SUMMARY SECTOR ASSESSMENT: FINANCE

Sector Road Map

1. Sector Performance, Problems, and Opportunities

1. The Philippine economy and finance sector have outperformed many regional peers since the onset of the 2008 global financial crisis. Economic growth has been impressive, strong inflows have produced a sustained current account surplus, and public debt has continued to decline leading to an upgrade in the country's credit rating to investment grade. However, underlying inefficiencies arising out of structural impediments remain. While the Philippines enjoys an investment-grade rating, its finance sector has more in common with countries exhibiting a sub-investment grade rating. Despite recent progress, inadequate development of the nonbank finance sector has long constrained intermediation between savers and investors.[1] Moreover, a chronic lack of long-term finance has contributed to pronounced infrastructure bottlenecks and further exacerbated the drag on economic growth and development. As a result, the government has been unable to meet its key commitments under the Philippine Development Plan, 2011–2016 in terms of growth and poverty reduction.[2]

2. **The banking sector is concentrated yet provides limited intermediation.** As of 30 June 2014, the Philippine banking sector accounted for 79% of total financial system assets. While the banking sector exhibits strong capital and earnings, it provides limited intermediation to the economy.[3] Bank credit to gross domestic product (GDP) is 51%, the fifth highest in Southeast Asia, but it exceeds only that of far less-developed countries including Cambodia, Brunei Darussalam, Myanmar, and the Lao People's Democratic Republic.[4] Utilizing extensive and unmatched distribution networks, banks have amassed a sizable base of short-term deposits which are, by definition, unsuitable for supporting long-term financing. Further, loan portfolios are concentrated as banks tend to invest in a small number of top-tier listed companies, including peers and affiliated organizations.[5] Risks are amplified as these conglomerates follow broadly similar business models and the central bank has selectively relaxed the single borrower's limit.[6] In response, the International Monetary Fund (IMF) expressed continuing concern regarding the sector's increasing exposure to real estate and large exposures to individual borrowers.[7]

3. **The bond market requires fundamental reforms.** The capital markets and, in particular, bond markets can provide a viable and well-suited alternative to finance long-term investment. While recent growth rates have been encouraging, development of the Philippine debt markets still lags relative to the region. As of 31 December 2014, the Philippines local currency debt market represented 37% of GDP. Many of its more advanced regional peers have local currency

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1 Through 31 December 2013, the Philippines local currency bond market registered some of the fastest growth rates in emerging East Asia. Through the third quarter of 2014, growth had slowed throughout emerging East Asia but the Philippines still registered respectable quarter-on-quarter growth (2.3%) and year-on-year growth (6.7%).

2 These strategies include attaining high, sustained economic growth through, among others, a stable macroeconomic environment coupled with investments in infrastructure.

3 Bangko Sentral ng Pilipinas. Status Report on the Philippine Financial System. First Semester 2014.

4 Asian Development Bank (ADB). 2013. *Key Indicators for Asia and the Pacific*. Manila.

5 The International Monetary Fund (IMF) estimates that the average leverage ratio of listed companies was 100% in 2012, but that this leverage is not evenly distributed, with firms with leverage ratios greater than 200% accounting for one-third of all corporate debt.

6 The exemption for oil purchases recently lapsed and the Bangko Sentral ng Pilipinas added provisions that now include affiliates in the single borrower's limit restrictions. The exemption for public–private partnerships will be allowed to lapse in 2016.

7 IMF. 2014 Article 4 Consultation. *IMF Country Report No. 14/245*.

debt markets that exceed 70% of GDP; local currency corporate debt markets are 3–8 times that of the Philippines. Liquidity in the government bond market, which is the fundamental foundation on which wider capital market development is built, is far below what would be expected in a country with an investment-grade credit rating. While the turnover ratio for government bonds is roughly in line with regional peers, the average bid–ask spreads for "on-the-run" securities is higher than all regional peers except for Viet Nam and Indonesia. As such, reforms will need to encompass a variety of technical issues but fundamentally the government needs to encourage higher levels of trading to increase market depth, liquidity, and transparency.

