MICROENTERPRISE ACCESS TO BANKING SERVICES (MABS)

BANGKO SENTRAL NG PHILIPPINES INCEPTION REPORT

By:
Carlos Alba

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THE PHILIPPINES: REGULATION AND SUPERVISION OF MICROFINANCE OPERATIONS OF RURAL, THRIFT AND COMMERCIAL BANKS

INCEPTION REPORT

INTRODUCTION

The General Banking Law No. 8791 of 2000 recognizes the need to promote the expansion of microfinancing and the Bangko Sentral ng Pilipinas (BSP) has issued several circulars that recognize microfinance as a specialized banking service, allow less rigid regulatory requirements for microfinance operations of banks, and create incentives for the banking system to go into microfinance. Also, the BSP has set up a Microfinance Committee and a Microfinance Unit, that will enhance the process of internalizing and institutionalizing microfinance supervision within the BSP, as well as a Microfinance Core Group inside the Department of Rural Bank Supervision.

In order to properly supervise the growing number of banks involved in microfinance, BSP is interested in developing appropriate examination policies and procedures to better measure the institutional risks and performance of the microfinance operations of banks.

ICC Inc. has been assigned (under contract with Chemonics Inc.) the task of conducting an initial assessment and draft a work plan to improve the capability of BSP to properly regulate and supervise microfinance operations of banks (rural, thrift and commercial). Specific activities of the consultancy are:

1. Develop an understanding of the microfinance operations of rural and thrift banks.

2. Review the current camel instrument and the bank examination manual and list modifications that will be required in order to analyze and evaluate microfinance operations.

Annex 1 contains the agenda of meetings and interviews by the ICC consultant, Mr. Carlos R. Alba, who wishes to express his appreciation for the valuable information given by the authorities and personnel of BSP and the rural and thrift banks visited, as well as the MABS personnel.

MICROFINANCE OPERATIONS OF RURAL AND THRIFT BANKS

Regulatory Framework

The General Banking Law of 2000 addresses the need to establish specialized regulations for microfinancing; particularly through section 40 “Requirements for grant of loans and other credit accommodations” which establishes that:

- Before granting a loan or other credit accommodation, a bank must ascertain that the debtor is capable of fulfilling its commitments to the bank.

- In formulating rules or regulations, the Monetary Board shall recognize the peculiar characteristics of microfinancing, such as cash flow based lending to the basic sectors that are not covered by traditional collateral.

The Monetary Board (MB) through resolution No. 40 of January 11, 2001, establishes guidelines for the implementation of sections 40, 43 and 44 of the General Law. Among others, these MB guidelines determine that banks engaged in microfinance shall have "well-defined standards, credit polices and procedures for microfinance loans which are in conformity with microfinance international best practices".

International best practices address microfinance activities from two perspectives:

1 Standards and policies for sound and profitable engagement in the business of microfinancing by any financial institution:
   a. Definition of microfinancing
   b. Lending and administrative technology
   c. Accounting, restructuring and provisioning

2 Standards and technical limits for financial institutions specialized in microfinancing (or microfinance-oriented):
   a. Licensing, including minimum capital for full deposit-taking and branching
   b. Overall lending limit
   c. Risk weighting and capital adequacy

Annexes 2 and 3 contain a summary of current regulations related to microfinancing, in the context of what are considered "international best practices".

Microfinancing operations of rural and thrift banks

Four rural and thrift banks were visited in order to gain a rough understanding of microfinancing operations: a rural and a thrift microfinance-oriented banks (majority-owned by microfinance NGOs) and two rural banks that are downscaling into microfinancing.

Strictly from the point of view of a bank supervisor who is mostly concerned with detecting signals of emerging or potential risks, it has been observed that:

- It seems quite evident that the microfinancial system, not unlike that of other countries, is highly segmented, with players incorporated under different legal frameworks: banks and financial institutions of different sorts, NGOs, savings and credit cooperatives, pawnbrokers. Competition, though hard to quantify in the absence of basic credit reference information, is perceived to be on the rise and with it the possibility of unfair, unduly risky and even "predatory" practices in lending.

