THE RURAL BANKING SYSTEM: NEED FOR REFORMS

by

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I. Introduction

The rural banking system (RBS) which has extensive network in the rural areas certainly plays a big role in providing the agricultural sector financial services. With a well-functioning rural banking system, the currently renewed emphasis on agricultural development should find few obstacles. Unfortunately, however, the rural banking system is currently fighting for its own survival. While they were adjusting to the new policy environment initiated in 1980, an economic crisis unprecedented in the country's post-war history struck in the middle of 1983. It has seriously affected the viability of most rural banks. The subsequent twist in policy which includes, among others, the use of market-related rediscount taxes, sharp reduction in rediscounting and withdrawal of tax exemptions, has further aggravated their problems.

Several questions immediately come to our mind. Under an entirely different policy environment, do rural banks have a role to play in this renewed emphasis on agricultural development? If so, what measures should be taken to rehabilitate the rural banking system and assure its survival under this new competitive environment?

This paper basically addresses those questions. The next section reviews important financial policies and performance of the rural banking system. Section III discusses possible roles of the RBS under this competitive environment. The last section presents some measures to rehabilitate and strengthen the RBS.

II. Review of Financial Policies and Performance of the Rural Banking System

Rural banks may well be considered as supply leading institutions. Their creation was primarily intended to provide folks in the rural areas access to financial services which financial institutions located in the urban areas failed to provide. The fairly wide distribution of rural banks in the countryside could enhance people's savings efforts and, at the same time, generate "favorable expectational and psychological effects on entrepreneurs." Since at the initial stage rural banks may not operate profitably, the government provided them substantial direct and indirect subsidies (see Table I). It is noteworthy that no timeframe for the withdrawal of these subsidies had been stipulated. Thus, rural banks have considered most of them as permanent features in their operation.

Rural Banks were designed to be small. In the first place, they were made unit banks. Their growth therefore, has to depend on the growth of the area they are serving. Secondly, they were permitted to lend only to small farmers who have 50 hectares of land or less dedicated to agricultural production and to small merchants and small business enterprises whose capital investments do not exceed ₱100.000. And lastly, tax policies tend to reward small banks and penalize big banks.

The low interest rate policy from the 50s up to the 70s was primarily aimed at stimulating investment. Savings mobilization was thus put to the background. For rural banks, it means that they have to take the responsibility of protecting small farmers and entrepreneurs from "loansharks". Since the low interest rate policy had served as a disincentive to saving, rural banks had to operate with severely limited loanable funds. Unmet credit demands, therefore, still had to go to the informal credit market.

The introduction of new farm technology in the second half of the 60s and the 70s substantially altered the agricultural credit policy of government from one of merely protecting small farmers into one of increasing agricultural output. Aside from acquiring knowledge about the new technology, additional working capital was needed so that farmers can adopt the new farm technology. Since small farmers usually realize only little savings from their farm income, the additional working capital has to come from the credit market. Instead of leaving to the rural banks the task of meeting new credit demands through increased savings mobilization--which admittedly could take a long time since interest rates on deposits were relatively unattractive--the Central Bank has tried to meet the increased credit demand partly through money creation, partly by taxing commercial banks (e.g. P.D. 717), and partly by borrowing abroad. The rural banks are made as conduits of these funds. There is no doubt that this policy has contributed to the rapid adoption of new farm technology, and hence, increased agricultural output. However, it has completely changed the character of rural banks. With the relatively attractive spread between rediscount and lending rates - which is supposed to cover administrative cost and credit risk - rural banks became increasingly dependent on borrowings from the Central Bank. In the 70s, the Central Bank vigorously pursued the policy of having a rural bank for each town. One of the objectives was to make the adoption of new farm technology more widespread by making cheap credit accessible to more farmers, especially small ones. This has resulted in the proliferation of rural banks even in marginal areas where it is impossible to have a viable rural bank without substantial government and Central Bank support.

