

LIBERALIZATION IN DIRECTED CREDIT PROGRAMS FOR SMEs

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INTRODUCTION

Government industrial development policy has focused on small and medium enterprises (SMEs) because of their efficiency in the use of capital, labor-intensity, and resilience to economic changes. However, SME growth is impeded by limited availability and high cost of financing. Banks do not provide sufficient financing for SMEs because of the small size of loans, limited credit information, and high rate of business failures. Government considers the banks' support to SMEs as inadequate for accelerated development of the sector. To increase supply of credit to SMEs, policymakers have responded with two types of approaches:

- 1) directed credit programs, and
- 2) legislated mandatory lending schemes.

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Research is needed to evaluate the effectiveness of these approaches in order to improve policies toward the development of SMEs. This article assesses the efficiency of directed credit programs and the impact of a liberalized design of a specific credit program.

Previous Philippine government policies to promote industrial development are in the nature of "second best" solutions (Bautista, R., John Power and Associates 1984). Applied to the problem of development in the SME sector, these approaches involve transfers from banks as suppliers of credit to SMEs as users of credit. The "first best" approach eliminates distortions that bring about lack of development of SMEs. "First best" solutions work on the credit demand of SMEs. However, these policies are made by those with political power who benefit from the economic distortions. For example, distortions in the SME sector are caused by policies that favor big business over SMEs, urban over rural citizens, and foreign exchange users over earners.

On the other hand, "second best" approaches attempt to increase the supply of credit to SMEs. The government, perceiving banks as reluctant to lend to SMEs, designs financing programs directed to meet what it perceives as specific requirements of SMEs. The danger is that it may allow inefficient SMEs to obtain access to credit and, at the extreme, lead to self-selection problems. For example, banks have complained about being induced to make small unprofitable loans to weak SMEs. A study reported that only a small portion of SMEs are aware of government assistance programs for small enterprises and that of those, only a small minority sought or received assistance (Hife 1984). Those receiving assistance were found to be the weaker performers.

Policies should be viewed against the backdrop of the state of the Philippine financial system. The Philippine commercial credit market is highly segmented, with commercial banks lending to large corporations in Metro Manila and smaller thrift and rural banks lending to SMEs in the countryside (Saldaña 1988). Commercial

banks set higher lending limits and lend from their Metro Manila head offices and regional units. Their portfolios do not include significant loans to SMEs outside Metro Manila. By comparison, private development banks and rural banks can be considered "community bankers" because they lend to business firms in the same geographic area where they gather deposits. These banks are able to lend to SMEs outside Metro Manila because they know the borrowers in their area, and can forego many credit evaluation formalities required by commercial banks.

Regulations in the Philippine financial system explain the segmentation of banks by clientele and geographic service areas. The difference in capital requirements across bank types account for larger asset and lending base for commercial banks compared to thrift banks. Some smaller thrift banks are unable to lend to larger SMEs because of the constraints imposed on banks by the single borrower limit (SBL) regulation of the Central Bank. Their limited size constrains them to lend to the SME market. Banks are also mandated under a number of laws to lend to preferred sectors, for example, to beneficiaries of agrarian reform. The residual portfolio that is subject to bank management decision is then allocated to the most productive and lower-risk clients. Due to their reduced amount of loanable funds, banks give priority to the larger and established business firms.

Directed credit policy intended for the SME sector's development can be seen within the framework of rent-seeking theory in development economics. Rent-seeking policy seeks to counteract the inability of the commercial banking system to respond to the needs of SMEs. Directed credit is rent-seeking because the government requires banks to serve SMEs under terms more favorable than can be obtained by SMEs in the market. By increasing the supply of credit to SMEs, government intends to develop SMEs into larger business firms which can participate in the commercial credit market.

ALTERNATIVE DEVELOPMENT FINANCING POLICIES FOR SMEs

A second best environment, as currently existing for SMEs, requires credit program assistance. The issue is whether the policy should be designed around directed versus liberalized credit, specifically:

- 1) *Directed Credit Policy: Increasing Quantity of Credit Under Pre-Specified Terms.* The current government policy is to increase the supply of credit to "target" beneficiaries by fully specifying the price and other terms and conditions of the credit programs. The banks' role is practically limited to selecting the SME.
- 2) *Liberalized Credit Policy: Improving Credit Quality on Terms Set by Transactors.* The alternative policy of emphasizing quality of credit by allowing price and other terms of credit to be determined by participating financial institutions (PFIs) and SMEs. The role of government is limited to choosing the types of beneficiaries and other basic rules of competition for the credit program.

Many directed credit programs have been structured to suit the policymakers' perception on the needs of SMEs. This has led to credit programs so over-designed and rigid that negative results can always be expected, *a priori*. It is inherent in rent-seeking policies to allow for special access to resources and/or subsidies to move credit to SMEs. Long-term official development assistance funds are channelled to banks for relending. Subsidies are in terms of loans with below-market interest rates for the final borrower, with below-market pass-on interest rates by government banks to PFIs for relending to SMEs, and with financing terms that eliminate the maturity risk of PFIs. The adverse results associated with subsidies are the reduced profitability of government banks administering the programs, the financing of weaker SMEs, increased cost of auditing and leakages, and the lack of incentives for banks to raise capital

for lending to SMEs. This policy can result in reduced supply of long-term capital for SME lending and increased dependence on government sources. In short, over-designed credit programs can initially increase credit to specific SME beneficiaries but inhibit the long-term supply of credit to SMEs by not providing the proper incentives.

