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Consultancy Report
***Financial Services on the Frontier: Developing a New Model of Rural
Financial Services***

Bolivia: Managed Rural Capital Resources Activity
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FINANCIAL SERVICES ON THE FRONTIER:

SELF SUSTAINING, COMMUNITY BASED RURAL FINANCIAL MARKETS IN DEVELOPING COUNTRIES

THE CHALLENGE DEVELOP A NEW MODEL OF RURAL FINANCIAL SERVICES

The model that guided rural financial sector development in the 1960-1980 period was that of a large state - owned and run agricultural "development" bank. These highly centralized and bureaucratic institutions were responsible for credit "programming"; "supervised" subsidized interest rate lending to agriculture; and managed loan collection, when for political reasons, the loans were not forgiven. They generally derived their funds from international lenders, who in turn were anxious to help these countries develop rural areas by extending banking and financial services beyond the orbit of commercial banks into rural areas. These Banks generally engaged in a single or a limited range of services, often lending primarily for agricultural production, frequently to clients identified by income and demographic characteristics or for activities designated as "priority activities" Within an overall national development plan, but seldom mobilizing saving or offering other financial services.

The results were generally that these banks produced massive and sustained losses. Throughout the developing world these banks were unable to become viable and self sustaining institutions. The collapse began in the 1980's and accelerated in the 1990's, as international lenders withdrew soft loans and grants that sustained them. Many of these institutions, no longer exist (Bolivia Peru) are much smaller (Mexico), or are being restructure into institutions based on models other than state guided paternalistic development organizations (Honduras Guatemala).

In the 1990's, there is general agreement that the old models will not work, if indeed they ever did a general search is on for new models to guide development of rural capital markets. in both academic and development communities.

The most promising paradigm to develop from this movement toward freer rural capital markets and less direct state intervention and participation capital markets is development of community bases, profit oriented, self sustaining financial institutions offering a broad range of financial services to the wide variety of economic groups that are found at the grass roots. For example, in Honduras the old BANADESA is being dismantled and a community based banking structure established . A similar model is under study in Guatemala.

In Peru, it has taken form of Cajas - Rurales to replace the now dismantled BAP. Under the

new authorizing legislation, these Cajas Rurales can provide a broad range of financial services and conduct almost all forms of financial intermediation in the rural areas where they are established. The new Bolivian Banking Law of 1 April 1993 opens similar possibilities for

building institutions to serve strata of the population previously unserved with a broad range of services.

While the model on which these institutions are built differ in details, all have some of the characteristics of the reiffeisen or the early Rabobank. They are based in the rural community that they serve. They are operated by locals who know the market and who generally risk some of their own capital in return for the franchise to operate a financial institution. They link the community to the broader financial markets through their intermediation. They are entrepreneurial and highly flexible. These new institution seek out oportunities, not only in the in the traditional fields of banking, but in non-traditional areas of financial services. They are often active participants in and frequently shareholders of the enterprises they serve. These institutions generally recognize they need to compete with the existing banking structure. Instead, they pursue a niche market in the rural areas currently not served or poorly served by the banking system. But, most importantly, they are innovative. They do not go to the rural areas with a fixed formula; instead they adapt to the conditions in the areas they serve.

The majority of their capital is generated locally and they do not depend upon funds from the center of the counsry or abroad to sustain their activities. When outside funds are used, they are acquired on a commercial basis. Neither are their activities guided by bureaucratic organizations' priorities at the center. They respond to the market conditions they encounter and seek growth opportunities by meeting needs of rural dwellers and business people within these markets. Their growth depends upon their ability to generate capital through savings mobilization, financial services and fee base.l incomes and not on allocations from the center. They survive and prosper by proving services rural people need and will pay for.

Through these institutions, banking is being moved from the urban areas further into the agricultural areas and a broader range of financial services is being made available to the agricultural industries that grow and thrive on the "frontier of Finance" (a term borrowed from J.D. Von Pische).

The challenge these new institutions confront is to develop the self-sustaining paradigm to enable these still small and fragile institutions to make the transition from weakly capitalized institutions to better capitalized organizations capable of meeting the financial needs of the agricultural based enuerprises and doing so profitably under the challenging conditions of rural areas.

