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Microfinance in the Philippines

During the last few years, the volume of microfinance activity has grown considerably in the Philippines and an increasing number of financial institutions have engaged in retail microfinance operations. While this sector has been traditionally dominated by rural banks, non-governmental organizations (NGOs) and finance cooperatives, in 2009 a number of commercial banks sought entrance into the retail microfinance market. This *Asia Focus* report reviews the growth of the Philippines microfinance industry and discusses the implications of commercial banks entering this market.

What is Microfinance?

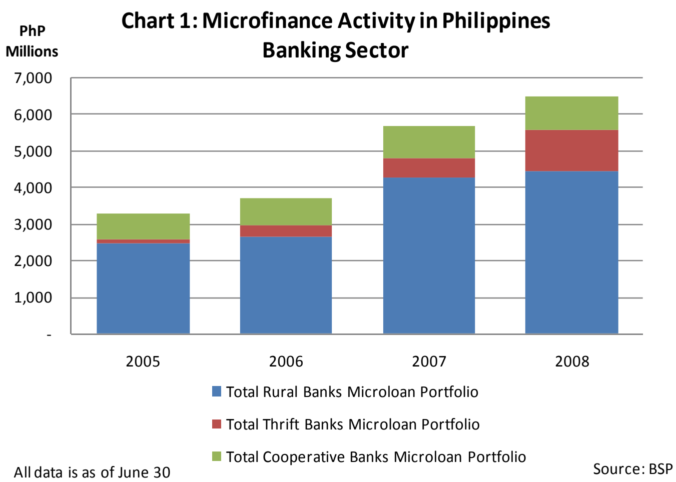
The Philippines central bank, *Bangko Sentral ng Pilipinas* (BSP), defines microfinance as the provision of a broad range of financial services such as deposits, loans, payment services, money transfers and insurance products to the poor and low-income households and their microenterprises.[i] The financial service most commonly provided is microcredit, which is typically issued in the form of a specific business loan for microenterprise purposes. A key defining characteristic of a microfinance loan is the ability to secure credit without collateral. In the Philippines, microfinance loans cannot exceed PhP 150,000 (US$3,218).[ii] Microfinance providers in the Philippines often employ a group lending approach, whereby each person within a small group is liable for any default by another group member. Other group lending-based methodologies being used in the Philippines include the ASA model, whereby each group member is responsible only for his or her own loan, and the Alliance of Philippine Partners in Enterprise Development (APPEND) Scale-Up Branch Model, which is based on the Trust Bank model.[iii,iv]

Development of Microfinance in the Philippines

The Philippines' microfinance sector is credited as one of the oldest and most active in the world.[v] While the roots of microfinance activity date back to the early 1900s through cooperatives, microfinance, as described today, surfaced in the 1980s and was codified into national law in 1997 with the signing of the Social Reform and Poverty Alleviation Act (RA 8425), and the establishment of both the National Anti-Poverty Commission and the National Strategy for Microfinance. With approximately 33% of the country's 92 million population considered to be living below the poverty threshold, poverty alleviation is one of the government's top priorities and microfinance is a primary tool to address this issue.[vi] The ultimate goal of the government's National Strategy for Microfinance is to create a sustainable private microfinance market, where the private sector drives market dynamics, such as products and pricing, and the government's role is limited to providing an environment which enables the market to thrive.

The General Banking Law of 2000, which mandated the recognition of microfinance as a legitimate banking activity, is one of the primary catalysts for accelerated growth and commercialization of microfinance over the last several years. The law empowered the BSP to create measures recognizing microfinance providers as banking institutions and to provide regulatory guidelines specific to the microfinance portfolios for institutions falling under the BSP's purview. Furthermore, banks engaging in microfinance activities were given certain allowances and relieved of certain restrictions; for example, they were granted exemption from a moratorium on branch licensing. Today, the BSP defines its commitment to the development of microfinance in the Philippines in three specific ways: i) providing an enabling policy and regulatory environment, ii) increasing the capacity of the BSP and banking sector with respect to microfinance operations, and iii) promoting and advocating the development of sound and sustainable microfinance operations.[vii]

Historically, the provision of retail microfinance services in the Philippines was achieved through rural and thrift banking organizations, as well as NGOs and finance cooperatives. Government financing programs also participated in the retail market. The BSP reports that government financing programs are transitioning away from direct retail business activities and toward providing wholesale funding for private microfinance institutions. Transitioning away from direct retail microfinance activity brings the government closer to achieving the ultimate goal of having a limited role in the microfinance market, as outlined in the National Strategy for Microfinance. Meanwhile, the private banking sector is playing an increasing role in the provision of microloans. Microfinance activity across the Philippines banking sector, as measured by the size of microloan portfolios at thrift, rural and cooperative banks, nearly doubled between 2005 and 2008 alone (see Chart 1). During the same time period, the number of microfinance borrowers grew by 40%.



