Forum Series on the Role of Institutions in Promoting Economic Growth

Assessing Microfinance and the USAID MABS Program in the Philippines: Under the Microscope of the New Institutional Economics

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New Institutional Economics and Development: Case Studies and Applications

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Executive Summary

Entrepreneurship drives development. But the imperfections of the market can create almost insurmountable hurdles for entrepreneurs trying to find the finance to bring their economic bets to life.

Our approach is a departure from the standard quantitative studies. We begin with the idea that knowledge, at the local level, is "a resource as powerful as any tangible tool." With this new type of data we are better able to evaluate the efforts of USAID in the area of Microfinance (Philippines) by providing a much thicker description than standard techniques have provided.

In this report we address the following issues:

1. The macroeconomic environment of the Philippines
2. A New Institutional Economics approach to Microfinance
3. Specific analysis of USAID's current efforts (MABS)
4. Recommendations to improve evaluation of these and related efforts

Overall security of property and freedom of contract are crucial ingredients of an institutional setting that promotes access to capital and enables a risk-taking environment. In the absence of secure property and the freedom of contract, or in situations where these

‘basic institutions’ are weak, as they are in the Philippines, MF practices have evolved to provide the capital for small-scale enterprises. These practices rely upon personal mechanisms of exchange to serve as proxies for collateral. And while these practices provide access to capital to the previously ‘unbankable’, providing real opportunities for substantial improvements in their standard of living, they cannot be the source of sustainable long-run development. Moving from institutions that promote personal exchange to those that promote market-based, impersonal exchange requires changes in the basic institutions of property and contract.

MF is having a real impact on the lives of individuals. But if mismeasured, the true benefits and value of MF may not be fully recognized and policy decisions may, with the best intentions, upset what is currently a delicate balance. Pouring cheap money into more and more MFIs may result in a significantly increased outreach, but it risks dampening the incentives and increasing the costs associated with building institutions that move individuals from personal to market relations and ultimately, a social system that is able to capture, to a much larger extent, the gains from exchange.

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I. INTRODUCTION

Entrepreneurship drives development. The ability of entrepreneurs to thrive is a function of the institutional environment in which they operate.[2] Entrepreneurial decision making is inherently risky, and depends on rich knowledge of the local scene. It is this

[1] I would like to thank Nimai Mehta who operated as the senior scholar in the preparation of the project and for almost one half of the time in the field. Nimai's insightful local knowledge and his previous experience in the Philippines provided a useful touchstone. Without Jojo's (Jocelyn A. Badiola excellent assistance the project would not have enjoyed the breathe of coverage we were able to attain. Her input was essential in forming many of the arguments as they appear in the paper.
[2] The development of the investor roadmap by USAID reflected the growing recognition of the essential role of the entrepreneur in producing substantial and sustainable economic growth and development. In fact the methodological assumptions of the IR work is that regulatory barriers and the uncertainty associated with those barriers can only stifle rather than promote an environment of risk taking. By this we do not mean to suggest that risk taking is in and of itself important, it is that the risky endeavor is of a nature that is potentially productive in providing products and services that are demanded but have been previously left unfulfilled.

knowledge of particular preferences at a particular place and time that enables the entrepreneur to see new opportunities for mutual gain.

By being alert to, and seizing, opportunities for mutual gain, entrepreneurs can profit.[3] Business activity generally requires some investment, but imperfect information, transaction costs, and moral hazard can make it difficult for the entrepreneur to find capital. In a world where capital and property are well defined and are fully transferable, the issues regarding access to capital are relatively clear. But where capital and property are not clearly defined, as is the case in much of the developing world, the economic incentives most likely to promote growth are distorted or muted. But it is not simply an issue of defining property; if the institutional arrangements can be improved then even the poor may turn their 'dead' capital into the finance that will bring their business ideas to life.

Hernando De Soto claims that this issue is at the heart of understanding why the West does so well. The less distorted the institutional environment the greater the likelihood of productive endeavors coming about.[4]

For example, the urban area of Manila is comprised of the very rich, in exclusive suburb living, and the very poor. Estimates suggest that more than 50% of the land in Manila possesses no sure ownership.[5] Whether De Soto is the definitive answer or not, it is hard to argue with the consistently strong correlation between the surety of property and economic growth. But on a more basic level, De Soto is suggesting that the lack of access to finance is impeding growth. The entrepreneur must obtain sufficient finance to

[3] Kirzner (1973)
[4] Baumol (1998)
[5] De Soto, 2000, 251

bet on his or her ideas and De Soto provides an explanation of why so many are unable to do so.

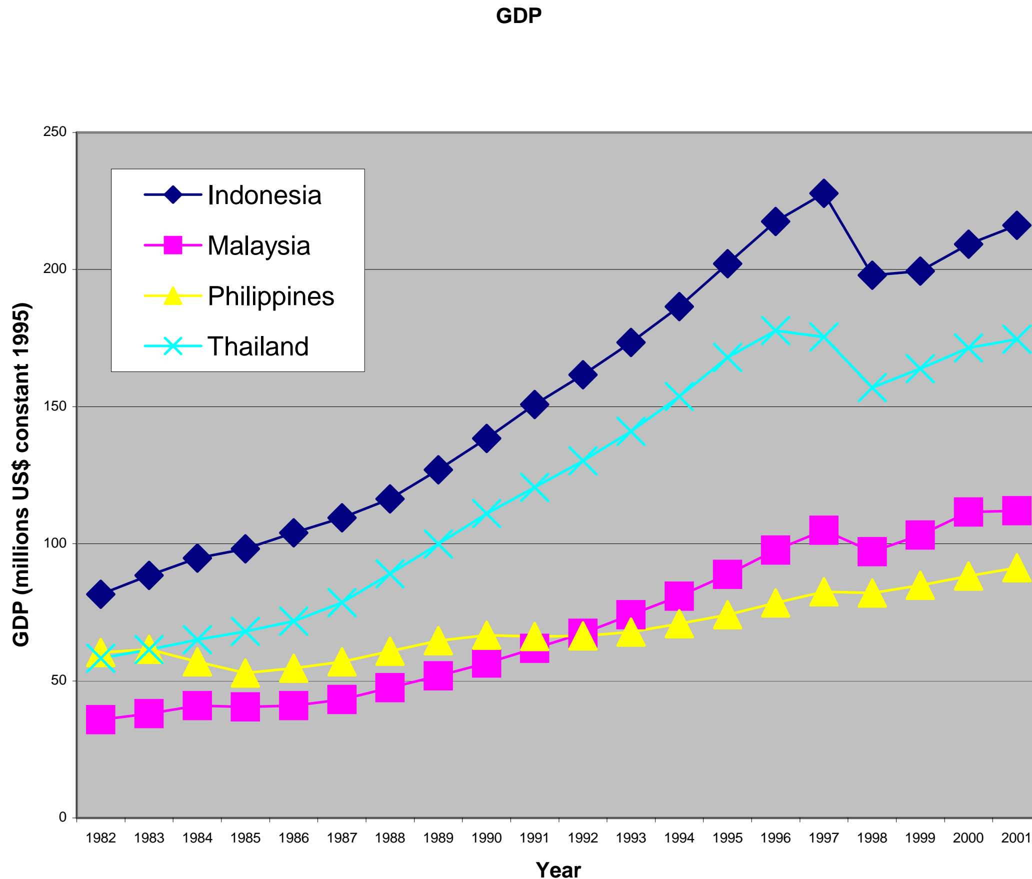
The Philippine project is an exercise in describing the environment in which microfinance institutions operate from the entrepreneurs' perspective and how this fits with the macroeconomic picture of the country generally. As such this report seeks to fill a gap within the current discussion regarding the effectiveness of microfinance in alleviating poverty and the role the differing lending methodologies play toward achieving that goal. With this perspective in mind we are better able to comment on the current USAID efforts in the area of microfinance in the Philippines, which may provide generalizable lessons (in conjunction with the suggested instrument) that we suggest is a useful beginning in designing new ways of examining the real impact of policy and aid programs.

II. HISTORY AND BACKGROUND

2.A The Macro Setting

The most recent census in the Philippines documents an increase in poverty. There had been small but continuous declines in the percentage of the population living below the poverty line from 1985 - 1997. In 2000 the percentage increased (34%) and number of people grew by 2.5 million, taking the total number of people living below the official measure of Php 13,823 per annum (US$ 260) to 26.5 million people. The 1997 Family and Income Expenditure Survey revealed that more than half of these households (5.2 million) rely on entrepreneurial activities to generate at least some of their household income. In light of these figures it is understandable why the current President has

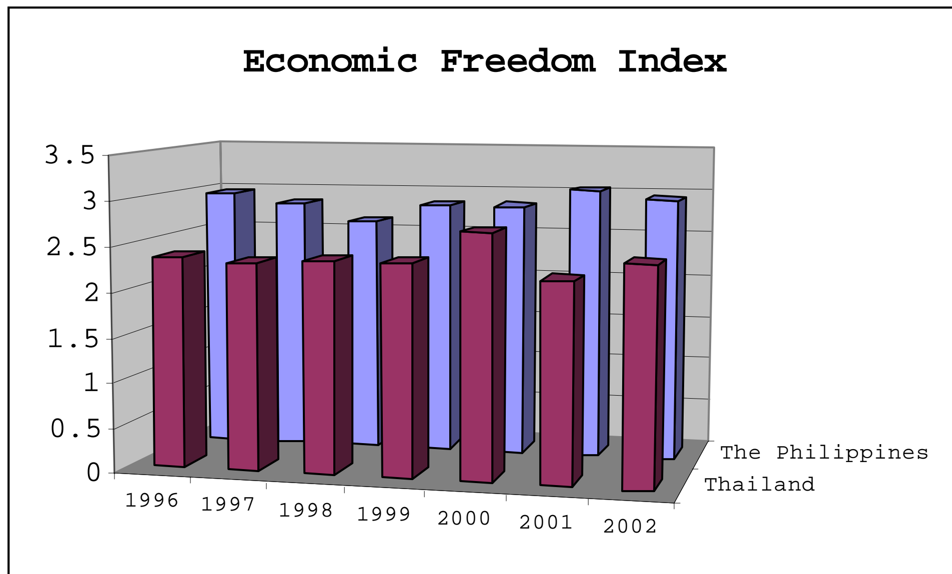
declared Microfinance to be the centerpiece of her government's poverty alleviation program.



