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Performance Standards for All Types of Microfinance Institutions in the Philippines

I. Introduction

The National Credit Council (NCC), an inter-agency body chaired by the Department of Finance (DOF), formulated and approved the **Regulatory Framework for Microfinance Institutions (MFIs) in July 2002 (Annex 1)**. The framework specifically directed the NCC, in coordination with concerned stakeholders, to formulate and develop a uniform set of performance standards that will cut across all types of institutions involved in microfinance. These standards will serve as the microfinance industry benchmarks to allow the comparison of performance among all institutions engaged in the delivery of microfinancial services. These benchmarks will also guide regulators in the assessment of financial institutions under their supervision. It should be noted, however, that these standards are only applicable to financial institutions that are engaged in retail microfinance operations.

The Performance Standards for All Types of Microfinance Institutions are based on international best practices, industry benchmarks and ratios that are being used by different players in the microfinance industry.

II. Purpose of Establishing a Common Set of Standards for Microfinance

As required under the Regulatory Framework for Microfinance Institutions, a common set of performance standards for all institutions engaged in microfinance was formulated and developed by the Technical Working Group (TWG) **(Annex 2)** to allow greater transparency in the operations of MFIs. More particularly, the standards will provide the user the basic tools that will facilitate the evaluation of any type of MFI and compare its financial performance with that of other MFIs, regardless of whether it is a bank, cooperative or an NGO.

The following are expected to use these standards in evaluating the performance of MFIs:

- MFI management;
- Appropriate regulatory authorities;
- Wholesale financial institutions (government and private);
- Donor agencies;
- Domestic and international private sector investors;
- Rating agencies; and
- Social policy institutions.

The indicators and standards can be used in various ways. Management can use these indicators and standards in identifying weak areas in their microfinance operations and in determining the appropriate measures to improve operations. Domestic and international private investors can use these standards as guideposts in deciding whether they will invest in an MFI or not. Wholesale financial institutions, whether public or private can use these standards in assessing the creditworthiness of MFIs. Donor agencies, on the other hand, can use these standards in identifying the type of assistance for a specific MFI.

III. General Features of Microfinance

- Clients come from the low-income sector, lack assets for collateral, usually self-employed in the informal sector, and are engaged in economic livelihood activities;
- Grant of loans is based on the borrower's household's net cash flow;
- Non-traditional forms of security are acceptable;
- Documentation requirements are simple, loan processing is fast, and loan release is timely;
- Lending methodology may be on a group or individual basis;
- Loan sizes are typically small, not exceeding P150,000; and
- Loans are typically short-term and amortizations are either on a daily, weekly, semi-monthly or monthly basis.

IV. Minimum Criteria in Evaluating Retail Microfinance Institutions

The minimum criteria below will provide a bird's-eye view of the nature and status of the MFI. These institutional criteria indicate whether the financial institution employs sound financial practices and has satisfactory performance and stable financial condition. Moreover, these criteria will indicate the financial institution's capability for and seriousness in microfinance operations.

1. Institutional viability criteria[1]

a. CAMELS rating for banks of at least 3, with management score of not less than 3; and
b. COOP-PESOS rating for cooperatives with savings and credit services of at least 70 with net institutional capital to total assets ratio of not lower than 5%.

[1] *Use of these criteria is optional for users depending on its purpose.*

2. **Governance**

   a. The institution is regularly audited by an independent external auditor. For banks, the auditor should be recognized by the Bangko Sentral ng Pilipinas (BSP); for cooperatives, the external auditor should be accredited by the Cooperative Development Authority (CDA); and for Non-governmental organizations (NGOs), the external auditor should be certified by the Philippine Institute of Certified Public Accountant (PICPA) as a member in good standing; and
   b. Audited financial statements are readily available.

3. **For microfinance operations:**

   a. Presence of program objective to reach the poor;
   b. Number of active microfinance clients, classified by gender - at least 500 for group lending or 200 for individual lending;
   c. At least one year in microfinance operations;
   d. Presence of a functioning and effective management information system (MIS) for regular monitoring of microfinance operations as evidenced by timely generation of basic financial, loans tracking, and aging reports using Portfolio at Risk (PAR);
   e. Manual of operations or product manual; and
   f. At least 2 full time account officers for microfinance operations.

V. Performance Standards for Microfinance (See Annex 3 for details)

After meeting the minimum institutional criteria, the microfinance operations of the MFI shall be subjected to the following performance standards:

1. **<u>Portfolio Quality</u>** – Two indicators below provide specific information on the state of financial health of the microfinance portfolio of the institution. Maintaining good portfolio quality is very important for continued delivery of microfinance services to the MFI's clients. Poor quality of loan portfolio will lead to losses to the institutions, making it difficult to sustain microfinance operations.

   a. **Portfolio at Risk (PAR) Ratio** – reflects the proportion of the microfinance loan portfolio with one day missed payment to the total microfinance loans outstanding at a given time, and shows the degree of riskiness of the total microfinance portfolio.

   Since microfinance loans are usually small and are payable within a short period of time, the likelihood of default of the entire loan balance is high when one amortization payment is missed. The formula for this indicator is:

Principal Balance of Loans with At Least One Day Missed Payment   ***Total Principal Loan Balance***

Restructured or refinanced loans shall be considered non-performing and no interest income shall be accrued thereon. These loans shall be included in computing PAR.

Restructured loans are loans that have been renegotiated or modified to either lengthen or postpone the original scheduled installment payments or substantially alter the original terms of the loan.

Refinanced loans are loans that have been disbursed to enable repayment of prior loans that would not have been paid in accordance with the original installment schedule. Refinanced loans shall be classified and treated as restructured loans.

STANDARD: 5%

b. **Loan Loss Reserve Ratio** – indicates the degree of protection of the institution against expected losses due to delinquency.

An allowance should be provided once the microfinance loan is considered at risk, since the likelihood of default increases as amortization payments are missed. Hence, allowance for probable losses is based on PAR. Restructured and refinanced loans are considered as risky and should be provided the appropriate allowance.

