A Status Report
on the Philippine Financial System

First Semester 2011
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A. SELECTED ACCOUNTS

1. Financial Reporting Package (FRP) is a set of financial statements for prudential reporting purposes composed of the Balance Sheet, Income Statement and Supporting Schedules. The FRP is primarily designed to align the BSP reportorial requirements with the provisions of the Philippine Financial Reporting Standards (PFRS)/Philippine Accounting Standards (PAS) and Basel 2-based Capital Adequacy Framework. It is also designed to meet BSP’s statistical requirements.

2. Total Assets refer to the sum of all assets, adjusted to net of “Due from Head Office/Branches/Agencies” and “Due to Head Office/Branches/Agencies” of foreign bank branches.

3. Financial Assets (Other than Loans and Receivables) refer to the sum of all investments in financial assets, net of direct equity investments. These include financial assets held-for-trading (HFT), designated at fair value through profit or loss (DFVPL), available-for-sale (AFS), held-to-maturity (HTM), unquoted debt securities classified as loans (UDSCL) and investments in non-marketable equity securities (INMES).

4. Equity Investments refer to equity investments in subsidiaries, associates and joint ventures.

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

6. Financial Liabilities Held-for-Trading (HFT) refer to the sum of derivatives with negative fair value held for trading and liability for short position.

7. Financial Liabilities Designated at Fair Value Through Profit or Loss (DFVPL) refer to financial liabilities that upon initial recognition are designated by the bank at fair value through profit or loss.

8. Unsecured Subordinated Debt (USD) refers to the amortized cost of obligations arising from the issuance of unsecured subordinated debt which may be eligible as Tier 2 (supplementary) capital of the bank, subject to certain terms and conditions.

9. Redeemable Preferred Shares refer to preferred shares issued which provides for redemption on a specific date.

10. Total Capital refers to the sum of paid-in capital of locally incorporated banks, assigned capital and the allowable qualified capital component of the net “Due To/Due From Head Office/Branches/Agencies” accounts of branches of foreign banks, other equity instruments, retained earnings and undivided profits, other comprehensive income, and appraisal increment reserves.

11. Earning Assets refer to the sum of due from BSP, due from other banks, financial assets-debt securities
(net of allowance), financial assets HFT-derivatives with positive fair value HFT-interest rate contracts (stand-alone and embedded), derivatives with positive fair value HFT-interest rate contracts (stand-alone and embedded) and TLP inclusive of IBL and RRP$s (net of allowance).

12. **Interest-bearing Liabilities** refer to the sum of financial liabilities HFT, financial liabilities designated at FVPL, deposit liabilities, bills payable, unsecured subordinated debt, bonds payable, redeemable preferred shares, derivatives with negative fair value held for hedging and finance lease payment payable.

13. **Liquid Assets** refer to the sum of cash and due from banks and other financial assets (net of allowance for credit losses).

14. **Total Operating Income** refers to the sum of net interest income and non-interest income.

15. **Net Interest Income** refers to the difference between interest income, provisions for losses on accrued interest income from financial assets and interest expense.

16. **Provision for Losses on Accrued Interest Income from Financial Assets** refers to the impairment loss on accrued interest income from loans and other financial assets, net of equity securities, charged against current operations.

17. **Non-Interest Income** refers to the sum of dividend income, fee-based income (including income from fiduciary activities), trading income, foreign exchange profits, profits from sale/derecognition of non-trading financial assets and liabilities, profits from sale/derecognition of non-financial assets, profits on financial assets and liabilities DFVPL, profits on fair value adjustment in hedge accounting and other non-interest income.

18. **Dividend Income** refers to cash dividends earned on equity securities held as HFT, DFVPL, AFS and INMES.

19. **Fee-based Income** refers to the sum of income from payment services, intermediation services, custodianship, underwriting and securities dealership, securitization activities, fiduciary activities and other fee-based income.

20. **Trading Income** refers to the sum of realized gains/(losses) from sale/redemption, and unrealized gains (losses) from marking-to-market of HFT financial assets, and realized gains/(losses) from foreign exchange transactions.

21. **Non-Interest Expenses** refer to the sum of compensation and fringe benefits, taxes and licenses, other administrative expenses, depreciation and amortization, impairment losses and provisions.

22. **Losses or Recoveries on Financial Assets** refer to the sum of provision for credit losses on loans and receivables and other financial assets, bad debts written-off and recovery on charged-off assets.

23. **Income Tax Expenses** refer to provision for income tax.

