Philippine Institute for Development Studies

Surian sa mga Pag-aaral Pangkaunlaran ng Pilipinas

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DISCUSSION PAPER SERIES NO. 2001-24

December 2001

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EXPANDING BANKING SERVICES TO MICRO, SMALL AND MEDIUM ENTERPRISES AND POOR HOUSEHOLDS IN THE PHILIPPINES

Mario B. Lamberte [*]

Abstract

This paper has reviewed existing policies and programs to encourage banks to expand their financial services to micro, small- and medium-sized enterprises (MicSMEs) and poor households. The overall policy environment for promoting microfinance in the Philippines has indeed considerably improved since 1990, and there are signs that banks have favorably responded to it. However, banks still face some constraints in expanding further their financial services to MicSMEs and poor households. This paper has discussed these constraints and recommended some measures to overcome them.

Key words: *microfinance, banks, credit programs, poverty, microenterprises; small and medium enterprises.*

I. Introduction

As of 2000, the population of the Philippines stood at 76.5 million. With a population growth rate of 2.36 percent, which is well above the 1.3 percent world population growth rate, 1.8 million will be added each year to the country's population, and many of them will likely fall below the poverty line if the economy does not perform better in the future. During the period 1985-2000 when the economy grew only modestly, the number of poor people had risen from 26.2 million to 31.3 million despite the fact that poverty incidence had declined from 49.3 percent to 40 percent in the same period.[1] As the 1998 Annual Poverty Indicators Survey (APIS) shows, 70 percent of poorest 40 percent of the respondents relied on entrepreneurial activities as main source of income. It is to be noted that only 25 percent out of the 8.5 million families with business surveyed had obtained credit to finance their business.

There is no accurate information on the number of micro, small and medium enterprises in the Philippines because many of them do not register with concerned government agencies. However, past and most recent statistics suggest that some 90 percent of manufacturing establishments employ less than 10 workers. This does not include those in the agriculture and service sectors.

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[*] President, Philippine Institute for Development Studies (PIDS). The author is grateful to Ms. Juanita E. Tolentino and Ms. Merle G. Galvan for their excellent research assistance.

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

This economic landscape has not gone unnoticed by policymakers in the country. Since the country gained its independence from the US in 1946, the government has put in place policies and programs to address the needs of small and medium enterprises and reduce poverty incidence. Among them are financial policies and credit programs, which have been used as instruments for mobilizing and moving financial resources to micro, small and medium enterprises (**MicSMEs** for short) and poor households. These have varying degrees of success or failure. At the end of the day, however, the country must address the question of how to make a much wider array of financial services easily accessible to a large number of MicSMEs and poor households in a more sustainable manner. Banks can very well play this role provided the policy environment is right. This is the main issue being addressed in this paper.

The next section gives a brief overview of the entire Philippine financial system. Although this paper deals only with the provision of banking services to MicSMEs and poor households, the overview helps in getting a clearer picture of the role of banking institutions in providing financial services to the above-mentioned sectors. Section III discusses the existing policy framework and programs for promoting microfinance in the country. A discussion on the current status of bank lending to MicSMEs and poor households is presented in Section IV. Section V discusses the constraints facing banks, especially private banks, in expanding their financial services to a large number of MicSMEs and also recommends some measures to address them. The last section concludes the paper.

II. Overview of the Philippine Financial System

The Philippine financial system consists of formal and informal financial sub-systems. The informal sector is composed of heterogeneous players, such as moneylenders, rotating savings and credit associations (ROSCAS), etc. The formal financial sub-system also consists of heterogeneous players, which can be grouped into banking institutions, i.e., those that are authorized to provide credit and accept deposits from the general public, and non-bank institutions, i.e., those that are authorized to extend loans but are not permitted to accept deposits from the general public.

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

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

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

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

As of December 2000, there were 16,676 offices (head offices, branches and extension offices) of the financial institutions in the country (**Table 2**). Of these, some 45 percent were offices of banking institutions. Over 50 percent of banking offices of commercial banks are concentrated in Metro Manila, while most banking offices of thrift and rural banks are located in areas outside Metro Manila. The offices of rural banks are widely dispersed in rural areas.

In terms of assets, the banking system overwhelmingly dominates the financial system. Its total assets as of December 2000 amounted to PhP3.3 trillion or 82 percent of the total assets of the financial system. The total assets of the commercial banking system stood at PhP3 trillion or 74 percent of the total assets of the financial system. Given the dominance of the banking system in the country's financial system, the biggest

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[2] See Lamberte et al. (1998) for an evaluation of the 37 special or directed credit programs implemented or managed by 13 non-financial government agencies.

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

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

challenge, therefore, is how to make a significant proportion of bank assets and other bank services easily accessible to MicSMEs and poor households.

III. Existing Policy Framework and Programs for Expanding Banking Services to MicSMEs and Poor Households

This section discusses the government's operational definition of MicSMEs and poor households and the elements of the policy framework and programs for expanding banking services to MicSMEs and poor households.

