VII. FINANCING FOR MICRO-ENTERPRISES, SMALL AND MEDIUM-SIZED BUSINESS AND POOR HOUSEHOLDS IN THE PHILIPPINES

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Introduction

The population in the Philippines currently stands at 76.5 million. With a population growth rate of 2.36 per cent, which is well above the 1.3 per cent world population growth rate, 1.8 million will be added each year to the country's population. Since the economy in the last 15 years has grown only modestly, the number of poor people inevitably keeps on rising. Thus, despite the fact that poverty incidence had declined from 49.3 per cent in 1985 to 40 per cent in 2000, the number of poor people has risen from 26.2 million to 31.3 million during the same period.[1] A great majority of the income earners of poor households are self-employed.

The 1998 Annual Poverty Indicators Survey showed that 70 per cent of the poorest 40 per cent of the respondents relied on entrepreneurial activities as their main source of income. However, only 25 per cent out of the 8.5 million families in business had obtained credit to finance their business.

There is no accurate information on the number of micro-enterprises, and small and medium-sized enterprises in the Philippines because many of them do not register with the concerned government agencies. The past and most recent statistics for manufacturing establishments alone suggest that some 90 per cent are those with an average total employment of less than 10 workers. This does not include those in the agriculture and service sectors.

This economic landscape has not gone unnoticed by policy makers in the country. Since the country gained its independence from the United States of America in 1946, the government has put in place policies and programmes to address the needs of small and medium-sized enterprises and to reduce poverty incidence. Financial policies and credit programmes have been used as instruments for mobilizing and moving financial resources to micro, small and medium-sized enterprises (MicSMEs for short) and poor households. This will be the main focus of the discussion below.

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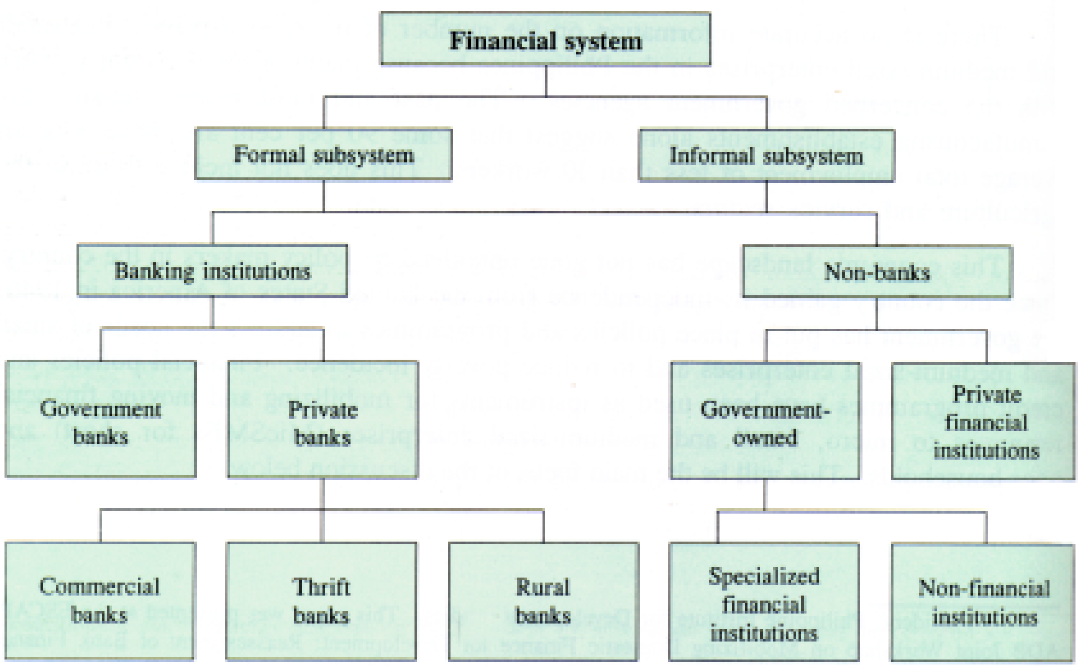
[1] In terms of number of families, poverty incidence declined from 44.2 per cent in 1985 to 34.2 per cent in 2000, but the number of poor families increased from 4.4 million to 5.2 million.

The next section gives an overview of the entire Philippine financial system. Although this chapter deals only with bank lending to MicSMEs and poor households, the overview gives a clearer picture of the role of banking institutions in lending to these sectors. Section B discusses the existing policy framework and programmes for bank lending to MicSMEs and poor households. A discussion on the current status of bank lending to MicSMEs and poor households is presented in section C. The last section analyses the constraints facing banks, especially private banks, in lending to MicSMEs and also recommends some measures to address them.

A. OVERVIEW OF THE PHILIPPINE FINANCIAL SYSTEM

The Philippine financial system consists of formal and informal financial subsystems (figure 1). The informal sector is composed of heterogeneous players, such as moneylenders, and rotating savings and credit associations. The formal financial subsystem can be broken down further into banking institutions, which are authorized to provide credit and accept deposits from the general public, and non-bank institutions, which are authorized to extend loans but are not permitted to accept deposits from the general public.

Figure 1. The Philippine financial system



Non-bank institutions include government specialized financial institutions and non-financial institutions. The two largest pension fund systems, namely the Social Security System and Government Social Insurance System, belong to the former. They provide housing and other small loans to their members. Other institutions that belong to the former are the specialized non-bank government institutions, which are created by law or administrative order for the purpose of providing credit to specific sectors. Examples are the Small Business Guarantee and Fund Corporation, which provides credit guarantees up to 100 per cent of the loan and extends credit to small and medium-sized enterprises, and the Quedan and Rural Credit Guarantee Corporation (QUEDANCOR), which provides credit-support mechanisms for the benefit of farmers, fisherfolk, rural workers, cooperatives, retailers, wholesalers and agricultural processors. It also implements a guarantee system to promote inventory financing of agri-agra commodities, to establish production and post-production facilities and to acquire farm and fishery equipment. Government non-financial agencies refer to regular government agencies, such as the Department of Agriculture, Department of Trade, and Department of Labour and Employment and their attached agencies that implement various directed credit programmes for the sectors they are mandated to serve.[2]

Both non-bank financial and non-financial government agencies obtain funds from the government and bilateral and multilateral donor agencies to finance their credit programmes.

Private non-bank financial institutions, on the other hand, include insurance companies, investment institutions, finance companies, lending investors, trust companies securities dealers, pawnshops, credit unions etc.[3]

The banking system is composed of the commercial banking system (universal and ordinary commercial banks), the thrift banking system (savings and mortgage banks, private development banks and stock saving and loans associations), the rural banking system, and government banks.[4] These different bank categories are authorized to perform different functions (table 1). Understandably, they have different minimum capital requirements commensurate to their authorized functions, i.e., those that are authorized to have more functions have higher minimum capital requirements than those that have limited functions (table 2). Among the different bank categories, the universal banks are allowed to perform the most number of functions (both commercial and investment functions). At the other end of the spectrum are the rural banks, which are authorized to perform a limited number of functions.

[2] Lamberte and others (1998) found that 13 non-financial government agencies have implemented or managed at least 37 special or directed credit programmes that were mostly inefficient and ineffective.

[3] Although credit unions are financial intermediaries that mobilize and lend money to their members, they are not considered part of the banking system.

[4] The rural banking system includes the rural cooperative banks.

