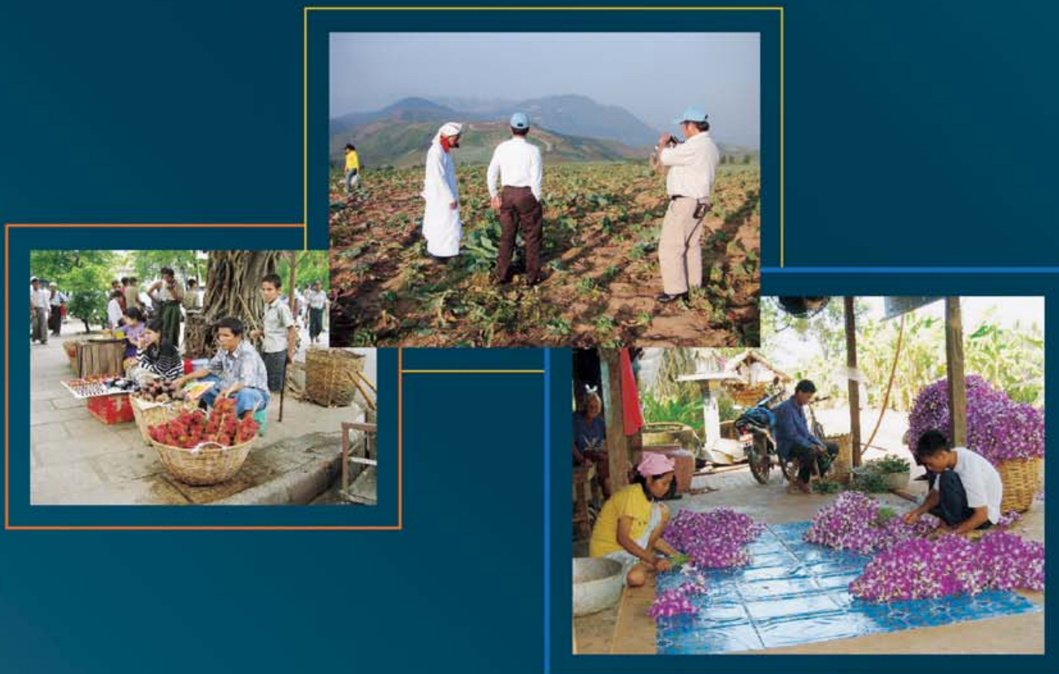
APRACA FinPower Program

CREATING A CONDUCIVE RURAL FINANCE POLICY ENVIRONMENT IN SELECTED ASIAN COUNTRIES



By Jocelyn Alma Badiola

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CREATING A CONDUCIVE RURAL FINANCE POLICY ENVIRONMENT IN SELECTED ASIAN COUNTRIES

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This book is published during the incumbency of Mr. Thiraphong Tangthirasunan (APRACA Chairman), Dr. Do Tat Ngoc (APRACA Vice-Chairman), Mr. Benedicto S. Bayaua (Secretary General).

MESSAGE from the

APRACA CHAIRMAN and VICE-CHAIRMAN

Greetings! This regional study, with three detailed national studies, on "Creating a Conducive Rural Finance Policy Environment" is a testimony of APRACA's strong commitment to pursue the promotion of efficient and effective rural financial systems and broadened access to rural financial services in order to help reduce rural poverty among countries in Asia and the Pacific. APRACA has successfully established among its members machinery for systematic interchange of information on sustainable rural and agricultural financial services, encouraged inter-country studies and provided training, consultancy, research and publication services on matters of common interest in the field of rural finance.

In all these aspirations, the International Fund for Agricultural Development or IFAD has played the role of APRACA's strategic partner under the FinPower Program. APRACA and IFAD share that mutual desire to pursue and create conducive rural finance policy environment and regulatory framework in Asian countries, including the development of sustainable financial services in rural areas, pilot testing of innovative approaches, delivery mechanisms and linkage programs, promoting finance reforms aimed at poverty alleviation, and disseminating best rural finance practices to more countries.

May we therefore thank Dr. Thomas Elhault, IFAD Asia Division Director, and Dr. Ganesh B. Thapa, Regional Economist, for the trust and confidence they have continuously bestowed on APRACA and for their commitment to help alleviate poverty and accelerate rural growth and development among countries in Asia and the Pacific.

We wish to congratulate Mr. Benedicto S. Bayaua, APRACA Secretary General and FinPower Regional Program Manager, for implementing the FinPower activities.

We also convey our thanks to APRACA's research and training arm, the Center for Training and Research on Agricultural Banking (CENTRAB), particularly to Ms. Jovita M. Corpuz, President and Atty. Eduardo Garcia, Managing Director, for their support and commitment to the FinPower Program. We sincerely wish that this book will continuously inspire policymakers, practitioners and other stakeholders in the different countries in Asia and the Pacific to work towards poverty reduction and rural development.

MR. THIRAPHONG TANGTHIRASUNAN
President, Bank for Agriculture and
Agricultural Cooperatives and
Chairman, Asia-Pacific Rural and
Agricultural Credit Association
2007

DR. DO TAT NGOC
Chairman, Vietnam Bank for Agriculture
and Rural Development and
Vice-Chairman, Asia-Pacific Rural
and Agricultural Credit Association
2007

MESSAGE from the APRACA-CENTRAB PRESIDENT

Greetings to all! It is my ardent wish for all the readers of this book to share in our quest to help uplift the lives of the rural poor through a conducive rural finance policy environment that will allow the delivery of adequate, timely and appropriate financial products and services in the rural areas.

The Center for Training and Research on Agricultural Banking (CENTRAB), the research and training arm of APRACA, takes pride in providing research expertise under the APRACA FinPower Program. Together, we promote the interchange of information among member countries through inter-country studies, training, consultancy, research and publication services in order to help these countries address critical issues and formulate strategies towards sustainable and effective rural financial markets.

This book is one of the major outputs of the FinPower Program. I would like to congratulate Dr. Thomas Elhault, IFAD Asia Division Director; Dr. Ganesh Thapa, IFAD Asia Division Regional Economist, Mr. Thiraphong Tangthirasunan, APRACA Chairman, Dr. Do Tat Ngoc, APRACA Vice-Chairman; and Mr. Benedicto Bayaua, Secretary General and FinPower Regional Program Manager; for their strong commitment to the program.

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May we all continuously be inspired to be generous in sharing our resources to help reduce poverty in this world.

MS. JOVITA M. CORPUZ
President, APRACA-CENTRAB and
Executive Director, Agricultural
Credit Policy Council of the Philippines
2007

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And finally, to "*the wind beneath her wings*", **Alec and Pancho**.

THE AUTHOR

Acronyms and abbreviations

ACCESS	Accelerating Change in the Countyside thru Equity Sharing Strategy
ACPC	Agricultural Credit Policy Council
ADB	Asian Development Bank
AFMA	Agriculture and Fisheries Modernization Act
APB	Agricultural Promotion Bank
APRACA	Asia-Pacific Rural and Agricultural Credit Association
ARBs	Agrarian Reform Beneficiaries
BAAC	Bank for Agriculture and Agricultural Cooperatives
BACs	Bank-assisted Cooperatives
BAFIA	Banking and Financial Institutions Act
BCEL	Banque pour le Commerce Exterieur Lao
BIBF	Bangkok International Banking Facility
BID	Banking Inspectorate Department
BoC	Bank of Ceylon
BoL	Bank of Lao PDR
BoT	Bank of Thailand
BRAC	Bangladesh Rural Advancement Committee
BRI	Bank Rakyat Indonesia
BSP	Bangko Sentral ng Pilipinas
CALF	Comprehensive Agricultural Loan Fund
CARL	Comprehensive Agrarian Reform Law
CARP	Comprehensive Agrarian Reform Program
CDA	Cooperative Development Authority
CENTRAB	Center for Training and Research on Agricultural Banking
CODI	Community Organization Development Institute
CPIP	Credit Policy Improvement Program
CUES	Credit Union Empowerment and Strengthening
DA	Department of Agriculture
DBP	Development Bank of the Philippines
DCCBs	District Central Cooperative Banks
DFIs	Development Financing Institutions
DSWD	Department of Social Welfare and Development
FFFCI	Federation of Free Farmers Cooperatives, Inc.
GBA	Grameen Bank Approach
GDP	Gross Domestic Product
GFIs	Government Financial Institutions
GFSME	Guarantee Fund for Small and Medium Enterprises
GHB	Government Housing Bank
GNP	Gross National Product
GSB	Government Savings Bank
IDB	Inter-American Development Bank
IFAD	International Fund for Agricultural Development
IRF	Integrated Rural Financing

JLG	Joint Liability Group
KKR	Koperasi Kredit Rakyat
KTB	Krung Thai Bank
LDB	Lao Development Bank
LDKP	Lembaga Dan Kredit Pedesaan
LGU	Local Government Unit
LPDs	Lembaga Perkreditan Desa
MABS	Microenterprise Access to Banking Services
MADB	Myanmar Agricultural Development Bank
MASSSPECC	Mindanao Alliance of Self-help Societies and the Southern Philippines Educational Cooperative Center
MCP	Microfinance Council of the Philippines
MFIs	Microfinance Institutions
MFPC	Microfinance Program Committee
MIS	Management Information System
MIX	Microfinance Information eXchange
MoF	Ministry of Finance
MTPDP	Medium-Term Philippine Development Plan
NABARD	National Bank for Agriculture and Rural Development
NAMVESCO	National Market Vendors Cooperatives Service Federation, Inc.
NAPC	National Anti-Poverty Commission
NATCCO	National Confederation of Cooperatives
NBC	National Bank of Cambodia
NBFCs	Non-bank Financial Companies
NCAC	National Cooperative Advisory Council
NCC	National Credit Council
NEDA	National Economic and Development Authority
NERUDO	Nepal Rural Development Organization
NBFIs	Non-bank Financial Intermediaries
NGOs	Non-government Organizations
NLSF	National Livelihood Support Fund
NORLU	Northern Luzon Cooperative Development Center, Inc.
NRB	Nepal Rastra Bank
NSO	National Statistics Office
PCFC	People's Credit and Finance Corporation
PCFs	People's Credit Funds
PFCCO	Philippine Federation of Credit Cooperatives
PHILEXIM	Philippine Export-Import Credit Agency
PSEI	Philippine Stock Exchange Index
QUEDANCOR	Quedan and Rural Credit Guarantee Corporation
RA	Republic Act
RBAP	Rural Bankers Association of the Philippines
RBI	Reserve Bank of India
RBs	Rural Banks
RFC	Rehabilitation and Finance Corporation
RDB	Rural Development Bank

ROSCA	Rotating Savings and Credit Associations
RRBs	Regional Rural Banks
RRDBs	Regional Rural Development Banks
SB Corp.	Small Business Corporation
SBGFC	Small Business and Guarantee and Finance Corporation
SBV	State Bank of Vietnam
SCBs	State Cooperative Banks
SCCs	Savings and Credit Cooperative Societies
SEC	Securities and Exchange Commission
SHGs	Self-help Groups
SMEs	Small and Medium Enterprises
TEKUN	Tabung Ekonomi Kumpulan Usaha Niaga
TRWS	Tharu and Razi Women Society
VBARD	Vietnam Bank for Agriculture and Rural Development
VBSP	Vietnam Bank for Social Policies

TABLE OF CONTENTS

Page

PART 1: RURAL FINANCE POLICIES IN ASIA

I. EVOLUTION OF RURAL FINANCE POLICIES IN ASIA 1
- 1.1 Characteristics of the Agricultural Sector and Rural Financial Markets in Asia 1
- 1.2 Directed Credit Paradigm 2
- 1.3 Directed Credit in East Asia 4
- 1.4 The Microfinance Revolution 5
- 1.5 A Market Approach 6

II. AN OVERVIEW OF THE CURRENT POLICY ENVIRONMENT AND REGULATORY FRAMEWORK IN SELECTED ASIAN COUNTRIES 6
- 2.1 Transition Countries 6
  - 2.1.1 Cambodia 7
  - 2.1.2 Lao PDR 8
  - 2.1.3 Myanmar 10
  - 2.1.4 Vietnam 11
- 2.2 Southeast Asia 12
  - 2.2.1 Indonesia 12
  - 2.2.2 Philippines 14
  - 2.2.3 Thailand 16
  - 2.2.4 Malaysia 19
- 2.3 South Asia 19
  - 2.3.1 India 19
  - 2.3.2 Nepal 21
  - 2.3.3 Sri Lanka 23

III. UNDERSTANDING THE ISSUES ON RURAL FINANCE DEVELOPMENT 23

IV. GEARING UP FOR CHALLENGES AHEAD AND STRATEGIES FOR RURAL FINANCE DEVELOPMENT 28

TABLE OF CONTENTS *(continued)*

Page

PART 2: A. RURAL FINANCE POLICIES IN CAMBODIA

I. SOCIO-ECONOMIC PROFILE 35

1.1 Geography 35
1.2 Climate 35
1.3 People 35
1.4 Languages 36
1.5 Economy 36

II. OVERVIEW OF THE RURAL FINANCIAL MARKET 38

2.1 The Institutional Structure 38
2.1.1 The National Bank of Cambodia 38
2.1.2 Commercial Banks 39
2.1.3 ACLEDA Bank 39
2.1.4 Rural Development Bank 39
2.1.5 NGOs 40
2.1.6 Informal Moneylenders 40
2.2 Demand for Financial Services in the Rural Areas 40

III. RURAL FINANCE POLICY ENVIRONMENT AND REGULATORY FRAMEWORK 41

3.1 Policy Environment 41
3.2 Regulatory Framework 42

IV. LESSONS LEARNED, ISSUES AND CHALLENGES 43

4.1 Some Lessons Learned 43
4.2 Issues 44
4.3 Challenges 45
4.4 Some Recommended Strategies 46

TABLE OF CONTENTS *(continued)*

Page

PART 2: B. RURAL FINANCE POLICIES IN LAO PDR

I. SOCIO-ECONOMIC PROFILE 47

1.1 Location and Topography 47
1.2 Climate 47
1.3 Natural Resources 47
1.4 People 47
1.5 Economy 48
1.6 Political Environment 48

II. OVERVIEW OF THE FINANCIAL SYSTEM 49

2.1 Institutional Structure 49
2.1.1 Formal Sector 49
2.1.1.1 State-Owned Banks 49
2.1.1.2 Private Banks 49
2.1.1.3 Ekphattana Microfinance Institution (EMI) 49
2.1.1.4 Foreign Banks 50
2.1.2 Semi-formal Sector 50
2.1.3 Informal Sector 50
2.2 Financial Market Structure 50
2.3 Financial Depth and Outreach 50

III. MICROFINANCE DEVELOPMENT 51

3.1 Meeting the Demand for Rural Finance/Microfinance Services 51
3.2 Microfinance Practices and Innovations 52
3.2.1 Microfinance and Sustainable Livelihood in LAO PDR Project (1997-2002) 53
3.2.2 Rural Development Project in Bokeo Province 53
3.2.3 Phongsaly District Rural Development Project 53
3.2.4 Women in Development Program in Vientiane Municipality 53
3.2.5 Community-based Rural Development to Reserve Watershed Project in Oudomxay Province 54
3.2.6 Development Project in Bolikhamxay Province 54
3.2.7 Lao-Luxembourg Integrated Rural Development Project In Bolikhamxay Province 54
3.2.8 The Community-Managed Livelihood Improvement Project 54
3.2.9 Oudomxay Community Initiative Support Project (OCISP) 54
3.2.10 Microfinance Capacity Building and Research Project (MCBR) 55
3.3 Technical Assistance for Microfinance Development 55

IV. POLICY AND REGULATORY FRAMEWORK 55

V. ISSUES AND RECOMMENDATIONS 57

TABLE OF CONTENTS *(continued)*

Page

PART 2: C. RURAL FINANCE POLICIES IN THE PHILIPPINES

I. **SOCIO-ECONOMIC PROFILE** 58

II. **THE PHILIPPINE RURAL FINANCIAL SYSTEM** 61

2.1 Overview 61
2.2 Institutional Structure 66
2.2.1 Main Players: Wholesale Level 66
2.2.1.1 Land Bank of the Philippines 66
2.2.2 The People's Credit and Finance Corporation 72
2.2.3 Small Business Corporation (SB Corp.) 73
2.2.4 Development Bank of the Philippines (DBP) 73
2.2.5 Quedan Guarantee Corporation (QUEDANCOR) 74
2.2.6 Bangko Sentral ng Pilipinas (BSP) 74
2.3 Institutional Players at the Retail Level 74
2.3.1 Rural Banks 74
2.3.2 The Cooperative Sector 76
2.3.3 Non-Government Organizations 78

III. **RURAL FINANCE POLICY DEVELOPMENT** 80

3.1 Before the Reforms 80
3.2 Liberalization and Deregulation of the Rural Financial Market 81
3.3 The Agricultural Credit Situation After the Financial Liberalization 81
3.4 Forward-Backward Policy in the Mid-Nineties: The Resurgence of Subsidized Credit Programs 82
3.5 Policy Reforms on the Rebound: The Agriculture and Fisheries Modernization Act (AFMA) of 1997 and Executive Order 138 82
3.6 Current Imperatives for Increased Access to Rural Finance 83
3.6.1 The Agro-Industry Modernization Credit and Financing Program (AMCFP) 83
3.6.2 Role of the Agricultural Credit Policy Council (ACPC) 84
3.7 Microfinance Revolution 85

IV. **FINAL REMARKS** 88

BIBLIOGRAPHY/REFERENCES 93

ABOUT THE AUTHOR 95

TABLE OF CONTENTS *(continued)*

Page

List of Tables

Table 1 Population and Average Annual Growth Rate Philippines: 1903-2000 59

Table 2 Rural/Urban Population in Southeast Asia (in percentage share) 59

Table 3 Employed Persons by Major Occupation Group: October 2005 and October 2006 60

Table 4 The Philippine Formal Financial System 62

Table 5 The Philippine Banking System, 2005 62

Table 6 Agricultural Loans Granted, By Type of Bank 63

Table 7 Major Microfinance Providers and Selected Indicators 65

Table 8 Borrowing by Major Source of Loans: 1996-2005 66

Table 9 Borrowing Incidence Among Farm Households in the Philippines Sub-Period Averages, Various Years 82

List of Figures

Figure 1 Banks' Loans Granted to Agriculture, Fisheries and Forestry, 2006 by Type of Banks, percentage 63

Figure 2 Proposed Institutional Set-up for the Regulation of Microfinance 89

List of Annexes

Annex 1 Subsec. X151.2 of BSP Circular 505, Series of 2005: Prerequisites for the grant of authority to establish a branch/banking office 90

Foreword

Through the years, the Asia-Pacific Rural and Agricultural Credit Association (APRACA) has aspired to work for rural growth and development, with priority emphasis on the uplift of rural poor. It has pursued the promotion of efficient and effective rural financial systems and broadened access to rural financial services. It has established, among its members, a machinery for systematic interchange of information on sustainable rural and agricultural financial services, encouraged inter-country studies, and provided training, consultancy, research and publications services on matters of common interest in the field of rural finance.

In all these aspirations, the International Fund for Agricultural Development (IFAD) has played the role of a strategic partner. Between 1996 and 2001, IFAD provided a technical assistance grant to APRACA under the APRACA MICROSERV program to disseminate replicable rural finance models to a wider audience. The dissemination was particularly enhanced through APRACA's vast network, resulting in broader geographic reach, cost-effectiveness and assured project continuity.

IFAD has again re-engaged APRACA, beginning in year 2007, in their mutual desire to pursue and create conducive rural finance policy environment and regulatory frameworks in Asian countries, including the development of sustainable financial services in rural areas, pilot testing of innovative approaches, delivery mechanisms and linkage programs, promoting finance reforms aimed at poverty alleviation, and disseminating best rural finance practices to more countries. The re-engagement is realized through the IFAD five-year technical and financial assistance grant to APRACA, officially dubbed as the APRACA Regional Program of Accelerating the Financial Empowerment of Poor Rural Communities in Asia and the Pacific through Rural Finance Innovations or dubbed as the IFAD-supported APRACA FinPower Program.

As one of the initial activities of the APRACA FinPower Program, this regional study on creating rural finance policy environment and regulatory framework in selected Asian countries and three detailed component national studies on rural finance policies in Cambodia, Lao PDR and the Philippines provide an insight into the state of the art of rural finance in the region. In tandem with the studies, FinPower conducted a forum in Kunming, China in 2007 in order to analyze the findings and build upon these to pursue a diverse, yet unifying course of action for the whole region.

APRACA draws expertise and support from its 57 member institutions as well as partner MFIs in 23 countries. FinPower, therefore, intends to highlight the rural finance policies in these countries as its contribution to the growing wealth of knowledge in rural finance, including agricultural finance and microfinance.

This book is intended for rural finance policy makers and practitioners alike. The presentation of varied rural finance landscapes provides the reader with ample information from which to base directions in its quest to identify the most appropriate rural finance policies that can be replicated in his own country.

The book is by no means complete. It is expected that newer and updated editions of the book, with additional countries in focus, shall be published in due course. Readers are therefore requested to provide further comments and suggestions on how to improve the contents and focus.

BENEDICTO S. BAYAUA
APRACA Secretary General and
FinPower Regional Program Manager

PART 1

RURAL FINANCE POLICIES IN ASIA

I. EVOLUTION OF RURAL FINANCE POLICIES IN ASIA

1.1 Characteristics of the Agricultural Sector and Rural Financial Markets in Asia

Most financial institutions have largely avoided serving the rural sector because of the many risks they face which make lending to this sector very costly. Consequently, most of the rural households borrow from informal lending agents which provide loans at exceedingly high interest rates but with very little or no documentation requirements making these lenders very accessible to the rural poor. Many of the poor and low-income households, therefore, lack access to formal or semi-formal credit and other financial services such as savings, money transfers and insurance.

The reality that banks virtually shy away from lending to farmers and other small agricultural producers can be explained by the inherent characteristics of the agricultural sector and rural financial markets in Asia which are:

- **Rural cash flows are cyclical.** Most farmers and other agricultural producers require cash during planting and harvesting seasons. Savings are mobilized cyclically as well, usually after harvest, when crops are sold (Binswanger and Rosenzwei, 1986).
- **High risk.** Given that large numbers of farmers produce the same crops, there is a covariant or common risk that affects these farmers almost simultaneously. This is because the forces of nature do not distinguish significantly between farmers. Few effective crop insurance programs exist, if at all (Roberts, Gudger and Gilboa, 1987). Most commercial bankers, operating in predominantly urban areas, have not developed the expertise in evaluating the risk of agricultural loans. Specialized state-owned institutions often use normal year projections as a basis for loan size and repayment capacity, even though agriculture is more vulnerable than other sectors to the vagaries of nature (Von Pischke, 1991).
- **Inefficient production units and poor linkages with complementary markets.** Many farmers operate small plots. Since most of these small farmers do not have access to marketing cooperatives and farmers organizations, they do not have economies of scale. In effect, subsistence farmers often lack the cash flow to pay back a loan.
- **Hence, small-scale, dispersed clients, small average loans and low household savings** increase the cost of financial intermediation per monetary unit.
- **Lack of infrastructure** (e.g., roads, transportation, marketing, communications, electricity and banking facilities) **and social services** (such as education and health) further increases risk which in turn, increases costs, limits sources of information and therefore, retards business activity and hampers risk management which pushes banks and other financial institutions further away from lending to the agriculture and fisheries sector.
- **Limited financial infrastructure.** ***Banks have limited or no access to information*** about the character and operations of potential clients given the absence or lack of facilities for credit information exchange such as credit bureaus and similar systems which increases lending

transaction costs. ***Banks have limited use of collateral.*** Fleisig (1994) indicated that the "absence of registries and routine foreclosure mechanisms" that are timely and inexpensive make it difficult or impossible to use movable property, crops and accounts receivable for collateral.

- **Educational/Institutional Limitations.** Small producers and businesses have limited understanding of formal financial institutions and instruments, and may lack the skills to apply for and manage financial services. Commercial banks are virtually absent from most rural markets. They require techniques and procedures that will lower the cost of evaluating risk and administering portfolios of small deposits and loans (Chaves and Gonzalez-Vega, 1994).

1.2 Directed Credit Paradigm

For several decades, therefore, after World War II, most countries in Asia pursued a supply-led development policy to promote credit access to the rural sector. Governments in these countries viewed credit as the solution to poverty. Since the poor had no access to formal credit given the costs and risks associated with lending to them, the strategy deemed appropriate was for government to intervene in order to attract financial institutions to lend to marginal groups including small farmers and fishermen. Lending by governments at subsidized interest rates was the predominant approach. Five common forms of government intervention used were, as follows (Meyer and Nagarajan, 2003):

- Loans given at subsidized interest rates;
- Lending requirements and quotas imposed on banks;
- Credit guarantees;
- Refinancing or rediscounting schemes; and
- Lending by development banks or specialized institutions.

Lending was therefore targeted at specific groups of farmers, specific areas or regions and specific crops. This was known as directed credit. Credit was incorporated into production programs like *the Masagana* 99 of the Philippines and the *Bimas* of Indonesia and was treated as an input like seeds and fertilizer. Governments were so focused on increasing the supply of loans that other support services like market linkaging and institution capacity building were given little attention.

Since the directed credit policy was deemed to be the most appropriate development approach at that time, multilateral and bilateral donor projects in the rural sector commonly supported directed credit projects to promote agricultural development. Meyer and Nagarajan (2003), for instance, indicated that the Asian Development Bank (ADB) provided a total of US$1.4 billion for 72 projects between 1970 and 1991 and of this amount, US$1.0 billion was allocated for 36 projects "providing credit to crop farmers and cooperatives for the acquisition of equipment".

For some time, the directed credit approach resulted in many innovations and encouraging developments based on a study done by ADB in Asia that covered a ten-year period, from mid-60s to mid-70s. Meyer and Nagarajan (2003) further indicated in their paper a summary of the findings of the ADB study, as follows:

- There occurred a major expansion in the number of banking outlets in the rural areas. Commercial banks in India had opened 5,000 new branches. The Bank of Ceylon had set up 400 rural branches. In the Philippines, over 500 rural banks had been established and the Philippine National Bank had set up 100 branches.

- Sharp increases in loan disbursements. Commercial banks increased agricultural lending in India by a factor of 32 from 1968 to 1974. Rural banks in the Philippines increased lending ten-fold during 1965 to 1975. In Sri Lanka, the People's Bank increased lending by a factor of almost 2.5 from 1969/70 to 1973/74.

- An expansion in the number of institutions making loans without collateral. Many were lending 100 percent of the cost of cultivation, and some were giving out long-term loans.

- Special programs had been introduced to increase food production by providing subsidized credit and inputs to farmers. The Bimas program began in Indonesia in 1967, while the Masagana 99 program started in the Philippines in 1973.

- Governments put up credit guarantee and crop insurance programs as well as credit quotas that mandated existing financial institutions to allocate a proportion of credit funds for agricultural lending.

Unfortunately, however, these developments were short-lived. While these interventions helped improve agricultural yields in the short term, they overwhelmingly entailed high costs that were unsustainable over the long term and thus, failed to reach the majority of farmers.

Altogether, the directed credit policy led to the following: 1) poor development of financial institutions which made them very dependent on government subsidies and neglected mobilization of deposits; 2) high loan default rates primarily because of the perception that since funds came from the government, they need not be paid which eventually resulted in the collapse of such programs like Bimas and Masagana 99; 3) poorly designed credit programs that had weak collection mechanisms; 4) excess demand for loans (because it's 'cheap') and that the benefits of receiving cheap loans were generally reaped by relatively wealthy and politically connected farmers than by the targeted smallholders; and 5) production inefficiencies since subsidized agricultural credit tended to target the wrong products and created artificial preference for capital-intensive investments that "crowd out" labor-intensive investments more appropriate for the rural poor.

The failure of the directed credit approach in promoting effective and sustainable rural financial markets led critics to question whether the government's scarce resources can be utilized more effectively and efficiently through other strategies or mechanisms for rural income expansion and poverty reduction. Thus, scholars and policymakers alike studied and debated on the appropriate agricultural credit policies that could make a much more positive contribution to rural development. There were increasing concerns about the wisdom of the directed credit paradigm.

Some of the points raised during such discussions and debates include the following:

- Credit cannot compensate for urban bias;

- Credit subsidies almost never reach the poor;

- The efficiency and effectiveness of rural financial systems and institutions should be measured not only in terms of outreach but of self-sustainability as well;

- A successful rural finance institution should be:
  - Rural-based and not just specialized in agriculture;
  - Autonomous;
  - Able to charge market interest rates;
  - Able to mobilize savings and reduce reliance on donor or state funds;

   - Able to collect on loans and have fewer losses; and
   - Able to provide staff incentives.

- The farm household should be seen as an economic unit with farm, non-farm as well as consumption requirements and that financial services are as critical to rural non-farm enterprises as they are to farming;

- Agricultural credit should be viewed not as a direct input in agricultural production, but is provided as the result of a process of financial intermediation (Meyer and Nagarajan, 2003);

- Credit is fungible, meaning, it can be diverted to other uses, making it costly and difficult for lending institutions to ensure that it is used for its intended purpose;

- Lenders should be allowed to charge market-determined interest rates so that they can totally cover their costs and in effect, sustain their operations;

- Reducing dependency on external funds will reduce the politics and/or government intervention in the rural financial markets;

- Reforms in financial market policies are more often hampered by political obstacles than by economic forces; and

- Governments should focus on creating a conducive policy environment, providing the needed infrastructure and support services including opportunities for institution building in order to increase participation of the private sector in the delivery of credit to agriculture.

By the 1990s, clearer evidence on the failure of the directed credit approach was established. In effect, donors exited and rural credit projects were discontinued. Von Pischke (1996) illustrates this, as follows:

> "…the Inter-American Development Bank's (IDB) rural finance operations that provided direct support for rural credit began in 1961. From 1976 to 1980, total funding was US$626 million. During the period 1981-85, the total was US$1.7 billion, and in 1986-1990, the amount was US$1.6 billion. From 1991 to 1998, the total was US$61 million."

1.3 Directed Credit in East Asia

The directed credit programs in East Asia, however, should be seen as a special case. In the East Asian countries "with strong civil societies and professional public financial institutions" such as Japan, the Republic of Korea, Singapore, Taipei and China, the directed credit strategy proved to be successful (World Bank, 1993). Government officials in Japan and other East Asian countries have advocated the merits of well managed and focused directed credit programs. According to this view, directed credit by the government is warranted "when there is a significant discrepancy between private and social benefits, when the investment risk of particular projects is too high, and when information problems discourage lending to small and medium size firms"

Some of the reasons that can explain the relative success of directed credit programs in East Asia are shown below (Vittas and Yoon, 1995):

- Credit programs in these countries are small in size with low levels of subsidy, a narrow focus and limited period of implementation that have clear provisions on program phase-out;

- These programs are supported by long-term funds meant to avoid inflation and macroeconomic instability;

- The programs are designed with a framework that promotes economic development, industrialization and export orientation, growth with equity and a sound financial system;
- The programs are being implemented by professionally managed, well-capitalized and autonomous financial institutions;
- The designs of the credit programs are based on a set of clear objectives and with a workable monitoring and evaluation system; and
- The programs are formulated through close consultations with both private and public sectors.

However, even with these success factors, the question of whether or not East Asia's experience could be replicated in other countries remains unanswered given the developing stage of economies of most countries in Asia and the uncertainty and volatility brought by the globalization of financial markets.

1.4 The Microfinance Revolution

Microfinance started as early as the seventies, gained momentum during the eighties and resulted in the emergence of best practices in the nineties. The pioneer microfinance practitioners performed far better than the agricultural credit programs during the same period in terms of outreach and loan recovery even in a country like Bangladesh which had very unfavorable economic conditions (Meyer and Nagarajan, 2003).