24. **Net Profit or Loss** refers to the difference of total operating income and non-interest expenses, plus (less) the recoveries (losses) on financial assets, share in the profit (loss) of unconsolidated subsidiaries, associates, joint ventures and minority interest in profit (loss) of subsidiaries.

25. **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. This applies to loans payable in lump sum and 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 in daily, weekly or semi-monthly installments when the total amount of arrearages
reaches 10 percent of the total loan receivable balance; and restructured loans which do not meet the requirements to be treated as performing loans under existing rules and regulations, including 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).

26. Real and Other Properties Acquired (ROPA) refer to real and other properties, other than those used for banking purposes or held for investment, acquired by the bank in settlement of loans through foreclosure or dacion in payment and/or for other reasons, whose carrying amount will be recovered principally through a sale transaction.

27. Non-Performing Assets (NPA) refer to the sum of NPL and ROPA, gross. Effective March 2003, NPAs exclude performing sales contract receivables, which met certain requirements under Circular No. 380. Based on the new FRP framework provided for under Circular No. 512 dated 3 February 2006 and effective on 31 December 2006, NPA should also include non-current assets held for sale.

28. Distressed Assets refer to the sum of NPLs, ROPA, gross, non-current assets held for sale, past due loans and receivables but not yet non-performing, and current restructured loans. Effective end-July 2004, performing restructured loans replaced current restructured loans.

29. Gross Assets refer to total assets plus: “Net of Due to Head Office/Branches/Agencies” of foreign bank branches, if any; allowance for credit losses on loans; allowance for credit losses on sales contract receivables (SCR); and allowance for losses on ROPA minus loans classified as loss fully covered by allowance for credit losses.

30. Allowance on NPAs refers to the sum of allowance for credit losses on loans, allowance for credit losses on SCR, allowance for losses on ROPA.

31. Non-Current Assets Held for Sale refer to ROPAs that are available for immediate sale in their present condition subject only to terms that are usual and customary for sales of such assets and the sale must be highly probable.

32. Sales Contract Receivable (SCR) refers to the amortized cost of assets acquired in settlement of loans through foreclosure or dacion in payment and subsequently sold on installment basis whereby the title to the said property is transferred to the buyers only upon full payment of the agreed selling price.
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 risk-based capital adequacy framework that took into account credit risks effective 1 July 2001 under BSP Circular No. 280 dated 29 March 2001. Under BSP Circular No. 360 dated 3 December 2002, which took effect on 1 July 2003, the computation of CAR for universal and commercial banks incorporates market risks in addition to credit risks. Under Circular No. 538 dated 4 August 2006, which took effect on 1 July 2007, the computation of CAR for universal and commercial banks incorporate operational risk in addition to credit and market risks.

2. Cost-to-Income ratio refers to the ratio of non-interest expenses to total 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. Distressed assets ratio refers to the ratio of distressed assets to total loans (gross of allowance for probable losses), inclusive of interbank loans, plus ROPA (gross of allowance for losses).

5. Earning asset yield refers to the ratio of interest income to average earning assets.

6. Funding cost refers to the ratio of interest expenses to average interest-bearing liabilities.

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

8. Liquid assets ratio refers to the ratio of liquid assets to total deposits.

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

10. NPA coverage ratio refers to the ratio of allowance on NPAs to total NPAs.

11. NPA ratio refers to the ratio of NPAs to total assets, gross of allowance for probable losses.

12. NPL coverage ratio refers to the ratio of allowance for credit losses on loans to total NPLs.

13. NPL ratio refers to the ratio of NPLs to total loans (gross of allowance for credit losses), inclusive of interbank loans.

14. Population-to-banking offices ratio (Customer Ratio) refers to the ratio of the total population to the total number of domestic banking offices.

15. Return on assets (ROA) refers to the ratio of net profit or loss to average assets.

16. Return on equity (ROE) refers to the ratio of net profit or loss to average capital.
Prologue

The Status Report on the Philippine Financial System is a semestral report prepared by the Office of Supervisory Policy Development, Supervision and Examination Sector, Bangko Sentral ng Pilipinas (BSP), and is submitted by the Governor to the President and the Congress, in compliance with Section 39 (c), Article V of Republic Act No. 7653 or The New Central Bank Act.

