Policy and Operational Framework For Microfinance In Agrarian Reform Areas

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POLICY AND OPERATIONAL FRAMEWORK FOR MICROFINANCE IN AGRARIAN REFORM AREAS[1]

I. BACKGROUND

Current government credit policy enunciated through the Agriculture and Fisheries Modernization Act (Republic Act 8435), Executive Order 138, Republic Act 8425 and the National Strategy on Microfinance prohibits government non-financial agencies (GNFAs) to directly participate in the implementation of government directed credit programs. These laws and issuances tasked government financial institutions (GFIs) to implement all credit programs. The GNFAs are instead directed to focus on the provision and facilitation of critical services such as basic rural infrastructure, human and organizational infrastructure to make rural-and urban-based micro-enterprises profitable. GNFAs can work with private sector institutions to provide capability building services to institutions involved in the delivery of credit services and technical assistance to their clients.

On the other hand, the Comprehensive Agrarian Reform Law mandates the government to provide credit as one of the support services to agrarian reform beneficiaries (ARBs). The Department of Agrarian Reform (DAR) has recognized microfinance as an important tool for poverty alleviation to complement their existing programs for support services to ARBs. DAR has expressed interest in promoting microfinance activities in the agrarian reform communities (ARCs).

Given the current government credit policy framework and the government's National Strategy on Microfinance, it is important that programs designed by DAR for ARBs be consistent with and supportive of this policy framework. But the more important reason is the need to have a policy and operational framework for sustainable microfinance in agrarian reform areas.

Objectives of the paper

1. Formulate a policy and operational framework for microfinance in agrarian reform areas;
2. Identify specific policy and operational issues in various programs with credit component being implemented by DAR that need to be resolved to effectively implement the proposed policy and operational framework;
3. Identify specific policy and operational reforms that need to be executed by DAR in its various programs with credit component.

II. MICROFINANCE AND RECENT POLICY INITIATIVES

[1] *Prepared by G. M. Llanto, Vice-President, Philippine Institute for Development Studies for the National Credit Council, the Credit Policy Improvement Program and the Department of Agrarian Reform.*

As a background to the formulation of a policy and operational framework for microfinance in agrarian reform areas, an understanding of the evolution of government's credit policy and the emergence of microfinance as a response to the need to provide micro-enterprises and poor households' access to savings and credit services is critical. This section provides a brief review of past credit policies and programs, the emergence of microfinance and recent policy initiatives by the government in support of microfinance development.

Policies of the 1970s[2]

Credit allocation, loan targeting, credit subsidies and directed loans to certain sectors were the hallmark of the supply-led finance approach in the 1970s and 1980s. Funding was sourced from government budgetary appropriations and foreign loans.

- ***Implementation of commodity-specific credit programs***. These programs were intended to meet the government's objective of attaining self-sufficiency in food requirements, particularly rice and corn.[7] The loans were channeled through the Philippine National Bank (PNB) and the Central Bank (CB) of the Philippines to rural banks which were given cheap funds for on-lending to small farmers at highly subsidized rates.

- ***Imposition of mandated credit quotas***. Presidential Decree 717 or the Agri-Agra Law, issued in 1975, mandated banks to set aside 25 percent of their loan portfolios for agricultural lending, 15 percent of which should be allocated to general agricultural lending and 10 percent to agrarian reform beneficiaries.

- ***Use of subsidized interest rates***. To lessen the cost of credit to the agriculture sector, the Central Bank of the Philippines opened a rediscounting window offering cheap funds for loans going to the agriculture sector. Rural banks were the chief beneficiaries of loans at highly subsidized interest rates from the Central Bank of the Philippines (CBP).

Policies of the 1980s and 1990s[3]

At the beginning of the 1980s, the government embarked on the liberalization of the financial markets and the deregulation of interest rates. Market-oriented financial and credit policy started to replace the financial repression policies of the earlier decades.

- ***Deregulation of interest rates***. In 1981, the government initiated a set of financial policy reforms which deregulated interest rates and gradually removed credit subsidies. The Central Bank rediscounting window, which served as the mechanism for preferential credit allocation was also closed. By the late 1980s, the Central Bank has moved out of development financing, having turned over to the Land Bank of the Philippines the

[2] *This section draws on Gilberto M. Llanto. 2001. "Sustainable Rural Finance: Policy and Design Issues".* ***PIDS Policy Notes*** *No. 2001-04.*

[3] *Llanto (2001).*

implementation of the World Bank-funded Agriculture Loan Fund (ALF). The use of market-based interest rates was adopted as a policy. In November 1994, the Bangko Sentral ng Pilipinas (BSP), which replaced the CBP, issued a circular lifting the ceiling on lending rates for rediscounted papers covering agricultural production, cottage and small industries and financing of working capital.

- ***Promotion of savings mobilization as source of loan funds***. After the government closed the taps of subsidized credit, the rural banks were forced to reduce their dependence on cheap government loan funds and to rely more on savings mobilization as source of their loan funds to the rural sector.

- ***Consolidation of directed credit programs in the agriculture sector***. In 1986, the different funds used for commodity-specific agricultural lending were consolidated into the Comprehensive Agricultural Loan Fund (CALF) by virtue of Executive Order 113. Some 19 funds administered by the Ministry of Agriculture and Food (MAF) and the CBP were consolidated into the CALF. Funds from the CALF were used to expand the guarantee operations of the Guarantee Fund for Small and Medium Enterprises (GFSME), the Quedan Guarantee Fund Board (QGFB), the Philippine Crop Insurance Corporation (PCIC) for agricultural production of small farmers and the Bagong Pagkain ng Bayan Program for rural-based projects of local government units. The credit guarantee program was intended to encourage private sector participation in agricultural lending by reducing the risks associated with agricultural lending.

- ***Implementation of Rural Bank Rehabilitation Program***. The financially repressive policies and programs implemented in the 1970s and the 1980s led to massive loan repayment problems and huge loan arrears among rural banks participating in the implementation of commodity-specific credit programs. Many rural banks closed shop as a consequence. In 1987, CBP Circular 1143, later amended by Circular 1172, implemented a rehabilitation program for rural banks. The rural bank rehabilitation program under the direction of the Central Bank of the Philippines required rural banks to provide fresh infusion of equity as a ticket to the rehabilitation package which includes, among others, a debt for equity conversion scheme and a rescheduling of past due obligations with the CBP, all intended to improve the balance sheets of the affected banks. In 1991, the Countryside Financial Institutions Enhancement Program (CFIEP) was established through CBP Circular 1315. Under the program, counterpart capital infusion by Land Bank was made available to match private capital infusion. Common stockholders were, however, exempted from the 20 percent ownership ceiling, and penalties and other charges on arrears covered by the program were waived. Finally, the 1992 Rural Bank Act provided for the implementation of a rehabilitation scheme for rural banks which allowed the conversion of a rural bank's arrears with the CBP into government-preferred stocks in the bank. Owners were required to infuse an equal amount of capital over a period of 15 years.

- ***Market-oriented financial and credit policies***. The AFMA was enacted in December 1997 mandating the adoption of market-based interest rates in the implementation of government credit programs in the agriculture sector. The AFMA also provided for the phase out of all directed (that is, *subsidized*) credit programs (DCP) implemented by government non-financial agencies in the agriculture sector over a four-year period. The proceeds from the phased-out DCPs in the sector will be consolidated into the Agricultural Modernization

Credit and Financing Program (AMCFP), which will then serve the credit demand of the agriculture sector at market-based interest rates. The program will be implemented through government and private financial institutions.

- ***Phase out of DCPs in other sectors***. To complement the credit policy provisions of the AFMA, that is, on the phase out of credit programs in the agriculture sector, the government issued Executive Order No. 138 for a similar phase out of all directed credit programs (DCP) in other sectors and the termination of the participation of government non-financial agencies in the implementation of credit programs. Executive Order No. 138 also mandates the adoption of market-based financial and credit policies and the use of government financial institutions as vehicles for the delivery of wholesale credit to private financial institutions that will take care of on-lending at the retail level. The underlying policy frame of AFMA and Executive Order No. 138 is the use of the market mechanisms in the allocation of financial resources and the reliance on domestic savings mobilization to fund credit programs.

Emergence of Microfinance

The failure of the formal banking system and the DCPs to provide small scale borrowers such as small farmers, micro-entrepreneurs access to loans led to the development and evolution of various micro-financing techniques among private microfinance institutions. Microfinance institutions (MFIs) comprised of credit-granting NGOs and some rural banks provide micro/ small loans without collateral at market rates of interest to small-scale clientele, mostly non-farm enterprises and micro-enterprises. Loan repayment is adjusted to the cash flow of the borrower, hence the term "cash flow-based lending" applied to microfinance loan operations. Documentation and lending procedures are simplified and loan repayments are made on time. A common denominator of successful MFIs' operations is their zero tolerance for loan defaults. This ensures borrower discipline and the sustainability of the MFI. The microfinance institutions use a variety of lending mechanisms such as group lending, individual lending; and market-based incentives to motivate good financial discipline among clients and loan officers. Other mechanisms such as the use of collateral substitutes like peer pressure and joint liability and focus on lending to women clients are key factors in the success of MFIs.

Credit-granting non-governmental organizations, credit cooperatives and, to some extent, a few rural banks have discovered the usefulness of microfinance as a sustainable approach to provide basic financial services to small-scale borrowers. These private lending institutions found out that it is possible to attain high levels of sustainability even without government credit subsidies.

