



Commercial Banking for Rural Development: a Cautionary Tale

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Abstract. This paper describes the strategy adopted by a large commercial bank to start lending for rural development, a sector with which it was not familiar. Nevertheless, it chose a supply-side (rather than demand-driven) approach to financing introduction of new crops, entered into a partnership with an ill-informed foreign aid agency, by-passed local institutional structures (both public and private), and failed to understand its intended clients – all of which doomed the project. The author explains how use of the AIC methodology could have led to a more successful project: most critical was to start with a learning process to identify key stakeholders and policy issues; then to generate a genuine consensus on project objectives and a strategy to overcome policy obstacles; establish cooperative relationships with key stakeholders; and finally devise incentives to motivate the bank's own staff.

Background.

Bank of Commerce International (BCI), a public sector bank in a South Asian country, had the reputation of being a successful and innovative bank, just as its private predecessor which had been nationalized in the late 1960s. Not surprisingly, when the country's Government started giving priority to the development of its rural areas, BCI decided to become a leader in rural development lending. And to that intent, it chose one of its branch offices, branch AB@, to pilot the program.

Branch AB@ had been established around 1985 with the objective of providing credit to the surrounding areas= villages with a population of about 300,000 people. Branch AB@ had the additional responsibility of being the convener of the Banker's Committee which was responsible for overseeing all Government programs in the District that relied on the banking sector for their implementation. By the late 1990s, as the area had been designated as a potential agricultural belt, branch AB@ was given ambitious targets by BCI's management not only regarding its profitability but also the volume of its agricultural lending and rural development activities.

As it happened, adoption of these new targets had coincided with a massive computerization program of BCI as a whole, which had required branch AB@ to reduce its staff by offering voluntary retirement options to existing employees. Progress with the computerization program, however, had been much slower than expected and had resulted in an excessive workload for the remaining employees.

To accelerate its expansion of lending for agriculture and rural development, BCI decided to associate with the Government's Horticulture Development project (HDP) which had been launched with the help of a European Union Development Agency (EUD). HDP's program was aimed at improving the production and marketing of fruits and vegetables and thus at raising farmers' incomes; and it was run by a new agency under the State's Government. The program proposed the formation of groups of farmers who were most likely to adopt the cultivation of fruits and vegetables; and once successful, these farmers groups were expected to disseminate to other farmers= groups the technical knowledge they had acquired. The project also proposed that the fruits and vegetables would be grown on all the project area's fallow lands which would be leased to the farmers' groups. And because the banks in the Sate were expected to play a crucial role as financiers of the new projects, the program was designed as a partnership between the banks and HDP. Under such partnerships, the banks were supposed to help HDP officials identify the potential adopting farmers and link their groups to the bank. Furthermore, contrary to the normal banking

¹ Final paper prepared for the PIDP seminar AInstitutional Design for Sustainable Development@, Fall 2004 and edited by Professor Francis Lethem.



principle that investment promotion should be kept separate from the appraisal of a client's creditworthiness, the HPD program, which disposed of only one official per project area, also expected the banks' agricultural lending officers to train the farmers they had identified, encourage them to take up cultivation of the new crops, and then lend to them.

Preoccupied with their lending targets (which in the case of branch AB^o corresponded to a 200 % increase of its agricultural loan portfolio), BCI officials reluctantly agreed to enter into the proposed partnership, with the hope that as a side benefit, such lending would enhance the bank's standing among the area's population. In addition, bank officials thought that the resulting closer linkages with the farmers would enable it to improve its performance regarding recovery of non-performing loans. Meanwhile, the State government and District officials were praising the program as it promised to dramatically change agricultural practices in the area and lead to increased farmers' incomes. The program was therefore inaugurated in 1999 in one pilot area with the formation of two groups consisting of 20 farmers each. The hope was that pretty soon, all farmers in the area would be constituted into similar groups and linked with the bank.

Project results four years later

A review of the program and the achievements of branch AB^o was carried out in late 2003 by BCI's regional office. It was found that the program had not increased the branch's agricultural lending. The number of groups formed was only 9, or about 10 % of the target. It was also found that very few farmers had taken up the new crops. HDP officials had almost abandoned activities in the area and were accusing the branch of not doing enough to promote the program. The branch officials, on the other hand, were arguing that the recovery of loans under the program was so poor that they could not continue to promote it and further add non-performing assets to its portfolio: that would have eroded its profitability and hence, its good name.

In light of the above findings, BCI's regional office requested that branch AB^o not proceed further with the program, which by the end of the year was closed altogether.

What went wrong with the pilot project and why?

