Regulatory Barriers to Innovative Lending Practices: Traditional Approaches to Bank Supervision

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Introduction

Availability of credit to small borrowers is crucial to the continued economic development and political stability of the Philippines. It is expected to make the greater segment of the population more productive and, thus, to bring about a more equitable distribution of wealth. The perception among some rural banks, non-government organizations (NGOs) and others promoting micro-lending is that traditional approaches to bank supervision constitute "one of the most serious barriers" to their work.

Respondents to the study expressed concern about the effects of banking laws, supervisory and regulatory practices (including collateral and documentation requirements), internal barriers, infrastructure, unregulated micro-lenders, charge-off policies, and unregulated deposit mobilization. These concerns are discussed in the following section.

The concerns and perceptions of the respondents regarding examiners and regulators are given consideration because if the concerns have merit and the perceptions are accurate then corrective measures must be taken so that bank supervision policies and practices do not impede the flow of credit to very small borrowers. But if the concerns have little or no merit, it would be prudent to look into the possible reasons for perceptions and find ways to reconcile differences to promote micro-lending within the context of prudential regulations.

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Potential Barriers to Micro Finance

Banking Laws

NGOs and other unregulated micro-finance institutions have mentioned that loan applicants are required to present formal financial statements and that this is one of the barriers to micro-finance activity. Most rural bankers agree that collateral and documentation expectations of bank examiners are the biggest obstacles that prevent them from engaging in micro-lending on a large scale. Banking laws, rules and regulations primarily aim to ensure prudent lending operations of banks to protect the general public's funds.[1] Sections 75 to 81 of the General Banking Act (R.A. 337), as amended, provide for the basic lending policies that all banks must observe *(see Annex 1)*.

There is nothing in the provisions of the law which mandates that small loans be secured and supported by formal financial statements. The law requires banks to carefully study the ability of borrowers to repay obligations upon maturity. Bankers have discretion in determining creditworthiness. A bank may demand submission of a statement of the assets, income and expenditures of an applicant to determine his or

1 *In the Philippines, about 92 percent of the assets of banks are financed by funds of the general public and only 8 percent by equity of the stockholders.*

her creditworthiness. The banking law does not specify a specific format for the statement of assets, income and expenditure, nor does it require that the statement be authenticated in any particular manner. Furthermore, no statement of assets, income, and expenditure need be submitted if the bank can assure itself of the borrower's capacity to pay in other ways.

While bankers may require collateral, there is nothing in the law that requires loans be so secured. In fact, the provisions of R.A. No. 337 which mandated collateral for loans have been repealed. Under the original provisions of Section 31 of the General Banking Act, medium-term loans for livestock, breeding, equipment, and long-term loans for the conservation, enlargement or improvement of productive properties, acquisition of machinery, etc., were required to be secured by a mortgage on the real estate, animals, machinery and equipment involved. This requirement was eliminated under Section 16 of Batas Pambansa Blg. 61.

The General Banking Act does not require banks to obtain collateral or a statement of assets, income and expenditure. If, in a bank's evaluation, a loan applicant can repay his or her obligations without relying on security, the bank is not mandated to require collateral. Banks may require collateral if their analysis concludes it is needed to ensure full repayment. In such cases, the law puts a limit on the loan values of collateral and provides for the manner by which foreclosure may be made. It thus appears that the General Banking Act's requirements for documentation and collateral do not pose a barrier to micro-finance activities.

As part of its supervisory functions over banks, and as specifically authorized under Section 78 of R.A. No. 337, as

amended, the Monetary Board (MB) of the Bangko Sentral ng Pilipinas (BSP) may, by regulation, prescribe security requirements to which various types of bank credit will be subject. So far, the MB has not issued any general regulation mandating the submission of collateral for micro-loans.

The MB has set general policies for the grant of unsecured loans (*Annex 2*). Thus, banks are mandated to require that unsecured loans be made under the signature of the principal borrower and at least one co-maker, except in the case of a principal borrower whose responsibility and financial capacity are unquestionable, in which case the signature of the borrower shall suffice. Bank management determines whether a co-maker is needed or not on a loan-by-loan basis. However, banks are required to keep records of the credit standing and financial capacity of borrowers. These records may be reviewed by examiners.

In the past, the BSP has sponsored several short-term special financing programs designed for small borrowers. Collateral was not mandatory in any of these programs. Thus, in the case of the "Masagana 99" and "Masaganang Maisan" programs for rice and corn producers, loans did not need to be secured but needed to be co-signed by parties acceptable to the banks *(see Annex 3)*. The same is true in the case of similar special programs for short-term loans to vegetable producers, retailers and others.[2]

The MB has mandated collateral requirements for larger medium- and long-term loans. Thus, loans granted under the Livestock Financing and Loans for Agriculture Inputs are

2 *The special financing programs mentioned have been terminated by the BSP. They have been shifted to the Department of Agriculture and to government lending institutions such as the DBP and the Land Bank.*

required to be secured by real or chattel mortgages, government securities, and other acceptable collateral. These loans, however, are not relevant to micro-financing.

Existing regulations require that an application for a loan be accompanied by a personal information sheet about the borrower, a certified copy of the borrower's income tax return, and a copy of the annual financial statement duly certified by an independent certified public accountant if the borrower is engaged in business and the loan applied for exceeds P100,000.[3] The requirement to submit audited financial statements for loans in excess of P100,000 is not relevant to micro-lending.

The requirement to submit the latest income tax return may need clarification. Micro-borrowers may not be able to submit income tax returns either because they are exempted from filing a return[4] or they have minimal income and do not file returns. The requirement to submit financial statements is a general requirement and is normally superseded by provisions of specific credit programs for small loans. Thus, income tax returns were not required to support loan applications in the "Masagana 99" and "Masaganang Maisan" programs.

As discussed above, there are no banking laws, rules or regulations that, in and of themselves, mandate that micro-loans be secured or be supported by formal financial statements. However, policies or examination practices may be biased against small loans not secured by collateral or not supported by formal financial statements.The perception that traditional approaches to bank examinations discourage banks from

3 *There is a pending proposal to increase this amount to P500,000.*

4 *Under the National Revenue Code, residents not engaged in business or not practicing a profession are not required to file income tax returns. In practice, residents engaged in small business with minimal income do not file income tax returns, and the government by its tolerance thereof has implicitly accepted this practice.*

granting micro-loans may be premised on anecdotal evidence, which indicates that some examiners require banks to increase loan loss reserves, thereby reducing equity, simply because micro-loans were unsecured or not supported by formal financial statements.

Examiners check compliance with banking laws, rules and regulations, soundness of systems for evaluating credit, supervision and collection of loans, and quality of portfolio during their examination of loan portfolios. Standard examination procedures require that samples of current loans together with all past due loans be included in the review. If the review indicates that many of the current loans have problems, then the sample is expanded to cover more loans. In accordance with established criteria, loans may be classified as "specially mentioned," "substandard," "doubtful," or "loss." Loans without collateral or clean loans classified "substandard" require a 25 percent provision for bad debts, while those classified "doubtful" or "loss" require 50 percent and 100 percent provisions, respectively ***(Circular 143, 1997)***. The provisioning of loan creates entries to expense and contra-asset accounts. The expense account is closed into capital at year-end and thus reduces the balance of the combined capital accounts. This, in turn, may cause the capital account balances to fall below the minimum capitalization level. Administrative sanctions may be imposed, such as suspension of lending operations and of authority to establish branches, prohibition from declaring dividends, and disqualification from the rediscount window if the capital account balances fall below the prescribed minimum capitalization level. Moreover, new stockholders must be sought if existing stockholders cannot or will not infuse additional capital to cover a deficiency, thus diluting current shareholders' ownership.

After completing the examination, the examiners present their loan classification to management for discussion, comment and guidance. Management is then given the chance to explain why provisioning is not needed in loans for which provisions for bad debts have been recommended by the examiners. If the explanation can be substantiated by some points that the examiners may have failed to appreciate, by records that the examiners may not have seen, or by subsequent events, such as loan payment after the date of examination, the examiners will review their classification. The BSP Circular on loan classification ***(see Annex 4)*** identifies specific criteria which minimizes the need to subject loans to examination. Historically, when the quality of the loan portfolio of a bank remained unsatisfactory despite admonitions from the BSP, the bank's right to grant unsecured loans was temporarily suspended until its credit policies and the quality of its loan portfolio improved.

There are perceptions that small loans not secured or not supported by formal statements are likely to be classified by examiners as problematic, for which provisions for bad debts must be made. The BSP has issued a set of guidelines for classifying loan portfolios and for setting-up provisions for losses ***(see Annex 5).*** These guidelines apply to all loans, big, small or micro, secured and unsecured. Nothing in the guidelines suggests that small loans not secured and not supported by financial statements should be adversely classified. The primary reasons for adverse classification are default in payment, absence of favorable credit information, unfavorable results from operations, and distressed economic condition of the industry of which the borrower is a part.

For unsecured loans, the lack of a tax return may result in the classification of some loans as "Loans Specially Mentioned." However, no provision for bad debt will be required provided there are no characteristics that cause the loan to be classified substandard, doubtful or loss (Circular 143, 1997). The absence of income tax returns, by itself, should not be the basis for sanctions imposed on banks.

The BSP released Circular 143 in October 1977 modifying some regulations to strengthen its loan classification procedure. It required that loans be considered "delinquent" for BSP review if one or more of the following apply:

- There is a loan balance outstanding after the final payment date of the loan, or

- The borrower has missed the following number of payments depending on the payment cycle:

Mode of Payment	Minimum Number of Installments in Arrears
Monthly	3
Quarterly	1
Semestral	1
Annual	1

- The Circular states that the total outstanding balance of a loan shall be considered past due, regardless of the number of installments in arrears, when the balance in arrears reaches 20 percent of the total outstanding balance of the loan receivable. In addition, the Circular requires that the entire balance of a loan receivable be considered delinquent when the past-due amount reaches 10 percent of the outstanding

loan balance for all modes of payment other than those listed above.

Assume that the first P5,000 monthly payment of a two-year, P120,000 loan is not paid. For purposes of classification only the P5,000 missed payment need be classified as past due. The remaining balance, P115,000, of the loan will be considered current. Under existing regulations interest accrual on the P5,000 missed payment will not be allowed while the accrual of interest on the remaining balance may continue until there are three past-due installments, in which case the entire loan is classified as past due. Since the P5,000 has been classified as past due, the examiner must determine if it should be subject to 25 percent, 50 percent or 100 percent loan loss provisioning. This classification will require analysis of the loan folder. If a review of the folder indicates that the entire loan should be adversely classified even if it is still current, the examiner may do so. Nothing in the BSP Circular on evaluation of risk assets ***(Annex 5)*** suggests that current loans may not be subject to loan loss provisioning. Current loans should be adversely classified if they show characteristics prescribed to be considered "substandard," "doubtful" or "loss." These parameters bring the regulator into the classification process much sooner than under previous regulations, where BSP involvement was often too late for most (if not all) types of loans.

There seems to be no basis in law or regulation for the perception that traditional approaches to bank supervision and examination are a major barrier to micro-lending. The law provides both specific and general requirements for bank lending activities, and most micro-enterprise lending activities fall under the general requirements of the law. Therefore, much is left to the discretion of bankers. This supports the argument

that the "law" is not a barrier to micro-lending. However, the banker's "discretion" is subject to evaluation by examiners, and that evaluation may hinder micro-finance activities. When examiners assess the competence of bank managers, the exercise of "discretion" is taken into consideration. Several sections of law and regulations allow bankers to exercise discretion in granting loans, but some provisions may hinder micro-lending by causing bankers to be very conservative in the exercise of "discretion," such as the passages below:

"Before granting a loan, banks must exercise proper caution to ascertain that the debtor is capable of fulfilling his commitment to the bank. Toward this end, banks ***may*** *demand of their credit applicants a statement of their property and of their income and expenditures . . .* [Emphasis added]*."* **(Republic Act No. 337, Section 76).**

"The purpose of all loans shall be stated in the contract between the bank and the borrower. If the bank finds that the funds have been employed without its approval, for purposed other than those agreed upon with the bank, the bank shall have the right to terminate the loan and demand immediate repayment of the obligation." **(Republic Act No. 337, section 77).**

". . . loans on the security of chattels shall not exceed fifty percent (50 percent) of the appraised value of the security . . ." **(Republic Act No. 337, Section 78).**

"Proof of financial capacity of borrower. As minimum requirements, . . . a certified true copy of the latest income tax return of the borrower, in all cases,. . ." **(Regulations, Section 1319.2).**

"Signatories. Banks shall require that credit accommodations against personal security be made under the signature of the principal borrower and at least one co-maker, except in the case of a principal borrower whose responsibility and financial capacity are unquestionable in which the signature of the borrower shall suffice." **(Regulations, Section 1319.4).**

Traditional forms of financial information and collateral often are not available in micro-finance lending. Moreover, there is little or no distinction between household and micro-enterprise finances, which may make compliance with Section 77 difficult. Repayment of loans is often based on current household income, and loan proceeds may be used for multiple purposes and intermingled with household operating funds. The phrase ". . . *principal borrower whose responsibility and financial capacity are unquestionable* . . . " sounds like a fairly high hurdle and co-makers are not always available. Just as commercial, real estate, and credit card lendings are very different products that require different management skills, underwriting requirements, types of file documentation and collateral requirements, types of management information systems, and levels of monitoring, etc., micro-enterprise lending is a different product that requires different information and management techniques.

Supervisory Practices

Because of the poor performance of borrowers under past specialized lending programs, some bankers and examiners take a conservative view of lending. To minimize risk, they tend to rely heavily on collateral and more formal forms of financial documentation. The micro-finance industry does not speak with a single voice, and perceptions differ greatly among the

parties involved. However, although some rural bankers do not feel that the BSP imposes unreasonable requirements on the clean (unsecured) loans, most of them generally feel that collateral and documentation expectations of bank examiners are the biggest obstacle to their doing micro-lending on a large scale. The expectations unnecessarily lengthen the time it takes to analyze and process small loans. They also feel that the amount of documentation and collateral desired by examiners is not necessary to support small loans, and thus they are at a competitive disadvantage vis-a-vis the lending investors. Although lending investors lend on an informed basis, they are more responsive to customer needs, in part because they require less formal documentation and collateral than banks.