This report is basically culled from the various periodic reports submitted by BSP supervised/regulated institutions to the Supervisory Data Center, Supervision and Examination Sector. At end-June 2011, BSP supervised/regulated financial institutions consisted of 739 banks with 8,176 branches and other offices, 6,555 non-bank financial institutions (NBFIs) with 9,953 branches and five offshore banking units (OBUs). (Schedule 1)

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 130 of Republic Act No. 7653, except the following: non-banks with quasi-banking functions and/or with trust license, non-banks which are subsidiaries or affiliates of banks and quasi-banks, non-stock savings and loan associations, including pawnshops.

Likewise, the supervision and regulation over building and loan associations were transferred to the Home Guarantee Corporation (HGC) effective 7 February 2002, in accordance with Section 94 of Republic Act No. 8791 (The General Banking Law of 2000).

Finally, pursuant to Circular No. 512 dated 3 February 2006 (as amended) and Circular No. 644 dated 10 February 2009, and in line with the adoption of the Philippine Financial Reporting Standards (PFRS) and Philippine Accounting Standards (PAS), the BSP amended the Manual of Accounts and the BSP reportorial requirements consisting of the Consolidated Statement of Condition (CSOC), Consolidated Statement of Income and Expenses (CSIE) and their supporting schedules issued under Circular 108 dated 9 May 1996 (as amended) for universal and commercial banks, Circular No. 270 dated 19 December 2000 (as amended) for thrift banks, and Circular No. 249 dated 26 June 2000 (as amended) for rural and cooperative banks, through the issuance of the new Financial Reporting Package (FRP) for banks. The FRP is designed to align the Manual of Accounts and the BSP reportorial requirements with the provisions of the PFRS/PAS.
The Philippine Financial System: An Assessment

The seeds of earlier reforms nurtured by the currently improving macroeconomic environment and global investor sentiment on the Philippine sovereign continue to bear fruit as the Philippine financial system sustained its growth spurt for the first semester of 2011 amidst global economic slowdown.

During the semester in review, the global financial system somewhat stabilized four years after the severe global financial maelstrom that rocked even the most advanced economies of the West to tether into recession and infested the nodes of some of the most iconic international financial institutions into financial decay and collapse. Risks may be less worrisome compared to prior semesters but fragilities lingered as global economic recovery remained uneven as growth prospects in these advanced economies currently being desiccated by the worsening sovereign debt crisis in Europe, high indebtedness of households and government in the US and the three-fold calamity\(^1\) that eroded the Japanese economy of its growth potential. Adding mildew to the global slowdown was the rising geopolitical tensions in several oil-rich countries within the Middle East and North Africa (MENA) region as highlighted by the escalating civil wars in Libya and Yemen. Supply disruptions from the MENA region led to higher oil prices which further threatened global economic and financial outlooks.\(^2\)

Meanwhile, stronger-than-expected growth in emerging economies due to relatively accommodative monetary policies irrigated their financial systems with strong capital inflows that could lead to potential buildup of vulnerabilities associated with mismatches across currencies and maturities, asset price bubbles and inflationary pressures. Fortunately on the domestic front, the Philippine economy still registered a respectable growth of 4.0 percent for the first semester of 2011 from year ago’s 8.7 percent despite the foregoing global economic slowdown and government under-spending\(^3\) during the period. In particular, the agriculture, hunting, forestry and fisheries sector recovered from the destabilizing effects of the El Niño phenomenon last year and posted the highest expansion of 5.6 percent among all the economic sectors. The economic expansion was achieved on account of the country’s strong external position particularly the healthy remittance inflows from migrant overseas Filipinos (OF) which continues to support domestic demand for consumer goods and real estate properties. Moreover, manageable inflationary pressures, stronger domestic currency and low interest environment in a seedbed of stable financial system all helped to keep market speculations in check and allowed the financial system to remain supportive of ongoing economic expansion.

Amid these generally favorable domestic macroeconomic conditions; the banking system, which remains the core of the Philippine financial system, indeed has reasonable silage from its strong core earnings and wide capital buffers to weather any potential spillover effects of the global economic slowdown.

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\(^1\)Refers to the earthquake, tsunami and nuclear scare that hit Japan during the first semester of 2011. On 11 March 2011, Japan was devastated by a destructive 8.9 magnitude earthquake that led to a tsunami killing thousands. Two days later, on 13 March 2011, Fukushima Daichi Nuclear plant suffered a meltdown as a result of these natural calamities. The AIR Worldwide, a disaster modeling firm, estimated that the potential loss of the Japanese economy to the earthquake and tsunami alone is between $14.5 billion to $34.6 billion.