Liberalized credit policy allows financial institutions and SMEs to negotiate credit terms and interest rates. It is still rent-seeking because scarce long-term credit is allocated by government only to "pre-qualified" banks. The pricing and terms of financing are determined by banks and SMEs in the market. The expected benefits of market-based financing are in increased profitability and refinancing of the credit program, the financing of the more profitable SMEs, reduced cost of monitoring and controls, and increased incentives for banks to refinance the credit program.

The benefits of liberalized policy have not yet been proven in practice. The government has not allowed most terms of credit to be determined by transactors because it has perceived that SMEs are in a weaker bargaining position relative to banks and that banks are not channelling funds to "correct" purposes. These are valid concerns. Few banks lend to SMEs located outside Metro Manila. Long-term credit has not been available to SMEs. PFIs may engage in internal cross-subsidies, using cheap long-term credit from program sources for short-term lending at higher interest rates. Diversion of funds by banks from SMEs to large companies has been a concern. The government has preferred delivery of "quality" credit through financing of fixed assets rather than working capital, extension of long-term rather than short-term loans, and giving priority to smaller rather than larger SMEs. Subsidies have been justified as a necessary cost associated with SME target beneficiaries. These predicted benefits need to be assessed in the context of a credit program that use the liberalized approach.

FEATURES OF DIRECTED SME CREDIT PROGRAMS

Major SME financing programs were implemented for relending by banks and non-bank financial institutions.

Among the special financing programs, the Industrial Guarantee Loan Fund (IGLF) and the Countryside Loan Fund (CLF) had the most significant impact on SMEs. This appeared to be due to the wide branch network of PFIs and the large funding provided to the wholesale government banks. However, special credit programs left a large untapped potential in the SME loan market (Lamberte et al. 1989) because:

- 1) terms were not flexible;
- 2) collateral was required;
- 3) information on SMEs and their projects were deficient; and
- 4) PFIs were not encouraged to increase deposits to sustain the credit program.

In special financing programs, lending criteria and requirements were pre-specified based on the programs' preconceived methods for achieving very specific goals for SME development. An example was the IGLF. It required that loans finance new fixed assets investment¹, thus defining the program's goal of "SME development" that ignores business conditions in some SME areas. It matched the tenor of the program loan to the tenor of the PFI sub-loan to the SME. The PFI had no need to mobilize deposits at the end of the special credit program's life. In effect, the program structured the loan agreement for the PFI.

These factors that constrained the success of special credit programs were addressed in the design of another SME credit program, the Small Enterprise Credit Program (SECP).

1. Working capital financing is allowed "to utilize an existing idle factory capacity," a condition which is difficult for a banker to verify.

FEATURES OF THE SECP AS A LIBERALIZED CREDIT PROGRAM

SECP was funded by a grant from the US government administered through USAID Manila Mission. The SECP was intended as a wholesale financing program channelled through existing financial institutions. The Philippine Business for Social Progress (PBSP), a non-profit organization, was chosen to administer the project. The PBSP accredited 16 private development banks and an investment bank as PFIs. PFIs identified qualified SMEs. PFIs submitted reports on SMEs for approval by PBSP's project committee, which in turn authorized the fund trustee, Development Bank of the Philippines, to release the funds to PFIs.

The SECP was designed as a financing program with liberal guidelines and reduced documentation requirements. It allowed PFIs flexibility in loan packaging, allowing them to process a loan within two weeks. Under SECP, PFIs had exclusive discretion over all lending terms to SME borrowers such as:

- 1) amount of loan,
- 2) interest rate,
- 3) tenor of loan, and
- 4) collateral.

The term of individual PFI loans to an SME was not required to be the same term as the financing source or loan by the PFI from the SEC. This was called the "portfolio financing" approach. A PFI was required to submit a group of projects (portfolio) for financing, instead of individual loans. While projects were individually checked whether they qualified under the Program, the limit on amount financed and tenor of the loan were calculated based on the portfolio's total amount and average term, not on individual projects. The SECP financed up to 80 percent of the total portfolio cost. A

PFI was allowed to allocate the financing to different projects. This meant that in some instances, a PFI used SECP to finance 100 percent of a project and 80 percent of another project in the same portfolio. The SECP allowed for PFI discretion on how to mix SECP with other sources of funds. For example, the PFI could use other external sources to fund the remaining 20 percent of the portfolio or require equity contribution from the SME borrower.

The tenor of the PFI's loan was based on the average tenor of the PFI's sub-loan. A mismatch between the tenor of the PFI's loan from SECP and its sub-loans thus emerged. The average maturity of the PFI's loans from the SECP was always shorter than that of the sub-borrowers' loans from the PFI. The SECP's design created this gap to encourage the PFIs to mobilize deposits as cover. As a result, the management of PFIs needed to exercise their liability management skills in order to repay the latter part of their maturing SECP loans.

The interest rates charged by SECP to PFI borrowers were market-based. The "market" in this case was the passive rate, calculated as the weighted average rate for the preceding six months of time deposits with maturities of more than one year. Instead of using the interest rate subsidies to encourage utilization, the SECP reduced the administrative requirements to make funds easily accessible to the PFIs. The market-based interest rate was also intended to mobilize deposits. Higher costs of fund, such as in the SECP, should encourage the PFI to find cheaper funds such as deposits. The resulting growth in deposit base would sustain SME lending initially funded by SECP.