The revolution in microfinance for the poor over the last two decades was led by practitioners who developed methodologies that achieved very high rates of repayment and cost recovery as well as reach predominantly poor clients, especially women (Robinson, 2001). For the first time, an increasing number of poor borrowers were having access to formal financial services due to these innovations which reduced lending costs and risks and enabled microfinance institutions to serve poor clients successfully without the collateral normally required by banks. Some of the techniques that led to the success of microfinance institutions are, as follows (adapted from Meyer and Nagarajan, 2003):

- Providing small loans intended for only a few weeks or months to be used primarily for working capital;
- Allowing repeat loans as incentives to motivate clients to maintain good repayment records;
- Frequent payments, often weekly or monthly, to allow close monitoring of borrower performance;
- Interest rates plus other fees that enable microfinance institutions to fully recover their costs;
- Generally, no hard collateral required; in its place, peer group formation and peer monitoring; for microfinance institutions that use the more conventional individual lending methodology, household goods and other assets that have high use value to their clients are accepted;
- Simple and decentralized lending procedures;
- Each loan officer handles, on the average, 75 to 100 group borrowers or 200 to 500 individual borrowers; and
- High loan recoveries of 95 percent or more; computerized systems are used to produce daily repayment reports; some institutions offer interest rebates for on-time or early payments; others charge penalty for late payments.

Countries throughout Asia, thus, embraced microfinance as a potent tool for poverty reduction.

1.5 A Market Approach

Financial reforms took place in the 'free world' in the 1980s. Policy changes that promoted financial liberalization were partly influenced by the experiences of Taiwan, South Korea, Hong Kong and Singapore in the 1950s and 1960s (Von Pischke, 1996). These economies experienced unprecedented growth after moving toward market-based policies governing trade, foreign exchange, interest rates, commercial bank reserve requirements, credit controls and restrictions on entry into the finance industry. Following the collapse of the directed credit regime, therefore, many donors promoted liberalization or the market approach as the new paradigm towards rural development. Under the new approach, three strategic priorities are emphasized:

- Creating a favorable policy environment;
- Strengthening the legal and regulatory framework; and
- Building the capacity of rural finance institutions to deliver demand-driven credit, savings and insurance services in a self-sustaining manner.

Two major policy reforms instituted in some countries were a result of liberalization: 1) greater freedom of entry into the financial market which increased the number and competitiveness of banks and other types of financial institutions including NGOs and cooperatives; and 2) deregulation of interest rates which, in effect, also helped further dismantle directed credit.

However, the transition from state control to market was not easy in many countries as the economic distortions brought by state control and ownership were revealed and new risks were created. Some sectors resisted reforms especially those that directly benefited from the directed program approach. There are, in fact, still a number of nations in Asia that have yet to fully liberalize their financial policies. Nonetheless, based on lessons learned from past policies, liberalization offers a better framework for much more productive and efficient financial sectors.

II. AN OVERVIEW OF THE CURRENT POLICY ENVIRONMENT AND REGULATORY FRAMEWORK IN SELECTED ASIAN COUNTRIES

In this section, the selected Asian countries are classified into three groups: 1) Transition Countries; 2) Southeast Asia; and 3) South Asia.

2.1 Transition Countries

A transition country refers to a country that is undergoing a shift from a centrally-planned economic system to a market economy. Countries that fall under this category include Cambodia, Lao PDR, Myanmar and Vietnam.

These countries are largely agricultural with majority of the population living in the rural areas. Although their financial sectors are still in the infancy stage, most of these countries have sowed the seeds for a market-oriented policy environment. However, outreach is still limited and majority of the population still have no access to financial services. Rural finance and microfinance technology are also not yet well developed. A significant and common characteristic of their rural financial markets is that agricultural banks as well as microfinance institutions are playing a central role as formal providers of financial services in the rural areas.

2.1.1 Cambodia

Institutional Forms. The **Cambodian** banking system started in the early 1990s when the government launched the economic reform program from a centrally planned to a free market economy. The banking system consists of the Central Bank (National Bank of Cambodia), individual unit banks and microfinance institutions (MFIs). As of end 2006, Cambodia has 20 banks of which 15 are commercial banks, 5 specialized banks and 2 representative offices of foreign banks. Commercial bank activities, however, are virtually confined in the cities. People in the rural areas have no access to commercial banks. There is also no state-owned agricultural bank that targets small farmers and fishermen. The only state-owned bank is the Rural Development Bank (RDB) which wholesales funds to MFIs for retailing to micro and small enterprises. In addition, there are 17 licensed MFIs, 26 registered credit operators and around 60 small unregistered NGOs operating in the rural areas.

The institutions that are able to address the financing requirements of the poor in the rural areas are, therefore, the MFIs. Most of these MFIs have been transformed from non-government organizations (NGOs) that were involved with humanitarian work among refugees in the Thai border. After the Paris Peace Accord in October 1991, the refugees had returned home. With the passage of time, NGOs have redefined their roles and have become very active in microfinance operations. Their main financial products include individual loans, group loans and savings from members.

Cambodian microfinance has, therefore, grown remarkably in 2006. This growth makes a significant contribution to economic development and poverty alleviation. With its credit and savings services, MFIs help people, especially the poor to relieve their family burdens and improve their livelihood.

The financial institution that has the largest network in both the urban and rural areas in Cambodia is ACLEDA Bank. It has grown from being an NGO, to a specialized bank and now a commercial bank. The ACLEDA Bank provides both commercial banking and rural financial services. Fully supported by international donors since its establishment, ACLEDA Bank has been expanding its range products in retail banking to include loans to small and medium enterprises, cash management and money transfer services and deposit services to the public. Savings mobilized by ACLEDA has been growing rapidly as well from 22.4 KHR million in 2002 to 255.9 KHR million in 2005.

Policy Framework. Among the Southeast and East Asian transition countries, it can be said that Cambodia is among the first that put into place the fundamentals of a market-oriented policy framework. It has adopted a market-oriented interest rate policy. Policy authorities in Cambodia are guided by the school of thought that since most sources of funds for MFIs are private funds, an interest rate cap could discourage growth because when microfinance operations are not profitable, there will be no further investments in this sector. Since it is market-driven, interest rates will be determined solely by competition in the market.

With respect to bank branching, MFIs are actively encouraged to open branches to both increase the outreach to the poor and to increase competition subject to evaluation by the National Bank of Cambodia.

Moreover, the Government of Cambodia is not directly involved in microfinance operations or lending. Microfinance operators make their own credit decisions without influence from the government. The government merely promotes the transformation of NGOs into MFIs and the

transformation of MFIs into commercial companies by setting simple conditions for them to comply with. The government has also focused its attention on the establishment and provision of appropriate support services in the rural areas. For instance, national and rural road systems have since been rebuilt in the remote areas. Better roads allow microfinance operators to enter and provide services at low costs which helps bring down interest rates. In addition, the construction of irrigation systems such as canals and ponds also contributes towards the increased capacity of microfinance borrowers to pay back their loans as they are able to increase their production and income. Other critical support services such as training on new farming technology including the correct use of fertilizers as well as proper animal feeding, have been given attention by the government in order to increase the creditworthiness of the poor.

Regulatory Framework. Cambodia has since established measures to ensure prudential lending operations among banks and MFIs. *One*, it introduced a framework in the banking law that enables eligible NGOs and other rural finance providers to become regulated microfinance institutions; and *Two*, it created a unit in the National Bank of Cambodia to supervise and monitor MFIs.

The National Bank of Cambodia (NBC) has, thus, started to issue and amend regulations in order to help NGOs become registered and licensed MFIs. Currently, specialized banks engaged in microfinance and NGO MFIs are integrated into the regulations of the NBC. With technical and financial support from donors, the NBC developed banking legislation that includes registration and licensing requirements and some prudential standards for larger MFIs. After receiving license and registration certificates, these institutions are subjected to NBC's regulation and supervision. Since 2002, the NBC has started to issue licenses and registration certificates to qualified NGOs. By the end of 2006, about 17 institutions have become licensed MFIs and 26 registered as rural credit operators. Majority of these institutions were former NGOs and the others, local private companies.

Institutional Development. In order to ensure a sustainable microfinance system, **Cambodia** recognizes the need to further strengthen the National Bank of Cambodia (NBC) to maintain its effectiveness and efficiency in the regulation and supervision of the microfinance sector. At the same time, authorities would like to make sure that all institutions taking deposits are properly guided and oriented and thus, should be subjected to graduated regulatory requirements and supervision based on the size and type of activities. There should also be a common standard for reporting in order to allow for sound financial performance analysis and information dissemination and consequently, help promote the sector's growth.

Savings Mobilization. The Asian Development Bank (ADB) conducted a survey on micro savings in some potential provinces in Cambodia. The survey showed that rural people are willing and able to save. Based on this result, the NBC is finalizing the regulations for deposit-taking institutions as well as the set of standards based on which MFIs applying for deposit-taking services will be evaluated. A license to mobilize or take deposits from the public will be issued to those who meet the standards.

2.1.2 Lao PDR

Lao PDR's rural financial market is still at an embryonic stage and is undergoing reforms. Only 7 percent of the poor have access to formal credit. Majority borrow from informal lenders. The financial sector of Lao PDR has very little intermediation with loans equal to only 7.4 percent of Gross Domestic Product (GDP). Loans absorb only half of deposits. The physical penetration of bank branches is very low, among the lowest in the world at 0.8 branch per 100,000 people.

Lao PDR therefore ranks alongside Ethiopia, Uganda and Tanzania in terms of branch penetration. The formal financial sector caters largely to the needs of a few entrepreneurs in major urban centers.

Institutional Forms. Lao PDR's financial sector is dominated by the state-owned commercial banks. The Agricultural Promotion Bank (APB) with its mandate to promote agriculture is the bank most engaged in delivering financial services in the rural areas. According to the ADB, the APB has been incurring operational losses and has accumulated a high level of problem loans, resulting in periodic recapitalization by the government. The APB's operations have been reportedly controlled by the government including the setting of the level of interest rates and thus, responsibility and management autonomy as a financial institution have been quite limited. Given the difficult operating environment for rural finance, the government has moved to introduce microfinance projects in the 1990s.

There are, thus, three main types of microfinance organizations present in the Lao PDR. These are: Microfinance institutions (MFIs), licensed and registered operating under Bank of Lao PDR (BoL) regulations; Savings and Credit Unions (SCUs) operating under BoL regulations; and Village Savings and Credit Groups (VSCGs) and Village Revolving Funds (VRFs), not operating under BoL regulations.

Moreover, the commercial banking industry has three principal groups: ***First,*** the State-owned commercial banks which include the (a) Banque pour le Commerce Exterieur Lao (BCEL), (b) Lao Development Bank (LDB), (c) Agricultural Promotion Bank and the (d) new Nayoby Bank (a Policy Bank, which does not accept deposits from general public); ***Second,*** the joint-venture and private banks such as the Joint Development Bank, Vientiane Commercial Bank, which now has a partnership with ANZ Bank, Lao-Viet Bank and the new 100 percent Lao private bank, Phongsavanh Bank; and ***Third,*** the foreign commercial banks: six branches of Thai commercial banks, one Malaysian bank and a Standard Chartered Bank representative office.

Policy Framework. With the help of ADB, Lao PDR has already started to institute policy reforms towards a market-oriented economy. Microfinance institutions are free to set their own interest rates on loans and deposits in order to allow them to cover their costs and have a reasonable profit margin. It is, however, still a work in progress. So far, there are still ongoing government programs which provide loans at subsidized interest rates to farmers, usually through the Agricultural Promotion Bank. The government, however, is already trying to terminate the implementation of such programs.

Through a US$10 million loan and US$3.5 million technical assistance grant from the Asian Development Bank, the Agricultural Promotion Bank will be recapitalized and restructured (owing to its huge past due loans and losses incurred from subsidized lending programs) and will be capacitated to stop all its subsidized lending activities and focus on microfinance (individual lending). It should be noted that when the government of Lao PDR first launched a strategy aimed at expanding the provision of financial services to the rural poor in the late 1990s, pilot initiatives in Lao PDR in the area of microfinance have reached about 70,000 micro borrowers most of whom are clients of APB which offered loans at interest rates lower than the rates offered by other banking institutions.

The bulk of the financial reform programs implemented, thus, consisted of restoring the health of the dominant ailing state commercial banks: Banque pour le Commerce Exterieur Lao (BCEL), Lao Development Bank (LDB) and the Agricultural Promotion Bank.

Regulatory Framework. Supervision by the Bank of Lao PDR is based on many decrees, regulations, rulings and presidential orders.

In 2005, the Bank of Lao PDR issued the Final Draft of the Microfinance Regulation which formed the basis for issuing licenses to qualified microfinance institutions. The regulatory framework, however, covers only formal financial institutions. NGOs remain unlicensed and unsupervised.

The Bank of Lao PDR is regulated by Law No. 5 on the Bank of Lao PDR. Agricultural Promotion Bank, the main provider of rural financial services, is regulated by a new Law on Commercial Banks, adopted by the National Assembly in December 2006. There is also Regulation No. 02/SB for credit cooperatives. Therefore, now, a regulation exists for each type of financial institution.

2.1.3 Myanmar

Institutional Forms. The Myanmar Agricultural Development Bank (MADB), a state-owned bank established in 1953, is virtually the only major source of institutional credit in the rural areas, with the exception of cooperative societies. The Myanmar Economic Bank (also state-owned) and private commercial banks are mostly confined to the urban centers. The MADB's mandate and funding priority have been for the benefit of the farmers, but the scale of loans is severely limited, mainly due to funding constraints. Also, the mountainous geography and poor infrastructure in the rural areas make provision of financial services very difficult. Hence, there is huge excess demand in the countryside.

Policy and Regulatory Framework. The government has initiated reforms in the financial system by promulgating banking laws in 1990 including: The Central Bank of Myanmar Law; The Financial Institutions of Myanmar Law and The Myanmar Agricultural Development Bank Law. These laws provided the: 1) legal framework for the operation of financial institutions, such as commercial banks, development or investment banks and finance companies; and 2) the establishment of financial institutions, whether private, state-owned, or jointly owned by the state and private sector, to perform financial activities with the permission of the Central Bank. Moreover, these laws require all existing state-owned commercial banks, along with newly emerged private banks, to engage both in domestic and foreign banking services. These laws likewise specify the functions, duties and powers of financial institutions, and regulatory provisions to be observed by the financial institutions.

However, microfinance in Myanmar is only of "project status". It is an exogenous phenomenon brought to the country in 1997 by some international NGOs contracted with the UNDP/UNOPS, who are interested in including microfinance in the poverty alleviation package for thee specially designated regions in the country. Although, the aggregate number of clients has grown very rapidly since the start of implementation, the geographical coverage of these projects is yet very small (only a few percent of the country's townships).

The Myanmar government, thus, including the Central Bank, has insufficient exposure to microfinance practices. Hence, the country lacks the policy framework, the legal structure for registering microfinance NGOs as well as the administrative structure that are needed in dealing with microfinance undertakings.

2.1.4 Vietnam

In Vietnam, about 75 percent of the population and 90 percent of the poor reside in the rural areas. Hence, in spite of the country's vigorous industrial growth and economic structural transformation throughout the 1990s, the rural economy is still dominant in Vietnam.

Institutional Forms. Microfinancing in Vietnam is provided by formal, semi-formal and informal sectors. The formal sector includes the Vietnam Bank for Social Policies, Vietnam Bank for Agriculture and Rural Development, Vietnam Postal Saving Company and the People's Credit Fund. The semi-formal sector, on the other hand, includes 57 international non-government organizations and 4 government-recognized microfinance organizations. The informal sector consists of the "Ho/Hui" (a popular form of rotating savings and credit associations (ROSCA)), relatives, friends, neighbors and other moneylenders.

Since its establishment in 1988, the Vietnam Bank for Agriculture and Rural Development (VBARD) has been the major source of credit and savings in rural Vietnam. VBARD is regarded as having contributed significantly to the agricultural expansion under the doi-moi (renovation) policies in Vietnam. Now the biggest commercial bank, it has a very extensive network (nearly 2,000 branches) and serves more than 5 million households.

The Vietnamese government also established the Vietnam Bank for the Poor (VBP) in 1995 to serve poor households that could not be reached by VBARD. Its major task is to provide subsidized credit through a joint liability group. The VBP used VBARD's extensive network of branches; it had no separate staff members and was not involved in any savings mobilization activity. While VBP's outreach in terms of amount of loans and number of households has reached substantial figures since 2002, the crucial issue is VBP's long-term viability and sustainability.

In 2002, one of the country's financial reforms included the reorganization of VBP. Thus, VBP was renamed the Vietnam Bank for Social Policies (VBSP) in March 2003, and started to develop its own network of branches, while serving a much broader population including students, disable people, and micro and small entrepreneurs. VBSP was established to take over the poverty targeting program run by VBARD and consolidate all governmental programs lending to the poor and other vulnerable social groups.

VBSP provides subsidized credit without requiring formal loan collateral. VBSP is supervised by the State Bank of Vietnam. At the end of 2003, VBSP was reaching 3.3 million clients, of which 1,000,000 were considered poor. At that time, VBSP had 9.75 trillion VND in loans outstanding and was expecting to reach 16 trillion by the end of 2004, which represents more than three quarters of the current loan portfolio of VBARD. VBSP is based in Hanoi and has 61 branches and 600 offices throughout all 64 provinces of the country.

The State Bank of Vietnam (SBV) was established in 1951. Until 1988, SBV played the role of a Central Bank, setting broad monetary policies and regulations, and the role of a commercial bank, carrying financial activities of a regular retail bank. Since 1988, and the reform of the financial system, the banking sector follows a regular two-tier system, with the establishment of specialized commercial banks. The law on the State Bank of Vietnam (1998) clarifies the roles and responsibilities of the Central Bank.

SBV lends to state-owned banks such as VBARD and VBSP, which conduct microfinance activities. It also directly supervises the People's Credit Funds system and issues individual licenses to new PCFs.

Policy Framework. Since 2002, the State Bank of Vietnam has liberalized interest rates, except for the VBSP. In practice, however, only a few organizations apply market-based rates to cover their costs, due to informal and political pressures. Hence, the government still follows the directed credit approach for most of its programs. In particular, government credit programs provide loans at subsidized interest rates to targeted sectors, groups and areas in the country through VBARD and VBSP. However, programs being implemented by NGO-MFIs and funded by international organizations already adopt microfinance techniques regarded as international best practices including market-oriented interest rates and no physical collateral requirement.

Regulatory Framework. The Laws on Banking and Credit Institutions enacted in 1997-98 covers the operations of licensed banks and non-bank financial institutions (PCFs and credit cooperatives). The SBV Banking Inspectorate Department (BID) is responsible for the inspections of all credit institutions covered by the law. The Cooperative Law (1996) provides a framework for the development of cooperatives, such as the PCFs. However, there is currently no comprehensive legal framework for microfinance services as they effectively fall outside the law on Credit Institutions.

2.2 Southeast Asia

Countries in Southeast Asia, particularly Indonesia, Malaysia, Philippines and Thailand are largely agricultural and majority of their population, thus, live in the rural areas. These are the countries that have been most affected by the 1997 Asian financial crisis. However, unlike the transition countries, their rural financial markets are relatively more developed. Majority, too, have put into place the fundamentals for the development of strong and viable market-based financial institutions following their long experience under the old directed credit policy regime. There had also been successful innovations and rural financial institutions which are worth replicating in other countries. Some of these countries, though, still have traces left of the old paradigm of directed and subsidized farm credit. Despite their far richer experience in rural finance and microfinance, however, majority of the poor in these countries' rural areas still have limited access to formal credit. Informal lenders continue to be the predominant source of loans among the poor.

2.2.1 Indonesia

Institutional Structure. In Indonesia, the nationwide banking network provides sustainable finance for poor rural communities. Within the last two decades, the Bank Rakyat Indonesia (BRI), a large state-owned commercial bank, has shown via its "unit desa" or local banking system that the demand for microfinance can be met sustainably on a large scale. Bank Rakyat Indonesia and Rural Banks are the leaders of agricultural credit and microfinance that serve the rural areas. Other microfinance interventions that are currently being undertaken by Indonesia include the *Permodalan Nasional Madani*, a state-owned entity managing microcredit and SME lending programmes and microfinance families such as the village credit agency, saving and credit cooperatives, credit unions and rural fund and credit institutions.

The NGO microfinance sector in Indonesia includes the following: cooperatives, Islamic lending cooperatives, foundations, and informal village banks.

1. **Cooperatives (Koperasi):** Cooperatives are a common form of MFI. They are often set up by a group of individuals who pool their funds and create a cooperative as an investment option. They allow non-members to borrow funds or create secondary members who can borrow but do not participate in annual profit-sharing. Most

cooperatives are small, local institutions with up to 5 staff and no more than 1,000 clients. They usually provide individual loans, including some that do not require collateral.

2. **Islamic-lending cooperatives (Baitul Maal wat Tamwil or Baitul Qirat):** Another common form of cooperative is the Islamic-lending cooperatives that use traditional profit-sharing schemes instead of charging an interest rate on their loans.

3. **Foundations (Yayasans):** This type of institution is the closest equivalent to the NGO MFIs found in most other countries. Foundations cannot collect savings from their members and they usually offer simple lending schemes, often utilizing group-based guarantees. This type of MFI used to be more common. However, a current Indonesia law stipulates that foundations will no longer be able to legally lend funds as of the middle of 2007 and that all foundations must re-register as a legal entity before then. As a result, the remaining foundations are trying to find ways of maintaining their poverty-lending focus while resolving their legal status.

4. **Self-help groups and Village banks:** These self-help groups and village banks (or village credit institutions) are group-based savings and lending institutions that are often governed by the village hierarchy or by local associations. They are usually not formally registered. Village members can take loans from the bank and sometimes save in it, based on approval from the village head. In the 1970s and 1980s the Indonesian government established many of these groups under the name Lembaga Dan Kredit Pedesaan (LDKP) or Rural Credit Fund Institutions. These groups have received funds and technical support from various government programs and may be linked to local community banks or regional development banks that help manage the funds. Some village banks have formalized and registered either as community banks or as NGOs, particularly the Lembaga Perkreditan Desa (LPDs) in Bali. Of all of these NGO MFIs, only a few have more than 5,000 clients and the only strong group of institutions are the LPDs in Bali. The largest NGO MFI is Yayasan Dana Bakti Parasahabat, based in Java, which has over 100,000 clients and uses a solidarity group lending model.

Policy and Regulatory Framework. In June 1983, the first of a series of major financial reforms was announced. Government banks were allowed to set their own interest rates on most loans and deposits. Among its other purposes, this deregulation served to provide an enabling environment for the transformation of BRI's local banking system. Following the reforms, the government decided that the subsidized unit banks would be converted into a sustainable system of commercial banking at the local level, and that a program of general rural credit at commercial interest rates would be implemented through the unit banking system. After an initial period, the loan program would be financed by locally mobilized savings. Commercial microfinance in the unit banks began in 1984 in the rural areas. In 1989 the unit banking system was extended to urban areas as well.

A 1996 report by the World Bank states clearly the reasons for the success of BRI's unit banks:

"The program succeeded because the banks loaned at market rates, used income to finance their operations, kept operating costs low and devised appropriate savings instruments to attract depositors. By mobilizing rural savings, [the unit banking system] was not only provided with a stable source of funds, it also kept financial savings in rural areas, thus helping development growth in the countryside. Other reasons for success included: the simplicity of loan designs, which enabled the banks to keep costs down, effective management at the unit level, backed by close supervision and monitoring by the center; and appropriate staff training and performance incentives."

The provisions in the 1992 Banking Act that paved the way for financial liberalization that started in 1983 is summarized below:

- Ceilings on loan rates and amounts were eliminated;
- Savings mobilization and financial intermediation were emphasized (through incentives for savings mobilization and deposit protection);
- State banks were placed on an equal footing with the private sector (they were permitted to issue shares and the Government's responsibility was limited to the amount of subscribed capital, although this was not borne out in practice);
- International prudential regulations based on the CAMEL rating system were introduced;
- The Central Bank was required to conduct routine monitoring and supervision operations, and penalties were introduced;
- The Government was empowered to call on all the banks (not only state institutions) to become involved in development programs; and
- The distinction between the "general banks" and the "people's credit banks" (BPR) was confirmed.

The liberalization process as summarized in the Banking Act resulted in simpler financial market operating procedures, since there were only two categories of banks, the classical commercial banks and the "people's credit banks" serving the rural population. The procedure for securing operating licenses was clarified. The rules allowed some flexibility.

In fact, amendments to the law were later instituted when the Banking Act set a five-year time limit for financial institutions to adjust to the new regulatory framework. This applied essentially to rural banks established between 1967 and 1970, which, despite the fact that they were described as "banks," had continued to be classified as non-bank financial institutions. However, any new institution which had joined the financial system since 1988 was required from the outset to comply with regulations governing banks. The Act explicitly stipulated what status banks were permitted to adopt: "General" banks could be set up as limited liability companies owned by the central or provincial governments or by private entities, or as cooperatives; people's credit banks could be established as limited liability companies owned by the provincial governments or private entities; these banks could take the form of cooperatives, or they could adopt some other forms as provided for in the law.

However, to some extent, the government continued to play a major role as both a direct and indirect actor in the rural finance/microfinance system and even retained the right to require banks to participate in certain development programs.

2.2.2 Philippines

Institutional Forms. In the **Philippines,** rural finance/microfinance delivery systems can be viewed at two levels: wholesale and retail. The main players at the wholesale level include the Land Bank of the Philippines, the Development Bank of the Philippines, the Rural Credit and Guarantee Corporation, the People's Credit and Finance Corporation, and Small Business Corporation. Those that provide rural finance/microfinance services directly to clients include: rural banks, NGOs and credit cooperatives. The Bangko Sentral ng Pilipinas (the country's central bank) classifies banks engaged in microfinance into two broad categories: (a) microfinance banks

and (b) microfinance-oriented banks. Microfinance banks are those whose loan portfolios are 100 percent microfinance loans. On the other hand, microfinance-oriented banks are those banks whose microfinance loans comprise at least 50 percent of their gross loan portfolio.

Policy Framework. The rural financial market in the Philippines has gone through various stages of development and experience – from a policy environment characterized by credit subsidies, credit allocations and loan targeting in the seventies; a liberalized and deregulated financial markets starting in the eighties; the resurrection of subsidized credit programs in the mid-nineties; and a rebound of financial reforms through the Agriculture and Fisheries Modernization Act starting 1998 up to the present. The Philippines, thus, has veered away from the directed credit approach and has fully shifted to the new market-approach in rural finance/ microfinance.

The Philippines, in fact, is one of a few countries with a well-defined policy and regulatory architecture for microfinance. Microfinance plays an important role in the poverty reduction plan of the national government and RA 8425 or the Social Reform and Poverty Alleviation Act provides that the government "shall expand microfinance services and capacity building" in support of sector-specific flagship programs.

The law provides that "the programs and implementing mechanisms of the social reform agenda's flagship program on credit shall be integrated, adopted and further enhanced to effectively support the objectives of this act along the following thrusts:

- Development of a policy environment especially in the area of savings generation, supportive of basic sector initiatives dedicated to serving the needs of the poor in terms of microfinance services;
- Rationalization of existing government programs for credit and guarantee;
- Utilization of existing government financial entities for the provision of microfinance products and services for the poor; and
- Promotion of mechanisms necessary for the implementation of microfinance services, including indigenous microfinance practices."

Prior to the passage of this law, the general policy and strategy framework for microfinance laid down by the National Credit Council (NCC) in the National Strategy for Microfinance provides a policy framework anchored on the following principles:

a. Greater role of the private sector and financial institutions particularly MFIs in the provision of financial services;

b. An enabling policy environment that will facilitate the increased participation of the private sector in microfinance;

c. Market-oriented financial and credit policies, e.g. market-oriented interest rates on loans and deposits; and

d. Non-participation of government line agencies in the implementation of credit/guarantee programs.

Regulatory Framework. Banks are generally supervised and regulated by the Bangko Sentral ng Pilipinas or the Central Bank. The basic law that paved the way for the creation of the favorable environment for banks engaged in microfinance is the General Banking Law of 2000.

It recognized the special features and peculiarities of microfinance and asked the BSP to issue appropriate implementing guidelines. Sections 40, 41 and 44 mandated the formulation of appropriate rules and regulations for microfinance operations. Section 40 recognizes the "peculiar characteristics of microfinancing, such as cash-flow based lending to the basic sectors that are not covered by traditional collateral." Section 41 provides for the issuance of regulations covering unsecured loans and Section 44 recognizes that "the schedule of loan amortization shall take into consideration the projected cash flow of the borrower and adopt this into the terms and conditions formulated by banks."

With respect to cooperatives, the Cooperative Development Authority (CDA) is tasked to regulate cooperatives under RA 6539. However, the CDA has not been an effective regulator because of institutional weaknesses and its pre-occupation over another major objective which is to develop and promote the cooperative sector. Thus, the CDA does not supervise nor examine the books of credit cooperatives (NCC, 2004). To help build the architecture for the effective regulation and supervision of credit cooperatives, the National Credit Council prepared a standard chart of accounts, an accounting manual and set of performance standards for credit cooperatives called the COOP-PESOS. The CDA Administrator issued a circular asking all credit cooperatives to use the COOP-PESOS performance standards starting January 2003 (Almario, 2002). The CDA has trained its field personnel in the application of the standard chart of accounts and the COOP-PESOS performance standards to credit cooperatives.

The NGOs are required to register with the Securities and Exchange Commission (SEC) as non-stock, non-profit organizations. They are not subject to prudential regulations. At present, there is no government agency that has supervision over the NGOs. The NGOs do not report to any oversight agency and hence, there is no single institution that has a complete set of relevant information on the financial performance of NGOs (NCC, 2004).

2.2.3 Thailand

Thailand is one of the countries in Southeast Asia that had been most affected by the 1997 Asian financial crisis. As a result of the crisis, the government recognized the importance of self-help organizations and microfinance as the means through which the country can recover from financial difficulties. The country has not fully embraced the market-approach as its policy framework but continues to come up with innovative ways to increase access of the poor to credit and other financial services.

Institutional Forms. The formal financial sector in Thailand consists primarily of commercial banks, non-bank financial institutions, specialized financial institutions established by the government and cooperatives. As of end 2005, there were 13 Thai commercial banks, 5 credit companies, 18 finance companies, 18 full foreign branches and 29 BIBFs (Bangkok International Banking Facilities). The Bank of Thailand supervises and regulates these institutions.

There are nine specialized financial institutions (four banks and five companies) supervised by the Ministry of Finance. Most notable among these are the Bank for Agriculture and Agricultural Cooperatives (BAAC) with 588 branches and sub-branches; the Government Savings Bank (GSB) with 587 branches; and the Government Housing Bank (GHB) with 128 branches. Specialized financial institutions are established and regulated under various individual laws. They are assigned special tasks to serve and fill in the gap in the credit market. For example, the Government Housing Bank specializes in lending for housing and residential activities. The Government Savings Bank focuses on mobilizing funds from the public and promoting public savings. The Bank of Agriculture and Agricultural Cooperatives provides credit to farmers and cooperatives.

The institutions that provide microfinance and rural finance services can be classified as follows:

Financial Institutions under Supervision of Bank of Thailand (BoT) and Ministry of Finance (MoF)

The **Government Savings Bank (GSB)** was established with the main objective to promote savings and to be the source of fund for government credit programs. Its role has been expanded significantly during the last few years; more diversified financial services have been launched which are expected to strengthen competitiveness and support the country's sustainable economic growth. The GSB has 587 branches all over the country with approximately 9,500 staff. The GSB is a financially healthy bank with a deposit to loan ratio of 50 percent, a Capital Adequacy Ratio of 30 percent and a Return on Equity of above 15 percent. Since 2001, the GSB is operating the so-called People's Bank which is a microcredit product for people from the lower income group.

