Innovations to Increase Access to Microcredit:

A Challenge for Mindanao's Rural Banks

Prepared for:
MABS Microenterprise Access to Banking Services in Mindanao

USAID Contract No.:492-C-00-98-00008-00

Chemonics International Inc.

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September 1998

Executive Summary

Those Philippine Rural Banks which have endured to serve their customers for five decades have done so because their owners and managers have adapted and changed when they faced economic downturns. Rural banks have the capacity and stamina to face an uncertain economic climate again. Now, however, in addition to a severe economic crisis and major, sudden devaluation of the Philippine currency, rural banks are facing increasing competition from major and well capitalized commercial banks.

Rural banks are losing some of their “bigger and better” customers to nearby commercial banks which are making inroads into the traditional rural bank customer base by offering services which such customers want or think they need. In order to keep such customers Rural banks need to consider becoming more like commercial banks by offering the services, products and added value which their “bigger and better” customers want.

In order to reverse the loss of customers to commercial banks, rural banks should seriously consider issuing customers debit cards which can be used in ATMs throughout the country as well as at the rural bank. This will help make rural banks more effective in retaining customers, who they have been losing to the commercial banks which offer a broader range of services and more customer convenience.

At the same time rural banks have not made significant inroads into the highly lucrative and riskier segment of the microcredit market served by 5/6 money lenders and pawnshop owners. Rural Banks need to adopt moneylender methods to reduce the transaction costs for the borrowers who now use moneylenders in order to provide microcredit services to the most reliable of these borrowers. In like manner, rural banks need to draw on the obvious success of pawnshop lending by dramatically and quickly increasing collaterized micro-lending now dominated so effectively by the ubiquitous pawnshops.

As part of technology innovation, an independent internationally certified credit card processing center NOT connected with a large commercial bank would allow rural banks to retain the Microcredit lending portfolio of their most credit worthy and sophisticated customers in an easily managed and low cost method. In fact credit card operations are the modern means of microcredit in developed countries. Currently, virtually all rural banks, must give up their best customers to their competitors if such customers want the convenience of a credit card.

Significantly, rural banks which aggressively pursue integration of their banks with the electronic banking tools of the larger commercial banks are more likely to retain their best and largest clients. In addition, however, they are also more likely to attract the lower end microcredit clients who may not have large transactions but who may well be the borrowers who generate the highest return.

Within the past six to nine months the overall percentage of loans at risk for all 800 rural banks in the Philippines has increased from an already high 18% to and even higher 25% of loans outstanding. This is an extraordinarily large and sudden rise in the percentage of loans at risk. The percentage of loan portfolios at risk has increased generally throughout the entire banking sector. But at risk loans in rural banks have increased at an even greater rate than elsewhere.

Initiating a Loan Portfolio Guarantee program in such an environment will tempt rural bankers to reduce their own exposure by making “half bad” loans (either by shifting at risk larger loans to the program or by using the LPG to show examiners that their loans are not really at risk) thus lessening the need for larger loan loss reserves. Now is not the time to initiate the LPG for microcredit in the Philippines.

In conclusion, merely addressing the tactical MIS systems, generic training and microcredit product marketing won’t have a strategic impact on rural banks. The most important activity for MABS-M is to strengthen the capacity of rural banks to offer the right products and services by doing five things:

- Offer commercial bank products and services the customer wants
- Emulate the best practices of moneylenders and loan pawnshops
- Manage problem loans
- Price loans to make a profit
- Control and Manage risk

When rural banks have the strength and capacity to implement the five elements listed, then they will be able to compete head-on with commercial banks, moneylenders and loan pawnshops: Then they will be able to manage expanded microcredit on a sustainable basis. Merely addressing the tactical MIS systems, generic training and microcredit marketing won’t have a strategic impact on rural banks. The most important activity for MABS-M is to strengthen the overall capacity of rural banks to compete, make a profit, and survive to provide microcredit.

