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Working Paper

Cooperative Banking: A Viable Approach To Microfinance - A Case Study in the Philippines

Working paper / University of Cologne, Development Research Center, No. 1999,6

COOPERATIVE BANKING: A VIABLE APPROACH TO MICROFINANCE
A Case Study in the Philippines [1]

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A leading cooperative bank in the Philippines has demonstrated that cooperative banking can be a viable approach to microfinance. Established in May 1975, the Cooperative Rural Bank of Bulacan, Inc. (CRBBI) integrates the components of rural banking and cooperativism: it is a rural bank owned and controlled by 180 primary organizations in Bulacan. CRBBI was registered with the central bank, *Bangko Sentral ng Pililipinas* (BSP) as a stockholding company in April 20, 1978. It has an authorized capital stock of P10 million ($263,158 at December 1998 exchange rate), of which P7.689M ($202,342) or 77% have been subscribed and fully paid. Its Head Office is located in the municipality of Plaridel at the heart of Bulacan province, while its seven (7) branches are spread in other municipalities of the same province. CRBBI's Board is composed of 11 members elected by the general assembly constituted by the Chairmen of primary organizations. The Board meets once a month together with some permanent invitees such as the Treasurer, the Secretary, the legal adviser, and the ex-Chairman who is retained as consultant to the bank.

The overriding purpose of CRBBI is to become an apex financial institution for its member organizations. Like most cooperative banks in the country, CRBBI lends wholesale to its member organizations, expecting the latter to retail loans to their individual clients. The bank continues to serve as an intermediary for the agricultural and rural credit programs of various government financing institutions, including the Land Bank of the Philippines (LBP), Agricultural Credit Policy Council (ACPC), Department of Trade and Industry (DTI), People's Credit and Finance Corporation (PCFC), and the National Livelihood Support Fund (NLSF). It has expanded its services in recent years and now provides a wide range of financial services to various sectors as a full-fledged commercial bank.

Like private rural banks, cooperative banks are regulated by the BSP. The major regulations affecting the rural banks are: minimum capital requirements, deposit taking, interest rates, and loan security. Prior to the policy reforms of 1986, capitalization of private rural banks, cooperatives, and cooperative rural banks were quite low and heavily subsidized by the government. They operated virtually as specialized financing institutions directed by the government through various subsidized credit programs to cater to specific target groups at prescribed rates of interest.

In the advent of the 1986 financial policy reforms[3], refinancing facilities for specialized credit programs were discontinued, and rural banks were encouraged to mobilize deposits from the public in general. Ceilings on the interest rates were removed, but BSP continues to require banks including rural banks and cooperative banks to secure their loans with tangible collateral. Following the full liberalization measures in 1993, capital requirements for rural banks were raised to higher levels ranging from P2 to P20 million (around $53,000 to $105,000). The underlying objective of these reforms is to have *a viable and sustainable private financial market.* Apart from the standard norms of liquidity, solvency and profitability vigilantly enforced by the Central Bank to maintain the general soundness of the banking system, there are no detailed prescriptions on how a rural bank should operate. The basic motivation of people to get together

1 This case study is part of a larger study on 'Social Capital Formation in Microfinance in the Philippines' undertaken by B. R. Quinones, Jr. and H.D. Seibel with funding support from the Pacific Basin Research Center (PBRC).

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3 For a comprehensive review of financial policy reforms, see Mario Lamberte & Gilberto M. Llanto, "Financial Sector Policies: the Philippines", in Financial Sector Development in Asia, Asian Development Bank, Manila: 1995.

to establish a rural bank is profit taking, although some might be goaded by a genuine desire to help in the development of local communities.

In case of primary cooperatives, their developmental activities are, in theory but not in actual fact, supervised by the Cooperative Development Authority (CDA). BSP does not regulate their financial activities (savings and credit) provided they apply only to the members. In this light, primary cooperatives in the Philippines may be considered 'unregulated and unsupervised'. Their annual reports sent to the CDA may not go unnoticed, but they are not monitored. There is not a notion of standards to be enforced. To the contrary, any standards that might exist for cooperatives as self-help organizations concerning the internal mobilization of resources are constantly undermined by well-meaning government interventions with cheap and easy money.

