Philippine Institute for Development Studies
*Surian sa mga Pag-aaral Pangkaunlaran ng Pilipinas*

# Deregulation of Bank Entry and Branching: Impact on Competition


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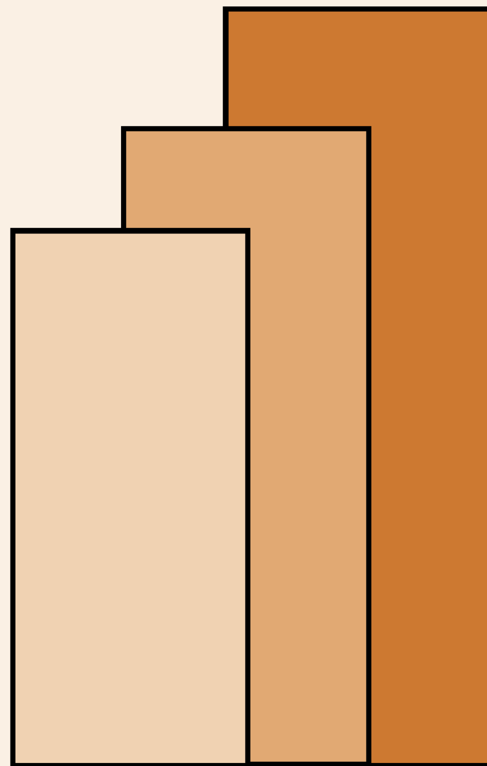
DISCUSSION PAPER SERIES NO. 2001-27

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December 2001


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*Revised draft*
*January 2002*

# DEREGULATION OF BANK ENTRY AND BRANCHING:

# IMPACT ON COMPETITION

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## Abstract

This paper looks at public policy towards bank entry and branching in the Philippines and its impact on the sector's structure, conduct and performance. In particular, it argues that regulatory restrictions on bank entry and branching have had adverse effects on competition, while the liberalization of these restrictions have led to a more competitive banking sector. The paper has two main sections. Section II presents the history of regulation of bank entry and branching in the Philippines. The impact of these regulations on the banking sector is then briefly discussed in Section III by looking at some indicators of changes in financial structure, measures of concentration and operational efficiency. Section IV then presents some policy implications.

Key words: banks, banking reforms, entry barriers

## Table of Contents


Page

Abstract ii

Table of contents iii

List of figures iv

List of tables iv

I. Introduction 1

II. Regulation of bank entry and branching in the Philippines 1

III. Some indicators of structure, conduct and performance of the banking sector 4

A. Financial structure 4

B. Measures of concentration 8

C. Operational efficiency 10

IV. Some policy implications 13

References 15

**List of Figures**


| Number | | Page |
|---|---|---|
| 1 | Assets of the Philippine financial system by type of institution, 1970-1999 (in billion pesos) | 5 |
| 2 | Total deposits and loans of banks by region, 1985-1999 (in million pesos, constant 1985 prices) | 7 |
| 3 | Distribution of commercial bank assets by type of banks, 1980-2000Q1 (in percent) | 9 |
| 4 | Measures of commercial bank asset concentration, 1990-2000Q1 | 10 |
| 5 | Operating costs and effective spread of commercial banks, 1993-June 2000 (in percent) | 13 |


**List of Tables**


| Number | | Page |
|---|---|---|
| 1 | Number of banking institutions, 1980-June 1999 | 6 |
| 2 | Number of banking offices by region and type of bank, 1985-1999 | 6 |
| 3 | Ratio of banking offices to total municipalities and cities by region, 1990-June 1999 | 7 |
| 4 | Number of head offices of commercial banks by type of bank, 1980-2000Q1 | 8 |
| 5 | Distribution of total assets, deposits and loans of commercial banks, 1990-2000Q1 | 9 |
| 6 | Commercial banks' average spread and rates of return (in percent) | 11 |

**Deregulation of Bank Entry and Branching: Impact on Competition**

Melanie S. Milo, Ph.D.

## I. Introduction

Competition has been referred to as the fundamental economic regulatory force. In a competitive market, several firms strive to produce goods and services at the cheapest price. Otherwise, more efficient firms, either actual or potential, will eliminate inefficient firms by undercutting their prices. In addition to its favorable impact on prices, competition may also lead to improved product quality and services, and encourage the production of new products and the use of new technologies. It may also lead to the availability of more and better information about products and product quality to consumers. Simply put, ensuring that markets operate in a competitive manner is welfare improving for society. Thus, international support for open markets has grown on account of the benefits of competition (Cabalu *et al* 1999).

In contrast, barriers to entry serve to limit the number of producers or sellers, and thus stifle or restrict competition (Lamberte *et al* 1992). Barriers to entry are factors that allow incumbent firms to raise and maintain prices above costs without fear that new firms would enter the market to contest it (Medalla 2000). In particular, regulations that restrict market entry are among those that have the most direct impact on competition[2]. Such restrictions are typically imposed for public safety or efficiency reasons, including preventing over-investment or overcrowding in certain markets. But primary importance is often placed on the elimination or reduction of government barriers to market entry to enhance the contestability of markets and the competitive process (Grimes 1999).

This paper looks at public policy towards bank entry and branching in the Philippines, and its impact on the sector's structure, conduct and performance.

## II. Regulation of bank entry and branching in the Philippines

Financial systems in both developed and developing countries have typically been subject to substantial public regulation. The basic rationale for this is that both the payments system, and public confidence in financial institutions and instruments on which the financial system is built, bear the qualities of a public good. Hence, the need for some government intervention to achieve market enhancing outcomes (Grimes 1999). In particular, there are two main reasons for regulating banks. One, regulation of banks provides protection against the risk that failure of one bank might lead to the failure of other banks, even if they are sound. The latter would lead to wider financial instability and overall economic disruption. Two, the asymmetry of information between depositor and bank means that a retail depositor does not have the capacity to assess the soundness of an individual institution. There is, thus, a need to provide some protection for depositors.

[2] Aside from direct entry restrictions, there are other policy-induced barriers to entry such as fiscal incentives and credit subsidies, as well as structural (e.g., scale economies) and behavioral (e.g., predatory pricing) entry barriers. For a review of the theory on entry barriers and an extensive discussion of entry barriers in the Philippines, see Lamberte *et al* (1992).