1. Operational Definition

It is important for policy direction and for evaluating the effectiveness of certain policies and programs to have a common definition of MicSMEs and poor households. When dealing with farm enterprises, the Comprehensive Agricultural Reform Law provides an operational definition of what constitutes small farm enterprises. Since the retention limit for agricultural lands is 5 hectares, small farm enterprises, therefore, refer to those who own and farm 5 hectares or less.[5] As regards MicSMEs, Section 3 of the Magna Carta for Small Enterprises (Republic Act No. 6977 as amended by Republic Act No. 8289) provides an operational definition. It states that "small and medium enterprise" shall be defined as any business activity or enterprise engaged in industry, agribusiness and/or services, whether single proprietorship, cooperative, partnership or corporation whose total assets, inclusive of those arising from loans, but exclusive of the land on which the particular business entity's office, plant and equipment are situated, must have value falling under the following categories:

Micro	: less than		Php1,500,001	
Small	: PhP1,500,001	–	PhP15,000,000	
Medium	: PhP15,000,001	–	PhP100,000,000.[6]	

The same law authorizes the Small and Medium Enterprise Development Council (SMEDC) to periodically review the above definitions and, if necessary, adjust them

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[5] Section 6 of RA 6657 on retention limits states that "Except as otherwise provided in this Act, no person may own or retain, directly, any public or private agricultural land, the size of which shall vary according to factors governing a viable family-sized farm, such as commodity produced, terrain, infrastructure, and soil fertility as determined by the Presidential Agrarian Reform Council (PARC) created hereunder, but in no case shall the retention by the landowner exceed five (5) hectares. Three (3) hectares may be awarded to each child of the landowner, subject to the following qualifications: (1) that he is at least fifteen (15) years of age; and (2) that he is actually tilling the land or directly managing the farm: Provided, That landowners whose lands have been covered by Presidential Decree No. 27 shall be allowed to keep the area originally retained by them thereunder; Provided, further, That original homestead grantees or direct compulsory heirs who still own the original homestead at the time of the approval of this Act shall retain the same areas as long as they continue to cultivate said homestead."

[6] The exchange rate as of 16 November 2001 was PhP52/US$1.

upon recommendation of sectoral organizations taking into account inflation and other economic indicators.[7]

In the context of the Social Reform and Poverty Alleviation Act (SRPAA) of 1997 (Republic Act 8425), the poor households refer to the "basic sectors", which include the disadvantaged sectors of the Philippine society, namely: farmer-peasant, artisanal fisherfolk (i.e., municipal, small scale or subsistence fishermen who use fishing gears which do not require boats or which only require boat below 3 tons), workers in the formal sector and migrant workers, workers in the informal sector, indigenous peoples and cultural communities, women, differently-abled persons, senior citizens, victims of calamities and disasters, youth and students, children, and urban poor. It also defines microenterprise, which is any economic enterprise with a capital of PhP150,000 and below. This does not necessarily conflict with the definition provided under the Magna Carta for Small Enterprises because the latter defines microenterprise in terms of assets inclusive of those arising from loans, whereas the former defines microenterprise in terms of capital.

2. <u>Elements of the Policy Framework and Programs</u>

a. Banking Structure

Banks have the natural tendency to be large to exploit economies of scale and scope. In the process, they tend to shy away from small savers and borrowers because of the relatively high transaction costs they incur and lack of related businesses they can generate with them. Thus, a banking system that consists of a few large banks will likely leave out small savers and borrowers from the formal financial system. Anticipating this problem, the Philippine authorities have structured a banking system that includes a sub-system that will cater to the needs of small savers and borrowers. The thrift banks and rural banks are expected to perform such functions. Since most small savers and borrowers are located in areas outside Metro Manila, the Bangko Sentral ng Pilipinas (BSP), which is the country's central bank, encourages thrift and rural banks to locate in these areas by requiring them low minimum capital requirements.

To improve the viability and competitiveness of thrift and rural banks that cater mainly to MicSMEs and poor households, the government has provided several incentives. One is that the reserve requirement ratio of their deposits is lower by 2 percentage points than that of commercial banks. Another is that they are exempt from the payment of all taxes, fees and charges of whatever nature and description, except the corporate income tax and local taxes, fees and charges, for a period of 5 years from the date of commencement of operations. These incentives enable thrift and rural banks to give competitive rates on their deposits and loans and, at the same time, to build up their capital.

[7] When RA 6977 was passed in 1991, the definitions were as follows: micro – less than PhP50,000; cottage – PhP50,001 to PhP500,000; small – PhP500,001 to PhP5,000,000; and medium – PhP5,000,001 to PhP20,000,000.

b. Microfinance-friendly Policy and Banking Regulation

The SRPAA provides the policy framework for microfinance services for the poor. More specifically, it sets out the following thrusts:

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

(ii) Rationalization of existing government programs for credit and guarantee;

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

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

The financial sector reforms initiated by the government in the 1990s (e.g., liberalizing bank entry and branching) have laid the ground for promoting microfinance in the country. This was further boosted by the recent passage of the General Banking Law of 2000, which includes 3 provisions that set a much clearer policy framework for promoting microfinance. In 2001, the Bangko Sentral ng Pilipinas (BSP) issued three circulars to implement said policy. In Circular No. 272 (January 2001), the BSP defines microfinance as "the provision of a broad range of financial services such as – deposits, loans, payment services, money transfers and insurance products – to the poor and low-income households, for their microenterprises and small businesses, to enable them to raise their income levels and improve their living standards."[8] This is important in that it conveys to the general public what kind of microfinance the government is promoting.