SECP financing did not require any collateral from PFIs. In effect, the SECP risk was that PFIs might become insolvent by virtue of risks they assumed for loans to SMEs. Instead of reimbursing PFIs for sub-loans to SMEs, the SECP provided cash advances to PFIs for relending within 90 days. SECP fund served as a transaction fund that provided immediate liquidity to PFIs. It

allowed PFIs to be more responsive to the requirements of SMEs for immediate releases of their loans.

About six months prior to the end of the project period, SECP's total loan fund of P252 million had been utilized through drawdowns and re-availments of P308 million. The average fund utilization (turnover) was 1.22 times.

RESEARCH METHODOLOGY

The evaluation of the SECP covered three areas, namely:

- 1) expansion of credit to SMEs;
- 2) contribution to SME growth; and
- 3) improvement in capacity of PFIs to sustain SME financing initiated under SECP.

The effectiveness of SECP in expanding credit to SMEs was measured by the number of new SMEs brought into the formal credit market and by the size of SMEs. The efficiency of PFI lending to SMEs was measured by the size of the PFI loans. The contribution of SECP to SME growth was assessed by the amount of long-term financing given to SMEs for investment in fixed assets. Sustainability was evaluated through the deposit generation policies and performance of PFIs. The contribution of SECP to the profitability of PFIs was also examined.

The research methodology took into account the potential differential impact of SECP due to the size of the resources of PFIs and of SMEs. Size of resources has a dominating influence on the capacity of PFIs to respond to changes in the needs of their SME clients and the opportunities offered by special financing projects like SECP. In fact, the accreditation and setting of credit limits of PFIs under SECP recognized differences in the range of resources among PFIs. The resources of SME-borrowers determine their capacity to sustain growth and remain viable clients of PFIs.

The evaluation approach classified PFIs into three categories based on assets. The cut-off levels of assets that delimited each category were based on perceived market segments of banks. The categories are as follows:

- 1) "*Group A*" PFIs. Large private development banks (PDBs) and one investment house with assets of P1.0 billion or more. These PFIs have head offices in Metro Manila and operate in the same general geographic areas as commercial banks. These PFIs compete in the market segment of commercial banks. They are referred to as "large" PFIs.
- 2) "*Group B*" PFIs. PDBs with assets between P100 million and P1 billion. These PFIs' credit operations are located outside Metro Manila. These PDBs did not compete with commercial banks and are referred to as "medium-size" PFIs.
- 3) "*Group C*" PFIs. PDBs with assets of less than P100 million. These PFIs' credit operations are mainly in their local areas. Limited resources enabled them to compete only in the lower-size range in the credit markets. These are referred to as "small" PFIs.

The methodology of the study involved a field survey of 14 out of 17 PFIs and a sample of about three to six SMEs from each PFI's portfolio, a detailed analysis of individual loans from the data bank at PBSP, a review of the financial statements of all PFIs and interviews with the administrators of SECP. The data bank at PBSP used in the statistical analysis involved more than 3,250 loan accounts. Pre-SECP (1988-1989) and post-SECP (1990-1991) financial data for PFIs were used with the former as a control group. Aside from using standard descriptive statistics, two statistical analysis procedures were applied: multiple regression and analysis of variance (one-way and two-way, nested). The analysis used five percent as the alpha for interpreting statistical significance, but, where a significant relationship was found, the probability

associated with the F-value is shown. The formulation of these methods are discussed as a statistical footnote when they are initially applied in this paper.

Subsequent sections present the results of the evaluation of SECP along the three areas and across the three PFI size categories. At the end of the evaluation results, three illustrative case studies are presented to relate PFI management policies and PFI performance. It shows that under a liberalized credit program, PFI management adjusts its policies to the opportunities and constraints offered by the financial and SME environment. Conclusions are summarized in the last section.

THE IMPACT OF SECP IN EXPANSION OF CREDIT TO SMEs

One of the objectives in rural finance development is to expand the SME borrower market for formal credit institutions. An indicator of whether a credit program was effective in credit delivery is the number of new borrower SMEs brought into the program by PFIs. Since the risks of lending to new borrowers is generally higher, any expansion by PFIs of loans to new SME clients indicates their willingness to support SMEs even at added risks and costs. Results demonstrate that new SME borrowers were provided by PFIs with financing under SECP, an indication of the quality of the additional loans and expansion in lending to SMEs under the project.

Table 1 shows that new SME borrowers outnumbered old borrowers by a ratio of 1.45 to one. Across the three groups, Group A had the highest ratio in favor of new borrowers at 2.4 to one, with Group B a close second at 1.7 to one. It is interesting to note that larger PFIs provided most of the expansion in number of new borrower-SMEs while smaller PFIs kept to their existing loan clients. Smaller PFIs appeared to be taking in fewer new borrowers because their limited resources constrain their capacity to take more risks and to fund the total financing requirements of existing clients.

