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Addressing Constraints in the Provision of Financial Services to MicSMEs and Poor Households

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Microfinance seems to be the flavor of the day. Understandably, then, almost everybody wants to get a piece of its action. A lot of stories have in fact been told on how several nonbank entities, which have been receiving funding support from local or foreign donors, have been able to provide small loans to microenterprises and poor households.

This is well and good. At the end of the day, however, we have to ask ourselves how to make a much wider array of financial services, other than credit, easily accessible to a large number of micro, small and medium enterprises (MicSMEs) and poor households in a more sustainable manner.[1]

This is a role banks can very well play provided the policy environment is right. This is the main issue being addressed in this *Notes*.

Microfinance-friendly policy and banking regulation

The financial sector reforms initiated by the government in the 1990s, e.g., bank entry and branching liberalization, have laid the ground for promoting microfinance in the country. This was further boosted by the recent passage of the General Banking Law of 2000, which includes 3 provisions that set a much clearer policy framework for promoting microfinance. In 2001, the Bangko Sentral ng Pilipinas (BSP) issued several circulars to implement said policy, one of which was Circular No. 272 which came out on 30 January 2001.

In this circular, the BSP defines microfinance as "the provision of a broad range of financial services such as deposits, loans, payment services, money transfers and insurance products to the poor and low-income households, for their microenterprises and small businesses, to enable them to raise their income levels and improve their living

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[1] *Some 90 percent of the total number of manufacturing establishments are small, i.e., those with average total employment of less than 10 workers. As of 2000, 31.3 million people had income below the poverty line.*

standards."[2] This is important in that it conveys to the general public the kind of microfinance the government is promoting.

There are four important paragraphs in Circular 272. *One* indicates that "microfinance loans may be amortized on a daily, weekly, bi-monthly or monthly basis, depending on the cash flow conditions of the borrowers." This is intended to give small borrowers flexibility in choosing their amortization schedule that would reflect the timing of their cash flow. *Two* is a statement on interest rate policy which says that "interest rate shall not be lower than the prevailing market rates to enable the lending institution to recover the financial and operational costs incidental to this type of microfinance lending." The statement is meant to send a clear signal to the public that the government intends to promote viable, self-sustaining microfinance institutions. This runs counter to the previous policy of promoting below-market interest rate for loans to MicSMEs and poor households, making it difficult for microfinance institutions to operate in a sustainable manner. *Three* refers to a guideline to do away with requirements that are not appropriate for or raise the cost of microfinance loans. Thus, it states that for microfinance loans, "a bank may not require from its credit applicants a statement of assets and liabilities and of their income and expenditures and such information as may be prescribed by law or by rules and regulations of the Monetary Board…." Obviously, small borrowers cannot present to a bank audited financial statements which are required of big borrowers. And *four* is the paragraph that encourages banks to lend to small borrowers not on the basis of a collateral but on the basis of borrowers' cash flows. This is to address the problem that small borrowers cannot borrow from banks to finance viable economic projects because they cannot present hard collateral to banks.

There are already signs that small banks are favorably responding to the new policy environment. For instance, the number of offices of thrift and rural banks combined increased from 2,685 in 1996 to 3,285 in June 2001. Unfortunately, many of these also failed during the same period. With cheap funds provided by the government drying up, banks, particularly rural and cooperative banks, have increasingly relied on deposits to finance their loans. The recent decision of the BSP to exempt microfinance-oriented banks such as thrift and rural banks from the moratorium on the licensing of new banks supports the effort of expanding financial services to MicSMEs and poor households.[3] Recently, a microfinance-oriented bank was established by a thrift bank jointly with foreign partners in the southern part of the Philippines. Based on the criteria formulated by the BSP for giving a license to microfinance-oriented banks, these banks are not like a regular rural or thrift bank.[4] The BSP also provides liquidity assistance to support and promote microfinance programs.[5]

Constraints to be addressed

Notwithstanding this considerably improved policy environment for microfinance to flourish, banks still face some constraints in expanding their financial services to MicSMEs and poor households.

Below is a discussion of these constraints and the recommended measures to address them.

Macroeconomic instability. Lending to MicSMEs and poor households is a very risky venture, especially if lenders base their decisions solely on the strength of the cash flow position and character of borrowers. Instability of the economy can make those loans much riskier because cash flows can easily dry up during a sudden downturn of the economy. This can lead to the collapse of banks, especially small ones, and ultimately undermine the public's confidence in the banking system. Such confidence is not easy to restore especially if a large number of small savers lose their money and otherwise good borrowers suddenly become delinquent borrowers. The experience of the Philippines in the last 25 years clearly demonstrates this point. From 1998

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[2] *This can be found in the Notes to Microfinance, an annex to Circular 272.*

[3] *See BSP Circular No. 273, 27 February 2001.*

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

[5] *See Circular No. 282, 19 April 2001.*

to 2000 alone, 12 thrift banks and 83 rural banks were closed by the Philippine Deposit Insurance Corporation (PDIC), thereby reducing the number of potential providers of financial services to MicSMEs and poor households. Indeed, a stable macroeconomic environment is conducive to the expansion of financial services to these sectors of the society.

