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Enhancing Program Coordination among Government Institutions Involved in Agriculture and Fisheries Finance

A Summary of the Results of the AFMA-Mandated Review of Charters, Programs and Performance of the ACPC, GFSME, LBP, PCIC and Quedancor

In compliance with Section 24 of RA 8435 or the Agriculture and Fisheries Modernization Act (AFMA) of 1997, a review of the charters, programs, and performance of the Agricultural Credit Policy Council (ACPC), Guarantee Fund for Small and Medium Enterprises (GFSME), Land Bank of the Philippines (LBP), Philippine Crop Insurance Corporation (PCIC) and the Quedan and Rural Credit Guarantee Corporation (Quedancor) was conducted in 2000-2001. The main objectives of the review were:

1. To evaluate the charters, programs, policies, and performance of ACPC, LBP, Quedancor, PCIC, and GFSME as per the policy objectives of AFMA;
2. To rationalize the mandates and functions of the institutions covered by the review to suit the thrusts and programs of AFMA and to recommend changes in their structures, if necessary; and
3. To design a framework to enable the institutions to operate cohesively, efficiently, and effectively.

The law (RA 8435) also mandated the creation of a Review Steering Committee, chaired by the Department of Finance (DOF), to oversee the conduct of the review. The review itself was done in 2000 - 2001 by a private consulting firm selected by the Steering Committee (i.e., PSR Development, Inc.). This paper presents a summary of the final report's salient findings and recommendations.

Overall Findings and Recommendations

A. Overall Findings of the Study on GFI/Agencies in the Agriculture & Fisheries Sector

1. The GFIs (LBP, Quedancor, GFSME and PCIC) were set-up under a different policy environment from that which is currently in place. That is, intervention was the thrust in the past, as opposed to the free market advocacy in the present;
2. Market reach has been declining over the past decade, depressing successful program implementation;
3. The charters of the different GFIs are at times conflicting, stemming from inadequate planning and support from

the government and resulting in lack of coordination and confusion in servicing clients and non-maximized output;

4. Since the board members of the GFIs are usually serving *ex officio*, they do not necessarily have the apt specialization and time, resulting in weak corporate governance and, ultimately, execution;
5. Since board members are serving a dual role with their primary seat of office elsewhere in the government, the GFIs tend to be run like bureaucracies, unresponsive to changing market conditions and operating regardless of bottom lines and profits;
6. GFI funds are usually eaten up by administrative expenses, with no effective threats of market share loss and profit contraction, since funds are easily allocated by the national government budget;
7. Instead of restructuring towards core competencies in the face of lower earnings and reach, GFIs have resorted to cross subsidy structures to support their operations;
8. The same set of subsidies and weak budget constraints serve as protection from market forces, suppressing the need to adjust and specialize; and
9. As the GFIs have virtually cornered their market, being the sole sources of specialized credit in their areas of operation, the lack of competition has led to complacency and lack of discipline.

B. Recommended Financial Architecture as a Framework for Cohesive, Effective and Efficient Operations of Institutions in the A-F Financial Sector

The present thrust of the government to let market forces dictate interest rate levels – thereby freeing funds and programs from constraints to profitability – is in line with the policy declaration contained in AFMA and Executive Order 138. AFMA aims to pursue development in the A-F sector through, among others, rational use of resources which would lead to sound allocation of public money and increased efficiency in terms of return on investments.

EO 138 also works to make the rural credit market more efficient as it directs all government entities that implement their own credit programs to adopt the credit policy formulated by the National Credit Council (NCC) under the Department of Finance (DoF). EO 138 was also issued on the basis of several empirical investigations affirming the ineffectiveness of directed credit programs (DCPs) implemented by government line agencies. Further, Administrative Order 86 gave NCC the mandate to rationalize DCPs in order to pull non-financial government agencies from participating in the credit market at the retail level and leave direct credit operations to GFIs.

