

The Philippine banking industry: competition, consolidation and systemic stability

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1. Introduction

Despite the generally difficult regional conditions which prevailed as a result of the onset of the Asian financial crisis in 1997, the Philippines has emerged as among the most resilient economies in the region. The lesser impact on the Philippine economy of the financial turmoil which hit Asia owes much to the country's sound macroeconomic fundamentals, as well as to the financial reform initiatives implemented by the Central Bank of the Philippines (BSP) even before the Asian crisis struck.

Already in the 1980s, measures were being pursued to encourage greater competition and strengthen supervisory and regulatory systems. In the 1990s, the reform efforts were intensified. A new and more independent central bank was created in 1993. Restrictions on the establishment of new banks, as well as of new branches, were eased. Foreign bank entry was liberalised in 1994, which led to the establishment of 10 new foreign bank branches in 1995. Meanwhile, tighter prudential measures continued to be introduced such as a higher set of minimum capital requirements, liquidity cover on foreign currency liabilities, a cap on loans to real estate and regulations on derivatives trading.

Thus, the Philippine banks entered the crisis period in a relatively well capitalised and robust condition.

2. Reforms during the Asian crisis

To further improve the capacity of banks to face adverse shocks, and to reinforce the institutional framework to deal with problem banks in the face of the Asian crisis, the BSP adopted a programme of reforms, which included:

- a further increase in the minimum capital requirements;
- stricter requirements for granting new bank licences, as well as for setting up new branches;
- higher qualification requirements for bank directors and senior officers;
- tighter regulations on insider loans;
- stringent rules on the restructuring of loans;
- redefinition of non-performing loans to align with the international standards;
- introduction of general loan loss provisioning requirements;
- higher specific provisioning for classified loans;
- expansion of bank disclosure requirements.

The BSP also made significant progress in improving its regulatory and supervisory practices with the adoption of a host of reforms, such as:

- shift in supervisory focus from a compliance-based process to a forward-looking and risk-based framework;

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- consolidated supervision of banks and quasi-banks, including their subsidiaries and affiliates engaged in allied activities;
- close monitoring of banks identified as potentially in distress based on a set of forward-looking and backward-looking indicators;
- adoption of a prompt corrective action policy and schedules of sanctions for banks that experience a shortfall in capital;
- a more efficient resolution of problem banks.

Moreover, the BSP continued to encourage mergers and consolidation, particularly of ailing banks with stronger banks as a means to hasten their rehabilitation or to avert a possible bank closure, by offering short-term incentives to merging/consolidating financial institutions.

These additional regulatory and supervisory initiatives had helped hasten the restructuring of the banking industry, enabling it to meet the demands of the economy, which was then recovering from the crisis.

3. Current policy direction

At present, the BSP is building upon the many banking reform initiatives it had started even before the outbreak of the Asian crisis. The objective is to promote a sound, stable and globally competitive financial system anchored on prudent risk management.

The strategy is two-pronged: first, the legislative framework is being strengthened; and second, internationally accepted practices are being integrated into the BSP regulatory and supervisory processes.

This year, substantial progress has been made towards strengthening and modernising the basic legal framework of the banking system.

The General Banking Law of 2000 (GBL) was signed into law on 23 May 2000, amending the country's 52-year-old General Banking Act. The law was primarily crafted to meet the challenges of and provide additional safeguards for new risks attendant on globalisation. The passage of the GBL is expected to enhance the supervisory capability and enforcement powers of the BSP, improve prudential and regulatory standards, and foster greater competition in the industry.

Some of the more important features of the new law are:

- a strong legal basis for consolidated supervision of banks;
- adoption of a stricter fit and proper rule for individuals elected/appointed as bank directors/officers;
- inclusion of at least two independent directors on the board of directors;
- adoption of a risk-based capital requirement in line with the recommendations of the Basel Committee;
- expansion of the coverage of the single borrower's limit;
- stronger safeguards against connected lending;
- liberalisation of foreign bank ownership of existing local banks up to 100% during a seven-year window;
- more flexibility in examining banks onsite in connection with supervisory matters;
- defining unsafe and unsound banking practices;
- greater transparency and disclosure requirements for banks.

Another key piece of legislation, which the BSP hopes to get approved soon, is the proposed amendment to the New Central Bank Act of 1993. The amendment aims, among other things, to promote further the independence of the BSP. The changes sought are mainly aimed at:

- promoting greater stability of the banking system;
- strengthening the supervisory capability of BSP;
- enhancing BSP effectiveness.

More fine-tuning of the BSP's prescribed prudential guidelines is also under way to ensure more competent bank management, greater transparency, reduced moral hazard and more effective bank regulation and supervision. Briefly, the specific actions being pursued include:

- prompting senior management to take full responsibility in the establishment of first lines of defence;
- adopting as a general principle the timely exit of problem banks;
- limiting bank entry only to viable entities meeting the prudential criteria;
- prescribing a minimum capital adequacy ratio;
- prescribing a ceiling on credit to selected industries and/or family/business groups;
- adopting sound accounting rules for the compilation of financial statements, including those relating to classification of loan accounts, loan loss provisioning and loan restructuring;
- compelling external auditors to report adverse findings;
- expanding banks' responsibilities for disclosure;
- adopting a ladder approach in imposing corrective and punitive measures on erring banks;
- providing supervisors with training and logistical support to perform risk-based examination.

4. Mergers and consolidation

A major feature of the reform initiatives undertaken even before the Asian crisis was the progressive increase in minimum capitalisation and the encouragement of mergers and consolidation. The aim has been to promote financially strong and well managed banking institutions.

