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PROJECT PERFORMANCE ASSESSMENT REPORT

PHILIPPINES THIRD RURAL FINANCE PROJECT (LN 4413-PH)

June 26, 2009

Sector Evaluation Division
Independent Evaluation Group

Currency Equivalents (February 2009)

Currency Unit = Peso (PhP)

Exchange Rate US$1.00 = PhP51.92 (weighted average project period)

Abbreviations and Acronyms

BSP	Bangko Sentral ng Pilipinas (The Central Bank of the Philippines)
CAR	Capital Adequacy Ratio
CAS	Country Assistance Strategy
CLF	Countryside Loan Fund
DBP	Development Bank of the Philippines
DFID	Department for International Development (UK)
DOF	Department of Finance
ERR	Economic Rate of Return
FRR	Financial Rate of Return
GTZ	German Technical Assistance Agency
ICR	Implementation Completion Report
IDP	Institutional Development Plan
IDA	International Development Association
IEG	Independent Evaluation Group (earlier OED)
IEGWB	Independent Evaluation Group (World Bank)
JBIC	Japan Bank for International Cooperation (now amalgamated with JICA)
KPI	Key Performance Indicator
LBP	Land Bank of the Philippines
LGU	Local Government Unit (include District and other government departments)
M&E	Monitoring and Evaluation
MFI	Micro-Finance Institution
MLF	Micro-Finance Loan Fund
MTR	Midterm Review
NGO	Non-governmental Organization
NPA	Nonperforming Asset
NPL	Nonperforming Loan
PAD	Project Appraisal Document
PAR	Portfolio at Risk
PCFC	Peoples Credit and Finance Corporation
PFI	Participating Financial Institution
PPAR	Project Performance Assessment Report
QAG	Quality Assurance Group (of the World Bank)
RCF	Retail Countryside Fund
SAR	Staff Appraisal Report
SDI	Subsidy Dependency Index
SME	Small and Medium Enterprise

Fiscal Year

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IEGWB Mission: Enhancing development effectiveness through excellence and independence in evaluation.

About this Report

The Independent Evaluation Group assesses the programs and activities of the World Bank for two purposes: first, to ensure the integrity of the Bank's self-evaluation process and to verify that the Bank's work is producing the expected results, and second, to help develop improved directions, policies, and procedures through the dissemination of lessons drawn from experience. As part of this work, IEGWB annually assesses about 25 percent of the Bank's lending operations through field work. In selecting operations for assessment, preference is given to those that are innovative, large, or complex; those that are relevant to upcoming studies or country evaluations; those for which Executive Directors or Bank management have requested assessments; and those that are likely to generate important lessons.

To prepare a Project Performance Assessment Report (PPAR), IEGWB staff examine project files and other documents, interview operational staff, visit the borrowing country to discuss the operation with the government, and other in-country stakeholders, and interview Bank staff and other donor agency staff both at headquarters and in local offices as appropriate.

Each PPAR is subject to internal IEGWB peer review, Panel review, and management approval. Once cleared internally, the PPAR is commented on by the responsible Bank department. IEGWB incorporates the comments as relevant. The completed PPAR is then sent to the borrower for review; the borrowers' comments are attached to the document that is sent to the Bank's Board of Executive Directors. After an assessment report has been sent to the Board, it is disclosed to the public.

About the IEGWB Rating System

IEGWB's use of multiple evaluation methods offers both rigor and a necessary level of flexibility to adapt to lending instrument, project design, or sectoral approach. IEGWB evaluators all apply the same basic method to arrive at their project ratings. Following is the definition and rating scale used for each evaluation criterion (additional information is available on the IEGWB website: http://worldbank.org/ieg).

Outcome: The extent to which the operation's major relevant objectives were achieved, or are expected to be achieved, efficiently. The rating has three dimensions: relevance, efficacy, and efficiency. Relevance includes relevance of objectives and relevance of design. Relevance of objectives is the extent to which the project's objectives are consistent with the country's current development priorities and with current Bank country and sectoral assistance strategies and corporate goals (expressed in Poverty Reduction Strategy Papers, Country Assistance Strategies, Sector Strategy Papers, Operational Policies). Relevance of design is the extent to which the project's design is consistent with the stated objectives. Efficacy is the extent to which the project's objectives were achieved, or are expected to be achieved, taking into account their relative importance. Efficiency is the extent to which the project achieved, or is expected to achieve, a return higher than the opportunity cost of capital and benefits at least cost compared to alternatives. The efficiency dimension generally is not applied to adjustment operations. Possible ratings for Outcome: Highly Satisfactory, Satisfactory, Moderately Satisfactory, Moderately Unsatisfactory, Unsatisfactory, Highly Unsatisfactory.

Risk to Development Outcome: The risk, at the time of evaluation, that development outcomes (or expected outcomes) will not be maintained (or realized). Possible ratings for Risk to Development Outcome: High Significant, Moderate, Negligible to Low, Not Evaluable.

Bank Performance: The extent to which services provided by the Bank ensured quality at entry of the operation and supported effective implementation through appropriate supervision (including ensuring adequate transition arrangements for regular operation of supported activities after loan/credit closing, toward the achievement of development outcomes. The rating has two dimensions: quality at entry and quality of supervision. Possible ratings for Bank Performance: Highly Satisfactory, Satisfactory, Moderately Satisfactory, Moderately Unsatisfactory, Unsatisfactory, Highly Unsatisfactory.

Borrower Performance: The extent to which the borrower (including the government and implementing agency or agencies) ensured quality of preparation and implementation, and complied with covenants and agreements, toward the achievement of development outcomes. The rating has two dimensions: government performance and implementing agency(ies) performance. Possible ratings for Borrower Performance: Highly Satisfactory, Satisfactory, Moderately Satisfactory, Moderately Unsatisfactory, Unsatisfactory, Highly Unsatisfactory.

Contents

This report was prepared by Ridley Nelson (Consultant), with guidance from John R. Heath and Nalini Kumar (Task Team Leaders). Ridley Nelson assessed the project in February and March 2009. Marie Charles provided administrative support.

Principal Ratings

PHILIPPINES THIRD RURAL FINANCE PROJECT (TRFP)

	*ICR**	*ICR Review**	*PPAR*
Outcome	Satisfactory	Satisfactory	Satisfactory
Institutional Development Impact **			
Risk to Development Outcome	Negligible	Moderate	Moderate
Sustainability ***			
Bank Performance	Satisfactory	Satisfactory	Satisfactory
Borrower Performance	Moderately Satisfactory	Moderately Satisfactory	Moderately Satisfactory

*The Implementation Completion Report (ICR) is a self-evaluation by the responsible operational division of the Bank. The Evaluation Summary (ES) is an intermediate IEGWB product that seeks to independently verify the findings of the ICR.
** As of July 1, 2006, Institutional Development impact is assessed as part of the Outcome rating.
*** As of July 1, 2006, Sustainability has been replaced by Risk to Development Outcome. As the scales are different, the ratings are not directly comparable.

Key Staff Responsible

PHILIPPINES THIRD RURAL FINANCE PROJECT (TRFP)

Project	*Task Manager/Leader*	*Division Chief/ Sector Director*	*Country Director*
Appraisal	Arie Chupak	Geoffrey Fox	Vinay Bhargava
Completion	Iain Shuker	Rahul Raturi	Bert Hofman

Preface

This report is the Project Performance Assessment Reports (PPAR) for the Philippines Third Rural Finance Project (TRFP), which was supported by an IBRD loan of US$150 million to the Land Bank of the Philippines, guaranteed by government. The loan was approved on 3 December, 1998 and closed on 30 September, 2007. There was an extension of 27 months with a US$2.5 million cancellation.

The PPAR was prepared by the Independent Evaluation Group (IEG). It was based on the project completion and appraisal reports, the Development Credit Agreements, a review of Bank files, and discussions with beneficiaries, Bank staff, government officials, non-governmental organizations, institutions, banks, donors, and private sector managers. The cooperation and assistance of all stakeholders, particularly the Land Bank of the Philippines and government officials, is gratefully acknowledged as is the support of the World Bank Country Office in the Philippines.

Following standard IEG procedure, copies of the draft PPAR were sent to the government for their review and comments. Comments are located at Annex D.

Summary

This report assesses the performance of the Philippines Third Rural Finance Project (TRFP). The project became effective at the height of the Asian financial crisis, a difficult time for the Philippines financial sector.

The Bangko Sentral ng Pilipinas (BSP), the Central Bank of the Philippines, manages the bank regulatory environment. Over recent years national accounting standards have been raised. However, at a lower level, the regulation of cooperatives and microfinance intermediaries is still evolving and regulatory capacity is weaker. Outside the banking sector, but significantly impacting on it, the State-Owned Enterprises continue to face major profitability problems and many still have opaque accounting practices.

The two key institutions in the project were the Land Bank of the Philippines (LBP), which served as the borrower and wholesale lender; and the People's Credit and Finance Corporation (PCFC), a non-bank, wholesale corporation for the microfinance component.

The objectives of the project were: (i) to provide financial support to the rural economy to overcome the difficulties created by the regional financial crisis; (ii) to assist the government in its efforts to alleviate rural poverty through the provision of financial and institutional support to the country's micro-finance system; (iii) to strengthen LBP, the main financial institution serving the rural areas and PCFC as the country's main conduit for micro-finance; and (iv) to help to enforce financial discipline on participating financial institutions (PFIs).

Project components were: (i) a line of credit to provide short, medium, and long-term credit channeled through LBP and, for the microfinance component, passed on to PCFC (planned cost, US$213.8 million; actual cost, US$232.3 million); and (ii) institutional strengthening for LBP and PCFC (planned cost, US$2.3 million; actual cost, US$2.7 million).

Project **outcome** is rated satisfactory. The objectives to provide financial support and to strengthen LBP and PCFC were fully achieved. These two are given the highest weighting, given the financial crisis at the time. No impact assessment was carried out to directly measure the project's poverty reduction effects, but there are intermediate indicators which point to a positive impact on low income groups, such as the creation of about 47,000 jobs in sub-sectors typically employing the poor and micro-financing reaching about 110,000 small households, far exceeding appraisal targets. The objective of enforcing financial discipline on PFIs was modestly achieved by the project; it was probably unrealistic to expect otherwise, given that the project funded a very small part of the PFI portfolio. The accredited PFIs exhibited wide variation in quality of reporting, but generally performed adequately with respect to profitability, solvency, and liquidity ratios. Although it is impossible to assess the project's impact on agricultural growth, IEG found field evidence that loans for input manufacture and processing had created significant rural employment for both women and men.

Bank performance is rated satisfactory. The weaknesses in quality at entry were more than offset by strong supervision. Despite the project's poverty alleviation objective, there was no attempt to rigorously evaluate the project's impact on poverty reduction. Also, relative to the scale of the project, there was insufficient support to enhance PFI capacity.

Borrower performance is rated moderately satisfactory. LBP performance was more than satisfactory but the government (through the Department of Finance) failed to adequately control subsidized wholesale lending through DBP, contradicting GOP Executive Order 138. This immediately undercut the lending rates defined in the Bank's loan agreement that had required funds to be on-lent at a weighted average interest rate of 91 day treasury bills.

This was a line-of-credit project channeled through a government owned wholesale bank; not the type of finance project generally designed today. In the absence of the Asian financial crisis, it would have been difficult to justify the line of credit focus. However, injecting medium and longer-term capital into the rural sector, even on a relatively modest scale, was clearly very important at the time, not simply for the provision of longer-term resources, but for overall confidence. LBP was a proven intermediary, well placed to respond to the challenges. Over the longer term, capacity building of intermediary and microfinance institutions will be a bigger priority.

This assessment identifies four major lessons:

- A government-owned bank within a generally sound enabling environment can reach out effectively and efficiently to rural areas through wholesale operations when other private players are still reluctant to take such risks in a challenging sector, and particularly at a challenging economic time. Notwithstanding government ownership, they can be independent enough to counterbalance political pressure to introduce unsustainable credit policies.

- It is important in a rural finance project involving a government owned bank, to analyze explicit and implicit subsidies for both the institution in question and the sector as a whole to ascertain the levelness of the playing field for non-government entrants. In this case, it is still not clear what advantages (or perhaps even net handicaps) LBP holds, and what this might mean for the optimal evolution of a competitive sector over the coming decade.

- When poverty alleviation is stated as a micro-finance objective, it is difficult to assess achievement without some form of beneficiary impact assessment even though, with rural finance, demonstrating causation from such assessments is difficult. Such assessments can also contribute evidence for the design of subsequent phases.