As defined by the cooperative law of the Philippines, the basic motivation of people to form a cooperative should be to pool resources for mutual help. Article 3 of the Cooperative code describes the general concept of a cooperative as follows: "A cooperative is a duly registered association of persons with a common bond of interest, who have voluntarily joined to achieve a lawful common social or economic end, making equitable contributions to the capital required and accepting a fair share of the risks and benefits of the undertaking in accordance with universally accepted cooperative principles." The Cooperative code further defines the objective of cooperatives as follows: "The primary objective of every cooperative is to provide goods and services to its members and thus enable them to attain increased income and savings, investments, productivity, and purchasing powers and promote among them equitable distribution of net surplus through maximum utilization of economies of scale, cost-sharing and risk sharing without, however, conducting the affairs of the cooperative for charitable purposes." 4

In reality, many cooperatives have been formed to avail of government resources, with no or little attempt at self-help.

Outreach and Financial Deepening

The Cooperative Rural Bank of Bulacan, Inc. (CRBBI) is one of the largest rural banks in the country in terms of assets, but its outreach in terms of the number of clients is not so large. In peso terms, the Bank's loan portfolio increased by 148.2% from P50.6 million in 1996 to P125.7 million in 1997 (see Table 1). In US currency, the Bank's loan portfolio in 1997 increased in absolute amount by US$1.37 million, or a growth rate of 70%. The number of its clients reported at 10,000 in 1996 and also in 1997 is clearly understated; but for some reason, the Bank continues to use this number although it excludes the individual clients not affiliated with the Bank's member organizations. The business generated from these individual clients must have grown much faster in recent years, leading the Bank to open two (2) new branches in 1997 and increase its staff from 59 in 1996 to 71 in 1997. This rapid expansion could not have been possible had the Bank not opened its services to non-cooperative members and the public in general.

Table 1. Cooperative Rural Bank of Bulacan, Inc. , Selected Performance Indicators, 1995-1997

Item	1995	1996	1997
Years in operation		22	23
No. of clients	NA	10,000 [a]	10,000

4 FAO Regional Office for Asia and the Pacific, 1998. A Study of Cooperative Legislations in Selected Asian and Pacific Countries. FAO RAP Publication: 1998/30, p. 15.

Ave. no. of clients added / year			
since establishment			435
Loan outstanding, Phil. Peso	NA	50,645,801	125,689,826
Growth rate (%)			148.2
Loan outstanding, US$	NA	1,933,046	3,307,627
Growth rate (%)			69.8
Repayment rate (%)	NA	89.0	92.0
Cost per peso lent	NA	0.181	0.220
Total internal resources, US$	NA	2,224,386	3,160,419
Growth rate (%)			42.1
Internal resources ratio, %		115.1	95.5
Operational self-sufficiency ratio, %	NA	88.5	100.6
Financial self-sufficiency ratio, %	NA	NA	79.3

Notes: a/ Includes only the individual members of primary organizations affiliated with the bank. Data were not available on the number of individual clients of the bank who are not members of primary organizations.
Exchange rate, US$ 1 to peso: 1995 - P25.90 ; 1996 - P26.20 ; 1997 - 38.00

Viability and Sustainability

CRBBI is a financially viable rural bank. Despite a slight deterioration in cost efficiency, the Bank attained a 100 percent operational self-sufficiency in 1997, which means its income from interest and fees on loans fully covered all its financial and operating costs as well as the provision for loan losses. CRBBI's cost per peso lent increased from P0.18 in 1996 to P0.22 in 1997. This was largely due to an increase in the cost of funds which constitutes roughly 60 percent of the total transactions cost of the Bank. First, the interest cost of deposits per peso lent increased from 0.077 in 1996 to 0.096 in 1997, and then also the interest cost of borrowings per peso lent increased from 0.027 in 1996 to 0.035 in 1997. However, the negative impact of higher costs on the Bank's profits was cushioned by an improvement in repayment rates from 89% in 1996 to 92 % in 1997.

