

RURAL FINANCE IN THE PHILIPPINES

Issues and Policy Challenges



Gilberto M. Llanto



Agricultural Credit Policy Council



Philippine Institute for Development Studies

Surian ng mga Pag-aaral Pangkaunlaran ng Pilipinas

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by

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Foreword

For decades past, we have been lamenting the lack of viable financial institutions and services in the countryside, a scenario that has deprived our farmers, fishers and rural folks of any hope of escaping the cycle of poverty that has ensnared their lives.

In the rural areas, financial services such as credit and insurance are not only few but also entail exorbitant interests and costs, thus effectively barring access to the rural households, restricting investment and trade opportunities for agricultural and nonagricultural rural enterprises and thwarting earnest attempts at poverty reduction and economic growth.

In the late 1980s, with the blessings of a restored democratic and constitutional government, the then newly-organized Agricultural Credit and Policy Council (ACPC) led the country's shift from subsidized targeted credit provision—an approach found too flawed and unsustainable—to a market-oriented rural finance system.

It has been 20 years since these market-oriented reforms were instituted. Since then, the ACPC has religiously monitored and evaluated the implementation of these policy and program reforms for purposes not only of revision and improvement but also of building up lives and capacities of rural stakeholders.

This time, therefore, we are proud and privileged to have partnered with one of the renowned and prolific rural finance experts in the country today, Dr. Gilberto Llanto, in coming out with a book on this issue. A dear friend, Dr. Llanto was formerly at the helm of ACPC before he became a Research Fellow at the Philippine Institute for Development Studies (PIDS) and subsequently its Vice-President. He is now a Research Fellow for the Rural Development Research Consortium of the University of California in Berkeley and a fulltime Research Fellow, again, at PIDS.

Dr. Llanto's book reviews the country's credit policies in the last 15 years. It is an extensive analysis of landmark studies and theories that shaped the growth

of the country's rural finance sector that has been embellished by trends and compared with those of neighboring countries in the hope of contributing to a "more responsive and responsible policymaking."

The study assembles recent studies and statistics to come up with the current state of rural finance in the country and underscores recent government efforts in rural financing, developments in Philippine rural financial markets, and the rural finance experiences of selected Asian countries particularly the Grameen Bank of Bangladesh (which the Philippines has started replicating), the Bimas Rice Intensification unit desas (BRI-UD) program of Indonesia and the Bank for Agriculture and Agricultural Cooperatives (BAAC) of Thailand.

Generously quoting and citing the findings and insights of local and foreign rural finance analysts, Llanto manages to provide a well-rounded view of the development of rural finance in the country as well as those of the Philippines' more successful neighbors.

I am confident that this book will help policymakers, practitioners, academicians and consultants to better understand the history and types of interventions that the ACPC and other rural finance institutions have made in the past.

Having moved into the era of increased globalization and market integration, the pivotal role of well-functioning financial markets cannot be refuted. It is therefore our hope that this historical review, situational analysis and future outlook on the country's rural finance will help rural stakeholders benefit from the lessons of the past and build on existing strengths to blaze new paths in rural finance reform and management.


JOVITA M. CORPUZ
Executive Director, ACPC


Foreword

The author emphasizes that this book is *not* an empirical assessment of the government's rural finance policies and programs in the last 15 years. Rather, it is a "descriptive analysis of policies and programs that can facilitate the identification of a future policy research agenda on rural finance in the country" and contribute to efficient policymaking on this area. This book presents researchers and policymakers alike with substantial and indepth information on rural finance as described by experts that could provide the needed direction for both research and policymaking.

While literature on rural finance abounds, this particular book reviews a carefully selected number, describes valuable experiences, and condenses the various significant results in order to present a much needed outline for policy research from which to build on the future of an efficient rural finance market. The author suggests a policy research agenda that focuses on a vision to promote the "provision of efficient, broadly-based, and sustainable financial products and services to various rural economic agents." He poses a challenge to the research community: *produce research studies that will offer recommendations to policymakers on how to remove the constraints on both the demand for and supply of financial services and products in the rural areas.*

In the end, efficient rural financial markets will be indispensable in addressing questions of rural growth and development, high poverty incidence, income inequality, and food security concerns.

Once again, Gilberto M. Llanto brings to fore in this book his expertise that has earned him a place in the field of rural finance. The management and staff of the Philippine Institute for Development Studies (PIDS), his primary family in the research community, are once again proud to have Gilberto Llanto on board. Together with our copublisher, the Agricultural Credit Policy Council (ACPC), we extend our congratulations.



JOSEF T. YAP, Ph.D.
President, PIDS

Preface

The Philippine economy may never get out of the poverty trap without a strong and vigorous growth in agriculture and in the rural areas. Various local studies have pointed out that poverty reduction and the promotion of equity hinge on the ability of the countryside to generate the jobs and incomes that will be indispensable in crossing the poverty divide. In this regard, the role of efficient rural financial markets should never be underestimated.

The Philippine government has shifted to market-oriented financial and credit policies after decades of implementing subsidized credit programs in the agricultural sector in a bid to improve the accessibility of financial services and various products to the rural areas. The new rural finance policy framework benefited from the studies and policy analyses on rural financial markets done by the research community, both local and international. The Agricultural Credit Policy Council (ACPC) and the Philippine Institute for Development Studies (PIDS) have produced significant research in rural finance over the years and will continue to provide painstaking analysis that will inform the policymakers in the years to come.

The present book is an attempt to provide the broad strokes of a future policy research agenda in rural finance that is built around the outstanding issues in rural finance: asymmetry of information, high transaction costs, systemic and covariant risks in agriculture and the lack of diversification in rural economies.

I would like to acknowledge the assistance rendered by the ACPC and PIDS staff members in producing the study and this book, more specifically, Gabrielle Laviña, Jennifer Liguton and Genna Manaog of PIDS and Adela Santos and Gregoria Guce of ACPC. I would also like to thank Executive Director Jovita Corpuz and Deputy Executive Director Jocelyn Alma Badiola of ACPC and Mario Lamberte, former president of PIDS, who have provided me the opportunity and time to write the report. Likewise, I owe a debt of gratitude to various Philippine researchers (whom I will not name individually lest I inadvertently omit a name) who have made their studies

available for this review and the comments provided by participants in the June 23, 2004 symposium on Rural Finance organized by ACPC and held at Holiday Inn Galleria Manila, Pasig City.

A handwritten signature in black ink, appearing to be 'G. Llanto', with a stylized, cursive script.

GILBERTO M. LLANTO, Ph.D.

Senior Research Fellow, PIDS

I

Introduction

A Challenge

In the last two decades, the rural financial markets in the Philippines have gone through various stages of development and experience. Among others, the government has pursued specific financial and credit policies and programs with a view to creating access to credit among small farmers and other smallscale borrowers in the countryside. The initial attempt at liberalization and deregulation of financial markets in the early 1980s led to the government's radical paradigm shift from a subsidized credit policy framework to a market-oriented approach and lesser government intervention in 1987. The government terminated around 42 subsidized credit programs in the agriculture sector and consolidated the remaining fund balances into the Comprehensive Agricultural Loan Fund (CALF), which was used to guarantee small farmer loans from private and government banks.

In a comprehensive review, Lamberte and Lim (1987) identify the outstanding policy issues in Philippine rural finance, including areas for policy research that were motivated by a shift to a new approach: market-oriented financial and credit policies in the rural financial market. In brief, these two researchers cite the importance of having a stable macroeconomic regime for the development of the rural financial market, removing the bias against rural development (e.g., reexamination of trade policies), and reviewing the monetary and banking policies that restrict the efficiency of the banking system, among others.

Recent developments in the rural financial markets must be examined in view of the critical role of finance in the agricultural and rural sector. Well-functioning rural financial markets enhance the production and consumption possibilities of farm and nonfarm households in the rural areas. As Esguerra (1996), Diamond (1984), Benston and Smith (1976) state, 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 re-

source allocation, an increase in the yield to capital and higher output growth. On the other hand, 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 combined (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.¹

Thus, the crucial challenge facing policymakers is how to frame efficient rural finance policies that will become a potent tool for development. To map out policy measures that respond to this challenge, one must first undertake a comprehensive study of recent developments in rural finance, thus identifying research and information gaps that should be addressed for efficient policymaking. This book therefore seeks to identify new research findings on rural finance as well as policy research issues that should be tackled to equip policymakers in their quest for efficient rural finance policies.

Objectives

This book aims to provide a review of recent developments in rural finance and thus recommend future directions for policy research on rural finance in the Philippines. Its specific objectives are as follows:

1. Review the findings and policy implications of recent literature on rural finance;
2. Analyze the rural finance policies and programs of the government;
3. Draw lessons from the experiences of the Philippines and other less developed countries on rural finance; and
4. Identify areas for future policy research studies on rural finance and draw up a research agenda on rural finance in the Philippines.

Scope and limitations

This book is *not* an empirical assessment of the government's rural finance policies and programs. It is a descriptive analysis of those policies and programs that can facilitate the identification of a future policy research agenda on rural finance in the country. Systematic policy research can provide

¹ USAID et al. 2003

policymakers with information for efficient policymaking. The book covers the last 15 years of rural finance development in the Philippines. While it does not attempt to provide a comprehensive review of the theoretical developments in rural finance, it focuses on studies, articles, and reports that can inform a policy research agenda that can contribute to efficient policymaking on rural finance.

Organization of the paper

Following a brief introduction in section I, section II presents the current state of rural finance in the country and recent government efforts in rural financing. Section III discusses the developments in Philippine rural financial markets and expounds on recent rural finance literature. Section IV presents a brief summary of some lessons drawn from the experience in rural finance development in selected countries. Section V weaves the lessons drawn from the Philippine and other country's experiences in rural finance and recent developments in rural finance literature into an array of future policy research issues or areas.

II

Rural Finance Situation and Government Efforts

The immediate goal of policy reforms in Philippine rural financial market in the late 1980s was to provide credit access to small farmers and other smallscale borrowers for their working capital and investment requirements. The shift to a market-oriented credit policy was expected to spur rural financing, especially by the private sector, which would help usher economic growth in the agriculture and rural areas. The liberalization and deregulation of the financial sector initiated in the early 1980s, which the government pursued throughout the subsequent decade, led to the establishment of more financial institutions (Table 2), an improvement in bank density ratios, albeit in the National Capital Region (NCR), the major urban area (Table 3 and Figure 1),² growth in bank deposits, and the provision of new and innovative products to bank customers. The improvement in bank density ratios indicates that banking facilities and services have become more accessible to various regions outside the NCR, which, however, maintained the highest bank density ratio as the center of the country's economic and business activities.

Financial depth

A proxy indicator to measure financial depth is the ratio of domestic liquidity (M3) to gross domestic product (GDP).³ This ratio reflects the size of financial intermediation although it does not give a complete picture of financial development. An increase in the ratio indicates an increase in financial deepening. The ratio of M3 to GDP throughout the period 1998-2002 remained constant at 5 (Table 1).

Bank density ratios and deposit performance

Following the 1997 Asian financial crisis, a slowdown in the creation of new banking offices and branches ensued, because of measures enforced by the

² See Annex A for details.

³ Researchers have shifted to using M3, a broader monetary measure, to overcome the limitations of M2. The difference, however, is insignificant.

Table 1. Financial depth indicators

	1998	1999	2000	2001	2002
Ratio of M2 to GDP	4.78	4.76	4.74	4.80	4.68
Ratio of M3 to GDP	4.83	4.78	4.77	4.81	4.69

Bangko Sentral ng Pilipinas (BSP) (e.g., increase in capitalization requirements, slowdown in the opening of new branches, etc.) to strengthen the industry and which the banking industry needed to comply with.

The NCR has always had the highest bank density ratio in the country. However, the availability of bank facilities and services in other regions has hardly improved, as indicated by a lack of growth in the region's bank density ratios. It was only the 1997-1998 period that witnessed a 6 percent growth. There was negative growth after the Asian financial crisis. The Central Luzon Region's average bank density ratio of 7 was a far second to NCR's 153 ratio. The Autonomous Region of Muslim Mindanao (ARMM) posted the lowest average ratio of 0.5 over a five-year period.

The concentration of banking facilities in the NCR accounts for a higher bank density ratio in this region compared to other regions. Urban clients outside the NCR compete for access to bank credit and other services with those in the rural areas, who predictably lag behind in access. Given the low bank density ratios outside the NCR, access to bank facilities and services by the rural sectors appears constrained.

Bank density directly affects the total bank deposits in a particular region. Thus, the NCR contributed the biggest share of total deposits, averaging 72 percent, during the period 1997-2001 (Table 4). Central Luzon, which ranks second in bank density, contributed an average of 4 percent in total deposits. Southern Tagalog, which had a 6 percent average contribution, had an average bank density ratio of 6 between 1997 and 2001. ARMM, posting the lowest average density, had the lowest contribution in total bank deposits with only 0.3 percent five-year average.

Increases in the deposits of other regions became evident, owing in part to the growth of urban centers in certain regions such as Cebu in Central Visayas and Davao in Southern Mindanao.

Loans outstanding to agriculture, fishery, and forestry

Loans outstanding of commercial banks to the agriculture, fishery, and forestry (AFF) sector have been decreasing over the years, with an average share

Table 2. Number of financial institutions

Item	1987	1990	1995	1996	1997	1998	1999	2000	2001	2002*
TOTAL	6,508	7,486	12,455	15,493	17,297	18,516	19,297	16,676	17,432	17,782
Commercial Banks	1,761	1,863	3,221	3,647	4,078	4,230	4,326	4,250	4,320	4,199
Thrift Banks	658	653	925	1,171	1,389	1,474	1,478	1,391	1,351	1,340
Specialized Government Banks ¹	76	76	77	-	-	-	-	-	-	-
Rural Banks	1,058	1,045	1,346	1,514	1,715	1,942	1,885	1,912	1,914	1,921
Nonbank Financial Institutions	2,955	3,849	6,886	9,161	10,115	10,870	11,608	9,123	9,847	10,322

Source: BSP

¹ Specialized government bank consists of Al-Amanah Islamic Investment Bank of the Philippines only starting February 1996 and starting 1997, the remaining specialized government banks (LBP and DBP) are consolidated with commercial banks.

* Figures as of September 2002 only.

Table 3. Bank density ratios in all cities and municipalities

	1997	1998	1999	2000	2001
Highest	144.4	153.6	157.5	154.7	155.6
Lowest	0.7	0.5	0.5	0.5	0.5
NCR-Metro Manila	144.4	153.6	157.5	154.7	155.6
I-Ilocos	2.8	3.1	3	2.9	3
II-Cagayan Valley	2.1	2.2	2.2	2.2	2.2
III-Central Luzon	6.3	6.7	6.7	6.5	6.5
IV-Southern Tagalog	5.5	5.8	5.8	5.8	5.9
V-Bicol	1.8	1.8	1.9	1.9	1.8
VI-Western Visayas	3.1	3.2	3.2	3.1	3
VII-Central Visayas	3.4	3.7	3.7	3.6	3.7
VIII-Eastern Visayas	0.9	0.9	0.9	0.9	0.9
IX-Western Mindanao	1.4	1.5	1.5	1.5	1.5
X-Northern Mindanao	2.8	3.1	3	3	3
XI-Southern Mindanao	4.5	4.9	4.9	4.7	4.6
XII-Central Mindanao	1.6	1.9	1.8	1.8	1.8
XIII-CAR	1.2	1.3	1.3	1.3	1.3
XIV-ARMM	0.7	0.5	0.5	0.5	0.5
XV-CARAGA	1.1	1.3	1.3	1.3	1.4

Source: BSP

Note: The offices include head offices, branches, subbranches, agencies, extension offices, savings agencies, money shops/suboffices. Excluded are offices located abroad.

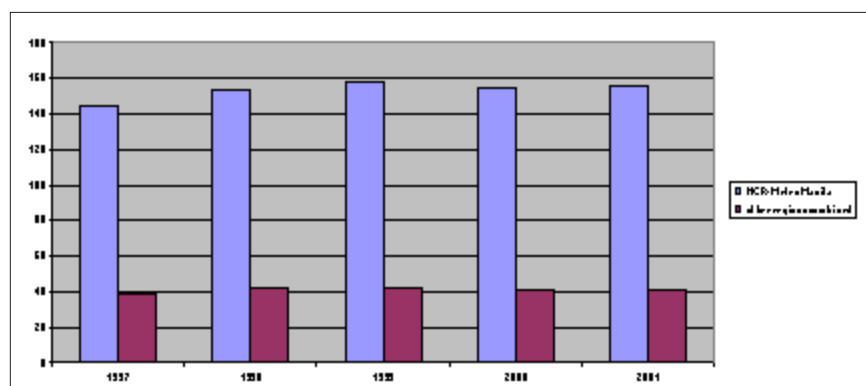
Figure 1. Bank density comparison between NCR and the rest of the regions

Table 4. Total deposit of the banking system (in P billion)

	1997	1998	1999	2000	2001
NCR	1,202.61	1,319.65	1,411.22	1,430.95	1,493.65
Ilocos	27.51	31.69	30.82	39.16	45.52
Cagayan Valley	12.33	13.51	14.00	16.06	19.06
Central Luzon	68.78	74.17	75.71	90.66	106.96
Southern Tagalog	103.08	105.02	108.42	130.47	151.52
Bicol	15.38	17.53	17.60	21.19	23.24
Western Visayas	38.57	44.19	45.38	54.52	64.57
Central Visayas	67.20	76.28	92.14	104.91	116.73
Eastern Visayas	10.64	11.62	11.66	14.22	16.08
Western Mindanao	13.33	14.82	15.99	18.98	21.41
Northern Mindanao	15.42	17.58	18.56	21.14	23.98
Southern Mindanao	33.19	36.06	38.80	40.28	52.69
Central Mindanao	5.60	6.10	6.43	6.91	8.65
CAR	12.90	14.76	14.89	19.65	23.08
ARMM	5.25	5.59	5.58	6.06	7.45
CARAGA	5.92	6.24	6.76	8.18	8.91
GRAND TOTAL	1,637.69	1,794.81	1,913.96	2,023.34	2,183.50

Source: BSP

of 5 percent of total commercial bank loans outstanding from 1995 to 2002 (Figure 2).⁴ The biggest share ever posted by the AFF sector was at 12 percent in 1987. The service sector was the dominant recipient of commercial bank loans, with an average share of 67 percent over the period 1995-2002. The industry sector followed with a 42 percent average share (see Annex B for details).

Despite the loan quota mandated under Presidential Decree (PD) 717 (the Agri-Agra Law), agriculture remains the least priority sector of commercial lenders. Thus, in the period 1987-2002, loans outstanding to the AFF sector barely increased while those for industry and the service sectors more than quadrupled during the same period (Figure 2). There is a wide gap

⁴ There is no disaggregation of loan data published by the BSP. It is safe to assume, though, that most of these loans are for agriculture.

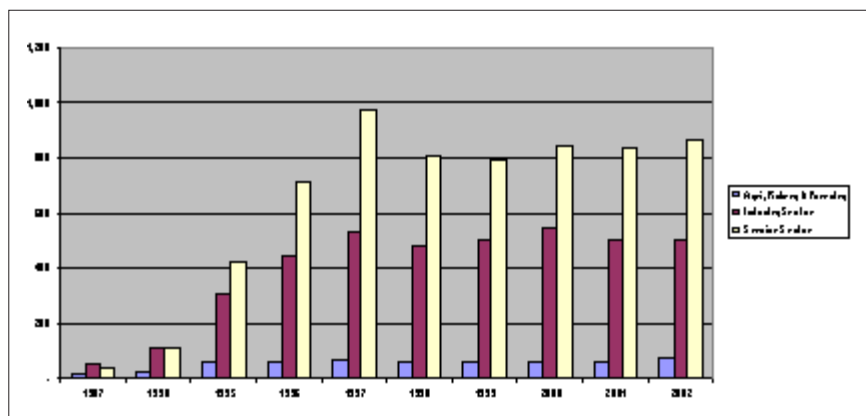
between the loans granted to the nonagriculture sector and those given to AFF. Financing support to AFF coming from formal financial institutions has been relatively small. The real figure can be smaller if the loans mandated by PD 717 (Agri-Agra Law) to be directed to agriculture and agrarian reform are discounted from the loan volumes reported by private banks. The Agri-Agra Law allows private banks to buy government securities and other related debt instruments of the government in substitution of actual loans to the agriculture and agrarian reform areas.

Loans granted to agriculture, fishery, and forestry

The average share of total loans granted by all banks in the period 1998-2002 varied from one sector to another (Table 5). The services sector had 86 percent average share; industry, 11 percent; AFF,⁵ 3 to 4 percent.

Through the years the proportion of loans to the agriculture, fishery, and forestry sector to total bank loans showed modest improvements. In 1998 the ratio of AFF loans stood at 3 percent of the total, which slightly increased to 4 percent in 1999 and 2000, and rose further to 6 and 7 percent in 2001 and 2002, respectively.

Figure 2. Industry share of loans outstanding from commercial banks



Source: BSP

⁵ Loans to AFF, as determined by the 1992 Inter-Agency Task Force on Agricultural Credit, cover loans classified by the Standard Industrial Classification (PSIC) system for production purposes under the following economic activities: agriculture, fisheries and forestry (excluding hunting). Also included, as determined by the Task Force, are selected agriculture-related loans classified under mining and quarrying, manufacturing, construction, and wholesale and retail trade.

Total AFF loans granted in the past five years averaged 5 percent of the total during the period. Loans allocated to the agriculture sector showed no significant increase, and there is a wide disparity between loans granted to the nonagriculture sector and those to AFF. Financing support to AFF coming from formal financial institutions has been minimal.

Agriculture production loans

Of the total loans granted to the AFF sector, only a portion went to agriculture production; all the rest went to other agriculture-related activities. Agricultural production loans made up 31 percent of the total agriculture loans given in 2002, translating to a mere 2 percent of the total loans granted to all sectors. Over a period of five years, an average of only 35 percent of the total agriculture loans went to production.

Commercial banks provided a significant share of the total agricultural production loans granted by all banks (Table 6). In 2002, private commercial banks' share of total agriculture-production loans granted was 63 percent. Both private and government commercial banks provided 60 percent of the total agriculture-production loans granted. As the dominant provider of agriculture-production loans, private banks extended 94 percent of those loans in 2002. On the other hand, the share of combined government banks was only 6 percent for that same year. Rural banks' share of agriculture-production loans in 2002 was 18 percent, its highest so far, while thrift bank had 17

Table 5. Loans granted by all banks, by to sector (in P billion)

	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: BSP

^aData came from revised reports from Agriculture Credit Policy Council (ACPC) based on BSP data; figures will not add up

^bData on private development banks (PDBs), stock savings and loan associations (SSLAs) and savings banks (SBs) only until October of 2000; Data on specialized government banks (SGBs) only until May 1994

*Except AFF sector, data is 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

Table 6. Agricultural production loans granted, by type of bank (in P billion)

	1987	1990	1995	1996	1997	1998	1999	2000 ^r	2001	2002P
Government Banks	1.49	5.93	6.46	8.05	8.38	9.09	9.39	8.39	7.62	8.55
PNB	0.70	1.68	a	a	a	a	a	a	a	
DBP	0.13	0.25	0.99	1.22	1.12	0.69 ^r	0.26 ^r	0.26	0.21	0.90
LBP	0.65	4.00	5.47	6.83	7.26	8.40	9.13	8.13	7.40	7.65
Private Banks	25.97	35.31	76.11	556.66	367.86	105.99	161.09	105.29	114.98	141.31
PKBs	21.01	27.25	43.27	519.75 ^r	335.24 ^r	73.03 ^r	123.01 ^r	68.63	77.98	89.37
TBs	1.51	3.12	20.37	20.61	22.94	15.31	18.76	20.75	21.04	25.28
PDBs	1.01	1.14	6.36	4.23	6.03	5.28	7.93	6.72	7.70	9.62
SMBs	0.09	1.34	7.04	4.35	4.74	4.17	5.28	8.65	6.30	6.78
SSLAs	0.41	0.64	6.96	12.03	12.17	5.86	5.55	5.38	7.04	8.88
RBs	3.46	4.94 ^r	12.47	16.30	9.69	17.66	19.32	15.92	15.96	26.65
ALL BANKS										
Total Agri Prod'n Loans Granted	27.46	41.25	82.57	564.72	376.24 ^r	115.08 ^r	170.48 ^r	113.69	122.60	149.86
Total Agri Loans Granted	n.a.	n.a.	n.a.	n.a.	n.a.	299.04 ^r	401.88	335.31	414.28	487.73
Total Loans Granted to All Sectors	404.35	590.08	6,262.83	10,636.25 ^r	10,141.48 ^r	8,650.83 ^r	9,909.13	9,478.18	7,123.32	6,874.93

Sources: BSP Department of Economic Research, Supervisory Research and Studies Office (SRSO), Statistical Bulletin, Rural Bank System Annual Reports, LBP and DBP.

n.a. Data not available

^r Revised, based on actual reports from BSP

P Preliminary. Amounts were forecasted due to nonavailability of actual data. For 2000 and 2001, LBP and DBP figures are actual amounts.

a Starting 1995, PNB was classified under private commercial banks (PKBs)

b For PKBs, estimated amount was based on actual data for the first semester of 2000. For TBs, annual amount was estimated from actual data for first three quarters, 2000.

percent. From 1995 to 2002, rural banks' share of agriculture-production loans was 14 percent while thrift banks had 15 percent.