4. Through their primary issuance of government bonds and support to efficient secondary trading, governments provide the essential price discovery, and associated yield curve, which is necessary to price private sector debt. In addition, the technical skills developed in the government bond market are a necessary precondition for a deep and diversified corporate bond market. To date, development of the government bond market has been restrained by the absence of a short-term money market and a framework to facilitate arbitrage. The government does not have a robust cash management system which would support the issuance of short-term bills. In addition, market fragmentation has depressed trading levels. More needs to be done to focus activity in a limited number of identified benchmark issues to achieve a critical mass of trading volume.[8] Currently, reliance on low-volume bellwether issues produces a low confidence yield curve that does not align with market-oriented actual prices. Compounding this problem is the fact that the market suffers from a bifurcation between taxable and nontaxable investors, as the application of disparate tax rates and a unique use of yield instead of price as a basis for market transactions has rendered trading between the two universes uneconomical.[9]

5. In addition, the number of primary dealers is too high and participants are not held to minimum obligations of participation in primary actions and secondary market making. Primary dealers lack the inventory management tools, such as repos and interest rate derivatives, necessary to make two-way markets. The inability of dealers to "short" bonds to offset long positions is considered a major impediment. For example, the Master Repurchase Agreement employed by the Philippine Dealing and Exchange Corporation is essentially a secured financing transaction, which does not support reuse of collateral, and as such attracts a documentary stamp tax.[10] Trading costs, which emanate largely from the usual retirement to map over-the-counter trades across an exchange, are arguably among the highest in the region.

6. **Cultivating a domestic investor base.** The Philippine insurance sector represents an engine of demand for capital market products and, in particular, long-tenor instruments. Whole life policies still represent a significant proportion of premium income and new policies. Further, growth trends are positive as the coverage ratio has increased to 24%, which represents an increase of one-third over 2011, and insurance density has doubled to P1,592 in 2012 from P859 in 2008. However, the sector remains small as insurance premiums were only 1.45% of GDP in 2011 and have shown nominal growth over the past several years. The development of the insurance sector has been constrained by financial literacy issues as well as restrictive investment guidelines coupled with narrow distribution channels.[11] Corporate and project bonds represent an especially challenging alternative given the lack of reliable national credit rating agencies (required by the Insurance Code) and the limited capacity of the Office of the Insurance

[8] Currently, only the 10- and 20-year benchmarks have achieved sufficient size to serve as reliable benchmarks.
[9] Currently, public pension funds hold approximately 12% of all government bonds outstanding.
[10] Likewise, the government has not established a framework to encourage the development of borrowing and lending of fixed-income securities.
[11] Diversification of investments is further hampered by the practice of requesting authorization for investments, on an instrument-by-instrument basis, from the Insurance Commissioner.

Commissioner (OIC) to review these options for suitability. There are also restrictions on expanding the range of insurance providers. Micro insurers cannot offer nonlife products. The nonlife sector, unlike the life sector, is inefficient as the nonlife market is dominated by a large number of small locally owned insurance companies. Tax distortions also hamper development as premium taxes in the nonlife sector are among the highest in the region.

7. **Diversity of participants is required.** To ensure an ample supply of long-term funding and to encourage higher levels of trading, the finance sector needs a greater diversity of participants with opposing business models. Over time, restrictions on the foreign ownership of domestic financial institutions have led to the development of a "one-way" market, wherein the vast majority of participants practice buy-and-hold strategies. As a result, those seeking transactions for hedging would be unlikely to find speculators willing to serve as a counterparty at reasonable cost. In addition, the lack of alternative business models and institutions has limited the development of more sophisticated business and trading strategies that are common to more developed markets.

