Document of
The World Bank

Report No. ICR0000559

IMPLEMENTATION COMPLETION AND RESULTS REPORT
(IBRD-44130)

ON

A LOAN

IN THE AMOUNT OF US$150 MILLION EQUIVALENT

TO

LAND BANK OF THE PHILIPPINES

FOR

THE THIRD RURAL FINANCE PROJECT

June 27, 2008

Rural Development, Natural Resources and Environment Sector Unit
Sustainable Development Department
Philippines Country Department
East Asia and Pacific Region

CURRENCY EQUIVALENT

Exchange Rate Effective June 24, 2008
Currency Unit: Peso (PhP)
PhP1.00 = US$0.0224
US$1.00 = PhP44.66

FISCAL YEAR

Land Bank of the Philippines: January 1 - December 31

ABBREVIATIONS AND ACRONYMS

ADBS	Agrarian and Domestic Banking Sector
BSP	*Bangko Sentral ng Pilipinas* (The Central Bank of the Philippines)
BSRL	Banking Sector Reform Loan
CAR	Capital Adequacy Ratio
CAS	Country Assistance Strategy
CFI	Countryside Financial Institution
CLF	Countryside Loan Fund
DBP	Development Bank of the Philippines
DOF	Department of Finance
EO	Executive Order
EPMD	Environmental Program and Management Department
ERR	Economic Rate of Return
FMS	Financial Management Specialist
FRR	Financial Rate of Return
GFI	Government Financial Institution
IDP	Institutional Development Plan
ISR	Implementation Status and Results report
IFI	International Financial Institution
JBIC	Japan Bank for International Cooperation
KPI	Key Performance Indicator
LBP	Land Bank of the Philippines
LIBOR	London Inter-Bank Offered Rate
M&E	Monitoring and Evaluation
MFI	Micro-Finance Institution
MLF	Micro-Finance Loan Fund
NGO	Non-governmental Organization
NPA	Non-performing Asset
NPL	Non-performing Loan
PAR	Portfolio at Risk
PDO	Project Development Objectives
PCFC	People's Credit & Finance Corporation
PFI	Participating Financial Institution
QAG	Quality Assurance Group
RB	Rural Banks
RCF	Retail Countryside Fund
TB	Thrift Banks
SDI	Subsidy Dependence Index
SCL	Single Currency Loan at Libor-Based Floating Rate
SMEs	Small- and Medium-Sized Enterprises
WAIR	Weighted Average Interest Rate
WBO	Wholesale Banking Operation

Vice President	James W. Adams, EAPVP
Country Director	Bert Hofman, EACPF
Sector Manager	Rahul Raturi
Project Team Leader	Iain Shuker
ICR Team Leader	Iain Shuker

The Philippines

The Third Rural Finance Project

Implementation Completion and Results Report

Contents

A. Basic Information			
Country	Philippines	**Project Name**	Third Rural Finance
Project ID	P057598	**Loan Number**	IBRD-44130
ICR Date	June 27, 2008	**ICR Type**	Core ICR
Lending Instrument	SIL	**Borrower**	Land Bank of the Philippines
Original Total Commitment	US$150.0 million	**Disbursed Amount**	US$147.5 million
Environmental Category:		B	
Implementing Agencies:		Land Bank of the Philippines People's Credit and Finance Corporation	
Co-financiers and Other External Partners:		Participating Financial Institutions Micro-Finance Institutions Sub-borrowers	

B. Key Dates				
Process	Date	Process	Original Date	Actual Dates
Concept Review	04/16/1998	**Effectiveness**	05/06/1999	05/06/1999
Appraisal	07/01/1998	**Restructuring**	-	-
Approval	12/03/1998	**Mid-term Review**	-	11/29/2002
		Closing	06/30/2005	09/30/2007

C. Ratings Summary	
C.1 Performance Rating by ICR	
Outcomes	Satisfactory
Risk to Development Outcome	Negligible
Bank Performance	Satisfactory
Borrower Performance	Moderately Satisfactory

C.2 Detailed Ratings of Bank and Borrower Performance (by ICR)			
Bank	Ratings	Borrower	Ratings
Quality at Entry	Satisfactory	**Government**	Unsatisfactory
Quality of Supervision	Satisfactory	**Implementing Agencies**	Satisfactory
Overall Bank Performance	Satisfactory	**Overall Borrower Performance**	Moderately Satisfactory

C.3 Quality at Entry and Implementation Performance Indicators			
Implementation Performance	Indicators	QAG Assessments (if any)	Rating
Potential Problem Project at any time	Yes	**Quality at Entry (QEA)**	Satisfactory
Problem Project at any time	Yes	**Quality of Supervision (QSA)**	None
DO rating before Closing	Satisfactory		

D. Sector and Theme Codes	Original	Actual
Sector Code (as percentage of total Bank financing)		
General finance sector	96	91
General public administration sector	1	1
Micro-finance and SME finance	3	8
Theme Code (primary/secondary)		
Rural markets	Primary	Secondary
Small and medium enterprise support	Secondary	Secondary
Other financial and private sector development		Primary

E. Bank Staff		
Positions	At ICR	At Approval
Vice President	James W. Adams	Jean-Michel Severino
Country Director	Bert Hofman	Vinay K. Bhargava
Sector Manager	Rahul Raturi	Geoffrey B. Fox
Project Team Leader	Iain G. Shuker	Arie Chupak
ICR Team Leader	Iain G. Shuker	-
ICR Primary Author	Arie Chupak and Steven Oliver	-

F. Results Framework Analysis

Project Development Objectives (from the Project Appraisal Document)

The project's development objectives were:

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

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

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

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

Revised Project Development Objectives (as approved by original approving authority)

The project development objectives (PDOs) of the project remained unchanged.

PDO Indicators

Indicator	Baseline Value	Original Target Values (from approval documents)	Formally Revised Target Values	Actual Value Achieved at Completion
Indicator 1: Amount of sub-project investments in rural areas (cumulative)				
Value	0	PhP 8.500 million		PhP11,123 million
Date achieved		December 31, 2006		September 30, 2007
Comments	131 percent of the target value was achieved			

Intermediate Outcome Indicators

Indicator	Baseline Value	Original Target Values (from approval documents)	Formally Revised Target Values	Actual Value Achieved at Completion or Target Years
Indicator 1: Number of sub-loans (cumulative) under Countryside Loan Fund (CLF) and the Retail Countryside Fund (RCF)				
Value	0	700	600	546
Date	March 31, 1999	December 31, 2006	April 29, 2004	September 30, 2007
Comments	91 percent of the revised target value was achieved			
Indicator 2: Number of jobs created (cumulative)				
Value	0	15,000	13,500	16,960
Date	March 31, 1999	December 31, 2006	April 29, 2004	September 30, 2007
Comments	126 percent of the target value was achieved			
Indicator 3: Number of loans (cumulative) under the Micro-Finance Loan Fund (MLF)				
Value	0	4,800	110,000	114,902
Date	March 31, 1999	September 30, 2005	April 29, 2004	September 30, 2007
Comments	105 percent of the revised target value was achieved.			

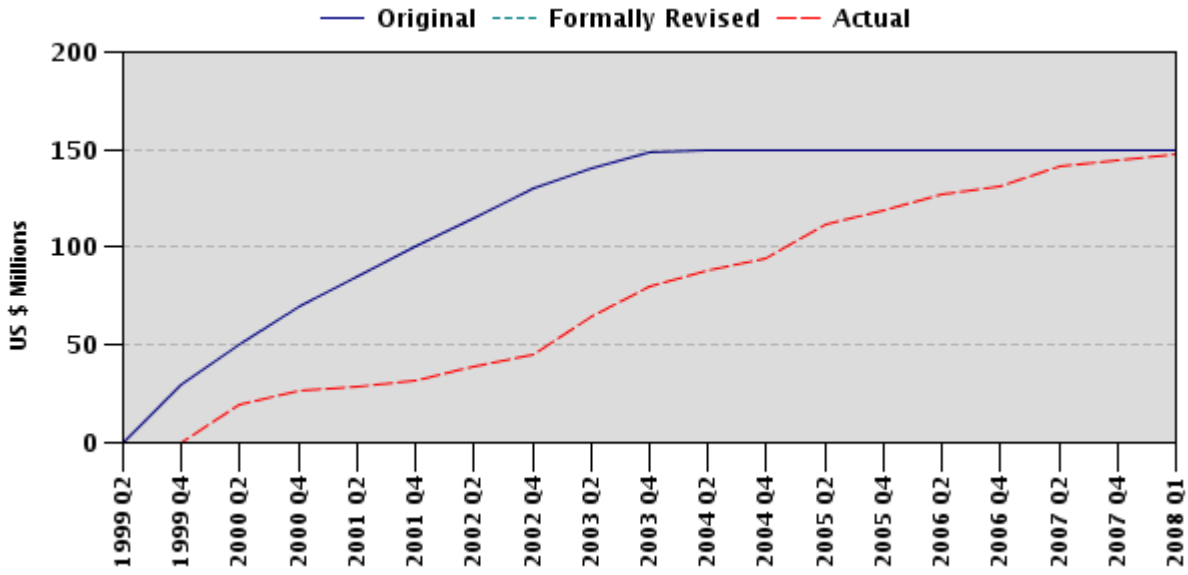
G. Ratings of Project Performance in Implementation Status and Results Reports (ISR)

No.	Date ISR Archived	DO	IP	Actual Disbursements (US$ million)
1	12/16/1998	Satisfactory	Satisfactory	0.00
2	06/11/1999	Satisfactory	Satisfactory	0.00
3	09/16/1999	Satisfactory	Satisfactory	7.00
4	05/10/2000	Satisfactory	Satisfactory	26.90
5	10/31/2000	Satisfactory	Satisfactory	26.90
6	06/21/2001	Satisfactory	Satisfactory	32.11
7	11/01/2001	Satisfactory	Satisfactory	37.52
8	12/10/2001	Satisfactory	Satisfactory	38.52
9	05/09/2002	Satisfactory	Satisfactory	45.02
10	06/25/2002	Unsatisfactory	Unsatisfactory	45.02
11	12/09/2002	Satisfactory	Satisfactory	58.50
12	05/12/2003	Satisfactory	Satisfactory	76.25
13	07/23/2003	Satisfactory	Satisfactory	83.64
14	12/24/2003	Satisfactory	Satisfactory	88.72
15	04/29/2004	Satisfactory	Satisfactory	92.85
16	06/25/2004	Satisfactory	Satisfactory	94.39
17	12/20/2004	Satisfactory	Satisfactory	110.25
18	05/20/2005	Satisfactory	Satisfactory	117.69
19	04/11/2006	Satisfactory	Satisfactory	129.19
20	04/17/2007	Satisfactory	Satisfactory	143.72
21	07/13/2007	Satisfactory	Satisfactory	144.72

H. Restructuring

No restructuring of the project took place.

I. Disbursement Profile



The Philippines

The Third Rural Finance Project

Implementation Completion and Results Report

1. Project Context, Development Objectives and Design

1.1 Context at Appraisal

1.1.1 The project supported two of the main goals of the Country Assistance Strategy (CAS)[1]: (a) to improve private business environment by improving availability of long term financing for viable rural investments; and (b) to 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 CAS Progress Report also reaffirmed the need to respond to both 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 the Bank's support through technical assistance and quick disbursing loans. In addition, lines of credit for agriculture and industry were to be provided in the light of the constrained availability of term credit to the private sector. This project was intended to 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.

Main sector issues and Government strategy:

1.1.2 The Philippine economy had recovered from its poor performance of the early 1990s and was growing during the four years between 1992 and 1996. However, the East Asian financial crisis had a negative impact on its growth and the stability of the banking sector. The annual rate of growth of real GNP declined 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. Inflation exceeded ten percent per year, unemployment in April 1998 had risen sharply to 13.3 percent, estimates of the fiscal deficit had rapidly escalated, the Peso had weakened, and (following a period of decline) market interest rates had begun to rise.

1.1.3 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, and the extension of dollar-denominated loans which generally were un-hedged by borrowers. The substantial depreciation since July 1997 had exposed a number of borrowers to liquidity and solvency problems.

1.1.4 Net foreign capital inflows declined sharply from about US$8 billion in 1996 to below US$1 billion in 1997, while the current account deficit widened in 1997 to about US$4.5 billion. This was mitigated by a 15 percent increase in Philippine overseas workers' remittances to about US$11.5 billion in 1997.

[1] CAS Report No.15362-PH (CAS) and R-98-41 (CAS Progress Report). Date of latest CAS discussion: March 24, 1998.

1.1.5 The banking system and the corporate sector, however, experienced stress from the financial shocks generated by tight credit. Credit provided by commercial banks during the fourth quarter of 1997 and the first half of 1998 remained stagnant. While the commercial banks as a group experienced healthy profit levels in 1997 as a result of widening gross interest margins, many of them faced problems such as the rising number of Non-Performing Loans (NPLs), the increased incidences of "roll-over" loans, falling real estate collateral values and compliance with legal reserve requirements. Thrift Banks (TBs) and Rural Banks (RBs) experienced even greater stress from the crisis. At the end of 1997, the gross NPLs of TBs and RBs were reported to be 10 percent and 14 percent, respectively. The stress faced by these banks 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 raised a number of concerns, including: the commercial banks' capital adequacy, loan classification and provisioning practices; the increase in NPLs; the 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 International Monetary Fund, had initiated a number of reforms to address these issues. The proposed project was also one step in the same direction.

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

1.1.6 The financial crisis was expected to weed out or to hasten the demise of weak and non-competitive enterprises, including possibly banks, but it was not certain that the weeding out process would be confined to such firms. Some banks, in their desire to protect their balance sheets from exposure to failing firms (especially those with un-hedged foreign exchange denominated loans), were expected not to distinguish between good and bad firms, and as a result tightened credit on all firms. A strategy of staying liquid while exploiting high-yielding Treasury Bills or taking a position in the foreign exchange market was a survival strategy adopted by several banks, leading to a degree of failure in the credit market. The appraisal revealed that the financial crisis had hit good borrowers, which would otherwise be considered creditworthy and viable, especially the small- and medium-size rural enterprises caught between reduced bank funding and higher credit requirements

1.1.7 Clear evidence of strong demand for medium- and long-term credit for rural investment had been shown by the fact that the Countryside Loan Funds (CLF I and II) set up under the earlier Rural Finance I and Rural Finance II projects, had been drawn down substantially ahead of target. There was a shortage of medium- and long-term Peso-denominated financial resources within the banking system and, given the financial crisis, this was not expected to change in the near future. Without such resources, banks had to finance investments using short-term resources, leading either to maturity mismatches or investors exposed to the risk of not having their short-term loans rolled over. Additional Bank resources to support rural investment through a wholesale credit line were intended to fill this gap and enable the PFIs and their clients to match the maturity of their funding to the maturity of their project or loan. The project intended to address these issues through Component 1(a), the Countryside Loan Fund (CLF III), a line of credit managed by LBP.

1.1.8 The increasing amount of micro-enterprise activities had resulted in a considerable demand for micro-enterprise loans in the rural sector, ranging from PhP25,000 to PhP100,000 for working capital and small capital investments. Most commercial banks did not lend to micro-enterprises because of the perceived costs associated with micro-finance lending. This market niche was served by micro-finance institutions mostly comprised of rural banks, cooperative rural banks, credit cooperatives, and credit-granting NGOs. Recognizing the role of micro-enterprise loans in poverty alleviation, the PCFC had been established by the government as a lead or apex financial institution for micro-finance. It was established as a non-deposit taking institution that would raise funds from the government, donors and financial markets and wholesale these funds to microfinance institutions. Micro-finance institutions would then on-lend these funds to microfinance borrowers. At appraisal, about 94 micro-finance

institutions (MFIs) were accredited by the PCFC, which was operating with very limited funds.

1.1.9 The wholesaling of funds was considered suitable because of the large number of banks and MFIs in the Philippines. The use of a wholesale mechanism allowed competition among the PFIs and the MFIs and gave access to funds to any qualified institution. Its effective implementation required the Apex Institutions to operate efficiently. Both Apexes (LBP and the PCFC) had prepared Institutional Development Plans (IDPs) to strengthen their ability to fulfill this task. PFIs and MFIs were also required to meet a fixed set of accreditation criteria to participate under the project.

