SECTION 3

TYPES AND ROLES OF FORMAL FINANCIAL INSTITUTIONS PROVIDING AGRICULTURAL CREDIT

Objective: Present the different types of financial intermediaries operating in the agricultural sector of Developing Countries with a specific accent on their institutional roles, typical performances and effectiveness in servicing the agricultural customer.

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3.1 Introduction: financial intermediaries and financial markets
3.2 Public power of Monetary Authorities in the formal market and the agricultural sector
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TYPES AND ROLES OF FORMAL FINANCIAL INSTITUTIONS PROVIDING AGRICULTURAL CREDIT

3.1 Introduction: financial intermediaries and financial markets

Financial intermediaries have traditionally been divided into different categories, according to specific characteristics, as concerns their institutional setting, the range of intervention, their organisation and services provided. Different bank classes can be found both in industrialised economies and in developing countries; the distinction among commercial banks, savings banks or development banks, for instance, is still very common. However, in some countries, this classification is becoming less significant, particularly on the operational side, because the evolution of the regulatory framework and the increasing competition led many banks to enlarge their fields of intervention. In some countries the distinction is still applicable.

Despite the process of homogenisation of bank classes, an analysis of the typical goals and average performance of different kinds of banks is still useful because current performances are affected by past institutional and operational objectives and constraints and because many countries are going now through a transitional phase where old bank categories exist but their institutional function are loosing specificity.

Public authorities have often led the process of differentiating the functions of various bank categories or non-bank financial intermediaries, through the legal definition of the institutional function of each class of intermediary; yet the financial intermediaries themselves often lead the process of specialisation, in accordance to their goals and available resources. This is typically the case for commercial banks, whose intervention in the agricultural sector of developing countries is often minimal as a consequence of their choice to limit their activity to other sectors of the economy.

Political and economic factors, as well as geographical and historical heritages affect the countries’ specific banking structure; however, the approach commonly followed in organising the formal financial system in many developing countries achieved similar results as concerns the intermediaries’ performance. Therefore a common framework of analysis can be found and generalisations on each bank category are possible.

The following paragraphs provide an overall description of bank categories, their institutional roles, typical performance and effectiveness in servicing the customer with an accent on their actual or potential activity in the agricultural sector.

Before entering this description, two important classifications are presented: the distinction between bank and non-bank financial intermediaries and between formal and informal financial markets.

On the first respect the following definitions are applicable:

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1 By Laura Viganò, Università di Bergamo, Italy on behalf of Fondazione Giordano Dell’Amore.
**Definition of bank**  
A financial intermediary is defined as a bank when it performs both savings mobilisation and lending.

**Definition of a non-bank financial intermediary**  
If a financial intermediary is only active on “one side of the balance sheet” (i.e. it offers deposits but does not lend out to the public, or it offers loans but gets funding from sources other than private savings) it is classified as a non-bank financial intermediary.

As concerns the formal and informal financial markets, the classification depends on the degree of regulation exerted by the monetary authorities on the intermediaries. Conventionally:

**THE INFORMAL FINANCIAL MARKET GROUPS ALL THE INTERMEDIARIES THAT ARE NOT REGULATED BY THE MONETARY AUTHORITIES OR ANY OTHER PUBLIC AUTHORITY AND WORK WITH A LOW DEGREE OF FORMALIZATION ON THEIR TRANSACTIONS** (Germidis et al.; Onado and Porteri).

The presence of an informal market should be given enough attention since it affects the effectiveness of monetary policies; furthermore, its relative success in reaching agricultural operators may lead monetary authorities and banks to re-consider their approach to rural areas.

*In order to better understand institutional goals and constraints of the formal markets and the potentialities of the informal market, an introduction on the typical monetary authorities interventions follows hereafter; it is further developed during the presentation of each class of intermediaries; a classification of the operators of the informal financial market will be presented in Part III of this manual.*

**3.2 Public Power of Monetary Authorities in the Formal Market and the Agricultural Sector**

Monetary authorities have the specific role to control the financial system and to address its development according to some objectives in line with the general economic policy of the country. Generally speaking, this means getting continuously up-dated information on the operation of each intermediaries in order to:
⇒ verify the level of financial aggregates such as money in circulation and credit and take appropriate measures to influence their trends
⇒ control the soundness of each institution and assure a certain level of stability of the financial system
⇒ promote efficiency in the financial market
⇒ implement public economic policies through ad hoc interventions.