One industry group, the Alliance of Philippine Partners in Enterprises Development (APPEND), suggested that there should be a different regulatory approach to micro-finance. They believe examiners look for the same type of financial documentation and collateral support in micro-loans and larger business loans, and this type of documentation and collateral is neither available nor practical in the case of micro-loans. Furthermore, they are concerned that regulators may take a dim view of micro-loans if collateral and financial support does not measure up to the standards applied to larger loans.

APPEND representatives believe that micro-loans fall into the category of "character lending,"[5] that these represent a distinct financial product (just as credit card lending is distinct from corporate lending) and should be viewed in the context of distinct micro-lending risk-profiles and performance

5 *Character lending is a misnomer. Most lenders take into consideration the character of borrowers. In this context, "character lending" refers to unsecured loans to reputable borrowers that have an aggregate household income sufficient to repay loans consistent with terms of the loans. These are loans based on the household cash flow of the borrowers.*

standards. They feel that standards and measures for existing products do not fit micro-lending. They are aware that micro-lending performance standards are being developed, and they would like these standards to be given a chance to evolve.

Commercial bankers feel that examiners do not look favorably upon business loans not supported by audited financial statements, even though these statements are prepared primarily for tax purposes and do not always adequately reflect cash flows and economic values. Bankers feel that audited statements are not needed if they are already familiar with a customer's business operations. One banker suggested that consideration be given to accounting for micro-loans on a cash basis rather than on traditional accrual basis if it would make regulators more comfortable.[6]

The CEO of an NGO that is in the process of converting to a licensed financial institution remarked: ". . . The greatest barriers to getting a license are misconceptions about micro finance." He thinks micro-lending is so different from traditional forms of lending that there is a need for a separate legal framework.[7] He indicated that bank supervisors take a dim view of unsecured lending and that loan portfolios cannot exceed 30 percent clean (unsecured) loans. He asserted that regulatory expectations for the loan application process are the same for both micro-loans and large commercial loans, and that standards should be different because micro-lending is different.

6 *If micro-lending is done on a sound basis, there is no reason to treat it differently from other types of loans. Seriously delinquent loans should be carried as non-accrual, the loan loss reserve should reflect potential losses, and charge-offs should be timely.*

7 *Historically, micro-enterprise lending has been done outside the formal financial sector. As this type of lending becomes more formalized, underwriting and performance standards will evolve as well the regulatory approach for supervising micro-lending.*

Although the banking law and regulations clearly do not impose specific documentation and collateral requirements, there is widespread uncertainty and concern about the expectations and requirements of regulators and examiners. This tends to discourage regulated institutions from innovating on their credit policies to come out with alternatives to collateral and formal financial statements as the basis for lending decisions. Regulated institutions may avoid micro-lending to exclude from their portfolio those loans considered problematic, and hence provisioned for losses, because small borrowers normally do not have financial statements or collateral. In addition, NGOs and other unregulated micro-finance institutions are reluctant to consider the use of deposit mobilization to expand their resources and serve more borrowers because of constraints that would be imposed on their lending practices and operations in general should they become a licensed financial institution.

Examiners think many bankers are uncomfortable with making unsecured loans, but not because of anything the examiners do. Examiners are of the opinion that commercial bankers tend to be conservative, preferring to lend against chattel mortgages and real estate. Commercial banks will lend on an unsecured basis, but not for small business loans.

Bank examination in the Philippines focuses on the primary or borrower-related risks associated with loans. Secondary or product-related risks are not consistently taken into consideration. Examiners say they are aware of secondary risks but do not develop risk profiles of individual products or services, nor do they formally appraise risk management systems, although some work has been done to move into that direction.

Examiners focus on loans, equities, fiduciary activities, foreign transactions and treasury operations, with heavy emphasis on loans and treasury operations. They also check compliance with banking laws, assess internal controls, and appraise management. They say they do not necessarily read the bank's lending policies since loans are evaluated based on BSP standards. They profile numerous loans, but do not necessarily hone in on the loans that are in the beginning stages of delinquency.[8]

While bankers have considerable discretion in granting loans, examiners have considerable discretion in evaluating the performance of bankers. Since evaluating bank management is a primary function of a bank examiner, bankers may feel it is better to avoid activities that will subject their judgment to so much evaluation. Clarification of law and regulations to address the peculiarities of micro-lending may make bankers feel more comfortable in exercising their judgment.

The BSP has, in the past, initiated several special lending programs designed to encourage banks to grant unsecured loans to small borrowers. Participating banks were given incentives, such as rediscounting facilities for loans granted under the programs at preferential rates of interest, and conversion of their borrowings from the BSP into equity through the Land Bank or DBP if these borrowings were utilized for lending under the special programs. Bank examiners have been actively involved in the implementation of these programs and have been trained to be more qualitatively perceptive in their evaluation to reduce the bias against small loans which are unsecured or unsupported by formal financial statements.

8 *Typically this would be loans that are two to six months behind in their contractual payment schedule.*

However, since there are negative perceptions, it would be useful for the BSP to conduct discussions with banks and groups espousing micro-lending. Special attention should be given to rural and cooperative banks which are widely engaged in micro-lending. Discussions should emphasize that existing laws and their implementing rules, as well as the examination processes, do not specifically require collateral and formal financial statements for micro-loans. It should also be pointed out that as long as loans are properly managed and banks have sufficient information records to support credit decisions, examiners will not criticize or classify loans that are unsecured or lack formal financial statements. At the same time, the Supervision and Examination Sector of the BSP should emphasize or clarify these matters with its examiners.

One reason for the examiners' conservative approach to examination may be the bank secrecy law, which makes it impossible for examiners of the BSP and the Philippine Deposit Insurance Corporation (PDIC) to verify individual account balances. There is thus a risk that banks may misstate deposit account balances and, because of the imposed scope restriction on the examination, the examiners are unable to detect such misstatements. A consequent and logical reaction of the examiners would be to become more conservative in the other areas of their examination.

Internal Barriers

NGOs and other non-regulated financial intermediaries are not the only institutions which can and should participate in micro-lending. Demand for micro-loans should be strong even in large metropolitan areas where the commercial banks and bigger thrift banks have their main offices. These

institutions have not entered into the micro-finance market because they do not feel an economic incentive to do so, not because of supervisory concerns.

It is worthwhile to note that 10 or 15 years ago large commercial banks deliberately shunned consumer finance despite its profitability. This business was left to smaller commercial banks, thrift banks and finance companies, which were able to develop this business extensively. Attitudes have changed dramatically during the last five years. However, larger banks have lost some of their best customers as a result of the development of capital markets (the ability of large corporations to raise funds through markets outside the banking system), the liberalization in branching policies for banks, and the entry of additional banks, including foreign banks. As large banks watched some of their traditional markets and customer base dissipate, they sought new markets and reconsidered their previous aversion to consumer loans. Today, many of these larger banks have opened consumer finance windows. As larger banks move into smaller markets, smaller banks which historically served these markets are forced to look at still smaller markets. In due time, larger banks may find it attractive to enter the micro-lending market.

Using traditional banking practices, micro-loans are expensive because of the tremendous work involved in the origination, supervision, collection and recording of a large number of very small loans. The high cost of micro-finance operations can be offset by charging a higher interest rate on the loans, and through cost reduction (process rationalization and/or computerization). Consumer education programs may offset the negative image caused by the necessity to charge higher interest rates on micro-loans. The main problem for

micro-enterprise borrowers is not the cost of credit but its availability. However, even though the margin on micro-loans can be equivalent to or greater than that of more traditional loans, commercial banks and large thrift banks still seem reluctant to enter the market. This may be due to the existence of sufficient demand for larger loans, which generate good returns with less work per loan.

Another internal barrier to micro-finance lending is the collective memory of previous bad experiences. For example, some borrowers in the "Masagana 99" program viewed their loan as a government grant, not a loan from a financial institution, and so did not feel obligated to repay. The president of a cooperative rural bank had a similar experience. His bank developed a well-functioning micro-finance lending program based on the Gramen Bank concept. A local politician told a local community during a campaign speech that he had made money available for loans through the local cooperative rural bank and suggested that they take advantage of it. The difference in delinquency rates between micro-loans granted before and after the speech was tremendous. Government leaders should monitor their actions and statements so that correct messages are sent to actual and potential borrowers. In addition, borrowers in micro-finance programs may sometimes need some type of training so that they may understand the nature of a loan and the effect of their nonpayment on the community.

Infrastructure

Bankers interviewed for this study generally responded that to promote micro-finance on a larger scale they need:

1. Better automated systems,

2. Better understanding of micro-lending practices, including performance measurement systems and risk management techniques, and
3. Better understanding of the BSP's views and standards on micro-finance regulation and supervision.

In general, participants in the study feel the need for better management tools and for a more transparent regulatory environment so that they can better respond to micro-enterprise customer needs. They said rural bankers do not have all the technology and training necessary to do micro-lending on a large scale, and more training is needed in the areas of understanding and analyzing household cash flows and micro-finance risk management. Collateral-based lending is the traditional form of lending in the Philippines, so bankers have little experience with other forms of lending.

A micro-finance institution must manage a very large portfolio of small loans to be profitable and competitive. The effort exerted to manage a micro-finance loan is at least as great as that for a traditional loan. The best way to manage the micro-loan portfolio effectively and to generate the information needed to manage risk is through computer-based information systems. Unfortunately, the majority of micro-finance institutions in the Philippines do not use automated systems. As a result, they lack timely and relevant information to manage portfolios effectively, and they must expend a great deal of manual effort, and incur the corresponding costs, just to update the loan records.

The most critical system that should be acquired by all micro-finance institutions is a loan portfolio management system. Such a system will track all activity on all outstanding

loans, permit the rapid identification of potentially troubled loans, provide an effective basis to evaluate borrower performance over time, and facilitate portfolio analysis and evaluation by examiners. A well-designed loan portfolio management system will also provide the information necessary for personnel at the local operating unit to manage the collection process and facilitate pre- and post-payment due data contacts with borrowers; for management to facilitate the performance evaluation of the operating personnel — for example, to identify loan officers with very low or very high delinquency rates — and for regulators to assess the overall risk level of the portfolio and the need for adjustments in the reserve for doubtful loan accounts.

Once institutions have implemented and mastered the loan portfolio management system, they could implement a general ledger/financial reporting system, which is critical in effective cost management and in the timely preparation of operating unit and of consolidated financial statements.

Section 25 of R.A. 337,[9] as amended, limits investments in bank premises and equipment (which include computer hardware) to not more than 50 percent of net worth. No implementing guidelines have been issued by the BSP as yet. The BSP should consider excluding computer equipment from the ceiling, provided computer hardware is used primarily for banking purposes. This is especially crucial for rural banks with small capitalization, considering the cost of bank premises and computer hardware.

9 *Under the revised Thrift Banks Law (R.A. No. 7906) and Rural Banks Law (R.A. No. 7353) provisions of the General Banking Law, as amended, which do not conflict with the former are deemed applicable also to rural and thrift banks.*

Competition

Rural bankers agree that there is a demand for micro-lending, but the demand is being met by the informal sector and by lending investors. The amount of documentation and collateral desired by examiners, which they feel is unnecessary to support micro-lending, is not required in the informal sector. Consequently, they are put at a competitive disadvantage. Lending investors lend on an informal but informed basis, and are more responsive to customer needs, in part because they require less formal documentation and collateral. They are required to register with the BSP but are not regulated by it. Consequently, they are more flexible in their loan evaluation and documentation practices.

Pawnshops, which provide micro-loans on the security of personal property, charge interest rates of 4-5 percent per month and appear to be thriving. The number of pawnshops registered with the BSP increased from 1,824 in 1990 to 3,931 in 1996. Private lenders charge higher interest rates and are proliferating, as the number of lending investor registered with the BSP increased from 823 to 2,032 from 1990 to 1996. Apparently, micro-loans provide good returns when properly managed.

Charge-off Policies

The timing of loan charge-offs appears to be a concern of almost everyone who was interviewed for this study. Transparent accounting requires that a loan be reclassified if no longer performing as an income producing asset and should be charged off if determined to have little or no value. Nonperforming loans should not be indefinitely kept in the books but should be charged off, but this reduces the banks' asset and capital

account balances. Almost everyone said the lending institution decided when a loan was to be charged off. Timing of the charge-off was determined in part by the loan's effect on capital position and on tax. There were instances when charge-offs were deferred because they would deplete capital and would trigger the minimum capital requirements — requiring the bank to bring in new capital. In some cases, if no new capital is available, the loans would simply not be charged off. Moreover, under existing Bureau of Internal Revenue rules, loans must be written off before they may be deducted for income tax purposes. Thus, the timing of loan write-off is part of the tax management process, and the BSP does not object provided the write-off complies with regulations.

If deferring charge-offs is common and has been practiced over time, it is likely that the financial statements of many banks overstate the value of assets and capital. Postponing proper accounting treatment of charging off loans does not improve the "real" financial strength of an institution. Postponing charge-offs, however, makes it difficult for anyone (including bank directors) to determine the true financial strength of an institution.[10]

As mentioned, once a payment on a loan is missed, the account is reviewed by the examiners. The refinancing or rewriting of a loan is considered in the process of classification. The BSP has promulgated specific rules for the renewal and restructuring of loans. For regulatory purposes, banks are required to immediately book provisions for bad debts when bad loans are determined after an examination of the portfolio by management or by BSP examiners. The BSP will consider

10 *Deferring charge-offs and non-transparent accounting makes the job of PDIC most problematic. It would complicate any off-premise risk analysis they would have to do for their insured Banks.*

the bad debt provisions as deductions from capital accounts, and the reduced amount will be the basis for compliance with all rules and regulations relative to capital account maintenance even if they are not booked immediately. Unreasonable delays in the booking of valuation reserves prescribed after on-site examinations are subject to administrative sanctions. Thus, the timing of write-offs is not very material for regulatory purposes.

Further, banks are required to submit quarterly reports of loan write-offs. The ratio of loan write-offs to total loan portfolio is one of the indicators used by the BSP for off-site supervisory purposes. The ratio of past due loans to total loan portfolio is considered more conservative and active since corrective measures can be imposed before actual losses are incurred, while the ratio of loan write-offs to total loan portfolio is considered reactive because action can only be taken after actual losses are incurred.

