Restructuring agricultural development banks in South Africa

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PART 2: COUNTRY CASE STUDIES

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4.1 Introduction

The policies of development finance and thus the development of financial markets are in a continuous search for the answer to whether there should be intervention in the market by governments and if yes, in what format should this intervention be. Over time the question of whether there should be intervention faded in the background in favour of the discussion on the format of intervention. If we only concentrate on the Post WWII period we see an emphasis on the agricultural development bank as intervention instrument up to the late 1970s. Thereafter the NGO bravely entered the arena while the development bank was pushed to the background.

Recently, in the late 1980s, the NGO push started to subside and other formats of intervention were once again dusted of or rediscovered. Commercial banks started to enter the fray and some development banks reformed into entities resembling commercial organisations with a development profile. Some NGOs shrugged of structural constraints and turned themselves into banks, once again with a commercial approach and a development profile. In many countries (and in South Africa) this range of players expanding the microfinance market broadened to include furniture stores, organised microlenders, agricultural processors, mining houses, self organised groups (in many guises, e.g. ROSCAs, Village Banks, Credit Unions) etc. Today the institutional profile of development finance at the retail level is wide and varied and far different from the mono-institutional culture of the 1950s to 1980s.

The result in terms of clients obtaining access to financial markets is staggering. Since the 1970s it is also an urban story. Access to financial services in rural areas of developing countries continue to be a vexing problem and the debate still rages of what would be the best institutional format for improving access. During this debate the “should there be intervention” lobby also made themselves heard from time to time. In this paper we are turning to these debates on a country specific basis. After providing an overview of the discussion on whether or not we should intervene we will start the discussion on a general overview of development banks (emphasising agricultural development banks) and then relate experience and lessons to the restructuring of development banks in South Africa. We will base our discussion on the experience in three provinces in South Africa, covering four development banks. The aim of this paper is to highlight issues and some initial experiences.

4.2 Beyond the market and the state[1]

[1] This section draws on a report by Graham, Coetzee and Brandes (1999).

Government intervention is typically defended to provide public goods (health, nutrition, mass vaccinations, education, etc.) since without this intervention supply would be less than optimal. This is due to the inability of private agents or suppliers of these services to internalise the positive externalities to society at large generated by the supply of these goods and services. These services have been characteristically supplied directly by government through traditional channels of Public Finance (i.e. government expenditures). However, more recently in some developed countries a voucher movement has emerged challenging the governments continued supply of these services.

Development finance, on the other hand, is not generally involved in supplying public goods. On the contrary, as the name implies development finance institutions (DFIs) supply loans or equity finance to, inter alia, private businesses, individuals and local authorities. The contrast to public finance is clear. DFIs are not engaged in generating expenditures. They expect to be repaid. The question arises why can't private lenders make these loans? What justification is there for the government to intervene in private markets to either provide these services or subsidise their supply by others?

Four arguments are frequently made to justify the intervention of government in financial markets: (i) monopoly; (ii) externalities; (iii) imperfect information; and (iv) contract enforcement problems. Monopolies are frequently associated with markets segmented by geography. Introducing more competition into these markets increases the supply of loans beyond the profit maximising level determined by the monopolist. Hence government intervention to correct for the under-supply of finance does not necessarily have to imply direct supply by a government lender. The same effect could be achieved indirectly by breaking down barriers to entry and encouraging additional competitors through temporary tax credits or subsidy schemes or increasing access to the segmented area through the expansion of public goods like roads that in turn generate other positive externalities. When the monopolist enjoys increasing returns to scale, governments typically intervene with marginal cost pricing formulas to regulate the monopolists output behaviour and returns.

Externalities are the classic form of market failure. In the realm of financial markets externalities can emerge on the side of borrowers or lenders. On the borrowers' side, defaulted borrowers increase interest costs to good borrowers as lenders pass on the higher costs of their bad lending experience to the rest of their clientele. Externalities exist on the lender's side when borrowers have access to more than one source of credit (i.e. obtaining partial funding for a project from more than one lender). This multiple lender scenario creates a potential free rider problem in monitoring since the lenders benefit each other via their monitoring. Another scenario is where a borrower borrows for several projects from different sources of credit. The effort on each project is not separable. The terms and conditions of one lenders contract can affect the effort and payoff for the other lender (Besley, 1992).

Multiple indebtedness, a feature common to rural financial markets where both formal and informal finance intermingles can generate more loans than is socially optimal (i.e. excessive indebtedness). While government interventions to deal with this feature of multiple indebtedness would be desirable, it is not clear what form this intervention could take. Private lenders could undertake denying or reducing the size of loans to those who are already in debt to another source. However, one would need to generate an all-embracing credit bureau that shared (or charged for) this universal information base for this to become effective. It is not clear what form government intervention could take to directly address this issue of excessive indebtedness through multiple lending unless it undertook to carry out or subsidise this credit bureau clearinghouse role.

Asymmetric or imperfect information is the third and most discussed perspective on market failure. This refers to the uneven, one-sided distribution of information favouring borrowers at the expense of lenders. Adverse selection highlights how interest rates do not clear the market between supply and demand since rising risk premiums only induce risk averse borrowers to leave the loan market while encouraging relatively more risk-prone borrowers with riskier projects to stay in the market. The end result is a rise in loan losses for the lender, hence lenders choose not to raise interest rates (beyond some reasonable risk adjusted level) but rather ration the quantity of credit in the market. This is considered socially inefficient since even a constrained Pareto optimum has not been reached with under-investment governing the supply of credit (i.e. some credit-worthy borrowers are denied credit since the lender cannot tell the difference between some good and bad borrowers). This is the classic market failure example used to argue for government intervention in credit markets.

Moral hazard underscores the possibility that individuals with loans will exert less effort to restrain risky behaviour the higher the interest rate. This adverse incentive effort on borrowers behaviour also increases the likelihood of a worsening portfolio for the lender who in turn faces this challenge by rationing credit at lower interest rates. The quantity of loans lent to an individual is restricted for incentive reasons.

