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Philippine Credit Policy and Microfinance Institutions: *Some Lessons from the Latin American Experience*

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Governments in developing countries have traditionally used subsidized credit programs and mandatory loan allocation to provide small-scale borrowers access to formal credit. This is because banks tend to discriminate against such borrowers thereby making the latter resort to borrowing from informal moneylenders. In light of this, the number of subsidized credit programs in developing countries, including the Philippines, has multiplied rapidly over the years.

Has this growth in number, however, eased the situation for the small-scale borrowers? Are these subsidized programs the best approach to provide small borrowers access to financial services?

This *Policy Notes* issue focuses on these concerns. In particular, it reports on the author's observations and conclusions regarding the experience of three Latin American countries as they move toward a sustainable, private-led effort to address this need and how said experiences may provide some lessons for the Philippines in terms of its credit policy framework.[1]

Observations

✻ Throughout the decade of the 1980s and until they liberalized their financial sectors in the 1990s, Guatemala, Peru and Bolivia implemented subsidized credit programs, targeting specific sectors of their respective economies in an attempt to provide these sectors access to credit. They used government banks like agriculture development banks to provide credit at highly subsidized lending rates, often using government resources as the source of loanable funds. The subsidized credit programs invariably failed and led to the closure of government banks in the three countries.

✻ Financial liberalization and deregulation of interest rates, meanwhile, encouraged the rise of nontra-

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[1]The author's observations and conclusions are based on his study visit of microfinance institutions and superintendencies of bank and financial institutions in Guatemala, Peru and Bolivia from the period January 25-February 6, 1999. He was with a study group composed of legislators and top executives of several Philippine government institutions.

ditional lending institutions which catered to sectors of society that could not access formal credit. These institutions are the credit-granting nongovernment organizations (NGOs) and microfinance banks which have developed very effective lending technologies that provide credit to low-income clients and exhibit high loan repayment rates. The best examples are GENESIS Empresarial in Guatemala, MIBANCO in Peru, and FIE, PRODEM and Banco Solidario in Bolivia.[2]

✼ In general, lending rates in Peru initially tended to be high. Still, they were lower than those imposed by alternative lending sources such as the informal moneylenders. Then, with the opening of credit markets to microfinance banks and other types of lenders, e.g., private financial funds (PFF) in Peru, and greater competition in the financial marketplace, the lending rates eventually declined even without the need for any legislation capping interest rates.

✼ In view of the lessons learned from the experiences of the failed subsidized credit programs which brought a huge fiscal burden on the governments of these three Latin American countries, their governments now put a strong emphasis on having sustainable microfinance institutions (MFIs). As such, they consciously observe the following policies:

- Government to provide the enabling environment for private sector participation in the financial marketplace;
- Deregulated interest rates to enable MFIs to cover the costs of lending and funds as well as the risks involved in microcredit;
- Emphasis on long-term sustainability of MFIs;
- Government to provide the necessary infrastructure, e.g., roads, water, sanitation and other basic services, to make the local economy viable; and
- Superintendencies of banks and financial institutions to have an appropriate regulatory framework for MFIs.

Greater private sector participation in the microfinance markets requires the market orientation of interest rates, freedom from government-directed credit programs, competition in the financial marketplace and a framework of laws and regulation that recognizes the special character of microfinance.

✼ The briefings conducted by the different MFIs and superintendencies of banks and financial institutions underscored the importance of:

- maintaining the high quality of the loan portfolios of the microfinance banks/institutions;
- imposing transparency in transactions through well-organized financial statements;
- having a database in the bank superintendencies that keeps a record of the loan transactions of borrowing clients of banks and registered NGOs; and
- avoiding the provision of credit subsidies to microfinance banks/institutions, whether the funds be from government or external donors.

✼ Solidarity group loans that make use of peer pressure within groups have been successfully used by microfinance institutions/banks to reach target clientele. The solidarity group thrives on the basis of good information about the members of the groups as well as on peer pressure exerted on each group member to repay his individual loan.

✼ Within a framework of a liberalized and deregulated financial market (competition among many lenders, market-oriented interest rates and credit policies) and good governance (a regime of appropriate laws and regulations, provision by government of basic infrastructure), the three countries were able to have thousands of low-income people gain access to basic financial services.

