ASSESSING MANDATED CREDIT PROGRAMS: CASE STUDY OF THE MAGNA CARTA IN THE PHILIPPINES

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Abstract

We examine the effects of a mandated credit program to small and medium enterprises in the Philippines (Magna Carta Law) using a panel dataset compiled from official data published by the Bangko Sentral ng Pilipinas. The final sample of 109 financial institutions represented over 90% of total finance sector assets in the Philippines. We highlight three important findings. First, although the total lending levels to micro, small, and medium enterprises (MSMEs) grew slightly, the percentage shares of loans allocated to MSMEs declined drastically from a peak of 30% of total loans in 2002 to 16.4% in 2010. Second, following the upwards revision of the loan target (from 6% to 8%) for smaller firms in 2008, there was a sharp increase in noncompliance especially amongst universal and commercial banks. On the other hand, total loans to medium enterprises were still more than threefold larger than the targeted 2%. Third, there is an increased heterogeneity in optimal loan portfolio across banks. Most surprisingly, the absolute level of MSME lending by rural and cooperative banks declined since 2008. Direct compliance amongst universal and commercial banks decreased beginning in the late 2007, while that of thrift banks increased to almost 100%. Abolishing the Magna Carta targets for medium-sized enterprise loans would most likely yield little adverse effects. Meanwhile, efforts to improve financial access to MSMEs should focus on alternative nondistortionary ways to increase financing supply, such as improving institutional framework for informational availability and development of equity and bond markets for MSMEs.

Keywords: Financial Inclusion, Financial Markets, Financial Policy, Philippines, SME, Targeted Lending

1. INTRODUCTION

Micro, small, and medium enterprises (MSMEs) is the lifeblood of most economies. A vibrant MSME sector is especially essential in spreading the economy's wealth in developing economies, by creating more opportunities in rural areas, maintaining social stability, and fostering inclusive economic growth. Central to MSME development is access to finance. Availability and cost of funds determine firms' ability to compete for market share, innovate, expand and withstand business-related stresses. However, since financial markets in most developing economies are largely underdeveloped with far from ideal regulatory frameworks, many governments in developing Asia have designed medium and long-term MSME development plans, with the main goal of improving financing for MSMEs.

In the Philippines, one of the most important inclusive financing policies is the mandated credit program known as the MSME Magna Carta (Magna Carta). MSMEs account for 99.6% of total firms and 61% of total employment in the Philippines. A recent study of the Philippines found that access to formal sector financing is indeed one of the key constraints that strongly affect firms' dynamism (see Khor, Sebastian, and Aldaba 2013). At the same time, MSMEs do not have easy access to the equities nor bonds market.

The main objective of the Magna Carta legislation was to promote, support, strengthen and encourage the growth and development of MSMEs in all productive sectors of the economy particularly rural and agriculture-based enterprises.[7] The Magna Carta was first enacted and implemented in 1991 (courtesy of Republic Act 6977)—a time when the authorities were grappling for ways to resurrect an ailing economy following a decade of tumultuous business climate. In the subsequent twenty years, the law was amended twice to take into account the changes in the business and economic conditions.

The Magna Carta mandated Filipino banks to allot 10% of their loan portfolio to MSMEs. Although not explicitly mentioned, there are three reasons why the regulation specifically targeted banks. Firstly, banks hold the biggest stock of financial resources in the Philippines, accounting for approximately 80% of domestic financial resources. Secondly, banks have the most extensive branches among credit intermediaries. Lastly, banks are administratively easier to monitor since they regularly report their activities to the Philippines central bank.[8]

[7] Republic Act No. 9501. Magna Carta for Micro, Small, and Medium Enterprises (MSMEs). http://www.lawphil.net/statutes/repacts/ra2008/ra_9501_2008.html

[8] While there were questions raised on the rationale of the policy, Medalla and Ravallo (1997) argued that this kind of

Mandated credit program such as the Magna Carta is not unique to the Philippines. Lending targets set for priority sectors, including small and medium enterprises (SMEs), are imposed in developing economies such as Afghanistan, India, Pakistan, and Sri Lanka. The Magna Carta is also not the first mandated credit provision imposed on Filipino banks. In 1974, the Philippines central bank had directed banks to allot a portion of their loan portfolio to the agriculture sector. This central bank issuance eventually became known as the Agri-Agra Law and continues to be an active regulation to date.

How has the Magna Carta impacted banks' lending towards MSMEs? Surprisingly, literature assessing the implementation of the law and its economic impact is very limited. Medalla and Ravallo (1997) assessed the way banks responded to the Agri-Agra Law and the Magna Carta. The authors found out that between 1975 and 1996, compliance with Agri-Agra Law had continuously declined. Furthermore, compounded annual growth of Agri-Agra Law loans during the period is roughly 3 percentage points lower than the annual growth of total loan portfolio of Filipino banks during the same period.[9] The authors also noted that from 1991 to 1996, aggregate compliance ratios to the Magna Carta by bank type remained above what the law requires by a good margin. They just highlighted that foreign banks tend not to comply with the law on a consistent basis and are drawn toward alternative compliance mechanisms rather investing directly in firms in spite of the general trend in the industry that is skewed heavily on direct lending.

Furthermore, little is known on the compliance with Magna Carta beyond 1996. This paper is thus undertaken to investigate the patterns of bank lending to MSME in the Philippines after the 2008 Global Financial Crisis and in conjunction to that, the compliance of banks to the Magna Carta lending provisions post 1996. We will also attempt to shed light on the characteristics of banks base on their lending exposure to the MSMEs in terms of bank type. To our knowledge, this is the first publicly available study on MSME lending in the Philippines from banks' perspective.

This paper is organized as follows: Section 2 briefly describes the domestic financial market conditions, the customary sources of credit of MSMEs in the Philippines and the government initiatives to boost MSME financing particularly the Magna Carta. Section 3 will layout the salient features of the lending provisions of the Magna Carta. Section 4 will assess the trends of bank lending to MSMEs as well as their compliance to the lending provisions of the Magna Carta using the datasets compiled by the central bank of the Philippines, Bangko Sentral ng Pilipinas (BSP) up to end of 2012. Section 5 will explain recent developments that could potentially influence banks' lending behavior concerning MSMEs in the near term and discuss areas for further research.

measure can be justified from a social standpoint since otherwise, banks are driven to channel funds to projects that generate high private returns but not necessarily social returns.

[9] Medalla and Ravallo (1997) also argued that until 1988, banks have taken advantage of alternative compliance in the form of special series treasury bills that masked the degree of decline in lending. When alternative compliance is accounted for, the drop in lending became very apparent.

2. FINANCING MICRO, SMALL, AND MEDIUM ENTERPRISES IN THE PHILIPPINES

2.1. Definitions

MSMEs in the Philippines are legally defined in two ways. The first definition is based on employment levels according to the National Statistics Office, while the second definition is based on asset values specified by the BSP (Table 1). According to employment-based classification, large firms are defined as those employing more than 200 workers, while micro-firms employ less than 10 workers, small firm 10 to 99 workers, and medium 100 to 199 workers. According to BSP, micro firms are those whose assets do not exceed PHP 3 million (approximately USD 70,000), while the asset limits for small and medium firms are respectively PHP 15 million and PHP 100 million (approximately USD 349,000 and USD 2.5million). Those whose assets exceed PHP 100 million are categorized as large firms. This sometimes presents a challenge when we examine data on MSMEs financing, since there exists no harmonized supply and demand-side dataset. Credit demand-side data on firms are usually based on employment clusters since these datasets are mostly compiled by the National Statistics Office. On the other hand, supply-side credit data such as total loans are typically based on asset clusters defined by the BSP since reporting banks have to follow the BSP's framework.

Table 1. Definitions of MSMEs in the Philippines

Firm Type	*NSO, Employment Level Range (number of employees)*	*BSP, Asset Size Range (P)*
Micro	1-9	<3,000,000
Small	10-99	3,000,001-15,000,000
Medium	100-199	15,000,001-100,000,000
Large	>200	>100,000,00

Note: BSP = Bangko Sentral ng Pilipinas, MSME = micro, small, and medium enterprise, NSO = National Statistics Office

Source: SMED Council Resolution No. 1 (2003); Republic Act 9501 (2008)

MSMEs comprise almost all of the total 820,255 firms in the Philippines. According to the 2011 survey data from the National Statistics Office, 90.6% were microenterprises, 8.6% small, 0.4% medium and 0.4% large (Table 2). Altogether MSMEs employ roughly 61% of the total employees in the economy. This distribution profile hardly changed in the last two decades. In spite of their enormous number, however, MSMEs only contributed 35.7% to gross domestic product (GDP) in 2011. The largest concentrations of MSMEs are found in wholesale, retail, and trade segment. Over 50% of them are located in the National Capital Region, Central Luzon (Region 3), and Calabarzon (Region 4A)—the top three regions which, as of 2012, contribute over 60% to the national GDP.[10]

[10] There are 16 regions in the Philippines.