Rationale for Bank involvement at the time of approval:

1.1.10 The Bank's then-current program of Adjustment and Policy-based lending sought to help the government to establish a stable macro-economic and financial environment through balance of payments and budgetary support. At the time this included a proposed Banking Sector Reform Loan (BSRL). Expansion of the regular lending program to include this project was intended to complement the measures undertaken under the BSRL, 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 as a result of strong economic and business prospects in the real sector and macro-economic stability brought about by a decade of structural reforms. The financial crisis brought severe credit problems, forcing rationing and shortening of loan horizons. To restore confidence in the financial markets and address the liquidity and working capital constraints of the business sector, it was essential to provide lines of credit for longer-term loans. 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 was considered to 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 1990s was to a large extent the result of its association with the Bank. This development would be further enhanced through the proposed project.

1.1.11 The project fitted comfortably within the agreed framework of Bank assistance to the Philippines, and was 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 addressed the critical but temporary difficulties of firms that remained economically viable but faced financial problems brought about by the volatility of the exchange rate and interest rates and a degree of market failure in the financial sector. Finally, its micro-finance loan package, designed to address unmet demand for credit by micro- and small-sized enterprises, provided strong support to the Bank's commitment to poverty alleviation.

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

1.2 Original Project Development Objectives (PDO) and Key Indicators (as approved)

1.2.1 The project's development objectives were: (a) to 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 CLF III; (b) to assist the government in its efforts to alleviate rural poverty through the provision of financial and institutional support to the country's micro-finance system; (c) to strengthen LBP (as the main financial institution serving the rural areas) and the PCFC (as

the country's main conduit for micro-finance); and (d) to help to enforce financial discipline on PFIs.

1.2.2 Key Performance Indicators (KPIs) were developed to measure the achievements of the Credit Components and the IDPs for both LBP and the PCFC. The KPIs by years defined at appraisal are presented in Annex 5.

Narrative Summary	Key Performance Indicators	Monitoring and Evaluation	Critical Assumptions
Selected Related CAS Goal			**CAS Objectives to Bank Mission**
(a) to improve the private business environment including the availability of medium- and long-term financing;	(a) Policy, regulatory, and institutional framework becomes more conducive for private sector activities and banks' sound development;	(a) Government laws, regulation and procedures introduced.	(a) Government remains committed to a market driven financial sector.
(b) to alleviate poverty	(b) Poverty incidence has been reduced.	(b) Progress report on poverty.	(b) Government remains committed to poverty reduction.
Project Development Objectives			**Development Objectives to CAS Objectives**
(a) to 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.	(a) The LBP and PFIs to increase term lending to private enterprises in the rural areas.	(a) LBP's quarterly and semi-annual reports as well as BSP statistics.	(a) the private sector will positively respond to the new framework and increase resource availability; the LBP continues not to be subject to undue political pressure with regard to its operational policy.
(b) to assist the government in its efforts to alleviate rural poverty by supporting financially and institutionally the country's micro-finance system.	(b) The PCFC and MFIs to increase lending and provide financial services to micro-enterprises.	(b) The PCFC's quarterly progress report.	(b) there is strong underlying demand for micro-finance; government facilitates institutional development of the PCFC.

Project Outputs and Components			Outputs to Development Objectives
1(a) 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.	Monitoring and evaluation would be regularly undertaken by LBP and the PCFC and would be reviewed by Bank missions.	The economy remains sufficiently buoyant for well-run enterprises to be financially sound.
1(b) Providing micro-finance on a commercial basis which would directly assist micro-enterprises and alleviate poverty.	* Number of micro enterprises financed under the project and their total investments.		The PCFC continuously enjoys government recognition and support specifically in advocating micro-finance as a major industry and as a widely-used poverty alleviation tool.
2 (a) Strengthening LBP as the main financial institution serving the rural areas.	* LBP increases its outreach to rural areas, improves its operational efficiency and remains financially sound.		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.
2 (b) Strengthening the PCFC as the wholesale micro-finance institution.	* The PCFC operates effectively, meets growth targets and is financially sound.		The PCFC is continuously exerting effort and working for government support to raise adequate equity.

1.3 Revised PDO (as approved by original approving authority and Key Indicators, and reasons/ justification

1.3.1 No revision was made to the PDOs. The Key Performance Indicators (KPIs), however, were adjusted to the changes in the country's economic conditions, the financial performance of the Philippine banking system, and the development of LBP and the PCFC.

1.3.2 Key indicators were reviewed and revised in 2004 to reflect the reality of the project at mid-point. The number of loans was adjusted downwards slightly under CLF/RCF and increased under the MLF to reflect the reallocation of funds between these categories. The targets of other indicators were modified and some new indicators were introduced, increasing the overall number of indicators from 12

to 18. The revised KPI targets and accomplishment at project completion are presented in Annex 5.

1.4 Main Beneficiaries

1.4.1 The CLF III was intended directly to assist small- and medium-sized economic entities operating in the rural areas of the Philippines. Based on the loan up-take of CLF I & II, it was estimated that about 700 economic entities would obtain credit under the project (in the first round of lending). These beneficiaries were expected to benefit from: (a) the restructuring of their viable operations that were financially distressed; or (b) from the establishment of new, or the expansion of existing, viable entities. It was estimated that about 100 PFIs would benefit from being retailers of CLF III. The availability of more medium-term financial resources was intended to help the PFIs to improve the structure of their balance sheets, to allow them to serve their clients better and to contribute to their profitability. The Micro Finance component was aimed at assisting micro enterprises in the rural areas, particularly those which were too small to receive regular commercial finance but larger than the "Grameen-style" clients of the PCFC's programs supported by the Asian Development Bank and the International Fund for Agricultural Development. Some 50 MFIs, mainly rural banks, NGOs and credit co-operatives, were expected to benefit from an expansion in the availability of the MLF, serving some 4,800 sub-borrowers. The institutional strengthening components for LBP and the PCFC were intended to strengthen the institutions themselves and to assist in improving the delivery of financial services to the rural areas.

Component	Sub-borrowers: Firms and Individuals	New Jobs	Number of PFIs/MFIs
CLFIII/RCFII	700	15,000	100
MLF	4,800		50

1.5 Original Components (as approved)

1.5.1 The project was scheduled to be implemented over a period of five years and comprised two components, each with two sub-components. The total project cost was estimated at US$216 million, of which the Bank loan of US$150 million would finance about 69 percent.

Component 1. Line of Credit

1.5.2 **Sub-component 1 (a) Countryside Loan Fund III (CLF III)**. Total estimated component cost was US$207 million equivalent, 96 percent of the project's total estimated cost. Bank financing of this sub-component was scheduled to be US$145 million equivalent and to finance no more than 75 percent of each sub-project cost. The CLF III was a fund established in LPB and on-lent to accredited PFIs on a short-, medium- or long-term basis at market interest rates. Sub-loans were made to sub-borrower meeting a set of eligibility criteria. Eligibility criteria included that the sub-borrower is located outside of major metropolitan areas, that the proposed sub-project is economically and financially viable, as well as technically and environmentally sound. The fund could be used for new investments and for restructuring distressed loans that required term restructuring as a result of the 1997/98 financial crisis. The CLF III was operated as a wholesale banking operation except for an agreed amount of US$15 million equivalent which was allocated to the RCF II under the CLF. This amount was allocated to accommodate LBP's own rural clients who were in financial distress as a result of the financial crisis. This component supported directly the first PDO (i.e., it provided financial support to the rural economy to overcome the difficulties created by the regional financial crisis). It also provided an incentive to PFIs to participate in the project and thus address the fourth PDO of enforcing financial discipline through the required compliance with bank accreditation criteria established under the project.

1.5.3 **Sub-component 1 (b) Micro Finance Loan Fund (MLF).** The estimated cost of the MLF was US$6.7 million equivalent (3 percent of total project estimated cost). Bank financing was scheduled to be US$5 million equivalent and to finance no more than 75 percent of each of sub-project. The MLF was established in the PCFC for on-lending to accredited MFIs for further on-lending to micro-enterprises to finance their working capital and small capital investment needs. It was intended that sub-loans under this component would range from PhP25,000 (US$625 at the exchange rate at the time of appraisal) to PhP100,000 (US$2,500). This component supported directly the second PDO (i.e., poverty alleviation through the provision of financial support to the country's micro-finance system).

Component 2. Institutional Strengthening

1.5.4 **Sub-component 2 (a) Institutional Strengthening of LBP.** The estimated cost of this component was US$2 million equivalent (0.9 percent of total estimated project cost), and was fully financed by LBP. Institutional strengthening of LBP was driven through an IDP prepared by LBP and agreed with the Bank. The focus of the IDP was on ensuring LBP's sustainability while continuing its rural lending expansion. Specifically, it would focus on:(a) improving the quality of LBP's commercial loan portfolio; (b) reducing unit losses on agrarian lending; (c) continuing the policy of automation of systems and management information flow; (d) staff training; (e) mobilization of medium- and long-term Peso resources; and (f) making adequate arrangements for capital build-up. This component supported directly the third PDO (i.e., the strengthening of the LBP).

1.5.5 **Sub-component 2 (b) Institutional Strengthening of the PCFC.** The estimated cost of this component was US$0.3 million equivalent (0.2 percent of total estimated project cost), and was to be fully financed by the PCFC. Under this component, the PCFC was to implement its own IDP to be agreed with the Bank. The IDP included the build-up of the PCFC's capital base and the strengthening of its staff capability to implement its various types of micro-finance programs. This component supported directly the third PDO (i.e., the strengthening of the PCFC).

1.6 Revised Components

1.6.1 No official revision of the components took place during project implementation. However, the RCF II, the retail lending facility for LBP clients, under CLF III was increased from US$15 million to US$35 million equivalent over the course of the project. As a result the RCFII became, for all practical purposes, a component on its own. As a result, the CLF III is related in this document to the Wholesale Banking Operation (WBO) under the project and the RCF II to its retail lending. Expansion of the RCF II had some positive impacts on the project by reaching more remote areas, targeting smaller-scale businesses and having a stronger primary production focus than the CLF III wholesale facility.

1.7 Other Significant Changes

1.7.1 The reallocation of Bank loan funds to the various components, and amendments to the Loan Agreement and to the CLF III/RCF II and MLF Policy Manuals, were all approved by management. These amendments and their related reasons are outlined below.

(a) To accommodate the increased demand for the MLF facility and to have a larger impact on poverty alleviation, MLF financial resources were increased from the equivalent of US$5 million to US$15 million, while the CLF III allocation was reduced from US$145 million to US$132.5 million equivalent.

(b) Considering the PFIs' cautious lending, particularly to small- and medium-sized enterprises (SMEs), and the LBP's interest in providing SMEs with term lending, the Loan Agreement was amended to allow a different distribution of funds between the wholesale operation of the CLF III

and its RCF II. The RCF II facility was increased, through two amendments to the Loan Agreement[2], from US$15 million to US$30 million equivalent in 2004 and to US$35 million equivalent in 2006; accordingly, the wholesale lending operation was reduced to the equivalent of US$97.5 million by 2006.

(c) The amount of US$2.5 million was cancelled at the request of the Borrower.

(d) To enable the project fully to achieve its PDOs, the Loan Closing Date was extended twice: from June 30, 2005 to December 31, 2006, and then to September 30, 2007, a cumulative extension of 27 months.

(e) Amendments to the Policy Manuals of CLF III and MLF were made to streamline the CLF/RCF/MLF lending operations and to improve the project funds' competitiveness. These include the following:

(i) Minimum sub-project financing contributions were changed from a sub-borrower contribution of 15 percent and a PFIs/LBP-Agrarian and Domestic Banking Sector (ADBS) or LBP contribution of 10 percent to a sub-borrower and/or PFIs/ADBS contribution of at least 25 percent and a CLF contribution of not more than 75 percent of a sub-project's investment costs.
(ii) To reduce the transactions cost for the PFIs/LBP in processing small loans, a "free limit" for prior approval of sub-loans by PFIs/LBP was introduced.
(iii) A provisional accreditation system was introduced that allowed PFIs that meet most but not all of the bank accreditation criteria to participate in the project. These PFIs were required to develop an IDP suitable to the Bank that included a time bound action plan for meeting all of the accreditation criteria in a reasonable time-frame.
(iv) Allowing CLF financing of firms with asset size of over PhP250 million, provided that it can be demonstrated that these investments are in under-serviced rural areas and that they produce a high level of social benefits (such as the creation of incremental jobs for the area).
(v) Expansion of eligible sub-projects by inclusion of lease financing and mass housing sub-projects.
(vi) An increase of a sub-borrower's asset size cap from PhP1.0 billion to US$50 million equivalent.
(vii) Adjustment of the benchmarks of accreditation criteria regarding solvency (Central bank of the Philippines - BSP - capital requirement, capital adequacy ratio (CAR) of at least 10 percent, and net past due to equity ratio not to exceed 25 percent by December 31, 2004), profitability (from positive real profit for the last three years to positive average real profit for the last three years), and liquidity (liquid ratio of at least 30 percent as of December 31, 2002).
(viii) Adjustment of RCF II maximum loan amount from P100 million to not more than 5 percent of LBP's equity as applied to all PFIs.
(ix) Allowing the utilization of RCF II funds for financing of start-up/expansion of sub-projects of SME sub-borrowers.
(x) Allowing financing under CLF and RCF of sub-loans of PhP25,000 and above.

[2] The first amendment, dated June 17, 2004, became effective only on July 6, 2004, after GOP and LBP officially confirmed it. The second amendment, of June 8, 2006, became effective on July 26, 2006 after GOP and LBP officially confirmed it.

1.8 Original Project Costs and Financing (US$ million)

Component/ Financing	LBP	PCFC	Sub-borrowers	PFIs/MFIs	IBRD	Total
CLFIII/RCFII			41.4	20.7	145.0	207.1
MLF			1.0	0.7	5.0	6.7
Sub-Total Credit			42.4	21.4	150.0	213.8
LBP-IDP	2.0					2.0
PCFC-IDP		0.3				0.3
Sub-Total IDP	2.0	0.3				2.3
Total	2.0	0.3			150.0	216.1

2. Key Factors Affecting Implementation and Outcomes

2.1 Project Preparation, Design and Quality at Entry

2.1.1 **Key factors and issues on the quality at entry.** Two main issues were dealt with during project design and preparation. These were: (a) the most suitable project designed to meet the PDOs; and (b) the capacity and the financial strength of potential PFIs, particularly RBs. The options for project design are discussed in Annex.7. It was clear during project preparation that because of the negative impact of the Asian financial crisis on the banking system, the number of PFIs would be much smaller than under RFI and RFII and that very few RBs would participate in the project. This was mainly the result of the limited ability of small banks (like RBs) to absorb even a small deterioration of the quality of their loan portfolio and still meet prudent accreditation criteria. The project's results suggest that the background analysis, the lessons learned and the rationale for Bank involvement carried out at appraisal were sound.

2.1.2 **Assessment of project design.** Generally, there are four main options for the design of a credit project: (a) a WBO to be carried out by an Apex Bank (AB); (b) several pre-determined participating banks, each of which would receive a line of credit for on-lending to its respective clients; (c) a pre-selected government bank to retail the credit to its clients and/or to the targeted group(s); and (d) a combination of the first and the third of the above (i.e., a basic wholesale banking operation with a relatively large line of credit to be extended directly (outside the WBO) to pre-selected PFIs). Out of the four options, the wholesale banking operation was selected for the following reasons:

(a) it allowed more banks to participate in the project, thus increasing banking competition in the rural areas; (b) it allowed the project to diversify the project's beneficiaries as each PFI would accommodate its own clientele; (c) it had a better fit with the basic concept of a demand-driven operation as it allowed potential PFIs to join and exit the program at their suitable timing; (d) except for appraising the Apex Bank, there was no need at the project preparation stage to fully appraise other financial institutions; (e) the system was already known in the Philippines and the banking system was already familiar with its operation and procedures; and (f) the social and economic impact of the project is spread, through the wholesale operation, throughout the country. Discussions on the advantages and the disadvantages of the other options are presented in Annex 7.

