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An Assessment of the Capacity and Financial Performance of Microfinance Institutions: The Philippine Case

("Nemo dat, quod non habet")*

GILBERTO M. LLANTO, EDGARDO GARCIA AND RUTH CALLANTA†

Executive Summary

The paper assesses the capacity and financial performance of a sample of microfinance institutions (MFIs) operating in the Philippines. It has the following objectives: (a) explain the microfinance policy environment in the country; (b) evaluate the institutional and financial capacity and performance of MFIs; (c) determine the issues and constraints affecting capacity and performance; and (d) recommend measures to strengthen the MFIs. The motivating philosophy of this paper is that unless MFIs become viable and sustainable financial institutions, they can never fully realize their objective of reaching a greater number of poor people, much less sustain the effort over the long term.

Banks rarely lend, if at all, to the poor, mostly because of information problems, high credit risk perception, lack of acceptable collateral and the high transaction costs of processing small loans. The government's response was to create a number of credit programs intended to provide the poor with access to financial services. The National Credit Council reports as many as 111 credit programs of which 13 are targeted to the ultra-poor. Despite the government's credit programs, the poor's access to microfinancial services persists. The private sector approach is to use MFIs such as credit nongovernmental organizations (NGOs),

*"Nobody gives what he does not have." – from the Latins.

†Research Fellow, Philippine Institute for Development Studies; Managing Director and Chairperson, respectively, Center for Community Transformation. The authors would like to acknowledge the assistance of the following case writers in the preparation of this paper: Ms. Magoo S. Casuga, Ms. Florenze S. Cordova, Mr. Ernesto I. Macabenta, Mr. Elrico V. Muñoz, Ms. Gina M. Estipona, Mr. Zaldy V. Barotil and Ms. Mary Ann Dizon. Presented at the Regional Workshop on Microfinance Capacity Assessment, Asian and Pacific Development Centre, Kuala Lumpur, Malaysia, December 10-12, 1996.

rural banks, cooperative rural banks and credit unions/credit cooperatives to reach the poor. However, the MFIs weak institutional capacity, lack of a viable and extensive delivery system, a small financial base and the huge investments in training clients hamper their attempts to reach a greater number of the target clientele. In the very short run, the MFIs may be able to expand their present reach, but because they are not viable and sustainable financial institutions, the effort cannot be sustained.

The paper addresses four areas that will enable MFIs to be self-sustaining financial institutions serving the poor. These four areas are as follows: (a) outreach and impact; (b) viability and sustainability; (c) resource mobilization; and (d) policy.

Expanding outreach

Outreach remains small and limited although the poor borrowers and savers predominate among MFI clientele, indicating an almost exclusive focus on the poor. This shows the effectiveness of the targeting mechanism used by the MFIs in identifying poor clients. The weak institutional capacity, the lack of an extensive and viable delivery system and a relatively small financial base prevent MFIs, especially credit NGOs, from reaching a greater number of clients.

The principal problem faced by credit NGOs is the lack of legal personality and authority to act as real financial intermediaries. This also results in a very limited capacity to develop and legally offer innovative financial products. More importantly, the informality of their organization makes illegal any attempt to mobilize deposits, develop various financial products and offer them to the public. The second problem is the lack of an extensive and viable financial delivery system that has substantial focus on the poor. While the rural banks and the credit cooperatives have a nationwide delivery system through branches and unit entities, they have yet to consider microfinancial markets as profitable opportunities. On the other hand, motivation of MFIs' staff to work with poor clients is not wanting but the MFIs face problems of rapid staff turnover.

Another problem area is the training of potential clients which represents a sizable investment cost that the MFIs may not be able to absorb. The paper makes a point that training of clients has some public good characteristics which makes it worthy of government and donor assistance. Matching government/donor funds with MFI funds for training may lead to better outreach performance because of the risk-sharing involved.

Thus, we recommend the following:

- *transform credit NGOs into full-pledged formal financial institutions, e.g, private bank, finance company, nonstock savings and loan association or credit cooperative;*

- *alternatively, credit NGOs may organize or invest in formal financial institutions,*
- *promote linkage banking with private banks which are interested in providing microfinance services for the poor through the MFIs whose institutional capacity must be upgraded;*
- *invest in training existing rural banks, cooperative rural banks and credit unions/credit cooperatives in microfinance technologies;*
- *externalize the training costs of the poor by providing MFIs access to grants and government financial assistance, but following the principle of matching grants with MFI own funds;*
- *continue staff training and the development of career paths for capable workers, and upgrade pay scales and incentive schemes to retain good personnel; and*
- *rationalize government credit programs and reallocate existing funds for livelihood projects to capacity building and training of existing MFIs.*

MFI viability and sustainability

To continue providing financial service to the poor on a sustaining basis, the MFIs themselves must be viable and sustainable. The paper shows that many of the MFIs are far from attaining this goal. A major factor determining viability and sustainability is the set of internal financial policies and organizational practices and procedures observed by the MFIs. Internal financial policies and practices need a lot of improvement, particularly in the installation of sound financial reporting and monitoring systems, portfolio management, assessment and management of risks, product packaging and pricing, management of loan arrears and strategic business planning. Related to these will be the need to upgrade and institutionalize performance standards, particularly in loan repayment, appreciation of loan default and aging of delinquent accounts, and the installation of appropriate accounting and internal audit systems. In addition, the capability for governance, leadership and management affects their performance. Improvement of management skills and professionalization of staff, appropriate, market-oriented pricing of financial products and services, and greater effort in loan recovery are needed to make the MFIs viable and sustainable.

Thus, the key issue is building sustainable institutions by having (a) the appropriate organizational form; (b) a strong equity and financial base; and (c) suitable systems and procedures.

We recommend the following:

- *build up the equity base of MFIs by infusing more capital from existing owners and new investors;*
- *diversify loans, savings and other financial products/services according to client demand;*
- *maximize savings mobilization opportunities;*
- *promote training in financial operations, resource mobilization, portfolio management, risk assessment and management, product packaging and pricing, management of loan arrears, strategic and business planning, among others;*
- *improve systems and procedures such as automating systems and operating procedures, upgrading and institutionalizing performance standards, setting up internal audit systems, conducting periodic management audits, installing updated and standardized accounting and reporting system; and*
- *professionalize the management and staff of MFIs.*

Resource mobilization

The MFIs have all attempted to mobilize resources but the informal character of their organization hampers the effort. Resources used are mostly grants and subsidies coming from donors and the government which ironically stunt their growth into viable and sustainable financial intermediaries. To stay competitive and viable, the MFIs must raise substantial deposits and develop various instruments, especially for the small savers, which will help them build up their financial base. Thus, they have not only to mobilize traditional deposits but also seek to broaden and deepen the financial products and services offered to meet existing demand at the lower end of the financial market. Broadening and deepening mean the development of new product lines and services, the design and implementation of new microfinance technologies, and practices which will strengthen their financial base.

We recommend the following:

- *to the MFIs—get the appropriate legal personality/authority to be able to mobilize deposits, raise equity capital and offer various financial products/services,*
- *invest in the development of new product lines and services, new microfinance technologies, adaptation of the "best practices in microfinance," etc., with counterpart funding from donors and the government;*

- *to the government—reallocate resources in the government's various livelihood programs for the broadening and deepening of microfinancial services; and*
- *to the donors—allocate resources for the broadening and deepening of microfinancial services instead of providing loanable funds to MFIs.*

Policy context

The necessity of bringing credit NGOs under a supervisory and regulatory framework cannot be overemphasized. Without such a framework, the following problems will persist: absence of performance standards, lack of uniformity and dilution of standards of credit evaluation, lack of portfolio supervision leading to poor loan recovery and deterioration of its quality and absence of prudential regulations over such activities as deposit taking. The installation of a supervisory and regulatory framework complements the building of the institutional capacity of MFIs, especially the credit NGOs. In this way, we will have strong MFIs which will no longer operate in a policy vacuum.

The alternative to a formal supervisory and regulatory framework is self-regulation by the credit NGOs. The argument goes that maintaining an informal self-regulatory framework will provide the credit NGOs with flexibility and room for initiative on various financial innovations to reach the poor. Furthermore, there will be no danger of losing focus on their target clientele which will be brought about by the transformation of credit NGOs to formal financial institutions. However, this paper points out the glaring need for performance standards, prudential regulations, etc., in short, a supervisory/regulatory framework that will ensure the safety and soundness of those institutions and the integrity of their transactions. The argument on losing focus on the poor does not hold water. It is because an organization's vision, mission and goal are not dictated by the organizational structure, e.g., banking firm, but by the people manning it and the policies being pursued.

The transformation into formal financial institutions may not be everybody's cup of tea. It is not for every NGO. There will be some which will choose to transform, but there will be others which will opt to remain as a development agency and, perhaps, organize a bank, with a distinct charter, character and function. The important outcome of this strategy is the unbundling of banking and development/social preparation functions which will increase efficiencies in the financial markets for the poor because the (NGO) development agency and the NGO-organized bank/financial institution can exploit their respective comparative advantage. From the public policy perspective, it becomes clearer what activities in microfinance programs for the poor properly constitute "social development costs" and what should rightly be considered "cost of providing the financial service," i.e., cost of doing business. The first set of costs may be subsidized or given access to grants in view of the externalities present in social training/preparation of *poor clients while the latter should be covered by appropriate pricing of the financial product. For the social development costs, the present thrust of raising private monies must be supported.*

We recommend the following:

- *to the government—provide for an appropriate supervisory and regulatory framework for MFIs, especially credit NGOs;*
- *to the NGOs—maintain a dialogue with the government on the installation of an appropriate supervisory and regulatory framework for MFIs;*
- *to the government—support the costs of social preparation/training through budgetary assistance that will be matched by private sector funds; and*
- *to donors—provide assistance to social preparation activities, development of microfinance products, training in microfinance technologies, and upgrading of performance standards, operating systems and procedures.*

I. INTRODUCTION

This paper is an assessment of the capacity and financial performance of a sample of microfinance institutions (MFIs) operating in the Philippines. It has the following objectives: (a) explain the microfinance policy environment in the country; (b) evaluate the institutional and financial capacity and performance of MFIs; (c) determine the issues and constraints affecting capacity and performance; and (d) recommend measures to strengthen the MFIs. The motivating philosophy of this report is that, unless MFIs become viable and sustainable financial institutions, they can never fully realize their objective of reaching a greater number of poor people, much less sustaining the effort.

The paper has four sections. The next section is a brief overview of recent developments in the country and the policy context of microfinance programs. Section III analyzes the main findings from case studies of MFIs and discusses the main issues and constraints affecting their capacity and financial performance. The last section concludes and recommends policy and institutional measures to strengthen MFIs and the implementation of microfinance programs in the country.

A chief limitation of this paper is the use of a purposive sample of seven MFIs to arrive at the analysis, conclusions and recommendations made. Drawing a larger and random sample of MFIs would have been ideal but time and budget constraints prevented it. Nevertheless, we believe that despite the limitation imposed by the available data and information set, the analysis, conclusions and recommendations have a great degree of validity because the sample MFIs are among those which have operated in the last several years. We assume that their performance largely reflects the general experience of MFIs.

II. OVERVIEW OF THE COUNTRY AND POLICY CONTEXT

1. Dimensions of Poverty, its Distribution and Incidence

Because poverty is such a pervasive problem in the Philippines, the government's development efforts in recent years focused on poverty alleviation and the improvement of income distribution, yielding modest gains in the war against poverty. The National Statistics Office reports that the poverty incidence declined by 4 percentage points from 1985 to 1988. The decline continued to 1994 with a poverty incidence of 35.7 percent compared to 39.9 percent in 1991. Based on the 1994 Family Income and Expenditure Survey, the total number of poor households decreased from 4.78 million in 1991 to 4.56 million in 1994.

