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**Creating an Enabling Environment for
Microfinance – the Role of Governments**

Experiences from Thailand

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German Technical Cooperation
(GTZ)

Introduction

The extent to which governments should engage in the development process remains a subject for discussion. Many pro-government economists believe that the role of governments should be confined to providing the institutional framework within which financial systems can operate but do not support the active involvement of governments. The debate about the role of governments in institutional development has hitherto focused solely on the question, whether, and to what extent governments should intervene. But even if we agree that efficient institutions do not emerge automatically as a result of an evolutionary process and further that governments have to intervene in order to compensate for market deficiencies, there is still no certainty that government intervention will take place at the right time with the right means. However, we all agree that development – economic, social and sustainable – is impossible without an effective government. Let us take a look at Thailand and the well-known BAAC (Bank for Agriculture and Agricultural Cooperatives), a major provider of rural- and microfinance services, and the role of the Thai government.

1 The example of Thailand

Thailand has a population of about 63 million people occupying an area of some 513 thousand square kilometers. The Gross Domestic Product in 2003 was US\$ 142.3 billion and the per capita income was US\$ 2,240.5. Over the last five years, the annual inflation rate in Thailand has fluctuated between less than one to 1.5%.

Between 1980 and 1995, the share of agriculture in GDP declined from 23% to 11%. This decline was matched by an increase in the share of industry. These changes had a significant effect on settlement patterns, with the proportion of urban population more than doubling, from 17% in 1980 to 36% in 1995. Fifty percent of the urban population lives in Bangkok.

There has been a drastic reduction in poverty in Thailand in recent years; official estimates suggest that the incidence of poverty has fallen again after the financial crisis to around 12% of the population. However, there is considerable regional variation. A long-term trend towards greater income inequality has been evident since the mid 70s.

1.1 The Macro Economic Environment

1.1.1 Favorable growth rates

In the fourth quarter of 2003, the economy expanded by 7.8%, accelerating from the previous quarter. Seasonally adjusted GDP growth increased by 2.7% - an indication of on-going economic expansion. Strong domestic demand, both consumption and investment, were the main driving forces of the economy. Greater domestic consumption and investment have expanded the range of production activities for the grassroots population, providing small entrepreneurs the opportunity to enter the market and earn more income.

1.1.2 Low inflation rates

Over the last five years Thailand has experienced its lowest inflation rates of less than one to 1.5%. These low inflation rates have been conducive to economic stability and growth. Under the inflation targeting system used since 2000, the Monetary Policy Committee of the Bank of Thailand sets short-term interest rates with a goal of sustainable growth while keeping core-inflation within a range of 0 to 3.5%. With inflation on the lower side of the target and a relatively strong external position thanks to a good export performance, the monetary policy fully promotes the recovery process.

1.1.3 Poverty reduction through improved export markets for rural products

The Thai government has recognized the importance of local rural production. In order to promote local products, the *One Tambon One Product* (OTOP) initiative was launched at the beginning of 2001 (a *tambon* is a group of villages or a sub-district) to enable each community to develop and market its own local products based on traditional indigenous expertise and local know-how. The government is further prepared to provide additional assistance in terms of appropriate modern technology and new management techniques to promote marketing through domestic and international outlets with a good retail network. The booming Thai tourist industry complements and fosters the sale of rural or locally produced goods. The *OTOP* initiative aims to channel income into local communities in Thailand thereby helping to raise standards of living throughout the country.

1.1.4 Infrastructure and bank branch networks

Road infrastructure is fairly well developed in Thailand and road conditions are quite satisfactory. Rural clients reach the nearest branch within fifteen to 30 minutes of traveling time. Clients living in remote locations are few. BAAC alone, which has an outreach of 92%¹ throughout its large rural network, is operating in nearly 600 branches and 888 field or service units.

1.1.5 Interest rates

A general ceiling of 15% interest is applied to loans. This ceiling is specified in the Civil and Commercial Code, and applies to all bodies and transactions unless they are specifically excluded. Exceptions are as follows: Since 1992, almost all financial institutions regulated by the Bank of Thailand are free to charge interest rates based on market conditions. However a few Specialized Financial Institutions (SFIs), thrifts and credit cooperatives are excluded and are subject to an interest rate ceiling of 19%, but their interest rates have yet to reach the ceiling.