2.1.3 The component design, with two broad components, and four sub-components kept the project simple and easy to implement. Having two key implementing institutions (LBP and the PCFC) also kept the project focused and easy to manage, while still having adequate capacity to implement the project. The use of 32 PFIs and 72 MFIs were adequate to ensure appropriate geographical distribution, out-reach to potential beneficiaries throughout the country, and competition among PFIs/MFIs to the benefit of the

rural population.

2.1.4 **Indications of borrower commitment and ownership.** LBP, the Borrower, 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 its IDP and the CLF III policy manuals, were undertaken by the Borrower. The PCFC, the implementer of a US$15 million Micro-finance Component indicated its commitment to the project by participating fully in the detailed preparation of the MLF sub-component, including the drafting of the MLF Policy Manual and its IDP.

2.1.5 **Risks**.

Risk	Risk Rating	Risk Minimize 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 would be made available at market rates, but with a longer term than generally available. This should keep them attractive for reinvestments, restructuring and new investments. PFIs and potential sub-borrowers have indicated strong demand for long-term funds which is confirmed by the up-take rate of CLF II.
Political interference in LBP lending operation and policy decision may prevent full IDP implementation.	M	LBP is a fully autonomous bank. Past experience does not indicate government interference in its lending decision to SMEs. There may be opposition to some of the IDP measures, particularly the prudent linkage of LBP's dividend (to government) to profit in real terms. This is dealt with through a specific loan covenant.
The PCFC may not achieve the necessary volume of lending to allow it to have low unit cost to be an effective wholesaler.	N	Focusing the PCFC's IDP toward effective market development and training of MFIs.
Overall Risk Rating	M	

Risk rating: H (High Risk), S (Substantial Risk), M (Moderate Risk), N (Negligible or Low Risk)

2.1.6 **Quality Assurance Group (QAG) and Quality at Entry.** Peer reviewers and Bank management were satisfied with, and endorsed, the project design, its features, conditionality and components. The QAG reviewed the project's quality at entry and rated it as "Satisfactory".

2.2 Implementation

2.2.1 The success of project implementation and its achievements were mainly due to the professional capacity and the efforts made by LBP's management and staff. For a number of reasons, all of them beyond the control of LBP, the disbursement rate of the Bank loan was slower than anticipated at appraisal. The key factors were:

(a) The weak state of both the corporate and the SME sectors from the adverse impact of the 1997/1998 Asian financial crisis persisted longer than anticipated

(b) PFIs' cautious lending, particularly to the rural SME sector, persisted longer than expected.

(c) The quicker than expected build-up of short-term liquidity in the banking sector after the financial crisis. In the last several years there has been a sharp increase of short-term liquidity and a decline in short-term interest rates. This caused the on-lending rate under the project to be uncompetitive as banks tended to use their own low-cost funds and even to roll over their short-term lending in financing mid-term investments.

(d) The upward movement in the Bank's US$ LIBOR-based cost of funds since June 2005 made the project's loan programs more expensive than the loan programs funded by LBP's and PFIs' internal funds.

(e) The most critical one, however, was the unfavorable wholesale lending environment that has been created by below-market rates of the Development Bank of the Philippines (DBP)/Japan Bank for International Cooperation (JBIC) medium- and long-term wholesale lending facilities. Almost immediately after the project's start-up, the JBIC provided a loan to the DBP for US$500 million equivalent which was being on-lent at 200 basis points below the prevailing market rate. Since the DBP/JBIC loan was basically targeted at a large group of the project PFIs (mainly commercial and universal banks), it had the effect of crowding-out lending under the project.

2.2.2 To address these difficulties and to enable the project to meet its objectives, several adjustments had to be made to the Loan Agreement (in two amendments) and to the CLF III/RCF II and MLF Policy Manuals; the IBRD loan had to be reallocated among the initial project's categories. (These adjustments are presented in Section 1.7, above.)

2.3 Monitoring and Evaluation (M&E) Designed, Implementation and Utilization

2.3.1 **M&E Design**. The M&E system designed under the project included: (a) the project KPIs as agreed at negotiations; (b) quarterly progress reports on the performance of the CLF III/RCF II and the MLF; and (c) semi-annual progress reports on the institutional development of LBP and the PCFC. The details of the reports and their contents were prepared by LBP and the PCFC and agreed with the Bank.

2.3.2 **M&E Implementation.** Progress reports were submitted to the Bank regularly and on time. They were used by the managements of LBP, the PCFC and the IBRD to review progress made, to identify outstanding issues and to take corrective actions if warranted.

2.3.3 **M&E Utilization.** The project's M&E system was very instrumental in the decisions made by LBP, the PCFC, and the IBRD in identifying and resolving outstanding issues. The M&E system was the basis for the adjustments made to the Loan Agreement, the CLF III, RCF II, and MLF Policy Manuals, the reallocation of IBRD loan, and the adjustment to the KPIs, including the rating of PDOs and Implementation Progress.

2.3.4 **Methodological "soundness", data quality and M&E sustainability.** The main source of collected data was from financial institutions' accounts that had all been subject to prudent financial management system, internal control and audit. IBRD missions confirmed the reliability and the quality of the collected data. The M&E system will be instrumental for addressing future outstanding issues and allowing appropriate decisions to be made by LBP and the PCFC managements. As long as the wholesale banking operation remains in place, the M&E system will be maintained. LBP and the PCFC, however, may make some adjustments to suit better their future needs. The methodology of the M&E system was sound. It was developed in 1991 when the first Rural Finance Project was initiated, modified during the implementations of the first and the second Rural Finance Projects, and further

modified under the project.

2.4 Safeguard and Fiduciary Compliance

2.4.1 The main fiduciary areas under the project were: (a) environmental safeguard arrangements and their implementation; (b) financial management operations; and (c) the project's procurement activities. All of these areas were regularly reviewed by Bank professionals and found to be generally in compliance with Bank policy and procedures. Minor problems were identified and LBP applied the agreed corrective measures to improve its performance in these areas. The final reviews found that the performance of the LBP's Environmental Program and Management Unit (EPMD) regarding environmental protection remain satisfactory. No significant deviations were found nor waivers required. The environmental procedures introduced under this project and earlier rural finance projects were adopted and mainstreamed into LBP's standard operating procedures. LBP has recently received an award for its environmental efforts. These projects have therefore had a significant positive impact on LBPs environmental policies.

2.4.2 All of the project's procurement was below US$5 million equivalent, the threshold for international competitive bidding. All procurement of goods, works and services financed by CLF III, RCF II and MLF sub-loans were carried out by private entities and, consequently, followed established private sector or commercial practices. No procurement issue was recorded.

2.4.3 The financial management system for the project was audited on an annual basis. Audits of the PCFC and LBP were submitted on time apart from a minor delay in 2006 when LBP switched to international accounting standards, and were satisfactory to the Bank. All audits were unqualified. The project financial management system was reviewed by the IBRD's Financial Management Specialist (FMS) on an annual basis and found to be satisfactory to the IBRD.

2.4.4 Site visits were carried out to a sample of sub-projects that were considered to be high risk in terms of safeguard violations. Implementation of the IBRD safeguard policies was found to be satisfactory.

2.5 Post Completion Operation/ Next Phase

2.5.1 The evaluation of post-completion operations relates to the use of reflows from the CLFIII, RCFII and MLF sub-loans made during the project implementation period. Subject to periodic adjustments, LBP has agreed to retain these funds in revolving fund which it would use under the same terms as established under the project. LBP has satisfactorily managed the reflows from the RFI and RFII projects in this way, so it is expected that they will continue to manage the project's reflows in the same way. The risks to achieving these objectives in the next phase are discussed in Section 4.

3. Assessment and Outcomes

3.1 Relevance of Objectives, Design, and Implementation

3.1.1 The project implementation and outcomes are considered to have been "satisfactory". The project objectives were relevant at the time of appraisal and remained relevant throughout project implementation. Implementation and achievement of development objectives was rated as satisfactory throughout the project apart from one supervision period in 2002. The project was very well managed by the LBP, the primary implementing agency for the project. The project has contributed to sustainable improvements in the management and financial strength of LBP and the PCFC. Project funds on-lent through the CLFIII facilities were used to restructure loans affected by the Asian financial crisis and for new investment loans. As discussed in more detail below, financial and economic rates of return on sub-

project investments was, on average, significantly higher than the lower thresholds established at appraisal, indicating that they provided positive support to the rural economy. The MLF was expanded significantly during project implementation, an indicator of its success in supporting microfinance sub-borrowers.

3.1.2 **Relevance of Objectives.** The PDOs were, and continue to be, important in the Philippines development context. The domestic financial market is well developed to mobilize and lend short-term financial resources but it is still very weak in the mobilization of long-term financial resources. There was, and continues to be, a shortage of term financing for long term investments. Investment projects are mainly financed by short-term loans that are rolled over, exposing borrowers to potential liquidity problems when financial markets tighten. The need to support the rural areas through the financing of new investments, generating more jobs, and supporting the micro-finance system, is still valid. Although the project has officially been completed, the CLF, RCF and the MLF will continue to lend project funds to rural beneficiaries. LBP and the PCFC will have to continue their efforts to strengthen their institutions and improve their financial performance. Furthermore, the CAS of June 2007 clearly stated that "*domestic investment has remained extraordinarily low*". The CLF/RCF medium- and long-term financial resources would be available for financing of private sector investments, thus contributing to the increase of local investments. The CAS also indicates that inequality in the distribution of incomes and overall poverty continues to be high. Through the provision of rural financing, whether for investments or for the poor, the CLF/RCF and the MLF have been and will continue to be instrumental in the generation of new jobs and in the improvement of the well-being of the rural poor, thus contributing to the reduction of poverty and inequality of income distribution.

3.1.3 **Relevance of Design**. The project design was appropriate for achieving the development objectives and played an important role in the success of the project. As anticipated at the start of the project, the apex bank arrangement provided the flexibility to include a broad spectrum of PFIs across all geographic areas of the Philippines. The use of three different funds, the CLF III, RCF II and MLF provided the flexibility to adjust the targeting of project funds to changing economic circumstances during the project implementation period. The use of IDPs to support institutional change at LBP and the PCFC was an important design feature of the project. It was successful in supporting institutional change at these institutions during project implementation and has been internalized into the standard operating procedures of LBP and the PCFC and will thus continue to be used after project implementation is complete. Minor changes were made to the sub-loan approval process in order to streamline procedures. A free-limit was set for PFIs, below which sub-loan approval was not required by LBP. Disbursements for these loans from LBP were made on the basis of a list of loans amounts and uses. This avoided a double approval process that was slowing down disbursements.

3.1.4 **Relevance of Implementation**. Project implementation was very well managed by LBP and was an important factor in the success of the project. The project was well integrated into the day-to-day operations of LBP, having a positive impact on LBP's management and financial situation. The project was managed by an exiting unit of LBP, the Program Lending Group. LBP was flexible in adjusting implementation to the changing economic conditions over the life of the project. It put in place good controls, monitoring systems and on site validation to ensure that sub-project implementation met the objectives of the project. The only issue related to implementation was the slow rate of disbursement, which was driven by factors largely outside the influence of the implementing agency. One external factor was a flawed, government-managed currency swap mechanism that is applied to all CFIs converting foreign currency loans to PhP. This mandatory currency swap mechanism works reasonably well when foreign currency interest rates are higher, but when rates are lower, as they were for 2005 – 2008, an unusual interest rate floor mechanism results in a PhP interest rate derived from US$-based loans that is: (a) higher than the PhP interest rates derived from Yen-based loans; and (b) higher than interest rates from domestic mobilization. A second external factor that affected disbursements was a

large Yen-based bilateral loan of US$500 million equivalent to the DBP, disbursed at 200 basis points below the prevailing market rate. Normally, Philippines Executive Order 138 would prevent this type of interest rate subsidization, but in this case the bilateral agreement overrode the domestic regulation. This created an overhang of cheap credit in the market slowing disbursements under this project. Repeated requests were made by the Bank to the government to address these two issues, but it was unable or unwilling to address them. The result was a slower-than-expected disbursement rate for the Loan. While this required the extension of the project implementation period, if did not have an adverse effect on the development outcome.

3.1.5 Through the implementation of their respective IDPs, the LBP and the PCFC became, during project implementation, much stronger and more viable financial institutions (objective c). There are two areas in which more effort should be made: (a) LBP's lending to small farmers and fisher-folk remains a loss-making operation with relatively high operating costs and low revenue; and (b) the quality of the PCFC's loan portfolio is not as good as it should be: a "past due" rate of 4.2 percent and a Portfolio at Risk (PAR) of 9.4 percent in September 2007 are evidence of weak risk management. Through the accreditation process under the CLF III and MLF, and the follow-up on the performance of accredited PFIs/MFIs, the project helps to enforce financial discipline on these institutions, but as the number of PFIs was much smaller than anticipated at appraisal, it is concluded that this objective (objective d) was only partially achieved. The IBRD did address this problem by allowing conditional accreditation for banks that met most, but not all, of the bank accreditation criteria set by the project. A bank's participation was conditioned on agreeing to implement an IDP that included a time bound action plan for achieving the accreditation criteria.

3.2 Achievement of PDO

3.2.1 The achievement of the project development objectives is considered to have been "satisfactory". By providing LBP and the PFIs with a source of stable long-term financing, the project, in its early years, was instrumental in restructuring short-term loans of viable operations that were distressed as a result of the 1997/1998 financial crisis (objective a). Despite slow disbursements, the project was able to finance rural investments of about PhP11 billion (about US$214 million equivalent), slightly more than the appraisal estimate of US$207 million equivalent, and significantly exceed the required rates of return set for the project. The median FRR was 28 percent, well in excess of the cost of funds. *Ex ante* analysis of Economic Rates of Return (ERRs) for a sample of sub-projects indicates that about 75 percent of those sub-projects had ERRs above 20 percent with a median ERR of 29 percent[3]. The project was also able to generate some 17,000 new jobs (objective a). The MLF tripled its original lending targets (an equivalent of US$15 million), accommodating some 110,000 beneficiaries (objective b). The financial condition of LBP has been strengthened since the start of the project and it has made substantial progress in implementing its IDP (objective (c)). The PCFC has significantly strengthened its financial condition and has been successful at promoting micro-finance lending (objectives (b) & (c)). Through accreditation criteria for PFIs, the project continues to provide a benchmark for financial discipline in those institutions that participated, although the impact of the project on improving the condition of PFIs has been limited (objective (d)).

3.3 Efficiency

3.3.1 The efficiency of financial institutions that carry out a credit project should be measured by their net income and an analysis of the incremental costs associated with the implementation of the credit project. CLF III and RCF II financial statement of September 30, 2007 (completion date) indicate an

[3] It should be noted that under the project a Financial Rate of Return (FRR) had to be calculated for all sub-projects (184) with sub-loans above the equivalent of US$200,000. Likewise, (ERRs had to be calculated for all (40) sub-projects with sub-loans above US$1 million equivalent. Smaller sub-projects were required to have a financial plan, including the sub-project's cash-flow.

accumulated profit[4] of about P1.0 billion which is about 16 percent of total available resources of that date. The incremental costs associated with CLF III/RCF II operation to LBP is minimal as the LBP's Program Lending Group that implements the credit component is managing many other lending program activities. The incremental cost to the PCFC as a result of the MLF operation is also minimal as no additional staff were needed to carry out the MLF. The MLF activities were fully undertaken by the existing PCFC staff. Sub-projects' investment are being carried out by private owners who have direct interest in running them efficiently.

3.3.2 Sub-borrowers' investments have been assessed as being profitable. *Ex ante* [5] analysis of sub-borrowers' FRRs indicates that for those sub-projects for which FRRs were estimated, amounting to about 55 percent of project investments, about 80 percent projected FRRs in excess of 20 percent. The median FRR was about 28 percent, well in excess of the cost of funds. *Ex ante* analysis of sub-projects' ERRs were estimated for 29 percent of all sub-projects required to calculate ERRs. Of these sub-projects about 75 percent had projected ERRs above 20 percent with a median ERR of 29 percent [6].

