Philippines

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Summary

There are a large number of microfinance institutions (MFIs) in the Philippines, and some rural banks also engage in microfinance. Low minimum capital requirements for rural banks have meant that the formal financial system has had much greater microfinance outreach than in most countries. However, the number of microfinance clients remains low compared with potential demand. Bangko Sentral ng Pilipinas (the central bank) has phased out most "developmental" activities in recent years, and has undertaken a number of "promotional" activities to support microfinance.

The principal driver of financial reform specific to microfinance, the National Credit Council, is located within the Ministry of Finance. Nonetheless, Bangko Sentral has been an active participant in the processes of drafting and recommending reforms. It should continue to promote a market-driven approach to microfinance by facilitating the engagement of banks in microfinance, supporting capacity building for MFIs, and collaborating in the establishment of performance and reporting standards. There is also a need for a regulatory framework governing deposit mobilization by MFIs.

Philippines

Currency Equivalent

Currency Unit – Peso/s (₱)
US$1 = P38.24 (at mid-1999)

Abbreviations

ASEAN	Association of South-East Asian Nations
BAP	Bankers' Association of the Philippines
BSP	Bangko Sentral ng Pilipinas
BWTP	Banking with the Poor Network
CARD	Center for Agriculture and Rural Development
CBP	Central Bank of the Philippines
CDA	Cooperative Development Authority
CGAP	Consultative Group to Assist the Poorest
CPIP	Credit Policy Improvement Program
DBP	Development Bank of the Philippines
DCP	directed credit program
GDP	gross domestic product
GNP	gross national product
IBRD	International Bank for Reconstruction and Development
IMF	International Monetary Fund
LBP	Land Bank of the Philippines
MFI	microfinance institution
NCC	National Credit Council
NGO	nongovernment organization
PCFC	People's Credit and Finance Corporation
PDTF	People's Development and Trust Fund
SEC	Securities and Exchange Commission
SES	Supervision and Examination Sector
USAID	United States Agency for International Development

Note

In this report, "$" refers to US dollars.

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Philippines

1 Introduction and Background

1.1 Economy

Since the collapse of the Marcos regime in 1986, the Philippines has struggled to keep its economy on a sustained growth path. It seems to be succeeding, as indicated by the fact that it was the economy least affected by the 1997 Asian financial crisis. It registered positive economic growth while its ASEAN neighbors faltered. The Philippines pursued market reforms in the real and financial sectors, thereby increasing the economy's integration with world markets, providing an outward orientation, and encouraging private sector participation in economic development.

The Philippines has undertaken substantial economic reform since 1986

In the period since 1986, the economy was opened up to foreign competition through trade and tariff reforms. As well, foreign exchange deregulation and foreign investment liberalization enabled the economy to gain access to foreign funds, easing the savings constraint. Privatization, the build-operate-transfer arrangement, the deregulation of selected industries (banking, transport, telecommunications, oil), and the dismantling of monopolies heightened competition in domestic markets, allowing greater market efficiency.

Though sustained economic growth seemed elusive in the past, the reforms instituted after 1986 have increased the economy's market orientation, resulting in economic growth. The efficiency gains brought about by market reforms bore fruit in terms of solid economic recovery from 1994 to the first half of 1997. Gross national product (GNP) grew by 5.3 percent in real terms in 1994, peaking to 7.2 percent in 1996 and declining to 5.3 percent in 1997. The Asian financial crisis and the El Niño weather phenomenon had a negative impact on the economy as GNP grew only by 0.1 percent in real terms in 1998.

1.2 Income Distribution and Welfare

In 1995 the Philippines successfully broke through the $1,000 per capita income level, and per capita gross domestic product (GDP) grew steadily in the following two years to $1,119 in 1997. However, the slowing down of economic growth and the peso depreciation in 1998 brought per capita GDP back down to $867.

Despite overall decline in poverty through most of the 1990s, nearly half the rural population remains poor

Economic growth has contributed to the decline in poverty incidence. Estimates of poverty incidence were 45.3 percent in 1998, 45.2 percent in 1991, and 40.2 percent in 1994 (Balisacan and Shigeaki 1999). However, while the overall poverty level has declined, nearly half of the rural population has remained poor. In terms of the United Nations Development Programme's (UNDP) Human Development Index, the Philippines ranked 77th among 174 countries in 1997, with a score of 0.740 (UNDP 1999).

1.3 Financial Development

The Philippines started liberalizing the financial system as early as 1980 by lifting interest rate caps. This was followed by the introduction of universal banking (1980); the rehabilitation of government banks and rural banks (1986–1987); the liberalization of bank entry and branching (1990–1993); the restructuring of the central bank (1993);

the privatization of the country's largest bank, the Philippine National Bank; and the entrance of foreign banks (1994). The series of reforms, coupled with the liberalization of the foreign exchange market in the early 1990s, resulted in the fast growth of the financial system. In real terms, the sector grew from 3 percent of GDP in 1986 to 5 percent of GDP by 1998.

Financial reforms have contributed to rapid financial sector growth

At the end of 1998, the resources of the financial system amounted to ₱3.4 trillion, equivalent to 129 percent of nominal GDP. The banking system lies at the heart of the financial system, accounting for 81 percent of its entire assets. Within banking, the 53 commercial banks in the country account for as much as 90 percent of the sector's assets at the end of 1998. On the other hand, the resources of the 117 thrift banks make up 7.7 percent of the banking system while the 826 rural banks account for only 2 percent. The number of financial institution service points (head offices plus branches) totaled 18,502 units in 1998, with banks numbering 7,646 units.

Despite the financial system's growth in recent years, it remains undeveloped compared to the financial sectors of other Asian countries. At the end of 1997, the country's M2/GDP ratio was only 43.5 percent, one of the lowest among the developing economies of East and Southeast Asia.

The banks account for more than 80 percent of financial assets

Philippine banks are adequately capitalized relative to their risk assets. Commercial banks had a capital adequacy ratio of 17.5 percent in 1998, well above the 10 percent statutory requirement. This is a major reason why the Philippine banking system has been better able to weather the 1997–1998 Asian crisis.

1.4 Challenges Ahead

The reforms instituted over the past decade and a half have resulted in real gains for the Philippine economy in terms of growth in output, income, and employment. Nonetheless, the country has yet to graduate from its boom-bust growth history. Also, as the experience with the Asian financial crisis showed, the fast growth of the banking sector in recent years does not necessarily mean that the financial system is healthy and sound. Financial liberalization encouraged more banking activities and the establishment of more banks, but the quality of banking institutions and their supervision did not keep pace with the growth in number. In the Philippines, as in other parts of Asia, prudential regulation and supervision have to be strengthened and improved to make banks more resilient to domestic and international shocks. The integration of financial and capital markets has shown that domestic banks are not insulated from adverse developments in foreign markets.

More importantly, the country has yet to reduce poverty significantly in the rural sector and to ensure that income gains are more equally distributed. Despite the falling share of agriculture in domestic value added, the sector continues to employ a large part (39 percent) of the country's labor force. There is a need to generate alternative employment opportunities for the rural people by providing incentives for growth and development. Micro-enterprises and agricultural activities which operate outside Metro Manila will require greater access to resources to spur growth in the countryside.

Most people have yet to benefit from political and economic reforms since 1986

It is in this context that this study has been written. Poverty is pervasive and despite the significant growth of the economy made possible by political and economic reforms, the majority of the population has yet to experience the fruits of a liberalized and deregulated economy. Greater participation in mainstream economic activity and access to resources by the low income group are key strategies to alleviate poverty. Access to microfinance services by small-scale borrowers — for example, microentrepreneurs traditionally excluded by the commercial banking system in the credit markets — offers a way to alleviate poverty in a substantial manner, especially in the countryside.

The study is organized into seven sections. After the Introduction, Section 2 discusses the development of microfinance in the Philippines. Section 3 analyzes the role of the Philippine central bank, the Bangko Sentral ng Pilipinas (BSP), in microfinance. Section 4 discusses central bank support for microfinance initiatives. Section 5 explores the regulation and supervision of banks while Section 6 discusses the regulation and supervision of nonbank microfinance institutions (MFIs). The last section concludes and recommends several measures to further improve and develop microfinance in the country.

2 Development of Microfinance

MFIs in the Philippines include rural banks, NGOs, and credit unions or cooperatives

Most micro-enterprises do not have access to financial services offered by banks. Micro-enterprises need timely, small-sized loans whose repayment terms coincide with their cash flow. They also have demand for savings services that are not satisfied in view of limited access to banking facilities and the lack of interest of traditional banks in mobilizing small-sized deposits. Micro-enterprises do not have a track record with conventional banks, nor the collateral traditionally demanded by them. These factors contribute to high transaction costs and perceived risks in lending to micro-enterprises. Because traditional banking cannot and did not serve the demand for financial services by low income or small-scale borrowers in many areas, non-traditional and non-conventional approaches emerged in the credit markets. MFIs as well as a variety of micro-lending technologies have emerged.[1]

Philippine MFIs are categorized into the following: rural banks, credit-granting nongovernment organizations (NGOs), and credit unions/cooperatives. These institutions cater to the demand of small-scale borrowers for savings, business, or personal financing. The market for MFIs includes market vendors, tricycle operators, petty traders, microentrepreneurs, and other small-scale borrowers.

