Philippine Institute for Development Studies

Policy Notes

January 2001 No. 2001-01

Risk-based Supervision of Banks Involved in Microfinance*

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". . . the only thing we require to be good philosophers is the faculty of wonder. . ."
Josten Gaarder, **Sophie's World**

Banks involved in microfinance or "microfinance banks," for short, are significantly different from the traditional banks in terms of their clientele, loan products, lending and collection technology, and the associated risks surrounding their loan portfolios, among others. Microfinance banks have shown a remarkable ability to reach low-income clients, some of whom are practically without bankable assets, and to collect almost 100 percent of their loans. To be able to further expand their reach to a wider clientele, these banks need to raise funds from both deposits and commercial sources. To be able to do this on a large scale, though, they should be able to show to the public and the regulatory authority that they are as trustworthy as the regulated nonmicrofinance bank.

But how should microfinance banks be regulated and supervised? The quick answer as this *Policy Notes* shall explain lies in adopting a risk-based regulation and supervision of microfinance banks that is more appropriate to their nature and set-up than the conventional approach to bank regulation and supervision.

In order to understand why this is so, it is first important to understand the nature of the microfinance clientele and of a microfinance loan.

Nature of the microfinance clientele

Microfinance loans are small loans granted to microenterprises by financial intermediaries on the basis of the borrower's cash flow.[1] These loans are typically unsecured and charge market-determined interest rates, enabling

*This Policy Notes *focuses on the regulation of microfinance banks. An earlier* PIDS Policy Notes (No. 98-09) *discussed the regulation of deposit-taking cooperatives.*

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[1]*The term "microfinance" refers to the loans and savings facilities provided by microfinance institutions to small-scale borrowers. Microfinance institutions consist of rural banks, credit cooperatives, credit-granting nongovernmental organizations (NGOs) and other banks providing microcredit.*

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microfinance institutions to cover operating costs, cost of funds and various risks as well as to generate profit margins.

A common characteristic of the microfinance institutions' type of clientele is their exclusion from the traditional banking system because of their perceived credit risks, inability to provide loan collateral and, generally, low incomes. Their failure to access formal credit has given rise to a plethora of government-directed credit programs that were established to provide subsidized credit but which invariably failed because of incentive incompatibility reasons.[2] In this regard, credit-granting NGOs have recently emerged as alternative sources of credit. In some instances, the NGOs mobilize "savings" from their borrowers. The "savings" are really "forced savings" since these are retained from the loans and kept by the NGO concerned to earn interest for the borrower while at the same time being used as some form of loan security.

Table 1. Sources of income by income group, 1998

Economic Activities	All Families	Lowest 40%	Highest 60%
Total number of families ('000)	14,370.7	5,748.1	8,622.6
% reporting income from:			
Wages and salaries	67.4	51.2	78.2
Family sustenance	50.1	74.2	34.2
Net share of crops, etc.	7.0	7.2	6.8
Entrepreneurial activities	61.2	70.0	55.5

Source of basic data: 1998 Annual Poverty Indicators Survey

Data from the 1998 Annual Poverty Indicators Survey (APIS) show why and how microfinance has become an important source of liquidity, e.g., working capital, for microenterprises. As shown in Table 1, poor families derived income from multiple sources, mainly wages and salaries, entrepreneurial activities and family sustenance activities (for home consumption). Of the more than 14.4 million families surveyed, 67 percent received wage income, 61 percent earned income from entrepreneurial activities, and 50 percent engaged in family sustenance activities to augment income. And among the poorest 40 percent of the respondents, more families (70%) depended on entrepreneurial activities rather than on wages and salaries (51%) for their income.

The multiplicity of income sources demonstrates how low-income families try to cope with the challenge of daily living since earnings from any one source are not enough to cover living expenses. Families engaged in microenterprises are especially constrained by the lack of sufficient funds to expand their micro businesses or even to sustain working capital requirements. Formal credit seems to be difficult to avail of. In fact, the 1998 APIS reports that out of 8.5 million surveyed families with businesses, only 25 percent were able to avail of credit to finance their businesses (Table 2).

"Characterizing" a microfinance loan

Having seen the need for outside sources of funds to fill the gap unserved by formal credit institutions, there is a need to understand the nature of a microfinance loan. Three elements are relevant in characterizing a microfinance loan, namely: (a) size of the loan, (b) basis for determining the borrower's ability to repay the loan, and (c) interest rates in microfinance operations.