3.3.3 The PFIs under the project have set interest rates and fees at levels which make project lending profitable to them. This, together with the long maturity of project funds, means that this type of lending, will be sustainable using project resources for more than another ten years, if they remain competitive (see 3.1.2 above). Beyond that, other long-term borrowing from development or commercial institutions, increased capitalization or the issuance of bonds would allow the levels of medium/long- term investment lending initiated under the project to be sustained and expanded.

3.3.4 As of September 30, 2007, total project cost/investment [7] amounted to P11,123 million (US$214 million) [8]. CLF sub borrowers contributed significantly more to investments than the minimum required (24 percent cf. the minimum of 15 percent). This, together with the PFI contribution of 14 percent of the sub-project investment cost (compared to a minimum requirement of 10 percent) helped to leverage Bank funds for CLF III and RCF II well beyond the appraisal estimate (US$1 of Bank loan supported US$1.62 of investment compared to the appraisal estimate of US$1.43). Training and IDPs costs were in line with the appraisal estimate.

3.4 Justification of the Overall Outcome Rating

3.4.1 **Rating.** The project overall outcome rating is considered to have been "satisfactory" for the following reasons: (a) project objectives as reflected in the revised KPIs were generally achieved; the project through its lending operation successfully provided financial support to the rural economy; (b) the project contributed to poverty alleviation through its micro-finance lending, and through CLF III and RCF II lending created about 17,000 incremental jobs; (c) as a result of the project there were positive impacts on the conditions of LBP and the PCFC; and (d) the project and its main features are still relevant. The project performance, however, was not rated "Highly Satisfactory" because of its limited impact on the performance of the PFIs (objective d) and the extended time needed for its completion.

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[4] The Loan Agreement stated that all CLF III profits should be retained in CLF accounts as its equity and would be used to augment the CLF financial resources for the financing of private rural investments.

[5] Because many sub-projects are relatively new, an *ex post* analysis of FRRs and ERRs would be premature at this stage. If resources could be found, an analysis of *ex post* sub-project financial and economic performance would be useful in about four years time, by when most of the sub-projects would be matured.

[6] It should be noted that under the project a FRR had to be calculated for all (about 168) sub-projects with sub-loans above the equivalent of US$200,000. Likewise, ERRs had to be calculated for all (40) sub-projects with sub-loans above US$1 million equivalent. Smaller sub-projects required a financial plan, including sub-project's cash-flow.

[7] Because this is a credit project, costs are mostly induced investments by private entrepreneurs borrowing under the project. The cost figures for the CLF and RCF components represent the value of investments partly (62 percent) financed by project resources.

[8] Weighted average exchange rate for the whole project – found to be about PhP51.92 per US$1 - is higher than the PhP44 per US$1 estimated at appraisal.

3.5 Over-arching Themes, Other Outcomes and Impacts

Poverty Impacts, Gender Aspects and Social Development

3.5.1 As a demand-driven credit project, no specific social objectives were set. The project was not supposed to, and did not, interfere in the target group financial and economic activities and related decisions. The project, through its credit facility, made financial resources available to the sub-borrowers. Sub-borrowers were totally free to determine their investments and whether or not to borrow project funds. Through financing of medium- and long-term rural investments, the CLF III/RCF II generated some 17,000 new jobs. Repayment rates and the strong demand, particularly for micro-finance loans, indicate that the availability of project funds had a positive impact on the sub-borrowers whether they borrowed from CLFIII/RCFII or from the MLF. The MLF contributed to poverty alleviation through its PhP742 million in sub-loans (US$15 million equivalent) disbursed through partner MFIs to finance livelihoods projects of 114,902 new borrowers of whom 92 percent were women. Total sub-loans including reflows amounted to PhP 1,497 million. The average loan size was about PhP13,028 (about US$296 equivalent). As of September 30, 2007, outstanding loans to the 72 active MFI partners amounted to PhP 672 million for 98,342 active borrowers.

Institutional Change and Strengthening

3.5.2 The project was initiated as a response to the negative impact on the Philippine economy and its banking system of the Asian financial crisis of 1997/1998. The negative impact, however, was not restricted to these two years only but lasted much longer. Even today, most of the Philippines' banks are still struggling with high levels of Non-Performing Loans (NPLs) and Non-Performing Assets (NPAs) that resulted from this crisis. LBP has not been an exception to the entire Philippine banking system and it suffered like others from high levels of NPLs and NPAs. The real sector, such as the corporate and SME sectors, have not yet fully recovered from the negative impact of the crisis.

3.5.3 The period 1999 to 2000 was difficult for LBP. Its ratio of "net past due" to equity was as high as 44 percent (1999) and 45 percent (2000), indicating that about half of LBP's equity was at a relatively high risk. Its CAR was only 10.1 percent in 1999 and 10.6 percent in 2000, slightly above the BSP requirement. In 1999, LBP's equity declined by about 7 percent in nominal terms with a real reduction (taking into account the 1999 inflation rate) of 12.6 percent. In this year, LBP was able to make a small nominal profit but a loss in real terms. The Subsidy Dependence Index (SDI) in these two years (1999 and 2000) was 2 percent and 21 percent, respectively, indicating that without the subsidy the financial result would have been even worse. As reflected in selected key performance and other important indicators, the contrast between the financial results of 1999 and 2000 and the LBP's financial performance of 2005, 2006 and 2007 are much more positive. "Net past due" to equity ratio was negative in 2005 (-28 percent), in 2006 (-21 percent) and in 2007 (-16.8 percent), indicating that provisions for loan losses were larger than the volume of loan past due. The CAR was 14 percent in 2005, 17 percent in 2006 and 14.9 percent in 2007. The SDI was negative (- 47 percent in 2005, - 33 percent in 2006 and - 36 percent in the first 9 months of 2007), indicating that LBP was a subsidy-free institution. More details are provided in Table 5 of Annex 2.

3.5.4 The PCFC continues to make progress in meeting its KPIs and other important financial indicators (Table 7 of Annex 2). It has become a much stronger financial institution than it was in 2002. The PCFC's equity has increased from PhP1.1 billion in 2002 to about PhP1.3 billion at the end of 2006, all from retained earnings. Total resources more than doubled between 2000 and 2006, reaching total assets of PhP3.5 billion in 2006. As a result, the PCFC's lending operation more than doubled from PhP1 billion in 2000 to over PhP3 billion at the end of 2006. Its operating cost as a percentage of average outstanding loans was significantly reduced, from 12 percent in 2000 to about 3 percent in 2006, and 2.4 percent at the project's completion date. This is, however, still inadequate for a wholesale

operation and the PCFC will have to reduce its operating cost further, through streamlining its operation and/or increasing its lending volume.

3.5.5 Collection rates are at a level of 98 percent, which is considered to be satisfactory. To ensure the quality of its assets, the PCFC has made adequate provisions for loan losses which as of 2006 year end fully cover its PAR and NPLs, resulting in an improvement of the quality of its assets. As of September 30, 2007, the PCFC past dues was recorded to be 4.2 percent and its PAR (measured as the balances of loans with past due over 30 days/outstanding loans) was 9.4 percent, (against a target of 5 percent maximum). This is quite high for a wholesale banking operation, and the PCFC will have to deal with this issue more seriously in the near future.

Unintended Outcomes and Impacts

3.5.6 There were no unintended outcomes.

3.6 Summary of Findings of Beneficiary Survey and/or Stakeholder Workshops

3.6.1 No official survey of beneficiaries took place. However, during project implementation LBP and the PCFC staff as well as Bank missions visited sub-borrowers. Overall, beneficiaries were happy with funds availability, particularly with its long maturity periods. There were, however, complaints regarding high interest rates, the need to submit many complicated documents such as financial plans and cash flows (which some of the sub-borrowers were unable to prepare on their own and had to use highly-paid consultants), and that it took too much time to get loan approval. The main complaint was related to the necessity of obtaining environmental clearances. The Bank and LBP did address the issue of processing time through setting a free limit for PFIs to disburse on the basis of a statement of expenditure, thus speeding up loan approvals. Interest rates were market based and no design change was made – high interest rates are a universal complaint of borrowers. Financing plans, cash flows and environmental clearances were deemed to be necessary for prudent lending and no changes were made.

3.6.2 Several meetings/workshops with PFIs were separately undertaken by LBP and Bank missions. Usually two sets of meetings took place on each mission, one with Commercial Banks and the large TBs, and one with the Countryside Financial Institutions (CFIs) which includes the RBs and rural TBs. Also, there were cases in which LBP staff or Bank missions met with individual banks to discuss matters related to accreditation and operational procedures.

3.6.3 As a result of these meetings with sub-borrowers and PFIs, LBP took actions to streamline its operation and simplify procedures and requirements; accreditation criteria were modified and the CLF III Policy Manual was amended to reflect all these changes.

4. Assessment of Risk to Development Outcomes

4.1.1 It is in the best interests of LBP, and LBP is committed, to continue to manage reflow funds under CLFIII and RCFII in the most efficient and effective manner possible. One risk to continued operation of these facilities is the cost differential between PhP interest rates derived from US$-based loans and the cost of domestic mobilization of PhP funds. Since 2005, PhP interest rates for domestically-raised short-term funds have been lower than PhP interest rates from the government-sponsored PhP-US$ swap arrangement used by Government Financial Institutions (GFIs) to convert US$-based loans from IFIs to PhP-based loans. Another risk is that the government sponsored PhP-Yen swap has a lower floor price than the PhP-US$ swap creating a risk that a large Yen loan in the Philippines banking sector could create an overhang of cheaper credit that would crowed out US$-based PhP loans. However, for longer-term funds the PhP rates derived from US$-based loans are still competitive and the long-term nature of the IBRD loan is attractive to LPB to reduce its maturity

mismatch. Therefore, it is unlikely that there will be prepayment of the IBRD loan and it is expected that the project funds will continue to be used in a sustainable fashion.

5. Assessment of Bank and Borrower Performance

5.1 Bank Performance

5.1.1 Overall, the Bank's performance is assessed as "satisfactory" throughout preparation, appraisal and implementation.

Bank Performance in Ensuring Quality at Entry

5.1.2 The Bank's performance in ensuring quality at entry is rated as "satisfactory". The main elements of project design, its procedures, PFI accreditation criteria, the Fund's policy manuals, and the proposed IDPs for LBP and the PCFC were carefully reviewed by Bank staff, peer reviewers and management. The team took appropriate account of lessons learned under the earlier Rural Finance Projects. The appraisal process was relatively smooth and rapid. The time period from Board approval (in December 1998) to negotiations, loan signing and effectiveness were quite reasonable and the loan became effective in May 1999. The QAG's rating on the project's quality at entry was "satisfactory".

Quality of Supervision

5.1.3 The Bank's performance in supervising the project is assessed as having been "satisfactory". Following loan effectiveness, the Bank mounted supervision missions once or twice a year. Most supervision missions were staffed by a financial analyst and a financial/agricultural economist, with additional support, on several occasions, by a micro-finance, financial management, procurement, disbursement and environmental specialists. The supervision missions worked closely with LBP on resolving problems concerned with the credit lines, including amending the Loan Agreement to increase the size of the RCF II, amending the CLF III Policy Manual to remove accreditation and procedures obstacles, and adjusting the KPIs to address the new challenges. They also participated in the review and up-dating of the IDP and its related KPIs, helped fine-tune policies to ensure adequate provisioning for agrarian loan losses, NPLs and NPAs, and maintained a dialogue with the government to ensure that the specific covenants that protected LBP's financial strength were met. The Bank was responsive to project outstanding issues and adopted a pro-active approach to problem-solving, particularly on the IDPs.

5.1.4 While the supervision performance of the IBRD is considered to have been satisfactory, the number of supervision missions was fewer than optimal because of budget constraints. To resolve issues in a more timely fashion missions should have been held twice per year and in some cases more frequently. This was particularly true in 2001, 2002 and perhaps 2003. It is quite likely that with more Bank inputs, project implementation could have been shorter than the eight years (since effectiveness) and with better results.

5.1.5 There were several meetings during the course of the project with the Department of Finance (DOF) to discuss possible changes to the interest rate setting mechanism. This project did not have sufficient leverage to induce the required changes, nor were these issues the subject of any condition attached to the Loan. The Bank's Finance Department has prepared a report, completed in 2006, making recommendations on possible changes that the DOF should make. The Bank's approach to this problem has been to try to improve this mechanism through higher-level dialogue with the government, rather than to try and institute change using this investment operation. No changes have yet been made. It seems, however, that the Bank, as a strong institution and an important donor, did not fully exercise its

power to influence the government and JBIC to take the necessary actions, at the early stage of project implementation, to resolve the problem caused by the subsidized lending rate of DBP/JBIC program.

Justification of Rating for Overall Bank Performance

5.1.6 Overall, the Bank's performance is considered to have been "satisfactory" throughout preparation, appraisal and implementation for the following reasons: (a) the appraisal was completed in a reasonable period of time, and was of satisfactory quality; (b) the initial design of the project was robust, worked well during implementation and did not require any major changes; and (c) project supervision had sufficient numbers of staff with the required skills being deployed on supervision missions. Supervision missions were responsive to problems that arose during implementation, making minor adjustments to the project to increase its effectiveness.

5.2 Borrower Performance

Government Performance

5.2.1 The government's performance with regard to the project is rated as having been "unsatisfactory". The government was the guarantor of the Bank's loan, but was also responsible for maintaining a healthy financial environment particularly among the GFIs. It failed to satisfactorily resolve the negative impact of the subsidized wholesale lending of DBP/JBIC and contradicted its own Executive Order (EO) 138 when it approved the DBP/JBIC subsidized loan. This undercut the lending rates stipulated by the Bank's Loan Agreement, which required that funds be on-lent at the Weighted Average Interest Rate (WAIR) of 91-day Treasury Bills, in accordance with the Philippines EO 138. EO 138 requires that all government funds to financial institutions be on-lent at the WAIR of 91 day Treasury Bills as a reflection of the prevailing market rates. Furthermore, the government failed to resolve the inconsistency between the floor on the government currency swap rate for PhP derived from US$-based loans and the floor on the currency swap rate for PhP derived from Yen-based loans. The result was that when international interest rates dropped to low levels the wholesale borrowing rate in PhP was lower for Yen-derived loans than it was for US$-derived loans.

5.2.2 The LBP's selection of the Bank's US$ floating rate loan for the project was not done without DOF guidance. It is reasonable that DOF would balance State liabilities among the various foreign currencies by suggesting that LBP would borrow in US$ while other GFIs may borrow in Yen or other currencies. Currently, the government is bearing the foreign exchange risk of all IFI lending. To ensure a "level playing-field" for competition between GFIs' wholesale operations, DOF should have taken the necessary actions to ensure that all wholesale lending floor prices[9] were the same level regardless of the original currency borrowed. DOF did not do this.

Implementing Agency Performance

5.2.3 The performance of the LBP (the Borrower) was "satisfactory". The LBP performed well in carrying out the CLF III and RCF II credit operations, financing the MLF, and the design and implementation of its IDP.

[9] The floor price is being determined by the nominal interest rate for the foreign currency plus a guarantee fee of 100 basis points plus taxes (GRT) plus a spread to the lender.

5.2.4 For most of the project implementation period, disbursements were slower than expected mainly because of DBP's wholesale lending program (JBIC-financed) which undercut the pricing of the CLF III by providing funds at 200 basis points below the market rate. Later in the project period, the liquidity in the Philippine banking system increased, reducing the cost of domestic fund mobilization significantly below the cost of this CLF III and RCF II, thus reducing demand for the funds. Despite these hurdles, the LBP managed to on-lend almost all of the funds (except US$2.5 million which was cancelled at the request of LBP).

5.2.5 The LBP has considerably strengthened its financial position and made substantial progress in carrying out its IDP, particularly increasing equity in real terms, sustaining its profitability in real terms, improving the quality of its loan portfolio, reducing its NPL and NPA volumes, increasing substantially the provisions to cover losses, expanding its lending to small farmers and priority sectors, and further improving its SDI. One area where LBP was not successful in implementing its IDP was in its efforts to make its lending to small farmers profitable. For this line of business, operating costs as a percent of lending remain too high and the related income remains too low. However, this is a relatively small share of its business and cross subsidization of this business line from more lucrative business lines has some political rationale.

