The Philippine banking system maintained its positive performance in the first half of 2014. Profit growth eased due to tempered trading gains. Banks, nevertheless, revert to lending activities as they prudently position their balance sheets and support the overall bottomline with interest-based income. Credit remains relatively skewed to the real estate sector. Universal/commercial banks have expanded their reach in areas considered as the home turf of rural banks, indicative of banks’ initiatives to support inclusive growth by providing access to finance for all Filipinos.
The Philippine Banking System

Overview

Recent waves of volatilities in the local and global markets posed challenges to the banking system’s landscape with market conditions reversing, leading to falling investment yields. Consequently, profitability eased owing to increased holdings of investment instruments amid banks asserting ‘search for high yields’. Banks, nevertheless, revert to lending activities as they prudently position their balance sheets against this scenario resulting to a net profit in the first half of 2014 that is highly driven by interest income. However, credit remains relatively skewed to the real estate sector. Universal/commercial banks (U/KBs) have expanded their reach in areas considered as the home turf of rural banks indicative of banks’ initiatives to support inclusive growth by providing access to finance for all Filipinos, regardless of their socio-economic status. The industry additionally continue to capitalize on its technology-enabled services such as electronic banking (e-banking) to cater to the needs of a diverse and increasingly sophisticated market.

Streamlined banking system landscape but accelerated network expansion

The banking system landscape remain streamlined on the back of continued industry mergers, consolidation and a number of small bank closures. For many banks, the option to consolidate or acquire other banks is driven by the need to grow their market and accelerate network expansion. As a result, even though there was a noted decline in the number of head offices, this was offset by the increase in the number of newly established regular branches and so-called “light branches” or other banking offices (OBOs)/microbanking offices (MBOs) that served as additional financial access points.

As of end-June 2014, the number of financial institutions under the supervision of the BSP reached 27,999 (with additional 589 institutions from last year’s 27,410). There are 10,120 operating banking units (up from 9,543 at end-June 2013) consisting of 664 head offices (683 head offices at end-June 2013) and 9,456 branches/other offices (8,860 branches/other offices at end-June 2013). Of these branches/other offices, 47 (up from 35 banking offices at end-June 2013) are domiciled offshore.

Banks account for 36.1 percent (up from 34.8 in end-June 2013) of all financial institutions being supervised by the BSP.

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6 There were 3 cases of mergers/consolidations reported in the first semester of 2014. Meanwhile, there were 7 banks (6 rural banks and 1 thrift bank) and 1 non-bank which closed during the semester. In addition, 2 representative offices of foreign banks ceased operations in the Philippines.

7 Merger/consolidation in the first semester of 2014 involved the: (1) consolidation of Bank of Florida, Inc. (A Rural Bank) and Bank of Lubao, Inc. (A Rural Bank) which will be known as BOF, Inc. (A Rural Bank) effective 02 January 2014; (2) merger between Unity Bank, Inc. (A Rural Bank) and China Bank Savings, Inc. with China Bank Savings, Inc. as the surviving entity effective 20 January 2014; and (3) merger between Green Bank, Inc. (A Rural Bank) and East West Banking Corporation with East West Banking Corporation as the surviving entity effective 31 July 2014.

8 A notable increase was observed in the Middle East where offices of universal and commercial banks rose to 21 units from 4 units in end-June 2013.
The current number of operating banks is lesser by 332 from its peak of 996 in 1998 (Figure 1). The reduced number of operating banks, nevertheless, is augmented by the establishment of OBOs, specifically, (MF-OBOs)/MBOs, apart from regular branches. MBOs are small, scaled down units of banks that readily serve the banking needs of clients in underserved/unbanked populations. The number of MBOs went up by 28.1 percent to 501 as of end-June 2014 from 391 a year ago (Appendix 4). They offer a wide array of financial products and services ranging from credit, savings, remittances, foreign exchange, e-money conversion, bills payment, and government pay-out benefits.

Apart from banks, the BSP also supervises non-banks with quasi-banking functions and/or trust license, financial allied subsidiaries/affiliates of banks and quasi-banks, non-stock savings and loan associations, pawnshops and other financial institutions which under special laws are subject to BSP supervision. Of these financial institutions, pawnshops hold the lion’s share at 62.5 percent or 17,513 offices at end-June 2014 (down from 63.9 percent or 17,514 pawnshops a year ago).

Across banking categories, rural and cooperative banks (R/CBs) continue to hold a bigger slice of operating head offices with a share of 84.1 percent (slightly down from 84.5 percent). This is followed by thrift banks whose share to total operating head offices stand at 10.5 percent (up from 10.2 percent a year ago).

In terms of share to total banking offices, universal and commercial banks (U/KBs) have the largest distribution network accounting for 58.7 percent (same as last year) and R/CBs at 22.2 percent (down from 23.4 percent).

The specific composition of banking offices by major banking groups is summarized in Figure 2 and in Appendix 58.

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Section 1(b) of Presidential Decree No. 1034 defines OBUs as a branch, subsidiary or affiliate of a foreign banking corporation which is duly authorized by the BSP to transact offshore banking business in the Philippines.

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For banks domiciled onshore, domestic banks by far outnumber foreign banks with R/CBs having the most number of operating banks at 558 head offices.\(^{11}\)

Of the 19 foreign bank branches and subsidiaries, on the other hand, U/KBs have the bigger proportion of head office units at 84.2 percent (Figure 3).

**The forthcoming ASEAN integration heightens competition among local banks**

With the forthcoming ASEAN integration, the challenge for local banks is to scale up their size and expand their reach to be able to compete with other bigger banks in the region. Total assets of the Philippine banking system is approximately more than three-fifths smaller than Singapore’s DBS Bank but 1.3x larger than Malaysia’s Maybank and more than thrice the size of Thailand’s Bangkok Bank.