\(^2\)Perceived weaknesses and fragilities of advanced economies and the US economy in particular, led the international credit watcher Standard and Poor’s to downgrade the US long-term sovereign debt from ‘AAA’ to ‘AA+’ on 05 August 2011 for the first time since 1917.

\(^3\)Government spending for the first semester of 2011 amounted to P304.8 billion, 6 percent lower than year ago’s P324.3 billion. Moreover, the January to June 2011 budget deficit of the National Government was at P17.2 billion, 88.7 percent lower than the programmed P152.1 billion deficit for the period (Source: DBM, DOF and BSP websites).
While confidence has not been fully restored in a number of banking systems in advanced economies as a result of the much closer interaction of banking risks with sovereign risks than expected, Philippine banks appeared to be deeply rooted but agile enough to withstand any adverse weather conditions or grow even in the tempest of market changes post crisis. Such ability of domestic banks to remain upright and unperturbed even in the midst of most violent global financial storms merited the approval of international credit watchers. On 15 June 2011, Moody’s upgraded the ratings of Philippine banks to Ba2 from Ba3 with stable outlook while Fitch and Standard & Poor’s both maintained their stable outlooks for Philippine banks.

**Philippine banks appeared to be deeply rooted but agile enough to withstand any adverse weather conditions or grow even in the tempest of market changes post crisis**

Accordingly, key performance indicators for the first half of 2011 showed the sustained strength of banks’ core balance sheet accounts: steady asset expansion, double-digit credit growth, stable funding base, ample liquidity, continuing improvement in overall asset quality and above standard solvency ratios. Banks similarly registered healthy bottom lines on account of cost-efficient and technology-enabled delivery of banking services to their chosen clientele.

Other Bangko Sentral ng Pilipinas (BSP) supervised financial institutions followed the same growth trajectory on fertile operating environment.

Moving forward, policymakers and market players have to continue in tilling closely together to keep the soil rich with financial reforms and innovations crucial for the sustained growth and stability of the Philippine financial system.

In order to maintain market confidence, enhance transparency in financial transactions and mitigate systemic liquidity risks, the BSP has been upgrading the banking system’s compliance with international standards and best practices (Box Article 1) following the early adoption of PFRS 94 and the Basel III5 conditions for non-common equity capital instruments. The early adoption of PFRS 9 aims to simplify the classification and measurement of financial instruments. The phased-in implementation of Basel III, which has been germinating for quite some time, bring to the fore the country’s intent to migrate into higher capital rules sooner with the adoption of Basel III standards for the inclusion of non-common equity component in banks’ capital base as basis for determining capital instruments that can be counted as regulatory capital effective 01 January 2011.

Specifically, the introduction of more stringent capital rules in the Philippines under Basel III will merit some careful examination of existing liquidity requirements of financial institutions to ensure that insolvency risks arising from individual financial institutions do not cause destabilizing systemic liquidity risks during severe periods of financial distress as costly experienced in the United States and in some European countries.

Apart from the introduction of countercyclical capital rules, the BSP is further promoting financial stability through periodic and credible stress tests, industry consolidation and closure of weak financial institutions. These compactions may be painful but necessary in order to further enrich the soil and allow the rest of the fruit-bearing seeds of reform to bloom over the medium-term.

Another area that merits careful consideration is keeping the delivery of banking services fully attuned to the needs and demands of the market. Vast advancements in technology particularly the proliferation of digital, handheld devices, point -of-sale (POS) technology and social networking sites are green shoots that need nurturing to bear significant fruits for e-banking in the Philippines. The growth of e-banking technologies remains significant in expanding financial access and in promoting inclusiveness to underbanked and unbanked areas of the archipelago. As stand-alone or off-site ATMs continue to proliferate in areas with heavy foot traffic and in areas where the establishment of branches is economically unviable, the BSP saw the merit of further cultivating this e-banking platform by allowing banks to outsource cash replenishment, first line maintenance, online availability monitoring and cash forecasting to qualified third parties6 this semester. The potential linking of BancNet7 with PhilPaSS8 similarly provides better cash management services to depositors since the interconnection reduces potential settlement risks that may come from the inability of member banks to meet ATM withdrawals.

