BANKING SECTOR REFORMS

Banking sector liberalization in Philippines: A win-win situation, not a zero-sum game

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On July 18th 2014, Philippines President Benigno Aquino III signed into law a landmark Bill allowing full control of domestic lenders by foreign banks. Under the new law, 1) Foreign banks are allowed to acquire, purchase or own up to 100% of the voting stock of an existing Philippines bank, from 60% previously; 2) invest in up to 100% of the voting stock of new banking subsidiary; and 3) establish branches with full banking authority. Likewise, limits to the number of foreign banks operating in the country have been eliminated – an important step towards implementing the ASEAN Banking Integration Framework (ABIF). As a part of the ASEAN Economic Community (AEC) integration, the ABIF aims to achieve parity of banking regulations across ASEAN, and in turn strengthen local banks through greater competition and wider market access.

The latest piece of banking legislation is rather rare amongst emerging economies and reflects the Philippines Government's commitment to hard and enduring reforms – a prerequisite for sustaining the economy's on-going favourable growth momentum. With wounds of the 2009 credit crisis yet to heal, most emerging economies have extended a guarded welcome to foreign banks, wary of allowing them full control of local lenders lest it fuels systemic risks to the domestic financial market. To a large extent, Philippines' open-up of its banking sector is encouraged by the economy's exceptional performance in the second half of last year despite the global financial turmoil caused by Fed's QE tapering expectations.

Against this backdrop, we evaluate the implications of the latest banking sector liberalization measures on the Philippines economy, on potential foreign bank entrants and on local domestic banks. We believe that the medium to long term benefits to - 1) the Philippines economy from a vibrant banking sector, 2) foreign lenders, looking expand their footprints in fast growing emerging economies, and 3) the domestic banks, looking to catapult into the big league, - far outweigh the short term painful adjustments that may take place as the Philippines economy and its lightweight banking sector is exposed to foreign banking heavyweights. Thus, we believe that the Government's bold banking reforms are a win-win situation for all its stakeholders over the long haul.

Table 1
Key macro indicators of ASEAN economies

		2014 IMF estimates					
Indicators		**Philippines**	**Indonesia**	**Malaysia**	**Thailand**	**Singapore**	**Vietnam**
GDP growth	% y/y	6.5	5.4	5.2	2.5	3.6	5.6
Inflation	% y/y	4.4	6.3	3.3	2.3	2.3	6.3
Current Account Balance	% of GDP	3.2	-3.0	4.1	0.2	17.7	4.3
Foreign Direct Investment	% of GDP (2013)	1.4	2.2	3.7	3.3	21.4	5.2
Investment rate	% of GDP	19.8	33.4	27.1	27.9	27.1	25.3
Import Cover	Months (2013)	13.2	6.5	7.8	9.7	8.8	2.9
Population	Million	99.4	251.5	30.1	68.6	5.5	90.6
Gross Government Debt	% of GDP	35.2	26.0	56.4	46.6	102.4	58.7
Unemployment rate	% of total labor force	6.9	6.1	3.0	0.7	2.0	4.4

Source: BBVA Research and IMF

Banking reforms come at an opportune time for Philippines as it looks to sustain rapid growth by reviving up PPP in infrastructure development

The latest round of banking reform comes at a crucial juncture for Philippines: Once written off as the 'sick man of Asia', Philippines has, over the past year, transformed itself into a bastion of good governance and the second fastest growing economy in Asia in 2013, trailing only China (7.25% y/y in 2013). Despite a string of severe natural disasters and slowing global growth, the economy picked up steam, led by wide ranging reforms, strong remittance inflow, an accommodative monetary policy and benign financial conditions. The economy has got a thumbs-up from global rating agencies with S&P, last May, upgrading Philippines by one notch to BBB with a stable outlook on the back of expectations that 'on-going reforms to address shortcomings in structural, administrative, institutional, and governance areas will endure beyond the current administration'.

