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microNOTE 13

Relevance of State-Owned Retail Banks for Development Finance[1]

Some restructured SORBs have worked. Incentives to leverage their advantages in micro and rural finance have produced dramatic results. The speed and extent of service expansion to new clients in these cases—including the well-known case of Bank Rakyat Indonesia's Unit Desa System and the more recent success stories related to Banco do Nordeste's CrediAmigo in Brazil, the establishment and turnaround of the National Microfinance Bank of Tanzania, and the restructuring and privatization of the former Agricultural Bank of Mongolia (now called Khan Bank)—have not been replicated in other models or development assistance projects.

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In many countries, state-owned retail banks (SORBs) are the only financial institutions in rural areas, and they have a wealth of assets in terms of branch infrastructure and institutional knowledge that can—under the right circumstances, strategies, and leadership—be leveraged and oriented toward sustainable and inclusive financial services for microentrepreneurs and small farmers. Nonetheless, given the poor performance, high cost, and political baggage of countless SORBs, many donors and other experts prefer to avoid considering these institutions as worthy players in development finance. While some SORB closures and privatizations have left the rural areas where they operated with no institutional financial service providers, well-designed and -implemented reform programs have reoriented banks to this market segment with dramatic results. Donors and governments need to know more about how state bank assets can be used to develop successful rural and microfinance institutions.

BACKGROUND

Many SORBs were created explicitly to serve lower-income customers. Through the 1960s, 1970s, and 1980s, SORBs with sprawling branch networks were created to reach farmers, small savers, and—in some cases—small and microentrepreneurs in both urban and rural locations. Often, the objective of deposit mobilization

[1] This microNOTE is based on the Accelerated Microenterprise Advancement Project (AMAP) Financial Services Knowledge Generation report, *State-Owned Retail Banks (SORBs) in Rural and Microfinance Markets: A Framework for Considering the Constraints and Potential,* prepared by Robin Young of Development Alternatives, Inc. (DAI) and Robert Vogel of International Management and Communications Corp. (IMCC). The full report and accompanying studies are available on www.microlinks.org.

was to raise funds to finance public enterprises.[2] In terms of lending, these institutions often used traditional corporate or cooperative banking models, and in rural areas they were sometimes linked to agricultural development programs.[3] State-owned finance companies also were created to provide longer-term financing, but often without the ability to provide a full range of banking services (for example, they did not offer deposit services) and usually without a focus on lower-income individuals or rural areas. Some state-owned financial institutions, such as postal banks, provide deposit and payment services and may have the potential to play an expanded role in payment, transfer, and remittances as well.[4]

[2] The outreach of state banks in terms of deposit mobilization often exceeds credit.

[3] Empirical evidence as presented at the World Bank conferences on public financial institutions indicates that the presence of public banks is correlated with a concentration of credit.

[4] While very important, neither of these types of limited state-owned financial institutions is a focus of this study. The few cases that did appear in the census in which public finance companies, postal banks, or newly created microfinance institutions have a specific focus on rural finance and/or microcredit have been included. To develop the SORBs research framework, a global census of SORBs was conducted. While not exhaustive, the geographically organized census tables, available on www.microlinks.org, present data on 234 institutions in 68 countries throughout Africa, Asia, Central and Eastern Europe, Latin America and the Caribbean, and the Middle East.

Unfortunately, in most cases, SORBs' potential was thwarted by poor practices and politics. In most cases where SORBs had micro credit portfolios, subsidized interest rates limited outreach and weak credit cultures fostered the neglect of underwriting and collection responsibilities. When such lending practices occurred, they resulted in losses for the bank and contaminated the local credit market by encouraging a poor credit repayment culture, which had a crowding-out effect and discouraged private banks from entering. Beyond micro credit, government mandates to carry out policy-based (or targeted) lending funneled the deposits of the poor, along with government and donor funds, to unprofitable borrowers resulting in an effective transfer of private and public funds to government-favored groups and projects. Meanwhile, isolation from market incentives restricted the development of customer-driven products and services within these banks.

From the 1970s through the early 1990s, many SORBs were bailed out repeatedly by governments, often tapping restructuring facilities offered by the international financial institutions. In the mid-1990s, with losses mounting again, and the consensus strategy of donors shifting firmly in favor of privatization, the failings of most SORBs were exposed in stark relief. Only a very limited number of SORBs underwent successful commercialization.

Despite the role of some SORBs as the sole provider of financial services in rural locations, international and fiscal pressure to liquidate or sell SORBs became increasingly intense during the 1990s because of their continued poor performance. The problem with closing SORBs was that, in many settings, private institutions were not emerging to take their place. While SORB service quality was generally low, in some cases SORBs were the only financial service providers in rural areas, and in many countries acted as the de facto payments system outside the main cities.[5]

While some governments and diverse interest groups hoped to ensure that such vital services would be preserved—with or without the SORB remaining intact—external cash for SORB restructuring was hard to come by in an environment in which past bailouts had failed to produce lasting change in the non-commercial practices of the state banks. Furthermore, donors had experienced disappointing results from costly pre- and post-privatization restructuring efforts with state-owned enterprises in Eastern Europe and the former Soviet Union in the early and mid-

[5] In some cases, private banks were prohibited from entering rural areas as a way of protecting these markets for SORB deposit mobilization that would be used to finance public deficits. For analysis of the effects of closing an agricultural development bank, please refer to the accompanying case study on the closing of the Banco Agrario del Peru.

1990s. There was little desire to repeat this experience with state banks in other countries.