✼ Low-income people save and pay their loans. They are not afraid of taking commercial loans because *what is more important to them is continuing access to credit, not the cost of credit*. A myriad of opportunities

[2] *The Annex enumerates and describes the institutions that were visited.*

for microenterprises exists which enables small borrowers to pay their loans on time and at a cost demanded by microfinance banks/institutions.

❇ The cost of credit comes down with competition in the market. This is exemplified by the experience of Bolivia's PRODEM which was charging an effective lending rate of 67 percent in 1991. Today, its effective lending rate is down to 43 percent. In contrast, the present effective lending rate in the Bolivian informal credit markets is 185 percent! With economies of scale and lending flexibility, PRODEM was able to bring its effective lending rate down dramatically without sacrificing outreach to low-income clients. Moreover, Banco Solidario, a recently-established microfinance bank that also caters to commercial borrowers, charges an average interest rate of 30 percent a year for loans of less than US$3,000.

❇ After the closure of bankrupt government banks, the financial systems of the three Latin American countries were dominated by a few private commercial banks which catered mainly to their respective countries' traditional trade and commercial activities. With no medium and small banks like the Philippines' development and rural banks in existence, these Latin American countries looked at the credit-granting NGOs and cooperatives (which catered to small, low-income borrowers) as the only alternative to informal moneylenders. As such, their governments saw the need to transform these credit NGOs into formal financial institutions. By so doing, these NGOs were brought under the regulatory umbrella of bank superintendencies. At the same time, these countries also adjusted their regulations to make them appropriate for microfinance operations, e.g., smaller capital requirement of US$1 million for NGOs converting into Private Financial Funds (PFFs) versus US$7 million for a private bank.

Lessons learned

❇ Government-subsidized and -directed credit programs provided the incentive for nonrepayment of loans. In the three Latin American countries cited in this *Notes*, the government banks that provided subsidized credit programs had to close because of huge operating losses. Some of the major factors that guaranteed the failure of these programs were political patronage, bureaucratic inefficiency and distorted incentives. The common experience was that heavy government intervention in the financial markets distorted the financial system and denied low-income clients access to financial services since influential and nonpoor borrowers were the ones who got hold of the credit subsidies.

❇ Stable macroeconomic and financial policies characterized by low inflation and reduction of the fiscal deficit were necessary pre-requisities for efficient financial markets.

❇ Deregulation of interest rates, competition in the financial marketplace and a stable macroeconomic environment were responsible for bringing down lending rates for the benefit of low-income borrowers and making credit more accessible to low-income clients.

❇ The legal framework for the licensing and regulation of MFIs was a critical factor that has encouraged their growth and sustainability. The appropriate legal status has allowed MFIs in Peru and Bolivia to expand their microfinance portfolios by:

- mobilizing savings to finance increasing loan portfolios, and
- borrowing from commercial loan markets.

❇ Sustainable microfinance can best thrive in a policy environment that is devoid of subsidies to the credit market. In Peru, all government credit programs were consolidated in the COFIDE which now acts as a second-tier bank for participating private financial institutions. The government allowed the creation of private financial institutions called EDPYMES to provide microfinance services to small clients. In Bolivia, all subsidized and directed credit programs were phased out during the financial crisis that hit the country in the early 1990s. The objective was to avoid undue government competition with the private sector in the microfinance market. A law also created the Private Financial Funds which have a much lower level of capitalization than commercial banks but are regulated by the superintendency of banks and financial institutions.

❇ The governments of the three Latin American countries now focus on providing basic infrastructure such as roads, bridges, water, sanitation, and basic education to make the local economy viable and the local residents creditworthy.

❇ Microfinance institutions and banks strive for sustainability in order for them to continue reaching low-income clients and also to expand their current outreach. It must repeatedly be emphasized that *only sustainable, not subsidized*, institutions can provide low-income clients access to financial services. Successful MFIs have aimed for long-term sustainability even at the start of their programs as clearly shown in the history of their operations in these three countries. They started and continue to operate without any subsidy coming from the government. Instead, most of them have strong support from the private sector in terms of leadership and active participation in their operations. Government assistance is provided mainly through appropriate regulation of MFIs.