The 1980 financial reforms have emphasized efficiency through competition. Barriers to competition which were legally imposed have been removed. Savings mobilization has to be stressed rather than borrowings from the Central Bank. All financial institutions are expected to adopt the posture of a real financial intermediary. For rural banks to be competitive in the new environment, capital build-up has been encouraged. However, rural banks still continued to enjoy the same Central Bank and government support. Hence, they preferred to remain mainly as conduits of Central Bank funds rather than intermediaries intermediating between surplus and deficit units in view of profit opportunities in this activity. It is understandable then that their ability to deliver credit to the agricultural sector largely depends on CB's rediscounting policy.

The rural banking system was badly affected by the economic crisis that struck in 1983. A lot of their borrowers were unable to repay their loans, and they in turn were piling up arrearages with the Central Bank. The switch to market-related rediscount rate, sharp reduction in the volume of rediscounting with the Central Bank, and sudden withdrawal of tax exemptions are market surprises that were not fully anticipated by rural banks. Adjustments to this new policy environment would certainly be more difficult than if they were predicted and properly discounted by the rural banks.

Perhaps it is worthwhile at this point to refer to some data about the financial performance of the rural banking system. Table II gives the system's sources of funds. Deposits used to be their main source of funds. Starting in 1974, however, the RBS tended to rely more on CB borrowings. This occurred at the time when the CB intensified further its support to the agricultural sector through its various rediscounting window. Note that deposits per rural bank have been increasing, indicating the success of rural banks in mobilizing savings in the countryside. The growth rates in deposits per bank were particularly higher during the floating interest rate regime. This may indicate the potentials of mobilizing savings in the countryside since surplus units respond to incentives. The growth rates in the capital accounts per bank were also significantly higher during the floating interest rate regime compared to the previous years. This may be one indication of the efforts of rural banks to position themselves in an increasingly competitive environment. Note, however, that even after the financial reforms, CB borrowings still constituted a major source of funds for rural banks.

The performance of rural banking system in terms of increasing its total resources pales in comparison with those of other banking institutions. The share of rural banking system in the total resources of the banking system has been declining (see Table III).

The rural banking system is the least successful in mobilizing savings among banking institutions (see Table IV). The share of its deposits in total deposits of the banking system has been shrinking. Its reliance on CB borrowings is more conspicuous than that of the commercial and thrift banking systems (see Table V).

The profitability of the rural banking system had been consistently declining over the past few years (see Table VI). However, it had been consistenly higher than those of the commercial and thrift banking systems. Its ROI (7.8%) in 1984 was higher than that of the commercial banking system (5.2%), but lower than that of the thrift banking system (10.4%). It should however be noted that the favorable performance of the RBS in this respect could be attributed mainly to the substantial CB and government subsidies it had received.

The 1985 financial performance of the rural banking system will likely be bleaker because of substantial reduction of their lending activities. In 1984, arrearages with the Central Bank already reached at unprecedented levels constituting about 72 percent of their outstanding rediscounts (see Table VII). They will probably have to scale down their lending operations, and since agricultural loans usually constitute about 80 percent of their loan portfolio, their reduced lending operations will certainly have severe consequences on the flow of credit to the agricultural sector.

III. Renewed Emphasis on Agricultural Development and the Role of the Rural Banking System

The renewed emphasis on agricultural development is anchored on the belief that the agricultural sector will assume the leading role in the economic recovery. However, the current approach adopted to stimulate the agricultural sector substantially differs from the previous one. Whereas before, the agricultural sector used to be pampered with subsidies, the current approach to agricultural development is market-oriented. Prices of both the agricultural products and factor inputs will be fully deregulated and subsidies be phased out. Under this framework, it is hoped that resources would freely flow into the agricultural sector in view of the relative attractiveness of this economic activity.

These reforms are accompanied with changes in monetary and credit policies. Whereas before selective credit policies were stressed, the recent policy will focus on the use of monetary instruments for stabilization purposes. Although Central Bank credit would still flow into the agricultural sector as well as to other sectors, this time the flow will be dictated by the market. The rediscounting rate will eventually be based on the prevailing market rate.