Unregulated Deposit Mobilization

Under existing laws only banks can accept deposits from the general public, and only entities authorized by the MB may borrow funds from the general public. Bank supervisory and examination practices ban NGOs from gathering funds from the general public, irrespective of their laudable objective of expanding micro-lending.

It would be counterproductive to allow NGOs and other informal organizations to receive funds from the general public without subjecting their operations, especially lending, to prudential regulations. The pyramid schemes and the collapse of a large number of unregulated savings and loan associations and loosely regulated credit unions and cooperatives argue

against allowing unregulated institutions to mobilize funds from the general public. While even closely regulated institutions fail, there are arrangements, such as the deposit insurance scheme of the PDIC, that minimize losses. Moreover, through close supervision by the BSP, unsound and unsafe practices by the banks can be uncovered and stopped before they cause extensive damage. The failure of some regulated entities only emphasizes the imprudence of allowing unregulated entities to mobilize funds from the general public. Ultimately, losses incurred by the public would make it more difficult to mobilize funds for micro-lending on an unsubsidized and sustainable basis.

3
Conclusions

Barriers exist, and one of the most significant is the lack of coherence and unity in the regulation of micro-enterprise lending. While everyone interviewed thinks micro-enterprise lending is a noble endeavor, it is apparent early in the study that perceptions of the micro-lending environment greatly differ. Examiners and regulators believe that their approach in evaluating loan quality and their collateral and loan documentation requirements are reasonable. In contrast, many outside the regulatory framework believe that examiners and regulators are less flexible in their approach. Differences in perceptions and views made it difficult to reach a consensus on what the barriers and hurdles are and what needs to be done to address them.

Many lenders subject to BSP supervision are either unclear about the BSP's views on small clean (unsecured) loans supported by informal financial information, or afraid that they will be criticized for making such loans. The law and regulations do not prohibit micro-enterprise lending, but there is language in them that causes lenders to think that to engage in such activity is to operate on the periphery of the law.

There have been poor experiences with clean loans in the past. This causes some bankers and examiners to be adverse to

risk and to lean toward lending with collateral. To some, being risk-adverse means not taking risk. To others it means mitigating risk through good management, systems and controls.

Banks, by definition, are in the business of taking and managing risk. For centuries bankers have assessed and managed risk intuitively, without the benefit of a formal and generally accepted framework or common terminology. Bank regulators, since bank regulation began, have also assessed risk without the benefit of a formal framework and common terminology. This informal analysis was possible because of the narrow scope of products and services offered by banks. However, the world is becoming far more complex. In recent years, the variety and complexity of products and services offered by banks have expanded dramatically. Virtually every product and service has multiple risks that must be recognized. Traditional methods for looking at risk are being strained and are often inadequate. Micro-loans are just another new and different product for which risks must be identified and evaluation frameworks designed and implemented.

The Office of the Comptroller of the Currency (OCC), United States Treasury Department, has developed a formal process and common terminology for assessing risk and risk management systems in U.S. national banks. The focus of the process is to develop accurate risk profiles for individual institutions and to evaluate each institution's ability to manage risks associated with products and services offered. The OCC has identified and defined nine risks necessary to develop accurate risk profiles:

- CREDIT RISK
- LIQUIDITY RISK

- PRICE RISK
- TRANSACTION RISK
- INTEREST RISK
- FOREIGN EXCHANGE RISK
- REPUTATION RISK
- STRATEGIC RISK
- COMPLIANCE RISK.

The last three categories of risk are less quantifiable than the first six. Evaluation of risk management systems is based on an institution's ability to identify, measure, control and monitor risks. The basic concepts of this framework apply as well to the largest global institutions as to the smallest rural banks. The concepts of understanding and managing risk are universal to banking. The Philippine supervisory system, which relies heavily on collateral to avoid rather than manage risk, should consider the merits of advanced risk management techniques. Good risk management techniques permit lenders to take on more risks, serve more borrowers, and earn higher returns associated with greater risk, while at the same time reducing risk of loss.

Historically, micro-enterprise lending has been done outside the formal financial sectors. Consequently, it has not been readily identified with banking. However, it is a financial product that can be delivered by the formal sector. Micro-lending has a unique risk profile and requires unique management skills and support systems. Standardized reports and performance measures are necessary to supervise and evaluate micro-enterprise loan portfolios, and good risk management techniques are required to administer the portfolio within the financial institution. Large-scale micro-lending is a high volume business, and advanced information systems are

needed to manage all the data associated with it. In addition, bankers need training in evaluating and mitigating risk associated with granting, managing and collecting micro-loans. Examiners expressed a desire for training in the development of risk profiles for financial products and risk management techniques, especially as they relate to micro-enterprise lending.

The more micro-lending moves into the formal sector and the more evidence that it can be done profitably, the more attractive it will be to commercial banks.

Recommendations

The following recommendations are submitted for consideration of appropriate government agencies in the Philippines and the USAID to promote micro financial services in the Philippines.

1. **Dialogue with banks and other organizations espousing micro-lending to clarify BSP supervision policies and laws, rules and regulations**

   The BSP has regular monthly meetings with various institutions under its supervision. Top ranking BSP officials are often invited by these institutions and other associations to talk about BSP policies on loans. During these occasions, the BSP may emphasize that, contrary to perceptions, neither BSP policies and practices nor the provisions of law, rules and regulations require micro-loans to be secured or supported by formal financial statements at all times. In addition, such loans will not be considered problematic merely on the basis of the absence of collateral or formal financial statements.

   BSP may also find it beneficial to reiterate its policy toward micro-enterprise lending to its Supervision and Examination Sector, especially to those assigned to the

examination of small thrift banks and rural banks. Part of that reiteration may emphasize that, in accordance with Central Bank Circular No. 1222 dated January 19, 1990, "no loan shall be classified substandard if repayment seems reasonably assured." Micro-loans should not be adversely classified if there are credit information records indicating that repayment seems reasonably assured, even if the loans are not secured and/or not supported by formal financial statements.

2. Modifications of laws and regulations to better reflect current policy

Although laws and regulations, in and of themselves, do not prohibit micro-enterprise lending, there is language in them that may cause lenders to believe that to engage in such activity is to operate on the periphery of the law. Consideration should be given to the merits of modifying language in laws and regulations to reflect current policy more clearly. For example, Section 76 of R.A. No. 337, which was cited above, may be changed to read:

> *"Before granting a loan, banks must exercise proper caution to ascertain that the debtor is capable of fulfilling his commitment to the bank. Banks* ***need not*** *demand of their credit applicants a statement of their property and of their income and expenditures* ***if they are able to ascertain, by other means, that the debtor is capable of fulfilling his commitment to the bank****. . .* [Changes emphasized]*."* **(Republic Act No. 337, Section 76).**

This change would send a clearer signal to banks that applicant's financial statements are not required for all loans.

A similar change may be made in Section 1319.2 of the Regulations which currently requires the submission of "... a certified true copy of the latest income tax return of the borrower, in all cases ..." This regulation should be changed to exclude micro-loans from the documentation requirement.

3. Better understanding of risk management techniques

Examiners and bankers expressed a desire to learn more about ways to reduce risk through risk management techniques than through avoidance . Risk avoidance means fewer people get loans. By providing training to both examiners and bankers in methodologies to identify, measure, control and monitor risks, more accurate risk profiles can be developed for products and services and for institutions as a whole. For institutions, risk management adds precision to managing their activities; for regulators, it adds precision to supervising the institutions for which they are responsible.

4. Assistance to rural banks and thrift banks with head offices outside of cities and first and second class municipalities in developing computer applications for loans and in servicing computer hardware

An effective system of supervising loans is indispensable in micro-lending. This involves: (a) up-to-date recording of loan grants and payments (principal and interest); (b) setting up of maturity ticklers and past due call-ups; (c) up-to-date recording of collateral, if any, and monitoring tax payments, insurance coverage, etc.; and, (d) generation of reports for use by management and by supervisory

authorities. If this can be facilitated, more banks will be willing to grant small loans. Supervisory and examination work for the BSP can also be facilitated by the presence of date-stamped records and files, which make it possible to determine the age of the data and the status of the loans. Because of the large number of loans involved in micro-lending, computerization is unavoidable.

Among banks, the rural banks are the most relevant to micro-lending, not only because they are mandated by law to give preference to applications for small loans, but because they are familiar with business conditions and borrowers and they have decision-making bodies in their areas of operation. While many of these banks may afford to acquire computer hardware, they may find it difficult to develop loan application software and maintain hardware and software individually because of the cost.

Assistance to small thrift banks and rural banks in setting up a common application program for recording and servicing loan accounts, and for servicing computer hardware and software will go a long way in promoting micro-lending. Computer application should provide information necessary to supervise and evaluate micro-loan portfolios such as:

A. Recording/Supervision of loans

1) Loan grant and related advances
2) Maturity tickler, in which the system should automatically print reminder letters
3) Payments
   a. Interest and penalties (with automatic interest computation)

b. Principal
4) Renewal, extension, or restructuring
5) Balances
6) Write-off, if any.

B. Recording and supervision of collateral, if any

1) Listing of collateral
2) Call up on:
   a. updating of taxes
   b. updating of insurance
   c. updating of inventories
   d. collectibles (interest on securities, dividends, rentals)

C. Management reports

1) Periodic listing of loan balances, maturity and collateral
2) Periodic aging (both on current and delinquent account)
3) Periodic reports on past due loans
4) Periodic reports on extensions or refinances
5) Listing of written-off accounts (items 3, 4 and 5 can be used as guides in processing future loan applications)

Technicians may be assigned to a group of thrift and rural banks in specific areas to service computer hardware on an intermediate to long-term basis. Arrangements with suppliers to provide for setting-up of application systems and for servicing of hardware may reduce cost of maintenance. Hopefully, after three years, the assisted banks would become more efficient in handling micro-loans and profitable enough to handle computer systems without further assistance. More importantly, their success in

handling micro-loans will encourage other banks to follow suit.[11]

5. Removal of investments in computers from ceilings on bank premises and equipment

As noted above, current regulations limit investments in bank premises and equipment (which include computer hardware) to not more than 50 percent of net worth. The BSP should consider excluding computer equipment from the ceiling, provided computer hardware is used primarily for banking purposes. This is especially crucial for rural banks with small capitalization, considering the cost of bank premises and computer hardware. This may be done through the issuance of a circular or an amendment to the law. If an amendment is needed, it should be worded in such a way as to give to the MB the discretion on what equipment may be exempted from the ceiling.

6. Strengthening CB supervision over micro-loan portfolios

It is impractical to examine every loan account during a bank examination. Depending on the quality of management, compliance with laws, rules and regulations, observance of sound and safe banking practices, and strong internal control system, examiners should focus on areas of highest risk and on risk management systems. In most instances, the loan review should include only a sampling of each loan type made by the institution. The sampling should include loans made since the last examination to test the quality of recent loan decisions and underwriting practices. Beyond the random sample review, emphasis may be placed on areas thought to represent additional risk such

as insider loans, new loan types started since the last exam large accounts, and loans more than two months contractually past due. In cases where a large number of small loans are granted under a special financing program, examiners should expect to see loan proceeds used to promote the purpose of the program.

In addition, examiners should examine bank systems for sound written underwriting standards and good collection policies and practices, and should review the adequacy and reliability of management information. Loan policies need to be read and understood by the examiner prior to profiling individual loans.[12] Evaluation of loan policies is a good way to assess the quality of management. Loan policies tell the examiner what the management's philosophy is with regard to loan products and risk management. In a well-run institution, especially in one that is maturing, a review of loan policies can be a major indicator of the loan quality. An individual loan review, done later in the examination, will be helpful to the examiner and management in assessing how well policies are being followed.

It is believed that BSP examiners can reduce the number of individual loans profiled by using a valid random statistical sampling technique. Random sampling can validate assessments of underwriting standards, collections, and supervision. Done properly, random sampling can help

11 *Some controversy exists about the ability of Microbanker to perform these functions; consequently, it is important that the Microbanker be carefully evaluated.*

12 *A side benefit of simply asking for loan policies (or any policy for that matter) is that the regulated entity will focus more on that area. Typically, management will improve an area simply because they know the examiner is looking at it. Policies reflect management's desire, and can be an effective way of better communicating what management wants.*

examiners detect the deficiencies and strengths from the statistical sample and from reviewing policies. This approach can be extrapolated to the entire loan portfolio.[13]

This same approach is appropriate for the assessment of most portfolios of small loans. In micro-enterprise lending it is critical to have the information necessary to address delinquencies immediately. Providing grace periods, which are common in other types of commercial lending, can be ruinous in micro-enterprise lending programs. History has demonstrated that not addressing delinquencies immediately can lead to rapid portfolio deterioration. Therefore, the following additional steps are recommended in reviewing the micro-enterprise loan portfolio.[14]

Review of collection problem loans

A. Determine the accuracy of the bank's individual loan delinquency calculation.[15] (An easy way is to check every loan profiled for delinquency using an inexpensive financial calculator that compares the principal balance outstanding to the theoretical amortized principal balance based on the contractual payment stream.)

B. Review each delinquent or non-performing loan and selected large loans to determine how much are losses or which are of doubtful collection. Note that the refinanced loans and extension agreements without an adequate payment history are considered non-performing and should be included for review. Add the anticipated amount of loss for each loan.

C. Compute the Bank's five-year average loss ratio.[16] Multiply this ratio by total loans outstanding less loan balances for loans which have been individually classified and reserved for per step (B). For those banks maintaining sufficient detail, computing a loss ratio by each loan category (e.g., auto, real estate, micro-enterprise, etc.) would be more appropriate.

D. The sum of steps (B) and (C) above should be compared to the existing Allowance for Loan Losses account balance, and the balance should be adjusted if it is materially inaccurate.[17]

E. The review in (B) above should also be used to evaluate the effectiveness of the bank's collection program.

Review of the banks' current loans

A. All current loans reviewed should be checked for delinquency, refinancing, and extensions.

13 The methods of extrapolating from statistical random sampling techniques are beyond the scope of this paper. The point is made here primarily because these techniques are widely available in computerized systems. Using these techniques might greatly reduce examiner time in profiling so many loans and free up time for other examination procedures.

14 Many of these steps probably should be incorporated in the review of other types of loans as well.

15 Our review of collection programs in better banks found that these banks had management information systems that could accurately provide delinquent loan lists based on how contractually delinquent a loan was. These delinquency calculations were made by the banks to maintain an effective collection program, exceeding the requirements of BSP regulations.