The present structure of GFIs and agencies, however, has given them fully separate identities, leading to several failures:

1. Policy-making and oversight of the A-F sector GFIs is quite fragmented between DA (Quedancor and PCIC) and DoF (LBP);
2. Monitoring of the A-F sector is inadequate, since ACPC does not have direct access to information from the various involved institutions;

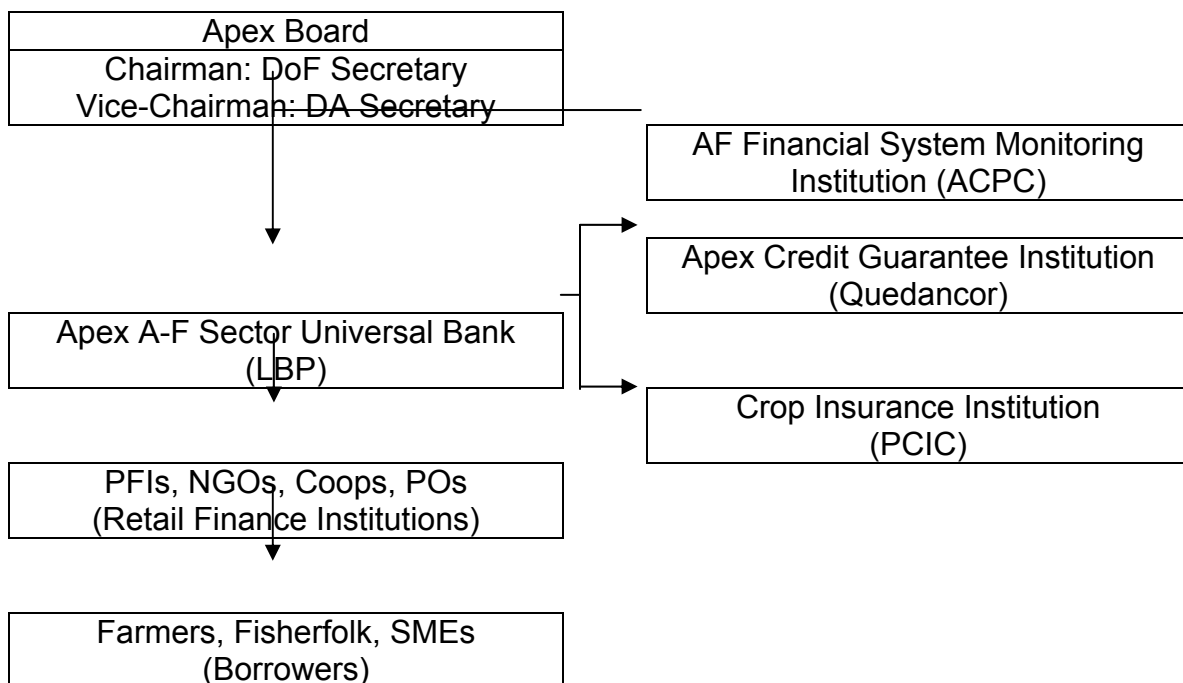
3. The major role of government at all levels of credit distribution counters its expressed preference for free markets and sends the private sector vague signals at best on getting involved in rural finance;

4. GFIs, being separate institutions, are prone to offer the same types of programs to the same financial institutions and the same final recipients, leading to high delivery costs and less actual reach.

From these characteristics of GFIs, several strengths and weaknesses can be observed:

Strengths	Weaknesses
<ul style="list-style-type: none"> • Established core market • Full range of services to the AF sector namely credit, guarantee, and insurance • Long institutional history of more than 20 years 	<ul style="list-style-type: none"> • Uncoordinated Boards of Directors and management across FIs and agencies • Duplication of roles • High delivery costs • Lack of focus with LBP, GFSME, and Quedancor serving non-AF clients • Uncoordinated operations of similar operations

From the above-cited strengths and weaknesses, as well as all the other observations noted in the review, the study recommends the following new structure for the financial system in the A-F sector:



The apex bank, LBP, will offer all financial services and take up marketing and operating functions on behalf of the other AFMA-mandated institutions in the sector. The Apex credit guarantee institution, QUEDANCOR, will develop and monitor credit guarantee programs. The crop insurance institution, PCIC, will develop and monitor all crop insurance programs. Both QUEDANCOR and PCIC will remain separate legal entities with their own Board of Directors and will be attached to LBP. The three institutions will form The Land Bank Group. AFMA-mandated institutions will focus on the design of credit, credit guarantee and crop insurance programs to benefit smallholders and to encourage participation of private institutions that deliver these services.

