Regulation and Supervision of Microfinance Activities:

The Philippines Case Study

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MICROENTERPRISE BEST PRACTICES
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Regulations and Supervisions of Microfinance Activities: The Philippines Case Study

by

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LIST OF ACRONYMS

ACPC	Agricultural Credit and Policy Council
ADB-IFAD	Asian Development Bank-International Fund for Agricultural Development
AKLAN	Cooperative Rural Bank of AKLAN, Inc.
APPEND	Alliance of Philippine Partners in Enterprise Development
ASKI	Alalay sa Kaunlaran sa Gitnang Luzon, Inc.
BSP	Bangko Sentral ng Pilipinas
CALF	Comprehensive Agricultural Loan Fund
CARD	Center for Agriculture and Rural Development
CDA	Cooperative Development Authority
CGAP	Consultative Group to Assist the Poorest
CPA	Certified Public Accountant
CPIP	Credit Policy Improvement Program
CRB	Cooperative Rural Bank
CTT	Center for Community Transformation
DBP	Development Bank of the Philippines
DSPI	Daan sa Pag-unlad, Inc.
FSSI	Foundation for Sustainable Society Inc.
HIRAM	Help Individuals Reach their Aspirations through Microfinance
HSPFI	Hagdan sa Pag-uswag Foundation, Inc.
KMBI	Kabalikat para sa Maunlad na Buhay, Inc.
LBP	Land Bank of the Philippines

NCC	National Credit Council
NGO	Non-Governmental Organizations
NLSF	National Livelihood Support Fund
NSM	National Strategy for Microfinance
PCFC	People's Credit and Finance Corporation
PDIC	Philippine Deposit insurance Corporation
RSPI	Rangtay sa Pagrang-Ay, Inc.
SBGFC	Small Business Guarantee and Finance Corporation
TPKI	Talete King Panluyong Kapampangan, Inc.
TSKI	Taytay sa Kauswagan, Inc.
TSPI	Tulay sa Pag-unlad, Inc.
TST	Tulong Sa Tao (Self-Employment Loan Assistance)
USAID	United States Agency for International Development

Philippines Statistics (1999)

Population	**:**	**76.78 Million**
Gross Domestic Product	**:**	**Php 917.4 Billion**
Inflation Rate	**:**	**6.7%**
Exchange Rate (average)	**:**	**US$ 1 = Php 39.089**

Source: Philippine National Statistics Office and the Bangko Sentral ng Pilipinas

CHAPTER ONE
INTRODUCTION

In 1985, the Government of the Philippines initiated a process of liberalization of its financial markets by implementing a set of policies aimed at reducing government intervention and fostering private sector participation in the economy. Interest rate ceilings were removed, banking entry and branching restrictions were liberalized, and major subsidies to the agricultural sector and institutions servicing it were suspended. Overall, the supervisory and regulatory framework experienced substantial changes to reflect a modern, market-oriented financial sector. Also during this period, poverty alleviation began to play a central role in the government's development strategy. Policies shifted from the rural sector—a traditional focus of credit market interventions—to the more urban-based small enterprise and livelihood sectors. Although most poverty-alleviation policies were not consistent with the market-oriented financial policies, together they led to the proliferation of financial institutions, regulated and non-regulated, providing microfinance services. The purpose of this case study is to analyze the provision of microfinance services in the Philippines formal financial system. The analysis centers on the financial regulations and supervisory practices of the Bangko Sentral ng Pilipinas (BSP) and its role in creating an environment conducive to the provision of these services.

Chapter Two describes the country's formal financial system. The chapter provides an overview of past and current developments in the system to the extent they affect microfinance services. To this end, the chapter describes the formal financial system and the institutions that comprise it. It also provides a detailed analysis of BSP regulations and supervisory practices, with emphasis on those bearing directly on microlending.

In view of the discussion of microfinance and the regulatory environment, Chapter Three analyzes the actual situation with regard to the provision of microfinance services within the formal financial system. It discusses the participation of regulated institutions such as the rural banks and, to a lesser extent, cooperatives in microlending. Examples from CARD-Bank and AKLAN Cooperative Rural Bank, as well as other banking institutions, are included in the analysis. Sub-sections discuss the potential for the "transformation" of nongovernmental organizations, given the regulatory environment and the current capacity of NGOs to provide credit effectively. A main conclusion is that managerial and technical weaknesses prevalent among most microfinance institutions, regulated or not, constitute the major barrier, preventing the expansion of microfinance services in the country.

Chapter Four discusses the prevalent distortions affecting microfinance, with a particular focus on those arising from government policies for poverty alleviation. This last chapter also discusses future steps toward improved microfinance supervision and regulation, the conclusions, and the lessons learned. The main conclusion is that the major barriers affecting the expansion of microfinance services in the Philippines are not found in the banking laws and regulations but in weaknesses in microfinance institutions, regulated or not, and the prudential and examination practices of the BSP.

CHAPTER TWO
MICROFINANCE AND THE REGULATORY ENVIRONMENT

OVERVIEW

In the mid-1980s, the Government of the Philippines embarked on a process of economic liberalization, adopting measures to reduce the degree of government intervention and participation in the economy. Financial reforms were undertaken that marked a shift in policy from the supply-leading approach to a market-oriented approach. Interest rate ceilings were lifted, and subsidized rediscounting programs at the BSP were largely abandoned as an instrument of development policy.

Bank entry was liberalized. This was accomplished in several stages after a period characterized by bank entry restrictions (1984-1988) in response to the financial crisis and the ensuing difficulties faced by banks in the first half of the 1980s.[1] Foreign banks became legitimate players in the local financial scene. In addition, branch banking, which had been subject to strict regulations in the past, became less regulated and was made contingent on certain financial requirements and the quality of bank management. Alongside the liberalization of branching and the entry of new banks, a rehabilitation program for financially distressed rural banks was also implemented to enable the rural banking system to recover the ground it had lost during the mid-1980s.

After substantial liberalization of branching by banks, the problems that grew out of the Asian economic crisis caused the BSP to place a moratorium on branching. However, banks are still permitted to open branches in areas where there are no other banking facilities. When and if the moratorium is lifted, banks are still required to fulfill an additional capital requirement to establish branches in cities and larger municipalities.

In the rural sector, following a traditional focus on credit-market interventions during the 1970s, financial reform found expression in the termination of numerous directed lending programs by non-financial government institutions. About 20 of the commodity-specific lending programs were consolidated under the Comprehensive Agricultural Loan Fund (CALF), a wholesale funding facility that would subsequently be tapped to serve as a guarantee fund for the government's crop insurance, loan guarantee, and other re-lending programs. The BSP rediscount window also ceased to be a source of cheap money for banks, as financial liberalization sought to improve the mobilization of domestic savings by financial intermediaries and to channel them to viable projects.

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[1] In 1989, restrictions on the opening of new branches in rural areas were lifted. This was followed in 1990 by the lifting of the moratorium on the entry of new banks. Branch banking was further liberalized in 1991 when franchises to establish branches were auctioned off and rural banks were allowed to establish branches nationwide. In 1992, incentives to establish branches in low-income municipalities were granted in the form of branching privileges in first-class cities or municipalities subject to certain limits. By 1993, branch banking was liberalized, subject only to capital adequacy, liquidity, profitability, and quality of management.

Under the new policy regime, the responsibility for providing loan and deposit services was entrusted primarily to private banks, while the government was expected to concentrate on providing an enabling policy environment for the efficient functioning of markets. Government financial institutions would be reoriented toward supplementing the private sector's initiatives in the provision of financial services.

The liberal environment spawned by the financial reforms instituted in the 1980s and continuing into the 1990s introduced larger numbers of banks and greater competition in the provision of financial services. Commercial banks, foreign and national, captured the corporate and large enterprise market and to a lesser extent the medium enterprise market. Thrift banks of various types were thereby forced to shift toward smaller enterprises, whereas rural banks have been traditionally more involved in microlending than other types of banks.

Notwithstanding financial liberalization, policy objectives of alleviating poverty motivated the government to continue to intervene in credit markets. While it pursued reforms to eliminate subsidies and directed credit programs in the agriculture sector, subsidized credit programs for small enterprises and livelihood activities multiplied. At the same time, several laws were passed mandating loan quotas for targeted sectors, specifically, the Agri-Agra Law (PD 717), the Magna Carta for Small and Medium Enterprises (R.A. 6977), and the Magna Carta for Small Farmers.[2] According to the Agri-Agra Law, banks must allocate a 25 percent minimum of their loan portfolios to agriculture. Specifically, 10 percent must be lent to agrarian reform beneficiaries and 15 percent to farmers in general. The same law limited the interest rates on these loans to 12 percent annually and fees and other charges to 2 percent or Php 150 annually. Under the Magna Carta for Small Enterprises,[3] all lending institutions were required to allocate 6 percent of their loan portfolios for credit to small enterprises and 2 percent for medium-sized enterprises.

A Cabinet resolution with regard to the anti-poverty program of the Aquino government (Resolution No. 29, 1988) allowed regular government line departments to implement livelihood programs and projects—in effect, authorizing the use of budgetary appropriations for directed credit programs. As a result, the government initiated directed credit programs that engaged regulated institutions, like rural banks, and non-regulated institutions, such as credit cooperatives and NGOs, as intermediaries.[4] Most of these programs were implemented through government agencies and involved large subsidy components. As of 1997, the Credit Policy Improvement Program reported a total of 86 directed credit programs managed by different department/line agencies, government financial institutions, government-owned and -controlled corporations, and non-bank financial institutions. These programs catered to specific sectors and were funded out of government budgetary allocations, special funds, development assistance from donor agencies, and other sources. Objectives included supporting the growth of the agriculture sector, promoting the expansion of small and

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[2] See the National Credit Council's "National Strategy for Microfinance."