Recommendations for Program Focus

> "*There is nothing more difficult to take in hand, more perilous to conduct or more uncertain in its success, than to take the lead in the introduction of a new order of things." —Nicolo Machiavelli*

Considering Rural Banks vs Commercial Banks

Philippine rural banks, which have endured to serve their customers for five decades, have done so because their owners and managers have adapted and changed when they faced economic downturns. They have made it through rough waters before, for example during the early 1980's when there were widespread bank failures. Rural banks have the capacity and stamina to face an uncertain economic climate again. In the late 1990's, however, in addition to a severe economic crisis and major, sudden devaluation of the Philippine currency, rural banks are facing a sea change as well as rough waters. Previously, large commercial banks saw rural banking as the preserve of the rural banks. More recently, given the advent of improved technology and improved communication, commercial banks are looking with interest at the domains of Rural Banks. As a result, rural banks are seeing increasing competition from major and well capitalized commercial banks.

In the past, rural banks could survive by quickly recognizing and adapting to meet the needs of their customers. They demonstrated their capacity to change, when necessary, by moving away from an earlier, heavy emphasis on agricultural sector loans, by refining their management skills and by focussing on certain sectors of the rural and microcredit market such as public market vendors, local small merchants and traders. Regrettably, even this remarkable resiliency may no longer be sufficient. Rural banks are losing some of their "bigger and better" customers to nearby commercial banks which are making inroads into the traditional rural bank customer base by offering services which such customers want or think they need. In order to keep such customers Rural banks need to consider becoming more like commercial banks by offering the services, products and added value which their "bigger and better" customers want.

Emulating the Best Practices of Moneylenders

At the same time as they are losing customers to commercial banks, rural banks have not made corresponding gains in a natural market -- the highly lucrative but more risky segment of the microcredit market served by 5/6 money lenders and pawnshop owners.

The 5/6 market in the Philippines is a well developed and highly refined service. Some bankers tend to speak of moneylenders in derisory terms. It is common to hear giggles and remarks such as "well, we don't want to become like the *Turkos*..." or "doing something like that is too *Bombay*."

In reality, 5/6 moneylenders, regardless of their background, perform a much needed and highly efficient, albeit expensive (about 20% monthly) source of instant cash at a very low transaction cost. The borrower doesn't have to go to the moneylender. He, and often she, delivers. Moreover, the borrower doesn't have to go to the bank to pay. The moneylender collects at the borrower's business or home. Not all moneylender business practices bear copying. However, much that they do is tried, tested and appropriate.

Drawing on the obvious success of the moneylenders, rural banks need to draw on their own contacts and networks to dramatically and quickly increase micro-lending to the best credit risks in the segment of the market now dominated so effectively by the moneylenders. This could be accomplished through the use of existing rural bank collectors or by establishing a network of bonded and insured bank agents or agencies. The Rural Bank Association may have to petition for a change in banking regulations to allow for the use of licensed agencies.

Such agencies could even be insurable "*sari-sari*" stores which already handle cash. Record keeping could be accomplished with use of a simple one-write manual system with triplicate pre-printed and numbered receipts. Such a manual system would offer sufficient documentation. A more "fool proof" secure system to record payments and deposits could be installed at nominal cost using smart cards and electric or battery operated off-line terminals

Adopting Successful Methods from Loan/Pawnshops

Given the acceptance and extensive use of Pawnshops (there is one on virtually every principal street in urban areas) Rural Banks should capitalise on this accepted form of credit and offer "pawnshop like" secured microcredit loans at attractive interest rates. Given the relatively low cost (5-10 per cent per annum) of funds for such lending through deposit mobilization, Rural Banks could offer an effective and profitable lending product at money cost far below the corner pawn shop.

Like many Asians, many Filipinos store a significant portion of family assets in jewellery or gold. Such tangible chattel assets are easily valued and commonly used for pawnshop loans. Banks can build both deposits and their microcredit portfolio by making short-term, 30-90 day loans using only genuine jewellery as collateral. Rural banks can readily hire experienced loan officers with experience in jewellery lending or use the appraisal services of an independent certified jeweller/gemmologist. By requiring prospective borrowers to open personal savings accounts in order to access such "pawnshop" loans, Rural Banks can build their deposit base. At the same time, the banks create an ongoing client relationship with new depositors, many of whom having little or no prior experience with the formal financial sector.

While some bank owners will dismiss outright such a "radical" addition to their portfolio as a formal and recognized "pawnshop" type lending program using jewellery as collateral, it is likely that a considerable number of banks already make "jewellery" loans for selected clients. However, even banks now engaging in such a practise may be reluctant to expand such lending by publicly promoting it.