On the other hand, there was also a decline in the total number of subsistence households from 2.45 million in 1991 to 2.32 million in 1994. There was a marked decline in urban poverty incidence from 35.6 percent in 1991 to 28.8 percent in 1994. Rural poverty incidence declined only slightly from 55.1 percent in 1991 to 53.7 percent in 1994. In addition to the magnitude of poverty, the government has also to contend with the highly inequitable distribution of income. However, there was an improvement in income distribution with a decline in Gini ratio from 0.468 in 1991 to 0.454 in 1994.[1]

Despite the government's well-intentioned effort, a very substantial number of households, especially in the rural areas, struggle to meet the basic food and nonfood requirements of decent living. In the rural areas, the incidence of poverty was highest at about two-thirds among farming and fishing families, while those in all occupations other than farming, forestry, fishing and agricultural services had an incidence of poverty of a little under two-fifths (Srinivasan 1993). Within agriculture, among

1. National Anti-Poverty Summit, Philippine International Convention Center, Manila, March 19-20, 1996.

the poorest were farm workers in sugarcane, rice, corn, coconut and forestry, and growers of coconut, corn and miscellaneous crops, as well as fishermen. A large number of the poor are in the rural agricultural sector.[2] Effective and efficient poverty alleviation efforts directed at this sector (for instance, by expanding the off-farm employment opportunities of rural households) will significantly reduce poverty incidence in the country (Intal 1993).

2. Macroeconomic Considerations

Over the past five years, the country's annual real GNP growth averaged at 3.4 percent (Table II-1). Per capita GNP, however, hardly grew as population over the same period grew roughly as fast (2.6 percent). The country's GDP for 1995 was valued at P1,905.3 billion ($74,135 million). Per capita GDP was posted at P27,114 ($1,055). Year-end average inflation rates have been single-digit (ranging from 7.6 percent to 9.8 percent) after a high double-digit average of 18.7 percent in 1991. For 1995, the average inflation rate was 8.1 percent. The policy and structural reforms under the Aquino and Ramos administrations have put the economy in the growth path after the crisis years of the 1980s. Investor confidence in the Philippine economy came back, together with domestic capital which took off for foreign shores during the Marcos regime. The renewed vigor of the economy led the Ramos administration to announce that its last few years in power would be focused on poverty alleviation and on the continuation of policy reforms.

In the financial sector, the creation of a new Bangko Sentral ng Pilipinas (BSP) in 1995 strengthened the formal financial system. The BSP pursued the financial reforms started in the 1980s, and recently, it relaxed the rigid bank entry and branching policy that it strictly implemented in the past. The financial sector was further liberalized by allowing the entry of foreign banks. The re-

2. See the various papers by A. Balisacan (1992, 1993, 1994, 1995) for a thorough and comprehensive analysis of the poverty situation in the Philippines.

TABLE II-1
Selected Macroeconomic Indicators, 1991-1995

Item	1991	1992	1993	1994	1995	% Annual Growth
Gross National Product (PM)						
at current prices	1,266,070	1,385,562	1,500,287	1,737,315	1,970,519	11.74
at constant 1985 prices	726,819	737,139	746,921	786,347	831,434	3.44
Per Capita GNP (P)						
at current prices	20,079	21,394	22,399	25,318	28,042	8.76
at constant 1985 prices	11,489	11,358	11,151	11,459	11,832	0.76
Gross Domestic Product (PM)						
at current prices	1,248,011	1,351,559	1,474,457	1,693,865	1,905,266	11.19
at constant 1985 prices	716,522	718,941	734,156	766,579	803,740	2.93
Per Capita GDP (P)						
at current prices	19,656	20,789	22,013	24,685	27,114	8.41
at constant 1985 prices	11,285	11,058	10,961	11,171	11,438	0.35
Population (million persons)*	63.49	65.01	66.98	68.62	70.27	2.57
Inflation rate	18.7	8.9	7.6	9.8	8.1	-13.85
Exchange rate (US$1.00=Peso)	27.48	25.51	26.99	26.45	25.70	-1.55

Population projection based on 1990 Census of Population and Housing.
Source: National Statistical Coordination Board.

cent reforms created a more competitive financial market, stimulating the increase in the number of banking establishments and the introduction of many innovative financial products.[3] Gross real savings of the country over the last five years have been increasing at an average rate of 5.8 percent per annum (Table II-2). A significant increase in real savings was noted after 1993 as the economy started to recover from stagnation in 1990-91. The increase, however, was mainly attributable to the growth in savings of government and corporations. The savings of households and unincorporated enterprises were at a high level in 1991 but slowly declined in the following years. The savings to national output ratio over the last five years averaged at about 20 percent.

Deposits and lending rates appear to have stabilized starting in 1993 (Table II-3). Nominal savings rates, while significantly higher in recent years (averaging 8 percent) than in 1991 (close to 5 percent), are still not very different from inflation rates; thus, negative or near zero real savings rates have persisted. Real time deposit rates have also been low, particularly in the last two years, averaging only at about 1 percent per annum. On the other hand, lending rates have been decreasing (Table II-3). Weighted average interest rates on loans granted by commercial banks averaged at 15 percent per annum in the last three years compared to 23 percent and 19 percent in 1991 and 1992, respectively.

3. Access of the Poor to Financial Services

Banks rarely lend, if at all, to the poor, mostly because of information problems, the lack of acceptable collateral, and the high transaction costs of processing small loans. Formal creditors view lending to the poor in agriculture as a high risk because of the risks associated with agricultural production.[4] Fur-

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3. For example, there is now a growing home mortgage market to meet the demand for middle class housing.

4. Various studies of the Agricultural Credit Policy Council have confirmed this. A recent survey of four of the poorest provinces in the country also made this observation. (See Llanto 1994.)

TABLE II-2
Savings Trends, 1991-1995

Item	1991	1992	1993	1994	1995	% Annual Growth
GNP Growth Rate (%)	0.08	1.42	1.33	5.28	5.73	
Nominal Savings (PM)	241,336	264,200	271,167	368,076	402,625	14.31
Real Savings (PM)						
Households and Unincorporated Enterprises	48,442	3,849	(2,854)	(18,619)	12,753	29.42
Private/Government Corporations	(1,899)	29,399	29,950	55,567	51,721	-391.91
General Government	30,141	37,493	29,136	38,962	36,216	7.19
Depreciation	56,304	57,912	65,505	68,589	63,135	3.18
Gross Savings	138,094	140,264	135,001	166,599	169,882	5.80
Savings as % of GNP						
Households and Unincorporated Enterprises	6.71	0.53	(0.38)	(2.37)	1.53	
Private/Government Corporations	(0.26)	4.03	4.01	7.07	6.22	
General Government	4.17	5.14	3.90	4.95	4.36	
Depreciation	7.79	7.94	8.77	8.72	7.59	
Gross Savings	19.12	19.22	18.07	21.19	20.43	

Source: National Statistical Coordination Board.

TABLE II-3

Selected Interest Rates, 1991-1995

Item	1991	1992	1993	1994	1995	% Annual Growth
Savings Deposits	4.7	10.6	8.0	8.3	8.2 p	26.0
Time Deposits (All maturities)	18.5	14.1	10.8	10.4	8.9 p	-16.3
Secured Loans (All maturities)	22.7	19.4	15.0	14.7	14.7	-9.8
Treasury Bills (91 days)	21.4	16.1	13.6	12.3	11.8 p	-13.5
Interbank Call Loan Rate (IBCL)	15.7	16.7	13.4	13.6		-4.1

Sources: 1993 Philippine Development Report and Bangko Sentral ng Pilipinas.

thermore, banks and other nonbank financial intermediaries are mostly concentrated in Metro Manila and other urban areas, leaving many of the regions without adequate banking facilities. The latest NEDA survey shows that less than 12 percent of low-income rural families had borrowed since 1991 (Herrin and Racelis 1992). Of those who borrowed, nearly two-fifths sourced their loans from relatives and friends while another one-third borrowed from private moneylenders and cooperatives. Only a small percentage relied on government and private banks for loans. The bulk of the low-income families who did not borrow from formal sources cited burdensome bank requirements, high interest rate and lack of collateral as well as ignorance of possible credit sources as major reasons for not borrowing. In general, it can be said that the poor's lack of access to formal financial services may be partly explained by the very structure of the financial system which is biased against the poor.

The government's response was to create a number of credit programs intended to provide the poor with access to financial services. The National Credit Council reports as many as 111 credit programs of which 13 are targeted to the ultra-poor. One nationwide program designed specifically for working women in the informal sector is the Women Workers Employment and Entrepreneurship Development (WEED) program of the Bureau of Women and Young Workers of the Department of Labor and Employment (DOLE). The program is envisioned to address the need of women for jobs either as employees or entrepreneurs. To achieve this objective, the program provides them with livelihood activities and harnesses their entrepreneurial abilities. Project beneficiaries are qualified women worker groups who will undergo social preparation, entrepreneurship and other appropriate training and, eventually, receive credit assistance for their entrepreneurial/income generating endeavors. Women group beneficiaries can borrow up to P200,000 with a maturity of two years at 6 percent interest rate per annum.

Another program that encourages lending to poor women is the Micro Credit Program for the Bottom Poor jointly implemented by the Agricultural Credit Policy Council (ACPC) of the

Department of Agriculture (DA) and the Land Bank of the Philippines (LBP). This program provides loans to qualified nongovernmental organizations (NGOs), cooperatives or cooperative banks (CRBs) which are to relend in turn to the bottom poor for their micro-credit livelihood projects. LBP provides a lending window for accredited NGOs/cooperatives/CRBs which can obtain a maximum credit line of P5 million. The loans shall be used solely for relending to groups or individually managed micro livelihood projects of households/individuals who belong to the bottom 30 percent income bracket. In addition, the participating NGOs/cooperatives/CRBs can avail themselves of a grant assistance to cover operating expenses related to social preparation, training and related activities intended for the institutional development of the beneficiaries. The program, launched in 1996, covers the poor priority provinces identified by the Presidential Commission on Countryside Development and the Presidential Commission to Fight Poverty (PCFP).

4. Public Policy and Microfinance Programs on Poverty Alleviation[5]

The seriousness of the poverty situation cannot be overemphasized. In formulating its strategies to address poverty, the Philippine government recognizes that: (1) the nature and intensity of the needs of the different poor groups are diverse, as are the causes of their problems; hence, solutions for them vary; (2) appropriate macroeconomic and sectoral policies induce vigorous and sustained economic growth which will have a powerful impact on reducing poverty, although not all poor people will benefit as much because they do not have the means to do so; and (3) the responses of different poor groups to government interventions targeted at poverty alleviation differ.

5. Drawn from the document "A National Strategy to Fight Poverty" prepared for the Presidential Commission to Fight Poverty by the Philippine Institute for Development Studies, 1995.

The government believes that direct intervention in the form of intensified delivery of basic services will be necessary to improve the lot of the subsistence poor. In addition, community organization will be indispensable in building capabilities, together with livelihood projects which can provide diverse sources of income to poor communities.

The Ramos administration, through the Presidential Commission to Fight Poverty (PCFP),[6] has identified five major strategies to address the problem of poverty.

1. *Promote and sustain economic growth to create employment and livelihood opportunities.* At the macroeconomic level, the goal is to attain and sustain rapid economic growth at 5 to 7 percent annually in order to reduce the number of families living below the income poverty line from 39.2 percent in 1991 to 30 percent by 1998. Thus, the government will undertake the following: (a) embark on a massive infrastructure program directed primarily at the rural areas and in areas with the greatest capacity to provide jobs; (b) improve revenue collection; (c) encourage investments by reducing interest rates to borrowers, and raise the interest rate on savings by reducing the government budget deficit, issuing small-denomination government notes for small savers, and removing unnecessary impositions on financial transactions; (d) emphasize voluntary arbitration on the resolution of industrial disputes; (e) continue reforms that will compel the large monopolized and protected sectors of the economy to become more competitive globally and reduce the biases against small and medium enterprises through tariff restructuring, liberal foreign investment rules and the passage of antitrust laws; and (f) ensure adequate national and local government funding for specific sectors such as education, health and housing.