2. Government's Sector Strategy

8. Finance sector development is a key part of the Philippine Development Plan. The strong reform agenda developed by the government has been further demonstrated by the appointment of reform champions in key positions in the Securities and Exchange Corporation, OIC, and the Bureau of the Treasury. To improve public financial management, the government launched a comprehensive public program with the adoption of the Philippine Public Financial Management Roadmap. This road map provides a whole-of-government approach that proposes to strengthen the financial management process and related information systems.[12] A key phase of this reform program focuses on the formation and effective operation of a Treasury Single Account to facilitate more efficient, cost-effective, and transparent management of the government's cash balances, and to encourage the development of a short-term money market.[13]

9. Within this framework, the government has adopted a revised and updated Capital Market Blueprint covering 2011–2016. Key reforms will focus on (i) promoting savings generation at the regional level but institutionalizing deployment of resources at the national level, and (ii) developing an enabling environment for long-term investments.[14] Initiatives have been identified to increase liquidity in the government bond market by rationalizing the primary dealer system, reducing fragmentation of issuances, and harmonizing pricing between participants. In addition, the government will launch an interdealer repo market with a master agreement, and introduce securities lending. Issuance of corporate debt will be encouraged by streamlining the shelf registration process and authorizing securitizations and exchange-traded funds. To provide for the necessary risk management, initiatives will be encouraged to build hedge protection markets. Capacity development will be provided to the regulatory agencies.

10. Savers will be provided the opportunity to become investors through an enabling environment that includes wider investment alternatives, appropriate prudential guidelines, infrastructure support, and a national financial education program. Efforts will focus on broadening the mix of collective investment schemes to provide additional alternatives for lower- and middle-income investors. Similarly, the Personal Equity Retirement Account will be launched

[12] This initiative is supported by the Philippines–Australia Public Financial Management Program. Australia, through its international aid program, has committed A$30 million to the program over 5 years.

[13] The creation of a Treasury Single Account is supported by Executive Order 55 issued in September 2011.

[14] Additional objectives include strengthening the governance framework of the financial system in line with international standards, and establishing a strong legal framework for finance sector development.

to provide a tax-deferred retirement savings vehicle for small savers. Real estate investment trusts, which are already authorized in law, will enable small investors to participate in large-scale commercial projects. Finally, efforts to neutralize and equalize taxation of financial products and services provide a crosscutting theme to all of the initiatives within the blueprint.

11. Efforts to enlarge, deepen, and diversify domestic financial markets will be supported through faster integration of the financial system into the Association of South East Asian Nations (ASEAN). Increased exposure to Asian financial markets can also encourage the rapid growth of the country's economy by increasing competition, diversifying participants and business models, and introducing new skill sets and avenues of financing. The Securities and Exchange Commission (SEC) is an active member of the ASEAN Capital Market Forum, which is part of the ASEAN Finance Ministers Meeting process.[15] Work is also progressing to promote credit rating comparability between domestic and international credit rating agencies. However, a fundamental barrier to participation in cross-border offerings of securities (multiple and secondary listings) and mutual funds is the Philippines' position in the International Organization of Securities Commission (IOSCO). The Philippines is the only country among the so-called ASEAN 6 that has not signed the Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information (Annex A).[16]

3. ADB Sector Experience and Assistance Program

12. The Asian Development Bank (ADB) has supported reforms in the finance sector with four program loans and technical assistance. Internal assessments have validated the importance of finance sector development,[17] while a recent program completion report covering the Financial Market Regulation and Intermediation Program cluster described the program's outcome as *successful* and provided useful lessons.[18] Subsequent technical assistance focused on identifying constraints on the corporate debt market, strengthening the capacity of the SEC, and developing a tax-deferred savings plan.[19] More recently, a collaborative effort between ADB, the International Monetary Fund (IMF), United States (US) Treasury, and the World Bank provided a highly focused diagnostic on constraints on developing the government bond market. The resultant action plan is being supported by ADB and the US Treasury through its resident advisor program.[20] Complementary support is being provided to support ASEAN integration[21] and to assist the OIC in implementing the revised insurance law.[22] To reduce vulnerabilities to natural disasters, foster financial inclusion, and increase the resiliency of the poor, ADB is also providing support to introduce earthquake insurance[23] in the Philippines and to foster the development of micro insurance.[24]

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[15] The Philippines is part of the ASEAN Corporate Governance Scorecard and the Working Group on Cross-Border Dispute Resolution and Enforcement Mechanism.

[16] Indonesia, Malaysia, Philippines, Singapore, Thailand and Viet Nam.

