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Strengthening Credit Institutions for Rural Poverty Alleviation

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PHILIPPINE INSTITUTE FOR DEVELOPMENT STUDIES

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I. INTRODUCTION

The objectives of the study are twofold: (a) present the current status of rural credit markets, rural credit institutions and the poverty situation and (b) recommend measures that will strengthen existing and potential rural credit institutions to make them more effective instruments for poverty alleviation.

The motivation is the awareness that in certain countries such as Bangladesh, and Indonesia, innovative credit programs implemented by a variety of credit institutions have helped very poor households out of their poverty situation.[2] The premise is that access to credit for productive activities is an important means to alleviate poverty in the rural areas.

However, despite the relative successes of the innovative credit programs, it is held that in many developing countries, the "formal rural lending institutions are meeting only a small percentage of the demand (for credit) of the rural poor. The commercial banks and specialized agricultural and development banks are, to a large extent, meeting the needs of

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[2] The Grameen Bank experience in Bangladesh is an example.

large borrowers and have not been able to reach fully the disadvantaged rural households."[3] Thus, the small farmers development programs in Nepal and Bangladesh have covered no more than 5-6 percent of the credit needs of small farmers. The Grameen Bank in Bangladesh has covered less than 20 percent of rural, landless families up to 1994.[4]

Recent discussion among donor agencies and implementors of credit programs for poverty alleviation centers on the slow pace of outreach to the poor. The impatience is reflected in the commitment of the Microcredit Summit, held in Washington, D.C. on February 2-4, 1997 to reach 100 million of the world's poorest families with credit for self-employment and other financial and business service by the year 2005. The estimated funds requirement is about US$21.6 billion to reach 100 million borrowers by 2005.[5]

After this introduction, the next section reviews briefly the present macroeconomic, agricultural and rural development situation. Section 3 discusses the poverty situation in the country and the government's Social Reform Agenda, a program to alleviate poverty through complementary interventions intended to provide the poor greater opportunities or access to resources. It notes that access to credit has been given a prominent role in poverty alleviation. It calls attention to the empirical observation that the poor are good credit risks and that lending to the basic sectors could be profitable. Section 4 discusses the situation in the rural credit markets with particular focus on the rural credit institutions. The section provides a general analysis of functions, growth patterns, structure, geographical and financial coverage to the extent permitted by available secondary data and information. This section reviews and analyzes the rural lending institutions and the role of informal lenders in the rural credit markets. It includes a discussion of the opportunities to widen rural lending, including new initiatives of non-traditional lending institutions, i.e., credit-granting non-governmental organizations (NGOs). Section 5 reviews the regulatory framework and institutional mechanisms affecting rural lending and innovative lending programs. An important

[3] Rural Development Section, RUDD, Economic and Social Commission for Asia and the Pacific (1997).
[4] *Ibid.*
[5] The Microcredit Summit: Declaration and Plan of Action, February 2-4,1997, Washington D.C.

observation is that macroeconomic stability is important for financial markets to grow and develop. However, the appropriate regulatory and supervisory framework must be present for monitoring the health of financial institutions, including the microfinance institutions and undertaking measures for continuing viability of those institutions. The last section concludes and recommends measures to improve rural credit markets and in particular, rural credit institutions.

II. REVIEWING THE PAST TO UNDERSTAND THE PRESENT

A false start

To understand the present situation, it may be worthwhile to review the past. The immediate conclusion that an astute observer of the Philippine economy will have is that in the recent past, the country missed several opportunities for growth by having flawed macroeconomic policies. This is ironic considering that the country has been endowed with rich natural and human resources. On hindsight, the current poverty situation would not have been as bad, had the country adopted earlier the recent macroeconomic and institutional reforms that brought it to the growth path after the disastrous Marcos years. This is to say that the basic condition for poverty alleviation is continuing, broad-based economic growth which is brought about by stable macroeconomic conditions and efficient markets.

In the 1950s, the Philippine economy adopted a development strategy characterized as industry-led, import-substituting and capital intensive. It ignored the fact that a labor surplus economy should consider a development strategy that will intensively use its most abundant resource and will exploit its comparative advantage in the world markets. The development strategy required the transfer of scarce resources from agriculture to industry as well as the heavy subsidization of capital inputs and industrial outputs, basically through a fixed exchange rate. Taxation of agriculture and market control by private and quasi-public monopolies and oligopolies were the instruments used in transferring scarce resources from agriculture to industries. An overvalued exchange rate strengthened import-substitution and the capital intensity of the economy.

The Philippine economy grew in the 1960s but the growth rate decelerated toward the 1970s because of very limited domestic markets for import substitutes, growing unemployment and a large trade account deficit. In the 1970s and 1980s, the government started to give emphasis to export promotion but the highly protective and distorted tariff system along with heavy government regulation of the different sectors of the economy, and the monopoly powers given by Marcos to certain industries continued to hinder economic growth and worsened that already inequitable distribution of income and wealth.

Economic growth virtually came to a halt by the late 1980s. Negative economic growth rates were experienced following the severe balance of payments' crisis in 1983-1985 and the assassination of Benigno Aquino, Jr., a political rival of Marcos in August 1983.

The hard and long effort to recover and return to the economic growth path began with the change of government from the Marcos dictatorial rule to the democratic Aquino administration in late 1985. However, even until the late 1980s, the trade and investment policy environment still favored inward-looking industries. Such policy environment has continued to heavily penalize the agricultural seotor. With the restoration of democracy, the government launched a series of macroeconomic and institutional reforms which initiated economic recovery.

A second wind: the road to recovery and growth

Under President Aquino, the country embarked on a series of major reforms which tried to minimize price distortions and lift institutional constraints against agriculture. In particular, the major reforms directly affecting the agricultural sector included the abolition of government-supported monopolistic structures in the sugar and coconut industries, further reduction of the National Food Authority intervention in rice and corn markets and its withdrawal from trading in wheat, flour, and feed ingredients.[6] The tax system was made more revenue productive and progressive. State owned banks were rehabilitated and strengthened and the private sector was given a greater role in the goods and financial markets. The trade liberalization program was pursued although at a graduated phase due to concurrent economic crises. On the downside, the huge foreign debt service and large fiscal deficit inherited from the Marcos administration forced the administration to skimp on new capital investments and even on routine maintenance of the country's physical capital. The negative result was a slowdown in economic recovery and growth.

The Ramos administration continued the policy reform efforts and turned around the economy by the mid-1990s. There were significant policy reforms, including the liberalization of foreign investments, liberalization of the foreign exchange markets, privatization of government owned and controlled corporations, and the opening up of previously oligopolistic industries such as telecommunications and shipping, among others. Greater private sector participation in the economy gave a fresh wind to the lagging economic growth. An example was the private sector involvement in solving through Build-Operate-Transfer arrangements the power crisis that hit the economy during the last two years of the Aquino administration.

[6] Balisacan, A.M. (1991) "Agro-Industrial Interphase in Rural Development" in Philippine Rural Development: Problems, Issues and Directions, UPLB Rural Development Study Team.

Those market-oriented policies are designed to gear up the economy for an outward-looking strategy based on comparative advantage. The banking industry was also liberalized by allowing the entry of foreign banks. Thus, the government pins its current development strategy on attaining world competitiveness through policy and institutional changes, including emphasis on human resource development.

The structure of the economy and the poor

The structure of the economy defines the opportunities open to the poor to participate in growth. An industrial structure that favors labor-intensive industries is good for the poor. In the case of the Philippines, however, despite recent growth, the industrial structure has not changed significantly. The industrial sector which contributed about a third of domestic output in 1970s continues to contribute practically the same proportion 25 years later. On the other hand, the agricultural sector's share in total output generally declined. This was accompanied by the rise in the contribution of the services sector to output. The long history of industrial protection and bias against the agricultural sector brought this kind of economic structure. The effect on employment is obvious.

The result was the lackluster employment generation record of the Philippine economy. This situation can be gleaned from the sectoral contribution to output and employment. As of 1995, the industrial sector, which contributed a third of output, absorbed only about 20 percent of employment. A striking case in the industrial sector 's manufacturing which contributed as much as 28 percent of domestic output but only 12 percent of employment. The agricultural sector, on the other hand, which has a declining share in output still contributes as much as 45 percent of employment generation. The contribution of the service sector to output is relatively stable but its share in employment generation is rising. The data indicate that it is the service sector rather than the industrial sector which is absorbing surplus labor. The unemployment record of the country is high by Southeast Asian standards.