2. *Sustain growth based on people-friendly strategies.* Economic activities must be made accessible to those who are poor while at the same time being efficient and productive enough to yield bet-

6. PCFP was subsequently replaced by the National Anti-Poverty Commission in 1997 through an act of Congress.

ter incomes. The following activities will be needed: (a) promotion of new labor-intensive industries with higher domestic value added, better export potential, and stronger links with agriculture, for example, food processing; (b) pursuance of policies that are consistent with efficiency, improve prices for agricultural products, lower prices for agricultural inputs, and promote diversification into products that have higher value, use more labor and make more efficient use of land; (c) active use of an exchange rate policy to promote agriculture and export-oriented industries while at the same time generating financing for safety nets to stem inflation and a wage-price spiral; (d) conservation and management of natural resources by entrusting these to their immediate communities, formulating and implementing policies on resource use and imposing higher taxes on the use of natural resources and on pollution; (e) protection of the gains under the Comprehensive Agrarian Reform Program while reassessing the pace of its future implementation; (f) revival of rural financing by wholesale lending to cooperatives and legitimization of NGOs, which should then retail the credit to farmers, marginal borrowers and people's organizations at market rates; consolidation of all resources currently used in the government's livelihood programs that are not focused on the core poor into a credit facility for the poor; strengthening and full development of cooperatives and NGOs as efficient retail credit institutions; keeping of commercial interest rates at low levels; and (g) devotion of more funds to agricultural research and extension, with continuing training for devolved extension personnel.

3. *Expand social services to provide minimum basic needs.* Minimum basic needs of the poor such as primary health care and family planning, elementary education, supplemental feeding, housing, water and sanitation will be addressed.

4. *Foster sustainable income-generating community projects.* Greater emphasis on livelihood projects with components including skills and technology training, credit and livelihood assistance, and technical extension is required. The following must be accomplished: (a) consolidation of lending programs for the

core poor, or those which include a subsidy element (i.e., those charging submarket interest rates) under the PCFP, and designation of such programs exclusively for the use of the poorest of the poor; (b) design of credit schemes according to the capabilities of poor groups; in general, credit should be extended at commercial rates exclusively and without collateral to the poor; (c) coordination of efforts in providing training for the poor in livelihood and income-generating projects, particularly by improving the quality and relevance of the training provided, as well as the quality of training facilities; (d) dissemination of information on available livelihood services, and decentralization or expansion of the reach of existing training programs.

5. *Build capabilities of the poor to help themselves.* The most important element in a strategy to fight poverty is not what it can provide or do for the poor but whether that strategy ultimately enables the poor to do something for themselves. The process of building capabilities among the poor may be done in the following ways: (a) rely on local governments as the main implementors of antipoverty projects in the critical municipal and barangay levels, so that local leaders may become directly accountable to the poor communities that are supposed to benefit from them; (b) mobilize NGOs and people's organizations (POs) as equal partners in planning priorities and selecting projects; (c) promote the formation of POs in poor communities to articulate their needs, design self-help programs, mobilize their own resources as well as outside resources, implement projects, and monitor and evaluate their own progress; and (d) keep track of the overall progress of poverty alleviation through a community-managed monitoring system in each barangay administered through local government units.

5. Regulatory Framework for Financial Institutions

The Philippine financial system is divided into a formal sector under the regulation and supervision of the BSP, the Insurance Commission and the Cooperative Development Authority, and an informal sector which is neither supervised nor regulated by any government agency (Figure 1). The formal financial sector

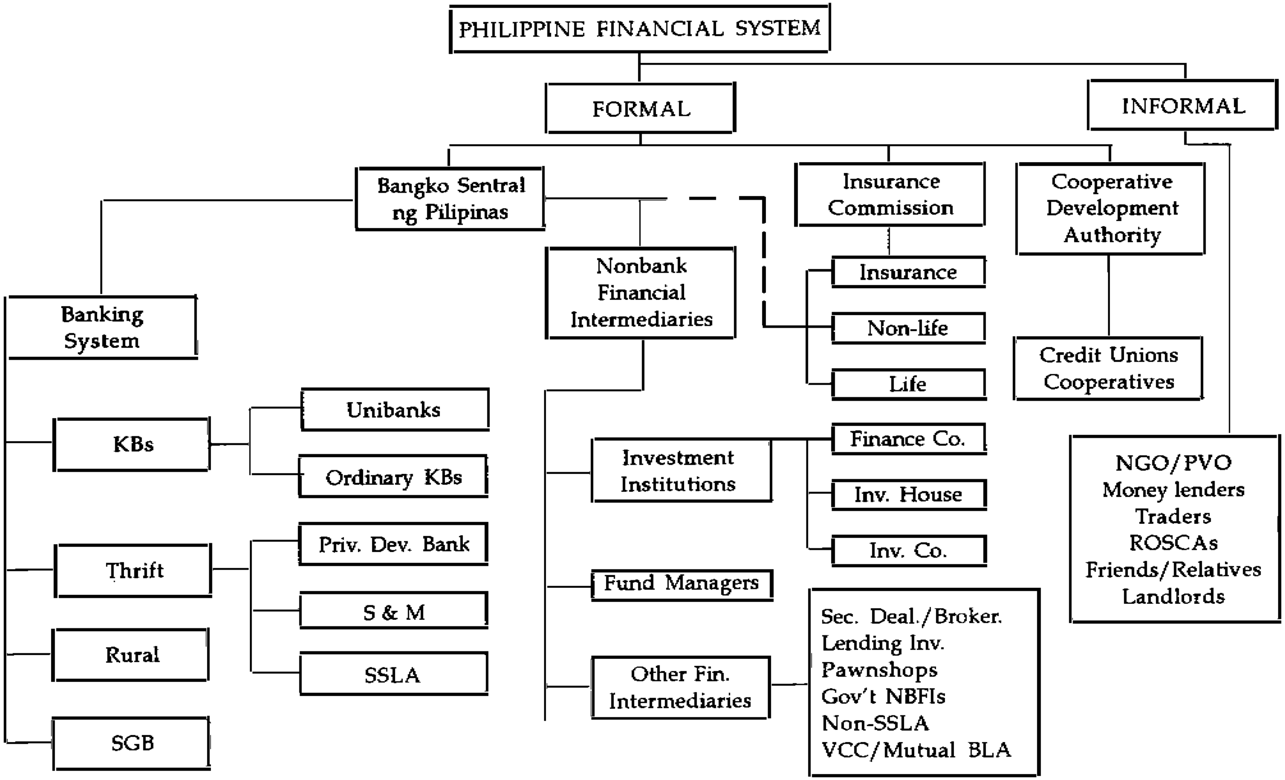

FIGURE 1
The Philippine Financial System

consists of a wide array of banking and nonbanking institutions performing various financial intermediation services. Following the financial reforms instituted over the past decade and a half, these financial institutions have engaged in a number of activities and have offered various financial products targeted to specific clientele in the formal financial markets. They have also expanded rapidly. In terms of resources, the formal financial system has been experiencing double-digit annual growth since 1987.[7]

All these institutions are under BSP supervision and/or regulation, with the exception of insurance companies which are supervised by the Insurance Commission, and the credit unions/credit cooperatives which are under the Cooperative Development Authority. However, the regulation of NBFIs is less strict compared to that of banks, one reason being that the latter are in the strict sense fiduciary institutions.

The Central Bank of the Philippines (later renamed *Bangko Sentral ng Pilipinas)* started a series of financial reforms for more efficient financial markets in the 1980s, and this continued into the 1990s. The reforms improved the financial policy environment and strengthened the supervisory and regulatory framework of financial institutions. Interest rate ceilings were removed; the Central Bank's subsidized rediscount window was made market-oriented; interest rates on special subsidized credit programs were aligned with market rates; bank entry and branching policy was liberalized and the areas of allowable equity investments of universal banks were expanded. In 1993, a new and strengthened institution, the BSP, replaced the Central Bank of the Philippines. More recently, the government liberalized the entry of foreign banks into the domestic financial market, allowing 10 foreign banks to set up shop in the country. The aim is to intensify competition in the domestic financial market.[8]

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7. A good reference is Lamberte and Llanto (1995).

8. Alongside this formal system exists an informal credit market which caters to the credit needs of low income groups, small and micro enterprises, small farmers and fisherfolk, and other marginal borrowers who were unable to access the formal financial market. See Llanto and Chua (1996), Chua and Llanto (1995), among others.

The financial sector reforms have created a more competitive financial marketplace, driving financial institutions, regardless of bank type, to compete with each other. Banks compete in deposit taking by offering a wide range of deposit instruments with diverse features and varied rates of interest. The innovative deposit products target different income groups. With extensive branch networks and automated teller machines, commercial banks have been able to mobilize nearly 80 percent of total deposits in the banking industry. On the other hand, credit unions and cooperatives offer members deposit instruments in the form of fixed deposits which earn interest but cannot be withdrawn until membership ends. They also offer savings and time deposits which pay interest and are withdrawable. Cooperatives and credit unions are outside the Bangko Sentral's regulation and supervision, but they are supervised by the Cooperative Development Authority (CDA). These institutions have no minimum capital requirement, no reserve requirement on deposits and are exempted from taxes imposed on financial institutions. Their recent performance shows a remarkable ability to mobilize deposits from small savers.[9] The NGOs, which are considered informal credit institutions, are not allowed to mobilize deposits.

The strict financial and credit policy framework of banking institutions in the early 1970s encouraged the establishment and growth of nonbank financial intermediaries (NBFIs). These institutions became subject to Central Bank control under the 1972 financial reforms. In general, the NBFIs are not allowed to borrow from the public. Some are subject to minimum capital and reserve requirements as well as loan ceilings and borrowers' limits. The NBFIs do not engage in deposit-taking activities but rely on their own capital for funds. Nonbank thrift institutions, pawnshops and investment companies follow the same practice. In contrast, NBFIs with quasi-banking functions source a large part of their funds from borrowing.

9. See Llanto (1994) for a more extensive discussion of Philippine credit unions/cooperatives.

Banks have, on the average, four branches while more than three-fifths of the NBFIs do not have branches. Some NBFIs are allowed to establish only one branch. In terms of regional distribution, more than one-third of the total number of offices of NBFIs are concentrated in the National Capital Region. Other regions are mostly served by lending investors, pawnshops and, to a smaller extent, finance companies.

Cognizant of the need to provide access to credit to the basic sectors of the economy, e.g., small-scale agriculture, small enterprises, etc., the government put in place several policies on credit allocation and deposit retention. These are the following:

(a) requiring 75 percent of the deposits generated from a regional grouping to be invested in that area;

(b) mandating banks 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 (agri-agra loan quota);

(c) mandating all lending institutions to lend at least 10 percent of their total loan portfolio to small enterprises whose total assets amount to P10 million and below;

(d) liberalizing bank branching regulations; and

(e) implementing various directed credit programs for the basic sectors.

In addition, the government has increasingly used NGOs as alternative credit conduits, instead of coursing credit funds solely through banks. Thus, credit programs such as the DTI Microcredit Project, the ACPC's Grameen Replication Project and the NLSF's loan program have used the NGOs as credit conduits.

III. FINDINGS AND ANALYSIS OF ISSUES AND CONSTRAINTS

This study uses a purposive sample of seven microfinance institutions (MFIs) composed of five credit NGOs, two of which are waiting for their banking license from the BSP, and one cooperative rural bank which has successfully used the Grameen technology in reaching the poor. This section used case studies of these MFIs for the analysis of the performance, issues and constraints faced by MFIs. Information on the legal identity, organizational history, objectives, etc., of individual sample MFIs can be found in their respective case studies. We organized the analysis into four subtopics, namely: (1) *outreach to the poor; (2) viability and sustainability;* (3) *resource mobilization;* and (4) *policy environment.*

1. Outreach to the Poor

Outreach to the poor depends on a variety of factors, namely: (1) effective targeting and exclusivity of focus; (2) institutional capacity; (3) range of financial services provided; (4) technical assistance for poor clients; and (5) regular or periodic impact evaluation of credit programs for the poor.

