PASCN
Philippine APEC Study Center Network

PASCN Discussion Paper No. 2000-11

Analysis of the State of Competition and Market Structure of the Banking and Insurance Sectors

Ma. Melanie R.S. Milo

The *PASCN Discussion Paper Series* constitutes studies that are preliminary and subject to further revisions and review. They are being circulated in a limited number of copies only for purposes of soliciting comments and suggestions for further refinements.

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Ma. Melanie R.S. Milo
Philippine Institute for Development Studies

January 2002

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Table of Contents

Pag

Table of Contents i

List of Figures ii

List of Tables ii

I. Introduction

II. Regulatory Framework 2
- A. Policies toward an efficient financial system: widening the scope for competition 2
- B. Current regulations and restrictions 4

III. Trends in Market Structure and Performance 19
- A. Banking sector 19
- B. Insurance sector 27

IV. Competition Policy Issues in the Financial Sector 30
- A. Banking sector 30
- B. Insurance sector 34
- C. Regulatory framework 3

V. Some Conclusions 3

References 40

List of Figures

Number		Page
1	Assets of the Philippine financial system by type of institution, 1970-1999 (in billion pesos)	20
2	Distribution of commercial bank assets by type of bank, 1980-2000Q1	2
3	Measures of commercial bank asset concentration, 1980-2000Q1	24
4	Measures of asset concentration in the insurance industry, 1970-1998	29

List of Tables

Number		Page
1	Authorized activities according to type of bank	
2	Limits on equity investments of commercial and universal banks	10
3	Minimum capital requirements for new and existing insurance companies	1
4	Number of financial institut ions, 1980-June 1999	2
5	Number of commercial banks by type of bank, 1980-2000Q1	2
6	Mergers and acquisitions in the commercial banking sector, 1998-2000	2
7	Ownership structure of private domestic banks: percentage share to total subscribed capital, 1997/98	2
8	Commercial banks' average spread and rates of return (in percent)	2
9	Share of the insurance sector in total financial and NBFIs assets, 1980-1998 (in percent)	27
10	Distribution of total assets of the insurance sector, 1980-1998	2
11	Number of insurance companies by type of insurer, 1980-1998	29

Analysis of the State of Competition and Market Structure of the Banking and Insurance Sectors [1]

Melanie S. Milo, Ph.D. [2]

I. Introduction

A successful financial market is characterized as being simultaneously sound and competitive. On the one hand, a competitive but unsound financial system is unsustainable because its lack of soundness will ultimately cause the system to break down. On the other hand, a sound but uncompetitive financial system will increase inefficiency in both the financial system and the entire economy. Both cases will have deleterious effects on the economy's growth potential and society's welfare. The major issue confronting financial regulation then is how to balance the need for both soundness and competitiveness. In most markets, simply removing state imposed regulations would improve competition. But in financial markets, some form of regulation is necessary to protect the reputation and soundness of the financial system, as well as the competitive process (Grimes 1999).

The regulation of the Philippine financial services sector, particularly the banking sector, has undergone considerable change in the last two decades. On the one hand, there has been the removal of certain regulations such as direct controls on interest rates, as well as a substantial relaxation in other regulations such as restrictions on entry, lines of business, and portfolios. The overall objective of such deregulatory reforms was to promote c ompetitive conditions to foster greater efficiency in the financial sector. On the other hand, there has also been a strengthening of prudential regulation, which was justified as necessary to protect depositors and to preserve the stability of the payments system. The design, implementation and enforcement of regulatory rules have expectedly affected the structure and nature of the Philippine financial services sector, especially since they continue to impose important constraints on the ownership and business powers of financial institutions. This, in turn, has important implications for the competitive process in the financial services sector and ultimately the type, quality and price of the products offered to consumers and business users. This chapter l ooks at how competition and efficiency in the financial services sector, particularly the banking and insurance industries, have been affected by the regulatory regime and market structure.

The regulatory framework itself is an important determinant of the structure of the financial system. The following section gives an overview of public policy towards the financial system, with particular focus on the role played by competition policy as an instrument for improving the efficiency and functioning of the financial system beginning in the 1980s. The section then shows the interaction between regulation and competition through a description of what is regulated and what is left to the market. In particular, it describes the current principal statutory regulations that affect the banking and insurance industries. Because the application of competition policy is significantly more advanced in the commercial banking sector, it can give important lessons and insights on how to develop competition policy for the other sectors of the financial system, as well as an overall competition policy for the Philippines. The insurance sector is important because of the potential role that it can play in the development of the Philippine capital markets.

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[1] This study was conducted under the auspices of the Philippine APEC Study Center Network (PASCN), as part of the Research Project entitled "Towards A National Competition Policy for the Philippines".
[2] Research Fellow, Philippine Institute for Development Studies. The usual caveat applies.

It is useful to monitor the evolution of deregulatory policies in order to identify areas that inhibit the working of market forces in financial markets. However, monitoring steps already taken in relation to remaining regulations does not give a clear/full picture of the extent to which playing fields are being leveled in practice. Thus, policy changes need to be considered in parallel with changes in the competitive structure of the financial sector. This is the focus of Section III. In particular, structural change in the banking and insurance sectors is monitored through the use of various indicators of changes in competitive structures and gains in competitive efficiency implicit in financial market performance.

While the application of competition policy in the banking sector has been fairly extensive and intensive, it is not yet complete and some competition policy issues remain. In contrast, reform of the private insurance industry occurred only in the mid-1990s and regulation remains highly restrictive. Thus, there are also continuing competition policy issues in the insurance sector that need to be addressed to further enhance competitiveness and efficiency in the sector. Finally, an efficient financial system also requires an efficient regulatory structure. Two aspects that need to be considered are the appropriate regulatory framework for the financial sector as a whole, and the application of a national competition policy framework to the financial sector. These competition policy issues are the focus of Section IV. Some conclusions and policy implications are then presented in Section V.

II. Regulatory Framework

A. Policies toward an efficient financial system: widening the scope for competition

Following more than 30 years of repressionist financial policies from the time the Central Bank of the Philippines (CBP) began operations in 1949, the Philippines formally embarked on a financial liberalization program in the early 1980s as part of an overall structural adjustment program[3]. It included the gradual liberalization of interest rates from 1981-83; the easing of restrictions on the range of operations financial institutions were allowed to conduct in the domestic markets, including the introduction of universal banking in 1980; and rationalization of financial market regulations, including higher capital requirements for banks and nonbank quasi-banks (NBQBs) (Remolona and Lamberte 1986).

But soon after the start of financial liberalization, the financial system underwent a crisis of confidence, which was triggered by the defaults of a prominent businessman who fled the country in 1981, and compounded by a series of investment frauds and stockbroker failures (Laya 1982). The financial crisis deepened as a result of the political and economic crises in 1983-85, which led to significant financial shallowing (World Bank 1986). An important lesson that emerged from the experience, which also proved true in other developing countries that undertook financial liberalization, was that there were prerequisites to a successful financial liberalization. The two most commonly cited factors were macroeconomic stability and adequate prudential regulation/supervision (Cho and Khatkhate 1989). As a result, subsequent financial reforms in the Philippines began to incorporate the imposition and/or tightening of regulations for prudential reasons, simultaneously with deregulatory reforms.

[3] In its original sense, financial liberalization refers to the substantial reduction of government intervention in setting interest rates and allocating credit. In the subsequent discussions, financial liberalization, financial deregulation and financial reform are used interchangeably to refer to all measures that are designed to encourage and to provide more scope for the working of market forces and competition in the financial sector. For a fuller discussion of the evolution of financial policy in the Philippines from the 1950s to the 1990s, see Milo (2000).

Financial reforms were resumed in 1986, which specifically addressed problems endemic to the system since the 1960s, and further highlighted by the earlier reform effort and financial crisis. These included the inter-linked problems of fraud or insider abuse by bank owners or officers and inadequate/ineffective prudential supervision and regulation of banks. Thus, policy reforms effecting prudential bank management included increased minimum capitalization requirements; compliance with minimum risk asset ratios; single borrower's limit; limit on loans to directors, officers, stockholders and related interests (DOSRI); limits on allowable interlocking directorships and officerships; provisions for loan loss or doubtful accounts; audit and reporting requirements; and stricter bail-out policy of problematic banks (Bautista 1992). The government also rehabilitated ailing financial institutions, notably the government-owned banks and rural banks. However, the problem was not just the lack of prudential rules, but a weakened CBP– both financially and politically, as well. And a strong central bank, which effectively carries out its role of supervising financial institutions, is a prerequisite for a stable financial system (World Bank 1988). Thus, the CBP was likewise rehabilitated in 1993, with the creation of a new, independent Central Monetary Authority called the *Bangko Sentral ng Pilipinas* (BSP).

Other banking reforms implemented in the 1990s included the deregulation of entry of new domestic banks and of domestic bank branching in 1993, which were further rationalized in 1995, and the easing of restriction on the entry of foreign banks in 1994. The government also moved to reduce its direct participation in the banking system by privatizing five of the six banks that it took over during the crises in the 1980s. The Philippine National Bank (PNB) also passed into majority private ownership in 1995.

Deregulation of entry was an especially important reform because it was a necessary complement to the removal of interest rate ceilings. As noted by Blundell-Wignall and Ishida (1990), the impact of removing interest rate ceilings is dependent on the degree of competitive pressure. Competition for deposits may not improve if there is no serious threat of entry into the banking system, or if other regulations, such as those concerning branching, become binding constraints. Particularly noteworthy was the continued fixity of the interest rate on savings deposits after interest rates liberalized, which had been attributed to some monopoly power of the large commercial banks (Tan 1989). Thus, a review of the Philippine financial sector following the reforms in the 1980s still identified the lack of competitive behavior among banks as an important feature needing reform (World Bank 1988).

There was also an effort to expand the coverage of financial sector reforms in the second half of the 1990s. It was recognized that the predominance of bank loans in corporate financing was one of the factors that complicated the Philippines' financial liberalization program in the early 1980s. The East Asian crisis also highlighted the dangers of a bank-dominated financial system. Thus, there was a need to improve the competitiveness of other financial institutions to provide savers and borrowers with alternatives to banks. It was also recognized that the country's sustained growth performance would require substantial mobilization of domestic resources from nonbanking sources. A more robust capital market that can mobilize and allocate long term resources efficiently would contribute greatly to this (World Bank 1992).

Reforms in the other sectors of the Philippine financial system included the liberalization of entry into the private insurance industry in 1996, and efforts to develop the equity markets such as the unification of the Manila and Makati Stock Exchanges to form the Philippine Stock Exchange in 1994. In particular, the liberalization of foreign investments and foreign exchange transactions in the 1990s had a significant impact on the development of the capital markets (Lamberte 1995). RA 8366, or the Investment Houses Law was enacted in October 1997, which increased the maximum foreign equity participation in investment houses from 40 to 60 percent

and raised the minimum capital requirement. The Financing Act of 1998 (RA 8556) also raised the maximum foreign equity participation in financing companies to 60 percent and the minimum capital requirement. And adjustments in the right direction were being made. Unfortunately, the 1997 Asian financial crisis disrupted the process of reform and adjustment. The 1997 Asian financial crisis again emphasized the importance of an efficient and well-developed financial system, and adequate prudential regulation and supervision of financial intermediaries, in the context of increasing deregulation and globalization of capital markets. Two important bills that were passed in the aftermath of the Asian crisis were the General Banking Act of 2000 (RA 8791), and the Securities Regulation Code (RA 8979) which was enacted two months after in July 2000. Both aimed to address some weaknesses, particularly in the regulatory frameworks governing banks and the securities market.

The rationale behind the various financial sector reforms that have been implemented in the Philippines was precisely to improve the workings of the financial system. In particular, a move away from interventionist and repressionist policies towards freeing up the system from various restrictions was seen as growth promoting. Policies to reform the financial sector evolved gradually over time, with reforms building on earlier reforms. However, the reform process was far from smooth and was fraught with difficulties. But despite some frictions in its operation, a deregulated (albeit also properly supervised) financial sector is still superior to a publicly managed one. For instance, the relative resilience of the Philippines to the ill effects of the Asian crisis was partly attributed to the financial sector reforms that had already been implemented, particularly the consecutive increases in the minimum capital requirements of banks and tighter prudential regulation. Financial liberalization is a process and not a one-off episode, and it necessarily takes time for governments to implement reforms and for institutions to adjust to these reforms. The key is to deepen the reforms in order for the expected benefits of financial liberalization to be fully realized, even as the government works to promote macroeconomic stability.

B. Current regulations and restriction

The previous section briefly discussed public policy towards the Philippine financial system, particularly the role of competition policy in enhancing the efficiency and functioning of financial institutions and markets. It included a wide range of domestic deregulation as well as external liberalization measures, such as the abolition of interest rate and other price controls, and easing of restrictions on the range of operations that financial institutions are allowed to conduct in the domestic and international markets, new entry restrictions and other obstacles to the functioning of financial markets. The overall disposition of authorities towards the development of markets and intensifying competition also forms part of such policies (Broker 1989).

Thus, most of the current regulations in the Philippine banking sector are justified for prudential reasons, that is, to protect the stability and soundness of the financial system. While it is recognized that prudential regulations can be anti-competitive, some limited level of prudential regulation can also promote competitive forces (Grimes 1999). The 1990s experience again emphasized the importance of adequate prudential regulation and supervision of financial intermediaries, especially given the increasingly global nature of capital markets. Current banking regulation also aims to address longstanding weaknesses in the sector, particularly the presence of many small banks, and concentration of ownership and the related issue of insider abuse. The following subsections review the current principal statutory regulations in the

banking and insurance sectors. In particular, they highlight the interaction between regulation and competition by describing what areas/activities are regulated and what are left to the market.

Banking sector. The primary governing law for the commercial banking sector used to be Republic Act No. 337 or the General Banking Act of 1948, as amended. A recent amendment to this Act was Republic Act No. 7721, which partially liberalized the entry and scope of operations of foreign banks in the Philippines and was enacted in 1994. It was only in May 2000 that a new general banking law, Republic Act No. 8791 or the General Banking Law of 2000, was enacted. The new general banking law was deemed necessary and overdue given the significant changes both in the domestic and international environments. Its goal was to "promote and maintain a stable and efficient banking and financial system that is globally competitive, dynamic and responsive to the demands of a developing economy" (Sec. 2). An important element of this Act was the adoption and incorporation of internationally accepted standards and practices into the BSP's supervisory processes. In addition, Republic Act No. 7653 or the New Central Bank Act of 1993 defined the BSP's general functions, operations and powers relating to the banking sector and other financial institutions. Finally, there are also specific legislations that govern the lending activities of banks.

