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APPROACHES TO REHABILITATING INSOLVENT GOVERNMENT-OWNED BANKS: BENEFITS & COSTS OF LIQUIDATING AN AGRICULTURAL BANK IN PERÚ

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A. Introduction

Government-owned banks were popular in many low-income countries until the late 1980s. They were built on the assumption that development could be accelerated through government interventions that were reinforced by directed credit. Major donors such as the World Bank, the Inter-American Development Bank, and the Agency for International Development eagerly supported these activities for several decades, but for a variety of reasons many of these banks floundered in the 1980s. The problems that emerged were exacerbated by changes in the dominant development paradigm from one focusing on central planning to one emphasizing market forces. Since a number of troubled development banks still await decisions about their future, it may be useful to glean lessons from experiences with earlier treatments of insolvent government-owned banks.

The first half of this paper provides a conceptual background to differentiate insolvency in government-owned banks from insolvency in private-sector banks. Both imply economic costs from the misallocation of resources reflected in bad loans and other sources of insolvency, but insolvent government banks also involve an immediate fiscal cost to the government which the government may be loath to admit, and the delays that can results may be even more costly in the case of insolvent government banks than in the case of insolvent private banks. Moreover, effective remedies can be quite different. Recapitalization is a normal cure for an insolvent private bank, but for an insolvent government bank no change in incentives can necessarily be expected that would keep the bank from soon becoming insolvent again. Other options often mentioned for dealing with insolvent government banks are liquidation and privatization. The second half of this paper examines in detail the costs and benefits of the liquidation of an insolvent government bank in Peru, the Banco Agrario. While the benefits appear to be more or less as expected, the costs have been surprisingly high, with the longer term costs coming in large part from the fact that the bad habits that drove the behavior of the Banco Agrario were not dealt with.

Along with the spread of financial liberalization policies since the early 1980s, there has also been a major upsurge in bank insolvencies. Such problems have not been limited just to developing countries and have been especially troublesome in the 1990s for economies in transition from plan to market. These insolvencies have been variously attributed to high real interest rates and the international debt crisis of the early 1980s, stabilization policies that have reduced the profitability of borrowers' investments, programs of structural adjustment that have negatively impacted previously favored borrowers in particular, flaws in the design and execution of programs of financial liberalization, and even financial liberalization itself.

Whatever the causes of this upsurge in bank insolvencies, the costs have often been substantial, amounting in many cases to a significant percentage of a country's total output. These costs take two major forms:

1. the losses imposed on depositors and other creditors of insolvent banks, losses that in many countries have ultimately been absorbed by the government as part of its fiscal obligations; and

2. economic losses, especially from the inefficient allocation of credit by insolvent banks.

These economic losses may be more difficult to detect, even after the fact when all the accounts have been settled, but they are no less real. Moreover, economic losses from inefficient credit allocation by insolvent banks not only reflect past mistakes in lending decisions wherein resources were allocated to loss-making activities but also involve incentives for more loss-prone behavior in the future. Owners and managers of insolvent banks may be no less competent than owners and managers of solvent banks, but once insolvency is reached incentives are created to undertake excessively risky lending and even to lend purely to hide insolvency.

The purpose of the present paper is not to reiterate the many lessons provided by experiences with bank insolvencies since the early 1980s. These have already been widely documented for a number of individual countries and in general, with a World Bank publication, *Bank Restructuring: Lessons from the 1980s*, providing an excellent summary to serve as a point of departure for the present paper. In the Bank's monograph, as in other publications dealing with the causes and costs of bank insolvencies and the merits of different approaches to bank restructuring, there is a general neglect of essential differences between state owned and privately owned banks with respect to the fiscal costs of insolvency and appropriate approaches to bank rehabilitation.

In addition to general lessons for bank restructuring, the Bank's publication, *Bank Restructuring: Lessons from the 1980s*, analyzes in detail the experiences of six developing and transitional economies: Colombia, Malaysia, Ghana, Yugoslavia, Chile and Argentina. In the case of Argentina, and especially in the cases of Ghana and Yugoslavia, state owned banks were a major part of the insolvency problem, while in Colombia, Malaysia and Chile state owned banks played a minimal role. However, other than passing references to cases in which state owned banks were particularly inefficient or had disproportionately large losses, there is no systematic differentiation between state owned and privately owned banks.

The present paper makes two main points with respect to the essential differences between insolvent state owned banks and insolvent privately owned banks:

1. the government has no real choice except to assume the losses of insolvent state owned banks, so that such losses become part of the government's fiscal burden as soon as they are incurred; and

2. whereas passing from solvency to insolvency or from insolvency to solvency has a clear impact on the incentives of owners and managers of private banks, there is no comparable impact in the cases of changes in the solvency of a state owned bank.

Moreover, the failure to recognize the essential difference in state owned banks is not merely academic but can create incentives for governments and international organizations to deal inappropriately with insolvent state owned banks, that is, to pursue policies of inaction in order to avoid "recognizing" losses from insolvency and to recapitalize state owned banks in ways that are especially costly, both in the present and in the future, without effectively dealing with the kind of behavior that may have contributed to insolvency in the first place.

In understanding the essentially different situation of state owned banks, it is useful to begin by reviewing briefly why insolvent privately owned banks present serious problems for efficient resource allocation and why they can also impose significant fiscal costs on a government. When a private bank becomes insolvent, its owners no longer have incentives to behave prudently but rather, because they have nothing left to lose, have incentives to undertake high risk activities in the hope of recouping, to continue lending to hopelessly bankrupt borrowers in order to disguise earlier losses, and to divert the bank's remaining assets to their personal use. Such actions are clearly not likely to be consistent with an allocation of credit to the most productive activities available and hence will likely result in an inefficient allocation of resources. Although in the absence of deposit insurance or similar guarantees the government is not obliged to assume the liabilities of an insolvent privately owned bank, it may nonetheless be forced to absorb a substantial proportion of the bank's losses (e.g., through paying depositors or through central bank credits to the insolvent bank) in order to avoid a political crisis or further damage to the country's financial system (e.g., depositor "runs" on solvent banks).

Although implementation may not always be easy either technically or politically, particularly when bank insolvencies are widespread, appropriate remedies for private sector bank insolvency are generally well known. Owners must be forced to restore the bank's capital to adequate levels or else lose ownership and control of the bank through its sale or liquidation. When capital inadequacy is detected early so that recapitalization can take place before complete insolvency is reached, the task can be less difficult, not primarily because the amounts involved are smaller but rather because owners still have some stake left in the bank. Another important lesson is that whatever money the government may find necessary or convenient to contribute to this process must not go to benefit the owners and management of the insolvent bank. Otherwise, incentives are created for more imprudent behavior by bank owners and managers in the future.

Arguing by analogy, governments and international organizations have often taken a similar approach to insolvent state owned banks. Arguments by analogy are always logically suspect and, in this case, are likely to be very costly for the governments involved. As noted above, there is no reason to assume that the incentives governing the behavior of a state owned bank change significantly when the bank passes from solvency to insolvency and back to solvency, as they do in the case of a privately owned bank. Moreover, no government realistically can refuse to honor the obligations of a state owned bank to depositors or other creditors. Hence, there is no doubt that there is an immediate fiscal cost to the government from insolvency (and even from losses due to non-performing loans) at a state owned bank, whether the losses remain on the books of the bank or are passed formally to the books of the central bank, the finance ministry or some other government agency. This point, the immediate impact of non-performing loans and insolvency of state owned banks on a government's fiscal situation, will be developed in the following section of the paper.

B. Non-Performing Loans, Government Debt and Fiscal Deficits

Even when a state owned bank does not become insolvent, when a loan at such a bank become non-performing (i.e., the borrower ceases to make payments), the government immediately suffers a loss, whether it is recognized or not on the books of the bank or some other government agency.[1] The government's net debt increases because the bank's liabilities have not changed, while corresponding assets are no longer as large, as shown in Chart 1. Moreover, the government's deficit increases because this debt must be financed. The government no longer has interest income from the non-performing loans, but it must still pay interest to the bank's depositors and other creditors and cover other expenses, as shown in Chart 2. Even deposits on current account, which pay no explicit interest but simply provide liquidity to depositors, contribute to a deficit because these liquidity services can only be furnished if salaries continue to be paid to bank staff and other expenses continue to be incurred.

Chart 1: Balance Sheet of State-Owned Bank

Initial Situation

Assets		Liabilities	
Performing Loans	$1,000	Deposits	$900
Other Assets	$500	Other Liabilities	$500
		Net Worth	$100

With Non-Performing Loans

Assets		Liabilities	
Performing Loans	$800	Deposits	$900
Non-Performing Loans ($200)		Other Liabilities	$500
Other Assets	$500	Net Worth	($100)

Chart 2: Income Statement of State-Owned Bank

Initial Situation

Income		Expenses	
Interest Income from Loans	$200	Interest Paid on Deposits	$90
Other Income	$50	Int. Paid on Other Liabilities	$50
		Other Expenses	$80
		Net Income	$30

With Non-Performing Loans

Income		Expenses	
Interest Income from Loans	$160	Interest Paid on Deposits	$90
Other Income	$50	Int. Paid on Other Liabilities	$50
		Other Expenses	$80
		Net Income	($10)

[1] In the present paper, non-performing refers to loans on which no payments are being made, with no expectation that payments will be made in the future. This is not the same as the definition of non-performing used by bank examiners in the United States, but is nonetheless clear and consistent for the present purposes.