In this respect, the experience of Bank Rakyat Indonesia (BRI), a large state-owned commercial bank is instructive. Sugianto and Robinson (1998) pointed out that "BRI has demonstrated on a nationwide scale in the world's fourth most populous country that financial services can be made widely available to lower-income clients at the local level; that adverse selection of borrowers can be overcome with knowledge of local markets; that there is massive demand for appropriate savings instruments among the poor; and that a commercial bank can operate a microfinance division profitably, without subsidy. Further it can do so viably over the

long term."[4] There are many other examples of successful MFI operations worldwide, e.g., BancoSol in Bolivia, MiBanco in Peru and Grameen Bank in Bangladesh with a common factor for success: the use of market-based interest rates, incentives and mechanisms in their micro-finance operations.

A study by Vogel, Christen and Rhyne found out that two variables account for the ability of microfinance institutions to have viable microlending programs for the poor: (a) effective rate of interest charged on loans and (b) appropriate human infrastructure[5]. Market-oriented interest rate policy allows microfinance institutions to charge effective rate of interest that cover cost of funds, administrative costs and profit margin for viability. Appropriate human infrastructure refers to the presence of quality management and staff that is responsible for good governance of the microfinance institution.

Self-sustaining operations are possible given the independence of those private lending institutions to establish lending policies and terms and conditions of the loan, including the manner of loan collection or repayment, the security required for the loan, borrower criteria and screening and design of loan product. A policy and regulatory environment conducive to sustainable microfinance also contributes to the success of those microfinance institutions. Regulation and supervision of banks engaged in microfinance have to adjust to the different character of microfinance operations[6].

Thus, the MFIs have proven to be sustainable and capable of reaching a large number of small borrowers who have viable projects and the determination to repay their loans on time. The reported outreach and volume of loans that have been provided by MFIs indicate that small-scale clients seem to have a better chance of accessing formal financial services under a market-oriented financial framework than under a subsidized credit approach. MFIs use a variety of innovative lending mechanisms and loan repayment techniques depending on the nature and type of clientele and the general circumstances surrounding the particular credit market. For example, Banco Sol in Bolivia "stresses the role of solidarity groups in assuring repayments, but as its clients have prospered at varying rates, lending approaches have diversified as well" (Morduch 1999)[7].

Pushing the financial markets frontier has been made possible by a number of innovative products, institutions and the open attitude adopted by the Philippine authorities with respect to the new paradigm. Voluntary savings mobilization is a key ingredient of this approach. This has equipped private microfinance institutions with a large liquidity base for funding the asset side of the balance sheet. For example, data from Bank Rakyat Indonesia as of August 1996 show that BRI

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[4] *Sugianto and Marguerite Robinson. 1998. "Sustainable Microfinance as Developed by Bank Rakyat Indonesia" in* ***The New World of Microfinance Conference Proceedings****. Makati City: TSPI Development Corporation, page 126.*

[5] *Robert Christen. 1998. "Microfinance Institutions Operating on the Frontier, " in* ***The New World of Microfinance Conference Proceedings****. Makati City: TSPI Development Corporation, page 11. Christen stated that institutions that charged a higher real effective rate of interest were more viable than those that charged a lower rate. Christen explained that some institutions understood that micro-clients will always pay a higher rate of interest for better service. These were the institutions that made high quality services available and were more financially viable than those that were hung up on interest rates, did not spend the necessary amount to make their services of a higher quality and were not nearly as viable.*

[6] *Gilberto M. Llanto. 2001. "Risk-based Supervision of Banks Involved in Microfinance".* ***PIDS Policy Notes.***

[7] *Jonathan Morduch. 1999. "The Microfinance Promise."* ***Journal of Economic Literature****. Volume XXXVII, December, pages 1569-1614.*

has mobilized savings amounting to US$2.8 billion held by 15.6 million deposit accounts. ***Annex A*** *summarizes lessons learned from successful microfinance programs in Latin America.*

The openness of Philippine authorities to market-based microfinance is indicated by the policy framework stipulated in the National Strategy for Microfinance. The market-based National Strategy for Microfinance is radically different from the traditional government approach to agricultural and rural credit programs characterized as (1) rigidly designed and commodity-oriented; (2) unsustainable though providing very cheap credit; (3) overly dependent on budgetary appropriation and external funding; and (4) dismissive of savings mobilization on the mistaken belief that rural households do not save and incomes are so marginal that such households cannot save.

National Strategy for Microfinance

The current policy and regulatory environment supports microfinance development. The government's National Strategy for Microfinance calls for the termination/rationalization of directed credit programs and the greater participation and involvement by microfinance institutions (MFIs) in providing access to micro-finance services by micro-enterprises and poor households. The Strategy tasks government financial institutions such as People's Credit and Finance Corporation, Land Bank of the Philippines and the Development Bank of the Philippines to provide wholesale loans to MFIs that in turn will cater to the retail side of the microfinance market. The government has also created the People's Development Trust Fund (PDTF) to provide funds for the capability building needs of MFIs. Unfortunately, PDTF has not started to operate for lack of funds. The Strategy also calls on the donors to provide assistance for capability building.

Rationalization of Directed Credit Programs

Through Executive Order 138, all subsidized credit programs in the non-agricultural sector shall be terminated and the outstanding cash balances of those programs would be transferred to government financial institutions for use as wholesale loan funds for microfinance. The Agricultural and Fisheries Modernization Act of 1998 mandated the termination of all subsidized agricultural credit programs and the transfer of the outstanding cash balances to government financial institutions also for use as wholesale loan funds for microfinance. The policy directives under AFMA and Executive Order No. 138 demonstrate the government's commitment that (private) MFIs should have a greater role in retail lending which is their comparative advantage over government credit programs. Invariably, government credit programs lose money because of non-repayment by borrowers, their capture by non-intended beneficiaries and political intervention.

Bangko Sentral ng Pilipinas Support to Microfinance

Following the provisions on microfinance in the General Banking Law of 2000 (Republic Act 8791), the Bangko Sentral ng Pilipinas (BSP) has issued circulars and other guidelines on the creation of and operations of banks involved in microfinance. The BSP has also provided a rediscounting facility for banks engaged in microfinance and has initiated work toward a supervision format that recognizes the peculiarities of microfinance, e.g., use of cash flow as basis for lending that eliminates the need for borrowers to present traditional collateral such as real estate; simplified documentation, etc.

Bangko Sentral ng Pilipinas issued ***Circular No. 272 (January 2001)*** with four important guidelines on microfinance[8]:

a) Microfinance loans may be amortized on a daily, weekly, bi-monthly or monthly basis, depending on the cash flow conditions of the borrowers;

b) Interest rates shall not be lower than the prevailing market rates to enable the lending institution to recover the financial and operational costs incidental to this type of microfinance lending;

c) A bank may not require from its credit applicants a statement of assets and liabilities, and of their income and expenditures and such information as may be prescribed by law or by rules and regulations of the Monetary Board; and

d) Lending to small borrowers shall not be on the basis of collateral but on the basis of cash flows.

Bangko Sentral ng Pilipinas' Circular No. 272 exempts microfinance loan borrowers from submitting the usual documentary requirements for credit evaluation and approval, e.g., audited financial statements or statements of income and expense.

Bangko Sentral ng Pilipinas' ***Circular No. 282 (April 2001)*** provides the guidelines for a rediscounting facility to provide liquidity support to microfinance-oriented banks. The facility is open to banks with:

a) At least 500 borrowers;

b) A past due ratio of 5% or less for the microfinance portfolio; and

c) A collection ratio of at least 95%.

The banks will be charged an interest rate equivalent to the 91-day Treasury bill rate. The interest rate of the rediscounting facility is in line with the government policy stated in Executive Order No. 138 to have market-oriented interest rates for microfinancing.

Government Support to Microfinance

[8] *See Gilberto M. Llanto. 2001. "Risk-based Supervision of Banks Involved in Microfinance".* ***PIDS Policy Notes No. 2001-01.***

Government support to microfinance is also manifested by the provision of loans to MFIs by the People's Credit and Finance Corporation (PCFC). PCFC was created by Administrative Order No. 148 on September 8, 1994. Republic Act 8425 of 1997 designated PCFC as the lead government institution for raising financial resources for microfinance services. PCFC provides wholesale loans to accredited MFIs which in turn lend to microfinance clients. ODA assistance has been provided to PCFC through the ADB-IFAD Rural Microfinance Project and the Microfinance Loan Fund, a component of the Countryside Loan Fund project of the World Bank with the Land Bank of the Philippines.

Another potential wholesaler to MFIs is the Land Bank of the Philippines which has a network of 564 rural and thrift banks out of about 800 such banks. However, Land Bank has focused on loans to multi-purpose cooperatives and credit cooperatives and has allowed PCFC to remain as the main vehicle for government wholesale loans to MFIs[9].

Performance Standards for Credit Cooperatives[10]

In a study conducted by CPIP in 1998, it was found out that despite the credit cooperatives potential for significant growth in the countryside, there was little information on their outreach or on financial performance, mainly due to the lack of uniform and transparent information on their financial operations. The same study showed that this is essentially due to the lack of effective regulation of cooperatives (Geron and others 2003)[11].

