4 Challenges to Microfinance Commercialization

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

INTERNAL CONSTRAINTS

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

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

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

Rural Banks

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

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

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

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

Cooperatives

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

However, unlike rural banks, cooperatives are considered semiformal institutions; they are regulated and supervised by the CDA but this supervision is known to be weak. Lack of transparency has historically been a major difficulty in assessing cooperative performance but, with the recent agreement by the NCC on a Standard Chart of Accounts and the COOP[74] administrative standards and PESOS[75] financial standards, the remaining challenge lies in the widespread adoption and use of these standards.

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

Microfinance NGOs

With the growing scarcity of donor funds for microfinance onlending, most microfinance NGOs are now faced with the challenge of finding funds from commercial sources or from deposits of their member-clients. Because deposits are considered a cheaper source of funds than commercial loans, the inability of NGOs to mobilize deposits legally poses a significant internal challenge. Lack of legal identity stemming from weak ownership and governance structures poses the greatest challenge to microfinance NGOs in accessing funds to provide microfinance on a commercial basis.

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

Related to constraints stemming from small size and weak capacity, many microfinance NGOs face the constraint of poor access to appropriate systems and support services. This issue was reflected in a January 2002 report by the Microfinance Council[76] containing survey responses from 90 leading MFIs in the Philippines (including all major microfinance NGOs and many leading rural banks and cooperatives with microfinance operations), which indicated what they saw as the major constraints to expanding their microfinance operations. Participating microfinance NGOs noted inadequate management information systems[77] and the lack of capacity to undertake market research as two major constraints curtailing their growth. The report indicated that "although computerization of systems has been identified as essential to the growth of MFIs, there still appears to be a supply problem in terms of affordable, commercially available, off-the-shelf software packages that suit the system and information requirements of MFIs."[78]

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

CONSTRAINTS IN THE OPERATING ENVIRONMENT

Private Sector "Crowding Out" by Government Microcredit Programs

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

Mandatory Lending and Investment

Presidential Decree 717, otherwise known as the Agri/Agra Law, mandates that all banks set aside 25% of their net loanable funds for agricultural lending, of which 10% is supposed to be lent to agrarian reform beneficiaries. While minimum lending requirements have been easily exceeded for the agricultural group, given the good number of creditworthy agribusinesses, compliance has not historically been met in terms of lending to the agrarian reform beneficiaries.[79] The main reason is that banks are not established to manage profitably the provision of small loans to the widely dispersed beneficiaries.

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

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

Threat of Policy Reversal

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

Box 4.1

Potential for Backsliding

"Section 43 [of the 2000 GBL] mandates that 'the Monetary Board shall regulate the interest imposed on microfinance borrowers by lending investors and similar lenders, such as, but not limited to, the unconscionable rates of interest collected on salary loans and similar credit accommodations. This provides regulators the dangerous authority, especially if political pressure is brought to bear, to regulate microfinance interest rates. Low, non-market interest rates prevent the recovery of operational and financial costs, plus an adequate margin for risks and long-run sustainability. In addition, also the possibility of even imposing such limits adds a new dimension to the risks of entering the field of microfinance."

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

Unclear Regulation and Supervision Concerning Microfinance Operations

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

Illegal Deposit Mobilization by Microfinance NGOs

A survey in 2001 of 23 of the largest microfinance NGOs showed that almost half of their combined outstanding loan portfolio was funded by a combination of savings or CBU,[82] despite the legal prohibition against deposit mobilization from the general public except with BSP licensure. Under the GBL, nonstock and nonprofit organizations are not permitted to accept savings and deposits in any form. So far, BSP has ignored the practice because the savings mobilized are only from microfinance NGO members and are mainly compulsory deposits, making the vast majority of members net borrowers.

Inadequate Access to Commercial Sources of Funds

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

No Credit Information Bureau that Captures Microcredit Information

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

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

Lack of Microfinance Training Centers

There is a variety of microfinance training programs. However, no "one-stop shop" yet exists for the provision of regularly scheduled, demand-driven, and affordable technical courses on microfinance program management and operation. CARD's microfinance training center is perhaps the best known and most widely used, but it cannot be considered as a wholly professional training institution that would attract a wide variety of regular students from different types of MFIs. AIM's Center for Development Management and Asian Center for Entrepreneurship and its leadership and creativity program offer advanced training and certificate programs in such areas as project management, social development, and entrepreneurship. However, AIM has not yet designed public training programs for MFI managers that exclusively address commercial microfinance issues. The institution that seems most suitable for offering additional microfinance training on a regular basis is Punla, provided that its management focuses on developing demand-driven courses suitable for a wide range of viable MFIs. To serve as the one-stop shop to build the technical capacity that the industry needs for further professionalization and commercialization, Punla will need to shift its focus more toward serving the complex and varied needs of commercial microfinance providers.