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CREDIT FOR AGRARIAN REFORM BENEFICIARIES:

THE FEASIBILITY OF AID FUNDING

FINAL REPORT

Bureau for Private Enterprise
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Prepared for: *USAID/Philippines*

Prepared by: *Eric B. Shearer*
Consultant to Arthur Young

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Arthur Young
A MEMBER OF ARTHUR YOUNG INTERNATIONAL

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LIST OF ACRONYMS

ACPC	Agricultural Credit Policy Council (Formerly TBAC)
ARB	Agrarian Reform Beneficiaries
AROF	Agrarian Reform Fund
CALF	Comprehensive Agricultural Loan Fund
CARL88	Comprehensive Agrarian Reform Law
CARP	Comprehensive Agrarian Reform Program
CB	Central Bank
CRB	Cooperative Rural Banks
DAR	Department of Agrarian Reform
GFSME	Guarantee Fund for Small and Medium Enterprise
ICI	Intermediate Credit Institution
ICM	Informal Credit Market
IFI	Intermediate Financial Institution
LBP	Land Bank of the Philippines
NEDA	National Economic and Development Authority
PCIC	Crop Insurance Institute
PVO	Private Voluntary Organizations
QGFB	Quedan Guarantee Fund Board
RFS	Rural Financial System
SN	Samahang Nayons (Local Farmers' Associations)
TBAC	Technical Board for Agriculture Credit (Now ACPC)

I. SOME PREMISES

The Comprehensive Agrarian Reform Law (CARL88), signed by President Corazon Aquino on June 10, 1988, is a legally complex and partially unclear piece of legislation. Its origins go back more than 20 years. The signing of the law was preceded by a year-long, bitter struggle in the Philippine Congress. The actual enactment of the "Comprehensive" program reflects strong grass-roots pressure for land redistribution in some areas of the Islands, as well as the belief that the program will be an effective weapon in the government's struggle against certain local insurgency movements.

Various dimensions of the CARL88 indicate that it is, at least initially, a program front-loaded with political goals. Whether developmental objectives will gain the upper hand in future years will depend on whether or not the program generates sufficient political momentum to avoid stalling halfway.

GOP executives charged with the task of reconciling CARL88's political and developmental goals will be hard pressed to satisfy both the politicians seeking quick, tangible, numerical impact that makes popular headlines, and the technocrats bent on assuring a developmental impact, in terms of the new agricultural development slogan of "making the farmer profitable." Moreover, several important public sector agencies are involved with the program, each of which will no doubt try to implement its own agenda while administering the program. There is every reason to expect that the clash of objectives will not be resolved in a formal and overt manner, at least in the short run.

If donors wish to support the CARL88, they must be prepared to live with a certain degree of ambiguity in the process. Above all, they will be well advised to tailor their assistance to the policy decisions of the responsible GOP authorities, rather than vice versa. Donor officials will want to show the appropriate understanding of policy decisions, regardless of their own institution's policy guidelines. In addition, they should be prepared to defend their agency's need to follow the GOP policies.

Those in the GOP who are prepared to interpret and implement an imperfect law sincerely and to the best of their ability will face a constant struggle against delaying forces or worse fates. It would be unfortunate if, in attempting to be helpful, donors were to complicate the situation by insisting on policy agendas which are justified in economic theory, but cannot be accepted locally at a particular point in time and might be irrelevant to the basic goals of CARL88.

For example, a massive credit program for Agrarian Reform Beneficiaries (ARB) would perforce have to be publicly funded, as explained in Section V below. Yet, the World Bank's 1987 Agricultural Sector Strategy Review recommended that no special programs be established for agrarian reform beneficiaries (p. 29).

In the case of AID, regardless of the specific components for which its initial contribution to Comprehensive Agrarian Reform Program (CARP) is earmarked, if it is found indispensable to tie disbursements to specific performance indicators, rather than to a more general, periodic progress finding, their design ought to avoid signaling to implementing officials that they should emphasize quantity over quality.

In any event, it will behoove AID to maintain a low profile as a probable minority member in a multilateral "consortium" for CARP support.

II. THE POSSIBLE ROLE OF CREDIT: OPPORTUNITIES, PROBLEMS AND LIMITATIONS

For a number of bureaucratic and political reasons, the idea of supporting a land reform program such as CARP with credit for the beneficiaries is no doubt appealing for a donor agency. In theory, credit is the one sure-fire, productive aspect of a complex process fraught with political, legal, procedural and administrative refinements. Those details often have little or no developmental impact and some of them - notably landowner compensation - are not considered suitable for external financing.

Donors and the responsible Philippine authorities seem to agree that a credit problem in support of CARP must be economically justified. The bottom line is that the loans must be shown a priori to have a high probability of being repaid. In other words, ostensibly there is agreement that welfare payments to agrarian reform beneficiaries will not be disguised as credit.

