Document of
The World Bank

Report No: 18328-PH

PROJECT APPRAISAL DOCUMENT

ON A

PROPOSED LOAN

IN THE AMOUNT OF US$150 MILLION EQUIVALENT

TO THE

THE LAND BANK OF THE PHILIPPINES

FOR A

THIRD RURAL FINANCE PROJECT

September 23, 1998

Rural Development & Natural Resources Sector Unit
Philippines Country Management Unit
East Asia & Pacific Region

CURRENCY EQUIVALENTS

(Exchange Rate Effective September 8, 1998)

Currency Unit = Peso (P)
1 Peso = US$0.0227
US$1.00 = 44 Pesos

FISCAL YEAR

Land Bank of the Philippines: January 1 - December 31

ABBREVIATIONS AND ACRONYMS

ARF	-	Agrarian Reform Fund
BSP	-	Bangko Sentral ng Pilipinas (The Central Bank)
CARP		Comprehensive Agrarian Reform Program
CLF	-	Countryside Loan Fund
DBP	-	Development Bank of the Philippines
DENR		Department of Environment and Natural Resources
DOF	-	Department of Finance
EMB	-	Environmental Management Bureau
GOP	-	Government of the Philippines
IDP		Institutional Development Plan
LBP	-	Land Bank of the Philippines
MLF		Micro-finance Loan Fund
NGOs		Non-Government Organizations
PCFC		People's Credit & Finance Corporation
PFIs	-	Participating Financial Institutions
RBs	-	Rural Banks
TBs		Thrift Banks
SDI	-	Subsidy Dependence Index
SCL	-	Single Currency Loan at Libor-Based Floating Rate

Vice President: , EAPVP
Country Manager/Director: Vinay K. Bhargava, EACPF
Sector Manager/Director: Geoffrey B. Fox, EASRD
Task Team Leader/Task Manager: Arie Chupak, EASRD

PHILIPPINES

THIRD RURAL FINANCE PROJECT

CONTENTS

Annexes

Philippines
Third Rural Finance Project

Project Appraisal Document

East Asia & Pacific Regional Office
Philippines Country Management Unit

Date: September 8, 1998	Task Team Leader/Task Manager: **Arie Chupak**
Country Manager/Director: **Vinay K. Bhargava**	Sector Manager/Director: **Geoffrey B. Fox**
Project ID: **PH-PE57598** Sector: **Rural Development**	Program Objective Category:
Lending Instrument: Financial Intermediary Loan	Program of Targeted Intervention: [x] Yes [ ] No

Project Financing Data [x] **Loan** [ ] **Credit** [ ] **Guarantee** [ ] **Other [Specify]**

For Loans/Credits/Others:

Amount (US$m/SDRm): **US$150 million**
Proposed terms: [ ] Multicurrency [x] Single currency, specify US$
Grace period (years): **5 years** [ ] Standard Variable [ ] Fixed [x] LIBOR-based
Years to maturity: **20**
Commitment fee: %
Service charge: %

Financing plan (US$m):

Source		Local	Foreign	Total
LBP		1.8	0.2	2.0
PCFC		0.2	0.1	0.3
IBRD		64.9	85.1	150.0
PFIs		21.4	-	21.4
Sub-borrowers		42.4	-	42.4
	Total	130.7	85.4	216.1

Borrower: The Land Bank of the Philippines (LBP)
Guarantor: The Republic of the Philippines
Responsible agency(ies): LBP and the People's Credit & Finance Corporation (PCFC)

Estimated disbursements (Bank FY/US$M):	1999	2000	2001	2002	2003	2004
Annual	30	40	30	30	19	1
Cumulative	30	70	100	130	149	150

For Guarantees: [ ] Partial credit [ ] Partial risk

Proposed coverage:
Project sponsor:
Nature of underlying financing:
Terms of financing:
Principal amount (US$)
Final maturity
Amortization profile
Financing available without guarantee?: [ ] Yes [ ] No
If yes, estimated cost or maturity:
Estimated financing cost or maturity with guarantee:

Project implementation period: 5 years Expected effectiveness date: 01/15/99 Expected closing date: 06/06/2005

OSD PAD Form: July 30, 1997

A: Project Development Objectives

1. Project development objective and key performance indicators (See Annex 1a & 1b)

Building on the achievements of the Second Rural Finance Project (Loans 3938, 3939, and 3940-PH), the proposed project would: (a) provide financial support to the rural economy to overcome the difficulties created by the regional financial crisis, and the devaluation of the Peso through the establishment of the Countryside Loan Fund III (CLF III); (b) assist the government in its efforts to alleviate rural poverty through the provision of financial and institutional support to the country's micro-finance system; (c) strengthen: (i) LBP as the main financial institution serving the rural areas, and (ii) PCFC as the country's main conduit for micro-finance; and (d) help to enforce financial discipline on PFIs.

Through CLF III the project would assist private sector enterprises, particularly small and medium sized operations, to help implement their expansion and modernization plans, to undertake new sub-projects, and to finance working capital requirements. These enterprises would thus be able to alleviate the operational and financial problems arising from the credit crunch and currency crisis and take advantage of new opportunities created by the recent economic developments.

The project would also assist LBP and PCFC in strengthening their institutions and increase their capacity to provide financial services to the rural areas and micro enterprises, respectively. Under the project, LBP and PCFC as well as PFIs would be required to apply high financial standards with regard to solvency , liquidity, profitability, and best management practices, as designed under the proposed Banking System Reform Loan. LBP and PCFC would each prepare an institutional development plan (IDP) to be agreed with the Bank and implemented during the project period.

To assist LBP's management and the Bank in monitoring and evaluating project implementation performance, a set of Key Performance Indicators (KPIs) related to project objectives was agreed at negotiations. The KPIs would include: (i) supporting rural development through financing of viable investments (number of sub-loans, total sub-project investments, and estimated incremental jobs created); (ii) strengthening LBP's capacity to finance private sector investments (real increase in equity, private deposit mobilizations, upgrading loan portfolio quality, and streamlining agrarian lending operations); and (iii) strengthening PCFC as a wholesale micro-finance institution by raising its equity and reducing its unit operating costs. More details are in Annex 1b.

B: Strategic Context

1. Sector-related Country Assistance Strategy (CAS) goal supported by the project (see Annex 1):

CAS document number: Document No. 15362-PH (CAS) and R-98-41 (CAS Progress Report)
Date of latest CAS discussion: March 24, 1998

The project would especially support two of the CAS main goals. It would (i) improve private business environment by improving availability of long term financing for viable rural investments; and (ii) contribute to poverty alleviation, directly through the financing of micro-finance enterprises and indirectly through job creation as a result of the provision of term lending for investments in the rural areas. The recent CAS Progress Report also reaffirmed the need to respond to both the the new opportunities resulting from the Mindanao peace agreement and the Asian financial crisis by enhancing the country's international competitiveness through, inter alia, strengthening and deepening the financial system. The CAS Progress Report, highlighted the need to intensify Bank's support through technical assistance and quick disbursing loans. In addition, lines of credit for agriculture and industry would be provided in light of constrained availability of term credit to the private sector. This project would provide some of this credit. Also, because it is directed towards the countryside, it would also provide essential support to the implementation of the Bank's rural development assistance strategy.

2. Main sector issues and Government strategy:

The Philippine economy has recovered from its poor performance of the early 1990s and has been growing for the last 4 years. However, the recent East Asian financial crisis has impacted negatively on the Philippine economic growth and the stability of the banking sector. Real GNP growth decelerated from 6.9 percent in 1996 to 5.8 percent in 1997, with a projection of a further decline to a negligible level in 1998. Currently inflation is exceeding 10%, unemployment as of April 1998 is reported to have risen sharply to 13.3%, estimates of the fiscal deficit have rapidly escalated, the Peso has weakened and following a period of decline, market interest rates have begun to rise.

The East Asian currency and financial disturbances in the latter half of 1997 revealed some weaknesses in the Philippine economy. The liberalization of capital account transactions in 1992 encouraged the inflow of foreign capital that led to a real appreciation of the peso while the nominal exchange rate remained stable. The stable peso and higher domestic interest rates relative to interest rates abroad, led to dollar-denominated borrowings by a number of companies and banks. This led to the extension of dollar-denominated loans which generally were unhedged by borrowers. Hence, the substantial depreciation since July 1997 exposed a number of borrowers to liquidity and solvency problems.

Because of a decade of structural adjustment effort assisted by Bank and IMF, a relatively shorter period of credit growth and reliance on private capital flows, the Philippines' financial problem seems to be of a different order of magnitude than those of neighboring countries. Net foreign capital inflow declined sharply from about $8 billion in 1996 to below US$1 billion in 1997, while the current account deficit widened in 1997 to about $4.5 billion. This was mitigated by an increase in Philippine overseas workers' remittance of 15 percent to about US$11.5 billion in 1997. Speculative attacks against the peso reduced international reserves by about US$3.4 billion in 1997. These led to the substantial reduction in the BSP's intervention in the foreign exchange market.

The commercial banking system is now much more liberal and open. Compared with 27 commercial banks in the late 1980s, there are now 54 banks operating in the country including 14 foreign banks. Credit has grown at an annual rate of 34% over the last five years and deposits have grown at an annual rate of 27%. Total assets of the banking system increased by 22 percent in 1997. Universal and commercial banks account for about 80 percent of these assets with thrift and rural banks accounting for the remainder. Overall, the commercial banking system appears to be healthy with a risk assets to equity ratio of about 7.5 (BSP requirement is 10), past due ratio was at its lowest point in 1996 (2.8%) but increased to 4.7% at the end of 1997. Profitability of commercial banks was substantially improved between 1994 to 1996 slightly exceeding 18% and 2% on equity and assets, respectively. As a result of the regional financial crisis, profitability in 1997 declined to about 15% on equity and 1.6% on assets.

The banking system and the corporate sector, however, still experienced stress from the financial shocks as evidenced by the current tightness in the credit environment. Credit of commercial banks during the fourth quarter of 1997 and the first half of 1998 was stagnant. While the commercial banks as a group experienced healthy profit levels in 1997 due to widening gross interest margins, a number of them had problems on rising non-performing loans, increased incidences of rollovers, falling real estate collateral values, and compliance with legal reserve requirements. On the other hand, thrift banks and rural banks experienced greater stress from the crisis. At the end of 1997, the gross non-performing loans of thrift banks and rural banks were reported to be 10 percent and 14 percent respectively. The stress faced by these banks has contributed to the credit squeeze in the rural economy particularly among the micro, small and medium enterprises. The regional crisis and its impact on the Philippines have raised concern about the commercial banks' capital adequacy, loan classification and provisioning practices, increase in non-performing loans, effectiveness of on-site inspection and off-site monitoring, off balance sheet activities, inadequate transparency, exit and entry requirements, liquidity in the system, and the availability of term credit. The government, in consultation with the Bank and the Fund, has initiated a number of reforms to address these issues. The proposed project is also one step in the same direction.

The credit squeeze while more severe among the small and medium borrowers also resulted in the slowing down in private consumption and investment. Unemployment is expected to be well over 10 percent by end 1998 compared with 8.7 percent in 1997. Non-prime corporate borrowers are suffering from the reduced availability of credit. As a result, the country's fiscal position is a concern in view of the possible slow down in revenue collection.

The pace of recovery from the sharp economic slowdown of 98 will depend on the depth and duration of the regional crisis and the effectiveness of the macro-economic and structural policies of the new administration. This means the adoption and continuation of reforms that promote macro-economic stability and investor confidence in the financial market which will enable the corporate and the banking sector to recover from the stress brought about by the credit squeeze and the currency depreciation. The administration is determined to adopt policies that would strengthen the banking system's capacity to be more resilient to future financial shocks. Likely measures include: (i) improvement of the prudential and supervisory systems and implementation of measures that would enable the authorities to deal expeditiously with problem banks, and (ii) the reduction of peso intermediation costs to reduce disparities between intermediation in different currencies.

The poor, however, will be provided assistance within a policy environment that promotes a viable and sustainable financial market. The policy for microenterprise lending has clearly been laid out in the recently enacted law on Poverty Alleviation. The law supports the provision of microfinance services within a policy environment that promotes a viable and sustainable financial market. It categorically states that the government will only provide funds for capability building of microfinance institutions. The proposed implementing rules and regulations also clearly espouse the use of market-based interest rates.

The country would need substantial support from both the Bank and the IMF to recover and resume a sustained growth path in the near term. Government policy of strengthening the financial sector as stated above and easing the the problems created by the credit crunch would be supported by the Bank through the Banking System Reform Loan and the two lines of credit to LBP and DBP, the Third Rural Finance Project (TRFP) and the Private Enterprise Credit Support Project, respectively. The TRFP would also assist government policy on poverty alleviation through the availabilty of credit facility for the financing of viable micro-enterprises. Its fiscal impact would also be positive.

3. Sector issues to be addressed by the project and strategic choices:

While the financial crisis will weed out or hasten the demise of weak and non-competitive enterprises, including possibly banks, it is not certain that the weeding out process will be confined to such firms. The banks, in their desire to protect their balance sheets from exposure to failing firms, especially those with unhedged dollar denominated loans, might not care or exert effort to distinguish between good and bad firms. A general credit squeeze is much easier to implement than a discriminating credit policy. Staying liquid while exploiting high yielding TBills, or taking a position in the foreign exchange market is a survival strategy that several banks have adopted, leading to a degree of failure in the credit market. Indeed, mission interviews indicate that the financial crisis has hit good borrowers which would otherwise be considered creditworthy and viable, especially the small and medium scale rural enterprises, who have been caught between reduced bank funding and higher credit requirements due to the depreciation of the Peso and resulting increased cost of inputs and higher receivables. Export-oriented firms are also finding it difficult to take advantage of weak Peso due to a lack of credit. The proposed project would address these issues project component (a).

Clear evidence of strong demand for medium and long term credit for rural investment has been shown by the fact that funds under CLF I and II which were set up to meet this demand at market rates have been drawn down substantially ahead of target. There continues to be an absence of medium and long term Peso denominated financial instruments within the banking system, and given the financial crisis, this is unlikely to change in the near future. Without such resources, either banks have to finance investments using short term resources, leading to maturity mismatches in the banking sector, or else investors are exposed to the financial risk of not having their short term loans rolled over. Additional Bank resources to support rural investment through a wholesale credit line would help to plug this gap and enable the Participating Financial Institutions (PFIs) and their clients to better match the maturity of their funding to the maturity of their project or loan. This issue would be addressed through the CLF component of the proposed project project component (a).

The increasing amount of micro-enterprise activities in the country results in a considerable demand for micro-enterprise loans in the rural sector. The loan demand of micro-enterprise clients range from P25,000 to P100,000 for working capital and small capital investments. Due to the perceived costs associated with small lending, most commercial banks do not lend to micro-enterprises. This market niche is being served by micro-finance institutions that are mostly comprised of rural banks, cooperative rural banks, credit cooperatives, and credit NGOs. With the increased demand for micro-enterprise credit and the reluctance of commercial banks to expose themselves to this type of portfolio, the government has recently created the People's Credit and Finance Corporation[1] (PCFC) which provides wholesale funds to micro-finance institutions. Recognizing the role of micro-enterprise loans in poverty alleviation, the PCFC has been given the task of lead financial institution in micro-finance. It has so far accredited 86 MFIs of which 46 are either rural banks or cooperative rural banks. At present, PCFC is operating with limited funds, which are mostly directed. Availability of wholesale funds for onlending to MFIs for micro-enterprises in the P25,000 (about US$625) to P100,000 (about US$2,500) range is severely limited. Most MFIs (especially credit NGOs) rely on donations, grants and a limited volume of commercial lending; they are not able to easily source finance for this type of lending. These issues are addressed by project component (b).

Wholesaling of funds, particularly aid resources is necessary because of the large number of banks and MFIs in the Philippines. The use of a wholesale mechanism allows for competition within the PFIs and the MFIs and gives access to funds to any qualified institution. Its effective implementation requires the Apex Institutions to operate efficiently and in addition, accredit and provide training to PFIs/MFIs. Both Apexes (LBP and PCFC) have drafted Institutional Development Plans (IDPs) to strengthen their ability to do this. Support for this under Part (d) of the Project is given to PCFC whilst LBP is supported under Part (c).

---

[1] PCFC was incorporated and registered with the Securities and Exchange Commission in 1996. Its charter calls for eventual privatization.

C: Project Description Summary

1. Project components (see Annex 2 for a detailed description and Annex 3 for a detailed cost breakdown):

Component	Category	Cost Incl. Contingencies (US$M)	% of Total	Bank-financing (US$M)	% of Bank-financing
CLF III A fund, at market interest rates, available through LBP to accredited PFIs on a short, medium or long term basis to finance private rural sub-projects that are economically and technically sound, including those which are under financial distress induced by the current financial crisis.	Credit	207.1	95.8%	145.0	up to 75% of sub-project costs
Micro Finance Loan Fund (MLF) Resource lent by LBP to PCFC at market rates would form the MLF which would provide finance for working capital and small capital investment of micro-enterprises. Sub-loans under this component would range from P25,000 (US$625) to P100,000 (US$2,500). Main MFI conduits would be rural banks and cooperative banks.	Credit	6.7	3.0%	5.0	up to 75% of sub-project costs
Strengthening LBP. An IDP agreed with the Bank and to be adopted by LBP would focus on ensuring LBP's sustainability while continuing its rural lending expansion. Specifically it would focus on (i) improving the quality of LBP's commercial loan portfolio, (ii) reducing unit losses on agrarian lending; (iii) continuing the policy of automation of systems and management information flow; (iv) staff training, (v) mobilization of medium and long term Peso resources; and (vi) making adequate arrangements for capital build up.	IDP	2.0	0.9%	None	N/A
Strengthening PCFC. Under this component, PCFC would also implement an Institutional Development Plan (IDP) to be prepared by PCFC and agreed with the Bank. This would include build up of PCFC's capital base and strengthening of its staff capability to implement its various types of micro-finance programs.	IDP	0.3	0.2%	None	N/A
	Total	216.1	100.0%	150.0	69.4%

2. Key policy and institutional reforms supported by the project:

The project has no direct policy component, but is consistent with the policy of a liberalized financial sector where onlending rates by LBP and the various participating financial institutions are negotiated freely. No major institutional reforms are involved, but the project would contribute towards institutional development of LBP and PCFC, PFIs, and MFIs.

3. Benefits and target population:

The CLF III would directly assist small and medium sized economic entities operating in the Philippines rural areas. Based on the loan uptake of CLF I & II, it is estimated that about 700 economic entities would obtain credit under the project (in the first round of lending). These would benefit from the restructuring of their economically and technically viable, but financially distressed businesses, or else from the establishment of new, or expansion of existing viable entities. The Micro Finance component would assist micro enterprises in the rural areas and be targeted towards those businesses which are too small to receive regular commercial finance, but larger than the Grameen style clients of PCFC's ADB and IFAD supported programs. About 100 PFIs would benefit from being retailers of CLF III. The availability of more medium term financial resources would help the PFIs to improve the structure of their balance sheets, allow them to service their clients better and contribute to their profitability. Some 50 MFIs, mainly rural banks and credit co-operatives, would similarly benefit from an expansion in the availability of term credit for onlending. The institutional strengthening components for LBP and PCFC would both strengthen the institutions themselves and assist in improving the delivery of financial services to the rural areas.

4. Institutional and implementation arrangements:

The loan would be made to the Land Bank of the Philippines (LBP) with the guarantee of the Republic of the Philippines. It would, therefore, make no demands on public sector financial resources and be independent of the administrative capacity of government line agencies.

The CLF III component would be operated as a wholesale banking fund guided by an agreed policy manual. The main elements of the policy manual would include: eligibility criteria of sub-projects; Participating Financial Institutions (PFIs) accreditation criteria; market interest rates; subsidiary and sub-loan maturities; appraisal; disbursement; environmental protection; and supervision of sub-projects. These are detailed in Annex 2b.

LBP would be responsible for implementing the agreed Institutional Development Plan (IDP). The IDP would be annually reviewed and if warranted, adjustments to the respective strategy, actions, and targets would be made. In addition a semi-annual report on the outstanding issues and implementation of the IDP would be prepared by LBP with contributions from the various departments involved in implementing the IDP. Part of the IDP would involve preparation and implementation of the project training and Technical Assistance (TA) programs. The preparation work for these would be completed by November 30, 1998. The programs would be updated annually and be submitted by LBP for Bank review by November 30 of each year commencing in 1999 for the immediately succeeding year. In carrying out the training program LBP will employ consultants whose qualifications, experience, and terms and conditions are satisfactory to the Bank. Details on the principles, targets, and timetable regarding the implementation of the IDP are provided in Annex 2a.

The micro-finance component would be carried out by PCFC. The credit element would based on an agreed policy manual which would cover: sub-borrowers' eligibility criteria, Micro Finance Institutions (MFIs) accreditation criteria, interest rate structure; appraisal and supervision of micro enterprises; and sub-loan disbursement arrangements. The funds for implementing the credit element of this component would be lent by LBP to PCFC from the proceeds of the IBRD loan to LBP. LBP's on-lending rates to PCFC would be variable and adjustable every quarter. It would be based on the 91 day Tbills rate. PCFC would also be responsible for the preparation of its IDP and its implementation. This would be reviewed annually and updated as necessary. Progress reports would be submitted to the Bank every six months. More details are provided in Annex 2a (IDP) and Annex 2d (credit).

Land acquisition and resettlement. Although the project will not finance land acquisition, LBP will have to ensure that land acquired for sub-project implementation would be on the basis of a freely negotiated agreement between buyer and seller. No involuntary land transactions will take place under the project.

5. Implementing Institutions

Land Bank of the Philippines (LBP, for more details see Annex 2c)

Ownership & Organizational Structure. LBP was established in 1963 with authorized capital of P 1.8 billion as the agency responsible for financing agrarian reform. Under the new Land bank Act of 1995, (RA7907) its authorized ordinary share capital was increased to P 7.8 billion all of which is Government owned. P 7.4 billion has now been paid up, through allocation from reserves. Additionally, SSS (the social security fund) holds P 1.2 billion of LBP preferred shares (yielding 14%). LBP has recently submitted an application for a further increase in total authorized capital to P 25 billion. LBP is controlled by a Board of nine Directors, including the Secretary of Finance (Chairman); the President of LBP, (Vice-Chairman); the Secretaries of Agrarian Reform; Agriculture and Labor and four other Board members appointed by the President of the Philippines to represent the Agrarian Reform beneficiaries, the landowners and the private sector.

LBP is now divided into three main sectors: (i) the Agrarian and Domestic Banking Sector (ADBS), (ii) the Institutional Banking Sector (IBS), and (iii) the Operations and Support Sector (OSS). Through over 300 branches, ADBS now has nation wide cover and the relative importance of branch banking is growing. Within the branches, LBP services its two types of client (agrarian[2] and commercial). IBS is still large compared to branch banking in terms of lending, and generates about 65% of loan business (down from over 80% in 1994), mainly through Head Office. OSS, which is head office based provides support to the earning parts of the bank, including manpower services, facilities management, controllership, treasury, and market research.