5.2.6 Private deposits have grown at about 11 percent per year in recent years as a result of the LBP's efforts. However, even more effort will be required in this area in the future to alter the balance between government and private deposits. Also, LBP has fully complied with all the three financial covenants set in the Loan Agreement under the project.

5.2.7 Apart from the LBP, the Borrower of the IBRD loan and the main implementing agency of the project, the PCFC successfully carried out the project's MLF and its own IDP. The performance of the PCFC under the project is rated as having been "satisfactory".

5.2.8 In terms of its credit KPIs, the PCFC performed well, meeting almost all of them. The PCFC increased its MLF lending volume to three times the appraisal estimate, from US$5 million equivalent to US$15 million equivalent. As a result, the project considerably increased its contribution to poverty alleviation in the Philippines. MLF lending volume at the completion date was about PhP742 million, accommodating about 114,902 beneficiaries. MLF financial resources have been channeled through 72 accredited MFIs of different types (NGOs, rural banks, thrift banks, cooperatives and cooperative rural banks) scattered over 80 provinces with a presence in all the country's regions, showing good distribution by institution type and by location. The average loan size was about PhP13,028 (US$296 equivalent) and 92 percent of project beneficiaries were women.

5.2.9 There were 72 active MLFs at the end of the project. The MLF's loan collection rate from these 72 MFIs to the PCFC was reported to be 98.75 percent. Loan collection rates from MLF's sub-borrowers to their related MFIs are reported to be generally good. Some 63 out of the 72 MFIs reported loan collection rates of over 90 percent, nine MFIs had loan collection rates of below 90 percent, and four of these MFIs had loan collection rates of below 80 percent (but above 70 percent). The PCFC will have to carefully review the performance of these nine MFIs. Based on this review, the PCFC's actions to safeguard itself and the MLF are needed.

5.2.10 The PCFC continues to make progress in meeting its institutional KPIs and other important financial indicators. It has become a much stronger financial institution than it was in 2002. During project implementation, the PCFC was able to increase substantially the number of its accredited MFIs from 87 in 1998 to about 200 in 2005, 202 in 2006, and 199 at completion date (September 30, 2007) (only 72 of these were actively participating as MFIs under this project). The PCFC's equity has increased from P1.1 in 2002 to above P1.3 billion at the project completion date, all from retained earnings. Total resources more than doubled between 2000 and September 2007, reaching total assets of

P3.5 billion at completion. As a result, the PCFC's lending operation increased almost three-fold from P1 billion in 2000 to over P2.9 billion at project completion date. Its operating cost as a percentage of average outstanding loans has been reduced significantly, from 12 percent in 2000 to about 2.4 percent in 2007. This is, however, still inadequate for a wholesale operation and the PCFC will have to reduce its operating cost further through streamlining its operation and increasing its lending volume.

5.2.11 Collection rates are at a level of 98 percent, which is considered to be satisfactory. To ensure the quality of its assets, the PCFC has made adequate provisions for loan losses, which as of September 30, 2007 cover about 90 percent of its PAR and NPLs. As of September 30, 2007, the PCFC overall past due rate was 4.1 percent and its PAR (measured as the balances of loans with past dues over 30 days divided by its outstanding loans) was 9.4 percent against a target of 5 percent maximum). This is quite high for a wholesale banking operation, and the PCFC will have to deal with this issue more seriously in the near future.

Justification of Rating for Overall Borrower Performance

5.2.12 The overall Borrower's performance is rated as "moderately satisfactory". The Borrower and implementing agency, LBP, and the PCFC, an implementing agency, performed well in implementing the project's components. However, the government's "unsatisfactory" performance brought down the overall rating. As a result of the great efforts made by the LBP and the PCFC, the project achieved its objectives although with a longer disbursement period than was envisaged at appraisal.

6. Lessons Learned

6.1.1 The generally successful project outcome underlines a number of positive experiences on which to draw the lessons learned when implementing credit projects in countries with a diverse banking system.

- Using a sound wholesale financial institution with a strong accreditation unit to appraise PFIs, rather than having the Bank review each one, can work satisfactorily in a system where there are many potential PFIs.
- This type of project is a suitable mechanism for disbursing a relatively large number of loans quickly to the private sector without placing much burden on government.
- Strong financial institutions with qualified and experienced management and staff at headquarters, branches and field offices, are crucial to project success.

6.1.2 There are two major points that should be addressed in future when implementing credit projects in which IFIs provide financing and the government assumes the foreign exchange risk. These are: (a) a domestic market interest rate should be applied; (b) in case the prevailing domestic market rate is below the cost of borrowing IFIs funds and, as a result, floor lending rates are used, a mechanism should be in place to ensure that these floor lending rates, excluding the lenders' margin, will be the same to all IFIs in a given country, regardless of the currency borrowed.

6.1.3 Other lessons that emerge from the review of the project are:

(a) Due to the volatility of interest rates it is necessary to shorten the period in which the market reference rate is being applied from once a month to a bi-weekly or even a weekly basis; this would reflect better the market rates and trends;
(b) To enable more banks to participate in the project, the PFIs accreditation criteria (and particularly the cut-off points) need to be periodically reviewed and adjusted to market conditions, and conditional accreditation procedures together with adequate action plans should be introduced at

the design stage; and

(c) To streamline a project's lending procedures and fund flows, a "free limit" procedure should be introduced at the onset of a credit project.

7. Comments on Issues Raised by Borrower/Implementing Agencies/Partners

(a) Borrower/Implementing Agencies

7.1.1 Detailed editorial comments on the draft ICR were received and these proposed changes have been incorporated into the text. General comments are attached in Annex 8.

(b) Co-financiers

7.1.2 Co-financiers of sub-projects' investment cost were LBP, PFIs, MFIs and sub-borrowers. Their comments were discussed under Section 3.6, above.

(c) Other Partners and Stakeholders

7.1.3 Apart from the comments made by PFIs and sub-borrowers (discussed under Section 3.6), no comments have been received from the project's partners and stakeholders.

Annex 1. Project Cost and Financing

Table 1. Project Cost and Financing (US$ million)

	Appraisal						Actual					
Financiers/ Components	**LBP**	**PCFC**	**SBs**	**PFIs/ MFIs**	**WB**	**Total**	**LBP**	**PCFC**	**SBs**	**PFIs/ MFIs**	**WB**	**Total**
CLF/RCF			41.4	20.7	145.0	**207.1**			51.1	30.7	132.5	**214.3**
MLF			1.0	0.7	5.0	**6.7**			2.0	1.0	15.0	**18.0**
Total Credit						**213.8**						**232.3**
LBP-IDP	2.0					**2.0**	2.2					**2.2**
PCFC-IDP		0.3				**0.3**		0.5				**0.5**
Total IDP	2.0	0.3				**2.3**	2.2	0.5				**2.7**
Grand Total	**2.0**	**0.3**	**42.4**	**21.4**	**150.0**	**216.1**	**2.2**	**0.5**	**53.1**	**31.7**	**147.5**	**235.0**

1. The increase of actual project cost/investment under CLF/RCF (component 1), is mainly due to the increase of sub-borrowers and PFIs contributions in financing sub-projects' investment cost. As can be seen from Table 1, sub-borrowers and PFIs each increased their participation by about US$10 million equivalent. To reduce their credit risk, PFIs requested sub-borrowers to increase their share in financing their sub-projects/ investments. It is likely that PFIs share was increased because of their excess liquidity and because the cost of their internal funds were lower than the US$-based loans provided by the CLF III and RCF II. By increasing their financing shares, sub-borrowers and PFIs increased the leverage of the Bank's Loan funds. One US$ of Bank loan generated US$1.62 in investments; compared with the appraisal estimate of leverage of 1.43.

2. Investment under the MLF was substantially increased from US$6.7 million to US$18 million equivalent, mainly because of much larger demand than the one estimated at appraisal time. The larger demand was met by the reallocation of Bank loan of US$10 million from CLF III to the MLF, bringing the total Bank financing of the MLF to US$15 million equivalent.

3. LBP and the PCFC cost were slightly increased, mainly on their staff training, and training of PFIs/MFIs staff on project's features and related procedures, environmental matters, and financial management requirement.

Annex 2. Outputs by Components

Performance of Credit Lines

Component 1. Lending through LBP

1. Project lending through LBP was carried out under the CLF III that used wholesale lending through PFIs and the RCF II which was used by LBP to on-lend to its retail clients.

The revised (as of 2004) KPIs, actual achievements and percentage of accomplishment are presented in Table 1.

Table 1: Credit Key Indicators.

Component 1: Lending through LBP		**Target at Completion**	**Actual at Completion** (September 30, 2007)	**Accomplishment** (%)
1	**No. of sub-loans CLFIII and RCF II** (cumulative)	600	546	91
2	**Sub-projects Investments** (PhP million, cumulative)	8,500	11,123	131
3	**Maximum CLF past due ratio** (%)	2.50	0.95	Positive
4	**CLF III & RCF II Incremental Jobs Created** (cumulative)	13,500	16,960	126

2. Total Investments Generated. Total investment generated by the project under CLF III and RCF II as of September 30, 2007 amounted to about PhP11.123 billion (about US$214 million equivalent). Under CLF III the PFI and sub-borrower contribution was 35 percent while for RCF it was 44 percent thus meeting the minimum target for this requirement of at least 25 percent.

3. Distribution of Sub-Loans by Sector and Use. The distribution of sub-loans by sector is as expected and does not indicate any unfavorable bias. For the CLF the service sector was the leading user of funds with about 36 percent of the amount lent, agriculture and aquaculture sector ranked second with 18 percent, followed by agro-processing and food with 15 percent. The rest of the funds financed the following sectors: trading 13 percent, manufacturing 11 percent, and tourism and property development at about 7 percent. For the RCF the service sector was also the leading user of funds with about 33 percent of the amount lent, agriculture and aquaculture sector ranked second with 23 percent, followed by trading 13 percent, agro-processing and food with 10 percent, manufacturing 9 percent, and tourism and property development at about 11 percent.

4. Fixed Assets *vs*. Working Capital Finance. For CLF III, the share of the volume of sub-loans for purely fixed asset investment was 41 percent, for purely working capital 38 percent and for a combination of fixed asset and working capital was 21 percent. Under the RCF II the share of the volume of sub-loans for purely fixed asset investment is 74 percent, for purely working capital is 21.6 percent and for a combination of fixed asset and working capital was 4.5 percent.

5. Distribution of Loans by Firm Size. While the project objective does not have a specific objective to support Micro & SMEs (MSMEs) exclusively, it was mentioned in the discussion of the objectives in the PAD as one of the priority target areas. The SME market in the Philippines has been underserved, and growth in this area is known to generate more jobs per dollar of investment than other sub-sectors. The project has tried to encourage lending to this segment of the market. The project financed Micro,

SMEs, and large sub-borrowers [10] as follow:

Table 2: Distribution of Loans by Firm Asset Size

	CLF III					RCF II				
	Micro	**Small**	**Med**	**Large**	**Total**	**Micro**	**Small**	**Med**	**Large**	**Total**
No. of sub-projects (SPs)	44	86	123	90	343	12	54	107	30	203
Percent of total SPs	13	25	36	26	100	6	26	53	15	100
Sub-loans amounts (PhP million)	191	318.5	1,275	3,240	5,024.5	21	155	1,011	668	1,855
Percent of total sub-loans amounts	4	6	25	65	100	1	8	55	36	100

6. The RCF II performed significantly better in this respect, providing about 64 percent of its loan funds to MSMEs. CLF III provided only 35 percent, with the balance going to large enterprises. This sharp contrast reflects: (a) LBP's better outreach to small borrowers in rural areas; (b) about 44 percent of the PFIs executing the CLF III are large commercial banks which concentrate on large borrowers and consider SMEs to be risky; (c) lending through rural banks, which would be a natural conduit for lending to MSMEs, has been limited by the inability of these banks to meet the project's accreditation criteria and excess liquidity in well performing rural banks. The project has allowed conditional accreditation of banks and has increased the free limit on prior approval of sub-loans made by PFI, but these had no impact on increase the number of PFIs. Average loan size under the project for CLF III was PhP14.6 million (about US$ 280,000)[11] for RCF was PhP9.1 million (about US$175,000). This excludes loans to MLF.

7. Portfolio Performance of PFIs. There are 32 PFIs currently accredited by LBP to borrow under CLFIII. At project closing on September 30, 2007 there were 20 PFIs actively borrowing. One PFI failed to meet its payments to LBP during the project resulting in the provisioning and probably write-off of PhP17.25 million. None of the other PFIs had past due loans to LBP at the end of the project. However, some of the PFIs had past dues from sub-borrowers. Based on the PFIs' quarterly progress report on CLF III sub-loans dated September 30, 2007, the past due to PFIs from sub-borrowers was slightly over PhP95 million or about 10 percent of total outstanding CLF III sub-loans. One commercial bank, two thrift banks and one non-bank PFI have these past due accounts; 14 PFIs recorded no past dues.

8. Compliance with On-lending Terms and Conditions for Sub-loans**.** During project implementation period Bank missions visited selected projects. These were randomly selected after categorizing project by expected risk (particularly environmental compliance). The high risk category was sampled at a higher rate. Generally, it was found that in most cases the required information and supporting documents were in place. There were clear indications that staff of the Wholesale Lending Department and Lending Centers have been carrying out appropriate due diligence, including field visits, to verify the information from the sub-borrowers. This includes checks on the reported incremental employment generated under each sub-project financed and environmental compliance.

[10] Micro enterprises are defined as enterprises with total assets of up to PhP3 million (about US$50,000); small enterprises are defined as those with total assets excluding land of more than PhP3 million but up to PhP15 million (about US$290,000); medium-sized enterprises are defined as those with total assets excluding land of more than PhP15 million but up to PhP100 million (about US$1.9 million).

[11] Applying the project a weighted average exchange rate of PhP51.92=US$1.00.

Component 2. Micro-finance Loan Fund (MLF)

Table 3: MLF Credit Key Performance Indicators

	MLF Credit Indicators	Project Completion Target	Actual (September 30, 2007)	Percent of Target Accomplished
1	**No. of MLF sub-loans (cumulative) ***	110,000	114,902	105
2	**MLF Volume of sub-loans incl. reflow (PhP million)**	617	1,497	243
3	**Max percent of MLF past due loans**	2.5	0.1	Positive

* The project target has been adjusted upward to reflect increased funding allocation

9. In terms of its credit KPIs, the PCFC's performance under the MLF is considered to be satisfactory. Almost all KPI targets were fully met (see Table 3). The disbursed amount of US$15 million equivalent including its reflow has been used by the PCFC to fund 114,902 sub-borrowers, more than six times the PAD target of 17,250 and about 104 percent of the modified target; MLF sub-loans made was about PhP 1.497 million or about 243 percent of a target of PhP617 million; MLF past due loans (MFIs to the PCFC) was recorded at 0.1 percent, much better than the target of maximum 2.5 percent.

10. The MLF funds of about PhP672 million have been channeled through 72 accredited MFIs of different types (see Table 4) scattered over 80 provinces with a presence in all the country's regions, showing good distribution by institution type and by location. The average size of loan for sub-borrowers was PhP13,028 (US$296), showing broad based distribution at the sub-borrower level.

Table 4: MLF Lending Distribution among MFIs Types (as of 09/30/07)

Type of MFI	No. of MFIs	No. of SBs	Outstanding balance September 30, 2007 (PhP'000)
Cooperatives	19	12,525	102,400
NGOs	22	30,076	299,255
Rural & Thrift Banks	25	56,862	205,040
Coop Banks	6	9,157	65,027
Total	72	108,620	671,723

Institutional Strengthening Components

Component 3: LBP

11. The LBP has strengthened its financial position considerably and made substantial progress in the implementation of its IDP, particularly increasing equity in real terms, improving the quality of its loan portfolio, reducing its Non Performing Loans (NPLs) and Non Performing Assets (NPAs) volumes, increasing substantially provisions to cover losses, expanding its lending to small farmers and priority sectors, and further improving its SDI. Private deposits have grown at about 20 percent per year in recent years. However, even more effort will be required in this area in the future to alter the balance between government and private deposits. Also, LBP has complied with all three of the financial covenants set in the Loan Agreement under the project.

