Philippines: Credit Line/Loan Fund for Small and Medium-Sized Enterprises I - Development Bank of the Philippines

Ex post evaluation

OECD sector	24030 - Formal sector financial intermediaries	
BMZ project ID	1999 65 021- Credit Line for Small and Medium-Sized Enterprises I (Credit Line) – sample 2008 2005 66 372 – Loan Fund for Small and Medium-Sized Enterprises I (Loan Fund)	
Project executing agency	Development Bank of the Philippines (DBP)	
Consultant	-	
Year of ex post evaluation report	**2008**	
	Project appraisal (planned)	**Ex-post evaluation (actual)**
Start of implementation	Credit Line: Q 3 1999 Loan Fund: Q 1 2006	Credit Line: Q 3 2000 Loan Fund: Q 1 2006
Period of implementation	Credit Line: 36 months Loan Fund: 12 months	Credit Line: 67 months Loan Fund: 3 months
Investment costs	Credit Line: EUR 25.56 mill. FC: EUR 12.78 mill. Loan Fund FC: EUR 5.28 mill.	Credit Line: EUR 30.67 mill. FC: EUR 17.89 mill. Loan Fund FC: EUR 5.28 mill.
Counterpart contribution	-	-
Financing, of which Financial Cooperation (FC) funds	Credit Line: EUR 25.56 mill. FC: EUR 12.78 mill. Loan Fund FC: EUR 5.28 mill.	Credit Line: EUR 30.67 mill. FC: EUR 17.89 mill. Loan Fund FC: EUR 5.28 mill.
Other institutions/donors involved	None	None
Performance rating	**3**	
• Relevance	**3**	
• Effectiveness	**3**	
• Efficiency	**2**	
• Overarching developmental impact	**3**	
• Sustainability	**2**	

Brief description, overall objective and project objectives with indicators

The project “Credit Line for Small and Medium-Sized Enterprises I - Development Bank of the Philippines” (BMZ no 1999 65 021, sample 2008) aimed at easing financing constraints to small and medium-sized Philippine enterprises (SMEs) and to municipalities, called local government units (LGUs). Due to its related contents, we have also taken account of the project “Loan Fund for Small and Medium-Sized Enterprises I” (BMZ no 2005 66 372) in the ex post evaluation. Financing was restricted at project appraisal in 1999 to financing of import needs of private enterprises, but the target group and the purpose of financing were widened in the course of the project. The main amendments to the project design were, that from 2001 on domestic costs and from 2003 on municipal projects were allowedfor financing. In addition, the project executing agency, the Development Bank of the Philippines (DBP), was authorised to refinance credit and microfinance institutions from the credit line. The credit line consisted of an FC budget loan amounting initially to EUR 12.78 million complemented bya loan of KfW's own funds of EUR 12.78 million. The FC loan was topped up by EUR 5.11 million in 2004. In 2005, another increase in FC budget funds of EUR 5.28 million was made under the separate project, Loan Fund for Small and Medium-Sized Enterprises I (BMZ no 2005 66 372). The project credit lines and replenishments were fully disbursed by April and July 2006 respectively.

The programme objective was to reduce financing constraints on micro, small and medium-sized enterprises (MSMEs) as well as to municipalities and, with that, to improve access for MSMEs to long-term financing to meet import needs. This way, the programme was to contribute to the promotion of the economy and to stabilize income, employment and foreign currency effects (overall objective).

Programme objective indicators were:

(1) About 2 years after FC funds were fully disbursed, 80% of the promoted MSMEs are paying interest and amortisaton as agreed on time.

(2) About 3 years after FC funds were fully disbursed, the promoted LGU sub-projects are paying interest and amortisation as agreed on time (only BMZ no 2005 66 372).

The following indicators were applied for overall objective achievement:

(3) About 2 years after FC funds were fully disbursed, 80% of the promoted MSMEs are operating profitably.

(4) About 3 years after FC funds were fully disbursed, at least 80% of the promoted LGU sub-projects are operational (only BMZ no 2005 66 372).