Let us look into each of these in detail.

❊ ***Microfinance loans are small loans without traditional loan security***. Microfinance loans are small loans that are typically unsecured and given on the basis of informal information about the borrower, e.g., enjoys a good reputation in the community. Documentation of a microfinance loan is very simple since the clients do not necessarily keep financial and other relevant records. However, to avoid potential abuse of the rules and regulations that would expressly authorize microfinance banks to provide uncollateralized loans, the maximum amount of a

[2]See Gilberto M. Llanto, Ma. Piedad Geron and Christine Tang (1999) who concluded that the Philippine experience "provides ample evidence that the implementation of directed credit programs and loan guarantee programs results in a huge waste of scarce government resources" (p. 147).

Table 2. Number of families availing of credit, 1998

	All Families	Lowest 40%	Highest 60%
Total number of families ('000)	14,370.7	5,748.1	8,622.6
Number of families with business ('000)	8,497.7	3,880.5	4,617.1
Number of families with credit to finance business ('000)	2,145.9	926.4	1,219.5
Families with credit to finance businesses (percent)	25.2	23.9	26.4

Source: 1998 Annual Poverty Indicators Survey

microfinance loan could initially be pegged at some nominal amount, say, P150,000. This is, at the current exchange rate, just about equivalent to ±US$3,000 which is the international norm for the maximum amount of a microfinance loan. The ceiling may be adjusted accordingly as circumstances permit.

❊ ***Loans are based on informal information and projected cash flows***. The calculation of the borrower's ability to pay is mainly based on his cash flow. Microfinance loans are typically clean loans, that is, given without the traditional collateral. The microfinance lender takes comfort from the projected cash flow and informal financial information about the borrower. Peers or third parties normally vouch for the borrower's creditworthiness and supply the required information. Meanwhile, the experience of microfinance institutions worldwide indicates that giving borrowers flexibility in loan amortization is key to successful loan repayment. Thus, microfinance loans may be amortized on a daily, weekly, monthly or bimonthly basis, depending on the cash flow condition of the borrower.

❊ ***Interest rates are market-based***. Successful microfinance institutions are those that charge market-based interest rates.[3] Interest rates on microfinance loans should enable the lender to recover financial and operational costs and to generate a profit margin. Thus, interest rates should not be lower than the prevailing market rates. To require microfinance lenders to impose a much lower rate is to constrain the sustainability of microfinance operations.

National Strategy for Microfinance

In recognition of the potential role of microfinance institutions in providing microenterprises and small borrowers in general access to deposit facilities and loans, the National Credit Council (NCC) formulated the National Strategy for Microfinance in 1997. The Strategy called on the government to create an appropriate policy environment that will encourage more participation by rural banks, credit cooperatives and credit-granting NGOs in the delivery of microfinancial services to the basic sector. The National Strategy recognized the importance of market-based microfinance and of creating a hospitable policy environment.

The first step adopted by the government has been to work for the dismantling of a number of subsidized credit programs that compete with private initiative in microfinance. Executive Order (EO) 138 issued in August 1999 directed government nonfinancial agencies to stop their involvement in direct lending and to use financial intermediaries instead in providing loans to target sectors. EO 138 also provided a phase-out schedule for subsidized credit programs in the nonagriculture sector. It thus complements the Agriculture and Fisheries Modernization Act (AFMA) of 1997 which has earlier sought the phase out of all subsidized credit programs in the agriculture sector and the creation of a market-based financing mechanism for the sector.

The encouragement given to microfinance has motivated a number of formal financial institutions, i.e., rural banks, to venture into this field. Credit cooperatives are also now becoming more active in it while credit-granting NGOs which have been in this field much earlier than the others are either now talking of expanding their operation with donor funds provided for the purpose or converting themselves into banks to be able to tap the deposit market.

[3] *The Latin American experience shows this. See Llanto (1999).*

A crucial component of the National Strategy is the issue of having an appropriate regulatory framework for microfinance institutions. Such a framework should enhance the efficiency and competitiveness of the financial markets whose end beneficiaries will be the small-scale borrowers of microfinance institutions. Appropriate regulation and supervision should help ensure the financial viability and sustainability of microfinance institutions.