12. The project was initiated as a response to the negative impact on the Philippine economy and its

banking system of the Asian financial crisis that took place in the second half of 1997 and in 1998. The negative impact, however, was not limited to these two years only but lasted much longer. Even today most of the Philippines' banks are still struggling with high level of NPLs and NPAs that resulted from this crisis. LBP has not been an exception to the entire Philippine banking system and it suffered like others from high levels of NPLs and NPAs.

13. The period 1999 to 2000 was difficult for LBP. Its net past due to equity ratio was as high as 44 percent and 45 percent, respectively, indicating that about half of LBP's equity was at a relatively high risk. Its Capital Adequacy Ratio (CAR) was only 10.1 percent in 1999 and 10.6 percent in 2000, slightly above the BSP requirement. In 1999, LBP's equity declined by about 7 percent in nominal terms with a real reduction of 12.6 percent (taking into account the 1999 inflation rate). In this year, LBP was able to make a small nominal profit but a loss in real terms. The Subsidy Dependence Index (SDI) in these two years (1999 and 2000) was 2 percent and 21 percent, respectively, indicating that without the subsidy the financial result would have been even worse. As reflected in selected key performance and other important indicators, the contrasts between the financial results of 1999 and 2000 and the LBP's financial performance of 2005 and 2006 are much more positive as can be seen in Table 5.

Table 5: LBP's Financial Highlight Ratios and Figures

	1999	2000	2005	2006	September 2007
Total loan Portfolio (Peso Billion)	106.7	108.8	121.5	120.4	119.2
Net Past Due/Equity (%)	44	45	-28	-21	-16.8
Net NPA/Equity (%)	109	138	33	20	18.2
NPA Coverage ratio[12] (%)	46	39	74	73	73.6
Equity growth (%)	-7	16	18	36	17.1[13]
Real Growth of Equity (%)	-13	11.5	9.5	28	14
Nominal Profit (P M)	627	509	3,019	3,531	4,218
Real Profit (P M)	-150	51	1,810	2,281	3,541
Real Return on Equity (%)	-1	0.4	8.64	9.24	11.95
Capital Adequacy Ratio (%)	10.0	11.0	14	20	14.9
SDI (LBP)[14] (%)	2	21	-47	-33	-36
Agrarian credit SDI (%)	137	114	92	5	34

14. LBP became one of the largest banks in the Philippines. With total assets of PhP360.8 billion by the end of 2006, LBP was ranked third in terms of total assets of the industry[15], fourth in terms of outstanding net loans, third in terms of deposits and fourth in terms of equity.

15. **Priority Sectors**. In 2006, lending to LBP's priority sectors[16] has increased to a level of PhP82.6 billion or 68 percent of total outstanding loans. LBP lending to priority sectors started in 2000 with a

[12] NPA coverage by provision for losses.
[13] Equity real growth of 17.1 percent is in relation to the equity amount of September 30, 2006 (PhP29,640 million). The real growth against the December 31, 2006 equity was only 0.4 percent.
[14] Subsidy Dependence Index of Land Bank of the Philippines
[15] The 'industry' includes all universal, commercial and foreign banks operating in the Philippines.
[16] Priority sectors comprise: (a) farmers and fishermen, 14 percent of total LBP loan portfolio of 2006 or PhP17.4 billion; (b) SMEs and micro enterprises, 16 percent or PhP19 billion; (c) livelihood loans, 2 percent or PhP2.1 billion; (d) agri-business, 12 percent or PhP14.2 billion; (e) agri-infrastructure (LGUs), 12 percent or PhP14.7 billion; (f) agri-related projects, 10 percent or PhP12.5 billion; and (g) environment related projects, 2 percent or PhP2.6 billion.

balance of PhP39.1 billion or 37 percent of 2000 outstanding loans. Since then LBP has steadily increased its lending to these sectors. The target of 65 percent as set by LBP was achieved in 2005 with a balance of PhP80.3 billion.

16. **Profitability.** LBP had a Return on Equity (ROE) of 14.4 percent and 14.3 percent at the end of 2005 and 2006, respectively. LBP continued to be above industry level of 7.6 percent at the end of 2006. Its ROE in real terms was 8.64 percent in 2005 and 9.25 percent in 2006. Since 2002, LBP's SDI was negative (ranging from -6.4 percent in 2002 to -32.6 percent in 2006), indicating that since 2002 LBP was a subsidy-free financial institution.

17. **Asset Quality:** The quality of LBP's assets is continuously improving. LBP's net NPA (NPA minus provisions) was in 2003 PhP21.9 billion, in 2004 it was slightly reduced to PhP19.3 billion, in 2005 it was significantly reduced to PhP8.2 billion, and in 2006 it was further reduced to PhP6.7 billion. LBP accounts for nearly 7.5 percent to 8 percent of the industry total NPAs[17]. Due to LBP's prudent policy regarding provision for losses, its NPA coverage ratio was in 2006 about 73 percent compared with 40 percent for the industry.

Table 6: LBP's Agrarian Lending Costs

	2001	2002	2003	2004	2005	2006	2007
Net agrarian outstanding loans (P M)	9,619	9,403	9,759	11,650	14,053	15,231	15,742
Agrarian operating costs (P M)	866	878	910	423	1,707	1,306	1,257
Operating costs as a percent of Av. Loans (%)	9.0	9.3	9.3	3.6	12.2	8.6	8
Cost of necessary provision (%)	7.6	3.	2.4	2.2	0.7	-2.2	1.3
Effective cost of funds (%)	9.9	5.5	6.4	7.3	6.4	5.4	3.7
Total cost as a percent of net loans (%)	26.5	18.7	18.1	13.1	19.2	11.8	12.9
Effective interest rate collected (%)	9.8	8.6	8.4	8.9	10.0	11.2	9.7
Incremental interest needed to break even (%)	16.7	10.2	9.7	4.2	9.2	0.6	3.2
Agrarian SDI (%)	170	119	116	47	92	5	34

18. **Agrarian Sector Performance**. Nominal operating costs of agrarian lending operation decreased from PhP1.7 billion in 2005 to PhP1.3 billion in 2006 and about the same in the first nine months of 2007. Despite LBP's efforts, agrarian lending continues to be a loss-making operation and its actual losses are being absorbed or subsidized by other LBP profit center units (see Table 6).

19. **Capital Adequacy Ratio (CAR**): LBP's Capital Adequacy was 16.8 percent at the end of 2006; though above the 10 percent BSP requirement, it was slightly lower than the industry average of about 17 percent. LBP estimates that the requirements to adhere to the Basel II standards by July 1, 2007, will decrease its CAR from the current 17 percent to about 13 percent to 14 percent. If LBP is to continue to grow, expand its financial resources and lending operation, a further capital increase will be needed.

20. **Private deposits** accounts for about PhP80 billion or 34 percent of LBP's total deposits in 2006. This figure indicates the progress made by LBP in this important area. Despite the steady growth of private deposits, the share of 34 percent is more or less unchanged. This is because government deposits in LBP are also increasing at about the same rate as the private deposits do.

[17] NPA includes all Non Performing Loans (NPLs) and all Real and Other Properties Acquired (ROPA).

Component 4: The PCFC's Institutional Strengthening Component

Table 7: The PCFC's Institutional KPIs and Other Important Indicators

Institutional Develop. Indicators	Targets at completion	Actual 09/07	Actual 12/06	Actual 12/05	Actual 12/04	Actual 12/03	Actual 12/02	Actual 12/01	Actual 12/00
Net loan bal. (P M)	N/A	2,695	3,102.2	2,971.9	2,753.2	2,457.0	1,963.0	1,346.5	1,029.6
Operating Cost ratio[18] (%)	4.5	2.4	3.23	3.59	4.23	3.67	5.38	8.0	12.6
Operating Cost/Av EAs (%)	N/A	1.96	2.99	3.35 Per	3.8	3.03	3.99	5.55	8.0
Past Due Rate[19] (%)	2.5	4.2	2.5	2.9	1.6	1.6	3.8	3.2	2.27
PAR [20] (%)	5	9.4	6	7.1	3.2	4.3	10.6	18.3	17.8
Collection Rate (%)	N/A	95.6	98.6	98.8	99.9	99.5	98.5	98.7	98.4
Real Profit[21] (%)	3.5	2.9	0.7	(1.6)	(1.3)	(1.9)	(0.8)	(3.0)	(3.42)
CAR (%)	14	48.2	41.9	42.5	43.0	45.7	54.2	74.6	91.4
NPD to Equity[22] (%)	15	(9.3)	1.1	3.5	2.4	1.9	3.3	1.8	1.7
Fin. Self Suff.[23] (%)	100	113	98.5	86	80.2	85.2	90.6	68.3	63.9
SDI (%)	N/A	2.6	(20.6)	2.83	53.8	61.4	19	51	72
T bills rate (%)	N/A	3.77	5.35	6.36	7.34	6.03	5.5	9.87	9.86
Inflation Rate (%)	N/A	3.55	6.24	7.63	5.98	3.45	3.0	6.8	4.39

21. The PCFC continues to make progress in meeting its Key Performance and other important financial Indicators (see Table 7, above). It has become a much stronger financial institution than it was in 2002. The PCFC's equity has increased from PhP1.1 billion in 2002 to about PhP1.3 billion at the end of 2006, all from retained earnings. Total resources more than doubled between 2000 and 2006, reaching total assets of PhP3.5 billion in 2006. As a result, the PCFC's lending operation increased three-fold from PhP1 billion in 2000 to over PhP3 billion at the end of 2006. Its operating cost as a percentage of average outstanding loans or average earning assets has been reduced significantly, from 12 percent in 2000 to about 3 percent in 2006. This is, however, still inadequate for a wholesale operation and the PCFC will have to further reduce its operating cost through streamlining its operation and/or increasing its lending volume.

22. Collection rates was recorded at 98 percent and considered to be satisfactory. The PCFC made adequate provisions for loan losses which as of 2006 year end fully cover its Portfolio At Risk

[18] Operating cost/average outstanding loans
[19] (Past due loans + items in litigation)/outstanding loan balance
[20] Portfolio at risk (PAR): balances of accounts with past due over 30 days/outstanding loan balance
[21] Profit in real terms = nominal net profit at the end of the year - [(equity at the beginning of the year – Net Fixed Assets at the beginning of the year) x annual inflation rate]
[22] Net Past Due to Equity Ratio
[23] Defined as: Operating income/(financial expenses + provisions for losses + adjusted total expenses).
Adjusted total expenses = total operating expenses (including provisions for losses) + [(average equity – average fixed assets) x annual inflation rate + (Treasury bill rate 91 days x average total liabilities - actual interest expense) + other costs (if any).

(PAR) and NPLs, resulting in an improvement of the quality of the PCFC's assets. As of March 31, 2007, the PCFC overall past dues were 2.5 percent and its PAR (measured as the balances of loans with past due over 30 days/outstanding loans) was 6 percent, 7.1 percent in 2005, and 3.2 percent in 2004 (against a target of 5 percent maximum). This is quite high for a wholesale banking operation and the PCFC will have to deal with this issue more seriously in the near future.

23. As of March 31, 2007, the PCFC has accredited a total of 202 MFIs, among them rural banks (82), cooperatives (52), NGOs (43), cooperative banks (21), thrift banks and lending investors (4). As of March 31, 2007, it had loans to all 202 MFIs, which in turn had slightly over 2 million sub-borrowers in 80 provinces. Loans outstanding as of March 31 2007 were slightly over PhP3 billion with a collection rate reported to be 98.7 percent. There are, however, few MFIs with collection rates ranging from 75 percent, to as low as 25 percent. This is very worrying, and the PCFC should address this issue in the very near future.

24. **Equity**. Performance concerning equity has been highly satisfactory. Since project appraisal, equity has increased to PhP1.3 billion, compared with a target KPI of PhP350 million. Most of the increase comprises PhP131 million retained earnings (as of 03/31/07) and PhP900 million[24] redeemable preferred shares. However, such redemption would require the agreement of the PCFC. Given their low 5 percent coupon, it is highly unlikely that a commercially minded board of directors, looking after the PCFC's best interests, would agree to their scheduled redemption (unless it was part of a package to replace them with even more favorable instruments). Therefore, for all intents and purposes, this equity increase should be considered permanent.

25. **The PCFC's operating costs** (excluding loan loss provisions) were 3.6 percent of average outstanding portfolio for 2005, 3.2 percent for 2006, and an annualized 2.8 percent for the first quarter of 2007. The latest figures are highly satisfactory, as they are below the target of 4.5 percent. It represents a considerable improvement over those of earlier years (2004 – 4.2 percent, 2003 – 3.7 percent, and 2002 - 5.4 percent), but it is still too high for a wholesale institution. Further reductions could be achieved by (a) further expanding the PCFC's loan portfolio, and (b) having the cost of much of the PCFC's 'development and training work' born by the People's Development Trust Fund , with the PCFC focusing on being an efficient wholesaler.

26. **Profitability**. The PCFC has been marginally profitable in real terms but continues to be subsidized. The level of the actual subsidy depends mainly on the prevailing market interest rate. The subsidy level is reduced when market interest rates are low, and increases when they are high. For example, in 2000, when market interest rates were much higher than at present, its SDI, which had been very high (72 percent for 2000, 51 percent for 2001) has improved to 19 percent in 2002. As the interest rate continued to decline, the SDI improved to 2.8 percent in 2005 and - 20 percent in 2006, indicating no subsidy dependency. The PCFC has been profitable mainly because its total resources are financed largely by equity (40 percent) and below-market fixed interest rate long-term loans from ADB/IFAD (29 percent). If it is to be viable on an expanded basis, the PCFC will need to increase its net profit through a further reduction of its costs, and if market rates trend up again, which will probably affect the cost of new resources, it may also need to raise the nominal interest rate that it charges to MFIs.

27. **Financial Self Sufficiency** (FSS). Another measure of the strength of a financial institution is FSS. It appears that this ratio is more commonly used among micro-finance institutions. The main difference between the SDI and the FSS is the way the equity is treated. While the SDI takes into account, among other things, the amount of subsidy that is provided to a financial institution through its

[24] This was invested as additional equity in the PCFC by the National Livelihood Support Fund (NLSF) in 1999 with the following features: (a) cumulative dividend at 5 percent per annum and fully participating; (b) preference on assets; and (c) redeemable within 10 years, at the option of both parties, as follows: 10 percent a year at the end of each of the 5th, 6th and 7th years; 20 percent at the end of each of the 8th and 9th years; and the balance of 30 percent at the end of the 10th year.

equity, the FSS takes into account the amount needed to maintain the equity in real terms (i.e., the amount needed to avoid erosion of related equity as a result of inflation). It appears that the results of the PCFC's FSS are mixed (see Table 3, above). While in 2002 the FSS was 90.6 percent it went down to 80 percent in 2004 and climbed up to 98.5 percent in 2006, almost full financial self-sufficiency. The volatility in these results are due to the small volume of the PCFC loans relative to operating costs but are also very sensitive to the level of the prevailing inflation rates. Higher inflation rate would tend to reduce the FSS and a low one would likely to increase it.

28. The PCFC's Future. Its main challenge is to mobilize sufficient financial resources at an affordable rate to further expand its lending operations and outreach through MFIs to individual poor and micro enterprises. As a non-bank financial institution, the PCFC cannot mobilize savings and deposits and its operation relies on its equity and borrowings. With high liquidity levels in the banking system, competition among banks including the micro-finance sector has substantially increased. Borrowing, however, is relatively expensive and has a great disadvantage *vis-à-vis* savings and deposit mobilization costs. Therefore, further borrowings at the prevailing market rates may make the PCFC's lending operation to MFIs an uncompetitive one. This significant factor will affect the future development of the PCFC. One of the long-term solutions is probably to provide the PCFC with easy access to savings and deposit based financial resources. This would require that the PCFC main shareholder would be replaced by a bank or the PCFC itself should be converted into a bank.

