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STATE-OWNED RETAIL BANKS IN RURAL AND MICROFINANCE MARKETS: A FRAMEWORK FOR CONSIDERING THE CONSTRAINTS AND POTENTIALS

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STATE-OWNED RETAIL BANKS (SORBs) IN RURAL AND MICROFINANCE MARKETS: A FRAMEWORK FOR CONSIDERING THE CONSTRAINTS AND POTENTIALS

The authors' views expressed in this publication do not necessarily reflect the views of the United States Agency for International Development or the United States Government.

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1 Introduction

This paper provides a research framework for the United States Agency for International Development (USAID) from the Development Alternatives, Inc. (DAI) consortium's Financial Services Knowledge Generation (FSKG) research team on the constraints and potential in rural and microfinance markets for state-owned retail banks (SORBs—a term we use to refer to all state-owned, retail-oriented financial institutions including agricultural development banks, commercial banks, savings banks, and postal banks). The report that follows provides an update on research activities and findings to date and outlines the next stages, activities, and objectives of continuing this research. It is accompanied by a bibliography which lists documents, publications and web sites on SORBs for those interested in further reading, three summary case studies of different types of SORBs prepared from existing documentation for illustrative purposes, and tables containing summary data collected during the survey of SORBs which were used for selecting cases for further field research.

2 Relevance

In many countries, SORBs are the only existing financial institutions in rural areas and have a wealth of assets in terms of branch infrastructure and institutional knowledge that can, under the right circumstances, strategies, and leadership, be leveraged and oriented toward sustainable financial services for microentrepreneurs and small farmers. While poorly planned SORB closures and privatizations have left the rural areas where they operated with no institutional financial service providers, well-designed and -implemented reform programs have produced dramatic results. Nonetheless, given the poor performance, high cost and political baggage of countless SORBs, many donors and other experts prefer to ignore or avoid considering these institutions as worthy players in development finance. More needs to be understood and disseminated about how to take advantage of SORBs' assets to develop successful rural and microfinance institutions.

There are four key reasons that SORBs are important for USAID's development finance agenda and FSKG project.¹

First, there are a few examples of restructured SORBs that have worked. Incentives to leverage their advantages in micro and rural finance have produced dramatic results. The speed and extent of service expansion to new clients in these cases—including the well-established case of Bank Rakyat Indonesia's Unit Desa System and the more recent success stories related to Banco do Nordeste's Crediamigo in Brazil, the establishment and turnaround of the National Microfinance Bank in Tanzania, and the restructuring and privatization of the Agricultural Bank of Mongolia (now called Khan Bank)—have not been replicated in other models or development assistance projects. There is a clear need to document the rationale for and prerequisites to successful SORB reform, the project interventions most likely to facilitate their ongoing success, and the continued access of traditionally underserved clients to a variety of sustainable financial services.

Second, preserving the access of low-income firms, farmers, and consumers to financial services, particularly in rural areas, requires that SORBs be addressed. SORBs usually have vast branch networks, often the most extensive of any financial institution in the country in which they operate, and they offer the only financial infrastructure in some rural areas. In fact, they are the core of the payment system in some regions. However, many SORBs face continued financial troubles as traditional donor bailouts have dried up. Moreover, financial sector liberalization and increased pressure to strengthen supervision of financial institutions have produced new competitive pressures with which SORB managers are unprepared to contend. In some cases, liquidating the SORB may provide the best answer, but it is an answer that requires attention to substitute vehicles for delivery of financial services. Alternatives worth examining to utilize valuable financial infrastructure include salvaging extensive branch

¹ It is important to emphasize that the relevance of studying SORBs and their potential, in some cases, for expanding sustainable rural and microfinance does not suggest denial of the many problems and challenges of working with SORBs.

networks or creating specialized institutions, such as lending agencies or limited financial institutions, which take advantage of SORB assets.

Third, increased interest in diverse strategies for restructuring SORBs and refocusing their activities on sustainable micro and rural finance has emerged in recent years. A greater recognition of the role of diverse institutions in financial system development in general and rural and microfinance in particular points toward the inclusion of SORBs in financial sector interventions. Therefore, a greater understanding of what works and what does not is necessary. USAID was crucial in supporting the successful turnaround and privatization of the Ag Bank of Mongolia (now known as Khan Bank), whose new and profitable business strategy is based on rural microfinance. The World Bank held global conferences in 2003 and 2004 on SORBs that included finance ministers and other high-level officials and discussed the challenges of transforming state-owned banks. The Bank also has helped to support institutions such as Banco do Nordeste in Brazil in developing microfinance operations. The establishment of Africa International Financial Holdings LLC (AIFH) is an indication of growing interest among donors and the private sector in investing in SORB privatizations that focus on microfinance as part of the restructuring strategy.

Finally, expansion of market-oriented rural and microfinance services in regions where SORBs have a presence necessitates a better understanding of the effect these institutions have on client behavior and competitive performance. SORBs can negatively affect access to market-oriented finance. SORBs with poor underwriting and lax collection practices contribute to an environment in which many clients are not willing to repay loans. Using public sector subsidies, SORBs can offer below-market interest rates on loans and above-market rates on deposits. Both types of behavior on the part of SORBs have a crowding-out effect that inhibits the private sector from expanding into the market segments and regions that SORBs target.

3 Background

Most state-owned retail banks were created with an explicit intent to serve low-income customers. Throughout the 1960s, 1970s, and 1980s, SORBs with sprawling branch networks were created to reach farmers, small savers, and in some cases small and microentrepreneurs in both urban and rural locations. Often, the objective of deposit mobilization was to raise funds to finance public enterprises.² In terms of lending, these institutions often used traditional corporate or cooperative banking models, and in rural areas they were sometimes linked to agricultural development programs.³ State-owned finance companies also were created to provide longer-term financing, but often without the ability to provide a full range of banking services (e.g., they do not offer deposit services) and usually without a focus on low-income individuals or rural areas. Some state-owned financial institutions, such as postal banks, provide deposit and payment services and may have the potential to play an expanded role in payment, transfer, and remittances as well. While very important, neither of these types of limited state-owned financial institutions is a focus of this study. The few cases that did appear in the census in which public finance companies, postal banks, or newly created microfinance institutions have a specific focus on rural finance and/or microcredit have been included.

Unfortunately, in most cases, the potential that SORBs embodied was thwarted by poor practices and politics. In most cases where SORBs had microcredit portfolios, subsidized interest rates limited outreach and weak credit cultures fostered the neglect of underwriting and collection responsibilities. When such lending practices occurred, they hurt the bank responsible and contaminated the local credit market by encouraging a poor credit repayment culture, which had a crowding-out effect and discouraged private banks from entering. Beyond micro credit, government mandates to carry out policy-based (also known as targeted) lending funneled the deposits of the poor, along with government and donor funds, to unprofitable borrowers resulting in an effective transfer of private and public funds to government favored groups and projects. Meanwhile, isolation from market incentives restricted SORBs' development of customer-driven products and services.

From the 1970s through the early 1990s, many SORBs were bailed out repeatedly by governments, often tapping restructuring facilities offered by the international financial institutions. In the mid-1990s, with losses mounting again, and the consensus strategy of donors shifting firmly in favor of privatization, the failings of the majority of SORBs were exposed in stark relief. There were only a very limited number of SORBs at which commercialization was implemented successfully.