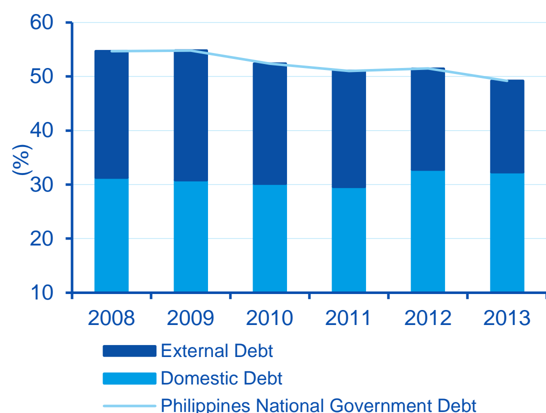
A favourable growth outlook is clouded by overheating risks as the economy hits infrastructure supply constraints: Looking ahead, although the medium term growth outlook remains favourable – official estimates of GDP growth for 2014: 6.5% to 7.5% and for 2015: 7% to 8% - , the economy has begun to hit infrastructure supply constraints, and in turn poses overheating risk (See Figure – 1). Foreign direct investments as a share of GDP as well as investment rate in Philippines is the lowest amongst major ASEAN countries (See Table – 1). The government is thus looking to bolster infrastructure development by ramping up public spending and supporting public-private partnership projects (PPP). In this regard, securing long term infrastructure financing warrants an improvement in the investment climate by removing administrative hurdles, ensuring policy clarity and quickening project clearances and easing foreign ownership norms.

Bold banking reforms to buttress investor confidence and augment long term capital inflows: A free hand for foreign banks to operate and expand via the organic as well as inorganic route would buttress investor confidence and in turn spur long term capital inflows and boost plans to mobilize funds for infrastructure development. In this context, the role of Government in encouraging banks to raise long term capital by floating infrastructure development funds is critical. Last year, an infrastructure fund dedicated to Philippines and led by Macquarie, the Australian bank, raised USD 625 mn. Furthermore, a free entry of foreign banks would deepen credit penetration, expand employment opportunities produce efficiency gains in the Philippines banking sector due to enhanced competition as foreign banks transfer the best practices in technology, risk management, human resource management and corporate governance.

Figure 1
Growth outlook remains positive but overheating risks warrant rapid infrastructure development

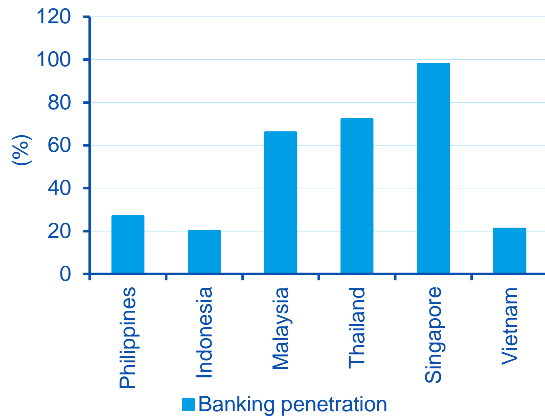
Source: BBVA Research

Figure 2
Falling debt burden is a credit positive for Philippines



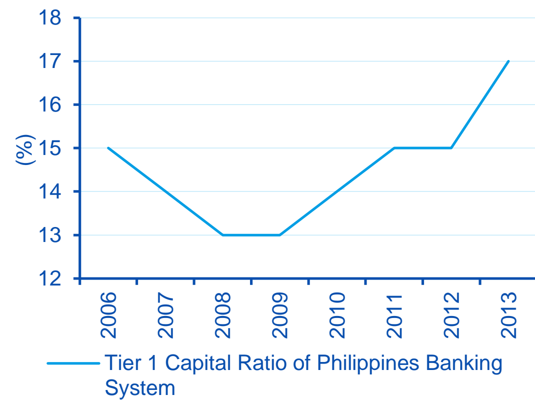
Source: BBVA Research and Philippines National Treasury

Figure 3
Banking penetration is low in Philippines



*Percentage of respondents (age 15+) with an account at a formal financial institution.
Source: BBVA Research, World Bank 2011

Figure 4
Capital Adequacy Ratios are healthy



Source: BSP, BBVA Research

Concerns over risks to financial stability are manageable: On the flipside, concerns are being raised over the risks to domestic financial stability by allowing 100% stake for foreign bank through acquisition, purchase or ownership. Policymakers in most emerging economies fear that foreign banks with full autonomy and a large presence in the domestic market might leave the domestic banking system highly vulnerable during a crisis period if it curtails its operations or withdraws completely. In this context, as a safety net, the new Philippines banking law requires at least 60% of total banking resources to be in the hands of domestic banks majority owned by Filipinos. In addition effective regulatory oversight in managing risks arising from cross border financial integration is critical. We believe that the risks to financial stability are manageable for Philippines, particularly so given its impressive debt ratios (See Figure - 2) and the Philippines Central Bank's - Bangko Sentral ng Pilipinas (BSP) – early adoption of Basel III norms starting January 2014. As per the IMF, the level of Philippines public debt has moderated further to 39% of GDP in 2014 - amongst the lowest in ASEAN, next only to Indonesia - while total external debt is projected to decline to 25.5% in 2015 from 28.8% in 2013.