Table 1. Authorized activities of various bank categories

Authorized activities	*Commercial banks*		*Thrift banks*	*Rural banks*
	Universal	*Ordinary*		
A. Commercial banking services				
1. Accept deposits	1	1	1	1
2. Issue LCs and accept drafts	1	1	1[a]	11[a]
3. Discounting of promissory notes and commercial papers	1	1	1	1
4. Foreign exchange transactions	1	1	11	*
5. Lend money against security	1	1	1	1
B. Nationwide branching operations	1	1	1	1
C. Equity investments in allied undertakings	11	11	11	11
D. Equity investments in non-allied undertakings	1	*	*	*
E. Trust operation	11	11	11	11
F. Issue real estate and chattel mortgage, bonds buy and sell these for its own account, accept/ receive in payment or as amortization of loan	1	1	1	1
G. Direct borrowing with Central Bank	1	1	1	1
H. Activities of investment houses				
1. Securities underwriting	1	*	*	*
2. Syndication activities	1	1	1	1
3. Business development and project implementation	1	1	1	1
4. Financial consultancy and investment	1	1	1	1
5. Mergers and consolidation	1	1	1	1
6. Research and studies	1	1	1	1
7. Lease real and/or personal properties	*	*	*	*
Money market operation	1	1	*	*

Source: Lamberte, Mario B., 1992. *"Assessment of the Financial Market Reforms in the Philippines 1980-1992".*

1– Authorized activities
11– Authorized but subject to Monetary Board Approval
*– Not authorized/prohibited
[a] Limited only to domestic letters of credit and drafts.

As of December 2000, there were 16,676 offices (head offices, branches and extension offices) of the financial institutions in the country (table 3). Of these, some 45 per cent were offices of the banking institutions. Over 50 per cent of the banking offices of commercial banks are concentrated in Metro Manila, while most banking offices of thrift and rural banks are located in areas outside Metro Manila. The offices of rural banks are widely dispersed in rural areas.

In terms of assets, the banking system overwhelmingly dominates the financial system. Its total assets as of December 2000 amounted to P3.3 trillion or 82 per cent of

Table 2. Minimum level of capitalization for new entrants as of August 2000

Bank category	*Minimum capital (in millions of pesos)*
Expanded commercial banks (universal banks)	4 950.0
Non-expanded commercial banks (ordinary commercial banks)	2 400.0
Thrift banks	
With head office within Metro Manila	325.0
With head office outside Metro Manila	52.0
Rural banks	
Within Metro Manila	26.0
Cities of Cebu and Davao	13.0
1st/2nd/3rd class cities and 1st class municipalities	6.6
4th/5th/6th class cities and 2nd/3rd/4th class municipalities	3.9
5th and 6th class municipalities	2.6

Source: Circular No. 257, Bangko Sentral ng Pilipinas, 15 August 2000.

Table 3. Total resources and offices of the financial system, 2000

Type	*Resources amount (PB)*		*Offices*	
		Per cent	*Number*	*Per cent*
A. Banking institutions	3 326.80	81.83	7 553	45.29
1. Commercial banks	3 013.60	74.12	4 250	25.49
2. Thrift banks	245.80	6.05	1 391	8.34
3. Rural banks	67.40	1.66	1 912	11.47
B. Non-banks	738.80	18.17	9 123	54.71
Total	4 065.60	100.00	16 676	100.00

Source: Bangko Sentral ng Pilipinas.

the total assets of the financial system. The total assets of the commercial banking system stood at P3 trillion or 74 per cent of the total assets of the financial system.

Going back to figure 1, this chapter will focus only on the banking system, which is only a part of the Philippine financial system that provides financial services to MicSMEs and poor households.

B. EXISTING POLICY FRAMEWORK AND PROGRAMMES FOR BANK LENDING

This section discusses the government's operational definition of MicSMEs and poor households and the elements of the policy framework and programmes for bank lending to MicSMEs and poor households.

1. Operational definition

It is important for policy direction and for evaluating the effectiveness of policies and programmes to have a common definition of MicSMEs and poor households. When dealing with farm enterprises, the Comprehensive Agricultural Reform Law provides an operational definition of what constitutes small farm enterprises. Since the retention limit for agricultural lands is seven hectares, then small farm enterprises refer to those who own and farm seven hectares or less. As regards MicSMEs, Section 3 of the Magna Carta for Small Enterprises (Republic Act No. 6977 as amended by Republic Act No. 8289) provides an operational definition. It states that "small and medium enterprise" shall be defined as any business activity or enterprise engaged in industry, agribusiness and/or services, whether single proprietorship, cooperative, partnership or corporation whose total assets, inclusive of those arising from loans, but exclusive of the land on which the particular business entity's office, plant and equipment are situated, must have value falling under the following categories:

Micro:	less than	1,500,001	Philippine pesos
Small:	1,500,001	15,000,000	Philippine pesos
Medium:	15,000,001	100,000,000	Philippine pesos[5]

The same law authorizes the Small and Medium Enterprise Development Council to periodically review the above definitions and, if necessary, adjust them upon the recommendations of sectoral organizations taking into account inflation and other economic indicators.[6]

In the context of the Social Reform and Poverty Alleviation Act of 1997 (Republic Act 8425), the poor households refer to the "basic sectors", which include the disadvantaged sectors of the Philippine society, namely: farmer-peasant, artisanal fisherfolk (i.e., municipal, small-scale or subsistence fishermen who use fishing gears which do not require boats or which only require a boat of less than 3 tons), workers in the formal sector and migrant workers, workers in the informal sector, indigenous peoples and cultural communities, women, differently-abled persons, senior citizens, victims of calamities and disasters, youth and students, children, and urban poor. It also defines micro-enterprise, which is any economic enterprise with a capital of 150,000 Philippine pesos and below. This does not necessarily conflict with the definition provided under the Magna Carta for Small Enterprises because the latter defines micro-enterprise in terms of assets inclusive of those arising from loans, whereas the former defines micro-enterprise in terms of capital.

[5] The exchange rate as of 16 November 2001 was 52 Philippine pesos to 1 US dollar.

[6] When Republic Act 6977 was passed in 1991, the definitions were as follows: micro – less than P50,000; cottage – P50,001 to P500,000; small – P500,001 to P5,000,000; and medium – P5,000,001 to P20,000,000.

2. Elements of the policy framework and programmes

(a) Banking structure

Banks have the natural tendency to be large in order to exploit economies of scale and scope. In the process, they tend to shy away from small savers and borrowers because of the high transaction costs they will incur and lack of related businesses they can generate with them. Thus, a banking system that consists of a few large banks will likely force small savers and borrowers to go to the informal financial system. Recognizing this possible consequence, the Philippine authorities have structured a banking system that includes a subsystem that will cater to the needs of small savers and borrowers. The thrift banks and rural banks are expected to perform such functions. Since most small savers and borrowers are located in areas outside Metro Manila, the Central Bank encourages thrift and rural banks to locate in those areas by requiring only low minimum capital requirements.

To improve the viability and competitiveness of thrift and rural banks that cater mainly to MicSMEs and poor households, the government has provided several incentives. One is that the reserve requirement ratio of their deposits is lower by 2 percentage points than that of commercial banks. Another is that they are exempt from the payment of all taxes, fees and charges of whatever nature and description, except the corporate income tax and local taxes, fees and charges, for a period of five years from the date of commencement of operations. These incentives enable thrift and rural banks to give higher interest rates on their deposits and lower interest rates on loans and, at the same time, to build up their capital.

(b) Microfinance-friendly policy and banking regulations

The Social Reform and Poverty Alleviation Act provides the policy framework for microfinance services for the poor. More specifically, it sets out the following thrusts:

(a) Development of a policy environment, especially in the area of savings generation, supportive of basic sector initiatives dedicated to serving the needs of the poor in terms of microfinance services;

(b) Rationalization of existing government programmes for credit and guarantees;

(c) Utilization of existing government financial entities for the provision of microfinance products and services for the poor;

(d) Promotion of mechanisms necessary for the implementation of microfinance services, including indigenous microfinance practices.

