FROM THE AMERICAN PEOPLE

microNOTE 14

Emerging Trends in State-Owned Retail Banks[1]

Diverse reform, reorientation, and restructuring efforts have taken place in the SORBs arena, and in many notable cases, microfinance has played a prominent role. The government's ownership objectives vary from some level of continued government involvement to full privatization, while the business strategies employed range from maintaining or developing a consumer or corporate orientation—with no particular focus on rural and/or microfinance—to having an exclusive focus on (or establishing a special division for)…some of the largest and most successful rural and microfinance institutions.

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Research and experience indicate that not all state-owned retail banks (SORBs) are alike. In many countries, SORBs are the only financial institutions in rural areas and have a wealth of assets including branch infrastructure and institutional knowledge that can—under the right circumstances, strategies, and leadership—be leveraged and oriented toward sustainable financial services for microentrepreneurs and small farmers. While poorly planned 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 produced dramatic results.

Our framework for organizing and examining SORBs—based on analysis of data collected on 234 institutions in 68 countries throughout the developing world—highlights four key strategies: closure, continued government involvement, creation of new SORBs, and privatization. These strategies, presented in Table 1 and described below, are common among the institutions identified.[2]

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[1] This microNOTE is based on the Accelerated Microfinance Advancement Project (AMAP) Financial Services Knowledge Generation (FSKG) 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., and Robert Vogel of International Management and Communications Corp. (IMCC). The text boxes summarize the accompanying case studies. The full report, census tables, and case studies are available on http://www.microlinks.org.

[2] To develop the SORBs research framework, a global census of state banks was conducted. While not exhaustive, the geographically organized census tables, available on http://www.microlinks.org, present data on countries throughout Africa, Asia, Central and Eastern Europe, Latin America and the Caribbean, and the Middle East.

Table 1: Strategic Framework for SORBs	
Closure	**No alternatives established (bank may not be performing well)** • Alternatives not needed (private-sector service providers where SORBs were present) • Alternatives not addressed (a void is created when the SORB is shut down) **Alternatives established** • Auction of branches to other financial intermediaries • New SORB created for a fresh start • New specialized public financial institution created (such as lending agency or wholesale financial institution) *Examples: National Agriculture Credit Bank in Benin, Banco Agrario del Peru, Agricultural Bank & Building Society in Lesotho, Botswana Co-op Bank, Banades in Nicaragua, Banrural in Mexico, and BANAP, Minas Caixa, and Bandern in Brazil*
Continued Government Involvement	**Business as usual** • No significant changes in operating strategy, client focus, or ownership; usually overall poor performance in terms of portfolio quality, profitability, and outreach *Example: Banco Nacional de Fomento of Ecuador* **Reform** • Ownership objectives may include continued government involvement or privatization • Business strategy may have a consumer or corporate orientation with no particular focus on rural and/or microfinance, or may have an exclusive focus on—or establish a special division for—rural and/or microfinance *Examples: Sberbank and the Bank Moskvi in Russia; Swazi Bank; Zimbank and Jewel bank in Zimbabwe; the Post Banks in Kenya, Uganda, and Tanzania; Bank Khyber in Pakistan; and the Land Banks in South Africa. The following have a microenterprise focus: National Microfinance Bank in Tanzania, Banco de Fomento Agropecuario of El Salvador, Banco del Estado de Chile, Bank Pertanian Malaysia Agricultural Development, the People's Bank of Sri Lanka, and Banque du Caire of Egypt. SORBs with microfinance units include Bank Rakyat in Indonesia, Banco del Estado in Chile, Banco do Brasil and Banco do Nordeste in Brazil, and Banque du Caire in Egypt; the Land Bank of the Philippines is a well-performing SORB with a rural and microfinance focus.*[3]
Creation of New SORB	General development or commercial banks; specialized microfinance institutions (MFIs) *Examples: Amhara Credit and Savings Institutions (ACSI) in Ethiopia, the Rural Development Bank of Cambodia, and Khushali Bank in Pakistan*[4]
Privatization	**Sold to private investors as standalone bank** • Ownership may be employee-based, initial private offering, or select strategic investors *Example: Khan Bank of Mongolia, Bank of Africa Benin (BOAB)* **Acquired by another bank and operations merged** • Assets exploited or sold off, taking on acquiring bank's strategy *Examples: Various state banks in Brazil were acquired and merged into existing private banks (Itau, ABN Amro, and Bradesco); Standard Bank acquired Uganda Commercial Bank and Lesotho Bank; First National Bank bought Financial Services Company in Botswana; Santander group bought Banca Serfin in Mexico, various state banks were sold in Cameroon; Bulbank and DKS in Bulgaria and Postabank in Hungary were privatized*

[3] Detailed case studies of Banque du Caire and the Land Bank of the Philippines are being prepared under this FSKG research activity and will be available on www.microlinks.org.