Implementation of this commendable resolve will put everyone's sincerity and ingenuity to the test. Indeed, the history of government-sponsored, institutionalized rural credit in the Philippines over the past quarter century does not allow for much optimism in this respect. According to a 1978 Technical Board for Agricultural Credit (TBAC) study, even during the height of official, subsidized commodity credit programs, not more than one-fourth to one-third of Philippine farmers were clients of institutional credit; the World Bank's 1987 sector study estimates that the proportion of smallholders in the formal credit market is currently no larger than 20% and remarks:

> "Only about 10-15% of agricultural production credit is currently provided through the formal credit system, and most of this goes to major agricultural enterprises or to smaller farmers with collateral. Thus very few small farmers have had access to formal credit in the past; most of them have financed their production from their own savings or through the extensive informal credit system." (p. 27)

Significantly, the 1985 Project Paper for AID's Rural Financial Services Project (Project Number 0394) states that the fact that government-funded credit problems have been "supply-led rather than demand driven has tended to discourage repayment by both intermediate institutions and final borrowers" (p. 7). It also reiterates that informed Filipinos (e.g., Sacay et al.) have asserted that:

> The sub-borrowers have come to regard government financed credit as temporary and with little or no penalty for

> nonrepayment . . . the long history of GOP leniency in rolling over past due loans . . . has impaired repayment discipline among both participating banks and final borrowers. (Sacay, Agabin and Tanchoco, Small Farmer Credit Dilemma, TBAC, Manila, 1985, pp. 7-8)

The Rural Financial Services Project Paper cites as the "predominant reason" for the prevailing attitude that:

> the nationwide implementation of the supervised credit programs ... conveyed the final borrowers' view that the special credit programs were dole-outs they were entitled to. (p. 8).

This phenomenon is closely related to the peasants' strong ties with the informal credit system. Their need to maintain their local credit rating is far greater than their need to repay impersonal private or public lending institutions. Behind the political and institutional causes of the peasants' unfortunate attitude towards official credit, as compared to their "responsible" behavior as clients of the informal credit market, is doubtless a deep frustration with the economics of small farmer credit, as reflected in the following statement:

> Lending to the likes of Mang Jose, who supports a family of seven with his annual earnings of no more than P/3,500 from his 1.7-hectare rice land and who is beset by ... deficiencies in the productive structure certainly entails a no mean degree [sic] of risk, uncertainty and costs. (Sacay et al., p. 35)

Section 2, "Declaration of Principles and Policies", of Chapter I of CARL88 states in part that:

> ... the State shall encourage the formation and maintenance of economic-sized farms to be constituted by individual beneficiaries and small landowners.

Yet, Section 23 of the same law provides that "no qualified beneficiary may own more than three hectares of agricultural land", without distinction for land quality and without a benefit similar to the additional retention acreage allowed for working-age children of affected landowners. (On the other hand, Section 40, para (5) may be interpreted so as to entitle bona fide women members of the farm labor force to a land ration on their own account.) Indeed the average size of the "farm" of the majority of the agrarian reform beneficiaries under the ongoing programs benefiting former sharecroppers is less than 1 1/2 hectares, and the projections for most of the CARP sub-programs are for similar average holdings.

Except in the case of irrigated bottomland, flooded rice and specialty tree crops, one may seriously question the commercial viability, and hence credit-worthiness, of the bulk of these parcels. In the existing documentation, there is no evidence of surveys or studies correlating farm size and cropping pattern with either net farm income or with the farm's capacity and record of credit use and repayment. Nor is there evidence of farming systems research to indicate at what size of traditional dryland minifundia formal credit institutions might minimize their risk. However, with respect to small farm borrowers' "ability to repay", Sacay et al. feel justified to state that:

> The common thread that seemed to run through all the studies was the role played by the economic viability of the borrowers alternatively measured by net income, production level, marketable surplus and other factors.

Whether there is sufficient liquidity in the country's formal banking system to cover any foreseeable incremental demand for credit from the credit-worthy minority of the agrarian reform beneficiaries is a matter of opinion even among informed, objective Filipinos.

According to the records of the Agricultural Credit Policy Council (ACPC, formerly TBAC) total government resources for agricultural lending or guarantees at the end of March 1988 were P6.2b ($310m), of which 65% was lendable; another 30% was in the Comprehensive Agricultural Loan Fund (CALF, see Section IV). Of the available lending funds of about P4b ($200m), nearly one-third was in the Central Bank's (CB) ALF rediscount facility. (See Section IV for explanations of both).

On the other hand, it is asserted that easing certain Central Bank (CB) restrictions on the banking system - such as those reportedly agreed by the Cabinet on July 22 - would lead, inter alia, to positive real interest rates on rural savings deposits and to moving excess rural cash balances to deficit rural areas rather than to urban banks. (There is also strong pressure for the establishment of Apex bank for rural banks).

Others object that it is not realistic to expect market forces to channel enough formal credit resources to the agrarian reform beneficiaries no matter how attractive the incentives might appear on paper, in view of the alternative opportunities. Many also point to the ineffectiveness, in practice, of the legal requirement that all banks set aside 25% of their total lending for agriculture (a regulation that is reportedly also on the way out). This school believes firmly that, because of its special efficiencies, the informal credit market should continue to be the source of credit for the non-bankable majority of small farmers, including most of the agrarian reform beneficiaries. (Informal credit markets are discussed in the following section.)

However, those ARB who are former sharecroppers will probably not be able to continue counting on their former landlords to provide farm inputs for credit, often at no interest.

In the final analysis, it is argued, by the World Bank and authoritative, reform-minded Filipinos, that funding of bankable credit for agrarian reform beneficiaries is of lower public budget priority than are the removal of a number of more critical, underfunded constraints such as feeder roads, and the extension and adaptive research for rainfed upland areas. The World Bank's 1987 sector analysis states the problem as follows:

> ... it is not credit itself that is important but the ability of the small farmer to utilize modern inputs or to make desirable farm investments.

It goes on to suggest that:

> [the] Government should investigate what use smallholders now make of such inputs, what problems they fact in gaining access to them, and what needs to be done to improve access.

Regardless of the principles and theoretical arguments, the CARP legislation (CARL88 and EO 229 of July, 1987) mandates considerable public sector involvement with, and funding of, credit for agrarian reform beneficiaries.

Section 13 of EO 229 states:

> Credit Support. Upon land transfer, each beneficiary who actually farms his land shall be eligible for a production loan to finance one crop cycle under terms and conditions to be determined by the LBP on a case to case basis, renewable upon repayment.