Despite the role of some SORBs as the sole provider of financial services in rural locations, international and fiscal pressure to liquidate or sell SORBs became increasingly intense during the 1990s because of their continued poor performance. The problem with closing SORBs was that, in many settings, private institutions were not emerging to take their place. While SORB service quality was generally low, in some cases SORBs were the only financial

² Outreach of SORBs in terms of deposit mobilization often exceeds credit.

³ Empirical evidence (presented at the World Bank conferences on public financial institutions) indicates that the presence of public banks is correlated with a concentration of credit.

service providers in rural areas, and in many countries acted as the *de facto* payments system outside the main cities.⁴

While some hoped to ensure that such vital services would be preserved—with or without the SORB remaining intact—external cash for SORB restructuring was hard to come by in an environment in which past bailouts had failed to produce lasting change in SORB practices. Furthermore, donors had experienced disappointing results from costly pre- and post privatization restructuring efforts with state-owned industrial enterprises in Eastern Europe and the former Soviet Union throughout the early and mid-1990s. There was little desire to repeat this experience in the 2000s with state banks in other countries.

Although a number of SORBs have been closed, and a few reformed and privatized, others continue to limp along—often losing money and rarely fulfilling their potential as nationwide providers of quality financial services to micro and small firms, farmers and rural families, and low-income consumers. Seen as part of the problem by donors, the potential advantages of many SORBs in developing large microfinance markets— including extensive branch networks, existing customer relationships, and the operational and legal ability to offer a full range of credit, deposit, and fee-based services—usually have been ignored. Instead, the focus of most microfinance initiatives has been to build and transform nongovernmental organizations (NGOs) into viable financial service providers. The result has been that much more effort has been expended trying to work around, rather than turn around, SORBs.

In a few cases, however, significant reforms have taken place, and SORBs have become leading microfinance providers—in some instances, radically increasing the size of domestic microfinance markets in as little as two years. These institutions continue to demonstrate resilience, growth and sustainability while they provide diverse financial services focused on rural households and microenterprises. Their business strategies, ownership and management structures, and operating environments vary greatly. What distinguishes these successful restructuring efforts from less successful SORB reform initiatives merits additional attention and documentation.⁵

While informed judgments will come from additional field research conducted by the DAI-led FSKG project, some lessons already are apparent. In particular, some SORBs have learned and applied lessons from microfinance—specifically, that sustainable microcredit is possible, that the poor are willing and able to pay relatively market based interest rates in exchange for low transaction costs, and that rural is not just agricultural. As a result of these lessons, credit methodologies have evolved with information requirements based on character references⁶ and capacity to pay based on cash flow analysis. Other key features of this new financial services paradigm, in which some SORBs are playing an important role, include the development of accessible points of service and a diverse financial service offering that includes

⁴ In many some cases, private banks were prohibited from entering rural areas as a way of protecting these markets for SORB deposit mobilization that would be used to finance public deficits. For analysis of the effects of closing an agricultural development bank, please refer to the accompanying case study on the closing of the Banco Agrario del Peru.

⁵ The accompanying case studies on a restructured agricultural bank in Mongolia and the microfinance program at Banco do Nordeste in Brazil provide more details on select experiences.

⁶ What began with checking with neighbors and business connections has begun to focus on the need to develop credit bureaus.

various deposit products and payment and transfer services as well as loans for business and personal needs.

Although the successful SORB examples to date still are the exception to the rule, diverse players are interested in taking advantage of SORBs to expand rural and microfinance. For example, the World Bank has held a series of high-level conferences on state-owned banks over the past two years. With a diverse agenda that has not focused exclusively on the role of SORBs for rural and microfinance, these conferences have included important research on the success and failure of diverse restructuring strategies. Over the past year, the World Bank's Consultative Group to Assist the Poor (CGAP) has been conducting a global study of alternative financial institutions that highlights the important participation of state-owned banks in financial services provision to traditionally unserved populations. The Ford Foundation and Food and Agricultural Organization (FAO) also are looking at the role of state banks in delivering rural financial services.

Interest in this topic goes beyond research and policy making. In countries from El Salvador to Sri Lanka, state-owned banks continue to receive government support and are increasingly focusing on banking for farmers and micro and small entrepreneurs, but with differing levels of expertise and success. While successful examples of SORBs that have been restructured around microfinance as a core business strategy and then privatized are limited (e.g., Khan Bank of Mongolia), increased interest in such an approach is growing. For example, AIFH was set up to acquire controlling positions in state banks that are being privatized in Sub-Saharan Africa. This joint public/private sector initiative will be targeted at banks with large branch networks. The intention is to support the privatization and restructuring efforts of such banks as well as to introduce microfinance as part of their services. The commitment to maintaining branch networks and investing in retail services for low-income populations is highlighted as a distinguishing feature compared to potential competitors.⁷

⁷ The following investors are involved: European Investment Bank (EIB), Kreditanstalt für Wiederaufbau (KfW), International Finance Corporation of the World Bank Group (IFC), and Nederlandse Financierings-Maatschappij voor Ontwikkelingslanden N.V (Netherlands Development Finance Company, FMO) on the donor side, and HSBC Investment Bank Holdings on the private side with WPA (Wendy Peter Abt Associates) as the fund manager. The plan is to invest in six to eight banks over the period 2004-2007. Currently \$115 million is committed, with a \$150 million target. A technical assistance alliance has been formed with CGAP as well as in collaboration with MicroSave. Other funders also may provide selective technical assistance support.

The objective of the census conducted between April and August 2004 was to provide the basic data necessary to identify the SORBs that present the highest potential for learning from additional research and case studies. While the research team made a great effort to ensure that the census search and resulting list was extensive, the census was neither designed nor intended to be a comprehensive list of SORBs nor was it an exhaustive data-gathering exercise. The research team believes that higher-quality and more reliable information that will lead to higher-impact learning will be gathered during in-depth analysis of specific, representative and best practice cases than would be garnered by massive data-gathering of unsubstantiated or noncomparable information on diverse SORBs.

The research team selected the following criteria for including institutions in the SORB population for the census.

State-owned: Currently or in the past the institution must have been completely or primarily owned by the state, including national or local governments.

Retail: Currently or in the past the institution must have had retail operations, that is, lending and/or deposit services for individuals and businesses. Institutions that always served as second-tier institutions are not included.

Banks: This category is broad enough to include postal banks (which usually only take savings), agricultural banks, and other development banks, as well as commercial banks as long as they operate as retail institutions. In some instances, state-owned finance companies that have extensive branch networks and have focused on micro or rural finance also have been included in the review.

Using these criteria, the team conducted a census of SORBs using literature and Internet searches, contacts through donor and other multilateral organizations, and development bank associations. While not completely exhaustive, the census tables that accompany this report present data on 234 institutions in 68 countries throughout Africa, Asia, Central and Eastern Europe, Latin America and the Caribbean, and the Middle East.

5 An Overview of Emerging Trends⁸

The 2004 census served to identify trends, select examples, and organize a framework for studying SORBs and extracting lessons that can help contribute to the expansion of sustainable rural and microfinance.

A consensus is emerging among donors, policy makers and other experts on the potential of SORBs in the new development finance paradigm,⁹ with a particular emphasis on their potential for rural finance. The rationale for making SORBs a priority in development finance stems from the fact that they are sometimes the only financial intermediary in rural areas and their existing infrastructure and institutional knowledge present significant potential for sustainable institutions serving traditionally marginalized sectors and regions. This has led to increased interest in SORBs among donors and others, which is spurring new experiments in closures, reform, restructuring, and privatization. While improving the quality of and access to rural financial services is a key driver in this renewed interest in SORBs, the strategy for successful SORBs often includes a mix of rural and urban operations and lessons from microfinance. This mix is necessary both for institutional development (risk diversification and profitability) as well as client service (access to a national network for business and personal needs).