The standard accounting entries for a bank with its non-performing loans will not, of course, be nearly so simple. On the balance sheet, there will be some kinds of "provisions" for non-performing loans, based on an assessment of the bank's ultimate rate of recovery of its loans, against which non-performing loans can eventually be charged off. Nonetheless, each increase in non-performing loans decreases the net worth of a bank and, when the bank is state owned, invariably increases the net debt of the government. On the income statement, there will be "accrued" interest on loans which represents the rate at which interest on performing loans would be collected if it were spread evenly through time.[2] When interest payments are not in fact received exactly when they are due, they nonetheless continue to be accrued for some period of time which varies according to the legal and accounting customs of the country. Such customs assume that failure to pay exactly on time does not necessarily imply that a loan is immediately non-performing. In any case, when a loan does pass beyond the customary period and become officially non-performing, not only must the accrual of interest cease but previously accrued interest that was never received must also be "de-accrued." This, of course, can cause dramatic fluctuations in a bank's income and net worth and thus make interest accrual policies and their enforcement an important element in the detection of bank insolvencies.

In the case of both privately owned and state owned banks, the detection of non-performing loans and bank insolvency may not be easy, particularly since managers have incentives to hide such bad news from owners and owners from government regulatory authorities.[3] In fact, in the absence of highly skilled auditors and bank examiners, detection often occurs only when the insolvent bank also becomes illiquid and cannot meet its immediate obligations. Anxious depositors can bring on illiquidity through "runs" even when a bank is not insolvent. However, depositor runs are extremely unlikely in the case of state owned banks because depositors know that the government must honor their claims, later if not sooner. In the case of privately owned banks, runs can be forestalled by official deposit insurance or by the assurances of government officials, through either credible public statements or past behavior, that the government will cover these deposits. This, however, can be a highly dangerous practice because losses due to insolvency can continue to mount as an insolvent bank attracts more deposits to maintain its liquidity while increasing the amount of its insolvency through making more loans that become non-performing.[4] In the case of state owned banks this is virtually inevitable, that is, without depositor fears of illiquidity, more deposits can be brought in through high interest rates and other aggressive marketing practices to maintain liquidity, so that the amount of the insolvency can increase through more non-performing loans until banking regulators are finally able to take command.

As indicated above, non-performing loans at state owned banks imply an immediate increase in the net debt of the government, and the lost interest receipts imply a greater fiscal deficit for the

[2]Interest on liabilities is similarly accrued.

[3]For simplicity, it has been assumed that non-performing loans are the only source of bank insolvency, but of course there can be many other causes ranging from operational inefficiency to foreign exchange losses to off-balance-sheet guarantees.

[4] It can also increase the amount of its insolvency by devoting funds from depositors to the operating expenses of the bank, including salaries, even excessive salaries, to high level bank management.

government to finance from that instant. The government, of course, has the usual options to deal with this:

- it can increase tax revenues (or reduce expenditures) enough to pay this debt immediately, that is, increase the assets or decrease the liabilities of the state owned bank by the amount of the non-performing loans;

- it can increase tax revenues (or reduce expenditures) enough to pay only the interest on this debt, that is, restore the interest income that is no longer being collected by the state owned bank; or

- it can do nothing and thereby immediately begin to accumulate additional debt on which it will have to pay additional interest, that is, allow the losses of the state owned bank to compound as the losses increase the liabilities which in turn increase the losses.

It should be emphasized that no recommendation is being made (or implied) at this point. The purpose of this section of the paper is just to clarify the accounting and fiscal realities of non-performing loans (and insolvencies) at state owned banks; it is in later sections that we will analyze and make recommendations on how best to deal with insolvent state owned banks.

Policies of structural adjustment and financial liberalization may or may not have exacerbated the fiscal problems of many reforming governments, but these policies have certainly tended to bring such problems to the fore. Many state owned enterprises were found to be insolvent, and central banks in many countries were likewise found to have substantial liabilities with no corresponding assets, often due to costly attempts to support overvalued exchange rates or developmental credits in the form of rediscounts to banks that, along with many of their borrowers, were insolvent. The magnitude of these debts made officials of governments and international agencies begin to speak of the importance of "quasi-fiscal" deficits, that is, deficits that were not included within the revenues and expenditures of the general or central government but were rather to be found on the books of enterprises owned by the government, including even the central bank.

For certain purposes it may be useful to distinguish quasi-fiscal deficits from standard fiscal deficits. For example, there may be much less certainty about the amounts of quasi-fiscal deficits until the assets and liabilities of state owned enterprises are carefully appraised or even until they are finally liquidated. Or, there may be reasons to think that the government may not ultimately have to be responsible for the debts of these enterprises, although, as noted elsewhere in this paper, it is extremely difficult to see how a government could avoid standing behind the deposits and other obligations of state owned banks. In addition, large quasi-fiscal deficits can be highly embarrassing to a government and the officials of international organizations who have just reached agreements based on a particular level of the fiscal deficit, only to discover subsequently there are also large and previously unrecognized deficits in various state owned enterprises, and to call these quasi-fiscal rather than fiscal may somehow ease the embarrassment.

In fact, governments and officials of international organizations have sometimes argued specifically that a quasi-fiscal deficit is not part of the official fiscal deficit until it is officially recognized as such. In the case of state owned banks, this can have at least three highly undesirable consequences:

1. to maintain honest credibility, a government would have to announce publicly that the deposits and other obligations of state owned banks found to be insolvent might not be honored by the government, with potentially disastrous consequences for financial sector stability;

2. if quasi-fiscal deficits are "quasi" only because they are uncertain in amount, this creates an opportunity to delay recognition further by not investigating their true extent -- and consequently not dealing with them -- because they would then have to be recognized; and

3. delaying the recognition of, and hence not dealing with, the insolvency of a state owned bank is almost certain to bring on mounting losses.

In the case of privately owned banks, why delay is disastrous has already been explained: the incentives of owners and managers of privately owned banks change for the worse with insolvency. In the case of state owned banks, as already noted and to be discussed in detail in a later section of this paper, it is unclear what happens to incentives. However, three aspects of state owned banks make it likely that losses will mount progressively:

1. nothing has been done to change behavior, for better or for worse, while recognition is delayed, so that losses will continue to compound;

2. state owned banks can continue to mobilize deposits to finance increasingly large losses, with the ultimate limit being only the overall size of the financial system; and

3. it may be tempting to try to improve the profitability of state owned banks in ways that can have negative implications for the rest of the financial system.

For example, the central bank might reduce or eliminate reserve requirements against deposits at state owned banks or it might provide rediscount funds to them at low or zero cost. This would not change the government's overall fiscal position, but would simply pass the deficit to the central bank (lower revenues, greater expenditures). At the same time, it would create a less "level" playing field because state owned banks without problem loans would have a competitive advantage over privately owned banks that could allow the state owned banks eventually to dominate the entire financial system.

The main conclusion of this section of the paper is that it is inappropriate to characterize the losses of state owned banks as part of a government's quasi-fiscal deficit, if such a characterization is believed to imply that these losses are somehow less than totally real until finally recognized as part of the official government deficit and consequently that nothing need be done to deal with them as quickly as possible. As indicated above, such losses immediately impact the fiscal position of the government, even if the amount is not fully known with certainty. Moreover, if such losses do not count for policymakers until they are officially recognized as part of the government's fiscal deficit, then incentives are likely to be created to delay as long as possible in their recognition and consequently in dealing with them. As argued above, such delays are likely to lead to the compounding of losses that will ultimately need to be covered by the government, especially since state owned banks can continue unimpeded in aggressively mobilizing deposits whenever more funds are not forthcoming directly from the government. Ascertaining the losses of banks is sufficiently difficult without providing incentives to leave them unrecognized.

C. Recapitalizing Insolvent State Owned Banks

The foregoing discussion does not provide a recipe by which governments can design schemes to deal with the insolvency or non-performing loans of state owned banks -- nor does the present section of this paper. The point of this section is rather to emphasize once again, but in a different dimension, that privately owned banks and stated owned banks are not analogous. It is widely agreed that recapitalizing insolvent privately owned banks is one key, if not ***the*** key, to restoring appropriate behavior in order to minimize further losses and to encourage efficient resource allocation in the future. This is because recapitalization clearly changes incentives in privately owned banks, but in state owned banks this is not true, at least for any obvious reason. As will be seen, for state owned banks, the most important attribute of schemes to deal with non-performing loans and insolvency is whether or not the particular scheme provides additional funds to the bank. Managers of state owned banks want liquidity, not necessarily solvency, and if they can obtain additional funds more easily and cheaply through recapitalization than through deposit mobilization, then recapitalization programs can be highly attractive to them -- so long as they involve recapitalization through the provision of additional assets rather than through reductions in liabilities.