Inadequate infrastructure. Poor infrastructure increases the cost of providing financial services to MicSMEs and poor households. Aside from good roads and sturdy bridges, cheap and reliable electricity and telecommunication system are important in improving the efficiency of microfinance institutions. Indeed, some thrift and rural banks are prevented from computerizing their operations because of inadequate and unreliable supply of electricity in their area. They badly need to computerize their system to be able to accurately process numerous small deposits and loans in a very short time. The government's thrust to give high priority to the improvement of the infrastructure system in rural areas is a step in the right direction. The government budget should reflect this.

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

Shortage of capital. Although small banks can mobilize more deposits, as many of them have already demonstrated, their limited capital sets a ceiling as to how much they can mobilize.[6] There are ways of dealing with this problem. One is to encourage large commercial banks to infuse equity into small banks such as rural banks by including such investment as an alternative instrument for complying with the existing loan portfolio regulation. They have to remain, however, as minority stakeholders.[7] Such arrangement can pave the way for a correspondent banking relationship between small and large banks in the country. This is a better option than compelling large commercial banks to lend to small enterprises or to buy eligible government securities.

In the case of cooperative rural banks, the expansion of their capital is constrained by the limited number of cooperatives that have the financial capability to invest in cooperative banks.[8] The Rural Banking Act must therefore be amended to allow cooperative rural banks to accept individual members as preferred shareholders.

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

Competition with government banks. It has been the policy of the government to give private financial institutions a bigger role in the provision of financial services, especially to small farm and nonfarm enterprises. The government financial institution's role, therefore, is only to fill up some gaps left out by private financial institutions and provide support to them in areas where they have comparative advantage. However, the number of offices of government banks has increased from less than 100 before 1990 to about 400 today. Because of the policy of the government to make these banks self-sufficient, they are currently intensely competing with private banks in mobilizing deposits. For instance, although the two government banks are engaged in wholesaling, they also do retail lending which directly competes with private banks. Unless the orientation of government banks is therefore changed, private banks will always find their (government banks) presence a serious constraint to the expansion of their (private banks) services in view of the undue competition.[9]

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[6] *This pertains to the capital adequacy ratio.*

[7] *Commercial banks seem to prefer to have a wholly-owned thrift bank.*

[8] *Under the existing law, only cooperatives can own shares in cooperative rural banks.*

[9] *Government banks are also designated depository banks of all government agencies and corporations. Hence, they maintain a large pool of cheap deposits. See Lamberte (2000) for a proposal to re-orient the LBP.*

Aside from government banks, government-owned nonbank financial institutions such as the Small Business Credit and Guarantee Corporation, the People's Credit and Finance Corporation (PCFC), and a host of special credit programs for MicSMEs and poor households implemented by nonfinancial government agencies also provide competition to private banks. Many of these special credit programs have performed badly. If continued, they could even undermine the discipline needed to promote market-based microfinance institutions.[10] Another immediate task is to privatize LBP's subsidiary, the PCFC, and convert it into a bank so that it can operate as a truly market-based microfinance bank.

Inadequate supervision. While the BSP encourages private banks to engage in microfinance, it must ensure that banks that do so remain safe and sound at all times so that financial services to MicSMEs and poor households will not be disrupted due to massive bank failure. Indeed, some banks are hesitant to venture into microfinance because of the fear that the failure of poorly managed, ill-supervised microfinance-oriented banks can undermine otherwise soundly managed microfinance- oriented banks.[11] In this regard, the BSP must adopt a risk-based supervision approach for microfinance and upgrade the capability of its staff to effectively utilize such approach.[12] It must also constantly finetune its regulatory system to discourage banks from doing regulatory arbitrage.

Loan portfolio regulations. Most rural banks and some thrift banks are not able to meet the requirement to allocate at least 2 percent of their total loan portfolio to medium enterprises. They can, however, easily meet the requirement to allocate at least 6 percent of their loan portfolio to small enterprises because of the nature and size of their operation.[13] The government should therefore review this law to give small banks such as rural banks and small thrift banks more flexibility in selecting their own clients.

[10]*See Lamberte et al. (1997, 1998).*

[11]*This is part of the information asymmetry problem wherein bank depositors and other creditors are not able to distinguish between good and bad banks in times of severe financial distress.*

[12]*See Fitzgerald and Vogel (2000), and Llanto (2001).*

[13]*Medium enterprises are currently defined as firms with assets of between PhP15,000,01 and PhP100,000,000. The Small and Medium Enterprise Development Council periodically reviews this definition and, if necessary, adjusts it, taking into account inflation and other economic indicators.*

Concluding remarks

This *Notes* has tried to emphasize the point that the policy environment matters a lot in expanding financial services to MicSMEs and poor households. Indeed, the policy environment has improved considerably since the early 1990s and banks have responded positively to it. Nonetheless, banks still face some constraints in expanding their services to the abovementioned clientele. The government must therefore address these constraints to promote market-based microfinance in the country.

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