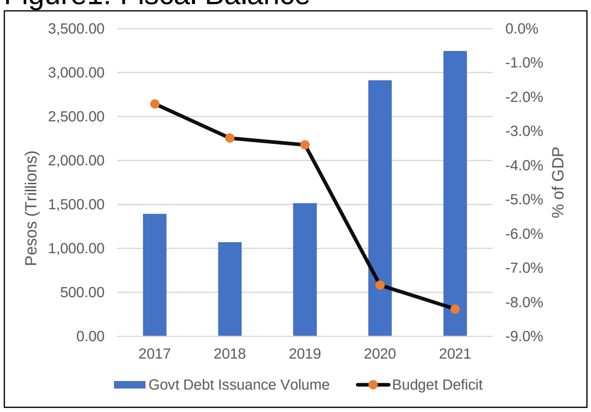
SECTOR ASSESSMENT (SUMMARY): FINANCE

A. Sector Road Map

1. Sector Performance, Problems, and Opportunities

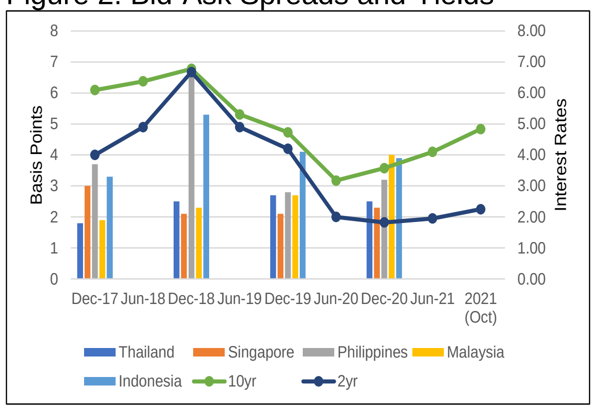
1. The Philippine economy outperformed many regional peers since the onset of the 2008 global financial crisis. During 2008–2017, gross domestic product (GDP) growth averaged 5.7%; it rose to 6.6% per annum during 2015–2019, with recent strength attributable to the government's signature "Build-Build-Build" infrastructure program.[1] However, the onset of the coronavirus disease (COVID-19) pandemic in 2020 drove the economy into recession. GDP contracted by 9.5% in 2020, reversing past progress in reducing unemployment and poverty. Growth recovered to 5.7% in 2021 and is expected to increase to 6.0% in 2022.[2] As the pandemic unfolded, fiscal revenues contracted, and expenditures ballooned due to the urgent need to provide medical support in response to the pandemic, as well as the necessary social support measures. The budget deficit swelled to 7.6% of GDP in 2020, reaching 8.6% in 2021 despite the recovery, and is expected to remain elevated at 7.7% of GDP in 2022.

Figure1: Fiscal Balance



GDP = gross domestic product
Source: Asiabondsonline, Philippine Statistics Authority

Figure 2: Bid-Ask Spreads and Yields



Source: Asiabondsonline

2. Since 2015, the Asian Development Bank (ADB) and its development partners, including the International Monetary Fund and the United States Treasury, have engaged with the government to support of capital market development. Starting with a focused plan to strengthen the government bond market, initiatives have been completed to improve its liquidity, transparency, and operation. Reforms include the replacement of the aging scripless registry with a web-based, vender-supplied system; conversion of the high-cost trading system to Bloomberg's e-bond; and the adoption of a reliable pricing mechanism. Through these efforts the absorptive capacity of the market has been increased, supporting a doubling of issuance volume to about ₱3 trillion in both 2020 and 2021 (Figure 1). In effect, the government bond market has been able to fund the increased expenditures (including infrastructure) and deficits, with limited impact on market liquidity and costs (Figure 2).[3] Both short-term (2-year) and long-term (10-year) bond yields have remained relatively stable, increasing only in tandem with other Association of

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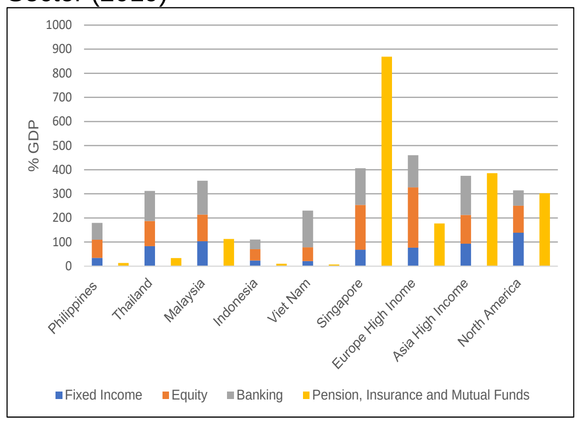
[1] Government of the Philippines. 2018. *'Build, Build, Build' Infrastructure Program*. Manila.
[2] Data provided by the Department of Finance and the National Economic Development Agency. The Asian Development Outlook estimates 2022 growth at 6.0% of GDP.
[3] ADB. 2021. *Asia Bond Monitor – September*. Manila.