2.1 Outreach of MFIs

As yet, there is no study on the outreach of all types of MFIs in the Philippines. Various partial studies and surveys provide some information on the extent of outreach of MFIs. Table 1 provides one such attempt to give a comprehensive picture of MFI outreach in 1995 but it is at best a very rough estimate.[2] The overall impression is that the outreach was quite limited then, and even today it still seems relatively small.

MFIs control assets equivalent to only 4 percent of commercial banking assets, but have twice as many trading outlets

A more recent study revealed that the resources of the three types of MFIs — that is, rural banks, credit unions/cooperatives, and credit NGOs — total some ₱77.1 billion, which is only about 4 percent of the resources of the commercial banking system in 1996 (Agabin 1998). However, the combined number of MFI offices, at 7,855 outlets, is more than twice the number of commercial bank offices. The distribution of bank offices is highly skewed toward the National Capital Region. This makes banking services less accessible to those in less-developed regions.

1 Rural banks form part of the traditional regulated banks and hence cater to traditional clients in the agricultural sector. However, they have started to venture into microfinance after seeing the profit potential of the sector.

2 Chua and Llanto (1995). Rural banks are excluded from Table 1 because information is lacking on their interest in, and involvement with, microfinance. Cooperative rural banks are included because data are available for their involvement with Grameen-type microcredit.

Table 1: Estimated Outreach of Microfinance Organizations, 1995

Institution	Estimated Number	Average Loan (Pesos)	Average Reach (Number of Individuals)	Total Reach (Number of Individuals)
Development NGOs	150	4,000	150	22,500
Grameen NGOs	40	2,000	500	20,000
Mature Credit NGOs	30	5,000	1,000	30,000
Beginning Credit NGOs	100	4,500	250	25,000
Cooperative Banks	42	21,700	2,000	84,000
Credit Cooperatives	1,500	10,000	300	450,000
People's Organizations	500	3,500	50	25,000
Total	**2,362**			**656,500**

Source: Chua and Llanto (1995).

In terms of loan size, the average loan sizes of rural banks are much higher than those provided by MFIs. As of September 1997, rural banks had a loan portfolio of ₱36.2 billion, or an average of ₱43.9 million per rural bank office.[3] Borrowers per office, on the other hand, averaged 634, which means that the average loans outstanding per borrower was around ₱69,200.

A sample of 17 credit NGOs, on the other hand, was found to have average loans outstanding per borrower of ₱5,687. These average loan amounts are significantly lower than those of commercial banks, which service loan demands of at least ₱100,000,[4] but generally cater to clients with funding needs in the millions of pesos. It has been estimated that in 1996 there were 600 NGOs involved in microfinance, with combined total assets of some ₱4.5 billion. The loan portfolio is about ₱920 million which is 2.5 percent of that of the rural banks.

Of the commercial banks, only government banks have ventured into microfinance on a wide scale

With respect to Philippine banks, only government-owned banks, such as the Land Bank of the Philippines (LBP), the Development Bank of the Philippines (DBP), and the People's Credit and Finance Corporation (PCFC), a government-owned finance company, have ventured into microfinance on a wide scale.[5] These government institutions provide wholesale loans to MFIs for on-lending to small-scale borrowers, thus developing a network of rural banks, cooperatives, and NGOs to serve as conduits of wholesale funds. This practice allows them to go into microlending without fully taking the risks involved. At the same time, they are not burdened by the high costs of the servicing and monitoring of small-scale borrowers.[6]

An important point to consider is that of the three types of MFIs, only rural banks are under the same supervisory body as commercial banks, that is, BSP. Credit NGOs register with the Securities and Exchange Commission (SEC) as nonprofit, nonstock corporate entities but are practically left unregulated. Credit cooperatives are regulated by the Cooperative Development Authority (CDA).

With respect to regulation, SEC and CDA are not as strict as BSP. Because of the lack of technical capacity and its decision to pursue the promotion of credit

3 All data on MFIs in this section are from Agabin (1998).

4 Extended against deposit collateral.

5 Llanto et al. (1996a) reported that the Bankers' Association of the Philippines (BAP), Credit Guaranty Corporation, and the Bank of the Philippine Islands Foundation have also extended credit lines to NGOs. However, these are not banks but subsidiaries of banks. The former is owned by a group of banks in the country.

6 LBP and DBP generate additional funds to the extent that MFIs deposit their funds with them.

MFIs in the Philippines

There are three classes of MFIs in the Philippines:

- rural banks — regulated by the central bank
- credit NGOs — registered with the Securities and Exchange Commission
- credit unions or cooperatives — regulated by the Cooperative Development Authority.

cooperatives' development, CDA has neglected the regulation and supervision of credit cooperatives. SEC, on the other hand, is saddled with larger problems, that is, private stock companies, and has not paid attention to the activities of non-stock, nonprofit entities like the credit NGOs (Llanto 1998b).

Unlike rural banks, which are owned and governed by private owners whose interests are represented in a governing board, credit NGOs are governed by volunteer individuals who do not own the institution. Members of the board are selected by, and often serve upon the invitation of, the founding members, usually being chosen for their reputation and expertise. Unlike cooperatives, NGOs are not member-based organizations.

2.2 Sustainability of MFIs

The sustainability of MFIs did not receive any major attention until late 1998. At that time, public attention was drawn to the sustainability issue as a result of a few studies of a small sample of MFIs and the survey done by the Coalition for Microfinance Standards, a major project of credit-granting NGOs, in its search for appropriate performance standards for members of the coalition (Llanto 1994; Llanto et al. 1996b). From a sample of 104 credit cooperatives, Llanto (1994) found the following:

(i) Credit cooperatives have demonstrated their potential for increasing membership, mobilizing deposits, and providing financial services to small savers and borrowers on a sustained basis.

(ii) Loans constituted the biggest share of assets (78 percent); share capital and deposits financed the loans and other services given to members.

(iii) Capital seemed adequate although there was a slight decline in capital adequacy in the period 1990–1992, the period under study. While credit cooperatives registered positive net earnings, there is some evidence that at least 53 credit cooperatives in the sample have been spared deterioration of asset quality.

Credit cooperatives often report good financial performance but verification is difficult

(iv) Overall, the sample yielded a positive financial performance but this statement has to be qualified by the fact that there was virtually no information on the overall quality of the loan portfolio. For example, credit cooperatives did not report delinquency rates or the structure and extent of delinquent loans, among other critical information necessary for an accurate assessment of their financial condition.

The Coalition for Microfinance Standards describes the present financial situation of credit NGOs in the Philippines as follows:

(i) **Capital substantially consists of donated funds.** Most of the operations of microcredit NGOs are financed by funds coming from donations from foreign donors, philanthropic organizations, or foundations set up by corporations.

(ii) **Limited borrowing from commercial sources.** Since microcredit NGOs are non-stock, nonprofit organizations, without clear ownership, they are usually faced with problems of governance and accountability. This poses a constraint

each time they attempt to borrow from commercial sources. In many cases, the members of the board are asked to be personally liable for the loan of the NGO by signing a document expressing that they are jointly and severally liable for the repayment of the loan. Some board members have expressed reluctance to assume personal liability, thereby creating a major difficulty for the potential commercial lender. Thus, most NGO borrowings have been sourced from donors and are priced at below-market or concessional rates.

Absence of "ownership" in NGOs leads to governance and accountability problems, hindering access to commercial financing

(iii) **Small amount of savings from members.** Microcredit NGOs are not legally allowed to mobilize deposits from the public. However, many microcredit NGOs do have savings mobilization schemes with their members. Through "capital build-up" schemes, some generate relatively large amounts of savings from their member-borrowers.

(iv) **Innovative lending techniques are employed.** The coalition's survey of 56 credit programs of NGOs reported the following loan features:

(a) the majority of the microcredit programs charge interest rates higher than 24 percent per annum with one program going as high as 39 percent;

(b) at least 18 programs compute interest rates on a flat basis (which is effectively double bank practice of computing interest rates on declining balance basis);

(c) some require hard collateral such as real estate mortgages but also accept post-dated checks, group guarantees, co-makers, character, and assignment of receivables, as alternatives; and

(d) a good number of programs adopt weekly and daily loan amortization.

Variations of the Grameen bank lending technique have been adopted by several microcredit NGOs while other techniques such as village banking, solidarity, or group loans have been used as well. The microfinance community in the Philippines has access to a worldwide menu of innovative lending techniques through their interaction with counterparts in other parts of the world, and with such groups as the World Bank's Consultative Group to Assist the Poorest (CGAP) and the Banking with the Poor Network (BWTP) in the Asia-Pacific region.

The findings of the Coalition for Microfinance Standards confirm the observations earlier made by Llanto et al. (1996b) whose review of MFIs showed that the credit NGOs are not viable and sustainable. As well, most are not operationally self-sufficient. While credit NGOs effectively target and reach poor clientele, they are neither effective nor efficient credit intermediaries because of their weak institutional capacity and financial position. These institutions seem capable of delivering financial services to the poor only because of their access to grants and concessional loans.