As a general provision, all current microfinance loans shall be subject to a 1% loan loss provisioning. The following shall be the basis in computing for loan loss reserves:

	Required Reserves
Current	1%
PAR 1 to 30	2%
PAR 31 to 60 and/or loans restructured once	20%
PAR 61 to 90	50%
PAR 91 & above and/or loans restructured twice	100%

- **Loan Loss Reserve Ratio**

Total Reserves Provided   ***Total Reserves Required***

STANDARD: 100% of the required reserve

2. **<u>Efficiency</u>** – The indicators under this category show whether the MFI is able to deliver microfinance services at the least cost to the institution. They also indicate the ability of the institution to generate sufficient income to cover the expenses related to the microfinance operations.

   a. **Administrative Efficiency –** measures the cost of managing the organization's assets.

$$\frac{\textit{Administrative Costs* (direct and indirect costs)}}{\textit{Average Gross Loan Portfolio**}}$$

**Administrative cost should include loan loss provision expense.*
***(Beginning Gross Loan Portfolio + Ending Gross Loan Portfolio) ÷ 2*

Indirect Costs is allocated in proportion to the number of personnel directly dedicated to each cost center. Indirect cost allocated to the microfinance operations is computed as:

Indirect Costs = (Number of Full-time MF Staff ÷ Total Number of Full-time Staff) x Total Indirect Costs

<u>Full-time MF Staff</u> refers to employees working full-time in the microfinance operations regardless of employment status, i.e., whether contractual or regular.

<u>Total Indirect Costs</u> refers to costs shared by both the microfinance and non-microfinance operations. It includes, among others, salaries and benefits, rent, office materials and supplies, publications and publicity, transportation, travel and training for overhead staff, telephone and postage, insurance, utilities, repairs and maintenance, legal, audit and consultant fees, bank charges, taxes, and depreciation.

STANDARD: 10 % and below

   b. **Operational Self-Sufficiency –** indicates whether or not enough revenues are earned to fully cover the costs of the microfinance operations.

$$\frac{\textit{Interest Income from Loans + Service Fees + Filing Fees + Fines, Penalties, Surcharges}}{\textit{Financing Costs + Administrative Costs (direct and indirect costs)}^{2}}$$

STANDARD: greater than 120%

   c. **Loan Officer Productivity** – measures the ability of loan officers to service microfinance borrowers.

$$\frac{\textit{Number of Active Borrowers}}{\textit{Number of Account Officers}}$$

[2] *Same as Administrative Cost used for computing Administrative Efficiency.*

STANDARD: Group: greater than or equal to 300
Individual: greater than or equal to 150

3. **Sustainability** – Two indicators below measure the ability of the institution to continuously finance its microfinance operations from internally generated funds in the long run without any subsidy.

   a. **Financial Self-Sufficiency –** indicates whether the organization is earning enough revenue to sufficiently cover in the long-run all operating costs and at the same time maintain the value of its capital and assets, without the need for subsidy.

$$\frac{\textit{Operating Revenue}}{\textit{Financial Expense + Loan Loss Provision Expense + Adjusted Expenses*}}$$

***Adjusted Expenses** = *Total Operating Expense + [(Average Equity – Average Fixed Assets) x Inflation Rate] + [(Market Interest Rate x Average Total Liabilities) – Actual Interest Expense] + Other Implicit Costs. Other Implicit Costs include those costs relevant to the conduct of its business such as grants, rent free building, donor paid technical advisor, or other subsidized expenses.*

STANDARD: greater than 100%

   b. **Loan Portfolio Profitability –** measures the proportion of net revenues generated from the MF lending operations to the MF loan portfolio. This ratio indicates whether earnings can sufficiently cover the annual depreciation of the peso.

$$\frac{\textit{Net Operating Income}}{\textit{Average Net MF Loan Portfolio}}$$

STANDARD: greater than the inflation rate during the period

4. **Outreach** - These indicators show the extent of reach of the MFI. They take into account the growth in the number of the active clients, the expansion of the microfinance portfolio, and the depth of outreach.

   a. **Growth in Number of Active MF Clients[3] -** measures the ability of the MFI to expand its operations through increases in its active clients (referring to those with outstanding MF loans with the institution).

[3] *All reference to growth rates should be computed on an annual basis. To get growth rate for a specific month, variable should be compared with the performance of the same variable in the previous year. For instance, to get the growth rate of clients as of November 2000, the no. of clients in November, 2000 should be compared with the no. of clients in November, 1999.*

Ending No. of Active MF Clients – Beginning No. of Active MF Clients
Beginning No. of Active MF Clients

STANDARD: ≥ 5%

b. **Growth in Microfinance Loan Portfolio** – determines the rate of expansion of the MF loan portfolio, which may be a result of an increase in the number of active clients or in the loan amounts, or a combination of both.

Ending MF Loans Outstanding – Beginning MF Loans Outstanding
Beginning MF Loans Outstanding

STANDARD: ≥ 5%

c. **Depth of Outreach** – indicates whether the MFI provides micro-financial services to clients belonging to the lower income segment of the economy.

Total Loans Outstanding ÷ Total Number of Active Borrowers
GNP per Capita

STANDARD: Not exceeding 20%

VI. Rating System

1. Portfolio Quality (40%)

a. Portfolio At Risk

Score	Equivalent Points
5% or less	20
> 5% to 10%	15
> 10% to 15%	10
> 15% to 20%	5
Above 20%	0

b. Loan Loss Reserve Ratio

Score	Equivalent Points
100%	20
70% to < 100%	15
50% to < 70%	10
30% to < 50%	5
Below 30%	0

2. Efficiency (30%)

c. Administrative Efficiency

Score	Equivalent Points
0 to 10%	10
> 10% to 15%	6
> 15 to 20%	4
Above 20%	0

d. Operational Self-Sufficiency

Score	Equivalent Points
120% & above	10
115% to < 120%	8
110% to < 115%	6
105% to < 110%	4
100% to < 105%	2
Below 100%	0

e. Loan Officer Productivity

Score	Equivalent Points
For group loans:	
300 and above	5
250 to 299	3
200 to 249	1
Below 200	0
For individual loans:	
150 and above	5
100 to 149	3
50 to 99	1
Below 50	0

Note: If MFI is using only one methodology, MFI gets an additional 5 points

3. **Sustainability (15%)**

f. Financial Self-Sufficiency

Score	Equivalent Points
100% & above	10
95% to < 100%	8
90% to < 95%	6
85% to < 90%	4
80% to < 85%	2
Below 80%	0

g. Loan Portfolio Profitability

Score	Equivalent Points
Greater than inflation rate	5
Equal to inflation rate	3
Less than inflation rate	0

4. Outreach (15%)

h. Growth in Number of Active Microfinance Clients

Score	Equivalent Points
5% or higher	5
0 to 5 %	3
Below 0	0

i. Growth in Microfinance Loan Portfolio

Score	Equivalent Points
5% or higher	5
0 to 5 %	3
Below 0	0

j. Depth of Outreach

Score in Percent	Equivalent Points
≤ 20	5
> 20 - 100	4
>100 -150	3
>150-200	2
>200-300	1
>300	0

VII. Overall Adjectival Rating

- **Rating 1 (90 to 100) – Excellent**. The MFI has strong performance that provides safe and sound operation. The microfinance operations of institutions in this category are resistant to external shocks and financial disturbances and are able to withstand adverse changes in the business environment.