Under this new policy framework, rural banks would lose their most important source of revenue, i.e., Central Bank subsidies through rediscounting. To remain in the market, they have to transform themselves from mere conduits of CB funds into real financial intermediaries. Like any other financial intermediary, the rural banks' main role is to stimulate saving in the countryside by offering surplus units a higher return on their savings than they would realize through self-financed investment and to allocate funds to the most productive activities.

The continuation of the operations of rural banks is indeed very important. Their wide distribution in the countryside would assure the continuous flow of intermediated funds to agriculture and agriculture-related activities. Moreover, their familiarity with the economic conditions in the areas where they are operating and their stock of information regarding the potentials of various economic activities in the locality and personal characters of prospective borrowers would allow them to make a better assessment of the risk and return of prospective economic projects.

In this case, rural banks would not tend to overestimate the risk of socially desirable projects; hence, the cost of loans will likely not be higher than their true social cost. If banks currently existing in the rural areas ceased to operate, other financial institutions will be less inclined to enter the area where no other financial institutions operate, except the rural bank. The adverse consequences on agriculture credit would likely be felt, unless the informal credit market fully picks up the slack.

The specific roles that rural banks will have to play in this new policy environment depends on the kind of relationship they would have with other financial institutions, notably big commercial banks. It may be worthwhile to explore some of the possible relationships.

(1) Rural banks may be directly competing with other financial institutions in a locality both in the deposit and loan markets. In this regard, the size of a rural bank is very important since it determines its ability to compete with other financial institutions, especially branches of commercial banks.

(2) Rural banks may not be directly competing with other financial institutions. That is, rural banks may opt to specialize in servicing small clients (e.g., small rice and corn farmers),

while branches of commercial banks may cater to the needs of big clients (e.g., sugar and banana planters) in the same region. Of course, their comparative advantage should dictate their choice.

(3) Rural banks and commercial banks may perform complementary functions. In this case, a formal tieup, either permanent or temporary, may be forged between rural and commercial banks so that the latter can participate in agriculture credit even if they do not have the same extensive market penetration as rural banks. For example, commercial banks may place deposits at rural banks at relatively attractive rates. The latter, in turn, on-lend them to local borrowers. Thus, commercial banks act as wholesalers while rural banks act as retailers. There are a lot of working arrangements that could be worked out between the two financial institutions, but what is important is that funds flow to the rural banks to augment the funds they have mobilized in their own locality.

(4) Rural banks may become branches or subsidiaries of commercial banks. In this regard, UCPB's experience may be worth

mentioning. It has "infused in some 16 rural banks and four thrift banks nationwide a total of ₱145 million in additional capital". Aside from increasing the capital base of these banks, UCPB has also introduced professionalism in the management of bank's resources by training the local bank owners and managers. Thus, the additional skills of local managers, their stock of information about local conditions and personal characters of potential clients, and the increased capital base are blended together to make those rural and thrift banks truly competitive in the countryside.

IV. Some Suggestions for Rehabilitating the Rural Banking System

The discussions above have pointed out the possible roles of rural banks in maintaining or increasing the flow of credit to the agricultural sector under the new policy framework. However, the present predicament of rural banks is indeed a big hindrance for them to play such roles in the future. Because of their very limited network and the concentration of their operations in urban centers, other banking institutions are in no position to substitute the rural banks even in the near future. It is, therefore, necessary to rehabilitate the rural banking system and allow them to adjust smoothly to the new policy environment. The following are some suggestions for rehabilitating the banking system.

(1) Restructuring of Arrearages

According to a TBAC study, about 80 percent of total operating rural banks cannot participate in government programs due to arrears with the Central Bank. Eighty (80) percent of total arrearages can be attributed to defaulted loans of borrowers. To help banks adjust to the new policy environment, the proposed 10-year restructuring scheme, which would include a five-year moratorium on the payment of loan principal should be considered seriously. However, in view of the policy of government to strengthen the rural banking system, the restructuring of arrearages has to be applied selectively. The set of criteria for restructuring arrearages of individual banks should include the following: (a) integrity of bank management; (b) agricultural output potentials of the area where the rural bank is operating; (c) banks' deposit growth potentials; (d) fulfillment of the required minimum net worth to risk assets ratio; and (e) potentials for broadening the capital base.