[3] R.A. 6977 of January 1991 was amended in May 1997 by R.A. 8229 to include medium-sized enterprises. The same amendment extend its expiration date to 2007.

[4] Llanto, Gilberto M., Geron, Ma. Piedad, and Tang, Marie-Christine G., *Directed Credit Programs in the Philippines: The Experience and Policy Reform Issues.* A report submitted to the Credit Policy Improvement Program and the National Credit Council, Department of Finance, October 1999 (published).

medium-sized enterprises, providing employment and livelihood opportunities, and increasing incomes of targeted clients.

The biggest operators of funds for directed credit programs were the Development Bank of the Philippines (DBP) for industrial and manufacturing enterprises and the Land Bank of the Philippines (LBP) for agriculture and related projects. The Department of Agriculture and the Agricultural Credit and Policy Council also had considerable funding for integrated rural development projects. The People's Credit and Finance Corporation (PCFC) was designated as the channel for government support of microfinance programs specifically targeting the poor.

Presently, the LBP, a specialized government bank, is a significant provider of microfinance loans through the National Livelihood Support Fund (NLSF). The NLSF extends credit to eligible NGOs, financial institutions, and people's organizations for relending to borrowers with incomes below the poverty line (for example, small farmers, fisherfolk, landless farm workers, and unemployed women). The NLSF finances two credit programs: Helping Individuals Reach their Aspirations through Microcredit (HIRAM) and the ADB-IFAD Rural Microenterprise Finance Project.

With total resources of P350 million (March 1998), the PCFC is the designated channel of government support for microfinance initiatives. The PCFC was created to be the lead financial institution in the wholesale delivery of funds to NGOs, people's organizations, and rural banks for relending to the poor or marginalized sectors of the economy. Another corporation, the Small Business Guarantee and Finance Corporation (SBGFC), supports the development of small and medium-sized enterprises through the provision of credit and guarantees. The SBGFC operates a guarantee program and two lending programs, the Small Enterprise Financing Facility and the Rediscounting Facility for Small Enterprise.

Outside of government-sponsored credit programs, NGOs, rural banks, cooperative rural banks, and credit unions have been trying to respond to the credit demand of the marginalized sectors. A discernible trend since the inception of the government's poverty alleviation policies and directed credit programs, however, has been the increase in the number of non-bank microfinance institutions. The semi-formal NGO sector already has been noted to be largely of post-1986 origins; in fact, for close to 90 percent of the NGOs, involvement in lending did not start before 1986-1988 (Agabin, 1988). According to statistics on the sector, there are 600 NGOs involved in microfinance. Similarly, statistics of International Development Support Services, Ltd., points to the increase in cooperatives from 4,000 to 17,000 during 1987-1992. Although it seems unlikely that all these are engaged in microfinance, the number registered as credit cooperatives with the Cooperatives Development Authority as of 1997 was still a substantial 2,865.

STRUCTURE OF THE FORMAL FINANCIAL SYSTEM

The formal financial sector of the Philippines comprises the BSP and the 979 banking institutions (Table 1). The BSP is responsible for granting bank authorizations and is the primary regulator for formal financial institutions. The banking regulations divide banking institutions into the following categories: expanded commercial banks, commercial banks, thrift banks, rural banks, and cooperative rural banks. A comparative summary of capital requirements, permissible activities, legal reserves, and capital asset requirements for regulated institutions is shown in Table 1.

Table 2: PDIC Member Banks, 1997*
(amounts in millions, accounts in thousands)

Bank Type	No. of Institutions	Loans Php and %	Deposits Php and %	No. of Insured Deposit Accounts	Insured Deposits
Total	979	1,750, 404	1, 674 083	21,573	Php 292,489 US$ 7,316
Commercial Banks	54	89.7%	89.7%	13,721	Php 230,715 US$ 5,771
Expanded Commercial Banks	18				
Non-Expanded Commercial Banks	15				
Foreign Banks	18				
Government Banks	3				
Thrift Banks	116	8.0%	8.1%	3,866	Php 41,085 US$ 1,028
Savings and Mortgage Banks	30				
Private Development Banks	39				
Savings & Loans Associations	47				
Rural Banks	809	2.3%	2.2%	3,987	Php 20,689 US$ 517

* All banks are members of the PDIC except those banks that have had their insurance coverage terminated for non-payment of premiums
Source: 1997 Philippine Deposit Insurance Corporation Annual Report
Exchange rate as of December 1997: US$ 1 = Php 39.98

Table 2: Capital Requirements Banking System

	Commercial Banks	Rural Banks**	Thrift Banks
Capital Requirements	Php 2.0 to Php 4.5 Billion (US$ 50 to US$ 112 Million)	Php 2 to Php 20 million (US$ 50 to US$ 500 Thousand)	Php 40 to Php 250 million (US$ 1 to US$ 6.25 million)
Legally Permitted Operations	Multiple operations	Savings, time, and checking accounts	Multiple operations including, savings, time, and checking accounts
Loan Classifications	Housing Consumption Commercial	Loans to farmers, fisherman, merchants, cooperatives, private and public employees	Housing Consumption

** Cooperative Banks provide primarily financial and credit services to cooperatives and may perform any or all of the services offered by rural banks. Minimum capital for cooperative banks ranges from P 1.25 million to P 200 million for national cooperative banks.
Source: Manual of Regulations for Banks, Banko Sentral ng Pilipinas, August 1999
Exchange rate as of December 1997: US$ 1 = Php 39.98

Commercial Banks

As of December 1997, there were 54 commercial banks in operation, including 18 expanded banks, 15 non-expanded banks, 18 foreign banks, and 3 government banks. The loan portfolio totaled Php 1,569.8 million, which represented 89.7 percent of the consolidated figure for financial system (Php 1,750.4 million or US$ 43,782 million). Deposits amounted to Php 1,501.6 million (US$ 37,559 million) in 21,573,000 accounts. They represented 89.7 percent of the total deposits in the financial system (Php 1,674 million or US$ 41,871 million).

The minimum capital requirement for the establishment of expanded commercial banks is Php 4.5 billion (US$ 112 million). Table 3 shows a summary of permissible activities. In addition to the permissible activities of commercial banks, the expanded commercial banks have the authority to exercise the powers of investment houses, invest in non-allied undertakings, and own up to 100 percent of a financial intermediary other than a commercial bank. With the approval of the Monetary Board, and after meeting certain conditions, commercial banks may be permitted to operate under expanded commercial banking authority.

Table 3: Permissible Operations of Commercial Banks

Expanded Commercial Banks	Commercial Banks
# Exercise the powers of commercial banks # Exercise the powers of investment houses # Invest in non-allied undertakings # Own up to 100% of a financial intermediary other than a commercial bank or a bank authorized to provide commercial banking services	# Exercise the general powers incident to corporations # Accept drafts and issue letters of credit # Discount and negotiate promissory notes, drafts, bills of exchange, and other evidence of debt # Receive deposits # Buy and sell foreign exchange and gold or silver bullion # Lend money against personal security, security consisting of personal property or mortgages on improved real estate and the insured improvements thereon # Accept or create demand deposits subject to withdrawal by check # Offer negotiable orders of withdrawal (now) accounts # Invest in equities of allied undertakings, whether financial or non-financial # Acquire readily marketable bonds and other debt securities

Source: Bangko Sentral ng Pilipinas.

Rural Banks

Republic Act No. 7353, or the Rural Bank Act of 1992, provides the legal basis for the establishment, operation, and regulation of rural banks at present. The same act defines their target clientele as "farmers, fishermen and merchants with small cash requirements." As of December 1997, there were 809 rural banks in the financial system. This number includes 51 cooperative rural banks, which are rural banks owned by cooperative organizations. As such, they share the same banking functions as rural banks (Table 4). The law limits ownership of rural banks to Filipino individuals, corporations, associations, or cooperatives, organized under Philippine laws. Minimum capital requirements for rural bank operation range from Php 2 million for those locating in fifth- and sixth-class municipalities to Php 20 million for those locating in major cities and Metro Manila. Capital requirements for cooperative banks ranges from Php 1.25 million for the first cooperative bank located in a province to Php 200 million for national cooperative banks.

Table 4: Permissible Operations of Rural Banks

Regular Operations	With Monetary Board Approval
# Extend loans and advances primarily for meeting the normal credit needs of farmers, fishermen, farm families as well as cooperatives, merchants, and private and public employees # Accept savings and time deposits # Act as correspondent for other financial institutions # Rediscount paper with the LBP, DBP, or any other bank, including its branches and agencies # Act as collection agent # Offer other banking services as provided in Sec. 72 of R.A. No. 337, as amended	# Accept current or checking accounts, provided the rural bank has net assets of at least Php 5 million # Accept NOW accounts # Act as trustee over estates or properties of farmers or merchants # Act as official depository of municipal, city, or provincial funds in the municipality, city, or province where it is located # Sell domestic drafts # Invest in allied undertakings

Source: Bangko Sentral ng Pilipinas.