The National Credit Council through the technical assistance by the Credit Policy Improvement Program (CPIP) has worked with government and private sector representatives from the cooperative sector to establish a better information infrastructure for credit cooperatives. An exemplary effort is the establishment of a set of performance standards for credit cooperatives. Starting from the development of standard chart of accounts and reporting format, the National Credit Council has completed work on performance standards for credit cooperatives. The standard chart of accounts and reporting format and the performance standards for credit cooperatives are a critical part of the information infrastructure on credit cooperatives that shall help build the market's confidence in them.

According to Geron and others (2003), the GFIs are in fact now adopting these standards as part of their evaluation criteria for assessing financial performance of potential credit cooperative clients. In addition, the Cooperative Development Authority is poised to issue a circular mandating the adoption of the performance standards developed for credit cooperatives as a management and supervisory tool.

III. BEST PRACTICES IN MICROFINANCE

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[9] *Land Bank of the Philippines was responsible for the creation of PCFC as the government finance company devoted to microfinance.*

[10] *See Gilberto M. Llanto. 2000. "Protecting Deposits in Savings and Credit Cooperatives".* ***PIDS Policy Notes No. 2000-08.***

[11] *Ma. Piedad Geron, Robet Vogel, Joselito Almario and Gilberto M. Llanto. 2003. "Market-based Credit Policies for Increased Access to Rural Finance." Paper presented at the* ***International Conference on Best Practices in Rural Finance****, Washington D.C., U.S.A., June 2-4, 2003.*

This section discusses some local best practices in microfinance and draws lessons from their experience to inform the policy and operational framework for microfinance in agrarian reform areas.

Micro-enterprise Access to Banking Services (MABS[12])

MABs is a project funded by U.S. Agency for International Development that provides technical assistance and training to rural banks in microfinance "best" practices. The program is designed to expand the profitable delivery of financial services to micro-enterprises. *It does not provide lending capital*. The program focuses on building the capability of rural banks on both micro-lending and savings mobilization. The MABS approach requires institutional assessment, senior management training, staff selection and training, market survey and business planning. *MABS best practices include standardized and simplified product documentation and procedures, defined client selection, frequent and small amortization payments, incentives for clients and zero tolerance for delinquent loans.*

Standardized and simplified product documentation and procedures will increase client satisfaction, improve efficiency, minimize mistakes and simplify training of staff and clients. The end goal is increased profitability. Client selection is based on character assessment and repayment capacity not the collateral that a client can offer. Thus, there is a clearly defined client group in a defined geographical area that is assigned to a particular credit officer.

MABS loan policy makes participating rural banks start with small loans. Microfinance lending can be done on an individual or group basis. The repeat loans may be increased in size based on successful repayment and a demonstrated improvement in the cash flow of the business. Frequent and small amortization payments are desired. The more frequent and the smaller the amortization payments, the easier they are for the clients to make, resulting in lower past due rates.

Part of the microfinance best practices is to allow MFIs to charge sufficiently high interest rates to make a good profit. Because the loans are small with frequent repayments, the transaction costs are high relative to standard commercial loans. It has been found out that micro-enterprise clients are willing to pay higher rates for good service.

To ensure greater accountability and better loan monitoring, MABS prescribes that the credit committee should include account officers, supervisors and the branch manager. Account officers should be responsible for recommending the approval of loans and then managing those clients on an on-going basis. Thus, account officers maintain continuous contact with clients. To motivate staff, the rural banks are asked to have an incentive system for bank staff based on the quantity and quality of the loan portfolio.

The incentive system is extended to the clientele. A reward is given for on-time loan repayments and a penalty for late payment. The client incentive system includes the following: rebate on the interest rate charged at the end of the loan term; increase in the amount of loan and/or loan term for subsequent loans; penalties for late payment. The MABS savings mobilization strategy has several features (see ***Box 1***)

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[12] *This draws on the MABS presentation material for the* ***DAR-NCC-CPIP Workshop on the Development and Formulation of the Policy and Operational Framework for Microfinance in Agrarian Reform Areas****, Marco Polo Hotel, Davao City, April 28-30, 2003.*

Box 1. Components of MABS Savings Mobilization Strategy

- Low minimum balance requirements;
- Regular deposits and higher daily balances are encouraged by increasing interest rates or rewarding those with higher balances;
- High quality client service;
- Standardized and simplified product documentation and procedures.

MABS is currently working with 37 rural banks with more than 100 branches in the three main regions of the country (Luzon, Visayas and Mindanao). ***Table 1*** provides a summary presentation of results as of March 2003.

Table 1. MABS Results as of March 2003

Number of participating units	105
Cumulative micro loans disbursed	P2.26 billion
Cumulative number of micro loans disbursed	233,224
Micro-loans outstanding	P239.72 million
Number of loans outstanding	35,351
Portfolio at risk (>30 days)	3.9%
Amount of new micro deposits	P199.29 million
Number of new micro depositors	144,334

MABS follows the following steps to ensure a successful operation for participating banks:

- Start with a study of the microfinance market;
- Design credit and savings services to meet the needs of the market;
- Emphasize careful and thorough documentation of policies and procedures;
- Follow process of cash flow lending and proper credit investigation
- Maintain a management information system
- Follow up with clients to ensure that they do not miss a payment;
- Treat micro-savers and micro-borrowers as business clients;
- Commitment to microfinance at the senior management level is crucial;
- View microfinance products as commercial products not as a social service and
- Adopt an attitude of zero tolerance toward loan delinquency.

Credit Union Empowerment and Strengthening (CUES) Project-Philippines[13].

The Credit Union Empowerment and Strengthening Project is a project of the World Council of Credit Unions (WOCCU) funded by the U.S. Agency for International Development. Its

[13] *From handouts provided by CUES to the* ***DAR-NCC-CPIP Workshop on the Development and Formulation of the Policy and Operational Framework for Microfinance in Agrarian Reform Areas****, Marco Polo Hotel, Davao City, April 28-30, 2003.*

successful implementation in 1997-2002 in Mindanao led to the development of a second phase (2003-2005). At present, it is working with 16 partner cooperatives in Mindanao. The Project will expand its technical assistance to 29 more cooperatives from the Visayas and cooperatives in conflict-prone areas in Mindanao. The expansion program in the Visayas is being implemented in partnership with VICTO, the NATTCO network in the Visayas.

CUES-Philippines transfers micro-finance technologies to partner cooperatives through two approaches: (a) model credit union building and (b) savings and credit with education. The Savings and Credit with Education (SCWE) program is an integrated financial and education delivery system[14]. It seeks to provide poor rural women access to financial services. It provides non-formal education on the formation of savings and credit associations, among others.

Model Credit Union Building (MCUB) consists of the following components: credit union institutional strengthening, savings mobilization and marketing focus, credit administration, safety and soundness and short-term technical assistance. A model credit union has the following characteristics:

- Follows good business sense in operations;
- Is a savings institution;
- Does not depend on subsidized international and government loans;
- Has adequate institutional capital;
- Offers competitive market pricing;
- Is a professional financial institution;
- Has capable and well-trained employees

Building a model credit union means imposing financial discipline in the management and operation of the organization. ***Box 2*** illustrates the different measures that a credit union must take to become an efficient credit intermediary.

[14] *SCWE program is a trademark of Freedom from Hunger (FFH), an international development organization promoting "self-help" to address the incidence of chronic hunger and malnutrition. It has projects in Africa, Asia, Latin America, North America and Europe. FFH is based in Davis, California.*

Box 2. Financial Discipline in the Model Credit Union of CUES-Philippines

Delinquency Control
- Portfolio at risk method
- Delinquency goal of below 5%

Control of Non-earning assets
- Maximize earning assets at 95%
- Non-earning assets goal below 5%

Capital Accumulation
- Raise coop capital to 10% of total assets
- Maintain adequate reserves

Provisions
- 100% loan loss provisioning for over 12 months delinquent
- 35% loan loss provisioning for 1-12 months delinquent

Earnings Improvement
- Establish interest rates to adequately cover all costs and provisions
- Limit costs while improving collection

Liquidity
- Maintain liquidity at minimum of 15% of deposits and withdrawable liabilities
- Asset liability management

The actual experience with building model credit unions shows the significant impact of market-based policies and practices of CUES-Philippines. ***Table 2*** shows the results of model credit union building among partner cooperatives in Mindanao.

Table 2. Impact of Model Credit Union Building

Measure	Dec 1998	Dec 1999	Dec 2000	Dec 2001	Dec 2002	Mar 2003
Delinquency ratio (%)	63.00	19.64	12.36	10.53	7.05	7.07
Non-earning Assets (%)	20.44	28.64	18.55	12.65	9.69	9.27
Net Institutional Capital (%)	-16.89	2.02	4.18	7.63	10.44	11.38
Provisions for loans 12 >months (%)	10.32	44.76	100.00	100.00	100.00	100.00
Provisions for loans 1-12 months (%)	0.00	60.90	100.00	83.05	99.83	100.00
Net income (%)	2.10	4.09	5.10	5.95	6.88	5.24
Net Operating Expenses (%)	8.12	9.92	10.62	10.54	9.83	9.68
Liquidity (%)	23.97	31.68	36.33	30.83	34.03	38.09
Savings (%)	35.11	47.97	54.48	57.47	57.65	58.78
External Credit (%)	7.03	2.89	1.52	0.76	0.50	0.47

Source: CUES-Philippines

Two things stand out in the CUES' approach: (i) emphasis on savings mobilization and (ii) strict credit discipline and adherence to performance standards. An innovation introduced by CUES Philippines is the cooperative branding strategy. It is the first Asian country to adopt it. The brand name is Finance Organizations Achieving Certified Credit Union Standards or FOCCUS. A coop that is certified FOCCUS means it has achieved certain international prudential financial ratios geared towards providing members the best financial service.