Characteristics of NGOs in Microfinance

- Capital sourced largely from donations
- Limited borrowing from commercial sources
- Limited reliance on members' savings
- Innovative lending techniques

3 Role of the Central Bank

3.1 Overview of Reforms in the Financial Sector

The Central Bank of the Philippines (CBP) was established in 1949 and, in its early days,[7] the monetary authorities pursued repressive financial sector policies. Thus, the following were imposed on the financial markets: exchange controls; selective credit policies (that is, directing funds to preferred sectors); use of the central bank's rediscount window for the allocation of subsidized credit to private banks; cap on interest rates; and the direct involvement of government financial and nonfinancial institutions in providing credit to target sectors. A major overhaul of the financial system was implemented in the early 1970s following amendments made to the General Banking Act and the Central Bank Act. However, weaknesses in the banking sector remained due to CBP's lax banking supervision and regulation, its continued pursuit of developmental functions, and its failure to check the political accommodations in lending at two government banks.[8]

BSP employed a wide range of financially repressive measures prior to the commencement of reform in the 1980s

An International Monetary Fund (IMF) – International Bank for Reconstruction and Development (IBRD) Financial Sector Survey was conducted in 1979, which recommended, among other things, the deregulation of interest rates and the introduction of universal banking to reduce fragmentation in the financial system. These reforms and others, including the rehabilitation of government banks and the rural banks, were carried out over the course of the 1980s. Banks were also required to raise their minimum capital levels. The reforms led to a decrease in the number of banks from 1,164 in 1980 to 940 by 1990. The number of commercial banks was trimmed to 31, thrift banks to 103, and rural banks to 804.

3.2 Mandate and Role of Bangko Sentral in the Financial Sector

The new Central Bank Act (RA 7653, 3 July 1993) created BSP, with the primary objective of maintaining price stability. The Act stressed BSP's independence, allowing it to enjoy fiscal and administrative autonomy and operate independently of other sectors of the Government.[9] The Act also explicitly prohibited BSP from engaging in development banking or financing, allowing it to concentrate on macroeconomic and monetary management. As the country's central monetary authority, BSP is also tasked with the supervision and regulation of banks and quasi-banks and their subsidiaries and affiliates. Capitalized at ₱50 billion, BSP is a stronger institution than the former CBP.[10]

Legislation in 1993 gave BSP independence and a mandate for price stability

The powers and functions of BSP are exercised by the Monetary Board which is composed of two government representatives (including the governor of BSP) and five private sector representatives, each with a term of six years. The governor sits as chairman of the Monetary Board. A deputy governor of BSP is in charge of the bank supervision and regulatory departments, the Supervision and Examination Sector (SES).

7 CBP was replaced by BSP in 1993 through an Act of Congress.

8 These are the so-called behest government loans to Marcos cronies.

9 Fiscal autonomy gives BSP full flexibility to allocate and use its resources; administrative autonomy frees BSP from interference by other government agencies.

10 The charter of the present BSP is now being reviewed. Among others, a bigger capitalization would be proposed for it.

SES is composed of five departments distinguished by the type of financial institution supervised. There are two departments in charge of commercial banks. The other three departments are the Department of Thrift Banks and Non-bank Financial Intermediaries, the Department of Rural Banks, and the Supervision Reports and Studies Office. The latter takes charge of reviewing systems and procedures related to supervision and proposing policy recommendations and amendments to existing policies, rules, and regulations. At end-1999, SES had 979 staff.

3.3 Effectiveness of BSP

Further financial sector reforms followed the reshaping of BSP, including the end of central bank "development" financing

The rehabilitation of the central bank in 1993 was perhaps the most important such program undertaken by the Government.[11] The former central bank generated losses in its operations. BSP, on the other hand, has been registering surpluses, the expected state of affairs for an institution with monopoly power over monetary creation. BSP's financial health allows it to concentrate more on macroeconomic management and pursue more credible policies.

With the newly found strength of the new BSP, another major wave of reforms was instituted in the 1990s to liberalize the financial sector further. One of the most significant reforms was the liberalization of the foreign exchange market. With the virtual opening of the country's capital accounts, the Government has likewise freed up the country's financial sector, enabling it to undergo a dramatic transformation.

Thus, since 1993, some of the most important reforms have included creation of a new and more independent central bank, BSP (1993); privatization of the Philippine National Bank (1994); and liberalization of foreign bank entry (1994).

Moreover, BSP introduced measures to strengthen prudential regulations. Hence, minimum capital levels were raised several times; the single borrower's limit was imposed; limits on loans to directors, bank officers, and related parties were set; guidelines on asset valuation and loan loss provisioning were established; and banks' reporting requirements were improved.

Financial reforms brought a market-oriented approach to the financial system. An important component of the reforms was the decision to remove from the central bank the function of providing development finance to the economy. Development finance had previously taken the form of giving highly subsidized credits to banks so that they might be able to finance government-directed programs in the agriculture sector. Removing this function from the central bank was a critical step toward the currently held view that it is only sustainable MFIs that can provide small-scale borrowers continuing access to financial services.

Further reforms to strengthen the financial system are in preparation

Further banking sector reforms will strengthen the financial system and provide better financial services to the general population, and BSP has agreed on a sector reform program with IMF and the World Bank. Measures include increases in minimum capital requirements for various categories of bank, including the smallest banks with potential for microfinance (discussed in more detail later). Other measures include increased loan loss provisioning, transparency of bank accounting reports, and strengthening of the central bank's supervisory powers.

3.4 Stage of Development of the Financial System

The financial reforms during the past decade and a half, together with reforms in the macroeconomy, have strengthened the financial sector. The sector's share in the

11 This paragraph and the following one are based on Intal and Llanto (1998).

Prudential regulation, disclosure requirements, and accounting and auditing standards need further attention

economy's gross value added expanded from 3.9 percent in 1980 to 5.1 percent by 1998. The ratio of M2 to GDP increased from 23 percent in 1980 to 28 percent in 1990 and further to 43 percent by 1998. Even so, this ratio is among the lowest in the region. The ratio of deposits to bank assets, a measure of the banking system's reliance on deposits to finance its activities, rose from 48 percent in 1980 to 58 percent in 1990, and further to 61 percent in 1998.

In summary, the financial sector has demonstrated robustness and growing sophistication following the strengthening of the central bank and the series of financial sector reforms. The sector has recovered from the crisis in the early 1980s, and resumed the trend toward financial deepening. Nonetheless, as the Asian financial crisis showed, prudential regulations in the financial system, as well as disclosure and accounting and auditing standards, need to be improved to prevent imprudent lending and mismanagement of banks which put the financial system at risk.

4 Central Bank Support for Microfinance Initiatives

4.1 Emerging Policy Environment for Microfinance

The policy environment for microfinance is largely anchored on the Government's objective to alleviate poverty within a framework of viable and sustainable financial institutions (see National Credit Council 1997). The supply-led approach employed in the past entailed large fiscal costs without solving the problem of lack of access to credit by the poor. Directed credit programs (DCPs) have played a prominent role in the supply-led approach. Notwithstanding the substantial funding parlayed by the Government into DCPs, these failed to achieve the objective of providing low income, small-scale borrowers access to formal credit.

The National Credit Council was established in 1993

Various studies have shown the inefficiencies and ineffectiveness of government intervention in the credit market.[12] Because of the failure of subsidized DCPs to reach the target clientele and achieve operational viability, it is argued that the Government should instead focus on providing the appropriate policy and regulatory framework for the efficient functioning of markets, leaving the private sector to provide financial services. A National Credit Council (NCC), located within the Department of Finance, and with the participation of BSP, was established in 1993 as an interagency body to determine and recommend appropriate policy and regulatory initiatives to government (see McGuire et al. 1998). It is evident that the move for reform in the Philippine financial system, with particular reference to microfinance, has been primarily an interdepartmental initiative in which the central bank has participated without taking the leading role.

Through NCC,[13] the Government has shifted to a policy that encourages the private sector to have a greater role in the (micro) financial market. Current policy calls for the Government to provide a competitive and liberalized market environment conducive to private sector participation in the financial markets generally. These policies are clearly indicated in the National Strategy for Microfinance that was adopted by the Government and the microfinance community in late 1996.

12 Llanto et al. (1997), Lamberte et al. (1997), Adams and Lim (1997), and Medalla and Ravalo (1997).

13 BSP is a member of the Executive Committee of NCC.

Profiling the National Credit Council

- Located within the Department of Finance, with participation of BSP.
- Objectives include rationalizing and optimizing government lending programs.
- Focused on small- and microcredit.
- Developed policy guidelines on credit for the poor.

The National Strategy for Microfinance pursues the following policy principles:

(i) Greater role of the private sector (MFIs) in the provision of financial services.

(ii) An enabling policy environment that will facilitate the increased participation of the private sector in microfinance.

(iii) Market-oriented financial and credit policies, for example, market-oriented interest rates on loans and deposits.

(iv) Non-participation of government line agencies in the implementation of credit and guarantee programs.

In line with these principles, the Government continues to pursue financial reforms to remove existing distortions in the financial market. Hence, it has embarked on the rationalization of all DCPs, since these are believed to provide disincentives for private sector participation in the delivery of credit services to the poor. Because of the large credit subsidies underlying DCPs, they provide unfair competition to the private sector. Moreover, they promote a "dole-out" mentality among borrowers resulting in very low repayment rates for these credit programs.[14] Borrowers tend to view cheap government loans as income transfers and not as loans that should be repaid.