AGROCAPITAL BOLIVIA PILOTING A NEW MODEL FOR BOLIVIAN AGRICULTURAL CREDIT:

One of the more interesting of these a new start-up community

based agricultural banks is AGROCAPITAL, located in Cochabamba, Bolivia. AGROCAPITAL, a start-up chartered initially as a development foundation, issued its first loans in 1992 for about \$1.7 million. Both production and agribusiness loans are on the books. Most have 6-7 year maturities and all are current. Most have 1-2 year grace periods on payment of principle.

AGROCAPITAL is designed as a pilot of model that can be expanded to other areas of Bolivia as the original model provides information and data to permit structural realignments in the institutions, its management and product mix. AGROCAPITAL understands its development mandate as providing both basic financial service to a previously unserved population, as well as the development and introduction of financial products and services that are new to the agricultural sector and help meet the development demands of the sector. The institution is, in the initial stages, capitalized through P.L. 480, which supplied the initial capital of \$1.5 million and is expected to supply additional start up capital of about \$4.5 million dollars (\$3 million this year, the balance next). This seed capital is adequate to start operations, but is too small to enable the institutions to reach a size that will enable it to cover all its administrative costs from reflows and permit the new institution to provide the range of financial services required in its niche market.

In addition, during the start up phase, P.L. 480 provides administrative support of 90% of the operating budget, enabling AGROCAPITAL to establish itself and to lend in substantially larger volumes than would be the case if capital were drawn down for administrative costs. Though this temporary grant funding, AGROCAPITAL has been able to establish an operation that can manage substantially larger volumes of loans than are currently on the books or are possible with the present level of capitalization. This support will be phased out and the entire administrative costs will be borne by AGROCAPITAL as the size of the institution grows. The current institutional challenge is to increase and diversify the sources of funding and to increase the volume of business conducted by the institution through its extensive rural network.

AGROCAPITAL'S CURRENT LENDING OPERATION:

The current terms of lending are at 13% in local currency indexed to the dollar through the sliding government determined peg, for the loans made in the coca growing region. This interest rate is imposed only on government programmed funds and will not prevail with funds generated from other sources. Outside the coca growing region, loans are made at 16%, again indexed to the dollar. Inflation is estimated at 12.7% in 1992. In addition, the exchange rate slides about 10% per year, perhaps leaving the Boliviano somewhat overvalued.

All of AGROCAPITAL's lending is done and will continue at positive interest rates. In fact, these rates are commercially quite attractive to lender and borrower alike. Currently, the Boliviano dollar-linked demand deposits draw 8-9%, while time deposit range from 11-13%. Lending at 16% (versus 18% at commercial banks, if available for rural based clients) provides a spread of 10% over demand deposit and perhaps 6-7% over time deposit. AGROCAPITAL's external administrative support enables it to offer a more attractive rate both

to establish itself and to create a customer base. However, as noted above, that support is to be phased out and these costs will be borne as part of the loan.

Many loans are made in the Chapare. This geographical restriction will not apply to new funds under AGROCAPITAL's management. New capital will be employed in the middle sized agricultural business niche where returns and guarantees are maximized and risks minimized.

AGROCAPITAL is not yet authorized to take deposits and engage in other forms of financial intermediation. A resolution seeking the authorization to obtain a banking charter will soon be put before the Board of Directors. While its external support enable it to obtain a banking charter will soon be put before the board of directors. While its external supports enable it to offer attractive terms and services not provided by commercial banks, it must seek additional capital from sources external if it is to grow during the initial period. In the interim, all loans originated are at sufficiently positive spreads over passive rates to absorb the administrative costs when AGROCAPITAL ceases to enjoy administrative support from outside and is able to "bootstrap" its operation to much larger scale.

There is some room for moving the rates upward following the election in June, either by raising them or charging for some of the free services that AGROCAPITAL currently offers its borrowers.

