RESTRUCTURING RURAL FINANCIAL INSTITUTIONS

Gerhard Coetzee
Policy Analyst, Centre for Policy and Information Analysis, Development Bank of SA, Midrand

South Africa is in a process of change. This is also true for the agricultural sector and thus all related services. Agricultural finance, as a segment of rural finance, is the topic of an intended commission of inquiry. The current and intended public sector agricultural financial support structure should be measured against a set of guidelines. These are elaborated on in this paper. In addition, given the framework, some views are put forward as to what direction rural finance, and specifically agricultural finance should take, and what structure should be applicable, given the principles as outlined. The paper is concluded with some remarks about institutional change in South Africa and the intended rural financial services commission of inquiry.

1. Introduction

In 1991, at this conference, a paper (Coetzee, 1991) was read on the challenges facing financial institutions financing agriculture in South Africa. These challenges were presented and summarised in terms of three possible change areas, namely:

- Acknowledgement of the total agricultural sector, meaning there are more farmers than large scale commercial farmers out there.
- The above should culminate in a total shift in mind set. Thus rethink the clients, the services and the rules.
- Leading to the third proposed change, that is, forget about the conventional definitions of collateral and security.

It is a fair question to ask how did financial institutions respond to these proposed changes? In the public sector both the Land Bank (Land Bank, 1994) and the Agricultural Credit Board (Task Team on Agricultural Financing, 1994) released policy statements indicating their willingness and proposals to serve the total agricultural sector. The Development Bank started financing equity schemes in the commercial farming areas (DBSA, 1994). All these institutions together with the development corporations, co-operatives and commercial banks worked actively together in looking for solutions to these proposed changes. In the private sector we saw COSAB (Council of South African Banks) supporting (financially) the establishment of the Community Bank. In the semi-public sector more NGO's were established as on-lenders to clients, unfortunately with mostly an urban bias. It seems that South Africa's financial institutions reacted to the challenges of our times.

In order to build on these positive initiatives the first aim in this paper is to propose some tests or guidelines for intended policy changes. Thus rather a test of policy proposals than the proposals themselves. In the second section proposals will be put forward in broad terms as to what direction rural finance, and specifically agricultural finance should take, and what structure should be applicable, given the guidelines as outlined. The paper is concluded with some remarks on the processes of change and specifically the Rural Financial Services Commission of Inquiry.

2. Guidelines

In earlier papers (see Coetzee *et al*, 1993; Coetzee *et al*, 1994) on the role and activities of the public sector in agricultural finance the emphasis was placed on policy proposals, for example, the state should as far as possible be a wholesale financier and how the state should apply subsidies. With the intended Rural Financial Services Commission of Inquiry and the current activities of most financiers in rethinking their approaches, guidelines for policy making becomes an important contribution to be made. These guidelines (or tests for policy) are mostly based on the work of Beghin and Fafchamps (1994) who proposed a simple taxonomy of institutions and governance concepts applicable to the comparative analysis of the political economy of agricultural policies.

The first question to be answered is how to bring about good institutions? Good institutions will lower transaction costs and increase efficiency in economic exchange. Good institutions further are based on clearly defined property rights and uncomplicated contract enforcement. This in turn is only possible if the correct information is available and the legal system is amiable. Thus two tests are evident, i.e. are property rights secured and is the rule of law enforced. In essence we are looking at clarity in terms of benefits of programmes and enforceability of the law related to these programmes.

Further, state programmes should be both implementable and predictable[1]. As stated earlier, the people should be clear on the rules of the programme and who the beneficiaries will be and the programme should be implementable in practise, for example, it should be in tune with the constitution and be implementable in terms of the capacity of institutions and the training of people. Thus it should be realistic.

The willingness of government to let the market discipline work and to ensure the mobility of resources (economic openness) and the contestability of political markets and public service provision, transparency of the policy making process and the participation of pressure groups (political openness) relate to openness in general. Openness is one of the underlying concepts of good governance.

Related to some of the above concepts, for example implementability, one can also test policy based on whether it "fits" the constitution. In practise this also relates to whether it is implementable within the central/provincial structure and whether it addresses the demands of the RDP (ANC, 1994).

If our aim is to achieve efficient institutions, what could be the role of government to reach this aim given the above broad guidelines? This in essence goes to the core of two views in economics on the role of government. Some economists argue that by understanding the causes of

[1] Begin and Fafchamps (1994) use the concepts of predictability and enforcement in relation to the rule of law. It should apply to all state actions.

market failure (symmetric and asymmetric information) we are led to the conclusion that there is little scope for efficiency enhancing government interventions (Besley, 1994). Other argue that the recognition of transaction costs and imperfect information justifies the traditional role of government, thus intervention (Stiglitz, 1989).

