

COMMERCIALIZATION OF MICROFINANCE

THE PHILIPPINES

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FOREWORD

The microfinance industry landscape has begun to change significantly in recent years. To date, however, the outreach of the industry remains well below its potential in the Asia and Pacific region. If the full potential of microfinance for poverty reduction is to be realized, it is essential to expand its outreach substantially. It is in this context that commercialization of the industry has become a subject of in-depth study. Although many industry stakeholders appear to believe firmly that commercialization is necessary, there is inadequate understanding of the complex process of moving toward a sustainable microfinance industry with massive outreach.

The Microfinance Development Strategy of the Asian Development Bank (ADB), approved in June 2000, provides a framework for supporting the development of sustainable microfinance systems that provide diverse, high-quality services to traditionally underserved low-income or poor households and their microenterprises. One element of this strategy is to “support development of viable microfinance institutions that can set in motion a process of commercialization of microfinance services.” As a first step, ADB approved in November 2000 a regional technical assistance project on Commercialization of Microfinance, to improve understanding of the process of microfinance commercialization as well as its challenges, implications, and prospects. The project, which was funded from the Japan Special Fund, has three components: country studies on microfinance commercialization, in-country workshops to discuss the country studies and specific institutional experiences, and a regional workshop to discuss each country study and institutional experiences in a comparative context.

The countries chosen for study – Bangladesh, Indonesia, Philippines, and Sri Lanka – represent different stages of microfinance development and commercialization of the industry.

The Philippines study was undertaken by Stephanie Charitonenko of Chemonics International, Inc. and involved numerous interviews with stakeholders from government and the private sector including private banks, nongovernment organizations, cooperatives, networks, and academe as well as group consultations in Luzon, Visayas, and Mindanao. The study culminated in a national workshop on 16–18 July 2002 in Manila, at which the draft report of the study was presented. The participants provided much additional information to improve the report, which is presented herein.

This publication is one of a series of papers resulting from the project. The series comprises four country reports (on Bangladesh, Indonesia, Philippines, and Sri Lanka, respectively) and a regional report covering these countries.

It is hoped that this publication series will contribute to a better understanding of the issues involved in commercialization of microfinance and lead to better approaches toward a sustainable microfinance industry that will provide a wide range of services to poor and low-income households not only in the Asia and Pacific region but also in other regions.

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ABBREVIATIONS

ADB	Asian Development Bank
APPEND	Alliance of Philippine Partners in Enterprise Development, Inc.
ARDCI	Agricultural and Rural Development for Catanduanes, Inc.
ASKI	<i>Alalay sa Kaunlaran sa Gitnang Luzon, Inc.</i>
ATM	automated teller machine
BAP	Bankers Association of the Philippines
BSP	<i>Bangko Sentral ng Pilipinas</i>
CARD	Center for Agriculture and Rural Development
CBU	capital buildup
CDA	Cooperative Development Authority
CGAP	Consultative Group to Assist the Poorest
CPIP	Credit Policy Improvement Project
COOP	Compliance to administrative and legal requirements, O rganizational structure, O peration and management, and P lans and programs
CRS	Catholic Relief Services
CUES	Credit Union Empowerment and Strengthening
EZF	E. Zobel Foundation
GBL	General Banking Law
GDP	gross domestic product
GNI	gross national income
GNP	gross national product
IFAD	International Fund for Agricultural Development
IPC	<i>Internationale Projekt Consult GmbH</i>
KMBI	<i>Kabalikat para sa Maunlad na Buhay, Inc.</i>
LBP	Land Bank of the Philippines
LCDP	loan collection and disbursement point
MABS	Microenterprise Access to Banking Services
MBB	MicroBanking Bulletin
MEB	Micro Enterprise Bank

MFI	microfinance institution
NATCCO	National Confederation of Cooperatives
NCC	National Credit Council
NGO	nongovernment organization
NWTF	Negros Women for Tomorrow Foundation
OIN	Opportunity International Network
PCFC	People's Credit and Finance Corporation
PESOS	Portfolio quality, Efficiency, Stability, Operations, and Structure of assets
Punla	<i>Punla sa Tao</i> Foundation
RBAP	Rural Bankers Association of the Philippines
RISE	Responsible Investments for Solidarity and Empowerment
SEAD	Small Economic Activity Development
SCWE	Savings and Credit with Education
TSKI	<i>Taytay sa Kauswagan</i> , Inc.
TSPI	<i>Tilay sa Pag-unlad</i> , Inc.
UNDP	United Nations Development Programme
USAID	United States Agency for International Development

CURRENCY EQUIVALENT

(AS OF 15 MAY 2002)

Currency Unit	–	Philippine Peso (P)
\$1.00	=	P49.70
P1.00	=	\$0.20

NOTES

- (i) The fiscal year of the Government ends on 31 December.
- (ii) In this report, "\$" refers to US dollars.
- (iii) In most currency conversions, numbers were rounded off at \$1 = P50.

Executive Summary

This report analyzes the progress toward commercialization of the Philippines' heterogeneous microfinance industry. It also explores the remaining challenges and implications for various types of stakeholders including microfinance clients, microfinance practitioners, government officials, and funding agencies. The report recommends positive approaches to the commercialization of microfinance while preserving the traditional social objective of microfinance institutions (MFIs) of expanding access by the poor to financial services.

UNDERSTANDING MICROFINANCE COMMERCIALIZATION

Commercialization of microfinance is a relatively accepted prerequisite to the sustainable expansion of outreach commensurate with demand by the poor in the Philippines. For many stakeholders in the Philippines and microfinance professionals worldwide, the term *commercialization* is associated with the adoption by MFIs of market-based principles in their microfinance activities, regardless of whether they are under prudential or nonprudential government regulations. There is a growing realization that commercialization allows MFIs greater opportunity to fulfill their social objectives of providing the poor with increased access to an array of demand-driven microfinance products and services.

This report considers commercialization of microfinance at both micro and macro levels. At the micro level, MFI commercialization implies progress along a continuum, described as follows.

- Adoption of a professional, business-like approach to MFI administration and operation, such as developing diversified, demand-driven microfinance products and services and applying cost-recovery interest rates.

- Progression toward operational and financial self-sufficiency by increasing cost recovery and efficiency, as well as expanding outreach.
- Use of commercial sources of funds; for example, nonsubsidized loans from apex organizations (wholesale lending institutions) or commercial banks, mobilization of voluntary savings, or other market-based funding sources.
- Operation as a for-profit, formal financial institution that is subject to prudential regulation and supervision and able to attract equity investment.

At the macro level, commercialization of the microfinance industry means the increased provision of microfinance by MFIs sharing the above characteristics in an enabling environment.

Commercialization of the microfinance industry involves several factors, including the degree to which the policy environment and the legal and regulatory framework are conducive to the development and growth of commercialized MFIs, the availability and access of commercialized MFIs to commercial sources of funds, and the existence of institutions that support the industry. Support institutions include credit information bureaus that contain information on microcredit, credit rating agencies, microfinance trade associations and networks, microfinance technical training institutions, and providers of business development services.

PROGRESS TOWARD COMMERCIALIZATION

Until recently, the performance of the microfinance sector in the Philippines has been largely disappointing. Although there are hundreds

of small-scale rural banks, cooperatives, and nongovernment organizations (NGOs) that provide microfinance, total outreach has been quite limited. It is only in the last 5 years or so that significant numbers of rural banks and cooperatives have begun to consider microfinance as a potentially profitable market niche. In addition, only a few microfinance NGOs have achieved scale or become financially viable.

The major providers of microfinance at present include many of the approximately 3,000 cooperatives registered with the Cooperatives Development Authority, at least 100 of the 786 rural banks, and about 500 of approximately 900 microfinance NGOs. In addition, a large number of small, regulated financial institutions—pawnshops and lending investors—serves the upper tier of the microfinance sector. The total volume of microcredit from formal and semiformal MFIs is unknown. Estimates of the outstanding balance are in the range of P6–8 billion (\$121–161 million). The number of poor with access to microfinance services is 600,000–1 million people, depending mainly on whether one includes consumer (i.e., salary-based) loans that may be borrowed from rural banks for microenterprise purposes. However, it is clear that even if 1 million people are served by MFIs, only 20% of the estimated 5.8 million poor households have access to microfinance.

Nonetheless, many providers of microfinance in the Philippines have made substantial progress along the commercialization continuum in the last few years, due in large part to several government initiatives and donor-supported projects. The largest MFIs in the industry can be considered to be now on a sound, commercial footing. Four major recent trends in the microfinance sector support this view. First, a few microfinance NGOs have recently transformed into microfinance-oriented rural banks or thrift banks. Second, new microfinance NGOs, such as the ABS-CBN (a national broadcasting company) Bayan Microfinance, are entering the market with a more aggressive and businesslike strategy than many older microfinance NGOs. The microfinance sector is also attracting microfinance-oriented banks. For example, a thrift bank was

established in mid-2001 to focus on the microenterprise market by a mix of domestic and international institutional investors led by the German consulting firm, *Internationale Projekt Consult*. Third, rural banks (and a few thrift banks) are increasingly downscaling their services to provide tailored microfinance products and services due in large part to donor support of focused microfinance technical assistance and training. Fourth, donor initiatives with cooperatives are also spurring the introduction or expansion of microfinance operations.

In addition, the Government has been aggressively working to create an enabling policy environment and legal and regulatory framework for the establishment and growth of sustainable MFIs. Interest rate deregulation (in the early 1980s) and relaxation of bank entry and branching (in the early 1990s) stimulated the increase in the number of banks, particularly rural banks, whose locations, small sizes, and lower minimum capital requirements make them well suited for providing commercial microfinance. The rapid expansion of banks also resulted in the introduction of a larger range of innovative financial products (financial broadening) and the outreach of financial institutions to new groups of customers (financial deepening).

The Government gave formal recognition to microfinance in 1997 and has been steadily improving the environment for MFI commercialization. Executive Order No. 138, issued in 1999, abolished subsidized directed credit programs and laid the framework for all government directed credit programs to be transferred to financial institutions by February 2002, and to be commercially managed following market-based interest rates. Several sections of the 2002 General Banking Law (GBL) paved the way for elaborating more appropriate regulation and supervision of microfinance operations. Some recent Central Bank (*Bangko Sentral ng Pilipinas* or BSP) circulars issued to implement the provisions of the GBL are geared to increasing the provision of microfinance on a commercial basis.

Emphasis on implementation of best practices is improving, with the adoption of microfinance NGO standards by the Microfinance Council of the

Philippines, donor support to rural banks and cooperatives to enable them to reach microfinance markets, and government wholesaling of microfinance through the People's Credit and Finance Corporation (PCFC). These developments have led to rapid expansion in total outreach and the microfinance sector appears poised for further growth.

CHALLENGES TO MICROFINANCE COMMERCIALIZATION

Expanding access by the poor and near-poor to sustainable microfinance is the greatest challenge facing the microfinance industry. Many Philippine microfinance stakeholders see provision of commercial microfinance as the way to address this challenge. However, several impediments to microfinance commercialization exist at the micro (institutional) and macro (environmental) levels. Some of the major impediments are discussed below.

Internal Constraints

Perhaps one of the most pervasive internal constraints to commercial microfinance is the perception problem. Because the microfinance market is not monopolized by microfinance NGOs, one big internal challenge faced by some players or potential players in the commercial microfinance market (e.g., rural banks and cooperatives) is the lack of appreciation of the viability and sustainability of microfinance as a market niche. The perception problem is partially based on the lack of ability or flexibility of the existing systems of rural banks and cooperatives to accommodate the unique features of microfinance technologies (e.g., daily or weekly monitoring of small repayments and small deposits).

Most other internal constraints to microfinance commercialization faced by existing MFIs and potential new entrants differ according to institutional type. Some of these constraints in rural banks, cooperatives, and microfinance NGOs are examined below.

- **Rural Banks**

Rural banks are ideally suited to the provision of commercial microfinance in that they are formal financial intermediaries, operate on a for-profit basis, and have a wide client base over which to diversify risk. Unlike commercial banks where management rotates every 2–3 years, rural banks are locally managed on a continuing basis with the same staff. This helps to keep information costs low for rural banks in selecting micro and small-scale borrowers and to build up trust and confidence among clients who want to deposit their small savings. These relations between customers and the bank, characterized by mutual trust, can even attract clients who could deposit with commercial banks.

Lack of a network is a constraint to rural bank operation of microfinance programs in terms of geographic distribution of credit risk and providing customers with possibilities to withdraw savings or otherwise access their accounts in other areas. In an increasingly competitive environment, the absence of a network constitutes a disadvantage linked to the institutional structure of a rural bank. The only solution to gain access to regional markets is to establish strategic alliances with other financial institutions or to branch out aggressively.

Access to support services is also a constraint for rural banks because of their largely unit-based structure. The development of new microfinance products and services, the training of staff, and the enforcement of effective auditing and control mechanisms are expensive. The costs involved are too large for a single rural bank. To compete over the long term, financial institutions of this type need effective support services that can be provided by a national apex organization, regional federations or, again, by alliances with other financial institutions.

- **Cooperatives**

Cooperatives are also well suited to the provision of microfinance. As with rural banks, they are close to their communities and have good access to information on their members. Member-clients also have a stake in the continued financial success of their cooperative, which helps to reinforce discipline in management and operations.

However, unlike rural banks, cooperatives are considered semiformal institutions because they are regulated and supervised by the Cooperative Development Authority (CDA), which is known to be weak. Lack of transparency has historically been a major difficulty in assessing cooperative performance, but there has been recent agreement by the National Credit Council (NCC) in coordination with the CDA and major credit cooperatives on a Standard Chart of Accounts and its accompanying Manual of Accounts, as well as the COOP (Compliance to administrative and legal requirements, Organizational structure, Operation and management, and Plans and programs) administrative standards and PESOS (Portfolio quality, Efficiency, Stability, Operations, and Structure of assets) financial standards. The remaining challenge lies in their widespread adoption and use. (The CDA Board of Administrators recently issued a circular requiring all cooperatives engaged in credit activities to use the standards by January 2003.)

The cooperatives, like rural banks, suffer from the lack of an effective network, although this is improving through the Canadian International Development Agency-funded National Confederation of Cooperatives–Financial Intermediation (NATCCO-FI) project. Access by cooperatives to support services also remains weak. Further strengthening of NATCCO will be necessary for the national federation to assist the cooperatives in many important areas, including improved management information systems, internal audit and control, human resource development, market research, and product development.

- **Microfinance NGOs**

Microfinance NGOs have weak ownership and governance structures. Their boards of directors lack true owners with a financial stake in the business. This can result in an overemphasis on the MFI's social agenda and hinder microfinance commercialization. In the Philippines, many of these boards lack members with sound background in finance and banking to guide the MFI through financial challenges. This becomes an especially

important issue if the NGO is mobilizing deposits and placing client savings at risk by onlending them. While NGOs are not legally authorized to mobilize deposits, many do so as a way to substitute donor funds and to fund their loan portfolios.

Commitment to balancing social with commercial objectives is also an important internal challenge faced by most microfinance NGOs. The vast majority of small microfinance NGOs has an inordinate focus on providing microcredit as a social service without adequate attention or commitment to sustaining the organization. Most microfinance NGOs, therefore, remain small and weak as institutions, and dependent on fresh infusions of subsidized funds for their survival. Those that have taken a more balanced approach in their provision of microfinance, such as the Center for Agriculture and Rural Development (CARD) and *Tulay sa Pag-unlad, Inc.* (TSPI), provide ample evidence that a commercial approach to microfinance can reinforce their desire and ability to assist the poor.

Constraints in the Operating Environment

- **“Crowding out” of the Private Sector by Government Microcredit Programs**

Executive Order No. 138 abolished subsidized directed credit programs and laid the framework for all government directed credit programs to be transferred to financial institutions. These phaseout and transfer processes began in 1999 and were supposed to be completed by February 2002, but they are still ongoing. In addition, several new government programs on poverty reduction have begun, giving what are essentially grants thinly disguised as interest-free loans. Such continued access to subsidized government credit programs “crowds out” provision of sustainable microfinance services by the private sector.

- **Mandatory Lending and Investment**

Presidential Decree 717, otherwise known as the Agri/Agra Law, mandates that all banks set aside 25% of their net loanable funds for agricultural lending, of which 10% is supposed to be lent to agrarian

reform beneficiaries and 15% for agricultural lending. While minimum lending requirements have been easily exceeded for the latter client group given the good number of creditworthy agribusinesses, compliance has not historically been met in terms of lending to the agrarian reform beneficiaries. The main reason is that banks are not structured to manage profitably the provision of small loans to widely dispersed beneficiaries.

Although the Government has provided other means for complying with this law, such as investment in various types of bonds and securities, the regulation essentially acts as an unnecessary tax, particularly on large banks, without addressing the root causes of lack of lending to small farmers.

Another regulatory measure, Republic Act 6977, or the so-called Magna Carta for Small Enterprises, acts as a similar drain on lending institutions.

- **Threat of Policy Reversal**

The very convenient nature of direct credit provision by government makes it politically expedient and tempting for policymakers to revert to the previous policy of regulating interest rates and supporting directed credit programs. The challenge to prevent such a reversal lies not only with the Government but with private sector MFI practitioners as well. It is imperative for all types of MFIs to close ranks and advocate actively that the Government continue moving away from direct credit provision and focus its interventions where it has distinct comparative advantage, such as provision of basic support infrastructure and an appropriate policy and regulatory environment, social preparation, and capacity-building activities.

- **Unclear Regulation and Supervision of Microfinance Operations**

Although significant improvements have been made in the last few years by the Government and BSP in recognizing microfinance and adapting regulation and supervision to the specialized nature of microfinance operations, the process of implementing several sections of the GBL of 2000 is still in progress. Until the rules of engagement of formal financial institutions in microfinance are complete,

uncertainties regarding the final form of regulation and supervision of microfinance-oriented banks may curtail efforts by formal institutions to downscale their operations.

- **Illegal Deposit Mobilization by Microfinance NGOs**

A 2001 survey of 23 of the largest microfinance NGOs showed that almost half of their combined outstanding loan portfolio was funded by a combination of savings or capital build up, despite legal prohibition of such mobilization from the general public except with BSP licensure. Under the GBL, nonstock and nonprofit organizations are not permitted to accept savings and deposits in any form. So far, BSP has ignored the practice because the savings are mobilized from microfinance NGO members only and mainly on the basis of compulsory deposits, making the vast majority of members net borrowers.

- **Inadequate Access to Commercial Sources of Funds**

One of the consequences for microfinance NGOs of not being able to visibly mobilize deposits is that many remain highly dependent on external funding that has historically come from donors. In recent years, PCFC has grown to become the largest single provider of wholesale funds to the microfinance sector. The interest rate that PCFC charges borrowers can be considered commercial in the current interest rate environment; in 2001 it was lending at 12% based on a declining balance (via its investment credit line) whereas the average prime lending rate by commercial banks was around 8%.

However, PCFC funds have been mostly directed toward participating organizations following the Grameen Bank approach, hindering use of the funds by MFIs using other models. Commercial bank loans to MFIs have been extremely rare, mainly because of the lack of transparency in the operational and financial performance of microfinance NGOs and cooperatives. Where commercial loans have been issued, they were sometimes backed by collateral, such as real estate, and always facilitated by personal relationships.

- **No Credit Information Bureau that Captures Microcredit Information**

A private, nationwide credit bureau run by the Bankers Association of the Philippines (BAP) has been in operation since 1990 and as of January 2002 contained data on more than 1.4 million borrowers. However, it is accessible to commercial banks only and does not capture microcredit information that would be useful to all MFIs. With increasing microcredit provision by NGOs, rural banks, and cooperatives, the presence of a credit bureau that captures microcredit information from these actors is becoming increasingly vital to the continued health of the industry.

- **Lack of Microfinance Training Centers**

There is a variety of microfinance training programs in the Philippines. However, no “one-stop shop” yet exists for the provision of regularly scheduled, demand-driven, and affordable technical courses on microfinance program management and operation. CARD’s microfinance training center is perhaps the best known and most widely used microfinance training center to date, but cannot be considered a wholly professional training institution for microfinance that would attract a wide variety of regular students from different types of MFIs. The Asian Institute of Management (AIM) Center for Development Management and Asian Center for Entrepreneurship, with its leadership and creativity program, offer advanced training and certificate programs in such areas as project management, social development, and entrepreneurship. However, AIM has not yet designed public training programs for MFI managers that exclusively address microfinance issues.

The institution that seems most suitable for offering additional microfinance training on a regular basis is the *Punla sa Tao* Foundation (Punla). It has the potential to serve as the one-stop shop that could help the microfinance industry build the technical capacity it needs for further professionalization. However, Punla will need to direct its focus more toward serving the complex and varied needs of commercial microfinance providers.

IMPLICATIONS OF COMMERCIALIZATION

The four major trends toward commercialization of the Philippines microfinance industry, outlined above, continue to have implications for the mix of providers, products and services offered, technologies employed, and different types of clients. Commercialization also has implications for increased competition, access to commercial sources of funds including private equity investment, and mission drift.

- **Increased Outreach and Competition between MFIs**

As more microfinance providers demonstrate the profit potential of microfinance, more entrants will be attracted to the market. In this sense, increased commercialization is likely to have a positive impact on outreach in the future, resulting in more clients served and increased competition among MFIs. However, because only about 20% of the market is currently served, few negative repercussions of such competition are likely to result in the next 5–10 years, except in a few urban and highly-populated rural areas where some localized competition is already growing.

Growth in the sector is not likely to come from the gradual expansion of the vast majority of existing microfinance NGOs. It is probable that other types of organizations (rural banks, cooperatives, lending investors, etc.) will increasingly enter the sector, as it becomes clear that the poor can be bankable and as methods for reaching the poor become better understood.

- **Improved Efficiency of MFIs**

As competition increases and MFIs strive to achieve financial self-sufficiency, the industry as a whole is being driven to reduce costs, lower interest rates, and improve productivity. Cooperatives, rural banks, and microfinance NGOs have all shown improvements in operating efficiency, indicating a positive trend in microfinance commercialization.

- **Increased Access to Commercial Sources of Funds**

Increased commercialization has already demonstrated its role in improving access to commercial sources of funds, especially in terms of savings mobilization, but also through private equity investment. As more and more rural banks and cooperative savings and credit banks enter the market, they bring with them the ability to mobilize savings deposits, including microsavings from low-income people in a cost-effective way. Rural banks mobilize a significant amount of microsavings deposits (amounts less than P15,000 [\$300]). These banks had P5.3 billion (\$106.6 million) in 4.3 million accounts as of March 2002. CUES-supported cooperatives nearly tripled their microsavings in just 3 years from \$3.3 million at the end of 1998 to \$9.3 million, the end of 2001, although the average savings balance declined from \$92 to \$86 over the same period. In this way, commercial MFIs serve an underserved market for small savings accounts while satisfying their need for funds for onlending.

Commercialization often paves the way for the entry of private capital, which, in turn, allows expansion into untapped markets and more diverse microfinance products. For example, as part of its transformation, CARD Bank tapped into another private source of funds by selling shares to clients and staff alike. At least one MFI, as part of its transformation, is accessing loans from a global social investment fund at what are arguably commercial interest rates. The formation of the Micro Enterprise Bank with a mix of donor and social investor capital also portends the future increased flow of private risk capital to formal MFIs in the Philippines.

- **Expanded Set of Microfinance Products**

Despite the historical emphasis on the Grameen model of microfinance delivery in the Philippines, other models are increasingly being adapted and local innovations are emerging from recent formal entrants into microfinance. Most microlending has been through group loans, but many MFIs are now introducing individual loan products. In addition to microcredit product diversification, different types of flexible savings services have been designed

specifically to attract microdeposits in a cost-effective way.

Microinsurance is another area attracting increasing interest. In addition, remittance services are being tried and leasing services may soon be offered by MFIs. New technologies are also helping to expand the array of microfinance products offered. All these trends should help increase access to microfinance dramatically over the next few years.

- **Potential for Mission Drift**

Two issues associated with NGO transformation are likely to cause mission drift: the requirement to include at least two independent members on the board of directors; and the requirement to reduce NGO ownership in the new bank to no more than 40% within 5 years of transformation.

How much mission drift occurs in various microfinance NGOs and the microfinance industry as a whole depends on a variety of factors. One is the extent to which microfinance NGOs seek to transform into regulated entities as a prerequisite to mobilization of significant voluntary savings deposits that would help them increase outreach substantially and sustainably. Becoming a formal, regulated financial institution can result in targeting higher-income clients with larger loans because of profit pressures from equity shareholders.

Mission drift ultimately depends on the nature of the regulatory and supervisory framework. For example, certain prudential standards applied to banks are not appropriate for formal MFIs, such as reporting requirements, limits on unsecured loans, requirements concerning loan documentation, supervision methods, and branching restrictions. Formal MFIs might target larger loans to ensure compliance with these standards.

However, mission drift may remain low in microfinance NGOs that are content with serving a localized market on a competitive basis. Such institutions will likely enjoy fewer opportunities to diversify their risks and not be able to take advantage of economies of scale in their operations. Despite having the advantage of being close to their target market, these institutions can be expected to remain weaker than formal MFIs. In other words,

diversification of target markets can be beneficial to MFIs in order to minimize risks and improve their ability to recover costs.

POSITIVE APPROACHES TO COMMERCIALIZATION

The array of challenges inhibiting the commercialization of microfinance implies specific roles for major stakeholders—the Government, the donor community, the MFIs themselves, and microfinance support institutions.

Roles of the Government

The main role that the Government should play in commercialization of microfinance is to create and maintain an enabling macroeconomic and sectoral policy environment and an appropriate legal and regulatory framework for microfinance. Detailed recommendations follow.

- **Complete the Phaseout of Government Directed Credit Programs**

The process to abolish subsidized directed credit programs and transfer remaining credit programs to financial institutions should be accelerated. In addition, new government programs that employ subsidized or interest-free loans instead of grants hurt the repayment culture necessary for commercial microfinance and should be discontinued. Although these new programs are understood to be of only limited scale, the damage that they do in terms of deteriorating a culture of repayment may take significant time and effort on the part of MFIs to overcome.

- **Remove Mandatory Lending and Investment**

Regulations under the Agri/Agra Law and the Magna Carta for Small Enterprises act as an implicit tax on banks and should be removed. As mentioned, the Government has provided other means than direct lending for complying with these laws, such as investments in various types of bonds and securities. However, the regulations act unnecessarily as a tax,

particularly on large banks, without addressing the root causes of lack of lending to small farmers and enterprises.

- **Continue to Adopt Appropriate Regulation and Supervision for Microfinance**

BSP should continue to balance carefully the need to adapt regulation and supervision to account for the specialized nature of microfinance operations with the need to protect the financial health of banks. The integration of risk-based supervision techniques, especially for microfinance operations, promises to be effective both for supervision and effective risk management.

- **Clarify the Conditions when Microfinance NGOs may Mobilize Deposits**

BSP cannot for much longer ignore the practice by microfinance NGOs of accepting deposits illegally. If one microfinance NGO fails and loses its member-clients savings, the whole microfinance industry could be affected, negatively affecting commercial MFIs legally authorized to accept savings. Consideration should be given to allowing microfinance NGOs to accept savings if these will only be for the purpose of compensating any outstanding loans the clients have with the microfinance NGO. The Government is considering requiring standardized financial reporting by NGOs to ensure that deposits do not exceed outstanding loan balances.