The above chart depicts GDP for the Philippines and three of its neighbors. The Asian crisis of 1997 is quite evident but the other striking feature is that twenty years ago the Philippine economy was slightly larger than Thailand's (by 4%), but as of 2001 it was equivalent to only 52% of the Thai economy.[6]

[6] Philippine economic growth has lagged behind most of its Asian neighbors over the past 30 years; not only behind the Asian "tigers," but also behind less advanced economies of the region. For example, 1999 per capita income in the Philippines (measured in terms of purchasing power parity) was $3,815. This exceeded only that of China ($3,291), economically troubled Indonesia ($2,439), and Vietnam ($1,755). However, the change in per capita income between 1975 and 1999 in the Philippines (measured in 1987 dollars) was only 14%, compared with 326% in Indonesia and 235% in China. In East Asia, only Burma, North Korea, and the economies of Indochina have performed more poorly. (USAID Country Profile - Philippines)

What could explain such a dramatic difference? The Heritage Foundation/Wall Street Journal Index of Economic Freedom, from its first publication in 1995 to the present, has always ranked Thailand ahead of the Philippines. In 2002, the Philippines score was 2.95 out of a possible 5 with 1 being the ideal, while Thailand's score was 2.4. What role does the Freedom Index score play in helping us understand the poverty question? The answer to this question becomes apparent when the imperfections of the Philippine market, and more particularly the financial sector, are discussed—something we will do shortly.



But it is not simply a question of economic freedom. In a recent survey of 500 businesses, 57 percent believed that companies in their sector used bribes to get contracts from the government, while only 30 percent believed that bribes were used to obtain contracts with other private firms. It was also believed that on average the bribe required to win the government work was double the amount necessary to win the private work. [Third annual SWS Survey of Enterprises About Public Sector Corruption.] The

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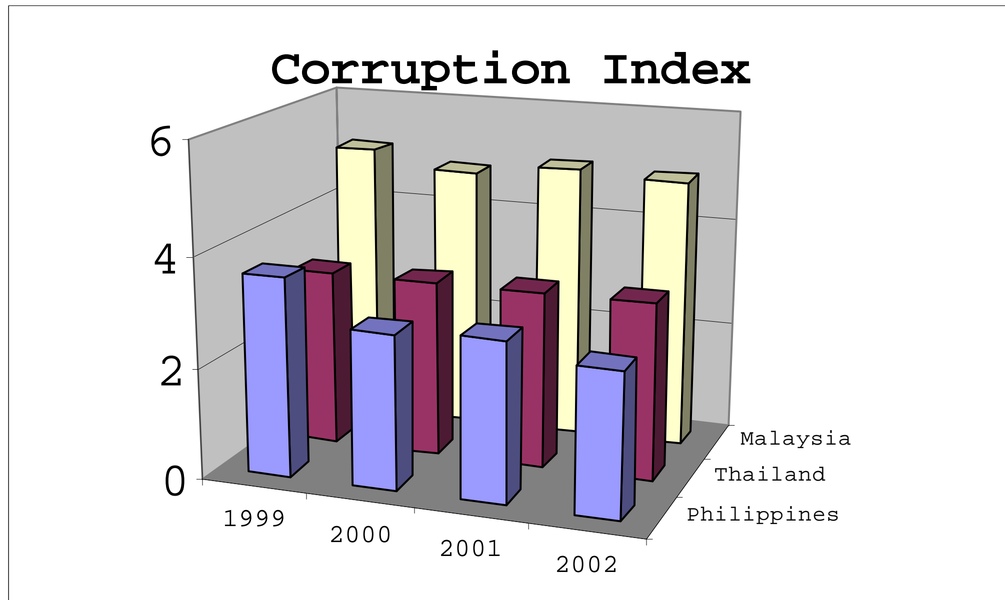
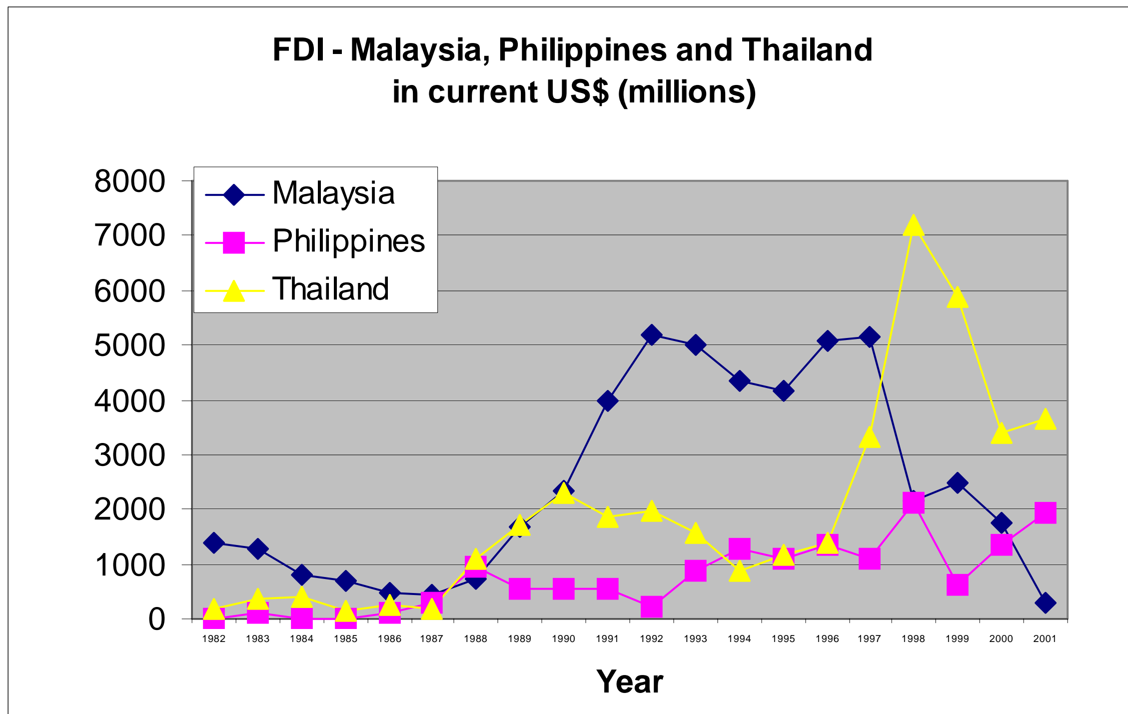
following table depicts the scores given to the Philippines and its neighbors in an attempt to depict the transparency of countries' dealings with political and public officers. The scores offer a more specific comparison on the issue of corruption.



The greater a country's score (out of 10), the more transparent transactions with government and public officials are deemed to be. While Malaysia and Thailand have remained fairly stable (in absolute score and comparative world ranking) the Philippines has experienced increasing corruption and a drop in their comparative world ranking (from 54th in 1999 to 77th in 2002 out of a possible 102 countries). The Philippines is more corrupt than Russia (71st) and tied with Romania and Pakistan. So not only is the Philippines perceived to be corrupt, it is considered to be significantly more so than its neighbors. So despite its long-running democracy, "[the Philippines] is mired in economic and fiscal limbo, justifying its reputation as one of the most corrupt economies in Asia".[7]

[7] USAID Philippines Overview

Endemic corruption coupled with heavy restrictions on foreign ownership dramatically impacts the potential to garner foreign direct investment (FDI). The legal limit for foreign ownership is set at a maximum of 40% for most sectors, and foreigners cannot own land except through a business structure in which Filipino citizens own at least 60%. The effect these restrictions have on FDI is apparent in the following chart.



Malaysia has struggled to entice foreign investors back to its shore since it imposed the capital controls it had legislated in the early nineties but did not use until the Asian Crisis of 1997. Thailand appeared to be the biggest beneficiary of its liberalized policy, while the Philippines failed to truly capitalize on the nervousness of investors by providing a safe shore. The ownership laws and widespread corruption are effective deterrents for foreign investors. These problems seem to far outweigh the comparative advantages the country should have been able to translate into an economic windfall, especially in wake of the 1997crisis. Close ties to the U.S, the oldest democracy in Asia,

and the largest percentage of English speakers in any Asian country should have been very tempting to businessmen interested in making a profit.

What problems within the domestic economy--and more particularly the financial sector--contributes to the above? One of the assumptions of Microfinance (MF) is that traditional formal financial institutions, even when operating efficiently, do not consider the poor a reasonable risk. The Philippine government has paid lip service on many occasions to the need to "clean up" the banking sector. But how bad is it really?