Based on Published Balance Sheet as of 30 June 2014, the top 5 banks in the country – composed of 4 universal banks and 1 government bank – account for 52.1 percent (up from 50.6 percent a year ago) of the total assets of the Philippine banking system. In terms of deposit share and capital accounts, these banks also represent a sizeable proportion at 55.5 percent (up from 53.1 percent) and 52.4 percent (up from 52.2 percent), respectively.

\(^{11}\) Inclusive of 7 microfinance-oriented rural banks
Highly urbanized and densely populated areas remain to be the prime location for banking activities

Bank coverage in most parts of the region remain concentrated in highly urbanized areas of the country. National Capital Region (NCR) has 100 percent bank coverage, followed by CALABARZON (Region IV-A) with 95.1 percent, Central Luzon (Region III) with 93.1 percent, Cagayan Valley (Region II) with 80.6 percent and Western Visayas (Region VI) with 78.9 percent. These regions are densely populated and mostly urbanized, making them viable hubs for business and other industries. These economic considerations make these regions prime locations for banking activities to thrive. Penetration of banks (banks per 1,000 sq. km.), nevertheless, stand at 34 banks from 33 banks.

There are 3,192 banking offices in NCR which accounted for 31.7 percent of total banking offices nationwide (slightly down from 31.9 percent or 3,046 banking offices last year). Other regions that registered hefty shares are: CALABARZON or Region IV-A with 15.3 percent or 1,542 banking offices (up from 15.0 percent or 1,433 banking offices at end-June 2013), Central Luzon (Region III) with 10.1 percent or 1,020 banking offices (down from 10.2 percent previous year but up from 977 banking offices), Central Visayas (Region VII) with 6.6 percent or 669 banking offices (down from 6.7 percent but up from 637 banking offices), and the Western Visayas (Region VI) with 5.8 percent or 581 banking offices (unchanged from last year’s share but up from 552 banking offices). These five leading regions account for 69.5 percent (lower than prior year’s 69.6 percent) of the total banking network nationwide.

On the other side of the archipelago, the Autonomous Region of Muslim Mindanao (ARMM) still has the least bank coverage with 8.5 percent of the region’s cities and municipalities having banking offices. Other cities and municipalities with low bank coverage are in Eastern Visayas (Region VIII) with 28.0 percent, Cordillera Autonomous Region (CAR) with 33.8 percent, and the Zamboanga Peninsula (Region IX) with 36.1 percent. Establishing bank branches in these parts of the country remains a challenge due to the generally low population density, geographic inaccessibility, and prevailing geo-political and socio-economic situations in these localities.

Accordingly, bank distribution in these areas remain sparse with ARMM’s 0.2 percent or 22 banking offices (unchanged from last year but up from 20 banking offices), CAR’s 1.5 percent or 149 banking offices (down from previous year’s 1.6 percent but unchanged in terms of number of banking offices), Eastern Visayas’ 1.9 percent or 188 banking offices (up from previous year’s 1.8 percent or 173 banking offices), Zamboanga Peninsula with 2.0 percent or 197 banking offices (unchanged from the previous year but higher than the recorded 190 banking offices) and SOCCSKSARGEN (Region XII) with 2.0 percent or 202 banking offices (down from 2.1 percent but up from 196 banking offices). Collectively, these underbanked regions account for only 7.6 percent (down from 7.7 percent last year) or 758 banking offices (up from 728 banking offices as of end-June 2013).

In terms of bank coverage in most parts of the country’s cities and municipalities, the range was between 60 to 79 percent as of end-June 2014 (Figure 5). Customer ratio improved by 4.5 percent to 9,823 persons served per banking office from 10,287 persons per each banking office in end-June 2013. Banks’ density ratio mirror dispersion pattern which is concentrated in highly populous, urbanized and higher income areas of the archipelago (Appendix 5). Distribution of banking offices were predominant...
Banking System

in NCR with 3,101 head offices/branches (Figure 4). Outside NCR, banking offices are mostly found in 1st class cities (1,930) and municipalities (1,477). Notably, U/KBs have expanded their reach in areas considered as the home turf of rural banks, i.e., in 1st to 3rd class municipalities with a total of 649 banking offices vis-à-vis R/CBs’ network of 1,216 offices/branches. Network expansion in these areas is indicative of banks’ initiatives to support inclusive growth by providing access to finance for all Filipinos.

Overseas bank branch distribution is clustered notably in the Middle East and in the Asia-Pacific region

For overseas bank branches, bank distribution is clustered mostly in the Middle East with 21 offices (from year ago’s 4 offices) and in the Asia-Pacific region with 17 offices (from 21 offices). Bank branches in the Middle East represent 44.7 percent of total branches abroad while those in the Asia-Pacific account for 36.2 percent (Figure 6). Meanwhile, five offices are located in North America and four in Europe. Notably, bank offices in the Middle East are mostly remittance desk offices at 15 offices as of end-June 2014. Banking presence (mostly offices of universal banks) in the Middle East reflects the strong remittance inflows coursed through the banking system. With banks as remittance channels, overseas Filipinos (OFs) and their beneficiaries gain access to a wider menu of financial services, including deposit accounts and various investment instruments.

Banks have capitalized on the use of various electronic banking (e-banking) channels to cater to the needs of a diverse and increasingly sophisticated market. As of end-June 2014, e-banking platforms such as electronic wallet are being offered by 60 banks, internet banking by 43 banks, cash/remittance cards by 29 banks, and hybrid mobile/internet via BancNet-MegaLink switch by 33 banks (Figure 7 and Appendix 7).

Automated teller machines (ATMs) remain a key e-banking platform. The number of banks with ATM network reached 116 (from 74 banks at end-June 2013), composed of 110 domestic

As of June 2014, the Philippines has a total of 14,843 ATMs with a YoY growth of 14.0%.

12 Aside from remittance desk offices, there are three representative offices, two marketing offices and one regular branch in the Middle East. Section X154 of the Manual of Regulations for Banks (MORB) sets down the rules for the establishment of branches or other offices abroad by domestic banks. These offices cover not only branches but also agencies, representative offices, remittance centers, remittance desk offices and other offices which are integral in the operations of the parent domestic bank.