Despite advances and developments in state-owned banks, including diverse approaches to financial intermediation in rural areas, access remains limited. In rural and remote regions in much of the world, access to financial services remains an issue. In some places, lack of licensed institutions impedes deposit mobilization in general; in others, private financial institutions are oriented toward wealthier segments and are not interested in small depositors. Even when deposits and other services are available, a credit gap and limited accessibility of services often exists in these same areas. The tendency toward a more urban focus for restructuring efforts often prevails, and the call for broader outreach and a more rural focus is often unheeded.

While many SORBs continue to operate as they did a decade ago, various strategies exist for reform, restructuring and privatization and, although limited, the number of successes is increasing. New privatization strategies, such as international management contracts and twinning arrangements, have been implemented in several Asian and African SORBs, but many other SORBs continue to limp along or have been closed down. Most SORBs throughout Eastern and Central Europe have been privatized, while others such as Sberbank in

⁸ This section is a broad overview and sampling of emerging trends and examples that have been identified through the census, bibliographic search, and interviews that the research team conducted. For more in-depth discussion on some of these points and cases, please refer to the extensive bibliography and resource guide that accompanies this report.

⁹ New development finance, which has been evolving and gaining support for the past two decades, has its basis in institution building and market strengthening to support sustainable microfinance and rural financial services versus a focus on directed credit programs.

Russia continue to be state-run and play an irreplaceable role in their national financial systems. The Middle East also has a significant number of SORBs, and in countries such as Egypt they dominate the financial sectors in which they operate although their performance is reportedly problematic. Nonetheless, they are less important in many countries in this region than they are in other parts of the world. Given the political and economic interest in microenterprise, many SORBs have launched microfinance operations within the existing SORB ownership and governance structure, but with different degrees of success. In other countries, such as Ethiopia, new types of state-owned financial intermediaries have been established with a microfinance mandate and what appear to be good practices and performance.

Although the trend over the past decade was toward privatization in most of Latin America, a wide variety of strategies have been employed, and a significant number of SORBs continue to operate with varying degrees of success. Many agricultural development banks have been closed down, and most of those remaining continue to limp along, staving off closures through political pressure rather than improved performance. However, some public sector banks have demonstrated impressive results, particularly in urban-based microfinance. Although public banks remain dominant players in both Brazil's (almost 20 public banks operate) and Costa Rica's (where four state owned banks operate) financial sectors, competition and government objectives have forced them to develop new strategies, including establishment of micro and small business finance operations.¹⁰ Over 20 state owned banks in Brazil have been privatized, liquidated or converted to development agencies (which can lend but cannot take deposits) over the past decade, while one that continues to operate, Banco do Nordeste, has developed a very large microfinance program, which is highlighted as a short case study that accompanies this report. In Mexico, another country in which many SORBs were privatized in recent years, a huge rural SORB (Banrural) has been closed, leading to the creation of a new state-owned financial institution with a focus only on deposit mobilization and another (Financiera Rural with 94 branches throughout the country) that will operate only as a lender. Banrural of Guatemala has been restructured with mixed ownership and a focus on rural and micro lending. Even in market-oriented Chile, a large public sector bank, Banco del Estado, using a targeted government subsidy program, competes with private sector institutions for micro and small enterprise business. In 2003, the bank had 310 branches and reported 90,000 microenterprise clients.

The countries of Central Asia, emerging from centrally planned economies and public banking sectors, have chosen different paths for dealing with SORBs, and have important restructuring successes. Among the countries of Central Asia, Mongolia has gone the furthest in eliminating its SORBs, in particular with the recent privatizations of two major banks that were successfully restructured before privatization. One is the former Agricultural Bank of Mongolia, now Khan Bank, whose unusual approach taken in its turnaround and significant lessons for other countries are described in brief in the accompanying case study. Today over half of all Mongolian households do business with the profitable and privatized Khan Bank. The other privatized institution is the Trade and Development Bank. Only the Savings

¹⁰ In Brazil, following the privatization and liquidation of dozens of state-owned banks, today almost twenty remain in operation. The largest SORB in the country, Banco do Brasil, in 2002, reported 3,155 branches, 9227 diverse points of service, over 15 million customers, including 4.7 million credit cards and almost 15 million debit cards, 78,600 employees, and reported an ROE of 22.6%.

Bank remains in the hands of the Mongolian government. The Kyrgyz Republic also has eliminated most of its SORBs as part of its process of financial liberalization, retaining only one significant bank at this point, the Savings and Settlement Company, effectively another savings bank. In addition, with strong donor support, the Kyrgyz Agricultural Finance Corporation (KAFC) was established and has expanded so successfully into a formerly underserved market niche that it is now being studied for possible conversion to a full-fledged commercial bank and/or privatization, so that it is also proposed for consideration for further study. Kazakhstan also has eliminated all of its significant SORBs in the process of developing the most advanced financial system in Central Asia to date. Only Tajikistan and Uzbekistan have maintained many, if not most, of their SORBs and appear to have suffered the consequences with low levels of financial intermediation and a resulting negative impact on economic efficiency and growth. Tajikistan's problems can be attributed, in part, to a long-running civil war that was only recently brought under control and Uzbekistan is suffering from retaining many elements of central planning, including failure to deal fully with its SORBs. Five Uzbek SORBs that were established in the early to mid 1990s are included in the census; two of these have been privatized.

In South Asia, SORBs made a major expansion of bank branches and directed credit to agriculture, but the trend has slowed in recent years. In India, between 1969 (when a number of banks were nationalized) and 1979, the number of public sector commercial bank offices nearly tripled; in addition, regional rural banks also were created in the 1970s. At least one study finds an association in this period between the increase in bank offices and the reduction of poverty and the expansion of nonagricultural output, although there are questions of simultaneity. The growth of public sector bank offices continued in the 1980s, albeit more slowly, and practically stopped in the 1990s, while cooperative banks and nonbank financial corporations grew. The 19 state owned banks identified in India for the census today have a combined total of over 38,000 branches and an average of 2,116 branches each. The Indian post office also is a major deposit taker and is revamping its operations to improve payments. Pakistan, following nationalization of all banks in 1974, also expanded its rural bank offices in the 1970s and 1980s. However, prior to the more recent privatization of most of the state banks, it closed a substantial number of bank branches. Today, the state-owned bank with the largest branch network in Pakistan is Habib Bank with 1425 domestic branches. Four SORBs in Bangladesh are included in the census, of which the Sonali National Bank alone has 1,185 branches, over half of which are in rural areas.