The Rural Bank Act authorizes rural banks to extend loans and advances primarily to meet the normal credit needs of farmers, fishermen, and farm families, as well as cooperatives, merchants, and private and public employees. Rural banks can accept savings and time deposits (Table 4). With Monetary Board approval, they can also perform commercial or thrift banking functions such as offering checking accounts (provided they have net assets of Php 5.0 million or more), NOW accounts and trust operations over estates or properties of farmers or merchants. As with commercial banks, rural banks fall under the regulation and supervision of the BSP.

Thrift Banks

Thrift banks include savings and mortgage banks, private development banks, and savings and loans associations. As of December 1997, there were 116 thrift banks in operation (Table 1). Their loan portfolios and deposits represented 8 percent and 8.1 percent of the totals in the formal financial sector, respectively. Capital requirements for the operation of thrift banks range from Php 250 million (US$ 6.1 million) minimum inside Metro Manila to Php 40 million (US$ 975,609) outside. The law authorizes thrift banks to grant loans, secured or unsecured. They can also extend loans against the security of jewelry, precious stones, and articles of similar nature. In contrast to commercial banks and expanded commercial banks, thrift banks are not authorized to operate checking accounts. However, with Monetary Board approval, they can operate checking and NOW accounts, as well as engage in trust, quasi-banking functions, money market and other commercial banking operations. The permissible activities of thrift banks are shown in Table 5.

Table 5: Permissible Operations of Thrift Banks

Regular Operations	With Monetary Board Approval
# Grant loans, secured or unsecured # Invest in readily marketable bonds and other debt securities, commercial paper and accounts receivable, drafts, bills of exchange, acceptances or notes arising out of commercial transactions # Issue domestic letters of credit # Extend credit facilities to private and government employees # Extend credit against the security of jewelry, precious stones, and articles of similar nature # Accept savings and time deposits # Rediscount paper with LBP, DBP, and other government-owned or -controlled corporations # Accept foreign exchange deposits # Act as correspondent for other financial institutions # Purchase, hold, and convey real estate under the same conditions as those governing commercial banks # Provide banking services as provided by provisions of law (Sec. 72 of R.A. No. 337, as amended)	# Accept current, checking and NOW accounts, provided the thrift banks has net assets of at least Php 5 million # Accept NOW accounts # Act as trustee over estates or properties of farmers or merchants # Act as official depository of municipal, city, or provincial funds in the municipality, city, or province where it is located # Sell domestic drafts # Invest in allied undertakings # Engage in trust, quasi-banking functions, and money-market operations # Act as collection agent for government entities, including the Bureau of Internal Revenue, Social Security System, and the Bureau of Customs

Source: Bangko Sentral ng Pilipinas

MICROFINANCE IN THE REGULATORY FRAMEWORK

Regulations

The regulatory and supervisory framework for the financial system of the Philippines contains no specific provisions or regulations to govern microfinance activities. *The Manual of Regulations for Banks* issued by the BSP provides both specific and general requirements for bank-lending activities, and most microenterprise lending activities fall under the general requirements of the Regulations. In general, some bank regulations are conducive to microfinance, whereas others may be detrimental. However, the major factors affecting the expansion of microfinance are not found in the banking laws and regulations but in the prudential and examination practices of the BSP.

First, interest rates ceilings, a major barrier to profitable microfinance services, are non-existent. According to Section X305 of the *Manual of Regulations for Banks*, issued by the BSP, "The rate of interest, including commissions, premiums, fees and other charges, on any loan, or forbearance of any money, goods or credits regardless of maturity and whether secured or unsecured shall not be subject of any regulatory ceiling." Usury laws, by which any interest rates above 15 percent annually were considered usury, have been recently revoked.

Second, although banks may require collateral, there is nothing in the provision of the Regulations mandating small loans to be so secured. In fact, the Regulations allow banks to maintain an "unspecified" portion of their portfolios with unsecured loans. This allows, at least in theory, formal financial institutions to support a specified portion of their portfolios with, for instance, group personal guarantees. Furthermore, under "secured" loans, the Regulations permit a wide variety of possibilities. For instance, according to Section X313, "loans may be secured by personal property which include…the expected harvest from the project to be financed or growing crops, up to forty percent (40%) of the calculated market value of the crop for which the loan is sought. In addition, loans may be secured by "any other personal property, up to fifty percent (50%) of the fair market value." In this case, the Regulation can be interpreted as allowing for small business equipment (such as sewing machines) and household appliances (for example, televisions, stereos, radios, and refrigerators) to be used as collateral. Loans can also be secured by time deposits for an unspecified value. This allows, at least in theory, the widespread Grameen groups to use their savings as additional security for loans.

Additionally, Section X101 specifies that thrift banks can extend credit "against the security of jewelry, precious stones and articles of similar nature." Jewelry and the like constitute other forms of security low-income families can borrow against. In addition, Section X3311.2 of the Regulations rules that "loans may be granted by rural and cooperative banks on the security of lands without title where the owner of private property can show five (5) years or more peaceful, continuous and uninterrupted possession in the concept of an owner." This regulation enables farmers to use their land as security even in the absence of a title.

Section X319.4 of the Regulations establishes general policies requiring "unsecured" loans to be made under the signature of the principal borrower and at least one co-signer, "except in

the case of a principal borrower whose responsibility and financial capacity are unquestionable, in which case the signature of the borrower shall suffice." The implication is that bank management determines whether a co-signer is needed on a loan-by-loan basis. In other words, if, in a bank's evaluation, a loan applicant can repay his or her obligations without reliance on security, the bank is not mandated to require collateral. Bank managers may require collateral if their analysis concludes that it is needed to ensure full repayment. In such cases, the Regulations put a limit on loan amounts based on the values of collateral and provides for the manner by which foreclosure can be made.

Third, regarding supporting documentation, there are no requirements in the provisions of the Regulations that mandate that small loans be supported by formal financial statements. However, the Regulations do require that banks carefully study the ability of borrowers to repay obligations upon maturity. In this regard, Section X319.1 states that "before granting credit against personal security, banks must exercise proper caution by ascertaining that the borrowers, possess good credit standing and are financially capable of fulfilling their commitments to the bank. For this purpose, banks shall keep records containing information on the credit standing and financial capacity of credit applicants." A bank may demand submission of a statement of the assets, income, and expenditures of an applicant for the purpose of such study. This information is usually deemed necessary to determine applicant creditworthiness. Notwithstanding, the Regulations do not require a specific format for the statement of assets, income, and expenditure, nor they require that the statement be authenticated in any particular manner. Bankers therefore have discretion regarding how they determine creditworthiness. Furthermore, according to Section X319.4 discussed previously, no statement of assets, income, and expenditure need be submitted if the bank can assure itself of the borrower's capacity to pay in other ways.[5]

Section X319.2, in contrast, requires that "(a) an application for a loan against personal security be accompanied by a copy of the latest income tax returns of the borrower; and, (b) If the credit accommodation exceeds Php 500,000, a copy of the borrowers balance sheet duly certified by an independent Certified Public Account (CPA), and in case he is engaged in business also a copy of the profit and loss statement duly certified by a CPA." The CPA certification is only required for loans above Php 500,000 (US$ 12,500) so most microborrowers would not be affected. The problem lies with requiring a copy of the borrower's latest income tax return, a requirement that most microentrepreneurs are unable to meet. Micro-borrowers may not be able to submit income tax returns either because they are exempted from filing returns or because they have minimal income and do not file returns.[6] Submission of financial statements is a general requirement and is normally superseded by provisions of specific credit programs for small loans. For instance, income tax returns were not required to support loan applications under the Masagana 99 and Masaganang Maisan programs for rice and corn producers. Similarly, neither collateral nor certified financial

[5] Fitzgerald, Thomas, Miranda, Feliciano et al., *Regulatory Barriers to Innovative Lending Practices: Traditional Approaches to Bank Supervision.* A report submitted to the Credit Policy Improvement Program and the National Credit Council, Department of Finance, January 2000 (published).

[6] Under the National Revenue Code, residents not engaged in business or not practicing a profession are not required to file income tax returns. In practice, residents engaged in small business with minimal income do not file income tax returns, and the government by its tolerance thereof has implicitly accepted this practice.

statements were mandatory. In the past, the BSP has sponsored short-term special financing programs designed for small borrowers. Collateral was not mandatory in any of them. The same is true in the case of similar special programs for short-term loans to small producers, microentrepreneurs, and others.[7]

Prudential and Supervisory Practices

Although there are no banking laws and regulations mandating that microloans be secured or supported by formal financial statements, prudential and examination practices of the BSP may have created biases against the provision of microfinance services. In general, the prevalent perception among the banks interviewed was that traditional examination practices discourage banks from granting small loans.[8] Among these practices, the most relevant are discussed below.

First, while the Regulations do not specify what percentage of a bank's loan portfolio may consist of "unsecured" loans, prudential practices of the BSP set the limit at 30 percent maximum. The implications for microlending are significant. Most micro and small-scale entrepreneurs have no marketable collateral or formal financial information to offer. Even when they do have collateral to offer, the cost of registering it usually exceeds the value of the loan. Therefore, many micro and small borrowers do not qualify for small bank loans.

