

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

METHODOLOGY AND ORGANIZATION

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

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

social programs or from traditional loan portfolios.

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

FRAMEWORK FOR ANALYZING MICROFINANCE COMMERCIALIZATION

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

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

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

MFI Commercialization

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

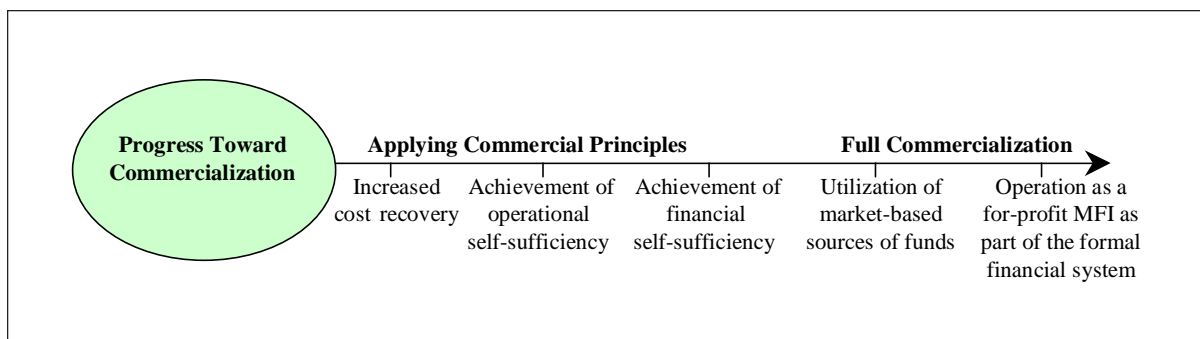
- Adoption of a professional, business-like approach to MFI administration and operation, such as developing diversified, demand-driven microfinance products and services and applying cost-recovery interest rates.

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

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

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

Figure 1.1: Illustrative Attributes of MFI Commercialization



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

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

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

Commercialization of the Microfinance Industry

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

1. Policy Environment

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

2. Legal Framework

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

3. Regulation and Supervision

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

4. Money Markets and Capital Markets

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

5. Support Institutions

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

NATIONAL CONTEXT

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

Socioeconomic Indicators

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

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

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

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

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

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

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

Table 1.1: Philippine Poverty Statistics

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

Source: World Bank 2002a, p.5.

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

Agriculture Development

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

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

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

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

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

Financial Sector Development

Composition of the Financial Sector

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

Table 1.2: The Philippine Formal Financial System

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

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

Source: Gochoco-Bautista 2000, p. 35.

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

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

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

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

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

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

Source: Philippines Deposit Insurance Corporation 2002.

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

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

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

Significant Developments in Banking

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

Box 1.1

Chronology of Important Philippine Banking Developments

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

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