- Most banks are engaging in group and individual lending at the same time, sometimes even in the same branch. Group lending is perceived as a safer methodology, given the lack of the essential infrastructure for the safe growth of individual lending: proper identification of clients and a credit reference system[1].

- The loan portfolios of the microfinance-oriented banks are still relatively small, compared with leading specialized institutions in other countries. The effective cost of money to the client, when computing all charges, compensatory deposits and in some cases capitalization of outstanding balances at refinancing (which involves repeat charging of interest and commissions on refinanced amount) ranges from 50% to over 100%.

- In downscaling banks, the microfinance portfolios are also small, even under 5% of the total loan portfolio.

- Significant "experimentation" is taking place, both in microfinance-oriented and in downscaling banks. For example, by engaging in individual lending without adequate know-how or technical assistance or by granting group loans of substantial amounts to newly formed groups. Early signs of unsuccesful "pilot projects" can be already perceived.

- In the case of individual lending, the completeness and quality of information in loan files varies from one bank to the other. In the case of group lending, the information systems of some banks do not capture some key information; for example, the history of payments done by group members on behalf of members in default.

- One bank still shares its information systems and other physical and managerial infrastructure with its main NGO shareholder, who continues to grant credit services (and to take deposits) on a parallel basis.

REVIEW OF SUPERVISORY INSTRUMENTS

Camel Instrument

Current CAMELS instrument appraises the bank's performance and overall condition by evaluating six critical measures with their respective weights: capital adequacy (20%), asset quality (20%), management (20%), earnings (15%), liquidity (20%) and sensitivity to market risks (5%). It must be said that it is an extremely thorough instrument, not only based on indicator/ratio analysis, but also on very detailed questionnaires on policies, procedures and internal controls.

Still, this instrument could be revised in order to introduce modifications or to annex technical notes on approach or methodology; for example, to answer complex questions such as:

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[1] A credit reference mechanism cannot work without a unique identifying number ("key") for each client. Biometric technology is available in the Philippines and could be utilized for a cost-effective creation of a "Microfinance ID Number".

- Is the Board actively involved in management? In a microfinance institution, the involvement of the Board shall emphasize policy setting and monitoring the correct implementation and internal control, not in management per se.
- Are salaries competitive? In a microfinance institution, a substantial portion of the total remuneration of loan officers may be linked to performance, where the actual salary is only considered a base amount.
- Does management exhibit technical competence? Rather than being a question, this could be the actual result of the evaluation.

Also, the CAMELS model can be reviewed to reduce the actual number of questions or procedures to be executed by the examiner. Currently, the model requires that 64 pages of data and questionnaires be completed, which entails the possibility that:

i) The examiner(s) might cut corners in depth of analysis of key elements, in favor of breadth.

ii) Some key questions (for example, when dealing with delinquency management) get diluted and "averaged out", such as:

- Are reports accurate and timely?
- Does management provide adequate supervision of the day-to-day activities of officers and employees?

These questions are included among 83 ratios/questions used to calculate the "management" element of CAMELS.

The CAMELS instrument could also be revised in order to introduce ratios considered "early warning signs" in microfinancial experience. Examples of such ratios are:

Early warning signs when looking at:	**Benchmark today in the industry:**
Portfolio at Risk: Outstanding balance on arrears > 30 days + total gross outstanding refinanced (restructured) portfolio)/ Total outstanding gross portfolio	The Best microfinance portfolios have PAR > 30 days of less than 3% with an average of 6%
Risk coverage ratio: Loan Loss Reserves/(outstanding balance on arrears over 30 days + refinanced loans)	The best institutions with microfinance portfolios have at least 90% of Risk Coverage Ratio, however on average they have around 70% coverage
Write-off Ratio: Write-offs/Average Gross Portfolio	The best institutions have 1% write-offs with an average range of 2-3%
Operating Expense Ratio: Operating Expenses/ Average Gross Portfolio	The best urban institutions doing individual lending are approaching levels less than 10% whereas the best in rural areas is around 15%
Loans per Staff: Number of Loans/Total Staff	The best ratio for institutions with individual lending is 215
Cost of Funds Ratio: Interest and Fee expenses on Funding Liabilities/Average	The cost of funds ratio reflects interest rates in the local markets

Early warning signs when looking at:	Benchmark today in the industry:
Funding liabilities	
Debt/Equity Ratio: Total Liabilities/Total Equity	The average debt/equity ratio for the best institutions with microfinance portfolios was 4 in 2000
Return on Equity: Net Income/Average Equity	The average in leading institutions has been 10% in 2000
Portfolio yield: Interest and Fee income/Average Gross portfolio	Average portfolio yield for the sector in 2000 was 39.5% down from 41.5% in 1999
Client Retention Rate: (Number of borrowers at the end of the period – number of new borrowers for the period)/Number of borrowers at the beginning of period	A normal retention rate should be around 80%.

