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Can a Government Loan Work for Microfinance? IFAD's Funding of the Agricultural Cooperative Bank of Armenia

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This case study documents how the International Fund for Agricultural Development creatively used a government loan to support the Agricultural Cooperative Bank of Armenia, enabling the institution to expand in rural provinces, strengthen its capital base, and become the largest bank in Armenia.

Overview

In late 1996, the International Fund for Agricultural Development (IFAD) initiated the Northwest Agricultural Services Project (NWASP) in Armenia. The objective of the four-year project was to develop sustainable agricultural support services for 40,000 people living in three rural provinces of northwest Armenia. At about the same time, the Agricultural Cooperative Bank of Armenia found itself at a critical juncture. Founded with European Union support, the bank had been operating with moderate success for just a year and was ready to implement a strategic expansion.

The objectives of the donor and the retail institution aligned beautifully. The two organizations persuaded the Armenian Ministry of Finance to accept a creative use of an IFAD loan that made sense for a growing microfinance operation. As a result, a US $4.5 million credit line was restructured into a loan and a grant for ACBA, allowing the bank to get its footing, reach self-sufficiency, and expand nationwide.

By 2000, ACBA had earned the distinction of "Bank of the Year in Armenia" from the Financial Times. As of December 2003, the bank had 32,640 customers and eight branches throughout the country—the largest geographical coverage of any bank in Armenia. Of US $21 million in its outstanding portfolio, US $8.8 million were agricultural loans. (In the rural provinces, 95 percent of ACBA's clients are farmers.) ACBA had total assets of approximately US $31 million, total equity of approximately US $9.5 million, and a US $ 0.8 million profit for 2003.

Setting the stage

After gaining its independence from the Soviet Union in 1991, the Armenian economy suffered one of the most severe contractions among transition economies, shrinking more than 50 percent in two years, while enduring a war, severe winters and hyperinflation. By 1994, two thirds of its approximately 3 million people were surviving on humanitarian assistance.

Against this background, ACBA was established in 1995 as a private cooperative bank to serve the rural community. Given that similar collective ventures had failed miserably in the Soviet Union, its creation was a bold move. The results of a European Union-sponsored feasibility study in 1993–94 had indicated, however, that Armenian farmers would participate in cooperatives and that the country's social structure would lend itself well to the format. The study, conducted by the French bank Crédit Agricole (CA) in cooperation with the Dutch Rabobank and the German DEG Bank, also made it clear that significant demand existed for rural loans in Armenia. CA has continued to be an important partner for ACBA, providing the bank technical assistance from inception through nationwide expansion.

Credit officer at ACBA Bank's Armavir Branch, with clients who are members of the local village association, 2000. (Photo: Printinfo).

By August 1995, ACBA had organized 2,340 farmer-members into 60 village associations (VAs) that were grouped into three regional unions of VAs (the actual shareholders of ACBA). It received its banking license from the Ministry of Finance in March 1996. At the end of that year, the bank had turned a small profit (US $17,000) and held 1,584 loans outstanding in a portfolio valued at US $557,000.

IFAD and ACBA's Complementary Strategies

IFAD launched the NWASP project to improve farm productivity and the incomes of farm families coping with the transition to market-oriented production systems. IFAD was looking for financial institutions to serve this target group in rural Armenia. ACBA was looking for funding to expand in the areas where IFAD wanted to create services. Its goal was to become a national bank.