The major regulations and restrictions currently in operation in the commercial banking sector are as follows[4]:

1. Restrictions on branching and new entry (including the entry of foreign banks)[5]

   Restrictions on branching and entry of new domestic and foreign banks were significantly eased only from 1993-95. New domestic banks, satisfying the laws of incorporation as approved by the Monetary Board, could be established as long as they met minimum capital and other prudential requirements. Geographical restrictions on domestic bank branching were lifted in 1993, and branches could be established anywhere subject to certain prudential requirements, such as those on capital adequacy, liquidity, profitability and soundness of management (Paderanga 1996). However, licensing of domestic bank branches still needed the prior approval of the Monetary Board, which continued to retain discretionary powers (Lamberte and Llanto 1993).

   Republic Act No. 7721, which was enacted in May 1994, partially liberalized the entry and scope of operations of foreign banks in the Philippines. In particular, foreign banks were authorized to operate in the Philippines through (only) one of the following modes of entry: (i) acquire, purchase or own up to 60 percent of an existing domestic bank; (ii) invest in up to 60 percent of the voting stock of a new banking subsidiary incorporated in the Philippines; or (iii) establish a branch with full banking authority. The third mode of entry was operative for only 5 years from the date of effectivity of the Act, and was limited to only 10 foreign banks. Each of the 10 foreign banks was entitled to six branches – 3 in locations of its choice, and 3 in locations to be designated by the Monetary Board. The four foreign banks operating through branches in the Philippines upon the effectivity of the Act were also accorded the same branching privilege.

   To qualify to establish a branch or a subsidiary, a foreign bank applicant had to be among the top 150 banks in the world or the top five banks in its country of origin. Furthermore, it had to be widely owned and publicly listed in its country of origin, or the government of its country of origin must own more than 50 percent of its capital stock. At least fifty

[4] This section also draws on the BSP's Manual of Regulations for Banks (1996) and more recent Circulars and Resolutions.
[5] For a fuller discussion of bank entry and branching regulations and their impact on competition, see Milo (2001).

stockholders, none of whom owns more than 15 percent of the capital stock, are required for a foreign bank to be considered as widely-owned.

However, in August 1999, the BSP again declared an indefinite moratorium on the establishment of new domestic banks, and the branch expansion of existing banks but excluding microfinance-oriented banks[6]. The foreign banks were exempted from the moratorium on local branch expansion, although the limit of six new branches remained. This policy, together with mandated consecutive increases in minimum capital requirements of banks, reflected the BSP's preference for and strategy of forcing more mergers and acquisitions to reduce the number and increase the average size of banks in the Philippines. Consolidation is in turn expected to result in a stronger and more stable banking system. Thus, prospective investors were encouraged to acquire existing banks instead of applying for new operating licenses, while banks wishing to expand could do so by taking over smaller banks. The current BSP Governor had expressed concern over the large number of banks in the Philippines, and noted that a few strong banks would be good for the industry, the economy, and eventually the consumers. He put forward a five-year scenario wherein 4 to 6 local banks, together with the 14 existing foreign banks, would dominate 80 percent of the industry's resources. The remaining smaller banks, on the other hand, could either develop into niche players or be weeded out of the system.

In accordance with RA 7721, the Philippines last granted licenses to 10 new foreign banks in 1995, which brought the total number of foreign banks branches in the country to 14. Since then, there have been no new licenses given to foreign banks[7]. There have also been 7 new locally incorporated foreign bank subsidiaries. With the reimposed moratorium on the entry of new banks, the only alternative for foreign banks to enter the domestic industry is to buy into existing domestic banks. Again, this fitted in with the BSP's push for more mergers and acquisitions in the banking system. The BSP has designated a critical role for foreign banks in its effort to consolidate the banking sector, that is, foreign buy-ins were especially encouraged. More consolidation and more openness to foreign banks were seen as positive factors for the Philippine banking system. In particular, a strong foreign banking presence– with credibility and capital – would result in improved efficiency and help to stabilize the system during times of stress.

While the drafters of RA 7721, as well as the BSP, recognized the role of foreign banks in creating a more competitive environment, the intention was not for them to dominate the local banks. RA 7721 also expressly stated that, "In allowing increased foreign participation in the financial system, it shall be the policy of the State that the financial system remain effectively controlled by Filipinos" (Sec. 1 para. 3). In fact, the Act required that control of at least 70 percent of the resources or assets of the entire banking system be held by domestic banks that are majority owned by Filipinos. In that sense, RA 7721 was even more restrictive than RA 337, which did not contain such a provision although it also intended to keep foreign participation in the domestic banking sector to a minority. Both past and incumbent BSP Governors, while amenable to the idea of another round of banking sector liberalization, also made the point that it should be legislated such that some "macroeconomic" protection would be retained for the local banks, such as imposing a time period for allowing 100 percent foreign ownership of existing domestic banks.

RA 8791, or the General Banking Law of 2000, formalized the moratorium on new bank entry by stipulating that "no new commercial bank shall be established within three years from the effectivity of this Act" (Sec. 8.3). It also tightened the licensing requirement by

[6] Monetary Board Resolution No. 1224 dated 27 August 1999.

[7] Bank of China was granted a license in 2000, replacing Development Bank of Singapore which surrendered its license to buy 60 percent of Philippine-based Bank of Southeast Asia in 1998.

including an assessment of the bank's ownership structure, directors and senior management in the licensing process (Sec. 8.3).

RA 8791 also expanded the coverage of RA 7721 by allowing a foreign bank to acquire up to 100 percent of the voting stock of (only) one bank, but only within seven years from the effectivity of RA 8791. This included foreign banks that had acquired 60 percent of the voting stock of a bank under RA 7721. Furthermore, RA 8791 contained the same provision as RA 7721, requiring the Monetary Board to ensure that banks which are majority owned by Filipinos control 70 percent of the resources or assets of the entire banking system. The rationale for this restriction is not explicitly stated in both Acts. Even if it is imposed for nationalistic reasons, its merit in the context of competition and efficiency needs to be established. It is not clear whether and how such a restriction addresses the primary concerns of efficiency and soundness of the banking sector.

Overall, government barriers to entry are typically imposed to limit and reduce the number, as well as increase the average size of banks in the Philippines. Bigger and fewer banks, in turn, were seen to promote the safety and soundness of the financial system. But it is also recognized that their removal would enhance market contestability and the competitive process. A balance needs to be struck between the potential costs and potential benefits of allowing greater competition. In particular, the potential adverse effects of enhancing competition through a lowering of barriers to entry can be addressed by properly applying prudential regulations and restrictions such as those currently in place, especially the fitness and properness criteria for bank owners and managers. The focus should not just be the size of banks per se, but whether they are sound, competitive and efficient.

2. Restrictions on pricing (interest rate controls and other controls on prices or fees)

   There are currently no statutory or regulatory controls that affect the behavior of banks in this area. Interest rates on all deposits and loans had been liberalized since 1983, and are now essentially market determined. The rediscount rate was also realigned to reflect prevailing market rates. The BSP influences interest rates through indirect mechanisms, such as its overnight rates. However, as a result of the Asian financial crisis, the BSP entered into an informal arrangement or "gentleman's agreement" with the Bankers Association of the Philippines (BAP) to bring down interest rates to support the government's efforts to stimulate investments and growth: banks agreed to keep lending rates 1.5-6 percentage points above the 91 day Treasury bill rate which the BSP supported, for instance by reducing reserve requirements in order to help bring down banks' intermediation costs, although the BSP was also prepared to impose sanctions on banks that violated the spread. This course of action clearly went beyond moral suasion and represented direct intervention in normal market mechanisms. Instead, the BSP should seek to develop other instruments and build up its technical capacity to maintain monetary control in an increasingly sophisticated financial world, as well as to induce the domestic financial system to intermediate more efficiently.

   RA 8791 also contained a general provision that allows the Monetary Board to prescribe the terms and conditions for various types of bank loans and other credit accommodations, "taking into account the requirements of the economy for the effective utilization of long-term funds" (Sec. 43). Thus, this aspect has once again become potentially subject to regulation.

3. Line-of-business restrictions and regulations on ownership linkages among financial institutions

   Table 1 presents the activities and functions that the different types of banks are authorized to undertake. Reforms in the early 1980s to reduce the enforced specialization of financial

institutions and broaden the range of their services significantly streamlined the different types and functions of banks. The result was a more flexible and dynamic institutional structure.

Table 1 **Authorized activities according to type of bank**

Activities	Universal banks	Commercial banks	Thrift banks	Rural banks
A. Commercial banking services				
1. Accept deposits	A	A	A	A
2. Issue LCs and accept drafts	A	A	A[1/]	C[2/]
3. Discounting of promissory notes and commercial papers	A	A	C	C
4. Foreign exchange transactions	A	A	A	P
5. Lend money against security	A	A	A	C
B. Equity investments in allied undertakings	A	A	C	C
C. Equity investments in non-allied undertakings	A	P	P	P
D. Trust operations	C	C	C	C
E. Issue real estate and chattel mortgage bonds, buy and sell these for its own account, accept/receive in payment or as amortization on loans	A	A	C	P
F. Activities of investment houses				
1. Securities underwriting	A	S	P	P
2. Syndication activities	A	A	C	C
3. Business development and project implementation	A	A	C	P
4. Financial consultancy and investment	A	A	C	P
5. Lease real and/or personal properties	A	S	P	P
G. Money market operations	A	A	C	C[3/]

Note: A - Authorized activites; C - Conditional/Authorized but subject to BSP approval; P - Prohibited; S - Through a subsidiary

[1/] Limited only to domestic Letters of Credit and drafts.

[2/] Limited to domestic drafts.

[3/] Limited to money market placements.

Source: Lamberte and Llanto (1993); Bangko Sentral ng Pilipinas.

Ownership ceilings are currently still in place, which were originally aimed to widen the ownership base of commercial banks, in particular, and hence mitigate the problem of insider abuse. Compared to RA 337 as amended, however, the ceilings set by RA 8791 are less restrictive but with stricter disclosure requirements. Previously, under the old General Banking Act, a Filipino individual and/or family group (individuals related up to the 3rd degree of consanguinity or affinity) could not own more than 20 percent of a domestic bank, while the ceiling for domestic corporations (not wholly or majority owned by an individual or family group) was set at 30 percent. RA 7721 then accorded Philippine corporations, banks and nonbanks that are listed in the stock exchange, or are of good standing for at least ten years, the same right as foreign banks to own up to 60 percent of the voting stock of a domestic bank, although they could do so for only one domestic bank in both cases. With respect to foreign equity held by an individual; a nonfinancial entity; or a nonbank financial

entity not owned or controlled by the bank, its subsidiary or holding company, the ceiling on total foreign equity participation in a domestic bank was 30 percent. This was upgradeable to 40 percent subject to the President's approval.

Under the new General Banking Law, the ownership ceilings were simplified and unified. Filipinos and domestic nonbank corporations are now subject to the same rule as foreign individuals and nonbank corporations, that is, they may own or control up to forty percent of the voting stock of a domestic bank. RA 8791 explicitly defines family groups and related interests, whose stockholdings must be fully disclosed in all their transactions with the bank. Individuals related to each other within the fourth degree of consanguinity or affinity, legitimate or common law, are considered as a family group or related interests, while two or more corporations owned or controlled by the same family group or same group of persons are considered as related interests. The citizenship of a corporation is now determined based on the citizenship of the controlling stockholders of the corporation, irrespective of the place of incorporation (Secs. 11-13). The simplified, more uniform, and even higher ownership ceilings make for easier monitoring because of greater transparency, especially since it is very difficult to uncover indirect ownership through individuals or companies where no visible connection is evident. On the other hand, tighter disclosure requirements shift the burden of regulation to the banks themselves.

Recent developments, particularly Lucio Tan's announcement that he had gained ownership or control of 46 percent of PNB through direct ownership and proxies, which was more than double the ceiling at that time, validate the necessity of tightening disclosure requirements for family and corporation ownership of bank shares. One loophole that the BSP recently addressed was the disclosure of ownership of shares of stock lodged with the Philippine Central Depository (PCD), the country's s ecurities storehouse. Previously, such shares were just recorded as being held by a "PCD nominee", since the PCD was supposed to hold such accounts for brokers for only a few days. It was the brokers who knew the ownership details. The BSP now requires all bank corporate secretaries to disclose the ultimate beneficial owners of their respective banks' shares in their consolidated list of stockholders, which is reported quarterly.

There are also current restrictions on interlocking directorships and/or officerships within the Philippine financial system. Interlocking facilitates collusion and the lobbying process (Tan 1991). Thus, such restrictions were also deemed necessary to safeguard against the exercise of undue influence over the operation and management of similar financial institutions by the same person or group of persons, which could have an adverse effect on competition or result in conflicts of interest situations. However, there are no restrictions on interlocking directorates among banks and nonfinancial corporations. It is the latter that has implications on resource allocation (Tan 1991).

4. Restrictions on the portfolio of assets that banks can hold (such as requirements to hold certain types of securities or requirements not to hold other securities; including requirements not to hold the control of nonfinancial companies)

   Table 2 presents the ceilings on equity investments of universal and commercial banks under the new General Banking Law. Universal banks may invest in the equities of both allied and non-allied enterprises, while commercial banks are limited only to allied enterprises. Both are subject to the prior approval of the Monetary Board. Overall, the ceilings have been relaxed under the new law.

Table 2 **Limits on equity investments of commercial and universal banks**

Activities	Commercial banks	Universal banks
Allied enterprises		
Financial allied undertakings[1/]	100%	100%
Commercial/Universal banks	100% [2/]	100% [2/]
Thrift banks	100%	100%
Rural banks	100%	100%
Investment houses	100%	100%
Others (leasing, credit card venture companies, etc.)	40%	100%
Insurance companies	0	51%
Non-financial allied undertakings	100%	100%
Non-allied undertakings		
Agriculture	0	35%
Manufacturing	0	35%
Public Utilities	0	35%
Other ceilings		
Equity investment in any single enterprise	25% of net worth	25% of net worth
Max. amount of equity investments	35% of net worth	50% of net worth

Notes: [1/] To promote competitive conditions, the Monetary Board may further limit equity investments of universal and commercial banks in quasi-banks to 40 percent.

[2/] For publicly listed universal or commercial banks; limited to only one other universal or commercial bank. Otherwise, the equity investment of a commercial bank in other financial allied enterprises, including another commercial bank, is limited to a minority holding.

Source: Bangko Sentral ng Pilipinas.

Limits on loans, credit accommodations and guarantees continue to be imposed on banks for prudential reasons, such as to avoid the concentration of credit in favor of a few individuals or groups. In this area, RA 8791 is stricter and affords the Monetary Board greater authority to govern such loans. The single borrower limit stipulates that the total credit commitment of a bank to any person, partnership, association, corporation or other entity shall not exceed 20 percent of the bank's net worth. Previously, the limit was 25 percent. This could be increased by an additional 10 percent subject to certain conditions, such as the additional liabilities being adequately secured.