A similar movement-wide branding strategy is implemented in the US, Poland, Australia, Central and Latin America by WOCCU. To achieve a FOCCUS brand, a cooperative must adhere to a set of prescribed ratios and other operational criteria. The introduction of cooperative branding has given a big boost to the objective of maintaining the soundness of the financial condition of the cooperative, thereby generating trust and confidence in the cooperative. The key international prudential standards adopted by FOCCUS are shown in ***Table 3***.

Table 3. Key International Prudential Standards in FOCCUS Brand

FOCCUS Ratios	Silver	Gold	Platinum
LLP > 12 months	100%	100%	100%
LLP 1-12 months	100%	100%	100%
Solvency	-	> or = 110%	> or = 110%
Net Loans	> or = 60%	70-80%	70-80%
Savings Deposits	> or = 50%	60-80%	70-80%
Net Institutional Credit	> or = 4%	> or = 8%	> or = 10%
Total Delinquency	< or = 15%	< or = 10%	< or = 5%
Non Earning Assets	Decreasing	< or = 10%	< or = 7%
Member Shares	-	> or = inflation	> or = inflation
Operating Expenses	< or = 12%	< or = 10%	< or = 10%
Liquidity	> or = 15%	> or = 15%	> or = 15%
Membership	> or = 5%	> or = 5%	> or = 5%
Total Assets	> or = inflation	> or = inflation	> or = inflation

Source: CUES-Philippines

Center for Agriculture and Rural Development (CARD) Rural Bank

CARD Rural Bank is the best-known local bank engaged in microfinance. CARD Rural Bank was established by CARD NGO in 1997, the same year it got its banking license from the Bangko Sentral ng Pilipinas. The overriding objective is to provide banking services to poor borrowers who can not provide the usual collateral demanded by banks but who have viable projects.

CARD NGO pilot tested a modified the Grameen Bank scheme for close to eight years before deciding to establish a rural bank. The pilot test began in January 1989 was successful. In late 1995, CARD NGO started to scale up its operations. By the time of the grant of a banking license to CARD Rural Bank, there were 10,868 active members. As of March 2003, CARD Rural Bank has 37,276 individual clients. Outstanding loans amounted to P328.6 million while portfolio at risk is 1.14%. Loan repayment rate was 98.46%. Operational self-sufficiency ratio was 121 while the financial self-sufficiency ratio was 105.

Critical success factors are the following: a visionary management and board, a commitment to staff development, strong credit discipline and innovative product development[15]. CARD Rural Bank has supported and has remained committed to staff development and training. Strong credit discipline has produced wonderful results. A policy of "zero arrears" combined with the threat to cut off the delinquent borrowers' access to future loans has contributed to a very strong loan repayment rate. The commitment of management and staff members, discipline in credit provision and loan collection, the use of market-oriented interest rate and deposit mobilization have made CARD Rural Bank a frontrunner among microfinance institutions in the country and has earned it worldwide recognition.

[15] *See Anita Campion and Victoria White. 1999.* ***Institutional Metamorphosis: Transformation of Microfinance NGOs into Regulated Financial Institutions****. The Microfinance Network Occasional Paper No. 4.*

IV. DAR CREDIT PROGRAMS

Agrarian reform communities (ARCs) are barangays or clusters of barangays composed and managed by ARBs who are willing to be organized into such communities and undertake the integrated development of the area. DAR has adopted the ARC strategy to facilitate the delivery of support services in agrarian reform areas and the countryside in general. Mainly with foreign donor support, DAR has created programs in ARCs with credit components.

A. Social Infrastructure Building and Local Capacity Building Program (SILCAB) [16]

SILCAB's objective is to "organize farmers as a solid group with direct involvement in the planning and implementation process towards their development." SILCAB "endeavors to build the capabilities of ARBs and their organizations in order to implement development interventions, manage area development and be actively involved in decision-making and enjoy support from other stakeholders in the community." One of its programs and projects is the ***Enterprise-based Cooperative Strengthening Assistance Program*** in agrarian reform communities. This is a tie-up between DAR and Land Bank with a total project cost of around P29.6 million sourced from the interest earnings of CAP-PBD.

The program was piloted in 1997-1998 initially covering 52 organizations in 41 ARCs in seven provinces. The three year extension (2000-2002) covers 95 cooperatives/organizations in 70 ARCs in eight provinces in Region II, IV, V, VI, X and CARAGA. The program has been extended for another three years (2003-2005). To date, a total of P14.7 million credit assistance was granted to 17 cooperatives in five provinces of which P13.02 million was sourced through CAP-PBD and P1.8 million through the Land Bank's regular lending program. Some 7,629 cooperative members wherein 5,846 are ARBs were assisted. About P7.9 million were raised as capital build-up of the cooperatives and P1.3 million of savings were mobilized.

B. Sustainable Area-based Rural Enterprise Development (SARED)[17]

One of the key components of the agrarian reform strategy is the Sustainable Area-based Rural Enterprise Development (SARED). The SARED framework includes major activities such as: (a) production and marketing assistance; (b) credit assistance and microfinance development; (c) economic and enterprise development; and (d) appropriate technology and extension services.

Under the credit assistance and microfinance development sub-component are the following: (a) Credit Assistance Program for Program Beneficiaries Development (CAP-PBD) Window 1; (b) CAP-PBD Window 2; (c) CAP-PBD Window 3; (d) DAR-Punla sa Tao Foundation Microfinance Capability Building Program for Grassroots Banking in ARCs; (e) DAR-NLSF (Erap Trust Fund) Livelihood Credit Assistance Program (LCAP), a joint undertaking between DAR and the NLSF since 1997; and (f) Countryside Partnership Scheme 5:25:70.

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[16] *This draws on the Transition Report, Bureau of Agrarian Reform Beneficiaries Development, January 2003.*

[17] *This draws on the Transition Report, Bureau of Agrarian Reform Beneficiaries Development, January 2003.*

CAP-PBD Window 1

This is a credit assistance program intended for ARB cooperatives or farmer organizations that could not qualify under the accreditation criteria of Land Bank. DAR set aside P355 million or 50% of the 1995 allocation for credit assistance under the ARF. DAR and Land Bank jointly implemented the ***Credit Assistance for Program Beneficiaries Development (CAP-PBD).*** This program is designed to be implemented nationwide for a period of 10 years.

After five years of operation, the credit assistance component accomplished the following:

- Provided funding amounting to P139.34 million to 8,519 ARBs of 138 cooperatives in 118 ARCs for 217 projects;

- For the period January to October 2002, 739 ARBS of 12 cooperatives in 10 ARCs received credit assistance amounting to P8.9 million for 14 projects. Total equity provided by the ARBs was P3.7 million; total project cost was P12.6 million.

CAP-PBD Window 2

This is a long term Rubber Replanting Financing Program to address the specific investment needs of rubber plantation cooperatives. Rubber replanting financing is given at 2% interest rate plus 2% supervision fee to be paid to ARB Rubber plantation cooperatives. A total of P105.6 million were loaned out to four cooperatives in Zamboanga del Sur and Basilan provinces. ***Table 4*** provides other details.

Table 4. Accomplishments of CAP-PBD Window 2

Number of region	1
Number of provinces	2
Number of ARCs	4
Number of cooperatives	4
Number of ARB beneficiaries	1,195
Number of funded projects	5
Number of hectares involved	1,667.35
Total loan amount (million pesos)	157.1
Of which CAP-PBD (million pesos)	105.6
Land Bank (million pesos)	51.4
Cooperative equity (million pesos)	28.3
Total project cost (million pesos)	185.4

Source: BARBD-DAR

CAP-PBD Window 3

This is a special credit window for ARB cooperatives intending to engage in oil palm production covering approximately 2,000 hectares of land. It will be jointly implemented by DAR and Land Bank with an initial funding of P30 million. The ARB beneficiaries are from cooperatives in Region XI and CARAGA. CAP-PBD Fund will charge 2% interest rate plus 2% supervision fee

that goes to the ARB cooperative. The Land Bank fund counterpart will charge 12% interest rate plus 2% service fee per annum.

So far consultation meetings with industry players and selected provincial and regional offices and project orientation in planning workshops have been conducted. Guidelines on the DAR-Land Bank Joint Financing for Palm Oil Production under CAP-PBD have been prepared.

DAR-Punla Microfinance Capability Building Program

The microfinance capability building program for ARCs is a project tie-up with Punla sa Tao Foundation, Inc., to promote the establishment and management of rural finance institutions or viable "community banks" in the ARCs. This is a two-year project initially implemented in 12 ARC organizations in six provinces (Pangasinan, Quezon, Iloilo, Bukidnon, Negros Occidental and Agusan Sur).

To date, the program have oriented 28 regional and provincial staff; conducted partners' appraisal assistance for 12 ARB organizations in 12 ARCs; trained 77 participants in basic courses on microfinance and savings mobilization, delinquency management and other basic programs.