13 For the period 2009 to 2013 the Top 10 destination of New Hires and Rehires Landbased Overseas Filipino Workers are: (1) Saudi Arabia; (2) United Arab Emirates; (3) Singapore; (4) Hong Kong; (5) Qatar; (6) Kuwait; (7) Taiwan; (8) Italy; (9) Malaysia; and (10) Bahrain. Source of data: Philippine Overseas Employment Administration.
banks and six foreign bank branches and subsidiaries. The system’s ATM network grew by 1,714 units (13.1 percent) to 14,843 from year ago’s 13,129 units (Figure 8). These ATMs are mostly on-site ATMs at 58.4 percent (slightly down from year ago’s 58.8 percent). Off-site ATMs, nonetheless, grew at a faster rate by 14.2 percent compared to on-site ATM’s growth of 12.2 percent year-on-year (Figure 9).

**Banking system displayed positive operating income, growing balance sheet, and above minimum required capital buffer**

**Profitability eased due to reduced earnings from non-interest based banking activities**

The industry ended first half of 2014 with a net profit of P63.7 billion. This is, however, lower by 34.7 percent from P97.7 billion in the same period last year. The recorded decline was due to the decrease in non-interest income of 45.5 percent to P63.7 billion which partly offset the increase in net interest income of P152.8 billion, or 22.9 percent increase from last year’s P124.3 billion (Figure 10).
Annualized cost-to-income (CTI) ratio, a common measure of bank efficiency, picked up to 65.1 percent at end-June 2014 from 58.7 percent last year. Meanwhile, annualized return on assets (ROA) and return on equity (ROE) ratios went down to 1.2 percent and 9.5 percent from 2.0 percent and 15.4 percent last year (Figure 11 and 12). Reduced profits from divestment, foreign exchange, and fair value adjustment of assets pulled down non-interest income.

Non-interest based revenues from trading securities and derivatives (down by 50.6 percent year-on-year (YoY) to P3.3 billion), foreign exchange (down by 74.1 percent YoY to P3.4 billion), and sale/redemption/de-recognition of non-trading financial instruments (down by 80.7 percent YoY to P10.6 billion) registered sizeable decline (Figure 13).

Traditional lending activities and lower expenses on deposit boosted net interest income. Interest income rose by 13.0 percent (P22.5 billion) to P195.0 billion while interest expense fell by 12.6 percent (P6.0 billion) to P42.0 billion for the period ended 30 June 2014. Of the interest income, interest earned on loans to individuals, corporate and government increased by 9.1 percent (P10.1 billion) across various subgroups profitability indicators presents that government banks were the most cost-efficient at 61.2 percent (up from last year’s 50.8 percent). Meanwhile, cooperative banks provided better returns with ROA and ROE ratios of 1.6 percent and 14.7 percent (up from previous year’s -5.0 percent and -51.0 percent), respectively.
to ₱120.9 billion accounting for 62.8 percent. Interest expense related to deposit taking activity, on the other hand, dropped by 7.3 percent (₱2.6 billion) to ₱33.5 billion representing 79.8 percent.

Universal and commercial banks’ (U/ KBs) revenue from loans exhibited considerable dependence on earnings from credit to private corporations accounting for 60.4 percent share (₱52.0 billion and 16.6 percent YoY growth) (Figure 14). Other counterparties which registered ample shares are: loans to individuals for credit card usage at 9.3 percent (₱8.0 billion and 31.2 percent YoY growth), small and medium enterprise at 6.4 percent (₱5.5 billion and -9.6 percent YoY), loans to individuals for housing purposes at 5.3 percent (₱4.6 billion and 2.2 percent YoY), government at 5.2 percent (₱4.5 billion and -6.3 percent YoY), and loans to individuals for auto loans at 5.1 percent (or ₱4.4 billion and -2.3 percent YoY).

While this may suggest constrained future profits as corporate lending provides thin margin, banks are seen to sustain positive growth in interest income given that a large proportion of the industry’s relatively high-yielding assets (compared to declining and low interest rates offered to deposits, see Figure 15) will reprice in the short-term when interest rates are expected to rise (Figure 16).

Asset growth driven by increased bank lending

System’s balance sheet expands further with total assets growing by a hefty 19.3 percent as of end-June 2014 to ₱10,279.5 billion. This accounted for 78.9 percent of the total assets of the financial system and 85.3 percent of gross domestic product.

*Consumer loans include loans to individuals for housing purposes, credit card usage, auto loans, and for other purposes.
Banks maintain a defensive portfolio position of raising the proportion of loans to its total assets in order to operate profitably when domestic and global financial markets worsen and take advantage of rising interest rates. Gross total loan portfolio (net of amortization) rose by 19.6 percent (P854.7 billion) to P5,213.9 billion (Figure 17). This behavior deviates from its conduct in 2013 when cash and due from BSP/other banks was the main contributor to growth in total assets.

Banks, nevertheless, maintained a substantial amount of liquid assets as cash and due from BSP or other banks increased further by 34.6 percent YoY (P620.3 billion) to P2,412.9 billion and gross financial assets other than loans (net of amortization) by 11.3 percent YoY (P213.3 billion) to P2,109.4 billion (Figure 17).

Liquidity is boosted by special deposit accounts which grew by 30.5 percent YoY (P720.3 billion) and Held-to-Maturity (HTM) financial assets by 132.5 percent YoY (P704.8 billion). Increased holdings of HTM further indicates that banks situate its asset mix to cover potential losses that may arise from volatile trading gains by locking in higher yields offered in investment instruments.

It is also worth noting that while the long-term trend of loans has been exhibiting accelerated upward movement it is not catching up with the tempo of deposits (Figure 17). This implies that banks can further maximize its resources either for more lending that would provide more funds to different sectors of the economy or for investment activities that would provide additional profits.
Bank lending remains notably skewed to real estate, renting and business services (RERBA)

Industries engaged in RERBA remain the largest loan recipients, ahead of Financial Intermediation (inclusive of interbank loans and RRP transactions). In particular, Real Estate’s loan intake of 18.2 percent as of end-June 2014 (slightly down from year ago’s 18.4 percent) is higher than Financial Intermediation’s 16.9 percent (same as year ago) (Figure 18).