Table 1
NUMBER AND AMOUNT OF SECP SUB-LOANS: BY BORROWER
(EXISTING VS. NEW CLIENTS) AND BANK TYPE
(In Million Pesos)

Types of Borrowers (Number and Average Amount per Loan)		PFI Group			
		Bank A	Bank B	Bank C	Total
New Bank Clients	Number	147	365	189	701
	Amount	433	197	167	239
Existing Bank Clients	Number	62	216	208	486
	Amount	768	216	164	264
Two-way ANOVA ²					
		Bank Type	Borrower Type		
	F-Ratios:	206.9	8.6		
	Significance:	.001	.01		

2. The analysis of variance (ANOVA): fixed effects model is about drawing inference regarding the effects of variables. Such effects are considered a reflection of the difference among population means. The linear model in the two-way (i.e., fixed effects of two variables) ANOVA is of the form:

$$Y_{jk} = m + a_j + b_k + e_{jk} + f_{jk}$$

where:

a_j is the effect of variable j (e.g., borrower type) and
 $a_j = m_j - m$

and

b_k is the effect of variable k (e.g., bank type) and
 $b_k = m_k - m$

In this model, the observed value, Y , is seen as the sum of five factors/effects: a population-wide characteristic (m), two variables under study (j and k), the interaction of j and k , and random error (e). The factor m_j is the mean of the

The liquidity provided by SECP allowed them to increase loans only to existing clients.

The statistical analysis on the amount of loans classified by type of borrower and banks is shown in Table 1. The amount of individual loans to existing clients, regardless of bank type, were significantly higher. PFIs were more willing to increase their exposure when dealing with existing accounts. However, the total amount of portfolios for new clients was higher across all PFIs because the number of new clients exceeded old clients. When the type of bank is considered, a significant concentration of the larger loans was found in the fewer existing clients of the largest PFIs. The interaction effect between PFI type and borrower type was not significant.

The efficiency of SECP in ensuring increased lending to SMEs depends on the capacity of PFIs to make small loans at low servicing cost. The predominant PFIs were development banks capable of serving SMEs because they had adapted to the SME

population for variable j while m_k is the corresponding mean for variable k , pooled over the variable j . The grand mean, m , is the mean of the entire population given variables j and k (e.g., loan size regardless of bank type and borrower type). The random error term is e_{jk} while f_{jk} is the interaction effect created by the combination of variables j and k . Statistical significance is set at the 5 percent level for this study.

Ideally, the experimental design for the two-way ANOVA should be orthogonal to permit separate estimates of direct and interaction effects of variables. However, an orthogonal design requires random and independent sampling and identical number of observations per *combination* of variables. These controls are feasible to implement under laboratory conditions but not under the social experiment context of SECP. The pre-selection of PFIs from all possible PDBs systematically favored those committed to SMEs. Strictly, the results of the statistical analysis are limited to SECP participants. At best, the conclusions from these results can only be extended to other non-participating financial institutions that share this management bias in favor of financing SMEs. In compensation for this shortcoming, the analysis emphasizes the management aspects of the results in order to help the reader apply the results of the study by looking at this variable in closer detail in future studies and policy formulation.

segment of the credit market. SME loans were usually small in amount. By comparison, commercial banks had high minimum lending limits and served larger business firms with requirements like deposits services in multiple branch locations. Policies restricting PDB operations constrained their capacity to compete with commercial banks for large firms. Meanwhile, rural banks had limited capital to compete with PDBs.

The distribution of loans indicates that the 17 PFIs operated mainly in the SME market. From Table 2, about 77 percent of SECP sub-borrowers were in the middle range. Only 13 percent of sub-borrowers took small loans of size associated with rural bank portfolios. Large sub-borrowers constituted only 10 percent of the total. PDBs appeared to dominate the SME segment, with competition from rural banks at the lower end of the loans market and from commercial banks at the higher end.

Table 2
SIZE DISTRIBUTION OF SECP LOANS
BY BORROWERS AND LOAN AMOUNT
(In Million Pesos)

Size (Loan "Type")	Borrowers		Loan	
	No.	(%)	Amount	(%)
P5-25,000 ("Rural bank")	167	13	3.1	1
P25-500,000 ("PDB")	977	77	152.1	48
Over P500,000 ("Commercial bank")	123	10	164.0	51
Total	1267	100	319.2	100

Field surveys identified the following reasons why PDBs incur lower transaction costs, enabling them to make small loans:

- 1) Lower documentation costs due to loan processing based on interviews, client visits, and familiarity of the banker with the borrower;
- 2) Timely decisions made by a few officers; and
- 3) Reduced formal procedures, and central office supervision and audits.

The success of SECP in encouraging PFIs to lend to new SMEs should be interpreted against the economic basis of directed credit -- rent-seeking theory. A rent-seeking approach is economically justified when market failure prevents banks from lending to creditworthy SMEs. Knowing that the Philippine financial system is segmented, credit programs can channel funds to community bankers to increase lending to SMEs. The evidence of SECP confirming this theory is that the market works in the same segment of the financial market and directed credit may not always be a rational development policy.

SECP'S CONTRIBUTIONS TO SME GROWTH

Developmental Goals of Lending to SMEs

Many special lending programs restricted loans to the financing of fixed assets, allowing for working capital only in special cases or as part of an SME expansion project. The intention was to use credit for new capacities that generate new employment. The field survey showed that median loan sizes for manufacturing and services were larger, implying fixed assets financing, compared to those in trading where the financing were for inventory and operating expenses. However, in many areas in the country, opportunities for capital expansion are limited and subject to higher risks. Furthermore, local

SME loan markets usually include many undercapitalized SMEs whose credit needs are for working capital. Directed financing programs are thus inaccessible to these SMEs.

