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AUDIT OF USAID/PHILIPPINES' RURAL FINANCIAL SERVICES PROJECT

Audit Report No. 2-492-89-09
April 6, 1989

UNITED STATES OF AMERICA

AGENCY FOR INTERNATIONAL DEVELOPMENT
REGIONAL INSPECTOR GENERAL/AUDIT
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MEMORANDUM

DATE: April 6, 1989

TO: Malcolm Butler
Director, USAID/Philippines

FROM: William C. Montoney
Regional Inspector General, RIG/A/M

SUBJECT: Audit of USAID/Philippines' Rural Financial Services Project (Project No. 492-0394)
Audit Report No. 2-492-89-09

This report presents the results of audit of the Rural Financial Services Project. Your comments to the draft audit report are attached as Appendix 1. Please provide written notice within 30 days of any additional information related to action planned or taken to implement the recommendation.

I appreciate the cooperation and courtesy extended to my staff during this audit.

Background

The purpose of the Rural Financial Services (RFS) Project was to strengthen the policy and institutional framework necessary to develop a self-sustaining rural financial system. Under the project, the Central Bank was to allow banks to charge market-oriented interest rates on agricultural loans and was to eliminate subsidies on agricultural credit. Also, an estimated 1,000 individuals were to be trained in various aspects of agricultural or agribusiness lending. The project began in September 1985 as a $20 million project which complemented a $100 million World Bank agricultural credit project.

Initially, USAID/Philippines' funding consisted of $17.4 million loan and $2.6 million grant. In August 1986, the project agreement was amended to fund the project entirely with grant funds. The project budget provided for the following: a) technical assistance - $1.3 million; b) credit - $17.4 million; c) studies and training - $450,000; and d) contingency and other - $850,000. The implementing agency

was the Government of the Philippines' Central Bank, through its Agricultural Loan Fund (ALF) Unit.

USAID/Philippines reimbursed the ALF Unit for the $17.4 million credit after the Unit had extended credit to the institutions participating in the project. The September 1985 project paper stated that the Central Bank had tentatively identified 137 financial institutions eligible for access to USAID and World Bank project funds. As of June 30,1988, the number of eligible institutions was 82. Of these, 53 had actually received Central Bank loans which were funded by either USAID/Philippines, World Bank, or both. Of these 53 institutions, 25 received USAID funds.

Audit Objectives and Scope

The Office of the Regional Inspector General for Audit/Manila made a program results audit of the Rural Financial Services Project. The objectives of the audit were to determine if the project was achieving its purpose and if the major components of credit, technical assistance, and training were effective and contributed to the project objective. To accomplish these objectives, the auditors reviewed pertinent project documents, records, and reports. The auditors also tested selected internal controls and compliance requirements and interviewed USAID/Philippines personnel, Central Bank officials, officials at three participating financial institutions and the technical assistance contractor.

The audit covered project activities from September 25, 1985 through September 30, 1988. Project expenditures of $17.8 million were audited. Audit field work was performed during the period October 1988 through January 1989. The audit was made in accordance with generally accepted government auditing standards.

Results of Audit

The project had generally achieved its purpose of helping to develop a self-sustaining rural financial system. The Central Bank implemented several policy changes during the project period which enhanced the rural financial system, such as allowing retail banks to charge borrowers market-oriented interest rates on loans and eliminating Central Bank subsidies on loans to borrowing banks. However, the project's $17.4 million credit component was loaned by the Central Bank to financial institutions which were already financially sound, and no plans existed to include weaker rural banks in the project. The project could have been more effective if it included a wider range of participating financial institutions (PFI's).

Other aspects of the project were also progressing towards the project purpose. The project components of technical assistance and training were being implemented. ALF Unit management stated that the technical assistance was providing useful information; however, specific project recommendations which will give the ALF Unit additional guidance in managing the project will be included in the final technical assistance report which is not scheduled to be issued until June 1989. As of September 30, 1988, over 800 bank officials had been trained and about 600 more were scheduled to be trained during 1989. The trainees came from the Central Bank, PFI's, and non-PFI's. Training curricula documents provided by the Central Bank Institute, the office responsible for project training, showed the training courses to be project related. The training target of 1,000 individuals should be exceeded before the project activity completion date of December 31, 1990.

Weaker Rural Banks Should Be Included in the Project - The project had generally achieved its purpose of developing a self-sustaining rural financial system. The project agreement provided weaker banks the opportunity to be strengthened through participation in the credit component of the project. However, the $17.4 million of credit funds was loaned by the Central Bank to 25 financial institutions whose financial positions were relatively strong. USAID/Philippines and the Central Bank could have included a wider range of institutions to participate in the credit component of the project.