Project design/major deviations from original planning and main causes

According to the appraisal report in 1999, the programme was designed to improve insufficient supply of longer-term credit for import needs of SMEs. At that time, the whole regional economy was still in a major downturn due to the Southeast Asian crisis, which resulted in a marked risk aversion of the Philippine banking sector. This in turn exacerbated the structural problems SMEs already had in gaining access to adequate financing. From the outset, however, demand for foreign currency loans under the credit line was low (with no foreign currency loan issued, according to DBP). Even when the project design was extended toallow for financing of domestic costs and refinancing of microloans in January 2003, demand did not pick up at first. Only when the credit line was made accessible for municipal financing in November 2003 were more loans requested.

The fundamental role of the **MSME sector** for the Philippine national economy has not changed since programme appraisal. In 2006, the official number of MSMEs in the Philippines came to 780,000 or 99.7% of all registered companies. Their actual number is likely to be far higher, though, since micro enterprises in particular frequently operate in the informal sector and are therefore not includedin the official statistics. Micro enterprises predominate in the MSME sector with a ratio of approx. 92%, followed by small enterprises (over 7%) and medium-sized enterprises (less than 1%). With a share of almost 70% in 2006, MSMEs are also the main employers, accounting for an estimated 30% of value added in manufacturing and making a contribution of approx. 25% to Philippine exports.

The main challenges of the sector still lie primarily in insufficient or non-available financing, especially for longer-term investments. The absence of a suitable credit technology for MSMEs plays a foremost role here. Other constraints on growth include comparatively low productivity and obsolescent production methods and technologies in MSMEs, inadequate management capabilities, limited marketing know-how and a generally adverse political and institutional-administrative environment in the Philippines. Progress in MSME development or private-sector activities in general is also hampered by endemic corruption and the judicial system, which is subject to external influence and ineffective.

MSME promotion is given high priority by the current Philippine Government. The SME Development Plan 2004-2010 has set ambitious targets, including the establishment or formalisation of 700,000 MSMEs.

The adoption of the Philippine Local Government Code (LGC) in 1991 marked a fundamental change in the national political-administrative setup. With the LGC, government functions and services were delegated to a large extent to the municipal level.

The municipalities, organized in **local government units** (LGUs), are now also responsible for planning and implementing municipal investments in the physical (e.g. covered markets, rural road and thoroughfare construction) and social (e.g. schools, health stations, water supply) infrastructure and for environmental protection measures. The LGUs thus play a strategic role in economic and social development and also present an important political platform for direct participation at local level.

In order to cope with their various economic and social tasks, however, LGUs need sufficient financial resources. Besides (still limited) revenue from local taxes and funds from vertical financial equalisation, the LGUs primarily depend on the supply of longer-term loans from the Philippine financial sector. Smaller and poorer municipalities in particular can only obtain loans from the two government development banks, LBP and DBP. For DBP (and LBP), the LGUs are relatively safe borrowers, as the financial appropriations from the national government - as LGU deposits - constitute ideal loan collateral for the two banks. Commercial banks only play a minor role in municipal finance and confine their lending business to cities.

Besides financing problems, the main deficits lie in municipal planning and financial and budget management. Shortcomings are particularly evident in smaller and poorer municipalities with restricted personnel capacities. Poor governance and corruption pose a permanent challenge also at municipal level in the Philippines. Municipal development is still accorded high developmental priority by the Philippine Government, since the LGUs make a significant contribution to economic, social and political progress at municipal level.

The Philippine **financial sector** is underdeveloped and dominated by banking. The capital market has showed only limited progress over recent years. In 2008, the banking system consisted of about 840 banks, but is dominated by 38 commercial and universal banks accounting for 87% of assets, 85% of outstanding loans and more than 90% of deposits. Rural and savings banks play only a local or regional role. The government has entrusted DBP and LBP with special developmental mandates, they belong to the 10 largest banks in the country. Although heavily fragmented, the Philippine banking sector is dominated by a few banks. At the end of 2007, the 10 largest banks accounted for about 62% and the three largest banks for a third of all assets. Bank concentration has increased since the nineties. Many of the large banks are part of family syndicates: Altogether, 20 banks with about 60% of deposits in the whole banking system belonged to six wealthy family clans at the end of 2007. Competition among these banks is only moderate.