- There is a need for better coordination between the Bank and IFC, and resolution of disputed areas of turf before preparation work on a potential project. The guidelines may need tightening, particularly with respect to mode and timing of coordination, and respective policy roles, and perhaps even some arbitration process. The Guidelines still seem to leave considerable discretion to staff.

Vinod Thomas
Director-General
Evaluation

1. Introduction

1.1 **The Enabling Environment.** The Philippines financial system is heavily dominated by banks, particularly commercial banks (Milo 2007) and this has not changed much over recent decades (see Annex A). Banks are relatively unrestricted in the types of activities they may engage in compared to other Asian countries. The banking sector is regulated by BSP, the securities market by the Securities and Exchange Commission (SEC), and the insurance sector by the Insurance Commission (IC). A Financial Sector Forum was formed in 2004 to coordinate these bodies but it is not a formal organization. The Philippines economy is heavily dominated by a powerful and wealthy political elite flourishing partly due to weak governance. Some observers point to this as the reason why, notwithstanding generally adequate policies and institutions (Rodrik 2003), the Philippines economy has performed relatively poorly. Patronage politics is reported to be widespread. However, observers also note (de Dios and Hutchcroft 2003) that years of deregulation and liberalization have given a more diversified economy and more participants in policy decisions and that, while powerful family conglomerates still exist, their power has been reduced by this increased openness. World Bank governance indicators for 1996 to 2005 (Kaufmann 2006) surprisingly place Philippines and Vietnam at a similar level but with the Philippines showing a significant decline over that period while Vietnam's rating was relatively flat. The priority need in Philippines is seen by a number of observers as being the need to improve the overall performance of government (de Dios and Hutchcroft 2003) and to reduce institutional uncertainty allowing players to better anticipate the rules of the game (Pritchett 2003).

1.2 Within the broader constraints of the environment outlined briefly above, the enabling environment for rural finance is generally adequate with no control on interest rates or imposed lending targets other than some requirements on banks for certain percentages of rural lending. However, there is more to be done in the regulation of microfinance although a consultant for one of the donors found it to be, "one of the better policy environments for microfinance."

1.3 At the time of appraisal in 1998 there were a number of emerging economic problems dictating quick action. GNP growth was decelerating, inflation was above 10 percent, unemployment was over 13 percent, and the fiscal deficit was escalating. The liberalization of capital account transactions that took place in 1992 with a stable nominal exchange rate led to an appreciation of the peso alongside often unhedged dollar-denominated borrowings, causing problems for borrower's following the depreciation in mid-1997.

1.4 **The Land Bank of the Philippines (LBP).**[1] As indicated in the ICR and LBP documents, LBP has had 45 years of experience in lending to the rural sector. It is the fourth largest commercial bank in the Philippines in terms of assets. It has the most extensive branch

1 Fitch Ratings find that LBP's net interest margins are above industry average due to a substantial low-cost deposit base. Due to its rural branch network it has a relatively high cost structure. It is burdened with the costs of financial intermediation for the Agrarian Reform Program. LBP has a high Non Performing Loans reserve level. The bulk of its NPLs arose from the Asian financial crisis. Following the Asian crisis, LBP shifted somewhat away from rural lending towards manufacturing and property development but it was from this that the majority of their nonperforming loans emerged. LBP therefore reverted back towards rural lending. Fitch Ratings of LBP for 2009 give LBP an AA long-term national level rating noting stable core profitability and moderate capitalization. They note that downside risk is mitigated by moderate support from the Government of the Philippines. Although they also note that while the government's propensity to support LBP is likely to be high, its ability to do so may be limited. They anticipate some asset deterioration due to the current crisis but note satisfactory levels of reserves.

network, having branches in all but one of the 81 provinces. LBP is a government-owned policy bank with a universal banking license established in 1963 as part of the Agricultural Land Reform Code.[2] It is involved in both wholesaling and retailing rural credit, a fact that presents some potential conflicts of interest and is of some concern to private banks. LBP was selected as the borrower and the wholesale lending institution of the project. Annex B, Table 1 gives a selection of key indicators; there are more in the ICR.

1.5 LBP's success has been attributed (USAID 2007) to: the sound enabling environment, including a requirement for adequate capital and the mandating of a market orientation in financial policy that reduced political pressure to subsidize lending; the ability to capitalize on its strong performance by persuading Congress to increase its financial capitalization; a huge deposit base as the only government depository bank with a large network giving it a virtual monopoly over the deposits of Local Government Units (LGUs);[3] strong risk management (arising partly from the technical assistance from donors such as the World Bank); portfolio diversification, capacity building assistance to strengthen client businesses including marketing capacity; and good deposit mobilization (about US$3.2 billion in 2005). Challenges ahead noted by USAID include the tension between wholesale and retail lending and the risk of "adverse selection" with loan officers giving excessive preference to a limited number of regular "easy" clients.

1.6 LBP is involved in a wide array of services including collection and tax management services to government, commercial banking, trust banking, corporate lending, investment banking, deposit products, consumer finance, remittance services (in USA and Italy), insurance, brokerage, leasing, real estate development, and marketing assistance. The net implicit subsidy effect, especially of the captive LGU deposits, warranted better analysis at appraisal. LBP's dividend to government is imposed upon it. This has been an area of uncertainty because, although the law requires a payment of 50 percent of the previous year's net income, in practice it has been a matter for annual negotiation.[4]

1.7 **The People's Credit and Finance Corporation (PCFC).** PCFC was the project's conduit for on-lending LBP funds to participating MFIs. It is a government owned and controlled corporation whose vision is to be the leader in the provision of microfinance products and services, was selected as the microfinance wholesaler under the project. PCFC is not a bank and cannot take deposits. It is a finance corporation registered with the Securities and Exchange Commission. It was established in 1995, only two years before the project, to provide financial services to the poor and later was given the mandate for the delivery of micro-finance services for the poor. PCFC's performance ratios are given in Annex B, Table 2.

1.8 Over the period of the project, PCFC has been strengthened in many respects, although there remain concerns about the longer term sustainability of an institution playing this role that cannot take deposits.

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2 It is important to understand that the staff of LBP are civil servants and subject to the same incentives and rules as other civil servants including the same level of job security, pension rights, rights of appeal and similar pay scales.
3 These include District and Provincial government departments.
4 As part of the Borrower response to the draft report, LBP commented: "LBP, being a government financial institution is required by law to declare 50 percent of its income from the previous year as dividend to the National Government. LBP always manages to negotiate for a lower dividend rate with the Department of Finance. For the last five years (2004 to 2008), the cash dividend rate averaged 25 percent of its net income and a total of P 1.1 billion stock dividends have been declared".

1.9 **Microfinance.** The government initiated an improved policy environment for microfinance through the National Strategy for Microfinance, the General banking Law of 2000, the Agriculture and Fisheries Modernization Act (market orientation of credit), and Executive Order 138 (phased out subsidized directed credit in the non-agriculture sector).[5] However, over the period of the project there were, and still remain, a number of regulatory issues with respect to land and microfinance (Llanto 2004 and 2007). These include: (i) the prohibition against mortgaging/selling land within 10 years of its award; (ii) a 5 ha ceiling on ownership; (iii) the designation of government as the sole buyer of awarded lands under the land redistribution program; (iv) a prohibition against tenancy arrangements; (v) the general demise of land markets due to agrarian reform; (vi) lack of an efficient mechanism to resolve land disputes; (vii) lack of information needed by courts to hear land cases. With respect to risk, crop insurance exists on a small scale but, as in so many other countries, has suffered from covariant risks due to lack of diversity.

1.10 RFIII followed immediately after RFII. Both RFI and RFII had been rated Satisfactory by IEG although Institutional Development was rated only Modest due mainly to LBP's inability to cut losses in the agrarian reform loan portfolio, the ad hoc basis of the dividend payable to GOP, and the application of GOP own funds to targeted lending at below market interest rates when political pressures were great enough. (These are all concerns that have remained to a greater or lesser extent under RFIII; however, pressures for below market rates may now be reduced.) At the time of appraisal, there were two other projects relevant to the financial sector, the Banking System Reform Loan and the Private Enterprise Credit Support Project.

1.11 There are a number of other donors who have supported rural finance over the last 10 years including particularly JICA (through DBP), KfW, ADB, and USAID. The majority have focused on microfinance.

1.12 Donor coordination is considered adequate by most respondents consulted by IEG. There is a Philippines Development Forum that includes government and meets regularly and has a number of thematic or sectoral subcommittees. However, in discussion, one donor staffer mentioned that insufficient action emerged from such meetings.

2. The Project

Objectives

2.1 The objectives of the project as stated in the Project Appraisal Document (PAD) were to:

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5 BSP Circulars on microfinance include: Circular 272 (2001) - Guidelines on General Banking Law; Secular 273 (2001) to Allow Entry of Microfinance Oriented Banks; Circular 282 (2001) - Guidelines on Rediscounting Facility; Circular 324 (2002) Expansion of Rediscounting Facility; Circular 340 (2002) Regulations for the Establishment of Branches; Circular 364 (2003) Reduction of Risk Weight for SMEs; Circular 365 and 369 (2003) Amendment of 340; Circular 374 (2003) Regulations for Barangay Microbusiness Enterprises Act; Circular 409 (2003) Regulations for Micro-financing Operations of Banks; Circular 501 (2005) Rules on the Writing off of Loans; Circular 547 (2006) Amendments on Government Borrowings; Circular 549 (2006) Amendment to the Manual of Regulations for Banks.

(a) provide financial support to the rural economy to overcome the difficulties created by the regional financial crisis;

(b) assist the government in its efforts to alleviate rural poverty through the provision of financial and institutional support to the country's micro-finance system;

(c) strengthen the Land Bank of the Philippines (LDP) as the main financial institution serving the rural areas and the People's Credit and Finance Corporation (PCFC) as the country's main conduit for micro-finance; and,

(d) help to enforce financial discipline on Participating Financial Institutions (PFIs).

2.2 These objectives were not changed over the life of the project. The Key Project Indicators (KPI) did not fully reflect all aspects of the objectives. While objectives (a), (c) and (d) were largely reflected in the KPI, there were no indicators related to rural poverty impact and some lack of indicators demonstrating institutional capacity changes of the type that might be observed by clients or managers, for example, days for loan approval or loans handled per loan officer.

Project Design

2.3 Total Project Costs were US$216 million of which the Bank loan was US$150 million (69%). There were two components:

(a) Line of Credit Component (Planned Total Costs US$213.8 million; actual US$232.3 million).[6] This was a line of credit to provide short, medium, and long-term credit channeled through LBP and, for the microfinance sub-component, passed on to PCFC. The micro-finance component had a planned project cost of US$6.7 million but an actual of US $18.0 million (increased during implementation).
(b) Institutional Strengthening Component (Planned Total Costs US$2.3 million; actual US$2.7 million). This component was for strengthening both LBP and PCFC but it was fully financed by the two institutions themselves.

2.4 The project had no direct policy component. Policies were considered generally sound including freely negotiated lending rates. As indicated in the ICR, there were some revisions to the balance of these components during implementation mainly due to increases in microfinance and also for the convenience of tracking. The micro-finance element of the Line of Credit Component was increased by US$15 million and the LBP retail lending facility to its own clients, the Retail Countryside Fund (RCF II) that did more restructuring and expansion of existing, small-scale businesses, and had a stronger agricultural focus than the wholesale Countryside Loan Fund III (CLFIII), was greatly increased, by US$20 million. This was agreed by the Bank to adjust for the cautious lending by PFIs to Small and Medium Enterprises. Thus, by 2006, the wholesale lending subcomponent was down to US$97.5 million equivalent.

6 Due to some interchange in the content between components (but with no overall objectives shift) it has not been possible to exactly reconcile the component costs as indicated in the Staff Appraisal Report (SAR) with the cost tables in the Implementation Completion Report.

2.5 **Extensions.** The project closed 27 months behind the original schedule partly due to the slow startup which, in turn, was caused partly by the surprise under-cutting by the Development Bank of the Philippines (DBP) donor-supported project (see later discussion under Borrower Performance).

1. **Implementation and Challenges.** Annex B briefly provides additional background and detail on the situation at the time and the structure of the financial system. The project faced difficult challenges with the Asian crisis. As noted in the Introduction, at the time of appraisal GNP growth was decelerating, inflation and unemployment were high, and the fiscal deficit was escalating. There had been an appreciation of the peso alongside often unhedged dollar-denominated borrowings, causing problems for borrower's following the depreciation in mid-1997. In order to protect their balance sheets, banks were inclined to pursue a general credit squeeze rather than pro-actively seek out good borrowers. Re-establishing confidence was an important element of the project's and LBP's role. With struggling institutions the first years of project implementation were particularly challenging and supervision input at that time from the Bank was very important.