Adverse selection and moral hazard jointly generate a socially inefficient supply of finance, i.e. a smaller supply that that which would obtain in a world without asymmetric information problems where truly creditworthy clients would not be rationed out of lender portfolios. This creates an argument for government intervention to deal with the problem of imperfect information. Creating the argument is one thing. Carrying it out is another thing altogether. This brings us to the fourth and most important dimension behind market failure, namely, the lack of an effective contract enforcement framework. Practically all the writers in the asymmetric information school assume away this problem. Perhaps this is due to the fact that they all live largely in the United States where contract enforcement is reasonably robust. However once one moves to the developing world, especially the world of the disenfranchised within the developing world, one has to face this issue and cannot assume it away. The lack of clearly specified property rights and cost effective and equitable contract enforcement machinery are severe problems for financial markets in these societies. The role of the government here is obvious. Strengthening property rights and streamlining more rigorous contract enforcement procedures and mechanisms are likely the most significant action governments can undertake in developing societies to improve the alleged market failure of financial market.

Most researchers of market failure invariably end their statements for government intervention by recommending once again, the tried and tested policies of government failure in the past, i.e. government credit programs, targeted credit, and subsidised interest rates. This is done despite the fact that the financial landscape of developing countries is littered with the carcasses of dead and half-dead government, targeted lending programs with subsidised interest rates. None of these traditional recommendations get to the "core" of the problem, i.e. the causes of information deficiencies and/or contract enforcement problems. They only address the issue of increasing the supply of loans through government auspices regardless of the costs.

Indeed the transfer of more lending into government hands carries the risk of increased moral hazard. Everyone in developing countries knows that the sector in which contract enforcement is weakest and frequently corrupt, is the government sector. Borrowers from government targeted credit programs know they likely will not suffer any consequences for defaulting on their loans, hence the large element of rent seeking behaviour in these programs. Yet analysts of market failure frequently overlook this fact, no doubt, because they assume in their modelling exercises no problem with contract enforcement.

It is instructive to note that the major breakthrough, substantially reversing financial market failure in the past decade, owes nothing to the traditional recommendations outlined above. This is the breakthrough in lending technologies for the "best practice" microenterprise organisations. These organisations directly addressed the core problem of substantially reducing the imperfect information problem, enhancing monitoring, and devising innovative ways around the contract enforcement problem. Direct government intervention in financial market variables played no role in this unique effort except to fund a select number of donors who in turn supported, in an ad hoc manner, consultant and non-profit organisations carrying out these innovations in financial technology.

A further aspect is that over time one would expect the private sector to play an increasingly important role in rural areas following the market based approach and the development of the aspects relevant to the existence of a market over time. Thus, based on the efficiency of the market based approach and the inefficiency of government based approaches, private sector institutions will provide services in preference to government based institutions. This line of thought is questioned where the private sector decrease services in rural areas based on the inability of rural private sector bank branches to adhere to increased profit targets. In South Africa we find an overall decrease in commercial bank branches (following international trends). For instance, whereas in 1995 approximately 54 percent of South Africans were in proximity of commercial bank branches, this decreased to 32 percent in 1998 (Eskom, 1998). The closure is more severe in rural areas and increasing.

4.3 Agricultural development banks

"Why are specialised farm credit institutions founded in low-income countries, and why do they frequently flounder?" were questions posed by Von Pischke (1978). Added to these inherent difficulties associated with specialised farm credit, institutions have often been used by states as conduits for carrying out agricultural and social policies, such as compensating the farm sector for excessive taxation of agriculture and urban bias. This has led to a lack of autonomy. It is this lack of autonomy that has crippled these institutions rather than state ownership *per se*. In effect, financial markets were used to allocate subsidies, rather than fulfil their role of efficient allocators of finance (Adams, 1992). Because government has pursued social and agricultural policy objectives *via* rural financial institutions, these institutions have been particularly vulnerable to collusion by their politically organised clients. Using specialised financial institutions to compensate farm sectors or pursue social objectives has mostly been futile. All the participants in the agricultural sector suffer from bad policies, bad prices and/or bad weather, however only a minority of better off clients have access to credit and therefore received "compensation".

The pendulum swung

The realisation of this state of affairs necessitated a re-look at the way rural financial markets are approached. This started with the publication of the USAID sponsored Spring Review of Agricultural Credit Programmes (Donald, 1976). In the period following the mid seventies the donor agencies tended to ignore the specialised farm credit institutions that they had created as part of their earlier effort to throw money at development problems. The market was rediscovered and these institutions, being supply-led in nature, obviously did not meet the requirements of the so-called new approach to rural finance. In the new approach a few basic rules changed:

- Savings were seen as important: It was realised that most poor people did not make use of credit and saved in some liquid form to serve as a reserve to be applied for consumption smoothing due to income shocks.
- Transaction costs were given more attention and the realisation dawned that the frictionless market of the neo-classical school is somewhat removed from reality.
- Information flows and risks inherent in asymmetric information situations were highlighted.
- Institutions mattered as sustainable services to poor clients were impossible without sustainable institutions. This unlocked research on all aspects of institutional sustainability.
- Financial markets were treated as markets and not as conduits anymore.

Unfortunately, in the mad rush towards the market the specialised credit institutions were sidelined. Recently, the realisation dawned that in countries with a weak private sector these were the only institutions providing services in rural areas, albeit within a skewed policy framework. Even where the private sector has a more prominent presence, it still is not willing to provide services on a broad basis in rural areas. The attention is now shifting back to these institutions as one institutional form of a range of retail institutional options to increase outreach. However it is not yet clear whether this refocus is noticed in the large multilateral development finance institutions. Further, development banks in their conventional guise would obviously hold no answers. Emphasis is placed on the restructuring of these institutions with the objective of emulating commercial operations with a development face, thus taking up the challenge of being self-sustainable and having a development impact and vast outreach at the same time. Indeed a formidable challenge and to date, with a limited success record.

4.4 Restructuring of specialised credit institutions

The latest approach on a possible role for specialised credit institutions can be illustrated with the following discussion drawn from the work of Graham (1995)[2]. Attempts to restructure credit institutions must recognise the high social costs and rent seeking behaviour of many of these institutions - qualities that characterised the performance that left many of them insolvent in the 1980s. In many African countries, especially in West Africa most development banks have been closed, or are in the process of closing.