The **Bank for Agriculture and Agricultural Cooperatives (BAAC)** was established in 1966, as a government owned agricultural development bank. The mandate of the bank has been to provide agricultural credit to farm households and agricultural cooperatives. Since the expansion of the branch network in 1988, the number of borrowers has doubled. In 2002, 5.2 million farm households registered as BAAC direct and indirect clients while 2.7 million of them are active BAAC borrowers. This represents about 92 percent, and 46 percent of the total farm households in Thailand. The number of savings accounts of almost 9.6 million provide strong evidence that rural clients in Thailand have high demand for the financial services of BAAC. The active rural savings mobilization program of the BAAC led to an almost revolutionary change in its financial resource base. The BAAC has become financially self-reliant and was able to significantly reduce its dependence and loans from domestic and foreign sources. By 2003, the loan-to-deposit ratio has reached 107 percent.

Since 1998, it has been clear that the financial crisis in Thailand did not leave BAAC unaffected. Therefore, matters concerning prudential regulation by the Central Bank and diversifying into non-agricultural lending have become serious issues. In 2003, the Ministry of Finance as supervisor and owner has decided that BAAC should implement more realistic provisioning rules to ensure the long-term sustainability of the BAAC operations.

In mid-2001, the BAAC implemented a debt suspension program for its borrowers with a credit outstanding of less than baht 100,000 (US$2,500) as one of the urgent policies of the government.

The Bank for Agriculture and Agricultural Cooperatives (BAAC) has successfully developed a loan mechanism that aims to increase access of farmers to financial services. The mechanism includes the following features:

- Non-collateral lending through joint liability groups or JLG;
- Peer monitoring;
- Flexible repayment schedule, such as annual repayment and calculation of interest rate base on the date of repayment;
- Simple and quick procedure for the loan disbursement; and
- Progressive lending based on the repayment performance.

The introduction of the JLG mechanism has been primarily responsible for the development of BAAC as an efficient and effective lending institution for small farmers and fishermen. BAAC has utilized JLGs to help in loan screening and peer monitoring on timely repayment. BAAC is able to cover the financing needs of more than 95 percent of all agricultural farm households in the whole country.

Krung Thai Bank (KTB) is a partly state-owned bank, which belongs to the group of the five largest commercial banks in Thailand. This bank has a large network with 511 branches and serves a rather medium-sized market segment. The bank has a total credit outstanding of 919.6 billion baht (nearly US$24 billion) as of 31 December 2003. The Ministry of Finance holds a share of 30.8 percent in the KTB. The latest financial year shows a Return to Equity of 4.9 percent. Recently KTB also got involved in the micro-rural finance market by pilot testing a microfinance program with a community bank. The community bank's role is not only to lend to the people in the community but also to provide technical assistance and training in order to build the creditworthiness of the people in the community.

Financial Institutions under Supervision of Other Government Agencies

Government agencies are supporting a number of microfinance services. For instance, the Prime Minister's Office supervises the National Village and Urban Community Funds. Under this procedure 1 million baht (US$25,000) are allocated to every village all over the country in order to enhance capacity building of the grassroots level within community-based organizations.

The so-called Production Credit Groups are supervised by the Community Development, Ministry of Interior. The group's objective is to gather members in the community together in order to invest in the community's businesses.

Community-based savings groups are supervised by the Ministry of Social Development and Human Security through the Community Organization Development Institute (CODI).

Self-Regulatory Financial Intermediaries

A number of community-based savings groups are supported by NGOs such as village banks, savings cooperatives and self-help savings groups.

The establishment of the saving groups comes naturally when people have difficulties in accessing the funds from the commercial banks and other financial institutions. This is because neither their collateral nor the value of their collateral is deemed adequate for the financial institutions.

The community has gathered the members who are interested to form a saving group. They elect the leaders and committees to manage the group for them. The rules and regulations are set based on the members' comments and suggestions.

Policy Environment and Regulatory Framework. Thailand's financial policies are partially deregulated. In 1992, financial institutions supervised and regulated by the Bank of Thailand were allowed to charge their interest rates based on market conditions. However, the government continued to regulate its interest rates on loans to the poor including small farmers and fishermen. The primary reason for such a policy is to give the poor more opportunities to engage in income-generating activities through cheaper credit. There is a general ceiling of 15 percent on interest rates on loans. This ceiling is spelled out in the Civil and Commercial Code, and applies to all bodies and transactions unless they are specifically excluded. Non-bank microfinance institutions like credit cooperatives are also allowed an interest rate ceiling of 19 percent.

While banks are supervised and regulated by the Bank of Thailand and the Ministry of Finance, credit cooperatives are governed by the Cooperative Law administered by the Ministry of Agriculture, with the Cooperative Promotion Department and Cooperative Auditing Department having direct responsibility. Informal groups like the so-called Production Credit Groups are supervised by the Community Development, Ministry of Interior. Community-based savings groups are supervised by the Ministry of Social Development and Human Security through the Community Organization Development Institute (CODI). There is no regulatory body that supervises village banks and self-help savings groups.

2.2.4 Malaysia

Institutional Structure. Microfinance in this country is being provided through government funding. Bank Negara Malaysia, the Malaysian Central Bank, is the institution tasked to ensure a sustainable and commercially driven microfinance industry. Because of the need to address the increasing demand for microfinance services, development financing institutions (DFIs) are being transformed into microfinance institutions. DFIs are under the regulation and supervision of Bank Negara Malaysia. Banks providing microfinance include the following: Amanah Ikhtiar Malaysia; Bank Pertanian Malaysia; Farmers Organization; Yayasan Tabung Ekonomi Kumpulan and the Usaha Niaga Nasional.

The two NGOs that are actively engaged in microfinance activities include the Amanah Ikhtiar Malaysia (AIM) and Tabung Ekonomi Kumpulan Usaha Niaga (TEKUN). While AIM focuses on providing financing to poor households and micro borrowers mainly for rural poverty eradication, TEKUN is specialized in the provision of small loans to micro enterprises of the indigenous groups (*Bumiputera*). There are also other NGOs that provide microfinance services such as Yayasan Usaha Maju (YUM) in Sabah, and the Koperasi Kredit Rakyat (KKR) in Selangor, but their operations are much smaller in scale compared to either AIM or TEKUN. Generally speaking, commercial banks in Malaysia are not significantly involved in microfinance. Their involvement is limited to extending lines of credit to AIM, and as a mediator for schemes such as the loan fund for hawkers and petty traders operated by Credit Guarantee Corporation (CGC).

Policy Environment. Given that microfinance development in Malaysia is still a work in progress, the government continues to provide funding support at subsidized interest rates in order to jump start the industry. The current policy of the government towards microfinance is, therefore, focused on assisting and developing microfinance programs to provide finance for microenterprises at lower costs. While government support is being used as a catalyst to boost microfinance activities at the initial stage, MFIs are not expected to depend on government subsidy. To ensure the sustainability of MFIs, therefore, the plan is for government support to be eventually replaced with a market-oriented microfinance program, where the MFIs will be able to use its own funds, adopt market-based lending rates and generate sufficient profits to finance its activities.

2.3 South Asia

2.3.1 India

Institutional Structure. India's credit market is characterized by an excellent financial infrastructure with a wide network. It has an extensive network of different types of rural financial institutions including banks, cooperatives and informal groups as well. The National Bank for Agriculture and Rural Development (NABARD) had a big role in identifying alternative models

of reaching the rural poor which brought the existence of informal groups of poor households to the fore. It was realized that the poor tended to come together in a variety of informal ways for pooling their savings and dispensing small and unsecured loans at varying costs to group members on the basis of need. This concept of self-help was discovered by social-development NGOs in the 1980s. Realizing that the only constraining factor in unleashing the potential of these groups was the "smallness" of their financial resources, NABARD designed the concept of linking these groups with banks to overcome the financial constraint calling it the SHG-Bank Linkage Program. The program has come a long way since 1992 passing through stages of pilot (1992-1995), mainstreaming (1995-1998) and expansion phase (1998 onwards) and emerged as the world's biggest microfinance program in terms of outreach, covering 1.6 million groups as of March 2005. It occupies a pre-eminent position in the sector accounting for nearly 80 percent market share in India.

Other institutional structures for microfinance, notably, independent, specialized microfinance institutions (MFIs) based on the Grameen model in Bangladesh have also emerged in recent years. But with a few exceptions, most Indian MFIs are small in size, region specific (concentrated in the south) and with a limited collective outreach. In addition to the relatively small-scale of their operations, Indian MFIs also tend to have a narrow scope, offering a limited range of financial services beyond credit. Only a handful offer savings or insurance as a service.

Policy Framework. In the early nineties, financial sector reforms were put into place to improve the soundness, efficiency and productivity of all credit institutions, including 'ailing' rural credit institutions. The reforms sought to enhance the areas of commercial freedom, increase their outreach to the poor and stimulate additional flows to the sector. The reform program also included liberalizing interest rates for cooperatives and regional rural banks (RRBs), relaxing controls on where, for what purpose and to whom rural financial institutions [RFIs] could lend, introducing prudential norms and restructuring and recapitalizing rural banks.

The deregulation of interest rates in India is a result of their past experience that limiting interest rates did not allow banks, particularly cooperative banks to recover their costs and gain sufficient margins in their lending operations. Thus, State Cooperative Banks (SCBs) and District Central Cooperative Banks (DCCBs) have been given freedom to determine their lending rates.

However, the government has sought exemption from this policy particularly for its poverty alleviation programs where loans for the poor are still given at subsidized interest rates. The government, in fact, borrowed some of the design features of the SHG-Bank Linkage Program and incorporated them into their poverty alleviation program. The government program, however, has a built-in subsidy element which tends to attract members and cause them to leave their original SHG-Bank linked groups and join the groups formed under the government programs.

Regulatory Framework. Banks are regulated and supervised by the Reserve Bank of India (RBI). They are governed by the RBI Act, Banking Regulation Act, Regional Rural Banks Act (for RRBs) and the Cooperative Societies Acts of the respective state governments (cooperative banks). For RRBs and District Central Cooperative Banks (DCCBs), the supervisory tasks have been delegated to NABARD.

Banks' involvement in microfinance is almost exclusively through linkages with SHGs. These linkages are either direct linkages between banks and SHGs or indirect linkages via MFIs. Non-bank Financial Companies (NBFCs) are registered under the Companies Act, 1956. They are also required to be registered with the RBI under the RBI Act, 1934, and must comply with directions issued by the RBI. Section 25 companies are not-for-profit NBFCs registered under Section 25

of the Companies Act. Under certain conditions, they are exempted from a number of legal requirements under the RBI Act.

There is no specific law catering to NGOs. Microfinance NGOs can be registered under the Societies Registration Act, 1860, the Indian Trust Act, 1882, or the relevant State Acts. The grassroots level formations or groups (Self-help Groups or Credit and Savings Groups), through which other financial institutions are channelling their financial services, are informal and unregistered. The main funding sources for NGOs are donors, government departments and to a small extent bank credit as well as the savings of the poor. The SHG-Bank Linkage Program opened up the banking system as an additional source of funds.

2.3.2 Nepal

Institutional Structure. Nepal has a reasonably diversified financial sector as evidenced by the number and variety of institutions that play an active role in the sector. The financial system remains, however, unnecessarily segmented – which has tended to reduce competition.

The rural finance and microfinance market in Nepal can be divided into three sectors: formal, semi-formal and informal. The **formal sector** is composed of: 17 commercial banks, 10 development banks, 57 finance companies and 9 rural microfinance banks. The rural microfinance banks are nine Grameen Bank replications. Five of the '*Grameen Bikas Banks*', or Regional Rural Development Banks (RRDBs) are publicly owned and are operating in the five development regions of Nepal (Far Western, mid Western, Western, Central and Eastern). Despite easy access to funding sources and impressive outreach in Nepal, these organizations have not been successful in terms of sustainability and portfolio quality. The *Grameen Bikas Banks* are currently going through a restructuring process led by the Nepal Rastra Bank (NRB), which will ultimately result in their privatization. The '*Paschimanchal Grameen Bikas Bank Ltd.*', which operates in the western development region, is the most successful Grameen Bikas Bank.

In comparison, the four private rural microfinance banks are doing better than their public counterparts. These are: *Nirdhan Uttan Bank Ltd*. and *Swabalamban Bikas Bank Ltd*., *Chhimek Bikas Bank* and the DEPROSC Development Bank Ltd.

The **semi-formal sector** is composed of Savings and Credit Cooperative Societies and financial intermediary NGOs. Savings and Credit Cooperative Societies (SCCS) are mostly community-based organizations that have evolved from informal self-help groups to credit and savings organizations and eventually to formal Savings and Credit Cooperatives Societies. As of end 2005, there were almost 3,000 SCCSs registered with the Department of Cooperatives. While most SCCSs developed spontaneously and as independent institutions, some were assisted by local or international NGOs. They are usually composed of 25 to 200 members, while the largest could reach 9,000 members.

Moreover, there are about 44 licensed NGOs (registered with the NRB) which, in effect, allows them to borrow from commercial banks for lending to clients. The most important NGOs are the organizations at the core of rural microfinance banks (such as Nirdhan, CSD, etc.) and 'regular' NGOs such as the Nepal Rural Development Society Center (NRDSC), Nepal Rural Development Organization (NERUDO) and Tharu and Razi Women Society (TRWS).

The **informal sector** includes informal community-based organizations at different stages of institutionalization, such as self-help groups and informal savings and credit organizations. Moneylenders, traders, friends and relatives can also be included in this group as they provide an

informal source of finance used by the majority of the poor population in Nepal. *Dhikuti* are informal groups that pool funds to extend informal credit to their members.

The microfinance practices of the organized sector that are prevailing in the country can be grouped broadly into seven microfinance models: Grameen Model (Grameen Bank and replication); Small Farmers Co-operative Model; Financial Intermediation by NGO's Model; Priority Sector and Deprived Sector Credit Model (Directed Lending for Commercial Banks); Savings and Credit Co-operative Model; Project-based Microfinancing Model; and Wholesale Model for Microfinance. At present, there are six major donor-funded microcredit programs that are running in the country. They are: Production Credit for Rural Women; Microcredit Project for Women; Poverty Alleviation Program in Western Terai; Third Livestock Development Project; Community Ground Water Irrigation Sector Project; and the Rural Microfinance Project. An emerging rural financial product is their Remittances and Loans for Migrant workers.

Policy and Regulatory Framework. The sector is overseen by Nepal Rastra Bank (NRB) which was established as the Central Bank in 1956. Along with the economic liberalization policy, many banking and finance policies, rules and regulations have been worked out and modified in the last two decades. These include the removal of entry barriers to new banks including joint-ventures, (1984), lowering the level of statutory pre-exemption (May 1986), deregulation of interest rates (August 1989), authorizing commercial banks to take convertible currencies (July 1985), relaxation of credit ceiling rules (1989) and introduction of prudential norms related to risk-weighted capital adequacy requirement, accounting, income recognition, loan classification and loan provisioning and exposure (1989).

However, the government, through its poverty reduction programs, continue to provide loans at concessional rates for specific groups or sectors. There are also no clear policies established with regards to the deposit-taking activities of microfinance institutions. For instance, while Section 47 of the Clause of the Banking and Financial Institutions Act (BAFIA) 2006 indicates that microfinance institutions are allowed to accept interest bearing or non-interest bearing deposits within the limit issued by the Nepal Rastra Bank (NRB), Clause-B of the same section of BAFIA provides that, these institutions can mobilize savings among their group members but not among non-group members. In terms of the area of business operation and branch expansion, microfinance institutions are given autonomy to expand, close or merge their branches within the approved geographical working area. However, the bank should seek prior approval from NRB before expanding. The opening up of a new branch should be based on the Business Plan approved by their respective Board.

Microfinance Development Banks, which were previously regulated under the Development Bank Act 1995, are now regulated by the recently introduced "Bank and Financial Ordinance 2004". The two apex organizations, RMDC and Sana Kisan Bikas Bank (Small Farmer Development Bank), as well as the five RRDBs, the four private rural microfinance banks have come under the umbrella of the new ordinance promulgated in 2004. Some other microfinance institutions come under the 'Financial Intermediary Act 1998', amended in 2002, which provides a limited banking license to NGOs.

The Small Farmer Development Bank Ltd., supervises the SFCLs and is itself owned and directly managed by the Agriculture Development Bank. Cooperatives are regulated by the Cooperative Act and therefore supervised by the ministry of agriculture, department of cooperatives. In addition, if cooperatives want to offer microfinance services to non-members, they need to register and seek approval of NRB to carry out 'limited banking activities' under the Financial Intermediary Act. There are still no specific regulations covering this type of 'cooperative banks', and as for

now the NRB has stopped providing such approval as the latest amendment of the Cooperative Act does not allow cooperatives to offer services to non-members.

2.3.3 Sri Lanka

Institutional Forms. Sri Lanka's rural finance sector includes savings, credit insurance and payment services delivered by Cooperative Rural Banks, Regional Development Banks, the National Development Trust Fund and Samurdhi Banking Societies and the SANASA Thrift societies. However, the sector remains fragmented and the institutions suffer from weak governance, poor repayment rates, high transaction costs, weak supervision and recurring losses. Being a State-owned Bank, the Bank of Ceylon (BoC) recognizes the important role it has to play within the scope of its national commitment and social responsibility. BOC extends full backing and cooperation to the Government's new approach towards accelerated national development. The implementation of novel schemes like the Gamata Naya (credit to villages) and Sookshma (a new microcredit scheme) are said to be producing excellent results.

Policy/Regulatory Framework. Sri Lanka's financial system remains subject to extensive government influence but has been growing rapidly since the government started pursuing privatization and liberalization policies. Regulations are largely consistent with international standards, but supervision and enforcement are insufficient. Foreign investors are free to access domestic capital markets, and the government allows 100 percent foreign ownership of commercial banks, insurance services and stockbroker services. At present the Social Service Department of Sri Lanka is empowered to grant permits for putting up microfinance institutions in the country.

In Sri Lanka, a microfinance entity is allowed to borrow from both domestic and foreign sources if they fulfill the necessary requirements. For instance, when borrowing from abroad, MFIs should demonstrate a sound financial statement for a period of three years. Collateral-free lending is not yet allowed, so that land, house and in some cases, small machinery are accepted as collateral. Moreover, foreign investment in the sector is not yet allowed by the government. With the implementation of the new Law on Commercial Banks, the situation can rapidly change which could result in more opportunities for foreign capital to come in and invest in the rural finance sector.

III. UNDERSTANDING THE ISSUES ON RURAL FINANCE DEVELOPMENT

For over two decades, most countries in Asia tried to achieve the objectives of productivity and increased incomes by ensuring the provision of adequate and timely credit at affordable interest rates to as large a segment of the rural population as possible. The strategy adopted for this purpose rested on three pillars:

- Expansion of the institutional structure to include state-owned banks and grassroot-based organizations like cooperatives, NGOs and other people organizations;
- Directed lending to disadvantaged borrowers and sectors; and
- Lower interest rates.

During this time, policy interventions by the government were considered necessary to overcome factors which were perceived as hampering the flow of rural credit such as high cost of lending, geographically dispersed clients and lack of collateral among marginal groups like the small farmers and fishermen, all of which kept away banks from lending to the rural sector. Significant government interventions

included targeting specific commodities, sectors and groups, providing credit at subsidized interest rates for poor households and creating guarantee schemes to encourage banks to lend to the rural poor.

Providing cheap credit (meaning, at subsidized interest rates) was one of the important elements of the strategy for making credit accessible to target groups or areas. The justification for offering credit at concessional rates to certain categories of borrowers was based on the argument that since small farmers do not have sufficient income nor a smooth and regular cash flow that could attract lending by banks, the government needed to subsidize in order to make credit affordable to the poor and at the same time, encourage banks to lend to the sector through cheap lending funds from the government. This was broadly the policy framework of Asian countries that prevailed for over two decades.

The experience as a result of the strategies within such framework helped develop a broad based institutional infrastructure for the delivery of credit which also ensured a wider access of financial services to the poor. More banks especially rural-based banks suddenly wanted to lend to farmers and, thus, avail of government funding. Other institutions like cooperatives mushroomed when governments announced they were channeling their funds through cooperatives. The growth of credit to agriculture as well as the number of farmers and other poor individuals who were able to borrow from formal lenders rose significantly during the seventies to the early eighties.

The significant increase in the credit flow from the institutional sources increased the expectations and confidence of government financial institutions. However, this expectation and confidence could not be sustained because the emphasis throughout was on achieving quantitative targets. There was pressure on these institutions to come up with high figures on the number of intended beneficiaries reached, volume of loans released, number of areas covered, etc. As a consequence, inadequate attention was made on the equally or more essential aspects of lending resulting in loan defaults and erosion of ethics on repayment or integrity, to a greater or lesser extent, by all categories of borrowers. The end result was a disturbing growth in overdues and default rates, which not only stalled the recycling of scarce resources of banks especially funds coming from the government, but also affected the profitability and viability of financial institutions.

Ultimately, the impact of rural finance was blunted and what followed were financial policy reforms aimed at improving the soundness, efficiency and productivity of all credit institutions including those institutions whose financial condition was far from satisfactory. The reforms sought to enhance freedom of institutions to respond to market changes and in effect, increase their profits, improve their products, increase their outreach to the poor and stimulate additional credit flows to the sector. The reform programs also included liberalizing interest rates, removing or relaxing controls on where, for what purpose and to whom rural financial institutions could lend, introducing prudential norms and restructuring and rehabilitating or recapitalizing these institutions.

However, not all countries have fully liberalized their financial policies. Most of the countries in Asia still have traces of loan targeting as well as lending at concessional interest rates to specific sectors or groups. The rationale for this is that while the benefits of policy reforms will still be felt over the long-term, the government should intervene through poverty alleviation programs so as not to disrupt the flow of credit to the rural poor which was started through the directed credit programs of the previous policy regime.

Nonetheless, as a result of the reform process, the financial health of banks, including rural banks and commercial banks, has improved in terms of capital adequacy, non-performing loans and return on assets consistent with international standards. However, commercial banks being more focused on profitability, gave lesser priority to marginal farmers.

Perhaps the best outcome of these reforms is the emergence of many innovations in product design and methods of delivery through better use of technology and institutional developments. These innovations came largely as a result of the flexibility given to institutions due to financial reforms. Some call it the microfinance revolution which gave rise to viable and effective institutions, including banks and non-banks like NGOs and cooperatives that were able to lend to the poor even at market rates of interest and achieved impressive repayment rates and increased profits.

Based on experience and field findings, therefore, microfinance is said to have:

- reduced the incidence of poverty through increase in income, helped the poor to build assets and thereby reduce their vulnerability;
- enabled households that have access to it to spend more on education and have reported better school attendance and lower drop out rates than non-microfinance clients;
- empowered women by enhancing their contribution to household income and allowing them better control over decisions that affect their lives; and
- to some extent, has reduced child mortality, improved maternal health and the ability of the poor to combat disease through better nutrition, housing and health, especially among women and children.

However, some outstanding issues that continue to surface among countries in Asia pertain to the continued exclusion of the rural poor particularly the marginal farmers and fishermen from the rural financial markets and the limited extent of institutional response to them. There has been great concern over the need to find ways and means to increase the flow of institutional credit to the rural poor, reduce the procedural and documentation hassles which characterize lending to them and ensure that affordable credit is provided at the appropriate time in adequate measure. Some of these issues and concerns include the following:

- High Interest Rates: Cheap Credit vs. Reliable Access to Credit;
- Government Intervention in Direct Lending to the Poor; and
- Making Microfinance Work in Agriculture.

High interest rates

Studies show that nominal interest rates on loans charged by microfinance institutions (MFIs) in the Asia-Pacific region range from 20 percent to 70 percent per annum (Fernando, 2006). The effective rates could even be higher because of other fees charged by MFIs. Many groups and sectors have highly criticized such rates indicating that microfinance, supposedly for the poor, is just so unaffordable. Many of them also question the reasons for charging high rates given that most MFIs source their funds from international donor-agencies that provide funds at low or even no interest rates.

Why do MFIs charge high interest rates? Like any other business enterprise, MFIs charge prices high enough to cover their costs so that they can continue and sustain their operations. Microfinance lending is a costly operation. It is labor-intensive. Personnel costs are, thus, high. In addition, administrative costs due to rent, office supplies, utilities, etc. make up a huge proportion of total cost. And microfinance being micro or small, making and collecting small loans can be very costly. The success of microfinance stems largely from close monitoring which entails regular and frequent visits of clients by microfinance staff. Transportation cost is even made higher by poor road conditions and telecommunication systems which all add significantly to the cost of microfinance operations. Donor

funds, on the other hand, are very limited usually only for a particular purpose and within a specific period and are, thus, not a permanent source of funds for most MFIs. MFIs, therefore, have to think long-term by making more income or profit through higher interest rates in order to sustain their lending operations.

When MFIs are able to cover their costs, then they will be able to sustain lending to the poor who can then have continued access to microfinance loans. MFIs have already developed the technology and acquired the expertise in microlending which commercial banks cannot do and cannot be expected to do. The question, therefore, should be: *cheap credit or reliable access to credit?*

Nonetheless, there could be effective and efficient means through which interest rates can be reduced. However, imposing interest rate ceilings is not one of them. Why is this so? First, if a rate ceiling is set at a level below the rate needed for cost recovery, the MFIs will incur losses. If this happens, the rationale behavior would be for MFIs not to expand further or worse, stop lending to the poor, look for other investment opportunities or just close shop and put an end to their operations. These would have an impact on the creditworthiness of MFIs and thus, affect their capacity to manage bigger funds from fund sources. This would, in effect, discourage potential investors and would drive them to put their funds somewhere else.

How to efficiently reduce interest rates? Innovation is the key. MFIs must develop innovative ways to improve their productivity and efficiency and reduce operating costs (Fernando, 2006). Cost-reducing innovations by MFIs should be encouraged. Incentives from both the government and private sectors should be provided in order to promote innovations. Moreover, through an enabling policy environment, competition is promoted which, in effect, motivates MFIs to innovate further in order to attract more clients.

One important reason why interest rates are high is because microfinance is truly a costly operation. It is costly because it is risky given the nature of its clients. Reducing the risk is a big problem as it requires medium and long-term solutions that policymakers should be able to address. Moreover, other impediments like lack of physical, human and financial infrastructure and lack of support for capacity building programs especially on product development and cost reduction all contribute to the risk and cost of microfinance lending. These are crucial factors, therefore, that should not be overlooked. Simple infrastructure improvements such as building of better roads and bridges especially in remote areas, and the reliable supply of electricity will have a positive impact on the operating costs of microlenders. Such improvements also expand economic opportunities for poor households. Fernando (2006) explains that:

"Operating costs result in a wedge between the interest rate borrowers pay and the return lenders receive. Reduced operating costs increases lenders' returns and the quantity of loans supplied. On the demand side, reduced operating costs will lead to a fall in the interest rate that borrowers pay and an increase in the quantity of borrowing A decline in interest rate brought about in this manner is a "win-win-win" proposition: it is beneficial for both lenders and borrowers, will reinforce rather than undermine the development of microcredit services, and will help policy makers achieve their objective of ensuring access to credit for the poor at affordable prices."

Government Intervention in Lending to the Poor

Governments have often intervened to what they view as market failures, i.e., when the poor most especially, are not able to have access to adequate and affordable loans. This is the reason why in most countries in Asia, governments still resort to subsidized direct lending particularly for their poverty alleviation programs. This remains an issue because when government financial institutions and other conduits implement such programs in areas where private microfinance institutions operate, the

government's programs compete with those of the MFIs'. How can MFIs compete when they charge relatively higher interest rates to cover their costs and the government's conduits offer much lower rates since these are usually subsidized by the government? The markets, therefore, become distorted and the fundamentals established towards efficient financial markets are eroded. Government programs often fail to emphasize discipline and zero tolerance for late payments which, in contrast, MFIs have incorporated into their programs as a strategy for full loan recovery. There is that perception that since most funds coming from the government are sourced from tax revenues, the borrower, being a taxpayer himself, would not be inclined to pay since the funds are seen as partly his own. Credit from the government is still viewed as a dole-out. The values instilled on the clients by MFIs regarding integrity and trust are thus, often compromised which lead to confusion and eventually, weakening of the basic fundamentals toward an efficient microfinance system.

What should be the role of government?

Numerous studies have concluded that governments should stay away from lending even if the intended clients are the poorest sectors of a country. The government does not have the expertise to lend and to collect the loans provided. The resources allocated to this endeavor can instead be utilized in undertakings that the private sector would not want to engage in such as building of roads and bridges, improving communication facilities in the remotest areas, providing electricity, marketing facilities and other public goods. The government should be able to provide the appropriate environment that would encourage the private sector to invest, innovate and improve their products and services. The government should not compete with the private sector. Government subsidy should be earmarked not for loans but for capacity building programs that aim to strengthen the creditworthiness of borrowers and the viability of rural financial institutions. The government should likewise focus on creating an enabling policy environment that would promote competition in the rural financial market and allow financial institutions to recover their costs as well as an appropriate regulatory framework that would ensure prudential bank operations and promote the growth of small microfinance institutions.

Making Microfinance Work in Agriculture

The APRACA forum discussions point to the reality that microfinance has not reached a majority of the poorest people and is, in fact, not widely used for financing farming activities. Empirical evidence shows that the amount of loans for farm production has been decreasing over time while credit for non-farm and off-farm projects has been increasing. It is a well-known fact that the provision of agricultural credit is inherently risky and is difficult to do given the wide geographical dispersion of rural households, weak market linkages, high transaction costs and lack of support services, among others.

What makes microfinance effective in serving poor households are the techniques employed by MFIs including the provision of small loans, frequent and regular repayments or amortizations, no collateral required and in its place, cash flow of the household and zero tolerance by MFIs for late repayments as a way of ensuring repayment of loans. However, given the nature of agricultural production projects, such techniques may be difficult to apply. There has yet to be a successful agri-microfinance program that can effectively address the financing requirements of farmers and fishermen for their production activities using microfinance technology. There are existing attempts, however, by countries like the Philippines, Thailand and Indonesia, to implement a microfinance program exclusive to the agricultural sector through their successful institutions, particularly the Bank for Agriculture and Agricultural Cooperatives (BAAC) of Thailand, the Bank Rakyat of Indonesia and the Land Bank of the Philippines.

How to make microfinance work in agriculture? The following elements should be considered when designing a microfinance program intended for agricultural producers:

- In lieu of collateral, the cash flow of the farm household that will indicate the capacity of the household to make frequent and regular payments on its microfinance loan even if income from the farm is highly seasonal;
- Loan products not only for the farmer but for the farmer's wife as well so that the household can diversify and even out its cash flow;
- Marketing linkages between the farmer, cooperatives/other institutions and MFIs that will ensure sale of farmers' produce and repayment of the farmers' loan;
- Crop insurance and/or micro insurance that will help mitigate risks of lending to farm production projects;
- Business development services that will help farm household maximize their returns and diversify income sources; and
- Linking with government agencies that will promote sanitation, better health and education of members of the farm household.

IV. GEARING UP FOR CHALLENGES AHEAD AND STRATEGIES FOR RURAL FINANCE DEVELOPMENT

Countries in Asia have gone through various phases of rural finance and microfinance development but need to measure up to the task of increasing and sustaining the flow of financial services in the rural areas, especially the poor. Thus, policymakers, practitioners and other stakeholders must be able to meet the challenges confronting them. What are the challenges facing them today?

The first challenge is promoting and sustaining an enabling policy environment that would promote efficiency and sustainability in rural financial markets; and focusing state control or government intervention on the delivery of public goods such as irrigation facilities, marketing networks, road links, bridges, communication facilities, electricity, health and sanitation, education and institution-building, among others.

The second challenge is establishing a regulatory framework that will ensure prudential banking operations while at the same time, promoting the growth and sustainability of small microfinance institutions. This should include formulating common performance standards for microfinance institutions as well as establishing a structure that would allow for the regulation of all MFIs, both banks and non-banks including NGOs and cooperatives.

The third challenge, thus, is building good financial institutions. Good financial institutions are those that are able to mobilize deposits and other market-based funding, depend less on donors, offer credit, facilitate transfers and payments and provide insurance.

The fourth challenge is how to increase the flow of credit from financial institutions to the poor in general and minimize dependence on informal moneylenders? How to reduce procedural and documentation hassles which characterize lending to the poor and ensure that affordable credit is provided to them at the appropriate time and in adequate measure?

