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# Policy Notes

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## Effecting Efficiency to Sustain MFIs: The Case of Cooperative Rural Banks

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### Microfinance and poverty alleviation

The 1999 Annual Poverty Indicators Survey (APIS) shows that 64 percent of the poorest 40 percent of Filipino families relied on entrepreneurial activities or business for their main source of income. Unfortunately, apart from experiencing fluctuations in their incomes from these businesses, these families also often have to use their small businesses' working capital or sell whatever marketable assets they have, e.g., cow, carabao, farm implements and others, in times of emergencies such as sickness and natural calamities. There is a need for them therefore to secure funding that would help them address both livelihood and consumption financing requirements.

As the 1999 APIS report also indicated, however, very few of them—in fact, only 24 percent of the 5.8 million

poorest families with businesses—had obtained credit from various sources. With the lack of reliable access to institutional finance, most of them had—and will continue—to rely on meager funds from savings and/or informal sources, thereby further limiting their capacity to raise their incomes.

In this regard, development practitioners and policy-makers view microfinance as one of the solutions to the growing demand for financial services by poor families. They also regard it as a possible answer to the reality that most formal financial institutions do not serve the poor because of the former's perception that the poor are high risks and are not able to provide the required physical collateral. These financial institutions also believe that transactions with the poor involve high costs and low profits. In this sense, their business culture is not geared towards servicing the poor and low-income families. Through microfinance, therefore, poor families will be able to have access to financial services like savings, credit, and insurance facilities. These will give them opportunities to smoothen their consumption, manage their risks, build their assets gradually, develop their microenterprises, enhance their income-earning capacity and enjoy an improved quality of life.

*PIDS Policy Notes* are observations/analyses written by PIDS researchers on certain policy issues. The treatise is holistic in approach and aims to provide useful inputs for decisionmaking.

This *Notes* is based on PIDS Discussion Paper Series No. 2002-12 entitled "Efficiency and expense preference in the Philippines' cooperative rural banks" by the same authors. The views expressed are those of the authors and do not necessarily reflect those of PIDS or any of the study's sponsors.

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For poor families to have continuous and reliable access to financial services, though, microfinance institutions (MFIs) must operate in a sustainable manner. As such, the sustainability of MFIs is of crucial importance for the benefit of the poorest of the poor and a thorough review of the characteristics of a healthy MFI, especially in terms of efficiency, should thus be given high priority by all regulatory agencies supervising such institutions.

This *Notes* therefore analyzes the extent of the efficiency of MFIs and the factors affecting such efficiency, with the aim of providing better information to regulatory agencies in regulating and supervising MFIs.

### Focus on cooperative rural banks

In the Philippines, MFIs can be categorized into the following: (a) rural banks, including cooperative rural banks (CRBs); (b) credit-granting nongovernment organizations (NGOs); and (c) credit unions/cooperatives.<sup>1</sup> Through the years, MFIs have steadily increased the volume of their loans to their clients. Yet, despite this, their combined market share has remained below 5 percent (Agabin 1998).

What could be the reason for this? One answer is that some MFIs may not have survived through time due to unsustainability. And a large factor for this, in turn, was due to inefficiency.

In this regard, this *Notes* focuses on the CRBs because unlike other banks, they have greater diffusion of ownership that could increase opportunities for managers to engage in expense preference behavior. This kind of behavior may then lead to inefficiency that may in turn undermine their sustainability. Thus, regulators should be more conscious in closely monitoring their transactions.

A CRB has a dual personality: that of being a cooperative, on one hand, and a bank, on the other. As such, it is governed by both banking and cooperative laws, particularly the New Rural Bank Act or RA 7353, the General Banking Law of 2000 or RA 8791, the Cooperative Code or RA 6938 and the Cooperative Development Authority

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(CDA) Act or RA 6939. CRBs are organized primarily to provide financial and credit services to cooperatives and may perform any or all of the services offered by stock rural banks such as accepting deposits and lending money to individual borrowers. Only duly established cooperatives and federations of cooperatives which are registered or re-registered with the CDA under Republic Act 6938 may become stockholders/organizers of CRBs.

One interesting development that has taken place in the last few years is the broadening in the ownership of CRBs where CRBs are no longer exclusively owned by farmer associations or cooperatives but also by other types of nonfarm associations such as market vendors. On the average, a CRB services around 5,000 individual borrowers (Guanlao 1999).

Thus, through the years, CRBs have metamorphosed from an almost inconspicuous to a now strategic segment of the rural financial system. From about 15 CRBs in 1975, there were about 50 operating CRBs supervised by the Bangko Sentral ng Pilipinas (BSP) and registered with the CDA as of 2000. At the same time, CRBs have also been increasingly diversifying their loan portfolio across major economic activities over time. As such, in contrast to the 1980s, CRBs' loans today are less concentrated in the agricultural sector. A substantial change in the way they finance their lending operations over the years has likewise been noted. Before the mid-1980s, a big chunk of

<sup>1</sup>Some small thrift banks are also going into microfinance.

CRBs' liabilities consisted of borrowings from the Central Bank and other special credit programs of the government. The radical change in rediscounting and interest rate policies in the mid-1980s has encouraged them to mobilize deposits and to rely less on the rediscounting window of the Central Bank for funds.