In Southeast Asia, SORBs continue to play a major role in rural banking. In Indonesia, Bank Rakyat Indonesia (BRI) has had well-publicized success after its change of direction in 1984, and its small scale lending and deposit mobilization, perhaps the largest in the world for a single institution, continued to perform well during the Asian financial crisis of the late 1990s. In 2003, BRI's Unit Desa system had over 4,000 outlets, almost 30 million deposit accounts worth US \$3.5 billion and 3.1 million loan accounts worth almost US\$1.7 billion.¹¹ Thailand's Bank of Agriculture and Agricultural Cooperatives (BAAC) also was very successful for a long time, although there has been no recent study of the bank to evaluate overall

¹¹ Seibel, Hans Dieter, 'The Microbanking Division of Bank Rakyat Indonesia: a flagship of rural microfinance in Asia,' pp. 8 and 11 in *Small Customers Big Market Commercial Banks in Microfinance* edited by Malcolm Harper and Sukhwinder Singh Arora, ITDG Publishing, United Kingdom, 2005.

performance. Bank Pertanian Malaysia Agricultural Development (BPM) has undergone steady reform, but the effects remain to be seen. Philippine SORBs have been less successful but still play an important role in the countryside where the Land Bank is the largest source of financing and bank access through its network of 350 branches and 301 ATMs.

China continues to be dominated by enormous state banks. An estimated 80-85% of financial sector assets are in four state-owned banks and one development bank. The Industrial and Commercial Bank of China has more than 20,000 domestic branches, the Agricultural Bank of China has more than 50,000 branches. However, the state banks are plagued by bad debt, have required re-capitalization, lack technology, are challenged to retain qualified human resources and are struggling to meet international banking standards such as minimum capital adequacy requirements. Discussion of reform exists.

The African experience with SORBs is similar to the experience in other regions although it has less to show in terms of successful transformations and reforms. This situation is due in part to a combination of market factors, such as lower population density in Africa and less competitive financial sectors that allow SORBs to operate and maintain a client base protected from strong competition. For years, moreover, governments in many African countries have carried the fiscal burden of SORBs through budgetary allocations and the provision of soft loan facilities. The political will to continue to improve access to financial services in rural areas has prevailed, supported by the supply-led approach to service delivery. Governments have continued to be involved in banking as evident by the more than 50 state-owned financial intermediaries in Africa identified for the census. This state participation has waylaid the transformation of many SORBs and has delayed reform and restructuring of rural financial markets.

6 Strategic Framework

Based on the census analysis, a framework for organizing and examining SORBs highlights four key strategies, presented in Box 1 and described below, that appear to be common among the institutions identified for the census.

Box 1: Strategic Framework for SORBs	
Closure	<p><i>No alternatives established</i></p> <ul style="list-style-type: none"> § Not needed (private sector service providers where SORBs were present) § Not addressed (a void is created when the SORB is shut down) <p><i>Alternatives Established</i></p> <ul style="list-style-type: none"> § Auction of branches to other financial intermediaries § New SORB created for a fresh start § New specialized public financial institution created (such as lending agency or second tier) <p><i>Examples: National Agriculture Credit Bank in Benin, Minas Caixa in Brazil, Banco Agrario del Peru</i></p>
Continued Government Involvement	<p><i>Business as Usual</i></p> <ul style="list-style-type: none"> § No significant changes in operating strategy, client focus or ownership; usually overall poor performance in terms of portfolio quality, profitability and outreach. <p><i>Examples: Banco Nacional de Fomento of Ecuador</i></p> <p><i>Reform</i></p> <ul style="list-style-type: none"> § Ownership objectives may include continued government involvement or privatization § Business strategy may have a consumer or corporate orientation with no particular focus on rural and/or microfinance, have an exclusive focus on or establish a special division for rural and/or microfinance. <p><i>Examples of reform efforts with microfinance specialization and plans for privatization include the National Microfinance Bank in Tanzania, while examples of the growing number of SORBs with microfinance units include BRI in Indonesia, Banco del Estado in Chile, Banco do Nordeste in Brazil and Banque du Caire in Egypt.</i></p>
Creation of New SORB	<p><i>General development or commercial banks</i></p> <p><i>Specialized microfinance institutions</i></p> <p><i>Examples: Amhara Credit and Savings Institutions (ACSI) in Ethiopia, the Rural Development Bank of Cambodia and Khushali Bank in Pakistan.</i></p>
Privatization	<p><i>Sold to private investors as stand-alone bank</i></p> <p>Ownership may be employee based, initial private offering or select strategic investors</p> <p><i>Example: Khan Bank of Mongolia</i></p> <p><i>Acquired by another bank and operations merged</i></p> <p>Assets exploited or sold off taking on acquiring banks strategy</p>

<i>Examples: Various state banks in Brazil were acquired and merged into existing private banks in the country including Itau, ABN Amro, and Bradesco; Standard Bank acquired Uganda Commercial Bank.</i>

6.1 The Collapse and Closure of Many Banks

The performance of many SORBS, with notable exceptions, has been dismal: their dependency on government or donor subsidies, their inability to mobilize savings or other domestic funding, and their poor lending practices, with low repayments rates and high transaction costs, led many to be liquidated with all of their branches shut down. Examples of banks that have collapsed and closed include National Agriculture Credit Bank in Benin, The Agriculture Bank & Building Society in Lesotho, the Botswana Co-op Bank, and BANAP, Minas Caixa, and Bandern (among others) in Brazil. In some cases these decisions were made without sufficient attention paid to what would fill the void, such as the case of Banco Agrario del Peru described in Box 2, where the closure was rapid and left a gaping hole in rural finance for millions of Peruvians. In others, new models have been employed to help ensure that access to some kinds of financial services would continue for traditionally marginalized regions or segments.

In the case of Banades in Nicaragua, closure of the bank included an auction and initial subsidy for private banks to buy and maintain rural branches in locations without adequate alternative financial service providers. In the case of Banrural in Mexico and numerous state development banks in Brazil, lending-only institutions were established.

6.2 Continued Government Involvement

Poor performance of many SORBS has led to their transformation and reform in some but not all instances. Despite this, governments have remained involved in SORB activities in varying degrees, ranging from share ownership, to governance and executive influence, to close operational control and management. In some cases, business has continued as it had for years, resulting in ongoing poor performance. These banks often are only kept alive through repeated capital injections. Examples include the agricultural development banks in Ecuador and Honduras. In many cases, these banks function primarily as a way to transfer subsidies, often to wealthier sectors, by taxpayers and pensioners. Some of the SORBs in Argentina and Indonesia fit this category. Others, such as the Banco Nacional de Fomento in Ecuador, fail to demonstrate much activity at all.

Diverse reform, reorientation and restructuring efforts have taken place with notable examples of microfinance playing a prominent role. The ownership objectives may include continued government involvement or privatization while the business strategies employed range from maintaining or developing a consumer or corporate orientation with no particular focus on rural and/or microfinance to having an

Box 2: Banco Agrario del Peru (BAP)—A Case Study on the Costs and Benefits of Liquidating Peru's Agricultural Bank

The liquidation of BAP in 1992 under pressure from the government, donors, and others made perfect sense at the time: long subject to financial mismanagement and political vagaries, the bank had failed, to a large extent, at its mission of providing credit access to farmers and it distorted the rural market and crowded out commercial banks. The assumption was that the private sector would fill most of the void in the rural financial market left by BAP's closure. However, this simplistic cost/benefit assessment did not anticipate that the yawning gap in rural access to finance could not necessarily be bridged by the commercial institutions; this gap persisted five years after BAP's liquidation. (Additional research is required to determine the current situation). The BAP case highlights the many costs that should be considered when liquidating state development banks and the weak private sector response to developing rural credit markets. It also highlights possible alternatives for taking advantage of existing assets, including human resources and banking infrastructure, in the face of closing SORBs.