AFMA-mandated institutions will not be involved in retail delivery of financial services. Instead, they will work under wholesale modes of distribution. By adopting a wholesale mode of delivery of credit, credit guaranty and crop insurance programs, the government sends a clear message to the private sector that it will not compete in delivery of those services to final beneficiaries. PFIs, NGOs, People's Organizations and cooperatives will directly provide the financial services to smallholders. The study recommends that the government carefully align incentives to encourage private sector participation by aggressively investing in building retail institutions that will deliver financial services to smallholders and by aligning the interest rates for credit programs, guaranty rates for credit guaranty programs and insurance premium for crop insurance programs to market rates taking risks into account.

The study recommends maintaining a dual monitoring system – ACPC for impact on sector beneficiaries and BSP for the financial viability of the institutions. ACPC will remain attached to DA and will mainly monitor the performance of the financial system supporting the A-F sector. It will conduct policy research and impact studies to determine the efficacy

and success of financial services and programs. With this role, ACPC will have to drop current activities that are not concerned with monitoring and research. Only two non-administrative units will have to be retained – one dedicated to A-F monitoring and another to policy research, with the latter needing to be spun off as a separate institute in order that it could be fully effective.

The BSP will continue to monitor LBP as an ordinary universal bank. To heighten the importance of conserving NG's capital, the BSP shall measure and monitor LBP's capital adequacy on a consolidated basis, i.e., including the capital of its two attached institutions. Adopting such policy will ensure that BSP's enforcement of standards for portfolio quality and capital adequacy will serve as "hard budget constraints" and consequently, provide financial discipline, not only for LBP but also for QUEDANCOR and PCIC.

In essence, the proposed new structure would be able to:

1. Unify policy-making and oversight of GFIs since the Apex bank will be headed by the DA and DoF Secretaries;
2. Monitor the A-F sector through an independent body. ACPC should be given a stronger mandate to have clout in gathering information from the financial institutions;
3. Deliver services through a wholesale system and fully involve the private sector, since such agents who specialize in risk management will be the ones directly dealing with the borrowers;
4. Consolidate marketing and operations with LBP in order to maximize economies of scope and scale and risk sharing benefits;
5. Define roles of GFIs and PFIs in order to encourage sustainable private sector participation in rural finance;

6. Orient and focus on beneficiaries represented by farmers, fisherfolk and SMEs as the main customers of the services;
7. Conserve funds of the mandated institutions.

Summary of Findings on the Mandates, Programs, Policies and Performance of Each Institution

Agricultural Credit Policy Council (ACPC)

ACPC's activities include the development and implementation of special lending schemes, support and maintenance of credit guarantee programs, conduct of research studies and seminar-workshops as well as the monitoring and evaluation of policies and programs affecting rural finance. In 1994, the agency reformulated its institutional objectives to meet the changing needs of its target clientele – the small farmers and fisherfolk. Consistent with this new thrust, ACPC performed the following tasks that would have an impact at the grassroots level: (a) realignment of some programs in support specifically of the Medium-Term Agricultural Development Plan (MTADP); (b) strengthening of existing programs such as the special financing scheme for the fisheries sector (i.e., the credit component of the Fisheries Sector Program or FSP); and (c) continuation of intervention programs such as the guarantee programs, special assistance schemes for coop formation and development, and information campaign on agricultural credit. At the same time, ACPC continued performing its basic functions and tasks, such as: (a) active support of policy measures to ensure the viability and sustainability of rural financial intermediaries; (b) administration and design of financial assistance programs, including their implementing guidelines; (c) support and conduct of institutional development programs

to enhance viability and sustainability of farmers' organizations, cooperatives and other lending conduits; (d) preservation and improved use of the Comprehensive Agricultural Loan Fund (CALF) for agricultural credit especially lending to priority sectors; and (e) linkage and network with the other executive departments, Congress and multilateral institutions.