LBP is the main financial institution in the Philippines that provides agricultural and rural credit through rural financial institutions and cooperatives to small farmers, fishermen, agricultural enterprises, and non-farm investments. Since July 1990, LBP, through its Program Lending Group (PLG), has successfully managed three bank-financed credit funds: the Agricultural Loan Fund (ALF, Loan 2570-PH), the first Countryside Loan Fund (CLF I, Loan 3356-PH), and CLF II (Loans 3938, 3939, and 3940-PH). PLG is managing not only the Bank credit funds but also those of ADB, IFAD, and OECF. It is

[2] Agrarian Loan is defined by LBP as production loans made to small farmers (up to 5 hectares of land, rice and corn up to 7 hectares), who are basically agrarian reform beneficiaries. It does not include other agricultural lending which is part of LBP's commercial banking operation.

staffed with qualified and experienced officers and management and was able over the years to deepen its exposure and experience in carrying out a wholesale banking operation. LBP is continuing to upgrade, through a regular and continuous training program, its own staff, and those of the PFIs and cooperatives. Finally, in terms of its experience, knowledge and institutional set up, LBP is qualified and suitable to implement the proposed project.

Resources and Assets. LBP has substantially expanded its available resources over recent years to a total of P168 billion (US$4.2 billion) as of March 31, 1998. These comprise equity P15 billion (9%), of which P12 billion is from retained profits; GOP deposits P77 billion (46%), private deposits P44 billion (26%), bills payable (including loans from the Bank, ADB, OECF, IFAD) P18 billion (11%) and other liabilities of P14 billion (8%). On the assets side, cash and investment in Government securities together totalled P54 billion or 32% of its total assets, and net loans (including interbank loans) P98 billion (58%), investments in non government securities, (3%), bank premises and other fixed assets (3%) and other assets (4%).

Lending Operations. LBP substantially expanded its lending portfolio during the last four years (1993 - 1997) at an annual nominal rate of 30% resulting in LBP's total gross loan portfolio increasing from P32.3 billion in December 1993 to P93.7 billion now (US$2.4 billion). This expansion was mainly in commercial lending (including to commercial agriculture and government agencies). Wholesale term lending under ALF, CLF I and CLF II, which uses Bank resources has grown at about 18% p.a. and now amounts to P6.5 billion or 7% of the loan portfolio. This wholesale lending has been both profitable and successful. Repayments have been excellent, and as of 1997 year end, there were no past dues from Participating Financial Institutions (PFIs). After seven years, LBP has only had one bad debt under this program, for a negligible amount of P0.5 million or less than one hundredth of one percent of the present outstanding balance.

Portfolio Quality. The quality of LBP's commercial loan portfolio is about average for large commercial banks in the Philippines. Net non performing loans improved from 2.8% in 1995 to 2.3% in 1996 but declined slightly to 2.7% in December 1997. This latter figure was in line with the average for Philippine commercial banks at the same date (2.5%). However if agrarian loans[3] are omitted from the analysis, LBP has fractionally less net past dues (2.49%) than the commercial banking sector average. Since 1995, the collection rate on agrarian loans and the quality of the agrarian portfolio has improved as LBP has provisioned adequately in line with the Institutional Strengthening Action Plan (ISAP) agreement under the Second Rural Finance Project (SRFP).

Impact of the Recent Financial Crisis and Peso Devaluation. Although LBP has foreign exchange borrowings and deposits amounting to about US$900 million, these are fully hedged; either the funds are reinvested or relent in matching currencies, or else, as in the case of multilateral and bilateral borrowings (about US$500 million), the foreign exchange risk is borne by Government. Indeed as at mid February 1998, LBP's unhedged foreign exchange risk amounted to only US$4.2 million, or about 0.1% of total assets. The main direct impact of the recent Peso devaluation on LBP therefore was to increase the size of both total assets and total liabilities by roughly the same amount, therefore slightly weakening its Risk Assets:Equity ratio. A second but more important point is the effect that the devaluation has had on LBP's clients and their ability to service their loans. This appears to be more problematic than the direct effect and in the period December 1997 to March 1998, the level of past dues on commercial loans has increased significantly. Overall, by March 1998, LBP's net past dues have increased to 6.2% of total net loan portfolio.

---

[3] See footnote 2 above.

Profitability, Liquidity and Solvency. LBP has made profits in each of the past ten years, with nominal profits averaging about P1.7 billion (US$ 60 million) from 1994 -1997. Real returns to equity have averaged about 7% for the same period. In 1997, LBP's net profit before tax of P1.7 billion was just under 1.1% of total year end assets, below the Philippine commercial bank average for 1997 of 1.64%. This lower return is because part of LBP's profit, which comes entirely from its commercial banking operations, is used to subsidize its agrarian lending. LBP has always maintained adequate liquidity, and its Risk Assets to equity ratio, has remained within the 8:1 ratio covenanted under the Second Rural Finance Project (SRFP).

Outstanding Issues. Since SRFP, LBP has solved the issues which it had in relation to Land Reform Bonds and its relationship with the Agrarian Reform Fund. The main issues which it will face over the years to come are (i) increasing its equity; (ii) ensuring that the quality and profitability of the commercial loan portfolio improves; (iii) reducing the unit losses on agrarian lending (through reducing operating costs and improving revenue - better collection and higher interest rates, if possible) and increasing outreach to small farmers and rural entrepreneurs; and (iv) resource mobilization, particularly medium and long term. These issues are addressed under the project through LBP's IDP.

People's Credit and Finance Corporation (PCFC (for more details see Annex 2d)

Ownership and Organizational Structure. PCFC is a government owned and controlled corporation registered in 1995 as a finance company with the Securities and Exchange Commission (SEC) under the Corporation Code. It is responsible for providing funds to microfinance institutions for onlending to micro-enterprises in the rural areas. It is initially capitalized at P100 million by the National Livelihood Support Fund, a fund supervised by LBP. A recently passed law, Republic Act 8425, the Social Reform and Poverty Alleviation Act, has required an increase in PCFC's capitalization by an additional P 500 million to be provided by the national government over a four year period.

PCFC is controlled by a Board of Directors, including three LBP officials (LBP's President sits as vice-chair of the PCFC Board), of the PCFC President, the Chairperson of the National Anti-Poverty Commission, Undersecretary of the Department of Finance and three private sector representatives, appointed by the President of the Philippines. The PCFC President who responsible for day today operation of PCFC, is assisted by two vice-presidents, one for the Operations Group and another for the Finance and Administration.

Under Executive Order No. 148 and the relevant provision of Republic Act 8425, PCFC will be privatized. The law provides that when the ownership of the majority of the issued voting stocks of PCFC shall have passed to qualified private investors, it shall be considered a privately organized entity subject to the laws and regulations generally applied to private corporations. A privatization plan is currently under preparation.

Resources and Assets. PCFC has resources amounting to P349.9 million as of March 31, 1998. These comprise equity P100.5 million (28.7%) of which P0.5 million is from retained earnings; bills payable (including a loan from the ADB-IFAD) P242.3 million (69.2%) and other liabilities P7.1 million (2%). On the assets side, loans receivable totaled P217.5 million (62.2%); investments in government securities P70.6 million (20.2%); deposits in banks P59 million (16.9%) and other assets P2.8 million (0.7%). As a finance company, PCFC is not authorized to mobilize deposits from the public; it can only source funds from a limited number of creditors.

Lending Operations. PCFC operates as a wholesale lending institution for microenterprise loans. It operates two loan windows: the HIRAM (Helping Individuals Reach their Aspirations through Micro-credit) Lending Program and the ADB-IFAD Grameen Program. It has a network of 87 active conduits comprised of rural banks, cooperative rural banks, cooperatives, credit unions and credit-granting NGOs. As of March 1998, PCFC has served a cumulative total of 70,725 end-borrowers. Accumulated loan releases under HIRAM reached P 754.8 million as of end March 1998. Total loans outstanding were P213 million. Total approved credit lines under the ADB-IFAD window amounted to P 136 million for 9 conduits, but total loan releases to only P 8.5 million.

Portfolio Quality. In its almost two years of operation, PCFC has maintained a high portfolio quality. It has a very high loan collection rate and has a past due ratio of only 0.78%. PCFC has adopted the standards set by BSP for non-bank and quasi-banking financial institutions and has strictly imposed the BSP general loan loss provisioning of 2%.

Profitability, Liquidity and Solvency. PCFC has made nominal profits in its first two years of operations. Although nominal profits were made in both 1996/7 to 1997/8, they were insufficient to cover for inflation. Real return on equity was -3% in the year to March 1997 and -7% in the year to March 1998. The negative profitability can be chiefly attributed to the small lending volume and PCFC's relatively high operating cost. PCFC maintains a very high liquidity position. Its current ratio is 3.1:1 which provides ample room for generating a bigger volume of microenterprise loans. Its Risk Asset to Equity ratio is very conservative at 2.2:1.

Outstanding Issues. PCFC is potentially a critical agency for the poverty alleviation program of the government in the countryside. To fulfill its task of providing private microfinance institutions funds for onlending to a vast number of micro-enterprises in the countryside, PCFC will need to be strengthened. Its present situation of low profitability but sound liquidity and solvency mainly reflect the fact that PCFC is a very new organization, which is still a long way from full development. Main issues to be addressed include: (i) weak equity base; (ii) inability to generate profits in real terms; (iii) need for improvement of its operating efficiency and (iv) lack of necessary personnel, inadequately trained staff and problem of retaining professional staff. These issues are addressed in PCFC's IDP.

D: Project Rationale

1. Project alternatives considered and reasons for rejection:

An alternative option for the design of this type of rural finance project, which has been used in some other countries, would have been for the Bank to lend directly to several retail financial institutions, without using the wholesale concept. Given the characteristics of the Philippine banking sector in rural areas (there are several hundred different banks which are creditworthy) such an approach would have necessarily restricted the number of potential participants. Furthermore a project which achieves only moderate cover in this way would have been costly to prepare as each of the pre-determined FIs would have needed to be appraised at the project preparation stage. Using a wholesaling approach provides every financial institution operating in the country, that meets the accreditation criteria, the opportunity to participate in the project and accommodate their own clients. Given that wholesale banking procedures have already successfully operated in the Philippines, the retail option was rejected and the project has been prepared as another wholesale operation using an existing conduit.

2. Major related projects financed by the Bank and/or other development agencies (completed, ongoing and planned):

Sector issue	Project	Latest Supervision (Form 590) Ratings (Bank-financed projects only)	
		Implementation Progress (IP)	Development Objective (DO)
Bank-financed			
$100 million in 1986 (completed)	Agricultural Credit Project	S	S
$150 million in 1991 (completed)	Rural Finance Project	S	S
$150 million 1996 (ongoing, $105 million disbursed))	Second Rural Finance Project	S	S
Other Development Agencies			
ADB $75 million	Cooperative Credit Project		
ADB/IFAD $34.7 million	Micro-Finance Project		
OECF $50 million equivalent (completed)	Agriculture Credit.		

IP/DO Ratings: HS (Highly Satisfactory), S (Satisfactory), U (Unsatisfactory), HU (Highly Unsatisfactory)

3. Lessons learned and reflected in the project design:

The broad lessons that emerge from the review of the previous agricultural and rural finance projects are: (i) directed credit by crop or type of investments, at subsidized interest rates, did not sustain economic growth, improve credit delivery mechanism in the rural areas, or increase access of rural borrowers to formal credit facilities; (ii) heavy arrears and poor financial conditions of the apex financial institution or the selected PFIs severely constrained sub-projects' sustainability; (iii) private financial resource mobilization is extremely important for institutional sustainability and; (iv) strong financial institutions along with qualified and experienced management and staff at headquarters, branches and field offices, are crucial to project success; and (v) when interest rates either fell significantly below or moved well above prevailing market rates, serious implementation problem have emerged: above market-rates resulted in slow disbursement, while below-market rates led to concentration of credit to relatively wealthier and large clients. These lessons have been incorporated in the design of the proposed project.

The ongoing Second Rural Finance Project (SRFP) is progressing well in all its components. Disbursement under the CLF II has reached about US$100 million (about 2/3 of the loans in two years after effectiveness), financing some 590 sub-projects with total investments of about P4.3 billion. With regard to the Institutional Strengthening Action Plan (ISAP), the main progress was in the performance of private sector resource mobilization and an increase in equity. KPI targets for the period have largely been met. The specific lessons learned from the ongoing SRFP and incorporated in the proposed project are: (i) due to the volatility of interest rates it is necessary to shorten the period in which the market reference rate is being calculated from one quarter to at most a monthly basis in order to better reflect the market; (ii) the premia for conversion from variable to fixed rates and the associated prepayment penalties require regular review and adjustment, if warranted; (iii) accreditation criteria for PFIs, particularly the cut off points, need to be periodically reviewed and adjusted to market conditions; (iv) within the institutional development plan (IDP), more attention should be given to the lending concentration issues and collection matters; and (v) IDP targets should be reviewed and updated more often than in the past to reflect better the new challenges and issues that LBP needs to cope with.

4. Indications of borrower commitment and ownership:

The proposed borrower, LBP has requested this project. It has a very good record of project implementation, has achieved substantial institutional growth, and has excellent operational relationship with the PFIs. All project preparation relating to LBP activities including the drafting of the related policy manuals, are being undertaken by the borrower, through its Program Lending Group which is headed by a Vice President of LBP. PCFC, which would implement the comparatively small (US$5 million) Micro-finance Component is a relatively new agency which falls under LBP supervision. It has indicated commitment to the project by participating fully in the detailed preparation of the Micro-finance component, including the drafting of a policy manual and its Institutional Development Plan.

5. Value added of Bank support in this project:

The Bank's ongoing program of Adjustment and Policy based lending seeks to help the government establish a stable macro-economic and financial environment through balance of payments and budgetary support. The latest element of which is the proposed Banking System Reform Loan (BSRL). Expansion of the regular lending program to include this project would complement the measures to be undertaken under the BSRL and would address the constrained availability of term credit for the private sector and assist in institutional development of the credit delivery system. Before the crisis, the local financial market had started to develop confidence in term credit due to strong economic and business prospects in the real sector and macro-economic stability, brought about by a decade of structural reforms. The financial crisis has brought severe credit problems, forcing rationing and shortening of loan horizons. Making available lines of credit for longer term loans which private credit markets are loathe to provide at present will help restore confidence in the financial markets and address the liquidity and working capital constraints currently faced by the business sector. Despite the limited size of the proposed project, compared with the overall need for term credit to the rural sector, a new loan of this type from the Bank would be an important signal for restoring investor confidence in Philippine markets. In addition, the progress that LBP has made in developing itself as an independent financial institution in the nineties is to a large extent due to its association with the Bank. This development would be further enhanced through the proposed project.

The proposed project fits comfortably within the agreed framework of Bank assistance to the Philippines. It is in line with the need to expand the Bank's regular lending program in the rural sector in response to growth opportunities. In addition, it addresses the critical but temporary difficulties of firms that remain economically viable but face financially-related problems brought about by the volatility of both the exchange rate and interest rates and a degree of market failure in the financial sector. Finally, its micro-finance loan package which is designed to address unfulfilled demand for credit by micro-and-small scale enterprises provides strong support to the Banks commitment to poverty alleviation.

The Bank's contribution to the institutional strengthening component (although not financed by it) was critical under SRFP. By its involvement in this project, the Bank would be able to continue to support the further institutional strengthening for LBP which has become increasingly important as a result of the financial crisis. Furthermore, through involvement in this project the Bank would be in a position to make a ground breaking contribution to the development of a wholesale micro-finance institution, with the good possibility that far reaching lessons on the successful implementation of this type of operation could be learned.

E: Summary Project Analyses (Detailed assessments are in the project file, see Annexes 4 and 2e).

1. Economic

The likely impact of the project on the economy as a whole would be that it would contribute toward maintaining growth and as a result help to boost confidence. The additional availability of medium term finance at market rate, will help ensure that viable firms would be able to finance their continuing operations. Without this financing, some of these viable firms might have been forced to retrench as a result of their banks trying to become more liquid. Given that the fiscal impact of the project is likely to be positive (see below), government has a strong incentive to guarantee a loan of this type.

As this is a credit operation, with no predetermination of investment, no quantitative assessment of the likely economic rate of return has been made. All sub-projects will be screened for ex ante financial viability (see below). The level of price distortion in the Philippines is not high (and is decreasing). Consequently, there is a reasonable expectation that the investments financed under the project would show sound ERRs, particularly those involved with job creation in the rural areas, where the shadow price of labor is well below the financial price.

2. Financial (see Annex 4):

Fiscal Impact: As the project would be implemented by government corporations (LBP and PCFC) and the private sector, it would not require any Government counterpart funding. The actual cash flow to Government depends on future inflation and interest rates, but in the base case, assuming a 12% Tbill rate, 7% inflation and a nominal 6% cost of WB finance the the net cash flow to Government estimated to rise from about P50 (US$1.1 million) in year one to about P720 million p.a. (US$14 million) by year five, before falling as the foreign exchange risk fund becomes drawn on (For details, see Annex 4). Direct inflows would include a Guarantee Fee of 1% p.a. (about US$ 1.5 million per year once funds are fully disbursed) and adequate[4] foreign exchange risk coverage fees, averaging about 3.3% of the outstanding balance. In addition, under present legislation there would be gross receipts tax of 0.65% p.a.on the loan from LBP to the PFI and about a further 1% on larger loans to sub-borrowers (together totalling about US$2.2 million p.a. by year 5). In addition, Government would benefit from incremental taxes (currently at 34%) on the incremental profits of LBP, PCFC, the PFIs and the sub-borrowers. Total, incremental taxes on incremental profits are estimated to amount to about US$7 million p.a. at full development.

Sub-borrowers: The project would provide credit assistance to sub-borrowers in supporting their investment which in turn would contribute to improvement of their business activities and/or welfare. The main financial impact of the project results from about $210 million of investment under the first round use of credit by small and medium sized rural based private businesses. These sub-projects will all be assessed as financially viable prior to investment and the ongoing interest rate to them will be market based (likely to be of the order of 7-10% in real terms). Consequently, only sub-projects which show sound ex ante financial rates of return will be supported. Under the similar CLF I and CLF II programs, ex ante financial rates of return have typically been in the 15% to 30% range, and similar results for SME investment would be expected under this project. Micro finance sub-borrowers would

4 On the basis that the differential between real Peso 91 day Tbill rates and real WB dollar lending rates remains the same as the average of the past five years, the FX fee paid to Government would be about 25% higher than needed to compensate for currency depreciation, assuming that purchasing power parity between the Peso and the dollar were maintained (see Annex 5(d).

receive credit which would otherwise have been unavailable. Investments under this component would normally be in fast turnover items.

PFIs: The project would have a positive impact on the profitability of PFIs because they are free to set their own spreads, and therefore, provided their managements' judgments are good, they would only participate in the project if they perceive it as profitable. As it would be a repeater project for most PFIs they would have a reliable basis for this. Participating in the project would also help to improve the liabilities side of PFIs' balance sheets, in that it would increase the average maturity of their resources.

LBP & PCFC. The project would contribute towards the profitability of both these institutions. In LBP's case, based on performance under CLF I and II, the incremental contribution to profitability is likely to be of the order of P70 million per year (US$ 1.4 million). Projections for PCFC indicate that on-lending these funds will contribute about P4 million (US$80,000) annually to its profit at full development.

3. Technical:

Most of the project is a repeater type operation with no significant technical impact or risk. The Apex, the PFIs and the sub-borrowers would all be operating in areas in which the technology is known. The one new area, which involves about 3% of the project cost is the wholesale micro-finance component. This is technically new in the Philippines, and the project will be breaking new ground in this regard.

4. Institutional:

Because of IDPs for both LBP and PCFC, the Project will have an important impact in strengthening those institutions. LBP is a capable institution which has handled previous wholesaling projects well. The institutional strengthening would be geared towards its other operations (commercial, retail and agrarian lending) and includes assisting in its maintaining a sound financial condition in the face of the currency crisis and ensuring that prudent levels of earnings are retained in the face of pressures from Government (LBP's shareholder) to pay more dividends than would be commercially justified. PCFC is a new institution, and its strengthening would be directed towards developing of its effectiveness as a wholesale finance institution through which funds can be efficiently channeled.

5. Social:

The project is expected to have a positive impact on employment. Indications from CLF II are that incremental employment is generated based on an investment of about US$10,000 per job. Consequently, some 20,000 incremental jobs could be expected from the CLF III component. In addition, the provision of critical financial support to economically sound, but financially distressed businesses would be important in reducing business closures and associated layoffs. The PCFC component would be expected to have a significant impact on poverty alleviation through making credit available to micro-enterprises. This would have a particular effect on underemployment through borrowers being able to make more profitable use of their own time and to a lesser extent, hire part time labors. In line with other micro finance initiatives, it is anticipated that the majority of beneficiaries from this component would be women.

6. Environmental assessment: Environmental Category [ ] A [x] B [ ] C

Adequate arrangements and procedures would be maintained to ensure that sub-projects with adverse environmental impact will not be financed under the project. LBP will specify that sub-borrowers for CLF III funded projects would comply with all laws and regulations of the Philippines related to environmental protection, consistent with environmental guidelines of the Bank. LBP would be in charge of supervising compliance. To reduce the risk that sub-projects with undesirable environmental or social impacts would be financed by CLF, the following measures would be taken. The existing procedures and guidelines agreed under SRFP among LBP, the Department of Environment and Natural Resources (DENR), and the Environmental Management Bureau (EMB) would prevail and be applied under the proposed project. All sub-projects would comply with the Presidential Decree 1586 and its related regulations, which describes the Philippine environmental legal requirements for new investments. For the following generic sub-projects: poultry and piggery, agro-processing, land clearing, and fish and pond development, and any other sub-project as the Bank may require, an Environmental Impact Statement (EIS), as required by the above Presidential Decree and in line with the guidelines established under SRFP, would be prepared. The Environmental Unit (EU) of LBP would provide LBP, PFIs, and related sub-projects with environmental technical assistance and coordination services. To enable performance evaluation in respect to environment, the EU will conduct, on a spot check basis, environmental audits of the projects endorsed. These should be done in the presence and assistance, to the extent possible, of the PFIs. The higher of 10% of the approved sub-projects which require environmental clearance, or 50 sub-projects would be audited and the level of compliance is expected to be no less than 80%. For more details see Annex 2e.

7. Participatory approach

The primary project beneficiaries are the sub-borrowers, the PFIs (including commercial banks, thrift banks, rural banks, micro-finance institutions and NGOs) LBP and PCFC. During the course of preparation, Bank Staff met with representatives of all of these groups to discuss the Project concept and to try to ensure that project design was in line with their needs and that the proposed procedures were well understood and acceptable. No controversial issues arose. Full stakeholder participation is assured as the project is a demand driven operation and as investments under the project are entirely determined by the participants themselves on a commercial basis.

F: Sustainability and Risks

1. Sustainability:

Sustainability of the CLF III operation depends on the profitability of the program to the sub-borrowers, PFIs, MFIs, PCFC, and LBP. In the long term sustainability would also require the effective mobilization of term resources to substitute this proposed loan when it becomes repaid. Medium term sustainability is highly likely.

- Experience from the ALF, CLF I and II operations has shown that the type of term financing available is attractive to sub-borrowers, the majority of which would be expected to make profitable use of the available funds. The fact that loans are fully collateralized would mean the small proportion of sub projects which went wrong would not jeopardize program sustainability.

- LBP is a financially sound and well established institution with qualified management and staff. It can therefore be expected to remain in a financial condition which allows it to continue to effectively implement this type of wholesale banking operation.

- The program requires an adequate number of active PFIs. There are now about 120 PFIs accredited with LBP, some 50 of which are active under CLF I and II. They are quite conservative in their lending decisions and will be likely to select only viable and creditworthy sub-projects. Inevitably, over the course of the project, poor results from individual PFIs would cause some of them to lose their accreditation: however, these would be substituted by others.