Perhaps, the most sensitive issue of restructuring arrearages is determining what interest rate to use. The Central Bank might prefer to use the market-related rediscount rate, while the rural banks might press for the use of the old rediscount rate. This paper suggests an alternative rediscount rate. That is a rate which is X% lower than the prevailing market rate but higher than the old rate may be used as a rediscount rate. It shall be adjusted each year until it reaches the market rate towards the last year of the restructuring period. To discourage rural banks from defaulting, the penalty for defaults should be related to the prevailing cost of money.

(2) Withdrawal of Tax Exemptions

The abrupt withdrawal of tax exemptions was ill-timed because it occurred at a time when revenues of rural banks were badly affected by the unusually high loan defaults of borrowers. Moreover, it was totally unexpected by rural banks. Such unexpected development would certainly result in greater dislocations than if it was anticipated and properly discounted by banks. Instead of abruptly withdrawing tax exemptions, this paper suggests a gradual phasing out of those exemptions within a certain period, say five years. In addition, tax credits may be given to rural banks who are making efforts to broaden their capital base. Such privilege should, however, be withdrawn after a certain period.

(3) Broadening the Capital Base

Broadening the capital base of rural banks should be encouraged. It may be accomplished in at least three, not mutually exclusive, ways.

a) Internal Capital Buildrup. A TBAC study shows the eagerness of bank owners to increase capitalization in order to continue operation after the economic crisis struck. This may not be a widespread practice, but it still shows some positive signs. There are reasons why bank owners may not want to infuse additional capital to their banks. One possible reason is that the withdrawal of tax exemptions has consistently reduced bank profits which could have been ploughed back. Our suggestion to gradually phase out the tax exemptions may encourage bank owners to increase bank capitalization by ploughing back profits. Another possible reason is that the 20 percent ceiling on individual/family group stockholding in a rural bank provides a disincentive to stockholders who might want to increase their shares. In view of the need to increase capitalization of rural banks in order to continue operation and stay competitive, the ceiling may be increased to 50 percent provided that it is accomplished through infusion of new money, not through buying the shares of other stockholders. Still another reason is the high yields on virtually riskless CB and Treasury Bills which are definitely more attractive than the yields on bank shares. This is a macroeconomic problem that must be approached from a more comprehensive view. However, it is important to point out here that the high interest rates on those securities may have also siphoned off capital that could have been used to increase rural bank capitalization.

(b) Attracting External Funds. This may involve selling shares to potential stockholders. However, the presence of high-yielding CB and Treasury Bills would give rural banks difficulty in selling their shares unless they guarantee equivalent yield. One feasible alternative is to encourage rural banks to sell shares, either preferred or common, to commercial banks. The investments of commercial banks on those shares may qualify as part of the mandatory requirement stipulated in P.D. 717. This may be less onerous to commercial banks. At the same time, it would give them a mechanism to find out the economic opportunities available in the rural areas.

(c) Merger/Consolidation. This has been stressed in the 1980 financial reforms as one of the means of broadening the capital base of rural banks. Perhaps, the experience of the First Consolidated Rural Bank of Bohol with regard to consolidation can be examined and shared with other rural banks as a way of encouraging more consolidation in other regions.