In particular, entry into the banking sector is one area that continues to be regulated even in the most liberalized or deregulated financial systems. All OECD countries, for instance, continue to regulate the entry of new domestic banks, although none of them imposes an outright ban on the entry of new banks. That is, new entry requires a license but is otherwise free. Controls on entry in the form of authorization criteria include minimum capital requirements, and more importantly fitness and properness criteria for controllers and managers of banks. On the other hand, the entry of foreign banks is relatively more restricted (OECD 1998). Thus, regulation of entry to the banking industry is primarily a tool of prudential regulation. "Free banking", or the removal of entry and other restrictions without accompanying prudential regulations, is also not deemed as tenable because it could lead to over-competition and excessive risk-taking, and thus compromise the stability and soundness of the banking system.

In the Philippines, government policy on domestic bank entry was initially lax in the 1950s and early 1960s, as the Central Bank of the Philippines (CBP) actively promoted the development of the banking system to finance the reconstruction of the economy after the war (CBP 1974). It became very restrictive beginning in the mid-1960s, as the rapid expansion of the banking system led to increased instability. By that time, the CBP became increasingly concerned over the large number of small banks, and decided to raise minimum capital requirements and essentially prohibited new bank entry (Emery 1976). The CBP also imposed tight restrictions on bank branching, especially in areas identified as heavily or over-branched. On the other hand, the moratorium on the entry of new foreign banks was imposed from the time the CBP began operations in 1949, for nationalistic reasons.

The Philippines' first attempt to reform its financial system occurred in the early 1970s. Among the measures introduced were a formal moratorium on new bank entry, coupled with a more favorable policy towards bank branching. In practice, though, rules on bank branching remained very restrictive and arbitrary (Lamberte and Lim 1987). Minimum capital requirements were again raised because authorities believed that bigger banks would lead to a more stable banking system. To meet the new requirement, mergers and acquisitions were especially encouraged to further reduce the number and increase the average size of commercial banks. Foreign equity participation of up to 30 percent of the voting stock of existing domestic banks was also allowed (Lamberte 1989).

The Philippines formally embarked on a financial liberalization program in the early 1980s, which included the deregulation of interest rates. However, it was noted that interest rate liberalization did not enhance competition because it was not accompanied by the complementary measure of deregulation of entry restrictions (Tan 1989). Again, the latter was due to the monetary authorities' belief that there were already too many banks in the Philippines. But the impact of removing interest rate ceilings depend on the degree of competitive pressure, which would not improve if there is no serious threat of entry into the banking system, or if other regulations such as those concerning branching become binding constraints (Blundell-Wignall and Ishida 1990). Banks' minimum capital requirements were also raised twice in the 1980s, with the intention of building up the sector, especially in the aftermath of the financial crises in the mid-1980s.

Regulations on new domestic bank entry and branching were relaxed in 1989, although in practice the CBP's policy remained restrictive and discretionary. In particular, new branches were allowed only in rural areas (Lamberte and Llanto 1993). It was only beginning in 1992 that restrictions on new domestic bank entry and branching were effectively relaxed, and these were further simplified and made uniform across banks in 1995. New domestic banks, satisfying the

laws of incorporation as approved by the Monetary Board, could be established as long as they met minimum capital and other prudential requirements. Geographical restrictions on domestic bank branching were lifted in 1993, and branches could be established anywhere subject to certain prudential requirements, such as those on capital adequacy, liquidity, profitability and soundness of management (Paderanga 1996).

The moratorium on foreign banks, which had been in place since the CBP was first established in 1949, was lifted in May 1994 with the passing of RA 7721. This law partially liberalized the entry and scope of operations of foreign banks in the Philippines. In particular, foreign banks were authorized to operate in the Philippines through (only) one of the following modes of entry: (i) acquire, purchase or own up to 60 percent of an existing domestic bank; (ii) invest in up to 60 percent of the voting stock of a new banking subsidiary incorporated in the Philippines; or (iii) establish a branch with full banking authority. The third mode of entry was operative for only 5 years from the date of effectivity of the Act, and was limited to only 10 foreign banks. Each of the 10 foreign banks was entitled to six branches – 3 in locations of its choice, and 3 in locations to be designated by the Monetary Board. The four foreign banks operating through branches in the Philippines upon the effectivity of the Act were also accorded the same branching privilege. In addition to the ten new foreign bank licenses granted in 1995, there have been seven new locally incorporated foreign bank subsidiaries.

These deregulatory measures were expected to improve access to banking services and enhance efficiency. Tan (1989) had argued that the restricted bank entry policy in the Philippines was responsible for the shallowness of the country's financial sector. In particular, the ultimate effect of the policy of restricted entry into the banking sector had been to shield both the big and small banks from competition, which allowed the big banks to earn abnormal profits and the small banks to operate at high costs. The restrictive bank branching policy also weakened the deposit mobilization process (Lamberte and Lim 1987).

The Asian crisis struck in July 1997, which led to systemic failure of financial institutions in Thailand, Indonesia, and South Korea. In contrast, only one fairly small and newly upgraded commercial bank failed in the Philippines, although the overall performance of the banking sector took a turn for the worse in the aftermath of the Asian crisis. In an effort to strengthen the banking sector, the *Bangko Sentral ng Pilipinas* (BSP) mandated consecutive increases in banks' minimum capital requirements. Furthermore, the BSP again declared an indefinite moratorium on the establishment of new banks and the branch expansion of existing banks, but excluding microfinance-oriented banks, in August 1999[3]. The foreign banks were also exempted from the moratorium on local branch expansion, although the limit of six new branches remained. This policy, together with higher minimum capital requirements, continued to reflect monetary authorities' preference for and strategy of forcing more mergers and acquisitions to reduce the number and increase the average size of banks in the Philippines. Consolidation is in turn expected to result in a stronger and more stable banking system. Thus, prospective investors were encouraged to acquire existing banks instead of applying for new operating licenses, while banks wishing to expand could do so by taking over smaller banks.