The development strategy which remained protective of industries and biased against agriculture has not only impeded the country's industrialization process but also resulted in high unemployment and persistent poverty particularly in the rural sector. The negative impact on the poor is obvious. Labor is the primary asset of the poor. A labor-intensive development strategy which brings about more sustainable, broad-based economic growth is favorable to the poor. On the other hand, a growth and development strategy which favors capital intensity harms the employment prospects of the poor.

To alleviate poverty, therefore, economic growth must be pursued but it must be broad-based. Labor using industries must be promoted and sustained. With broad based economic growth, the need for targeting various interventions to the poor may no longer be necessary as the fruits of growth become more widely available, except perhaps for the poorest who could not participate in the market economy by their own effort.

III. POVERTY SITUATION, POVERTY ALLEVIATION AND CREDIT IN THE SOCIAL REFORM AGENDA

The poverty situation[7]

The overall poverty incidence declined from 44.2 percent in 1985 to 35.5 percent in 1994 representing an average annual decline of less that 1 percent. (Table 1) In contrast, Indonesia, Malaysia and Thailand posted an average annual decline of 2.0, 1.6 and 1.4 percent, respectively. As in many developing countries, the decline of poverty incidence

[7] The excellent source of information and analysis of the poverty situation is the research on poverty conducted by Arsenio Balisacan of the University of the Philippines.

in urban areas is much faster compared to the rural areas. The National Capital Region exhibited the fastest decline and the lowest poverty incidence. While poverty incidence is declining in many regions, the stark reality is that there is an increasing number of poor households.

The majority of the poor are dependent on agriculture for livelihood. Within the agricultural sector, rice farmers, rice and corn farm workers, foresters and deep-sea fishermen have very high incidence of poverty. In terms of numbers, however, the rice farmers dominate.

The National Economic and Development Authority (NEDA) study on poverty and the low income groups (bottom 30 percent) revealed several characteristics of the poor (Table 2). In 1992, 3.4 million households composed of 20.3 million individuals are found in the lowest three income deciles. About 70.6 percent of the poor households are in the rural areas while 29.4 percent are residing in the urban areas. The poor households are relatively larger in size with 56.8 percent of them having six or more members. The continuing high population growth rate may be partly attributed to the poor households' tendency to have larger families. The growth of low income households has also increased the absolute number of families below the poverty line in 1991. The proportion of males is slightly higher than that of the females with shares at 51.4 and 48.6 percent, respectively. The shares of household members in the working age and those who are below 15 years old are almost equal.

During the period 1985-88, the average real income of the poor grew by 15.7 percent while its average real expenditure for the same period grew by 11.5 percent. The growth rates in average real income and expenditures are comparable with the growth rates of income and expenditure of households in the upper 60 percent of the income ladder. The growth figures indicate that economic growth during the period 1985-88 has a significant positive impact on the real incomes of households not only in the upper income deciles but also in the lowest three income deciles.

The incomes of the poor households are largely sourced from entrepreneurial activities with crop farming accounting for 27.2 percent of total income in 1991. Other income and wages and salaries accounted for 29.5 percent and 26.6 percent of total income in 1991, respectively. Assistance from domestic and foreign sources is also becoming an important source of the poor households' income over the years but assistance from domestic sources accounted for a larger share in total income.

The labor force participation rates of both male and female in the bottom 30 percent are higher than the corresponding figures for the national population. Similarly, the employment rates of the household members belonging to the poor are higher than the national rates. Almost three-fourths of the male working age population from the poor households are engaged in agriculture, fishery, forestry, logging and hunting as primary occupation. About 18.4 percent are engaged in production and transport activities. More than one-half of the female working age population from the poor households are also engaged in agriculture and related occupations. However, the females from poor households are engaged in varied economic activities. A significant proportion of females from poor households are engaged in sales, production and transport, and service occupations accounting for 18.2 percent, 12.5 percent and 11.5 percent, respectively.

Almost one-half of the male working age population from the poor households are self-employed without any employee. This indicates that the males in poor households have gained lesser access to formal employment. About 29.1 percent of these males work for private establishments while 14.6 percent work without pay on own-family operated farm or business. A large proportion of the females from poor households are also self-employed without any employee (33.6 percent). However, a significant proportion of poor females (37.1 percent) remained as workers without pay on own-family operated farm or business.

The NEDA (1994) study of low-income groups reveals that the following characteristics are very evident in poor households: lack of productive assets or control over such assets; limited use of modern technology in production activities; limited access to basic economic and social services; and limited human capital. The Survey of the Bottom 30 Percent which also provides information on the access of the low income households to basic services confirms the findings of the 1994 NEDA study.

In general, the poor households particularly those in the rural areas, are found to have inadequate access to basic services (health, water, sanitation, family planning services, credit). The inadequate provision of the minimum basic needs results in poor welfare outcomes and income prospects.

Causes of poverty

Various studies on poverty done by a number of Philippine analysts[8] enumerated the causes of poverty in the country to wit, (1) the failure of economic growth and the lack of employment opportunities; (2) the inequality of income; (3) high population growth; (4) declining productivity; (5) inadequate provision of social services (De Dios, et al. (1993); (6) poor or degraded resource base; and (7) unresponsive and graft-ridden politics and bureaucracy. **Table 3** below presents a summary of the causes of poverty and the suggested interventions.

Lack of sustained economic growth is the single most important reason for the very slow decline in poverty incidence. Lack of growth is also the primary reason for lack of employment opportunities. In addition, the lack of employment content of growth also contributes to lack luster employment generation performance. It has been claimed that although respectable growth rates in the 1970s were achieved, these did not benefit the poor owing to the inequitable structure of the economy. The extent of inequality of income is

[8] Arsenio Balisacan, Emmanuel de Dios and others.

indicated by the fact that for the past ten years the share of the bottom 30 percent has never gone beyond 10 percent of income while the share of the top 10 percent for the same period has never gone below 36 percent.

The continuous decline in total factor productivity (Hooley (1985), Sanchez (1983), Cororaton et al. (1995)) makes the economy less competitive. This situation is even more pronounced in the agricultural sector where a large majority of the poor are dependent for livelihood.

During the period of low and later negative growth, the provision of social services which benefit the poor also deteriorated. However, it is laudable that the government tried to protect the share of the social sector. Capital spending, e.g., on infrastructure was cut but the Aquino administration tried to maintain, if not increase the budgetary allocation to the social sector. Nonetheless, slow growth limits the government's ability to provide more resources to the social sector whose main beneficiaries would be poor households.

However, despite limited and declining budget, there opportunities to raise the effectiveness of social service delivery and to provide the sector more resources (Manasan, Llanto and Nuqui (1995). What is lacking is the political will to do it. Thus, the lack of responsiveness and commitment of both politicians and bureaucrats further limits the opportunities of the poor to get out of the poverty situation.

With economic growth, the prospects for asset redistribution through agrarian reform and structural change are there, although the political and economic processes to make this a reality are slow and difficult. Thus, it is clear that in the short term, nothing dramatic could be expected for poverty alleviation unless the government and Congress are fiercely determined to make a concerted effort to address the poverty situation.

Broad poverty alleviation initiatives

A poverty incidence reduction target based on the headcount ratio was set at the start of the term of the current administration in 1992. The target is from 45 percent in 1991 to 30 percent in 1998.

The current development strategy is based on the twin pillars of global competitiveness and human development. It is a growth-based strategy which seeks to eliminate barriers to the efficiency of markets and to invest in human resource development and people empowerment. Given these, there are significant broad poverty alleviation initiatives pursued by the Ramos administration, namely: (1) sustained economic growth, (2) the social reform agenda, (3) the use minimum basic needs indicators, (4) a strategy to fight poverty, and (5) institutional support for poverty alleviation. Sustained economic growth is included because it is a necessary condition for sustained poverty alleviation efforts.

The role of sustained economic growth on poverty alleviation was highlighted in the middle of 1980s when the economy was not growing. The poverty problem in the Philippines then was diagnosed as mainly due to the absence of economic growth. With a turbulent political condition, it was difficult to launch a coordinated effort to achieve economic growth. Immediately after the restoration of the democratic process in 1986, the economy started to grow but in a boom-bust fashion reflective of a weakened economic structure. In more recent years, however, economic growth has been sustained and there is great expectation of continuing growth in the future.

It worth noting that an estimate for the country of the elasticity of poverty gap to a distributionally-neutral growth is -1.8, that is, a 10 percent growth in GDP per capita would reduce the average poverty gap by 18 percent (Balisacan (1994). Therefore, assuming that the preliminary estimate of poverty incidence in 1994 of 36 percent is correct, the country's real per capita GDP needs to grow by an average of 3.4 percent between 1995 and 1998 to achieve the 30 percent target.