Prudential surveillance report by purpose on real estate loans (RELs), on the other hand, presents an expansion driven by increased commercial RELs of 25.7 percent to P575.7 billion. Residential RELs growth was recorded at 18.3 percent to P348.2 billion. At this rate, total RELs grew by 22.8 percent to P923.9 billion with its long-term trend displaying a steep curve and above trend actual levels which highlights rapid growth.
Residential RELs likewise accounted for the largest share of the consumer loan portfolio at 43.3 percent, followed by auto loans and credit card receivables at 25.7 percent and 19.6 percent, respectively. Total consumer loans went up to P803.3 billion from year ago’s P680.4 (Figure 19).

In terms of counterparty exposures, bank credit is also biased towards private corporations involved in manufacturing (P548.0 billion or a share of 20.8 percent) and real estate (P453.4 billion or 18.1 percent share) (Figure 20).

RERBA, based on the 2009 Philippine Financial Social Accounting Matrix (PFSAM2009)\textsuperscript{17}, is one of the key industries with large forward linkages to the other sectors in the economy. It ranked as 5th important supplier of goods and services for other industries, and 3rd significant income generated after financial intermediation among ten (10) types of industries operating in the country. With a loan portfolio profile that is hinged on revenues of relatively productive sectors in the economy, the system’s performance is seen to endure receding gains from other balance sheet accounts.

However, network analysis suggests that in the event of a downturn in the real estate sector a series of defaults within the banking system can occur as the top lending banks that are largely exposed to said sectors are the highly connected banks (Figure 18). Cognizant of the systemic risk associated with distress in real estate sector, the BSP has effected prudential\textsuperscript{18} measures to single counterparty or a group of counterparties to ensure balanced exposure to real estate developments.

Banks continuously provide credit accommodations to micro, small and medium enterprises (MSMEs)
The system is also able to set aside a total of P323.8 billion of their loanable funds for agriculture and agrarian reform credit under R.A. No. 10000 (the Agri-Agra Reform Credit Act of 2009). Rural and cooperative banks’ agri-agra compliance ratios of Agra at 19.9 percent and Agri’s 43.8 percent were far above the required ratios of 10 percent for Agra and 15 percent for Agri, respectively. As such, despite limited share in the system’s TLP, rural and cooperative banks are able to cater to the needs of agri-agri as well as MSME borrowers that may be underserved by larger banks.

The system maintained its loan quality amid continued growth in lending. Gross NPLs remained low at 2.7 percent of the total loan portfolio, improving from year ago’s 3.3 percent. The growth in total loans came with a decline in gross NPLs to P140.0 billion from year ago’s P146.0 billion (Figure 21).

Aside from maintaining the gross NPL ratio below four percent since end-June 2011, the banking system is able to continue to set aside loan loss reserves larger than their gross NPLs. In particular, the NPL coverage ratio strengthened to 116.4 percent from year ago’s 110.8 percent with the increase in loan loss reserves to P163.0 billion from P161.8 billion.

The decrease in real and other properties acquired (ROPA) to P127.0 billion from year ago’s P129.2 billion, together with the NPL decline, resulted to a lower non-performing asset (NPA) level at P267.0 billion.
Meanwhile, non-performing loan (NPL)\textsuperscript{19} ratios by industry have declined for RERBA (at 2.8 percent as of end-June 2014 from 3.4 percent the previous year), financial intermediation sector (0.8 percent from 1.0 percent), manufacturing (2.6 percent from 3.5 percent), and wholesale & retail trade (at 3.2 percent from 3.9 percent) sectors. NPL ratio of agriculture, hunting, fishing and forestry, nonetheless, inched up to 7.0 percent as of end-June 2014 from 6.5 percent in the same period last year (Figure 21).

Investment instruments are mostly booked as Available-for-Sale (AFS)

Financial assets other than loans (net of accumulated market gains/losses and allowance for credit losses) were made up of government issued debt securities (P1,986.1 billion or a share of 95.5 percent) and booked as Available-for-Sale (AFS) at P1,066.2 billion or a share of 51.7 percent. Residents, specifically domestic universal banks and government banks, hold a substantial fraction of portfolio and direct equity investments (Figure 22).

The value of AFS holdings has been declining since March 2013 as evidenced in the reduced level of Other Comprehensive Income (OCI)\textsuperscript{20} (Figure 23 and 24). From a hefty gain of P99.6 billion (driven by unrealized gains in debt and equity AFS holdings), AFS posted a loss of P7.9 billion as of end-June 2014 (due to unrealized losses in AFS debt securities of P18.6 billion). Aggregated annual losses in market value of AFS holdings amount to P107.5 billion (Figure 24).

\textsuperscript{19} Figures are computed in accordance with the NPL definition under Circular No. 772 dated 16 October 2012 effective 01 January 2013.

\textsuperscript{20} Other Comprehensive Income (OCI) refers to, among others: (1) contra account of Accumulated Market Gains or Losses from Available-for-Sale Debt and Equity Securities; (2) Gains and Losses on Fair Value Adjustments of Hedging Instruments and (3) Cumulative Foreign Currency Translation. OCI forms part of the banking system’s total capital accounts.

from year ago’s P275.2 billion. Asset quality thus improved with the NPA ratio at 2.5 percent, lower than year ago’s 3.1 percent. Moreover, the NPA coverage ratio widened to 73.5 percent due to the increase in NPA reserves to P196.3 billion.

The distressed assets ratio, as a broader measure of asset quality, likewise improved to 5.4 percent from year ago’s 6.5 percent ratio. This came as distressed assets contracted to P291.0 billion from year ago’s P293.1 billion.
Unwarranted large holdings of AFS subject the banking system to mark-to-market losses especially in an environment of rising interest rates which subsequently, compromises the industry’s capital position. Close monitoring is therefore necessary as Basel III framework on minimum capital requirement now includes net unrealized gains/losses of AFS debt securities in the computation of CET1, Tier 1 and Capital Adequacy Ratio (CAR) thereby, cementing a direct transmission channel of market risk from banks’ balance sheet exposures to its capital position.