Overall Performance of Participating Financial Institutions (PFIs)

29. Currently there are 32 financial institutions that have been accredited under the CLFIII of which seven (22 percent of total PFIs) are Rural Banks (RBs); 14 (44 percent) are commercial/universal banks (KBs), 7 (22 percent) are Thrift Banks (TBs), and 4 (12 percent) are Non-Bank Financial Institutions (NBFIs). Participation rates under this project have been lower than in earlier projects because (a) there has been excess liquidity in the banking system during the later years of the project implementation period; and (b) the unfavorable wholesale lending environment that has been created by lending at below market rates of other medium- and long-term wholesale lending facilities (mainly the DBP/JBIC financing programs). In addition, the banking system in general has not fully recovered from the 1998 financial crisis and some of them (mainly CFIs) were unable to meet some of the accreditation criteria, particularly those related to liquidity, profitability in real terms, and net past due to equity ratio. Many banks are also carrying high levels of foreclosed assets, estimated to be PhP159 billion for the industry in 2006, making banks more cautious and less able to lend.

30. To ensure a satisfactory performance of the PFIs and safeguard the project's funds, a set of accreditation criteria were established. In November 2001, some criteria were modified to allow PFIs more time to meet these criteria. The IBRD reviewed the financial status of about 70 percent of the 32 active PFIs under CLF 3[25] against the accreditation criteria established. The lines of credit of 12 PFIs (not included in the 32 PFIs) were suspended by LBP for various reasons, mainly due to deterioration in their financial performance, and as a result failed to meet one or more of the accreditation criteria.

31. Through several missions and review of related documents it was re-confirmed that LBP/FID has developed prudent systems for monitoring the performance of commercial banks, NBFI, and thrift banks located in Metro Manila. The CFIs, however, do not enjoy the same quality of financial review and follow-up. The review of CFIs files indicate that there is no consistency in collecting and presenting data regarding CFIs' financial performance, information is not always up-to-date, and there are cases of which a delay of up to one year in submission by the CFI of its financial statement. Also, in some cases there was no follow-up on the CFI action plan and a delay in reviewing the latest financial statement that reached the Lending Center. One of the primary reasons for this difference in standards is that the CFIs

[25] 24 files of PFIs were reviewed, of which 5 out of 14 were commercial banks, 6 out of 8 thrift banks, 9 out of 10 rural banks, and 4 out of 4 non-bank financial institutions.

are accredited and monitored by Regional Lending Centers of LBP and not the headquarters-based unit that appraises and monitors the other banks. In addition, LBP changed its policy of having an assigned staff member to focus on wholesale operations, meaning that the staff member assigned to monitoring these rural finance institutions had many other tasks.

32. Despite the problems identified with the monitoring of CFI performance, a file review of PFIs' financial performance indicated that all of the fully-accredited PFIs were performing quite well in terms of solvency, profitability, and liquidity. Those that were conditionally accredited were complying with their action plans. This is also evident by the high repayment rate of PFIs to LBP. The very low past due rate of sub-loans to their related PFIs demonstrate that, in general, PFIs' staff and management are capable of making good CLF loans. There was only one PFI, the Hermosa Savings and Loan Bank (HSLB), that failed to meet its payment to LBP. Total gross past due that was created by the HSLB was PhP17.25 million or 0.95 percent of total outstanding WBO loans. LBP has fully provided for this bad debt and it is quite likely that this amount will be written off once the legal process is complete.

33. While the project had a positive impact on the performance of LBP and the PCFC, the impact on improving the financial performance of PFIs has been marginal. There are a few reasons for this. Firstly, CLF 3 funds were very small compared with the existing loan portfolio of most of the PFIs, providing very little leverage for change at these banks. Secondly, in the early stages of the project only banks that fully met the minimum accreditation criteria were accepted into the program, leaving little room for improvement.

Compliance with Environmental Safeguards

34. The project complied with the agreed environmental safeguard requirements and processes both at the loan application and implementation stages. At the loan application stage and as part of its appraisal process, the EPMD of LBP undertook environmental screening of each loan application/proposal to identify any environmental issues and assign the environment category of the proposal according to the DENR project categories. During the project implementation period, the EPMD reviewed about 710 sub-projects' applications of which 638 were approved for lending[26]. Out of these 638 sub-projects, 318 were categorized as Non-Coverage Projects (NCP - projects, which are unlikely to cause adverse environmental impacts), 317 were categorized as environmentally critical area (ECA) and three were defined as environmentally critical Project (ECPs). These sub-projects were required to have an acceptable Environmental Management Plan (EMP); ECA and ECP sub-projects with an acceptable Environmental Compliance Certificate (ECC) issued by DENR.

35. The EPMD conducts an annual compliance audit of at least 10 percent of the approved and implemented sub-projects to check and validate compliance of the sub-borrowers to the mitigating measures and ECC conditions. A feedback system is also being developed to require the sub-borrowers to comply with and/or institute the necessary corrective measures in case of violation. The EPMD's performance in terms of the annual audit has been satisfactory and the target of 10 percent has been historically exceeded. The EPMD audited some 196 sub-projects, of which CLF III and RCF II accounted for 143 sub-projects or about 26 percent of total CLF III and RCF II sub-projects. Out of these 143 audited sub-projects, 76 percent (109 sub-projects) were in full compliance and about 34 partially complied with the environmental requirements.

36. Field visits of the Bank's missions to some of the sub-projects and interactions with the concerned sub-borrowers validated the presence and maintenance of the good environmental safeguard system described above and the implementation of corrective measures by the sub-borrowers. Almost all the visited projects had their respective EA documents and ECCs and the sub-borrowers were implementing

[26] EPMD's endorsement depends on the completeness of environmental requirements (documents) submitted by the sub-borrower through the LBP's Wholesale Lending Department, PFIs, and LBP's lending centers.

the relevant mitigating measures. Bank's missions also recognized the high awareness of the sub-borrowers on the environmental issues that pertain to their projects and the extra efforts exerted by them to address the issues.

Financial Management System Requirements

37. The financial management system of the project was found to be satisfactory. The Financial Management (FM) arrangement and related staff capacity was considered adequate.

38. Counterpart funding – Based on the selected loan files inspected and on the quarterly progress reports for the project, the counterpart funding provided by the sub-borrower and PFI in the case of CLF and by the sub-borrower and LBP in the case of RCF has exceeded the minimum requirement under the project.

39. Internal controls – The internal controls system over the project was considered adequate. There is proper segregation of duties and review procedures over the processing and recording of transactions. The LBP Credit Review Department (CRD) of the Internal Audit Group has covered WLD in its scope of work annually. The latest review by the CRD was in September 2006, which did not disclose any major issues. As part of its continuous effort to improve the quality of WLD's management system, WLD was able to complete the up-dated manual of operations for the department. LBP was awarded the Certificate of Registration to the ISO9001:2000 on the Quality management System of the bank's foreign-funded Commercial wholesale lending Operations in 2007.

40. Monitoring and Reporting The quarterly progress reports were submitted to the Bank regularly 60 days after the end of each quarter. The reports provided adequate information on the status of the project. Not included in these reports though is the quarterly financial statements for RCF II. In the past, there were problems gathering the transaction reports from the accounting centers in various parts of the country to produce the annual consolidated financial statements for RCF II on a timely basis. The annual audited consolidated financial statements for RCF II, however, were submitted on time starting in 2004.

41. External Audit and Audited Financial Statements Audited financial statements were provided to the IBRD for each year of the project. The auditors rendered unqualified opinions on those financial statements. LBP adopted the International Accounting Standards and International Financial Reporting Standards for the first time in its 2005 financial statements as required by BSP, which was the main reason for not meeting the June 30, 2006 deadline of submission of the audited financial statements to the Bank.

42. Inspection of sub-borrowers' folders at LBP head office and visits to selected sub-projects and LBP Lending and Accounting Centers generally validated the presence and maintenance of an acceptable recording system.

Annex 3. Economic and Financial Analysis

1. As this was a credit project, no financial or economic analysis of the project as a whole was undertaken. No specific estimate was made, at appraisal, of the entire project's likely Economic Rate of Return (ERR), Net Present Value (NPV) or Financial Rate of Return (FRR) because it was not clear, at that time, what types of demand-led investments would be made. For CLF III and RCF II, the PAD stated (page 37 paragraph 14) that "… f*or each medium- and long-term sub-loan, the PFIs and LBP would prepare a financial plan including sub-project's cash-flow. The PFI shall estimate a FRR for all sub-loans above P8 million (the equivalent of US$200,000), For the sub-project 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 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 percent in real terms or any other rate established from time to time by the National Economic and Development Authority (NEDA)*". For the MLF, the requirements were that the MFIs would prepare for each sub-loan a financial plan including the sub-project's cash-flow.

2. Sub-borrowers investments under CLF III and RCF II have been assessed as being profitable. *Ex ante*[27] analysis of sub-borrowers FRRs indicates that of those sub-projects for which FRRs were estimated, amounting to about 55 percent of project investments, about 80 percent projected FRRs in excess of 20 percent. The median FRR was 28 percent, well in excess of the cost of funds. *Ex ante* analysis of sub-projects ERRs indicates that about 75 percent of those sub-projects for which ERRs were estimated, amounting to about 29 percent of project investments, about 75 percent projected ERRs above 20 percent with a median ERR of 29 percent[28].

3. MLF beneficiaries amounted to about 110,000 sub-loans, of which the weighted average of sub-loan size was about PhP5,000 (or the equivalent of US$110). Sub-loan collection from sub-borrowers to their MFIs reported to be about 98 percent on average. This is a clear indication that these sub-projects generated sufficient income to allow that strong repayment rate.

Ex ante FRR on 184 sub-projects, which accounted for 55 percent of total sub-project investment, gave a frequency distribution of expected FRRs as follows:

[27] Because many sub-projects are relatively new, an *ex post* analysis of FRRs and ERRs would be premature at this stage. If resources could be found, an analysis of *ex post* sub-projects financial and economic performance would be useful in about four years time, by when most of the sub-projects would have matured.

[28] Under the project a FRR had to be calculated for all sub-projects (184) with sub-loans above the equivalent of US$200,000. Likewise, ERRs had to be calculated for all (40) sub-projects with sub-loans above US$1 million equivalent. Smaller sub-projects were required to have a financial plan, including a sub-project cash-flow.

Predicted FRR (%)	Number of Projects	Percent of Those with Projections	Total Sub-Project Invest. (P Million)	Percent of Total Investment for Sub-projects with projections
≤ 15 percent	15	8.1	411	6.7
15 – 20 percent	28	15.2	644	10.6
20 – 25 percent	31	16.9	1,048	17.2
25 – 30 percent	34	18.5	1,626	26.7
30 – 40 percent	36	19.6	1,098	18.0
> 40 percent	40	21.7	1,269	20.8
Total with Projected FRR	184	100	6,096	100
Smaller Sub-Projects W/0 FRR	362		5,027	
Total Sub-Projects	546		11,123	

The median FRR is in the 25-30 percent range, and the average, weighted by investment, is about 31 percent.

Ex ante economic analysis on 41 sub-projects, which accounted for about 29 percent of project investment, gave a frequency distribution of expected ERRs as follows:

Predicted ERR	Number of Projects	Percent of those with projections	Total Sub-projects Investment (PhP million)	Percent of Total Investment for sub-projects with projections
≤ 15 percent	1	2.4	50.0	1,6
15 – 20 percent	9	22.0	362.4	11.4
20 – 25 percent	6	14.6	472.5	14.8
25 – 30 percent	6	14.6	515.2	16.2
30 – 40 percent	10	24.4	1,166.8	36.6
> 40 percent	9	22.0	621.3	19.4
Total with Projected ERR	41	100.0	3,188.2	100
No Projection Made	505		7,934.8	
Total Sub-Projects	546		11,123	

The median ERR is in the 25-30 percent range, and the average, weighted by investment, is about 32 percent.

Annex 4. Bank Lending and Implementation Support/Supervision Processes

Task Team Members

Names	Title	Unit	Responsibility/ Specialty
Lending			
Arie Chupak	Sr. Financial Analyst	EASRE	Task Team Leader
Wijaya Wickerma	Financial Management Specialist	EASRE	Financial Management
Cecilia Vales	Operations Officer	EAPCO	Procurement/Disbursement
Vimala Abraham	Disbursement Officer	LOADM	Disbursement
Hoi-Chan Nguyen	Legal Counsel	LEGEA	Legal
Brenda Phillips	Program Assistant	EASRE	Program Assistant
Paul Harrison	Consultant		Agric. Econ. And Banking Specialist
Gilbert Llanto	Consultant		Financial Econ. and Micro-finance Specialist
Yaacov Ziv	Consultant		Environmental Specialist
Supervision/ICR			
Arie Chupak	Sr. Financial Analyst	EASRE	Task Team Leader
Lisa Valenzuela	Micro-finance Specialist	EASRE	Task Team Leader/Micro-finance
Xiaolan Wang	Operation Officer	EASRE	Micro Finance
Guzman Garcia-Rivero	Operations Officer	EAPRE	Advisor
Steven Oliver	Senior Agricultural Economist	EASRE	ICR preparation
Iain Shuker	Agric. Economist	EASRE	Task Team Leader/Agric. Economist
Sameer Goyal	Sr. Financial Sector Specialist	EASFP	Financial Sector
Preselyn Abella	Financial Management Specialist	EAPCO	Fin. Management Spec.
Yaacov Ziv	Consultant		Environmental Specialist
Paul Harrison	Consultant		Agric. Econ and Banking Specalist
Gilbert Llanto	Consultant		Financial Econ. And Micro-finance Specialist
The Dzung Nguyen	Operations Officer	EASVS	Operations Officer
Joel Syquia	Consultant		Procurement
Noel Sta. Ines	Procurement Specialist	EAPCO	Procurement Officer
Josefo Tuyor	Operations Officer	EASRE	Environmental Specialist
Maya Gabriela Q. Villaluz	Operations Officer	EASRE	Environmental Specialist
Irene L. Villapando	Consultant		M&E Specialist

Annex 5. Appraisal's Numerical Key Performance Indicators

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

KPIs for the MLF would measure: (a) the number of sub-loans to beneficiaries; and (b) amount of loan releases.

Institution Building.

LBP's IDP is aimed at: (a) maintenance of LBP's solvency & liquidity; (b) ensuring LBP's sustainability and profitability; (c) taking steps to make Agrarian Lending becomes more important and more sustainable; (d) improving the quality of commercial loan portfolio; and (e) resource mobilization.

* Achievement of (a) 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 percent; net non-performing loans to equity ratio less than 25 percent, 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 LBP's 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 percent of loan portfolio by 2002
Real growth of agrarian lending to exceed 10 percent p.a.
Current collection rate from co-ops to exceed 90 percent
Provisioning formula to be met
Agrarian operating costs down to 6 percent by 2002
Necessary agrarian provisions down to 4 percent by 2002
Interest collection on agrarian lending to increase to at least 10.5 percent 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 Agrarian SDI is targeted to fall to 150 percent, 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 percent 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 was 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 the PCFC's IDP was monitored through its achievement of an adequate capital increase, the reduction in its operating costs and the achievement of real profits within three years.