Appraisal and Quality at Entry

2.6 The Quality Assurance Group (QAG) reviewed Quality at Entry (QAE) and rated it Satisfactory. As discussed later under Bank Performance, this is downgraded in this assessment to Moderately Satisfactory due to lack of an Impact Study, need for a wider analysis of LBP's place in the sector, limited support for training, and somewhat narrow indicators.

2.7 As required, the PAD discussed the project alternatives but essentially only one, the option to lend to several retail financial institutions rather than a single wholesale institution. It would have been useful for Bank management to have been offered, in addition to this, more argument on the broader issue of a very dominant government-owned bank, possibly at least implicitly subsidized, within an expanding population of quite promising private banks and non-bank institutions.

2.8 While this assessment largely accepts the relevance of the design at the time of appraisal, there are some questions about the resilience of that design up to the end of the project. This is taken up again more fully under the heading Relevance.

3. Performance Ratings

OUTCOME

3.1 As with IEG's ratings of RFI and II, Outcome is rated, on balance, **Satisfactory** due to Substantial Relevance, Efficacy and Efficiency but, as in those cases, not without some areas of reservation.

RELEVANCE

3.2 Out of the main three evaluation ratings of Relevance, Efficacy and Efficiency, the most questions arise over Relevance, mainly relevance of design. However, on balance, and after consideration of counterfactuals, Relevance is rated Substantial.

3.3 **Relevance of Objectives.** It is recalled that the objectives had four parts (summarized): to provide financial support to the rural economy to overcome the regional financial crisis; to assist the government to alleviate rural poverty; to strengthen the Land Bank and the People's Credit and Finance Corporation (PCFC); and to help enforce financial discipline on PFIs. These were broadly consistent with the relevant CASs at the time. The 1996 CAS (pre-the Asian financial crisis), under the Rural Development category, proposed "improved access to credit and increase employment among poor upland and lowland farmers" and "improvement of rural financial intermediation." However, the CAS mentioned in the assistance strategy matrix the Second Rural Finance Project but not a third, suggesting that the third was at least partly a response to the crisis that followed while also, as noted in the ICR, continuing the institutional strengthening of LBP against a new financial challenge. The 1999 CAS (post the crisis but only just after the approval date), set as priorities: to address the crisis, to enable expansion of the private sector, and, to pursue sustainable rural development.

3.4 **Relevance of Design.** The relevance of project design is judged in this section against the background of the Asian financial crisis at the time of appraisal and the importance of Bank presence and skills in the sector at that time. Deducing a theory-based evaluation logic, the first objective suggests that the solution to the problems within the rural finance sector that arose from the financial crisis was seen as the provision of a line of credit that would enable a recovery of lending to the rural sector particularly through longer-term lending and restructuring of loans to still viable enterprises under temporary stress. The mission found evidence in field visits that the line of credit, particularly due to the longer terms than competitors and the availability for restructured loans, enabled clients to borrow when other banks were, as one LBP client put it, "nowhere to be seen". However, at the core of the problem lay the fact that there were firms and banks in financial trouble partly related to un-hedged foreign currency loans and banks with already insufficient loan loss provisioning were de-leveraging, reducing risk, and opting for safer T bills.[7] The Line of Credit (LOC) was, at the time, a palliative but could not alone resolve the underlying issues. However, the objectives to strengthen LBP and PCFC and to help enforce financial discipline on Participating Financial Institutions (PFIs) did start to address one modest piece of the underlying vulnerability of financial institutions to future shocks. Obviously, the current global crisis represents a renewed test of how far this overall financial reform and strengthening was achieved but it is still too early to assess that although there are expectations of bank mergers.

3.5 While the project design, with its microfinance component, was not inconsistent with the later Bank's 2003 Rural Financial Services Strategy, particularly given the exigencies of the Asian financial crisis, the support to MFIs was relatively more limited as a proportion of the whole than that strategy would suggest. But that strategy, a product of the prior "Reaching the Rural Poor" Bank strategy, came five years after the project was approved.

3.6 While relevance of design was found to be generally sound, this assessment finds four areas of weakness and expands on some of them in the subsequent paragraphs. First, and by far the most significant, the design should have included an impact study to assess poverty impact since poverty alleviation was both an explicit objective of one of the components and a broader

7 There are, of course, echoes of such strategies in US and European bank behavior under the current global financial crisis.

objective of the CAS. Second, a wider analysis of LBP's place in the sector and advantages (or penalty) from its public ownership would have helped to better set the lead institution in sectoral context and might possibly have altered project design or policy focus. This is a study still worth doing. Third, the project design gave limited training support for the strengthening of PFIs or NGOs and groups; the main focus was on LBP and PCFC, yet much of the rural finance constraint in rural areas, both then and now, lies with institutional capacity and skills. It was too optimistic to expect that the pressures of accreditation along with the existing training capacity of LBP and PCFC, in any case of uncertain additionality since these were partly on-going programs, would address skills development sufficiently. Fourth, the indicators were somewhat narrowly focused on the two wholesale institutions. Some indicators tracking the sector as a whole and on the performance of PFIs would have aided decision-making. While some of this data was available from LBP accounts and MIS, placing such criteria into the KPIs would have given higher profile. In the light of these weaknesses, and since this was a third project, notwithstanding many strong elements in project design, Quality at Entry is rated, on balance, Moderately Satisfactory.

3.7 The following paragraphs look at each sub-objective with respect to the relevance of design to that objective.

3.8 On the stated objective to provide financial support to overcome the crisis, channeling the line of credit through a government owned wholesale lending organization was almost certainly the most effective approach for quick action. It was clearly important to inject funds into the rural sector quickly to stem the impact of the crisis. Longer-term lending including some business restructuring was needed. It was, and remained through the life of the project, important to provide a source of stable longer term financing to the rural sector since there was a shortage of long term deposits. Even when the economy improved, while short term financing picked up, longer term financing was still short and in strong demand. However, as mentioned later under Borrower Performance, the objective of longer term lending was initially undercut by the lower cost lending under a DBP loan. We do not fault design or Bank Performance for this, we have faulted GOP. If this subsequent competitive project had been known about at the time of appraisal the design would, no doubt, have been adjusted. Subsequent adjustments by the borrower and the Bank eventually mitigated this competition problem.

3.9 However, there is another aspect of the relevance of the financial support objective. The size of loans in this project covered a very wide range as discussed later.[8] While the crisis gave some justification to support large as well as smaller firms for growth and employment reasons at a time of contracting lending, especially for longer-term loans, this did lead to lending to large firms that, at least later, should have had access to other sources. The Bank would normally seek to be a lender of last resort.

3.10 The objective of relieving poverty was arguably relevant and certainly consistent with the government's stated strategy although in this case it was never assessed with an impact study. However, in the RFI and RFII project IEG PPAR, IEG questioned whether such an objective was realistic for a demand-driven credit project. This assessment finds that, while the objective itself was relevant, the original design focused on poverty to a fairly modest scale. However, this was

8 There were 90 loans to the largest firm asset category that were above an asset size excluding land of about US$1.9 million.

partly due to the Asian crisis and the need to get rapid resumption of growth and employment through medium to large enterprises. During implementation, as the crisis came under control and circumstances changed, funds were shifted significantly towards smaller scale lending.

3.11 The design to meet the objective of strengthening LBP and PCFC was relevant. However, the fact that these are both government owned banks calls for assessment about whether, in this case and at this time, this strengthening exacerbated a tilt in the playing field sufficient to constitute an undue brake on competing private bank development and whether there was too much focus on LBP and PCFC relative to the strengthening of PFIs. In this respect, we note that the vision statements of both institutions suggest an aim to dominate. For example, the LBP Vision Statement includes the language, " ... Landbank shall be the dominant financial institution in countryside development ..." While this would be an entirely appropriate vision for a private bank, it presents something of a moral hazard for a publicly owned institution unless the evidence shows that, in all respects, LBP competes on entirely even terms. It is probable that, over the period of the project in some areas of its activities, LBP held some competitive advantages, although this has been changing over time and, in fact, LBP also claim significant imposed obligations.[9] The Vision Statement of PCFC is somewhat more modest but in the same vein, calling for PCFC to be "the viable and sustainable *leader* (our italics) in the provision of microfinance products and services ..."

3.12 More broadly, by the time the project closed, the development of the financial sector and rural finance within it (with some credit to the project support) had reached a depth and coverage of services that has almost certainly now reduced the social necessity of supporting rural financial services through a publicly owned institution. The question is increasingly now how to enable private banks and other non-bank financial institutions to gain a wider foothold. The project as designed focused somewhat too heavily for the good of the sector on LBP and PCFC relative to potential and actual PFIs so that, with changing circumstances and increased non government owned banking, the design for this particular objective was somewhat less relevant at closing than at appraisal.

3.13 With respect to the relevance of design for the fourth objective of enforcing discipline on PFIs, this was highly relevant, particularly given the emerging financial crisis at the time. However, it carried with it the incentives problem that those PFIs that most needed financial discipline were unlikely to qualify, those who least needed it were likely to qualify, and only those that lay somewhat below the level of the accreditation criteria were likely to be enticed to lift their performance in order to do so. Project design did not offer enough to support skills capacity of PFIs and MFIs. Capacity in risk management is particularly acknowledged as a weakness by PFIs and, to a limited extent, was supported by on-going PCFC training with own funds. In microfinance, the need for skills is identified as a key weakness and area of focus of the USAID Access to Banking Services Program (associated with the Rural Bankers Association of the Philippines). This limited training funding may have been due partly to the fact that this was a loan to the LBP guaranteed by government and therefore a less easy vehicle for channeling training grant funds to other banks including non-PFIs, some competing with LBP.

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9 It would take a substantial study to weigh the benefits and costs of the many government imposed roles but for example, until recently, LBP had a captive deposit source in Local Government Units (LGUs), and an insurance arm that had captive government clientele. On the other hand, they do not, or have not in the past, received sufficient payment for certain imposed services, such as processing tax payments.

EFFICACY

3.14 Efficacy is rated Substantial based on Substantial ratings on three objectives with a high weight given to the financial support objectives but a modest rating on the objective of enforcing discipline on PFIs. With respect to the objective of providing financial support to the rural economy, this was clearly achieved and is rated Substantial. The project almost fully disbursed (with a cancellation of US$2.5 million) and the financial support was given to a level of 131 percent of the target for the predominant CLF III and RCF II lending and to 112 percent of the target for the microfinance MLF element. Based on ICR data, about 90 percent of the total lending amount went to medium to large enterprises with the remainder going to small and micro enterprises. Briefly, the following were the main portfolio characteristics (LBP Progress Report 2007) as at the project closing date of September 30, 2007.[10]

3.15 For the CLFIII component:

- PFI Type: 48 percent of accounts through Commercial Banks; 41 percent through Thrift Banks; 6 percent through non-bank financial institutions; and, 5 percent through Rural Banks.
- Loan Size: by amount released: 42 percent small (below PhP 5 million, about US$96,000), 51 percent medium (PhP5 million to PhP50 million about US$97,000 to US$960,000), and 7 percent large (above PhP50 million (US$960,000). In terms of total amount, 65 percent went to the large asset size group.
- Subloan Maturity: 15 percent short-term, 68 percent medium term, 17 percent long-term.
- Subloan Purpose: 37 percent for fixed assets, 54 percent for working capital, 9 percent a combination.
- Nature of Project: 84 percent business expansionary, 9 percent start-up, 7 percent restructuring.

3.16 For the RCFII Component:[11]

- 75 sub-projects were for loan restructuring, 100 for small business expansion, and 28 new start-up projects.

3.17 For the MLF channeled through 72 MFIs (actual project cost US$18 million):

- Lending was entirely for working capital for both farm and non-farm purposes including both production (crop and livestock, etc.) and services (e.g. retail shops), average loan was US$296 and 92 percent was to women.

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10 Actual project cost of CLFIII and RCFII combined was US$214.3 million, approximately 75 percent CLFIII/25 percent RCFII.

11 At appraisal this was treated as part of the CLFIII component but later, with increased funding, it began to be treated as a separate component.

3.18 Under the MLF covering microfinance, average loan size was about US$250. Thus the majority of lending by amount lent (82 percent) was above the microfinance level but the largest number of loans was for microfinance.

3.19 We give substantial weight to the achievement of this particular financial support objective because both the documents and the design of the project as well as the facts of the financial crisis suggest that this was a major and urgent preoccupation at the time.