1. *Targeting and exclusivity.* Not all the sample MFIs target exclusively the poor although most of those that use the Grameen Bank technology do have an exclusive focus, especially on poor women. Some do not exclusively target poor women. On the other hand, a few credit NGOs implement credit programs targeted to both poor and nonpoor borrowers. A common reason given is that the profits from loans to the nonpoor are used to subsidize the (losing) less profitable credit program for the poor. For the sample bank, the credit program for the poor is just one of many other product offerings of the bank. The MFIs identify the poor through a means testing, an examination of their asset ownership, and a housing index which reveals the income or wealth status of the prospective client. The means testing and use of house index are mostly done by the Grameen replicators. Interviews and home visits complement the means testing. They

also conduct a general assessment of the clients' incomes and ownership of simple assets such as farming implements, farm animals, home furniture, as well as of the types of houses, building materials used in house construction, access to or availability of water and sanitation, and educational attainment of the household head and family members.

The sample MFIs conduct the following: (a) area scanning to identify the area with a large percentage of families living below the poverty line; (b) orientation screening to introduce the credit program, orient and train the groups on the value of discipline and team responsibility; and (c) individual background investigation to effectively target clientele. Tables III-I and III-2 show the sample MFIs' outreach to poor borrowers and savers, respectively.

In sum, the poor borrowers and savers predominate, indicating an almost exclusive focus on the poor. This shows the effectiveness of the targeting mechanism used by the MFIs in identifying poor clients.[10] *The credit NGOs and the private bank replicating the Grameen technology use an effective means to identify and reach the poor. However, their outreach is still limited to a few thousand poor borrowers.*[11] *The credit NGO community, composed of about 500 individual institutions, estimates their outreach to cover some 30,000 borrowers.*[12]

2. *Institutional capacity.* The 1992 NEDA Socioeconomic Survey showed that only about 12 percent of ultra-poor families had access to credit. Some 38 percent of credit came from friends and relatives, 18 percent from private moneylenders, and 13 percent from cooperatives. Only very few of the poor were able to get a loan from government specialized banks and private

10. It could also be that, by the very nature of these MFIs, the poor would naturally be drawn to them as potential clients—a case of self-selection.

11. Even the largest credit NGO in the country which has been in operation for the past 10 years had only 3,119 borrowers and 3,024 savers as of-end 1995.

12. A Strategy to Fight Poverty: Philippines, The World Bank, March 1996.

TABLE III-1
MFI's Outreach to Poor Borrowers

MFI	Female		Male		TOTAL
	Poor	Non-Poor	Poor	Non-Poor	
A	1,695	–	–	–	1,695
B	5,866	–	–	–	5,866
C	3,980	–	69	–	4,049
D	1,307	10	231	4	1,552
E	1,330	279	–	183	1, 792
F	1,993	–	1,126	–	3,119
G	764	106	256	75	1,196
TOTAL	16,935	395	1,677	262	19,269

TABLE III-2
MFI's Outreach to Poor Savers

MFI	Female		Male		TOTAL
	Poor	Non-Poor	Poor	Non-Poor	
A	1,695	–	–	–	1,695
B	6,952	–	–	–	6,952
C	3,980	–	69	–	4,049
D	1,160	10	203	4	1,377
E	1,415	672	–	496	2,583
F	1,941	–	1,083	–	3,024
G	1,058	–	201	–	1,259
TOTAL	18,201	682	1,556	500	20,939

banks.[13] The NGOs provided only 2.9 percent of credit in urban areas and 1.9 percent in rural areas. On the other hand, (private) cooperative rural banks seem to have reached a greater number of poor clients compared to other MFIs. In 1993 they reported that about 37,000 mostly individual loans with an av-

13. A more recent set of estimates noted that the "basic sectors" composed of rural residents and farmers, operators of small enterprises and the self-employed and the ultra poor had great difficulty in accessing the formal financial system (Adams et al. 1995). More specifically, it is estimated that only 168,000 out of 581,000 municipal fishing operators and 80,000 out of 317,490 small nonagricultural establishments had access to the formal credit system.

erage size of P22,000 were given. Some loans were as small as P1,000.[14] The experience of the Cooperative Rural Bank (CRB) of Sta. Cruz, Laguna, showed the capacity of the cooperative rural bank to provide microfinancial services to the poor. This same experience was reported by the Cooperative Rural Bank of Aklan, the Davao Cooperative Bank and several MFIs, and most rural banks and cooperative rural banks in Mindanao which accept small deposits (as low as P100) and provide loans as small as P1,000.[15] Table III-3 shows more recent estimates of MFIs' outreach. The credit cooperatives and the cooperative rural banks have a greater reach than the NGOs and people's organizations, and this may be partly explained by their more extensive delivery network and relatively larger financial base.[16]

Among private lending institutions, pawnshops, credit unions and lending investors also provide credit to small enterprises and individuals but their lending is collateral-based. Pawnshops require the pledging of certain assets such as jewelry, wrist watches, appliances, etc., while lending investors can require pledging of motor vehicles and other important assets. In the case of credit unions, the fixed deposits serve as collateral (Llanto 1994 and Chua and Llanto 1995).

Any discussion of the outreach of microfinance programs should include those of the government's various livelihood/credit programs targeted to the poor. The government has 111 subsidized credit programs of which 13 are targeted to the ultra-poor (Table III-4). These are implemented through various government agencies and specialized government banks. For example, the Department of Trade and Industry uses the NGOs, cooperatives, and rural banks as credit conduits of funds sourced from the Asian Development Bank and from budgetary allocation. As of March

14. World Bank, ibid.

15. The senior author was a member of a team of consultants who conducted a survey of 40 MFIs in Mindanao, Philippines, in 1996. The information on the Cooperative Rural Bank of Aklan was supplied by M. Agabin of the Social Weather Stations and a researcher from ACPC.

16. There are more than 1,000 rural banks and 42 cooperative rural banks in the country. Credit cooperatives are much more numerous than these banks.

TABLE III-3
Estimate of Institutional Reach in Micro Finance

Institutions	Estimated Number	Average Loan Size	Average Reach	Estimated Total Reach
1. Development NGOs	150	4,000	150	22,500
2. Grameen Replicators	40	2,000	500	20,000
3. Credit NGOs/Mature	30	5,000	I ,000	30,000
4. Credit NGOs/Beginning	100	4,500	250	25,000
5. Coop Rural Banks	42	21,700	2,000	84,000
6. Credit Cooperatives	1,500	10,000	300	450,000
7. People's Organizations	500	3 500	50	25,000
TOTAL	2,762	_	_	656,500

Source: R. Chua and G. Llanto (1995).

TABLE III-4
Government Livelihood Programs, Philippines, 1995

	Borrowers Targeted				
	Agri-Credit	Ultra-Poor	Salaried & Self-Employed	Small & Medium	TOTAL
No. of Programs	39	13	21	38	111
No. of Implementing Agencies	19	4	12	9	
Estimated Funds Available	>P11.06 billion	No data available	>P3.2 billion	>P16.7 billion	>P30.9 billion
Interest Rate (per annum)	6-14%	0%; 6% to market rate	3-18%	7-24%	

Source: National Credit Council.

1996, the NGO Microcredit Project of the Department of Trade and Industry *Tulong sa Tao* Program had released about P1.2 billion in loans to 82,157 borrowers through 1,944 conduits.

Another government line department, the Social Welfare and Development Department, provides the poor with small loans ranging from P1,000 to P3,000 through the Self-employment Assistance Program. Under this program, the DSWD has directly lent some P164 million to 45,250 clients. The Agricultural Credit Policy Council has a Grameen Bank Replication Project involving 23 NGOs, cooperatives and cooperative rural banks as replicators. As of December 1994, the replication project had enabled 13,432 borrowers to avail themselves of loans amounting to P31 million.

The Land Bank of the Philippines, a specialized government bank, has been the main source of funding for agrarian reform beneficiaries and small farmers, using rural banks and about 8,000 cooperatives as credit intermediaries. Recently, it organized the People's Credit and Finance Corporation (PCFC), a government finance company which will be its principal arm in lending to the poor. The objective is to use PCFC for poverty alleviation lending programs so that Land Bank may concentrate on its mandate to be the financing arm of agrarian reform and to service the agriculture sector's growing demand for various financial services. Prior to the creation of PCFC, the government used the National Livelihood Support Fund (NLSF) under the Office of the President to provide microfinance loans. In 1995, the NLSF made available P83 million in credit lines to about 60 MFIs. The maximum loan amount per borrower is P25,000. As of March 1996, the NLSF had lent about P46 million to 28 rural banks and 10 cooperative rural banks which in turn provided loans to 4,345 clients.

Despite all these attempts by the government, the private sector cooperatives and banks and the credit NGOs, the overall outreach to poor borrowers has been very limited. On the government side, only five agencies, namely, the Departments of Social Welfare and Development, Agriculture, Agrarian Reform, Trade and Industry and the National Livelihood Support Fund[17] have programs that can potentially reach a larger number of the poor. However, Philippine experience has shown the gross inefficiency and high costs of using government nonfinancial institutions to implement credit programs. Recent research has shown the unsustainability of government supply-led credit programs,

17. At present, the PCFC is the main arm of the government in lending to the poor.

the likelihood of leakage of the benefits of government credit programs to the nonpoor, the duplication and overlapping of a number of credit programs leading to gross inefficiencies, the distortion of the financial market, and the weakening of private sector incentive to innovate.[18]

On the part of the private sector, the private banks, except for some rural banks and cooperative rural banks, have not serviced the financial requirements of the poor because of the high transaction cost, the lack of information to and understanding by the poor, and the absence of a financial delivery mechanism suitable for delivering financial services to the poor. Even with the legal mandate under the agriculture-agrarian loan quota, the Magna Carta for Small Enterprises and the various loan guarantees offered by the government, the private banks' response to the poor's demand for financial services has been limited to making available wholesale loan funds which will be retailed by NGOs, or to purchasing government securities as a way of alternatively complying with the agriculture-agrarian loan quota.

The Bankers' Association of the Philippines (BAP) organized the BAP Credit Guaranty Corporation (BCGC) as its conduit for lending to the basic sectors. According to the BCGC, only seven NGOs have availed themselves of loans from a credit line amounting to P17.5 million which was opened by the corporation to MFIs. The Bank of the Philippine Islands Foundation has also provided loans to accredited NGOs and cooperatives which will retail loans to the poor. More recently, a commercial bank has given loans to a credit NGO to augment the latter's loanable funds to the poor. Thus, the MFIs use a variety of funds, namely: (a) donor funds; (b) concessional loans from the government agencies and specialized government banks; and (c) credit lines from the private banking sector for their lending operations to the poor.

The credit NGOs are the only institutions with an almost exclusive focus on the poor. However, they are hampered by

18. This has been documented in various research on the implementation of agricultural credit programs. See, for example, Neri and Llanto (1985), Lamberte and Lim (1986), Esguerra (1981), Llanto (1993), among others.

their weak institutional capacity. In interviews conducted by these authors, the inadequate institutional capacity of MFIs, especially the credit NGOs, in handling microfinance emerged as the principal reason for the slow availment of the credit lines. The nonformal character of their organization partly explains this weakness. Without a legal personality as full-fledged financial institutions, credit NGOs can neither raise sufficient equity nor tap deposits to sustain their operations. Lending funds are available from many sources, (e.g., BCGC, NLSF and other government agencies and financial institutions) but the weak absorptive capacity of MFIs such as the credit NGOs appears as a binding constraint to a greater outreach to the poor.

What compounds the problem is the absence of an extensive and viable network for delivering financial services to the poor. The nationwide branch network of various types of private banks, including unit banks such as rural banks, is a potential medium for banking with the poor. The main drawback lies in the apparent reluctance of the private banking network to deal with this type of clientele. The rural banks and cooperative rural banks have a great potential. In fact, some of them such as those in Mindanao are already into microfinance programs. Perhaps, as more information on the profitability of banking with the poor is made available to them, and as more of the experience with banking with the poor is shared with private financial institutions, the rural banking system will in time pick up the challenge.