Some banks and NGOs have successfully developed alternative loan underwriting practices using informal financial information, personal character, work ethic, and group guarantees to support their lending decisions. However, many bankers are not comfortable with these approaches because they fear examiners may take a dim view of microlending if collateral and financial support do not measure up to the traditional standards applied to larger loans. Banks may be subject to sanctions and/or increased loan loss reserves if they have more than 30 percent unsecured loans in their portfolios or too many loans are classified by examiners for inadequate loan documentation or perceived poor judgment on the part of loan officers. These sanctions include disqualification from the credit facilities of the BSP and/or prohibition from the extension of additional credit against personal security.[9] For instance, CARD Rural Bank, reputedly one of the best formal microlending institutions in the Philippines with an arrears rate of 0.02 percent, is currently sanctioned under X319.6 (a) of the Regulations. CARD is thereby disqualified from using the credit facilities of the BSP because CARD's loan portfolio does not meet the BSP's prudential practice of having 70 percent of the loan portfolio secured. Virtually all of the loans at CARD Rural Bank are unsecured and supported by group guarantees. A waiver from the Monetary Board would be required to permit them to borrow from the BSP despite CARD's excellent portfolio performance.

Second, prudential standards and practices of the BSP are more conservative than the provisions of the Regulations. This has come about over the years because of the number and

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[7] The special financing programs mentioned have been terminated by the BSP. They have been shifted to the Department of Agriculture and to government lending institutions such as the DBP and the LBP.

[8] A detailed list of institutions interviewed is included as Annex A.

[9] Section X319.6. *Sanctions.*

magnitude of problems in the banking system. Many of the problems can be attributed to poor management. So, even though the Regulations allow bankers considerable discretion with regard to what type of security and financial documentation is needed to support a loan, bankers are hesitant to exercise much discretion for fear of being criticized or penalized by the BSP. Both bankers and the BSP will need to develop a better understanding of microentrepreneurs and microenterprise lending before the discretionary aspects of the Regulations can be used to facilitate and foster microlending activities.

Third, bankers are concerned that unsecured microloans supported by non-traditional financial documentation may be subject to classification and to higher loan loss reserves. The BSP classifies loans as "specially mentioned," "substandard," "doubtful," or "loss." Loans classified "substandard" require a 25 percent provision for bad debts, whereas those classified "doubtful" or "loss" require 50 percent and 100 percent provisions respectively (Circular 143, 1997). Provisioning for classified loans is an expense to the bank and increases the loan loss reserves. This expense is netted against income and can have an adverse impact on capital. This, in turn, may cause capital account balances to fall below minimum acceptable capitalization levels. If capital account balances fall below the prescribed minimum capitalization level, administrative sanctions may be imposed, including suspension of lending operations, suspension of authority to establish branches, prohibition from declaring dividends, and disqualification from the rediscount window. Moreover, new stockholders must be sought if existing stockholders cannot or will not infuse additional capital to cover a deficiency, thus diluting current shareholders' ownership.[10]

According to loan classification guidelines, the primary causes of adverse classifications are default in payment, absence of favorable credit information, unfavorable results from operations, and distressed economic condition in the industry of which the borrower is a part. There is nothing in the guidelines suggesting that small loans that are unsecured and not supported by traditional financial statements should be adversely classified merely for these reasons. The absence of collateral or traditional financial documentation should not be the sole basis for sanctions to be imposed by the BSP. However, given the lack of understanding about how to manage the risks associated with small loans, on the part of both bankers and the BSP, plus bad experiences with the government's widespread directed credit programs, small unsecured loans are not likely to be viewed favorably in the near term.

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[10] Fitzgerald, Thomas, Feliciano, Miranda et al. (January 2000).

CHAPTER THREE
MICROFINANCE SERVICES IN THE FORMAL FINANCIAL SYSTEM

MICROFINANCE SERVICES

In view of the forgoing discussion of microfinance and the regulatory environment, an analysis of the actual situation in the provision in microfinance services within the formal financial system is useful. Among the regulated institutions, rural banks and, to a lesser extent, cooperative rural banks have been traditionally involved in small-scale lending. CARD Rural Bank, an offspring of CARD-NGO, constitutes the only example of "transformation" in the country. As of September 1999, 47 rural banks, 22 cooperative rural banks, and 2 thrift banks have participated under the different microlending loan funds of the PCFC, the largest government intermediary for the support of microfinance initiatives. The following sections discuss rural banks and commercial rural banks as microfinance service providers. Examples are drawn from CARD-Bank and AKLAN Cooperative Rural Bank as well as other banking institutions. Subsequent sections discuss the potential for transformation of NGOs given the regulatory environment and the current capacity of NGOs to provide credit effectively. One conclusion is that managerial and technical weaknesses prevalent among microfinance institutions, regulated or not, constitute the major barrier preventing the expansion of microfinance services in the country.

RURAL BANKS

Rural Banks

The Rural Bank Act stipulates the target clientele of rural banks as farmers, fishermen, and merchants with small cash requirements. As a result of this mandate, since their inception in 1952 rural banks have been viewed as agents of rural development, providing small farmers, merchants, rural enterprises, and cooperatives with credit to finance their productive activities. This sense of mission also supplies the basis for fiscal, financial, and other incentives that over the years have been granted by law to rural banks. In the days of government-sponsored credit programs during the 1970s, rural banks enjoyed even greater incentives, particularly access to cheap funds from the Central Bank rediscount window. As a result, rural banks proliferated and became a major source of formal credit in rural areas. However, with financial liberalization, subsidies and incentives were either substantially reduced or eliminated. Almost 300 rural banks deemed unfit were either closed down or placed under receivership, while another 300-350 rural banks in financial distress came under a rehabilitation program. The rehabilitation program succeeded in revitalizing the rural bank system, even as competition increased as a result of the financial reforms. As of September

1997, 824 rural banks with 1,650 branches nationwide were servicing over half a million borrowers.[11]

At present, rural banks are predominantly small and family owned. In fact, most are owned by family units that reside in the area of operation. Although rural banks represent 82 percent of all the banking institutions in the country, their consolidated assets represented only 2.3 percent as of December of 1997.[12] In terms of size of clientele, BSP statistics show that loans of Php 10,000 and smaller comprised 60 to 80 percent of total loans of the rural banks system from 1991 to 1993. Table 6 shows the portfolio statistics for four of the top rural banks that are current clients of the small lending window of the PCFC as of September of 1999. According to the figures, the average loan size for these rural banks ranges from US$ 39 to US$ 209. These averages indicate that, regarding depth of outreach, rural banks reach very small borrowers. The microfinance window of the PCFC has 47 rural banks and 22 cooperative rural banks out of a total of 135 client institutions. Together, the rural banks and cooperative rural banks cover 51 percent of all borrowers reached with PCFC funds.[13]

Table 6: Portfolio Statistics of Four of the Top Rural Banks (September 1999)

Institution	Number of Clients	Portfolio		Average Loan Size	
		Philippines Peso	US Dollar*	Philippines Peso	US Dollar*
Card Rural Bank	15,485	24,463,391	611,126	1,580	39
Mallig Plains Rural Bank	6,678	28,745,452	718,098	4,304	108
New Rural Bank of Lianga	2,389	20,000,000	499,625	8,372	209
People's Rural Bank of Caraga	1,642	9,371,747	234,118	5,708	143
TOTAL AVERAGE	**6,548**	**20,645,147**	**515,742**	**3,153****	**79****

* Exchange Rate: US$ 1 = Php 40.03 (September 1999)
** Weighted Average
Source: PCFC Statistics

Rural banks are predominantly small in scope. The average number of borrowers per rural banks for the system as a whole was 4,200 as of December 1999. CARD-Bank has the largest outreach with 15,485 clients,[14] followed by Mallig Plans Rural Bank with 6,678 clients. These figures are strikingly low in that the Philippines has a population of 76.78 million people. In addition, poor portfolio performance is the rule rather than the exception. According to PCFC statistics, as of June 1999, the arrears rate for the rural bank system was

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[11] Esguerra, Emmanuel, Lapar, Lucila et al., *The Effectiveness and Efficiency of Microfinance in the Philippines: A Comparative Analysis.* A report submitted to the Credit Policy Improvement Program and the National Credit Council, Department of Finance, August 1999 (unpublished).

[12] BSP Statistics Bulletin, 1997.

[13] PCFC financial statistics as of September 1999.

[14] This figure does not include about 10,000 clients served through CARD-NGO.

19 percent.[15] Moreover, the arrears rate has consistently increased in recent years, from 14 percent in 1996 to 19.8 percent in 1999 (Table 7). The limited outreach, together with the high arrears rate, indicates problems with management, the lending technology, or both. In fact, the poor quality of management has been identified by the BSP as the major problem affecting the performance of rural banks. The problem is compounded by the absence of proven effective technologies among rural banks in the provision of small loans. In most cases, rural bank lending technologies lack any methodological pattern. At best, they use poor adaptations of Grameen or similar group lending technologies.