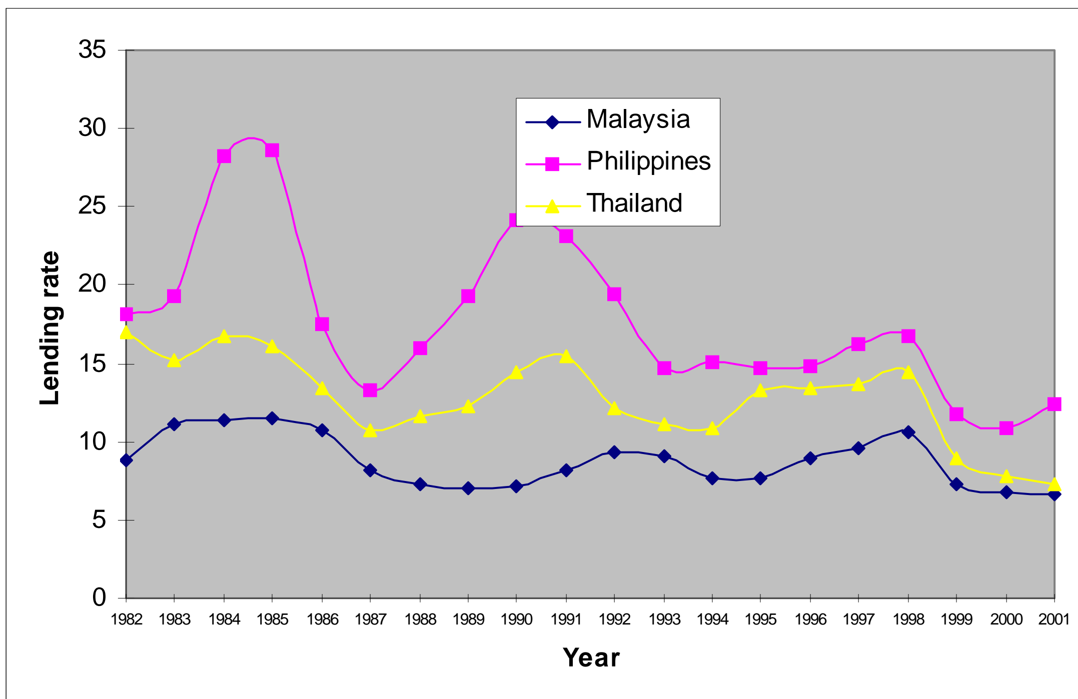
First, it is important to realize the country has a small elite who are able to wield a great deal of influence through a concentrated ownership structure in the corporate sector as well as through cross shareholdings between banks and corporations which they hold.[8] The elite benefit from corruption that inhibits the development of more competitive markets.[9] The financial sector itself is highly concentrated; the ten largest banks (which include nine domestic and one foreign bank) account for more than 55 percent of the banking systems' resources and demand liabilities.[10]

This concentration has meant a stifling of market forces as evidenced by the higher-than-average lending rates, and a considerable interest rate spread.

Interest Rate Spread

[8] IMF-Financial Sector Crisis and Restructuring Lessons from Asia
[9] Tanzi, 1995; USAID Philippines Overview
[10] IMF Occasional Paper No. 187 Rodlauer et al. 2000--IMF Staff Country Report No. 99/92

Country	Avg annual rate 1982-2001 (variance)	Years > 4%	Years > 5%
Malaysia	2.36 (1.7)	2	1
Philippines	5.18 (2.19)	17	11
Thailand	3.00 (.99)	3	0



The Philippine Government recognized the role it played in the distortions of the sector and sought to increase competition. In 1995, in response, the government licensed ten new foreign banks.[11] This did increase competition, but it did no do so across the board. While specific areas such as trade finance, top-tier corporate finance and wholesale portfolios benefited, the many legislative restrictions still in place ensured that the domestic banks remained the dominant force in the retail-banking sector.

[11] Rodlauer et al. 2000

Due to the tax advantages and less stringent reserve requirements of the rural banks, the domestic banks did face some competition from these smaller financial institutions. In 1998, however, the Central Bank (*Bangko Sentral ng Philipinas*), through the Monetary Board, issued a Circular Letter that imposed a moratorium in branching for all types of banks. Banks wanting to expand were given three options: 1) buy existing branches of other banks, 2) merge with other banks, or 3) be microfinance-oriented (the only way a new branch opening would be approved). The purpose of this policy was to strengthen the banking system in the wake of the Asian financial crisis, while at the same time developing and encouraging microfinance. The Central Bank encouraged the big/strong banks to buy the weaker banks. But this had the 'unintended' consequence of reducing the potential competition the large domestic banks would face from the rising rural banks.

In conjunction with the restrictions on foreign banks (in retail banking), this allowed the small group of bank owning families to continue making large profits. This, at the expense of the domestic businesses as borne out by the consistently higher spread available to them on account of the protection their sector enjoyed.

These facts will help us understand the role that microfinance can and does play in the development of the Philippine economy. The imperfections of the financial sector, the high domestic rates, and the lack of competition faced by the larger incumbent domestic banks combined to create an environment of muted business activity (compared to the possibilities if interest rates and competition were similar to those of its neighbors). This creates a two-tier interest structure where the elite enjoy cheaper rates due to access to offshore markets.

Elected officials' talk of reform was usually empty. Estrada, the previous president, spoke of changing the constitution and removing economic restrictions. But after two years in office he stated, "it is a conviction ...that must for the moment yield to more urgent, more short-term . . . efforts that are more likely to produce results in less time and at less cost to national unity . . . As a leader, I must listen."[12] Economic liberalism would damage the vast holding of the elite, and their role in Estrada's downfall should not be underestimated.

But Estrada is not unique. Philippine leaders often appeal to the rhetoric of "cleaning up" inefficiency, but are unable to counter the resistance of the elite. When the market is squeezed (as in the moratorium on new bank branches), opportunities will fall through the cracks to the bottom. As long as the individuals picking up the opportunities remain on a small and do not come to the attention of the elite, they will be left alone. If the international community has been unable to "help" local leaders effectively reform, it may be too much to expect sudden and sustained improvements in the macro environment. So if MF is contributing to a well-functioning secondary market we may well have to content ourselves with a "second best" economic system.

As a consequence of much of the above, and the extent of poverty in the Philippines, successive governments have attempted to provide either direct assistance or more responsive institutions (through subsidies, grants or legislative enactment). We have provided a summary (Appendix 1) of some of the key government poverty-reduction initiatives spanning the last three decades.

2.B Ambitious goals and humble beginnings (MABS): The USAID effort:

[12]Asian Times Online, Jan 11, 2000

"A thousand ways to do it wrong."[13]

Prior to 1998, USAID ran an 'NGO office' from which they administered a grant program that gave money to approximately 50 different NGOs actively involved in Microfinance. USAID Washington requested a change in the program that would enable a greater outreach. A commissioned study determined that the existing supply of MF services was penetrating less than one percent of the market and it was believed that there was a great demand for "reasonably priced credit".

By chance, at the same time, the World Bank was conducting a study of Cooperative Rural Banks in the Philippines. The USAID staff involved in MF "tagged along" and while the World Bank initiative appeared to go nowhere, there were lessons from the study that where considered generalizable. The USAID staff realized that the rural banks operated with low fixed costs and possessed a great deal of the local knowledge that would be necessary to be an effective microfinance lender. These lessons pointed to the use of the rural bank structure in dramatically expanding outreach, which would both satisfy Washington and, potentially, have a real impact in increasing the credit opportunities of the poor.

The key to succeeding would be to somehow incorporate all of the "best practices" of microfinance while avoiding or overcoming some principal concerns felt to be hampering the growth and effectiveness of the NGOs.

The first problem was a tension in the mission of NGOs. As non-profit organizations they seek to serve some social goal, such as transforming the poor and alleviating poverty by lending to those previously designated as unbankable. But this goal can conflict with the aim of financial sustainability or profitability when zero tolerance

[13] Robert Barnes, Economic Growth Advisor. USAID: Philippines Mission

(intervention is immediately called for as soon as a payment is not made according to the payment schedule) is deemed the only real path to guaranteed long-term survival.

The second oft-cited problem regarding NGOs is the constraint on growth faced by institutions that are not commercialized—that do not operate as financial intermediaries. It was hoped that by not providing subsidized or “cheap” money the institution would develop the ability to mobilize savings. Research has made it quite apparent that even those considered very poor were willing to save with financial institutions if appropriate avenues existed. The problem of savings mobilization is compounded within the NGO framework because they cannot legally hold deposits [14] (they do technically hold members' money through the forced savings mechanisms put in place, although no interest is paid). This coupled with the fickle nature of donors resulted in hard constraints that limit the potential growth of the organization through outreach or significant loan portfolio growth.

Armed with these lessons, the MF best practices, and a new approach to working with credit providers (there were to be no disbursements) and an emphasis on individual lending, Micro Access to Banking Services (MABS) was born.

In the first year of MABS, USAID had hoped to have 10 banks join the program. They began with 5 and after some difficulties with one of the banks (USAID asked them to leave), they pushed on with the four founding member banks. Robert Barnes, the Economic Growth Advisor of the Philippines USAID Mission Office, did not know if MABS would work, so a bailout option was incorporated for USAID in case they did not see acceptable results. From the beginning, USAID and its contractor worked with the

[14] This technically is overcome at least for members in the program as the institutions compulsory savings ensures that every member/client has a positive "savings" balance.

Rural Bankers Association, and this had important benefits. Notwithstanding USAID's early trepidation, the bailout option was never exercised, and more rural bank clamored to enter the program.

Five years into the program there are about 110 member banks. The current program requires a six-month investment on the part of the bank. They must learn the system and put all of the necessary pieces into place. For example, one guidelines states that new staff must be hired and trained specifically for MF operations; old staff members, it has been found, have too many bad habits that hinder the MF program.

Under the current regime, the capacity for expansion is roughly 20 banks per annum. The contractor, Chemonics International, is currently training 5 local firms so they can be certified to provide MABS induction and continuing technical assistance. It is hoped that once these firms begin actively providing services as many as 100 rural banks a year could be added to the program. It is believed that through savings mobilization and the implementation of the MABS methodology the outreach of an expanding MABS program will significantly reduce the business of the informal money lenders (the five-sixers). It is believed that by offering significantly reduced interest rates new borrowers will enter the credit market and that those accustomed to using informal lenders will cease to do so, preferring to avail themselves of the much lower rates.