Southeast Asian Nations member states due to emerging inflation expectations. However, all segments of the Philippines' capital market are small and underdeveloped, which limits credit availability, COVID-19 recovery efforts, and economic growth.

3. **Banking Sector.** The banking subsector represents the largest component of the capital market but provides limited intermediation (Figure 3). Structural issues, such as the preponderance of services, means the economy may not have the same need for credit as its peers. Nevertheless, credit is not widely available and represented only 44.3% of GDP (2017) as compared to Malaysia (116.4%), Singapore (127.8%), and Thailand (160.7%). Small businesses and the agriculture sector face challenges in borrowing. While mandated by law, aggregate credit to micro, small and medium-size enterprises (MSMEs) represented only 6.6% of gross loans as of July 2021. Moreover, credit conditions have tightened during the pandemic, with 71% of MSMEs facing difficulty raising small amounts of funds (₱50,000) quickly despite needing up to ₱10 million ($200,000) to survive.[4] Banks have become risk adverse as distressed assets are approaching 8% of gross loans, a level not seen since the Asian financial crisis.[5]

Figure 3: Composition and Size of the Finance Sector (2019)



GDP = gross domestic product
Source: World Bank

4. **Government bond market.** The government bond market is providing the necessary funding to the government and the pricing benchmarks needed by the private sector. Issuance volume has expanded significantly since the onset of the pandemic (Figure 1). During 2017–2019, the Bureau of the Treasury (BTr) issued an average of ₱1.3 trillion in government securities per year; this increased to ₱2.9 trillion in 2020, and ₱3.2 trillion in 2021. The size of the government bond market reached 41.8% of GDP in 2021, up from 26.3% as of the end of 2019.[6] While the rate of growth of Philippines government debt is one of the highest in the region (32.7% year-on-year through the 2nd quarter (Q2) of 2021, compared with 19.7% for Singapore and 11.5% for Malaysia) debt levels remain low, and well under the emerging East Asia average of 59.7% of GDP.[7] The government has also maintained a balance between longer and shorter-dated maturities, thereby limiting the possibility of debt distress. However, more needs to be done to facilitate more complex stages of development (e.g., sophisticated trading strategies and hedging instruments). To increase trading volumes and liquidity–which will provide more reliable price disclosure–the government must fully develop a culture of distributing its securities to the larger market through a small number of market-makers, who maintain firm and executable bid or ask prices on each issue.[8] In addition, the government should address the broader issue of financial inclusion through outreach to retail investors, which also diversifies its funding sources.

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[4] ADB. 2021. [COVID-19 Impact on Micro, Small, and Medium-Sized Enterprises under the Lockdown: Evidence from a Rapid Survey in the Philippines]. Manila.

[5] Distressed Assets refer to non-performing loans, repossessed real estate, and performing restructured loans.

[6] The Philippines Central Bank (Bangko Sentral ng Pilipinas) has established a bond buying program. Bond purchases represented 1.5% of GDP, or about ₱270 billion in 2020. Data for 2021 are not yet available.

[7] Peoples Republic of China, Hong Kong, China, Republic of Korea, Indonesia, Malaysia, Philippines, Singapore, Thailand and Viet Nam.

[8] In 2019, 71% of all trades occurred in 10 bonds that collectively represent 24% of the outstanding stock. Their average turnover ratio was 84%, compared to 28% for government securities as a whole.

5. **Corporate bonds.** Typically, the capital market would provide an alternative source of intermediation to those underserved by banks, but the corporate bond and equity markets, and more critically the contractual savings sector, have not developed in line with GDP growth. While growth has been accelerated, in part as a result of reforms described above (para. 2), the corporate bond market remains small and exclusive to a limited number of issuers. As of Q2 2021, corporate bonds had increased to 8.2% of GDP from 7.7% as of Q3 2019, well below the emerging East Asia average of 36.5%, and regional comparators Malaysia (55.4%) and Thailand (24.3%). Moreover, the top 30 corporate issuers accounted for 89.7% of the total corporate bond market, which is significantly more concentrated than Malaysia (55.4%), Thailand (24.3%), and Viet Nam (64.2%), despite the latter reporting a smaller bond market as compared to GDP. Growth is constrained by the preponderance of banks within conglomerates; liberal legal lending limits; high taxation and issuance costs, which are patterned off the rules for equity; and a focus on retail investors, which limits the development of an institutional investor base. To expand this sector, the government needs to deepen the institutional investor base, improve trading and post-trading infrastructure to reduce friction costs, streamline the bond issuance framework and differentiate it from equity, and rationalize the existing tax regime.