The fifth challenge is providing microfinance services for agricultural production activities and making it work. How can microfinance institutions be motivated to develop products for small farmers and fishermen?

The sixth challenge is encouraging financial institutions to provide credit to microfinance borrowers who are ready to graduate from being micro to small entrepreneurs and thus filling in the "missing middle".

The final challenge is for governments of countries to learn from past mistakes and embrace the market-approach as a better alternative to promote effective and efficient rural financial markets.

Given these challenges, a country's rural finance strategy should, therefore, be based on developing an efficient rural financial market with sustainable rural financial institutions capable of providing savings, credit, insurance, payments and other services with significant penetration to reach the poor. The strategy should focus on the following points:

- **Establishing the fundamentals of a sound external operational environment.** For rural finance and microfinance development to succeed, experience has shown that a stable macroeconomy and a liberalized financial environment are essential. So far, policy reforms that have been implemented in some Asian countries include liberalizing interest rates, relaxing controls on financial institutions, privatizing banking services and enhancing bank competition. In some countries, however, policy issues may still need to be addressed at the levels of macroeconomic management and financial sector policies. In addition to deregulating interest rates, financial sector reforms should remove lending targets and administrative directives and facilitate entry into and exit from the rural financial system. Other sectoral policies that may need reform to reduce bias against rural production and finance include agricultural price and marketing controls, high taxation of agricultural exports, high effective rates of protection for domestic industry and budgetary biases toward urban infrastructure and social services (World Bank, 2004).
- It is also important to note that the legal, regulatory and supervisory framework for MFIs of a country should be able to strike a balance among:
  - Encouraging development of innovative methodologies for reaching the poor;
  - Providing a legal basis for MFIs that want to mobilize savings from the public; and
  - Protecting depositors and the financial system from unsound practices and institutions.

While differing views have emerged, there is a growing consensus that an appropriate framework consists of different tiers, allowing for licensing of specialized MFIs with lower minimum capital requirements than commercial banks, while defining minimum criteria that trigger regulatory requirements and leaving small, less formal organizations outside the regulatory regime (Van Greuning, Gallardo and Randhawa, 1999). Since protection of depositors is usually viewed as the principal rationale for licensing restrictions, the benefits of regulation generally appear unlikely to warrant the substantial costs of overseeing the large majority of MFIs including NGOs and self-help groups that do not take voluntary deposits from the public. To facilitate the existence of small organizations using their own (or donated) funds to reach underserved clients and to act as financial agents, financial legislation needs to be complemented by other regulations and procedures that permit their voluntary formalization and legal operation.

- **Strengthening internal institutional capacity of rural financial institutions to enhance viability and outreach.** This means exposure of banks and microfinance institutions to and training in best practices to enable them to expand their outreach and develop sustainable operations, along with performance-based support for capacity building (e.g. MIS systems, internal controls, governance, risk management, new product development) and measures to promote linkages to commercial sources of funds.

- **Developing innovative strategies that address the requirements of the poor.** Since there is no "one size fits all" strategy, it is important for MFIs to know who their clients are so that they can design and apply that appropriate strategy which can be effective in addressing their clients' requirements. As seen from the experience of Asian countries for instance, the interventions for the subsistence poor or ultra poor are different from the interventions for the so-called entrepreneurial poor or those with existing microenterprises. The ultra poor are those without business experience while the entrepreneurial poor are of two types: I) those that have the incipient entrepreneurship ability and are already engaged in livelihood income generating projects with potential to become microenterprises; and II) those who are slightly below or have crossed the poverty threshold and have existing microenterprises that would need financing for growth and expansion.

Some suggested strategies, according to type of client, are as follows:

The Ultra Poor

Since these households have no business experience, credit is unlikely to succeed. For microfinance to be appropriate, a pre-existing level of ongoing economic activity, entrepreneurial capacity and managerial talent is needed. If not, the ultra poor may not be able to benefit from credit and will simply be pushed into debt. There should be pre-existing efforts to reduce vulnerability and to build skills, confidence and a minimal financial base. Hence, among the ultra poor households, interventions may be done in three phases:

First Phase. Under this phase would be social intermediation in order to build social capital and basic skills within the community. They should have basic ideas of health, nutrition and family planning, among others in order to give these households better chances of improving their quality of life. At the very outset, the appropriate intervention may not be loans but welfare type of assistance to improve literacy, health and nutrition conditions and provide opportunities for education of household members. Appropriate government institutions like those on social welfare and health concerns will have a critical role in this phase. A similar model implemented in Bangladesh called the Income Generation for Vulnerable Groups Development (IGVGD) Program of the Bangladesh Rural Advancement Committee or BRAC, provides free food (several bags of wheat each month) to the participating destitute poor.

Still under the first phase, the next step would be to form the households into groups which others call self-help groups or SHGs in order to establish group solidarity and cooperation. Communication would be easier and learning, faster. Once formed, the SHGs will undergo intensive training on value formation where clients are given inputs on self-worth to establish culture of credit discipline and savings.

Second Phase. Thereafter, these households should be provided with technical assistance on simple business or microenterprise development so that they can identify, plan and implement simple microenterprises. These households, including those already engaged in some subsistence type of income generating activities like mono-crop farming and other agricultural projects will be engaged in skills-training programs on specific income-generating activities. Government institutions on education and technology can be tapped for technical assistance and for the conduct of training programs.

Third Phase. When they are ready, the group may be granted microcredit to start an income-generating activity making use of indigenous materials or resources from the area. The loan, however, should require a cash counterpart from the participating households in the form of regular contributions to a savings fund of the self-help group.

This type of clients usually requires small amounts of loans usually not more than US$100 to finance their start-up or existing business like petty trading, animal raising, food vending, garbage collection and other labor intensive income generating activities. Experience of poverty-focused MFIs have shown that the oft-cited reason for joining by very poor clients is to have capital to start a basic livelihood income generating project or activity or additional capital for existing ones. Hence, it can be said that access to microfinance services allows very poor clients to capitalize their income generating activity or project with potential to become microenterprises.

The Entrepreneurial Poor

Type 1. The Type 1 entrepreneurial poor households, as described earlier, have rudimentary micro-entrepreneurial activities. They operate existing microenterprises and their experience in operating them provides an opportunity for further growth of those microenterprises. They are still below the poverty threshold but can get out of the poverty trap once given the appropriate access to financing and other investment opportunities.

Loans and technical assistance are the appropriate intervention instruments for these households. With respect to loans, these households should have access to loan products that would support agricultural as well as non-agricultural enterprises. Based on the experience of selected Asian countries, only rural-based banks as well as specialized state-owned banks provide loans for agricultural production. These loans, however, are mostly traditional loans that required collateral and are, therefore, not microfinance. MFIs, therefore, should be able to design loan products that would allow financing for households that operate agricultural enterprises.

These households may require an average of US$100-300 to finance their existing microenterprises such as village stores, trading, crop and livestock production, among others. Empirical evidence indicates that this group of poor households knows how to spread business risk and increase its income by diversifying its income sources. Moreover, this type of clients requires bigger and more diversified loan windows to support a variety of investments: children's education, more business activities, housing improvement and purchase of household and productive assets. They also need microinsurance to protect the gains they derive from the loan service such as life, loan redemption, educational, and health. As a result of their bigger economic portfolio, this group is more likely to have extra cash, hence, the need for savings instruments.

In addition to training on value formation and group building or center formation, the Type 1 entrepreneurial poor households will require assistance in market access and linkages which they will need as their microenterprises grow over time. Market access is important because it will allow them to get the best price for their goods and not be beholdened to exploitative middlemen. This is especially true among crop farmers and fishing operators as well as manufacturers. To facilitate market access, establishing linkages is critical.

Hence, a holistic package of interventions that should include not only financial assistance but further trainings on value formation and business management as well as market linkages should be provided.

Type 2. These entrepreneurial poor households are those slightly below or have crossed the poverty threshold. They might slide back to the poverty situation by one calamity. However, their microenterprises have the potential to grow into small enterprises. They would need continuing assistance in order for them to become small enterprises. As small enterprises, they would be able to generate more employment and greater output thereby contributing both to economic growth and poverty reduction. It will be important to ensure support to these households both for economic growth and poverty reduction purposes.

These households may have an ongoing microenterprise or two or more microenterprises that need bigger capital and better service facility to be able to expand. They also have their own asset (land) either through owning them or leasing it. The average loan requirement of this group ranges from US$400 to US$1,000 even up to more than US$2000. They also require other kinds of loan products such as housing loan, emergency loans and equipment loans. They require not only regular savings instruments but also other facility like checking accounts for their business transactions. They also require higher microinsurance for their loans, life educational and health. For those who have a member of the family working abroad, they require remittance facilities. MFIs should be sensitive to their needs so that they are able to move to higher level from being a microentrepreneur to becoming small business entrepreneur such that they will generate more employment opportunities for the poor.

Finally, worth mentioning are the recommended courses of action by participants in the different policy fora conducted by APRACA under the FinPower Program, as follows:

1. Study structural risks associated with the MFIs, in terms of governance and ownership and how this will work in the agriculture sector. There is a pressing need to identify and define microfinance markets in each of the participating countries in terms of definitions – geographically, sectorally, in size and in scope to address the issue of sustainability. In line with this, there is also a requirement to define and elaborate on the scope of alternative financing sources at the local levels (moneylenders, family, friends, village banks, cooperatives, etc.). This will serve as the basis for MFIs in their product development and for the government in making the appropriate policies;

2. Improve the provision of management information system (MIS) for MFIs. At present, the quality of software and systems varies considerably, with some MFIs unable to access integrated accounting and loan portfolio systems, while others have very expensive and effective systems. Create capabilities to support other forms of microfinance institutions i.e. community-based, non-registered, etc. to broaden the types of needs being met, and introduce greater variety and flexibility into the system;

3. Establish credit information systems/credit bureaus as well as MFI capacity ratings systems, based on commercial ratings support and credit information exchange. The information exchange should include both positive and negative information;

4. Develop credit policies based on international best practices. Expansion of microfinance services can only be effective if all parties play a role – with the government initiating an improved legal framework following international best practices and an improved national microfinance policy that phases out unsustainable microfinance programs. There is a need for the government/policymakers to learn from the best practices of successful rural lenders who have found a way to deal with the factors that constrain the provision of financial services in the rural areas. Hence, the need to document and replicate success stories, innovations and best practices;

5. Build up an effective organization and management capacity for microfinance institutions. Efficient financial intermediation leads to more efficient resource allocation, increased yield in capital and higher output growth. Conduct of continuous institutional capacity building activities for coops, FIs, and MFIs is necessary;

6. Conduct of dialogue/workshops or financial education or credit counseling on policy regulations focusing on interest rates, transaction costs, savings mobilization, risk management, credit insurance, delivery mechanisms including remittance system of member countries and meeting the needs of modern agriculture-supply chain financing;

7. Develop a brief for political leaders on the rules and regulations governing microcredit highlighting issues on microfinance. There is a need to strengthen partnership between the national and local governments, and financial institutions for financial inclusion; and

8. Pursue with more vigor the setting up an APRACA Fund to support fund-deficit member countries.

PART 2

A. RURAL FINANCE POLICIES IN CAMBODIA

I. SOCIO-ECONOMIC PROFILE

1.1 Geography

Cambodia is located in Southeast Asia. It is bordered by Lao PDR, Vietnam, and Thailand. It has a total land area of 181,035 sq km, about half the size of Vietnam. The capital of Cambodia is Phnom Penh, the largest city in the country.

What makes up most of the country is a low-lying alluvial plain in the center although in the south is the Mekong Delta. There are several mountainous regions, one of which forms a border along the coastline with another separating Cambodia from Thailand. The tenth largest river in the world, the Mekong River, is the longest river in Southeast Asia and the most important river in Cambodia. One of its important uses is that it is navigable for most of its "run" through the country, as well as the Mekong Delta in the South.

Cambodia is also home to the largest lake in Southeast Asia, the Tonle Sap (Great Lake), which connects with the Mekong River in Phnom Penh. The Tonle Sap enlarges to four times its normal size when the Mekong rises during the monsoon season thus causing the Tonle Sap River to flow northward into the Lake.

During the dry season it reverses its flow and goes back into the Mekong River. As a result of this, the Tonle Sap Lake is a great resource for freshwater fish, actually being one of the richest sources in the world.

1.2 Climate

There are two monsoons which make up Cambodia's climate, a cool, dry, north-eastern one that is rather dry and comes from November to March and a south-western one which brings with it heavy rain, high winds and high humidity from May to early October. December and January are considered to be the coolest months and fall in the dry monsoon season. Annually, Cambodia gets about 1,400 mm (55 in) and the temp averages around 27 degrees C (80 degrees F).

1.3 People

Most (about 90-95 percent of total population) of the people who live in Cambodia are ethnic Cambodians, making Cambodia the most homogenous country in Southeast Asia. Vietnamese make up the largest minority group with about five percent of the population and Chinese make up another one percent. With one of the highest population growth rates in Asia (2.5 percent per year), Cambodia had a population of a little over 11 million in 1998. Due to the Khmer Rouge rule during which residents were forced to move out of the cities, most of the population lives in rural areas, with only about a tenth living in urban areas. An estimated 85-90 percent of the population lives in rural areas. Cambodia's urban population (10-15 percent of the total) is principally located in two centers: Phnom Penh and Battambang. Phnom Penh has an estimated population of 1.0 million and an annual rate of growth of 3.5 percent.

The Cambodian population presents several important features. First, due to the baby' boom after 1979, it is a young population with at least half (50 percent according to some sources, more according to others) under 18 years of age now. Secondly, the proportion of women in the adult population is high, 56 percent of those who are 18 years old or more being females. Also as a result of the war, there is a rather high proportion of women-headed households; at least 25 percent according to UNICEF. Cambodia's population almost doubled after a span of 10 years as shown below:

Population	1990	2000
Population in Thousands, 2003, **Total, Male**	4,638.1	7,060.0
Population in Thousands, 2003, **Total, Female**	5,105.7	7,421.5
TOTAL	**9,743.8**	**14,481.5**
Population Growth Rate, Percent	3.6	2.4

Source: UNFPA.

1.4 Languages

Khmer is the country's official language. It is spoken by more than 95 percent of the population. French, as a second language, is also spoken, mostly by older people. English is more commonly spoken by the younger generation. The majority of Cambodians, even those who are not ethnic Khmer, speak Khmer, the official language of the country. Ethnic Khmer living in Thailand, in Vietnam, and in Lao PDR speak dialects of Khmer that are more or less intelligible to Khmer speakers from Cambodia. Minority languages include Vietnamese, Cham, several dialects of Chinese, and the languages of the various hill tribes. Khmer, in contrast to Vietnamese, Thai, Lao, and Chinese, is "nontonal". Native Khmer words may be composed of one or two syllables. Khmer is uninflected, but it has a rich system of affixes, including infixes, for derivation. Generally speaking, Khmer has nouns, verbs, adverbs, and various kinds of words called particles. The normal word order is subject-verb-object. Khmer uses Sanskrit and Pali roots much as English and other West European languages use Latin and Greek roots to derive new, especially scientific, words. Khmer has also borrowed terms-especially financial, commercial, and cooking terms-from Chinese, French, and English as well. These latter borrowings have been in the realm of material culture, especially the names for items of modern Western technology. The language has symbols for thirty'-three consonants, twenty-four dependent vowels, twelve independent vowels, and several diacritics (Wikipedia, 2006).

1.5 Economy

Cambodia's economy has been traditionally agricultural. About 85 percent of the cultivated area is devoted to the production of rice, while rubber trees account for a major part of the remainder. Prior to the war years, Cambodia's rice crop was usually ample enough to permit exports. The Tonle Sap is one of the major fishing reservoirs in Asia, and its products have played a key role in the Cambodian economy and diet. Cattle breeding is another important source of income. During the 1970-75 period, Cambodia's economy came to rely critically on US assistance, as the expansion of the war caused widespread damage and limited economic activity. The Pol Pot regime, which came to power in April 1975, was determined to emphasize the growth of agriculture and restore national self-sufficiency. The entire population was mobilized in a mass labor campaign to improve agricultural production through massive irrigation projects in the countryside. The cities were virtually emptied, and industrial production drastically declined. Private ownership of land was disallowed, and landholdings were transferred to the state or to state-organized cooperatives. All industrial enterprises were similarly transferred to state ownership. Sparse food supplies were distributed through a system of government food rationing and other forms of allotment.

When the PRK government took over in 1979, it was faced with a major challenge in restoring the national economy. The first problem was to end the threat of famine. A massive international campaign to feed the population took place during 1979-82. In the meantime, similar efforts were undertaken to stimulate the industrial sector and expand exports in order to obtain needed foreign exchange. Reliable sources note that the infrastructure was so severely degraded that it had only 40-50 percent of prewar capacity. By the mid-1980s, the economy had essentially returned to the level of the pre-1975 period, although the regime was still vitally dependent on foreign aid, chiefly from Vietnam and the former USSR. In July 1986, the PRK issued an emergency appeal to international organizations for rice.

Rule by the Khmer Rouge, 20 years of civil war, economic isolation, and a centrally planned economy imposed heavy burdens on Cambodia. Serious damage to basic infrastructure, industrial and agricultural production, and human resources required massive rehabilitation and reconstruction. Market-oriented reforms have been introduced which dismantle the centrally planned economy. Since 1989 Cambodia passed legislation to restore the right to own and inherit property, freed prices, passed a liberal foreign investment code, began to privatize state assets, and property, decontrolled the official exchange rate, and liberalized foreign trade. Reforms generated increased agricultural production and foreign investment. Phnom Penh and other urban areas received the greatest benefit from this economic activity.

In the 1990s, Cambodia remained predominantly agricultural with more than 80 percent of workers employed in agriculture. Inflation rose steadily, the price of domestic commodities increased at least 140 percent in 1990, but by only 15 percent in 1998. In 1991 Cambodia halted the free trade of gold as part of an effort to stabilize the value of the currency, the riel. Triple-digit inflation made currency worthless in 1992 and it was pulled from circulation. In 1994, the riel was stabilized at 2,400-2,600 riel to one US dollar. In 1991-1993, the transition period from a command to a market-driven system, the presence of 22,000 UN personnel aided the Cambodian economy, although the growth was mainly urban, barely affecting rural areas. Western consumer goods such as motor vehicles, tinned food, alcohol, and cigarettes, were readily available in Phnom Penh and other cities. In 1990, GDP was negative, increasing to 13.5 percent in 1991 and estimated of 6-8 percent in 1992. On 4 January 1992 President Bush announced the lifting of the US trade embargo against Cambodia shortly after the signing of the Paris Peace Agreement on Cambodia in 1991.

Recovering from three decades of conflict, over this last decade, Cambodia has undergone dramatic economic, political, and social transitions. Cambodia experienced rapid institutional changes as it restored peace, moved from a centrally planned to a market-oriented economy, and moved from isolation to regional and global integration. In this context, the 2002 and 2003 local and national elections, the sustained 6 percent economic growth rate of the last decade, and the accession to the World Trade Organization constitute major achievements.

Cambodia has achieved political and macroeconomic stability and has initiated key structural reforms. Nevertheless, Cambodia's economy remains vulnerable, and economic growth has not translated into widespread poverty reduction. With a GDP per capita of US$280 and social indicators showing little progress since the 1960s, Cambodia remains one of the poorest countries in the world. The legacies of war, which include the losses in physical and social capital, depleted human capital, and the remaining land mines, will continue to challenge the country's overall development in the medium term. In addition, the country's small and open economy is faced with the challenge of establishing institutions and infrastructure that will allow it to realize the benefits and mitigate the risks of regional and global integration, in an increasingly competitive regional environment.

To a great extent, progress will depend on achievements in rural areas. Ninety percent of Cambodia's poor live in rural areas. Over the last decade, gaps between rural and urban areas have deepened, and little progress on overall poverty reduction has been made. Thus, the general consensus is that more inclusive growth and progress on poverty reduction will depend largely on addressing the key constraints faced by the rural economy. The government recognizes the need to deepen and accelerate reforms and to focus the limited resources on four pillars: agriculture and rural development, education, health, and infrastructure.

II. OVERVIEW OF THE RURAL FINANCIAL MARKET

2.1 The Institutional Structure

Cambodia's financial sector is at a rudimentary stage, with limited financial intermediation. In early 2000, loans and deposits accounted for approximately 8 percent and 12 percent of gross domestic product (GDP), respectively.

Cambodia had a mono-banking system when the National Bank of Cambodia (NBC) operated through its provincial branches. Structural reforms were then initiated in 1989 through a Government decree to establish a two-tier banking system by separating the function of commercial banks from NBC. This decree allowed the formation of private commercial banks as limited liability companies. In 1990, treasury operations were transferred to the Ministry of Economy and Finance (MEF), and NBC was designated as a ministry and largely used to finance budget deficits. In 1991, the first private commercial bank was established as a joint venture between NBC and the Siam Commercial Bank of Thailand. Commercial banks operated under the framework of a law on the supervision of financial institutions, which was enacted in August 1992, and the sub-decree on the supervision of commercial banks approved in November 1992. In 1996, NBC was established as the Central Bank as the result of the promulgation of the Law on the Organization and Conduct of the National Bank of Cambodia (the Central Banking Law). The period of political stability has allowed financial sector development. Following the reestablishment of NBC in 1996, the Government adopted the Law on Banking and Financial Institutions (the Banking Law) in 1999 and a new Insurance Law in 2000. The Banking Law introduced more appropriate definitions for banking activities and a refined legal framework for banks. It also allowed microfinance institutions (MFIs) to undertake financial operations under the supervision of NBC. Furthermore, in 2000, the Government embarked on a comprehensive bank restructuring program with the assistance of the International Monetary Fund (IMF) to enhance public confidence in the banking system.

Currently, Cambodia has only 20 commercial banks as a result of NBC's re-licensing program, which revoked the licenses of 12 non-viable banks. Other financial institutions operating in Cambodia include insurance companies, currency exchange bureaus, and microfinance institutions (MFIs).

In the rural areas, banking activities are even scarcer; the microfinance operations of non-government organizations (NGOs) are the main and de facto providers of credit there. At present, there are 17 licensed MFIs, 26 registered credit operators and around 60 unregistered NGOs operating in the rural areas (NBC, 2007).

2.1.1 The National Bank of Cambodia (NBC). The NBC is the Central Bank of Cambodia. It was established in 1996 through the *Law on the Organization and Conduct of the NBC* which also provides the NBC with autonomy in carrying out its mandates. The NBC's main functions are: (1) to act as the monetary authority; (2) to act as the sole issuer of national currency of the country; (3) to act as the supervisory authority over the banking/financial system; (4) to oversee the payment system of the country; and (5) to manage the international reserves of the country.

2.1.2 Commercial Banks. These banks are governed by the Law on Banking and Financial Institutions. They are authorized by law to lend to the public as well as to mobilize deposits from them. It should be noted that while the activities of commercial banks remain concentrated in the urban centers and are focused on large commercial transactions including those on real estate and multinational corporations, these banks have recently started to reach out to the countryside by providing wholesale funds to microfinance institutions.

2.1.3 ACLEDA Bank. The financial institution that has the largest network in both the urban and rural areas in Cambodia is ACLEDA Bank. It has grown from being an NGO, to a specialized bank and now a commercial bank. ACLEDA Bank provides both commercial banking and rural financial services. Fully supported by international donors since its establishment, ACLEDA Bank has been expanding its range of products in retail banking to include loans to small and medium enterprises, cash management and money transfer services and deposit services to the public.

According to their Annual Report, total assets of ACLEDA Bank increased by 80.2 percent to US$223.2 million. Net Profit After Tax rose by 58.6 percent to a record US$6.7 million. This translated into a Return on Average Equity of 26.7 percent – a substantial increase over 2005's 22.6 percent. These achievements can be attributed to the following:

- Improved control over costs which reduced Operating Expense ratio from 61.4 percent to 59.2 percent;
- Expansion in loan portfolio reaching US$156.6 million, a 59 percent increase over 2005 figures due largely to strong economic growth particularly in the small and medium enterprise sectors which also resulted in the good performance of the microfinance sector. The Non-performing Loan ratio also fell from 0.16 percent to 0.10 percent due to strong credit management discipline and the favorable economic environment;
- Deposits reached 78 percent of Total Loans against 62 percent the previous year contributing to a reduction in average cost of funds. The deposit growth of 99 percent has been one of the bank's greatest achievements in 2006 primarily because of new clients in the provinces who did not previously keep their savings in banks; and
- Non-interest Income's contribution to gross income rose from 9.7 percent to 11.57 percent with Fee and Commission earnings almost doubling. This was mainly due to the growth in domestic and overseas fund transfers 97 percent and 156 percent, respectively.

Also in 2006, ACLEDA's office network expanded from 139 to 156 offices, mainly in the rural districts with the bank already represented in every province in the country.

2.1.4 Rural Development Bank (RDB). The RDB was created by the government of Cambodia through a sub-decree in January 1998. It received commercial bank status in June 1998 and obtained a license as a specialized bank involved in rural finance. In November 1999, RDB was given additional mandates, as follows:

- Provide financing and refinancing facility for licensed MFIs and banks involved in rural and microfinance;
- Collaborate with commercial banks in agriculture and rural development;
- Negotiate with international donors and investors to support the financing of agriculture and rural development; and
- Provide technical support and training for MFIs.

It should be noted that representatives from the private sector comprise RDB's Board of Directors including representatives from commercial banks and microfinance institutions.

Since 1998, RDB has terminated all of its retail financing operations to focus exclusively on wholesale financing.

The Rural Development Bank has played an important role in mobilizing domestic and foreign financial capital resources to support the provision of rural credit through microfinance activities. Initially capitalized by the government of Cambodia, RDB received grants from international donors to support its agricultural activities.

It has, so far, provided long-term loans for family rubber plantations in Kampong Cham province. RDB has also supported the rural water supply project in Takeo province. RDB continues to provide support for the development of SMEs and has provided credit to commercial banks for lending in rural areas.

2.1.5 NGOs. International NGOs had a big hand in the establishment of local NGOs as microfinance institutions (MFIs). These organizations usually provide loans to group members of the same occupation or type of business. Loans are usually provided on a 6-month cycle basis. Most of the smaller NGOs have compulsory savings requirements where members control group savings and use these savings for lending among members. However, the management and staff of most NGOs lack the expertise in managing savings and credit schemes. Many NGOs have no defined policies and procedures with regards to lending and collection of savings. There is, therefore, an urgent need for appropriate supervision. The smaller indigenous NGOs, on the other hand, are in locations that are difficult to reach and their financial activities may be too small to warrant the costs of supervision (NBC, 2007).

In 2000, the NBC started to issue and amend the regulations in order to help transform NGOs into registered and licensed MFIs according to their scope of operations. After receiving license and registration certificates, those institutions have been regulated and supervised by the NBC. Since 2002, some NGOs have been licensed and some others have been registered. Majority of these institutions were originally NGOs while others were private companies.

2.1.6 Informal Moneylenders. A significant proportion of the rural population turn to informal moneylenders for their financing requirements. Some common informal moneylenders include traders, private moneylenders, relatives, friends and neighbors. According to the 1996 socio-economic survey, about 704,000 rural households obtained loans in the amount of US$120 million during the period 1994-1995. About 54,000 of them obtained loans from traders; 114,000 from private moneylenders; 400,000 from relatives; and 114,000 from friends and neighbors. The rest obtained loans from banks (7,000) and NGOs (71,000).

2.2 Demand for Financial Services in the Rural Areas

An undeveloped banking system cannot fully address the demands of the poor for microfinance services to help smoothen their consumption, build assets, and make microenterprises grow. Furthermore, it is also not structured to meet the demand of the middle and upper segments of the rural markets for financing commercial cultivation, agricultural trading, and rural and agriculture-related enterprises such as rice milling and dairy. Nearly 40 percent of rural households in Cambodia have no access to formal bank branches according to a survey done by the Asian Development Bank. Only 6 percent of total loans granted by the banking sector are for agriculture or related activities. The estimated rural finance demand of $120-$130 million per annum is only "fractionally met by institutional sources" (Cambodia's Financial Sector Blueprint, 2001-2010).

Although many factors contribute to poverty, the most apparent manifestations are insufficient household income, lack of productive assets, and inaccessibility of affordable financial services. Rural finance faces a number of constraints in expanding outreach and attaining sustainability. The demand-supply gap for institutional rural finance, even at the current level of economic activities, is significant. The majority of rural households, including the poor, have no access to institutional finance at affordable terms. Although the collective outreach of the informal sector (that is, friends, relatives, moneylenders, input suppliers, etc.) is large, the terms and conditions limit the ability of rural households to participate actively in and benefit from the development process.

The demand for savings, although not quantified, is significant and largely unmet because of (i) the absence of secure and reliable savings facilities, (ii) the lack of appropriate products, (iii) the high cost of service delivery, (iv) inaccessibility, and (v) the relative inexperience of NGOs in managing savings.

Reliable savings facilities are generally not available in rural areas or to the poor. Currently, about 90 NGOs supported by funding agencies such as the *Kreditanstalt fur Wiederaufbau, Gesellschaft fur Technische Zusammenarbeit* of Germany, the United Nations Children's Fund, International Fund for Agricultural Development, United States Agency for International Development provide microfinance to nearly 420,000 poor households, or 15 percent of the total, with most of the borrowers being women. In 2000, the estimated aggregate outstanding microcredit was $30 million, and savings mobilized was $1.4 million. Service delivery is through "village banks" consisting of 100-200 members and managed by a village credit committee. Members are organized into groups and are provided with some basic training; they are given individual credit with group liability. Loans varying from $20 to $300 are provided for 3-12 months with equated installments and incentives for timely repayment. Interest rates on loans range from 3 to 5 percent per month. Repayment rates are 80-95 percent. Informal sources also play an important role in providing microfinance services to the poor. Despite high interest rates, borrowers continue to borrow from informal lenders for the following reasons: (1) Easy access; lesser documentation; (2) flexibility in repayments; (3) personal relationship; and (4) lack of better alternatives.

III. RURAL FINANCE POLICY ENVIRONMENT AND REGULATORY FRAMEWORK

3.1 Policy Environment

Among the Southeast and East Asian transition countries, it can be said that Cambodia is among the first that put into place the fundamentals of a market-oriented policy framework. It has adopted a market-oriented interest rate policy. Policy authorities in Cambodia are guided by the school of thought that since most sources of funds for MFIs are private funds, an interest rate cap could discourage growth because when microfinance operations are not profitable, there will be no further investments in this sector. Since it is market-driven, interest rates will be determined solely by competition in the market.

With respect to bank branching, MFIs are actively encouraged to open branches to both increase the outreach to the poor and to increase competition subject to evaluation by the National Bank of Cambodia.

Moreover, the Government of Cambodia is not directly involved in microfinance operations or lending. Microfinance operators make their own credit decisions without influence from the government. However, the government promotes the transformation of NGOs into MFIs and the transformation of MFIs into commercial companies by setting simple conditions for them to comply with. The

government has also focused its attention on the establishment and provision of appropriate support services in the rural areas. For instance, national and rural road systems have since been rebuilt in the remote areas. Better roads allow microfinance operators to enter and provide services at low costs which helps bring down interest rates. In addition, the construction of irrigation systems such as canals and ponds also contributes towards the increased capacity of microfinance borrowers to pay back their loans as they are able to increase their production and income. Other critical support services such as training on new farming technology including the correct use of fertilizers as well as proper animal feeding, have been given attention by the government in order to increase the creditworthiness of the poor.

Institutional Development. In order to ensure a sustainable microfinance system, **Cambodia** recognizes the need to further strengthen the National Bank of Cambodia (NBC) to maintain its effectiveness and efficiency in the regulation and supervision of the microfinance sector. At the same time, authorities would like to make sure that all institutions taking deposits are properly guided and oriented and thus, should be subjected to graduated regulatory requirements and supervision based on the size and type of activities. There should also be a common standard for reporting in order to allow for sound financial performance analysis and information dissemination and consequently, help promote the sector's growth.