One of the lessons of the East Asian financial crisis is that banks must be well-regulated and adequately supervised. However, new prudential regulations, if applied uniformly to all types of banks, could further force banks to ration out small borrowers. Thus, the newly passed General Banking Act tries to achieve a balance between the objectives of tightening up prudential regulations and ensuring the flow of financial services to MicSMEs and poor households. This law includes three provisions that touch on microfinance, especially on issues regarding collateral-based lending, unsecured loans, interest to be paid by microfinance borrowers and amortization on loans. In view of the substantial increase in the non-performing loans in the wake of the East Asian financial crisis, a significant portion of which were unsecured, the new law encourages banks to demand from their credit applicants a statement of assets and liabilities and of income and expenditures and other information. Obviously, microfinance borrowers cannot meet such a requirement. Thus, the law exempts them from this regulation and instead encourages banks to lend to them not on the basis of a collateral they can present but on the basis of their cash flows. As regards interest rate, the Central Bank has issued a circular that clearly spells out the policy that the "interest rate shall not be lower than the prevailing market rates to enable the lending institution to recover the financial and operational costs incidental to this type of microfinance lending". This runs counter to the previous policy that promoted a below-market rate of interest for loans to MicSMEs and poor households.

Banks normally require payment on their loans either on a monthly, quarterly or annual basis. In the microfinance market, however, borrowers usually borrow small amounts and are given a more flexible amortization schedule that reflects their cash flow. Thus, the Central Bank is given authority by the law to formulate more flexible guidelines in so far as loan amortization is concerned. The new guidelines issued by the Central Bank allow microfinance loans to be amortized on a daily, weekly, bi-monthly or monthly basis, depending on the cash flow conditions of borrowers. The Central Bank has issued the "Notes on Microfinance" to guide banks in implementing the new policy on microfinance (see annex).

The existence of adequate banking offices in all areas in the country can improve the access of MicSMEs and poor households to banking services. Beginning in 1989, the Central Bank relaxed the regulation on bank entry and branching. This led to the proliferation of banks and branches in the country. Many of these banks became in distress in the aftermath of the East Asian financial crisis and the El Niño weather phenomenon that struck in 1998. Thus, the Central Bank has declared a moratorium on the opening of new banks and has encouraged merger or consolidation to strengthen their financial position. However, to ensure that microfinance services will not diminish, the Central Bank recently approved a partial lifting of the general moratorium on the licensing of new thrift and rural banks to allow the entry of microfinance-oriented banks. A rural bank to be established as a microfinance bank is required to have a minimum paid-in capital of 5 million Philippine pesos while the existing capitalization requirement for thrift banks applies (see table 2).

(c) Loan portfolio regulations

Loan portfolio regulations pertain to those regulations that require banks to allocate a certain proportion of their loanable funds to specific sectors of the economy. There are three existing regulations. First is the deposit retention scheme. Under this scheme, at least 75 per cent of the total deposits, net of required reserves against deposit liabilities and total amount of cash in vault, accumulated by branches, agencies, extension officers, units and/or head offices of specialized government banks, in a particular regional grouping outside the National Capital Region, must be invested as a means to develop that region. This policy is used to deal with the problem of fund diversion, that is, banks with a nationwide branch network mobilizing deposits in rural areas where most of the MicSMEs and poor households can be found and lending them to large enterprises in urban areas, more specifically, Metro Manila. This is detrimental to the development of MicSMEs and poor households in rural areas because they are denied badly needed funds. For purposes of this regulation, the country used to be divided into 13 regions. Commercial banks were against this policy because they could hardly find borrowers in rural areas that would pass their credit criteria. As a result, they were discouraged from intensively mobilizing deposits. Borrowers and savers ultimately borne the cost of this regulation in terms of higher interest rates on loans and lower interest rates on deposits. Thus, in 1990, this regulation was relaxed by reducing the number of regional groupings from 13 to 3, which gives banks greater scope for diversifying their loan portfolio and sources of funds, at least geographically.

The second loan portfolio regulation is Presidential Decree No. 717, otherwise known as the "agri/agra law", that mandates all banking institutions to set aside 25 per cent of their net incremental loanable funds for agricultural lending, 10 per cent of which is to be lent to agrarian reform beneficiaries and 15 per cent for general agricultural lending. Commercial and thrift banks have not found difficulty in complying with the latter because there is a good number of credit-worthy agribusiness corporations, such as plantation farms, some of which are domestic corporate giants and multinational firms. In contrast, they have difficulty in complying with the former simply because their operations are not structured to provide small loans to the widely dispersed agrarian reform beneficiaries. In other words, they face severe information asymmetry problems when it comes to lending to agrarian reform beneficiaries. Worse, the number of agrarian reform beneficiaries has not grown much in recent years owing to the delay in the implementation of the comprehensive land reform programme while deposits of banks have grown tremendously. This has complicated further the problems faced by commercial and thrift banks in complying with this requirement. However, the government has provided banks with alternative instruments for complying with the law, such as investing in government securities declared eligible by the Central Bank for the compliance of the law. Examples are the Pag-IBIG Bonds, the proceeds of which will be used by the government for low-cost housing projects; investment by banks in the authorized capital stock of QUEDANCOR or loans extended by banks to farmers, fishermen, cooperatives, rural workers and rural enterprises covered by guarantees of QUEDANCOR; investment by banks in NDC Agri-Agra ERAP Bonds, the proceeds of which are going to be used exclusively for the development of the agriculture and agrarian sectors and in priority development projects to these sectors identified by the National Development Company, Department of Agrarian Reform, and the Department of Agriculture; and investment by banks in Special Purpose Treasury Bonds to finance the comprehensive agrarian reform programme-related expenditures. The Central Bank has recently increased the penalties for non-compliance/under-compliance of the law.

The third loan portfolio regulation is the mandatory credit to small enterprises as provided for under Republic Act 6977, otherwise known as the Magna Carta for

Small Entrprises. Under this law, all lending institutions were mandated to lend at least 10 per cent of their total loan portfolio to small enterprises. This requirement was tiered and was time bound: 5 per cent of the total loan portfolio by the end of 1991 to rise to 10 per cent by the end of 1992 through 1995 and to decline to 5 per cent by the end of 1996 and zero by the end of the seventh year. As expected by many, the law was amended in the seventh year (Republic Act 8289). Thus, for a period of 10 years after the introduction of the law, all lending institutions were required to set aside at least 6 per cent and at least 2 per cent for small and medium-sized enterprises, respectively, of their total loan portfolio and to make it available for small and medium-sized enterprises credit. Only instruments issued by the Small Business Guarantee and Credit Corporation which do not pay market rates and non-interest bearing deposits with the Central Bank are deemed alternative compliance to the this loan portfolio regulation.

(d) Direct participation by the government in the banking system

The government directly participates in the provision of financial services to MicSMEs and poor households through its banking institutions. It currently maintains two banks that perform special functions. These are the Development Bank of the Philippines and the Land Bank of the Philippines.[7] These banks lend to MicSMEs and poor households including farmers and land reform beneficiaries either directly through their retail lending windows or indirectly through their wholesale lending in windows. Because they have been largely used by the government as instruments for increasing the access of MicSMEs and poor households to financial services, we will describe them in length here.[8]

Development Bank of the Philippines

Charter/legal mandate. The Development Bank of the Philippines was created by Republic Act No. 85 in 1947 primarily to provide credit facilities for the rehabilitation, development and expansion of agriculture and industry, the broadening and diversification of the national economy, and to promote the establishment of private development banks in the countryside. Executive Order 81 issued on 3 December 1986 revised the bank's charter giving it a new development mandate. Under this new charter, the bank's principal objective is to provide banking services particularly to meet the medium- and long-term financing needs of small and medium-scale agricultural and industrial enterprises. The bank's orientation has similarly been changed to that of a primarily wholesale bank with a significant retail presence. Guided by its new mandate, the Development Bank's priority areas for financing include export promotion, new entrepreneurs and infrastructure, including loans for local government units.

On 20 December 1995, the Central Bank of the Philippines granted the Development Bank of the Philippines a permit to operate as an expanded commercial bank. As an expanded commercial bank, the Development Bank currently offers the following products and services to its clients: (a) deposit products and services; (b) fund transfer

[7] A third bank, the Philippine National Bank, has been privatized.