Table 2. Profile of firms in the Philippines, 2011

	Micro	*Small*	*Medium*	*Large*	*MSME*
Number of firms	743,250	70,222	3,287	3,496	816,759
Share (%)	90.6	8.6	0.4	0.4	99.6
Employment (million)	1.78	1.64	0.45	2.47	3.87
Share (%)	28.0	25.9	7.1	39.0	61.0
Firm distribution by industry (%)					
Wholesale, retail, and trade	48.7	29.8	16.9	11.3	47.0
Manufacturing	13.6	14.3	27.4	29.3	13.7
Accommodation and food service	12.6	16.0	5.8	2.4	12.9
Others	25.1	39.9	49.9	57.0	26.5
Regional location, firm distribution (%)					
National Capital Region	24.2	43.2	45.0	46.3	26.0
Region 3	10.3	8.8	8.1	5.6	10.2
Region 4A	15.4	11.1	14.1	17.5	15.0
Others (13 regions)	50.0	36.9	32.9	30.5	48.8

Note: MSME = micro, small, and medium enterprise
Source: National Statistics Office

2.2. Sources of credit

Firms' need for additional capital is typically addressed by (i) banks; (ii) bonds market; (iii) equities market; (iv) nonbank lending institutions like quasi banks and investment houses, pawnshops, financing cooperatives, savings and loans associations, insurance companies, venture capitalists, and specialized government lending corporations; and (v) informal sector players, such as family members, friends, and unaccredited retail lenders.

Just like in many developing economies, MSMEs in the Philippines have limited access to the equities market. MSMEs accounted for a mere 0.005% of total market capitalization by end of 2012, and are also not considered reputable enough to enter the bonds market.[11] Other large scale credit sources like quasi banks, investment houses, and insurance companies typically also shy away from MSME clients while the role of venture capital firms remain quite small. Thus, given that access to formal financing is relatively scarce for MSMEs, capital options usually narrow to informal sectors, such as financing cooperatives, savings and loans associations, pawnshops, and informal sector lenders.

Assessments of credit provisions suggest that MSMEs rely on their internally generated resources to bankroll up to 78% of their operations (Table 3). In contrast, formal financial institutions only contribute somewhere between 11% and 21% of the MSMEs' funding. The lack of reliable financial information from MSMEs leads to the perception of higher risk. In addition, lower expected profitability, the absence of acceptable collateral by MSMEs, the lack of a national credit rating system for MSMEs contribute to the low loan releases from banks to the sector.

2.3. The micro, small, and medium enterprise Magna Carta

In an effort to aid MSMEs with their credit needs, the Philippine authorities enacted the Magna Carta in 1991, mandating banks to allocate 10% of their lending portfolio to MSMEs. The MSME Magna Carta also laid out a number of important supporting measures. These measures include classification of enterprises by asset size (micro, cottage, small, and medium) and laying out a coordinated structural support and safeguards system to enhance the growth of each category of enterprises.

The Magna Carta led to the creation of several government agencies across several ministries. The Small and Medium Enterprise Development Council[12] was created as an attached agency of the Department of Trade and Industry to carry out the objectives of the law and appointed the Bureau of Small and Medium Enterprises Development (BSMBD)[13] as the council secretariat. The Small Business Guarantee and Finance Corporation was set up to improve production operations and business network of firms, provide financial services to small and medium enterprises (except those involved in trading and crop-level production) and develop alternative modes of financing and guarantee loans secured by qualified SMEs. The Small Business Guarantee and Finance Corporation and the Guarantee Fund for Small and Medium Enterprises[14] were merged in November 2001 to form the Small Business Corporation (SBC) to consolidate their resources.[15] Today, the SBC and the much older Philippine Export-Import Credit Agency are presently the two main agencies charged to expand financial access for MSMEs.[16]

[11] By the end of December 2012, the declared market capitalization of SMEs in the Philippine stock exchange is P586.4 million ($14.2 million) whereas the total market capitalization is P10.9 trillion ($265.3 billion).

[12] This agency was later renamed as the Micro, Small, and Medium Enterprise Development Council (MSMEDC).

[13] This bureau was later renamed as Bureau of Micro, Small and Medium Enterprises Development (BMSMED).

[14] The Guarantee Fund for Small and Medium Enterprises was established earlier in 1984 operated by the Livelihood Corporation attached to the office of the president tasked to provide guarantee services to participating financial institutions (PFIs) that had been lending to SMEs. (ADB 2010)

[15] The agency which was put under the supervision of the central bank has a board comprised of representatives both from the private sector and the public sector, namely the National Government, Land Bank of the Philippines, Development Bank of the Philippines, Department of Trade and Industry, and Department of Finance (DOF).

[16] The Philippine Export-Import Credit Agency (PhilEXIM) was established in 1977 under the DOF to pursue the policy of the State "to encourage and promote the expansion of Philippine exports and to establish a strong and credible export credit institution, which shall be dedicated to the provision of export financing facilities and services to support the country's sector (See PhilEXIM's website). See also ADB (2005).

Table 3. SMEs' sources of funding (% of current funding)

	SERDEF-UP ISSI, 1992	WBES, 2000	ICPS-ADB, 2004	PEP-IFC, 2006	WBES, 2009[a]
Own resources	78	52	60	69	76.4
Bank loans	15	21	11	19	10.2
Nonbank financial institution					0.9
Informal credit[b]	7	27	29	12	12.4
Total	100	100	100	100	100

Note: ICPS-ADB = Investment Climate and Productivity Study, Asian Development Bank, PEP-IFC = Private Enterprise Partnership for the Philippines (PEP-Philippines) SME Financing Survey, International Finance Corporation, SERDEF-UP ISSI = Small Enterprise Research and Development Foundation-University of the Philippines Institute for Small Scale Industries; SME = small and medium enterprise, WBES = World Bank Enterprise Survey; [a] Shares in the firms' working capital; [b] Purchases on credit from suppliers/advances from customers + loans from moneylenders, friends, and relatives

Source: Nangia and Villancourt 2007; WBES 2009

These agencies unified and simplified business procedures and requirements, making government services readily available to businesses outside the centers of commerce and "incentivizing" financing to the MSMEs. The latter include both monetary and nonmonetary incentives, as well as directing public government banks (which at that time including the Philippine National Bank, the Development Bank of the Philippines and the Land Bank of the Philippines) to provide financing assistance to MSME entrepreneurs.

The Magna Carta was amended twice in 1997 and 2002 (RA 6977 amended by RA 8289 and RA 9501) to adjust the legislation to firms' needs and changing economic conditions. Most importantly, the thresholds for asset-based enterprise classification were significantly adjusted in these two revisions. The thresholds for micro and medium firms changed the most, approximately tripling between 1991 and 1997, and roughly doubling between 1997 and 2002 (Table 4). These variations would prove to be very important to banks in their compliance to the mandated lending provision of the law. The increased thresholds mean that their target market for MSMEs had also increased in size.

In addition, the coverage of the law and the mandated share of MSMEs bank lending have also changed over the years (Table 5). In 1991, the initial mandated share of bank lending to small firms was 5% of total bank lending. This was doubled in 1992 to 10%, and then reduced to 5% again in 1996. The 1997 revision recognized that medium firms are fundamentally different from smaller firms, and established of two separate compliance rates for medium and smaller firms: for the next ten years, Philippines banks were mandated to set 6% of their total loan portfolio to small firms and another 2% to medium firms. In the 2008 revision, the law was extended to cover microenterprises, and mandated all banks to allocate 2% of their total loan portfolio to medium firms, and a further 8% to micro and small firms.

Table 4. Evolution of asset-based definition of MSMEs

Law/ regulation	Year enacted	Micro	Cottage	Small (P)	Medium	Large
RA 6977	1991	<50,000	50,001–500,000	500,001–5,000,000	5,000,001–20,000,000	>20,000,000
RA 8289	1997	<1,500,001		1,500,001–15,000,000	15,000,001–60,000,000	>60,000,000
SMED Council[a] and RA 9501	2003 2008	<3,000,000		3,000,001–15,000,000	15,000,001–100,000,000	>100,000,00

Note: MSME = micro, small, and medium enterprise; RA = Republic Act; SMED = Small and Medium Enterprise Development; [a] Refers to SMED Council Resolution No. 1 (2003)

Table 5. Mandatory share of MSME in banks' loan portfolio

Law	Year Enacted	Coverage (enterprises)	Share in Banks' Loan Portfolio (years in effect)
RA 6977	1991	Small	5% (1991); 10% (1992–1995); 5% (1996); 0% (1997)
RA 8289	1997	Small and medium	Small: 6% (1997–2007)[a] Medium: 2% (1997–2007)
RA 9501; BSP Circular 625 (2008)	2008	Micro, small, and medium	Micro and Small: 8% (2008–2018) Medium: 2% (2008–2018)[a]

Note: BSP = Bangko Sentral ng Pilipinas; RA = Republic Act; [a] RA 8289 should have ended in May 2007 but implementation of the lending provision was extended until early December 2008 (BSP Circular Letter 2007-039) because the BSP issued circular 625-2008 pursuant to RA 9501 only on 14 October 2008, which became effective 15 days after it was published on 20 October 2008

Firms considered eligible to be covered by the law have to satisfy the following four conditions. First, firms need to be registered with the appropriate agencies as presently provided by law. Second, firms should be fully (100%) owned, capitalized by Filipino citizens, whether single proprietorship or partnership. If the enterprise is a juridical entity, at least 60% of its capital or outstanding stocks must be owned by Filipino citizens. Third, firms should be participating in a business activity within the major sectors of the economy, namely, industry, trade, services, including the practice of one's profession, the operation of tourism-related establishments, and agribusiness. Lastly, eligible firms are those that are not a branch, subsidiary or division of larger scale enterprises.

