SECTOR ASSESSMENT (SUMMARY): FINANCE[1]

A. Sector Performance, Problems, and Opportunities

1. A perception of heightened instability, low investor confidence, and inefficiencies arising out of structural impediments has constrained financial sector development. Inadequate intermediation between savers and investors, and limited access to finance, continue to slow Philippine economic growth and development, and have limited the government's progress in reducing poverty.

2. **Despite their prominence, banks have not provided substantial intermediation to the market.** Banking institutions account for a high percentage of financial system assets, most of which are family owned. Commercial and universal banks dominate the banking sector, accounting for 88% of total banking assets, with the top five universal banks (excluding state-owned banks) accounting for 50% of total commercial banking assets. Philippine banks tend to invest in a small number of top-tier creditworthy firms, including peers and affiliated organizations, due to an inability to accurately judge credit risk. In addition, bank density is heavily skewed towards three large regions, leaving about one third of all municipalities in the Philippines without a banking office.[2] This uneven distribution of financial delivery channels also constrains the provision of basic financial services such as credit, savings, payment transfers, remittances, and insurance to these areas and has disenfranchised members of society that deserve access to finance, such as women.

3. **The nonbank financial subsector remains underdeveloped.** The Philippines bond market recently exhibited some very promising trends, reporting the second best performance in Asia (excluding Japan) through the third quarter of 2010. Nevertheless, the nonbank financial subsector is still too small to compensate for the limited level of bank intermediation.[3] Short-term government debt securities, mostly treasury bills, account for almost 30% of the market, while corporate issues constitute less than 5% of the market. The number of primary dealers is too high, which transforms the process into a private placement format, and the dealers do not have the inventory management tools necessary to make two-way markets. Corporate issuance has also been constrained by tax and regulatory disincentives that constrain potential investors as well as a weak insolvency regime. The limited supply of investment products and vehicles, such as open-end mutual funds, has discouraged small investors, and an active fund management industry has yet to emerge.

4. **The equity market remains shallow, with little growth.** About 60% of market capitalization is composed of around 25 family-controlled corporations. The small market size and limited turnover increase the risk of insider dealing and market manipulation. In addition, cross shareholdings and limited disclosure make it difficult to track intercompany transactions and exposures. Efforts to follow through on the demutualization of the stock market have stalled, and effective self-regulatory systems have not yet been established. Since 2003, the Philippine Stock Exchange has suspended minimum float requirements, which has not been conducive to ensuring sufficient liquidity.

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[1] This summary is based on ADB. 2011. *Southeast Asia Regional Department Sector Strategy and Road Map: Philippines Financial Sector*. Manila: ADB. Available on request.

[2] The National Capital Region, Central Luzon and Calabarzon (Calamba, Laguna, Batangas, Rizal and Quezon).

[3] The nonbank financial subsector comprises the Philippine Stock Exchange and a variety of financial intermediaries including investment houses, finance companies, broker-dealer firms, mutual funds, investment management companies, insurance companies, and pre-need plan companies.

5. **The small insurance subsector is plagued by restrictive legislation and regulation.** Life insurance premiums represent less than 1% of gross domestic product and have shown nominal growth over the past 10 years. There are restrictions on expanding the range of insurance providers, as well as on microinsurers introducing nonlife products. Tax distortions also hamper development efforts, but, more significantly, the state-owned Government Services Insurance System competes directly with the private market.

6. **Lack of sufficient direction and sustained stakeholder support.** A Capital Market Development Plan (CMDP) was published in 2006 along with a sequenced implementation action plan. However, the plan was regulatory-centric and overly prescriptive. Implementation was incomplete, and a sizable number of deviations were noted. In an effort to refocus its reform efforts, financial sector development has been positioned as a key part of the Philippine Development Plan (PDP), 2011–2016 and the associated CMDP. A review of the PDP has confirmed the emergence of a strong reform agenda under the incoming administration and the appointment of reform champions in key positions in the Securities and Exchange Commission (SEC) and Investment Committee (IC). However, a number of constraints remain unaddressed. First, the CMDP has not been backstopped with a detailed implementation plan that establishes key policy actions and associated deadlines or, most importantly, who is responsible for implementing the reforms. Further, an overall champion has yet to emerge to take a leadership role in building a consensus across a diverse group of stakeholders.