In general, ACPC's programs were deemed sound and aligned with the market-oriented reforms being pushed by the government. However, the study observed that the original mandate of ACPC was as large and broad as the role of the DA itself in the area of agriculture and fisheries (A-F) finance, and was quite tied to the department. This made the success of ACPC dependent on the success of the DA's programs and leadership. The dependence had both positive and negative effects, the positive effect being ACPC's ability to support the DA's policy implementation and review activities, and the negative making ACPC vulnerable to being mandated to perform DA's roles.

As to ACPC's organization, the view of appointing the Secretaries of Agriculture and Finance with the BSP Governor and the Secretary General of NEDA was to coordinate agricultural credit programs with the overall economic and government support policies and the banking system. However, as with the other organizations under study, with the already numerous *ex officio* memberships of the said positions, council members could not effectively participate and attend council meetings, limiting the decisions that could be made and lengthening the time it takes to make them.

Guarantee Fund for Small and Medium Enterprises (GFSME)

GFSME focused on the agriculture sector in the initial years of its operations. It sought to “establish a financial system that would give the participating financial institutions the confidence to lend more of their funds to small and medium agricultural projects.” Later, this focus on the agriculture sector diminished as GFSME shifted to the industry sector as it introduced programs for light industries. Its beneficiaries now are mainly small and medium enterprises in the manufacturing and services sectors.

Yet, among the credit guarantee institutions, GFSME was the only one that focused solely on providing credit guarantee. It was consequently able to build a local market for credit guarantees to SMEs by implementing innovative credit guarantee programs catering to the various market needs. Over the period 1985-1999, GFSME proved to be extremely profitable – its income reaching more than twice its expenses. However, this profitability was misleading as income actually came mostly from financial investments and not guarantee activities. Looking exclusively at guarantee operations, GFSME was deep in the red with its income (from guarantee fees) being able to cover only around 35 percent of expenses. Administrative costs accounted for the largest share of expenditures with personnel expenses accounting for 58 percent of administrative expenses.

GFSME’s beneficiary outreach only averaged 35 persons for every P1M worth of loans guaranteed prior to the currency crisis, and 20 persons for every P1M after. With its institutional network reaching a total of only 54 FIs in 15 years, GFSME’s reach to financial institutions (FIs) was quite insignificant given the number of FIs in the country.

Land Bank of the Philippines (LBP)

LBP implemented a series of credit and support programs to operationalize its agrarian and countryside development mandate. It implemented the following programs for its agrarian operations: (a) financing the acquisition of agricultural estates for division and resale to small landholders, (b) purchasing of landholding of agricultural lessee, (c) collection of land amortization, (d) bond trading and expanding use of 10-year LandBank Bonds, (e) processing of land transfer claims, (f) providing investment assistance, emergency loans and special lending window facilities to landowners, (g) land valuation and (h) compensating all lands covered under the Comprehensive Agrarian Reform Program (CARP). The bank also provided technical assistance, which was likewise focused on the agrarian reform beneficiaries. Starting in 1986, cooperatives became the focal point of LBP’s countryside development initiatives. It organized farmers into cooperatives to improve their productivity. In 1987, the bank began the shift from retail to wholesale lending to broaden credit distribution in the countryside. It also began strengthening partnership with the countryside financial institutions.

LBP, however, is administering various forms of external and internal subsidies. Its external subsidies are its subsidies to the national government (NG), which includes the operating cost of agrarian land transfer, losses on loans to CARP beneficiaries, advances to compensate landowners, and dividend payments to NG. Its internal subsidies are its subsidies to the agriculture sector which includes interest subsidy to agricultural borrowers for lending at 12 to 14 percent versus the market rate and within agricultural loans, subsidy to weak cooperatives. The subsidy structure is reflected in the organization, management and operations of

LBP as it is deeply ingrained in its Charter and policy. The subsidies represent about 263 percent of LBP's average annual income over the period 1995-1999.

Because of the need to source funding to support its mandate, the bank had to utilize its universal banking license and transact with more bankable sectors. Eventually, this strategy pulled the bank away from devoting its services fully to the A-F sector. Despite this, the bank has high past due rates on both its commercial loans and small farmer loans that it extended via cooperatives.

