information systems that clarify, not cloud, the financial performance of the banks. Forcing development banks to manage large numbers of targeted lines of credit diminishes transparency.

Perhaps one of the most important lessons that can be drawn from the BAP case relates to expectations and discipline. Traditional development banks such as BAP often perform poorly because donors, governments, and politicians are not disciplined in the way they use these banks. This is reinforced by the lack of discipline among bank leaders and employees, along with lack of client discipline. In many cases, the expectations about performance of these banks are set too low and this then becomes a self-fulfilling prophecy: no one expects these banks to provide high-quality services, nobody expects them to recover their loans or to earn a profit, and no one expects them to mobilize deposits or to become subsidy-independent. Successful reform of these banks involves elevating expectations about performance and enforcing more discipline on all those whose actions affect the bank. The changes in expectations and discipline involved in successfully developing new financial infrastructure to replace that which is eliminated by liquidation of development banks may turn out to be identical to the changes needed to successfully reform development banks. If policy makers cannot effect these changes through reforming development banks, they may be unable later to effect the changes in expectations and in discipline needed to create successful institutional replacements.

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