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4Refers to Philippine Financial Reporting Standards. The guidelines on the early adoption of PFRS 9 are outlined under Circular No. 708 dated 10 January 2011.
5Cf: Circular No. 709 dated 10 January 2011.
6Cf: Circular No. 723 dated 26 June 2011.
7One of the largest ATM consortia in the Philippines with 5,200 ATMs for its 77 member institutions.
8Refers to Real Time Gross Settlement (RTGS) System operated by the BSP through its Payments and Settlements Office (PSO). It is an automated facility to effect high value payment transactions between banks and other non-bank financial institutions. BancNet and the BSP signed a Memorandum of Agreement (MoA) last 17 September 2011 for the former’s ATM transactions.
Upgrading Compliance with International Standards on Financial Reporting and Bank Capital

In keeping with its mandate to promote a safe and sound banking system, the BSP remains focused on strengthening prudential standards such as those relating to the promotion of fairness, accuracy and transparency in financial reporting and the establishment of an appropriate risk-based capital adequacy framework for banks/quasi-banks.

In line with this, the Monetary Board (MB) recently approved the guidelines on the early adoption of the Philippine Financial Reporting Standards (PFRS) 9 Financial Instruments by banks and other BSP-supervised financial institutions (Fs). The MB also approved amendments to the existing risk-based capital adequacy framework for banks/quasi-banks, particularly with respect to implementing certain provisions of Basel 3 aimed at improving the quality of bank capital.

Early adoption of PFRS 9 Financial Instruments

The BSP has issued two circulars detailing the guidelines for the adoption of PFRS 9. Circular No. 708 dated 10 January 2011 initially dealt with the classification and measurement of financial assets under PFRS 9 (2009). Circular No. 733 dated 5 August 2011 amends the provisions of Circular No. 708, providing additional guidelines for the implementation of PFRS 9.

The additional guidelines essentially expand the coverage of PFRS 9 (2009) so as to include the classification and measurement of both financial assets and financial liabilities, in line with the provisions of PFRS 9 (2010).

As a background, PFRS 9 (2009) simplifies the classification and measurement of financial assets to either at amortized cost or at fair value depending on: (1) the entities’ business model for managing financial assets; and (2) the contractual cash flow characteristics of the financial assets.

PFRS 9 (2010), on the other hand, consolidates the provisions of PFRS 9 (2009) on financial assets together with the new PFRS 9 provisions on financial liabilities. The PFRS 9 provisions on financial liabilities generally retain the accounting standards on the classification and measurement of financial liabilities under Philippine Accounting Standards (PAS) 39, except for the treatment of changes in fair value of financial liabilities that are attributable to credit risk which shall be presented in “Other Comprehensive Income”, except in certain cases.

Banks and other BSP-supervised Fs have the option to adopt the provisions of PFRS 9 (2009) on financial assets or PFRS 9 (2010) on both financial assets and financial liabilities prior to its mandatory effectivity date of 1 January 2013, provided they meet the prescribed prudential requirements such as the submission of a one-time solo Report on Initial Application of PFRS 9.

A bank/quasi-bank (QB), and each of its subsidiary banks/QBs, that opt to early adopt PFRS 9 shall submit the one-time solo Report on Initial Application of PFRS 9, in accordance with the following timelines:

If the initial application of PFRS 9 is on or before 31 December 2010, the submission of report should be not later than 31 January 2011.

If the initial application of PFRS 9 is in 2011, the submission of report should be not later than 15 banking/business days from the end of the month when such initial adoption is reflected in their books.

If the initial application of PFRS 9 is in 2012, the submission of report should be not later than 15 banking/business days from the end of the first month of the calendar or fiscal year of initial application of PFRS 9; in the case of rural and cooperative banks, submission of report should be not later than 15 banking or business days from the end of the first quarter of the calendar or fiscal year of initial application of PFRS 9.

The report shall include disclosure of the cumulative impact of the Fi’s adoption of PFRS 9 on selected balance sheet accounts, net income and capital position reckoned from the beginning of the Fi’s calendar or fiscal year, as applicable.

Early adopters are also required to submit a Supplementary Report on Early Adoption of PFRS 9, together with the prescribed monthly/quarterly Financial Reporting Package/Consolidated Statement of Condition reports.