However, in practise we have examples of both the outcomes predicted by both approaches. In terms of the first view, i.e. government intervention where the market already failed, we can use the conventional approach to farm credit programmes and the failure of this approach as an example (Coetzee, 1988). For the alternative view and in rural financial markets, only a few examples are known (e.g. Bank Rakyat in Indonesia) (Chaves and Gonzalez-Vega, 1993). For the latter view a collection of experiences serves as basis for arguing why and how governments should intervene in rural financial markets.

Further, government can indirectly intervene by facilitating transactions between different agents in the economy. In agrarian communities local agents have superior information about the expected behaviour of community members (Fafchamps et al, 1994). This information allows them to reduce adverse selection and moral hazard but they are constrained in their ability to diversify risk and more potential exists for enforcement problems due to close relationships with local power structures. One way to solve this through government action is the linking of external and internal agents, thus solving external agents' information problems and internal agents' risk managing and enforcement problems.

Fafchamps *et al* (1994) provide several examples of how the state can intervene on behalf of competitiveness. These examples range from state intervention on the incentive of gains based on institutional change; intervention based on the ability to provide information superior to that of civil society; redistribution of assets and the redefining of property rights; investment in infrastructure, education and technology (Thompson, 1994) in order to reduce transaction costs and to oil the working of the market; the diffusion of information; and the decreasing of risk for poor families by, for example, food for work programmes.

Thus opportunities are plentiful, but these interventions can easily backfire through rent seeking and mismanagement. These interventions also need to navigate the political economy of political feasibility (Fafchamps *et al*, 1994). This in itself is a challenge to any government.

3. Future public sector support for agricultural finance

3.1 Role of the state in agricultural financing

The purpose of this section is to reflect on current thought on the role of the state in agricultural financing. In the past the state played a broad role. From the early eighties there was a clear turn about in that role. This is also true of other supporting services provided by the state. The changing role of the state in agricultural marketing is a clear example. As for financing, the turn about began as a change of the role of the state in the financial market. From the beginning of the 80's the farming community was exposed to positive real interest rates and the tax benefits of farmers changed. The abnormal droughts of the late 80's and early 90's also caused such increases in state guarantees to farmers that the state was compelled to reconsider its role. The drought relief package of R3,8 billion had as purpose the reconciliation of aid given to farmers outside the budget. In this manner the state therefore gave a clear message to the commercial farming sector, i.e. blanket guarantees are over.

Currently the role of the state in agricultural financing is being examined again on a broad base. In reaction to the above discussion of guidelines the role of the state is:

- To create a favourable milieu within which the private sector can perform. This is not only true for private sector financiers, but for all the other support services provided by the private sector. The core of the objective is therefore to decrease the private sector's perception of risk in respect of agriculture. This could be achieved essentially by making information available and/or enabling the private sector to build up an information base of its farming clients on its own.
- To pay intense attention to agricultural development. For current circumstances this implies that the approach of the state in effect shifts from exclusive attention to the commercial farming sector to the developing farming sector. This does not, however, imply neglect of the commercial sector, but rather that the commercial sector benefits from the state's actions regarding the creation of a milieu and the developing sector from the second role, the development of agriculture.[2]

3.2 Financing functions of the state

The current role-players in agricultural financing are shown in this section (see Table 1). An effort is also made to identify future role-players on the strength of the proposed financing function of the state (see Table 2).

The role of the state in respect of agricultural financing can be divided into four basic functions, viz.
- Emergency relief
- Land financing
- Risk financing
- Short and medium term development financing

3.2.1 Emergency relief

This is regarded as the role of the state in situations of abnormal drought and other disasters caused by floods and fire. The emphasis is on abnormal, which affects entire regions. Specific measures apply to this relief that will not be dealt with in detail in this report. The Department of Agriculture (National and/or Provincial level) bears the primary responsibility for the financing of emergency relief.

[2] The agricultural history of South Africa serves as a good guide for discussions. At the beginning of this century, the government emphasised their responsibility towards agricultural development. All agricultural policies (and agricultural legislation) were aimed at developing agriculture, and to protect the developing agriculture against the harsh realities of the market. The farming community that was supported was the white farmers. The current shift in emphasis constitutes a return to that role for the state, but on an inclusive rather than an exclusive basis.