[4] A detailed case study on ACSI has been prepared under this FSKG research activity and will be available on www.microlinks.org.

THE COLLAPSE AND CLOSURE OF MANY BANKS

The performance of many SORBs, with a few notable exceptions, has been dismal. Their dependency on government or donor subsidies, their inability to mobilize savings or other domestic funding, and their poor lending practices—with low repayment rates and high transaction costs—led to the liquidation of many SORBs and the shut-down of their branches. In some cases, these decisions were made without sufficient attention to what would fill the void, as was the case with Banco Agrario del Peru (Box 1), where the rapid closure left a gaping hole in rural finance for millions of Peruvians.

In others, new models have been employed to help ensure that access to some kinds of financial services would continue for traditionally marginalized regions or segments. In the case of Banades in Nicaragua, closure of the bank included an auction and initial subsidy for private banks to buy and maintain rural branches in locations without adequate alternative financial service providers. In the case of Banrural in Mexico and numerous state development banks in Brazil, lending-only institutions were established in the rural areas in which these banks operated.

Box 1: Banco Agrario del Peru (BAP)—A Case Study on the Costs and Benefits of Liquidating Peru's Agricultural Bank

The liquidation of BAP in 1992—under pressure from the government, donors, and others—made perfect sense at the time. Long subject to financial mismanagement and political vagaries, the bank had failed, to a large extent, at its mission to provide access to credit to farmers, and it distorted the rural market and crowded out commercial banks. In liquidating BAP, it was assumed that the private sector would fill most of the resulting void in the rural financial market. However, this simplistic cost/benefit assessment did not appreciate the full extent of the problem with access to finance in rural areas, a gap that could not be bridged by the commercial institutions. This gap persisted for five years after BAP's liquidation. (Recently the Government of Peru opened a new agrarian development bank and additional research is required to determine the current situation.)

The BAP case highlights the many costs that must be considered when liquidating state development banks and the weak private sector response to developing rural credit markets. It also highlights possible alternatives for taking advantage of existing assets, including human resources and banking infrastructure, when closing SORBs.

CONTINUED GOVERNMENT INVOLVEMENT

The poor performance of many SORBs has led to transformation and reform in some cases. Governments have remained involved in SORB activities to varying degrees, ranging from share ownership through governance and executive influence to close operational control and management. In some cases, business has continued as it had for years, resulting in ongoing poor performance. Such banks often are only kept alive through repeated capital injections, as in the case of the agricultural development bank in Honduras. In many cases, such as with some SORBs in Argentina and Indonesia, these banks function primarily as a way to transfer subsidies, often to wealthier sectors, from taxpayers and pensioners. Others, such as the Banco Nacional de Fomento in Ecuador, fail to demonstrate much activity at all.

Diverse reform, reorientation, and restructuring efforts have taken place in the SORBs arena, and in many notable cases, microfinance has played a prominent role. The government's ownership objectives vary from some level of continued government involvement to full privatization, while the business strategies employed range from maintaining or developing a consumer or corporate orientation—with no particular focus on rural

Box 2: Banco do Nordeste

A Case Study of a Microfinance Unit in a SORB in Brazil

Although 70 percent of Brazilians lack access to financial services, the Brazilian environment—with its sophisticated and profitable commercial banking sector, pervasive subsidized credit programs, and lack of credit culture—historically has not been conducive to sustainable microfinance. However, state-owned Banco do Nordeste's new business focus on market-oriented financing for micro and small businesses in the impoverished northeast region (through its CrediAmigo division)—made possible by technical and financial assistance from the World Bank and other donors—is expanding rural outreach for some of Brazil's poorest citizens while maintaining financial viability. Despite the challenges presented by Brazil's current socialist political mandate, Banco do Nordeste proves that state-owned banks can fill the gap left by commercial banks and MFIs on a sustainable basis. Key results include:

- **Points of service:** More than 265 branches in 195 northeastern municipalities.
- **Outreach: T**he program is one of the largest in Latin America in terms of number of clients (138,497)—average outstanding loan size is $185 and 49 percent of its borrowers are women.
- **Sustainability:** CrediAmigo is sustainable, covering its costs through operational revenues.

and/or microfinance—to having an exclusive focus on (or establishing a special division for) rural and/or microfinance. In fact, some of the largest and most successful rural and microfinance institutions, such as Bank Rakyat Indonesia (BRI), are government owned and run. In the case of BRI, reform efforts began years ago with the creation of the Unit Desa system as part of Indonesia's financial sector modernization (including liberalizing interest rates) and a concerted focus on deposit mobilization and cost recovery of lending operations through improved underwriting, accurate pricing, and aggressive collection.

A growing number of restructuring programs feature continued government involvement. The success of these

Box 3: Land Bank Philippines

The Successful Experience of a Government-Owned Bank in Rural and Microfinance

The Land Bank, owned by the Government of the Philippines, has been mandated to provide financial services to rural clients and to give special attention to promoting rural development, assisting small farmers, supporting rural infrastructure, and providing services to agrarian reform beneficiaries. Land Bank provides services directly at the retail level and at the wholesale level through financial intermediaries. Its performance is remarkable, considering that it has survived for 40 years without requiring bailouts to avoid bankruptcy and continues to serve a large and diverse rural clientele.

In the last five years, Land Bank focused on diversifying and expanding its loan portfolio within priority sectors, including farmers and fisherfolk, micro and small and medium-sized enterprises, income-generating (livelihood) projects, agribusiness, agri-infrastructure, and other agricultural and environmental conservation projects. Land Bank provided loans to an average of 352,000 small farmers and fisher-folk per year, working indirectly through some 1,400 partner cooperatives and 458 countryside financial institutions. To strengthen these high-priority clients and expand their access to credit, Land Bank grants technical, marketing, and other types of development assistance to farmers and fisherfolk cooperatives.

In addition to its lending activities and various other client services, Land Bank is a major provider of deposit services, with more than 2 million deposit accounts, including many small-scale rural depositors. The importance of small accounts for Land Bank is striking—of the passbook accounts, 62 percent had balances of less than 10,000 pesos (US$181), while of the ATM accounts, 92 percent had less than 10,000 pesos ($181).

The most important lessons from Land Bank's long history include: 1) the importance of a good policy environment; 2) a change in focus from agrarian reform to rural portfolio diversification; 3) a governance and management structure and operating policies that avoid behest loans; 4) development of its own deposit base, profitability resulting in budgetary independence; and 5) strong risk management policies, including an internal audit and controls.

Box 4: Amhara Credit and Savings Institute—Ethiopia

ACSI began operations in 1995 as a department of a local NGO, and was licensed as a separate microfinance share company in April 1997. Its primary mission is to improve the economic situation of the low-income, productive poor in the Amhara region—primarily through increased access to lending and savings services. ACSI seeks to maintain cost-effectiveness in service delivery and integrates its activities with government and NGOs working to achieve food security and alleviate poverty. From the outset, ACSI has had a strong link with government. The state government holds 25 percent of ACSI's shares and the Deputy Head of Amhara National Regional State Government chairs ACSI's board. ACSI could be described as an anomaly when compared to the conventional wisdom on MFI performance and efficiency.

During its first decade of operations, ACSI has grown its loan portfolio to $44.5 million, with deposits totaling $21.1 million. Portfolio quality has consistently been excellent (even though most of the portfolio is agricultural in nature), and operational efficiency has tended to improve every year—even though efficiency levels are already high. The key measure of operating efficiency, the operating expense ratio,[5] has dropped to 6.0 percent, amongst the lowest in the world for an MFI. ACSI operates in a very tough environment, given that most of its clients are rural and poor. ACSI's average loan size is below $100. Additionally, it is heavily state influenced and has poverty alleviation as its ultimate goal. In many other settings, this would lead to political patronage and financial disaster, yet ACSI has managed to achieve high levels of sustainability and financial independence.

programs is mixed, although they display lower tolerance for some of the unsavory practices of the past, such as interest rate subsidies and targeted lending. In many cases, these reform and restructuring efforts have a microenterprise focus, although they tend to be in urban areas where they compete against private-sector players moving into these markets.