*As discussed in the Exposure Draft on the Mandatory Effective Date of IFRS 9 published by the IASB, early application of IFRS 9 is generally permitted. There is, however, a proposal to change the mandatory effective date of IFRS 9 so that entities would be required to apply them for annual periods beginning on or after 1 January 2015 rather than being required to apply them for annual periods beginning on or after 1 January 2013. Since the timeline for completion of the remaining phases of IFRS 9 has been extended, the IASB has drafted the proposed amendments to IFRS 9 to allow entities to apply IFRS 9 from all phases of the project at the same time. The IASB will accept comments on the exposure draft not later than 21 October 2011.
Meanwhile, the new guidelines grant regulatory relief to banks/other BSP-supervised FIs that will early adopt PFRS 9 by giving them up to 31 December 2011 to reflect the requirements of PFRS 9 in their prudential reports, provided the BSP is notified of the details of the actual implementation in the one-time solo Report on Initial Application of PFRS 9, including the month-end date when such initial adoption is reflected in their books. PFRS 9 has done away with “Available for Sale” (AFS) and “Held to Maturity” (HTM) categories, together with the “tainting rule” which forces entities to reclassify HTM securities to AFS securities in the event that any of those instruments booked under the HTM category is sold. For this reason, early adopters of PFRS 9 will no longer be subject to the “tainting rule” for HTM securities. PFRS 9 is the local counterpart of the International Financial Reporting Standards (IFRS) 9 Financial Instruments. The adoption of PFRS 9 marks the first of the three-phased improvement project by the International Accounting Standards Board (IASB) to ultimately replace International Accounting Standards (IAS) 39 Financial Instruments: Recognition and Measurement. Phases 2 and 3 deal with impairment and hedge accounting, respectively.

**Implementation of certain provisions of Basel 3**

The BSP issued Circular No. 709 dated 10 January 2011 which sets forth the amendments to the existing risk-based capital adequacy framework for Philippine banks/quasi-banks. The amendments essentially adopt the Basel 3 criteria for inclusion of non-common equity components in banks’ capital base as a basis for determining capital instruments that can be counted as regulatory capital by Philippine banks from 1 January 2011 onwards.

Basel 3 revises the existing international capital standards, commonly referred to as Basel 2.

Notably, e-banking technologies have yet to take deeper roots as an alternative service delivery channel compared to the established brick-and-mortar physical presence of bank branches in terms of promoting greater financial access and inclusiveness in the Philippines. As of end-June 2011, bank density nonetheless continue to show urban bias towards the highly populous, higher income and greatly urbanized areas of Metro Manila, CALABARZON, Central Luzon and the Davao region. Such uneven distribution of banking offices and urban bias in financial development remain an ongoing challenge for regulators in an era where technological advancements significantly democratized the ownership of digital, handheld devices, access to social networking sites and the use of credit cards including e-money. Moreover, the spate of weeding out of weak financial institutions in the last decade left the market thoroughly ploughed for new entrants to effectively respond to changing demands of modern banking.

In response to recent market dynamics, the BSP has implemented the two-phased liberalization of bank branching (Box Article 2) in eight restricted areas of Metro Manila to promote further competition in the delivery of banking services. Under Phase 1 of the liberalization program, second-tier private domestic universal and commercial banks including thrift banks with less than 200 branches have until 30 June 2014 to branch out in these restricted areas. Qualified banks have until 12 October 2011 to submit the applications. Under Phase 2 of the liberalization program, all banks, except rural and cooperative banks which are not generally allowed to establish branches in Metro Manila, may branch out in these restricted areas beginning 01 July 2014.

The prevailing weaknesses in Western financial systems and global investors’ search for higher yield led to stronger capital flows into emerging markets including the Philippines. As of end-June 2011, net investments reached $2.9 billion from $0.3 billion a year ago. Net foreign direct investments (FDI) amounted to $0.8 billion, 16.4 percent higher than year ago’s $0.7 billion. Meanwhile, net foreign portfolio investments totaled to $3.1 billion from $0.9 billion a year ago. These inflows, if left unattended, are like couch grasses that could result to speculative investments in the domestic currency and financial markets.

Integral to the liberalization of its foreign exchange framework, the BSP now allows the regular banking units of thrift banks (TBs) to invest in readily marketable foreign currency-denominated debt instruments. These relaxation in foreign exchange regulation coupled with that of prior liberalization of BSP’s derivatives rules in 2008 and 2009 led to

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9 Refers to the cities of Makati, Mandaluyong, Manila, Parañaque, Pasay, Pasig, Quezon and San Juan. Cf: Circular No. 728 dated 23 June 2011.
10 Refers to non-resident’s placements less non-resident’s withdrawals.
11 Refers to non-resident’s purchase less non-resident’s sale of equity and debt securities based on the report of custodian banks.
Box Article 2

Promoting a Competitive Market Environment through Phased Lifting of Branching Restriction

The Monetary Board (MB) recently approved the lifting of the branching restriction in eight strategic areas in Metro Manila. These areas, previously not covered by the liberalization on bank branching, include the cities of Makati, Mandaluyong, Manila, Parañaque, Pasay, Pasig, Quezon and San Juan.

