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Is LandBank EO138 Ready?

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In the wake of the issuance of Executive Order (EO) No. 138, one of the institutions expected to play a pivotal role is the Land Bank of the Philippines. Given its current set-up and focus, is it ready to take up the challenge? This Policy Notes *issue examines the matter and puts forth certain recommendations to help in the execution of the EO.*

On August 10, 1999, President Estrada issued EO No. 138, mandating, among others, the transfer of directed credit programs implemented by government nonfinancial agencies to government financial institutions. Included in the said EO is the formal declaration of a policy that the provision of financial and credit services to the basic sectors, i.e., small farmers, fisherfolk, cottage industries, small and medium enterprises (SMEs), should follow a market-oriented approach. Under this new policy environment, government financial institutions such as the LandBank, Development Bank of the Philippines (DBP) and others are expected to play a significant role in providing financial services to the basic sectors.

The Philippines is one of the few remaining countries that maintain subsidized credit programs managed by nonfinancial government agencies. In most countries, market-oriented credit programs for small farmers and SMEs have been and are successfully managed by financial institutions, some of which are government-owned while others are purely or substantially owned by the private sector. The Bank Rakyat Indonesia (BRI) in Indonesia, Bank for Agriculture and Agricultural Cooperatives (BAAC) in Thailand and the Grameen Bank in Bangladesh can be cited as examples. The reform in the government credit programs as envisioned in EO 138 is thus a step in the right direction. *It will not take away resources meant for the small farmers and SMEs. Rather, it will ensure that those resources will be efficiently allocated to those who need them most and enhanced through better repayment rates and savings mobilization over time to cope with the growing demands for credit by the basic sectors*.

This envisioned reform, however, requires a financial institution that can efficiently provide financial services

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to small farmers and SMEs. Is the LandBank ready for this job?

What LandBank does today

The purpose for the creation of LandBank, as contained in one of the chapters of Republic Act (RA) 3844 (August 1963) introducing land reform in the country, was to finance the purchase of agricultural estates offered for sale and to resell the lands to farmer beneficiaries under a 25-year amortization period. In 1973, Presidential Decree (PD) 251 was issued, giving LandBank expanded commercial banking powers so that it can earn profit from its commercial banking activities and use it to cross-subsidize the cost of its agrarian land transfer operations and loans to small farmers. Other laws were subsequently passed that significantly affected LandBank's operations.

With total resources reaching P160.1 billion by December 1997 and with P98 billion or 61 percent of total assets in the form of loans and discounts and P36.1 billion or 22.6 percent in the form of investments, LandBank plays a dual role: development banking and commercial banking.

As a development bank, it is undoubtedly the largest provider of financial services, either directly or indirectly, to individual farmers, land reform beneficiaries, and farmers' cooperatives/associations. Its agrarian lending operations include financial assistance to small farmers and fisherfolk; assistance to rural financial institutions in the form of rediscounting, liquidity support and support for cooperative bank formation; land transfer operation; and assistance to farmers and fisherfolk cooperatives. It also has loan programs for SMEs and nonagri-based cooperatives and is currently the major lender to local government units (LGUs) for countryside infrastructure projects. Aside from such financial services, LandBank also provides technical assistance to cooperatives and serves as an implementing agency of the Comprehensive Agrarian Reform Program (CARP) involved in land valuation, compensation to owners of private agricultural lands, and collection of amortizations from CARP farmer-beneficiaries.

> "LandBank's agrarian lending operations include financial assistance to small farmers and fisherfolk; assistance to rural financial institutions...; land transfer operation; and assistance to farmers and fisherfolk cooperatives."

Despite being the largest lender to the agricultural sector, however, it is to be noted that LandBank's loan portfolio (including ALF/CLF and agricultural reform/other agricultural loans) to this sector is only equivalent to about 13 percent of its total assets.

On the other hand, as a universal bank performing both commercial and investment banking functions, LandBank's total commercial and industrial loans (which include loans to large corporate enterprises in the country) comprised about 43 percent of its total assets in 1997. It has an active investment banking activities, with investment portfolio comprising 23 percent of its total assets. It also has an international business and foreign exchange operation as well as a consumer banking operation. Taken as a whole, therefore, LandBank's investment and commercial banking portfolio drowns its agricultural loan portfolio.

This particular distribution of assets shows that LandBank *has substantially deviated from its original mandate over the years*.