Food commodities receive approximately half the total agricultural production loans while export and commercial crops get about 20 percent of those loans. Among the food commodities, livestock and poultry get the biggest share, with 30 to 40 percent, while cereals and the fruit, vegetable, and rootcrops food group receive about 25 percent each. Annex C provides a detailed breakdown of loans granted to each commodity group.

The large commercial farms (agribusiness, plantation farms producing exportable crops, e.g., pineapple, bananas) have access to loans from commercial banks. Large agribusiness firms that operate those commercial farms have entered into contract-growing schemes with farmers to grow those crops. They have also utilized their internal funds to finance commercial operations. On the other hand, those farms that have shifted to livestock and poultry were also able to borrow from private banks. The large demand for chicken and pork in rapidly urbanizing areas has made livestock and poultry business a profitable venture for commercial growers. Private commercial and thrift banks have lent to these borrowers without having to depend on government credit funds.

Smallholder agriculture devoted to rice and corn production has not been able to get substantial funding from private commercial and thrift banks. The main sources of formal loans are the Land Bank of the Philippines (LBP) and rural banks.⁶ The credit programs of government financial institutions currently supporting agriculture are mainly for primary production of rice and corn. The focus on rice and corn production implies that major government support (infrastructure, research and development, extension, technology and financing) has remained concentrated on those particular crops. However, in reality, a very large number of farmer borrowers (60%) continue to depend on informal lenders for their production financing as reported in a 2002 survey of the ACPC.⁷

It appears that Philippine agriculture is not production-credit constrained but investment-credit constrained. Smallholder agriculture get financing from a variety of loan sources, both formal and informal. Exportable and commercial crops receive financing from private commercial banks but a serious gap remains with other types of high value crops such as long-gestating crops (e.g., rubber, oil palm). Private banks have not provided fi-

⁶ LBP has traditionally provided agricultural production loans to small rice and corn farmers especially agrarian reform beneficiaries.

⁷ The informal lenders are composed of the traditional moneylenders, rice traders and input suppliers. The informal lenders are able to provide loans that are timely, without the traditional collateral required by banks and with no requirement for tedious loan documentation.

nancing for long-gestating crops. They are more comfortable financing short-term, high value crops, livestock and poultry.

In general, there is a dearth of long-term financing in the agriculture and rural sector, e.g., financing for long-term crops such as palm oil, rubber and others. Access to financing is easier for traditional annual crops such as rice and corn but perhaps, near to impossible for long gestating crops. According to a bank official, recent LBP total lending to agriculture projects is about Php70 billion, of which barely P200 million is for long-gestating crops.

One reason for the lack of long-term financing is the banks' negative response to the fragmentation of agricultural lands brought about by agrarian reform. Lands have been traditional collateral to bank loans and from the bank's perspective, agrarian reform has a negative impact on the collateral value of those lands. Certain provisions in the Comprehensive Agrarian Reform Program (CARP) such as: (a) ownership ceiling; (b) transferability of the lands and the holding period; (c) uncertainties created by the slow implementation of agrarian reform and the (d) negative effects on land consolidation and the collateral value of agricultural lands have effectively acted as barriers to private investments in agriculture and the rural areas (David et al. 2003; and Llanto and Estanislao 1993). The issue of agrarian reform as a barrier to private investments and access to private commercial financing is an important issue that policymakers have to address in the near future.

The negative impact of agrarian reform on the collateral value of agricultural lands does not seem insurmountable as indicated by the experience of successful commercial farms in Mindanao that grow commercial and export crops (e.g., banana). They were able to consolidate extensive lands for cultivation by entering into contract growing schemes and leaseback arrangements with agrarian reform beneficiaries to produce the export crop. The contract growing schemes include support for quality inputs as well as. More recently, a few large agribusiness firms have entered into contract farming arrangements with small farmers for raw materials and other inputs. Those agri-business firms get financing from commercial banks which implies that indirect financing is being given to small farmers with contract farming arrangements with those firms.

Financing support: loan to output ratio

A rough indicator of formal financing support to the agriculture, fishery, and forestry sector may be the ratio of loans granted to the sector to gross value added (GVA) of the sector. Overall loan-to-output ratio is highest in the service sector (Table 7), since it received the largest financing support from

banks. In 1998-2002, the AFF sector received less than P1.00 in loans from the banks for every peso output in agriculture.

The loan-to-output ratio for agriculture production was 25 percent in 2002, a slight increase from 22 percent in 2001 (Table 8). This means a financing support of P0.25 from banks for every peso output of the agriculture-production sector. Loan-to-output ratio in 1996 was a hefty 126 percent, a clear departure from the normal trend. The BSP reported on that particular year a significant increase in agriculture-production loans granted by all banks.⁸

Averaging the loan-to-output ratio of the last five years, the banks financed only P0.26 of every peso output of primary agriculture.

Table 7. Loan to output ratio, by sector

	1995	1996	1997	1998	1999	2000	2001	2002*
AFF	n.a.	n.a.	n.a.	66.21	78.72	63.76	75.41	82.33
Industry	29.96	198.75	136.35	123.42	108.06	84.13*	n.a.	n.a.
Service	134.81	838.23	728.51	541.97	557.94	474.65*	n.a.	n.a.

Source: BSP

* Data up to Oct. 2000

Table 8. Ratio of production loans to GVA in agriculture, in percent

	1987	1990	1995	1996	1997	1998	1999	2000	2001	2002
Loan to Output Ratio	16.75	17.48	20.03	126.11	82.15	25.48	33.40	21.62	22.32	25.30

Diversification of rural income source

Rural income still largely comes from farm production although income from nonfarm activities is becoming significant. Data show that in 1987, on-farm income dominated total rural income, with a 56 percent contribution, while off-farm income had seven percent. This means that 63 percent of rural

⁸ This seems an abnormal performance. ACPC and/or BSP would do well to determine the reason or reasons for this.

income came from farm production⁹ (Table 9). However, by 1990, farm production income (onfarm and off-farm incomes) had declined to 57 percent while income from nonfarm and other sources increased to 43 percent. Income from nonfarm activities and other sources has become a significant source of rural incomes.

Table 9. Distribution of monthly income of farm households (in percent)

	Total	Onfarm	Off-Farm	Nonfarm	Other Sources
1987	100	56	7	25	12
1990	100	47	10	31	11

Source: BAS

Note: An updated version of data will soon be released by BAS.

Remittances from overseas Filipino workers (OFWs) and relatives based abroad have also become an increasing source of income for many Filipino families. They contributed 32 percent of the total income generated within the period 1991-2000 and helped keep the economy afloat (Table 10). With the decrease in incomes from agriculture and agriculture-related activities, remittances have become an alternative and significant source of income for rural families. Although a large number of OFWs are from urban areas, such as the NCR and Southern Tagalog, many of them also come from regions where poverty levels are high (Table 11).

Some families depend entirely on these remittances as their main source of income while others have used a portion of these funds to pursue informal lending activities that provide external financing to farmers and entrepreneurs. Thus, these remittances either directly or indirectly provide the rural areas with the necessary funds that formal institutions cannot supply. Either way, the increase in remittances has contributed to the growth of business and economic activities in the rural areas.

Continuing reliance on informal credit

Smallholder agriculture has continued to rely on informal sources of financing. The symposium series of the ACPC in 1999 concluded that despite the financial reforms pursued by government, agricultural and fisheries lending

⁹ Onfarm income comes from a farmer's own farm; off-farm income comes from working on another farmer's farm.

Table 10. Percentage distribution of income received from selected sources

	1988	1991	1994	1997	2000
Total	100	100	100	100	100
Wage and salaries	43.3	41.7	44	45.6	52.1
Agricultural	5	4	4	3.2	3
Nonagricultural	38.3	37.6	40	42.2	49.1
Entrepreneurial activities	29.8	30.5	27.7	26.2	25.1
Crop farming and gardening	9.9	8.9	8.6	7	6.7
Livestock and poultry raising	1.1	1.1	1.1	0.9	0.4
Wholesale and retail trade	9.7	9.7	9.1	8.7	8.3
Manufacturing	2.1	1.8	2	2	1.5
Other entrepreneurial activities	7	9	6.9	7.6	8.2
Other sources	26.9	27.8	28.3	28.2	22.8
Net share of crops	1.5	1.5	1.1	0.9	0.5
Receipts from abroad	7.5	8.4	8	6.8	11.1
Rental value of occupied dwelling units	7.9	8.4	9.4	10.3	3.6
Family sustenance activity	2.2	1.9	1.8	1.3	0.2
Others	7.8	7.6	8	8.9	7.4

Source: BSP

had remained unattractive to banks while access of small farmers to formal loans had not improved. Caneda and Badiola (1999) opine that agriculture has not become a profitable sector, adding it has become riskier while banks have become more selective in lending.

Traditional banks have failed to innovate and develop savings and credit products nor contributed to the simplification of lending procedures that would fit the requirements of the small farming and nonfarming sectors in the rural areas.

In the 2002 Small Farmer and Fisherfolk Credit Accessibility Survey conducted by the ACPC, the majority of respondents indicated that access to credit had become more difficult in 2001. These respondents expressed the

Table 11. 1997 distribution of OFWs, by region

Distribution of OFWs		Rank
PHILIPPINES	100	
NCR	19.1	1
CAR	2	12
Ilocos	12.6	3
Cagayan	5	6
Central Luzon	12	4
Southern Tagalog	18.9	2
Bicol	2.7	9
Western Visayas	9.4	5
Central Visayas	4.2	7
Eastern Visayas	1.8	14
Western Mindanao	3	8
Northern Mindanao	1.3	15
Southern Mindanao	2.6	10
Central Mindanao	2.4	11
ARMM	1.9	13

Source: Go 2002

opinion that obtaining loans from banks remained difficult and that government support on credit was inadequate. The main source of credit was still the informal lenders although there seemed to be a shift to formal sources in recent years (Table 12).

Distribution of loans is more concentrated among large farmowners, who can present acceptable loan collateral and who probably have better risk management techniques while small farmers or rural borrowers are limited to informal moneylenders. High transaction costs of small farmer loans dis-

Table 12. Borrowing by major source of loans: 1996-2002

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
Formal and informal lenders			5.3

Source: ACPC 2002

courage bank lending. It seems informal moneylenders have solved this problem and thus, continue to lend to those excluded by the banking system.

Borrowers are more concerned about accessibility and timeliness of loans than they are with interest rate. The costs involved in processing a formal loan application and the time spent to meet the loan requirements outweigh the low interest rates offered by government formal financial institutions.

Informal credit markets, on the other hand, offer products that are specifically designed to meet the needs of borrowers while alternative collateral (e.g., third-party guarantees) is widely accepted. However, these informal moneylenders operate on a very limited supply of funds, which is not sufficient to service a large number of borrowers. They may have the ability to service those borrowers excluded by the formal banking system, but they cannot expand their outreach and face covariant risks arising from the contiguity of areas where they operate and the relative homogeneity of borrowers they serve, thus constraining their financing capacity.

Lack of financial depth and limited access

Despite government efforts to increase the flow of credit toward the rural sector, formal financial institutions have largely ignored the sector. Financial depth is still lacking and very limited access to financial services continues to hound the rural sector. Loans granted to the agriculture, fisheries, and forestry sector have barely increased throughout the years. Loans granted by banks, specifically to agricultural production, have remained insignificant. Rural economic agents have limited access to financial products and services and bear the high costs of limited financial services they can obtain. It seems that information problems, high transaction costs, the lack of instruments to mitigate and manage various risks affecting the sector (e.g., weather and price risks), and the general state of the rural economy, including the attendant problems associated with land ownership issues, lack of infrastructure, etc., have worked against the sector's ability to get more formal financing support. Yet, despite the lack of funding from banks, the agriculture sector has contributed 20 percent to overall GDP.¹⁰

With more efficient and longer-term financing, the agriculture and rural sector would have registered higher growth. The availability of formal and longer-term financing is important in view of the growing importance of

¹⁰ In 1995, GDP contribution was 21 percent for agriculture, fishery and forestry; 35 percent for industry, and 43 percent for the service sector.

nonfarm activities as a source of rural incomes. Data show the decreasing share of incomes from onfarm production and off-farm activities to total rural incomes. Nonfarm activities now contribute an increasing share to total rural incomes. Thus, rural financing should be expanded to serve the non-farm, rural enterprises as well instead of being limited to agricultural production. There is a need to develop innovative financial products and services beyond short-term production credit facilities. Financial products such as medium and long-term credit, deposits, insurance, leasing, inventory credit, among others, that are demanded by nonfarm processing and small manufacturing enterprises can boost the rural economy. OFW remittances as a newfound source of liquidity and funds for countryside investments should be harnessed to meet the huge savings-investment gap confronting the country.

The duality of economy in the rural sector is a serious problem that hinders sufficient financial services from being properly extended to the rural borrowers. This implies that the rural financial market is seriously constrained by several factors: weak institutions, imperfect information-sharing networks, inadequate mechanisms for enforcing credit contracts and poorly developed systems for supervising rural financial entities. These explain why rural customers, especially small and medium-sized entrepreneurs and farmers, are excluded as potential clients by formal institutions (Agabin and Daly 1996).

Government efforts in rural financing

From 1970s to the mid-1980s, the government provided loans at highly subsidized rates to bring down the cost of borrowings among targeted sectors. The most famous example of subsidized credit was the supervised credit component of the Masagana 99 rice production program. Other subsidized credit programs were also created to bring about higher production of corn and other farm products, fish, etc.

Financial market reforms came in the 1980s. Interest rates were deregulated and a market-based interest rate policy was adopted. Subsidized rediscounting programs at the central bank were also terminated while the former Central Bank of the Philippines started to move away from development financing, leaving this function to government financial institutions, namely, the Development Bank of the Philippines (DBP) and the LBP. In 1986, the Aquino administration abolished a number of subsidized credit programs for the agricultural sector. It consolidated 20 agricultural credit programs under CALF and established a credit guarantee fund for small farmer loans to encourage banks to lend to small farmers who did not possess the traditional collateral, that is, real estate, required by banks.

The credit guarantee schemes for the agriculture sector were found ineffective in increasing the flow of formal credit to small farmers based on evaluations both on the financial institutions' side and that of the end-borrowers (Llanto and Magno 1994). Banks continued to demand the traditional collateral (e.g., real estate) in addition to the credit guarantees provided by the government. It is said that banks preferred to lend to their regular clientele (not the intended clients—the small farmers), believing that the government's guarantee facilities might not have adequate reserves to meet a sufficiently large claim (Esguerra 1996).

Unfortunately, other government agencies continued to implement their respective subsidized credit programs. It was only in the agriculture sector that subsidized credit programs were terminated. Responding to the clamor by various groups, such as farmers, for access to cheap credit, politicians and government bureaucrats alike revived subsidized credit programs. 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 and the viability of formal rural financial markets.

Subsidized credit programs, or the so-called directed credit programs (DCPs), remained the major source of credit for small farmers and fisherfolk, next to informal lenders. However, DCPs had created much duplication, segmentation, and distortion in the rural financial markets. The provision of credit subsidies resulted in an enormous fiscal burden. These undermined the development of viable and sustainable rural financial markets. The lack of adherence to market-based policies and principles failed to ensure that access to financial services by small and marginalized borrowers would be met. Thus the need to terminate direct subsidized lending by government agencies (Llanto et al. 1999).

As of 2003, there were 27 agriculture-lending programs, primarily for farm and farm-related improvements. The brief profiles of selected agriculture-lending programs are presented below from descriptions provided by ACPC.

Development Assistance Program for Cooperatives and People's Organization (DAPCOPO)

DAPCOPO's main objective is to provide assistance to agriculture-based activities not serviced by banks. It does this through cooperative federations, people's organizations, and nongovernmental organizations (NGOs). Eligible conduits of financial assistance coming from the Department of Agriculture (DA)-ACPC are national or regional federations of farmers' groups

with management capabilities and satisfactory lending track record. Regional federations are expected to be sponsored by a national organization. Also eligible are agriculture-based organizations not financed by LBP or other banks.

A 1995 ACPC review of the program indicated high loan repayment rates but low utilization level. The program was found to have underperformed in terms of utilization level, for which the explanation given was the inadequacy of the program design and faulty implementation. In addition, the institutional development component was not properly implemented.

Program monitoring had been directed to primary organizations while activities of federations had not been monitored. The results were irregular submission of quarterly monitoring reports and low utilization level of DAPCOPO loans. The evaluation study recommended that the program's objectives be simplified, that it invest in institutional development and improve its monitoring. With regard to the design and implementation of the program, the study suggested the following:

1. Eliminate retention at the program level and capital contribution at the federation level;
2. Use financial institutions instead of cooperative federations;
3. Set up a central project management office with federations involved on a fee-for-service basis;
4. Maintain a revolving credit line for each federation;
5. Strengthen loans marketing capacities of federations;
6. Select one financial institution to approve loans and allocate program funds;
7. Require federations to share in the loan default risk;
8. Avoid making direct loans;
9. Pick winners and support them fully; and
10. Revise program design.

Grameen Bank Replication Program (GBRP)

The GBRP seeks to extend loans to the poorest of the poor, eliminate exploitation by the moneylenders, and create opportunities for self-employment. At the program level, the eligible conduits are development foundations, people's organizations, and cooperative rural banks. At the beneficiary level, eligible borrowers are the members of the group, particularly women, the landless, or those cultivating land not exceeding five hectares, and residents of depressed areas.

An ACPC evaluation shows that the GBRP has made a significant impact on the standard of living of its beneficiaries. It was also found to have

reduced dependence on informal sources. The program has exhibited high repayment rates, ranging from 94 to 98 percent. Institutions replicating the Grameen Bank approach have been able to secure low-cost funds for lending, improve their staff capability through training conducted by ACPC, and realize their vision for their respective communities. Of those replicating the program, banks have performed better financially while cooperatives have the highest profitability ratios, mainly because they received greater financial assistance from the government. The participants in the program have demonstrated that they can be effective channels of affordable credit to the poor, provided incentives or subsidies are given to them.

Following are recommendations to improve the program:

1. Review loan ceilings periodically to account for changes in the general price level;
2. Allow institutions to charge market-oriented interest rates on loans and to offer market-based savings product;
3. Promote savings mobilization; and
4. Intensify efforts to develop entrepreneurship among borrowers.

The government, for its part, should focus on institution building and staff training, and act as broker of funds for lending by participating institutions to beneficiaries. It should also limit assistance during the initial years of the program. Guarantee funds for programs should also be eliminated.

Integrated Rural Financing (IRF)

The IRF is sponsored by the LBP, DA and ACPC. It provides financing through rural financial institutions to enhance the production income and repayment capacity of organized small farmers and fishers. Eligible conduits for this program are rural financial institutions such as rural banks, cooperative rural banks, private development banks, and cooperatives while end-borrowers are small farmers and fishermen.

Based on a review of the program conducted for ACPC, LBP's loan portfolio targets have largely influenced program performance and led to provision of loans to cooperatives that do not have adequate social and institutional preparation. The institutional-building component has no policy for graduation of cooperatives and lacks standardized tool for assessing training needs of cooperatives and measuring the impact of cooperative training. The monitoring system is heavily oriented toward outreach and loan disbursements, paying very little attention to performance indicators of potential operational and structural problems.

The overall program performance shows that IRF was able to reach poor rural households. Loan repayment rate was high at the start of the program but was not sustained over time. Overall savings-to-loans outstanding ratio is low, reflecting poor deposit mobilization efforts among cooperatives. Most cooperatives exhibit either mediocre or low-level financial performance. The cost of implementation has been on the low side, notwithstanding its nationwide coverage. The sustainability of IRF loan funds cannot be determined having been mixed with other LBP funds.

The study suggested the following to improve the program:

1. Review the program objectives;
2. Ensure loan repayment by having zero tolerance for loan delinquency;
3. Revise the monitoring system;
4. Define the policy framework for graduation of cooperatives;
5. Develop standard tools for assessing the training needs of cooperatives;
6. Develop and promote savings and loan products that are suitable to client needs and preferences;
7. Review current administrative supervision by LBP;
8. Tap experienced service providers in view of limited capacity of current service providers, or build the latter's capacity through an incentive system;
9. Conduct an internal review of staff caseloads;
10. Track separately the loan funds of the program from those of the LBP;
11. Apply a standard system of cooperative performance and reports;
12. Focus on savings mobilization; and
13. Provide guidelines on how cooperatives could perform efficiently.

Fisheries Sector Program (FSP)

The FSP, funded by the Asian Development Bank, seeks to alleviate poverty among fishermen through the diversification of their sources of livelihood. Target areas are several priority bay areas. Eligible conduits are rural financial institutions accredited by the LBP, DBP, Philippine Crop Insurance Corporation, and Quedan Rural Credit and Guarantee Corporation (Quedancor). The endborrowers are marginal coastal fishermen's cooperatives and small aquaculture operators.

Despite its small credit outreach, the FSP's program administrators have allowed credit provision even to non-priority areas. Survey results indicate that while utilization of FSP loans may have improved in the priority bay

areas, the program's impact on promoting alternative livelihood has been severely stifled by the limited outreach of the program's credit and other components, and by the provision of credit even to nonpriority areas.

According to ACPC, FSP could have improved its performance had information about the program been effectively disseminated, and mechanisms to ensure sustainability installed and program intervention confined to priority areas.

Central Cordillera Agricultural Program II (CECAP)

The European Union-funded CECAP seeks to increase rural incomes and living standards in target areas. Eligible credit conduits of this program are cooperatives, Annual Savings and Loans Assembly, and agricultural savings organizations. Eligible borrowers are beneficiaries of CECAP-implemented micro-projects, members of accredited producer groups, savings and loans groups, and the poorer members of target communities.

In its review of the programs, Euronet Consulting pointed out that the first phase of the project, a direct lending program, failed. In the second phase, the project developed a parallel financial market by linking CECAP-established groups to municipal key cooperatives. The attempt was largely unsuccessful. Viability, especially in remote areas, was a perennial major concern. An effective and efficient loan tracking system was not introduced at all. CECAP thus realized that its role as a wholesaler of loans was not sustainable and the program design needed a review, with emphasis on savings mobilization, collection of outstanding balances, and appropriate institution building.

Upland Development Program in Southern Mindanao (UDP)

Funded by the European Union, the project's primary objectives are (a) to develop and test a replicable model for sustainable management of the natural resources in the uplands of five provinces in Region XI; (b) to enable upland communities to address their subsistence needs; and c) to produce new marketable surpluses through sustainable market-led agricultural development. Eligible credit conduits for this program are rural banks, cooperatives, and NGOs. Eligible borrowers are small farmer producers, small entrepreneurs within the program area, and cooperatives.

The UDP microfinance approach is described as an institution-building and strengthening exercise that complements the existing formal financial market. At the grassroots level, farmers are organized into groups. Besides the support on a complementary institutional scheme, the project also seeks to forge a cofinancing agreement with partner financial institutions.

Thus, it goes beyond what most credit projects supported by the European Union have done.

Euronet Consulting's review of the program indicated that local government units should not be part of the lending scheme. Although this requirement was explicitly stated in the Financing Memorandum between the government and the European Union, it was never observed during the program implementation. The credit strategy pursued by the participating banks deviated from the planned credit strategy of the program.

Aurora Integrated Area Development Project Phase (AIADP)

This project, funded by the European Union, aims to alleviate poverty, promote growth with equity, and develop environmentally sustainable economic activities. Eligible borrowers are farmer owner-operators or share tenants with 0.5 to 2 hectares of land, and the rural poor with viable projects within the province of Aurora.

The project has developed a parallel financial arrangement with the Cooperative Bank of Aurora, but it was shortlived. This has raised questions about the viability of the credit component of the program. The Cooperative Bank of Aurora needs capital infusion to facilitate the implementation of lending and institution-building measures.

Catanduanes Agricultural Support Programme (CATAG)

This project is also funded by the European Union and was established to assist rural communities to initiate and sustain increases in income for all economic activities with a view to reducing poverty. Eligible borrowers in this program are the rural poor of the 11 municipalities of Catanduanes.

CATAG was instrumental in the establishment and strengthening of a local NGO operating on Catanduanes Island. It needs further institution building and must expand its services to include other areas of the Bicol region.

Economic Self-Reliance and Southern Cordillera Agriculture Development Programme

This program aims to help the indigenous rural folk in highland areas by promoting an agro-based local economy that will allow them to improve their lives and enable them to remain where they are. Target areas for implementation are Benguet, Nueva Viscaya, and Nueva Ecija. Small farmer producers, small entrepreneurs within the program area, and cooperatives are the eligible borrowers of this program.