The interest rate ceilings impact differently on various institutions and could be a constraint to the development of microfinance, particularly when the costs of funds are increasing. Given the higher transaction costs associated with microfinance, the chances of the ceiling acting as an impediment should be closely monitored.²

¹ BAAC has a direct or indirect outreach covering 92% of the farm households in Thailand.

² Bank Indonesia – GTZ High Level Policy Meeting on Micro and Rural Finance in Asia, Yogyakarta, Indonesia, February 26 – 28, 2004

2 Thailand's financial sector

The formal financial sector in Thailand consists primarily of commercial banks, non-bank financial institutions, specialized financial institutions established by the government and cooperatives. By 2002, there are 13 Thai commercial banks, 5 credit foncier companies, 18 finance companies and 18 full foreign commercial bank branches, and 29 BIBFs (Bangkok International Banking Facility). There are 3,632 bank branches throughout the country, all under the supervision of the Bank of Thailand.

There are nine specialized financial institutions (four banks and five companies) supervised by the Ministry of Finance and inspected by the Bank of Thailand. Most notable among these in regard to micro- and rural financial services is the Bank for Agriculture and Agricultural Cooperatives (BAAC) with 588 branches and sub-branches.

3 The Bank for Agriculture and Agricultural Cooperatives (BAAC)

3.1 General

BAAC is a “front rider” with regard to outreach: 92% of farm households in Thailand have been reached directly or indirectly by BAAC. However outreach is meaningful only if it remains sustainable.

The Bank of Agriculture and Agricultural Cooperatives (BAAC) was established in 1966 as a government-owned agricultural development bank. The mandate of the bank has been to provide agricultural credit to farm households and agricultural cooperatives. Since the expansion of the branch network in 1988, the number of borrowers has doubled. By 2003, more than 5 million farm households were registered as BAAC's direct and indirect clients while 2.7 million of them are active BAAC borrowers. This represents about 92%, respectively 46% of the total farm households in Thailand. Savings accounts totalling almost 9.6 million provide significant proof that there is a high demand among rural clients for BAAC's financial services. BAAC's pro-active rural savings mobilization³ has brought about what is virtually a revolutionary change in the financial resource base. BAAC has become financially self-reliant and has been able to significantly reduce its dependence on and loans from domestic and foreign sources. By 2003, or in just a decade, the deposit-to-loan ratio has reached 100%.

An ongoing process of change is underway at BAAC and reforms are far from complete; important lessons can be learned from BAAC's experience. BAAC has gone through several evolutionary steps. For many years it tried hard to secure an amendment to the 1966 Act and to obtain permission to expand its lending operations to non-farm activities in rural areas. In 1993, a first window was opened when BAAC was allowed to provide loans for farm-related activities and, as a second step in early 1999, the government approved amendment to the BAAC Act. GTZ, as part of its technical cooperation with BAAC, was helping the bank to develop a system for non-farm lending and to conduct testing in selected branches.

³ The Thai-German Microfinance Linkage Project supported BAAC in its savings mobilization efforts.

BAAC has generated positive returns on assets and equity throughout the 36 years of operations. During this time BAAC has been able to cross-subsidize its lending business with interest income from investments and, more recently, from fee-based income and has managed to maintain its overall profitability. BAAC has benefited from various types of hidden incentives and indirect subsidies, such as an exemption from minimum reserve requirements and income tax.

Since 1998 it has been evident that the financial crises in Thailand has not left BAAC unaffected and consequently matters concerning prudential regulation by the central bank and diversifying into non-agricultural lending have become serious issues. In 2003, the MoF as supervisor and owner decided that BAAC should implement more realistic provisioning rules to ensure the long-term sustainability of its operations.

3.2 Governance, ownership and interventions

BAAC is categorized as a so-called specialized bank providing financial services in rural areas. Ownership has hitherto largely remained with the government. More than 99% of the shares in the Bank are held by the Ministry of Finance, with the balance mainly in the hands of agricultural cooperatives.

BAAC operates under the supervision of the Ministry of Finance, as do all other SFIs, while the commercial banks are supervised by the Bank of Thailand (BoT). The State Audit Office, a government agency, performs the annual external audit. In addition, BAAC's performance is annually assessed by the Thai Rating and Information Service (TRIS) within a framework designed for state-owned enterprises which focuses on five aspects (operational effectiveness and efficiency, stakeholder issues, management, organizational development, good governance).