There are four important paragraphs in Circular 272 that must be noted well. The first is that "microfinance loans may be amortized on a daily, weekly, bi-monthly or monthly basis, depending on the cash flow conditions of the borrowers." This is intended to give small borrowers flexibility in choosing their amortization schedule that would reflect the timing of their cash flow. This virtually mimics credit arrangements prevalent in the informal credit markets. Second is an important statement on interest rate policy. Specifically, it states that "interest rate shall not be lower than the prevailing market rates to enable the lending institution to recover the financial and operational costs incidental to this type of microfinance lending." This is to send a clear signal to the public that the government intends to promote viable, self-sustaining microfinance institutions. This runs counter to the previous policy of promoting below-market rate of interest for loans to MicSMEs and poor households, which made it difficult for microfinance institutions to operate in a sustainable manner. Third is a guideline to do away with requirements that are not appropriate for or raise the cost of microfinance loans. Thus, it states that for microfinance loans "a bank may not require from its credit applicants, a statement of assets and liabilities, and of their income and expenditures and such information as may

[8] This can be found in the Notes to Microfinance, which is an annex to Circular 272 (see Annex A of this paper).

be prescribed by law or by rules and regulations of the Monetary Board…." Obviously, small borrowers cannot present to a bank audited financial statements, which are required of big borrowers. Fourth is that it encourages banks to lend to small borrowers not on the basis of a collateral but on the basis of borrowers' cash flows. This is to address the problem that small borrowers cannot borrow from banks to finance viable economic projects because they cannot present hard collateral to banks.

The existence of adequate banking offices in all areas in the country can improve access of MicSMEs and poor households to banking services. Beginning in 1989, the then Central Bank relaxed the regulation on bank entry and branching. This led to the proliferation of banks and branches in the country. Many of these banks became in distress especially in the wake of the East Asian financial crisis and the El Niño weather phenomenon that struck in 1998. Thus, the BSP has declared a moratorium on the opening of new banks and has instead encouraged merger/consolidation to strengthen the financial position of existing banks. However, to ensure that microfinance services will not be diminished, the BSP recently approved a partial lifting of the general moratorium on the licensing of new thrift and rural banks to allow entry of microfinance-oriented banks.[9] A rural bank to be established as a microfinance bank is required to have a minimum paid-in capital of PhP5 million while the existing capitalization requirement for thrift banks apply (see **Table 1**). In addition, the BSP has reconfigured its rediscounting facility to provide liquidity assistance aimed at supporting and promoting microfinance programs.[10]

c. Loan Portfolio Regulations

Loan portfolio regulations pertain to those regulations that require banks to allocate a certain proportion of their loanable funds to specific sectors of the economy. There are 3 existing regulations. First is the deposit retention scheme. Under this scheme, at least 75 percent of the total deposits, net of required reserves against deposit liabilities and total amount of cash in vault, accumulated by branches, agencies, extension officers, units and/or head offices of specialized government banks, in a particular regional grouping outside the National Capital Region, shall be invested therein as a means to develop that region. This policy is used to deal with the problem of funds diversion; that is, banks with nation-wide branch network mobilize deposits in rural areas and lend them to large enterprises in urban areas, more specifically, Metro Manila, leaving nothing for MicSMEs and poor households in rural areas. This is detrimental to the development of MicSMEs and poor households in rural areas because they are denied of badly needed funds. For purposes of this regulation, the country used to be divided into 13 regions. Commercial banks were against this policy because they could hardly find borrowers in rural areas that would pass their credit criteria. As a result, they were discouraged from intensively mobilizing deposits. Borrowers and savers ultimately borne the cost of this regulation in terms of higher interest rate on loans and lower

[9] See BSP Circular No. 273 (February 2001).
[10] See BSP Circular No. 282 (April 2001).

interest rates on deposits.[11] Thus, in 1990, this regulation was relaxed by reducing the number of regional groupings from 13 to 3, which gives banks greater scope for diversifying their loan portfolio and sources of funds at least geographically.

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

The third loan portfolio regulation is the mandatory credit to the small enterprises as provided for under Republic Act (RA) 6977, otherwise known as the Magna Carta for Small Entrprises. Under this law, all lending institutions were mandated to lend at least 10 percent of their total loan portfolio to small enterprises. This requirement was tiered and had a time bound: 5 percent of the total loan portfolio by the end of 1991 to rise to 10 percent by end-1992 through 1995 and to decline to 5 percent by the end of 1996 and zero by the end of the 7th year. As expected by many, the law was amended by the 7th year (RA 8289). Thus, for a period of 10 years after the effectivity of the new law, all lending institutions are required to set aside at least 6 percent of their total loan portfolio for small enterprises and at least 2 percent for medium enterprises, and make it available for small and medium enterprises credit. Only instruments issued by the Small Business Guarantee and Credit Corporation, which do not pay market rates, and non-interest