Increasing deregulation and consolidation have led to a general improvement of the Philippine banking system since programme appraisal (PP). Financial stability, profitability and efficiency have increased and banking supervision and regulation are more effective. With almost 15% capital adequacy (in line with the Basel II definition), the banks were well capitalised and liquid at the end of 2007. Portfolio quality has improved further, with the ratio of non-performing loans at the end of 2007 amounting to less than 4.5% according to data from the Bangko Sentral ng Pilipinas - BSP (with FitchRatings putting this at 5.8%). At a coverage ratio of 93.3%, provisions for risk would appear sufficient. Moody's and FitchRatings assess overall portfolio quality as satisfactory, also accounting for the relatively high ratio of real estate still in need of liquidation as loan collateral. With return on assets of 1.4% and on equity of 11.8% in 2007, profitability in the Philippine banking system is satisfactory. The Philippine banking system still suffers from comparatively low operating efficiency. The cost-to-income ratio at the end of 2007, for example, was 69% and average operating costs amounted to 3.7% of bank assets, above the regional figure. The net interest rate margin came to 4.3% at the same time.

Increase in lending has only been moderate over the last few years. The loan-deposit ratio amounted to 52%, about 25% of assets in 2007 were held as portfolio investments. The high interest on low-risk government debentures in particular has had an adverse effect on lending in the past. The banking system primarily refinances itself via deposits, which made up about 72% of liabilities at the end of 2007.

The Philippine Government and the central bank (BSP) have carried out various fundamental reforms in the last few years, gradually bringing the banking system into line with the Basel II regulations. Large deficits remain in framework legislation (e.g. the ineffectual insolvency code). Moreover, widespread poor governance and intransparency in the Philippines along with legal uncertainty in effectively enforcing legitimate claims and the limited readiness for reform in the country’s elitist democracy also work to the detriment of the banking and financial sector.

The supply of longer-term financing is still insufficient, due to the underdeveloped capital market. The constraints analysis underlying the programme design thus still applies today. The sustainable improvement of access for MSMEs to adequate financing does not, however, depend solely on the provision of longer-term refinancing; it also calls for corresponding changes in the organisation of the banks and the application of special MSME credit technologies in particular.

Altogether, the programme executing agency, the **Development Bank of the Philippines (DBP)** has developed well since appraisal. At the end of 2007, DBP numbered among the best institutes in the country, in terms of profitability, portfolio quality, capital endowment and efficiency. According to FitchRatings, DBP holds one of the best lending portfolios of all commercial banks in the Philippines, with particularly sound liquidity reserves.

The main risks were seen in politically influenced or motivated lending and the relatively high percentage of MSME finance. As a development bank (and one of the largest universal banks in the country), DBP can also rely on supportive measures by the central bank and the Philippine Government in the event of crisis. In May 2008, it was assigned a better financial strength credit rating of D by Moody's.

As a government development bank with 77 branch offices and approx. 2,200 employees, DBP exercises a broad developmental mandate. It is a long-standing partner of FC and a major executing agency for ODA funds. DBP is subject to the supervision and the regulations of the Philippine central bank and has been accorded formal political independence since the end of the nineties. This also means it has to align its business policy with commercial standards. Its organisational and operational structure is adequate to its current tasks and is continually adjusted to cope with new ones. Loan appraisal is carried out on the basis of the credit rating system developed by BSP. In wholesale lending to other financial institutions, DBP applies an accreditation system with quantitative and qualitative criteria based on relevant BSP provisions. Wholesale lending is primarily used in microlending, while DBP prefers direct lending to SMEs. The financial statements are prepared in accordance with IFRS; risk management was largely adjusted to current requirements of Basel II. DBP is regularly assessed by international rating agencies (Fitch, Moody's).