BAAC has an internal audit department for the ongoing financial and management audit of its operations. Periodic reports from the provincial and branch offices are channeled to BAAC's senior management in order to monitor the sources and uses of funds.

BAAC is governed by a fifteen-member Board of Directors. The Board controls the policies and business operations of the Bank. The composition of the Board is outlined in the Act of 1966 to include representatives of the Prime Minister's Office, the Ministry of Finance, Ministry of Agriculture and Cooperatives, Cooperative Promotion Department, the Agricultural Land Reform Office, the Bank of Thailand and one representative from the agricultural cooperatives. The president of BAAC is an ex-officio member of the Board. The Finance Minister is officially the chairman of the Board, but the Deputy Finance Minister is assigned to act on his behalf. In general, the Board comprises mainly public officials representing the interests of the government.

The composition of the Board has several important implications. First, it implies a primarily short-term agenda, which may not support the long-term objectives of financial health and sustainability of the institution. Second, major internal policies are based on well-intended and general development considerations, rather than financial business principles. Third, due to its highly emphasized policy status as the major agricultural arm of the government, BAAC has to accommodate the particular interests of ministries and

government agencies by implementing a considerable number of “special projects”, in addition to its regular lending operations.⁴

Such “development projects/programs” have often had a negative impact on the financial viability of the Bank. In response, BAAC has adopted a strategy of “interventions against compensations” through negotiations with the government and members of parliament. The latest and most significant program implemented through BAAC was debt suspension for all borrowers with an outstanding loan of less than Baht 100,000 (US\$ 2,300) with BAAC. Under the program, borrowers who choose the debt suspension are permitted to suspend loan principle and interest payments for three years.

The government compensates BAAC for the interest payments not made. Borrowers under the debt suspension program cannot borrow from BAAC during the three-year period. The government expects the policy to boost the purchasing power of those given temporary relief from loan repayment. When farmer borrowers join the program, they are supervised and helped by the committee to improve and restructure their operations. The program was launched at the beginning of 2001. About 50% of eligible farmers opted for debt relief and their suspended loans accounted for around 21% of BAAC’s total loan portfolio. Borrowers who opted out of the program are entitled to a privilege card - a mark of their good credit standing. This is a powerful incentive to keep up the discipline of the credit system, while ensuring that those in real need of debt relief have an option. The debt suspension has definitely been an obstacle on BAAC’s path towards viability and poses a potential threat to its long-term sustainability. An increase in the reserves by BAAC became unavoidable.

In the past, government interventions were mainly confined to policy level, ensuring that the operational level enjoyed a high degree of autonomy. BAAC has managed to resist the pressure from political interest groups as well as interference from local governments with regard to borrower selection and lending decisions. However, the government-directed debt suspension program in 2001 affects the autonomous nature of BAAC’s operations. BAAC thoroughly monitors the existing status of debt suspension and has established adequate reserves in an effort to prepare its “firewall” for any eventual moral hazard.

By 2004, the Ministry of Finance and the Bank of Thailand had implemented new prudential measures on the basis of Basle II for BAAC.

3.3 Major restructuring initiated by policy changes lead to remarkable results

One of the core elements of BAAC’s reform process has been the fundamental restructuring of the sources of funds. The restructuring of the liability side progressed over a period of 30 years.

In its early years, BAAC operated almost exclusively with government funds. The major share (about 60%) came as equity contribution and a minor share (about 20%) was in the form of a special credit facility on preferential terms from BoT.

⁴ Dr. Maurer, Rural Finance, Working Paper No. B 6, IFAD

Ten years later (1975-1987), mandatory deposits from commercial banks were the major source of funds (about 40%), following the agricultural credit policy issued in 1975. At the same time, BAAC started borrowing from international financial agencies, which made this source the second most important (about 30%) in the 1980s. Finally, deposit mobilization from the general public started to gain importance towards the end of the 80s. In 1987, deposits mobilized by BAAC already accounted for one fourth of BAAC's funds.⁵

The period from 1988-2001 brought another major change in the funding structure. During this time, BAAC made deposit mobilization a major activity of its banking operations and, consequently, deposits mainly from the rural areas evolved into the single most important source of funds. The liberalization of the agricultural credit policy caused commercial banks to reduce their mandatory deposits with BAAC which led to a substantial stimulation to BAAC's savings mobilization efforts. While borrowings fell to a low of 4.6% in 2003, BAAC suffered considerable losses as a result of exchange rate fluctuations associated with foreign loans and adopted a more cautious stance towards borrowings from abroad.