For more details, please refer to the accompanying report.

exclusive focus on or establish a special division for rural and/or microfinance. In fact, some of the largest and most successful rural and microfinance institutions, such as BRI, mentioned previously, are government owned and run. In the case of BRI, reform efforts began years ago with the creation of the Unit Desas as part of overall financial sector modernization (including liberalizing interest rates) and a concerted focus on deposit mobilization and cost recovery of lending operations through improved underwriting, accurate pricing, and aggressive collection. In a growing number of cases, continued government involvement is part of restructuring programs. The success of these programs is mixed, although a lower tolerance for business as usual often exists. Some examples of this type of reform in Africa include Swazi Bank; Zimbank and Jewel bank in Zimbabwe; the Post Banks in Kenya, Uganda, and Tanzania; and the Land Banks in South Africa. **In many cases these reform and restructuring efforts have a microenterprise focus,** although often in urban areas where they compete against private sector players that are also moving into these markets. Banco de Fomento Agropecuario and Banco Hipotecario of El Salvador, Banco del Estado de Chile (participating in a state-subsidized microfinance program along with private banks in that country), Bank Pertanian Malaysia Agricultural Development, the People's Bank of Sri Lanka, and Banque du Caire of Egypt all fit into this category. Following reforms in the mid-1990s, the Banco do Nordeste in Brazil launched a specialized microcredit program (see Box 4 and accompanying case study), and more recently the very large Banco do Brasil, among other large Brazilian banks, launched microfinance operations. The Bank of Khyber is the most active microlender of the public banks in Pakistan. Sberbank and the Bank Moskvi, among others in Russia, continue to be 100 percent publicly owned; a number of banks in Hungary, Romania, and Poland have been partially privatized and remain partially state owned.

6.3 Creation of New State-Owned Financial Intermediaries

Over the past decade, new SORBs and other types of state-owned retail financial intermediaries have been created and discussions of such initiatives are on the increase in a number of countries. These institutions often have an explicit strategic and operational focus on rural and microfinance. Examples of these new state-owned retail financial institutions with a microfinance focus include Amhara

Box 4: Banco do Nordeste—A Case Study of a Microfinance Unit in a State-owned Retail Bank in Brazil

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

- § **Points of Service:** More than 265 branches located in 195 municipalities of the northeast region.
- § **Outreach:** The program is one of the largest in Latin America in terms of number of clients (138,497), an average outstanding loan size of \$185, and 49 percent women borrowers.
- § **Sustainability:** CrediAmigo is sustainable: the program is covering its costs through operational revenues.

For more details, please refer to the accompanying report.

Credit and Savings Institutions (ACSI) in Ethiopia which transformed from an NGO to a legally registered microfinance institution in 1995, the Rural Development Bank of Cambodia which was established in 1998 and Khushali Bank which was established as the first microfinance bank in Pakistan in 2000.

6.4 Privatization of SORBS

The sale of state banks to investors (in most cases commercial banks, although other types of strategic investors as well as employee stock ownership programs and initial public offerings have been used¹²) has become increasingly common in recent years. Commercial banks have sometimes taken advantage of institutions on the brink of bankruptcy, bought them, and turned them into successful retail operations with or without a particular focus on rural or microfinancial services. In other cases, restructuring efforts were undertaken by governments to improve operations before privatization began. Diverse approaches for such restructurings include hiring outside managers (e.g., the Ag Bank of Mongolia, described in Box 3) or twinning arrangements that are currently operating in several Asian countries. Various state banks in Brazil were first shifted to the federal government, restructured, and then privatized, and were bought mostly by the private banks Itau, ABN Amro, and Bradesco. In some cases, however, a government-supported restructuring program takes on a life of its own, and privatization plans are postponed repeatedly and perhaps indefinitely. Other examples of privatization of SORBs include the following: Standard Bank acquired Uganda Commercial Bank and

¹² For further discussion of these privatization strategies, including examples and case studies, please refer to the World Bank 2004 conference session on this topic. A link to the conference Web site is included in the resources section of this paper.

Box 3: Khan Bank of Mongolia
A Case Study in SORB Restructuring and Privatization Based on a Rural Microfinance Strategy

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

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

Note: DAI was hired for the USAID-supported management contract, was retained by the new owners, H.S. Securities of Japan, and recently became a minority shareholder in the bank. For more details, please refer to the accompanying report.

Lesotho Bank, and First National Bank bought Financial Services Company in Botswana. Cameroon has witnessed the sale of some of its state banks. BOAB, Bank of Africa Benin, a private bank, was established after the collapse of the banking system in Benin. In Mexico, Banca Serfin was privatized and bought by the Santander group. Public banks throughout Eastern and Central Europe have been restructured and privatized over the past decade; these include Bulbank and DKS in Bulgaria and Postabank in Hungary. Given that many of these privatizations are recent, little follow-up research has been conducted to understand how the new owners have maintained, diversified, or dropped existing services for rural regions and microentrepreneurs.

7 Future Research

While the census and existing literature provide valuable information and lessons on SORBs, important issues remain that merit further examination. Therefore, field-based case studies and comparative analyses are planned to explore a series of questions in diverse environments and with banks that have undertaken various strategies to expand rural and microfinance.

The institutions recommended for further examination have been selected from the census; all of them are now or were at some time in the recent past a SORB. The cases represent diverse examples that together will paint a full picture of SORB strategies, experiences, and lessons.

Criteria for prioritizing the SORBs for field-based case studies included:

- § Learning potential for other countries and banks,
- § Focus on rural and microfinance,
- § Good outreach, portfolio quality and sustainability,
- § Variation in reform and restructuring efforts (privatization, continued government involvement, creation of new state-owned financial intermediary), and
- § Variation in regions, countries and political context.

Based on these criteria, the following list of banks is recommended for consideration for field-based study. In some instances, a comparative case study approach is proposed; in other cases, the focus will be on a particular bank and the environment in which it operates. The final selection of banks to be included for additional research will depend on the interest of USAID's Microenterprise Development Unit and select missions as well as the willingness of government officials and bank management to cooperate with the study.

7.1 Creation of New Microfinance Focused State-owned Retail Financial Institution: Amhara Credit and Savings Institution (ACSI), Ethiopia

This legally registered microfinance institution is not a formal bank, although under the microfinance legislation in Ethiopia it is allowed to lend and mobilize deposits, and it is effectively controlled and partly owned by the state. ACSI transformed from an NGO in 1995 into one of the largest microfinance institutions in Ethiopia, currently serving more than 300,000 clients. Its outstanding loan portfolio is more than \$20 million. The institution makes predominantly agricultural loans using a group lending methodology through its regional network of ten branches and 162 subbranches. One of its main sources of funding is client savings (May 2003: \$12 million). The balance comes from donors, equity, and the state-owned Commercial Bank of Ethiopia. MicroRate completed an evaluation of the institution in July 2003, noting its remarkably low operating expense ratio (7.5 percent), its good portfolio quality

(3.6 percent portfolio at risk over 30 days), and strong state government support. However, MicroRate also noted a key weakness: the state continues to have firm control of the institution, which carries the risk that political considerations will substantively influence management decision making. Already ACSI is used to disburse agricultural input loans (at no direct risk to ACSI). ACSI offers an excellent learning opportunity with respect to state and private partnerships in the delivery of financial services to the poor with a particular rural focus. ACSI's loan prices are considered to be still well below any others MicroRate has seen in more than 100 African and Latin American microfinance institutions.

