INSTITUTIONAL ALTERNATIVES TO SUPPLY SMALL FARMER FINANCIAL SERVICES: THE PHILIPPINES AND PORTUGAL COMPARED

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I. INTRODUCTION

Both the Philippines and Portugal have created institutions to supply financial services for a lower income clientele in rural areas. In the Philippines a large number of unit banks were established for this purpose over the past two decades or more. These banks were given a municipal charter to operate in one locale (as a single unit bank). By the early 1980s roughly 1,167 small rural banks were operating with these charters. Portugal, on the other hand, has created Agricultural Mutual Credit Cooperatives (CCAMs), a savings and loan cooperative, to operate in comparable settings, i.e. rural districts or municipalities (conselhos). These are institutionally distinct forms to service credit needs. One is a small private bank with capital shareholders while the other is a cooperative made up of members who are farmers. Nevertheless, both institutions have faced similar problems and continue to struggle with similar issues. This is the theme of this paper, namely, the numerous problems compromising the financial viability of institutions serving a small farmer clientele.

II. RELEVANT HISTORICAL BACKGROUND

A. The Philippines Case

The recent history of the rural banks in the Philippines is instructive. Up to 1973, they were growing slowly but securely with their agricultural portfolios. Then from 1973 to 1980, the Massagana 99 Rice Program was launched to promote the adoption of new rice varieties in the Philippines. The dispersed network of rural banks was utilized as the principal vehicle to channel the credit financing this program. The central bank, using a rediscount line of credit for rice, increased credit flows many multiples beyond the volumes previously serviced by these banks. Moreover, this credit was issued at concessionary (i.e. subsidized) interest rates which during some years became negative in real terms. The accumulated consequences of this action can be summarized as follows:

1. Local deposit and savings mobilization was substantially discouraged and non-deposit, external sources of funding became the principal source of funding for these banks due to the low interest rates offered through the rediscount lines of credit;
2. The lack of local deposit mobilization activity meant that there was no local constituency promoting depositor interests. Instead all

procedures and practices were designed to facilitate borrower interests. Credit was pushed quickly with little to no credit-worthiness studies and weak and passive loan recovery efforts;

3. The heavy emphasis on a single crop meant that the rural bank portfolios became highly concentrated and more risky compared to earlier times; this lack of effective diversification of risk was reinforced by the lack of networking (i.e. not being part of a broader geographically based branch network). Each bank was forced to make loans in their small geographical setting in largely a single type of loan.

This increasingly concentrated portfolio, financed through external funding sources at subsidized interest rates with little to no credit evaluation or rigorous loan recovery practices, led to growing arrears. By the early 1980s with the decline of the Massagana Rice Program loan facility, many rural banks were unable to maintain loan activity due to an insufficient local deposit base for on-lending and limited experience in mobilizing and satisfactorily servicing local deposits. Past dues (i.e. arrears) increased dramatically. More and more banks fell into arrears with the Central Bank as their field level arrears with farmers meant they could not repay their rediscounting obligations with the Central Bank.

By the end of 1986, rural bank failures had reduced the total number of banks from 1,167 in 1981 to 867 banks. Of these remaining banks, over 200 have insufficient capital (a risk asset ratio of less than 10 percent, i.e. net worth over total assets minus non-risk assets) and past due ratios (arrears) above 25 percent. These banks will be closed shortly. This state of affairs had led to an extensive bank rehabilitation program in which selected banks may convert all or part of their Central Bank arrearages into common stock owned by a government land bank in the Philippines. To gain access to their right of conversion, the private owners of rural banks must come forth with fresh new capital to bring their risk asset ratio up to 10 percent or to 10 percent of their outstanding Central Bank arrears whichever is higher. They would then have an obligation to buy back their equity converted arrears from the Land Bank of the Philippines in equal monthly installments not to exceed ten years. The lessons learned from this widespread financial collapse of the Philippines rural banking systems are several. They will be reviewed following a discussion of the Portuguese case.

B. The Portuguese Case

The CCAMs in Portugal have had a much longer history than the rural banks in the Philippines. However it is only the recent history that concerns us here (i.e. from the 1970s to the present). Salient characteristics can be summarized as follows:

1. In the 1970s the CCAMs had very little autonomy as they fell under the national network of the Caixa Geral de Depositos (CGD). In a sense they were a retail outlet for special lines of credit channeled through the CGD for small scale agricultural finance. Local deposit mobilization was minimal to non-existent and autonomy in portfolio management was severely restricted through the CGD link and supervisory role.

