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AEC 2015: How Prepared Are We?

The Case of the Philippine Financial Services Industry[1]

A Position Paper Submitted to the Committee on Economic Affairs, House of Representatives

An Overview

One of the primary goals under the ASEAN Economic Community is to have a semi-integrated, efficiently functioning regional financial market by 2020 as stipulated in the ASEAN Financial Integration Framework (AFIF). This will be accomplished by further liberalizing capital account systems and connecting capital markets. To be more specific, the areas of financial integration include the liberalization of financial services through the removal of restrictions on ASEAN banks, insurance companies, and investment companies; the liberalization of capital accounts through the removal of restrictions on foreign exchange transactions (in capital accounts, FDIs, portfolio investments, and other flows), while enforcing adequate safety standards; capital market development through the harmonization of domestic laws and regulations and linkage of market infrastructure; and the harmonization of the payments and settlement systems (PSS). Recognizing, however, that each member has its own initial conditions such as financial market development, economic structure, country priorities, among others, the envisaged financial integration can proceed at distinct paces for each member state.

The guiding frameworks or pre-conditions for financial liberalization have been agreed upon as stated in the ASEAN Banking Integration Framework. This includes the harmonization of principles of prudential regulations; financial stability infrastructure; capacity building; and setting up a set of criteria for Qualified ASEAN Banks (QAB).

Some Issues and Challenges

There are benefits to be gained in the long-run as financial integration can encourage competition and technology transfer, benefitting from allocation efficiency and risk divergence, which can help boost the regional financial sector. But risks have to be managed as there are chances of contagion such as the exposure of domestic financial market to spill-over effects of challenges (e.g. economic shocks) faced by financial service institutions in their own countries. Additionally, financial institutions run the chance of engaging in speculative behaviors that will heighten the volatility of capital inflows into the local economy (Park and Lee, 2011).

[1]Presented by Gilberto M. Llanto, President, Philippine Institute for Development Studies (PIDS) to the House of Representatives Committee on Economic Affairs in response to House Resolutions 666 and 746, on November 25, 2014. Inputs from Pinky S. Padronia, Associate Director of Bankers Association of the Philippines and Cherry Ann D. Madriaga, Research Associate, PIDS are gratefully acknowledged.

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There remain issues to be solved as the ASEAN has not intensified its efforts in cross-border liberalization of products and services, mutual recognition of market professionals, common exchange linkages, and bond market development. Moreover, restrictions on inward and outwards foreign investments remain (Wihardjha, August 2014). Furthermore, foreign banks are not actively penetrating the ASEAN banking market, except for the Philippines, as shown in **Tables 2** and **3**. According to Gopalan and Pajan (2010), this can be largely attributed to the merging and domestic restructurings among local banks.

Table 2. Number of Foreign Banks

Country	1997	Latest Year Available
Indonesia	44	37 (2005)
Malaysia	14	13 (2005)
Philippines	**13**	**22 (2008)**
Thailand	21	16 (2008)

Source: Gopalan & Pajan (2010)

Table 3. % Share of Bank Assets by Foreign Banks with Majority Ownership

Country	1997	2007-08
Indonesia	5.8	47
Malaysia	21.6	23
Philippines	**8.5**	**13.2**
Thailand	7.1	12.6

Source: Gopalan & Pajan (2010)

The Philippines saw a steady financial assets-GDP ratio from 2001 to 2010. However, the country needs to deepen the financial sector and develop the domestic capital market through the accumulation of larger stocks of financial assets as well as designing a more organized equity and bond markets. Compared to other ASEAN economies, the country's government and private bonds market and capital markets are small [Lee and Takagi, 2013].

Banks, which largely dominate the financial services industry, and other financial institutions are not large enough in terms of asset size and capital base to compete effectively against global players in international financial markets. The average bank assets of an ASEAN bank of US$4.8 billion are considerably lower compared to the average bank assets size of the 500 largest [global] commercial banks with US$14 billion. The country's top three banks, BDO Unibank, Metrobank, and Bank of the Philippine Islands, have a total capital worth the size of Bangkok Bank alone. However, looking at the usual criteria such as the capital adequacy ratio, non-performing loans ratio, and return on assets, the Philippine banks are quite sound relative to other banks.

Moreover, the Philippines insurance industry is relatively less developed as the total penetration ratio from 2004-2010 is the lowest compared to Singapore, Malaysia, Thailand, Indonesia, and Vietnam. Insurance companies are also comparatively small in terms of asset size (Lee and Takagi, 2013).

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Data shows that the Philippines consistently had a capital adequacy ratio of more than 15.0 percent, higher than the BSP's minimum prescribed rate of 10.0 percent and the Bank of International Settlement's (BIS) 8.0 percent. In terms of the non-performing loans (NPL) the country showed a declining ratio over the years, from double-digit rates in 2002 to a mere 1.9 percent in 2012. Meanwhile, the country's return on assets is slightly better than Singapore and Thailand on the average.