**Main source of funds remains to be resident retail customers**

Deposit liabilities rose by 24.5 percent to P7,901.2 billion which accounts for 76.9 percent of total assets. The bulk of deposits comprised of peso deposits at 83.4 percent (P6,588.0 billion) and is mostly from residents representing 98.8 percent (P7,806.3 billion).

Furthermore, deposits are primarily held in savings at 47.2 percent (down from 48.4 percent as of end-June 2013), followed by time at 30.5 percent (up from 28.9 percent), demand and NOW at 21.2 percent (down from 21.7 percent) accounts, and Long-Term Negotiable Certificate of Deposits (LTNCD) at 1.1 percent (up from 0.9 percent) (Figure 25).

This profile, which remains to be retail-based and domestically-oriented, denotes a stable funding stream and partial insulation against currency exchange rate fluctuations. It is also indicative of sustained depositor confidence in banks. Retail funding sources are normally less sensitive to sudden changes in the condition of bank’s operation. Meanwhile, the other source of funds for banks’ operations - owner’s capital rose - by 10.3 percent to P584.0 billion.

A close assessment of the funding position of the industry indicates that banks’ balance sheet is in a tight stance on servicing its maturing liabilities

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particularly, deposits in the short-term. Negative gaps were recorded at time buckets of ‘up to 1 year’ residual maturity profile of net performing assets and liabilities (Figure 26). The existence of such maturity mismatches should not necessarily denote high liquidity risk exposure because risk management practices such as contingency funding/liquidity plan and limits on the nature and amount of risk banks are willing to assume have been set up to control risk.

**Banks’ capital still above minimum required limits**

Universal and commercial banks remain well-capitalized against risks at 16.3 percent on a consolidated basis and 15.4 percent on a solo basis as of end-March 2014 (Figure 27). While this is still above the BSP regulatory requirement of 10.0 percent and the Bank for International Settlements (BIS) standard of 8.0 percent, compared to previous periods, the ratio is lower because of contraction in total qualifying capital (TQC). The decrease in qualifying capital was mainly brought about by deductions from investments in non-allied undertakings and assets with uncertain realizable value in times of adverse financial conditions such as intangible assets, goodwill and defined benefit pension fund assets. Unrealized losses from AFS financial assets also pulled down TQC. Philippines’ CAR on both consolidated and solo basis are among the highest in ASEAN-5 as of end-March 2014.

Nevertheless, should the landscape of the banking system persist to be a picture of concentrated lending to real estate sector, rising household credit growth, and continued preference for non-interest based revenues as complementary income stream, rising interest rates following the normalization of monetary policy in Advanced Economies pose risks on sustainable profitability which may eventually increase the likelihood of falling capital positions.

**OFF-BALANCE SHEET**

**Lower derivatives transactions pull down off-balance sheet activities of banks**

*Selected off-balance sheet assets of banks posted a negative year-on-year growth*

The banking system’s selected contingent accounts which represent off-balance sheet activities stood at P6,329.3 billion (61.6 percent of total assets), 7.3 percent lower than year ago’s level of P6,830.1 billion (Figure 28). The contraction is driven mainly by the decline in derivatives transactions which similarly reported a year-on-year contraction of 6.2 percent.

Selected off balance sheet assets of banks consist of derivatives instruments (45.0 percent), trust department accounts (38.9 percent), commitments (11.2 percent), bank guarantees (3.0 percent) and trade related accounts (1.9 percent).
Notional value of derivatives continue to drop on the back of modest treasury-related operations of banks

Total notional value of derivatives transactions contracted by 6.2 percent to P2,845.9 billion from P3,034.5 billion last year on the back of tempered treasury-related operations of banks. On trend, the more sophisticated and bigger universal and commercial banks capture the lion’s share of the local derivatives market.

Foreign exchange contracts still spearheaded the largest share of the local derivatives market at 71.3 percent or P2,029.1 billion. Year-on-year, foreign exchange contracts declined by 10.1 percent. Other derivatives in the Top 3 are interest rate contracts at 28.5 percent or P811.3 billion and credit derivatives at 0.2 percent or P5.6 billion.

Strong global demand for locally produced goods results in positive outturn in trade-related contingent accounts

The banking system’s total trade-related contingent accounts stand at P118.7 billion, 71.5 percent higher than year ago’s level of P69.2 billion on account of strong global demand for locally produced goods. For the first six months of 2014, trade-in goods was at a deficit amounting to US$7.1 billion due to level fluctuations of both merchandise exports and imports (Figure 29). Aggregate merchandise exports for the first six months of 2014 showed an increase of 8.3 percent from $27.515 billion in 2013 to $29.812 billion in 2014. Similarly, aggregate merchandise imports for the first six months of 2014 amounting to $31.452 billion exhibited a 5.7 percent increase compared with $29.752 billion in the same six months of last year.

The bulk of the total trade-related contingent accounts of the banking system is accounted for by foreign commercial letters of credit (LC) outstanding at 78.7 percent or P93.4 billion from 76.4 percent or P52.9 billion last year. These were foreign LCs of universal and commercial banks which held 99.5 percent of the banking system’s total foreign LCs. The rest, in descending order, went to export LCs at 8.6 percent or P10.2 billion, shipside bonds and airway bills at 8.5 percent or P10.1 billion, and domestic commercial LCs confirmed at 4.1 percent or 4.9 billion.