❇ There is concern about the proper use of external donations and grants. These funds are better used in building the capacities of microfinance institutions/banks to reach low-income clients rather than in using them as sources of subsidized credits. Donors should not prescribe lending methodologies to be adopted by MFIs since the success and effectiveness of these methodologies largely depend on the area and types of clients being serviced. Donors to MFIs in Latin America provide funds for capability-building.

Recommendations

❇ The Bangko Sentral ng Pilipinas (BSP) should review current regulations affecting rural banks' microfinance operations. Given the experiences of MFIs in Latin America and the unique risks faced by MFIs, there may be a need to review the present regulatory environment and the current standards and performance indicators applied by supervisory and regulatory authorities to the rural banks. This is to determine their relevance and applicability to banks providing microfinance services.

❇ Congress should review the current law that created the Cooperative Development Authority (CDA), with the objective of strengthening and making it focus on its regulatory mandate over credit cooperatives.

❇ The National Credit Council (NCC) should issue a clear policy terminating and prohibiting the provision of credit subsidies. Credit subsidies distort the financial markets and intervene in the efficient functioning of financial institutions.

❇ The BSP, Philippine Deposit Insurance Corporation, CDA and NCC should all work toward an appropriate regulatory framework for microfinance institutions.

❇ The Land Bank, CDA and NCC should join efforts in building the capabilities of MFIs for efficient, viable and sustainable operations.

❇ Finally, the Land Bank of the Philippines should focus on providing wholesale funds for microlending by credit cooperatives and private banks such as rural banks and savings banks at market-oriented rates.

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Annex

Latin American Institutions Visited

Federacion Nacional de Cooperativas de Ahorro y Credito Servicios Varios (FENACOAC), Guatemala City. This is the National Credit Union Federation in Guatemala that provides technical assistance to member cooperatives and, at the same time, operates a central liquidity fund for members. Major emphasis was given to the sustainability of the federation and its members by pursuing market-oriented credit and interest rate policies.

Budget, Finance and Monetary Committee, Congress of Guatemala. The courtesy call at this important Congressional committee revealed the efforts by the government and the legislators in implementing major financial and economic reforms that provided macroeconomic stability and strengthened the financial markets.

Superintendencia de Bancos, Guatemala City. The Superintendencia pointed out that a more modern approach to supervision, namely, risk-based supervision, is very critical in building confidence in the financial system and providing regulators a key instrument in monitoring the health of financial institutions.

BanRural, Guatemala City. This bank used to be a government bank but because of very high default rates and huge losses, it was converted into a private development bank. Borrowers viewed loans from the former government bank as dole-outs and thus, did not repay their loans. Private investors were later invited to invigorate the bank with fresh capital and management expertise.

Ministry of Finance, Guatemala City. The ministry informed the group that the government and legislators are working on a special legislation for microfinance institutions. The reform efforts of the Guatemalan government contributed to economic stability and the strengthening of the financial markets.

GENESIS Empresarial, Guatemala City. This is a nongovernmental organization (NGO) established to provide credit, advisory services and training to micro and small enterprises. It has several programs, namely, microenterprise promotion, support to small enterprises, village banks, credit for electrification of rural areas, credit for introduction of drinking water in the rural areas and credit for rural housing. All the programs are noted for their profitability as they are based on market-oriented principles.

La Union Argeta (Credit Union), Solola, Guatemala. This is a credit union that is a member of FENACOAC. It offers a variety of loan and savings products to members. The briefing emphasized the importance of market-oriented interest rates in screening borrowers and motivating depositors to save with the credit union. Accessibility of the credit union to members gives it a distinct advantage over other alternative lending institutions.

Superintendencia de Bancos, Lima, Peru. This is the institution that regulates and supervises financial institutions in Peru. It supervises the EDPYMES—small finance companies which are legally allowed to provide credit but not to accept savings from the public. The revised banking law in Peru provided for the creation of EDPYMES which formalized the provision of credit by NGOs and their supervision as well by the superintendency. The standard supervisory requirements imposed on regular financial institutions are applied to EDPYMES by the superintendency.