Discussion - The purpose of the Rural Financial Services Project was to strengthen the policy and institutional framework necessary to develop a self-sustaining rural financial system. As of December 31, 1987, more than one thousand financial institutions were operating in the Philippines. Of these institutions, 29 were commercial banks; 28 were thrift banks; and 875 were rural banks. The Central Bank determined that 82 were eligible for World Bank and USAID funding as of June 30, 1988. The 82 eligible institutions included 20 commercial banks, 16 thrift banks, 44 rural banks and two non-banking institutions.

The Agricultural Loan Fund Policy Manual detailed the qualifying criteria for participating financial institutions. Institutions applying for participation in the project's credit component had to comply with conditions relating to sound banking practices, as well as maintaining low total arrearages. Regarding arrearages, the Central Bank could determine a financial institution to be eligible if the institution met one of the following criterion:

(1) Its total sub-loan arrears were less than 15 percent of the outstanding loan portfolio;

(2) It received a satisfactory institutional appraisal by the ALF Unit confirming the financial viability and management capability of the commercial bank with sub-loan arrears less than 20 percent and of the thrift or rural bank with arrears less than 25 percent;

(3) It exceeded specified arrears ceilings but had unimpaired equity and reserves sufficient to meet Central Bank's minimum capital requirements and received a satisfactory institutional appraisal; or

(4) It met condition (3) above, had arrears over 35 percent, and obtained approval from the World Bank and USAID.

The Central Bank loaned the $17.4 million of USAID credit funds to 25 PFI's as of June 30, 1988. The 25 PFI's consisted of nine commercial banks, eight thrift banks, seven rural banks and one non-banking institution. Two-thirds of the USAID funds were loaned to PFI's whose original total loan arrears ratios met criterion number 1. The remaining one-third went to PFI's whose original loan arrears ratios did not exceed ALF arrearage criterion number 2. A majority of the 25 PFI's improved their total arrearage positions after receiving project credit. However, rural banks with arrears over 25 percent did not receive USAID funds, even though these banks may have been strengthened by the project's credit component. A schedule showing USAID funding and beginning and latest total arrears percentages for the 25 PFI's is shown in Exhibit 1.

The ALF Policy Manual also outlined the lending terms for project funds. The lending criteria were sufficient to ensure that project loans would be adequately secured, including a requirement that subloans to end borrowers be properly collateralized. As of September 30, 1988, less than one percent of the project loans were in arrears. In its project agreement with USAID/Philippines the Central Bank also agreed to reloan principal, which was repaid by PFI's to the Agricultural Loan Fund, for agricultural and agribusiness purposes. On September 30, 1988, the ALF had about $43 million in repaid World Bank and USAID loan principal available for relending. A Central Bank official estimated that $10 million of the $43 million was repaid USAID principal.

Only two percent of the original USAID credit went to rural banks and USAID/Philippines and the Central Bank did not

establish procedures to ensure that additional rural banks could receive project funds. Although the $17.4 million credit grant was totally disbursed by Central Bank, the project agreement required that repayment of principal by PFI's to the Central Bank be available to reloan for the same purposes as the original credit. As of September 30, 1988, about $43 million of repaid loan principal was in the Agricultural Loan Fund.

Several factors indicated that more rural banks should be included in the reloaning of project funds. The majority of institutions which received USAID funds were strenghtened as evidenced by improved total arrears ratios. The lending criteria for project loans, developed and implemented by the ALF Unit, were very strong and resulted in very low project arrearages. Also, several hundred officials from non-PFI's had been trained or were scheduled to be trained and therefore, the management and agri-banking knowledge of these institutions should be improved. Overall, the project had made strides towards achieving its purpose of creating a self-sustaining rural financial system. To be most effective, USAID and Central Bank should now attempt to bring weaker rural banks into the project by actively encouraging rural banks with arrears ratios over 25 percent to participate in the relending of the original credit.

At the audit exit conference, USAID/Philippines' officials agreed that more rural banks could participate in the reloaning of project funds. However, the officials were concerned that the auditors wanted USAID and Central Bank to possibly include banks that were poorly managed or financially unstable.

The audit did not disclose any need to lessen the eligibility or lending criteria. It showed that two-thirds of the original USAID credit went to PFI's within arrearage criterion number 1 (less than 15 percent arrears). The remaining USAID credit went to PFI's within arrearage criterion number 2 (between 15 and 25 percent arrears). It seems reasonable for USAID and Central Bank to take a slightly greater risk by encouraging more institutions within criterion numbers 2 and 3 to participate in the reloaning of the project funds.