6. **Equity market.** The Philippine Stock Exchange remains small relative to GDP in terms of the number of listings, turnover, and concentration. Market capitalization was $312 billion, representing 93% of GDP in 2018. There were only 267 listed companies in 2018, an increase of just 10 companies since 2013. Given the corporate structure in the Philippines, recent listings have been too small to attract foreign institutional buyers. Retail participation is almost nonexistent. Legacy governance issues continue, and costs (e.g., initial public offering taxes and broker commissions) remain high. Friction costs were estimated at 77 basis points (bps) compared to 5 bps in Singapore and 21 bps in Thailand. Initial efforts to encourage growth should include improving investor confidence by enhancing supervision and enforcement, minimizing transaction taxes, and reducing fees and commissions.

7. **Contractual savings.** To fully develop the capital market, a domestic institutional investor base is required to boost demand, particularly for long-duration instruments such as those used to finance infrastructure, and to provide professional oversight of market activities on behalf of the investing public. However, the contractual savings sector—insurance, pensions and mutual funds—is too small to support capital market development. Insurance premiums represent only 1.33% of gross national income, one of the lowest levels in Southeast Asia, and assets held by the subsector represent only 8.0% of GDP, below that of Thailand (23.2%) and Malaysia (20.3%). Growth in the sector has been constrained by low levels of financial literacy, high costs, and legacy governance issues coupled with weak oversight. Industry estimates indicate that 20%–30% of the sector's overhead costs are due to complex and highly prescriptive insurance regulations, and extensive and duplicative reporting requirements. The Insurance Commission's independence should be strengthened, and the supervision function migrated away from compliance-based examinations. The sector's underlying legal and regulatory framework needs to be modernized, along with data submission and collection.

8. In the pension subsector, the Philippines has established the recommended three-tier pension structure; a means-tested old age pension administered by the Department of Social Welfare and Development (Pillar 1), government social pensions and mandatory corporate pensions (Pillar 2), and the voluntary Personal Equity and Retirement Account (PERA) (Pillar 3). Nevertheless, the Philippines received an overall grade of "D" from the Mercer CFA Institute Global Pension Index in both 2019 and 2020, meaning that despite having some desirable

features, the country's system has major weaknesses and/or omissions that must be addressed.[9] This low rating is due to a low basic social pension (Pillar 1), low overall coverage of the population, and low effective replacement rates (Pillar 2). In the Philippines, pension assets represent only about 4.0% of GDP, well below regional comparators Malaysia (60.0%), Singapore (32%), and Thailand (6.9%). High income countries in the Organization for Economic Co-operation and Development typically report pension assets in excess of 100% of GDP.[10] Pension systems, both public and private, face constraints to broadening the pool of contributors due to (i) the size of the informal sector and persistence of informal employment contracts; (ii) noncompliance, even in the formal sector; and (iii) the significant portion of the productive population that works overseas, who until recently did not have to contribute. Only about 38.4% of the economically active population contributes to a public pension scheme, while only 19.7% of the population aged 60 and above are benefiting from a public retirement scheme.[11] These issues are reflected in the limited scope and coverage of the minimum corporate pension as mandated under Republic Act No. 7641: a limited one-time lump-sum payment, lack of portability, and no requirement to prefund accrued pension liabilities. While public pensions provide relatively generous replacement rates (estimated at 30%–40%), corporate pensions provide a replacement rate of 50% for the average employee with 10-years of service, but for only 1 year. Moreover, stringent vesting requirements penalize youth, who typically change jobs frequently, and the lack of prefunding increases risks to employees in the event of bankruptcy.[12] Thus, despite its favorable structure, pension systems in the Philippines do not serve their intended objectives of smoothing consumption over an individual's lifetime, or channeling pension assets through the financial sector to support growth.

9. **Strategic direction and participation.** For many years, the government's capital market development plans were led by regulators with little input from the market, a process that produced limited tangible results. With ADB support the government launched the first government-led, multistakeholder-coordinated capital market development plan focused on the government bond market.[13] Results have been encouraging, and the World Bank noted that "the initiatives undertaken represent a prudent and well-structured approach towards developing capital markets which should be continued".[14] However, to accomplish this, the Capital Market Development Council needs legal standing, and both the council and the capital market development plan must be expanded to include the contractual savings sector. Moreover, laws and regulations need to be upgraded and implemented. In the short-term, the proposed Collective Investment Schemes Law needs to be adopted, and the revised central bank charter and corporation code need to be implemented. Over the longer term, there is a need to upgrade and modernize the Securities Regulation Code (2000) and the Insurance Code (2013), and to resolve long-standing weaknesses surrounding control of money laundering and terrorist financing.