- **Rating 2 (80 to 89) – Very Satisfactory**. The MFI has satisfactory performance. They have safe and sound operations and are able to withstand business fluctuations. However, there are some areas in its operations that need special attention which, if left unchecked may negatively affect its microfinance operations.

- **Rating 3 (70 to 79) - Satisfactory**. There are areas in the microfinance operations that need special attention. Key performance measures indicate that the operations may be adversely affected and may deteriorate further when left unchecked.

- **Rating 4 (Below 70)** – Needs Improvement. The microfinance operation has serious problems and needs close supervision.

Annex 1
Regulatory Framework for Microfinance in the Philippines

The government recognizes microfinance as one of the important tools in the current government's fight to alleviate poverty. This is clearly articulated in the President's State of the Nation Address (SONA) in July 2001. The specific policies and strategies to be pursued for the effective delivery of microfinance services are spelled out in the National Strategy for Microfinance (NSM) **(Annex 1.1)**. The government's microfinance policy is built on the following principles:

- Greater role of private microfinance institutions (MFIs) in the provision of financial services;
- An enabling policy environment that will facilitate the increased participation of the private sector in microfinance;
- Market-oriented financial and credit policies, e.g. market-oriented interest rates on loan and deposits;
- Non-participation of government line agencies in the implementation of credit and guarantee programs.

Using these policy principles, a framework for the development of the microfinance industry was formulated. This framework provides the government's thrust and policy direction for the microfinance industry and delineates the role and the responsibilities of each of the players[4] in the microfinance industry in both the public and the private sector.

The government's clear policy directions on microfinance resulted in an increased number of private institutions engaged in the provision of micro-finance services. Because of this, appropriate supervision and regulation of microfinance institutions is an important issue that has recently been brought to the fore by both the government and the microfinance practitioners. Appropriate regulation and supervision of microfinance is important to ensure that risks associated with microfinance are minimized and appropriately managed by the concerned MFIs. The continued viability and sustainability of these institutions is important for microfinance to effectively contribute to the poverty alleviation objective.

Recognizing the importance of appropriate regulation in ensuring the delivery of sustainable and efficient microfinance services, the Executive Committee of the National Credit Council (NCC) and the National Anti-Poverty Commission (NAPC)

[4] *The Framework for Microfinance Development categorizes the following players in the microfinance industry: the clients, microfinance institutions, wholesale lenders, service institutions, and concerned government agencies involved in microfinance policy formulation and regulation. The framework outlines the different activities that will be pursued by the concerned players given the policies and strategies espoused in the National Strategy for Microfinance. This regulatory framework forms part of the Framework for the Development of Microfinance.*

created a technical working group,[5] which is tasked to work on the formulation of an appropriate regulatory framework for microfinance. This paper provides such framework.

I. What is microfinance?

Microfinance is the viable and sustainable provision of a broad range of financial services (savings and credit) generally, by the private sector to poor and low-income households[6] engaged in livelihood and microenterprise activities using non-traditional and innovative methodologies and approaches (e.g. non-collateralized cash-flow based lending). The maximum individual loan amount provided for microfinance loans is P150,000.[7]

II. Vision for microfinance

To make microfinance the cornerstone for poverty alleviation, the vision is to have a **viable and sustainable private (micro) financial market.** This will be achieved in a liberalized and market-oriented economy where the private sector plays the major role and the government provides the enabling environment (through the appropriate policy and institutional framework) for the efficient functioning of markets. (National Strategy for Microfinance, 1997). This will be achieved through among other things, the following:

i. Adoption of market-based financial and credit policies
ii. Greater private sector participation in the delivery of microfinance services to the basic sector
iii. Establishment of an appropriate regulatory framework for microfinance

[5] *The Technical Working Group (TWG) is composed of representatives from the following government agencies: Bangko Sentral ng Pilipinas (BSP), Cooperative Development Authority (CDA), Philippine Deposit Insurance Corporation (PDIC), Peoples Credit and Finance Corporation (PCFC), National Anti-Poverty Commission (NAPC), Land Bank of the Philippines (LBP), Development Bank of the Philippines (DBP), Department of Labor and Employment (DOLE), National Commission on the Role of Filipino Women (NCRFW), Agricultural Credit Policy Council (ACPC) The TWG is also composed of representatives from the private sector i.e. Rural Bankers Association of the Philippines (RBAP), National Confederation of Cooperatives (NATCCO), and the Microfinance Council of the Philippines (MCP).*

[6] *The 1997 NEDA poverty estimates show that the established annual per capita poverty threshold for the Philippines is P11,319. The annual per capita poverty threshold in the urban areas and rural areas is P12,577 and P10,178 respectively. Below this threshold or minimum income, that individual will be considered "poor."*

[7] *This definition is consistent with the provisions of RA 8425 (Social Reform Agenda).*

III. Objectives of the Regulatory Framework

A. To protect the financial system from unsound (i.e. excessively risky) practices by deposit-taking institutions (either from the public or its members) and thereby, protect the country's payments system;

B. To protect small clients; and

C. To promote the establishment of an accurate, reliable and transparent set of financial information for all types of MFIs.

IV. Scope of Microfinance Regulation

Only institutions taking deposits from the general public and/or from its members are subject to prudential regulation and supervision. Since microfinance NGOs are not supposed to take deposits from their clients, they will not be subjected to prudential regulations. However, those microfinance NGOs that collect savings beyond the compensating balance will be subject to the appropriate regulatory agency.

V. Definition of Terms

A. **Compensating balance** – this refers to the proportion of the total loan of an MFI client, which is retained with the MFI as capital build-up or savings. This amount serves as a hold-out deposit on the loan of the client and can be used by the MFI to off-set the client's outstanding balance in case of default. In view of this, the client is considered a net borrower from the MFI rather than a net saver (i.e. as a borrower of his own savings rather than as a depositor who finance other client's borrowings/loans).

B. **Deposit-taking Institutions** – these are financial institutions engaged in the mobilization of savings either from its own members or from the general public.

C. **Micro Finance Institutions (MFIs)** –these are institutions engaged in the delivery of microfinancial services (e.g. microsavings and microcredit). Examples of these institutions are rural banks and cooperative banks, thrift banks, credit cooperatives and microfinance NGOs.

D. **Microfinance Regulation** – this refers to the issuance of the necessary rules and regulation, including cancellation, suspension and sanctions, governing the intermediation of microfinancial services. The rules and regulations are expected to make sure that all microfinance institutions employing innovative and non-traditional lending methodologies are using sound and prudent practices in their operations.

E. **Retail Microfinance Institutions** - these are financial institutions that provide direct micro-financial services to microfinance clients.