Table III-5 presents the Philippine NGO situation. More than 30,000 NGOs have enlisted with the Securities and Exchange Commission, of which 7,000 are categorized as "development NGOs." Of the lot, some 500 are the so-called "credit NGOs," of which less than 50 employ commercial lending and partly cover their costs. On the other hand, the rural banks and cooperative rural banks have a nationwide, viable delivery network.[19] How-

19. The rural banking system was weakened by the high default rates and nonrepayment of loans under the government's subsidized agricultural credit programs during the 1970s and 1980s. The BSP had to implement several rehabilitation programs to revive and strengthen the system.

TABLE III-5
Philippine NGO Situation

A. Number

>30,000 NGOs Nationwide
<7,000 Development NGOs
<500 Credit NGOs
<50 NGOs doing commercial approach to lending and covering part of their costs

B. Reach

* average of 100-200 borrowers per NGO
* 2% of credit needs of poor borrowers

Source: CODE-NGO, NEDA Monitoring Study, TSPI estimate.

ever, little is known yet about their actual outreach to the poor through microfinancial services, except the information gathered through several quick field appraisals. For example, rural banks and cooperative rural banks in Mindanao do provide microfinancial services. In 1995, the number of loan accounts per rural bank and cooperative rural bank averaged 2,000 while the number of deposit accounts averaged 6,000, implying a loans-to-deposit accounts ratio of 3.[20] However, despite the more extensive network of rural banks and cooperative rural banks, they do not have the same familiarity with and substantial exposure to the poor as do the credit NGOs. The irony is that those institutions with almost exclusive focus on the poor do not have the institutional capacity to reach a greater number of the poor.

The MFIs provide their field staff with basic training in the identification of the target clientele, appraisal of projects submitted for financing, and credit investigation of the loan applicant. The existing lending technology for the poor (e.g., Grameen, group lending and various adaptations of these approaches) is labor-intensive, requiring great patience, dedication and technical skills on the part of field staff. Field staff are carefully se-

20. The comparable ratio is six depositors to one borrower in Bank Rakyat Indonesia's Unit Desa, and a 1:1 ratio in Grameen Bank (see Robinson 1994).

lected based on their high motivation in helping the poor, educational background and willingness to work with the poor.

Some MFIs report problems of high turnover of staff because of the relatively low salaries that they can offer. Once trained and experienced, those field staff become eligible for related jobs in the government agencies involved in livelihood programs, and in the private banking sector, more specifically, rural banks and cooperative rural banks. The high turnover of field staff and the difficulty of retaining present staff prevent the buildup of capacity to provide efficient and effective microfinance services to the poor.

In sum, both the weak institutional capacity and the lack of an extensive and viable delivery system prevent MFIs, especially credit NGOs, from reaching a greater number of clients. The principal problem faced by credit NGOs is the lack of legal personality and authority to act as real financial intermediaries. The second problem is the lack of an extensive and viable financial delivery system that has substantial focus on the poor. Motivation of MFIs' staff to work with poor clients is not wanting but the MFIs face problems of rapid staff turnover.

3. *Range of financial services provided.* Most MFIs provide simple loans and savings facilities for poor clientele. This is consistent with the nature of the demand of the poor for financial services. As of 1995, the sample MFIs had provided total loans amounting to P128.7 million, the bulk of which went to poor clients (Table III-6). It is to be noted that not all of the sample MFIs have the poor as their exclusive clientele, except those practicing the Grameen technology.[21] The MFIs also provide "savings" facilities.[22] As of 1995, total savings amounted to as much

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21. The cooperative rural bank, which also uses the Grameen technology, provides loans both to poor and nonpoor clients.

22. Technically, the credit NGOs are not authorized to accept deposits. The "savings" deposits mentioned here refer to the obligatory or forced savings deducted from the loan amounts granted to borrowers. Also, the groups mobilize savings from among the members and deposit them in a bank through the representation of the NGO. The exception is the cooperative rural bank which is authorized to mobilize voluntary savings.

TABLE III-6
Amount of Loans Outstanding in Pesos

MFI	Female		Male		TOTAL
	Poor	Non-Poor	Poor	Non-Poor	
A	3,476,006	–	–	–	3,476,006
B	8,003,607	–	–	–	8,003,609
C	12,608,216	–	248,152	–	12,856,368
D	10,679,595	400,920	2,020,690	155,180	13,256,145
E	3,18,160	12,921,534	12,177,694	–	28,247,388
F	5,309,480	–	50,609,250	–	55,918,928
G	2,590,982	1,682,800	1,374,286	1,325,500	6,973,568
TOTAL	45,816,046	15,005,254	66,430,072	1,480,680	128,732,012

as P17.6 million. It is to be noted that poor clients were able to save a substantial amount as shown in Table III-7. Because the credit NGOs are not authorized to mobilize deposits, several innovative products have arisen. Some examples are the "mutual aid fund," "the capital buildup," and the "group fund." The mutual aid fund comes from the contribution of 5 percent of the regular loan amount while the group fund is a pool of weekly personal savings from each member of the group.

In general, we observe that most, if not all, of the loans carry short-term maturities and are used primarily for working capital and immediate consumption needs. The rural banks and cooperative rural banks try to offer competitive rates on deposits, usually 1 to 2 percentage points above those offered by commercial banks, while the credit NGOs offer innovative "savings" products to mobilize savings from their clientele.

The immediate constraint is the inability of MFIs, especially NGOs which are poorly capitalized, to offer more innovative financial products with longer term maturities, and the lack of information regarding the financial services/products that will satisfy the target clientele. As the economy develops, there will be an increased demand for more varied (and ultimately, sophisticated) financial services and loans with longer maturities in order to address certain investment needs such as the purchase of more modern farm implements, basic equipments, etc. Thus,

TABLE III-7
Amount of Savings Outstanding in Pesos

MFI	Female		Male		TOTAL
	Poor	Non-Poor	Poor	Non-Poor	
A	168,418	–	–	–	168,418
B	3,309,800	–	–	–	3,309,800
C	2,793,770	–	77,424	–	2,871,194
D	1,402,850	153,250	214,165	61,600	1,831,865
E	908,661	1,580,058	1,401,790	–	3,890,509
F	835,436	–	3,996,800	–	4,832,236
G	599,655	–	128,624		728,279
TOTAL	10,018,590	1,733,308	5,818,803	61,600	17,632,302

the MFIs must strive to improve their limited capacity to supply innovative financial products. The estimated amount of total financial services as of 1995 provided by the sample MFIs is shown in Table III-8. The average loans outstanding and the average savings mobilized are shown in Tables III-9 and III-10. This indicates the potential of the sample MFIs to provide a full range of financial products and services once the limitation of the NGO organizational structure has been overcome.

In sum, the limited capacity to develop and offer legally innovative financial products hampers the cause of credit NGOs. This limitation arises from their limited experience or lack of familiarity and experience in product development and innovation. More importantly, the informality of their organization makes any attempt to mobilize deposits, develop various financial products and offer them to the public illegal.

4. *Technical assistance for clients.* On the part of the target clientele, training consists of orientation in the value and use of credit, the need to have credit discipline, group cooperation and organization, and the handling of the savings fund of group members. Table III-11 shows the range of technical assistance provided to beneficiaries. The use of peer pressure and the threat of cutting access to future credit in case of loan default are important motivational strategies employed by the MFIs to en-

TABLE III-8
Total Financial Services

MFI	Female		Male		TOTAL
	Poor	Non-Poor	Poor	Non-Poor	
A	3,644,422	–	–	–	–
B	11,313,407	–	–	–	–
C	15,401,986	–	325,575	–	15,727,561
D	12,082,445	554,170	2,234,855	217,480	15,088,010
E	4,056,822	14,501,592	–	13,579,484	32,137,898
F	6,144,916	–	54,606,050	–	60,750,966
G	3,190,637	1,682,800	1,502,910	1,325,500	7, 701,847

TABLE III-9
Average Loan Outstanding in Pesos, 1993

MFI	Female		Male	
	Poor	Non-Poor	Poor	Non-Poor
A	2,050	–	–	–
B	1,364	–	–	–
C	3,168	–	3,596	–
D	8,171	40,092	8,748	38,970
E	2,367	46,314	–	66,545
F	774 (11,165)	–	12,104 (42,258)	–
G	3,514	12,005	5,475	13,107

TABLE III-10
Average Savings Mobilized in Pesos, 1995

MFI	Female		Male	
	Poor	Non-Poor	Poor	Non-Poor
A	99	–	–	–
B	476	–	–	–
C	702	–	1,122	–
D	1,209	15,325	1,005	15,400
E	642	–	–	2,826
F	261 (7,909)	–	3,659 (8,571)	–
G	678	–	640	–

sure high loan repayment rates. The problem is not the lack of interest on the part of the poor clientele to train and acquire various skills related to credit and savings, but the cost of training incurred by the MFI.

Training or social preparation as termed by the NGOs is a significant component of the transaction cost of lending to the poor. A case study of two NGOs estimated a social preparation cost of as much as P0.11 for each peso loan granted (Llanto and Chua 1996). The case studies of MFIs for this country paper also confirm this observation. An estimate of the unit cost of various training programs is shown in Table III-11. At present, social preparation or training is conducted mostly at the own initiative of the MFIs. Except for some insignificant financial assistance coming from government agencies,[23] the MFIs have to rely either on their own meager funds or external donors to cover the costs of training.

The current issue is who will finance the training of clients, i.e., social preparation. One view is that this is a public good whose production must be shouldered by the government. This view states that subsidies for training must be made available to MFIs which implement microfinance programs for the poor. The contrary view states that the cost of training should be incorporated in the lending rate charged by the MFI or absorbed by the MFI itself as part of the cost of doing business. This is practiced by one of the sample MFIs which charges a training and monitoring fee of 2 percent of the loan amount.

It seems that there is some capacity to transfer the burden of the training costs to the clients themselves who have no alternative but to absorb them. However, this view might lead to underproduction of social training because the MFIs may not want to increase the cost of lending to poor clients; they may not want either to absorb the cost of social training. This could lead to a suboptimal level of social preparation/training. The benefits

23. The ACPC provided the Grameen replicators with a grant covering the initial year's salary and training expenses of field staff who will handle the replication.

TABLE III-11
Technical Assistance Provided to Beneficiaries

Technical Assistance/ Education Service	Objective	Delivery Method	Average Cost Per Participant (Ps)
Program Orientation	sell program; provide savings and loan guidelines; familiarize with member responsibilities	Field exposure seminar	52.32
Gender Sensitivity Issues	Unburdening of gender concerns; understanding regular gender issues;	included in meetings	0.00
Ecological Awareness	resource conservation and optimizaton creativity in resource mobilization	field exposure	0.00
Marriage Enrichment Seminar	marriage values God-centered in life	included in regular meetings	0.00
Value Formation Seminar	self-enhancement; values clarification; discipline; group-building	seminar	74.49
Leadership Training	facilitation skills; communication & documentation skills	seminar; field exposure	126.36
Livelihood Skills Training	specific skills enhancement	seminar/field exposure	44.63
Simple Business Management	learn simple accounting planning/and budgeting	seminar	88.40
Simple Bookkeeping	learn bookkeeping	seminar	204.32
Financial and Business Management	sound business accounting & management	seminar	268.18
Organization Development	facilitation skills; communication skills	included in regular meetings	0.00

TABLE III-11 (CONTINUED)

Technical Assistance/ Education Service	Objective	Delivery Method	Average Cost Per Participant (Ps)
Training on Loan and Evaluation	instill guidelines on targeting and loans-for credit committees	seminar	42.35
Project Management & Development	planning and strategizing of business; expand creativity	seminar field exposure	42.35

of having "trained clients" will not be totally appropriated by the MFI which initially trained them because clients shop around for the lowest borrowing cost. It is also possible that over time the "trained client" will need to go to another lender who can satisfy his increased demand for credit because his old MFI can no longer meet that demand. Thus, some amount of shirking of the training responsibility may occur, leading to a social loss.