2 . Critical Risks

The main risk to the success of the CLF III operation is associated with the possible deepening of the financial crisis to a level which would substantially curtail the ability of LBP and the PFIs to carry out this project. Under severe crisis, credit demand from sub-borrowers would also be substantially dampened, and rapidly changing conditions could cause investments which ex-ante were viable to become losers ex post. Overall this macro-economic risk, which is directly related to the overall performance of the economy appears acceptable, but the perception of it could change quickly over time. Therefor it will be important to reassess it if there is any delay in project processing. Another concern on the implementation side is that the introduction of agreed policy measures could be thwarted or postponed by political considerations, thereby weakening LBP as a financial institution and reducing its capacity to effectively implement both the lending programs under the project and its own institutional strengthening action plan.

Risk	Risk Rating	Risk Minimization Measure
Demand for credit under CLF III may decrease due to deepening of the financial crisis and PFIs may become extremely risk averse. As a result, the loan may not be utilized on time.	M	CLF III Funds under the project would be made available at market rates, but with longer term than generally available. This should keep them attractive - for reinvestment or restructuring - if not for new investment. PFIs and potential sub-borrowers have indicated strong demand for long term funds which is confirmed by the uptake rate of CLF II.
Political interference in LBP's lending operations and policy decisions may prevent full IDP implementation.	M	LBP is a fully autonomous bank. Past experience does not indicate Govt. interference in its lending decisions to SMEs. There may be opposition to some of the IDP measures, particularly prudent linkage of LBP's dividends (to Govt.) to profit in real terms. This is dealt with through specific loan covenant.
PCFC may not achieve the necessary volume of lending to allow it to have low enough unit costs to be an effective wholesaler	N	Focusing PCFC's IDP towards effective market development and training of MFIs.
Overall Risk Rating	M	

Risk Rating - H (High Risk), S (Substantial Risk), M (Modest Risk), N (Negligible or Low Risk)

3. Possible Controversial Aspects

The project proposes to finance economically viable businesses which are under financial stress. This would include the finance of working capital, and would have the effect of lengthening the maturity of sub-borrowers' debts. While this is unusual for a Bank project, it is a timely response to the financial crisis and responds to the perceived needs of SMEs in the Philippines.

G: Main Loan Conditions

1. Effectiveness Conditions:

- The approval by LB's Board of: (i) the Institutional Development Plan (IDP); and (ii) the Policy Manual for CLF III.

2. Conditions for Disbursement

- The signing of a Memorandum of Agreement satisfactory to the Bank between LBP and PCFC to reflect the detailed arrangement regarding the operation and obligations associated with MLF.

- The approval by the PCFC Board of (i) its IDP along with the related time table; and (ii) the Policy Manual for the Micro-Finance operation.

3. Other Conditions

- LBP would exclude itself from retailing the CLF III except for up to US$15 million which would be used to accommodate LBP's own clients whose operations are viable but under financial distress.

- LBP would operate CLF on a commercial basis and the latter's net profit would remain within the Fund as LBP's investments.

- LBP would submit to the Bank: (i) quarterly progress reports with regard to the CLF III component two months after the end of each quarter, i.e. on February 28, May 31, August 31, and November 30, of each year commencing with May 31, 1999 ; and (ii) semi-annual report with regard to the IDP on March 15, and September 15, each year, commencing on September 15, 1999; (iii) a mid-term review on project implementation and operational issues on March 31, 2001; and (iv) LBP's written contribution to the project's Implementation Completion Report within six months after the loan closing date.

- LBP and the CLF III accounts would be annually audited. The annual audit would be conducted by an independent auditor acceptable to the Bank and would follow Terms of Reference (TORs) in accordance with appropriate auditing principles, as approved by the Bank, and such audit, along with auditors' report on LBP, CLF III, the Project's Special Account, and Statements of Expenditure related to project activities would be submitted to the Bank within six months after the end of LBP's fiscal year.

- LBP would follow existing guidelines and procedures for environmental protection and would take the necessary actions as detailed in Chapter E6 of the PAD and Annex 2e.

- The project annual training program would be submitted for Bank review by November 30 of each fiscal year commencing on November 30, 1998.

- LBP would maintain the following financial indicators: equity to risk assets would not be less than 10%, the liquidity ratio would be not less than 45% of short term liabilities, and net past due loans to equity of not more than 33% commencing on January 1, 1999, not more than 30% commencing on July 1, 1999, and not more than 25% commencing on January 1, 2000.

- LBP would take all the necessary actions to ensure that dividends would be paid only on profit in real terms (after provisions for possible loan losses and adjustment for the impact of within year inflation).

- The Policy Manual (PM) for the CLF III would be issued, incorporating agreement with the Bank as noted below. Further changes in the PM would not be made without the Bank's prior concurrence:

  (i) Eligibility criteria for CLF III including minimum funding requirements and equity contribution of PFIs and sub-borrowers as discussed in Annex 2b of the PAD;
  (ii) Interest rates structure as discussed in Annex 2b of the PAD;
  (iii) PFIs Accreditation Criteria;
  (iv) Sub-project appraisal and computation of ERR and FRR;
  (v) Sub-project review, disbursement and supervision;
  (vi) Sub-loan maturity;
  (vii) Conformity with environmental laws and regulations;
  (viii) Principles regarding acquisition of land and compensation therefor.

PCFC

- PCFC would exclude itself from retailing the Micro-finance Loan Funds (MLF) and would operate the MLF on a commercial basis and the latter's net profit would remain within the MLF as PCFC's investment;

- PCFC's dividend payments would be made only after: (i) allowing adequate provisioning for loan losses, (ii) adjusting for the impact of within year inflation, and (iii) when profits allowed, retaining earnings at a level equal to at least 15% of the growth of PCFC's loan portfolio;

- During project implementation PCFC would maintain the following financial ratio: (i) risk assets to net equity of not more than 7:1, (ii) a maximum of net past due to equity of not more than 15%, and (iii) liquid assets to short term liabilities of at least 25%;

- PCFC would submit to the Bank (i) quarterly progress report with regard to the MLF component two months after the end of each quarter, i.e. on February 28, May 31, August 31, and November 30, of each year commencing on May 31, 1999; (ii) semi-annual report with regard to the IDP on February 28, and August 31 of each year commencing on August 31, 1999; (iii) a mid-term review on project implementation and operational issues on March 31, 2001; (iv) audited accounts along with auditor's report on PCFC, and statements of expenditure related to project activities within six months after the end of PCFC's fiscal year; and (v) part two of the component's Implementation Completion Report within six months after the loan closing date.

- PCFC would follow existing guidelines and procedures for environmental protection and would take the necessary actions as detailed in Chapter E6 and Annex 2e of the PAD.

- The PCFC training program would be submitted for Bank review by November 30 of each year, starting November 30, 1999.

- Policy Manual (PM) for the MLF would be issued, incorporating agreement with the Bank as noted below. Further changes in the PM would not be made without the Bank's prior concurrence:

  (i) Eligibility criteria for borrowing under the MLF including minimum funding requirements and equity contribution of accredited conduits and sub-borrowers as discussed in Annex 2b of the PAD;
  (ii) Interest rates structure as discussed in Annex 2b of the PAD;
  (iii) Conduits Accreditation Criteria;
  (iv) Sub-project appraisal;
  (v) Sub-project review, disbursement and supervision;
  (vi) Sub-loan maturity;
  (vii) Conformity with environmental laws and regulations.

H. Readiness for Implementation

The Program Lending Group (PLG) of LBP, has been in operation since July 1990. The PLG has managed successfully three bank-financed credit funds: the Agricultural Loan Fund (ALF, Loan 2570-PH), the first Countryside Loan Fund (CLF I, Loan 3356-PH), and CLF II (Loans 3938, 3939, and 3940-PH). PLG is managing not only the Bank's credit lines but also those of ADB, IFAD, and OECF. PLG is adequately staffed with qualified and experienced officers and management and was able, over the years, to deepen its exposure and experience in carrying out a wholesale banking operation. Finally, in terms of its experience, knowledge and institutional set up, LBP is qualified, suitable, and ready to implement the proposed project.

I. Compliance with Bank Policies

This project complies with all applicable Bank policies, i.e. OP and BP 4.01 on environmental impact, OP and BP 10.02 on financial management, and OD 8.30 on Financial Intermediary Lending.

Task Team Leader: Arie Chupak

Sector Manager: Geoffrey B. Fox

Country Director: Vinay K. Bhargava

Annex 1a
Project Design Summary

Philippines
Third Rural Finance Project

Narrative Summary	Key Performance Indicators	Monitoring and Evaluation	Critical Assumptions
Sector-related CAS Goal:			**(CAS Objectives to Bank Mission)**
(a) improve private business environment including availability of medium and long term financing.; (b) Alleviate poverty	(a) Policy, regulatory, and institutional framework becomes more conducive for private sector activities and banks' sound development.; (b) Poverty incidence has been reduced.	(a) Govt. laws, regulations, and procedures introduced. (b) Progress reports on poverty.	Govt remains committed to a market driven financial sector (b) Govt. remains committed to poverty reduction.
Project Development Objectives			**(Development Objectives to CAS Objectives)**
(a) provide financial support to the rural economy to overcome the difficulties created by the regional financial crisis and augment the CLF to finance viable investments in the rural areas; (b) assist the government in its efforts to alleviate rural poverty through the provision of financial and institutional support to the country's micro-finance system.	(a) LBP and PFIs increase term lending to private enterprises in the rural areas; (b) PCFC and MFIs to increase lending and providing financial services to micro-enterprises	(a) LBP's quarterly and semi annual reports as well as BSP statistics; (b) PCFC's quarterly progress reports.	(a) private sector will positively respond to the new framework and increased resource availability; LBP continues not to be subject to undue political pressure with regards to its operational policy. (b) There is strong underlying demand for micro-finance; Govt facilitates institutional development of PCFC.
Project Outputs			**(Output to Development Objectives)**
Lending to viable economic entities in the rural areas to improve their economy, increase employment opportunities, and thus indirectly contribute to poverty alleviation.	* Total investments of sub-projects. * Number of sub-projects financed. * Increase in employment.	M&E would be regularly undertaken by the LBP and PCFC and be reviewed by Bank missions.	The economy remains sufficiently bouyant for well run enterprises to be financially sound.

Providing micro-finance on a commercial basis which would directly assist micro enterprises and alleviate poverty. Strengthening PCFC as the wholesale micro-finance institution. Strengthening LBP as the main financial institution serving the rural areas.	* Number of micro enterprises financed under the project and their total investments. * PCFC operates effectively, meets growth targets and is financially sound. * LBP increases its outreach to rural areas, improves its operational efficiency and remains financially sound.		PCFC continues to enjoy Govt support and is able to raise adequate equity. The effect of the financial crisis on LBP's borrowers does not have an excessively adverse effect on LBPs own financial condition. LBP continues not to be subject to undue political pressure with regard to its interest rate, lending and dividend policies.
Project Components			**(Components to Outputs)**
CLF III	* Number of loans. * Total sub-project investment. * Estimated incremental jobs created.	Program Lending Group of LBP.	Strong private sector demand for CLF resources.
Micro-Finance	* Number of sub-borrowers * Volume of Loans Provided * PCFC's operating costs * PCFC real increase in equity.	PCFC	Strong MFIs and sub-borrowers demand for micro-financing.
LBP IDP	* Real profitability and increase in equity. * Improvement in quality of Commercial Lending * LBP's SDI. * Proportion of private deposits. * LBP's agrarian lending costs.	CORPLAN of LBP.	Management and staff committed to IDP's targets.

Annex 1b

Philippines
Third Rural Finance Project

Key Performance Indicators

Key Performance Indicators (KPIs) have been developed both to measure the effectiveness of the Credit Components and the IDPs for both LBP and PCFF.

Credit Component

On the Credit component, KPIs for CLF III measure (i) the investment made under project sub-loans, which is a proxy for its economic impact, (ii) the number of sub-projects financed, which indicates the degree to which the project has widened its outreach and (iii) ex ante assessment of incremental employment, which is an indicator of the social benefits achieved.

KPIs for the MLF would measure (i) the number of subloans and (ii) amount of loan releases.

Institution Building.

LBP's IDP is aimed at (i) maintenance of LBP's solvency & liquidity; (ii) ensuring LBP's sustainability and profitability, (iii) taking steps to make Agrarian Lending becomes more important and more sustainable, (iv) improving the quality of commercial loan portfolio; and (v) resource mobilization.

- Achievement of (i) will occur if LBP adheres to the various indicators which are included in the IDP and in some cases form loan covenants viz: Risk assets:equity ratio less than 10:1, Liquidity above 45%; Net non performing loans to equity ratio less than 25%, provisions to at least meet an agreed formula related to levels of past dues and restructured loans.

- Sustainability and profitability are important areas, and KPIs are established for both. - real rate of return on capital as a profitability measure, and LBPs Subsidy Dependency Index (SDI) as an indicator of sustainability.

- There are many factors required to make agrarian lending more sustainable and important. Targets for these include:

  Agrarian lending to reach 15% of loan portfolio by 2002
  Real growth of agrarian lending to exceed 10% p.a.
  Current collection rate from co-ops to exceed 90%
  Provisioning formula to be met
  Agrarian operating costs down to 6% by 2002
  Necessary agrarian provisions down to 4% by 2002
  Interest collection on agrarian lending to increase to at least 10.5% on net loans by 2001.

  To take account of these, a composite KPI for agrarian lending is set, based upon parameters set out in Appendix A. In addition, the Agaraian SDI is targetted to fall to 150%, by year 5. A figure that implies that if the opportunity cost of funds is taken into account, the income from agrarian collections would need to increase by 150% for there to be no subsidy.

- Measures to improve commercial loan quality (relating gross and net past dues to total portfolio and on reduction in loan concentration) are included in the IDP, while the relationship between net past dues and equity will be covenanted under the loan.

- KPIs are set to measure both the proportion of private deposits and the improvement in maturity of resources.

The success of PCFC's IDP will be monitored through its achievement of an adequate capital increase, the reduction in its operating costs and the achievement of real profis within three years.

Key Performance Indicators

LBP (Jan - Dec Year)	1999	2000	2001	2002	2003
PCFC (Apr - Mar Year)	1998/99	1999/00	2000/01	2001/02	2002/03
Indicator					
CLF Lending					
Number of Sub-Loans (Cumulative)	60	180	380	550	700
Amount of Sub-Project Investment (P M)	2,200	4,300	6,300	7,700	8,500
Estimated Incremental Jobs (Cumulative)	800	3,000	7,000	11,000	15,000
MLF Lending					
Number of Sub-Loans (Cumulative)	500	1,400	2,600	3,700	4,800
Volume of Sub-loans ex reflows (P M)	50	125	200	230	230
Strengthening LBP					
Profit in Real Terms (+ve ROE)	No target	2%	3%	5%	7%
SDI to be less than	No target	0	-2%	-3%	-3%
Proportion Private Deposits	30%	35%	40%	45%	50%
% of Peso liabilities with over 1 yr maturity	5%	6.5%	8%	10%	12.5%
Agrarian Index (see appendix A)	50	65	70	80	90
Agrarian SDI lower than	225%	200%	180%	160%	150%
Strengthening PCFC					
Increase in Capital - Net Equity (P Million)	200	200	250	300	350
Operating Costs as % Average Net Loans	5.5%	5.0%	4.7%	4.6%	4.5%
Real Return on Capital	No target	No target	positive	positive	positive

Project Classification at Mid-Term and Completion Reviews

At completion and mid-term reviews, the project's outcome will be classified as 'Highly Satisfactory', 'Satisfactory', 'Unsatisfactory' or 'Highly Unsatisfactory', depending upon the extent to which it has reached its objectives. It is proposed to use criteria based on the Key Performance Indicators (KPIs) as a major input in making this classification. Consequently, 70% of the project's classification will be determined by achievement of the pre set indicators shown in Appendix B, and 30% based on the qualitative asessment of the Mid-Term and the Implementation Completion Reporting teams. This latter assessment will pay particular attention to the achievement of improved confidence of the Banking

System, the way in which LBP has adapted to change over the project period and the overall management of the project.

Calculation Details. Calculation would be done by assigning a weighting of 70% to the actual KPI achievement and 30% to the qualitative assessment. Assuming that the project were rated as Satisfactory on the qualitative assessment and that the achievement of KPIs were as in the example given in Appendix B, the calculation would be as follows. With a weighted average score of 2.9, the project would be classified as Satisfactory.

	Weighting	Numerical Score in Example	Grade in Example	Weight times Score/Grade
Objective KPI Achievement (see Appendix B)	70%	2.88		2.016
Qualitative Assessment of ICR Mission on other factors	30%		S = 3.0	0.900
Total	100%			2.916

Note: HS = 4; S = 3; U = 2; and HU =1.

Appendix A. KPI Scoring for Agrarian Lending To become More Important and More Sustainable

Net Agrarian Loans as Proportion of net Loan Portfolio	Basis	under 10%	10 - 12.4%	12.5 - 14.9%	15% +
	Score	0	5	8	10
Real Disbursement Growth over Previous Year	Basis	zero or neg	0 - 4.9%	5 - 9.9%	10% & over
	Score	0	5	10	15
Current Collection Rate from Co-ops based on one year earlier releases	Basis	below 70%	70 - 79%	80 - 89%	90% +
	Score	0	5	10	15
Provisioning Formula to be Met	Basis			Not Met	Met
	Score			0	10
Agrarian Operating Costs (excl provisions) as percent of Av Net Outstanding Loans	Basis	12.1% +	9.1 - 12%	6.1 - 9%	6% & under
	Score	0	5	10	15
Annual Provisions needed to meet formula as % of Av net outstanding loans	Basis	10.1% +	7.1 - 10%	4.1 - 7%	4% & under
	Score	zero	10	15	20
Actual Interest Rate on Agrarian Loans - Collections of interest (include service charge)/Av Net Outstanding Loans	Basis	below 8%	8 - 9%	9 - 10.4%	10.5% +
	Score	0	5	10	15

ANNEX B Key Performance Indicators at Mid Term and Completion

INDICATOR	Mid Term Target 2000/01	Completion Target 2002/03	Importance Weighting	Benchmarks for Mid Term if less than target A	Benchmarks for Mid Term if less than target B	Benchmarks for Completion if less than target A	Benchmarks for Completion if less than target B	Example at Completion: Actual Out-turn	Bank Grade	Numeric Grade	Grade X Weight
CLF Lending											
Amount of Sub-Project Investment (P M)	6,300	8,500	15.0%	4,200	1,200	7,000	4,000	9000	HS	4	0.6
Max % CLF III Loans Past Due	2.5%	1.5%	15.0%	3.0%	6.0%	2.0%	4.0%	3%	U	2	0.3
Estimated Incremental Jobs (Cumulative)	7,000	15,000	10.0%	4,000	1,000	8,000	2,000	9000	S	3	0.3
MLF Lending											
Number of Sub-Loans (Cumulative)	2,600	4,800	2.5%	1,500	600	3,000	1,200	2000	U	2	0.05
Max % Past Due Loans	2.0%	2.0%	2.5%	3.5%	7.0%	3.5%	7.0%	3.0%	S	3	0.075
Strengthening LBP											
Profit in Real Terms (+ve ROE)	3%	7%	10.0%	2.0%	-2.0%	4.0%	0.0%	6%	S	3	0.3
SDI to be less than	-2%	-3%	10.0%	0.0%	10.0%	0.0%	10.0%	-1%	S	3	0.3
Proportion Private Deposits	40%	50%	5.0%	30%	20%	40%	25%	52%	HS	4	0.2
% of Peso Liabilities with over 1 yr maturity	8%	12.5%	10.0%	6%	10%	10%	15%	27%	S	3	0.3
Agrarian Index (see appendix A)	70	90	15.0%	60	40	75	45	65	U	2	0.3
Strengthening PCFC											
Increase in Capital - Net Equity (P Million)	250	350	2.5%	200	150	250	150	350	HS	4	0.1
Operating Costs as % Average Net Loans	4.70%	4.50%	2.5%	6%	8%	5%	7%	6%	U	2	0.05
			100.0%					**Weighted Average**			2.88
								Equivalent Nearest Grade			S

Note on Calculation of Ratings for KPI Achievement. Each indicator of the Project is graded Highly Satisfactory (HS), Satisfactory (S), Unsatisfactory (U) or Highly Unsatisfactory (HU). If KPI Targets are met, the rating is Highly Satisfactory (HS) for that indicator. If worse than target but better than the Benchmark set in column A, the rating is classified as Satisfactory (S). If the performance is between Column A and Column B, the rating is Unsatisfactory (U), and if worse than B, the rating is Highly Unsatisfactory (HU). To assess the rating of the whole project in terms of KPI achievement, weightings are given to each indicator and scores assigned to each rating (HS=4, S=3, U=2, HU=1) and a weighted average grade is calculated. In the example, the weighted average of KPI achievement is 2.88, which is between 2 (i.e. U) and 3 (i.e. S), but closer 3, so the overall rating for KPI achievement would be Satisfactory.

Annex 2a

Philippines
Third Rural Finance Project

Detailed Project Description

The Credit Component 1 (CLF III - US$207 million; MLF - US$6.7 million)

1. Credit, under the project, would comprise two funds: the Countryside Loan Fund III (CLF III) and the Micro finance Loan Fund (MLF). CLF III would provide sub-loans totalling about US$165 million which would finance private rural investments of at least US$207 million. The MLF would finance sub-projects in the equivalent of about US$6.7 million.

Countryside Loan Fund III (CLF III)

2. The sub-component would be operated under the Countryside Loan Fund III (CLF III) to be established by LBP. The CLF III would provide two types of loans: a Peso or US Dollar sub-loans to accommodate the sub-borrowers' needs.

3. The CLF III would be a wholesale banking operation except for an agreed amount (up to US$15 million) which will be assigned to accommodate LBP's own rural clients who are under financial distress due to the current regional financial crisis. This would be made available only for the first generation of disbursement. Resources becoming available from repayments of these funds will be relent through the PFIs under regular wholesale banking procedures. The CLF III operation would be determined by market forces and would continue to be oriented to serve small and medium sized investors in the rural areas. LBP would be the apex institution for channeling the funds through accredited participating financial institutions (PFIs) for a broad spectrum of agricultural and non-farm viable rural investments. The CLF III would provide short, medium, and long term loans to finance private investments in agriculture and other viable rural operations, and would assist private sub-projects that are operating in the rural areas that are economically, technically and commercially sound but under financial stress induced by the current crisis.

4. The main arrangements under the CLF III would be as follows: (i) to ensure that only economically and technically viable sub-projects would be assisted under this program, a rapid but thorough feasibility study on the likely recovery/rehabilitation program would be carried out by accredited consultants/the PFIs or the LBP; (ii) the credit risk would be borne by the PFIs; (iii) maturity of these loans would be determined on the basis of sub-borrowers' cash-flow but would not exceed 15 years; (iv) interest rates on these loans would be market, with an on-lending rate to prime PFIs averaging about TBills + 1% for variable rate loans; (v) such sub-loans would be fully secured; and (vi) a certain portion of the CLF III (US$15 million equivalent) would be made available to assist LBP's own clients. The foreign exchange risk would be borne by the Government for small and medium sized sub-borrowers in exchange for a market related fee payable by LBP. The foreign exchange risk for US$ sub-loans would be borne by the sub-borrowers and their PFIs. The CLF III would be operated on the basis of an agreed Policy Manual.

5. **Single Currency and Peso Sub-Loans**. Under the project, sub-borrowers would be able to select sub-loans denominated in US dollars or Pesos under the SCL expanded program offered by the Bank. A survey of potential and existing sub-borrowers under the existing Countryside Loan Funds (CLFs) operations has shown that a number of them are well situated to bear the foreign exchange risks of a single currency loan because they generate foreign exchange revenue through direct and indirect export of their products. The survey further indicated that the US dollar would be the most appropriate currency for serving the needs of potential sub-borrowers.

