# Amando M Tetangco, Jr: Prospects for and developments in the Philippine banking system

Speech by Mr Amando M Tetangco, Jr, Governor of Bangko Sentral ng Pilipinas (BSP, the central bank of the Philippines), at the Philippine International Banking Convention 2015, Makati City, 2 October 2015.

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I am pleased to be joining you again for this Philippine International Banking Convention. For five years now, we have gathered to consider the pressing issues of the time as a way for us to take an inward look at how the Philippine banking system is positioned.

For today's conference, the organizers have chosen for us to look at the Philippine financial system through the lens of ASEAN financial integration. I particularly like the operative word of today's theme – "transforming". The word evokes movement over time, change, reaction, adaptation. In other words – dynamism. This is what really is needed in a time of flux.

But perhaps what we need to be reminded of is that our regional operating environment has already been changing even before recent times when ASEAN Economic Community (AEC) and ASEAN integration have become more talked about.

## Prospects of an integrated regional financial market

The reason possibly why ASEAN integration has become more elevated in public consciousness lately is that the AEC will be "formally" launched at year-end. But, we should not be misled to believe that end December represents a "switch-on" for regional integration. The reality is, even if we count only the AEC, integration efforts have been unfolding under an AEC Blueprint since 2008. The Blueprint contains four pillars, 17 core elements, 176 priority actions and 414 targeted measures. Based on the most recent scorecard, ASEAN has completed 80.7% of its economic integration program (i.e., 334 out of 414 measures completed as of end 2014).

For those of us in the financial markets, however, the more critical target is 2020 at which time the ASEAN Financial Integration Framework or AFIF is expected to be in place. This initiative has many moving parts and perhaps the best way to appreciate it is to understand the underlying philosophy behind an integrated ASEAN.

It is actually a rather simple story with a compelling business case. Instead of 10 separate economies, a single market provides an enormous base within which consumers and providers can operate. Measured by GDP, this single base is significant. In addition, ASEAN has a track record of strong growth. At the end of 2014, ASEAN (at $2.57 trillion GDP) was just smaller than France and the United Kingdom but larger than Brazil, Russia and India.[1] The expectation, however, is that ASEAN will continue to outpace the rest of the world. In fact, in a May 2014 report[2], McKinsey & Company projected that ASEAN will be eventually the 4th largest economy in the world by 2050.

To achieve this single base, however, barriers to trade have to be minimized to the fullest extent possible. This allows the economics of "comparative advantage" to take over, effectively unbundling distribution of goods and services from their production. In other words, not every jurisdiction needs to produce each and every good that it requires. Already,

[1] At end 2014, ASEAN GDP stood at $2.57T. France and UK were are $2.829T and $2.942T, respectively while Brazil, Russia and India were at $2.346T, $1.861T and $2.067T, respectively.

[2] "Understanding ASEAN: Seven things you need to know". McKinsey & Company. May 2014.

ASEAN is home to 227 of the world's largest companies, ranking us 7th in the world by that metric.[3]

This "unbundling", in turn, is important if ASEAN is to service its diverse population with differentiated needs. This demographic detail is key. With 81 million households already in 2013, this is projected to double to 163 million households by 2030[4], creating an engine that naturally fuels further demand and further growth.

Creating and sustaining this growth will of course require more labor resources. Simulations from the joint work[5] of ADB and the ILO show that high-skill employment in Cambodia, Indonesia, Lao, Philippines, Thailand and Vietnam could grow by 41% between 2010 and 2025. With Mutual Recognition Arrangements (MRAs) in place and intended to be expanded, labor mobility will all the more be enhanced.

Financial markets will certainly play a critical role within this vision. This is because financing is needed by the entrepreneurial initiatives in that single market, augmenting what the respective jurisdictions can provide on their own. For the financial consumer, more choices present themselves under integration. The idea is that under integration, a Filipino investor would be able to take on financial instruments out of Hanoi nearly as seamlessly as investing in Manila itself.