Drawing on the obvious success of the pawnshops, rural banks need to dramatically and quickly increase collateral based micro-lending now dominated so effectively by the ubiquitous pawnshops which appear to be on every major street. While the pawnshops charge an interest rate significantly less (7-10 per cent per month) than the 5/6 lenders, they nonetheless charge double what rural banks charge.

It is worthwhile to note that at least one major Manila based bank has an active marketing campaign promoting a pawnshop-like instant loan program using jewellery as collateral.

Introducing Debit Card technology for selected Rural Banks

To retain existing customers and gain new customers, rural banks should seriously consider issuing Debit Cards which could be used in ATMs throughout the country as well as at the rural bank. This would help make rural banks more effective in retaining depositors and borrowers presently lost to the commercial banks, which offer a broader range of services and more customer convenience.

Significantly, rural banks which aggressively pursue integration of their banks with the electronic banking tools of the larger commercial banks are more likely to retain their best and largest clients. However, they are also more likely to attract the lower end microcredit clients who may not have large transactions but who may well be the borrowers who generate the highest return. Retaining business clients, while bringing in and finding means to provide low cost service to the high profit microcredit borrower, will significantly increase the value of rural banks and make them likely take-over candidates.

Sentiment is strong that Philippine rural banks will inevitably consolidate. Well run, profitable rural banks will take-over weaker banks. Branch networks especially will become merger candidates. Within the next few years economies of operation will become more important for banks just as banking convenience will become more and more important to the Filipino customer.

Microbanker software, used at least in part by more than half of the Philippines 800 rural banks, has developed an ATM (automated teller Machine) interface which may prove to be a useful "connection" for rural banker links to the broader banker community.

Establishing an Independent Visa/Mastercard Processing Center

An essential part of the long-term solution to increasing rural bank microcredit lending includes use of bank issued credit cards. Use of bank credit cards world-wide is expanding rapidly especially in markets which ten years ago restricted bank credit card use to elite segments of the population. Establishment of an independent ,internationally certified bank credit card processing center NOT connected with a large commercial bank would allow rural banks to retain the Microcredit lending portfolio of their most credit worthy and sophisticated customers in an easily managed and low cost method. In fact, bank credit card operations are the modern means of microcredit in developed countries.

Currently, virtually all rural banks, must give up their best customers to their competitors if such customers want the convenience of a credit card. This is because the rural banks have no access to credit card processing centers which are Visa/Mastercard certified other than through the large national commercial banks, mostly headquartered in Manila.

Given the advent of such an independent Visa/Mastercard Processing center, rural banks can then issue both customer credit cards which feature a revolving line of credit with an appropriate ceiling and microcredit merchant accounts. The merchant accounts allow their microenterprise business customers a way to extend instant credit (for a fee) as well. Offering merchant accounts will allow rural banks to retain larger depositors and more sophisticated users of their banking services.

Moreover, since the bank charges the Merchant a percentage of every customer transaction, the bank has yet another source of revenue. In fact, a well risk managed, credit-graded Visa/Mastercard operation is likely to be the most profitable part of the loan portfolio for many rural banks, just as such bank credit card operations have proven to be for many banks across the world.

The main feature of a bank credit card, in addition to its facility and ease of use, is the bank's ability to offer a number of easily tracked and managed customer lending programs at varying interest rates dependent upon risk and customer credit information. But all use the same universal, automated system.

Given the lack of a reliable national credit bureau, rural banks offer an invaluable credit information resource which no large commercial bank can hope to provide, individual knowledge of character and capacity of the rural client.

In rural areas, where there is no formal credit rating service, rural banks rely not only on the information gathering of their loan officers but also on local *barangay* officials and residents who have personal knowledge of prospective borrowers. This informal credit rating service is reliable and developed to the extent that some *barangay* officials post the names of residents who have not paid their loans!

Considering Use of USAID's Loan Portfolio Guarantee Program (LPG)

The MABS-M activity has been requested to review the suitability of using the LPG program which is centrally administered for supporting microcredit lending in Mindanao. Given the large number of countries where LPG has been used and the long duration of the program – it began to expand rapidly more than a decade ago—it would seem natural to extend the credit guarantee program from predominantly small business to include microenterprises.

