ASIAN DEVELOPMENT BANK

TECHNICAL ASSISTANCE PERFORMANCE AUDIT REPORT

ON THE

INSTITUTIONAL STRENGTHENING OF THE AGRICULTURAL BANK OF PAPUA NEW GUINEA (TA No. 1661-PNG)

IN

PAPUA NEW GUINEA

December 1996

I. BACKGROUND

A. Introduction

1. The Rural Development Bank of Papua New Guinea (RDB) is a Government-owned financial institution. It was established in 1965 as a statutory corporation called the Papua New Guinea Development Bank. In 1984, the name was changed to Agricultural Bank of Papua New Guinea, to emphasize the importance of agriculture in the country's development, and in 1994, as part of a change in Government policy, the name was changed to Rural Development Bank of Papua New Guinea.

2. Between 1971 and 1982, the Bank made three loans to RDB.[1] At the time of postevaluation, these loans were all found to have been partly successful. In addition, the Bank provided technical assistance (TA) grants to RDB for overseas training of one staff member,[2] and for institutional strengthening of RDB's commercial and industrial subproject appraisal procedures,[3] but following a change in orientation of RDB's activities to require it to concentrate on agriculture lending, this latter TA was canceled unused in January 1989.

3. In spite of assistance provided by the Bank, RDB's financial performance was generally unsatisfactory. The need for Bank TA for institutional strengthening of RDB was identified by a Country Operational Program Mission and by the Project Completion Review Mission for the *Third Papua New Guinea Development Bank Project*.[4] It was considered that an improvement in RDB's operations would complement the Government's efforts to enhance income growth and employment generation in the agriculture and manufacturing sectors. In addition, under technical assistance for a study of agricultural credit and rural savings, it was recommended that there should be a major review of RDB's institutional and operational aspects including its policy, lending and administrative operations, and organizational structure.[5]

B. Rationale, Objectives, and Scope

4. The rationale for the TA was that RDB's ability to promote the development of private enterprises in the agriculture, industry, and commercial sectors was considered to have been hampered by institutional weaknesses, including high recurrent expenditures, poor staff quality in project appraisal and supervision, and inadequacies in its management information

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[1] Loan No. 84-PNG(SF): *Papua New Guinea Development Bank Project,* for $4.5 million, approved on 14 December 1971; Loan No. 342-PNG(SF): *Second Papua New Guinea Development Bank Project,* for $7.0 million, approved on 1 June 1978; and Loan No. 611-PNG(SF): *Third Papua New Guinea Development Bank Project,* for $11 million, approved on 9 December 1982.

[2] TA No. 84-PNG: *Development Bank Staff Training Scheme,* for $3,600, approved on 15 February 1973.

[3] TA No. 497-PNG: *Papua New Guinea Development Bank,* for $210,000, approved on 9 December 1982.

[4] Loan No. 611-PNG(SF): *Third Papua New Guinea Development Bank Project*.

[5] TA No. 1239-PNG: *Agriculture Credit and Rural Savings Study,* for $340,000, approved on 12 December 1989.

systems. The main objective of the TA was, therefore, to strengthen the institutional and operational aspects of RDB and to enhance the skills of its staff by providing on-the-job training in project promotion, identification, appraisal, processing, implementation, and monitoring. Other objectives were (i) to review and implement improved institutional and operational systems, procedures and manuals; (ii) to enhance RDB's loan portfolio quality through improved collection performance and the reduction of arrears; (iii) to prepare a corporate plan including detailed implementation strategies; (iv) to review the existing management information system (MIS) and make recommendations to implement an integrated system; (v) to review the terms of reference prepared by RDB for an MIS study and recommend improvements where necessary; (vi) to investigate new avenues of resource mobilization and business development; and (vii) to improve RDB's organization structure and internal efficiencies.

5. It was expected that following implementation of the TA, RDB would become a financially viable development finance institution. This is therefore a major criterion for assessing the TA.