This will probably be the key provision during the start-up period of CARP, i.e., at least the first four years. Some conceptual implications of this mandate are discussed in Section V below; its funding implications are found in Section III.

III. THE POSSIBLE DIMENSIONS OF CREDIT REQUIREMENTS UNDER GIVEN ASSUMPTIONS

Planning for the implementation of CARP is still very tentative due to a highly deficient data base, as well as certain ambiguities and gaps in the CARL88 and its companion decrees. Any estimates or projections of the magnitude of the task and its financial implications are highly speculative at this time. To base external assistance on such estimates is thus "shooting at the proverbial moving target"; indeed, in all probability the target will continue moving for a number of years.

The latest data being prepared in the CAR for presentation both to the Philippine Congress and to external donors are composites of projections prepared in the several implementing agencies in response to the various legislative mandates, without regard to the physical and institutional capability for converting these projections into targets. A specialized consultant with deep insight into Philippine realities, Dr. David King, is currently attempting to incorporate these data into a meaningful, general analysis for AID of the programmatic and financial implications of CARP.

The present report will therefore not attempt to produce a premature and ill-informed analysis of CARP implementation. Nor will it present a demand analysis for credit, for which there is an absolute lack of information at this time. Rather, this section will be limited to a judicious utilization of some of the available data for the sole purpose of arriving at a possible range of financial requirements for a massive credit problem under the CARP sub-programs that the Law mandates for implementation in the next four years. It will indicate their relative dimension in comparison with the projections for other principal financial costs of the program.

Considering only the targets for the completion of the PD 27 rice and corn lands reform, and the projections for the idle and abandoned lands provision and the voluntary offers of land, under Phase I, plus the redistribution of private non-corn, non-rice agricultural lands in properties and 50 ha or more under Phase II, approximately 1.9m ha are to be occupied by about 2.6m agrarian reform beneficiaries between 1988 and 1992. (The average is 1.4 ha for PD 27 and 3 ha for the other sub-programs.) The rough average target figure currently used for credit needs per hectare is P5000.

On the basis of the year-by-year projections, the following estimates were made, assuming a constant repayment rate for each year's loans of (a) 50% and (b) 70%. Converted to dollars at 2 pesos per dollar the annual reimbursement would be as follows (in millions):

	1988	1989	1990	1991	1992	TOTAL
Assumption (A)	37	102	60	51	16	266
Assumption (B)	37	100	54	45	10	239

The <u>net</u> outlay (i.e., the "subsidy") per beneficiary for the five years would be about $100 under assumption (a), and about $90 under assumption (b).

It should be noted that this calculation, as well as the projections of the Land Bank of the Philippines (LBP) cited below, completely exclude the public lands settlement sub-program (the former Program D) under Phase I. As Dr. King's analysis will show, the projections for this sub-program fluctuate widely from week to week because of the lack of basic data. There is also considerably more uncertainty regarding actual land availability and implementation capability in this sub-program than in the other Phase I and II sub-programs; there is also considerable uncertainty about the development requirements in terms of credit and infrastructure.

A different projection is based on the LBP's latest submission to the Department of Agrarian Reform (DAR), covering their best guess of the credit requirements for <u>all</u> sub-programs (except D). (Their assumptions for repayment appear to be 65% for year 1 credits, 76% for years 2 and 3, and between 80% and 100% for subsequent years; the exact formula used is not known.) This is what their projections for <u>net</u> requirements look like, translated into million dollars:

1989	1990	1991	1992	SUB-TOTAL	1993-97	GRAND TOTAL
111	85	82	116	394	243	637

For the discussion of subsidies in Section V below, it may be of interest to observe that the total projected net outlay for credit for the years 1989-92 (most of which the LBP expects to flow back in future years) is equivalent to barely 28% of the $1.4 billion projected to be the net cost of landowner compensation for the same period.

IV. THE EXISTING CREDIT DELIVERY SYSTEM

In the 1970s and early 1980s it became fashionable to try to overcome the limitations for agricultural development by the conventional financial market by pumping commodity-targeted public money - national and foreign - into the system. Dozens of such special programs were started. Some of them continue to function until their termination dates, but the GOP has refused to initiate any new ones since the crisis of 1983.

Aside from the usual market distortions introduced by targeting, many of these programs entailed subsidized interest rates. Moreover, some, notably the giant Masagana 99 rice program, resulted in sizeable borrower delinquency and serious problems for the Rural Banks (see below).

Cumulative data compiled by the ACPC show that as of March 31, 1988 the 22 major credit problems and projects still in operation had loans outstanding of nearly P2b, of which only 6% was past due. Total cumulative lending activity had exceeded P5.8b. The record of the various "quedan," or crop warrant post-harvest loan programs is remarkable. With cumulative loans of P4.4b and loans outstanding of P688m, the past due ratio is only 1.5%, and the cumulative repayment rate is 99.7%. Thus, there is no reason or intention to close this important window, which is a very desirable alternative to government crop purchase schemes. Indeed, there have been proposals to expand it.

By contrast, the record of the eight major programs/projects that had ceased lending operations was characterized by a past due ratio of 68% of the P970m of loans still outstanding (out of cumulative lending activity of P4.1b). Nevertheless, even in these programs the overall, cumulative repayment rate was nearly 90% (no thanks to the 50% past due ratio of the nearly P400m of outstanding loans of the "foreign assisted" programs!)

Three years ago the World Bank and AID determined that, because lending with government funds "was supply-led rather than demand driven", the financial intermediaries had little incentive for maximizing collection of overdue and delinquent loans. Final borrowers had little interest in repaying. The Project Paper for AID Project 0394 pointed out that the number of government-financed special credit programs increased from 4 to 36 between 1970 and 1984. Three-fourths of these programs were commodity-oriented, while they have assisted "a very small percentage of the nation's farmers."