Regardless of the arguable success of AID's LPG, however, we need to consider use of the LPG in the particular environment for microcredit lending in the rural areas of the Philippines and Mindanao where the MABS-m project operates.

Within the past six to nine months the overall percentage of loans at risk for all 800 rural banks in the Philippines has increased from an already high 18% to and even higher 25% of loans outstanding. This is an extraordinarily large and sudden rise in the percentage of loans at risk. The percentage of loan portfolios at risk has increased generally throughout the entire banking sector. But at risk loans in rural banks have increased at an even greater rate than elsewhere.

It is difficult to measure or predict whether the percentage of loans at risk will continue to increase at the rate of the past few months since Philippine banking laws do not require a loan to be placed at risk or past due until after loan have not been made for 90 days. Under the same regulations, the loan is not declared in default until the final due date of the loan regardless of how long the loan has been non-accruing and past due.

As a result, when more conservative measures are used the current percentage of loans at risk in Mindanao's rural banks may be and is likely to be even greater than 25%. In addition to the increasing percentage of loans at risk, many banks are experiencing a shrinkage in liquidity i.e.

deposits are decreasing. While geographically limited anecdotal evidence cannot be necessarily extrapolated nation-wide, rural bankers interviewed say depositors are withdrawing cash to pay for basic living expenses. If this is the primary reason, deposits will likely continue to be withdrawn. Deposits will steadily decrease until the economic tide turns for rural bank savers.

This condition puts rural banks between two sides of an ever tightening vice. On the one hand, cash is tight because available money to lend decreases, while on the other hand, cash is tight because loan repayments are not made.

Some rural banks may be tempted to try a number of devices to mask the deteriorating condition of their loan portfolios including rescheduling payment terms or rewriting loans so that the loans appear new. In this manner the percentage of loans at risk will *appear* smaller. Banks may consider such devices because their lack of liquidity will be made even worse by central bank requirements to increase loan loss reserves which are put in gear when an ever higher percentage of loans are at risk. This necessary regulatory requirement will decrease available cash and operating flexibility even faster.

Moreover, during the next two years the Philippines is gradually doubling the percentage of funds which all banks must put aside for loan loss reserves.

All of these factors will be exacerbated by an expansion of microcredit loans. Such a loan, usually unsecured, is classified by bank examiners as a non-conforming and substandard loan. As a result, the loan loss reserve requirement for each unsecured microfinance loan increases to 25% of the loan! This further reduces management options.

While central bankers in Manila are discounting the possibility of a massive number of rural bank failures, they are evidently initiating new regulations which will ease and streamline requirements for bank mergers and take-overs. They have been quoted as expecting a major consolidation of banks in the coming months.

Initiating a Loan Portfolio Guarantee program in such an environment will tempt rural bankers to reduce their exposure by making “half bad” loans either by shifting at risk larger loans to the program or by using the LPG to show examiners that their loans are not really at risk thus lessening the need for increasing loan loss reserves. Now is not the time to initiate the LPG for microcredit in the Philippines.

Even when economic recovery in the Philippine country-side is sound, LPG use should be limited to tried and true microborrowers who need larger loans and who are in fact graduating to become small business borrowers. This would then serve to free up funds for greater numbers of borrowers needing even smaller loans. LPG is not recommended for any other use in connection with microcredit in the Philippines.

In general, the unhealthy increase in loans at risk weakens the banking sector throughout the Philippines. However, compared to commercial and urban banks, rural banks are weaker still.

Identifying Immediate Specialized Training Needs

While MABS-M has a comprehensive Training Needs Assessment underway which will identify a comprehensive range of training needs, it is nonetheless appropriate and important to identify those training needs which have become apparent from interviews with Rural Bank Association officials and reviews of MABS-M bank analyses.

Given the perilous state of rural bank loan portfolios and the need for the MABS-M program to expand micro-lending at a time when the entire banking sector will likely constrict and reduce lending, it is important to be realistic about the capacity of Rural banks to take on more risk. As a result please note the following recommended courses and topics.