The limits on loans to directors, officers, stockholders and related interests (DOSRI) were also tightened to make insider abuse more difficult. In particular, RA 8791 requires loans to a director or officer of a bank to be approved by the majority of the directors of the bank, excluding the director concerned, and reported to the supervising and examining department of the BSP. The new general banking law's inclusion of two independent directors in a bank's board of directors, who are not officers or employees of the bank, its subsidiaries or affiliates, or related interests, was meant to further minimize the risks associated with DOSRI loans. The total outstanding credit accommodation should not exceed the unencumbered portion of a DOSRI's outstanding deposits plus the book value of his paid-in capital contribution in the lending bank. The definition of a DOSRI loan was also expanded to include investments of the bank in enterprises owned or controlled by the respective

DOSRI. DOSRI borrowers are also required to waive the secrecy of their deposits in all banks in the Philippines.

In addition, loans and other credit accommodations against real estate should not exceed 75 percent of the appraised value of the real estate security, plus 60 percent of the appraised value of the insured improvements. Previously, the ceiling was 60 percent. There is also an aggregate limit on real estate loans of commercial banks, which is 20 percent of their respective total loan portfolio. These two provisions were imposed in May 1997, just before the outbreak of the Asian financial crisis.

As noted earlier, the policy of despecialization by widening the range of permissible activities and products of financial institutions aimed to enhance competition and efficiency in the financial sector. Financial institutions were thus accorded greater flexibility in responding to new business opportunities under changing demand and supply conditions. However, the separation of some securities-related activities from commercial banking has also been justified based on perceived conflict of interest reasons and concerns relating to the concentration of power in the financial sector (Broker 1989). In fact Yap *et al* (1990) found that the interlocking of commercial banks with investment institutions increased the relative importance of some banks and made the money market less diversified. The restrictions on ownership, and interlocking directorships and officerships were meant to address these concerns. Furthermore, RA 8791 accorded the BSP authority to examine an enterprise that is wholly or majority owned or controlled by the bank (Sec. 7). The corresponding provision in RA 7653 is more defined and restrictive, in that it also allows the BSP to supervise and examine banks and quasi-banks' subsidiaries (i.e., corporations where a bank or quasi-bank owns more than fifty percent of the voting stock) and affiliates (i.e., corporations where a bank or quasi-bank owns fifty percent or less of the voting stock, or is related or linked through common stockholders or other such factors as may be determined by the Monetary Board) engaged in allied activities (Sec. 25). These restrictions and provisions, together with the limits on loans and credit accommodations, are intended to mitigate insider abuse, which is still the primary cause of bank failure in the Philippines.

This issue is particularly relevant with the failure of Urban Bank, which was attributed to problems in its investment house subsidiary, Urbancorp Investments, Inc. Urban Bank was one of the smallest commercial banks before it was downgraded to a thrift bank last March 2000 because it was unable to meet the new capitalization requirement. Urbancorp operated as an investment house without quasi-banking functions and engaged in trust operations. The latter, which had significant real estate exposure, suffered liquidity problems when its investors preterminated their holdings due partly to the failure of another investment house. Urban Bank, in turn, suffered heavy withdrawals due both to the pretermination of placements by its subsidiary's investors, and loss of public confidence following its downgrade. The simultaneous weakening of these two financial institutions was clearly interlinked. They are both currently under receivership. Failure to detect problems in Urbancorp has been attributed to some lapse in supervision/regulatory oversight, which in turn arose from confusion in the proper assignment of regulatory function over investment houses between the BSP and the Securities and Exchange Commission (SEC). RA 7653 also provided for the transfer of regulatory powers over finance companies without quasi-banking functions and other institutions performing similar functions from the BSP to the SEC, within five years from the effectivity of the Act (Sec. 130). However, the implementing rules and guidelines had not yet been drawn up at the time.

Abuses of conflicts of interest situations have significant implications on efficiency, investor protection, financial safety nets and stability of the financial system. But given the competition and efficiency gains associated with despecialization, reverting to an

institutional separation of functions in the financial sector is also not the solution. Thus, the emphasis is once again on prudential regulation. Some tightening in the trust operations of banks may be warranted, but ultimately the issue is notjust the lack of some detailed code of conduct but the proper implementation of existing regulations.

Also in this context, the provision in RA 8791 which states that "a bank may, subject to prior approval of the Monetary Board, use any or all of its branches as outlets for the presentation and/or sale of the financial products of its allied undertakings or of its investment house units" (Sec. 20) needs to be carefully evaluated and prudently applied because it could lead to conflicts of interest situations and unduly expand the coverage of the financial safety net.

5. Compulsory deposit insurance

The deposit liabilities of any bank or banking institution must be insured with the Philippine Deposit Insurance Corporation (PDIC). The PDIC offers partial coverage, with insured deposits equivalent to the net amount due to any depositor for deposits in an insured bank (after deducting offsets) but not to exceed P100,000. The assessment rate is a flat rate and not related to the risk of a bank, that is, the same rate applies to all banks and banking categories. It also has a ceiling of 1/5 of 1 percent per annum, and currently stands at 1/2 of 1/5 of 1 percent. A bank's semi-annual assessment is equal to the amount of the rate times the assessment base or the total deposit liabilities of the bank, but shall not be less than P250. The semi-annual assessment base is defined as the average of total deposits at the close of each quarter. Overall, the current level of deposit insurance does not seem excessive. But the more relevant issue may be implicit insurance, particularly the BSP's explicit policy of not allowing big banks to fail.

The PDIC is also seeking amendments to its charter, which include higher deposit insurance coverage and more powers to improve its regulatory functions (e.g., improved access to BSP records; authority to assume receivership of a bank that has declared a bank holiday).

6. Restrictions on capital adequacy

The minimum capital requirement is differentiated according to the type of bank, and increases significantly the more functions or activities a bank was allowed to undertake. Over time, minimum capital requirements have been progressively increased because authorities believed that bigger banks would lead to a more stable banking system. For expanded commercial banks or universal banks, the increase was from 500 million pesos in 1980 to 1 billion pesos in 1990, 2.5 billion pesos in 1995, and 4.95 billion pesos in 1999. For commercial banks, the corresponding amounts are 100 million pesos, 500 million pesos, 1.25 billion pesos, and 2.4 billion pesos, respectively. Still, Philippine banks are fairly small compared to those in the region. Increases in banks' minimum capital requirements have typically been used as a barrier to entry. Also, mergers and acquisitions are especially preferred as a means of meeting higher capitalization requirements to reduce the number and increase the size of banks in the Philippines. Thus, the BSP grants various incentives for bank consolidations, including temporary exemptions from some restrictions.

The final stage of the mandatory capital build-up program was supposed to raise minimum capital requirements by the end of 2000 to 5.4 billion pesos and 2.8 billion pesos for universal and commercial banks, respectively. The BSP decided to cancel this final stage in line with its adoption of the Basle risk-based capital adequacy standard, which is one of the major provisions of the new General Banking Law. The decision to shift to this new framework for measuring capital adequacy was actually made by the Monetary Board in

June 1993[8], but its implementation was subject to the amendment of the old General Banking Act. The BSP is also set to allow Tier 2 capitalization. Under this scheme, banks can issue convertible notes with a given yield for a prescribed time period. Investors will then have the option to convert the Tier 2 notes into bank equity, although they have no voting rights and their shares are subordinate to common shares.

7. Reserve requirements

Reserve requirements are imposed on all peso deposit liabilities, deposit substitutes and common trust funds of banks and nonbank quasi-banks. They take two forms – regular reserve requirements and liquidity reserves. Of the former, at least 25 percent but not to exceed 40 percent must be held as deposits at the BSP, and the balance in the form of cash in vault and government securities. Deposits maintained with the BSP are paid an interest rate of 4 percent per annum based on the average daily balance and are credited quarterly, while eligible government securities must bear an interest rate of not more than 4 percent per annum, be non-negotiable and carry BSP support. On top of the regular reserve requirements, liquidity reserves, which may be maintained in the form of short term, market yielding government securities, were imposed beginning in May 1995 accompanied by reductions in the regular reserve requirements to allow banks to earn higher remuneration on their required reserves. Regular reserve requirements for commercial banks currently range from 7-9 percent, while liquidity reserves are set at 3 percent for all peso deposits and deposit substitutes and 6 percent for common trust funds. The current reserve requirements are significantly lower compared to previous levels. This, together with higher interest rates paid on reserves, served to reduce banks' cost of intermediation, which in turn should have a positive impact on the level of intermediation activity.

Foreign exchange deposit liabilities of commercial banks authorized to operate an FCDU require a 100 percent asset cover, which may take the form of foreign currency notes and coins on hand; foreign currency deposits with the BSP, foreign banks abroad, OBUs and other FCDUs; foreign currency loans authorized by the BSP; investments in foreign currency denominated debt instruments; and other assets as may be determined by the BSP.

8. Requirements to direct credit to favored sectors

The government continues to direct credit to certain sectors of the economy through both regulatory and statutory restrictions. The loan to deposit ratio or deposit retention scheme requires that at least 75 percent of total deposit liabilities, net of required reserves and cash in vault, accumulated by branches and other banking offices in a particular geographical grouping outside of Metro Manila be invested there. This was to help in the development of that particular area, for instance by ensuring that funds do not flow from branches in the rural areas to head offices in the urban areas. According to Relampagos and Lamberte (1988), this regulation impinged on banks' capacity to intermediate more efficiently. The reduction of the geographical groupings from 13 to 3 (Luzon, Visayas, Mindanao) in 1990 has presumably reduced such adverse effects.

A longstanding statutory restriction on bank's credit allocation is the 1975 Presidential Decree No. 717, or the Agri-Agra law that requires all banks to allocate 25 percent of their loanable funds to agriculture, with at least 10 percent earmarked for agrarian reform credit. Because of banks' frequent inability to meet this requirement, they were allowed to hold alternative investments. In particular, unused funds earmarked for agrarian reform credit can be invested temporarily in government securities expressly declared eligible for the purpose

[8] Resolution No. 544 dated 25 June 1993.

by the BSP, but such securities: (a) must be monetized, encashed, or repurchased whenever funds are needed by the bank for lending to the beneficiaries of agrarian reform; and (b) cannot be hypothecated or encumbered in any way or earmarked for any other purpose. The unused funds set aside for agricultural credit in general may also be invested in commercial papers issued by entities engaged in agricultural production, processing, storage, marketing, or exportation of agricultural products; and importation, manufacture, distribution of farm machineries and equipment, fertilizers, etc. used for agricultural production. All unused Agri-Agra allocation funds in the preceding year shall also be invested in socialized and low-cost housing provided the utilized portion was solely devoted to agricultural and agrarian reform credit. Finally, loans extended by banks to finance educational institutions, cooperatives, hospitals and other medical services, low cost housing, and to local government units, without national government guarantee, are included in determining compliance with the provisions of PD 717.

In 1991, Republic Act No. 6977, or the Magna Carta for Small Enterprises, was signed into law mandating all banks to allocate a certain portion of their total loan portfolio to small enterprises. The effectivity of this law had a time period, and set the mandated credit allocation at 5 percent in 1991, 10 percent in 1992-95, 5 percent in 1996, and possibly lifted by the end of 1997. In 1996, RA 6977 was amended by Republic Act No. 8289, An Act to Strengthen the Promotion and Development of, and Assistance to Small and Medium Scale Enterprises. This law required all lending institutions, for a period of ten years from August 1997 to August 2007, to set aside at least 6 and 2 percent of their total loan portfolio for small and medium enterprises, respectively. Banks could report compliance on a groupwide basis, provided that the subsidiary banks are at least 75 percent owned or controlled by the parent bank. Such loans are also eligible for guarantee coverage to be issued by the Small Business Guarantee and Finance Corporation, which was also established under RA 8289.

For government corporations that perform banking or credit functions, credits to the economic activities falling under Priority II (real estate loans, consumption and other non-productive, speculative activities) of the Schedule of Credit Priorities must be limited to 50 percent of their outstanding loans at any time.

Banks have long been calling for the removal of mandated credit requirements. The IMF and the World Bank have also recommended that the government abandon its mandatory lending policies because they only bring up the cost of lending in the country. Even the BSP shares the same sentiment. In fact, one of the priority legislative agenda identified under the Medium Term Philippine Development Plan for 1999-2004 was the amendment of the Agri-Agra Law to lift the 25 percent quota of loanable funds to agriculture. It should also be noted that both the New Central Bank Act and the General Banking Law had done away with the developmental objective. Such requirements posed distortions in the banking system, and ran counter to the government's thrust of making the system more market oriented. Also, the government already had in place various credit programs that target these sectors, although the general consensus was that they were not very effective or successful (Llanto *et al* 1990; Magno 1988; RIDA 1995). Strict compliance has been fairly low. And efforts to make them more flexible by allowing other means to comply with the provisions (e.g. subscription to Erap bonds, bonds for socialized housing) clearly defeat the purpose of such policies to direct credit to priority sectors, and serve to magnify their overall ineffectiveness.

9. Special rules concerning liquidation, winding up, insolvency, composition or analogous proceedings in the banking sector

The exit procedure in the banking sector is fairly well defined under the New Central Bank Act. A bank or quasi-bank that is found to be unable or unwilling to maintain a condition of

liquidity deemed adequate to protect its depositors and creditors may be placed under the authority of a conservator by the Monetary Board. The conservator is empowered to overrule or revoke the actions of the previous management and board of directors of the bank or quasi-bank, as well as exercise all powers to be vested by the Monetary Board as it deems necessary. The Monetary Board shall terminate the conservatorship when it is satisfied that the institution can continue to operate on its own.

If a bank is found to be insolvent, the Monetary Board may summarily and without need for prior hearing forbid the bank from doing business, and designate the PDIC as its receiver. If the PDIC finds that the bank cannot be rehabilitated, the Monetary Board shall notify the board of directors and direct the receiver with the liquidation. The assets of the bank shall be converted to money for the purpose of paying its creditors and other parties, in accordance with the rules on concurrence and preference of credit under the Civil Code of the Philippines.

Technically, the PDIC has 90 days to decide whether to rehabilitate or liquidate a bank. The decision to close small banks, such as rural banks, is fairly quick and straightforward. When it comes to bigger banks, however, there is an implicit policy of preventing their closure because of potential contagion effects on the entire banking sector. Thus, the BSP, PDIC and the SEC have been heavily involved in the rehabilitation of some failed banks such as Orient Bank, which failed in 1998, and more recently Urban Bank and Prime Savings Bank. Charges of fraud and engaging in unsafe and unsound banking practices have also been filed against the officials of these banks, as well as a number of rural banks. Although similar cases have previously been filed, regulators have yet to successfully prosecute a banker accused of fraud.