Financial markets, however, come in different colors and rich hues. To make an integrated market come alive, we need the breadth and depth of capital markets. The ability to raise capital is necessarily premised on having thriving fixed income and equity markets so that surplus funds can be invested on those willing to take an entrepreneurial risk.

Doing so requires a payments and settlements system that is holistic and efficient, from large-value to retail payment systems and securities settlements. This must be supported by the necessary financial market infrastructures – CCPs, CSDs, TRs – run under uncompromising standards of good governance and risk management. All of these must be in place in each jurisdiction and then linked and aligned with the rest of the ASEAN jurisdictions[6]. As I understand, there is still much work to be done in this area, particularly in light of the global market reform agenda.

We need a functioning insurance market so that stakeholders can either hedge their risk exposures or transfer the risks to those who are better positioned to manage them. The notion of an "insurable event" for both property and finance has shifted through time and the same dynamism is necessary if we are to adapt to a fast evolving market landscape.

And certainly, we need indigenous ASEAN banks to bridge markets, offer products and services and meet the varied needs of consumers and producers. ASEAN's saving – at 31% of GDP and 11 percentage points higher on average than the rest of the world – needs a repository before these can be intermediated or invested. With collective GDP at USD2.57 trillion[7] in 2014, the amount of economic saving is not trivial.

ASEAN banks must have the depth of risk capital and the breadth of expertise if they are to handle cross-border banking. This is for a region that has consistently grown but is also defined by the diversity of its member states.

[3] Ibid.

[4] "Southeast Asia at the Crossroads: Three Paths to Prosperity". McKinsey & Company. November 2014.

[5] "ASEAN Community 2015: Managing integration for better jobs and shared prosperity". ADB & ILO. 2014.

[6] The current linkage is the ASEAN Trading LINK – on equity exchanges of Thailand, Malaysia and Singapore.

[7] Data from ASEAN website.

## Market “Surprises”: what we learned

For all ASEAN’s current strength and potential, recent global developments have had an impact.

One would surmise that ASEAN trade exposures to Greece would not be that significant. Yet, when the prospect of a “Grexit” heightened, global financial markets recoiled. ASEAN was not spared from the contagion even though the impact was not protracted.

When China devalued the Renminbi, this was, literally, closer to home and the impact was more pointed. The devaluation on August 11 was itself a significant surprise but to see it done on three consecutive days raised considerable concern over the potential extent of a slowdown of the Chinese economy.

And certainly, we have all talked about the “normalization of US monetary policy” for a considerable period now. We went through the taper tantrums in 2013 – 2014 and then anticipated the lift off in 2015, only to find ourselves still reading between the lines of Fed pronouncements.

The impact that these developments have had on ASEAN does not reflect in any way on any potential weakness of ASEAN itself. Instead, the lesson that I take away is the reminder that we – either as a collective bloc or as individual jurisdictions – are deeply integrated to the ebb and flow of the global financial markets.

The Philippine boat may not be the large vessel of other jurisdictions but the fact that we have been able to steer through the turbulent and uncertain waters of the last decade is itself the testament of our resolve and our strength as a market.

In part, we have been able to steer the economy through these disturbances because over the years we have built the foundations of a strong macroeconomy. In 2002, we adopted a rigorous framework for monetary policy formulation – inflation targetting. The discipline that this framework requires has caused us to be focused on maintaining stable prices, which has in turn been central in building market confidence. That said, we constantly also find ways of doing things better. For instance, just last week, the Monetary Board approved the adoption of an interest rate corridor system for the conduct of monetary policy. This operational change is expected to make the signals from monetary policy more effective, strengthen price discovery and therefore make the transmission of monetary policy more efficient.

We have also consciously crafted market-based banking regulations consistent with the evolving international reform agenda. This has created an operating environment that encourages our banks to innovate while being conscious of risks.

In line with this, we have also sustained a foreign exchange rate policy wherein the exchange rate is allowed to be essentially market-determined, with scope for official action only to limit excessive price movements.

## Are we ready?

This brings me to my point today: are we ready for what lies ahead?