Any restructuring plans should recognise that institutions that specialise in farm finance are frequently candidates for failure since they do not diversify risk in their portfolios (thus high incidence of covariant risk). Hence any reform of agricultural development banks must accept the fact that they should increasingly diversify. In some countries they are the only banks operating in rural areas, giving them a potential franchise value. When their current financial state does not make them sufficiently attractive to investors for immediate privatisation, consideration should be given to improving their condition to the point where they can be sold to private buyers. If this is not possible, a second best alternative may be to restructure radically their internal organisation and external mission to survive as sustainable institutions supplying realistically priced financial services earning decent rates of return.

Much of what follows distils the experience gained in reformed state banks in South East Asia (Yaron *et al,* 1996; Yaron, 1992) and in a recent South African study (Strauss Commission, 1996; Coetzee, 1997). "Banks fail because of bad policies, poor banking practices and weak institutional frameworks" (Sheng, 1996). This statement was made regarding commercial banks in developing countries. If we add to these reasons all the additional ailments of state agricultural banks, it is clear that restructuring becomes a formidable task. The question is how to reorganise these institutions so that they do not fall prey to the same vices that largely destroyed their usefulness as financial institutions in the past. Based on the experience restructuring and transformation should attend to the following general areas (Coetzee, 1997; Strauss Commission, 1996; Graham, 1995;):

Role of government, clarity of role and functions, and political commitment
Experience shows that government is rarely successful when it tries to engage directly in financial markets. However, government should provide an environment that is conducive to the development of financial markets and set the operational framework for financial institutions that use public funds. Day to day political interference is detrimental. Political support and objectives must rather be embodied in the institution's purpose and policies. Operational autonomy is then the only approach that can be considered.

Autonomy and governance
This implies protection against political intrusion, which in turn requires a Board of Directors in which no government official is the chairperson, on which no elected officials should serve, and where members drawn from the private sector carry more weight than those drawn from the public sector. This approach mooted by Graham (1995) has an interesting twist. Consider the approach that one should have a link

[2] The rest of this section is drawn from the work of Graham (1995). Graham and Von Pischke (1995) were of the first researchers to question these extremes in approaches to rural financial markets.

between ownership and governance, but also would like to get away from government interference. Thus, what we ask from government is to capitalise, but not to govern. If we expand ownership to the private sector, one surely will loose much of the development imperatives. Thus, ensure viable business with the current clientele end convince the government that their commitment is reflected in their hands-off approach!

Institutional considerations
South Africa is characterised by a multitude of uncoordinated public sector institutions with overlapping mandates and competencies. The creation of new, additional institutions should not be actively promoted, given existing limitations on human resources and other capacities. There also is a dire need to optimise cost effectiveness in the operations of financial institutions and to rationalise public institutions that serves the same clientele. Where applicable, therefore, existing institutional structures should be transformed to serve the needs of the reconstruction and development process.

Flexibility
As different circumstances prevail in different provinces, and due to the dynamic nature of developments in South Africa, institutions should be allowed the flexibility to focus on local circumstances, provided that they do so within a coherent framework. An expansion of this argument is that within the basic guidelines reflect the reality of context.

Minimising systemic (DFS) and institutional (individual DFI) risk
The prudent management of systemic risk requires that financial institutions manage diversified portfolios. The stability of the development finance system depends on development finance institutions spreading risk across different types of clients, different sectors and/or different geographic areas. The high potential for covariant risk, especially where institutions are locked into serving one sector (for example agriculture), should be mitigated by diversifying portfolios.

Systemic risk is also related to funding structure (as reflected by balance-sheet ratios) and should be minimised, *inter alia*, by subjecting institutions to regulation and strict commercial principles. Cost recovery is central to commercial principles. Subsidy-dependent entities should not be supported in the long term and subsidy support should be minimised in order to contain government fiscal exposure.

Sound management information systems are critical to minimising institutional risk. DFIs must have accurate, timely and reliable financial information to be able to plan and measure performance and impact under various sectoral conditions and in dynamic financial markets and to take early, appropriate corrective actions. To the extent that DFIs make use of public resources, they need to comply with and report on the basis of specific standards, codes of conduct, disclosure and information requirements.

Mobilising financial resources
Commercial principles are essential to the financial and fiscal soundness of a development finance system. Innovative approaches to the mobilisation of funds to ensure less reliance on government contributions are needed. This could be achieved, for example, by an institution that has a strong deposit base, offering a wide range of

deposit facilities throughout its branch network. The matching of financial instruments on the mobilisation and application side is part of a sound approach.

Capitalisation

Initial re-capitalisation should be done by the government (if necessary), with additions to capital limited to retained earnings and sales of shares to the public. The institution's charter should specify its minimum capital ratio (for example for a financial institution).

Allocation of resources

DFIs should preferably function on the basis of pinpointed financial market failures and should design and use appropriate risk-sharing arrangements to maximise private sector financial involvement. They need to develop innovative financial mechanisms to address neglected or emerging markets (for example, the venture capital market).

Loan policy

Interest rate policies should be designed so that the DFI does not crowd out private sector involvement. An emphasis on portfolio diversification is appropriate, especially in rural areas, where non-farm rural enterprises should be regarded as just as important as farming enterprises, in order to decrease risk exposure. Explicit targeting should be avoided. Commercial short-term overdraft facilities should be incorporated into the loan portfolio to balance medium-term lending, along with remunerative government treasury bills up to a specified portion of its financial assets. This gives the institution the means to manage both risk and liquidity.

Staffing

A DFI requires an efficient employment policy of creating the right potential capacity, where no government interference is allowed in terms of placements and termination of employment, within acceptable national norms and rules as espoused by the national labour legislation.