A joint World Bank-AID effort resulted from the Bank's analysis of the problems of rural lending institutions and practices. A loan of almost $120 million was issued to establish a rediscounting facility in the Central Bank for short-term loans to agricultural producers of all sizes. It was supplemented by $2.5 million of AID grant funds for studies, training, technical assistance and evaluation designed to effect tangible changes in the rural banking system. Thus far, neither the Bank nor AID has conducted an evaluation of the project, which terminates in 1990. The facility is reportedly moving increasingly in the direction of medium and long-term loans. While it is not believed that the facility has been of tangible benefit to small farmers so far, it may become a useful vehicle for CARP if an effort is made to orient it towards worthwhile cooperative and agro-industrial initiatives under this program.

A monumental study on "Strategies for the Expansion of Banking Services in the Rural Areas" was commissioned by the CB with World Bank funds. The report was delivered in September, 1987. A number of its recommendations were recently adopted by the supreme planning body, the National Economic and Development Authority (NEDA), and approved by the Cabinet for gradual implementation.

On the other hand, AID is funding a long-term advisory and training activity for the Rural Banks which are being rehabilitated by the CB (see below). AID is also funding an ongoing program of research directed by the Ohio State University. Of particular interest should be the report on Rural Financial Market Mobilization which will presumably deal in-depth with the very important issue of the mobilization of savings and their retention in rural areas.

Of greatest institutional relevance for rural finance today are two main formal delivery systems and a few minor ones; the bulk of rural credit is furnished by the informal credit market (ICM).

A. The Land Bank of the Philippines

It appears that GOP policy is to entrust the overall administration of the public funds for agrarian reform credit to the Land Bank of the Philippines (LBP), a large, public but commercially-oriented corporation with total resources at the end of 1987 of 12.6 billion pesos ($632m). The LBP also has legislatively mandated stewardship of the entire complex, ill-defined scheme for landowner compensation and collection of land payments from the reform beneficiaries. (In fact, the LBP was created in 1963 expressly to finance the acquisition and redistribution of landed estates.) According to some observers, the dual responsibility will put excessive strain on the bank's institutional capacity. It also results in a conflict of interest, as has already been demonstrated, in that the LBP refuses to lend to the numerous existing ARBs who are in arrears for more than three years in their payments for the land. On the other hand, some may feel that the dual function is appropriate because it gives the LBP the power to impose financial responsibility on the agrarian reform beneficiaries. In any event, the LBP has become increasingly willing to "restructure" delinquent mortgage and credit accounts.

The LBP was virtually excluded from the 1985 World Bank-AID project because the World Bank's previous experience with the LBP was disappointing. Indeed, from 1978 to 1983 (more recent data were unobtainable) the LBP's share of total agricultural lending by the banking system was only three percent, and its agricultural portfolio averaged only 16% of its total loans outstanding during those years. The LBP's total lending in 1987 amounted to 5.322 billion pesos ($266 million). There is general agreement that the LBP cross-subsidizes the high overhead cost of its insignificant small farmer loan program with its profits on commercial operations, many funded from low-interest government paper. As a financial institution, it keeps itself sound, especially as it makes sure that it gets reimbursed for losses on risky, officially funded programs.

The LBP has the second most extensive network of regional and field offices of any bank in the country (after the Development Bank of the Philippines, which is not concerned with seasonal crop loans nor the small individual farmers). The LBP is in the process of expanding its number of branch offices to a total of 31 in 1988; the branch offices will be responsible to five regional offices. It also has 33 field offices around the country which reportedly deal exclusively with small farmers.

At the end of 1987, there were 176 field representatives in 29 field offices potentially servicing 140,243 agrarian reform beneficiaries. Actually, the LBP made only about 14,000 loans in 1987, for a total number of P105m ($5m). The number of clients was only 10% of the total number of agrarian reform beneficiaries, in part because the majority were in arrears or default on their land mortgage payments and/or on previous production loans, and thus had to recur to the informal market. There is a great deal of excess institutional capacity in these field offices. They averaged only 424 loans and P3.2m ($160,000) each, with staffs of 20-40 persons, and P7,300 ($365) per loan.

There seems to be no doubt that the LBP's normal banking operations are financially sound. As long as the GOP lives up to its legal obligations, the LBP's operations in the agrarian reform will be carried out in separate accounts and thus will not affect banking finances. CARL88 (Section 64) provides clearly that the LBP "shall be the financial intermediary for the CARP". (It is less clear how a bank is to implement the same section's mandate that the LBP "shall insure that the social justice objectives of the CARP shall enjoy a preference among its priorities.") Thus, all extraordinary losses and overhead expenditures for agrarian reform are reimbursed by the GOP from the Agrarian Reform Fund (AROF) created by EO 229 in 1987 and legislatively confirmed by Section 63 of the CARP law. In fact, of the 595 million pesos of disbursements received on this account in 1987, the bank had utilized only 150m by the first quarter of 1988. Of this amount, only P41m went into production credit. Administrative expenses absorbed P26m, and 47m was used for redemption of land bonds.

In effect, the LBP is scheduled to wear at least two hats in the CARP administration: one, as general financial agent for the GOP in the land bond market, landowner compensations, beneficiary land payments and as intermediate financial institution (IFI) for ARB credit channelled through other institutions; the other, as one of the intermediate credit institutions (ICI) that will make loans to ARBs or their groups. The LBP's financial stability is not in doubt. The questions to be asked then, are whether or not the LBP believes it is prepared to face enormous new institutional responsibility, how it is gearing up for the task, and what kind of external help it might need, aside from funding, which is a GOP responsibility.