3.20 While there were no explicit indicators set for types of capital to be provided, the project was expected to contribute more to fixed asset lending than working capital on the argument that fixed asset investment would have a greater impact on growth than simply annual re-cycling of working capital. Approximately 37% of CLFIII went for fixed assets.

3.21 There is very limited aggregate data on the sector, but to put the scale of the microfinance component in some perspective, there are approximately 4.9 million farmers in the Philippines. It was estimated by USAID in 2008 that rural banks and other microfinance institutions were reaching about a third of the households engaged in micro-business activities. A 2002 study by USAID found a potential demand for microfinance of PhP26 billion against a supply of about PhP 9 billion, suggesting that about one third of the demand was being met at that time. Assuming MLF lending of about PhP1.5 billion over say 6 fully effective years this would put the MLF component at about 3 percent of lending and about 1 percent of total demand.

3.22 On the objective of alleviating poverty, the evidence is predominantly output level evidence rather than outcome evidence. It should be noted (Ledgerwood, J 1999) that defensible outcome evidence on poverty is notoriously problematic with credit programs due to the fungibility issue. In this case, the output evidence for poverty impact such as it is includes the following. The amount of microfinance lending more than doubled over the target and the number of microfinance loans reached approximately 110,000 small household level loans, far beyond the target. However, this was due partly to reflows measured cumulatively over a considerably extended project period. The scale of the LBP retail component RCFII (aimed at smaller-scale businesses with employment impacts, a focus on agricultural production and reaching more remote areas) was more than doubled. Employment creation based on sub-borrower loan documents reached the target and is reported as 16,960 jobs created under the CLFIII and RCFIII components.[12] There were no separate estimates of job creation from the microfinance component. However, PCFC estimates across all its lending indicate approximately one job created for every two clients. The mission observed employment gains of approximately this order of magnitude during field visits with generally expanding businesses (as found in USAID studies) and calculated costs per job created at around US$800.[13] This is somewhat higher in real terms than an estimate by ADB over ten years ago. Based on these estimates, jobs created under the microfinance component would probably lie between about 20,000 and 50,000. It is concluded that the total microfinance employment was of the order of 30,000 and employment impact of the project as a whole would therefore have been about 47,000. The

12 Mission assessment in the field found that the estimates of jobs created reflected the reality quite well although incrementality is always difficult to assess.

13 ADB's second microcredit loan had found by 1996 an average cost of about US$200 per job created. While by 2009 this would be higher due to inflation and economic growth it seems low based on mission findings. Field visits by the mission confirmed that the estimation of truly incremental job creation was not a simple task.

priority sector enterprises,[14] that constituted about two thirds of the total, are generally indicative of relatively poor rural people. Mission field visits found microfinance borrowers to be poor and the majority of those incremental wage earners employed by the larger CLFIII borrowing enterprises to be poor also and in one case, a poultry enterprise, nearly all those employed were women. (The evidence on lending to agriculture, a sector supporting many of the poor, is given in Box 1.)

3.23 However, there was no beneficiary assessment or impact study to assess the poverty levels of beneficiaries. Other things being equal, the lack of data in this case would have allowed only a modest rating to the achievement of this poverty objective. However, the greatly increased scale of micro and small business lending achieved, the very high repayment rate, the predominant lending to women, and the employment evidence based on loan application and loan supervision evidence is just sufficient to support a Substantial poverty impact rating based on output evidence. In making this assessment the difficulty of proving causation in rural credit even with beneficiary surveys has been taken into account.

3.24 With respect to the third objective of strengthening the LBP as the main financial institution serving the rural areas and the PCFC as the country's main conduit for micro-finance, the achievement was Substantial although there are still concerns about PCFC's strength and sustainability since, as a non-bank institution, it cannot take deposits. In this rating more weight is given to the larger institution, LBP. The performance ratios of the two institutions are given in Annex A, Tables 1 and 2. Both institutions had Institutional Development Plans (IDPs) at the outset of the project. LBP has made substantial progress. Most of the strengthening, including internal training programs, in these two institutions was carried out with own funds. As noted under Relevance, while it was not an objective, the project should have supported these two institutions to do more training for PFIs since a main constraint in the expansion of rural financial services is capacity at the lower levels of the system.

3.25 With respect to the fourth objective which was to help to enforce financial discipline on Participating Financial Institutions (PFIs), the ICR found limited impact and this assessment concurs, rating achievement Modest. The number of PFIs, originally expected to be close to 100, was far less, at 32 but with only 20 active at project closing. This was partly a reflection of the competition from DBP's competitive lower rate lending discussed further under Borrower Performance, and partly the continuing impact of the crisis. However, this fourth objective is somewhat discounted in the assessment since it was plainly excessively optimistic that a project design offering very small funding compared to PFI total portfolios at the time could significantly influence PFI management and systems on any scale. Simply meeting the accreditation criteria was probably only a significant incentive for a relatively narrow band of PFIs who were within reach and were complying with their action plans. Those comfortably above the criteria did not face any strong incentive to reach higher and those well below would have had little incentive to strive for something plainly out of reach. Nevertheless, the accredited PFIs, while exhibiting wide variation in quality of reporting, did generally perform adequately with respect to ratios such as profitability, solvency and liquidity. Only one failed to meet payments to LBP. Beyond the pressures that came through accreditation, there was no direct

14 Farmers and fisherfolk, micro enterprises and SMEs, agribusiness, agri-infrastructure, other agri-related projects, and environment related projects, with a smaller percentage of livelihood loans.

provision under the project for enhancing financial discipline. This has been mentioned as a design weakness. In this respect, the wider BSP pressures towards performance due to the regulatory requirements (supported over the years by the Bank) were more significant than the project itself.

Unanticipated Outputs and Outcomes

3.26 **Agricultural Productivity.** There was no stated objective to increase agricultural productivity, however, CASs have consistently discussed the importance of agriculture. There is some evidence that the project contributed to agricultural growth although the relative scale of the project was certainly insufficient to expect to pick this up in national agricultural growth statistics which have been disappointing relative to a number of other countries in the region. It should be emphasized that, although this was labeled a rural finance project, a substantial share of lending went to sub-borrowers with no immediate connection to agriculture, such as investments in hospitals, transport, hotels, printing, and medium-sized manufacturers, although, as required, they were located outside the metropolitan areas. In fact, mission analysis showed that in the category of the larger loans over US$200,000, such loans with no direct agriculture connection constituted over 50 percent by number. However, in many rural provinces the share of household income is now more than 50 percent from non-farm sources. The project was essentially targeted at non-city growth and income not necessarily agriculture although such things as fisheries, poultry, piggeries, aquaculture, grain milling, input manufacture, and agricultural produce transport benefited substantially as confirmed by mission visits.

3.27 **Policy Role.** While not an explicit objective, notwithstanding its ownership by government, LBP has, over the years, been a not unimportant source of financial sector policy pressure on government particularly in the area of counteracting behest lending and interest rate policy. While Bank support seems to have provided some backing to some of the on-going policy debate, this project was not a significant vehicle for national level financial policy dialogue. It focused more at the wholesale institution change.

3.28 **Environment.** While also not an explicit objective, the project made very substantial strides in the incorporation of environmental criteria into rural lending. This was associated with both the strengthening of government regulations and the strengthening of capacity within LBP. The mission was impressed with the extent to which the mitigation of environmental impacts had been internalized within the lending procedures, for all LBP lending not simply the project line of credit. It is very unlikely that this level of environmental focus and subsequent mainstreaming would have emerged from a wholesale bank that was not government owned. Moreover, LBP's performance in this area seems to have impacted on the way other banks handle environmental regulations. This is a significant unintended impact.

EFFICIENCY

3.29 Efficiency is rated Substantial on balance, although, as with most credit projects, evidence is limited. There are three elements to efficiency. First, what the financial and economic returns are for the sub-project loans that were analyzed. Second, what evidence is there, either quantitative or qualitative, for those below the size individually analyzed? Third, how efficient were the participating banks? Fourth, was there additionality?

3.30 No overall project ex ante or ex post economic analysis was done by the PAD or ICR. FRRs were carried out ex ante for all sub-loans over US$200,000 and ERRs over US$1 million. A small sample of 23 FRRs and ERRs was analyzed by LBP ex post based on follow-up visits by LBP staff to borrowers.[15] Although a small sample, it is not clear why this was not used in the ICR. The data show that FRRs fell from the ex ante to the ex post. However, they fell from very high average levels to still mostly high levels but there was a wide range. For the 13 CLFIII loans in the sample the arithmetic average[16] FRR fell from 42 percent to 29 percent, but with 4 of the 13 falling below a 10 percent FRR. For the 10 RCF loans the average fell from 32 percent to 25 percent, with 4 out of 10 falling below a 10 percent FRR. With a somewhat larger sample it could be informative to correlate FRRs with repayment performance but in this case, with high repayment rates, it would be of little value.

3.31 The mission found the value of doing sub-project ERRs ex ante was somewhat questionable from an operational efficiency perspective. LBP staff could not recall any case where an ERR on top of an FRR had changed the lending decision. In any case, nowadays, with fewer distortion adjustments, the FRR and ERR are often very similar.

3.32 **Efficiency of the Micro-finance Component.** With respect to the smaller and micro lending that was not subject to any FRR analysis, a few qualitative points can be made. Based on discussion with PFIs and observations from mission visits, most clients' businesses seemed to be growing, suggesting that the loan had triggered small business growth. While not from the same sample (although there may be some overlap of borrowers) USAID (USAID 2005) came to a similar conclusion in their study of their 2005 Micro-enterprise (MABS) Program, that borrowers have been steadily gaining ground in diversifying their business activities. They have also been steadily increasing their savings. That study concluded that, since repayments were high at 95 percent to the MFIs and savings have been increasing, the loan funds had probably been used efficiently.[17]

3.33 In RFIII, the repayment rate from MFIs to PCFC was close to 100% but this would not necessarily be indicative of the health of the sub loans. The repayment rate to the MFIs was reported as 95 percent[18] which, backed by some field verification, is more indicative of the probable efficient use of the loans.

3.34 Another measure of efficiency would be the unit costs of employment creation. Field visits and some data from LBP and PCFC suggest average costs per job created between about $800 and $13,000 from smaller to larger enterprises. These are approximately in line with industry experience in the Philippines and the levels the PAD had projected. (The higher costs in

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15 The mission was able to rather superficially review the methodology adopted for the FRRs and ERRs and found it broadly sound.

16 Note that the arithmetic average calculated here is not a true representation of the average of all the net benefit streams since it is invalid to average FRRs from different streams. The steams themselves would need to be added together and scale and phasing differences would have an impact. But in the absence of the resources to aggregate the original streams and recalculate a true average this is the next best option. It should be interpreted with care.

17 In that study, sub-borrower lending rates ranged from 18 percent to 48 percent with an average of 28 percent.

18 Project monitoring data shows that about half the microfinance lending was channeled through Rural and Thrift Banks and the rest through Cooperatives, Cooperative Banks, and NGOs. NGOs constituted about 25% of the MLF lending.

the larger enterprises are partly due to substitution of machinery for labor.) The Bank and borrower could have exploited more the data on costs per job created.[19]

3.35 **Efficiency of Institutions.** With respect to the efficiency of institutions, LBP is a generally efficient institution. Its performance is shown in the key indicators in Table 1. These indicators have generally improved over the period of the project and since. Return on Equity rose from 9.3 percent in 2003 to 15.2 percent by August 2008 and Nonperforming Loans (NPL) fell from 14.7 percent in 2003 to 3.6 percent by August 2008. As noted by USAID, LBP's performance is considered to be remarkable considering that it has survived for 45 years without requiring bailouts to avoid bankruptcy as was required by two other government owned banks in the Philippines with less demanding missions. LBP has also performed particularly well in the implementation of environmental requirements.[20]

3.36 PCFC is a moderately efficient institution but the data are not readily comparable with LBP because of the different nature and remit of the institution. It has been able to act as an important guiding wholesale lender over a period when wholesale funding for microfinance was far below demand and microfinance was still in its infancy. The more difficult question, addressed below, is with respect to sustainability.

3.37 **Additionality.** The mission found no convincing evidence in either direction on this question. At the individual borrower level, the majority of those spoken to appeared to have a number of alternative lenders. This is not surprising since they were all expected to be eligible borrowers who would have been eligible in the eyes of most lenders. However, after the Asian financial crisis, many found the project to be the only source of longer-term and restructuring funds and found that other lenders were "nowhere to be seen", suggesting additionality. Looking at the question from a sector perspective to find an incremental spike in lending that might suggest additionality is not useful because the volume of lending through the project was too small[21] to find significance.