[11] See Relampagos and Lamberte (1988).

bearing deposits with the BSP are deemed alternative instruments for complying with this loan portfolio regulation.

d. Government's Direct Participation in the Banking System

The government directly participates in the provision of financial services to MicSMEs and poor households through its banking institutions and numerous directed credit programs. It currently maintains two banks that perform special functions. These are the Development Bank of the Philippines (DBP) and the Land Bank of the Philippines (LBP).[12] These banks lend to MicSMEs and poor households including farmers and land reform beneficiaries either directly through their retail lending windows or indirectly through their wholesale lending windows. Because they have been largely used by the government as instruments for increasing access of MicSMEs and poor households to financial services, we will describe them lengthily here.[13]

(i) Development Bank of the Philippines (DBP)

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

On December 20, 1995, the Bangko Sentral ng Pilipinas (BSP) granted the DBP permit to operate as an expanded commercial bank or universal bank. As a universal bank, DBP offers the following products and services to its clients: a) deposit products and services; b) fund transfer services including provision of telegraphic transfer services and acceptance of PLDT/SSS/BIR payments; c) fund management services including government securities dealership and servicing of foreign currency remittances; d) trust products and services including dealership of blue chips and trusteeship of asset-backed securities; e) merchant banking services including underwriting and loan syndications; f) wholesale lending services; g) retail lending services; h) export financing; and i) guarantee services. At present, DBP has five regional offices and 70 branches nationwide.

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[12] A third bank, the Philippine National Bank (PNB), has been privatized.
[13] This draws on Lamberte et al. (1998).

Major Policies/Strategies. In its wholesale banking operations, DBP taps participating financial institutions (PFIs) as conduits.

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

The DBP maintains three lending modes or windows as part of its retail lending services. Window I (WI) caters to short-term working capital needs with maturities of up to 18 months. The DBP internal funds are usually used for this purpose. Window II (WII) finances the acquisition of fixed assets and permanent working capital with repayment term of up to five years. Lastly, Window III (WIII) assists activities that have catalytic effects on the country's economic development. Loans under this window are for infrastructure, fixed asset acquisition and/or working capital with repayment period of more than 5 years. This window is also noted to be the centerpiece of DBP's retail lending operations that support the government's Social Reform Agenda. Most of the programs under WIII are implemented in cooperation with government line agencies such as the Department of Science and Technology, Department of Agriculture and Department of Agrarian Reform, and Congress. Eligible borrowers under WIII social programs, in general, include cooperatives, associations, non-government or private institutions engaged in developmental activities. Relatedly, DBP is mandated to maintain at least 20 percent of its loan portfolio for WIII. Thirty percent of the net income of DBP after tax is used to fund this window. There are also domestic sources of funds, e.g. Social Security System (SSS), that finance WIII. WIII accounts comprised about 18 percent of its outstanding loan portfolio.

Special credit programs implemented. The DBP currently administers 19 special credit programs that are financed by foreign or domestic borrowings and special funds. These are apart from those that they administer for government line agencies. Of the 19 programs, 10 fall under its wholesale lending operations and use the participating financial institutions (PFIs) as conduits of funds. The remaining nine (9) programs are implemented as part of its retail operations and cater directly to end-borrowers.

(ii) Land Bank of the Philippines (LBP)

Charter/Mandate. LBP was established on August 8, 1963 as a government-owned financial institution by virtue of Republic Act 3844 otherwise known as the Agricultural Land Reform Code. LBP was primarily mandated to serve as the financial arm of the land reform program. In 1973, LBP was given a comprehensive commercial or universal banking status through a presidential decree. LBP put up its commercial banking arm to cater to agribusiness projects and rural industries, which since then was known to support its agrarian reform operations.

With the enactment of Republic Act 6657 or the Comprehensive Agrarian Reform Law (CARL) in 1988, LBP expanded its agrarian operations as the comprehensive agrarian reform program (CARP) covers all agricultural lands, both private and public, regardless of tenurial arrangement and commodity produced. Under CARP, cooperatives have emerged as the main conduit of LBP support to agrarian reform beneficiaries.

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

Major Programs and Lending Strategies. In its bid to address all aspects of progress, LBP implements the Total Development Option-Unified LandBank Approach to Development or TODO-UNLAD program. TODO-UNLAD links cooperatives, farmers' cooperatives, private companies, rural banks, non-government organizations and local government units in specific areas around an integrated area development project through LBP's various lending programs and support services. Each project under the program entails linking producers to markets and processors as well as the strengthening of cooperatives and local government units. TODO-UNLAD prioritizes communities covered by CARP and communities belonging to the 20 priority provinces identified under the Social Reform Agenda. Qualified for financing are farm production, farm-to-market roads, rural electrification, telecommunication systems, processing and post-harvest facilities, among others.

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

LBP bank also provides support to the small and medium enterprises (SMEs). In 1996 it launched six new credit programs for SMEs, foremost of which are the "Negosyo Mo, Susuportahan Ko" and the "Todo Kaya: Isulong ang Pagsulong" even as it remains a preferred conduit of the Social Security System and the Development Bank of the Philippines in their SME financing.