In sum, training of potential clients represents a sizable investment cost that the MFIs may not be able to absorb. While the government and donors may be willing to provide funding for training, a compromise solution lies in asking the MFIs to shoulder part of the training costs. Thus, a matching of government/donor funds with MFI funds for training may lead to better performance because of the risk-sharing involved.

5. *Impact evaluation.* The MFIs do not, in general, conduct formal internal impact evaluations of their credit programs for the poor because of the attendant costs. However, they do make informal and quick evaluation of program implementation which guides their decisions such as retraining of field staff, expansion of coverage, etc. Neither are there independent and periodic evaluations of these credit programs for the poor except for the evaluation of the ADB NGO Microcredit Project (MCP) that paved the way for the second NGO MCP, and of those done by

GTZ and JICA, respectively, on two of the sample MFIs. The evaluation conducted by the ACPC itself on the progress of its Grameen Replication Project is not an independent evaluation.

In sum, periodic impact evaluation is very important because the information generated will be useful in measuring the success of microfinance programs, addressing various problems, improving the project/program supervision, and designing future projects.

2. Viability, Sustainability and Resource Mobilization

1. *Financial policies, delivery mechanism and management.* The MFIs' viability and sustainability are critically linked to their financial policies, delivery mechanism and loan collection techniques. With respect to financial policies, adherence to "sound credit practices and response to market signals" (Sacay and Randhawa 1995) is practiced by the sample MFIs. They lend at market-based interest rates and are aware that they must at least cover their operating costs. A nominal rate of 30 percent per annum exclusive of a service charge (typically, 1 percent of the loan amount) and application fee is common.[24] The sample MFIs employ sound credit screening and appraisal techniques and provide noncollateralized loans to the poor. The nonconventional loan security instruments used consist of joint liability agreement, peer pressure and pledging of group savings. Thus, loan repayment rates are generally high, usually on the order of 95 percent.

The MFIs have used a variety of incentives to ensure loan repayment and financial discipline. Forced savings have been extracted from the borrowers which serve both as a pool of funds to be used for emergency purposes and as collateral to the loans extended by the MFIs. An interesting strategy for credit discipline of one MFI is a 5 percent prompt payment guarantee which is given back as rebate to clients who consistently pay

24. For example, one credit NGO charges a nominal rate of 30 percent per annum or 3.5 percent per month and requires a service fee of 1 percent of the loan amount—P10 for the (loan) record book and P10 application fee.

their loan amortization on time, and a 2 percent surcharge for loan balances after the past due date.

While the credit policies, loan screening, appraisal and collection techniques appear sound, the sample MFIs have inadequate financial reporting and monitoring practices which make it difficult to determine (a) past due loans; (b) which part of the loan portfolio is nonperforming; and (c) the extent of the arrearages problem. Without an adequate financial reporting and monitoring system, the MFIs will find their liquidity severely constrained and their capital impaired by nonperforming loans. We failed to find any monitoring system that tracks loan delinquencies and arrears and evaluates the aging of problem loan accounts to give timely advice to management.

The lack of adequate and uniform performance standards is evident among the MFIs. For example, the Grameen replicators are urged to use as benchmark for "on-time" repayment rate the ratio of "interest and principal collected during the year" to "interest and principal due during the year." This definition is too lax and grossly underestimates the severity of the loan collection problem. Similarly, defining "default rate" as the ratio of "principal and interest not paid at the end of the loan term" to "total loans outstanding at the end of each year" also encourages laxity in loan collection and unnecessarily creates a credit risk because management loses sight of the need to take immediate remedial action on nonperforming loans. Thus, at any given time, the MFIs cannot determine accurately what proportion of their loan portfolios will be at risk given the incentive for financial indiscipline.

The absence of adequate and sound performance standards and of a standardized accounting and reporting system also makes it difficult to evaluate the relative performance of MFIs. A commercial bank or donor which is willing to invest in microfinance programs will find it very difficult to assess the financial position of MFIs. This will result in underinvestment in potentially rewarding enterprises.

In sum, internal financial policies and practices need a lot of improvement, particularly in the installation of sound financial reporting and monitoring systems, portfolio management, assessment *and management of risks, product packaging and pricing, management of loan arrears and strategic business planning. Related to these will be the need to upgrade and institutionalize performance standards, particularly in loan repayment, appreciation of loan default and aging of delinquent accounts, and the installation of appropriate accounting and internal audit systems.*

2. *Resource mobilization.* Viability and sustainability are conditional on the ability of the MFI to mobilize substantial resources which can be leveraged. Despite sound credit practices and management, the lack of resources, be it in the form of equity capital, borrowings and deposits, spells the difference between a self-sustaining MFI and one which is subsidy dependent.[25] Earlier, we adverted to several creative and innovative ways by which MFIs could mobilize resources but the lack of legal personality and authority hampered the effort. The absence of prudential regulations to safeguard the interest of the depositors and shareholders also makes it untenable for creative ways to mobilize resources.

The inability to mobilize deposits is offset by the access to cheap funds from external donors and government concessional loans. Grants and concessional loans are disappearing phenomena in an era of budgetary crunches. The emerging policy and institutional framework in the country now leans toward reliance on private resources to deliver goods and services to the public as much as possible, and to the use of scarce grants/ government funds to create an enabling framework for private institutions to operate more efficiently. It is in this context that the mobilization of private deposits assumes an important role in the viability and sustainability of MFIs.

The immediate results of the dependence on grants and concessional loans are the unwarranted bias for lending and the failure to develop deposit instruments suitable to poor clients. It has been argued by some researchers that demand for savings

25. The subsidy comes either as grants or concessional loans from government/ donors.

and other financial services may even exceed the demand for credit; thus, an inordinate emphasis on loan provision may be a disservice to poor people.[26] Consequently, the sample MFIs, with the exception of the sample cooperative rural bank, have not developed as "full service" financial institutions that could have provided the poor with better and more financial services. From the point of view of the MFIs' interest, it can be argued that "self-sustainability of (rural) financial institutions is based on the ability to mobilize resources and attain financial viability."[27]

Indeed, while the MFIs appear free to craft appropriate financial and credit policies, they are hamstrung by their meager financial resources which limit their leverage capacity. Thus, the credit NGOs depend very much on grants, subsidies and concessional loans which ultimately undermine their viability and sustainability. The dependence on donor grants makes their financial and credit programs donor-driven, i.e., serving the objectives of the fund source. An immediate effect is the practice of using scarce management and technical resources for the preparation of proposals that solicit donor assistance. One MFI even employs two staff members who do nothing but prepare project proposals which target particular donors. The ultimate result is that the financial and credit programs become too sensitive to the biases of project finance to the neglect of real financial intermediation.

In sum, the MFIs have all attempted to mobilize resources but the informal character of their organization hampers the effort. Resources used are mostly grants and subsidies coming from donors and the government which ironically stunt their growth into viable and sustainable financial intermediaries.

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26. This paraphrases Dale Adams, for example, who pointed out that poor people cannot be made better off with more indebtedness, and that there exists evidence (e.g. ownership of jewelry and other tangibles) that demand for savings services outweighs demand for credit.

27. See Sacay and Randhawa (1995). They argue that BAAC attained financial viability and eliminated subsidy dependence when major steps were taken to generate more deposits. BAAC found that deposits were a cheaper source of funds than borrowings.

3. *Management and administration.* The management and administration of MFIs exert a great influence on their viability and sustainability. Huge overhead expenses relative to the financial services delivered erode their profitability and sustainability. What we saw from the sample data is that the MFIs are generally inefficient and not cost-effective. They have high management and overhead expenses relative to the number of clients served and the volume of business generated. The relative efficiencies of the sample MFIs are summarized in the various tables of this subsection. In 1995, the gross return on average loans outstanding ranged from 8 percent to 36 percent (Table III-12). The performance results are somewhat mixed, with some MFIs even showing a deterioration as shown by the big drop in this figure recently. The cost per average peso loan outstanding is relatively very high, especially for the credit NGOs but with the exception of the sample cooperative rural bank (Table III-13). A more complete picture of the cost of delivering the financial services (i.e., loans and savings facilities) is shown in Table III-14. Only the cooperative rural bank seems efficient and cost-effective relative to the rest of the sample MFIs. Available information on relative overhead expenses is captured in Tables III-15 (number of field staff to head office staff), III-16 (salaries as a percentage of total financial services) and III-17 (administrative cost per peso of assets).

The huge overhead expenses would have been offset by a greater number of clients and a wider range of financial products; but with a weak institutional capacity and a small financial base, this is just not possible at the moment. It is also important to note that a reason for the cost-ineffectiveness of credit NGOs is the lack of consistency between the perceived vision and mission of the MFI and the actual requirements of the business of delivering financial services. While top management is conscious of the need to be cost-effective and promote financial discipline in the organization and the clientele being served, the field staff have difficulty reconciling the social orientation of their organization's vision and mission with the business side of financial services delivery. Thus, the field staff give a lot of emphasis to training and community organizing rather than the

TABLE III-12
Gross Return on Average Loan Outstanding, 1993-1995

MFI	1993	1994	1995
A	0.12	0.19	0.27
B	0.33	0.02	0.08
C	028	0.56	0.34
D	0.27	0.25	0.31
E	0.30	0.28	0.26
F	–	0.30	0.27
G	0.16	0.14	0.17

TABLE III-13
Cost Per Average Peso of Loan Outstanding

MFI	1993	1994	1995
A	1.52	1.14	1.30
B	1.21	1.31	1.00
C	1.55	1.10	0.71
D	0.38	0.35	0.48
E	0.21	0.19	0.19
F	-	0.38	0.29
G	0.90	0.31	0.34

TABLE III-14
Cost Per Average Peso of Financial Services, 1993-1995

MFI	1993	1994	1995
A	1.11	0.80	1.06
B	0.90	0.92	0.70
C	1.49	1.12	0.70
D	0.61	0.30	0.41
E	0.16	0.16	0.17
F	0.29	0.35	0.27
G	0.81	0.28	0.32

TABLE III-15
Number of Field Staff to One Head Office Staff

MFI	1993	1994	1995
A	4.00	1.12	1.50
B	4.00	3.00	4.00
C	4.88	5.13	5.80
D	1.14	1.13	1.50
E	4.00	4.00	4.00
F	1.34	1.70	2.00
G	2.50	2.75	2.67

TABLE III-16
Percentage of Salaries to Total Financial Services

MFI	1993	1994	1995
A	44.00	52.00	45.00
B	64.00	46.00	30.00
C	93.00	41.00	29.00
D	11.00	10.00	9.00
E*	2.28	6.57	7.32
F	14.00	16.00	13.00
G	12.40	12.20	7.10

*Grameen replication program.

TABLE III-17
Administrative Cost Per Peso of Assets

MFI	1993	1994	1995
A	0.32	0.24	0.39
B	0.11	0.11	0.10
C	0.08	0.13	0.13
D	0.16	0.12	0.14
E	0.04	0.07	0.07
F	0.18	0.19	0.12
G	0.30	0.18	0.12

development and packaging of financial products, and other profitmaking activities. Because training and community organizing costs are generally activities that generate costs instead of revenues, overhead expenses increase unless these costs are absorbed by an external donor or by a government grant.

In sum, the MFIs must streamline their operations by a conscious cost reduction policy, develop new clientele and innovative financial products, and expand their financial base and outreach capacity.

4. *Degree of self-sufficiency.* Most of the sample MFIs are not operationally self-sufficient, much less financially self-sufficient. In 1995, only one credit NGO was operationally self-sufficient, although two of them nearly posted operational self-sufficiency with ratios of 0.66 and 0.67, respectively (Table III-19). The financial self-sufficiency ratio shows that only the sample cooperative rural bank became financially self-sufficient, a result which is hardly surprising, given our analysis of the constraints faced by nonformal financial intermediaries such as the credit NGOs (Table III-20.) Attaining full self-sufficiency takes time, and the constraining impact of the organizational form of the credit NGOs makes this task arduous. While they effectively target and reach the poor clientele, they could not be as effective and efficient given their weak institutional capacity and financial position. These institutions seem capable of continuing with their delivery of financial services to the poor only because of access to grants and concessional loans. However, as earlier pointed out, grants and concessional loans are becoming scarcer as hen's teeth as time goes on.[28]

3. Policy, Macro Factors and the Environment

The prevailing growth trend of the economy and the liberalized economic and financial environment augur well for microfinance programs and the MFIs. A growing economy and a more competitive financial marketplace will stimulate the de-

28. Only myopic politicians and bureaucrats believe that the barrel of goodies such as concessional loans is bottomless, but at the expense of taxpayers and depositors.