National Microfinance Strategy

The National Microfinance Strategy of 1997 emphasizes:

- provision of services by the private sector
- the importance of an enabling policy environment
- benefits of allowing market forces to operate
- need for withdrawal of government line agencies (as distinct from financial institutions).

4.2 Rationalization of Directed Credit Programs

The rationalization program terminates the participation of government nonfinancial agencies in the credit market and identifies government financial institutions as the major vehicle for credit. Government nonfinancial agencies will instead focus on the provision of infrastructure and support services to their former credit clients. Also, under the rationalization program all credit programs that will be implemented by the government financial institutions will use market-based interest rates. Likewise, savings mobilization among financial institutions will be given emphasis.

The rationalization of DCPs will be implemented under a law signed in August 1999. This provides for the phase-out of all subsidized credit programs in the

14 A comprehensive discussion is in Llanto et al. (1997).

agriculture sector within a four-year period. In addition, Executive Order No. 138 mandates government nonfinancial agencies implementing directed (or subsidized) credit programs to terminate those credit programs and transfer all funding to government financial institutions. The latter will lend the funds to private financial institutions that, in turn, will onlend or retail to borrowers.

NCC has been mandated under Administrative Order No. 86 to rationalize DCPs in all sectors and to formulate the necessary policy guidelines. An inventory of 86 DCPs in both the agriculture and non-agriculture sectors has been made. After audit by the Commission on Audit, the remaining fund balances of those DCPs will be transferred to the government financial institutions. Under the credit policy guidelines stated in Executive Order No. 138, credit decisions will be made by the government financial institutions based on market conditions and the creditworthiness of private credit conduits.

Subsidized credit programs are to be phased out, and government agencies are to surrender control

Executive Order No. 138 espouses the same policy principles stated in the National Strategy on Microfinance. It likewise calls for the adoption of market-based interest rates for government credit programs. At the minimum, this calls for the recovery of financial and operational costs of wholesale/retail financial conduits in interest rate setting.

Executive Order No. 138 has also directed that government nonfinancial agencies should no longer be involved in the implementation of credit programs. The survey conducted by the Credit Policy Improvement Program (CPIP) of NCC has reported that as of March 1997, there are 86 DCPs implemented by 21 executing agencies. Government nonfinancial agencies implement 37 programs while government financial institutions handle 31 programs. Government nonbank financial institutions and government-owned and controlled corporations handle the rest of the DCPs.

Executive Order No. 138 has significant fiscal implications:

(i) There will be no future budgetary allocation for government line agencies for the implementation of credit programs.

(ii) More government resources will be available for infrastructure and capacity-building services.

(iii) Distortionary government credit subsidies in the financial market will be eliminated (National Credit Council 1999).

4.3 Capacity Building of MFIs

In line with these policy thrusts, the Congress of the Philippines in 1997 enacted into law the Poverty Alleviation Act which, among other measures, promotes the adoption of a market-based approach in addressing the demand for financial services of the poor. It specifically mentions the promotion of a viable and sustainable financial market and the adoption of market-based interest rates in the provision of credit services to the poor as key elements of the policy and strategy for microfinance in the country.

PCFC and PDTF are institutions established to support MFIs

The People's Credit and Finance Corporation (PCFC) was identified as the government financial institution that will be responsible for the delivery of financial services to the poor, acting as a "second tier institution." This is accomplished by lending wholesale to accredited MFIs that, in turn, make the credit decisions at the retail level.

Congress also created the People's Development and Trust Fund (PDTF) to build the capacity of MFIs in providing microfinance services to the basic sectors of the economy. Earlier research has shown the lack of capacity of MFIs in many aspects of microfinance activities as a major weakness in the microfinance industry (Llanto

1997). Only the interest earnings of PDTF will be utilized to finance the capacity building of MFIs so that by keeping intact the principal amount provided, it may be able to serve the microfinance sector's capacity-building needs continuously.

4.4 Information Infrastructure for Effective Regulation

The credit cooperative and NGO sectors are starting to realize that a deregulated environment does not necessarily preclude outside (for example, government) regulation of a deposit-taking microfinance institution. What is important is that government regulation does not constrain MFIs from responding to the needs of the market. In this respect, NCC together with BSP is currently undertaking a review of the regulatory environment for banks and nonbank MFIs with the aim of formulating an appropriate regulatory framework for those institutions.

A standard chart of accounts is the first step toward an "information infrastructure" for MFIs

The review is aimed at establishing an appropriate regulatory and supervisory framework suited to the needs and peculiarities of MFIs. The envisioned framework is one which will enable MFIs to develop new and innovative product lines and services to cater to the demands of poor households and micro-enterprises, without necessarily putting at risk the financial condition of MFIs — that is, their viability and sustainability.

An initial step toward this objective is the current review of the chart of accounts for deposit-taking cooperatives. NCC has found that different groups and federations of credit cooperatives use different accounting systems. The situation is compounded among multi-purpose cooperatives in which financial and nonfinancial (that is, mercantile) activities are both considered as important services for members.

A standard chart of accounts is currently being formulated which will be used in establishing and implementing an appropriate regulatory framework for deposit-taking cooperatives. Part of the regulatory framework is the development of performance standards for credit cooperatives — that is, for cooperatives with major deposit-taking functions. Likewise, the Coalition for Microfinance Standards, the coalition of credit NGOs, has spearheaded the formulation of performance standards for NGOs engaged in micro-lending. A standard chart of accounts for these institutions is yet to be formulated. It is envisioned that these initiatives, coupled with the current review of the regulatory framework for rural banks, will help in formulating an appropriate regulatory framework for credit NGOs and credit unions, respectively.

In addition, NCC, in cooperation with the federations of credit unions/cooperatives and primary credit unions/cooperatives, has started to work toward the preparation of a standard chart of accounts for credit unions/cooperatives and well-defined accounting rules and performance standards which are the necessary infrastructure for effective regulation.

BSP's role in support of microfinance has both micro- and macroeconomic aspects

In summary, BSP's direct support of microfinance comes in terms of its active participation in the activities of NCC, all of which are aimed at having market-oriented, private sector-led financial markets. BSP has also put its considerable influence behind NCC's effort to rationalize DCPs and to get nonfinancial government agencies out of the business of lending. As a member of NCC (which is funded by the Government and responsible for credit policy making), BSP supports the National Strategy on Microfinance which seeks a market-oriented environment for MFIs. Thus, BSP works with NCC on the creation of a favorable microeconomic environment for microfinance through appropriate regulation and supervision of MFIs. It is also responsible for the macroeconomic environment in which microfinance is conducted, by virtue of its overriding concern for price stability. This is the primary concern of most contemporary central banks and also one of the most important, if indirect, forms of support for microfinance which a central bank can provide.

Funding support or development funding for microfinance is entirely out of the question because BSP moved out of development finance a long time ago. As discussed previously, the former central bank expanded its developmental functions in the 1970s by overseeing the implementation of a number of selective credit programs to target or favored industries and their funding through the rediscount window (Intal and Llanto 1998). The liberal access to the CBP rediscount window by the rural banks ultimately undermined the rural banking system because the banks became largely conduits of cheap government funds, neglecting the mobilization of deposits and the judicious management of loan portfolio (see also Neri and Llanto 1985). When arrears mounted in the late 1970s and access to the rediscount window became restrictive, many rural banks became insolvent. The lesson was well learned and it has steered BSP away from development finance, especially subsidized credit programs.

5 Regulation and Supervision of Banks

5.1 Macroeconomic and Financial Environment

Despite a favorable macroeconomic and financial environment, banks remain averse to microfinance

Over the past two decades, liberalization and deregulation of the financial markets have improved the environment for banks. In particular, the lifting of interest rate caps on loans over the 1980–1984 period allowed banks to discriminate among loans of different risk types and to charge differential interest rates accordingly. As well, the deregulation of bank branching in 1993 enabled banks to establish branches all over the country, thereby reaching small savers and borrowers. Similarly, heightened competition in the financial marketplace following the series of reforms has prodded banks to seek out previously unserved market segments, increasing the public's access to banking services. Thus, more than ever, the current macroeconomic and financial environments favor bank entry into the microfinance market.

Nevertheless, judging from small entrepreneurs' continued clamor for bank credit, it seems that banking services remain out of their reach and that banks, especially commercial banks, remain averse to doing business with small-scale borrowers. Microfinance is a strange product for them. The lack of appropriate information on, and exposure to, microfinance, and differences between microfinance and regular banking technology mitigate the desire to have microfinance as part of the banks' regular financial products. Among reasons posited is that existing central bank policies and regulations make bank entry into microfinance difficult, if not unprofitable. Jansson (1997) identified the following bank regulatory areas which "may hide a differential policy bias against microfinance":

(i) macroeconomic controls (interest ceiling, reserve requirements);

(ii) structural controls (entry requirements and limits on the activities of financial institutions); and

(iii) prudential controls (loan documentation, provisioning and capital adequacy requirements).

The macroeconomic environment may be favorable for the development of microfinance but, at the level of banks and firms, policies and the regulatory framework may not be as favorable.