The various objectives and possibilities of intervention of monetary authorities have already been presented in the first part of this manual. Particular measures that are typically implemented in order to develop the agricultural sector are the following:

- the imposition of credit ceilings on non-priority sectors and floors on the agricultural one to assure a minimum flow of resources towards agriculture;
- special rediscount rates at which banks can have access to public funding if they invest in the agricultural sector;
- the imposition of concessionary interest rates on loans to agricultural operators;
- the implementation of public agricultural credit programmes for target beneficiaries through public or private banks;
- the creation of ad hoc intermediaries to implement specific financial development programmes for agriculture.

These measures can concern the whole system, i.e. private or public banks or non-bank intermediaries, but are usually more easily implemented through public banks, on which monetary authorities have a more effective control.

The effectiveness of these measures in reaching their purpose of promoting agricultural development have been questioned by policy makers, academicians and practitioners; the reasons for these criticisms are presented in section 4, while examining agricultural development banks which usually undergo these public interventions with questionable results.

Besides the possible weaknesses to the “interventionist approach”, a more general consideration can be made:

PUBLIC INTERVENTIONS IN FINANCIAL MARKETS ARE EFFECTIVE ONLY IF MONETARY AUTHORITIES CAN ACTUALLY MONITOR FINANCIAL INTERMEDIARIES, WITH APPROPRIATE INSTRUMENTS, TECHNOLOGIES AND PERSONNEL.

This is not always the case in many developing countries where, furthermore, an important share of the market is covered by informal intermediaries whose existence is (or was) often officially ignored by public powers.
3.3 The Formal Financial Market and Agricultural Credit

**FORMAL FINANCIAL MARKETS GROUP THE INTERMEDIARIES THAT ARE RECOGNIZED BY THE GOVERNMENT AND, THEN, ACT UNDER THE MONETARY AUTHORITIES SUPERVISION OR ARE AT LEAST CONNECTED WITH SOME PUBLIC FUNCTION.**

Typical operators in these markets are:

⇒ commercial banks,
⇒ savings banks,
⇒ official co-operative banks or credit unions,
⇒ development banks,
⇒ other non-bank financial intermediaries as insurance or leasing companies

The latter group of intermediaries has practically no relations with the agricultural sector; even within the bank categories, the agricultural sector can represent a marginal activity for some of them while for others it is the major focus of intervention.

3.3.1. COMMERCIAL BANKS

In almost every country operate one or some commercial banks. Generally speaking, typical operations of commercial banks are the collection of savings from private and public depositors and lending to the private and public sectors. In developing countries they typically have the following characteristics:

- **Commercial banks operate the most with the private sector, particularly for what concerns lending.**

- **Commercial banks generally concentrate their activity on offering financial services to the more dynamic sectors of the economy,** often linked to foreign capital.

- **Their capital can be divided among private and public owners or they can be fully private or controlled by the government.** When they are performing, they usually attract foreign capital; in some countries, branches of foreign commercial banks operate.

- **Commercial banks usually operate according to advanced managing principles and standards,** typical of industrialised economies, particularly when they are privately-owned.

- **Public commercial banks operations are sometimes led by governmental directions,** which can be different from banking managerial principles and may lead banks to pursue social rather than economic objectives.
• However, on average, commercial banks are the most performing of the financial system (see, for instance, the statistics of the case study in this section).

• Their intervention in agriculture is often limited.

Commercial banks management usually assert that agriculture is a too risky sector and, since they have valuable alternatives, they prefer to avoid heavy involvement in it. They rather invest in trade or other safer industrial activities. When the Central Bank imposes a credit floor on agriculture, they often try to fulfil this obligation through loans to agricultural trade or to agro-industry, which they consider less risky than small-scale agricultural production. In fact, the profit orientation of commercial banks lead them to be conservative in lending.

AVOIDING THE AGRICULTURAL SECTOR, HOWEVER, DOES NOT NATURALLY MEAN OBTAINING THE BEST RESULT: THE BANK MAY LOOSE PROFIT OPPORTUNITIES EVERY TIME IT RENOUNCES TO LEND TO AGRICULTURAL POTENTIAL BORROWERS THAT ARE SAFE AND HAVE A HIGH PROBABILITY TO REPAY.

The difficulty for commercial banks in this respect lies in the peculiar characteristics of agricultural firms where creditworthiness evaluation may rests on special information techniques, as compared to normal banking standards (see the proposal of Viganò 1993).

FINDING A WAY TO GET EFFICIENTLY INVOLVED IN THE AGRICULTURAL SECTOR MAY BECOME A CHALLENGE FOR COMMERCIAL BANKS, IN AN ENVIROMENT WHERE COMPETITION WITH OTHER BANKS IS GETTING STRONG EVEN IN THOSE SECTORS WHERE COMMERCIAL BANKS HAVE ALWAYS PERFORMED AT THEIR BEST.