By 2003, BAAC's source of funds consists of only 4.6% from borrowings which is divided into 28% from foreign loans (JBIC) and 72% from local borrowings.

In the last 13 years, BAAC has become increasingly self-reliant in financial terms and has been able to significantly reduce its dependence on government funds, mandatory deposits from commercial banks and loans from domestic and foreign sources. In just a decade, the deposit-to-loan ratio has doubled to 100% in 2003.

Since 1995 GTZ has been supporting this major restructuring process at BAAC by jointly planning and implementing a savings mobilization strategy, savings product development and a savings delivery system.

3.4 Policy changes lead to innovations in financial service delivery

3.4.1 Savings mobilization

During the first twenty years of operations, BAAC concentrated almost exclusively on credit services while savings, - as in many agricultural development banks elsewhere - largely remained the "forgotten half" of rural finance. In the early years, BAAC implemented a **compulsory** savings scheme for borrowers, requiring each borrower to deposit an amount equivalent to 5% of the loan value in a savings account. The scheme was costly to administer and was terminated in 1979.

Only since the mid-1980s, has BAAC recognized the importance of **voluntary** savings mobilization, not only from its own perspective of deposits as a stable and reliable source of funds, but also from the viewpoint of its rural clients, who need safe, liquid and convenient deposit facilities. The Bank realized that there is a strong demand for deposit facilities, especially among farm households that are forced to synchronize income and expenditure in the course of the agricultural production cycle. Furthermore, savings act

⁵ The Challenge of Sustainable Outreach (GTZ/BAAC), The Case of Bank for Agriculture and Agricultural Cooperatives, (BAAC) Thailand, January 2003 by Marie Luise Haberberger, Luck Wajananawat, Nipath Kuasukul,

as a buffer against the uncertainty governing the rural economy. In the wake of unforeseen events and emergencies, financial savings perform a basic insurance function.⁶

Over the past decade, the Bank has campaigned effectively to mobilize rural savings. The branches were instructed to set annual mobilization targets, and savings mobilization became one of the major criteria for evaluating branch performance. As a result, BAAC has achieved remarkable success in deposit mobilization. Deposits from the general public grew at average annual rates of 17% and increased from only Baht seven billion (US\$ 280 million) in 1986 to more than Baht 321 billion (US\$ 7.3 billion) in March 2004.

3.4.2 Demand-oriented savings products

In 1995, BAAC introduced an innovative savings product, called *Om Sap Thawi Choke* or *Save and Get a Chance*, primarily targeted at the low-income market. This product was developed by BAAC Savings Promotion Division together with the GTZ-supported Microfinance Linkage Project. The minimum opening deposit is only Baht 50 (US\$ 1.15) and, although the interest rate of 0.75% (2002) paid on deposits is one percent below the standard rate, BAAC pays for savings accounts, and the account holder is entitled to participate in semi-annual tombola-drawing parties offering goods popular in rural areas as prizes. After successful pilot testing in selected branches, the product was launched nationwide in early 1996 and, by the end of 2003, had attracted more than 2.5 million depositors with an average deposit of Baht 3,800 per account holder (US\$ 87).

The most recent product introduced in 1997, with the objective of attracting medium-term funds is the BAAC Savings Bond (*Thawi Sin*). The savings bonds have a nominal value of Baht 500 (US\$ 11.40) each and a term of three years. The three-year bonds carry an interest rate of only 1.33% per annum (2002) but - as a compensation for the low yield - bond holders participate in a highly publicized prize draw at national level.

More than 75% of BAAC's deposits are generated mainly through four core products, which include the two mentioned above. The two other products are Time Deposits and Passbook Savings.

Institutional deposits are made up of a relatively small number of accounts with large amounts. They are held in both savings and fixed deposits on an almost equal balance. Furthermore, institutional deposit accounts are subject to considerable fluctuations, depending on budget allocations and expenditures, which exposes the Bank to a considerable liquidity risk.

