Ploughing for access to credit:

The story behind Philippine rural finance

The Executive Summary of the Proceedings of the International Conference on Best Practices on Paving the Way Forward for Rural Finance (USAID et. al 2003) stated that concern for food security and the vulnerability of the population in rural communities, the high incidence of poverty and the growing income disparity between the urban and rural areas necessitate an efficient rural financial market. Like most developing countries, rural finance in the Philippines is faced with challenges that need to be addressed in order to meet the Millennium Development Goal 1.

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Research findings in the 2005 Rural Finance book by Gilberto Llanto, on which this paper is largely based, revealed that the liberalization and deregulation of the Philippine banking sector led to the establishment of more financial institutions and to the improvement of bank density ratios. However, the increase in the number of financial institutions is felt more in the National Capital Region (NCR) as compared to the other regions of the country. The other region's bank density ratios are also a far cry from that of the NCR thereby causing urban clients outside the NCR to compete for access to bank credit and other services with those in the rural areas. This situation constrains the rural sector's access to financial services.

Discrimination of the rural areas

Loans to the Agriculture, Fisheries and Forestry (AFF) sector have also been decreasing over the years. Despite the loan quota mandated by Presidential Decree (PD) 717 – known as the Agri-Agra Law –, agriculture remains the least priority area for banks. This situation is exacerbated by a provision of PD 717 that allows private banks to buy government securities and other related government debt instruments as substitutes to granting of actual loans to the agriculture and agrarian reform areas. Furthermore, of the total loans granted to the AFF sector, the majority goes to agri-related activities instead of agricultural production.

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Several possible factors contribute to this observed decline in agricultural financing. Strict provisioning requirements of the Bangko Sentral ng Pilipinas (Central Bank of the Philippines) make banks wary of the agriculture sector. Legislated interest rate ceilings also impose undue cost burden on banks thus making them shy away from extending small farmer loans. Continued implementation of the directed credit programs (DCPs) of the National Government also prevents rural borrowers from venturing into other rural-based enterprises since these DCPs are usually commodity-specific and thus leads to inefficient allocation of funds. The seasonality of rural incomes, systemic risks in agricultural production and high transaction costs associated with small farmer loans have also discouraged banks from lending to this customer segment. Small borrowers are also rationed out of the formal financial system since the banking sector has a tendency to go for familiar mainstream clients in order to ensure their own business viability. Lack of appropriate collateral has also led to the non-improvement of small farmers' access to formal loans.

Current distribution of loans is more concentrated among large farm owners who can present acceptable loan collateral and have better management techniques. As a result, small farmer borrowers continue to depend on informal lenders (composed of traditional money lenders, rice traders and input suppliers). Unlike banks and other financial institutions, these lenders can provide loans that are timely and without the traditional collateral and tedious documentation required by banks. However, they operate on a very limited supply of funds which would not be sufficient to service a very large number of clients. They also face substantial risks since they usually serve contiguous areas and relatively homogenous borrowers.

The Philippine agricultural and rural sector is also characterized by a shortage of long-term capital financing or for long-gestating crops such as palm oil and rubber. This situation resulted from the agrarian reform program implemented by the

National Government which had a negative impact on the collateral value of lands and again hampered a farmer's access to credit in the formal financial market. Estanislao and Llanto (1993) and David et. al (2003) explain that certain provisions of the Comprehensive Agrarian Reform Program (CARP) such as: ownership ceiling of agricultural land at 5 hectares; prohibition against mortgaging/selling of land within 10 years of its award and upon full payment by farmer beneficiaries to the LBP; designation of the government as the sole buyer of awarded lands; and prohibition against share-tenancy arrangements have led to the distortion of land markets in the rural area and prevented the transfer of land from less productive to more productive uses as well as better farmers. Furthermore, these provisions limited the choice of more efficient contractual arrangements in smallholder agriculture.