Table 6: Portfolio Performance of the Rural Banking System (1996-1999)

Year	Portfolio		Arrears		
	Philippines Peso (millions)	US Dollar (millions)	Philippines Peso (millions)	US Dollar (millions)	Percent
1996*	33,403	1,270	4,723	$179.58	14.1%
1997**	40,684	992	6,271	$152.95	15.4%
1998***	41,831	1,071	7,796	$199.64	18.6%
1999****	41,930	1,043	8,237	$204.90	19.8%

* US$ 1 = Php 26.3, as of 12/31/1996
** US$ 1 = Php 41.0 , as of 12/31/1997
*** US$ 1 = Php 39.05, as of 12/31/1998
**** US$ 1 = Php 37.98, as of 06/30/1999
Source: PCFC Statistics

Part of the managerial problem plaguing rural banks results from the absence of trained professional staff. However, in spite of a growing concern for upgrading staff competence in bank operations, only a few rural banks systematically provide training programs for their staff and officers. Most rural banks depend mainly on training programs conducted by the LBP, BSP, other commercial banks, and the ACPC, and few have taken advantage of government-sponsored training programs covering new financial technologies for reaching the poor.[16]

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[15] Non-performing loans of Php 8,237 million out of an outstanding portfolio of Php 41,930 million as of March 1999.

[16] Agabin, Meliza and Daly, Jorge, *An Alternative Approach to Rural Financial Intermediation: The Philippine Experience,* May 1996.

Cooperative Rural Banks

Cooperative rural banks are rural banks owned by cooperative organizations. They share many of the features and have the authority to perform the same banking functions as rural banks. Because they are owned by cooperatives and their federations, cooperative rural banks have a mandate to provide their banking services primarily to their constituents in the cooperative movement. As of December 1997, there were 51 cooperative rural banks in operation out of 809 rural banks (6 percent).

The first cooperative rural banks were established in 1973-1974 during the heyday of government credit subsidies. They were organized by agriculture-based village associations (called *samahang nayons*) composed of small-scale rice and corn farmers.[17] Just like the family-owned rural banks that mushroomed in the mid-1970s, the cooperative rural banks benefited from government subsidies in the form of matching capital, cheap funds through the Central Bank rediscount window, and various tax exemptions. Also like the rural banks, cooperative rural banks were affected by the financial liberalization measures of the mid-1980s.

Because cooperative rural banks provide services to cooperatives, most of which serve low-income groups, their portfolios largely comprise small loans. Alongside the rural banks, cooperative rural banks have been traditionally regarded as the providers of financial services to the low-income segments of the population. Despite the agricultural focus of their original constituency, BSP-required increases in rural bank minimum capital opened the ownership of cooperative rural banks to non-agricultural cooperatives, thus broadening the ownership base and diversifying the portfolios of cooperative rural banks. In addition, most government subsidies and poverty alleviation strategies shifted to micro and small enterprises. Consequently, cooperative rural banks have increasingly focused on non-farm, off-farm, and farm-related rural enterprises, while de-emphasizing direct farm lending. Many have expanded their borrower clientele beyond member cooperatives as well.[18]

Table 8 shows the portfolio statistics for four of the top cooperative rural banks in terms of outreach, portfolio, and arrears, under the livelihood and small enterprise funds of the PCFC. The figures indicate that outreach is limited for most cooperative rural banks. AKLAN-CRB, reputedly one of the most successful microfinance institutions in the country, had 17,383 active clients as of September 1999. Although some of the active clients may be cooperatives, average loan sizes (US$ 54 to US$ 105) suggest that most of them are individuals. The outreach for other cooperative rural banks listed among the largest ranges from 8,266 clients (Bulacan-CRB) to 1,777 clients (Lanao del Norte-CRB). Regarding the size of clients, average loan sizes ranging from US$ 72 (AKLAN-CRB) to US$ 105 (Ilocos Norte-CRB) indicate they reach very small clients. In fact, AKLAN and many other cooperative rural banks use the Grameen group lending technology for the provision of small loans. Notwithstanding, arrears rates have been consistently high for the cooperative rural bank system as a whole (14 percent to 19 percent during 1996-1999), similar to what the

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[17] The rice and corn sectors were the targets of massive subsidies during the 1970s.

[18] Esguerra, Emmanuel, Lapar, Lucila et al. (August 1999).

consolidated figures for the rural banking system as a whole indicate. Reportedly, over 50 percent of cooperative rural banks are still plagued by problems of repayment from farmers financed by earlier special government credit programs.

Table 8: **Portfolio Statistics of Four of the Top Cooperative Rural Banks (as of July 31, 2000)**

Institution	Number of Clients	Portfolio		Average Loan	
		Philippines Peso	US Dollar*	Philippines Peso	US Dollar
Cooperative Rural Bank of Aklan	20,933	42,641,406	961,474	2,037	45
Cooperative Rural Bank of Bulacan	8,288	30,908,836	696,930	3,729	84
Cooperative Rural Bank of Nueva Ecija	5,485	11,485,097	258,965	2,094	47
Cooperative Rural Bank of Cebu	5,808	22,059,000	497,384	3,798	86
Total Average	**10,128**	**26,773,585**	**603,688**	**2,643****	**60****

* Exchange Rate: US$ 1 = Php 44.35, as of July 2000
** Weighted Average
Source: PCFC Statistics

NGO Transformation

As of August 1999, only one NGO, CARD, had transformed into a formal financial intermediary. CARD-NGO started operations in 1988 as a training-focused community and livelihood assistance program for landless workers. Loans were provided to organized groups called *samahan,* or associations. By early 1990, however, the Landless People's Development Fund Project, a Grameen-type replication, became the focus of CARD operations. During the following years, the institution concentrated on expanding operations through a network of branches and focused on achieving sustainability. The number of clients grew from 307, at the beginning of the program in 1990, to 4,240 in 1995. At that time, the Board of Directors began discussing the transformation of CARD into a bank, as a natural extension of its original vision. The strategy would provide the legal basis for mobilizing deposits from the public and enable tapping commercial sources of funds. The Board opted to seek a rural bank license because of the low capital entry requirements and the rural focus. CARD Rural Bank was registered with the Securities and Exchange Commission on May 1997. In August 1997, the BSP gave it the authority to start operations with an initial capital of Php 5 million (US$ 167,000). By August 1999, CARD Bank had become a successful operation with 24 branches,[19] 26,112 clients, a portfolio of Php 107.4 million (US$ 2.7 million), deposits of Php 52.1 million (US$1.31 million),[20] and a portfolio-at-risk rate[21] of only 0.03 percent. Since the

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[19] Only 8 branches are licensed; the remaining number operate under the NGO.

[20] US$1 = Php 39.7400, Source: www.oanda.com. (8/31/99)

[21] The portfolio at risk rate is defined as the outstanding balance of all loans with overdue payments of 30 days or more as a percentage of the loan portfolio.

bank's start-up, the number of clients has increased from 10,000 in 1997 to 20,6117 in 1998, 26,112 in July 1999, and 32,389 by November 2000. As of November 2000, the outstanding portfolio amounted to Php 198.1 million (US$ 4.75 million) with an average loan of Php 6,116 (US$ 147). First loans are granted for an amount of Php 2000 (US$ 50[22]); subsequent loans scale up to a maximum of Php 125,000 (about US$ 3,000). A summary of CARD financial statistics is shown in Table 9.

Table 9: CARD Main Statistics, 1995-2000

Items	1995	1996	1997	1998	Aug 1999	Nov 2000
OUTREACH						
1. Number of Active Clients* (Bank/NGOs)	4,240	6,844	10,868	20,617	26,112	32,389
2. Average Loan (Php, millions)	3,333	3,112	4,771	3,205	4,112	6,116
(US$, millions)	*130*	*119*	*169*	*131*	*105*	*147*
PORTFOLIO QUALITY						
3. Outstanding Portfolio (Php, millions)	14.13	21.30	51.85	66.08	107.36	198.15
(US$, millions)	*0.56*	*0.81*	*1.76*	*1.62*	*2.74*	*4.75*
4. Portfolio at Risk	0.17%	0.12%	0.00%	0.06%	0.00%	0.15%
5. On-time Repayment Rate	97.10%	99.30%	99.70%	n.a.	n.a.	n.a
SUSTAINABILITY						
6. Operational Self-Sufficiency	46.22%	77.03%	122.17%	100.48%	109.68%	n.a.
7. Financial Self-Sufficiency	37.70%	51.88%	70.46%	72.29%	85.62%	n.a.
8. Cost Efficiency Ratio	69.48%	46.05%	32.89%	45.60%	29.53%	n.a.
CAPITAL ADEQUACY						
9. Equity to Asset Ratio	39.37%	25.31%	25.07%	35.76%	35.97%	n.a.
LIQUIDITY						
10. Current Ratio	176.46%	125.44%	220.15%	270.80%	273.88%	n.a.

*These figures represent the combined active clients of CARD Bank and Card NGO. The total for CARD Bank alone is 15,485 active clients, as of August 1999
Source: CARD Statistics

[22] US$ 1 = Php 40.20, Source: www.oanda.com. (10/31/99)

Table 10 shows CARD-Bank's shareholder composition. As of July 2000, CARD-NGO owned 45 percent of the shares and clients owned 30 percent. The remaining shares are redistributed among Board members (13 percent) and staff (12 percent). As of July 1999, CARD Bank funding sources were composed of the German Savings Bank (Php 8 million); deposit liabilities (Php 17.8 million); PCFC (Php 13.5 million); and Grameen Bank Trust, CGAP, and FSSI (Php 18 million).