16 The bank examiner will have to determine whether this is a reasonable ratio to apply to the balance of the loan portfolio in light of current economic conditions and unusually high or low charge-offs in prior periods.

17 A somewhat philosophical discussion of why one would add (B) and (C) rather than use just one or the other can be found in NCUA Letter to Federally Insured Credit Unions # 126 "Interim Guidance for Establishment and Maintenance of the Allowance for Loan Losses" dated September 1991. The process is a compromise between two opposing views as to when a loan loss is recognized. One view is to recognize the loss when the loan is made. Another view is to recognize the loss when a reasonable person would devalue a specific loan.

B. Reduce the number of loans required to be reviewed by examiners by using a random sampling technique. If an insufficient number of loans are selected for a loan type, selected sampling can be added to the random sample.

These suggestions for examining micro-loan portfolios may be incorporated in the manual of examination procedures used by BSP examiners. The immediate effect of adopting the more conservative classification system will likely result in greater Allowance for Loan Loss needs because: (1) it requires looking for loans to classify earlier in the delinquency process than is being done now, and (2) a loss factor is applied to the current loan portfolio, which is not being done now at all. However, over time it should result in the earlier recognition of problem loans and theoretically result in earlier collection efforts before the loans become hopelessly delinquent. Also, the accounting results in recognizing losses earlier and gradually reduces the severity of the financial impact when losses are fully recognized.

BSP Office Review of Examiners' Work

It is suggested that the BSP office reviewers develop a system for evaluating the adequacy of the Allowance for Loan Loss determinations made by the field examiners. Components of the system would have to include obtaining and tracking charge-off statistics and delinquency statistics. For example, the delinquency statistics could classify loans by number and amount in the following contractually delinquent categories – 0-2 months delinquent, 2-6 months delinquent, 6-12 months

delinquent, 12-18 months delinquent, and more than 18 months delinquent. Using a statistical sampling of banks whose Allowance for Loan Losses accounts were determined to be adequate, a regression analysis could be done of the delinquency and charge off ratios to derive a formula[18] for approximating the examiners' evaluations.

The formula will not replace the examiners' determinations but can be used for comparison with the examiner-determined allowance for loan loss valuation.

The formula can be used as the quick check of the banking industry as a whole. Used over time and comparing its results to capital, the formula can help determine trends in financial strength of individual institutions or the industry. It can be used as a yardstick to measure individual examiner performance. For example, examiners with loan-loss valuations consistently above or below the formula determination for loan loss allowance may have to undergo additional training and supervision, or they may be assigned to financial institutions with unusual characteristics. In either case, the consistent difference should be considered a red flag, indicating the need for additional analysis and management attention within the BSP.

18 *For such a formula to work, it is critical that delinquency and charge-off statistics be absolutely accurate. It would also require consistent rules for refinancing and extension agreements to the extent that those agreements change the reported delinquency rate. The formula would have to be tested and changed periodically to keep up with changing economic situations and improvements in tracking the delinquency, extensions, refinancing, and charge-off ratios. The regression analysis will take some time to develop. Accurate underlying data need to be obtained first.*

7. Assistance to the Bangko Sentral ng Pilipinas (BSP), Cooperative Development Authority (CDA), and the Philippine Deposit Insurance Corporation (PDIC) to enhance their capabilities in supervising institutions engaged in micro lending

To enhance the capability of the BSP and the PDIC in supervising banks engaged in micro lending, it is recommended that they be provided technical assistance so that their officers and staff can gain the knowledge necessary to regulate and supervise micro-lending in ways that minimize risk to the depositing public without unnecessarily inhibiting such lending. This knowledge can be gained through formal and informal training and observing successful programs. To reach a large number of regulators and examiners, much of the training should be done in the Philippines. However, visits outside the Philippines by a smaller number of bank supervisors would have merit. In addition, lending policies of local rural banks which were successful in the field of micro-lending should be studied to identify the principal characteristics of their loan policies and procedures that account for such success. Based on these observations, training, and studies, policies and procedures for supervising/examining micro-loan portfolios of banks should be developed to adequately cover programs for micro-loans within an acceptable time frame. It is also recommended that the CDA develop similar guidance so that it can supervise credit unions more effectively.

8. Changes needed in the Law for PDIC and BSP to carry out their missions

PDIC insurance can play an important role in mobilizing savings from the poorer rural sectors, in areas where micro-enterprise lending has the highest potential demand. PDIC insurance can give rural depositors the confidence to place his funds in the local financial institution. PDIC backing of a credit union can be a major factor for continued growth of these financial institutions.

However, PDIC has a major legal impediment – not being able to verify depositors' balances. It appears that Philippine law does not allow government authorities to review deposit account balances. If so, that law puts PDIC in an impossible situation vis-à-vis protecting the depositors.

First, any liquidation pay-out will be unusually difficult. At the point of liquidation, a financial institution's records are often in a state of disarray. Not having a prior verified deposit record can be an overwhelming obstacle in paying out the liquidation properly – not to mention within a reasonable time frame.

Basic internal controls within a financial institution require verification of accounts of depositors. The BSP or PDIC examiner cannot determine if this is properly done by the financial institution or by an outside auditor.

An inherent strength of the dual entry system is that it provides built-in controls to maintain accounting integrity. The dual entry requirement makes embezzlements more difficult to effect. Accounting irregularities or embezzlements can often be detected by tracing the audit

trail left from the second side of the dual entry.[19] However, there is no way the PDIC can trace any activity when the second side of the entry is to a deposit account. It would be relatively easy to commit fraud and bury it with entries to deposit accounts. Since a major portion of the liability side of the balance sheet is the deposit account, the exposure to material fraud is great.

It is recommended that PDIC (or the BSP examiners doing an examination on its behalf) be given the authority to review second party verification of deposit accounts. Likewise, the examiner must be able to trace accounting entries through the deposit side of the balance sheet. Certainly, any new type of financial institutions that PDIC insures (such as credit unions) should not be hindered by legal impediments that prevent the government from reviewing deposit accounts.

9. NGOs should establish thrift, rural and cooperative banks, non-stock savings and loan associations or credit unions

When an institution is allowed to administer the funds of the general public, the government should regulate the use of such funds for safety. NGOs should look at the constraints imposed on lending practices and operations of entities receiving general public funds not as barriers to micro-lending but as an indispensable measure to insure the continued flow of funds. Abuses resulting from unregulated use of public funds can perpetuate biases against mobilization of funds from the general public for micro-lending.

NGOs should consider establishing rural banks or cooperative banks supervised by the BSP so that they can accept deposits from the general public. The capitalization required for rural and cooperative banks is within the reach of some NGOs. In fact, this alternative has been adopted by some NGOs.

Alternatively, NGOs may establish credit unions and/or non-stock savings and loans associations (which are supervised by the CDA and BSP, respectively) and campaign for wide membership to generate more funds for micro-lending. After such credit unions have shown good track records, they can readily obtain credit from banks and other lending institutions to augment their funds for micro-lending. Ultimately, these credit unions may establish their own cooperative bank which can generate deposits from the general public.

10. Moderate negative perceptions associated with charging the poor the higher interest rates required to do micro-lending on a self-sustaining basis

Micro-lending, as a financial product, has higher inherent risks and higher delivery costs than more traditional loan products. The politics of openly discussing this fact among government entities, formal and informal lending institutions, and the media should be considered.

19 *For example, if a cashier is tempted to take cash, he can simply show it as being withdrawn from a deposit account. A bank has many built-in checks or internal controls and balances which can be used to trace the General Ledger reduction to a specific deposit account. Daily entries to the Journal and Cash record tie to the total daily work. The subsidiary accounts tie to the confirmations sent to the depositors. Subsidiary records of individual deposit accounts can be tied to the General Ledger Account. However, none of this can be confirmed by the outside government regulator. There is no independent verification of the transactions to deposit accounts that the bank can show to the examiner. There is no way the examiner can determine if the bank is following proper accounting procedures for internal control.*

For micro-enterprises, the availability of credit is typically more important then the cost. The better this fact is understood and accepted, the more likely that formal lenders will be attracted to the micro-lending market.

11. Establishment of formalized micro-enterprise lending training programs

Micro-enterprise lending is a financial product with a unique risk profile and performance pattern. To do micro-lending on a large scale requires specialized management skills and specialized management information and support systems. To promote successful micro-lending on a large scale, several things are needed, including resource information, support and training. This may be achieved by several means, such as providing technical and financial assistance to existing trade groups[20] or developing a micro-enterprise financial services institute separately or in conjunction with industry groups and others currently involved in financial training and in promoting micro-enterprise financial products. The assistance may be technical and financial, in the form of:

a. Remuneration for instructors and speakers
b. Cost of drawing-up a course on micro-lending (curriculum, references, case studies)
c. Rental of equipment
d. Supplies and stationeries
e. Miscellaneous

20 *One trade association this study found suited for this type of training assistance is the National Confederation of Cooperatives (NATCCO). It already has training facilities in different regions of the country.*

Annex 1

Sections 75 to 81 of the General Banking Act (R.A. No. 337, as amended)

Section 75. Banks shall grant loans only in the amounts and for the periods of time essential for the effective completion of the operations to be financed.

Section 76. Before granting a loan, banks must exercise proper caution to ascertain that the debtor is capable of fulfilling his commitments to the bank.

Towards this end, banks may demand of their credit applicants a statement of their property and of their income and expenditures. Should such statement prove to be false or incorrect in any material detail, the bank may terminate any loan granted on the basis of said statement and shall have the right to demand immediate repayment of the obligation.

Section 77. The purpose of all loans shall be stated in the contract between the bank and the borrower. If the bank finds that the funds have been employed, without its approval, for purposes other than those agreed upon with the bank, the bank shall have the right to terminate the loan and demand immediate repayment of the obligation.

Section 78. Loans against real estate security shall not exceed seventy percent (70%) of the appraised value of the respective real estate security, plus seventy percent (70%) of the appraised value of insured improvements, and such loans shall not be made unless title to the real estate, free from all encumbrances, shall be in the mortgagor. In the event of foreclosure, whether judicially or extra judicially, of any mortgage on real estate which is security for any loan granted before the passage of this Act or under the provisions of this Act, the mortgagor or debtor whose real property has been sold at public auction, judicially or extra judicially, for the full or partial payment of an obligation to any bank, banking or credit institution, within the purview of this Act shall have the right, within one year after the sale of the real estate as a result of the foreclosure of the respective mortgage, to redeem the property by paying the amount fixed by the court in order of execution, with interest thereon at the rate specified in the mortgage, and all the costs and other judicial expenses incurred by the bank or institution concerned by reason of the execution and sale and as a result of the custody of said property less the income received from the property. However, the purchaser at the auction sale concerned shall have the right to enter upon and take possession of such property immediately after the date of the confirmation of the auction sale and administer the same in accordance with the law.

Similarly, loans on the security of chattels shall not exceed fifty percent (50%) of the appraised value of the security requirements to which the various types of bank credit shall be subject, and, in accordance with the authority granted to it in section one hundred eleven of the Central Bank Act, the Board may be regulation reduce the maximum ratios established in the present section, but in the exercise of the aforementioned

authority, the Board shall in no case fix ratios greater than those established herein.

The Monetary Board may, similarly, in accordance with the authority granted to it in section one hundred eleven of the Central Bank Act, reduce the maximum permissible maturities specified in this Act for various types of bank loans, but in no case shall the Board exercise such power to authorize maximum maturities greater than those established in this Act. Any reduction by the Board of the maximum maturities specified in this Act shall apply only to loans made after the date of such action.

Section 79. The amortization schedule of bank loans shall be adapted to the nature of the operations to be financed.

In the case of loans with maturities of more than three years, provision must be made for periodic amortization payments, but such payments must be made at least annually: *Provided, however*, That when the borrowed funds are to be used for purposes which do not initially produce revenues adequate for regular amortization payment to be deferred until such time as said revenues are sufficient for such purpose, but in no case shall the initial amortization date be later than three years from the date on which the loan is granted.

Section 80. Borrowers may at any time prior to the agreed maturity date prepay, in whole or in part, the unpaid balance of any bank loan.

Section 81. The Monetary Board may by regulation prescribe the conditions and limitations under which banks may grant extensions or renewals of their loans.

Annex 2

Regulations on Unsecured Loans of Banks

Secured Loans

SECTION 1311. Loans and Secured by Real Estate Mortgage. Loans against real estate security shall not exceed seventy per cent (70%) of the appraised value of the respective real estate security, plus seventy per cent (70%) of the appraised value of the insured improvements, and such loans shall not be made unless title to the real estate shall be in the mortgagor. In the event of foreclosure, whether judicially or extrajudicially, of any mortgage on real estate which is security for any loan granted before the passage of Republic Act No. 337, as amended, or under the provisions of said Act, the mortgagor or debtor whose real property has been sold at public auction, judicially or extrajudicially, for the full or partial payment of an obligation to any bank, banking or credit institution, within the purview of said Act, shall have the right, within one year after the sale of real estate as a result of the foreclosure of the respective mortgage, to redeem the property by paying the amount fixed by the court in the order of execution, or the amount due under the mortgage deed, as the case may be, with interest thereon at the rate specified in the mortgage, and all the costs and judicial and other expenses incurred by the

bank or institution concerned by reason of the execution and sale and as a result of the custody of said property less the income received from the property. However, the purchaser at the auction sale concerned shall have the right to enter upon and take possession of such property immediately after the date of the confirmation of the auction sale and administer the same in accordance with law.

Section 1311.1. Insurance on real estate improvements. The required insurance on improvements used, as collateral for loans should be such as shall be sufficient to secure seventy per cent (70%) of the appraised value of such improvements or, if inadequately insured, the loan value shall correspond to the extent of insurance taken on such improvements.