[8] This draws on Lamberte and others (1997 and 1998).

services including the provision of telegraphic transfer services and acceptance of PLDT/SSS/BIR payments; (c) fund management services including government securities dealerships and servicing of foreign currency remittances; (d) trust products and services including dealership of blue chips and trusteeship of asset-backed securities; (e) merchant banking services including underwriting and loan syndications; (f) wholesale lending services; (g) retail lending services; (h) export financing; and (i) guarantee services. At present, the Development Bank of the Philippines has five regional offices and 70 branches nationwide.

Major policies/strategies. The Development Bank of the Philippines was restructured into a predominantly wholesale bank in 1990 following the recommendations of a study conducted under the World Bank Financial Sector Adjustment Loan in 1987. Participating financial institutions were tapped as conduits of the bank's wholesale funds.

In order not to share the same market segment and avoid competition, wholesale and retail banking operations have been distinctly separated, such that wholesale resources are not employed to fund retail activities. Likewise, both operations are also administered separately by two different groups in the bank. The major functional departments of the retail banking operation are the Institutional Banking Group, the Branch Credit Group and branches, and the Window III group. Wholesale banking, on the other hand, is handled by the Wholesale Banking Group and is still considered centralized.

The Development Bank of the Philippines maintains three lending modes or windows as part of its retail lending services. Window I caters to short-term working capital needs with maturities of up to 18 months. The bank's internal funds are usually used for this purpose. Window II finances the acquisition of fixed assets and permanent working capital with repayment terms of up to five years. Lastly, Window III assists activities which have catalytic effects on the country's economic development. Loans under this window are for infrastructure, fixed asset acquisition and/or working capital with repayment periods of more than five years. This window is considered the centerpiece of the bank's retail lending operations that support the government's Social Reform Agenda. Most of the programmes under Window III are implemented in cooperation with government line agencies, such as the Department of Science and Technology, Department of Agriculture and Department of Agrarian Reform, and Congress. Eligible borrowers under Window III social programmes, in general, include cooperatives, associations, and non-government or private institutions engaged in developmental activities. The Development Bank is mandated to maintain at least 20 per cent of its loan portfolio for Window III. Thirty per cent of the net income of the bank after tax is used to fund this window. There are also domestic sources of funds, for example the Social Security System. Window III accounts comprised about 18 per cent of its outstanding loan portfolio.

Special credit programmes implemented. The Development Bank of the Philippines currently administers 19 special credit programmes that are financed by foreign or domestic borrowings and special funds. These are apart from those that they administer for government line agencies. Of the 19 programmes, 10 fall under its wholesale lending operations and use the participating financial institutions as conduits of funds. The remaining nine programmes are implemented as part of its retail operations and cater directly to end-borrowers.

Land Bank of the Philippines

Charter/mandate. The Land Bank of the Philippines was established on 8 August 1963 as a government-owned financial institution by virtue of Republic Act 3844, otherwise known as the Agricultural Land Reform Code. The Land Bank was primarily mandated to serve as the financial arm of the land reform programme that advances payments to landowners and collects amortization from farmer beneficiaries. In 1973, the Land Bank was given a comprehensive commercial or universal banking status through a presidential decree. It then established its commercial banking arm to cater to agribusiness projects and rural industries.

With the enactment of Republic Act 6657 or the Comprehensive Agrarian Reform Law in 1988, the Land Bank expanded its agrarian operations as the law covered all agricultural lands, both private and public, regardless of tenurial arrangement or commodity produced. Cooperatives emerged as the main conduit of the Land Bank's support to agrarian reform beneficiaries.

Until it was given a new charter under Republic Act 7907 on 23 February 1995, the Land Bank utilized a structure that tried to balance its universal banking and countryside development mission through a unique combination of branches and field offices that are scattered throughout the archipelago. Its branch network handled commercial banking while its field offices were in charge of its developmental or agrarian reform functions. The profits derived from its commercial banking operations finance development initiatives that benefit small farmers, fisherfolk and other countryside-based small and medium-sized entrepreneurs. However, under its new charter wherein the Land Bank was authorized to pursue a developmental approach in banking, it implemented the Unified Systems Project. While the balancing act remains, the United States Project merged the field banking and agrarian operations and placed them under one roof in order to operate as a one-stop-shop. The Project was meant to enable the Land Bank to cut down on operating expenses and ensure a more efficient delivery of services. Moreover, this was intended to provide more convenience to clients and enable the bank to undertake more ambitious projects for the development of the rural areas and ensure food security for the country.

Major programmes and lending strategies. In its bid to address all aspects of progress, the Land Bank implements the Total Development Option-Unified Land Bank Approach to Development or TODO-UNLAD programme. TODO-UNLAD links cooperatives, farmers' cooperatives, private companies, rural banks, non-government organizations and local government units in specific areas around an integrated area development project through the Land Bank's various lending programmes and support services. Each project under the programme entails linking producers to markets and processors as well as strengthening cooperatives and local government units.

TODO-UNLAD prioritizes communities covered by the Comprehensive Agrarian Reform Programme and communities belonging to the 20 priority provinces identified under the Social Reform Agenda. Qualified for financing are farm production, farm-to-market roads, rural electrification, telecommunication systems, processing and post-harvest facilities, among others.

The Land Bank has access to various bilateral and multilateral institutions for special credit facilities whose target beneficiaries belong to the priority sectors: farmers and fisherfolk cooperatives, local government units, small and medium-sized enterprises, agrarian reform beneficiaries and micro-enterprises. Through these financing programmes, the Land Bank strives to address the country's need for long-term loans, dispersal of economic activity, infrastructure and support for agrarian reform beneficiaries. The Land Bank's international partners include the World Bank, the ADB, Overseas Economic Cooperation Fund and Kreditanstalt fur Wiederaufbau of Germany.

The Land Bank of the Philippines also provides support to SMEs. In 1996 it launched six new credit programmes for SMEs, foremost of which are the "Negosyo Mo, Susuportahan Ko" and the "Todo Kaya: Isulong ang Pagsulong" even as it remained a preferred conduit of the Social Security System and the Development Bank of the Philippines in their SME financing.

The Land Bank of the Philippines continues to tap rural banks as conduits in its credit delivery. It is in fact the major institution which rehabilitated the rural banks through various capital infusion and rediscounting programmes.

The Land Bank also attempts to immediately respond to the emergency requirements of the agricultural/agrarian sector. For instance, it launched PROGRESS or its Programme for Grains Productivity Enhancement and other Support Services in response to the rice crisis that hit the country in 1995. This programme makes available appropriate financing schemes to increase rice and corn production while ensuring the profitability of farmers' cooperatives. PROGRESS integrates all aspects of farm operation from crop production, storage and milling up to marketing. Through the programme, the Land Bank finances the production of certified seeds, the provision of communal irrigation systems, the acquisition of post-harvest facilities, and the extension of marketing assistance.

Special credit programmes implemented. The Land Bank currently implements 13 special credit programmes. Nine of these are funded by foreign loans while the rest are supported by domestically-sourced special funds. This count excludes those being administered by the bank for government line agencies.

C. CURRENT STATUS OF BANK LENDING

This section presents an overview of the compliance of banks with loan portfolio regulations, specifically those that pertain to the "agri-agra" law and the Magna Carta for Small Business, and the status of lending by various types of banks to MicSMEs and poor households.

1. Overview of the banks' compliance with loan portfolio regulations

Private commercial banks usually cater to large and upper medium-sized enterprises. The loans they book under the agri-agra law include loans they extend to large agri-business corporations and plantation farms and investments in substitute instruments for complying with the law. Thus, it cannot be said that commercial banks are directly lending to small farmers.

As regards lending to MicSMEs under the Magna Carta for Small enterprises, the Central Bank is required to submit a quarterly report to the Small and Medium Enterprise Development Council with respect to the banks' compliance with the law. Table 4 shows that the banking system as a whole has greatly exceeded the minimum loan requirement for both small and medium-sized enterprises. As of June 2001, 93 per cent of the total credit allocation for SMEs was directly lent by banks to such enterprises. The bulk of the loans to MicSMEs came from commercial banks (table 5).