2. From June, 1980 onwards ample financing for the agricultural credit cooperatives was made available through IFADAP. At the same time new legal statutes allowed the CCAM network to gain their autonomy from CGD tuteledge to operate independently with IFADAP funding. IFADAP funding largely replaced previous funding on the liabilities side of the CCAMs balance sheet. The increased importance of the CCAM's was aided by a large emphasis on increasing agricultural credit at this time. Some modest local deposit mobiliza-

tion was also undertaken. This phase, in the unfolding transformation of the CCAMs, was somewhat comparable to the ample financing of rice farming in the Philippine scenario in that many CCAMs gained access to volumes of IFADAP funding many times larger than they had been used to in the past. Not surprisingly an OSU evaluation of rural financial markets in Portugal in early 1985 discovered that many of these CCAMs were experiencing high arrears.

3. From 1984-5 to the present, the CCAMs moved into yet another phase in their evolution in which local deposit mobilization became much more visible as the principal source of funds and a Central Liquidity Fund (Caixa Central) was established to act as a funds clearinghouse for the national network of CCAMs. At the same time national policies have been implemented liberalizing financial markets. Thus by the mid 1980s rural financial markets are being serviced by a healthier and more competitive mix of intermediaries than that characterizing the late 1970s.

C. Remaining Problems and Challenges for the Agricultural Credit Cooperatives (CCAMs) in Portugal.

Prior to outlining some remaining problem areas, it is useful to complete the CCAM scenario with some additional facts concerning their operations in the financial markets of Portugal. Loan rates in CCAMs are around 19 to 20 percent. Deposit rates are approximately 8.5 percent for savings accounts and 12 percent for time deposits. Hence if we assume an even balance between the two funding sources the gross margin of financial intermediation is roughly 10 points. To determine the net margins, one would have to estimate non-financial operational costs and subtract these from the gross margin. With inflation between 9 to 11 percent, savers are either breaking even or losing purchasing power through a slight negative real rate of interest on their deposits. Borrowers, on the other hand, are paying positive real rates of interest on their loans. Loans are partially "targeted" in that they are presumably only for agricultural purposes.

The CCAMs are linked to three institutions in Portugal. The Central Bank is responsible for examining and auditing their accounts. The CCAMs are exempt from reserve requirements. CCAM deposits are also exempt from income tax obligations which (in combination with no reserve requirements) would give the CCAMs a competitive advantage over the nationalized commercial banks in being able to offer higher deposit rates.

This competitive advantage, however, is partially negated through the reserve requirement CCAMs have to contribute to the general funds of the Central Liquidity Fund (Caixa Central) which is the same rate as the reserve requirement for commercial banks. Currently this is 15 percent on checking deposits and 8 percent on time deposits. If we assume a liability structure made up of 70 percent time deposits and 30 percent checking deposits, this gives a weighted average of 10 percent for the reserve requirements of the CCAMs. This reserve requirement contribution along with a small share in the Caixa Central and allows the CCAMs the opportunity to participate in the clearinghouse services for their excess funds. At present, the Caixa Central pay CCAMs 16 percent for their excess funds. The Caixa largely invests these in risk-free government securities at 16.5 percent and, occasionally, services the loan demand of deficit CCAMs (currently at an 18 percent loan rate. Since its opening in 1984, 190 CCAMs have become members of the Caixa Central. In large part this membership is forced since the CCAMs are prohibited from depositing their excess reserves in the branches of commercial banks. With no other outlet possible for clearing purposes and reserve management needs, CCAMs have no option other than joining the Caixa Central.

The third institution linked to the CCAMs is FENACAM. This is the National Federation of CCAMs which acts as a lobbyist on behalf of the National Membership. It also offers professional technical assistance and auditing services for its member CCAMs. At the same time FENACAM generates centralized information on the CCAM network and provides additional services such as check books, calendars, etc...for their member CCAMs. The member cooperatives contribute 2 percent of their annual profits to support FENACAM. Finally, FENACAM is also a shareholder in the Caixa Central along with the member CCAMs.