TABLE I

EXEMPTIONS AND PRIVILEGES OF RURAL BANKS

Exemptions		Privileges	
Taxes, charges and fees[1]	Others	From Central Bank	From Other Gov't Agencies
1. Income Tax 2. Fixed tax for banks[2] 3. Documentary stamp tax 4. Tax on income of banks 5. Firearms tax 6. Deposit interest tax 7. Real Property Tax 8. All local tax (such as transfer tax, building permit fee, municipal secretary's fee, market fees or rentals, tolls for roads, bridges and canals, permit to engage in business and residence tax) except for the annual business tax 9. Property registration fees 10. Docketing fees, sheriff's fee 11. Regulation fees for motor vehicles 12. Fees to the Securities and Exchange Commission	1. From registration fees, charges and documentary stamps on any instrument relating to transactions or loans extended by the RB. 2. From publication in newspapers of foreclosure notices where the principal of the loan and interest due do not exceed ₱10,000.00.	1. Free technical assistance 2. Free training of bank officers 3. Free from management takeover expenses 4. Loan by CB to RB on collateral of assets of RB, in emergencies and financial crisis 5. Loan to RB through CB of funds from international lending institutions 6. Rediscounting of STD Funds from CB	1. Advice on Business and farm management by other gov't. agencies 2. Counterpart fund from the Development Bank of the Philippines 3. Free notarial service on documents by municipal and city judges 4. Borrowings from the Development Bank of the Philippines 5. Compulsory deposit insurance coverage 6. Guarantee coverage of certain supervised

[1] Exemption applies only when net assets less counterpart does not exceed ₱1M; however, if it exceeds ₱1M but does not go beyond ₱3M, the taxes, charges or fees shall be levied in proportion to that said excess bears to the net assets. When net assets exceeds ₱3M, the RB shall pay all taxes, fees and charges.

[2] Fixed tax of ₱2,000.00 shall be collected form banks, insurance companies, finance and investment companies, doing business in the Philippines and franchise grantees (Sec. 192 gg). Fixed taxes in the National Internal Revenue Code refer only to fixed taxes on business.

Source: [illegible] (1990)

TABLE II

RURAL BANKS' SOURCES OF FUNDS

Year	Deposits No. of RBs	Borrowings No. of RBs	Capital Accounts No. of RBs
1972	544839.2	395939.0	487309.6
1973	699044.5 (28.3)	611464.9 (54.4)	514331.2 (5.5)
1974	821022.7 (17.4)	1454545.4 (137.9)	532670.4 (3.6)
1975	882812.5 (7.5)	1940104.1 (33.4)	554687.5 (4.1)
1976	1062111.8 (20.3)	1903105.5 (-1.9)	619875.7 (11.8)
1977	1211764.7 (14.1)	1860000.0 (-2.3)	644705.8 (4.0)
1978	1387755.1 (14.5)	2070891.5 (11.3)	675617.6 (4.8)
1979	1580838.3 (13.9)	2395209.5 (15.7)	706586.8 (4.6)
1980	1646317.8 (4.1)	2710271.3 (13.2)	731589.1 (3.5)
1981	1974038.4 (19.9)	3104807.6 (14.6)	850000.0 (16.2)
1982	2489835.4 (26.1)	3804453.0 (22.5)	979670.8 (15.2)
1983	2978095.2 (19.6)	4209523.8 (10.6)	1158095.2 (18.2)

Note: Figures in parentheses are growth rates.

Source: Central Bank of the Philippines

TABLE III

DISTRIBUTION AND GROWTH RATES OF RESOURCES OF BANKING INSTITUTIONS
(IN PERCENT)

Banking System (₱M)	80380.0	96666.0 (20.3)	123276.0 (27.5)	157024.8 (27.4)	193559.2 (23.3)	228580.0 (18.1)	276056.6 (20.8)	330943.4 (19.9)	403700.4 (22.0)
Commercial Banks	73.8	72.9 (18.7)	74.3 (30.0)	74.8 (28.2)	74.6 (22.9)	74.8 (18.3)	74.1 (19.7)	75.0 (21.4)	74.1 (20.5)
Thrift Banks	3.8	4.2 (34.9)	4.5 (37.4)	4.9 (36.9)	5.4 (37.6)	4.2 (-8.1)	4.5 (29.5)	4.9 (28.3)	3.7 (-7.9)
Rural Banks	3.8	3.4 (10.2)	3.3 (21.3)	3.1 (21.9)	2.8 (12.3)	2.8 (17.5)	2.9 (22.9)	2.8 (16.9	2.2
Specialized Gov't Banks	18.6	19.4 (25.4)	17.9 (17.2)	17.2 (22.4)	17.1 (22.8)	18.2 (25.3)	18.5 (22.9)	17.3 (12.1)	20.0 (41.3)

Note: Figures in parentheses are growth rates.