3.2 Regulatory Framework

Cambodia has since established measures to ensure prudential lending operations among banks and MFIs. *One*, it introduced a framework in the banking law that enables eligible NGOs and other rural finance providers to become regulated microfinance institutions; and *Two*, it created a unit in the National Bank of Cambodia to supervise and monitor MFIs.

The National Bank of Cambodia (NBC) has, thus, started to issue and amend regulations in order to help NGOs become registered and licensed MFIs. Currently, specialized banks engaged in microfinance and NGO MFIs are integrated into the regulations of the NBC. With technical and financial support from donors, the NBC developed banking legislation that includes registration and licensing requirements and some prudential standards for larger MFIs. After receiving license and registration certificates, these institutions are subjected to NBC's regulation and supervision. Since 2002, the NBC has started to issue licenses and registration certificates to qualified NGOs. By the end of 2006, about 17 institutions have become licensed MFIs and 26 registered as rural credit operators. Majority of these institutions were former NGOs and the others, local private companies.

The regulations issued by NBC include the criteria for licensing registration; minimum capital requirement; solvency ratio; liquidity ratio; uniform chart of accounts; reporting requirements and interest calculation. The specific regulations are, as follows:

- Criterion for Licensing and Registration: there should be permanent shareholders; influential shareholders must hold 20 percent or more of the capital;
- Requirement for Licensing: NGOs that have an outstanding loan of KHR 1,000 million or more; or at least 1,000 borrowers;
- Minimum Paid-Up Capital: KHR 250 million;
- Liquidity Ratio: 100 percent, compared to 50 percent for commercial banks;
- Solvency Ratio: 20 percent of networth;
- Capital Guarantee: 5 percent compared to 10 percent for commercial banks;
- Reserve requirement: 5 percent compared to 8 percent for commercial banks;

- Calculation of interest rate shall be based on the remaining balance of loans;
- Reporting requirement: monthly for licensed MFIs and quarterly for registered NGOs;
- Reports: Asset and liability statement; profit and loss statement; statement of deposit and loan classified currency and by type, loan classification and branch network;
- Introduction of uniform chart of accounts of the NBC into the MIS;
- Annual license fee: KHR 1 million for each MFI with no fee per branch, with the purpose of promoting the expansion of branches in order to reach more poor households in the rural areas; and
- No fee for registered NGOs.

Savings Mobilization. The Asian Development Bank (ADB) conducted a survey on micro savings in some potential provinces in Cambodia. The survey showed that rural people are willing and able to save. Based on this result, the NBC is finalizing the regulations for deposit-taking institutions as well as the set of standards based on which MFIs applying for deposit-taking services will be evaluated. A license to mobilize or take deposits from the public will be issued to those who meet the standards. Meanwhile, majority of the NGOs still source their funds from foreign organizations.

In order to ensure compliance with these regulations, the NBC conducts off-site supervision to validate reports regularly received as well as onsite supervision.

IV. LESSONS LEARNED, ISSUES AND CHALLENGES

Following the change towards a liberal environment which led to the development of institutions including MFIs, Cambodia's microfinance industry raced forward. By 1998, MFIs were serving more than 214,000 clients with a $15.3 million loan portfolio. The leading five MFIs covered 80 percent of this market. However, questions began to arise concerning the ownership, governance, regulation, and supervision of these NGO/MFIs, leading stakeholders to recognize that a legal and regulatory framework for microfinance was needed. In response, the National Bank of Cambodia and others developed a framework that incorporated microfinance into the country's Financial Institutions (Banking) Law. A sub-decree was also issued to recognize the unique nature of microfinance and establish a legal basis for deposit-taking. The Cambodian microfinance industry has, since then, enjoyed a robust growth and healthy environment. Several MFIs each serve tens of thousands of clients and have achieved financial sustainability. Some have started the process of their transformation from NGOs to formal financial institutions.

4.1 Some Lessons Learned

Larson, Pierce, et al. (2004) has identified some lessons that have emerged from Cambodia's experience that might be valuable for microfinance in other post-conflict settings. These are:

- Microfinance can be successfully implemented following conflict, despite the enormous obstacles that often exist. Notwithstanding some failures and setbacks, microfinance in Cambodia has enabled significant, lasting changes in the lives of many very poor people.
- When it is properly designed and implemented, microfinance can benefit a country not only for relatively short immediate post-conflict period but also for the long run. By focusing on institutional and financial sustainability, many Cambodian MFIs are now in a position to serve communities on a permanent basis.

- As with any business, a demand for financial services must exist. A demand for financial services existed in Cambodia in the early 1990s. While the economy was in dire straights, it was sufficiently active to allow microenterprises to develop.
- Relative security and accessibility must be present. MFIs had to choose geographical areas of operation that were sufficiently secure and accessible. This restricted initial operations to urban and semi-urban areas.
- Start slowly to set a foundation for future growth. MFIs started cautiously with pilot programs and set very modest objectives. This allowed them to adjust policies and practices, systematize operations, train staff and understand the operating context. In due time, they were able to scale up, but only after building solid foundations.
- Where human resources are limited, it may be wise to invest in external technical assistance and in extensive staff development programs. Every MFI contacted for this study cited limited human resource capacity as one of their greatest constraints, which is a common theme in post-conflict settings. At their peak, each of the Cambodian organizations had between three and twelve expatriate staff, significantly higher than the global norm. However, this level of support was required not only for initial operations but, more importantly, for training Cambodians for the long-term. Human resource development activities included in-country training and study programs and workshops, seminars, exchange visits, and courses abroad.
- "Conflict" doesn't end after the fighting stops. Violence can affect the way that the people of a country deal with disagreements long after the shooting has ended. Behavior of some (such as the case described in footnote 3 above) included lack of respect for the rule of law and incidents of threats, intimidation, and violence.
- Internal conflict can be reduced by developing strong internal controls and by conducting training in the areas of governance and management. MFIs in Cambodia experienced a host of internal problems as they grew. However, many of these might have been averted if sufficient attention had been devoted to internal controls and to training staff in the basics of NGO governance.
- Governmental policy and regulatory frameworks may not be necessary at the outset, but will be required in due time. The Cambodian government was not in any condition to develop an appropriate legal framework for microfinance when MFIs began operating. However, in time, it gained competence and was able to address this issue when it was needed. It appears that MFIs and the government found the right balance between needing a certain amount of laissez faire policies in the beginning but tighter controls as the industry expanded and matured.

4.2 Issues

However, like other countries still in the 'budding' stage, Cambodia has emerging policy and institutional issues that need to be addressed carefully. Some of these are:

- **Lack of defined policy/regulatory framework and the existence of short-term, subsidized development projects.** The government of Lao PDR started to support microfinance with several development projects being implemented through bilateral cooperation, and the involvement of the Agricultural Promotion Bank. Most projects are credit-oriented, supply-led, and do not consider long-term sustainability as a major objective. The governments' strategy, while meaning well, is not likely to boost the industry's development, as it is not sufficiently focused on the sustainability of MFIs.

- **Difficult and costly access to the economically active poor which limits outreach and results in high interest rates on loans for the poor.** Vast regions of Lao PDR have low population density, low-skilled rural populations, poor infrastructure and limited cash economy. The poor therefore have limited opportunities to develop their microenterprises and have to rely on subsistence economy.

- **Weak institutions.** Microfinance/rural finance institutions have a lack of awareness of international best practices and a general understanding and practice of microfinance principles; sustainable interest rates, methodologies and controls and systems. Only a few local institutions and international NGO (INGO) projects have the potential to be transformed into MFIs. Banking supervision of the Bank of Lao PDR (BoL) also needs further improvement especially with respect to the following: (1) lack of clear accountability in the management of the financial sector; (2) organizational weaknesses within the supervisory structure; (3) inconsistency in application of laws and regulations; there is feedback that private banks feel they receive unequal treatment in terms of information disclosure by the regulator and that many rules and regulations have been issued without consultation and dialogue; and (4) absence of real corporate governance and lack of transparency, both in the institutions under the purview of the Central Bank, and in the supervisory process.

- **Sustainability of microfinance institutions.** More specifically, this pertains to the mobilization of resources by MFIs so that they can be self-reliant and depend less on external sources. Deposit mobilization is the key. However, NBC has yet to formulate specific policies and regulations with regards to the MFIs qualified to collect deposits from the public. The question that needs an answer is: Should licensed and registered NGOs be allowed to accept public deposits?

- **NBC-Supervision of NGOs.** Should NBC allow small microfinance institutions that are not yet registered and have no license to continue to operate? If yes, would this be fair to licensed NGOs?

- **On Interest Rate Policy.** Given the country's market-determined interest rate policy, how can interest rates be made affordable to the poor?

- **Lack of Lending Mechanisms for the Poor.** What can be done to encourage banks to lend more to the poor especially those without collateral? What specific measures can be adopted to reduce the risk of lending to the poor?

- **On Capacitating the Poor/Small Entrepreneurs.** What support should be provided to increase the capacity of the poor and small entrepreneurs in starting/managing their businesses and repaying their loans? What can the government do to improve marketing as well as technical assistance for the poor/small entrepreneurs?

4.3 Challenges

Given these issues, the major challenges facing NBC and the Royal Government of Cambodia are the following:

- Making existing policies increase access of the poor to rural finance/microfinance services;
- Ensuring prudential lending and deposit-taking operations while at the same time promoting the growth of small microfinance institutions;
- Developing MFIs into strong, responsive and sustainable institutions; and
- Promoting the development of innovative products and services in order to meet the requirements of the rural poor.

4.4 Some Recommended Strategies

- Development of an enabling microfinance regulatory framework;
- Institution Building Program for Stakeholders including NBC, RDB, other MFIs and even microfinance clients;
- Technical assistance for NBC and RDB to make operations more effective and efficient;
- Create a venue for effective communication among stakeholders especially clients, MFIs, the government and donors to better address issues and concerns; and
- Development and/or replication of innovative schemes or approaches that will increase access of the poor to financial services and at the same time, encourage microfinance institutions to continue and sustain lending in the countryside including difficult or hard-to-reach areas.

PART 2

B. RURAL FINANCE POLICIES IN LAO PDR

I. SOCIO-ECONOMIC PROFILE

1.1 Location and Topography

Lao PDR is located in the heart of the Indochina peninsular, in Southeast Asia with latitude of 14 to 23 degrees north and longitude of 100 to 108 degrees east. Laos is a landlocked country. The country has a total land area of 236,800 square kilometers, three-quarters of which is mountainous. The country has three distinct regions. The North is dominated by mountains which average 1,500 meters above sea level. It has three large plateaus: Phouane Plateau in Xieng Khouang province, Nakai Plateau in Khammuan province, and Boloven Plateau in southern Laos, 1,000 m above sea level. The country has large and small plains along the Mekong River. The largest of these is the Vientiane Plain. Also significant are the Savannakhet Plain, on the lower reaches of the Se Bang Fai River and Se Bang Hieng River, and the Champassak Plain, which is on the Mekong River, stretching between the Thai and Cambodian borders. Blessed with fertile soil, these plains represent one quarter of the total area and are the "granaries" of the country.

1.2 Climate

Lao PDR is a tropical country. The weather in the mountains in the north and in the high range of the Annamite Chain bordering Vietnam in the east is semi-tropical. The difference between day and night temperatures is about 10°C. Lao PDR has around 2,300-2,400 hours of sunlight per year. The dry season is during the months of November to April, with the rest of the year, rainy. There is a sharp difference in rainfall between regions. For instance, in the Phou Luang (Annamite Chain), the annual average rainfall is around 300 millimeters. In Xiengkhouang, Luang Prabang and Sayaboury provinces, annual rainfall is 100-150 millimeters and about 150-200 millimeters of rain is experienced in Vientiane and Savannakhet every year.

1.3 Natural Resources

Lao PDR is rich in natural resources. Beneath the earth's surface, the mineral deposits include tin, iron, coal, zinc, copper, gold, silver, sulphur and sapphires. Although mining is still in its infancy, prospecting surveys show that quantity and density of mineral deposits are quite high. On the surface the country has a wealth of forests, covering 47 percent of the surface. They comprise a variety of species, with many of high economic value such as Khagnoung, Khamphi, Dou, Eaglewood and Longleng. The forest regions are also rich in non-timber products such as shellac, benzoin, cardamon, pine resin, rattan and medicinal plants. The forests also have a wide range of fauna, including elephants, tigers, bears, deer and a newly-discovered species of deer called Saola.

1.4 People

The population of Lao PDR has reached about 5.2 million according to the 2000 Census with an annual growth rate of 2.4 percent. Women dominate the population; there are 60,000 more women than men. The average population density is 21 per square kilometer, giving Lao PDR the lowest population density in Asia. The highest population density in Lao PDR is in the Vientiane municipality, with 149 per

square kilometer, while the lowest population density is in Saysomboun Special Zone, at 8 per square kilometer. By major province, the estimated population is shown below:

Vientiane Municipality	598,000
Savannakhet	766,000
Champassak	572,000
Luang Prabang	416,000
Sayaboury	333,000

About 85 percent of the population live in the rural areas. Over 70 percent (2,220,547) are engaged in productive work; 936,870 are unemployed which include students (69.4 percent), domestic workers (12.6 percent) and the aged (14.6 percent). There are 576,758 people that work in urban centers and 2,580,659 in the countryside. An age-group breakdown gives: 0-14 years – 2,251,600; 15-59 years – 2,548,800; 60 years and above – 290,700 people. The population consists of 49 ethnic groups that belong to four main linguistic families, according to preliminary figures given to a symposium on the names of ethnic groups on August 13-14, 2000.

The **Lao-Tai family** includes eight groups: Lao, Phouthai, Tai, Lue, Gnouane, Young, Saek, and Thai Neua. The **Mone-Khmer family** has 32 ethnic groups including Khmu, Pray, Singmou, Khom, Thene, Idou, Bid, Lamed, Samtao, Katang, Makong, Try, Trieng, Ta-oi, Yeh, Brao, Harak, Katou, Oi, Krieng, Yrou, Souai, Gnaheune, Lavy, Kabkae, Khmer, Toum, Ngouane, Meuang, and Kri. The **Tibeto-Burmese family** includes seven ethnic groups: Ahka, Singsali, Lahou, Sila, Hayi, Lolo and Hor. The **Hmong-Ioumien** category has two main tribes: Hmong and Ioumien *(Yao)*.

1.5 Economy

Despite increasing shares of the Industry and Services Sector to the country's Gross Domestic Product (GDP), agriculture remains to be the backbone of Lao PDR as it accounts for 51 percent of its Gross Domestic Product (GDP) (Fukui and Llanto, 2003). About 80 percent of its labor force work in the agriculture sector. Following economic growth, the percentage of people living below the poverty line has gone down from 46 percent in 1992-93 to 33.5 percent in 2002-03 and is expected to decline further to about 23 percent to 28 percent by 2010 (ADB,). The economy is projected to grow at a steady rate of 6-7 percent over the next few years.

1.6 Political Environment

Lao PDR has started to move towards a market-oriented economy from a centrally-controlled economy following reforms in 1986. It is therefore in transition. The government of Lao PDR has, since then, been establishing institutional reforms which have resulted in steady and significant economic growth.

II. OVERVIEW OF THE FINANCIAL SYSTEM

2.1 Institutional Structure

The country's financial system consists of formal, semi-formal and informal financial sectors.

2.1.1 Formal Sector. The formal sector is composed of three state-owned banks; three local private banks; eight branches of foreign banks as well as microfinance institutions (MFIs). The formal banking system is mostly concentrated in Vientiane and other cities, and have limited outreach in rural areas, with only 11 percent of the rural population having access to formal financial institutions, and only 1 percent making saving deposits (Fukui and Llanto, 2003). An exception is the Agricultural Promotion Bank, which has a rural branch network in all of the country's provinces.

2.1.1.1 State-Owned Banks

The State-Owned Banks include the Agricultural Promotion Bank (APB), the Banque pour le Commerce Exterieur Lao (BCEL) and the Lao Development Bank. The three public banks serve 70 percent of the financial sector. These banks are also undergoing a restructuring process in order to reduce non-performing loans and to modernize its operations. The Agricultural Promotion Bank is particularly important in rural finance (including microfinance) because it is the only bank with branches in all the provinces of the country. The Agricultural Promotion Bank (APB), in particular, is mandated to provide loans at subsidized rates to farmers. However, about 30-40 percent of its outstanding loan portfolio is said to be non-performing and that 43 percent of its loans were past due. Some of the reasons cited for these are: poor client selection; inadequate group formation; the perception that loans from APB are grants; and lack of an aggressive collection policy. The APB is, therefore, gradually terminating its subsidized lending as it goes through a rehabilitation process made possible through a loan from the Asian Development Bank. APB is now providing microfinance services to about 40,000 households (or 5 percent of the population).

2.1.1.2 Private Banks

The few domestic private banks are said to be weak and the foreign banks have a very small market share due in part to existing barriers to entry and expansion. Some of these private banks include the Vientiane Commercial Bank, the Joint Development Bank and the Phongsavanh Bank.

2.1.1.3 Ekphattana Microfinance Institution (EMI)

The EMI is the first licensed microfinance institution in Lao PDR. It commenced its lending operations in March 2006 in Vientiane starting with "foreign employment" loans. This MFI works with a local firm that places Laotian workers in Thai firms. Loans from EMI cover the fees and initial resettling costs of the workers which are then directly reimbursed to the EMI through the workers' wages. The EMI has also started to provide individual loans both for consumption and business. Its loans are provided at a flat rate of 4 percent per month. No collateral is required but clients are required to form a joint-liability group of five members. The EMI has savings products as well particularly passbook savings and fixed term deposits. The interest rate on deposits is 1 percent higher compared to that of commercial banks. While EMI is currently serving only Vientiane, the capital of Lao PDR, it aims to

establish two branches in 2008 and two other branches in 2009. It aims to put up ten branches by 2012 with about 17,000 clients. It is hoped that the monetary authorities in Lao PDR would formulate a regulatory framework that would not be too restrictive especially with regards to product development in order to allow MFIs like EMI to grow and compete with informal lenders.

2.1.1.4 Foreign Banks

Five Thai banks operate full branches in Vientiane including Bangkok Bank, Bank of Aduthaya, Krung Thai Bank, Siam Commercial Bank and the Thai Military Bank. There is also one Malaysian bank.

2.1.2 Semi-Formal Sector. The semi-formal sector is dominated by credit unions and cooperatives, local organizations, international NGOs as well as government agencies that implement development projects funded by bilateral and multilateral aid. Since the mid-nineties, the government, at national and local levels, has participated in microfinance projects, using mass organizations such as the Lao Women's Union as microfinance conduits (Fukui and Llanto, 2003). The development of a modern cooperative movement in Lao PDR is still in its early stages. There exist only young and relatively small organizations. The main cooperatives are the Fonds Cooperatif and its network of Credit Cooperative for Promotion of Small Producers.

2.1.3 Informal Sector. The informal sector is composed of private moneylenders as well as thousands of traditional, autonomous savings and credit associations, using revolving loan funds set up at village level. Most village revolving loan funds were established by international projects and NGOs, in partnership with the Lao Women's Union, using its experience and extensive network. Even if these schemes have been active in community development, they are not generally seen as effective financial intermediaries, charging below-inflation interest rates, and lacking management capacity to reach sustainability.

The other main forms of informal finance are banks that provide credit in-kind (e.g., rice and buffalo), ROSCAs (or Houay), loans from friends and family, credit from suppliers (to a limited extent), and private moneylenders (mostly in urban areas).

2.2 Financial Market Structure

Lao PDR has a small banking system with assets of less than $500 million and loans of $250 million. Three state-owned banks account for about 56 percent of the loan market, three domestic private banks for 31 percent and 8 foreign banks for 14 percent of the market. Portfolio quality of the state-owned commercial banks is generally poor. Loans to agricultural enterprises only account for 12 percent of total assets, but have been increasing in recent years.

2.3 Financial Depth and Outreach

Lao PDR has a very rudimentary and shallow financial sector with very little intermediation. Loans equal only about 7.4 percent of GDP based on early 2005 figures. The sector is highly liquid since loans absorb only about half of deposits. At the same time, physical penetration of bank branches is very low, among the lowest in the world. With 0.8 branches per 100,000 people, Lao PDR ranks alongside Ethiopia, Uganda, Tanzania, Madagascar and Honduras in terms of branch penetration.

III. MICROFINANCE DEVELOPMENT

3.1 Meeting the Demand for Rural Finance/Microfinance Services

According to a report from the Bank of Lao PDR (2002), the potential microfinance market is 268,000 borrowers and 560,000 depositors. The same report shows that only 25 percent of this market is currently served by microfinance providers (mostly by APB). Microfinance institutions (MFIs) have not been aggressive in delivering their services in the rural areas because of difficult and costly access to the economically active poor who have limited opportunities to develop their microenterprises and thus, rely heavily on subsistence economy. Moreover, vast regions of Lao PDR have a low population density, low-skilled rural population, poor infrastructure and limited cash economy. So far, government agencies and mass organizations provide 80 percent of the microfinance services, while banks provide 15 percent and semi-formal community-based organizations serves 1 percent of the population. The Lao Women's Union is the largest provider in terms of number of beneficiaries.

Service Provider	Targeting	Saving	Interest rate	Methodology	Sustainability
FORMAL SECTOR					
State-owned Commercial Banks Lao Development Bank BCEL	Mainly urban and semi-urban communities involved in micro and small enterprise activities	Compulsory savings required to access loan	Interest rate fixed by government policy	Accessibility difficult due to paperwork and formalities	Under restructuring
APB	Semi-urban and rural farmers	Compulsory Saving required to access loan	Subsidized interest rate, will change in future	Solidarity Groups. Accessibility is difficult due to paperwork and formalities	Heavy losses. Large number and volume of non-performing loans. Restructuring program.
Formal Credit Cooperatives	Mostly micro and small urban entrepreneurs. Some from rural areas	Private shareholders and cooperative members. Voluntary and compulsory savings	Trends towards using market-based interest rates	Cooperative legal status, limited company	Aim at reaching operational sustainability
SEMI-FORMAL SECTOR					
Credit Union	Rural poor communities	Shares of equity capital. Aims at providing positive return on savings	Cover operational costs and consider growth of capital	Business orientation, community membership	APB with technical assistance from ADB launched pilot in 4 provinces

Service Provider	Targeting	Saving	Interest rate	Methodology	Sustainability
NGO Projects	Mostly poorest and remotest area (such as ethnic minorities)	Compulsory and voluntary savings (cash or in kind)	Often subsidized interest rate determined by the management committee	Self-Help group (CBOs, Village banking) with focus on institutional development	Usually high subsidies involved (but exceptions exist)
Bilateral Projects	Urban and rural poor	Credit orientation. Savings are not often required	Often subsidized interest rate determined by the management committee	Several methodologies followed	Difficult to sustain after project hand over
INFORMAL SECTOR					
Savings and Credit Groups	Poor and poorest people	Encouraged voluntary savings in addition to compulsory savings	Often subsidized interest rates determined by the management committee	Self-Help group (CBOs, Village banking)	Difficult to sustain after project hand over
Other (ROSCAs, money lenders, huayi, traders and money-lenders)	No specific target people	No savings required, good understanding and trust are key factors	High	Informal operations	Very quick and prompt services. Interest rate covers high risk

Source: (ARCM, 2005).

3.2 Microfinance Practices and Innovations

Microfinance institutions usually tap community-based models (self-help groups, village banking, cooperative and credit unions) in delivering microfinance services in poor communities through the revolving loan fund concept which is used to disburse loans to members of solidarity groups. It is estimated that the largest mass organization, the Lao Women's Union (LWU) has initiated revolving loan funds in more than 1,600 villages. Traditional Rotating Savings and Credit Associations (ROSCAs) also operate in Lao PDR. In fact, community-based models seem to be the most suitable methodology for Lao PDR, given the low density of population and the difficult access to remote areas. In more densely populated regions, more formal cooperatives seem to obtain good results.

The community-based schemes seem also more adequate for rural populations with low education level, as these schemes include non-financial assistance, such as management training, capacity building exercises, and aims at fostering the empowerment of local communities.

As in many parts of the world, savings seem to be the forgotten half of microfinance in Lao PDR. Among international development projects, only two put emphasis on savings mobilization. The Women in Development Project (implemented by LWU/FIAM) in Vientiane municipality and the

community-based Rural Development Project for Reservation of Watersheds in Oudomxay Province (implemented by GAA). These projects established village savings and credit schemes by mobilizing local savings.

Microfinance finance practices as well as innovations in Lao PDR can be seen in some projects implemented in the country, as follows:

3.2.1 Microfinance and Sustainable Livelihood in LAO PDR Project (1997-2002)

This microfinance pilot project was supported by UNDP-UNCDF, and managed by the Ministry of Finance. At the national level, the project provided support for capacity building including consultancy services on microfinance to public entities as well as the development of a regulatory framework. At the provincial level, the project supported the development of MFIs called 'Accredited Agents' (AA) which served as local branches of APB, the Lao Women's Union and the international NGO, Save the Children. It also supported the development of local cooperatives. The project used solidarity groups for credit operations and compulsory savings. During the latter years of implementation, the project aimed to create a MFI with a nationwide network in order to better address the financial needs of low-income groups and thus, reduce poverty. The proposal included the transformation of AAs into branches of the said MFI. However, the project ended in 2002 and failed to reach the institutionalization stage as the government of Lao and UNCDF-UNDP disagreed on the modalities of the project. Some of the project groups, however, are still active in microfinance. In addition, some former staff members have initiated their own microfinance organization, charging market interest rates to their clients.

3.2.2 Rural Development Project in Bokeo Province

This project was implemented by GTZ in 1997. It established "Village Contribution Funds" in targeted villages of the country. The project provided contributions "in-kind" to villagers who then repaid part of the loan in cash into Village Development Funds. Each of the fund was managed by a village committee and was used for lending. A few years later the funds were transformed into Village Revolving Funds (VRF), providing credit only, and replenished by contributions from villagers. As of July 2003, there were 3,200 families participating in 46 village VRFs.

3.2.3 Phongsaly District Rural Development Project

Also established in 1997, the project introduced a self-managed village bank approach. It is implemented by the French NGO, *Comité de Cooperation avec le Laos* (CCL). In the initial phase, the project set up 5 pilot village credit schemes, called Village Development Funds (VDF), which have been extended to 54 village credit schemes. The VDF capital was established and maintained through annual members' contributions. Loans are guaranteed by solidarity groups of five to ten families. As of 2004, there were 2,154 families members of 54 VDFs. However, problems with repayment were reported.

3.2.4 Women in Development Program in Vientiane Municipality

The main objective of the program is to strengthen the capacity of women in setting up community-managed savings groups. The program started with 15 savings groups in 1997, through a partnership between Lao Women's Union, FIAM (a Thai NGO) and the Foundation for Community Development (FCD). The initial project capital contribution focused on technical support only. The savings groups started to provide loans to its members only after three months using the savings accumulated from members.

3.2.5 Community-based Rural Development to Reserve Watershed Project in Oudomxay Province

This was implemented by the NGO German Agro Action (GAA). In 2001, the project started to set up savings funds in 6 villages in from members' savings and project contributions. There are now 16 Savings Funds in 15 villages, managed by a local village committee. Members can obtain loans from the funds and are entitled to dividends at the end of each year.

3.2.6 Development Project in Bolikhamxay Province

Implemented jointly by Save the Children Australia and the Lao Women Union, the project began by setting up four pilot village savings and credit schemes (VSCS) in 2001. The project aimed to strengthen the local capacity of women, especially of providing access to credit in support of income generating activities. The project contributions were made through loans to VSCS. The loans repaid two years later were used to establish 7 additional funds. The funds are generated by savings and initial profits made on the project contribution revolving fund, and are used to disburse credits. The loans are guaranteed through a solidarity group mechanism, which consists of five to ten families including one or two poor families.

3.2.7 Lao-Luxembourg Integrated Rural Development Project in Bolikhamxay Province

The project started its microfinance component at the end of 2003. It set up two pilot "Village Cash Credit Schemes" (VCCS), through annual project contributions, 9 times what members have made in voluntary contributions, over a three year period. Loans from the VCCS are guaranteed by a solidarity group (8-10 families) methodology.

3.2.8 The Community-Managed Livelihood Improvement Project

This is funded by a US$1 million from the Japan Fund for Poverty Reduction, managed by the ADB. It includes village-based revolving funds. The funds provide members with small initial loans of 500,000 kip ($50) and is increased over time.

3.2.9 Oudomxay Community Initiative Support Project (OCISP)

This is funded through a loan from IFAD with financial support from Lux Development and WFP. The project is an eight-year project that started in 2002 covering 150 villages and reaching 10,000 households. It had five components: community development, agricultural development, rural finance services, rural infrastructure, and institutional capacity building. In 2004, the rural finance services component of the project aimed to build and use community-based organizations, village-based savings and credit schemes, as conduits for microfinance. It used a savings-based model, where members are required to save during nine months, before receiving a matching fund of 9 is to 1 in proportion to the savings accumulated. During the pilot phase, the project worked with 14 groups of 30 members, with the objective of reaching 60 groups overall. Eventually, the groups were given more autonomy in making decisions, and after one to two years became fully independent.

3.2.10 Microfinance Capacity Building and Research Project (MCBR)

The MCBR is a four-year project (2003-2007), implemented by the National Economic Research Institute (NERI)/Committee for Planning and Cooperation (CPC) with support from Concern Worldwide. The project aims to address several major barriers impeding the growth of the microfinance sector. The overall goal of the project is to improve the livelihood security of poor people in Lao PDR by the promotion of diverse microfinance services through sustainable mechanisms. Under this project, NERI aims at developing a national microfinance unit, action research projects with microfinance practitioners, to establish a microfinance resource center and links with national, regional and international networks.

In addition, a group of private individuals has created the "Microfinance Training Center", a component of Mekoxab Business Development Consulting Company which provides microfinance training starting in 2005.

3.3 Technical Assistance for Microfinance Development

Through ADB financing, a microfinance fund has been set up to support the creation and development of MFIs in Lao PDR.

The APB and the Bank of Lao PDR benefits from a US$10 million loan and a US$2 million technical assistance grant from the Asian Development Bank. The goal is to develop a sustainable, market-oriented rural financial system to contribute to poverty reduction. The project includes support for the development of rural finance policies and the transformation of the APB into a commercial-oriented institution just like Bank Rakyat Indonesia. A major portion of the loan will also be used for the recapitalization of APB, a smaller portion for the modernization of MIS and the IT system. In addition, the funding will be used to pilot-test three commercial-based savings and credit unions, with WOCCU involvement.

IV. POLICY AND REGULATORY FRAMEWORK

The Bank of Lao PDR (BoL) is the supervising and regulating body for the financial industry. Its work is based upon a number of decrees, regulations, rulings and presidential orders. On June 22, 2006, the Bank of Lao PDR issued Regulation No. 10 and was endorsed by the Government of Lao PDR. The regulation outlines the following:

- The definition of microfinance in the context of the Lao PDR;
- Licensing procedures for deposit taking microfinance providers (those that will take voluntary savings deposits from the general public for the purpose of on-lending);
- Registration procedures for non-deposit taking microfinance providers (those that provide services not including voluntary deposits unless specifically authorized by the Bank of Lao PDR); and
- The legal obligations of all microfinance service providers in relation to operations, including service provision, reporting standards and financial transparency.

The regulation provides a platform for all microfinance activities in the Lao PDR and is the framework within which all service providers need to operate.

To ensure full implementation of the regulation, current initiatives by BoL include the following:

- Ensuring service providers are aware of the microfinance regulation to ensure that at the point of registration as MFIs, providers are able to comply with regulatory requirements;
- Assisting institutions currently required to follow the regulation to understand and adhere to their legal requirements;
- Constantly reviewing and taking practitioner feedback on the regulation and developing a new draft regulation that takes into account this feedback.

It should also be noted that the government set up an inter-ministerial committee called the "Rural and Microfinance Committee" (RMFC) in 2002. Chaired by the Central Bank, the committee's major task is to prepare a national policy and action plan towards the development of an enabling environment that will promote the growth of the microfinance sector. The committee was established as a consultative body with limited decision-making capabilities.