Table 1: Current role players

Organisation	Source of funds	Finance function	Target
Public sector Land and Agricultural banks DBSA Departments of Agric. Other Departments? Dev. Corporations	Public sector/National capital market/ Foreign capital markets	Land General agricultural development Emergency aid	Specific institutions targeted specific farmer groups
Private sector Commercial banks Co-operatives NGOs Moneylenders Family and friends Other financiers	Own funds Savings/Investors Loans Levies	- Range from short to long term credit - Production credit	As decided by the institution

Table 2: Future financiers

Organisation	Source of funds	Finance function	Target
Public sector - Dept. of Agriculture/ Provincial Departments of Agriculture/ Development Corporations - Land Financier - Development financier - Risk financier	Public sector/National capital market/ Foreign capital markets/donor funds	- Land - Emergency aid - Risk finance - Short and medium term development finance - Infrastructure: Social and physical	- Emergency aid (inclusive) - Other finance (exclusive) - Infrastructure (inclusive)
Private sector Commercial Banks Co-operatives NGO's Credit Unions Community Banks Money lenders Informal groups Family and friends	Own funds Savings/Investors Loans Levies Public sector	Range from short to long term finance	As decided by the institution

The following three financing functions are aimed broadly at agricultural development. Also, agricultural restructuring necessitates investment in the process of restructuring. This entails facilitation and research costs and are normally borne by the state or financed by donor contributions. The latter method however runs the danger of being used or the perception created that external agents have more impact on government actions than civil society.

3.2.2 Land financing

The purpose of this function is to cause access to agriculture for those farmers, including the small holders, who did not have ready access to agricultural land in the past. The financing institution that becomes involved must have experience of and the capacity for land financing.

3.2.3 Risk financing

There is a clear need for a financier that could serve as a bridging financier between the public and the private sector. A client who is ready to be serviced by the private sector in cases where the private sector is still unwilling to bear all the risk immediately, would therefore be the target market of this type of financing. Support in this instance will be as guarantees (partial) which will contribute to the clients' ability to conform to the collateral requirements of the private sector financiers.

3.2.4 Short and medium term development financing

This financing need will of necessity be applicable where the private sector is unwilling to be the financier (except in cases where guarantees can be made applicable[3]). The public sector can then provide the financing as wholesaler of agricultural financing by means of other institutions. The types of institutions can range from co-operatives, credit unions, NGO's, community banks to credit co-operatives[4].

3. Their are more instruments to use than only guarantees. Where the public sector finances the infrastructural component (e.g., bulk water supply for an irrigation project) the risk is decreased for the private sector to enter as a financier, due to a decrease in weather risk). In this example the public sector created a conducive milieu for the private sector within which to enter as a financier.

4 Credit union and credit co-operative refers to an organisational form where the members save as a group and credit is extended to members only. Community Bank refers to a similar structure that provide broader financial services, does not involve contractual savings - it is similar to the original building societies in South Africa and fills a gap in the market not serviced by commercial banks.

3.3 The role of the current state agricultural financiers

The current range of state financiers of agriculture (see Table 1) are mostly still captured by their traditional roles. Policy declarations and discussions however reflected the willingness to change. The whole system still emphasis credit as an instrument. However, concepts like market related interest rates are now more easily accepted by the financiers.

3.4 Future financing structure

At this time the only way in which to reflect a view on the future structure of public sector agricultural financing is to look at the convergence of strategic views. These views are the culmination of discussions and analysis over the past few years by both the state agricultural financiers and private sector financiers. This view is also based on the discussion of the guidelines in an earlier section.

Constitutionally agriculture is a responsibility of the provincial governments. In practise all related services provided by government will also be implemented at provincial level. It therefore makes a lot of sense that financial intermediation at the ground level will firstly be a ground level private sector responsibility, and that where we find that markets do not exist, or market failure could be argued, a role can be considered for the state. Should enough justification be found for state intervention it calls for a state supported financing mechanism at provincial level.

According to the new views on the method of intervention (see Coetzee et al (1993) for a discussion of these views) this should take place in the form of an financial intermediary that provide a range of services (savings facilities, credit and transmission services) across a broad range of sectors. This intermediary should be both wholesaler and retailer. The wholesale function would accommodate the links between ground level information sources and the intermediary and also a retail function with larger clients would apply. In this way the intermediary can also manage risk by having a diverse range of clients in terms of scale and activities. Savings mobilisation must be emphasised by these intermediaries and support in the form of subsidies from government should not be applied to decrease interest rates but rather to decrease transactions cost, enhance infrastructure and the capitalization of the institution.

This support and government sources of finance can flow from specialised wholesalers at the national level. In this way activities can be co-ordinated horizontally at the wholesale level nationally and at the retail level provincially. In this regard at the national level institutions are needed that will fulfil the financing functions as described earlier. Part of the wholesale development support function at the national level will be a financier that cuts across sectors, financing the enabling environment creator role of the state in terms of the demands of the RDP.