Suppose that a state owned bank has so many non-performing loans that its liabilities exceed its assets after appropriate adjustments have been made to its balance sheet to account for these losses, that is, it is technically insolvent. Should the government wish to make this bank solvent again for some reason, rather than liquidating it, there are two possible approaches:

1. increase the bank's assets; or

2. reduce the bank's liabilities.[5]

Reducing the liabilities of this bank (e.g., by canceling some debts that it owes to the central bank) in fact solves two problems:

1. the bank becomes technically solvent (see Chart 3); and

2. claims against the bank's reduced interest income (due to the non-performing loans) are thereby reduced by the amount of interest that the bank formerly had to pay on these liabilities,

[5]As discussed above, it should again be noted that neither of these approaches deals with the question of changing incentives for management, but rather with the question of providing additional funds.

so that the bank can better cover its operating expenses without having to try to operate with spreads higher than its competitors (see Chart 4).

Chart 3: Balance Sheet of Insolvent Bank with Solvency Restored by a Reduction in Liabilities

Insolvent

Assets		Liabilities	
Performing Loans	$800	Deposits	$900
Non-Performing Loans ($200)		Rediscounts at Central Bank	$300
Other Assets	$500	Other Liabilities	$200
		Net Worth	($100)

Solvent Through Reduction in Liabilities

Assets		Liabilities	
Performing Loans	$800	Deposits	$900
Non-Performing Loans ($200)		Rediscounts at Central Bank	$100
Other Assets	$500	Other Liabilities	$200
		Net Worth	$100

Chart 4: Income Statement of an Insolvent Bank with Solvency Restored by a Reduction in Liabilities

Insolvent

Income		Expenses	
Interest Income from Loans	$160	Interest Paid on Deposits	$90
Other Income	$50	Interest Paid on Central Bank Rediscounts	$30
		Interest Paid on Other Liabilities	$20
		Other Expenses	$80
		Net Income	($10)

Solvent Through Reduction in Liabilities

Income		Expenses	
Interest Income from Loans	$160	Interest Paid on Deposits	$90
Other Income	$50	Interest Paid on Central Bank Rediscounts	$10
		Interest Paid on Other Liabilities	$20
		Other Expenses	$80
		Net Income	$10

A review of recapitalization experiences with stated owned bank reveals few, is any, examples of recapitalization through reductions in liabilities. It is useful to explore the possible reasons why this might be the case. The most obvious could be that the net worth and income of the central bank are reduced:

- net worth is reduced through the elimination of the central bank's assets that are the counterpart to the state owned bank's liabilities that have been reduced (see Chart 3a); and

- income is reduced because interest is no longer received on the assets that have been eliminated (see Chart 4a).

Chart 3a. Balance Sheet of Central Bank with Solvency of State-Owned Bank Restored by a Reduction in Central Bank Assets

Initial Situation

Assets		Liabilities	
Loans to Banks	$300	Reserves of Banks	$500
Government Securities	$700	Currency in Circulation	$400
Other Assets	$200	Other Liabilities	$200
		Net Worth	$100

After Reduction in Assets

Assets		Liabilities	
Loans to Banks	$100	Reserves of Banks	$500
Government Securities	$700	Currency in Circulation	$400
Other Assets	$200	Other Liabilities	$200
		Net Worth	($100)

Central bank officials may also suffer some embarrassment in explaining why loans were made in the first place to a bank, albeit state owned, that later turned out to be insolvent. Nonetheless, the overall fiscal and financial position of the government does not change, as there is an equivalent reduction in government assets and liabilities; on a consolidated basis, debts between government entities do not matter. Moreover, it is highly unlikely that the central bank would be able to enforce its claims on an insolvent state owned bank in any case since this inevitably would involve putting its claims ahead of those of depositors, other domestic creditors and international lenders – something that in general is not politically realistic.

There is, however, one class of international lenders -- not commercial lenders who would see the government to be morally if not contractually liable, but rather international organizations – that might help a central bank and its government to deal with an insolvent state owned bank. After all, a major role of international organizations, especially in an era of financial liberalization, is to assist governments in dealing with financial sector problems that almost always include insolvent banks. As shown above, an insolvent state owned bank could be made solvent again by a reduction in its liabilities, but international organizations as creditors to insolvent state owned banks have seldom been any more willing than commercial lenders to write off such loans, and just standing by while a government and its central bank simply write down assets and liabilities on their own account is unlikely to be seen as providing much assistance. An attractive solution for both governments and international organizations can instead be increased lending by international organizations, always high among their objectives, to governments wanting to recapitalize insolvent state owned banks. Such lending can be used not only to recapitalize an insolvent state owned bank but also to provide additional funds for lending – always a high priority for the management of any state owned bank, especially those who do not relish the task of deposit mobilization.

Chart 4a: Income Statement of Central Bank with Solvency of State-Owned Bank Restored by a Reduction in Central Bank Assets

Initial Situation

Income		Expenses	
Interest Income on Loans to Banks	$30	Interest Paid on Bank Reserves	$25
Interest Income on Gov't. Securities	$70	Interest Paid on Other Liabilities	$15
		Net Income	$60

After Reduction in Assets

Income		Expenses	
Interest Income on Loans to Banks	$10	Interest Paid on Bank Reserves	$25
Interest Income on Gov't. Securities	$70	Interest Paid on Other Liabilities	$15
		Net Income	$40

Using funds from loans from international organizations to recapitalize insolvent state owned banks is in fact one example of the second approach to recapitalization, that is, increasing a bank's assets rather than reducing its liabilities. Before examining in detail the role that a loan from an international organization could play in this recapitalization, it is useful first to examine exactly how an increase in assets not only restores solvency but can also restore profitability.[6] It is clear that a sufficiently large increase in assets can restore the solvency of an insolvent state owned bank (see Chart 5). However, in order to know if the profitability of the insolvent bank has likewise been restored, it is necessary to know what rate of return these assets will earn. As shown in Chart 6, only if the rate of interest on these assets is high enough will the bank be profitable so that solvency can be maintained over time. A government is deceiving itself if it believes that it can in fact rehabilitate an insolvent bank without providing a flow of resources to the bank by paying an adequate rate of interest on the assets that have been provided to the bank. In the extreme suppose, for example, that the asset provided is a perpetuity with a high face value, but one that pays no interest. Further, even suppose that the asset is negotiable -- but the market value of a perpetuity that pays no interest would be zero, thus illustrating that a flow of resources is essential for restoring solvency.

[6]It is important to recall that simply increasing assets to restore solvency does not provide a solution unless income is also increased to restore profitability so that solvency can be maintained.

Chart 5: Balance Sheet of Insolvent Bank with Solvency Restored by an Increase in Assets

Insolvent

Assets		Liabilities	
Performing Loans	$800	Deposits	$900
Non-Performing Loans ($200)		Rediscounts at Central Bank	$300
Other Assets	$500	Other Liabilities	$200
		Net Worth	($100)

Solvent Through Increase in Assets

Assets		Liabilities	
Performing Loans	$800	Deposits	$900
Non-Performing Loans ($200)		Rediscounts at Central Bank	$300
New Assets	$200	Other Liabilities	$200
Other Assets	$500	Net Worth	$100

Chart 6: Income Statement of Insolvent Bank with Solvency Restored by an Increase in Assets

Insolvent

Income		Expenses	
Interest Income from Loans	$160	Interest Paid on Deposits	$90
Other Income	$50	Interest Paid on Central Bank Rediscounts	$30
		Interest Paid on Other Liabilities	$20
		Other Expenses	$80
		Net Income	($10)

Solvent Through Increase in Assets Earning No Interest

Income		Expenses	
Interest Income from Loans	$160	Interest Paid on Deposits	$90
New Assets with No Interest Income	$0	Interest Paid on Central Bank Rediscounts	$30
Other Income	$50	Interest Paid on Other Liabilities	$20
		Other Expenses	$80
		Net Income	($10)

Solvent Through Increase in Assets Earning Interest

Income		Expenses	
Interest Income from Loans	$160	Interest Paid on Deposits	$90
New Assets with Interest Income	$20	Interest Paid on Central Bank Rediscounts	$30
Other Income	$50	Interest Paid on Other Liabilities	$20
		Other Expenses	$80
		Net Income	$10

Restoring the solvency of an insolvent state owned bank through increasing the assets of the bank achieves it objectives, at least in the short run, if the asset transfer is sufficiently large and if the rate of interest paid on the assets is sufficiently high. It is nonetheless worth asking how this differs from restoring solvency by reducing the liabilities of the insolvent state owned bank (illustrated above in Charts 3 and 4). If the finance ministry increases the assets of the insolvent state owned bank by an amount equal to the decrease in liabilities in the earlier example (compare Charts 3 and 5) and pays the same rate of interest on these assets as was being received on the liabilities (compare Charts 4 and 6), then it makes no difference whatsoever. There is no difference in the net income of the state owned bank in the two cases because there is no difference in net interest received. Net worth is also the same in the two case. Although there appears to be some difference because the assets (and liabilities) of the state owned bank are higher in the second case than in the first case, the assets of the central bank are correspondingly lower in the first case and the liabilities of the finance ministry corresponding higher in the second case, so that the overall net worth of the government is not changed (beyond the initial impact resulting from the increase in non-performing loans).