SECTION 1312. Increased Loan Values of Collaterals. Pursuant to Section 78 of Republic Act No. 337, as amended, the following special cases shall have increased loan values:

a. Loans for house building and subdivision development for low and middle-income families against real estate security may be granted up to eighty per cent (80%) of the appraised value of the real estate security: provided, That –

    1) such loans shall not be made unless the title to the real estate security is in the name of the borrower or mortgagor; and

    2) The subdivision/housing project or plan has been approved by the proper authorities or up to ninety per cent (90%) of the appraised value of the real estate security if such loans are fully guaranteed by the Home Financing Commission (HFC) or other similar

government institutions, in addition to the foregoing conditions.

a. Loans for the acquisition of any instrument, machinery and other equipment for the use of the borrower in the production, processing, transformation, handling or transportation of agricultural and industrial products may be granted up to sixty (60%) of the appraised value of the assets so acquired with the proceeds of the loan: Provided, That such loans shall not be made unless title to the chattels is in the name of the borrower or mortgagor. If such loan is secured by real estate, the loan may amount up to eighty per cent (80%) of the appraised value of the real estate: Provided, That title to the real estate security is in the name of the borrower or mortgagor.

SECTION 1313. Loans secured by Time Deposits. The following rules shall govern the grant of loans secured by hold-outs on and/or assignment of certificates of time deposits issued by banks, i.e., the lending bank, or any bank other than the lending bank, as well as their branches or subsidiaries abroad:

a. The original copy of the Certificate of Time deposit subject to hold-out or assignment shall be surrendered to the lending bank, covered by a Deed of assignment or hold-out agreement;
b. The depository bank, other than the lending bank, shall be furnished a copy of the Deed of Assignment or hold-out agreement on the deposit used as collateral;
c. If the term of the Certificate of Time Deposit subject to hold-out or assignment is shorter than the term of the loan, there shall be an agreement in writing that renewal of the time deposit upon maturity shall be made at least

coterminous with the term of the loan;

d. There shall be no pre-termination of the time deposit without the consent of the lending bank and unless an acceptable substitute collateral for the loan has been made; *(Effective September 6, 198)*

e. The lending bank shall keep a complete record of all pertinent loan documents, such as but not limited to the original copy of the Certificate of Time Deposit subject to assignment or hold-out; Deed of Assignment or hold-out agreement; and written waiver of the depositor required in item f below, which shall be made available for inspection and/or examination by the appropriate supervising and examining department of the Central bank; and *(Effective February 23, 1987)*

f. The loan documents should include a waiver on the part of the depositor of his rights under existing law to the confidentiality of his deposits. *(Effective May 5,1986)*

SECS. 1314-1318 (Reserved)

Unsecured Loans

SECTION 1319. Loans against Personal Security. The following regulations shall govern credit accommodations against personal security granted by banks authorized to grant such credit accommodations.

Section 1319.1. General Guidelines. Before granting credit accommodations against personal security, banks must exercise proper caution by ascertaining that the borrowers, co-makers, indorses, securities and/or guarantors possess good credit standing and are financially capable of fulfilling their commitments to the bank. For this purpose, banks shall keep

records containing information on the credit standing and financial capacity of credit applicants.

Section 1319.2. Proof of Financial Capacity of Borrower. As *minimum requirements,* in addition to the usual personal information sheet about the borrower, banks shall require that an application for a credit accommodation against personal security *be accompanied* by:

a. a certified true copy of the latest income tax return of the borrower, in all cases, and

b. a certified true copy of the corresponding annual financial statement duly certified by an independent certified public accountant, if the borrower is engaged in business and the credit accommodation applied for exceeds P100,000.

Section 1319.3. Amount and terms of credit accommodations; renewals. Banks shall grant credit accommodations against personal security only in amounts and for the periods of time essential for the completion of the operations to be financed. *Any extension or renewal of such credit accommodations may be granted only in the amounts and for the periods of time essential for the completion of the particular operation originally financed, subject to the provisions of Subsec. 1304.4 on renewals.*

Section 1319.4. Signatories. Banks shall require the credit accommodations against personal security be made under the signature of the principal borrower and at least one co-maker, except in the case of a principal borrower whose responsibility and financial capacity are unquestionable in which case the signature of the borrower shall suffice.

Section 1319.5. Collateral Requirements. When, circumstances so warrant, banks may require applicants for credit accommodations against personal security to furnish collaterals, without subjecting such collaterals to the maximum loan values prescribed under the first and second paragraphs of Section 78 of Republic Act No. 337, as amended. Such credit accommodations shall continue to be subject to the provisions of this section.

Section 1319.6. Sanctions. The SES Department I/VI may recommend to the Monetary Board, for a violation of the provisions of this section, the imposition of any or a combination of the following sanctions:

a. Disqualification of the bank concerned from the credit facilities of the Central Bank; and
b. Prohibition of the bank concerned from the extension of additional credit accommodation against personal security.

SECS. 1320-1325 (RESERVED)

Source: Manual of Regulations for Banks and Other Financial Intermediaries

Annex 3

Masagana 99 and the Maisan Program

SECTION 3356. Masagana 99 Rice Production Program. The following implementing guidelines shall govern the M-99 Rice Production Program.

Section 3356.1 Strategy of Implementation.

a. ***Use of package of technology.*** Masagana 99 makes use of a package of technology, which has been proven, productive and effective in the country. The package includes the use of high-yielding varieties: timely application of the proper amount of fertilizers; judicious use of insecticides, herbicides and rodenticides and proper water management practices.

Supplementary programs like double cropping and direct seeding, which are innovative strategies to further increase the production are likewise implemented.

b. ***Supervised credit.*** Non-collateral production loans under a supervised credit scheme are extended to needy farmers who have to organize themselves into a joint liability group known as selda. Farmers, who can put up the necessary

collateral need not become members of a selda to qualify for a Masagana 99 loan, however, proper technical supervision should be provided them by production technicians.

In addition, criteria that shall determine the farmers who are qualified to obtain production loans under the Masagana 99 program have been set-up.

Section 3356.2. Borrowing policies and procedures

a. Borrowing policies

1) Qualified borrowers

(a) Bonafide farmers who have participated in previous Masagana 99 phases and have no outstanding loans from any financial institution and do not belong to a selda with a delinquent member. In cases where the farmer has no delinquent loan but belongs to a selda with a delinquent member, he may entitled to participate in the program provided he follows the guidelines with respect to the restructuring of the selda.

(b) Bonafide farmers who have not participated in previous Masagana 99 phases but whose ricefields are fully irrigated, as attested to by the production technician.

(c) Bonafide farmers who have not participated in any previous phase of Masagana 99 and whose ricefields are purely rainfed ("Sahod Ulan" or irrigated purely by rainfall), may be allowed to participate only after a very close analysis of the farm plan and budget indicates the ability of the farmer to pay his loan. In this case, the production technician and the manager of the financing

institution concerned would be answerable for any improper assumption or deficiencies in the preparation of the farm plan and budget of the farmer, which would result in the farmer's inability to pay his loan.

Bonafide farmers cultivating rainfed ricefields in previous Masagana 99 phases that do not have any outstanding Masagana 99 loan or belong to seldas with delinquent member (s) are also eligible.

2) ***Disqualified borrowers.*** Farmers whose farms are in upland areas are not eligible to participate in this rice production program.

3) ***Loan per hectare.*** The maximum loaning rate is P3, 000.00 per hectare. The PT shall use his wise judgement in determining the actual credit requirement of the farmer, but in no case shall it exceed P3,000.00 per hectare, as follows:

Input Portion

Seeds	P 200.00
Fertilizer	1,675.00
Chemicals/Rodenticides	960.00
Sub-total	P2,835.00
Barrio Savings Fund (BSF)	90.00
Crop Insurance	75.00
TOTAL	P3,000.00

Deduction for BSF from farmer-borrowers under the Special Financing Program is now optional. It may be made

only on a voluntary basis and when authorized in writing by the Samahang Nayon member. *(Effective Jan.11, 1985)*

4) All production technicians are advised to safeguard and see to it that the loan proceeds are utilized by the farmer according to the approved farm plan and budget.

The above aggregate amount of P3,000.00 is loan ceiling only and final approval is still the bank manager's prerogative. *(Effective Dec. 26, 1984)*

5) *Loan term.* The term of all loans granted under this program and other food production programs (agricultural loans) should be co-terminus with the production period of the crops to be financed with an allowance of two (2) months for marketing. In effect, the loan term for rice production loans shall in no case exceed six (6) months.

6) *Loan collection.* To strengthen collection of loans, production technicians are granted the following incentive allowances:

   (a) For the duration of the loan, fifty centavos (P0.50) per month for every farmer supervised. However, full payment of the loan prior to maturity date shall entitle the production technician to the balance of the total amount corresponding to the loan period which is three (P3.00) for Masagana 99 and the two pesos and fifty centavos (P2.50) for Masaganang Maisan.
   (b) Six pesos (P6.00) upon full payment of the Masagana 99 loan on or before maturity date; six pesos and fifty centavos (P6.50) upon full payment of the Masaganang Maisan loan on or before maturity date.

(c) There shall be a one peso (P1.00) deduction from the six pesos (P6.00) for every month the loan is past due.
(d) In no case, however, shall the production technician receive less than three pesos (P3.00) on the fourth month that the loan is past due or thereafter when the loan is fully repaid. This also covers restructured loans.

b. Borrowing procedures

1) *Organization of the selda.* Before a farmer can be extended a loan under the Masagana program, they have to organize themselves into seldas consisting of five (5) to seven (7) members with one of them to be elected as selda leader, based on one or a combination of the following criteria:

(a) Affinity of farmers. Farmers must know each other intimately either as friends, neighbors in the barrio, or better still, closely related to each other.
(b) Contiguity of farms. Farms must be adjacent or near each other in the same barrio.
(c) Size of farm. The landholding of farmers constituting the selda shall more or less have the same size.
(d) Yield. Productivity of the farms of selda members should be more or less the same.
(e) Cropping seasons. Selda members must at least have the same number of crops per year based on available irrigation facilities or cropping patterns in case the second crop is not rice.
(f) Willingness to undertake the joint liability concept. Prospective borrowers must be aware of the duties and responsibilities of members of the selda, particularly, their joint obligation to pay the unpaid loan of the delinquent members of their selda.

2) ***Restructuring of the selda.*** Farmers who previously belonged to a different selda can regroup themselves, and from the above-listed criteria provided, however, that all members have paid their loans. In the event that there is one or more delinquent member, they can only be allowed to join a new selda after signing a promissory note undertaking to pay, on an amortization basis, the unpaid balance of delinquent members of their original selda under a plan of payment to be drawn between the previous co-selda members and the financing institution concerned. In the event that the bank will succeed in effecting collections from their delinquent co-selda members, the paying members of the selda shall be reimbursed accordingly. However, no loan shall be extended them under their new selda unless the first installment of the amortization covering the unpaid loan of their delinquent co-selda members has been made.

Old seldas that meet the above criteria can be maintained with the same membership. They likewise will be granted new loans on condition that they have paid their loan obligations. However, in case of default of any member/s, all the other members will have to enter into an undertaking to amortize these overdue loans under the same terms and procedures described in the immediately preceding paragraph.

3) *Steps in securing production loan*

(a) A farmer should get a certification from the barangay leader attesting that he is a bonafide farmer in that barangay. In addition to this, production technicians must request a masterlist of farmer-cooperators from

the DAR field offices which should indicate the area of landholding per individual and the lot number as specified by par-cellary maps conducted by the Bureau of Lands. In the absence of this, the PT must refer to a masterlist of former-cooperators provided by NIA if ever possible. On the other hand, those farmer-borrowers issued with identification cards need not accomplish the above procedures. Farmers may use their Ids in securing production loans.

(b) The farmer, assisted by the production technician, prepares his farm plan and budget in accordance to his actual credit needs.

(c) On the second page of the farm plan and budget, the PT fills up a sworn statement certifying the farmer-borrower to be a bonafide farmer and the rice are he tills. Likewise, the barangay leader access to the farm plan and budget by affixing his signature.

(d) The farmer then applies for the loan by filling up the prescribed forms, attaches the duly prepared farm plan and budget and ID or certification of his identity as farmer from the barangay leader.

(e) The selda leader consolidates the farm plan and budget and loan applications of the individual members of the selda, to which he attaches one set of duly, accomplished promissory note.

(f) The farmer, with the assistance of the PT, shall arrange for the procurement of certified seeds from any authorized seed distributor through the seed chit system. Farmer-borrowers shall be required to use certified seeds for the loan application to be approved.

c. Release of loans

The proceeds of the loan are released in one lump sum and are automatically credited in a Special Savings Deposit Account (SSD) in the name of the farmer-borrower. The proceeds earn an annual interest rate of 12% while the farmer is charged a monthly 1% rate of interest on the total amount of the loan he gets.

Withdrawal from the SSD is on a staggered basis in accordance with the approved farm plan and budget.

d. Repayments

The farmer shall pay his loan, either in cash or in kind, at the end of the loan period.

Prices for payment in kind shall be based on the government price support or the prevailing price whichever is higher. Payment in kind can be made to any NFA operated or designated warehouse.

1) **Method I – Payment in cash**

(a) The PT reports to the banks concerned harvest schedules of farmer-borrowers under his coverage. Immediately after threshing, the production technician shall again report to the bank the volume of harvest of individual borrowers. Thereafter, the PT renders a continuous report on all harvesting and threshing activities of his farmer-borrower to the lending institution including yield whenever possible.

(b) The PT checks with the bank the outstanding

obligations of his farmer-borrowers and consequently reminds them of their due dates and amounts they have to pay. The selda leader, in particular, is tapped so he could initiate his selda members into paying their loans, clearly explaining to them that payment in cash immediately frees them from the marketing contract provided for in the promissory note/trust receipt.

(c) The farmer-borrower goes to his bank and presents his cash payment to the cashier, who, in turn automatically credits the payment to his SSD account.

2) **Method II – Payment in kind through NFA.** The payment-in-kind scheme under Letter of Instruction No. 372 was implemented throughout the country effective Phase VII. The Scheme in general, contains the following basic points:

(a) The farmer-borrower delivers to an NFA collection center or NFA-operated or designated warehouse, a portion of his farm produce equivalent to his outstanding loan obligation with the financial institution concerned computed at the current government support price.

(b) From the collection centers, the farm produce shall be delivered by NFA-operated/designated warehouses for drying and/or storage. NFA shall immediately issue a purchase receipt to said farmer-borrower for the palay/corn delivered in payment of the loan and shall forthwith authorize PNB or the lender rural bank to credit the account of the farmer-borrower with the corresponding peso value of said produce.

(c) Upon presentation to the bank by the farmer-borrower of the warehouse purchase receipt which also indicates

the cash value of the palay deposited, the bank credits to the borrower's account the cash value of the palay and pays the farmer any amount in excess of the loan.