F. **Regulation** – the act of defining and establishing a set of rules and regulations governing the intermediation of financial resources between savers and borrowers. This also includes the issuance of necessary measures to ensure that financial intermediaries operate in a sound and prudent manner. Rules and regulations are issued to ensure the stability of the payments system.

G. **Risk-based Supervision** - this is a supervision approach wherein the supervisor/examiner identifies, classifies and measures the different types of risks faced by the financial institutions in its operations.

H. **Supervision** – this refers to the systematic oversight of micro finance institutions to ensure their compliance with the established rules and regulations.

I. **Wholesale Microfinance Institutions** – these are financial institutions, which lend out loanable funds to microfinance institutions.

VI. Current Situation of Regulatory Environment

A. At present, there are a number of institutions involved in the delivery of micro-financial services to the basic sectors, e.g. the rural banks, thrift banks, credit cooperatives and the micro-finance NGOs. Thrift banks and rural banks are currently being supervised by the Bangko Sentral ng Pilipinas (BSP) while the credit cooperatives are legally under the supervision of the Cooperative Development Authority (CDA). The microfinance NGOs are not being supervised nor regulated by any government regulatory agency.

B. Regulatory Environment for Banks

B.1. The BSP is the regulatory authority over all banking institutions including those engaged in the provision of micro financial services. BSP issues the necessary rules and regulations for the safe and prudent operations of banks. As part of its regulatory mandate over banks, BSP supervises and conducts regular examination of banks. During examination, examiners check for compliance with banking laws, rules and regulations, soundness of systems for evaluating credit, supervision and collection of loans and the quality of the loan portfolio. While the laws and regulations do not prohibit micro-enterprise lending, most banks are not keen on providing micro-finance loans for fear of being penalized by bank examiners. A study conducted by the Credit Policy Improvement Program (CPIP) reported that lenders subject to BSP supervision guidelines and practices are unclear about the BSP's view on small, clean and unsecured loans that are supported by informal financial information.

B.2. With the issuance of the National Strategy for Microfinance in 1997, the NCC advocated for the issuance of the necessary measures to implement the policy principles and strategies espoused in the NSM. This led to the inclusion of certain provisions in the General Banking Law that specifically pertains to microfinance.

B.3. Section 40 of the General Banking Act of 2000 specifically recognized the peculiar characteristics of microfinance and directs the Monetary Board to issue relevant measures specifically to address the apprehension cited by most banks regarding microfinance. Hence, the following circulars were issued by the BSP:

- BSP Circular 272 dated January 30, 2001, which recognizes the peculiar characteristics of microfinance and directs its exemption from rules and regulations issued by the Monetary Board with regards to unsecured loans;

- BSP Circular No. 273, dated January 30, 2001, which lifts the moratorium on bank branching for those banks engaged in microfinance activities;

- BSP Circular No. 282 dated 19 April 2001 opens a rediscounting window for microfinance.

C. Regulatory Environment for Credit Cooperatives

C.1. The Cooperative Development Authority is mandated under Republic Act 6539 to provide oversight functions for all types of cooperatives. However, despite its legal mandate to regulate and supervise credit coops and other coops with credit services, CDA is not effectively performing this function. CDA has been mostly engaged in development activities[8], which is also allowed by their present charter. At present, the CDA does not supervise nor examine the books of credit cooperatives.

C.2. In 1997, the National Credit Council through the Credit Policy Improvement Program (CPIP) conducted a review of the regulatory environment for Credit Cooperatives. The review found out that the CDA is not able to effectively implement its regulatory mandate due to conflicting mandates of regulation and development. In view of this, it has mostly been involved in the registration of cooperatives and in the conduct of promotion and development activities for cooperatives. Results of the review also showed that the CDA does not have the necessary basic information for the effective regulation of credit

[8] *The Cooperative Code adopts the principle of subsidiarity wherein the cooperative sector will take the lead in the conduct of development activities such as training, promotion and education.*

cooperatives (i.e. there is no standard chart of accounts and performance standards for credit cooperatives).

C.3. In 1998, the NCC, in coordination with the CDA, the credit cooperative sector and other government agencies working with the cooperative sector spearheaded work on the establishment of a standard chart of accounts for credit cooperatives and other types of cooperatives with credit services. The CDA has recently issued a circular directing all concerned primary credit cooperatives to adopt and implement the standard chart of accounts.

C.4. The NCC, in coordination with the CDA, the credit cooperative sector and other government agencies, is also currently working on the establishment and adoption of a set of performance standards for credit and other types of cooperatives with credit services.

D. Regulatory environment for Microfinance NGOs

D.1. At present, there is no single agency that has supervision over microfinance NGOs. Microfinance NGOs register with the Securities and Exchange Commission (SEC) as a non-stock, non-profit organization. SEC, however only registers microfinance NGOs. It does not regulate nor supervise them. In view of this, microfinance NGOs do not report to any oversight agency (whether private or public) and hence, there is no single institution that has a complete set of relevant information on the financial performance of microfinance NGOs.

D.2. Almost all microfinance NGOs collect forced savings (sometimes referred to as capital build-up) from their borrower-clients. A number of them argue that the savings they collect from their members are only compensating balances. In view thereof, there is consensus among microfinance NGOs that they should be allowed to collect savings from their clients without prudential regulation provided that these do not exceed their total loan portfolio. There is concern, however that a number of microfinance NGOs may have collected savings beyond the compensating balance.

D.3. As mentioned earlier, there is no available set of uniform and transparent information that can be used to determine whether the savings collected by the microfinance NGOs are only compensating balances. Since no single agency collects a uniform and transparent set of information among microfinance NGOs. While the Microfinance Council of the Philippines (MCP) is an umbrella organization comprised mostly of microfinance NGOs, not all members submit relevant and uniform set of information to the Council.

D.4. To ensure that microfinance NGOs are operating in a viable and sustainable manner, the Microfinance Council of the Philippines has adopted a set of performance standards for microfinance NGOs. A standard chart of accounts has, likewise, been formulated. Both the performance standards and the standard chart of accounts are however, yet to be widely adopted by the microfinance NGOs.

D.5. The non-adoption of the performance standards and the standard chart of accounts by most microfinance NGOs is attributed to the absence of incentives for adoption.

D.6. The recommended chart of accounts for microfinance NGOs will be reviewed to make this comparable with the chart of accounts of the banks and the credit cooperatives. A technical working group comprised of representatives from both the microfinance practitioners and other stakeholders is currently reviewing the existing set of performance standards for microfinance NGOs. The review is aimed at coming up with a set of standards that are consistent with the performance standards for other types of MFIs (e.g., banks, cooperatives). The NCC will use the results of the review in the formulation of performance standards that cuts across all types of MFIs.