Lingering market volatilities in global and domestic markets led to increased demand for risk protection

The inherent risks in many business transactions as well as the lingering concerns on slower global growth and market volatilities brought by normalization of monetary policy in advance economies resulted in increased demand for risk protection instruments such as bank guarantees. The banking system’s guarantees posted a double-digit growth of 32.1 percent to P191.6 billion from last year’s P145.0 billion. Bank guarantees are either stand-by LCs or outstanding guarantees issued. LCs made up 87.7 percent or P168.1 billion of total bank guarantees. The balance is accounted for by outstanding guarantees issued at 12.3 percent or P23.6 billion. Most of bank guarantees are issued by universal and commercial banks which continued to hold the lion’s share at 99.7 percent or P191.0 billion.

Credit card lines represent a large portion of total bank commitments

Total commitments rise year-on-year by 16.7 percent to P709.8 billion and are mostly issued by universal and commercial banks. The increased credit extended to households for family and other personal expenditures which expanded by 9.6 percent to P461.3 billion from P421.0 billion last year contributed to the huge increase in accounts under the item “others”. Credit card lines account for 65.0 percent of total commitments.
The Trust Operations

Despite the less than ideal performance of the trust entities of banks, total trust and other fiduciary services was kept from dropping further, supported by Investment Houses, which grew by 69.1 percent (Php 45.6 billion) owing to its agency accounts. These have always formed bulk of its managed funds and unlike those maintained at banks, its agency account clients did not shift to trust or deposits. Rather, agency accounts increased, especially the institutional agency accounts with Investment Management Accounts (IMA). Meanwhile, assets shifted to equity securities following the second quarter rally at the stock market. It is also worth noting that debt securities that were held to maturity slightly more than doubled to Php 68.6 billion from Php 31.9 billion) to avoid marked-to-market losses from assets that were available for sale as the rising interest rates pushed down bond prices.
Trust Operations

Overview

Trust and other fiduciary accounts continued to seek a more stable level, posting P2,576.3 billion at the end of the June 2014, almost going back to its June 2011 level of P2,565.6 billion from a high of P3,039.3 billion at the end of June 2013. Comparing the latest data with year ago figures, the decline mostly came from Cash and Due from Banks just as it did in June 2013. In particular, the effects of the issuance of Memorandum No. M-2013-021, which limited access to the Special Deposit Account (SDA) facility through Unit Investment Trust Funds (UITFs) effective 1 January 2014 and Memorandum No. M-2012-034, which prohibited the use of the SDA facility by non-residents, persisted causing Special Deposit Accounts (SDAs) to slide down further, registering P438.3 billion from P1,110.9 billion a year ago. It is worth noting though that quarter-on-quarter, the SDA level has started to recover from a low of P372.3 billion at end-December 2013.

As a proportion of total trust assets, SDAs accounted for 36.6 percent (P1,110.9 billion) of the total at end-June last year. It went down to 17.0 percent during the period in review, now a distant second to the 51.5 percent (P1,327.4 billion) accounted for by net financial assets. The SDAs’ decline was however tempered by the 56.4 percent (P148.4 billion) rise in Deposits in Banks to P411.8 billion, almost twice the P263.4 billion it recorded in June 2013. Likewise, the 6.3 percent (P78.8 billion) increase in net financial assets also contributed to asset growth as investors got drawn to the safe haven provided by bank accounts along with the trend of increasing interest rates. On the other hand, while debt securities still held bulk of financial assets including investments in non-marketable equity securities (INMES) at 56.2 percent (P787.1 billion), there has been a shift to equity securities from a share of 36.4 percent (P480.9 billion) to 43.7 percent (P611.9 billion). The preference for financial assets, especially equity securities was fuelled by the second quarter rally at the stock market backed by strong earnings of the companies listed at the local bourse as well as Standard and Poor’s upgrade of the Country’s credit rating to a notch above investment grade. It also helped that there was positive news from overseas on the economies of the Philippines’ trading partners, Japan and U.S. These made up for the marginal decline at the stock market during the first quarter due to the negative sentiments triggered by disappointing economic developments abroad at the time.

It is also worth noting that debt securities booked as held to maturity (HTM) a little more than doubled to P68.6 billion from P31.9 billion as the rising interest rates pushed down bond prices. As a result, it was more profitable to hold on to debt securities until maturity by locking on to the prevailing interest rates instead of incurring marked-to-market losses from assets booked as available for sale.

Figure 30
Trust Asset Mix
In terms of accountabilities, although the appetite for SDAs remained as evidenced by the 41.6 percent (P177.5 billion) increase in the UITF, the only type of pooled fund that was allowed to invest in SDAs, UITF growth for this period was not as much as it was a year ago nor was it enough to offset the 47.3 percent (P618.6 billion) decline in agency accounts which stemmed mostly from other individual agency accounts (P337.3 billion) and other institutional agency accounts (P284.2 billion). Thus, leading to lower trust accountabilities for the period.

By managed fund, compliance with the memorandum limiting the access to the SDA was most evident in agency accounts which no longer held cash and due from accounts as of end-June 2014. In lieu of which, financial assets were maintained for such accounts. This was also the case with other fiduciary accounts and special purpose trust, but in other fiduciary accounts the assets shifted to deposits in banks instead of financial assets while for special purpose trust, assets were further concentrated on equity investments and other assets due to the nature of said funds. Similarily, the effects of the same memo, which limited access to the SDA were reflected in the asset mix of trust accounts, but unlike agency accounts, the movement is not a reduction in cash and due from accounts, but rather an increase in said account because of the UITFs which were allowed to invest in SDAs.
Investment Houses Buoy Trust And Fiduciary Accounts

Among the financial institutions with trust entities, although universal/commercial banks (U/KBs) still provided the primary influence on the direction of the movement of trust resources being its biggest contributor with 94.5 percent (P2,435.1 billion) of the total, it was non-bank financial institutions that buoyed trust and fiduciary accounts after U/KBs and thrift banks’ (TBs) trust resources fell by P508.6 billion combined. The reduction came mostly from cash and due from banks as well as loans. In contrast, non-bank financial institutions went up by 69.1 percent (P45.6 billion), spurred by financial assets on the resources side and agency accounts on the managed funds side. Thus, allowing it to breach the hundred billion mark at P111.6 billion.

