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Rural finance in the Philippines: *a continuing saga in policy challenges*

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In the last two decades, the rural financial market in the Philippines has gone through various stages of development and experience. In the early eighties, the government[1] liberalized and deregulated the financial markets. It asked the Central Bank of the Philippines, for one, to stop its involvement in government credit programs and to transfer the Agricultural Loan Fund to the Land Bank of the Philippines (LBP). With prodding from donors, the government also started to dismantle the subsidized agricultural credit programs which had been funded at great cost to taxpayers, yet had failed to provide the intended beneficiaries, that is, the small farmers and other small-scale borrowers, access to bank credit. Thus, in 1987, the government terminated 42 subsidized credit programs in the agriculture sector and consolidated the remaining fund balances into a loan guarantee scheme for farmers called the Comprehensive Agricultural Loan Fund (CALF). It then announced that the CALF shall be used to encourage private bank lending to small farmers and other small-scale borrowers. The expectation was that by taking as much as 85 percent of the credit risks of small farmer loans, the CALF would be able to encourage private banks to lend to small farmers.

The paradigm shift: what happened?

The paradigm shift to a market-oriented credit policy was expected to spur rural financing by the private sector. Rural financing would help usher growth in the agriculture and rural areas. The financial and credit policy reforms led to an increase in the number of financial institutions, an improvement in bank density ratios as banking facilities and services became more accessible to various regions outside the National Capital Region, and the provision of new and innovative products to bank customers. Notwithstanding these, however, the expected increase in credit flows to small farmers and other small-scale borrowers did not materialize.

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[1]This is used in a generic sense and thus, includes the central bank.

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Why? For one, other government agencies continued to implement their respective subsidized credit programs. And in the agriculture sector which was the only sector where the government tried to terminate subsidized credit programs, it did not take long before politicians and government bureaucrats resurrected the subsidized credit programs due to the clamor of various interest groups. As such, by the end of the Aquino administration, subsidized credit programs had once again mushroomed, undermining the government's own market-oriented credit and financial policy reform efforts. Both government financial and nonfinancial agencies vied with each other in implementing a plethora of subsidized credit programs.

As the nineties wore on, it therefore became apparent that credit access to farmers and small borrowers was not gaining ground as a result of this continuing "competition" between the government's avowed market-oriented credit and financial policy and the presence of the various government (also)-implemented directed credit programs. Llanto and others reported in 1999 that there were as many as 86 directed credit programs being implemented by 21 government agencies. Data on the initial fund allocation for 63 directed credit programs show that more than P40 billion or 1.8 percent of GNP in 1996 was invested in these programs of different agencies, the bulk of said funds having been borrowed from foreign sources. And in terms of beneficiaries, limited data from 24 reporting directed credit programs show that for two years (1995-1996), approximately 685,794 farmers/ borrowers received loans from these programs. A miniscule number, considering that billions of pesos were made available to said agencies.

In short, the directed credit and subsidized programs have become a costly, financial albatross around the neck of the government. Because of this, the government once again decided to rid itself of these money-losing directed credit programs[2] and embrace market-oriented credit and financial policies as provided for in the 1998 Agriculture and Fisheries Modernization Act (AFMA) and Executive Order 138 issued in 1999.

Current situation: outcome of "forward-backward" policy

A "forward-backward" policy inevitably leads to certain costs. For this "forward-backward" policy in rural finance, what has been the result so far?

The 1999 credit symposium series of the Agricultural Credit Policy Council (ACPC) concluded that lending to the agricultural and fisheries sectors has remained unattractive to banks and thus, the expected access of small farmers to formal loans did not materialize. The 2002 Small Farmer and Fisherfolk Credit Accessibility Survey also conducted by the ACPC affirmed the situation: majority of the respondents indicated that access to credit has become more difficult in the past year (2001).

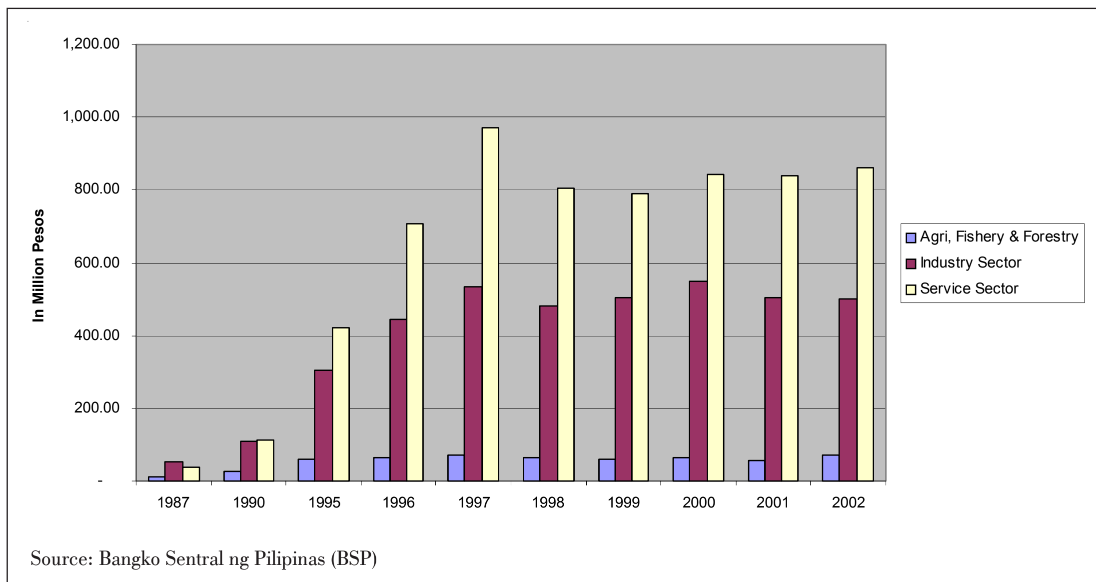
Despite government efforts to increase the flow of credit toward the rural sector, formal financial institutions thus seem to have largely ignored them. Today, the rural areas continue to suffer from the lack of access to financial services of banks. And as seen in Figure 1 and Table 1, bank loans granted to the agriculture, fisheries and forestry (AFF) sector have barely increased and have been insignificant through the years. The distribution of loans is more concentrated on large farm owners who can present acceptable loan collaterals while small farmers or rural borrowers continue to depend on informal moneylenders whose presence, albeit a perceptible decline over time, remains a major force to reckon with (Table 2).