LBP continues to tap rural banks as conduits in its credit delivery. In fact, it played a big role in the program to rehabilitate several ailing rural banks through various capital infusion and rediscounting programs.

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

Special credit programs implemented. LBP currently implements 13 special credit programs. Nine (9) of these are funded by foreign loans while the rest are supported by domestically-sourced special funds. This count excludes those being administered by LBP for government line agencies.

IV. Current Status of Bank Lending to MicSMEs and Poor Households

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

1. <u>Overview of the Banks' Compliance with Loan Portfolio Regulations</u>

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

As regards lending to MicSMEs under the Magna Carta for Small enterprises, the BSP is required to submit a quarterly report to SMEDC with respect to banks' compliance of said law.[14] **Table 3** shows that the banking system as a whole has greatly exceeded the minimum loan requirement for both small and medium enterprises. As of June 2001, 93 percent of the total credit allocation for small and medium enterprises was directly lent by banks to such enterprises. The bulk of the loans to MicSMEs came from commercial banks (**Table 4**).

The data, however, hide a few important information. One is that foreign banks and large domestic banks, which are predominantly wholesale banks, comply with the requirement mainly by depositing the required amount with the BSP, rather than by exerting effort to look for small and medium enterprises as borrowers. Another is that several rural banks did not submit any report to the BSP. A major reason is that these banks can hardly find medium enterprises in small towns where they operate. Thus, they find it better to pay the fines rather than set aside non-income generating funds for lending to medium enterprises.

2. Government Banks

As already mentioned above, the government has utilized DBP and LBP as instruments for providing financial services to MicSMEs and poor households. For 2000, DBP granted short- and long-term loans to SMEs amounting to almost PhP22 billion. Outstanding exposure of DBP to SMEs stood by year-end at PhP17 billion for both wholesale and various retail lending programs cited above through its 77 branches across the country. Under Window III, which finances innovative and socially desirable projects with high development impact, the total loan outstanding reached PhP1.72 billion. All this comprises only 17 percent of the total loan portfolio of DBP because it also provides large loans to private enterprises for large projects, such as infrastructure projects, acquisition of modern technologies, transport and telecommunications.

LBP extends financial services to its clients through its 300 branches distributed across the country. Its outstanding loans to small farmers and fisherfolk stood at PhP13.5 billion as of end-2000. Loans for this sector were released through 1,797 cooperatives and 464 countryside financial institutions (rural banks, cooperative banks, thrift banks), which serve as LBP's channels of credit to farmers and fisherfolk. Its outstanding loans to MicSMEs for the same period reached PhP12.3 billion. Seventy (70) percent were directly lent by LBP to SMEs and the remaining, through some of its programs that either use wholesale or retail lending.

LBP has a subsidiary – People's Credit and Finance Corporation – that specializes in microcredit with loans ranging from PhP5,000 to PhP10,000. It works closely with NGOs and microfinance institutions to implement its program. As of December 2000, it already granted loans amounting to PhP2.6 billion to 324,108 borrowers with a very good repayment rate (**Table 5**).

3. Thrift Banking System

[14] Banks are also required to include this in their published quarterly financial reports.

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

Table 6 shows that thrift banks' loans granted and outstanding both in nominal and real terms had been rising up until the East Asian financial crisis. As of 1998 when most recent published data became available, loans granted in nominal terms reached PhP342 billion, while loans outstanding in nominal terms stood at PhP104 billion. About half of these loans are short-term for the purpose of financing working capital of MicSMEs. There is no information on the number of borrowers; hence, it is not possible to estimate the average size of loans they grant. However, personal interviews conducted among a few thrift banks in Metro Manila indicate that their minimum loan size ranges from PhP20,000 to PhP100,000 and the maximum loan sizes from PhP5 million to PhP10 million. Most thrift banks have branches operating within a certain region. However, a few large thrift banks have nation-wide branch network.

4. <u>Rural Banking System</u>

The rural banking system truly caters to small savers and borrowers. In 1998, it granted more than one million loans to farmers, fisherfolk, and small non-farm enterprises (**Table 7**). The rural banking system's average loan size rose from PhP4,600 in real terms in 1980 to PhP15,000 in 1995, and thereafter tapered off reaching PhP11,000 in 1998.[15] In nominal terms, the system's average loan size amounted to PhP28,000 or US$684 in 1998, which was well below the PhP150,000 loan ceiling for microenterprise under the SRPAA. At present, rural banks grant loans as low as PhP10,000, which is approximately US$200 per borrower.

Aside from increasing geographical diversification, rural banks have been increasingly diversifying their loan portfolio across major economic activities. In the 1980s, rural banks' loans were mostly concentrated in the agricultural sector (**Table 8**). This is understandable because rural banks were merely serving as conduits of government funds, most of which were directed to the agricultural sector. In addition, a large chunk of their loan portfolio was supposed to be for the agricultural sector. Over the years, however, rural banks have been able to reduce their exposure to agriculture in relative terms, and increased the shares of other economic activities, such as commercial, industrial and other economic activities in rural areas. Thus, the share of agricultural

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

loans in the total loan portfolio of rural banks went down from 89 percent in 1980 to 46 percent in 1998. In contrast, the shares of commercial, industrial and other loans increased from 6.1 percent, 2.5 percent and 2.3 percent, respectively, in 1980 to 16.7 percent, 5.9 percent and 31.3 percent, respectively, in 1998. This suggests two things. One is that there are some people in rural areas who are engaged in viable non-farm activities needing financial services from banks. Second, if left to themselves, rural banks will find a way of diversifying their loan portfolio as ordinary banks do to manage risks in lending.