MSME lending and longer-term financing for the LGU sector form part of DBP's core developmental business. The establishment of special MSME and LGU divisions underline the corporate policy role of both market segments, also for the future.

Altogether, business development over the last few years has been satisfactory. Average annual asset growth rate amounted to more than 15% in 2003-2007. During the same period, the lending portfolio increased on average by 13% a year, making up approx. 30% of total assets. At the end of 2007, 80% of lending was issued as direct loans, while wholesale lending decreased. The DBP lending portfolio is spread broadly across sectors. MSMEs accounted for 89% of loans at the end of 2007 and almost 9% of the lending volume at DBP. In the developmental lending portfolio (88% of the overall portfolio with an upward trend), the predominant loans are in infrastructure (30%), MSMEs (22%) and the social sector (9%), which includes LGU financing.

Major sources of refinancing remain the Philippine Government and foreign donors with almost 70% of liabilities, while ODA makes up about half of long-term loans.

Key results of impact analysis and performance rating

With the original FC loan, the programme has financed altogether 140 individual projects worth PHP 2.31 billion or EUR 35.95 million. In the MSME component, 88 loans were issued (63% of loans; 44% of lending volume), while the LGU component comprised 52 individual loans (37% of loans and 56% of lending volume). The regional distribution of loans is concentrated in Luzon (38% of loans, 51% of lending volume) and Visayas (41% and 35% resp.).

In the MSME component, most loans are made to medium-sized enterprises (68% of loans and 90% of lending volume). All financing was disbursed in the service (58% and 56% resp.) and trade (42% and 44% resp.) sectors. In services, medical services (37% and 47% resp.) and hotels (27% and 27% resp.) predominate. The average loan amount came to PHP 11.4 million or almost EUR 170,000.

Within the LGU component (31% of loans and 40% of lending volume), loans were primarily used to procure heavy machinery for road maintenance, followed by building measures for public markets (29% and 13% resp.). About one third of all LGU loans was allocated to poorer municipalities in classes 4 and 5. Only some of the financed investments generate limited income for the municipalities. Debt is therefore primarily serviced out of the municipal budget. The average LGU loan amounted to PHP 25 million or EUR 371,000.

At the time of ex post evaluation, DBP had already started the second round of lending with 25 projects (15 LGUs, 10 MSMEs) worth PHP 344 million (approx. EUR 5.5 million). The counterpart fund as at 30 September 2008 amounted to around PHP 277,000 (EUR 4,500). On a small scale, measures in the MSME sector have already been financed from this.

We assess the developmental efficacy of the programme as follows.

<u>Relevance:</u>

The programme design addressed Philippine financial and/or banking sector deficits in long-term investment finance. This was a correct assessment at the time of programme appraisal and still applies today considering the underdeveloped Philippine capital market.

The needs of MSMEs as the original target group were, however, evidently assessed wrongly or over-optimistically. Only after enlarging the design scope to include municipalities in the target group and financing for domestic costs was sufficient demand generated. In addition, many borrowers are not new DBP customers. Thus, the underlying impact chain does not represent adequately the implemented project design.The high share of financing for medium-sized enterprises in the hotel sector also questions at least partially the developmental relevance of individual loans and the subsidiarity of the DBP engagement.

The impact chain was not adjusted to the changes in programme design, particularly the new target group of LGUs. However, the relevance of the programme for the LGU target group is not in doubt.

The programme is in line with the current development strategy of the Philippine Government with its priorities attached to poverty reduction, MSME and LGU promotion. MSME and LGU support also makes up an important priority in other donor activities (e.g. ADB, CIDA) and GTZ in the Philippines. The programme also conforms to the current BMZ financial sector strategy.

Altogether, we assess the **relevance** of the programme as **satisfactory** (**rating: 3**).

<u>Effectiveness:</u>

- Accounting for the inclusion of municipalities in the credit line, the <u>programme objective</u> is: Removal of constraints on lending to micro, small and medium-sized enterprises (MSMEs) as well as to municipalities and, with that, improvement of access for MSMEs to long-term financing to meet import needs.