The program strategy is to simultaneously upgrade grassroots-based institutions and improve the accessibility of savings and credit services of microfinance institutions. However, the sustainability of credit projects in remote areas remains a concern.

Agriculture and Fisheries Modernization Act (AFMA)

AFMA (Republic Act 8435), enacted into law in late 1997, is the government's response to help transform and modernize the agriculture sector. AFMA provides a vision and program for comprehensive rural development. It mandates public investments in rural infrastructure, irrigation systems, research and development as well as the reform of government's agricultural credit programs. The Act declares it a policy of the state to vigorously promote the growth of the countryside economy through access to credit by small farmers, fisherfolk, women, and the small- and medium-scale enterprises involved in the production, process, and trading of agriculture and fisheries products. It also encourages active participation of private banks and government financial institutions in the rural financial system.

Since AFMA authorized the termination of directed credit programs (i.e., subsidized credit programs), Congress created the AFMA-mandated Agro-industry Modernization Credit and Financing Program (AMCFP), which will lend government loan funds to the agriculture sector through private financial institutions. Based on the ACPC's design of the program, the disbursement of credit funds by the AMCFP will be determined by the market demand of its wholesalers and retailers and will be at market rates.

One of the most important institutions in agricultural credit is LBP, whose role in agrarian reform and in the delivery of credit services to the agriculture sector has been reaffirmed by AFMA.

Aside from LBP, another institution envisaged to provide credit support for farmers, fishermen, rural workers, cooperatives, retailers, wholesalers, and primary processors of agricultural and aquatic commodities under AMFCP is Quedancor. AFMA mandated Quedancor to develop an appropriate credit guarantee program for small farmers and fisherfolk.

Role of foreign donors

Donor-supported credit programs, that is, funded through grants, do not seem to be sustainable on a long-term basis, because once donor support is withdrawn, funds start to dry up, indicating the lack of viability of those donor-designed credit programs. The implementing agencies are paralyzed for lack of funds, resulting in the abandonment of the programs. When an-

other batch of donors comes in, another round of negotiations will ensue, and new programs designed by consultants hired by donors will be implemented. There is no continuity of programs, and little interest in sustainability is exhibited. The boom-bust cycle of donor grant-funding, coupled with the lack of funds once the donor leaves the program, has proved detrimental to the rural financial markets. It has also discouraged efforts to have viable credit programs and a vibrant rural financial market due to donor dependency among credit conduits and loan recipients.

It is, however, to the credit of the donor community, that the shift toward market-oriented credit and financial policy and sustainable credit programs has happened following pressure from some donors who realized the futility of subsidized credit programs.

The World Bank's Operational Directive 8.30 shifted the bank's policies from the fund transfer objectives of traditional agricultural credit projects to those of building viable financial institutions that operate in rural financial markets. A preferred strategy is to develop the rural financial intermediaries by linking the formal with the informal credit systems. As long as the institutions are competitive and market-based, there would be no market segmentations (Yaron et al.1995).

The Consultative Groups Assistance to the Poorest reports the following problems that plague donors' financial sector operations: (a) imperatives to move money overriding technical concerns; (b) lack of clarity of goals; (c) a narrow view based on objectives that resonate with citizens of the country providing the assistance rather than in response to local concerns in recipient countries; and (d) staff who are not well versed in institution building. The largest continuing threat posed by donors' efforts to create a better world through credit projects and provision of other financial services is inconsistency in creating or selecting institutions that are capable of pursuing donors' visions within any given public policy milieu (Von Pischke 2003).

Donor support, though, can play an important role in ensuring the progress of the rural sector in the Philippines. Developing innovative products and services, for example, could benefit from donors' assistance, as the government is usually budget-constrained while the private sector does not have the initiative to invest in such experimental ventures. The next round of donor assistance, for example, could focus on how to support the emergence of a diverse system of financially sustainable institutions that have the motivation to innovate and adapt their lending technologies to specific socio-economic and agrarian context of the Philippine countryside (Llanto and Fukui 2003).

III

RECENT DEVELOPMENTS IN RURAL FINANCE

Sound macroeconomic framework and financial sector reforms

The basic infrastructure of a sound financial system is a sound macroeconomic framework. High inflation, large government fiscal deficits and flawed economy-wide policies undermine the growth of rural economies and rural financial markets.

The need for an enabling policy environment

Unsound macroeconomic policies result in volatile and high real interest rates that can adversely affect all financial intermediaries, while misaligned exchange rates distort price signals and lead financial markets to channel excessive resources to inefficient sectors. In addition, inadequate regulatory oversight, inappropriate interventions in financial markets, and financial repression increase the risks and constrain the development of financial markets (Yaron et al. 1998). On the other hand, favorable macroeconomic and sector policies are necessary conditions for expanding the frontier of rural financial services (Gonzalez-Vega 2003). Bad macroeconomic management, on the other hand, can thwart the gains brought about by financial market reforms (Lim 1998).

Since the postwar period, agriculture and rural development has suffered from policies that tended to favor industry and urban growth. For example, the postwar protectionist policy environment in the country favored the import-substituting manufacturing sector. This protectionist bias has disadvantaged the agriculture and rural sectors, which eventually lagged far behind the urban sector. Esguerra (1996) notes that economic policies biased against the agriculture sector as a whole, or against the food crop sector, where smallholder production dominates, necessarily lead profit-maximizing financial institutions to lend away from these unprofitable sectors. Negative real interest rates further induce banks to choose the safer and bigger urban-based borrowers instead of the risky and small rural farm producers.

This obstructs the flow of funds into the rural sector, constraining the productivity and growth of the sector. However, trade reforms and liberalization in the 1990s (e.g., tariff reforms during the Aquino and Ramos administrations) somehow lifted the bias against the agriculture and rural sectors. The economy's integration with global markets and the accession to the World Trade Organization have helped ease the policy bias.

The importance of eliminating the policy bias against certain sectors of the economy is highlighted, for example, by a study by Mundlak et al. (1990), which shows the effects of macroeconomic and trade policies on the different sectors of the economy through the prices of inputs and the tradability of goods. They trace the influence of macroeconomic policy on the relative prices of exports, imports, and home goods. The importance of trade in a sector's income and the influence of macroeconomic policy on the prices of the sector's goods, which both accounted for the sector's degree of tradability, determine the magnitude of the effect of policies on a particular sector. Thus, Mundlak et al. (1990) argue that economy-wide policies have substantial effects on both the real exchange rate and the incentives to agricultural exports. As most product groups have both traded and non-traded components, they are affected by changes in the real exchange rate. Bautista et al. (2001) maintain that biases against agriculture, namely, (a) a direct bias wherein producer prices were suppressed by sector-specific policies in the form of agricultural export taxation, and (b) an indirect bias through the effects of policies on exchange rates, affected agricultural incentives as well as agricultural and rural sector growth. One of the highlights of Lamberte and Lim's (1987) review revolves around the importance of maintaining a sound macroeconomic framework, including a market-based exchange rate policy. The overvaluation of the peso, which hurt agriculture more than the other sectors, and the urban-biased development of infrastructure, supported the import-substitution policy pursued by the government in the postwar years, and this continued until many decades later. They thus recommended a re-examination of trade and exchange rate policies and the construction of more farm-to-market roads and other physical infrastructure to promote agricultural productivity.

Financial sector development and growth

The study of Khan and Senhadji (2000) shows a positive link between financial development and economic growth. It is the more developed countries that have sophisticated and more developed financial markets. The study's empirical results reveal a strong positive and statistically significant relationship between financial depth and growth. Their study also suggests a nonlin-

ear relationship between financial depth and growth. Earlier, McKinnon and Shaw (1973), pointing out the close relationship between financial depth and growth, argued that hindering the development of financial markets would ultimately reduce growth. In this regard, King and Levine (1993) conclude that financial development has predictive powers for future growth, as evidenced by the causal relationship running from financial development to growth.

Financial sector development is both a function and a determinant of economic growth. Promotion of economic development through creation of an enabling environment for the private sector, public enterprise reform, and efficient and effective delivery of functions by the government, including maintenance of macroeconomic stability, will also promote financial sector development. At the same time, economic development depends on an efficient, competitive, and responsive financial system, capable of mobilizing savings for the funding of investment projects.

Robust financial sector development is essential to growth and poverty reduction. Globalization spawns new challenges to the design of the financial sector, potentially replacing domestic with international providers of some of the financial services, and recasting the role that government can efficiently play in the financial markets. Creating the right policy mix or environment will lead to efficient markets. Financial and rural credit markets, on the other hand, require the right financial and rural credit policies.

Finance has a crucial role in the production and consumption opportunities of a household in an economy. An inefficient credit market, for example, would constrain the production and consumption possibilities of the affected households or economic agents, leading to a lower level of welfare. Esguerra (1996) states that a well-functioning financial market contributes to development by mobilizing deposits from savers with inferior investment opportunities and allocating these funds to borrowers with high-yielding investments. This process makes resource allocation efficient, increases the yield on capital, and brings about a higher growth of output.

Financial sector reforms

Yaron et al. (1998) believe that an assessment of the efficiency of markets, particularly rural financial markets, is a useful starting point for the formulation of policies aimed at increasing rural incomes and reducing poverty. The assessment should constitute, among others, an appreciation of the macroeconomic framework governing the functioning of markets, specific urban-biased policies that reduce the attractiveness of agriculture and nonfarm rural sector, and policy distortions that devastate rural financial markets. Once

factors impinging on the efficiency of those markets have been identified, key policy options could then be evaluated. One such key policy options is the promotion of financial sector reforms.

The liberalization and deregulation of the financial sector in the Philippines began in the 1980s. Some of the reform efforts in the 1980s were ironically biased against the growth and development of financial markets. Yet, the Central Bank justified those reforms as means to stabilize the financial system (Chan 1991). The establishment of bank branches in the early 1980s was based on the density of bank presence in service areas. Thus, according to the Central Bank, if a particular area was “overbanked,” branching was restricted in that area. Banks were also required to invest in government securities and comply with certain paid-in capital requirements before they could set up branches in other locations. The conditions for branching led to the setting up of most bank units in the urban areas, with the National Capital Region capturing 31 percent of total bank units in the country. Hence, the growth of banking facilities and services was concentrated in Metro Manila.

Central Bank Circular No. 1200, issued in 1989, provided for the reduction in bank entry restrictions. The restrictions shielded both the big and small banks from competition, allowing big banks to earn abnormal profits while leaving small banks to operate at high costs. When closely examined, Circular No. 1200 proved to be restrictive, since the Central Bank also continued to increase the minimum capital requirement for banks (Lamberte and Llanto 1995). Mergers and consolidations were still encouraged, suggesting that the Central Bank preferred few but large banks. Bigger and fewer banks were believed to promote the safety and soundness of the country’s financial system. The dominance of large banks resulted in a concentration in market power among these banks, giving them oligopolistic power over pricing. It was only in 1992 that these restrictions to bank entry began to be effectively relaxed. In 1995, they were further simplified and made uniform across banks. The geographical restrictions on domestic bank branching were lifted in 1993 (Milo 2001).

The 1997 Asian financial crisis led the BSP to impose a moratorium on the establishment of new domestic banks and branch expansion of existing banks except for microfinance-oriented banks. Increases in the capital requirement were also mandated in a bid to restore the financial health of the banking industry that had been weakened by nonperforming loans. The downside to the BSP requirement for increased bank capitalization and the moratorium on the establishment of new banks and branches was the erection of an effective barrier to entry within the banking industry. The cost of

setting up a new rural bank, for example, became prohibitive for small investors. This prevented small banks like rural banks, which could have served the rural areas, from opening. Milo (2001) notes that BSP mandated consecutive increases in the minimum capital requirement for new banks. The General Banking Act 2000 finally formalized a three-year moratorium on new bank entry.

The passage of Republic Act 7721 in 1994 promoted competition in the banking industry. The Act partially liberalized the entry and scope of operations of foreign banks, but tight branching restrictions remained. A survey by Hapitan (2001) shows that foreign banks initially catered more to wholesale banking, thereby increasing competition in that area. However, notwithstanding the reform efforts at liberalization and deregulation, access to credit was not necessarily made easier for certain borrowers (e.g., rural borrowers, small farmers, etc.). In his paper on the effects of reforms on the agriculture sector, Kraft (1998) finds no positive impacts on bank lending to the agriculture sector over the past decade. By 1998, the share of agricultural loans from commercial banks fell to less than 1 percent from a range of 6 to 7 percent in the late 1980s. Agricultural loans from rural banks also fell from an average of 65 percent of their total loans in the late 1980s to around 47 percent in the period 1990-1998. There was also a decline in the demand side, as shown by the share of farm household-borrowers dropping to 34 percent in 1994-1996 from 49 percent in the 1980s.

Llanto (1990) emphasizes that there was no certainty that small farmers would gain access to bank credit in a liberalized financial environment. Lamberte and Llanto (1995) agree that a deregulated environment does not necessarily make credit available to all types of borrowers if the macroeconomic environment constrained microeconomic behavior. Both structural (e.g., urban-biased development of infrastructure) and policy reforms (e.g., financial liberalization) were needed to enable rural economic agents to benefit from financial liberalization and deregulation.

Subsidized and directed credit was also heavily criticized because it discouraged deposit mobilization. It damaged the ability of the financial system to assist in more efficiently allocating resources within the economy. Access to cheap rediscounting facilities made financial intermediaries more dependent on the outside funds for on-lending and lessened their willingness to provide attractive deposit services for clients, especially those dealing in small amounts (Adams and Lim 2000).

Credit programs could be effective in alleviating poverty if poor people capture most of the subsidies. However, despite the targeting of credit programs to particular groups and activities, the actions of both lenders and

borrowers are beyond their control (Adams and Lim 2000). As such, those who can enjoy the subsidies more are those with greater access to credit loans. Small farmers who can only obtain small loans are disadvantaged by the practice of banks to grant big landowners bigger loans, thus enabling the latter to capture bigger credit subsidies.

There were changes to the approach in rural lending. The credit programs, although still heavily focused on agriculture, already provide financing for a comprehensive range of activities instead of being confined to a specific commodity and activity, such as what happened in the past. Group lending, rather than individual lending, is emphasized. Savings mobilization has been included as a component, although still comprising only a minor part, of the programs (Esguerra 1996).

Yet, despite the huge amount of financial resources being poured into the sector, Llanto (2001) observes that many farm households still have no access to formal credit. Therefore, they still rely on the informal sector for their consumption and investment, including working capital, requirements.

The failure of (subsidized) credit programs to reach the rural borrowers, particularly the poor, may well be because these programs only address the symptoms rather than the causes of inadequate rural financial intermediation (Sharma 2000, quoted in Llanto and Fukui 2003).

The end of subsidized credit

In an attempt to stimulate growth and reduce poverty in the rural sector and perhaps to compensate for the policy biases against agriculture, the government provided farmers with cheap funds at highly subsidized rates. Targeted programs for rice, corn, and other commodities were implemented, especially in the 1970s-1980s. Mandated credit quotas for agriculture and agrarian areas and a deposit retention scheme in favor of rural areas were imposed, and special time deposits and a subsidized rediscounting facility were made available by the Central Bank.

Stiglitz (1994) contends that the rationale behind interventions in the market, such as targeted credit programs, is that without government's initiatives, the banks will not allocate funds to those projects for which the social returns are the highest. Directed credit, in contrast to subsidies, does not require the government to raise revenues. The effectiveness of directed credit is that controlling the quantity of credit is a surer way of providing for macroeconomic stability than controlling the price (or the interest rates), and is even more effective than controlling the price through subsidies (Stiglitz 1994).

However, as several researchers (Esguerra 1981; Neri and Llanto 1985; Lamberte and Lim 1987) observe, these government interventions did not achieve the intended goal of providing small farmers and other small-scale borrowers with access to credit. Rather, the results were sometimes perverse as unintended beneficiaries captured the subsidies and rural banks developed dependency on the Central Bank. The supply of formal agricultural credit declined from 18 percent of total bank loans in 1966 to 5 percent in 1975 and less than 10 percent in 1985 (Abiad and Llanto 1989). Survey results also showed that the proportion of farmers who borrowed from banks decreased from 37.1 percent for the period 1967-1974 to 23 percent in 1981-1986 (Llanto 1990).

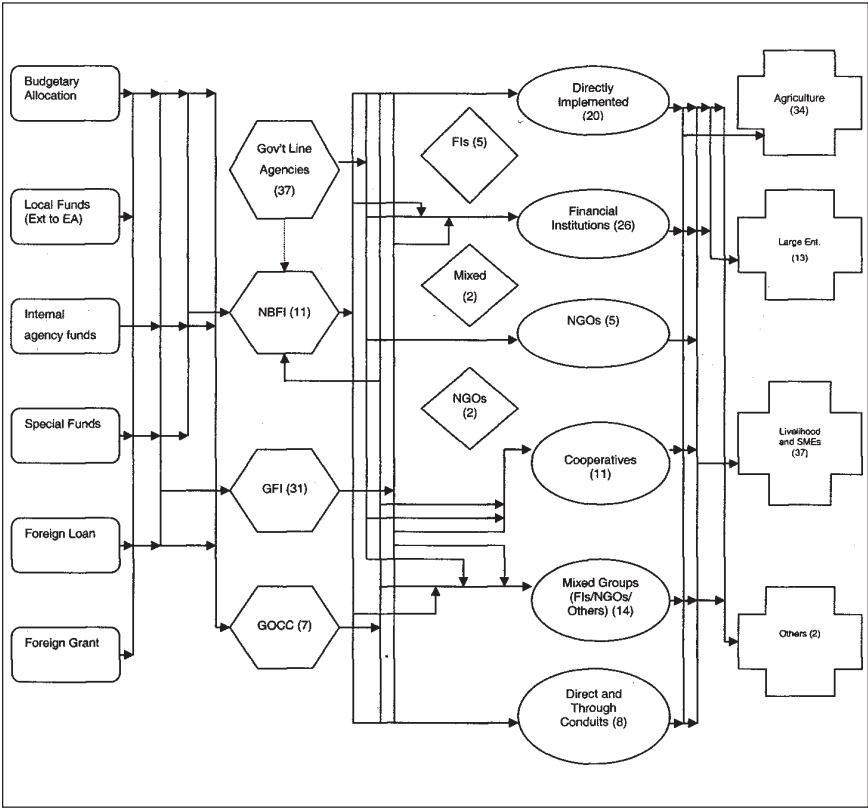
The Philippines' experience showed that directed credit programs (DCPs) were too costly for the government because the subsidized interest rates and the preferential treatments toward implementing financial institutions resulted in very low loan recovery. Financial discipline was weakened because of the distortions introduced in the financial markets by DCPs. The widespread non-performing loans led to the dependence of financial institutions on government funding.

The government's subsidized agricultural credit programs were fragmented into 46 separate, commodity-oriented programs, resulting in inefficient and wasteful utilization of credit funds and the subsequent impairment of the rural banking system, which was mainly used as credit conduits (Llanto 1990). Figure 3 shows the complex mechanism used by the government to channel credit to target endborrowers. The layering produced a complicated maze of conduits which rendered the credit programs inefficient while the subsidized pricing made them unsustainable.

According to Herdt and Rosegrant (1988), as much as 65 to 90 percent of the credit subsidies accrued to financial intermediaries as incentives to lend to small farmers. Esguerra (1996) cited the "incentive effect of artificially cheap funds on financial intermediaries" that discouraged deposit mobilization, led to dependence on cheap funds from the state, and made rural banks mere retailers of government funds. Thus, as Lamberte and Lim (1987) pointed out, subsidized credit was not at all cheap and the benefits of the subsidy were only captured by large farmowners, thus frustrating the objective of subsidized credit programs.

The subsidized credit programs introduced a costly distortion in the rural financial market and impaired its growth. To eliminate this distortion and achieve efficient rural financial markets, government shifted to market-oriented, market-determined interest rates. To promote competitiveness in

Figure 3. Directed credit program (DCP) flow of funds



the banking industry, government advocated liberalization of the banking sector.

The Central Bank played a huge role in implementing special (subsidized) credit programs (Lamberte and Lim 1987). In the latter part of the 1980s, the World Bank provided a US\$100 million loan to the Philippines for the development of its agriculture sector. The loan was called the Agricultural Loan Fund, one of the conditionalities of which was for the Central Bank to end its involvement in development finance. In 1993, the New Central Bank Act was signed into law, creating the BSP, which then replaced the bankrupt Central Bank of the Philippines. According to the law, the BSP should not undertake quasifiscal activities, since its main objectives are price stability through sound monetary policy and the effective supervision of financial institutions under its jurisdiction.

Importance of savings mobilization

ACPC and the Philippine Institute for Development Studies (PIDS) have undertaken research focusing on the crucial role of savings mobilization in strengthening rural financial institutions. Their rural savings mobilization project has shown that rural financial institutions would be sustainable and viable with savings mobilization, thus weaning them away from state or donor fund infusion. Earlier, Neri and Llanto (1985) cited the negative impact of rural bank dependence on the Central Bank for on-lending funds. The special time deposits and the subsidized rediscount facility of the Central Bank that were used by the government to provide on-lending funds to the rural banks spawned such dependence and considerably led to a weakened rural banking industry in the mid-1980s.

The shift to financial intermediation highlighted the importance of financial intermediaries and their roles in providing financial services to the rural areas. This approach emerged from the recognition that rural households did have savings and that they could become more productive if given the needed financing.

Savings mobilization is the antithesis of government's subsidized credit programs, through which financial institutions, or the rural banks that participated in those programs, engendered dependence and financial weakness. On the other hand, savings mobilization strengthens the balance sheet of banks. Blanco and Meyer (1989) point out that a large potential financial market could be tapped in rural areas due to its large share of population and GDP. Their study, covering the period 1977-1986, shows a "considerable urban bias in the financial system" (Blanco and Meyer 1989). The study also notes that rural loans and deposits comprised a fairly small share of total banking activity in the country, and confirms that past efforts to provide substantial subsidies and cheap funds to rural banks may have had a disincentive effect on rural deposit mobilization.

Rural bank rehabilitation program

Lim (1998) believes rural banks are the proper conduits for financing and lending, both to nonagricultural and agricultural microenterprises, for they could provide cheaper credit than informal markets while maintaining the market discipline and monitoring that usually evade NGOs. Compared to commercial banks, they are more approachable and people-oriented, making them more attractive to small clients. Thus, they are perceived to be the most conducive instrument for channeling funds to viable and sustainable microenterprises. However, the rural banking system has not always had this positive image, having been on the verge of collapse several years ago. The

nonrepayment of the (subsidized) Masagana 99 loans and other loans under the government's subsidized credit programs, mismanagement, and other problems had led to the closure of many rural banks toward the end of the end of 1980s. Out of 1,167 rural banks operating in 1981, only 856 were operational by 1986, of which 82 percent were in arrears with the Central Bank (Abiad and Llanto 1989).

Loans to the agriculture sector dropped in real terms between 1981 and 1987 (Esguerra 1996, quoting Lim 1998). This was partly due to the inability of many rural banks to continue lending as a result of insolvency (Esguerra 1996), a problem brought about by the government's policy to provide subsidized credit. Thus, the government and the Central Bank felt the need to rehabilitate rural banks.

Together, the ACPC, the LBP, and the Central Bank formulated a rural bank rehabilitation program. Central Bank Circular No. 1143, issued in 1987, aimed to rehabilitate the failing rural banks. The main instrument of this scheme was the conversion of loan arrears of rural banks into government-preferred stocks. Central Bank Circular No. 1143 was amended twice on pressure from rural bankers to relax the requirement for fresh capital infusion and to extend the plan of payment from ten to 15 years. There was much debate on the appropriate approach to rural bank rehabilitation until finally Congress enacted the Rural Banks Act of 1992, which provided several incentives to rural banks to strengthen themselves. The rehabilitation scheme allowed the conversion of a rural bank's arrears with the Central Bank into government-preferred stocks in the bank. Owners were required to infuse an equal amount of capital over a period of 15 years (Llanto 2001b).

Lim and Agabin (1993) conducted three case studies that yielded varying conclusions on the effects of the rehabilitation program. In one case, the program was found crucial to the successful turn-around of a failing rural bank. In the other two cases, the rehabilitation program did not seem to affect rural bank performance. The two authors concluded that banks that benefited from the program already had capable management and good performance in deposit and loan operations.

Learning important lessons from the failed subsidized credit programs, rural banks were able to regain financial strength in recent times. A rural bank study by Lim (1998) shows a rapid increase in deposit and loan expansion in the period 1991-1996. There was also improvement in past due performance as the share of past due loans fell steadily, which was partly a result of the transition of the country from recession (1990-1992) to growth (1993-1996). At the onset of the Asian financial crisis and the El Niño and La Niña phenomena, rural banks experienced lower deposit mobilization and higher

past due problems, prompting them to be more cautious in their lending. BSP regulations also compelled them to improve their banking practices in both deposit mobilization and credit allocations and to raise more capital. The latter proved to be difficult to achieve for many rural banks.