Deposits from individuals have generally been much more stable. More than 90% of deposits from private individuals were held in simple savings accounts including *Om Sap Thawi Choke*, a pattern typical of rural customers. The number of savings accounts increased from 4.1 million in 1994 to 9.5 million in 2002 - an increase of about one million savings accounts a year.

The size distribution of savings accounts by number and volume reveals a considerable concentration. The vast majority (97%) of the savings accounts have a balance of less than Baht 50,000 (US\$ 1,140). This may indicate that the majority of BAAC depositors

⁶ Dr. Klaus Maurer, Rural Finance, Working Paper No. B 6, IFAD

belong to the lower-income segment. However, these accounts generate 36% of the deposit volume, while a few large depositors (slightly above 10,000 clients or 0.1% in 2002) account for 24% of the volume.

Table 1: Change in BAAC's sources of funds structure 1967 to 2001

	1967	1973	1980	1987	1993	1998	2001	2003
Deposits from the public	11%	17%	12%	25%	48%	62%	76%	83%
Mandatory deposits from CBs	--	--	39%	39%	7%	1%	-	-
Borrowings	19%	22%	35%	29%	32%	25%	13%	4.6%
Shareholders' Equity	66%	57%	12%	6%	8%	7%	7%	8.4%
Other liabilities	4%	4%	2%	1%	5%	5%	5%	4%
Total	100%	100%	100%	100%	100%	100%	100%	100%
Deposit-to-loan ratio	14%	19%	21%	38%	66%	83%	98%	100%

Source: BAAC

3.5 Service-oriented mindset

BAAC pays attention to the quality of its service and continuously stresses the importance of a service-oriented mindset among its work force. This emphasis reaped positive results in the TRIS (Thai Rating and Information Services) annual performance appraisal: 90–95% of BAAC's clients appreciate the Bank's services. The annual TRIS evaluation is a tool used by the MoF to control BAAC's overall quantitative and qualitative performance. Client satisfaction is highly valued and assessed every year. One should bear in mind that the TRIS evaluation result impacts on BAAC staff remuneration. The "BAAC Service Culture" which is an Organizational Development Intervention has become internalized in the entire bank as a permanent subject. It has been progressively developed further. While the initial focus was only on behaviour, it has more recently also encompassed competency such as product and customer knowledge. Although BAAC has hundreds of products, as is the case with the financial products of many other banks in the world, the so-called Pareto rule also applies to BAAC: about 20% of the products and services generate almost 80% of the business. That explains the focus on the products that account for the 20%, as they enhance profitability and efficiency.

BAAC has an outreach (direct and indirect) of 92% (2001) to rural families. The more direct outreach is that 46% of the rural families in Thailand have one active BAAC borrower. In every rural household, there is a BAAC savings account. BAAC holds a market share of 34% of rural deposits (Table 2) and 5.5% on a nationwide basis.⁷

⁷ The Challenge of Sustainable Outreach (GTZ/BAAC), the Case of Bank for Agriculture and Agricultural Cooperatives (BAAC), Thailand by Marie Luise Haberberger, Luck Wajananawat, Nipath Kuasuakul, January 2003

Table 2: Customer Orientation

	1999	2000	2001
Number of loan products	-	2	2
Number of savings products,	5	5	5
Number of other financial services	-	5	5
Loan Portfolio			
Number of active borrowers (000's)	2,686	2,676	2,738
Of which rural borrowers (000's)	2,685	2,676	2,738
Number of accounts (000's)	4,556	4,281	4,413
Outstanding gross portfolio in US\$ (000)	6,257,975	6,007,649	6,120,851
Average outstanding loan balance in US \$	1,345	1,355	1,321
Average outstanding loan size/per capita income in %	66.7	64.9	62.5
Average loan processing time	2 weeks	2 weeks	2 weeks
% of rural population served	8.7	8.5	8.5
Savings Portfolio			
Number of savings accounts (000's)	8,298	8,633	9,570
Portfolio size in US \$ (000)	2,036,458	1,960,920	2,586,757
Average deposit balance in US \$	245	227	270
Average deposit balance/per capita income in %	12.2	10.9	12.8
% of rural population served	27	27	29
Market share in rural deposits	31%	33%	34%

Source: BAAC

3.6 Branches become Profit Centers

Profitability - expressed by return on assets (ROA) - is becoming an important criterion for measuring branch performance.