II. ASSESSMENT OF IMPLEMENTATION

A. Design of the TA

1. Concept and Approach

6. RDB was considered to be the main financial instrument of the Government to promote the growth of viable small and medium-scale enterprises in Papua New Guinea (PNG) and an important conduit for channeling funds to the private sector to promote economic development of the country. The TA was seen, by the Government, as a means of overcoming the weaknesses of RDB and thus enhancing the Government's strategies. Further, the TA was fully consistent with the Bank's strategy for PNG. In 1991, the Bank's Country Operational Program included provision for a fourth line of credit to RDB and, given this, a technical assistance of this type would seem to have been appropriate as a prerequisite for the loan.[1]

7. The TA provided for four consultants, a development banking expert, a commercial banking expert, a rural credit expert, and an MIS expert. The total number of person-months for the consultancy was 24. It was expected that the consultants would have experience in developing countries. The consultants' expertise and the time provided was appropriate.

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[1] The fact that it was eventually decided not to provide a fourth line of credit to RDB can be attributed, at least in part, to institutional, financial, and operational weaknesses identified by the consultants during the TA and the failure of the Government to respond to those weaknesses.

2. RDB Involvement in TA Design

8. There is little information on which to base a determination of the extent of RDB's involvement in project design. The Fact-finding Mission did, however, have discussions with most senior officers in RDB and visited regional offices. In addition, there is evidence that RDB played an active role in formulating the MIS component of the TA.

3. Terms of Reference of Consultants

9. The Technical Assistance Performance Report (TPAR) Mission endorses the comments made in the Technical Assistance Completion Report (TCR) regarding the terms of reference for the consultants. The scope of work was appropriate, clearly and comprehensively defined, and focused on the objectives of the TA. The consultants' terms of reference were also detailed and comprehensive.

10. The schedule adopted for implementation of the TA was appropriate. Under this schedule, the consultants were to prepare a draft corporate plan, an MIS report, and a training plan during a first phase of the TA. A second phase was to involve on-the-job training, preparation of operational manuals, and assistance in implementation of the corporate plan.

11. In general, the time allowed for the TA and its components was adequate. There were suggestions that the time-frame allowed for formulation of a corporate plan and implementation of the plan was too optimistic. However, it appears that delays (see para. 0) were largely attributable to the length of time required by the Government to make a decision on the draft corporate plan; this could not have been foreseen at the time the TA was prepared.

B. Engagement of Consultants

12. The consultants were engaged in accordance with the Bank's *Guidelines on the Use of Consultants*. The work was carried out by a team of four consultants working under the auspices of two consulting firms. This arrangement seems to have been satisfactory and except for illness of one of the consultants there were no problems. The recruitment was undertaken efficiently and the consultants commenced field work on 20 July 1992, about two weeks behind schedule.

C. Organization and Management

13. The approach adopted by the consultants to the preparation of the report was generally appropriate and they worked closely with the management and staff of RDB. They appear to have had a cordial relationship with personnel in RDB and to have been respected. There was full consultation on all issues of importance. This involved regular progress reporting

and reviews and the close involvement of RDB's management in the development of the Draft Corporate Plan, which was a key output of the TA. There was some criticism that the training section had not been consulted closely enough by the consultants in the formulation of the training component, but it was recognized that at the time this component was being formulated, there were uncertainties concerning the future of RDB that made it difficult to determine what training was appropriate.

D. Implementation Schedule and Financing Arrangements

14. There were virtually no problems in implementation of the first phase of the TA (i.e., up to the completion of the Draft Corporate Plan). This Plan was completed in December 1992, precisely on schedule. However, the second phase of the TA was affected by the failure of the Government to reach a decision concerning adoption of the proposed Corporate Plan. This led to delays in the implementation of the training program and in the submission of the revised final report, which was not submitted until September 1993, about six months behind schedule.