Regulation of microfinance banks

The Philippines has a variety of institutions involved in the delivery of microfinancial services. These include the rural banks, some private development banks, credit cooperatives and the microfinance NGOs. The Bangko Sentral ng Pilipinas (BSP) regulates and supervises the banking system.[4] Rural banks and other banks involved in microfinance continue to be subject to BSP regulation and supervision. On surface, there seems to be a working framework for regulating and supervising microfinance banks but a closer scrutiny reveals some inadequacies.

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A 1997 study by the NCC, for instance, reported that the BSP's stance on small clean (unsecured) loans supported by informal information is not clear and, worse, vague to banks subject to BSP supervision. Banking regulations do not prohibit the grant of small clean loans. However, in practice, there has been a traditional regulatory bias against the grant by banks of loans with insufficient collateral or without any form of security or collateral. BSP bank examiners tend to check for compliance with banking laws, rules and regulations and to establish the soundness of the bank on the basis of procedures for loan approval, supervision and collection that would apply to traditional banks. Since microfinance loans are typically given without collateral, there is a risk that examiners will criticize banks making such loans. This constrains the expansion of microlending, much to the disadvantage of small-scale clientele who need such loans.[5]

Microfinance in the General Banking Law

The enactment into law of the General Banking Law of 2000 has brought microfinance into a new era. Microfinance has now become part of mainstream banking in the country because of the explicit recognition given to it by Sections 40, 41, 43 and 44 of the General Banking Law of 2000 or Republic Act 8791 which mandates the Monetary Board to formulate appropriate rules and regulations on microfinance operations.

Section 40 describes the information that may be required by a bank for the grant of loans or other credit accommodations such as a statement of assets and liabilities and of income and expenditure. The same section also provides that "in formulating rules and regulations under this Section, the Monetary Board shall recognize the peculiar characteristics of microfinancing such as cash flow-based lending to the basic sectors that are not

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[4]The Cooperative Development Authority (CDA), meanwhile, is the regulatory authority for credit cooperatives. The credit-granting NGOs, on the other hand, are not supervised by any organization. However, second-tier organizations such as the Land Bank of the Philippines and the People's Credit and Finance Corporation maintain some sort of credit supervisory authority over NGOs which borrow from them.

[5]There is hope that the regulatory attitude toward uncollateralized microloans will change. The revised General Banking Act will pave the way for an appropriate regulatory and supervisory treatment of uncollateralized microenterprise loans. The BSP is also taking steps to familiarize itself with microfinance. Two members of the Monetary Board, the policymaking body of the BSP, and a managing director of the BSP visited the Center for Agriculture and Rural Development (CARD) Rural Bank in San Pablo City on March 30, 2000 to learn about that rural bank's experience with microfinance. The BSP is an active member of the NCC and also a member of the Policy Advisory Group of the Coalition for Microfinance Standards, a group of microfinance NGOs that is attempting to develop performance standards for microfinance NGOs.

covered by traditional collateral." To this end, Section 41 authorizes the Monetary Board "to issue such regulations as it may deem necessary with respect to unsecured loans or other credit accommodations that may be granted to banks." Related to this is the provision under Section 44 regarding "the amortization on loans and other credit accommodations" stating that "the amortization schedule of bank loans and other credit accommodations shall be adapted to the nature of the operations to be financed. . . In case of loans and other credit accommodations to microfinance sectors, the schedule of loan amortization shall take into consideration the projected cash flow of the borrower and adopt this into the terms and conditions formulated by banks."

The revised General Banking Law provides an excellent opportunity to develop rules and supervisory practices that are appropriate to microfinance banks. The microfinance loan portfolio differs in a very significant way from a conventional bank portfolio. An adequate appreciation of risks associated with microfinance loans, together with the technical know-how on dealing with those risks, would ensure that microlending is not unduly constrained. Furthermore, the loan portfolio is the single most important asset of a microfinance bank but this cannot be simply funded from public deposits unless there is appropriate regulation and supervision to ensure the soundness of the microfinance bank and the safety of those deposits.

On the other hand, under Section 43, "the Monetary Board shall regulate the interest imposed on microfinance borrowers by lending investors and similar lenders such as, but not limited to, the unconscionable rates of interest collected on salary loans and similar credit accommodations." In this respect, the regulatory authority should exercise extreme care in regulating the interest rates because a nonmarket rate will prevent recovering operational and financial costs and realizing an adequate profit margin that will be necessary for financial viability and sustainability.