RA 8791, or the new General Banking Law of 2000, formalized the moratorium on new bank entry by stipulating that "no new commercial bank shall be established within three years from the effectivity of this Act" (Sec. 8.3). It also tightened the licensing requirement by including an assessment of the bank's ownership structure, directors and senior management in the licensing

[3] Monetary Board Resolution No. 1224 dated 27 August 1999.

process (Sec. 8.3). RA 8791 also expanded the coverage of RA 7721 by allowing a foreign bank to acquire up to 100 percent of the voting stock of (only) one bank, but only within seven years from the effectivity of this law. This included foreign banks that had acquired 60 percent of the voting stock of a bank under RA 7721. With the reimposed moratorium on the entry of new banks, the only alternative for foreign banks to enter the domestic industry is to buy into existing domestic banks. Again, this fitted in with the BSP's push for more mergers and acquisitions in the banking system. The BSP had designated a critical role for foreign banks in its effort to consolidate the banking sector, that is, foreign buy-ins were especially encouraged. More consolidation and more openness to foreign banks were seen as positive factors for the Philippine banking system. In particular, a strong foreign banking presence – with credibility and capital – was expected to result in improved efficiency and help to stabilize the banking system during times of stress. However, both RA 8791 and RA 7721 also contained a provision requiring the Monetary Board to ensure that 70 percent of the resources or assets of the entire banking system is controlled by domestic banks that are majority owned by Filipinos at all times.

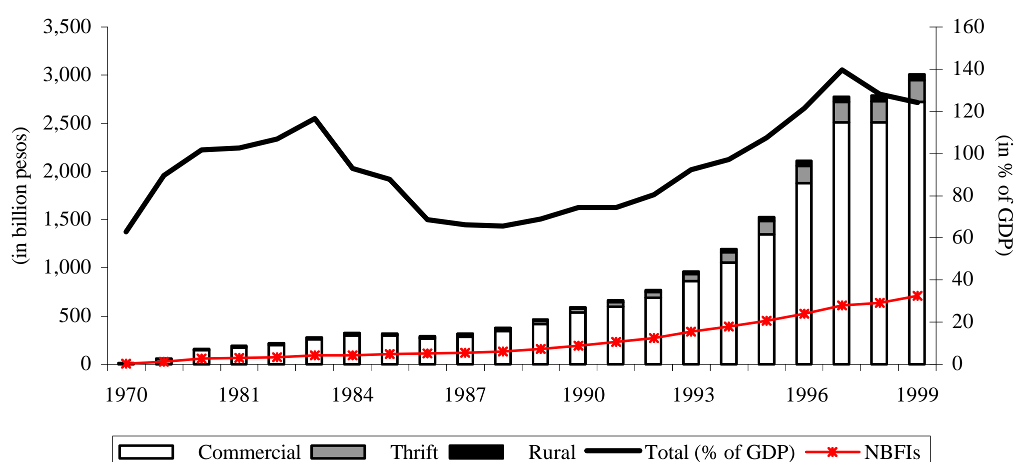
Overall, government barriers to bank entry, which included direct entry restrictions and higher capitalization requirements, were imposed primarily to limit and reduce the number, as well as increase the average size of banks in the Philippines. The problem was a weak structural base in that the financial system consisted of too many weak small banks, and a few strong, big banks. Bigger and fewer banks, in turn, were seen to promote the safety and soundness of the financial system. However, barriers to entry also had an impact on the banking sector's structure, conduct and performance. The following section briefly discusses these effects.

## III. Some indicators of structure, conduct and performance of the banking sector

**Financial structure.** The Philippine financial system consists of banks and nonbank financial institutions (NBFIs). RA 8791 classifies banks into commercial banks, universal banks (expanded commercial banks), thrift banks (savings and mortgage banks, stock savings and loan associations and private development banks), rural banks, cooperative banks and Islamic banks. NBFIs include, among others, insurance companies, investment houses, financing companies, securities dealers and brokers, fund managers, lending investors, pension funds, pawnshops and nonstock savings and loan associations.

Figure 1 shows the total assets of the Philippine financial system from 1970-99. Total assets of the financial system as a percentage of GDP rose from 63 percent in 1970 to 117 percent in 1983, then fell to 66 percent in 1988 as a result of the financial and economic crises in the mid-1980s. The ratio rose to around 140 percent in 1997, and again declined to 124 percent in the aftermath of the Asian crisis. The total assets of commercial banks, in particular, grew significantly in the 1990s due to the successive increases in minimum capital requirements, the upgrading of the specialized government banks, and the entry of new domestic and foreign banks.

Figure 1 **Assets of the Philippine financial system, by type of institution, 1970-1999 (in billion pesos)**




**Note:** Total assets are plotted on the right axis, while assets by type of institution are plotted on the left axis.
**Source of basic data:** Bangko Sentral ng Pilipinas ; National Statistical Coordination Board.

The Philippine financial system has consistently been dominated by commercial banks. In fact, the importance of commercial banks even increased over time. The banking system accounted for 81 percent of total financial assets in 1999, compared to around 76 percent in 1970. The asset share of commercial banks also increased from around 57 percent in 1970 to 73 percent in 1999. In contrast, the asset share of rural banks fell from around 3 percent in the 1970s to less than 2 percent in the 1999, while the asset share of thrift banks slightly rose to 6 percent in 1999 from 4 percent in 1970. On the other hand, the share of NBFIs in total financial assets fell from a high of 28 percent in 1975 to 19 percent in 1999.

Thus, there has been no significant structural change in the Philippine financial sector in the last 30 years. A bank-dominated financial system is not necessarily bad. The issue is whether such a structure is a market-outcome, or the result of government policy and regulation. In the case of the Philippines, it was clearly the latter. The banking sector has historically been the focus of financial sector policy, development and reform. In contrast, efforts to reform and develop the other sectors of the financial system began only in the mid-1990s[4].

Table 1 shows the number of banking offices in the Philippines from 1980 to 1999. The easing of restrictions especially on bank branching was very evident in the rapid growth of banking offices in the 1990s. Compared to just 0.5 percent in the 1980s, the number of banking offices in the 1990s grew by 8.7 percent, with all bank categories posting significant growth. In particular, double-digit growth rates were recorded in the number of branches of rural banks beginning in 1990, and beginning in 1992 for commercial and thrift banks. The period after the deregulation of foreign bank entry but before the Asian crisis was also marked by a dramatic increase in the number of commercial and thrift bank branches. The increase in the number of head offices of commercial banks was largely due to the entry of foreign banks beginning in 1995. In terms of number of branches, however, foreign banks were at a serious disadvantage. For instance, private domestic commercial banks had a total of over 4,000 branches in 1999. In contrast, foreign bank branches and subsidiaries had only around 219 branches.