DAR-Erap Trust Fund (NLSF) Livelihood Credit Assistance Program (LCAP)

Under the LCAP, the NLSF provides for the funds to accredited conduits that in turn extends direct micro-credit assistance and institutional development to ARB household members in ARCs to finance livelihood activities. This program started in 1977. Erap Trust Fund will provide the credit funds to finance the credit requirements of accredited program conduits/program partners that will provide microloans to ARB households. DAR will facilitate the provision of technical and institutional development interventions for program implementers, partner organizations and program conduits in the ARCs.

The program has the following accomplishments:

- 43 program partners/conduits have availed themselves of P370 million of credit funds to cover microloans to 25,253 beneficiaries in 276 ARCs;
- 180 regional and provincial officials of DAR were oriented on the program;
- Memorandum circular, operating guidelines on the decentralization of the program have been issued;
- A proposal on the conduct of orientation for field staff on the decentralization of the program has been prepared; and
- A program-based monitoring system has been installed and maintained.

C. 5:25:70 Countryside Partnership Scheme

On May 16, 1993, DAR and Land Bank signed a memorandum of agreement to implement a 5:25:70 countryside partnership scheme that makes available crop production credit and affordable pre-and-post harvest facilities and other fixed assets to deserving small farmer cooperatives. DAR contributed P100 million which was deposited in trust with Land Bank in the account of the partnership. Twenty-five percent of project cost will be charged to this amount. The unused

portion of the DAR counterpart remains deposited in trust with Land Bank. The partnership was to be implemented for a period of 10 years commencing in 1993.

Under the partnership, the following scheme is implemented:

- 70% of total project cost shall be provided as a loan by Land Bank out of its regular funds; Land Bank shall use its prevailing system and procedures for assistance for fixed asset acquisition and production loan;
- 25% of the project cost shall be provided by DAR interest-free; and
- 5% of the project cost shall be shouldered by the borrower as his equity.

The accomplishments of this scheme are shown in **Table 5.**

Table 5. 5:25:70 Program Accomplishments as of September 30, 2002

Number of coop beneficiaries	120
Number of farmer beneficiaries	31,681
Number of regions	14
Loans granted Of which: DAR (million pesos) Land Bank (million pesos)	394.9 148.3 246.6

Source: BARBD-DAR

As of November 18, 2002, as reported by the Land Bank Trust Banking Group, DAR has a fund balance of P43.2 million for credit and accumulated income of P6.8 million for institutional development activities.

D. Support to Agrarian Reform Communities in Central Mindanao (STARCM)[18]

STARCM's purpose is to provide support to farming households in 50 ARCs in the provinces of Sultan Kudarat, Cotabato, Lanao del Norte and Lanao del Sur in Central Mindanao in order to increase their self-reliance, living standards and quality of life. One of the main problems addressed by the project is "the difficulty faced by farmers and cooperatives in accessing credit from formal financial institutions". The financing agreement with the European Commission provides 1 million Euro of the EC grant as a credit fund for "on-lending through conduit banks in accordance with prevailing government rules and regulations."

STARCM has a Rural Finance component that has the following components:

- Capacity building for target groups to strengthen their capacity to manage internally generated funds and graduate them to formal financial institutions for their funding needs in the future;
- Partnership with Land Bank to provide funding to ARC cooperatives and with PCFC for microfinance operations at the ARC level;
- Adherence to Land Bank's cooperative accreditation criteria which is a set of cooperative performance standards and requirements prescribed by Land Bank to prepare the cooperatives' formal integration into the banking system;

[18] *This draws on the unpublished DAR document "Credit Strategy for the Project Providing Support to Agrarian Reform Communities in Central Mindanao," January 2003.*

- Use of existing financial products, systems, policies, guidelines, procedures for beneficiary selection and loan processing; STARCM's credit strategy provides that "no new credit accounts will be introduced for the non-bankable ARC cooperatives or for those with past due accounts;
- Assistance for restructuring loans of cooperatives with past dues[19];
- Support for microfinance initiatives of microfinance institutions "providing institutional support that will strengthen their capacity to expand microfinance services in the ARCs;"
- Savings mobilization will depend on the decision of "the target groups and the partner institutions based on their individual needs and the existing policies, systems and procedures of LBP and PCFC."

Two credit schemes. Two credit schemes will be implemented by the Rural Finance component, namely: (a) support to the 5-25-70 partnership scheme with Land Bank[20] and (b) support to the microfinance program of PCFC. For the Land Bank scheme, STARCM will provide credit funds to expand the coverage of the 5-25-70 scheme. STARCM will provide funds for PCFC's institutional credit for MFIs expanding their microfinance programs. Thus, STARCM will provide institutional and credit support to providers of formal credit and borrowers in the ARCs, respectively.

Target of Land Bank credit scheme (5-25-70). The target groups for this scheme are (a) the potentially new accessing cooperatives, that is, cooperatives that have satisfied the Land Bank cooperative accreditation criteria but have not accessed loans from any formal source; and (b) Land Bank-assisted cooperatives with past due. The latter represent 27% of the cooperatives within the STARCM area that will be assisted through the 5-25-70 partnership scheme with Land Bank.

PCFC partnership scheme. STARCM's support for institutional credit will be directed to rural banks and cooperatives that "are willing to service the microfinance needs of borrowers based on their existing credit line and lending systems and procedures." The credit strategy document reports that "a number of rural banks and cooperative banks would be interested to work with STARCM in serving the microfinance needs of interest groups (that is, women borrowers, entrepreneurial individuals and indigenous persons) in the ARCs.

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[19] *According to STARCM's credit strategy document "these groups constitute a significant portion of the cooperatives in ARCs covered by the project." The document recognizes that "an appropriate restructuring program based on a detailed assessment of individual (cooperative) needs is imperative."*

[20] *This is one of the credit sub-components of SARED which is discussed in the preceding paragraphs.*

E. DAR-UNDP SARDIC Land Bank Joint Financing Program[21].

The program was conceptualized in 1997 and was implemented in 2000 in six provinces: Iloilo, Capiz, Samar, Lanao del Norte, Davao del Sur and North Cotabato. The Joint Financing Program was established under the Organizational and Entrepreneurial Development Component of the SARDIC Programme. A seed fund of P6 million was allocated from UNDP grant funds as the Programme's counterpart fund in the Joint Financing Program with Land Bank. The seed fund will support the entrepreneurial development of the ARC cooperatives. The DAR-UNDP SARDIC-LANDBANK Joint Financing Program became effective on October 2, 2000 through a memorandum of agreement among the stakeholders.

Objectives. The financing program has three objectives:

a. Provide financial assistance to ARC cooperatives and ARB households in identified priority provinces of the Joint Financing Program either through (i) joint financing between DAR-UNDP SARDIC Programme and Land Bank or (ii) a microfinance window established by DAR-UNDP SARDIC Programme and administered by Land Bank;

b. Facilitate the development of agribusiness ventures and rural enterprises in the ARCs covered by the Programme; and

c. Provide capability building interventions for ARC cooperatives and ARB households in the management and operation of their agribusiness or microenterprise projects.

Three components. The Program has three components, to wit: (a) joint financing scheme; (b) microlending scheme and (c) capability building assistance.

The joint financing scheme caters to ARC cooperatives embarking on agribusiness projects that require capital financing for fixed assets. ***Table 6*** provides the features of the scheme.

Table 6. Features of the Joint Financing Program

Source	Share to total project cost	Interest Rate to Coop Borrowers
SARDIC Seed fund	25-45%	Interest free
Land Bank	40-70%	Land Bank's prevailing rate
Borrower's equity	5-15%	

The official reasons given for the concessional rate on loans under this scheme are the following: to ease the burden of payment of cooperatives on fixed asset acquisition and to meet the AFMA provision on credit to ARBs. The AFMA provision has been interpreted by DAR as continuing with the subsidized credit to ARBs despite the market-orientation of interest rates on agricultural credit under this law.

The microlending scheme was intended for projects not exceeding P500,000 in cost and whose proponents could not readily meet Land Bank requirements. This scheme employs conduits (NGOs and cooperatives) to channel the funds to target beneficiaries. It served as an

[21] *This draws on the unpublished document "The DAR-UNDP SARDIC-LANDBANK Joint Financing Program" undated handout provided by DAR.*

"experimental" window with Land Bank in anticipation of its assumption of credit programs of government non-financial agencies under Executive Order 138 of 1999.

SARDIC provided P6 million to the Program broken down as follows: P3 million for the joint financing scheme and P3 million for the microlending scheme. The seed fund is deposited as a trust fund in Land Bank and earns an interest on its outstanding balance based on the prevailing bank rate. Interest earnings from the trust fund are used for capacity building assistance to cooperatives.

Program performance. The joint financing scheme targeted 9 projects. Of these, 8 were endorsed for financing but only 4 were approved by Land Bank. Loans for two projects have been fully released while the other two projects are awaiting release of their respective loans pending completion of requirements[22].

For the microlending scheme, 5 program partners composed of two NGOs and three cooperatives were endorsed to the Land Bank for evaluation. The target was three-conduits. However, the scheme failed to get the support of proposed conduits because of the following: (a) unwillingness to borrow at market rates; (b) their adverse attitude towards the tedious documentation requirements imposed by Land Bank and (c) withdrawal of two proposed conduits due to heavy arrears incurred by their respective members which affected their financial position.

