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microNOTE 32
The Case of Land Bank in Philippines

How does a government-owned bank such as Land Bank manage to maintain its viability despite its politically driven mandate?

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The Land Bank is a universal bank[1] owned by the Philippine government. The government established the Land Bank to provide financial services to a wide array of rural clients and to give special attention to promoting rural development, assisting small farmers, supporting rural infrastructure, and providing a variety of services to agrarian reform beneficiaries (ARBs). The Bank does this directly at the retail level and at the wholesale level through a variety of financial intermediaries, including rural banks, credit cooperatives, and a few thrift banks.

The Bank's performance is remarkable considering that it has survived for 40 years without requiring bailouts to avoid bankruptcy, and it continues to serve a large and diverse rural clientele. In contrast, most other government-owned agricultural/rural development banks around the world have experienced episodes of bankruptcy that have required massive government and donor bailouts. In the Philippines itself, moreover, the two other major government-owned banks both experienced costly bankruptcies during the past 15 years despite the fact that their missions are much less demanding.

How does a government-owned bank such as Land Bank manage to maintain its viability despite its politically driven mandate?

In order to draw lessons for policy makers, this microNOTE looks closely at the external and internal factors that have driven Land Bank's successful performance.

[1] A bank that offers investment services in addition to services related to savings and loans.

STRATEGIC THRUSTS AND PROGRAMS

Expansion and Diversification of Loan Portfolio. In the last five years, Land Bank focused its efforts on diversifying and expanding its loan portfolio within identified priority sectors, including farmers and fisherfolk, micro and small and medium-sized enterprises (SMEs), income-generating projects commonly known as livelihood projects, agribusiness, agri-infrastructure, and other agri-related and environmental conservation projects. Thus, from a narrowly defined loan portfolio consisting of small farmers and fisherfolk, including ARBs, Land Bank has increased the share of these other sectors from 36 percent of its total portfolio in 2000 to 62 percent, amounting to 77 billion pesos ($1.4 billion), by the end of 2005.

Lending to Small Farmers and Fisherfolk. The amount of loans Land Bank released to small farmers and fisherfolk through cooperatives and countryside financial institutions (CFIs) increased at a modest rate from 13 billion pesos ($294 million) in 2000 to about 17 billion ($296 million) in 2004. Outstanding loans to this sector comprised 23 percent of loans to priority sectors and about 12 percent of Land Bank's gross loan portfolio. On an annual basis, Land Bank provided these loans to an average of more than 352,000 small farmers and fisherfolk indirectly through about 1,400 partner-cooperatives and 458 CFIs.

Land Bank Operational Highlights (2004)

Loan portfolio–Philippine pesos (PHP) 124.9B ($2.2B)

Loans to farmers–P16.6B ($296M)

No. of small farmer clients–352,333

No. of partner cooperatives–1,442

No. of partner countryside financial institutions (CFIs)–458

Deposits P214.9B ($3.8B)

No. of deposit accounts–2,008,756*

Resources–P287.6B ($5.1B)

Liabilities–P266.7B ($4.8B)

Capital–P20.9B ($373M)

Net income–P2.3B ($41M)

Income to loans ratio–8 percent

Return on equity 11 percent

Return on assets–0.8 percent

Capital adequacy ratio 14 percent

Note: Peso-dollar rate used is 56.0866, the monthly average rate for year 2004 (Bangko Sentral ng Pilipinas [BSP, Central Bank of the Philippines]).

*As of February 2005

Capability-Building Assistance Programs. To strengthen priority clients and thereby expand its credit program to them, Land Bank grants development assistance to farmers and fisherfolk cooperatives. The Bank provides various forms of technical assistance to promote technology transfer and to improve productivity, product quality, and value-adding operations. The Bank also provides marketing capability-building assistance to enhance the competence of bank-assisted cooperatives in preparing and implementing a marketing plan.

Deposit Mobilization. Land Bank is a major provider of deposit services, including for many small-scale depositors in rural areas. As of February 2005, Land Bank had almost 180 billion pesos ($3.2 billion) on deposit in just more than 2 million accounts (with foreign currency deposits adding another 10 percent). Because of Land Bank's role as a government depository, government entities—mainly, local government units (LGUs)—account for about two-thirds of the Bank's peso deposits distributed over 63,000 peso deposit accounts. The private sector holds the remaining one third of deposits that comprise 95 percent of the 2 million peso deposit accounts. The importance of small accounts for Land Bank is striking—62 percent of individual passbook accounts and 92 percent of automated teller machine (ATM) accounts had balances below 10,000 pesos ($181), leaving little doubt of the crucial importance of Land Bank in providing deposit services for small-scale clients.