What makes the growth in trust accounts all the more interesting is that it stemmed from agency accounts (other institutional agency accounts and other individual agency accounts) and not trust where the UITF is booked.

Trust Accounts vs. Deposit Accounts

Year-on-Year starting June 2007, percentage growth of trust assets held by banks with trust licenses have exceeded the growth of their respective deposit liabilities. However, starting June 2013 to the period in review, deposit liabilities of banks have outpaced trust assets, so much so that the ratio of trust assets to deposit liabilities dropped to 34.5 percent from 52.3 percent at end-June 2013.

Revenue from Trust

For the period in review, net income went down to P2.4 billion from P3.2 billion (22.5 percent) caused by the combination of lower fees and commissions (from P4.8 billion to P4.5 billion) as well as higher expenses (from P 1.7 billion to P2.1 billion).
The banks authorized to engage in FCDU operations continued to register positive performance and able to weather the headwinds coming from US normalization policy with stronger balance sheets and sustained profitability. Overall, these banks complied with the 100 percent asset cover and 30 percent liquidity requirements of the BSP.
Overview

Banks authorized to engaged in FCDU operations continued to register positive performance and able to weather the headwinds coming from US normalization policy on improved macroeconomic environment characterized by low inflation and interest rate environment and general strengthening of the domestic currency against the US dollar during the review period. The FCDU assets expanded by 11.8 percent year-on-year as banks maximize potential returns on cheaper greenback through a more active FCDU loan window. Liquidity tightened as evidenced by the narrowing of liquid assets-to-deposits ratio, increased leveraging of banks with FCDU authority and increased intra system transactions such as interbank borrowings and repos for liquidity purposes. Nonetheless, most banks with FCDU operations complied with the 30 percent liquidity requirements including the 100 percent asset cover requirement. FCDU net profit stayed in the positive territory at US$793.9 million but the year-on-year growth decelerated on the back of revaluations and marking-to-market of foreign currency denominated financial assets during the review period.

Banks with FCDU authority remains almost the same

There are 78 banks (36 universal and commercial banks, 30 thrift banks and 12 rural and cooperative banks) with FCDU authority. A total of 33 banks, all of which are universal and commercial banks, has an expanded FCDU authority. This is lower by one bank from end-December 2013 due to the placement of the Rural Bank of Lingayen, Inc. under receivership. Banks engaged in FCDU operations still accounted for 11.7 percent of total operating banks in the Philippines.

Profitability softened on tempered non-interest income

Banks engaged in FCDU operations remained profitable as net profit stood at US$793.9 million, albeit 30.8 percent lower than the 2013 level (Figure 35). FCDU net profits averaged at US$954.5 million for the last five years. It also accounted for 57.2 percent of the total net profit of the banking system.

The deceleration in the growth of net profit may be traced to the 55.5 percent decline in non-interest income, whose level also dropped more than twice or US$385.4 million to US$309.6 million from the significant losses incurred from the sale/redemption/de-recognition of non-trading financial assets and liabilities (US$372.7 million) and losses on financial assets and liabilities designated at fair value through profit and loss (US$24.2 million). Trading income was still in the red at (US$10.3 million) but US$5.4 million better than same period recorded in 2013.

The deceleration in non-interest income could be attributed to the uptick in domestic interest rates as illustrated by the comparative yield curve in Figure 31. Accordingly, banks with FCDU authority reported higher revaluation and marking-to-market losses on

Figure 35
FCDU System Results of Operations
For End-June of Periods Indicated
In US$ Millions

28 Prepared in compliance with Foreign Currency Deposit Act (Republic Act No. 6426)
financial assets amounting to US$416.5 million, which is more than eight times the losses posted in the same period in 2013.

Meanwhile, net interest income slightly grew by 2.0 percent year-on-year mainly due to the movements in interest income and upbeat lending activities of banks in foreign currency. Despite the modest growth, this was sufficient to support the positive bottom line of banks engaged in FCDU operations as net interest income accounted for 69.3 percent of total operating income and 88.1 percent of net profit of the FCDU system. Moreover, these were markedly higher than the respective shares of 49.7 percent and 59.8 percent same period in 2013.

Non-interest expenses declined by 17.6 percent year-on-year to US$172.9 million driven by the significant cost reductions in compensation and fringe benefits amounting to US$12.7 million (20.9 percent) and other administrative expenses totaling US$21.1 million (17.5 percent). Combined, these two accounts represented 85.2 percent of total non-interest expenses of banks with FCDU authority. Yet, this cost-cutting in overhead costs was insufficient to maintain overall cost-efficiency as annualized cost-to-income (CTI) ratio rose to 17.1 percent from 15.2 percent same period in 2013.

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Other profitability indicators exhibited marginal softening as annualized return on assets (ROA) eased to 2.0 percent from 2.1 percent. Despite the marginal softening, the ROA ratio of banks with FCDU authority hovered around 2.0 percent in the last five years. The same behavior is noted for the net interest margin (NIM) of the FCDU system, which tracked around 2.0 percent in the last five years.

**FCDU assets expanded on brisk lending activities**

Total resources of the FCDU system reached US$37,475.6 million and accounted for 15.9 percent of total system-wide assets. This is slightly smaller than last year’s 17.0 percent resulting from the contraction of FCDUs of thrift banks (TBs) by 5.7 percent year-on-year. Nonetheless, total FCDU assets expanded by 11.8 percent year-on-year (Figure 37) Majority of banks also with FCDU authority complied with the 100 percent asset cover for their foreign exchange exposures as required by law and BSP regulations.

By banking group, universal and commercial banks (UKBs) held the largest FCDU share at 17.2 percent, followed by TBs at 5.7 percent while RCBs had negligible shares.

By asset mix, financial assets, net, consistently accounted for the bulk of FCDU assets. These accounted for the 45.3 percent (smaller from year ago’s 50.9 percent) of the total FCDU assets, followed by loans at 39.0 percent (higher than year ago’s 35.7 percent), cash and due from banks at 13.0 percent (larger than year ago’s 10.3 percent) and other assets...
at 2.7 percent (lower than year ago’s 3.1 percent). The preference towards investment activities of banks engaged in FCDU operations made the FCDU system highly susceptible to market risks such as foreign exchange risk and interest rate risk as well as inflation risk.