2.4. Other initiatives to encourage lending to micro, small, and medium enterprises

To keep bank funds flowing steadily to the MSME sector, the BSP also instituted a number of measures to compensate lending institutions for the burden brought about by the Magna Carta. These include:

- Allowing the establishment of microfinance-oriented thrift banks and rural banks as an exemption from branching moratorium;
- Exemption of microfinance loans from normal documentation applicable to regular bank loans;
- Reduction of the reserve requirements on thrift banks and rural banks which deal with SMEs and small borrowers;
- Reduction of the risk weight applicable to qualified SMEs and microfinance loan portfolios from 100% to 75% subject to certain conditions, such as performance and financial soundness of the bank and adequacy of risk management system;
- Exemption of SME loans without latest income tax returns and/or audited financial statements from "Loans Especially Mentioned" classification provided said loans are current, have not been restructured, and are supported by income tax return and/or audited financial statement at the time they were granted;
- Deferment, for a period of 1 year, of the implementation of the market-based pricing mechanism for rediscount loans below the 91-day Treasury bill rate to help jumpstart SME lending; and
- Approval of the 12-point accreditation guidelines for rural and thrift banks and the lending features of short- and long-term loans for direct or retail lending by participating government financial institutions under the SME Unified Lending Opportunities for National Growth (SULONG).

The government also tried to increase the appeal of banking MSMEs, such as (i) establishing an effective loan guarantee system, (ii) finding ways to deal with collateral requirement issues, (iii) creating a public credit bureau, (iv) developing more appropriate ways to assess risk associated with lending to SMEs, and (v) optimizing the network of state-owned firms in delivering services to SMEs.

In order to alleviate information gaps, one important solution considered by both regulators and financial institutions is the creation of a reliable credit scoring system to assess the credit viability of firms that can be used by the entire banking system. Notably, according to ADB report (2004), "SBC's management has discovered (as have many other lenders in many places) that there is no clear correlation between the kind and quality of collateral offered to a lender and loan default. This implies that loan underwriting techniques that do not rely on traditional collateral are highly relevant in the Philippines."

To further strengthen its overall approach to facilitate financing for SMEs, the government implemented the SME Unified Lending Opportunities for National Growth (SULONG) program. The SULONG program, launched in 2003, essentially sought to provide SMEs alternative credit sources through participating government financial institutions.[17] The general objectives of the program were to: (i) simplify and standardize the lending procedures, (ii) reduce documentary requirements and expedite procedures, (iii) provide SMEs greater access to short- and long-term funds, and (iv) lower the effective cost of borrowing by SMEs and liberalize the requirement.

More recently, the BSP rolled out the Credit Surety Fund program on 2 July 2008. The rationale of this fund is "to increase the credit worthiness of MSMEs that are experiencing difficulty in obtaining loans from banks due to lack of acceptable collaterals, credit knowledge and credit track records" (BSP 2013b). Essentially, the Credit Surety Fund can serve as: (i) an alternative to acceptable collaterals, (ii) security for loans of MSMEs that are members of a cooperative, and (iii) an assurance for payment of bank loans. Investors in the fund are comprised of cooperatives, nongovernment organizations, local government units, banks, donors, and the BSP. Eligible borrowers include MSMEs who are members of cooperatives and who have businesses that meet certain conditions (BSP 2013c).

2.5. The structure of the banking industry in the Philippines

The banking industry in the Philippines forms the core of the financial system in the Philippines. Banks hold 80% of the approximately P10 trillion of total domestic financial assets as of end of 2012.[18] Nonbanks, which include investment houses and companies, among others, accounted for the remaining 20%. For the last 3 decades, this distribution hardly changed despite a fivefold growth in total financial assets from 1990 to 2000, and another 2.5-fold growth from 2000 to 2012 (Table 6).

Overall, banks in the Philippines are supervised by the BSP as prescribed by the General Banking Law passed in 2000. The law also classified banks in the Philippines as universal banks, commercial banks, thrift banks, rural and cooperative banks, or Islamic banks. The Monetary Board, which is the decision-making body of the central bank, may also create another type of bank if the need arises. The minimum capitalizations are highest for universal banks (P4.95 billion), followed by commercial banks (P2.4 billion), thrift banks (P1 billion for those headquartered in Manila and P250 million for others). The minimum capital requirement for rural banks and cooperatives are much lower, ranging from P100 million for those headquartered in Manila to below P5 million for those based in rural 5th–6th class municipalities. In our subsequent analysis, we group all these institutions into three broad groups: universal and commercial banks (UKBs), thrift banks (THBs or thrifts), and rural and cooperative banks (RCBs or rural co-ops). The average UKB has approximately 20 times the assets of the average thrift bank, which in turn has average total assets 20 times the average rural and cooperative banks.

[17] These include the Development Bank of the Philippines, Land Bank of the Philippines, Small Business Guarantee Corporation, and the Social Security System.

[18] This is approximately equivalent of $250.4 billion, based on the exchange rate of P42 per US dollar.

Table 6. Total resources of the Philippine financial system (PHP, billion)

Year	*Total*	*UKB*[a]	*THB*[b]	*RCB*	*Total Banks*	*Nonbanks*[c]
1970	18.8	17.2	0.9	0.7	18.8	
1980	248.1	172.6	10.6	5.6	188.8	59.3
1990	800.2	558.2	37.6	13.9	609.7	190.5
2000	4,077.9	3,013.6	245.8	67.4	3,326.7	751.1
2010	9,046.3	6,423.7	626.4	180.1	7,230.2	1,816.1
2012	10,516.2	7,486.7	681.6	190.1	8,358.3	2,157.8

Note: RCB = rural and cooperative bank, THB = thrift bank, UKB = universal and commercial bank; [a] Includes specialized government banks; [b] Includes savings and mortgage banks, private development banks, and stock savings and loan associations; [c] Includes investment houses, finance companies, investment companies, securities dealers/brokers, pawnshops, lending investors, nonstock savings and loan associations., venture capital corporations, credit card companies, which are under BSP supervision, and private and government insurance companies (e.g., Social Security System and Government Service Insurance System)

Source: Bangko Sentral ng Pilipinas

As of end of 2012, there were a total of 696 banks in the Philippines, of which 36 are UKBs, 70 are THBs, 589 are RCBs, and 1 Islamic Bank (which is also classified by the BSP as a UKB). Although universal and commercial banks were the least numerous out of the three broad banking classifications, they have the most extensive branch networks and hold the biggest proportion of banking resources (e.g., asset, loans, deposits, and capital). All of the 37 UKBs accounted altogether for 89.4% of total banking assets, 86.3% of total loans, 88.6% of total deposits, as well as 54.7% of total bank offices around the country. Within this UKB group, there was also a huge dispersion in terms of resources: the biggest 10 UKBs housed 74.4% of the segment's assets, release 74.3% of the segment's loans, handle 71.9% of the segment's deposits, and operate 83.7% of all the segment's offices. In other words, two-thirds of the Philippines' total financial assets and loans were concentrated in the top 10 universal and commercial banks in the country.

Compared to the universal and commercial banks, the other banking institutions in the Philippines were comparatively much smaller. Rural and cooperative banks, which accounted for 84.6% of all banking institutions (589 institutions out of 696 total in 2012), only accounted for 2.4% banking sector's value, 3% of total lending, 2.2% of total deposits while running just 28.1% of all the banking counters nationwide. Thrift banks, which were represented by 70 institutions, hold only 8.3% of the sector's total assets, disburse 10.7% of total loans, and manage 9.2% deposits through their 1,619 bank offices (17.2% of total) (Table 7).

Table 7. Financial indicators and bank network (units) by bank type, Philippines, 2012

Level (PHP billion)	*Assets*	*Loans*	*Deposits*	*Capital*	*Head Office*	*Branches*	*Total Offices*
UKB[a]	7,193.8	3,617.2	5,097.5	937.1	37	5,108	5,145
of which: Top 10	5,350.2	2,686.6	3,931.1	673.6	10	4,297	4,307
THB	666.2	446.6	529.8	81.1	70	1,549	1,619
RCB	189.7	127.5	126.4	33.3	589	2,057	2,646
Total	8,049.7	4,191.3	5,753.6	1,051.5	696	8,714	9,410
Distribution (%)							
UKB	89.4	86.3	88.6	89.1	5.3	58.6	54.7
of which: Top 10							
% of UKB	*74.4*	*74.3*	*77.1*	*71.9*	*27.0*	*84.1*	*83.7*
% of Total	*66.5*	*64.1*	*68.3*	*64.1*	*1.4*	*49.3*	*45.8*
THB	8.3	10.7	9.2	7.7	10.1	17.8	17.2
RCB	2.4	3.0	2.2	3.2	84.6	23.6	28.1

Note: RCB = rural and cooperative bank, THB = thrift bank, UKB = universal and commercial bank; [a] Al-Amanah Islamic Investment Bank of the Philippines is subsumed under UKB (per BSP directory of Banks)

Source: Bangko Sentral ng Pilipinas; Annual Reports and Press Releases of the top 10 banks (by asset size) for the number of branches

Each category of banks operated in generally distinct markets, though the market niches are starting to overlap. Rural and cooperative banks typically focused on retail clients and microloans in the countryside. The universal and commercial banks, on the other hand, serve as the primary arteries of credit for larger urban firms and are usually part of a bigger conglomerate groups themselves. Lastly, the thrift banks, some of which were large enough to compete with universal and commercial banks for big borrowers, normally focus on small and medium enterprises in metropolitan and provincial business centers left unaddressed by the UKBs. It is also important to note that a number of major thrift banks are likewise either affiliates of UKBs or financial arms of big holding companies.