AS the institutions becomes better know and capitalized, the externally supported services will be costed into the loan. In all cases, AGROCAPITAL will seek to charge a market rate of interest to all borrowers on funds generated from sources other than government and will make loans only when the spread is sufficient to gradually replace the current administrative support budget. If a loan is not profitable for AGROCAPITAL, it is rejected.

BOLIVIA'S EMERGING PRIVATE SECTOR AND POLITICAL STABILITY:

Bolivia is currently restructuring its economy to become both more market oriented and less dependent on mineral exports. The privatization and decentralization that arise from this move to freer markets will offer substantial opportunities for a financial institution serving the agricultural sector. In addition, Bolivia has a unique geographical position to become the low costs supplier to currently more prosperous markets such as Northern Argentina and Chile for tropical products. Through the rail an river system, Bolivia has substantial opportunities to export processed and unprocessed cereals, grain, fibers and oil seeds from its still abundant, productive and inexpensive agricultural lands. It has abundant natural gas, the feedstock of agrochemicals. In some departments, there are extensive lands suited both for dairying and meat production, both industries in their infancy, but with a domestic market that will consume more animal proteins as income levels rise and for export markets.

The political situation has stabilized and if as expected the June election goes off peacefully, bolivia will have had three constitutional transitions.

In this situation, AGROCAPITAL has a unique niche market into which it can grow and expand without confronting any competitive pressure on its margins. In fact, in its chosen market, AGROCAPITAL confronts no competition. It is the first to recognize the potential and has this strata of the agricultural market entirely to itself. The demand for the range of services that AGROCAPITAL currently offers and will offer in the future far exceed its capitalization. Thus, AGROCAPITAL, is actively seeking partners to help exploit this market in a country that is following the Mexican, Venezuelan, Argentine, and Chilean model of privatization and market led development. There will be abundant activities in the agricultural sector, and AGROCAPITAL is seeking partners prepared to make a long term commitment to grow and profit with AGROCAPITAL in this new market.

AGROCAPITAL'S DEVELOPMENT PROGRAM:

AGROCAPITAL has found a substantially larger demand for loans and financial services than initially estimated, even in its initially limited geographical area of operations. There are a broad range of potential borrowers engaged in production, processing, marketing and exporting of agricultural products or are servicing these industries that have the resource base and skills to use a wide variety of financial services, including, but not restricted to, lending. These clients tend to be the middle tier of agricultural based economic activities beyond the geographical range of traditional banks or unserved by traditional banks for other reasons.

Chief amongst the reasons that this segment of the market is unserved is that most would-be clients are first time borrowers and do not have the knowledge and skills to meet the requirements of banks for projects preparation and, sometimes, even rudimentary accounting. Given AGROCAPITAL's administrative support, its large investment in skilled manpower in the countryside, and its definition of its development mission, these borrowers can be brought into the financial system.

These borrowers are however by no criteria "substandard". In fact, quite the opposite is true. AGROCAPITAL has found a niche market characterized by some well qualified borrowers. One indication of the demand for credit from well qualified borrowers is that AGROCAPITAL rejected far more requests for credit than it granted. The collateral, even after the values were marked to market by AGROCAPITAL's financial analysts, were in excess of 200%. This coverage characterizes both agroindustrial and farm loans. While below the 300-350% that characterizes commercial banks, all projects were projected to generate sufficient cash flow to repay the loans and other obligations and still produce a net profit for the borrower. It is this niche market that will be the primary focus of AGROCAPITAL's activities.

The agro-business segment is expected to increase loan volumes markedly over the next few years. The farm lending program will continue and increase in absolute volume, although its percentage participation in the portfolio will decline. AGROCAPITAL is committed to farm lending both as a part of the development philosophy underlying the institution and because it is good business if properly conducted. When small and medium sized farmers are efficient and

profitable producers and able to offer good collateral, they are excellent clients. However, increasingly AGROCAPITAL will seek the lowest cost delivery vehicle for making, serving, and collecting these loans. Many will be converted from direct lending to supplier credits extended by their agroindustrial clients, providing AGROCAPITAL both administrative savings and lower risks.