- **Strengthen the Regulation and Supervision of Cooperatives**

Consistent with the recent circular issued by the CDA to have all cooperatives use the newly approved Standard Chart of Accounts and its accompanying Manual of Accounts by January 2003, the CDA should change from a purely developmental entity to an effective regulatory agency. The regulatory framework for microfinance, which recommends the creation of a special regulatory unit within CDA, was approved by the NCC Executive Committee regulatory on 9 July 2002. BSP should assist CDA in developing the appropriate prudential rules and regulations based on the agreed COOP and PESOS

standards for cooperatives undertaking savings and credit activities.

- **Develop Microfinance Performance Standards that Cut Across Institutional Types**

As part of the rules for minimizing risks in microfinance, the Government should also initiate the establishment of performance standards for all types of MFIs. The ingredients for such generalized performance standards could be PESOS, the CAMEL rating system for banks, and the microfinance NGO performance standards developed by the Microfinance Council. Establishment of these standards would allow MFIs to compare their performance against each other objectively and encourage their drive to improve efficiency and financial self-sufficiency.

- **Allow Expanded Use of PCFC Funds and its Privatization**

Access to PCFC funds should depend more on the financial health of the participating organization and not the methodology it employs. The PCFC should work to streamline its lending criteria while adequately containing its credit risks. In addition, to support microfinance commercialization, PCFC should allow its wholesale lending interest rate to vary according to the interest rate environment at a spread that will ensure institutional viability, and that the onlending interest rate employed by borrowing MFIs is high enough to cover their cost of lending. Privatizing the PCFC would increase its emphasis on lending to sustainable institutions and rewarding financially healthy institutions with lower interest rates. This would support the commercialization of microfinance by allocating funding sources to the most efficient MFIs rather than to donor-dependent MFIs.

Roles of Funding Agencies

The donor community, in close coordination with the Government, has several major roles to play in the commercialization of microfinance. These are discussed below.

- **Support an Effective Policy Environment and Legal and Regulatory Framework**

Donors should work with the Government to ensure an enabling environment for microfinance conducive to MFIs' progress toward financial self-sufficiency. This includes advising on macroeconomic and sectoral policies and on the legal and regulatory framework. Donors should continue building the capacity of BSP and CDA to implement the evolving regulatory and supervisory framework for microfinance effectively.

In addition, donors should support the adoption, installation, and implementation of the appropriate information systems needed by regulatory authorities in their off-site and on-site supervision of MFIs. An important element in the regulation and supervision of all types of MFIs will be donor support to establish a system of accreditation of external auditors for use by government regulatory agencies and MFIs. Assistance will also be required in the development of commonly accepted organizational, operating, financial, and reporting standards, especially to support effective self-regulation by the Microfinance Council of member microfinance NGOs.

- **Build MFI Institutional Capacity**

Donors should help to build institutional capacity by providing exposure to and training in microfinance best practices, along with performance-based technical assistance so that MFIs can expand their outreach and develop cost-effective sustainable operations (through the use of fee-based assistance providers).

- **Assist in the Development/Dissemination of Management Information Systems**

There are several management information systems currently on the market for MFIs. However, there still appears to be a supply problem in terms of affordable, commercially available, off-the-shelf software packages that suit the system and information requirements of MFIs. Donors should support an objective evaluation of existing systems, using the evaluation criteria already developed by the Consultative Group to Assist the Poorest

(CGAP). Such an evaluation could serve as a useful starting point for MFIs considering the positive and negative attributes of different systems in their quest to improve their systems.

- **Encourage Innovation in Enterprise Development**

Donors, in cooperation with the Government, should promote the development of innovative microfinance methodologies and products as well as complementary, grant-based social service and business development service programs.

- **Promote Linkage Development**

Finally, donors should promote the development of linkages between commercial banks and microfinance NGOs as a means to increase the latter's access to more commercial sources of funds.

Roles of Microfinance Institutions

MFIs themselves have several roles to play in their own commercialization and that of the industry. Common to all MFIs, whether they are rural banks, cooperatives, or microfinance NGOs, is the need to improve their institutional capacity to broaden the scale of their microfinance operations (by increasing depth and breath of outreach as well as financial self-sufficiency) and to strive continually to improve operational efficiency. Some roles, however, can be segregated by institutional type and a few of these are elaborated below.

Rural Banks

- **Expand Geographic Coverage and Access Support Services**

In an increasingly competitive financial market, community-based banks must explore the possibilities of access to regional networks to allow their customers to access their accounts in other areas of the country. One way may be establishing an apex bank for the system of rural banks. In addition, because investments in human resource or product development are very costly and cannot be covered in the long-term by a single bank with a

small capital base, access to support services is crucial for a rural bank involved in microfinance. Active participation in the Rural Bankers Association of the Philippines (RBAP) or the development of strategic alliances with other financial institutions could be the means to access these services at low cost.

- **Maintain Liquidity above the Average for Commercial Banks**

Financial institutions with a small capital base engaged in mobilizing microdeposits, such as rural banks, should maintain a high liquidity ratio. This means maintaining liquidity at least above the banking industry's average. In the Philippines context, a 20% liquidity ratio for microfinance institutions appears to be sufficient to meet unexpected situations.

Cooperatives

- **Explore Opportunities to Access Support Services**

Similar to the rationale for rural banks, cooperatives with microcredit and savings services should consider actively participating in NATCCO or the development of strategic alliances with other financial institutions.

- **Improve Transparency of Operational and Financial Performance**

Internal regulations and supervisory mechanisms are crucial at present, because external regulation and supervision remain weak and under development within the CDA. Adoption of the Standard Chart of Accounts and the accompanying Manual of Accounts should take place as soon as possible. Tracking and use of the COOP and PESOS standards should begin thereafter.

Microfinance NGOs

- **Overcome Weaknesses in Ownership and Governance**

Ownership and governance weaknesses should be acknowledged and minimized through the establishment of clear lines of responsibility, staff

incentives that promote sustainable outreach, and adequate systems to monitor progress toward commercialization. Accountability and transparency need to be built in through integrated systems and practices, and professional management culture. Improving boards of directors by including members with understanding of business and finance is crucial. Preparing standard income statements and balance sheets and having them audited will increase the transparency of microfinance NGOs' operations and enable performance improvements. Ultimately, these improvements should improve access to commercial sources of capital. Transformation into a regulated entity should also be considered as a means to access deposits as a source of funds and to become a bona fide part of the formal financial system.

- **Improve Institutional Capacity**

Missions should be clarified and incorporate a sustainable view of microfinance provision, balancing the social mission with a commercial approach. Increased attention should be given to building human resource strength in financial analysis and banking. Active participation in the Microfinance Council should also take priority in order to exchange positive and negative experiences, learn about local and international best practices, and access various types of professional microfinance training services, such as the recently completed market research courses.

- **Increase Efficiency**

Efficiency in operations should be made an institutional priority for accountability to a microfinance NGOs' funders as well as its clients. The emphasis on cost efficiency is in line with the social objectives of such organizations in that increases in cost efficiency allow for commensurate reduction in the interest rate that needs to be charged for cost recovery. CARD Bank's achievements in this regard are proof that dramatic cost efficiency can be attained, even when serving poor clients. All MFIs have a responsibility to reduce costs in order to provide their clients with the most affordable, demand-driven microfinance services possible.

Roles of Key Support Institutions

Several types of support institutions can be considered as key in the development and growth of a microfinance industry.

- **Microfinance Networks**

The three microfinance networks, in cooperation with PCFC and other microfinance stakeholders, should continue to work toward introducing a Standard Chart of Accounts and reporting among its members, as should other MFIs. PCFC's efforts in spreading acceptance of established performance standards for microfinance NGOs (standardized accounting practices, subjectivity to external audit, and standard presentation of financials with a view toward eventual ratings) are commendable and should also be continued. The networks should continue to play a role in linking their members with PCFC funds and whenever possible, commercial bank credit.

- **A Credit Information Bureau that includes Microcredit**

The credit bureau run by BAP was recently expanded to include microcredit information and holds promise in terms of further expansion to include a greater number and type of MFIs. This private sector credit information bureau could play an increasingly important role in stabilizing the microcredit market in a few highly competitive areas and in discouraging client over-indebtedness.

- **Microfinance Training Centers**

The training institution that has arguably provided the most specialized microfinance training on a regular basis is Punla. It has the potential to serve as the one-stop shop that could help the microfinance industry build the necessary technical capacity for further professionalization and commercialization. However, Punla will need to make a stronger commitment to serve the specific needs of commercial MFIs if it is to become their microfinance training center of choice in the future.

Punla should conduct market research to explore what types of managerial and operational courses

would be most attractive to microfinance professionals at various levels within different types of institutions, and to determine willingness to pay. It should also build on its relationship with CGAP to seek additional strategic linkages with national, regional, or international networks, such as the Microfinance Council or the Small Enterprise Education and Promotion Network (based in

Washington, D.C.), to expand its course offerings based on market research results. Building local linkages with existing, smaller microfinance training programs, such as those run by RBAP and CARD Bank, would be ideal in order to leverage their significant investments in developing microfinance training modules.

This country study analyzes the progress toward commercialization of the Philippines' relatively heterogeneous microfinance industry.¹ It also explores the remaining challenges, implications, and positive approaches to the commercialization of microfinance in the Philippines.

METHODOLOGY AND ORGANIZATION

The study on which this report is based includes theoretical considerations drawing from the “financial systems” paradigm² and practical field experience for analyzing the commercialization of microfinance. The main findings and recommendations presented here are the product of extensive consultation through individual and group meetings with a wide variety of microfinance stakeholders, including microfinance clients, microfinance institutions (MFIs),³ government officials, state-owned commercial banks, private banks, cooperatives, nongovernment organization (NGO) MFIs, international NGOs, funding agencies, and academics. In addition, relevant domestic and international studies have informed this study, as noted throughout.

Responses to questionnaires eliciting stakeholders' views on microfinance commercialization and their latest institutional and financial data have been incorporated where possible. In addition to collecting such data and holding a wide variety of stakeholder meetings in Manila, the author also gathered data during field visits to several other provinces.⁴ It is important to note that all institutional and financial data were self-reported by the MFIs, unless otherwise noted. Readers should be mindful that self-reported data provided by MFIs are often based on estimates only. This is particularly an issue with microfinance NGOs that do not separate microfinance from other

social programs or from traditional loan portfolios.

The remainder of this chapter elaborates on the framework for analyzing the commercialization of microfinance used throughout this study and establishes the country context as it affects the microfinance industry. Chapter 2 examines the historical development of the microfinance industry and evaluates the progress made by current MFIs toward commercialization, assesses MFI access to commercial sources of funds, and outlines four major trends in the commercialization of microfinance in the Philippines. Chapter 3 analyzes how conducive the operating environment is to the commercialization of microfinance by focusing on enabling attributes of the policy environment, the legal and regulatory framework, and the existence of key microfinance support institutions. Current challenges to microfinance commercialization are the focus of Chapter 4, which reveals stakeholder perceptions, internal constraints facing MFIs, and external impediments in the operating environment. Chapter 5 explores the implications of commercialization in terms of expected changes in outreach and access to commercial sources of funds, as well as product offerings and target markets. The evidence of and potential for competition and mission drift⁵ are also assessed in Chapter 5. Chapter 6 recommends positive approaches to commercialization for government, funding agencies, various types of MFIs, and microfinance support institutions.

FRAMEWORK FOR ANALYZING MICROFINANCE COMMERCIALIZATION

Commercialization of microfinance is a relatively accepted prerequisite to the sustainable expansion of outreach commensurate with

demand by the poor in the Philippines. The term *commercialization* is associated by many stakeholders in the Philippines, and indeed by microfinance professionals worldwide, with “the adoption by MFIs of market-based principles in their microfinance activities regardless of whether they are under prudential or nonprudential government regulations.”⁶ There is a growing realization that commercialization allows MFIs greater opportunity to fulfill their social objectives of providing the poor with increased access to an array of demand-driven microfinance products and services, not only through credit but also savings, insurance, payments, money transfers, etc.

This report adopts a comprehensive view of microfinance commercialization at two levels: the institutional factors (MFI commercialization) and attributes of the environment within which the MFIs operate (commercialization of the microfinance industry).

MFI Commercialization

In this report, MFI commercialization is considered as progress along a continuum, which is depicted in Figure 1.1 and described as follows.

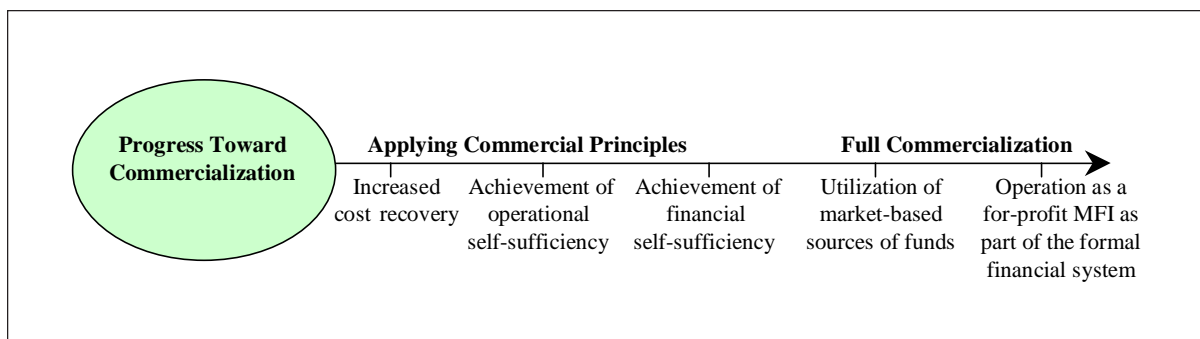
- Adoption of a professional, business-like approach to MFI administration and operation, such as developing diversified, demand-driven microfinance products and services and applying cost-recovery interest rates.

- Progression toward operational and financial self-sufficiency by increasing cost recovery and efficiency, as well as expanding outreach.
- Use of commercial sources of funds, such as unsubsidized loans from apex organizations (wholesale lending institutions) or commercial banks, mobilization of voluntary savings, or other market-based funding sources.
- Operation as a for-profit, formal⁷ financial institution that is subject to prudential regulation and supervision and able to attract equity investment.

Progress toward MFI commercialization is usually hastened by a strategic decision of an MFI’s owners/managers to adopt a for-profit orientation, accompanied by a business plan to operationalize the strategy to reach full financial self-sufficiency and to increasingly leverage the MFI’s funds to achieve greater levels of outreach. The recognition that the key to achieving substantial levels of outreach is building a sound financial institution essentially means that the MFI needs to charge cost-covering interest rates and continually strive for increasing operational efficiency.

Advocates of this approach rightly argue that charging cost-covering interest rates is feasible because most clients would have to pay, and indeed do pay, even higher interest rates to informal moneylenders. MFIs that charge

Figure 1.1: Illustrative Attributes of MFI Commercialization



cost-covering interest rates are an attractive option for this clientele even though the interest rates that an MFI might charge may seem high relative to the corresponding cost of borrowing from a commercial bank. The relevant basis for interest rate comparisons in the eyes of the client is the informal sector where she or he usually can access funds, not the commercial banking sector, which rarely serves this market.⁸

As an MFI's interest and fee revenue covers first its operating costs and then the cost of its loanable funds, it may be considered to be increasingly operating on a commercial basis. MFI profitability enables expansion of operations out of retained earnings or access to market-based sources of funds. Operating as a for-profit, formal financial institution may be the most complete hallmark of MFI commercialization because this implies subjectivity to prudential regulation and supervision and that the MFI has become fully integrated into the formal financial system.

However, MFIs strive for varying degrees of commercialization; not all aim to become formal financial institutions. This decision is usually closely linked to a host of external factors affecting the commercialization of microfinance, discussed next.

Commercialization of the Microfinance Industry

Commercialization of the microfinance industry involves several factors, including the degree to which the policy environment is conducive to the proliferation of commercial MFIs, the extent to which the legal and regulatory framework supports the development and growth of commercial MFIs, the availability and access of commercial MFIs to market-based sources of funds, and the existence of several principal support institutions. The main attributes of the operating environment that determine the commercialization of the microfinance industry can be divided into the following five main categories.

1. Policy Environment

- Government policies that affect the ability of MFIs to make progress toward commercialization (examples of policies that may hamper MFI commercialization are interest rate caps and selective, ad hoc debt forgiveness programs).
- Presence of subsidized government or donor-supported microcredit programs that may stifle the development and growth of commercial MFIs.

2. Legal Framework

- The legal framework for secured transactions—the creation (legal definition), perfection (registration), and repossession (enforcement) of claims—as well as for microenterprise formation and growth.⁹
- The licensing options available to new MFI entrants or semiformal MFIs interested in transforming into formal financial institutions.

3. Regulation and Supervision

- The prudential regulations and supervision practices that govern MFIs mobilizing voluntary public deposits specifically or financial institutions in the broader financial markets generally, and the institutional capacity of the regulating body to carry out its mandate effectively.

4. Money Markets and Capital Markets

- Availability and access of MFIs to commercial sources of funds, such as unsubsidized loans from apex organizations (wholesale lending institutions) or banks, mobilization of voluntary savings, private investment funds, or other market-based funding sources.

5. Support Institutions

- Existence of credit information collection and reporting services, such as credit information bureaus and credit rating agencies, that capture information useful to MFIs regarding borrower creditworthiness, loans outstanding, types of collateral pledged, etc.; or to potential MFI investors. Examples include ratings of MFIs based on their portfolio quality and asset values, microfinance trade associations and networks, microfinance technical training institutions, and providers of business development services.

NATIONAL CONTEXT

Socioeconomic development and macroeconomic and sectoral stability are important considerations in determining the suitability of the operating environment to promote growth of the microfinance industry and its possible commercialization. This section presents social development indicators, recent macroeconomic performance, and performance of the country's agricultural and financial sectors as a basis for establishing the context for the commercialization of microfinance.

Socioeconomic Indicators

The Philippine archipelago has a total population of about 80 million persons spread over 7,107 islands. Population density is around 268 people per square kilometer (km²), which is higher than that of most other countries in the region.¹⁰ Total land area is 300,000 km², 94% of which is on 11 major islands.

In terms of human development, the United Nations Development Programme (UNDP) classifies the Philippines as a "medium level country" and for 2001, the country ranked 70 out of 162 countries.¹¹ The Human Development Index rose from 0.603 in 1985 to 0.740 in 2001 and all major health indicators reflect similar

positive trends (see Annex 1 for additional social indicators). Most human development indicators are commensurate with those of other countries in the region; however, the literacy rate in the Philippines at 94% is among the highest in the region.

Economic growth in the Philippines has been modest but steady since the 1998 economic slump associated with the 1997 Asian financial and economic crisis, and inflation has been contained at low and stable levels (Annex 2 contains summary economic indicators). Real gross national product (GNP) grew at 3.7% in 2001 and inflation was contained at 6.1% for the year.¹²

However, investment remained conspicuously low in 2001 at 16.6% of GNP, compared with more than 23% in the mid-1990s. Export growth fell to single digits in 2000 for the first time since 1992 and contracted by about 16% (in US dollars) in 2001, due to the sharp slowdown in the world economy and, in particular, in the world electronics trade, on which the country has a high export reliance.¹³

Gross national income (GNI) per capita (2000) was \$1,040,¹⁴ but high levels of poverty persist. The incidence of poverty in the Philippines fell sharply in the first part of the 1990s, dropping from 34% in 1991 to 25% in 1997, with much of the improvement occurring between 1995 and 1997.¹⁵ Since then, however, poverty reduction has stagnated; preliminary data from the Family Income and Expenditure Survey (FIES) 2000 suggest that poverty incidence in 2000 of around 26% was a little above the 1997 level.¹⁶ The stagnation in poverty reduction is also reflected in the absence of any decrease in the proportion of people living on less than \$1 per day (equivalent) and less than \$2 per day (Table 1.1).

The Philippines had made strong gains in growth and poverty reduction in recent years until it was hit by the 1997 regional financial and economic crisis and the 1998 *El Niño* weather shocks. During 1994–1997, Philippine economic growth averaged 5% per annum and the incidence of poverty fell substantially. During these years, the government budget was balanced, exports were growing at around 20% per annum, investment was 23% of GNP, and

Table 1.1: Philippine Poverty Statistics

Year	% Population living on less than \$1/day	% Population living on less than \$2/day
1985	22.8	61.3
1990	19.1	53.3
1996	14.8	46.5
1997	12.1	45.2
1998	14.6	47.7
1999	13.7	47.1
2000	12.7	45.9

Source: World Bank 2002a, p.5.

there was optimism about the prospects for lasting peace throughout the country. The impact of the *El Niño* droughts was heavier on the relatively poor agriculture-based households whereas the financial crisis affected the relatively better off wage earners more severely.¹⁷ Poor households have not been able to smooth consumption as well as have other households.

Agriculture Development

The agriculture sector represents an important but declining source of income. Agriculture employed 36.5% of the population or 11.0 million people in 2000. Agriculture as a share of gross domestic product (GDP) was 21.9% in 1990, falling to 15.9% by 2000. Growth rates for virtually all crops decelerated in the 1980s and the early half of the 1990s because of: (1) a decline in expansion of areas under cultivation; (2) the downturn of world commodity prices; (3) a series of natural calamities and droughts; (4) tapering off in the early 1980s of growth rates associated with the green revolution; and (5) policy-related factors including policy uncertainty regarding the Comprehensive Agrarian Reform Program and sharp decline in public investments in agriculture.¹⁸

Services increased during the same period, growing from 43.6% of GDP in 1990 to 52.9% by 2000.¹⁹ During 1985–1997, the incidence of poverty declined twice as rapidly among households dependent on industry and services as

among those dependent on agriculture, but the sectoral composition of poverty remained stable, reflecting the shift of the population out of agriculture.²⁰ Agriculture-dependent households currently account for over two thirds of the poor, but represent only a little over one third of the population.

Faster agricultural growth and a swifter structural shift out of agriculture are crucial for poverty reduction. Higher productivity in agriculture is important for improving incomes of the poor. Particularly important are policies and investments to improve infrastructure and support services. Expanding irrigation will help boost grain yields; strengthening the research and extension system will enhance agricultural productivity and facilitate onfarm diversification; and improved rural infrastructure will reduce transport costs and increase accessibility of markets and public services.

Such improvements have the potential to increase the financial returns to agricultural production, including that of smallholders, and to boost the effective demand for microfinance. However, there are limits to improving productivity in agriculture, and accelerating the shift out of agriculture is arguably more important for the poor. Labor productivity is lowest by far in agriculture—output per worker is one half that in services and less than one fourth that in industry—so that expanding opportunities in higher productivity sectors will be an important part of reducing poverty and promoting economic growth.²¹ Access to commercial microfinance will be an important element in facilitating this transition.

Financial Sector Development

Composition of the Financial Sector

The financial system is composed of formal, semiformal, and informal financial service providers. The formal institutions (Table 1.2) are licensed and regulated by the *Bangko Sentral ng Pilipinas* (BSP) except for insurance companies, which are the responsibility of the Insurance Commission. BSP was established as an

Table 1.2: The Philippine Formal Financial System

Type of Institution	Components
Banking Institutions	Universal banks Commercial banks Thrift banks Rural banks Specialized government banks
Nonbank Financial Intermediaries (NBFIs)	Investment houses Financing companies Securities dealers Investment companies Fund managers Lending investors Pawnshops Government NBFIs ^a Venture capital corporations
Nonbank Thrift Institutions	Mutual building and loan associations Nonstock savings and loans associations

^a Government NBFIs include the Social Security System, the Government Service Insurance System, and the Home Development Mutual Fund.

Source: Gochoco-Bautista 2000, p. 35.

“independent central monetary authority” in 1949, but it underwent a substantial restructuring and modernization per the New Central Bank Act of 1993. BSP’s main responsibility is to formulate and implement policy in the areas of money, banking, and credit. BSP is not permitted

to engage directly in development banking or financing. The Monetary Board, as BSP’s highest policymaking body, is composed of two representatives of the government sector and five full-time members from the private sector. The President of the Philippines appoints members of the Monetary Board for terms of 6 years.

The financial sector is dominated by banks, which on a combined basis make up over 90% of financial assets. As of September 2001, the banking sector was composed of 44 commercial banks, 107 thrift banks, and 786 rural banks (including 52 rural banks owned by cooperatives).²² In terms of ownership, the banking sector included 13 foreign bank branches, seven subsidiaries (five commercial banks and two thrift banks) and three government banks.²³

Banking in the Philippines is highly concentrated, with the largest six commercial banks controlling around 60% of all financial assets and 90% of all banking assets (Table 1.3). Commercial banks are often part of family-owned business conglomerates, and tend to operate as in-house banks for the nonbank business and commercial operations of the controlling families.²⁴ The major category of loans made by commercial banks (24% of the total) in 2001 was for manufacturing. The largest category of lending (26%) by thrift banks was “real estate, renting, and business activities.” Total lending by rural banks was predominantly agricultural (40%) and for activities classified by BSP as “wholesale, trade, and repair” (18%).²⁵

Table 1.3: Banking System Total Assets, (Gross Outstanding) Loans, and (Domestic) Deposits, as of March 2002

	Total Assets (P billion)		Total Loans (P billion)		Total Deposits (P billion)	
		% of Total		% of Total		% of Total
Commercial Banks	2,961	90.3	1,616	89.5	2,005	90.4
Thrift Banks	243	7.4	143	7.9	163	7.3
Rural Banks	74	2.2	46	2.6	49	2.2
Total	3,278	99.9	1,805	100.0	2,217	99.9

Source: Philippines Deposit Insurance Corporation 2002.

Lending investors and pawnbrokers are the dominant providers of credit among the formal nonbank financial institutions. The semiformal financial sector is composed of an estimated 10,000 (multipurpose and credit) cooperatives, 500 NGOs, and more than 50 donor and government target-group oriented credit programs. The Cooperative Development Authority (CDA) registers and regulates the cooperatives while the Securities and Exchange Commission (SEC) manages NGO registration. The informal financial sector comprises a variety of actors, including moneylenders, trade creditors and farmer lenders, self-help groups (such as *paluwagan* which are rotating savings and credit associations), and friends and family.

In terms of banking outreach, commercial banks are predominantly located in urban areas including first-class municipalities. Thrift banks predominantly serve small- and medium-scale enterprises outside the national capital region. With the exception of the rural banks, the banking sector has traditionally been urban based. Because of this, competition among financial

institutions in towns, cities, and first- and second-class municipalities is high. However, rural areas in fourth- and fifth-class municipalities are often characterized by the presence of only one financial institution, which is, in most cases, a rural bank. The majority of rural people must rely on the services provided by semiformal financial institutions and informal financial providers.

Significant Developments in Banking

Since the mid-1980s, the regulatory framework for the financial sector has improved in terms of increasing the efficiency and stability of the banking system. A series of measures tightened the regulations related to minimum capitalization, the limitations and restrictions of loans to a single enterprise, and the allocation of loans to management and shareholders (Box 1.1). The capital adequacy ratio is uniform for all banks at 10% of risk-weighted assets. Also, reporting standards are generally similar and apply to all types of banks.