This approach is also in line with a typical objective of commercial banks, i.e. pursuing a certain market share, which would enlarge if they are also involved into agricultural operations.

The following balance sheet scheme can help summing up the typical operations of commercial banks; only those activities that are specific for commercial banks have been pointed out; all the other operations are grouped into the “other assets” - “other liabilities” classes.

COMMERCIAL BANK
3.3.2. **SAVINGS BANKS**

In many Developing Countries, there is still a need to invest energies and resources in mobilising urban and particularly rural potential savings and to educate people to the benefit of saving in monetary forms. This was the main reason for the establishment of savings banks. In fact:

- **Savings banks were created with the specific purpose of promoting savings mobilisation** particularly for low-income groups in both urban and rural areas.

- **Their widespread network**, often shared with the post offices, **usually allows savings banks to achieve a certain savings mobilisation target**.

- However, **some of them experienced a stagnation in deposits trend** and a reduction in their savings mobilisation potential.

- At the same time, **given the public nature of savings banks, in many cases the savings deposited were drained from rural to urban areas**: the money collected financed public spending and sometimes public consumption, with no direct contribution to the financial development of the regions where funds were raised (Mottura).
• In fact, the objective of policy makers establishing savings banks turned out to be the channelling of funds from the public to the government, in order to finance public spending.

• According to the previously given definition of bank, savings banks that do not perform any lending cannot be considered as proper banks.

• The role of savings banks has often been conceived as very peculiar, not a typical banking one but more related to other functions, such as collecting money for public investment or implementing some agricultural development project. In fact, in many countries the supervising ministry for Savings Banks is not the Ministry of Finance but one covering some other functions, such as the Ministry of Communications or the Ministry of Agriculture.

Sometimes the Government is the sole owner of savings banks and has the right to intervene in the banks management, especially for more strategic decisions. These government interventions in bank management can turn into heavy interference with a loss of flexibility in the decision-making process and an increase in the bank’s global risk, particularly when the government forces the bank to invest the bulk of its assets in public financing with a concentration of risk in just one big customer.

The almost complete absence of private lending in many savings banks is partially due to their interrelations with the post office branches which are often the field representatives of the banks and perform money collection on their behalf. Post-office employees usually have a professional background that differs significantly from what a bank officer should have. In some cases, special schemes, mainly housing loans, are proposed to savers.

IT HAS BEEN EXPERIENCED THAT A LIMITED LENDING MAY HAVE A NEGATIVE EFFECT ON SAVINGS MOBILIZATION SINCE IT CAN DISCOURAGE SAVERS FROM DEPOSITING IN THE BANK IF THEY DO NOT HAVE ANY PERSPECTIVE TO BORROW IN THE FUTURE.

When the interface is represented by a post office, potential customers can perceive a distorted image of the savings banks since they do not see them as a body that can directly contribute to the development of their region (Onado and Porteri).

A RESTRUCTURING OF “INCOMPLETE” SAVINGS BANKS IS DEEMED NECESSARY BY THE BANKS THEMSELVES. IN SOME COUNTRIES EITHER THEY ARE NOW OPENING TO A WIDER RANGE OF PRODUCTS OR THEY TEND TO DISAPPEAR. IN PARTICULAR, THEY TEND TO OPEN UP THEIR SERVICES TO RURAL CUSTOMERS, NOT ONLY FOR SAVINGS MOBILIZATION BUT ALSO FOR LENDING.
Typical items of the balance sheet for a savings bank are the following:

### SAVINGS BANK

#### Balance Sheet

<table>
<thead>
<tr>
<th>Cash and other liquidity</th>
<th>Private deposits</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(often collected through Post Offices)</td>
</tr>
<tr>
<td>Loans to:</td>
<td>Other liabilities</td>
</tr>
<tr>
<td>- Treasury</td>
<td>(Government)</td>
</tr>
<tr>
<td>- Public Sector</td>
<td></td>
</tr>
<tr>
<td>- Special schemes</td>
<td></td>
</tr>
<tr>
<td>(ex. housing)</td>
<td></td>
</tr>
<tr>
<td>-...</td>
<td></td>
</tr>
<tr>
<td>Other assets</td>
<td>Capital owned by the Government</td>
</tr>
</tbody>
</table>

#### Other assets

<table>
<thead>
<tr>
<th>Other assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Private deposits (often collected through Post Offices)</td>
</tr>
<tr>
<td>Other liabilities (Government)</td>
</tr>
<tr>
<td>Capital owned by the Government</td>
</tr>
</tbody>
</table>

### 3.3.3 COOPERATIVE BANKS

**Any form of financial intermediary in which a group of people associates in order to offer to its members specific financial services at accessible contractual conditions can be included in the cooperative bank class.**

These forms of co-operation are usually characterised by various development stages. In rural areas of Developing Countries:

- **a typical form of financial co-operation is the savings and credit group** where members/depositors are the only ones who can benefit from loans; management is often assured on a voluntary base, paperwork is very limited and the bank-customer relationships are built prevalently on personal knowledge.