There can, however, be a difference if the assets provided by the finance ministry are negotiable. In this case, the state owned bank could sell these assets and increase its loans outstanding by an equivalent amount. The impact on the income statement of the state owned bank would, of course, depend on the difference in interest rates between the assets and the loans, the additional administrative costs incurred in making and recovering the loans, and especially what proportion of the new loans turn out to be non-performing. The question of the negotiability of these assets will be discussed further below in the context of recapitalization loans from international organizations that are used to fund the assets.

It is also interesting at this point to contrast recapitalization through either approach with simply doing nothing. As discussed in an earlier section of the paper, if the insolvency of a state owned bank is not dealt with in any way, losses will continue to mount, the net worth of the government will continue to deteriorate as more debt is accumulated by the state owned bank, and the government's fiscal burden will increase with the need to finance this growing debt. It thus appears that a stroke of the pen, either increasing the assets or the reducing liabilities of the insolvent state owned bank, has magically solved a portion of the government's fiscal problems. Obviously this cannot be the case – otherwise, there would be no fiscal problems. What in fact has happened is that the burden has simply been passed from the insolvent state owned bank in the case of a reduction in liabilities to the equally state owned central bank which now earns less seigniorage (revenue from money creation) or indulges in more inflationary money creation. In the case of an increase in assets of the insolvent state owned bank, the burden has been passed to the finance ministry, as shown in greater detail below when a recapitalization loan from an international organization is examined.

Earlier in this paper it was argued that it was urgent to deal with the insolvency of state owned banks and, consequently, that calling their losses quasi fiscal rather than fiscal was bad if it delayed recognizing and dealing with these losses. Now it seems that recapitalization does not matter. Before pursuing further why recapitalization might or might not make a difference, depending on how it is done, it is worthwhile to comment briefly on what happens to the portfolio of non-performing loans of the insolvent state owned bank. In many countries, the recapitalization of insolvent banks, privately owned as well as state owned, has involved the exchange of new interest earning assets for the bank's existing portfolio of non-performing loans. In this case, the relevant question is not about the current value of this loan portfolio (presumably zero) but whether the administration of this loan portfolio will pass to a new entity that might have some success in collecting a portion of this portfolio of non-performing loans.

As mentioned above, international organizations often find it potentially attractive to participate in the recapitalization of insolvent state owned banks because it affords them the opportunity to fulfill their lending function while also assisting a government to overcome problems that may be associated with financial liberalization. One positive aspect of this is that part of the recapitalization process involves establishing as far as possible the extent of the state owned bank's insolvency, and this lesson from the past may serve as a warning for the future. Nonetheless, as demonstrated above, recapitalizing a state owned bank does not, per se, change the overall fiscal situation of the government and only basically affects the state owned bank itself if new resources are made available for additional lending. A recapitalization loan from an international organization in fact typically does precisely this, that is, it provides new assets that can be converted to additional lending. As will be argued below, this change is only for the good if future lending is better than past lending (results in a lower proportion of non-performing loans).

An unintended benefit of the recapitalization of an insolvent state owned bank through a loan from an international organization is that it shows more clearly the costs of the insolvency. The government's finance ministry not only borrows to recapitalize (see Chart 5a), but it must also pay interest on the loan (see Chart 6a), albeit at rates that may be below international commercial rates. In any case, it is the interest on this recapitalization loan (along with its amortization) that reflects the costs of the insolvency. It is there for all to see (unless the government specifically tries to hide it) rather than being hidden in an unrecognized quasi fiscal deficit or in transfers between the insolvent bank and the central bank, the finance ministry or some other government agency.

Chart 5a: Balance Sheet of Finance Ministry with Solvency of State-Owned Bank Restored Through an Increase in Assets Based on a Loan from an International Organization

Initial Situation

Assets		Liabilities	
Other Assets	$500	Domestic Debt	$200
		Foreign Debt	$200
		Net Worth	$100

After Loan from International Organization to Restore Solvency of State-Owned Bank

Assets		Liabilities	
Other Assets	$500	Domestic Debt	$200
		Foreign Debt	$400
		Net Worth	($100)

Chart 6a: Income Statement of Finance Ministry with Solvency of State-Owned

Bank Restored Through an Increase in Assets Based on a Loan from an International Organization

Initial Situation

Income		Expenditures	
Tax Revenues	$800	Non-Interest Expenditures	$800
		Interest on Domestic Debt	$20
		Interest on Foreign Debt	$20
		Net Income	($40)

After Loan from International Organization to Restore Solvency of State-Owned Bank

Income		Expenditures	
Tax Revenues	$800	Non-Interest Expenditures	$800
		Interest on Domestic Debt	$20
		Interest on Foreign Debt	$40
		Net Income	($60)

D. Insolvency, Funds for Lending, and Incentives

An insolvent bank, whether privately owned or state owned, can incur further losses only if it has some assets or can secure additional funds to lose. As already established, an insolvent privately owned bank will have incentives to lose more if it has the assets or can secure the additional funds. These perverse incentives are the key reason that bank regulators need to move as rapidly as possible to deal with insolvent privately owned banks. At the same time, it is clear that regulators would be foolish to allow insolvent privately owned banks to have access to additional funds (e.g., central bank rediscounts or deposits) until solvency has been restored and incentives have thereby been changed. Nonetheless, this is easier said than done because pressure is always on central banks to continue to fund insolvent privately owned banks to avoid a liquidity crisis, and on central banks or some other government agencies to guarantee deposits for the same reason. Notwithstanding the obstacles, central bank discipline and market discipline are clearly necessary until the insolvency of a privately owned bank can be dealt with.

As already indicated, the situation for insolvent state owned banks is quite different. Leaving aside for a moment the issue of incentives, two things are clear:

1. deposits do not need to be guaranteed by some agency to forestall a potential liquidity crisis because they are already guaranteed by the fact that the bank is state owned; and,

2. likewise, the central bank does not need to lend to a state owned bank to deal with a liquidity crisis stemming from depositor runs.

The importance of dealing quickly with an insolvent state owned bank does not come from the fact that incentives can deteriorate suddenly with insolvency but rather from the fact that an insolvent state owned bank can simply continue unimpeded to mobilize deposits and to lose them through the same lending behavior that led to the non-performing loans in the past. Likewise, "developmental" or politically motivated funding can continue to be provided by the central bank or other agencies. The danger is thus not that incentives deteriorate but that no mechanisms exist to impede mounting losses.

International organizations that provide loans to governments to fund the recapitalization of insolvent state owned banks are thus faced with a dilemma with respect to the use of the funds. Adding to the assets of the insolvent state owned bank to make it solvent provides additional funds that can be used for lending, which is undoubtedly the primary objective of the management of the bank. However, there is no reason to suppose that the behavior of the state owned bank will change, as would that of a privately owned bank, when it becomes solvent again. Thus, a significant percentage of the new lending by the state owned bank is likely in the future, as in the past, to lead to non-performing loans. There is no reason to think that insolvency will not recur because nothing has yet been done to change the incentives of the state owned bank. Incentives do not need to get worse to produce a high level of non-performing loans again after the recapitalization has returned the bank to solvency -- it is just that nothing has been done to change the incentives.

International organizations are, of course, not unaware of the need to improve the performance of insolvent banks that are being recapitalized, and they often include funding for technical assistance and training in their recapitalization loans for the purpose of improving bank performance after the return to solvency. In the case of privately owned banks, once solvency has been restored, incentives will be present to purchase the required technical assistance and training on their own in the market. In the case of state owned banks, they could also acquire such training and technical assistance to improve performance on their own in the market, but they may have no particular incentives to do so. What the state owned bank may therefore need is instead technical assistance directed toward changing incentives, so that it would, like the privately owned bank, acquire in the market the technical assistance and training that it needs to perform better. Recipes for changing the incentive structures of state owned banks are not easy to find, short of privatization, and in any case this is beyond the scope of the present paper.

E. Summary and Tentative Conclusions -- a Prelude to the Case Studies

The fiscal costs to the government from the insolvency of state owned banks are immediate and can easily amount to much more than the costs from the insolvency of privately owned banks. Furthermore, the traditional remedy of recapitalizing insolvent state owned banks is likely to contribute to continuing losses. Two aspects of the traditional view in particular lead to this problematic approach:

1. losses at state owned banks stemming from reductions in the value of assets (e.g., due to non-performing loans) are believed to become a fiscal burden for the government only when the government chooses to recognize such losses; and

2. the main element in the rehabilitation of insolvent state owned banks is their recapitalization, with recapitalization being based on additions to assets rather than reductions in liabilities.