Box 1.1

Chronology of Important Philippine Banking Developments

- 1981** Deregulation of all interest rates, except for short-term loans and short-term receivables purchases.
- 1982** Increase in paid-up capital requirements of thrift banks (TBs) and rural banks (RBs) from P10 million to P20 million.
- 1983** Deregulation of interest-rate ceilings on short-term loans and provision of incentives to universal commercial banks (UCBs) and RBs that establish branches in areas inadequately served or unoccupied by RBs. Imposition of requirement for commercial banks (CBs) and TBs to purchase 5-year *Bangko Sentral ng Pilipinas* (BSP) certificates of indebtedness (CIs) to establish a branch.
- 1984** Suspension of bank branching in areas classified as overbranched.
- 1987** Conclusion of the rehabilitation of Philippine National Bank and Development Bank of the Philippines and the transfer of accounts to the national Government. Launching of an RB rehabilitation program.
- 1988** Removal of the required investment in CIs for bank branching.
- 1989** Initiatives to enhance competition among banks. Removal of all restrictions on the opening of new branches in priority rural areas. Unification of reserve requirements. Increase in the required minimum capital for UCBs and CBs to P1 billion and P500 million, respectively.
- 1990** Lifting of moratorium on the entry of new domestic banks. Increase in the minimum paid-in capital requirement for TBs.
- 1991** Liberalization of bank branching: franchises to establish branches are auctioned off. Nationwide bank branching for RBs. Increase in minimum capital requirements for UCBs and CBs. Incentives for bank mergers/consolidation.
- 1992** Rural Bank Act of 1992. Incentive for branching: for every three branches established in 5th - and lower-class municipalities where there are less than four banks, a bank can establish a branch in first-class cities or municipalities, without bidding, provided the area is still open to new branches.
- 1993** Bank branching only subject to capital adequacy, liquidity, profitability, and soundness of management. New Central Bank Act.
- 1994** Liberalization of entry of foreign banks. Revision in the minimum paid-in capital requirement for TBs. Reduction of the required equivalent capital for a TB to establish a branch. Lifting of prohibition to pay interest on demand deposits.
- 1995** Increase in the required minimum paid-in capital for banks. Thrift Bank Act of 1995.
- 2000** Passage of the General Banking Law of 2000.
- 2001** Circulars 272, 273, and 282 issued to implement key provisions of the 2002 General Banking Law related to microfinance-oriented banks.

Source: Adapted from Gochoco-Bautista 2000, p.37.

2 Historical Development and Trends in Commercialization

This chapter focuses on the progress toward commercialization by Philippine MFIs as a whole and by institutional type. A historical overview of the establishment and development of the various types of MFIs is provided and their current collective and individual performance is summarized in terms of outreach, financial self-sufficiency, and efficiency. Major government and donor efforts to inculcate sustainable microfinance practices by institutional type are also reviewed as are four related recent trends in MFI commercialization: rural bank downscaling, commercialization of cooperatives, NGO transformation, and new market entry.

In general, rural banks offer enormous microfinance potential because of their local-level ownership and knowledge. Cooperatives have good outreach but need more work on standards and ensuring self-sufficiency. Most microfinance NGOs are small and offer little commercial potential. However, a few of the larger NGOs have demonstrated commercial success and are moving toward more outreach by transforming into regulated financial institutions. These few successes have attracted some new market entrants that have begun microfinance operations as commercial institutions from the outset. Their commercial structure will allow them to grow quickly and become bigger microfinance players in the future.

OVERVIEW

Three main types of retail MFIs currently serve the market: a large proportion of the 2,865 cooperatives registered with the CDA,²⁶ about 500 of approximately 900 microfinance NGOs, and at least 100 of 786 rural banks. The oldest of these suppliers are the cooperatives,²⁷ which

began in the early 1900s. Initiated in 1952, the rural banks continue to be the dominant provider of commercial micro- and small-scale financial services to a wide range of rural entrepreneurs. Since the 1980s, the number of microfinance NGOs has steadily increased, targeting poor populations without access to formal financial services.

Each of these retail MFIs has expanded its provision of microfinance due to numerous recent and ongoing government and donor-supported programs to expand microfinance outreach to the poor on a commercial basis. However, while the rural banks and credit cooperatives have a nationwide delivery system through their unit entities and local branches, relatively few of them are familiar with microfinance technologies and microfinance markets as profitable opportunities. Numerous microfinance NGOs are trying to fill the demand gap, but nearly all are small, capacity-constrained institutions that have more of a social than commercial focus.²⁸

In addition to these three main types of MFIs are various other formal, semiformal, and informal providers of microfinance (Table 2.1). In areas with low population density and little physical infrastructure where few if any formal and semiformal MFIs operate, informal providers, such as moneylenders called “5-6ers”²⁹ or Mumbai,³⁰ provide microcredit for 1–6 months, usually at nominal interest rates ranging between 10% and 30% (flat) per month. Other informal providers include trade creditors and farmer lenders, self-help groups, such as rotating savings and credit associations, and friends and family. The most recent estimates suggest that informal providers supply about two thirds of microcredit loaned outside the handful of urban centers and highly-populated rural areas, where

Table 2. 1: Major Providers of Microfinance in the Philippines

Type	Ownership	Legal Basis	Regulated by	Supervised by	Main Funding Sources	Authorized Activities	Target Market
<i>Formal Institutions</i>							
Thrift Banks	Private investors	Thrift Banks Act, Law on Corporations	BSP, PDIC	BSP, PDIC	Equity, commercial loans, deposits	Savings deposits and loans	General public
Rural Banks	Private investors	Rural Banks Act, Law on Corporations	BSP, PDIC	BSP, PDIC	Equity, commercial loans, deposits	Savings deposits and loans	General public
Pawnshops	Private investors	General Banking Law	BSP, SEC	None	Equity, commercial loans	Pawn loans	General public
Lending Investors	Private investors	General Banking Law, Law on Corporations	SEC	None	Equity, commercial loans	Loans	General public
<i>Semiformal Institutions</i>							
(Savings and Credit) Cooperatives	Individual members	Cooperatives Code	CDA	None	Capital plus member deposits	Saving deposits and loans to members	Members
NGOs	Private trustees	Law on Trusts and Nonprofit Foundations	Annual Reports to SEC and BSP	None	Grants, donations, commercial loans	Loans to individuals and groups	General public

BSP = *Bangko Sentral ng Pilipinas*; CDA = Cooperative Development Authority; NGO = nongovernment organization; PDIC = Philippine Deposit Insurance Corporation; SEC = Securities and Exchange Commission.

Source: Adapted from Gallardo 2001, p.17.

some local competition exists between formal and semiformal MFIs.

The total volume of microcredit from formal and semiformal MFIs combined is unknown, but the estimates of the outstanding balance are in the range of P6 billion to P8 billion (\$121 million to \$161 million). The largest category of poor people served by the formal financial sector comprises agrarian reform beneficiaries and other small agricultural producers who access funds wholesaled by Land Bank of the Philippines (LBP) through some 460 rural banks and 1,700 cooperatives. It is estimated that as of December

2000, P6 billion (\$121 million) of these wholesaled funds were lent to about 600,000 poor borrowers.³¹ Estimates of the total number of poor with access to microfinance services range between 600,000 and 1 million people,³² depending mainly on whether one includes consumer (i.e., salary-based) loans that may be borrowed from rural banks for microenterprise purposes. However, it is clear that even if 1 million people are served by MFIs, outreach is low compared to the estimated 5.8 million poor households;³³ market penetration is slightly less than 20%.

Market penetration is highest around urban centers and highly populated rural areas outside Metro Manila. In general, commercial microfinance has made the most headway in areas with developed physical infrastructure and adequate social service provision. Such areas include San Fernando, Bacolod, and Davao as well as Cagayan de Oro in the three major island regions of Luzon, Visayas, and Mindanao, respectively. There are a few exceptions to this, including VisionBank's expansion in five municipalities within the province of Catanduanes, which has low population density and traditionally no access to microfinance.

Some thrift and rural banks have not been able to automate their operations because of the unreliable supply of electricity in their areas.³⁴ These and other types of MFIs need to computerize their systems to be able to process efficiently numerous small-scale financial transactions in an accurate and timely manner and expand their geographic coverage. Weaknesses in physical infrastructure (power, telecommunications, transport, etc.) as well as basic health and education services will continue to constrain effective demand for microfinance until there are substantial improvements in these areas.

In the areas where MFIs have penetrated, group lending is still predominantly the norm, reflecting the early widespread adoption of the Grameen methodology adopted by the vast majority of early, major microfinance NGO leaders. With an expansion of commercial microfinance, increased individual lending can be expected as successful group borrowers "graduate" to higher levels of debt capacity and as MFIs of all types widen their market base from the entrepreneurial poor as a group to micro and small-scale enterprises. The increased provision of commercial microfinance by formal MFIs, means that deposit mobilization will likely play an increasing role in funding growth. Increasing the access to voluntary saving accounts should become more of a focus for the industry.

There are several plausible reasons for the lack of extensive microfinance outreach. Most obvious are the difficulties associated with the geographic dispersion of clients in an archipelagic nation, and their cultural and language diversity. The United Nations (UN) has recorded a total of 110 regional and ethnic groups in the Philippines and many different dialects exist, even in the same geographic area. Other important factors include the fact that government directed credit programs, although on the wane now, have been historically costly and unsustainable, leading to gross financial sector distortions and inefficiencies and a general weakening of private sector incentives to innovate. The incorporation of microfinance best practices that balance commercial and social missions by rural banks, cooperatives, and microfinance NGOs is relatively new and may also be an explanation for the low levels of outreach.

Despite the relatively low market penetration of MFIs to date, many have made substantial progress toward commercialization and the largest providers of microfinance can be considered to be on a sound commercial footing. Four major trends in the sector support this. First, rural banks and a few thrift banks are increasingly downscaling their services to tap the microenterprise market, largely as a result of focused microfinance technical assistance and training by donors. Second, donor initiatives to commercialize cooperatives are also spurring their introduction or transformation. Third, several microfinance NGOs have recently transformed into microfinance-oriented rural banks or thrift banks. Fourth, the microfinance sector is also attracting new entrants. For example, a microenterprise-oriented thrift bank was established in mid-2001 by a mix of domestic and international institutional investors led by the German consulting firm, *Internationale Projekt Consult* (IPC).

RURAL BANK DEVELOPMENT AND DOWNSCALING

The roots of commercial microfinance date back to 1952, when a law was passed that allowed for the creation of small regulated banks suitable for providing microfinance on a commercial basis. Based on private ownership and initiatives, the rural banking system was to “promote and expand the rural economy in an orderly and effective manner by providing people of rural communities with the means to facilitate and improve productive activities and to encourage cooperatives.”³⁵ The original target market of the rural banks included low-income, rural entrepreneurs. Rural banks spread quickly in the 1970s, but it was not until the mid-1990s that several of them started engaging in microfinance on a commercial basis, either independently or with assistance from the United States Agency for International Development (USAID)-sponsored Microenterprise Access to Banking Services (MABS) program.

Historical Overview and Recent Performance

The Rural Banking Act of 1952 allowed duly established cooperatives to organize rural banks or subscribe to the shares or stock of any rural bank. Thus, the rural banking system is composed of two subsystems: rural banks, owned and organized by individuals; and cooperative rural banks, owned and organized by cooperatives and other farmer associations.³⁶ To stimulate the proliferation and expansion of both types of rural banks, the Government offered a number of incentives, including exemptions from taxes, charges, and fees that would normally be assessed to formal financial institutions, as long as the bank’s net assets were below a certain level.³⁷ In addition, BSP provided free technical assistance and training as well as access to loans and rediscounting facilities at preferential rates. The system enjoyed rapid growth, with 224 rural banks acquiring over P140 million in assets by 1962. By 1972, there were 591 rural banks and

by 1982, there were 1,033, including more than 25 cooperative rural banks.

Unfortunately, government interference in the rural banking system nearly caused its demise. Through incentives and moral persuasion, the Government convinced rural banks to participate in numerous directed credit programs that encouraged risky lending practices. One of the most extensive agricultural extension programs, *Masagana 99*, wreaked havoc on the rural banking system—rural banks served as the major conduit of unsecured loans to small rice farmers during the 1970s. BSP allowed the banks to rediscount 100% of the loan values at 1% per year; the loans already had low interest rates of 10–12% per annum. Furthermore, BSP allowed the rural banks to exclude arrears under the *Masagana 99* program in their computation of past-due ratios. This allowed the rural banks to continue to borrow from BSP when their past-due ratios had exceeded the normal 25% limit.

The rural banks complied with the Government’s request for their participation partly as a result of the threat that new rural banks would be allowed to open in their geographic territory if they did not participate. In addition to the adverse impact of their participation in several directed credit programs, the rural banks suffered adverse economic conditions including high inflation, a liquidity crisis, trade imbalances, and large fiscal deficits. These difficulties led to tight monetary policies and the partial liberalization of the financial system in the early 1980s. From 1979 to 1982, a few assistance programs were implemented to rehabilitate the rural banks, including capital buildup and loan restructuring, which resulted in minimal relief only. In 1984, the rural banks’ major source of credit funds, BSP’s rediscount window, dried up and rural banks’ real assets dropped substantially. The highest rate of rural bank failures occurred in the 1980s when 182 rural banks closed.³⁸

The Countryside Financial Institutions Enhancement Program of 1991 aimed to rehabilitate the rural banks and restore risk asset ratios to at least 10% for those rural banks that could infuse sufficient additional capital. This program, as well as the passage of the revised

Rural Bank Act of 1992, indicating the Government's commitment to allow the rural banks to compete freely in the market, reversed the negative trends of the past. By 1992, the rural banking system reported positive real growth rates in assets, capital accounts, and net loans, with 787 rural banks reaching 463,000 borrowers. Steady growth has continued and the rural banks are now poised for significant expansion. At present, there are over 790 rural banks with more than 1,800 branches that cover 85% of the municipalities in the Philippines. As a whole, the system of rural banks has the widest branch network of any financial institution in the country. While some rural banks have focused on larger, more traditional collateralized loans, most are now returning to lower-income entrepreneurs as a growth market.

Gauging rural bank financial performance in microfinance operations is extremely difficult because there is very little information on their activities other than from those that are members of the national microfinance network called the Microfinance Council of the Philippines or from the MABS Project. The 41 rural banks that participated in the Microfinance Council's survey reported as of June 2001 a combined 105,739 clients, P553.2 million (\$11.1 million) in outstanding loans, and an average

outstanding loan per client of P5,231 (\$105). This average outstanding loan amount is only slightly higher than that reported by the 22 microfinance NGOs (P3,742 or \$75) and 23 cooperatives (P4,853 or \$98) also reporting to the Microfinance Council.

The rural banks reported value of voluntary and mandatory savings (referred to in the Philippines as "capital buildup" (or CBU) was P184.1 million (\$3.7 million). Table 2.2 demonstrates that as a whole, the banking sector is liquid—all bank types have total deposits in excess of total (gross) outstanding loans, although the rural banking system has the least liquidity, with its deposit-to-loan ratio of just 1.06. Nonetheless, the rural banks mobilize the highest percentage of small deposits. More than 90% of their deposit base is from accounts with P15,000 (\$300) or less. In fact, many rural banks have shown creativity in mobilizing deposits. For example, some require only a minimum of P100 (\$2) to open a savings account.³⁹ A few rural banks offer checking accounts and automatic teller machines (ATM) to their clients. Aggressive marketing campaigns for deposits are implemented by many rural banks through print and broadcast media, by sponsoring important events in the communities, or by conducting raffles and games.

Table 2.2: Asset and Liability Structure of Banks, as of March 2002

Institutional Category	Total Assets (P billion)	Gross Outstanding Loans (P billion)	Total Deposits (P billion)	Total Deposits Valued < P 15,000 (P million)	% Small Deposits of all Deposits (by number)
Commercial Banks	2,961.5	1,615.8	2,005.5 (in 19.4 million accounts)	33,452.0 (in 14.7 million accounts)	76.0
Thrift Banks	243.4	143.0	162.8 (in 2.8 million accounts)	4,640.0 (in 2.2 million accounts)	76.5
Rural Banks	73.6	46.4	49.3 (in 4.7 million accounts)	5,234.8 (in 4.3 million accounts)	90.7
Total	3,278.5	1,805.2	2,217.6 (in 26.9 million accounts)	43,326.8 (in 21.2 million accounts)	78.6

Notes: The institutional category Rural Banks includes rural banks and cooperative rural banks. Total deposits include only domestic deposits.

Source: PDIC 2002.

Rural Bank Downscaling

Feeling competitive pressures from above (commercial and thrift banks) and below (pawnshops, lending investors, and finance companies), many rural banks are expanding their provision of specialized microfinance services (Box 2.1). For instance, some rural banks have adopted various microfinance methodologies, including individual, solidarity, and variants of the Grameen model in order to penetrate high-risk, small borrowers at low cost. 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 provide specialized microfinance services for their clients.⁴⁰

Box 2.1

Rural Bank Attraction to Microfinance Profit Potential

"The success of microfinance for the poor in the Philippines for the past decade has encouraged us to venture into a new field of banking: lending to the extreme poor."

Marilou Genuino
President, BMS Rural Bank

Source: Maekawa 2002.

Given the suitability of rural banks for engaging in the sustainable provision of microfinance (Box 2.2), the USAID-funded MABS program is working to bring about a sizable expansion of loan and deposit banking services to microenterprises and other groups at lower socioeconomic levels by assisting participating rural banks to significantly increase the services they provide to the microenterprise sector. The primary local project partner is the Rural Bankers Association of the Philippines (RBAP), which has developed a MABS Technical Services Unit with technical assistance provided

Box 2.2

Suitability of Rural Banks to Provide Commercial Microfinance

"Of all the banks, it is the rural banks that are the best placed to engage in microfinance. Rural banks are established to meet the credit needs of borrowers who are often outside the catchment areas of commercial banks and/or who may be considered poor risks by other banks...In addition, cooperative (rural) banks may be organized to perform banking and credit services for the cooperatives...The World Bank (1996, p. 64) comments that sufficient evidence exists of the profitable provision of savings and credit services to the poor by cooperative rural banks to suggest that '...these banks offer an interesting possibility for reaching the poor effectively without setting up alternative institutions.'"

Source: McGuire, Conroy, and Thapa 1997, p. 237.

by the international development firm, Chemonics International, Inc. Using what has been called the "MABS approach," the program provides technical assistance, training, and limited resource support to participating rural banks (and cooperative rural banks) so they can profitably and sustainably expand their loan and deposit portfolios to microenterprises.

The MABS approach includes intensive one-on-one technical assistance, workshops, seminars, on-the-job coaching, and exposure and training visits to participant banks. Each bank is assigned a technical advisor who checks that the training and technical assistance are being delivered properly and efficiently. Each participating bank receives focused attention and support, which includes institutional assessment, senior management orientation, market survey, product development/enhancement, improvement of management information systems, business planning, on-the-job training (including sessions on cash-flow lending and zero tolerance toward delinquency), and development of in-house training capacity.

Since its inception in 1998, the MABS program has helped 81 rural banks/branches, most of which are in Mindanao, to expand their microfinance operations. As of March 2002, MABS rural banks had 23,965 active loan clients, with a total outstanding loan portfolio of P144.8 million (Table 2.3). Since the program started, microdeposit balances (accounts with balances of P15,000 [\$300] or less) of MABS partner banks increased by P128.8 million, corresponding to 96,185 additional depositors' accounts. More than 96,000 microdepositors have also opened savings accounts at MABS participating rural banks.

Having successfully assisted rural banks in Mindanao to achieve profitable microfinance departments, RBAP formed the Microfinance Technical Services Unit in November 2000 to replicate the introduction of the MABS approach in the Luzon and Visayas regions. The RBAP-MABS Technical Services Unit currently works with eight pilot participating rural banks in Luzon and the Visayas and also provides support to the 20 participating banks in Mindanao.

COOPERATIVE DEVELOPMENT AND COMMERCIALIZATION

Cooperatives have been actively providing micro- and small-scale financial services to poor and low-income households since the early 1900s, but most have only recently begun to commercialize their operations and make headway in the sustainable provision of specialized microfinance based on best practices.

Historical Overview

The cooperative movement was initially sponsored by civic and regional groups that registered the earliest cooperatives under the first Corporation Law enacted in 1906, followed by the Agricultural Credit Associations Act of 1915, and the Cooperative Marketing Law enacted in 1927. In the late 1960s and early 1970s, the cooperative movement had two major influences that would dramatically expand it and shape its culture.

Table 2.3: Performance Highlights for MABS Rural Banks, as of March 2002

Indicator	Pilot Banks	1st Rollout Banks	2nd Rollout Banks	3rd Rollout Banks	Total/Average
Number of Bank Branches	4	37	23	16	80
Number of Active Borrowers	1,991	14,147	5,348	780	22,266
Number of Loan Officers	19	140	117	43	319
Value of Loans Outstanding (P million)	14.2	79.7	37.9	12.9	144.7
Average Loan Balance (P)	7,141	5,634	7,092	16,557	9,106
Average Loan Portfolio per Loan Officer (P)	748,282	569,300	324,154	300,337	485,518
Portfolio at Risk More Than 30 Days (%)	3.20	3.37	3.50	0.19	2.57
Depth of Outreach (Average Loan Balance/ Gross National Product Per Capita, %)	13	10	13	31	16.75

Notes: Pilot banks started operations in October 1998. First rollout banks started operations in September 1999. Second rollout banks started operations in March 2000. Third rollout banks started operations in July 2001.

Source: Data from RBAP-MABS Program as of 31 March 2002.

First, responding to the call of the Second Vatican Council for direct participation in the solution of poverty and social injustice, the Catholic Church in the Philippines passed a resolution in 1967 recognizing the need to organize cooperatives in parishes. Church efforts resulted in the organization of thousands of cooperatives that stressed education as a tool for economic liberation and on voluntarism and self-reliance as the motivating forces for leadership and membership in cooperatives.

Second, to support the agrarian reform program, former President Marcos repealed the Cooperative Marketing Law and issued a new decree on cooperatives in 1973. Cooperatives were directed to prepare tenant farmers for their new role as landowners and to provide them with basic economic and social services. Many new cooperatives were organized overnight with government sponsorship. These laws governed the cooperatives along with some other sectoral regulation until all of them were brought under one law, the "Cooperative Code of the Philippines," in 1989. In 1997, the National Confederation of Cooperatives (NATCCO) was organized with the main objective of providing improved education and training components for the primary and secondary member-affiliates.

The movement has historically had a much stronger social orientation than commercial focus because of the influence of church and government use of cooperatives as conduits for agricultural credit. While social values are very important, they are often used as an excuse for poor business management. This lack of commitment to a commercial approach, added to the fact that there is virtually no regulation or supervision of cooperatives and they can be started with less than \$100 equivalent and 15 members, has resulted in a large percentage of cooperative failure. Of some 42,000 cooperatives registered under the Cooperative Code in 1997, half were inoperative.⁴¹ Lack of prudential standards has resulted in high delinquency, low capital accumulation, and little or no savings mobilization, which, in turn, has resulted in very high external dependency. Donor efforts to improve the viability of cooperatives have

also allowed a few of them to expand their microfinance operations in a sustainable manner.

As with the rural banks, measuring the performance of cooperatives' microfinance operations is extremely difficult given the little available information on their activities other than data captured by those cooperatives participating in the Microfinance Council or donor-funded projects. The 24 cooperatives that participated in the Microfinance Council's survey reported a combined 41,248 clients and P200.2 million (\$4.0 million) in outstanding loans, with an average outstanding loan per client of P4,853 (\$98) as of June 2001. The participating cooperatives also reported the value of savings and capital buildup combined to be P85.0 million (\$1.7 million).

The cooperative movement has demonstrated its potential for mobilizing deposits and providing financial services to small savers and borrowers, and it has been able to finance its lending from share capital and deposits, quite apart from its role as a conduit for government funding.⁴² Many well-run cooperatives in the Philippines are sustainable and show positive financial performance, although the limited financial reporting required of them by the CDA and their poor supervision make it difficult to determine how many fall under this category.

Commercialization of Cooperatives

The focus on the commercialization of cooperatives and their provision of specialized microfinance products and services is relatively recent. It is actively promoted by various government and donor efforts, including technical assistance, training, and funding support. Commercialization is being addressed at two levels: the national federation and selected primary cooperatives.

The largest of the four national federations of cooperatives is NATCCO, which was formed primarily to coordinate the provision of training and educational services at the national level, and serve as the voice of cooperatives belonging to its network. Today, NATCCO is the strongest such national federation in terms of geographic reach, membership, financial capacity, and array

of services. At the core of the NATCCO network are the 1,200 affiliated primary cooperatives located in both rural (75%) and urban areas (25%). Membership is composed of various types of cooperatives: 18% are pure credit cooperatives; 71% are multipurpose cooperatives, with savings and credit as the bulk of their business; 5% are consumer or marketing cooperatives; and the rest (6%) are service and producers' cooperatives and a few cooperative rural banks. Members total more than 1 million individuals: farmers and fishers (24%), self-employed (21%), salaried workers (29%), housekeepers (16%), and students and other groups (10%).

Efforts to strengthen the cooperative movement as a whole are being supported by a number of donor-funded projects. Through the financial intermediation component of the Socio-Economic Development of Cooperatives in the Philippines (SEDCOP) project, international banking standards are being introduced to the cooperatives (Box 2.3). The project aims to professionalize the cooperatives' operations and to build their confidence in undertaking financial intermediation. Through capacity-building assistance, the NATCCO-Financial Intermediation (FI) project is attempting to raise the overall professional capability and profitability of participating cooperatives by improving their accounting and reporting transparency, management information systems, operating efficiency, product diversification including the development of microfinance products and services based on local and international best practices, and marketing.

As part of SEDCOP's strategy to improve cooperative financial intermediation, it has identified (using the software MASS-SPECC; as of May 2002) 29 primary cooperatives in the Northern Luzon, Mindanao, and Visayas regions for technical support designed to improve efficiency in operations and their ability to meet their members' need for loans and capital and, therefore, improve their profitability as well.

These cooperatives have experienced reduction in their delinquency ratios, increases in assets, and professionalization of their staff. Delinquency rates of the Mindanao and Northern

Box 2.3

Efforts to Commercialize Cooperative Microfinance

"We are trying to professionalize our savings and credit operations to raise our level of competitiveness and competence to be at par with big commercial and international banks. We do this through the use of internationally accepted prudential ratios, common standard chart of accounts, computerization, and capability-building. We continue to test, develop viable and innovative enterprises that provide livelihood, income opportunities and basic products and social services to families and individuals."

Source: NATCCO 2002.

Luzon cooperatives, for example, were reduced from around 40% at the start of the project (31 December 2000) to around 20% by end-2001 (Table 2.4).

Among SEDCOP's initiatives with the pilot cooperatives is improvement in the accounting and management information systems. The software MASS-SPECC is able to computerize the savings and credit operations of the cooperatives using the MASS-SPECC Standard Run-time Edition. The software consolidates the database of the cooperative so that if a member's account is called up, all the information required to evaluate a loan application, for example, is immediately available. This information includes outstanding obligations from previous loans as well as the size of the member's capital share and account balance. An important feature of the software is its ranking of a member based on the frequency of deposits and settlement of previous loans. Such ranking guides the loan officer's appraisal of a loan, which is an incentive for management to collect information on delinquent loans and react rapidly to any adverse changes.

The other major donor-funded effort aimed at commercializing cooperatives, the Philippine Credit Union Empowerment and Strengthening (CUES) program was a \$3.7 million project

Table 2.4: Delinquency Reduction at NATCCO-FI Cooperatives

	Delinquency Rate at Project Start (%)	Delinquency as at End-2001 (%)
Northern Luzon		
Galimuyod MPC	47	13
Suyo MPC	48	22
Alilem MPC	63	10
Sta. Cruz	16	12
BAMARVEMCO	36	38
La Trinidad	41	24
BABUDEMCO	46	15
FATIMA	19	10
Average	40	18
Mindanao		
AIMPC	78	33
BUGEMCO	5	5
MCC	76	35
MSUIIT MPC	5	2
OIC	37	21
PMPC	26	16
SAFRAGEMC	28	16
TCMPC	78	41
Average	42	21

FI = Financial Intermediation; MPC = multipurpose cooperative; NATCCO = National Confederation of Cooperatives.

Notes: Initial delinquency rates (project start) were as of end-2000. Delinquency is based on maturity except for Alilem MPC, which uses a portfolio-at-risk greater than 30 days percentage.