TABLE III-18
Debt-Equity Ratio

MFI	1993	1994	1995
A	2.00	2.00	2.00
B	8.00	3.00	2.00
C	0.32	0.86	1.90
D	2.10	–	–
E	2.00	2.60	1.64
F	0.30	0.36	0.49
G	0.89	0.23	–

TABLE III-19
Degree of Operational Self-Sufficiency

MFI	1993	1994	1995
A	0.08	0.17	0.21
B	0.27	0.32	0.08
C	0.18	0.45	0.51
D	0.72	0.72	0.67
E*	1.40	1.45	1.34
F	0.63	0.90	1.13
G	0.22	0.60	0.66

*Grameen.

TABLE III-20
Degree of Financial Self-Sufficiency

MFI	1993	1994	1995
A	0.06	0.17	0.19
B	0.26	0.29	0.07
C	0.17	0.40	0.42
D	0.36	0.78	0.48
E*	0.83	1.22	1.18
F	0.77	0.77	0.93
G	–	–	–

*Grameen.

mand for more microfinancial services. A conducive financial policy environment is essential for improving the efficiency and effectiveness of MFIs in reaching a greater number of poor people (see Annex A for a list of recent financial sector reforms).

With interest rate deregulation and a liberal bank entry and branching policy, there is room for the creation of more MFIs/ branches of MFIs or the transformation of the mature credit NGOs into formal financial institutions. Another tack is to maintain the NGO's social development thrusts and to leave financial intermediation to a separate organization, i.e., a formal financial institution that will be organized by the NGO. Alternatively, the NGO can buy into an existing formal financial institution. This paper is not the place to evaluate each of these transformation strategies. However, we would like to think that this strategy seems to be a realistic approach to the problems of lack of outreach, viability and sustainability of many credit NGOs.

Under the present legal and regulatory framework, a credit NGO can opt to become a bank, credit cooperative or finance company. These options take advantage of laws already in place and eliminate the long wait for enabling legislation that will allow these credit NGOs to mobilize deposits. Only duly authorized banking entities are allowed to mobilize deposits. As formal financial institutions, the credit NGOs will be private and autonomous institutions that can generate their own equity, mobilize deposits and offer a wider range of financial products to the target clientele. More specifically, as a bank, they can mobilize deposits from the public; as a credit cooperative or credit union, they can gather deposits from members.

A common and mistaken argument raised against the proposed transformation of credit NGOs into formal financial institutions, e.g., as private banks or finance companies duly supervised/regulated by the Bangko Sentral ng Pilipinas, is that they run the risk of losing their sense of mission for the poor.[29] We

29. One member of the Board of Trustees of a credit NGO which submitted an application for a banking license resigned on the ground that the NGO has lost its moorings, i.e., focus on the poor, by attempting to organize a bank.

argue that this will not necessarily result from such transformation. On the contrary, doing so would put in place the legal structure to deal with different clientele, generate additional capital, and mobilize deposits, thereby strengthening their capacity to serve the poor. We must distinguish between the organization and the individuals managing the organization. Thus, losing one's sense of mission for the poor during or after the transformation only magnifies what has been there all along—an empty commitment to the poor.

At present, the credit NGOs operate in a policy vacuum.[30] There are no clear policies and no supervisory/regulatory framework governing their credit intermediation activities. Since credit NGOs are not duly authorized banking entities, they cannot legally mobilize deposits.[31] There is no oversight body to supervise/regulate their financial activities. Thus, there are neither performance standards that will be important for monitoring the financial standing of those organizations nor prudential regulations to protect depositors, creditors, etc. Either the banking or the credit cooperative route could eliminate the need to reinvent the wheel of supervision and regulation since the oversight authorities are already in place, namely, the Bangko Sentral for banks and the Cooperative Development Authority for credit cooperatives.

There are pressing arguments on why credit NGOs should consider converting themselves into formal financial entities. The present deregulated and financial environment has made the financial markets more dynamic and competitive. There is a greater number of financial institutions with new and innovative products and financial technologies than the country has ever seen before. Over time many small unit banks such as the present rural banks will have grown and transformed them-

30. This paragraph is drawn from Llanto and Agabin (1996).

31. Cooperatives and credit unions can only mobilize deposits from their own members. NGOs are reported to have an informal "deposit-taking" relationship with "members." This is like skating on thin ice because of potential legal sanctions against this illegal activity.

selves into bigger entities which will cater to a different set of clientele and offer different financial products. The promise of potential profits and the impact on development will undoubtedly attract new formal and informal institutions into the financial markets. In this context, the credit NGOs are potentially the formal financial institutions which will address the demand for financial services of the poor. They can do a better job by being formal financial institutions, with full powers and authority to engage in real financial intermediation activities. As Llanto and Agabin (1996) pointed out, the lessons of experience from other countries (e.g., Grameen in Bangladesh, BancoSol in Bolivia) show that the transformation of NGOs into full-fledged formal financial institutions was a necessary condition for them to be viable and sustainable in the long term. Lessons from the transformation suggest that to do otherwise is to continue operating through donor or government subsidies. In an era of declining subsidies, the choice seems clear. How many local credit NGOs are ready to transform themselves into formal financial institutions is currently unknown. Presently, at least two NGOs have already become rural banks, i.e., those in Nueva Ecija and Zambales provinces, while one is in the preparatory process of becoming one.

Present government policy uses the specialized government banks to wholesale loans to MFIs, and mandates the People's Credit and Finance Corporation (PCFC) to assume the responsibility of providing loan funds and technical assistance to improve and strengthen the NGO network of institutions that promotes the Grameen technology. While the loan quotas for intended beneficiaries are still binding on financial institutions, this legal mandate is currently under review.[32] The Department

32. The ACPC and the Bankers' Association of the Philippines argue that the loan quotas, together with other impositions on financial institutions, e.g., gross receipts tax, serve only to increase the financial intermediation cost, and thus must be scrapped. Congress has a different view of loan quotas, i.e., those imposed by PD 717 (agri-agra loan quota) and RA 6977 (mandatory lending to small and medium enterprises). Several bills have been filed to retain them and to eliminate the purchase of government securities as an alternative mode of compliance with the loan quotas.

of Finance, together with the National Credit Council, is leading efforts to rationalize the 111 government credit programs which have been criticized for being inefficient, highly politicized, uncoordinated and unsustainable. The presence of these credit programs sends a confusing signal to MFIs and clients alike. While ostensibly the government promotes savings mobilization and equity buildup for sustainability, making available highly subsidized credit funds to MFIs erodes the resource mobilization effort and promotes financial dependence on government.

The Philippine government has also put in place a Social Reform Agenda with a particular focus on poverty alleviation. It has also recognized the use of microfinance as an instrument to alleviate poverty, and has drafted legislation creating the People's Development Fund to be managed by PCFC for the capacity building of MFIs. The People's Development Fund will receive budgetary support from the national government. In addition, the 1997 budget of the government will include a poverty alleviation budget which will be incorporated into the respective budgetary programs of the designated implementing agencies. The poverty alleviation budget will be used for livelihood, potable water development and sanitation, health and nutrition, basic child care, environment resource management, basic education, resettlement and housing. The government has allocated P100 million of the poverty alleviation budget for the capability building of microfinance institutions.

The commercial banks admit their limitations in regard to microfinance programs. However, the private banking sector can help create an enabling environment for microfinance. It can finance rural infrastructure projects; it can also encourage corporate clients to locate their projects in the countryside.[33] On the other hand, the private sector has also responded by creating the *Punla sa Tao* Development Foundation that is a pool of

33. In March 1996 the World Bank sponsored a seminar on innovations in microfinancing at the AIM. An official from BAP said that "big banks do not have the skills nor the temperament to deal with the inherent risks that do with microfinancing."

private funds intended for the capability building of credit NGOs. Likewise, the two networks of credit NGOs have successfully worked with donors in raising capability building funds.

The donor community has also provided assistance to NGO capability building. The United States Agency for International Development (USAID) has approved the funding of a proposal submitted by a credit NGO and an NGO network for capacity building of credit NGOs. The Asian Development Bank, together with the International Fund for Agricultural Development (IFAD), has provided the government with a concessional loan and grant funds for the replication and expansion of the Grameen approach. More recently, the Australian government received a proposal for funding a capability building program for NGOs. On the other hand, several World Bank missions have visited the country regarding the need for financial sector reforms, e.g., development of long-term credit markets, housing finance and pension funds reforms. A recent World Bank paper encouraged the government to put in place the appropriate regulatory framework for MFIs and to pay attention to the capability building needs of these institutions.[34]

IV. CONCLUSIONS AND RECOMMENDATIONS

The conclusions and recommendations address four areas that will enable MFIs to be self-sustaining financial institutions serving the poor. These four areas are as follows: (a) *outreach and impact;* (b) *viability and sustainability;* (c) *resource mobilization;* and (d) *policy.*

Outreach and impact. The MFIs are able to reach the poor because of an effective targeting mechanism which rules out the leakage of benefits to the nonpoor. A highly motivated field staff also contributes to effective targeting. The MFIs seem to satisfy their poor clients' demand for short-term loans (e.g., working capital); and some even provide the clients with savings facilities.

34. A Strategy to Fight Poverty: The Philippines, The World Bank, 1996.

However, their outreach is limited to a few thousand clients because of their weak institutional capacity, small financial base, high turnover of staff, and high cost of training clients (or social preparation). A comparison of the performance of the sample MFIs indicates that only the cooperative rural bank has the capacity for full financial self-sufficiency. This is not surprising given the advantages and authority given to a formal financial institution such as the cooperative rural bank.

To address outreach problems and the lack of a viable and effective delivery system, it is argued that huge investments in the creation of NGO branches must be made. A common sensitivity model employed by NGOs indicates that to reach 400,000 borrowers over a five-year period, 300 new branches of present credit NGOs must be established. Because of the labor-intensive nature of microfinance lending technology such as the Grameen approach, some 3,000 field personnel must be trained. This will require as much as P100 million for branch expansion and training of new personnel. We believe that to reach a greater number of poor people in a shorter period of time, P100 million should be used to train *existing, viable and sustainable financial institutions,* such as rural banks, cooperative rural banks and credit cooperatives whose network of branches and unit banks is on a nationwide scale, on *microfinance technologies.* This in our mind is a more cost-effective approach to the problem of outreach and sustainability of microfinance programs. As Table III-3 shows, the actual outreach of cooperative rural banks, rural banks and credit cooperatives is far greater than those of credit NGOs. Investing in the creation of new branches of NGOs appears to be more costly and risky than investing in the training of existing formal financial institutions in microfinance technologies.

The credit NGOs will forever be in a disadvantaged position compared to other financial institutions. They cannot exercise the full range of financial intermediation activities. For example, they lack the legal authority to mobilize deposits, and can only leverage to a very limited extent their meager fund balances. Because they are neither finance companies nor nonstock savings and loans associations nor credit cooperatives/credit unions, their borrowing capacity is limited, making them very dependent on grants and soft loans from the government. This also adversely affects their viability and sustainability.

With respect to the problem of motivation and attitude, the MFI staff must deal with traditional attitudes that regard credit to the poor as "social credit"[35] leading to inappropriate pricing of loans, laxity in collection and unsustainable lending programs (Llanto and Agabin 1996). This view of credit as "social credit" is an invitation to nonrepayment of the loan because it is "government money" to which everyone else is entitled.