10. Industry regulator

The BSP is the banking sector's principal regulatory and supervisory authority, as provided for under RA 7653 or the New Central Bank Act. Two specific departments help to carry out this function - the Supervision and Examination Sector (SES), which is the operating department, and the Supervisory Reports and Special Studies Office (SRSO), which receives the regular financial reports, generates the statistical reports for the use of the operating departments, and reviews systems and procedures related to supervision. The PDIC also monitors the activities of banks, although it primarily relies on information gathered by the BSP. The PDIC especially oversees rural banks, since RA 7653 (New Central Bank Act of 1993) transferred the receivership and liquidation of rural banks from the BSP to the PDIC. Finally, the SEC registers the banks' articles of incorporation, but only if they are accompanied by a certificate of authority to operate issued by the Monetary Board (Intal and Llanto 1998; Lamberte and Llanto 1993).

The BSP's supervisory powers over the operations and activities of banks include the issuance of rules of conduct or the establishment of standards of operation; the conduct of examination to determine compliance with laws and regulations; regular annual investigation to determine whether an institution is conducting its business on a safe or sound basis; inquiring into the solvency and liquidity of the institution; and enforcing prompt corrective action. RA 8791 also granted the BSP supervisory and regulatory powers over quasi-banks, trust entities, and other financial institutions, which under special laws are subject to BSP supervision.

That the initial CBP was given the task of supervising the overall financial system, that is both banks and nonbank financial institutions (NBFIs), in the early 1970s proved auspicious with the broadening of the range of services and activities that banks, particularly commercial banks, were allowed to undertake in the early 1980s. In particular, the cross-

ownership and/or interlocking directorships of banks and NBFIs have resulted in overlapping regulatory and supervisory functions. For instance, the SEC, which acts as the registrar for all companies, also regulates and supervises the securities market. Insurance firms, excluding government-owned insurance corporations which are governed by their respective charters, are regulated and supervised by the Insurance Commission of the Philippines. Given such overlaps, well delineated roles for and coordination among all regulatory/supervisory bodies in any capacity are vital in the proper regulation or supervision of the financial sector, particularly the banking sector. This would help to ensure that all risks are accounted for, and that regulatory avoidance or arbitrage does not become a problem. In this context, the off-loading of supervisory and regulatory functions over some financial institutions from the BSP to the SEC, for instance, needs to be evaluated. Although as was noted earlier, there are provisions in the New Central Bank Act and General Banking Law that allow the BSP to examine banks' subsidiaries and affiliates, and thus ascertain the overall or consolidated condition of banks. The issue then becomes how to put these provisions into operation.

As this review of current regulations show, the BSP continues to have pervasive powers over banks from their entry to their exit. The new General Banking Law served to reinforce this by increasing both the depth and width of regulation. In particular, it allows the BSP to potentially regulate areas that are not currently subject to regulation, including those that had been deregulated in the past. Thus, the BSP can strongly influence the behavior of banks, and the overall status and structure of the banking sector.

Insurance sector[9]. The regulation and supervision of the insurance industry is the responsibility of the Insurance Commission, which was set up as an autonomous body in 1949 when it was split from the Central Bank of the Philippines. It falls under the jurisdiction of the Department of Finance (DOF), although the latter's role is not well defined and weak, especially with respect to its oversight functions. The Insurance Commission is a powerful government agency with licensing, regulatory, and adjudicatory functions. The Insurance Code of 1978 is the overall regulatory framework of the industry. Changes to the 1978 Code had been very few.

Historically, the regulatory framework governing the insurance industry was marked by conservatism and risk aversion. Although this resulted in overall financial soundness, it was also deemed as overly cautious and thus constrained the growth and development of the industry. In particular, the Philippine insurance industry was deemed as lagging behind in terms of product development and innovation. An even more adverse effect of this stance was that it prevented the industry from playing a more active role in the development of the Philippine capital market. Unlike the mismatch between the maturities of banks' assets and liabilities, for instance, life insurance companies can lend their funds on a long term basis since the policies they sell are also long term.

As in the commercial banking sector, one of the provisions of the Insurance Act of 1966 was to ban the entry of new insurance companies. The restriction on entry was also retained under the 1978 Insurance Code, although the Insurance Code did not provide specific conditions for approval to engage in insurance business and was not particularly restrictive. The rationale was also similar: there was a rapid growth in the number of insurance companies in the 1950s and 1960s, many of which were found to be inadequately capitalized, as well as engaged in fraudulent activities (Emery 1976). The industry was also deemed as overcrowded, hence the restriction on new entry.

[9] The historical discussion of regulation of the insurance sector draws on World Bank (1992).

With respect to foreign participation in the industry, the Insurance Commission was also stricter relative to the general restriction on foreign investments in the country. The Foreign Investment Act allowed foreign equity participation of up to 30 percent in certain industries including insurance. This limit was raised to 40 percent in 1987. But in the insurance industry, the Insurance Commission further restricted foreign equity participation by limiting them to the nonlife insurance sector. In contrast, no foreign equity participation was allowed in the life insurance sector other than the foreign companies that were already in operation. This dichotomy in policy was due to the difference in the structure of the nonlife relative to the life insurance sector. The former was characterized by a large number of weakly capitalized companies, while the latter was judged to be overcrowded but adequately capitalized. Thus, foreign investment was encouraged in the nonlife sector to strengthen its capitalization. There was also the perception that it would be better for Filipinos to own life insurance companies because they mobilized domestic savings. This could also be the rationale for the policy of limiting foreign banks to a minority position.

Thus, in contrast to the banking sector, the nature of regulation in the insurance industry did not evolve over time. However, the reform particularly of entry restrictions was fairly quick when it came in the 1990s. In March 1992, the Department of Finance issued an order which opened the insurance industry to new entrants[10]. The restriction on foreign equity in the life insurance sector was also removed. In particular, foreigner equity participation of up to 40 percent in both existing and new life insurance companies was allowed. However, significantly higher minimum paid-up capital requirements were set for the new companies.

In October 1994, the Department of Finance issued another set of guidelines on the entry of new foreign insurance or reinsurance companies or intermediaries[11]. In particular, a foreign insurance or reinsurance company or intermediary was allowed entry under (only) one of the following modes: (i) ownership of the voting stock of an existing domestic insurance or reinsurance incorporated in the Philippines; (ii) investment in new insurance or reinsurance company or intermediary incorporated in the Philippines; or (iii) establishment of a branch, but not for an intermediary. To qualify for entry, the companies had to belong to the top 200 foreign insurance or reinsurance or intermediaries in the world or among the top 10 in their country of origin, and had been in business for at least ten years. To qualify as a branch or as a new company incorporated in the Philippines, a company also had to be widely owned and publicly listed in its country of origin, unless it was majority owned by the government. And to be considered as "widely owned", no single stockholder of the applicant must own more than 20 percent of its voting stock.

A foreign insurance or reinsurance company that would operate as a branch, or where foreign equity in the company or intermediary was more than 40 percent, was allowed entry only within two years from the effectivity of the Order. During this period, the number of foreign insurance or reinsurance companies or intermediaries that would be allowed entry was five each, although this could be increased to ten upon the recommendation of the Department of Finance and the approval of the President. No composite license was to be issued to an insurance applicant under these guidelines.

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[10] Department Order No. 27-92 issued on 17 May 1992.

[11] Department Order No. 100-94 issued on 24 October 1994. The Insurance Code classifies a company as either domestic or foreign, depending on its place of incorporation. Domestic companies are those formed, organized, or existing under Philippine laws. That is, the Insurance Code considers foreign registration and not foreign ownership as the deciding factor.

Full liberalization of entry came with the enactment of Republic Act No. 8179 in March 1996, which deleted the Negative "C" List from the Foreign Investment Act and allowed up to 100 percent foreign equity in the insurance sector. Any insurance company must satisfy capital, asset and other requirements, such as qualifications of executive officers and key officials of the company, to obtain a Certificate of Authority to transact any insurance business from the Insurance Commission. The Certificate of Authority is renewed annually, which makes it possible for the Insurance Commission to maintain tight control over the industry. Prior authorization is also needed before an insurance company can transact both life and nonlife insurance business. There are also pricing restrictions, lines of business restrictions, and restrictions on interlocking directorships and officerships.

Other requirements under the Insurance Code included minimum paid-up capital and contributed surplus, which were adjusted from time to time. The Code also contained specific provisions concerning capital and required reserves. The 1994 guidelines, for instance, raised minimum capital requirements for new companies, with the amount increasing significantly as the foreign equity in the company increased (Table 3). Aside from paid-up capital, stockholders were also required to pay a contributed surplus in cash to the company. In addition, foreign insurance companies had to deposit with the Insurance Commission eligible securities equivalent to the actual market value of not less than the minimum paid-up capital required of domestic insurance companies. At least 50 percent of such securities had to consist of bonds or other evidences of debt of the Philippine government and government owned or controlled corporations (GOCCs), including the Philippine central bank. In the case of domestic companies, they had to deposit 25 percent of minimum paid-up capital with the Insurance Commission, also in the form of government or associated securities. Foreign insurance or reinsurance companies seeking to establish branches were further required to deposit with the Insurance Commission allowable securities to the market value of not less than ₱ 300 million or ₱ 500 million, respectively.

Table 3 **Minimum capital requirements for new and existing insurance companies**

	Paid-up capital	Contributed surplus
New entrants		
Foreign equity is less than 40 percent	₱ 75 million	₱ 25 million
Foreign equity is between 40 and 60 percent	₱ 150 million	₱ 50 million
Foreign equity is 60 percent or more	₱ 250 million	₱ 50 million
Existing	₱ 50 million	₱ 25 million

Source: Insurance Commission.

In contrast to the policy on entry, the requirements of the Insurance Code on investment policies and practices were quite restrictive, which resulted in very conservative investment choices by the insurance companies. In particular, the Insurance Commission defined its role in regulating investments as follows: "By the very nature of insurance business, insurance companies need investments which are safe and free from excessive market price fluctuations since a relatively small shrinkage in asset values could endanger their solvency" (World Bank 1992: 126). Restrictions on the portfolio of assets that insurance companies could hold include limits on investments in stocks, bonds and other certificates of indebtedness, real estate investments, investment in a single enterprise, and investments in foreign currency. These restrictions, coupled with the required security deposits, led to a relatively high proportion of the industry's portfolio in short term assets and government paper.

Another important effect of the tight and conservative regulation of the insurance industry was the emergence of the pre-need industry, over which the Insurance Commission had no jurisdiction. Instead, the SEC is responsible for the overall regulation and supervision of the pre-

need industry, which is fairly liberal compared to the Insurance Commission. In recognition of this disparity in regulation, the SEC recently issued a circular[12] that set limits on the investment portfolio of pre-need companies. In particular, the circular restricted pre-need companies' trust fund investments to fixed income instruments, mutual funds, blue chip equities, and real estate in first class cities and municipalities. There is also a pending bill in Congress, the Pre-need Plans Security Code, which seeks to strengthen the protection offered to pre-need plan holders by placing this industry under the authority of the Insurance Commission. Considering the similar nature of their business, such a move would serve to harmonize the regulation of the pre-need industry with that of the insurance industry, and hence dissipate any undue advantage of the former over the latter.

Overall, the reform process in the insurance sector is just beginning and more needs to be done. The Insurance Commission is in the process of revising the Insurance Code to address significant changes brought about by financial liberalization and globalization of financial markets. It would do well to learn from the experience of the banking sector in this regard.

While it is important to monitor the evolution of financial policies, the broader process of structural change in the financial system needs to be assessed as well. In particular, the use of indicators, which help to monitor the broader process of structural change in the financial system, would provide a more critical and thorough assessment of financial reforms. The government would then be better guided in its reform efforts. This is the focus of Section III.

III. Trends in Market Structure and Performance

It is useful to monitor the evolution of deregulatory policies in order to identify areas that continue to inhibit the working of market forces in financial markets. However, monitoring steps already taken in relation to remaining regulations does not give a clear/full picture of the extent to which playing fields are being leveled in practice. Thus, policy changes need to be considered in parallel with changes in the competitive structure of the financial sector. The monitoring of structural change in the banking and insurance sectors can be done through the use of some indicators of changes in competitive structure and indicators of gains in competitive efficiency implicit in financial market performance.

A. Banking sector

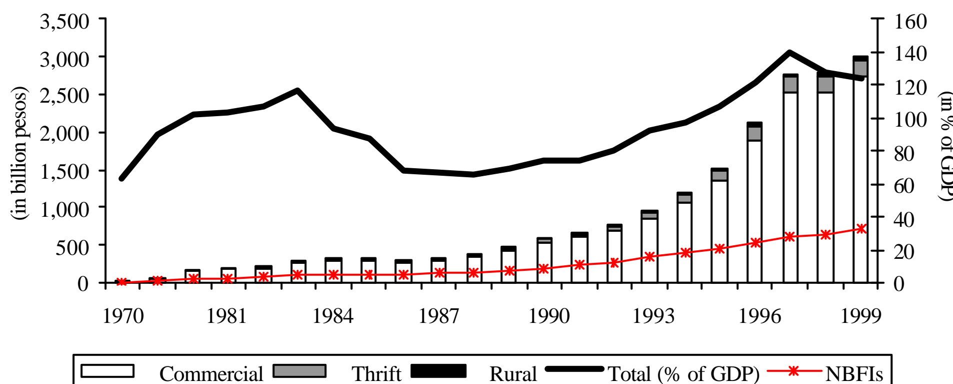
Financial structure. The Philippine financial system consists of banks and nonbank financial institutions (NBFIs). RA 8791 classifies banks into commercial banks, universal banks (expanded commercial banks), thrift banks (savings and mortgage banks, stock savings and loan associations and private development banks), rural banks, cooperative banks and Islamic banks. NBFIs include, among others, insurance companies, investment houses, financing companies, securities dealers and brokers, fund managers, lending investors, pension funds, pawnshops and nonstock savings and loan associations.

Figure 1 shows the total assets of the Philippine financial system from 1970-99. Total assets of the financial system as a percentage of GDP rose from 63 percent in 1970 to 117 percent in 1983, then fell to 66 percent in 1988 as a result of the financial and economic crises in the mid-1980s. The ratio rose to around 140 percent in 1997, and again declined to 124 percent in the

[12] Memorandum Circular No. 1, which took effect on 21 June 2000.

aftermath of the Asian crisis. The total assets of commercial banks, in particular, grew significantly in the 1990s due to the successive increases in minimum capital requirements, the upgrading of the specialized government banks, and the entry of new local and foreign banks.

Figure 1 **Assets of the Philippine financial system, by type of institution, 1970-1999 (in billion pesos)**



Source of basic data: Bangko Sentral ng Pilipinas ; National Statistical Coordination Board.