Source: NATCCO 2002.

(1996–2002) funded by USAID’s Office of Microenterprise Development and implemented by the World Council of Credit Unions (WOCCU) to extend microfinance services to men and women in Mindanao. This program aimed to improve financial discipline and savings-driven growth utilizing the Model Credit Union Building (MCUB) methodology and the PEARLS (Protection, Effective financial structure, Asset quality, Rates of return, Liquidity, and Signs of growth) evaluation and monitoring system. CUES worked with 18 Mindanao credit cooperatives.

As of 30 April 2002, all cooperatives participating in the MCUB program were submitting quarterly PEARLS ratio reports and understood the implications of the financial ratios in decision making. From December 1998 to December 2002, loan loss provisions for loans delinquent more than 12 months increased from 10.3% to 100.0%, while delinquency decreased from 63.0% to 9.6%. In the same time period, member-client outreach increased 499.3% from 36,443 to 218,354. Three quarters of these member-clients were women. Voluntary savings deposits increased by 540.8% from \$3.4 million in December 1998 to \$21.6 million in December 2002. These and other performance highlights are shared in Table 2.5.

A unique element of the program was a partnership between WOCCU and Freedom From Hunger that enabled credit unions to offer a village banking product, Savings and Credit with Education (SCWE), to poor rural women, in addition to their regular savings and credit services. SCWE is a microfinance program designed specifically to meet the needs of the very poor rural women in the communities of the credit unions with demand-driven, commercially-priced financial services. Along with saving and lending activities, trained field agents provide education on such topics as breast-feeding, rehydration therapy, and nutrition. For some of the women, this is the first access to credit and educational information they have ever received.

Of the 18 Mindanao cooperatives participating in the MCUB program, 11 were also participating in the SCWE program. As of June 2002, cooperatives participating in the SCWE Program had mobilized a total of over 900 active savings and credit associations with 24,300 women members receiving access to financial services. As of 30 April 2002, a total of 21,432 borrowers had P63 million (\$1.3 million) in outstanding loans and the membership had deposited P10.6 million (\$213,000) in savings. Portfolio at risk (30-days overdue) was 3.78%.

In 2002, CUES was selected to receive the Herb Wegner Memorial Award for Outstanding Organization/Program from the National Credit Union Foundation. The project was honored for

Table 2.5: Outreach and Financial Performance Indicators of the 11 (Batch One) and 5 (Batch Two) CUES Philippine Credit Unions

Indicator	End-1998	End-2002	% Change
Number of Members	36,433	218,354	499.3
% of Women Members	65.7	74.7	13.7
Number of Outstanding Loans	0	107,744	
Average Outstanding Loan Amount (\$)		271	
Total Outstanding Loans (\$)	5,936,546	29,247,584	392.7
Average Deposit Size (\$)	92	90	-2.2
Total Deposits (\$)	3,366,164	21,571,135	540.8
Average Share Size (\$)	110	42	-61.8
Total Shares (\$)	3,147,164	10,202,805	224.2
Total Assets (\$)	9,588,614	40,329,441	320.6
Deposits / Total Assets (%)	35.1	53.5	52.4
Operating Expense / Average Assets (%)	8.1	10.3	27.2
Net Income / Average Assets (Unadjusted Return on Assets, %)	2.1	6.1	190.5

Notes: Exchange rate used in Table: end-1998: \$1 = P40.2; end-2002: \$1 = P50.0. Blank entry means data not available.

Source: WOCCU 2002a.

its success as an innovative effort to provide affordable financial services to people, especially women, in some of the poorest areas of the Philippines. The CUES project plans to continue conducting training to incorporate the recommended financial disciplines and prudential standards in an increasing number of cooperatives.

DEVELOPMENT AND TRANSFORMATION OF MICROFINANCE NGOS

Historical Overview and Recent Performance

A few NGOs began microfinance activities in the 1980s and hundreds more have incorporated microfinance as part of their service menu since the early 1990s due to substantial government, donor, and international NGO financial and nonfinancial support. The influence of the Grameen model of service delivery has been very strong among microfinance NGOs due in large part to various forms of support available to Grameen replicators. Expansion of microfinance NGOs following the Grameen model has been bolstered since 1996 when a \$35

million Asian Development Bank (ADB)–International Fund for Agricultural Development (IFAD) project started, allowing funds to be wholesaled through the government apex organization, People’s Credit and Finance Corporation (PCFC), to Grameen replicators for onlending by microfinance NGOs to groups of women borrowers. Also since the mid-1990s, other models, such as the Association for Social Advancement (ASA) in Bangladesh, have been promoted among microfinance NGOs with technical assistance provided by UNDP and other donors.

Since 1997, the Government has been explicitly incorporating microfinance into its poverty reduction strategies and encouraging microfinance NGOs to develop sustainable microfinance programs. High educational levels and exposure of MFI managers to international best practices in microfinance have helped a few of these NGOs to progress toward making their operations commercially viable. In addition, the existence of several networks and donor-funded projects has strengthened the ability of the microfinance NGO industry to grow over time.

However, the vast majority of microfinance NGOs is neither viable nor sustainable. While

microfinance NGOs effectively target and reach poor clientele (due in large part to widespread use of means testing associated with the Grameen model), they are not efficient intermediaries because of their weaknesses in ownership and governance, and institutional capacity. As nonstock, nonprofit organizations, microfinance NGOs have difficulty accessing loan capital from commercial sources. Considered individually, however, a few of the older microfinance NGOs have achieved financial self-sufficiency and have efficient operations. Data from the Center for Agriculture and Rural Development (CARD) and *Tulay sa Pag-unlad, Inc.* (TSPI), which both began as NGOs in the 1980s, are indicative (Table 2.6).

Large-scale Microfinance NGOs

CARD and TSPI are two of only three MFIs that had loan portfolios exceeding P100 million (\$2.0 million) as of end-2001. The third was the Negros Women for Tomorrow Foundation (NMTF) (Table 2.7). The Foundation's combined loan portfolio of P754 million (\$15.2 million) accounts for an estimated two thirds of all microfinance NGOs' combined portfolios. Its combined outreach of 158,425 clients accounts for about half of the total of all microfinance NGOs. With plans for large-scale expansion, these three large microfinance NGOs are expected to continue dominating the microfinance NGO sector in terms of outreach, sustainability, and efficiency over the next 3 years. CARD and TSPI, in particular, are regarded by the NGO sector as pioneers in microfinance commercialization in the Philippines, in that they have achieved full financial self-sufficiency and charge interest rates that more than cover their costs.

The size of CARD's loan portfolio in 2001 grew by 58% over the previous year. This high growth rate was made possible in large part by its creation of a rural bank and ability to mobilize savings. Repayment rates continued to be maintained at close to 100% with a portfolio-at-risk ratio of less than 0.5%. CARD independently reported an operational self-sufficiency ratio of 140% and a financial self-sufficiency ratio of 118% at end-2001.

CARD employs a variety of microfinance methodologies, but the bulk of its microlending is based on a modified Grameen model. Its target clients are landless female rural workers who have no regular jobs and have total marketable assets of less than P50,000 (about \$1,000). CARD provides initial membership training, including value formation and leadership development. CARD also offers its mature clients the CARD Loan Acceleration Program, a credit line of up to P120,000 (about \$2,400). Effective interest charges of 44% per annum are built into the weekly amortization plans. CARD's formalization and its operational and financial performance continue to make it a leading commercial player in the microfinance sector. Almost all of CARD's clients live below the poverty line in rural parts of the country. About 50% of the clients are in agriculture, 30% in commerce, 15% in manufacturing, and 5% in services.

Established in 1981, TSPI was the first Philippine NGO to specialize entirely in providing microfinance. In contrast to the combined loan growth rate for CARD (Bank and NGO) of nearly 60%, TSPI's loan portfolio increased by 15% in 2001. Repayment rates continue to be high and stable at 98.5% while the portfolio-at-risk ratio is a reasonable 3.0%.⁴³ Improvements in TSPI's operational and financial performance are reflected in its self-reported operational self-sufficiency (OSS⁴⁴) ratio of 126.6% and financial self-sufficiency (FSS⁴⁵) ratio of 102%.

As of April 2002, TSPI's total loan portfolio was P206.9 million (\$4.2 million) with 44,044 active clients. TSPI offers three loan products: (i) the *Kabuhayan* (Livelihood) Program, which uses Grameen methodology to deliver loans of P3,000–20,000 (\$60–400) to poor women in groups of 20 and carries a flat interest rate of 18% for 6 months; (ii) the *Sasakyan ng Bayan* (tricycle) loan product, which also uses group guarantees, but with only six members, for loans of P75,000–85,000 (\$1,500–1,700) that carry a 36% flat interest rate per annum with a term of 30 months; and (iii) individual loans for business expansion to successful microenterprises that are not yet ready

Table 2.6: Selected MicroBanking Bulletin Indicators

Indicator	CARD ^{a, b}	TSPI ^c	Asia-Pacific	All MFIs
Outreach and Institutional Indicators				
Age of Institution (year)	13	19	10	8
Number of Offices	21	21	7	13
Number of Active Borrowers	28,531	18,344	9,266	10,710
Women Borrowers (%)	100	88	77	62
Profitability				
Portfolio Yield (%)	39.0	43.0	44.0	38.1
Adjusted Return on Assets (%)	-1.4	-2.5	2.4	-3.7
Adjusted Return on Equity (%)	-4.0	-5.3	7.3	-8.6
Operational Self-Sufficiency ^d (%)	102.0	96.0	116.0	102.0
Financial Self-Sufficiency ^e (%)	95.0	92.0	110.0	90.0
Efficiency				
Total Admin. Expenses/Avg. Gross Loan Portfolio (%)	30.6	35.8	28.3	30.4
Salary Expenses/Avg. Gross Loan Portfolio (%)	16.9	21.7	15.5	16.2
Productivity				
Average Salary (Multiple of GNP/Capita)	1.6	3.0	2.8	5.1
Staff Productivity	102.0	83.0	86.0	114.0
Portfolio				
Portfolio at Risk > 90 Days (%)	0.0	3.7	1.9	2.1
Average Loan Balance (\$)	129.0	194.0	261.0	466.0
Depth (Loans as % of GNP/Capita)	12.3	18.5	40.7	46.0

CARD = Center for Agriculture and Rural Development; GNP = gross national product; MFI = microfinance institution; TSPI = *Tulay sa Pag-unlad*, Inc.

^a CARD operates a rural bank and an NGO and combines the operating results of the two organizations for reporting purposes (Microfinance Council of the Philippines 2002b, p.7).

^b CARD's MBB-adjusted data presented here (with permission from the MFI) is as of end-1999, the most recent MBB data available at the time of the study.

^c TSPI's MBB-adjusted data presented here (with permission from the MFI) is as of July 2000. The data for Asia-Pacific and All MFIs are also as of this date. It should be noted that TSPI independently reports its number of active borrowers as of end-2001 as 25,939, its OSS as 126.6%, and its FSS as 102%.

^d Operational self-sufficiency (OSS) = operating revenue/(loan loss provision expense + operating expense + financial expense). OSS measures how well an MFI can cover its costs through operating revenues.

^e Financial self-sufficiency (FSS) = adjusted operating revenue/(loan loss provision expense + financial expense + adjusted operating expense). FSS measures how well an MFI can cover its costs taking into account a number of adjustments to operating revenues and expenses for subsidies, inflation, and nonperforming loans. The purpose of most of these adjustments is to model how well the MFI could cover its costs if its operations were not subsidized, and if it were following international accounting standards and funding its expansion with commercial-cost liabilities.

Source: MicroBanking Standards Project Finance Performance Reports prepared for each institution for inclusion in the MicroBanking Bulletin (MBB).

to access loans from commercial banks. Loan sizes under this program are in the range of P50,000–400,000 (\$1,000–8,000) and carry a flat interest rate of 36% per year with terms of 6–12 months.

About half of TSPI's funds are derived from client deposits and most of the remainder is composed of loans borrowed at what can be

considered fully commercial interest rates—the interest rate of their borrowings exceeds the prevailing prime rate by more than 5 percentage points on average. Given its good operational and financial performance and its significant reliance on commercial sources of funds, TSPI continues to be a major player in the microfinance market and its level of commercialization can be

Table 2.7: Status of Large Microfinance NGOs, as of End-2001 (more than P100 million in outstanding loans)

Indicator	CARD	TSPI	NWTF
Number of Branches	30	26	15
Number of Borrowers and Savers	84,037	39,378	35,010
Total Number of Staff	337	309	224
Number of Field Staff	307	249	163
Value of Loans Outstanding (P)	378,991,438	195,630,587	179,429,318
Value of Collateral Savings (P)	156,042,718	85,626,502	54,408,927
Average Loan Balance (P)	4,110	5,984	5,125
Average Portfolio per Field Staff (P)	1,234,500	785,665	1,100,793
Repayment Rate (%)	99.9	98.5	99.2
Portfolio at Risk (%)	0.43	3.0	2.1
Operating Cost Ratio (%)	24.0	35.8	34.4
Operational Self-Sufficiency (%)	139.5	122.7	102.4
Financial Self-Sufficiency (%)	118.5	100.8	85.7
Equity to Asset Ratio (%)	30.4	44.6	32.0
Current Ratio	2.3	1.7	2.8
Collateral Savings to Loan Ratio (%)	41.1	43.8	30.3

CARD = Center for Agriculture and Rural Development; NGO = nongovernment organization; NWTF = Negros Women for Tomorrow Foundation; TSPI = *Tulay sa Pag-unlad*, Inc.

Source: Microfinance Council of the Philippines 2002b, p 8.

expected to increase because it plans to obtain approval for the operation of a microfinance-oriented thrift bank in the near future.

Founded in 1984, NWTF was incorporated in March 1986 as a nonstock corporation (i.e., NGO) with the mission to create opportunities for the self-employed by providing poor people with access to integrated credit facilities, and to reduce the exploitation of the poor by moneylenders through a comprehensive credit program. NWTF's loan portfolio increased in 2001 by almost 60% over that in the previous year and is reported at P179.4 million (\$3.6 million). NWTF continues to maintain repayment rates of 99.2% and a portfolio-at-risk ratio of 2.1%. At the end of 2001, NWTF reported OSS and FSS ratios of 102% and 86%, respectively.

NWTF started Project Dunganon in October 1989 using the Grameen model to serve women in rural households belonging to the poorest 30% of the population. Loans are provided based on joint liability to group members at a flat 32% interest rate per annum. Although this interest rate has allowed NWTF to reach OSS, the

organization has not yet attained FSS, which is, however, a priority. An NWTF senior manager noted that they are striving to achieve FSS by "lowering operational costs, increasing outreach, improving client retention, repackaging loan products to suit client needs, improving funds management, leveraging equity, and providing staff incentives." In line with its clients' needs, loan sizes are small, ranging between P1,500 and P2,000 (\$30–40) for the first loan with stepped lending on subsequent loans to a maximum of P7,000 (\$140).

NWTF has other credit products, such as education loans, utility loans (for electricity and water), and family loans (flexible loans for any consumer or business purpose). Most of the clients (77%) engage in commerce, with 14% in agriculture, 6% in services, and 3% in manufacturing/production. NWTF's strong client orientation, balanced with its focus on achieving FSS, suggests that this microfinance NGO will progress along the commercialization continuum, albeit more slowly than CARD or TSPI, because NWTF is not yet ready to formalize its operations

in an effort to fuel further growth via deposit mobilization.

Three microfinance NGOs are classified as medium-sized MFIs: *Taytay sa Kauswagan*, Inc. (TSKI), Agricultural and Rural Development for Catanduanes, Inc. (ARDCI), and *Alalay sa Kaunlaran sa Gitnang Luzon*, Inc. (ASKI) (Table 2.8). They have not yet achieved financial self-sufficiency, but planned to focus on efficiency and productivity of their operations in 2002 while continuing their present growth path. It is expected that these three MFIs will continue to grow and report improved performance in 2003 and beyond.

Small-scale Microfinance NGOs

Six of the leading small-scale microfinance NGOs are members of the Microfinance Council and their summary performance data are in Table 2.9. *Ahon sa Hira* Foundation, Inc. (ASHI) and First Consolidated Bank Foundation Inc. (FCBFI) appear to have consolidated their operations with only minor increases both in outreach and size

of loan portfolios. The other four microfinance NGOs—Norfil Foundation, Inc. (NORFIL), Milamdec Foundation, Inc. (MILAMDEC), Cebu Micro-Enterprise Development Foundation, Inc. (CMEDFI), and Jaime V. Ongpin Foundation, Inc. (JVOFI)—experienced substantial increases in number of clients and loan portfolio size in 2001. All six MFIs are experiencing repayment rates exceeding 90% and three of them have repayment rates of at least 97%; however the portfolio-at-risk rates of 10% or higher for three of them indicate that growth may be coming at the cost of declining repayment performance. Only three are nearing 10,000 clients. In terms of OSS ratios, three of the six reported ratios exceeding 100%, meaning that they are covering operational costs from revenues derived from microcredit activities. While a few of these small microfinance NGOs offer some potential for sustainable growth in the future, the vast majority of the hundreds of such microfinance NGOs is not commercially viable and would be forced to close in the absence of donor funds.

Table 2.8: Medium-sized Microfinance NGOs, as of end-2001 (between P30 million and P100 million in outstanding loans)

Indicator	TSKI	ARDCI	ASKI
Number of Branches	8	4	6
Number of Borrowers and Savers	32,036	13,304	12,479
Total Number of Staff	209	78	102
Number of Field Staff	126	62	85
Value of Loans Outstanding	90,390,116	63,256,221	43,287,351
Value of Collateral Savings	30,446,713	21,861,063	10,197,217
Average Loan Balance	3,515	9,260	3,469
Average Portfolio per Field Staff	717,382	1,032,000	901,820
Repayment Rate (%)	97.3	99.5	85.0
Portfolio at Risk (%)	7.31	2.4	18.0
Operating Cost Ratio (%)	33.3	28.1	41.0
Operational Self-Sufficiency (%)	110.6	119.0	85.6
Financial Self-Sufficiency (%)	88.7	84.0	82.1
Equity to Asset Ratio (%)	28.4	62.1	21.0
Current Ratio	3.5	2.5	2.0
Collateral Savings to Loan Ratio (%)	33.7	34.0	23.0

ARDCI = Agricultural and Rural Development for Catanduanes, Inc.; ASKI = *Alalay sa Kaunlaran sa Gitnang Luzon*, Inc.; TSKI = *Taytay sa Kauswagan*, Inc.

Source: Microfinance Council of the Philippines 2002b, p 7.

Table 2.9: Small-scale Microfinance NGOs, as of End-2001 (less than P30 million in outstanding loans)

Indicator	ASHI	FCBFI	NORFIL	MILAMDEC	CMEDFI	JVOFI
Number of Branches	9	1	9	8	4	1
Number of Borrowers and Savers	9,044	3,793	9,778	8,595	3,066	691
Total Number of Staff	68	19	53	46	22	8
Number of Field Staff	61	14	51	36	18	5
Value of Loans Outstanding	28,537,539	23,397,390	19,880,846	17,489,545	7,567,227	1,856,800
Value of Collateral Savings	16,999,427	6,221,001	10,287,936	6,854,541	2,741,633	806,401
Average Loan Balance	3,155	6,169	2,140	2,495	2,702	3,774
Average Portfolio per Field Staff	713,438	1,799,799	389,821	485,821	420,401	372,115
Repayment Rate (%)	97.4	91.0	94.0	94.0	97.0	99.8
Portfolio at Risk (%)	2.3	15.0	24.0	2.4	12.0	1.1
Operating Cost Ratio (%)	43.0	10.0	93.0	34.0	14.0	
Operational Self-Sufficiency (%)	76.0	124.0	77.0	110.0	86.0	102.6
Financial Self-Sufficiency (%)	65.0	104.0			74.0	
Equity to Asset Ratio (%)	55.0	26.0	43.9	21.0	47.0	-4.7
Current Ratio	4.9	2.6	1.8	2.7	3.3	0.08
Collateral Savings to Loan Ratio (%)	59.6	27.0	51.7	39.0	36.0	43.4

ASHI = *Ahon sa Hirap* Foundation, Inc.; CMEDFI = Cebu Micro-Enterprise Development Foundation, Inc.; FCBFI = First Consolidated Bank Foundation Inc.; JVOFI = Jaime V. Ongpin Foundation, Inc.; NORFIL = Norfil Foundation, Inc.; MILAMDEC = Milamdec Foundation, Inc.

Source: Microfinance Council of the Philippines 2002b, p 7.

Microfinance NGOs cannot legally accept deposits but are mobilizing substantial savings, as can be seen in the Tables above. Collectively, almost half their loan portfolios is funded from savings deposited by members or funds collected via capital buildup programs (both are largely made up of mandatory deposits). Transformed NGOs, such as CARD, are having better success at tapping voluntary savings. The savings of all BSP-regulated entities (including, for example, the thrift banks and rural banks that are active in microfinance) are insured up to P100,000 (about \$2,000) by PDIC. This insurance is generally sufficient to protect formal MFIs' deposits but not the savings in microfinance NGOs or cooperatives, which also raise funds via member deposits.

NGO Transformation

Diminishing access by microfinance NGOs to government- or donor-subsidized funds and grants is increasingly motivating microfinance NGOs to transform into regulated rural banks or thrift banks to gain access to consumer deposits

as a reliable source of funds. Although apex funds are available through the government apex organization (PCFC), many microfinance NGOs find the terms too restrictive (because most of their funds must be used strictly in accordance with their prescribed Grameen or ASA methodologies) or the terms are too short (PCFC's lending terms are further described in Chapter 3). The graduated or tiered licensing system has been an indispensable element in substantially expanding the ability of MFIs to mobilize financial resources beyond traditional grants and donations.⁴⁶ There have been four cases of NGO transformation to date: CARD Bank in 1997, Opportunity Microfinance Bank (OMB) in 2001, ARDCI's Vision Bank in April 2002, and most recently, *Banco ng Masa* in mid-2002.

An October 2001 survey of institutional plans conducted by the Microfinance Council⁴⁷ indicated that although most respondent rural banks are content to maintain their institutional form, 14 of 23 respondent microfinance NGOs, which arguably represent most of leading microfinance NGOs in the industry, were

planning to establish a bank. Interestingly, there were also 12 cooperatives that expressed intent to transform into a bank.

CARD Bank

A group of 15 rural development practitioners organized CARD as an NGO in 1986 with the basic objective of improving the quality of life of the landless rural poor. Part of that original mission was to establish a bank created for, owned, and managed by the landless rural poor. In 1997, CARD Rural Bank received its operating license from BSP. With an initial capitalization of P5 million (\$167,000 equivalent at the time), 12 of CARD’s 25 branches were converted into CARD Bank; the remaining branches continued to operate as CARD NGO.

Initially, CARD Bank was owned by CARD NGO (27%), a few members of the board of directors, and management staff (73%). This ownership has shifted over time away from the board and staff ownership and to client ownership through the issuance of stock—a process that started in 2000 (Box 2.4). At the end of 2001, CARD Bank’s ownership structure was CARD NGO (44%), CARD Bank and NGO staff and board membership (26.5%), and clients (29.3%). CARD’s transformation experience has resulted in substantial increases in scale because it has been able to diversify and expand the funding base. Transformation is also expected to result in eventual, full private ownership through additional issuance of preferred stock shares to qualified clients-investors. CARD plans to transfer full ownership to the landless poor, consistent with the CARD vision. While the empowerment of landless poor women is a noble aim, one concern is that such owner-investors lack the “deep pockets” that may be necessary to access additional sources of funds should CARD Bank have financial hardship.⁴⁸

Opportunity Microfinance Bank

Opportunity Microfinance Bank (OMB) was established in May 2001 to provide a range of financial products and services to the enterprising

Box 2.4

CARD Bank: Creating a Vehicle for Asset Ownership by the Poor

“Day by day, the vision that we set for CARD that aims ultimately to empower the poor people, especially women, serves as our guiding light and inspiration in everything that we do. Currently, we have two women members who are representing our more than 50,000 client-members on the Board of Directors of CARD Bank...[and] more than 1,500 members have been issued Certificates of Stocks of CARD Bank, a certificate that says that they are not just borrowers but they are now owners and stockholders of a bank that is dedicated to eradicating poverty.”

Dolores Torres
President and CEO, CARD Bank

CARD = Center for Agriculture and Rural Development

Source: Grameen Foundation USA, 2002, p.1.

poor. As the first microfinance-oriented thrift bank in the Philippines, OMB is able to supplement traditional microfinance loan products, such as group loans and forced savings, with individual loans, voluntary savings accounts, and certificates of deposit. The structure of the bank allows it to access diverse capital resources (including deposit mobilization) and allows both commercial and private investors to purchase shares, so as to ensure a deep outreach to those most in need (Box 2.5). As of August 2002, OMB had 19,000 active borrowers under its group lending program and 291 active borrowers under its individual lending program. OMB’s total lending portfolio was P57.0 million (\$1.2 million). Its deposits amounted to P29.5 million (\$0.6 million).⁴⁹

OMB was formed initially as a small bank venture under the Philippine Scale-up project managed by the Alliance of Philippine Partners in Enterprise Development, Inc. (APPEND), a network of microfinance NGOs. With financial assistance from the Opportunity International

Box 2.5

OMB's Drive for Deposits

As a microfinance-oriented (thrift) bank, OMB can accept deposits, the lifeblood of regular banking, and thereby broaden its funding base. The new bank is trying to recruit wealthier citizens to open savings accounts by offering higher interest rates on government-guaranteed deposits. While most Philippine banks currently [in 2001] pay about 6% a year on deposits, "we're offering a 10% interest rate if (customers) keep it there for a year," says Ricardo Jumawan, the OMB's chairman. "This isn't just charity, it's good business. We'll even tell depositors who we are lending to, so they know that good use is being made of their deposits."

OMB = Opportunity Microfinance Bank

Source: Hookway 2001.

second, by utilizing the strengths of the partner NGOs to develop and run branches in new regions until they are sustainable, at which time they will be bought by OMB, either for cash paid directly to the NGO or as equity in the thrift bank. This arrangement appears to be viable but only time will tell if the incentives are properly aligned to induce the NGOs to continue turning over their best performing branches to the bank for cash or equity.⁵¹ OMB's aim is to establish 75 new branches with the ability to support 1 million poor families within 5 years.⁵²

From its inception, OMB has been unique in that it is the first Christian bank to be established by a network of MFIs, expressly for the purpose of providing the entrepreneurial poor with greater access to microfinance services. The process of its establishment will also be used as a model in the organization of other formal MFIs around the world under the leadership of the OIN, one of the largest international NGO providers of microfinance in the world.

*Agricultural and Rural Development for
Catanduanes, Inc. VisionBank*

To assist poor farmers and micro and small-scale entrepreneurs in accessing much needed capital and provide an option to traditional moneylenders, the microfinance NGO Agricultural and Rural Development for Catanduanes, Inc. (ARDCI) initiated the establishment of a microfinance-oriented rural bank in Bato (Box 2.6). The Monetary Board of BSP approved the establishment of VisionBank, Inc. in April 2002, the first microfinance-oriented rural bank established under BSP Circular 273, which partially lifted the general moratorium on the licensing of new thrift and rural banks and allows the entry of microfinance-oriented banks.