In contrast, SECP allowed PFIs to select the type of assets to be financed by an SME loan. PFIs could have concentrated their lending to lower-risk working capital financing. The evaluation results did not show this to be the case. The distribution of SME beneficiaries by type of business activity is shown in Table 3. About half of SECP loans were used to finance SMEs involved in trading while the remainder were allocated to SMEs in services and manufacturing. There was a balance in the overall allocation of SECP credit to SMEs in various classes of business. There is no statistically significant interaction effect between bank type and loan purpose. Larger banks allocated less for trading compared to manufacturing and services. The smaller banks actually allocated a better part of their loan portfolios for SMEs engaged in trading.

These figures are explained by field survey results showing that smaller PFIs in Group C were located in a market environment where there were fewer manufacturing activities compared to

Table 3
DISTRIBUTION OF SECP LOANS BY PURPOSE AND PFI GROUP
(In Million Pesos)

Bank Type	Trading	Manufacturing	Services	Total
Group A	53.4	28.2	37.0	121.4
Group B	55.6	25.7	27.5	112.1
Group C	50.0	12.1	23.2	85.7
Total PFI's	159.0	66.0	87.7	319.2

Two-way ANOVA	Bank Type	Business Type	Interaction
F-Ratios:	8.40	34.0	0.97
Significance:	0.001	0.001	n.s.

trading. Further, the accreditation process assured SECP that PFIs were committed to SME lending, resulting in a wide array and balanced allocation of uses for credit and types of SMEs served. Smaller banks could tolerate less risk, inducing a priority for working capital financing of SMEs for easier repayment.

SECP Loans as a Term Lending Facility

SECP loans classified by term is shown in Table 4, revealing a concentration in tenor of SECP loans within less than one-year to one to three-year loans. The amount of loans under the long-term classification (over one year) was over 60 percent of the total. The majority of the amount of loans under SECP exceeded one year. There is a statistically significant difference in the distribution of SECP loans according to tenor across all PFIs. The statistical results show a significant interaction effect that the propensity for long-term lending depends on bank type. Larger PFIs used SECP primarily for term lending. Due to their larger SME markets, it was

Table 4
DISTRIBUTION OF SECP LOANS BY TENOR AND PFI GROUP
(In Number and in Million Pesos)

Term of Loan	A		B		C	
	No.	P	No.	P	No.	P
1 - 180 days	0	0	32	4.3	118	6.4
271 - 360 days	0	0	413	43.2	152	31.3
1 - 3 years	118	86.3	174	78.2	114	24.9
TOTAL	222	86.3	642	125.7	416	62.6
Median loan term	3 years		1 year		1 year	
Two-way ANOVA	Bank Type	Tenor	Interaction			
F-Ratio:	12.3	3.8	2.88			
Significance:	.001	.001	.01			

feasible for these PFIs to find SME clients and to match loan maturities to a variety of needs. Larger PFIs, being more liquid, used internal funds for short-term lending and SECP for long-term. Smaller banks maintained more short-term loans but this was not necessarily "undesirable" because they operated in smaller SME markets.

Cost Effectiveness in PFI Lending and Loan Size

The capacity of PFIs to service the smaller loan requirements of SMEs depended on their operating cost efficiency and resource constraints, primarily the SBL limitation. The average size of loans to SMEs was larger for larger PFIs. The distribution of SECP borrowers by loan size is shown in Table 5. The median loan size for PFIs in Group A was P250,000, with P96,700 and P70,000 for PFIs in Groups B and C, respectively. Banks preferred larger loans because they were more cost-effective to process, price, and administer. Smaller PFIs could not make larger loans due to SBL constraints.

Table 5
DISTRIBUTION OF BORROWERS BY LOAN SIZE BY PFI GROUP
(In Million Pesos)

Loan Size	Bank Type		
	A	B	C
"Small"	0	1.1	1.7
"Medium"	34.0	72.8	45.4
"Large"	87.5	38.1	38.5
Median loan size	P250,000	P96,700	P70,000