There has also been a substantial change in the way rural banks finance their lending operations over the years. In 1980, deposits comprised only 43 percent of their total liabilities (**Table 9**). A big chunk of their liabilities comprised borrowings from the Central Bank and other special credit programs of the government. The radical change in rediscounting and interest rate policies in the mid-1980s has encouraged banks to mobilize deposits and to rely less on rediscounting window of the Central Bank. Thus, by 1998, the share of deposits in the total liabilities of rural banks rose to 74 percent. Another way of looking at it is to take the ratio of deposits to loans, which shows the extent to which deposits have financed loans. In 1980, deposits financed 45 percent of every peso lent by rural banks. This rose to 88 percent in 1998.

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

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

A number of rural banks have adopted variants of the Grameen Bank technology so that they can penetrate high-risk, small borrowers at very low cost. One example is CARD Rural Bank's modified Grameen Bank project. The bank's target clients are landless women rural workers who have no regular jobs and have total marketable assets of less than PhP50,000 or a little less than US$1,000. In 1997, it was able to organize 1,654 groups with a total of 9,968 members (Hossain and Diaz 1997). Access to CARD's loans, despite an effective loan rate of 44 percent per annum, has yielded some benefits to the borrowers in terms of higher income, employment, productivity and capital accumulation. Many rural banks have also created special credit windows for salaried people in rural areas whose families are engaged in small and cottage enterprises. All this indicates that rural banks are steadily enhancing their capabilities to assess credit risks as they seek to build good relationship with their clients.

Many rural banks have shown some creativity in mobilizing deposits. For instance, they require only a minimum of PhP100 or US$2.00 to open a savings account and a modest minimum average daily balance for deposits to earn interest, which could be as low as PhP100.[16] They offer different types of deposits that suit the varying tastes of their clients at rates much more attractive than commercial and thrift banks. Some rural banks already offer checking accounts to their clients. Most rural banks are now aggressively campaigning for deposits through print and broadcast media, by sponsoring important events in the communities, or by conducting raffles, bingo, etc.

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

5. Commercial Banks' Credit Programs for MicSMEs

Although commercial banks mainly cater to large borrowers, however, they have tried to formulate innovative lending programs to address the credit needs of small borrowers. In 1991, the commercial banks' Bankers Association of the Philippines (BAP) established the BAP Credit Guaranty Corporation (BCGC) funded by contributions of its members. Its paid-up capital is more than PhP100 million. Legally, BCGC is considered a lending investor, not a bank. It provides loans to those who do not normally qualify for a loan under the regular loan windows of its member banks. It has greater flexibility than commercial banks because it can grant loans not on the basis of the quantity and quality of the collateral but on the basis of the viability of the projects to be funded and the potential repayment capacity of borrowers. Loans are mostly for short-term working capital requirement of microenterprises. The minimum size of the loan is PhP50,000. It charges the usual commercial bank rate on its loans, which is much lower than the interest rate charged by lending investors, pawnshops and informal money lenders. Some of its borrowers already graduated to the regular loan windows of commercial banks. To increase its outreach, BCGC has decided to also go into wholesale lending by tapping existing NGOs that have a good track record in managing credit programs.

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

V. Constraints of Providing Financial Services to MicSME and Poor Households

[16] Commercial and thrift banks usually require at least P1,000 to open a savings account.

As indicated in the discussion above, banking policies have become more conducive to the expansion of financial services to MicSMEs and poor households. In fact, there are already signs that small banks are favorably responding to this. For instance, the number of offices of thrift and rural banks together have increased from 2,685 in 1996 to 3,285 in 2001 (June) despite the fact that many of them had failed during the same period. Recently, a microfinance-oriented bank was set up by a local thrift bank jointly with foreign partners in the southern part of the Philippines. Based on the criteria formulated by the BSP for giving a license to microfinance-oriented banks, these banks are not like ordinary rural bank or thrift bank.[17]

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

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

Inadequate infrastructure. Poor infrastructure increases the cost of providing financial services to MicSMEs and poor households. Aside from good roads and sturdy bridges, cheap and reliable electricity and telecommunication system are important in improving the efficiency of microfinance institutions. Indeed, some thrift and rural banks have not been able to automate their operations of inadequate and unreliable supply of electricity in their area. They badly need to computerize their system to be able to accurately process numerous small deposits and loans in much shorter time. The government's thrust to give high priority in its development agenda the improvement in infrastructure system in rural areas is step in the right direction. The government budget should reflect this.