Perhaps regulatory policies discriminate against commercial bank engagement in microfinance

The existing regulatory environment differs for different types of MFIs. The regulation of rural banks is much stricter than that of cooperatives or NGOs. Rural banks have the advantage of being able to generate deposits from the public, giving them access to potentially large amounts of low-priced funds for lending. It is this edge, however, that subjects them to tight regulation and supervision by BSP. For

instance, they are required to maintain a 10 percent capital adequacy ratio, provide reserves against deposits, limit loan exposure to a single party as well as to any one sector, and set aside funds for possible loan losses. They are subjected to examination by BSP and the Philippine Deposit Insurance Corporation once every 12 months.

5.2 Minimum Capital Requirements

There appears to be a bias in favor of big banks

At the policy level, there is currently a BSP bias towards having larger scale operators in the banking sector as may be seen in the higher minimum capitalization requirements and various incentives given for mergers and consolidation. The attitude toward having a few big banks creates an unfortunate bias against microfinance. Indeed, BSP does not disguise its preference, reinforced by the Asian crisis, for a financial system made up of a few big banks. The implicit bias for higher capital for banks arises from the belief that banks with bigger capitalization have a stronger chance of surviving financial crises that can rapidly materialize in highly integrated financial markets. A 1999 BSP circular (No. 181) has prescribed higher minimum capital requirements according to the schedule shown in Table 2.

The bias toward a financial system dominated by a few big banks has another potentially negative effect. This could result in less competitive financial markets because the few big banks might use their dominant position in the market to their advantage and at a cost to clients. In addition, the higher capital required of banks could result in a change in the cost structure of banks that may lead them to offer bigger size loans. Thus, a rural bank that has been required to put in extra capital might be tempted to "upscale" its operations by providing more big loans than before and hence move beyond true microfinance.

All things equal, it seems that a bank with a higher capitalization will be better able to weather financial crises. However, it is really the quality of bank management that matters in the final analysis because big banks do close from time to time as shown by the country's experience, while smaller banks continue to operate.[15] More often than not, mismanagement, insider abuse, or fraud committed

Table 2: Minimum Capital Requirements, by Type of Bank

Type of Bank	Current[a] (Pesos million)	By 12/31/99 (Pesos million)	By 12/31/2000 (Pesos million)
Expanded Commercial Banks	4,500	4,950	5,400
Commercial Banks	2,000	2,400	2,800
Thrift Banks			
Within Metro Manila	250	325	400
Outside Metro Manila	40	52	64
Rural Banks			
Within Metro Manila	20	26	32
Cities of Cebu and Davao	10	13	16
1st/2nd/3rd class cities and 1st class municipalities	5	6.5	8
4th/5th/6th class cities and 2nd/3rd/4th class municipalities	3	3.9	4.8
5th/6th class municipalities	2	2.6	3.2

a mid-1999
Source: BSP Circular 181 (1999).

15 Indeed, the experience in Indonesia shows small banks were disproportionately represented among those institutions which survived the crisis in good financial condition. See the Indonesia country study, this volume.

by bank personnel, not the bank's small capitalization, have been commonly cited reasons for a bank's demise.

5.3 Reserve Requirements

Reserve requirements are lower for small banks — no bias against microfinance there

Reserve requirements for commercial banks have gradually been reduced from a high of 24 percent in January 1993 to just 12 percent by 1999. This has greatly encouraged bank intermediation with the loans-to-GDP ratio rising from 27 percent in 1990 to 64 percent in 1998.

Reserve requirements are even lower for the smaller thrift and rural banks. For rural banks, the reserve requirement on peso savings and time deposits is only 4 percent, while that on peso demand deposits is 9 percent (Appendix 1). This helps cut rural banks' intermediation costs but it is not enough to give them an overall cost advantage over commercial banks. However, given that rural banks cater more to microentrepreneurs than commercial banks, the lower reserve requirements for rural banks can be said to encourage more micro-lending. Still, it is important to point out that the differential reserve requirements imposed on different bank types create inefficiencies in the financial system by giving one bank type undue advantage over the other.

5.4 Capital Adequacy

Capital adequacy and risk classification criteria are neutral to microfinance

BSP currently requires banks to maintain a 10 percent ratio of capital to risk assets. Understandably, this is stricter than the 8 percent Basle capital adequacy standard because Philippine banks are less diversified than United States or European banks. Despite this and other differences between BSP and the Basle capital adequacy computations, there is no discrimination against microfinance in the BSP practice. Microfinance loans are given the highest risk weighting, but so are all other private loans. Unlike Argentina, BSP does not discriminate against loans with high interest rates or loans with little collateral, which are characteristics of microfinance loans. Indeed, in this area, the BSP practice follows that of the Basle Accord. BSP's risk classification is thus neutral to microfinance.

As argued by McGuire et al. (1998) in a related study, most commentators suggest a higher capital adequacy ratio for small banks and specialist microfinance banks. The commonly cited figure is a capital adequacy ratio of 20 percent. The less diversified portfolios and greater concentration of risk in microfinance banks and the relatively high costs of microfinance operations are some of the reasons given for suggesting a higher capital adequacy ratio for microfinance banks. Further, a microfinance bank that is hit by nonperforming loans experiences a faster decapitalization than ordinary commercial banks.

5.5 Loan Loss Provisioning

BSP's loan classification norms also seem free of bias

Some bias against microfinance loans may be attributed to the importance given collateral in classifying loans. For instance, BSP used to have different provisioning requirements for substandard collateralized loans (12.5 percent) and substandard uncollateralized loans (25 percent). Starting mid-April 1999, however, BSP eliminated this differential treatment between collateralized and uncollateralized loans, requiring banks to put up 25 percent for loans classified generally as "substandard." While collateral remains a consideration, it seems it is no longer used as a principal parameter to place a loan in classified status. Hence, it is difficult to accuse BSP's loan classification scheme of bias against microfinance loans.

While there seems to be nothing in BSP regulation that prohibits banks from providing unsecured loans, including small clean loans, the biases against microfinance of BSP examiners constrain it. The collateral and documentation expectations of bank examiners are such that banks are discouraged from going into micro-lending. Interviews with banks indicated that (i) examiners do not look favorably upon business loans not supported by audited financial statements, and (ii) bank supervisors take a dim view of unsecured lending.[16] Hence, bank examiners may classify an unsecured loan lacking a tax return as "loans especially mentioned" necessitating a 5 percent provisioning. This practice clearly discriminates against microfinance loans.

But subtle biases do appear to operate

BSP is unclear about its position regarding loans supported by informal financial information, and banks are therefore afraid that examiners would criticize them if they make such loans. This results in an inhibiting atmosphere that prevents the expansion of micro-lending. Bank examiners lack a clear understanding of micro-enterprise loans, which discourages banks from developing and using non-conventional lending techniques to reach small borrowers.[17]

The attitude of bank examiners can be traced to the use of traditional methods of bank examination, where the BSP examiners put emphasis on compliance with banking rules and regulations and focus almost entirely on credit risks. Fortunately, BSP is now moving towards risk-based bank examination which is characterized by a comprehensive review of all the risk types (not just credit but market, interest rate, and foreign exchange as well as internal control risks) faced by banks and an evaluation of banks' risk management techniques. Ultimately, the aim of risk-based supervision is to alert BSP examiners to various types of risk, encourage them to profile the risks, evaluate potential problem areas, and take measures at an early stage to prevent or minimize losses and other bank problems.

BSP's emphasis on a strict implementation of loan provisioning requirements without due consideration of the relative risks of various loan products could make it prohibitive to lend to micro-enterprises. Traditional banking puts small-scale borrowers, especially the poor, at the far end of the lending scale. Bias against micro-enterprise loans could, then, be exacerbated by the loan classification actually implemented by bank examiners. A more reasonable approach should take into account the ageing of delinquent loans and the risk profile of the loan portfolio when loan provisioning is required. This means that loan provisioning will not be a uniform percentage to be applied across banks involved in microfinance.

5.6 Prudential Limits

Unsecured Loans

Clear bias against microfinance exists regarding unsecured loans

This is one area where BSP regulations create biases against microfinance loans. BSP wants to make sure that commercial and thrift banks' unsecured loans do not exceed 30 percent of their loan portfolio. While this rule does not apply to rural banks, BSP uses moral suasion to keep rural banks' unsecured loans within the same ceiling. Clearly, given the nature of microfinance loans, this regulation would necessarily limit banks' micro-lending activities. On the other hand, credit NGOs tend to rely on such collateral substitutes as co-makers, post-dated checks, and group guarantees. Real estate mortgages are accepted only if available. In contrast, banks generally do not treat these substitutes as effective forms of collateral, requiring borrowers to present "hard" collateral such as real estate mortgages. The problem arises when a rural bank

16 Fitzgerald et al. (1997). See also Llanto (1998a).

17 "Non-conventional" means that these are loans not covered by the usual collateral (for example, real estate mortgage) required by banks.

becomes heavily involved in unsecured microfinance loans. It will be inviting BSP moral suasion to go slow on micro-lending.