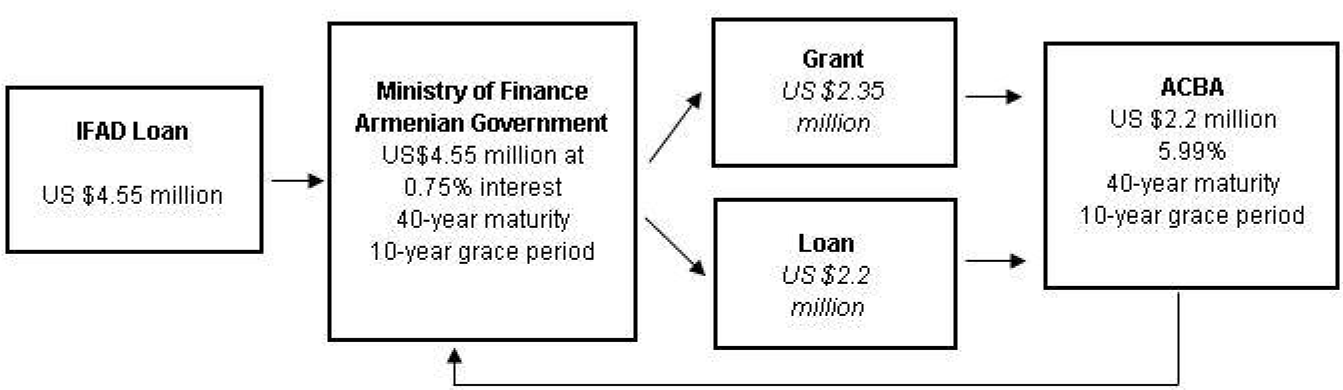
IFAD selected ACBA despite the fact that the bank had just begun operations and did not yet have an extensive branch network. Critical to IFAD's decision was ACBA's strategic clarity and successful track record with small-holder loans (up to US $700). In its first year of operations, the bank reported 100 percent loan repayment.

ACBA selected IFAD as a major donor because IFAD understood its financing needs. IFAD agreed with ACBA management that a credit line would not create a sustainable solution for the bank, which required funds for capacity building as well as on-lending. In a departure from its traditional lending method, IFAD worked with ACBA to restructure a planned credit line to the government into pass-through funding for ACBA.

IFAD would extend the government a US $4.5 million loan at 0.75 percent interest for a 40-year term, with a 10-year grace period. The government would in turn provide ACBA a US $2.35 million grant and US $2.2 million loan at 5.99 percent interest. (See graphic below.) The government would make enough profit on the loan portion to make the grant feasible, since the blend of loan and grants would cover the costs of the IFAD loan. Also, the government would potentially collect income taxes after the bank became profitable.

The government of Armenia was understandably reluctant to take a loan for capacity building for a private entity. According to Stepan Gishyan, General Manager of ACBA, the negotiations with the Ministry of Finance were the most challenging part of the project. "*IFAD helped us to show the government why it was necessary to create a structure that would live beyond the project*," he noted. "*We had to show them documentation and research. We provided examples of how this worked in other European countries.*" Gishyan's combination of European banking experience (an internship at CIC Bank, France) and work experience inside the Ministry of Finance, gave him valuable skills to manage this process. After the government accepted the grant/credit proposal, a subsidiary loan agreement between the Ministry of Finance and ACBA was signed in 1998. This agreement was cosigned by the Minister of Agriculture and endorsed by IFAD.

Graphic Summary of the IFAD–Ministry of Finance–ACBA Financing Arrangement



ACBA Expands Capacity and Performance

ACBA used the US $2.35 million grant to create many more village associations, (they were the key to a high quality portfolio and took time and money to develop) expand agricultural branches, and diversify its financial services. Whereas an ordinary credit line would only have added to the liabilities on its balance sheet, grant resources were used to contribute to the capital and reserves of the bank, helping it to build equity. This equity was then leveraged through other bank loans and savings mobilization.

IFAD Support to ACBA	
GRANT	**USE**
$300,000	Creation of 2 new regional unions
$450,000	Creation of new branch offices
$1,600,000	Equity investment
LOAN	**USE**
$2,200,000	Credit line for on-lending

The results of the bank's expansion were impressive. From March 1998–November 2003, ACBA extended 21,580 small loans to farmers, representing a value of US $14.8 million. The average loan was about US $700, with a maturity of 14 months. IFAD research indicated that ACBA borrowers had slightly larger farms than other farmers and managed to raise their incomes by 47 percent in 1998, the first full year of the NWASP project.

Loan performance has been exceptional, with only a few overdue loans, most of which have been recovered. In 1999, fraud caused a US $258,000 write-off, and ACBA management responded quickly. The staff of the branch office responsible for the fraud was dismissed immediately and replaced. Lending from the branch resumed within a few months. By the end of 2002, ACBA's reserves and equity equaled US $8.5 million, making it the largest bank in the country in terms of capital.