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

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

Shortage of capital. Although small banks can mobilize more deposits, as many of them have already demonstrated, their limited capital sets a ceiling as to how much further they can mobilize deposits.[18] There are ways of dealing with this problem. One is to encourage large commercial banks to infuse equity into small banks, such as rural banks, by including such investment as an alternative instrument for complying with the existing loan portfolio regulation so long as they remain minority stakeholders.[19] Such arrangement can pave the way for correspondent banking relationship between small and large banks in the country. This option is better than compelling large commercial banks to lend to small enterprises or to buy eligible government securities.

In the case of cooperative rural banks, the expansion of their capital is constrained by the limited number of cooperatives that have the financial capability to invest in cooperative banks.[20] The Rural Banking Act must, therefore, be amended to allow cooperative rural banks to accept individual members as preferred shareholders.

The recent establishment of a microfinance-oriented bank is a welcome development. However, the BSP should also look into possibilities of encouraging other commercial and thrift banks to venture into microfinance business. Perhaps, it can organize training programs for banks to expose them to microfinance lending technologies.

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

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[18] All banks are mandated to meet the capital adequate ratio for prudential reason.
[19] Commercial banks seem to prefer to have a wholly-owned thrift bank.
[20] Under the existing law, only cooperatives can own shares in cooperative rural banks.

expansion of their services since they will be facing undue competition from those banks.[21]

Aside from competing with government banks, private banks also compete with government-owned non-bank financial institutions, such as the Small Business Credit and Guarantee Corporation, the People's Credit and Finance Corporation (PCFC), etc., and a host of special credit programs for MicSMEs and poor households implemented by non-financial government agencies. Many of these directed credit programs have performed badly, which, if continued, could undermine the discipline needed to promote market-based microfinance institutions.[22] Another immediate task is to privatize LBP's subsidiary, the PCFC, and convert it into a bank so that it can operate as a truly market-based microfinance bank.

Inadequate supervision. While the BSP encourages private banks to engage in microfinance, it must ensure that banks that do so remain safe and sound at all times so that financial services to MicSMEs and poor households will not be disrupted due to massive bank failure. Indeed, some banks are hesitant to venture into microfinance for fear that failure of poorly managed, ill-supervised microfinance-oriented banks can undermine otherwise soundly managed microfinance-oriented banks.[23] In this regard, the BSP must adopt a risk-based supervision approach for microfinance and upgrade the capability of its staff to effectively utilize such approach.[24] It must also constantly finetune its regulatory system to discourage banks from doing regulatory arbitrage.

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

VI. Concluding Remarks

This paper has demonstrated that policy environment does matter a lot in expanding banking services to MicSMEs and poor households. Indeed, the policy environment for microfinance to develop has improved considerably since 1990 and banks have positively responded to it. However, banks still face some constraints in expanding further their services to MicSMES and poor households. The government

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[21] Government banks are also designated depository banks of all government agencies and corporations. Hence, they maintain a large pool of cheap deposits. See Lamberte (2000) for a proposal to re-orient the LBP.
[22] See Lamberte et al. (1997, 1998).
[23] This is part of the information asymmetry problem wherein bank depositors and other creditors are not able to distinguish between good and bad banks in times of severe financial distress.
[24] See Fitzgerald and Vogel (2000) and Llanto (2001).

should therefore address these constraints to promote a sustainable, market-based microfinance in the country.

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Table 1
Minimum Level of Capitalization for New Entrants
As of August 2000

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

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

Table 2
Total Resources and Offices of the Financial System, 2000

Type	**Resources** **Amount (P B)**	**%**	**Offices** **No.**	**%**
A. **Banking Institutions**	**3326.80**	**81.83**	**7,553**	**45.29**
1. Comnmercial banks	3013.60	74.12	4,250	25.49
2. Thrift banks	245.80	6.05	1,391	8.34
3. Rural banks	67.40	1.66	1,912	11.47
B. **Non-banks**	**738.80**	**18.17**	**9,123**	**54.71**
Total	**4065.60**	**100.00**	**16,676**	**100.00**

Source: Bangko Sentral ng Pilipinas

Table 3
Distribution of Credit
For Small and Medium Enterprise
(In Billion Pesos)

	Small Enterprise -				Medium Enterprise -			
	June 2001		March 2001		June 2001		March 2001	
	Amount	% to Total	Amount	% to Total	Amount	% to Total	Amount	% to Total
Direct Compliance	137.0	93.1	117.7	92.1	84.4	93.4	95.6	94.7
Indirect	4.2	2.8	4.6	3.6	3.9	4.3	3.6	3.6
Funds Set Aside:	6.0	4.1	5.5	4.3	2.1	2.3	1.8	1.8
Cash on Hand	0.6	0.4	0.5	0.4	0.3	0.3	0.2	0.2
Due from BSP	5.4	3.7	5.0	3.9	1.8	2.0	1.6	1.6
Total Credit	147.2	100.0	127.8	100.0	90.4	100.0	101.0	100.0
Net Loan Portfolio	962.1		1,007.5		962.1		1,007.5	
Min. Amt. Required to Set	57.7		60.4		19.2		20.1	
Excess	89.5		67.4		71.2		80.9	
Rate of	15.3		12.7		9.4		10.0	