6. **The demand** for medium and long term funds is currently running at a level substantially above their availability. Future needs for term lending resources, and hence the rate of drawdown of the loan, would be dependent on the overall performance of the economy, interest rate relative to other rediscounting sources, and the level of investment and reinvestment in the rural sector. It is estimated that the total investment requirement to maintain existing agricultural facilities and provide for planned sectoral economic growth of about P400 billion per annum over five years. On this basis, LBP's available medium and long term resources would provide about 2% of total agricultural investment. Under a more modest scenario of lower 1% annual growth, investment needs would be reduced to about ₱200 billion over five years, mostly for reinvestment. In this case the combined CLFs (CLF I, II, and III) resources, which would amount to about ₱15 billion would provide about 8% of total agricultural investment. This should be readily attainable, provided the fund is well administered and its cost is in line with wholesale market interest rates. As another indicator of loan demand, the total loan portfolio of commercial and rural banks in the Philippines is in the order of ₱2 trillion. Total CLF resources would be the equivalent of about 0.7% of that. Assuming half of total borrowing is in the eligible Geographical area, and a quarter of that is for investment or other purposes applicable to CLF I, II or III, CLF only needs to capture a total market share of some 5-6% of its target market to be used up.

7. **The records** of the CLF III operations would be kept separately within LBP's accounts. As LBP would operate the CLF III on a commercial basis, it should make profits. Such net profits would be reflected in LBP's Profit and Loss Account, and would remain within the CLF III as LBP's contribution.

8. **MLF.** The Micro-finance Loan Fund (MLF) would be a wholesale lending operation which would channel its resources through accredited microfinance institutions comprised of rural banks, cooperative banks, cooperatives, credit unions and credit-granting non-governmental organizations (NGOs). The MLF would finance sub-projects that would create positive socio-economic impact in the countryside. The MLF would provide short and medium term loans (one to three years) to finance private microenterprise investments that would boost productivity, generate employment and raise countryside incomes, thus, contributing to growth and poverty alleviation in the rural areas.

9. The MLF operation would be determined by market forces and would serve microenterprises in the rural areas. PCFC would channel the funds through accredited microfinance institutions for a variety of microenterprise activities operated by small scale, countryside-based entrepreneurs. MLF would support the private MFIs' role in providing the entrepreneurial poor's access to formal credit and basic banking services.

10. The main arrangements under MLF would be as follow: (i) to ensure that the funds will be used efficiently, a two stage screening process will be employed by PCFC in accrediting MFIs; (ii) MLF would finance up to 75% of sub-project cost, thereby making the MFIs share part of the credit risk; (iii) interest rate on MLF loans would be market-determined based on the cost of the subsidiary

loan from LBP plus a spread sufficient to cover PCFC's operating costs and risk for microenterprise loans; (iv) maturity of MLF loans would be determined on the basis of sub-borrowers' cash-flow but would not exceed three years.

11. MLF will assist microenterprises operating in the Philippine. Sub-borrowers are engaged in a variety of microenterprise activities such as handicraft, small scale manufacture of garments, toys and bags, backyard animal fattening, etc. It is estimated that some 3,800 sub-borrowers would immediately benefit from the MLF window at PCFC through access to credit for incremental working capital and fixed assets investments. Within a year from implementation, MLF would assist some 17,250 sub-borrowers in the rural areas[5]. MLF addresses an important gap in microcredit markets. At present, microenterprises could neither be served by the traditional banks that cater to bigger borrowers nor by the NGOs that provide very small loans to petty and subsistence type of activities, e.g., the average Grameen type of loans of about US$30 to less than US$100. Thus, MLF would complement the PCFC's current lending program for microenterprises (HIRAM or Helping Individuals Reach their Aspirations for Microcredit) where PCFC reports loan repayment rates of MFI conduits to be on average about 98%. MFI conduits loan collection rates ranges from 90% to almost 100%.

The Institutional Strengthening Component 2 - (LBP US$2 million PCFC US$0.3 million)

12. **Strengthening of LBP** To guarantee LBP's continued strong performance in the rural areas and to allow for sustainable expansion, LBP has prepared an Institutional Development Plan (IDP) agreed with the Bank which would be implemented as part of the proposed project. The approval of the agreed IDP by LBP's Board would be a condition of loan effectiveness.

13. The IDP focuses on ensuring the long term sustainability of LBP whilst it continues to expand its rural lending outreach. Main elements include:

(i) steps to be taken to improve the quality of LBP's loan portfolio including (a) reducing concentration, (b) improving commercial loans collections in the short term though a series of specified actions, thereby reducing the level of gross past dues in LBP's commercial lending portfolio, and (c) setting overall provisioning targets for commercial loans similar to those for agrarian loans so as to objectively relate provisions to past dues - this will result in the necessity to increase provisioning in the short term and so reduce the present net past dues percentage;

(ii) reducing the heavy unit losses which continue to occur on agrarian lending through improved operating efficiency including manpower reduction, expansion of the use of RFIs as conduits, better loan collection rates and the adoption of higher interest rates, if possible;

(iii) in parallel with (ii) expanding total lending to the agrarian/small farmer sector;

(iv) continuing the policy of automation of systems and management information flow;

(v) upgrading staff of LBP (and co-operating PFI) through appropriate training - main areas for training include (a) credit analysis; (b) remedial management including foreclosure procedures, legal processes and loan work-outs; (c) familiarisation of treasury personnel with new and emerging financial instruments; (d) various skills training for staff whose

[5] PCFC survey of potential conduits for MLF, May 21-23, 1998.

responsibilities have changed as a result of the recent reorganization; (e) environmental issues - including PFI staff; (f) upgrading the knowledge and skills of LBP's CLF unit staff for reviewing and appraising sub-project feasibility studies and, in particular, supervising PFIs and their sub-projects, and developing PFI staff skills, especially among the RFIs, in the preparation and presentation of sub-project financing requests;

(vi) continuing to emphasize the mobilization of private deposits and focusing efforts on extending the average term of resources through mobilization of medium and long term Peso resources once the markets become suitable; and

(vii) making adequate arrangements for a build up of capital, so as to ensure LBP's ability to expand its lending and outreach to countryside farmers and entrepreneurs. This includes both increasing LBP's authorised share capital and ensuring that dividends are paid only from real profits, after allowing for deduction of all provisions for loan losses (specific and general) and the effect of within year inflation on the real value of net financial assets.

14. **PCFC's IDP** would center on ensuring the sustainability of PCFC as it continues to expand its outreach to the country micro-entrepreneurs. The main elements of the IDP are detailed in the Matrix, Appendix 1 and summarised as follows:

(i) build up of PCFC equity through capital infusion by the LBP and the Government, and offer of preferred shares to institutional and private investors;

(ii) generation of profits in real terms through the adoption of market-determined interest rates, appropriate accreditation of MFI conduits; increasing lending volume, thus, increasing staff efficiency;

(iii) recruitment of necessary personnel and upgrading of existing staff through appropriate training and incentive system; and

(iv) improvement of its operating efficiency through the strengthening of its operations group, expansion of the network of MFI conduits, better loan collection rates and better screening of MFI conduits.

To generate the volume of loans that would meet the credit demand of micro-enterprises, PCFC needs to widen its network of MFIs conduits. This would require an effective marketing of MLF to the MFIs conduits.

Annex 2a

Philippines
Third Rural Finance Project

Appendix A: Institutional Strengthening Matrix for PCFC

Goals	Current Status	Strengthening Needs	Action Plan/Steps to be Undertaken
Financial Goals			
Strengthening of Financial Condition	Capital - equity is 45.9 percent of total risk assets. Risk asset ratio is 2.2. Real profits - negative. Liquidity - high at 3.13:1. Debt to equity ratio is 2.49:1. 28.7 percent of total assets is provided by capital from stockholders.	• Need to increase profitability in real terms. To do this--need to increase interest spread to cover for inflation erosion. • Need to increase volume of loan portfolio but to do this--need to increase capital base so as to maintain a reasonable risk asset ratio. This is important because microfinance has higher risks compared to regular loans.	• Capital infusion by government or private investors. • Timely payments by PCFC's institutional partners on their loans for relending. • Use of market-determined interest rate spreads on lending. • Increase its lending volume.
Strengthening Lending Operation	There are only two lending programs: HIRAM and the ADB-IFAD term loan. The former is a revolving credit facility while the latter is a 7-year term loan. Collection rate is 99.06 percent. A two percent loan loss provision is applied on all loans outstanding. At present, interest rates are determined by the PCFC board. It charges 14 percent interest rate on both of its program. PCFC incurs institution building and social preparation costs for institutional partners.	• Need to improve portfolio management. • Need to come up with more loans with shorter maturities. • Need to share credit and market risks with the MFI and the sub-borrowers. • Need to reduce lending costs to institution partners. • Need to institute sound and efficient MIS that would reduce costs of loan evaluation and supervision by account officers.	• Improved portfolio management will be done by encouraging equity participation by the MFI and the sub-borrowers. This will enable the MFI and the sub-borrower to share credit and market risks. • Loans with shorter maturities than the ADB-IFAD loans will be extended. The proposed Bank loan will address this. • Installation of an MIS that allows tracking of loans and efficient evaluation of MFIs' financial condition. This includes the timely generation of management and operations report. • Automation of loan transactions and pertinent reports to facilitate identification of defaulting borrowers and non-performing accounts. • Facilitating tie-ups with concerned government agencies, bilateral and multilateral agencies to address the support services needed by the MFIs.

Goals	Current Status	Strengthening Needs	Action Plan/Steps to be Undertaken
Institutional Strengthening Goals			
Widening the resource base	There is a severe shortage of funds which is a major impediment for institution building and expansion of programs and services. This also resulted in cost controls that inhibit PCFC to invest in capital equipment needed for efficient operations.	• Need for additional capital.	• Offer preferred equity shares to LBP by converting its bills payable to LBP. • Additional capitalization from the government. • Tapping private investors (privatization plan is currently being drafted).
Capacity building of the microfinance sector	Most of the MFI clients of PCFC lack a good information system that improve cost efficiency in their operations. This would also aid them in evaluating the end-borrowers.	• Need for technical assistance for the MFIs especially in the areas of information systems, risk management and financial management.	• The UNDP Microfinance Support Program is currently being negotiated. This program will address the capability building needs of the MFIs. • The PDTF in the recently enacted Social Reform and Poverty Alleviation Act will also be used for capability building of MFIs.
Training of PCFC staff	A recently conducted training needs assessment among PCFC staff showed that they need training on the following: communicating skills, auditing skills and financial statement analysis skills.	• Need for a staff development training courses.	• PCFC has earmarked P1.2 million for a staff development program which is comprised of the following courses.
Establishment of a structurally sound and dynamic organization	PCFC incurs very high costs for monitoring its clients. It has a very small staff complement, hence most of the staff have multi-functions.	• Need for reorganization to effectively and efficiently service its clients.	• Establish collaboration / complementation with LBP. • Establish service area teams in account management. • Set-up account services unit.
Institutionalization of management and operational systems	PCFC has just completed its manual of operations for the HIRAM and ADB-IFAD programs There is yet no institutionalized system for performance appraisal of account officers that is tied up to improving their productivity. There is also inadequate MIS.	• Need to come up with manual for PCFC's management and operations. • Need to come up and implement an incentive plan which is tied up with the staff productivity for PCFC employees. • need to install and use a customized database management system for loan tracking, monitoring program partner performance. The database should provide sufficient information to support management in its decisions and operations. • need to review staff compensation benefits to approximate current market conditions.	• Manualize existing operations. • Formulate an incentive plan for staff of PCFC to improve their productivity.

Annex 2b

Philippines
Third Rural Finance Project

Credit Implementation Arrangements

Countryside Loan Fund (CLF) III

1. The credit operation would be carried out by the Wholesale Lending Department (WLD). The Countryside Loan Fund III (CLF III or the Fund) unit would handle day-to-day implementation of the CLF III operations. While overall responsibility of the credit component would rest with LBP, the responsibility to implement the CLF III would rest with LBP's Program Lending Department.

2. The WLD would onlend project funds to the PFIs and provide them, as necessary, with technical assistance on CLF III operation. It would process sub-loan applications from PFIs; provide guidelines to PFIs on sub-project selection and appraisal; carry out selective end-use verification of sub-projects funded by CLF III; monitor sub-project performance; conduct training with PFIs; and manage the overall CLF III relationship with the PFIs.

3. Credit Operating Policies and Procedures. Under the proposed project LBP would continue to enhance its capabilities as a second tier bank. The credit operation would be carried out on the basis of policies and procedures established in a Policy Manual (PM) for the Fund, to be approved by LBP's Board, and satisfactory to the Bank. The PM would be periodically updated to reflect necessary policy changes. Policies to be incorporated under this loan are outlined below and will be incorporated in the respective PM. The adoption and implementation of the PM, satisfactory to the Bank would be condition of loan effectiveness. Key policy issues discussed below include: eligibility criteria for Fund resources; interest rate structure and foreign exchange coverage fee; PFIs accreditation criteria; sub-projects appraisal sub-project review and disbursements; sub-loan rescheduling; sub-loan maturities; environmental protection; and supervision of CLF III sub-loans; accounting and audit arrangements. The PMs would not be revised without prior consultation with and approval of the Bank.

Eligibility Criteria

4. Sub-borrowers under CLF III will be limited to private sector individuals or enterprises, provided that CLFs' total exposure under sub-loans to any single borrower shall not exceed 5% of LBP's equity. Eligible investment would be short, medium, and long term private investment financed for the establishment of new enterprises, expansion of existing enterprises, or reinvestment in existing enterprises. All agricultural and rural industries based projects would be eligible, including fisheries, agro-industries, and agricultural service enterprises. To qualify, proposed sub-projects would have to be appraised by the PFIs and/or LBP as technically feasible, financially viable, environmentally sound, and in the case of larger investment sub-projects exceeding US$1 million equivalent, economically justified.

5. Project financing is extended to basically support private small and medium-sized firms in the rural sector, which do not presently have easy access to funds over one year's duration for their own operation and real new investments. Peso sub-loans would be offered to small and medium sized sub-

borrowers. Project funds would finance investments in fixed assets such as new buildings and machinery and working capital. Land, existing buildings, or other assets previously used within the rural sector (except breeding livestock) would be ineligible. Under the CLF III the PFIs would be required to provide, for each sub- project, at least 10% of the financing package from their own funds. The minimum equity contribution by the sub-borrower would be determined by the PFIs and LBP on the basis of its sub-project appraisal, but should not be less than 15%. Bank financing of any single sub-project, under the CLF III would not exceed, in any case, 75% of sub-project costs.

6. US$ Lending. In addition to the above eligibility criteria, appraisals of sub-projects for a US$ loans must include an assessment of sub-borrowers' foreign exchange revenues and a demonstration that projected revenues are adequate to service the US$ sub-loan. For indirect exporters, revenues may be in pesos, provided that the appraisal establishes a clear linkage between sub-borrowers revenues and foreign exchange.

Interest Rates

7. Under the proposed project interest rates would be as follows: for the US$ lending program interest rate would be variable market rate based on the Bank's prevailing rate for this type of loans plus an adequate spread to cover cost of GOP guarantee, operating costs, and associated risk of LBP and PFIs. The foreign exchange risks associated with these sub-loans would be fully borne by the sub-borrowers. Interest rates on PFIs' and LBP's financial peso participation would be freely set by the PFIs and LBP. For Peso sub-loans interest rates would: be market as required by GOP policy and in line with interest rate arrangements under the latest and on going Bank credit loans to LBP and DBP. It is not likely that the smaller borrowers who are not direct or indirect exporters would be in a posi tion to bear the foreign exchange risks and therefore, the foreign exchange risk, in the case of Peso sub-loans, would be borne by the Government. In both cases (SCL and Peso sub-loans) the system would allow free negotiations between LBP and PFIs, on the one hand, and between PFIs and the final borrowers on the other, to set rates which reflect market forces and risks involved.

8. The onlending interest rates charged by LBP to the PFIs for the proposed peso sub-loan operation would be variable and adjustable every quarter. It would be based on the Weighted Average Interest Rate (WAIR) for 91 day Treasury Bill (TBills). The possibility of using the WAIR of time deposits, rather than Tbills, and then adjusting for the net cost of reserve and liquidity requirements was considered, but rejected because (a) the calculation is relatively complex and (b) Tbill data is more readily available, reliable and transparent. Tbills of 91 day maturity, rather than longer instruments, are proposed because they are the local bellweather and secondly the practice for variable rate lending is quarterly repricing. To mitigate the lag problem, the interest rates for an interest period would be based on the average WAIR of Tbills for the first three weeks of the month prior to the period. This would be redone on a monthly basis, to allow close to market pricing of new loans, although once loans are established, interest rates would normally be reset quarterly.

9. As stated above, the interest rate on these Peso loans would be market, with an on-lending rate to prime PFIs averaging at about 1% over the WAIR for 91 days TBills rates (the reference rate). The cost of Bank funds to LBP would, therefore, be determined by the reference rate less the 'agreed' (among LBP, DOF and the Bank) spread to LBP (1.5% to 2%). LBP, however, would be free to charge a particular PFI a higher or a lower rate than the reference rate, based on market conditions and the associated credit risk. In such cases the LBP's actual spread will be accordingly higher or lower than the 'agreed' one.

10. Sub-borrowers would be given a choice of a fixed rate (the prevailing variable rate plus a premium) for several years or a variable interest rate periodically adjusted. There is not a well developed secondary market in Government Securities of varying maturities which would allow fixed interest conversion premia to be predetermined by a formula linked to the market. Consequently, fixed rates would be reset in an ad hoc way, acceptable to the Bank. To mitigate DOF's risk, it is anticipated that the rates would be determined on the basis of the highest level of the following: (i) the rates resulting from the current formula for variable rates plus/minus the change in expected inflation rate for the lending period concerned; or (ii) long term market rate equivalents (e.g. lending rates of insurance companies to end borrowers for long term mortgage loans minus the respective PFI spread established under the sub-loan).

11. Fee for Coverage of Foreign Exchange Risks. Under the CLF III operation, the difference between the WAIR +1 of 91 day T-Bill rate and the World Bank loan costs, minus LBP's spread of 1.5% to 2% (to cover LBP's wholesale operating costs) would be passed on to DOF. This amount is intended to cover the foreign exchange risks, the GRT, and the guarantee fee. It should be noted, however, that given that the T-Bill rate is market-determined, there cannot be a guarantee that the fees passed on to the DOF would always be sufficient to cover the foreign exchange risks involved, especially in times when there is excess liquidity. Nevertheless, given that the T-Bill rate reflects an active market and there do not seem to be major distortions, it is expected that over longer periods of time-provided that monetary policy is balanced-this formula would provide an adequate fee to the Government for undertaking the foreign exchange risk. Analysis of Peso and US$ short term interest rates and inflation rates over the past seven years has been undertaken. In the past, the interest rate differential has been more than adequate to cover the Philippine:USA inflation differential. It is projected that similar differentials remain in future. This means that if purchasing power parity is maintained, through future devaluation (the base case in our analysis), the payments to Government would be adequate to compensate for FX risk, provided interest income on the guarantee fee pool is taken into account (for more detailed analysis see Annex 4).

PFI Accreditation Criteria

12. Accreditation criteria of Participating Financial Institutions (PFIs) would ensure that four fundamental aspects are complied with: solvency, liquidity, profitability, and quality of ownership and management. Criteria would be credible, transparent, unequivocal, and compatible with sound and generally accepted financial principles and with the Bangko Sentral ng Pilipinas (BSP) regulations. While accessory factors could be taken into account for fine tuning purposes (e.g. reviewing LBP's credit ceiling limits), care would be exercised to avoid deviation from the main criteria. The following types of Financial Institutions (FIs) would be allowed to participate in the CLF III program, provided that they meet the financial and administrative criteria: Universal, Commercial, Rural, Thrift, and Cooperative Rural Banks, including non-bank financial institutions such as Investment and Trust Corporations, Investment Houses, Finance & Leasing Companies, and Rural Credit Unions.

(a) BSP Banking Regulations. Eligible FIs would comply with all BSP regulations, particularly those related to the review of loan portfolio and other risk assets, definition of past due loan accounts, loan classifications, and adequate provision for expected loan losses.

(b) Solvency Requirements. Eligible FIs would comply with a minimum net equity base of at least 10% of their risk assets. The net equity base would be computed applying the criteria established by BSP, at the time of accreditation. Also, eligible FIs would maintain a net past due over equity of not more than 25%. Taking into account the impact of the financial crisis, this target may be gradually obtained as follows: 35% by December 31, 1998; 30% by July 31, 1999; and 25% by December 31, 1999.

(c) Liquidity. Eligible FI would comply with minimum of liquidity ratio (liquid assets over short-term deposits and bills payable) of 30%.

(d) Profitability Requirements. Eligible FIs would demonstrate their profitability in real terms during the life of the sub-loans. If their adjusted[6] profit obtained is positive, then it would be considered that the real profitability criteria has been met A financial intermediary complying with all other requirements except real profitability would be qualified provided that concurrence would be obtained in advance from the Bank. While such an exception may be required, it would need to be qualified for exceptional cases such as when a PFI has taken write-offs accruing to several past years or when the negative real profitability has been an exception and financial projections clearly demonstrate that in the future the PFI would make real profits.

(e) Ownership and Management Quality Requirement. Ownership and management quality should be satisfactory to LBP. This would include qualified management team of good reputation, presence of adequate and qualified staff, sound operation policies and procedures, compliance with all relevant laws, decrees and regulations.

13. In the event that a PFI loses its accreditation status (having failed to meet one or more of the accreditation criteria), then LBP would: (i) cancel the uncommitted portion of the line of credit granted to the PFI; (ii) take the necessary actions to safeguard the committed portion extended to the said PFI; and (iii) notify the Bank on actions taken.

14. Sub-project Appraisals. Sub-loan appraisals would be the responsibility of the PFIs, whose capability would be determined by LBP according to CLF III qualifying criteria. Appraisals of medium- and long-term sub-loans would be based upon the technical and financial features of the sub-projects. For each medium- and long-term sub-loan, the PFI and LBP would prepare a financial plan including the sub-project's cash flow. The PFI shall estimate a financial rate of return (FRR) for all sub-projects with sub-loans of more than ₱8 million (US$200,000) equivalent. For the sub-projects to be acceptable, the real FRR shall be greater than the real interest rate of the sub-loan. LBP would ensure that an estimation of an economic rate of return (ERR) would also be carried out for all sub-projects with sub-loans of more than US$1 million equivalent. These sub-projects should yield an ERR of not less than 12% in real terms or any other rate established from time to time by NEDA. The appraisals of sub-projects under the SCL program would have to ensure that this type of sub-loans would be offered only to those sub-borrowers, regardless of their size, who: (a) are direct or indirect exporters and have a need for a single currency loan to match revenues earned in or tied to foreign exchange; and (b) have the capability to manage the risks associated with the foreign currency compositions of their assets and liabilities.