The preparation and analysis of some of these ratios will require preparation of segmental information by banks involved in microfinance as an additional line of business.

Bank examination manual

The bank examination manual has three parts that are relevant to microfinancing operations. Two of these (General Instruction and Risk Assessment) are of a general and conceptual nature, and need not be modified. Their detailed structure is the following:

Part I: General instructions

- *Introduction (including role, qualities and attributes of the bank examiner)*
- *Frequency, objectives and scope of examinations*
- *Risk-based supervision and examination*
- *Supervision on a consolidated basis*
- *Planning an conducting the on-site examination (including program guide, first day/entry letter, exit conference and report writing)*
- *CAMELS rating system and off/site surveillance activities*

Part II - Risk assessment

- *Elements of a sound risk management (active board and senior management oversight; adequate policies, procedures and limits; effective risk monitoring and management information system; comprehensive internal controls)*
- *Types of risks (credit, market, interest rate, foreign exchange, liquidity, operational, legal, other)*

The third part is Lending Operations - Loans and discounts. This part is detailed and could be amended in many sections. The main modifications are suggested in the following chart:

Section	Suggested modification
Nature	Introduce concept of individual and group microloans
Valuation	Regulation on specific loan loss provision should be made more precise, particularly on

Section	Suggested modification
	basis of aging and restructuring in the case of individual loans and on guarantee refusal in the case of group loans
Income recognition	Introduction of cash basis
Financial statements presentation	Balance sheet and income and expenditure statements for microfinance as a segment of business should be produced by the banks and reviewed by the examiners (as well as internal and external auditors), in accordance with international accounting standards
	Segmental presentation could also be prepared for commercial, consumer and housing finance segments
Examination objectives	OK
Examination procedures	It should be stated that microfinancial examination is based on: • information systems' audit of aging and restructuring of loan portfolio, aimed at confirming/correcting the specific loan valuation results, as well as the security, integrity and accuracy of the information systems • statistical sampling for detection of lending technology degradation and internal control violations, aimed at establishing general provisions due to the additional credit risk, yet to be reflected in arrearage or restructuring
	Annex on the adequacy of credit policies and procedures for the microlending portfolio
	Annex on the adequacy of data collection and evaluation of cash flow, financial situation and repayment capacity

Section	Suggested modification
	Scope of evaluation of bank's compliance with its own policies, to verify observance of at least: • identity of client and domicile verification • payment history and investigation of other liabilities • levels of discretion for approval of loans • loan amounts and terms for the client's level of cash flow and business net worth • relending and restructuring policies • client monitoring policies • other policies such as collaterals, terms, interest rates. • policies on selection and evaluation of co-debtors and guarantors • exception policies and procedures • proper evaluation of cash flow, financial situation and repayment capacity
	Review of information systems' reports at the following levels: • loan officer (timely and complete delinquency reports and other reports for administration of loan portfolio) • branch supervisor or branch manager (delinquency and productivity reports for each loan officer) • area supervisor or credit manager (delinquency and productivity reports for each branch and officer) • senior management and board of directors (delinquency, productivity, profitability)

WORK PLAN

The work plan is the following:

January – February 2003:	Draft of the modifications to the examination manual and CAMELS instrument
April – May 2003:	Field test in at least three financial institutions.
June 2003:	Draft of final adjustment to the modifications and office training of personnel designed by BSP.