FACTORS LEADING TO STRONG PERFORMANCE

External Factors

Good policy environment. A good policy environment underpins Land Bank's achievements over the years. Financial reforms pursued by the government since the early 1980s when interest rates were deregulated and economic policies that dismantled monopolies in sugar and other sectors provided the foundation for low inflation and economic growth. A critical component of the package of reforms was the adoption of banking standards recommended under the Basle Accord wherein Bangko Sentral ng Pilipinas (BSP), the Central Bank of the Philippines, required Philippine banks to put up adequate capital, improve board governance, and adhere to various prudential regulations. Moreover, the market orientation of financial and credit policies, as mandated under the Agriculture and Fisheries Modernization Act of 1997 and Executive Order No. 138 (1999), reduced political pressure on Land Bank to provide subsidized lending itself.

Internal Factors

Outreach and portfolio diversification. Changing its focus from ARBs to becoming a universal bank also has promoted Land Bank's survival and viability. To achieve this, Land Bank actively engaged policy makers in a continuing dialogue on the implications, costs, and risks of operating as a bank with a single portfolio: ARBs. Learning from the experience of the costly bailouts of Philippine National Bank (PNB) and Development Bank of the Philippines (DBP), the Philippines Congress recognized the need for sustainable banking and revised the charter of Land Bank to make it more capable of meeting the challenging demands of its mandate. Land Bank's capitalization was increased, and it was given free rein to diversify its loan portfolio. Thus, Land Bank has seized opportunities to create new loan products and to develop lending programs for LGUs, local housing, and rural infrastructure.

Avoiding behest loans. A combination of strong leadership, board structure that balances competing interests and its orientation as an agricultural reform bank with a constituency of restive farmers helped shield the Land Bank from corrupt politicians using the public bank to make behest loans. This experience is in contrast to that of PNB and DBP, which were required to make behest loans.

Developing own financial muscle through good performance, client support, and deposit mobilization. Land Bank ingeniously has used its good performance and the support of clients based in the countryside as an advantage in persuading Congress to increase its capitalization. Land Bank also has drawn financial muscle from its huge deposit base to fund lending, substantially reducing its dependency on multilateral and bilateral sources and the government for providing its loan funds. The partial privatization of PNB and the downsizing of DBP have left the Land Bank as the only government depository bank with an extensive branch network. It currently enjoys a monopoly of LGU's deposits, but it has in turn responded with attempts to provide a full range of financial services to LGUs and other local depositors, including rural banks. Its extensive branch network, which serves poorer regions, provinces, and municipalities, gives it the necessary presence in those areas and is rewarded by sizeable local government and private deposits.

Good risk management and internal audit and control. Land Bank has adopted good risk management practices and internal audit and controls as required by the BSP in the wake of the 1997 Asian financial crisis. To its credit, Land Bank was especially serious about these aspects of effective bank management even before the Asian financial crisis. Its long association with the donor community has strengthened this crucial aspect of Land Bank's management and operations because loan covenants with multilateral and bilateral lenders require the presence of effective risk management and internal audit and controls as a condition for financial assistance.

CONCLUSIONS: FUTURE CHALLENGES

In addition to maintaining the good practices that have sustained Land Bank over the past decades—in particular the diversification and risk management strategies of recent years—tension between wholesale and retail lending remains. International development agencies have urged Land Bank to curtail retail lending and to focus on wholesaling to avoid crowding out private initiatives lending to end-borrowers. Land Bank argues that it needs to continue providing retail services, in addition to wholesale finance, because other commercial lenders would not ordinarily cater to its retail clients, in particular the LGUs in the poorer areas of the country that apply for rural infrastructure loans.

In its efforts to focus on the wholesale lending function, it is important for Land Bank to give specific attention to threats and opportunities. First, it is important that wholesale lenders, such as Land Bank do not provide funding to retailers at below market interest rates or other subsidy elements. The reason for this should be clear: such subsidies discourage deposit mobilization, and financial institutions that do not rely primarily on deposits for their funding are less likely to be sustainable. Similarly, government-supported wholesale lenders should be cautious about providing long-term funds to support retailers' long-term lending. This will reduce incentives for retailers to develop their own private sources of long-term funds and, perhaps more importantly, to fail to understand that a stable pool of large numbers of small savings deposits can provide excellent support for long-term lending. Land Bank, like any wholesale lender, faces the risk of adverse selection. This risk may increase if program officers show preference to those clients that draw most heavily and most frequently on Land Bank's offers of funding.

In attempting to optimize its balance between wholesale and retail lending, Land Bank might consider a variety of innovative products and services at the wholesale level that would avoid problems of adverse selection and/or disincentivize institutions from pursuing their own deposit mobilization efforts. An example includes liquidity services for rural banks whose local economies are potentially subject to major shocks (for example, adverse weather, insect pests, or substantial falls in prices for some major agricultural products). This would be a significant departure from Land Bank's current focus on rediscounting rural bank loans to final borrowers, who were selected primarily because they correspond to Land Bank's target clientele. Land Bank should also build the capacity of its staff to differentiate between rural banks experiencing sudden onsets of liquidity problems due to adverse, short-term, external shocks, and those with liquidity problems that are symptomatic of deeper institutional problems and a possible indication of potential insolvency. Additional potential opportunities lie with providing financing to increasingly transparent nongovernmental organization (NGO) microfinance institutions (MFIs) and credit unions.