To be able to have an effective set of rules and regulations, an appropriate framework for banks involved in a specialized field such as microfinance should be considered. And as suggested by this *Policy Notes*, this framework is a risk-based supervision approach for microfinance banks.

"...A different approach to bank supervision called "risk-based supervision" seems more appropriate for microfinance banks. Risk-based supervision draws from a more comprehensive understanding of risks faced by a microfinance bank."

Risk-based supervision: a proposed approach to microfinance

Traditionally, the BSP and banks alike have concerned themselves mainly with credit risk. However, a different approach to bank supervision called "risk-based supervision" seems more appropriate for microfinance banks. Risk-based supervision draws from a more comprehensive understanding of risks faced by a microfinance bank. The microfinance world presents a different environment and structure of credit markets as may be gleaned from a reading of the nature of the clientele, the microfinance loan products and from the experience of successful microfinance banks.[6] The personal circumstances of the clientele (poor, without bankable assets, with or without basic education, among others), the use of informal financial information, and innovative lending and loan collection techniques create different types of risks and show the inadequacy of traditional prudential regulation and supervision approaches to deal with those risks.

Under the proposed approach to microfinance regulation, the BSP, as the regulatory authority, should consider a broader spectrum of risks affecting the microfinance bank rather than be concerned with the lack of formal financial information, documentation and loan collateral be-

[6] *Banco Solidaridad in Bolivia, Bank Rakyat Unit Desa in Indonesia and CARD Rural Bank in San Pablo City, Laguna, Philippines are some examples of successful microfinance banks.*

Box 1. A broad spectrum of risks affecting microfinance banks

- *Credit risk exists when a bank is dependent upon another party to make or keep the loans integral. On and off-balance sheet exposure creates credit risks for banks.*
- *Liquidity risk arises when a bank has insufficient access to funds and is too heavily dependent on limited sources of funding. Inability to meet deposit withdrawals and loan requests and to liquidate assets without significant loss to the bank constitutes liquidity risk.*
- *Transaction risk comes from problems associated with service or product delivery. This is also known as operating or operational risk. The accuracy and timeliness of reports, presence of security controls, fraud prevention and fraud detection measures are important elements of bank operation and the inadequacy of these measures creates transaction risk.*
- *Interest rate risk refers to the risks arising from the movement of interest rates that affect the portfolios of financial institutions and from the inability to adjust interest rates to changing economic and financial conditions.*

hind microfinance loans. Some of the relevant risks include credit risk, liquidity risk, interest rate risk and transaction risk (Box 1).[7] In this respect, the BSP can create a risk profile of the microfinance bank and use this as reference for assessing its financial condition and performance to anticipate and prevent systemic risk in the microfinancial markets.

Key issues

What are the key issues or elements associated with this proposed approach to microfinance?

❊ ***Asset quality, portfolio at risk and more aggressive provisioning***. To ensure asset quality, the microfinance bank should focus on portfolio at risk and should have more adequate loan loss provisioning than that required of traditional banks. The latter does not mean, however, a high provisioning for unsecured loans since the very nature of microfinance loans is to provide such without the traditional or conventional collateral. On the contrary, adequate loan loss provisioning is predicated on a periodic aging of loans past due and adopting a portfolio at risk approach to loan portfolio management.

Under the portfolio at risk approach, a microfinance bank considers the entire loan (principal and interest) at risk once a loan amortization is missed one day after due date.[8] Through this approach, the microfinance bank can be assured that the quality of the loan portfolio is maintained. Since microfinance loans are not provided the usual loan collateral that can be captured by the lender upon default (collateral substitutes such as third party guarantees, peer pressure and moral suasion take the place of the traditional collateral),[9] the risk of rapid decapitalization due to huge and rapid loan default is very great in microfinance operations. Thus, a loan tracking mechanism that incorporates portfolio at risk as an indicator of performance is critical. Without one in place, therefore, the concerned microfinance bank should be prohibited from engaging in microfinance operations.

A portfolio at risk approach will require the BSP to check on the historical record of the loan portfolios and draw a risk profile of the loan portfolio. Instead of using a spot loan-by-loan review, the BSP will have to draw a statistical sample of past dues, analyze the reasons behind the arrears and evaluate the adequacy of loan repayment policies, among others. As in informal credit markets, timely and reliable information is key to effective loan management.

