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MAKING LAND BANKS VIABLE: TWO SUCCESSFUL APPROACHES TO COLLECTING LOANS MADE TO SMALL FARMERS IN CENTRAL AMERICA AND THE CARIBBEAN

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Many agricultural credit programs in Latin America founder, in part because interest rates are too low to cover operating costs and the true cost of obtaining loanable funds.[2/] However, the biggest cost component is usually losses for uncollectible loans. Just as for loans to large farm operators, the delinquency rate is often more than 20% and may reach 50% or more. It is neither possible nor fair to attempt to cover such a loss rate with the interest rate charged to borrowers who do repay.

Various governments in Central America and the Caribbean are now considering the feasibility of creating Land Banks or similar mortgage financing facilities to enable the landless and small farmers to buy parcels of farm land in the market. Like agricultural production credit, if any Land Bank is to be viable and replicable, borrowers must be persuaded that debts must be repaid. This will not be easy, given decades of traditional Governmental tolerance of non-payment of production debt and of land debts under land reform programs.

Nonetheless, it is possible to eliminate delinquency as a major part of operating costs of credit programs. This report describes two real

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2/ The classic critique of "soft" agricultural lending programs in Latin America is by Dale W. Adams and Douglas H. Graham, Undermining Rural Development with Cheap Credit. Colorado: Westview Press, 1984.

programs, one public and one private, in which lenders actually obtain 100% collection of loans made, with very low costs and no serious political costs. The first uses long-term leases with an option to buy, as a method of land purchase finance. The second uses a novel, temporary, peer intervention as an effective method of collecting production credit without the costs and hassles of foreclosure on the borrower's land.

Persons analyzing the feasibility of Land Banks and similar programs in any country might well discuss these two cases with bankers and politicians, in order to build in methods of obtaining an equally solid collection record in any new financial programs.

I. Land Sales in El Salvador

The record of campesino payment of land debts in El Salvador is as bad as that of large landowners; very poor. Before the 1980 land reforms, the Banco de Fomento Agropecuario had financed the transfer of about a dozen farms to cooperatives; the Bank paid the former owner, and then the cooperative failed to repay the Bank. The Bank, state-owned, was politically unable to evict the cooperative, and the loans were just rolled over year after year.

In Phase I of the 1980 land reform, farm holdings in excess of 500 hectares were transferred to cooperatives made up essentially of the former resident laborers of those farms.

ISTA, the agency involved, was rife with paternalism and patronage politics. Many of its staff wanted to turn their temporary jobs into lifetime career employment, supervising the land reform cooperatives. What were supposed to be cooperatives in transition to worker-owned and worker-managed enterprises thus became de-facto state farms. Sensing this, the cooperatives maximized fringe benefits and made very few payments on their land debts. Since no one was evicted and no other sanctions were applied, the tradition that land debts need not be paid was strengthened. The Cristiani Government has begun a process of genuine sale, but progress is slow.[3/]

A. A Private Sector Alternative:

Meanwhile, a commercial real estate broker has developed a highly-successful program to divide suburban lands into house lots, which he sells on long-term leases with an option to buy, by merely making the last payment on time. The advantage of this method is that in El Salvador it is easy to evict someone for non-payment of rent, whereas foreclosure of a mortgage is a long and difficult process.

Knowing that he can and will be evicted promptly if he fails to make a payment, the land buyer makes the necessary effort to keep up to date. The broker has one resident employee at each subdivision, who collects payments but also counsels the delinquent to sell their rights to someone else, rather than be evicted. The new buyer simply assumes the remainder of the debt; the former buyer gets back whatever part of his investment he can persuade the new buyer to pay him.

According to the broker, delinquency has never exceeded 8% of amounts due, and that occurs at Christmas time, when it is the broker's policy

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3/ For an exhaustive bibliography of reference material on the Salvadoran Agrarian Reform, see J. Strasma, "Bibliografía Sobre la Reforma Agrarian Salvadoreña," Staff Paper No. 290, Department of Agricultural Economics, University of Wisconsin - Madison, 1989. An analytical update appeared in the summer of 1990, as J. Strasma, "Consolidating Agrarian Reform," a Report to USAID, San Salvador.

to tolerate one overdue payment where the employee believes the hard luck story told by the buyer. However, by the time the second payment is overdue, the buyer/tenant must pay up or move out.

B. Professionals and Yuppies are Not Wanted in this Program:

Most of this broker's business is in ten suburban subdivisions, which are sold as house and garden lots rather than for farming. While urban middle class employees and professionals often buy rural lots along paved roads, for weekend pleasure cottages, this broker is not interested in selling to them on credit. He much prefers to sell to campesinos, whom he finds to be much more likely to pay in full and on time. Also, they live on their lots, so the broker's employee can find them easily when payment is overdue.

When an architect or other urban professional buys a lot for a weekend pleasure retreat and gets behind, he has to be pursued by telephone or with a trip to the city. He hides behind a secretary, or tells you "the check is in the mail," raising the cost of collection and eviction. And at times the broker himself must deal with politically-influential debtors, whereas his field agent can deal with the campesino or urban poor who buy most of his lots.

C. This Model Has Been Applied to One Farm Already:

The broker has already divided up one farm into parcels for campesinos, and is eager to do more. His main problem is to find landowners willing to sell on his model. In that model, the broker puts up all the costs of surveying, internal roads, tilting, sales and collection, and the landowner only puts in the land. However, the seller agrees to accept his share of payments only at the rate at which they are made by the buyers, which is typically 20% down and 8 years for the balance, with no grade period.

This model would appear to be ideal for farms held by banks that have foreclosed on land given as collateral for unpaid loans. Thus far, however, the banks have refused to hire the broker to dispose of the land, often because the overdue debt with interest exceeds the real market value of the land. The bank prefers to carry the overdue debt rather than write it down to the true market value of the collateral -- so the land remains poorly-run and unavailable to small farmers.