Identifying Potential Problem Loans and Developing Rehabilitation Strategies

The course should use a case study method. After completing the course participants should be able to:

- Understand the causes of problem loans
- Identify potential problem loans before they are obvious
- Execute first steps to proactively address emerging problem loans
- Conduct an effective meeting with a potential problem borrower
- Evaluate options available to resolve a potential problem loan
- Understand how to prepare for bankruptcy
- Avoid lender liability
- Apply the concepts in a case study

This course should be geared to loan officers and managers with 2-4 years of experience and certain more experienced loan managers who are supervising multiple loan officers or who have an increasingly at risk portfolio.

Comprehensive Risk Management

The essence of banking is risk management. Banks make money by taking risk and lose money by failing to adequately manage risk. The course should use a workshop method to focus on the key areas of risk management including: identification, measurement, monitoring and control. At the end of the workshop the participants should be able to:

- Identify the elements of risk
- Define the process of risk management
- Define the risk equation
- Identify and quantify inherent business risks
- Evaluate the quality of management controls
- Construct a comprehensive risk profile for the institution
- Interpret the risk profile and use it to make decisions about managing the portfolio
- Structure the organization for comprehensive risk management

This course should be geared to owners, managers, department heads and senior administrative personnel.

Steps to Better Loan Pricing

Loan pricing should not border on irrational. Too often lenders bow to pressure to compromise rate and terms in order to get the deal. Many lenders have no concept of the required rate to cover the bank's cost and meet its profit objective nor have they learned how to win the borrowers business on a basis other than price. Banks need to learn how to price for risk. Lenders need to have a clear sense of how to translate risk ratings to risk premiums incorporated in loan pricing.

The course should use a case study method. After completing the course, participants should be able to:

- Define the measurement and determinants of Bank Profitability
- Understand the Bank's strategic direction, competitive strategy and pricing philosophy
- Translate strategies goals into profit objectives
- Calculate the required rate on a loan
- Price for risk
- Price based on value of the relationship
- Convince the Customer that the bank lender has added value to the relationship
- Sell benefits not costs
- Apply the concepts in a case study

This course should be geared to loan officers with 1-3 years of experience, senior management and certain more experienced loan managers who supervise loan officers.

In conclusion, merely addressing the tactical MIS systems, generic training and microcredit product marketing won't have a strategic impact on rural banks. The most important activity for MABS-M is to strengthen the capacity of rural banks to offer the right products and services by doing five things:

- Offer commercial bank products and services the customer wants
- Emulate the best practices of moneylenders and loan pawnshops
- Manage problem loans
- Price loans to make a profit
- Control and manage risk

When rural banks have the strength and capacity to implement the five elements listed above, they will be able to compete head-on with commercial banks, moneylenders and loan pawnshops: then they will be able to offer and manage expanded microcredit on a sustainable basis.

ANNEX A

List of Acronyms and Abbreviations

ATM	Automated Teller Machine
BAP	Bank Association of the Philippines
BSP	Banko Sentral ng Pilipinas (Central Bank of the Philippines)
COP	Chief of Party
CRBs	Co-operative Rural Banks
DRBSLA	Department of Rural Banks and Savings and Loan Associations
GEM	Growth and Equity Mindanao
LBP	Land Bank of the Philippines
MABS-M	Microenterprise Access to Banking Services - Mindanao
MB	MicroBanker Software
MFI	Microfinance Institutions
MICROENTERPRISE	Firm with 10 or less employees including family workers
MIS	Management Information System
NGO	Non-governmental Organization
OPMIN	Office of the Presidential Assistant for Mindanao
RBAP	Rural Banker's Association of the Philippines
RBRDFI	Rural Banker's Research and Development Foundation
RBs	Rural Banks
SAF	Special Activities Fund
UNFAO	United Nations Food and Agriculture Organization
USAID	United States Agency for International Development

ANNEX B

PERSONS CONTACTED FOR MABS-M SHORT-TERM CONSULTANCY IN THE PHILIPPINES

USAID/Philippines

Tess Espenilla, CTO;
Mary Reynolds, RCO
Thea Pura, Contracting Specialist

MABS-M Program Personnel

Mercy Almanzor, office manager
Raike Quinones, microenterprise outreach specialist
Eduardo de Castro, banking operations and training specialist
Jaja Catalan, administrative assistant receptionist
Mateo Ty, short-term consultant
Dehlia Capeding, short-term research assistant
Rosario Tan-Padua, short-term research assistant
Mely Agabin, short-term specialist
Bill Pendleton, training needs assessment specialist
C.Y. Ollero, interim acting chief of party