[17] ADB. 2008. *Philippines Country Assistance Program Evaluation: Increasing Strategic Focus for Better Results.* Manila.

[18] ADB. 2013. *Completion Report - Financial Market Regulation and Intermediation Program.* Manila.

[19] ADB. 2011. *Technical Assistance to the Republic of the Philippines for Capacity Development of Financial Regulators*. Manila.

[20] ADB. 2013. *Technical Assistance to the Republic of the Philippines for Strengthening Treasury's Liquidity Management*. Manila; and ADB. 2014. *Technical Assistance to the Republic of the Philippines for Strengthening Treasury Operations and Capital Market Reform*. Manila.

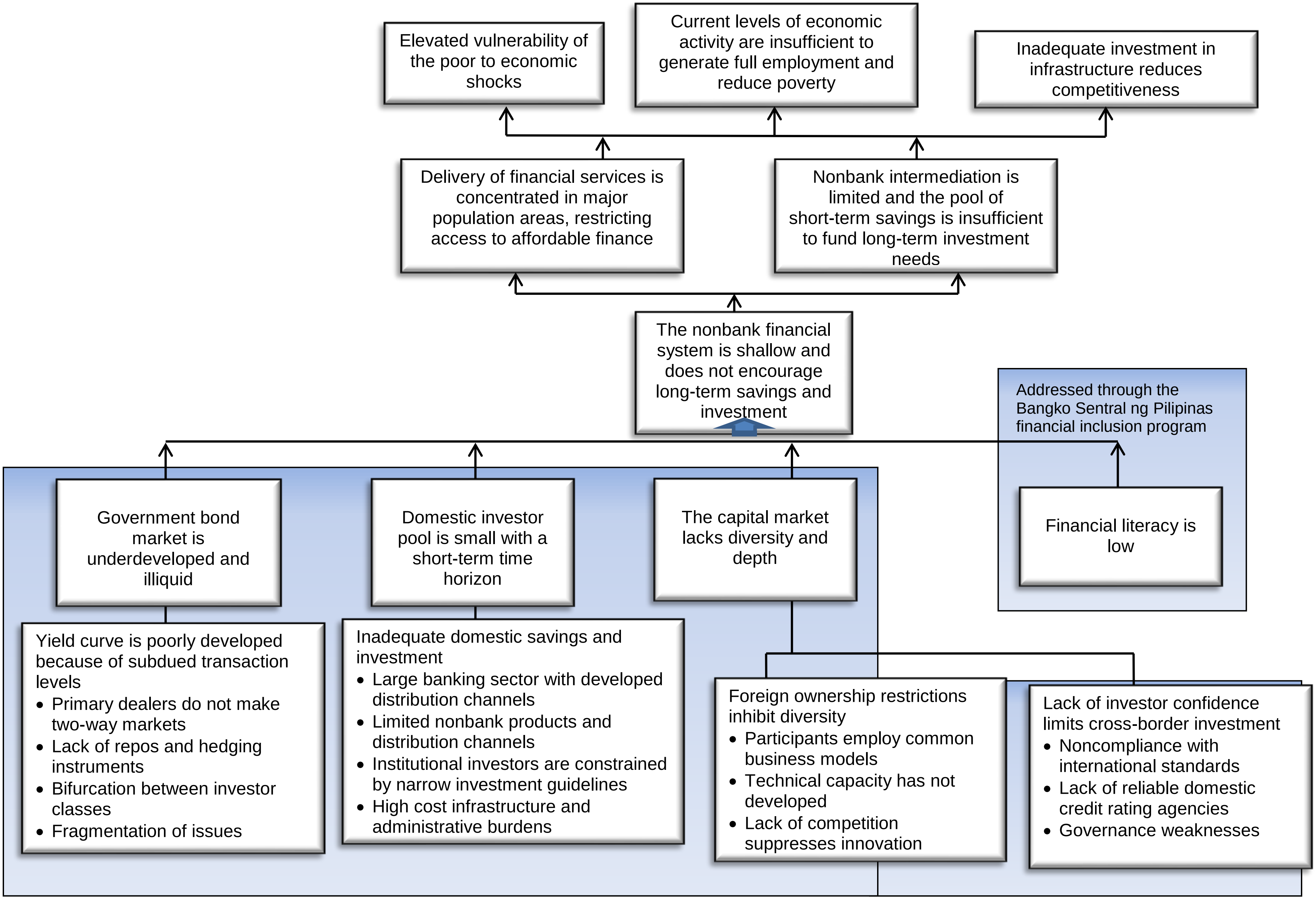
[21] ADB 2010. *Regional Technical Assistance Promoting an Interlinked ASEAN Capital Market.* Manila (TA 7576).