- **Groups can take the legal form of a co-operative or remain almost informal**: in fact, they are often classified as semi-formal intermediaries (see Part III).

- **On the contrary, financial co-operation can also be implemented through big co-operative banks** where the membership rule is sometimes relaxed and both deposits and loans contracts are also offered to non-members.
• In many cases it is a growth and transformation process that leads an informal group to become a co-operative, often qualified as credit union, in which operations become more formalised, recognised by public authorities (such as the Ministry of Rural Development in the case of rural credit unions) and, at last, to get the status of proper bank with an extended range of activities.

• In some instances, small co-operative banks, formal or semi-formal, become important partners of other kinds of banks, such as commercial or development banks. Savings they collect can be deposited in these banks and they, in turn, get loans from commercial or development banks which they on-lend to their members. This is a way for official banks to approach small-scale operators, especially in rural areas where they have few branches or none.

• In some other instances, co-operative banks co-ordinate in a network and create central bodies offering various supporting services, such as training or technical assistance, as well as centralised financial operations: surplus units can deposit in the central body and deficit units can borrow from it; it this case it is the central body which usually interacts with the banking system (see the case study).

• The co-operative form has always encountered great success among donors in the case of financial development projects; the flexibility and adaptability to different operating contexts, as well as the learning process implied by the mentioned transformation, make them particularly attractive. Donors sometimes represent a subsidiary source of funds for them; they also support certain operating expenses (such as personnel, rents) in the initial stages of development.

The case of agricultural credit for small farmers is meaningful in this respect. Small farmers are characterised by:

- low average investments;
- minimal real assets to be offered as guarantees;
- weak information systems on their productive and financial performance;
- limited knowledge of financial contracts.

Co-operative banks in their simpler forms can satisfy small-farmers borrowing requests since they can:

IN FACT, COOPERATIVE BANKS, IN THEIR VARIOUS FORMS, CAN BE QUITE EFFECTIVE IN REACHING DIFFERENT LAYERS OF THE POPULATION, ALSO THOSE IGNORED BY COMMERCIAL BANKS SINCE CONDITIONS OFFERED BY COOPERATIVES ON FINANCIAL CONTRACTS PROVED TO BE THE MOST APPROPRIATE FOR THE CHARACTERISTICS OF THEIR MEMBERS.
⇒ provide small-size loans;
⇒ substitute the member’s personal knowledge for both lack of guarantees and weak information systems; they base their creditworthiness analysis on more flexible scheme than traditional standards;
⇒ use simple and understandable financial contracts.

Savings mobilization and lending to members are the main activities of cooperative banks. In some cases lending is strictly linked to savings

In fact, eligibility to loans is often evaluated according to the savings performance of the potential borrower: regular savings for a certain period of time give the right to get a proportional loan amount. Linking savings and credit is typical of simpler forms of financial co-operation offered to small-size customers: on one side, the borrowing perspective attract savers and, on the other side, lending becomes safer when backed by a certain deposit performance.

Acting on a small-scale and dealing with somehow naïve customers implies facing high operating expenses, i.e. time and personal resource investments are relatively important.

Co-operative banks are usually keen to accept these operating costs; profit maximisation may not be very important while they seek to efficiently reach their members. In fact, their overall purposes can be expressed as:

⇒ offer attractive financial services to their members;
⇒ expanding membership;
⇒ reaching a certain level of profitability allowing for self-sustainability.

A critique that sometimes is raised about co-operative banks is that either they cannot respect the profitability constraint because they have many expenses as compared to actual revenues and they take big risks when they lend to rural operators, or they become conservative and limit their activity to savings mobilisation, investing the bulk of their assets in treasury bonds in order to reduce the overall risk of assets. When this policy is implemented in rural co-operative banks, the same situation as for savings banks occurs: funds are drained from the agricultural sector towards the government and rural operators are penalised in their investment projects.

Given the preceding consideration a schematic hypothetical balance sheet for a co-operative bank can be the following:
3.3.4. DEVELOPMENT BANKS

**Development banks are established**, usually under the governments’ control and upon governmental or foreign donors funding, **with the specific purpose of promoting economic growth of the most important or least developed sectors of the economy**, through the provision of credit.