E. Role of Wholesale Financial Institutions

E.1. Generally, loanable funds for microfinance are provided by wholesale lenders that include the following: commercial banks, GFIs and the PCFC, a government-owned and controlled corporation which is specifically tasked to provide wholesale funds for microfinance.

E.2. Current government policy directs the GFIs to provide wholesale funds at market rates to private financial institutions engaged in microfinance.

E.3. Commercial banks also provide wholesale funds to private financial institutions engaged in microfinance using their own funds and adopting their own lending criteria.

VII. Establishing the Regulatory Framework

A. Basic Premises

A.1. Should existing regulatory institutions lack the capability to effectively undertake the necessary regulatory functions for microfinance, appropriate measures will be adopted for the establishment of an alternative structure. Otherwise, necessary technical assistance for institutional strengthening will be sought from relevant donor agencies.

A.1.1 Only deposit taking institutions will be subjected to regulation.

A.1.2 Banks, including GFIs that provide wholesale funds for microfinance, will continue to be regulated by the BSP. General rules and regulations on bank supervision and examination will be applied. Specific rules[9] to consider the peculiar and unique characteristics of microfinance services will only be applied where applicable, provided these will not unduly affect the stability of the financial system.

A.1.3. Credit cooperatives are under the regulatory authority of the CDA.

A.1.4. Microfinance NGOs are considered non-deposit taking institutions and therefore, will not be subject to prudential regulation and supervision by any government regulatory authority provided that the total savings collected from their clients should not exceed the total loan portfolio of the microfinance NGO at any point in time.

- ♦ Microfinance NGOs that collect savings beyond the compensating balance will be required to transform into a formal financial institution (either a credit coop or a bank) to be able to continue collecting savings from their borrower-clients.

A.2. Establishment of a transparent set of information to include sex disaggregated data for microfinance will be promoted among all types of microfinance institutions.

- ♦ Since majority of microfinance clients are women, their specific needs should appropriately be considered in the design of microfinance products.

A.3. A credit information system containing data on all microfinance loans should also be established by the private sector.

A.4. There will be a core set of performance standards for microfinance operations for all types of financial institutions. These standards should be defined and be consistent with international best practices. These standards should likewise be endorsed and adopted by a rating agency, concerned MFIs and regulatory authorities.

[9] *International best practice shows that risk-based supervision is most applicable for microfinance. In view of this, the supervision and examination process currently used by the BSP is being reviewed in the light of its impact on microfinance operations of the banks.*

B. Institutional Set-up for Micro-Finance Regulation *(see Figure 1 for the Organigram)*

B.1. Bangko Sentral ng Pilipinas

B.1.1. To act as the regulatory and supervisory authority for banks engaged in microfinance operations

B.1.2. To provide the necessary technical assistance to the regulatory unit for credit cooperatives within the CDA responsible for issuing appropriate rules and regulations for credit cooperatives and other cooperatives with credit services. These regulations should be consistent with existing regulations for banks with appropriate adjustments to consider the different structure of the credit cooperatives compared with banks.

B.1.3. To establish a credit information bureau for all loans, including microfinance loans, by all types of banks supervised by BSP.

B.2. Cooperative Development Authority

B.2.1. To act as the regulatory agency for credit cooperatives;

B.2.2 To establish a regulatory and supervisory unit for credit cooperatives responsible for the regulation of credit cooperatives and other types of cooperatives with credit services. This unit will coordinate closely and will be provided technical assistance by the BSP for the issuance of effective rules and regulations.

B.2.3 In the interim that CDA is not yet institutionally ready to directly conduct regulatory activities for credit cooperatives, accredited federations/unions of credit cooperatives and other types of cooperatives with credit services whose membership is voluntary may be authorized to perform quasi self-regulation. The federation/union will supervise and examine the operations of member-coops on a fee-basis using rules and regulations issued by the CDA. The recently approved set of performance standards will be used to rate and brand credit cooperatives and other types of cooperatives with credit services.

B.3 Microfinance Council of the Philippines

B.3.1. The MCP is proposed to serve as the repository of information of microfinance NGOs[10]. Using information submitted by the different MFIs, the MCP will inform concerned regulatory authorities when a microfinance NGO collects savings from members beyond the compensatory balance.

B.3.2. The MCP may collaborate with the SEC and the Philippine Council for NGO Certification on the establishment of incentive mechanisms to enjoin all microfinance institutions (especially the microfinance NGOs) to submit a uniform and consistent set of information regarding their operational and financial performance.

B.3.3. In coordination with concerned agencies and the private sector, the MCP will work toward the establishment of a private risk-rating agency for all financial institutions involved in the delivery of microfinance services. Concerned regulatory authorities for each type of microfinance institutions may use the risk ratings of these institutions in their off-site supervision activities. Donors may also use the ratings in determining the necessary technical assistance appropriate for certain microfinance institutions.

C. Establishment of the necessary infrastructure for financial transparency

C.1. Risk Rating Agency

C.1.1 A private sector risk rating agency will be promoted to provide risk ratings for MFIs that will be used by concerned institutions such as the regulatory authority, donors and wholesale financial institutions (e.g. GFIs and commercial banks) in evaluating the financial performance of the MFIs.

Risk ratings are expected to provide a clear and concise summary of the institutions' risk profile that can be understood by investors who have limited knowledge about the MFI's business operations.

[10] *The microfinance NGO should issue a certification that it is not collecting savings from its clients beyond the compensatory balance. The MCP may use this certification as basis in monitoring the MFI's compliance with the law not to collect savings from the public.*

C.1.2 Government should only provide an appropriate policy and institutional environment for private sector to initiate work on the establishment of a risk-rating agency.

C.2. Credit Bureau for microfinance

C.2.1 A Credit Bureau for microfinance shall act as the repository of all credit information regarding microfinance clients;

C.2.2 The credit bureau for bank clients may be established within the BSP. Technical assistance to initiate the establishment of the bureau may be sought from relevant donors.

C.2.3 A privately initiated credit bureau may also be established to supplement the information from BSP. Information from a privately initiated credit bureau in most cases is more comprehensive than those from the credit bureau within the superintendency of banks. These include credit information of borrowers outside of the banking system (e.g. utilities bill, credit card, other MFI clients etc.).