The bank is 87% owned by ARDCI and is complemented by conversion of savings into shares of stock, and mobilization of quasi-equity and private investment. The capital position of VisionBank is P80 million (\$1.6 million) authorized capital, P20 million (\$400,000) subscribed, and P9 million (\$180,000) paid-up capital. P32 million (\$640,000) have been made

Network (OIN), APPEND began forming a "network" bank in consultation with its partner NGOs. OMB was created when these parties and member-investors including *Kabalikat Para sa Maunlad na Buhay, Inc.* (KMBI), TSKI, and ASKI signed a Memorandum of Understanding in December 2000. However, it was not until the BSP Monetary Board lifted a ban on issuing new bank licenses in January 2001 that OMB was able to apply to conduct business. The application was approved on 17 May 2001 and OMB began operation as a formal financial institution with an authorized capital stock of P800 million (\$16.1 million) and an initial paid-in capital of P58.1 million (\$1.2 million).⁵⁰

OMB, APPEND, and APPEND's partner NGOs are working closely together in this venture to ensure its successful operation. Although OMB will assume control of the front-line microfinance services, APPEND and the NGOs will continue to coexist with the bank and will play an important role in helping the bank's network grow. New branches will be formed in two ways: first, by integrating the branches of the four partners into the OMB structure; and

Box 2.6

ARDCI's Quick Path to Sustainability

Catanduanes, the province in which ARDCI operates, has very poor road conditions and a dispersed population of 200,000. Despite having a clientele comprised of over 90% of the poorest families in this rural province, the microfinance NGO managed to attain full OSS after just five years of operation.

ARDCI senior management attributes this in part to having its vision clearly articulated from the board to the management and staff to the membership, to "increase incomes through the provision of financial services to the enterprising poor delivered by a viable rural financial institution" (ARDCI 2001). Other factors include strong human resource development and market research.

Recognizing ARDCI's good performance, the BSP (2002d) noted, "ARDCI is a member in good standing of the Microfinance Council...and has a performance rating of 'Very Satisfactory.' As a young microfinance NGO, ARDCI was able to achieve relatively fast growth in terms of assets and outreach. At present, there is no other bank in Bato or in other municipalities of the province."

ARDCI = Agriculture and Rural Development for Catanduanes, Inc.

*Banco ng Masa*⁵⁴

The Monetary Board of BSP approved the establishment of the *Banco Ng Masa* in Calatagan, Batangas, in May 2002, the second microfinance-oriented rural bank established under BSP Circular 273. The newly-approved bank has an authorized capital stock of P80 million (\$1.6 million) with an initial paid-in capital of P5 million (\$100,000). The majority shareholder is the E. Zobel Foundation (EZF), an NGO headed by its chairperson, Enrique Zobel, which implies that the *Banco ng Masa* will not reap the full benefits of commercial ownership; it will be guided by an NGO representative rather than an investor with his or her own assets at risk.

EZF is driven by a social mission, established in 1986 primarily to help people with disabilities. In 1988, however, EZF shifted to helping microentrepreneurs without access to financial services. EZF provided microcredit within the range P3,000–30,000 (\$60–600) at annual effective interest rates lower than those offered by local moneylenders. *Banco ng Masa* was conceptualized and organized to take over the EZF *Palabra de Honor* (PDH) microfinance program based on the Grameen model. The PDH program was started by EZF in 1998 with 14 members, mostly women market vendors, with an initial loan of P165,000. As of 15 April 2002, PDH had cumulatively disbursed P29.2 million in loans to 1,500 microentrepreneurs. During the first quarter of 2002, PDH disbursed slightly more than P4.2 million (\$84,000) in loans and as of 15 April 2002, there were close to 1,000 active members.

As a relatively new microfinance NGO, EZF has made commendable progress in outreach and financial self-sufficiency. With the establishment of a rural bank, prospects for continued good performance are even more improved. Despite its formal structure, however, *Banco ng Masa* will have to shift ownership progressively from the NGO toward private ownership in order for true commercial incentives to be in place and for the bank to operate on a fully commercial basis.

available through grant funds from the European Union, but will only be infused gradually to the bank from the paid-up loan portfolio of ARDCI's four existing branches. P38 million (\$760,000) will come from the retained profits of the ARDCI microfinance NGO infused to VisionBank gradually. A further P10 million (\$200,000) will be from preferred shares of stock, which will be converted to common shares as shares are sold to individual ARDCI microfinance NGO members using their savings, and to private investors.⁵³ To encourage deposit mobilization as a major source of funds, Vision Bank will become a member of the PDIC. VisionBank was expected to commence operations in October 2002.

TSPI

Although TSPI has not yet transformed itself from a microfinance NGO into a rural or thrift bank, its process of considering and moving toward transformation is one of the longest in the history of microfinance NGOs in the Philippines and sheds light on some the difficulties usually associated with transformation. As the first microfinance NGO in the country, TSPI initially considered transformation in the mid-1990s as a means to enlarge its operations and expand its services to the poor. At the time, however, senior management and members of the TSPI board were ideologically tied to the poverty lending approach to microfinance and were wary that transformation could lead to mission drift away from the poor toward higher-income clients. In addition, virtually no NGO transformation cases were available at that time to prove that mission drift was not a necessary byproduct of formalization.

Following the Asian financial and economic crisis of 1997–1998, the issue of TSPI transformation again came to the fore, as part of a consortium of microfinance NGOs making up the APPEND network that were aspiring to create a bank with the help of OIN. Although more cases were available by 1999 to provide evidence that transformation did not necessarily result in mission drift away from the poor, the TSPI board saw that the original mission of TSPI might also suffer, because many other organizations were involved in the formation of the thrift bank that was eventually to become OMB. TSPI's former Executive Director, Dr. Ricardo B. Jumawan, moved from TSPI to OMB to become its Chairperson and the TSPI Board of Trustees appointed Mr. Ruben C. de Lara to succeed him effective 1 February 2001. Although he is strongly aligned with the original mission of TSPI, Mr. de Lara brings a decidedly commercial approach to TSPI's microfinance operations, having served as a senior manager with multinational corporations for much of his professional life. Dr. Jumawan continues to serve as a member of TSPI's board, under Mr. de Lara's leadership.

TSPI has applied for a thrift bank license and is expecting approval. Both the strong financial and other support that TSPI has enjoyed based on its good performance over the last several years and the successful track record that CARD Bank has created in keeping to its original mission, bode well for TSPI's microfinance bank.

NEW MARKET ENTRANTS

In addition to the transformation of microfinance NGOs into formal banks, the microfinance market has attracted new entrants. The new market entrants are microfinance NGOs and a microfinance-oriented bank that employs a commercial approach to microfinance. Both types of MFIs are entering the market with a more aggressive and businesslike strategy than many older institutions.

Bayan Microfinance

Bayan Microfinance is a program run by the corporation ABS-CBN, well known in the Philippines as a leading broadcasting and media firm. The company's social service institution, the ABS-CBN Foundation, which mainly carries out relief activities, began a small microcredit project in 1993. In 1997, it decided to make the project into a major program. Bayan Microfinance runs on a business-like basis, without need for major subsidies from the company. Its financial statements show OSS, with interest income on loans exceeding operating expenses. It has good portfolio control with portfolio at risk (over 30 days) less than 5%. The MFI has grown aggressively from 1,500 clients at the end of 1998 to 20,450 by September 2001, with the intent to reach 50,000 by the end of 2005.

Micro Enterprise Bank

The Micro Enterprise Bank (MEB) was established as a microfinance-oriented, thrift bank in October 2001 on the initiative of several multilateral, bilateral, and local institutions. It was founded with the objective of providing financial

services that are specifically tailored to private microenterprises in the Philippines, a sector neglected by the formal financial institutions. Therefore, MEB will effectively compete with moneylenders and will reduce the reliance of microenterprises on self-financing. The shareholders are convinced that microlending can and should be conducted on a profitable basis (Box 2.7). MEB management supports the view that by creating a lasting and reliable supply of microfinance in a supportive institutional setting, target group-oriented lending can eventually become donor independent and have a significant ongoing developmental impact.

MEB was incorporated with a total authorized share capital of P100 million (\$2.0 million), with an initial capitalization of P60 million (\$1.2 million) to be followed by a second capital subscription of P40 million (\$0.8 million). The international shareholders, which together hold 60% of the total share capital, are the Doen Foundation and Netherlands Development Finance Company; the International Finance Corporation (IFC), which is a member of the World Bank Group; and IMI, an investment company based in Germany. Planters Development Bank, a reputable commercial bank based in Manila with experience in lending to medium-sized enterprises, is the bank's local investor, holding the remaining 40% of the shares. MEB plans to expand the shareholder structure by adding a local investor from Mindanao, who will provide invaluable knowledge of that local environment.

The shareholders designed a management team with extensive experience in the establishment and management of MFIs. The management team is backed by IPC, which has more than 20 years of experience in microfinance and promotes a commercial approach. While not all of MEB's shareholders are true commercial investors, IMI is primarily owned by individuals who work for IPC. Because several of IPC's consultants also have a stake in IMI and, therefore, the performance of MEB, strong incentives exist for the management of MEB to develop a commercially viable microfinance operation. As with other IMI investments, it is

Box 2.7

The Commercial Microfinance Corporate Philosophy of MEB

"Good intentions alone do not bring about the desired social impact... A commercial approach to microfinance is needed. Essentially this means that institutions lending to the target group should charge cost-covering interest rates... By charging its clients commercial interest rates through an appropriate lending technology, by continuously striving to improve its efficiency and streamline its operations, and by establishing a large branch network and thus exploiting economies of scale, MEB will achieve its other goal: financial self-sufficiency. This implies a rate of return on capital that accommodates the level of risk incurred and a modest profit sufficient to enable the institution to grow. Striving to achieve the twin goals of profitability and target-group orientation is the key factor that will ensure the bank's future success."

MEB plans to turn a profit after 11 months and break even during its third year of operations. The bank plans to attain an average return on equity (ROE) of almost 15% by the end of the third year. Management believes this is attainable by "lending at commercial rates, applying an appropriate credit methodology, employing a customized MIS, offering attractive products, and achieving economies of scale by expanding the branch network."

MEB = Micro Enterprise Bank

Source: MEB 2001, p.2-3.

expected that MEB's reliance on IPC consultants will be phased out over time to be replaced by local professionals equally committed to following a commercial approach to microfinance.

Microcredit is the main focus of the new institution's business activities. MEB will issue business loans only in amounts according to demand, currently in the range P2,000-300,000 (\$40-6,000), for expansion of inventory and acquisition of fixed assets. Initially, loans will be

short term, with maturities gradually increasing over time. First-time loans have terms of 6 months and subsequent loans have a maximum maturity of 1–2 years. Repayment is in regular equal installments in amounts depending on the cash flows of the economic enterprise undertaken with the loan. After MEB has been

in operation for one year, future loan products may include long-term investment loans, agricultural loans, salary loans, and loans to small-scale enterprises (in addition to microenterprises). MEB estimates that the net loan portfolio will yield an average of 4.5% per month.

3 Conduciveness of the Operating Environment

Compared to other Asian countries, the Philippines offers a fairly supportive legal and regulatory environment in which MFIs can operate. The Government has recently taken positive measures to support the expansion and commercialization of microfinance, based on difficult lessons of the past with targeted lending programs and subsidized lending to the agriculture sector and the poor. Through BSP, the Government has issued several circulars that allow for favorable treatment of microfinance portfolios. Nonetheless, the operating environment for MFIs is still lacking in the sense that MFIs are not able to meet the stringent borrowing criteria for commercial loans. In addition, many of the key microfinance support institutions, including microfinance networks and training centers, are geared toward the traditional NGO model and group lending methodologies, and lack the commercial perspective necessary to serve the needs of many of the commercial MFIs.

ENABLING POLICIES AND PROGRAMS

Financial reforms in the early 1980s saw the lifting of one of the most effective barriers to sustainable and viable financial intermediation. The removal of interest rate restrictions allowed banks to price their products and services by taking into account the full recovery of their operational and financial costs.⁵⁵ Liberalized bank entry and branching in the 1990s allowed banks, and rural banks in particular, to expand access to financial services in traditionally underserved areas. Liberalization of the financial sector during the 1980s and early 1990s allowed a policy focus on sustainable microfinance to emerge by the mid-1990s.

Policies laying the groundwork specifically for promoting sustainable microfinance as an instrument for poverty reduction and economic growth began in the mid-1990s and efforts to create an enabling policy environment for microfinance have been gathering momentum since then. This was conveyed in the 2001 State-of-the-Nation address by President Macapagal-Arroyo wherein she promoted microfinance as a cornerstone in the Government's fight against poverty (Box 3.1).

The Government established the National Credit Council (NCC) in 1994 to rationalize government directed credit programs and develop a national credit delivery system capable of addressing the issues of poverty.⁵⁶ The NCC's

Box 3.1

Microfinance as a Cornerstone in the Government's Fight Against Poverty

"Whether in Metro Manila or in the countryside, we will make microfinance a cornerstone in our fight against poverty. This means we will expand access to working capital for small businesses. The OMB has just been issued a bank license and it is the first microfinance program to transform into a thrift bank. Each year, as a national target, an additional 300,000 poor women will benefit from access to microfinance. It is time for the poor to benefit from the savings of this country. Rest assured that the poor can repay, successful MFIs have repayment rates of at least 98 percent."

(Translated from Tagalog)
State-of-the-Nation Address
by President Gloria Macapagal-Arroyo
23 July 2001

focus has been exclusively on small credit and microcredit and one of its early tasks was to draft and disseminate “Policy Guidelines for Credit for the Poor” for government agencies implementing lending programs. In 1997, the NCC published the National Strategy for Microfinance (Annex 3) that has set the national framework for microfinance, emphasizing the role of the private sector, including MFIs, and the need for an enabling policy environment.

With the National Strategy in place, several laws and executive directives were issued to make it effective. The Social Reform and Poverty Alleviation Act of 1998 reinforced the market-oriented approach toward microfinance and further emphasized the importance of MFIs by establishing an institution to enhance their capacities. It created the People’s Development Trust Fund to provide grants and other financial assistance, excluding equity, to deserving MFIs for capacity building. The Government recently issued Executive Order 110, which specifies the guidelines to implement the provisions of that law.⁵⁷

Also in 1998, the Agriculture and Fisheries Modernization Act was passed, calling for the rationalization of all agriculture-related credit programs of the Government. This was followed by the issuance of Executive Order 138, covering not only the agriculture-related credit programs but also all other government directed credit programs. The law and the presidential directive prohibit government line agencies from directly implementing credit programs and instead makes use of government financial institutions in channeling government funds to their targeted clientele. To avoid direct competition with the private sector, these institutions are limited to wholesaling the funds to participating financial institutions with emphasis on using community-based organizations, such as cooperatives and microfinance NGOs, as conduits. These participating institutions are, in turn, to retail the funds directly to their client-borrowers.

A major donor-funded project has been supporting implementation of these positive initiatives, the Credit Policy Improvement Project (CPIP), a USAID-supported technical assistance program to the NCC. CPIP’s objective is to help the NCC, through the secretariat, rationalize the government-sponsored credit and loan guarantee programs⁵⁸ through the following activities:

- modification of inappropriate policies and/or inefficient practices in government-sponsored credit and loan guarantee programs;
- formulation of appropriate savings and credit policies to guide the Government in facilitating access to financial services by the basic sector;
- implementation of viable alternatives to directed credit and loan guarantee programs; and
- increased participation of the private sector in the delivery of financial services.

CPIP includes policy review, analysis, and advocacy. For example, CPIP conducts studies that review, analyze, and recommend credit policies that are consistent with the establishment of a viable and sustainable financial market. CPIP technical assistance to the NCC has resulted in a number of critical credit policy reforms and has contributed to the strengthening of the NCC as the governmental interagency body in charge of credit policy formulation and monitoring. Results of CPIP include the national strategy as well as the laws and executive directives mentioned above. CPIP is currently assisting the NCC in finalizing the creation of a Standard Chart of Accounts and management standards in support of the credit cooperative movement. The aim is to ensure that bank and cooperative members’ funds are safe and that the benefits of microfinance are sustainable.

ACCOMMODATING LEGAL FRAMEWORK

For some time there has been a legal framework friendly to the establishment of formal, small-scale banks conducive to offering microfinance on a commercial basis. Although all banks are regulated by BSP, they are licensed under different Acts. The most significant difference among banks is with regard to minimum capital requirements (Box 3.2), ranging from as little as \$52,000 for rural banks in some municipalities to almost \$100 million for universal commercial banks. This tiered licensing structure has allowed the establishment of many small rural banks since 1952. Today, there are around 786 rural banks, covering 85% of all municipalities, mainly catering to micro and small-scale entrepreneurs.

In addition to the tiered licensing system favorable to the provision of microfinance on a commercial basis, the recent enactment of the General Banking Law of 2000 (GBL) has set the stage for specific legal and regulatory adaptations concerning microfinance. The GBL “has the potential to initiate a new era for microfinance through its explicit recognition of microfinance in Sections 40, 41, and 44, which mandate the formulation of appropriate rules and regulations for microfinance operations.”⁵⁹ Section 40 describes the information that may be required by a bank as part of an applicant’s consideration for a microloan and recognizes “the peculiar characteristics of microfinancing, such as cash flow-based lending to the basic sectors that are not covered by traditional collateral.” Section 41 authorizes 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 GBL thereby lays the groundwork for the issuance of new regulations and modified supervisory practices that are conducive to the increased provision of commercial microfinance (Box 3.3).

Box 3.2
Minimum Capital Requirements

	Amount (P million)	Amount (\$'000)
1) Universal Commercial Banks	4,950.0	100,000
2) Regular Commercial Banks	2,400.0	48,000
3) Thrift Banks		
With Head Office		
Within Metro Manila	325.0	6,500
With Head Office Outside Metro Manila	52.0	1,050
4) Rural Banks		
Within Metro Manila	26.0	520
Cities of Davao and Cebu	13.0	260
1st to 3rd class cities and 1st class municipalities	6.5	130
4th to 5th class cities and 2nd to 4th class municipalities	3.9	78
5th to 6th class municipalities	2.6	52

Source: BSP 2002d.

Section 34 of the GBL also gave the Monetary Board of BSP the authority to prescribe the minimum ratio that the net worth of a bank must bear to its total risk assets. As of July 2001, the Monetary Board-approved guidelines for the risk-based capital adequacy ratio took effect. The new guidelines are patterned after the Basle risk-based capital framework, which is currently the international standard for setting minimum capital adequacy requirements.

The Philippine framework has, however, made some modifications to take into account local conditions and practices. It initially covers only capital requirement for credit risks, pending the issuance of supplementary guidelines to incorporate market risks. It sets the required minimum ratio at 10%, maintaining the minimum capital ratio under the current system, while the

Box 3.3

Traditional Banks and Microfinance

"In the last couple of years, microfinance has made much progress towards the mainstream, thanks largely to the continuing efforts of the pioneer NGOs. Their methods and practices have been refined further to move the delivery of credit to the poor...towards a paradigm of sustainable free enterprise with a social conscience.

The banking community, with its greater access to resources and its broader network, is in a position to magnify the impact of microfinance. Banks can better serve the poor by combining the effective credit delivery systems of microfinance pioneers with their existing fund and risk management skills.

We don't need to re-invent the wheel, but we need to learn from the experience of microfinance institutions by offering the poor financial products suited to their needs. Average loan size is small, around P2,000 to P5,000, just enough to provide working capital. Loan terms are short and payment terms depend on cash flow ranging from daily, weekly or semi-monthly. Interest rates are high enough to cover higher transaction costs, overhead, provisions, as well as profit. Physical collateral is substituted with social collateral that relies on borrower's reputation. Loan disbursement is quick and documentary requirements are kept simple.

Using this formula, microfinance institutions have been able to lend successfully to the poor, earning reasonable returns and keeping non-performing loans extremely low, certainly, much lower than current non-performing loan (NPL) averages across the whole banking industry. No less important, they are able to mobilize significant amounts of savings from the same base, laying the basis for self-sufficiency."

Source: Buenaventura 2001.

internationally recommended minimum ratio is 8%.

The new risk-based capital adequacy requirement will be applied not only to the internationally active banks but also to all other types of banks including thrift banks and rural banks. Changing from traditional supervision to risk-based supervision is important for the expansion of commercial microfinance because it dispenses with the necessity for traditional collateral and financial documentation in favor of systems, policies, and procedures to demonstrate ability to manage credit risk.

SUPPORTIVE REGULATION AND SUPERVISION

To implement the sections of the 2000 GBL dealing with microfinance, BSP has issued four circulars. Circular 272 (issued in January 2001) modified BSP regulations, consistent with the GBL, to accommodate cash flow-based lending rather than lending focused on traditional collateral. Circular 273 (February 2001) lifted the moratorium on the establishment of new banks to allow the entry of new microfinance-oriented thrift banks and rural banks. As a follow-up to Circular 273, Circular 340 (July 2002) elaborated the rules and regulations concerning the establishment of branches/loan collection and disbursement points (LCDPs) of microfinance-oriented banks established under Circular 273 and the establishment of microfinance-oriented branches/LCDPs of banks that are not wholly microfinance-oriented. Circular 282 (March 2001) opened a special rediscount window to provide liquidity for microfinance loans meeting BSP criteria.

Adaptation of Bank Regulation and Supervision for Unsecured Microcredit

Circular 272 established guidelines on "microfinancing loans" and implemented several of the provisions found in Sections 40, 41, and 44 of the GBL. In issuing the Circular, BSP recognized the peculiar characteristics of

microfinance, particularly its focus on cash flow-based lending that is not normally covered by traditional collateral.

Microcredit was defined in Circular 272 as “small loans granted to the basic sectors, on the basis of borrower’s cash flow and other loans granted to the poor and low-income households for their microenterprises and small businesses. These loans are typically unsecured. The maximum principal amount of microfinance loans shall not exceed P150,000 (\$3,000), which is equivalent to the maximum capitalization of a microenterprise as defined in law.” This definition of microfinance was important not only to convey a common understanding of what microcredit is but also what it is not. The emphasis on allowing microborrowers flexibility in choosing their amortization based on the underlying cash flow of their microenterprise is a clear indication that microcredit is not based on the traditional terms of commercial loans. Microfinance loans may be amortized daily, weekly, bimonthly, or monthly, depending on the cash flow condition of the borrowers.

As stated in Circular 272, interest on microcredit shall be “reasonable but shall not be lower than the prevailing market rates to enable the lending institution to recover its financial and operational costs.” This is a clear indication that BSP is interested in promoting viable, financially self-sufficient MFIs and overtly discourages subsidized lending. As an incentive, Circular 272 noted that all microfinance loans shall count toward compliance with mandatory credit requirements for small and medium-sized enterprises. To ensure the safety of lending financial institutions, BSP outlined several conditions for compliance. These include the setting up by lending banks of: (1) well-defined standards, credit policies, and procedures for microfinance loans; (2) a loan portfolio and other risk-asset review system; and (3) specific measures to ensure collections.

Facilitating Transformation and Branching

BSP partially lifted the general moratorium on the licensing of new thrift and rural banks in

Circular 273 to allow the entry of microfinance-oriented banks on a very selective basis. Markets not yet fully served by existing rural banks are to be given preference in licensing consideration. Subject to the standard requirements for the establishment of branches, microfinance-oriented banks are also exempted from the general moratorium on the establishment of bank branches. Further, existing microfinance organizations may be allowed to convert their existing branches/offices into branches of the proposed bank by applying for such authority. These measures support the commercialization of microfinance and the transformation of NGOs into regulated microfinance institutions.

An applicant microfinance-oriented bank, either a thrift bank or a rural bank, should meet certain conditions in implementing Circular 273, including that capital should be owned by private persons, multilateral entities, or a combination thereof. In addition, there are minimum capital requirements (see below).

Moreover, organizers must have the capacity to engage in microfinancing. Among the indicators of this principle are: (1) at least 20% of paid-in capital of the bank must be owned by persons with track records in microfinancing; (2) the majority of board members must have experience in microfinancing, with at least one member having actual banking experience; and (3) the proposed bank must have, as a minimum, an adequate loan tracking system that allows daily monitoring of loan releases, collection and arrearages, and any restructuring and refinancing.

In addition, the organizers must submit a clear vision and mission statement of their commitment to reach low-income clients, including a written manual of operations inclusive of the administrative and credit program systems and procedures. Once operational, the microfinance-oriented bank is required to maintain at all times its microfinance loan portfolio, as defined under existing BSP regulations, equivalent to at least 50% of the bank’s gross loan portfolio.

Building on Circular 273, Circular 340 lays out the regulations for the establishment of branches/LCDPs of microfinance-oriented banks

and the establishment of microfinance-oriented branches/LCDPs of banks that are not microfinance-oriented. For microfinance-oriented banks, capital requirements for each branch/LCDP were set at P20 million (about \$400,000) for commercial banks, P5 million (\$100,000) for thrift banks, and only P2.5 million (\$50,000) for rural banks.⁶⁰ The bank's risk-based capital adequacy ratio at the time of filing the application must not be lower than 12%. For banks that are not microfinance-oriented, at least 70% of the deposits generated by the branch to be established shall be actually lent out to qualified microfinance borrowers and the microfinance loans of the branch shall at all times be at least 50% of its gross loan portfolio. For microfinance-oriented banks, the only additional requirement is that they have been profitable for at least 1 year.

Rediscounting Window for Microfinance

Circular 282 contains the guidelines for accessing liquidity assistance from BSP by microfinance-oriented banks. This circular is expected to encourage rural banks to expand their microfinance activities by providing them additional liquidity to fund their lending operations. The new rediscounting window should also help microfinance institutions to diversify their funding sources to enhance their ability to serve a greater number of low-income communities with microfinance services.

Under the new scheme, rural banks/cooperative rural banks have to meet the following eligibility requirements: a 1-year track record in microfinance lending; at least 500 active microfinance borrowers; and (3) an efficient loan collection performance. The criteria for efficiency are a ratio of past due loans to loans outstanding less than 5% as of the preceding month, and a collection ratio of at least 95% based on the ratio of total collections to total loans (inclusive of past due loans) during the preceding 12-month period.

The loan value of rediscounting credits for microfinance shall be equivalent to 80% of the outstanding balance of the microfinance

borrower's promissory note. The maturity of rediscounting credits extended by BSP is up to 360 days and their interest rate is based on the 91-day T (Treasury)-bill rate for the last auction date of the preceding month.

Loans to small and medium-sized enterprises can be rediscounted with BSP as long as they meet certain requirements. Moreover, in recent years the monetary authorities have approved the opening of various rediscounting windows to improve access to credit by other productive sectors of the economy. These windows include the Exporters Dollar and Yen Rediscount Facility, which provides dollar- or yen-denominated credits to banking institutions against eligible papers of their exporter-borrowers; the rediscounting window for low-cost housing, which allows banks to rediscount amortizations covering principal payments due within 1 year from the date of the rediscount; and the rediscounting of both export and import domestic-use bills of exchange arising from the sale or movement of goods, excluding capital goods and deferred payments in letters of credits secured by a trust receipt. These efforts demonstrate that BSP is continuously reviewing its rediscounting facilities to ensure greater market orientation and availability to a wider sector of the economy.⁶¹

Regulation of Cooperatives

Although cooperatives have been in existence since the early 1900s, their potential to be viable and sustainable MFIs has been neglected. Previous government efforts have been more toward the promotion and proliferation of cooperatives (and their registration) than toward strengthening and encouraging financial self-sufficiency. Realizing this potential, the NCC, in coordination with the CDA and major credit cooperative representatives, initiated moves to strengthen the cooperative sector by formulating a Standard Chart of Accounts and its accompanying Manual of Accounts. The approved Standard Chart of Accounts approximates that of the banking sector. The CDA Board of Administrators issued a circular

requiring all cooperatives engaged in credit activities to use the standards by January 2003.⁶²

SOURCES OF COMMERCIAL FUNDS

People's Credit and Finance Corporation

PCFC was established in 1995 as an apex organization (wholesale lending institution) for lending to the poor. PCFC is a registered finance company and its Articles provide for it to be privatized. In 1995, it also received ADB-IFAD funding for onlending to MFIs, in particular those following the Grameen model. It is also the executing agency of UNDP's MicroStart Program for institutional development of ASA replicators. PCFC funds MFIs, including NGOs, rural banks, cooperatives, and other intermediaries as conduits for onlending to the poor. These intermediary organizations are required to operate in a self-sustaining and operationally viable manner.⁶³ PCFC started operations in 1996 by taking over the capital and loan portfolio of LBP under an earlier anti-poverty initiative, the National Livelihood Support Fund, with an initial (common) capital contribution of P100 million. This was augmented in 1998 by P900 million (preferred),⁶⁴ earning dividends of 5% per annum.