3. COMPLIANCE TO THE MICRO, SMALL, AND MEDIUM ENTERPRISE MAGNA CARTA

3.1. Direct compliance

The most important part of the MSME Magna Carta is the legal mandate for mandatory credit allocation that all lending institutions have to set aside 8% of their total loan portfolio for micro and small enterprises (MSEs), and a further 2% for medium enterprises (MEs). The BSP allows banks various channels to comply with the mandatory credit allocation for MSMEs. Basically, these can be divided into two categories namely, the direct compliance and the indirect compliance. As stipulated in BSP Circular 625 issued in 2008, ways to comply directly are enumerated below, and vary across the targeted firm size.

For micro and small enterprises:

- Actual extension of loans to eligible MSEs, other than to Barangay Microbusiness Enterprises (BMBEs) which are covered in Item "c(3)" hereof:[19] Provided, however, that loans granted to MSEs other than BMBEs, to the extent funded by wholesale lending of, or rediscounted with, another bank shall not be eligible as compliance with the mandatory credit allocation; or
- Loans granted to export, import, and domestic micro and small scale traders, other than to BMBEs which are covered in Item "c(3)" hereof: Provided, however, that loans granted to MSEs other than BMBEs, to the extent funded by wholesale lending of, or rediscounted with, another bank shall not be eligible as compliance with the mandatory credit allocation; or
- Purchase of eligible MSE loans listed in Items "i" and "ii" of this list on a "without recourse" basis from other banks and financial institutions; or
- Purchase/discount on a "with or without recourse" basis of MSE receivables, other than BMBE receivables which are covered in Item "c(3)" hereof; or
- Wholesale lending or rediscounting facility granted to participating financial institutions (PFIs) for on-lending to MSEs, other than to BMBEs which are covered in Item "c(3)" hereof; or
- Wholesale lending or rediscounting facility granted to PFIs for on-lending to export, import, and domestic micro and small scale traders, other than to BMBEs which are covered in Item "c(3)" hereof; or
- Commercial letters of credit outstanding, net of margin deposits, issued for the account of MSEs.

For medium enterprises:

- Actual extension of loans to eligible MEs provided that loans grantedf to MEs to the extent funded by wholesale lending of, or rediscounted with, another bank shall not be eligible as compliance with the mandatory credit allocation; or
- Loans granted to export, import, and domestic medium scale traders provided that loans granted to MEs to the extent funded by wholesale lending of, or rediscounted with, another bank shall not be eligible as compliance with the mandatory credit allocation; or
- Purchase of eligible ME loans listed in items "i" and "ii" of this list on a "without recourse" basis from other banks and financial institutions; or
- Purchase/discount on a "with or without recourse" basis of ME receivables; or
- Wholesale lending or rediscounting facility granted to PFIs for on-lending to MEs; or
- Wholesale lending or rediscounting facility granted to PFIs for on-lending to export, import, and domestic medium scale traders; or
- Commercial letters of credit outstanding, net of margin deposits, issued for the account of MEs.

3.2. Alternative compliance

Acknowledging the difficulty and the risks of lending to fledgling enterprises early on, the government has established a set of alternative vehicles in order to comply with the MSME lending provisions of the Magna Carta.

Alternative compliance for either or both MSEs or/and MEs are allowed on the following grounds: first through paid subscription or purchase of liability instruments offered by the SBC, through paid subscription of preferred shares of stock of the SBC, or through loans (irrespective of sources) granted to Barangay Microbusiness Enterprises.[20]

Earlier, banks can also set aside special accounts consisting of cash or "due from BSP" for MSMEs which are free, unencumbered, not hypothecated, not utilized or earmarked for other purposes and include the corresponding amounts to their compliance reports as per BSP Circular 147 (1997). But this was no longer included as a mode of compliance under the new Magna Carta (RA 9501) beginning from 2008.

Another interesting feature of the law is the provision for aggregated group compliance. BSP Circular 625 (2008) states that "banks may be allowed to report compliance on a groupwide (i.e., consolidation of parent and subsidiary bank/s) basis so that excess compliance of any bank in the group can be used as compliance for any deficient bank in the group on the following conditions: (a) provided that the subsidiary bank/s is/are at least majority-owned by the parent bank and (b) provided further that the parent bank shall be held responsible for the compliance of the group."

3.3. Penalty for noncompliance

In case of non-compliance, the current penalty is relatively lenient compared with the previous versions of *Magna Carta* law. Under initial versions of the law, non-compliant banks are fined by an amount no less than P500,000 and other officers of the erring lending institutions shall be individually liable for imprisonment of not less than 6 months. The subsequent revision of the law in 1997 extended the loan earmarking program for SMEs to 2007, and dropped imprisonment provision while maintaining the monetary fine (Table 5).

The monetary penalty for noncompliance varied according to bank types though the amount was miniscule compared to the average banking assets of these institutions. Based on the most recent revision in 2008, banks were mandated to allocate 2% of their loan portfolio to medium enterprises, and 8% to micro and small enterprises. Yet banks were fined a mere \$2,300 for every percentage point that the banks failed to meet the stipulated medium enterprises loan share, and a mere \$9,300 for every percentage point below the stipulated micro and small enterprises share of the banks' loan portfolio. The penalty for other non-

[19] Item c(3) under subsection X342.3 (Eligible credit exposures) of the BSP Manual of Regulations for Bank (MORB) 2008 stipulates the mechanisms considered as "Alternative compliance for either or both MSEs or/and MEs." The provision classifies "Loans from whatever sources granted to BMBEs as provided under Subsection X365.5" as a form of alternative compliance. Section 365 of MORB 2008 covers regulations concerning "Loans to Barangay Micro Business Enterprises" while subsection X365.5 pertains to the "Incentives to participating financial institutions."

[20] See BSP No. 625 dated 14 October 2008. Subsection X365.5 of circular explains fully the details of this item.

compliant reporting behaviors was even smaller—the daily fines for the delay in submitting compliant reports range from a mere $2 for rural and cooperative banks to $28 for universal and commercial banks (Table 8).

Table 8. Penalty matrix

Item	*PHP*	*$ equivalent*
Zero compliance	500,000	11,628
Undercompliance, end of each quarter:		
Micro and small enterprises	% of undercompliance* (P400,000)	* (9,302)
Medium enterprises	% of undercompliance* (P100,000)	* (2,326)
Willful false statements to the BSP	P500,000 per quarter-end	
Nonsubmission/delayed submission of reports on compliance (per calendar day of delay)		
Universal and commercial banks (UKBs)	1,200	27.9
Thrift banks (THBs)	600	14.0
Rural and cooperative banks (RCBs)	80	1.9

Source: Republic Act 9501

4. ASSESSING BANK COMPLIANCE TO THE MICRO, SMALL, AND MEDIUM ENTERPRISE MAGNA CARTA

Given the low levels of legal penalty stipulated for non-compliance with the MSME Magna Carta, we assessed actual bank compliance to the law. This section intends to shed light on the levels and trends of bank lending to MSMEs in the Philippines and to assess banks' compliance to the Magna Carta. We proceed in two steps. First we provide an industry-level analysis, which examines the overall aggregate MSMEs lending activity of banks as a group. Second we use bank-level data to analyze patterns of compliance to the Magna Carta for MSMEs by individual universal and commercial banks, and thrift banks.

4.1. Data sources

For the industry aggregate-level analysis, we used the data on banking industry's lending to MSMEs provided by the BSP. The data series present information about the compliance to the Magna Carta for MSMEs of the three major bank types (UKBs, thrifts, and rural co-ops) covering the years from 1999 to 2010. Moreover, the data show the disaggregation of the MSME compliance to the Magna Carta according to type of compliance; in other words, we know whether the banks complied through direct compliance, indirect compliance, or "funds set aside for MSMEs."[21] However, as mentioned earlier, funds set aside for MSMEs are no longer considered as mode of compliance beginning 2008.

To assess compliance at the bank-level, we compiled a comprehensive panel dataset from the Published Statements of Condition of each lending institution posted on the BSP's website. The data series covers periods from the first quarter of 2005 to the second quarter of 2011 but limited to UKBs and thrifts because the BSP does not post the compliance information for individual rural co-ops. While these published statements comprised the most complete data publicly available on the compliance patterns of financial institutions, we note two caveats pertaining to the quality of data. Firstly, the format of the compliance ratios in these published statements (i.e., whether in percentage or absolute terms) is not consistent across reports. Thus, caution was exercised in building the panel dataset of compliance ratios. Secondly, a number of banks do not report their Magna Carta compliance ratios in some of their public statements. Hence, we distinguished zero lending to MSMEs from absence of data. Nevertheless, our post-cleaning final sample with complete data consists of 109 financial institutions (out of an initial sample of 136), which altogether represented over 90% of the finance sector assets in the Philippines.

4.2. Descriptive statistics of aggregate lending

The outstanding amount lent by all lending institutions to MSMEs increased modestly from 1990 to 2010 (Figure 1). Financing to MSMEs rose from P248.2 billion to P308.5 billion in those 12 years, representing a growth rate of 2.3% per year. UKBs provide the bulk of these bank loans. Although their share decreased from 83.7% in 1999, they still accounted for 72.9% of the total loans in 2010. Thrifts, on the other hand, saw their share of MSME lending rising from 13% in 1999 to 19.8% in 2010. The strongest growth in market share is observed for rural co-ops, which tripled their share of MSME financing from below 3.3% to12.6% in 2009, before retreating to just above 7.3% by the end of 2010.