15. Sub-project's Review and Disbursements. As under the previous operations, LBP would receive the sub-project credit evaluation carried out by the PFI in all cases. On an ex-ante basis-before disbursing-LBP would review a summary of the appraisal work prepared by the PFI, so as to ascertain that the sub-projects are consistent with project guidelines, in which case it would authorize the respective disbursements. LBP would grant up to 60 days to PFIs to submit sub-loan documentation and evidence of

---

6 The adjustments proposed to the nominal profits would simply be two: (i) the initial equity, multiplied by the inflation between the beginning and ending accounting period dates would be deducted from the nominal profits; and (ii) the initial fixed assets multiplied by the inflation between the same dates would be added to the nominal profits. If the resulting number is positive then it would be accepted that the real profitability has been positive.

payments and procurement. LBP would declare the sub-loans due and demandable and charge a penalty fee if PFIs do not submit the required documentation within the 60 day period after LBP's disbursements or if the submitted documentation does not satisfactorily support sub-projects that are eligible under the project. In any case, LBP would maintain rights to visit sub-projects after the sub-loan disbursements have been made. Bank concurrence would be required for all sub-loans above US$5 million equivalent. Disbursements to the PFIs would be subject to compliance with both pre-release and post-release documentation required. Proceeds would be credited to an account opened with LBP for this purpose. If a PFI advances a sub-loan release to a sub-borrower, the PFI can apply for rediscounting from CLF III within 120 days after the date of advance. On the other hand, the PFIs must release the full proceeds to the sub-borrowers within 15 working days of the receipt from LBP.

16. Sub-loan Maturities. The repayment period for CLF III medium- and long-term sub-loans will be based upon the sub-project's cash flow and the sub-borrower's overall repayment capability. Repayment of most sub-loans would be within five to ten years, but would not exceed fifteen years or the pay-back period of the sub-project, whichever is shorter. Reasonable grace periods may be granted by LBP for the repayment of the principal based upon the sub-project's cash flow projections and the sub-borrower's repayment capability. Maturity of subsidiary loans to PFI under CLF III would conform the maturity of the related sub-loan. Short term sub-loans shall be payable within a period of 12 months.

Environment

17. LBP will specify that sub-borrowers for CLF III funded projects should comply with all laws and regulations of the Philippines related to environmental protection, consistent with environmental guidelines of the Bank. LBP would be in charge of supervising compliance. To reduce the risk that sub-projects with undesirable environmental or social impacts would be financed by CLF, the following measures would be taken. The existing procedures and guidelines agreed under the Second Rural Finance Project among LBP, the Department of Environment and Natural Resources (DENR), and the Environmental Management Bureau (EMB) would prevail and be applied under the proposed project. All sub-projects would comply with the Presidential Decree 1586 and its 1992 regulations, which describes the Philippine environmental legal requirements for new investments. For the following generic sub-projects: poultry and piggery, agro-processing, land clearing, and fish and pond development, and any other sub-project as the Bank may require, an Environmental Impact Statement (EIS), as required by the above Presidential Decree and in line with the guidelines established under the Second Rural Finance Project, would be prepared. The Environmental Unit (EU) of LBP would provide LBP, PFIs, and related sub-projects with environmental technical assistance and coordination services. The EU is staffed by a core of professional and administrative assistants, supported by qualified consultants which are providing periodic short term services. In addition, the EU would be responsible for the implementation of the training program for the project related staff in LBP and the PFIs. This program would include courses on environmental issues to increase CLF III related staff capacity to review and monitor environmental aspects of sub-projects. Also, and in light of EMB's and DENR's manpower difficulties, the EU with the support of the Bank, would accredit consultancy firms to review and provide EIS and recommendations with regard to sub-projects. These consultants would extend the following services: (i) provide environmental scoping; (ii) review project descriptions and EIS prepared by sub borrowers; (iii) prepare descriptions and EIS for sub-borrowers which do not posses the technical capability to undertake them; and (iv) follow up and accelerate processing of applications within the clearing and permitting system of DENR and EMB.

Project Supervision

18. Supervision of Sub-projects. The supervision of the sub-loans would be the responsibility of the PFIs and LBP with the requirements that specific officers would be designated for this purpose. PFIs and LBP would ensure through supervision that sub-borrowers use the CLF III resources only for the approved purposes. This would be achieved through direct payments to suppliers of inputs and materials, as practicable, and through a careful follow up of funds application. In fact, as LBP would receive documentation and evidence of procurement after disbursements, LBP would have an adequate basis for determining whether or not the CLF III have been used for approved purposes. Furthermore, sub-project visit would be a normal part of the supervision process. PFIs and LBP would also obtain periodic operating and financial reports from sub-borrowers and LBP would conduct selective end-use verification of funded sub-projects. In this manner, LBP would issue an annual assessment of the overall financial condition of the PFIs and shall use such findings in the annual renewal of PFI accreditation. Thus, the PFIs would be required to submit such reports as prescribed by LBP (WLD) from time to time that allow LBP to properly monitor the PFI's sub-loan appraisal, disbursement and supervision processes and capabilities.

19. LBP Supervision of PFIs would be a permanent effort. A monitoring system to enable LBP to take corrective measures as soon as possible has been established under the previous CLF. This system would be used to monitor PFIs' performance under the proposed project. LBP's supervision will focus on sub-loan promotion, appraisal, disbursements, and recovery, as well as sub-project supervision by the PFIs. The overall financial conditions of PFIs would be assessed and findings and recommendations included in comprehensive annual supervision reports to be prepared by LBP on each of the PFIs. Also, LBP would prepare an annual report on PFIs, summarizing their overall conditions and main issues affecting the principal categories of PFIs (CBs, TBs, and RBs). This annual report would also include technical assistance as well as remedial action recommendations to enhance the financial, technical, administrative and developmental conditions of PFIs.

20. Accounting and Audit Arrangements for Project-Related Disbursements. The PFIs would be required to maintain adequate records and accounting of CLF III sub-loans that are satisfactory to WDL within LBP, especially to accurately reflect balances and movements in the CLF III. PFIs would also be required to furnish their audited financial statements, at least annually. The external auditors and the format of the report should both be satisfactory to LBP. LBP would communicate its requirements on external audits of PFIs in a timely manner, so as to allow the external auditors know in advance about LBP needs, especially those related to PFI accreditation requirements under the project.

MLF

21. The credit operation would be carried out by the Operations Group of PCFC that is headed by a Vice President who reports directly to the PCFC President. Day to day implementation would be carried out by the Group. Overall responsibility of the credit operation would rest with the PCFC President.

22. The Operations Group would onlend project funds to the MFIs and provide, as necessary, with technical assistance on MLF operations. It would process sub-loan applications from MFIs; provide guidelines to MFIs on sub-project selection and appraisal; conduct selective end-use verification of sub-projects funded by MLF; monitor sub-project performance; conduct training with MFIs on MLF operations and manage the overall MLF relationship with the MFIs.

Credit Operating Policies and Procedures

23. Under the proposed project PCFC would operate as wholesale lending institution to MFI conduits. The credit operation would be carried out on the basis of policies and procedures established in a Policy Manual for the MLF to be approved by PCFC's Board of Directors and satisfactory to the Bank. The Policy Manual would be periodically updated to reflect necessary policy changes. Policies to be incorporated under the MLF are outlined below and will be incorporated in the Policy Manual. The adoption and implementation of the Policy Manual (PM) satisfactory to the Bank would be a condition for disbursement. Key policy issues discussed below include: eligibility criteria for MLF resources; interest rate structure; MFI's accreditation criteria; sub-projects appraisal, review and disbursements; sub-project loan rescheduling; sub-loan maturities; supervision of MLF sub-loans; and accounting and audit arrangements. The PM would not be revised without prior consultation with and approval of the Bank.

Eligibility Criteria

24. Sub-borrowers under MLF will be limited to microenterprises operating in the country. Eligible sub-projects would be small scale and microenterprise activities such as trading, handicraft/small manufacturing, backyard animal production, food processing and production of vegetables and fruits, excluding production of rice and corn. To qualify, proposed sub-projects would have to be appraised by the MFIs and/or PCFC as technically feasible, financially viable, and environmentally sound.

25. Project financing is extended to support private microenterprises that do not have easy access to formal credit facilities. These microenterprises could neither be served by traditional bank lending programs that cater to bigger enterprises/borrowers, nor by the NGO microcredit facilities that provide only very small individual loans. Peso sub-loans would be provided to microenterprise sub-borrowers. Project funds would finance investments in fixed assets such as simple machinery or equipment and working capital. Land acquisition would be ineligible. The MFIs would be required to provide for each sub-project at least 25% of the financing package from their own funds. The minimum equity contribution by the sub-borrower would be negotiated with the MFI concerned. Bank financing of any single sub-project would not exceed in any case 75% of sub-project costs.

Interest Rates

26. Under the proposed MLF, interest rates would be in line with market rates as required by GOP policy. MLF would allow free negotiation between PCFC and MFIs on the one hand, and between the MFIs and the sub-borrowers on the other, to set the rates which reflect market forces and the risks involved. The onlending interest rates charged by PCFC to MFIs would be based on the cost of funds from LBP plus reasonable spread sufficient to cover operating costs and associated risks.

MFI Accreditation Criteria

27. The accreditation criteria ensure that the participating MFIs pass the tests of solvency, profitability and quality of ownership, lending performance, management and monitoring system. It has two steps: (a) the MFI would meet certain minimum requirements before a thorough evaluation of its financial performance and operations is made and (b) the credit evaluation process upon satisfaction of the pre-qualifying criteria.

28. The following institutions would be allowed to participate in the MLF: rural banks, cooperative banks, cooperatives, credit unions and credit-granting NGOs. To the extent that they have or would be ready to implement microfinance programs, thrift banks, private development banks and commercial banks would also be allowed to participate.

29. <u>BSP Banking Regulation</u>. In the case of banks, compliance with BSP's minimum capital requirements is a necessary condition for accreditation. In the case of cooperatives, credit unions and credit NGOs, submission of a capital build-up program ready for implementation that will be reviewed and approved by PCFC in addition to the following would be required: (i) meet other MLF criteria; and (ii) fully cover their MLF availment or line with acceptable collaterals.

30. <u>Solvency Requirement</u>. Eligible MFIs will comply with minimum net equity base of 10 percent of their risk assets or as may be required by BSP, whichever is higher. At the time of accreditation, the net equity base shall be computed applying the criteria established by BSP. Eligible MFIs would also maintain a net past due over equity of not more than 20%. The eligible cooperatives,

credit unions and credit NGOs will maintain a net capital (or fund balance for NGOs) ratio of at least 12 %. of their risk assets.

31. Liquidity. Eligible MFIs would comply with a minimum liquidity ratio (liquid assets over short-term liabilities, e.g., deposits and bills payables) of 30%.

32. Profitability Requirements. Eligible MFIs would demonstrate their profitability in real terms during the life of the sub-loan. An MFI complying with all other requirements except real profitability would be qualified provided that concurrence would be obtained in advance from the Bank. Such an exception may be allowed in justifiable cases, e.g., when a MFI has write-offs accruing to several past years or when the negative real profitability has been more of an exception and financial projections clearly demonstrate that in the future, the MFI would make real profits.

33. To calculate profitability in real terms, the adjustments to the nominal profits would simply be two: (i) the initial equity, multiplied by the inflation between the beginning and ending accounting period dates would be deducted from the nominal profits; and (ii) the initial fixed assets multiplied by the inflation between the same dates would be added to the nominal profits. If the resulting number is positive then it would be accepted that the real profitability has been positive.

34. Ownership and Management Quality Requirement. There should be no material adverse feedback on the reputation and competence of owners and management of the MFI. For this purpose, the following shall be the bases for feedback: checking with the banks and the courts; credit investigation and audit reports; newspapers, subscription, and other publications; BSP and government financial institutions.

35. In the event that an accredited MFI loses its accreditation status (having failed to meet one or more of the accreditation criteria), PCFC would: (a) cancel the uncommitted portion of the line of credit granted or suspend the subsequent drawdowns to the MFI; (b) take the necessary actions to safeguard the committed portion extended to said MFI; and (c)) notify IBRD on actions taken.

Sub-projects Appraisals

36. Sub-loan evaluation and approval will be the responsibility of the MFIs, whose capability to undertake these activities will be determined by PCFC according to the MLF qualifying criteria. Evaluation of short and medium term loans shall be based on the technical and financial characteristics of the sub-project. For each short and medium term sub-project, the MFI shall prepare a financial plan including sub-project cash flow.

Sub-projects Review and Disbursement

37. PCFC shall receive the list of sub-borrowers with corresponding sub-projects together with the required report from the MFIs, as a general rule, on an ex-ante basis. It will review on an ex-ante basis the said documentary requirements and check whether these are consistent with MLF guidelines to authorize disbursements. PCFC may, at its option, allow post-ante review for MFIs with good track record.

38. PCFC will grant up to 30-day for the MFIs to submit post-release sub-loan documentation. Appropriate sanctions and penalties will be applied against the MFIs should they fail to meet the said 30-day period, following loan release to the MFIs.

39. PCFC, on a selective basis, will conduct selective end-use visitation or verification of funded sub-projects after loan release to ensure that the funds are properly used.

40. Disbursements to the MFIs will be subject to compliance with both pre-release and post release documentation. Proceeds will be credited to a deposit account opened with LBP for this purpose. If the MFI advances the loan release to clients, the MFI can apply for rediscounting within 90 calendar days from date of initial advances. In this case, the computation of the loan amount to be provided to the MFI is computed based on outstanding balance before the loan release (i.e. 75% of the outstanding balance).

Sub-loan Maturities

41. The repayment period for MLF short and medium term sub-loans will be based on the sub-project's cash flow and the sub-borrower's overall repayment capacity. Repayment of sub-loans would be within one to three years. Reasonable grace period for repayment of the principal could be given based on the sub-project's cash flow projections and the sub-borrower's repayment capability.

Sub-project Loan Rescheduling

42. Loan restructuring may be effected by reason of force majeure directly affecting specific projects of the sub-borrowers resulting in the inability of the sub-borrower to pay its loan to the MFI which in turn affects the MFI's capability to repay its loan to PCFC. The loan restructuring will provide a recovery/rehabilitation period that will strengthen the paying capability of the MFIs sub-borrowers.

43. The MFI must submit a specific proposal at least 30 days after the occurrence of the fortuitous event. Such restructuring will consist of a revision in the repayment terms of the outstanding sub-loan.

Supervision of Sub-loans and Sub-borrowers

44. Supervision of sub-loans will be the responsibility of MFIs which will designate specific officers for this purpose. MFIs will ensure that sub-borrowers use project funds only for approved purposes. MFIs will also obtain periodic operating and financial reports from sub-borrowers.

Supervision of MFIs

45. PCFC shall conduct an annual review of the overall financial condition and performance of the MFI and shall use the findings thereon as basis in the yearly renewal of the MFIs' accreditation under the MLF.

46. PCFC shall supervise on a selective basis sub-borrowers to determine if the sub-loans had been used for the intended purposes.

Reporting Requirements

47. The MFI shall be required to submit the following regular reports in a format prescribed by the PCFC and such other reports as may be required by PCFC: (i) annual audited accounts; (ii) quarterly un-audited financial statements; (iii) quarterly status report; (iv) annual detailed status report; and other reports as may be required by PCFC.

48. MFI shall maintain separate books of accounts and separate identifiable subsidiary ledgers for full accounting of the subsidiary loan and its utilization by the sub-borrowers .

Accounting and Audit

49. The MFIs will submit to PCFC their audited financial statements at least annually. PCFC will ensure that the accreditation criteria are satisfactorily met. PCFC may also conduct surprise audit as may be deemed appropriate by the PCFC management. MFIs are enjoined to provide their cooperation in complying with these control measures to protect the Fund.

Annex 2c

Philippines
Third Rural Finance Project

LBP's Operations, Financial Performance and Projections

Mandate & Ownership.

1. The Land Bank of the Philippines (LBP) was established under the Land Reform Code Act (RA3844) in 1963 as the agency responsible for financing agrarian reform. It had an authorized ordinary share capital of P1.8 billion which by the early 1990s had been fully subscribed by the Government. Under the Land Bank Act of 1995, (RA7907) LBP's authorized ordinary share capital was increased to P7.5 billion, (of which P7.4 billion has now been paid up through allocation from reserves). At the end of 1996 and in early 1997, LBP's capitalization was further strengthened by SSS (the social security fund) taking up P1.2 billion of preference shares (yielding 14%). Now that LBP's ordinary share capital is almost fully paid up, LBP's board has submitted an application for the authorized capital to be increased further to P25 billion. Since 1973, LBP has had full banking powers, allowing it to receive demand, savings and time deposits without limitation, and to engage in underwriting activities. It has expanded rapidly over the past decade, and is now one of the five largest banks in the Philippines.

Organizational Structure.

2. In line with normal commercial bank practice, LBP is controlled by a Board of Directors, which comprises nine members. These include the Secretary of Finance, who is Chairman; the President and CEO of Land Bank, who is Vice-Chairman; the Secretaries of Agrarian Reform; Agriculture and Labor, all of whom are ex-officio members. Another four Board members are appointed by the President of the Philippines to represent the Agrarian Reform beneficiaries, the landowners and the private sector.

3. LBP is now divided into three main sectors, (i) the Agrarian[7] and Domestic Banking Sector (ADBS), (ii) the Institutional Banking Sector (IBS), and (iii) the Operations and Support Sector (OSS). This is a relatively new structure. Previously LBP had operated its commercial banking completely separately from its agrarian operations even to the extent of having separate channels within the countryside (branches for commercial banking and field offices for agrarian). The new structure has amalgamated the old branches and field offices, under the Agrarian and Domestic Banking Sector and separated out the largely head office based Institutional Banking Sector. LBP's 298 branches (up from 32 in 1990 and 161 in 1994) now give it nation wide cover and the relative importance of branch banking is growing. Within the branches, LBP still services its two types of client (agrarian and commercial) which continue to have substantially different needs. However the fact that agrarian borrowers now deal with branches rather than specialized agrarian offices has the marketing advantage that LBP is able to offer them other services, such as savings and checking which previously were not available from the 'field offices' which dealt only with loans to small farmers. LBP's Institutional Banking Sector is still large compared to branch banking in terms of lending, and generates about 65% of loan business (down from over 80% in 1994), mainly through Head Office. The Operations and

[7] See definition in Footnote 2 page 8 of the PAD.

Support Sector, as its name suggests, provides facilities and back up for the earning parts of the bank. Among others, it includes manpower services, facilities management, controllership, treasury, and market research. It is head office based.

Resources and Assets.

4. LBP has substantially expanded its available resources over recent years to a total of P160 billion (US$4.0 billion) as of December 31, 1997. About P14.7 billion of these resources are equity (over P11 billion of which result from retained earnings). The main source of funds at December 1997 was government deposits of P74 billion or 46% of total resources. Private deposits, which have grown rapidly amounted to 24% of total resources and bills payable (including loans from WB, ADB, OECF, IFAD and foreign CDs) to 11%. On the assets side, cash and investment in Government securities together totaled P50 billion or 31% of its total assets, and net loans amounted to P94 billion, 59%. The balance was made up of investments in non government securities (4%), bank premises and other fixed assets (2%), and other assets (4%).

Impact of Devaluation.

5. Although LBP has foreign exchange borrowings and deposits amounting to about US$900 million, these are fully hedged; either the funds are reinvested or relent in matching currencies, or else, as in the case of multilateral and bilateral borrowings (about US$500 million), the foreign exchange risk is borne by Government. Indeed as at mid February 1998, LBP's unhedged foreign exchange risk amounted to only US$4.2 million, or about 0.1% of total assets. The main impact of the recent Peso devaluation on LBP therefore was to increase the size of both total assets and total liabilities by roughly the same amount, therefore slightly weakening its Risk Assets:Equity ratio.

Lending Operations.

6. LBP substantially expanded its total lending portfolio during the last four years (1993 - 1997) at an annual nominal rate of 30% resulting in LBP's total gross loan portfolio increasing from P32.3 billion in December 1993 to P93.7 billion in December 1997 (US$2.4 billion). Included within this figure is wholesale term lending under ALF and CLF, which uses Bank resources. This wholesaling activity has been both profitable and successful. Repayments have been excellent, and the end of 1997, there were no past dues from Participating Financial Institutions (PFIs). Over seven years, LBP had only one bad debt under this program, for a negligible amount of P0.5 million or less than one hundredth of one percent of the present outstanding balance.

Portfolio Quality.

7. Analysis of LBP's balance sheets indicates that the proportion of net loans either past due or in litigation improved from 2.8% in 1995 to 2.3% in 1996 but declined slightly to 2.7% in 1997. This latter figure is in line with the average for Philippine commercial banks at the same date (2.53%). If agrarian loans are omitted from the analysis, LBP has fractionally less net past dues than those for the Philippine Banking sector as a whole (2.49%) of net portfolio in 1997. This represents a decline in portfolio quality since 1995 and 1996 when net past due rates were 0.6% and 1.4% respectively. The apparent decline between 1996 and 1997 results partly from a definition[8] change introduced by BSP in November 1997 in

---

8 As at December 31, 1997, some P 1.9 billion of commercial loans (2.2% of the portfolio and about half of all commercial past dues) were less than 90 days overdue - many of these loans would not have been classified as past due under the pre November 1997 rules.

response to the financial crisis. Since 1995, the quality of the net agrarian loan portfolio has improved, as collections have got better and LBP has provisioned adequately in line with the Institutional Strengthening Action Plan (ISAP) agreement. This is reflected in the table below which shows net non performing loans declining as a percentage of net loans from 17.2% in 1995 to 5.3% in 1997.

Summary of LBP Gross Loans and Net Non Performing (NP) Loans (P Million)

	1995	1996	1997
Gross Agrarian Loans	9,201	10,673	11,288
Net NP Agrarian Loans as % Net	17.2	9.6	5.3
Gross Commercial Loans	51,025	72,984	87,212
Net NP Commercial Loans as % Net	0.6	1.4	2.5
Gross Total Loans	**60,226**	**83,657**	**98,500**
Total Net NP Loans as % Total Net	**2.8**	**2.3**	**2.7**

Profitability, Liquidity and Solvency.

8. Profitability. LBP has made profits in each of the past ten years and nominal profits have averaged about P1.7 billion p.a. (US$ 60 million) between 1994 -1997. Real returns to equity have averaged about 7% for the same four year period. In 1997, LBP's net profit before tax of P1.7 billion was just under 1.1% of total year end assets, below the commercial bank average for 1997 of 1.64%. This is because part of LBP's profit, which comes entirely from its commercial banking operations, is used to subsidize its agrarian lending[9].

9. Over the five years 1993-1997, since Agrarian Reform Fund (ARF) support was withdrawn, and LBP has borne the full cost of agrarian lending, the operating costs of Agrarian Reform Loans (ARLs) have averaged about 12% of the outstanding net portfolio and necessary provisions a further 8%. This compares with net collections of interest which have averaged under 9%. The net 'losses' as a result of agrarian lending, calculated using SDI methodology (see below), which take account of the 'economic price' of funds used have averaged P1.9 billion (about US$70 million) per year.

10. One means of evaluating LBP's overall operational performance and its self sustainability is to review its Subsidy Dependence Index (SDI)[10]. LBP's SDI worsened up between 1990 and 1992 (from 5% to 32%) as the volume of agrarian loans was increased, but has improved up until 1996 as the size of the banking operations expanded relative to loans to small farmers. In 1995 and 1996, the SDI was numerically negative, indicating that LBP would have been sustainable without the implicit subsidies of

9 As defined in Footnote 2, page 8 of the PAD.

10 The definition of the SDI is the percentage by which the average annual lending interest rate would need to be raised, over the interest rate actually collected, in order to fully cover the cost of both explicit and implicit subsidies. For these estimates, it is assumed that LBP was always responsible for loans to small farmers but that its operations in land purchase and Agrarian Reform Mortgages (ARMs) prior to 1994 were as an agent of Government/ARF who provided the necessary funding and fully covered LBP's related operating costs. LBP's technical support for cooperative development is considered an integral part of LBP's small farmer lending operations, and therefore, its own responsibility.

not paying dividends at Tbill rates and receiving below market government deposits. In 1997, the SDI changed sign, to indicate subsidy dependency again. This was largely because of the historically high level of provisions charged on commercial lending as a result of the financial crisis. The SDI is now 0.5%, indicating that in 1997 LBP needed an effective subsidy of roughly 0.5% of its gross interest earnings in order to be sustainable.