In fact, a recent study by the Economist Intelligence Unit (EIU) assessing the microfinance environment within countries[viii] ranked the Philippines first in Asia and third overall on its microfinance index, after Peru and Bolivia. The EIU microfinance index categorized its indicators into three main groups: i) regulatory framework, ii) investment climate, and iii) institutional development. EIU awarded the Philippines a perfect score for its regulation of microfinance activities at financial institutions, adding that "*the government has promoted a regulatory environment conducive to microfinance operations.*"[ix] While the Philippines also received a perfect score for the legal environment surrounding the formation and operation of specialized microfinance institutions, the EIU study highlighted a need to increase the diversity of microfinance products and services available to customers. Until recently, the microfinance industry in the Philippines has been primarily focused on microcredit products. Lately, there has been a broadening of services to include savings and microinsurance, but the portion of microfinance providers in the Philippines that are offering such services remains small.

The Changing Role of Commercial Banks in Microfinance

Traditionally, commercial banks' role in the Philippines microfinance market has been exclusively through wholesale lending, by providing funds to microfinance institutions which then re-lend the funds in the form of microcredit, and the provision of general financial services to microfinance institutions. However, in the face of heightened competition and a challenging operating environment due to the global financial and economic crisis, commercial banks are seeking new viable revenue options. As a result, some commercial banks recently have entered into the retail microfinance market. For example, Rizal Commercial Banking Corporation, the nation's seventh largest lender, acquired JP Laurel Rural Bank in February 2009 and issued its first microfinance loan in July through JP Laurel Rural Bank's branches.[x] This marked the first microfinance retail operation by a large commercial bank in the Philippines. Since then, Asia United Bank, ranked twentieth by asset size, acquired Rural Bank of Angeles to take advantage of its microfinance network.[xi] In addition, Bank of the Philippine Islands, the nation's third largest lender and the first privately owned commercial bank to engage in wholesale microfinance lending, was granted permission to launch the country's first mobile microfinance bank.[xii]

Demand for microfinance loans is expected to increase considerably over the next year as a key part of the rebuilding of Metro Manila, which was severely damaged by typhoon Ketsana in September 2009. Further demand is anticipated from displaced overseas Filipino workers, as a result of the global crisis, as these workers and their families turn to microenterprise business activities as a means to supplement family income. These increases in demand for microfinance loans, coupled with the reduced supply of microfinance providers resulting from the high rural bank closures in the last 18 months,[xiii] provide additional incentive for commercial banks, as well as other players, to enter the retail microfinance sector.

Risks and Benefits Associated with the Retail Microfinance Market

As commercial banks begin to venture into retail microfinance, they face a range of challenges that are specific to the microfinance market. Microfinance is highly specialized. It requires the loan officers to have significantly more personal knowledge of the microclient than is usually required for a client of a traditional loan. It also calls for knowledge of the intricacies related specifically to the needs of rural communities and the different risks inherent to microfinance. Traditional loan officers typically need extensive training before transferring into a microlending environment.[xiv] Furthermore, commercial banks may not have the infrastructure in place to reach micro-clients who often live in rural areas. Toward this end, rural banks and NGOs have a competitive advantage in terms of specialized knowledge and necessary infrastructure; therefore, it is not surprising to see commercial banks entering the market through the acquisition of rural banks.

Micro-clients are considered to be inherently risky, largely due to their extreme susceptibility to declining economic conditions and lack of information on their creditworthiness. This risk is somewhat mitigated by the use of the group lending methodology and more frequent repayment schedule options. During challenging economic times, institutions engaged in microfinance activity face not only the risk of rising delinquencies, but also the risk of default of other financial institutions with payment or funding obligations to these microfinance institutions.[xv] This particular risk is less of an issue for commercial banks than for other microfinance providers, as commercial banks hold sufficient deposits and do not rely on donations or wholesale funding to finance their microfinance activity.

In addition, "credit pollution", a term used in microfinance to describe when customers borrow from multiple institutions and often use loans from one institution to fund payments on a loan from another institution, is a growing problem in the Philippines microfinance market. This type of "pollution" appears to worsen as competition increases. As more microfinance players enter the market, micro-clients have more institutions from which to borrow. Because the Philippines has no information sharing vehicle or credit bureau in place, there is nothing to help microfinance providers identify borrowers who might be over-extended across institutions. The Credit Information System Act, which was signed into law on September 1, 2008, should eventually help to address this issue as it calls for the development of an appropriate credit information system. This should not only help the institutions address credit pollution, but also help micro-clients receive better and more efficient access to credit.