Reliance on internally generated funds has firmly placed the bank in the path of sustainability. In 1997, however, the Bank's financial self-sufficiency ratio reached only 79.3%. This means the revenues of the Bank were not sufficient to cover transactions costs adjusted for subsidies and inflation. A factor that adversely affected the Bank's financial self-sufficiency was the rapid expansion of external borrowings by some 222% in 1997, primarily from subsidized sources, while deposit liabilities increased at a slower pace of 107%. As a result, the Bank's internal resources ratio dropped from 115.1% to 95.5%, still quite high by rural bank standards, but which significantly increased the Bank's dependence on subsidies.

Measures that Enhance Viability and Sustainability

(i) Good governance

Members participation in ownership and governance: **A fundamental principle of cooperativism is the participation of members in the ownership and governance of the organization. The Board and management of CRBBI believe that the policies of the Bank truly reflect the aspirations of member organizations because the Board members who formulate policies belong to the member organizations and they represent their interests. They continue to uphold the policy of wholesale lending which ties CRBBI (as wholesale lender) to**

member organizations (as retail loan outlets), concretizing the principle of cooperation which CRBBI stands for.

Participation in the Bank's equity is *sine qua non* to participation in governance. The 138 member institutions hold an equity of P3.87 M ($101,842) in common shares, while five other agencies hold P3.819 M ($100,500) in preferred shares. Among the member organizations, 10 organizations contributed equity shares of at least P100,000 ($2,632) while the rest contributed an average of P5,000 ($ 132) per organization. It must be noted also that three of four preferred shareholders are cooperative rural banks (CRB of Nueva Ecija –P1.0 M, CRB of Pampanga – P1.0M, and CRB of Tarlac – P0.5M), further reinforcing the cooperative principle upon which the Bank is established. The fourth preferred shareholder is the government, which is also the major source for low-cost cooperative loans to farmer-members. The government share, valued at P911,000 ($23,974) or around 12 percent of the paid-in capital, is currently being retired.

Forward-looking professional management and staff: **Another measure indicating good governance (and thus contributing to sustainability) is the hiring of full-time professional staff led by a General Manager who, together with the Board members, have a forward-looking approach to cooperative banking. Working closely with the Board, the Bank's management was responsible for making CRBBI the first cooperative bank to install an on-line computer system for its banking operations with the support of the UN-FAO MicroBanker Project. The MicroBanker Project has helped CRBBI standardize its accounting and internal control system, loan and deposits processing, interest rate calculations, scheduling of loan disbursements and collections, cash flow management, reports generation, and many other operating systems.**

Establishing effective control over moral hazard: **Majority of CRBBI's member organizations are farmers' cooperatives and Samahang Nayons (village associations) organized in the 1970's and 1980's for the purpose of channeling agricultural credit in support of the government's rice production program called 'Masagana 99'. Many of them sunk under the weight of massive loan defaults and became defunct, weakening the financial health of CRBBI in the process. One of CRBBI's earlier measures to effectively control moral hazard was to re-evaluate and re-accredit its institutional members, leading to the weeding out of 42 financially unviable member organizations. This trimmed down the number of CRBBI institutional members to 138 at present and improved the Bank's financial standing.**

(ii) Broadening outreach

Venturing into commercial banking: The shared normative framework of cooperation was necessary for the establishment of the bank, but it did not provide enough room for CRBBI to grow and develop into a robust bank. CRBBI realized it can not be financially viable if it merely functions as a bank for cooperatives that caters exclusively to its member organizations. The interest rate on wholesale lending (20% p.a.) is lower than on direct lending (24% p.a.), and there is no evidence that the former approach is more profitable than the latter. Moreover, expansion of the bank's outreach to enlist more primary organizations as retail outlets is quite limited because of accreditation requirements. There is nothing in CRBBI's charter that prohibits it from going public; rather, its charter provides the option for the bank to cater to the public in general. What held the bank from exercising this option were the restrictions of government's specialized financing programs imposed on participating institutions during the pre-reform days.