A weak rural financial market

Another issue is the lack of lending techniques and a coherent development strategy to address the needs of enterprises transitioning from micro to small business status. Successful microfinance borrowers are faced with a credit gap which hinders their continued growth. Their financing requirements are now beyond the capacity of the microfinance institutions which gave them their initial working capital funds. However, they are still considered an unattractive clientele and similar to small farmers are also perceived as high credit risks by the formal financial sector due to their lack of appropriate collateral.

Rural finance policy experts are also faced with the challenge of addressing several other constraints inherent in the country's rural financial market. These constraints include weak institutions, imperfect information-sharing networks as banks, microfinance institutions and cooperatives which are not closely linked, inadequate mechanisms for enforcing credit contracts, and poorly developed systems for supervising rural financial entities.

Finally, another supply-side challenge is the lack of viability in donor-designed credit programs or those funded by grants. As soon as donor support is withdrawn, implementing agencies are constrained by the problem of a lack of funds which implies that the program is not sustainable in the long-run. The sustainability issue is also worsened by the lack of continuity of donor-funded projects. When new donors come in, new negotiations are made and the consultants hired by the funding agency often design different programs for implementation. The existence of funding sources also resulted to donor-dependencies among the financial intermediaries and the credit beneficiaries and inhibited efforts to develop feasible credit programs and a more dynamic rural financial market.

A high demand for financial services

The existence of informal credit markets indicates that formal institutions cannot meet the excess demand for credit of a significant segment of the borrowing population issues of loan accessibility and timeliness have more weight for rural borrowers as compared to interest rates. The costs and time involved in securing a formal loan prevail over the low interest rates offered by government formal financial institutions. Thus, small farmers continue to depend on informal lenders regardless of the exorbitant interest rates they charge. Recent trends also show that diversification of rural income source is occurring. Non-farm activities as well as remittances from Overseas Filipino Workers (OFWs) have become a significant source of rural income. The inflow of remittances has spurred the development of other production and consumption activities in the rural areas. This implies that the rural population has potential access to funds that formal institutions cannot supply.

How to improve the Philippine rural finance sector?

The primary responsibility of the government in the rural sector is the creation of an enabling environment that would encourage financial intermediation. To achieve this, a sound macroeconomic framework is a necessary requisite. A re-examination of macroeconomic and trade policies is the first step that should be undertaken in order to identify any direct or indirect bias against agricultural production and rural sector growth. Provisions of existing legislation that affects the agricultural sector either directly or indirectly should also be reviewed by policymakers for coherence and long-term viability. This exercise will ensure that the agricultural sector and the rural financial market and its participants will not suffer from conflicting laws and policies. Experience has shown that financial liberalization on one side and the continued protectionist rural programs on the other side do not work together.

The directed credit programs (DCPs) should be gradually terminated and adherence to market-based principles and functioning of the financial market should be promoted. The provisions of the Agri-Agra Law should also be reviewed. The use of certain government bonds and securities as substitutes for actual lending to the agriculture and agrarian sector should be minimized and if possible totally removed. This will hopefully increase loans to the agricultural sector.

Another necessary element of a favourable policy environment for the efficient functioning of rural markets is the provision of infrastructure support to the agriculture and rural sectors. A sufficient physical and social infrastructure will help boost rural productivity and expand economic activity in the rural sector. The increased accessibility of rural areas will also encourage financial and non-financial institutions to provide their products and services in these areas.

An effective corporate governance has also become a key issue in the performance and viability of financial institutions and so to address the different issues and challenges identified above and at the same time complement improvements in the macroeconomic framework and stability, financial sector reforms are imperative. Yaron (1992) posits that Institutional development is the first step towards reforming the financial system and ultimately strengthening the rural financial markets. Dependence on donors and other

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Improving rural infrastructure is one important prerequisite for the efficient functioning of rural markets.

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funding agencies as sources of funds for lending should be minimized since this is not sustainable in the long-run.