CAPACITY OF PFIs TO FINANCE SME GROWTH

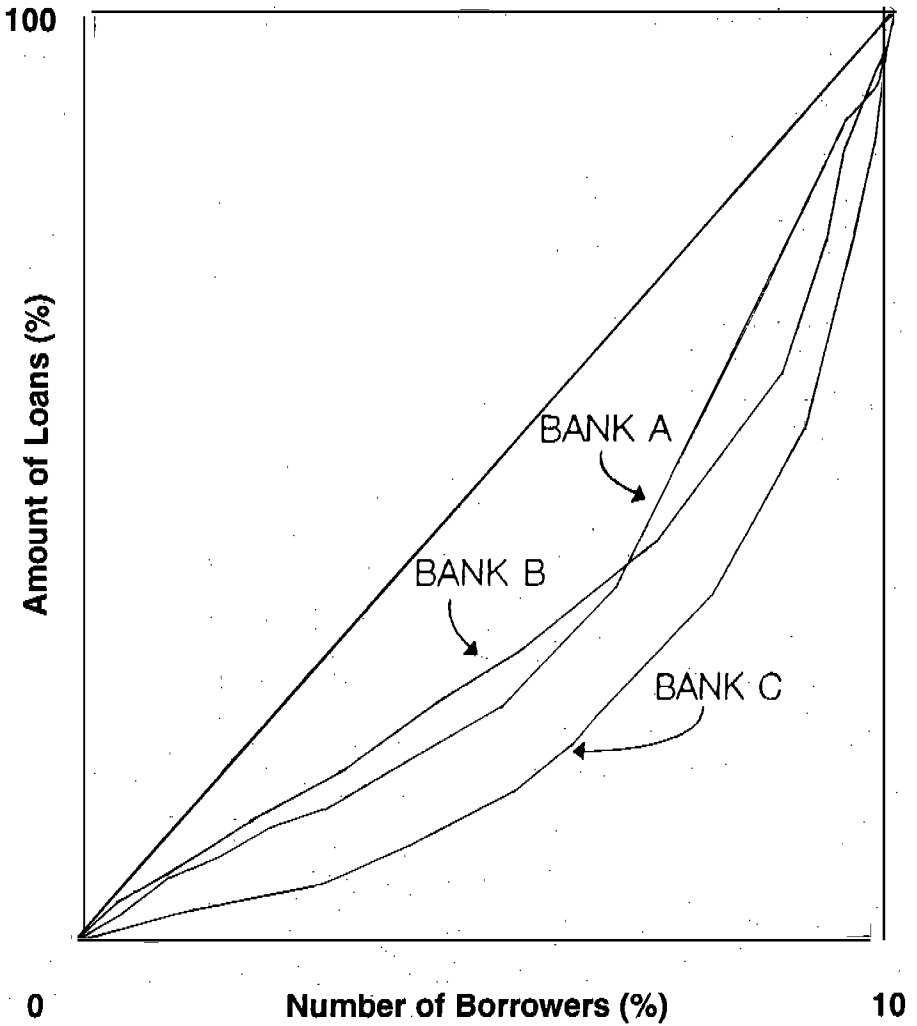
A similar approach is to examine PFIs in relation to the asset size of their SME borrowers. Large PFIs lent to SMEs with median asset size of P1 million, medium PFIs of P500,000 and small PFIs of P250,000. The two-way ANOVA confirms the statistical difference among bank types in the asset size of the SMEs served.³ There was a significant interaction effect between the type of bank and the size of SME-borrowers. Large PFIs served larger SMEs while small PFIs served smaller SMEs. Figure 1 presents a Lorenz curve of SECP loans by number of borrowers versus amount of loans distributed according to the amount of assets of the borrowers. Figure 1 shows that the Lorenz curve of small PFIs has the biggest divergence from the 45° degree line compared to those of the medium and large PFIs. Small PFIs made small loans to many small SMEs which constituted only a relatively small proportion of their total portfolios. The larger proportion was allocated to a few large SMEs. In contrast, medium and large PFIs allocated a smaller proportion of their portfolios to small SMEs and lent to more medium and large SMEs.

Larger PFIs could meet the credit needs of larger borrowers because they offered a wide range of banking services. In contrast, smaller PFIs were themselves SMEs in the financial sector. They were severely constrained in extending continued assistance to faster-growing SMEs. When these more progressive SMEs outgrew the limited financing and services capabilities of the smaller PFIs, they moved out to larger banks. This was a process of self-selection, which, in a differentiated rural financial market, could eventually lead

3. The results of a two-way ANOVA (n = 572 loans):

	Bank Type	SME Asset Size	Interaction
F-Ratio:	6.9	3.7	2.11
Significance:	0.002	0.001	.01

Figure 1
DISTRIBUTION OF NUMBER OF BORROWERS AND AMOUNT
OF LOANS BASED ON BORROWER ASSET SIZE



to smaller PFIs serving the high-risk end of the SME clientele. Larger PFIs had the resources to meet the growing needs of SMEs.

Sustainability of the Credit Program's Benefits

Special financing programs normally have limited implementation periods. PFIs need to plan beyond the program to sustain their financing of SMEs. The capacity of the PFIs to sustain SME lending depends on its performance and policies on the generation of deposits. Table 6 shows the average deposits-to-assets ratio of PFIs. Large PFIs had an average of 55 percent of assets financed by deposits. The comparison ratios for medium and small PFIs were 64 and 32 percent, respectively. The difference in deposits-to-assets ratio is statistically significant across bank types. Larger PFIs could accumulate larger deposit bases while smaller PFIs lagged behind in deposits and relied on borrowings to finance their assets.

SECP significantly expanded the financing sources of medium and small PFIs. A substantial proportion of the increase in borrowing of these banks came from SECP. From Table 6, SECP financing constituted only 3 percent of large PFIs total borrowing in

Table 6
DEPOSIT PERFORMANCE OF PFIs (1988-1990)
(In Percent)

Bank Type	Deposit Assets	SECP Loan Borrowings	Loan Deposits
Group A	54.9	3.3	90.0
Group B	63.7	18.1	98.8
Group C	32.3	72.2	189.6
One-way ANOVA			
F-Ratios:	68.8	3.88	7.04
Significance:	.001	0.05	0.01

1991. For medium and small banks, SECP funds contributed 18 and 72 percent, respectively of these banks' external borrowings. The statistical analysis shows a significant difference across bank types due to smaller PFIs, which, as a group, had limited deposits and could not borrow from commercial sources. These banks depended on special financing programs to fund their asset growth. Since SECP was a temporary funding source, the smaller banks faced refinancing problems. Two ways to address this need are by:

- 1) deposit mobilization; or
- 2) shrinkage in the SME portfolio.