[4] See Milo (2001).

Table 1 **Number of banking institutions, 1980-June 1999**

| | 1980 | 1985 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | Jun-99 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Banking Institutions | 3,419 | 3,632 | 3,638 | 3,791 | 4,296 | 4,657 | 5,096 | 5,569 | 6,335 | 7,182 | 7,646 | 7,689 |
| Head offices | 1,209 | 1,055 | 940 | 919 | 920 | 912 | 920 | 938 | 961 | 1,003 | 996 | 976 |
| Branches/Agencies | 2,210 | 2,577 | 2,698 | 2,872 | 3,376 | 3,745 | 4,176 | 4,631 | 5,374 | 6,179 | 6,650 | 6,713 |
| A. Commercial Banks | 1,501 | 1,744 | 1,813 | 1,923 | 2,254 | 2,477 | 2,776 | 3,047 | 3,650 | 4,078 | 4,230 | 4,326 |
| Head offices | 32 | 30 | 30 | 31 | 32 | 32 | 33 | 46 | 49 | 54 | 53 | 52 |
| Branches/Agencies | 1,469 | 1,714 | 1,783 | 1,892 | 2,222 | 2,445 | 2,743 | 3,001 | 3,601 | 4,024 | 4,177 | 4,274 |
| B. Thrift Banks | 671 | 671 | 653 | 663 | 718 | 780 | 821 | 925 | 1,171 | 1,389 | 1,474 | 1,478 |
| Head offices | 144 | 118 | 103 | 101 | 98 | 97 | 100 | 99 | 108 | 117 | 117 | 118 |
| Branches/Agencies | 527 | 553 | 550 | 562 | 620 | 683 | 721 | 826 | 1,063 | 1,272 | 1,357 | 1,360 |
| C. Rural Banks | 1,155 | 1,117 | 1,045 | 1,063 | 1,140 | 1,195 | 1,274 | 1,346 | 1,514 | 1,715 | 1,942 | 1,885 |
| Head offices | 1,030 | 904 | 804 | 784 | 787 | 780 | 784 | 790 | 804 | 832 | 826 | 806 |
| Branches/Agencies | 125 | 213 | 241 | 279 | 353 | 415 | 490 | 556 | 710 | 883 | 1,116 | 1,079 |

**Source:** Bangko Sentral ng Pilipinas.

Table 1 showed the rapid expansion of banking offices as a result of deregulation of entry and branching. Furthermore, the rapid growth of banking offices took place across all regions of the country (Table 2), which also led to an improvement in banking density ratios across all regions (Table 3).

Table 2 **Number of banking offices by region and type of bank, 1985-1999**

| | 1985 | 1990 | 1995 | 1996 | 1997 | 1998 | 1999 |
|---|---|---|---|---|---|---|---|
| **PHILIPPINES** | **3,624** | **3,641** | **5,574** | **6,341** | **7,182** | **7,641** | **7,685** |
| Commercial Banks | 1,746 | 1,821 | 3,053 | 3,656 | 4,078 | 4,225 | 4,322 |
| Thrift Banks | 661 | 650 | 925 | 1,171 | 1,389 | 1,474 | 1,478 |
| Rural Banks | 1,117 | 1,045 | 1,346 | 1,514 | 1,715 | 1,942 | 1,885 |
| Government Banks[1/] | 100 | 125 | 250 | 318 | 379 | 396 | 411 |
| **Luzon** | **2,540** | **2,577** | **4,085** | **4,664** | **5,342** | **5,663** | **5,726** |
| Commercial Banks | 1,276 | 1,339 | 2,303 | 2,520 | 2,832 | 2,938 | 3,013 |
| Thrift Banks | 555 | 559 | 785 | 975 | 1,114 | 1,167 | 1,175 |
| Rural Banks | 668 | 630 | 862 | 990 | 1,173 | 1,326 | 1,300 |
| Government Banks | 41 | 49 | 135 | 179 | 223 | 232 | 238 |
| **Visayas** | **575** | **561** | **820** | **900** | **981** | **1,042** | **1,031** |
| Commercial Banks | 254 | 255 | 417 | 445 | 479 | 498 | 503 |
| Thrift Banks | 48 | 52 | 85 | 110 | 159 | 173 | 172 |
| Rural Banks | 252 | 232 | 273 | 291 | 284 | 307 | 286 |
| Government Banks | 21 | 22 | 45 | 54 | 59 | 64 | 70 |
| **Mindanao** | **509** | **503** | **669** | **777** | **859** | **936** | **928** |
| Commercial Banks | 216 | 227 | 333 | 373 | 388 | 393 | 395 |
| Thrift Banks | 58 | 39 | 55 | 86 | 116 | 134 | 131 |
| Rural Banks | 197 | 183 | 211 | 233 | 258 | 309 | 299 |
| Government Banks | 38 | 54 | 70 | 85 | 97 | 100 | 103 |

1/ Grouped with commercial banks starting 1996.

**Source:** Bangko Sentral ng Pilipinas.

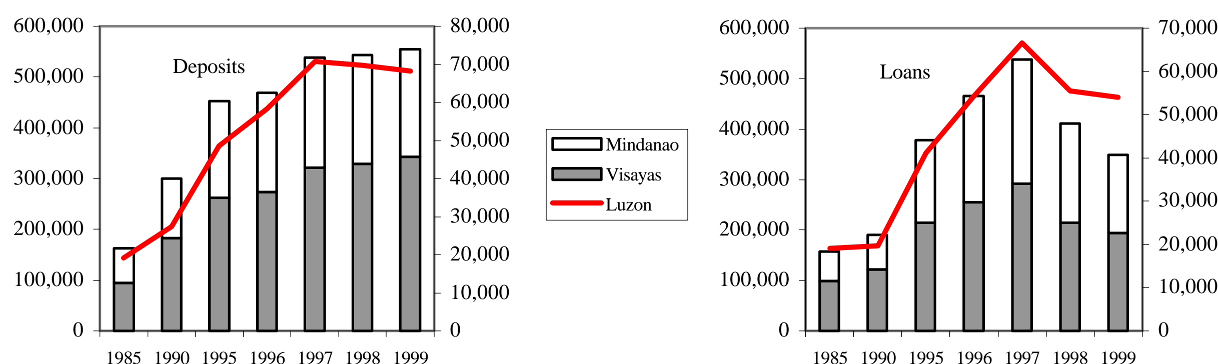
Table 3 **Ratio of banking offices to total municipalities and cities by region, 1990-June 1999**