Table 4. Risk-Weighted Capital Adequacy Ratios (% of risk-weighted assets)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Indonesia	22.4	19.4	19.4	19.3	21.3	19.3	16.8	17.4	17.2	16.1
Malaysia	13.2	14.0	14.3	13.6	13.1	12.8	12.2	14.9	14.4	14.8
Philippines	16.6	17.4	18.7	17.7	18.5	15.9	15.7	16.0	17.3	
Singapore	16.9	16.0	16.2	15.8	15.4	13.5	14.7	17.3	18.6	
Thailand	13.0	13.4	12.4	13.3	13.9	14.9	14.0	15.8	16.1	14.8

Source: ARIC

Table 5. Non-performing Loans (% of commercial bank loans)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Indonesia	7.9	6.8	4.5	7.6	6.1	4.1	3.2	3.3	2.6	2.2	1.9
Malaysia	9.3	8.3	6.8	5.6	4.8	3.2	2.2	1.8	2.3	1.8	1.4
Philippines	15.0	14.1	12.7	8.5	6.0	4.5	3.5	3.0	2.9	2.2	1.9
Singapore	7.7	6.7	5.0	3.8	2.8	1.5	1.7	2.4	1.6	1.2	
Thailand	15.7	12.9	10.9	8.3	7.5	7.3	5.3	4.8	3.6	2.7	2.3

Source: ARIC

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Table 6. Rate of Return on Commercial Bank Assets (% per year)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Indonesia	1.4	2.6	3.4	2.6	2.6	2.8	2.3	2.6	2.9	3.0	3.1	3.0
Malaysia		1.3	1.4	1.3	1.3	1.5	1.5	1.2	1.5	1.5	1.6	1.4
Philippines	0.8	1.1	0.9	1.1	1.3	1.4	0.8	1.2	1.4	1.5	1.6	2.0
Singapore	0.8	1.0	1.2	1.2	1.4	1.3	1.0	1.1	1.2	1.0	1.1	
Thailand	0.2	0.6	1.2	1.3	0.8	0.2	1.0	0.9	1.1	1.1	1.2	

Source: ARIC

Recent Policy Developments

Last July 2014, President Benigno Aquino III signed into law Republic Act No. 10641 or the Act Liberalizing the Entry and Scope of Operations of Foreign Banks in the Philippines, which gives permission for more foreign banks to operate in the country without constraints. Below are some of the salient provisions under RA No. 10641 which in effect levels the playing field between domestic and foreign banks:

- Foreign banks are now allowed to own 100% of voting stock of a local bank and the share of total resources of domestic banks to the industry was reduced from 70% to 60% (Section 2)
- Foreign banks authorized to operate under Section 2 will enjoy the same privileges, and be subject to the same limitation imposed upon a domestic bank of the same category (Section 5)
- Foreign bank branches are required to assign permanent capital to the Philippines of an amount not less than the minimum capital required for domestic banks. Moreover, foreign banks are authorized to open up to 5 sub-branches. The same banking privileges as domestic banks will likewise be enjoyed by locally incorporated subsidiaries of foreign banks (Section 3)

Overall, the BSP has required the Philippine banks to be compliant to the Basel III requirements ahead of other ASEAN countries. This is part of the regulator's initiative to ensure that the Philippine banking system is strong, resilient and competitive as the country move towards a more liberalized economy. To further strengthen the financial services sector and make them more competitive, the Bangko Sentral ng Pilipinas (BSP) announced last October 2013 its policy to increase the minimum capital requirement for all banks, universal, commercial, thrift, rural, and cooperative banks.

Particular to the banking sector, the Philippines is currently preparing to deliver to its commitment under the ASEAN Banking Integration Framework (ABIF). Moreover, amendments

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were introduced on securities rules and regulations in preparation for the integration of the capital markets in the region. This particularly relates to the ASEAN Multi-currency Bond Integration Framework (AMBIF) for the fixed income market and the ASEAN Capital Markets Framework (ACMF) which covers the equities market.

The same liberalization intent is seen in the insurance industry. In general, the Philippines can be viewed as having a liberalized insurance industry. Republic Act No. 10607 [otherwise known as the Insurance Code] required companies increase substantially their capitalization in preparation for a more competitive insurance sector. One further development with the enactment of RA 10607 is the removal of the required equity ownership of a bank to an insurance company to perform cross-selling activities. This effectively allows fully owned foreign-invested company to perform bancassurance activities in the Philippines. However, while this is allowed by law, the insurance industry continues to advocate for a clear rule that will implement this provision as current regulation only provides for insurance companies that belong to the same financial conglomerate to undertake cross-selling activities with the bank.

Some financial groups remain skeptical with the upcoming integration. Based on newspaper reports [August 2013 in various broadsheets], the Philippine Stock Exchange remains doubtful in joining the integration of ASEAN stock markets since the country is not ready and needs more ample time to be organized. Some quarters in the banking industry think that several Philippine banks are unprepared to compete with their ASEAN counterparts [July 2013 and reiterated May 2014 in various broadsheets] given their small sizes.

Final remarks

The upcoming regional integration will most likely put pressure on the domestic banks to merge to enable them to compete with the much larger ASEAN banks that could come in the country. But consolidation alone would not be sufficient if the other equally important challenges will remain unaddressed. While the BSP and Insurance Commission are on right track in liberalizing the financial services industry and at the same time taking steps to strengthen the domestic players, it is imperative for them to advise the domestic players to respond to the challenges of the integration by shaping up—put in more capital, maintain and hire good professionals, engage in financial innovations and others. The domestic banks may maximize the potential benefits of the upcoming integration by preparing mechanisms that would enable them to 'learn' from the incoming ASEAN banks –may it be through good regulatory practices or through the technology that they will bring into the country. Financial integration does not happen overnight but on the way toward it domestic financial services firm have to really understand the ASEAN market. It may be beneficial for the domestic banks to craft an overall plan or step-by-step strategy that would prepare them in the upcoming integration.

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The public fear on the detrimental effects of such risks and other undesirable occurrences (e.g. chances of 'contagion') can be minimized or managed given the proper monitoring / oversight, implementation of well-crafted policy actions of the concerned regulatory agencies, and good leadership of the BSP. While the possible costs to these risks cannot be ignored, the actualization of financial integration could actually prove to be highly beneficial to the country as it can help the government augment, for instance, the financial resources needed in the implementation of major infrastructure projects (e.g. PPP projects) in the country.

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