15. The total cost of the TA was expected to be $648,000 equivalent, of which the foreign exchange component was estimated to be $580,000. This included contingency allowances of $58,000. The Bank was expected to cover the full foreign exchange cost and $2,000 of domestic air travel. The balance of the cost was to be covered by RDB. The actual cost of the TA was $536,177 of which the Bank financed $501,002.

E. Supervision

16. The TPAR Mission agrees with the comments of the TCR that the TA was adequately supervised by the Bank. The files show that there was frequent interaction between the Bank and the consultants and between the Bank and RDB. The Project Director for the consultants visited Manila for discussions with the Bank and Bank staff participated in a mid-term tripartite review meeting, which was held in Port Moresby, to consider the Draft Corporate Plan, a draft training plan, and a final report on the MIS.

17. RDB demonstrated the fullest commitment to the TA. It provided the necessary support facilities for the consultants to enable them to undertake their work effectively. The comments of RDB indicate that there was good interaction between the consultants and senior management.

III. EVALUATION OF OUTPUTS AND IMPACT

A. Adequacy and Quality of Reports and Services Provided

18. During the first phase of the TA, the consultants produced a series of 13 working papers covering (i) Mandate, Financing and Organizational Structure; (ii) Staffing; (iii) Training and Manpower Development; (iv) Rural Credit; (v) Commercial and Industrial Credit; (vi) Financial Management; (vii) Portfolio Management; (viii) Management Information Service; (ix) Financial Performance; (x) Business Development; (xi) Corporate Objectives; (xii) Strengths, Weaknesses, Opportunities and Threats Analysis, Strategy and Policy Framework; and (xiii) the Draft Corporate Plan.

19. From RDB's point of view the Corporate Plan was perhaps the most important output of the TA and it was based on the other 12 working papers. These working papers showed that RDB was insolvent and illiquid, and had inadequate loan loss provisions, no loan classification system, and an inadequate MIS system. The Draft Corporate Plan was regarded as providing a sound base for turning RDB into a self-sustaining financial institution. At the mid-term tripartite review meeting, RDB's management indicated that they endorsed the Draft Corporate Plan and the Bank's representative commended the consultants for their work.

20. Although the Corporate Plan was completed some time ago, it is clear that it continues to have a major influence on decision making within RDB. It is still being used by senior management of RDB as the main tool in determining the direction that RDB should take.

B. Training

21. The TA placed heavy emphasis on training (see para. 0). It was recognized that RDB's operational performance had been adversely affected by, among other things, a lack of up-to-date project appraisal methods and techniques, and inadequate and out-dated project monitoring procedures. On-the-job training to rectify these problems was therefore an important component of the TA. Preparation of a training plan and materials was to take place during the first phase of the TA but actual training was scheduled for the second phase, after the tripartite meeting on the Draft Corporate Plan. The proposals for training submitted at the end of the first phase were related to the adoption of the recommendations for the future direction of RDB that were made in the Draft Corporate Plan. The consultants found that there were major gaps in the skills of middle management as well as more junior staff and the major areas for training were identified as the basic elements of lending: appraisal, financial analysis, marketing, and supervision. In addition to in-house on-the-job training, the consultants identified a need for training of selected staff at various institutions in PNG.

22. However, in early 1993 there was some uncertainty as to the future of RDB and whether it would remain a separate entity or be absorbed into the PNG Banking Corporation. This delayed the start of the training program because it was considered that committal of funds to training would be hard to justify when RDB was not sure about its future or which staff would be retained. Initially, RDB proposed that the training program should effectively be abandoned and the funds reallocated. However, the Bank considered that training was critical to the successful development of RDB and accordingly refused to approve a reallocation of the funds.

Consequently, a modified training program was eventually agreed among the Bank, RDB, and the consultants. Whereas it was originally expected that about 100 staff would be trained, the revised program covered only 87 staff and the cope was reduced provided for less than half the number of officers to be trained. The revised program also involved a reduction in scope.