Following reforms in the mid-1990s, the Banco do Nordeste in Brazil launched a specialized microcredit program (see Box 3), and more recently the very large Banco do Brasil, among other large Brazilian banks, launched microfinance operations. Others, such as Sberbank and the Bank Moskvi in Russia, continue to be 100 percent publicly owned; and a number of banks in Hungary, Romania, and Poland are part privatized, part state owned.

CREATION OF NEW STATE-OWNED FINANCIAL INTERMEDIARIES

Over the past decade, new SORBs and other types of state-owned retail financial intermediaries have been created. Moreover, talk of creating new state banks is on the increase in various countries, especially in Latin America, following the election of more socialist-oriented governments. These institutions often have an explicit strategic and operational focus on rural and microfinance. An example of a new state-owned retail financial institution with a microfinance focus is Khushali Bank, which was established as the first microfinance bank in Pakistan in 2000.

PRIVATIZATION OF SORBS

The sale of state banks to private investors (in most cases commercial banks, although other types of strategic investors, employee stock ownership programs, labor unions, and initial public offerings have been used[6]) is increasingly common. Commercial banks have sometimes taken advantage of institutions on the brink of bankruptcy, bought them, and turned them into successful retail

[5] Defined as operating expenses for the period divided by the average outstanding portfolio for the period.

[6] For further discussion of these privatization strategies, including examples and case studies, please refer to the World Bank 2004 conference session on this topic. A link to the conference Web site is included in the resources section of the complete version of this paper.

operations, with or without a particular focus on rural or microfinancial services. In other cases, restructuring efforts were undertaken by governments to improve operations before privatization began. Diverse approaches for such restructuring include hiring outside managers (as was the case at Khan Bank, described in Box 5) or twinning arrangements that are currently operating in several Asian countries. Various state banks in Brazil were first shifted to the federal government, restructured, and then privatized, and were bought mostly by the private banks Itau, ABN Amro, and Bradesco. In some cases, however, a government-supported restructuring program takes on a life of its own, and privatization plans are postponed repeatedly and perhaps indefinitely. Public banks throughout Eastern and Central Europe have been restructured and privatized over the past decade such as Bulbank and DKS in Bulgaria. Given that many of these privatizations are recent, little follow-up research has been conducted to understand how the new owners have maintained, diversified, or dropped existing services for rural regions and microentrepreneurs.

Box 5: Khan Bank of Mongolia

A Case Study in SORB Restructuring and Privatization Based on a Rural Microfinance Strategy

Counter to the conventional wisdom of the international financial institutions—which urged the Government of Mongolia to close the state-owned Agricultural Bank in light of its dire financial condition—the government launched a successful donor-financed remediation program in 2000 centered on rural delivery of microfinance products via the existing and valuable branch network. Within months of hiring outside international managers under a USAID-supported management contract and suspending normal governance structures, the Ag Bank was breaking even, without retrenching from the low-income rural market. The bank was successfully privatized in 2003 and is now one of the most profitable commercial banks in Mongolia. Key successes of the turnaround include:

- **Management:** Government assurance for independent, international management team, recruited and contracted through USAID, the management team set the tone and led the organization to develop a commercial culture based on operating discipline and service innovation.
- **Points of Service:** Increased from 269 to 379, including 354 offices in the countryside reaching 98 percent of rural communities.
- **Outreach:** Average outstanding loan size of $382; 90 percent of lending occurs in rural areas.
- **Sustainability:** Profits grew from accumulated losses of US$5.2 million in 1999 to a monthly pretax average profit of $300,000 in 2004.
- **Privatized:** Sold to H.S. Securities in March 2003 for $6.85 million in cash and $15 million in investment commitments.

As financial markets develop and as donors and governments seek to address the problems of SORBs through modernization, restructuring, and privatization programs, new models and lessons will arise. The examples highlighted above can inform the current thinking on SORBs and provide valuable learning experiences for state banks in other countries as they seek to maintain and advance valuable financial services for traditionally marginalized populations.