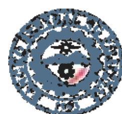
A Status Report on the Philippine Financial System

First Semester 2003



Bangko Sentral ng Pilipinas
Manila, Philippines

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GLOSSARY OF TERMS

A. SELECTED ACCOUNTS

1. ***Total assets*** refer to the sum of all assets, adjusted to net off the accounts "Due from Head Office/Branches/Agencies" and "Due to Head Office/Branches/ Agencies" of foreign bank branches.

2. For purposes of computing the average, one period covers 12 months
   a. ***Average assets*** refer to the sum of total assets for two periods divided by 2.
   b. ***Average capital*** refers to the sum of total capital accounts for two periods divided by 2.
   c. ***Average earning assets*** refer to the sum of earning assets for two periods divided by 2.
   d. ***Average interest-bearing liabilities*** refer to the sum of interest-bearing liabilities for two periods divided by 2.

3. ***Total capital*** refers to the sum of paid-in capital of locally incorporated banks, assigned capital and the qualified capital allowable component of the net "Due To/Due From Head Office/Branches/Agencies" accounts of branches of foreign banks plus surplus, surplus reserves, undivided profits and appraisal increment reserves.

4. ***Distressed assets*** refer to NPAs and current restructured loans.

5. ***Earning assets*** refer to the sum of loans (gross of allowance for probable losses) and investments (gross of allowance for probable losses), exclusive of equity investment (gross of allowance for probable losses).

6. ***Fee-based income*** refers to the sum of bank commissions, service charges/fees, and other fees/commissions.

7. ***Gross assets*** refer to total assets, net of reserves plus loan loss reserves (LLR) plus provision for ROPOA.

8. ***Interest-bearing liabilities*** refer to the sum of deposit liabilities and borrowings.

9. ***Liquid assets*** refer to the sum of cash and due from banks and investments (net of allowance for probable losses) exclusive of equity investments (net of allowance for probable losses).

10. ***Net income before tax*** refers to the sum of net operating income and extraordinary credits/(charges).

11. ***Net interest income*** refers to the difference between total interest income and total interest expense.

12. ***Net operating income*** refers to the difference between operating income and operating expenses.

13. ***Non-interest income*** refers to the sum of fee-based income, trading income, trust department income and other non-interest income.

14. ***Non-performing loans (NPL)*** refer to past due loan accounts whose principal and/or interest is unpaid for thirty (30) days or more after due date (applicable to loans payable in lump sum and loans payable in quarterly, semi-annual or annual installments), including the outstanding balance of loans payable in monthly installments when three (3) or more installments are in arrears, the outstanding balance of loans payable daily, weekly or semi-monthly installments when the total amount of arrearages reaches ten percent (10%) of the total loan receivable balance, restructured loans which do not meet the requirements to be treated as performing loans under existing rules and regulations, and all items in litigation. Effective September 2002, NPLs exclude loans classified as Loss in the latest BSP examination which are fully covered by allowance for probable losses and applicable to a bank with no unbooked valuation reserves and other capital adjustments required by the BSP (Circular No. 351).

15. ***Non-performing assets (NPA)*** refer to the sum of non-performing loans (NPL) and real and other properties owned and acquired (ROPOA). Effective March 2003, NPAs exclude performing sales contract receivable, which met certain requirements under Circular No. 380.

16. ***Operating expenses*** refer to the sum of bad debts written off/provisions for probable losses, overhead costs and other expenses.

17. ***Operating income*** refers to the sum of net interest income and non-interest income.

18. ***Overhead costs*** refer to the sum of non-loan related operating expenses such as compensation/fringe benefits, depreciation and amortization, etc.

19. ***Trading income*** refers to the sum of trading gains/(losses), foreign exchange profits/(losses), gold trading gains/(losses) and profit/(loss) on sale of redemption of investments.

B. FINANCIAL AND OTHER RATIOS

1. ***Capital adequacy ratio (CAR)*** refers to the ratio of capital to risk weighted assets computed in accordance with the new risk-based capital adequacy framework (patterned after the 1998 Basle Capital Accord) which has been formally adopted effective 1 July 2001.

2. ***Cost-to-income ratio*** refers to the ratio of operating expenses (exclusive of bad debts written off/provisions for probable losses) to operating income.