D. Minimum set of Parameters for assessing the performance of microfinance institutions

D.1. **P**ortfolio Quality
- D.1.1. Portfolio at risk
- D.1.2. Past due ratio
- D.1.3. Provision for loan losses

D.2. **E**fficiency Indicators
- D.2.1. Administrative efficiency
- D.2.2. Operational self-sufficiency
- D.2.3. Financial self-sufficiency

D.3. **S**tability Indicators
- D.3.1. Liquidity
- D.3.2. Net institutional capital

D.4. **O**utreach Indicators for microfinance
- D.4.1. Growth of no. of clients
- D.4.2. Growth of microfinance loan portfolio
- D.4.3. Growth of savings

E. Measures to be undertaken by concerned institutions

E.1. Bangko Sentral ng Pilipinas

E.1.1. Review existing regulatory, supervision and examination procedures and guidelines to consider the peculiar characteristics of microfinance. Adopt an appropriate approach for the supervision and examination of banks engaged in microfinance operations (e.g. risk based supervision approach).

E.1.2. Revise, when necessary, relevant rules, regulations and circulars to ensure that regulatory and supervisory guidelines and procedures do not pose as barriers for banks to engage in microfinance operations (e.g. branching guidelines, new banks guidelines, performance indicators, manual of examination etc.)

E.1.3. Provide appropriate technical assistance to the regulatory and supervisory unit of the CDA for credit cooperatives.

E.2. Cooperative Development Authority

E.2.1 Establish a regulatory unit for credit cooperatives

E.2.2 In coordination with the BSP, formulate and establish relevant regulatory guidelines, policies and procedures for the operations of credit cooperatives.

E.2.3 Issue rules and regulations for the effective supervision of credit cooperatives and other types of cooperatives with credit services.

E.2.4 Formulate and establish relevant supervision and examination procedures.

E.3 Microfinance Council of the Philippines

E.3.1. In coordination with the relevant stakeholders, formulate and establish necessary guidelines and systems for its effective functioning as the repository of information of all MFIs.

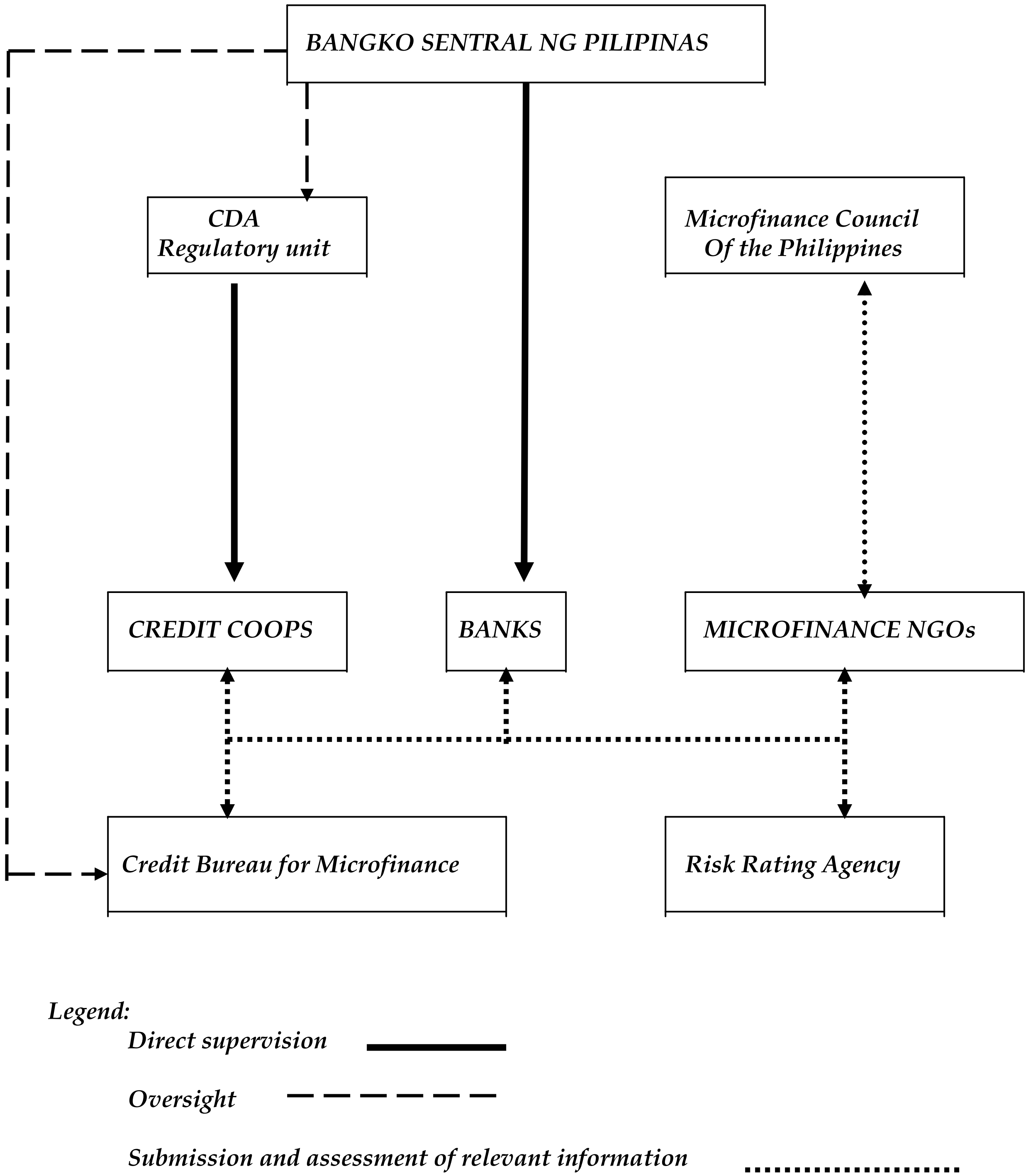
E.3.2. In coordination with the relevant stakeholders and with appropriate support from relevant government agencies, advocate and work towards the establishment of a credit bureau and risk rating agency for microfinance.

E.4. National Credit Council

E.4.1. In consultation with MFIs, relevant private organizations/networks and other concerned government agencies, formulate and establish performance standards for MFIs using the parameters identified in this framework as basis.

E.4.2. In consultation with concerned institutions (both public and private), promote and advocate for the establishment of a rating agency and a credit information system.

Figure 1
Proposed Institutional Set-up for the Regulation of Microfinance



Annex 1.1
National Strategy for Microfinance

THE PROBLEM

One of the major socio-economic problems besetting the Philippine economy is the pervasiveness of poverty. Based on the 1994 Family Income and Expenditure Survey (FIES), there are about 4.7 million poor Filipino households. This translates into a poverty incidence of 35.7 percent, with rural poverty incidence (53.7 percent) significantly higher than urban poverty incidence (28.8 percent).

A good number of poor households below the poverty line are engaged in microenterprises. A perennial problem of these microentrepreneurs is the lack of access to financial services. The latest NEDA survey indicated that less than 12 percent of low-income rural families borrowed since 1991. Of these, nearly two-fifths sourced their loans from relatives and friends while another one-third borrowed from private moneylenders and cooperatives. Only a small percentage relied on banks (government or private) for loans.

