SA's Land Bank can be fixed: change the funding model and narrow the focus

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It is disheartening to see how many South Africans, including parliamentarians, have forgotten the simple and influential role the Land and Agricultural Development Bank (Land Bank) played in South African agriculture.

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The former minister of agriculture, Derek Hanekom, summarised this role nicely in his foreword to the bank's 1997 annual report:

> *"The Land Bank was a conduit for cheap money for mortgage finance for farmers, for production finance to co-operatives, and for the liquidity of the marketing boards."*

The Land Bank, established in 1912, had a narrow mandate for many decades. Its focus was on mortgages for White farmers to acquire farmland. It also provided wholesale finance to agricultural cooperatives and marketing boards who on-lend production (short-term) finance to individual farmers.

These loans were offered at below-market rates. This was because the bank was well-supported by the state through an initial capital endowment, annual parliamentary allocations and state guaranteed long-term debentures and bonds sold in the capital market.

Its funding model and its narrow mandate meant that, for decades, it was a stable institution. But critical mistakes have been made over the past 25 years that have compromised its critical role as a development finance institution in the agricultural sector.

Due to poor governance and wrong decisions in the early 2000s, Land Bank was virtually bankrupted and had to be resuscitated around 2008. Even after this, critical mistakes continued to be made. At the end of the 1997 financial year, Land Bank had R1.7bn (about $368m at an annual average exchange rate for that year) in reserves that was built up over many years from government capital endowments, annual appropriations and retained earnings. In today's value, it would be R6.5bn (about $346m). It was all lost, either through irregular expenditure, or poor credit decisions and lending to activities outside the bank's mandate.

The result has been that the bank no longer provides a service to the agricultural sector as a whole. This has compromised the success of land reform beneficiaries, aspiring Black commercial farmers and the growth and food security outcomes of the agricultural sector at large.

We believe the problems can be solved and that the bank can play its role as a financier of land reform and provide the same preferential finance terms to aspirant Black farmers as their White counterparts enjoyed between 1912 and 1996. Based on our experience in the sector, and drawing lessons from its early years of success, our proposed solution is simple: get back to basics.

There are two main parts to this. The first mistake that must be fixed is Land Bank's funding model. It cannot be a "development finance institution" if the cost of funds is too high. Its funding sources need to be reorganised so that its cost of capital is reduced.

Secondly, the bank's activities must be refocused to mortgage finance for land purchases and wholesale finance for production credit.

Funding

For most of its existence, Land Bank was well supported by the state through an initial capital endowment, annual parliamentary allocations and state guaranteed long-term debentures and bonds sold in the capital market.

The table below depicts the bank's long-term loan book from 1977-1980, expressed in 2022 values. The 1980 loan book of R26bn was funded through R8bn of government capital and Land Bank reserves (R3.4bn), all at zero-interest rates, with the balance obtained in the capital market at market-related interest rates.

With this mix of funds, its cost of capital was far below the prime rate. Even adding an interest margin to cover operational costs, the bank was able to on-lend to farmers below commercial prime lending rate and at very favourable terms (25-40-year mortgages, for example). This was not something the commercial banks could do.

In essence, Land Bank, in a true sense, fulfilled its development mandate – it provided affordable finance.

But critical mistakes were made after 1996. Some of these changes increased the costs of lending to agriculture. As a result, the bank has been unable to achieve its development mandate.

The government decided in 1999 to cancel its capital allocation to Land Bank. As a result, the bank had to borrow the money, increasingly from the capital markets.

Since 2010, the bank's main source of funds has been the money market, with maturity within one year. These funds are expensive. It is also impossible for farmers to start a business with interest rates above the prime lending rate.

New leadership also changed the nature of the Land Bank to be more commercially focused and to compete with commercial banks.

That same year, 1999, the bank changed its policy on interest rates. It had always charged farmers a simple interest rate. But it began calculating interest rate payments using a compound interest rate. This meant that interest was estimated monthly not annually.

The sudden change led to an increase in non-performing loans as arrears accumulated. The bank was taken to court since credit contract terms were changed unilaterally without informing farmers. The bank lost the court case.

The other big change involved Land Bank linking its lending rate to the prime rate. This had never been done before as the bank estimated its own interest rates irrespective of the decisions taken by the South African Reserve Bank.

Currently, all Land Bank's pricing is linked to the commercial prime lending rate.

Other mistakes were made too. These included:

- lending to non-agricultural activities such as property development, soccer teams and cotton gins, which depleted capital reserves,
- engaging in non-traditional transactions such as structured finance deals,
- reducing the number of offices in the country and the number of field staff to manage and assist clients,
- using intermediaries to manage short-term production loans, resulting in poor credit controls and massive losses for the bank.

What needs to be done

The bank's cost of capital should be lower than the repo rate (rate at which the Reserve Bank lends to commercial banks). This implies that the source of funds should be reorganised. Here, the state has an important role to play.

The bank's balance sheet should consist of a mix of funds to ensure an appropriate funding cost that enables sustainable development finance. This could happen through a one-off parliamentary appropriation of R10bn (about $533m). Then one can add annual funds from the agriculture department and the provinces earmarked for agricultural development and blended finance, contributions from retailers, food processors interested in growing the pool of commercial Black farmers, and long-dated instruments in the capital market for the balance to get to a total book of R25bn.

Lastly, the Land Bank book should be mainly focused on mortgage finance for land purchases and wholesale finance for production credit (but not via unfavourable service level agreements). It can thus become the financier of land reform.

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