The decline in commercial banks' market share is partially a result of tepid growth in their overall lending operations between 1999 and 2010, which saw a compounded annual growth rate of only 0.72%. Thrifts expanded their loans to MSMEs by over 7% annually during the 11-year span. Rural co-ops were even more aggressive in lending to MSMEs, growing their MSME portfolio by 20% annually until 2008 until a pullback beginning in 2009. In 2009, total MSME lending by rural co-ops declined by 1.4%, and then contracted sharply in 2010 by 41.9%.[22]

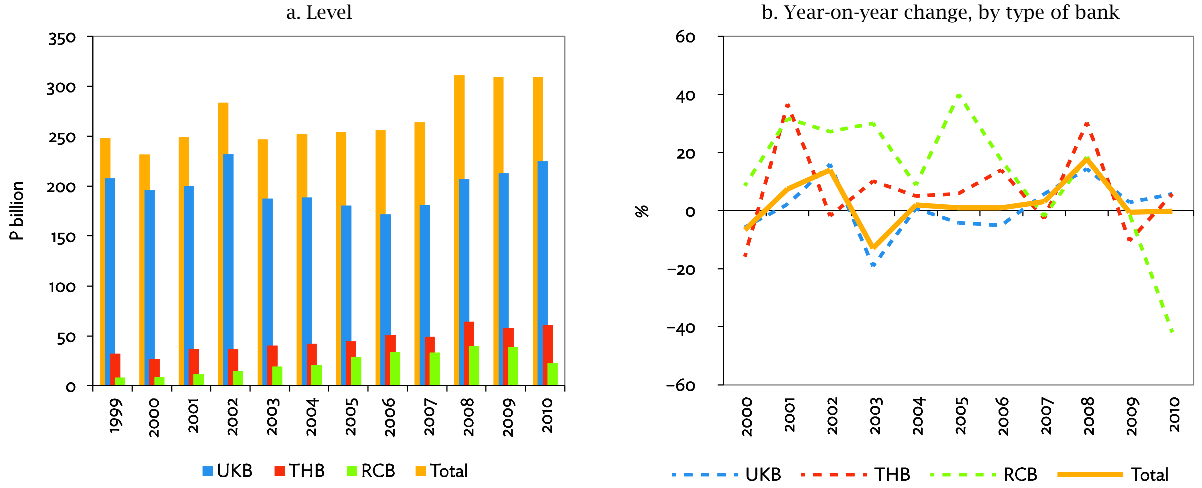
The aggregate data reveals two important trends. Firstly, despite the increase in total lending volume, the share of MSMEs in the banking sector's lending portfolio has declined significantly since

[21] The "funds set aside for MSMEs" is defined by the BSP (as indicated in the data file) as the item consisting of either Cash on Hand and Due from BSP which are free, unencumbered, not hypothecated, not utilized or earmarked for other purposes. The Due from BSP is a special account deposited with the BSP and does not form part of the bank's legal reserves. Under the new mandatory credit allocation (RA 9501).

[22] The compounded annual growth rate of MSME lending for thrifts was 6%. In contrast, the compounded annual growth rate for rural co-ops was 19.3% from 1998 to 2008, and compounded annual growth from 1998 to 2010 fell to 9.8%.

2002. Secondly, despite the decreasing share in MSME loans, aggregate lending to the MSME sector still far exceeds the explicit 10% goal of the Magna Carta. At the peak in 2002, MSMEs accounted for 30% of the total loan portfolio of all lending institutions. This declined to 16.4% in 2010 (Figure 2). The reduction in banks' MSME exposure is common across banking groups. Thrifts have started moving away from the MSME market in 2000. The UKBs followed a similar track in 2002. And even the rural co-ops began expanding more in non-MSME market in 2006.

Figure 1. Bank lending to MSMEs



Note: MSME = micro, small, and medium enterprise; RCB = rural and cooperative bank; THB = thrift bank; UKB = universal and commercial bank

Source: Bangko Sentral ng Pilipinas

It is important to point out that despite the decline, lending to medium firms in 2010 was more than 300% above the Magna Carta target of 2%, while that for micro and small firms were closer to the targeted 8% of total bank lending. Not so surprisingly, the reduction affected smaller firms more than medium firms (Figure 2). What is intriguing is that in 2010, the bank lending to medium firms, despite declining from a peak of 12.6% of all loans, was still more than threefold of the relevant Magna Carta target. Meanwhile, lending to the micro and small segment was closer to the mandatory requirement of 8%. This is mainly driven by the continuous decline of UKB lending to medium-sized enterprises—which in itself is already 1.4 percentage points below the legal requirement in 2010. Thrifts and rural co-ops, on the other hand, still keep their ratios above what is mandated by the Magna Carta but the pace at which these ratios are decreasing raises the question of the future trends for loans to micro and small firms. These trends imply that although absolute levels of lending to MSMEs are rising, the growth rates of lending to the said target sectors are consistently slower than the growth of bank lending to other sectors.

4.3. Direct compliance versus alternative compliance

As we can see from Figure 3, banks favored direct compliance since 1999 and even more so since 2008. Data provided by the central bank indicate that banks have actually reduced exposure to other facilities and instead increased direct lending operations since 2008 to almost 100% of their lending to MSMEs. The lack of attractiveness of the yields of alternative notes appears to be one of the key issues.[23] SBC's wholesale lending also took a hit during the height of the global financial crisis when the central bank expanded and reduced the interest rate of its re-discounting facility to keep the banking system liquid, which directly competed with SBC's wholesale lending operations (ADB 2010).

In response, the SBC, through Memorandum No. 6 (2011), has decided to narrow the spread of its notes against the benchmark secondary bond rate (PDST-F) from 33% of the yields of the corresponding reference fixed-income notes (1 year and 6 months) to 20%.[24] SBC also issued preferred shares worth P1.6 billion at P100 per share (minimum of 2,000 shares) to further boost its capital. Notably, the ADB loan granted to SBC has been the corporation's biggest infusion of rolling capital between 2000 and 2010. In 2005 the loan accounted for 11% of the corporation's total lending in 2006, 51% in 2007, 61% in 2008, and 76% in the first half of 2009 (ADB 2010).

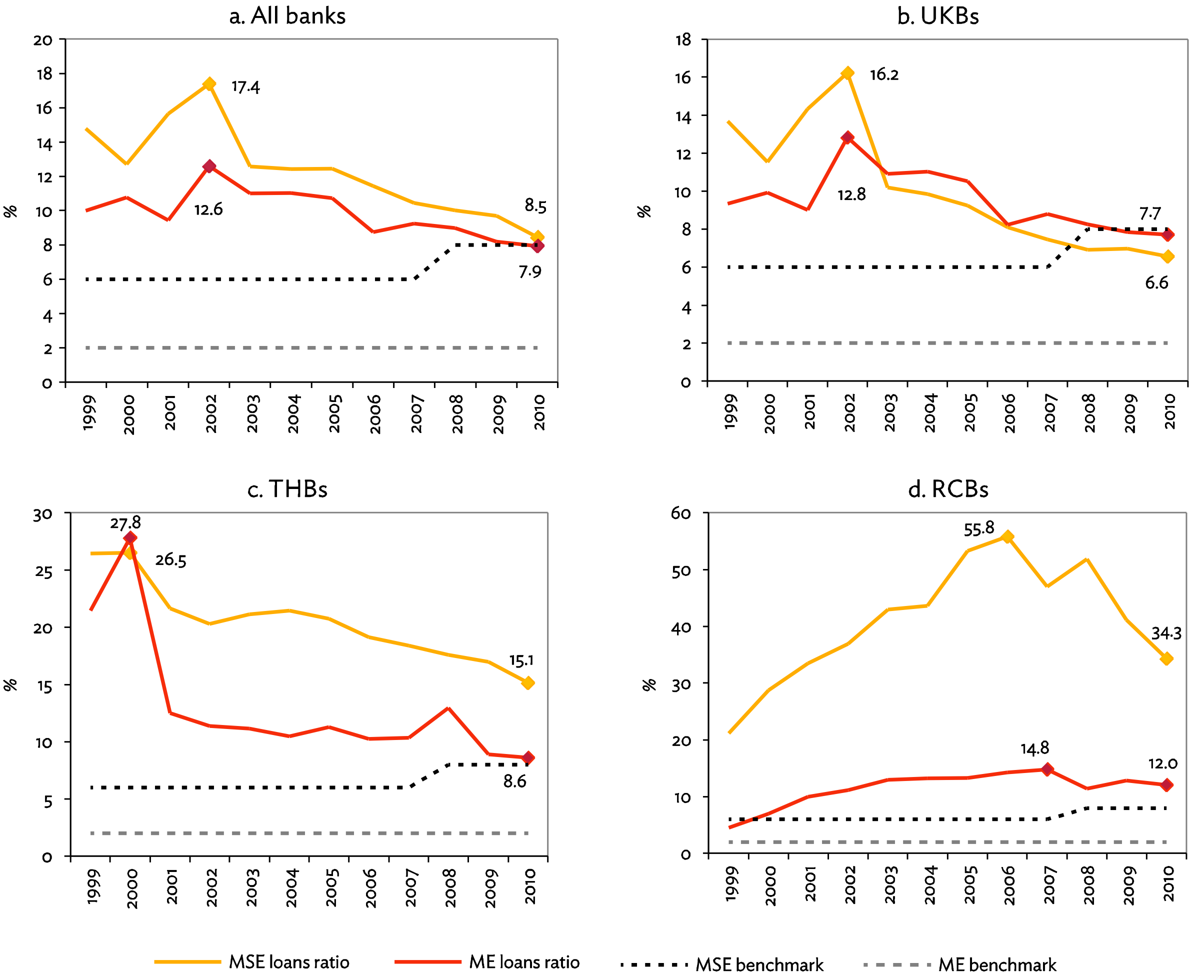
4.4. Bank-level data and descriptive statistics

This section examines individual bank compliance to the Magna Carta for MSMEs, using comprehensive panel data that we have compiled. This is, as far as we are aware, the first panel data and analysis on this question. Data on these individual lending institutions were available quarterly from 2005 to 2011, and did not cover rural and cooperative banks.