Section 3356.3 Technicians as collection agents. At the option of the financing institution, bonded production technicians may be allowed to collect cash payments directly from farmers.

All collections made by the production technician for the day should be turned over before closing hour of the same day to the banks concerned for proper application to the accounts of their respective farmer-payees. All payments should be covered by official receipts issued by the banks in the names of the paying farmers.

Section 3356.4 Guarantee procedures

a. Losses. The Land Bank shall guarantee any loss that may be incurred by a participating lending institution as a result of non-payment due to force majeure of loans granted to farmer-cooperators under this program. The provisions and procedures are prescribed in the implementing guidelines set forth by the Land Bank of the Philippines.
b. Payments of arrearages. To restore the good credit standing of banks with the Central Bank of the Philippines (CB) and to regain their capability to render financial services to the rural communities and thus, enable them to continue their participation in the supervised credit program, the Philippine National Bank (PNB) and rural banks

may avail themselves of guarantee payment on their past due Masagana 99 loans from a special revolving trust fund constituted from national budgetary releases and administered by the Philippine Crop Insurance Corporation (PCIC), as provided under Letter of Instructions No. 1242.

(1) *Coverage.* Guarantee payments shall cover eighty-five percent (85%) of farmer's past due Masagana 99 loans with PNB and rural banks which are: (a) past due for three (3) years or more as of date of effectivity of the LOI; and (b) not previously subject of claims payments and/or advances under the Agricultural Guarantee Fund. *(Effective Feb. 2, 1983).*

However, past due Masagana 99 loans already written off in the books of accounts of rural banks and other banking institutions shall be excluded from the coverage of guarantee payments.

2) *Qualification requirements.* The Philippine National Bank and all rural banks with eligible M-99 arrearages covered by Item (1) may qualify for guarantee payments, except those banks which are under receivership or those which have committed serious irregularities.

3) *Application for guarantee payment.* The PNB and rural banks concerned shall file an application with the PCIC, thru the Central Bank, in the prescribed form with the following documents:

(a) Resolution of the board of directors authorizing the bank to avail itself of guarantee payments under this measure;

(b) A list of eligible loans for guarantee payments as defined in Item (2) certified under oath by the president or other duly authorized officers of the lending institution, and favorably endorsed by the Central bank;
(c) A deed of undertaking to submit with a reasonable time the farmer's restructured loans subject of the claim for guarantee payment;
(d) Such other documents as may be required by the PCIC and the Central Bank.

4) *Schedule of releases.* The PCIC shall release to PNB and to the rural banks (thru the Central Bank) such amounts not exceeding eighty five percent (85%) of loans subject of claims for guarantee payment according to the following schedule:

Year 1 – 25 percent of eligible loans
Year 2 – 30 percent of eligible loans
Year 3 – 30 percent of eligible loans

5) ***Restructuring of loans***

(a) The principal amount and accrued interest of eligible M-99 loans of farmers, exclusive of penalties and other charges shall be consolidated and restructured over a period of five (5) years. Thereafter, no interest and penalty charges shall be imposed on the restructured loans.
(b) Where, for one reason or another, restructuring of loans is not possible, the bank shall submit a list of these accounts together with the reasons or justifications for non-restructuring, certified and attested to by authorized barangay officials.

6) *Restructuring of rediscounting obligations.* The principal amount and accrued interest of M-99 Bills Payable of rural banks covered by Subsec. 3356.4b, exclusive of liquidated damages, shall be consolidated and restructured over a period of three years. Thereafter, no interest and/or penalties and other charges shall be imposed on such restructured Bills Payable.

7) *Application of collections.* All collections on loans already covered by guarantee payments shall be proportionately shared as follows:

   (a) Eighty five percent (85%) of collections made by banks under Subsec. 3356.4b shall be remitted to PCIC, as Administrator of the Trust Fund, within thirty (30) days after the collection.
   (b) Fifteen percent (15%) of all such collections, plus accrued interest, shall be retained by the bank.

8) ***Accounting***

   (a) Loans covered by Subsec. 3356.4b shall be segregated from other loan accounts of the bank concerned and shall be lodged under "Restructured Loans (LOI No. 1242)" account, which account shall be excluded from the computation of past due ratio and risk assets ratio.
   (b) Guarantee payments received from the PCIC shall be credited to a "Special Guarantee" account in the bank's books. Remittances to PCIC of collections on farmers' loans which are the subject of Subsec. 3356.4b shall be charged against this "Special Guarantee" account.
   (c) In the case of rural banks with M-99 rediscounting obligations with the Central bank, releases of guarantee

payments thru the central Bank shall be charged against past due "Bills payable" account and credited to "Special Guarantee" account in the bank's books.

(d) The cut-off date for accrual of interest charges on past due loans for purposes of restructuring shall be the date of payment/approval of the claim for guarantee payment shall also be the basis in computing interest on payments to the Central Bank. *(Effective Feb. 7, 1984)*

Section 3356.5 Input distribution scheme. In order to maintain the proper distribution of fertilizers, chemicals and seeds to Masagana 99 farmers, the following distribution scheme be observed:

(a) Use of chits

1) *Seed chit.* Chit A corresponds to the chit used in withdrawing the seed requirement of the farmer.
2) *Fertilizer chits.* There will be three (3) kinds of fertilizer chits. Chit B shall be used in withdrawing the fertilizer allocation for basal application. Chit B_1 shall be used in withdrawing the fertilizer allocation of first top dressing and Chit B_2, for the second top dressing.

   Effective Phase VIII, self-financed Masagana 99 farmers shall no longer be issued fertilizer coupons, there being a uniform price of fertilizer for food and export crops.
3) *Chemical chit.* Chit C corresponds to the chit used in withdrawing chemicals of which there are three (3) kinds, namely: C_1 for insecticides, C_2 for herbicides and C_3 for rodenticides.

(b.) Routing of chits. The chits shall be accomplished and issued out with the farm plan and budget by the

technician to the farmer before the loan is approved by the bank. The bank shall stamp its seal on the chits upon the approval of the loan and issue to the farmer the bank" and dealer" portions of the chits, which shall be presented to the dealer for input withdrawal. The dealer shall then submit the bank" copy of the chit to the bank concerned and keep his copy for audit purposes.

*c. **Issuance of chits.*** The PT issues four (4) corresponding to the input requirements discussed in the preceding paragraphs together with the farm plan and budget before the bank approves the loan. The PT should have fully filled out chit with the following information:

(1) name of farmer
(2) effective date of chit

Source: Manual of Regulations for Banks and Other Financial Intermediaries

Annex 4

Nature of Operations and Capital Requirements of Principal Sources of Loans in the Philippines

I. SOURCES OF LOANS

A. Banks

1. Types

a. Commercial banks (Universal and ordinary)
b. Thrift banks
(1) Savings and mortgage banks
(2) Private development banks
(3) Stock savings and loan associations
c. Rural banks
d. Cooperative banks

2. Sources of Funds

a. Deposits. Commercial banks accept all kinds of deposits. Thrift, rural and cooperative banks may accept demand deposits (checking accounts) with prior authority of the Monetary Board (MB) of the Bangko Sentral ng Pilipinas (BSP).

b. Borrowings from the general public (quasi-banking authority or QB). All banks must obtain prior

authority of the MB before they can borrow from the general public. The term "general public" is interpreted as 20 or more lenders. The BSP has suspended the grant of QB license. Most of the commercial banks and the bigger thrift banks have been granted QB authority. Those without QB authority must limit their borrowings from 19 lenders only.

c. *Capital*

The minimum capital of banks at present are as follows:

Types of Banks	Amount
(1) **Universal Banks**	P4.5 million
(2) **Ordinary Commercial banks**	P2.0 million
(3) **Thrift banks:**	
– with head office in Manila	P250 million
– with head office outside Metro Manila	P40 million
(4) **Rural banks:**	
– In 1st, 2nd and 3rd class cities of and 1st class municipalities	P5 million
– In 4th, 5th and 6th class cities and 1st, 2nd, 3rd and 4th class municipalities	P3 million
– In 5th and 6th class municipalities	P2 million
– In the cities of Manila, Kalookan, Quezon, Pasay, Mandaluyong and Makati and the municipalities of Malabon, Navotas, San Juan and Paranaque[1]	P20 million
– In the cities of Cebu and Davao	P10 million
(5) **Cooperative banks:**	
– National (may operate anywhere in the country)	P12.5 million minimum private paid-in capital
– Local (may operate only in a particular place in the country)	
– In Metro Manila	P20 million minimum private paid-in capital
– In cities of Cebu and Davao	P10 million minimum private paid-in capital
– Other cities	P5 million minimum private paid-in capital
– Other areas	P1.25 million minimum private paid-in capital

1 No new rural banks may be established in these areas.

Aside from above minimum capital requirements, all banks must maintain a capital-to-risk asset ratio of at least 10%. There is a bill pending before Congress authorizing the BSP to require banks to maintain minimum capital as per BIS standard. Preliminary computations indicate the existing capital accounts of banks will exceed minimum capital to be observed under the BIS standard.

3. Lending Authority

a. Purpose

Banks may grant loans for any purpose. The charter for the rural banks, however, provides that rural banks shall grant loans primarily for the purpose of meeting the normal credit needs of farmers, fishermen or farm families owing or cultivating land dedicated to agricultural production as well as normal credit needs of cooperatives and merchants and that preference shall be given to applications of farmers and merchants whose cash requirements are small. The Cooperative Code provides that a cooperative bank is one organized primarily to provide financial and credit services to cooperatives.

b. Maturity

Loans granted by banks may be short-term, medium-term or long-term. The General Banking Act (R.A. No. 337, as amended) provides That:

(1) Loans shall be granted only for the periods of

time essential for the effective completion of the operation to be financed.

(2) The amortization schedule of banks loan shall be adapted to the nature of the operations to be financed.

(3) In case of loans with maturities of more than 3 years, provision must be made for periodic amortization payments at least annually and that when the borrowed funds are to be used for purposes which do not initially produce revenues, the bank may permit the initial amortization payments deferred until such time said revenues are sufficient for such purpose but in no case shall the initial amortization be later than three years from the date on which the loan is granted.

c. *Security*

(1) Loans may be granted on a clear or secured basis. The decision is entirely up to a bank. However, when the examination of a bank show very poor quality of the loan portfolio, the examiner may recommend suspension of the grant of clean loans until credit policies and collection systems are improved.

(2) All types of assets, including expected harvest and untitled land, may be accepted as collateral depending on the evaluation of a bank.

(3) Before granting a loan, banks must exercise proper caution to ascertain that the debtor is capable of fulfilling his commitment to the bank. Credit investigation reports used, as basis for the grant of loans must be on file with the bank.

(4) An application for a loan against personal security shall be accompanied by a copy of his latest income tax return. If the borrower is exempt from filing an income tax return, he should state such fact and the reasons therefore. If the amount of loan applied for is more than P100,000.00, a copy of the borrower's balance sheet and profit and loss statement duly certified by an independent CPA must be submitted.2

(5) Clean loans must have at least one co-maker except in the case of a principal borrower whose responsibility and financial capacity is unquestionable in which case, the signature of the borrower alone shall suffice.

d. Amount of loan. Banks shall grant loans only in the amounts needed for the effective completion of the operations to be financed and which the borrower can repay.

e. Supervisory/regulatory agency

(1) All banks are supervised and examined by the BSP and the Philippine Deposit Insurance Corporation (PDIC)

(2) Guidelines on the operations of cooperative banks shall be formulated by the BSP upon consultation with the Cooperative Development Authority (CDA) and the cooperative movement. These guidelines shall give due recognition to the unique cooperative nature and character of cooperative banks. To this end, cooperative banks may be exempted from Central Bank rules and regulations, applicable to other types of banks, which would impede the cooperative rural bank from performing legitimate financial and banking services to its members.

B. Non-bank Financial Intermediaries

1. Investment Houses (IH)

These entities are engaged in underwriting activities. They are also allowed to grant loans to the general public. Loans may be granted on a clean or secured basis for any maturity (on demand, short, medium and long-term loan).

IHs is not allowed to accept deposits. Some have been granted QB authority by the BSP. Those without QB authority may borrow only from less than 20 lenders.

The minimum capital requirement for IHs is P250 million. In addition, those IHs, which have been, granted QB authority by the BSP must maintain a capital-to-risk asset ratio of 10%.

IHs with QB authority are supervised and examined by the BSP. Those without QB authority are supervised by the Securities and Exchange Commission (SEC).

2. Finance Companies (FC)

These entities are organized primarily to extend credit to consumers and to industrial, commercial or agricultural enterprises by factoring commercial papers, leasing motor vehicles, equipments, machineries and other movable properties. They are also authorized to grant loans to the general public. Loans may be granted on a clean or secured basis for any maturity (short-term, medium-term or long-term) although a large portion of such loans are short-term.

PCs are not allowed to accept deposits. Some have been granted QB authority by the BSP. Those without QB authority say borrow only from less than 20 lenders.

The minimum capital requirement for PCs is P10 million. Those which have been granted QB license were required then to have a minim capital of P50 million and capital-to-risk asset ratio of 10%. FCs without QB authority can borrow only from less than 20 lenders.

FCs granted QB authority are supervised and examined by BSP. Those without QB authority are supervised by the SEC.

3. Non-stock Savings and Loans Associations

These entities shall confine their membership to a well-defined group of persons and shall not transact business

with the general public. They shall be primarily engaged in servicing the needs of households by providing personal finance and long-term financing for home building and developmental activities.

1. *Sources of funds*

    1. Savings and time deposits
    2. Membership contribution of at least P50.00 per member.
    3. Borrowings which should not exceed 20% of total assets. This may be increased to 30% subject to approval by the MB. Borrowings can be obtained only from public lenders and from such private lending institutions as may be approved by the MB and in the case of NSSLAs organized by employees of an entity, such association may borrow from said entity.

2. *Lending operation*

    1. Loans shall be limited to the member's savings and time deposits plus his four months salary or regular income or 70% of the fair market value of any property acceptable as collateral on first mortgage that he may offer as security; provided that no loan shall have a maturity of more than 5 years, except loans on the security of real estate for the purpose of home building and home development which may be granted with maturities not exceeding 30 years and medium or long-term loans to finance agricultural projects subject to regulations that may be prescribed by the BSP.