Given the population growth rate of 2.32 percent, this would imply a GDP growth rate of 5.72 percent annually. In order to achieve the poverty target, the current economic growth record must be increased and sustained.

With structural reforms already in place and sustainable growthin sight, the government in 1994 explicitly turned its attention to the plight of marginalized sectors. It launched the Social Reform Agenda (SRA) as an umbrella framework for all poverty alleviation efforts of the government.

The Social Reform Agenda

The umbrella framework for poverty alleviation in the Philippines is the Social Reform Agenda (SRA) which was launched in September 1994. The agenda is built on five principles, namely: (1) a continuing and coordinated effort; (2) partnership between government and the private sector; (3) provision of minimum basic needs to disadvantaged group; (4) explicit targets and commitments; and (5) a conducive policy environment for a sustainable implementation.

To give these agenda a sense of priority, the President heads the policy-making council behind the SRA known as the Social Reform Council. The council is composed of key implementation officers for each of the flagship programs, heads of allied national government agencies, and representatives from local government units and the private sector. To ensure a continuing effort, the activities under the SRA are included in the normal operations and budgeting of the national government line departments. In addition, regular monitoring and semi-annual assessment of the progress of implementation are conducted.

Targeting is done both by geographic area and by sector. At the start of the program a total of 20 out of the 77 provinces have been identified as priority provinces. Subsequently, the list of priority provinces has been expanded to include all the provinces. Seven disadvantaged groups (the program calls them basic sectors) have also been identified as the target beneficiaries of the SRA. These groups include: (1) farmers and landless rural workers, (2) fisherfolk, (3) urban poor, (4) indigenous cultural communities, (5) informal sector workers; (6) others including women, youth, disabled, elderly, and victims of disasters and calamities.

The SRA adopted the following strategies:

- *Promote and sustain economic growth to create employment and livelihood opportunities.* This will be done through infrastructure development, fiscal reforms, financial sector reforms and development, other reforms to remove barriers to growth, and targeted government expenditure policy.
- *Sustain growth based on people-friendly strategies.* This consists of labor intensive technologies, redirection of credit for "livelihood" to programs for the ultra poor, removal of policy bias against agriculture, reform in the rural credit markets to make credit more accessible to the poor.
- *Expand social services to provide minimum basic needs.* The package is composed of primary health care, basic education, nutrition, housing, water supply and sanitation.
- *Foster sustainable income generating community projects.* This includes "livelihood" programs providing skill training, extension of credit at commercial rates but without collateral, technical extension.
- *Build the capabilities of the poor.* This consists of local leadership training in cooperation with the local governments, assistance through the private voluntary organizations, e.g., NGOs, and formation of people's organizations.

Specific programs were drawn for each basic sector depending on the situation analysis conducted by each group in separate sectoral consultations. The programs include both broad policy reforms for the sectors as well as specific projects. For instance, the identified problems of farmers and landless rural workers include limited rural infrastructure, uncertain land tenure, limited access to technology and limited access to product and credit markets. Thus, the program designed for this group is agricultural development consisting of intensified implementation of the Comprehensive Agrarian Reform Program, concentration of agricultural development resources using agrarian reform communities as main conduits, increasing the budget for basic rural infrastructure such as irrigation systems, post-harvest facilities and farm-to-market roads and technology input for improved productivity.

Overcoming poverty through credit

Poverty can be significantly reduced and eradicated through a number of measures. Policies that promote equitable growth and encourage the intensive use of labor resources will indeed benefit the population, particularly the poor. The provision of social services which builds up the human capital of the poor and expands their access to productive resources will help achieve the poverty alleviation. In addition, the Social Reform Agenda has identified the provision of access to credit as a significant mechanism for poverty alleviation.

But are the poor good credit risks? Will a strategy seeking to expand the access of the poor to the formal financial markets unnecessarily create risks for the private financial institutions participating in credit programs for the poor? In response to these questions, we cite, among others, the findings of 8 case studies of different experiences in Bangladesh, India, Indonesia, Malaysia, Nepal, Pakistan, the Philippines and Sri Lanka reported in the volume **Banking with the Poor** [9]:

[9] Banking with the Poor, Report and Recommendations based on Case Studies Prepared by Leading Asian Banks and Non Governmental Organizations, The Foundation for Development Cooperation, Brisbane, Australia, 1992.

- The poor are good credit risks; they have a high propensity to save if opportunity and motivation are given to them, and they are fully "bankable."

- The main problem the poor experience is how to achieve better access to credit, rather than to reduce its cost.

- Given better access to credit, the poor are willing and able to help themselves.

- Women borrowers have proved to be the most reliable and successful borrowers.

- Non-governmental organizations and self-help groups of the poor are playing a key role in giving the poor better access to credit. They are able to mobilize group savings, to provide group guarantees as a substitute for collateral, to reduce transaction costs through group action and voluntary labor, and to achieve high repayment rates on loans.

- Banks can meet the credit needs of the poor by adopting well-conceived delivery systems, using NGOs and self-help groups as financial intermediaries. Commercially sound linkages have been established between commercial banks and NGOs and self-help groups active in providing credit for the poor.

The specific experiences of Grameen Bank of Bangladesh and the local credit-granting NGOs under the two networks, Alliance of Philippine Partners for Enterprise Development (APPEND) and PHILNET in their credit programs with the poor indicate that the poor are good business partners and that poverty alleviation programs which use credit as an intervention instrument has a chance to succeed.

The National Credit Council (NCC) was created in 1993 to rationalize the different government credit programs and coordinate the efforts of different government agencies on providing credit to the poor. This is necessary in view of the many separate directed credit programs of the government that target the poor but were unsuccessful in their attempt. In addition, there is a need for policy reforms in the rural credit markets to create an enabling environment for private lending institutions to participate in those markets[10]. The presence of numerous government directed credit programs stifles the needed enabling environment. Worse, the perception arises that credit for the poor is a dole-out, a loan that should not necessarily be paid because it is funded by the government.

A key achievement of the NCC is the adoption of a National Strategy for Microfinance in 1997 which put microfinance in the broader context of financial sector reforms and development and gave it a key role in poverty alleviation. There is a recognition commonly shared now by government and the private sector that the poor require not only access to credit but also savings facilities. Hence, the shift from microcredit to microfinance and the emphasis on the role of microfinancial institutions such as credit cooperatives, rural banks, cooperative banks in providing sustainable microfinance services to the poor.[11]

A key development in credit for the poor programs is the recognition of savings as an important financial product for the poor.[12] The poor demand credit and savings opportunities, e.g., banking facilities as well. The experience of the cooperative movement and the credit-granting NGOs indicate that the poor save and that substantial amounts can be mobilized from them given the appropriate incentive structure.

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[10] A recent survey by Llanto, Geron, and Tang (1997) documented the "complexity and waste of public resources involved in the implementation of directed credit programs."

[11] The credit NGOs, i.e., those NGOs providing microcredit are also active microlending institutions. They mobilize group savings, that is, the forced savings of group members, but are not allowed to mobilize deposits from the public. Only duly licensed banks can mobilize deposits from the public. The credit NGOs have benn lobbying for exceptional treatment with respect to deposit mobilization but the current policy thrust is to confine this activity to banks.

[12] Borne out by the experience of Bank Rakyat Indonesia and Grameen Bank of Bangladesh.

Thus, any discussion today of microcredit or credit for the poor will invariably mention the need to mobilize savings from this sector of the economy. This means that the objective to provide the poor access to (formal) credit must recognize the importance of savings. The immediate implication is that a strategy that seeks greater access to (formal) credit for the poor must include the mobilization of deposits from the poor and the rural sector in general. The goal is to have self-sustaining microfinance programs and/or institutions that will draw resources not only from the repayment of microloans but more generally, from mobilized deposits.

This is not a mirage because other countries such as Bangladesh and Indonesia have shown microfinance to be a very practical and successful approach in dealing with poor clients. For example, deposits in Bank Rakyat Indonesia-Unit Desas increased from US$26 million in 1983 to US$3.0 billion by December 1996 in 16.2 million accounts. This provides a savings to loans ratio of 174 percent making the system fully self-sustaining without subsidy (Church, Yaron and Patten 1997).

IV. THE PRESENT SITUATION IN RURAL CREDIT MARKETS

The government's macroeconomic reforms reduced the huge fiscal deficit, boosted exports and stabilized the price level. The financial reforms introduced greater competition in the financial marketplace with the entry of more banks and financial innovations. These are necessary steps to bring about vibrant and efficient rural credit markets. Indeed, financial deregulation and liberalization brought financial innovations, more competitive lending rates and made banking services more generally available in the countryside[13].