To interpret the causes of the pilot project's failure and propose an alternative approach, this paper reviews the project's experience with the help of the AIC methodology of institutional design. This methodology is based on consideration of an institution's external environments, namely the enabling/policy environment that it must appreciate and value since it does not have control or influence over it; and its *Ainfluenceable*^o institutional environment which consists of those entities whose support it needs to achieve its purposes B i.e., in addition to its *Ainternal*^o or *Acontrollable*^o environment (see chart in annex for a graphic representation of the project's three institutional environments). The AIC methodology also requires design to start by ensuring the legitimacy of the institution in the eyes of its key stakeholders who should share, or at least not oppose, its purposes and constitutes the *Aappreciative*^o stage of design. Only then would the design of the necessary interagency linkages be carried out (*Ainfluence*^o stage of design), followed by the application of the classical organization design theories to the *Ainternal*^o environment².

² See <http://www.odii.com/> under the section "Papers", Wholeness: The Development of a New Philosophy and Model and Process of Organization, by William E. Smith, Ph.D. 2001; and The Design of Organizations for Rural Development, World Bank Staff Working Paper no. 375 March 1980, by William E. Smith, Francis Lethem, and Ben Thoolen.



A. Appreciated/ enabling institutional environment

In this case, the most important aspect of the project was the degree of farmers' involvement. But before implementing the program, the farmers' preferences and interests were not assessed. It was **assumed** that the farmers would accept the program as long as the bank was willing to finance it. In the project area, however, most of the farmers were cultivating rice and other cash crops such as rubber, and were not prepared to switch to new crops just because of the availability of financing. In other words, there was little demand for the program in that area and no steps had been taken to create such a demand for the program. As a minimum, market demand should have been assessed, and a "model farm budget" prepared, with and without the project, to test its profitability for individual farmers vs. that of present crops; and the availability of farmers= time needed for such additional activities.

Program designers were also at fault for not having considered whether there would be regulatory obstacles to the eligibility of farmer groups as borrowers. Unfortunately, it turned out that while the program envisaged cultivation by farmers= groups on leased lands so as to utilize all the area=s unused lands, various banking rules forbade financing of new projects on temporarily leased land.

I. Influenceable institutional environment

While project designers informed the local government and other government agencies such as the State agricultural department about the program before it was launched, these agencies were not involved in its design, the selection of beneficiary farmers, or the selection of appropriate crops for the area. For instance, before proposing the establishment of a new market for farmers under the program, designers should have assessed the suitability of existing marketing systems in the area. All these design elements were agreed upon exclusively between the bank=s branch and HDP officials. The local government=s reaction was to campaign against the program and oppose the establishment of a new local market. As a consequence, the farmers who had joined the program had to sell their produce to existing market intermediaries at lower prices than anticipated. And even though the issue of establishing new marketing arrangements was ultimately resolved, the delays adversely affected the willingness of other farmers to join the program.

Regarding the State agricultural department, since they had been left out of the program and HDP/bank officials did not coordinate with them on the content of the extension messages communicated to the farmers, such messages turned out from time to time to be contradictory. Again, it took a lot of time and efforts for the bank and HDP to discover and repair the damage, and to find out that the agricultural department was already using farmers= associations for technology transfer -- and thus that they could have cooperated with such existing associations from the very beginning of the program. Worse, some of the farmers= associations which had not been consulted, had initially (and correctly) advised their members not to join the program on the grounds that there were no assured markets for the new produce.

C. Controllable environment

There were also problems with the branch=s internal environment. First of all, as a result of the slow implementation of BCI=s computerization program, branch B=s clerical staff whose number had been reduced by almost half, were clearly overloaded. Contrary to the design expectations, they were therefore unavailable to assist with the HDP program. Worse, it turned out that the branch=s senior manager didn't have much authority over its clerical staff: even though they formally reported to him, he had no authority



over them in matters of financial rewards or punishments. Branch B's senior manager thus had few incentives at his disposal to get the staff to cooperate with the program, except through their annual performance appraisal. But even that was of little use, as many of the clerical staff who had been with the bank for almost 20 years didn't care about their appraisal reports which had no impact on their salary level. In fact their main worry was that they would have a too good performance appraisal, which might lead to a promotion and that such promotion would most likely entail a transfer to a distant location and getting more responsibilities -- though with only limited additional compensation. Finally, the clerical staff was strongly unionized and their unions had objected to their members being asked to do the additional work required for the program's success.