RBAP

Virgilio S. Conronado Jr., Rural Bank of Bongabong (Oriental Mindoro)
Jose Lustre, President Rural Banker's Association
Pablo Ronquillo, Attorney
Ricky Morales, Advisor

Ateneo de Manila - Institute of Banking

Myra Gavino, Ateneo/Manila - BAP
Larry Marasigan, Ateneo/Manila Institute of Banking

ANNEX C

SCOPE OF WORK

Philippines MABS-M Short-term Consultancy
Chief of Party Candidate Visit/Banking Analyst and Training Expert
Gerald Andersen
Contract No. 492-C-00-98-00008-00

Introduction

MABS-M project implementation has been underway since early 1998. At the beginning of June, the original chief of party was removed from the project due to serious problems with leadership, management, and technical direction. The MABS-M program is currently managed by an acting chief of party, Lief Doerring, a Chemonics home office employee. As part of the process involved in replacing the originally proposed COP, it has been decided to field the potential COP replacement candidate to allow USAID, Chemonics, the RBRDFI, and OP-MIN an opportunity to assess the suitability of the candidate in person. The tasks for the COP candidate on this assignment are outlined below. It is assumed that the candidate will dedicate roughly two weeks to the assignment.

General Scope of Work

The consultant will provide technical assistance in two of MABS-M components, institutional strengthening and program management.

A. *Program Management.* Discuss MABS-M program needs and present his experience and skills in microfinance and banking to USAID, Chemonics, MEDCO, the RBRDFI, and the MABS-M team to enable these MABS-M stakeholders to assess the candidate's suitability for the COP position.

B. *Institutional Strengthening*. Present a half-day workshop event to the candidate pilot banks. The exact details of this training will be worked out with the MABS-M team in the first week of the assignment, with the actual event itself occurring in the second week.

Specific Duties

- Prepare for assignment: explore possible workshop topics and review technical work plan and reports.

- Meet with Alex Buenaventura, executive director of the RBRDFI. Discuss MABS-M program needs, including those of participating banks, the RBRDFI, and RBAP.

- Meet with Euphemia Calderon, executive director of MEDCO (representing OP-MIN) and chairwoman of the MABS-M Management Committee. Discuss MABS-M program needs and OP-MIN expectations and requirements.

- Meet with Tess Espenilla, CTO; Bob Barnes (if available); Mary Reynolds, RCO; Thea Pura, Contracting Specialist; and any other relevant USAID officials. Discuss MABS-M program needs, USAID requirements, relevant skills and experience, and suitability for the COP position.

- Meet with C.Y. Ollero, interim acting chief of party, and Lief Doerring, acting chief of party (returning August 28, 1998). Discuss MABS-M program needs, contractor expectations and requirements, and suitability for the COP position.

- Meet with the MABS-M technical team, including Raike Quinones, microenterprise outreach specialist; Ed de Castro, banking operations and training specialist; and Anthony Petalcorin, MIS specialist. Discuss MABS-M work done to date, current needs, and expected needs and plans for the rest of the year.

- Meet with relevant MABS-M short-term specialists, including Mely Agabin and Bill Pendleton. Discuss their terms of reference, MABS-M technical and training needs, current activities, and upcoming activities.

- In conjunction with the MABS-M activities with candidate pilot banks, present a half-day workshop to participating banks' staff. Possible topics include microfinance practices, strategic planning, making microfinance sustainable and profitable (covering portfolio monitoring and repayment management), or another topic to be developed in the first week of the candidate COP's consultancy.

- With input from the MABS-M team, develop and design the workshop listed in item 7 above.

Deliverables

- Training plans for sessions presented in the half-day workshop

- A brief report (4-7 pages) analyzing MABS-M current activities and outlining recommendations for improvements in MABS-M technical interventions, plans for training, and overall program direction. This report shall be due to the MABS-M acting chief of party within 21 days of the candidate's last day in the Philippines.