This view is reinforced by a proposed law that seeks to create a network of "community banks of the poor" to be capitalized by the government. The proposed law only serves to strengthen the attitude that government has to be heavily involved in microfinancial markets to ensure the poor's access to financial services. Citing as reasons the imperfection of the financial market and market failure, proponents of the "community bank of the poor" have tried very hard to convince government and the legislature to pass the proposed law.

This naïve view of the appropriate role of the government in the financial market ignores the failure of past government intervention in the credit markets through subsidized credit programs, and the inefficiency and waste of scarce public resources arising from the present overlapping and duplication of 111 government credit programs. Indeed, government intervention may be warranted only if the government can demonstrate that it can do better than the imperfect market, and that the net social benefits of government intervention are positive.

Thus, the following are recommended:

- *transform credit NGOs into full-fledged formal financial institutions, e.g, private bank, finance company, nonstock savings and loan association or credit cooperative;*

35. This is quite prevalent among politicians who unabashedly promote patronage and continuing dependence of the poor on them.

- *alternatively, credit NGOs may organize or invest in formal financial institutions;*
- *promote linkage banking with private banks which are interested in providing microfinance services for the poor through the MFIs whose institutional capacity must be upgraded;*
- *invest in training existing rural banks, cooperative rural banks and credit unions/credit cooperatives in microfinance technologies;*
- *externalize the training costs of the poor by allowing MFIs access to grants and government financial assistance, but following the principle of matching grants with MFI own funds;*
- *continue staff training and the development of career paths for capable workers, upgrade pay scales and incentive schemes to retain good personnel; and*
- *rationalize government credit programs and reallocate existing funds for livelihood projects to capacity building and training of existing MFIs.*

MFI viability and sustainability. To continue providing financial services to the poor on a sustained basis, the MFIs themselves must be viable and sustainable. The study shows that many of the MFIs are far from attaining this goal.

The MFIs' viability and sustainability depend first and foremost on the nature of their organization and the business and investment activities which they are allowed to undertake within the legal and regulatory structure of the country. Any limitation on their investment and business activities (e.g., prohibition to mobilize deposits from the public, investment in allied undertakings) constrains profitability and growth. The MFIs have relatively little financial resources which limit their leverage capacity. The credit NGOs' dependence on grants and subsidies also undermines their viability and sustainability. Thus, they have to raise more funds and become more efficient credit intermediaries.

The second major factor which determines credit NGOs' viability and sustainability is the set of internal financial policies and organizational practices and procedures. In addition, the capability for governance, leadership and management affects their performance. Improvement of management skills and professionalization of staff, appropriate market-oriented pricing of financial products and services, and greater effort in loan recovery are needed to make the MFIs viable and sustainable.

Thus, the key issue is building sustainable institutions by having (a) the appropriate organizational form; (b) a strong equity and financial base; and (c) suitable systems and procedures.

The following are recommended:

- *build up the equity base of MFIs by infusing more capital from existing owners and new investors;*
- *diversify loans, savings and other financial products/services according to client demand;*
- *maximize savings mobilization opportunities;*
- *promote training in financial operations, resource mobilization, portfolio management, risk assessment and management, product packaging and pricing, management of loan arrears, strategic and business planning, among others;*
- *improve systems and procedures such as automating systems and operating procedures, upgrading and institutionalizing performance standards, setting up internal audit systems, conducting periodic management audits, installing an updated and standardized accounting and reporting system; and*
- *professionalize the management and staff of MFIs.*

Resource mobilization. The "forgotten" half of finance is deposit mobilization,[36] and this is conveniently forgotten in the

36. Dale Adams, Ohio State University.

face of donor grants, subsidized credit funds from government, and other doleouts. To stay competitive and viable, the MFIs must raise substantial deposits and develop various instruments, especially for the small savers, which will help them build up their financial base. Thus, they not only have to mobilize traditional deposits but also seek to broaden and deepen the financial products and services offered to meet existing demand at the lower end of the financial market. Broadening and deepening mean the development of new product lines and services, and the design and implementation of new microfinance technologies and practices which will strengthen their financial base.

The following are recommended:

- to the MFIs—*invest in the development of new product lines and services, new microfinance technologies, adaptation of the "best practices in microfinance," etc., with counterpart funding from donors and the government;*
- to the government—*reallocate its resources in various livelihood programs for the broadening and deepening of microfinancial services; and*
- to the donors—*allocate resources for the broadening and deepening of microfinancial services instead of providing loanable funds to MFIs.*

Policy issues. The necessity of bringing credit NGOs under a supervisory and regulatory framework cannot be underestimated.[37] Without such a framework, the following problems will persist: absence of performance standards, lack of uniformity and dilution of standards of credit evaluation, lack of portfolio supervision leading to poor loan recovery and deterioration of its quality and absence of prudential regulations over such activities as deposit taking. The installation of a supervisory and

37. The rural banks and cooperative rural banks, finance companies, and credit unions/cooperatives are already supervised/regulated by the pertinent government agencies.

regulatory framework complements the building of the institutional capacity of MFIs, especially the credit NGOs. In this way, we will have strong MFIs which will no longer operate in a policy vacuum.

The alternative to a formal supervisory and regulatory framework is self-regulation by the credit NGOs. The argument goes that maintaining an informal self-regulatory framework will provide the credit NGOs with flexibility and room for initiative on various financial innovations to reach the poor. Furthermore, there will be no danger of losing focus on their target clientele which will be brought about by the transformation of credit NGOs into formal financial institutions. However, the review made by this study points to the glaring need for performance standards, prudential regulations, etc., in short, a supervisory/regulatory framework that will ensure the safety and soundness of those institutions and the integrity of their transactions. The argument on losing focus on the poor, as pointed out earlier, does not hold water. It is because an organization's vision, mission and goal are not dictated by the organizational structure (e.g., banking firm) but by the people manning it and the policies being pursued.

The transformation into formal financial institutions may not be everybody's cup of tea. It is not for every NGO. There will be some which will opt for transformation, but there will be others who will choose to remain as a development agency and, perhaps, organize a bank with a distinct charter, character and function. The important outcome of the latter strategy is the unbundling of banking and development/social preparation functions which will increase efficiencies in the financial markets for the poor because the (NGO) development agency and the NGO-organized bank/financial institution can exploit their respective comparative advantage. From the public policy perspective, it becomes clearer what activities in microfinance programs for the poor properly constitute the "social development costs" and what should rightly be considered "cost of providing the financial service," i.e., the cost of doing business. The first set of costs may be subsidized or given access to grants in view of the externalities present in social training/preparation of poor clients while the latter should be covered by appropriate pricing of the financial product. For the social development costs, the present thrust of raising private monies must be supported.

The following are recommended:

- to the government—*provide for an appropriate supervisory and regulatory framework for MFIs, especially credit NGOs;*
- to the NGOs—*maintain a dialogue with the government on the installation of an appropriate supervisory and regulatory framework for MFIs,*
- to the government—*support the costs of social preparation/ training through budgetary assistance that will be matched by private sector funds; and*
- to donors—*provide assistance to social preparation activities, development of microfinance products, training in microfinance technologies, and upgrading of performance standards, operating systems and procedures.*

ANNEX A

Policy Measures	Before Reform	After Reform	Date
I. Selective Credit Control			
1. Central Bank rediscount window	Rediscount rate: varies by type of economic activities (allowable spread: 1%-11%)	Uniform floating rate for all; no prescribed spread.	November 1985
	Rediscount value: varies by type of economic activities (value: 60%-100%)	Uniform: 80%	November 1985
2. Central Bank Special credit programs	Directly managed special credit programs	Central Bank-managed special credit programs transferred to government financial institutions	1987-1988
II. Bank Competition			
1. Bank Entry	New commercial banks - moratorium since 1980; other banks - no moratorium.	New commercial banks - moratorium lifted	1989
	Foreign banks - no entry since 1949.	Ten foreign banks allowed to have 6 branches each; foreign banks may acquire or establish a bank up to 60% of the total equity of each bank.	1994
2. Branching	Restrictive branching policy -- the country was divided into five service areas; heavily overbranched areas; overbranched areas; ideally branched areas; underbranched areas; and encouraged branching areas.	Branching was liberalized but the Central Bank retained discretionary power with respect to the opening of branches in certain areas considered "overbanked."	May 1989
		Banks may open branches anywhere they like provided they meet the required minimum capital requirement.	May 1993

ANNEX A (CONTINUED)

Policy Measures	Before Reform	After Reform	Date
3. Government Banks	Largely doing lending that directly competes with private banks.	More focus on wholesale lending using private banks as conduits.	since 1987
4. Interest Rates			
a. Deposit rates	No cap since 1981		
b. Lending rates			
Private banks	No cap since 1983	same	1987
Special credit programs	Cap on end-user rate	No cap on end-user	
III. Prudential Measures			
		Prohibiting concurrent officerships between banks or between a bank and a nonbank financial intermediary except with prior approval of the Monetary Board.	September 1986
		Requiring each bank to cause an annual financial audit to be conducted by an external independent auditor not later than 30 days afler the close of the calendar year.	December 1986
		Requiring all banks and nonbank financial intermediaries to adopt the Statements of Financial Accounting Standards.	December 1987
		The Central Bank declared a policy that it shall refrain from sustaining weak banks, except in times of general financial emergency or when specific banks face problems of liquidity rather than of solvency.	May 1989

ANNEX A (CONTINUED)

Policy Measures	Before Reform	After Reform	Date
		Including contingent liabilities in the determination of the limit to which banks can lend to a single borrower or a group of affiliated borrowers.	June 1993
	Deposits of insider-borrower were protected by the Secrecy of Bank Deposits Law.	Insider-borrower shall waive the secrecy of their deposits for examination purposes.	
		Increasing the minimum capital requirements for banks. Latest:	
		Universal banks: P2.25B Commercial banks - P1.125B Thrift banks - P150M Rural banks - P20M	
IV. Foreign Exchange Markets			
1. Foreign exchange trading	On-floor	Off-floor through an electronic screened based network for sharing information and undertaking transactions.	December 1992
2. Export receipts	Mandatory surrender of foreign exchange receipts.	Foreign exchange earners may retain 100% of total receipts and can use them freely without prior Central Bank authorization.	September 1992
3. Foreign exchange purchases	Limits on foreign exchange purchases such as travel, educational expenses, etc.	No limit.	September 1992

ANNEX A (CONTINUED)

Policy Measures	Before Reform	After Reform	Date
4. Repatriation and remittances of investments	Staggered from 3-9 years subject to Central Bank approval.	Full and immediate repatriation without Central Bank approval for foreign investments duly registered with the Central Bank or custodian bank.	September 1992
5. Outward investment by residents	Not allowed.	Allowed initially up to US$1M, but lately increased to US$6M.	1992-1994
6. Access to domestic FCDU loans.	No access.	Direct exporters allowed access	September 1992
		Indirect exporters allowed access	July 1994

Source: Lamberte and Llanto (1995).

ACRONYMS

ACPC	Agricultural Credit Policy Council
BAAC	Bank for Agriculture and Agricultural Cooperative
BAP	Bankers Association of the Philippines
BCGC	BAP Credit Guaranty Corporation
BSP	Bangko Sentral ng Pilipinas
BWYW	Bureau of Women and Young Workers
CARP	Comprehensive Agrarian Reform Program
CDA	Cooperative Development Authority
CRBs	Cooperative Rural Banks
DA	Department of Agriculture
DAR	Department of Agrarian Reform
DOLE	Department of Labor and Employment
DSWD	Department of Social Welfare and Development
DTI	Department of Trade and Industry
GDP	Gross Domestic Product

GNP	Gross National Product
IC	Insurance Commission
IFAD	International Fund for Agricultural Development
LBP	Land Bank of the Philippines
MCP	Microcredit Project
MFIs	Microfinance institutions
NBFIs	Nonbank Financial Intermediaries
NLSF	National Livelihood Support Fund
NGOs	Nongovernmental Organizations
PCFC	People's Credit and Finance Corporation
PCFP	Presidential Commission to Fight Poverty
POs	People's Organizations
SRA	Social Reform Agenda
USAID	United States Agency for International Development
WEED	Women Workers Development and Entrepreneurship Development

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