Under these circumstances, the branch's senior manager felt that he had no choice but to entrust the entire program to his already overburdened five officers and the HDP technical specialist, and to do without the input of the branch's clerical staff. But that again assumed that the bank officer in charge of the program would have the necessary knowledge to appraise and finance agricultural projects B which unfortunately was not the case. This led to arbitrary and ill-informed lending decisions, and undermined the bank's credibility in the eyes of the farmers. As to the other officers, their workload was such that they had too little time to even renew the existing working capital loans that were being repaid by the farmers B which resulted in discouraging timely loan repayments. And needless to say, these bank officers could not find the time to attend the farmers' group meetings so that these stopped altogether. Ultimately, the membership of the program declined, as the farmers and their group leaders lost interest.

What could have been done with the use of the AIC methodology?

As so often when reviewing cases of institutional failure, it helps very much to go back to the first, Appreciative@, stage of design and imagine what could, or should have been done; then to proceed to the Influence@ stage of design; and only at this point look into the Controlled@ stage of design.

1. Appreciative stage of design.

Before launching the project, HDP and bank officials should have identified all key stakeholders, carried out a thorough field study and project appraisal, and in particular consulted in depth with the farmers and local government. They should probably also have convened a meeting of key stakeholders, namely the farmers, the bank's staff, local government officials, representatives of farmers' associations, the State agricultural department, and the local agri-business community. They should have explained to them the project concept and its expected beneficial effects, with the help of model farm and manpower budgets. They should have verified that there was a consensus on the program's objectives and merits, and that all key stakeholders were committed to its success. And only then should they have started to design the program, while lobbying with BCI's senior management, senior HDP officials, and European Union representatives to obtain the necessary changes in banking regulations regarding lending for new projects on leased land.

2. Influence stage of design

a. Bringing local farmers under the project. One of the most important factors in the program's failure was that farmers were not comfortable switching from grain production to growing horticultural crops that required more intensive farming and greater use of chemicals. Since the recommended early consultations should have revealed this problem, HDP and the bank could have conducted classes for farmers about the appropriate use of chemicals and other agricultural practices, and should have obtained their agreement about the types of crops that would be introduced in the area and at what pace. Also, information should have been given about the marketing opportunities for these crops and about successful precedents in the country. To reinforce their advice, HDP and the bank could have



organized field trips for potential lead farmers and leaders of farmers= associations identified by the Sate agriculture department to learn from other ongoing programs in the country that were operating well. This would have allowed the farmers and their representatives to observe things in practice and discuss their concerns with their peers until satisfied with their answers. Thereafter, HDP would have been in a better position to launch a pilot and demonstration program in the area with some of these lead farmers, before attempting to replicate the program with other farmers/ groups.

b. Getting the bank=s employees to work for the project. In the case of branch AB@, since its staff was outside management=s control, influence techniques should have been used to overcome the staff=s fears that HDP and the BCI=s regional office were attempting to further increase their workload without proper compensation. For instance, the bank=s regional management could have consulted the clerical staff and their union leaders, and made arrangements to reduce their other workload; or if not feasible, proposed a bonus system and other forms of monetary and non-monetary compensation. Such a dialogue and possible agreement would have gone a long way towards benefiting the program, especially since many of the staff were familiar with the local area and could have become some kind of resource persons for the farmers= groups.

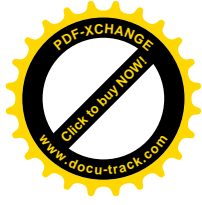
3. Control stage of design

In the long run, if BCI is to be able to replicate its pilot project into a viable agricultural lending program, it must expand its Acontrollable@ environment at branch level. This can be done through various ways. One way would be to increase the attractiveness of promotions for the staff, e.g., by providing them with incentives such as major increases in salaries or other benefits, as well as by reducing the hardships created by the transfer policy and related displacements. In addition, branch managers should be given a budget and the authority (a) to reward financially individual staff for good performance; and (b) to organize the necessary training for both branch officers and staff before launching new programs such as this one. Finally, periodic reviews of program performance and design should be conducted, so as to allow suitable corrective actions at branch, regional, and national levels, as necessary to ensure replicability of the program to all of BCI=s rural branches.

Conclusion

In this case study, it can be seen that at the time of design, none of the three institutional environments were favorable for the implementation of the program, and that measures were not taken to understand these environments and correct the deficiencies. This led ultimately to the program=s failure. Instead, a sequential and more participative approach to design (and redesign) should have been adopted, starting with (A) identification of key stakeholders and policy issues, and establishment of common purposes and a common vision; followed by (I) cooptation of farmers= associations, groups and individual farmers, as well as of BCI=s branch staff; and finally (C) expanding the controllable institutional environment at branch level while establishing the necessary feedback and learning mechanisms at all levels of the bank.

While this experience was painful for BCI, it should also be seen as an opportunity for it to rethink its approach to the financing of rural development projects, as well as the launching of other new activities in the future.



THE PROJECT'S INSTITUTIONAL ENVIRONMENTS