Corporacion Financiera de Desarrollo (COFIDE), Lima, Peru. COFIDE is a state-owned second-tier development bank. It provides loan funds to rural and municipal "cajas," cooperatives and EDPYMES for on-lending to small clients and microenterprises. COFIDE's funds are from the following: local and foreign commercial banks, multilateral banks, proceeds from technical cooperation and agreements, and the national treasury. Funds from the national treasury come in the form of a guarantee.

Annex (cont'd.)

MIBANCO, Lima, Peru. MIBANCO is a recently-organized microfinance bank. It was organized by the Accion Communitaria Peru, a large credit NGO with help from Accion International (an American NGO) and some private investors. A special law was enacted which allowed private banks to invest in another bank. It is a profitable microfinance bank because of its conscious adoption of market-based principles.

Fondo Financiero Privado FIE, S.A., La Paz, Bolivia is a private financial fund—a type of regulated financial institution—that serves micro and small enterprises in Bolivia. As a regulated financial institution, it is able to access public savings. Supervision by the Superintendency of Banks and Financial Entities gives FIE credibility and confidence with its creditors and the public.

Fundacion para la Promocion y Desarollo de la Micro Empresa (PRODEM), La Paz, Bolivia. PRODEM organized Banco Solidario (popularly known as BancoSol), the first microfinance bank in Latin America. It owns 35 percent of BancoSol. At present, PRODEM continues to provide microcredit, mostly to rural microentrepreneurs, in Bolivia. With growing competition among MFIs in Bolivia, PRODEM has recently resumed lending to urban microentrepreneurs who are also clients of BancoSol. Hence, PRODEM now acts as a direct competitor to BancoSol. Market-based principles guarantee profitability which enables PRODEM to increase its outreach to rural microentrepreneurs.

Banco Solidario, La Paz, Bolivia. BancoSol is a commercial bank which is engaged in providing microfinance services to microentrepreneurs in Bolivia. As a bank, it is allowed to provide both credit and savings services to microentrepreneurs. Using market-oriented principles in its solidarity (group) loans to clients, BancoSol has demonstrated how a microfinance bank could be a very profitable bank. Its widely-acclaimed success paved the way for the enactment of a law which allows the creation of Private Financial Funds (PFF)—small regulated financial entities that provide microfinance services to Bolivia's microenterprises. They have lower capital requirements compared to regular banks.

FUNDAPRO, La Paz, Bolivia. This is a second-tier private foundation which was created in 1992 with initial funding from USAID and the Bolivian government to provide loan funds to MFIs in Bolivia. It has a financing program and a development program for microfinance institutions. Under its financing program, it provides loan funds to private institutions working with microenterprises. Under its development program, it provides technical assistance (mostly capability-building) to new credit NGOs and PFFs. As a second-tier organization, it evaluates the performance of MFIs that borrow under its financing program. It has already developed a set of indicators for evaluating MFI clients. At present, FUNDAPRO is helping to establish deposit insurance in Bolivia.

Superintendencia de Bancos y Entidades Financieras, La Paz, Bolivia. Under the 1928 banking law, the Superintendencia used to regulate only banks. In 1993, a new banking law was passed which allows the Superintendencia to regulate new financial entities such as savings and loan associations, credit unions and NGOs providing microcredit. In line with this is the creation of regulated Private Financial Funds (PFFs) that cater to microenterprises. The regulatory standards for banks are applied to the PFFs. There is, however, an ongoing technical assistance from USAID which is reviewing these standards in terms of their applicability to microfinance institutions.

Ministry of Finance, La Paz, Bolivia. The government established the Microcredit Fund as an operational mechanism of the Program for Support to Microcredit and Rural Financing to be administered by the Fund for the Development of the Financial System and Support to the Productive Sector (FONDESIF). The Microcredit Fund will allow the access to formal financial services by larger segments of the Bolivian population. The financial NGOs are the conduits for credit extension. The Ministry of Finance has tasked a vice-minister with the specific function of overseeing FONDESIF's administration of the Microcredit Fund.