Need for a fresh approach

Market-oriented credit and financial policies form the basic infrastructure for efficient financial markets. It will certainly be a mistake to reverse policy and go back to the

[2]See Gilberto M. Llanto, Ma. Piedad Geron and Christine Tang, 1999. Directed credit programs: issues and framework for reform. Manila: National Credit Council-Credit Policy Improvement Program; Dale Adams and Joseph Lim, 2000. Interest rate subsidies and directed credit programs in the Philippines. Manila: National Credit Council-Credit Policy Improvement Program; and Emmanuel Esguerra, 1996. Rural credit programs in the Philippines: lessons and policy issues. Manila: Agricultural Credit Policy Council.

Figure 1. Industry share of loans outstanding from commercial banks



Source: Bangko Sentral ng Pilipinas (BSP)

Table 1. Loans granted by all banks according to sector (in billion pesos)

	1996	1997	1998	1999	2000	2001*	2002
AFF sector (a)	n.a.	n.a.	299.04	401.88	335.31	414.28	487.73
Industry sector (b)	1,385.04	1,063.26	1,034.73	984.51	874.13	n.a.	n.a.
Service sector (b)	8,610.66	8,661.74	7,452.40	8,677.83	8,275.20	n.a.	n.a.
Total loans granted (a)	10,636.25	10,141.48	8,650.83	9,909.13	9,478.18	7,123.32	6,874.93

Source: Bangko Sentral ng Pilipinas
(a) Data came from revised reports of the ACPC based on BSP data; figures will not add up
(b) Data on private development banks (PDBs), Stock Savings and Loan Association (SSLA) and savings banks (SBs) only until October of 2000; data on specialilzed government banks (SGBs) only until May 1994
(*) Except for the AFF sector, data are only from commercial banks (KBs)
Note: Loan figures, except AFF, were based on reported loans granted to subsectors according to reports by each type of bank; 'AFF' means agriculture, fisheries and forestry.

Table 2. Source of loans, 1996-1997, 1999-2000, 2001-2002

Source	1996-1997 %	1999-2000 %	2001-2002 %
All borrowers	100.0	100.0	100.0
Formal institutions	24.0	38.6	34.4
Informal lenders	76.0	61.3	60.3
Both formal and informal			5.3

Source: Various surveys, ACPC

directed credit program approach that has proven to be ineffectual and costly. What is needed is to craft policies and interventions, if need be, that draw motivation from the peculiar characteristics of an agro-agrarian setting in which rural financial markets operate. The previous mistake of government was to draw up policies and interventions that largely ignored such peculiar characteristics of agro-agrarian economies.

Well-functioning rural financial markets enhance the production and consumption possibilities of farm and non-

farm households in the rural areas. As pointed out by various researchers, efficient financial intermediation results in the transfer of deposits from surplus units (savers) with inferior investment opportunities to deficit units (borrowers) with high-yielding investments. The net result is efficient resource allocation, an increase in the yield to capital and higher output growth. On the other hand, as pointed out in a recent international conference on rural finance, weak rural financial markets can produce traps that worsen poverty over time, discourage the rate of rural growth and distort income distribution.

Having efficient rural financial markets is important because of the combination of (a) a high incidence of poverty in rural areas and growing income inequality between urban and rural markets, and (b) concerns for food security and population vulnerability in rural communities. The question is not whether to address these issues, but how to do so.[3]

Thus, the crucial challenge facing policymakers is how to frame efficient rural finance policies so that they may become a potent tool for development. First, however, the vision and goal must be clear: to promote the provision of efficient, broadly-based and sustainable financial products and services to various rural economic agents. What can drive the rural finance policy reform agenda are the facts of life in the rural economy: *imperfect information, high transactions cost and the risks inherent to an agriculture-agrarian setting*.

In the past, the government—with good intentions—implemented loan quotas, subsidized interest rates and directed credit programs, among others. All these, however, did not help since they dealt with the symptoms and not the factors underlying the rural economy and which mold rural financial markets. It will thus be useful for policymakers to learn from the behavior of successful rural lenders who have found a way to deal with the factors that constrain the provision of financial services to rural economic agents. These economic agents use informal lending techniques, group guarantees, collateral substitutes and microinsurance to address the problems of imperfect information, high transaction cost and the risks inherent to an agriculture-agrarian setting.

At the same time, it is crucial for policymakers to address the following issues:

- Sectoral economic policy biases and barriers to productivity and higher incomes in the rural areas;
- Development of an appropriate legal and regulatory framework that deals with risks and cost of financial intermediation in the rural areas;
- Development of the capacity of financial institutions for rural financial services;
- Financial innovations and services that meet the needs of rural economic agents;
- Identification and management of risks in rural finance; and
- Understanding of the role of institutions and governance in rural financial markets.

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[3]Executive Summary, 2003. Paving the way forward for rural finance: an international conference on best practices. International Trade Center, Washington, D.C., USA, June 2-3.