Decentralisation and incentive measures

A branch-based approach should be followed, qualified by opening branches in phases, from part-time to full time, as the volume of transactions justifies it. Decentralised decision-making should prevail at branch level. Performance based remuneration and related bonus schemes should prevail for branch managers and relevant loan evaluation and collection personnel, based on criteria such as the number and volume of loans, loan recovery, and deposit mobilisation. Bonus schemes should only be triggered after meeting a high loan recovery standard. Transfer pricing incentives would be required to reward deposit mobilisation beyond that used to fund local loans. DFIs should furthermore provide the appropriate incentives and penalties to align the behaviour of their clients with market signals and principally real interest rates. Client-responsiveness is also closely related to incentives and penalties.

Transparency, measurement of performance and reporting
State-owned institutions, especially financial institutions, should be at the forefront of disclosure. Accountability should include quarterly and independently audited annual reports issued to the public, specifying financial conditions truly and fairly. Reports should include balance sheets, income statements, source-and-application of funds statements, and additional tables showing the ageing of loan arrears by loan type, write-offs, reserves and the market value of the investment portfolio. Most importantly, subsidy dependence indexes should be carried out yearly and must figure prominently in all annual reports. Price differentials between market prices and the pricing policy of the institution should be included in reports. *Large exposures* and large defaulters should be listed by name and not afforded the confidentiality that is appropriate for private banks and their clients. Specialised government supported institutions should clearly differentiate between those activities they execute as an *agent for government* and for which government should pay them, and those activities on which they should achieve full cost recovery.

Following the private sector emphasis on reporting by companies to a level above financial reporting, e.g. the impact of the company's activities on the environment and contribution to social development, more and more pressure will be exerted on public sector entities to report in even more detail. Several innovative measurements already exist to measure outreach of development finance institutions and reliance on subsidies. The public and government would expect to be able to evaluate the level of investment needed of keeping the institution afloat compared to the resultant development performance of the institution.

Co-ordination
Experience in the current system and internationally suggests that the most efficient development impact is generally achieved where development investment occurs within a coherent and economically sustainable framework. This requires linkages between aspects like marketing and production and between investments in, for example, physical and social infrastructure. It also requires co-ordination between different state supported and owned institutions, as well as with the private sector, to ensure that no duplication of efforts and subsidies exist and that programmes are being executed comprehensively.

Donor support (external)
Donations (where received) should generally not be used to fund loans, but rather to build up human capital to manage credit risk intelligently. Important here is the implementation of a management information system that permits the tracking of loans on a weekly basis. Thus training, technical assistance and judicious support for computerisation are appropriate. Some of the institution's own funds should be committed to these endeavours as well, to ensure continued investment in management information systems upon donor withdrawal. Support should also not be directed at institutions, but at a sector. Therefore the same assistance should be possible through other institutions serving the same clients.

If such an institution performed well, it could offer through its extensive rural branch network a range of deposit and savings services for the poor (as legitimate a demand as for loans) far better than many NGO programmes (Graham & Von Pischke, 1995). Moreover portfolio diversification and extensive branching would alleviate the covariant risk associated with site specific unit banks or limited reach NGOs. These institutions can serve an agricultural clientele that is rarely included in NGO portfolios. Reformed state-owned banks should be in a good position to serve the input suppliers and output buyers at the wholesale level who play such an important role in lending downstream to micro-entrepreneurs. In short, these banks could positively shape the market environment within which micro-enterprises operate. In the end reformed rural development banks and NGOs (as well as other financial service providers) could complement each other in rural areas.

These reformed institutions would clearly not expand as rapidly as in their heyday of irresponsible portfolio growth. However, it is important that agricultural producers be relieved of any price penalisation and indeed benefit from well-designed government investments in human capital formation, agricultural research and related support services. Otherwise there will be an unfortunate tendency for policy makers to resort to subsidised credit through development banks as a convenient substitute for their failure to provide these services. In short, a threat will always exist for donors and the government to re-colonise these institutions with targeted loan programs and a political agenda, however, this is less likely in countries with intelligent agricultural support services and appropriate price policies (Graham, 1995).

4.5 Experience in South Africa

The transformation of South Africa reaches widely and has in many ways caught the country unawares. The transformation of its development finance system did not receive priority attention. Rather, specific institutions were transformed in piece meal fashion and the rest of the development finance sector had to take its cue from the implied policy of government emanating from restructuring of national level institutions. The process at the provincial level (retail level) was rather unstructured and transformation approaches were not standardised between provinces. This led to a range of development finance institutional formats being present. In some provinces the functions were pooled in one institution and these provide a so-called one-stop service. Other institutions were closed. The end result was that of the more than 150 parastatal institutions in the country in 1990 very few survived the political and institutional changes. The reasons mostly focus around the abolishment of the homeland system in the country with the demise of apartheid and gross inefficiencies as indicated by the Strauss Commission (1996).

The development banks and specifically the agricultural development banks escaped the willy-nilly approach to transformation. A national level study precedes the restructuring of the provincial development banks (Strauss Commission, 1996). This study investigated access to financial services for rural people and concluded that all institutions providing retail financial services in rural areas suffers from running at extremely high costs or suffering from limited reach, or both. This includes commercial banks, NGOs and development banks.

Immediately after the Strauss Commission reported the four development banks servicing rural areas were submitted to restructuring studies and strategies. These were the Ithala Development Finance Corporation[3] (Ithala) in the KwaZulu Natal province (who started the process already while the Commission was active), the Agricultural Bank of North West Province (Agribank), the Ciskeian Agricultural Bank (CAB) and the Agricultural Bank of Transkei (ABT), both from the Eastern Cape Province. In the rest of this section the main experiences gained during the restructuring processes of these institutions will be highlighted and compared. It will be shown that specific differences in the restructuring processes resulted in specific outcomes. Note that the restructuring processes are not complete and that we are highlighting preliminary lessons.

4.5.1 Three case studies

The background and relevant context of each institution will be sketched and then the restructuring process will be compared in terms of ownership, governance and the management of the process of transformation. The objective is to highlight essential difference in process and concomitant differences in outcome.