SECP borrowings provided PFI management with a target funding level that had to be replaced largely by new deposits. Such targets for deposit generation were quite high especially for small banks, given the constraints these banks faced in the deposits market. For banks which could not refinance SECP through deposits, the remaining option was to reduce loans, which meant that their growth in SME loans could not be sustained.

The financing of loans by deposits is reflected in the loans-to-deposit ratio in Table 6. The difference in this ratio is statistically significant across the three PFI groups. Eight of 12 large and medium banks showed ratios of less than 100 percent. Small PDBs lent nearly twice the level of their deposits, revealing a dependence on external sources to finance loans. Smaller PDBs would have difficulties sustaining lending to SMEs because of higher cost of funds, liquidity pressure from external financing, and high concentration of large depositors.

SME credit programs were sustainable only if loans to SMEs were profitable to PFIs. Since SECP re-lending rates to PFIs were set at market, profitability was not assured. Liberalized conditions enabled PFIs to modify loan terms and management policies to *make every loan profitable*.

A related question is whether the SECP increased the profitability of PFIs, given that loans to SMEs substantially increased due to the program. The analysis uses a regression model relating PFI income with two variables: PFI assets and an indicator for pre- and post-SECP.⁴ The statistical results indicate a significant relationship between returns and resources. Significance of the indicator variable implies that SECP increased the profitability of PFIs.

Rent-seeking policies such as subsidized interest rates and "soft-term" loans have been justified by claims that market failure, in the form of transaction costs, makes small loans to SMEs unprofitable. SECP's results show that PFI lending to SMEs are profitable because, under the liberalized program, PFIs can negotiate mutually-beneficial terms with SMEs. High transaction costs are covered by margins acceptable to SME beneficiaries. PDBs with better familiarity with local borrowers avoid many substantial costs in documentation and investigation normally incurred by commercial and multi-branch banks.

4. The multiple regression model is as follows:

$$Y_{jk} = a + bX_{jk} + cI_{jk} + e_{jk}$$

where:

Y_{jk} is the return on equity of the j th PFI in year k .

X_{jk} is total assets of the j th PFI in year k .

and

I_{jk} is an indicator variable that takes the value 0 for year k prior to 1990 and 1 otherwise for the j th PFI.

The resulting regression estimates (df = 64) are:

$b = 4.485E-08$	$c = 0.0623$	$a = 0.0581$
$t = 2.675$	$t = 2.164$	
Prob. = 0.00948	Prob. = 0.03418	
Multiple R = 0.4165	F-ratio = 6.715	

Table 7
PERFORMANCE OF THREE PFIS

Performance Data	Asiatrust Bank	Bank of Cebu	S. Negros Devt. Bank
Bank Data (In million pesos, Dec. 31, 1991)			
o Assets	1624.1	120.5	78.6
o Loans	898.7	45.7	41.5
o Deposits	1040.2	72.0	33.5
Bank Performance Indicators: SECP			
1. Effectiveness of credit delivery to SMEs			
o Median loan size (P 000s)	1000	87.5	50.0*
o New vs. old clients	0.8:1	13.5:1	0.2:1
2. Contributions to SME growth			
o Trading vs. manufacturing/ service loans	4:1	0.2:1	5.7:1
o Median loan term	3 years	1 year	1 year*
3. Sustainability (percent, Dec. 31, 1991)			
o Loans/Deposits	94.0	66.0	168.5
o Increase in deposits/ SECP loan balance (1990-1991)	5385.0	484.0	124.2
o Return on shareholders' equity	21.4	9.2	12.5
*Excluding loans of P10,000 and less.			

THREE CASE STUDIES ILLUSTRATING THE IMPACT OF SECP ON BANK MANAGEMENT POLICIES AND PERFORMANCE

The impact of SECP for three PFIs are shown in summary statistics presented in Table 7. The banks' performances were differentiated by management policies and decisions and market opportunities. *Southern Negros Development Bank (SNDB)* was a small bank that operated in the province of Negros Occidental. In 1984, SNDB reoriented its lending towards SMEs because management noted that SMEs were more able to cope with the poor economic conditions at that time and the bank's SME loan portfolio had a better collection performance.

SNDB's success in the SME loan market may be attributed to the following lending policies:

- 1) Adoption of a simplified loan evaluation procedure that focused primarily on the proponents' knowledge of their business, allowing for immediate decisions on credit applications;
- 2) Personalized approach to loan servicing to enable the bank to know the client well and respond to their service needs; and
- 3) Choice of traders as target SME borrowers because they can afford high interest rates.

The *Bank of Cebu (BC)* was a medium-sized development bank located in Cebu City that had a concentration of its lending portfolio in SMEs. BC shifted to SMEs in manufacturing in 1990 after a long history of lending to trading and commercial businesses, apparently in order to take advantage of a shift in the economy of the Cebu City area.