Given the rapid pace of globalisation and accelerating technological advancement, the BSP sees mergers and consolidation as a means to create stronger and globally competitive banking institutions.

Mergers and consolidation will help merged/consolidated banks harness with greater efficiency their collective experience, expertise and technological know-how. It is implicit that parties to mergers and consolidation must have a strategic vision to make their merged enterprise more competitive, since mergers and consolidation will allow them to complement each other in terms of the markets they serve and the products and services they offer, allowing them to focus on core competencies.

Some of the incentives that merging/consolidating banks may avail themselves of include:

- revaluation of bank premises, improvements and equipment;
- staggered booking of unbooked valuation reserves;
- temporary relief from full compliance with the prescribed net worth to risk assets ratio;
- amortisation of goodwill up to a maximum of 40 years, if warranted;
- payment in instalments of outstanding penalties on legal reserves and interest on overdrafts with the BSP as of date of merger/consolidation;
- higher rediscount ceiling with the BSP;
- restructuring/plan of payment of past due obligations of the proponents with the BSP as of date of merger/consolidation;
- concurrent officership at a merged/consolidated bank/financial institution and another bank/financial institution.

There have been 11 mergers, acquisitions and consolidations since the new package of incentives came into effect in September 1998. These cases involved 15 commercial banks, three thrift banks, two rural banks and four non-bank financial institutions.

To determine the effect of the policy of encouraging mergers and consolidations on market concentration, the BSP conducted a study on the competitive structure of the local commercial banking industry using the Herfindahl-Hirschman Index. The HHI is a statistical measure of market concentration that is used to suggest the degree of monopoly power. The study indicated that the local commercial banking market is still far from oligopolistic, whether in terms of deposit distribution or loan distribution, as there are a relatively large number of competitors with significant market shares. The HHI was 585 for domestic banking deposits and 498 for loans as of end-June 1999. An HHI value of more than 1,800 is considered to indicate an oligopoly within a given industry/market.

The study also showed that while recent big mergers increased market concentration, they were not enough to pose a threat to the overall competition levels since market share remained relatively well dispersed among the remaining players. The study also confirmed that the commercial banking industry still has enough room for more mergers and consolidation without necessarily inhibiting effective competition.

This policy of encouraging the formation of bigger banks does not, however, mean that smaller banks have no place in the financial system. Smaller banks, which cater to a different segment of the population, are expected to reach markets that larger banks may be unable or unwilling to service. On 27 February 2001, the general moratorium on chartering activities was partially lifted to allow the establishment of microfinance oriented banks on a very selective basis, ie particularly in areas not served by existing rural banks or microfinance-oriented entities.

Steadily, the Philippines is moving towards an industry structure with a few domestic megabanks at the centre, with efficiency still being promoted through effective competition from foreign banks and from many niche players.

5. Liberalisation of foreign bank entry

Another major feature of the reform initiatives was the liberalisation of foreign bank entry in 1994. It aims to create a more competitive environment through greater foreign participation in the domestic banking system. The enabling law allows three modes of entry, namely:

- by acquiring, purchasing or owning up to 60% of the voting stock of an existing bank;
- by investing in up to 60% of the voting stock of a new banking subsidiary incorporated under the laws of the Philippines;
- by establishing branches with full banking authority, provided that a foreign bank may avail itself of only one mode of entry, and may own up to 60% of the voting stock of only one domestic bank or new banking subsidiary.

The law further stipulates that the number of foreign bank entrants via the third mode shall be limited to only 10, and that the share of the foreign majority-owned banks shall not exceed 30% of the total resources or assets of the banking system.

The recently approved GBL further liberalised the provisions of the aforementioned law by removing the 60% ceiling on the voting stockholding of foreign banks in a domestic bank or a new banking subsidiary, within seven years of the law taking effect.

As of end-March 2001, there were 13 foreign banks with branches (including four grandfathered foreign banks) and eight foreign bank subsidiaries operating in the Philippines. In terms of market share, foreign bank branches and subsidiaries accounted for 15% of the total resources of the Philippine banking system.

6. Electronic banking

Another development that is expected to boost efficiency and growth in the banking sector is the passage of the E-Commerce Act on 24 June 2000. An emerging trend in the financial industry today is the use of electronic banking. This technology, which is still at an early stage of development, is seen as an effective tool in reducing information and transaction costs. However, given the degree of uncertainty often associated with technological innovations, there are certain risks posed by electronic banking. The E-Commerce Act addresses such risks by defining the legal and regulatory parameters for online commercial transactions. It also provides the legal framework that will promote the security of electronic transactions.

For its part, the BSP has issued regulations requiring banks, among others, to seek prior clearance before they can provide electronic banking services. This is to ensure that the bank has put in place a risk management system that can adequately assess, control and monitor banking risks.

7. Conclusion

The gains in the banking sector notwithstanding, the BSP will continue to implement market-oriented reforms that will further promote the soundness, stability and global competitiveness of the Philippine banking system. To this end, the BSP will continue to pursue legislative reforms and the alignment of supervisory and risk management processes with internationally accepted standards.

At the top of the legislative agenda are the amendments to the 1993 New Central Bank Act, as well as the enactment of anti-money laundering legislation. In addition, prudential regulations will continue to be rationalised and aligned with international best practices, while improvements will be made to regulatory oversight through the full implementation of consolidated supervision and risk-based examination.

The combined effect of these moves should promote a stable and competitive Philippine banking system, more suited to the growing demands of a globalised economy. Domestic banks, with their flexibility in adapting to the changing financial environment, will continue to be the lead players, while foreign banks, with their increased participation, will continue to provide the additional impetus needed to sustain and enhance the competitiveness of the Philippine banking industry.