Table 4. Distribution of credit allocation for small and medium-sized enterprise credit (in billion of pesos)

	Small enterprise – 6 per cent				*Medium-sized enterprise – 2 per cent*			
	June 2001		*March 2001*		*June 2001*		*March 2001*	
	Amount	*Per cent to total*	*Amount*	*Per cent to total*	*Amount*	*Per cent to total*	*Amount*	*Per cent to total*
Direct compliance	137.0	93.1	117.7	92.1	84.4	93.4	95.6	94.7
Indirect compliance	4.2	2.8	4.6	3.6	3.9	4.3	3.6	3.6
Funds set aside:	6.0	4.1	5.5	4.3	2.1	2.3	1.8	1.8
Cash on hand	0.6	0.4	0.5	0.4	0.3	0.3	0.2	0.2
Due from Central Bank	5.4	3.7	5.0	3.9	1.8	2.0	1.6	1.6
Total credit allocation	147.2	100.0	127.8	100.0	90.4	100.0	101.0	100.0
Net loan portfolio	962.1		1 007.5		962.1		1 007.5	
Minimum amount required to set aside	57.7		60.4		19.2		20.1	
Excess (deficiency)	89.5		67.4		71.2		80.9	
Rate of compliance	15.3		12.7		9.4		10.0	

Source: Small and Medium Enterprises Development Council.

The data, however, hide a few things. One is that foreign banks and large domestic banks, which are predominantly wholesale banks, comply with the requirement mainly by depositing the required amount with the Central Bank, rather than by looking for small and medium-sized enterprises as borrowers. Another is that several rural banks did not submit any report to the Central Bank. A major reason is that these banks can

Table 6. People's Credit and Finance Corporation Summary of performance

	For the year 1999	*As of 31 December 1999*	*For the year 2000*	*As of 31 December 2000*
Loans granted (PM)	775 578	1 661.3	693.6	2 564.1
Loans outstanding (PM)		769.7		
Current		756.0		
Past due		12.1		
Restructured		1.6		
Repayment rate (%)		98.5		
Past due ratio (%)		1.6		
No. of borrowers/no. of loans	105 084	217 239	106 869	324 108
No. of programme partners	49	143	35	178
Non-governmental organizations	6	24	3	27
Cooperatives	17	42	14	56
Rural banks	20	51	15	66
Cooperative banks	5	23	1	24
Thrift banks		2	2	4
Lending investors	1	1		1

Source: People's Credit and Finance Corporation.

hardly find medium-sized enterprises in the small towns where they operate. Thus, they find it better to pay the fines rather than set aside non-income generating funds for lending to medium-sized enterprises.

2. Government banks

As already mentioned above, the government has utilized the Development Bank of the Philippines and the Land Bank of the Philippines as instruments for providing financial services to MicSMEs and poor households. For 2000, the Development Bank granted short- and long-term loans to SMEs amounting to almost 22 billion Philippine pesos. The outstanding exposure of the Development Bank to SMEs stood by year-end at 17 billion Philippine pesos for both wholesale and various retail lending programmes through its 77 branches across the country. Under Window III, which finances innovative and socially desirable projects with a high development impact, the total loan outstanding reached 1.72 billion Philippine pesos. All this comprises only 17 per cent of the total loan portfolio of the Development Bank because it also provides large loans to private enterprises for large projects, such as infrastructure projects, acquisition of modern technologies, transport and telecommunications.

The Land Bank of the Philippines extends financial services to its clients through its 300 branches distributed across the country. Its outstanding loans to small farmers and fisherfolk stood at 13.5 billion Philippine pesos as of the end of 2000. Loans for this sector were released through 1,797 cooperatives and 464 countryside financial institutions (rural banks, cooperative banks, thrift banks) which serve as the Land Bank's channels of credit to farmers and fisherfolk. Its outstanding loans to MicSMEs for the same period reached 12.3 billion Philippine pesos. Seventy per cent were directly lent by the Land Bank to SMEs and the remaining through some of its programmes that either use wholesale or retail lending.

The Land Bank has a subsidiary – People's Credit and Finance Corporation – that specializes in microcredit with loans ranging from 5,000 to 10,000 Philippine pesos. It works closely with NGOs and microfinance institutions to implement its programme. As of December 2000, it had already granted a total of 2.6 million Philippine pesos loans to 324,108 borrowers with a very good repayment rate (table 6).

Table 6. People's Credit and Finance Corporation
Summary of performance

	For the year 1999	*As of 31 December 1999*	*For the year 2000*	*As of 31 December 2000*
Loans granted (PM)	775 578	1 661.3	693.6	2 564.1
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Rural banks	20	51	15	66
Cooperative banks	5	23	1	24
Thrift banks		2	2	4
Lending investors	1	1		1

Source: People's Credit and Finance Corporation.

3. Thrift banking system

The thrift banking system provides production and commercial loans to SMEs, mortgage loans to households and other retail financial services to small savers and borrowers. Some large commercial banks that want their presence to be felt in the retail market have established wholly owned thrift banks. Thrift banks have a lower cost structure than commercial banks. Therefore, they can accommodate small deposits and loans more efficiently than commercial banks. Under this setting, large commercial banks indirectly provide financial services to small savers and borrowers through their subsidiary thrift banks. Presently, the country's thrift banking system consists of independent thrift banks and subsidiaries of commercial banks.

Table 7 shows that thrift bank loans granted and outstanding in both nominal and real terms had been rising up until the East Asian financial crisis. As of 1998 when the most recent published data became available, loans granted in nominal terms reached 342 billion Philippine pesos, while loans outstanding in nominal terms stood at 104 billion Philippine pesos. About half of these loans are short term for the purpose of

Table 7. Loans granted and outstanding of thrift banks
(in millions of pesos)

Table 7

Year	*Loans granted*		*Loans outstanding*	
	Nominal	*Real**	*Nominal*	*Real*
1990	65 069.8	135 115.9	17 842.8	37 050.2
1991	65 585.6	114 773.4	24 646.8	43 131.4
1992	124 919.5	200 653.2	25 440.5	40 864.1
1993	180 843.5	269 942.6	36 461.5	54 425.6
1994	252 235.3	345 310.1	70 391.0	96 365.3
1995	338 479.4	428 921.7	69 590.9	88 185.7
1996	342 589.9	398 249.7	92 893.1	107 985.2
1997	467 615.3	513 089.9	110 478.3	121 222.1
1998	341 510.5	341 510.5	104 616.2	104 616.2

Source: Bangko Sentral ng Pilipinas.

Note: CPI Base Year: 1998 = 1.00.

financing the working capital of MicSMEs. There is no information on the number of borrowers; hence, it is not possible to estimate the average size of loans they grant. However, personal interviews conducted among a few thrift banks in Metro Manila indicate that their minimum loan size ranges from 20,000 to 100,000 Philippine pesos and the maximum loan sizes from 5 million to 10 million Philippine pesos. Most thrift banks have branches operating within a certain region. However, a few large thrift banks have nationwide branch networks.

4. Rural banking system

The rural banking system truly caters to small savers and borrowers. In 1998, it granted more than one million loans to farmers, fisherfolk, and small non-farm enterprises (table 8). The rural banking system's average loan size rose from 4,600 Philippine pesos in real terms in 1980 to 15,000 in 1995, and thereafter tapered off reaching 11,000 in 1998.[9] In nominal terms, the system's average loan size amounted to 28,000 Philippine pesos or $684 in 1998, which was well below the 150,000 Philippine pesos loan ceiling for micro-enterprises under the Social Reform and Poverty Alleviation Act. At present, rural banks grant loans as low as 10,000 Philippine pesos, which is approximately $200 per borrower.

Aside from increasing geographical diversification, rural banks have been increasingly diversifying their loan portfolio across major economic activities. In the 1980s, rural bank loans were mostly concentrated in the agricultural sector (table 9). This is understandable because rural banks were merely serving as conduits of government funds, most of which were directed to the agricultural sector. In addition, a large chunk of their loan portfolio was supposed to be for the agricultural sector. Over

[9] The figures for 1997 are not comparable with those of other years because they include non-supervised credits only.