Decline of agricultural credit

Numerous studies show the decline of agricultural credit. Rice (1993) observes marked declines in the international and domestic supplies of formal agricultural credit, in part due to reductions in the agricultural-credit portfolios of multilateral development banks and bilateral donors and in part due to reductions in domestic fiscal transfers for this purpose. Gonzalez-Vega and Graham (1995) recognized the substantial losses and eventual decapitalization of most state-owned agricultural development banks and the failure of most targeted farm-lending programs used as channels for government and donor funds. Bayadas et al. (1997) explain that the decline occurred because of the slow supply responses of private commercial banks in expanding their operations toward the rural areas, following financial liberalization programs and/or the demise, closure, or privatization of state-owned agricultural development banks.

Most studies, such as those by Stiglitz, Llanto and Fukui, and Vogel, among others, confirm that the primary reason for the failure of the traditional credit approach was that it did not address the real problems. In effect, it created distortions in the market, defeating its purpose of bringing credit to the rural poor to improve their agricultural productivity. Subsidies on interest rate of credit created excess demand that had to be rationed through transaction costs (Vogel 2003). Thus, those who benefited were the large borrowers who could offset the cost of transactions with the subsidies. Credit rationing resulted in the denial of credit to small borrowers.

The fungibility of credit also explains why agricultural output has not increased despite the abundance of cheap credit (Vogel 2003). The fungibility of credit makes it difficult for rural financial institutions to control and monitor loan utilization and loan repayment. Failing to recognize the presence and importance of other nonfarm activities in the rural areas, those lenders implementing subsidized credit programs apparently missed a critical opportunity to increase rural output by financing those non-farm activities. A new approach to rural finance which is discussed below rectifies the error by emphasizing the importance of deposit mobilization, financial intermediation and the diversity and variety of rural economic activities as subsidized credit programs proved too costly to sustain for the government and the donors.

During the period of deregulation in the Philippines, there were expectations that credit would finally become accessible to all sectors of the economy. This did not happen. The ratio of agricultural loans to total loans granted by the banking sector drastically declined from 22 percent in 1981 to 8 percent in 1983 and less than 1 percent in the late 1990s, signaling a declining amount of financial resources going to the agriculture sector. The decline of financing for agriculture and the countryside was most evident among commercial banks. On the part of rural banks, the proportion of loans granted to agriculture likewise decreased. The LBP which tried to fill the gap increased agriculture loans from 7 percent in 1987 to about 30 percent in the late 1990s. However, the volume of loans provided was still considered small relative to the demand. Thus, notwithstanding the supply-led financing strategy of the government, private banks chose to ignore the rural sector and instead focused on the urban sector (Llanto 2001b).

Kraft (1998) cites some possible reasons for the decline of agricultural financing. The factors on the supply side that prevented the credit market to adjust despite liberalization and deregulation efforts were as follows:

1. The agriculture and agrarian loan quotas spawned inefficiency in funds allocation and increased banks' opportunity costs;
2. The overly strict loan provision requirements of the Central Bank to ensure greater prudence made most banks wary of the agriculture sector;
3. The reduction in the number of existing banks due to mergers weakened the impact of interest deregulation; big banks gained increased control of pricing, resulting in lower levels of real interest rates for savings and deposits and consequently discouraging savings in the rural areas;
4. Banks shied away from extending small farmer loans and low-cost credit following the enactment of two laws: the Magna Carta for Small Farmers (Republic Act 7607) of 1992, which provided that interest rates for small farmer loans should not be greater than 75 percent of prevailing commercial rates; and RA 7900 of 1999, which stipulated that low-cost credit be made available to high-value crops.
5. The continued implementation of DCPs, which promoted inefficient fund allocations, prevented rural borrowers from venturing into other rural-based enterprises because these DCPs were usually commodity-specific.

On the demand side, Kraft cites the lack of collateral value of land and the poor credit rating of the small farmers as reasons for the failure of formal

financial institutions to provide credit access to rural areas. Furthermore, the financial liberalization on one side and the protectionist rural programs on the other side did not seem to work together.

Rural finance: a new view

The ACPC identified the problems underlying the government's subsidized credit programs: low repayment rates, failure to properly monitor program performance, and rural bank dependency on the state and the Central Bank for on-lending funds.

Rural finance, a more comprehensive approach to the problem of farmers' lack of access to credit, displaced the focus on traditional agricultural credit, as governments and donors the world over became disenchanted with it. The emerging view was characterized by a paradigm shift from a subsidized credit regime to a market-oriented financial system's approach. The importance of financial intermediation was stressed as reforms to the financial system were pushed. Vogel (2003) says that rural finance is not only about agricultural credit. It is also about providing other financial services such as deposit or savings facilities, remittances, and insurance, among others. Rural finance is also not limited to agriculture as empirical studies have shown that there are economic activities in the rural areas other than agriculture.

In the Philippines, the first feature of the subsidized credit program that had to go was the highly concessionary interest rates. Llanto (1990) recounts that the ACPC embarked on a credit strategy based on two guiding principles: (a) a greater reliance on the market mechanism in the allocation of financial resources and (b) the termination of direct lending programs by non-financial government institutions. The ACPC espoused three broad measures in this regard (Llanto 1990): (a) measures to increase government expenditures for rural infrastructure, marketing facilities, and technical assistance to the rural sector and to continue policy reforms; (b) measures to build farmer creditworthiness and (c) measures to reduce the risks and transaction and monitoring costs faced by banks in lending to agriculture.

The core of the third measure is the CALF that operated as a credit guarantee facility to cover small farmers' loans. The CALF guarantees up to 85 percent of the loan default of small farmer borrowers, with 15 percent to be absorbed by the lending bank. Several studies on the credit guarantee programs (Llanto and Magno 1994; Llanto and Orbeta 1999) show that this intervention scheme which sought to encourage private bank lending to small farmers did not result in more access to formal credit by small farmers, notwithstanding the intention of policymakers. Instead, banks stuck to their traditional clientele and continued to demand the traditional real estate

mortgages or liquid financial instruments (e.g., government securities) as collateral. Sensing the failure of using credit guarantee to encourage private banks to lend to small farmers, the government reinstated credit subsidies (Llanto 1990; Esguerra 1996) amidst a clamor for funding for livelihood programs.

There was dissatisfaction among policy makers over the continuing lack of access to formal credit by small borrowers.

The Aquino administration passed Cabinet Resolution No. 29 (November 1988) which restored subsidized credit program. The resolution provided a set of guidelines for funding government-sponsored livelihood programs. Thus, subsidized credit was eventually extended by several nonfinancial government agencies (e.g., Department of Social Welfare and Development, Department of Trade and Industry, Department of Agrarian Reform, etc.) through banks and NGOs. The major difference lies in the use of credit channels. During the period of Masagana-99 and other subsidized credit programs in the agriculture sector, the government used rural banks as credit channels. Under the Aquino administration, the government used its own agencies to channel credit directly to end-borrowers and discovered the NGOs as credit conduits in addition to banks. The common factors were the use of government funds for on-lending to target borrowers and the use of concessionary interest rates.

An important element of the new view of rural finance is the market-orientation of interest rates. Some agencies of government, specifically the ACPC and the Central Bank, believe that private and government banks should be allowed to charge market-oriented rates to enable them to recover the cost of lending and post a profit margin. They also maintain that credit risks should be partially covered, that is, up to 85 percent of the outstanding loan balance, by the CALF.

However, RA 7607 states that interest rates of small farmer loans should not exceed 75 percent of prevailing commercial rates, while RA 7900 stipulates that low-cost credit should be made available for high-value crops. These laws put pressure on the banks and subsequently made the agricultural portfolio unattractive. Ceilings on interest rates artificially cheapened the cost of capital, making the unprofitable seem otherwise; imposed undue cost burden on financial institutions, which hindered their development; and further restricted small borrower access to institutional credit and worsened income distribution (Esguerra 1996).

The agriculture sector, perceived as unprofitable, became more unattractive because of these legislated interest rate ceilings. Llanto (2001b) observes that the government's inconsistent interest rate policy threatens

the growth and sustainability of rural financial markets. While BSP and other government agencies like the National Economic and Development Authority (NEDA) and the Department of Finance (DOF) have supported financial reforms, specifically the adoption of market-based interest rates, these measures do not seem to have been implemented at the operational level of government financial institutions, since interest rate subsidies continue to be provided in some credit programs of the government.

Esguerra (1996), although critical of the imposed ceiling, cautions that removing interest rate restrictions should be weighed against concerns involving high levels of interest rates and their negative effects on investment, financial stability, and growth, believing free-floating interest rates become problematic when the macroeconomy itself is unstable. Esguerra's warning is meant to call attention to the macroeconomic situation of the country in which high and variable inflation rates, large fiscal deficits, overvalued peso and high nonperforming loans drive interest rates up.

The ACPC currently advocates the importance of market-oriented interest rates, the consolidation of all agriculture- and fisheries-directed credit programs, as mandated by RA 8435 (or the Agriculture and Fisheries Modernization Act), and their transfer to government financial institutions for on-lending through private financial institutions (e.g., rural banks).¹¹ RA 8435 has a provision calling for the market orientation of interest rates.

The misconception on the creditworthiness of rural borrowers in the past, which led to banks' preference for urban-based borrowers, is still very much felt in the Philippine countryside, notwithstanding the reforms undertaken in the rural financial markets, as earlier explained. The result is a segmented financial market, a "dualistic financial sector where the formal exist together with the informal and where the informal sector predominates" (Abiad 1993). Financial dualism occurs when agents with inexpensive access to information and monitoring mechanisms may not have enough resources or may be too risk averse to provide widespread financial services while those who do have the resources and the required attitudes towards risks have no access, at reasonable costs, to the required information and contract enforcement. If this problem is not properly addressed, the inequality, exclusion, high entry barriers and economic stagnation that shape the existence of large numbers of rural population will be perpetuated (Abiad 1993).

Financial liberalization has not demonstrated its pivotal role in "pushing outward" the frontiers of formal finance according to Agabin and Daly

¹¹ Adela Santos of ACPC is acknowledged for this information.

(1996). Private commercial banks still target their operations to a traditional urban clientele or a handful of large rural enterprises devoted to the export of profitable crops. The majority of small and medium-sized rural enterprises seem to have nowhere to go except to traditional moneylenders, input suppliers, marketing agents and other informal lenders.

With advanced technology, the emergence of the so-called digital divide added another dimension to the financial gap already existing between the rural and urban firms and households by making access to financial services more difficult for those who are not using modern computers and communication technologies (Meyer and Nagarajan 2000).

Apart from their urban bias, banks are also inhibited from making large exposures in the agriculture sector due to the inherent characteristics of the sector. Among others, the agriculture activities are location-specific and have varying terms of trade. Agriculture relies on natural conditions for the success of its production, which requires time and is seasonal. The sector also suffers from widespread poverty and often has to contend with highly volatile prices (Gonzalez-Vega 1993). All these explain why financial institutions prefer to operate in the urban areas. In this light, institutional and technological innovations and adaptation are crucial to reducing transaction costs (Gonzalez-Vega 2003).

Meanwhile, pioneering NGOs experimented with the provision of microcredits to urban-based, poor microenterprises in the Philippines. They drew inspiration from the success of Grameen Bank and the Latin American NGOs funded by Accion International. The advent of microfinance in the country in the late 1990s gave smallscale borrowers an alternative to the informal moneylenders who had catered to their borrowing needs.

Microfinance institutions were left free to charge market-oriented interest rates, thus enabling them to charge cost-recovering interest rates and ensuring the sustainability of their operations in the long run. Control of interest rates had been proven ineffective and even detrimental to the agriculture and rural sectors.

Flexible market-oriented interest rates have helped the microfinance institutions expand their credit operations among borrowers that could not provide the traditional collateral demanded by formal financial institutions.

A new perspective on government intervention

Despite the general consensus that the financial markets should be left to the market forces, some observers highlight the importance of the role of the government. According to Yaron (1992), full reliance on market forces is not always preferable. In the absence of intervention in the financial market, the

supply response or the adoption of new technologies would be slow. Gonzalez-Vega (2003) supports this view, saying that exclusive reliance on market forces may not result in the theoretically optimum rate of expansion and must be accompanied by correctly designed political interventions.

The challenge facing policy makers is how to correctly design those interventions. The bottom line is that interventions in the rural financial markets should always be designed to improve market conditions, that is, make them more competitive in the long-term (Yaron et al. 1998). Direct government interventions in the rural financial markets have been shown to be detrimental to the sector. The prevailing problem in credit subsidies is that they are most often captured by rent-seekers and crowd out the small borrowers, while financial institutions receiving soft-loans and similar forms of support from the government never develop into sustainable and independent financial intermediaries.

Stiglitz (1994) posits that although it is not sufficient to conclude that the existence of market failures by itself justifies intervention, it is necessary to appreciate the limits, as well as the strengths, of government intervention. As market failures seem to be more pervasive in financial markets, there exist forms of government intervention that will not only make these markets function better but will also improve the performance of the economy. The government has powers arising from its ability to compel and proscribe, which the private sector lacks. Yet, it is also subject to certain constraints and limitations, including those relating to equity and its ability to enter into commitments, rendering it less effective than private sector enterprises.

According to Stiglitz (1994) the principles of financial intermediation lie in the roles of transferring capital from savers to borrowers; agglomerating capital; selecting projects; monitoring; enforcing contracts; transferring, sharing, and pooling risks; and recording transactions. In other words, it is concerned with the transfer of generalized purchasing power from economic units with surpluses to those with deficits (Esguerra 1996).

The allocative function of financial intermediation is carried out by mobilizing savings from savers with inferior investment opportunities. Making these funds available to borrowers with high-yielding investments will greatly contribute to the development of financial markets. Successful deposit mobilization will eliminate the need for soft loans from the government, thereby strengthening financial institutions. It is equally important to discover the incentives and technological and institutional innovations that will drive financial institutions to strive to lower transaction costs and efficiently manage risks.

The usual point of contention is when and to what extent government should intervene. The prevailing sentiment seems to be that the government should provide an enabling environment for economic agents to efficiently transact. Under this view, the role of government is to ensure the proper functioning of markets by providing an appropriate legal and regulatory infrastructure for the financial system. It is not to provide subsidized funds to financial institutions which ironically serve to weaken them.

Esguerra (1996) says the role of government in the rural sector lies primarily in the creation of an environment that is conducive to financial intermediation. This means effecting policies that help reduce transaction costs associated with lending and borrowing, thus increasing volume of financial market activity and the number of market participants. An environment conducive to financial intermediation also requires the provision of water, road networks, farm-to-market roads, feeder roads, ports, bridges, storage facilities, power and telecommunications that will increase rural productivity and improve economic activity in the rural sector. Thus, a crucial part of a favorable policy environment where rural financial markets could efficiently function is the provision of infrastructure support to the agriculture and rural sector.

Public investment is needed in instances where the required technological and institutional innovations required to deepen the financial system and to serve the poorer segments of the population can be readily replicated by for-profit financial institutions, resulting in free-rider problems that discourage the private sector from sufficiently investing. However, the required public investment should be more labor- and knowledge-intensive and far less capital-intensive (Zeller 2003).

Yaron et al. (1998) stress the importance of cost-effective alternatives such as increased investment in rural infrastructure and human development to increase incomes and reduce poverty. Rural financial institutions that efficiently provide a broad range of services to the target clientele could expand incomes and reduce poverty. Thus, the evaluation of the performance of credit programs is based on outreach and self-sustainability. The willingness and ability to pay of farmers and entrepreneurs for savings, credit, and insurance services at market prices are the primary premise in this new paradigm.

In the macroeconomic scene, the government is responsible for economic and political stability and sound financial infrastructure. It is also charged with the deregulation of interest rates and the creation of a legal environment that protects the integrity of loan contracts and the rights of lenders, savers, and borrowers. It is also tasked to encourage sound banking

practices by drawing up appropriate incentives. The 1997 Asian financial crisis brought to the fore the need for the government to set up appropriate prudential regulations to promote stability in the financial system and viability among financial institutions. Effective corporate governance has become a key issue in the performance and viability of financial institutions.

Information asymmetry and credit rationing

Rural credit markets are composed of very heterogeneous rural economic agents whose attributes and personal circumstances may not be acceptable to banks, which in turn may be totally alien to many of these agents. Thus, the rural borrower is denied effective access to financial resources and the bank loses the opportunity to intermediate the rural surplus (Llanto 1989). Formal financial institutions may have little or no information at all about potential clients, especially small borrowers and savers. This asymmetry in information increases transaction costs that discourages private sector participation in rural financing.

To induce desired borrower behavior and avoid problems like non-repayments, a lender may employ indirect mechanisms such as imposing interest rates that could regulate the risk composition of the loan portfolio. A lender could also employ the threat of cutting off credit or impose contractual terms (such as those applied by landlords or merchants) in other exchanges to ensure repayment (i.e., market interlinkages). There are also direct screening mechanisms such as those used in informal credit markets (e.g., geography and kinship) which make information asymmetries negligible (Hoff and Stiglitz 1990). Hoff and Stiglitz enumerate schemes that could limit the consequences of information asymmetries and enforcement problems. Examples are collateral and usufruct loans, which enable a lender to occupy and use the borrower's land until the principal is repaid (pawning).

These techniques help ensure that borrowers will undertake actions desired by the lender and thus, create a "reputation effect" (Hoff and Stiglitz 1990) for the borrower that builds the lender's confidence in the creditworthiness of the borrower.

The presence of moral hazard and adverse selection arising from asymmetric information could lead to a rationing of credit even when collateral is used to differentiate among borrowers with differing probabilities of default. Credit rationing occurs (a) when there is residual uncertainty; (b) when the adverse selection/adverse incentive effects of changing interest rate, or the no-price terms of the contract, must be sufficiently strong that it is not optimal for the lender to use these instruments fully to allocate credit; and (c)

when the supply of funds must be such that where demand equals supply, the expected returns to the lender are lower than for some other contract. Credit rationing is also observed when there are legal restraints on the level of interest rates (Stiglitz and Weiss 1992).

Transaction costs

Recent literature identifies transaction costs as a major hindrance to credit accessibility and expansion of credit. According to these literature, the viability of a rural financial institution may depend on how well it can cope with or circumvent the transaction costs involved and deliver bank services efficiently. Untalan and Cuevas (1989) define transaction costs as the cost incurred as banks perform its intermediation role in the financial markets among savers and users of funds. High transaction costs impede the intermediary's efficiency in resource allocation and distribution. Serious constraints faced by rural markets due to weak or poorly developed institutions, such as information-sharing networks, mechanisms for enforcing credit contracts and adequate systems for supervising financial entities, drive up explicit and implicit costs of transaction (Agabin and Daly 1996).

Abiad et al. (1988) cite two determinants of transaction costs: distance and type of bank. Distance would certainly be a major consideration for a borrower applying for a loan, as farmer-borrowers were found responding to transaction costs the same way they did to interest rates. Therefore, transaction costs play an important role in the demand for and rationing of credit among borrower classes.

Transaction costs also vary depending on the type of bank. Examining the costs of each bank activity, Untalan and Cuevas (1989) found that funds mobilization activities account for a greater part of total cost among all banks. In commercial banks (KBs), a larger portion of the cost is contributed by funds mobilization than by their lending operations; the opposite is true for rural banks. Their research shows that KBs are more funds-generating while RBs are more lending-oriented institutions. Private development banks (PDBs) have a balanced operation on both funds mobilization and lending.

Lending transaction cost is also higher in KBs than in PDBs, while RBs loan recovery cost is higher than KBs and PDBs. With regard to the cost of funds mobilization, a greater part is spent on deposit mobilization by KBs and PDBs; a greater portion of RBs funds mobilization cost comes from mobilizing funds from the Central Bank's rediscount window. KBs and PDBs have relatively lower cost per peso of loan and lower cost per peso deposit mobilization than RBs, indicating their comparative advantages (Untalan and Cuevas 1989).

Untalan and Cuevas (1989) maintain that commercial and private development banks serve as deposit-mobilizing units for their head offices. The larger portion of their transaction cost consists of cost of fund mobilization. On the other hand, rural banks, which have less incentives to raise funds and which depend on the Central Bank, derive a larger portion of their transaction cost from their lending operations. The authors argue in favor of bigger capitalization for smaller banks to allow them to expand their operations and viability by exploiting economies of scale in their operations. They explain that a bigger operating capacity for smaller banks would lower the transaction cost and effectively lower their average cost of delivery. Other recommended measures to lower transaction cost are the following: (a) liberal bank entry to introduce more competition that forces banks to deliver services at the least cost possible; (b) improvements in farm productivity to lower the risk faced by the lending bank; and (c) improvements in rural infrastructure to improve farm productivity and increase household incomes (Untalan and Cuevas 1989).

One way of reducing transaction costs is by improving farm productivity which improves the loan repaying capacity of borrowers and directly lowers the risks faced by bank. The main solution, according to Geron (1989), is to increase rural incomes. By increasing the incomes of farmer-borrowers and by making those fixed investments normally owned by trader-lenders available and accessible to the farmer, problems of market segmentation and high transaction and risk costs may be addressed.

In a case study of the transaction costs of lending to the poor, Llanto and Chua (1995) showed that the bank-NGO-self-help group-poor linkage approach can reduce the cost of screening loan applications and borrowers. It can also create a mechanism for loan repayment, enforcing the loan contract and recovering the loan. However, successful reduction in transaction costs of lending to the poor depends a lot on the quality of the self-help group and the efficiency of banks and NGOs.

Interlinked markets and transactions

According to Lamberte and Lim (1987) interlinked markets could lower the cost of transactions between lenders and borrowers and forge a lending relationship. They cite empirical studies showing that informal lenders were more efficient in channeling funds to rural borrowers because they were able to reduce transaction costs and risk costs through the use of interlinked markets. High transaction and risk costs associated with rural lending could be addressed by interlocking market transactions so that costs associated with one market could be absorbed by the other market. Flexible lending arrange-

ments enable agents to efficiently operate (Geron 1989). Market interlocking is a common practice among informal lenders which explains why they can circumvent both the transaction and risk costs and become more successful than formal institutions.

A great advantage of informal lenders is their ability to lower the transaction costs of lending to small farmers and smallscale borrowers. One way to achieve this is to engage in interlinked deals defined by Geron (1989). Interlinked deals lower the transaction costs of informal lenders (Floro 1986; Bardhan and Rudra 1978). Geron observes that rural agents engage in interlocking market transactions to minimize costs due to underdeveloped rural markets, evidenced by the existence of incomplete and imperfect markets, asymmetry of information, high risks and the nature of agricultural activities.

The existence of interlinked deals in the informal rural credit market addresses efficiency problems. Interlocking market transactions address the high transaction and risk costs in rural lending. Geron concludes that in an economy where income is low, where market is segmented, and where high transaction and risk costs exist, informal lenders are useful on efficiency grounds. Such usefulness, however, may not apply on equity grounds, she argues. If so, the first policy that the government must adopt is to increase rural incomes by enforcing overall agricultural policies favorable to the agriculture and rural sectors (e.g., stronger support services like marketing services, timely credit information, etc.). Increasing farm incomes and making assets and rural infrastructure accessible to farmers will address the problems of market segmentation and high transaction and risk costs.

The personalistic relationships that characterize the foundation of informal credit led to market interlinkage as an instrument for dealing with information asymmetry and for improving contract enforcement (Floro and Yotopoulos 1991). Interlinkages in the presence of asymmetric information had been stressed in the literature as a means to reduce the cost of screening prospective borrowers and control and monitor borrower behavior.

In interlinked contracts or transactions, trader-lenders have information on farmer-borrowers, and vice versa, because of their numerous economic dealings with each other. Such is a strong motivating factor for the prevalence of market interlinkages. Floro and Yotopoulos (1991) cite three possible reasons why interlinking lending and marketing may be advantageous to traders. The first involves local economies of scale, which means having a fixed cost that is greater than the variable cost which presents an incentive to the trader to maximize his profit opportunities. The second relates to the seasonality of agriculture production, which in the past encouraged the proliferation of informal credit markets in rural areas. The liquidity

of a trader is negatively correlated to that of the farmer. Thus, getting into interlinkages will be beneficial to both parties. The third states that a trader can purchase crops at a discount price.

Imperfections in the credit market rationalize these factors. Teh (1994) explains that interlinkages can be explained by the traders being spared the costs of searching for low-priced sources of output. This is because search costs are bound to be high due to poorly linked markets and underdeveloped infrastructure and communication facilities.

The other explanation, which was advanced by Fabella (1993), says that unbundled and bundled credit and marketing contracts are a choice between cash-for-cash arrangements and kind-for-cash arrangements, respectively. A risk-averse farmer would naturally choose a bundled contract to hedge price risks. The trader would also benefit from the bundled contract by capturing the insurance premium the risk-averse farmer would be willing to pay. Apart from the premium, the trader would also enjoy market power.

These two explanations for the presence of interlinkages point to the imperfections in both the insurance and credit markets. Interlinked contracts, whether these respond to imperfections in the credit market or the insurance market, represent a successful response to the high transaction costs and asymmetry of information plaguing credit market. Formal financial institutions which follow the traditional approaches to lending certainly miss the opportunities in small client lending that are profitably exploited by informal lenders, traders and input suppliers.