[13] On the downside, of course, are the new types of risks facing financial institutions, and the inadequacy of banking supervision and regulation to deal with an entirely new financial marketplace.

Financial sector reforms[14]

The country stated the deregulation of the financial sector in the 1980s and went on to liberalize it in the 1990s. Restrictions on interest rates were lifted, the banking industry was made more competitive by relaxing the bank branching policy and allowing more entrants to the industry. At the same time, prudential regulations were put in place and supervision was improved to safeguard the health of the financial system. More recently, the Bangko Sentral ng Pilipinas called for greater capital adequacy of the banking system, introduced a 2 percent loan loss provision and put a cap on exposure of banks to the property sector to strengthen the financial system.

Formal financial sector

Figure 1 shows the institutional structure of rural credit delivery in the country. The formal sources of rural credit includes banking and non-banking financial institutions. These formal lending institutions include the Land Bank of the Philippines (LBP), Philippine National Bank (PNB), (PKBs), rural banks (RBs), lending investors, cooperatives, government-owned and controlled agencies (GSIS, SSS, Pag-ibig) and pawnshops (see also Table 8). The informal sources of credit are also shown. Commercial agriculture is shown to have access to formal financial markets while small holder agriculture, microenterprises and the poor in general depend on the informal credit sources.

1. Banks

Formal loans granted by banks in the rural sector are mostly used for agricultural production purposes. During the period 1986-95, formal agricultural production loans posted large and positive increases in terms of volume growing at an average annual rate of 11 percent[15] (Table 6) With the rehabilitation of the two large government banks - the

[14] See Lamberte and Llanto (1995) for an extensive discussion of recent financial sector reforms..
[15] ACPC

Philippine National Bank (PNB)[16] and the Land Bank of the Philippines (LBP) in 1988 and 1989, the volume of agricultural loans granted by government banks increased significantly. Agricultural loans granted by government banks rose by 45 percent during the period 1985-95. Agricultural loans granted by private banks on the other hand, rose by 10.2 percent with SMBs and SSLAs accounting for the large growth rates at 57.4 and 77.3 percent, respectively.

In terms of proportion of agricultural production loans to total loans granted by type of bank, the rural banks have extended the largest share of loans to agricultural production with an average proportion of 55.5 percent during the 10-year period. (Table 7) The proportion of agricultural production loans to total loans granted by SSLAs reached an average of 21.8 percent while that of the LBP was 16.9 percent. The shares of agricultural loan to total loans granted by PDBS and SMBS were the lowest at 4.6 percent and 2.0 percent, respectively.

It can be observed that while the volume of agricultural production loans granted by banks increased, the proportion to total loans granted has been declining during the 10-year period. For government banks, agricultural loans as proportion of total loans has declined to 9.1 percent in 1995 from a high 30.1 percent in 1991. On the overall, the proportion of agricultural loans granted by banks to total loans granted was only about 5.1 percent during the period. Moreover, the proportion of loans granted by banks that went to the agricultural sector has also declined over the period. This decline has been attributed to the removal of most credit subsidies to agricultural production loans[17] and the improved performance of the industrial sector during the period of economic recovery. It did not help that the agricultural sector performed poorly relative to the other sectors of the economy.

[16] PNB has since then been privatized.

[17] The government provided huge subsidized loan funds to the rural banks through special time deposits with the Central Bank of the Philippines to finance its agricultural credit programs such as Masagana 99.

2. *Non-bank financial institutions*

The less restrictive monetary policies and a more liberalized financial environment gave rise to the expansion of the formal nonbank financial institutions. Lending investors and pawnshops in both rural and urban areas increased their loans to small borrowers using a variety of traditional collateral and collateral substitutes.[18] Lamberte and Llanto (1995) noted that the were about 1,559 lending investors composed of 1,436 offices and 123 branches nationwide as of 1993. Cooperatives and credit unions have also grown considerably in terms of number and resources, providing small borrowers in the urban and rural areas a wide variety of financial services not otherwise available from traditional lending institutions.[19] These cooperative credit unions have been successful in encouraging savings mobilization among rural people and increasing their access to low cost credit on a sustained basis.

The non-governmental organizations (NGOs) have also been very active in providing credit to small borrowers. The good performance of these credit-granting NGOs has been attributed to the following factors:[20] (1) they are community-based and have adequate information about the credit worthiness of the borrowers and can monitor them at least cost; (2) they have built-in mechanism for continuous savings mobilization; (3) they can exert strong social pressure on borrowers in securing prompt repayment; and (4) most of them have dedicated leaders. However, the credit-granting NGOs face problems of financial sustainability unless they develop access to commercial finance, improve their management, accounting and auditing systems, solve their governance problems and others (Llanto, Callanta and Garcia 1996).

[18] Chua and Llanto (1995).
[19] Llanto (1994).
[20] Lamberte (1995)

Informal financial sector

The informal financial sector is composed of heterogeneous groups of agents ranging from private moneylenders, relatives, friends, landowners, employers, traders, store owners, dealers, etc. The informal credit sources are large and predominant particularly in low-income urban and rural areas[21] An attempt to estimate the size of the informal financial sector[22] showed that 59 percent of the total borrowing of the households which amounted to P45 billion came from informal credit markets. The proportion of the loans sourced from the informal credit markets was higher in the rural than in the urban areas. This is a clear indication of the importance of informal financial markets to individuals and small enterprises in the rural areas which are not served by the formal financial institutions, except by a handful of rural banks and cooperative banks. This is also a result of the bias of the formal financial system in favor of non-agricultural credit and more established borrowers.

The proliferation of various savings and loan related institutions as well as the continuous existence of informal credit sources in the rural areas are seen to have helped augment rural lending. Such condition is expected to assist a wider scope of rural poor households enabling them to undertake economic activities in a more competitive environment.

Trends and growth in rural credit

The rural financial sector in the Philippines has significantly grown in the past years as the need for rural credit became more pronounced among the rural poor.

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[21] Ibid.
[22] Agabin (1986) cited in Lamberte (1995)

This is evidenced by the high incidence of borrowing in the rural areas which reached 48 percent of the population in selected provinces.[23] Nationwide surveys on the level of indebtedness in the rural areas conducted by the Social Weather Station (SWS) showed that about 33 to 44 percent of the rural households needed and obtained credit. (Table 4)

Rural credit is channeled to the households and individuals through formal and informal financial markets. The formal financial market is regulated and includes bank and nonbank financial institutions involved in lending while the informal credit market which is unregulated includes private moneylenders, large farmers, traders and millers, relatives, friends.

During the period 1985-95, the informal credit sources accounted for the larger proportion of rural credit. About 65 to 85 percent of the credit availed by the rural households are sourced from informal lenders. On the other hand, the formal sources of rural credit accounted for the remaining 20 to 32 percent. Various studies on rural and agricultural credit report the same average figures (Llanto 1993). For instance, the study of rural nonfarm enterprises in selected Visayan provinces by Lapar (1994) showed that 51.6 percent of the surveyed rural non-farm enterprises obtained credit from informal sources, 25.3 percent from the formal sources and 23.1 percent from both formal and informal sources.

Among the sources of formal credit, the government-owned and controlled institutions such as GSIS, SSS and Pag-ibig were the largest source of credit by households, accounting for about 9 to12 percent of credit obtained during the period 1989-1995. (Table 5) Credit cooperatives also accounted for a significant share with 4 to9 percent during the same period while as expected, the banks accounted for smaller shares at 2 to 3 percent. However, we note that the households which borrowed from these government institutions are mostly the non-poor households. The poor households rely on the informal sources to satisfy their credit demand.

[23] The 1988 ACPC survey showed that 48% of the rural population obtained credit in the provinces of Pangasinan, Batangas, Camarines Sur, Iloilo, Negros Oriental, and Misamis Oriental.

The borrowing rural households have remained dependent on friends and relatives as sources of credit. During the period 1989-95, 33 to 62 percent of the borrowing households or an average of 44.8 percent relied on these credit sources. An average of 10 percent of the borrowing households relied on professional moneylenders while the rest availed of credit from landowners/employers, trader/wholesaler, store owners, suppliers and paluwagans.

Recent important initiatives

In the past years, a number of important initiatives where taken to improve the poor's access to credit. Among these important initiatives was the emergence of credit programs which are designed, managed, and implemented in a way that fits the conditions of the poor. The best example of this kind of program is the one which institutionalized the Grameen Bank of Bangladesh. Similar programs are in place in the Philippines to improve the credit delivery for the poor. The PHILNET represents the network of Grameen replicators in the country.