7.2 Continued Government Involvement: Comparative Analysis of Successful Microfinance Units within SORBs: Banque du Caire, Egypt; Banco do Nordeste, Brazil; and Bank Rakyat Indonesia

Other successful SORB cases that focus on rural and microfinance, such as **BRI** and **Banco do Nordeste** (described in Box 4), have been well documented but merit additional, focused research under FSKG. Specifically, in the case of these SORBs, a comparative analysis highlighting the lessons of how a microfinance unit can function and perform well in terms of outreach and sustainability within a SORB that continues to be state owned (and itself may show poor results) would provide useful lessons on the conditions required for success of such programs. Other less-known examples that could be considered in this category include Banque du Caire (described below) as well as the People's Bank of Sri Lanka¹³. Specific questions to examine as part of this comparative analysis include: What are the main features in terms of activities, structural organizations, mandate, governance and outside assistance of these highly rated microfinance programs in public banks? What are the "best practices" followed by the "best performers"? Are these lessons applicable for other institutions or are they exceptions?

§ **Egypt—Banque du Caire** . This is one of the four state-owned banks that dominate the Egyptian market (combined they hold more than 50 percent of market share). Established in

¹³ While the People's Bank of Sri Lanka demonstrates problems in terms of bad debt and repeated re-capitalization, its microfinance program may merit further examination. Financial sector liberalization began in 1977; however, two state-owned banks still dominate the financial sector with 55 percent of banking assets. The first fully state-owned bank, the People's Bank has grown over the past 40 years to 511 branches that are set up specifically to cater to the cooperative sector and to meet the needs of the "small man." The almost 200 mini-branches do not operate current accounts, but they do handle savings, and a significant part of their business is pawning. In the face of fiercer competition from foreign banks, the People's Bank reports that it is improving its services, investing in technology such as ATMs, and learning new techniques. The bank has been recapitalized more than once over the past decade and posted significant losses and bad debts in the late 1990s. As a result, important restructuring efforts have been taking place over the past few years. The Rural Banking Innovations Project (RBIP), implemented with technical assistance from the German donor agency, Gesellschaft für technische Zusammenarbeit (GTZ), was established in 1996 to support the People's Bank and to reorient it toward commercial lending activities for micro, small, and medium enterprises. Through this initiative, field officers set up regular mobile savings and credit services in rural areas where no branches exist. Best practices such as using branches as profit centers and establishing incentive systems are also being put into place as part of the recent restructuring. Although GTZ prepared an extensive case study on this bank as part of its 2003 paper on state banks in Asia, an update focusing on the bank's performance, privatization plans, and expanding microfinance activities would be very useful as this is a relatively little-known case, despite its more than three million borrowers and eight million savers.

1952, Banque du Caire is the third largest bank in Egypt by asset size. The bank operates a retail network consisting of 224 branches and other units, giving it a strong position in the domestic retail market. It was the first Egyptian bank to turn its attention to microlending receiving technical assistance from EQI, a local consulting firm, with USAID project support. In 2003 the Bank's microcredit program made loans to about 100,000 families, and the experience reportedly showed remarkable success. As of October 2004 it reported having disbursed 169,260 micro-loans, serving 70,211 such clients with a portfolio at risk of 0.71%. Subsequently, in 2004, the privatized Banque Misr began a pilot microlending program in five of its 400 branches, also with EQI's technical assistance and IFC support. In late 2004, with 3,318 loans disbursed and 2,932 outstanding with no portfolio at risk, Banque Misr had plans to expand to additional branches.

7.3 Continued Government Involvement where Business as Usual Appears to be Working: Land Bank of the Philippines

The **Land Bank of the Philippines (LBP)** has survived for forty years without requiring bailouts to avoid bankruptcy and continues to serve a large and diverse rural clientele. In contrast, most other government owned agricultural/rural development banks around the world have experienced episodes of bankruptcy that have required massive government and donor bailouts. In the Philippines itself, the two other major government owned banks both experienced costly bankruptcies during the past fifteen years despite the fact that their missions are much less demanding than the LBP's: the Philippine National Bank (PNB) is a full-service commercial bank, while the Development Bank of the Philippines (DBP) focuses primarily on larger enterprises involved in international trade. The LBP is 100 percent owned by the Philippine government; nonetheless, it has been able to resist the kinds of political intrusions that undermined both the PNB and the DBP. The proposed in-depth case study of the LBP would identify the key factors in the LBP's organizational structure that have enabled this successful resistance – has it been due to the kinds of governmental (or non-governmental) entities that have been represented on its Board of Director, to the structure and characteristics of its management team, to its systems of internal audit and financial controls, or to still other features?

The LBP is one of the largest banks in the Philippines (third in deposits, fourth in assets and fifth in capital and in loans), with 350 branches, 301 ATMs and some 8,000 employees. As a specialized government bank with a universal banking license, the LBP has the power to provide the widest possible range of banking services, but at the same time with a mandate to provide these services in large part to a clientele that is often relatively difficult to reach. LBP results for 2003 showed net income of some PHP2 billion (about US\$36 million) on total revenue of PHP18.5 billion (about US\$335 million), with an ROA of slightly less than 1 percent and a ROE of 9 percent. To the extent that the LBP has adequately provisioned for losses in its loan portfolio and for contingencies, these results do not compare too poorly with Philippine private banks and with government owned banks elsewhere (though they are clearly not up to international standards for private banks). On the deposit side, at the end of 2003 the LBP had mobilized a total of PHP185 billion (over US\$3 billion), representing some 70 percent of its total resources and on the lending side, 13 percent of its loan portfolio went for micro and small

business finance, 11 percent for farming and fishing (plus another 14 percent for agri-business, agri-infrastructure and agri-related projects), while housing accounted for 9 percent and rural infrastructure 8 percent.

The LBP has been mandated to provide financial services to a wide array of rural clients but, at the same time, to give special attention to promoting rural development, assisting small farmers, supporting rural housing and providing a variety of services to agrarian reform beneficiaries. This is done not only directly at the retail level, but also at the wholesale level through a variety of financial intermediaries, including rural banks, credit cooperatives, and various types of thrifts banks. Some of these lending activities are supported with the LBP's own funds and others with funding from government and donor agencies through a number of different credit lines.

From the experiences of other government owned retail development banks, it has been shown that such banks can be rehabilitated and then privatized (e.g., Mongolia's agricultural bank) or can set up independent units that can carry out micro-finance operations with excellent outreach and sustainability (e.g., BRI's Unit Desas or Banco Nordeste's CrediAmigo program), but what about agricultural/rural development banks in countries where the government does not see these options as politically available and does not wish to liquidate? The main lesson from the proposed case study of the LBP would be to see how this might be achieved, that is, what has made the LBP sustainable (especially compared to its two "sister" banks, PNB and DBP) and to what extent has this sustainability been achieved without abandoning its mandate to serve, in large part, a rural low income clientele? In examining these questions, the proposed case study would focus on pinpointing the size and "ruralness" of the bank's clients, as well as trying to estimate the costs of reaching such target clients as compared to those that are more commercial. Another objective of the case study would be to analyze the extent to which the variety of financial services, with different funding sources and requirements, has been provided in an integrated or in a compartmentalized way in order to draw lessons about the advantages and disadvantages of diverse approaches to organizational structure.

7.4 Additional cases

The previous sections describe the highest potential cases proposed for priority research during the coming year. The second level of research priorities are described in the following paragraphs and are recommended pending project resources.