Banks, self-help groups, cooperatives, and group lending

Llanto (1989) cites an emerging phenomenon in the rural areas of interlinking transactions between banks and rural-based organizations—the emergence of self-help groups that seem to be a convenient mechanism to ensure access to bank credit and discipline among borrowers. The serious information problem in rural financial markets engenders a credit market structure that is complex and very information-dependent (Llanto 1989). Loan contracting becomes a formidable problem for those small borrowers who cannot send the appropriate signals of creditworthiness to banks. Asymmetric information denies rural borrowers effective access to financial services so that the bank loses the opportunity to intermediate the rural surplus (Llanto 1989). However, as some literature point out, interlinked transactions are an efficient economic response to unequally distributed information arising from uncertainty in agriculture. They are also a crucial screening device to reduce transaction costs, since it can prevent borrower default (Basu 1984).

The linkage between a bank and a self-help group may be the initiative of either of them. A case documented by the Llanto and Morte (1989) shows that such linkage seems to be a mutually beneficial economic and financial exchange between two parties. The self-help group screens loan applications, instructs farmers on the importance of financial discipline, and acts as collection agents for the lending bank. The ability to process valuable inside information leads to the creation of a norm of contractual behavior which makes the members of the self-help group honor loan contracts. Willful default can lead to peer sanctions and even to eviction from the group (Llanto 1989).

The linkage strategy recognizes the roles played by the small local groups within the sector and the formal institutions in attempting to have loan transactions. It focuses on self-help groups as grassroots financial intermediaries between banks and the vast numbers of microenterpreneurs and small farmers to cut down on transaction costs for both banks and customers (Seibel 1998). The self-help groups or organizations that work closely with the rural population can supply the necessary information to the bank so that information asymmetries would be eliminated.

After 1986 when several subsidized credit programs in the agriculture sector were consolidated into the CALF which was used to encourage private bank lending to small farmers, an important feature of credit programs emerged—the emphasis on group lending (Esguerra 1996). The lender extends a loan to a group which in turn on-lends to and collects loan repayments from members. A variant of this approach is for the group to act as “facilitator” in getting a loan for individual members who agree to guarantee repayment of each of the members’ loans. This became popular following the success of the Grameen bank approach. Esguerra (1996) cautions against the issue of group size and composition. Homogeneity among group members underscores commonality of interests that must sustain the group. The informational advantage of the group may be dissipated beyond a certain group size.

Esguerra (1996) notes that the group may be a cooperative, a federation of cooperatives, an NGO, or any collection of individuals organized to access credit under some agreed set of rules (e.g., joint liability arrangement). The could create a situation where policymakers may be tempted to organize groups, such as cooperatives, to channel credit to specific sectors. This was precisely the approach taken by the LBP in the late 1980s until the early 1990s, which then gave rise to the slogan “the cooperative is the only way.” The Land Bank of the Philippines organized farmers into different types of cooperatives—agricultural, marketing, etc., with the sole purpose of

channeling loans to small farmers. The experiment failed because thousands of cooperatives closed down due to nonrepayment of loans by member-borrowers.

Huppi and Fedder (1989) argue that the process of group formation must give due importance to the development of positive expectations about the group among its members. This is hardly achieved when groups are formed merely to take advantage of reduced lending costs and to be used as channels for cheap government funds (Esguerra 1996).

By and large cooperative movements in the country have been disastrous in contrast to the successful experience of other countries with cooperatives (Lamberte and Lim 1987). This is due to government's excessive intervention that has bred dependence on cheap credit subsidies, which in turn led to financially weak cooperatives. Financial discipline was not stressed among members while the leaders were not trained to enforce the appropriate rules needed in sustaining their cooperatives. Thus, it may be argued that a cooperative can only be successful when the government is not directly involved in its activities and its members are equipped with appropriate knowledge on funds mobilization and allocation. Cooperative success could also be best assured if the needed values, like discipline in loan repayments, are in place to keep the organization viable (Llanto 1994).

Rise of microfinance

NGOs pioneered the use of lending techniques patterned after those of informal moneylenders (e.g., use of third-party guarantees, timely processing, and quick release of loans, lending without requiring traditional collateral, etc.). Through appropriate mechanisms, NGOs have successfully catered to the needs of small borrowers. Grameen Bank in Bangladesh and BancoSol in Bolivia, among others, have emerged from their NGO origins to provide microcredit to millions of poor borrowers.

Microfinance institutions mostly operate in densely populated urban-poor areas where microentrepreneurs demand financing for their working capital requirements and whose businesses are characterized by rapid turnover (e.g., petty trading, vending). Lim (1998) maintains that rural banks are in the best position to use microfinance techniques, because they can provide cheaper credit than what informal lenders offer and at the same time practice the discipline of formal banks.

In the Philippines, the failure of the formal banking system to effectively respond to the credit demand of smallscale economic agents and the cost-directed credit programs imposed on the government's fiscal position have led to the emergence of microfinancing techniques employed by vari-

ous microfinance institutions. Private commercial banks confine their operations to traditional urban clientele while the majority of small and medium-sized rural entrepreneurs have nowhere to go except to traditional money-lenders and other informal lenders (Agabin and Daly 1996). Such demand has paved the way for some institutions to provide micro-credit to a specific group of clients. Credit-granting NGOs, credit cooperatives, and, to some extent, rural banks have utilized microfinance as a sustainable mechanism to provide basic financial services to smallscale borrowers (Llanto 2001a).

The challenge to microfinance institutions is whether they can also profitably operate in the rural areas whose main economic and business activities are farm-based and farm-related ones, and off-farm activities such as minor processing and manufacturing, with populations scattered over vast areas and a rural economy strongly dictated by seasonal crops and changing weather conditions.

Faulty assumptions in the past about the willingness and ability of poor farmers and other entrepreneurs to pay for financial services led to flawed credit policy designs and implementation. Such assumptions about the clientele and its demand were used as justification for inaction and policy recipes that promoted ill-adapted services, institutions, and market structures. However, given the success of the savings mobilization programs of microfinance institutions serving the financial needs of the poor, both government and the private sector now recognize that the poor, given the right incentives, do save and require savings facilities. The experience of successful microfinance institutions has also shown that the poor use their loans in income-generating enterprises and they do repay their loans.

Over the last decade, pioneering efforts of NGOs and others across the developing countries have shown that the poor, particularly women, can successfully use small loans to earn income and are prompt and reliable loan repayers (Christian Aid Reports 1997). The experience seems to indicate that the traditional collateral may be unnecessary and procedures can be designed to ensure credit extension that is practical and cost-effective, and that lending to the poor is financially sustainable.

Microfinance lending techniques adapted by microfinance institutions can help achieve high levels of sustainability with almost 100 percent loan recovery. The wide network of low-income clients of microfinance institutions indicates that there is a great demand for credit by the poor, who can successfully use these small loans for their benefit.

Building viable and sustainable microfinance institutions (MFIs) requires an appropriate legal authority, a strong equity and financial base, and sound internal policies, systems, and procedures (Llanto 1997). Regula-

tions that greatly affect the operations of MFIs involve capital requirements, deposit taking, interest rates, and loan security (Llanto and Sanchez 1998). The strategic measures to developing microfinance are regulation reforms, e.g., requiring capital requirements that do not hinder microfinance operations, institutional transformation that ensures the viability of institutions, and the practice of sound policies.

The microfinance approach has the potential to address the needs of rural borrowers. Its localized function has broken information asymmetries and monitoring problems. Microfinance is successful in densely populated urban areas, where borrowers are concentrated and can be more easily reached and monitored. However, the sustainability and capability of MFIs to provide long-term agricultural loans have yet to be established. MFIs rely on the quick loan turnover while small farmers engaged in agricultural production and processing would longer term loans in accordance to the seasonality of their crops and the nature of their agroprocessing activities.

According to Llanto and Sanchez (1998), the government has an important role to play in developing these microfinance institutions. Apart from creating a policy environment conducive to sustainable microfinance that would allow MFIs to flourish, the government should also provide technical assistance and support to capacity building. It should also terminate its directed credit programs and consolidate the funds from these programs for re-lending to the poor.

The traditional prudential regulation and supervisory practices of the BSP can have prohibitive effects on banks engaged in microfinance (Fitzgerald et al. 1998). Thus, a risk-based regulation and supervision of MFIs that is more appropriate to these institutions' nature and lending activities is aproposed. This approach focuses on the risk profile of the MFIs and their loan portfolio and requires a deep understanding of various risks confronting lending institutions, their risk management techniques, their manner of dealing with loan delinquencies, etc.

The "missing middle"

It is possible that a financial institution's capacity to provide loans grows in tandem with the increase in financing requirements of their most successful borrowers. However, microfinance clients who "graduate" from micro loans provided by MFIs face a credit gap. Such clients' requirements are now too large to be met by the MFIs that gave them their initial economic impetus. Yet, they constitute a still-unattractive clientele for the formal financial sector (Bastelaer undated). The lack of formal financial institutions addressing the liquidity and investment requirements of small- and medium-sized enter-

prises thus creates a gap, which could constrain those enterprises' growth. A constraint to these enterprises' access to a formal institution's services comes from the collateral requirements needed for loan applications. A more serious constraint arises from the lack of lending technology to address the credit demand of an enterprise transitioning from micro to small enterprise.

The loan portfolios of rural and cooperative banks mostly benefit the bigger borrowers at the expense of micro borrowers. This is a clear example of small borrowers being rationed out of the formal financial system because the tendency of the banking sector is to go for more familiar mainstream clients to achieve business and financial viability. The banking sector, especially the commercial bank sector, perceives countryside lending to be too risky because of the seasonality of rural incomes and the risks in agricultural production. They carry the same perception over microenterprises that are in transition to become small and possibly, medium enterprises.

Thus the emergence of a "missing middle" problem in credit markets.

The "missing middle" concept is generally attributed to hidden and largely inadvertent biases in the economic policies of countries that militate against the gradual and organic growth of enterprises. The lack of coherent development strategies for small and medium enterprises, which take into account the three dimensions of enterprise evolution (i.e., startup, survival, and growth) and the different needs of enterprises in their various stages of evolution, is another important contributory factor (UNCTAD undated).

If policymakers want to deepen the formal financial markets and extend their coverage to include the most productive and commercial actors in the local economy, which includes the poor whose productivity is high given access to needed credit, they must design lending institutions that can extend loans more efficiently than any that currently exists. Formal institutions could approach the rural sector by adopting the techniques of the informal credit markets such as establishing close relationships with the clients, bringing the loans to the borrowers, providing timely credit, supervising the loans, charging commercial interest rates, and being strict in collecting loan repayments. Finally, formal institutions trying to break into the rural financial market should not rely on the methodologies of formal banking, which would make their operations more expensive and unsustainable (Christen 1992).

According to Seibel (1998), the institutional adaptation or downscaling of bank operations would involve a delivery system, or bringing the bank to the people and adjusting the corporate culture of banks to the microeconomy's orientation. Business and product policies should be oriented toward savings and demand-driven, sound banking. Simplifications and modifications of bank procedures should be carried out to fulfill the

requirements of microentrepreneurs and households. Banks should also have sufficient measures to avoid and/or manage risks.

Importance of informal credit markets

The existence of informal credit markets signifies that there is an excess demand for credit from a significant segment of the borrowing population, which the formal institutions can not satisfy. Factors such as information asymmetry, transaction costs, and risks make it very difficult for formal institutions to serve the rural areas without incurring losses. Informal lenders, on the other hand, can overcome these barriers, being in close proximity to the borrowers and familiar with the activities in the rural countryside. In this regard, they can offer diverse and flexible credit arrangements to accommodate the problems of market imperfections, thus addressing efficiency issues.

In an economy where income is low, markets are segmented and high transaction and risk costs exist, the presence of informal lenders is useful on efficiency grounds. Their usefulness may not necessarily be true, however, when equity considerations are made (Geron 1989). The implication is that they may exercise monopoly power in credit markets which makes borrowing very costly for small borrowers.

The volume of informal financial transactions expands or shrinks in response to developments in the formal sector (Esguerra 1996). The persistence of the share of informal credit to total agricultural loans also indicates that credit absorption is a growth issue, meaning the rural economy has not grown to the extent that it will attract substantial formal banking activities (Llanto 2001b).

Adams (1992) identifies the lessons that could be learned from these informal lenders and which could benefit formal institutions.

1. Deposits, small loans, and short-term loans make up a majority of the services provided by informal lenders.
2. They provide services that are usually lacking from formal credit programs for the poor.
3. Informal finance almost always involves participants in orderly processes that result in increasingly disciplined behavior. Lenders, on the other hand, must learn to judge creditworthiness and mobilize deposits if they are to survive in the business. Borrowers must earn the privilege of borrowing through disciplined behavior that include saving before borrowing and repaying small loans to receive larger loans.

4. The large amount of savings that surface in informal financial markets are a clear indication of propensities to save voluntarily and the failure of most formal systems to provide attractive deposit services.
5. Many forms of informal finance involve reciprocity, which implies a need for emergency credit in the future.
6. Informal finance is laced with innovations to reduce transaction costs.
7. Informal finance has kept transaction costs low by bringing financial services to places and at times that are convenient to clients. In contrast, formal finance focuses mainly on reducing the transaction costs of the financial intermediary, with little concern given to its potential effects on depositors and borrowers.

A problem with informal finance is its inability to sustain the credit needs of a growing rural economy and to intermediate the rural surplus (Llanto 1989). This is so because informal lenders are also constrained by their own financial limitations. Informal lenders are also confined within a particular location and can not easily diversify. Furthermore, it is limited by the wealth constraints and the covariant risks of the local economy, rendering it shallow. Its services are valuable but not deep enough. However, the government should not repress the informal markets as rural welfare would decline. Rather, it should provide new financial services that can complement the valuable contributions of these informal sources (Gonzalez-Vega 2003).

Regulatory avoidance in informal financial markets¹²

Regulatory avoidance in informal financial markets is often the result of the repression of financial transactions, which enjoy considerable demand. Such repression is typically the result of economic regulation of the financial sector, such as when interest rate restrictions are a binding constraint for financial intermediaries. Disequilibrium in the financial market then arises. Once disequilibrium is substantial enough, alternatives evolve such as informal financial markets that operate independently of the formal sector regulations (Vogel and Weiland 1992). However, Although informal credit markets may be a convenient response to rural financial demands, the lack of supervision and regulation exposes the practice to exploitations and widens the financial segmentation.

¹² Primarily drawn from Vogel and Weiland (1992).

Regulatory policies are designed to facilitate the proper functioning of markets, yet some policies may be constricting the market. The policy-induced constraint gives rise to the emergence of unregulated entities in the financial sector. The regulatory authority should understand the factors underlying the incentives for regulatory avoidance with a view to introducing policy reforms.

Lending behavior in informal credit markets¹³

Esguerra and Fabella (1990) indicate that the significant factors influencing the behavior of rural lenders are the supply of marketable surplus such as farm area, the enforceability of repayment, and the extension of the linked contract to include residual output purchase. Found insignificant in the behavior of lenders are the borrower information, determined by the duration of stay, and labor linkage.

The larger the likelihood that the residual output is accessed by the trader-lender, the smaller is the interest rate charged. Thus, the more encompassing the linked arrangement, such as when the sale of the residual output is included, the more interest discount the farmer can enjoy. Interest rate falls with the increased likelihood of repayment. In the same manner, the enforcement of the debt service becomes easier if the farmer's loan is elastic. If it is inelastic, the trader may exploit his monopoly position.

Financial infrastructure, legal and regulatory systems

Financial infrastructure development is more important than support for a specific institution, because an improved infrastructure contributes not only to the particular institution but, more importantly, to the entire financial sector (Meyer and Nagarajan 1999). This view promotes policy reforms as paramount to the development of the financial markets. A combination of a stable macroeconomic framework and financial reforms contribute to the efficiency of transactions in the financial markets which face problems of information asymmetry and high transaction costs.

Yaron et al. (1998) claim that proper policy instruments can correct the presence of structural barriers, which affect the flow of transactions through the sector. The financial sector needs a clear set of supervising guidelines and regulatory systems to protect the players of the sector (i.e., lenders and borrowers) while allowing the financial markets to function competitively. Lenders need a system that provides formal procedures for claims against property and enforcement of financial contracts. Borrowers and depositors,

¹³ Drawn from Esguerra and Fabella (1990).

on the other hand, need protective measures for their investments and from unfair dealings.

An efficient financial infrastructure has as a critical element be an efficient information system designed to overcome the information asymmetries in the markets. An appropriate legal and regulatory system that is consistently and fairly enforced strengthens the financial institutions as well as protect the institutions' clients. Having a well-defined system of property rights will greatly benefit transacting agents.

An inadequate financial infrastructure leads to what Gonzalez-Vega (2003) calls the "inefficiency gap." This gap separates current achievement from the potential supply, which means that resources are not being used efficiently (Gonzalez-Vega 2003). The frontier of production possibilities is not fully reached because of technical inefficiencies caused by the absence of correct regulatory structures that determine property rights and appropriate governance.

The legal and regulatory systems provide the rules and guidelines on how agents in the financial markets should conduct themselves. An appropriate system levels the playing field for all participants in the market, promoting competitiveness and at the same time imposing measures to avert crisis in the market. The susceptibility of financial markets to shocks is determined to a large extent by the effectiveness of its legal and regulatory framework.

According to Gonzalez-Vega (2003), regulations should establish a competitive environment for all types of financial organizations. Regulatory framework should also be flexible enough to allow the regulation of different intermediaries that take on different types of risks in varying modes. Thus, a regulatory policy should not hinder the development of the financial sector. Yet, prudential regulations are important in building the strength and stability of the financial markets. Sound regulations should (a) maintain high net worth and capital requirement, (b) restrict interest rates on insured deposits, (c) and restrict ownership and transactions where fiduciary standards are likely to be violated (Stiglitz 1994).

The lack of an appropriate regulatory framework gives rise to the lack of the following: (a) performance standards, (b) uniformity and dilution standards of credit evaluation, and (c) portfolio supervision, which leads to poor loan recovery and deterioration of loan quality. It also gives rise to moral hazards and incentive problems (Llanto 1997).

Vogel (2002) maintains that to implement an effective regulatory environment for credit cooperatives, an essential first step is to ensure there is a standard chart of accounts with standard definitions for all credit coopera-

tives. Still another important step in this direction is to secure an agreement on key indicators of condition and performance. The environment for non-deposit-taking credit cooperatives should encourage the provision of transparent information so that potential donors, lenders, and investors can make well-informed market-based decisions. Improved internal auditing and external audits by qualified auditors following a prescribed format can also contribute to the transparency of nonregulated credit cooperatives. This will reduce audit cost as efficiency stemming from standardized accounting (Vogel 2003) improves.

A well-functioning credit cooperative, which effectively delivers the financial services needed in the community where it is based, using its own funds in its operations, reflects the degree of development of the sector as well as the maturity of the government as a regulatory body of the financial sector.

In this regard, RA 6938 (Cooperative Code of the Philippines) and RA 6939 (Cooperative Development Authority) were enacted in 1990 to promote cooperatives as vehicles for the delivery of basic economic and financial services to the rural poor, and to encourage private sector involvement in the actual formation and organization of cooperatives. It may be timely to review the impact of these two laws on the development of the cooperative sector.

The Cooperative Development Authority (CDA) is the supervising and regulating body of cooperatives. However, CDA maintains only a very limited "regulatory" role, since it is confined to the registration and, to some extent, monitoring of cooperatives (Arbuckle et al. undated). It has yet to impose a minimum capital requirement, reserve requirement, and mandatory credit allocation. It also has not conducted a financial audit of cooperatives. Unlike bank deposits, however, deposits in cooperative groups and credit unions are not covered by any insurance. Although there has been no case yet in the country where a collapse of one cooperative affected the entire cooperative system (Lamberte 1995), effective regulation and supervision are still necessary to protect the deposits of millions of small depositors in cooperatives (Llanto 2000).

Information systems and credit bureaus

In a market abounding with asymmetry in information, lenders should have a way of appraising prospective borrowers to avoid loan defaults. Depositors as well as shareholders, on the other hand, should also know how to determine the profitability of their investments. In this regard, a database of information has to be developed to overcome information asymmetries, using

statistics that link default behavior of past clients to a range of objective indicators (Rhyne and Christen 1999).

Credit bureaus provide detailed information that allows financial institutions, including microfinance institutions to evaluate a borrower's ability and willingness to pay. Microfinance institutions operate on a principle of reciprocity among members, which addresses a fundamental tension between the parties involved in a credit transaction. Through these institutions, transaction costs are lowered, risks are reduced, greater transparency is achieved, competition is promoted, and better incentives for repayment are encouraged (Haider 2000).

Thus, according to Haider, the government should initiate the establishment of such institutions because, first, it is essentially a public good and, second, there are fixed costs involved. Private entities will only enter the market after a public credit registry has made a headway through the market. Privately managed bureaus will then complement the records of the public credit register by expanding the breadth, quality, and accessibility of information. A problem, however, arises in linking credit bureaus with financial institutions. Based on existing bank secrecy laws, which stipulate that only regulated entities can have access to these facilities, microfinance institutions are automatically excluded (Haider 2000).

Another issue is the cost, particularly for small banks and microfinance institutions with few transactions. Integration of microfinance into the credit information system would need (a) national initiatives to promote linkages of large unregulated MFIs with public credit bureaus; (b) willingness on the part of MFIs to share information and develop standard reporting systems; (c) technical assistance providers that can help to set up information systems and develop MFI capacity to fulfill information reporting requirements, and (d) where credit bureaus do not exist or are underdeveloped, donor support to encourage legal framework for public and/or private credit bureaus (Campion and Venezuela 2001).

Emergence of credit bureaus in the Philippines¹⁴

While the use of credit bureaus has long been implemented in many developed countries, this information system has barely been adopted in the Philippine banking sector. The main reason for this is that the personal credit history available to lenders for assessing risk is typically limited by custom or law. Historically, credit reporting began with the sharing only of so-called

¹⁴ The discussion on credit bureaus drew on information supplied by the ACPC.

negative information, or reports on bad experiences with borrowers such as delinquencies, charge-offs, bankruptcies, and other similar problems.

Only gradually and recently has information about the successful handling of accounts (prior and current) been added to the data repository of some Philippine banks. These are the *positive data* that include such information as account type, account age, current balance, credit limit, among others.

The majority of the banks that presently practice the sharing of positive information are commercial banks situated in urban areas. These banks have organized a common screening system and a depot of information, primarily to keep records of corporate as well as personal accounts.¹⁵ Among other things, this system can provide banks with information on how much a borrower owes other banks. With the ready availability of this type of information, the risks to the entire banking system can be minimized.

The management of data on good and bad bank borrowers started with the founding of the Credit Information Bureau, Inc. (CIBI) and the Bankers Association of the Philippines (BAP)-Credit Bureau in the mid-80s and early part of the 1990s, respectively. However, these credit bureaus have mainly served the information requirements of banks in Metro Manila. Both the CIBI and BAP, however, are planning to expand the area coverage of their credit bureaus to the countryside by encouraging the cooperatives and rural banks to participate in their respective credit bureau systems.

Presently, the existence of a credit bureau is already part of the prerequisites to the implementation of the Basle Capital Accord II by the Bank for International Settlement (BIS) in 2005.¹⁶ The Philippines recently became a member of the BIS, which is among the stronger and more prestigious advocates in international fora of bank supervision (Malaya 2003).

As a leading institution in credit policies, ACPC has taken initial steps toward the establishment of credit bureaus in the countryside. It plans to pilot a rural credit bureau in the near future, which is chiefly geared to promote a sustainable and effective delivery of financial services to the countryside by disseminating information and strengthening the market base of the rural and cooperative banks in the countryside. ACPC aims to pursue the second tack by fusing its technical resources to the existing credit bureau

¹⁵ Particularly those holding credit cards.

¹⁶ Also known as the Basle Committee, which is composed of senior representatives of bank supervisory authorities and central banks. Among the original member-states are Belgium, Canada, France, Germany, Italy, Japan, United Kingdom, Netherlands, Sweden, Switzerland, and the United States. To obtain public policy benefits, the New Basle Capital Accord focuses on improved capital adequacy framework zeroing in on developing capital regulation and increasing substantially the risk sensitivity of minimum capital requirements.

operating in Metro Manila and instilling discipline in making payments, especially among small borrowers like farmers and fisherfolk.

The BSP is currently working with the National Credit Council (NCC) of DOF to study and develop a viable business option for effective credit bureau operation given the current Philippine policy and regulatory environment. Bangko Sentral ng Pilipinas should facilitate the proper and valuable development of the use of credit references in commercial and financial transactions. BSP should motivate financial institutions to exchange references with credit bureaus (Bolaños 2000).