In seeking out SMEs engaged in manufacturing, the bank linked up with the Department of Trade and Industry Region VII to identify industries which were to benefit from government support and with local industry associations, like the Cebu Chamber of Commerce, for client referrals. It also conducted seminars for businessmen

which were intended to present how bank loans could be used to sustain the growth of the business. The willingness of SME owners to attend these "loan development activities" was a criterion used by BC in loan evaluation. In 1991, BC launched a major financing program for SMEs and reorganized its credit unit to support the program. The Bank found SECP's flexible loan conditions to be very supportive of its focus towards SMEs. In particular, the SECP was able to open a new lending window for exporters using nontraditional securities like letters of credit and purchase orders. The bank management related its increased capacity for such new types of credit to SECP. Unlike the SNDB which accepted applications from SMEs with minimum operating experience of five years, BC financed new businesses but charged a high interest rate (8 to 10 percent above prime) in compensation for the added risk involved.

The *Asiatrust Bank* was the second biggest SECP participating bank which had been essentially serving Metro Manila-based SMEs since 1960. The SECP provided financing support to lending activities at its two branches in Cavite and Isabela. Based on the P1.0 million median loan size of its SECP sub-loans, *Asiatrust* appeared to have targeted the larger SMEs. Management considered SECP as having only a marginal impact on its liquidity and lending operation, given the size of the bank's resources and capacity to generate funds. However, management believed that SECP expanded the Bank's range of loan products which made banking with *Asiatrust* attractive to SMEs and other clients.

The three sample banks were financing SMEs primarily because of their own favorable evaluation of the credit-worthiness and profitability of this market. Each of the banks had different SME orientations in terms of size and activities and implemented different credit policies. The flexibility of the SECP loan terms enabled the banks to package credit programs for SMEs that were consistent with their respective profit and risk objectives. The SECP achieved

different levels of success in each of the banks as shown by the expansion in the number and types of SMEs served.

RESULTS AND CONCLUSIONS

The SECP provided a laboratory, a kind of social experiment, for evaluating the results of liberalized credit policy. The SECP pre-qualified PFIs based on their commitment to SME lending, set credit limits for PFIs, and defined the purpose and scope of financing to end-borrowers. Other terms were set by PFIs and SMEs based on prevailing market conditions. The results indicate that the SECP achieved success in terms of:

- 1) increased PFI lending to SMEs;
- 2) the high quality of such increased lending in terms of desirable development of capacities and new SME credit market;
- 3) delivery to the SMEs of the financing suited to their needs; and
- 4) improved position of PFIs for sustained SME financing.

A significant increase in lending to SMEs was observed after the implementation of SECP. New borrowers dominated the expanded credit provided to SMEs showing the development of a formal credit clientele under SECP. The increased lendings of PFIs under SECP were generally acceptable credit risks because the PFIs selected SMEs which were successful and expanding their business. The SMEs supported by PFIs were about equally distributed between trading and manufacturing or services.

The benefits gained by SECP were due to two key factors: the choice of development banks as PFIs and a design that allowed PFIs and borrowers to negotiate the terms of credit based on their own profit motives.

Rent-seeking policies justified subsidies and "soft terms" in credit programs by assumptions of market failure and high transactions cost. The results of this study cast doubts on whether

the SME financing markets actually fail and whether transaction costs impede lending or profitability of PFI loans to SMEs. Recognizing the segmentation of credit markets, SECP identified development banks as the "community bankers" which reached out to the SME market. These PFIs had the advantage of knowing their SME clients better, leading to lower transaction costs for smaller loans. By reducing documentation requirements from PFIs, SECP ensured low transactions costs. The reduced transaction costs ultimately benefited SMEs the way direct interest subsidy did but without distortions in credit allocation since it was a reduction of a deadweight loss. PFIs selected SME projects whose expected returns met the commercial financing terms and whose risks were controlled through prudent loan structuring. SECP did not impede the PFI's lending decision process — from search, loan evaluation and approval, loan structuring to collection. In contrast, other directed credit schemes did not build stronger PFIs by creating two credit approval processes: one for special financing and another for their own funding. The larger PFIs demonstrated greater capacities to generate deposits and to avail of profit opportunities provided by SECP.

The SECP experience shows that the detailed structuring that characterized most special credit programs may be unnecessary. When this is done, adverse results in terms of distortions in credit allocation can be expected even before launching the program or making the first loan. Prudent selection of PFIs which serve the intended borrower segments provide the targeting mechanism for SECP. The Philippines has an uneven distribution of SMEs in size and location, a segmented financial system, and widely differing states of economic progress outside Metro Manila. By allowing each PFI to structure the terms of credit appropriate for each SME and for business conditions in the area, SECP enabled PFIs to control their risks while continuing to provide financing to SMEs. In a second best setting of underdeveloped financial system, government provides development financing to beneficiary sectors

like SMEs. However, the SECP experience indicates that government should veer away from trying to channel credit toward specific benefits through detailed program structuring that only distorts the price of credit. Instead, it should try to get the price and terms of credit right based more on market forces than on government intervention.

Lastly, this article presents a *behavioral explanation* for why benefits can be achieved under a liberalized credit scheme, namely that banks adjust their management policies to take advantage of opportunities for lending to SMEs. A liberalized scheme is superior to a directed credit program in the way it channels financing by PFIs to developmentally "desirable" purposes and terms *based on the conditions in the PFI market and when they are financially capable to assume the risks of lending to SMEs*. The key advantage of a liberalized credit program is the way it gets the price of credit right by allowing credit terms to be set by transactors who are subject to the rewards and costs of credit.

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