Governments do not suffer fiscal losses that they must deal with immediately from non-performing loans or insolvency at privately owned banks; in fact, a government is generally well advised not to cover such losses, or to do so only if the owners and managers of such banks do not benefit from the government's actions. Recapitalization of an insolvent privately owned bank does indeed restore the main incentives for prudent behavior in that bank, and in the banking system in general, so long as the recapitalization does not benefit the owners and managers who participated in the insolvency.

On the other hand, a government must begin to bear the fiscal costs of the insolvency of a state owned bank from the moment that such a bank begins to have "significant" (above average) problems with non-performing loans. A government cannot postpone dealing with such losses whether or not it shifts them among government agencies (e.g., the central bank or the finance ministry) or calls them "quasi-fiscal," nor does it really have the option of repudiating a insolvent state owned bank's liabilities due to the impact on the government's credibility and the stability of the financial system.

Recapitalizing an insolvent state owned bank does not change the basic incentives facing the bank and its managers and other key personnel. Unless other actions are taken to change the basic incentive structure of the bank, further losses and another round of insolvency are likely to occur. Moreover, since the recapitalization of state owned banks almost always involves additions to assets rather than reductions in liabilities, the government's fiscal burden is likely to increase further in the future because more funds have been provided to make more non-performing loans. The source of the apparently strong preference for recapitalization through additions to assets, even though recapitalization might be achievable just as well in many cases through reductions in liabilities, may often be due to the behavior of international organizations.

The concepts emphasized in first part of the present paper have been applied to analyze actual experiences in dealing with insolvent state owned banks. The following case study is an analysis of the benefits and costs of liquidating an agricultural development bank in Peru and reveals some surprising results.

II. CASE STUDY: BENEFITS AND COSTS OF LIQUIDATING AN AGRICULTURAL BANK IN PERU

A. Introduction

In the following we briefly review the history of the Banco Agrario del Peru (BAP), summarize the events that led to its liquidation, outline the benefits and costs of closing BAP, and then draw lessons from this experience that may be useful elsewhere. A range of options have been used in the past several years to deal with problematic development banks. These include living with chronic crises in these banks; reforming, restructuring, recapitalizing and refinancing them; privatization of parts or all of the stressed banks; consolidating insolvent banks with other financial institutions; and the most extreme option, bank liquidation--the option exercised in Peru.

B. BAP'S History

The progenitor of BAP was formed in 1931 to provide loans to cotton, sugar, and rice producers in the coastal region. Over time the range of products financed by BAP broadened and the bank was also allowed to accept deposits and handle transfer payments through letters of credit.

Starting in the mid-1950s the bank increasingly attracted donor support, with the World Bank making its first loan to BAP in 1954 followed by a series of 5 additional loans that were disbursed until early 1987 worth $148.3 million in total.[7] AID also gave or lent resources to BAP during the 1960s--sometimes with the Ministry of Agriculture as an intermediary--through a series of agreements that were mostly for a supervised credit program, amounting to the equivalent of $43 million (Carranza, p. 30). The Inter-American Development Bank (IDB) likewise lent a substantial amount to BAP from 1971 through 1983 in the form of 7 projects summing to about $226 million, including $11.5 million of International Fund for Agricultural Development funds channeled through IDB.[8] In total, donors put nearly $420 million into BAP which is equivalent to much more than an half billion 1997 US dollars. In addition to these donor loans and grants made directly to BAP, the bank was also responsible for distributing loans funded by other agencies such as the Ministry of Agriculture, which in turn used donor funding.

The acceptance of these external funds exposed BAP to donor fads and practices, including reporting and evaluation requirements that boosted BAP's administrative costs. For example, in the early 1980s there were 27 employees in the head office of BAP devoted full time to satisfying the requirements of IDB loans (Inter-American Development Bank, p. 23). Although not carefully documented, the AID-sponsored supervised credit program during the 1960s undoubtedly cost BAP far more than the 7 to 9 percent nominal interest rates that were allowed on loans made under

[7]The World Bank deobligated in February 1987 an additional $31.3 million of its last loan to BAP, primarily because of disagreements over interest rate policies.

[8]Sources for this information were various unpublished project proposals and other documents in the Agency for International Development, the Inter-American Development Bank, and the World Bank.

this program (Carraza; North Carolina State University Mission).[9] Unfortunately, none of the World Bank's evaluations of its programs with BAP report on the additional costs that were imposed on BAP in handling World Bank money. The ebbs and flows in donor funding certainly increased BAP's liquidity management problems, and the access to subsidized donor and government funds deflected the bank from aggressively seeking deposits.

In the late 1960s and early 1970s BAP's activities were reoriented to support land reform and central planning. In addition to providing subsidized credit, the bank softened its collateral requirements and attempted--with little success-- to make more term loans with donor funds. This was reinforced by laws that required BAP to lend at least half of its loans to poor farmers. Through numerous laws and decrees BAP was increasingly subjected to political whims throughout the 1970s and 1980s. These shifts in mission were pronounced when the political party in power changed. To the long-run detriment of the bank, neither donors nor politicians paid much attention to the financial health of BAP or to reinforcing an information system that provided a timely and accurate record of its solvency. Information about costs and solvency were usually relegated to obscure Appendices in BAP's annual reports, while the main body of these reports mostly presented information showing the bank was achieving political or donor mandates. The transparency of the bank's financial health was clouded by the actions of donors and government, the very parties that should have been most concerned about monitoring the bank's performance.

Both the number of employees and number of BAP offices rapidly expanded during the 1970s and early 1980s to provide increasingly subsidized loans in remote areas. From early 1975 to late 1979, for example, the number of BAP employees increased by 46 percent, even though the real value of its loan portfolio declined by more than a quarter--due to negative real rates of interest--over the same period (World Bank, 1981, p. 2).[10] Part of the expansion in number of employees was related to the opening of hundreds of small temporary offices (albergues) that dispensed and collected loans during planting and harvesting seasons. In addition, BAP rapidly expanded its communication network during the late 1980s putting two-way radios in more than 200 offices, buying telexes for 125 offices, purchasing computers, and providing telephones for more than 100 offices.[11] The adverse effects of this expansion on administrative costs were paralleled by hefty rates of inflation that substantially exceeded the nominal interest rates charged on BAP loans. In the later 1980s BAP was required to make loans in disadvantaged areas at zero nominal rates of interest, with the promise that government would reimburse BAP for the interest rate subsidy, a promise that was not kept.[12] High administrative costs, sticky interest rate policies and accelerating

[9]Research on a similar AID-funded supervised credit program in Colombia in the mid-1960s documented lender costs in excess of one-quarter the value of loans made (Adams and others).

[10]The real rates on interest charged by BAP were negative throughout the 1970s and 1980s. In the late 1970s and early 1980s these negative rates ranged from 40 to nearly 60 percent and later in the 1980s became even more highly negative.

[11]At closing, BAP had the most sophisticated, country-wide communication system of any bank in Peru.

[12]The loans made during the late 1980s at zero interest rates made up 10 to 15 percent of BAP's portfolio and at the time of closure the government's debt to BAP for the interest rate subsidy amounted to something between $150 million to $380 million, depending on what exchange rate (official or black

inflation evaporated the purchasing power of BAP's loan portfolio and converted the bank into a dependant of the Central Bank by 1990. This was accompanied by wide swings in the purchasing power of BAP's loan portfolio. Between 1987 and 1988, for example, the purchasing power of BAP's loan portfolio was about cut in half and the bank was forced to suspend term lending (Table 1).

At least five notable trends stand out in BAP's history: First, as can be seen in Table 1, over the period 1970 to 1989 BAP steadily increased its loan coverage from less than 4 percent of all farmers to about a quarter of them in 1989, a substantial achievement. The more than doubling in percentage of farmers receiving BAP loans from 1985 to 1986 resulted from a reorientation of the bank to making many more and smaller loans outside the coastal region. In the late 1980s BAP extended loans to farmers who cultivated about half of the farm land in the country, although many borrowers likely received much smaller loans than their opportunities justified because of severe credit rationing by BAP.

Second, it can also be noted in Table 1 that the ratio of new-BAP-loans to the-gross-domestic-product-from-agriculture grew steadily from 1970 to 1980 and then fluctuated substantially over the 1980s until plummeting below early 1970s levels in 1987. In large part, the fluctuations in this ratio were due to ebbs and flows in the real value of BAP's new lending caused by inflation.

A third trend was the crowding-out of commercial banks by BAP. In 1950 BAP provided a third of all formal agricultural credit in the country, with commercial banks supplying the rest. Over the next three decades BAP increasingly extended a larger percentage of total agricultural loans, until capturing more than 90 percent of the formal agricultural loan market in 1976 and 80 percent-plus thereafter (Palomino, 1993b, p. 5). Commercial banks were crowded out of the rural financial market by BAP's subsidized loans and were further discouraged from making agricultural loans by land reform.