Barriers to the development of local credit bureaus

A well-established bureau depends on certain test-components such as its market reach, sphere of operation, number of subscribers, social responsibility, and impact on the lives of the people who can attest to the depth of its experience in the business. Fitting models of this kind are the BAP-Credit Bureau and the CIBI, which are both considered prime movers in the development of commercial credit information system in the country.

As an organization grows, problems and issues also arise, which could hinder its efforts to further develop its systems and increase its reach. A major constraint is the unwillingness of rural and cooperative banks and credit cooperatives to share information on clients. Little appreciation for new technology, additional overhead cost to the maintenance of database (e.g., training and hiring of new staff), and perceptions that their current and prospective clients are open to piracy by competitors are some of the other reasons why it is difficult to set up a credit bureau.

The current setup of the BAP Credit Bureau and CIBI caters mainly to the needs of commercial banks. Business viability is the two institutions' primary consideration, which explains their reluctance to venture into the rural financial market. The assumption seems to be that the rural financial markets sustain the financial requirements of maintaining the services of a credit bureau.

Credit bureau, as a disciplinary tool for dealing with delinquent borrowers, may further drive away the small borrowers such as the small farmers and fisherfolk from obtaining credit from formal institutions like banks. The instability and seasonality of rural borrowers' farm incomes make it difficult for them to pay their obligations as scheduled, and this could prevent them from obtaining another loan in the future. Hence, they are often forced to turn to informal lenders for the needed loans. An offsetting factor may be the presence of off-farm incomes which may be more stable and regular. Another factor may be the willingness of a financial institution to adjust loan repay-

ment schedules to the cash flow of the borrower and this is an area where MFIs have shown expertise.

Legislating bank participation in credit bureaus may be unnecessary. The BSP can require this kind of participation by giving incentives to banks, such as additional points in their respective performance ratings, should they comply with the requirement. The BSP that pushes for the establishment of credit bureaus, under the existing laws, is in itself legally constrained from financing a subsidiary or undertaking for private or commercial purposes such as this. Recently, the BSP urged anew the banks to form their credit bureaus to allow the sharing of vital credit information and blacklist notorious borrowers. It also encouraged the participation of other government agencies in this undertaking. On the one hand, banks can form an independent organization where each of them is represented and has a voice in the administration of the credit information system. The sharing of authority and responsibility gives the formed body a level of independence and neutrality as far as the whole operation is concerned.

Property rights, agrarian reform and credit markets¹⁷

The system of property rights has a profound effect on incentives and on the scope of market transactions in land and credit. For one, property rights provide agents with the incentives to use land efficiently and to invest in land conservation and improvement. For another, it has been determined that information is positively correlated with property rights, which means that a clear and well-enforced property rights will produce critical information about economic agents. Land's usefulness as collateral depends on the absence of uncertainty and asymmetric information with regard to certain rights such as transfer rights (Feder and Feeny 1991).

The absence of clearly defined owners and other attenuations of property rights usually lead to inefficiencies and high transaction costs. Weak property rights discourage formal banking transactions and motivate economic agents to engage in informal transactions such as buying, selling and mortgage of usufruct rights over property.

In the Philippines, the government introduced agrarian reform which had far-ranging and deep impact on agriculture and the rural sector in general. It aimed to address the highly unequal distribution of rural incomes caused mainly by the inequitable distribution of lands and the high incidence of poverty in the countryside. In 1972, then President Marcos enacted

¹⁷ This section draws from Llanto and Dingcong (1994).

Presidential Decree 27, provided tenants in rice and corn lands the right to own the lands they tilled. Under this decree, tenants could purchase farm lands on installment basis payable in 25 years, while others could shift from share to fixed-rent leasehold tenancy.

The agrarian reform coverage under PD 27 (or An Act Decreeing the Emancipation of Tenants from the Bondage of the Soil) focused only on tenant-farmers and private agricultural lands planted to rice and corn. It also suffered from implementation problems, since in a span of 15 years since it took effect, Operation Land Transfer achieved only 15 percent of its original target for emancipation patents. This low completion rate was due to lack of funds, lack of strong political will, inadequate agrarian reform policies, and various technical and documentation difficulties (Cornista 1987, as quoted by Llanto et al. 1994). A more comprehensive agrarian reform law called the Comprehensive Agrarian Reform Law (CARL) enacted by Congress in 1988 sought to improve land tenure systems and enhance the socioeconomic status of beneficiaries through the delivery of support services. However, implementation problems also arose. Several authors criticized the CARL's slow implementation, including David (1998) and Kraft (1998), as the delay increased the distortions and uncertainties in the land market.

Agrarian reform introduced structural adjustments such as changes in the size distributions of farms, which would affect production levels according to the existence of economies or diseconomies of scale and access to technology, changes in centuries-old tenancy arrangements that would alter the rewards of investing capital and utilizing labor in agricultural lands. The implementation of the agrarian reform program de-linked tenants (now called agrarian reform beneficiaries) from their landowners who used to supply them farm inputs and credit. The government's strategy was to use the Land Bank of the Philippines in servicing the credit requirements of agrarian reform beneficiaries. The agrarian reform beneficiaries would also amortize the lands through the LBP.

Although the LBP was mandated to deliver credit to the agrarian reform beneficiaries, the magnitude of credit requirements and the number of borrowers cannot be accommodated by the available resources of this bank. The national government could not accommodate either the huge credit requirements of the agriculture and agrarian sector in view of perennial fiscal deficits. The agriculture and agrarian sector would have to depend on the willingness of the formal financial system to supply finance. However, the increase in the number of smaller-scale farms and individual farmers, the change in the collateral value of land, the shift in the asset-holding of former landowners from land to financial assets, and the increase in lender transac-

tion costs resulting from the new milieu in rural areas will be critical factors formal financial institutions have to consider in granting credit to the rural sector. And because of extreme competition in loan applications, only the most bankable will likely avail itself of credit. Meanwhile, the informal lenders continue to hold sway in rural credit markets.

The agrarian reform program had adverse effects on the collateral value of agricultural lands. Farm lands are not accepted as collaterals by some banks due to uncertainties in their ownership while emancipation patents, which are nontransferable, and certificate of stewardship contracts, which are not negotiable instruments, are not acceptable either to banks. Most banks only service large, commercial clients because agrarian reform beneficiaries are perceived as greater credit risks. The uncertainties unintentionally brought about by CARL adversely affected the willingness of banks to provide financial services to the rural areas. Based on the surveys undertaken by Llanto and Dingcong (1994), marketability of collateral and borrower reputation are considered the most important factors in the evaluation of loan applications by banks.

The emerging bias against agricultural activities was evidenced by the higher proportion of rationed borrowers engaged in agricultural activities compared to the proportion of borrowers engaged in nonagricultural activities. This implies that agrarian reform beneficiaries have difficulty accessing loans from financial institutions. The program unintentionally intensified the bias of private banks against the rural sector, particularly smallholder agriculture.

Enhancing the creditworthiness of farmer-borrowers will definitely take some time. Thus, in the interim, government interventions that would support the viability of the activities undertaken by rural borrowers and the rural economy in general are necessary. Government policies and programs will also greatly affect the ability of beneficiaries to access the financial services of formal financial institutions.

What is emerging as a short-term policy tool to address the problem of credit is the use of cooperatives and people's organizations (POs) as channels for credit delivery. The basic idea is to use the low-cost funds in the formal financial sector while taking advantage of the monitoring, information, and enforcement technologies of cooperatives and POs. In the nineties, the Land Bank tried to use thousands of cooperatives as credit channels to agrarian reform beneficiaries. The belief was that the joint liability among cooperative members in a particular loan contract serves as a relatively efficient risk-sharing device and as a collateral substitute that can secure the loan. The hypothesis is that an efficient bank-cooperative/people's organi-

zation-end borrowers linkage is likely to address the access to credit problems of agrarian reform beneficiaries because of the lower transaction costs, including monitoring and loan enforcement technologies of cooperative and people's organizations.

The shift in land ownership brought about by CARL also increased the transaction costs between the lender and borrower, which in turn raised the total borrowing costs of farmers. In effect, banks shifted away from agricultural lending. Based on a sample of banks, Casuga (1994) shows that banks have considerably higher lending transaction costs than nonbank financial institutions (NBFIs) such as credit cooperatives. She reports an advantage in using NBFIs over banks in servicing small farmer credit needs in terms of transaction costs. Furthermore, the total transaction costs incurred by borrowers of banks in availing themselves of loans were found to be twice as much as the expenses incurred when transacting with NBFIs.

Existing bank policies and regulations discourage their operations in rural areas and make the urban areas more attractive. The inherent characteristics of the countryside also aggravate the bias of banks against it. Improving the transport infrastructure and supporting the development and diffusion of appropriate technology will increase rural productivity and result in lower transaction costs.

As the delivery of support systems is a part of CARL's component, the LBP—being the principal institution mandated to provide support services—should have the institutional capability to accommodate both the landowners' and beneficiaries' financial needs. A primary factor, which restrains the LBP from fully servicing the agrarian reform beneficiaries, is the difficulty arising from being both a universal bank and an apex bank for agrarian reform. As a universal bank, the LBP services an extensive range of clientele and provides a wide array of financial products and services. It is also regulated by the BSP. As an 'apex bank' for agrarian reform, the political expectation is that it should service the credit requirements of millions of agrarian reform beneficiaries and focus on the agrarian sector. While there is a need to provide access to credit for agrarian reform beneficiaries, the subsidies that the government provides through Land Bank should be evaluated in terms of cost-effectiveness and equity impact. Furthermore, Land Bank must stay viable and profitable to discharge its functions. The arrangements for buying land under CARL pose potential problems to the Land Bank because of the mismatch between payments to landowners and receipts from small farmer mortgages. In case the Agrarian Reform Fund is not fully funded, Land Bank would still be expected to finance future liabilities on land purchases. This has severe implications on its balance sheet.

Banks, thus, should be equipped to deal with agrarian reform beneficiaries. This implies that government should initiate activities that would enable banks to deal with these beneficiaries. The government tried to reduce the risks faced by banks in lending to the agriculture and agrarian sector through credit guarantee and crop insurance programs. ACPC studies in this area seem to indicate that adverse selection and moral hazard problems contributed to the failure of those programs. How to craft an incentive system that would encourage private bank lending to smallholder agriculture and agrarian sector remains a key challenge.

Current issues on the collateral value of farmlands

As of December 2002, 68.6 percent of agricultural lands for distribution under the agrarian reform had been distributed. To a certain extent, rural incomes had improved and poverty had been alleviated.

However, an unintended cost arose: the demise of land markets in the rural areas because of certain CARL provisions (Estanislao and Llanto 1993). Among the law's provisions are:

1. Prohibition against mortgaging/selling of land within 10 years of its award and upon full payment by farmer beneficiaries to Landbank;
2. Setting of ceiling on ownership of agricultural lands at 5 hectares;
3. Designation of government as sole buyer of awarded lands; and
4. Prohibition against share-tenancy arrangements

Estanislao and Llanto (1993) and David et al. (2003) explain that those provisions of the law eroded the collateral value of land, which hampered a farmer's access to credit, particularly in the formal financial markets. The distortion of land markets had a negative impact on resource allocation. The provisions constrained the transferability of land from less productive to more productive uses and better farmers. They also limited the choice of more efficient contractual arrangement in smallholder agriculture.

Despite the prohibition against pawning and selling of agrarian lands, anecdotal evidence shows the occurrence of these prohibited activities, particularly in informal markets. Under informal land market transactions, the benefits to farmer-beneficiaries of land reform have been reduced, because the price paid to farmers who pawn or sell the land is discounted by the high transaction cost of future (informal) sale or mortgage of the same land. Because the transactions are informal, farmers who engage in informal pawning and selling lack legal protection. An interesting phenomenon is the increase in pawning or selling of usufruct rights to the land in some agrarian

reform areas as a substitute to actual transfer of land ownership which as has been discussed above is constrained by certain CARL provisions.

Policymakers are now studying the deregulation of land markets. Supporters of this policy change expect a revival of land markets. This is likely to result in an increase in land market transactions, changes in land ownership distribution and possibly an increase in land prices arising from perceived investment and land speculation opportunities. It could also accelerate land conversion and facilitate access to credit if banks are convinced they can foreclose the land following a loan default and dispose of it in a functioning land market. Those who oppose this proposal contend that it will result in land ownership concentration which the agrarian reform program sought to demolish and in the dispossession of farmer-beneficiaries of lands awarded to them by the state.

One legislative measure that seeks to enhance the acceptability of agricultural lands as security for loans obtained from lenders, banks, and other financial institutions is House Bill (HB) 5511, known as the Farmland as Collateral Bill, which was filed in 2002. The proposed law aims to promote access to rural credit by setting up a guarantee fund that will be used to guarantee the mortgage. The Senate version, Senate Bill (SB) 2553, on the other hand, disregards the guarantee provision of HB 5511 and instead focuses on restoring the legal rural land market by allowing the mortgaging of awarded lands to any person. In the event of default, the mortgagee may foreclose the land, provided that the farmer-beneficiary shall have two years to redeem the land. The five-hectare ceiling will also be removed. This would result, according to Fabella, in land price disclosure, thus improving land marketability. It would also correct the pricing of emancipation tenants (EPs) and Certificates of Land Ownership Agreement (CLOAs), thereby improving the capacity of collateral to sufficiently repay the lender's exposure. Banks would also be allowed to foreclose and own more land than the CARL limit (ACPC 2003).

Institutional development

According to Yaron (1992), targeted credit without institution building in rural financial institutions is almost a sure recipe for prolonged dependence on donor or state funds and bailouts. He submits that institutional development is the first step toward strengthening rural financial markets.

A financial institution has to achieve the self-sufficiency required to become sustainable and viable. Von Pischke (2003) indicates that sustainability requires self-correcting-mechanisms and dynamism through innovations. Competitive markets are probably the most subtle and sensitive self-correct-

ing mechanism because every transaction has the power to make some change, however small it may be. However, the lack of institutional development creates what Gonzalez-Vega (2003) calls “insufficiency gap,” which separates the potential supply from the willingness and capability of the rural population to demand different types of financial services at competitive prices and terms.

Poor performance of government and donor-assisted credit programs can be traced to their inability to sustain their operations, which, in effect, heavily taxes the government. Meyer and Nagarajan (2000) recommend that to achieve high levels of outreach and sustainability, rural financial institutions also need appropriate governance, loan recovery, and proper design of products and services.

Savings mobilization has long been advocated in literature. Although not all agricultural credit programs have savings mobilization as one of their major components, several of them are already implementing it, according to the evaluation reports of selected current programs that this study has obtained.

Lim (1998) recounts that before the Asian crisis, many rural banks had successfully mobilized deposits from small savers by implementing incentive schemes, advertising their products, having competitive interest rates on savings and time deposits, and establishing credit links to attract clients. When the crisis and the El Niño phenomenon hit, large and medium-sized depositors preferred large established commercial banks. The stricter prudential regulations implemented by BSP after the crisis should improve rural banks’ practices in credit allocation and savings mobilization.

Miller (2003) relates poor savings mobilization to the abundance of “easy” or “cold” money from donors. The regulatory environment could also act as hindrance to the deposit taking among the poor in the rural areas. Finally, microfinance institutions do not exhibit an image of solvent and reliable deposit-taking institutions. Miller recommends that government should loosen the reserve and reporting requirements in rural areas of branches that maintain total deposits below a predetermined threshold, and support strategic alliances between regulated and nonregulated entities. Donors, on the other hand, should direct any subsidy toward human resource development, financial management, market intelligence, management information systems development, and well-priced funds for loan portfolios.

In their study of the different rural financial markets in different countries, Meyer and Nagarajan (2000) note that successful rural credit institutions in other countries have highly professional management and enjoy an autonomous operation. This implies not only highly development manage-

ment and technical skills but also maturity among management and staff. The maturity of the institution is reflected in the behavior of its clients through the firm implementation of loan repayments and other such transactions.

Professional and accountable management of an institution would keep it along its core objectives and that institution would efficiently and continuously strive to attain these goals. A dynamic management would also encourage innovations in banking practices. Continuous improvement in the design of products and services would enable those institutions to serve rural areas and to be responsive to the demand of the rural communities for financial products and services. Meyer and Nagarajan (2000) argue that financial institutions must design their products and services according to the expected demand in rural areas, taking into consideration the presence of informal credit sources and how costs could be recovered and profits generated. The effort would lead to an expanded outreach in the countryside. A case in point is the problem of loan recovery in dispersed communities in rural areas which has proven to be a daunting task for many formal financial institutions. The process of discovering cost-effective loan recovery techniques should consider three factors cited by Meyer and Nagarajan (2000), namely: (a) the design of products which can enhance a borrower's ability to pay, (b) the length of relationship between the institution and the client, (c) and timely information about the clients.

Risk-mitigation instruments

Following normal practice in managing portfolio investments, risks should be well understood and managed. In an environment where risks are correlated, rural financial markets should avoid concentration on a particular crop or agricultural activity. The funds transfer operations of commercial banks with rural branches, where funds could be circulated among several of a bank's branches depending on the demand of funds to circumvent negative effects of crop seasonality in rural areas, are one way to address the risk in rural financing (Relampagos and Lamberte 1989).

The lack of diversification of activities in rural areas presents a major hurdle for rural lenders, both informal and formal lenders.

Notwithstanding the diversification efforts of smallscale farmers and most other rural residents, especially low-income ones, rural areas themselves remain largely undiversified economies. This is illustrated by an example from Vogel and Llanto (2005) as follows: shopkeepers in a rural town will be adversely affected if the major product (e.g., rice) suffers a decline in price or loss of output due to adverse weather or insect pests. Thus, a rural lender does not escape this lack of diversification by lending to shopkeepers

rather than to farmers. In finance, such risks are dealt with by portfolio diversification, but for a local lender the opportunities for loan portfolio diversification are sharply limited, so the lender is likely to be left with the alternative of holding relatively large amounts of liquid assets and thereby curtailing local lending.

Skees (2003) differentiates the strategies in risk management from that of risk coping. Risk management strategies attempt to address risk problems *ex ante* while risk coping strategies address problems *ex post*. Portfolio diversification is a common *ex ante* risk management strategy. Capital build-up of risky borrowers in a credit cooperative or NGO is an example of a risk-coping strategy. Since access to liquidity in formal rural financial markets is limited, the small economic agent's accumulation of assets that can be liquidated to smooth consumption during adverse events is one way to cope with perceived risks. However, problems arise when the accumulated asset cannot be easily liquidated and the value of the asset may be affected by a shock, e.g. a systemic financial crisis.

On the part of rural borrowers, information disclosure, building good reputation, regular savings with financial institution help improve their image before formal financial institutions. These risk-mitigating mechanisms reduce moral hazard and adverse selection that affect the efficient allocation of credit and help create the confidence among rural financial institutions that they could recover loans provided to small rural borrowers.

Innovations in rural financial markets

Financial innovation is the creation by financial intermediaries of new products, instruments or processes, intended to improve their liquidity position, decrease risks, and increase the flow of credit and/or the level of deposits. It has been shown, through the examples of rural financial markets in other Asian countries such as Bangladesh, that innovations can reduce intermediation costs and risks, resulting in the widening, deepening, and integration of capital markets (Bhatt 1988, as quoted by Abiad 1993).

Because of the differences in the degree of maturity of the financial markets and the regulatory framework within which the markets operate and the openness of the economy, the innovations in developed countries differ from those in underdeveloped countries. The catalysts for innovations in developed countries are usually inflation, interest rate variability, internationalization, technological advancements, and legislative initiatives. Due to the presence of structural elements such as an oligopolistic financial market, and inconsistent and ineffective regulatory enforcements, innovations in the underdeveloped countries are usually spurred by external forces like the

policy environment. Catalysts of developed countries, on the other hand, are market forces (Abiad 1993).

Buchenau (2003) views innovations quite differently, however. For him, innovations are by-products of a competitive market. An indicator that financial institutions are competitive is when they are continuously improving their quality and pricing of services to protect and expand their market shares.

A more general view is that innovations occur either as by-products of a competitive environment or as improvisations in the face of imperfect structures. Either way, the primary objectives in the emergence of innovative products and processes in financial markets are: (a) to make formal institutions available to those groups which did not previously have access, (b) to reduce the transaction and risk costs on both the lender's and the borrower's side, (c) to increase loan amounts and loan terms to accommodate the needs of borrowers, and (d) to maintain the profitability of financial institutions.

The government has a big role to play in underdeveloped countries like the Philippines in creating a policy environment that would encourage competitive financial markets where innovations can flourish and benefit consumers. The government should support institutional innovations as opposed to product and process innovations, which the private sector can handle. Innovations, particularly in the technological area, require investments that the government, given its perpetual budget constraints, cannot finance and that the private sector cannot fully assume because of externalities and free-rider problems (Llanto and Fukui 2003).

Collateral substitutes

One way financial institutions can reach the rural borrowers is by studying and adapting mechanisms used in informal credit markets, such as collateral substitutes, to extend loans to small borrowers. Collateral substitutes are used to enforce repayment in the informal credit markets in the absence of traditional collateral such as real estate mortgages. Some of these are pawning of cultivation or usufruct rights and required sale of output to the trader-lender.

The use of various forms of collateral substitutes in the informal credit markets derives from the fact that the different types of informal lenders lend for diverse reasons. Lenders tend to specialize in lending to certain borrower classes according to the collateral substitute used. Specialization according to collateral substitute used implies that certain types of lenders have an advantage over others in lending to particular types of borrowers.

Casuga and Hernandez (1996) point to various forms of collateral substitutes in rural financial markets such as joint liability, or having a guarantor to back up the loan, mutual guarantee by group members and interlinked

contracts. They show that collateral substitutes were used as tools to reach the target clients, broaden the clientele base, enforce loan repayments, and source additional funds or external funding. It seems the use of collateral substitutes enabled some formal rural lenders to expand their loan portfolios and experience higher loan recovery rates.

Llanto et al. (1996) look at how collateral substitutes have enhanced access to formal credit in three Southeast Asian rural financial markets in recent years. They examined two hypotheses, namely: (a) collateral substitutes are equivalent to conventional or traditional collateral or security instruments in protecting the lending institution against loan default losses; and (b) the adoption of collateral substitutes depends on the nature of ownership of the bank, its credit market experience on the use of collateral substitutes, and the legal and regulatory environment affecting the use of collateral substitutes. Comparing the performance of loans made under traditional collateral with those under collateral substitution, the lending institutions' general experiences seem to indicate the potential of collateral substitution in providing protection to banks, given their familiarity with its use and the ability to determine good borrowers and viable projects. Collateral substitutes per se do not directly ensure high loan repayment rates but because of the stricter screening procedures imposed on smallscale borrowers under collateral substitution schemes, loan recovery rates can be improved. This indicates that it is still the creditworthiness of borrowers, not the presence of any type of collateral—traditional or substitute—that determines loan repayment. An effective collateral substitute, however, can orient conservative banks toward a new mindset: smallscale borrowers who cannot provide the traditional collateral are not necessarily high credit risks. The survey indicates several factors that encourage the use of collateral substitutes: (a) the profit-generating potential of collateral substitutes that prevents banks from turning down creditworthy clients who cannot present traditional collateral; (b) government support in terms of loan funds that induce banks to accept collateral substitutes; (c) design of the collateral substitute. The banks that were asked about their experiences on collateral substitution prefer collateral substitutes that are flexible, easy to implement and with minimal transaction costs.

IV.

RURAL FINANCE DEVELOPMENT IN SELECTED ASIAN COUNTRIES

Poverty, unsound policy framework, and heavily constrained financial markets often characterize rural economies in less developed Asian countries. Most Asian countries, such as the Philippines, have pursued a supply-led credit policy to promote credit access to the rural sector. This strategy, however, has created pressure on the limited resources of governments, which then led to the emergence of financial services and techniques that attempted to respond to the needs of the rural sector. Some of these institutions succeeded.

This section looks into the profiles of four Asian countries in an attempt to glean some lessons from their experience. Space limitations only allow for a brief but hopefully informative discussion. India and Bangladesh are poor and densely populated countries that have experienced heavy interventions in rural credit markets from their governments, while Indonesia and Thailand are two rapidly growing economies which were able to develop formal financial institutions with massive outreach to small rural borrowers and savers. An interesting lesson is that in three of these countries emerged financial institutions that became successful in providing credit and other financial services to the rural poor. These are the Grameen Bank of Bangladesh, the Bank Rakyat Indonesia Unit Desa of Indonesia, and the Bank for Agriculture and Agricultural Cooperatives of Thailand.

Bangladesh

The formal financial system of Bangladesh consists of a central bank (the Bangladesh Bank), four nationalized commercial banks, 18 private commercial banks, 12 foreign commercial banks, four nationalized special banks, and four specialized development financial institutions, two of focus on agricultural development. Two cooperative networks serve the rural sector.

Before gaining independence from Pakistan, financial institutions were used as cheap sources of credit for priority sectors. Thus, upon the country's independence, it inherited a repressive financial system. The state priori-

tized nationalized industries, which led to the rationing of loan supply to private sector demand. Principal donors provided sizeable lines of credit to the private sector and entrepreneurs without proper screening. The country's aid-based development strategy was alleged to contribute to the bad-debt problem.