3. ***Density ratio*** refers to the ratio of the total number of domestic banking offices to the total number of cities/municipalities in the Philippines.

4. ***Earning asset yield*** refers to the ratio of total interest income to average earning assets.

5. ***Funding cost*** refers to the ratio of total interest expense to average interest-bearing liabilities.

6. ***Interest spread*** refers to the difference between earning asset yield and funding cost.

7. ***Liquid assets ratio*** refers to the ratio of liquid assets to total deposits.

8. ***Net interest margin*** refers to the ratio of net interest income to average earning assets.

9. ***NPA coverage ratio*** refers to the ratio of allowance for probable losses on non-performing assets (NPA) to total NPA.

10. ***NPA ratio*** refers to the ratio of NPA to total assets, gross of allowance for probable losses.

11. ***NPL coverage ratio*** refers to the ratio of allowance for probable losses on non-performing loans (NPL) to total NPL.

12. ***NPL ratio*** refers to the ratio of non-performing loans (NPL) to total loans (gross of allowance for probable losses), inclusive of interbank loans.

13. ***Population-to-banking offices ratio*** refers to the ratio of the total population to the total number of domestic banking offices.

14. ***Return on assets*** refers to the ratio of net income after tax (NIAT) to average assets.

15. ***Return on equity*** refers to the ratio of NIAT to average capital.

PROLOGUE

As of end-June 2003, the number of Financial Institutions (FIs) supervised or regulated by the Bangko Sentral ng Pilipinas (BSP) reached 6,413 head offices with additional 109 new entities from 6,304 at end-year 2002. The operating FIs consisted of 906 banks with 6,542 branches and other offices, 5,497 non-bank financial institutions (NBFIs) with 5,087 branches and 10 offshore banking units (OBUs) with one other office (Schedule 1).

The expansion in total FIs was largely due to the increase in NBFIs, particularly head offices/branches of pawnshops. On the other hand, the decline in the number of head offices of banking institutions from 912 at end-year 2002 to 906 at end-June 2003 was caused by the closure of 4 rural banks and the merger of 2 rural banks with 2 other rural banks.

Effective 3 July 1998, the supervision and regulation of the BSP over non-banking entities were turned over to the Securities and Exchange Commission (SEC) for corporations and partnerships and to the Department of Trade and Industry (DTI) for single proprietorships in accordance with Section 30 of R.A. No. 7653 (The New Central Bank Act), except the following: *non-banks with quasi-banking functions and/or with trust or* Investment Management Account (IMA) license, non-banks which are subsidiaries/affiliates of banks and quasi-banks, non-stock savings and loan associations, pawnshops and venture capital corporations. Likewise, the supervision and regulation over building and loan associations were transferred to the Home Guarantee Corporation effective 7 February 2002 in accordance with Section 94 of R.A. No. 8791 (The General Banking Law of 2000).

THE PHILIPPINE FINANCIAL SYSTEM: AN ASSESSMENT

The banking system continued to show further progress in the first half of 2003. Nothing spectacular to be sure, but remarkable enough given that every single gain had to be painstakingly coaxed from a domestic economy struggling valiantly to stay afloat in the face of major international and domestic disturbances.

Negative events that loomed large included the outbreak of war in Iraq and its global fallout as well as the regional crisis sparked by the SARS epidemic that virulently radiated out of Southern China. On the domestic front, seemingly incessant political hubbub repeatedly interrupted economic momentum. More fundamentally, an alarmingly large fiscal deficit presented a basic source of potential instability.

But mitigating the negatives, skillful economic management kept inflation firmly under control, interest rates at relative lows, and exchange rate volatility within manageable bounds. These positives proved sufficiently conducive in nurturing steady consumer demand and re-starting investment activity.

This was fertile enough ground for the banking industry as a whole which reported moderate asset growth, further deposit expansion, improved capitalization and higher profitability. However, the average industry numbers tended to conceal the actual dispersion of individual performances. The more successful banking institutions clearly benefited from stronger balance sheets where asset quality is reasonable and the underlying economic capital is adequate. The flip side to these are banking institutions that remain heavily burdened by non-performing assets, with limited flexibility to initiate new business.