Because of information problems, inadequate collateral and the high transaction costs associated with processing small loans, private banks rarely, if at all, lend to microentrepreneurs. The borrowers themselves do not approach the banks due to burdensome requirements, high interest rates, lack of collateral and lack of information on possible sources of financing. As a result, the microenterprise credit market consists mostly of credit cooperatives, credit unions, some rural banks, and a handful of credit NGOs. Government agencies implementing various loan programs are also present.

In general, these microfinance institutions (MFIs) have limited outreach. Among MFIs. Cooperative banks and credit cooperatives have the widest estimated outreach. Recent field observations show that these two groups, together with rural banks and credit unions, have the network necessary to provide microfinance on a national scale.

ATTEMPTS TO ADDRESS THE PROBLEM

One of the government's strategies to alleviate poverty is to provide poor households engaged in microenterprise activities access to production and consumption-smoothing credit. Hence, in the 1970s and 1980s, the government created a number of directed credit and guarantee programs, especially in the agriculture sector. Some common features of these programs are:

a) Funding came from government budgetary appropriations, the Central Bank's rediscounting window and foreign borrowings;

b) Funds were provided through specialized banks (e.g., rural banks, development banks, and government financial institutions) for direct availment by the targeted borrowers; and

c) Funds were given at highly concessional rates.

These programs provided massive credit subsidies to bring down the cost of borrowing for the targeted sectors. But instead of benefiting small borrowers, the eventual credit rationing and high loan defaults enabled large-scale borrowers to capture the subsidies. Moreover, due to the availability of cheap loan funds, deposit mobilization was neglected leading ultimately to the weakening of rural banks.

These experiences, coupled with the fiscal costs of the programs, led the government to pursue financial market reforms in the mid-1980s. These reforms included:

a) Adoption of market-oriented interest rates;

b) Termination of subsidized rediscounting programs at the Central Bank;

c) Consolidation of existing agricultural credit programs into the Comprehensive Agricultural Loan Fund (CALF) which served as a loan guarantee fund for agricultural loans granted by banks; and

d) Termination of direct lending by government agencies implementing agricultural credit programs.

While these reforms were introduced and implemented in the agricultural sector, there was a proliferation of programs in other sectors. Subsidized credit programs for small and medium-scale enterprises as well as for livelihood projects multiplied. Many of these were implemented through government agencies. At the same time, laws were passed mandating loan quotas for targeted sectors. These include the Argi-Agra Law (PD717), the Magna Carta for Small and Medium Enterprises (RA6977) and the Magna Carta for Small Farmers.

With the Ramos Administration came, increased emphasis on private sector participation. The 1991-1998 Medium-term Philippine Development Plan articulated the government's twin strategies of global competitiveness and people empowerment. In the financial sector, these meant the implementation of market-based financial and credit policies and the increased participation of the private sector in the marketplace. The government will only play an enabling and strategic role through the provision of an appropriate policy environment for markets to function efficiently. Government financial institutions, on the other hand, will be re-oriented toward supplementing the private sector's initiative in providing financial services to microentrepreneurs.

Even as the government pursued reforms to enhance market efficiency, it adopted the Social Reform Agenda (SRA) to address the poverty problem in the country. Among others, the SRA's action agenda include providing the poor access to economic opportunities within a liberalized and deregulated market. This has encouraged a number of financial (rural banks, cooperatives, etc.) and non-financial (credit NGOs) institutions to engage in innovative lending techniques to address the credit demand of microentrepreneurs. However, despite the avowed market orientation of financial and credit policies, there is still pressure from various interest groups for government to provide credit subsidies and create a more directed credit programs.

The result is a basic inconsistency between microfinance policies and credit programs intended to support those policies. The policy-program inconsistency creates a flawed incentive structure that encourages various players in the microfinance market to pressure government for more credit subsidies, loan quotas and other distortionary measures. The end product is a microfinance market that appears more constrained in providing the target clientele access to financial services.

THE VISION AND THE OBJECTIVE

The vision is to have a **viable and sustainable private (micro) financial market**. This will be achieved in a liberalized and market-oriented economy where the private sector plays the major role and the government provides enabling environment (through the appropriate policy and institutional (framework) for the efficient functioning of markets.

Specifically, the objective is to provide low income households and microenterprises access to financial services. The target group consists of those who live below the poverty line and are engaged in some form of business or economic activity, but who do not have access to or are inadequately served by the formal financial sector.

REALIZING THE OBJECTIVE

The Policy Framework

In accordance with the vision, private microfinance institutions (MFIs) will provide microentrepreneurs financing services on available and sustainable basis while the government will provide a competitive and liberalized market environment. The government's microfinance policy is built on the following principles:

- Greater role of the private sector (MFIs) in the provision of financial services;
- An enabling policy environment that will facilitate the increased participation of the private sector in microfinance;
- Market-oriented financial and credit policies, e.g. market-oriented interest rates on loan and deposits;
- Non-participation of government line agencies in the implementation of credit and guarantee programs.

Hence, the government will avoid costly, unsustainable and distorting credit subsidies that, in the past, failed to reach their intended beneficiaries, led to the weakening of the rural banking system, and saddled the government with huge fiscal burden. Instead, emphasis will be placed on financial intermediation to ensure the efficient channeling of surplus financial resources to viable projects. A conscious effort will, therefore, be made to promote savings mobilization by MFIs.

Moreover, credit policy will be distinguished from welfare policy. Welfare assistance will be provided to address the needs of the really poor households through the appropriate government departments. Welfare will not be extended through financial institutions, whether government or private.

Credit demand of microentrepreneurs, on the other hand, will be met through a variety of innovative financial products provided by the private microfinance market. The government will assist in capacity building of MFIs and in providing the appropriate supervisory and regulatory framework to make markets more efficient and institutions, more viable.

The Institutional Framework

Given the policy framework, the respective roles of the various players in microfinance, based on their relative comparative advantages, are:

- **Microfinance Institutions (MFIs)**: to engage in sound, sustainable and viable microfinance intermediation;

- **National Government through the National Credit Council (NCC)**: to provide a market-oriented financial and credit policy environment which will promote efficient financial markets and will help MFIs broaden and deepen their microfinance services;

- **People's Credit and Finance Corporation (PCFC)**: to provide wholesale funds and technical assistance to MFIs; to support the development of innovative financial products and services for microentrepreneurs;

- **Commercial and other private banks**: to provide wholesale funds and financial services to MFIs;

- **Government Financial Institutions (GFIs)**: to provide wholesale funds (including those sourced from foreign borrowings) to MFIs that do not have access to funds from private commercial banks;

- **NGOs**: to facilitate linkages between microentrepreneurs on one end and MFIs and community organizations on the other end; to assist in capacity building of target clientele;

- **Donors**: to provide assistance for social preparation activities that will broaden and deepen microfinance services (e.g., development of microfinance products, training in microfinance technologies, and upgrading of performance standards, operating systems and procedures); to assist in areas that have been identified through a consultative process between the NCC and MFIs.