MABS provides the technology of non-collateral lending in the hope that the bank will find it profitable to lend to those they would never have considered bankable clients. But MABS goes further. It is akin to a franchise system in which everything about the business plan is laid out from the external marketing to the internal accounting and reporting systems. Not only are the borrowers expected to be disciplined, through strict

adherence to a zero tolerance policy, but the banks themselves must be disciplined with respect to whom they lend to. Most businesses fail within 12 months of commencement, and so MABS provides guidelines, which require that a loan should never be extended to a businessperson unless they have had their current business running for at least 2 years.

In summary, the MABS program was a radical new approach for several reasons:

1. The primary target group of this program was existing rural banks, not charitable organizations or NGOs.
2. There was and is still no lending or granting of funds to member rural banks.
3. The program does not entail directing the efforts or the decisions of the member banks.
4. Membership is voluntary and mutually reviewed.
5. The banks must pay for continued access to technical training and assistance that the MABS program provides.

It seems fairly clear that the program has had some significant success. One banker[15] told us MABS had helped them "discover" clients they would have never considered as borrowers. It has also helped the banks become more profitable. Another banker[16] told us that only 20% of their total loan portfolio deals with microfinance and yet this fifth of their revenue earning potential is responsible for over half of their net profit (55%).

2.C A quick primer on Microfinance

[15] Ganzon, Teresa
[16] Pineda, Lourdes

It will perhaps be useful to the reader to provide a simple introduction to the differing lending methodologies of Microfinance.[17] The main lending methodologies used in the Philippines can generally be grouped into one of three classes. The common theme throughout micro lending is use of substitutes for what would historically have passed for collateral. Because the aim of microfinance is ostensibly to reach the poor, the targeted borrowers are least likely to possess collateral in the traditional sense.[18] Given this, different lending models account for the risk of default in different ways as they strive for sustainability and/or profitability.

First, the Grameen model from Bangladesh is built upon the following principles:

1. Group and center formation: Persons wishing to join a Grameen program must find others who also wish to join. Once there are five members they in effect join together. This group is then part of a center, which consists of anywhere from 5-10 groups of borrowers. Each week the center meets to review payments and receive training with their loan officer. Attendance is required to remain in good standing, as is prompt repayment.

2. Collective responsibility: this is the mechanism whereby the lender reduces their own risk by relying on the group guarantee. Members of a group jointly guarantee each other's loans. This can be enforced by requiring other members of the group to pay the defaulting member's payment or by restricting access to new loans, even if the individual is paid up but a member of their group is in default.

3. Graduated loans: the member most often starts with a very small loan. In the Philippines most start at four or five thousand Php (US$ 75 - 90). As the individual and

[17] For a comprehensive survey we suggest Joanna Ledgerwood (1998) Microfinance Handbook; World Bank

[18] Rhyne, 1999

the group establish their credibility over time larger, loan amounts become available. Within the Grameen model of lending, the loan cycles gradually increase in a systematic way. Most organizations do not exceed fifty thousand Php (US$ 900).

4. Compulsory savings: this provides a safety net for the individual member, while at the same time decreasing the risk of the lending institution. Typically a percentage of the loan amount is withheld when the loan is drawn, with weekly contributions also added to their repayment.

5. Weekly repayment: Members must make payments each week.

At the other end of the micro-lending spectrum is individual lending. This requires the lender to use a more character-based approach, with frequent visits to the borrowers' place of business. There are no groups to be formed and the borrower is only accountable for their own loan. While, in principle, the individual methodology does not require compulsory savings, in practice many of the formal institutions using this method do require some savings as security. This can sometimes be a required "savings" balance of twenty or thirty percent of the loan amount. So while weekly saving contributions are not necessarily required, many institutions do require some form of positive savings when loans are extended. The other important difference is that the loan amount reflects the ability of the individual to properly utilize the loan, and there is a proven capacity to meet the repayments. As mentioned above, if the borrower is required to have been in their current business for at least the last two years, then there is a history by which the bank (or lending institution) may judge the repayment capacity. Most institutions are willing to lend up to one hundred thousand Php, with some potentially lending more

(150,000 Php), and others less (50,000 Php), before requiring more traditional forms of collateral.

Between both of these lending models is ASA[19]. It had been recognized that the Grameen model presented a barrier to many potential borrowers who did not like the concept of group liability. Some lenders, however, believed that there was real value in the group concept, as it allowed the lender to rely on the locals within the community to determine the credit worthiness of the client. ASA therefore tries to keep what is best about the Grameen model while also trying to reach as many people as possible. Groups are still required to meet weekly[20], but the use of the group concept is more liberally applied. Centers or groups (the words can be interchanged harmlessly when discussing ASA) may have anywhere from ten to thirty members. These members meet together with their loan officer, but they are never required to pay for the loan of another group member, and their ability to obtain loans is never contingent upon the credit rating of their fellow members. Compulsory savings are also required. ASA in many ways is similar to Grameen with the exception of group liability and loan graduation. In regard to to loan amounts, ASA is geared toward a capacity to pay, as opposed to regular, periodic loan amounts increases.

III. AN ALTERNATIVE APPROACH

[19] ASA:

[20] Although some variations where found. For example, CARD Bank although centers who have had no missed payments for one year to move from having required weekly meetings to a monthly meeting. While a reward on the one hand it because a powerful mechanism for ensuring future 'on time' payment as members do not wish to return to weekly meetings (the required 'punishment' if a single payment is missed or late). It would take another year for the center to qualify once again for the monthly meeting.

Teresita Nerves lives in Tay Tay Riza, Pasig, Manila. She is a 56-year-old widow and mother of four. After being laid off from the factory she received a payment from the Social Security System, and sent her children to her sister, who lives in the provinces. During the course of her interview[21], Teresita shared some of the details of her life prior to joining the Philippine Enterprise Development Foundation (PEDF--an NGO using the Grameen lending methodology).

Teresita used part of her severance money to buy spices like garlic and black peppercorns in bulk from Divisoria. After repackaging them into small quantities she would sell them to sari-sari stores. To supplement her income she would also work as a Kristo (bookie) in a cockfighting arena.

When she joined PEDF in June 2002, the additional capital allowed her to open her own sari-sari store, and she begin to offer new products in addition to the spices, for which she had developed a reputation. Just three months ago she was able to fortify her home with concrete. Teresita is doing considerably better now than a year ago. While working at the cockpit (cockfighting arena), Teresita often had little money for food and ate mostly cooked porridge (rice boiled with water). If she did have a little extra money it was most often spent on alcohol. Teresita has given up drinking and is especially thankful for PEDF. Since before her experience she had believed an institution like PEDF would never trust "people like [her]". Teresita is "definitely better off" now. She expressed her satisfaction with being her own boss and talked of her next loan. She now eats healthy and regular meals. She hopes to buy a refrigerator so that she can begin selling cold soda;

[21] During the months of June and July 2003 roughly eighty microfinance recipients were interviewed. The Research team of Jocelyn Badiola (June and July), Nimai Mehta (June only) and Stephen Daley (June and July) were based in Manila but also interviewed MF recipients in Mindanao, Cebu and several different locations in Luzon (eg Manila, Laguna, Baguio and Batangas).

something she believes will do well in her area. She also looks forward to the day when her children will be living with her again.

Ruth Sombrero lives in Baseco. She has been a member of CCT (Center for Community Transformation –an organization providing microfinance services) for the last few years. In which time she has been able to dramatically increase her income. With her first few loans she bought a TV and a video and the rights to a lot across from her own sari-sari[22] store, which she turned into a little movie theatre. Ruth also bought an incubator so that she could raise fighting cocks. Together these activities have resulted in the tripling of Ruth's family income.

These are wonderful stories. But they suggest that existing measures of determining the success of a program or intervention—measures that rely on a micro measure applied against a macro ruler (e.g., taking the individuals average income and comparing it against a statistically devised poverty line)—fail to capture some very meaningful information. For example, Ruth's dramatically increased income will have a negligible impact on the average income of her suburb. Baseco is home to a quarter of a million people. This population in conjunction with the one percent outreach of MF means that even if all of the MF recipients tripled[23] their income the per capita income of Baseco would rise by less than two percent.[24]

[22] Often this stores begin as a hole in the side of their dwelling through which they sell their products to those who passby. Over time, and with investment, these stores can become quite permanent with glass cases for food display.

[23] Both of these assumptions will biased our estimate upwards, overstating the impact of a Ruth type increase.

[24] With a poverty level of 13,800 Php per capita and an average household size of 3.84 the average income for the household would be 53,076 Php. If one percent of these household (650) tripled their income it would result in an overall increase in the Baseco income of sixty-nine million Php. When spread across all households the final increase in average per capita household income is 1,061 Php a 1.9% increase.

If the goal of Microfinance is to relieve poverty, one would hardly think that such slow progress (Ruth's income tripled in three years) justifies the resources required when the macro measures, even at a regional level, are the inputs that influence the policy decision. Obtaining income information can be a challenge in itself. Many of the people we spoke with (clients) do not keep accounting records. Estimates of income require detailed questioning rather than a simple request for copies of last years tax return.[25] Simply put, adding up income and counting heads will not reveal the extent of impact for good or ill of a microfinance program. A richer evaluation is therefore required.

Our approach begins with the idea that knowledge, at the local level, is "a resource as powerful as any tangible tool."[26] In contrast, the studies of Microfinance in the Philippines to date can be grouped within the following four categories:

1. The policy regime, and the impact of possible changes to that policy on the behavior of the Microfinance Organizations (MFIs) that will be affected.
2. Methodological comparisons. This type of study attempts to provide some meaningful comparisons of, for example, the Grameen model of lending to that of ASA or individual lending. The standard measures of outreach, loan portfolio and repayment rates are the most commonly cited indicators and points of comparison.
3. Evaluation of an MFI's impact through a study of the institutions' clients (much like the story of Teresita (above) or through an examination of the sustainability of the MFI itself.