B. The Rural Banks, Cooperative Rural Banks and Other Institutional Intermediaries

There exist several alternative delivery systems for credit to small farmers. The principal, formal institutional channels are the locally and privately owned Rural Banks (RB) and the GOP-created Cooperative Rural Banks (CRB), both of which have considerable experience in lending to small farmers. Local Credit Cooperatives (CC) had total resources in 1986 of P312m ($16m). They are said to be in general the most viable class of cooperatives in the country. An inventory of CC and their locations has been completed by the Department of Agriculture and its processing by the ACPC may be completed in August.

It is the RB and, to a far lesser extent, the CRB, that have traditionally been the retail banks for agricultural production loans. All three systems - with combined resources of P10.3b ($517m) - appear to be in some financial trouble, the intensity of which varies among the local entities. (There are some differences of opinion regarding the relative degree of responsibility to be ascribed to their participation in GOP credit schemes and to poor management, respectively.)

Finally, there are two systems which have not yet been involved in ARB lending: one, the institutional, private voluntary organizations (PVOs), and the other the highly localized, informal credit market (ICM). The latter, while not subject to any official controls, is responsible for the majority of rural credit (for all purposes) outstanding at any one time.

The resources of the RB, the number of local affiliates and the amount of lending activity in the past two years are about 30 times those of the CRB. The proportion of their respective loans going to agriculture was quite similar (around two-thirds), and so were their past due portfolios (around 40%). Dimensions aside, the great difference between the two systems is, of course, that the RB are established for private profit while the CRB are owned cooperatively by local farmers' associations (Samahang Nayons or SN). Reportedly, there are nearly 5,000 SN affiliated with the CRB, with a membership of 305,000 farmers, in addition to 241 registered cooperatives with more than 30,000 members.

While appropriate data have not been found, it can be assumed that the CRB by their very nature are accustomed to making relatively small loans. The RB system also seems to be oriented towards the small borrower: in 1986, 83% of the RB loans were below 10,000 pesos ($500), and one-half were for 1,000 to 5,000 pesos ($50-$100).

The CB has initiated an ambitious auditing and rescue operation among the 858 operating, licensed RB (another 171 were already in receivership), of which 58% were found to be "weak", and it has developed criteria for continued admittance of sound or "rehabilitated" individual RB to participating in CB rediscounting. As of March, 1988, applications for "rehabilitation" had been received from half the operating RB and one-third of these (155) had been "approved". The number of rehabilitated RB had risen to over 200 in July.

Information is lacking on the financial and management status of the 29 CRB, but indications are that, aside from the past due rate, they may be in better relative shape than the RB because they are closely (for some, too strictly and without proper coordination) supervised by the three different government agencies.

The great majority of the true CC rely exclusively on paid-up capital and deposits for their lending resources; only a few large ones have access to outside sources.

About 1,000 PVO throughout the country are engaged in development work; many are involved in training and education, others also act as ICI in rural areas. However, it was found that their generally ready access to grant funds, makes them reluctant to borrow for lending purposes from IFI such as the LBP or the CB.

An important innovation was introduced in 1986 when the balances remaining in 17 of the 39 separate commodity loan funds were consolidated into the CALF. However, these moneys have not been returned to the credit pool. Rather, the CALF became a guarantee fund for rural loans of various kinds. It is administered by the ACPC through the Crop Insurance Institute (PCIC), the Guarantee Fund for Small and Medium Enterprise (GFSME) and the Quedan Guarantee Fund Board (QGFB). The Fund supposedly guarantees 85% of the banks' risk exposure. PCIC is concerned mainly with small farmer production credit; in 1987 it covered 381m pesos ($19m) of loans to 52,000 borrowers (an average of 7,300 pesos or $366). The other guarantee institutions, which deal with more entrepreneurial, agro-industrial and agribusiness-type borrowers, insured 800 clients for nearly 1.6b pesos ($79m), an average of nearly 2m pesos ($100,000) per client.

Information still needs to be obtained regarding the performance of the various guarantee funds in terms of their cost to clients, the speed and fairness of claim investigation and settlement, and most importantly, the funds' ability to create real incentives for risk lending. In the case of crop loan insurance, it has been learned that GOP has been subsidizing eight points of the real actuarial cost of 11% with the bank and the borrower sharing the remaining three points. This would seem to be a fully justifiable subsidy.

As of March, 1988, the Fund's total balance was P1.4b ($65m) of which 52% was in cash deposited in the CB.

C. Group Credit

This form of administering credit to small farmers, including ARB, is becoming increasingly popular in developing countries. The basic economic aims are to lower transaction cost per dollar lent and to lower the lending risk by improving collections through collective responsibility. PVO's have been notably successful with this approach, probably because the relatively modest dimensions of their projects allow more intensive assistance and monitoring. In some countries, public and private credit institutions have also had good results.

It is assumed that credit cooperatives are perhaps the most suitable vehicles in the P.R. While the system has not been widely utilized in the Philippines, there are indications that certain local institutions, particularly the LBP, are ready to begin exploiting its potential. They will be well-advised to the cohesion within the credit groups, on the one hand, and the great potential for massive failure inherent in a program that limits small farmer loans to groups and thus foments the rise of phantom or pro forma groups. The guarantee funds under the CALF umbrella and the CB rediscount facility might do their part by encouraging participating ICI to give preference to group initiatives.