In 1997, BAAC introduced the transfer price mechanism. Transfer price is the internal interest rate applied on funds transferred between the branches and the head office. When a branch requires funds for its lending operations, it borrows from the head office and is charged the transfer price, and vice versa: when a branch mobilizes savings and deposits, then head office pays, based on the transfer price. In principle, the transfer price is set by the management in accordance with the market cost of funds. It can also be used as an important policy instrument.

BAAC with the support of GTZ and the German Bankakademie has introduced a new Branch Management Information System (BMIS) in all its branches. It provides a complete framework for managing a branch network, based on a decentralized branch-controlling concept. This new BMIS includes monthly provisioning, transfer pricing and realistic cost allocations for the branches. This instrument supports head office with its central treasury department and the branches in implementing the overall bank strategy. The fully computerized BMIS has been operational since early 2003.

3.7 Government-secured lending versus viable credit products

3.7.1 Government-secured lending

In addition to its normal lending business, BAAC grants a large number of government-secured loans or so-called “special agricultural development projects and policy lending programs”. There are around 200 “special projects and programs”, some nationwide, some of them regionally concentrated. However, these special projects entail a heavy workload. First results from the decentralized branch controlling (BMIS) indicate that they are loss-making products. Moreover, they divert the attention of credit officers from their mainstream lending activities. Most special lending programs supported by government departments carry preferential interest rates, which have occasionally caused some confusion among clients. BAAC is compensated by the government in the form of fees and interest compensation. “Special loans” with its old supply-driven approach or “old paradigm” accounted for 7.3% of the total net loans in 2003.

A research study conducted in 1996 by the well-known TDRI (Thai Development Research Institute) confirmed the following:

- loans under government-secured lending programs do not reach the poor farmers for whom they were designed, but rather the better off and more informed farmers who know the officers of the Agricultural Extension Service.
- subsidized loans are not tailored to the needs of poor farmers, because they are designed by agricultural department officials who think they know what is best for poor farmers.
- most government-secured or subsidized loans create moral hazard or unwillingness to repay the loan. This results in low repayment performance. These subsidized loans also create confusion among other BAAC borrowers.

3.7.2 Shift from wholesale to retail lending

The initial success of direct lending to farmer clients organized in small Joint Liability Groups on the one hand and the problems experienced in lending to agricultural cooperatives on the other caused a shift in the lending policy in the late 70s. BAAC decided to focus mainly on retail lending to farmer clients. From the founding of BAAC until today, the share of wholesale lending through cooperatives dropped from 70% to only 6% in 2003.

3.7.3 Client orientation through credit technology

The development of the Joint Liability Groups concept dates back to the founding of BAAC in 1966. As few Thai farmers had land title documents to use as collateral in the 60s, BAAC adopted joint liability, as the principle form of security for small loans. Joint liability has been at the heart of the BAAC’s lending ever since.

Joint Liability Groups are formed by people who know and trust each other. They vary in size from a minimum of 5 to a maximum of 30 and usually average about 15 members. In general, Joint Liability Groups are primarily client groups and not what is normally

understood as self-help groups with organization and administration. BAAC Joint Liability Groups do not function as financial intermediaries. Individual loans up to Baht 150,000 (US\$ 3,400) are granted on the basis of joint liability. Loans above this amount must be secured by tangible collateral, usually through mortgage of land and buildings.

All transactions are conducted between BAAC and the individual members; the group leader has no role in disbursements or recovery of loans and is responsible for distributing repayment notes and reminding the members of their obligations.

Since in the more recent years, the majority of the BAAC borrowers earn income from agricultural and non-agricultural activities, the loan assessment has to become in line with the total household cashflow of the borrower and not just follow agricultural harvesting schedules.

3.7.4 BAAC's new market segment – cashflow-based lending

For many years, BAAC has tried hard to secure an amendment to the 1966 Act and to obtain permission to expand its lending operations to non-farm activities in rural areas. While a first window was opened in 1993, when BAAC was allowed to provide loans for farm-related activities, as a second step, in the beginning of 1999, the government approved amendment to the BAAC Act. This allowed the expansion of lending operations into non-farm activities for farmers - up to 20% of the total portfolio. BAAC with the support of GTZ has developed a system and a credit product for cashflow-based lending which is in line with the total household cashflow of the borrower. In 2003, the Thai cabinet decided that BAAC was a Rural Development Bank and no longer restricted to agricultural lending.