[25] We spoke to a number of people who operate their businesses informally. Because of the scale of many of the businesses we spoke with, even of those who are registered, only local registration with the barangay is required and this involves a once a year registration fee (which is fixed). The comment regarding tax returns is obviously 'tongue in cheek'.
[26] Thomas, p. 61;Hayek (1945)

4. A survey of a specific area or region and the activity of MFIs within this geographically designated space. Outreach, poverty and the level of social services currently provided are the common focus of this type of research.

This study is different in two important respects. First, the method of the survey was of an ethnographic nature, the data is the story of the individuals spoken to. But it is not simply a story; it is an attempt to understand their opportunities and choices in light of the barriers they have faced in attempting to bring their ideas to life. A directed conversation avoids the problems of a 'written in stone' (rigid) survey, which can become a crutch that hobbles the researcher in their pursuit of data.[27] This structured discussion enabled the respondents to express ideas and tell stories. These can often be essential ingredients that are missed when the sole aim is to generate a sterile imperfect data set that can be analyzed with the latest regression techniques.[28] The key to gathering data in this manner is to guide the discussion through a few key themes with open-ended questions. Doing so enabled us to understand the issues from the unique perspective of the client, which is essential if we are to truly understand the impact of any program.

As mentioned above, gathering information regarding income is challenging when individuals run businesses without accounting records. Another illustration deals with the informal leaders. Some clients were originally interviewed with representatives of their MFI present. It became apparent to the research team that in the presence of the loan

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[27] Thomas p. 40

[28] A caution oft forgot! "Econometric theory is like an exquisitely balanced French recipe, spelling out precisely with how many turns to mix the sauce, how many carats of spice to add, and how many milliseconds to bake the mixture at exactly 474 degrees of temperature. But when the statistical cook turns to raw materials, he finds that hears of cactus fruit are unavailable, so he substitutes chunks of cantaloupe; where the recipe calls for vermicelli he uses shredded wheat; and he substitutes green garment dye for curry, ping-pong balls for turtle's eggs, and for Chalifougnac vintage 1883, a can of turpentine" (Valavanis, 1959, p. 83)

officer (or MFI representative) the clients would not truthfully answer some of our questions. Most MFIs make it a condition of borrowing that the borrower should only deal with one lender. Once the loan officer had left, answers to the same types of questions regarding informal borrowings could be very different. While several previous surveys have documented the interest rate differentials, the perspective of the clients we gained is very instructive. The informal lenders are often deplored as loan sharks and usurers by the government and the lending organizations. But those who have consistently used the mumbai (or other informal lenders) shared only positive comments. It is this type of information, or data, that is not being currently captured. It is assumed that to pay a higher rate is always determinant and thus the poor must be 'saved' from this sorry predicament. We contend that knowing the interests rates is only the beginning and discussions must be held to understand the motivation of the borrowers that continue to borrow from these higher rate informal lenders when 'cheaper' funds are supposedly available. One MFI executive, in contrast to many of his peers, did not believe the mumbai should be gotten rid of immediately as they had been "responsible for food on the tables of many people".[29]

The second important difference is determining the impact of the differing lending methodologies on the entrepreneurs' ability to obtain the necessary finance. This entailed speaking to existing MFI clients who had been selected from different lending models while also attempting to speak to those who are not members of any MF program and others who had been but where not currently active members. But we did not only speak with clients (approx 80 interviews), we also interviewed the loan officers and executives of the MFIs (10 MFIs were selected). These institutions represented the rural

[29] Gaunzon, Jovy

banks in the MABS program, and various NGOs. Many of the organizations were using more than one lending methodology, although in every case the programs are administered by different employees and as such are distinct even when they are ultimately run by a single organization.

We also spoke with officials with government organizations tasked with alleviating poverty, NAPC (The National Anti-Poverty Commission), PCFC (People's Credit & Finance Corporation) and ACPC (Agricultural Credit Policy Council). Speaking to such a wide variety of people allowed the richness of the day-to-day reality to become clearer. It is interesting to note that the government is not presenting a unified front in its battle against poverty. Each department or agency has it's own agenda. Each believes it is on the right track and the consequent turf wars can only channel resources even further from the desired end.[30]

The diversity of actors interviewed once again illustrates the utility of our approach. A rigid survey instrument would rely on one set of questions and possible answers for all groups' surveyed, whereas our technique allows for the nuanced responses one would expect given the unique experiences and positions of each respondent.

[30] NAPC (National Anti-Poverty Commission), while it has already been in existence for 5 years many other government agencies still do not know about or understand their mission. Some of NAPC's activities are targeted at educating the bureaucracy of the Philippines rather than being engaging 100% in their mandated mission.

The emerging consensus: Dividing up the poor

There is a consensus in the literature a la Robinson and others[31] dichotomizing the poor into two distinct groups. There are the economically active poor and the extremely poor. The following chart (from Robinson, 2001) demonstrates this division quite clearly.

[31] Robinson 2001,2001,2003; Ledgerwood 1998; Harper 2003; Rhyne 1999.

Income Level	Commercial financial services			Subsidized poverty alleviation programs
Lower middle income	Standard commercial bank loans and full range of savings services		Interest-bearing savings accounts for small savers	
Economically active poor		Commercial microloans		
Official poverty line				Poverty programs for such purposes as food and water, medicine and nutrition, employment generation, skills training, and relocation
Extremely Poor				

Reproduced from Robinson 2001, p 21

"The extremely poor are those living below the minimum subsistence level, they include those who are unemployed or severely underemployed, as well as those whose work is so poorly remunerated that their purchasing power does not permit the minimum caloric intake required to overcome malnutrition. Also included are people who live in regions severely deprived of resources; those who are too young, too old, disabled to work; those who for reasons of environment, ethnic identity, politics, gender, and the like have little or no employment opportunities -and who have no earning assets or household

members to support them; and those who are escaping form natural or humanmade catastrophes."[32]

The application of this dichotomized thinking is clear. Those who are poor but economically active should have access to loans. While those who are extremely poor should not. It has been suggested that loans either (1) do not help the poor but actually contribute to worsening their condition or (2) none of the lending methodologies actually cater to the truly poor (a point to be considered in more detail later). This suggests that the extremely poor, the most marginalized of the society, are in desperate need of social services and handouts to alleviate their dire circumstances. We contend this model is flawed both theoretically and on the basis of our empirical evidence.

The theoretic argument addresses the question of policy implementation and the possible incentive distortion that can result. As Robinson demonstrates in the above diagram, there is a clear overlap between the earnings of the e-poor and the extremely poor. This is not accidental. But this creates a huge problem for anybody ("organization") that wishes to distinguish between the e-poor and the extremely poor in deciding between loan disbursement and the provision of welfare.

The distinction between the worthy poor and unworthy is not new but this presents an interesting new twist whereby the economic activity suggests the person is 'unworthy' or it is deemed to be unnecessary. Distinguishing between individuals and families regarding their entrepreneur-activity status is surely fraught with danger considering the models suggestion that the e-poor and the extremely poor could potential have the same income.

[32] (Robinson 2001, 18)

Perhaps greater resources devoted to the differing programs would remove much of the uncertainty. But identification is not the only issue. Once the social programs are implemented the e-poor in the same income range have an incentive to disguise their e-poor status in order to receive the same free benefits as their neighbors. In an environment where many of these small businesses are not registered and many of the owners have no intention of registering, this type of distinction can only be discovered at the local level with insider knowledge. This incentive to act as if extremely poor discourages the risk taking of the e-poor, which could have a positive and long lasting impact on their income and the economic environment in which they live. This has serious implications for any poverty alleviation program that attempts to distinguish between the poor that live in the small areas and have similar income levels.

The above criticism essentially assumes that if the dichotomization of the poor is correct then there are serious issues that may determine that wide scale programs of alleviation will not necessary result in the intended outcome. We now turn to an empirical argument against such a simple dichotomy.

Who are the poorest of the poor? Using Robinson's definition, a family eating one meal a day, with no immediate prospects for improvement would certainly qualify. We met and interviewed many who had been in this predicament. Employing the dichotomized poor model suggests that these people require welfare-style assistance and not loans. But in many of the cases we found loans were effective in empowering these individuals.

In the heart of Welfare Vill, Ortigas, Manila lives Josephine Posada (on the left) and her family; she has worked very hard and leveraged her MF loans, over the last two

years, into a thriving scrap collection business. During the course of her interview Josephine shared some details of her life prior to joining the Philippine Enterprise Development Foundation Program (PEDF- an NGO using the Grameen lending methodology).[33] Before the scrap business Josephine felt that she and her family were extremely poor. She washed clothes to earn money to supplement the earnings of her husband who worked as a tinsmith. She spoke of how she would often cry at night as her children went to bed hungry because they had no food for supper. Her parents who are also very poor would sometimes come to the house to ask for help. Josephine explained how terrible she felt turning them down because she too had basically nothing. The home she and her family shared, a shanty, failed to protect them adequately from the rain. She recalled how vividly she remembered being wet and cold.