ANNEX 1

AGENDA OF MEETINGS
(in chronological order)

Mr. John Owens and Ms. Cecil Cornejo, MABS Project

Mssrs. Eduardo Jimenez and Pia Roman, Microfinance Unit, and Mr. Rogelio Encinas, Department of Rural Banks

Mr. Alberto Reyes, Deputy Governor, BSP

Mr. Wilfredo Domo-Ong, Director, BSP

Mssrs. Paulino Apilado, Jerry Butardo, Dino Camba, Hermie Sonsing and Rino Zerna, Bank Examiners, BSP

Mr. Nestor Espenilla, Managing Director, BSP

Mr. Ricardo Lirio, Managing Director, BSP

Mr. Melito Salazar, Monetary Board Member, BSP

Mr. Antonito Alindogan, Monetary Board Member, BSP

Mrs. Ludy Albances, Bank Officer III, BSP

Mssrs. Aristeo Dequito, Cinthia Baldeo, Lerma Lailo and Ana Castulo, Officers of Card Rural Bank Inc.

Mssrs. Josaias de la Cruz, Peri Cartera, Anacleto Difuntorum, Rochelle Rocapor and Daisy Nitro, Officers of Opportunity Microfinance Thrift Bank Inc.

Mr. Ronald Robin, ACLT Computing Inc.

Mssrs. Ricky Ocampo, Edith Millendez and Henry Berber, Officers of First Macro Rural Bank Inc.

Mssrs. Armida Caguitla and Nonito Vir. D. Jurado, Officers of Community Rural Bank of Catmon Inc.

ANNEX 2

STANDARDS AND POLICIES FOR MICROFINANCING AS A LINE OF BUSINESS

Definition of Microfinance loans	
Circular 272 of Jan.30.01	***International best practices***
Poor and low income households, including: i) landless engaged in agriculture and manual laborers, ii) small and marginal farmers, rural artisans and urban self-employed, iii) medium farmers and small entrepreneurs and those in villages and slums engaged in processing and manufacturing activity	Client does not have formal financial statements, tax returns, salary slips or operational/administrative records and Client has not provided registered collateral as security for the loan Maximum amount dependent on lending technology and net worth of financial institution
Typically unsecured	
Amount not to exceed P150.000	
Daily, weekly, bi-monthly or monthly amortization	
Interest not lower than prevailing market rates	
Statement of assets and liabilities and of income and expenditures not required	
Lending and administrative technology	
Circular 272 of Jan.30.01	***International best practices***
An adequate loan tracking system that allows daily monitoring of the status of loan releases, collection and arrearages, any restructuring of refinancing	Same
Regular monitoring of past due loans and portfolio at risk	Same
Measures to be undertaken to ensure collection, including close supervision of borrowers' projects and operations	Formal supervision of all borrowers' projects and operations may be unduly costly; zonification for credit officers can be established instead
Granted on basis of cash flow	Cash flow (to determine maximum installment amount) as well as pro-forma balance sheet (to determine maximum principal amount)
Circular 273 (Feb.27.01)	***International best practices***
Written manual of operations, which shall include the administrative and credit program systems and procedures, and be consistent with "core principles, characteristics and features of microfinance" (established in IFAD Draft Appraisal Report, National Microfinance Support Programme, May 2000)	Should include procedures for internal control of microfinancing operations with specific provisions regarding audit track

Accounting, restructuring and provisioning	
Circular 248 (Jun.26.00)	***International best practices***
The total outstanding balance of loans payable in monthly installments is considered past due when 3 installments are in arrears (1 if quarterly, semestral or yearly installments) or when the total amount of arrearages reaches 20% of the total outstanding balance (10% if daily or weekly installments)	The total outstanding balance of loans on the first day after any installment or portion thereof goes unpaid
Loans payable in lump sum and loans payable in quarterly, semi-annual or annual installments become non-performing when unpaid for 30 days or more after due date; other loans (monthly, daily or weekly installments) become non-performing when considered past due	Income is recognized on cash basis; otherwise, interest accrual suspended on first day after any installment or portion thereof goes unpaid
Circulars 247 (Jun.2.00) and 313 (Dec.27.01)	***International best practices***
Specific provision of 100% apparently when past due six months or more (i.e. 270 days in arrears: 180 plus 90 days from date of first missed installment) General provision of 5% for unclassified restructured loans and 1% for unclassified current loans (excluding those guaranteed by deposits)	Specific provision of 1% for normal (current) loans and stepwise increase to 100% when in arrears more than 90 days General provision in relation to additional risk such as inadequate loan policies or procedures, internal control deficiencies or violations, overindebtedness of clientele
Loans may be renewed with payment of 20% of the principal	Loans may be refinanced (through an even larger loan) when at least 70% of the principal has been paid according to agreed schedule (no balloon payments)
Circular 202 (May.27.99) and Circular Letter 99-17 (Jun.8.99)	***International best practices***
Loans restructured loans for a second time classified “substandard” and provisioned 25%	Loans restructured for a second time provisioned 100%