More pros than cons to foreign bank entry in Philippines

Prima facie, a 100% bank ownership law should be a sweet deal for foreign banks. Particularly so in a fast growing emerging economy such as the Philippines where banking and credit card penetration is the lowest amongst ASEAN countries at 27% and 2% respectively (See Figure – 3). We believe there are strong reasons to support foreign bank expansion in Philippines.

A progressive and clear policy framework for foreign banks to operate: The new banking reform lays down a clear policy framework and accords full national treatment to foreign banks. Riders, in the form of safety nets, are kept at a bare minimum. This should facilitate foreign bank expansion in a hassle-free environment without overbearing government regulations and administrative bottlenecks. Importantly, under the new law, foreign banks would be allowed to participate in foreclosure sale of real estate property mortgaged to them and take possession for a period of 5 years.

Strong and stable banking sector fundamentals in the host country: The Philippines banking sector fundamentals are healthy and dovetail the economy's favorable outlook. The operative environment for banks is marked by a low fiscal deficit (1.4% of GDP in 2013) and a robust consumption and investment demand. Loan growth averaged +20% y/y in 1H14, up from 19% in 2013, banking system liquidity remains strong and Tier-1 capital adequacy ratios are well over Basel III requirement of 8.0% (See Figure – 4). Despite a string of natural disasters including typhoon 'Haiyan' and 'Glenda', asset quality has improved further (See Figure – 5). Since 2013, Non Performing Loan (NPL) ratios have fallen further by up to 100 bps to around 1.5%. Strong loan growth has propelled net interest incomes (up 26% y/y in 1Q14 for the largest 3 banks). For the sector as a whole, since 2011, net interest margins (NIM) have remained stable around

3.3% to 3.5% while Return on Equity (RoE) has improved from 10.9% in 2011 to 15.6% in 2013 (See Figure – 6). Looking ahead, funding costs are expected to stay low given a relatively low Loan to Deposit Ratios (at 68%). A robust loan growth outlook bodes well for net interest incomes of banks. Also, an increase in public spending would benefit foreign banks earnings, particularly those with corporate loan exposure.

Mobile phone payments adoption is significantly high in Philippines: From the market's perspective, despite poor banking and internet infrastructure, Philippines tops other ASEAN economies in terms of mobile phone payments penetration (See Figure - 7) – an opportunity for technology savvy foreign banks to exploit until banking penetration rates gain traction.

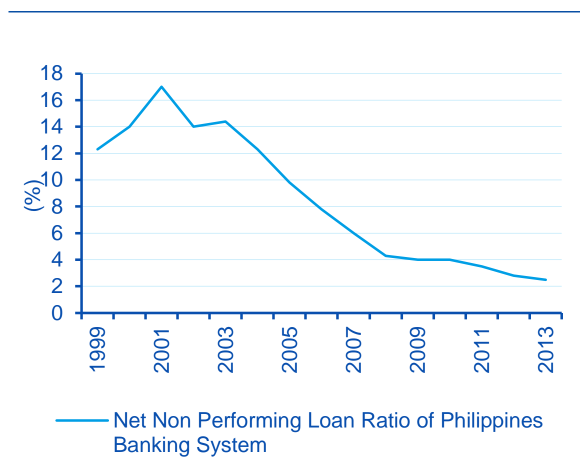
Remittance services are an important area for foreign banks to participate and highly benefit: Overseas Filipino workers remitted whooping USD 21 bn last year, up 7% y/y and about 9% of GDP. Remittances are a key factor supporting Philippines public finances and also sustaining domestic demand. In this regard, foreign banks would also play a valuable role in reducing money transfer costs for overseas Filipino workers.