The Philippine financial system has consistently been dominated by commercial banks. In fact, the importance of commercial banks even increased over time. The banking system accounted for 81 percent of total financial assets in 1999, compared to around 76 percent in 1970. The asset share of commercial banks also increased from around 57 percent in 1970 to 73 percent in 1999. In contrast, the asset share of rural banks fell from around 3 percent in the 1970s to less than 2 percent in 1999, while the asset share of thrift banks only slightly rose to 6 percent in 1999 from 4 percent in 1970. On the other hand, the share of NBFIs in total financial assets fell from a high of 28 percent in 1975 to 19 percent in 1999.

Thus, there has been no significant structural change in the Philippine financial sector. A bank-dominated financial system is not necessarily bad. The issue is whether such a structure is a market-outcome, or the result of government regulation. In the case of the Philippines, it was clearly the latter. The banking sector has historically been the focus of financial sector policy, development and reform. In contrast, efforts to reform and develop the other sectors of the financial system began only in the mid-1990s. A theory on the relationship between financial development and economic development in a market-oriented economy posits that the banking system, which initially leads financial development, declines in importance as real growth and financial development continue (Goldsmith 1969). One observed characteristic of the process of economic development over time in a market-oriented economy is an expansion and elaboration of the financial structure (institutions, instruments and activities). On the other hand, economic development is retarded if financial intermediaries do not evolve (Patrick 1966). This was also borne out by recent empirical literature (e.g., King and Levine 1996; Lee 1991).

Table 4 shows the number of offices of financial institutions operating in the Philippines from 1980 to 1999. The easing of restrictions on bank branching was very evident in the rapid growth of banking offices. Compared to just 0.5 percent in the 1980s, the number of banking offices in the 1990s grew by 8.7 percent, with all bank categories posting significant growth. In particular, double-digit growth rates were recorded in the number of branches of rural banks beginning in 1990, and beginning in 1992 for commercial and thrift banks. The period after the deregulation of foreign bank entry but before the Asian crisis was also marked by a dramatic increase in the number of commercial and thrift bank branches. The increase in the number of head offices of commercial banks was largely due to the entry of foreign banks in 1995. However, foreign banks

were at a serious disadvantage in terms of number of branches. For instance, private domestic commercial banks had a total of over 4,000 branches in 1999. In contrast, foreign bank branches and subsidiaries had only around 219 branches.

Table 4 **Number of financial institutions, 1980-June 1999**

	1980	1985	1990	1991	1992	1993	1994	1995	1996	1997	1998	Jun-99
Phil. Financial System	4,894	5,554	7,258	7,732	8,668	9,692	10,826	12,144	15,238	17,025	18,242	19,023
Head Offices	2,387	2,676	3,915	4,096	4,413	4,914	5,428	6,007	7,234	7,790	8,139	8,379
Branches/Agencies	2,507	2,878	3,343	3,636	4,255	4,778	5,398	6,137	8,004	9,235	10,103	10,644
I. Banking Institutions	3,419	3,632	3,638	3,791	4,296	4,657	5,096	5,569	6,335	7,182	7,646	7,689
Head offices	1,209	1,055	940	919	920	912	920	938	961	1,003	996	976
Branches/Agencies	2,210	2,577	2,698	2,872	3,376	3,745	4,176	4,631	5,374	6,179	6,650	6,713
A. Commercial Banks	1,501	1,744	1,813	1,923	2,254	2,477	2,776	3,047	3,650	4,078	4,230	4,326
Head offices	32	30	30	31	32	32	33	46	49	54	53	52
Branches/Agencies	1,469	1,714	1,783	1,892	2,222	2,445	2,743	3,001	3,601	4,024	4,177	4,274
B. Thrift Banks	671	671	653	663	718	780	821	925	1,171	1,389	1,474	1,478
Head offices	144	118	103	101	98	97	100	99	108	117	117	118
Branches/Agencies	527	553	550	562	620	683	721	826	1,063	1,272	1,357	1,360
C. Rural Banks	1,155	1,117	1,045	1,063	1,140	1,195	1,274	1,346	1,514	1,715	1,942	1,885
Head offices	1,030	904	804	784	787	780	784	790	804	832	826	806
Branches/Agencies	125	213	241	279	353	415	490	556	710	883	1,116	1,079
II. NBFIs	1,475	1,922	3,620	3,941	4,372	5,035	5,730	6,575	8,903	9,843	10,596	11,334
Head offices	1,178	1,621	2,975	3,177	3,493	4,002	4,508	5,069	6,273	6,787	7,143	7,403
Branches/Agencies	297	301	645	764	879	1,033	1,222	1,506	2,630	3,056	3,453	3,931

Source of basic data: Bangko Sentral ng Pilipinas.

Overall, the Philippine banking system continued to be characterized by the presence of a few large commercial banks and a lot of very small thrift and rural banks. The continued dominance of a few, large commercial banks raises the issue of market power. Table 5 shows the number of commercial banks by ownership. In contrast to previous decades, the period after 1995 was characterized by significant movement in the commercial banking sector in terms of new entries and consolidations. In particular, while the number of foreign bank branches and subsidiaries increased as a result of deregulation. The number of domestic private banks initially increased in the first half of the 1990s as a result of deregulation of entry, then decreased towards the latter half due to mergers and acquisitions. Although the BSP encouraged mergers and acquisitions to meet the higher capital requirements, the latter primarily took place among the biggest banks (Table 6). Thus, the motivation would seem to be to protect market share.

Table 5 **Number of commercial banks by type of bank, 1980-2000Q1**

Type of bank	1980	1985	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000Q1
TOTAL	32	30	30	31	32	32	33	46	49	54	53	52	47
Private domestic banks	27	25	25	26	27	27	28	30	31	33	32	30	25
Foreign bank branches	4	4	4	4	4	4	4	14	14	14	13	13	13
Foreign bank subsidiaries										4	5	6	6
Government banks	1	1	1	1	1	1	1	2	4	3	3	3	3

Note: Data for the first quarter of 2000 incorporate the mergers and acquisitions reported in Table 6.
Source of basic data: Bangko Sentral ng Pilipinas.

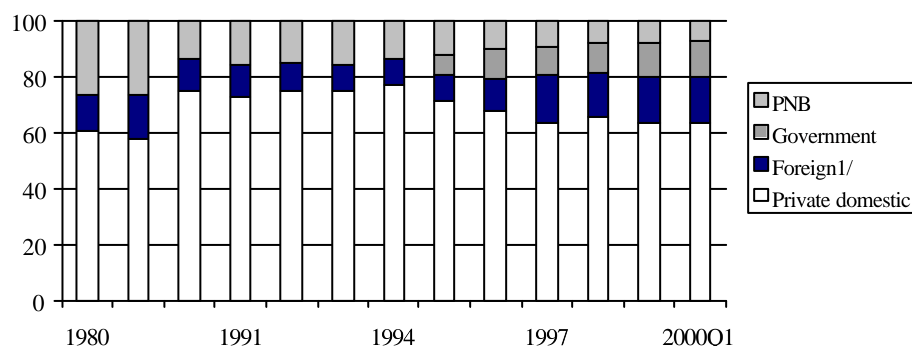
Table 6 **Mergers and acquisitions in the commercial banking sector, 1998-2000**

Year	Consolidating banks	Surviving entity	Effectivity[1]
1998	Bank of Southeast Asia / DBS Bank of Singapore	DBS Bank (Philippines), Inc.	9/9/98
1999	Equitable / PCI Bank	Equitable PCI Bank	9/28/99
2000	Global Bank / Asian Bank	Gobal Bank	2/9/2000
	Gobal Bank / Philbank	Gobal Bank	3/24/2000[2]
	BPI / Far East Bank & Trust Co.	BPI - Far East	4/7/2000
	Prudential Bank / Pilipinas Bank	Prudential Bank	5/2/2000
	Metrobank / Solidbank	MetroBank	6/30/2000

Note: [1]Refers to dates of effectivity as stated in the Circular Letter, unless otherwise stated.
[2]Date of Monetary Board approval.
Source: Espenilla (2000).

Figure 2 shows the distribution of commercial bank assets according to ownership of banks. Private domestic banks consistently accounted for over 60 percent of total commercial bank assets. Private domestic banks' share rose to as high as 77 percent in 1994, before subsequently falling to around 67 percent in 1999, with the entry of the ten foreign banks in 1995. If the share of Philippine National Bank (PNB), which passed into majority private ownership in 1995, is included, the share rises to around 76 percent in 1999. On the other hand, the asset share of foreign bank branches and subsidiaries rose from around 9 percent in 1995 to 17.5 percent in 1997. Finally, the share of government owned commercial banks declined from less than 27 percent in 1980 (accounted for by PNB) to 12.6 percent in 1999.

Figure 2 **Distribution of commercial bank assets, by type of bank, 1980-2000Q1 (in percent)**



Source of basic data: Bangko Sentral ng Pilipinas.
Note: 1/Includes branches and subsidiaries of foreign banks.

With respect to the ownership of private domestic commercial banks, Table 7 shows that very few remained purely Filipino owned, which indicates the impact of liberalizing foreign equity participation in the domestic banking industry.

Table 7 **Ownership structure of private domestic banks: percentage share to total subscribed capital, 1997/98**

	Filipino	Foreign		Filipino	Foreign
Allied Banking Corp.	100	0	Phil Bank of Communications[2]	86	14
Asia United Bank	70	30	Philippine Banking Corp.[2]	76	24
AsianBank Corp.[1]	87	13	Philippine Comm'l Int'l. Bank[2]	72	28
Banco de Oro	100	0	Philippine Trust Co.[2]	100	0
Bank of Commerce[1]	100	0	Philippine Veterans Bank	84	16
Bank of the Philippine Islands	78	22	Pilipinas Bank	70	30
China Banking Corp.[2]	87	13	Prudential Bank[2]	84	16
Bank of Southeast Asia	100	0	Rizal Comm'l Banking Corp.[2]	100	0
East West Bank	100	0	Security Bank Corp.[2]	84	16
Equitable Banking Corp.[2]	87	13	Solidbank Corp.	60	40
Export and Industry Bank	70	30	TA Bank of the Philippines, Inc.	52	48
Far East Bank and Trust Co.[2]	58	42	Traders Royal Bank	93	7
Global Business Bank	60	40	Union Bank of the Philippines[3]	98	2
International Exchange Bank	100	0	United Coconut Planters Bank	100	0
MetroBank and Trust Co.	82	18	Urban Bank[2]	98	2
Panasia Banking, Inc.	70	30	Westmont Bank	na	na

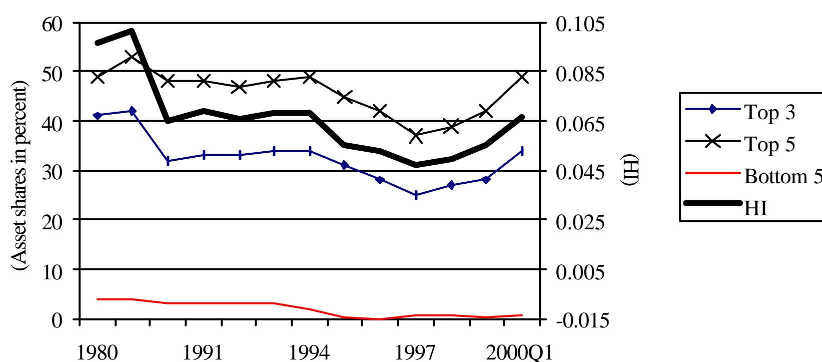
Notes: [1] Percent share in total common stocks issued; [2] Percent share in top 20 stockholders; [3] Percent share in top 20 stockholders, as of 30 June 1999. Na means not available
Source of basic data: Securities and Exchange Commission.

Measures of concentration. Figure 3 presents some measures of asset concentration of the Philippine commercial banking system. Although the actual value of the Herfindahl index (HI) [13] may not be indicative of undue concentration, given its very low values, it would also be useful to look at the trend. The HI was fairly stable from 1990-94. It began to decline beginning in 1995 with the entry of the new foreign banks, indicating that the system was becoming less concentrated. However, this trend was reversed beginning in 1998, which means that the mergers and acquisitions also resulted in increasing concentration. Similar trends are also evident when one looks at the asset share of the three and five largest commercial banks, which are all domestic banks. Before the restriction on new bank entry was eased in 1995, the five largest commercial banks consistently accounted for around half of the sector's total assets. Their share declined to around 37 percent in 1997, but this trend has since been reversed. Also, the wide gap between the five biggest and five smallest commercial banks is stark.

The concern with excessive concentration is that it is a potential source of monopoly power. Tan (1989) further argued that the institutional setting was likely to enhance the power of dominant banks in the industry. First, all the head offices of commercial banks were located in Metro Manila. Second, their owners/managers belonged to a loosely-knit and geographically proximate social group. And in a number of cases, their business interdependence extended beyond banking and included banking conglomeration in production and trade. Thus, there is a need to monitor the concentration process even in a deregulated environment to detect any further strengthening of the oligopolistic group, and ensure that it does not lead to misuse of market power.

[13] The Herfindahl index, which is a commonly used measure of industrial concentration, is calculated by squaring and summing the share of industry size accounted for by every firm in the industry, with a maximum value of 1 (or 10,000 where the market share is measured in percentage terms) indicating a monopoly.

Figure 3 **Measures of commercial bank asset concentration, 1980-2000Q1**



Source of basic data: Published balance sheet statements of commercial banks.

Operational efficiency. Operational efficiency is a microeconomic concept, but it is also used to characterize a financial system. In particular, the market structure could be reflected in the spread between the cost of funds and the lending rate: a financial system is considered operationally efficient if the interest spread is low. The latter, in turn, arises from two factors. On a microeconomic level, the more cost efficient banks are, the lower the spread will be under reasonably competitive conditions. On a macroeconomic level, systemic risks also affect the spread. A more stable and confident environment will lead to a lower risk premium over lending, thus leading to a lower spread (Ersel and Kandil 2000).

A high intermediation margin would imply a smaller intermediation activity (Tan 1989). One of the structural weaknesses identified in the Philippine banking sector in the past was the large spread between commercial bank deposit and lending rates, which in turn was attributed to high intermediation costs mainly in the form of taxes and reserve requirements, as well as high profit margins (World Bank 1986). Tan (1989) also pointed out that the interest rate differential might not just be due to taxes, but to some monopoly power of the large commercial banks as well. More recently, the World Bank (1998) noted that high intermediation costs continued to be a feature of the Philippine banking system, especially when compared to other Asian economies[14]. Average net interest margin as a ratio of total assets from 1988-95 was 4.2 percent. Figures for comparable countries like Indonesia and Thailand were 3.5 and 3.1 percent, respectively (Demirguc-Kunt and Huizinga 1997; in Claessens and Glaessner 1998).