Nevertheless, LBP emerged as the most important creditor of small farmers through cooperatives in its relatively short history. Loans to small farmers and fisherfolk increased from P300M in 1989 to P8.3B in 1999. Like the entire banking sector, however, LBP's share of loans to the A-F sector compared to total loans disbursed declined from 39.1 percent to 13 percent between 1991 and 1999 due to the difficulty in managing risk in the sector.

Philippine Crop Insurance Corporation (PCIC)

The PCIC was established in June 1978 to provide insurance coverage, initially, for palay crops only. PCIC was mandated to operate as an insurance institution that would manage its own risks and provide NG with an institutional corporate entity to subsidize the insurance premium of marginalized subsistence farmers who cannot bear the full cost of crop insurance premium. The intended benefits of an agricultural insurance institution were better management of risk in agriculture, stabilized farmers' income and improved access to lending institutions. The coverage of PCIC's insurance program later expanded to include livestock, plantation crops and high value crops. It also launched the personal accident insurance in 1996. In 1997, it started the fire,

property floater, commercial car and other non-crop insurance lines. Also, PCIC implemented guarantee programs like the CALF and Fisheries Sector Program (FSP) guarantee programs.

PCIC was organized and staffed, though, on the basis of a P750M initial budget promised by NG. However, the government could only provide less than P100M, which seemed to start the GFI on the wrong foot. NG's failure to provide its mandated capital and premium subsidy resulted in labor-intensive operations but lesser premium income for the corporation. Yet, because of the corporation's inability to respond (or slow response) to market changes, it was not able to reduce its administrative costs until 1999, when it reorganized to cut its workforce by half.

The number of rice and corn farmers – PCIC's main beneficiary group – that benefited from guarantee programs declined from 336,000 in 1991 to less than one fifth of this number (i.e., 61,000) in 1998, partly due to the reduced number of farmer-borrowers. This, in turn, further reduced PCIC's gains and sustainability. On a positive note, however, PCIC was able to generate/collect greater premiums than claims even as more than 50 percent of the regions still incurred negative gains. What made PCIC's financial position ultimately worse was the inability of the corporation's underwriting profits to cover its operating losses.

Quedan and Rural Credit Guarantee Corporation (QUEDANCOR)

Quedancor was mandated to establish credit support mechanisms (e.g. co-financing arrangements and incentives) for farmers, fishermen, rural workers, cooperatives, retailers, wholesalers and primary processors of agricultural and aquatic commodities; and to implement a guarantee system to promote

inventory financing of agri-aqua commodities, establishment of production and post-production facilities, acquisition of farm and fishery machinery, equipment and implements, and investment in production inputs and labor.

Like PCIC however, Quedancor immediately felt the government's lack of funding capacity upon its conversion into a government-owned corporation. Instead of getting P1.2B worth of funds from the NG as mandated, Quedancor was able to source only half of this amount, limiting its capacity to guarantee only up to P3B in 1998, instead of P10B.

To maximize operational efforts and to implement its mandate as promoter and guarantor of agricultural credit, Quedancor consequently also adopted several modes of directly delivering credit to its target clientele. Most of the corporation's lending programs was designed for retail operations, taking up between 37 to 95 percent of its lending portfolio in 1992-1999. Over the same period, Quedancor showed overall average annual losses of P1.5M, i.e., earning from investments and operations and spending on personnel, maintenance, and operating expenses. By itself, the guarantee operations incurred losses mainly due to (a) the high costs of credit

delivery, (b) implicit subsidy of private financial institutions (PFIs) via low guarantee rates, (c) low market reach, and (d) doubtful capacity of the present guarantee system based on traders to achieve the corporation's mandate of "improving the bankability and access to formal credit" of farmers. Thus, income from guarantee operations for the corporation averaged P19M annually over 1993-1998, while expenses averaged P83M during the same period.

Status of the Project

The final report of the review was accepted by the Steering Committee on March 2002. Consequently, the report was submitted to the Congressional Oversight Committee on Agriculture and Fisheries Modernization (COCAFAM). Also, copies of the report were provided to the Secretary of Agriculture, the House Committee on Economic Affairs as well as other members of Congress to further advocate the translation of the review's recommendations into legislation, which could lead to enhanced program coordination and better efficiency & effectiveness among government institutions involved in agriculture and fisheries finance.

Based on a report prepared by PSR Development, Inc.