| Region | 1990 | 1995 | 1999 (as of June) | No of municipalities and cities (Jun 99) | Without Banks (Jun 99) |
|---|---|---|---|---|---|
| **Philippines** | **2.3** | **3.4** | **4.7** | **1,600** | **674** |
| NCR - Metro Manila | 9.8 | 112.2 | 154.9 | 17 | 0 |
| I - Ilocos | 1.6 | 2.2 | 3.0 | 125 | 30 |
| II - Cagayan Valley | 0.9 | 1.7 | 2.2 | 93 | 39 |
| III - Central Luzon | 3.1 | 4.7 | 6.6 | 122 | 9 |
| IV - Southern Tagalog | 2.4 | 3.9 | 5.9 | 222 | 51 |
| V - Bicol | 1.2 | 1.5 | 1.8 | 115 | 55 |
| VI - Western Visayas | 2.0 | 2.6 | 3.1 | 131 | 34 |
| VII - Central Visayas | 1.7 | 2.8 | 3.8 | 132 | 47 |
| VIII - Eastern Visayas | 0.6 | 0.7 | 0.9 | 142 | 98 |
| IX - Western Mindanao | 0.7 | 1.2 | 1.5 | 75 | 55 |
| X - Northern Mindanao | 1.3 | 1.7 | 3.0 | 70 | 24 |
| XI - Southern Mindanao | 2.2 | 2.8 | 4.8 | 81 | 25 |
| XII - Central Mindanao | 0.8 | 1.5 | 1.8 | 40 | 25 |
| CAR | - | 1.0 | 1.3 | 77 | 58 |
| ARMM | - | 0.6 | 0.5 | 85 | 77 |
| CARAGA | - | - | 1.3 | 73 | 47 |

**Source:** Bangko Sentral ng Pilipinas.

Thus, deregulation of branching in particular had a significant impact on regional access to basic banking services in terms of deposits and loans, as shown in Figure 2. Any portfolio shifts from holding savings in the form of physical assets to financial assets would lead to more efficient financial intermediation. In turn, the improvement in financial intermediation would have a positive impact on the economy. In terms of distribution, however, most of the bigger commercial banks in particular were located in Metro Manila. The distribution of financial resources would necessarily be biased in its favor still.

Figure 2 **Total deposits and loans of banks by region, 1985-1999** (in millions pesos, constant 1985 prices)




**Note:** Figures for Luzon are plotted on the left axis, while figures for Visayas and Mindanao are plotted on the right axis.

**Source of basic data:** Bangko Sentral ng Pilipinas; National Statistical Coordination Board.

Overall, the Philippine banking system continued to be characterized by the presence of a few large commercial banks and a lot of very small thrift and rural banks. As noted earlier, restricted

bank entry policy had fostered such a structure. The following subsections discuss the impact of banking structure on banks' conduct and performance.

**Measures of concentration.** The continued dominance of a few, large commercial banks raises the issue of market power. Thus, there is a need to monitor the concentration process even in a deregulated environment to detect any further strengthening of the oligopolistic group, and ensure that it does not lead to misuse of market power.

Table 4 shows the number of commercial banks by ownership. In contrast to previous periods, the period after 1995 was characterized by significant movement in the commercial banking sector in terms of new entries and consolidations. In particular, the number of foreign bank branches and subsidiaries increased as a result of deregulation. The number of domestic private banks initially increased in the first half of the 1990s as a result of deregulation of entry, then decreased towards the latter half due to mergers and acquisitions. Although the BSP especially encouraged mergers and acquisitions among the small banks to meet the higher capital requirements, the mergers and acquisitions primarily took place among the biggest banks.

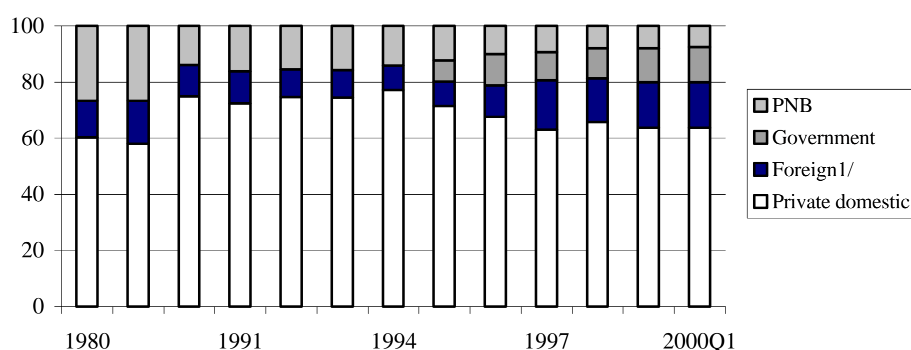
Table 4 **Number of head offices of commercial banks by type of bank, 1980-2000Q1**

| Type of bank | 1980 | 1985 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000Q1 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| TOTAL | 32 | 30 | 30 | 31 | 32 | 32 | 33 | 46 | 49 | 54 | 53 | 52 | 47 |
| Private domestic banks | 27 | 25 | 25 | 26 | 27 | 27 | 28 | 30 | 31 | 33 | 32 | 30 | 25 |
| Foreign bank branches | 4 | 4 | 4 | 4 | 4 | 4 | 4 | 14 | 14 | 14 | 13 | 13 | 13 |
| Foreign bank subsidiaries | | | | | | | | | | 4 | 5 | 6 | 6 |
| Government banks | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 2 | 4 | 3 | 3 | 3 | 3 |

**Note:** Data for the first quarter of 2000 incorporated the approved mergers and acquisitions.
**Source of basic data:** Bangko Sentral ng Pilipinas.