[23] Lamberte (2002) observes that alternative modes of compliance like SBC notes "do not pay market rates" while deposits with the central bank allotted for SMEs do not bear interest.

[24] This secondary bond rate is also referred to as the Money Market Association of the Philippines (MART 1) benchmark rate.

Figure 2. Bank lending to MSMEs, by type of bank (% of loan portfolio)



Note: ME = medium enterprise; MSE = micro and small enterprise; MSME = micro, small, and medium enterprise; RCB = rural and cooperative bank; THB = thrift bank; UKB = universal and commercial bank; Total loan portfolio is net of certain exclusions per BSP Circular 625 (2008)

Source: Bangko Sentral ng Pilipinas

4.4.1. General trends of direct compliance

Data from individual lending institutions reveals significant heterogeneity in the direct compliance of various lending institutions to the law. In particular, there was a decrease in direct compliance amongst universal and commercial banks beginning in the late 2007. Based on the data, approximately 33% of all the UKBs reporting data to the BSP were lending less than 8% of their total loan to micro and small enterprises by 2011. Another 10% of all UKBs also did not meet the 2% of loan portfolio mandatory lending requirement to medium enterprises (Figure 4).

This was a stark contrast to the earlier years, when direct compliance was much stronger. In 2005, non-compliant UKBs were only about 5% (small) and 5.3% (medium) of the group. Moreover, about a quarter of the supervised banks did not indicate their MSME lending ratios in their reports. Approximately three quarters of these banks with no data are foreign-owned. Based on the available information on loan portfolios of foreign-owned banks, it is possible that the actual noncompliance among UKBs could exceed 60% for micro and small, and around 25% for medium enterprises.[25]

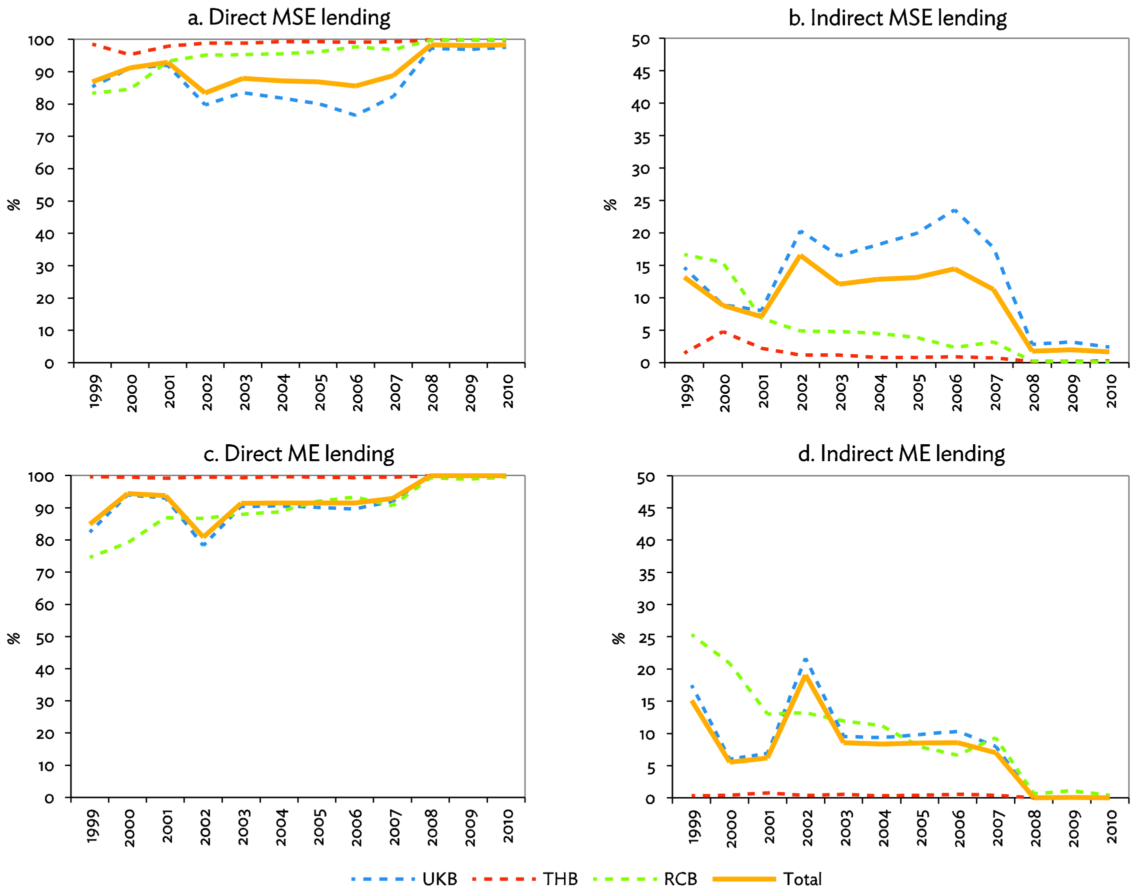
One of the reasons the sharp decrease in direct compliance could be the increase in the mandated MSME loan share from 6% to 8% following the revision of the law in 2008. It is possible that many UKBs found it challenging to increase their loans to micro and small enterprises by another 2 percentage points when the regulation was altered. Even though microenterprises were added into the equation, this proved to be of little value to them since microenterprises were not the focus of most UKBs. Unfortunately the data does not disaggregate loans to small and microenterprises. As for UKBs' declining share of loans to medium firms, one potential explanation could be the uncertainties of the economic conditions that affected the country's external position following the global financial crisis of 2008.

On the other hand, direct compliance among thrift banks has increased from 86% in 2005 to almost 97% as of the first quarter of 2011 (Figure 5). Although it appears that the revision in the Magna Carta

[25] In a separate study, SBC also estimated that 60% of UKBs are not complying with the mandated MSE portfolio while 32% of UKBs are not complying with the mandated ME portfolio (See Lagua 2011).

compounded by the sudden downturn in the general business climate has affected the UKBs lending to MSMEs adversely, these factors seem to have muted effect on thrift banks. Perhaps, the policy change may have even benefited them since thrift banks have better access to microenterprises than the universal banks. Hence, the inclusion of microenterprises in the mandated lending requirement has most likely allowed some of these thrift banks that are formerly below the benchmark to meet the legal requirement in spite of the 2 percentage point increase in the legal threshold.

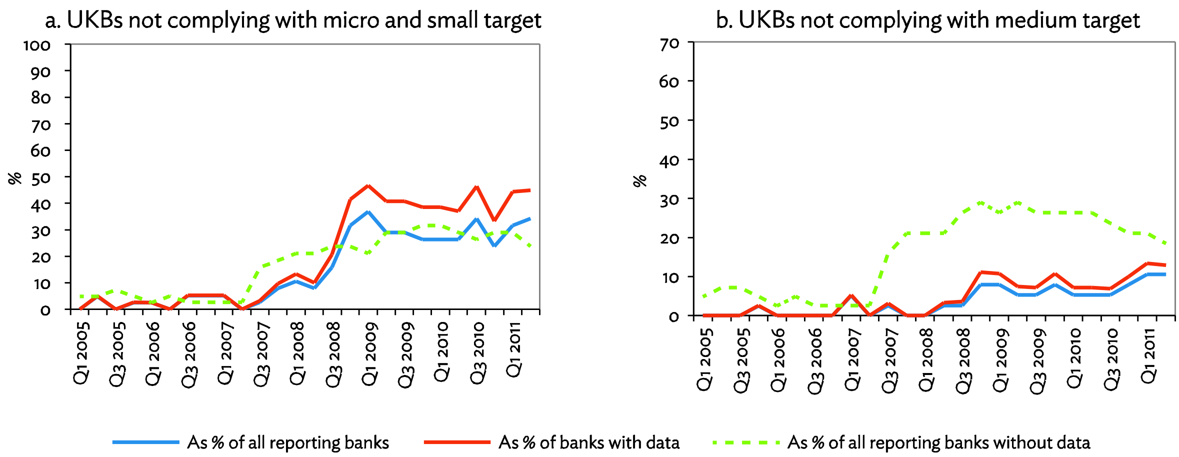
Figure 3. Distribution of direct and indirect lending to MSMEs, by type of bank (% of total compliance)



Note: ME = medium enterprise; MSE = micro and small enterprise; MSME = micro, small, and medium enterprise; RCB = rural and cooperative bank; THB = thrift bank; UKB = universal and commercial bank; Indirect compliance includes "Funds Set Aside for MSMEs" for the years 1999-2007