The lifting of the branching restriction in these eight cities is part of the two-phase liberalization reform policy of the BSP aimed at promoting a competitive market environment that will ultimately translate to better service to the public.

Under Phase 1 of the liberalization, second-tier private domestically incorporated universal and commercial banks (U/KBs) and thrift banks (TBs), defined as banks that have less than 200 branches in the so-called restricted areas as of 31 December 2010, shall be given a time-bound window until 30 June 2014 to apply for and establish branches in the said restricted areas. Qualified banks have until 12 October 2011 to submit their application.¹

Under Phase 2 which will start on 1 July 2014, branching in said areas will be open to all banks, except rural and cooperative banks which are generally not allowed to establish branches in Metro Manila.

In the case of government banks, they may already apply for a license to open branches in the restricted areas provided they comply with the licensing requirements prescribed for private banks and present their justification for opening a branch.

Minimum capital requirements. Applicant banks must meet the minimum capital requirements for establishing a branch. In order for a U/KB to qualify for setting up a branch in the restricted areas, it must have combined capital accounts of at least P10 billion. On the other hand, a TB must have combined capital accounts of at least P3 billion. An applicant U/KB or TB that does not meet the required capital shall be allowed to execute an undertaking to build up capital for a maximum period not later than 30 June 2014.

Conclusions

Promotions for PCA. In addition, neither the applicant bank nor any of its subsidiary banks should be under Prompt Corrective Action (PCA) or if under PCA, it should be compliant with PCA resolution guidelines. Approved branches shall not be allowed to be opened until the applicant bank has met the capital requirement and/or until the bank’s PCA status is lifted.

Number of branches allowed. Qualified banks may apply for as many branches in the restricted areas as their qualifying capital can support, taking into account theoretical capital requirements for U/KB and TB branches in Metro Manila. The final number of branches that may be established by qualified banks in the restricted areas under Phase 1 may be subject to adjustment by the MB depending on the total number of applications received. Should the total number of branch applications exceed the total number determined by the MB to be optimal over the Phase 1 period, each qualified applicant bank shall be granted a pro-rata share based on the total number of branches applied for.

Special licensing fee. A non-refundable special licensing fee of P20 million per U/KB branch and P15 million per TB branch shall be charged for approved applications. An applicant bank should also comply with the other standard requirements for setting up of branches. Approved branches under Phase 1 should be opened on or before 30 June 2014. Failure by the bank to do so may result in forfeiture of the branch licensing fee and the right to open the branch.

A significant portion of the special licensing fees that will be generated will be used to fund projects that will address the need of the unbanked and underbanked sectors for broader access to quality financial products and services.

The two-phase liberalization reform is seen to further boost banks’ efforts to scale up their operations in order to be competitive and participate fully in promoting greater financial inclusion.

¹ Application period under Phase 1 is within 90 calendar days from the effectivity date of Circular No. 728.
A major component of Basel 3 involves changes to the definition of bank capital. To recall, under Basel 2, banks’ qualifying capital consisted of Tier 1 and Tier 2 capital. Tier 1 capital is further divided into Core capital and Hybrid Tier 1 capital, while Tier 2 capital is divided into Upper and Lower categories. Tier 2 capital could contribute up to 100 percent of the amount of Tier 1 capital to form a bank’s capital base. Basel 3 still retains the division between Tier 1 and Tier 2 capital but Tier 1 capital is now subdivided into two components: Common Equity and Additional Going-Concern capital. Meanwhile, the subcategories of Tier 2 capital no longer apply under Basel 3.

Moreover, majority of the capital base must be in the form of Common Equity elements. Basel 3 also sets out minimum criteria for instruments to qualify in each of the subcategories of capital. Philippine banks are still following the Basel 2 definition of capital. Over time, they have issued capital instruments such as Unsecured Subordinated Debt (UnSD) that have qualified as either Hybrid Tier 1, Upper Tier 2 or Lower Tier 2 capital. Under the new guidelines, banks’ issuances must prospectively comply with Basel 3 criteria for Additional Going-Concern capital in order for these to qualify as Hybrid Tier 1 capital, and the criteria for Tier 2 capital for these to qualify as Lower Tier 2 capital.

The BSP will no longer allow new issuances of capital instruments to be included in Upper Tier 2 capital.

The BSP is studying the other components of Basel 3 in order to determine how the principles can be best applied to local circumstances.