The opportunity to break out of the constraints of membership-based banking came when policy reforms were instituted, enabling the bank to venture into commercial banking and henceforth provide a full range of banking services to any customer. To put this rather ordinary step into a proper perspective, it is important to understand that the leading commercial banks in the country, having increased their capitalization in response to the financial reforms, expanded their branch networks in the countryside, thus encroaching on territories that were once the domain of rural banks. Commercial banks offered financial services that rural banks have not hitherto provided (e.g. checking account, combined savings and checking account, money transfers, insurance, etc.), they catered to clients rural banks never thought of serving in the past (e.g. market vendors, shopkeepers, handicraftsmen, salaried employees, children, etc.), and they even sought to attract the potential and existing clients of rural banks who are largely small farmers.

The advance of commercial banks in the countryside gradually encroached into the niche market of rural banks, but it also awakened the idling rural bankers and opened their eyes to the vast potentials of commercial banking. It was therefore inevitable for CRBBI to go the way of commercial banking, taking advantage of the flexibility enshrined in its charter to offer financial services to all types of clients for all kinds of purposes.

The shift to commercial banking generated new values and practices that gradually overshadowed the old values/ practices of cooperative banking. Cooperative banking is sort of a closed circuit system, grounded on the principle of mutual help among *bona fide* members of the organization. It aims to maximize socio-economic benefits of the members through resource pooling and sharing. In contrast, commercial banking is an open system, the thrust of which is to provide a full range of financial services to satisfy all banking requirements of the individual client, whether or not he is a cooperative member.

(iii) Enhancing viability

***Adopting a market-oriented interest rate*: To gain competitive edge in the new environment, CRBBI had to institute a rigid process of planning for viability, also a mark of good governance. Setting aside three full days each year to follow through the whole process, the bank devotes considerable effort to determining the level of viable operations, taking into prior consideration the amount of funds it could mobilize in the ensuing year. It then sets the target volume of business and the allocation of its portfolio by sector and purpose. With estimates of the expected revenue from the targeted business volume, the bank then determines the budgetary requirements for operation giving special consideration for a reasonably generous amount for workers' benefits.**

Allocation of loanable funds to sectoral portfolios is largely determined by fund sourcing. To date, CRBBI finances the credit requirements of cooperatives and their member-farmers with relatively cheap money sourced from directed credit programs of government financial institutions such as the Land Bank of the Philippines (LBP), the Agricultural Credit Policy Council (ACPC), the People's Credit and Finance Corporation (PCFC), and the National Livelihood Support Fund (NLSF). These credit programs are now being dismantled by the National Credit Council and the Department of Finance. The question looms large: will the discontinuance of these programs impel CRBBI to throw wide open its favored sector to universal banking practices? We will return to this question later.

An integral part of viability planning is the determination of a market-oriented interest rate, in itself a specific viability measure. CRBBI's management exerts the strongest influence in determining the bank's rates of interest. While the Board oversees the bank and makes policy decisions, it feels that management has a better gauge of market rates because it obtains regular feedback from clients, staff and other sources on the interest charges of other local banks and on responses of local people to marginal interest rate changes.

Management gives prior consideration to the cost of funds in determining the bank's level of interest rate. For instance, funds from ACPC and PCFC bear interest rates of 14% p.a. and 12% p.a. respectively. Hence, lending rates of 20% p.a. for wholesale loans to cooperatives and 24% p.a. for individual loans provide a reasonable interest spread for CRBBI, estimated at an average of 7.5%. But in addition to the cost of funds, the bank must also cover its administrative costs and provision for loan losses, estimated to range at an historical average of between 3% to 6% of the total loan portfolio. CRBBI achieves this by charging an additional service fee of 5% on the loan amount.