By late 1980s and in 1990s, attempts were made by the government to implement financial sector reforms. The results included significant deregulation of interest rates, decreased directed credit, recapitalization of and greater autonomy of nationalized commercial banks, and introduction of loan provisions. However, political interferences in the financial markets persisted. In fact, in 1996, the government permitted a blanket rescheduling of all bank loans on the basis of a 10 percent down payment. This aggravated the bad-debt culture and an unsound banking system.

Provision of financial services in the rural sector has been subjected to government and political interventions that led to disastrous results. An important feature of Bangladesh, however, is that it has a strong NGO network that, along with the Grameen Bank, serves small towns and peri-urban areas whose activities are not necessarily limited to agriculture.

There were efforts to push financial services, especially loans to the rural sector. From 1978 to 1981, banks were required to put up rural branches, which led to a large commercial share of rural loans and deposits. Lending rates were controlled and banks were encouraged to make agricultural loans that the Bangladesh Bank would refinance at subsidized rates. Five interest exemption programs were implemented during 1982-1991. Agricultural loan repayments did increase but at a huge cost.

Nationalized commercial banks, development financial institutions, and cooperatives play dominant roles in agriculture lending. They provide loans to individual farmers and focus on crop lending, but they do not serve the wider demands for rural finance. An important development has been the emergence of member-based institutions such as Grameen Bank and hundreds of nongovernmental microfinance organizations that make loans, often to group of borrowers.

The Grameen Bank (GB) approach follows the idea of joint-liability of the group members. Clients are mostly women. Membership is limited to people who have similar economic status and live within the same village. Loans are given to borrowing groups so peer pressure for repayment is created. Each member is obligated to make a weekly savings, is required to make a 5 percent contribution from each loan received and a 25 percent contribution of the total interest due on the loan principal to an emergency fund for use as insurance against potential default.

There are about 1,000 NGOs that are also microfinance organizations (MFOs) in Bangladesh. All provide loans, some mobilize savings and many provide nonfinancial services. Most use the group lending technology popularized by the GB, but like the Association for Social Advancement (ASA) use a variation of the group lending approach popularized by Grameen Bank.

The most important factor affecting the sustainability of FIs is loan recovery. GB disbursements for general crop loans, which comprise 25 percent of its portfolio, has had very high loan recovery rates. Other NGOs that lend to agriculture also showed good recovery. However, Murdoch (1999) estimates that since GB's report is based on the amount overdue as a fraction of loans due, there is a declining trend in loan repayment at the latter part of the period. The second most important factor to sustainability is net income. The GB and the NGOs are dependent on foreign funds and domestic subsidies, which help keep interest rates low.

The GB and other microfinance NGOs have surpassed the banks in providing loans to rural areas and have avoided serious loan default problems. They have succeeded in developing systems to deliver highly standardized small loans to poor people. They have been more successful at serving female clients.

The chief weakness, however, is that many NGOs are very dependent on government and donor funding. Thus, they are not self-sustaining in spite of good loan recovery. The inescapable conclusion is that the rural financial system in Bangladesh is fragile. Important reforms are required before the country can be assured of an efficient and sustainable rural financial system.

India

Government has intervened heavily in the banking sector, with policies for bank branching, mandatory quotas, and below-market interest rates. The well-known loan *melas* in the 1980s, in which large volumes of funds were imprudently issued as subsidized loans to the supposedly weaker segments of society and loan waivers offered until 1991, is an example.

State-mandated branch banking might have contributed to the expansion of commercial banks in the rural areas and to their lending to the rural population. Policies such as directed credit, loan waivers, subsidies, and the bailing out of nonperforming institutions contributed to a decline in borrower discipline and weakened the financial sector. The performance of loans made to the priority sector under the directed credit program has been especially dismal.

In the 1990s, the country embarked on a paradigm shift in its approach to the financial sector. By mid-1996, the country's banking regulatory framework was considered satisfactory while supervisory quality and transparency were improving. However, the political hold on the banking sector is still significant as indicated by substantial state intervention.

Overall structure, conduct, and performance of the financial system have a profound impact on the rural sector. The increase in rural poverty has become a great concern for the government, leading to the formulation of several policies for poverty alleviation.

Rural finance was an offshoot of such efforts for the rural poor. Thus, a supply-led approach was employed for rural and agricultural finance to cater to the rural population. The majority of state interventions were done with the rural sector as primary focus.

The government launched the Integrated Rural Development Program. Loans were made through the banking system at subsidized rates to those who belonged to a particularly low-income group. Besides the loan, a cash subsidy was paid to borrowers and was set at 25 percent of the total cost for projects financed for small farmers, 33 percent for projects for agricultural laborers, and 50 percent for lower-caste persons. On the other hand, microfinance has been attempted on a large scale since the early 1990s. The importance of self-help groups (SHGs) was also recognized in the late 1980s.

In 1992, a pilot linkage program was initiated under the directive of the government to link SHGs with banks either directly or through NGOs as guarantors or intermediaries. The commercial banks have also introduced several innovative schemes to finance the rural sector such as the green card scheme which allows established farmer clients to access credit on demand without lengthy paperwork, agricultural overdraft schemes that provide credit throughout the year for farming and installment schemes for the purchase of machinery and equipment for small businesses.

By 1998, the country had 32,662 rural and semi-urban branches of commercial banks, a cooperative network with 92,682 primary agricultural credit societies, over 2,000 branches of land development banks that primarily provided term loans for the purchase of land and land improvements, and about 14,136 branches of regional rural banks. The Reserve Bank of India is responsible for broad financial sector policies and is the general regulatory authority for commercial banks and urban credit cooperatives. The National Bank for Agricultural and Rural Development is an apex refinancing institution for cooperatives, regional rural banks, and commercial banks engaged in rural lending.

During the period 1950-1969, the role of privately owned commercial banks in rural finance was minimal and indirect. There were few commercial bank branches in rural areas despite the Reserve Bank of India directive in 1954 to have at least one branch in "un-banked" rural and semirural areas for every branch opened in previously banked areas. Thus, 14 major commercial banks were nationalized in 1969 to improve the services in rural areas. After nationalization, the share of bank loans in rural areas increased. The lead bank scheme was also introduced in which all districts were allocated to the nationalized banks and a few private banks to initiate and lead development in each area. Differential rates of interest were introduced in early 1972, when public banks faced a ceiling of 4 percent nominal rate per annum for loans made to sectors identified as weak in the rural society.

Estimates of the effect of bank expansion on agricultural investment and output indicated that an increase in the number of commercial bank branches increased investment in animals and water pump sets. The expansion in bank outlets had a direct impact on crop output and a larger increase on the demand for fertilizers. However, the impressive expansion was not matched by outreach, in fact, there had been a decline in real volume of credit to the agriculture sector in 1996.

Many rural financial institutions face problems of sustainability. Most of the institutions are plagued with huge arrears and have incurred high transaction costs in providing financial services. Loan losses and transaction costs are invariably higher than earnings such that they require constant refinancing and recapitalization by the apex institutions.

The most serious problem confronting rural finance development in India is poor loan recovery. Repayment problems have become pervasive and are eroding the discipline among borrowers. Transaction costs are also high for both lenders and borrowers.

However, the financial sector has significantly expanded over the years, especially in the rural areas. The country has an excellent infrastructure with its wide networks of financial institutions. Interventionist policies have resulted in high absolute credit volume and high levels of rural bank branch penetration in rural areas.

By the 1990s there was a gradual policy shift toward a market-based financial system. The 1992 reforms placed greater emphasis on the viability and sustainability of institutions, transparency of operations, competition, quality of services, and reduction in state interference. Rural deposit mobilization has been vigorous, especially by commercial banks.

Nevertheless several factors constrain the effective functioning of rural financial markets: (a) the state still plays a dominant role; (b) financial insti-

tutions have limited freedom to collect loans because of political pressure; (c) commercial banks still face an interest rate ceiling; (d) mandatory lending for priority sectors still exist; (e) despite the low viability of many rural branches, urban cooperatives are still permitted to establish their operations in rural areas, and (f) the skill level of banking sector employees is still low.

Indonesia

Indonesia has a long history of deregulation of its economy and the financial sector, mixed with a high degree of state intervention designed to allocate credit on the basis of preferential programs. This mixed policy environment produced contradictory results.

Indonesia has employed a variety of agricultural and rural development strategies that have influenced the evolution of financial markets. Rice sufficiency was the priority in the 1960s and early 1970s. Infrastructure investments were made and direct cash grants were given by the central government to individual villages. Self-help groups and cooperatives were given special roles to support food self-sufficiency and smallscale rural enterprises. Subsidized programs were implemented to intensify agriculture, to stimulate rural nonfarm enterprises, and to increase rural employment. Transmigration projects were implemented to create employment and reduce population density.

Two nationwide programs were specifically created to benefit the rural economy: (a) the Bimas rice intensification scheme and (b) the small investment and permanent working capital schemes. The green revolution offered new production opportunities but required huge investments in irrigation. To accelerate the green revolution, the Bimas rice intensification program was established in 1969. The Bank Rakyat Indonesia (BRI) unit *desas* were selected to channel subsidized credit to rice farmers.

The first major financial deregulation occurred in 1970 with the adoption of a unified exchange rate and the opening of the capital account to free inflow and outflow of funds. To strengthen indigenous Indonesian businesses, programs for short-term and long-term loans were created, while medium-term investment programs were reserved for firms with indigenous majority ownership. Credit ceilings for each bank were introduced in response to inflationary pressures.

In the 1970s and 1980s, the government actively intervened in financial markets by creating special credit programs with regulated terms and conditions. Moreover, both the national and provincial governments employed a variety of grants, capital transfers, and subsidies to start and strengthen financial institutions. The second nationwide credit program was introduced

in 1974 to improve credit access for small businesses, especially for indigenous Indonesians. The banks lent at a 12 percent nominal annual rate and Bank Indonesia refinanced the loans at 3 percent. In addition, the state-owned loan insurance company insured 75 percent of loan losses. However, like Bimas, these programs encountered heavy losses, widespread fraud, and high default rates. Several other government and donor programs were initiated to expand banking services to the poor which eventually failed. In 1974, a loan window was also created primarily for nonfarm activities. In 1976, the unit *desas* were authorized to mobilize rural savings through the national saving program.

In 1980, a program was introduced for making large nonagricultural loans. All these loans carried an annual 12 percent nominal interest rate. In 1982, 19 categories of short-term credit were specified with seven different lending rates, three discount rates, and eight rediscount percentages. This approach may have contributed to increase output but the price paid was in terms of costly subsidies and distortion in the financial markets.

Following the collapse of Bimas, three key policy changes were introduced between 1983 and 1984 to reform the unit *desa* system. One, the units were transformed into full service rural banks. Two, each unit was treated as a discrete profit or loss center within Bank Rakyat Indonesia. Three, the units were evaluated on profitability rather than on hectares covered or money lent.

One of the unique features of the unit *desas* is that they make individual loans based on collateral, usually in the form of land, and loans are made for one to three years. Local village officials are involved in the screening by acting as character references for the borrowers. As such, the unit *desa* system ranks as one of the most effective rural financial institutions in Indonesia. The transformation of the BRI unit *desa* system in 1983-84 produced spectacular results in outreach and financial performance. Because of this positive experience, unit *desas* were opened in selected urban neighborhoods.

The 1983 reforms introduced private savings mobilization and the measures for credit allocation were altered. These included the following: (a) credit ceilings were abolished, (b) state bank deposits and loan rates were deregulated; (c) central bank preferential financing was curtailed; and (d) so was the central bank's subsidized direct lending.

In 1988, regulations on bank branching and licensing of new private domestic and foreign banks were relaxed. In 1989, controls were removed for offshore borrowing by banks. In 1990, there was a further reduction in the subsidized loan programs and an upward adjustment in refinance rates.

However, banks were required to extend at least 20 percent of their total loans to small and medium enterprises. A banking law enacted in 1992 removed the distinction between development and savings banks.

In 1991, liquidity loans to troubled financial institutions began to expand and controls were re-imposed on overseas borrowing by banks. The near collapse of some private banks in 1994 prompted a wave of prudential regulations to prevent banking abuses. Credit controls were re-imposed in an attempt to control inflation. In December 1995, the central bank moved to exercise control over nonbank financial institutions. In 1996, the government adopted the policy of increased selectivity in the licensing of new bank branches to forestall excessive competition among banks.

The devaluation of the rupiah in 1997 resulted in tightened prudential regulations. The political and economic crisis brought about by the Asian financial crisis brought back the discredited subsidized credit programs as part of the government and donor response to economic and social problems.

In addition to the BRI unit desa system, another major institution in Indonesian rural financial markets is the provincial BKK system, which provides short-term loans to rural families primarily for nonfarm productive purposes. The BKK units were over 3,000 village posts (from a total of about 8,200) that are staffed once a week, usually on local market days. The BKKs are locally administered and are financially autonomous. It has political accountability because it is incorporated into the local government structure.

The sustainability of rural financial institutions in Indonesia varies. Unit desas are self-reliant and subsidy-independent, since they have a high interest rate policy and high level of efficiency. In contrast, Central Java BKKs suffer from several weaknesses. BRI unit desa also has attractive savings products. Many of the other financial organizations, however, rely on subsidies.

The relative success of BRI unit desa system and some other rural financial institutions is due in part to Indonesia's dynamic economy and political environment until mid-1997. A strong demand for credit and the generally good repayment performance of borrowers stimulated the emergence of rural financial institutions.

Several key features of institutional design also explain the successful performance of financial intermediaries. These are as follows: (a) important information problems in lending have been resolved by establishing a network of semi-independent locally operated financial institutions with a comparative advantage in gathering necessary information; (b) performance-based incentives and efficiency wages are given to managers; (c) managers of financial institutions were given autonomy over interest rates and other key

performance variables; (d) one-time subsidies in the form of start-up loans and grants nurtured the organization without creating dependency; and (e) clients value their banking relationship due to rapid loan disbursement, low transaction costs, and the possibility of pledging nontraditional forms of collateral.

Indonesia has explicitly included savings mobilization in its policies to expand financial services. The Indonesian experience provides important lessons for rural Asia in developing a sound and efficient rural financial system. A favorable policy environment cannot be emphasized enough. The massive mobilization of savings has proved that rural people do save given attractive savings products. Policies and institutions can be designed to achieve high levels of outreach, serve the very poor, and attain financial and institutional sustainability using an individual lending technology.

Thailand

The Thai government has intervened in the economy and the financial sector to a lesser degree compared to most other Southeast Asian countries. Until the late 1980s, the Bank of Thailand's (central bank) policy focused largely on the stability and solvency of financial institutions and the use of credit instruments to promote agriculture and exports. Financial operations in Thailand were subject to (a) interest rate ceilings on both on deposits and loans, (b) regulations on portfolio and branching, and (c) various types of compulsory credits. Deregulation was initially undertaken gradually, beginning with interest rate reform. The Bank of Thailand implemented a reform plan in the 1990-92 period that further deregulated interest rate, relaxed portfolio requirements and foreign exchange controls, improved the supervision and examination system, adjusted capital requirements, promoted financial innovations, and improved the payment system.

The second plan of the Bank focused on savings mobilization, development of a country into a regional financial center, and improvement of the central bank's operations. Liberalization of the financial system without appropriate regulatory safeguards, however, contributed to the country's currency and financial crisis in 1997.

An important feature of Thailand's financial history has been the relative autonomy of the Bank of Thailand and its ability to restrain the growth of preferential or directed credit, with agriculture being the primary exception. Thailand has traditionally been a food-surplus country and has never implemented major, highly subsidized agricultural credit programs such as the Bimas program in Indonesia and the Masagana 99 program in the Philippines. Since 1916, the government has experimented with different institu-

tional frameworks to provide cheap credit to the rural sector. Targeted financial support through the banking sector began with the rediscount facility, introduced in 1958, to support exports, which were essentially agricultural.

The country's land tenure system has been a constraint for commercial banks and other financial institutions that use traditional collateral-based lending to screen borrowers and enforce loan contracts. Many farmers on private lands and squatters on public lands do not have legal documents that lenders will accept as collateral. Collateral substitutes are needed in this situation.

The creation in 1966 of the Bank for Agriculture and Agricultural Cooperatives (BAAC) as a specialized institution under the Ministry of Finance to provide loans to farm households, and its subsequent funding and regulation, represents the country's most important effort to support small and medium-sized farmers. An interesting aspect of financial development in Thailand is how the country has managed to avoid the errors of other countries that also created specialized agricultural finance institutions. The rapid growth of agriculture and the rural economy provided a strong demand for rural financial services, but several problems, including the land tenure system, have constrained the development of competitive financial institutions.

Commercial banks, BAAC, and cooperatives are the most important rural financial institutions in Thailand. The number and distribution of banking outlets have a strong influence on access to banking services in rural areas. Transaction costs for savers and borrowers fall when banking outlets expand and move closer to rural businesses and residences.

An analysis of BAAC yields interesting insights into access to formal rural finance. It has recently received a great deal of international attention because of its impressive performance in outreach, lending portfolio, savings mobilization, efficiency, profitability, and subsidy independence. The problem of access to loans by persons without loan collateral has been resolved by BAAC by making joint liability group loans, in which the farmer-members guarantee each other's loan repayment. Presently, BAAC represents about half of the total agricultural lending, and its outreach is reported to be about 90 percent of farm households. Depth of outreach is also impressive. During the 1990s, BAAC began to mobilize savings more aggressively and has relied less on commercial deposits.

The issue of sustainability of rural financial institutions largely concerns BAAC and the agricultural cooperatives. BAAC is dependent on subsidies, although not as heavily as many specialized agricultural lending institutions in developing countries. Also, the Thai government requires its agen-

cies and offices to hold their deposits in government-owned financial institutions. This results in an additional subsidy of unknown magnitude.

Meanwhile, BAAC's need for subsidies cannot be attributed to low levels of efficiency. In fact, it is noted for its high productivity and efficiency. Rather, it can be attributed to the relatively poor financial results, partly due to its five pricing policies. One, it tries to maintain low interest rates. Two, it charges higher rates for larger loans and cross-subsidizes its small clients. Three, interest rates were not adjusted to cover the rise in inflation. Four, in 1995, nominal interest rate was reduced from 11 percent to 9 percent for loans less than 30,000 baht. Five, BAAC charges 3 percent less on wholesale loans made to cooperatives and associations than on retail loans to individual borrowers.

Rural savings mobilization has not been a particularly strong feature of financial policy in Thailand. Moreover, specialized microfinance services are not important in Thailand. One reason for this is that BAAC has already achieved a large outreach. A second reason is that poverty is not as serious in this country as it is in some other Asian countries.

V

TOWARD A POLICY RESEARCH AGENDA

This book has provided a review of carefully selected literature and descriptions of valuable experiences that it hopes could lead to a policy research agenda on rural finance in the foreseeable future. Such an agenda must be drawn from this vision: to promote the provision of efficient, broadly-based, and sustainable financial products and services to various rural economic agents. The policy research agenda should aim at producing research studies that will offer recommendations to policy makers on how to remove the constraints on both the demand for and supply of financial services and products in the rural areas. The proposed agenda should specifically address the issues confronting the rural economy today: asymmetric information, high transactions cost, systemic and covariant risks in agriculture and the lack of diversification in rural economies.

In the past, loan quotas, subsidized interest rates, directed credit programs among others, were implemented by a well-intentioned government but to no avail. Local research studies indicate that such efforts dealt with the symptoms and not the roots of the problems confronting an ailing rural economy and rural financial markets. As the paper has shown, heavy government interventions in the rural financial markets failed to solve the problem of lack of access of small scale economic agents to financial services in the formal financial markets. Those interventions brought perverse results: distortion in the rural financial markets, a weakening of rural financial institutions and huge fiscal costs.

However, when government shifted to an enabling role and began to craft a policy environment, including a market-oriented interest rate policy, that encourages greater private sector participation in rural financial markets, economic agents responded by finding a way to deal with various constraints to access of smallscale economic agents to financial services (e.g., informal lending techniques, the emergence of microfinance institutions, among others).

A future policy research agenda should examine carefully the rural financial markets, understand the behavior of economic agents and the incentives and risks that influence behavior, investigate the roles played by institutions (e.g., property rights, etc.). Based on the foregoing, this book proposes an investigation of the following thematic areas:

1. Sectoral economic policy biases and barriers to productivity and higher incomes in the rural areas;
2. Appropriate legal and regulatory framework that deals with risks and costs of financial intermediation in the rural areas; regulatory barriers to rural finance;
3. Development of the capacity of financial institutions for rural financial services;
4. Financial innovations and services;
5. Identification and management of risks in rural finance; and
6. Role of institutions and governance in rural financial markets.

Annex A. Bank density ratios by type of bank

	Commercial Banks					Thrift Banks					Rural Banks				
	1997	1998	1999	2000	2001	1997	1998	1999	2000	2001	1997	1998	1999	2000	2001
Highest	112.4	117.4	120.6	119.2	120.5	29.2	32.4	32.9	31.2	30.8	2.8	3.8	4.1	4.3	4.4
Lowest	0.4	0.4	0.4	0.4	0.4	0	0.1	0	0.1	0.1	0.2	0.1	0.1	0.1	0.1
NCR-Metro Manila	112.4	117.4	120.6	119.2	120.5	29.2	32.4	32.9	31.2	30.8	2.8	3.8	4.1	4.3	4.4
I-Ilocos	1.1	1.1	1.1	1.1	1.1	0.4	0.5	0.4	0.4	0.3	1.3	1.5	1.4	1.5	1.5
II-Cagayan Valley	0.8	0.8	0.8	0.8	0.8	0.2	0.1	0.1	0.1	0.1	1.1	1.3	1.3	1.3	1.3
III-Central Luzon	2.5	2.6	2.7	2.6	2.7	1.5	1.5	1.6	1.4	1.4	2.3	2.6	2.5	2.4	2.5
IV-Southern Tagalog	1.9	2	2.1	2.1	2.2	1.5	1.4	1.5	1.4	1.4	2.1	2.4	2.3	2.3	2.3
V-Bicol	0.8	0.8	0.8	0.8	0.8	0.2	0.3	0.3	0.2	0.2	0.7	0.8	0.8	0.9	0.8
VI-Western Visayas	1.7	1.8	1.8	1.8	1.7	0.4	0.4	0.4	0.4	0.4	1	1	0.9	0.9	0.9
VII-Central Visayas	1.9	2	2	2	2	0.7	0.8	0.8	0.8	0.8	0.8	0.9	0.9	0.9	0.9
VIII-Eastern Visayas	0.5	0.5	0.5	0.5	0.5	0.1	0	0.1	0	0	0.4	0.4	0.4	0.4	0.4
IX-Western Mindanao	1	1	1	1	1	0.1	0.2	0.2	0.1	0.1	0.3	0.3	0.3	0.3	0.4
X-Northern Mindanao	1.5	1.4	1.4	1.4	1.4	0.5	0.6	0.6	0.6	0.5	0.8	1.1	1.1	1.1	1.1
XI-Southern Mindanao	2.5	2.6	2.6	2.6	2.6	0.7	0.8	0.8	0.7	0.6	1.3	1.5	1.5	1.5	1.4
XII-Central Mindanao	0.9	1	1	1	0.9	0.1	0.1	0.1	0.1	0.1	0.6	0.8	0.7	0.8	0.8
XIII-CAR	0.7	0.7	0.7	0.7	0.7	0.1	0.1	0.1	0.1	0.1	0.4	0.5	0.5	0.5	0.5
XIV-ARMM	0.4	0.4	0.4	0.4	0.4	-	-	0	-	-	0.2	0.1	0.1	0.1	0.1
XV-CARAGA	0.5	0.5	0.5	0.5	0.5	0.1	0.1	0.1	0.1	0.1	0.5	0.7	0.7	0.7	0.8

Source: BSP

Note: The offices include head offices, branches, subbranches, agencies, extension offices, savings agencies, money shops/suboffices but exclude offices located in foreign countries

Annex B. Loans outstanding of commercial banks by sectors (in P million)

	1987	1990	1995	1996	1997	1998	1999	2000	2001	2002
TOTAL	101.11	248.18	783.81	1,216.97	1,576.93	1,348.19	1,354.23	1,451.50	1,399.24	1,432.66
Agri, Fishery and Forestry	12.43	26.92	59.60	63.43	70.71	62.93	58.86	62.10	56.82	72.43
Industry Sector	51.75	108.30	303.57	445.59	534.10	479.76	505.39	547.74	505.31	500.61
Service Sector	36.94	112.96	420.64	707.95	972.12	805.50	789.98	841.67	837.11	859.62

Source: BSP

Note: Data on Loans Outstanding of KBs by industry from 1981 to 1989 was based on credit reports while data from 1990 onwards was based on consolidated statement of conditions. Starting 1986, transfer of nonperforming assets/liabilities of two government banks to the National Government is already reflected.