PCFC also plays an informal supervisory role. As lender to a wide range of small MFIs, it has a legitimate concern to safeguard its resources by requiring their adherence to appropriate accounting and reporting standards and operational methods. In addition, it has concern for capacity building among its client organizations. In this regard, it cooperates with the People's Development and Trust Fund, which was created specifically for capacity building of MFIs. PCFC maintains dialogues with MFIs, their networks, and with such external agencies as the Washington-based Consultative Group to Assist the Poorest (CGAP), which is influential in defining performance standards for MFIs.

The interest rate that PCFC charges borrowers can be considered commercial in the current interest rate environment: 12% per

annum (via its investment credit line) on a declining balance basis (the average prime lending rate by commercial banks at the time of this study was around 8% on the same basis). A notable requirement for accessing PCFC funds is that the participating organizations borrowing under the ADB-IFAD Rural Microenterprise Finance Project (for Grameen replicators) must charge a minimum 24% (flat basis) annual interest rate, ensuring an adequate return for PCFC's borrowers.

At the end of 2001, there were 193 participating organizations borrowing from one or more of PCFC's three wholesale lending programs (one for Grameen replicators, one for ASA replicators, and one for subwholesalers of funds for onlending to their primary members). PCFC's outstanding loan portfolio of P1.39 billion (\$28.0 million) grew 31% during 2001 and collection rates remained high at 98.6% and past dues stable at 2.5%. At the end of 2001, the active participating organizations by institutional type included 94 rural banks (including 26 cooperative rural banks), 63 cooperatives, 30 microfinance NGOs, 5 thrift banks, and 1 lending investor. These participating organizations onlent PCFC funds to some 158,000 clients in 2001, a cumulative total of 482,000 clients from inception of the program.⁶⁵

Donor-funded Second-tier Loan Funds

Two second-tier loan funds funded by international NGOs also deserve mention—the Responsible Investments for Solidarity and Empowerment (RISE) program of Catholic Relief Services (CRS) and the Small Economic Activity Development (SEAD) program of CARE—because they are incorporating terms and conditions facilitating microfinance NGO access to market-based sources of funds in addition to enhancing their technical capacities.

RISE Program

RISE was officially certified as a financial company in April 2000. While it charges cost-recovery interest rates, RISE is not very

commercial in the sense that it is partly owned by CRS along with four other NGOs. RISE is a for-profit financial company established for the purpose of lending to Grameen Bank replicators in the country. Although RISE indicates that it lends to microfinance NGOs at commercial interest rates, its own structure is not completely commercial primarily because of its NGO ownership. Despite this, RISE's financial services and the capacity-building assistance of CRS to MFIs continue to play an important role in disseminating information on current microfinance trends and best practices, as well as developing the efficiency of partner organizations. CRS also aims to create a learning center that will provide capacity-building assistance to RISE borrowers and their clients.

Since the mid-1990s, CRS has been nurturing 10 church-linked microfinance programs. To date, 8 of them have registered as NGOs specializing in microfinance. These microfinance NGOs are all self-sufficient and successfully mobilizing client savings, albeit without regulation and supervision. CRS and RISE are working together to improve the outreach and sustainability of these microfinance NGOs. As of September 2001, borrowers from RISE collectively had disbursed \$1.4 million in microloans to a total of 29,618 borrowers. The clients are disadvantaged but entrepreneurial poor nationwide, and 99% of them are women. RISE envisions increasing the employment opportunities and household income of poor women by improving their access to loans. The RISE target is to reach a total of 80,000 poor female entrepreneurs by 2006.

SEAD Program

The SEAD program assists poor entrepreneurs, mostly women, to increase income and savings for household livelihood security by providing continuous access to savings, credit, and business development services through local partnerships. The SEAD program operates in more than 15 provinces with 13 full-time staff. The program implements two subprojects. First is the MicroEnterprise Assistance Program (MAP), a credit, savings, and capacity-building

program; it is also a performance-based lending program, whereby loans are released contingent to meeting agreed performance standards. Current MAP focus areas are the provinces adjacent to the National Capital Region (NCR). The second project is MicroEnterprise Assistance through Cooperatives for Real Outreach (MACRO). It is an offshoot of MAP to address the issue of scale in outreach and sustainability of services. It aims to develop technically more competent and efficient financial intermediation among cooperatives.

At the end of 2001, there were just over 100 partner organizations in the SEAD program, most of which were cooperatives. MAP funds are available on a commercial basis to cooperatives, rural banks, and microfinance NGOs at 14% plus a 2% technical assistance fee based on diminishing balance. Credit lines range from P500,000 to P4 million (\$10,000–80,000), payable in 2 years (maximum) per drawdown. Succeeding drawdowns are based on how the partner organization can maintain the standards set by the program. These organizations then onlend funds to their clients at cost-recovery interest rates ranging between 1.5% and 4.0% per month (flat) rate payable from 3 months to 1 year. In total, the partner organizations had an outstanding microloan portfolio of P72 million (\$1.5 million) to 48,815 borrowers (80% women) at the end of 2001. The average loan size was P8,490 (\$170) and repayment rates averaged 96%. The total amount of savings and CBU generated from members was P215 million (\$4.3 million). Total net income generated by the partner organizations was P29 million (\$580,000) and CARE estimated its MAP to have OSS and FSS of 132.6% and 121.4%, respectively.

Private Bank Loans to MFIs

Most private commercial banks in Asia and the Pacific have been extremely tentative in their approach to microfinance.⁶⁶ While there is a long tradition of government-subsidized loans channeled through banking systems, lending to MFIs as a profitable business is comparatively rare.

Although MFIs are generally not able to meet the stringent borrowing criteria required for commercial loans in the Philippines, there are some cases where private commercial banks have made lines of credit available to particular MFIs. However, in one case this occurred at a submarket rate of interest (below prime) and in another, the bank concerned channeled the money through its charitable foundation to allow for a tax write-off in case the loans failed.⁶⁷

Good performance by certain NGOs encouraged some banks to risk lending to them, but the crisis in 1997 cut short this experiment. At that time a single NGO, TSPI Development Corporation, had eight loans from three leading commercial banks and its financial performance was exemplary. TSPI's funders for 2000 and 2001 included Bank of the Philippine Islands (BPI), the BPI Foundation, Inc., Development Bank of the Philippines; LBP; and Small Business Guarantee and Finance Corporation. Most loans that TSPI and other microfinance NGOs have recently accessed from private commercial banks are at interest rates above prime and could, therefore, be considered commercial or market based. However, interviews suggested that personal relationships between board members of TSPI and senior bank executives were the primary motivation for these arrangements.⁶⁸

EXISTENCE OF KEY SUPPORT INSTITUTIONS

The existence of several microfinance networks and training institutions has helped the microfinance industry to grow and strengthen over the last 10 years. However, many of these support institutions are geared toward the traditional NGO model and group-lending methodologies and lack the commercial perspective necessary to serve the needs of many commercial MFIs. The Philippines lacks some key support institutions, such as credit bureaus and credit rating agencies, to support a truly commercial microfinance environment.

Microfinance Networks

There are three major MFI networks that provide a means for coordination and limited self-regulation. Each has only small membership compared to the total number of MFIs (including microfinance-oriented NGOs, rural banks, and cooperatives), although they were established in the early 1990s. There is also a regional network, CASHPOR, Inc., in which many of the Grameen replicators in the Philippines are quite active. These networks are described below.

Microfinance Council of the Philippines

The Microfinance Council is the largest domestic network with 17 regular members and 6 associate members (comprised of a mix of microfinance-oriented NGOs, rural banks, thrift banks, and cooperatives) and 6 allies: ADB, BSP, NCC, PCFC, UNDP, and USAID. With high credibility among practitioners, government agencies, and donors, the Microfinance Council undertakes five major activities: coalition forming, research, developing and promoting standards, training, and advocacy. The Microfinance Council began with USAID funding for the creation of a Coalition for Microfinance Standards and continues with significant counterpart contributions from membership of the now renamed Microfinance Council of the Philippines.

One of the major early achievements of the predecessor of the Microfinance Council was the formation of a coalition of 69 microfinance NGOs, government agencies, microfinance networks, government and donor-funded microfinance programs, and other support institutions; and their agreement on a set of performance standards to guide the transformation of microfinance NGOs into viable and sustainable operations. Standards were set in 1998 to cover performance areas, such as outreach, portfolio quality, collection efficiency, sustainability, capital adequacy, and liquidity. Major activities of the Microfinance Council now include producing a semiannual newsletter that includes performance comparisons of members,

and running specialized microfinance training programs. The latest of these was a Market Research for Microfinance course that was developed by microfinance experts associated with MicroSave Africa, a project funded by UNDP, CGAP, and the United Kingdom Department for International Development.

In 2002, the Small Enterprise Education and Promotion (SEEP) Network selected the Microfinance Council as one of 10 participating national networks worldwide to join SEEP's Technical Assistance and Action Research Project (TAARP). SEEP will assist the Microfinance Council in delivering demand-driven fee-based services to members and MFI clients, improving dissemination of international and domestic microfinance best practices, improving the monitoring and benchmarking of the microfinance industry, increasing transparency in MFI financial performance, and representing members' interest to the Government and funding agencies. As such, selection by SEEP to participate in the TAARP project has the potential to strengthen significantly the Microfinance Council's ability to assist in professionalization and commercialization of the microfinance industry in the Philippines.

PhilNet

PhilNet, the Philippine Network for Helping the Hardcore Poor, Inc., is a national network of 10 Philippine microfinance NGOs employing the Grameen Bank approach. PhilNet works to reduce extreme poverty in the Philippines, targeting women particularly, through livelihood and business enterprises for the very poor. With an emphasis on poverty reduction, PhilNet does not have a clear mission to support commercial MFIs. Instead, the network promotes and initiates start-up microfinance NGOs and provides linkages through exposure training and shared advice. PhilNet strengthens current programs by serving as an information and technical source for member MFIs. PhilNet also facilitates and conducts research to seek advancement for its member MFIs while mobilizing resources from funding agencies.

In 1999, PhilNet began working with CASHPOR under an \$837,000 agreement with the Finnish Government to strengthen Grameen replicators in the Philippines. CASHPOR is a network of 22 Grameen Bank replicators in nine Asian countries working to reduce poverty in the region through financial services to poor women. The CASHPOR network was established in 1991 through the felt need of Grameen replicators for an organization to strengthen their capacity to expand and to provide management training, quarterly monitoring, technical assistance, and information exchange. CASHPOR worked jointly with PhilNet so that the latter could take over the full range of training and technical assistance required by its members.

PhilNet has been a major actor in the microfinance scene in the Philippines for some time. Four of the members—ASHI, CARD, Project Dunganon, and TSPI—have been in existence for more than a decade and have already overcome the problems of start up and institutionalization. CARD has a rural bank as well as a microfinance NGO, while ASHI, Project Dunganon, and TSPI are professionally-run microfinance NGOs. These four PhilNet programs are responsible for nearly half of the current clients currently reached by PCFC. In addition, PhilNet has run a "Basic Series" of management training workshops several times. Its members have an in-house training capacity used by PCFC and donors to train start-up MFIs in the Grameen methodology. Despite the longevity of PhilNet, its influence seems to be waning, because its largest members appear to be more active in their participation in the Microfinance Council. The latter has attracted significant membership and credibility, with a clear mission to support a broader range of commercial MFIs than does PhilNet.

Alliance of Philippine Partners in Enterprise Development, Inc.

Incorporated in 1991, APPEND has the mission to promote national economic transformation by harnessing and strengthening the resources of Christian development

organizations involved in microfinance. APPEND has a number of core microfinance NGO members: ASKI, Center for Community Transformation (CCT), *Hagdan Sa Pag-uswag* Foundation, Inc. (HSPFI), KMBI, *Rangtay sa Pagrang-ay*, Inc. (RSPI), *Talete King Panyulung Kampangan*, Inc. (TPKI), TSKI, and TSPI Development Corporation.

APPEND's main sources of funds are from consulting to other organizations, onlending membership dues, and training. Also and if APPEND secures project funding for a member, it receives 10% of the project amount. The network's main programs and services are to

- manage projects and funds;
- oversee network relations and provide a secretariat;
- act as the regional representative of Opportunity International;
- provide bridge (loan) funds to member organizations;
- provide microfinance and microenterprise development training and field exposure to local member organizations, other NGOs, and international partners;
- assist partners in fundraising through packaging proposals, negotiation with local and international donors, etc.;
- lead and facilitate the development and installation of effective and efficient systems of products and service delivery, management information systems, human resources development, governance, transformation, and resource mobilization; and
- assist partners in setting up such structures as rural banks.

Consultancy services have included setting up microfinance projects (e.g., the president of APPEND was instrumental in establishing

microfinance projects in Latin America and Asia using a group methodology that produced branch viability within 12 months), impact evaluations, microfinance project and fund management, and building capacity of new and advanced MFIs. As part of Opportunity International, Inc., APPEND has helped microfinance NGOs to extend loans totaling more than \$100 million to microenterprises in the Philippines. APPEND believes that it is only through banks that member MFIs can sustain the burgeoning needs of micro and small-scale entrepreneurs and poor families. As discussed in Chapter 2, this thinking led most of the members of the APPEND network to form the OMB in 2002.

Training Institutions

A variety of microfinance training institutions exists in the Philippines. CARD's microfinance training center is perhaps the best known and most widely used to date. In addition, the Asian Institute of Management (AIM) Center for Development Management and the Asian Center for Entrepreneurship, with its leadership and creativity program, offer advanced training and certificate programs in areas such as project management, social development, and entrepreneurship. The institution that has arguably provided the most specialized microfinance training on a regular basis is the *Punla sa Tao* Foundation (Punla). It has the potential to serve as the "one-stop shop" that could help the microfinance industry build the technical capacity it needs for further professionalization and commercialization. Much depends on whether Punla's management decides to tailor its training programs in a sustainable fashion to a wide range of MFIs committed to commercial microfinance and able to pay for high-quality, demand-driven technical training in microfinance.

Punla is a nonprofit foundation organized to build the capacity of institutions to provide financial services to the poor in the Philippines and elsewhere in Asia. It is a social enterprise that offers entrepreneurial management services of training and consultancy, market research,

program management, and social investments to microfinance institutions, donors, and investors. Punla currently manages capacity-building programs for various government departments and funding agencies, including an P8 million grassroots banking program for the International Labour Organization in six rural and urban communities. These multiyear programs currently seek to develop the institutional capacities of 19 cooperatives, 5 NGOs, and several people's organizations. It has managed similar capacity-building programs for the Canadian International Development Agency (CIDA), the CDA, and the Department of Labor and Employment, benefiting some 17 cooperatives and NGOs since 1996. These programs, totaling P14.3 million, represent a major capacity-building investment in microfinance.

Punla's most active service is to train microfinance workers on how to bank with the poor. Punla offers customized courses to institutions as well as public offerings attended by participants from around Asia. Punla is also the Southeast Asian partner of the CGAP and

offers both Punla-designed and international CGAP courses. Its CGAP courses are being offered in partnership with the AIM faculty and are constantly updated to reflect new findings from global practices. Current CGAP courses offered are Delinquency Measurement and Setting Sustainable Interest Rates, Accounting for MFIs, Financial Analysis for Microfinance, Business Planning with Microfin, and Information Systems for Microfinance. The objective of these courses is to provide participants with practical, immediately-usable tools. The skills and knowledge gained in these courses often lead to better institutional and operational policies for the MFI.

Punla does not advocate a particular MFI technology but leaves the choice to the institution. Thus, it is able to serve all MFI institutional types—rural and cooperative rural banks, cooperatives, and NGOs. From 1997 to 2001, Punla trained more than 2,000 professional microfinance workers from 500 rural banks, cooperatives, and microfinance NGOs in the Philippines as well as some from other Asian countries.

4 Challenges to Microfinance Commercialization

Expanding access of the poor and near-poor to sustainable microfinance is the greatest challenge facing the Philippine microfinance industry. Many microfinance stakeholders see provision of commercial microfinance as the way to achieve this goal. However, several challenges to microfinance commercialization exist at the micro (institutional) and macro (operational environment) levels. Below are a few of the most pressing challenges.

INTERNAL CONSTRAINTS

Perhaps one of the most pervasive internal constraints to commercial microfinance is the perception problem. Because the microfinance market is not monopolized by microfinance NGOs, a big internal challenge faced by some players or potential players in the market (e.g., rural banks and cooperatives) is the lack of appreciation of the viability and sustainability of microfinance as a market niche.⁶⁹ Both the rural banks and the credit cooperatives have long been in operation but have only been recently engaged in the microfinance business. It is believed that the inadequacy or lack of appreciation of “success stories” testifying to the profitability of the venture is a major challenge to the commercialization of microfinance.

The perception problem, however, is partially based on the lack of ability or flexibility of the existing systems of rural banks and cooperatives to accommodate the unique features of microfinance technologies (e.g., daily or weekly monitoring of small repayments, and small deposits). Although most banks (especially thrift banks) have the ability to undertake market research, existing market research capabilities may not be appropriate to discern the needs and demands of microfinance clients.⁷⁰

Most other internal constraints faced by existing MFIs and potential new entrants have significant differences according to institutional type. The internal constraints in rural banks, cooperatives, and microfinance NGOs are examined below.

Rural Banks

Rural banks are ideally suited to the provision of commercial microfinance in that they are formal financial intermediaries run on a for-profit basis and have a wide client base over which to diversify risk. Unlike commercial banks in which management rotates every 2–3 years, rural banks are managed on a continuing basis with the same staff. This helps to keep information costs low when selecting micro- and small-scale borrowers and helps to build trust and confidence among clients who want to deposit small savings. These relations between customers and the bank, characterized by mutual trust, also attract some clients who could deposit with commercial banks.⁷¹

The other internal constraints to microfinance commercialization are relatively minor. Lack of a network, however, poses a constraint to the operation of microfinance programs by rural banks in terms of ability to distribute credit risk geographically and to provide customers with possibilities to withdraw savings or otherwise access their accounts in other areas. The only solution for gaining access to regional markets is to establish strategic alliances with other financial institutions or to branch out aggressively.⁷²

Access to support services is also a constraint.⁷³ The development of new microfinance products and services, the training of staff, and the enforcement of effective auditing and control mechanisms are expensive. The costs involved are too high for a single rural bank. To compete

over the long term, financial institutions like rural banks need effective support services that can be provided by a national apex organization or regional federations, or by alliances with other financial institutions.

Cooperatives

Cooperatives are also well suited to microfinance provision. Like rural banks, they are close to their communities and have good access to information on their membership. Member-clients also have a stake in the continued financial success of their cooperative, which helps to reinforce discipline in management and operations.

However, unlike rural banks, cooperatives are considered semiformal institutions; they are regulated and supervised by the CDA but this supervision is known to be weak. Lack of transparency has historically been a major difficulty in assessing cooperative performance but, with the recent agreement by the NCC on a Standard Chart of Accounts and the COOP⁷⁴ administrative standards and PESOS⁷⁵ financial standards, the remaining challenge lies in the widespread adoption and use of these standards.

Cooperatives, like the rural banks, suffer from a lack of an effective network, although this is improving through the CIDA-funded NATCCO-FI project. Access by cooperatives to support services also remains weak. Further strengthening of NATCCO will be necessary in order for it to assist the cooperatives in many important areas, including management information systems, internal audit and control, human resource development, market research, and product development.

Microfinance NGOs

With the growing scarcity of donor funds for microfinance onlending, most microfinance NGOs are now faced with the challenge of finding funds from commercial sources or from deposits of their member-clients. Because deposits are considered a cheaper source of funds than commercial loans, the inability of NGOs

to mobilize deposits legally poses a significant internal challenge. Lack of legal identity stemming from weak ownership and governance structures poses the greatest challenge to microfinance NGOs in accessing funds to provide microfinance on a commercial basis.

Commitment to balancing social and commercial objectives is also an important internal challenge faced by most microfinance NGOs. The majority, especially small microfinance NGOs, have an inordinate focus on providing microcredit as a social service without adequate appreciation of or attention to sustaining themselves as a “going concern.” Most microfinance NGOs, therefore, remain small and weak and dependent on fresh infusions of subsidized funds for their survival. Those that have taken a more balanced approach in their provision of microfinance, such as CARD and TSPI, provide ample evidence that their commercial approach to microfinance operations is compatible with their desire to assist the poor in gaining access to diversified, demand-driven microfinance products and services.

Related to constraints stemming from small size and weak capacity, many microfinance NGOs face the constraint of poor access to appropriate systems and support services. This issue was reflected in a January 2002 report by the Microfinance Council⁷⁶ containing survey responses from 90 leading MFIs in the Philippines (including all major microfinance NGOs and many leading rural banks and cooperatives with microfinance operations), which indicated what they saw as the major constraints to expanding their microfinance operations. Participating microfinance NGOs noted inadequate management information systems⁷⁷ and the lack of capacity to undertake market research as two major constraints curtailing their growth. The report indicated that “although computerization of systems has been identified as essential to the growth of MFIs, there still appears to be a supply problem in terms of affordable, commercially available, off-the-shelf software packages that suit the system and information requirements of MFIs.”⁷⁸

Software is a particularly acute problem for microfinance NGOs that, because of their limited funds, have had to develop ad hoc management information systems that are unable to accommodate sustained increases in outreach. Coupled with this problem in most microfinance NGOs is the lack of a research and development function to conduct market research on a regular basis. Market research is a relatively new concern for most MFIs, prompted by increased client exit (heightened drop-out rates) and the desire to improve repayment performance. Given the strong recent interest in undertaking market research, the need to build this capacity in MFIs is great, especially in microfinance NGOs, which face limited funding to support their increased lending.

CONSTRAINTS IN THE OPERATING ENVIRONMENT

Private Sector “Crowding Out” by Government Microcredit Programs

Executive Order No. 138 abolished subsidized, directed credit programs and laid the framework for all government directed credit programs to be transferred to financial institutions. These phaseout and transfer processes began in 1999 and were supposed to be completed by February 2002, but they are still ongoing. In addition, several new government poverty reduction programs have begun, giving what are essentially grants thinly disguised as interest-free loans. Such continued access to subsidized government credit programs “crowds out” provision of private, sustainable microfinance services.

Mandatory Lending and Investment

Presidential Decree 717, otherwise known as the Agri/Agra Law, mandates that all banks set aside 25% of their net loanable funds for agricultural lending, of which 10% is supposed to be lent to agrarian reform beneficiaries. While

minimum lending requirements have been easily exceeded for the agricultural group, given the good number of creditworthy agribusinesses, compliance has not historically been met in terms of lending to the agrarian reform beneficiaries.⁷⁹ The main reason is that banks are not established to manage profitably the provision of small loans to the widely dispersed beneficiaries.

Even though the Government has provided other means for complying with this law, such as investment in various types of bonds and securities, the regulation essentially acts as an unnecessary tax, particularly on large banks, without addressing the root causes of lack of lending to small farmers.

Another regulatory measure, Republic Act 6977, the so-called Magna Carta for Small Enterprises, acts as a similar drain. Under the Act, all lending institutions are now required to set aside at least 6% of their total loan portfolio for small businesses and at least 2% for lending to medium-sized enterprises. Only instruments issued by the Small Business Guarantee and Credit Corporation, which do not pay interest, and noninterest bearing deposits with BSP are deemed alternatives for complying with this regulation.⁸⁰

Threat of Policy Reversal

The very convenient nature of direct credit provision by government makes it politically expedient and tempting for policymakers to revert to the previous policy of regulating interest rates and supporting directed credit programs (Box 4.1). The challenge to prevent this lies not only with the Government but also with private sector MFIs. It is imperative for all types of MFIs to close ranks and advocate actively that the Government continue moving away from outright credit provision and focus its interventions where it has distinct comparative advantage (e.g., provision of basic support infrastructure and an appropriate policy and regulatory environment, social preparation, and capacity-building activities).⁸¹

Box 4.1

Potential for Backsliding

"Section 43 [of the 2000 GBL] 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."

Source: Gomez, Fitzgerald, and Vogel 2000, p.29.

Unclear Regulation and Supervision Concerning Microfinance Operations

Significant improvements have been made in the last few years by the Government and BSP in recognizing microfinance and adapting regulation and supervision to the specialized nature of microfinance operations. However, the process of implementing several sections of the 2000 GBL is still in progress. Until the rules of engagement of formal financial institutions in microfinance are complete, uncertainties regarding the final form of regulation and supervision of microfinance-oriented banks may curtail efforts by formal institutions to downscale their operations.

Illegal Deposit Mobilization by Microfinance NGOs

A survey in 2001 of 23 of the largest microfinance NGOs showed that almost half of their combined outstanding loan portfolio was funded by a combination of savings or CBU,⁸²

despite the legal prohibition against deposit mobilization from the general public except with BSP licensure. Under the GBL, nonstock and nonprofit organizations are not permitted to accept savings and deposits in any form. So far, BSP has ignored the practice because the savings mobilized are only from microfinance NGO members and are mainly compulsory deposits, making the vast majority of members net borrowers.

Inadequate Access to Commercial Sources of Funds

One of the consequences of not being able to mobilize deposits overtly is that many microfinance NGOs remain highly dependent on external funding, which has historically come from donors. In recent years, PCFC has grown to become the largest single provider of wholesale funds to the microfinance sector. The interest rate that PCFC charges borrowers can be considered commercial in the current environment because in 2001, it was lending at 12% based on a declining balance (via its investment credit line), whereas the average prime lending rate by commercial banks then was around 8%. However, these funds have been mostly directed toward participating organizations following the Grameen Bank approach,⁸³ hindering use of its funds by MFIs that follow other models.⁸⁴ Commercial bank loans to MFIs have been extremely rare, mainly due to a lack of transparency in the operational and financial performance of microfinance NGOs and cooperatives. The commercial loans that have been issued were in some cases backed by collateral, such as real estate, and always facilitated by personal relationships.

No Credit Information Bureau that Captures Microcredit Information

A private, nationwide credit bureau run by the Bankers Association of the Philippines (BAP) has been in operation since 1990. As of January 2002, this negative-file information system contained data on more than 1.4 million borrowers. However, it is only accessible to

commercial banks and does not capture microcredit information that would be useful to the full range of MFIs engaged in microfinance. With increasing microcredit provision by microfinance NGOs, rural banks, and cooperatives, creation of a credit bureau that captures microcredit information from these actors is becoming increasingly vital to the continued health of the industry.

Lack of Microfinance Training Centers

There is a variety of microfinance training programs. However, no “one-stop shop” yet exists for the provision of regularly scheduled, demand-driven, and affordable technical courses on microfinance program management and operation. CARD’s microfinance training center is perhaps the best known and most widely used, but it cannot be considered as a wholly professional training institution that would attract a wide

variety of regular students from different types of MFIs. AIM’s Center for Development Management and Asian Center for Entrepreneurship and its leadership and creativity program offer advanced training and certificate programs in such areas as project management, social development, and entrepreneurship. However, AIM has not yet designed public training programs for MFI managers that exclusively address commercial microfinance issues. The institution that seems most suitable for offering additional microfinance training on a regular basis is Punla, provided that its management focuses on developing demand-driven courses suitable for a wide range of viable MFIs. To serve as the one-stop shop to build the technical capacity that the industry needs for further professionalization and commercialization, Punla will need to shift its focus more toward serving the complex and varied needs of commercial microfinance providers.