The national policy statement, drafted by the RMFC, with support from the World Bank, ADB and the NERI-Concern Worldwide microfinance project has been approved by the office of the Prime Minister. The general policy statement proclaims "Sustainable rural and microfinance can be effective tools for poverty reduction, which can help Lao PDR to emerge from Least Developed Country status by 2020. The government of Lao PDR's reform program in rural and microfinance will enable the sector to expand significantly, with diversity, security and future sustainability."

The action plan to implement the Rural and Microfinance Sector (RMF) reforms consist of three main areas:

1. Build common understanding and consensus on government's policy and vision of the RMF reform;
2. Strengthen existing RMF initiatives and institutions to ensure their sustainability and their contribution to poverty alleviation (currently the majority of RMF initiatives are unsustainable); and
3. Develop enabling legal and policy environment for the establishment and development of diverse MFIs. (currently, the majority of RMF initiatives are operated by public entities).

However, this policy has yet to be fully implemented especially among government agencies and mass organizations. This is because subsidized lending programs are still being implemented by these institutions which adversely affect the development of other microfinance organizations.

The ADB financing package also includes support to the Bank of Lao PDR in the creation of an enabling policy framework. Under the draft microfinance law, large MFIs would need to be licensed, while smaller MFIs and CBOs only need to be registered.

Moreover, the government has promoted the development of a national microfinance resource center and provided capacity building and research support to the microfinance sector, housed in NERI and supported by Concern Worldwide.

Finally, the development of the microfinance sector has also been supported recently by a group of donors' "first initiative" funding worth US$4 million for technical assistance to include the setting up of a microfinance unit in the Bank of Lao PDR, training and capacity building in APB, external technical assistance to government entities, and seed capital for microfinance pilot projects.

V. ISSUES AND RECOMMENDATIONS

As shown above, the microfinance industry in Lao PDR is still at an early stage of development. With the first initiatives launched in 1997, the microfinance sector in Lao PDR is still young and constrained by public interventions, lack of a well-defined regulatory framework and the existence of short-term, subsidized development projects. There is also a general lack of understanding of microfinance principles.

The government of Lao PDR started to support microfinance with several development projects being implemented through bilateral cooperation, and the involvement of the Agricultural Promotion Bank. Over the years, international donors and NGOs have initiated various village-based revolving funds, usually as a component of a larger project, often in-kind, and typically through Lao Women's Union. Most projects are credit-oriented, supply-led, and do not consider long-term sustainability as a major objective. Despite the success in including women and minorities as microfinance clients, and the widespread use of community-based delivery mechanisms, the development of the microfinance sector in Lao PDR still face major challenges.

There is also a lack of awareness of international best practices and only a few local institutions and projects of international NGOs have the potential to be transformed into MFIs. There is generally a lack of understanding and practice of "cost-recovering" interest rates, efficient methodologies, controls and systems.

With policy reforms being instituted in the country, the government's new market-oriented policy has the potential to have a significant positive impact on rural finance/microfinance development. The following recommendations should be seriously considered:

- carrying out concrete actions to operationalize the new market-oriented policy;
- phasing out directed lending from government-initiated programs;
- formulating an appropriate policy, legal, and regulatory framework that will promote efficient and sustainable microfinance institutions (MFIs) and encourage the growth of new and small MFIs;
- ensuring that private microfinance initiatives follow good practices and focus on sustainability from the outset; and
- holding regular stakeholder meetings to provide feedback to the authorities and propose new solutions to further develop the rural finance sector.

PART 2

C. RURAL FINANCE POLICIES IN THE PHILIPPINES

I. SOCIO-ECONOMIC PROFILE

Based on the national income accounts prepared by the National Economic and Development Authority (NEDA) for the second quarter of 2007, the country's gross domestic product (GDP) and gross national product (GNP) increased by 7.5 percent and 8.3 percent, respectively, exceeding forecasts by both the NEDA and private firms.

Economic growth drivers for the period were the industry (8.0 percent) and services (8.4 percent) sectors, which made up for the lackluster showing of the agriculture sector (3.9 percent), whose growth was severely hampered by a prolonged dry spell. On the demand-side, growth was stimulated by household and government consumption, which expanded by 6.0 and 13.5 percent, respectively. Capital formation (8.2 percent) also grew robustly compared to the 1.5 percent growth recorded in the same period last year.

Despite moderate growth in agriculture, palay production (4.4 percent) remained healthy on account of increases in area harvested due to better irrigation and policy interventions (i.e. DA-GMA Rice Program). High value crops, fishery and forestry also supported the sector's growth.

The mining and quarrying sector sustained its growth in the first quarter, getting a boost from the upturn in construction due to the property market boom and strong growth in public construction (39.6 percent). Likewise, the services sub-sectors also thrived, led by finance (11.8 percent), transportation, communication and storage (9.8 percent), private services (8.6 percent) and trade (8.4 percent). The country's sound macroeconomic fundamentals and strong corporate profits drove up the Philippine Stock Exchange Index (PSEI). Higher earnings of banks and other financial services providers; affordable airfares and intensive marketing promotions in the air transport sector also helped fuel economic growth.

Is economic growth felt by the poor? The trickle-down nature of economic growth in developing countries, coupled with the unchecked population management problem in the country, makes it hard for the poor to immediately reap the benefits of whatever economic gains the country is having. Although the annual population growth rate exhibited a generally declining trend since the 1960s (see Table 1), the decline appears to have slowed down during the 1990s and reversed the trend by again increasing from 2.32 in 1995 to 2.36 in 2000, a figure which is still very high relative to our Southeast Asian neighbors.

Apart from population growth *per se*, another demographic aspect of population that has a significant bearing on the impact of economic growth is the proportion of the population living in rural and urban areas. In the Philippines, the number of rural dwellers declined significantly from about 63 percent (of the total population) in 1980 to only 39 percent in 2003. The opposite trend was exhibited by urban dwellers, which increased from only about 37 percent in 1980 to 61 percent in 2003 (see Table 2).

Although not directly attributable, this phenomenon gives a strong indication that rural to urban migration has taken place, and it is no secret why. Lower wages, limited job opportunities, uncertainty in agriculture – the main livelihood in rural areas – are among the things that force rural settlers to migrate to urban areas in search of higher-paying jobs. However, it is a well-known fact that many migrants eventually end up settling for menial jobs in the informal sector (e.g. as household help).

Table 1. Population and Average Annual Growth Rate Philippines: 1903-2000

Year	Population (millions)	Average Annual Rate of Increase Over Previous Year (percent)
1903	7.6	–
1918	10.3	1.90
1939	16.0	2.22
1948	19.2	1.91
1960	27.1	3.06
1970	36.7	3.01
1975	42.1	2.78
1980	48.1	2.71
1990	60.7	2.35
1995	68.6	2.32
2000	76.5	2.36

Source: National Statistics Office (NSO), 1903-2000 censuses.

Table 2. Rural/Urban Population in Southeast Asia (in percentage share)

		1980	1990	1995	2000	2002	2003
Southeast Asia							
Brunei Darussalam	Rural	40.1	34.0	31.0	0.0	0.0	0.0
	Urban	59.9	66.0	69.0	0.0	0.0	0.0
Cambodia	Rural	89.7	88.4	85.6	84.0	84.0	0.0
	Urban	10.3	11.6	14.4	16.0	16.0	0.0
Indonesia	Rural	77.5	69.1	63.9	59.8	0.0	54.4
	Urban	22.4	30.9	36.1	40.2	0.0	45.6
Lao PDR	Rural	86.6	81.4	79.0	76.5	80.0	79.4
	Urban	13.4	18.6	21.0	23.5	20.0	20.6
Malaysia	Rural	62.5	45.3	45.3	41.2	37.6	37.4
	Urban	37.5	54.7	54.7	58.8	62.4	62.6
Myanmar	Rural	76.0	75.2	74.0	72.3	71.0	70.5
	Urban	24.0	24.8	26.0	27.7	29.0	29.5
Philippines	Rural	62.7	51.4	46.0	41.4	40.0	39.0
	Urban	37.3	48.6	54.0	58.6	60.0	61.0
Singapore	Rural	0.0	0.0	0.0	0.0	0.0	0.0
	Urban	100.0	100.0	100.0	100.0	100.0	100.0
Thailand	Rural	82.4	82.3	81.7	81.5	71.4	71.4
	Urban	17.6	17.7	18.3	18.5	28.6	28.6
Timor-Leste	Rural	91.6	92.2	92.5	92.5	92.4	92.3
	Urban	8.4	7.8	7.5	7.5	7.6	7.7
Vietnam	Rural	80.7	80.5	79.3	75.8	74.9	74.2
	Urban	19.3	19.5	20.7	24.2	25.1	25.8

Source: www.unescap.org/stat/data/statind/pdf/t3_dec04.pdf

Poverty incidence, rural vs. urban. Racelis [2003] remarked that the Philippines serves as a typical example of a developing country whose economy is growing but which faces serious problems in its efforts to end poverty. One major cause is the skewed distribution of investments and hence, economic benefits existing between rural and urban areas, resulting in huge disparities (in terms of development) which tends to favor the latter. According to a DSWD Survey in 2002, 16 of 80 provinces show poverty incidence levels of over 50 percent, with Sulu in the south having the highest level at 76.6 percent, and Metro Manila and adjacent provinces having the lowest, at 9 percent.

Racelis [2003] also cited the following results:

- Rural poverty is over twice that of urban poverty (46.9 percent vs 19.9 percent), which also means that one out of every two Filipinos in rural areas is poor compared to one of five in urban centers (Reyes, 2000);
- Approximately one-third ($3^1/_2$ million) of Metro Manila's population live in informal settlements (squatter areas or illegal shantytowns) in varying levels of poverty and poorly served by urban services; and
- Urban areas are growing much faster than rural ones. The urban rate of population increase is 3 percent, while the rural equivalent is less than 1 percent. Urban areas also account for 80 percent of all population growth and absorb 1 million people annually (Webster, Corpuz and Pablo 2002).

Major occupation of population, rural vs. urban. Out of a total sample of almost 33 million employed persons nationwide (as of October 2006), about 32 percent are composed of laborers and unskilled workers while some 19 percent are either farmers, forestry workers or fishermen (2006 Labor Force Survey, See Table 3). The latter could be classified almost exclusively as a rural occupation while the former may be subdivided into both rural and urban. Although no data exists as to the exact number of rural and urban workers by major occupation, it is certain that more than one-fifth (19.1 percent-agricultural workers) are rural workers.

Table 3. Employed Persons by Major Occupation Group: October 2005 and October 2006

Major Occupation Group	October 2005		October 2006	
	Number ('000)	Percent	Number ('000)	Percent
Philippines	33,185	100.0	32,875	100.0
Officials of Government and Special Interest Organizations, Corporate Executives, Managers, Managing Proprietors and Supervisors	3,874	11.7	3,767	11.5
Professionals	1,437	4.3	1,391	4.2
Technicians and Associate Professionals	913	2.8	871	2.6
Clerks	1,564	4.7	1,465	4.5
Service Workers and Shop and Market Sales Workers	3,177	9.6	3,042	9.3
Farmers, Forestry Workers and Fishermen	6,263	18.9	6,268	19.1
Trades and Related Workers	2,688	8.1	2,767	8.4
Plant and Machine Operators and Assemblers	2,533	7.6	2,553	7.8
Laborers and Unskilled Workers	10,591	31.9	10,612	32.3
Special Occupations	145	0.4	139	0.4

Notes: Details may not add up to totals due to rounding. Estimates are preliminary and subject to change.

Source: Income and Employment Statistics Division, Household Statistics Department, National Statistics Office.

This data, when combined with the high poverty incidence in rural areas (relative to urban areas) as well as strong evidence of rural to urban migration, could serve as an indicator that rural workers, including those in agriculture, are not sufficiently being compensated in their current work and are looking for better jobs elsewhere, particularly in urban areas.

The Philippine agricultural economy. Agricultural productivity in the country has perpetually been under threat of either inclement weather conditions (e.g. typhoons), prolonged drought, *force majeure* (e.g. calamities) or pests. Agricultural workers are oftentimes operating under a veil of risk and uncertainty, disrupting the steady flow of income and, hence, the need for more stable, if lower paying jobs in urban areas. Nevertheless, the government is finding ways to work around these inherent problems in agriculture. Some measures include: boosting the productivity of the sector during the "good times" (e.g. suitable weather), providing safety measures such as crop insurance during the "bad times" (e.g. in case of typhoons, calamities), and improving the overall viability and sustainability of the sector by improving support services such as infrastructure, post-harvest facilities, marketing strategies, and credit support.

In 2006, the sector proved to be resilient amidst shocks and severe weather disturbances. It actually performed better in 2006 compared to previous years despite missing the growth targets set under the Medium-Term Philippine Development Plan (MTPDP). The sector's performance hit 4.1 percent from 1.8 percent in 2005, barely missing the low-end MTPDP target of 4.2 percent. A major reason is that job generation proved to be difficult with the decreasing number of jobs created for the sector. On the other hand, agriculture grew because of good performance of the crops, livestock and fisheries (particularly seaweeds) sub-sectors as the volume and value of production increased, compensating for the contraction in the poultry sub-sector. The forestry sub-sector likewise contributed to the growth in the sector, with increased log production from industrial tree plantations (NEDA Socio-Economic Report 2006).

Credit as key in developing new agribusiness lands and creating jobs. The NEDA Report also acknowledged the crucial role that credit plays in the attainment of *Goal 1*[1] of the agriculture sector. The government aims to increase the flow of credit to the agriculture sector by making available farm credit facilities and financing programs for new agribusiness lands thereby creating more work opportunities intended for small farmers and fisherfolk.

II. THE PHILIPPINE RURAL FINANCIAL SYSTEM

2.1 Overview

Agabin and Owens [2006] describe the country's financial system as being composed of formal, semi-formal, and informal financial institutions and providers. Formal institutions include banks that are regulated and supervised by the Philippine Central Bank, the Bangko Sentral ng Pilipinas (see Table 4). The formal sector is also complemented by other semi-formal institutions that offer financial services such as credit cooperatives, which operate under the cooperative law, and non-government organizations (NGOs), which are registered organizations but not regulated or supervised by any government entity.

[1] One of two national goals set by the Department of Agriculture which is also cited in the MTPDP. Goal 1 is specifically aimed at developing at least two million hectares of new land for agribusiness by maximizing the transformation and use of the following: 1) underused farmlands, 2) idle and marginal lands, and 3) idle offshore and inland bodies of water into productive agribusiness enterprises.

Table 4. The Philippine Formal Financial System

Type	Institution
Banking institutions	Universal banks Commercial banks Thrift banks Rural banks Specialized government banks
Non-bank Financial Intermediaries (NBFIs)	Investment houses Financing companies Securities dealers Investment companies Fund managers Lending investors Pawnshops Government NBFIs* Venture capital corporations
Non-bank Thrift Institutions	Mutual building and loan Associations Nonstock savings and loans Associations

* government NBFIs include the Social Security System, the Government Service Insurance System, and the Home Development Mutual fund.

Source: Gochoco-Bautista, Ma. Socorro. 2000. The Past Performance of the Philippine Banking Sector and Challenges in the Post-crisis Period. In *a Study of Financial Markets, Volume 10*, Manila: Asian Development Bank, p. 35.

The financial sector is dominated by banks comprised of 41 commercial and universal banks, 84 thrift banks, and 754 rural and cooperative banks. The combined number of bank branches and head offices total 7,670 (see Table 5). Rural banks comprise 27 percent of this total number, with almost two thirds of their branches being located in 3rd, 4th, 5th, and 6th class municipalities that are mostly rural.

Table 5. The Philippine Banking System, 2005

Type	Head Offices	Branches	Total	Percent Share
Commercial and Universal Banks	41	4,227	4,318	56
Thrift Banks	84	1,209	1,293	17
Rural and Cooperative Banks	754	1,305	2,059	27
TOTAL	**879**	**6,791**	**7,670**	**100**

Source: Bangko Sentral ng Pilipinas.

While rural banks are the major players in many rural areas, there are also other financial service providers including formal non-bank institutions such as lending investors and pawnshops; semi-formal financial institutions comprised mainly of credit cooperatives and NGOs; and informal financial providers such as moneylenders, and traders/millers who also provide credit.

Which institutions provide agricultural finance and microfinance services? Commercial and rural banks, credit cooperatives, and farmers cooperatives/organizations are known to provide agricultural

finance services (e.g. for production and other agricultural loans). Banks, in particular, are mandated by Presidential Decree 711 (Agri-Agra Law) to set aside 25 percent of their total loanable portfolio for agriculture/fisheries and agrarian lending. On the other hand, NGOs, rural banks and cooperatives are considered the major providers of microfinance services according to the benchmarking report conducted by the Microfinance Council of the Philippines, Inc. (MCPI) and the Microfinance Information eXchange (MIX).

Bank lending to agriculture. According to reports of the *Bangko Sentral ng Pilipinas* (BSP), the combined loans granted to the agri-fishery and forestry sectors (AFF) in 2006 amounted to P584.6 billion, a mere 3.3 percent of the total credit disbursements of P17.9 trillion by the banking system. Nonetheless, total agricultural loans granted increased by as much as 12 percent, which is a half percentage point higher than the growth rate in 2005.

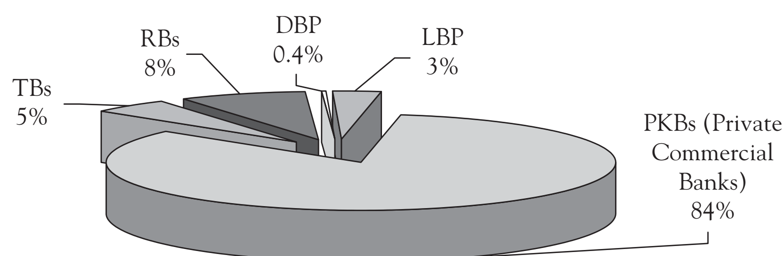
Among financial institutions, private commercial banks (PKBs) remained the major source of loans for the AFF sector because of their sheer size and huge capitalization. For 2006, PKBs accounted for nearly 84 percent of all loans granted to the sector, or 2.7 percent of the loans channeled by these institutions to all the sectors of the economy. Meanwhile, loans granted by the Land Bank of the Philippines (P18.5 billion) increased by 18 percent. Loans granted by rural banks have also consistently increased every year since 2000, with the highest increase registered in 2006 at P44.25 billion (See Table 6 and Figure 1).

Table 6. Agricultural Loans Granted, By Type of Bank (Amounts in PM)

Financial Institution	2005		2006		Percent Increase (Decrease)
	Amount	Percent Share	Amount	Percent Share	
Government Banks	29,124.6	5.6	20,969.2	3.6	(28.0)
DBP	13,437.3	2.6	2,436.6	0.4	(81.9)
LBP	15,687.3	3.0	18,532.5	3.2	18.1
Private Banks	492,573.7	94.4	563,661.6	96.4	14.4
PKBs	428,968.1	82.2	488,266.9	83.5	13.8
TBs	25,197.8	4.8	31,143.7	5.3	23.6
PDBs	2,994.6	0.6	3,080.5	0.5	(2.9)
SMBs	17,879.7	3.4	22,859.0	3.9	27.8
SSLAs	4,323.6	0.8	5,204.2	0.9	20.4
RBs	38,407.7	7.4	44,251.0	7.6	15.2
TOTAL	**521,698.3**	**100.0**	**584,630.7**	**100.0**	

Source: Agricultural Credit Policy Council 2006 Annual Report.

Figure 1. Banks' Loans Granted to Agriculture, Fisheries and Forestry, 2006 by Type of Banks, percentage



Source: Agricultural Credit Policy Council 2006 Annual Report.

Among commercial banks, the Land Bank of the Philippines is particularly mandated by law to provide financial services to small farmers and fisherfolk. It is by far the largest formal credit institution in the countryside and services more than 5,000 cooperatives and farmers groups benefiting about 500,000 small farmers and fishfolk. The bank provides credit to small farmers and fisherfolk through cooperatives and rural financial institutions (e.g. rural banks and cooperative rural banks) to finance various livelihood projects, which include the production of agricultural crops, livestock/cattle raising and the acquisition of pre- and post-harvest facilities, among others.

On the other hand, the Quedan and Rural Credit Guarantee Corporation (QUEDANCOR), a non-bank government financial institution, also caters to the credit needs of small farmers and fisherfolk. In 2006, QUEDANCOR facilitated the release of P3.6 billion in loans and guarantee assistance nationwide.

The Onset of Microfinance. Microfinance is currently one of the ten-point agenda identified in the MTPDP for 2004-2010 as one of the more significant tools favored by the current administration for poverty reduction. As mentioned, the MIX/MCPI benchmarking reports NGOs, rural banks, and cooperatives as the three major providers of microfinance services in the Philippines. The report estimated that 500 NGOs, 195 banks and 4,579 savings and credit cooperatives are currently engaged in microfinance. Many other types of registered cooperatives also provide some form of financial services. As of September 30, 2007, BSP reports 224 banks engaged in microfinance, 8 of which are microfinance-oriented rural banks with an outreach of about 819,000 clients and loan portfolio of Ph7.8B.

The National Credit Council also reports that as of June 30, 2007, 2.7 of 3.9 million poor households have been reached by microfinance and a total of P70 billion had been released within 3 years since 2004.

Table 7 shows the main microfinance providers with their amount of gross loan portfolio and number of active borrowers (as of December 2005):

The informal lending market. Llanto [2004] cites the continued existence of informal credit markets as evidence of excess demand for credit from a significant segment of the borrowing population that the formal institutions can not satisfy. Factors such as information asymmetry, transaction costs and risk costs make it difficult for formal institutions to serve the rural areas without incurring losses. Informal lenders, on the other hand, are able to hurdle the information barrier in rural credit markets and maintain low transaction costs, making their lending operations cost-effective. Various credit arrangements allow the informal lender to eliminate or minimize the costs of information, monitoring and enforcement. For instance, they have the liberty of setting the loan interest rates, which many consider as already usurious. Interlinking credit with other markets is another commonplace arrangement, particularly in the Philippines. The threat of withdrawing future credit to prevent default also works well particularly in credit markets practicing segmentation. However, the rural borrower and the lender know each other well enough for the latter to form a more accurate probability distribution of the former's default risk and factor it into the loan contract. The information wedge can thus be easily eliminated because both transactors operate within the same or familiar socio-cultural and economic milieu. The informal lender has the distinct comparative advantage of knowing his borrower and the specific rural community where the borrower lives. He also has at his disposal a reliable (although informal) communication network and a set of informants that help him assess the likelihood of repayment and default.

Table 7. Major Microfinance Providers and Selected Indicators

Microfinance Institution	Charter Type	Gross Loan Portfolio (PhP)	Gross Loan Portfolio (US$)	Number of active borrowers
TSPI Development Corporation	NGO	613,728,146	11,565,156	151,714
Taytay sa Kauswagan, Inc. (TSKI)	NGO	603,269,563	11,368,074	162,867
Center for Agricultural and Rural Development (CARD), Inc.	NGO	473,828,363	8,928,870	109,477
Negros Women for Tomorrow Foundation (NWTF), Inc.	NGO	356,368,241	6,715,440	67,982
CARD Bank, Inc.	Rural Bank	281,213,999	5,299,225	31,479
CCT Credit Cooperative	Cooperative	247,342,519	4,660,948	63,084
Kabalikat para sa Maunlad na Buhay, Inc.	NGO	231,989,325	4,371,631	80,078
New Rural Bank of San Leonardo, Inc. (June 2005)*	Rural Bank	160,071,772	3,016,409	15,699
Opportunity Microfinance Bank, Inc.	Thrift Bank	137,984,972	2,600,203	23,044
ABS-CBN Bayan Foundation, Inc. (December 2004)	NGO	137,382,059	2,588,842	38,422
Producers Rural Banking Corporation (December 2004)*	Rural Bank	122,529,316	2,308,955	24,336
Alalay sa Kaunlaran sa Gitnang Luzon, Incorporated	NGO	103,059,979	1,942,073	31,099

* Data for Producers and NRB San Leonardo cover their microfinance operations only.

Note: ER December 2005: US$1 = PhP 53.067

Source: MIX/MCPI Benchmarking 2004 Report.

Tolentino [1987] also notes that, compared to banks, informal lenders are very accessible to borrowers, often providing the loan at the farmer's house, and collecting the repayment at the farmgate. In addition, payments in kind are accepted in many cases. Informal lenders also demand minimum processing and paperwork and lend not only for production but for consumption purposes as well.

Informal Lending Still Persists… Despite the outreach of Landbank, QUEDANCOR, and other formal and semi-formal rural financial intermediaries, a sizeable number of small farmers and fisherfolk still flock to the informal sector for their loans albeit at a decreasing rate as shown by the 2005 Small Farmer Credit Access Survey conducted by the ACPC. Of the 813 borrowers surveyed, 44 percent have accessed their loans purely from formal institutions while 48 percent reported that they have availed only from informal institutions. Around 8 percent claimed that they sourced their loans from both institutions.

…But increasing trend in formal borrowing continues. Over the past four surveys covering the period 1996-2005, data show that formal sources have slowly penetrated the rural market which used to be the turf of informal lenders. There is an up trend of borrowing from formal sources with an average increase of about 25 percent. The largest increase occurred from 1996 to 2000 at 60 percent. Borrowing from informal institutions, in contrast, is on the down trend which has an average decline of 14 percent over the 4 survey periods (see Table 8). If the trend continues (treating other factors equal), informal lenders may be overtaken by formal sources in the coming survey periods.

Table 8. Borrowing by Major Source of Loans: 1996-2005

Loan Source	1996-1997 %	1999-2000 %	2001-2002 %	2004-2005 %
Formal	24.0	38.6	40.0	44.0
Informal	76.0	61.3	60.0	48.0
Both formal and informal				8.0
TOTAL	**100.0**	**100.0**	**100.0**	**100.0**

2.2 Institutional Structure

The Philippines has two levels of rural finance delivery: wholesale and retail. The main players at the wholesale level include Land Bank of the Philippines, People's Credit and Finance Corporation (PCFC), Development Bank of the Philippines and Small Business Corporation. Those that provide rural finance/microfinance services directly to clients include: rural banks, NGOs and credit cooperatives. In addition, there are two thrift banks with main focus on the provision of microfinance services[2]. Some cooperative rural banks, that is, rural banks owned by primary cooperatives are also engaged in microfinance. The Bangko Sentral ng Pilipinas (BSP) classifies banks engaged in microfinance into two broad categories: (a) microfinance banks and (b) microfinance-oriented banks. Microfinance banks are those whose loan portfolios are 100 percent microfinance loans. On the other hand, microfinance-oriented banks are those banks whose microfinance loans comprise at least 50 percent of their gross loan portfolio.

2.2.1 Main Players: Wholesale Level

2.2.1.1 Land Bank of the Philippines

By far, the largest single source of credit to small farmers and fisherfolk is the *Landbank*, which was established in 1963 to purchase landholdings and finance their distribution to tenants under the Agricultural Land Reform Code of that year. It is fully owned by the government with a capitalization of P1.8 billion. In 1973, it was given a license to operate as a universal bank and it has steadily stepped up its support of agrarian reform operations as their scope has widened through the series of land reform acts over the years.

The Landbank is organized into three sectors: (a) the Agrarian Sector which provides lending and extension services to agrarian reform beneficiaries, in particular and small farmer in general; (b) the Banking Sector which handles its commercial banking functions; and (c) the Executive Operations Support Sector which provides administrative support.

The semi-formal financial sector (composed of cooperatives and NGOs) is handled by the Field Operations Group in the agrarian sector staff, through a network of field offices at the regional and provincial level. Also part of the agrarian sector staff is the Countryside Financial Institutions Group, which is responsible for accrediting Rural Banks and processing rediscounting lines to them and equity infusion as part of the scheme to strengthen them.

[2] The two thrift banks have been established by private investors to focus on microfinance activities. They are thus, called 'microfinance-oriented' thrift banks. In general, thrift and commercial banks are not engaged in microfinance because they are not structured to handle very small loans without collateral. The commercial banks and thrift banks cater to bigger clientele who provide the traditional collateral such as real estate, commercial papers, etc. The structure of the Philippine banking system is shown in Annex 1-4.

Regular commercial lending, including that to private and corporate agriculture, is handled by banking sector staff through a separate branch network.

Under the Comprehensive Agrarian Reform Law (CARL) of 1987, Landbank has primary responsibility for land valuation and payment of compensation to land owners under the Comprehensive Agrarian Reform Program (CARP), and for collection of land amortization payments from Agrarian Reform Beneficiaries (ARBs). To further expand its outreach of ARBs/small farmers, it adopted the strategy of wholesaling funds through cooperatives or through private rural financial institutions such as rural banks through the Landbank's rediscounting program.

With the wholesale lending thrust, Landbank employed a Cooperative Accreditation Criteria in 1994. The objective is to rationalize and systematize the delivery of financial and technical assistance to bank-assisted cooperatives (BACs). A set of criteria is applied to cooperatives to enable the Field Offices to assess, rationalize and calibrate credit assistance to BACs based on their loan absorptive capacity; and to plan and implement timely, adequate and necessary measures to graduate BACs to a higher level of growth. To access appropriate financial and technical assistance a cooperative must first meet a set of performance standards and credit requirement. The accreditation criteria depend on whether the cooperative is a newly accessing cooperative or an existing bank-assisted cooperative. Eligible projects range from crop and livestock production, post-harvest and processing activities, cottage industries, irrigation facilities to other income-generating projects.

Landbank's lending facilities in support of countryside development can be classified into three broad programs: (a) Cooperative Credit Delivery Program for financing cooperatives' projects; (b) RFI Rediscounting Program for the liquidity requirements of accredited rural financial institutions (RFIs) including rural banks, cooperative rural banks, private development banks, stock savings and loan associations; and (c) Special Financing Programs which are being implemented by or in coordination with other government agencies.

Landbank is also tasked to implement the AFMA-mandated Agro-Industry Modernization Credit and Financing Program or the AMCFP as one of the program's wholesalers. As provided for in the Agriculture and Fisheries Modernization Act (AFMA) or RA 8435 of 1997, the AMCFP is meant to replace the different credit programs under the Department of Agriculture in order to make credit delivery to small farmers and fisherfolk efficient, responsive and sustainable.

In 1995, the Landbank fully capitalized the *People's Credit and Finance Corporation (PCFC)* as its principal arm in lending to the poor. PCFC became fully operational in June 1996. The objective is to use PCFC for poverty alleviation lending programs.

More recently, the Landbank has also decided to play an active role in microfinance. It has recently launched a nationwide microfinance program. It expects to have a complementary role with PCFC in providing wholesale loans to various MFIs. Before this happened, Landbank's involvement in microfinance has been mainly to guarantee the loans obtained from ADB-IFAD and the World Bank for the funding needs of PCFC. The loans of Landbank to PCFC is in the amount of 1.62 billion pesos as of December 31, 2003. Before the pilot test of 12 microfinance accounts, Landbank has not lent directly to microfinance institutions (MFIs) at the retail level although some bank officers believe they have actually been doing microfinance through rural banks and cooperatives under their other programs.

Landbank has an extensive network presence in 79 provinces of the country with 356 field units (285 branches, 38 extension offices and 33 lending centers). The Bank has a total of 731 ATM units located in strategic areas throughout the country. It has manpower complement of 7,106 personnel as of December 31, 2006.

In 2006, Landbank attained a net income of P3.5 billion which is 17 percent higher than its 2005 net income of P3.01 billion. Landbank was able to surpass its year-end net income target of P3.3 billion by 7 percent.

Landbank performed very well in terms of major performance indicators. Resources increased by P50.3 million or 16 percent from P310.4 billion to P360.7 billion. Deposits grew by P24.9 million or 10 percent from P242.8 billion to P267.7 billion. Capital improved by P8.9 billion or 36 percent from P24.7 billion to P33.6 billion. Its loan portfolio grew by 15.6 percent from P120.6 billion to P139.5 billion.