In addition to high reserve requirements and the mandated credit requirements discussed earlier, other contributing factors to the Philippines' high intermediation costs were high operating costs and insufficient competition (World Bank 1998). Operating costs of Philippine banks were found to be significantly higher in the Philippines compared to other Asian economies. In particular, average overhead costs as a ratio of total assets in 1988-95 was around 4.4 percent, compared to 2.9 percent and 2.0 percent for Indonesia and Thailand, respectively. Despite the higher operating costs, Philippine banks were also found to be more profitable. The ratio of net profit to total assets was around 2 percent for Philippine banks during the same period, against 0.9 and 1.1 for Indonesia and Thailand respectively (Demirguc-Kunt and Huizinga 1997; in Claessens and Glaessner 1998). Thus, the World Bank (1998) noted that the "high profits despite high costs indicate lack of competition, which is also evidenced by the fact that there is high concentration in the banking sector…" (p. 23).

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[14] The interest spread is often used for international comparisons of financial sector efficiency. But as Claessens and Glaessner (1998) noted, cross-country comparisons should be done with care because a number of country-specific regulatory, tax, macroeconomic and microeconomic factors affect the costs of financial intermediation.

Tan (1989) had previously argued that the ultimate effect of the policy of restricted entry into the banking sector had been to shield both the big and small banks from competition, which allowed the big banks to earn abnormal profits and the small banks to operate at high costs. Thus, it is important that the banking industry be sufficiently competitive if financial intermediation is to be carried out efficiently. The partial liberalization of foreign bank entry in 1994 precisely aimed to increase competition and improve efficiency in the domestic banking sector. By increasing competition, it was expected that market forces would reduce bank spreads. Although the entry of more foreign banks led to some changes in the banking structure, particularly the decline in concentration ratios, there has been no significant impact on bank spreads. Table 8 shows domestic commercial banks' average spread and rates of return both prior to and after the restriction on foreign bank entry was eased in 1995. Both only slightly declined during the post-liberalization years prior to the Asian crisis.

Table 8 **Commercial banks' average spread and rates of return (in percent)**

	Average spread[1]	Average rate of return	
		on Assets	on Equity
Pre-liberalization: 1991-94[2]	4.733	2.51	25.66
Post-liberalization: 1995-97	4.345	2.23	18.83

Notes: [1]Difference between lending and deposit rates adjusted for the gross receipts tax and changes in required reserves; [2]1987-94 for Average rate of return.
Source: Lamberte (1999).

Recent studies have examined the impact of the entry of more foreign banks on domestic banks' interest rate spreads and efficiency (e.g., Manzano and Neri 2001, Montinola and Moreno 2001, Unite and Sullivan 2001). Overall, their results indicate that foreign bank entry has had limited impact. Manzano and Neri (2001) noted that the effects on competition might not have been felt immediately because of a period of adjustment for the foreign banks, and/or because liberalization did not go far enough. But ultimately, they attributed the persistence of high bank spreads to the government's macroeconomic policy mix. In particular, the overvalued exchange rate before the crisis encouraged foreign borrowing and dollar intermediation by banks, which dampened the competition for peso deposits and upward movements in the deposit rate. On the other hand, the government's high interest rate policy to defend the exchange rate caused banks' lending rate to remain high. Thus, the impact of macroeconomic factors could have masked the impact of foreign bank entry on domestic banks' interest spread. According to Montinola and Moreno (2001), the scope of liberalization was limited, hence its modest effects on competitiveness and efficiency.

A more in-depth study of the determinants of bank net interest margins would be useful to establish the impact of the change in the structure of bank competition. Apart from the market structure component, regulatory components in the form of reserve requirements and capital to asset ratios, and a risk premium component to account for uncertainty in the macroeconomic environment facing banks would have significant effects on bank net interest margins (Saunders and Schumacher 2000). With respect to the regulatory components, it has also been argued that part of the reason for the high bank spreads is that Philippine banks are heavily capitalized and less leveraged. In the years prior to the 1997 Asian crisis, Philippine banks' capital adequacy ratio, defined as the ratio of net worth to risk assets, was between 17-20 percent compared to the Bank for International Settlement's requirement of 8 percent. Holding equity capital is relatively costly when compared to debt, and so banks that have relatively high capital ratios can be expected to try to cover some of this cost by imposing an extra spread (Saunders and Schumacher 2000). On the other hand, reserve requirements in the 1990s were significantly

lower compared to previous periods. This, together with higher interest rates paid on reserves, should have served to reduce banks' cost of intermediation. Finally, the mandatory credit requirements continued to act as a tax on banks that gets translated into a higher spread.

While the entry of more foreign banks in 1995 has not had a visible impact in terms of reducing domestic banks' interest spread, this does not mean that foreign banks have had no impact whatsoever on domestic banks' operations and the level of competition in the banking sector. Focusing on price or interest competition does not take into account the dynamic aspect of competition and efficiency. The latter refers to the structural response of banks to deregulation as reflected for instance in their balance sheets, that is, the changes in the structure of their assets and liabilities. Audretsch *et al* (2001) noted that competition and anti-trust policies in the developed economies such as the European Union have been based on traditional static models and analyses of industrial organization, wherein technology and consumer demand are given and price (output) is the firm's main, if not its only, choice variable. In contrast to the static models' focus on price competition, more recent dynamic models of industrial organization argue that firms in reality are "engaged in a continuing dynamic competitive process, constantly creating and adopting new products and processes in order to gain advantage over their rivals" (p. 618). And in a dynamic economy, the latter may have a more significant effect on welfare than the former in the long run. The issue is especially relevant to financial markets as they operate in more deregulated and globalized environments, and become increasingly characterized by technological advancements and product innovations. This emphasizes the need to augment traditional analyses of industrial organization, such as Bain's (1956) Structure-Conduct-Performance paradigm, with more dynamic analyses of markets and institutions in order to come up with a fuller depiction of competition (Audretsch *et al* 2001).

In the Philippines, foreign banks traditionally competed with local banks primarily in corporate lending and non-branch based financial services. A survey of selected local banks on their reactions to the entry of more foreign banks in 1995 indicated that the latter has led to a more competitive environment particularly in wholesale banking (Hapitan 2001). The entry of more foreign banks further reduced the already thinning spreads from servicing corporate accounts because of the entry of more local banks in the early 1990s. This induced local banks to tap other segments of the market that would generate higher returns. Thus, local banks shifted their focus towards developing products and services for the middle and retail consumer markets, and to some extent the previously neglected small and medium sized enterprises. Local banks also sought to improve existing product lines and services, especially by introducing technology based enhancements such as phone banking, bills payment, point of sale transactions, and internet banking (AAC 1998). But as Hapitan (2001) also noted, re-engineering was undertaken by the domestic banks as a strategy in itself, and not because of the entry of more foreign banks per se.

Local banks' greater focus on retail operations could also account for the persistence of high banks spreads, both from the cost and profit aspects. Banks whose services are directed more toward retail operations normally have higher operating costs compared to banks that are more oriented toward wholesale markets. This is due to the former's need for more branches, equipment, and personnel to serve retail customers. Higher operating costs then translate into a higher spread (Brock and Suarez 2000). Branches of domestic commercial banks expanded rapidly especially in 1995-97, which accounts for the increasing trend in their operating costs during that period. The shift towards more profitable retail lending could have also allowed banks to maintain their profit margins. The New General Banking Law has allowed foreign banks to fully own an existing local bank, thus relaxing the restriction on branching by foreign

banks. In December 2000, Hong Kong Shanghai Banking Corporation (HSBC) acquired a local thrift bank, which could further enhance competition in the middle and retail consumer markets.

B. Insurance sector

It was noted earlier that the share of NBFIs in total financial assets fell from a high of 28 percent in 1975 to 19 percent in 1999. A major sector under NBFIs is the insurance sector. In fact, the share of the insurance sector in total NBFI assets steadily increased over the past two decades, from 47 percent in 1980 to 71 percent in 1998 (Table 9). Over half of the assets of the insurance sector were in turn accounted for by two government insurance corporations. However, the share of the insurance sector in total financial assets fell in the 1990s with the rapid expansion of the banking sector.

Table 9 **Share of the insurance sector in total financial and NBFIs assets, 1980-1998 (in percent)**

	1980	1985	1990	1995	1996	1997	1998
Assets (billion pesos)							
Total financial	249.67	492.80	802.98	2,080.57	2,680.81	3,429.98	3,473.39
NBFIs	58.36	104.17	194.13	443.11	507.86	582.40	622.88
Insurance	27.54	59.40	132.87	286.86	334.34	388.74	439.84
Distribution of insurance (%)							
Government[1]	64	66	66	65	64	64	64
Private	36	34	34	35	36	36	36
Share in total financial (%)							
Insurance	11	12	17	14	12	11	13
Government	7	8	11	9	8	7	8
Private	4	4	6	5	4	4	5
Share in NBFIs (%)							
Insurance	47	57	68	65	66	67	71
Government	30	38	45	42	42	43	45
Private	17	19	23	23	24	24	25

Note: [1]SSS and GSIS.
Source of basic data: Social Security System; Government Service Insurance System; Bangko Sentral ng Pilipinas.

There are two broad categories in the insurance industry: life and nonlife. These two categories not only offer entirely different products, but also have different structures, modes of operation, constituent characteristics, and regulatory requirements. Although the industry is largely private owned, it also includes five government insurance corporations: the Government Service Insurance System (GSIS), Social Security System (SSS), Philippine Crop Insurance Corporation (PCIC), Philippine Deposit Insurance Corporation (PDIC), and the Home Mortgage and Guarantee Fund (HMGF). These government corporations are governed by their respective charters and do not fall under the authority of the Insurance Commission. The government sector has consistently been twice as big as the private insurance industry in terms of assets. Another important sector is the pre-need industry, which also operated outside of the purview of the Insurance Commission. Thus, the pre-need industry grew significantly since it operated under a less restrictive regulatory environment relative to the life and nonlife insurance sectors.

Table 10 shows the total assets of the private insurance industry. Total assets in real terms grew very fast in the 1990s compared to the 1980s - 8.5 percent per annum from 1991-98 as opposed to just 2 percent from 1980-90. The real growth rates of total assets by sector (life and nonlife) and ownership (domestic and foreign) also showed a similar trend over the same periods. As a percentage of GDP, though, there was only a slight increase in total assets from around 4 percent

in 1980 to less than 6 percent in 1998. The life insurance sector grew at a faster rate of 10 percent per annum in the 1990s, while the nonlife insurance sector grew by around 6 percent. In terms of percentage distribution, life insurance accounted for over half of total assets, with its share significantly growing in the 1990s.

Table 10 **Distribution of total assets of the insurance sector, 1980-1998**

	1980	**1985**	**1990**	**1995**	**1996**	**1997**	**1998**
Total assets (million pesos)	9,997	20,284	45,151	100,269	120,234	140,203	157,546
Total assets (% of GDP)	4.1	3.6	4.2	5.3	5.5	5.8	5.9
Domestic (% of Total)	64.2	59.9	58.2	58.4	58.5	56.9	54.4
Foreign (% of Total)	35.8	40.1	41.8	41.6	41.5	43.1	45.6
Life (% of Total)	51.1	51.8	56.5	66.6	68.9	66.3	67.7
Domestic (% of Life)	51.3	47.4	46.3	44.7	46.3	44.6	41.7
Foreign (% of Life)	48.7	52.6	53.7	55.3	53.7	55.4	58.3
Nonlife (% of Total)	43.8	43.5	40.6	31.6	29.2	31.7	30.3
Domestic (% of Nonlife)	75.8	71.0	72.4	85.6	85.6	80.7	80.4
Foreign (% of Nonlife)	24.2	29.0	27.6	14.4	14.4	19.3	19.6
Prof'l reinsurer (% of Total)	5.1	4.8	2.9	1.8	1.9	2.0	2.0
Domestic (% of Prof'l)	93.0	93.9	90.5	86.6	87.0	87.8	88.3
Foreign (% of Prof'l)	7.0	6.1	9.5	13.4	13.0	12.2	11.7

Note: Domestic and foreign are defined according to ownership, not place of incorporation. Thus, foreign companies include branches and domestically incorporated but foreign owned companies.
Source of basic: Insurance Commission.

In contrast to the banking sector, there was significant foreign participation in the insurance industry even prior to deregulation of entry. In particular, total assets of the life insurance sector were roughly equally divided between domestic and foreign owned companies. Also, total assets of foreign owned insurance companies in real terms grew at an average annual rate of 11 percent in the 1990s, which was double that of domestic companies. This was due to the deregulation of foreign entry. Most of the new foreign entrants were life insurance companies, which also accounts for their increasing share in this sector. In contrast, there was a decline both in the overall asset share of the nonlife sector and the share of foreign owned nonlife companies. This indicates that the objective of increasing the industry's capitalization by allowing greater foreign participation was being achieved only in the life insurance sector.

The deregulation of entry led to an increase in both domestic and foreign private insurance companies (Table 11). There were around 148 private insurance companies in 1998 compared to 129 in 1995, around 70-80 percent of which are domestic nonlife insurance companies. As noted earlier, most of the new foreign entrants were life insurance companies, which increased their number and asset share from 1995 to 1998. Although there were also more domestic life insurance companies, their asset share declined to around 42 percent in 1998. In contrast, the number of foreign nonlife insurance companies was relatively unchanged over the same period, while the number of domestic companies increased further to 96 in 1998. Taking into account the decline in the asset share of the domestic nonlife insurance companies over this period, this suggests that their problem of weak capitalization may have even worsened.

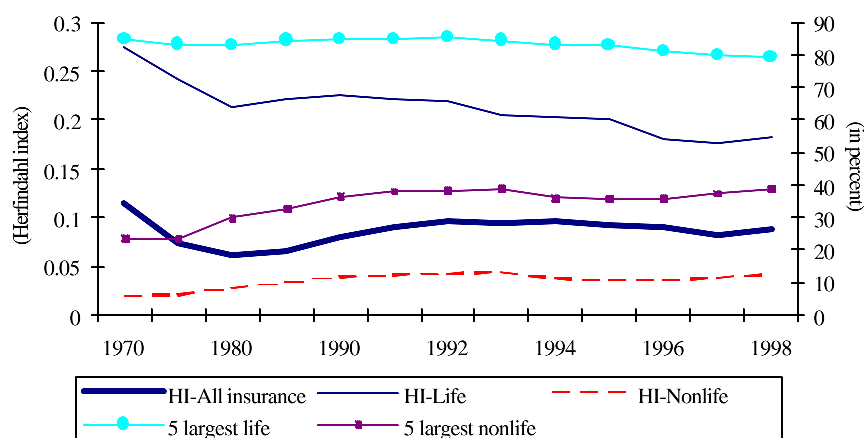
Table 11 **Number of insurance companies by type of insurer, 1980-1998**

	1980	1985	1990	1995	1996	1997	1998
TOTAL	135	130	130	129	134	145	148
Domestic	111	103	108	112	114	121	122
Foreign	24	25	20	16	18	22	23
Composite	-	2	2	1	2	2	3
Life	23	22	23	26	29	34	35
Domestic	19	18	19	21	22	24	23
Foreign	4	4	4	5	7	10	12
Domestically incorporated	2	2	2	3	5	8	10
Branch	2	2	2	2	2	2	2
Nonlife	107	101	101	98	99	105	106
Domestic	88	81	86	88	89	94	96
Foreign	19	20	15	10	10	11	10
Domestically incorporated	6	6	5	4	4	5	4
Branch	13	14	10	6	6	6	6

Source: Insurance Commission.