Summary of LBP's Profit and SDI 1990 - 1997

	1990	1991	1992	1993	1994	1995	1996	1997
Net Profit per accounts Excluding Capital Gains	855	967	859	900	1,220	1,314	1,601	1,700
ADJUSTED NET PROFIT (after taking account of underprovisioning and use of interest free capital)	-96	-724	-1,173	-246	-1,182	468	644	-71
Net interest income	2,073	2,982	3,640	6,110	7,676	8,190	11,645	15,041
SDI - proportion by which overall interest rate would need to increase to cover costs & eliminate subsidies	4.6%	24.3%	32.2%	4.0%	15.4%	-5.7%	-5.5%	0.5%

11. Liquidity. LBP's liquid assets as a percent of short term deposits has declined from a very high level, of over 100% in the early 1990s to 53% in 1996 and 55% in 1997. Both figures are well above the 45% covenanted under the Second Rural Finance Project. Compared with the Philippine commercial bank sector as a whole, LBP has above average liquidity.

12. Solvency. LBP's equity as a share of total assets has dropped slightly from 10.1% in December 1995 to 8.9% in 1997. Because a significant proportion of LBP's assets are held as cash or government securities, which are not considered to be 'Risk Assets' it remains in a reasonably strong position with respect to capital adequacy. LBP's Risk Assets to Equity Ratio was 7.6:1 at the end of 1997, which is substantially better than the 10:1 required by BSP, although worse than the Philippine commercial bank average, reported as 6.3:1. LBP has significant property assets which have not been revalued in recent years and in addition holds investments in tradable securities for which the market value is substantially above the balance sheet figures. This provides some comfort against the possibility that LBP's loan portfolio quality may deteriorate. LBP is adequately solvent at the present time, and assuming that the effects of the financial crisis are not catastrophic, it is expected to remain so (see Projections below). However in the interest of prudence, it will be important to ensure that the dividend policy imposed upon it by Government (it has paid dividends of P1.4 billion or about US$50 million in the past four years) would not weaken its financial position. During negotiations agreement was reached that dividends would only be paid out of real after tax profits, and after equity build up to support increased agrarian and CLF lending is provided for.

13. Projections. Appendices A, B, and C summarize LBP's performance for the recent past and make projections for the future. These were made by the mission, based on discussions with the corporate planning staff of LBP, but may need some amendments once LBP finalizes its IDP. Details of the assumptions and results and the EXCEL model used are on the project file. In summary, the projections stem from the 1997 balance sheet and are based on a growth target of 10% p.a. in real terms for agrarian lending, but only a 2% growth in the real commercial loan portfolio. For agrarian lending, necessary

provisioning and interest collection are projected to progress roughly in line with the key indicators, so that by 2002, interest on agrarian loans is 12% and necessary annual provisions are down to 5% of the opening net portfolio. Inflation is projected to fall from 9% in 1998 to 5% in 2002 and interest rates are related to Tbill rates, which in turn are projected at 4.5% above inflation (the average for the past 5 years was 4.7%). In response to the financial crisis, annual provisions on commercial loans are projected to be about 3% of the outstanding net opening balance in 1998, before falling to 1.5% in 1999 and 2000 and a normal 0.75% thereafter. Gross receipts tax is projected to average 4.5% on interest income, in line with the recent LBP average. Tax on profits has been projected on the assumption that GFIs do not get special treatment under the new Tax system, and that gross income from Tbills is treated[11], in the same way as other income.

14. Profit is expected to fall sharply in 1998, but to just remain positive in nominal terms (about P200 million before tax, P135 million after tax), although showing a negative real return on equity (-6%). The nominal profit, at that level would be insufficient to meet the year's preference share dividend, without drawing from reserves. LBP should recover significantly in 1999, (to about a nominal profit of P1.5 billion before tax, P1.0 billion after tax) which represents a 2% real return on total equity. With preference dividends to meet, and agrarian growth to provide for, this profit level would not justify payment of dividends on ordinary shares. By 2001, when provisioning levels have been normalized, LBP is projected to be back on a growth track with profits of P3.3 billion, before tax, (P2.2 billion after tax). At this stage, the ordinary share dividend, at 50% of the surplus after providing for equity maintenance and supporting agrarian growth would be P0.6 billion.

15. At the projected level of performance, LBP would continue to be able to meet its liquidity and equity covenants. In practice, it may chose to cash in some of its open profits on securities, and so be able to make provisions out of these, rather than solely at the expense of the bottom line, as has been conservatively projected here.

16. Outstanding Issues. Since SRFP LBP has solved the issues which it had in relation to Land Reform Bonds and its relationship with ARF. The main issues which it will face over the years to come are (i) increasing its equity; (ii) ensuring that the quality and profitability of the commercial loan portfolio improves; (iii) reducing the unit cost of agrarian lending and increasing outreach to small farmers and rural entrepreneurs; and (iv) resource mobilization, particularly medium and long term. These issues are addressed under the project through LBP's .IDP.

- Equity Build Up. So as to ensure LBP's ability to expand its lending and outreach to countryside farmers and entrepreneurs. it will need to make adequate arrangements for a build up of capital. This will require both new capital to be issued and a more conservative approach to the retention of real profits and consequently a dividend policy which reflects this.

- Commercial portfolio quality and profitability. LBP needs to focus explicitly on reducing the level of gross past dues in its commercial lending portfolio, and, if necessary increasing provisioning so as to reduce the net past dues percentage. To provide a framework for maintaining the quality of the net loan portfolio, provisions should cover 100% of past dues more than one year old, 50% of

---

11 Prior to 1998 'final tax' of 20% was paid on Tbill income. The whole of that income was then excluded from the taxable profit of the Bank. With tax rates at 35% in the past, there was a tax arbitrage gain of 15% at the margin. In LBP's case, because it had so much Tbill interest income, removal of that from the P&L account left it making a 'loss' and so LBP has not paid tax on profits. Since January 1, 1998 the new legislation provides for there to be no tax arbitrage gain on Tbills.

other past dues plus 25% of performing restructured loans. As a control, the net past dues should not exceed an 25% of equity. Improved profitability of commercial lending should result from a positive effort to reduce portfolio risk concentration and increase the proportion of commercial lending to medium sized clients, and away from the very large low margin loans.

- Agrarian Lending. LBP's outreach to agrarian beneficiaries, other small farmers and entrepreneurs is modest. To fulfill its mandate this needs to be increased, but only to the extent that it is affordable. To do this, LBP needs to focus on reducing its unit losses from its 'agrarian' lending. This will require improved operating efficiency including manpower reduction, expansion of the use of CFIs as conduits, better loan collection rates and the adoption of higher interest rates as possible.

- Resource Mobilization. Over the past three years, LBP has successfully attracted private deposits, but these are mostly short term. For term resources, which are required to prudently match its term lending, LBP has relied on the issuance of preference shares and foreign exchange borrowings, both from private and ODA sources. An important aim in the medium term should be to develop new instruments, such as medium term peso bonds, or longer dated savings products in order to replace the foreign denominated debt which will need to be repaid over time.

Annex 2c Appendix A

LBP Profit & Loss Account Projections (Millions Pesos)

	1996 (actual)	1997 (actual)	1998 (projected)	1999 (projected)	2000 (projected)	2001 (projected)	2002 (projected)
EARNINGS							
Interest on Loans &, Advances	7,924	10,717	15,154	15,585	15,540	16,071	16,743
Interest on Deposits with Banks	1,108	1,201	1,369	1,846	1,633	1,560	1,529
Earnings on Funds and Securities	2,876	3,561	5,448	5,611	5,344	5,342	5,423
Other Income	1,282	886	983	1,081	1,173	1,264	1,356
TOTAL Operating Income	13,190	16,365	22,955	24,123	23,691	24,237	25,051
EXPENSES							
Cost of Funds	5,776	6,768	14,020	14,676	13,429	12,989	12,758
Compensation & Benefits	2,033	2,186	2,405	2,620	2,816	3,006	3,194
Other Administrative Expenses	1,691	2,075	2,283	2,487	2,673	2,853	3,031
Gross Receipts Tax etc.	557	647	963	1,012	990	1,010	1,043
Provision for Probable Losses	1,532	2,989	3,174	2,037	2,174	1,493	1,683
TOTAL EXPENSES	11,589	14,665	22,844	22,831	22,081	21,352	21,709
NET INCOME PRE TAX	1,601	1,700	111	1,292	1,610	2,885	3,343
Provision for Tax	0	0	38	439	547	981	1,136
PROFIT AFTER TAX	1,601	1,700	73	853	1,063	1,904	2,206
Inflation Adjustment	481	718	971	573	383	394	420
Real Profit after Tax and Inflation adjustment	1,120	982	(898)	279	680	1,511	1,786
REAL RETURN ON EQUITY Before Tax	10.4%	7.5%	-6.3%	2.0%	4.6%	9.7%	10.6%

Annex 2c Appendix B

Actual and Projected Balance Sheets (Million Pesos)

	1996 (actual)	1997 (actual)	1998 (projected)	1999 (projected)	2000 (projected)	2001 (projected)	2002 (projected)
ASSETS							
Cash & Deposits With Banks	18,367	19,953	22,184	24,211	26,177	28,169	30,169
Loans and Advances incl Interbank	80,076	93,660	104,012	115,372	126,849	138,297	149,270
Investments	29,398	36,122	49,602	53,751	57,764	61,857	66,007
Fixed Assets	1,618	3,425	5,925	8,425	8,425	8,425	8,425
Other Assets	4,497	6,989	7,618	8,151	8,640	9,116	9,571
TOTAL ASSETS	133,956	160,149	189,341	209,910	227,856	245,864	263,442
LIABILITIES & SHAREHOLDERS FUNDS							
Deposits	91,125	113,187	129,718	144,002	158,710	174,481	191,338
Borrrowings	15,817	18,363	29,826	34,331	35,779	35,796	34,128
Other Liabilities	14,051	14,385	15,679	16,777	17,784	18,762	19,700
Shareholders Equity(after providing for tax & divs)	12,963	14,214	14,117	14,800	15,584	16,825	18,276
TOTAL LIABILITIES & NET WORTH	133,956	160,149	189,341	209,910	227,856	245,864	263,442

Annex 2c Appendix C

LBP - Summary of Key Financial Indicators (Million Pesos)

	1995 (actual)	1996 (actual)	1997 (actual)	1998 (projected)	1999 (projected)	2000 (projected)	2001 (projected)	2002 (projected)
Within Year Inflation	11.1%	5.1%	6.3%	9.0%	7.0%	6.0%	5.5%	5.0%
Operating Income	9,727	13,190	16,365	22,955	24,123	23,691	24,237	25,051
Cost of Funds	3,849	5,776	6,768	14,020	14,676	13,429	12,989	12,758
Income net of Interest Cost	5,878	7,414	9,597	8,935	9,447	10,263	11,248	12,293
Total Admin Costs (excl GRT & Provisions)	2,677	3,724	4,261	4,687	5,107	5,489	5,859	6,225
Net Income Before Tax	1,314	1,601	1,700	111	1,292	1,610	2,885	3,343
Net Income After Tax	1,314	1,601	1,700	73	853	1,063	1,904	2,206
Equity (year end after prov for dividend & tax)	10,818	12,963	14,214	14,117	14,800	15,584	16,825	18,276
Total Assets (P billion)	106.9	134.0	160.1	189.3	209.9	227.9	245.9	263.4
Capital to Total Assets	10.1%	9.7%	8.9%	7.5%	7.1%	6.8%	6.8%	6.9%
Risk Assets to Equity	6.2	6.9	7.6	8.6	9.2	9.6	9.6	9.5
Liquid Assets/Deposits	50%	46%	46%	52%	51%	50%	49%	47%
Average Yield on Loans (before GRT)	10.1%	11.9%	12.3%	15.3%	14.2%	12.8%	12.1%	11.6%
Average Cost of Borrowings	5.0%	5.8%	5.6%	9.6%	8.7%	7.2%	6.4%	5.9%
Net Income after Tax to Average Assets	1.29%	1.33%	1.16%	0.04%	0.43%	0.49%	0.80%	0.87%
Net Income after Tax to Opening Equity (nominal)	13.3%	14.8%	13.0%	0.5%	6.0%	7.2%	12.2%	13.1%
Net Income after Tax to Opening Equity (real)	3.7%	10.4%	7.6%	-6.3%	2.0%	4.6%	9.7%	10.6%
Admin Expenses/Income Net of Interest Cost	46%	50%	44%	52%	54%	53%	52%	51%

Annex 2d

Philippines
Third Rural Finance Project

PCFC Operations, Financial Performance and Projections

I. Institutional Background

A. *Legal Structure.* The People's Credit and Finance Corporation (PCFC) is a government owned and controlled corporation which is registered as a finance company with the Securities and Exchange Commission. PCFC was created on February 9, 1995 to provide financial services to the poor by virtue of Executive Order No. 148 and Administrative Order No. 261. This mandate was strengthened under Republic Act No. 8425, which identifies PCFC as the vehicle for the delivery of microfinance services for the exclusive use of the poor.

B. *Ownership.* PCFC is initially capitalized by funds coming from the National Livelihood Support Fund (NLSF). NLSF is a fund that has its own juridical personality and is supervised and controlled by the Land Bank of the Philippines. Under EO No. 148, PCFC will eventually be privatized. At present, the PCFC is preparing its privatization plan.[12]

C. *Board of Directors.* The Board of Directors acts as the governing body of the PCFC. It is composed of nine representatives from both the government and the non-government sector. The government is represented by six representatives from the Land Bank of the Philippines, the Presidential Commission to Fight Poverty and the Department of Finance. The non-government sector has three representatives who were appointed by the President of the LBP. The President of Land Bank is the Chairman of the Board while the President of PCFC acts as Vice-Chairman.

D. *Leadership and Organizational Structure.* The President who also sits as vice-chairman of the Board manages the PCFC. Two vice presidents, one for operations and another for finance and administrative support him. The organizational chart is shown as attachment 1. At present, PCFC has 26 employees,10 of them are account officers while the remaining are support staff and management.

II. Operations

A. *Geographical Coverage.* With its meager resources, PCFC is tasked to provide wholesale funds to MFIs in all the provinces of the country. At present, it provides loans to MFIs in 51 out of the 79 provinces in the country. Of the 51, PCFC has served 10 of the 20 identified poor provinces. It is not able to serve the remaining 10 in view of the lack of qualified MFIs in the area based on the PCFC's accreditation criteria.

B. *Source of Funds.* Aside from the P100 million capital funds from the NLSF, PCFC has funds coming from the ADB-IFAD Rural Microenterprise Finance Project. This amounts to $33.7 million of which $7.4 million is for institutional capability building of MFIs. It will be provided to the MFIs as a loan to finance their start-up costs in establishing new branches, training of branch managers, field and office staff and the costs associated with institutional preparation and formation of Self-Help Groups.

[12] The privatization plan is currently being prepared in compliance with the commitments under the ADB-IFAD Rural Microenterprise Loan.

C. *Financial Services*. PCFC provides a revolving credit facility and term loan to its MFI clients. The former is financed from the NLSF money while the latter is funded from the ADB-IFAD loan. The revolving credit facility is called the HIRAM (Helping Individuals Reach their Aspirations through Microcredit) Lending program. Under this program, funds are made available for eligible conduits using any type of credit methodology. It is priced at market rates and has at the least six-month maturity period. As of March 31,1998, total accumulated releases under HIRAM was ₱ 754.8 million reaching some 70,175 end-borrowers. Total loans outstanding, as of the same date is ₱ 212.6 million. The term loan on the other hand, can currently only be availed by Grameen Replicators. It is priced at 14 percent per annum and has a seven-year maturity with a three-year grace period on principal amortization. Total approved credit line as of March 31, 1998 is ₱ 136 million for 9 conduits. Of this line, only ₱ 8.5 million has been released benefiting some 8,500 end borrowers. Total institutional loans released was ₱ 7.6 million.

D. *Clientele*. Micro-finance institutions are the main clientele of PCFC. These include the rural banks, cooperative rural banks, credit NGOs, credit cooperatives and some private development banks providing loans to microenterprises. As of March 1998, it has 87 MFI clients.

III. Vision and Mission

The following are the vision and mission of the PCFC:

A. *Vision*

- PCFC's central role in poverty alleviation shall give emphasis on giving the entrepreneurial poor nationwide the opportunity to start, maintain or expand their microenterprises.

- PCFC shall be a profitable and financially viable organization, offering strength and stability to its clients.

- PCFC shall drive the growth of the Philippine Microfinance Industry, offering new products, technologies, concepts, and support services. It shall be the model microfinance apex company, encouraging parallel efforts from the private sector.

B. *Mission*

- PCFC will provide financial services to the poor through viable micro-finance institutions.

- PCFC shall offer loans and technical assistance to microfinance institutions and shall explore other financial products and services to complement what it already offers.

PCFC's competitive edge shall remain distinctive. It will be the major wholesaler of micro-credit funds. Its monitoring activities shall be enhanced by close coordination with banking and non-banking microfinance institutions.

IV. Financial Performance

A. *Financial Condition*

Table 1 shows the balance sheet and income statement of PCFC. It uses the cash method. Barely in its second year of operations, it has registered very minimal nominal profits. When inflation is accounted for, real profits become negative.

The balance sheet distribution shows that most of PCFCs assets are in loans receivable. Its liabilities on the other hand are mostly in the form of bills payable. As a finance company, it cannot mobilize savings from the public. It can only source funds from creditors. Hence, aside from the NLSF money, the ADB-IFAD loan is used to augment its resources. Its main source of income is the interest income on loans and some minimal income from its investments in treasury bills.

B. *Profitability*

PCFC registered very minimal profits for the period ending March 1997 and 1998. An improvement in nominal net income was, however posted from 1997 to 1998. In real terms, however, negative profits were posted. Real return on equity for both periods were also negative (- 3.41 percent and –6.6 percent for March 1997 and March 1998 respectively). The negative profitability is attributed to the fact that PCFC lending volume is still too small.

V. Cost Efficiency

In terms of cost efficiency, PCFC spent 8 percent and almost 10 percent of its average net portfolio for the period ending March 1997 and March 1998. This may still be brought down as PCFC deepens its financial operation through the extension of bigger sized loans at shorter maturities to its MFI clients. It seems that the 7-year term maturity of the ADB-IFAD loan is too stringent and costly for PCFC.

A. *Loan Portfolio Quality*

PCFC maintains a high quality of loan portfolio to date. It has a very high collection rate and maintains a past due ratio of only 0.5% of its loan portfolio. It also allots 2 percent provisioning for loan losses.

B. *Liquidity*

PCFC maintains a very high liquidity position. Current ratio is posted at 3.13:1. This provides room for PCFC to further deepen its financial services and increase its operational income.

C. *Capital Adequacy*

Capital cushion to absorb loan losses is high. Capital to risk asset ratio declined from 66 percent in 1997 to 46 percent in 1998. This is due to the increase in PCFC's loan portfolio during the period. The current ratio is higher than the BSP's minimum standard for banks which is only 10 percent. Current operations show a risk asset ratio of only 2.2:1 which is also way below the BSP standards. PCFC, however is inclined to maintain a low risk asset ratio considering that microfinance loans are deemed more risky than regular loans.

PCFC's current capital position is deemed inadequate for the institution to operate efficiently and profitably. At present, it is only operating using the P100 million NLSF money and the ADB-IFAD money that has very stringent requirements. 28.7 percent of its total assets is provided for by its stockholders.

VI. Financial Projections

Tables 1-3 show the financial projections for PCFC for the next five years. These projections use the following assumption: start of the use of the proposed WB money by the fourth quarter of 1998, drawdown of $500 million from the ADB-IFAD money during the five year period, an interest spread of 7 per cent for the period, a 9 percent cost of money, an inflation rate of 7 percent. Preferred shares (worth P200 million) will also be declared during the period with 10 percent dividends.

Table 1. PCFC Balance Sheet Projections (P Million)

		MARCH 31 FISCAL YEAR					
		1998	1999	2000	2001	2002	2003
ASSETS:							
a	Deposits In Bank	58.00	45.50	73.80	101.40	128.20	154.30
	Receivables/Loans, net						
b	Current	215.40	449.00	730.00	1,001.50	1,264.00	1,518.50
c	Net Past Due	1.60	6.00	8.00	12.50	18.00	24.50
		217.00	455.00	738.00	1,014.00	1,282.00	1,543.00
d	Investments in Bonds & Other Debt Instruments	70.00	207.93	220.14	285.82	354.63	429.75
e	Furnitures, Fixtures & Equipment, net	2.00	3.50	5.50	7.70	10.78	15.09
f	Other Assets	2.00	3.00	4.00	5.00	6.00	7.00
Total Assets		349.00	714.93	1,041.44	1,413.92	1,781.61	2,149.15
Liabilities and Capital Funds:							
g	Bills Payable	-	-	-	-	-	-
h	Long Term	149.00	350.35	568.26	780.78	987.14	1,188.11
i	Short Term	93.00	150.15	243.54	334.62	423.06	509.19
	Total	242.00	500.50	811.80	1,115.40	1,410.20	1,697.30
j	Accrued Expenses Payable	5.00	10.01	16.24	22.31	28.20	33.95
k	Other Liabilities	1.00	2.00	3.00	4.00	6.00	7.00
l	Capital Stocks						
m	Common	100.00	150.00	150.00	150.00	150.00	200.00
n	Preferred	-	50.00	50.00	100.00	150.00	150.00
	Total	100.00	200.00	200.00	250.00	300.00	350.00
o	Retained Earnings, Beginning	-	1.00	2.42	10.40	22.21	37.21
p	Add: Net Income	1.00	6.42	12.98	21.81	30.00	38.69
q	Less: Preferred Dividends		5.00	5.00	10.00	15.00	15.00
r	Retained Earnings, Ending	1.00	2.42	10.40	22.21	37.21	60.90
Total Liabilities and Capital Funds		349.00	714.93	1,041.44	1,413.92	1,781.61	2,149.15

a This represents 10% of net receivables financed
b projected/estimated amount
c Related to capital - grows by 1% per annum, reaching 6% of share capital by 2003.
d balancing figure
e projected/estimated amount
f The amount is estimated to grow by 1M per annum.
i This represents 110% of net receivables financed
j This represents 2% of bills payable.
k projected/estimated amount
l projected/estimated amount

Table 2. PCFC Profit and Loss Projections (P Million)

		MARCH 31 FISCAL YEAR					
		1998	1999	2000	2001	2002	2003
a	Financing Income	20.00	49.83	88.43	129.86	169.91	208.69
b	Interest Income						
c	Investments	6.00	18.07	27.82	32.89	41.63	50.99
d	Deposits	2.00	5.18	5.97	8.76	11.48	14.13
	Gross Income	28.00	73.07	122.21	171.51	223.02	273.80
e	Interest Expense	10.00	29.70	52.49	77.09	101.02	124.30
f	Provision for Probable Losses	3.00	4.81	10.56	11.70	13.12	17.45
g	Taxes	-	7.14	11.18	14.82	19.12	23.46
h	Manpower Costs	7.00	12.00	18.00	23.00	29.00	34.00
i	Operating Costs	7.00	12.00	18.00	23.00	29.00	34.00
	Total Expenses	27.00	66.65	109.23	149.61	192.26	233.21
	Net Income before Income Tax	1.00	6.42	12.98	21.90	30.76	40.59
	Provision for Income Tax	-	-	-	0.09	0.76	1.90
	Net Income	1.00	6.42	12.98	21.81	30.00	38.69
		-	0.00	0.00	(0.00)	0.00	0.00

a Average net current receivables times relending rate
b Average balance times estimated/projected rate
e Average bills payable times cost of fund
f estimated/projected amount
g This represents final tax for interest income and percentage tax for financing income
h estimated/projected amount
i estimated/projected amount

Table 3. PCFC's Financial Indicators and Ratios

	1998	1999	2000	2001	2002	2003
Inflation Protection - Total Equity (P million)	7.50	6.93	13.92	14.34	18.52	22.85
Real Profit after tax - Total (P million)	(6.50)	(0.50)	(0.94)	7.47	11.48	15.84
Risk Asset to Equity	2.19	2.29	3.71	4.08	4.29	4.43
Liquid Asset to Short Term Liability	1.29	1.56	1.12	1.07	1.06	1.06
Net Past Due to Equity	0.02	0.03	0.04	0.05	0.05	0.06

ASSUMPTIONS:

Inflation	7.00%
Interest on Investment	13.00%
Cost of Funds	8.00%
Interest	15.00%
Interest on Preferred Shares	10.00%
Interest on H-Yield Deposits	10.00%

Annex 2e

Philippines
Third Rural Finance Project

Environmental Technical Services

1. The objectives of the environmental technical services are to: (i) ensure that projects financed under the Third Rural Finance Project (TRFP) are environmentally sound; (ii) assure compliance of projects with Government's environmental laws and regulations; and (iii) accelerate the processing of official environmental clearances and permits. The environmental protection process under the proposed project would be governed by modified procedures of the existing CLF II operation, that are based on prevailing GOP regulations.