In these circumstances, AGROCAPITAL must grow to meet the needs of its market. The current estimate is that the market needs about \$3.75 million of loans per year this year and a growing volume thereafter. At present, it lacks capital to sustain that volume of lending. It is currently seeking an additional \$10 million infusion of capital. This infusion would in the 1993-1995 period be destined to agricultural production (\$2.0 million) and to agroindustries (\$8.0 million).

AGROCAPITAL is undertaking a far ranging study of alternative means to capitalize adequately to meet the demands in its niche market and to serve its client population. This capitalization strategy is divided into several different areas of activity that are being explored simultaneously. The ultimate goal is to create a profitable agricultural financial service institution that can pursue rural based opportunities throughout Bolivia among the tier of rural based business not currently served by banking. These capitalization options include:

SAVINGS MOBILIZATION: AGROCAPITAL anticipates seeking a bank charter that will permit the present foundation to own a bank and to conduct all authorized banking activities in Bolivia's rural areas. These activities will include savings, checking and other financial services, including leasing, bonded warehouse operation, factoring, loan syndications, foreign exchange, money transfers, and letters of credit, among others.

Savings mobilization will have a unique feature in the case of AGROCAPITAL. AGROCAPITAL has a significant rural network whose primary purpose has been to supervise loans made by the Cochabamba office. This field staff will become agents of the new bank and will be authorized to conduct simple financial activities, such as deposit taking and perhaps even small short term loans. They will be compensated in part on a fee basis. This is a novel "franchise" approach to extending basic financial services to the smallest villages in Bolivia and to bringing all Bolivians into the national financial services market. The present spreads between active and passive rates are very attractive, especially in areas not served by commercial banks.

FEE BASED SERVICES: AGROCAPITAL will offer fee based services in rural areas. These include, but are not limited to, those listed abroad. Through the rural network, AGROCAPITAL may also act as agents for insurers who in turn write insurance or bonds on borrowers lives, goods, and fidelity. In addition, AGROCAPITAL will offer the extensive field staff to other financial institutions, both to assist in the preparation of loan documents and in loan collections. The rural network will over time be converted from salaried employees into a commissioned force that will be compensated based on production. In addition, AGROCAPITAL is studying the possibility of compensating its

rural field force for identifying potential borrowers and financeable projects in their areas of operation. The ultimate objective is to pursue viable loans wherever they may arise and to take the necessary banking services to the producer.

LEASING: Leasing is new to the agricultural sector and AGROCAPITAL view it as potential profit center. Under a banking charter, AGROCAPITAL would be authorized to conduct leasing activities. The field of interest is agricultural machinery and equipment. AGROCAPITAL will seek opportunities to import machinery that will subsequently be leased to its borrowers as part of the overall financial package. In addition, when capital permits, it will offer financial services to established implement dealers to permit them to lease their products to producers.

EXPORT DEVELOPMENT AND ALLIED SUPPORT INDUSTRIES: Bolivia has several agricultural industries whose comparative advantage would permit them to export primary products to regional markets, and in some cases, agricultural commodities to and international markets. Pineapples, bananas, brazil nuts, garlic and black pepper, are some examples. The growers lack both capital to produce for markets, facilities to process the product and knowledge, finance, and connections to export. AGROCAPITAL intends to explore the profitability of becoming involved in all financial transactions inherent in export activities.

BOLIVIAN LOAN SYNDICATIONS: AGROCAPITAL has encountered several very interesting agricultural based projects whose capital requirements far exceed its financial capacity. As a result, AGROCAPITAL will explore with other Bolivian commercial banks profitable opportunities to originate these loans and to syndicate them among the commercial banks. AGROCAPITAL would participate in the loan and generate a loan management fee for running the book. In addition, some of the agro-business loans currently on the books could be sold to commercial banks at terms they would find very attractive, as AGROCAPITAL meets the loan administration costs from other funds, thus reliquifying AGROCAPITAL and permitting it to continue its lending program at an undiminished rate.