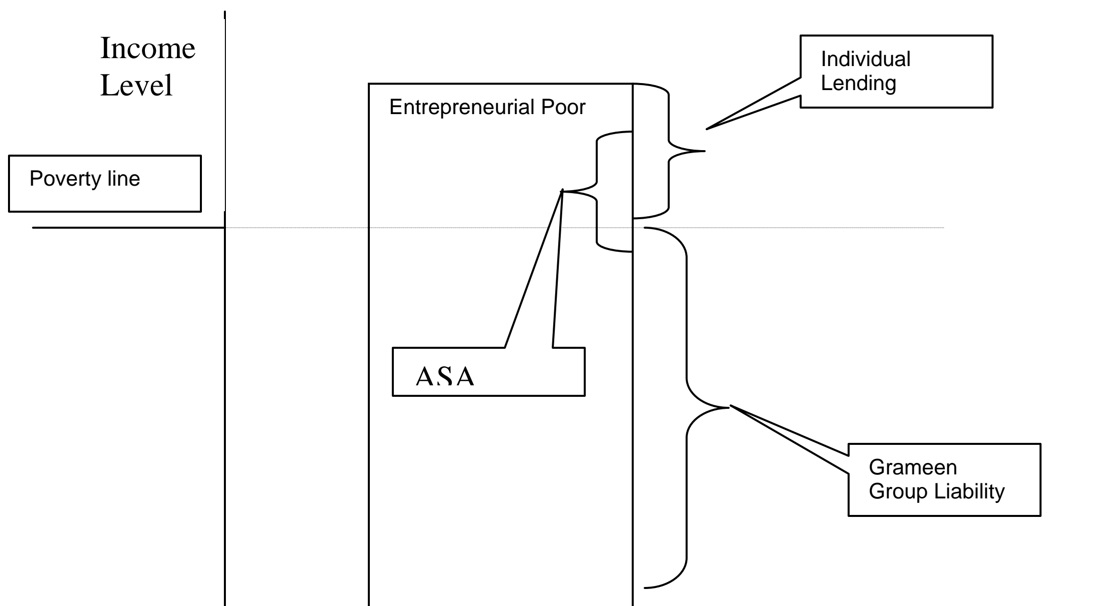
Since beginning her business, things have changed for the better. Today, Josephine's family not only eats regular meals, they are able to eat the food they like. Josephine now goes to the grocery store every Sunday to buy snacks for her children that they can take with them to school. They will also go to the mall occasionally and will sometimes eat at Jollibee[34]. In addition to being able to buy toys for very special occasions, the family home has been significantly improved. The roof has been repaired, so that there are no more leaks even during heavy rains, and the floor is now made of concrete. They have a television set and audio equipment and Josephine proudly sports her mobile phone. The loan has done much more than allow Josephine to increase her earning potential. It has dramatically improved her outlook for the future and that of her

[33] The interview took place in Teresita's home in July 2003
[34] The Philippine equivalent of McDonalds

children. She has gone from feeling helpless to feeling empowered, and in control of her own life.

Robinson's dichotomization of the poor would have landed Josephine squarely in the 'extremely poor' and ruled out the idea of giving Josephine a loan. But the loan has done more than just increase Josephine's income. Her business provides employment for others, and she is a model in her neighborhood of what can be accomplished with hard work and a little capital.

This is not to suggest that every individual who is extremely poor will enjoy the success experienced by Josephine. But it is not only insulting to those who possess industry and character, such that when capital is available they are able to utilize it in a way that better their circumstances, it is detrimental to their welfare and the welfare of the community in which they live. Josephine's story illustrates the hope that microfinance offers to the poor, an opportunity to lift themselves out of poverty. How then does this change the way we see the poor. We suggest that the diagram could be redrawn to relate the following principle.



The story of Josephine illustrates the futility of the poor/e-poor dichotomy, and the harm that may arise from basing policy upon it. The extremely poor can be entrepreneurial once they can find access to sufficient capital.

In the case of Josephine, (in keeping with the dichotomization of the poor) imagine a scenario where this dichotomy held and she was given a handout. Instead of being empowered she would be dependent. With this dependence, the feelings of helplessness would have continued. And rather than providing employment for others she would have been teaching her children dependence through welfare, and the life she has began to enjoy (which she once thought was unattainable) would still be unattainable.

IV. FINDINGS

4.A What is MABS really doing? Poverty Alleviation and Professionalization.

MABS is professionalizing the rural banks. These are organizations that have traditionally been owned and poorly managed by prominent families living within the local area, making financial decisions based on status and personal reputation. But making the banks more professional does not guarantee that they in turn will help alleviate poverty.

The USAID and MABS emphasis on individual borrowing fits neatly within the paradigm of Robinson and others.[35] By lending to those owners of "going concerns" who have been operating their present business for at least two years, MABS almost guarantees it will only be lending to those poor who are already economically active and therefore not to the extremely poor.

[35] Robinson 2001,2002,2003;

This two-year provision may reinforce the Robinson doctrine, according to which the poor are dichotomized into the poor who are currently active in entrepreneurial endeavors (and those who are not and are therefore considered the “extremely poor.”) Once the poor are seen in this light, the division between the lending possibilities and the need for social services is neatly drawn (as demonstrated in Robinson and above). This point was supported by several of the banks with whom we spoke; they see their role (and not inappropriately) as serving their board and the shareholders and so believe it is not their place to lend to the "poorest of the poor". This is not to say that MABS member banks are not reaching new clients. The MABS banks told a common story. They are now lending to people/clients that they had never considered profitable prior to their introduction to the MABS program. As mentioned previously, one rural bank executive[36] shared how MABS had helped them "discover" new clients. The following diagram[37] depicts the lending mechanism against the income of the potential clients.

It has been suggested that the MABS methodology, and therefore the lending practices of their member banks, fails to reach only the lowest 30% of the poor[38] (Although that could be considered optimistic given the findings from our cross-sectional sample of microfinance recipients). It should be clear that the restrictions imposed upon entering clients, in MABS and other individual based lending, do preclude lending to the poorest of the poor, such as Josephine, Teresita or Ruth.

There is recognition within the literature that group lending with collective responsibility has the ability to reach, on average, a poorer clientele than individual

[36] Interview with Teresa Ganzon of Bangko Kabayan (Ibaan Rural Bank Inc.)
[37] The above diagram is not to suggest that there is no overlap between the Grameen and the Individual programs but if such an overlap occurs it is generally because of the departure of the Grameen lenders from the strict screening of entering clients to sufficiently establish the extent of their poverty.
[38] Interview with Andrew Baird at the MABS office in Manila

lending. Recent literature suggests that even group lending does not reach all the way into the very poor because of issues regarding group formation.[39] The collective responsibility model, however allows, that even those without a current business can access a loan if they are able to find others who are willing to take a chance on them (through exercising social capital), and this access to funds is beyond what they would have been able to secure under an individual lending structure.

Our research indicates that the Grameen system is actually lending to clients who are much further down the economic ladder than the other lending methodologies.[40] While under the hybrid Grameen systems, which replicate the group structure but do not impose group liability, the clients begin to look more and more like the clients of individual lenders.[41] This was clearly seen in one organization that had recently changed from group liability to individual liability[42]. While some of the organization's members could be classified as extremely poor at the time they joined the program (while still Grameen) it is doubtful that clients of a similar socio-economic level are being accepted today. This suggests that while MABS banks miss a large percentage of the poorest of the poor, alternative models are reaching further.

Is MABS achieving its goal of alleviating poverty by making microfinance available to the poorest of the poor? Clearly, no. This should not however be taken to suggest that MABS is not successful by another important measure. MABS has helped

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[39] Johnson and Rogaly 1997; 12; Robinson 2001, XX; Osmani, 1989

[40] Although there are indications that it is not just use of the Grameen system but also a firm commitment from management to target the extremely poor while seeking to inculcate them with credit discipline and habits, such as saving, which will facilitate not only repayment of the loan but skills which will increase the likelihood of their succeeding.

[41] The collective responsibility as risk sharing, no longer is it just the financier taking on the risk but also the clients. Many of those running ASA recognize the burden this places on the poor it is trying to help but by removing the burden they no longer are catering to the same clients. -creeping up the socio economic ladder

[42] CCT = Center for Community Transformation

rural banks become more profitable. It has helped them "discover" new clients, who are lower on the socio-economic scale. The banks are now lending without traditional capital to individuals outside of strict familial and community networks and doing so with a confidence in return and profitability previously thought impossible.

By transforming the rural banks within the program into more profitable and professionally run banks, in a country of endemic corruption, MABS is providing an extremely valuable service. When the local people see formal institutions, like banks, being run professionally, confidence in the formal financial institutions is built, enabling the influence of the institutions to expand. We heard people comment on more than one occasion that they trusted their organization based on its responsibility. Many trusted the people at whatever organization they were dealing with because they either (1) followed the rules (e.g., when someone did not repay a loan, action was taken), or (2) the organization and its staff kept commitments to clients.

This, in effect, builds the kind of institutional capacity in the Philippines that is the best sustainable path to development. As people come to rely more and more on institutions that enable "impersonal exchange"[43] (e.g., bank loans based on proven fiscal profitability rather than familial or communal reputation) due to increased confidence in the institutional arrangements, the Philippines will enable entrepreneurial activity to a degree previously unseen in this struggling country. MABS is helping to create such an environment and can be seen as successful to the extent that it helps to promote the kind of environment in which the genuinely poor do have an opportunity to prosper.[44]

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[43] North 2003; McCabe 2003.
[44] It is worth noting that unless MABS is evaluated in light of this goal as opposed to the goal of reaching the extremely poor, the program may risk elimination in favor of another program toward those ends. Based on our results, this would be unwise given alternative proposals, which we examine in the next

4.B Creativity, innovation and avoiding the temptation to intervene

While it is obvious that the Grameen method enables even the extremely poor to obtain finance, it can do so for only a given period of time. During the life of the entrepreneur, we would expect growth and development of the individual and his or her venture. We observed this time and time again, regardless of the system. But with group liability, what first enabled growth and development can come to be a serious barrier to further growth and development[45]. Much has been made over the issue of "graduating Grameen."[46] We contend that while the Grameen system may be advantageous at the beginning, by lending to those who do not qualify for an individual loan, it is certainly no panacea, and in the end acts as a barrier to future growth.

There is much work to be done in understanding the mechanisms that can best enable the poor to enjoy greater access to capital. If a certain mechanism can enable access to capital, it is a valuable resource in the effort to alleviate poverty. However, if this same mechanism also retards movement to market mechanisms of impersonal exchange and more formalized credit markets, then its limitations must be acknowledged. De Soto argues for codification of what "even the dog knows"; a program of titling. MF as a formal intervention that seeks to utilize personal rather than impersonal mechanisms will face limitations – an issue which will receive further attention shortly. This is not a mere theoretical issue. Two of the MABS banks we spent time with are working within

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section, and based on the unique value the MABS program is creating with respect to building institutional capacity in the Philippines.