Environmental Unit (EU)

2. Environmental technical services would be provided by the EU that was established under the Second Rural Finance project (SRFP). The scope of its activities are detailed in Appendix A. The EU provides services to the PLG (for the CLF II and RCF credit programs), Account Management Group (AMG), and Domestic Banking groups of LBP, as well as any present and future Bank's environmental projects for which the LBP acts as the main financial intermediary. The EU is staffed by 4 professionals plus administrative assistants, and supported by qualified consultants which would be providing environmental services to sub-projects and the EU, when required. To assure quality and conformity of consulting services, a pool of pre-selected consulting firms was established, out of which consulting services would be provided on a competitive basis. Recommended criteria for consultants selection are detailed in Appendix B. So far, 20 consulting firms have been accredited by LBP. Services that may be provided by the consultants are specified in Appendix A.

3. Sub-borrowers under the project may choose to seek the assistance of LBP's accredited consultants, or any other consultant accredited by DENR, in the preparation of Initial Environmental Examination (IEE) or the Environmental Impact Statement (EIS). The cost associated with this assistance would be borne by the sub-borrowers. LBP would bear the cost of all other services detailed in Appendix A.

4. Technical Support to the Environmental Management Bureau (EMB) would be provided by the EU when required. The main points of the technical support would mainly include environmental scoping, preparation of Conditionalities attached to environmental clearances, construction permits or operating permits. Conditionalities imposed by EMB or DENR may include emission limits, mitigation measures, environmental management plans, and monitoring plans, consistent with GOP regulations.

5. The officials of the EMB have confirmed already, during the SRFP, their acceptance and welcomed the initiative taken by LBP. On June 1996, DENR signed an MOA with the LBP that formalizes the contribution of the EU to environmental quality in projects financed by it. The MOA confirms that LBP shall, for all project financed by it: (i) ensure that all projects which require environmental clearances, are environmentally sound; (ii)provide technical training to clients and participating financial institutions (PFIs) on the concepts of integrating environmental considerations into project planning; (iii)conduct pre-screening, checking the consistency of documentation required for Initial Environmental Examination (IEE) and EIS; (iv) coordinate with DENR on the expeditious processing of official environmental clearances and permits in coordination with LGUs, EMB and other DENR agencies; (v) support DENR and EMB in environmental

scooping and conduct public hearings and provide assistance in the clearance process; and (vi) designate a permanent technical representative to the EIA Review Committee for LBP financed projects. The DENR, on its part would: (i) provide training to the EU; (ii)expedite processing of clearances, or submission of EIA requirements; and (iii) provide LBP with all relevant guidelines, procedures and regulations required under the EIA System. The same agreement would prevail under the Third Rural Finance Project.

<u>Training</u>

6. The existing ongoing training program under the SRFP, for loan and executive officers would be continued by LBP as part of the institutional strengthening program. This will be a continuous program aimed at basic initial training followed by annual or semi annual updating and recap. Trainees would be assigned from PLG, AMG loan centers, the branch supervision unit, other related head office units and PFIs. Altogether, more than 150 participants are expected annually, out of which about 100 would be nominated by the PFIs.

7. A thematic outline of the training program was prepared by LBP and is attached as Appendix D. The duration of the training program was estimated as follows: (i) one week for the basic training; and (ii) two days every year for updating and recap. Subdivision of each of the above components may be considered to avoid disruption of routine work. The estimated cost of this environmental training program, including the related technical assistance is US $200,000 throughout project duration.

Annex 2e

Philippines
Third Rural Finance Project

Appendix A: List of Services to be Provided by the EU and the Consultants

Objective

The Environmental Unit (EU) was setup to render environmental technical services to LBP, PFIs and sub-borrowers. To carry out these opjectives the EU, the PFIs and sub-borrowers would be assisted by private consultants which the scope of their services as well as those of the EU are specified below.

Scope of Services

1. Independent environmental scoping, environmental auditing and monitoring.

2. Review Initial Environmental Examination (IEE) and Environmental Impact Statement (EIS) prepared directly by sub-borrowers.

3. Prepare IEE and EIS, at full cost recovery, on behalf of the project sub-borrowers.

4. Follow-up and accelerate processing of applications for clearances and permits within the administrative system of DENR and EMB.

5. Support EMB or DENR branch offices in preparation of environmental scoping and technical Conditionalities requires at various junctions of the permitting process (making sure, however, that their clearance capacity remains intact). These may include emissions and effluent levels, mitigation measures, environmental management plans, monitoring plans.

6. Contract services of accredited consultants.

7. Supervise and update the environmental training program of LBP.

8. Participation in public consultation.

9. Participate as public representative in EIS review panels.

10. Review with the related sub-projects the ECC stipulations, upon its receipt, make sure they are understood and encourage him to contract the services of accredited environmental consultants if required.

Philippines
Third Rural Finance Project

Appendix B: Recommended Criteria for Consulting Firms Selection

1. Firms operating for at least 5 years in the Philippines. Past experience may be considered in special cases, when the 5 year condition can not be fulfilled.

2. Experience in environmental aspects of industry, agro-industry, agriculture and infrastructure.

3. Familiarity with environmental regulations and permitting process in the Philippines.

4. Demonstrated working experience with EMB and DENR regional offices.

5. Experience in preparation and processing for clearance of IEE and EIS.

6. Preferred, although not mandatory, affiliation with experienced environmental overseas consulting firms.

7. Experience in organizing environmental workshops and training seminars.

8. DENR accreditation

Annex 2e

Philippines
Third Rural Finance Project

Appendix C: Outline for Land Bank Environmental Training Program

The aims of the proposed training program would be to:

1. Familiarize both LBP and the PFIs with the administrative structure of DENR/EMB and other government offices responsible for environmental affairs (e.g. LGUs, HLURB, LLDA), NGOs, environmental affiliations of various economic sectors in the country and international organizations and related environmental activities.

2. Provide regular communication and dialogue with DENR/EMB regarding the processing of environmental clearances and permits in the Philippines.

3. Familiarize both LBP and PFIs on the basic steps of environmental scoping and impact assessment systems.

4. Stress the importance of basic natural resources and its impact on the quality of life and the economic prosperity of the Philippines.

5. Help ensure compliance with environmental laws and regulations, basic emissions and effluent standards; as well as air and water quality standards.

6. Environmental management and monitoring programs.

7. Environmental auditing.

8. ISO 14000 use in enforcing environmental compliance.

9. Environmental risks and liability in the banking system.

Annex 3

Philippines
Third Rural Finance Project

Estimated Project Costs and Financing Plan

Project Component	**Local**	**Foreign**	**Total**
	-----US $ million-----		
Credit Components [13]			
Line of Credit for CLFIII	124.0	83.1	207.1
Line of Credit for MLF	4.7	2.0	6.7
Sub-Total	128.7	85.1	213.8
Institutional Development			
Institutional Strengthening LBP (Training Element)	1.8	0.2	2.0
Institutional Strengthening PCFC (Training Element)	0.2	0.1	0.3
Sub-Total	2.0	0.3	2.3
Total Project Cost	**130.7**	**85.4**	**216.1**
Financing Plan			
IBRD	64.9	85.1	150.0
LBP/PFIs	22.5	0.2	22.7
PCFC	0.2	0.1	0.3
MFIs	0.7	-	0.7
Sub-borrowers	42.4	-	42.4
Total Financing	**130.7**	**85.4**	**216.1**

[13] Tentative estimates, including buildings, machinery and equipment and working capital items as well as taxes, duties and contingencies. Final estimates would depend on individual sub-project cost estimates and financing plans which would be prepared at the time of sub-project appraisal.

Philippines
Third Rural Finance Project

Financial and Fiscal Impact

Financial Impact on Participants

1. Sub-borrowers: The project would provide credit assistance to sub-borrowers in supporting their investment which in turn would contribute to improvement of their business activities and/or welfare. The main financial impact of the project results from the support of about $210 million of investment under the first round use of credit by small and medium sized rural based private businesses. Part of the loan is likely to be used for new investment and part in support of existing investments through the provision of longer-term finance. Sub-projects will all be assessed as financially viable prior to investment and the ongoing interest rate to them will be market based (likely to be of the order of 7-10% in real terms). Consequently, only projects which show sound ex ante financial rates of return will be supported. Under the similar CLF I and CLF II programs, ex ante financial rates of return have typically been in the 15% to 30% range, and similar results for SME investment would be expected under this project. Micro finance sub-borrowers would receive credit which would otherwise have been unavailable. Investments under this component would normally be in fast turnover items.

2. PFIs: The project would have a positive impact on the profitability of PFIs because they are free to set their own spreads, and therefore, provided their managements' judgment is good, they would only participate in the project if they perceived it as profitable. As it would be a repeater project, for most PFIs they would have a reliable basis for this. Under CLF I and CLF II PFIs typically set spreads of 4%, after GRT, their interest margins averaged just over 3%. Taking account of incremental operating costs, they might be expected to show incremental margins of about 2% on incremental loan volume resulting from the project, provided they are careful in sub-project selection. Participating in the project would also help to improve the liability side of PFI's balance sheets, in that it would increase the average maturity of their resources.

3. LBP & PCFC. The project would contribute towards the profitability of both these institutions. In LBP's case, based on performance under CLF I and II, the incremental contribution to profitability is likely to be of the order of P 60 million per year (US$ 1.5 million). Projections for PCFC indicate that on-lending these funds will contribute about P4 million (US$100,000) annually to its profit at full development.

Fiscal Impact

4. The Bank loan for the project would be guaranteed by Government but made to Land Bank, a self financing Government owned entity. Therefore it would not require any Government counterpart funding.

5. The actual cash flow to Government resulting from the project will depend on future inflation and interest rates, and on the extent to which the project comprises new finance, rather than replacing the financing source for loans which (in aggregate) would have been made anyway. Inflows to Government include:

a. 1% p.a. guarantee fee, calculated on the outstanding balance of the loan.

b. A Foreign Exchange Risk Cover (FXRC) fee, which is calculated as the onlending rate to LBP, minus the Guarantee fee, minus the gross receipts tax, minus the rate paid to the Bank. Under the base case assumptions (see below) the FXRC fee would be 3.35%.

c. Gross receipts tax on the loan from LBP to the PFI. In the base case, with LBP making an average spread of 2%, this would amount to 0.65% p.a. of the outstanding loan balance.

d. Gross receipts tax on the larger loan from PFI to sub-borrower; (this loan also combines some of the PFIs own resources). Assuming a 10% contribution to sub-project cost by the PFI, and a 4% average gross spread over the cost of funds from LBP, this tax amounts to the equivalent of about a further 1% p.a. on that part of the outstanding Bank loan balance which supports incremental lending.

e. In addition to these revenues, which are automatically from the loan, Government would also benefit from incremental taxes (currently at 34%) on the incremental profits of LBP, PCFC, the PFIs and the sub-borrowers. These taxable profits are estimated to increase as follows: (i) LBP is assumed to earn an incremental profit of 1% (half of the spread) on the whole loan; (ii) PFIs are assumed to make incremental profits of 2% (also half of the spread), but only on incremental lending, i.e. lending for new investment; and (iii) sub-borrowers are assumed to make an incremental 25% nominal return (before finance charges) on their incremental investment, lagged one year, – resulting in incremental taxable profit, after deducting finance charges of about 11% on incremental investment.

6. Base case assumptions are set out below. These assume a 12% Tbill rate, 7% inflation and a nominal 6% cost of Bank finance. These figures are fairly close to the average of the past five years. If the whole loan were used for incremental investment, the net cash flow to Government is estimated to rise from about P50 million (US$1.1 million) in year one to about P720 million p.a. (US$14 million) by year five. A cumulative net inflow of some US$41 million (US$ 28 million excluding the activities of the FXRC). Assuming only a part of the loan is for investment, Government income resulting from second round GRT (D above) and income tax revenue from PFIs

(E (ii) above) and sub-borrowers (E(iii) above) would fall pro rata. This would result in a cumulative net inflow, other things being equal, as follows:

Summary of Government Revenues – Years 1-5 US$ Million

Proportion of Loan for new Investment	100%	75%	50%	25%	Zero
Cumulative Government Revenues by Year 5 (Total)	41	36	31	26	22
Cumulative Govt. revenues excluding FXRC	28	23	18	13	9

7. On the basis of historical real interest rate spreads between the Philippines and the Bank US$ variable rate, the FXRC fee will be adequate to compensate for currency depreciation in line with changes in purchasing power parity. This model implicitly assumes a real Tbill rate 1.76% above the real Bank onlending rate. This is in line with the average 1993-1997 of 1.75% (only in one year of the past seven was the spread less than this). In this case, sufficient fees and income from reinvesting them would have accrued to the FXRC fund to cover exchange losses, and if the loan were repaid at the end of year five, the FXRC fund would show a small after meeting currency losses of P15 million.

8. Overall, this project has a positive impact on Government finances, and there is virtually no risk that the overall fiscal effect will be negative. If it is eventually decided to allow the Apex insitutions a spread of 1.5%, rather than 2% as in the base case, the projected surplus on the FXRC fund would rise from about US$0.3 million by the end of year 5 to about US$3.2 million. Conversely, there would be a reduction over the five years in taxes collected, as LBP's incremental income would fall. Total non FXRC revenues over the five years would then be about US$27 million.

Assumptions

Bank Rate (US$ variable)	6.0%
91 day Tbill interest rate	12.0%
Rate from DOF to LBP (91 day Tbill rate - 1.0%)	11.0%
Average rate from LBP to PFI (2.0% spread)	13.0%
Average Rate PFI - sub-borrower (4% spread)	17.0%
GRT (percentage of interest income)	5.0%
PFI's contribution (percent project cost)	10.0%
Sub-borrower's contribution (percent of project cost)	20.0%
Incremental Profit Margin to LBP	1.0%
Incremental profit margin to PFI	2.0%
Av. Nominal FRR to sub-b. (1 year lag) – pre finance cgs	25%
Tax Rate	34%
Philippine annual inflation rate	7.0%
US annual inflation rate	3.0%
Guarantee Fee to DOF	1%

Derived

Av FXRC Fee	3.35%
GRT on loan LBP to PFI	0.65%
GRT on loan PFI to Sub-b (as a percent of LBP loan to PFI - figure Takes account of larger loan & higher Interest rate)	0.97%
Incremental av. % return to sub-b. after finance cgs	11.4%

	Base case Assumption	Average Av. 93-97
Real 91 day Tbill rate	4.67%	4.73%
Real US$ rate ex WB	2.91%	2.98%
Differential	1.76%	1.75%

Table 1. Estimated Cash Flow to Government (P Million unless otherwise stated)

	1999	2000	2001	2002	2003
FX Rate – year average[14]	45.06	46.81	48.63	50.52	52.48
Loan Disbursement					
Amount in US$ Million	30	50	50	19	1
Amount in Pesos (Million)	1,352	2,340	2,431	960	52
Cumulative – Outstanding Loan (PM)	1,230	3,692	6,124	7,083	7,136
Inflows to Government					
A. Guarantee Fee	7	25	49	66	71
B. FXRC Fee	23	84	164	221	238
C. GRT LBP-PFI	4	16	32	43	46
D. GRT PFI – Sub-borrower	7	24	48	64	69
E, Incremental Income Tax					
(i) LBP	2	9	17	22	24
(ii) PFIs	5	20	38	51	55
(iii) Sub-borrowers		27	101	196	264
Total Incremental Income Tax	8	55	156	270	343
Total Gross Cash Flow to Govt.	48	206	449	664	768
Paid Out for FX cover on interest		2	10	25	44
Net Cash Flow to Govt.	48	204	439	639	724
Net Cash Flow to Govt. (US$ M)	**1.1**	**4.4**	**9.0**	**12.7**	**13.8**
Cum Net C. Flow to Govt. (US$ M)	**1.1**	**5.4**	**14.4**	**27.1**	**40.9**
Cumulative Net Cash Flow to Govt. excluding FXRC (US$ Million)	**0.6**	**3.2**	**9.0**	**17.8**	**27.9**

ADEQUACY OF FXRC FEES (PM)

	1999	2000	2001	2002	2003
FXRC Fee	23	84	164	221	238
Paid Out for FX cover on interest		2	10	25	44
Net FXRC Cumulative – yr end	23	105	260	456	650
FXRC Pool including accumulated interest at year end[15]	24	114	292	535	805
Open Loss on Capital at yr end[16]	26	121	305	544	790
Net FXRC Position at yr end[17]	(2)	(7)	(13)	(9)	15

Note: These base calculations are made considering 100% of the loan being used for financing new investment. In the likely event that the proportion is lower, A, B, C and E (i) would remain the same, but income from D, E(ii) and E(iii) would fall pro rata.

---

[14] Assumes an exchange rate of US$1 = P44 at the start of the period and purchasing power parity is maintained.

[15] Fund value at year end assuming interest at Tbill rate accumulates on FXRC pool.

[16] FX loss assuming loan were repaid at year end - exchange rate at end of end year t is average of the rate for year t and that for year (t+1).

[17] Net profit assuming currency loss on fully repaying loan at year end were covered by currency pool fund.

Annex 5

Philippines
Third Rural Finance Project

Procurement and Disbursement Arrangements

Procurement

Procurement Methods (Table A):

1. Procurement procedures for goods, works, and serviced financed with loan funds would comply with those customary for industrial development finance operations. LBP and PFIs will satisfy themselves that the goods, works, and services to be purchased are for the investment subprojects and are reasonably priced, by ensuring that the subborrowers have canvassed the main sources of supply and purchased from the most advantageous source. Contracts above US$5 million equivalent will normally be procured by International Competitive Bidding(ICB) in accordance with Bank procurement guidelines ("Guidelines for Procurement under IBRD Loans and IDA Credits" of January 1995 revised in January and August 1996 and September 1997), including the use of Bank's standard bidding documetns. In evaluating ICB tenders, a margin of 15% of the c.i.f. or c.i.p bid price or actual custom duties, whichever is less, would be allowed for preference to domestic manufacturers. All ICB packages will be subject to Bank prior approval. Exception to ICB in contracts costing more than US$5million equivalent will be allowed in the following cases: (a) Direct contracting will be used in modernization or expansion projects if standardized equipment or proprietary parts are needed for compatibility with existing equipment; (b) Limited International Bidding (LIB) will be used for machinery that is available only from a limited number of suppliers worldwide; and (c) where the procedures are otherwise justified for technical reasons. These cases would be subject to Bank prior approval.

2. Other procurement would follow established commercial practices which are satisfactory to the Bank. Contracts below US$5 million equivalent would be procured following established private sector or commercial practices which are acceptable to the Bank. Acceptable practices will be defined in the Project Implementation Document.

Prior review thresholds (Table B)

Disbursement

Allocation of loan proceeds (Table C)

1. The proposed loan of US$150 million would be disbursed over a period of 5.5 years (1999 to mid 2005). The project would be completed on December 31, 2004 and the expected loan closing date would be June 30, 2005. The projected disbursement schedule is based on experience under the Philippine last three projects of this type. The Bank would disburse against 100% of expenditures for the subloans financed by LBP to PFIs up to the financing share made up by eligible expenditures and requested for the respective subproject. Retroactive financing of up to US$15 million is also proposed for eligible credit sub-loans made after July 1, 1998. These sub-loans were made under the pressure of the heavy demand for CLF resources resulted from the financial crisis, which lead LBP and PFIs, in anticipating of additional financing, to use short-term and/or unrelated resources to support eligible rural sub-projects.

Use of statements of expenditures (SOEs):

2. Disbursements would be made on the basis of statements of expenditures for subloan valued at less than US$5 million equivalent. LBP would retain documents supporting the statement of expenditures and would make these statements available for inspection and review by Bank supervision missions and for regular audit by auditors acceptable to the Bank. All other disbursements will be made against fully documented expenditures.

Special account:

To facilitate efficient disbursement, LBP may open a Special Account in dollars with an authorized allocation of $10 million (based on four months of estimated average disbursement) with an initial withdrawal of US$7 million and the balance to be withdrawn when the amounts disbursed and committed total US$30 million. Applications to replenishe the Special Account, supported by appropriate documentations, would be submitted regularly (preferably monthly, but not less than quarterly) or when the amounts withdrawn equal 50% of the initial deposit.

Financial Management Requirements

The Land Bank of the Philippines(LBP) has been the borrower for two projects. The First Rural Finance (Loan 3356-PH) and for the Second Rural Finance (Loans 3938, 3939 and 3940-PH) projects. The first project was completed in 1993 and the loan has been closed. the other three loans are being successfully implemented and likely to be closed in the first half of 1999. The sub-loan accounting systems of the LBP and the financial statements are prepared in accordance with accepted accounting principles and has been acceptable to the Bank. The Commission on Audit (COA) is responsible, under the Philippines constitution, to carry out an external audit. COA has carried out audits on the Bank financed projects and the financial statements of the LBP and has expressed satisfactory opinions. Based on the above assessment, the LBP financial management system is considered capable of producing timely and accurate information on the status of sub-loan disbursements financed by the project.

One of the main project objectives is to improve overall financial management of LBP operations which goes far beyond ensuring adequate project related financial management. In order to achieve this objective, the Bank, the Government and LBP have agreed to require COA to carry out expanded financial statement audits and submit long-form audit reports commencing the Financial Statements to be prepared for the year ending December 1998. Agreement of COA and LBP to carry out an expanded audit based on terms of reference acceptable to the Bank and with the assistance of an internationally acceptable audit firm was a condition of negotiation which was fully met. The audit shall be conducted in accordance with the International Auditing Standards issued by the International Federation of Accountants. The auditors should also be guided by the latest guidelines on Audit and Accounting for Banks and Savings Institutions issued by the American Institute of Certified Public Accountants. The audit will assess, inter alia, the adequacy of systems of internal control, quality of the loan portfolio including the adequacy of loan loss provisioning, exposure risks on key projects, borrowing groups, connected parties or major economic sectors and the quality of liquidity, asset and solvency management. The auditors are also required to make recommendations on capital fund adequacy based on the above review. Detailed terms of reference for COA and the assisting auditors agreed are given in the Project implementation File. The agreements would ensure that the international consultants will actively participate in the expanded audit and the services of the international consultants will be contracted as long as considered necessary by the Bank and the Government.