D. The Informal Credit Market

Perhaps the most intriguing part of the Philippine rural credit system is the localized ICM which, according to one researcher, is essentially tied to the extended family. Numerous studies since the 1950s indicate that, except during a period of exceptionally large public finding in the 1970s, the ICM provides the bulk of rural credit. One reason for this is no doubt the fact that more than 40% of the country's municipalities were completely without banking services of any kind in 1986. As is true elsewhere, the

ICM is composed of a large spectrum of diverse operators, ranging from input and output marketing firms to family members. The operators have low transaction cost, great flexibility and knowledge and the local environment. Borrowers, are heavily dependent upon the operators.

Interest rates, to the extent that they can be directly or indirectly determined, range from slightly below to significantly above institutional market rates, reflecting high risk as well as lack of local competition. The 1978 TBAC survey found that average annual interest rates varied among three provinces between 33% and 83%, with the three levels strongly correlated with the degree of local competition among farm supply dealers (see WB Sector study, Vol II, p. 82). A widespread practice is the "5/6" system, meaning that the borrower returns (in cash or kind) six units for every five borrowed. This translates to an APR to 20%, i.e., close to the market rate of formal ICI. However, it is probably a much higher effective rate because the loans tend to be for less than a year.

There also seems to be a widespread practice of no-interest loans, perhaps typical of the Muslim area but also said to be practiced in intra-family lending and between landlords and sharecroppers.

Sacay et al. observe that:

> ... around three-fifths of the number of informal loans fall above the total cost of getting a bank loan. Looking at it more positively, it becomes significant that about two-fifths of the informal loans carried rates comparable to, and even lower than, the cost of obtaining a bank loan by a small farmer. (p. 27)

Their finding that "isolation of borrowers from financial institutions seems to foster much higher interest rates on informal loans" (p. 78) may well be of operational significance.

With respect to repayment rates, a TBAC study concluded that they were higher than among formal institutions. It also found that private lenders were able to adjust interest rates to individual clients (see WB Sector study, Annex, p. 82-83).

No reference has been found to any Philippine experiences with funneling official (or even private institutional) funds through the ICM. However, the Institute for Agrarian Studies is about to issue an initial report on the Dutch aid project that channels fertilizer for sale on credit through local dealers.

It has also been suggested that the experience of the Brameen banks in Bangladesh (studied by the International Food Policy Research Institute) may have some lessons for application in the Philippines. (The names of Mike Katubic of the APDC and of Boy

Mercado of Xavier University have also been mentioned in this connection.) Finally, more information about other ASEAN countries' experience with the informal market might be obtained through the offices of the director of APRACA in Bangkok, who is a former director of TBAC.

V. POLICY AND INSTITUTIONAL CONSIDERATIONS FOR AN EFFECTIVE CREDIT DELIVERY SYSTEM

It was stated earlier that the responsible Philippine authorities and donors seem to agree that a credit program in support of CARP beneficiaries must be economically justified.

If the decision is made to use the bulk or all of the US funds for the support of the credit component, and if it is determined that this needs to be accompanied by assurance that the credit program achieve tangible and measurable economic impact, certain policy considerations would be appropriate.

Above all, there must be awareness that credit (as distinct from welfare subsidies) is merely a tool for accomplishing the economic objectives of CARP. Credit is not capable of converting a program designed essentially for socio-political impact into an economically viable one. Thus, before even looking into policies governing credit <u>per se</u> there must be assurances that objectively verifiable conditions exist to make the credit component effective: variable farm size considering the land use pattern, price policies and market conditions, appropriate technology, input accessibility (and prices) and a minimum of useful extension-type activity. If these conditions are not found to apply universally, efforts may be made to identify geographic areas where they do, or promise to, apply and to identify within those areas the types of ARB and farm that do or would qualify as credit-worthy.

The two main policy issues related to the economic effectiveness of a credit program <u>per se</u> are interrelated:

i. targeting of ARB versus targeting all small farmers without discrimination, and

ii. selectivity among ARB.

Both issues have legislative and political as well as equity dimensions which may well outweigh the purely economic ones.

As quoted in Section II above, EO 229 (whose provisions are automatically included under CARL88, as per Section 75 of the latter, unless they specifically conflict with those of the Law) mandates a one-time credit for all ARB. This is quite justifiable on equity grounds as an effort to provide each beneficiary with the bare essentials of the factors of production, to which they contribute merely their labor.

What might appear to be a "give-away" feature is mitigated by the creation of an incentive for those who wish to become regular credit clients in the second year of possession or resettlement by requiring that they repay the first loan to become eligible.

The equity case is also strengthened by the very social nature of CARP, illustrated inter alia by the substantial subsidy (up to 70% based on past experience) between the GOP's acquisition cost of the land and the price charged to the recipient, on "affordability" criteria sanctioned by EO 228. The ARB get an additional break with the six-percent interest rate and the 30-year amortization for land repayment. For good measure, the law permits the CARP to make special provisions of the first five years and establishes that during this time payments shall not exceed 5% of the gross value of production (Section 26). The combination of these welfare measures should make amortization of the land mortgage relatively painless after a few years, assuming an annual inflation rate around 10%. The long-run financial cost to the GOP of absorbing non-repaid one-time grants/loans (perhaps "groans"?) will be only a fraction of that entailed by these provisions.

The "real" credit phase can thus also begin with an objective ex post measure of credit-worthiness among the ARB, based on whether or not they repaid the initial "groan", or whether they are at least having it restructured. This would also remove a political bone of contention (as well as an equity conundrum) about a priori selection of credit-worthy ARB.