Institution-wise, the credit markets saw the emergence of new alternative institutions that focus on the poor. The most important of these institutions are the credit-granting NGOs. These NGOs decided to concentrate on microlending in contrast to other NGOs which continued to provide a wide variety of services, e.g., health and nutrition, including microcredit to the poor.

The lending investors may also be cited as a new phenomenon in the credit markets. A lending investor is a lender who lends directly to small entrepreneurs with or without collateral and at market rates. Those who require collateral, accept vehicle registration certificates or anything of value to the borrower. Lending investors are presently found in cities and municipalities which have experienced increasing commercial activities, especially in public markets. They use their own funds or borrowings from private bank and other sources for their lending operation. The lending investors submit reports to the Bangko Sentral ng Pilipinas although they are not subject to any formal regulation and supervision. They are, however, subject to the normal requirement of lenders to disclose to the borrower the interest charges and other fees imposed on loans. Some of these lending investors are former informal moneylenders who decided to formalize their lending operations.

Alternative approaches to rural credit delivery

The provision of credit to the poor as part of the poverty alleviation program requires the development of alternative and innovative lending schemes to bridge the gap between the demand and supply of credit for the rural poor households. This is in light of the fact that the small rural borrowers have limited access to formal credit and while they have greater access to informal credit finance, these sources are limited by its nature.[24] The alternative and innovative lending schemes recognize the link between the formal credit sector and informal credit which makes possible a wider access of rural borrowers to formal finance. Those schemes try to mimic the important characteristics of informal credit such as payment based on cash flow, close monitoring and regular loan collection and others.

Several alternative credit mechanisms have started to be recognized as "better" providers of credit to small borrowers. These are group lending, linkage banking, cooperative banking and microfinance (versus microcredit). Studies (e.g., Esguerra 1995; Schmidt et al 1996; Dichter 1996, Llanto, Callanta and Garcia 1996) have dealt with issues concerning the design, incentive problems, organizational structure, linkage with the formal sector and others.[25] This section draws from these studies and the existing literature and highlights the important features of the alternative credit mechanisms that could help poverty alleviation programs.

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[24] Esguerra, E. (1995)

[25] These credit mechanisms sometimes overlap. For example, linkage banking is an approach used by credit granting NGOs to fund their microfinance programs.

1. *Group lending*

Under this type of credit mechanism, groups are formed from members of the community and a loan is granted either by the government, a bank or private institution. The loan may be provided to any member of the group or to the group itself which in turn allocates the credit to its members. Group lending has low loan administration costs due to scale economies in the processing of transactions. Experiences of other countries (e.g., Indonesia and Bangladesh) showed that group lending can be utilized by the banks to reach the rural poor at lower transaction costs.

Group guarantee provided to individual member loans, joint liability for the loan and peer pressure are important feature of the scheme. These help reduce the cost of borrowing and act as a form of security against loan default by members. Delinquency on loan repayment is avoided because the scheme has a built-in incentive to enforce loan repayment because default will penalize the whole group. Moreover, the group also has a strong incentive to screen the applicants (future and existing members) because loan delinquency of any member again affects the group's future borrowing prospects.

Field experience in the country seems to indicate that some Grameen replicators have successfully reached poor clients through group lending. The experience of two credit-granting NGOs, namely, the Center for Agriculture and Rural Development (CARD) and Tulay sa Pag-Unlad, Inc. (TSPI) shows that well-organized groups have good loan repayment records and that savings can be effectively mobilized through group effort. In the case of CARD, forced savings deducted from the member's loan proceeds as well as voluntary savings figure prominently as a good reason for its successful microcredit program among landless farmers..

One pitfall of group lending is that a group may be artificially formed to take advantage of loans usually offered by government institutions. There is little regard, therefore, for loan repayment and the future sustainability of the group itself and the credit scheme. Thus, there is mixed experience in group lending among cooperatives especially those organized by government agencies.

In view of moral hazard problems, group lending will work well only when undertaken by groups whose members have already developed mutual trust and interest in maintaining the group over a long period of time. Newly organized groups are credit risks. Time must test the members' cohesion and commitment to cooperate with each other.

2. *Linkage banking*

A large commercial bank which is interested in using credit for poverty alleviation has used a foundation it has organized as lending conduit to a credit-granting NGO. To its surprise, the experiment seems successful after several years of operating this way. The NGO was able to reach many poor clients who religiously repaid their loans. The NGO was able repay the foundation and asked for a larger loan to finance its growing microcredit business. Because of this successful experiment, there is now interest among other commercial banks to get involved in microfinance programs, either by lending directly to microfinance institutions (e.g., credit-granting NGOs) or establishing/acquiring smaller banks (e.g., rural bank) to implement microfinance programs.

This approach links the substantial financial resources at the disposal of commercial banks to the field information and transaction cost advantage of microfinance institutions. The latter have better information on poor clients and can reduce the transaction cost of lending to the poor[26] They are thus, better equipped to engage in retail lending to poor clients. On the other hand, the commercial banks[27] have the resources, management expertise and others that they can use to provide wholesale loans to the credit intermediaries that will deal with the retail side of the market. Linkage banking, thus, offers a new tack in rural credit intermediation. This can be exploited by all types of credit institutions, that is,

[26] See Llanto and Chua (1995).
[27] Or other types of banks, e.g., rural banks, thrift banks.

rural banks, cooperative banks, credit-granting NGOs, cooperatives, lending investors, and even the informal moneylenders to reach small clients who are outside the reach of the larger banks or institutions.

One instrument to promote linkage banking is the savings of groups, cooperatives and similar organizations. By opening a deposit account with a bank and maintaining carefully that depository relationship, the group or individual provides crucial information that will help the bank establish a better business relationship with the depositor-client. This way, the provision of credit becomes only one of several services that the bank or formal institution can offer its client. It bears to note that the success of Indonesia's Bank Rakyat-Unit Desa system hinges largely on its successful mobilization of deposits in the countryside which served as the first link of the poor clients to a formal institution.

3. *Microfinance versus microcredit*

A lot has been said of microfinance elsewhere in this paper. But it is worth emphasizing that this newfound approach to poor clients has proven to be effective and efficient. An important element of microfinance is savings mobilization. The problem though is that the country seems to have paid only lip service to savings mobilization. There seems to be no concerted drive to really mobilize domestic resources despite the respectable economic growth exhibited in the past few years. However, the government has recently established a National Commission on Savings which has been mandated to orchestrate a nationwide savings mobilization campaign.

It must be pointed out that part of the lack of interest in savings mobilization by formal financial institutions may be attributed to the existence of a big number of government directed credit programs which target specific sectors of the economy. The directed credit programs provide loanable funds which are used to reach target clientele, e.g., the basic sectors. With the abundance of funds from the directed credit programs, there seems to be little incentive to mobilize savings on the part of those financial institutions involved in agricultural and rural credit for poor clientele.

The credit-granting NGOs and the cooperatives are uniquely situated and organized for any campaign to mobilize savings. They are presently mobilizing savings from members but because they are not banks, they are not authorized to receive deposits from the general public. Because of the fiduciary character of deposits, these institutions must transform themselves into banks if they want to tap the deposit market and conduct financial intermdediation in the true sense of the term.

Credit cooperatives are community-based organizations that mobilize savings and extend loans to its members. The members are both owners and borrowers of the institution. The cooperatives rely heavily on the contributions of its members for its lending operations. Some cooperatives enjoy funding support from government and foreign donors for their credit operations. On the other hand, some NGOs build up local credit groups which they link to private banks. Since the NGOs are community-based they are well-situated to help in savings mobilization and linking poor clients to the banks.

4. *Cooperative banking*

Cooperative banking is not new to the Philippines. In the past, a number of cooperative rural banks have been established to cater to the credit demand of small farmers. They participated in the subsidized agricultural credit programs and encountered loan repayment problems from borrowers. The Central Bank of the Philippines (now, the Bangko Sentral ng Pilipinas) and the Land Bank of the Philippines presided over the successful rehabilitation of many rural banks, including cooperative rural banks during the past decade.

What is new is the current drive of cooperative banks to mobilize countryside deposits and provide microcredits. The cooperative banks have learned to depend less and less on government funds for their credit programs and to rely on the commercial loan and deposit markets. They have also tried to diversify their loan portfolios to reduce credit risks but maintained the focus on the countryside. The advantage of cooperative banks is that they are owned by cooperatives whose members include small farmers and microentrepreneurs, among others. Presently, the government encourages the establishment of a cooperative bank in each province For example, the Cooperative Rural Bank of Aklan, situated in one of the poorest provinces of the country, has a successful Grameen-type microcredit program and an aggressive deposit mobilization in the countryside.