Secondly, as discussed earlier, BSP examiners tend to be critical of unsecured loans, making banks uncomfortable about extending clean loans. Thus, although the law does not prohibit unsecured loans, banks tend to shy away from unsecured lending. Third, BSP requires that clean loans be accompanied by the signature of at least one co-maker, except in the case where the principal borrower's "responsibility and financial capacity are unquestionable."[18]

Prohibition Against Deposit Pick-up Services

A 1999 BSP Circular (No. 118) could adversely affect the rural banks' deposit mobilization performance since it appears to prevent house-to-house visits to pick up deposits. Small savers have shown reluctance in going to the banks to make deposits for a variety of reasons. For instance, bank offices or branches may be too far from their residence or their place of micro-business and therefore the transaction cost of making deposits appears to be high. Thus, some rural banks have devised a way to generate small amounts of deposits by offering pick-up services to regular depositors.

Bank Branching Regulations

Regulation of issues such as deposit pick-ups and branching may prove discriminatory

Currently, BSP requires banks to put up additional capital for every branch established. While the requirements for rural bank branches do not seem to be high, these can prove difficult for rural banks wanting to venture into microfinance. Because of security reasons, BSP imposes certain standards on the branches' physical structures. These could be obstacles for expansion of microfinance banks' deposit-taking activities. For these institutions, it would be more effective if they are allowed to set up, say, mobile banking units that allow them to reach out to small clients at a minimal cost. On the positive side, current banking regulation does not place limits on banking hours, giving microfinance banks the opportunity to adopt flexible banking hours.

Bank branching, together with the opening of new banks, was suspended indefinitely by BSP in 1999.[19] The closure of some rural and thrift banks, as well as the Asian financial crisis, motivated this decision. Before the suspension, rural banks, after satisfying the requirement for additional capital, could branch out anywhere in the country except in the greater Manila area. The suspension works to the disadvantage of rural banks that seek to diversify their portfolios. Experience has shown that a unit rural bank — that is, a rural bank confined to a specific geographical area and serving one particular type of clientele (agricultural borrowers) — can be exposed to covariant risks.

Ceiling on Fixed Assets

BSP limits banks' investments in fixed assets to 50 percent of net worth. In this regard, computer equipment should be excluded from the ceiling, especially for rural banks with small capitalization. This would allow rural banks to gain efficiency by automating banking operations and making loan tracking and monitoring easier. It is noted that the success of microfinance operations relies to a great extent on the ability of the microfinance banks to track and monitor loan quality and other performance indicators.

18 Fitzgerald et al. (1997) finds the latter "a fairly high hurdle" and noted that "co-makers are not always available."

19 Except in municipalities without banks.

5.7 Supervisory Procedures

In addition to the issuance of regulations, BSP also conducts on-site bank examinations at least once every 12 months. It also requires banks to submit regular reports — that is, daily, weekly, monthly, quarterly, or annually — as part of its off-site monitoring. Except for bank deposits, the BSP bank examiners are authorized to look into all books, documents, papers, or records of the banks as well as the books and records of persons and entities in connection with the activities of the banks. Bank assessment is based on the CAMEL rating system.[20]

In terms of bank supervision, recent research indicates that Philippine bank regulation and supervision have assessed risk without the benefit of a formal framework and terminology. The common practice is simply to check for compliance with banking laws and regulation, assess internal controls, and appraise management. This does not necessarily ensure that activities or decisions posing the greatest risk to the bank's continuing operations are being considered at all. Nor do examiners necessarily evaluate the bank's lending policies. Although they profile loans, they do not necessarily consider loans that are in the beginning stage of delinquency (Fitzgerald et al. 1997). As well, prudential regulations cover only credit risk and not the spectrum of risks in the banking industry.[21]

Regulatory discrimination against microfinance suggests conservatism and a lack of understanding

Overall, there is some bias in the current regulatory environment against banks choosing to go into microfinance. BSP regulations are not deliberate efforts to discriminate against microfinance but, to the extent that they constrain micro-lending, they could be seen as the result of a lack of understanding of microfinance and a desire to protect the banking system through conservative regulations. Regulations that inhibit banks from expanding or even venturing into microfinance should be reviewed and modified accordingly. As demonstrated by successful MFIs all over the world, micro-loans are not necessarily more risky than the typical loan covered by traditional collateral such as a real estate mortgage.

The review of BSP regulatory and supervisory practices should consider the specialized nature of microfinance. As has been argued, micro-lending is very different from banks' other loan products, requiring different management skills, documentation procedures, management information systems, and levels of monitoring. Understanding these differences would be the first step towards developing regulations that will not restrict banks from engaging in microfinance activities. Ultimately, it would be an advantage for the country to have financial regulations that would encourage banks to go into microfinance without necessarily creating unmanageable risks on both the part of the microfinance bank and the regulatory authority.

Regulatory Factors Which Discriminate Against Microfinance

Regulatory discrimination against microfinance is not deliberate, but shows limited understanding of the consequences for microfinance of:

- the preference for fewer, bigger, banks
- some attitudes and practices of bank examiners
- limits imposed on unsecured lending
- concern with credit, as opposed to other, risks
- nonfinancial regulation, of such matters as deposit pick-ups, physical facilities and location of branches, and investment in fixed assets.

20 Capital, asset quality, management, earnings, liquidity (set of criteria used for rating banks developed by ACCION International).

21 Including liquidity, market, transaction, interest rate, foreign exchange, regulation, strategic, and compliance risks.

6 Regulation and Supervision of Nonbank MFIs

Among MFIs, only rural banks are regulated and supervised by BSP. Since these institutions perform a fiduciary function by taking deposits from the public, they are subject to strict prudential regulation. In contrast, regulation of nonbank MFIs is relatively lax, if not effectively nonexistent. The two types of nonbank MFIs are (i) credit unions/cooperatives and (ii) credit-granting NGOs.

Regulation of nonbank MFIs is comparatively lax

While BSP is strict with rural banks with the protection of depositors in mind, CDA and SEC generally leave the cooperatives and credit NGOs alone. (Because of the principle of subsidiarity enshrined in the Cooperative Code, CDA claims to have taken an arms-length approach in regulating cooperatives.) With its mandate to regulate credit cooperatives, CDA has generally paid more attention to the promotion and development of cooperatives. It provides training and education assistance to those who want to establish a cooperative, and also gives out highly subsidized loans to cooperatives.

6.1 Credit Unions and Deposit-taking Cooperatives

CDA limits its supervisory function mainly to registering cooperatives. Cooperatives are not subjected to minimum capitalization requirements, and other prudential restrictions and monitoring is confined to submission of annual reports and cooperative visits by CDA's field agents. Examination means checking with compliance with CDA registry rules. It was recently found that the registry is not efficiently handled by CDA, which creates doubt regarding its ability to do a good job in regulating cooperatives, especially deposit-taking cooperatives. [22]

The responsible authority has neglected the regulation of credit cooperatives

According to Llanto (1999), CDA has neglected the regulation of cooperatives. Another recent study has pointed out that officially, as of 1997, there are some 52,000 cooperatives registered with CDA, of which only 60 percent seem functional. Of the 60 percent reported to be functional, only 17 percent submit audited financial statements (Arbuckle et al. 1998).

There is currently a bill in Congress (House Bill No. 6406) that seeks to restructure CDA to make it focus on the regulation of cooperatives. BSP is not involved in the regulation of deposit-taking cooperatives and has no desire to play this role, citing its mandate to regulate banks and CDA's developmental and regulatory functions over cooperatives. However, BSP supports the development of appropriate regulation of deposit-taking cooperatives in view of prudential concerns over deposits held by them.

6.2 NGOs Providing Credit Services

On the other hand, credit NGOs, which are not considered financial intermediaries, do not have a supervisory body overseeing their activities. SEC acts merely as their corporate registry. This lack of legal status to act as real financial intermediaries is the principal problem faced by credit NGOs (Llanto et al. 1996b). They cannot mobilize deposits and are dependent on donor funding. As a result, they have limited outreach and their operations are financially unsustainable.

Credit NGOs realize the need for deposit mobilizations. Some have been mobilizing savings from their member-borrowers and booking these as capital build-

22 See Arbuckle et al. (1998), Llanto (1998b), National Credit Council (1999).

up, group funds, or mutual savings funds. BSP has chosen to adopt a hands-off policy with respect to this practice, provided it is not abused. Its position is that unless the law *explicitly* mandates it to regulate these institutions, it will not do so.[23] BSP feels that it already has a large enough task looking after 53 commercial banks, 117 thrift banks, and 826 rural banks, as well as a host of quasi-banks, thousands of pawnshops, and other nonbank financial intermediaries. Adding another nonbank intermediary group is therefore not a welcome and feasible prospect.

Credit NGOs are not overseen by any regulatory authority since they are not regarded as financial intermediaries

Nonetheless, BSP agrees that there is need for appropriate supervision and regulation of deposit-taking MFIs (that is, the rural banks and credit unions), to ensure their solvency and financial soundness. In this regard, it is taking a supportive role in developing standards of performance for MFIs. As a member of NCC, BSP is helping in current efforts to develop a chart of accounts for credit cooperatives by providing information on the chart of accounts for rural banks. BSP also shares its expertise with credit NGOs in their efforts to develop standards of performance. Both BSP and NCC are members of the Coalition for Microfinance Standards.