With respect to concentration of ownership of assets, the Herfindahl index (HI) does not indicate undue concentration in the nonlife insurance sector, while the life insurance sector is significantly more concentrated (Figure 4). The latter becomes even more evident when one looks at the asset share of the five largest life insurance companies, which consistently accounted for at least 80 percent of total assets of this sector. In contrast, the asset share of the five largest nonlife insurance companies was less than 40 percent. But the latter also signifies a high degree of concentration given the greater number of nonlife insurance companies. The World Bank (1992) noted that these small, weak companies are one of the principal causes of inefficiencies and even abuses in the nonlife sector. In contrast, concentration in the life insurance sector was not deemed a problem, and was noted to be common in other countries as well. There was also a slight downward trend in the HI for the life insurance sector, with the entry of more foreign companies. But as in the banking sector, the oligopolistic structure in both life and nonlife insurance is very evident.

Figure 4 **Measures of asset concentration in the insurance industry, 1970-1998**



Note: The Herfindahl index is plotted on the left hand scale, while the asset share of the five largest companies is plotted on the right hand scale.

Source of basic data: Insurance Commission.

The rapid growth of the insurance industry in recent years augurs well for the development of the country's capital markets and overall economic growth. In particular, life insurance is far more likely to add to long term capital growth than nonlife insurance, or banks. Since the policies they sell are typically long term, life insurance firms can also lend their funds on a long term basis. It should also be noted that the industry grew under a still restrictive regulatory framework.

Again, as in the banking sector, the danger inherent in a policy of closed markets should also be underscored and competition encouraged in the insurance industry. In particular, the presence of subsidiaries or branches of foreign insurers, as well as the acquisition by foreign companies of minority or majority interests contributes to the development of the domestic insurance sector. Foreign presence brings with it innovation and transfers of know-how, while at the same time giving access to additional financial resources, improving insurance rules, fostering greater diversification of business, expanding capacity, broadening the scope of products offered and increasing financial security (OECD 1997). But clearly, further reforms are needed to complement the deregulation of foreign entry into the Philippine market. In particular, overly conservative and restrictive investment policies and practices led to rather perverse results in that they encouraged investments in short term assets, especially government securities. This created an unfortunate mismatch between the maturities of the industry's assets and liabilities, especially given the country's serious need for long term capital (World Bank 1992). Needless to say that some prudential regulation of investment would still be necessary to balance profitability with soundness.

While both the banking and insurance sectors started off as highly regulated, even repressed, industries, only the regulatory framework in the former evolved over time. In contrast, it was only very recently that deregulatory reforms in the insurance sector were initiated. Overall, the results indicate that one recent policy reform had an especially significant positive impact on the competitive structure of the commercial banking sector, that is, the liberalization of entry of new banks, particularly foreign banks. In particular, it led to less concentration and presumably market power of the domestic banks, and greater competition. Why this has been so, despite the fact that the process of financial liberalization has been on going for more than a decade, is explored further in the next section. In particular, the section looks at the regulation of the financial sector in the overall context of competition policy.

IV. Competition Policy Issues in the Financial Sector

This section seeks to identify some relevant issues pertaining to competition policy in the financial sector, which need to be examined further.

A. Banking sector

Overall, the banking sector in the Philippines is still subject to extensive government regulation. This is not surprising since even banks in developed economies are typically subject to substantial public regulation. While most of the current regulations are justified for prudential reasons, particularly to protect the stability and soundness of the financial system, some longstanding restrictions are clearly meant to achieve some social objective. Also, some regulations may no longer be necessary for prudential reasons, thereby restricting competition unnecessarily. Thus, an appraisal of existing regulations is always instructive to ascertain their impact on competition and efficiency, and their overall effectiveness in the rapidly changing financial environment.

It is repeatedly pointed out in the literature that better prudential regulation and supervision are of paramount importance in dealing with the consequences of liberalization and globalization of financial markets. However, better regulation does not necessarily call for the institution of more or stronger rules, but a different kind of rules. New approaches to the supervision of financial institutions have been characterized by a shift in focus away from formulaic capital standards and mandated portfolio structures, toward improvements in transparency and in the supervision of risk management systems (Hendricks and Hirtle 1997). Prudential supervision is designed for balance sheet regulation, and the rise in off balance sheet activities of banks diminish the importance and effectiveness of such regulation. Thus, there is also a need to strengthen disclosure, transparency, and bankruptcy rules. Reporting requirements seem to be comprehensive and adequate for supervisory needs in the Philippines. What needs to be ensured is that all data and information are effectively utilized.

In the case of the Philippines, the need for stronger prudential regulation and supervision is partly due to the explicit, and more importantly the implicit guarantees in the financial system. Ultimately, the way to reduce the former would be to minimize the latter. Prudential regulation in effect substitutes the judgment of regulators for that of regulated financial institutions and their customers. Thus, the former absorbs risks that would otherwise be borne by the latter. And in order to minimize its own risk exposure, regulators have an incentive to further limit the behavior of regulated institutions. But prudential regulation lessens competitive pressure and carries efficiency costs (Wallis *et al 1997*). And it should be pointed out that regulators also have the potential to engage in moral hazard. That is, regulators may cover up problems in the financial system, whether to hide their mistakes or because of political pressure (Aoki 1997). Over-regulation is costly, cumbersome, and counter-productive. The issue then becomes, what constitutes appropriate prudential regulation?

One area of public policy that has had a significant impact on the structure and performance of the Philippine banking sector is on entry and branching. In particular, restrictions on entry and branching led to an uncompetitive and inefficient banking system. On the other hand, their deregulation enhanced the contestability and competitiveness of the market, and facilitated changes in banking trends, such as the introduction of new products, services and technologies.

Entry into the banking sector is one area that continues to be regulated even in the most liberalized or deregulated financial system. For instance, even the OECD countries continue to regulate the entry of new domestic banks, although none outrightly ban new entry. That is, new entry requires a license but is otherwise free. Controls on entry in the form of authorization criteria include minimum capital requirements, and more importantly fitness and properness criteria for controllers and managers of banks. On the other hand, the entry of foreign banks is relatively more restricted (OECD 1998a). Thus, regulation of entry to the banking industry is primarily a tool of prudential regulation. “Free banking”, or the removal of entry and other restrictions without accompanying prudential regulations, is not deemed as tenable because it could lead to over-competition and excessive risk-taking, thus compromising the stability and soundness of the banking system. In contrast, current entry regulations in the Philippines contain similar prudential requirements, as well as an outright ban on new entry of commercial banks.

Overall, government barriers to entry are typically imposed to limit and reduce the number, as well as increase the average size of banks in the Philippines. Bigger and fewer banks, in turn, were seen to promote the safety and soundness of the financial system. But it is also recognized that their removal would enhance market contestability and the competitive process. A balance needs to be struck between the potential costs and potential benefits of allowing greater competition. In particular, the potential adverse effects of enhancing competition through a

lowering of barriers to entry can be addressed by properly applying prudential regulations and restrictions such as those currently in place, especially the fitness and properness criteria for bank owners and managers. The focus should not just be the size of banks per se, but whether they are sound, competitive and efficient. Although in the Philippines, one merit of having direct entry restrictions is that it frees monetary authorities from political interventions in the licensing process. On the other hand, the policy bias has shifted in favor of foreign banks

The literature on foreign banking typically asserts that foreign bank entry can render national banking markets more competitive, thereby forcing domestic banks to operate more efficiently. For instance, Claessens *et al* (1998) provide empirical evidence that significant foreign ownership share of banks does reduce the profitability and overall expenses of domestically owned banks. The results demonstrate how foreign bank entry can improve the functioning of national banking markets, with positive overall welfare implications for banking customers and the economy, even as it reduces domestic banking profits. An interesting finding of their study is that the number of entrants, rather than their market share, is the critical factor. That is, the impact of foreign banks on competition is immediately upon entry rather than after they have gained substantial market share. Papi and Revoltella (1999) likewise concluded that foreign direct investment in the banking sectors of transitional economies also provided valuable opportunities for the development of the host banking sector and the host economy as a whole. In this context, the recent move to further liberalize foreign bank entry in the Philippines is a step in the right direction. Also, it would seem that the aggregate 30 percent asset share limit on foreign majority-owned banks is not that potentially restrictive.

Another potential positive impact of greater foreign participation in the Philippine banking sector is on the ownership structure of domestic banks. As noted earlier, very few domestic banks have remained purely Filipino owned, and foreign stakes could increase further. To date, the asset share of foreign bank branches and subsidiaries is around 15 percent of total banking assets. And with the higher limit on total foreign equity participation of individuals and nonbanks in domestic banks, there is still considerable room for increased foreign participation in the banking sector. This could serve not just to widen the ownership base of domestic banks, but change the nature of ownership and hence banking in the Philippines.

Concentration of ownership continues to be a concern essentially because of its adverse implications on allocation of credit, the worst case being DOSRI abuses. A related issue here is interlocking ownership among financial and nonfinancial firms. The overall experience of developing countries was that when industrial conglomerates control financial institutions, this led to a worsening in resource allocation, decreased competition and conflicts of interest, and problems of financial inflexibility and instability. These problems were particularly serious in developing countries with weak prudential regulation and supervision, as well as tight restrictions on entry into the banking industry (Fry 1988). Ironically, such linkages could have contributed to the stability of the Philippine financial system, for instance by helping to avert massive loan defaults during the crisis in the early 1980s. Banks typically restructured loans to allied firms to avoid provisioning and write offs for bad loans, and thus protected both nonfinancial and financial firms from bankruptcy. More recently, the Bankers Association of the Philippines spearheaded efforts to assist ailing investment houses, which was still an after effect of the Asian crisis. This should thwart possible contagion effects on the banking sector, as what happened to Urban Bank.

But while such linkages may contribute to the stability of the commercial banking sector in the short run, any resulting adverse efficiency effects would eventually backfire on the banks themselves. The cases of Japan and South Korea clearly demonstrated this, with grave

consequences for the entire economy. As long as scarce loanable funds are not channeled to borrowers who can use them most productively, the level and quality of investments and, consequently, the rate of economic growth will be severely affected. Thus, a change in the nature of Philippine banking is warranted. In particular, a move away from a relationship-based system of financial intermediation, to one of explicit market based transactions would enhance competition and efficiency.

In addition to the policy on entry and branching, other key policy issues with respect to competition in the commercial banking sector that need to be examined further include:

1. Anti-competitive agreements: The question of collusion and cartelization is a longstanding one in the commercial banking sector. Another issue is the potential misuse of market power, with the continued dominance of a few large commercial banks. One way to deal with both these issues is to make the threat of potential entry available at all times. Two main areas of concern with respect to market concentration and collusion are overpricing of financial products and underprovision of services essential to economic growth and welfare. For instance, it had been observed among OECD countries that anti-competitive practices, such as non-itemized charges and financial penalties for account closure, occurred more frequently with the deregulation of financial services. Also, as banks enter into more cooperative arrangements (e.g., the interconnection of networks such as ATMs; operation of international credit card systems or national debit transfer systems), these may give rise to competition concerns. Finally, it should be noted that anti-competitive agreements could transpire not just between banks, but between banks and regulators as well.

2. Competitive neutrality: Although the government's share in total assets of commercial banks has declined, it is still quite substantial. The two government owned banks were the fifth and seventh largest banks as of the first quarter of 2000, and together accounted for almost 13 percent of total commercial bank assets. The strong presence of government banks in the industry could lead to distortions in competition, especially since they have shifted from development financing to commercial and industrial lending to directly compete with private banks. More importantly, they are very prone to "behest loans", which was the cause of the collapse of government banks in the early 1980s. Land Bank of the Philippines (LBP), together with the Philippine National Bank (PNB), again experienced financial difficulties and sought assistance from the BSP in 2000. The LBP even considered transferring its losses to the national government, but the latter's growing deficit did not allow it. The government is also making moves to regain control over PNB. Clearly, undue advantages because of their direct link to the government served to compromise their competitiveness and efficiency.

3. Unjustified regulatory restrictions on competition: In addition to market entry restrictions, restrictions on competitive behavior, such as portfolio restrictions (e.g., mandatory credit requirements), also need to be assessed. But a distinction needs to be made here between credit restrictions designed to channel funds to specific sectors to achieve some social objective, and those imposed for prudential reasons.

   Obliging banks to subsidize and/or service certain activities compromise their efficiency, and may not be sustainable in a competitive environment. That is not to say that the credit needs of the targeted sectors are not valid, but the issue is the effectiveness of directed credit. Their credit needs can be more efficiently dealt with through other means, such as direct government funding, transfer payments or provision of services. For instance, it has been suggested that the government banks, which have become increasingly involved in commercial lending, revert to their original mandate of development financing.

   It is also important to have an effective treatment of the "exit problem". This is influenced by policies toward exit, downsizing, bankruptcy, and public bailout commitments. It is desirable,

from the viewpoint of efficiency, that inefficient and noncompetitive institutions discontinue their operations. But if a series of banking failures is not handled well, it could trigger a crisis of confidence crisis and thus threaten the stability of the entire financial system. In general, insolvent banks should be allowed to fail. Competition is distorted by policies that prevent banks from exiting from the marketplace in the normal manner. Policies that seek to prevent bank failures m ay also deter entry into the industry. Competition is further distorted when the statutory powers of the state is used to assist a failing bank, which may constitute a form of "state aid" (OECD 1998a). Thus, the IMF had been pushing for greater powers forthe BSP and the PDIC in dealing with problematic banks. In should also be noted that losses due to its bail-out of troubled banks in the 1980s partly caused the collapse of the Central Bank of the Philippines, which required its rehabilitation in 1993.

4. Mergers and acquisitions: In addition to their potential impact on market power, potential effects on competition and efficiency need to be clearly identified and considered. It needs to be pointed out that not all mergers and acquisitions are healthy for the economy. They could also lead to some problems especially if they are regulation-driven, such as using capitalization requirements to drive consolidation. For instance, one problem of increasing capital through mergers and acquisitions is the potential additional risks in credit. Combining banking with nontraditional activities, such as insurance[15], may also extend the financial safety net. There should be a thorough evaluation of the potential effects of consolidation. This would include both direct effects (e.g., increased market power and/or improved firm efficiency) and indirect effects (e.g., reduction in the availability of financial services to small customers). There are also potential systemic consequences, such as changes in the efficiency of the payments system and the safety and soundness of the financial system (Berger *et al* 1998). On the other hand, the Philippine commercial banking sector has been found to still exhibit economies of scale in the 1990s (Okuda 1999). Thus, it stands to benefit from more consolidation, particularly among the smaller sized banks.