Implementation bottlenecks. A review conducted by DAR pointed out the following implementation bottlenecks:

- ***Poor financial standing of cooperatives***. A number of cooperatives have weak financial base and cannot provide equity for their projects. There are only a limited number of eligible cooperatives because many of them have arrears and outstanding loans with the Land Bank and other financing programs. Thus, the limited number of eligible borrowers under the program.

- ***Difficulty of borrowers in meeting Land Bank accreditation and lending criteria***. Despite capability building interventions on organizational and entrepreneurial development, internal fund generation, core team management and financial management, many ARC cooperatives still had low organizational maturities. Only a few cooperatives managed to get endorsement for financing under the program.

- ***Lack of well-defined and packaged projects***. Most of the identified projects are traditional crop production projects which have low financial viability. Borrowers still have to learn project development techniques. The lack of well-defined and packaged projects for the ARCs has contributed to low loan utilization under the program.

- ***Incomplete documentation.*** Proponent cooperatives took a long time to submit the documentation required by Land Bank. The proponents might not have the required documents readily on hand. The other reason given is that the Land Bank was not clear in the documentation requirements and gathered documents on piecemeal basis.

[22] *DAR notes that the 50% approval of the endorsed projects is a "record high vis-à-vis other lending programs of the Department considering that the joint program has only been implemented for over a year."*

- ***Tedious evaluation process undertaken by Land Bank***. Evaluation of loan applications of proponent cooperatives suffered from the voluminous documentation requirements and tedious processing by Land Bank's regional lending centers.

- ***Less priority given to SARDIC project by account officers who prefer big accounts***. Loan officers of some Land Bank branches prioritized the processing of bigger loans because of the higher transaction costs of smaller loans of proponent cooperatives.

- ***Lack of market for proposed products.*** The lack of a stable market for the products of ARC cooperatives reduced the viability of their proposed projects. Most ARC cooperatives still cannot meet either the supply requirements of institutional buyers or the quality standards required of their products.

- ***Imposition of market-oriented rates.*** The proposed conduits did not favor the market-oriented lending rate of Land Bank. It was claimed that "the high risks involved in catering to small borrowers and the transaction costs involved in handling small loans are the reasons for their preference for lower than 12-14% interest rate imposed by Land Bank to cooperative borrowers.

Status of seed fund. For the period January to December 2002, total funds made available under the seed fund amounted to P6.93 million including interest earnings. Fund utilization and fund balance are shown in ***Table 7***. On October 18, 2001, the Joint Program's Management Committee decided that the un-appropriated seed fund including the portion intended for micro-lending scheme (P3,777,541.00) will instead be used for other capacity building assistance to DAR. Proposals for capacity building were drawn up by various DAR units (FAPSO, BARBD and PPLAO) and were submitted for UNDP's consideration in November 2001. Of four proposals submitted for funding, only the project aimed to provide legal assistance at the grassroots was approved. Funding will be in the amount of P7.5 million.

Table 7. SARDIC Seed Fund Status

	(Amounts in pesos)
Total funds available	6,930,616.44
Original amount	6,000,000.00
Interest earnings as of 12/31/02 net of taxes	930,616.44
Loans approved	
Number of loans	4
SARDIC share	2,222,459.21
% of original amount	37
Loans released	
Number of loans	4
SARDIC share	2,222,459.21
Loan balance (reverted to UNDP)	3,777,540.79
Interest earnings (net of taxes)	
Total interest earnings as of 12/31/02	930,616.44
Amount used for capability building	500,000.00
Balance of interest earnings	430,616.00
Fund balance as of 12/31/02	430,616.00

Source: DAR

Lessons learned. DAR-UNDP-Land Bank review of the program yielded the following lessons learned:

- The conduct of social preparation as a prelude to credit facilitation and actual implementation of entrepreneurial activities is imperative to improve the access of ARC coops to credit and increase the probability of success of their projects;

- The limited absorptive capacities of the ARC coops are reflective of their limited financial base. Savings mobilization and capital build-up programs should be incorporated in capacity building interventions provided to farmer-beneficiaries;

- Capacity building interventions should tailor fit coop needs and requirements and should include on-the-job or hands-on components;

- There may be a need for alternative lending schemes to suit the capacities of ARC coops. In particular, appropriate lending schemes for coops with existing arrearages and outstanding loans and microfinance projects may need to be formulated or facilitated; and

- ARC cooperatives and their stakeholders need to be trained on project development techniques to improve the acceptability and viability of their proposals. Facilitation for project development and resource mobilization need to be institutionalized at the field level with DAR as coordinating unit.

F. Belgian Integrated Agrarian Reform Support Programme (BIARSP)[23]

The BIARSP is a bilateral programme between the governments of the Philippines and Belgium started on March 2, 1998. The phase 2 of the programme terminates on August 31, 2003. The general objective of the programme is to improve the conditions for self-reliant and sustainable rural development in the selected areas. The programme envisions that "farmers are able to use their resources in more efficient, productive and profitable way, through, among others, cooperative-based credit systems to finance farm inputs." The programme covers ARCs in Regions VII and IX with 22 pilot cooperatives as partners.

A study during the inception months of phase 2 of BIARSP reviewed and evaluated the BIARSP experience. The study pointed out that a major weakness of the intervention is the lack of savings mechanism in the partner cooperatives. It observed that cooperative-based credit systems without a savings component will not be sustainable due to its dependence on the BIARSP revolving fund. An important realization is that the support being basically external blunts the sense of ownership by coop-members resulting in loan repayment problems[24]. Thus, the study recommended the transformation of the existing credit-based system into a savings-based credit system to ensure a sustainable credit system for ARBs. The study further recommends the development of savings and credit cooperatives as the most appropriate micro-finance systems for the ARCs.

An important strategy in BIARSP is the use of the model credit union building technologies promoted by CUES Philippines[25]. Model building efforts stress asset accumulation, savings-based systems, mixed outreach, application of strict financial discipline and catering on individual loans based on capacity to pay measure. BIARSP believes that cooperatives are best run from a business perspective that is "by being strict and profitable, the cooperative will be able to give more services to its member-clientele, which is the ultimate objective (of the cooperative)." Thus, partner-cooperatives are enjoined to maintain a healthy financial structure. ***Box 3*** reports the BIARSP experience in promoting a savings-based credit system among partner-cooperatives.

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[23] *This draws from* ***BIARSP Savings and Credit Implementer's Manual****, May 20, 2003 prepared by Franklina Mantilla (BIARSP PMO VII Community Organizing Specialist and Jan Delbaere (BIARSP Chief Technical Adviser).*

[24] *Mantilla and Delbaere pointed out as negative experience of a partner cooperative its acceptance of a grant of P200,000.00 for credit operation from another donor (funding) agency. The authors maintain that "this promoted the dole out mentality and is counterproductive to the efforts of internal funds generation thru saving" (page 14 of the BIARSP Manual).*

[25] *See the section on CUES above.*

Box 3. BIARSP Experience with Building Financially-healthy Credit Cooperatives

- "Better earnings or surplus was realized by the partner cooperatives due to observance of strict financial discipline as monitored through PEARLS and the application of loan loss provisioning. As of March 2003, the 22 pilot cooperatives registered total earnings of almost P700,000.00 at the average of P5,000 per coop per month. Never in their history of operation they managed to earn this much. On the contrary, they had more often losses than surplus in the past."

- "As of March 2003, less than a year after launching of the first pilot cooperative, the 22 pilot sites generated a total of P5.3 million as savings by 3,856 savers of which about 40% are ARBs."

- "One important output of the training is the collection plan prepared by the coops. This helps them practiced some collection strategies learned during the training. After three months, upon evaluation, a remarkable success on collection was realized. Currently the overall repayment rate is 96%."

Source: Mantilla and Delbaere (2003).

V. A PROPOSED POLICY AND OPERATIONAL FRAMEWORK: RECOMMENDATIONS

Workshop on a Framework for Microfinance in Agrarian Reform Areas

It is instructive to note at this juncture the lessons learned during the Workshop on the Development and Formulation of the Policy and Operational Framework for Microfinance in Agrarian Reform Areas held in Davao City on April 28-30, 2003. DAR participants came up with the policy directions and specific steps (that is, *what not to do; what to do*) that are consistent with a market-based or financial markets approach to microfinance (see ***Box 4***).

Box 4. Davao City Workshop Results

Policy Directions

- Adherence to the credit policy principles of EO 138;
- Sustainable growth of coops through internally generated funds;
- Developing ARBs as entrepreneurs; and
- DAR and its partners to focus on technical and capability building assistance in the implementation of microfinance in agrarian reform areas

On what should be done by DAR

- Provide appropriate policy environment for microfinance implementation in agrarian reform areas;
- Support the development of critical microfinance infrastructure support systems;
- Integrate microfinance best practices and principles in the existing cooperative activities in ARCs;
- Provide technical assistance to existing MFIs in developing loans and savings products for ARCs;
- Identify strong ARC coops and build capabilities to become conduits;
- Link ARBs to MFIs to access microfinance services;
- Mobilize technical assistance/funds for microfinance development; and
- Identify appropriate microfinance scheme for the ARC coops and ARB household associations.