The application of the discussed rule here would test such a structure. Does it fit constitutionally? Is it implementable? Is the environment conducive ito clear laws and economic and political openness? As stated by De Gorter and Swinnen (1994), is the legal, regulatory and institutional framework of such a nature that it enables the working of government policy, and more important, the activities in the market between agents?

3.5 Financing functions of the private sector

In principle, the public sector cannot directly instruct the private sector where, how and who to finance. The state, can however, by providing an incentive structure, influence the private sector to provide services in circumstances where, without state assistance, the private sector normally will not be willing to intermediate, due to perceived risks. The state can achieve this by, for example, providing equity financing mechanisms and guarantee schemes. This should be approached cautiously, as inadequate structuring of schemes may lead to inefficiencies.

In essence commercial banks state the prerequisite of the profit objective in a legal environment. They acknowledge the role in socio-economic development, but it should still adhere to the profit motive. A careful analysis of the financial behaviour of rural dwellers (mostly black rural dwellers)[5] indicates that a small segment of rural dwellers is already in a position to qualify as commercial bank clients, given their stated criteria. It is perceived that commercial banks themselves do not possess enough information on this segment to structure and provide services. The state, in its role as the creator of the conducive environment, should in its policy planning address this information need of the private sector. This could be achieved by using mechanisms such as, for example, guarantee systems.

4. Conclusion

The planned Rural Financial Services Commission of Inquiry will address the future financing structure in rural areas in more detail. The above structure and especially rules should be considered by the inquiry. In practise most institutions in agricultural finance have been party to discussions in this regard. It is evident that there is a convergence of strategic notions. Thus in practice the inquiry is a formalisation of an already ongoing process. One would expect that some of the future recommendations of the commission therefore would already be in implementation. However, the danger of such a statement may well be to interpret it as the status quo being followed. Our interpretation is that that will not be the case, and therefore that each institution need in earnest and with an open mind to revisit the proposals of 1991 and to study what we offered in this paper.

It also has to be said that institutional restructuring should emphasise rationalisation, to cut out overlaps, but not to lose expertise, capacity, experience and to make sure that this is applied efficiently. We in South Africa has done things that the rest of the world cannot even conceptualise. We are therefore convinced that we, as South Africans, will solve this one as well, and in fact, we are solving it even now.

References

ANC. (1994). The reconstruction and development programme.

---

[5] Done by Charles Simkins of the University of the Witwatersrand for the Community Bank.

BEGHIN, JOHN AND FAFCHAMPS, MARCEL. (1994). Constitutions, institutions and political economy of farm policies: What empirical content? Invited paper read at the International Conference of Agricultural Economists, Harare, August 22-29.

BESLEY, TIMOTHY. (1994). How do market failures justify interventions in rural credit markets. World Bank Observer, 9:27-47.

CHAVES, RODRIGO AND GONZALEZ-VEGA, CLAUDIO. (1993). Incentive systems in rural financial intermediaries: Case studies from Indonesia. Finance 2000 Conference, 25-26 May, Washington D.C.

COETZEE, GK; BREYTENBACH, S AND STANDER, J. (1994). An agricultural finance servicing structure for the Western Cape from a government point of view. Proposal prepared for the Working Group on the Restructuring of the Department of Agricultture in the Western Cape, Elsenburg.

COETZEE, GK; KIRSTEN, MA AND CHRISTO-DOULOU, NT. (1993). Financing entrepreneurs in rural areas: A new approach. Paper delivered at the Annual conference of the Agricultural Economics Association of South Africa, Cape Town.

COETZEE, GK. (1991). Financing agriculture - challenges to financial institutions. Agrekon, Vol 30, No 4:203-209.

COETZEE, GK. (1988). The financing of small farmer agricultural production (in Afrikaans). Unpublished MSc dissertation, University of Stellenbosch.

DBSA. (1994). Development Bank of Southern Africa, Annual Report 1993 - 1994. Halfway House.

DE GORTER, HARRY AND SWINNEN, JO. (1994). Political and institutional determinants of agricultural policy. Paper read at the International Conference of Agricultural Economists, 22-29 August, Harare.

FAFCHAMPS, MARCEL; DE JANVRY, ALAIN and SA-DOULET, ELIZABETH. (1994). Transaction costs, Market failures, Competitiveness and the state. International Conference of Agricultural Economists, August, Harare.

LAND BANK. (1994). Agricultural Financing. Land and Agricultural Bank of South Africa.

STIGLITZ. JOSEPH. (1989). The economic role of the state. Blackwells, Cambridge.

TASK TEAM ON AGRICULTURAL FINANCING. (1994). Draft minutes of the meeting of the Task Team on Agricultural Finance held at Secosaf, Pretoria, 17 May.

THOMPSON, ROBERT. (1994). Summary and final comments on the 1994 IAAE conference. 22-29 August, Harare.