**Banks with FCDU authority had tempered trading activities**

Year-on-year, portfolio investments or financial assets other than loans continued to hold the lion’s share of FCDU assets at 45.3 percent, albeit lower than year ago’s 50.9 percent (Figure 38). Total portfolio investments of the FCDU system stood at US$17.0 million and 0.4 percent lower than year ago’s level due to the 16.4 percent or US$1,956.3 million contraction in available-for-sale (AFS) financial assets to US$9,973.2 million. The contraction was attributed to marking-to-market (MTM) losses incurred as a result of recent uptick in domestic interest rates as shown in rising Philippine yield curve (Figure 36) during the first half of 2014. AFS financial assets accounted for 58.8 percent of total portfolio investments of banks engaged in FCDU operations from 70.6 percent a year ago. Moreover, the contraction in the overall level of AFS holdings have implications in the overall liquidity position of banks with FCDU authority since these financial assets accounted for 45.6 percent of the System’s liquid assets (down from 58.1 percent a year ago).

Further drill down of FCDU system’s portfolio investment indicated that the bulk of these portfolio investments at 74.1 percent were investments in debt securities issued by the Philippine Government. Government-issued debt securities stood at US$8,238.6 million and 9.4 percent or US$850.5 million lower than year ago’s level of US$9,089.1 million. Foreign currency denominated sovereign debt securities or ROPs, which contracted by 10.6 percent year-on-year or US$822.3 million, still cornered the largest share of FCDU system’s holdings of government-issued debt securities at 84.3 percent to US$6,946.3 million even if lower compared to year ago’s share of 85.5 percent to US$7,768.6 million.

Meanwhile, banks engaged in FCDU operations showed increasing preference in investing in debt securities issued by non-residents as portfolio investments in non-resident issues grew by 4.0 percent or US$229.2 million year-on-year. At US$5,944.4 million, the FCDU share of portfolio investment in non-resident issues rose to 34.8 percent from 32.7 percent a year ago. While still small and manageable, these exposures make banks with FCDU authority more susceptible to cross-country and foreign exchange risks, which may warrant careful monitoring from bank supervisors.

**Largest FCDU loan recipients were manufacturing, utilities and financial intermediation sector**

Foreign currency denominated credit expanded by 22.7 percent year-on-year to US$11,655.9 million on improved macroeconomic environment. FCDU loans accounted for 39.0 percent of the total resources of the FCDU system. It also represented 11.2 percent of the total loan portfolio of the banking system and 4.3 percent of the country’s gross domestic product (GDP). These broadly indicate that the foreign exchange exposure of banks remained manageable despite the strong growth recorded during the review period.

By economic industry, manufacturing (24.4 percent), electricity, gas and water (16.9 percent), financial and insurance activities/financial intermediation (7.7 percent), transport, storage and communication (5.0 percent), and real estate activities (4.9 percent) continued to be the major FCDU loans beneficiaries.

By type of counterparty (borrower), most of FCDU loans went to public utilities with a share of 20.8 percent or US$2,372.4 million, producers/manufacturers at 16.1 percent or US$1,834.9 million and merchandize exporters at 10.2 percent or US$1,160.1 million.

As to maturity, all of FCDU loans were long-term (more than five years) loan transactions and an improvement from year ago’s share of 40.8 percent.

In terms of asset quality, the non-performing loan and non-performing asset (NPL/NPA) ratios of the FCDU system remained at less than 0.3 percent.

**The FCDU system maintains a stable liquid position**

Deposit liabilities still funded the majority of total resources at 79.7 percent (higher than year ago’s
76.5 percent), followed by bills payable at 9.2 percent (lower than year ago’s 10.3 percent), bonds payable, net at 3.8 percent (down from 4.2 percent), due to banks at 4.6 percent (lower than year ago’s 6.4 percent), capital accounts at 1.6 percent (higher than year ago’s 1.3 percent) and other liabilities at 1.1 percent (lower than year ago’s 1.3 percent). FCDU deposit liabilities stood at US$29,850.2 million and 16.5 percent higher than year ago’s level of US$25,629.3 million. These deposit liabilities accounted for 79.7 percent of total assets and more than twice the amount of its total loan portfolio. The current dollarization ratio, measured by FCDU deposits against M2, stood at 19.1 percent. The dollarization of FCDU deposit liabilities enhances savings in the economy through the mediating effect on inflation and contributory factor in financial deepening.

Resident depositors accounted for the 97.0 percent share of total deposit liabilities while the remaining 3.0 percent share was sourced from non-resident depositors. These broadly indicate that FCDU funding is relatively stable and domestically-oriented.

Apart from the affordability of the US dollar as a commodity currency due to exchange rate movements in the market, the increase in demand for bank accounts denominated in foreign currency may be attributed to the growth of foreign currency deposits with inflation.

Intra-system liquidity transactions, measured by movements in interbank loans as well as loans and receivables arising from repurchase agreements, certificate of assignment, participation with recourse and securities lending and borrowing, grew by 35.5 percent (P916.2 billion) year-on-year to P3,494.5 billion. Most of these liquidity-induced intra-system transactions were interbank loans at 84.2 percent, which also grew year-on-year by 19.3 percent (P475.7 billion) to P2,942.5 billion.

Liquid assets-to-deposits ratio (inclusive of ROPs) narrowed at 73.3 percent from 80.1 percent last year. Meanwhile, liquid assets-to-deposits (exclusive of ROPs) slightly widened at 50.0 percent from 49.7 percent last year. Loans-to-deposits ratio increased to 49.4 percent from year ago’s 47.2 percent. Overall, the 30 percent liquidity coverage requirement was well met by majority of banks with FCDU authority including their 100 percent asset cover.

In the last five years, the country’s inflation rate is high by ASEAN-5 standards.