Notwithstanding the benefits, doing business in Philippines under the new liberal framework would pose unique challenges for new and existing foreign banks. These include:

Catering to a geographically dispersed population with low banking penetration: Philippines is an archipelago country comprising over 2000 inhabited islands. Apart from the smaller communities, nearly 37% of large cities and municipalities (totaling 611) in Philippines were unbanked as of 2012 according to the IMF. Catering to the widely dispersed households, which rely mainly (about 65%) on informal lenders and family/friends for their financing needs, could incur significant fixed costs for foreign bank in their initial years of expansion.

Dancing with a weak legal system: World Bank indicators such as the 'Rule of Law Indicator', and the 'Strength of Legal rights Index', are ranked low for Philippines - below most major ASEAN economies except Indonesia. The Strength of legal Rights Index measures the degree to which collateral and bankruptcy laws protect the rights of borrowers and lenders, facilitating lending.

Figure 5
Asset quality of banking system has improved



Source: BBVA Research and company data

Figure 6
Philippines banks have seen improving ROE and stable Net Interest Margins

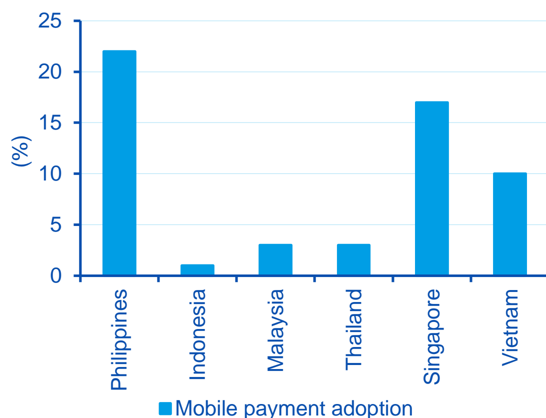
Source: BBVA Research and BSP

Domestic banks roll up sleeves in the wake of increasing competition

The Filipino banking sector comprises 696 banks - 37 universal and commercial banks, 70 thrift banks and 589 rural and cooperative banks. In addition, there are a more than 6000 quasi-banking intuitions operating in the country under license from the BSP. Amid rising risks to financial stability arising from large credit exposure to the real estate sector, especially of quasi-banks, the BSP has undertaken several prudential measures over recent months, including tighter oversight and containment of real estate lending and mandatory compliance with Basel III capital requirements.

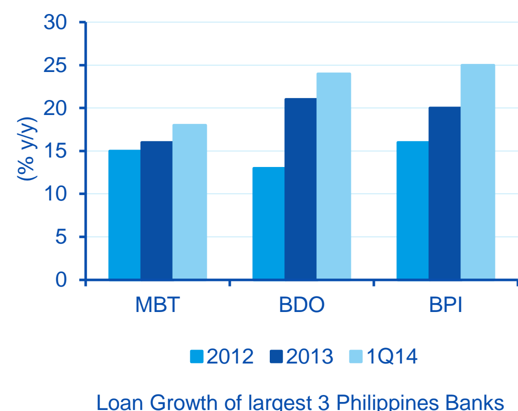
The five largest private universal banks account for about 58% of total sector assets. Of this, the top three banks, namely the Bank of the Philippine Island (Market Cap of USD 8.7 bn), BDO Unibank (USD 7.3 bn) and Metropolitan bank and trust company (USD 5.4 bn) account for 49% of loans and 43% of deposits (See Figure – 8). However, in terms of size, the Philippines banking system pales in front of large foreign banks - total assets of the entire system are only 70% of Singapore's DBS assets. Risks from increasing competition and dilutive acquisition in the wake of potential foreign entrants has pushed several large domestic Filipino banks to raise capital and scale up operations through the M&A route. To expedite the process, the BSP has put in place a program that provides tax incentives for stable banks to acquire weak rural lenders. The scurry to consolidate would pick up steam over the coming years ahead of the implementation of the ASEAN banking integration framework by 2020.

Figure 7
Philippines has a high mobile payment adoption rate compared to other ASEAN countries



*Mobile payment adoption refers to percentage of respondents who reported using mobile phones to pay bills in past 12 months. Source: BBVA Research, World Bank 2011

Figure 8
Largest three banks have been the key drivers of loan growth in Philippines



Source: BSP, BBVA Research

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