7. **Weak financial supervision continues to lower investor confidence.** The quality and coordination of supervision have improved considerably, but weaknesses remain and continue to dampen investor confidence. Gaps in capacity and coverage between, and poor enforcement coordination among, the key financial sector regulators have encouraged regulatory arbitrage by financial entities. A key underlying cause of these governance and operational weaknesses is the lack of fiscal and administrative autonomy. Combined with a suppressed budget, the high demands of the noncore functions have limited the capacity of staff to address higher value core functions under SEC's mandate. Compounding this problem, the lack of budget support has compromised SEC's ability to develop and retain staff with the skill sets necessary to provide an overall enabling environment for capital market development while at the same time assuring financial stability. In the absence of timely reforms, the financial sector will remain vulnerable to systemic risks, and investors will be vulnerable to fraud and misconduct.

8. **Microfinance subsector faces uneven regulation and lacks microinsurance.** With Asian Development Bank (ADB) assistance, the government has been formalizing the cooperative sector, placing financial service-engaged cooperatives under the prudential supervision/regulation of the Cooperative Development Authority (CDA) in accordance with Republic Act No. 9520 or the Cooperative Code.[4] However, CDA has yet to transform itself to a financial regulatory body as mandated by the Cooperative Code. The Microinsurance Regulatory Framework supported by ADB, along with the National Strategy for Microinsurance, was officially launched on 29 January 2010. However, regulatory and operational capacities need to be built, and a national financial literacy program focusing on microinsurance needs to be developed and implemented.

[4] The Cooperative Code covers insurance products that offer coverage to low-income households. A microinsurance plan provides protection to individuals who have little savings and is tailored specifically for lower valued assets and compensation for illness, injury or death. A financial cooperative is a financial institution that is owned and operated by its members. The goal of a financial cooperative is to act on behalf of a unified group as a traditional banking service.

B. Government's Sector Strategy

9. The government's sector strategy is anchored in the PDP, 2011–2016. Reforms in the domestic financial system will be guided by the associated CMDP and will promote further deepening of the financial system through the balanced development of the banking system and capital market. These reforms are anchored in an enabling environment, progressive adoption of international standards and best practices, and good governance and transparency. Key reforms will focus on (i) promoting savings generation at the regional level but institutionalizing deployment of resources at the national level, (ii) developing an enabling environment for long-term savings, (iii) strengthening the governance framework of the financial system in line with international standards and best practices, and (iv) establishing a strong legal framework for financial sector development.

10. An overall framework will be developed by the government to provide an enabling environment that balances financial inclusion objectives with financial stability goals. To broaden financial inclusion, the government will promote the use of alternative products and delivery channels to reach underserved and unserved areas of the country, including microinsurance, a credit surety fund program, and microhousing. To encourage long-term savings and investment, auxiliary markets will be developed through the forward and cash markets.

11. To strengthen the governance framework of the financial system, the regulatory agencies will pursue sustained capacity development in conjunction with the passage of amendments to strengthen the legislative mandates of the Bangko Sentral ng Pilipinas, SEC, and IC. Regulatory and supervisory oversight will be harmonized through cooperative arrangements among domestic and international financial regulators to address the growth of financial conglomerates. In addition, the government will establish a strong legal framework to support financial sector development and to enhance financial stability. The existing microprudential approach to supervision will be supplemented with macroprudential policies to ensure the resilience of the financial system. Momentum to further deepen the domestic financial markets will be supported through faster integration of the financial system into the Association of Southeast Asian Nations region.

12. The government will continue, but refine, existing efforts to support its social agenda of reducing poverty through mandated credit to certain sectors of the economy such as small and medium-sized enterprises and the agriculture sector. The market-based policy environment includes adoption of market-based interest rates in microfinance, phase-out of subsidized directed credit programs in agriculture, and nonparticipation of nonfinancial government agencies in lending. The government also plans to develop cooperative financial services and microinsurance based on the same market-based principles.

C. ADB Sector Experience and Assistance Program

13. ADB has supported reforms in the financial sector for more than 10 years, with four program loans[5] between 1995 and 2010.[6] The 2008 Philippines Country Assistance Program

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[5] ADB. 1995. *Report and Recommendation of the President to the Board of Directors: Proposed Loan and Technical Assistance for Capital Market Development Program in the Philippines* (2 tranches). Manila; ADB. 2001. *Report and Recommendation of the President to the Board of Directors: Proposed Loan and Technical Assistance Grant for the Non-bank Financial Governance Program in the Philippines* (1 tranche). Manila; ADB 2003. *Report and Recommendation of the President to the Board of Directors: Proposed Loan and Technical Assistance Grant for the Second Non-bank Financial Governance Program in the Philippines* (2 tranches). Manila. ADB. 2006. *Report and*

Evaluation[7] identified intermediation and savings as a key driver of poverty reduction and as an area where both institutional knowledge and potential impact are high. Recommendations included (i) strengthening capital market development planning; (ii) improving market functions; and (iii) strengthening supervision and regulation overall, and in the nonbank subsector specifically.