If we go by mainstream indicators, the Philippine banking industry remains to be in a position of strength. Total resources of universal and commercial banks (whose share dominates the industry) grew by 11.6% between 2010 and June 2015 while their July NPL ratio was at 1.9%. The capital adequacy ratio of these banks was at 15.1% with stress test results confirming that there is enough capital buffer in the event of extreme shocks.

Beyond these traditional measures, I want to focus on how financial technology or FinTech has positively transformed our banking industry.

Today’s banking experience is more personal in the sense that it is driven by FinTech. Those of us in Generation X may find that to be a contradiction in terms because we grew up not equating “service” with “gadgets”. Yet, this is precisely the world of the “millennials” who capture thoughts and experiences in gigabytes.

Over the counter withdrawals now run in parallel to online banking services where the speed of transactions is limited only by bandwidth. ATMs are no longer just cash-dispensing machines since the networks offer a full range of consumer and corporate banking services. The widespread use of e-money means that payment systems can clear and settle the most retail of transactions without cash physically moving from wallet to wallet.

Yes ladies and gentlemen, this is the banking landscape of today and our banks have, by and large, redirected their attention to these facets. From a policy perspective, this was the wherewithal for crafting Circular 854 which adjusted the minimum capital levels required of banks. It is a recognition that banking has moved on from the folders and filing cabinets of old to the systems and interfaces of today.

We put in place an IT Risk Management framework (under Circulars 808 and 859) so that all of these are governed by appropriate standards. To instil continuing credit discipline, Circular 855 provided for credit risk management practices that, among others, de-emphasize reliance on collaterals and nurture verifiable credit underwriting decisions of banks. And to protect the consumer, the BSP has issued the landmark Consumer Protection Framework (under Circular 857) that sets our expectations on the behaviour and actions of covered institutions.

All these matter because our own demographic profile points to half of the population at younger than 25 years old, precisely the millennials. We are also an archipelago and we need to bring banking to the people rather than expect people to adjust to banking. Thus, it should come as no surprise that the BSP has pushed actively on our financial inclusion campaign.

Financial inclusion literally binds all our efforts because it creates a sustainable link between economic activity, financial products and services as well as the universal aspiration for a better future through economic growth and financial well-being.

**Stronger onshore conditions provide better offshore links**

Ladies and gentlemen, if you are wondering how inclusion, fintech and millennials relate to ASEAN financial integration, the connection is not complicated.

To be able to compete in the broader offshore market of ASEAN, Philippine banks need to establish what their comparative advantages are onshore. It would be difficult to imagine how a bank can actively engage in the potential of ASEAN integration if it cannot be competitive in its own domestic market.

This issue becomes even more significant in light of the passage in 2014 of legislation (RA 10641) which fully liberalized our domestic banking system, allowing for 100% foreign ownership of our banks.

Is the Philippine banking system ready? We are clearly in a position of strength as an industry and, individually our banks have been enlarging their domestic footprint – constructing brick and mortar branches outside of the greater metropolis, creating “other banking offices”, which are scaled-down bank operations, and capitalizing on e-banking technology.

While the biggest of the ASEAN banks can indeed penetrate smaller jurisdictions, the diversity of ASEAN suggests there are niche markets that can be realized, different needs that can be explored and pockets of expertise that can be harnessed.

This is an important reality to bear in mind. And as you can appreciate, this “distinctiveness” of ASEAN is the pressing motivation why our banks are currently focused on fortifying their domestic franchise in a variety of modes. We can, however, only surmise that this insular perspective will not be the norm for long.

The peculiar diversity of ASEAN ensures that banks across the 10 jurisdictions will have a role to play in the ASEAN. This also ensures that the gains from regional banking integration will not only accrue to the biggest of ASEAN banks.

That said, competition creates fluidity and the possibility of external shocks is a constant. As we scan the horizon, the waters may appear to be relatively calm for us now, but there are shifts in the currents. We have to be able to adapt to the market flows and we cannot make the mistake of being oblivious to the under-currents.

In the end, as they say, if each member jurisdiction is successful in shielding itself from the currents of change, if together we are successful in transforming ourselves within the context of an integrated market, then ASEAN may just prove the case that the whole would indeed exceed the sum of its parts.