An increase in deposit financing is a normal trend for growing MFIs. As confidence of consumers towards the institution grows, governmental and grant financing can be reduced in favor of greater amounts of bank deposits. While this trend is very positive, it also brings about an additional consideration—the decentralization of the sources of financing from a few major donors to various small depositors. Greater diffusion in sources of funds enables managers to act more freely and thus gives room for expense preference. This creates a vicious cycle called “growth-diffusion of financing-failure.” In order to avoid this cycle, regulators should always keep the phenomenon in mind and thus closely monitor the expenses of CRBs.

### CRBs' efficiency: extent and factors affecting it

Given the above information, it is thus important to see the extent of the efficiency (or inefficiency) of CRBs and to know the factors that bring up such condition so that regulators will be aware of what to closely monitor.

Estimating the extent of cost efficiency among 50 CRBs in 1995-1999, the results of the authors' study showed that on the average, the costs of these CRBs were 10.25 percent higher than the most cost-efficient CRB.<sup>2</sup> In addition, the results noted that the extent of cost efficiency varies very little among asset size groups.<sup>3</sup>

The extent of cost efficiency of the CRBs could have been affected by four sets of factors. One set refers to the *economic environment* where they operate. Among the three proxy variables for economic environment, namely, (a) geographic location (i.e., rural vs. urban areas), (b) growth of regional domestic product, and (c) banking density, only the latter was found to have a significant impact on the CRBs' efficiency. More specifically, CRBs op-

erating in a province where banking density is less tended to be less cost-efficient. It seems that lack of competition does not motivate CRBs to improve their efficiency.

The second set of factors relates to *corporate governance*. Corporate governance can be defined as the combination of all measures that ensure that managers act in the best interest of investors, e.g., investors receive an adequate return on their investment. It was demonstrated that an adequate corporate governance scheme can reduce agency costs within corporations. Concentration of ownership induces managers to be more efficient since major stakeholders have stronger negotiating power when they face managers and have better incentives to keep track of decisions made by the latter.

Conversely, diffused ownership of an institution such as a CRB could induce managers to become inefficient. This view is generally known as the “large shareholders theory.” Another theory related to corporate governance—the “free cash flow theory”—stipulates that significantly large free cash flows available can give rise to expense preference behavior of managers. Still another, meanwhile, which is included under the “managers' compensation theory,” suggests that a higher compensation for managers may give them sufficient incentives to improve cost efficiency. A number of studies have argued that performance-based compensation is preferable to fixed compensation in order to give adequate incentives to managers to maximize the value of the firm. The empirical results found significant support for the first two theories but not for the third theory. More specifically, CRBs that have more widely dispersed ownership and have more cash flows available for perks are likely to be more cost-inefficient.

<sup>2</sup>The original paper applied two models to cost and profit functions. This Notes utilizes the results of the model using stochastic frontier approach for estimating cost efficiency.

<sup>3</sup>The CRBs were grouped into the following asset-size groups: (a) below P20 M; (b) P20 M to less than P30 M; (c) P30 M to less than P60 M; and (d) above P60 M.

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The third set of factors relates to *agency costs*. Three variables representing different dimensions of agency costs have a statistically significant effect on CRBs' cost efficiency. The ratio of deposits over credit—a measure of funds acquired from members and depositors that are not used for financial intermediation but rather wasted in inefficient operations such as maintaining luxury offices, cars for managers, etc.—is negatively correlated with cost efficiency. A similar result is obtained for the proportion of fixed assets to total assets. A higher proportion of fixed assets to total assets means that assets are diverted into unproductive uses of funds. Contrary to *a priori* expectations, however, the sufficiency of financial margin to cover operational expenses tends to raise the cost inefficiency of CRBs. This result, though, needs to be investigated further.

The fourth set of factors is related to *the proclivity of CRBs to expose themselves to greater risk*. Among the three measures of risks, namely, credit risk, leverage ratio and interest rate risk, only the first appears to have a statistically significant, negative correlation with cost efficiency. In other words, inefficient CRBs tend to accept higher credit risk than efficient ones.

Interestingly, the extent of support provided by the government to CRBs significantly improves cost efficiency. At first blush, this seems to be contrary to common belief but it is to be noted that CRBs that received financial assistance from the government have been closely monitored by the BSP. As such, the intervention of the government in the activities of some CRBs proved to be fruitful.

## Conclusion and policy implications

The effort to alleviate poverty in the Philippines can be enhanced with the creation of efficient and sustainable MFIs. In order to increase the sustainability of such institutions, regulatory agencies must know the extent of the efficiency of MFIs and identify the factors that contribute to such state.

This *Notes* has focused on CRBs, one type of MFIs whose basic characteristic of having a much wider diffusion of ownership makes its operations more prone to being cost-inefficient.

By recognizing the areas where CRB's efficiency may be improved, regulatory agencies can formulate appropriate policies and regulations meant to correct them. For instance, the findings suggest that CRBs tend to be more cost-efficient in a more competitive environment, that is, where bank density is high. As such, the BSP should take this into account in its policy regarding bank entry and branching. In particular, limiting entry to microfinance-oriented banks, which is BSP's current policy, proves to be less optimal than a much more comprehensive liberal bank entry and branching.

Closely monitoring CRBs, regardless of whether they obtain financial assistance from the government or not, can also help in improving CRBs' efficiency. On the whole, the results of this study suggest that BSP should play a more active role in monitoring MFIs that have greater diffusion of ownership. 📄

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