The problems and challenges facing the CCAMs in Portugal are several. The main theme characterizing the problems and the challenges is the issue of centralization versus decentralization or, put differently, a paternalistic concern to direct and control the operations of these small rural intermediaries vs the interest of allowing these institutions substantial independence to manage their own liquidity and portfolio free from centralized targeted controls. Within this thematic context the remaining problems and challenges can be summarized as follows:

1. The most important remaining problems in the CCAMs is the lack of geographical and portfolio diversification. Restricting CCAM lending activity to a single municipality and, moreover, to agricultural loans alone increase the likelihood of an unbalanced, high cost portfolio concentrated into the riskiest sector of activity. Further, the lack of a wider geographical territory and broader range of allowable loans prevents the CCAMs from expanding sufficiently to enjoy scale economies lowering their unit costs of operation;
2. The biggest challenge facing the CCAMs today is acquiring the skills to manage a growing base of liquidity and a more diversified portfolio from locally mobilized deposits. In previous eras, targeted loans and heavy supervision largely precluded the need to develop an independent loan evaluation skill. With the growth in the local deposit base replacing external, targeted funding sources, local management has to upgrade their liability and asset management skills.
3. The high reserve requirement for CCAMs in the Caixa Central (around 10 percent) raise questions concerning the benefits gained from such a cost. To date the Caixa Central merely invests these excess funds in risk-free government bonds thereby

financing the government deficit. The benefits would be clearer if this clearinghouse role included more inter-spatial intermediation within the national network of CCAMs.

4. More information is needed on the viability of CCAMs by size and geographical setting. It is important to document the costs per escudo lent to determine the scale economy potential in the national network. Similarly present accounting practices are ambiguous concerning the classification of delinquent loans and loan loss provisions. Until both the costs and arrears data are better documented and reported, it is difficult to determine if the current gross margin of financial intermediation is excessive or insufficient to achieve financial viability.

5. Current economic conditions appear to have created excess reserves in the CCAM network. This could be due to three factors: a depressed economy and a low demand for loans; poor management unable to find good loan opportunities; and too restricted a local market to market all the locally mobilized deposits. If the root causes for this high excess liquidity are the second two factors mentioned above, technical assistance and regulatory changes could help expand the loan activity of CCAMs.

6. The Central Bank may find it convenient to promote the growth of the Caixa Central since its facilitates its administrative responsibilities with respect to the member caixinhas. While the Caixa Central's clearinghouse role of intermediating between deficit and surplus emits in the system is a valuable function, reporting and examination responsibilities should always remain in the Central Bank. Finally, and this is of strategic importance, a growing Caixa Central should primarily emphasize financial intermediation among its member coops and not overload the system by bringing large amounts of external funds into the system. This could create increased moral hazard, patronage and default.

7. Finally a new national agricultural cooperative - commercial bank may gradually emerge in the future from the evolving network of CCAMs and the Caixa Central in which the 220 caixinhas could become branches in a national network controlled through a head office in Lisbon. This is not necessarily an unwelcome process if the new bank becomes a strong healthy national institution servicing an agricultural (and a non-agricultural) clientele efficiently. However, an alternative scenario should also be considered, namely, allowing

regional banks to emerge in 15 to 20 districts throughout the country in which local caixinhas become formal branches of a regionally based cooperative bank. This could create a more competitive set of institutions in the country than the single national bank discussed above. The pros and cons of these two alternative expansion paths merit discussions.

III. CONCLUDING COMMENTS: LESSONS LEARNED

Although institutionally distinct, the Philippines and Portuguese small farmers financial intermediaries have experienced many common problems and faced similar challenges. First, both have experienced the difficulties of relying heavily upon external funding sources. This external source of funding transforms the institution into an incomplete financial intermediary that only offers loans and minimizes deposit services for their local clientele. Secondly, once a successful deposit mobilization effort had been undertaken, both institutions faced the challenge of acquiring new management skills. In the absence of targeted loans from higher authorities, local management now have to determine the credit worthiness of local loan demand in such a way as to minimize the risk of default to protect depositor interests.

Thirdly, both institutions face the problem of a restrictive charter that limits geographical and portfolio diversification and, consequently, the potential for scale economies. In both cases, more detailed cost studies are required to determine the transaction costs of servicing their clientele and the appropriate margins for financial intermediation. At the same time, better arrears accounting is necessary to aid in an on-going review of their financial viability.

Finally, in the case of Portugal, it is instructive to evaluate the benefits and the costs of the Caixa Central from the point of view of the CCAMs. A clearing house function that engages in significant interspatial intermediation clearly improves resource allocation through the financial system. The question here is the degree to which this is occurring and at what cost to the member CCAMs.

In summary, both sets of institutions in the two countries are excellent examples of small scale intermediaries attempting to service a small scale local clientele. It should not be surprising to note similar problems and challenges. It is to be hoped that studies can continue to monitor the performance of these two systems as they face a challenging future in an increasingly deregulated financial milieu characteristic of both countries in the mid-to-late 1980s.