ANNEX 3

STANDARDS AND TECHNICAL LIMITS FOR FINANCIAL INSTITUTIONS SPECIALIZED IN MICROFINANCING

Licensing	
Circular 340 (Jul.30.02)	***International best practices***
US$13 million of minimum capital for full deposit-taking and branching capacity	US$1-2.5 million for specialized institutions
Majority of board members with experience in microfinancing and at least one board member with banking experience	Same
President, CEO or general manager must have at least 2 years experience in banking **or** have microfinance experience and be a college graduate	Management should have microfinance experience
Branching only after one year of profitable operations	Viability of branch itself prioritized and its contribution to the coverage of fixed costs (otherwise, fixed costs may be covered through undue increase in lending rate)
Proof that area is not fully served by an existing rural bank necessary for branch approval	Competition is encouraged to promote reduction of lending rate
Lending limit	
Section 35 of R.A. 8791 (2000)	***International best practices***
Limit on loans, credit accommodations and guarantees to a single client at 20% of net worth of the bank, including microfinance-oriented banks	Specialized institutions Limit at 1% of net worth for unsecured loans and 3% for loans secured by registered collateral
Circular 340 (Jul.30.02) and	***International best practices***
At least 50% of the gross portfolio in microfinance loans	All loans at or under 3% of net worth
Risk weighting and capital adequacy	
Manual of Bank Regulations	***International best practices***
At par with any other type of loan and with any other bank or financial institution	Same

Circular 273 (Feb.27.01)

Establishment of microfinance-oriented banks:

- Thrift and rural banks only
- Owned by private persons, “multilateral entities”
- Minimum capital P5 million (rural bank)
- At least 20% owned by persons or entities with track record in microfinancing
- Majority of board members with experience in microfinancing
- At least one board member banking experience
- Loan tracking system, including daily monitoring of arrearages and restructuring
- “Commitment” to reach “low-income” clients
- Written manual of operations
- At least 50% of the gross portfolio in microfinance loans
- President, CEO or general manager must have at least 2 years experience in banking **or** microfinance experience and be a college graduate
- Branching only after one year of profitable operations
- Proof that area is not fully served by an existing rural bank necessary for branch approval

Circulars 282 and 324 (Apr.19.01 and Mar.12.02)
Rediscounting facility for rural, cooperative and thrift banks

Circular 340 (Jul.30.02)

Establishment of branches and loan collection/disbursement points (LCDP)

- For branches and LCDP of microfinance-oriented banks and microfinance-oriented branches and LCDP of not microfinance-oriented banks
- Minimum capital of P10 million and capital adequacy ratio of 12%
- “Un-leveraged” capital of P2.5 million (rural banks), P5 million (thrift and cooperative banks) and P20 million (universal banks).
- Brach may only be established in places “not fully served” by existing microfinance banking offices
- LCDPs may collect, disburse and release loans and accept deposits, but may not retain cash at the end of the day; security and infrastructure requirements of branches waived for LCDPs
- Nationwide branching requires a minimum of P650 million
- Non microfinance-oriented banks: 70% of branch deposits lent to microfinance borrowers and microfinance loans at least 50% of gross portfolio
- Microfinance-oriented banks: profitable operation for at least one year

OJO BALANCE SHEET
Commercial banks in fact prohibited from engaging in microfinancing
Informal microentrepreneurs of lat America, asia, eve Africa manage important inventories and capital assets. Enticing them to formalize through initial access to banking services might prove a better strategy than denying financial services until they formalize.
Cash flow information seems to be only to comply with formal requirements, not as an instrument of internal credit decision and internal control.