Thus, unless these credit NGOs convert themselves into banks or non-stock savings and loans associations, they will not formally come under BSP supervision. Any bank that they may establish or organize will, of course, be subject to BSP regulation and supervision. On the part of BSP, it neither encourages nor discourages the conversion of credit NGOs into banks. While many credit NGOs feel the need to convert into banks or organize banks to become more effective in microfinance, they seem reluctant to do so because of fear of being subjected to BSP's strict regulations. The relatively huge capitalization requirement of banks is also a source of anxiety to credit NGOs although it seems that the average equity now held by those NGOs would be sufficient to meet the capitalization requirement of a small rural bank.

6.3 Entry Requirements

There is now increasing realization among nonbank MFIs that unless they are able to increase their pool of funds via deposit mobilization, they will not achieve any significant outreach and the sustainability of their operations will forever hinge on donor funding. The pressure to increase deposits is more pronounced for credit NGOs than for, say, credit cooperatives because the latter can raise deposits from their members. Rural banks have the authority to mobilize deposits from the public. On the other hand, credit NGOs are reliant on subsidized funding from either government or donors for their loan funds as well as operational expenses. Thus, some credit NGOs have expressed a desire to organize or establish a formal financial institution (such as a rural bank) to enable them to mobilize deposits and have arms-length commercial transactions in the financial markets.

Nonbank MFIs see the need to mobilize savings for growth and outreach, and one has set up a rural bank for this purpose

One such credit NGO, Center for Agriculture and Rural Development (CARD), has already set up a rural bank. To encourage more credit NGOs to do the same, it is important that BSP's minimum capitalization requirement is not set at too high a level as to bar MFIs from organizing regulated financial institutions. The current level of required capital of rural banks seems manageable from the vantage point of credit NGOs as indicated by the experience of CARD.

23 Under the new Central Bank Act, BSP is tasked with the supervision and regulation of banks and quasi-banks (as well as their affiliates and subsidiaries) only. With the exception of pawnshops, non-stock savings and loan associations, and building and loan associations, BSP's supervision over other nonbank financial intermediaries has been transferred to SEC.

Rural banks outside major cities now have less demanding capital requirements

6.4 Minimum Capitalization

As mentioned previously, BSP announced a new schedule of minimum capitalization that banks are required to meet by the year 2000. The requirements for commercial banks are very high. For rural banks, however, especially those established outside Metro Manila and the cities of Cebu and Davao, the capitalization requirements are less demanding. This is important since MFIs are more likely to go into rural banking than commercial banking.

At end-1999, a nonbank MFI wishing to organize a rural bank located outside the key cities needed to put up ₱6.5 million (around $170,000). The amount may even go as low as ₱2.6 million ($68,000) for rural banks that choose to locate in very poor areas (Appendix 1).

A survey of 16 NGOs indicated that at the end of 1996 the average NGO already had ₱7.2 million in equity (Agabin 1998) and hence will be able to meet the new capitalization requirement for rural banks in lower level municipalities. Following Jansson's (1997) analysis, assuming that (i) the NGO-turned-rural bank maximizes the 10 percent capital adequacy ratio, and (ii) its loan portfolio comprises 70 percent of its assets, a ₱6.5 million capital implies a loan portfolio of ₱45.5 million. At ₱5,000 per borrower, a rural bank dedicated to microfinance needs only 9,100 clients to remain fully leveraged. This number of clients does not seem too hard to achieve given that in mid-1997, the average credit NGO, with no access to deposits, already had 3,502 borrowers with the largest of the sample NGOs having as many as 8,183 borrowers (Agabin 1998).

The lower capital requirements could be met by NGOs, though only one has so far set up a bank

BSP's present minimum capital requirement does not pose too large a hurdle for credit NGOs wishing to organize microfinance rural banks. If CARD Rural Bank may serve as a useful example, BSP seems supportive of the plan of credit NGOs to organize or establish a regulated rural bank. The minimum capitalization requirement for other types of banks (for example, a development bank devoted to microfinance) might be a problem for credit NGOs and private investors who have limited capital but want to establish this type of bank. This is because of the higher capitalization requirement for establishing thrift banks.

Thus far, only one credit NGO has opted to go into banking.[24] Because it is mainly a microfinance rural bank, it has a relatively large pool of unsecured loans. Because of its efficient management of its loan portfolio, BSP does not appear to have made an exception or criticism of it when the BSP examination was conducted. BSP has, however, encouraged it to limit its unsecured loans to the equivalent of its equity and to require securities or collateral on loans funded out of deposits.

The one microfinance bank encounters some regulatory bias against its unsecured loan portfolio

This shows that BSP is currently resorting to moral suasion on the issue of bank exposure to unsecured loans. However, there is always the possibility that BSP might go beyond mere moral suasion to force microfinance banks to be less active in providing unsecured loans. This could be done by putting a cap on unsecured loans — that is, by limiting micro-lending to a certain percentage of the microfinance bank's loan portfolio. Adoption of such a policy would be detrimental to microfinance.

An alternative, perhaps, is for BSP to recognize that a microfinance bank can also use non-conventional collateral substitutes used by credit NGOs to ensure financial discipline from small-scale borrowers. Collateral substitutes may be in forms such as joint liability covenants and blocked savings, which several financial intermediaries in the ASEAN region have used to reach small-scale borrowers successfully (Llanto et al. 1996a).

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24 CARD Rural Bank of San Pablo City, Laguna, Philippines.

7 Conclusions and Recommendations

7.1 Conclusions

Bangko Sentral ng Pilipinas (BSP) has a critical role in the development of the microfinance sector. Maintaining a stable macroeconomic environment through a regime of low inflation and low interest rates contributes to increasing confidence in the financial system. At the microeconomic level, efficient prudential regulation and supervision strengthens the financial system and enhances the capacity and viability of regulated microfinance institutions (MFIs) — that is, rural banks.

The well-known information asymmetry problem in financial markets informs BSP's responsibility as an oversight agency for the financial system. Because the owners and/or managers of the lending institution have more and better information on the performance of a banking institution than the investing or depositing public, an oversight agency is needed to attest to the good performance of the institution concerned. A large investor or depositor may be able to gain the necessary information, but this option does not exist for the ordinary depositor. Bank customers, clients, and fund suppliers therefore have to rely on an oversight agency that regulates and supervises financial entities for the necessary information about the financial condition and performance of banks.

7.2 Recommendations

(1) The central bank should act as an advocate for sustainable microfinance.

BSP should adopt an advocacy role

BSP should maintain its public support for the policies of the National Strategy for Microfinance and, in particular, the need to provide an enabling environment so that the private sector might participate in the provision of microfinance services.

(2) BSP should continue to promote market-driven interest rate and credit policies.

BSP should continue to promote the market orientation of interest rate and credit policies and should resist every effort of certain sectors — for example, legislators — to put a cap or ceiling on interest rates for any class of lending, including poverty alleviation lending.

(3) Government initiatives to terminate subsidized credit programs and programs requiring direct government involvement in retail microfinance are worthy of BSP's support.

Work to eradicate subsidies and direct government involvement

BSP should support the Government's continued implementation of Executive Order No. 138 that terminates subsidized credit programs and transfers the loan funds to government financial institutions for wholesale lending to private MFIs.

(4) The central bank should continue to play an active role to facilitate the engagement of banks in microfinance.

Support NCC efforts to establish a supportive regulatory environment

This study has pointed out specific regulatory and supervisory practices which can either encourage or inhibit the involvement of regulated banks in microfinance. BSP should, therefore, review those regulations and practices with the objective of establishing a regulatory framework that is appropriate for microfinance banks or microfinance operations. At the same time, that framework should ensure the protection of depositors. BSP should continue its active role in the National Credit Council (NCC), lending its expertise to NCC efforts to improve the regulatory environment for banks to facilitate their engagement with microfinance.

Capital requirements and entry conditions need to be reviewed

(5) A central bank review of minimum capital requirements for rural banks is needed.

BSP should review its policy regarding minimum capital requirements for rural banks in tandem with the prescribed capital adequacy ratio to avoid any unnecessary barrier to NGOs' wishing to organize rural banks for microfinance.

(6) BSP should also review current policy on entry conditions for new banks.

BSP should review its current policy suspending the entry of new banks and the establishment of new bank branches with specific reference to the disabilities imposed on microfinance by current regulations.

(7) BSP should continue to work with relevant agencies on the development of an appropriate regulatory framework for nonbank MFIs.

BSP should continue to work very closely with the Department of Finance's NCC, the Cooperative Development Authority (CDA),and the Microfinance Council of the Philippines in developing an appropriate regulatory framework for nonbank MFIs.[25]

Cooperate with NCC and other agencies to create the right regulatory environment for nonbank MFIs

Having an appropriate regulatory environment for nonbank MFIs is crucial. As observed in a related study (Quinones et al. 1999), the absence of such a regulatory framework in the case of credit unions and credit NGOs denies the concerned institutions critical social capital. What has been observed is that the unregulated lending institutions such as credit unions and credit NGOs reach the limits of their financial intermediation capabilities much sooner than the regulated financial entities. They fail to mobilize deposits, which makes their loans more costly than those offered by regulated entities which have the advantage of tapping relatively cheap deposits from the public. Thus, unregulated entities have to rely on their limited equity, donor grants or, perhaps, relatively high-cost commercial loans to sustain their operations.