Because of this, Landbank was able to maintain its ranking among the top five banks in the industry.

Landbank's Rural Finance/Microfinance Programs. To date, 68 percent (Peso82 billion) of Landbank's loan portfolio are in direct support of agricultural related projects including agribusiness, trading, processing and infrastructure. On top of the regular agri-production and infrastructure lending programs, the Landbank also implements various program approaches to provide a more holistic assistance to the clients. These programs include:

TODO UNLAD Program. TODO UNLAD stands for Total Development Options Unified Lending Approach for Development. It is Landbank's flagship program for countryside development and implemented in Phases (Enterprise Development Phase and Integrated Area Development Phase). Through its various lending programs and support services, TODO UNLAD links cooperatives, local government units, private corporations, small and medium enterprises and non-government organizations in specific areas. TODO UNLAD promotes synergy of effort and resources among the key players in the area. It hopes to increase productivity, improve basic infrastructure and pave the way towards industrialization by linking producers, processors and markets.

TODO UNLAD projects are composed of a combination of two or more of any of the following loans or services: 1. local government lending, 2. commercial lending, 3. cooperative lending, 4. production or post harvest-facilities financing, 4. market matching and production, marketing and management agreements, 5. cooperative strengthening, 6. LGU advisory services, 7. import/export financing and 8. integrated loan packages for agrarian reform communities.

Among the Program's features and characteristics include the following: 1. integrated packaging of lending services for local government units, 2. private sector, 3. cooperatives and 4. rural financial institutions.

ACCESS Program. ACCESS stands for Accelerating Change in the Countryside thru Equity Sharing Strategy. ACCESS is an initiative of Landbank aimed at inviting key players in rural development (farmers and fisherfolk cooperatives and their federations, private entities, non-government organizations, LGUs and other interested investors) to become partners of the Bank in undertaking equity investments in agri-related or off-farm economic

projects. It aims to catalyze countryside development by promoting livelihood and rural employment, and by priming up local agri-related and off-farm economic projects to raise productivity and income in priority areas of the Philippines. Program features include equity investment, provision of professional management team, technology transfer and marketing assistance and equity divestment.

Landbank provides equity investment to augment the financial strength of farmers, fisherfolk, cooperatives, NGOs, LGUs, private entities, and other interested investors, to engage in new economic ventures or expand existing economic projects through pooling of resources. The extent of partners' participation shall be determined based on capital requirement, viability, social and economic impact of the identified economic projects.

To ensure operational cost-effectiveness and efficiency of the new economic activity, the Program also promotes and facilitates the transfer of appropriate technology and marketing assistance to partner organizations.

The Program also makes provision for the tapping of professional management team to assist in project planning, implementation, and monitoring to ensure profitability and sustainability.

Another program component is equity divestment which refers to the gradual recovery of the Bank's equity investment for over a period of time depending on the projected cash flow of the economic projects but not to exceed 15 years.

Innovative Financing Scheme (IFS). The IFS is a joint program between the ACPC and Landbank. It is an alternative (non-traditional) way of financing the credit needs of small farmers and fisherfolk who are not eligible to access credit from formal lending institutions.

IFS is a non-traditional way of providing financing assistance to small farmers and fisherfolk who are not a member of Landbank's traditional conduits such as cooperatives and not eligible to borrow from other formal lending institutions.

This program calls for the participation of non-traditional lending agents such as agri-based enterprises (i.e., input suppliers, processors, rice millers, etc.), people's organizations and non-government organizations to provide financial assistance to small farmers and fisherfolk.

SME Unified Lending Opportunities for National Growth (SULONG). SULONG is a program jointly implemented by different government financial institutions (GFIs), composed of Landbank, Development Bank of the Philippines (DBP), National Livelihood Support Fund (NLSF), Philippine Export-Import Credit Agency (PHILEXIM), Quedan and Rural Credit Guarantee Corporation (QUEDANCOR), Social Security System (SSS) and Small Business and Guarantee and Finance Corporation (SBGFC) in support of the government's National Small and Medium Enterprise Development Plan. The Program adopts a simplified and unified lending procedure and guidelines, thereby enhancing the SME's access to credit fund from various GFIs with Landbank as the biggest contributor of credit funds.

Under the program, the SMEs may avail of credit funds to finance an export business, temporary/permanent working capital for any eligible business, purchase of equipment, or for the construction of building/warehouse to support their businesses for a maximum loan

amount of P5.0 M loan per borrower. To date, part of the P19.0 billion outstanding loans for MSMEs were lent in support to SULONG, the national government's credit flagship program.

LBP Microfinance Program for Microfinance Institution (MFI). The Microfinance Program of Landbank aims to support the government's thrusts of poverty alleviation and jobs generation. Under the Program, the Bank provides credit assistance to small farmers and fisherfolk and micro entrepreneurs to finance their livelihood projects through various Microfinance Institutions (MFIs) retailers and wholesalers.

The Landbank Microfinance Program is also in support to the government's call to address the credit requirements of the Barangay Micro Business Enterprises (BMEs) and the poor sector by opening a special wholesale financing window for various MFIs. The program aims to support government efforts to alleviate poverty by empowering the marginalized sector through the provision of microcredit. Landbank's microfinance loans are extended to retailers such as cooperatives, non-government organizations, and rural banks.

Landbank's MFI-retailers are the cooperatives, non-government organizations and countryside financial institutions (i.e., rural and cooperative banks) that passed the bank's accreditation criteria under the program. On the other hand, Landbank's existing MFI-wholesalers are the PCFC, and Philippine Business for Social Progress.

Similar to SULONG, a Microfinance Program Committee (MFPC) has been formed consisting of Landbank, PCFC, SBGFC, NLSF, DBP, National Anti-Poverty Commission (NAPC) and the Department of Social Welfare and Development (DSWD) for possible areas for convergence and coordination. Standardization of the lending criteria, to the extent possible, of all agency partners with microfinance lending operations is being worked out by the Committee.

Landbank Development Advocacy (DevAd) Program. The DevAd Program aims to generate a different perspective in lending to the mandated and priority sectors of the Bank. In lending to small farmers and fisherfolk and MSMEs, the DevAd Program will consider the core fundamentals of credit, but appreciate the same in the light of the peculiarities of the mandated/priority sectors.

In essence, the DevAd Program is an institutional approach to increase confidence in using new approaches/methodologies in extending loans to the small farmers and fisherfolk and MSMEs and other emerging markets.

Through the DevAd Program, the Bank hopes to further expand its reach and increase financial assistance to the small farmers and fisherfolk and MSMEs. The Bank will likewise hope to develop lending modalities/approaches that appreciate the use and strength of other credit instruments.

The Development Advocacy Fund (DAF) will be set up from the Landbank's internal funds, and will have an initial allocation of One Billion Pesos (P1.0 B). This will be used specifically to support new lending approaches, technologies and conduits, including emerging markets/products.

The loan portfolio supported by the DAF will be reviewed periodically, performance of which (loan portfolio) will determine whether or not the DAF will be increased.

Countryside Financial Institutions Enhancement Program (CFIEP). This is a joint program of the Bangko Sentral ng Pilipinas (Central Bank), LANDBANK and Philippine Deposit Insurance Corporation meant to strengthen the capital base of the RFIs. The program consists of three (3) modules, namely:

Module 1 – Purchase of Countryside Financial Institution (CFI) Arrearages with the CB. Under this module, the RFI is required to put in fresh capital equivalent to 50 percent of the total amount of arrearages where such amount shall be used to purchase Negotiable Promissory Notes (NPN) with face amount equivalent to twice the amount actually infused by the investor. The NPN will be used to redeem arrearages with the CB.

Module 2 – Landbank's equity investment program is extended to Rural Banks and Thrift Banks to strengthen their capital base where Landbank puts in capital in preferred shares not exceeding forty-nine percent of the bank's issued capital stocks. Landbank sits in the RFI board to ensure close monitoring of the bank's operations. The program has three (3) sub-modules such as developmental, business and risk recovery type. Developmental module is meant for newly-established bank and those undergoing merger, consolidation and acquisition. Business module is made available for relatively strong banks. Risk recovery is meant for banks that act as collecting agent for written-accounts in the Landbank's previous lending programs where 85 percent of the amount collected is converted into equity investment.

Module 3 – Merger, Consolidation and Acquisition Incentives. The amount of financial assistance shall be the amount that would generate income spread to the surviving or consolidated RFIs equivalent to 50 percent of the undercapitalized CFI's eligible non-performing loans and value of acquired assets.

Capacity Building and Enterprise Development Programs. As major development partner in the countryside, development assistance has been extended to support cooperatives. This is essentially aimed at improving the absorptive capacity of these cooperatives. Development assistance consists of two key interrelated components, namely, capacity and institution building (IB) and business or enterprise development (ED). IB interventions are meant to enhance the operations and economic viability, while ED support aims at increasing productivity and improving market efficiency of cooperatives. The most significant technical or development assistance being provided by the Bank to these cooperatives includes: (i) cooperative accreditation which involves evaluating the qualifications of potential/newly accessing cooperatives using the Cooperative Accreditation Criteria (CAC); and (ii) key cooperative strategy which aims to identify, strengthen, and accredit at least one key cooperative per municipality nationwide, which can act as LBP's valued development partner and credit conduit.

Integrated Rural Financing (IRF) Program. The IRF is a comprehensive financing program for small farmers and fisherfolk cooperatives. In partnership with the ACPC and the DA, cooperative development technicians (referred to as "Institution-building Specialists or IBS) provide on-site, hands-on technical support – business/enterprise project identification, planning, and packaging, marketing assistance, technology transfer, project monitoring and documentation, operations management training and the like to some 574 cooperatives in 12 regions and 29 provinces nationwide. Credit assistance is provided by Landbank, with P230 million seed fund from DA-ACPC.

The program is in consonance with the DA's present thrust of pursuing increased agricultural production and Landbank's expansion of agri-credit in the countryside. However, these can only be achieved through continued extension of development assistance to farmers and fisherfolk. The program directly supports the Agro-Industry Modernization Credit and Financing Program through provision of institution and capability building activities to farmers cooperatives.

The IRF program management structure consists of Executive Committee as the highest policy making body. It consists of Landbank, ACPC and DA. Supporting the Executive Committee is the Program Management Committee consisting of DA, QUEDANCOR, Cooperative Development Authority (CDA), ACPC and Landbank. The Program Management Office was established to undertake the day-to-day implementation of the program.

Landbank-Local Government Unit (LGU) Cooperative Strengthening Partnership Program. This Program is envisioned to enhance the partnership with the LGUs in cooperative strengthening thru identification, planning, and implementation of needed interventions and projects to hasten cooperative development under the 'resource-sharing arrangement.' The provincial or municipal government provides the necessary funds, on an annual basis, as its equity contribution to the Program to defray costs of cooperative strengthening activities, such as training, workshops, business development forums, etc. LGUs also provide seed or guarantee funds for those cooperatives that fall short of certain eligibility requirements for Landbank financing.

Gawad sa Pinakatanging Kooperatiba (Gawad Pitak). Over the years, Landbank has given recognition to model cooperatives that have exhibited exemplary performance as countryside developers. This is meant to showcase outstanding cooperative and cooperative banks in various categories such as agri-based, non-agri based cooperatives, cooperative rural banks, ginintuang Gawad Pitak, Hall of Fame, and Special Awards, to inspire other cooperatives to perform and strive harder in their business operations.

The Gawad Pitak Program targets the thousands of active cooperatives operating in all parts of the country that have pooled their resources and expertise to uplift the lives of their member and their communities.

Technology Promotion Centers (TPCs). The TPC Program is a partnership among Landbank and state universities and colleges (SUCs) for field testing and commercialization of matured and viable agri-based technologies for adoption by farmers and fisherfolk. The basic strategy is for SUCs to undertake inventory of agri-based technologies that had been developed through research. Such technology shall be validated through field testing to determine suitability and viability. Only those technologies proven viable will be commercialized and financed by Landbank. On the other hand, private entities, called Private Technology Providers, are also allowed to validate and promote their developed technologies thru the TPC.

2.2.2 The People's Credit and Finance Corporation

The leading Philippine government agency on microfinance is the People's Credit and Finance Corporation (PCFC). It was established in June 1996 as a subsidiary of Landbank of the Philippines. The objective is for PCFC to focus on poverty alleviation lending programs while Landbank concentrates on its mandate to be the financing arm of agrarian reform and to service the agriculture sector's growing demand for financial services.

The PCFC provides credit to accredited NGOs, financial institutions and people's organizations, collectively called "program partners", that implement credit assistance programs for the poor. It also provides credit for institution and capability building activities related to the lending program. Its institutional policy for reaching the poor is to deliver credit to the twenty priority provinces considered the poorest in the country based on poverty incidence statistics. The PCFC also aims to cover 57 provinces in 12 regions. Targeting the poorest provinces forms part of the government's development agenda to fight poverty in rural as well as in the urban sectors.

To implement PCFC's programs are its account officers in all the regions of the country. These officers usually have accounting, economics or development studies degrees. They do partial credit investigation, processing of application documents, conduct financial analysis, prepare program proposals, conduct field validation and monitoring. The account officer is the front-liner of the organization in the field and deals directly with clients.

PCFC encourages the formation of self-help groups basically because it lends to NGOs who utilize the Grameen Bank technology and its variants. The corporation views the SHGs as essential in instilling credit discipline and in enforcing repayment. The NGOs are basically the ones in charge of the group formation. Formation is done within the targeted population. There are five self-chosen members but not more than one member coming from the same household. Officers are rotated. Contiguous group training is conducted where there are discussions on benefits, responsibilities, rules and regulations, compulsory savings and verbal contracts. After the training, there is a group recognition test where there is a verification of the eligibility criteria and verbal testing of prospective members.

2.2.3 Small Business Corporation (SB Corp.)

The SB Corporation is the result of a merger between the Small Business Guarantee and Finance Corporation (SBGFC) and the Guarantee Fund for Small and Medium Enterprises (GFSME). SBGFC was created under a law passed by Congress in 1991 and amended in 1998. The law is known as the Magna Carta for Small and Medium Enterprises. SB Corporation is under the direct supervision of the Department of Trade and Industry. The accounts of SB Corporation are examined by the Bangko Sentral ng Pilipinas (BSP) and the Commission on Audit. The mandate of SB Corporation to undertake microfinance operations is included in the BMBE Act of 2002. Its existing loan portfolio consists largely of loans to small and medium enterprises (SMEs) and only a small fraction for microfinance.

2.2.4 Development Bank of the Philippines (DBP)

DBP was established by an act of Congress in 1949. It had its origins in the defunct Rehabilitation and Finance Corporation (RFC) which was established after the Second World War to help finance the reconstruction and rehabilitation efforts designed to revive the war-ravaged economy. RFC was renamed DBP in the late 50s'. DBP is a development bank catering mainly to small and medium enterprises (SMEs). The bank is under the administrative supervision of the Department of Finance and also under the regulatory supervision of the BSP. It is likewise audited by the Commission on Audit. Its mandate to undertake microfinance operations is spelled out under the BMBE Act of 2002. Under the bank's Window III operations[3], the bank has allocated the amount of 500 million pesos for wholesale lending to retail MFIs. DBP is relatively new to microfinance. Its main clientele are SMEs, mostly those in the manufacturing and agri-based processing sectors.

[3] Window III is a special loan facility established by the bank to serve the microcredit needs of the urban and rural poor sectors.

2.2.5 Quedan Guarantee Corporation (QUEDANCOR)

The Quedan Guarantee Corporation (QUEDANCOR) was created by an act of Congress, namely, R.A. 7393. Its primary purpose is to accelerate the flow of investments into the countryside in order to increase productivity, livelihood and income opportunities. Under R.A. 8435 known as the Agriculture and Fisheries Modernization Act (AFMA), QUEDANCOR is mandated to manage the agriculture and fisheries credit guarantee fund to enable it to focus on providing guarantees to the loans of small farmers and fisherfolk. The intention of the AFMA law is for QUEDANCOR to provide guarantees to loans and not necessarily extend direct credit to farmers and fisherfolk. Discussions with the National Credit Council (NCC) identified the LBP and PCFC as the major wholesale loan providers for microfinance. QUEDANCOR's focus should be on providing loan guarantees to small farmer loans.

2.2.6 Bangko Sentral ng Pilipinas (BSP)

Bangko Sentral ng Pilipinas opened a rediscounting window for microfinance in support of the provisions of R.A. 8791 or The General Banking Law of 2000 (R.A. 8791). Specific provisions in the law indicate the need for the Monetary Board to consider the "peculiar characteristics of microfinancing" (Sec. 40, R.A. 8791) and for the Monetary Board to "regulate the interest imposed on microfinance borrowers by lending investors and similar lenders" (Sec. 43, 8791). Bangko Sentral's major objective in opening said rediscounting facility is to support those banks that have achieved efficiency in their microfinance activities while adhering to BSP standards. The BSP rediscounting facility for MFIs targets those that are able to meet the following eligibility requirements: (1) a one-year track record in microfinance; (2) those with at least 200 borrowers; and (3) a repayment rate of not less than 95 percent during the preceding twelve month period. The BSP also requires the submission of a policy manual on the MFI operations of applicant-banks.

Data from BSP indicate a total number of 220 banks engaged in microfinance, 8 of which are microfinance-oriented banks with an outreach of about 700,000 clients as of September 30, 2007.

2.3 Institutional Players at the Retail Level

Recent data on the state of rural finance/microfinance in the Philippines indicate that the potential suppliers of loans at the retail level include 1,809 rural banks (including branches); about 300 NGOs; 462 credit cooperatives; 7,513 pawnshops; and 2,594 lending investors (Llanto, 2000).

2.3.1 Rural Banks

Rural Banks are private banks that were established in the 1950s with government assistance and subsidies, to service the agricultural sector. They constitute a system of unit banks that is unique in the developing world, and many of them grew out of the operations of moneylenders. They participated heavily during 1973-81 in the Masagana 99 credit program that aimed to bring about self-sufficiency in rice production. Through special deposits and rediscount facilities, the government provided about P6 billion of subsidized and uncollateralized production loans, through them, 80 percent of which were never recovered. This and the discontinuation of rediscount lines in 1985 led to widespread closures. About 850 of these banks were rehabilitated by Bangko Sentral ng Pilipinas.

To date, there are 754 rural banks, 54 if which are cooperative rural banks. In addition to the 754 head offices, the rural banking system has 1,305 banches and offices for a total network of 2,059 bank units.

Rural banks are present in 106 out of 114 cities and in 753 out of 1,493 municipalities. About 71 percent of the municipalities covered by the rural banking system are classified as 3rd, 4th, 5th, and 6th class municipalities. As such, the rural banking system is a potential dominant player in the microfinance sector. The system is a significant partner of the Landbank in countryside development.

Rural banks in general are familiar with individual lending as this is the methodology employed in their regular banking operations. The individual lending approach targeted to poor clients was formally promoted among the rural banks by a USAID-funded project, called the Microenterprise Access to Banking Services (MABS). The MABS Program provides technical assistance and training to rural banks in microfinance best practices. The program is designed to develop the capability of rural banks to profitable provide financial services to microenterprises. The MABS approach involves training and technical assistance geared toward understanding microfinance best practices. On the other hand, about 15 rural banks also learned the group lending methodology generally patterned after the Grameen Bank Approach (GBA) to microlending. Rural banks that had an early start on GBA are reporting higher than average outreach compared to other RBs that are into individual lending. RBs using the GBA are among the top-ranked conduits of PCFC.

Under regular banking operations, the clients of rural banks generally belong to the non-poor. In this case, rural banks require collateral which, in effect, prevents access by the poor to banking services. Thus, for their microfinance operations, rural banks target microenterprises based on cash-flow lending, requiring no collateral from the borrowers. Rural banks target the entrepreneurial poor located in and around centers and small cities. Lending rates to microenterpreneurs are in the range of 24 percent to 30 percent per annum, computed on a flat rate basis. The rates include payment of upfront service fees, commonly in the range of 2 percent to 5 percent. Frequency of loan collection for microfinance loans is either daily or weekly. Majority of loans are collected on a weekly basis.

Moreover, rural banks are authorized by law to collect savings from the public. Under the MABS approach, rural banks are trained to mobilize savings from micro depositors. One significant achievement of the MABS program is that the number of micro deposit accounts has increased to four times the number of micro loans. The amount of the aggregate micro deposits is approaching the aggregate value of micro loans outstanding. This fact suggests that rural banks are able to finance their micro loans with micro deposits mobilized from the public.

Rural banks are supervised and regulated by the BSP. Most rural banks are members of the Rural Bankers Association of the Philippines (RBAP), a national tertiary organization for rural banks. These banks are also members of their own provincial networks and regional federations. RBAP and the regional federations are effective lobby groups that advocate for policy change. One constraint identified by rural banks in expanding their microfinance operations is the very slow process exhibited by the BSP in approving applications for the opening of new branches. Rural banks view the BSP process for approving new branches as very conservative.

Managers of rural banks engaged in microfinance claim that microfinance best practices like zero tolerance for delinquency and enforcement of strict credit discipline have positively affected their normal rural bank lending operations. Staff in-charge of regular banking operations are learning good practices from the microfinance unit of the bank. As such, significant improvements in

financial performance are being felt by rural banks that established microfinance operations. Some rural banks also continue to innovate and come up with new financial products that address the needs of their respective clients.

2.3.2 The Cooperative Sector

The Cooperative Development Authority (CDA) supervises the registration of cooperatives in the country. CDA reports that cooperatives have grown rapidly in recent years from a total of 2,888 cooperatives and pre-cooperatives (or Samahang Nayon) in 1987 (according to a census conducted by NATCCO, in that year) to over 60,000 registered with the CDA as of end June 2004. One reason for this rapid growth could be the encouragement given to cooperative formation during the "people power" administration of President Aquino in 1986 and the liberalized rules for registration. In the Marcos era, no cooperative could be formed without going through the government sponsored pre-cooperative or Samahang Nayon, or village association stage. At their peak were about 20,000 Samahang Nayon which collapsed following the termination of the Masagana 99 Program of cheap credit in the 1970s. Another reason could be the massive expansion on the use of cooperatives as conduits for small farmer credit by the Landbank, which has formed and assisted over 10,000 cooperatives since 1987.

There are several types of cooperatives: multi-purpose cooperatives, consumer cooperatives, marketing cooperatives, savings and credit cooperatives, housing cooperatives and electricity distribution cooperatives. CDA estimates that 50 percent of registered cooperatives or 33,000 are functioning. While Credit cooperatives used to account for about half of the total number of cooperatives, multi-purpose coops now dominate the rest, with a share of about 85 percent. However, many of them are multi-purpose only in name, at least so far, since the Landbank encourages its cooperatives to register as multi-purpose so as to avoid having to re-register should they engage in other activities later. By coverage of membership, cooperatives are also classified into "institutional" (i.e., those restricted to the employees of an institution, such as the office employees of a company), and "community", where membership is open to all residents, say, of a municipality. However, there are many overlapping categories such as "market" based, whose members are the vendors in a public market, and who are organized in their own national federation like the National Market Vendors Cooperatives Service Federation, Inc. (NAMVESCO). During the period 1973-1986, while the government development policy focused on assisting agricultural, electric and transport cooperatives, the other sectors in the cooperative movement were left on their own with little support from the government. This was a blessing in disguise because these non-agricultural cooperatives pursued a self-reliant and progressive development that contributed to their business viability and success.

A network of regional cooperatives training centers was established by the private sector initially to provide cooperative training and education services to cooperatives and self-help groups. Later on, these centers branched out to provide management consultancy services, inter-lending and inter-trading programs among its members and affiliates. These centers are located in five areas, namely: the Mindanao Alliance of Self-help Societies and the Southern Philippines Educational Cooperative Center (MASSSPECC) to serve the Mindanao cooperatives; the Visayas Cooperative Development Center, Inc. (VICTO) to serve the cooperatives in the Visayas; the Northern Luzon Cooperative Development Center, Inc. (NORLU) to serve the cooperatives in the Mountain Province and Northern Luzon; the Tagalog Cooperative Development and Education Center, Inc. (TAGCODEC) for the cooperatives of Metro Manila and the Tagalog provinces; and the Bicol Cooperative Development Center, Inc. (BCDC). These regional cooperative training centers formed a national association in June, 1977 now known as the National Confederation of Cooperatives (NATCCO).

Other tertiary federations/unions of cooperatives operating nationally include the Philippines Federation of Credit Cooperatives Inc. (PFCCI); Federation of Free Farmers Cooperatives, Inc. (FFFCI) and the NAMVESCO. Many primary cooperatives and provincial and regional federations are affiliated to more than one of the national federations and draw services from the latter on a selective basis. NATCCO, PFCCI, FFFCI and NAMVESCO representing the four privately initiated cooperative movements in the country, have come together to form the National Cooperative Advisory Council (NCAC) – an informal, non-registered body which liaises regularly on cooperative issues. NCAC officially represents the four federations in advocacy, lobbying and legislative activities.

The principal services provided by the national/regional federations to their affiliates comprise: (a) training in cooperative principles, leadership and management and in accountancy, bookkeeping and auditing; (b) audit services; (c) consultancy and advisory services to member cooperatives; (d) inter-lending through the establishment of a central fund system involving both lending of self-generated funds between member cooperatives and the channeling of additional externally sourced funds; (e) assistance with business development; and (f) inter-trading programs among affiliates.

Cooperatives have recently become active in providing microfinance services through their affiliation as program partners of PCFC. Cooperatives engaged in microfinance are community-based open-type savings and credit cooperatives. Data from CDA indicate that there are around 100 savings and credit cooperatives that have assets exceeding 100 million pesos. Around 50 coops are deemed to be engaged in microfinance operations. This figure is partly confirmed by the number of cooperatives (50) reported as conduits of PCFC, having an aggregate loan portfolio of 485 million pesos.

With respect to methodology, cooperatives generally employ the individual lending methodology in their lending operations. The current practice is to lend amounts that are a factor of the value of share capital and savings deposit of the member-borrower. Cash flow-based lending is slowly being accepted as a better lending method by cooperatives. A microfinance methodology, essentially based on solidarity group lending was introduced by a USAID-funded project namely the Credit Union Empowerment and Strengthening (CUES) Project. The microfinance methodology, called Savings and Credit with Education (SCWE) targets poor women as clients.

Membership rules in open-type, community-based savings and credit cooperatives do not distinguish between poor and non-poor members. While the SCWE methodology specifically targets poor women, the self-selection process in solidarity group lending tends to screen out the very poor in entering the program.

Savings and credit cooperatives charge interest rates on loans to members ranging from 18 percent to 24 percent per annum. Some cooperatives additionally charge an upfront service fee ranging from 2 percent to 5 percent on loans. Collection frequency on loans is weekly, bi-weekly or monthly. Cooperatives are authorized by law to collect savings from their members. They submit required reports annually to the CDA but remain largely unsupervised and unregulated. A number of cooperatives are affiliated with tertiary organizations like the National Confederation of Cooperatives (NATCCO) and the Philippine Federation of Credit Cooperatives (PFCCO). Cooperatives tend to operate within the municipality where they are registered. Opening a branch in other municipalities outside the original place of registration generally includes informing any registered cooperative operating in the locality about the planned establishment of a branch in the said area.

Like the rural banking system, the cooperative sector has a big potential to be a significant player in microfinance because of its extensive network. However, there are too few financially strong cooperatives; great efforts need to be exerted to build up the capacity of cooperatives to undertake microfinance in a sustainable manner.

2.3.3 Non-Government Organizations

There are more than 30,000 Non-Government Organizations (NGOs) registered with the Securities and Exchange Commission as private, non-profit foundations, although only a small number of these, say two to four thousand are developmental in the strict sense of the term. NGOs received a major impetus under the 1986 constitution which requires the State "to encourage non-governmental and community-based organizations" and under Cabinet Decision 29 of the Aquino administration which calls for the nine line agencies and several government corporations implementing livelihood programs to directly channel all future assistance through financial institutions or NGOs as conduits.

Most NGOs are small and highly localized organizations with a small full-time staff. Because of their strong social orientation including value formation and community organizing, their operational cost tends to be high. Many of them see their role as organizing cooperatives or associations that will eventually be in a position to access credit directly. There are a growing number of them, however, that see a continuing role for themselves in delivering credit especially to the poorest of the poor and there are some NGOs in fact that undertake only microfinance projects.

It was originally estimated that around 300 NGOs were involved in some form of delivery of microcredit to the poor, but slightly over a hundred NGOs responded to a survey conducted in 1998 by the Microfinance Council of the Philippines. NGOs with a respectable size of operation in microfinance number around 30. The responses of microfinance NGOs to questions in this survey reflect their continuing commitment to service the needs of poor people. Survey results show that most NGO respondents provide small-sized loans and are reaching more clients, indicating to a large extent that poor clients are being reached with microfinance services albeit on a limited scale. Further, a growing awareness on the characteristics of the poor prompted most of them to focus on specific poverty sectors: small farmers and fishing communities, women, market vendors, and marginal entrepreneurs.

Survey results indicate further that the inability of a number of microfinance NGOs to provide information for this survey, particularly financial data, is one of the glaring evidences of their poor record-keeping practices. This further translates to capacity and institutional problems that could be a result of failure to effectively monitor basic performance indictors, identify problems and areas for strengthening, and come up with appropriate measures and interventions. Furthermore, varying accounting practices did not allow accurate presentation of some statistics on financial performance. These findings put emphasis on the need to standardize reporting among microfinance NGOs and upgrade record-keeping capacities.

However, there are microfinance NGOs, albeit small in number, which are performing well. Presumably, these are institutions which, through the years, have steadily expanded in terms of microfinance operations, outreach and assets and have reached desirable levels of sufficiency and efficiency. In fact, the sector can be seen as having two extremes: the bigger, more established NGOs, and the smaller ones. There is hardly a sector in between.

The presence of two extremes in the sector should not be seen as a setback against the microfinance NGOs' continuing role in poverty alleviation. Instead, the extremes may be seen as an indication that there are institutions which have succeeded and are successfully operating microfinance operations. In a sector still within its youth, much interaction can transpire between the two to somehow bridge the gap, and with the appropriate interventions, there is potential toward greater outreach and sustainability.

With respect to methodology, the NGO sector engaged in microfinance is the chief proponent of the group lending methodology, essentially patterned after the Grameen Bank Approach (GBA) to microlending. The experience of NGOs in GBA spans a period of more than 15 years. GBA is the preferred methodology by NGOs due to its feature of group accountability for loans. The introduction of the ASA methodology by a UNDP-funded project called Microfinance Support Program (MSP) is overhauling the group lending methodology by doing away with the group accountability feature. Groups are still formed in the ASA method but group members are solely accountable for the payment of their respective loans.

Both the GBA and ASA methodologies specifically target the poor, especially women with existing microenterprises. GBA and ASA utilize the Housing Index and the means test to screen out the non-poor from entering the microfinance program.

NGOs generally charge interest on loans at rates ranging from 24 percent to 40 percent per annum flat rate, inclusive of upfront service fees of 2 percent to 5 percent. Collection of loan payments is done weekly. NGOs are not expressly authorized by law to collect deposits from the public but nevertheless collect compulsory savings from member-borrowers as a form of compensating balance for members' outstanding loans. NGOs are not supervised nor regulated by any government agency. They are, however, required by law to submit audited financial statements to the SEC.

NGOs with a sizeable scale of operations are affiliated with the Microfinance Council of the Philippines. Another network, the Alliance of Philippine Partners for Enterprise Development (APPEND), groups together Christian development organizations engaged in microfinance. NGOs have no visible constraint to branch expansion. They can establish branches in any place they want to. Inadequate funding is generally the reason why NGOs cannot expand their number of branches as fast as their plans warrant.

The ASA methodology is offering a way to low-cost fast growth and rapid expansion of the branching network.