Table 10: Card Bank Capital Structure

Shareholders	As of September 1997	As of July 2000
CARD-NGO	50%	45%
Board and Management	50%	13%
CARD Members/Borrowers	0%	30%
CARD Staff	0%	12%
TOTAL	**100%**	**100%**

The results of transformation are seen by CARD's managers as highly satisfactory. In addition to the outreach expansion and savings mobilization, the managers affirm that transformation has brought financial discipline, credibility, and visibility to the institution. Access to financial resources has expanded substantially, and, as a bank, it has been easier for CARD to attract funding from donor agencies. At the same time, pressure to perform and deliver a viable bank is great. The BSP is paying attention to CARD's performance and the microfinance community holds high expectations, so that the future of microfinance services may be somewhat at stake.

With the success of CARD-Bank, other NGOs in the country are seeking transformation as well. Alalay sa Kaunlaran sa Gitnang Luzon, Inc. (ASKI) plans to become ASKI Rural Bank by 2001, although no official request has been submitted to the BSP yet. ASKI was established as an NGO in 1987 to offer individual and Grameen-type group loans. The institution is seeking transformation as a vehicle to mobilize deposits, access commercial sources of funding, and expand lending operations. By 2002, outreach is expected to grow to 40,000 clients from the current base of 8,579. As of September 2000, ASKI had a portfolio of nearly US$ 1 million, about 10,620 active clients, and a portfolio at risk rate of 26 percent.

Tulay sa Pag-unlad, Inc. (TSPI) and eight other NGOs affiliated with the APPEND[23] consortium are also discussing possibilities of transformation into rural banks. TSPI, the first microfinance NGO in the Philippines, was established in 1981 to promote small enterprise

[23] Alliance of Philippine Partners in Enterprise Development (APPEND) is a network of nine microfinance NGOs: Alalay sa Kaunlaran sa Gitang Luzon Inc. (ASKI); Center for Community Transformation (CCT); Daan sa Pag-unlad, Inc. (DSPI); Hagdan sa Pag-uswag Foundation, Inc. (HSPFI); Kabalikat para sa Maunlad na Buhay, Inc. (KMBI); Rangtay sa Pagrang-ay, Inc. (RSPI); Taytay Sa Kauswagan, Inc. (TSKI); Talete King Panluyong Kapampangan, Inc. (TPKI) and Tulay sa Pag-unlad, Inc. (TSPI).

development. It became a Grameen bank replicator in 1992. As of September 2000, TSPI had 20,321 active clients, a portfolio of Php 158.7 million (about US$ 3.8 million)[24] and a portfolio-at-risk rate of 9 percent. Instead of creating branches for expanding operations, TSPI established 8 NGOs in different parts of the country that later became the APPEND consortium. Together, they had an outreach of 94,940 active clients as of September 2000.[25] The number of clients, together with high arrears and portfolio-at-risk rates, suggests that APPEND resources may be strained.

Most discussions of transformation have focused on the benefits derived from becoming a formal intermediary, particularly the access to public deposits. Little attention has been paid to what managerial and technical capabilities are needed to provide effective savings services and to manage the added interest rate risks and liquidity risks. The underlying assumption is that capacity to manage credit automatically translates into capacity to manage savings. The specifications of savings management, costs, internal controls, staff qualification, and customer service requirements *are not thought to be an issue.*

There is a common misperception among many NGOs that, if they become formal licensed financial institutions, improvement in operational efficiency and financial performance will automatically follow. APPEND and many other NGOs see deposit mobilization, along with increased access to donor and commercial funds if they operate under banking rules, as a solution to their funding problems. Although it is true that a banking license would provide access to public deposits, before the BSP licenses NGOs to become formal depository institutions, these NGOs will have to meet minimum capital requirements and demonstrate they have the management and earnings to support their operations and protect depositors. Moreover, the extent of problems experienced by regulated financial institutions over the years indicates that even a banking license will not overcome inadequacies in operations and performance.

NGOs also entertain overly ambitious goals regarding client outreach as set forward at the latest microfinance summit. Here, the Philippines government committed to reach 2 million families with lending initiatives by 2004. The APPEND group committed to reach 250,000 families out of the government target. On average, this commitment translates into 30,000 families per NGO, or a rate of 7,000 families per year. Most affiliates have been in operation for nearly 20 years (for example, TSPI since 1981), and the greatest outreach is 20,321 clients (TSPI), which amounts to an average of only 1,069 new clients per year. NGOs take for granted that transformation will help them reach the 2004 outreach targets. This belief exists despite current difficulties in expanding a relatively small clientele without seriously compromising portfolio quality. For instance, for all APPEND members with the exception of TSPI, growth in active clients has been accompanied by higher arrears and portfolio-at-risk rates, as the figures in Table 11 show.

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[24] US$ 1 = Php 41.7, Economic Statistics 2000.

[25] As reported by Tulay sa Pag-unlad, Inc. (TSPI).

Table 11: APPEND Portfolio Quality Indicators (September 2000)

Institution	Number Of Clients	Portfolio (millions)		Average Loan		Portfolio Quality	
		Philippines Peso	US Dollar	Philippines Peso	US Dollar	Arrears (%)	Risk (%)
Tulay sa Pag-unlad, Inc. (TSPI)	20,321	158,758,711	3.8	7,813	187	5%	9%
Kabalikat para sa Maunlad na Buhay, Inc. (KMBI)	16,646	47,053,550	1.1	2,827	68	12%	13%
Taytay sa Kauswagan, Inc. (TSKI)	15,502	50,544,873	1.2	3,261	78	9%	17%
Alalay sa Kaunlaran sa Gitnang Luzon, Inc. (ASKI)	10,620	39,706,203	1.0	3,739	90	18%	26%
Hagdan sa Pag-uswag Foundation, Inc. (HSPFI)	9,201	19,612,320	0.5	2,132	51	28%	35%
Center for Community Transformation (CCT)	8,155	14,129,782	0.3	1,733	42	13%	20%
Rangtay sa Pagrang-Ay, Inc. (RSPI)	7,343	33,406,901	0.8	4,549	109	24%	42%
Talete King Panluyong Kapampangan, Inc. (TPKI)	3,904	39,539,068	0.9	10,128	243	16%	25%
Daan sa Pag-unlad, Inc. (DSPI)	3,248	8,016,609	0.2	2,468	59	0%	13%
TOTAL APPEND Network	94,940	410,768,017	9.9	4,327	104	11.4%**	18.0%**

* Exchange Rate: US$ 1 = Php 41.7
** Weighted Average
Source: Alliance of Philippine Partners in Enterprise Development (APPEND)

In general, microfinance NGOs in the country have advocated BSP regulation and supervision through their different federations. APPEND, the Microfinance Coalition, and the Microfinance Council of the Philippines have been advocating regulations that would enable and authorize NGOs to mobilize savings legally. However, this is not likely for several reasons. As a result of the effects of the Asian economic crises, the BSP is discouraging applications for de novo financial institutions. Given the already large number of banking institutions, many considered to be in financial distress, the BSP's preference is to consolidate the industry through acquisitions and mergers of weaker institutions. In addition, BSP examination and supervisory resources are already spread thin with their present responsibilities, and most NGOs do not meet the minimum requirements for public depository institutions.

REMAINING DISTORTIONS

As a Result of Government Interventions

Despite efforts toward liberalization, the government continues many of its interventions in the financial sector that direct the allocation of resources toward targeted economic sectors. The most relevant distortions are produced by government-directed credit programs and by the mandatory credit allocations of the Magna Carta. Approximately 86 directed credit programs were in operation as of August 1999, most of which involved large institutional

and/or client subsidies. Among other adverse effects, these have discouraged deposit mobilization and weakened the ability of the financial system to assist in allocating resources efficiently. For example, a rural bank with access to rediscounting facilities or other sources of loanable funds, that cost only 4 percent will not be interested in mobilizing savings deposits on which it must pay higher interest rates.

Following the adoption of market-determined interest rates in the 1980s, the BSP abolished the preferential pricing of credit to specific sectors and stopped providing rural banks with special time deposits at below-market rates of interest. Yet most directed credit programs, especially those funded out of government appropriations and congressional funds, imply subsidized interest rates for the target client. Subsidized credit has prevented strong formal financial intermediaries from servicing the microfinance sector and has further weakened the financial situation of those already involved. It creates incentive-compatibility problems on the part of intermediaries (by displacing efforts to mobilize deposits) and borrowers (by perpetuating a hand-out mentality). Because directed credit programs form part of the formal financial system, the presence of government-subsidized credit is one sign of a financially repressed economy. Moreover, because subsidies are provided by the government mainly for political reasons, subsidized credit creates the perception among borrowers that repayment is optional.

Similar distortions are found in mandatory credit allocations. Government of the Philippines R.A. 6657 (Comprehensive Agrarian Reform Law), R.A. 7607 (Magna Carta for Small Farmers), and R.A. 7900 (on high-value crops), in addition to resurrecting ceilings on interest rates, mandate all banks to set aside percentages of their portfolios for lending to the agriculture and agrarian reform sectors and to small and medium-sized enterprises. The Agri-Agra Law dictates an allocation of 25 percent minimum of a bank's portfolio to agriculture loans; more specifically, 10 percent must be lent to agrarian reform beneficiaries and 15 percent to farmers in general. The same law limits interest rates on loans to 12 percent annually and fees and other charges to 2 percent or Php 150 annually. Similarly, under the Magna Carta for Small Enterprises,[26] all lending institutions are required to allocate 6 percent of their loan portfolios for credit to small enterprises and 2 percent for medium enterprises.