Fourth, despite being a development bank that supposedly emphasized medium- and long-term loans, BAP was unable to increase, or to even sustain, the portion of its portfolio used for long-term investments. Despite a number of large credit projects funded by the World Bank and IDB that were primarily aimed at lengthening the term structure of BAP's loan portfolio, the portion of total BAP lending for investment purposes was usually less than 10 percent over the 1970-1988 period, and in some years all new loans made were for periods of less than a year (Palomino, 1991, p.8).

Fifth, the mix of money used by BAP to fund its loans changed dramatically during the latter part of the 1980s; the importance of additional deposits and loans repaid declined in real and relative terms and BAP was driven into the arms of the Central Bank for funds. Despite being allowed to offer slightly higher interest rates on deposits than commercial banks, and receiving preferential treatment on reserve requirements, BAP was unable to attract many deposits from rural households. As can be noted in Table 1, the real value of deposits in BAP fluctuated widely from year-to-year due to inflation and changes in exchange rates, but fell sharply after 1986. Shortly before being liquidated most of BAP's deposits were comprised of quasi-compensatory

market) is used to convert local currency to dollars.

balances deposited by merchants who sold inputs to BAP clients and congealed deposits owned by farm organizations such as the coffee producers. From 1986 through 1989 the increase in nominal deposits provided less than 3 percent of the funds used in BAP lending (Palamino 1993b, p. 23).

Table 1: Agricultural Bank of Peru: loans, deposits, and inflation, 1970-1991

Year	Loans $US million*		New Loans /GDP ag. %	Loan*** coverage %	Deposits** $US million*	Annual inflation rate
	New loans	Outstanding balance				
1970	84	124	7	4	62	5
1971	84	112	6	4	54	7
1972	93	129	7	4	64	7
1973	122	149	7	4	85	14
1974	186	230	9	4	104	19
1975	212	237	9	5	97	24
1976	242	269	15	6	57	45
1977	213	296	13	6	9	32
1978	206	206	16	6	12	74
1979	364	252	22	7	40	67
1980	491	411	25	7	41	61
1981	532	466	21	8	66	73
1982	402	452	16	7	81	73
1983	322	358	15	7	83	125
1984	336	490	14	9	84	112
1985	284	294	14	10	76	158
1986	690	552	25	23	121	63
1987	257	469	5	22	43	115
1988	52	92	3	20	10	1,722
1989	183	203	6	25	34	2,775
1990	205	272	5	-	27	7,650
1991	nil	82	-	-	25	139

Source: Various Central Bank; Superintendent of Banks and Insurance, and Agricultural Bank of Peru publications. Also Palomino, 1993a.

**Converted to $US using parallel market rates of exchange.*
***Includes substantial amounts of deposits made by agricultural associations and organizations.*
****Percent of all farmers in Peru who received a loan*

C. The Roots of BAP's Problems

Some of BAP's difficulties were due to forces beyond the bank's control while other wounds were self inflicted. Following human nature, individuals associated with BAP blame others for most of the bank's problems, while others assign most blame to BAP--the truth likely lying somewhere in between. The outside forces included an unstable and sometimes hostile macroeconomic environment, drastic changes in the role assigned to BAP, and macrofinance policies that often made it impossible for BAP to operate profitably. The internal problems included a non-bank culture, dependency on outside funding, lack of deposit mobilization, high administrative and transaction costs, and lack of grass roots political support for the bank.

The economic environment

Providing formal financial services in rural areas is problematic and costly--especially in Peru. At various times in the past, unstable incomes and low returns to agricultural investments limited the number of farmers who were creditworthy, reduced the ability of borrowers to repay loans, crimped deposit mobilization, and shrunk the opportunities to realize economies-of-scale and economies-of-scope in finance The lack of investment in public services in rural areas, policies that turned the terms-of-trade against agriculture, and natural disasters often dampened the economic environment in agriculture and deflected bankers from rural areas. The relatively small size of transactions, combined with the geographic spread of clients, elevated the average cost of financial intermediation and further discouraged bankers from penetrating rural areas. Periodic droughts, price- or exchange-rate controls, the rugged Andes that divide the country, and limited amounts of fertile land also formed an unfavorable economic environment for BAP borrowers and depositors.

Inflation and the heavy hand of donors and politicians undoubtedly were the most powerful outside force that adversely affected BAP, especially in the two decades before its liquidation. Inflation eroded the real value of its capital base, increased the difficulty of mobilizing deposits, and, combined with concessionary interest rate policies, melted the real value of its loan portfolio. Terrorism during the 1980s and 1990s likewise damped the economic environment in rural areas and added substantially to BAP's costs. During the worst periods of terrorism, the BAP was spending an average of $2,000 a month per office for added security.

Role changes

BAP's problems were compounded by abrupt changes in the roles assigned to it. These ranged from largely financing commercial agriculture in the coastal region, through supporting land reform throughout the country, to offsetting with subsidized credit the distortions caused in agriculture by macroeconomic policies, to channeling fiscal transfers to borrowers. The BAP passed through several cycles where it was first asked to assist with boosting production, and then told to be primarily a social or civil defense agency that addressed poverty or terrorism problems.

Macrofinance policies

During most of its life BAP was forced to operate under interest rate ceilings. This limited its ability to price financial products according to their costs and risks. In some cases the bank was required to charge the least on loans that were the most costly (and risky) per unit of money to administer. Combined with periodic surges in inflation, concessionary interest rate policies repressed the term structure of BAP's loan portfolio and eventually decapitalized the bank. Battling to survive, BAP was often forced to shorten the term structure of its loans, thus backing away from credits that supported long-term investments--a negation of a primary justification used for forming agricultural banks.

Lack of banking culture

Close ties with the Ministry of Agriculture limited the ability of BAP to create a banking culture and provided few fire walls between the bank and politics. Essentially, BAP was a division of the Ministry of Agriculture and many of its employees came from that Ministry--especially its leadership. It tended to promote from within and employed individuals with knowledge of agriculture, rather than with banking experience. Most of its employees viewed credit as an input in achieving agricultural or social objectives, rather than viewing loans as being half of financial intermediation, and seeing deposits as a ladder out of poverty. The measures that BAP used to gauge success were such things as loans made, crops planted, livestock financed, investments funded, geographic locations of loans, and size of the organization.[13] Little attention was paid to bank profits, to administrative costs, to transaction costs, to quality of services, or to financial innovations. Because of its links with the political system, loan making and loan repayment decisions were sporadically taken out of the bank's hands.

Dependency

Because BAP mobilized few depositors and did not generated significant real profits, it usually depended on donors or on the Central Bank for the majority of its loanable funds. This had unintended consequences that over time adversely affected the vitality and sustainability of BAP. For example, this dependency increased the vulnerability of BAP to political intrusions and to donor fads. In addition, managing a relatively large number of idiosyncratic lines of credit provided by the World Bank, IDB, other donors, and the Government of Peru substantially increased the administrative costs of BAP, as well as the transaction costs of borrowers. An unknown number of BAP staff undoubtedly spent millions of hours processing data on dozens of lines of credit administered by the bank, preparing periodic reports on same, and assisting with evaluations of donor funded programs. In 1988, for example, BAP handled 22 lines of credit from different sources. Much of the data processing in the bank tracked these lines of directed credit and this crowded out critical management information such as loan recovery status, administrative costs, transaction costs, profit information, and solvency of the bank.

Over much of its life, it was cheaper for BAP to draw on Central Bank money, donor funds, or concessionary loans from commercial banks than it was to mobilize small deposits from rural households.[14] The Bank had no incentive to promote deposit mobilization, to provide innovative deposit options, to lower savers' costs of making deposits, or to broaden its client base by aggressively seeking more depositors. The Central Bank provided most of the funds through rediscount facilities that prolonged BAP's existence for several years.

Lack of grass-roots support

[13]The skimpy information about BAP's financial performance in its annual reports is an indication of the non-bank role assigned to the bank (see, for example, Palomino, 1993b).

[14]In some years the government imposed agricultural loan quotas on commercial banks. These banks could meet the terms of these quotas by lending money to BAP at subsidized rates.

This dependency had a long-run impact on the grass-roots political support for the Bank. In the final years of BAP's life many of its borrowers evolved into rent seekers who did business with the bank because it distributed large subsidies in the form of cheap credit. During the late 1980s many BAP borrowers were eager to repay their subsidized loans to qualify later for even more heavily subsidized loans.[15] When the government announced in 1991 that BAP was to be liquidated most of its borrowers elected not to repay their loans since future loan subsidies would be unavailable, regardless of the borrower's loan repayment record. The ungrateful borrowers jumped ship once credit subsidies were terminated and had few good things to say about BAP. Most complained because of the withdrawal of credit subsidies, but few were willing to argue in favor of the BAP without subsidies. There may have been more grass-roots support for continuance of the Bank if it had had a large base of depositor clients who were satisfied with its savings services. Those who sought to curry voters' favor through cheap credit--both politicians and BAP leaders--found borrowers' approval was fleeting and largely illusory.