This model, of a long-term lease that can be transferred freely to another small farmer if the first one is unable to make payments, and which becomes a registered, freehold property ownership when the last payment is made, has been 100% successful in eliminating loan delinquency in land sale finance.

II. Agricultural Production Credit in the Dominican Republic

The Agricultural Bank (BAGRICOLA) of the Dominican Republic, part of the public sector, has been no more successful at collecting loans made than have most similar institutions elsewhere. However, their loans to rice grower cooperatives in the Rincon area, in the center of the country, achieve virtually 100% repayments, on time, thanks to the invention of a sort of temporary peer intervention, in replacement of traditional collection methods.

The Bank makes one loan, wholesale, to each Cooperative. These are made up of land reform beneficiaries who now farm individual parcels, but use the Cooperatives to solve problems of input supplies, land preparation, and access to credit. The Cooperative then on-lends to each member.

All members of each Cooperative accept liability for the production credit debts of all other members. However, unlike many solidarity groups elsewhere, the model appears to be viable. The reason is that the members have agreed in advance that when a member is delinquent in repayment, the group may seize his parcel informally, at once, and without legal proceedings. The parcel is then farmed by the cooperative itself, or more commonly, is rented out to a member who can handle more land than he now has. With the cash thus obtained, the cooperative reimburses itself for the loan repayment it made on behalf of the delinquent borrower.

B. <u>Payments Due Must Not Exceed Rental Value of the Land</u>

This model is now five years old, and according to the Bank and to the Cooperative leaders interviewed, it is working perfectly. An acid test was passed last year, when the President and the Treasurer of one of these cooperatives themselves got involved in an off-farm project and their harvests were poor, so that they were unable to repay all of their own production debts.

These members could have abused their position of power and prestige in the Cooperative. However, they said in a regular meeting that they were perfectly aware of the rules, and that in order to make it clear that the rules apply to all, they were leaving their parcels for six months so that the Cooperative could rent out the parcels and pay off the debts due. With this solid precedent, much applauded by the campesinos, the model appears to be viable.

For success, of course, it is essential that the amount of debt due not exceed the rental value of the parcel. That is attainable when the debt is production credit, with the loan being a fraction of the value of the harvest expected. It might not be possible when the debt includes principal and interest on a land debt, possibly in addition to production credit due.

Thus, as with all land sale programs through market mechanisms, the price of land must be low enough to permit repayment out of the income earned by farming, or from off-farm earnings. The market value of land often includes elements of prestige, inflation-hedging, or other non-farming values.[4/] However, this is not always the case, and even where it is, a significant down payment may bring the periodic debt service down to the point where the campesino land buyer can make the payments.[5/]

4/ Hans Binswanger (at the World Bank) argues strenuously that this fact makes it all but impossible for campesinos to buy land through market processes, or for governments to carry out compensated land reforms in which the beneficiaries are supposed to pay for the land they receive. I believe he is too pessimistic, in part because land values are sometimes depressed by the fear of violence or confiscatory expropriation, and in part because some campesinos are perfectly able to make down payments, if governments will abandon paternalistic attitudes and demand down payments from those who want to be among the first beneficiaries of a land program. Church and non-governmental organizations are also often well able to identify truly promising potential small farmers, and to finance down payments on their behalf on a grant or soft loan basis.

5/ The down payment is absolutely necessary for success in land market finance mechanisms. I will analyze that issue further in a forthcoming Staff Paper on Land Banks, to be published by the Land Tenure Center in 1991.

Conclusion

At least two programs have shown that it is possible to achieve 100% recovery of debts from campesinos in Central America and the Caribbean, if one insists on it, and sets up a mechanism that evicts the debtor at low cost in the event of non-payment.

Success also means that governments and lenders must abandon any paternalistic attitude that assumes that campesino land buyers must be kept on the land even if they do not make enough money farming to meet their debt service. On the contrary, those who suffer personal misfortunes or are not successful farmers for whatever other reason, must be allowed to transfer their land to another campesino and move on.

In many countries, including El Salvador and the Dominican Republic, this means repealing present laws or rules that forbid a campesino from selling his assigned parcel to someone else. The essence of the success of the two programs described is that they have both succeeded in evading these rules. The program in El Salvador is set up as a lease, not a sale, but upon making the final agreed-upon payment, the lessor gets the parcel with a full freehold title, duly registered in his or her name. And the lessor/buyer is free at any time to transfer his rights to another campesino for whatever price they agree upon; the new lessor\buyer just assumes the balance of the debt due.

In the Dominican Republic, the program works because the land reform agency and the government bank look the other way. Despite laws prohibiting rents and the transfer of land reform parcels, the debtor's friends and neighbors foreclose, temporarily, on the delinquent borrower and rent his parcel out for cash with which to pay off his overdue debt. Thus the campesinos themselves overcome one of the problems associated with the obstinate refusal of successive Dominican governments to issue negotiable, alienable land titles to campesinos, even 26 years after the land reform began.[6/]

Successful Land Bank programs must adopt these or equally effective methods of ensuring repayment, or their capital will soon be exhausted and they will be neither viable nor replicable.

6/ Non-campesinos, on the other hand, have succeeded in obtaining registered freehold titles to land reform agency land in more than 1,000 instances. In some cases, this land was government urban property given in payment to those whose land was expropriated for land reform. However, in many instances it appears to have been ordinary corruption, in which agency staff and even the Director enriched themselves by selling land reform land to private individuals for cash. See F. M. Gil, Traspasos de Terrenos del Instituto Agrario Dominicano, 1962-1989. Santo Domingo: Unidad de Estudios de Politica Agropecuaria, 1990.