5 Implications of Microfinance Commercialization

So far, this analysis of the progress of microfinance commercialization and the challenges that remain has assumed that commercialization would have a positive impact on poverty reduction, including increased outreach, improved efficiency, and long-term viability of microfinance providers. For MFIs, commercialization is expected to pave the way for the entry of private capital. This, in turn, will provide more capabilities for expansion into untapped markets and more diverse microfinance products. However, some stakeholders are concerned that further commercialization could have negative social impact or result in mission drift, such as shifting the target market from microentrepreneurs and poor households to small enterprises and household at or above the poverty line. This chapter reviews a few of the most common likely implications of microfinance commercialization and addresses the related concerns.

INCREASED OUTREACH AND COMPETITION

As more microfinance providers demonstrate the profit potential of microfinance, more entrants will be attracted to the market. In this sense, increased commercialization is likely to have a positive impact on outreach in the future, resulting in more clients served and increased competition among MFIs. However, given the fact that only about 20% of the market is currently served, few negative repercussions of such competition are likely to result in the next 5–10 years, except in a handful of urban and highly-populated rural areas where some localized competition is beginning to increase.

Growth in the sector is not likely to come from the gradual growth of the vast majority of existing microfinance NGOs. It is likely that other types of organizations (for example, rural banks, cooperatives, microfinance-oriented banks, etc.) will increasingly enter microfinance, as it becomes clear that the poor can be bankable, and as the methods for reaching the poor become better understood. This has happened in other countries with relatively developed financial sectors as microfinance has matured (particularly in Latin America). Only a few microfinance NGOs will likely become self-sufficient and able to raise resources without resorting to donors and these will offer most of the outreach by microfinance NGOs. Most of the older microfinance NGOs that have not yet broken through the threshold of 5,000 active clients appear to be steeped in a multisectoral, social-service orientation that is fundamentally incompatible with large-scale outreach and viability and unlikely to change. Given the size of the Philippine market for microfinance, there is clearly a role for a number of MFIs, as long as these organizations can achieve genuine financial viability. As for expanding geographic coverage, it will take a mix of large nationwide or regional organizations and smaller local providers to cover the whole country.⁸⁵

IMPROVED EFFICIENCY

As discussed in Chapter 3, the legal and regulatory environment is becoming increasingly conducive for MFI geographic expansion and this is creating some friction. Before MFIs achieve financial self-sufficiency, the players in the field are generally allies but once they break-even and begin to strive for scale, they act more like

competitors (Chu 1997). Striving for competitive edge in large part depends on an MFI increasing its level of operational (or cost) efficiency. Competition is one factor that can lead MFIs to drive down costs so that they can provide more demand-driven products and services on increasingly favorable terms to their clients. This allows MFIs to expand breadth and/or depth of outreach simultaneously while increasing profitability.

This trend has been demonstrated by a range of MFIs in the Philippines over the last few years. Cooperatives offering the SCWE loan product as part of their participation in the CUES project increased their OSS from 109% in 1996 to 126% by 1999; CUES cooperatives that did not offer the poverty product showed a smaller increase, from 111% to 119%, during the same period.⁸⁶ In addition, Freedom from Hunger, a collaborating partner on the project, reported that participating cooperatives offering the SCWE product generally earned a better return on assets than other cooperatives and lowered their operating expense ratio after introducing SCWE (Table 5.1). The World Council of Credit Unions, as the technical partner for the CUES project, reported that the operating expense ratio of all participating cooperatives decreased from 9.8% in 1996 to 8.0% at the end of 2001.⁸⁷

Also, rural banks participating in the RBAP-MABS program are increasingly bringing down

their costs through adoption of time- and money-saving technologies (Box 5.1). Use of linkages to cut costs via ATM technology is also helping to achieve greater efficiencies at TSPI (Box 5.2). Other microfinance NGOs, such as NWTF (Table 5.2), have increased their administrative and operational efficiency without sacrificing the quality of products and services.⁸⁸ Once NWTF achieves FSS, it can be expected to concentrate on providing microfinance on increasingly attractive terms to clients in order to increase its outreach.

INCREASED ACCESS TO COMMERCIAL FUNDS

Increased commercialization has already resulted in improved access to commercial sources of funds, especially in terms of savings mobilization, but also through private equity investment. As more and more rural banks and cooperative savings and credit banks enter the market, they bring with them the ability to mobilize savings deposits, including microsavings (amounts under P15,000) from low-income people, in a cost-effective way. Rural banks mobilize a significant amount of microsavings deposits: P5.3 billion (\$106.0 million) in 4.3 million accounts as of March 2002. CUES-supported cooperatives have nearly tripled their

Table 5.1: Profitability and Costs of CUES Cooperatives

	1996	1997	1998	1999
Return on Assets (%)				
Cooperatives w/ SCWE (8)	2.4	3.4	3.3	4.4
Cooperatives w/o SCWE (4)	2.3	2.6	2.5	4.1
All CUES Cooperatives (12)	2.4	3.2	3.0	4.3
Operating Expenses/Average Total Assets (%)				
Cooperatives w/ SCWE (8)	10.6	10.7	9.1	9.7
Cooperatives w/o SCWE (4)	8.2	8.6	8.0	9.8
All CUES Cooperatives (12)	9.8	10.0	8.7	9.7

CUES = Credit Union Empowerment and Strengthening; SCWE = Savings and Credit with Education.

Source: Stack and Thys 2000, p.12

Box 5.1

Cutting Transaction Costs with Information and Communication Technology

Regardless of the legal structure of an MFI, achieving scale is critical to success. From an institutional perspective, the key to providing a wide variety of services for large numbers of clients is to reduce transaction costs. Average transaction costs can be reduced by increasing the number of transactions, and per-unit transaction costs can be trimmed by using new technologies and modes of delivery (for example, the use of ATMs through linkages; see Box 5.2).

New information and communication technology, such as smart cards and personal digital assistants (PDAs), can allow MFIs to drive down their costs as well as the transaction costs incurred by their clients. These cost savings can enable MFIs to offer more affordable and flexible products and services to greater numbers of clients in more diverse geographic areas.

For example, a few rural banks participating in the MABS program have been experimenting with use of PDAs. PDAs are small, portable handheld computers that can allow loan officers access to his/her institution's management information system from the field. Depending on location, information can be updated by the loan officer to the head office instantaneously or every day (which decreases the need for data entry clerks). The PDAs used in the pilot branches of the participating rural banks have greatly reduced the time needed for transactions between the loan officer and clients, leading to lower costs per transaction, improved service, and greater efficiency.

ATM = automated teller machine; MABS = Microenterprise Access to Banking Services; MFI = microfinance institution.

way, commercial MFIs serve an underserved market for small savings accounts while also satisfying their own need for a source of funds for onlending.

Commercialization often paves the way for the entry of private capital, which, in turn, allows for expansion into untapped markets and more diverse microfinance product offerings. The Philippines presents some early evidence that this is indeed the case. For example, as part of its transformation, CARD Bank tapped into another private source of funds by selling shares to clients and staff alike (Box 5.3). Other cases of transformation have potential to yield similar results. In addition, at least one MFI as part of its transformation is accessing loans from a global social investment fund at what are arguably commercial interest rates (13% per annum). The formation of MEB with a mix of donor and social investor capital also portends the future increased flow of private risk capital to formal MFIs.

However, large-scale inflow of private risk capital to formal MFIs in the Philippines is likely still several years off because of at least two major factors. First, the track record of transformed MFIs is still extremely short. Second, the particulars of regulation and supervision pertaining to microfinance-oriented banks are still unclear. Until there is clearer profit potential (based on at least 2 years of performance by the newly transformed NGOs and new entrant MEB) and the regulatory and supervisory framework is clarified, the microfinance sector will likely have to wait some time for the entry of substantial private risk capital.

EXPANDED ARRAY OF MICROFINANCE PRODUCTS AND DELIVERY TECHNOLOGIES

Despite the historical emphasis on the Grameen model of microfinance delivery in the Philippines, other models are increasingly being adapted and local innovations are emerging from recent formal entrants into microfinance. As competition increases from new and expanding MFIs, microfinance providers will need to

microsavings in just 3 years from \$3.3 million at the end of 1998 to \$9.3 million the end of 2001, despite a decline in the average savings balance from \$92 to \$86 in the same time period. In this

Table 5.2: NWTF Selected Efficiency Indicators

	1997	1998	1999	2000	2001
Administrative Efficiency (Administrative Costs ^a Excluding Financial Costs as % of Average Net Loan Portfolio)	61.20	42.50	45.10	40.93	34.71
Operational Efficiency (Operational Costs ^b as % of Average Loan Portfolio)	79.00	35.66	29.59	32.63	31.87
Personnel Costs as % of Total Administrative Costs	51.00	65.00	63.01	63.70	59.72
Number of Active Loan Clients per Loan Officer (Year End)	235	206	147	263	278
Outstanding Portfolio per Loan Officer (Year End) (Pesos)	468,797	588,779	452,233	995,954	1,407,502
Number of Clients per Branch Office (Year End)	1,176	1,378	1,413	2,010	2,334

NWTF = Negros Women for Tomorrow Foundation.

Notes: ^a NWTF's administrative costs include nonfinancial expenses directly related to the provision of financial services or other services that form an integral part of their financial services relationship with their clients. Examples include personnel expense, depreciation, utilities, supplies, advertising, transportation, training, communications, and consulting fees.

^b NWTF's operational costs include all administrative expenses, but exclude all financial expenses and loan loss provision expenses.

Source: ADB 2002c, p.15.

become more sensitive to the specific needs of their clients and develop an array of products and delivery mechanisms that keep customers satisfied.

In addition to microcredit product diversification, different types of flexible savings services are being designed specifically to attract microsavings in a cost-effective way. Microinsurance is another product attracting increasing interest. In addition, remittance services are being tested and leasing services may be on the horizon for MFIs. New technologies are helping to expand the array of microfinance products offered (see Boxes 5.1 and 5.2). All these trends should help increase access to microfinance over the next few years to an expanded set of clients in more diverse geographic locations.

Microcredit Products

Although much of the microfinance industry in the Philippines still draws from the Grameen model based on group lending, this is increasingly changing, as new methodologies (including individual lending, such as that of the ASA, are being adapted to the Philippines context. In addition, there is domestic experimentation and innovation by rural banks and cooperatives, as market research techniques are being promoted by several major donor-funded technical assistance projects. Moreover, new entrants are importing their particular brand of proven microfinance methodology, as in the case of MEB. These forces are contributing to a burgeoning in the types of microfinance products and services offered as well as achieving scale through reductions in average transaction costs.⁸⁹

Box 5.2

Use of ATMs in Microfinance

TSPI and the Land Bank of the Philippines (LBP) signed on 4 December 2001 a Memorandum of Agreement paving the way for use of ATMs (automated teller machines) in the delivery of microfinance to poor women entrepreneurs. A first in the Philippines microfinance industry, the use of ATMs in loan disbursement is seen as an important step toward improving efficiency in microfinance operations, facilitating expansion and outreach. ATMs allow clients to withdraw loan funds without use of a check, eliminating the check cashing process and reducing time spent waiting in line at the bank.

Use of ATMs likewise improves efficiency in branch accounting by reducing the volume of paperwork related to check preparation. Cost-saving measures not only relate to reduction of workload and paper use but also release the branch accounting clerk to concentrate on other important tasks.

TSPI = *Tulay sa Pag-unlad, Inc.*

Source: TSPI 2002, p.1–2.

Box 5.3

CARD Bank's Stock Sales

Initially, CARD Bank was owned by the CARD NGO (40%) and a few members of the board of directors and management staff (60%). In 2000, it initiated the sale of stock shares to its clients. As of May 2002, CARD Rural Bank's ownership structure consisted of the following equity owners: CARD NGO (44.2%), CARD Bank and CARD NGO staff (3.9%), CARD Bank and CARD NGO board members (22.6%), and clients (29.3%). CARD plans to transfer full ownership to landless poor women in the future, consistent with its original vision.

CARD = Center for Agriculture and Rural Development; NGO = nongovernment organization.

Source: ADB 2002e, p.5.

Leasing

MFIs are uniquely positioned to play an active role in the expansion of the leasing market for second-tier equipment, particularly because microenterprises comprise the largest segment of manufacturing, commerce, and industry in the developing world. Leasing provides MFIs with new opportunities to reach borrowers and expand into existing markets. The rapid growth of leasing in a number of developing countries indicates that leasing is addressing an important unsatisfied demand for financing. Leasing has the potential to develop into an effective financing technique that MFIs can use to reach those enterprises with financial needs that cannot be satisfied by traditional microfinance approaches.⁹⁰

Remittance Transfers

BSP reported that remittances in 2001 were \$6.2 billion, of which about 60% was from the United States and Canada.⁹¹ Formal institutions, such as rural banks, are increasingly tapping into this large market niche and, given the scale of remittances, may become an important part of the microfinance service menu for many. Some rural banks have been developing linkages with international remittance transfer companies, such as Western Union or commercial banks.⁹² Rural banks are prohibited from foreign exchange transactions; thus, they enter into an arrangement with commercial banks, which are allowed to perform foreign exchange transactions, so that the Philippine peso equivalent of the foreign exchange earnings of overseas workers can be remitted to their accounts with rural banks.

The scale of remittance transfers in the Philippines suggests that the development of remittance services may have high potential to expand the customer base of MFIs and add to their profitability. Indeed, some experimentation by CARD Bank in providing remittance services in cooperation with a domestic money transfer service provider has already taken place. In addition to the fee income generated by remittance services, other benefits for MFIs also may lay in

their ability to cross-sell other services. For the consumer, the advantages of MFIs as transfer agents may include lower costs compared to those of established transfer agencies, transparency about exchange rates disclosed at the point of sale, and increased reliability/security and speed.

Microinsurance

MFIs in the Philippines are increasingly experimenting with offering microinsurance products and in doing so are following both social and commercial agendas. With regard to their social missions, several microfinance NGOs are recognizing households' needs for protection against risk. Microinsurance is seen as a means for clients to reduce their vulnerability when taking advantage of economic opportunities. In addition, access to insurance from the social perspective allows clients to reduce the impact of losses that could exacerbate their poverty situation. Regarding their commercial agenda, MFIs venturing into microinsurance desire to enhance their sustainability and profitability by reducing the impact of client risk on MFI loan and savings portfolios, by generating additional revenue, and by having better services than their competitors (Box 5.4).⁹³

CARD Bank has ventured into microinsurance with well-balanced commercial and social perspectives. CARD Bank learned that when members died, their family members were often unable to pay back the loan. CARD set up an insurance fund called the Members Mutual Fund to cover death, disability, and pension benefits, based on actuarial recommendations concerning pricing and benefits. The management of the Fund was turned over to the members in September 1999 and it has been registered with the SEC as a separate legal entity called the CARD Mutual Benefit Association. Now CARD Bank, through its Mutual Benefit Association, provides life insurance, loan redemption, and provident fund/retirement savings. Fully owned by the clients, the management of the Association was turned over to them in 1999. It is now governed by its own board elected from among their ranks. Total assets

Box 5.4

TSPI's Microinsurance Initiative

As a means to help clients deal with risk, TSPI invited 11 insurance companies to bid on becoming its insurance service partner. The bidders worked around a "shopping list" of client needs and fixed fees based on payment capacity of poor microentrepreneurs. Eight insurance companies provided proposals and TSPI chose three of them to present to a sample of 79 clients for feedback. Based on client response, TSPI selected Cocolife as their insurance partner for women microentrepreneurs participating in TSPI's *Kabuhayan* (Livelihood) program (which follows the Grameen model).

Effective in October 2001, TSPI extended microinsurance coverage through Cocolife to an initial 29,968 clients. As of March 2002, TSPI had enrolled 37,743 clients for coverage. The benefits include (1) life insurance of P25,000 (\$500) (amount doubled in case of accidental death), (2) disability insurance up to P25,000, (3) medical expense reimbursement up to P2,500 (\$50) per year, and (4) settlement of the unpaid loan balance in case of client death. As of March 2002, TSPI had received 29 insurance claims and 15 claims for medical expense reimbursement.

TSPI has noted increased client satisfaction and motivation to participate in its broadening services. In a recent TSPI impact assessment of its *Kabuhayan* program, clients ranked "other financial services," notably the microinsurance coverage, as the most-liked program feature. Thus, while TSPI's main intention in offering microinsurance was to help clients and their families cope with risk, its offering has likewise helped TSPI to retain and expand its client base. Microinsurance benefits TSPI by decreasing its average cost of servicing loans, supporting the organization's efforts to sustain services, and assisting clients to mitigate risk while taking advantage of economic opportunities.

TSPI = *Tulay sa Pag-unlad*, Inc.

Source: TSPI 2002, p.1-2.

are valued at more than P42 million (\$845,000), with benefits paid amounting to P2.7 million (about \$54,000) to date.

POTENTIAL FOR MISSION DRIFT

The potential for mission drift is mainly a concern of those institutions, mainly microfinance NGOs, that provide microfinance to the lowest level of entrepreneurial poor. The potential for mission drift is less of an issue for new or potential entrants.⁹⁴ Debate centers on whether transforming credit NGOs into banks and subjecting them to formal regulation and supervision will lead to a loss of focus and sense of mission to the poor.

Two issues associated with NGO transformation are at the forefront when considering the potential for mission drift. The first has to do with the legal requirement to include at least two independent members as part of the board of directors. The second concerns the requirement to dilute ownership of the NGO in the new bank to no more than 40% within 5 years of transformation (Box 5.5).

The case of CARD Bank is instructive. Although these two legal requirements were not in place at the time of CARD's transformation, its performance provides some evidence that disputes concerns for mission drift in terms of target market, loan sizes, and effective interest rate. CARD has the longest experience with NGO transformation in the Philippines and its experience gives some indication of how transformation might affect other recently-formed, regulated commercial MFIs with regard to mission drift.

As part of its transformation, CARD raised the effective rate of interest on its loans by charging a service fee of 4% from 1996 and increased the initial loan amount from P1,000 to P2,000, suggesting possible mission drift. However, from 1998 to 31 May 2002, the yield on CARD Bank's loan portfolio actually dropped from 46% to 41%. This is comparable to that of other providers in the sector, including microfinance NGOs whose nominal interest rates range between 24% and 36%

Box 5.5

Transformation and the Potential for Mission Drift

"As an NGO migrates into becoming a bank, a medium-term issue on ownership will have to be addressed within a five-year time frame. The case of TSPI is one where 100% of the proposed bank will be owned initially by the NGO. Philippine laws require TSPI, as a single institution, to divest its ownership down to no more than 40% in five years time. A skillful handling of this delicate issue should be pursued in a way that the future ownership structure should sustain the purity of TSPI's vision and mission for the poor."

Ruben De Lara
Executive Director
TSPI Development Corporation
Manila, 2002

NGO = nongovernment organization; TSPI= *Tulay sa Pag-unlad, Inc.*

(flat) plus service charges generally in the range of 2–4%. In addition, its average loan balance of P5,450 was only about P1,000 higher than it was in 1998 (which means it actually declined in real terms). This is also in line with others in the industry (Box 5.6).

How much mission drift occurs in various microfinance NGOs and the microfinance industry as a whole depends on a variety of factors. One is the extent to which microfinance NGOs seek to transform into regulated entities as a prerequisite to mobilize significant voluntary savings (to allow them to increase their outreach substantially and sustainably). Becoming a formal, regulated financial institution can result in targeting higher-income clients with larger loans, because of profit pressures from equity shareholders.

Mission drift will also depend on the "friendliness" to microfinance of the ultimate regulatory and supervisory framework. Given that the prudential standards being developed for microfinance-oriented banks are appropriate for

Box 5.6

CARD Bank's Maintained Focus on its Original Target Market

"A recent evaluation of the CARD Rural Bank's modified Grameen Bank project yielded the same results (Hossain and Diaz 1997). The bank's target clients are landless women rural workers who have no regular jobs and have total marketable assets of less than P50,000 (\$1,000). Access to CARD's loans, despite an effective loan interest rate of 44% per annum, has yielded some benefits to the borrowers in terms of higher income, employment, productivity, and capital accumulation."

CARD = Center for Agriculture and Rural Development.
Source: Lamberte 2000, p.12.

formal MFIs (such as reporting requirements, limits on unsecured loans, requirements concerning loan documentation, supervision methods, and branching restrictions), there appear to be no regulatory or supervisory reasons for institutions to shift focus up-market to ensure compliance.

For those microfinance NGOs that are content to serve a localized market on a competitive basis, there will likely be little to no mission drift. But such institutions will likely enjoy fewer opportunities to diversify their risks and not be able to take advantage of economies of scale in their operations. Despite the advantages of being close to their target market, these institutions can be expected to remain relatively weak compared to other types of MFIs that may expand their geographic coverage or their client base. In other words, some diversification of target markets can be beneficial to MFIs to minimize risks and improve their ability to recover costs.

6 Positive Approaches to Microfinance Commercialization

Commercialization of microfinance in the Philippines holds the promise of capitalizing on the achievements in outreach that MFIs have made to date. General improvements in MFIs' financial self-sufficiency are promising, but the industry is far from reaching all the potential benefits of microfinance commercialization. Many stakeholders have a role in moving microfinance commercialization further in the Philippines, including the Government, donors, MFIs, and support institutions. This chapter draws conclusions from the study and makes recommendations for each of these key stakeholders.

ROLES OF THE GOVERNMENT

The main roles the Government should play in commercialization of microfinance are to create and maintain an enabling macroeconomic and sectoral policy environment and an appropriate legal and regulatory framework for microfinance. The Government is key to the successful advancement of microfinance commercialization, which requires the following actions.

Complete the Phaseout of Government Directed Credit Programs

Progress with abolishing subsidized, directed credit programs and transfer of the remaining credit programs to financial institutions are behind schedule; the process was to have been completed by February 2002. This process should be accelerated. In addition, new government programs that employ subsidized or interest-free loans instead of grants are hurting the repayment culture necessary for commercial microfinance.

Even though these new programs are understood to be of limited scale, the damage that they do in terms of damaging the culture of repayment may take significant time and effort on the part of MFIs to overcome.

Remove Mandatory Lending and Investment

Regulations under the Agri/Agra Law and the Magna Carta for Small Enterprises act as an implicit tax on banks and should be removed. As mentioned earlier, the Government has provided means other than direct lending for complying with these laws, such as investments in various types of bonds and securities. But the regulations act unnecessarily as a tax, particularly on large banks, without addressing the root causes of lack of lending to small farmers and enterprises. Ample experience worldwide over the last 30 years has proven the failure of similar measures to accomplish their aims of greater bank lending to farmers or small businesses in an efficient and sustainable manner.

Continue to Adopt Appropriate Regulation and Supervision for Microfinance

BSP has taken several very positive steps toward adopting appropriate regulation and supervision of microfinance through its issuance of several circulars implementing provisions of the GBL of 2000. It should continue to balance carefully the need to adapt regulation and supervision to account for the specialized nature of microfinance operations with the need to protect the financial health of banks. The integration of risk-based supervision techniques, especially for microfinance operations, promises to be effective both for supervision and risk management.

Clarify Deposit Mobilization by NGOs

BSP cannot ignore for much longer the practice by microfinance NGOs of accepting deposits illegally. If a single microfinance NGO fails and runs away with its member-clients savings, the whole microfinance industry could be affected and negatively affect MFIs legally authorized to accept savings. Consideration should be given to allowing microfinance NGOs to accept savings if these will only be for the purpose of compensating any outstanding loans the clients have with the microfinance NGO. Such deposits are often technically referred to in other sectors as cash collateral or hold-out deposits.⁹⁵ Microfinance NGOs are not currently regulated by any authority and the Government is currently considering requiring standardized financial reporting by NGOs to ensure that deposits do not exceed outstanding loan balances. The adoption of a Standard Chart of Accounts for microfinance NGOs is, therefore, imperative, along with the widespread use of uniform disclosure guidelines for microfinance NGOs to report on operating and financial performance.

Strengthen the Regulation and Supervision of Cooperatives

Consistent with the recent circular issued by the CDA to have all cooperatives use the newly approved Standard Chart of Accounts and its accompanying Manual of Accounts, the CDA should transform itself from a purely developmental entity to an effective regulatory agency. The regulatory framework for microfinance⁹⁶ recommends the creation of a special regulatory unit within CDA. BSP should assist CDA in developing the appropriate prudential rules and regulations based on the agreed COOP and PESOS standards for cooperatives undertaking savings and credit activities.

Develop Microfinance Performance Standards that Cut Across Institutional Types

As part of the rules to be established for minimizing risks in microfinance, the Government should also initiate the establishment of performance standards that cut across all types of MFIs.⁹⁷ The ingredients for such generalized performance standards could be PESOS, the CAMEL⁹⁸ rating system for banks, and the microfinance NGO performance standards developed by the Microfinance Council. Establishment of these standards would allow MFIs to compare their performance against each other objectively. Also, the adoption of these standards to gauge the performance of MFIs is especially important for private investors and wholesale lenders who would like to invest in an MFI. Commercialization involving the entry of private risk capital will only be possible if investors have sufficient and reliable transparent information for making their investment decisions. Such standards may also form the basis for ensuring in the future a level playing field for access to deposit insurance, based on meeting certain criteria.

Allow Expanded Use of PCFC Funds and its Privatization

Currently, due mainly to stipulations associated with the bulk of its funding, PCFC provides wholesale funds to Grameen and ASA replicators only. Ideally, access to wholesale funds should depend more on the financial health of the participating organization and not the methodology it employs. PCFC should work to streamline its lending criteria while adequately containing its credit risks.

In addition, to support microfinance commercialization, PCFC should allow its wholesale lending interest rate to vary according to the interest rate environment, at a spread that will ensure institutional viability and require that the onlending interest rate employed by a borrowing MFI is high enough to cover the MFI's cost of lending as well. Finally, PCFC's privatization is overdue because of inappropriate

implementation arrangements. Consideration should be given to allowing partial privatization (given PCFC's large capitalization) and opening the bidding beyond cooperatives, NGOs, and people's organizations. Privatizing the PCFC should increase its emphasis on lending to sustainable institutions and reward financially healthy institutions with lower interest rates. This will support the commercialization of microfinance by allocating funding sources to the most efficient MFIs rather than to donor-dependent MFIs.

ROLES OF FUNDING AGENCIES

The donor community has several major roles to play in the commercialization of microfinance in the Philippines, in close coordination with the Government. These are discussed below.

Support an Effective Policy Environment and Legal and Regulatory Framework

First, donors should work with the Government to ensure an enabling environment for microfinance conducive to MFIs' progress toward financial self-sufficiency. This includes advising on macroeconomic and sectoral policies as well as the legal and regulatory framework. Donors should continue building the capacity of BSP and CDA to implement effectively the evolving regulatory and supervisory framework for microfinance. In addition, donors should support the adoption, installation, and implementation of the appropriate information systems needed by regulatory authorities in their off-site and on-site supervision of MFIs.

An important element in the regulation and supervision of all types of MFIs will be donor support to establish a system of accreditation of external auditors for use by government regulatory agencies and MFIs. Assistance will also be required in the development of commonly-accepted organizational, operating, financial, and reporting standards, especially to support effective self-regulation by the Microfinance Council of member microfinance NGOs.