23. Ultimately, however, the training program covered 87 RDB staff members and was given in regional/branch/representative office locations. Because of staff movements and organizational changes it is difficult to identify the impact of the training program. The Training Manager informed the Mission that, although he had been in agreement with the proposals of the consultants regarding training, the actual training component had been undertaken hurriedly and the task had not been completed. However, the Manager considered that this was largely attributable to factors beyond the consultants' control. At the time the training was being given, uncertainties about the future and in particular the Government's lack of commitment to RDB had made it difficult to determine who should be trained and, in some cases, individuals who received training were subsequently made redundant.[1]

C. Institution Building

24. There is general agreement that the Corporate Plan proposed by the consultants provided a sound basis for the rehabilitation of RDB.[2] The Plan had three central strategies:

Restructuring the Balance Sheet — (a) conversion to equity of K35 million of debt to the Government and rescheduling of other debt, (b) introduction of K5 million in new capital, and (c) disposal of nonperforming assets and surplus premises.
Generating an Operating Surplus — (a) reductions in staff numbers by about 50 percent, (b) closure or downgrading of about one third of bank outlets, (c) increases in interest rates to bring them closer to market rates, and (d) payment for nonbanking services performed by RDB on behalf of the Government.
Improving the Quality of Lending Operations — (a) introduction of sound lending practices, (b) more diversified activities, (c) operating branches on a profit center basis, (d) improved MIS and upgrading of equipment, and (e) introduction of a comprehensive training program.

25. The success of these strategies required a strong political commitment, by the Government, and strong support from management of RDB. However, action on the recommendations in the Corporate Plan was initially quite slow. The Government's position was equivocal, reflecting a lack of commitment by the Government to the consultants' recommendations. When the Government announced new policy guidelines for RDB (including a change of name), in November 1993, these changes were not fully compatible with the recommendations of the consultants, and at the time of the TPAR Mission, the Corporate Plan had still not been formally adopted by the Government.

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1 The Executing Agency commented that although the uncertainty had an impact on the training program, it was considered that the training program was poorly delivered and that RDB would have benefited if well structured materials on subjects such as appraisal techniques, project monitoring and evaluation, loan recovery techniques, and portfolio management had been made available for future use.

2 Further details of the Corporate Plan are given in Appendix 1.

26. The response of RDB was more positive and the Plan was accepted by the management of RDB. In part this is reflected in a reduction in staff from 405 at the beginning of 1993 to 315 at the beginning of 1994.[1] This reduction is impressive, especially given the difficulties of retrenching staff in PNG. However, the management and the Board of Directors of RDB were beholden to the Government and this inhibited action to implement the Plan until August 1995, when the Managing Director and the Deputy Managing Director of RDB were suspended for alleged mismanagement and an interim administration was appointed. Under this interim administration, there has been considerable progress in implementing those recommendations made by the consultants that were within the competency of RDB. There is now a concern about the future of the organization and with this in mind RDB has followed the Corporate Plan as closely as possible.

27. A new corporate structure for RDB has been introduced (see Appendix 2). This structure became effective on 1 January 1996 and involved reductions in the size of RDB, with the closure of financially nonviable offices and continued reductions in staff numbers, and introduction of the profit center concept recommended by the consultants. In addition, RDB has been introducing a new MIS system during 1996.

28. By the beginning of 1996, the number of staff had been reduced to 249 and it is expected that, with the implementation of the MIS, the number will be reduced to about 210, as recommended by the consultants. In addition, the ratio of head office staff to field staff has fallen from 0.753 at the beginning of 1993 to 0.717 at the beginning of 1996.

29. Perhaps the most important development has been the establishment of a lending committee comprising senior managers of RDB. The main objective of this committee is to reduce the scope for outside pressures to influence RDB's lending decisions. It is anticipated that this will lead to a significant improvement in the quality of lending by RDB.