V. CREDIT POLICIES AND REGULATORY MECHANISMS

Credit policy environment

In principle, the government believes that it must have a limited role in the credit markets. It is to provide a market-oriented credit policy environment and financial infrastructure which will encourage a greater role for and participation by the private sector. The National Credit Council has developed a set of guidelines, namely, the 'Policy Guidelines for Credit for the Poor' which defines the respective roles of government, private banking system and donors.

As mentioned above, a crucial development is the growth of microfinance institutions and programs which showed an alternative way of reaching the poor. The overall credit policy thrust is that the private sector will provide the poor access to microfinance and that the government must at best provide the enabling environment for this to happen. Lending must be channeled through banks and other types of microfinance institutions. A critical role of the government is to provide a market-oriented credit policy and to assist the microfinance institutions in developing their capacity for implementing microfinance programs Thus, the government is expected to provide microfinance institutions technical assistance and support to capacity building for outreach and financial sustainability. The donors must provide mostly technical assistance..

National microfinance strategy

The microfinance strategy represents a fresh alternative to the traditional subsidized directed credit programs targeting the poor, small farmers, small fisherfolk and microentrepreneurs. The strategy has three parts as indicated in Box 1.

Box 1. Components of the National Strategy for Microfinance

1. *Market-oriented financial and credit policy environment which is conducive to the efficient functioning of the financial market*

- market-oriented interest rate policy
- increased competition among all types of financial institutions
- removal of distortions in the financial markets, e.g., loan quotas
- rationalization of government directed credit and guarantee programs
- greater role for the private sector in credit markets

2. *Market-driven broadening and deepening of microfinancial services*

- development of innovative microfinance products and services
- implementation of innovative microfinance technologies
- promotion of savings mobilization and linkage banking
- development of appropriate supervisory and regulatory framework for microfinance institutions
- establishment of performance standards for microfinance institutions

3. *Capability-building program for microfinance institutions*

- provision of technical assistance to microfinance institutions
- documentation and dissemination of information on successful microfinance practices
- participation of research and academic institutions in conduct of studies, policy discussions on microfinance

Source: National Strategy for Microfinance, National Credit Council, Department of Finance

The agricultural and rural credit policy conforms with the policy guidelines on credit for the poor. Six basic policy thrusts guide current agricultural and rural credit policy[28] :

- Government policy must respond to both the equity and efficiency potential and needs of the agricultural and rural sector.
- Government must not be involved in direct lending. This means that credit programs must be implemented only by financial institutions and not by the government.
- In order to be self-sustaining, credit programs must be operated as financial intermediation programs which mobilize savings and transform them into loans.
- Credit should be provided only to viable projects and creditworthy/bankable borrowers.
- Credit assistance is a complementary form of assistance to small farmers and agrarian reform beneficiaries.
- People's organizations can serve as effective institutions for credit provisions.

While the NCC and ACPC have laid down clear policy guidelines on microfinance and agricultural and rural credit policy, respectively, these agencies do not have the regulatory powers to persuade lenders to conform to these guidelines. At best, these guidelines are only persuasive in character. There is no penalty for non-conformity.

On the part of the government, while the market-orientation of financial and credit policy thrusts is clear and commonly accepted, in practice, government agencies with support from a populist Congress have continued with a number of subsidized directed credit programs. The 86 government directed credit programs are inconsistent with the market-

[28] Agricultural Credit Policy Council

oriented credit policy thrusts of the government[29]. They create a disincentive to private sector participation in microfinance programs.[30]

In fairness to the government, it is currently involved through the Department of Finance-National Credit Council in rationalizing the directed credit programs and pursuing further policy reforms for greater efficiency in the financial markets.

It must be stressed that the NCC and ACPC credit policy guidelines adhere to the overall market-oriented credit policy thrusts of the Bangko Sentral ng Pilipinas (BSP). The BSP has supervisory and regulatory powers over private financial institutions, e.g., private banks. There is no governmental regulation or supervision of the credit NGOs and people's organizations which implement credit for the poor programs. However, once a credit NGO becomes a formal financial institution, e.g., a private bank , it falls under the BSP's authority.

Major regulations affecting microfinance programs

The major regulations affecting the microfinance/credit for the poor programs of banks are those affecting: (a) minimum capital requirements, (b) deposit taking, (c) interest rates, and (d) loan security (Box 2). All banks types are allowed to mobilize deposits, enjoy flexible interest rates on loans and deposits and provide both secured and non-secured loans. In general, the minimum capital requirement for rural banks or and cooperative rural banks allows the establishment of community-based banks that can provide credit to the poor.

The BSP requires a capital adequacy ratio of 10% of risk-weighted assets for all banks. Reserve requirements differ according to the type of bank. The general reserve requirement

[29] A recent survey by Llanto, Geron and Tang (1997) pointed out the negative impact of those directed credit programs on the fiscal position of the government and on the willingness of the private sector to participate in microfinance programs.

for demand, savings and time deposits, and deposit substitutes is 13%. For thrift banks, this will be 11% and for rural banks, 5%. All financial intermediaries should maintain liquidity reserves in the form of short term market yielding treasury bills. The ratio varies depending on BSP's target for domestic liquidity.

It must be noted that the BSP does not require all loans to be secured.[31] However, loan loss provisioning is required and loans not secured by collateral are treated differently as secured loans. In response to the need to cover banks from loan defaults, e.g., property sector loans, the BSP require banks to adopt a 2% loan loss provision.[32]

Box 2. Major Regulations Affecting Microfinance/Microcredit Programs/Institutions

Type of Bank	Capital Requirement	Deposit Taking	Interest Rates	Loan Security
C'mmercial	₱4.5 billion, for expanded. ₱2 billion for ordinary	allowed	no ceiling	traditional collateral as well as clean loans allowed
Thrift	₱250 million for Metro Manila; ₱40 million outside MM	allowed	no ceiling	traditional collateral as well as clean loan
Rural	₱2 to ₱20 million	allowed	no ceiling	traditional collateral as well as clean loan

[30] There are as many as 13 separate credit programs for the poor according to tje National Credit Council. The NCC seeks to rationalize these and other credit programs for greater efficiency and outreach and lower fiscal support.
[31] Except loans to directors, officers and share holders.
[32] According to a Bangko Sentral ng Pilipinea (BSP) official, the banks generally have self-imposed a loan loss reserve ratio ranging from 1% to 1.5%.

The absence of any ceilings on lending rates and the authority to provide loans secured by non-traditional collateral, such as joint and several liability agreement should encourage more banks to lend to the poor. Thus, the constraint to bank lending to the poor is not that bank regulations are too stringent which prevent them from dealing with the poor or small microentrepreneurs. The constraint lies on the bank's own limitations, e.g., lack of commitment or willingness to lend to the poor, severe information problem in the credit markets for the poor, high transaction cost of lending to the poor. The banks also perceive that loans to the poor will create credit risks that they do not know how to manage. This might put them at variance with the regulatory authorities.

However, some banks claim that part of the hesitation to provide non-secured loans, e.g., loans to the poor, is the fear that the BSP bank examiners will render a judgment that unnecessary risks have been taken by the concerned bank, which will produce exceptional reports on their lending behavior.

On the other hand, the Cooperative Development Authority (CDA) has supervisory authority over the cooperatives and credit unions under the Cooperative Code of 1989. However, its regulatory and supervisory function seems to conflict with its developmental role which CDA has avidly implemented.[33] The Cooperative Code allows cooperatives to mobilize savings from members and use these for giving loans to members for productive or providential purposes. They are not allowed to accept deposits from the public. Under certain conditions, cooperatives are exempt from the payment of taxes for a period of 10 years after their formation. However, they are not efficiently supervised by CDA which lacks the institutional supervisory capacity. A recent move by the credit cooperatives to establish a deposit guarantee scheme[34] will require the setting of performance standards among members and thus, impose some amount of self-regulation among members.

[33] For instance, the CDA provides various types of loans to cooperatives.

[34] Reported by the National Confederation of Cooperatives (NATTCO), one of several national federations of cooperatives.

In sum, the credit policy environment and the regulatory/supervisory framework allow banks and various types of microfinance institutions to provide the poor greater access to microfinance services. At first blush, it seems that somehow there are barriers to innovative credit schemes which address the problem of lack of access to credit by the poor. On close examination, there are no legal provisions prohibiting the grant of small or micro loans whether or not these are secured or non-secured. The law only requires that banks maintain prudence and adherence to sound credit policies and standards. This means that the banks must ascertain the creditworthiness of any type of borrower.