Figure 3 and Table 5 show the distribution of commercial bank assets according to ownership of banks. Private domestic banks consistently accounted for over 60 percent of total commercial bank assets. Private domestic banks' share rose to as high as 77 percent in 1994, before subsequently falling to around 67 percent in 1999, with the entry of the ten foreign banks in 1995. If the share of Philippine National Bank (PNB), which passed into majority private ownership in 1995, is included, the share rises to around 76 percent in 1999. On the other hand, the asset share of foreign bank branches and subsidiaries rose from around 9 percent in 1995 to 17.5 percent in 1997, which indicates a decreasing dominance of the domestic commercial banks. Finally, the asset share of government owned commercial banks declined from less than 27 percent in 1980 (accounted for by PNB) to 12.6 percent in 1999. The share of foreign bank branches and subsidiaries in total deposits and loans likewise increased beginning in the mid-1990s.

Figure 3 **Distribution of commercial bank assets, by type of bank, 1980-2000Q1 (in percent)**




**Source of basic data:** Bangko Sentral ng Pilipinas.
**Note:** 1/Includes branches and subsidiaries of foreign banks.

Table 5 **Distribution of total assets, deposits and loans of commercial banks, 1990-2000Q1**

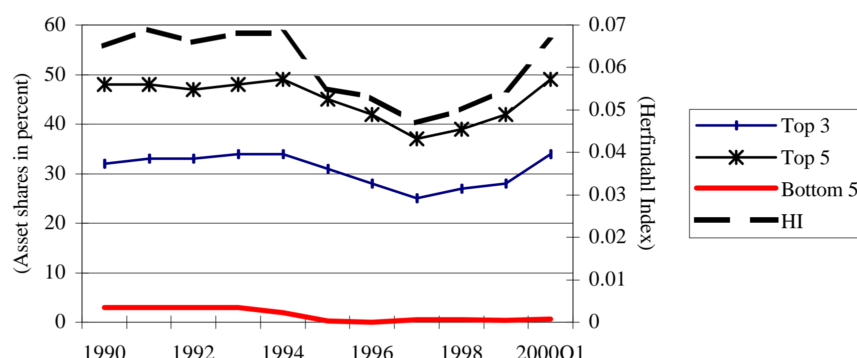
| | 1990 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000Q1 |
|---|---|---|---|---|---|---|---|
| Total Assets (bil P) | 488.9 | 1,386.4 | 1,885.6 | 2,581.1 | 2,638.6 | 2,744.1 | 2,623.4 |
| % Domestic KBs | 88.6 | 91.3 | 87.3 | 82.5 | 84.4 | 83.6 | 83.7 |
| % Foreign KBs | 11.4 | 8.7 | 12.7 | 17.5 | 15.6 | 16.4 | 16.3 |
| Total Deposits (bil P) | 306.1 | 898.0 | 1,249.5 | 1,476.4 | 1,652.2 | 1,767.3 | 1,726.6 |
| % Domestic KBs | 92.5 | 95.2 | 95.4 | 91.8 | 90.6 | 87.3 | 87.4 |
| % Foreign KBs | 7.5 | 4.8 | 4.6 | 8.2 | 9.4 | 12.7 | 12.6 |
| Total Loans (bil P) | 181.8 | 810.0 | 1,122.6 | 1,366.0 | 1,369.1 | 1,269.9 | 1,203.7 |
| % Domestic KBs | 91.4 | 92.8 | 91.7 | 88.4 | 88.7 | 86.6 | 86.7 |
| % Foreign KBs | 8.6 | 7.2 | 8.3 | 11.6 | 11.3 | 13.4 | 13.3 |

**Source of basic data:** Bangko Sentral ng Pilipinas.

Figure 4 presents some measures of asset concentration of the Philippine commercial banking system. Although the actual value of the Herfindahl index (HI) [5] may not be indicative of undue concentration, given its very low values, it would also be useful to look at the trend. The HI was fairly stable from 1990-94. It began to decline beginning in 1995 with the entry of the new foreign banks, indicating that the system was becoming less concentrated. However, this trend was reversed beginning in 1998, which means that the mergers and acquisitions also resulted in increasing concentration. Similar trends are also evident when one looks at the asset share of the three and five largest commercial banks, which are all domestic banks. Before the restriction on new bank entry was eased in 1995, the five largest commercial banks consistently accounted for around half of the sector's total assets. Their share declined to around 37 percent in 1997, but this trend has since been reversed. Also, the wide gap between the five biggest and five smallest commercial banks is stark. As noted earlier, the concern with excessive concentration is that it is a potential source of monopoly power.

[5] The Herfindahl index, which is a commonly used measure of industrial concentration, is calculated by squaring and summing the share of industry size accounted for by every firm in the industry, with a maximum value of 1 (or 10,000 where the market share is measured in percentage terms) indicating a monopoly.

Figure 4 **Measures of commercial bank asset concentration, 1990-2000Q1**




**Source of basic data:** Published balance sheet statements of commercial banks.

**Operational efficiency.** Operational efficiency is a microeconomic concept, but it is also used to characterize a financial system. In particular, the market structure could be reflected in the spread between the cost of funds and the lending rate: a financial system is considered operationally efficient if the interest spread is low. The latter, in turn, arises from two factors. On a microeconomic level, the more cost efficient banks are, the lower the spread will be under reasonably competitive conditions. On a macroeconomic level, systemic risks also affect the spread. A more stable and confident environment will lead to a lower risk premium over lending, thus leading to a lower spread (Ersel and Kandil 2000).

A high intermediation margin would imply a smaller intermediation activity (Tan 1989). One of the structural weaknesses identified in the Philippine banking sector in the past was the large spread between commercial bank deposit and lending rates, which in turn was attributed to high intermediation costs mainly in the form of taxes and reserve requirements, as well as high profit margins (World Bank 1986). Tan (1989) also pointed out that the interest rate differential might not just be due to taxes, but to some monopoly power of the large commercial banks as well. More recently, the World Bank (1998) noted that high intermediation costs continued to be a feature of the Philippine banking system, especially when compared to other Asian economies[6]. Average net interest margin as a ratio of total assets from 1988-95 was 4.2 percent. Figures for comparable countries like Indonesia and Thailand were 3.5 and 3.1 percent, respectively (Demirguc-Kunt and Huizinga 1997; in Claessens and Glaessner 1998).