JOINT VENTURES: Several projects have come to the attention of AGROCAPITAL where the return is sufficiently more attractive than AGROCAPITAL could expect as a lender. In selected cases, subject to Board of Directors approval, AGROCAPITAL would like to participate in the business. However, the new banking law's Article 51 prohibits the banks from owning shares in other than banks and insurance companies. The leasing provisions in Articles 59-62 are broadly drawn so that AGROCAPITAL could purchase the machinery and equipment and lease it to the company. There are no provisions as to what a lease contract must contain. Therefore, the lease contract could specify a monthly rent, as well as a participation in the profit achieved through the utilization of the equipment. This activity is likely to be combined with others such as loan syndication, as the capital requirements of these projects often exceed the ability of a

single bank to finance.

By way of example, there are excellent opportunities in privatizing a milk processing plant, a fertilizer plant, poultry production and export, establishing processing and marketing companies for agricultural exports such as bananas and pineapples in the southern cone. The wide variety of agroecological niches found in the Bolivian tropics and temperate high valleys, coupled with inexpensive and abundant labor offer an opportunity to realize a substantial return on AGROCAPITAL's funds.

DOMESTIC AND INTERNATIONAL LINES OF CREDIT: *AGROCAPITAL is actively seeking to negotiate wholesale lines of credit both in the Bolivian market and in the international market. These lines of credit would allow AGROCAPITAL to expand geographically to cover the entire country and to meet the growing demand for agricultural credit, especially in agribusiness. AGROCAPITAL has a unique structure both in its extensive field network and in the administrative support budget that absorbs many costs that would normally be charged against the loan recoveries. Within the financial constraints of a new institution, AGROCAPITAL is also prepared to co-lend and manage loans for domestic and international lenders.*

COLLATERAL FINANCIAL MARKET ACTIVITIES: *Bolivia is in the process of organizing a stock market that will initially trade debt instruments. AGROCAPITAL is considering buying a seat on the new exchange, both as a means of marketing its own debt, as well as serving as a market maker for the debt of some of the rural based businesses in which it participates either as a lender or as a equity partner.*

INCREASING AGROCAPITAL'S FINANCIAL STRENGTH THROUGH BORROWING AND EQUITY PARTICIPATION:

As part of the bootstrapping of the capital base, AGROCAPITAL is seeking lines of credit and equity participation for 10 million dollars disbursed over 3 years. It is prepared to contract the loan at a reasonable spread over LIBOR. The use for the funds would be primarily to expand the profitable agricultural, and in particular agro-industry, lending in Bolivia, as well as initiate profitable fee-based services for the rural communities. It is expected that the funds will be drawn down as required over 3 years and will be lent at the prevailing 16% interest rate. This rate however may rise over the term of the loan if market conditions permit. Additional fee income may arise from charging for some of the assistance to borrowers currently made available free of charge.

Recognizing that AGROCAPITAL is a new institution and still unknown in international capital markets, AGROCAPITAL is further prepared to offer lenders certain enhancements that will increase their spreads. A profit share, after reasonable allowances for administrative costs, would also be considered. In certain cases, AGROCAPITAL would welcome the equity participation in the newly established bank by established experienced and reliable partners who

bring with them a commitment to the rural sector development philosophy of AGROCAPITAL, and a long term investment horizon.

AGROCAPITAL MANAGEMENT TEAM:

AGROCAPITAL offers lenders and equity partners a strong management team backed by the resources and knowledge of ACDI and the American agricultural cooperative credit movement to manage the loans. Through this organization all tie and whit funds from USAID, AGROCAPITAL has the ability to bring in world class consulting and management talent to help with project design and implementation, as well as in problem solving. In addition, AGROCAPITAL, has an extensive network of professionals in the rural areas to identify projects and bring them to the attention of management as well as to supervise their implementation and intervene if required.

The management and staff consist of an expatriate general manager supplied by ACDI, the overseas development arm of the U.S. agricultural cooperative movement, under contract to USAID. The Bolivian professional staff is divided into several areas. The "agropecuario" section has a manager, a regional agent and 7 field agents. The agroindustrial area is also manned by a manager and 6 professional staffers. In addition, support staff in the central office supplies general administrative services to the professional staffers.