As a Result of Regulation and Supervisory Practices

One significant impediment to microenterprise lending that distorts market forces is the BSP's prudential practice of a 30 percent ceiling on unsecured loans. This practice not only limits a bank's ability to meet the credit needs of small borrowers but also prevents the expansion of micro and small lending among formal financial intermediaries. Rural and cooperative banks involved in microlending, whose portfolios exceed the defined limit, need a waver from the Monetary Board to access the rediscount facilities of the BSP.

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[26] R.A. 6977 of January 1991 was amended in May 1997 by R.A. 8229 to include medium-sized enterprises. The same amendment extends its expiration date to 2007.

Regulations on branching constitute an additional distorting factor. Requirements on security, hours of operation, and infrastructure make operating small branches very costly and, in some cases, prohibitive. For example, Sections X156 and X156.1 set minimums and maximums on banking days and hours. All branches must be open a minimum of six hours a day for at least five days a week. This means that full-time employees must staff all branches, and it prevents a bank from serving multiple locations on a part-time basis. In the United States, financial institutions sometimes operate branch activities at major employers' places of business at lunch time several days a week for the convenience of workers. Also, Section X156.1 says in part ". .Banks may, after prior written notice, also remain open beyond the maximum six (6) hours for banking services other than the servicing of deposits and withdrawals (which they can do before and after 8:00 a.m. and 8:00 p.m.) but in no case shall such banking hours start earlier than 8:00 a.m. nor extend beyond 8:00 p.m. . . ." with some exceptions for international airports and major fishing ports. This restriction inhibits banks' ability to meet the early-morning credit needs of day borrowers such as some market vendors who may want to receive their loans early in the morning and make loan payments late at night.

Application of the laws and regulations is an obstacle to microenterprise lending primarily because of the lack of experience and familiarity of BSP regulators and examiners with microfinance. Prevalent misconceptions regarding risks associated with small-scale lending are reinforced by the poor performance of bank managers and poor experience with widespread directed credit programs and have led both bank managers and examiners toward biases against small-scale lending. Lending institutions provide a wide variety of loan products, many of which require specialized lending skills. Like many other types of lending, microenterprise lending requires specialized skills to manage successfully and to examine. Much training of bankers and examiners will be required before microenterprise lending gains widespread acceptance. CARD-Bank is a good example of how one approach to microlending can work well.

CHAPTER FOUR
CONCLUSIONS AND FUTURE STEPS

CONCLUSIONS

The expansion of microfinance services in the Philippines has been negatively affected by three main factors: inconsistent government policy orientation, biases in the prudential and supervisory practices of the BSP, and poor managerial capacity of microfinance institutions.

Government Policies

At present, the regulatory environment for microfinance in the Philippines is characterized by two inconsistent policy orientations. The first is a market-oriented development policy as exemplified in various measures to liberalize financial markets. The second is the policy objective of alleviating poverty as demonstrated through various attempts by the government to intervene in credit markets. These two policies have produced a tension between an approach that relies on the coordinative function of markets and specific programs that rely on official directives. This has created a flawed incentive structure that encourages the players in the microfinance market to pressure the government for more credit subsidies, loan quotas, and other distortionary measures. The end product is a microfinance market that appears fragmented and constrained in providing the target clientele access to financial services. There is a plethora of programs and institutions but relatively limited outreach. In addition to the government's 86 directed credit programs, there are 600 microfinance NGOs, 800 rural banks, and 2,800 credit cooperatives that target small depositors and borrowers. With the exception of CARD Bank (26,000 clients), AKLAN-CRB (18,000), TSPI-NGO (20,321), and KMBI-NGO (16,646), average outreach falls below 7,000 clients.

Regulation and Supervision

With regard to the legal environment, the major factors affecting the expansion of microfinance services in the Philippines are not found in the banking laws and regulations but in the prudential and examination practices of the BSP. Interest ceilings and usury laws, major barriers to profitable microfinance services, are fortunately non-existent. Although hard collateral is usually required to support a loan, regulations, nonetheless, allow a bank to maintain "unspecified" portions of their portfolios in unsecured loans. Thus, at least in theory, formal financial institutions could support an unspecified portion of their portfolios with, for instance, group guarantees. As for support documentation, regulations do require banks to study carefully the ability of borrowers to repay obligations. They do not, however, specify a required format for the statement of assets, income, and expenditure, nor do they mandate that financial statements be authenticated in any particular manner. Bankers therefore have discretion regarding how they determine creditworthiness.

Although there are no banking laws or regulations setting ceilings on interest rates or mandating that microloans be secured or supported by formal financial statements, prudential and examination practices of the BSP may have created biases against the provision of microfinance services. Regulations do not specify what percentage of a bank's loan portfolio may be composed of "unsecured" loans, but the prudential practice sets it at a 30 percent maximum. CARD Rural Bank, reputedly one of the best formal microlending institutions in the Philippines with an arrears rate of only 0.02 percent, is presently disqualified from using the credit facilities of the BSP because its loan portfolio does not meet the 30 percent limit. A waiver from the Monetary Board would be required to permit them to borrow from the BSP, despite its excellent portfolio performance. Furthermore, although it is true that bankers have considerable discretion in granting loans, it is also true that examiners have considerable discretion in evaluating the performance of bankers.

The discretionary aspects of regulations may be used to facilitate and foster microlending activities. However, they are more likely to have adverse effects because of the lack of experience and familiarity of examiners with microlending, prevalent misperceptions of risks associated with small loans, and bad experiences with the government's widespread use of directed credit programs. Nonetheless, barriers related to the discretionary aspects of regulations could be substantially reduced through the training of bankers, bank regulators, and examiners on microlending and the risks and managerial controls associated with micro and small loans.

NGOs and Transformation

Concerning the possibility of transforming NGOs into formal financial intermediaries, the regulations are flexible. Capital requirements for establishing a rural bank, for instance, go as low as Php 2 million (US$ 50,000), an amount that should be easy for most NGOs to raise. Information and reporting requirements are not cumbersome. In fact, CARD-Bank reported no major obstacles in obtaining a license or in complying with reporting requirements. As for supervision, CARD reports having a good experience with BSP examiners during its first examination this year.

In contrast to the situation in other countries, there is no need to create a new legal entity for microfinance services in the Philippines. For NGOs seeking transformation, there already are alternatives among the current legal types of banking institutions. Rural banks have been the preferred transformation option, in part because of low capital requirements. Moreover, rural banks are mandated by law to work with small borrowers and are traditionally seen by regulators as the providers of financial services to marginalized sectors. Therefore, the BSP may be more willing to grant rural bank licenses to NGOs seeking transformation. In addition, the ownership structure allows a single individual or institution (in this case an NGO) to own 100 percent of the shares.

Notwithstanding, a major barrier to expanding microfinance services within the formal financial framework in the Philippine system is found in the limited managerial and technical capacity of most rural banks, cooperative rural banks, and NGOs seeking transformation. In

general, these institutions have the mandate to work with disadvantaged groups, and, as such, their credit programs are targeted toward micro and small-scale entrepreneurs and farmers. Average loan size is usually smaller and women's participation larger than for commercial and other types of banks. However, these institutions have limited capacity to expand financial services and deliver them effectively and efficiently. Rural banks and NGOs alike have small outreach. New financial approaches to providing credit services to the poor are not yet fully understood or accepted. Misconceptions about the poor's capacity to repay loans have resulted in below market interest rates and excessively long loan terms, with severe consequences for arrears, costs, and sustainability. Most credit programs use ill-suited adaptations of individual and group-lending technologies. Consequently, administrative costs are too high for institutions and transaction costs too high for clients. Loan follow-up and collection systems are weak as well. Arrears rates currently stand at 19 percent for rural and cooperative rural banks as a whole, and 17 percent for ASKI, the NGO planning to become a rural bank.

FUTURE STEPS

Bank Regulation

The recent enactment of the General Banking Law of 2000 (R.A. 8791) has the potential to initiate a new era for microfinance through its explicit recognition of microfinance in Sections 40, 41, 43 and 44, which mandate the formulation of appropriate rules and regulations for microfinance operations. Specifically, Section 40, which describes the information that may be required by a bank for granting loans or other credit accommodations, provides for recognition of "the peculiar characteristics of microfinancing, such as cash flow-based lending to the basic sectors that are not covered by traditional collateral." Section 41 goes on to authorize the issuance of regulations deemed necessary for unsecured loans, while Section 44 states specifically that, "in case of loans and other credit accommodations to microfinance sectors, the schedule of loan amortization shall take into consideration the projected cash flow of the borrower and adopt this into the terms and conditions formulated by banks." The revised General Banking Law thereby provides an excellent opportunity to issue new rules and modify supervisory practices in ways that can make the regulatory environment more appropriate to microfinance.

In contrast, Section 43 mandates that "the Monetary Board shall regulate the interest imposed on microfinance borrowers by lending investors and similar lenders, such as, but not limited to, the unconscionable rates of interest collected on salary loans and similar credit accommodations." This provides regulators the dangerous authority, especially if political pressure is brought to bear, to regulate microfinance interest rates. Low, non-market interest rates prevent the recovery of operational and financial costs, plus an adequate margin for risks and long-run sustainability. In addition, also the possibility of even imposing such limits adds a new dimension to the risks of entering the field of microfinance.