The adoption of PFRS 9 and the new criteria for capital instruments is part of the BSP’s steadfast commitment to institute reforms at par with international standards that will promote a stronger banking system.

Box Article 1 continuation...

Concerns whether non-deliverable forwards (NDF)\textsuperscript{13} are currently being used for speculative transactions apart from pure hedging instruments. To mitigate any possible impact to the currency and financial markets should there be instances of speculative transactions in the NDF market, the BSP requested banks to submit reports\textsuperscript{14} of their NDF transactions now on a daily basis instead of a weekly basis. This allows regulators to better understand the NDF market in terms of size, direction and timing of transactions while maintaining a liberal policy framework for foreign exchange transactions.

Parallel to these, the BSP remains an active supporter of capital market reforms with the issuance of guidelines governing trust corporations (Circular No. 710 dated 19 January 2011) and revised rules on securities custodianship operations (Circular No. 714 dated 10 March 2011) to lessen the exposure of the banking system from downside risks during economic downturns. In addition, efforts have been concerted to reinforce a deeper culture of good corporate governance in the financial system with the issuance of general governance principles and standards for banks and their related non-government organizations (NGOs)/foundations engaged in retail microfinance (Box Article 3). While the unique synergy between these organizations has tremendously benefited the microfinance market in terms of product innovation, growth and sustainability throughout the years, the same close relationship may be prone to the infestation of abuse and conflicts of interests arising from common board memberships and shared resources.

Summing up, financial reforms are seeds that need to be carefully chosen and planted well in advance when the soil is fertile and weather conditions are ideal. These reforms are periodically nurtured through constant dialogues with various stakeholders and vigilant monitoring of market developments to ensure that these seeds of reform take strong roots to remain upright but pliable enough against the harshest financial storms and debilitating infestations. It is only then that such fruit-bearing seeds of reform can yield a bountiful harvest.

\textsuperscript{13} Refers to a financial derivative (forward contract) that is short-term and normally settled in cash between two parties who agreed to settle the difference between the contracted forward rate and the prevailing spot rate.

\textsuperscript{14} Cf. Memorandum to All Banks/Non-Bank Financial Institutions No. M-2011-028 dated 26 May 2011.
Box Article 3

General Governance Principles and Standards for Banks and Their Related NGOs/Foundations Engaged in Retail Microfinance

In its continuous efforts to reinforce a culture of good corporate governance in the banking system, the BSP has issued new regulations and a set of general governance principles and standards that shall govern the business relationships between banks and their related non-governmental organizations (NGOs)/foundations when both are engaging in retail microfinance operations.

Rationale. Over the years, a number of banks and their affiliated NGOs/foundations have forged a unique synergy in retail microfinance, strongly benefiting the microfinance sector in terms of product innovation, growth in resources and sustainability. However, this special relationship has its share of risks – such close relationship may be subject to abuse as a result of common board memberships and shared resources, among others that could, in turn, increase the potential for operational, governance and reputational risks. The new regulations (issued under Circular No. 725 dated 16 June 2011) and governance standards (issued under Memorandum to All Banks No. M-2011-033 dated 15 June 2011) are aimed at mitigating risks resulting from this unique relationship.

Governance principles and standards. Under the new regulations, bank officers are prohibited from holding any position that may cause them to be involved in the daily microfinance operations of related NGOs/foundations. The regulations also defined as related interests those NGOs or foundations that are incorporated by any of the stockholders and/or directors and/or officers of related banks and are engaged in retail microfinance operations. For transparency purposes, banks and their related NGOs/foundations are also required to present in writing any agreement/contract covering transactions entered into by banks and their related NGOs/foundations. This should help in mitigating risks that may arise from the increased volume of transactions entered into by both parties in the course of their microfinance operations.

Under the set of general principles on governance, the bank’s board of directors and management have full responsibility for ensuring adherence to the pillars of corporate governance in their dealings with related NGOs/foundations: fairness, accountability and transparency.

The board of directors is tasked to formulate policies that shall govern dealings of the bank with its related NGO/foundation. This includes policies that prohibit or limit transactions/activities that may lead to a conflict of interests.

An important feature of the regulation is the liberal interpretation of DOSRI rules to encourage clients of NGOs/foundations to open formal microdeposit accounts with the related banks in lieu of alternative savings mobilization mechanisms in NGOs/foundations such as “capital build-up” schemes. This practice is seen as a means to help protect customer savings and promote the interests of microfinance clients.