Table 8. Total loans granted by rural banks

Year	*No. of loans*	*Amount (in millions of pesos)*	*Average loan size (in thousands of pesos)*		*Exchange rate (P/US $) (Period average)*
			Nominal	*Real*	
1980	923 229	3 775	4.09	4.63	7.51
1981	942 671	4 389	4.66	5.13	7.90
1982	947 201	5 204	5.49	6.04	8.54
1983	895 065	5 721	6.39	9.61	11.11
1984	666 001	4 429	6.65	9.17	16.70
1985	519 230	3 891	7.49	8.37	18.61
1986	498 818	4 467	8.95	10.05	20.39
1987	531 997	5 650	10.62	11.57	20.57
1988	558 807	6 516	11.66	11.66	21.09
1989	739 257	9 884	13.37	11.92	21.74
1990	684 991	9 349	13.65	10.65	24.31
1991	537 788	10 519	19.56	12.87	27.48
1992	564 939	12 708	22.50	13.58	25.51
1993	747 759	18 548	24.81	13.92	27.12
1994	505 880	15 187	30.02	15.45	26.42
1995	892 303	27 770	31.12	14.82	25.71
1996	1 138 791	35 944	31.56	13.86	26.22
1997	300 923	18 743	62.28	26.05	29.47
1998	1 368 063	38 291	27.99	10.74	40.90

Source: Bangko Sentral ng Pilipinas.

Notes: CPI Base Year: 1988 = 1.00.
1997 data consist of non-supervised credits only.

the years, however, rural banks have been able to reduce their exposure to agriculture in relative terms, and to increase the shares of other economic activities, such as commercial and industrial, in rural areas. Thus, the share of agricultural loans in the total loan portfolio of rural banks went down from 89 per cent in 1980 to 46 per cent in 1998. In contrast, the shares of commercial, industrial and other loans increased from 6.1 per cent, 2.5 per cent and 2.3 per cent, respectively, in 1980 to 16.7 per cent, 5.9 per cent and 31.3 per cent, respectively, in 1998. This suggests two things. One is that there are some people in rural areas who are engaged in viable non-farm activities needing financial services from banks. Second, if left to themselves, rural banks will find a way of diversifying their loan portfolio as ordinary banks do to manage risks in lending.

There has also been a substantial change in the way rural banks finance their lending operations over the years. In 1980, deposits comprised only 43 per cent of their total liabilities (table 10). A big chunk of their liabilities comprised borrowings from the Central Bank and other special credit programmes of the government. The radical change in rediscounting and interest rate policies in the mid-1980s has encouraged banks to mobilize deposits and to rely less on the rediscounting window of the Central

Table 9. Distribution of loans of the rural banking system by purpose (in millions of pesos)

Year	Total	Agricultural		Commercial		Industrial		Other loans	
		Amount	Per cent share	Amount	Per cent share	Amount	Per cent share	Amount	Per cent share
1980	4 762.7	4 241.2	89.05	291.2	6.11	120.5	2.53	109.8	2.31
1981	5 488.1	4 876.6	88.86	269.8	4.92	147.6	2.69	194.1	3.54
1982	6 669.0	5 770.7	86.53	383.8	5.75	208.9	3.13	305.6	4.58
1983	7 648.0	6 514.9	85.18	484.6	6.34	226.8	2.97	421.7	5.51
1984	7 022.5	6 039.7	86.00	444.0	6.32	197.1	2.81	341.7	4.87
1985	6 636.3	5 555.7	83.72	449.0	6.77	160.5	2.42	471.1	7.10
1986	6 790.5	5 471.7	80.58	566.6	8.34	187.7	2.76	564.5	8.31
1987	7 227.0	5 504.0	76.16	712.8	9.86	219.3	3.03	790.9	10.94
1988	7 970.2	5 769.6	72.39	864.0	10.84	253.4	3.18	1 083.2	13.59
1989	8 859.0	6 086.6	68.71	1 106.8	12.49	323.5	3.65	1 342.1	15.15
1990	9 735.7	6 429.1	66.04	1 274.3	13.09	358.2	3.68	1 674.1	17.20
1991	10 744.1	6 826.1	63.53	1 416.6	13.18	387.8	3.61	2 113.6	19.67
1992	12 671.1	7 855.6	62.00	1 691.9	13.35	512.2	4.04	2 611.4	20.61
1993	15 543.8	8 859.6	57.00	2 196.9	14.13	745.6	4.80	3 741.7	24.07
1994	19 135.6	10 246.0	53.54	2 805.7	14.66	978.8	5.12	5 105.1	26.68
1995	24 874.0	12 381.6	49.78	3 822.0	15.37	1 415.0	5.69	7 255.4	29.17
1996	33 403.2	15 230.2	45.60	5 530.3	16.56	1 917.4	5.74	10 725.3	32.11
1997	40 803.7	18 674.2	45.77	7 007.0	17.17	2 408.6	5.90	12 713.9	31.16
1998[1]	41 176.3	18 964.5	46.06	6 894.8	16.74	2 417.1	5.87	12 899.9	31.33

Source: Bangko Sentral ng Pilipinas.

[1] As of June 1998.

Bank. Thus, by 1998, the share of deposits in the total liabilities of rural banks rose to 74 per cent. Another way of looking at it is to take the ratio of deposits to loans, which shows the extent to which deposits have financed loans. In 1980, deposits financed 45 per cent of every peso lent by rural banks. This rose to 88 per cent in 1998.

The significant change in the structure of the sources of funds of rural banks supported loan diversification by rural banks. In this regard, it can be said that the relaxation of restrictions on the loan portfolio of rural banks and the change in the rediscounting and interest rate policies of the Central Bank were definitely a step in the right direction.

Some rural banks are now increasing their capital to strengthen their balance sheets and hence, their competitive position. Most of them can easily meet the recent increase in the minimum capital requirement. An interesting development in the last few years is the broadening in the ownership of cooperative rural banks. More specifically, cooperative rural banks are no longer exclusively owned by farmer associations, but also by other types of non-farm associations, such as market vendors. A cooperative rural bank services an average of 5,000 individual borrowers (Guanlao 1999).

Table 10. Selected balance sheet items of the rural banking system

Year	Assets		Loans		Deposits				Capital	
	Millions of pesos	*Per cent of GNP*	*Millions of pesos*	*Per cent of total assets*	*Millions of pesos*	*Per cent of total liabilities*	*Per cent of total liabilities and capital*	*Deposit to loan ratio*	*Millions of pesos*	*Total liabilities to capital accounts ratio*
1980	5 524	2.27	4 572	82.77	2 051	43.00	37.12	0.45	755	6.32
1981	6 490	2.31	5 347	82.39	2 427	43.30	37.40	0.45	884	6.34
1982	7 978	2.54	6 510	81.60	2 996	43.01	37.55	0.46	1 013	6.88
1983	9 324	2.57	7 472	80.14	3 591	44.29	38.52	0.48	1 216	6.67
1984	8 819	1.73	6 818	77.31	3 316	44.14	37.60	0.49	1 306	5.75
1985	8 822	1.59	6 636	75.22	3 019	41.69	35.10	0.45	1 360	5.32
1986	9 351	1.57	6 790	72.62	3 626	47.38	39.83	0.53	1 452	5.27
1987	9 961	1.48	7 143	71.71	4 516	55.75	46.68	0.63	1 575	5.14
1988	11 018	1.39	7 970	72.33	5 269	58.67	49.27	0.66	1 713	5.24
1989	12 522	1.37	8 659	69.15	6 254	49.94	43.25	0.72	1 939	6.46
1990	13 862	1.28	9 736	70.23	7 067	50.98	43.78	0.73	2 280	6.08
1991	15 936	1.26	10 744	67.42	8 547	53.64	45.93	0.80	2 674	5.96
1992	18 641	1.35	12 671	67.97	10 512	70.29	57.87	0.83	3 209	4.66
1993	22 667	1.51	15 544	68.58	13 422	73.49	60.57	0.86	3 893	4.69
1994	28 191	1.62	19 135	67.88	17 553	76.06	63.48	0.92	4 576	5.04
1995	36 653	1.87	24 875	67.87	23 347	76.70	64.76	0.94	5 611	5.43
1996	48 039	2.12	33 403	69.53	30 279	75.57	63.94	0.91	7 290	5.50
1997	57 635	2.28	40 804	70.80	36 667	76.08	64.51	0.90	8 644	5.58
1998	56 838	2.03	41 831	73.60	36 615	74.04	62.34	0.88	9 274	5.33
1999	61 500	1.96	–	–	–	–	–	–	–	–

Source: Bangko Sentral ng Pilipinas.