Although a number of SORBs have been closed, and a few reformed and privatized, others continue to limp along—often losing money and rarely fulfilling their potential as nationwide providers of high-quality financial services to micro and small firms, farmers and rural families, and low-income consumers. Seen by donors as part of the problem, SORBs and their potential advantages in the development of large microfinance markets—including their extensive branch networks, their existing customer relationships, and their operational and legal ability to offer a full range of credit, deposit, and fee-based services—usually have been ignored. Instead, the focus of most microfinance initiatives has been to build and transform nongovernmental organizations into viable financial service providers. The result has been that much more effort has been expended trying to work around, rather than turn around, state banks.

In a few cases, however, significant reforms have taken place, and SORBs have become leading microfinance providers—in some instances, substantially increasing the size of domestic microfinance markets in as little as two years. These institutions continue to demonstrate resilience, growth, and sustainability while they provide diverse financial services focused on rural households and microenterprises. Their business strategies, ownership and management structures, and operating environments vary greatly. What distinguishes these successful restructuring efforts from less successful SORB reform initiatives merits additional attention and documentation.[6]

EMERGING LESSONS

Additional field research will better inform judgments in this field,[7] but some lessons already are apparent. Some SORBs have learned and applied lessons from microfinance—specifically, that sustainable microfinance is possible, that the poor are willing and able to pay relatively market-based interest rates in exchange for low transaction costs, and that rural is not synonymous with agricultural. As a result of these lessons, SORBs' credit methodologies have evolved to include information requirements based on character references[8] and evaluation of capacity to pay based on cash flow analysis. Other key features of this new financial services paradigm, in which some SORBs are playing an important role, include the development of accessible points of service and a diverse financial service offering that includes various deposit products and payment and transfer services, as well as loans for business and personal needs. Although successful SORBs remain the exception to the rule, diverse players are interested in utilizing SORBs to expand rural and microfinance.

RELEVANCE

Given this background and the current state of SORBs around the globe, there are four key reasons that SORBs are important for USAID's and other donors' development finance agenda, notwithstanding the many problems and challenges involved in working with SORBs.

First, some restructured SORBs have worked. Incentives to leverage their advantages in micro and rural finance have produced dramatic results. The speed and extent of service expansion to new clients in these cases—including the well-known case of Bank Rakyat Indonesia's Unit Desa System and the more recent success stories related to Banco do Nordeste's CrediAmigo in Brazil, the establishment and turnaround of the National Microfinance Bank of Tanzania, and the restructuring and privatization of the former Agricultural Bank of Mongolia (now called Khan Bank)—have not been replicated in other

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[6] The accompanying case studies on a restructured agricultural bank in Mongolia and the microfinance program at Banco do Nordeste in Brazil provide more details on select experiences.

[7] In-depth case studies on SORBs in Egypt, Ethiopia, Philippines, and Tanzania are included in this research initiative.

[8] What began with checking with neighbors and business connections has begun to focus on the need to develop credit bureaus.

models or development assistance projects. There is a clear need to document the rationale for—and prerequisites to—successful SORB reform, the project interventions most likely to facilitate their ongoing success, and the consequences for traditionally underserved clients in terms of their access to sustainable financial services.

Second, preserving the access of lower-income firms, farmers, and consumers to financial services, particularly in rural areas, requires that SORBs be addressed. SORBs usually have vast branch networks, often the most extensive of any financial institution in the country in which they operate, and they offer the only financial infrastructure in some rural areas. In fact, they are the core of the payment system in some regions. However, many SORBs face continued financial troubles as traditional donor bailouts have dried up. Moreover, financial sector liberalization and increased pressure to strengthen supervision of financial institutions have produced new competitive pressures with which SORB managers are unprepared to contend. In some cases, liquidating the SORB may provide the best answer, but in such cases policy makers must consider substitute vehicles for delivery of financial services. Alternatives worth examining to utilize valuable financial infrastructure include salvaging extensive branch networks or creating specialized institutions, such as lending agencies or limited financial institutions, that take advantage of SORB assets.

Third, there is increasing interest in diverse strategies for restructuring SORBs and refocusing their activities on sustainable micro and rural finance. A greater recognition of the role of diverse institutions in financial system development in general (and rural and microfinance in particular) points toward the inclusion of SORBs in financial sector interventions, but practitioners require a greater understanding of what works and what does not. USAID was crucial in supporting the successful turnaround and privatization of the former Agricultural Bank of Mongolia (Khan Bank), whose new and profitable business strategy is based on rural microfinance. The World Bank held global conferences in 2003 and 2004 on SORBs—attended by finance ministers and other high-level officials—to discuss the challenges of transforming state-owned banks. The World Bank also has helped to support institutions such as Banco do Nordeste in developing microfinance operations, as well as the Government of Tanzania in its efforts to turn around and privatize the National Microfinance Bank of Tanzania. Similarly, the Asian Development Bank is interested in supporting the turnaround of state banks in many south Asian countries.

Finally, expanding market-oriented rural and microfinance services in regions where SORBs have a presence requires a better understanding of the effect these institutions have on client behavior and competitive performance. SORBs can adversely affect access to market-oriented finance. SORBs with poor underwriting and lax collection practices contribute to an environment in which many clients are not willing to repay loans. Using public-sector subsidies, SORBs can offer below-market interest rates on loans and above-market rates on deposits, both of which have a crowding-out effect that inhibits the private sector from expanding into the market segments and regions that SORBs target.

The need to better understand SORBs' roles in local financial markets, the opportunity to leverage their resources for expanding sustainable market-based financial services to rural areas and other traditionally marginalized communities, and the emerging lessons from SORB modernization, restructuring, privatization, and closures provide compelling reasons to consider SORBs as part of rural and microfinance research and development projects.