Comparative Analysis of SORB Strategies and Results in Central America. The countries of **Central America** have taken very diverse routes regarding SORBs that provide the opportunity to conduct a comparative analysis of the diverse options described in the strategic framework. Guatemala's privatized agricultural development bank, now known as **Banrural** would be an interesting case to update to evaluate if the ownership structure and business strategy have sustained real growth in micro and rural finance as well as truly improving institutional performance. For comparison, a study of **BANADESA** in Honduras could be used to show an institution with ongoing losses and shrinkage in outreach and would thereby help to address the issue of why poorly performing banks are not liquidated. Nicaragua would present

another interesting comparison because of the thoughtful way that the liquidation of **BANADESA** was carried out. Specifically, potential labor force issues were faced straight on (cf., Peru's BAP) and branches were auctioned to private banks, including a subsidy to maintain those branches that operated in towns where no other financial intermediary was present. It would be interesting to learn if these branches were maintained significantly after the liquidation and privatization process. The relatively large (for the Latin American region) **Banco Nacional** in Costa Rica could be included (as a possible success story and example of how SORBs can survive even in the face of financial sector liberalization and competition), as well as **Banco de Fomento Agropecuario** (BFA) and **Banco Hipotecario** (BH) in El Salvador, both of which have continued to limp along despite poor performance, but have recently launched microcredit (BFA) and small and medium enterprise (BH) programs.

Reform and Privatization with Microfinance Focus: National Microfinance Bank (NMB), Tanzania. This institution was formed from the restructuring of National Bank of Commerce, a large state-owned bank that was restructured into two banks. NMB was further restructured using a management contract (World Bank financed, and the Government of Tanzania hired Development Alternatives, Inc.) with the aim of turning around the bank in order to privatize it. Lending to micro and small entrepreneurs has been underway for almost five years and the bank is on track to be privatized in 2005. With technical assistance, the bank's management was restructured, new products were developed, all levels of staff were trained and retrained, new information technology and management information systems were put into place, and numerous capital investments were made. Currently, NMB maintains a broad branch network in 108 locations throughout Tanzania and provides micro, salaried worker, personal, and pension loans and deposit, remittance, and payment services to more than 131,398 clients. It maintains an outstanding microcredit portfolio of 61.3 Tanzanian shillings made up of loans to small and microenterprise clients. Additionally, NMB is providing financing to small sugar cane growers affiliated with a large sugar processor. In 2004, the bank is working to roll out small and medium enterprise (SME) loans and loans for agriculture. Although under its current contract DAI is limited in the information it can directly release about NMB, the bank offers a prime post-privatization case example and privatization is planned for 2005.

Comparative Analysis of SORB Strategies and Outcomes in Brazil. As a federation with significant government involvement in the financial sector, the Brazilian states as well as the national government have played an important role, essentially dominating the country's financial system. While many of these public banks were closed, privatized, or converted to development agencies over the past decade, a few have continued to operate and have begun to play an important role in microfinance in the country (such as Banco do Nordeste, described in Box 4). In addition, a private/public sector alliance between the private Bradesco (which has bought up several privatized banks) and the post office system-established Banco Postal is focused on moving more Brazilians, including microenterprises, into the formal banking sector. An examination of the impact on financial services in select regions as a result of the diverse strategies taken by different SORBs (closing, privatizing, restructuring but remaining SORB,

becoming a development agency) would provide valuable lessons for others contemplating diverse strategies and forecasting potential outcomes.¹⁴

Reform Efforts at Bank Pertanian Malaysia Agricultural Development. This 100 percent government-owned bank was established in 1969. Its main objective is to promote agricultural development through lending facilities and mobilization of deposits in rural areas. It seeks to achieve its objectives through four programs: Deposit, Investment, Loan and Training. In particular, it offers specific microcredit loans. It provides credit line assistance to agro-based micro and small enterprises for farm machinery/equipment, estate development, research and development, food processing, and food packaging. Following the crisis in 1997, BPM had a loss of RM46 million in 1997 and RM150 million in 1998, compared to a profit of RM23 million in 1996. In 1999, due to the improved business environment and the various measures taken, it recovered and made a profit and has continued to do so. As of September 2003, BPM manages the RM500 million microfinance facility. This bank provides the opportunity to examine the success of reform efforts, including microfinance programs, within ongoing state-run banks.

Kyrgyzstan—Kyrgyz Agricultural Finance Cooperation (KAFC). This is a government-owned rural lender (but not a bank) that is being analyzed to become a bank and/or to be privatized. There is some rather strong opposition to this in spite of KAFC's apparently very good performance. KAFC was founded as a financial institution to provide credit to support farm reform and privatization. Its main activity is to provide credit facilities to medium and large rural producers and agribusiness enterprises. It also provides short-term loans for the purchase of farm inputs and services to individual farmers involved in crop and livestock production as well as medium- and long-term loans for on-farm investments and businesses. A special KAFC program is the SFCOP (Small Farmers Credit Outreach Program), which supports poor farmers who lack access to KAFC commercial credit through a special credit line and the development of farmers' self-help organizations.

Review of Reform Initiatives and Results of Select African SORBs. A number of African SORBs have undertaken reform and restructuring programs in recent years. In addition to NMB in Tanzania, the following cases appear to demonstrate the highest potential for additional learning regarding the viability of these efforts for expanding rural and microfinance in Africa.

§ **Angola—Banco Paupanca Credito—Credit & Savings Bank.** The Credit & Savings Bank was created when the private Commercial Bank of Angola was abandoned by its owners and nationalized just before independence in 1975. It continued to operate as a commercial bank, and in 1991 was restructured, and later privatized, with a focus on savings mobilization and credit provision in mostly low-income populations and in rural areas. Its current share capital is owned by the public and one percent is owned by the Institute of National Security, a government-owned entity. The bank has an extensive branch network throughout the country, operating in 14 of the 18 provinces

¹⁴ A short case study on Banco do Nordeste's CrediAmigo program is included as a companion document to this report; data on dozens of SORBs in Brazil are included in the census tables; and an analysis of diverse strategies on the performance of SORBs is presented in Beck, Thorsen, et al. 2003. "State Bank Transformation in Brazil—Choices and Consequences." World Bank, November.

in Angola. It manages government payments, taking over the role previously played by the Central Bank. Among the services it offers is online banking, which is targeted in particular to small and medium enterprises to facilitate their access to banking services.