Although ACBA began by focusing on primary production by offering small loans to farmers, the bank diversified as the country's economy developed. Today, ACBA has a diverse client base and provides a full range of financial services, including demand and time deposits, bank card services, collateralized loans, installment lending, agricultural lending, lending to small- and medium-sized businesses, and the sale and purchase of promissory notes and securities. Savings products are in high demand with a 68 percent growth in retail customer deposits from December 2002 to December 2003.

Keys to Success for the Restructured Government Loan

IFAD's funding of ACBA was successful for four main reasons.

1. **ACBA found a creative way to make the IFAD loan work for sustainable microfinance and the Government of Armenia.** The terms and conditions of the IFAD concessional loan to the Armenian government made the ACBA funding package appealing to the government. The result has been a sustainable, profitable institution that will continue to serve its clientele beyond the term of IFAD funding *and* generate tax income for the government.

> *"ACBA now pays in taxes much more than they would receive in assistance from the government; that is an important factor to monitor [which can be used] to help persuade governments to do loan/grant combinations. If you set up the financial assistance to help an MFI really grow and thrive, the tax revenue from their success will more than pay for the assistance they received."*
>
> Henri Dommel, Rural Finance Advisor, IFAD

2. **The priorities of IFAD and ACBA were aligned.** IFAD wanted to serve clients in regions where ACBA wanted to expand. The objectives of both organizations were in synch. Convinced of the soundness of the bank's management and strategy, IFAD offered it the means to achieve expansion and sustainability.

> *"We were lucky to find each other. ACBA had done their research. They had a clear vision and sophisticated management. We evaluated their strategy to become a national bank and we thought it was sound. . . . We gave them the strategic capital they needed at the right time."*
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> Henning Pedersen, Country Program Manager for Armenia, IFAD
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> *"IFAD's assistance was important because it allowed us to expand to new regions. This permitted us to achieve the objectives of our strategy and respond to the demand from the farmers. The other banks were not providing financial services for them."*
>
> Stepan Gishyan, General Manager, ACBA

3. **ACBA followed commercial practices.** ACBA avoided political interference that can sometimes accompany government funds. Specific clauses were

inserted in its contract with the government to make ACBA responsible for all loan decisions and to ensure the effective and transparent flow of IFAD funds. "*ACBA stuck to its principles*," said IFAD's Pedersen, "*Not a loan has gone out of that bank as a result of a political favor*."

Clauses in the ACBA Agreement with the Government of Armenia that Protect ACBA

Clause 3.12(b): Sub-loan modalities. Current ACBA modalities for lending shall be applied, including inter alia: (i) the analysis and approval of applications for sub-loans shall be according to established ACBA procedures . . .

Clause 5.04: The Government shall take all action which shall be necessary on its part to enable ACBA to perform its obligations under this Agreement and shall not take or permit any action which would interfere with the performance of such obligations.

4. **ACBA's use of the cooperative structure in credit delivery, ensured high portfolio quality.** The delivery system used by ACBA to extend loans to farmers—village associations and regional unions—was compatible with the local social fabric. The VAs function as a screening mechan-ism for ACBA clients. VAs vet potential borrowers before appraisal by ACBA. Because an applicant is "approved" by the community, not just the bank, applicants view their promise to repay loans very seriously.

Conclusion

IFAD's funding of ACBA is an excellent example of innovation in donor practice. The agency restructured a traditional credit line into a grant-loan package, thereby transforming credit into a capacity-building investment. The IFAD-ACBA partnership is also a success story for donor financing of sustainable microfinance. Although multiple external donors (including the EU, the World Bank, The European Bank for Reconstruction and Development, Credit Agricole, Kreditanstalt für Wiederaufbau, as well as IFAD) have worked with ACBA, their support is no longer required for the bank's survival. "*ACBA is the best financial institution in Armenia,*" says Henri Dommel, Rural Finance Advisor at IFAD, *"It's the highest-quality portfolio and the best return on equity, the best and only bank with a significant rural presence. ACBA is a jewel."*

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Maggie Dugan is a writer and business innovation consultant. She recently facilitated the CGAP Donor Team's Training of Trainers program in Paris. This case study is based on the above references as well as personal interviews with Henning Pedersen and Henri Dommel of IFAD and Stepan Gishyan of ACBA.

Harvesting an ACBA clients' grapes, Ararat. 2000. (Photo: Printinfo)