Source: Bangko Sentral ng Pilipinas

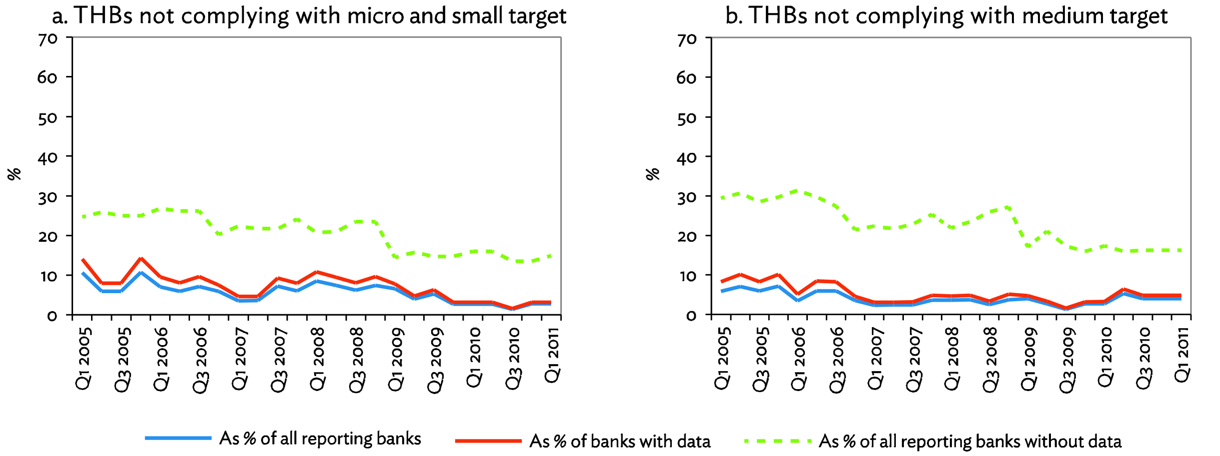
Figure 4. Share of UKBs not directly complying with the Magna Carta



Note: UKB = universal and commercial bank; Lending to small enterprises mandated by law was increased from 6% to 8% of total portfolio starting in 2008

Source: Author's calculation using BSP data (published statements of conditions)

Figure 5. Share of THBs not directly complying with the Magna Carta



Note: THB = thrift bank; Lending to small enterprises mandated by law was increased from 6% to 8% of total portfolio starting Q4 2008

Source: Author's calculation using BSP data (published statements of conditions)

4.4.2. Robustness of direct compliance from 2005 to 2010

Just as the aggregated data has highlighted, the average loan shares of both micro and small enterprises and medium enterprises were far higher than the legal targets of 6% and 2% respectively (Table 9). On average, the banks in this truncated sample increased the share of micro and small enterprises loans within their portfolio from an average of 15.8% in 2005 to 17.5% in 2010. Thus the average lending institution (out of 130) was lending 3 times the targeted share for small and medium enterprises. However, loans to medium firms were only slightly higher than targeted: in 2010, the average bank lent 10% of their portfolio to medium firms.

Table 9. Summary statistics of MSME lending, 2005-2010

	2005	*2006*	*2007*	*2008*	*2009*	*2010*	*All*
			% of loans to micro and small: Whole sample				
Mean	15.8	16.07	17.31	16.51	15.79	17.49	16.64
Std Dev	14.44	15.29	16.73	14.99	14.8	15.6	25.34
Min	0.95	0.59	1	0.77	0.55	1.12	0.55
Max	87.99	75.57	84.56	87	88.31	88.18	88.31
			% of loans to medium: Whole sample				
Mean	11.12	10.63	11.7	11.7	10.32	10.01	10.92
Std Dev	11.4	11.06	12.68	11.05	9.08	9.56	10.91
Min	0.53	0.22	0.09	0.15	0.1	0.12	0.09
Max	61.83	59.04	63.5	62.45	54.01	62.39	63.5
			% of loans to micro and small: UKB				
Mean	8.16	7.54	7.57	7.78	7.66	7.66	7.73
Std Dev	3.8	3.19	3.45	3.17	2.95	3.1	3.31
Min	5.27	5	4.75	1.79	1.97	1.74	1.74
Max	30.05	23.83	27.34	22.63	15.73	21.54	30.05
			% of loans to medium: UKB				
Mean	7.13	6.35	6.49	7.53	7.43	7.86	7.06
Std Dev	5.25	4.51	4.57	4.83	4.18	5.12	4.78
Min	1.98	2	1.64	0.15	0.1	0.12	0.1
Max	24.93	20.98	21.85	19.39	17.18	24.53	24.93
			% of loans to micro and small: Thrift banks				
Mean	20.78	21.31	22.61	20.52	20.71	21.81	27.3
Std Dev	16.51	17.29	18.61	16.5	16.07	16.94	17.01
Min	0.95	0.59	1	0.79	0.55	1.12	0.55
Max	87.99	75.57	84.56	87	88.31	88.18	88.31
			% of loans to medium: Thrift banks				
Mean	13.93	13.32	14.65	13.66	11.54	10.98	12.99
Std Dev	13.54	12.96	14.7	12.52	10.24	10.86	12.58
Min	0.53	0.22	0.09	0.2	0.31	0.26	0.09
Max	61.83	59.04	63.5	62.45	54.01	62.39	63.5

Source: Authors' calculations using data from the ADB SME Financing Survey

Nonetheless, there is considerable dispersion in banks' decisions to lend to MSMEs. Although UKBs supplied the biggest amount of loans to MSMEs, their own loan portfolio reflected that lending to MSMEs were not their priorities. For these banks, the share of micro and small firms in their loan portfolios ranged from 1.7% to 25.4% in 2010, while the share of medium firms ranged from 0.1% to 24.9%. It is noteworthy that the average UKB reported only 7.7% of loans to micro and small enterprises, which is below the Magna Carta target.

Meanwhile, there is even greater dispersion in the portfolio decisions of the smaller thrift banks although on average they greatly exceeded the Magna Carta targets. The average thrift bank allotted 21.8% of its loans to micro and small firms (almost 3 times the target), and another 11% to medium firms (over 5 times the target). This suggests that on average, the focus of thrift banks was indeed the smaller firms. Nevertheless, the share of loans to micro and small firms ranged from 1.1% to 88.2%, while that of medium firms ranged from 0.2% to 62.4%. Clearly, some thrift banks were focusing on micro and small firms, while some focused on larger firms.

The trends from individual banks reporting data can be summarized in the following three points. First, universal and commercial banks tend to not focus on MSMEs though they supplied the bulk of credits to MSMEs. Second, loans to medium firms were much higher than legally mandated across all banks. Third, there was a huge dispersion across banks in their optimal loan portfolio choices.

How many banks were directly complying with the Magna Carta Law? Our panel dataset on compliances included 24 quarters of data that can shed some light on the dispersion in portfolio choices (Table 10). We find that only 65.4% of all banks were complying directly on the target for micro and small enterprises at least one quarter. In other words, 36.4% of banks reported at least one incident of under-compliance. Only 2.1% of all banks reported under-complying with the target of direct lending to the micro and small enterprises for 13 to 16 quarters (more than half of all the periods observed). Another 5.5% of banks reported under-complying between 9 and 12 quarters. More importantly, the majority of banks reported over-complying (and even super-complying) with the micro and small lending targets for at least one quarter. In fact 8.4% of all banks reported that they super-complied for most of the periods observed.

Table 10. Frequency of bank direct compliance to the Magna Carta targets across bank types in the Philippines, 2005–2010

Whole Sample	*Number of quarters the banks complied with the Magna Carta*						
	0	*(1-4)*	*(5-8)*	*(9-12)*	*(13-16)*	*(17-20)*	*(21-24)*
Loans to micro and small enterprises							
Undercomply	65.4	20.1	6.9	5.5	2.1	0.0	0.0
Justcomply	51.6	22.1	9.7	11.8	3.5	1.3	0.0
Overcomply	39.1	22.2	15.2	13.2	8.3	1.4	0.6
Supercomply	48.8	15.9	5.5	10.4	5.5	5.5	8.4
Medium enterprises							
Undercomply	84.8	11.8	2.1	0.0	1.4	0.0	0.0
Justcomply	75.1	17.3	3.5	2.8	0.7	0.7	0.0
Overcomply	55.7	19.4	14.5	5.5	3.5	1.4	0.0
Supercomply	30.8	10.4	4.8	10.4	9.7	8.3	25.6
UKBs							
Loans to micro and small enterprises							
Undercomply	49.2	26.5	6.6	13.3	4.4	0.0	0.0
Justcomply	18.2	17.7	22.1	26.5	11.1	4.4	0.0
Overcomply	27.1	26.5	11.1	19.9	13.3	0.0	2.2
Supercomply	75.7	19.9	0.0	2.2	2.2	0.0	0.0
Medium enterprises							
Undercomply	86.7	13.3	0.0	0.0	0.0	0.0	0.0
Justcomply	64.6	19.9	6.6	6.6	2.2	0.0	0.0
Overcomply	49.2	15.5	17.7	8.8	8.8	0.0	0.0
Supercomply	29.3	15.5	6.6	2.2	6.6	6.6	33.2
Thrift banks							
Loans to micro and small enterprises							
Undercomply	72.8	17.1	7.1	2.0	1.0	0.0	0.0
Justcomply	66.8	24.2	4.0	5.0	0.0	0.0	0.0
Overcomply	44.6	20.2	17.1	10.1	6.0	2.0	0.0
Supercomply	36.5	14.1	8.1	14.1	7.1	8.1	12.1
Medium enterprises							
Undercomply	83.9	11.1	3.0	0.0	2.0	0.0	0.0
Justcomply	79.9	16.1	2.0	1.0	0.0	1.0	0.0
Overcomply	58.7	21.2	13.1	4.0	1.0	2.0	0.0
Supercomply	31.5	8.1	4.0	14.1	11.1	9.1	22.2

*Note: UKB = universal and commercial bank; UNDERCOMPLY (lending < mandated), JUSTCOMPLY (mandated=lending< 1.1*mandated), OVERCOMPLY (1.1*mandated≤lending< 2*mandated), and SUPERCOMPLY (lending≥2*mandated)*

Source: Authors' calculations using data from the ADB SME Financing Survey

Not surprisingly, banks were better able to comply with the legal targets for medium enterprise loans. Most banks (69.2%) reported super-complying at least for one quarter by lending more than twice the legal mandate to medium firms. Only 15% of all banks reported any incidence of under-compliance. Furthermore, only 3.5% of all banks reported that they failed to comply with the medium-firm targets for more than 4 quarters during the period we observed.