2. Government's Sector Strategy

10. As a result of the impact of the COVID-19 pandemic, the Philippine Development Plan was revised to focus policymakers' objectives on recovery and resilience through three key pillars—(i) building a high-trust society; (ii) transforming towards equity and resilience; and

[9] Mercer. (2019 and 2020). Mercer CFA Institute Global Pension Index. Mercer, Melbourne.

[10] World Bank Financial Sector Database (2021).

[11] OECD (2018), World Bank Pension Database; National Reports and ADB's calculations for the Philippines. While mandatory pensions for private sector workers appear to broadly cover workers, roughly half of registered members actually contribute, indicating compliance is a problem.

[12] Workers are eligible for a pension upon reaching the age of 60, but not beyond 65, and must have worked for the company for at least 5 years. The pension is calculated as at least .5 months of salary for each 1 year of service.

[13] ADB. Philippines: Capital Market-Generated Infrastructure Financing Program (Subprogram 1). Manila.

[14] World Bank. 2021. Philippines Financial Sector Assessment Program. Washington, DC: World Bank, Financial Sector Assessment Program, p. 33.

(iii) increasing growth potential.[15] Initiatives will focus on bolstering social protections and supporting industry as companies recover from the pandemic and position themselves to capitalize on changes arising from extended quarantines and supply chain upheavals. Many of these initiatives will require government and private sector financial support. As such, the government has intensified its drive to build a domestic currency capital market. Efforts will focus on further diversifying funding sources and instruments and increasing liquidity in the government securities market, as well as improving price discovery and enhancing regulatory oversight. A specific focus has also been added to further open the debt market to large corporations and medium-sized enterprises, and to encourage growth in the contractual savings sector, including pension reform.

3. ADB Sector Experience and Assistance Program

11. Beginning in 1995, ADB's initial focus rationalized regulatory responsibilities, strengthened regulations, and developed governance over the stock market.[16] The succeeding program revised and updated the Securities Regulation Code, reorganized both the Securities and Exchange Commission and Philippine Stock Exchange to improve operations and governance, and strengthened market oversight. The program also established the foundation for a fixed-income debt market.[17] The Financial Market Regulation and Intermediation Program aligned financial reporting with international standards, improved settlement and payment systems, and strengthened regulatory capabilities, including cross-sector supervision[18] Risk-based capital was introduced to the insurance subsector.[19] More recently, a collaborative effort between ADB, the International Monetary Fund, and the United States Treasury provided a highly focused diagnostic on constraints to developing the government bond market.[20] Building on this diagnostic, the Encouraging Investment through Capital Market Reforms Program introduced a more structured and sequential approach starting with money markets and the government debt market.[21] The program included initiatives to strengthen cash management and enhance the technical capacity of the BTr. In addition, the program sought to increase trading activity and liquidity, improve price transparency and disclosure, and provide a reliable term structure of interest rates. The Capital Market Generated Infrastructure Financing Program has now introduced the next stage in capital market development, which is a transition to more directly supporting the development of an institutional investor base (footnote 10). Complementary support is being provided to support Association of Southeast Asian Nations integration, including efforts to strengthen corporate governance and the anti-money-laundering regime.[22] Finally, parallel efforts are helping to foster financial inclusion, develop microinsurance[23]and increase the resilience of the poor.[24]

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[15] National Economic and Development Authority. 2021. *Updated Philippine Development Plan, 2017–2022*. Manila.

[16] ADB. 1995. *Report and Recommendation of the President to the Board of Directors: Proposed Programmatic Approach and Policy-Based Loan for Subprogram 1 to the Republic of the Philippines for the Capital Market Development Program.* Manila.

[17] ADB. 2001. Report and Recommendation of the President to Board of Directors: Proposed Loan and Grant to the Republic of the Philippines for the Nonbank Financial Governance Program, Subprogram 1. Manila.

[18] ADB. Philippines: Financial Market Regulation and Intermediation Program, Subprogram 1.

[19] ADB. Philippines: Capacity Development to Support Regulation and Oversight at the Insurance Commission.

[20] ADB. Philippines: Strengthening Treasury's Liquidity Management; ADB. Philippines: Strengthening Treasury Operations and Capital Market Reform.

[21] ADB. Philippines: Encouraging Investment through Capital Market Reforms Program, Subprogram 1.

[22] ADB. Regional: Enhancing Association of Southeast Asian Nations Capital Market Integration..

[23] ADB. Philippines: Capacity Building for Microinsurance.

[24] ADB. Philippines: Inclusive Finance Development Program (Subprogram 1).

Problem Analysis Diagram for the Finance Sector