As NGOs dealing in credit are not allowed to accept deposits, they depend mostly on grant financing from national or international NGOs or bilateral donors. But due to dwindling donor funds, coupled with increasing competition from rural banks and cooperatives, the role of the NGO sector in microfinance may diminish in the long run. However, there will remain some 10 to 20 NGO MFIs that will continue to operate with a mission to serve the poorest while maintaining their drive towards financial sustainability. These NGOs will operate on a scale that can match the competition posed by rural banks and cooperatives engaged in microfinance.

III. RURAL FINANCE POLICY DEVELOPMENT

3.1 Before the Reforms

Prior to reforms, the Philippine rural financial market followed the supply-led approach through a massive infusion of institutional credit using cheap credit funds from the government (Corpuz and Kraft, 2005). Various commodity-specific agricultural credit programs such as the *Masagana* 99 for rice, *Masaganang Maisan* for corn, *Gulayang Pangkalusugan* for vegetables, and *Bakahang Barangay* for livestock, among others were implemented through rural banks as conduits. Rural banks were, thus, 'gifted' with 'cheap' funds (i.e., at very low interest rates) via the Central Bank's rediscounting window as an incentive for them to lend to small farmers. Without the 'incentive', these banks would normally not lend to these farmers because lending to the latter is generally perceived as risky and quite costly to administer. Moreover, some government non-financial agencies did the lending themselves, providing loans directly to program beneficiaries but without putting in place an appropriate loan collection mechanism. It was during this period that the borrowing incidence among small farmers greatly increased and the country achieved self-sufficiency in rice production. However, these positive effects were short-lived since farmers started to default on their loan repayment, government funds dwindled and a great number of rural banks closed shop and went bankrupt. While some farmers blamed the weather, others simply refused to pay because of the notion that government funds are a dole-out and need not be returned. In addition, the government agencies that implemented credit programs did not exercise due diligence in loan collection. And because of too much dependence on cheap funds from the government, most rural banks neglected deposit mobilization and demonstrated leniency in loan screening and collection which led to poor repayment rates.

Numerous research studies have documented this experience and it is now well-recognized and accepted that a supply-led strategy or the massive infusion of institutional credit at subsidized interest rates is not effective and can be very costly. Some of the lessons learned from this experience can be summarized as follows:

- Lending by government non-financial agencies is costly and not sustainable; lending should, thus, be a function of banks or financial institutions;
- Government should focus on creating a conducive policy environment, providing the needed infrastructure and support services including opportunities for institution building in order to increase participation of the private sector in the delivery of credit to agriculture;
- Banks should be capable of generating its own funds and be less dependent on the government and other external sources;
- In order to encourage banks to lend to agriculture, banks should be allowed to cover its lending costs through market-determined interest rates and lend only to qualified borrowers and/or viable projects; other means to reduce the risk of lending to agriculture should be pursued by both the government and private sectors such as making the crop insurance and guarantee programs work; and
- Credit access is not just a supply issue but a demand issue as well; it is critical to work towards making clients or borrowers creditworthy through capability building programs including the provision of technical assistance in order to promote viability of their projects.

3.2 Liberalization and Deregulation of the Rural Financial Market

In response to the mounting arrearages problem as well as the failure of the low-interest rate policy which gave rise to the bankruptcy and closure of many rural banks, the government started to liberalize and deregulate the financial markets in the early eighties. Greater reliance on market principles especially in pricing as well as allocating credit funds was the basic framework for reforms. Interest rates were therefore deregulated and subsidies gradually removed. For one, the Central Bank of the Philippines was asked to stop its involvement in government credit programs and to transfer the Agricultural Loan Fund (ALF) to the Land Bank of the Philippines. The government also dismantled subsidized agricultural credit programs which had been funded at great cost to taxpayers but failed to succeed in making credit more accessible and sustainable to the small farmers. Also part of the reform package was the promotion of universal banking or expanded commercial banking along with an increase in the required minimum bank capitalization. While restrictions were imposed on bank branching and entry especially after the financial crisis of 1983, this was liberalized in September 1989 which led to the increase in the number of banks and branches particularly of commercial banks and Land Bank of the Philippines (Lim and Esguerra, 1996). Essentially, the objective of financial liberalization was to encourage private banks to lend more to agriculture by allowing these financial institutions to cover their lending costs through market-determined interest rates and to lend only to viable projects.

One of the major efforts made in 1987 was the termination of 42 subsidized agricultural credit programs and the consolidation of the remaining fund balances into a loan guarantee scheme for farmers called the Comprehensive Agricultural Loan Fund or CALF (Llanto, 2004). The CALF was meant to encourage private bank lending to small farmers and other small-scale borrowers. The expectation was that by taking as much as 85 percent of the credit risk of small farmer loans, the CALF would be able to encourage private banks to lend to small farmers.

3.3 The Agricultural Credit Situation After the Financial Liberalization

Unfortunately, however, the expected increase in credit flows to small farmers and other smallholder-borrowers following the paradigm shift to a market-oriented credit policy did not happen. In fact, the proportion of loans granted to agriculture by various types of banks declined steadily during the early 1990s including commercial banks and rural banks. It was only Landbank, which is the government bank mandated to serve agrarian reform beneficiaries, that increased its share of agricultural loans relative to its total loan portfolio from 7 percent in 1987 to about 30 percent in the late nineties. In general, however, the share of agricultural loans dipped from 21-23 percent before the 1980s to proportions of less than 1 percent in the late nineties (Castillo and Casuga, 1999).

At the borrower level, the incidence of borrowing among small farmers also declined from 60 percent in the seventies to 35 percent in the nineties when policy reforms should have already started bearing "fruits" through increased access to formal credit (Table 9).

Why the decline in agricultural credit despite the policy reforms? **One,** banks continued to find lending to agriculture risky, costly and therefore totally unattractive despite the existence of a local guarantee scheme for farmers called the Comprehensive Agricultural Loan Fund or CALF. Without the 'carrots' in the form of cheap government funds, banks would not venture into agricultural lending using their own funds. **Two,** there was a slow growth in agricultural output and per capita output during the nineties which, on the average, was a low 1.9 percent per annum below the population growth rate of nearly 3 percent per annum. **Three**, a significant number of farmers were disqualified from borrowing due to arrearages incurred under government credit programs especially in the late seventies and early eighties. And **four**, given the reduced access to formal credit, more farmers preferred to finance farm operations from savings, liquidation of fixed assets and income from off-farm and non-farm activities.

Table 9. Borrowing Incidence Among Farm Households in the Philippines Sub-Period Averages, Various Years

Period	Percent Borrowers	Percent Non-Borrowers
1954-1960	76	24
1967-1970	55	45
1974-1978	60	40
1981-1988	49	51
1990-2000	59	41
2001-2002	64	36
2004-2005	68	32

3.4 Forward-Backward Policy in the Mid-Nineties: The Resurgence of Subsidized Credit Programs

As the nineties wore on, it became evident that credit access to farmers and other smallholders was not gaining ground. While other government agencies (outside the Department of Agriculture) continued to implement subsidized credit programs, the agriculture sector through the Agricultural Credit Policy Council was the only sector that tried to terminate such programs and consolidated the remaining fund balances for the CALF. However, it did not take long before politicians and government bureaucrats 'restored to life' the subsidized credit programs due to the clamor of various interest groups. In effect, by the end of the Aquino administration, subsidized credit programs had once again mushroomed, undermining the government's own market-oriented credit and financial policy reform efforts. In fact, there were as many as 86 government credit programs implemented in 1999 by 21 government agencies (Llanto, Geron and Tang, 1999), more than three times the number of directed programs before the policy reforms in 1986. Llanto and others (1999) further showed that more than P40 billion or 1.8 percent of GNP in 1996 was invested in these programs of different agencies (DA and non-DA), the bulk of said funds having been borrowed from foreign sources. In terms of beneficiaries, limited data from 24 reporting directed credit programs indicate that for two years in 1995-1996, about 686,000 farmer-borrowers obtained loans from these programs – quite a miniscule number considering that billions of pesos were made available to said agencies. Again, the directed credit and subsidized programs proved to be a costly load on the government's shoulders.

3.5 Policy Reforms on the Rebound: The Agriculture and Fisheries Modernization Act (AFMA) of 1997 and Executive Order 138

The government once again decided to do away with these money-losing directed credit programs and embrace market-oriented credit and financial policies as provided for in the AFMA of 1997 and Executive Order 138 issued in 1999. In particular, the AFMA calls for the phase-out of directed credit programs (DCPs) in the agriculture sector and the consolidation of funds from these programs into a comprehensive agricultural credit program called the Agro-Industry Modernization Credit and Financing Program or the AMCFP; the rationalization of loan guarantee programs; adoption of market-based interest rates; and non-provision of credit subsidies. So far, all directed credit programs (DCPs) have already been consolidated by the Agricultural Credit Policy Council (ACPC), an attached agency of the Department of Agriculture, into the AMCFP and loan releases under these programs have been stopped. However, loans previously disbursed under these DCPs continue to be collected through the ACPC. In order to continue the flow of credit to the countryside, the AMCFP is already being implemented using funds previously collected from the DCPs.

Similarly, EO 138 directs government agencies implementing credit programs to adopt the Credit Policy Guidelines of the National Credit Council which includes: (i) non-participation of government non-financial agencies in the implementation of credit programs; (ii) government financial institutions to be the main vehicle in the implementation of credit programs; (iii) adoption of market-based financial and credit policies; and (iv) increased participation of the private sector in the delivery of financial services.

Other reforms include the enactment of the General Banking Act on May 2000 which consists of provisions mandating the Bangko Sentral ng Pilipinas to recognize the unique nature of microfinance as it formulates banking policies and procedures. As such, the moratorium on branching was lifted specifically for microfinance banks; BSP Circular 272 was issued on January 2001 implementing the microfinance guidelines of the General Banking Act (see Annex A); and the supervision and examination process was reviewed to reflect the special nature of microfinance, i.e. non-collateralized loans. Another policy reform was the enactment of the Barangay Microenterprise Business Act which directs the adoption of market-based credit policies in the provision of financial services to barangay or village-based microenterprises. Under this Act, government wholesale financial institutions are directed to create special credit windows adopting market based interest rates for private financial institutions intending to provide credit to barangay microenterprise business.

3.6 Current Imperatives for Increased Access to Rural Finance

Considering lessons learned from the past twenty years, current imperatives aimed at increasing and sustaining access to rural finance, follow the market-based policy principles of the AFMA, as follows:

- Provision of a conducive policy environment, critical support and capability building services that would facilitate increased participation of the private sector in the delivery of credit;
- Greater role of the private sector including rural banks, cooperative rural banks, cooperatives and NGOs in the provision of financial services;
- Adoption of market-oriented interest rates; and
- Active participation of government financial institutions in the delivery of credit services and non-involvement of government non-financial institutions in credit decision making.

3.6.1 The Agro-Industry Modernization Credit and Financing Program (AMCFP)

As provided for in the law (AFMA of 1997), all directed credit programs are to be terminated and replaced by the AMCFP as the umbrella credit program of the Department of Agriculture. The Agricultural Credit Policy Council (ACPC) took the lead in developing a system whereby government credit resources are administered more efficiently through the AMCFP. The following features make the AMCFP different from the past credit programs of the government: (i) it is demand-driven and not supply-led; (ii) it is not commodity-specific but covers a whole gamut of income-generating projects which farm households may choose to undertake (see Annex B for list of projects); (iii) the government is not involved in any credit decision making as the program is implemented as a two step loan program with government financial institutions as wholesalers and qualified private banks as retailers (see Figure 1 for illustration of AMCFP structure); and (iv) it adopts market-determined rates as opposed to the subsidized rates of the past.

3.6.2 Role of the Agricultural Credit Policy Council (ACPC)

As the agency tasked to oversee the country's rural financial system, the ACPC adopts a holistic approach towards an efficient, effective and sustainable delivery of rural financial services in the countryside. Towards this goal, the ACPC performs the following:

a. Policy Formulation, Planning and Advocacy

As mandated by Executive Order 113 of 1986, ACPC provides policy directions on agricultural credit towards a healthy and sustainable rural financial system. It reviews and makes recommendations on the socio-economic soundness of ongoing and proposed agricultural credit programs, legislations, and other policies that aim to increase the flow of credit to agriculture. The ACPC makes sure that the alternative strategies and policies being proposed are able to address the needs of its stakeholders particularly financial institutions, the policymakers and the small farmers and other smallholders and that these proposed policies are accepted by them. So far, many of the credit policies advocated by the ACPC eventually reached legislation especially with the passing into law of the AFMA in 1997.

b. Credit Facilitation

Credit facilitation means allowing credit to flow to the countryside by bridging the gap between the lenders (supply side) and the borrowers (demand side). The problem of poor access to credit is, therefore, addressed as the credit requirements of small farmers and fisherfolk are determined and private financial institutions are encouraged to finance these requirements. Small farmers and fisherfolk, even those without collateral to offer, are given the opportunity to have access to formal financing while banks are able to reduce the risk of lending to these borrowers. Through the implementation of the Agro-Industry Modernization Credit and Financing Program (AMCFP) and innovative schemes developed by ACPC, credit facilitation can help the government spur growth in the agriculture and fisheries sector by responding to the financial requirements of small farmers and fisherfolk needed for agricultural production.

Agro-Industry Modernization Credit and Financing Program (AMCFP). Through Resolution No. 1 series of 1999 issued by the Council of the ACPC, the ACPC was given the oversight function over the AMCFP. As program oversight, ACPC is tasked to steer program implementation, address policy issues, and monitor and evaluate fund utilization.

The ACPC is also mandated to handle/administer the funds to be transferred from directed credit programs previously implemented by the government to the AMCFP. Part of the function is to conduct a full inventory and accounting of all directed credit programs (DCPs) in agriculture and review their enabling laws/instruments; and to exercise due diligence in ensuring that loans released under these DCPs are collected and that these funds are transferred to the AMCFP. The primary objective is to ensure that the program is able to increase credit access of its intended beneficiaries, i.e., the small farmers and fisherfolk and that the loans released under AMCFP are returned to the program for sustainability.

Innovative Financing Schemes. The ACPC continuously designs and pilot-tests innovative financing schemes particularly those who for some reason do not have access to bank loans or lending facilities of formal institutions. With these schemes, the ACPC is able to identify credit delivery mechanisms that can work for small farmers and be adopted by financial institutions, particularly government as well as private financial institutions for implementation on a wider scale.

c. Institutional Capacity Building/Training

The ACPC believes that credit alone cannot achieve countryside development. Thus, it extends grant funds for the conduct of institutional capacity building activities aimed at strengthening the financial/lending capacities of farmers' cooperatives/associations and improving access to financial services of small farmers and fisherfolk. The ACPC believes that grass roots-based institutions like farmers and fisherfolk organizations can be developed and strengthened into effective and efficient lending and collection entities through institutional capacity building (ICB) mechanisms. It is through these institutions that marginal farmers and fisherfolk can have better access to credit. When more of these organizations are strengthened, access to financial services by small farmers and fisherfolk is likely to increase as well.

d. Information Support

Since information is vital in planning, policy formulation and project development, a monitoring system has been developed and installed by ACPC to monitor implementation of the AFMA-mandated AMCFP, other ongoing credit, guarantee and insurance programs, lending to agriculture by the entire banking system as well as the progress of projects and programs in consonance with President Arroyo's State of the Nation Address (SONA) commitments. The extent to which farmers organizations, NGOs, cooperative banks and other institutions provide credit in the rural areas are also being monitored.

3.7 Microfinance Revolution

To complement the provision of agricultural credit in the countryside, microfinance services have become more accessible to farm households as a result of policy reforms that encouraged financial institutions to engage in microfinance. The availability of microfinance services has allowed farm households to diversify and increase their income as well as improve their quality of life. In fact, in the recent Small Farmer Credit Survey done by the ACPC, the incidence of borrowing from formal sources among small farmers has increased significantly mainly because of the increased accessibility of microfinance services in the rural areas. Bangko Sentral ng Pilipinas defines microfinance loans as *small loans granted to the basic sectors, as defined in the Social Reform and Poverty Alleviation Act of 1997 (Republic Act 8425), and other loans granted to the poor and low-income households for their microenterprises and small businesses so as to enable them to raise their income levels and improve their living standards. These loans are granted on the basis of the borrowers' cash flow and are typically unsecured.*

Policy Framework

The Philippines is actually one of a few countries with a well-defined policy and regulatory architecture for microfinance. The government through the National Credit Council (with ACPC as head of the sub-group on agricultural credit) and the Credit Policy Improvement Program (CPIP) has worked for the creation of a favorable environment. The National Strategy for Microfinance provides the policy framework for microfinance and is anchored on the following principles:

1. greater role of the private sector/MFIs in the provision of financial services;
2. an enabling policy environment that will facilitate the increased participation of the private sector in microfinance;
3. market-oriented financial and credit policies, e.g. market-oriented interest rates on loan and deposits; and

4. non-participation of government line agencies in the implementation of credit/guarantee programs.

The national microfinance policy framework, therefore, includes the following specific strategies:

1. In providing for a conducive policy environment: a) implementing a market-oriented interest rate policy; b) pursuing financial policy reforms with the end in view of removing existing distortions in the financial market; c) rationalizing all existing government credit and guarantee programs
2. In establishing a market-oriented financial and credit policy environment which is conducive for the broadening and deepening of microfinancial services: a) provision of appropriate supervisory and regulatory framework for MFIs which will enable them to engage in the development of new and innovative product lines and services appropriate to the demand for financial services/products by poor households and microenterprises; b) establishment of standards of performance and business practices to guide the operations of MFIs; c) promotion of broad-based savings mobilization, linkage banking technology and other microfinance technologies; d) provision of information and training on best practices in microfinance to MFIs.
3. In implementing a capacity building program for MFIs: a) provision of technical assistance to MFIs with particular emphasis on local deposit mobilization; financial and project management; use of information technology; and development and establishment of microfinance technology, innovative product/servicelines; b) documentation, packaging and dissemination to MFIs of practitioner-based training and technical services; c) encouraging research and academic institutions to conduct studies, convene policy level discussions that will promote awareness of microfinance as a sound commercial investment.

The favorable environment has contributed to the rapid growth of outreach of MFIs (which include rural banks, NGOs and credit cooperatives as well as some thrift banks) as well as the strengthening of the microfinance programs of rural banks/cooperative rural banks/microfinance-oriented banks. The Bangko Sentral ng Pilipinas (BSP) classifies banks engaged in microfinance into two broad categories: (a) microfinance banks and (b) microfinance-oriented banks. Microfinance banks are those whose loan portfolios are 100 percent microfinance loans. On the other hand, microfinance-oriented banks are those banks whose microfinance loans comprise at least 50 percent of their gross loan portfolio.

As of September 30, 2007, BSP reports 224 banks engaged in microfinance, 8 of which are microfinance-oriented rural banks with an outreach of about 819,000 clients and loan portfolio of Ph7.8 B.

Regulation of Banks Engaged in Microfinance

The basic law that paved the way for the creation of the favorable environment for banks engaged in microfinance is the General Banking Law of 2000. It recognized the special features and peculiarities of microfinance and asked the BSP to issue appropriate implementing guidelines. Sections 40, 41 and 44 mandated the formulation of appropriate rules and regulations for microfinance operations. Section 40 recognizes the "peculiar characteristics of microfinancing, such as cash-flow based lending to the basic sectors that are not covered by traditional collateral." Section 41 provides for the issuance of regulations covering unsecured loans and Section 44 recognizes that "the schedule of loan amortization shall take into consideration the projected cash flow of the borrower and adopt this into the terms and conditions formulated by banks."

Regulation of Cooperatives[4]

The Cooperative Development Authority (CDA) is tasked to regulate cooperatives under R.A. 6539. However, the CDA has not been an effective regulator because of institutional weaknesses and its pre-occupation over another major objective which is to develop and promote the cooperative sector. Thus, the CDA does not supervise nor examine the books of credit cooperatives (NCC, 2004). To help build the architecture for the effective regulation and supervision of credit cooperatives, the National Credit Council prepared a standard chart of accounts, an accounting manual and set of performance standards for credit cooperatives called the COOP-PESOS. The CDA Administrator issued a circular asking all credit cooperatives to use the COOP-PESOS performance standards starting January 2003 (Almario, 2002). The CDA is training its field personnel in the application of the standard chart of accounts and the COOP-PESOS performance standards to credit cooperatives.

Registration of NGOs[5]

The NGOs are required to register with the Securities and Exchange Commission (SEC) as non-stock, non-profit organizations. They are not subject to prudential regulations. At present, there is no government agency that has supervision over the NGOs. The NGOs do not report to any oversight agency and hence, there is no single institution that has a complete set of relevant information on the financial performance of NGOs (NCC, 2004).

NGOs collect "forced" savings or the so-called "capital build-up" as compensating balance or the proportion of the loans of their microfinance clients (NCC, 2003). The consensus among the NGOs is that they should be allowed to collect savings from their clients without being subject to any prudential regulation provided that these collected savings do not exceed their total loan portfolios. Those that collect savings beyond the compensating balance shall be required by the government to transform themselves into either a bank or credit cooperative, both of which are regulated entities.

The present view of the NCC is that only regulated financial institutions shall be allowed to take deposits from the public. Banks which are regulated by BSP are considered 'deposit-taking institutions'. Cooperatives which are regulated by CDA mobilize deposits among their members. On the other hand, NGOs are not regulated entities and thus, no external body monitors their performance and imposes sanctions for poor performance, implying that depositors would not be adequately protected from misbehavior by NGOs. Thus, NCC has ruled that NGOs shall not be allowed to mobilize deposits from the public. The NCC also ruled that the total 'forced' savings collected from clients shall not exceed the value of their total loan portfolio at any point in time.

The Microfinance Council of the Philippines, Inc. (MCPI) has adopted a set of performance standards for NGOs. This set of performance standards has not yet been widely adopted and the NCC attributes this to the "absence of incentives for adoption." On the other hand, the NCC and the CPIP have recently collaborated in formulating a set of performance standards that are applicable for all types of MFIs.

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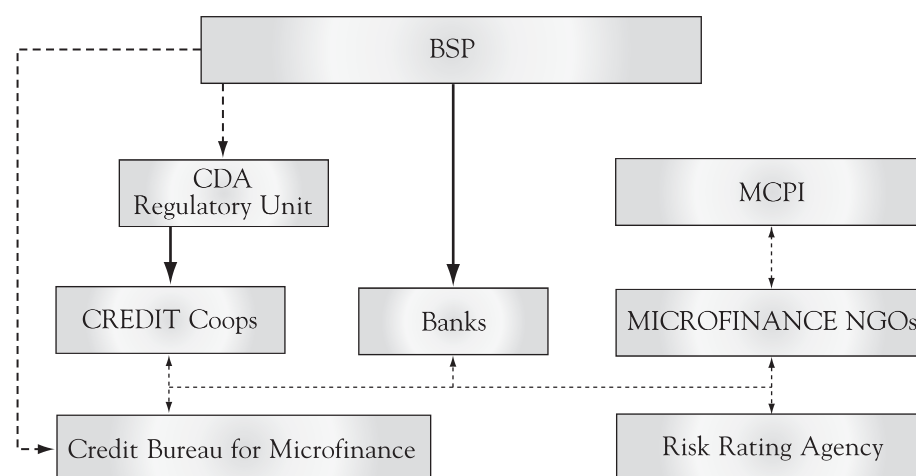
[4] The government through the NCC has recognized the potential of cooperatives in microfinance. In this report, "cooperative" means both cooperatives and credit unions. Credit unions are solely engaged in providing savings and credit services to members and are usually located in the urban areas. Cooperatives may be engaged not only in providing savings and credit services but also other services, e.g., marketing, input supply, to members. Cooperatives may be found chiefly in rural areas.

[5] Llanto (2003).

Proposed Institutional Framework for Regulation of Microfinance Institutions

The proposed institutional set-up for the regulation of microfinance as developed by the National Credit Council is shown in Figure 2. The proposed institutional set-up shows a comprehensive framework where regulators have their respective regulatory focus and there is coordination between BSP and CDA. Private institutions such as the Microfinance Council of the Philippines, Inc. (MCPI) and a credit bureau also play an important role.

Figure 2. Proposed Institutional Set-up for the Regulation of Microfinance



Legend:

- Direct supervision
- Oversight
- Submission and assessment of relevant information

Source: NCC

The Bangko Sentral ng Pilipinas as well as the National Credit Council have worked assiduously to advocate for the creation of a comprehensive credit information system in the country. For microfinance, this initiative hopes to increase the access to credit by micro, small and medium enterprises as well as answer problems of credit pollution and multiple borrowings. On a larger scale, the sharing and dissemination of information through such a credit information system will result in the following: 1) ability of lenders to more accurately identify good borrowers, 2) creation of better risk management, 3) increase in volume of lending, 4) extension of credit to underserved sectors such as micro, small and medium enterprises (MicSMEs), and 5) strengthening of credit discipline leading to the over all lowering of default rates. Over all, the information exchange will lead to a sound, healthy and vibrant credit market. The legislative bodies, however, have yet to approve and enact the law for the establishment of the credit bureau.

IV. FINAL REMARKS

The experience of the country in rural finance for the past two decades has shown that market-oriented credit and financial policies form the basic infrastructure for efficient financial markets. It would definitely be a mistake to go back to the directed credit program approach that has proven to be totally ineffective and very costly. Well-functioning rural financial markets enhance the production and consumption possibilities of farm and non-farm households. As pointed out in many research studies,

efficient financial intermediation means transferring deposits from surplus units (i.e. savers) with inferior investment opportunities to deficit units (borrowers) with high-yielding instruments. The net result is efficient resource allocation, an increase in the yield to capital and higher output growth (Llanto, 2004). On the other hand, weak rural financial markets discourage rural growth and distort income distribution.

However, the challenge to policymakers lies in utilizing efficient rural financial policies as a potent development tool and in having a strong political will to implement these policies. It will also be useful for policymakers to learn from the best practices of successful rural lenders who have found a way to deal with the factors that constraint the provision of financial services in the rural areas. Some of the best practices utilize informal lending techniques, group guarantees, collateral substitutes and microinsurance to address the problems of imperfect information, high transaction cost and the risks inherent to an agriculture setting. While promoting a market-approach to rural lending via the AMCFP, the ACPC, for instance, continuously experiments on innovative schemes that can encourage banks to lend to agriculture and to improve the creditworthiness of small farmers. The ACPC also believes in building the capacity of grass root-based institutions as a way of reaching out to more small farmers and other smallholder-borrowers.

Annex 1

Subsec. X151.2 of BSP Circular 505, Series of 2005: Prerequisites for the grant of authority to establish a branch/banking office. **With prior approval of the monetary board, banks may establish branches subject to the following pre-qualification requirements:**

1. Compliance with the minimum capital required or as may be required under existing regulations, which at present are as follows:

Bank Category	Minimum Capital (In Millions)
Expanded Commercial Banks	₱ 4,950
Non-expanded Commercial Banks	₱ 2,400
Thrift Banks: With Head Office within Metro Manila With Head Office outside Metro Manila	 ₱ 325 ₱ 52
Rural Banks: Within Metro Manila Cities of Cebu and Davao 1st/2nd/3rd class cities and 1st class municipalities 4th/5th/6th class cities and 2nd/3rd/4th class municipalities 5th and 6th class municipalities	 ₱ 26 ₱ 13 ₱ 6.5 ₱ 3.9 ₱ 2.6

2. The bank's risk-based capital adequacy ratio at the time of filing the application is not lower than twelve percent (12%);

3. Te bank's camels composite rating in the latest examination is at least "3", with Management component score not lower than "3";

4. The bank has established a risk management system appropriate to its operations, characterized by clear delineation of responsibility for risk management, adequate risk measurement system, appropriately structured risk limits, effective internal control system and complete, timely and efficient risk reporting system;

5. No major supervisory concerns outstanding on safety and soundness, i.e., the bank has complied, during the period immediately preceding the date of application with the following regulatory checkpoints:

a) No unbooked valuation reserves	as of date of application
b) Regular and liquidity reserve requirements on deposits and deposit substitutes	12 weeks
c) Asset and liquidity cover for EFCDU/FCDU liabilities	3 months
d) Ceilings on loans to DOSRI	3 months
e) Liquidity floor on government deposits	3 months
f) Loans-to-deposits ratio	2 quarters
g) Past due loans ratio does not exceed twenty percent (20%) of total loan portfolio	as of date of application

h) No outstanding violation on single borrower's loan limit and limit on total investment in real estate and improvements including bank equipment	as of date of application
i) No past due obligation with the BSP or with any financial institution	as of date of application
j) No float items outstanding in the "Due From/To Head Office/ Branches/Offices" and "Due from BSP" accounts exceeding 1 percent of the total resources as of end of preceding month	3 months
k) Mandatory allocation of credit resources to small and medium enterprises	2 quarters
l) Mandatory allocation ofloanable funds for agrarian reform and agricultural credit in general	2 quarters
m) Real estate loans ratio does not exceed twenty percent (20%) of total loanportfolio (for EKBs/KBs only)	as of date of application
n) No findings of unsafe and unsound banking practices	6 months
o) Accounting records, systems, procedures and internal control are adequate	as of date of application
p) The applicant bank has generally complied with banking laws, rules and regulations, orders or instructions of the Monetary Board and/or BSP Management	as of date of application
q) Member in good standing of the Philippine Deposit Insurance Corporation	as of date of application

6. For purposes of evaluating branch applications, theoretical capital shall be assigned to each branch to be established, including approved but unopened branches/offices, as follows (in millions):

Location/Type of Bank	UB/KB	TB/National Coop	RB/Local Coop
1) National Capital Region and the Cities of Cebu and Davao	₱ 50	₱ 15	₱ 5
2) 1st to 3rd class cities	₱ 25	₱ 5	₱ 2.5
3) 4th to 6th class cities	₱ 25	₱ 5	₱ 1.5
4) 1st to 3rd class municipalities	₱ 20	₱ 5	₱ 1.0
5) 4th to 6th class municipalities	₱ 15	₱ 2.5	₱ 0.5

The assigned theoretical capital shall be deducted from existing qualifying capital as defined under Subsec. X116.1 for purposes of determining compliance with the ten percent (10%) risk-based capital adequacy ratio.

If the applicant bank's risk-based capital adequacy ratio after deducting the assigned capital for the proposed branch from the existing qualifying capital would be less than ten percent (10%), its application shall not be processed unless it infused such amount as may be necessary to maintain its risk-based capital adequacy ratio to at least ten percent (10%).

7. The bank has been operating profitably for the year immediately preceding the date of application, or in the case of newly-established banks, the submitted projection showed that profitability will be attained on the third year of operations, at the latest;

8. Additional requirements for the establishment of branches of microfinance-oriented banks and/or microfinance-oriented branches of regular banks:

   a) Manual of operations on microfinancing duly approved by the board of directors (for microfinance-oriented branches of regular banks only);

   b) The branch shall have an adequate loan tracking system that allows daily monitoring of loan releases, collections and arrearages, and any restructuring and refinancing arrangements;

   c) The proposed branch shall be managed by a person with adequate experience or training in microfinancing activities; and

   d) At least seventy percent (70%) of the deposits generated by the branch to be established shall be actually lent out to qualified microfinance borrowers and the microfinance loans of said branch shall at all times be at least fifty percent (50%) of its gross loan portfolio (for microfinance-oriented branches of regular banks only).

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Jocelyn Alma R. Badiola has more than 20 years of experience in rural development work with special focus on microfinance/agricultural credit, rural savings mobilization and institution-building. She has done policy research and advocacy work on microfinance and rural finance including monitoring and evaluation of specific programs and projects, conceptualization and administration of farm/household surveys, analysis of policy issues and credit program packaging. She has also done consultancy work for international institutions like the International Fund for Agricultural Development (IFAD), United Nations Development Program (UNDP), the World Bank, the United States Agency for International Development (USAID), the European Union, Japan Bank for International Cooperation (JBIC), Asian Productivity Organization (APO), the Asia-Pacific Rural and Agricultural Credit Association (APRACA), CODESPA of Spain and non-government organizations in the Philippines. She has likewise been invited as resource speaker on various rural development issues in the Philippines and in other countries as well. She is blissfully married and mother to a happy 14-year old son.

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