It is expected that the quality of the COA audits and the resulting recommendations to LBP management will enhance the financial viability of the LBP. The Bank will follow up on the implementation of the recommendations through its supervision of project implementation.

Annex 5

Philippines
Third Rural Finance Project

Table A: Project Costs by Procurement Arrangements[18]

(in US$million equivalent)

Expenditure Category	Procurement Method				Total Cost (including contingencies)
	ICB	NCB	Other	N.B.F	
1. Works			63.8 (0.00)		63.8 (0.00)
2. Goods			150.00 (150.00)		150.00 (150.00)
3. Services			2.3 (0.00)		2.3 (0.00)
4. Miscellaneous					
Total			216.5 (150.0)		216.5 (150.0)

Note: (a) N.B.F. = Not Bank-financed includes elements procured under parallel cofinancing procedures, consultancies under trust funds, any reserved procurement, and any other miscellaneous items.

(b) Figures in parenthesis are the amounts to be financed by the Bank loan.

(c) Other includes procurement under limited international bidding, direct contracting, and international shopping.

(d) Miscellaneous items include taxes, duties and freight, etc.

18 For details on presentation of Procurement Methods refer to OD11.02, "Procurement Arrangements for Investment Operations." Details on Consultant Services can be shown more easily in the Table A1 format (additional to Table A, where applicable).

Annex 5

Philippines
Third Rural Finance Project

Table B: Thresholds for Procurement Methods and Prior Review[19]

Expenditure Category	Contract Value (Threshold)	Procurement Method	Contracts Subject to Prior Review / Estimated Total Value Subject to Prior Review
	US $ millions		US $ millions
1. Works		ICB	0
2. Goods	$5 million	ICB	$10 million
3. Services	none		
4. Miscellaneous	none		
	Total value of contracts subject to prior review:		$10 milliom

[19] Thresholds generally differ by country and project. Consult OD 11.04 "Review of Procurement Documentation" and contact the Regional Procurement Adviser for guidance.

Annex 5

Philippines
Third Rural Finance Project

Table C: Allocation of Loan Proceeds

Expenditure Category	Amount in US$million	Financing Percentage
Credit -CLF III	145.0	100% of amount disbursed
Micro-finance - MLF	5.0	100% of amount disbursed
Total	150.0	100% of amount disbursed

Annex 6

Philippines
Third Rural Finance Project

Project Processing Budget and Schedule

A. Project Budget (US$180,000)	Planned (At final PCD stage)	Actual
		140,000 1/

B. Project Schedule	Planned (At final PCD stage)	Actual
Time taken to prepare the project (months)	3 months	3 months
First Bank mission (identification)	02/22/1998	02/22/1998
Appraisal mission departure	06/11/1998	07/01/1998
Negotiations	08/24/1998	08/31/1998
Planned Date of Effectiveness	01/15/1999	

Prepared by: The Land Bank of the Philippines

Preparation assistance: none

Bank staff who worked on the project included:

Name	Specialty
Arie Chupak	Task Team Leader/Financial Analyst
Brenda Phillips	Task Assistant
Hoi-Chan Nguyen	Legal Counsel
Vimala Abraham	Disbursement Officer
Khalid Siraj	Peer Reviewer
Jacob Yaron	Peer Reviewer
McDonald Benjamin	Peer Reviewer
Cecilia Vales	Oper. Off. - Procurement/Disbursement
Wijaya Wickerma	Accounting and Audit

Consultants:

Paul Harrison	Agriculture Economist & Bank Specialist
Gilberto Lllanto	Financial Economist & Micro-Finance Specialist
Piedad Geron	Economist & Micro-Finance Specialist
Yaacov Ziv	Environmental Specialist

1/ About US$43,000 of this was charged to the strategic compact.

Annex 7

Philippines
Third Rural Finance Project

Documents in the Project File*

A. Project Implementation Plan

1. CLF III Policy Manual
2. MLF Policy Manual

B. Bank Staff Assessments

1. Project Supervision Plan
2. Working Paper - LBP's Financial Performance

C. Other

1. PCFC's IDP
2. LBP's IDP
3. Project Implementation Document

Annex 8

Philippines
THIRD RURAL FINANCE PROJECT

Status of Bank Group Operations in Philippines
IBRD Loans and IDA Credits in the Operations Portfolio

Project ID	Loan or Credit No.	Fiscal Year	Borrower	Purpose	Original Amount in US$ Millions				Difference Between expected and actual disbursements a/	
					IBRD	IDA	Cancellations	Undisbursed	Orig	Frm Rev'd
Number of Closed Loans/credits: 190										
Active Loans										
PH-PE-4566	IBRD43010	1998	REP OF PHILS	EARLY CHILD DEV.	19.00	0.00	0.00	19.00	0.00	0.00
PH-PE-4576	IBRD42270	1998	GOP	WATER DISTRICT DEV.	2.30	0.00	0.00	2.30	3.44	0.00
PH-PE-4576	IBRD42280	1998	GOP	WATER DISTRICT DEV.	54.50	0.00	0.00	54.50	3.44	0.00
PH-PE-4595	IBRD42990	1998	GOP	COMMUNITY BASED RESO	50.00	0.00	0.00	50.00	2.32	0.00
PH-PE-51386	IBRD43000	1998	GOP	SZOPAD SOCIAL FUND	10.00	0.00	0.00	10.00	1.50	0.00
PH-PE-37079	IBRD41090	1997	GOP	AGRARIAN REFORM COMM	50.00	0.00	0.00	46.72	2.52	0.00
PH-PE-40981	IBRD41110	1997	SUBIC BAY METRO. AUTH.	SECOND SUBIC BAY	60.00	0.00	0.00	58.92	36.92	0.00
PH-PE-4602	IBRD41080	1997	REP OF PHILS.	THIRD ELEM EDUCATION	113.40	0.00	0.00	110.40	33.30	0.00
PH-PE-4613	IBRD41100	1997	GOP	WATER RESOURCES DEVE	58.00	0.00	0.00	56.39	17.40	0.00
PH-PE-4571	IBRD3996A	1996	GOP	TRANS GRID REINFORCE	66.10	0.00	0.00	63.24	-48.04	0.00
PH-PE-4571	IBRD39970	1996	GOP	TRANS GRID REINFORCE	150.00	0.00	0.00	89.36	-48.04	0.00
PH-PE-4611	IBRD40190	1996	GOP	MNLA 2ND SEWERAGE PR	57.00	0.00	9.00	48.00	30.66	.67
PH-PE-4614	IBRD3938A	1996	LBP	RURAL FINANCE II	25.93	0.00	0.00	25.93	-20.67	0.00
PH-PE-4614	IBRD39390	1996	LBP	RURAL FINANCE II	50.00	0.00	0.00	5.06	-20.67	0.00
PH-PE-4614	IBRD39400	1996	LBP	RURAL FINANCE II	50.00	0.00	0.00	12.33	-20.67	0.00
PH-PE-4567	IBRD3852A	1995	GOVT OF THE PHILS	WOMENS HEALTH & SAFE	16.70	0.00	0.00	16.33	3.97	0.00
PH-PE-4584	IBRD3700A	1994	NPC AND PNOC	LEYTE CEBU GEOTHERMA	19.65	0.00	0.00	18.91	31.85	0.00
PH-PE-4607	IBRD3746A	1994	GOV OF PHILIPPINES	LEYTE LUZON GEOTHERM	24.15	0.00	0.00	23.64	79.05	0.00
PH-PE-4607	IBRD37470	1994	GOV OF PHILIPPINES	LEYTE LUZON GEOTHERM	114.00	0.00	0.00	65.33	79.05	0.00
PH-PE-4609	IBRD37450	1994	SBMA	SUBIC BAY FREEPORT	40.00	0.00	0.00	3.18	1.85	0.00
PH-PE-4568	IDA25060	1993	GOP	URB HEALTH & NUTRITI	0.00	70.00	0.00	49.86	30.56	0.00
PH-PE-4589	IBRD3607A	1993	GOP	IRRIG OPER SUPP II	22.94	0.00	0.00	21.14	17.86	0.00
PH-PE-4599	IBRD3603A	1993	GOVT. OF PHILIPPINES	TAX COMPUTERIZATION	25.46	0.00	0.00	24.87	24.90	0.00
PH-PE-4538	IDA23920	1992	GOP	SECOND VOCATIONAL TR	0.00	36.00	0.00	9.86	9.06	0.00
PH-PE-4592	IBRD3455A	1992	GOP	MUNICIPAL DEV III	33.25	0.00	0.00	31.29	26.83	6.63
PH-PE-4597	IBRD3430A	1992	GOP	HIGHWAY MANAGEMENT P	59.21	0.00	0.00	47.87	43.24	-2.59
PH-PE-4558	IBRD3360A	1991	GOVT. OF PHILS.	ENV. & NAT. RES. MGT	18.56	0.00	0.00	17.76	14.47	0.00
PH-PE-4572	IBRD3261A	1991	ROP	COMMUNAL IRRIG. II	18.63	0.00	3.34	15.29	18.64	.78
PH-PE-4552	IBRD3204A	1990	R.P.	COCONUT FARMS DEVT.	40.88	0.00	0.00	35.76	36.62	14.89
Total					1,249.66	106.00	12.34	1,033.24	391.36	20.38

	Active Loans	Closed Loans	Total
Total Disbursed (IBRD and IDA):	306.54	7,659.13	7,965.67
of which has been repaid:	0.00	3,663.55	3,663.55
Total now held by IBRD and IDA:	1,343.30	4,046.29	5,389.59
Amount sold :	0.00	31.35	31.35
Of which repaid :	0.00	31.35	31.35
Total Undisbursed :	1,033.24	54.37	1,087.61

a. Intended disbursements to date minus actual disbursements to date as projected at appraisal.
b. Rating of 1-4: see OD 13.05. Annex D2. Preparation of Implementation Summary (Form 590). Following the FY94 Annual Review of Portfolio performance (ARPP), a letter based system will be used (HS = highly Satisfactory, S = satisfactory, U = unsatisfactory, HU = highly unsatisfactory): see proposed Improvements in Project and Portfolio Performance Rating Methodology (SecM94-901), August 23, 1994.

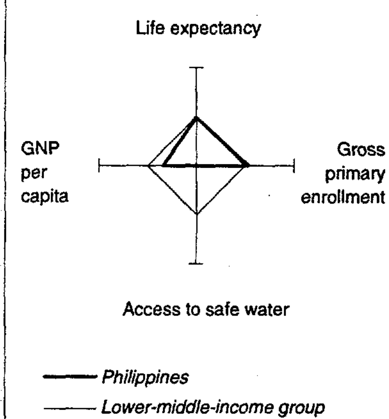
Note:
Disbursement data is updated at the end of the first week of the month.

Philippines at a glance

4/8/98

POVERTY and SOCIAL	Philippines	East Asia	Lower-middle-income
Population mid-1996 *(millions)*	70.0	1,726	1,125
GNP per capita 1996 *(US$)*	1,190	890	1,750
GNP 1996 *(billions US$)*	83.3	1,542	1,967
Average annual growth, 1990-96			
Population *(%)*	2.2	1.3	1.4
Labor force *(%)*	2.7	1.3	1.8
Most recent estimate *(latest year available since 1989)*			
Poverty: headcount index *(% of population)*	54	..	..
Urban population *(% of total population)*	54	31	56
Life expectancy at birth *(years)*	66	68	67
Infant mortality *(per 1,000 live births)*	39	40	41
Child malnutrition *(% of children under 5)*	30	..	..
Access to safe water *(% of population)*	85	77	..
Illiteracy *(% of population age 15+)*	5	17	..
Gross primary enrollment *(% of school-age population)*	111	117	104
Male	110	120	105
Female	111	116	101

Development diamond*

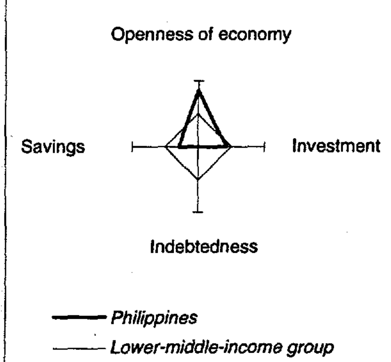


KEY ECONOMIC RATIOS and LONG-TERM TRENDS

	1975	1985	1995	1996
GDP *(billions US$)*	15.0	30.7	74.2	83.8
Gross domestic investment/GDP	30.9	15.3	22.2	24.2
Exports of goods and services/GDP	21.0	24.0	36.4	42.0
Gross domestic savings/GDP	24.8	17.4	14.4	14.4
Gross national savings/GDP	26.6	15.9	17.8	19.7
Current account balance/GDP	-6.2	-0.1	-4.4	-4.7
Interest payments/GDP	0.8	3.1	2.6	2.1
Total debt/GDP	27.8	86.6	53.2	49.2
Total debt service/exports	14.4	31.6	16.5	14.4
Present value of debt/GDP	..	..	..	..
Present value of debt/exports	..	..	..	..

(average annual growth)	1975-85	1986-96	1995	1996	1997-05
GDP	3.0	3.1	4.8	5.7	..
GNP per capita	0.3	1.5	2.6	4.7	..
Exports of goods and services	7.6	8.8	12.0	20.3	..

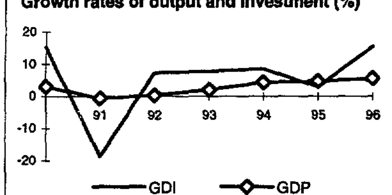
Economic ratios*



STRUCTURE of the ECONOMY

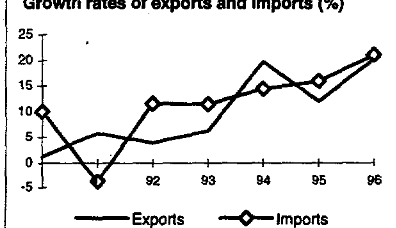
(% of GDP)	1975	1985	1995	1996
Agriculture	30.3	24.6	21.6	21.4
Industry	34.6	35.1	32.1	31.7
Manufacturing	25.7	25.2	23.0	22.6
Services	35.0	40.4	46.3	46.9
Private consumption	64.5	75.0	74.2	73.9
General government consumption	10.7	7.6	11.4	11.7
Imports of goods and services	27.1	21.9	44.2	51.7

Growth rates of output and investment (%)



(average annual growth)	1975-85	1986-96	1995	1996
Agriculture	2.2	1.8	0.8	3.0
Industry	2.6	3.2	7.0	6.3
Manufacturing	1.8	3.1	6.8	5.6
Services	3.8	3.8	5.0	6.5
Private consumption	3.3	3.9	8.5	5.3
General government consumption	0.4	4.2	5.4	5.2
Gross domestic investment	-0.4	6.7	3.0	15.6
Imports of goods and services	3.9	12.0	16.0	21.1
Gross national product	2.7	3.8	5.0	6.9

Growth rates of exports and imports (%)

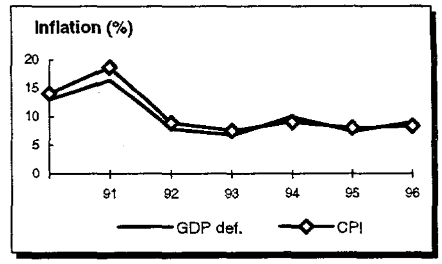


Note: 1996 data are preliminary estimates.

* The diamonds show four key indicators in the country (in bold) compared with its income-group average. If data are missing, the diamond will be incomplete.

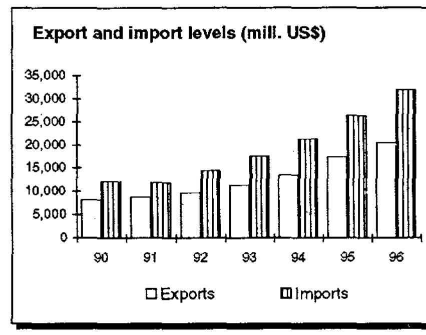
PRICES and GOVERNMENT FINANCE

	1975	1985	1995	1996
Domestic prices				
(% change)				
Consumer prices	6.8	23.1	8.1	8.4
Implicit GDP deflator	9.3	17.6	7.5	9.0
Government finance				
(% of GDP)				
Current revenue	..	12.1	18.9	18.7
Current budget balance	..	2.4	3.8	..
Overall surplus/deficit	..	-2.0	0.6	0.3



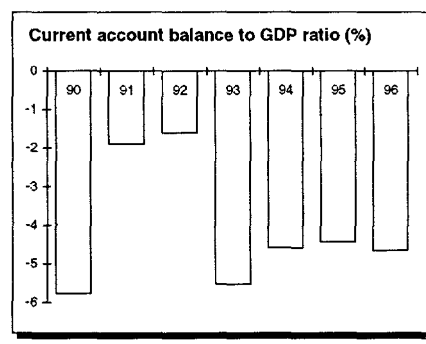
TRADE

	1975	1985	1995	1996
(millions US$)				
Total exports (fob)	..	4,629	17,447	20,543
Coconut oil	..	347	826	571
Sugar	..	185	66	136
Manufactures	..	2,539	13,868	17,106
Total imports (cif)	..	5,111	26,391	31,885
Food	..	256	1,204	1,578
Fuel and energy	..	1,452	2,461	3,008
Capital goods	..	769	8,029	10,472
Export price index *(1987=100)*	..	81	124	124
Import price index *(1987=100)*	..	63	124	126
Terms of trade *(1987=100)*	..	127	100	99



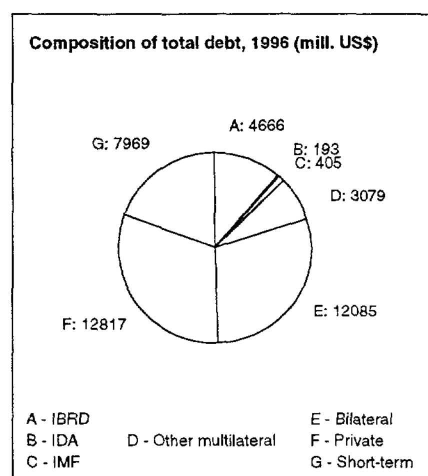
BALANCE of PAYMENTS

	1975	1985	1995	1996
(millions US$)				
Exports of goods and services	3,000	6,864	21,978	27,627
Imports of goods and services	4,116	5,961	33,329	41,371
Resource balance	-1,116	903	-11,351	-13,744
Net income	-126	-1,317	7,172	9,241
Net current transfers	318	379	882	589
Current account balance, before official capital transfers	-923	-35	-3,297	-3,914
Financing items (net)	912	867	3,928	8,021
Changes in net reserves	11	-832	-631	-4,107
Memo:				
Reserves including gold *(mill. US$)*	1,458	1,098	7,762	11,745
Conversion rate *(local/US$)*	7.2	18.6	25.7	26.2



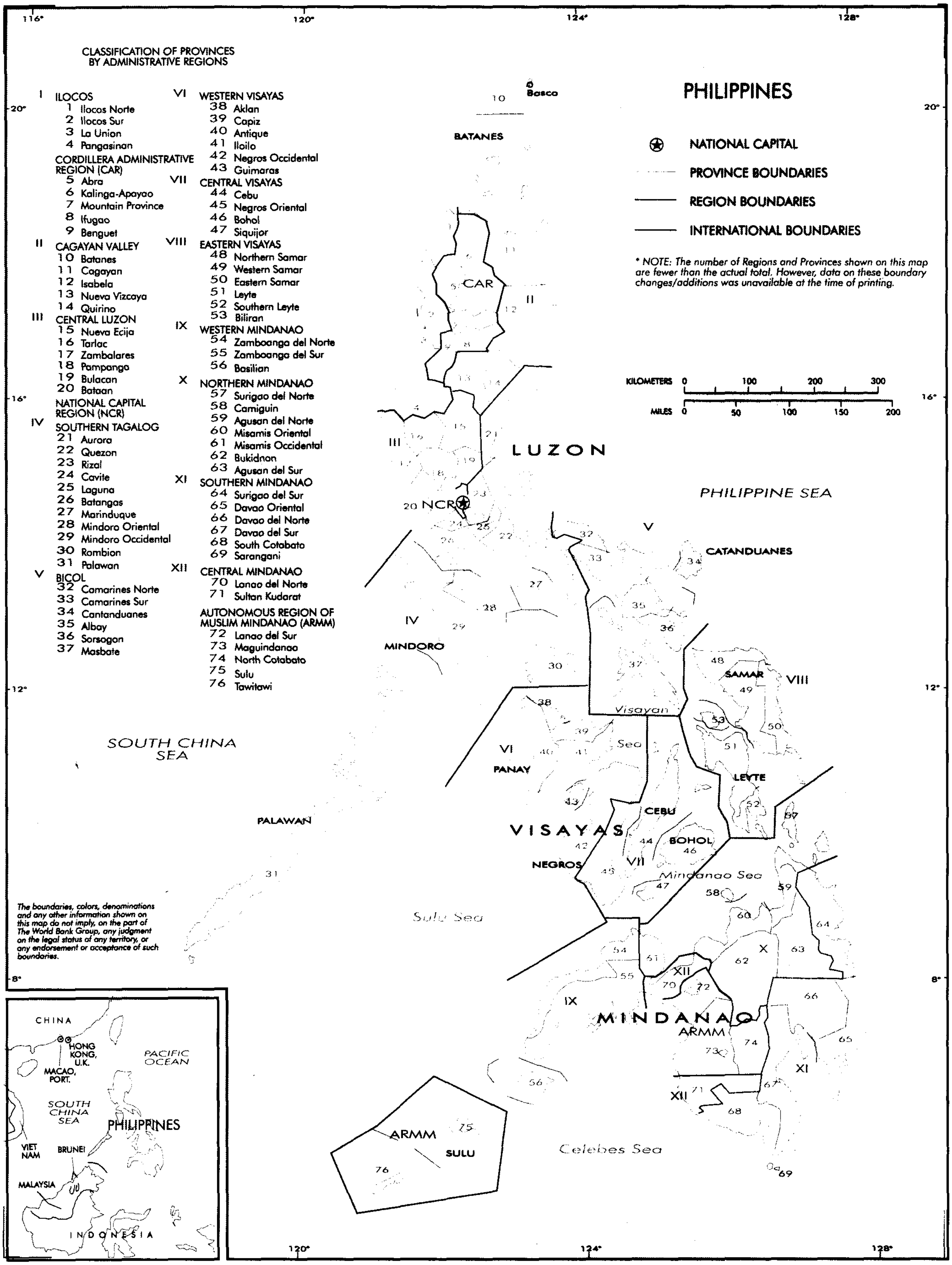
EXTERNAL DEBT and RESOURCE FLOWS

	1975	1985	1995	1996
(millions US$)				
Total debt outstanding and disbursed	4,171	26,637	39,446	41,214
IBRD	238	2,420	5,002	4,666
IDA	17	84	183	193
Total debt service	457	2,534	5,337	5,778
IBRD	26	285	789	766
IDA	0	1	3	3
Composition of net resource flows				
Official grants	72	139	276	246
Official creditors	185	360	-626	-310
Private creditors	348	796	1,141	1,859
Foreign direct investment	98	12	1,478	1,408
Portfolio equity	0	0	1,961	1,333
World Bank program				
Commitments	114	104	168	528
Disbursements	94	276	402	457
Principal repayments	12	110	415	426
Net flows	82	166	-13	31
Interest payments	14	176	377	343
Net transfers	68	-10	-390	-312



MAP SECTION

IBRD 27553



11/8/1995