The financial crisis last year (1998) propelled the bank to put to good use the flexibility brought about by the financial policy reforms. As the financial situation in the country worsened and became volatile, CRBBI raised the bank's lending rate to as high as 30% p.a. for institutional (wholesale) loans, and up to 34% p.a. for individual loans, aiming to maintain a gross spread of 7.5%. Adjustments in the lending rates enabled CRBBI to avoid staff retrenchment. But it exercised extra caution in its operations. For instance, CRBBI has set its liquidity ratio at a critical minimum of 25% (tight liquidity) and a maximum of 35% (too much liquidity). When the ratio fell below 25%, the bank froze its lending operations and resumed again when more funds began to flow back into the bank, especially when depositors of other commercial banks that closed shop transferred their savings to CRBBI. With greater prospects of growth in sight, CRBBI inaugurated two new branches in 1998.

***Incentives for excellence, penalties for below-standard performance*: To keep the bank workers loyal to the organization and committed to its goals, the Board provides them a variety of fringe benefits: centennial bonus, anniversary bonus, quarterly bonus, and a monthly group incentive on top of the usual 13th month pay. No bank staff is penalized for non-collection of loans. On the other hand, delinquent borrowers are promptly charged a penalty of 3% per month. As a standard procedure, a loan that is unpaid within 30 days after due date is registered as overdue. If after 60 to 90 days the overdue loan is not repaid, it will be restructured and the delinquent borrower will be blacklisted by the bank. To clear one's name from the blacklist, the borrower must repay fully the outstanding loan, both principal and accrued interest, and in addition, he/she must secure clearances from other banks operating in the area such as the LandBank, the Philippine National Bank, and/or the nearest rural bank.**

(iv) Enhancing sustainability

***Weaning away from government-directed credit programs*: A question earlier raised is whether wholesale lending will continue to be sustainable when the directed credit programs of the government are eventually dismantled. The answer to this question is affirmative: CRBBI has prepared adequately for the eventual discontinuance of directed credit programs. Firstly, it complied with the new capitalization requirements of the central bank, and cleared its ranks of financially ill primary organizations. This has off-loaded significant amount of non-performing assets in the bank's portfolio. Further, there are in place screening and accreditation criteria that help the bank in the future to weed out the financially unviable institutions from its clientele base.**

Secondly, the flexibility of CRBBI arising from its adoption of commercial banking practices has been tried and tested - in the midst of the Asian financial crisis. CRBBI came out of the financial crisis stronger and healthier: it did not only withstand the crisis without firing a worker, it also managed to attract the clients of local commercial bank branches that closed shop. To cap it all, it opened up two new branches when two other neighbouring banks collapsed.

Thirdly, as a result of market-oriented planning, CRBBI has diversified its portfolio of deposit products to meet the savings requirements of the local population, and with attractive yields: 5% p.a. for ordinary savings deposits , 10 to 14% p.a. for time deposits, and a hefty 25% p.a. for special deposits of more than P1.0 million with maturity of at least 3 years. With the inflation rate hovering around 8 to 9 % p.a. during the period 1995-1997, the real returns were negative for ordinary savings deposits and positive for time and special deposits. Nevertheless, the total deposits (personal, voluntary, fixed) it generated from the public in

1998 were greater than its borrowings. There seems to be truth in the management's claim that the bank's remarkable performance in savings mobilization stems from the growing public confidence in the bank and its officers.

CRBBI also rolled out innovative credit products to reach out to new types of clients. On top of the usual loans to traditional clients, it now offers payroll servicing and salary loans for employees of small and medium scale companies, a service once available only with big commercial banks. It also has loans for market vendors, and livelihood loans for poor households.

CONCLUSION

With these timely measures, one can conclude that CRBBI will continue to be a bank for cooperatives while at the same time growing more robustly each day as a commercial bank. Owing to its peculiar make-up, however, success in striking a balance between these two roles will not be easy. CRBBI will have to deal with membership-based banking while at the same catering to a growing number of clients who are non-members. One nagging issue will continue to haunt the bank and its member organizations: how best could CRBBI contribute towards the institutional strengthening of its member institutions as financial intermediaries? As a form of apex financial organization for primary organizations that uses member organizations as retail loan outlets, CRBBI will always grapple with the question of whether or not it should lend to member organizations, especially if alternative investments elsewhere are better. It will also struggle with the thought that, with its latest thrust to open up more branches, it might unwittingly compete with its own member organizations.