Flawed paradigm

With the benefit of hindsight, BAP's demise was built into its birth and nurtured throughout its life. It was structurally unsound. It was designed and operated under the old directed credit paradigm that was only compatible with subsidies, suppression of market forces, and central planning (Vogel and Adams). Given the inflexibility of BAP and its habits, it was seen by some as an anachronism when a new financial market paradigm came into vogue in the late 1980s and early 1990s that emphasized market forces, elimination of subsidies, and efficient and sustainable financial institutions.

It is paradoxical that the organizations which had earlier used and abused the BAP (donors and various Peruvian governments) were the ones who ultimately turned on the bank and forced its liquidation.[16] The explicit reasons given for closing the bank included the perception that BAP was insolvent, that it had far too many employees, and that it had become a black hole into which government funds went, never to be seen again. In addition, a few decision makers had concluded that BAP no longer performed a useful function. Some key policy makers, including the Minister of Economics and Finance at the time, felt that the relationship between formal credit and agricultural production was weak (Palomino, 1993a, p. 30).[17] A strong push to disentangle the Central Bank from providing development funds reinforced the decision to liquidate BAP.

[15]Over the period 1984 to 1988, for example, the BAP's loan default rate declined from about 13 percent of its portfolio to less than 5 percent. Earlier loan default rates were much higher, especially during the 1960s and early 1970s when 20 to 30 percent rates of default were common--possibly because borrowers then were unaccustomed to persistent negative real rates of interest (Carranza, p. 33).

[16]The posture taken visa-a-visa the BAP by the World Bank, the Inter-American Bank, and representatives of the Peruvian Government was similar to the harsh judgements made by some ex-smokers about those who continue to smoke.

[17]Ironically, this minister was earlier head of BAP and later Minister of Agriculture during the period when BAP experienced rapid growth in number of employees, number of offices, and in use of donor funds.

D. Liquidation

There was little consideration given to reforming and recapitalizing BAP before the final decision was make to liquidate the bank. Liquidation was based on the assumption that the private sector would fill most of the void in the rural financial market left by BAP's closure and the collapse of other rural financial institutions.[18] There was recognition that rural finance problems might persist, but that this was something that could be put on the back burner for several years by policy makers.

Prior to liquidation, some policy makers briefly supported consolidating all five government-owned development finance organizations into one development bank with BAP forming the core of this new bank. It was proposed that this new Banco de Fomento Nacional would be restricted to making small loans to farmers and other microentrepreneurs, be prohibited from accepting deposits, and be denied access to Central Bank funding (see Palamino, 1991). This new bank was only formed on paper for a couple of months, however, before the decision was made by a new Minister of Economics and Finance to liquidate all four government development banks and convert the remaining government agency, COFIDE, into a wholesale or second story bank that provided funds for on-lending by retail financial institutions. The International Monetary Fund (IMF) and IDB staff applied substantial pressure to close BAP, reinforcing similar sentiments in the Ministry of Economy and Finance, in the World Bank, and in the Central Bank.

As a bridge between the liquidation of BAP, and the hoped-for voluntary expansion of private sector lending to farmers, the government implemented several measures before or soon after BAP was closed in May, 1992 (Palomino 1993a). The first measure continued an agricultural loan quota of 10 percent on the loan portfolios of commercial banks. A second measure liberalized restrictions on the sale of farm lands with the hope this would enhance their use as loan collateral. In 1992 the government initiated a third measure that provided a temporary credit program for funding farm inputs, called FONDEAGROS, that was managed by the Ministry of Agriculture in the form of loans in kind.[19] Over 1992 to 1995 the government committed about $US230 million to these programs (Falconi). A companion program called Fondos Rotatorios was the fourth measure that involved government expenditures of about $US 92 million from 1992 to 1995 (Falconi). It was also managed by the Ministry of Agriculture and provided loans in areas outside the coast at subsidized interest rates. The fifth measure was to promote through the Ministry of Agriculture formation of private Cajas Rurales to replace part of the financial infrastructure formerly provided by BAP. In early 1997 there were 17 of these Cajas, and they had a loan portfolio of about $US 44 million, mostly funded by the second-story bank, COFIDE (Falconi).

E. Benefits and Costs of Liquidation

The economics of closing the BAP are easier to qualify than quantify. Some of the most important benefits and costs are implicit rather than explicit and some costs are still being incurred

[18] Most of the rural credit unions and mutuales collapsed during the 1980s.

[19] Only a small portion of these loans were repaid.

years after the bank's liquidation. The hyper inflation during the final few years of BAP's life also complicates the conversion of nominal values to real values.

Benefits

Perhaps the most clearly perceived benefits of closing BAP were extracting the government from subsidized credit, insulating the Central Bank from politics, disentangling fiscal from monetary policies, and economic stabilization. On a practical level, government and donor officials felt BAP and its Central Bank funding was a major cause of inflation. To cool inflation and to constrain government spending, policy makers felt BAP's demise would simplify solution of these problems. The decision to close BAP was driven primarily by stabilization policy, supported by a philosophical shift in favor of private enterprise.

Understandably, commercial bankers were supportive of liquidating BAP, but few of them rushed in later to fill all the breach left by BAP's closure. Although undocumented, informal finance likely filled part of this breach and some of this informal finance undoubtedly drew on loans from commercial banks.

Costs

The most prominent cost of liquidating the BAP was the loss of virtually all of its loan portfolio which, on paper, had a book value of about $US270 million in 1990. If the bank had continued to operate it likely would have recovered substantially more of this portfolio--possibly as much as a-third-or-more--than the less-than 1 percent recovered by the commission responsible for liquidating the bank. At least some of BAP's borrowers would have repaid their loans if they knew the bank would persist and provide loans in the future, even though these new loans lacked subsidies. The announcement in 1991 that BAP was to be liquidated destroyed the perceived value of borrowers maintaining a good credit rating with the bank through loan repayment, along with undermining the morale of BAP employees.

Another sizeable but unmeasurable cost of closing BAP was the loss of "information capital." Financial intermediation is based on the knowledge (information capital) assembled about each other by intermediaries and their clients. Borrowers and depositors develop a working relationship by collecting information about how to do business with a bank, while bankers assemble knowledge to screen loan applicants for creditworthiness. It is much easier and less costly to borrow and lend among people who know each other than it is to do these transactions among strangers. The liquidation of BAP terminated working relationships between the bank and its clients amounting to about one-quarter million rural households, relationships that will be costly and time consuming to rebuild. It will cost hundreds of millions of dollars and many years to rebuild similar numbers of working relationship in rural areas--witness the slow and costly expansion of the Cajas Rurales. The 17 Cajas Rurales that were operating in 1997 provided only a small fraction of the financial services provided by the more than 500 offices--about 170 being full-time facilities--that BAP had at its zenith (Alvarado 1997a).

Liquidation also sharply decreased the value of most of BAP's physical assets--the use value of these assets was much higher than their salvage value. At closing, half of the offices owned by BAP were in relatively new buildings (about 80). The ownership of some of these buildings was transferred to commercial banks at "fire sale" prices to clear BAP debts, other offices were sold for modest prices, and still others remain vacant. BAP vehicles were given to various government agencies, including the military, and most of BAP's computers were scrapped along with BAP's sophisticated radio communication system. It may be fortunate that donors have short memories. Otherwise there would have been much gnashing of teeth among them when the physical assets they helped BAP purchase were so ignominiously scrapped or used for other purposes.

BAP had an inordinately large number of employees, down from something near 5,500 earlier to about 4,500 at closing. The initial cost to terminate these employees was about $US8 million. Court cases were still pending in 1997, however, that involved some unknown quantity of additional liability for future payments to ex-employees. The costs involved in lawyers and courts haggling over the assets and liabilities of BAP were also still ongoing five years after BAP was liquidated. Inefficiencies in the judicial system were a major reason the liquidating commission gave up on collecting most debts owed to BAP.[20]

After BAP was liquidated the government was forced to use alternative--even less efficient--channels to provide agricultural credit (Alvarado 1997a). A significant portion of the funds provided by COFIDE to the Cajas Rurales, for example, will not be recovered (Alvarado and others). Likewise, the periodic funding of temporary credit programs administered by the Ministry of Agriculture--FONDEAGROS and various Fondos Rotatarios--have cost the government hundreds of millions of dollars since the closure of BAP and many of these loans will not be recovered.[21] The costs of these stop-gap programs and the costs of reconstructing new financial infrastructure to fill the gap in rural financial markets--especially in deposit services and in microlending--left by the closure of BAP will likely continue for some time, including the private costs of building new banking facilities in rural areas.