The programme objective indicators have been fully met. The ratio of non-performing loans in the overall portfolio amounts to 1.8%, well under the set targets at appraisal of 20% each, with the MSME component recording 5% and the LGU component with no arrears. The high repayment rate of municipal loans is presumably the result of securitisation through government appropriations, which are deposited at DBP. Even at a slightly more ambitious target of at least 10%, the indicators would therefore have been met in full.

Of favourable note also is the acceptable pro-poor impact with 140 individual loans granted so far and revolving credit already underway. This is also implied in the relatively small average loan amounts of some EUR 170,000 in the MSME component and around EUR 371,000 in the LGU component.

The large delays due to small demand in the first three years were detrimental to programme effectiveness. Even after the necessary changes in design, the programme has not reached the (implicit) original target group of SME producers. Possible mutually reciprocal reasons for this are: the general preference of MSMEs for informal sources of credit, particularly in longer-term investment financing, the lack of special MSME lending technology and the higher risk of industrial MSME loans as seen by the banks.

We assess programme planning and steering by DBP as adequate.

Altogether, we consider **programme effectiveness as satisfactory** (**rating: 3**).

Efficiency:

We judge the productive efficiency of the programme as good. The executing agency, DBP, operates with adequate efficiency. The net interest rate margin has diminished and measured by return on total assets and on equity, the profitability of DBP can rate as good considering its developmental mandate and in comparison with the banking sector. The portfolio-at-risk has improved much since programme appraisal, keeping well under the sectoral average at the end of 2007. With real positive final borrower interest, lending was in line with market conditions.

In microeconomic allocative efficiency, the loans have been put to sensible use by all borrowers, as evidenced by the good loan repayment rates and the findings of the field visits. After the necessary adjustments to programme design, fund disbursement stepped up. As a general rule, the financed facilities entered operation in an adequate timeframe (DBP information and field visits of the ex-post evaluation mission).

Altogether, we rate the **efficiency** of the programme as **good** (**rating 2**).

Overarching developmental impact:

The overall objective was defined as a contribution to stimulating the economy and to stabilising income, employment and foreign currency effects. The overall objective indicators chosen were:

- About 2 years after the allocation of FC funds or full loan disbursement, 80% of the promoted MSMEs are profitable.
- About 3 years after the allocation of FC funds or full loan disbursement, at least 80% of the promoted municipal projects are operational (only BMZ no 2005 66 372).

No specific details are available on the degree of overall objective achievement. In view of the low NPL ratio and only 3 loan defaults in all, however, we may assume that more than the requisite 80% of enterprises in the MSME component earn a profit. This supposition has been confirmed by the findings of the field visits. In the case of the LGU component, the financed investments are inspected and accepted after conclusion of the construction or procurement measures by DBP. This could be confirmed in the on-site inspections of 5 projects. No aggregate data is available for the LGU portfolio, however.

Due to the financing portfolio shift, the possible overarching developmental impacts must also be located at a different level to that originally intended.

The beneficial impacts are most notably evident in the LGU component. LGUs play a major role in providing an adequate social and physical infrastructure at local level. Financing for numerous direct (public markets, bus terminals, hospitals, schools, bridges and roads, waterworks, social housing) and indirect (heavy equipment for construction and maintenance of farm-to-market roads) infrastructure measures can be expected to have beneficial effects on the private sector and poverty reduction. These are also enhanced by the relatively high ratio of poorer municipalities in the LGU lending portfolio overall.

Only limited overarching developmental impacts can be attributed to the MSME component. The relatively high ratio of investments in medical services (hospitals, clinical complexes, medical centres) can be construed as a contribution to improved medical care. The relatively low number of small businesses (17 of 140), the intermediation of only 3 microfinance institutions (accounting for less than 1% of the disbursed MSME lending portfolio) and the lack of financing for (the usually comparatively) labour-intensive manufacturing sector also point to less positive effects on employment, poverty reduction and MDG attainment.