2. In the case of a borrower who is a permanent employee or wage earner, the Treasurer, Cashier or Paymaster of the office employing him is authorized to make deduction from his salary, wage or income and to remit said deduction to the NSSLA concerned.

3. Supervisory agency

The BSP supervises and examines all NSSLAs.

4. Pawnshops

Persons or entities engaged in the business of lending money on the security of personal property. They may also grant loans on the security of real estate.

Pawnshops may grant such amount of loans as may be agreed upon between the parties, provided that the amount of the loan shall, in no case, be less than 30% of the appraised value of the security offered as collateral except when the borrower manifests in writing the desire to borrow a smaller amount.

They are not authorized to accept deposits. Funds used in lending operation come from capital. Minimum paid-in capital is P100,000.00. Borrowings can be made only from less than 20 lenders.

5. Credit Union

These entities shall confine their membership to a well-defined group of persons and shall not transact business with the general public.

Loans granted may be secured or clear, for any purpose and maturity.

The main sources of funds are fixed deposits (not subject to withdrawal) and savings deposits of members. They may also borrow from less than 20 lenders. The income (after overhead and interest on savings deposits), are distributed as rebates to borrowing members and dividend to fixed depositors.

These entities are supervised by the Cooperative Development Authority.

C. Insurance Companies

1. Type

a. Government

- Government Service Insurance System. Provident and insurance fund of government officers/staff.
- Social Security System. Provident and Insurance fund of officers/staff of private entities as well as those who are self-employed.

b. Private (life and non-life insurance companies)

2. Sources of funds

a. Capital
b. Premium or insurance policies
c. Contribution from members

3. Lending operations

a. Loans may be for any purpose and maturity.
b. Loans are granted to members on the security of insurance policies.
c. Loans may also be granted to non-members on secured basis.

4. Supervisory agency

Insurance companies are supervised by the office of the Insurance Commissioner.

D. Others

1. Corporate lending investors

These entities are regularly engaged in lending business. Loans granted may be for any purpose, maturity and may be clean or secured. Principal source of funds is capital and borrowings from less than 20 lenders. As corporations, they supervised the SEC> They are also required to register with the BSP>

2. Individual lending investors

These persons are regularly engaged in lending business. Loans granted may be for any purpose, maturity and may be clean or secured. Principal source of funds is capital and borrowings from less than 20 lenders. They are not supervised by any government agency.

3. **Merchants**

These parties are not in the regular business of lending funds. However, in the conduct of their business, they find it necessary to extend credit to their customers. Thus, rice dealers advance money to palay farmers to tie-up the laters' production. Fertilizer dealers supply fertilizers to farmers on credit payable upon sale of their crops. This increases sales volume of merchant.

4. **Other loose organizations such as non-government organizations (NGOs)** which are formed to provide credit facilities to specific identified sectors such as micro-borrowers. They are unregulated by any government agency.

Most of the above groups of lenders use their own capital to finance their lending operations. In the case of NGOs, fund donations from benefactors provide additional loanable funds.

There are indications that these lenders have been regularly borrowing funds from the general public to augment loanable funds without authority of the BSP. Under the General Banking Act, persons or entities found by the MB to be performing banking or quasi-banking functions without prior authority of the MB, may in addition to the proceedings provided under Sec. 34 of R.A. No. 265, as amended, (monetary fine and imprisonment due to failure to present books of accounts for examination or refusal to be examined) may be subjected to the imposition of fine of not in excess of P500.00 per day reckoned from the date the

unauthorized banking or quasi-banking functions were performed and may be referred to the SEC for the revocation of its license to do business.

II. INTEREST RATES

There is no ceiling on interest rates that may be charged borrowers. This is entirely up to the parties. Where no interest rate is stipulated, interest rate is stipulated, interest rate of 12% p.a. is assumed.

Creditors are required to furnish each borrower a clear statement in writing setting forth certain information which will enable the borrower to determine the true and effective cost of borrowing.

Violators are punishable by monetary penalty up to P5,000.00 and/or imprisonment up to one year.

III. RISK ASSETS REVIEW SYSTEM

To ensure that timely and adequate management action is taken to maintain the quality of a bank's risk assets and that adequate loss reserves are set up and maintained at a level sufficient to absorb the loss in such risk assets, each bank is required to establish a system of identifying and monitoring existing or potential problem assets and evaluating credit policies vis-à-vis prevailing circumstances and emerging portfolio trends. The system of identifying and monitoring problem assets and setting up allowances for probable losses shall include but is not limited to the criteria contained in Annex 1. This requirement had been circularized to all banks.

The criteria prescribed by BSP has no bias against small loans which may not be supported by collateral and/or financial statements. Where are these are absent, credit information indicating the ability of the borrower to pay his loan is generally accepted as substitutes therefor. The main basis for adverse classification of loans are delinquency, defects in documentation, improper supervision and lack of credit information.

Annex 5

Guidelines in Identifying and Monitoring Problem Loans and Other Risk Assets and Setting Up of Allowance for Probable Losses

Central Bank of the Philippines
Supervision and Examination Sector

CIRCULAR NO. 1222

The Monetary Board, in its Resolution No. 1093 dated: December 22, 1989, approved the following amendments to Books I, II, III and IV of the Manual of Regulations for Banks and Other Financial Intermediaries:

Section 1. The following are hereby added to Part I of Books I, II, III and IV of the Manual of Regulations to read as follows:

"_____ ***Management of Risk Assets.*** It shall be the responsibility of the board of directors of a bank/NBQB to formulate written policies on the extension of credit and risk diversification and to set of guidelines for evaluation of risk assets. Well-defined lending policies and sound lending practices are essential if a bank/NBQB is to perform its credit-creation function effectively and minimize the risk inherent in

any extension of credit. The responsibility should be approached in a way that will provide assurance to the public, the stockholders and supervisory authorities that timely and adequate action will be taken to maintain the quality of the loan portfolio and other risk assets."

Section 2. The following are hereby added to Part III books I, II, III and IV of the Manual of Regulations to read as follows:

"_____ 2/ ***Loan Portfolio and Other Risk Assets Review System.*** To ensure that timely and adequate management action is taken to maintain the quality of the loan portfolio and other risk assets and that adequate loss reserves are set up and maintained at a level sufficient to absorb the loss inherent in the loan portfolio and other risk assets, each bank/NBQB shall establish a system of identifying and monitoring existing or potential problem loans and other risk assets and evaluating credit policies vis-à-vis prevailing circumstances and emerging portfolio trends. Management must also recognize that loss reserve is a establishing factor and that failure to account appropriately for losses or make adequate provisions for estimated future losses may result in misinterpretation of the bank's/NBQB's financial condition.

"The system of identifying and monitoring problem loans and other risk assets and setting up of allowance for probable losses may include but is not limited to the following criteria:

"Subsec. _____ 3/ ***Classification of loans.*** In addition to classifying loans as either current or past due the same should be qualitatively appraised and grouped as *Unclassified or Classified.*

"Subsec. _____ 4/ ***Unclassified loans.*** These are loans that do not have a greater-than-normal risk and do not possess the characteristics of classified loans as defined in the succeeding subsection. The borrower has the apparent ability to satisfy his obligations in full and therefore no loss in ultimate collection is anticipated.

"Subsec. _____ 5/ ***Classified loans.*** These are loans, which possess the characteristics outlined hereunder. Classified loans are subdivided into (a) Loans especially mentioned; (b) Substandard; (c) Doubtful; and (d) Loss.

"a. Loans especially mentioned. These are loans or portions thereof which are superior in quality to those classified as *substandard*, but which are potentially weak, e.g., where there is lack of collateral, credit information or documentation and thus require closer management supervision. These loans do not have sufficient adverse information to warrant *Substandard* classification.

"This category may include the following:

1. Loans with technical defects and collateral exceptions, such as:

   (a) Unlocated collateral folders and documents including but not limited to title papers, mortgage instruments and promissory notes;
   (b) Improper execution of the supporting deed of assignment/pledge agreement/chattel mortgage/real estate mortgage;
   (c) Unregistered and/or unnotarized mortgage instruments as required in the loan approval;

(d) Collaterals not covered by appraisal reports or appraisal reports of which are unlocated;
(e) Collaterals not insured or with inadequate/expired insurance policies; and
(f) Loans to firms not covered by board resolutions authorizing the borrowings.

2. Loans not supported by up-to-date and adequate financial statements or adequate credit information. Regardless of size of the financial intermediary, it s important that all avail credit information on its borrowers be compiled in the credit folders/files for effective credit supervision. Included in this group are:

   (a) Loans renewed without updated financial statements, income tax returns and/or statements of assets and liabilities; and
   (b) Loans without credit investigation reports or updated credit information.

3. Loans which need the attention of management for special and/or corrective action. Common to this group of loans are:

   (a) Loan accounts wherein effort to collect is not evident or is deemed inadequate;
   (b) Loans granted beyond the limits of approving authority;
   (c) Availments against expired credit line; availments in excess of credit line; or availments against credit line without prior approval by appropriate authority;
   (d) Demand loans outstanding for an unreasonable length of time;
   (e) Loans granted without compliance with conditions

set forth in the approval;

(f) Loans with promissory notes signed unauthorized officers of the borrowing firm;

(g) Loans secured by property the title to which bears an uncancelled annotation of lien or encumbrance; and

(h) Loans to firms with profitable operations but belonging to a distressed industry.

4. Loans the repayment of which may be endangered by economic or market conditions that in the future may affect the borrowers ability to meet scheduled repayments such as declining or fluctuating operation, illiquidity, or increasing leverage trend in the borrower's financial statements.

*"b. **Substandard loans.*** These are loans or portions thereof which appear to involve a substantial and unreasonable degree of risk to the institution because of unfavorable record or unsatisfactory characteristics. There exists in such loans the possibility of future loss to the institution unless given closer supervision. No loan should be classified *Substandard* if repayment seems reasonable assured. Loans classified as *Substandard* must have a well-defined weakness or weaknesses that jeopardize their liquidation. Such well-defined weakness may include adverse trends or development of financial, managerial, economics or political nature, or a significant weakness in collateral.

"The basic characteristics of loan accounts subject to *Substandard* classification are as follows:

1. **Secured Loans**

(a) Loans under litigation;

(b) Past and circumstances are such that there is an imminent possibility of foreclosure or acquisition of the collateral because of failure of all collection efforts;
(c) Past due for more than six (6) months without reduction in principal but in process of collection; and
(d) Current loans to borrowers with inadequate net worth, poor earnings, or whose properties securing the loan have declined in value materially or have been found with defects as to ownership or other adverse information.

"Loans possessing any of the above characteristics should be classified *Substandard* at the full amount except portions thereof secured by hold-outs on deposits, margin deposits or government-supported securities. The portions so secured are not subject to classification.

2. **Unsecured loans**
   (a) Items under litigation;
   (b) Loans past due for more than ninety (90) days;
   (c) Renewed/extended loans without at least twenty percent (20%) repayment of the principal before renewal or extension;
   (d) Unmatured loans which have become unsound due to unfavorable results of operations of the borrower, minimal capitalization of the borrower in relation to the loan and/or project financed, weaknesses inherent to conduit loans or loans availed of for the benefit of another party, or absence of favorable track record showing borrower's financial responsibility; and

(e) Loans to distressed industries repayments of which are imperilled.

"c. ***Doubtful loans.*** These are loans or portions thereof which have the weaknesses inherent in those classified as Substandard, with the added characteristics that existing facts, conditions, and values make collection or liquidation in fully highly improbable and in which substantial loss is probable.

"The basic characteristics of loan accounts subject to *Doubtful* classification are as follows:

1. All past due clean loans classifieds as *Substandard* in the last Central Bank examination without at least twenty percent (20%) repayment of principal during the succeeding twelve (12) months or with current unfavorable credit information;
2. Past due loans secured by collaterals which have declined in value materially such as inventories, receivables, equipment, and other chattels without the borrower offering additional for the loans coupled by the weakened financial condition of the borrower;
3. Past due loans secured by real estate mortgage title to which is subject to an adverse claim rendering settlement of the loan through foreclosure doubtful;
4. Loans the possibility of loss of which is extremely high but because of certain important and reasonably specific pending factors that may work to the advantage and strengthening of the asset, its classification as an estimated loss is deferred until a more exact status may be determined.

*"d. **Loss.*** These are loans or portions thereof of which are considered uncollectible or worthless and of such little value that their continuance as bankable assets is not warranted although the loans may have some recovery or salvage value. The amount of loss is difficult to measure and it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be obtained in the future. Also included under this category are statutory bad debts as defined under Subsection _____6/.

"The basic characteristics of loan accounts subject to *Loss* classification are as follows:

1. Past due clean loans and advances the interest of which is unpaid for a period of six (6) months;
2. Past due well secured loans and advances not in process of collection, interest of which is unpaid for a period of six (6) months;
3. Loans payable in installments where amortization applicable to interest is past due for a period of six (6) months, unless the loan is well secured and in process of collection;
4. When the borrower's whereabouts is unknown, or he is insolvent, or his earning power is permanently impaired and his co-makers or guarantors are insolvent or that their guaranty is not financially supported;
5. Where the collateral securing the loan is considered worthless and the borrower and/or his co-makers are insolvent;
6. Loans considered as absolutely uncollectible; and
7. Loans classified as *Doubtful* in the last Central Bank examination and without any payment of interest or substantial reduction of principal during the succeeding

twelve (12) months, or has current unfavorable credit information which renders collection of the loan highly improbable.

Subsec. _____ 7/. ***Investments and other risk assets.***

1. Temporary investments in stocks and bonds should be valued at lower of cost or market. The lower of cost or market should be applied to the portfolio in its entirety. A valuation reserve account should be set up to reflect a material or major market decline equivalent to at least ten percent (10%) of the book value.
2. Equity investment in affiliates shall be booked at cost or book value whichever is lower on the date of acquisition. If cost is greater than book value, the excess shall be charged in full to operations or booked as deferred charges and amortized as expense over a period not exceeding five years. Subsequent to acquisition, if there is an impairment in the recorded value, the impairment should adequately be provided with allowance for probable losses.
3. Other Property Owned or Acquired.

    a. The basic characteristics of real estate property acquired subject to *Substandard* classification are as follows:

        1) Acquired for less than five (5) years unless worthless.
        2) Converted into a Sales Contract Receivable.
        3) Sold to subject to a firm purchase commitment from a third party before the close of the examination.

b. The basic characteristic of real estate property acquired subject to Loss classification are as follows:

1) The accrued interest, foreclosure expenses, and other charges included in the book value.
2) The excess of the book value over the appraised value.
3) Property whose title is definitely lost to a third party or is being contested in court.
4) Property wherein the exercise of the right of usufruct is not practicable or possible as when it is eroded by a river or is under any like circumstances.