RISK TO DEVELOPMENT OUTCOME

3.38 Risk to Development Outcome has several dimensions: the risk that the financial support to the rural sector will not be sustained; the risk that the strengthening of the two wholesale institutions will not be sustained; the risk that the micro-finance elements will neither be sustained nor achieve the intended poverty alleviation; the risk of beneficiaries falling back into poverty if the benefits are not sustained; and the risk that what limited enhancement to financial discipline that was instilled in PFIs will not be sustained. Overall, Risk to Development Outcome is rated **Moderate**.

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19 While one would not expect employment analysis to influence lending decisions, given the ready availability of employment data for the larger loans and the relative ease of getting approximations for the smaller loans, the available employment data with a wide range of costs per job created could have been informative for future rural development interventions and at low marginal cost.

20 In 2008, they received recognition for environmental due diligence from the Association of Development Financing Institutions in Asia and the Pacific.

21 In 2005 the Agricultural Credit Policy Council estimated total loans granted by both government and private banks for agriculture at P525 billion (about US$10 billion) with about P190 billion (about US$4 billion) for agricultural production. At that time about 60 percent came from private banks. Thus the lending under the project was less than 1 percent of the total lending in the sector. However, although the total data by year is not available it would have been a much higher percentage of the medium to long term lending.

3.39 Financial support to the rural sector continues to grow through an ever widening range of intermediaries. Competition in the rural areas is quite intense. The mission heard a number of complaints from different players that a particular bank or NGO had "stolen a client". This assessment expresses some concerns elsewhere about the impact of the dominant position of LBP on the growth of private banking and nonbanking institutions but the fact remains that LBP has been a strong organization providing wholesale financial services.

3.40 With respect to the strengthening of LBP and PCFC, LBP's performance ratios including return on equity, loan loss provisioning, and expanding lending and deposit volumes suggests only a modest risk for the future unless the current global financial turmoil not only impacts on their revenue but triggers a return to greater government pressures for behest loans and subsidized rates.

3.41 As noted in the ICR, the longer term sustainability situation for PCFC is of greater concern. The privatizing of PCFC mentioned in the RFIII PAD never eventuated although it appears to be widely acknowledged that it must be, and will be, done in due course. PCFC has no low-cost deposits sources and depends substantially on donors. It has been profitable with the help of a high share of equity in its total resources and below market interest rates from donors. As indicated by the Subsidy Dependency Index it has been subsidized in most years. It is difficult to see a sustainable future without it being converted into a bank or being absorbed into one of the existing banks. This scenario has already been quite widely discussed and anticipated and seems likely to be the course government would take at the appropriate time. As PCFC is constituted now, the Risk to Development as an institution would be rated High but with the expectation of change in the future, arguably the risk is only Moderate, particularly given the relative ease with which a change in status would be possible. Finally, the Risk to the achievement in enhancing financial discipline in PFIs is High but of low weight in the aggregate rating since the achievement was, in any case, modest.

3.42 With respect to the risk of beneficiaries falling back into poverty, lack of data makes assessment difficult. However, the limited number of small borrowers visited by the mission were mostly impressive in both their ambition and achievement to date in growing their small businesses.

3.43 While, as noted, the proposed fourth project in the series did not materialize, this makes little difference to the rating of Risk to Development since LBP is now such a strong bank. In any case, future development will need to gradually shift focus towards an increasing share of non-government banks in the sector and the building of capacity at lower levels in the system.

BANK PERFORMANCE

3.44 Bank Performance is rated **Satisfactory** overall with some weaknesses in design along with significant strengths but with very strong supervision. In many respects, as in the previous two Rural Finance Projects, Bank staff did an excellent and sustained job of shepherding Philippines rural finance towards a generally stronger and more competitive institutional structure and enabling environment. There was enormous praise for the Bank Task Team Leader from the borrower side.

3.45 **Quality at Entry**. As noted earlier, the Quality Assurance Group (QAG) rating of Quality at Entry was Satisfactory. In project design, Bank staff made a thorough assessment of the apex institutions, drew appropriately from the lessons of global and regional experience and the lessons of the previous two projects. Bank staff brought strong skills in this area. Project objectives were, by and large, realistic with the exceptions noted. Loan conditions were appropriately designed. However, there was a lack of a baseline survey that would have enabled assessment of poverty impact. Environmental elements were particularly strong.

3.46 **Quality of Supervision**. In supervision, Bank performance was strong. It could be argued that the major impact of this project was the technical support provided to the two wholesaling institutions as the project unfolded. Some LBP staff members attribute their perceived relatively strong current position in loan provisioning, that is helping them to combat the impacts of the current global crisis, on the Bank support and advice, against some LBP doubts at the time. Over the series of projects, the borrower observed some differences in the strictness with which agreed standards were applied by the Bank in supervision but no inconsistencies of a serious nature. The Bank practiced due diligence with the apex institutions and PFIs although monitoring of performance evidence from PFIs was weaker. The Bank made a determined effort to sort out with the Department of Finance the interest rate problem with the JBIC loan to DBP.

3.47 However, it is questionable whether the Bank should have acceded to raising the sub-loan ceiling size and firm asset size to accommodate large companies who should have been able to access other sources rather than scarce World Bank funds. This response may have been more related to the slow start due to the DBP competition than to the priorities of the sector. But, on balance, supervision is rated Satisfactory.

3.48 Beyond the period of the RFIII there was a further performance issue that falls outside this rating but needs to be described. Needless to say, there was unhappiness in LBP over the way the proposed RFIV follow-on project was dropped at such a late stage after the raising of expectations and also over the tardiness of the formal written communication about this. This issue of coordination with IFC appears not to have been well handled by either Bank Group party. Much of the preparatory work was completed for this proposed RFIV project, LBP was expecting it, a PHRD grant had been disbursed for technical assistance, and appraisal was anticipated. Bank staff had discussed with IFC staff the possibility of IFC TA support for PFIs as part of the project through a trust fund. IFC working level staff were interested. However, IFC unexpectedly argued from the senior management level that support such as this type of project in the financial sector was IFC's responsibility. There were exchanges at the senior management level of both parties and it was finally agreed that this was IFC's "turf". The Bank guidance on which of the two parties held responsibility revolves partly around the extent to which there is a need for sector dialogue, this being seen as lying outside IFC's remit. In this case, looking at the language of the guidance, it is not entirely clear whether the proposed project fell within IFC's remit or not and under those circumstances the presumption should have been to stay with the status quo set by the preceding project particularly given the extent of preparation work already completed. But, in any case, the collective decision over this "turf battle" seems ill-advised since IFC did not, in fact, proceed to occupy this particular disputed turf. At a minimum, better coordination was needed at an earlier stage. Bank staff report that there is now better coordination with IFC including coordination on the CAS.

BORROWER PERFORMANCE

3.49 Borrower performance is rated, as in the ICR, **Moderately Satisfactory** overall.

3.50 *Government performance* is rated Unsatisfactory due to the failure to initially prevent, or subsequently resolve, the subsidized wholesale lending through DBP by JBIC, contradicting GOP Executive Order 138. This immediately undercut the lending rates defined in the Bank's Loan Agreement that had required funds, as per EO 138, to be on-lent at a weighted average interest rate of 91 day Treasury Bills. In addition, the government did not resolve the inconsistency between the floor on the currency swap rate for the Peso derived from US dollar loans and the floor on the swap rate for the Peso derived from Yen-based loans. Thus, when interest rates dropped, Yen-derived loans were cheaper than US$-derived loans. Department of Finance (DOF) should have ensured that all wholesale lending floor prices were at the same level regardless of currency borrowed. These two problems resulted in a significant handicap in implementing the project against the DBP competition. Had these two things being known in advance, the project would have been designed in a different way.

3.51 Following mission discussion with DOF, it is still not entirely clear how this situation came about. It seems possible that it was simply an inadvertent error by DOF that occurred partly as a result of the very fast (three to four week) appraisal process of JBIC (now JICA after the amalgamation) calling for quick decisions and little time to inform other players. The Bank somehow needs to devise ways of picking up such events earlier.

3.52 Overall, the *implementing agencies' performance* was Satisfactory (defining the agencies as LBP and PCFC). In the case of LBP, performance was exemplary. Other country's institutions (e.g. Vietnam) sent significant numbers of staff to LBP on training visits which were much appreciated. LBP, as the borrower, carried out its assigned task efficiently over a period of difficult challenges and over that period still was able to gain in capacity and efficiency as shown by most of the performance ratios. PCFC performed adequately with the microfinance component and became stronger over the project period. However, as noted in the ICR, their overall operating costs remain quite high for a wholesale operation and sustainability awaits resolution.

MONITORING AND EVALUATION

3.53 Performance of M&E is rated **Substantial**. Monitoring and Evaluation within a financial sector project takes a somewhat different form to M&E of a traditional investment project since much of the monitoring element is related to the quality of the financial institutions' accounts that are the subject of internal control and audit. LBP because of its maturity has strong, long-standing, monitoring capacity. However, in both design and implementation there were weaknesses in poverty monitoring since there was no Impact Study although some PCFC data and some USAID evidence from similar micro-finance interventions give some indirect indications of poverty impact.

3.54 *M&E Design.* The Land Bank, having had two earlier projects, had an established M&E system since 1991 when the first Rural Finance Project was approved. However, we have noted above some lack of breadth in the KPIs agreed with the Bank and this seems to have partly contributed to the lack of a beneficiary impact assessment. For both the participating wholesale

banks, LBP and PCFC, M&E design is rated Substantial mainly due to very thorough data management by LBP.

3.55 *M&E Implementation.* M&E implementation is rated Substantial, indeed for LBP close to High. LBP's reporting is thorough and well presented.[22] The agreed quarterly and semiannual progress reports were submitted promptly and the quality of the reports seen was good. However, there was some weakness in the quality of reporting by PFIs. Inevitably, there was quite wide variation in their skills.

3.56 *M&E Utilization.* As noted by the ICR, the findings of M&E were used in the adjustments of the funding allocations and to make some adjustments at mid-term in the indicators. These were used by both the wholesale banks and, as is evident from supervision files and reports, by World Bank missions that drew on them. Utilization is rated Substantial.

4. Findings and Lessons

4.1 This was a traditional line of credit project channeled through a government owned wholesale bank, not the type of finance project generally designed today. However, it is a case of an efficient publicly owned banking institution satisfactorily wholesaling credit to the rural sector. In the absence of the Asian financial crisis, it would have been difficult to justify the predominant line of credit focus. One would have expected more focus on capacity building of intermediary and microfinance institutions, on building absorptive capacity and demand, and arguably more attention to further leveling of the playing field for competitors. However, injecting moderate amounts of medium and longer-term capital into the rural sector was clearly very important at the time and LBP was a strong, available and proven vehicle.

4.2 It would have helped strategic decisions if the Bank had better understood several issues including: the place of LBP within the sector with respect to the levelness of the playing field and the probable implicit net LBP subsidies and competitive advantages through their captive deposits and various other government programs; and, more broadly, the role of other government and nongovernment banking and microfinance institutions in channeling different types of funding to the sector.[23]

4.3 It would also have helped, particularly given the current circumstances and the need for employment creation, to better understand data related to the efficiency of employment generation from different types of enterprise and the growth and equity impacts of that employment. The apparent wide ranges of costs per job created and financial returns offer fertile ground for analysis. This is particularly so in an only moderately targeted project design that seems to exhibit some ambivalence about whether to lend to the poor or the less poor, where to place the boundaries of "non-rural", and whether to lend for large or small enterprises.

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22 Their website is indicative of their reporting and information sharing capacity.

23 The Bank Region points out that the Subsidy Dependency Index for LBP was closely monitored and improved over time and now shows a negative subsidy. This is correct. However, IEG's concern lay more in the possible implicit advantages that LBP held over the project period with its captive government services. Such advantages do not show up in SDIs. They also argue that the combination of wholesale and retail lending worked well to both encourage private sector bank expansion and to reach remote areas. IEG has concerns, as do some other players and academics, about the conflict of interest in being a wholesaler and a retailer competitor to those receiving wholesale funds, an issue referred to in the World Bank's operational policy.

4.4 The utilization of LBP as the wholesale bank was sound at the time. However, as the rural financial sector has been evolving rapidly over the period of the project, circumstances have changed. If the Bank were to support a further rural finance project, the role of LBP in the sector would warrant re-examination although it would remain a serious contender for support because of its exceptional capacity and ongoing attention to enhancing efficiency and modernization. But deeper analysis may show it to have significant net benefits[24] over competitors conferred by its government-owned status. This may be less healthy in the future for growth in the rural finance sector as a whole. On the other hand, the judgment should not be one of principle but of the effectiveness and efficiency facts, not all of which were sufficiently understood at appraisal.