Credit unions and credit NGOs, most particularly, need the "stamp of approval" of strong financial condition and good performance that appropriate regulation and supervision can provide. The absence of an appropriate regulatory framework tends to arrest the growth and development of credit unions and credit NGOs because there is no "stamp or badge of approval" that can signal the commercial market for investments and the depositor market for deposits in these institutions.

Nonbank MFIs should be able to earn a "stamp of approval" for deposit taking

Currently, Philippine banking laws and regulations allow only banks to mobilize deposits. The banks perform a fiduciary function and are, therefore, regulated and supervised by BSP. Rural banks and cooperative banks have staying power in the financial market because of their authority to mobilize deposits. They can also broaden and deepen the financial services they offer without fear that their operation will be criticized or labeled "illegal," because they have the license to do so. Credit unions to a very limited extent can innovate and stay competitive in the market, and are allowed to mobilize members' deposits only. Credit NGOs, on the other hand, do not have the authority to mobilize deposits. Neither do they have a license to do business, strictly speaking, since the authorities and the public view them as nonprofit, non-stock organizations providing some form of public service by providing social or microcredit.

(8) BSP needs to collaborate on the formulation of appropriate reporting, and performance standards for nonbank MFIs.

BSP should work with other stakeholders in developing performance and reporting

25 The MFIs under the Coalition for Microfinance Standards recently registered the Microfinance Council of the Philippines as a non-stock, nonprofit corporation with SEC. One of its self-appointed tasks is to develop a standard chart of accounts for credit NGOs, and performance standards that are based on the need to have sustainable MFIs.

standards for nonbank MFIs. In due course this could make the development of a ratings system for MFIs feasible.

(9) The central bank should provide support for capacity building of nonbank MFIs.

BSP should support the capacity building of nonbank MFIs by providing technical assistance through the Microfinance Council of the Philippines.

(10) BSP needs to educate its own staff on the special nature of microfinance.

BSP should educate its bank examiners on the special nature of microfinance loans, with the objective of sensitizing them to issues of "differential policy bias" against microfinance.

(11) Finally, the central bank must continue to focus on ensuring monetary stability.

BSP must continue to ensure price stability which provides the underlying conditions for microfinance development.

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Appendix 1: Capital, Reserve, and Other Requirements

Particulars	Commercial Banks	Thrift Banks (Savings and Mortgage, Stock Savings and Loan Association, Development)	Rural Banks/ Cooperative Rural Banks
Ownership	Individual and/or family group: 20% ceiling Corporate: 30% ceiling Foreign: 30% ceiling (may be raised subject to approval of the Philippine President)	Exempted from ownership ceilings until 16 March 2005 At least 40% owned by citizens of the Philippines	Exempted from ownership ceiling for 10 years from 2 April 1992
Institutional set-up	Stock corporation	Stock corporation	Stock corporation
Capitalization requirement (end-1998)[a]	EKBs: P4.5 billion KBs: P2 billion	Metro Manila: P250 million Outside Metro Manila: P40 million	1st/2nd/3rd class cities and 1st class municipalities: P5 million 4th/5th/6th class cities and 2nd/3rd/4th class municipalities: P3 million 5th/6th class municipalities: P2 million Cities of Manila, Kalookan, Quezon, Pasay, Mandaluyong, Makati and municipalities of Malabon, Navotas, San Juan, Paranaque: P20 million Cities of Cebu and Davao: P10 million
Financial products and services	Deposits: savings, time, demand Credit (loans, discounts, bills, lines of credit etc.) Common trust funds Foreign currency deposit units (subject to BSP approval) Investment banking services (EKBs only) Derivative products (subject to BSP approval)	Deposits: savings, time, demand, foreign currencies Credit (loans, domestic L/Cs, etc.) Common trust funds Correspondent services Collecting agent Mortgage and chattel mortgage issuance and trading	Deposits: savings, time, demand Credit Correspondent services Collecting agent Depository of government funds Act as trustee over estates
Market served	Wide class of people from different industries; bias for the high-income	Entrepreneurs requiring medium- and long-term loans	People of rural communities; farmers, merchants, and their cooperatives
Enabling law	RA 337, General Banking Act RA 7721, An Act Liberalizing the Entry and Scope of Operations of Foreign Banks in the Philippines BSP Circular 51 (for foreign banks)	RA 7906, Thrift Banks Act, 1995	RA 7353, Rural Banks Act, 1992
Regulatory body	BANGKO SENTRAL NG PILIPINAS		

EKB = expanded commercial bank, DOSRI = directors, owners, shareholders, and related interest, FX = foreign exchange, KB = commercial bank, L/C = letter of credit, NCR = National Capital Region, TB = thrift bank. See also Abbreviations.
a BSP has imposed a continuing capital build-up program for banks over the next two years.
Sources: Manual of Regulations for Banks; Thrift Banks Act, 1995; Rural Banks Act, 1992.

Particulars	Commercial Banks	Thrift Banks (Savings and Mortgage, Stock Savings and Loan Association, Development)	Rural Banks/ Cooperative Rural Banks
Legal and regulatory environment	Capital-to-risk asset ratio: 10% Long FX position not to exceed 5% of unimpaired capital; short FX position not to exceed 20% of capital Single borrowers' limit of 25% of unimpaired capital DOSRI ceilings • Individual: not to exceed outstanding deposits and paid-in capital in lending bank; unsecured loans not to exceed 30% of total credit extended • Aggregate: not to exceed the lower of (a) 15% of loan portfolio or (b) 100% of adjusted net worth Loan-to-deposit ratio: 75% Reserve requirement: • Peso deposits: 10% statutory, 4% liquidity • Common trust funds • Government deposits: 50% liquidity floor	Capital-to-risk asset ratio: 10% Single borrowers' limit = KBs DOSRI ceilings • Individual: not to exceed outstanding deposits and paid-in capital in lending bank; unsecured loans not to exceed 30% of total credit extended • Aggregate: not to exceed the lower of (a) 15% of loan portfolio or (b) 100% of adjusted net worth; unsecured loans not to exceed 30% of the lower of (a) allowable aggregate ceiling or (b) outstanding loans Loan-to-deposit ratio = KBs Reserve requirement: • Peso deposits: 11% statutory, 3% liquidity • Common trust funds • Government deposits: 50% liquidity floor FX deposits: 100% cover Investment in fixed assets = KB	Capital-to-risk asset ratio: 10% Single borrowers' limit = KBs DOSRI ceilings = TBs Loan-to-deposit ratio = KBs Reserve requirement: • Peso deposits: 5% • Govt deposits: 50% liquidity floor Investment in fixed assets = KB Ceilings on equity investments: • Maximum amount: 25% of net worth • In a single enterprise: 15% of net worth of investing bank • In allied undertakings Branching (subject to Monetary Board approval) capital requirements: Greater Manila Area – P5 million; Cebu and Davao – P2.5 million; 1st/2nd/3rd class cities and 1st class municipalities – P1.25 million; 4th/5th/6th class cities and 2nd/3rd/4th class municipalities – P0.5 million; other municipalities – none
	FX deposits: 100% cover Investment in fixed assets: not to exceed 50% of net worth Ceilings on equity investments: • Max amount: 50% of net worth for EKBs, 25% for KBs • In a single enterprise: 15% of net worth of investing bank • In allied undertakings • KBs: up to 49% • TBs and rural banks: 100% • Others: 100% • In non-allied undertakings (for EKBs only): up to 35% • Branching (subject to Monetary Board approval) capital requirements: NCR, Cebu and Davao – P20 million; other – P10 million	Ceilings on equity investments: • Max amount: 25% of net worth • In allied undertakings: 15% of net worth Branching (subject to Monetary Board approval) capital requirements: NCR, Cebu and Davao – P10 million; other cities and 1st class municipalities – P5 million; 2nd/3rd/4th class municipalities – P3 million; other municipalities – none Taxation: except for corporate income taxes and local taxes/fees/charges, exempted from paying all other taxes, fees and charges for a period of five years from the date of operation of the bank	Taxation: Exempted from all taxes, fees and charges for a period of five years from start of operations

EKB = expanded commercial bank, DOSRI = directors, owners, shareholders and related interest, FX = foreign exchange, KB = commercial bank, L/C = letter of credit, NCR = national capital region, TB = thrift bank. See also Abbreviations.
a BSP has imposed a continuing capital build-up program for banks over the next two years.
Sources: Manual of Regulations for Banks; Thrift Banks Act, 1995, Rural Banks Act, 1992.

Appendix 2: Persons Consulted

Albances, Ludy	Senior Examiner, Bangko Sentral ng Pilipinas
Almario, Mr. Joselito	Deputy Director, National Credit Council, Department of Finance
Domoong, Mr. Wilfredo	Director, Rural Banks, Bangko Sentral ng Pilipinas
Garcia, Mr. Edgardo	Project Manager, Coalition for Microfinance Standards
Hernandez, Mr. Antonio	Senior Vice President, Land Bank of the Philippines
Javier, Ms. Noemi	Vice President, Philippine Deposit Insurance Corporation
Jayoma, Fr. Benedicto	Administrator, Cooperative Development Authority
Lamberte, Dr. Mario	Acting President, Philippine Institute for Development Studies
Lirio, Ricardo	Managing Director, Bangko Sentral ng Pilipinas
Paez, Congressman Cresencio	House of Representatives
Torres, Ms. Dorie	President, CARD Rural Bank