Annex C. Agricultural production loans granted,* by commodity, 1990-2002 (amounts in P million)

Commodity	1987	1990	1995	1996	1997	1998	1999	2000r	2001	2002P
Food commodities	12.38	22.80	39.24	364.83	233.95	65.04	99.89	54.05	61.09	76.55
Cereals	2.72	6.07	12.49	67.74	46.22	15.17	23.12	14.38	14.25	17.28
Palay	2.13	5.42	11.21	62.81	42.82	13.99	20.95	12.43	12.89	16.14
Corn	0.55	0.60	1.19	4.72	2.83	1.02	2.07	1.80	1.24	0.99
Sorghum	0.02	0.01	0.04	0.01	0.11	0.01	0.02	0.00	0.01	0.04
Soybeans and feedgrains	0.02	0.04	0.05	0.19	0.45	0.14	0.09	0.15	0.11	0.11
Fruits, Veg. and rootcrops	4.54	3.25	6.21	21.44	34.43	9.96	12.30	7.20	14.48	20.47
Livestock and poultry	2.42	7.81	12.76	222.51	125.76	21.12	40.43	22.12	21.88	30.08
Fisheries	2.70	5.68	7.78	53.14	27.54	18.79	24.04	10.35	10.48	8.73
Export and commercial crops	10.98	10.77	21.04	93.25	43.50	20.24	30.65	21.64	20.74	21.24
Abaca and other fibers	1.51	0.44	1.11	4.58	7.41	0.99	1.84	0.37	0.34	0.32
Coconut	3.06	3.10	7.02	28.03	10.64	4.88	9.77	6.04	3.43	4.83
Coffee and cacao	0.45	0.40	1.33	5.06	1.68	0.85	1.49	0.60	0.96	1.36
Cotton	0.12	0.14	0.23	4.04	0.68	0.04	0.63	0.07	0.09	0.14
Rubber	0.06	0.08	0.12	0.92	0.79	0.06	0.17	0.23	0.08	0.08
Sugarcane	5.51	6.23	10.78	49.98	17.79	13.09	16.04	14.25	15.81	14.47
Tobacco	0.28	0.37	0.44	0.65	4.51	0.33	0.71	0.07	0.04	0.04
Forestry	1.20	1.99	2.08	1.09	9.69	1.92	2.11	4.32	1.48	1.79
Others	2.49	5.05	13.25	93.52	76.93	12.56	19.08	12.93	18.25	24.99
Subtotal	27.05	40.60	75.61	552.69	364.08	99.77	151.72	92.94	101.56	124.58
PDB Loans ^a	-	-	-	-	-	5.28	7.93	6.72	7.70	9.62
SMB Loans ^a	-	-	-	-	-	4.17	5.28	8.65	6.30	6.78
SSLA Loans ^a	0.41	0.64	6.96	12.03	12.17	5.86	5.55	5.38	7.04	8.88
TOTAL	27.46	41.25	82.57	564.72	376.24	115.08	170.48	113.69	122.60	149.86

Sources of data: BSP, LBP and DBP.

^r Revised based on actual data for all bank types, except for distribution of RBs by commodity, which was estimated.

^p Preliminary; basic data was based on average shares in past years.

^a A breakdown of loans of thrift banks by commodity is not available. Caution should be exercised in using the figures in this table, if loans granted by thrift banks are to be accounted.

Appendix A. Profile of agrilending programs

Program and Objectives	Target	Eligible conduits, borrowers	Funds (in million pesos)			
			Fund source	Total credit seed fund	Total loan releases	Total available credit fund
DA-ACPC						
Dev't Assistance Program for Cooperatives and People's Organization (DAPCOPO) DCP 1990-96 To provide assistance to agri-based activities not serviced by banks through existing coop federations, POs and NGOs; to develop and strengthen viable rural community-based orgs	Nationwide	Nat'l/reg'l-based federations of farmers' groups and coop; w/ management capability and satisfactory lending track record; Reg'l federations should be sponsored by a nat'l-based org; Agri-based orgs not financed by LBP or other bank	ACPC CALF	41.3	68.5	NA
Agri-Mechanization Financing for Farmer Coops 05-25-75 1994- To promote farm mechanization	Nationwide	LBP accredited coops within priority areas endorsed by ACPC	GAA/CALF	48.7 as of Dec 00	47.8	82.94
The Grameen Bank Replication Program 1990 To extend banking facility to the poorest of the poor; eliminate exploitation by moneylenders; create opportunity for self-employment for utilized and underutilized manpower	Nationwide	Program level-Development foundations, POs and cooperative rural banks. Beneficiary borrowers level-members of a group, preferably women, landless or cultivating land not exceeding 5 has; residing in depressed areas; with income of P3,900 and total asset of not exceeding P10,000.	-	-	-	-

Terms / conditions					Credit Risks	Savings Mobilization
Loan purpose	Loan ceiling	Collateral requirement	Loan maturity	Interest rates		
For relending to primary-affiliate/ chapters	Varied based on credit need of target primaries and repayment capacity of applicant	Joint and several signatures of at least 3 officers and/or Board Members; Counter-guarantee by nat'l-based federation; and/ or other forms of acceptable collateral	Maximum of 5 years	LBP to fedns- 6% (reg'l/ nat'l)8% (prov'l);From fedns/ POs to primary coops- negotiated rate (IR caps and subsidy)	100% fed'n	Later required (at 15 -20% loan retention
Fixed assets acquisition	95% of total project cost	Depends on the project type	Depends on the project type	16%	25% ACPC; 70% LBP	None
Program level- Operating support fund Beneficiary level Microenterprise	Program level- P100,000 per NGO per year for a max. of 3 yrs (grant Amt does not exceed 50% of total project operating cost) Beneficiary level - 1st loan - P1,000; 2 nd loan -P2,000; 3 ^d loan P3,000	-	50 weeks	Free market rate	-	-

Appendix A continued

Program and Objectives	Target	Eligible conduits, borrowers	Funds (in million pesos)			
			Fund source	Total credit seed fund	Total loan releases	Total available credit fund
DA PROGRAMS						
BAI Multilivestock Dispersal Loan Program DCP 1989- To increase the country's breeder base; To upgrade genetic make-up of local stock To provide additional income to farmers; and to improve nutritional status of people	Nationwide	Retailers: RBs/ CRBs Endborrowers: A good standing member of coop/ farmers' org'n for at least 1 year; must not be an owner of 2 or more heads of cattle/ carabao	AgencyFund: DA-BAI	219.8	231.8	219.8
DA–Central Cordillera Agricultural Program II (CECAP) DCP 1996-2004 To increase rural incomes and living standards in the project area; support ecologically stable and diversified farming systems; and strengthen local capabilities in planning, implementation, operation, maintaining, monitoring and evaluating development efforts.		Retailers: Coops, Annual Savings and Loans Assembly (ASLA); Agricultural Development Organizations (ADO) Endborrowers: beneficiaries of CECAP-implemented micro-projects; members of accredited producers groups (PG); savings and loans group (SLG) or ADO; belong to the poorer sector of the community.	EU grant	49.31*	24.77*	49.31*

* Up to June 2001 only

Terms / conditions					Credit Risks	Savings Mobilization
Loan purpose	Loan ceiling	Collateral requirement	Loan maturity	Interest rates		
Cattle breeding or fattening	P14,000 per farmer <i>(represents cost per stock)</i>	Chattel mortgage	5 years for breeding; 1 year for fattening	10%	100% BAI	None
Production and acquisition of agrisupport facilities; Providential and emergency loans for SLG members only.	P15,000	Group guarantee and depending on the conduits policy	1 year	15%	100% DA	Required

Appendix A continued

Program and Objectives	Target	Eligible conduits, borrowers	Funds (in million pesos)			
			Fund source	Total credit seed fund	Total loan releases	Total available credit fund
DA-Upland Development Program in Southern Mindanao (UDP) 1998-2002 To develop and test a replicable model for sustainable management of the natural resources in the uplands of 5 provinces in Region XI; and to enable upland communities to address their subsistence needs and to produce new marketable surpluses through sustainable market-led agricultural development	Five provinces of Southern Mindanao	Retailers: RBs, Coops, NGOs Endborrowers: small farmers producers, small entrepreneurs within the program area; coops	EU grant	1.45	0.81	1.45
DA-Aurora Integrated Area Development Project Phase (AIADP) DCP 1988-2002 To alleviate poverty; To promote growth with equity; and To develop environmentally sustainable economic activity	Aurora Province	Farmer owner-operator or a share tenant with 0.5 to 2 has. of land; rural poor with viable projects.	EU grant	27.8 (or 58.02 thru conduits)	29.48	32.68
DA-Catanduanes Agricultural Support Programme (CatAg) DCP 1994-99 To assist rural communities, to initiate and sustains increases in income for all economic activities hereby reducing poverty.	11 municipalities of Catanduanes	Rural poor	EU grant	40.0	40.0	40.0
DA-Economic Self-Reliance Agri Dev't Programme (CASCADE) DCP 1992- To help mainly indigeneous rural people of the highland areas in promoting agro-based local economy that will allow them a better and standard of living & will give them opportunity to remain settled where they reside.	Benguet, Nueva Viscaya and Nueva Ecija	Retailers: <i>still to be identified</i> Endborrowers: small farmer producers, small entrepreneurs within the program area; coops	EU grant	4.35	4.55	4.55

Terms / conditions					Credit Risks	Savings Mobilization
Loan purpose	Loan ceiling	Collateral requirement	Loan maturity	Interest rates		
Dev't or expansion of rice/corn mills, shellers, threshers, coffee depulpers Terms/ conditions Loan purpose and storage, drying facilities etc., working capital for micro projects and agri business; Industrial, tree and fruit tree projects, livestock, fattening/ breeding projects	Actual credit needed by the target group	-	-	-	-	-
Crop prod'n, Improvement of irrigation facilities, Livestock prod'n, Fishery, Coop projects, Postharvest facilities, Marketing, Other agri-related or livelihood	P100,000	Mortgage-able items	Crops – 6 mos. to 4 years Livestock - 2 years	15%	-	-
Short-term loans for crops, livestock, fisheries, agroprocessing, trading, services and machinery	P20,000	none	Six months to 1 year	36%	-	-
Financing of agricultural crops and livestock production activities include off farm and nonfarm micro enterprises of out of school youth women and artisans	Prod. Loan - P10,000 Commodity Loan – P30,000 Facility Loan – P200,000 and above	Savings – equity and fixed assets	Prod. Loan: 6 to 12 months Commodity Loan: 6 – 12 months Facility Loan: 24 – 36 months	-	-	-

Appendix A continued

Program and Objectives	Target	Eligible conduits, borrowers	Funds (in million pesos)			
			Fund source	Total credit seed fund	Total loan releases	Total available credit fund
LBP-DA/ACPC -Integrated Rural Financing Program (IRF) DCP 1989- To provide financing through rural financial institutions to enhance the prod'n, income and repayment capacity of organized small farmers and fishers.	Nationwide	Retailers: RFIs (RBs, CRBs, PDBs, Coops) Endborrowers: Small farmers and fishermen	Special fund	233.09	1,078.0	233.09
LBP-DBP-DA/ACPC- Fisheries Sector Program (FSP) DCP 1990- Alleviation of poverty among fishermen through diversification of their sources of livelihood.	Priority bay provinces	Retailers: Accredited RFIs of LBP, DBP and accredited FIs of PCIC and Quedancor Endborrowers: Marginal coastal fishermen's coops and small aqua-culture operators	ACPC-GAA	330.45M (LBP) 260M (DBP) 73.6 (Quedancor) 54.35 (PCIC)	754.07 LBP 549.70 DBP 165.48 Quedancor	330.00 LBP 260 DBP
Agricultural Competitiveness Enhancement Fund (ACEF) DCP 2000- A more equitable distribution of opportunities, income and wealth; a sustained increase in the amount of goods and services produced by the nation for the benefit of the people; and an expanding productivity as the key to raising their quality of life, esp. the underprivileged	Nationwide	Farmers/ fisherfolk and agribusiness enterprises	GAA	62.48	38.85	62.18
NFA						
Farm Level Grains Center II (FLGC II) DCP 1995- To establish farm-level infrastructure that provide coops with mktg. capability to obtain max. return for their harvest; To accelerate the provision of low-cost credit to uplift income opportunities and livelihood of small farmers.	Nationwide	Primary coops located in irrigated palay/corn producing province listed under DA Key Grain Areas.	Proceeds from importing Thai rice	86.9	153.6	100.7

Terms / conditions					Credit Risks	Savings Mobilization
Loan purpose	Loan ceiling	Collateral requirement	Loan maturity	Interest rates		
Crop prod'n Fishery, Poultry, Livestock-raising	Depends on the project type	Real estate/ chattel mortgage of the object of financing	Max. of 1 year	12% for coop members 14% for individual farmers	-	-
Agricultural production loan, Working capital, Fixed assets acquisition	Depends on the project type	Depends on the project type	Depends on the project type	Agri Prod'n/ Working Capital - 12% FA-16%	-	-
Eligible projects and activities for ACEF support are limited to those which are directly related to a) enhancing the global competitiveness of the agri products; b) establishment of enabling mechanism for eligible proponents	Minimum of P500T	Collateral free	Depends on the project type	Interest free	-	-
Lot acquisition (LA); Warehouse Construction (WHsC); Marketing loan (ML)	(LA) - P100T WHsC - P750T ML - P500T - Terms/ conditions	Real estate mortgage on the lot and warehouse; Built-in on the warehouse loan for ML	5 years and 3 years for ML - Terms/ conditions	14%	-	-

Appendix A continued

Program and Objectives	Target	Eligible conduits, borrowers	Funds (in million pesos)			
			Fund source	Total credit seed fund	Total loan releases	Total available credit fund
Japan Internat'l Cooperation Agency Postharvest Facilities Assistance Program JICA-PAP DCP 1987- The project aims to provide farmers orgn's with post harvest facilities to reduce grains losses, lessen postharvest cost and shorten the time period for the various in farm operations.	Nationwide	Primary coops located in irrigated palay/corn producing province	Proceeds from RP-Japan Project	17.19	25.52	17.19
Quedancor						
Agrikulturang MAKAMASA for Local Gov't Units (AM-LGU) DCP 1997-2002 The program seeks to enable LGUs to extend financial assistance that would support the social upliftment of their constituents in accordance with the approved local development plan and public investment program	Nationwide	Individual farmers/ fisherfolk or association of farmers/ fisherfolk Wholesale: LGUs	DA-GAA	75.0	112.75	Not available
Agrikulturang MAKAMASA for Rice and Corn-Based Farming System (RCBFS) DCP 1997-2014 To finance projects on production of palay and corn and its inter/rotation/ relay crops.	Nationwide	Farmers/Sole Proprietors/ Cooperatives/ Partnerships/ Corp./ LGUs/ FPOs/POs/ RFIs	DA-GAA	557.0	756.56	Not available
Agrikultura ng MAKAMASA For High Value Commercial Crops (AM-HVCC) DCP 1998-2013 To provide support to hasten development of the HVCC industry	Nationwide	Farmers/Sole Proprietors/ Cooperatives/ Partnerships/ Corp./ LGUs/ FPOs	DA-GAA	208.57	298.28	Not available

Terms / conditions					Credit Risks	Savings Mobilization
Loan purpose	Loan ceiling	Collateral requirement	Loan maturity	Interest rates		
Construct'n of post harvest facilities Terms/ conditions	-	Real estate mortgage on the lot and warehouse; Built-in on the warehouse loan for ML	-	-	-	-
Relending for agrifishery projects	P 50,000 and above	LGU must secure the loan by the assignmt of Internal Revenue Allotment (IRA) covering total project cost; shall properly be supported by a local Sanggunian resolution	Max of 3 years	8% p.a. to LGU (pass-on rate to indiv farmers/ fisherfolk or association shall be 14%)	-	-
Production of palay and corn and its inter/ relay/ rotation crops, Processing/ marketing Acquisition/ construction of prod'n and post-prod'n facilities, machineries and equipments.	For conduit P500T and above Lending to farmers P100T and above	REM/CM/ Assignment of gov't bonds/ securities/ comm'l shares of stock or bank dep./place-ments /co-makers/ hold-out/ JSS/ IRA	Prod'n: Max of 1 yr. Marketing/ Processing - Max 3yrs Acquisition of facilities and equip't: Max 3yrs	-	-	-
To finance projects on agri production, processing, marketing, acquisition of products, and postharvest prodn., facilities or joint venture involving high value crops	For conduits: P500T and above Lending to farmers: P100T and above	REM/CM/ Assignment of gov't bonds/ securities/ comm'l shares of stock or bank deposits/ placements/ co-makers/ hold-out/ JSS/IRA	Production: 2-12 years depending on cash flow and crop gestation Marketing/ Processing – Max of 5 years; Add'l working capital: Max. 3yrs	SGM: Bank rate GCFM/SWM: for conduit, 8%; to farmers 12% (based on present value of annuity)	-	-

Appendix A continued

Program and Objectives	Target	Eligible conduits, borrowers	Funds (in million pesos)			
			Fund source	Total credit seed fund	Total loan releases	Total available credit fund
Agrikulturang MAKAMASA for Sugar Modernization (AM-SM) DCP 1999-2014 To revitalize the sugar industry through mechanized farming; and to promote the bankability and access of sugar farmers/ planters to formal credit institutions	Nationwide	Sugar farmers/ planters endorsed by SRA	DA-GAA	60.0	31.06	Not available
Integrated Livelihood Program for Fisherfolk (ILPF) DCP-FSP? 1997- To improve the living conditions of smallscale fisherfolk; and To increase income of fisherfolk thru the provision of alternative livelihood projects.	Nationwide	Smallscale fisherfolk engaged in aquaculture, marine based, agri-based and nonagri-based project.	ACPC-GAA	73.6	165.48	Not available
Poverty Alleviation Fund for Direct Assistance to Farmers (PAF-DAF)1997-20021 1. Special Credit Window for Individual Farmers DCP1998- To provide credit assistance to individual farmers who are not eligible for financing under regular financing programs of banks.	Selected areas only	Creditworthy farmers/farm-households in the identified priority areas whose per capita income does not exceed the poverty threshold				
2. Calamity Housing Loan Window DCP1998- To provide interest-free credit for the construction/repair of houses of farmer-victims in calamity-stricken areas.	Selected areas only	Farm households who belong to the poverty threshold line and whose dwellings were damaged by calamities such as typhoon, flood, fire and other natural calamities				

Terms / conditions					Credit Risks	Savings Mobilization
Loan purpose	Loan ceiling	Collateral requirement	Loan maturity	Interest rates		
To finance and guarantee the purchase of tractor/ implements	P250,000 and above	10%-farmer's cash equity; 50% CM on purchased tractor/ implement 40% - any or combn of REM, CM, assgnmt of gov't bonds/ sec., commercial shares of stock or bank deposit/ placement	1-5 years to be determined by the lending bank	Bank rate	-	-
Smallscale agri and nonagri based projects	P50,000 Terms/ conditions Loan ceiling	Real estate/ chattel mortgage Loan comakers	Max. of 5 years	coop - 8% Terms/ conditions Interest rates indiv. - 10%	-	-
For relending to eligible farmers/ farm households to finance agri production, marketing and/ or other livelihood projects	To lending conduits: Loan exposure not to exceed the total fund allocation of a particular prov. and shall not exceed 10 times the conduit's equity. To endborrower: Not specified.	none	To lending conduits: max. of 10 years for term loans and 15 months for credit line. To end-borrowers: not specified	Shall be set by the ACPC in consideration of Sec. 21 of the Magna Carta for Small Farmers	-	-
For relending to eligible farmers/ farm households to finance construction/ repair of houses damaged by calamities in the priority areas.	Max. of P20,000 per household	none Terms/ conditions Collateral requirement	Max of 2 years Terms/ conditions Loan maturity	0% Terms/ conditions Interest rates		

Appendix A continued

Program and Objectives	Target	Eligible conduits, borrowers	Funds (in million pesos)			
			Fund source	Total credit seed fund	Total loan releases	Total available credit fund
Quedancor-NFA Farm Level Grains Center (FLGC I) DCP 1995 To establish farm-level infrastructure that provide coops with marketing capability to obtain max. return for their harvest; To accelerate the provision of low-cost credit to uplift income opportunities and livelihood of small farmers.	nationwide	Primary coops located in irrigated palay/corn producing province listed under DA key Grain Areas	NFA-Japan	43.7	2.08	Not available
Non-DA Prog TLRC						
Agro-Industrial Technology Transfer Program (AITTP) DCP 1984- To facilitate the transfer of production and processing technology; To develop domestic and export markets; and To generate livelihood opportunities for the rural sector	nationwide	Corporations, individuals or registered farmers' coops/ associations	OECF	447.41	680.17	255.3
Non-DA program DAR						
Credit Assistance Program for Program Beneficiaries Development (CAP-PBD) 1996 To provide financial assistance to ARBs particularly for agri-related livelihood	nationwide	Retailers: LBP Endborrowers: ARBs coops/ organizations in identified ARCs accredited by DAR				
Countryside Partnership Scheme (DAR-CPS) DCP 1993-2003 To enable deserving small farmer cooperatives to own affordable pre- and postharvest facilities and other fixed assets in order to improve their productivity and increase their income	nationwide	Retailers: LBP Endborrowers: ARB coops endorsed by DAR				

Terms / conditions					Credit Risks	Savings Mobilization
Loan purpose	Loan ceiling	Collateral requirement	Loan maturity	Interest rates		
Lot acquisition (LA); Warehouse Construction (WHsC); Marketing loan (ML)	LA- P100T WHsC- P750T ML- P500T	Real estate mortgage on the lot and warehouse; Built-in on the warehouse loan for ML	5 years and 3 years for ML	14%	100% LBP	required
Fixed assets (excluding land) acquisition, Working capital, Anchor projects, Relending to small farmers Pioneer technology, commercialization	P40 M (depending on loan type)	Shortterm - max. of 1 yr Medium to Long Term - based on project cash flow and borrower's overall repayment capacity	Short term working capital loans mature in 12 mos. Medium to Long term repayable in 5 yrs with grace period and a max of 15 yrs.	Short-term-12% Med/LongTerm-13% Frontend fee Short term - 3% Long term 4% p.a. of approved loan	-	-
Agricultural production loan, Working Capital (WC), Fixed assets acquisition	Depends on the project type	Depends on the project type	Depends on the project type	AP/WC- 14% FA-16%	-	-
Agricultural production loan, Working capital, Fixed assets acquisition	Depends on the project type	Depends on the project type	Depends on the project type	AP/WC-14% FA-16%	25% DAR 70% LBP	required

Appendix A continued

Program and Objectives	Target	Eligible conduits, borrowers	Funds (in million pesos)			
			Fund source	Total credit seed fund	Total loan releases	Total available credit fund
DAR-Quedancor Program for CARP-Barangay Marketing Center (CARP-BMC) DCP 1992 To establish farm-level infrastructure that provide coops with the marketing capability to obtain maximum return for their harvest; To accelerate the provision of low-cost credit to uplift the inc. opportunities and livelihood of agrarian reform beneficiaries	nationwide	Retailers: Quedancor Endborrowers: Primary coops located in irrigated palay/corn producing province listed under DAR SOPs/ ARCs and/or DA's KGAs	ARF	171.82	121.41	171.82
Non-DA program						
NLSF						
LCAP, Livelihood Credit Assistance Program for ARCs, Special Tie-up, BSK DCP			Agency fund	313.85	313.85	313.85
DBP						
Cattle Financing Program (CFP) 1991- To increase the country's breeder base.	nationwide	Individual or corporate cattle raisers with good track record for the last 5 years and with a minimum of 20 existing breeding cows				

Source: ACPC

Terms / conditions					Credit Risks	Savings Mobilization
Loan purpose	Loan ceiling	Collateral requirement	Loan maturity	Interest rates		
Warehouse Construction Marketing Loan Rice Mill Loan Trucking Loan	P750T (more or less)P1MP200T (more or less) P300T (more or less)	REM on the lot and waterhouse; Built-in on the warehouse loan; Chattel Mortg on ricemill, truck	8 years 4 years 5 years	12% 12% 12%	100% Quedancor	without
Purchase of breeding stock, Pasture development and/or maintenance; Other purposes that contribute directly in increasing productivity	Based on actual needs of the project	REM/CM, Assignment of leasehold rights over the land covered by Pasture Lease, Agreement Livestock Ins.	Maximum of 15 years inclusive of 3 years grace period	Fully secured: 15% Not secured: 17%	100% DAR	-

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This book provides a review of carefully selected literature and descriptions of valuable experiences that could lead to a policy research agenda on rural finance. Such an agenda must be drawn from a vision to promote the provision of efficient, broadly based, and sustainable financial products and services to various rural economic agents.

The policy research agenda should aim at producing research studies that will offer recommendations to policymakers on how to remove the constraints on both the demand for and supply of financial services and products in the rural areas. The proposed agenda should specifically address the issues confronting the rural economy today: asymmetric information, high transactions cost, systemic and covariant risks in agriculture and the lack of diversification in rural economies.

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