In addition to high reserve requirements and the mandated credit requirements, other contributing factors to the Philippines' high intermediation costs were high operating costs and insufficient competition (World Bank 1998). Operating costs of Philippine banks were also found to be significantly higher in the Philippines compared to other Asian economies. In particular, average overhead costs as a ratio of total assets in 1988-95 was around 4.4 percent, compared to 2.9 percent and 2.0 percent for Indonesia and Thailand, respectively. Despite the higher operating costs, Philippine banks were also found to be more profitable. The ratio of net profit to total assets was around 2 percent for Philippine banks during the same period, against 0.9 and 1.1 for Indonesia and Thailand respectively (Demirguc-Kunt and Huizinga 1997; in Claessens and Glaessner 1998). Thus, the World Bank (1998) noted that the "high profits despite

[6] The interest spread is often used for international comparisons of financial sector efficiency. But as Claessens and Glaessner (1998) noted, cross-country comparisons should be done with care because a number of country-specific regulatory, tax, macroeconomic and microeconomic factors affect the costs of financial intermediation.

high costs indicate lack of competition, which is also evidenced by the fact that there is high concentration in the banking sector…" (p. 23).

The partial liberalization of foreign bank entry in 1994 precisely aimed to increase competition and improve efficiency in the domestic banking sector. By increasing competition, it was expected that market forces would reduce bank spreads. Although the entry of more foreign banks led to some changes in the banking structure, particularly the decline in concentration ratios, there has been no significant impact on bank spreads. Table 6 shows domestic commercial banks' average spread and rates of return both prior to and after the restriction on foreign bank entry was eased in 1995. Both only slightly declined during the post-liberalization years prior to the Asian crisis.

Table 6 **Commercial banks' average spread and rates of return (in percent)**

| | Average spread[1] | Average rate of return | |
|---|---|---|---|
| | | on Assets | on Equity |
| Pre-liberalization: 1991-94[2] | 4.733 | 2.51 | 25.66 |
| Post-liberalization: 1995-97 | 4.345 | 2.23 | 18.83 |

**Notes:** [1]Difference between lending and deposit rates adjusted for the gross receipts tax and changes in required reserves; [2]1987-94 for Average rate of return.

**Source:** Lamberte (1999).

Recent studies have examined the impact of the entry of more foreign banks on domestic banks' interest rate spreads and efficiency (e.g., Manzano and Neri 2001, Montinola and Moreno 2001, Unite and Sullivan 2001). Overall, their results indicate that foreign bank entry has had limited impact. Manzano and Neri (2001) noted that the effects on competition might not have been felt immediately because of a period of adjustment for the foreign banks, and/or because liberalization did not go far enough. But ultimately, they attributed the persistence of high bank spreads to the government's macroeconomic policy mix. In particular, the overvalued exchange rate before the crisis encouraged foreign borrowing and dollar intermediation by banks, which dampened the competition for peso deposits and upward movements in the deposit rate. On the other hand, the government's high interest rate policy to defend the exchange rate caused banks' lending rate to remain high. Thus, the impact of macroeconomic factors could have masked the impact of foreign bank entry on domestic banks' interest spread. According to Montinola and Moreno (2001), the scope of liberalization was limited, hence its modest effects on competitiveness and efficiency.

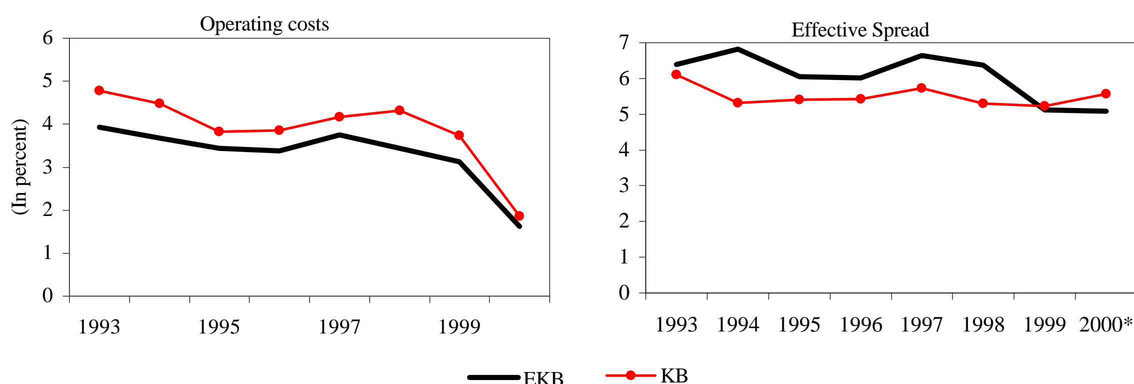
A more in-depth study of the determinants of bank net interest margins would be useful to establish the impact of the structure of bank competition. Apart from the market structure component, regulatory components in the form of reserve requirements and capital to asset ratios, and a risk premium component to account for uncertainty in the macroeconomic environment facing banks would have significant effects on bank net interest margins (Saunders and Schumacher 2000). The persistence of high interest rate spreads despite financial reforms was also observed in Latin America (Brock and Suarez 2000). This was attributed to a combination of microeconomic and macroeconomic factors, including high operating costs, high levels of nonperforming loans, high reserve requirements, and uncertainty in the macroeconomic environment facing banks. In the Philippines, it has also been argued that part of the reason for the high bank spreads is that banks are heavily capitalized and less leveraged. In the years prior to the 1997 Asian crisis, Philippine banks' capital adequacy ratio, defined as the ratio of net worth to risk assets, was between 17-20 percent. Holding equity capital is relatively costly when compared to debt, and so banks that have relatively high capital ratios can be expected to try to cover some of this cost by imposing an extra spread (Saunders and Schumacher 2000).