On what should not be done by DAR

- Provision of subsidized credit and socialized interest rates for all credit programs in ARCs;
- Practices not consistent with MFI practices; and
- Directly providing grants for lending activities

Microfinance strategic approaches

- Undertake policy dialogue with project PMOs and mobilize technical and financial support for effective implementation of microfinance in agrarian reform areas;
- Categorize coops to identify those with potential to become efficient MFIs; and
- Link individual ARBs or households to MFIs in agrarian reform areas

Market-oriented Policy and Regulatory Environment

The core issues in the proposed policy and operational framework are how to: (i) develop the access of agrarian beneficiaries/households to financial services (*effective outreach*) and at the same time (ii) ensure the institutional viability and sustainability of MFIs providing financial services to those households (*long-term viability of MFIs*).

The experience of "best" practices in microfinance shows that the twin goals of: (i) effective outreach and (ii) viability and sustainability of MFIs can be best satisfied under a market-oriented policy environment. MFIs should be able to charge interest rates that cover administrative costs, cost of funds and to have an adequate profit margin. Further, a market-oriented policy environment motivates MFIs to innovate and thus, reduce their transaction costs that will allow them to reach a greater number of the target agrarian beneficiaries/households. MFIs need the flexibility in setting interest rates and pursuing financial policies that contribute to their long term viability because they serve clients that have varying financial requirements and differing risks. The positive incentive for them is the ability to generate adequate profits from the enterprise. The significance of a market-oriented policy environment for sustainable microfinance institutions and programs has been amply demonstrated by the experiences of successful MFIs worldwide.

The findings and learning from the workshop and field exposure of the Davao City workshop participants confirm this view as indicated by the lessons learned shown in **Box 4** above[26]. The workshop also involved visits to selected microfinance institutions in the province of Davao that use market-based best practices in microfinance. Those microfinance institutions are namely, United Sugarcane Planters of Davao, the Bansalan Cooperative Society, Silangan Multi-purpose Cooperative and the Rural Bank of Sto. Tomas.

Recommendation No. 1: *DAR's microfinance/credit programs should be pursued under a market-oriented policy framework.*

The viability and sustainability of MFIs will be a necessary condition for providing adequate access to financial services by the agrarian beneficiaries/households (the *target groups*). To develop the MFIs' viability and sustainability, three basic measures are necessary:

- Market-based credit policies, including interest rate policy that allows MFIs to design credit and savings services that respond to market needs and to adjust their interest rate structure to cover administrative costs, including cost of funds and profit margin;

- Appropriate regulatory framework of the Bangko Sentral ng Pilipinas (BSP) that supports the creation of banks oriented toward microfinance; and government support to the development of efficient and sustainable cooperatives, credit cooperatives or credit unions while respecting the principle of subsidiarity; and
- Adequate supervision of MFI-banks by BSP examiners that recognizes the peculiar characteristics of microfinance operations; and government support to the cooperative

[26] *The proposed policy and operational framework for DAR's microfinance programs take off from the learning and experience of the exposure visits after the workshop.*

sector's effort to improve their financial performance and to make them viable credit intermediaries in general.

The last two measures are under the purview of the BSP's regulatory and supervision powers. DAR can do something about the first one by making it a feature of the credit component of its donor-assisted projects and its credit programs with Land Bank and Erap Trust Fund.

Recommendation No. 2: *DAR's credit programs and/or the credit component of donor-assisted projects should adopt market-based credit policies, including a market-based interest rate structure. Donor-assisted projects or programs should not be allowed to undermine the government's established policy of adopting market-based interest rates in financial markets.*

Operational Framework

The first best situation is for DAR not to have anything to do with the provision of credit to agrarian beneficiaries. DAR is not organized or structured to be an efficient provider of credit. It should learn from the sad experience of the Department of Agriculture when that department got involved in an activity (credit provision) that it is ill-suited and ill-prepared to accomplish. The Department of Agriculture has committed the mistake of getting involved in credit provision and unfortunately, it has done a bad job of it. Despite hundreds of millions of funds poured and channeled through subsidized (directed) credit programs, small farmers continue to decry their lack of access to credit and blame the Department of Agriculture for it. Having hundreds of millions of credit funds at its disposal has created the expectation among small farmers that somehow the Department of Agriculture is responsible for their access or lack of access to credit, as the case may be.

Worldwide experience of successful rural financial institutions (e.g., Bank Rakyat Indonesia, Grameen Bank, K-REP, etc.) shows that credit provision is a job best done by financial institutions. DAR will be better off if it focuses on the non-credit part of its legally-mandated role to provide "support services" to agrarian reform beneficiaries. It has enough problems providing non-credit support services and taking on another critical responsibility- credit management and provision- would just be too much for its meager budget, personnel and management expertise. To put it bluntly, DAR's credit programs are not making a significant impact notwithstanding the huge amounts of funds provided and the different modalities for channeling credit to target groups. It should get out of this conundrum quickly. The only exception to this statement seems to be the market-based approach of BIARSP.

As illustration of the insignificant impact, consider that CAP-PBD (1 and 2) has reached only 14,365 ARBs based on latest report; a ten year program started in 1993, that is, the 5-25-70 LBP partnership scheme- has reached only 31,681 ARBs while DAR-UNDP SARDIC-LBP Joint Financing Program has approved only 4 loans of which only 2 loans have been released. Let it be the problem of GFIs and PFIs/MFIs to provide credit to small farmers and agrarian reform beneficiaries. These are the institutions best designed to do the job.

First best recommendation: *The first best recommendation is to move all the funds intended for credit to the government financial institutions as mandated by Executive Order No. 138 and to allow the financial markets to take care of the agrarian reform beneficiaries' demand for financial services. DAR*

should concentrate on land acquisition and distribution and the provision of non-credit support services.

However, the political reality is that it seems DAR wants somehow to be involved in credit programs albeit indirectly as evidenced by a number of donor-assisted projects with a credit component. Further, donors also find it politically attractive to include a credit component to their programs supporting agrarian reform in the country. The design of those donor-assisted projects invariably includes a credit component. DAR has tried to accommodate both this political reality and the demands of Executive Order No. 138.

To its credit, DAR has tried to comply with the policy direction set by EO 138 that non-financial government agencies should not be involved in direct lending to target groups or beneficiaries. For example, BIARSP's Implementer's Manual has made it clear that it is following the guidelines laid by Executive Order No. 138. DAR has used the GFIs, basically the Land Bank to implement the credit component of DAR's donor-assisted projects and also in its own partnership scheme with Land Bank (5-25-70 scheme). It is on the right track when it decided to course credit funds through GFIs and cooperatives to reach target beneficiaries/households. Microfinance is a business and is neither charity nor welfare transfers to target households. As a business, microfinance has to be implemented professionally by MFIs, whether these are the credit-intermediary type (e.g., microfinance NGO) or the financial intermediary type e.g., bank or credit cooperative. The problem starts when the design of the credit program includes the subsidization of interest rate which discourages private sector participation in the credit markets. The problem is compounded when loan products are centrally designed. The experience of successful microfinance programs/institutions shows that decentralized decision making leads to innovations, e.g., design of loan products responsive to market demand, that benefit both the clients and the lending institution. The MFIs know the market and they are better equipped to respond to market needs than some centralized bureaucrat in a donor's or GFI's desk.

The envisaged operational framework is anchored on the experience of successful microfinance programs/institutions that make use of private sector institutions (e.g., microfinance NGOs, credit cooperatives, associations, rural banks) in delivering financial services to target groups/beneficiaries and using market-based credit policies. Government financial institutions can also be critical partners in microfinance development in the country provided they are given some degree of autonomy and flexibility to implement market-based credit policies, e.g., Bank Rakyat Indonesia.

A comment provided by a participant in the presentation of the proposed policy and operational framework for microfinance in agrarian reform areas that was held on June 27, 2003 in Discovery Suites, Ortigas Center, Pasig City is that "*the first best recommendation is worth pursuing provided that phase-out plan is set in place so as not to jeopardize the existing initiatives under the DAR credit programs and allow smooth transition to mainstreaming with GFIs vis-à-vis their willingness and readiness to serve ARCs.*"

This paper's author remarks that if DAF would so decide to have a "phase-out plan" it should be clear that: (a) DAR has the political will to implement a time-bound "phase-out plan" that should have concrete milestones to chart progress toward a market-based financing program; (b) market-based credit and interest rate policies should inform the "phase-out plan;" and (c) there is an agreement and commitment between DAR and the GFIs to draw up a market-based financing

program in place of subsidized credit programs with a view to involve private MFIs during the transition phase and the resulting market-based programs. If the GFIs are not ready to assist DAR with a market-based financing program for ARBs, then the participation of private banks and other credit intermediaries should be explored.

Recommendation No. 3: *DAR's operational framework should continue to have the GFIs and MFIs as credit intermediaries that are able to make use of market-based credit policies, make independent credit decisions, and assume the risks of the financial markets.*

In reaction to Recommendation No. 3, a suggestion was made during the June 27, 2003 workshop with DAR officials and staff members for "DAR to test a MFI-link approach considering the following:

- Absorptive capacity of MFIs in terms of manpower and credit resources;
- Willingness to assume risks, especially in agriculture;
- Willingness and ability to innovate considering that most of them deal with urban-based entrepreneurs and big savings accounts;
- Impact on its product pricing as a result of high transaction cost in serving ARBs;
- Paradigm shift because the bottom-line is on net profit attitude of MFI-Rural Banks; and
- GFI's subsidization mentality."