In developing or transitional countries:

- they often concentrate on the agricultural sector

- given the predominantly public nature of development banks, government interventions, characterised by the imposition of interest-rates ceilings and credit ceilings and floors, **were easily implemented**

- Agricultural or rural development banks were encouraged to operate with public or foreign lines of credit, at low interest rates, which they on-lent to target beneficiaries at conditions usually determined by the sponsoring agency (government, donor). Experiences run according to these credit schemes proved to be quite ineffective both in terms of the achievement of development targets and for the banks’ general performance.
• **In many cases, development banks were not performing any savings mobilisation.** They could be considered as the “second half” of savings banks when the latter did not lend. In this way clients funds passed from Savings Banks to Development Banks through the government and a redundancy of intermediaries occurred.

In the case of agricultural/rural development banks, the flow of funds from and to the rural sector can be represented in the following scheme through the hypothetical balance sheets for each actor of the process:

<table>
<thead>
<tr>
<th>Development Bank</th>
<th>Government</th>
<th>Savings Bank</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loans to farmers</td>
<td>Public lines of credit</td>
<td>Loans shares T-bonds sold to Savings</td>
</tr>
<tr>
<td>Public equity</td>
<td>Public lines in Development Banks</td>
<td>T-bonds</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Savings from farmers</td>
</tr>
</tbody>
</table>

The redundancy of financial intermediaries and the intermediation of the government appear from the scheme. If just one intermediary could mobilise savings and re-invest them directly with customers, the other funds transfers could be avoided. These transfers, besides being costly and time consuming, are usually inefficient. The whole process in many cases proved to be weak.

**WHEN LENDING IS NOT PERFORMED CORRECTLY DEVELOPMENT BANKS EXPERIENCE DEFAULTS AND LOSSES. RECOVERING PROCESSES OR THE CREATION OF NEW BANKS REPLACING THE BANKRUPT ONES ARE NOW CHARACTERIZING MANY DEVELOPMENT BANKS.**

Some of them are going through structural changes such as new legal set-ups, while others are progressively revising their internal policies. Section 4 of this Part of the handbook is devoted merely to this issue, considering both the causes for failure of past policies and recovering processes.

**NEW DEVELOPMENT BANKS PROGRESSIVELY RESEMBLE TO COMMERCIAL BANKS IN THEIR OPERATIONAL FEATURES AND CAN BECOME THEIR COMPETORS.**
They often offer similar products while, as stated, hierarchy and specific roles of different bank categories tend to disappear; however, development banks seldom have the same international connections as commercial banks; they still operate mainly in local markets and are much more interested in expanding towards rural areas. They consider rural areas as potential customers reservoirs, as they can effectively be, given their institutional goals. In fact, development banks can have different general objectives and attitudes towards risk as compared to commercial banks.

**DEVELOPMENT BANKS THAT WANT TO SUCCEED IN THE MARKET MAY WISH IS TO PURSUE AT THE SAME TIME:**

1. A HIGHER RISK LEVEL THAN COMMERCIAL BANKS BECAUSE OF THEIR CONCERN TO PROMOTE ECONOMIC GROWTH.
2. AN *EFFICIENT ADAPTATION* TO RURAL MARKETS ALLOWING TO PRESERVE THEIR FINANCIAL EQUILIBRIUM, WHICH MIGHT IMPLY CO-OPERATION WITH OTHER RURAL FINANCIAL INTERMEDIARIES (on these issues see section 4).

A balance sheet containing typical items for an agriculture development bank follows and will be further analysed in section 4.

**DEVELOPMENT BANK**

**Balance Sheet**

<table>
<thead>
<tr>
<th>Cash and other liquidity</th>
<th>Borrowed funds from:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>-Government</td>
</tr>
<tr>
<td></td>
<td>-Donors</td>
</tr>
<tr>
<td></td>
<td>(low-cost resources)</td>
</tr>
<tr>
<td>Loans to target-groups</td>
<td>Other borrowing</td>
</tr>
<tr>
<td>Other assets</td>
<td>Capital owned by:</td>
</tr>
<tr>
<td></td>
<td>-Government</td>
</tr>
<tr>
<td></td>
<td>-Donors</td>
</tr>
</tbody>
</table>
3.4. Types of contracts offered in the formal market

It is quite difficult to describe all types of contracts offered in the formal financial market of developing countries. Each country may have ad hoc legislation on banking operations that can technically differ from other countries; moreover, different types of banks can offer different loan schemes.

Very common contracts in the agricultural sector are the following:

**Short-term lending:**

1. *seasonal loans:* the farmer requires a loan to buy seasonal productive inputs, such as seeds, fertilisers or to pay for tractor rents. Loans are usually granted one-two months before the rainy season and expire after harvest. Seasonal loans can also be granted to breeders for the time they grow their animals before sale.