Source: Small and Medium Enterprises Development Council

Table 4
Distribution of Credit Allocation
By Bank Category

	6%		2%		Total	
	Amount	% Dist.	Amount	% Dist.	Amount	% Dist.
Total Banking System	147.2	100.0	90.4	100.0	237.6	100.0
Commercial Banks	119.6	81.2	75.7	83.7	195.3	82.2
Expanded KBs	104.5	71.0	61.5	68.0	166.0	69.9
Non-Expanded KBs	11.1	7.5	12.7	14.0	23.8	10.0
Branches of FX Banks	4.0	2.7	1.5	1.7	5.5	2.3
Thrift Banks	19.0	12.9	12.0	13.3	31.0	13.0
Savins & Mortgage	8.7	5.9	4.5	5.0	13.2	5.5
Private Devt. Banks	9.0	6.1	6.7	7.4	15.7	6.6
Stock Savings & Loan	1.3	0.9	0.8	0.9	2.1	0.9
Rural Banks	8.6	5.9	2.7	3.0	11.3	4.8

Source: Small and Medium Enterprise Development (SMEDC).

Table 5
People' Credit and Finance Corporation
Summary of Performance

	For the Year 1999	As of Dec. 31, 1999	For the Year 2000	As of Dec. 31, 2000
Loans granted (PM)	775.578	1,661.3	693.6	2,564.1
Loans outstanding (P M)		769.7		
Current		756		
Past Due		12.1		
Restructured		1.6		
Repayment rate (%)		98.5		
Past due ratio (%)		1.6		
No. of borrowers / no. of loans	105,084	217,239	106,869	324,108
No. of program partners	49	143	35	178
NGOs	6	24	3	27
Cooperatives	17	42	14	56
Rural Banks	20	51	15	66
Cooperative Banks	5	23	1	24
Thrift Banks		2	2	4
Lending Investors	1	1		1

Source: People's Credit and Finance Corporation.

Table 6
Loans Granted and Outstanding of Thrift Banks
(In Million Pesos)

Year	Loans Granted		Loans Outstanding	
	Nominal	Real*	Nominal	Real
1990	65069.8	135115.9	17,842.8	37050.2
1991	65585.6	114773.4	24,646.8	43131.4
1992	124919.5	200653.2	25,440.5	40864.1
1993	180843.5	269942.6	36,461.5	54425.6
1994	252235.3	345310.1	70,391.0	96365.3
1995	338479.4	428921.7	69,590.9	88185.7
1996	342589.9	398249.7	92,893.1	107985.2
1997	467615.3	513089.9	110,478.3	121222.1
1998	341510.5	341510.5	104,616.2	104616.2

Notes:
CPI Base Year: 1998=1.00
Source: Bangko Sentral ng Pilipinas

Table 7
Total Loans Granted by Rural Banks

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

Notes:
CPI Base Year: 1988=1.00
Data on loans granted by rural banks consist of supervised and non-supervised credit and were reported on annual basis starting 1995. However, 1997 data consist of non-supervised credits only.
Source: Bangko Sentral ng Pilipinas

TABLE 8. DISTRIBUTION OF LOANS OF THE RURAL BANKING SYSTEM BY PURPOSE
In Million Pesos

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

[1/] *As of June 1998*
Source: Bangko Sentral ng Pilipinas

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

Source: Bangko Sentral ng Pilipinas

Annex A

NOTES ON MICROFINANCE

A. Definition of Microfinance

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

B. Core Principles for Microfinance

- The poor needs access to appropriate financial services
- The poor has the capability to repay loans, pay the real cost of loans and generate savings
- Microfinance is an effective tool for poverty alleviation
- Microfinance institutions must aim to provide financial services to an increasing number of disadvantaged people
- Microfinance can and should be undertaken on a sustainable basis
- Microfinance NGOs and programs must develop performance standards that will help define and govern the microfinance industry toward greater reach and sustainability

Characteristics and Features of Microfinance

Characteristics	Distinguishing Features
Type of Client	Low Income Employment in informal sector; low wage bracket Lack of physical collateral Closely interlinked household/business activities
Lending Technology	Prompt approval and disbursement of micro loans Lack of extensive loan records Collateral substitutes; group-based guarantees Conditional access to further micro-credits Information-intensive character-based lending linked to cash flow analysis and group-based

	borrower selection
Loan Portfolio	Highly volatile Risk heavily dependent on potfolio management skills
Organizational Ideology	Remote from/non-dependent on government Cost recovery objective vs. profit maximizing
Institutional Structure	Decentralized Insufficient external control and regulation Capital base is quasi-equity (grants, soft loans)

C. Definition of Microfinance Loans

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

D. Level of Microfinance Loan

Average microfinance loan of an NGO microfinance institution or of a cooperative bank or credit union in the Philippine case is aobut ₱25,000 (from a low of ₱2,000 to ₱5,000). To be realistic, the maximum principal amount of a microfinance loan can be pegged at ₱150,000. This is equivalent to the maximum capitalization of a microenterprise under RA 8425.

E. Collateralization of Microfinance Loan

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

F. Interest on Microfinance loans

Old Approach

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

New Approach

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

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

G. Segments of Demand for Micro-credit

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

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

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

Source: BSP Circular No. 272 (30 January 2001).