These are points well-taken. It is important for DAR to engage the GFIs and MFIs in a serious and earnest discussion of the problems currently facing agrarian reform credit and to consider market-based solutions to those problems.

Rationalizing Overlapping Credit Programs

Design-wise, the DAR's current credit programs stand improvement. They either overlap with or duplicate each other and have highly subsidized interest rate structures. What has obtained is a fragmentation of DAR credit programs that have been designed and implemented according to certain covenants with donors. Fragmentation gives rise to high transaction costs and inefficiency. High overhead costs as one of the components of transaction costs make the credit programs expensive and unsustainable.

Recommendation No. 4: *The solution is to unify them into one window or program with a GFI that would be tasked to develop/offer a diversity of financial products in consultation with MFIs/PFIs taking into consideration the demand in the financial markets. The GFI can act as wholesale lending institution to PFIs/MFIs that will help design a demand-driven financing program.*

A suggestion made in the June 27, 2003 workshop is "to test first the recommendation (No. 4) in order to gain enough experience. Develop as ARB MF Window but biased towards agriculture; cater to resource-poor areas such as ARCs, etc.

The LBP and PCFC have enough experience in operating a wholesale loan window that is accessed by private rural banks and other types of credit intermediaries. PCFC has accumulated substantial experience with microfinance operations. Thus, pilot testing may no longer be necessary.

Introducing Market-based Interest Rates

Another feature of DAR's credit programs that should be reviewed is their highly subsidized interest rate structure. (Please see ***Table 8*** below.) The problem with this set up is that private financial institutions, e.g., rural banks will find it difficult to participate because they are up against credit programs that are artificially cheap. The subsidization of the credit component creates a distortion in the credit markets. For one, it discourages PFIs to play a significant role in rural credit markets because of the unfair and undue competition provided by government's subsidized credit programs.

The inability of those private financial institutions to actively participate in the credit markets has limited the access of agrarian beneficiaries/households to a variety of private sector lenders. One adverse impact of this phenomenon is lack of sustainability of DAR credit programs. They will operate only as long as either DAR or a foreign donor is able to provide subsidized funds but this not certain given the government's huge fiscal deficit and donor fatigue over providing cheap funds for on-lending. DAR's intervention in the microfinance market in ARCs should improve the effectiveness of those MFIs to provide the agrarian beneficiaries/households access to financial services on a *sustainable basis*.

The intention behind the subsidized interest rate structure is to bring down the cost of credit to small borrowers. This is done by blending DAR's interest rate free (0%) funds with Land Bank's loans carrying a regular interest rate (12%). The irony is that there is low utilization of the subsidized funds. It seems that the problem does not lie with the cost of credit but with the lack of absorptive capacity or lack of readiness of the target groups to use the loans and repay them.

Recommendation No. 5*: DAR's credit/microfinance programs should have market-based interest rates.*

Table 8. Interest Rate Structure of DAR Credit Programs

Credit Program	Interest Rate Structure
SARED CAP-PDB Window 1	Agri & Working Capital – 12% + 2% Fixed Asset – 14% + 2%
SARED CAP-PBD Window 2 Land Bank fund counterpart	2% + 2% 12% + 2%
SARED CAP-PBD Window 3 Land Bank fund counterpart	2% 12%
DAR-Erap Trust Fund LCAP ➢ NLSF to conduit ➢ Conduit to beneficiaries ➢ Soft loan for capacity building, etc.	 12% Not to exceed 24% 3%/annual payable in 3 years
DAR-LBP 5-25-70 Partnership Scheme of which: *DAR (25% of project cost)* *LBP (70% of project cost)* *Borrower's equity = 5%*	Zero interest 12%
STARCM of which *Support to 5-25-70 Partnership scheme* *Institutional Credit through PCFC*	 Zero interest on DAR loan; 12% on LBP counterpart fund ?
DAR-UNDP SARDIC-LBP program of which: *SARDIC (25-45% of project cost)* *LBP (40-70% of project cost)* *Borrower's equity (5-15% of project cost)*	Zero interest Prevailing LBP rate
DAR-UNDP-SARDIC Microlending Program	LBP to conduit – 12% + 2% Conduit to beneficiary – market rate

Emphasis on Savings Mobilization

Sustainable microfinance depends on two factors: (i) sound financial practices (based on market-based credit policies that contribute to the MFIs long-term viability and sustainability) and (ii) mobilization of internal resources, basically savings. Savings mobilization frees MFIs (that is, rural banks and cooperatives)[27] from dependence on the government and donor funding in the long term. Internal resources include share capital (for cooperatives), savings deposits, retained earnings and equity (for MFI-banks). GFIs/MFIs (rural banks and cooperatives) should be encouraged to promote internal resource mobilization as part of a long-term strategy in providing agrarian reform beneficiaries access to financial services. Those ARBs need both credit and savings services. Among DAR's credit programs, BIARSP is outstanding for stressing the importance of a savings-based credit system.

Recommendation No. 6**:** *Include internal resource mobilization by GFIs and MFIs as part of a long term strategy to provide ARBs access to credit and savings services***.**

[27] *NGOs are not allowed the country's banking laws, rules and regulations to mobilize deposits.*

Table 9 summarizes and puts in contrast the features of the current DAR credit programs and a financial markets approach to a microfinance program that is suggested as the proposed policy and operational framework for a new DAR microfinance/credit program.

Table 9. Current DAR Credit Programs and a Financial Markets Approach to Microfinance

Features	DAR Credit Programs	Financial Markets Approach
1. Problem definition	Lack of access to credit by ARBs	Lack of access to finance services by ARBs
2. Methodology	Subsidized credit thru a GFI and cooperatives	Efficient market intermediation thru a variety of MFIs
3. View of users	Beneficiaries/target groups needing subsidies	Clients: borrowers and savers
4. Sources of funds	Government budget; LBP, donors	Initially government and donors; in long term internal resources, e.g., savings, etc.
5. Design of product	Centralized and done by DAR/LBP; in some cases donor consultants	Decentralized; MFIs design products to meet needs of the market
6. View of product	Loan product fulfilling a social service, hence need to subsidize	Microfinance products as commercial products
7. Interest rate structure	Subsidized	Market-based
8. Attitude to loan delinquency	Tolerant; soft	Zero tolerance toward delinquency; no arrears
9. Sustainability	Doubtful because of subsidy issue and risk of politicization	More likely depending on sound financial practices based on market-based policies

A Road Map: Specific Steps

The road map consists of a paradigm shift for DAR. It is envisaged that DAR shall confine itself to being a ***service not a credit provider*** to ARBs. In this capacity, DAR can provide technical assistance to ARBs, cooperatives and other groups in ARCs with the end goal of creating a conducive environment for private credit intermediaries, e.g., MFIs, credit cooperatives, etc. to design and develop products and finance services that meet market demand. Thus, the proposed policy and operational framework is market-based and makes greater use of the private sector in designing and implementing capacity building and credit/microfinance programs. Based on the foregoing, a road map that provides the specific steps that DAR can take is as follows:

1. Make a decision to turn over all credit provision responsibilities to the GFIs, e.g., Land Bank. This will entail an amendment or amendments to agreements made with donors on having a credit component in donor-assisted/funded projects. DAR may need the help of the National Credit Council and the NEDA in negotiating with the donors to make the amendment/amendments. Explore the possibility of converting credit programs into technical assistance on enterprise development or infrastructure support in ARCs where MFIs will operate.

2. Provide credit policy directions but allow the Land Bank and/or PCFC and private microfinance institutions (MFIs) to design and implement credit/microfinance products that respond to the market situation. This will enable the private sector to use a variety of innovations in microfinance that provide small scale clients access to financial services, e.g, solidarity lending, village banking, savings mobilization campaigns, etc.

3. Ensure that savings mobilization among ARBs becomes a hallmark of microfinance programs to be implemented by Land Bank and/or PCFC and the MFIs, cooperatives. This will build the asset base of ARBs and strengthen the financial position of MFIs, e.g., rural banks, credit cooperatives.

4. A parallel track is for DAR to work on linking ARBs with established MFIs and/or credit cooperatives for a jointly (that is, by ARBs and MFIs) determined and designed microfinance products.

5. As part of its support services to ARBs, DAR can develop an appropriate capacity building program on microfinance for target groups, e.g., ARBs, cooperatives in ARCs, etc. The capacity building program can be designed and implemented through established microfinance service providers, e.g., Punla sa Tao Foundation, Philippine Christian University, CARD Rural Bank training group, etc. There could be separate but interrelated tracks for: (a) potential MFIs, that is, cooperatives, farmers' associations in ARCs that have a potential for microfinance and (b) ARB clients of MFIs. Tap those with microfinance experiences and technologies for agri-based activities and financing start-up enterprises.

6. DAR's design and implementation of the capacity building program for ARBs, cooperatives, potential MFIs in the ARCs, etc., should take into account the uniqueness of the agrarian sector. It will be important to work with the private sector, e.g., MFIs, NGOs, professional service providers, etc., in designing and implementing capacity building programs.

7. In view of the market-based credit policies of AFMA and Executive Order No. 138, the National Credit Council/Department of Finance should conduct a policy study on the following provision of Republic Act No. 6657 (Item No. 5, Paragraph 2, Section 35, Chapter IX), that is: "extending to small landowners, farmers' organizations the necessary credit, like concessional and collateral-free loans, for agro-industrialization based on social collaterals like guarantees of farmers' organizations."