4.5 The main lessons are the following:[25]

(i) A government-owned bank within a generally sound enabling environment can reach out effectively and efficiently to rural areas through wholesale operations when other private players are still reluctant to take such risks in a challenging sector and particularly at a challenging economic time. Notwithstanding government ownership, they can be independent enough to also serve as a useful counterbalance to government and political pressures towards unsustainable credit policies.

(ii) It is important in a rural finance project involving a government owned bank, to analyze explicit and implicit subsidies for both the institution in question and the sector as a whole to ascertain the levelness of the playing field for non-government entrants. In this case, it is still not clear what advantages (or perhaps even net handicaps) LBP holds and what this might mean for the optimal evolution of a competitive sector over the coming decade.

(iii) When poverty alleviation is stated as a micro-finance objective it is difficult to assess achievement without some form of beneficiary impact assessment even though, with

24 We use the term "net benefits" advisedly since it is clear that LBP's government ownership status confers on it significant costs as well as significant benefits. Without substantial study is not clear how balanced or unbalanced these costs and benefits may be.

25 It is worth recalling the main lessons of the IEG assessment of Rural Finance I and II. Summarized, these were (in parenthesis comments of this current assessment are added): (i) Project focus should be as narrow as possible to achieve the objectives but broad enough to include elements important to long-run sustainability. The narrowing of focus that took place between RFI and RFII was good in that it was more realistic about what could be accomplished. However, it was bad to the extent that it avoided dealing with policies potentially important for project success. (Still a dilemma with trade-offs, but RFIII probably erred somewhat on being too narrow in microfinance/capacity building.) (ii) Financial liberalization is more than just the controlling of interest rates. This refers to the lack of a level playing field with subsidized interest rates for certain classes of borrowers and the BSP continued intervention in branching decisions by banks that satisfied regulatory requirements. (Branching decisions now less constrained but this assessment still urges better analysis of the levelness of the playing field with respect to LBP role.) (iii) The sustainability of credit operations requires ongoing access to funding and credit projects should include incentives and monitor and promote this. This refers to the need for more attention to rewarding deposit mobilization by PFIs. (Still arguably an area for greater attention in rural areas but electronic banking is rapidly moving in this direction to ease deposit making.) (iv) Poverty alleviation and environmental objectives may exceed the reach of a project designed to meet market based demand driven credit needs. (The evidence suggests that environmental objectives were quite well achieved under RFIII suggesting that such an objective did not exceed the reach of the project. Poverty alleviation to a modest level probably also did not exceed the reach of the project and probably occurred but was inadequately measured.)

rural finance, demonstrating causation from such assessments is difficult. Such assessments can also contribute evidence for the design of subsequent phases.

(iv) There is a need for better coordination between the Bank and IFC and resolution of disputed areas of turf before preparation work on a potential project. The Guidelines may need tightening particularly with respect to mode and timing of coordination and respective policy roles and perhaps even some arbitration process. The Guidelines still seem to leave considerable discretion to staff.[26]

26 This lesson was inspired by an event after RFIII closed (see paragraph 3.48 above).

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Note: This reference list does not include all the World Bank CASs, PADs, ICRs, and PPARs referred to for the lending programs and agriculture projects.

Annex A. Basic Data Sheet

PHILIPPINES: Third Rural Finance Project (IBRD-44130)

Key Project Data *(amounts in US$ million)*

	Appraisal estimate	*Actual or current estimate*	*Actual as % of appraisal estimate*
Loan/Credit amount	150	147.5	98
PFIs/MFIs	21.4	31.7	148
SBs	42.4	53.1	125
PCFC	0.3	0.5	167
LBP	2.0	2.2	110
Total project costs	216.1	235.0	109

Project Dates

	Original	*Actual*
Concept Review	04/16/1998	04/16/1998
Begin Appraisal	07/01/1998	07/01/1998
Board approval	12/03/1998	12/03/1998
Signing	12/11/1998	12/11/1998
Effectiveness	05/06/1999	05/06/1999
Restructuring	--	--
Mid-term Review	--	--
Closing date	06/30/2005	09/30/2007

Mission Data

Bank Lending and Implementation Support/Supervision Processes

Task Team Members

Names	Title	Unit	Responsibility/Specialty
Lending			
Arie Chupak	Sr. Fin. Analyst	EASRE	Task Team Leader
Wijaya Wickerma	Fin. Mgmt. Spec.	EASRE	Fin. Mgmt
Cecilia Vales	Operations Officer	EAPCO	Procurement/Disbursement
Vimala Abraham	Disbursement Officer	LOADM	Disbursement
Hoi-Chan Nguyen	Legal Counsel	LEGEA	Legal
Brenda Phillips	Program Assistant	EASRE	Program Asst.
Paul Harrison	Consultant		Agric. Econ. And Banking

			Spec.
Gilbert Llanto	Consultant		Fin. Econ. And Micro-Fin. Spec.
Yaacov Ziv	Consultant		Env. Spec.
Supervision/ICR			
Arie Chupak	Sr. Financial Analyst	EASRE	Task Team Leader
Lisa Valenzuela	Micro-Finance Spec.	EASRE	Task Team Leader/Micro-Finance
Xiaolan Wang	Operation Officer	EASRE	Micro Finance
Guzman Garcia-Rivero	Operations Officer	EAPRE	Advisor
Steven Oliver	Sr. Agric. Economist	EASRE	ICR Preparation
Iain Shuker	Agric. Economist	EASRE	Task Team Leader/Agric. Economist
Sameer Goyal	Sr. Financial Sector Spec.	EASPF	Financial Sector
Preselyn Abella	Fin. Mgmt. Spec.	EAPCO	Fin. Management Spec.
Yaacov Ziv	Consultant		Environmental Spec.
Paul Harrison	Consultant		Agric. Econ. and Banking Spec.
Gilbert Llanto	Consultant		Fin. Econ. And Micro-Finance Spec.
The Dzung Nguyen	Oper. Officer	EASVS	Oper. Officer
Joel Syquia	Consultant		Procurement
Noel Sta. Ines	Procurement Spec.	EAPCO	Proc. Officer
Josefo Tuyor	Oper. Officer	EASRE	Env. Spec.
Maya Gabriela Q. Villaluz	Oper. Officer	EASRE	Env. Spec.
Irene L. Villapando	Consultant		M&E Spec.

Annex B. Background, Enabling Environment and Institutions

1. **Agriculture.** Agriculture, including Fisheries and Forestry, constitutes about 20 percent of GDP and about 35 percent of employment. Agricultural growth has been relatively modest over the last two decades averaging 1.7 percent over the period 1981 to 2003 compared to a GDP growth over that period of 2.6 percent. However, from about 1998 there was some improvement. The productivity of labor is low partly due to high levels of underemployment (Mudlak, Larson, and Butzer 2002).

2. **The Enabling Environment.** The Philippines financial system is heavily dominated by banks, particularly commercial banks (Milo 2007) and this has not changed much over recent decades. Banks are relatively unrestricted in the types of activities they may engage in compared to other Asian countries. The banking sector is regulated by BSP, the securities market by the Securities and Exchange Commission (SEC), and the insurance sector by the Insurance Commission (IC). A Financial Sector Forum was formed in 2004 to coordinate these bodies but it is not a formal organization. The Philippines economy is heavily dominated by a powerful and wealthy political elite flourishing partly due to weak governance. Some observers point to this as the reason why, notwithstanding generally adequate policies and institutions (Rodrik 2003), the Philippines economy has performed relatively poorly, for example compared to Vietnam. Patronage politics is reported to be widespread. However, observers also note (de Dios and Hutchcroft 2003) that years of deregulation and liberalization have given a more diversified economy and more participants in policy decisions and that, while powerful family conglomerates still exist, their power has been reduced by this increased openness. World Bank governance indicators for 1996 to 2005 (Kaufmann 2006) surprisingly place Philippines and Vietnam at a similar level but with the Philippines showing a significant decline over that period while Vietnam's rating was relatively flat. The priority need in Philippines is seen by a number of observers as being the need to improve the overall performance of government (de Dios and Hutchcroft 2003) and to reduce institutional uncertainty allowing players to better anticipate the rules of the game (Pritchett 2003).

3. Within the broader constraints of the environment outlined briefly above, the enabling environment for rural finance is generally adequate with no control on interest rates or imposed lending targets other than some requirements on banks for certain percentages of rural lending. However, there is more to be done particularly in microfinance although a consultant for one of the donors found it to be, "one of the better policy environments for microfinance."

4. However, at the time of appraisal there were a number of emerging economic problems dictating quick action. GNP growth was decelerating, inflation was above 10 percent, unemployment was over 13 percent, and the fiscal deficit was escalating. The liberalization of capital account transactions that took place in 1992 with a stable nominal exchange rate led to an appreciation of the peso alongside often unhedged dollar-denominated borrowings, causing problems for borrower's following the depreciation in mid-1997.

5. Compared to the 1980s, by the time of appraisal, there had been nearly a tripling of the number of banks operating in the country. Following the Asian crisis in 1997, there was an increase in nonperforming loans contributing to a credit squeeze in the rural economy. In order to

protect their balance sheets, banks were inclined to pursue a general credit squeeze rather than seek out the good firms from the bad.

6. There are three regulators in the system. Banks are regulated by BSP, cooperatives are regulated by the Cooperative Development Authority, and NGOs are regulated by the SEC. BSP regulations are generally sound and implemented. These include regulations for the review of portfolios and other risk assets, Risk Assets to Equity Ratio, minimum capital requirements, the definition of past due loan accounts, loan classifications, minimum net equity base, and provisioning for loan losses. However, the other two regulatory institutions are still quite weak. A Credit Bureau/Registry has been approved and is expected to be operational by next year although, for larger borrowers, there are already private credit agencies.

7. The banking system in the Philippines has changed substantially over the last two decades. At the start of the Rural Finance III Project there would were 54 commercial banks operating in the country including 14 foreign banks against only 27 commercial banks in 1980. At the start of the project, universal and commercial banks accounted for approximately 80 percent of the assets of the banking system while thrift and rural banks accounted for the remaining 20 percent. The profitability of commercial banks had improved by 1996 at approximately 18 percent on equity and 2 percent on assets but with the crisis this declined the following year to about 15 percent and 1.6 percent respectively.

8. Interest rates are largely based on prevailing market rates but there is intermittent political pressure to reduce rates. The agrarian loans for land acquisition are handled under a separate program and, for example, in 2008, under the Rice Productivity Program, concessional interest rates were adopted for farmer's organizations (8.5 percent) and SMEs conduits (7 percent). At various times within the last 5 years there have been interest free or subsidized loans through the Department of Agriculture, for example, through the Agricultural Competitiveness Enhancement Fund. Last year, interest rates to cooperatives were lowered for social policy reasons. Within LBP's portfolio there are a number of different windows of directed credit aimed at particular purposes, for example the lending to Local Government Units (LGUs).

9. In most areas there is no land title and the only options for a lender for some degree of security are vicinity maps, location plans, tax declarations, realty tax evidence, or affidavits of neighbors.

10. Outside the banking sector, but significantly impacting on it, the State-Owned Enterprises still face major profitability problems and typically have opaque accounting practices.

11. **The Land Bank of the Philippines (LBP).**[27] LBP is a government-owned policy bank with a universal banking license established in 1963 as part of the Agricultural Land Reform

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27 Fitch Ratings find that LBP provides financing at sub-commercial rates but that its net interest margins are above industry average due to a substantial low-cost deposit base. Due to its rural branch network it has a relatively high cost structure. It is burdened with the costs of financial intermediation for the CARP. LBP has a high Non Performing Loans reserve level. The bulk of its NPLs arose from the Asian financial crisis. Following the Asian crisis, LBP shifted somewhat away from rural lending towards manufacturing and property development but it was from this that the majority of their nonperforming loans emerged. LBP therefore reverted back towards rural lending. Fitch Ratings of LBP for 2009 give LBP an AA long-term national level rating noting stable core

Code. It is involved in both wholesaling and retailing rural credit, a fact that presents some potential conflicts of interest and is of some concern to private banks. LBP was selected as the borrower and the wholesale lending institution of the project. In 1988, the Comprehensive Agrarian Reform Law was signed and became the legal basis for the Comprehensive Agrarian Reform Program (CARP) for which LBP is the financial intermediary. In 1995 it became an official government depository thereby giving it access to deposit funds from the government and government linked bodies.