Source: <u>Fact Book, Philippine Financial System (Various Issues)</u>

TABLE IV

DISTRIBUTION AND GROWTH RATES OF DEPOSITS OF BANKING INSTITUTIONS
(IN PERCENT)

	1976	1977	1978	1979	1980	1981	1982	1983	1984
Banking System (₱M)	34666.0	42506.3 (22.6)	54343.0 (27.8)	69780.5 (28.4)	89498.2 (28.2)	99594.2 (11.3)	119364.5 (19.8)	142181.7 (19.1)	153400.8 (7.9)
Commercial Banks	78.2	80.7 (26.5)	81.5 (29.2)	81.5 (28.3)	81.5 (28.2)	80.6 (10.1)	81.8 (21.7)	84.8 (23.4)	90.1 (14.7)
Thrift Banks	6.9	7.7 (37.5)	8.5 (39.9)	9.0 (36.6)	8.9 (26.9)	7.0 (-12.7)	7.8 (33.3)	7.8 (20.2)	4.5 (38.4)
Rural Banks	2.4	2.4 (21.1)	2.4 (25.4)	2.3 (22.5)	1.9 (7.3)	2.1 (20.9)	2.2 (25.3)	2.2 (21.6)	1.9 (-8.6)
Specialized Gov't Banks	12.4	9.1 (11.0)	7.6 (6.4)	7.2 (21.9)	7.7 (37.0)	10.3 (49.2)	8.2 (-4.7)	5.2 (-24.9)	3.5 (-26.5)

Note: Figures in parentheses are growth rates.

Source: <u>Fact Book, Philippine Financial System (Various Issues)</u>

TABLE V

RATIO OF LOANS TO DEPOSITS

	1976	1977	1978	1979	1980	1981	1982	1983	1984
Banking System	1.49	1.44	1.43	1.44	1.34	1.40	1.38	1.44	1.53
Commercial Banks	1.41	1.28	1.32	1.32	1.22	1.29	1.23	1.28	1.12
Thrift Banks	0.85	0.87	0.83	0.81	0.82	0.87	0.86	0.96	1.38
Rural Banks	3.00	2.68	2.59	2.57	2.69	2.60	2.53	2.39	2.38
Specialized Gov't Banks	2.06	2.89	2.92	3.24	2.95	2.36	3.10	4.35	N.A.

N.A. = Not Available

Source: Fact Book, Philippine Financial System (Various Issues)

TABLE VI

RATIO OF NET INCOME TO GROSS OPERATING INCOME,
SELECTED YEARS

Year	Commercial Banks	Thrift Banks	Rural Banks	Total
1978	18.1	7.7	21.3	16.5
1979	14.1	8.0	19.1	12.6
1980	10.6	6.6	14.5	9.9
1981	8.1	(5.0)	14.1	7.1
1982	6.7	6.6	12.1	6.3
1983	8.0	5.7	10.1	6.9
1984	3.6	6.4	9.3	5.4

Source: Central Bank of the Philippines.

TABLE VII

RURAL BANKS' REDISCOUNTING ARREARAGES WITH
THE CENTRAL BANK, 1979-1984

Period	Amount	% Change Over Previous Year	Past Due Ratio (%)
I. As of end December			
1979	570.0		28.0
1980	720.0	26.3	28.5
1981	870.0	20.8	29.4
1982	960.0	10.3	26.3
1983	1201.7	25.2	29.9
1984	2579.1	114.5	72.2
II. 1984 Selected Months			
June 1984	1748.4		46.8
Sept 1984	2249.6		61.2
Oct 1984	2370.7		65.5
Dec 1984	2579.1		72.2

Source: TBAC (1985)

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