2. *counter-seasonal loans:* some agricultural products grow between two common agricultural seasons (i.e. in the dry season); special loan schemes can be provided to finance input purchase.

3. *personal loans:* especially in the dry season, producers may need bridge loans to cover personal (and productive) expenses, either because they have already invested all the proceeds of previous harvest, or because they have not sold yet all their crops. Banks may intervene with a consumer loan.

4. *trade loans:* traders of agricultural products are usually offered bank loans covering the purchase of the product; these loans are often very short-term and are repaid when the products acquired are sold.

**Long-term lending:**

*Investment loans:* farmers that want to improve their productive structure, to increase the crop surface, to buy machinery or animals can apply for a long-term loan (often 3-5 years). Repayments are done by annual instalments; mortgage or pledge are usually required.

3.5. Islamic Banking

Given the widespread presence of the Arab culture in developing and transitional economies, a note is necessary to briefly explain the main differences between Western-style banking and Islamic banking.

Since the Koran does not allow the practice of interest rates on loans both for productive and consumption loans, lending activity should be considered as a charitable act. Profit participation, on the contrary, is allowed. Therefore, banks in the Islamic culture, differ in their operations from Western banks.

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2This paragraph has been written according to what stated by Muhammad Nejatullah Siddiqi, *Il sistema bancario islamico: teoria e pratica*
Islamic banks are limited liability joint-stock companies; shareholders manage the bank through the Board. The main activity of the bank is collecting funds from the public through a *mudaraba* contract and grant funds to entrepreneurs with the same system.

The main difference between a loan contract and the *mudaraba* concerns the degree of risk that the bank takes. In a loan contract the bank perceives a fixed remuneration for the money it invests, independent from the actual performance of the beneficiary firm. The bank receives the same amount either if the borrower has a profit much higher than expected or much lower (except when the borrower is a defaulter). In the *mudaraba* system, the bank participates to the borrower profits in a fixed percentage; if the borrower has no profit, the banks only receives the capital; the borrower’s financial obligations are then a variable amount according to the performance of his/her firm. In the case of *mudaraba*, the bank is much more involved in the firm performance and should be convinced of the value of the investment project.

The bank gross revenue derives from the profit shares the bank has in the business of entrepreneurs it has lent to. The bank deducts the general expenses and distribute the net revenue to depositors and shareholders. In the *double mudaraba*, deposit remuneration depends on the actual profits deriving from investments. This may reduce the bank’s risk of mismatching between asset and liability characteristics.

Of course, this is a simplified version of the Islamic banking scheme: many different contracts can take place and complicate the picture.

For instance the *murabaha* contract is used to finance the purchase of goods: the banks buys the goods that the customer needs and sells them back to him at a higher price that the customer pays in instalments. The *ijara* contract is a leasing contract; the *salaam* is a contract in which the customer sells the goods to the bank, receives immediately the price but delivers the goods later.

Investors also have various alternatives: they can choose among *mudaraba* certificates; investment certificates or leasing certificates, issued also by other financial intermediaries than commercial banks; all these instruments respect the principle of profit participation.

### 3.6 Appendix: The Bank’s Financial Statements

As explained in part I of this manual, banks and other financial intermediaries contribute to transfer funds from surplus (savers) to deficit unit (investors). These financial flows that “pass through the bank” shape the structure of its Balance Sheet, and originate costs and revenues, reflected in the Income and Expense account.

Generally speaking, banks are financed through depositors’ money and use this money to finance borrowers; in this process they charge different interest rates on deposits and loans, which make the bulk of their profits.
3.6.1 The Balance Sheet

Bank asset and liability composition differ quite substantially as compared to other firms operating, for instance, in the trade or manufacturing sectors. Banks are usually financed to a larger extent by borrowed funds, i.e. banks are less capitalised than other non-financial firms. On the assets side, banks own fewer real assets since the bulk of their investments is represented by financial assets (cash, loans, bonds, ....).

The banks’ LIABILITIES, their sources of funds, can be classified into different groups, according to their maturity:

⇒ demand deposits can be withdrawn at any time; in some countries they do not bear any interest while in others they earn a rate that, at least in principle, should cover the depositors from the money depreciation due to the inflation rate and compensate for the temporary renunciation to consumption;

⇒ current/checking accounts are demand deposits where depositors can write checks to withdraw their money;

⇒ time deposits have a fixed maturity that can be quite short (some months) or longer (more than one year), according to the laws of different countries. They can take the form of a passbook deposits or a certificates of deposit; the latter are often negotiable in specific markets. Time deposits usually imply early-withdrawal fees.