Eastern Cape province in context

The Eastern Cape is one of the poorest provinces in South Africa (see Table 4.1 for a comparison with South Africa). It suffers from the legacy of gross inefficiencies of the Transkei and Ciskei homeland governments. The inclusion of these two homelands' government departments made it difficult to rationalise the provincial government institutions. Major problems were experienced in the transformation and closure of a plethora of development parastatals. The process included court cases between the administration of the Eastern Cape and the employees of these parastatals. The two agricultural development banks were excluded from the transformation process of the rest of the parastatals for two reasons. Firstly, based on a specific strategy of the restructuring committee to separate the processes, and secondly, due to the fact that these two institutions were under the jurisdiction of the Department of Agriculture while several of the other parastatal institutions resorted under the Department of Economic Affairs of the province.

[3] This is the new name of the institution after the new legislation with respect to this institution was promulgated in March 1999. Previously the institution was known as the KwaZulu Finance and Investment Corporation.

Table 4.1: Some comparative indicators for South Africa and the Eastern Cape Province			
Indicators	Eastern Cape	South Africa	Eastern Cape/ South Africa (%)
Area (Km^2)	170 616	1 223 201	13.9
Population (1996)	6 302 000	40 583 000	15.5
Population growth, 1985-94 (%)	2.96	2.7	109.6
Functional urbanisation level, 1994 (%)	43.3	57.9	86.6
Literacy rate, 1991 (%)	72.34	82.16	87.9
Life expectancy, 1991 (years)	60.65	62.77	96.6
Human development index, 1991	0.507	0.677	74.8
Labour absorption capacity, 1993 (%)	44.8	50	89.6
Unemployment rate, 1994 (%)	45.3	32.6	139.0
Personal income per capita, 1994 (R)	3 985	8 418	47.3
GDP growth, 1980-91 (%)	1.7	1.3	130.8
Contribution to GDP, 1991 (%)	7.6	100	7.6
Real GGP per capita, 1991 (R)	2 971	6 438	46.1

The political instability in the province also impacted on the transformation process of the two agricultural banks. In the beginning of the process the provincial minister of agriculture resigned and a new minister took over. Midway in the proc ess, this was repeated, thus another new minister. The time spend by the minister on parastatal restructuring was mostly focused on those with problematic restructuring processes, including court cases. Thus, those not providing problems that had more low key approaches did not get the necessary attention and support from the political powers.

North West Province

Indicators	North West Province	South Africa	North West/ South Africa (%)
Area (Km^2)	118 710	1 223 201	9.7
Population (1996)	3 355 000	40 583 000	8.3
Population growth, 1985-94 (%)	3.2	2.7	118.5
Functional urbanisation level, 1994 (%)	49.8	57.9	86.0
Literacy rate, 1991 (%)	69.46	82.16	84.5
Life expectancy, 1991 (years)	59.66	62.77	95.1
Human development index, 1991	0.543	0.677	80.2
Labour absorption capacity, 1993 (%)	50	50	100.0
Unemployment rate, 1994 (%)	36.6	32.6	112.3
Personal income per capita, 1994 (R)	4 995	8 418	59.3
GDP growth, 1980-91 (%)	1.2	1.3	92.3
Contribution to GDP, 1991 (%)	5.7	100	5.7
Real GGP per capita, 1991 (R)	4385	6 438	68.1

The North West province depends largely on mining, agriculture and the public sector for its economic activity. Thus the Agribank of North West Province is supposed to play a prominent role in terms of financing development agriculture. Unfortunately the Bank is a classical example of the conventional agricultural bank extending severely subsidised products, very inefficient in follow-up and arrears management resulting in a periodic transfer from government to carry the Bank. Several attempts have been made to restructure the bank and earlier reports advised the bank to broaden its portfolio to include non-farm lending, to improve efficiency and to mobilise savings. However, none of the proposals were implemented and the Bank suffered from political interference, both during the time of the homeland government and after the political changes in South Africa. It is indeed also unfortunate that after the Bank's restructuring report was tabled in 1997 (Agribank Restructuring Report, 1997) no action was taken by the provincial Minister of Agriculture towards implementation. This political indecision resulted in further weakening of the Bank.

KwaZulu-Natal

KwaZulu-Natal is the province with the largest population is South Africa. Geographically it is a province of large contrast and the topography ranges from the fertile flatlands of the Natal midlands to the majestic peaks of the Drakensburg. It has a relatively large rural population involved in a myriad of activities

The Kwa-Zulu Finance and Investment Corporation (KFC), now Ithala, has been active in the province as the only provincial development finance institution and one of a relatively small number of parastatal institutions in the province. Ithala is engaged in three functional areas, viz. property development to house entrepreneurs, training and financial services. These three functions are operated separately. Whereas the other three banks are servicing only the agricultural sector, Ithala is engaged in various economic sectors, including agriculture. This must be considered in the interpretation of comparative figures.

Indicators	KwaZulu-Natal	South Africa	KwaZulu-Natal/ South Africa (%)
Area (Km^2)	91 481	1 223 201	7.5
Population (1996)	8 417 000	40 583 000	20.7
Population growth, 1985-94 (%)	2.91	2.7	107.8
Functional urbanisation level, 1994 (%)	45.9	57.9	79.3
Literacy rate, 1991 (%)	84.26	82.16	103.0
Life expectancy, 1991 (years)	61.55	62.77	98.1
Human development index, 1991	0.602	0.677	88.9
Labour absorption capacity, 1993 (%)	44.8	50	89.6
Unemployment rate, 1994 (%)	32.2	32.6	98.8
Personal income per capita, 1994 (R)	5 924	8 418	70.4
GDP growth, 1980-91 (%)	1.7	1.3	131.0
Contribution to GDP, 1991 (%)	14.9	100	14.9
Real GGP per capita, 1991 (R)	4 559	6 438	71.4

The transformation process unfolded within a political context that reflected the struggle between two strong political parties in the province. However, the transformation process directly resorted under the jurisdiction of the Minister of Economic Affairs and Tourism (today the Deputy President of South Africa) who is a strong political figure and who was closely involved with and supported the whole transformation process.