Bank Supervision

As a direct result of the 1997 Asian economic crisis, bank supervision in the Philippines is being revised and updated. Donor agencies have been pouring in resources to improve the economy after the crisis. Under World Bank and International Monetary Fund loan conditions, the Government of the Philippines is required to upgrade bank supervision and regulation. The Asian Development Bank, in addition, has been providing funds for institutional capacity building at the Philippine Deposit Insurance Corporation (PDIC). USAID is providing funds for projects to upgrade the financial infrastructure, including improvements at PDIC, the BSP, and possibly even the Cooperative Development Authority. These efforts, however, need to be accompanied by a comprehensive training of personnel responsible for regulating and examining formal financial institutions involved in microenterprise lending.

One of the most important developments is that the BSP, assisted by a team of consultants, is working toward adopting and implementing the U.S. approach to risk-based bank supervision. This includes looking at the multiple risks associated with each significant banking activity and the steps that bank management is taking to reduce the adverse consequences of risk-taking. The format of bank examination reports of the BSP has been changed to emphasize the focus on risks and risk management. Changing from traditional supervision to risk-based supervision requires a cultural shift on the part of examiners, bank supervision leaders, and the banks themselves. Considerable progress is being made. A typical barrier to overcome is the opposition to treating banks differently based on their demonstrated ability to manage risk. Traditionally, supervisors have dealt with risk in the banking system by placing prudential limits on the risks that banks may take. Bank supervisors have a bias toward averting risks as opposed to considering ways to better manage risks, but this is slowly changing as the concepts of risk-based supervision take over. Risk-based supervision has the potential of providing a more accommodating environment for microfinance.

Both the BSP and PDIC are developing off-site early warning systems, using quarterly financial information from individual banks, to identify adverse changes in the risk profiles of individual institutions and the industry as a whole before adverse changes show up in financial performance—that is, earnings, capital, and liquidity. Notwithstanding, it will probably take several years before these systems are perfected.

Transformation

A necessary step toward increasing the chances of successful transformation of microfinance institutions is to upgrade their managerial, financial and technical capabilities. In this regard, the Microfinance Coalition has developed a set of "Standards for Microfinance" (performance measurements) specifically aimed at upgrading the capacity for outreach and profitability of microfinance institutions. On the whole, the standards seek to encourage greater efficiency in the microfinance sector and to raise the attractiveness of microfinance institutions to potential investors. The standards were completed and published in August

1998 as “Microfinance Standards towards Outreach and Sustainability.” Most microfinance NGOs are adopting these standards.

With regard to transformation of NGOs, an expected development is the creation of ASKI Rural Bank. While the BSP’s position on the issue is still uncertain, the success of CARD Bank and the pressure from donor agencies may contribute to a favorable result despite the BSP’s reluctance to see the entrance of new institutions. More certain, however, is the transformation of PCFC into a microfinance-oriented commercial bank. PCFC is currently a government corporation and the largest provider of funds to microfinance institutions. The government order that created PCFC mandates its privatization by 2002. At present, PCFC plans to transform its microfinance window into a commercial bank exclusively devoted to servicing the sector. PCFC currently provides loans for micro and small lending activities to 137 institutions, including 47 rural banks, 22 cooperative rural banks, 2 thrift banks, 23 NGOs, and 43 cooperatives. Although PCFC has been involved in second-tier operations only, as a bank it expects to carry out first-tier operations as well. Reportedly, PCFC deems that it will have to serve the market directly because client institutions, albeit the best in the market, are unable to absorb the amount of funding available.

Eliminating Directed Credit

In August 1999, the President of the Philippines signed Executive Order 138, thereby eliminating the participation of government non-financial agencies and government-owned and -controlled corporations in the implementation of credit programs. This Executive Order constitutes an important step toward eliminating the distortions that affect financial markets, while enhancing the provision of microfinance services by formal financial intermediaries. According to the Order, government non-financial agencies and government-owned and -controlled corporations will no longer engage directly or indirectly in the provision of credit. Instead, they are to focus on the provision of non-financial services such as rural, human, and organizational infrastructure aimed at making rural and urban-based microenterprises profitable. In partnership with private sector institutions, they also will focus on the provision of capacity-building services (such as education and training and information centers) to those institutions involved in the delivery of credit services to the basic (low-income) sectors. In addition, the Order dictates that government financial institutions will be the main government vehicle for the delivery of credit services by providing wholesale funds to private financial institutions. These institutions include rural banks, thrift banks, development banks, cooperative rural banks, and other financial institutions regulated by the BSP that have acceptable experiences in credit delivery, as well as non-regulated institutions, including cooperatives and non-government organizations. The Order also specifies that government financial institutions may provide retail services to sectors not adequately served by private financial institutions.

The future role of funding by donor agencies is defined as well. In this respect, the Order stipulates that both the government and government financial institutions will tap external funding sources only if the terms of the funding do not result in the distortion of financial markets. Furthermore, grant funds from donor agencies will be used to finance institutional

capacity-building activities. Grant funds for on-lending may be allowed as long as the re-lending terms and conditions for the funds conform to the guidelines given in the Order. In this respect, loan funds from donor agencies will be subject to approval by the Department of Finance. Under this framework, the government will eliminate the use of donor funding that has distorting conditionalities attached, such as subsidized interest rates to final borrowers. In particular, the Order stipulates that interest rates charged by government credit programs should not be lower than prevailing market rates. It further adds that recovery of financial and operational costs by wholesale and retail financial intermediaries should be a paramount consideration in interest rate setting.

With Executive Order 138, the government seeks to bring consistency between policies and programs, as the objective of poverty alleviation is pursued within a deregulated financial environment. The specifications of the Order should contribute substantially toward eliminating the most prevalent distortions that have affected financial markets and microlending in particular for the past 20 years. Putting the Order into effect, however, may take at least two years, given the large number of programs and institutions involved. The National Credit Council is directed by the Order to formulate the Order's operational guidelines in consultation with the concerned government agencies and to implement a rationalization program for directed credit programs using the policy guidelines of the Executive Order.

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ANNEX A

INSTITUTIONS INTERVIEWED

INSTITUTIONS INTERVIEWED

Rolando Victoria
Executive Director
Alalay sa Kaunlaran sa Gitnang Luzon, Inc. (ASKI)
Cabanatuan City, Philippines

Galo Weagan
President
Alliance of Philippine Partners for Enterprise Development (APPEND)
Quezon City, Philippines

Jeng Juan
Officer-in-Charge
Alliance of Philippine Partners for Enterprise Development (APPEND)
Quezon City, Philippines

Alberto Reyes
Governor
Bangko Sentral ng Pilipinas (BSP)
Manila, Philippines

Wilfredo Domo-ong
Director
Department of Rural Banks
Bangko Sentral ng Pilipinas (BSP)
Manila, Philippines

Ludivina Albances
Bank Officer/Examiner
Department of Rural Banks
Bangko Sentral ng Pilipinas (BSP)
Manila, Philippines

Ricardo Lirio
Director
Department of Supervision and Examination
Bangko Sentral ng Pilipinas (BSP)
Manila, Philippines

Candon Guerrero
Director
Department of Thrift Banks and Non-Bank Financial Institutions
Bangko Sentral ng Pilipinas (BSP)
Manila, Philippines

Dolores Torres
Executive Director
CARD Bank
San Pablo City, Philippines

Candelario Versoza
Executive Director
Cooperative Development Authority (CDA)
Quezon City, Philippines

Benedicto Jayoma
Administrator
Cooperative Development Authority (CDA)
Quezon City, Philippines

Charito Librando
General Manager
Cooperative Rural Bank of Cebu
Cebu City, Philippines

Gilberto Llanto
Chief of Party
Credit Policy Improvement Program (CPIP)
Manila, Philippines

Lois Kitsch
Chief of Party
CUES-Philippines
Davao City, Philippines

Luis Sasuman
Deputy Chief of Party
CUES-Philippines
Davao City, Philippines

Arjeo Mellisimo
President
First Consolidated Bank of Bohol
Tagbilaran City, Philippines

Feliciano Miranda
Retired BSP Governor
Independent Consultant
Makati City, Philippines

Mariano Jose Laurel
President
Jose P. Laurel Rural Bank
Tanauan, Batangas, Philippines

Herminio Vibas
Vice President
Jose P. Laurel Rural Bank
Tanauan, Batangas, Philippines

Phil Bruton
Chief of Party
Microenterprise Access to Banking Services (MABS)
Davao City, Philippines

Jose Medina
President
People's Credit and Finance Corporation (PCFC)
Makati City, Philippines

Ed Lantaca
General Manager
Perpetual Help Credit Cooperative
Dumaguete City, Philippines

Ernest Leung
President
Philippine Deposit Insurance Corporation (PDIC)
Makati City, Philippines

Geronimo Zapata
General Manager
Philippine Federation of Credit Cooperatives
Quezon City, Philippines

Armando Yambao
General Manager
Rural Bank of Panabo
Panabo, Davao del Norte, Philippines

Rosele Solis
General Manager
Rural Bank of Santo Tomas, Inc.
Santo Tomas, Davao del Norte, Philippines

Josaias de la Cruz
Executive Director
Tulay sa Pag-unlad, Inc. (TSPI)
Makati City, Philippines

Andres Panganiban
President
San Leonardo Rural Bank in Nueva Ecija
San Leonardo, Nueva Ecija, Philippines

Ma. Teresita Espenilla
Cognizant Technical Officer
United States Agency for International Development (USAID)
Manila, Philippines

Edgardo Comeros
Executive Director
VICTO-VCF
Cebu City, Philippines