⇒ long-term debt is represented by notes and bonds a bank can issue, with a maturity longer than one year, 18 months or even more in different countries.

⇒ short or long term loans can also be granted to the bank by other banks, foreign agencies or governments, especially in developing countries;

⇒ stockholders equity is the capital representing the bank ownership. Equity comprises stocks, undivided profits and reserves. By definition shares do not have a fixed maturity since they are worth until the termination of the bank’s life.

The cost of the different kind of resources vary according to various parameters; generally speaking longer term resources are more expensive but some complementary factors, such as the type of depositor or lender and the currency of denomination influence the actual borrowing cost. Shares bear a variable cost represented by paid-out dividends.

On the ASSET side, again, a classification of the different investments according to their maturity is possible:

⇒ cash and due from banks group vault cash, demand deposits held at the Central Bank or in other banks;
⇒ **short-term interest bearing investments** have the function to meet the bank’s liquidity needs, partially compensating the trade-off liquidity/profitability. In fact, in opposition to vault cash, they may earn an interest but they can be easily transformed into cash, with a minor loss;

⇒ **loans** represent the most typical class of banks’ assets and generate the greatest amount of income. On the other side, they are usually quite illiquid, since they are hardly negotiable, and they originate one of the banks’ major risk: the risk of default. Loan management is then very crucial for banks’ performance.

Loans can be classified according to:
- the nature of the borrower (ex. business, personal loans),
- the sector of intervention (ex. agriculture, commercial, real estate loans),
- their maturity (short-term, medium or long-term loans)
- the currency of denomination.

*Problem loans*, those whose repayment is not regular, go through progressive stages: from simple delays in repayments to actual charge-offs. These general definitions apply:

*Outstanding loan*: uncollected, unpaid loan (it does not necessarily mean default as the bank may agree on the loan outstanding balance)

*Doubtful loan*, nonaccrual loan, problem loan: a loan that is not earning the contractual rate of interest in the loan agreement, due to the financial difficulties of the borrower. Interest accrual have been suspended because full collection of principal is in doubt, or interest payments have not been made for a sustained period of time (for example 90 days).

*Insolvency*: inability to pay debts as they mature

*Substandard loan*: a loan that is protected inadequately by current net worth and paying capacity of the borrower, or the collateral pledged.

*Arrear, Default*: a loan due but unpaid

*Charge-off, write-off*: loan written off as uncollectible debt. When full repayment is considered unlikely, loans are removed from the lender’s balance sheet and charged against the loan loss reserves account for bad debts.

*Banks make special provisions* to cover themselves from future loan losses; these provisions can be directly deducted from the loan total amount so that the net value is indicated in the balance sheet, or they can be grouped in a special fund of liabilities, according to different country laws.

⇒ **investment securities** group bills and bonds with various maturities issued by public or private bodies. Their risk is functional to the quality of the issuer. Government securities are usually considered as risk-free assets. The bank can purchase securities for its own investment policy or in order to satisfy the customers’ periodical demand;

⇒ **shares/equity participations** appear sometimes among banks’ assets; in some countries banks are not allowed to hold participations in other firms, particularly in the case of non

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3Thomas Fitch, *Dictionary of Banking Terms*
financial firms; in other countries universal banking is allowed, usually within certain limits in order to avoid a high concentration of risk;

⇒ **real assets**, as stated at the beginning of this paragraph, are usually small in value as compared to financial assets. They are represented, among other things, by the real estates where the bank operates and investments in information technology.

*As in the case of liabilities, the interest earned on financial assets is also related to their maturity and to other factors such as the quality of the beneficiary. For instance, a high risk customers pays in principle a higher interest rate than a lower risk one.*

Of course, the classes proposed above group the most important and common liabilities and assets of a bank, while each bank may have its own specific items. Residual items of minor importance may also be grouped into the “**other assets**”, “**other liabilities**” categories.

**OFF-BALANCE SHEET items** can become quantitatively very important; they group the countervalue of relevant operations the banks runs without modifying its own assets or without issuing new liabilities, because the operations do not “pass through” the bank even if they engage it somehow. For instance, if the bank receives a mortgage as a collateral for a loan, it keeps it until the loan is repaid without being the owner of the real estate. The bank may also become the guarantor of some obligations of a customer towards a third party and, until the customer has autonomously fulfilled it, the bank has to keep track of this potential monetary outflow.