Nevertheless, irrespective of the one-time "groan" provision, the risk factor for credit intermediaries among the ARB will continue to be initially high. This was also the experience in a number of "credit" schemes implemented in connection with agrarian reforms in Latin America. For a number of reasons that need to be specified here, agrarian reform "beneficiaries" are not as a rule preferred bank customers, especially when one deals with formerly landless day laborers who are suddenly expected to behave like entrepreneurs or like old-time Rochdalers. A high default rate on loans, at least during the initial weeding-out period (which may also be characterized by substantial parcel abandonment), is probably inevitable. So, once more, because this is essentially a social development program, this risk can be considered as an additional financial cost and budgeted as such. Indeed, conservative CGIAR Chairman (and former World Bank Vice President) David Hopper reportedly supports considering losses from small farmer credit defaults as a relatively small, admissible subsidy to the agricultural sector.

The interest rate, which is the most fashionable and perhaps for AID least negotiable of the policy considerations, appears not to represent a problem. Because there is growing understanding of the market distortions introduced by concessionary rates, all relevant Philippine authorities seem to agree that the recently established policy of applying market rates to all official programs will remain in force. AID may wish to consider limiting its conditionality to this generalization, rather than attempting to fine-tune the rate. This would allow Philippine institutions ample margin for adjusting the rate structure freely, in accordance with subordinate policies such as the spreads to be allowed to IFI and ICI, including local entities. It would also allow them to decide how much of the extraordinary administrative overhead and losses from loan delinquency of ARB lending should be charged to the final borrower, to the intermediary, and to the GOP budget respectively. There is no economic rationale for piling the entire cost of transaction and risk of such a program onto the "beneficiaries" in general and most specifically onto those who do meet their financial obligations.

With the interest rate issue resolved in principle, the question of collateral for small farmer loans, particularly for the ARB, deserves much more attention than it has received. It is stated that, in principle, the formal credit system calls for land as collateral even for short-term crop loans, although this is perhaps observed in practice only exceptionally. (It is proverbial in the Philippines, as elsewhere, that many informal moneylenders require mortgaging the land in the hope of foreclosing on their debtors.) For a number of reasons, it would be advisable to study ways to overcome this hurdle, perhaps with the help of CALF through the Quedan system.

As regards medium-term loans for machinery, equipment and livestock, chattel mortgages ought to be sufficient, particularly if the loan is held down to a reasonable proportion of the purchase price.

This leads to another policy consideration: the long-term viability of the intermediary institutions. Poor management (and perhaps some dishonesty) in a large number of ICI in the years leading up to the 1983 crisis led to sizeable losses from their participation in official farm credit programs. Although they were not permitted to charge market interest rates, the low borrowing rates for the ICIs reportedly allowed them liberal spreads. However, the GOP did not offer to reimburse them for losses incurred, owing to extraordinary transaction costs and risk exposure. One of the objectives of a sound credit program is the long-term strengthening of rural financial institutions (for capturing savings as well as for making loans). Thus, it will probably not be appropriate to repeat the experience of using various ICI mechanisms as mere funnels for public funds and then abandoning them when the borrowers default.

There are various policy options for providing incentives to the ICI to participate in the ARB credit program. Clearly, based on various experiences in the recent past, the time for compelling banking and thrift institutions to pump a specified amount of public money into official programs has passed. On the other hand, the institutions can no longer expect unconditional generic government guarantees against wholesale default. Even if such guarantees are given, they are probably no longer credible. The question then is how to cushion, or even insure, the ICI against the special risk of a socially-oriented credit program while maintaining or creating incentives for maximizing collections.

One solution might be through the CALF (See IV above). This fund and its implementing agencies may be at least a temporary answer to the concern over incentive guarantees. However, the crop credit insurance may need to be broadened beyond the _force majeure_ risk to comprise all bad debts of ARB, (i.e., those not recoverable with normal means) if the additional social cost is found to be acceptable. The additional actuarial cost in the case of ARB can probably be initially estimated from past experience.

The other funds will be useful for guaranteeing medium and long-term loans to cooperative or mixed coop-private investments in livestock, farm equipment, tree plantings, land development, irrigation, etc. and in post-harvest or pre-harvest marketing and processing facilities and transport equipment.

An alternative solution that comes to mind is to allow the ICI a wide enough spread between the cost of the money to them and the interest rate charged to borrowers so that they can absorb unusual defaults. This system has the advantage of relieving the State of the need for any further intervention. The ICI will have to behave the way a bank is expected to by selecting eligible borrowers in accordance with normal risk criteria. Also, when the source money is free, as in the case of the AID grant, the cost of money to the ICI - even while reflecting market rates - can be held down to a level at which the ICI's extraordinary transaction cost and risk can be absorbed. In that case, the borrower would not need to be saddled with special fees that would raise his effective interest rate beyond normal market rates. The ICI's incentive for using the funds efficiently would not need to be reduced as long as the cost of money for all ICI is uniform.

The only official supervision required, aside from normal auditing, will be to assure that the subsidized source money is limited strictly to the specified clientele because the incentive for abuse is substantial. So long as the State controls this single requirement, the "market" should regulate the rest of the system by rewarding the more efficient ICI with higher rates of operating income. One additional provision in the case of privately owned banks such as the RB (or informal channels - see below) may be to provide tax incentives for setting aside a certain percentage of their net operating income (above a level that would not tend to diminish their efficiency incentive) for socially useful and privately profitable investments in the community, including perhaps buying equity in cooperative ICI.

The third major policy issue regards the institutions through which ARB credit is to be channeled. From the existing evidence, the most viable and appropriate ICI appear to be the credit cooperatives and the CRB. However, the since their geographic coverage is far from blanketing the countryside, the rehabilitated RB also need to be involved. Where none of the above are established, the LBP field offices might continue to play a principal role at least until locally based institutions can take over. Finally, a special effort could be made to maximize involvement of local PVOs.