14. However, recent experience has produced mixed results. The Financial Market Regulation and Intermediation program (FMRIP) cluster was originally envisaged to run from January 2005 to December 2009.[8] Subprogram 1 was designed to promote liquidity, deepen financial markets, broaden the investor base, reduce systemic risk, and strengthen policy and regulatory capabilities. Subprogram 2 was to be submitted for Board consideration approximately 18 months after the first subprogram. However, a number of governance issues within SEC and IC arose that delayed the progress of planned reforms. Based on an assessment conducted in mid-2009, the timeframe for implementation for Subprogram 2 was extended to allow more time for progress on targeted reforms as well as the completion of additional measures.[9]

15. Concurrent with the recent change in government, Subprogram 2 was reactivated in May of 2010.[10] The program was also reformulated to address the government's revised priorities, which arose out of the global financial crisis including the need to address the governance and administrative weaknesses in SEC and IC that contributed to the delays in implementing Subprogram 2. ADB supported this reformulation, given the emergence of a strong reform agenda under the incoming administration and the appointment of reform champions in key positions in SEC and IC. Further, recent missions have documented an increasing level of consistency between the development constraints and reform priorities identified by the government, ADB, and a wide range of market participants and stakeholders.

16. While the outlook for financial sector development has improved, ADB has not included support to the financial sector in the Country Partnership Strategy for 2011–2016 in view of the

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Recommendation of the President to the Board of Directors: Proposed Program Cluster, Loan and Technical Assistance Grant for Financial Market Regulation and Intermediation Program in the Philippines (2 tranches). Manila; ADB. 2010. *Report and Recommendation of the President to the Board of Directors: Proposed Loan for Subprogram 2 of the Financial Market Regulation and Intermediation Program in the Philippines* (1 tranche). Manila.

6 In the sub-sector of microfinance, ADB'S Rural Microenterprise Finance Project (ADB. 1996. *Report and Recommendation of the President to the Board of Directors: Proposed Loan and Technical Assistance Grant in the Philippines for* Rural Microenterprise Project. Manila.) was implemented from 1996 to 2002 and laid the foundation for successful microfinance wholesale lending operations by the People's Credit and Finance Corporation (PCFC). ADB also supported strengthening of the microfinance sub-sector policy, regulatory environment, operational capacity, and financial literacy through the Microfinance Development Program (ADB. 2005. *Report and Recommendation of the President to the Board of Directors: Proposed Loan and Technical Assistance Grant in the Philippines for* Microfinance Development Program. Manila.) (2005–2007), the JFPR Project for Developing Financial Cooperatives (ADB. 2006. *Grant Assistance to the Philippines for Developing Financial Cooperatives Project Financed by the Japan Fund for Poverty Reduction. Manila.)* operational since 2006, and the JFPR Project for Developing Microinsurance (ADB. 2008. *Grant Assistance to the Philippines for Developing Microinsurance Project Financed by the Japan Fund for Poverty Reduction*. Manila.) operational since 2008.

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

8 ADB. 2006. *Report and Recommendation of the President to the Board of Directors: Proposed Program Cluster, Loan and Technical Assistance Grant to the Republic of the Philippines for the Financial Market Regulation and Intermediation Program.* Manila.