For good or ill, the BAP was the primary source of medium- and long-term credit in Peru for farm investments. The private sector has filled little of this important market niche since BAP was liquidated. The lack of these longer-term loans will impose costs on the economy, especially where farm units and agro-industries should make substantial investments that are usually supported by borrowings before competing in international markets. Commercial banks have been more successful in expanding short-term lending for agricultural purposes, especially in coastal areas. In 1996 commercial banks lent about $US350 million for these purposes (Falconi).[22] The Cajas Municipales and a few Non-governmental Organizations also lent minor amounts, possibly as much as $US12 million, in agricultural loans in 1996 (Falconi).

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[20]In some cases debts were uncollectible because BAP records disappeared or were left in disarray at BAP's closing.

[21]In August, 1997, for example, the government directed $31 million in ad hoc funding through the Ministry of Agriculture for in-kind loans for fertilizer, farm chemicals, and seed.

[22]It is unclear how much of this amount involves loans to farmers. A substantial portion may be in loans to facilitate exports and imports of agricultural goods and also loans to agricultural marketing intermediaries.

BAP was liquidated because dominant policy makers, including donor employees, concluded the benefits of closing the bank exceeded perceived costs. With the aid of hindsight, one can speculate on whether-or-not costs were estimated accurately by decision makers. Would they have closed the bank if they knew at the time that almost none of BAP's loans would be collected later, that most of the bank's physical assets would have little salvage value, that employee compensation litigation would drag on for years, that five years later commercial banks would fill only part of the breach in rural lending, that term lending for agriculture would disappear, that the government would be forced to do substantial ad hoc financing of agriculture after BAP's liquidation, and that replacement rural financial infrastructure would take so long to build? In fairness to those who weighed the costs and benefits of closing BAP, it was likely easier for them to see the substantial near-term benefits of their actions than it was to predict accurately the ultimate costs, many of which occurred years later.

F. Lessons

Each country is different. One must be cautious, therefore, in drawing lessons from a case in one country and applying them where conditions may be substantially different. Prudent judgements about liquidating, or not liquidating, a government bank are still more of an art than a science. Nevertheless, the lessons learned from this Peruvian case might provide a useful check-list of what may happen when government-owned banks elsewhere are liquidated. Several of these lessons reinforce the received wisdom from earlier experience in other countries, while other insights may be relatively new.

1. It was probably unrealistic to expect that the private sector would build in Peru most of the financial infrastructure necessary to support rural development. In most countries governments play some role in laying or in maintaining such infrastructure. At a minimum, this includes prudential regulation and supervision, especially of those institutions handling deposits. It may also include, as a minimum, some seed capital to start up new institutions and limited subsidies to strengthen existing financial institutions. The gap that persists in Peru's rural financial market five years after the liquidation of the BAP is an indication of the reticence of commercial bankers to jump into making small loans in rural areas, into term lending, and into rural deposit mobilization, especially after a country has experienced severe economic stress.

2. Rural finance is costly but experience in several countries shows it can be done profitably, if done correctly--even by government-owned development banks. It was not done correctly in Peru and these costs strangled BAP and forced it into dependency on outside subsidies. Correct policies include allowing lenders to charge rates of interest that cover their costs and maintenance of value, plus allowing a margin for profit. With this, the intermediary should be encouraged to reduce transaction costs and realize economies-of-scale and scope. Inflation twined with concessionary interest rate policies sapped the vitality of BAP.

3. When new financial organizations are created to fill part of the void left by liquidated agricultural development banks, they will likely use some of the rubble left from the liquidated bank: buildings, employees, and old banking practices and habits (Alvarado and others). The new organization must also deal with clients' banking habits and perceptions and sink or swim in the economic and political environment that may-or-may-not favor its survival. Changing habits and

the economic environment requires time, changes in incentives, and patience. This includes changes in the role assigned to new and existing organizations. If these systemic problems are not resolved, the performance of new financial institutions may echo that of liquidated institutions.

4. Financial institutions are vulnerable to political intrusions when they are dependent on donor or government funding or are integrated with a government ministry. Some measure of independence comes from mobilizing deposits. Rural banks may also have more independence from the whims of donors and politicians if their governance is dominated by central banks, ministries of finance, and superintendents of banks, rather than by non-bank agencies, as was the case of BAP.

5. The perceived benefits of liquidating a development bank are more readily apparent and occur earlier than do the costs of the action. Many of these costs are impossible to access accurately in advance because they involve time and effort involved in building new financial infrastructure to replace the old. A minister of finance and an IMF country representative may cure some of their short-term headaches in reforming and stabilizing an economy by closing the agricultural bank, but other even more persistent headaches may appear later in the office of the President, the Ministry of Agriculture and in donor offices when they try to rebuild rural financial infrastructure.

6. Especially in the case of agricultural development banks, their practice of providing highly subsidized credit in the past discouraged alternative sources of finance from expanding in rural areas. Thus, when these types of banks are liquidated they leave a larger void in rural financial systems than might have been the case if non-subsidized lenders had not been driven out by unfair competition. The time and costs involved in filling this void can be substantial.

7. In part, development banks encountered problems because their operations were not transparent enough. In private banks transparency allows depositors and share holders to participate in the regulation of bank behavior through making decisions about being clients or owners of the bank. In government-owned banks it is the responsibility of donors and the government to assist in regulating bank behavior by withholding funds from banks that perform poorly. This requires governments and donors to care about the solvency of the bank and to insist on information systems that clarify, not cloud, the financial performance of the banks. Forcing development banks to manage large numbers of targeted lines of credit diminishes transparency and submerges information that is useful for efficient managers in a flood of largely useless directed-credit data.

8. The BAP experience also suggests that donor projects and their associated evaluations were flawed. Most of these projects were primarily designed to provide additional foreign exchange for targeted lending. The designers of these projects ignored fungibility, did not consider how the project would affect the transaction costs of participants, ignored the effect of the project on the willingness of BAP to mobilize deposits, and failed to explain why more foreign exchange was required to lend in local currency. Until the 1980s, the designers of these donor projects largely ignored interest rate policies and, in some cases, reinforced subsidized interest rate policies that undermined the financial vitality of BAP. The evaluations of these projects were too narrow in scope, largely viewed BAP as an inert channel for funds, ignored the wear-and-tear of the project on BAP, and failed to track systematically the financial health of the bank. There was no attempt by donors to take a "holistic" view of BAP. For example, successive World Bank projects were

aimed at increasing the volume of medium- and long-term lending by BAP with no discernable positive change over time in the make-up of BAP's loan portfolio. Still, until their last project, the World Bank considered these projects to be successful because they yielded estimated internal rates of return that were high.[23]

9. Perhaps the most important lesson that can be drawn from the BAP case is about expectations and discipline. Traditional development banks such as BAP often performed poorly because donors, governments, and politicians are not disciplined in the way they use these banks. This is often accompanied by the lack of discipline among bank leaders and employees, along with lack of client discipline. In many cases, the expectations about performance of these banks were set too low and this then became a self-fulfilling prophecy: no one expected these banks to provide high quality services, nobody expected them to recover most of their loans or to earn a profit, and no one expected them to mobilize deposits or to become subsidy independent. Successful reform of these banks involves elevating expectations about performance and enforcing more discipline on all those whose actions affect the bank. The changes in expectations and discipline involved in successfully developing new financial infrastructure to replace that which is eliminated by liquidation of development banks may turn out to be identical to the changes needed to successfully reform development banks. If policy makers cannot effect these changes through reforming development banks, they may be unable later to effect the changes in expectations and in discipline needed to create successful institutional replacements.

G. Conclusions

Whether 'tis better to liquidate or to reform a government-owned bank is an open question whose answer will likely vary from country to country. It is easy to condemn these banks and to close them without diagnosing why they performed poorly, estimating the closure costs and how much it will take to create alternative financial infrastructure, and whether new infrastructure will perform better than did the old. Any financial institution performs below expectations if it operates in an unfavorable economic environment, if it is immersed in allocating subsidies, if it lacks freedom to set its prices, if its lending decisions are invaded by politicians, if its administrative costs are elevated by donor fads, if it is administered by someone who knows little about banking, or if it must dance with the minister of agriculture rather than consort with an agency interested in sustaining financial infrastructure. The old saying about "putting new wine into old bottles" provides useful insights in this regard for both wine makers and for policy makers who wish to liquidate a development bank, but who may be later forced to form new institutions using rubble from the old bank.

In some critical respects, the conditions needed to reform successfully a traditional agricultural development bank, or to create efficient and durable alternative financial infrastructure in rural areas, are the same. Both require a favorable macroeconomic environment, both require macrofinance policies that reinforce--rather than destroy--financial infrastructure, and both require discipline. Old dogs do not learn new tricks through changing the name of the dog house or even

[23]To its credit, the Inter-American Development Bank was the only provider of funds to BAP that analyzed information about BAP's costs (Inter-American Development Bank).

by moving the dog into a new dwelling. One either has to teach the dog new tricks, or provide a different set of incentives so the dog learns new tricks on its own. Training, higher expectations, and incentives are critical in both reform of badly performing banks as well as in creating new financial institutions. Kicking the directed credit habit is necessary whether a bank is liquidated or reformed.

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