Implementation of a meaningful geographic credit coverage strategy will require a detailed study of the location of existing, viable ICI compared with the priority areas for implementation of various CARP sub-programs. Lamentably, this information exists currently only on the supply side (and even there is still incomplete, v. the Credit Cooperatives).

In the previous section the possibility was raised of coopting part of the informal credit system because of its ubiquitousness, its flexibility, knowledge of local conditions and clientele, and low transaction cost to complement the outreach. The major objection, of course, has to do with equity; assuming, of course, that only controllable local agents are to be involved, how can one make the system reasonably foolproof in terms of (a) assuring that only the target group benefit; and (b) preventing windfall profits from accruing to local sharks through usurious interest rates, no matter how they are disguised.

It has been learned reliably that the rural farm supply business is generally highly competitive, though with regional differences (see above). (A similar appraisal is needed for the output marketing system.) At the same time, it is known that the input and output market operators perform important informal credit functions, as they do in many developing (and even some developed) countries. What may be needed fundamentally is the local infusion of enough lendable funds through an ICI to keep interest rates competitive among the merchants and to stimulate them to search out credit clients. It should not be difficult to devise a system under which (a) participating merchants would be selected by the community on the basis of their reputation; (b) if found necessary, they would be provided periodically with a list of legally recognized ARB and with forms specifying conditions and terms under which the merchant could extend supply or crop credit in cash or kind to individual or associated ARB; (c) the merchant would periodically present the forms, signed by himself and borrower, to the nearest participating ICI for screening and immediate discounting with the terms of the Program; and (d) he would be responsible for collection and subsequently would redeem his loans from the ICI. The existence of a functioning system of crop warrants (Quedan) might facilitate the crop marketing-related credit portion of such an experiment.

Detailed discussions with enlightened local merchant/moneylenders and farmer association leaders would help avoid building unnecessary rigidities into a control system design. The existence of such rigidities would tend to defeat one of the main purposes behind the possible involvement of the ICM.

VI. OPTIONS FOR AID

As might be inferred from the discussion in Sections I and II above, it is suggested that AID needs to determine whether its goal is to unconditionally help the GOP overcome critical constraints of CARP during the politically crucial initial period, or whether its aim is to use a CARP-oriented credit program as one more tool in the ongoing effort to improve rural financial systems (RFS). Without such a clear definition frustration and disappointment on all sides are likely to develop on all sides during program negotiation and implementation.

It might be helpful to AID to consider, in arriving at a decision, that, in the light of the preceding analysis, a program targeted exclusively at ARB might not be an appropriate vehicle for promoting lasting reform of the RFS. This is true mainly because in the reform thrust to date there has been a shift, from the pre-1983 habit of infusing targeted public funds into rural systems, towards policy and procedural reforms designed to mobilize financial market resources and rural savings. Even if this were not so, the eminently political nature and massiveness of CARP and its built-in credit rationalization would militate against its use for lasting rural credit rationalization. Consider also that a healthy, independent rural financial system must be the <u>result</u> of socio-economic development in the area, rather than vice versa. It must be the task of the GOP and donors to create a policy environment, via temporary incentives and training opportunities, in support of such development, rather than suppressing it with massive public programs. Moreover, there is no evidence that there is an acute shortage of credit funds for viable agrarian reform farmers or that, even if that were the case, it would be a major constraint in the immediate future.

Viewed in this light, the attractiveness of the credit component of CARP as an investment of all, or the bulk of, the $50m package might not appear as great as it did at first sight. Indeed, AID's financial contribution to CARP might well be a program grant to the AROF with a minimum of strings attached. The conditions might be limited to exclusion of funding with AID money of any aspects of landowner compensation, or they might limit permissible funding to key activities, which support agrarian reform beneficiaries' socio-economic viability but are currently weak and underfunded, such as certain components of training at all levels, research and extension, development of feeder roads and other infrastructure. Note, however, that it will be virtually impossible to limit the benefits exclusively to ARB.

Nevertheless, credit remains a fairly well-defined and self-contained component that <u>could</u> be targeted exclusively on ARB, if it is found that such is the Congressional intent. In that case, there would seem to be several options:

i. Co-mingling the local currency proceeds from the $50m with GOP budget and other donor funds in a special CARP credit account in the CB or LBP, under jointly agreed policy and procedural criteria.

ii. Setting up a special, locally targeted program for follow-up loans exclusively to ARB who survive the first year of settlement with a clean credit record.

iii. Other options could be to bolster the guarantee funds for agricultural lending through CALF and/or the CB's rediscount facility, with ARB as targets.

It will be important for AID to bear in mind that there are influential policy formulators who, for extremely valid reasons, oppose targeting credit programs exclusively towards ARB. In their minds, the ARB will be replicas of the type and size of peasant farmer that already prevails in the country and who is, at this time, typically outside the institutional credit market. They argue persuasively that neither equity nor efficiency is served by artificial discrimination.

As a post-scriptum, a few suggestions are made below designed to strengthen AID's assistance to CARP and to RFS in general:

i. There would seem to be an urgent need to commission an inventory of relevant existing studies, such as the TBAC's small farmer indebtedness study, various Philippine University and International Rice Research Institute studies, the farming systems research of a recently concluded DAR project in upland farming improvements, etc. They should be searched for data allowing correlations among (a) loan repayment records of individual borrowers; (b) key objective farm level variables (e.g., tenure status, farm size, crops, yields, pre-credit net income); and (c) application of eligibility criteria by the various credit institutions.

ii. Both the CARP support activity and the various pieces of action in support of RFS improvement might be rationalized into long-term projects. Such projects should have a clear mandate and work program, each under one contractual umbrella and, in so far as feasible, under full-time Mission management.