The barrier may consist of the banks' misperception or bias against microlending. It may arise from the information asymmetry in the credit markets and the high transaction cost of small loans. These do not seem to be insurmountable as indicated by the successful linkage experiment conducted by a foundation owned by a bank with its NGO client. An agency arrangement can very well solve the information and transaction cost problem. At the same time, the microfinance technologies may not be that familiar to the regulatory/supervisory authorities making them somewhat apprehensive about the ability of banks to handle numerous microloans. In addition, the authorities may not have the technology and skill for managing the risk arising from the innovative loan products developed by microfinance institutions.

In contrast, the non-formal institutions, that is the NGOs, foundations and people's organizations implementing credit for the poor programs have an unregulated environment. The NGOs[35] and the informal lending institutions are not supervised o. regulated. At present, there are no prudential regulations on capital adequacy, interest rates, loan security or collateral requirement, except on deposit taking from the public. The NGOs and similar types of organizations are not authorized to mobilize deposits from the public. .Thus, a

[35] The NGOs must register with the Securities and Exchange Commission and are required to file audited annual financial statements but are not effectively supervised. As non-stock, non-profit organizations they can get tax exemption from the Bureau of Internal Revenue. They observe minimum wage legislation and social security listing of employees. Foreign grants are reported in the annual financial statements but are not subject to any control or supervision.

permissive environment prevails in so far as these non-formal institutions' lending business is concerned.

However, recent developments in the credit-granting NGO community indicate a trend for self -regulation. There is deep interest in developing performance standards which will substitute to some extent for the absent prudential regulations. This is to ensure that the credit -granting NGOs will be efficient microfinance providers[36] and that the interest of the borrowing members will be protected. In this respect, the two networks of credit-granting NGOs, namely, the Association of Philippine Partners for Enterprise Development (APPEND) and the PHILNET, a group of NGOs engaged in Grameen replication are most active in developing performance standards. The effort must be supported.

VI. CONCLUSIONS AND RECOMMENDATIONS

The Philippines' economy has recovered and is on the growth path. However, poverty incidence remains high and is curently the most significant problem for the country. The government's Social Reform Agenda is an attempt to alleviate poverty. Part of the strategy is to provide the poor greater access to microfinance services, not just microcredit. The National Strategy for Microfinance calls for a market-oriented credit policy and an emphasis on deposit mobilization and the use of private institutions as instruments for providing the poor greater access to credit. The credit policy reforms in the agricultural and rural sector conform to the strategy for microfinance.

The private sector is expected to have a greater role in the microfinance markets. Government's role is to provide an enabling environment for greater private sector

[36] Llanto et al. (1996) found that many credit-granting NGOs have inadequate financial reporting and monitoring. The absence of sound performance standards and a standardized accounting and reporting system does not contribute to healthy financial performance of the credit-granting NGOs.

participation. In this respect, to expand the poor's access to microfinance/microcredits, the following recommendations are made:

1. **Terminate the government's subsidized directed credit programs and consolidate the funds into a wholesale fund for re-lending to the poor.** The rationalization of the directed credit programs will stop the inefficient use of scarce funds by government line agencies which do not have the comparative advantage of financial intermediaries. The directed credit programs prevent the participation of private financial intermediaries in the rural credit markets because they cannot compete with the subsidized lending by the government line agencies. The consolidated funds will be managed either by the Land Bank of the Philippines or the People's Credit and Finance Corporation which will be the wholesale lending institutions.

2. **Use private financial intermediaries for relending to the poor.** It is important to use the comparative advantage of private credit institutions in lending to poor clients. They can more easily address the information asymmetry and transaction cost problem of the credit markets than government agencies. The retail institutions will consist of the microfinance institutions such as credit NGOs, rural banks, cooperative banks which have credit programs for the poor.

3. **Encourage the linkage between banks and microfinance institutions.** Microenterprise finance is a profitable venture for private banks as shown by the experience in other countries. The linkage between banks and microfinance institutions must be supported. The deposit mobilization among the poor could be an important mechanism for linking them to commercial lenders. Some commercial banks have established or acquired rural banks to take advantage of the deposit taking capabilities of the latter and as well, to be able to service the vast loan market of the countryside through these types of banks.

4. **Promote cooperative banking.** For poor people who have the inclination to cooperatives, the cooperative bank represents a favorable mechanism for accessing financial services. The cooperative banks can exploit the private nature of their ownership to go out and mobilize deposits and lend to a wider variety of clients.

5. **Provide credit NGOs and other MFIs (such as rural banks, cooperative banks, credit unions/cooperatives) technical assistance to become more efficient financial intermediaries.** These organizations have shown the capability of dealing with the information problem, credit risk and high transaction cost of lending to the poor. They have the comparative advantage in dealing with poor clients compared to big banks. However, they are deficient in a number of ways, e.g., standardized accounting and reporting systems, etc., which hamper their more effective role in the countryside. Hence, technical assistance will make them more efficient.

6. **Promote the transformation of credit NGOs into formal financial institutions. Alternatively, encourage their investment into banks or the establishment of banks owned by credit NGOs where they have a controlling stake.** The transformation of those NGOs into private banks, for example, will enable them to exploit fully the powers and authority given to banks, e.g., deposit mobilization. This will make them more efficient and effective. The alternative option provides them a stake, perhaps even a controlling stake, in private banks which can be geared toward greater exposure to the poor.[37]

7. **Support initiatives to develop and apply performance standards for microfinance institutions.** This will professionalize the credit NGO community, improve the delivery of microfinance services to the poor and establish a more healthy microfinance industry. For the cooperatives, another type of microfinance institution, the development of their

[37] An extended discussion is in Llanto (1997).

own performance standards must be supported. The CDA must provide technical assistance to the cooperatives in this task.

8. **Establish greater coordination between the National Credit Council, the credit NGO networks, the Cooperative Development Authority and the Rural Bankers' Association of the Philippines in the implementation of credit programs for the poor undertaken by the private sector.** The NCC is uniquely situated to spearhead and coordinate various efforts to provide the poor greater access to microfinance/microcredit. This will avoid unnecessary duplication of programs, forge better linkages among institutions, provide access to information which will help in providing the poor greater access to microfinance/microcredit.. The combined resources and expertise in microfinance/microcredit programs can make a big dent in poverty alleviation.

FN: C\: Strengthening credit institutions/20nov97

Table 1

POVERTY INDICATORS

Poverty Indicators	***1985***	***1988***	***1991***	***1994***
Poverty head count ratio	49.3	45.5	45.3	40.6
Poverty incidence of families	44.2	40.2	39.9	35.5
Subsistence incidence of families	24.4	20.3	20.4	18.1
Number of poor families	4,355,052	4,230,484	4,780,865	4,531,170
Number of subsistence families	2,403,195	2,139,303	2,445,065	2,303,168
Poverty gap	-	-	16,199	19,063
Poverty gap ratio	-	-	37.0	35.8

Source: Family Income and Expenditures Survey (NSO)

Table 2
CHARACTERISTICS OF THE HOUSEHOLDS AND HOUSEHOLD MEMBERS IN THE BOTTOM 30 PERCENT, 1992

1. URBAN-RURAL DISTRIBUTION

	URBAN	RURAL	TOTAL
Philippines	29.4	70.6	100.0
Total Population (M)	6.0	14.3	20.3

2. HOUSEHOLD SIZE

Less than six members	43.2
Six or more members	56.8

3. AGE AND SEX DISTRIBUTION

	Male	Female	Total
Below 15 years old	25.4	24.1	49.5
15 years old and over	26.1	24.4	50.5
Total	51.4	48.6	100.0
Total Population (M)	10.4	9.8	20.3

4. GROWTH RATE OF AVERAGE REAL INCOME AND EXPENDITURE (%)

Bottom 30%
Income
Expenditure

Upper 60%
Income
Expenditure

5. DISTRIBUTION OF INCOME RECEIVED BY HOUSEHOLDS IN THE BOTTOM 30% BY SOURCE (30%)

Source of Income	1985	1988	1991
Wages and Salaries	27.0	27.7	26.6
Agricultural	13.6	14.9	13.8
Non-agricultural	13.4	12.8	12.9
Entrepreneurial Activities	41.5	42.1	43.9
Crop farming	25.6	26.0	27.2
Other ent. activities	15.6	16.1	16.7
Other Income	31.5	30.2	29.5

6. LABOR AND EMPLOYMENT INDICATORS 1992

	National Population July 1992		Bottom 30%	
	Male	Female	Male	Female
LFPR (%)	81.7	47.2	88.3	53.8
Employment Rate (%)	75.8	42.2	85.7	46.8