Despite these challenges and risks, the entry of commercial banks into the retail microfinance market in the Philippines may hold benefits from both commercial banks' and micro-clients' perspectives. The largest attraction from the commercial bank's perspective is the fact that microfinance loans tend to provide a high margin due to the considerably high interest rates charged. As a result, commercial banks are able to earn a significant return on a small percentage of their portfolio. Moreover, the repayment schedules for microfinance loans tend to be more frequent (the most common repayment option is weekly), and therefore commercial banks may be attracted by the prospect of a faster return on their investment than under a traditional loan contract.

Furthermore, microfinance clients tend to have higher repayment rates than conventional borrowers. Prior to the global financial crisis, repayment rates of as high as 98% had been cited by the most successful microfinance institutions.[xvi] According to a review conducted by the Federal Reserve Bank of St. Louis, the "*coexistence of high repayment rates… and higher interest rates (a 30 to 60 percent interest rate is common) in microfinance has "puzzled" economists"*.[xvii] Various theories offered for this paradox include the inelasticity of the demand for microfinance loans,[xviii] the use of unconventional calculations for repayment rates and default rates by some microfinance institutions,[xix] and missing or imperfect labor markets for poor women in developing countries where microfinance activity takes place.[xx] In addition to higher repayment rates, commercial banks may also benefit from diversification by entering a new and growing business line.

Micro-clients benefit from the entry of commercial banks into the retail microfinance market as increased competition will likely lead to lower costs and more competitive pricing for microloans. Furthermore, some market participants argue that the increased efficiencies often seen in larger commercial banks make them better equipped than rural banks to tap the market's growth potential by bringing a more diverse range of microfinance products to the market. Currently, microfinance providers are only reaching approximately one-third of total poor households, suggesting that there is room in the market for additional players, such as commercial banks, to reach even more customers.

Conclusion

The entry of commercial banks into the retail microfinance market is a natural progression in the commercialization of the Philippines' microfinance industry. Over the last thirteen years, the Philippines has amended its policy and regulatory environment to increasingly support the microfinance industry. Furthermore, although still limited, financial institutions are beginning to offer a broader range of microfinance products and services. However, a substantial portion of the microfinance population remains underserved. The current interest of some commercial banks in embracing retail microfinance may provide this underserved population heightened access to credit. Various players may bring different advantages to that marketplace; for commercial banks it is size and economies of scale, and for rural banks and NGOs it is the specialized knowledge. Ultimately, the provision of retail microfinance by commercial banks could prove to be a milestone in the Philippines' quest for a more expansive microfinance market.

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[i] Bangko Sentral ng Pilipinas Website (www.bsp.gov.ph).
[ii] Exchange rate US$1 = PhP 46.62 (as of January 29, 2010)
[iii] Philippines Financial Sector Assessment, United Nations Advisors Group on Inclusive Financial Sectors, March 2008.
[iv] The Trust Bank methodology involves group structures of 10 – 30 entrepreneurs, mostly consisting of women, managed by elected leaders in the group. Group members must often undergo business training.
[v] *Microfinance in Action: The Philippine Experience*, Stephen Daley and Federic Sautet, February 2005.
[vi] National Statistics Office, Republic of the Philippines, 2009 (latest available poverty census data is for 2006).
[vii] Bangko Sentral ng Pilipinas Website (www.bsp.gov.ph).
[viii] The study covered countries throughout Latin America, Asia, Africa, Eastern Europe and the Middle East.
[ix] "*Global Microscope on the Microfinance Business Environment*", Economist Intelligence Unit, 2009.
[x] Microfinance Focus News, July 2009 (http://www.microfinancefocus.com/news).
[xi] *Microfinance Risks Abound*, BusinessWorld, October 20, 2009
[xii] *BSP approval paves way for BPI mobile microfinance*, BusinessWorld, October 13, 2009.
[xiii] *Small Bank Closures Trimmed Sector in H1*, Philippine Daily Inquirer, November 12, 2009.
[xiv] Bangko Sentral ng Pilipinas Website, *Facts About Microfinance* (www.bsp.gov.ph).
[xv] *Managing Microfinance Risks: Some Observations and Suggestions*, Nimal A. Fernando, Asia Development Bank, July 2008.
[xvi] Microfinance: macro benefits, Lennart Bage, http://www.ifad.org/events/microcredit/op.htm.
[xvii] *The Microfinance Revolution: An Overview*, Rajdeep Sengupta and Craig P. Aubuchon, Federal Reserve Bank of St. Louis Review, January/February 2008.
[xviii] *Ibid.*
[xix] *The Microfinance Promise*, Jonathan Murdoch, Journal of Economic Literature, December 1999.
[xx] *Microfinance and Missing Markets,* Shahe Emran, M., Morshed, A. K. M. Mahbub and Stiglitz, Joseph E., March 2007.

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