Recommendation

We recommend that USAID/Philippines, in conjunction with the Central Bank, establish a plan which provides for:

(a) the relending of A.I.D. principal which has been repaid to the Agricultural Loan Fund,

(b) specifications to select banks which had not previously participated in the project's credit component including banks with arrearage ratios higher than those banks which had received original loan funds, and

(c) the Central Bank to periodically report to USAID/Philippines the status of plan provisions (a) and (b) for one year after the project assistance completion date.

USAID/Philippines agreed with the report finding. However, the Mission requested that a reasonable time frame be included in the recommendation for monitoring the lending of the A.I.D.-funded reflows. The Office of Inspector General modified the final report recommendation. The recommendation can be resolved when the plan is established and can be closed after USAID/Philippines has accepted the first status report as meeting the plan's objectives.

EXHIBIT 1

LIST OF PARTICIPATING FINANCIAL INSTITUTIONS UNDER THE RURAL FINANCIAL SERVICES PROJECT AS OF NOVEMBER 30, 1988

	PERCENTAGE OF PAST DUE LOANS		USAID FUNDS RECEIVED	PERCENTAGE OF USAID FUNDS RECEIVED
	START OF PROJECT	MOST RECENT		
A. COMMERCIAL BANKS				
1. The International Corporate Bank	9.40%	4.22%	$ 2,754,000	15.83%
2. Citytrust Banking Corporation	3.68	6.00	1,789,000	10.28
3. Far East Bank & Trust Company	2.62	1.07	555,000	3.19
4. The Consolidated Bank & Trust Company	20.10	11.54	307,000	1.76
5. Philippine Bank of Communications	20.00	11.40	286,000	1.64
6. United Coconut Planters Bank	6.90	2.00	174,000	1.00
7. Allied Banking Corporation	20.93	20.00	172,000	.99
8. Union Bank of the Philippines	14.80	23.30	141,000	.81
9. Philippine Commercial Int'l Bank	11.31	4.42	129,000	.74
TOTAL FOR COMMERCIAL BANKS			$ 6,307,000	36.24%
B. THRIFT BANKS				
1. BPI - Agricultural Development Bank	15.70	1.10	$ 4,326,000	24.86
2. Asiatrust Development Bank	11.43	4.82	2,705,000	15.55
3. Planters Development Bank	14.00	4.55	1,589,000	9.13
4. Town Savings & Loan Bank	10.67	13.50	751,000	4.32
5. Northern Mindanao Development Bank	.59	1.04	692,000	3.98
6. Southern Negros Development Bank	20.00	15.97	477,000	2.74
7. Hermosa Savings & Loan Association	5.15	2.35	89,000	.51
8. Dumaguete City Development Bank	12.80	2.00	7,000	.04
TOTAL FOR THRIFT BANKS			$10,636,000	61.13%
C. RURAL BANKS				
1. Cooperative Rural Bank of Davao City	18.44	22.00	$ 161,000	.93
2. Malarayat Rural Bank	20.51	17.00	88,000	.50
3. Sta. Maria Rural Bank	17.40	20.87	52,000	.30
4. Rural Bank of Pulilan	12.00	11.80	41,000	.24
5. Rural Bank of Odiongan	9.90	16.00	14,000	.08
6. Rural Bank of Tagum	17.00	22.30	11,000	.06
7. Rural Bank of Pagsanjan	13.00	11.18	10,000	.06
TOTAL FOR RURAL BANKS			$ 377,000	2.17%
D. NON-BANKING INSTITUTIONS				
1. Private Development Corporation of the Philippines	23.00	8.53	$ 80,000	.46%
TOTAL			$17,400,000	100.00%

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APPENDIX 1

UNITED STATES GOVERNMENT

Memorandum

TO : Mr. William C. Montoney
Regional Inspector General, RIG/A/M

DATE: MAR 2 1989

FROM : Malcolm Butler, Director, MB
USAID/Philippines

SUBJECT: Mission Response
Draft Audit Report on USAID/Philippines
Rural Financial Services Project (492-0394)

We agree with the findings in the report. However, we propose that the plan to be established in accordance with the audit recommendation cover the lending of the reflows of AID-funded subloans for a reasonable length of time. Given the demands of a growing program on the Mission workforce vis-a-vis the need to monitor ALF relending, we therefore propose that the plan cover a period ending one year after the PACD.

APPENDIX 2

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