7. DISTRIBUTION OF WORKING AGE POPULATION BY PRIMARY OCCUPATION, 1992

Primary Occupation	Male	Female
Professional technical	0.5	1.0
Administrative, managerial	0.1	0.1
Clerical	0.8	0.9
Sales workers	3.7	18.2
Service workers	2.4	11.5
Agriculture, fishery, forestry & logging & hunting	73.9	55.8
Production and transport	18.4	12.5
Workers N.E.C.	0.1	0.1

8. DISTRIBUTION OF WORKING AGE POPULATION BY CLASS OF WORKER, 1992

Class of Worker	Male	Female
Worked for private households	2.9	8.3
Worked for private establishments	29.1	18.3
Worked for gov't./gov't. corporation	1.7	1.3
Self-employed w/o any employee	48.6	33.6
Employer in own family operated farm or business	2.7	0.8
Worked with pay in own family operated farm or business	0:5	0.4
Worked w/o pay on own family operated farm or business	14.6	37.1

Sources: Herrin and Racelis (1993); Virtucio (1994)

Table 3

CAUSES OF POVERTY AND INTERVENTION

Causes of Poverty	*Interventions Required*
Failure of growth and lack of employment opportunities	* Sustained economic growth * Labor-intensive growth * Removal of discrimination against activities in rural areas where most of the poor reside
Inequality of incomes, wealth and access to resources	* Asset redistribution, i.e., agricultural land, natural resources, credit access
High population growth	* Aggressive population management program
Declining factor productivity	* Removal of price distortions * More investments in R&D particularly in agriculture
Inadequate provision of social services	* Protecting the social sector budget * Increasing internal efficiency - more basic education and primary health care
Poor or degraded resource base	* Better management of resources under open access
Unresponsive and graft-ridden politics and bureacracy	* Encourage popular participation and consultation in policy formation and design projects

Table 4
INCIDENCE OF BORROWING AND DISTRIBUTION OF BORROWERS BY SOURCE
1985-95
(in percent)

Period	*Incidence of Borrowing*	*Source*	
		Formal	*Informal*
1985-86	32	32	65
1986-87	37	28	66
1988-89	44	20	82
1991-92	35	26	85
1992-93	36	32	68
1994-95	33	31	69
Average	36.2	28.2	72.5

Source: ACPC and SWS ; Table 2 in ACPC

Table 5

HOUSEHOLD BORROWING SOURCES 1986-1995

(in percent)

Source	*1986*	*1987*	*1989*	*1992*	*1993*	*1995*	*Ave. % Share*
Formal Lending Institutions	32	28	24	34	35	31	30.7
LBP			2	2	1	1	1.5
PNB			1	1	2	1	1.3
PKBs			0	2	1	2	1.3
RBs			3	3	4	3	3.3
Lending Investors			0	5	3	4	3.0
Cooperatives			4	8	9	8	7.3
GSIS/SSS/Pag-ibig			12	11	10	9	10.5
Pawnshops			0	1	1	1	0.8
Informal Lending Institutions	65	66	78	67	66	69	68.5
Friends/Relatives			62	45	33	39	44.8
Professional Moneylenders			4	11	13	12	10.0
Landowners/Employee			1	5	3	3	3.0
Traders/Wholesalers			1	4	5	7	4.3
Retailers/Sari-sari Store			0	2	3	3	2.0
Input Dealers/Suppliers			2	1	5	2	5.0
Paluwagan			1	1	1	1	1.0

Source: ACPC and SWS; Table 3 in ACPC

Table 6

AGRICULTURAL PRODUCTION LOANS
GRANTED, BY TYPE OF BANK, 1986-1995
(Amounts in P Million)

Financial Institutions	*1986*	*1987*	*1988*	*1989*	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*Ave. % Share*	*Ave. Growth Rate*
Government Banks	579.0	1,485.8	3,492.5	5,838.9	5,934.5	8,450.9	10,386.4	9,817.4	8,058.6	8,638.7	13.4	45.5
PNB	574.8	702.4	2,631.4	3,394.6	1,680.5	na	3,009.4	3,216.0	2,067.3	2,612.9	5.2	39
DBP & PAB	4.2	131.2	458.7	210.6	251.4	336.3	356.0	747.4	961.9	933.2	0.9	379.3
LBP	na	652.2	402.4	2,233.7	4,002.6	8,114.6	7,021.0	5,854.0	5,029.4	5,092.6	8.7	69.5
Private Banks	24,535.4	25,974.2	31,797.5	25,367.0	35,357.6	37,713.6	45,723.2	44,768.1	48,343.7	53,573.0	86.6	10.2
PKBs	20,008.8	21,007.1	23,777.0	18,558.5	27,250.8	28,937.9	35,177.8	31,069.8	31,354.6	37,016.0	64.6	8.7
PDBs	858.1	1,013.4	1,190.3	1,481.1	1,132.2	1,678.7	1,491.1	1,985.1	3,972.4	2,862.4	3.8	17
SMBs	97.1	90.2	201.6	355.9	1,338.6	842.4	768.4	1,044.0	1,572.0	1,679.1	1.6	57.4
RBs	2,948.1	3,456.4	3,854.8	4,402.7	4,993.1	5,487.2	6,429.5	8,406.0	9,843.4	8,962.2	13.2	13.6
SSLAs	623.3	407.1	2,773.8	568.8	642.9	767.4	1,856.4	2,263.2	2,601.3	3,053.3	3.4	77.3
All Banks	25,114.4	27,460.0	35,290.0	31,205.9	41,292.1	46,164.5	56,109.6	54,585.5	56,402.3	62,211.7	100.0	11.4

Source: Table 4 ACPC

Table 7

PROPORTION OF AGRICULTURAL PRODUCTION LOANS TO TOTAL LOANS GRANTED, BY TYPE OF BANK, 1986-1995

(in percent)

Financial Institutions	*1986*	*1987*	*1988*	*1989*	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*Average*
Government Banks	2.3	6.7	5.1	11.4	27.4	30.1	8.0	8.5	10.0	9.1	11.9
PNB	2.3	5.8	15.2	13.9	18.4	na	3.2	2.8	3.1	2.8	6.8
DBP & PAB	10.3	65.0	16.6	4.6	7.8	4.8	5.6	9.4	4.1	5.4	13.4
LBP	na	6.6	0.8	10.1	32.5	38.6	23.3	21.5	17.9	7.3	16.9
Private Banks	7.9	7.2	7.7	7.5	6.1	4.7	6.9	6.3	4.4	5.2	6.4
PKBs	6.9	6.4	6.6	5.4	5.5	3.5	3.3	2.1	3.2	2.8	4.6
PDBs	13.8	13.5	14.1	14.4	12.2	13.4	17.4	10.9	9.7	1.0	13.0
SMBs	1.3	0.7	0.7	1.6	2.2	1.7	8.5	0.7	0.8	1.6	2.0
RBs	66.0	61.2	59.2	55.2	53.4	52.2	50.6	45.3	54.5	57.3	55.5
SSLAs	13.1	17.7	28.1	24.0	21.6	23.4	20.7	27.8	19.2	22.6	21.8
All Banks	7.5	7.2	7.4	6.6	7.0	5.2	4.4	2.0	1.8	1.7	5.1
Source: Table 5 ACPC											

Table 8
FINANCIAL SERVICES AND MARKETS OF VARIOUS FORMAL FINANCIAL INSTITUTIONS

Financial Institution	***Minimum Loan Size***	***Type of Borrower***	***Type of Loans***	***Type of Collateral***
1. Commercial Banks	Business Loans: P 0.5 million Consumer Loans: P 0.1 million	Predominantly large corporate enterprises and high net-worth individuals	Predominantly short-term loans for working capital	Predominantly real estate
2. Thrift Banks	P 20,000 to P 100,000	Non-farm SMEs	Short/medium/long-term loans for working capital and fixed asset acquisition	Real estate and others
3. Rural Banks (including CRBs)	P 10,000	Small farm and non-farm enterprises	Predominantly for short-term production loans	Real estate, standing crops and others
4. Credit Cooperatives	none	Small farm and non-farm enterprises Salaried employees	Short-term production and consumption loans	Predominantly unsecured
5. Finance Companies	none	Non-farm SMEs	Medium and long-term loans for fixed asset acquisition	Secured by acquired fixed assets
6. Pawnshops	none	Small farm and non-farm enterprises; individuals	Short-term loans for working capital and consumption	Pledges
7. Lending Investors	P 3,000	Small farm and non-farm enterprises. Salaried employees	Short-term loans for working capital and consumption	Predominantly unsecured

Source: Lamberte (1995) Table 23

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