- § **Senegal—Senegalese Post Bank (PB).** Transformed in 1995 into a postal bank, the Senegalese PB is currently involved in facilitating money transfers within the country. It is also extensively involved in savings mobilization and provides credit to small rural enterprises. The Senegalese PB began mobilizing deposits from NGO clients, and later started providing microcredit to women's unions and groups. Following a government recommendation, the Senegalese PB began to establish relations with NGOs offering deposit- services to micro clients. The bank also acts as a broker and negotiates loans with commercial banks on behalf of women's unions. It was able to obtain credit on better conditions from the commercial banks than the women could ever have achieved directly as individuals or as groups. It is looking into ways to extend microfinance services using its extensive branch network and agencies in the country.
- § **Swaziland—Swazi Bank.** The bank was originally established as an agriculture bank, but its mandate was later extended to include commercial and industrial development. The bank suffered serious losses up until 2001, largely due to nonoperating loans, and this had a serious impact on liquidity and deficiency in capital adequacy. A new executive team and a new board of directors were appointed in December 2000. The government, as the sole shareholder of the bank, was called upon to increase its shareholding from E9.8 million to E54.8 million (equivalent to US\$1.6 million and US\$9.1 million respectively using January 2005 exchange rates of E1=US\$0.17). As of June 2001, bank operations were back to normal, with new savings products and lending products such as school fees loans, vehicle loans, commercial loans, housing loans, etc. The bank currently has 90,000 customers. Currently the loan portfolio of the bank is around E880 million (US\$147 million). As of March 31, 2004, the bank posted an operating profit of E42.3 million (US\$7 million). It has the widest branch infrastructure in the country and is committed to providing financial services to the rural and the underserved. It would be interesting to see what path Swazi Bank has taken and whether this recent restructuring will be successful.
- § **Nigeria—Nigerian Agricultural Cooperative & Rural Development Bank (NACRDB).** The NACRDB was formed by a merger among the defunct Nigerian Agricultural and Cooperative Bank, the People's Bank of Nigeria, and the risk assets of the Family Economic Advancement Program. The amalgamation offers an interesting angle to transformation. The NACRDB was established by the federal government initially for credit delivery to the agricultural sector of the economy. The bank's role is to provide more comprehensive coverage to the agricultural sector through adequate funding of viable farm and nonfarm production activities. A microcredit scheme meant to improve access by small-scale enterprises to loan facilities has been recently launched in Nasarawa state. Managed by the NACRDB,

the scheme will provide credit facilities worth more than N11 million to various traders in the state. The NACRDB has a long history of lending to the agricultural sector of the economy and it has a wide network of branches nationwide.

Success of Small and Medium Enterprise Finance at Privatized Banks: DKS Bank, Bulgaria and the Romanian Development Bank (BRD). The state savings bank was established in 1951 as Bulgaria's only retail savings and lending institution. In 1998 it was transformed to **DKS Bank** and was licensed to operate as a full-service bank with the ability to offer a full range of loan and deposit products and services, foreign currency excluded. The bank was privatized last year and was bought by OTP, a Hungarian bank. DKS is Bulgaria's second largest bank and, with 67.5 percent market share in the BGN-denominated retail market, is the leader in retail banking with more than 350,000 consumer loans and 15,000 mortgage loans. DKS Bank ended 2003 with a record profit, and the U.S. magazine *Global Finance* named Bulgaria's DKS as the country's Best Bank in 2004. The prize was awarded for the bank's overall strategy and the development carried out by its new owner, and for its economic indicators: growth in assets, profits, client service, competitive pricing, and innovative products, including a number of SME initiatives. A study of this bank could provide valuable lessons on the preconditions for privatization and the ongoing role of SME finance post-privatization. **The Romanian Development Bank** was recently privatized with the acquisition by Société Générale (SG) of 51 percent of its shares. It holds a third of the credit card market and approximately 20 percent of the loan market. With 186 points of service across the country, BRD is the second largest retail bank in Romania and has more than one million customers, including many small enterprises. It had a reputation before privatization for being a small enterprise-oriented bank and has continued this trend under SG. In fact, BRD-Groupe Société Générale was the winner of the award for Best Bank for small enterprises, over nominees that included Banca Romaneasca, Banca Transilvania, HVB Romania, and Volksbank. As of August 2004, BRD posted a net profit of €8 million, up by 47.65 percent (32 percent in real terms) year-on-year; the bank's assets increased 26 percent in real terms. A study of this bank could provide valuable lessons on the preconditions for privatization and the ongoing role of SME finance post-privatization.

8 Case Study Framework

Each case study will follow a similar research framework structured around three general areas—environment, institution, and restructuring. The three general areas for examination presented below include a series of subtopics to be explored in order to identify and discuss the key factors that have contributed to or hampered performance in terms of outreach, sustainability, and innovation. It is not expected that each case will include an exhaustive discussion of all of these factors; rather, each case should focus on the most relevant causes for the given outcomes and highlight the most important lessons learned. The researchers will strive to garner insiders’ insights and illustrative anecdotes that describe what really worked and why at each bank. It is hoped that, taken together, the diverse cases selected will paint a more complete picture of the constraints, potential, and options for SORBs to contribute to rural and microfinance.

8.1 Context/Environment

The development of state banking takes place against a backdrop of macroenvironmental influences. Political turmoil and unstable economies do not create an environment conducive to lasting reform. Continued government interventions driven by political ambitions have contributed to misuse and strained performance of SORBS in many countries. Government commitment to reform of state banks, respect for banks’ operational autonomy, and adherence to commercial practices are some of the guiding principles for the successful transformation of SORBS. The role and capacity of the private sector, the investment climate, and openness to foreign investment also are important. In addition to these external factors, it is important to look at the sequencing of restructuring, privatization, closure, and other activities. For example, BRI started its turnaround in 1984, far before privatization was a point of discussion on the table, and the Ag Bank of Mongolia was quickly turned around, within a few years, as a prerequisite for privatization. Questions regarding the relationship among the stability of political systems and economic approaches to the timing, types of changes, and success of SORB restructuring are critical areas to explore.

Specific issues to examine in this area include:

- § Political factors (stability, strategic outlook, extent of corruption),
- § Legal and regulatory framework,
- § Market (extent of competition, size of segment),
- § Economic factors (inflation, growth, income, etc.),
- § Size and geography of country/region, and
- § Demographics of country/region.

8.2 Institution

Internal and structural factors are critical to understand the institutional performance and what drives it. A level of trust among the researcher and management and directors will be critical in order to gain access to accurate information for a meaningful analysis of the banks to be studied.

Areas to explore will include:

- § Ownership and capitalization;
- § Governance (e.g., board selection and eligibility, how CEO is named);
- § Management, structure, independence, capacity, and vision;
- § Operations, delivery systems, points of service, human resources, products, and services;
- § Market segment and geographic focus;
- § Measurement, systems, reporting, transparency, and disclosure;
- § Risk management policies and procedures; and
- § Technical assistance and how has it been used to build branches and technical capacity.

8.3 Restructuring

One of critical key areas to explore for this study is the area of restructuring, as a key outcome of this research is to be a set of tools for donors to use in assessing the feasibility of restructuring and structuring a restructuring assistance package.

Topics to examine in this area will include:

- § Who was involved and what was the role of the government, donors, private sector?
- § What was the objective of the involved parties?
- § How was it structured and conducted?
- § How much was spent, in what forms and sequence and for what purposes?
- § How long did it take?
- § What was the outcome?
- § What were critical issues in success or failure?

Box 6: Key Questions to Answer with Future SORB Research

- § What market factors justify SORB restructuring? What problems with private finance exist that a SORB restructuring could overcome?
- § What elements of markets and institutions make them most conducive to SORB restructuring?
- § What characteristics and internal capacities should a SORB demonstrate to have a successful turnaround and microfinance focus?
- § How important is it to bring in long-term technical assistance?
- § What sorts of assistance are most likely to achieve restructuring goals?
- § What determines whether branch networks should be preserved, reduced, or expanded?
- § What products and services are most successful in terms of outreach and profitability?
- § Must the SORB be recapitalized?
- § Should the SORB be expected to collect on its existing nonperforming portfolio?
- § Is privatization the only possible end game?
- § What institutional options exist to efficiently and effectively provide financial services in the absence of a restructured SORB (e.g., strengthened deposit and transfer only institutions, credit agencies, sale of rural branches with incentives for continued operations, etc.)?
- § What if the government is unclear about its commitment to SORB reform?

Following preparation of the case studies, a synthesis report will then draw lessons from these cases to attempt to answer the questions summarized in Box 6.



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