12. By December 1997 LBP's available resources had reached approximately US$4.0 billion. The main source of funds was government deposits which constituted at that time 46% of total resources. Private deposits amounted to 24% of total resources and bills payable including loans from WB, ADB, OECF and IFAD, represented 11%. On the asset side, cash and investment in government securities totaled 31% of assets and net loans amounted to 59%. There was 4% in non-government securities. LBP premises and other fixed assets represented 2% and other assets 4%.

13. As indicated in the ICR and LBP documents, LBP has had 45 years of experience in lending to the rural sector. It is the fourth largest commercial bank in the Philippines in terms of assets. It has the most extensive branch network, having branches in all but one of the 81 provinces. Deposits have risen steadily to P334 billion by end of 2008 with deposits from government increasing somewhat more than deposits from private depositors. Assets reached P434 billion by the end of 2008 and total loan portfolio about P185 billion. Return on Equity rose from 9.3 percent in 2003 to 15.6 percent by end of 2008. Capital Adequacy Ratio (CAR) held fairly steady from 2003 to 2008 at 14-15 percent, well above the BSP's requirement of 10 percent and the Basle 2 requirement of 8 percent. LBP's Liquidity Ratio had been healthy even prior to the project. In 1999, it was about 58 percent. By the time of project closing it had reached about 79 percent. Nonperforming Loans (NPL) fell from 14.7 percent in 2003 to 2.9 percent by end of 2008 thus improving to the pre-1997 Asian crisis level after a difficult period. As of September 2007, the past due loans level stood at 1.58 percent. By 2007, 72 percent of loans by amount went to the designated priority sectors, i.e. to farmers, fisherfolk, micro and SMEs, agribusiness, agri-infrastructure (to Local Government Units), agri-projects (to government owned corporations), environment-related projects, and livelihood loans.

14. LBP's success has been attributed (USAID 2007) to a number of things including: generally sound enabling environment including a requirement for adequate capital and the mandating of a market orientation in financial policy that reduced political pressure to subsidize lending; the ability to capitalize on its strong performance by persuading Congress to increase its financial capitalization; a huge deposit base as the only government depository bank with a large network giving it a virtual monopoly of LGU deposits; strong risk management (arising partly from the knowledge support from donors such as the World Bank); portfolio diversification, capacity building assistance to strengthen clients including marketing capacity; and good deposit mobilization (about US$3.2 billion in 2005). Challenges ahead noted by USAID include the

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profitability and moderate capitalization. They note that downside risk is mitigated by moderate support from the Government of the Philippines. Although they also note that while the government's propensity to support LBP is likely to be high, its ability to do so may be limited. They anticipate some asset deterioration due to the current crisis but note satisfactory levels of reserves.

tension between wholesale and retail lending and the risk of "adverse selection" with loan officers giving excessive preference to a limited number of regular "easy" clients.

15. As documented in LBP's Annual Reports, LBP is involved in a wide array of services including collection and tax management services to government, commercial banking, trust banking, corporate lending, investment banking, deposit products, consumer finance, remittance services (in USA and Italy),insurance, brokerage, leasing, real estate development, and marketing assistance. The net implicit subsidy effect, especially of the captive LGU deposits warranted better analysis at appraisal.

16. LBP's performance improved over the project period in most respects. By project closing in 2007, Real Return on Equity had reached 12 percent, Real Growth in Equity 14 percent, the Subsidy Dependency Index reached negative 12% (however the Agrarian Reform SDI was still significantly positive at 23 percent), the proportion of loans to priority sectors had steadily increased to 69 percent (in 2000 it was 36 percent), Non-Performing Asset Provisions Coverage had reached 74 percent, on the Countryside Loan Fund the past-due ratio was 1.58 percent.

17. LBP's dividend to government is imposed upon it. This has been an area of uncertainty because, although the law requires a payment of 50 percent of the previous year's net income, in practice it has been a matter for annual negotiation.[28] As indicated in the PAD, at the time of appraisal, there remained a need for civil service reform, more prompt audit submission in some projects, deepening of the capital market, contractual savings reform, strengthening of banking regulations in some areas, and enhancement of the regulatory environment for private sector participation in infrastructure. With respect to risk but subsequent to project appraisal, Philippine national regulators had developed the Internal Credit Risk Rating System, a scale system. This was adopted by LBP.

18. The government created a favorable policy environment for microfinance through the National Strategy for Microfinance, the General banking Law of 2000, the Agriculture and Fisheries Modernization Act (market orientation of credit), and Executive Order 138 (phased out subsidized directed credit in the non-agriculture sector).[29] However, over the period of the project there were, and still remain, a number of regulatory issues with respect to microfinance (Llanto 2004). These include (Llanto 2007): (i) the prohibition against mortgaging/selling land within 10 years of its award; (ii) a 5 ha ceiling on ownership; (iii) the designation of government

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28 As part of the Borrower response to the draft report, LBP commented: "LBP, being a government financial institution is required by law to declare 50 percent of its income from the previous year as dividend to the National Government. LBP always manages to negotiate for a lower dividend rate with the Department of Finance. For the last five years (2004 to 2008), the cash dividend rate averaged 25 percent of its net income and a total of P 1.1 billion stock dividends have been declared".

29 BSP Circulars on microfinance include: Circular 272 (2001) - Guidelines on General Banking Law; Secular 273 (2001) to Allow Entry of Microfinance Oriented Banks; Circular 282 (2001) - Guidelines on Rediscounting Facility; Circular 324 (2002) Expansion of Rediscounting Facility; Circular 340 (2002) Regulations for the Establishment of Branches; Circular 364 (2003) Reduction of Risk Weight for SMEs; Circular 365 and 369 (2003) Amendment of 340; Circular 374 (2003) Regulations for Barangay Microbusiness Enterprises Act; Circular 409 (2003) Regulations for Micro-financing Operations of Banks; Circular 501 (2005) Rules on the Writing off of Loans; Circular 547 (2006) Amendments on Government Borrowings; Circular 549 (2006) Amendment to the Manual of Regulations for Banks.

as the sole buyer of awarded lands under the land redistribution program; (iv) a prohibition against tenancy arrangements; (v) the general demise of land markets due to agrarian reform; (vi) lack of an efficient mechanism to resolve land disputes; (vii) lack of information needed by courts to hear land cases. With respect to risk, crop insurance exists on a small scale but, as in so many other countries, has suffered from covariant risks due to lack of diversity.

19. While there is now no usury law, there are still intermittent political threats to subsidize credit programs and cap interest rates, particularly at election times. So far these seem to have been resisted but the threats remain. However, there are a number of programs including the Agrarian Reform program of land redistribution with subsidized lending and other programs through the Department of Social Welfare, some at zero percent interest, in support of 47 of the neediest provinces. There are also a number of grant plus cost recovery social welfare programs in certain sectors that provide the equivalent of subsidized interest rates and there are also a number of subsidies to Local Government Units (LGUs). There has been no aggregate analysis of what the net effect of all these market distortions is on the levelness of the playing field for the entry of other players.

20. **The People's Credit and Finance Corporation (PCFC).** PCFC, a government owned and controlled corporation whose vision is to be the leader in the provision of microfinance products and services, was selected as the microfinance wholesaler under the project. PCFC is not a bank and cannot take deposits. It is a finance company registered with the Securities and Exchange Commission. It was established in 1995, only two years before the project, to provide financial services to the poor and later was given the mandate for the delivery of micro-finance services for the poor. It was initially capitalized by funds from the National Livelihood Support Fund. PCFC is LBP's main conduit for the delivery of microfinance services and was so under RFIII. It is expected that eventually PCFC will be privatized and there is apparently an executive order to that effect. PCFC has the remit to provide wholesale funds to micro-finance institutions in all provinces. It has had funds from a number of sources including an ADB/IFAD Rural Micro-enterprise Finance Project (US$33.7 million of which US$7.4 million was for institutional capacity building of micro-finance institutions).

21. PCFC's performance ratios indicated in the PAD at the time of appraisal showed that it had so far maintained a high-quality of loan portfolio with a past-due ratio of only 0.5% of its loan portfolio. It was, at that time, allotting 2 percent to provisioning. It had high liquidity. Capital to risk asset ratio declined from 66 percent in 1997 to 46 percent in 1998 due to the increase in the loan portfolio. Financial projections prepared for PCFC at about the time of appraisal showed expectations of increasing Real Profit after tax and improved Risk Asset to Equity ratio.

22. Over the period of the project, PCFC has been strengthened in many respects, although there remain concerns about the longer term sustainability of an institution playing this role that cannot take deposits. It has become a stronger financial institution than it was in 2002. Equity has increased somewhat, all from retained earnings. Total resources more than doubled. Lending increased threefold. Operating costs have been reduced significantly from 12% in 2000 to about 3% in 2006 but, as noted in the ICR, this is still high for a wholesale operation. Table 2 shows a selection of the main ratios.

23. BSP have, over recent years, issued a number of Circulars to ensure the safety and soundness of microfinance institutions but BSP recognizes that it will take systematic training to develop the capacity to adequately supervise microfinance institutions. Donors have been supporting this effort. The regulation of credit cooperatives and credit unions has been weak through the Cooperative Development Authority. The National Cooperative Council developed performance indicators that have now been tested and adapted. The main microfinance need now is for MFI skills to make sound lending judgments while substantially expanding operations to both smaller and larger clients.

24. **Targeted Lending in the Rural Sector.** While the targeting of lending under the project was relatively loose, simply excluding metropolitan areas, over the period of the project there was substantial targeted lending in the agriculture sector under various Department of Agriculture schemes. Targeting was by both agricultural enterprise (even separating Inbred Rice from Hybrid Rice) and by region. LBP was the conduit for some of this lending but private banks had a larger share. The Agri-Agra Law (PD717) required certain mandatory percentages of all bank's credit to go to Agrarian Reform Credit and Agricultural Credit programs. However, since 1999, alternative compliance was permitted through such means as investment in LBP agricultural bonds, other bonds, low-cost housing, and special-purpose treasury bonds for agriculture.

25. **Bank-funded Projects.** RFIII followed immediately after RFII. Both RFI and RFII had been rated Satisfactory by IEG although Institutional Development was rated only Modest due mainly to LBP's inability to cut losses in the agrarian reform loan portfolio, the ad hoc basis of the dividend payable to GOP, and the application of GOP own funds to targeted lending at below market interest rates when political pressures were great enough. (These are all concerns that have remained to a greater or lesser extent under RFIII, in particular pressures for below market rates may now be reduced.)

26. At the time of appraisal, there were two other projects relevant to the financial sector, the Banking System Reform Loan and the Private Enterprise Credit Support Project. Currently, there are a number of projects with links to the rural sector either recently closed or still active. These include: the Community Based Resources Management Project, the Local Government Units Finance and Development Project, Mindanao Rural Development Project (First and Second Phase), the Diversified Farm Income and Market Development Project, the National Program Support for Environment and NRMP, and the Second Agrarian Reform Communities Development Project. There are three projects with some funding channeled through LBP, a new project supporting investment for LGUs and the private sector for local services,[30] Manila Third Sewerage Project, and a National Fluorocarbon Phase out Grant.

27. **Donor Coordination.** There are a number of other donors who have supported rural finance over the last 10 years including particularly JICA (through DBP), KfW, ADB, and USAID. The majority have focused on microfinance. USAID has had success with their Micro-enterprise Access to Banking Services Program (MABS). This has helped many rural banks to become major players in the microfinance sector. It offers a step-by-step approach to

30 This project took the Board slot of what would have been RFIV.

microfinance taking into account the multiplicity of income from various sources, the ability of farmers to make rational decisions, the borrower's character and capacity to repay. The program has also supported participating rural banks in offering mobile phone banking services.

28. Donor coordination is considered adequate by most respondents. There is a Philippines Development Forum that includes government and meets regularly and has a number of thematic or sectoral subcommittees. However, in discussion, a few Bank and other donor staff appeared to suggest that not enough concrete progress on the important issues was made at such meetings.