4 Conclusions

Although BAAC is now self-sufficient in its source of funds, and subsidized credit programs have dwindled, elements of the old and the new paradigm coexist. Two years ago at the Sri Lanka Conference, on "The Challenge of Sustainable Outreach": How can Public Banks Contribute to Outreach in Rural Areas?" there was evidence that the "paradigm shift" in rural and microfinance – in particular after the financial crisis - is becoming increasingly evident in Thailand. BAAC is now focusing on economic viability and sustainability, as well as on the outreach of financial services.

BAAC has managed to resist the pressure exerted by political interest groups as well as interference from local government with regard to borrower selection and lending decisions. The government-directed debt suspension program in 2001, however, affects the autonomy of BAAC's operations. BAAC thoroughly monitors the existing status of debt suspension and has established adequate reserves in an effort to prepare its "firewall" for any eventual moral hazard.

In the wake of the financial crisis, an important and positive change was initiated in October 1998 when the government decided in principle to place BAAC under the prudential regulation of the BoT. Prudential regulations and banking standards in line with international standards set out in the Basle Agreement have been developed by the BoT to take effect in the new Thai Banking Law. An on-going dialogue with the Ministry

of Finance about the preparation of prudential measures has been concluded and the measures implemented.

The implementation of the decentralized branch controlling system, with its BMIS, is a strong tool to delegate more responsibilities and accountability to branch managers and is a step in the right direction. BAAC knows the financial performance of each of its core products. Moreover, the bank knows that government-secured loans are loss-making for BAAC. This leads to a more appropriate compensation through the government.

Streamlining all BAAC products by identifying the most important ones or core products is a positive step towards accelerating product knowledge and cross-selling among staff.

Reform processes at the BAAC are gradually on-going over a period of 36 years which is very different from other Agricultural Banks where reforms are implemented quick and massive. At times, the reform processes in the BAAC move slowly, but gain momentum in other periods. In terms of focus and content, reform processes have been directed at the transition from agricultural credit to rural-micro finance and at the institutional transformation of BAAC from a specialized credit institution to a diversified rural bank. The gradual diversification of financial services is a clear indication of this evolution.⁸

The BAAC's pro-active rural savings mobilization has caused revolutionary changes to the financial resource base. The BAAC has become financially self-reliant and has significantly reduced its dependence and cut down on loans from domestic and foreign sources. In just a decade, the deposit-to-liability ratio has reached 83%, and the deposit-to-loan ratio 100%. This can be assessed as an outstanding result.

The BAAC has developed a fundamental eagerness for cost effectiveness, productivity and efficiency. BAAC's management pays constant attention to branch performance. The delegation of authority and responsibility to managers at all levels and the implementation of profit centers in the branches contribute to this achievement.

5 What lessons can be learnt?

Political interventions and government-subsidized loans

Populist political interventions carry a high prize for governments and must be compensated by those who initiate them. A government has to be thoughtful in initiating relevant policies that meet the needs of the lower income groups. The providers of financial services must operate in a sustainable manner and refrain from wasting scarce taxpayers money and depleting their own funding base. Governments should not underestimate the risk of moral hazard which some interventions can cause for a very long time.

Of interest in the Indian context could be the finding of the TDRI research confirming that loans under the government-secured lending programs do not reach the poor farmers for whom they were designed, but rather the better off and more informed farmers who know the officers of the Agricultural Extension Service. The subsidized loans are not tailored to the needs of the poor farmers, because they are designed by officials who

⁸ Dr. Klaus Maurer, Rural Finance, Working Paper No. B 6, IFAD.

think they know what is best for poor farmers. Most of the subsidized loans create moral hazard or an unwillingness to repay which is resulting in low repayment performance.

A decentralized branch controlling system or BMIS can become a powerful tool which is essential for a financial institution in its negotiations with governments when it comes to presenting the government with a bill for intervention.