A number of rural banks have adopted variants of the Grameen Bank technology so that they can penetrate high-risk, small borrowers at very low cost. One example is CARD Rural Bank's modified Grameen Bank project. The bank's target clients are landless women rural workers who have no regular jobs and have total marketable assets of less than 50,000 Philippine pesos or a little less than $1,000. In 1997, it was able to organize 1,654 groups with a total of 9,968 members (Hossain and Diaz 1997). Access to CARD's loans, despite an effective loan rate of 44 per cent per annum, has yielded some benefits to the borrowers in terms of higher income, employment, productivity and capital accumulation. Many rural banks have also created special credit windows for salaried people in rural areas whose families are engaged in small and cottage enterprises. All this indicates that rural banks are steadily enhancing their capabilities to assess credit risks as they seek to build good relationships with their clients.

Many rural banks have shown some creativity in mobilizing deposits. For instance, they require only a minimum of 100 Philippine pesos or $2.00 to open a savings account and a modest minimum average daily balance for deposits to earn interest, which could be as low as 100 Philippine pesos.[10] They offer different types of deposits that suit the varying tastes of their clients at rates much more attractive than commercial and thrift banks. Some rural banks already offer checking accounts to their clients. Most rural banks are now aggressively campaigning for deposits through print and broadcast media by sponsoring important events in the communities or by conducting raffles, bingo etc.

Most rural banks have now automated their operations to bring down the cost of processing numerous, small transactions. The rapid decline in the cost of computer hardware and software development has become a boon to rural banks. A highly computerized rural bank can process so many small deposit and loan accounts in a very short time – a development that favour small savers and borrowers.

5. Commercial banks' credit programmes for MicSMEs

Although commercial banks mainly cater to large borrowers, they have tried to formulate innovative lending programmes to address the credit needs of small borrowers. In 1991, the commercial banks' Bankers Association of the Philippines (BAP) established the BAP Credit Guaranty Corporation funded by member contributions. Its paid-up capital is more than 100 million Philippine pesos. Legally, this corporation is considered a lending investor, not a bank. It provides loans to those who do not normally qualify for a loan under the regular loan windows of its member banks. It has greater flexibility than commercial banks because it can grant loans not on the basis of the quantity and quality of the collateral and established credit track record of borrowers, but on the basis of the viability of the projects to be funded and the potential repayment capacity of borrowers. Loans are mostly for short-term working

[10] Commercial and thrift banks usually require at least 1,000 Philippine pesos to open a savings account.

capital requirements of micro-enterprises. The minimum size of the loan is 50,000 Philippine pesos. It charges the usual commercial bank rate on its loans, which is much lower than the interest rate charged by lending investors, pawnshops and informal money lenders. Some of its borrowers have already graduated to the regular loan windows of commercial banks. To increase its outreach, the BAP Credit Guarantee Corporation has decided to go into wholesale lending by tapping existing NGOs that have a good track record in managing credit programmes.

The BAP Credit Guarantee Corporation is currently facing the problem of a lack of funds. Being classified as a lending investor, it is not allowed to mobilize deposits or to borrow from more than 19 individuals/corporations, including BAP members.

Aside from the BAP Credit Guarantee Corporation, which is a collaborative effort among commercial banks, some commercial banks came up with certain initiatives on their own to meet the credit demands of small borrowers who do not have access to their regular lending facilities. These special lending windows are funded out of their own resources, not from the special credit programmes of the government. One example is the Equitable-PCI Bank's successful lending programmes to small footwear manufacturers in Marikina, a city within Metro Manila. Another example is the Export Dragon Fund of the Rizal Commercial Banking Corporation. This facility provides loans for working capital to small exporters who have little or no hard collateral, such as real estate, to offer to banks.

D. CONSTRAINTS AND ISSUES IN BANK LENDING

The current policy environment (for example, no interest rate ceiling) is already conducive for banks to expand their services to MicSMEs and poor households. In fact, there are already signs that small banks are favourably responding to this. For instance, the number of offices of thrift and rural banks together have increased from 2,685 in 1996 to 3,285 in 2001 (June) despite the fact that many of them had failed during the same period. The recent decision of the Central Bank to exempt microfinance-oriented banks, such as thrift and rural banks, from the moratorium on the licensing of new banks supports the effort to expand financial services to MicSMEs and poor households. Recently, a microfinance-oriented bank was set up by a thrift bank jointly with foreign partners in the southern part of the Philippines. A large commercial bank followed suit by establishing a wholly-owned microfinance-oriented bank. Based on the criteria formulated by the Central Bank for giving a licence to microfinance-oriented banks, these banks are not like ordinary rural banks or thrift banks.[11]

[11] For example, Section 1.4 of the Central Bank Circular No. 273 that organizers must have the capacity to engage in microfinancing, which may be indicated by the following: (a) at least 20 per cent of the paid-in capital of the proposed bank must be owned by persons or entities with a track record in microfinancing; (b) the majority of the members of the board of directors have experience in microfinancing with at least one member having actual banking experience; and (c) the proposed bank must have, as a minimum, an adequate loan tracking system that allows daily monitoring of loan releases, collection and arrearage, and any restructuring and refinancing.

Notwithstanding this favourable policy environment, banks still face some constraints in expanding their financial services to MicSMEs and poor households. We will discuss them below and also recommend some measures to address them.

Macroeconomic instability. Lending to MicSMEs and poor households is a very risky venture, especially if lenders base their lending decisions solely on the strength of the cash flow position and character of borrowers. Instability of the economy can make those loans much riskier because cash flows can easily dry up during a sudden downturn of the economy. This can lead to the collapse of banks, especially small ones, and ultimately undermines the public's confidence in the banking system. Such confidence is not easy to restore especially if a large number of savers lose their money and otherwise good borrowers become known delinquent borrowers. The experience of the Philippines in the last 25 years clearly demonstrates this point. From 1998 to 2000 alone, 12 thrift banks and 83 rural banks were closed by the Philippine Deposit Insurance Corporation, thereby reducing the number of potential providers of financial services to MicSMEs and poor households. Indeed, a stable macroeconomic environment is conducive to the expansion of financial services to these sectors of the society.

Inadequate infrastructure. Poor infrastructure increases the cost of providing financial services to MicSMEs and poor households. In particular, some thrift and rural banks are prevented from computerizing their operations because of a lack of adequate and reliable supply of electricity in their area. They badly need to computerize their systems to be able to accurately process numerous small deposits and loans in a short time. The government, therefore, should give infrastructure improvements in rural areas high priority in its development agenda.

Regulation on deposit mobilization. The key to expanding financial services to MicSMEs and poor households is for banks to mobilize more deposits. Several studies have shown that even poor households save, and if properly compensated, they place their savings in banks. Many of them reside in areas quite far from where banks are located and transport costs are very high. Microfinance-oriented banks can mobilize more deposits at lesser cost only if they are allowed to make house-to-house visits to pick up deposits. The Central Bank, therefore, has to rethink the circular it issued in 1999 prohibiting banks from doing this (Llanto 2000).

