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Financial sector development: A review

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A country's financial system consists of its financial institutions, including banks, insurance companies, other nonbank financial institutions (NBFIs), and financial markets, as well as the underlying financial infrastructure (World Bank 2018). It is an intermediate sector, which provides at least four core functions (RBA 2014):

- Value exchange, the utilization of payments to support the day-to-day business of an economy
- Intermediation, the transferring of resources between savers and borrowers
- Risk transfer, the pricing and allocation of certain risks
- Liquidity, the conversion of assets into cash without undue loss of value

While these functions are important in the functioning of an economy, they are not generally ends in themselves. Any economic transaction requires efficient and reliable access to financial services to some degree (McGuire 2002). Thus, financial services should be provided in the most efficient and sound way to support economic growth and development.

This *Policy Note* reviews the country's financial sector development, or the expansion and elaboration over time of the financial structure, a major policy issue and objective in itself. Using the data from World Bank Global Financial Development database[1], it juxtaposes the local situation against the financial sector development in other member-states of the Association of Southeast Asian Nations (ASEAN).

Financial sector development in ASEAN

The World Bank (2018) provides an extensive range of measures in assessing the financial system of 206 economies, including those within ASEAN, over a long period. These measures include the following:

- Financial depth, or the size of financial institutions and markets
- Access, or the degree to which individuals can and do use financial services
- Efficiency of financial intermediaries and markets in facilitating financial transactions
- Stability of financial institutions and markets

Within ASEAN, World Bank (2018) classifies Brunei Darussalam and Singapore as high income and Malaysia

[1] The World Bank's full Global Financial Development Database, which includes definition of terms used in this Policy Notes, is available online (http://pubdocs.worldbank.org/en/183691533221875299/July-2018-global-financial-development-database.xlsx).

and Thailand as upper middle income. Meanwhile, the rest of the ASEAN member-states, including the Philippines, are classified as lower middle-income economies. In terms of gross domestic product (GDP), Cambodia, Lao PDR, Myanmar, and Viet Nam have the lowest GDP per capita. Nonetheless, they also recorded the biggest increases in GDP per capita from 1993 to 2017.

In terms of financial depth

- The size of the banking sector in the Philippines is much smaller compared to Malaysia and Thailand. It is, however, comparable to that of Indonesia. Moreover, the banking assets of Viet Nam starkly increased from 1999 to 2016, although its ratio to GDP was just half of the Philippines in 1999.
- The dominance of banks in the upper middle-income member-states was not as significant compared in the lower middle income, including the Philippines. In the case of Singapore, NBFIs even dominated over banks in terms of assets. In Malaysia and Thailand, NBFIs' assets significantly grew from 2005 to 2015/2016.
- An alternative measure to total banking assets is private credit, defined as deposit money bank credit to the private sector (World Bank 2018). While banking assets are a more comprehensive measure of size, it is also useful to know whether the claims of financial intermediaries are on the public or the private sector. Except in Myanmar, total banking assets predominantly consisted of private credit. However, private credit was lowest at 75 percent for the Philippines in 2016. Except for Brunei Darussalam, the high and upper middle-income member-states had the highest ratios of deposit money bank credit to the private sector together with Viet Nam in 2016. Moreover, Viet Nam's performance was the most striking, rising from 14 percent in 1992 to 114 percent in 2016. The Philippines' ratio used to be higher than those of Malaysia and Thailand in 1964, but had significantly lagged behind them over the years.
- A traditional indicator of financial deepening is the ratio of liquid liabilities or broad money to GDP, which equals currency plus demand and interest-bearing liabilities of banks and other financial intermediaries divided by GDP. By including all banks, bank-like, and nonbank financial institutions, it is the broadest available indicator of financial intermediation. Viet Nam had the highest ratio in 2016, significant considering its very low ratio in 1992. Despite having similar level in 1964, financial deepening in the Philippines was modest compared to that of Malaysia and Thailand in 2016. Nonetheless, it was better than that of Indonesia, whose ratio was even lower than Cambodia and Myanmar in 2016.
- Correlation coefficient between GDP per capita and financial depth as measured by private credit and liquid liabilities was just around 40 percent for ASEAN. But if outliers, namely Brunei Darussalam, Singapore and Viet Nam, are excluded, the correlation increases to 80 percent.
- In terms of insurance, two concepts are relevant. These are insurance density, which indicates the current state of the market, and insurance penetration, which indicates potential growth. Singapore had the highest insurance density at USD 3,777 in 2016, higher than the average for advanced markets at USD 3,505. In terms of insurance penetration, Singapore was close to the average for advanced markets at 8 percent in 2016. Malaysia and Thailand were considered transitional markets, with insurance density and penetration significantly higher than the average for emerging markets at USD 149 and 3.2 percent in 2016, respectively. Meanwhile, Indonesia, the Philippines, and Viet Nam's performance was significantly lower than the average for emerging markets. They were all considered incipient insurance markets, with still significant room to grow.
- For financial markets, the biggest markets belong again to Singapore, Malaysia, and Thailand. The Philippine stock market has been more slowly but consistently growing in the last three decades. Markets

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in Singapore, Thailand, and Malaysia are also the most active. On the other hand, activity in the Philippine and Indonesian stock markets has been still quite low, if not stagnant, in the last 20 years.