4.5.2 Performance indicators before restructuring

The Strauss Commission (1996) evaluated the four institutions under discussion in detail in 1995. Certain performance indicators are presented in Table 4.4. It is clear from the table that these institutions (excluding Ithala) had limited reach and were quite costly to operate. The analysis shows the portrait of conventional development banks. To bring it in context with international institutions a comparison was drawn with a few well-known international institutions and Agribank of Northwest province.

Table 4.4: Performance indicators for the provincial development banks (1995)

Indicator	CAB	ABT	Agribank	Ithala
SDI (%)	807,57	307,03	63,16	54,33
Typical loan %	16	14	14	16
Implied lending rate (%)	124,08	99,35	39,62	25,43
Market reference rate (%)	16,00	16,00	16,00	16,00
Return on equity (%)	1,98	-51,47	17,33	4,31
Branches	2	5	12	40
Deposit accounts	10882	0	225	214297
Average deposit size	510	n/r	217034	797
Loans outstanding	1775	4774	4431	30980
Average loan size	3671	3122	16713	20805
Agricultural loans outstanding	1323	4774	4431	10702
Average agricultural loan size	6705	3122	16713	2773
Arrears (% by volume)	14	39	35	12
Loans/staff	-	106	47	69
Volume lent/staff	465426	331215	787819	1432300
Loans/loan officer	254	238	148	620
Volume lent/loan officer	930839	745236	2468500	12890700
ROA	-4%	-74%	4%	4%
Implicit subsidy (Rmillion)	6,4	4,1	10,0	55,0
Implicit subsidy/borrower (R)	3,634	858	2,369	1,775
Interest earned/average portfolio	19	24	24	17
Interest paid/average portfolio	15	0	11	4
Gross margin	4	24	13	13
Non-interest expences/Ave. Port.	136	122	21	12
Return on averag loan book	-132	-98	-8	0
Typical deposit %	6	n/r	13	4

Table 4.5: Comparative indicators

1993/4 data	K-Rep Kenya	ACEP Senegal	FINCA C.Rica	Corposol Colombia	Bancosol Bolivia	Agribank NWP*
Loan book - $ million	1.1	2.1	1.5	11.7	24.8	23.4
Number of borrowers	5,303	2,109	5,121	32,022	46,428	4,015
Average loan size in $	207.4	995.7	292.9	365.4	534.2	5828.2
Salaries as % of average portfolio	12.9	10.6	8.7	18.2	12.5	11.3
Other operating expenses as % of average portfolio	6.1	8.5	4.7	3.3	8.5	4.6
Admin. expenses as % of average portfolio (incl. salaries)	19.0	19.1	13.4	21.5	21.0	15.9
Salaries as % of total administrative expenses	68	55	65	75	60	71

* ($1 = R4.5). Source: Eastern Cape Banks Restructuring Committee, 1997.

Table 4.6: Selected statistics for South African niche banks					
	Fidelity	Future	Mercantile	NRB	Agribank
Provision / gross advances (%)	1.8	3.5	n/a	1.1	0.1
Costs / total income (%)	40.8	67.2	92.1	60.8	113.9
Source: IBCA (1995) quoted by Eastern Cape Banks Restructuring Report, 1997.					

In Table 4.5 and 4.6 it is clear that performance of Agribank is lacking when compared to both international development finance institutions and South African niche banks. The situation of Agribank was representative of all the development banks (excluding Ithala) at the same time in South Africa.

4.5.3 The restructuring process

Several issues are at stake in the restructuring process of development banks. **Firstly**, the argument need to made whether a specific institution should continue to exist, thus an economic justification is needed for its existence. Where the institution is highly successful the argument can be made that it may be crowding out the private sector. Where it is quite inefficient it can be argued that it is costing the state more than the benefits flowing from it. This will be the first arguments made and the first hurdle to cross on the way to restructuring.

The **second** issue of importance is the guidelines or framework of restructuring. This refers to the emphasis of the new approach to development finance where institutions should strive to be self-sustainable and have a positive development impact and outreach. In this regard the issues concentrate on governance, ownership, autonomy, incentive-based systems and many more (see section 5 for the discussion of these aspects). These guidelines will ensure that most of the negative elements of the conventional approach will not be present in a restructured institution. Of paramount importance is the governance rules and application of those rules in the selection of appropriate governors and application of the governance rules. This emphasis echoes the international trends in the corporate sector where governance is being regarded as an important aspect of the organisation and where Board Members of institutions have an increased responsibility. It is steeped with principal agent problems and the cost of enforcement of contracts and monitoring these contracts.

The **third** important component has to do with the management of transformation and restructuring. Even where a good argument has been put forth on the reason for the institution and all governance and other rules have been adhered to the process of transformation and the way this process is managed and supported will ensure the difference between success and failure. Kotter (1995) argues that most transformation efforts fail due to the inability to manage the process of transformation. He proposes eight steps that should be followed (see table 4.7).

Once again following the eight steps in Table 4.7 may not necessarily lead to a successful transformation. It is important to ensure that the people responsible for change and being impacted on by change must accept all the benefits and the costs of change. People who perceive the changes and transformation to threaten their interests and positions will do anything in their power to block and derail the change process (Strebel, 1997). In the case of the transformation of the development banks in South Africa the four essential groups to buy into the process of change will be the clients of these institutions, the political establishment, the employees and their trade unions and the management of the banks. This translates to the **fourth** important component of transformation, being the politics of the change process. In the change process stakeholders can be classified in terms of the strength of their response to change and their attitude to change. It can be a strong reaction but positive, thus it will assist the transformation. If it is a weak response but negative, it can be managed. But a strong negative reaction can be severely damaging to the change process.