*Banks in different countries, and different banks in the same country, tend to have different asset and liability compositions, according to their institutional set-ups, their organisation, their strategic choices, and so on.*

As shown in this section, banks in developing countries also have typical balance sheets depending on their category and function. For instance, savings banks in the past had a liability compositions where deposits prevailed but on the assets side they made few loans; on the contrary, development banks usually had a wide (sometimes unhealthy) loan portfolio but they collected few deposits and rested more on public/external loans.

The present reality, however, leads the various bank types to diversify their activities; development banks are now improving their savings mobilisation potential and their balance sheet structure becomes closer and closer to the one of commercial banks. What matters in this process is that the banks’ performance improves, both in terms of sustainability and ability to satisfy target customers.
Bank balance sheet summary table

<table>
<thead>
<tr>
<th>ASSETS</th>
<th>LIABILITIES</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash and due from banks</td>
<td>Demand deposits</td>
</tr>
<tr>
<td>Short-term interest bearing investments</td>
<td>Current/checking accounts</td>
</tr>
<tr>
<td>Loans (net of provisions for losses)</td>
<td>Time deposits</td>
</tr>
<tr>
<td>Investment securities</td>
<td>Long-term debt</td>
</tr>
<tr>
<td>Shares/equity participations</td>
<td>Other loans</td>
</tr>
<tr>
<td>Other assets</td>
<td>Other liabilities</td>
</tr>
<tr>
<td>Real assets</td>
<td>Equity (including profit)</td>
</tr>
<tr>
<td><strong>TOTAL ASSETS</strong></td>
<td><strong>TOTAL LIABILITIES</strong></td>
</tr>
<tr>
<td>Off-balance sheet assets</td>
<td>Off balance-sheet liabilities</td>
</tr>
<tr>
<td><strong>GRAND TOTAL</strong></td>
<td><strong>GRAND TOTAL</strong></td>
</tr>
</tbody>
</table>

3.6.2 The Income and Expense account

The Income and Expense account originates from the composition of assets and liabilities and from the bank organisational structure. In fact, the main bank revenues derive from the different bank investments, as reported in the assets side of the balance-sheet, while important costs originate from the different sources of funds. Other important costs, in turn, pertain to overhead expenses, such as personnel and real assets entertainment and depreciation.

The main revenues can be classified as follows:

◊ **Interests earned** on loans, deposits at other institutions, securities or the investment in other financial products can be group in the post *Interest Income*

◊ **Fees and other service charges**, paid by customers on financial or non-financial services received (such as safety-deposit boxes), and the *revenues deriving from trading securities* or from selling investment securities make the *Noninterest Income*

Costs, in turn, can also be grouped in two categories:

◊ **Interests paid** on sources of funds, such as deposits, other short or long-term debt are grouped in the post *Interest Expense*

◊ **Provisions for loan losses** are a noncash expense that indicates the management’s perception of the quality of the loan portfolio. In fact, these provisions should be proportionate to the estimated quota of the loan portfolio that could default during the current year. If the provision policy is correct enough, this source of expense becomes an indicator of the loan portfolio risk for external observers. The sum of the provisions made each year can appear in the Balance Sheet among the liabilities or is deducted from the value of total loans of the asset side.
◊ Other expenses, such as salaries and other employment costs, rents and depreciations of equipment, and utilities, represent the Noninterest Expense or Operating Expenses, since they originate from the banks’ operations.

It is almost always the case that Noninterest Expense exceeds Noninterest Income, while Interest Income is higher than Interest Expenses, even if the so called Interest Margin (Interest Income - Interest Expenses) is shrinking in many banks due to competition pressure.

The Income and Expense Account and its posts can be represented in a way that intermediate results can be highlighted, before getting to the Net Operating Income, and, after tax deduction, to the final result: the Net Profit or Loss, as follows:

| Interest Income | on loans, due from banks, securities, other financial investments, ...
| - Interest Expense | on deposits, other short and long-term debt, ...
| INTEREST MARGIN |  
| +Fees and commissions | on bank’s financial and non-financial products trading and investment securities for services received |
| +Revenues from trading securities - Fees and commissions paid |  
| MARGIN ON FINANCIAL INTERMEDIATION |  
| - Provisions for loan losses | reasonable estimate of current potential losses |
| NET MARGIN ON FINANCIAL INTERMEDIATION |  
| - Salaries | indicated separately because of their importance |
| - Other operating expenses | rents and depreciations of equipment, and utilities |
| NET OPERATING INCOME |  
| - Income Taxes |  
| NET PROFIT |  

Agricultural Training Manual 21
Practical illustration:

A description of the institutions operating in the country where participants come from should be presented, with synthetic figures on their activities in the agricultural sector and their performances. Information on the informal market should be given, when available.

Case study:

The Durang financial sector and the new approach to the rural environment
References