Key Performance Indicators

LBP (Jan - Dec Year) PCFC (Apr - Mar Year) **Indicator**	1999 1998/99	2000 1999/00	2001 2000/01	2002 2001/02	2003 2002/03
CLF Lending					
Number of Sub-Loans (Cumulative)	60	180	380	550	700
Amount of Sub-Project Investment (PM)	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 (PM)	50	125	200	230	230
Strengthening LBP					
Profit in Real Terms (positive 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
percent of PhP liabilities with over 1 year 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 percent Average Net Loans (%)	5.5	5.0	4.7	4.6	4.5
Real Return on Capital	No target	No target	positive	positive	positive

Annex 6. Revised KPIs – Targets and Accomplishment

Component 1: CLF III and RCF II Credit KPIs		Target at Completion	Actual 09/30/07	Percent accomplished
1	No. of sub-loans CLFIII and RCF II (cumulative)	600	546	91
2	Amount of Sub-projects Investments (PhP million, cumulative)	8,500	11,123	131
3	Maximum CLF past due ratio (percent)	2.50	1.58	Positive
4	CLF & RCF Incremental Jobs (cumulative)	13,500	16,960	126
Component 2: MLF - Lending through PCFC				
5	No. of MLF Sub-loans (cumulative)	110,000	108,620	99
6	MLF Volume of sub-loans including reflows (PhP million)	600	672	112
7	Maximum percent of MLF past due loans (PAR over 30 days as defined under BSP's Circular No. 409) (percent)	2	0.1	Positive
Component 3: LBP - Institutional Development KPIs				
8	Profit in Real Terms (ROE) (percent)	Positive real profit	12	Positive
9	Real Growth in Equity (percent)	3	14	460
9	LBP's SDI (percent)	-3	-12	-36
	Agrarian SDI (percent)		23	34
10	Proportion of Loans to Priority Sectors (percent)	65	69	106
11	Gross Loans to farmers & fisher-folks as percent of Loan Portfolio (percent)	15	13.4	89
12	Nominal Growth in Total Loan Portfolio (percent)	5	4.9	98
13	Adequacy of NPA Provisions – Coverage (percent)	> 41[29]	73.6	180
14	Nominal Growth of local Private Resources (percent)	< 5	6.2	124
15	LBP's Agrarian operating costs to net Agrarian loans (percent)	13.50	12.7	12.9
Component 4: PCFC				
16	Operating Costs as percent of Average Loans Outstanding (percent)	3.50	2.4	Positive
17	Overall PCFC PAR over 30 days * (percent)	3	9.4	Negative
18	PCFC Profit in Real Terms (percent)	3.50	11	314

[29] Higher than the industry that was 41 percent in 2007

Annex 7. Options for Project Design

Pre-determined PFIs

This option would be the most expensive one in terms of project preparation and supervision as it would involve the appraisal of several banks and later on routine supervision of the performance of each of the selected financial institutions and the way they were implementing the project. The main disadvantage is that such a design is inflexible, specifically it would: (a) prevent other financial institutions from joining the project in a later stage; and (b) limit the number of PFIs that are able to participate under the project, thus limiting project impact on enhancing banking competition in the rural areas and diversification of its beneficiaries. Experience in other countries has indicated that there are often problems in making desirable re-allocations of committed funds from institutions which are unable to disburse funds quickly to those which could use them. This 'predetermined' option, if selected, would reduce the likelihood that the project would fully meet all its objectives.

Single Pre-selected Bank

Another option is to use one bank to finance viable rural economic activities. The advantages of using this option are: (a) the operation is simple; (b) only one bank needs to be appraised and later on supervised; and (c) focusing on one bank may improve efficiency in terms of credit delivery and loan collection.

The main disadvantages, however, are that: (a) banking competition will not be enhanced, thus the project would indirectly provide to the selected bank a monopoly power in term lending; and (b) the project would have no impact on strengthening other rural financial institutions. This option, if selected, would defeat project objectives that are associated with diversification of rural investment and enhancing banking competition.

A combination of a WBO and a Pre-selected Bank/PFI

This option tries to combine the benefits of the first and the third options. The apparent advantage is that while maintaining the WBO concept with all its benefits, it would save the pre-selected bank the need to apply for renewal of its CLF line of credit and it would save one operational stage of re-lending from the AB to this pre-selected bank. There are, however, several disadvantages to this option. It would force the pre-selected bank to operate within its initial allocation of funds, unable to increase it over the life of the CLF (up to 20 years). If in future the pre-selected bank were to decide, for its own reasons, to reduce the use of CLF resources, these funds would be unavailable to the rural economy. Finally, this option would reduce flexibility in allocating project funds to the various PFIs, and also lead to a reduction in banking competition in the rural areas, which is not beneficial to the rural people.

Annex 8. Summary of Borrower's ICR and/or comments on Draft ICR

THIRD RURAL FINANCE PROJECT

IMPLEMENTATION COMPLETION AND RESULTS REPORT

I. Evaluation of the Project

A. Project Objectives

The project development objectives were to: (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); and (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.

The project aimed to assist the private sector enterprises, particularly the small and medium enterprise (SME) operations in the implementation of their expansion and modernization plans as well as in undertaking new sub-projects and finance their working capital requirements. This, in a way, will lead to the alleviation of operational and financial problems arising from the credit crunch and currency crisis.

Likewise, the project aimed to strengthen institutionally the Land Bank of the Philippines (LBP) and the People's Credit & Finance Corporation (THE PCFC) and increase its capacity to provide financial services to the rural areas and micro enterprises, respectively. The LBP is the main financial institution serving the rural areas while THE PCFC is the country's main conduit for micro-finance.

Another objective of the TRFP was to help enforce financial discipline on the Participating Financial Institutions (PFIs).

The LBP and THE PCFC as well as the PFIs were required imposition of high financial standards with regard to solvency, liquidity, profitability, and best management practices. Both LBP and THE PCFC were required to prepare an Institutional Development Plan (IDP) for World Bank's approval and would be implemented within the project period.

All subprojects financed under the TRFP should be compliant with the Philippine environmental laws and regulations. This is to ensure that the sub-projects with adverse environmental impact will not be financed under the project.

B. Project Design

The design of the wholesale credit component was effective as it was developed based on the experiences, organizational set-up, and systems and procedures of the three predecessor projects which LBP successfully implemented – the Countryside Loan Fund I & II and the Agricultural Loan Fund. The credit components were as follows:
The CLF III funds for wholesale operations inclusive of the agreed amount (originally at US$15 M) which was utilized to accommodate LBP's own rural clients (known as the Retail Countryside Fund

II or RCF II) who were under financial distress due to the regional financial crisis. The wholesale funds, at market rates were made available through LBP to the accredited PFIs on a short, medium or long-term basis to finance rural sub-projects that were economically and technically sound, including those which were financially distressed induced by the financial crisis.

The Micro Finance Loan Fund (MLF) shall be relent by LBP to THE PCFC at market rates for further relending to its accredited Micro Finance Institutions (MFIs). The MLF provided funding for working capital and small capital investment of micro-entrepreneurs (ranging from P25,000 – P100,000). The rural banks and cooperative banks were the main MFI conduits of the program.

As in the past, the project has proven that the wholesale approach, with LBP as the lead financial institution, was effective in reaching out to more beneficiaries nationwide. LBP's strong presence in the rural areas, as well as the geographical location of the rural banks, thrift banks, and the branch network of the universal/commercial banks also contributed to the wide dispersal of the fund.

The project was likewise designed to continuously respond to the needs of the countryside economy, catering to all types of projects previously eligible under the CLF II Program. Besides, the CLF III loan in US Dollar denomination became available to serve the long term foreign currency loan requirements of the sub-borrowers.

The inclusion of retail component (RCF II) in the design supplemented the wholesale component in addressing financial difficulties and in boosting countryside development.

The Institutional Strengthening Components were as follows:

The IDP approved by World Bank and adopted by LBP focused on ensuring LBP's sustainability while continuing its rural lending expansion. It focused on: (1) improving the quality of LBP's commercial loan portfolio; (2) reducing unit losses on agrarian lending; (3) continuing the policy of automation of systems and management information flow; (4) staff training; (5) mobilization of medium and long-term Peso resources; and (6) making adequate arrangements for capital build-up.

THE PCFC also implemented an IDP which included build-up of the PCFC's capital base and strengthening its staff capability to implement its various types of micro-finance programs.

The LBP EPMD, formerly the Environmental Unit, followed the existing procedures and guidelines under the Second Rural Finance Project ensuring compliance to the laws and regulations on Philippine environmental protection. The environmental due diligence conducted under program was designed to evaluate CLF/RCF projects on their environmental performance in compliance with World Bank requirements. It also provided the LBP, PFIs and related sub-projects with environmental technical assistance and coordination services with concerned agencies (i.e., Department of Environment and Natural Resources and Environmental Management Bureau).

C. **Project Implementation and Operational Experience**

The loan components were implemented strictly in accordance with the agreed CLF III, RCF II and MLF policy manuals.

Since the project started, disbursements under the loan have been slow. This has been attributed to the JBIC Yen-based loan of about US$ 500 million issued to the Development Bank of the

Philippines which is being on-lent at below market rates. Simultaneously, the liquidity situation in the banking system improved and the cost of deposit mobilization at commercial banks declined, reducing the attractiveness of this type of the WB on-lending facility. Despite these hurdles, LBP managed to on-lend all of the funds, excluding the cancelled amount of US$ 2.5 million, prior to the loan closing date of 30 September 2007.

Loan defaults within the banking sector increased sharply, thus, PFIs became more cautious in lending to SMEs. Coupled with the weakening in the financial position, particularly the smaller banks, the number of accredited PFIs decreased by as much as 20%.

II. **Achievement of objectives**

Achievement of the project's credit objectives was rated satisfactory as proven by the following:

The project increased the volume of medium and long term credit in the countryside with an aggregate amount of P 6,870.01 Million for 546 projects as of 30 September 2007. More importantly, the project was able to encourage the financial participation of the PFIs and sub-borrowers at a level exceeding the minimum requirements of the project. Under the CLF Program, the PFIs and sub-borrowers provided a combined participation of 35%, exceeding the 25% minimum participation. Under the RCF Program, the 45% combined sub-borrowers' equity and LBP's internal fund exceeded the 25% minimum requirement.

Loan drawdowns had been behind the 5-year drawdown schedule. After 3 years from effectivity date, only 30% of the US$150 Million had been drawn from the Loan Account. As of original loan closing date of June 2005, only 79% of the US$150 Million had been drawn from the Loan Account. Nonetheless, as of the final loan closing date of 30 September 2007 the loan had been fully drawn, excluding the cancelled amount of US$ 2.5 million.

Disbursements were slower than expected because of various reasons. The PFIs had been cautious in its lending, particularly to SMEs due to high NPLs. The DBP's wholesale lending program (JBIC's ISSEP II) is priced below market and this undercut the pricing of the CLF Program. Later in the project period, the liquidity in the Philippine banking system increased thus, reduced the demand for funds. Consequently, prepayment of the existing portfolio had been experienced under the CLF Program as PFIs moved to refinance outstanding loans from their own funding sources.

The project's key performance indicators (KPIs) which included total project investments, number of loans, employment generation as well as financial participation were all surpassed.

The project contributed positively to the overall financial performance of LBP, THE PCFC and the sub-borrowers. However, its impact on improving the financial performance of PFIs has been marginal due mainly to: (1) low CLF funds compared with the existing loan portfolio of most of the PFIs; and, (2) limitation of program access to banks that met the minimum accreditation criteria. Aside from increased economic activity in the countryside, the project created socio-economic impact through employment generation and revenues to the government.

All sub-projects had been reviewed and endorsed as environmentally acceptable by LBP-EPMD. The conduct of environmental due diligence on all sub-projects is in accordance with LANDBANK's implementation of an Environmental Management System. In so doing, all projects financed by LBP or through the LBP are encouraged to integrate environmental protection practices in their operations.

III. **Evaluation of Borrower's Own Performance**

Borrower's performance under the credit component was satisfactory. The KPIs were all surpassed. Though the loan disbursements, particularly under the wholesale component, had been slow and behind the drawdown schedule, LBP had managed to fully disburse the funds, except the cancelled amount of US$ 2.5 million. Aside from the good product design, this could be attributed to the various marketing initiatives of LBP which include client calls, conduct of product briefings/presentations to PFIs and potential sub-borrowers, strong linkages with bank associations, and annual recognition/awarding of outstanding PFIs and sub-borrowers.

Collection rates had been satisfactory as a result of a good PFI accreditation process. There is a high repayment rate of PFIs to LBP. The very low past due rate of sub-loans to PFIs demonstrate the PFIs' capability of making good CLF loans. Past due level was at 1.58% as of 30 September 2007.

It is worth mentioning that LANDBANK's Financial Institutions Department has developed prudent systems for monitoring the performance of the commercial banks, thrift banks and non-bank financial institutions located in Metro Manila.

LANDBANK's environmental due diligence system was given an award by the Association of Development Financing Institutions in Asia and the Pacific (ADFIAP). LBP was cited as one of ADFIAP's 2008 Awardee under its Environmental Development category. The award recognizes / demonstrates the importance and benefits of ensuring the environmental compliance of projects eligible for financing / those being financed with environmental laws / regulations, in terms of reducing associated penalties and credit risks.

Lessons Learned

As far as interest rate was concerned, the program could not compete with other wholesale funds as WB-funded projects were more expensive.

A good set of accreditation criteria and a good system of PFI performance review were critical to the success of a wholesale lending program. The low past due level despite the financial crisis proved that LBP successfully implemented the PFI accreditation process.

LBP's prudent strategy of changing the scope of the project (i.e., additional eligible subprojects, reallocation of funds to other loan components, KPI revisions, introduction of free limit policy) to suit the current financial environment particularly doing it at the middle of the program implementation helped the slow-paced fund disbursement.

As part of continuous improvement, monitoring system of pending environmental requirements (e.g., Environmental Management Plan, ECC, etc.) of sub-projects would be enhanced to facilitate tracking of submission of documents by concerned PFIs/LBP Lending Units.

IV. **Evaluation of World Bank Performance**

The Bank's project supervision could be rated as highly satisfactory. The Borrower's queries and requests for approvals/comments were promptly acted upon, e.g., amendments to the Loan Agreement and to the CLF III / RCF II and MLF Policy Manuals such as reallocation of funds to various components, partial loan cancellation, KPI revision, revision in financing mix, introduction of the "free

limit" policy, extension of loan closing date, etc.

The frequency of the supervision missions was sufficient to closely monitor the project and resolve any program issues.

Fund applications / replenishments were processed by WB and received by LBP within reasonable time.

The periodic WB supervision of the environmental aspect of the project created a positive impact in the subproject evaluation and monitoring. This provided the EPMD direction in the project implementation and evaluation relative to its environmental soundness. The incorporation of environmental audit and project monitoring of subprojects during its operation phase through the validation done by the EPMD, allowed WB to confirm the environmental performance of subprojects financed under the TRFP.

V. **Future Operations**

The first generation funds were fully disbursed on 30 September 2007, except the cancelled amount of US$2.5 million. Reflows or collections will be relent in accordance with the approved CLF III / RCF II policy manuals.

The accreditation process and PFI performance review, particularly for the countryside financial institutions, will be further strengthened thru enhancements of the organizational structure for CFI lending operations

The Revised Procedural Manual for DAO 2003-30 in the Implementing Rules and Regulations of the Philippine Environmental Impact Statement (EIS) System was circulated by the DENR thru Memo Circular 002 Series of 2007, entailing the need to integrate the new provisions in EPMD's evaluation of environmental performance of in-house / foreign funded projects. EPMD shall conduct series of road-shows among LBP's Lending Units to familiarize the Account Officers of the recent changes in the EIS System.

Annex 9 List of Supporting Documents

1. Project Appraisal Document Report No. 18328-PH
2. Loan Agreement of December 11, 1998 Loan No. 4413-PH
3. CAS dated June 21 2007 – Report No. 40085-PH
4. CLF III and MLF Policy Manuals
5. List of CLF revisions prepared by LBP.
6. Two letters to Govt. and LBP dated June 17, 2004 and June 8, 2006 regarding Loan amendments
7. Data regarding sub-projects' FRR and ERR prepared by LBP
8. LBP's Medium Term Business Plan (2003-2007) dated June 2004
9. PCFC's IDP progress report dated March 31, 2007
10. CLF/RCF Quarterly Progress Report dated 09/30/07 (the Project completion date)
11. CLF III and RCF II quarterly Progress Report dated 03/31/07
12. LBP's semi annual progress reports
13. LBP's EPMD 2006 Progress Report
14. LBP's EPMD Progress Report dated 09/30/07
15. CLF III and RCF II Financial Statements dated 09/30/07 (the project completion date)
16. ISRs and Missions' Aide-Memoires,
17. BSP's Poverty Incidence Data