B. Insurance sector

It was noted earlier that the reform and deregulatory process in the insurance industry is still in the initial stages and more needs to be done. As such, it can learn a lot from the way competition policy has been implanted in the banking sector. One key lesson is the importance of policy consistency. An essential policy reform in the banking sector, which occurred rather belatedly, was the deregulation of entry. In contrast, this was the first major reform in the insurance industry. However, it should be noted that the easing of entry restrictions in the banking sector was also preceded by other deregulatory measures, such as those on pricing and range of operations. In addition, proper safeguards were instituted, including the buildup of regulatory capacity. Given the complementary nature of these reforms, the full benefits of financial liberalization could have been realized sooner had their implementation been properly paced, if not simultaneous. But one benefit of the delay in liberalization of entry was that it gave the regulatory and supervisory body ample time to also evolve. Thus, as in the banking sector, adequate prudential and regulatory provisions should be established to ensure the soundness of the insurance industry and the protection of consumers, together with a regulatory and supervisory body that is capable of carrying out these tasks. The strengthening of the regulatory and supervisory framework should be in parallel with other market-oriented reforms, particularly competition and liberalization measures, to improve the efficiency of the insurance industry (Kawai 1997).

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[15] That is, "bancassurance", which is the merging of bank products with insurance products. An example would be BPI and the Ayala group of insurance companies.

Another important issue that needs to be addressed with respect to the regulatory and supervisory framework is the lack of consistent regulation. In particular, the regulation of the pre-need industry should be harmonized with the regulation of the private insurance industry (World Bank 1992). Furthermore, regulatory and supervisory authorities need to ensure that state-owned companies and private firms are treated equally. That is, regulations should ensure fair treatment among the different insurers operating in the same areas (competitive neutrality). At the same time, the importance of having different regulations applying to different sectors (e.g., life and nonlife insurance) must also be recognized. Each of these sectors operates under its own constraints and requires specific management and regulatory structures (OECD 1997).

Other fundamental aspects of insurance regulation and supervision that need to be addressed to enhance competition and efficiency include:

1. Investments: Regulations governing the management of assets are typically based on a list of admissible investments. Governing principles include those on diversification, spread and liquidity; localization; currency matching; and maturity matching. Over-regulation should be avoided. The insurance regulatory framework must encourage stability, while maintaining the necessary flexibility to meet developments in the market (OECD 1997).
2. Liberalization and competition: A program of removing monopolies and privatizing state-owned companies should be seriously considered. Considering the size of the public sector relative to the private insurance industry, efforts to improve the competitiveness and efficiency of the latter could be hindered unless similar efforts are undertaken by government owned insurance corporations.
3. Distribution and management of insurance products: The emergence of new insurance companies and products necessitates the development of modern distribution networks, with the possibility of an adequate combination of several types of intermediaries (insurance company staff, agents, brokers, direct sales, etc.) (OECD 1997). In the Philippines, life insurance is almost exclusively sold through agents, while a mixture of agents and brokers sells nonlife insurance. Thus, the focus is on the licensing of agents, while little attention is given to the effectiveness of the agency management processes within the industry. But the structural inefficiencies of such a distribution network hamper the industry's potential for growth, and unduly involves the regulatory body in the management of the network. Thus, the development of more effective networks is necessary. In other countries, agents are a less important channel of distribution, while other channels are relatively well developed such as banks (World Bank 1992).

   The current limit on a universal bank's equity investment in an insurance company is 51 percent. Increasing bank ownership of insurance companies may help to improve the capitalization of the insurance industry and thus the capacity to grow without further reliance on overseas capital. But the issue then becomes the effective supervision of both the banking and insurance sectors, and requisite coordination and cooperation between their respective regulatory bodies.
4. Taxation: This is a key issue in any discussion of the insurance industry's growth and development. Taxes imposed on the insurance industry have been described as onerous. They are also not uniformly applied (World Bank 1992). There are current proposals to amend the tax structure by simplifying it, lowering the rates and leveling the playing field.

C. Regulatory framework

Identifying the appropriate level and form of intervention is a serious challenge to government. Regulatory efficiency factors in overall economic performance. Inefficiency results in costs to the community through higher taxes and charges, poor service, uncompetitive pricing, or slower economic growth. In order to control costs and ensure effectiveness, regulation has to be placed within a consistent framework. To do this, it is necessary to establish clearly what needs to be regulated and why, as well as to define the principles for effective and efficient regulation (Wallis *et al* 1997). A corollary to this would be the identification of the appropriate regulatory structure. The development of a national competition policy is a necessary and useful step in this direction, and enhancing the role of competition in regulation may be one guiding principle.

In the financial sector, there are two aspects pertaining to regulatory framework that need to be considered. First is the appropriate regulatory framework for the whole financial sector. Second is how a national competition policy framework should apply to the financial sector.

In addition to economies of scale, Philippine commercial banks were also found to exhibit economies of scope (Okuda 1999). As such, they could achieve more efficient production if they broadened the scope of their operations. The current regulatory framework is supportive of such move towards diversification, given that line-of-business restrictions have been eased under the new General Banking Law. Cross-sectoral ownership restrictions have likewise been relaxed. The interlocked structure of the Philippine financial sector could further diminish the effectiveness of such restrictions. Convergence or consolidation among financial institutions, overlapping of functions, and blurring of product boundaries (e.g., between banks and insurance companies; cross-selling) would necessarily have an impact on the effectiveness and efficiency of regulation. Furthermore, new technology has allowed the unbundling and repackaging of individual products in a various ways. This makes it easier to circumvent regulations that prohibit an activity through product innovation to produce a close substitute (Herring and Santomero 1995). Thus, an important issue that needs to be considered is the competition effects of regulations affecting banks and insurance companies separately, for instance, within financial conglomerates.

The different standards of regulation and supervision of financial institutions by the various government agencies have become more problematic recently. There have been some efforts to harmonize regulations, such as the SEC's attempts to coordinate more with the Insurance Commission and the BSP to improve the regulation of pre-need firms and investment houses under its jurisdiction, respectively. But a more wholistic and formalized approach is warranted. The regulatory approach governing line-of-business restrictions in the Philippines is the "conglomerate" approach. The formation of cross-sector financial conglomerates (through the use of subsidiaries or holding companies) is allowed but there exist separate regulatory regimes for the traditional categories of financial sector institutions, including banks, securities firms and insurance companies. It is worth considering whether this approach needs to be supplanted by a "coordinated" approach[16]. That is, the separate regulatory regimes for the parts of the conglomerate would still exist, but they are combined with regulatory and supervisory practices that explicitly take into account the conglomerate nature of the regulated institution (OECD 1998b). The latter would ensure consistency of regulation and prevent regulatory avoidance or arbitrage. Tan (2000) goes further and suggests that, for efficiency and streamlining of regulation, an Omnibus Act for all financial institutions may be the inevitable way forward.

[16] A third approach is the "pillars" approach, wherein separate regulatory regimes for the major traditional categories of financial sector institutions exist, and line-of-business and ownership restrictions prevent these "pillars" from competing in each others' markets (OECD 1998b).

Consolidating existing supervisory roles, regulatory structures, and financial services legislation is deemed to be more cost effective and efficient. Both accord with the view that the complexity of financial products and markets, their intrinsic risks, and the detailed knowledge required to deliver efficient regulation in this sector argue strongly for continued specialized regulatory arrangements in the financial sector. In which case, a separate regulatory agency (or agencies) to conduct such specialized regulation is also still necessary (Wallis *et al* 1997).

Under the New Central Bank Act, the BSP has to some extent become the de facto "super-regulator" of the financial system, with its authority to supervise and examine banks' subsidiaries and affiliates engaged in allied activities (Sec. 25). The Act also gave the Monetary Board considerable leeway in defining a bank affiliate. Furthermore, the General Banking Law allowed the Monetary Board to examine any enterprise that is wholly or majority owned or controlled by a bank (Sec. 7), and to define the term "related interests" (Sec. 36). Finally, Section 38 of the New Central Bank Act allows the Monetary Board to "… determine and provide for such operating departments and other offices, including a public information office, of the *Bangko Sentral* as it deems convenient for the proper and efficient conduct of the operations and the accomplishments of the objectives of the *Bangko Sentral*". This provision then allows the BSP to set up the necessary structure to put into operation the provisions relating to its supervision of financial conglomerates.

One advantage of the above option is that the BSP is a relatively more experienced regulator in the financial sector, especially in a deregulated environment. It could then set the standard for the other regulators in the sector. But the setup could also lead to duplication of functions, which could result in conflicts with other regulatory agencies. Thus, complementary arrangements in the other regulatory agencies are also called for in order to minimize duplications as well as oversights, and to maximize coordination efforts. Such coordinated approach would entail institutional capacity building for all regulators, and not just the BSP. Otherwise, the BSP might become overstretched in fulfilling its supervisory functions over other financial institutions for which it does not have the expertise. A related point to consider here would be whether the BSP's regulatory and supervisory functions need to be separated from its monetary functions. But one problem with this option is that it is limited to financial institutions linked to banks, and preserves the centrality of banks in the system. The requisite buildup of other regulatory agencies would presumably translate to better supervision and regulation of the other financial institutions under their separate jurisdictions. But ultimately, what is needed is a broader perspective in the supervision and regulation, as well as the strengthening and development of the different sectors of the Philippine financial system. The BSP alone is not equipped to efficiently and flexibly address these tasks because its primary operational relationships are with banks, and its operational skills and culture have long been focused on banking.

The second aspect with regard to the regulatory framework is how a national competition policy framework should apply to the financial sector. Clearly, there are specific financial market characteristics and issues that may complicate the application of general competition principles to the financial sector, and which therefore need to be taken into consideration. But almost all OECD countries, for instance, apply their national competition law to the banking sector without exception. Most enforce the competition law through the competition authority, although a few do so through the banking regulator. Major structural changes in the banking sector, particularly mergers and acquisitions, also fall under the jurisdiction of both the banking regulators and the competition authority, thus necessitating some mechanism for resolving possibly conflicting regulatory decisions (OECD 1998a). Grimes (1999) likewise argued that the general competition principles identified by the Pacific Economic Co-operation Council (PECC) to guide the development of an international competition policy framework, and are intended to provide a

framework for all industries as well as investment and cross-border transactions, should apply to financial institutions with just some clarifications.

Similar to the regulation of all goods and services markets, financial system regulation may be classified into three: general market regulation, regulation for (financial) safety, and regulation for social purposes (Wallis *et al* 1997). General market regulation aims to ensure that markets work efficiently and competitively. It includes conduct and disclosure regulation to prevent fraud and prohibit anti-competitive behavior; ensure market integrity (i.e., that participants act with integrity to promote confidence in the efficiency and fairness of markets) and consumer protection (i.e., that retail consumers have adequate information to facilitate informed judgments, are treated fairly and have adequate avenues for redress); and promote the overall competitiveness of markets. Wallis *et al* (1997) argued for specialized regulation in the areas of financial market integrity and consumer protection. But they also argued that the case for specialized arrangements in the area of competition regulation is relatively weak. Although financial products are complex and any assessment of competition would require detailed analyses of markets, the key features relevant to competition assessment in this sector are not unique. Thus, the application of an economy wide competition regulation to the financial sector would ensure greater regulatory consistency and efficiency.

But it is also recognized that the market mechanism is restricted by the nature and structure of the market itself, which in turn would necessitate some regulatory intervention to achieve welfare enhancing outcomes. Thus, there is also regulation for financial safety, particularly in the form of prudential regulations to ensure soundness and stability. But again, prudential regulation lessens competitive pressure and imposes efficiency costs. In the case of the Philippines, there has been a tendency towards increasing and tightening prudential regulation, which reflects the BSP's bias for soundness and stability. Thus, a better balance between the twin objectives of soundness/stability and competitiveness/efficiency needs to be achieved. One benefit of having a national competition policy/law administered by a separate agency is that it could serve to complement, even check the BSP by specifically focusing on competitiveness and efficiency. Some mechanism for resolving any conflict in regulatory decisions would also be needed.

With respect to regulation for social purposes, requiring banks to service certain activities or sectors compromises their efficiency. Even if it is deemed worthwhile to purposely restrict competition to pursue wider equity objectives, a national competition policy can then require the government to justify its interventions and restrictions in the market. That is, another aspect of competition policy would be to make such government interventions and restrictions transparent, and open to public scrutiny and assessment of their effectiveness at achieving distributional and other objectives (Cabalu *et al* 1999).

V. Some Conclusions

Financial reforms implemented in the Philippines from the 1980s to the 1990s have been fairly extensive and intensive, particularly in the banking sector. But the reform process is not yet complete, both in the banking sector but more so in the other sectors of the Philippine financial system. Overall, despite the difficulties in its implementation, financial liberalization per se is still a valid concept for efficiency enhancement. It is in the implementation that the liberalization process is often compromised, particularly the nonmarket approach and ineffective supervision (Tan 2000). The East Asian crisis once again highlighted the dangers of a bank-dominated financial system. Thus, there is a need to improve the competitiveness of other financial institutions to provide savers and borrowers with alternatives. For instance, the insurance

industry has a potentially more important role to play in this regard. Thus, the scope of competition policy must be widened to include the other sectors of the Philippine financial system. An appraisal of existing regulations in the other sectors would also be very instructive.

The discussion especially highlighted the role of government in promoting a stable and efficient financial system in terms of the regulatory framework. But the most important contribution that the government can probably make to promote the development of the financial system is to provide a stable and consistent macroeconomic environment (Herring and Santomero 1995). Financial stability is simply not feasible without it. On the other hand, confidence in a country's financial system is also critical to macroeconomic stability. But as the Asian crisis demonstrated, unanticipated shocks do occur even in a stable macroeconomic environment. Thus, it is also important for the government to nurture a resilient financial structure that is capable of withstanding financial market volatilities, and that does not amplify the shocks to the real economy. In the more deregulated and globalized environment, a static and dynamically efficient financial structure coupled with effective regulation becomes imperative to enable the real economy to succeed in the global marketplace (Herring and Santomero 1995).

Some problems continue to exist and persist in the Philippine financial system. However, that does not mean that all of them are directly rooted in the financial system. Financial liberalization does not take place in a vacuum, and it must be coordinated with real sector policies. Ultimately, the performance of the financial sector reflects that of the real sector, and even the best financial institutions will encounter problems if real sector distortions persist. As long as there are market imperfections in the real sector, financial deregulation is not likely to develop a competitive market structure in the financial system (Park 1991). This underscores the importance of developing a national competition policy for the Philippines.

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