LandBank and the banking system

The banking sector is one of the sectors in the domestic economy which has substantially been liberalized in the 1990s. The twin policy of the government is to establish and maintain a level playing field in the banking system and to reduce its presence in areas where the private banking system can do better. As of the second quarter of 1999, there were 53 universal and ordinary commercial banks in the country. LandBank ranks number 4 in terms of assets, loan portfolio and deposit liabilities.

The domestic banking system is expected to undergo a substantial restructuring in the coming years as it becomes more integrated with the international financial system. The recent mandatory increase in the minimum capital requirement for banks has already forced some banks to consolidate or merge with others to meet such requirement. With more foreign banks expected to enter the domestic banking system after the passage of the proposed General Banking Act currently pending at Congress, even more mergers/consolidations and acquisitions are expected to occur, resulting in fewer but larger and highly competitive banks that are able to project themselves as regional, if not global, players. While large banks will work hard to make their presence felt in almost all segments of the financial system, some banks, particularly the small ones, will be looking for a niche where their competitive edge lies or specializing in a few areas where they can find great value for themselves and their customers.

> "What LandBank should focus on is to remain as a bank for the agriculture sector. As such, it must fashion a structure that will enable it to have frequent contacts with local farmers and fisherfolk on a firmer basis."

Finding its niche

Where does LandBank fit into this emerging banking structure? Where is its niche? To answer this question, it is necessary to invoke the previously-mentioned twin policy of the government for the banking system.

As a government bank, LandBank must play a special role in the domestic banking system, which means that it must not encroach into areas that private universal and commercial banks can sufficiently cover. It must play a catalytic and supportive role, not as a competitor to private banks. This is the value-added expected of a government bank.

At present, however, LandBank directly competes with private banks, especially in the areas of investment and commercial banking. But since these are areas which are already adequately served by private universal and commercial banks and will become even more crowded and highly competitive with the expected entry of new global players into the domestic banking system in the coming months, there is no reason for the LandBank to continue its operations in these areas. Nor is there a need for it to project itself as a regional or global player. What it should focus on is to remain as a bank for the agriculture sector. As such, it must fashion a structure that will enable it to have frequent contacts with local farmers and fisherfolk on a firmer basis.

Reexamining certain tenets and operations

The withdrawal of LandBank from the investment and commercial banking business will raise the government's credibility in establishing and maintaining a level playing field in the domestic banking system. As a government bank, it cannot be denied that LandBank enjoys some undue advantages over private universal and commercial banks in investment and commercial banking business. The fact that its total liabilities are either explicitly or implicitly guaranteed by the national government in full and that it has easy access to cheap and more stable sources of funds being an official government depository and a conduit of several ODA funds, makes its cost of funds and operations much lower than private universal and commercial banks. Withdrawing from this particular area of banking business will thus fulfill the aspect of the government's twin policy in banking on establishing and maintaining a level playing field.

But why, in the first place, did the LandBank engage in investment and commercial banking? Certain quarters point out that said operations are needed to generate profits that will be used to expand and subsidize LandBank's less profitable development banking operation. This Robin Hood or "cash cow" approach to development financing, however, must be examined carefully. It may have worked well under a less competitive banking system wherein banks can easily realize above-normal profits. But under a competitive market structure to which the Philippine banking system is heading, such abnormal profits would disappear, making the "cash cow" approach detrimental to the long-term viability of LandBank itself.

Cross-subsidization does not sit well either with the present thrust of the government to make all subsidies transparent and make government institutions more accountable to the public for their performance.[1] Moreover, such approach automatically assumes that farm enterprises are not bankable entities, a thinking that has been debunked by a number of successful cases of financial institutions in the country and elsewhere in providing financial services to small, uncollateralized borrowers, including small farmers and landless farm workers using a market-oriented approach.

Finally, the losses recently incurred by the LandBank from some of its commercial and industrial loans to large private corporations have further weakened the "cash cow" argument. Without proper loan loss provisioning, LandBank will have a hard time determining how much cross-subsidization it has to make as well as how much dividend it should declare to the government, an issue which cropped up in 1998 and which has not yet been resolved between the Bank and the Department of Finance at this time of writing.

What should LandBank do to become EO138 compliant

One of the perennial problems of small farmers, fisherfolk and urban and rural SMEs is the lack of access to bank credit. The final outcome of the current banking restructuring, i.e., having large and stable banks, may improve their access to bank credit because some banks will be forced to look for new markets and, hopefully, the small borrowers will appear in their radar screen.

Such improvement, however, will certainly not happen in a significant way. Not that small borrowers are not bankable. But simply because the appropriate lending technologies like the Grameen Bank's technology of lending must first be well-conceived and/or thought of. Thus, the design of a credit program matters a lot when it comes to lending to small borrowers who can offer very little collateral.