[45] The expected burden on the nondefaulting group members when a client defaults can become so large as to effectively destroy the whole group credibility.

[46] Stearns

the MABS framework while also using the Grameen system. Both are confronting the serious issues of graduation by experimenting with programs that will lift their successful group-lending clients into individual or impersonal relations directly with the bank.

We have discussed the entrepreneurial aspirations of the poor and the innovation of the MABS program without mentioning the organizations that actually provide the MF services. The extent of microfinance providers in the Philippines is encouraging and the diversity of lending methodologies and client outreach indicates (and our investigation confirms) that organizations are acting on local, context-specific knowledge. These organizations must be given the room to innovate and mutate. There is space in the market for all types of organizations offering different kinds of products. It would be easy to argue that, because of financial intermediation, only individual lending in the end will be truly sustainable and therefore should be the only option.[47] But the process of competition is improving the existing lending technology – demonstrated by the market replicating fee-for-service MABS program – in an effort to increase the credit and savings opportunities of the poor.

The real danger to the continued success of MABS and MF in the Philippines is a government that violates the simple principles that have enabled MABS to be such a success. The government's well-meaning attempts to alleviate poverty could well result in serious short and long-term consequences for the Microfinance sector. PCFC, the government organization tasked with providing the funds for lending organizations that do MF, currently has a working relationship with roughly 200 organizations. This represents less than 10% of all MFI in the Philippines. By supplying the "favored" organizations with cheap money or subsidized credit serious distortions will occur. The

[47] Robinson 2001

incentive to repay (by the clients) can be damaged, as recently witnessed with farmers who did not repay their loans, because they saw no need to repay the government -- especially when the government often fails to seriously push collection. The incentives of the organizations with the cheap money are weakened as they may fail to adhere to their lending program as strictly as they should. An important long-term consequence may be that efficient but non-favored organizations cease to exist as they are pushed out of the market by their subsidized competitors. When, at a later date, the government allocates the funds that once were once allocated to MF to another area, are the organizations truly sustainable without the government handouts? If they are not, will the other organizations that once operated in this sector be willing to begin again, considering the government intervention has caused them to miss out on opportunities and/or post losses? Direct government outlays, such as those suggested by President Aroyo's recent announcement, which may be considered as an alternative to MABS, risk falling prey to corruption and cutting against the gains MABS and successful NGO lenders have made toward building needed institutional capacity in the Philippines. Rather, we suggest that if there is a role for government-sponsored programs with respect to MFIs, it is within the purview of the following section.

4.C Issues of Measurement

Next we suggest that the methods for measuring MF success need to be reassessed. The current triangle--outreach, repayment rate, and portfolio--tells us where the institution is today, but fails to tell us anything truly meaningful in relation to the clients the organization is serving.

The current methods of evaluation represent the two extremes. The first is the anecdotal method, or the success story. As the above analysis suggests (the story of Josephine, for example), MF can change lives for the better.[48] But we have yet to meet an executive or loan officer who volunteered to introduce us to "drop outs" from their program. There is certainly an element of marketing that serves the interests of the organization as it attempts to attract either new clients and/or additional funding from those who are impressed by such positive results.

The second method focuses on the standard triumvirate of repayment rate, outreach (number of clients who are borrowers), and size of the loan portfolio--aggregated figures that are most often cited in an attempt to understand the success or struggles of MFIs. Each measure can be misleading as the examples below demonstrate. While it is true that the outreach figure does gauge the growth of the program, we are not sure that this figure in and of itself is interesting. What is to be said of an organization that loses fifty clients each month but attracts sixty new clients? Would we look more favorably on another who lost no clients but only gained nine clients? The small "entry" loans enable the organization to dramatically increase the numbers in their program or to easily replace them with the smallest amount of risk.[49] So outreach provided scant information in relation to the sustainability or ultimate health of the lending organization.

Maintaining a high repayment rate is difficult in the face of widespread default, but with small difficulties it can be easily managed. Prior to the MF best practice, including accounting procedures, it was the case that a loan could sit on the books as

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[48] While using examples ourselves we are trying to illustrate the ideal cases rather than justify the success or failure of any particular institution or program. For example the story of Josephine is useful, not because of the success of the Grameen program, but the fact that a person categorized as extremely poor can effectively use a loan. It is almost a proof by contradiction.

[49] Especially in the Grameen which begins with small entry loans, four or five thousand Php. (US$ 70-90)

current until the payment schedule expired, even in the event of default for many periods prior to the end of the loan. With greater attention paid to the repayment rate, as a seemingly good measure of success, the incentives facing the MFI to report more responsibly have led to an interesting phenomena. Rather than just report the loan as "defaulting" until the end of the loan schedule, the incentive is for the organization to "write-off" the loan after the period in which it is first reported as defaulting.[50] This ensures that a defaulting loan can only "hurt" the repayment rate once, without revealing the extent of a potentially ongoing default problem within an organization's membership.

Aggressively writing off debts[51] negatively impacts the loan portfolio, but this is overcome as clients within the program graduate to higher loans, helping off-set and basically mask the failure of the organization to keep clients. One financial controller of one NGO was asked about his organization's barriers to growth. We were told they just did not have sufficient capital. This 'lack of capital' was difficult to reconcile with the organization's 21,000 clients, a repayment rate of close to 99% and an interest rate of 4% a month. A lending business with these figures would almost surely be flush with cash. Something is happening, but the triumvirate of measures fails to tell us what we need to know.[52] We contend the relative merit or success of lending methodologies or the sustainability of different organizations cannot be judged using the standard measures. This would be tantamount to using a broken clock to tell the time; it may be right twice a day but its shortcomings far exceed any benefit.

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[50] By aggressively monitoring your PAR you can move to write off loans that have gone back, this stops the bad debt total from mounting and impacting negatively the reported repayment rate.

[51] Which on another level could be seen as writing off people. Another tension between the need to be sustainable, and in this case report 'good' figures and the mission of alleviating poverty and assisting in the social transformation of the community in which they operate.

[52] Otero p. 19-27

In light of the above, we suggest the following must be considered if we are to gain a greater appreciation of the impact of a program:[53]

a) The profile of the clients on entering the program (a qualitative baseline).

b) Documenting the length of time clients remain in the program.

c) The reasons clients 'exit' the program.

d) The use of other sources of credit. (This will establish the effectiveness of MFIs with respect to fulfilling 100% of their clients' capital requirements.)

V. Conclusion

Access to capital is an essential feature of a dynamic capitalist economy. Our experience in the Philippines demonstrates that entrepreneurs must be able to find the financing to bring their economic bets to life and when they are, they play a vital role in the development of their economy and the progress of society. Overall security of property and freedom of contract are crucial ingredients of an institutional setting that promotes access to capital and enables a risk-taking environment. In the absence of secure property and the freedom of contract, or in situations where these 'basic institutions' are weak, MF practices have evolved to provide the capital for small-scale enterprises. These practices rely upon personal mechanisms of exchange to serve as proxies for collateral. And while these practices provide access to capital to the previously 'unbankable', providing real opportunities for substantial improvements in their standard of living, they cannot be the source of sustainable long-run development.

[53] For a more detailed explanation of these steps, refer to the Mercatus Center Field Guide that accompanies this report.

Moving from personal to impersonal exchange requires changes in the basic institutions of property and contract. Less is more. USAID Philippines Mission Economic Growth Advisor, Robert Barnes, emphasized that donors could never obtain the outreach of Financial Intermediaries. This same lesson when applied to aid is humbling, because it implies that USAID, or the government, as just another donor (albeit with a lot more money) will fail to meet the demand for credit, thus USAID like the NGO will be unable to eradicate poverty. But there is cause for optimism. Marginal changes in the quality of basic institutions can ultimately change the overall environment. If the environment can become one that enables people, even the poorest, to take advantage of market opportunities then the people will lift themselves out of poverty on a scale previously deemed unimaginable.

We conclude with a note of optimism that must also include a warning. MF is having a real impact on the lives of individuals. But if mismeasured, the true benefits and value of MF may not be fully recognized and policy decisions may, with the best intentions, upset what is currently a delicate balance. Pouring cheap money into more and more MFIs may result in a significantly increased outreach, but it risks dampening the incentives and increasing the costs associated with building institutions that move individuals from personal to market relations and ultimately, a social system that is able to capture, to a much larger extent, the gains from exchange.

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Appendix 1.

THE POLICY ENVIRONMENT

Rural Finance

In the 1970s, rural finance policy in the Philippines took a supply-led approach characterized by credit subsidies, credit allocations, and loan targeting. In May of 1975 the Agri-Agra Law was issued mandating banks to set aside proscribed percentages of their net funds for various agricultural activities. For the financing to be agri-agra eligible, these beneficiaries must use the funds for the acquisition of work animals, farm equipment, machinery, and inputs (i.e. seeds, fertilizers, etc.) as well as in the operations of the different phases of the economic cycle (i.e., from production to sale) listed under eligible agriculture credits. However, after a decade in force, the effect of this credit quota policy in inducing greater agricultural credit flows remained minimal at best (Castillo and Casuga, 2000).