The Strategies to Be Pursued

The following strategies, aimed at providing microentrepreneurs greater access to microfinance services, will be pursued:

a) Provision of a financial and credit policy environment that is conducive to the effective and efficient functioning of the financial market. This will be done by:

    - Implementing a market-oriented interest rate policy

    - Pursuing financial policy reforms with the end view of removing existing distortions in the financial market (e.g., loan quotas, earmarking of public funds for direct lending, etc.)

- Rationalizing all existing government credit and guarantee programs towards encouraging greater private sector participation in a market-oriented setting

b) Establishment of a market-oriented financial and credit policy environment which is conducive to the broadening (development of new product lines and services, implementation of new microfinance technologies and practices) and deepening (increased microfinance intermediation) of microfinance services. This will be accomplished by:

- Providing the appropriate supervisory and regulatory framework for MFIs that will enable them to develop new and innovative product lines and services to cater to the demands of poor households and microenterprises;

- Establishing standards of performance and business practices to guide the operations of MFIs;

- Promoting broad-based savings mobilization, linking banking technology with microfinance technologies;

- Providing information and training to MFIs on best practices in microfinance.

c) Implementation of a capacity-building program for MFIs. This will be implemented by:

- Providing technical assistance to MFIs, stressing (1) local deposit mobilization, (2) financial and project management, (3) use of information technology, (4) development and establishment of microfinance technology, innovative product/service lines.

- Documenting, packaging and disseminating practitioner-based training and technical services to MFIs, through the PCFC.

- Encouraging research and academic institutions to conduct studies and convene policy level discussions that will promote awareness of microfinance as a sound commercial investment. These institutions will identify best practices in microfinance, develop and install training and microfinance technology packages.

Annex 2
Members of the Technical Working Group (TWG)

The Technical Working Group on the formulation of the Performance Standards for All Types of MFIs is comprised of representatives from the following:

- *Bangko Sentral ng Pilipinas (BSP)*
- *Cooperative Development Authority (CDA)*
- *Credit Policy Improvement Program (CPIP)*
- *Credit Union Empowerment and Strengthening (CUES) Program in Mindanao*
- *Department of Finance (DOF)-National Credit Council (NCC)*
- *Department of Labor and Employment (DOLE)*
- *Development Bank of the Philippines (DBP)*
- *Land Bank of the Philippines (LBP)*
- *Microenterprise Access to Banking Services (MABS)*
- *Microfinance Council of the Philippines (MCPI)*
- *National Anti-Poverty Commission (NAPC)*
- *National Confederation of Cooperatives (NATCCO)*
- *National Economic and Development Authority (NEDA)*
- *People's Credit and Finance Corporation (PCFC)*
- *Philippine Deposit Insurance Corporation (PDIC)*
- *Rural Bankers Association of the Philippines (RBAP)*
- *Securities and Exchange Commission (SEC)*

Annex 3
Summary of the Performance Standards for Microfinance
(P.E.S.O.)

Area	Indicator	Definition/ Ratio	Standard	Weight
I. PORTFOLIO QUALITY				**40**
	Portfolio at Risk	Balance of loans with at least one day missed payment / Total Loans Outstanding	PAR - 1 5 %	20
	Loan Loss Reserve Ratio	Total Allowance Provided / Total Required Allowance	**Required Reserves:** Current – 1% PAR 1 to 30 – 2% PAR 31 to 60 – 20% PAR 61 to 90 – 50% PAR 91 & above and/or loans restructured twice – 100%	20
II. EFFICIENCY				**30**
	Administrative Efficiency	Administrative Costs[1/] (Direct & Indirect Costs[2/]) / Average Gross Loan Portfolio[3/]	10% & below	10
	Operational Self-sufficiency	Interest Income from Loans + Service Fees + Filing Fees + Fines, Penalties, Surcharges / Financing Costs + Administrative Costs (Direct & Indirect costs)	≥ 120%	10
	Loan Officer Productivity	Number of Active Borrowers / Number of Account Officers	Group – ≥ to 300 Individual - ≥ to 150	10
III. SUSTAINABILITY				**15**
	Financial Self-sufficiency	Operating Revenue / Financial Expense + Loan Loss Provision Expense + Adjusted Expenses [4/]	≥ 100%	10
	Loan Portfolio Profitability	Net Operating Income / Average Net MF Loan Portfolio	Greater than inflation rate during the period	5

Area	Indicator	Definition/ Ratio	Standard	Weight
IV. OUTREACH				**15**
	Growth in Number of Active MF clients	Ending No. of Active MF Clients [5] – <u>Beginning No. of Active MF Clients</u> Beginning No. of Active MF Clients	Increasing	5
	Growth in Microfinance Loan Portfolio	Ending MF Loans Outstanding – <u>Beginning MF Loans Outstanding</u> Beginning MF Loans Outstanding	Increasing	5
	Depth of Outreach	Total Loans Outstanding ÷ <u>Total Number of Borrowers</u> GNP per Capita	20% or below	5
TOTAL				**100**

[1] *Administrative cost should include loan loss provision expense.*

[2] *(Beginning Gross Loan Portfolio + Ending Gross Loan Portfolio) ÷ 2*

[3] ***Indirect Costs** are allocated in proportion to the number of personnel directly dedicated to each cost center. Indirect cost allocated to the microfinance operations is computed as:*

***Indirect Costs** = (Number of Full-time MF Staff ÷ Total Number of Personnel) x Total Indirect Costs*

Where:

- ***Full-time MF Staff** – refers to employees working full-time in the microfinance operations regardless of employment status, i.e., whether contractual or regular.*
- ***Total Indirect Costs** – refers to costs shared by both the microfinance and non-microfinance operations. It includes, among others, salaries and benefits, rent, office materials and supplies, publications and publicity, transportation, travel and training for overhead staff, telephone and postage, insurance, utilities, repairs and maintenance, legal, audit and consultant fees, bank charges, taxes, and depreciation.*

[4] ***Adjusted Expenses** = Total Operating Expense + [(Average Equity – Average Fixed Assets) x Inflation Rate] + [(Market Interest Rate x Average Total Liabilities) – Actual Interest Expense] + Other Implicit Costs. Other Implicit Costs include those costs relevant to the conduct of its business such as grants, rent free building, donor paid technical advisor, or other subsidized expenses.*

[5] *Active MF clients shall be those clients with savings and/or loans.*