Real estate property acquired are not sound bank assets. Because of their nature, that is, non-liquid and non-productive, their immediate disposal through sale is highly recommended. If such is not possible, they should be charged-off by annually providing a valuation reserve in accordance with the following schedule starting at the expiration of the statutory redemption period.

End of Year After Expiry of Redemption Period or Perfection of Contract	Annual Provision (1% to Cost of ReserveAquisition)	Accumulated Reserve
6th Year	10%	10%
7th Year	10%	20%
8th Year	10%	30%
9th Year	10%	40%
10th Year	10%	50%

4. Acquired or Repossessed Personal Property

   a. All personal property owned or acquired held for three (3) years or less from date of acquisition shall be classified as *Substandard* assets.
   b. The basic characteristics of acquired or repossessed personal property classified as Loss are as follows:

      1) Property not sold for more than three (3) years from date of acquisition;
      2) Property which is worthless or not saleable;
      3) Property whose title is lost or is being contested in court;
      4) The accrued interest, foreclosure expenses and other charges included in the book value of the property; and
      5) The excess of the book value of the property over its appraised or realizable value.

   Valuation reserves shall also be provided for foreclosed personal property in accordance with the following schedule, reckoned from the date of foreclosure or from the perfection of the contract, if acquired through dation in payment.

End of Year After Expiry of Redemption Period or Perfection of Contract	Annual Provision (1% to Cost of ReserveAquisition)	Accumulated Reserve
1st Year	50%	50%
2nd Year	30%	80%
3rd Year	20%	100%

5. Accounts Receivable

   a. Accounts receivable arising from loan and investment accounts should be classified similar to their respective loan and investment accounts.
   b. All other accounts receivable should be classified in accordance with age as follows unless there is good reason for non-classification:

No. of days Outstanding	Classification
61-180	Substandard
81-360	Doubtful
361 or more	Loss

The classification according to age of accounts receivable should be used in classifying other risk assets not covered above. However, their classification should be tempered by favorable information gathered in the review.

6. Accrued Interest Receivable

   a. Accrued interest receivable on loans or loan installments still uncollected after six (6) months from the date such loans on loan installments have matured or have become past due shall be provided with a 100% allowance for uncollected interest on loans, in accordance with Subsections _____ 8/ of the Manual of Regulations for Banks and Other Financial Intermediaries.
   b. All other accrued interest receivable on loans or loan

installments shall be classified similar to the classification of their respective loan accounts.

Subsec. _____ 9/ ***Allowance for probable losses.*** An allowance for probable losses on the loan accounts and other risk assets should be set up in accordance with the following:

Classification	Allowance
a. Unclassified	0%
b. Loans Especially Mentioned	0%
c. Substandard (Unsecured Portion)	25%
d. Doubtful	50%
e. Loss	100%

"The allowance for probable losses shall be adjusted accordingly for additional allowance required by the Central Bank.

"Management is encouraged to provide additional allowance as it deems prudent and to formulate additional specific guidelines within the context of the herein-described system.

"Subsec. _____ 10/ ***Transitory provision.*** Compliance with the establishment of the Loan Portfolio and Other Risk Assets Review system shall not be later than December 31, 1999 and submit to the Central Bank on or before January 31, 1990 a copy of such system and submit thereafter any subsequent change within thrity (30) days from date of such change.

"Allowance for probable losses on the unsecured portion of loans and other risk assets classified *Substandard* shall be set up quarterly based on the result of the examination conducted by the Central Bank after date of Circular in accordance with the following schedule reckoned from the date of the examination:

a. Expanded Commercial Banks, Commercial Banks and NBQB's-Two (2) years
b. Thrift Banks – Five (5) years
c. Rural Banks – Five (5) years: *Provided.* That where the total amount of allowance to be set up would impair a rural bank's net worth such as to constrict its lending operations, the period may be extended to a maximum of ten (10) years, upon prior approval of the Central Bank.

"Allowance for probable losses for loans and other risk assets classified as Doubtful and Loss as required by the Central Bank shall be set up immediately."

"Subsec. _____ 11/ Sanctions. Compliance with the requirement in Subsection _____10/ shall be a condition for the processing and/or approval of any of the following requests:

"a. For authority to establish new banking offices, regardless of type or category;
"b. For permit to operate new banking offices, regardless of type or category; and
"c. For availment of Central Bank credit facilities and other special financing programs managed by the Central Bank, except as may be allowed under Section 90 of

republic Act No. 265, as amended."

Section 3. Subsections 1304.8, 3304.4c, and 4304Q.7 of Books I, II, III and IV, respectively, are hereby deleted.

This Circular shall take effect immediately.

FOR THE MONETARY BOARD:

(Sgd.) GABRIEL C. SINGSON
Senior Deputy Governor

Annex 6

Regulations on Loans-to-Deposit Ratio

MISCELLANEOUS PROVISIONS

SECTION 1393. Loans-to-Deposit Ratio. The following policies and guidelines shall govern the loans-to-deposits ratio of head offices, branches, agencies, extension offices, etc., in regions outside National Capital Region, of commercial banks, expanded commercial banks and specialized government banks. *(Effective Sept. 15, 1998)*

Section 1393.1. Statement of Policy. At least seventy-five percent (75%) of total deposits, net of required reserves against deposit liabilities and provision for "till money", accumulated by branches, agencies, extension offices, etc., and/or head offices of commercial banks, expanded commercial banks, and specialized government banks, in a particular regional grouping outside the National Capital Region, shall be invested therein as a means to develop that region.

For purposes hereof, "deposits" shall exclude (a) government deposits subject to 75% liquidity floor requirement and (b) deposits of banks maintained for clearing purposes in areas

where there are no Central bank clearing units; while "till money" shall be an amount equivalent to 1% of the outstanding "deposits" as herein defined, but not to exceed 10% of cash on hand of the branch, agency extension office, etc., and/or head office concerned. *(Effective Sept. 15, 1998)*

Section 1393.2. Other methods of compliance. The policy shall be deemed complied with if, in a particular region, the bank's lending for the financing of agricultural and export industries aggregated 60% of its deposits.

Loans granted by the head office and other offices in a region may be assigned and considered part of the loans of offices in another region, subject to the presentation of acceptable proof that the end-users of the loan proceeds are located in the latter region. Acceptable proof may include but need not be limited to the following: (a) ticket showing that the loan proceeds were released by an office in that region and/or (b) cable advice from the lending office to the office in the region where end-users are located re: approval of loan and release thereof. *(Effective Sept. 15, 1998)*

Section 1393.3. Government securities as eligible investments. (Deleted by Circular 1183, Sept. 15, 998)

Section 1393.4. Clarifications (Deleted by Circular 1183, Sept. 15, 1998)

Section 1393.5 Sanctions for non-compliance. Compliance with the loans-to-deposits ratio for four (4) consecutive quarters shall be one of the conditions for the processing and/or approval of any of the following applications or requests of banks:

a. For authority to establish new banking offices, regardless of type or category;

b. For permit to operate new banking offices, regardless of type or category; and
c. To avail of Central Bank credit facilities and other special financing programs managed by the Central Bank, except as may be allowed under Section 90 of Republic Act No. 265, as amended. *(Effective Sept. 15, 1998)*

Section 1393.6. Regional groupings. For purposes of this policy, the twelve (12) regional groupings shown in Appendix 29 are reduced to three (3) enlarged groupings, as follows:

Luzon (Regions I, II, III, IV-A and V)
Visayas (Regions VI, VII and VIII)
Mindanao (Regions IX, X, XI and XII)

The enlarged groupings shall be used for purposes of determining the regional retention of deposits. *(Effective Sept. 15, 1998)*

Section 1393.7. Reporting requirements (Deleted by Circular 1183, *(Effective Sept. 15, 1998)*

Section 1393. 8. Grace period. For purposes of determining compliance with the investment-deposit-ratio, banks shall be granted a six-month grace period from every reporting date within which to invest their loanable funds. (Effective July 22, 1976)

All banks are allowed a grace period of one year from September 15, 1988 within which to comply with the prescribed ratio after which the prescribed sanctions for non-compliance shall be imposed. *(Effective Sept. 15, 1998)*

Source: Manual of Regulations for Banks and Other Financial Intermediaries

Persons Interviewed in the Field Work

June 1997

Noel M. Alcaide	Executive Director KMBI Kabalikat Para Sa Maunlad Na Buhay, Inc.
Clodoveo "Odie" P. Atienza	First V.P. Credit Supervision & Review UnionBank of the Philippines
Robert F. Barnes	Chief, Office of Economic Development, USAID
Rescina S. Bhagwani	V.P. Special Action and Assistance Group, Philippine Deposit Insurance Corporation
Alex V. Buenaventura	Executive Director, Rural Bankers Research and Development Foundation

Jose R. Chanyungco	First V.P. Controllership Group UnionBank of the Philippines
Ronald T. Chua	Professor, Asian Institute of Management
Jerry B. Coloma, Jr.	Chairman of the Board/ President, Zambales Bank, Rural Bank of Castillejos, Inc.
Ma. Teresita F. Espenilla	Project Management Specialist, USAID
Alegria A. Javier	First V.P., UnionBank of the Philippines
Eduardo C. Jimenez	Executive Director, Alliance of Philippine Partners in Enterprises Development (APPEND)
Ernest Leung	President, Philippine Deposit Insurance Corporation
Ricardo P. Lirio	Managing Director, Bangko Sentral ng Pilipinas

Alteo C. Malabuyoc	Corporate Executive Officer I, Field Examination Center II, Philippine Deposit Insurance Corporation
Delfin P. Narvaez	President, Rural Bankers Association of the Philippines
Cayetano W. Paderanga, Jr.	Member, Monetary Board
Flordeliza F. Ramos	V.P. Insurance and Bank Monitoring Group, Philippine Deposit Insurance Corporation
Pablo LR. Ronquillo	Chief Operating Officer, Rural Bankers Association of the Philippines
Andres I. Rustia	Director, Department of Commercial Banks I, Bangko Sentral ng Pilipinas

Oscar A. Delos Santos	Deputy Director, Public Information, Relations and Special Events Office, Bangko Sentral ng Pilipinas
Henry M. Sungsai	Bank Officer II, Department of Rural Banks, Bangko Sentral ng Pilipinas
Ricardo M. Tan	Executive Vice President, Philippine Deposit Insurance Corporation

About the Author

THOMAS M. FITZGERALD retired from the Office of the Comptroller of the Currency (OCC) in 1997 after thirty-two years of service. The OCC is part of the U.S. Treasury Department and is responsible for the supervision and regulation of all National Banks chartered in the U.S.

During his years as a National Bank Examiner with the OCC, Mr. Fitzgerald served as an examiner of bank automated systems, Examiner-in-charge (EIC) of Baltimore, Md., EIC of Washington, D.C., Director of Multinational Examinations, Washington, D.C., and District Administrator of the Central District with offices located in Chicago, IL. Mr. Fitzgerald oversaw the rehabilitation of more than two hundred problem banks during the 1980's and was a pioneer in the development of risk-based supervision.

Since retirement, Mr. Fitzgerald has consulted for International Management and Communication Corporation (IMCC). His areas of focus have been risk-based supervision, micro-finance, and institution capacity building at the Philippine Deposit Insurance Corporation.

FELICIANO L. MIRANDA is President-nominee of the Philippine National Bank (PNB). He was formerly Deputy Governor of the Bangko Sentral ng Pilipinas where he rose from the ranks, providing himself to be an expert on the regulation and supervision of banks. Prior to his nomination to the presidency of PNB, he was consultant to several commercial banks.

He received his Bachelor of Science in Commerce degree from the Far Eastern University (FEU) on 1950. He pursued post-graduate studies at the Georgetown University in Washington, D.C. (USA).

DAVID S. MURPHY is a CPA and professor of accounting, and most of his career has been centered on information systems for auditing and accounting, particularly in regard to financial institutions. To any project, Dr. Murphy brings outstanding skills in accounting and auditing of financial institutions; broad skills in the needs assessment, design, implementation and training for automated financial system controls; experience both as a professor and as a trainer in the US and abroad; and experience as a project manager. Of particular value to his consulting work is his long experience in management information systems.

Dr. Murphy has worked with International Management and Communication Corporation (IMCC) on its projects in Bolivia, Peru and the Philippines. His assignments included: technical assistance to the Superintendents of Banks in Bolivia and Peru in areas related to supervision and evaluation of bank information systems. Also for IMCC, he has been the Director of the Masters in Auditing

and Financial Controls at the Catholic University in La Paz, Bolivia, under the USAID-funded Human Resources for Development Project. Additional experience involving computerized financial accounting came from his work in Bolivia on the design for general accounting and loan portfolio management software for Crecer and for Freedom from Hunger.

Dr. Murphy is highly in demand as a trainer. More than most university level teaching, the teaching of auditing and accounting is very training-oriented. His strong training skills have been forged as a teacher of several university level auditing, accounting, and information systems courses at the Catholic Universities of Bolivia and Peru, California State Fullerton, Oklahoma State, Idaho University, and Washington State.

He has a Ph.D. in Accounting from Washington State University on 1989.

GERALD C. SCHULZ has been involved since 1982 in assuring the financial safety and soundness of credit unions in the United States, and in assisting developing countries to implement prudential regulation of their credit union systems. Presently, he is a Supervisory Examiner for the National Credit Union Administration (NCUA), the United States' regulatory authority for the credit union system. He is responsible for the leadership, training and direction of a group of nine examiners who cover more than 250 Chicago area credit unions with more than $3billion in assets.

He began his career at NCUA as an Examiner in Detroit in 1982, and at that time he had to deal with many unprofitable or marginally profitable credit unions that presented serious risk exposure to the National Credit Union Share Insurance Fund. Throughout his career at the NCUA. Mr. Schulz has been active in helping develop prudential regulations, in the computerization of examination activities and of the training of examiners.

He received his Bachelor of Arts in Business Administration and Accounting from Michigan State University on 1976.