Shortage of capital. Although small banks can mobilize more deposits, as many of them have already demonstrated, their limited capital sets a ceiling as to how much they can mobilize. There are ways of dealing with this problem. One is to encourage large commercial banks to infuse equity into small banks, such as rural banks, by including such investment as an alternative instrument for complying with the existing loan portfolio regulation so long as they remain minority stakeholders.[12] Such arrangements could pave the way for correspondent banking relationships between small and large banks in the country. This is definitely a better option than compelling large commercial banks to lend to small enterprises or to buy eligible government securities.

[12] Commercial banks seem to prefer to have a wholly-owned thrift bank.

In the case of cooperative rural banks, the expansion of their capital is constrained by the limited number of cooperatives that have the financial capability to invest in cooperative banks.[13] The Rural Banking Act must, therefore, be amended to allow cooperative rural banks to accept individual members as preferred shareholders.

The establishment of a microfinance-oriented bank by a large commercial bank is a welcome development. The Central Bank should look into the possibilities of encouraging other commercial banks to venture into the microfinance business. Perhaps, it can organize training programmes for banks to expose them to microfinance lending technologies.

Competition with government banks. It has been the policy of the government to give private financial institutions a bigger role in the provision of financial services, especially to small farm and non-farm enterprises. The role of government financial institutions, therefore, is to fill some of the gaps left by private financial institutions and provide support to them in areas where they have a comparative advantage. However, the number of offices of government banks has increased from less than 100 before 1990 to about 400 today. Because of the policy of the government to make these banks self-sufficient, they are currently intensely competing with private banks in mobilizing deposits. Although the two government banks are engaged in wholesaling, they also do retail lending, which directly competes with private banks. Unless the orientation of government banks is changed, private banks will always find a serious constraint to the expansion of their services since they will be facing undue competition from those banks.[14]

Aside from competing with government banks, private banks also compete with non-bank financial institutions, such as the Small Business Credit and Guarantee Corporation, the People's Credit and Finance Corporation and a host of special credit programmes for MicSMEs and poor households implemented by non-financial government agencies. Many of these special credit programmes have performed badly, which, if continued, could undermine the discipline needed to promote market-based microfinance institutions.

Inadequate supervision. While the Central Bank encourages private banks to engage in microfinance, it must ensure that banks that do so remain safe and sound at all times so that financial services to MicSMEs and poor households will not be disrupted because of a massive bank failure. Indeed, some banks are hesitant to venture into microfinance because the possibility that the failure of poorly managed, ill-supervised microfinance-oriented banks can undermine otherwise soundly managed microfinance-oriented banks.[15] In this regard, the Central Bank must adopt a

[13] Under the existing law, only cooperatives can own shares in cooperative rural banks.

[14] Government banks are also designated depository banks of all government agencies and corporations. Hence, they maintain a large pool of cheap deposits. See Lamberte (2000) for a proposal to reorient the Land Bank of the Philippines.

[15] This is part of the information asymmetry problem wherein bank depositors and other creditors are not able to distinguish between good and bad banks in times of severe financial distress.

risk-based supervision approach for microfinance and upgrade the capability of its staff to effectively utilize such an approach. It must also constantly fine-tune its regulatory system to discourage banks from doing regulatory arbitrage.

Loan portfolio regulations. Most rural banks and some thrift banks are not able to meet the requirement to allocate at least 2 per cent of their total loan portfolio to medium-sized enterprises, but they can easily meet the requirement to allocate at least 6 per cent of their loan portfolio to small enterprises because of the nature and size of their operation. The government should, therefore, review this law to give small banks, such as rural banks and small thrift banks, more flexibility in selecting their own clients.

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ANNEX

NOTES ON MICROFINANCE

A. Definition of microfinance

Microfinance is the provision of a broad range of financial services such as deposits, loans, payment services, money transfers and insurance products to the poor and low-income households, for their micro-enterprises and small businesses, to enable them to raise their income levels and improve their living standards.

B. Core principles for microfinance

- The poor need access to appropriate financial services
- The poor have the capability to repay loans, pay the real cost of loans and generate savings
- Microfinance is an effective tool for poverty alleviation
- Microfinance institutions must aim to provide financial services to an increasing number of disadvantaged people
- Microfinance can and should be undertaken on a sustainable basis

Characteristics and features of microfinance

Characteristics	*Distinguishing features*
Type of client	• Low Income • Employment in informal sector; low wage bracket • Lack of physical collateral • Closely interlinked household/business activities
Lending technology	• Prompt approval and disbursement of micro loans • Lack of extensive loan records • Collateral substitutes; group-based guarantees • Conditional access to further micro-credits • Information-intensive character-based lending • Linked to cash flow analysis and group-based borrower selection
Loan portfolio	• Highly volatile • Risk heavily dependent on portfolio management skills
Organizational ideology	• Remote from/non-dependent on government • Cost recovery objective vs. profit maximizing
Institutional structure	• Decentralized • Insufficient external control and regulation • Capital base is quasi-equity (grants, soft loans)

- Microfinance non-governmental organizations and programmes must develop performance standards that will help define and govern the microfinance industry toward greater reach and sustainability

C. Definition of microfinance loans

Microfinancing loans are small loans granted to the basic sectors, on the basis of the borrower's cash flow and other loans granted to the poor and the low-income households for their micro-enterprises and small businesses to enable them to raise their income levels and improve their living standards. These loans are typically unsecured, but may be secured in some cases.

D. Level of microfinance loans

The average microfinance loan of a non-governmental organization microfinance institution or of a cooperative bank or credit union in the Philippine case is about 25,000 Philippine pesos. To be realistic, the maximum principal amount of a microfinance loan can be pegged at 150,000 Philippine pesos. This is equivalent to the maximum capitalization of a micro-enterprise under Republic Act 8425.

E. Collateralization of microfinance loans

A microfinance borrower is not likely to be able to borrow from a large commercial, thrift or rural bank but from a non-governmental organization microfinance institution or perhaps from a small rural or cooperative bank. Thus, microfinance loans are typically unsecured, for relatively short periods of time (180 days) with monthly (or more frequent) amortizations of interest and principal, and often featuring a joint and several guarantee of one or more persons and, certainly, seldom with tangible collateral. But in some cases, they can also be secured, depending on the capacity of the borrower to offer collaterals acceptable to the lending institution.

F. Interest on microfinance loans

Old approach

The old (and by now highly discredited as ineffective) approach to loans for low-income borrowers emphasized subsidized interest rates. It did not recognize that subsidized below-market interest rates do not necessarily result in opening up access to financial services for low-income households and micro-enterprises.

New approach

The new approach, which has been demonstrated by global experience, is characterized by a market-based interest rate regime which permits the institution providing microfinance services to cover administrative costs, provisions for loan losses and intermediation/funding costs. This basis is consistent with financially sustainable rural finance and microfinance. Invariably, the global experience continues to validate the proposition that what matters most to the poor and underserved segments is access to financial services rather than their interest-rate cost – most especially because micro-enterprise and small business borrowers will take a microfinance loan whose repayment periods match the additional cash flows they hope to generate.

Therefore, interest on such microfinancing loans should be reasonable, but should not be lower than the prevailing market rates. This is to enable the lending institution not only to recover the financial and operational costs incidental to this type of microfinance lending, but also to realize some bottom line gains.

G. Segments of demand for microcredit

(1) The landless who are engaged in agricultural work on a seasonal basis and manual labourers in forestry, mining, household industries, construction and transport require credit for consumption needs and also for acquiring small productive assets, such as livestock.

(2) Small and marginal farmers, rural artisans, weavers and those self-employed in the urban informal sector as hawkers, vendors and workers in household micro-enterprises require credit for working capital, including a small part for consumption needs. This segment largely comprises the poor but not the poorest.

(3) Medium farmers/small entrepreneurs who have gone in for commercial crops and others engaged in dairy or poultry. Among non-farm activities this segment includes those in villages and slums engaged in processing or manufacturing activity. These persons barely live above the poverty line and also suffer from inadequate access to formal credit.