30. RDB has also persuaded the Government to allow some increases in interest rates. In September 1995, the Government allowed RDB to increase interest rates on most loans. The increases were generally greatest for the borrowers that had previously received the most concessional rates. Nonetheless, RDB's current interest rates continue to discriminate among borrowers on noncommercial grounds with smaller borrowers and "disadvantaged" areas, and rural borrowers receiving preferential rates. Further, although comparisons are difficult, RDB's existing rates appear to be still below prevailing market rates.

D. Performance of Consultants

31. The consultants completed their assignment in accordance with their terms of reference and, frequently, under difficult circumstances. During the technical assistance, their performance was favorably commented on by both the Bank and RDB. The TCR Report comments that RDB particularly commended the team leader for his meticulous planning and

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[1] Both figures include nine expatriates.

absolute dedication to the task. The TPAR Mission found that these comments on the consultants were fully supported by the records and through discussions with RDB personnel and the consultants. It is considered that the performance of the consultants was generally satisfactory except in the training component.

IV. CONCLUSIONS

32. RDB has played the major role in providing finance to the rural sector. Indeed, in most areas it is the only source of formal credit. Its extensive branch network has meant that RDB has had an important influence on the development of agriculture and rural activity. However, this has been achieved at considerable cost. The balance sheets show that the Bank is insolvent and deeply indebted to the Government (see Appendix 3). RDB has a negative capital adequacy ratio and at the end of 1995 its assets covered less than 85 percent of liabilities. This represents a deterioration from the situation at the end of 1994 when assets covered 89 percent of liabilities.

A. Key Issues

33. Noncommercial factors have had an adverse impact on RDB. It has been subject to a number of policy conditions on its lending activities. Thus current policy conditions require that RDB participate in the promotion of Special Government Schemes including those relating to lending to women and youth groups, and micro-businesses, lend only in rural locations and focus lending on small and medium activities. In the past, RDB has been required to concentrate on agriculture lending. As in most developing economies this is risky but in PNG the problem is aggravated by land tenure problems, which limit the use of land as collateral.

34. For RDB, the problem has been further compounded by the concentration on tree crops, principally coffee and cocoa. The prices of these two commodities have been subject to considerable volatility in recent years.[1] This has therefore had a major impact on the repayment capacity of borrowers and adversely affected RDB's financial position.

35. There also seems to have been a high level of politically directed lending. There are allegations that loans are made to Board members or to others with political connections, that there is usually little prospect that such loans will be repaid and that little effort is made to enforce repayment. The establishment of a lending committee (see para. 0) represents an attempt to reduce such politically motivated lending.

36. The political constraints on lending have meant that RDB's lending has been concentrated in the most risky areas of the economy; areas in which other lenders would have

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[1] The price of coffee dropped from $4.51 per kilogram (kg) in 1980 to $0.88 per kg in 1992. Although there has been some recovery of prices recently, the 1995 price of $2.41 per kg was still low relative to recent years. Movements in the price of cocoa have been similar but not as severe.

little interest. The riskiness of RDB's portfolio has not been reflected in its interest rates. These have also been subject to political control and have generally been low relative to other lenders in the economy.

37. The above factors have led to relatively high defaults on loans, heavy losses, an erosion of equity, and high arrears. Accordingly, RDB's financial performance has been adversely affected and its future jeopardized.

38. Although the concept of the TA was sound and the outputs have provided a realistic framework for the development of RDB, the successful outcome of the TA appears to have been inhibited by the approach of the Government. While the management of RDB is using the Corporate Plan as the basis for most of its actions, the failure of the Government to formally endorse the Plan and to accept the key strategies outlined in the Plan has created uncertainty among the management and staff of RDB. This has not contributed to the creation of an environment conducive to the resuscitation of RDB. The lack of a Government commitment has made it difficult to recruit good staff and has limited management's willingness to undertake the necessary reforms.