To achieve this, savings mobilization strategies in the rural areas should be pursued. Savings mobilization is the antithesis of the government's subsidized credit programs while strengthening banks' balance sheet. The population size of rural areas and the amount of funds obtained by the informal financial sector from this population segment implies that there is an existing propensity to save that is an opportunity waiting to be tapped. By offering specially designed deposit products to match the unique characteristics of this customer segment, banks will be able to address the savings-investment gap and ensure access to funds that are more viable. Formal financial institutions can also continue to use cooperatives and peoples' organizations (POs) as channels for credit delivery in the short-term. The basic idea is to use the low-cost funds in the formal financial sector while taking advantage of the monitoring, information and enforcement technologies of these groups.

Another part of the institutional reforms is the adaptation of formal institutions of the techniques used by informal credit markets and the downscaling of bank operations. This entails adjusting the culture of banks to the rural micro-economy's orientation. Simplification and modification of bank procedure should also be carried out to meet the needs of rural households and micro-entrepreneurs.

Facilitating access to credit

The asymmetry in information is one of the major hindrances to credit accessibility and the further expansion of credit. It increases transaction costs and credit risks thereby discouraging private sector participation in rural financing. In the short-run, banks and other formal financial institutions can limit the consequences of information asymmetries and enforcement problems by employing certain schemes. They can adopt some of the techniques used by informal lenders to induce desired borrower behaviour and avoid problems like loan defaults. Alternative strategies involve the use of farmer self-help groups, cooperatives, or group lending. Self-help groups or organizations such as cooperatives can screen loan applications and supply banks with the necessary information so that information asymmetries would be eliminated. These groups can also instruct farmer-borrowers on the importance of financial discipline and act as collecting agents for the banks.

Peer sanctions or even eviction from the group can be a disincentive for deliberate default on the part of the borrower. Thus, transaction costs and default risks are minimized. In the longer run, institutional and technological innovations and adaptation are necessary to reduce transaction costs. Lenders should have an appraisal system or tool to help them measure the creditworthiness of prospective borrowers. Depositors and shareholders, on the other hand, should also be able to determine the profitability of their investments. A database of information such as a credit bureau should be established with services extending outside the National Capital Region.

Institutional development is the first step towards reforming the financial system and ultimately strengthening the rural financial markets.

To address the issue of borrower reputation and lack of appropriate collateral, small farmers should consolidate their lands with other owners of smaller-scale farms and enter into contract growing schemes and leaseback arrangements. Information on these alternative methods of obtaining funds should be part of the agriculture extension programs provided by the government. Cooperatives have also played an important role in mobilizing savings and facilitating the acquisition of credit for small farmers. Taking this into consideration, the government should continue to promote cooperatives as vehicles for the delivery of basic economic and financial services to the rural poor. It should also encourage private sector involvement in the actual formation, establishment and organization of such entities.

However, it takes time to enhance the creditworthiness of farmer borrowers using these strategies. As such, in the interim, the government should also engage in interventions that would support the viability of the other economic activities undertaken by rural borrowers and the rural economy in general. This includes non-farm activities and initiatives that give a significant contribution to rural income. Rural financial intermediaries should therefore develop innovative financial products and services beyond short-term production credit facilities. It is in this aspect that donors' assistance can be channelled by providing information and the necessary skills to bank personnel in the design of viable long-term credit products and instruments.

Conclusion

Rural finance is not only about agricultural credit. It also involves the provision of other financial services such as deposit or savings facilities and insurance products among others. After careful examination of the rural financial markets and understanding the behaviour of economic agents as well as the role played by various institutions, the improvements advocated in this paper attempts to address the constraints confronting Philippine rural finance policy today. These aims to tackle the root causes of the inefficient functioning of financial markets and its participants in the rural sector which are basically asymmetric information, high transaction cost, and conflicting government policies and legislations. In the end, it is hoped that rural finance policy in the country would be improved to the extent that efficient, broad-based, and sustainable financial products and services would be accessible to various rural economic agents. This development would be an important contributor to the vision of the government to achieve the MDG 1 and eradicate poverty in the rural areas.