Table 4.7: Eight steps to transforming an organisation

Step 1	Establishing a sense of urgency	Thorough examination of the market, identifying and discussing crisis, potential crisis, and potential opportunities
Step 2	Forming a powerful guiding coalition	Assembling a group with enough power to lead the change effort and encouraging the group to work together as a team
Step 3	Creating a vision	Creating a vision to help direct the change effort and developing strategies for achieving that vision.
Step 4	Communicating that vision	Using every vehicle possible to communicate the new vision and strategies, teaching new behaviours by the example of the guiding coalition
Step 5	Empowering others to act on visions	Getting rid to obstacles of change, changing systems and structures that seriously undermines the vision, encouraging risk taking and non-traditional ideas, activities and actions
Step 6	Planning for and creating short term wins	Planning for visible performance improvements, creating those improvements, recognising and rewarding employees involved in the improvements
Step 7	Consolidating improvements and producing still more change	Using increased credibility to change systems, structures and policies that do not fit the vision, hiring promoting and developing employees who can implement the vision, reinvigorating the process with new projects, themes, and change agents
Step 8	Institutionalising new approaches	Articulating the connections between the new behaviours and success of the organisation, developing the means towards leadership growth and succession

Assessment of the transformation process of the provincial development banks

In this section the transformation process in the three provinces is discussed in terms of the four aspects outlined, viz. the rational for the existence of the institutions, the guidelines assisting in refocusing the institutions, the management of the change process and the politics of change. The transformation process of each of the three banks (considering CAB and ABT as one process) is described in broad brush strokes in Tables 4.8 to 4.10.

Table 4.8 specifically refers to the transformation process of Ithala. It is clear that governance and transformation process management issues were emphasised in the transformation. A closer analysis of the process reveals a close adherence to the eight steps of transformation (Kotter, 1995).

The formation of a powerful guiding coalition was embodied in the formation of this guiding group at ministerial level (as mentioned the Chairperson has recently been elected as Deputy President of South Africa). Consultation with all stakeholders throughout the process ensured that the politics of change were attended to and this resulted in a well-managed process that progressed, slowly, but surely from initiation to completion and implementation. It must be noted that the sound corporate governance structure that was in existence, track record and financial position of

Ithala and the less complicated parastatal structures in the province must have contributed to the level of success of the transformation process thus far.

In the case of the Eastern Cape Banks the justification of the motivation for a state assisted development bank was based on the lack of financial services in the rural areas of the province and the closure of a large number of commercial bank branches. The process of transformation of the Eastern Cape Banks is depicted in Table 4.9.

Table 4.8: Transformation process of Ithala from 1995 - 1999

03/95 to 01/96 ❑ Review business practises, suggest process of transformation, some initial organisational restructuring, review products and services, adoption of single trading name Ithala	07/96 to 09/96 ❑ Workshop with responsible minister and department officials. ❑ Provincial cabinet establishes restructuring body consisting of minister and members of parliament and representative of KFC board. ❑ Brief: recommend mandate, governance structure, funding and name	11/96 to 07/97 ❑ Establish a resource team and team of specialists to draft policy and legislation. ❑ First consultation with stakeholders to explain process and invite comments on process. ❑ Correspondence from Minister informing stakeholders of progress
10/97 to 02/98 ❑ Submit policy document ❑ Consult with external stakeholders ❑ Incorporate written comments by stakeholders	02/98 to 05/98 ❑ Inviting and addressing extended stakeholder comments period ❑ Investigated private sector equity participation ❑ Finalise policy document	06/98 to 09/98 ❑ Draft and finalise legislation ❑ Request comments from all formal bodies ❑ Submit legislation to cabinet committee and approve for submission to parliament
10/98 to 02/99 ❑ Submission and publication of legislation ❑ Public hearings ❑ Approval for submission to provincial parliament	03/99 to 04/99 ❑ Ithala Development Finance Act promulgated ❑ Board of Directors nominated, selected and appointed ❑ Inaugural Board Meeting ❑ Shareholder confirms Chairperson and Deputy Chairperson	05/99 to 06/99 ❑ Roll-out of transformed organisation, launch of new corporate identity, review of current activities

Table 4.9: Transformation process of Eastern Cape Banks from 1996 - 1999		
09/96 to 02/97	03/97 to 06/97	01/98 to 12/98
❑ Appoint restructuring team ❑ Investigate and study the two banks ❑ Submit restructuring report detailing current state of banks, principles for reform, reform strategy in broad brush strokes	❑ Minister studies the report ❑ Minister approves report and present it to stakeholders	❑ Appoint same interim board for both banks with brief to implement restructuring process ❑ Also brief to oversee operation of banks in interim period ❑ Process slow and drawn-out with no specified milestones ❑ Board selected designated CEO
01/99 to 03/99	04/99 to 05/99	06/99 to 09/99
❑ Completed legislation and submitted ❑ Devised business plan ❑ Consult with employees ❑ Devised information sy stem requirements ❑ Legislation not served as scheduled	❑ Legislation not served as scheduled ❑ Task teams work on human resources policy, credit and financial policy ❑ Delays provide opportunities for unionisation of one bank and entrenchment of the power of labour unions	❑ Still awaiting legislation to be passed by parliament and cabinet

The guidelines for transformation and following the new approach were well defined and reflected in the Eastern Cape Bank's Restructuring Report (1997). When one consider the third aspect, management of the change process, it is clear that several elements have been neglected. The most prominent being the formation of a powerful coalition to drive the process and secondly the achievement of short term gains. However, the biggest problem in the Eastern Cape was the complete lack of management of the politics of change. Neglect of this aspect resulted in polarisation of the transformation team. This was especially severe in that the transformation process will necessarily result in retrenchment of some staff, a situation that was capitalised on by the trade unions. This was aggravated by the neglect of the political players to afford the process the necessary attention resulting in continuous delays and a lack in the sense of urgency regarding transformation.

In the case of the Agribank of the North West Province the same arguments were followed to justify the transformation decision. Similar to the other rural areas concerned commercial bank activity was on the decline and a political imperative was placed on the development of the small farmer sector. The guidelines in terms of the new approach were applied in the transformation proposals. However, it was evident that these were not to the liking of the political fraternity who commissioned the transformation report. Autonomy of the institution and a specific structuring of the governance structure to ensure no political interference with day to day management of the Bank went directly against the profile of interaction between the powers at be and bank management. Management of the transformation process could not be implemented, as government has never formally accepted the report. The subsequent decisions by the government in the province reflected their tacit disagreement with the report as their decisions were directly opposite to the guidelines that directed the thinking of the transformation team and that was stated in the report (Agribank Restructuring Report, 1997). The transformation process of Agribank is summarised in Table 4.10.