During this same period a number of commodity-specific credit programs were implemented. It was hoped that these programs would meet the government's objective of food self-sufficiency, particularly for rice and corn. One such program, Masangana-99 (aimed at rice self-sufficiency) provided non-collateral loans at subsidized interest rates for the purchase of farm inputs. During these times, a liberalized and expansionary rediscounting policy was used as an allocative mechanism, with rediscount rates well below the cost of deposits and as low as 1 to 3% for agriculture. Rural banks were

allowed to borrow up to four times their net worth plus three times the average of their savings and time deposits which made the system highly leveraged and dependent on government and inimical to savings mobilization. Along with liberal funding available from special programs, the most important of which was Masagana-99 which pumped about 6 billion pesos into the system in its 14-year life span, the rural banks sourced more than half of their funds from the Central Bank in the 1970s. However, with the economic crisis and consequent tight monetary policies in the mid-1980s which resulted in the termination of liberal rediscounting along with massive loan defaults by farmers participating in Masagana-99 and other similar lending programs of the government, the Rural Banking System collapsed and the supply of agricultural loans especially from rural banks greatly diminished. It is now well recognized that the credit allocation and credit subsidy schemes eventually led to the collapse of many rural banks and the demise of supervised credit programs.

The failure of the existing policy led to the Philippine Government initiating a set of financial reforms that where among the conditions of a structural adjustment loan from the IMF and World Bank in 1981. Interest rates where deregulated and subsidies were gradually removed. The Central Bank's subsidized rediscounting rate was discontinued in 1985 and there were restrictions imposed on bank entry and the opening of new branches. In 1986 the government withdrew from the business of direct lending and consolidated 46 separate programs into the Comprehensive Agricultural Loan Fund (CALF) in compliance with Executive Order 113. To replace the supervised credit programs, initial investments from the CALF were used to fund the expansion of the guarantee operations

of the Guarantee Fund for Small and Medium Enterprises, the Quedan Guarantee Fund Board, the Philippine Crop Insurance Corporation and the Bagong Pagkain ng Bayan. Despite these guarantee schemes, the government believed the demand for credit in the agricultural sector was not being met and within two years had once again entered into direct credit programs. Today there are 76 reproted government-funded credit programs directed at the agricultural sector –more than three times the number of directed credit programs before the policy change of 1986. With respect to performance, more recent studies indicate the government programs and credit schemes have lower repayment rate and higher past due rations than programs run by financial institutions. (Lamberte, Casuga and Erfe, 1997 and 1998) These studies found that GFIs, particularly banks, can manage directed credit programs for small borrowers, including small farmers, more efficiently and effectively than government non-financial agencies. Compared to the programs in the seventies, the performance of government-funded programs in the 1990s has not been an better. Evaluation studies have shown that these programs are inefficiently administered or that the government is not able to fully recover its costs.

Present efforts (The Agricultural and fisheries Modernization Act of 1997) provides for (a) greater participation of the private financial institutions including rural banks, cooperatives and non-governmental organizations, as well as government financial institutions in the delivery of credit to small farmers; (b) adoption of market-determined interest rates (but exempting existing arrangements with agrarian reform beneficiaries); and (c) emphasis on the proper management and utilization of credit funds.

It was hoped that the AFMA would be the only government-financing program in operation by the year 2002. It was meant to replace 39 separate agricultural credit programs administered by 13 agencies whose credit funds would have been consolidated into the AMCFP within a period of four years ending in February 2002. The established goal was not met although significant progress has been made.[54] The ACPC envisions the AMCFP to be efficient, responsive, and sustainable "credit and financing system for the use and benefit of farmers; fisherfolk; those engaged in food and non-food production; processing and trading; cooperatives; farmers'/fisherfolk's organizations; and small and medium enterprises (SMEs) engaged in agriculture and fisheries" (Section 22, RA 8435).

Consistent with the current policy thrusts, the AMCFP will be demand - or market-driven. Unlike the earlier approach of pushing into the system credit allocations for specific commodities, the AMCFP will provide credit to projects that can demonstrate viability. Also under the program, no government non-financial agency will be involved in directly lending to end-borrowers; only banks, viable NGOs, and cooperatives will lend directly to end-users. Moreover, lending rates charged under the program will be market-determined.

[54] The process of consolidating the funds is ongoing. The AFMA provides for the phase out of the DCPs and the consolidation of funds form these programs into the AMCFP. It was only early this year (2003) that the joint circular between the Department of Budget and Management, the Department of Finance and the Department of Agriculture had been signed. This joint circular outlines the rules and regulations and the procedures for consolidating or transferring the DCP funds into the AMCFP fund. A great deal of time and effort was required to formalize the process of consolidation on account of the resistance form various sectors, especially the farmers, and the lack of political will of the politicians in charge of the various departments to implement reforms. At the present time there are still 6 of more than 20 original programs of the Department of Agriculture which are still to be consolidated.

Along with providing loans to financial institutions for re-lending to various agriculture and agriculture-related projects, the AMCFP will provide guarantees on non-collateral loans to farmers and fisher folk. Another incentive for increasing access to credit of small farmers venturing into high value commercial crops with long-gestation period is contained in Section 24 of the AFMA, which provides for a longer grace period on the repayment of loans for long-gestating agriculture and fisheries projects. The Departments of Agriculture and Finance have endorsed to the Monetary Board a maximum grace period of seven years in lieu of the existing 3-years.

In order for the AMCFP and these initiatives to be successfully implemented, government agencies, corporations, and financial institutions expected to play key roles in the provision of credit and risk-reducing instruments such as credit guarantees and commodity insurance, need to be streamlined and strengthened. Thus, the AFMA also calls for a review of the mandates and programs of the Land Bank, Quedancor, Guarantee Fund for Small and Medium Enterprises (GFSME), Philippine Crop Insurance Corporation (PCIC) and Agricultural Credit Policy Council.

These principles shape NCC's policy response mandating the withdrawal of non-GFIs at the retail level and the re-chaneling of their programs to provision of public goods, e.g., capacity-building of rural financial institutions and basic infrastructure. Except for GFIs which are mandated to participate in the market for financial services, government will withdraw form direct transactions with beneficiaries of its programs.

Over the past three decades, the government has made various attempts to do something about small farmer credit. There are perceptions that it might have "done too much", resulting in the failure of many rural financial institutions, large-scale loan defaults and loss of credit discipline. Furthermore, there is a lack of definitive and conclusive evidence that small farmers benefited from the huge resources that the government has spent on the numerous credit programs it has implemented.

While the government has always tried to involve the private sector in lending, major banks have not responded to this call despite incentives, moral persuasion and sanctions given by monetary authorities. There are, therefore, current initiatives to design and implement innovative financing schemes that will directly address the concern of making credit flow to the basic sectors given the issues of agri-lending risk, liquidity of rural lenders and information gaps between urban fund managers and agriculture and fisheries borrowers meanwhile that the positive impact of the reforms envisioned under AFMA and EO 138 has yet to take effect.

Microfinance

In the Philippines, microfinance has become increasingly important as an effective poverty alleviation strategy for several reasons: (a) By providing savings, credit and insurance facilities, poor households are able to smoothen their consumption, manage their risks, build their assets gradually, develop their microenterprises, enhance their income earning capacity and enjoy an improved quality of life; (b) Without permanent

access to institutional microfinance, most poor households continue to rely on meager funds from informal sources which limit their income and production capacities; (c) Microfinance services can also contribute to the improvement of resource allocation, promotion of markets and adoption of better technology.

Recent studies show that poor and low-income households have a large demand for microfinance services to finance their livelihood activities and consumption requirements including lumpy nonfood expenses like education and housing improvements. Microfinance is widely is seen as the solution to this growing demand and to the reality that most formal financial institutions do not serve the poor because of perceived high risks, high costs involved in small transactions, perceived low profitability and inability of the poor to provide the required physical collateral. The business culture of these institutions is also not geared to serve poor and low-income households. However, in the Philippines more rural banks are shifting their gears towards microfinance although NGOs continue to dominate the market. The United States Agency for International Development (USAID), the Philippine Government and the Rural Bankers Association of the Philippines (RBAP) have joined together in the "Microenterprise Access to Banking Services" (To be discussed in detail in the following section)

So far, the leading Philippine government agency on microfinance is the People's Credit and Finance Corporation (PCFC). It was established in June 1996 as a subsidiary of Land Bank of the Philippines. The objective is for PCFC to focus on poverty alleviation lending programs while Land Bank concentrates on its mandate to be the financing arm

of agrarian reform and to service the agriculture sector's growing demand for financial services. The PCFC provides credit to accredited NGOs, financial institutions and people's organizations, which are implementing credit assistance programs for the poor. It also provides credit for institution and capability building activities related to the lending program. Its institutional policy for reaching the poor is to deliver credit to the twenty priority provinces considered the poorest in the country based on poverty incidence statistics. The PCFC also aims to cover 57 provinces in 12 regions. Targeting the poorest provinces forms part of the government's Social Reform Agenda to fight poverty in rural as well as in the urban sectors. The Corporation has about P3 billion including the money from ERAP Trust Funds for microfinance.

In addition to PCFC, Bangko Sentral ng Pilipinas has opened a rediscounting window for microfinance in support of the provisions of RA 8791 or The General Banking Law of 2000 (R.A. 8791). Specific provisions in the law indicate the need for the Monetary Board to consider the "peculiar characteristics of microfinancing" (Sec. 40, R.A. 8791) and for the Monetary Board to "regulate the interest imposed on microfinance borrowers by lending investors and similar lenders" (Sec. 43, 8791). Bangko Sentral's major objective in opening the rediscounting facility is to support those banks that have achieved efficiency in their microfinance activities while adhering to BSP standards.

The proposed BSP rediscount facility for MFI will have the following eligibility requirements: (1) a one-year track record in microfinance; (2) those with at least 200 borrowers; and (3) a repayment rate of not less than 95 percent during the preceding

twelve month period. The BSP will also require the submission of a policy manual on the MFI operations of applicant-banks.

Recent data on the state of microfinance in the Philippines indicate that the potential suppliers of microfinance in the country include 1,919 rural banks; 300 NGOs; 462 credit cooperatives; 7,513 pawnshops; and 2,594 lending investors (Llanto, 2000). Of these figures, approximately 200 of these institutions use PCFC funds. PCFC has no plans to expand the number of institutions it deals with, as it prefers to expand microfinance outreach with those organizations with which they have already developed a working relationship.