The capacity-building effects on the Philippine financial sector are assessed as limited. This is primarily due to the dominance of retail lending in the MSME component with 90% of loans and 77% of lending volume. DBP only lent on to other banks as intermediaries in 9 individual MSME loans, with participation by only three microfinance institutions in all. Possible learning and demonstration effects on the banking system can hardly be expected. The LGU component was implemented solely as retail lending business by DBP.

Altogether, we assess the programme's **overarching developmental impacts** to be **satisfactory** (**rating 3**).

Sustainability:

DBP's finances are secure and it has sufficient capital resources at its disposal. Even if further write-offs are needed for non-performing assets (NPAs), capital cover should be adequate.

Both MSME and LGU financing fall under the developmental mandate of DBP and its core business. The recent establishment of a special SME department and LGU Unit indicates longer-term business and development-policy interest on the part of DBP in both client segments. There are also no signs that the Philippine Government as DBP owner will attach less priority to promoting MSMEs and LGUs in the future.

The loan fund provided by FC has already entered a second lending phase. The still underdeveloped Philippine capital market, however, is likely to make the refinancing of special MSME and LGU projects heavily contingent on the provision of longer-term ODA facilities in the future also.

No detailed information is available on the status of the financed programme measures. Based on the findings of the field visits and in view of the low loan losses, though, the financed facilities can generally be assumed to be in sustainable operation. This holds in particular for the financed MSMEs, whose loan repayment ability ought to depend heavily on the sustainable profitability of the financed investments. Corresponding items are provided for in municipal budgets for the operation and maintenance of the financed facilities.

Altogether, we rate the **sustainability** of the programme as **good** (**rating 2**).

In all, we attest both projects **satisfactory performance** (r**ating 3**).

General conclusions

No general conclusions have been drawn.

Notes on the methods used to evaluate project success (project rating)

Projects are evaluated on a six-point scale, the criteria being relevance, effectiveness (outcome), "overarching developmental impact" and efficiency. The ratings are also used to arrive at a final assessment of a project's overall developmental efficacy. The scale is as follows:

1	Very good rating that clearly exceeds expectations
2	Good rating fully in line with expectations and without any significant shortcomings
3	Satisfactory rating – project falls short of expectations but the positive results dominate
4	Unsatisfactory rating – significantly below expectations, with negative results dominating despite discernible positive results
5	Clearly inadequate rating – despite some positive partial results the negative results clearly dominate
6	The project has no positive results or the situation has actually deteriorated

A rating of 1 to 3 is a positive assessment and indicates a successful project while a rating of 4 to 6 is a negative assessment and indicates a project which has no sufficiently positive results.

Sustainability is evaluated according to the following four-point scale:

Sustainability level 1 (very good sustainability)

The developmental efficacy of the project (positive to date) is very likely to continue undiminished or even increase.

Sustainability level 2 (good sustainability)

The developmental efficacy of the project (positive to date) is very likely to decline only minimally but remain positive overall. (This is what can normally be expected.)

Sustainability level 3 (satisfactory sustainability)

The developmental efficacy of the project (positive to date) is very likely to decline significantly but remain positive overall. This rating is also assigned if the sustainability of a project is considered inadequate up to the time of the ex post evaluation but is very likely to evolve positively so that the project will ultimately achieve positive developmental efficacy.

Sustainability level 4 (inadequate sustainability)

The developmental efficacy of the project is inadequate up to the time of the ex post evaluation and an improvement is very unlikely. This rating is also assigned if the sustainability that has been positively evaluated to date is very likely to deteriorate severely and no longer meet the level 3 criteria.

The overall rating on the six-point scale is compiled from a weighting of all five individual criteria as appropriate to the project in question. A rating of 1 to 3 indicates a "successful" project while a rating of 4 to 6 indicates an "unsuccessful" project. In using (with a project-specific weighting) the five key factors to form a overall rating, it should be noted that a project can generally only be considered developmentally "successful" if the achievement of the project objective ("effectiveness"), the impact on the overall objective ("overarching developmental impact") and the sustainability are considered at least "satisfactory" (rating 3).