The financial statements may not necessarily provide accurate information on the actual condition of a bank when there is failure to classify problem assets and provision for losses as well as to apply consistent charge-off or write-off policies. Apparently, Philippine practice in this area is deficient. Again, the 1997 NCC study mentioned earlier revealed that there is no official or uniform charge-off or write-off policy in the country. Banks are required to submit quarterly reports on loan charge-offs. The BSP uses the ratio of loan charge-offs to the total loan portfolio as

[7] *These are some of the 9 different types of risks identified by Thomas Fitzgerald, formerly of the Office of the Comptroller of Currency in the United States that should be monitored under risk-based supervision.*

[8] *A loan is delinquent if loan repayment is one day past due date.*

[9] *For a discussion of collateral substitutes used in rural financial markets in the Philippines, Indonesia and Malaysia, see Llanto and others (1996).*

an indicator for its off-site supervision. However, while lending institutions determine when a loan is to be charged off, the timing of the loan charge-off depends partly on its effect on the bank's capital position and the associated tax effect. Thus, a loan charge-off could be postponed if it will deplete capital that then triggers the need to bring in more capital. If no new capital is in sight, then the loan charge-off is deferred.

The tax angle also comes to the picture because under the country's tax rules, loans must first be charged off before they are allowed as deduction for income tax purposes. Thus, the timing of the charge-off is partly determined by the tax avoidance process of banks and not necessarily by the need to reflect their true financial condition. Clearly, the priority is to have a transparent charge-off policy that considers the reflection of the bank's true financial condition as the paramount objective.

"Liquidity is the lifeblood of microfinance operations and thus, the inability to track loan performance on a daily basis constrains the efficiency of the microfinance bank. An adequate management information system will enable bank management and supervisors to keep track of asset quality, capital adequacy and the liquidity position of microfinance banks."

❇ ***Adequate management information system***. The BSP should require microfinance banks to have an adequate management information system, including an effective loan monitoring system that enables them to keep a daily track of loan approvals and releases, collection, arrearages, loan restructuring or refinancing, if any. Worldwide experience shows that microfinance lenders are very sensitive to liquidity risk. Liquidity is the lifeblood of microfinance operations and thus, the inability to track loan performance on a daily basis constrains the efficiency of the microfinance bank. An adequate management information system will enable bank management and supervisors to keep track of asset quality, capital adequacy and the liquidity position of microfinance banks. It will also be indispensable for formulating an internal mechanism and set of audit procedures for fraud prevention. The huge number of microfinance clients and the daily turnover nature of the operation ordains the need for effective fraud prevention for the institution.

❇ ***Information disclosure and adequate accounting and auditing standards.*** Effective monitoring rests on adequate information disclosure by the supervised microfinance bank. Because of the BSP's limited supervisory resources, off-site surveillance is extremely necessary. Adequate information disclosure is thus imperative. Philippine banks generally adhere to the accepted accounting and auditing standards and thus provide information that is reflective of their true financial condition.[10] They submit regular reports that can help supervisors gauge their financial condition. However, the accounting and auditing standards must be strengthened. Standards to be established include guidelines for asset classification, stricter definition of past dues and nonperforming assets, prohibition against capitalization of refinancing of interest which is due and unpaid, reversal of previously accrued but uncollected interest on nonperforming assets, and adequate provision for actual or potential loan losses, among others.[11] It goes without saying that these standards should strictly apply to microfinance banks.

Policy recommendations

In conclusion and in view of the foregoing, this *Policy Notes* recommends the following measures:

❇ Adopt a risk-based supervision approach for microfinance banks.

❇ Allow microfinance banks to use informal information, projected cash flows, and nonconventional collateral in their client screening and loan approval process.

[10] *Mario Lamberte and Gilberto M. Llanto (1995).*

[11] *Polizatto (1990).*

❇ Allow microfinance banks to charge market-based interest rates.

❇ Define microfinance clients and operations in the BSP circular that will implement the microfinance provisions of the revised General Banking Law.

❇ Require microfinance banks to use "portfolio at risk" to monitor asset quality.

❇ Require microfinance banks to have an adequate management information system.

❇ Impose transparent financial accounting and reporting standards on microfinance banks.

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