5. POLICY IMPLICATIONS AND AREAS FOR FUTURE RESEARCH

To summarize, our results highlighted three trends. First, although the total lending levels to MSMEs remained fairly stable, the percentage shares of loans allocated to MSMEs declined drastically from about 30% of total loans in 2002 to 16% of total loans in 2010. Second, banks are finding it harder to meet the target for loans to smaller firms, especially after the target was revised upwards in 2008. The new mandates resulted in a sharp increase in noncompliance in direct lending to micro and small firms, especially amongst universal and commercial banks. Kernel density estimates suggest that the revision of the Magna Carta in 2008 was binding for small firm lending particularly for the universal and commercial banks. Third, there is an increased dispersion in optimal loan portfolio across banks. Most surprisingly, the absolute level of MSME lending by rural co-ops declined since 2008.

Looking ahead, we see various developments recently could potentially further reduce banks' lending to MSMEs. For one, the implementation of the new Basel 3 framework, which raises banks' minimum financial ratios (e.g., Common Equity Tier 1 ratio, Tier 1 ratio and capital adequacy ratio), introduces new parameters such as liquidity coverage ratio and net stable funding ratio, and at the same time increases the risk weights of several asset items, could potentially siphon credit away from the MSME sector. These include the implementation of the Basel 3 parameters, the relaxation of foreign investor participation in rural co-ops, the establishment of the long-awaited credit information bureau, and the expansion of the Credit Surety Fund program of the BSP. There appears to a consensus that the new set of Basel 3 bank soundness criteria will have a dampening effect on MSME lending, not to mention that the BSP just announced a much higher set of ratios than what were prescribed by Basel 3. On the positive side, the latter three developments will most likely boost MSMEs' bankability.

Nonetheless, the BSP shows not only its willingness to adhere to the new set of standards but directed Philippine banks to maintain financial ratios that are 1.5 to 2 percentage points higher than the international benchmarks (BSP Circular No. 781 of 2013). It stipulated that inclusive of conservation buffer of 2.5% of risk-weighted assets, banks should maintain a Common Equity Tier 1 ratio of 8.5% (versus 7% in the B3F), a Tier 1 ratio of 10% (versus 8.5% in the B3F) and a capital adequacy ratio of 12% (versus 10% in the B3F). In the same circular it was noted that the new set of guidelines will be effective beginning 1 January 2014.[26]

Another potential drag on MSME financing is the continued decline in the number of rural co-ops (See box). A spate of bank closures has reduced the number of rural co-ops from 617 by end 2011 to 577 by the end of June 2013. This trend may not have a severe impact on the total value of loans by virtue of the small size of rural co-ops relative to the entire banking sector. But, adverse effect could be felt in terms of the number of MSME clients in the countryside that could lose access to formal credit and better served by rural co-ops prioritizing micro and small clients.

On the upside, recognizing the challenges faced by rural banks, the government passed RA 10574 on 24 May 2013 that effectively increased the allowable equity share of foreigners in rural banks from 40% to 60%. The new law, which amended Sections 4 to 8 of the Rural Bank Act of 1992 (RA 7353), sought to assist rural banks in meeting the capital requirements and put them "on a level playing field with its thrift and commercial banking counterparts that are able to take in foreign partners" according to one of the bill's authors in the Senate (Macrohon 2013).

The prospect of having a fully functional credit information bureau by end of 2014 could also help a lot in improving the transparency of MSMEs' financial standing. Named Credit Information Corporation (CiC), the government-owned and controlled credit bureau was established courtesy of the passage of the Credit Information System Act (RA 9510) on 31 October 2008. The implementing rules and regulations of RA 9510 were ironed out on 27 May 2009. However, it took more than 2 years before CiC started operating on 16 December 2011 and another 5 months before its board members were appointed by the President.[27] Recently, the Securities and Exchange Commission, which is the government agency taking charge in setting up CiC, announced that it is expecting the new credit bureau to function fully in December 2014 (Dumlao 2013).

The CiC, which will mainly target small businesses, is a public–private partnership co-owned by the government (60%) and the private sector (40%). As of November 2012, the private sector parties with stakes in the corporation include the Philippine Cooperatives Center, Bankers Association of the Philippines, Credit Card Association of the Philippines, Chamber of Thrift Banks, Rural Bankers Association of the Philippines, and the Philippine Credit Reporting Alliance (CiC 2012). Note that, prior to the establishment of CiC, two credit bureaus have been created. These are the Credit Information Bureau Inc., which was an initiative of the Central Bank of the Philippines and the Financial Executives Institute of the Philippines, and the Credit Bureau set up by the Bankers Association of the Philippines in 1991.[28] However, the aforementioned two credit bureaus have largely confined their operations to large companies.

The expansion of the BSP's Credit Surety Fund program is an additional booster to MSME lending. From just one fund, the number of pooled resource financing vehicle rose to 27 by the end of March 2013. Since 2010, the approved loans increased fivefold from P134 million to P679.2 million by the

[26] OECD (2012) argued that "the retail risk rating (75%) can be used to weight SME loans, provided the bank's portfolio is diverse and the bank's loan to an SME borrower is less than EUR1 million." Nevertheless, it also noted that "the weighting system also favors many large enterprises over small ones: large companies with good external credit ratings (AAA) are assigned a 20% risk weight, whereas SMEs that are unrated have risk weightings of 100% or 75%. Under Basel III, the difference in core Tier 1 capital the bank needs to hold against their loans is remarkable: 7% of the loan for SMEs with 100% risk weighting, as opposed to 1.4% (7% × 20%) for a large company with an AAA rating."

[27] See CiC Milestones: Historical Background and Timeline.

[28] The Central Bank of the Philippines was renamed Bangko Sentral ng Pilipinas in 1993.

end of the first quarter of 2013. In the same period, released loans increased over sixfold from a little less than P82.2 million to P501.6 million.[29]

Despite the Magna Carta and its subsequent revisions along with the accompanying support measures, bank lending to MSMEs has not increased much. More disconcertingly, MSME lending is generally on a decline as a ratio of banks' total loan portfolio. A substantial drop in MSMEs' share in bank loans is particularly evident among UKBs. Even thrifts and rural co-ops, which are supposed to be the ones absorbing the MSME credit demand, have likewise reduced their lending ratios to the MSMEs quite significantly from 2004 to 2010. Although nominal values show that lending by thrifts and rural co-ops to MSMEs are growing at a decent pace, it appears that their lending to other sectors are expanding even more briskly.

Smaller firms are impacted more than medium-sized firms with the ongoing migration of bank lending portfolio to non-MSME clients. UKBs as a group have already decreased their MSME lending below the mandated 8% ratio. At the level of individual institutions, there is also a notable increase in the number of UKBs not complying with the MSE lending provision of the Magna Carta. In other words, it is more profitable for UKBs to pay the penalties rather than lend to MSEs.

On the other hand, MSE lending of thrifts and RCBs continues to expand. But, lending data illustrate that the share of MSEs in their credit disbursements has declined significantly although still well above the Magna Carta's required ratio. Further research would be required to understand the determinants of this pattern. Nonetheless, understanding these recent changes in MSME lending preferences would be essential in crafting future financial inclusion programs. On a positive note, bank-level data suggest that more thrifts have recently become more compliant to MSE lending requirement.

We conjecture that perhaps abolishing the Magna Carta targets for loans to medium-sized enterprises might not have much adverse effects. It is also notable that consistently, banks do not have trouble complying with the mandated lending ratio for middle-sized firms. As of 2010, UKBs, thrifts and rural co-ops maintained a good positive margin with respect to the legal requirement and noncompliance was limited. However, the steady downward trend in MSME loan allocation across bank groups in recent years cannot be overlooked. This trend parallels the downward drift of banks' lending ratio to micro and small firms explained above. The differences lie in the degree of the decline —which is more muted in the case of lending to medium firms whereby the banks' allocation was still much higher than mandated by law.

The overall pattern of decreasing share of bank lending to MSMEs thus suggests a need to revisit, if not redesign, the current MSME lending policy framework. While the dynamism of the MSME sector hinges upon having reliable access to financing, banks in return should be given reasonable incentives to align their business models with the government's social agenda. In addition, there are ways to increase alternative sources of credit for MSMEs, such as developing equities and bonds market suitable for MSMEs. The government could also further improve measures to increase financing supply by harnessing untapped domestic savings and foreign exchange reserves rather than relying on a strict mandate on banks' portfolio allocation. Banks were finding it increasingly onerous to comply with the law and more than a half of commercial and universal banks undercomplied for at least a quarter during the period we observed. Expanding alternative means of financial access for MSMEs would be even more important given looming policy and institutional changes.

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