Table 1. LBP's Financial Ratios and Figures

	1999	2000	2005	2006	2007	2008
Loan Portfolio (Peso bill.)	106.7	108.8	121.5	120.8	134.6	184.7
Net NPA/Equity %	109.4	138.3	33.2	19.9	12.5	10.6
Real Return on Equity %	-1	0.4	8.64	9.24	10.19	6.47
CAR %	10.1	10.6	14.4	13.5	14.0	14.4
SDI %	2.0	20.8	-47.0	-32.6	-35.9	NA

Table 2. PCFC Financial Ratios and Figures

	1999	2000	2005	2006	2007	2008
Net Ln. Balance (P. mill.)		1,027	2,972	3,102	2,849	3,237
Net Past Due/Equity (%)		(2.5)	(8.0)	(10.9)	(4.3)	(0.6)
Real Profit (%)[31]		(6.1)	(0.3)	2.8	2.9	3.9
Portfolio at Risk (%)		17.8	7.1	6.0	8.5	10.3
CAR (%)		91.4	42.5	41.9	44.0	34.9
SDI		72	2.83	(20.6)	2.6	NA

31 Real Profit = Nominal profit -((equity start of year – net fixed assets at start of year) * inflation rate)

Annex C. People Met[32]

World Bank
Iain Shuker
Arie Chupak
Carolina Figueroa-Geron
Mark Woodward
Hoonae Kim

Land Bank
Cecelia Borromeo, Exec. Vice President, Institutional Banking and Subsidiaries Sector
Julio Climaco, First Vice President, Strategic Planning Group
Noemi Dela Paz, Vice President, Program Lending Group
Gabriel Jayme, Vice President, Wholesale Lending Department
Antonio Hugo, Vice President, Corporate Planning and Central MIS Department
Vivian-Manuel Canonero, Dept. Manager, Iloilo Lending Center
Margarita Cabrera, Head PMIS Unit, WLD
Briccio Creag, Team Head, PLEM Unit, WLD
Erwin Almacen, Bank Executive Officer, Corporate Planning
Blesilda Coroza, Accounts Officer, WLD
Prudencio Calado, Acting Head, Environmental Program and Management Department
Maria Veronica Tuala, Accounts Officer, WLD

PCFC
Edgar Generoso, President and CEO
Atty. Noel Poso, Vice President Account Management Group

Bangko Sentral ng Pilipinas (Central Bank)
Mr. Botardo, MicroSME Unit
Z. Rino, MicroSME Unit

Government
Charissa Hipolito, Director III, Corporate Affairs Group, Department of Finance
Rena Cuarez, Head Dept, Corporate Operations

Other PFIs
Sheryl Luy, Banco De Oro, Manila
Roland Dillague, Vice President Special Lending, Banco De Oro
Nanette Biason, Senior Manager, Bank of the Philippine Islands, Iloilo
Adonis Liang, Manager Account Officer, Bank of the Philippine Islands, Iloilo
Ana Kwan, Senior Vice President, Credit Supervision and Services Group Head, Planters Development Bank
Staff of Taytay sa Kauswagan, MFI NGO

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32 In a few cases interaction was by phone.

Donors
Teresita Espenilla, Project Management Specialist, USAID
Flerida Chan, Senior Program Officer, JICA (now amalgamated with JBIC)

Clients
William How, President, Universal Harvester Inc.
Milagros Ong-How, Executive Vice President, Universal Harvester Inc.
J. Bautista, Manager, Armour Milling, Batangas
Davy Barlin, General Manager, A1 New Creations, Iloilo
Rowena Barte-Zulueta, Executive Director, Illonggo Producers Association, markets handicrafts
Manager, Retcom Aquafarm, Iloilo
Andy Sibayan and Dennis, Agri Poultry Dressing Plant, Sta Barbara, Iloilo
Noreimi, small business client in Iloilo baranguy and chair of group
Madelaine, small business, client in Iloilo

Others
Staff of South East Asia Fisheries Dev. Center
Gilbert Llanto, Vice Chairman CARD (NGO and commercial bank) and academic researcher

Annex D. Borrower Comments

LAND BANK OF THE PHILIPPINES
Official Depository Bank of the Republic of the Philippines

June 25, 2009

MS. MONIKA HUPPI
Manager
Sector Evaluation Division
Independent Evaluation Group
The World Bank

Dear **Ms. Huppi:**

This refers to the draft Project Performance Assessment Report on the Third Rural Finance Project (IBRD – 44130).

Generally, we find the assessment report acceptable. However, we are enclosing our comments to some observations and we have updated some data on the report for your consideration.

Thank you and best regards.

Very truly yours,

GILDA E. PICO
President and CEO

cc: Mr. Rahul Raturi
Sector Manager
Rural Development, Natural Resources and Environment Sector Unit

Mr. Bert Hofman
Country Director
WB Manila Office

Mr. Iain Shuker
Task Team Leader
WB - EASRE

LAND BANK OF THE PHILIPPINES
LANDBANK PLAZA
1598 M.H. Del Pilar cor. Dr. J. Quintos Streets
Malate, 1004 Manila, Philippines
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www.landbank.com

LBP's Comments on the draft World Bank – IEG Project Performance Assessment Report

1. Page xi -5th paragraph,

   - line 4, please put "o" in micro-finance system
   - line 5, please correct the acronym of Land Bank of the Philippines as *LBP* instead of LDP.
   - line 7, to delete the word "to" between the words help and enforce)

2. Page 2, Para. 1.6 – the last two sentences state that:

   "LBP's dividend to government is imposed upon it. This has been an area of uncertainty because, although the law requires a payment of 50 percent of the previous year's net income, in practice is has been a matter for annual negotiation."

   - We suggest the following revisions:

     "LBP, being a government financial institution is required by law to declare 50 percent of its income from the previous year as dividend to the National Government. LBP always manages to negotiate for a lower dividend rate with the Department of Finance. For the last five years (2004 to 2008), the cash dividend rate averaged 25 percent of its net income and a total of P 1.1 Billion stock dividends have been declared."

   - This revision should also apply to para. 18 of page 28 under Annex B.

3. Page 2, para. 1.7, 2nd line – Please revise as "government owned and controlled corporation" instead of " . . . government-owned bank". This will also correct page 29, para. 22 which should read as "PCFC, a government-owned and controlled corporation" instead of "government-owned bank. ."

4. Page 2, footnote no. 2 and Page 27, footnote no. 26 - we suggest **deletion** of both footnotes which state that *"It is important to understand that the staff of LBP are civil servants and subject to the same incentives and rules as other civil servants including the same level of job security, pension rights, rights of appeal and similar pay scales."*

5. Page 6, Para. 3.6 - "While relevance of design was found to be generally sound and is rated Substantial, this assessment finds four areas of weakness and expands on some of them in the subsequent paragraphs. . . . Third, the project design gave limited support for the strengthening of PFIs or NGOs and groups; the main focus was on LBP and PCFC, yet much of the rural finance constraint in rural areas, both then and now, lies with institutional capacity and skills. It was too optimistic to expect that the pressures of accreditation along with the existing training capacity of LBP and PCFC, in any case of uncertain additionality since these were partly on-going programs, would address skills development sufficiently."

LBP's Comments on the draft World Bank – IEG Project Performance Assessment Report

LANDBANK has conducted various trainings on financials and Philippine environmental laws intended for the Account Officers of various PFIs (including Rural Banks) during the RF I and II implementation which WLD continued during the TRFP implementation. These endeavors were reported in the Progress Reports submitted to World Bank on a quarterly basis. PCFC also has continuing training programs for its MFIs.

6. Page 9, Footnote no. 9 was not reflected on this page.

7. Page 11, para 3.24 – to correct "LDP" as " LBP."

8. Page 14, para. 3.35, line 7 - We suggest that "over **40** years" be replaced with "**45** years".

9. Page 24, Annex A – To reflect as "Ms. Lisa Valenzuela" instead of "Calenzuela". On page 32, to revise the following listed on Annex C:

   Ms. Carolina Figuero**a** – Geron
   Ms. Vivian Manuel – Cañon**e**ro
   Mr. Prudenci**o** Calado
   Ma. **Veronica** Tuala
   Margarita Cabrera, Head, PMIS Unit, **WLD**
   Mr. Briccio Creag, Team Head, PLEM Unit, **WLD**

10. Page 27, para. 14 - We suggest the following revisions to update data under Annex B:

From	To
Deposits . . ."P 290 billion in 2008	"**P 334** billion **by end of** 2008"
Assets . . ."P 380 billion"	"**P 434** billion"
Return on Equity . . ."15.2 percent by August 2008"	"**15.6** percent by **end of** 2008"
Nonperforming Loans (NPL) . . . 3.6 percent by August 2008 . . .	Nonperforming Loans (NPL) **ratio**... **2.9 percent by end of 2008** . . .

11. Page 31, Annex B, Table 1 - Revision of 2006 Loan Portfolio from "120.4" to **"120.8"**.

12. Page 31, Table 2 – PCFC requested the update of financial ratios and figures as follows (computation attached):

	2000	**2005**	**2006**	**2007**	**2008**
Net Loan Balance (P M)	1,027	2,972	3,102	2,849	3,237
Net Past Due / Equity	-2.5%	-8.0%	-10.9%	-4.3%	-0.6%
Real Profit	-6.1%	-0.3%	2.8%	2.9%	3.9%
Portfolio at Risk	17.8%	7.1%	6.0%	8.5%	10.3%
CAR	91.4%	42.5%	41.9%	44.0%	34.9%

PEOPLE'S CREDIT & FINANCE CORPORATION
A Micro-Finance Company

June 24, 2009

MR. HERMEO G. BAUTISTA
Department Manager
Programs Management Department I
Land Bank of the Philippines
1598 M. H. Del Pilar cor. Dr. Quintos Streets
Malate, Manila

Dear Mr. Bautista:

This has reference to the draft copy of the Project Performance Assessment Report on the Third Rural Finance Project (IBRD-44130).

In this connection, please be informed that PCFC generally concurs with the report except for minor notation on pages 11 and 25-Annex B, wherein PCFC was termed as "a government owned bank". PCFC is "a government owned and controlled corporation".

Also, we also noted some discrepancies and blank portions in Annex B, table 2 – PCFC's financial ratios and figures. We enclosed herewith a copy of our financial data and computation on the ratios based on our audited financial statements for verification.

Thank you and regards.

Very truly yours,

EDGAR V. GENEROSO
President and CEO

305 Sen. Gil Puyat Ave. M.C.P.O. Box. 1594, 1209 Makati City, Philippines · Tel. (632) 897-8821 to 23 · Fax (632) 325-8448 · Website: www.pcfc.ph

PCFC Financial Ratios and Figures

	2000	2005	2006	2007	2008
Net Loan Balance (P.Mill.)	1,027	2,972	3,102	2,849	3,237
Net Past Due/Equity	-2.5%	-8.0%	-10.9%	-4.3%	-0.6%
Real Profit	-6.1%	-0.3%	2.8%	2.9%	3.9%
Portfolio at Risk	17.8%	7.1%	6.0%	8.5%	10.3%
CAR	91.4%	42.5%	41.9%	44.0%	34.9%
SDI					

a) Net Loan Balance (P.Mill.)					
Total Loan Receivable	1,075,820,961.52	3,167,659,692.19	3,331,678,529.63	3,057,732,278.03	3,478,792,358.53
Less: Allowance for Prob. Loss	(48,950,311.33)	(195,711,334.93)	(228,767,233.31)	(208,977,750.52)	(241,265,355.50)
	1,026,870,650.19	2,971,948,357.26	3,102,911,296.32	2,848,754,527.51	3,237,527,003.03
b) Net Past Due/Equity					
Past Due Receivables	19,923,681.50	82,885,448.05	48,292,216.89	104,427,293.78	185,515,854.87
Items in Litigation	3,525,819.35	9,035,459.35	34,474,786.09	49,066,137.46	49,066,137.46
Less: Allowance for Prob. Loss	(48,950,311.33)	(195,711,334.93)	(228,767,233.31)	(208,977,750.52)	(241,265,355.50)
Net Past Due	(25,500,810.48)	(103,790,427.53)	(146,000,230.33)	(55,484,319.28)	(6,683,363.17)
Equity	1,039,992,908.73	1,290,641,672.25	1,334,273,793.83	1,284,063,148.15	1,152,445,042.84
Ratio	-2.5%	-8.0%	-10.9%	-4.3%	-0.6%
c) Real Profit					
((Profit After Tax -[(E -FA X AIR])/E)					
Profit After Tax -[(E -FA X AIR	(63,056,192.99)	(3,603,615.25)	35,760,739.58	39,248,174.37	44,502,468.32
Equity	1,036,154,622.86	1,214,374,143.32	1,290,641,672.25	1,334,273,793.83	1,152,445,042.84
	-6.1%	-0.3%	2.8%	2.9%	3.9%
inflation rate(per LBP)	6.70000	6.63490	4.13410	1.01819	0.00473
d) CAR					
Capital	1,039,992,908.73	1,290,641,672.25	1,334,273,793.83	1,284,063,148.15	1,152,445,042.84
Risk Assets	1,137,911,009.55	3,036,404,005.35	3,185,406,728.18	2,917,884,954.06	3,302,012,966.95
	91.4%	42.5%	41.9%	44.0%	34.9%