Table 4.10: Transformation process of Agribank of Northwest Province 1997 - 1999		
03/97 to 07/97	08/97 to 11/97	12/97 to 09/99
❑ After earlier attempts in 1992 and 1994 appoint restructuring team ❑ Investigate and study the bank ❑ Bank suffers from staff corruption and loose large amounts ❑ Submit restructuring report detailing current state of bank, principles for reform, reform strategy in broad brush strokes	❑ Minister studies the report ❑ Several discussions on the report, no conclusive decisions ❑ Minister decide to amalgamate bank and another parastatal	❑ No evidence of implementation ❑ Bank arrears increase at alarming rate and suffers from internal problems

It is clear from the above analysis that the three transformation endeavours have distinct differences that resulted in distinctly different outcomes. In the next section the performance of these institutions are measured to ascertain the impact of the transformation process (incomplete as is) on the performance of the institutions.

Measurement of performance

The direct relationship between specific approach to transformation and concomitant impact on development performance indicators has not been investigated. Some development performance indicators are however presented in this section merely as indicative of the performance of the different institutions during the transformation period. Data was not available from all the institutions for all the years. The 1995 analysis of the Strauss Commission (1996) serve as benchmark of the start of the transformation period in most of these institutions under discussion. Information was available from all the institutions except Agribank of North West Province, for which the latest information available is for the 1997 financial year.

In figure 4.1 the changes in the SDIs of the different banks are indicated. Ithala managed to improve their SDI over the period from 54 to 20 per cent. In the same period Ithala increased the number of savings clients from 214 297 in 1995 (total value of R171 million and average balance of R797) to 731 145 in 1998 (total value R421 million). In 1999 the number of savings accounts opened increased by a further 123 807 accounts to 854 952 (total value of R561 million and average balance of R648). Ithala is the only provincial level development finance institution that provides information on development performance. They reported in 1999 (Ithala Annual Report, 1999) on agricultural land redistributed, home owners created, jobs created, people trained and total enterprises assisted and established. These were all favourable improvements on a year to year basis over the last five years. For every R1 share capital of the provincial government Ithala invested R5.48 in development in the province in 1999. The Ithala investments further incentivised a private sector investment on a Rand to Rand basis over the same period. The subsidy flow from the provincial government to Ithala decreased from 17 per cent of total capital investment to 8 per cent of total capital investment. The provincial government's transfer is used as a source of capital for further investment rather than a source of funds for recurrent expenditure.

Agribank's SDI worsened from 63 per cent in 1995 to 153 per cent in 1997. They further experienced major difficulties with the repayment of debts and repayment of clients. Internal problems, including corruption, also contributed to this dismal performance (Coetzee, 1997; Coetzee et al, 1999).

The SDIs of the Eastern Cape Banks indicate a mixed performance. ABT's SDI worsened from 307 per cent in 1995 to 749 per cent in 1998. The bank's bad debt and arrears situation worsened and today the Bank is incapable of expanding its book with a minimum of new loans added on a monthly basis. Thus both sustainability and outreach suffered tremendously during the transformation process. The CAB's performance measured in terms of the SDI improved from 808 per cent in 1995 to 249 per cent in 1998. Their outreach decreased in terms of larger loans (to farmers) and increased in terms of smaller loans that are extended on a group basis to a broad spectrum of rural entrepreneurs. The uptake of the latter is at a high rate and over the last 18 months a repayment rate of 100 per cent was achieved. The SDI of this bank is negatively influenced by a conservative approach to expanding their book, resulting in a large portion of funds kept in reserves.

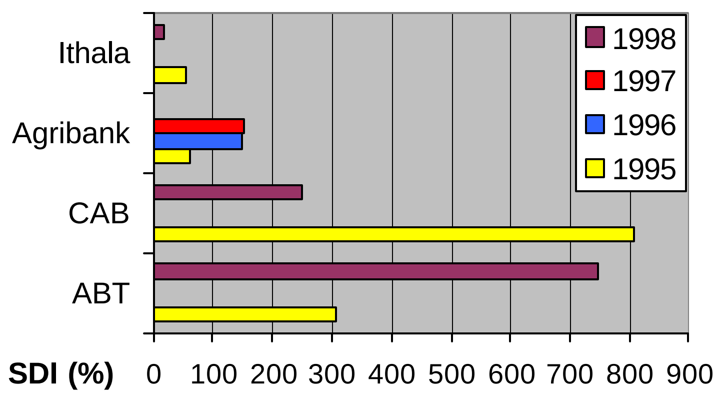

Figure 4.1: Changes in Agricultural Development Bank SDI values (%) - 1995 to 1998

The discussion on the performance indicators does not attempt to relate the changes as experienced directly to the transformation process. Several other influences are not discussed, inter alia, the management approach and efficiency of each organisation, the economic and agro-climatic reality of the environment that they operate in, the overall existence of other support services and the state of physical and social infrastructure. This implies that the improvement or deterioration in levels of indicators may be ascribed to several other influences, than only the impact of the transformation process. However, it is argued that the transformation process will also have an impact and that a loose correlation would exist between the success of transformation processes and the broad environment within which it take place.

4.6 Conclusion

The reality of the absence of private sector retail financial institutions in rural areas, compared to urban areas, necessitate the application of a broad range of institutions and also a re-look at the role of agricultural development banks. This, however, implies development banks in a different guise and also implies the need for restructuring and the economic rationale and principles of restructuring need to be clearly spelled out. This is also not enough. The process of transformation must be managed efficiently and the political aspects of transformation must be attended to as well. This relates to the impact of transformation on the different stakeholders in these institutions. Experience in South Africa indicates that over and above the four critical rules or questions, the process must have a clear vision of the eventual outcome and all stakeholders must share this. Also, specifically with respect to the political leaders the process will not succeed without the political will to go through with the transformation. Financial and development indicators provide a good indication of the success story when these aspects have been adequately addressed in the transformation process.

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