This, however, requires expertise and total dedication on the part of the lending institution. In rural areas, there are some linkages between farm and nonfarm enterprises both in the consumption and production sides. It is important to point out that rural family business enterprises are, in most cases, multi-product firms. Thus, the design of rural credit programs must take these factors into account. Credit programs that would focus only on one segment of a rural family enterprise, say only rice production rather than considering the rural family as one business enterprise engaged in several economic activities, would likely be less successful in attaining their objectives.

This Notes *therefore suggests that LandBank should focus on providing financial services only to small farmers and fisherfolk, and to rural and urban cottage industries and SMEs*. It should not distinguish between farm and nonfarm enterprises anymore nor between rural and urban SMEs.[2] It may lend to small farmers and SMEs either directly or indirectly through financial conduits as what it has been doing in the past few years so long as it does not compete with microfinance institutions. It may continue lending to LGUs for small countryside infrastructure projects and also provide technical assistance to financial institutions that are interested in developing their capacity to lend to farmers, fisherfolk and rural and urban SMEs. As a microfinance development institution, the LandBank should engage in action research to develop lending technologies such as variants of the Grameen Bank technology. Said technologies should reduce transaction costs and risk in lending to small borrowers. The LandBank should

[1] *To date, LandBank has never disclosed the total amount of cross-subsidization it has made over the years and the costs and benefits of such program to the entire country. The government is now in the process of phasing out cross-subsidization in other sectors of the economy such as telecommunications and energy sectors.*

[2] *As mentioned earlier, the private universal and commercial banks can look after the financial needs of large commercial and industrial enterprises.*

"...To meaningfully serve the provisions of EO No. 138 and provide financial services to the basic sectors, the LandBank should focus on its development banking function and shed off its commercial and investment banking functions."

also share the results of such research to those who would like to engage in lending to small borrowers.

Critics have charged that LandBank has not been sympathetic to the needs of small borrowers and has instead been very accommodating to large corporate enterprises. They therefore raise some fears that the transfer of several credit programs from nonfinancial government agencies to the LandBank stipulated under EO 138 will starve agriculture of credit because LandBank will continue to behave like a private universal or commercial bank, paying more attention to commercial and investment banking. The proposal to transform LandBank into a microfinance development institution (MFDI) and for it to withdraw its commercial and investment functions will squarely allay such fears.

Recommendations: Measures to be taken

To facilitate the implementation of the provisions of EO 138, this *Notes* puts the following recommendations forward:

✼ To transform LandBank into a MFDI, the government must come up with a clear policy stating that LandBank should focus only on development banking function. To give flesh to that policy statement, the government must require LandBank to formulate and implement a program for winding down its commercial and investment operations and for establishing itself as a microfinance development institution over a three-year period. The transition period is long enough for the LandBank to restructure its operations and acquire new expertise needed for its operations while it gradually sheds off expertise that it no longer needs for its development banking function.

✼ The proposed restructuring in the operation of LandBank does not require a legislative action nor does it require changing its charter. It simply has to emphasize Section 75 of RA 3844, as amended, which states that LandBank shall have the power, among others, "to grant short-, medium- and long-term loans and advances against security of real estate and/or other acceptable assets for the establishment, development or expansion of agricultural, industrial, home buildings or home financing projects and other productive enterprises."

✼ The issue of possible overlap with the DBP can also be addressed administratively by clearly delineating the roles of DBP and the LandBank. This *Notes* suggests that DBP should focus on financing large-scale development projects while LandBank focuses on the provision of financial services only to small farmers, fisherfolk, cottage industries and SMEs. This should be taken into account during the transition period.

Conclusion

If the LandBank is to meaningfully serve the provisions of EO No. 138 and provide financial services to the basic sectors, then it should focus on its development banking function and shed off its commercial and investment banking functions. More specifically, LandBank should be transformed into a real market-based microfinance development institution, providing financial services to the basic sectors either directly or indirectly through private microfinance institutions. In this way, LandBank can play a more significant role in enhancing employment opportunities both in rural and urban areas and in raising the productivity and incomes of small farmers, landless farm workers, fisherfolk, cottage industries and SMEs.

It is to be noted that the Agriculture and Fisheries Modernization Act (AFMA) has called for a review of the mandates of the LandBank and other government financial institutions that play a key role in the delivery of credit to farmers and fisherfolk. This *Policy Notes* hopes to serve as an input to said review.

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