In terms of access

Another characteristic of a well-functioning financial system is the provision financial services to a wide range of households and firms, not just large companies and rich individuals. Using the data from World Bank (2018), the study found the following:

- The number of individuals who reported having an account at a financial institution increased across ASEAN from 2011 to 2017. Nonetheless, the Philippines has significantly lagged behind other comparable ASEAN member-states in terms of access to banking services. In particular, the Philippines' number of deposit accounts per 1,000 adults was even lower than Lao PDR's in 2016, even if it had more bank branches per 1,000 adults than the latter.
- The number of reported account holders with the inclusion of accessing mobile money service also increased. In particular, there was significant growth in the use of debit cards and electronic payments. Not surprisingly, the more advanced ASEAN member-states, such as Singapore, Malaysia, and Thailand, reported the highest access to digital financial services in 2017, followed by Indonesia, Viet Nam, and the Philippines.

In terms of efficiency

The third characteristic that World Bank (2018) tried to measure is the efficiency of financial intermediaries and markets. Efficiency of intermediaries relates to the cost of intermediating resources, and includes crude indicators, such as overhead costs to total assets, net interest margin, lending-deposits spread, noninterest income to total income, and cost to income ratio.

An efficient financial market facilitates financial transactions. For stock markets, a basic measure of efficiency is the turnover ratio, the value of domestic shares traded divided by their market capitalization.

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In particular, the higher the turnover ratio is, the more liquid is the market, and hence the more efficient is the market. But few transactions taking place in a thin market can lead to price volatility and less liquid assets.

Net interest margin (NIM) denotes the difference between the interest income earned and the interest paid by a bank relative to its interest-earning assets. A positive NIM indicates that it has invested its funds efficiently, and a higher NIM would increase a bank's profitability.

Indonesia is the most profitable in terms of NIM, followed by the Philippines, Viet Nam, and Thailand. However, in terms of operating expenses as a ratio of income and total assets, commercial banks in Singapore and Malaysia are the most efficient.

Meanwhile, the turnover ratio is highest in Thailand in recent years, followed by Viet Nam, Singapore, and Malaysia. The Philippines had the lowest turnover ratio indicating the thinness of its stock market.

In terms of stability

The last characteristic covered by World Bank (2018) is financial stability. As Cihák et al. (2012) noted, rapid growth of credit could lead to instability if banks' lending standards are loose and/or financial regulation and supervision are inadequate, which could also lower their costs. Thus, financial stability is also key to financial development, as well as overall macroeconomic stability. Indicators of financial

stability covered in the database include the Z-score, regulatory capital to risk-weighted assets, and nonperforming loans (NPLs) to total gross loans.

- The Z-Score is a key variable used to measure banking stability by comparing buffers (capitalization and returns) with the potential for risk (volatility of returns). That is, it captures the probability of default of a country's banking system. Based on this variable, the study found that Singapore's banking system is the most stable, followed by the Philippines and Malaysia.
- Overall, bank NPLs to gross loans ratio has been declining in ASEAN especially in recent years.

Conclusion

Overall, the comparative review of financial sector development in ASEAN indicated that the Philippines has lagged behind other comparable ASEAN member States, particularly Malaysia and Thailand, with respect to financial deepening, access, and efficiency. Nonetheless, the Philippine banking system fared better with respect to financial stability. In many measures of financial development, Viet Nam has also overtaken the Philippines, but the latter has generally performed better than Indonesia.

The dominance of the banking sector is common in developing economies, including in ASEAN. It should be noted that the banking sector in the Philippines has proven to be resilient in the face of global financial crises, underpinned by a strong regulatory and supervisory framework. However, a review of the state of the Philippine financial services sector indicated that there has been no significant transformation over the past three decades. A review of the financial regulatory framework also showed that key domestic regulations remain restrictive (Sandoval and Milo 2018).

Moving forward, the goal should be a more diversified, dynamic, competitive, and resilient financial system that offers a wider range of financial products and services both to consumers and businesses through more efficient delivery channels. Drawing up a comprehensive and detailed long-term strategic action plan for the Philippine financial sector would help to identify reforms to address the weaknesses, and hence actualize the vision of a truly inclusive financial sector that is supportive of the country's economic growth and development.

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