The painful lesson of borrowing from abroad

The experience of borrowing from abroad has been mixed. BAAC was required to take on the foreign exchange risk on most of the loans and, as a consequence, suffered substantial losses due to exchange rate fluctuations. The losses were severe in the wake of the financial crisis and the devaluation of the Thai currency when half of the bank's equity was wiped out. This was a painful lesson.

Relevance of a favorable macro-economic environment

A stable macro-economic environment, including favorable growth rates, low inflation rates and positive interest rates on (small) savings, poverty reduction strategies, good road infrastructure and bank branch network are of relevance for the growth of sustainable rural and micro finance.

BMIS or Branch Controlling System

The new Branch Management Information System (BMIS) in all BAAC branches provides a complete framework for managing a branch network, based on a decentralized branch-controlling concept. This new BMIS includes monthly provisioning, transfer pricing and realistic cost allocations for the branches. This instrument supports head office with its central treasury department and the branches in implementing the overall bank strategy. The fully computerized BMIS can also be implemented on a manual basis. BMIS could be interesting for the Indian Banking sector, as it enables branch managers to manage their branches in a timely and effective manner. Simultaneously it can also be used by the management of a bank's head office to insert its policies efficiently.

Successful mobilization of small savings leads to a revolutionary change of the funding structure

Demand-driven approaches to rural financial services offer opportunities for success. There is a large demand for savings facilities in rural areas, so that the self-financing of rural lending is entirely possible. Safety and convenience rather than high interest rates are the main concerns of potential depositors. The success in small savings mobilization is rooted in BAAC's ability to provide a balanced combination of what small savers want and need: safety, convenience, liquidity and positive yields. BAAC has successfully addressed these four elements in its savings mobilization. An accelerated and voluntary savings mobilization in the rural areas could also be of interest in India, especially in the context of upgrading SHG members or when they require a more flexible liquidity arrangement. Accelerated and voluntary savings mobilization could also be an important source of funds for a financially healthy CCS.

The Joint Liability Group Concept – a low cost credit delivery system

The BAAC experience of more than three decades with the Joint Liability Group concept as the core credit product of the bank deserves attention. In the past, few Thai farmers had land title documents to use as collateral, which is why BAAC adopted joint liability as

the principle form of security for small loans. Joint Liability, which has been at the heart of the BAAC's lending since 1966, is a highly cost efficient credit delivery model and has contributed substantially to BAAC's remarkable outreach. The majority of BAAC's borrowers are served through Joint Liability Groups. The concept of Joint Liability could become a viable alternative to the SHG Linkage Banking in India.

Cashflow-based lending – a new credit delivery system for small borrowers

The cashflow-based lending technology is BAAC's latest credit delivery system and is geared very much to its future. This credit product corresponds fully with the cashflow of the small enterprise/farmer combined with his/her household, as 90% of the rural borrowers have income from agriculture and non-agriculture. This relatively new BAAC credit product suits the changes in rural Thai society, which is no longer just agriculture based. Income from non-agricultural sources plays a more significant role while "rural" and "urban" are coming closer. Cashflow-based lending calls for substantial capacity building, as it brings about a change from stereotypical agricultural lending to a more need-oriented cashflow-based lending. In the Indian context, there are important similarities to the Kisan Credit Card. This is where the capacity building of the BAAC cashflow-based lending could be studied.

Connecting qualitative and quantitative performance to remuneration

Total performance-based evaluations like the TRIS in Thailand are impacting on staff remuneration. A possible option could be to build in performance indicators for government-owned banks which have an influence on staff remuneration.

Joint cooperation results in significant leverage

The BAAC-GTZ cooperation in the context of micro-finance has served as a laboratory for developing and testing innovative features, products and approaches in selected branches. This cooperation has shown high leverage in supporting BAAC in its savings mobilization, improving staff competence, developing a decentralized branch controlling system and the system and instruments for cashflow-based lending.

Abbreviations

BAAC	Bank for Agriculture and Agricultural Cooperatives
BMIS	Branch Management Information System
BoT	Bank of Thailand (Central Bank)
GTZ	Deutsche Gesellschaft für Technische Zusammenarbeit
IFAD	International Fund for Agricultural Development
NPL	Non performing loans
OTOP	<i>One Tambon (village) One Product</i>
SFI	Specialized Financial Institutions
TRIS	Thai Rating and Information Service

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