While the entry of more foreign banks in 1995 has not had a visible impact in terms of reducing domestic banks' interest spread, this does not mean that foreign banks have had no impact whatsoever on domestic banks' operations and the level of competition in the banking sector. Focusing on price or interest competition does not take into account the dynamic aspect of competition and efficiency. The latter refers to the structural response of banks to deregulation as reflected for instance in their balance sheets, that is, the changes in the structure of their assets and liabilities. Audretsch *et al* (2001) noted that competition and anti-trust policies in the developed economies such as the European Union have been based on traditional static models and analyses of industrial organization, wherein technology and consumer demand are given and price (output) is the firm's main, if not its only, choice variable. In contrast to the static models' focus on price competition, more recent dynamic models of industrial organization argue that firms in reality are "engaged in a continuing dynamic competitive process, constantly creating and adopting new products and processes in order to gain advantage over their rivals" (p. 618). And in a dynamic economy, the latter may have a more significant effect on welfare than the former in the long run. The issue is especially relevant to financial markets as they operate in more deregulated and globalized environments, and become increasingly characterized by technological advancements and product innovations. This emphasizes the need to augment traditional analyses of industrial organization, such as Bain's (1956) Structure-Conduct-Performance paradigm, with more dynamic analyses of markets and institutions in order to come up with a fuller depiction of competition (Audretsch *et al* 2001).

In the Philippines, foreign banks traditionally competed with local banks primarily in corporate lending and non-branch based financial services. A survey of selected local banks on their reactions to the entry of more foreign banks in 1995 indicated that the latter has led to a more competitive environment particularly in wholesale banking (Hapitan 2001). The entry of more foreign banks further reduced the already thinning spreads from servicing corporate accounts because of the entry of more local banks in the early 1990s. This induced local banks to tap other segments of the market that would generate higher returns. Thus, local banks shifted their focus towards developing products and services for the middle and retail consumer markets, and to some extent the previously neglected small and medium sized enterprises. Local banks also sought to improve existing product lines and services, especially by introducing technology based enhancements such as phone banking, bills payment, point of sale transactions, and internet banking (AAC 1998). But as Hapitan (2001) also noted, re-engineering was undertaken by the domestic banks as a strategy in itself, and not because of the entry of more foreign banks per se.

Local banks' greater focus on retail operations could also account for the persistence of high banks spreads, both from the cost and profit aspects. Banks whose services are directed more toward retail operations normally have higher operating costs compared to banks that are more oriented toward wholesale markets. This is due to the former's need for more branches, equipment, and personnel to serve retail customers. Higher operating costs then translate into a higher spread (Brock and Suarez 2000). Branches of domestic commercial banks expanded rapidly especially in 1995-97, which accounts for the increasing trend in their operating costs during that period (Figure 5). The shift towards more profitable retail lending could have also allowed banks to maintain their profit margins. The New General Banking Law has allowed foreign banks to fully own an existing local bank, thus relaxing the restriction on branching by foreign banks. In December 2000, Hong Kong Shanghai Banking Corporation (HSBC) acquired a local thrift bank, which could further enhance competition in the middle and retail consumer markets.

Figure 5 **Operating costs[1] and effective spread[2] of commercial banks[3], 1993-June 2000** (in percent)




**Notes:** [1]Ratio of other operating expenses (overhead costs including personnel costs) to total assets.

[2]Effective spread $= \frac{\text{(Interest income on loans)}}{\text{(Ave. current loans)}} - \frac{\text{(Interest expenditures on deposits)}}{\text{(Ave. deposits)}}$

[3]Domestic expanded commercial or universal banks (EKB) and regular commercial banks (KB).

**Source:** Philippine Deposit Insurance Corporation.

## IV. Some policy implications

One area of public policy that has had a significant impact on the structure and performance of the Philippine banking sector is on entry and branching. In particular, restrictions on entry and branching, coupled with other regulatory restrictions on competition, led to an uncompetitive and inefficient banking system. On the other hand, their deregulation enhanced the contestability and competitiveness of the market, and facilitated changes in banking trends. In particular, the results indicate that deregulation of bank entry and branching had a positive impact on financial intermediation and dynamic efficiency of commercial banks.

Government barriers to bank entry are imposed primarily to limit and reduce the number, as well as increase the average size of banks in the Philippines. The problem was a weak structural base in that the financial system consisted of too many weak small banks, and a few strong, big banks. Bigger and fewer banks, in turn, were seen to promote the safety and soundness of the financial system. However, the focus should not just be the size of banks, but whether they are also sound, competitive and efficient. And in the latter aspect, entry barriers have clearly had a negative effect. Clearly a balance needs to be struck between the potential costs and potential benefits of allowing greater competition. In particular, the potential adverse effects of enhancing competition through a lowering of barriers to entry can be addressed by properly applying prudential restrictions already in place, particularly the fitness and properness criteria for bank owners and managers. Although it should also be noted that one merit of having direct entry restrictions in the Philippines is that it frees monetary authorities from political interventions in the licensing process.

On the other hand, the policy bias has somewhat shifted in favor of foreign banks. The literature on foreign banking typically asserts that foreign bank entry can render national banking markets more competitive, thereby forcing domestic banks to operate more efficiently (Claessens *et al* 1998) Another potential positive impact of greater foreign participation in the Philippine banking sector is on the ownership structure of domestic banks. Very few domestic banks have remained purely Filipino owned, and foreign stakes could be increased further. This would serve not just to

widen the ownership base of domestic banks, but also change the nature of ownership and hence banking in the Philippines. Concentration of ownership of Philippine banks continues to be a concern essentially because of its adverse implications on allocation of credit, the worst case being DOSRI abuses. But any resulting adverse efficiency effects would eventually backfire on the banks themselves, as the cases of Japan and South Korea clearly demonstrated, and with grave consequences for the entire economy. As long as scarce loanable funds are not channeled to borrowers who can use them most productively, the level and quality of investments and, consequently, the rate of economic growth will be severely affected.

Finally, in addition to the policy on entry and branching, there are other key policy issues with respect to competition in the commercial banking sector that need to be examined further. These include other unjustified regulatory restrictions on competition such as the mandatory credit requirements, which are also a contributing factor to the Philippines' high intermediation costs; the effective treatment of the "exit problem", competitive neutrality, mergers and acquisitions, and potential anti-competitive agreements as banks enter into more cooperative arrangements (e.g., the interconnection of networks such as ATMs; operation of international credit card systems or national debit transfer systems)[7].

[7] Milo (2000) discusses these issues more fully.

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