The non-performing asset situation appears to have stabilized but improvement has been limited. The SPV law finally became operational with the promulgation of its implementing rules and regulations in April 2003 but it has yet to be a major factor in facilitating asset clean up given the reluctance of banks to accept the deep discounts being offered by potential wholesale buyers. Meanwhile, banks have forged ahead with smaller individual deals based on available opportunities to unload some non-performing assets.

Banks concerned will need to be more realistic in valuing the damaged component of loan portfolios and factor in the non-zero cost of waiting for better prices. So far, the BSP has tried to play a largely catalystic role, content to let market forces drive transactions. But in the absence of more decisive movements toward stronger asset quality, it may need to consider additional measures to induce the sale of non-performing assets.

To some extent, recent improvements in bank profitability have benefited from economic gains arising from growing exposure to high yield Philippine government debt. Banks can scarcely be blamed for maximizing this opportunity. However, this can be overdone. While credit risk may not be significant, banks will need to be careful in managing other kinds of concurrent risks particularly interest rate risk and liquidity risk. This early, the BSP has been reminding banks to exercise the necessary restraint consistent with sound risk management principles. For the real economy, excessive exposure to government debt may also limit the scope for fresh lending to the private sector.

In any event, banks will need to stay focused on basic reforms particularly improvements in internal credit process, the lowering of overhead costs, and further capital build-up. These elements are especially key to full recovery of the banking system.

Towards strengthening risk management, a key feature of the banking reform agenda is the upgrading of the regulatory framework in line with international standards and best practices. Significant progress is already being achieved in this area as evidenced by the stepped-up flow of new regulations implementing international standards. Strong emphasis is also placed on improved bank risk management not just for bank safety and soundness purposes but also so that destructive economic phenomena such as the formation of asset bubbles, other imbalances and misalignments will have less chance to occur.

In conjunction, stronger coordination is being arranged with domestic regulators so as to converge towards international best practice in the respective areas of banking, securities, and insurance. Initial Memorandum of Agreements (MOA) between the BSP and other regulators, such as the SEC and the PDIC have been finalized. This is work in progress that will continue to occupy the agenda of financial system regulators.

The promotion of good governance in banks and other financial institutions is another important program. Primary responsibility is squarely placed on the board of directors to ensure the proper conduct of banks. The values and practices of the directors are cascaded into the organizations through their policies and business decisions. Along this line, the BSP accredited seven (7) training providers to conduct corporate governance seminars to facilitate the implementation of the new requirement for the board of directors. These training providers are recognized institutions in the academe and the banking industry, namely: (1) Asian Institute of Management (AIM); (2) Ateneo-Bankers Association of the Philippines (BAP) Institute of Banking; (3) Bankers Institute of the Philippines, Inc (BaIPhil); (4) De La Salle University (DLSU) Professional Schools, Inc. – Graduate School of Business; (5) Development Finance Institute (DFI); (6) Institute of Corporate Directors (ICD); and (7) Rural Bankers Association of the Philippines (RBAP).

For the years 2002-2003, the training providers have offered a total of 181 corporate governance seminars attended by 6,170 participants including officers, consultants and stockholders. As of end-June 2003, 77 percent of the 5,760 directors of all banks have attended the required corporate governance seminar. The BSP aims to have all bank directors complete the process as a concrete step to fully empower the board of directors as a bedrock of good internal governance.

Beyond the strengthening of the banking system, the BSP recognizes the essential role of a well functioning and versatile domestic capital market as a critical element of a truly effective financial system. Historically, the banking system has played a dominant role in catering to the economy's financing requirements. But there are limitations to that role primarily because of inherent funding mismatches where short-term liabilities in the form of deposits are mobilized to finance the constant need for long-term assets.

To address this need, the BSP is working closely with the banking industry and other market players to establish a legitimate debt securities market that can more flexibly handle developmental financing needs. This involves significant building of market infrastructure that can efficiently and safely handle debt securities transactions. Hopefully, by mid-2004, the Fixed Income Exchange shall have been established.

Summing up, in assessing the state of the financial system, it is important to look not just at the quantitative outcomes but also to take note of qualitative developments. Although the numbers are still relatively modest at this point of time, the underlying pace of reform in the financial system has been progressing quite rapidly. Since much of these involve institution building, it will take time for the initiatives to fully bear fruit. But without doubt, these will have a powerful positive impact on the economy's future.