[22] ADB. 2013. *Technical Assistance for Capacity Development to Support Regulation and Oversight at the Insurance Commission.* Manila.

[23] ADB. 2012. *Technical Assistance for Structuring a Public–Private Earthquake Pool in the Philippines*. Manila.

[24] ADB. 2012. *Technical Assistance to the Philippines for Capacity Building for Microinsurance.* Manila (JFPR TA 8258).

PROBLEM TREE FOR FINANCE SECTOR



Country Sector Outcomes		Country Sector Outputs		ADB Sector Operations	
Sector Outcomes with ADB Contribution	**Indicators with Targets and Baselines**	**Sector Outputs with ADB Contribution**	**Indicators with Incremental Targets**	**Planned and Ongoing ADB Interventions**	**Main Outputs Expected from ADB Interventions**
A deeper, more diversified, and resilient nonbank finance sector Increased and sustainable access by poor and low-income households to micro insurance services	Share of nonbank finance sector assets to exceed 30% by 2016 Current values (BSP): 2011: 20.76%; 2012: 23.00% Investment ratio at 22% of GDP by 2015 (baseline: 15.0% in 2009) Current values: 2011: 19.1% 2012: 19.7% M2-to-GDP ratio above 55.0% (baseline: 51.0% in 2009). Current values: 2011: 59.8% 2012: no data % of population with private life-insurance policy Current values: 2011: no data 2012: no data Increased number of poor and low-income households covered by micro insurance products. Current value (SER, NEDA) 2011: no data 2012: 7 million	Comprehensive, coordinated, and widely supported capital market development plan implemented Enabling policy and regulatory environment created Investor confidence strengthened Institutional demand increased Increased financial literacy and capacity of poor and low-income households to utilize lending and insurance products Sustainable micro insurance system based on market principles	Level of outstanding debt securities as % of GDP and frequency of turnover Current values: 2011: no data 2012: no data Number of issues of debt and equity securities Current values: 2011: no data 2012: no data SEC and IC achieve administrative and fiscal autonomy Number of PERA accounts Current values: 2011: no data 2012: no data Number of institutions providing micro insurance products. Current values (SER), NEDA): 2011: 2012: 42	**Pipeline projects** Deepening Intermediation through Nonbank and Treasury Reforms Program (2014: Firm. $300 million, $500,000 PPTA) CDTA: Strengthening Treasury Operations and Capital Market Reform (2014: $0.5 million). **Ongoing projects** Financial Market Regulation and Intermediation Program (2010: $200 million) CDTA: Capacity Development of Financial Regulators (2011: $1.0 million) CDTA: Capacity Building for Micro Insurance in the Philippines (2012: $1.0 million) S-TA: Strengthening Treasury's Liquidity Management (2013: $0.210 million)	**Pipeline projects** Capital market development, nonbank finance sector reforms, strengthened supervision and enhanced treasury operations **Ongoing projects** Capital market development, market functions, and supervision/regulation particularly in nonbank sector Advice on regulatory environment for micro insurance Capacity development for Bureau of Treasury and preliminary technical advice to support the development of a primary dealer system and Treasury single account.

ADB = Asian Development Bank, BSP = Bangko Sentral ng Pilipinas, CDTA = capacity development technical assistance, GDP = gross domestic product, M2 = broad money, IC = Insurance Commission, NEDA = National Economic Development Authority, PERA = Personal Equity Retirement Account, PPTA = project preparatory technical assistance, SEC = Securities and Exchange Commission, SER = socio economic report, S-TA = small scale technical assistance.
Source: Asian Development Bank.