Build MFI Institutional Capacity

Donors should help to build institutional capacity by providing exposure to and training in microfinance best practices. In addition to training, donors should offer performance-based technical assistance support so that MFIs can expand their outreach and develop cost-effective, sustainable operations (through the use of fee-based assistance channeled through local providers). In other words, donors should provide technical assistance rather than direct capital subsidies to MFIs to avoid creating distortions in the market.

If onlending funds are provided by donors at all, they should be coupled with time-bound, quantitative performance indicators, the achievement of which determines the timing and amount of subsequent funding within a maximum 2–3-year time horizon on continued funding access.

With regard to building institutional capacity, it will be especially important for donors to focus on increasing the domestic availability of microfinance training courses and programs, such as helping Punla to become a veritable one-stop shop for affordable, demand-driven courses on microfinance management and operations.

Assist in the Development/Dissemination of Management Information Systems

There are several management information systems currently on the market for MFIs. However, there still appears to be a supply problem in terms of affordable, commercially available, off-the-shelf software packages that suit the system and information requirements of MFIs. There are a few programs that are somewhat adaptable to the varying needs of microfinance, including MicroBanker and Rural Banker 2000 (RB2000), which was developed under the MABS program and has already been introduced into more than 50 rural banks. MicroBanker operates very similarly to a traditional bank platform, but has been simplified and adapted for microfinance operations. RB2000 is a windows-based system that has been specifically designed for rural banks to manage

microfinance group and individual loan products as well as manage savings and other services.

Donors should support an objective evaluation by the Microfinance Council of existing systems including RB2000, using the evaluation criteria already developed by the CGAP. Such an evaluation could serve as a useful starting point for MFIs considering the positive and negative attributes of different systems in their quest to improve their management information systems.

Encourage Innovation in Enterprise Development

Donors should promote the development of innovative microfinance methodologies and products as well as complementary, grant-based social-service and business development service programs in cooperation with the Government. This is especially important in the areas of social mobilization (group formation and amalgamation), basic skills development, business training, and building physical infrastructure, especially in rural areas. In addition, assistance from the donor community will be important for developing and piloting new or adapted delivery methods and products that can be used to increase access by underserved groups to financial services.

Promote Linkage Development

Finally, donors should promote development of linkages between commercial banks and microfinance NGOs as a means to increase the latter's access to more commercial sources of funds. Efforts by donors to improve transparency of MFI operations and financial performance, as discussed above, may assist in removing some of the obstacles between MFIs and commercial banks so that mutually beneficial business relationships can develop between them.

ROLES OF MICROFINANCE INSTITUTIONS

MFIs have several roles to play in their own commercialization and that of the industry. Common to all MFIs, whether they be rural banks, cooperatives, or microfinance NGOs, is the need to improve their institutional capacity to reach scale in their microfinance operations (through increasing depth and breath of outreach as well as financial self-sufficiency) and to strive continually to reduce transaction costs and to increase operational efficiency. Some roles, however, can be segregated by institutional type and a few of these are elaborated below.

Rural Banks

Explore Opportunities to Expand Geographic Coverage and Access Support Services

In an increasingly competitive financial market, community-based banks must explore possibilities of linking to regional networks in order to allow their customers to access their accounts in other areas of the country. One possibility may be the opening an apex bank for the system of rural banks. Investments in human resource development and product development are very costly and cannot be covered in the long term by a single bank with a small capital base. Thus, access to support services is crucial for a rural bank involved in microfinance. Active participation in RBAP or the development of strategic alliances with other financial institutions could be means to access these services at low cost.

Maintain Liquidity above the Average for Commercial Banks

Financial institutions with a small capital base, such as rural banks, engaged in mobilizing microdeposits should maintain a high liquidity ratio. This means maintaining liquidity at least above the banking industry's average. In the Philippine context, a 20% liquidity ratio for

microfinance institutions appears to be sufficient⁹⁹ to meet unexpected situations.

Cooperatives

Explore Opportunities to Access Support Services

Similar to the rationale used for the rural banks, cooperatives with microcredit and savings services should consider actively participating in NATCCO or develop strategic alliances with other financial institutions. Participation will help to ensure the standardization of cooperative operations and help them to improve their sustainability.

Improve Transparency of Operational and Financial Performance

External regulation and supervision remain weak and are under development within the CDA; thus, internal regulations and supervisory mechanisms are crucial. Adoption of the Standard Chart of Accounts and the accompanying Manual of Accounts was to take place as soon as possible. Tracking and use of the COOP and PESOS standards should begin thereafter. Close cooperation with NATCCO during this transition period will also be especially important.

Microfinance NGOs

Overcome Weaknesses in Ownership and Governance

Weaknesses in ownership and governance should be acknowledged and minimized through the establishment of clear lines of responsibility, staff incentives that promote sustainable outreach, and adequate systems to monitor progress toward commercialization. Accountability and transparency need to be built in through integrated systems and practices and a culture of professional management.

Ensuring that boards of directors include members who understand business and finance is crucial. Preparing standard income statements and balance sheets and having them audited will

increase the transparency of operations of microfinance NGOs and enable improvements in their performance. Ultimately, these improvements should facilitate access to commercial sources of capital. Transformation into a regulated entity should also be considered as a means to access deposits as a source of funds and to become a bona fide part of the formal financial system.

Improve Institutional Capacity

Given that institutional and management capacity in the majority of microfinance NGOs is weak, improvements in several areas should take top priority. Missions should be clarified to incorporate a sustainable view of microfinance provision, balancing the social mission with a commercial approach. Increased attention should be given to building human resource strength in financial analysis and banking at least to the extent that strategic planning and business plans to operationalize such planning can take place. Active participation in the Microfinance Council should also take priority in order to exchange positive and negative experiences, learn about local and international best practices, and access various types of professional microfinance training services, such as the recently completed market research courses.

Increase Cost Efficiency

An emphasis on cost efficiency is in line with the social objectives of microfinance NGOs in that increases in cost efficiency allow for commensurate reductions in the interest rate that needs to be charged for cost recovery. CARD Bank's achievements in this regard are proof that dramatic cost efficiency can be attained, even when serving poor clients. All MFIs have a responsibility to reduce costs in order to provide their clients with the most affordable, demand-driven microfinance services possible.

ROLES OF KEY SUPPORT INSTITUTIONS

Several types of support institutions can be considered to be vital in the development and growth of a microfinance industry. The roles of a few support institutions, such as PCFC, have been addressed above, based on their government ownership or close ties with funding agencies. Roles for other, key, stand-alone support institutions include the following.

Microfinance Networks

The three microfinance networks, in cooperation with PCFC and other microfinance stakeholders, should continue to work toward introducing a Standard Chart of Accounts and reporting among members. Other MFIs should do the same. The efforts of PCFC related to spreading acceptance of established performance standards for microfinance NGOs (standardized accounting practices, subjectivity to external audit, and standard presentation of financials with an eye toward eventual ratings) are commendable and should also be continued. The networks should continue to play a role in linking their members with PCFC funds and, whenever possible, with commercial bank credit.

With donor assistance, the Microfinance Council may also consider conducting the objective assessment of various management information systems described earlier as one of its services for members. This is especially important because the bulk of members listed these systems as their main constraint to expanding their microfinance operations in a sustainable manner.

Support Expansion of a Credit Information Bureau Including Microcredit

With increasing microcredit provision by microfinance NGOs, rural banks, and cooperatives, there is increasing need for a credit bureau that captures microcredit from these actors. The credit bureau run by BAP was recently expanded to include microcredit

information and could expand to include a greater number and additional types of MFIs. An expanded private sector credit bureau could play an increasingly important role in stabilizing the microcredit market in a few highly competitive areas and in discouraging client over-indebtedness.¹⁰⁰ Instead of potentially creating new credit information bureaus to support expansion of the microfinance industry in the Philippines, donor support to increase user friendliness of this system and its accessibility is merited.

Microfinance Training Centers

The training institution that has arguably provided the most specialized microfinance training on a regular basis is Punla. It has the potential to serve as the one-stop shop that could help the microfinance industry build the technical capacity it needs for further professionalization and commercialization. It should conduct market research to explore what managerial and operational courses would be most attractive to microfinance professionals at various levels within different types of institutions and to determine their willingness to pay.

Punla should also build on its relationship with the CGAP to seek additional strategic linkages with national, regional, or international networks, such as the Microfinance Council or the Small Enterprise Education and Promotion Network based in Washington, D.C., to expand its course offerings based on market research results. Building local linkages with existing, smaller microfinance training programs, such as those run by RBAP and CARD Bank, would be ideal for developing microfinance training modules in the Philippines.

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Annexes

ANNEX 1: SOCIAL INDICATORS

Item	1985	1990	Latest Year	
Population Indicators				
Total Population (million)	54.7	62.0	75.6	(2000)
Annual Population Growth Rate (% change)	2.5	3.2	1.8	(2000)
Social Indicators				
Total Fertility Rate (births per woman)	4.4 (1984)	4.1 (1993)	3.4	(2000)
Maternal Mortality Rate (no. per 100,000 live births)	213 (1980–1986)	36.8	35.3	(1998)
Infant Mortality Rate (below 1 year; per 1,000 live births)	45.3	36.8	35.3	(1998)
Life Expectancy at Birth (years)				
Female	64.9	68.8	71.0	(2000)
Male	61.3	63.3	67.0	(2000)
Adult Literacy (% of people aged 15+)	83.3 (1980)	94.0 (1990)	94.0	(1994)
Primary School Enrollment (% of school-age population)		84.6 (1990–91)	89.2	(1995–96)
Secondary School Enrollment (% of school-age population)				
Female	65		75	(1996)
Male	64		71	(1996)
Child Malnutrition (% of under age 5)	33 (1982)	34	32	(2000)
Population below Poverty Line (%)	49.3	45.3 (1991)	37.5	(1998)
Income Ratio of Highest 20% to Lowest 20%	10	11 (1991)	13	(1997)
Population with Access to Safe Water (%)	71	81	81	(1998)
Population with Access to Safe Sanitation (%)	68	70	74	(1998)
Public Education Expenditure as % of GDP	1.8	3.1	3.9	(1998)
Public Health Expenditure as % of GDP	0.6	0.8	0.52	(1998)
Human Development Index	0.603 (1980)	0.677 (1992)	0.740	(2001)
Human Development Ranking	92	100	70	(2001)

Note: 2001 data are from UNDP 2001, 2000 data from World Bank 2002b, and all other data from ADB 2000b.

Blank entries mean no data available.

Years in parentheses are those from which data were taken when not in the year indicated at the top of the column on their left.

Sources: ADB 2000b, p.25, UNDP 2001, and World Bank 2002b.

ANNEX 2: ECONOMIC INDICATORS

Item	1996	1997	1998	1999
Income and Growth				
GDP per Capita (\$, current)	1,200.4	1,164.0	909.0	1,046.0
GDP Growth (% , constant prices)	5.8	5.2	-0.5	3.2
Agriculture	3.8	2.9	-6.6	6.6
Industry	6.4	6.1	-1.9	0.5
Services	6.4	5.4	3.5	3.9
GNP Growth (% , in constant prices)	7.2	5.2	0.1	3.6
Savings and Investment (at current market prices, % of GNP)				
Gross Domestic Saving	18.5	19.6	22.3	19.8
National Saving	23.0	24.9	20.4	18.8
Government Finance (% of GDP)				
Revenue	18.2	18.7	16.6	15.2
Expenditure	17.9	18.6	18.3	18.8
Overall Surplus/Deficit (-)	0.3	0.1	-1.8	-3.6
Balance of Payments				
Merchandise Trade Balance (% of GNP)	-13.1	-13.0	0.0	5.4
Current Account Balance (% of GNP)	-4.6	-5.1	2.3	9.0
Export (\$) Growth (annual % change)	17.7	22.8	16.9	18.8
Import (\$) Growth (annual % change)	20.8	14.0	-18.8	4.1
Money and Inflation (Annual % Change)				
Broad Money (M3)	15.8	21.0	7.4	9.3
Consumer Prices (1994 = 100)	9.1	5.9	9.8	6.6
External Payments Indicators				
International Reserves (\$ billion, end of period – months of imports)	11.7	8.8	10.8	15.1
External Debt Service (% of goods and services)	12.7	11.6	12.7	13.1
External Debt (% of GNP)	48.6	53.1	70.0	65.0 ^a
Memorandum Items				
GDP (current prices, P billion)	2,171.9	2,421.3	2,667.1	2,989.1
GNP (current prices, P billion)	2,261.3	2,522.9	2,794.1	3,137.9

^a As of April 2000.

Source: ADB 2000b, p.24.

ANNEX 3: NATIONAL STRATEGY FOR MICROFINANCE

The Vision

The vision is to have a viable and sustainable private micro (financial) market, with the government providing a supportive and appropriate policy environment and institutional framework to that market.

The Objective

The objective is to provide access to financial services to the majority of poor households and microenterprises by the year 2005.

This will be achieved in a liberalized and market-oriented economy where the private sector plays a major role and the government provides the enabling environment for the efficient functioning of markets and the participation of the private sector.

Realizing the Vision and the Objective

The Policy Framework

The government's microfinance policy is built on the following principles:

- Greater role of the private sector/MFIs in the provision of financial services;
- An enabling policy environment that will facilitate the increased participation of the private sector in microfinance;
- Market-oriented financial and credit policies, e.g. market-oriented interest rates on loan and deposits;
- Non-participation of government line agencies in implementation of credit/guarantee programs.

The government will pursue market-oriented financial and credit policies that create incentives for greater private sector participation in the financial markets. It will avoid costly, unsustainable and distorting credit subsidies that in the past failed to reach their intended beneficiaries, led to the weakening of the rural banking system, and saddled the government with a huge fiscal burden.

A distinction is made between credit and welfare policy. In the past, there has been confusion between the need for welfare assistance by really poor households and legitimate credit demand by poor households/microenterprises. Those needing welfare will be provided assistance through the appropriate government departments. Welfare will never be provided through concessional credit, loan quotas and other financially repressive measures and never through government or private financial institutions.

On the other hand, the credit demand by poor households/microenterprises will be met through a variety of innovative financial products provided by the private microfinancial market. The government will be ready to provide assistance to build the institutional capacity of microfinance institutions and

the appropriate supervisory and regulatory framework to make markets more efficient and institutions, more viable.

The Institutional Framework

The respective roles of various players in microfinance are determined by the policy framework and their relative comparative advantages in providing financial services to the poor. Thus, their respective roles are as follows:

- Microfinance Institutions (MFIs): to engage in sound, sustainable and viable microfinance intermediation;
- National Government through the National Credit Council: to provide a market-oriented financial and credit policy environment which will promote efficient financial markets, and help private microfinance institutions broaden and deepen their microfinancial services;
- National Credit Council (NCC): as microfinance policy making body, to ensure such policy environment;
- People's Credit and Finance Corporation (PCFC): as the government credit corporation focused on poor households and microenterprises, to provide wholesale (loanable funds) and technical assistance to the MFIs and support the development of innovative financial products/services for poor households/microenterprises;
- Government financial institutions: to provide wholesale funds (including those sourced from foreign borrowings) to MFIs which do not have access to wholesale loans from private commercial banks;
- Commercial and other private banks: to provide wholesale funds and financial services to MFIs;
- NGOs: to provide technical assistance in facilitating the linkage between the poor households/microenterprises and microfinance institutions, community organizations and capacity building of the target clientele;
- Donors: to provide assistance to social preparation activities, and those that will lead to the broadening and deepening of microfinancial services such as: development of microfinance products, training in microfinance technologies, and upgrading of performance standards, operating systems and procedures. Donors will be encouraged to provide assistance in those areas that have been clearly identified from a consultation process with the NCC and microfinance institutions.

The Strategies to be Pursued

To realize the objective of providing poor households/microenterprises greater access to microfinancial services, the following strategies will be pursued:

- Provision of a policy environment that is conducive to the effective and efficient functioning of the financial market. This will be carried out by doing the following:
 - Implementing a market-oriented interest rate policy in microfinancial intermediation (both on the savings and lending side).
 - Pursuing financial policy reforms with the end in view of removing existing distortions in the financial market, e.g., loan quotas, earmarking of public funds for direct lending, etc.
 - Rationalizing all existing government credit and guarantee programs toward the objectives of implementing microfinance programs in a market-oriented setting and encouraging greater private sector participation in the delivery of microfinance services.
 - Establishment of a market-oriented financial and credit policy environment which is conducive for the broadening and deepening of microfinancial services. Broadening and deepening mean the development of new product lines and services, the design and implementation of new microfinance technologies and practices which will result to increased microfinance intermediation between the target clientele and MFIs.

This will be accomplished through the following:

- Provision of appropriate supervisory and regulatory framework for MFIs which will enable them to engage in the development of new and innovative product lines and services appropriate to the demand for financial services/products by poor households and microenterprises;
- Establishment of standards of performance and business practices to guide the operations of MFIs;
- Promotion of broad-based savings mobilization, linkage banking technology and other microfinance technologies;
- Provision of information and training on best practices in microfinance to MFIs.

Implementation of a capacity-building program for MFIs. The program will be implemented through the following:

- Provision of technical assistance to MFIs. The following areas of capacity building will be given emphasis in the provision of technical assistance: (1) local deposit mobilization, (2) financial and project management, (3) use of information technology, (4) development and establishment of microfinance technology, innovative product/service lines.
- Documentation, packaging and dissemination to MFIs of practitioner-based training and technical services. This will be done through the PCFC.

- Encouraging research and academic institutions to conduct studies, convene policy level discussions that will promote awareness of microfinance as a sound commercial investment. These institutions will identify best practices in microfinance, develop and install training and microfinance technology packages.

Source: National Credit Council 1997.

ENDNOTES

- 1 This country study adopts the Asian Development Bank's definition of microfinance provided in its Microfinance Development Strategy: "Microfinance is the provision of a broad range of financial services such as deposits, loans, payments, services, money transfers, and insurance to the poor and low-income households and their microenterprises" (ADB 2000a, p.25). Microcredit in the context of the Philippines generally refers to loans up to P150,000 (about \$3,000) (as defined in Section 3 of the Magna Carta for Small Enterprises [Republic Act No. 6977, as amended by Republic Act No. 8289]), although the industry's average microloan is much lower, averaging around P5,000 (\$100) in 2002.
- 2 The financial systems approach to microfinance considers microfinance as part of a country's general financial services market, focuses on the development of sustainable (subsidy-free) financial institutions, and recognizes that microfinance clients are willing to pay the full cost of these services, if they are designed and delivered consistent with their specific needs (Von Pischke 1988; Otero and Rhyne 1994).
- 3 An MFI is defined herein as a single organization (for example, a nongovernment or government organization providing microfinance) or a unit whose primary business is microfinance within a diversified institution (for example, a microfinance unit within a commercial bank).
- 4 Microfinance client group meetings were held in several chartered cities and peri-urban areas of five major provinces of the Philippines. From north to south, the provinces visited were Tarlac, San Pablo, Negros Occidental, Cagayan de Oro, and Bukidnon.
- 5 Similar to Christen's (2000, p.5) use of the term, *mission drift* in this study refers to the shift in MFI focus from targeting microfinance services to the poor or poorest to relatively higher-income clients.
- 6 Almario 2002, p.3.
- 7 "*Formal institutions* are defined as those that are subject not only to general laws and regulations, but also to banking regulation and supervision. *Semiformal institutions*, are those that are formal in the sense of being registered entities subject to all relevant general laws, including commercial laws, but informal insofar as they are, with few exceptions, not under banking regulation and supervision. *Informal providers* (generally not referred to as institutions), are those to which neither special banking law nor general commercial law applies, and whose operations are such that disputes arising from contact with them often cannot be settled by recourse to the legal system" (Ledgerwood 1999, p.12-13).
- 8 *Internationale Projekt Consult GmbH* 2002.
- 9 Fleisig 1996, p.45; Lyman 2000, p.39-41.
- 10 McGuire, Conroy, and Thapa 1998, p.231.
- 11 UNDP 2001.
- 12 *Bangko Sentral ng Pilipinas* 2002a.
- 13 World Bank 2002a, p.2-3.
- 14 World Bank 2001, p.1. GNI (formerly referred to as GNP) is used here as a basis for calculating per capita income because it measures the income generated by a nation's residents from international and domestic activity. In the context of the Philippines, GNI is preferred to GDP, which only includes income generated from domestic activity of residents (and nonresidents) of

the country. Overseas workers' dollar remittances comprise a large portion of the country's GNI (amounting to \$6.3 billion in 2001) and account for the generally half a percentage point difference between GDP and GNI (BSP 2002b).

- 15 According to World Bank (2002b) estimates.
- 16 The Family Income and Expenditure Survey 2000 estimates of inflation-adjusted average family income indicate a decrease of 3.9% over the same period. The preliminary official poverty estimates using income-based poverty lines (used by the Government) indicate a somewhat larger increase in poverty incidence, from 36.8% of the population in 1997 to 40.0% in 2000. Family incomes declined in 10 of the 16 regions of the country (World Bank 2002a, p.4).
- 17 World Bank 2000, p.v.
- 18 Mundlak, Larson, and Benzer 2002, p.33.
- 19 World Bank 2001, p.1
- 20 World Bank 2000, p.ii.
- 21 Ibid., p.iii.
- 22 The number of banks as of end-September 2001, which had a total number of 6,644 branches (BSP 2001c, p.61).
- 23 BSP 2001c, p.1.
- 24 World Bank 2002a, p.33.
- 25 BSP 2002a.
- 26 As of 1997 according to ADB 2001, p.3.
- 27 There are six types of cooperatives in the Philippines: (1) credit cooperatives, (2) consumer cooperatives, (3) producers' cooperatives, (4) marketing cooperatives, (5) service cooperatives, and (6) multipurpose cooperatives. As of September 2000, there were 56,557 cooperatives registered with the CDA. Considerably fewer are active, but no reliable estimate is available because not all cooperatives submit annual reports to CDA, despite the requirement to provide such reports and financial data to CDA (Cosio and Kanda 2000).
- 28 Llanto 1997, p.2.
- 29 5-6ers earned their name because people who borrow from them have to pay back P6 for every P5 borrowed.
- 30 For more than a century, Indians in the Philippines have been the source of cash to launch microenterprises. Most of these Indian moneylenders are referred to locally as "Mumbai," the Hindi name of Bombay.
- 31 ADB 2001, p.1.
- 32 Based on estimates included in Microfinance Council of the Philippines 2002b, p.5; Llanto 2000, p.253; and Lamberte 2001, p.1.
- 33 The percentage of those in the lowest 40% income strata having a business (70.4%) was higher than that in the highest 60% income strata (54.5%) (National Statistics Office 1999).

- 34 Lamberte 2001, p. 17.
- 35 Agabin and Daly 1996, p.II-6.
- 36 Lamberte 2000, p.5.
- 37 The level was initially pegged at P1 million, with benefits declining for rural banks with net assets of P1 to P3 million.
- 38 Lamberte 2000, p.8.
- 39 Ibid. p.16.
- 40 Ibid. 2000, p.16.
- 41 McGuire, Conroy, and Thapa 1998, p.238.
- 42 Llanto 2000, Council of the Philippines 2002b, p.6.
- 43 The portfolio-at-risk percentage included here follows the Microfinance Council standards for reporting. It is the outstanding balance of all loans overdue longer than 30 days divided by the total loan portfolio (as opposed to the longer-than-90-days overdue criterion for past dues reflected in Table 2.6, following the MBB reporting format).
- 44 Operational self-sufficiency (OSS) = operating revenue/(loan loss provision expense + operating expense + financial expense). OSS measures how well an MFI can cover its costs through operating revenues.
- 45 Financial self-sufficiency (FSS) = adjusted operating revenue/(loan loss provision expense + financial expense + adjusted operating expense). FSS measures how well an MFI can cover its costs taking into account a number of adjustments to operating revenues and expenses for subsidies, inflation, and nonperforming loans.
- 46 Gallardo 2001, p.19.
- 47 Microfinance Council of the Philippines 2002a, p.13.
- 48 Campion and White 1999, p.83.
- 49 ADB 2002a, p.8.
- 50 OMB 2002, p.3.
- 51 A similar arrangement with BancoSol in Bolivia failed to offer adequate incentive for its founding NGO, PRODEM, to turn over its most profitable branches over time.
- 52 Opportunity International, Inc. 2002.
- 53 VisionBank 2002.
- 54 Reference for this section is the Business Section, Philippine Star newspaper, 8 May 2002.
- 55 Almario 2002, p.1.
- 56 Conroy 2002, p.21.
- 57 Almario 2002, p.2.
- 58 A survey conducted by the CPIP of NCC reported that in 1997, there were 86 directed credit programs implemented by 21 executing agencies. Nonfinancial agencies of the Government implemented 37 programs while government financial institutions handled 31 programs.

- Government nonbank financial institutions and state-owned corporations handled the other programs (Llanto 2000, p.260).
- 59 Gomez, Fitzgerald, and Vogel. 2000, p.29.
- 60 While branches require initial capitalization of P2.5 million, the rural banks (and cooperative rural banks) themselves require unimpaired capital accounts of at least P10 million (\$201,000) in order to establish a branch or loan collection and disbursement point.
- 61 BSP 2001b.
- 62 Almario 2002, p.2-3.
- 63 Llanto 2000, p.260.
- 64 Conroy 2001a, p.21.
- 65 Does not include those clients reached through a partner organization's use of other sources of funds.
- 66 Goodwin-Groen 1998.
- 67 Ibid.
- 68 Ibid, p.27.
- 69 Almario 2002, p.4.
- 70 Ibid.
- 71 Wehnert 1999, p.11.
- 72 Ibid.
- 73 Ibid.
- 74 COOP stands for **C**ompliance to administrative and legal requirements, **O**rganizational structure, **O**peration and management, and **P**lans and programs.
- 75 PESOS is the acronym for **P**ortfolio quality, **E**fficiency, **S**tability, **O**perations, and **S**tructure of assets
- 76 Microfinance Council of the Philippines 2002a.
- 77 The lack of "well supported hardware, software, and development tools" was cited as the main constraint in this regard (Microfinance Council of the Philippines 2002a, p.15).
- 78 Ibid.
- 79 Lamberte 2002, p.8.
- 80 Lamberte 2001, p.8-9.
- 82 Almario 2002, p.4.
- 81 Microfinance Council of the Philippines 2002a, p.5.
- 83 In accordance with the terms of the \$35 million ADB-International Fund for Agricultural Development loan agreement, which has funded much of PCFC's activities since 1995.
- 84 However, PCFC has recently added a credit line to address the funding needs of ASA replicators.

- 85 Rhyne 1999.
- 86 Stack and Thys 2000, p.12.
- 87 WOCCU 2002b.
- 88 ADB 2002c, p.16.
- 89 Christen and Drake 2002, p.14.
- 90 Bass and Henderson 2000, p.10.
- 91 BSP 2001c, p.28.
- 92 Lamberte 2000, p.16.
- 93 Brown 2000, p.3.
- 94 Chua 2002, p.14.
- 95 Almario 2002, p.4-5.
- 96 The Executive Committee of the NCC approved the regulatory framework for microfinance on 9 July 2002 (Almario 2002, p.5-6).
- 97 Ibid.
- 98 The CAMEL rating system is a supervisory tool for evaluating the soundness of financial institutions on a uniform basis and for identifying those institutions requiring special supervisory attention or concern. Under the CAMEL rating system, a bank is assigned ratings based on performance in five areas: the adequacy of Capital, the quality of Assets, the capability of Management, the quality and level of Earnings and the adequacy of Liquidity.
- 99 As suggested by Wehnert 1999, p.26.
- 100 Campion and Valenzuela 2002, p.269.