39. A particular concern has been the failure of the Government to provide the necessary funding for restructuring the balance sheets. In November 1993, in line with the recommendations of the consultants, the National Executive Council decided to inject K19.2 million of new equity into RDB and to convert K50 million of loans and interest into equity capital.[1] This decision has not been implemented because, according to the Department of Finance, it is necessary to get the consent of external loan agencies. The Government continues to support RDB through loans that may be called in at anytime. Conventional indicators of the performance of banks are therefore misleading to decision makers both within and outside RDB. Inadequacies in the MIS and distortions brought about because of the need to meet social objectives make it difficult to assess the performance of RDB or to determine how successful the management has been in improving performance.[2] It also raises the possibility that decisions regarding the future of RDB may be made on the basis of inappropriate and inaccurate information.

B. Overall Assessment

40. Most indicators (e.g., reductions in the number of staff, closure of branches, income and expenditure data, and loan collections) and the changes in the structure (e.g., the establishment of a lending committee and the dissemination of greater powers to the branches and subbranches) suggest that the TA for *Institutional Strengthening of the Agricultural Bank of Papua New Guinea* has contributed to the strengthening of institutional and operational aspects of RDB, one of the major objectives (see para. 0). The new structure appears to be suited to the

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1 National Executive Council, Decision No. 175/93.

2 For example, data provided to the Mission suggest that at the end of 1995 assets covered less than 77 percent of RDB's liabilities whereas data provided in the annual report (see Appendix 3) show a figure of 84 percent.

needs of a commercial bank and there appears to be confidence within RDB that it can operate without Government support provided that it is given adequate autonomy. However, because of the continued failure of the Government to adopt the consultants' report and to provide RDB with sufficient autonomy, RDB has not been able to achieve financial viability (see para. 0). Further, the benefits of the training under the TA were limited by the uncertainties surrounding the future of RDB in 1993.

41. In line with the findings of the TCR, the TA is rated as partly successful. The consultants performed generally satisfactorily except with regard to the training component and, particularly in recent times, the management of RDB has proved committed to the successful implementation of those parts of the TA for which they have authority. But the full benefits of the TA cannot be realized without the adoption of the report by the Government, and in particular of the recommendations relating to the restructuring of the balance sheet. It is considered that the adoption of the report and the implementation of its findings would have created an appropriate framework for the operation of RDB as a viable institution and would thus have made this TA fully successful.

C. Lessons Learned

42. The most important lesson to emerge from this technical assistance is the importance of having the resolve and commitment of the Government to a TA and its findings. At the time the TA was being formulated, it would have been appropriate to have had some indication from the Government that it was indeed prepared to provide greater autonomy to RDB, to undertake the necessary financial restructuring, and to liberalize interest rates.

D. Follow-up Actions and Recommendations

43. The Bank should continue to exert pressure on the Government to adopt the consultants' report and to support the recommendations of the report. Efforts should be made to ensure that the Government provides an unambiguous indication concerning the future role of RDB. The Bank should ensure that RDB operates as an autonomous entity according to normal commercial banking practices. As the consultants' report indicates, a crucial step in this process will be the recapitalization of RDB through the injection of capital and the conversion of loans to equity. In addition, the Government should continue with the liberalization of interest rates and should remove any obligation for RDB to provide noncommercial services on behalf of the Government. Where a need for such services is identified and RDB is considered to be the most effective vehicle for their provision, they should be undertaken only on the basis of full cost recovery.

44. In addition, the Bank should use its influence to increase the autonomy of RDB and to reduce political interference in RDB's operations and in appointments to the Board of Directors and to senior management. The Government should be encouraged to privatize or corporatize RDB. This was proposed during the TA but was not pursued. The Bank might

consider technical assistance to assist with privatization or to support an organization that has greater autonomy.[1]

45. These follow-up actions would best be undertaken in the context of the Bank's annual country programming exercise.

[1] RDB commented that privatization would mean that most rural people would not have adequate access to credit finance, that RDB is an important vehicle for rural development, and that any recommendation to privatize RDB should first identify alternate sources of rural credit.