9 ADB letter to Secretary Teves dated 30 July 2009.

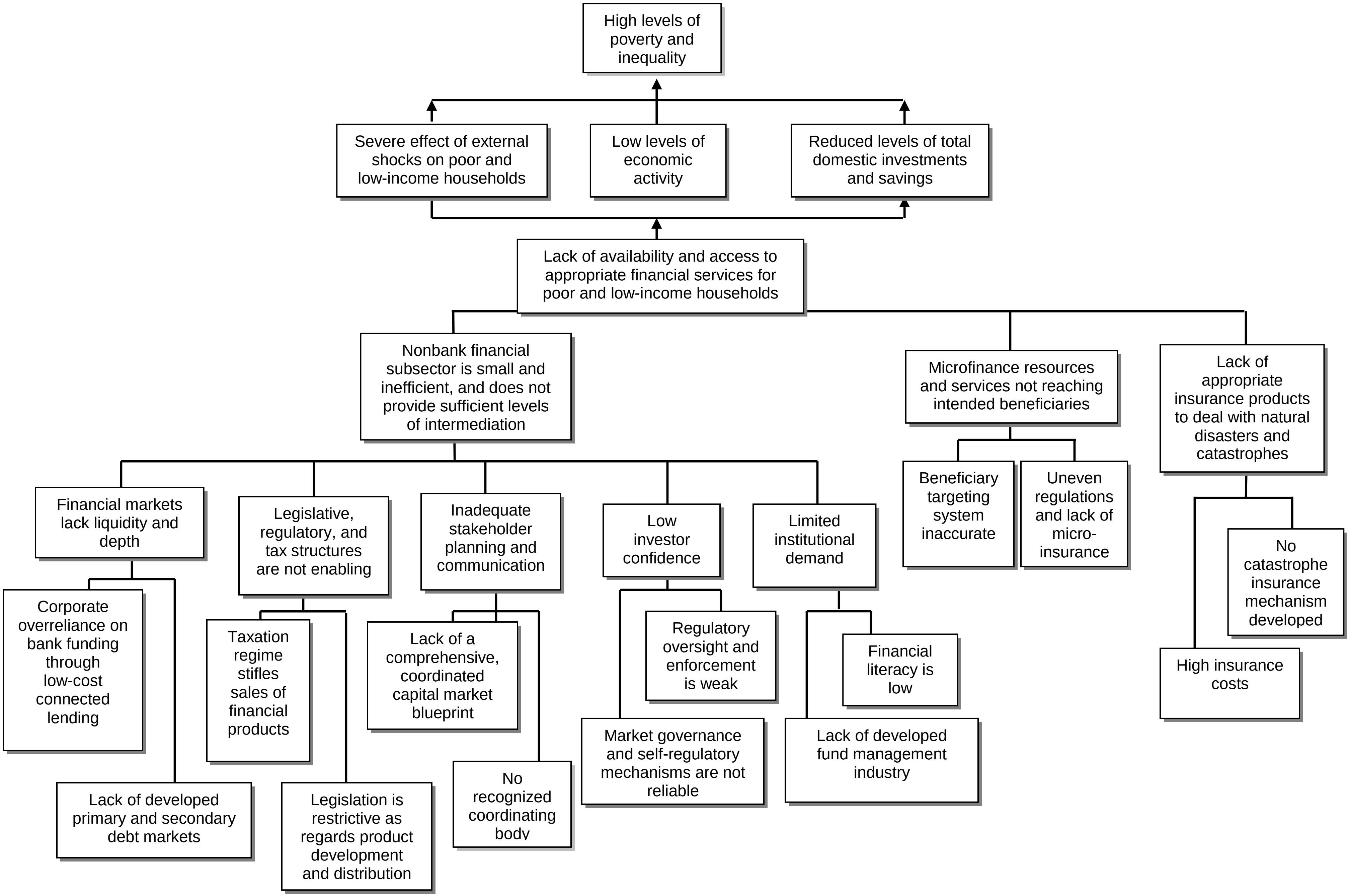
10 ADB. December 2010. *Report and Recommendation of the President to the Board of Directors: Proposed Loan to the Republic of the Philippines for Financial Sector Development.* Manila.

need to prioritize the program in light of (i) PDP priorities, (ii) importance of prioritizing the most critical development constraints, (iii) CAPE recommendations, and (iv) strategic cooperation among development partners. Nevertheless, recent developments are encouraging and could lead to a reassessment of ADB's support to the financial sector. Specifically, the government has met the funding triggers necessary to disburse FMRIP Subprogram 2. A substantial budget increase has been provided to the SEC to provide retro-active salary increases in compliance with the Revised Securities Regulation Code, additional staff and salary scale adjustments, and to support capital projects including the automation of corporate registrations. Further, the SEC will, with the support of ADB technical assistance, begin an active engagement with the private sector to develop a comprehensive and realistic action plan to further develop the Philippine capital market.

17. While ADB is willing to support additional policy development lending programs to the financial sector, this support will be conditioned on the government's success in implementing these newly emerging reform priorities, the degree and pace with which reforms contemplated under the Financial Market Regulation and Intermediation Program are implemented, and the emergence of a clear and sustained champion to lead these difficult reform efforts. In the interim, technical assistance support will be provided to the financial sector to maintain ADB's long-standing policy dialogue and to provide assistance in implementing key reform priorities under the Post Partner Partnership Framework and the CMDP. A continuation of ADB's long-standing support to microinsurance will be considered only, if it is supporting social protection and/or disaster risk mitigation objectives that have been identified as priorities under the country partnership strategy.[11]

[11] Such support would be covered under social protection. See: Health and Social Protection Assessment Summary (accessible from the list of linked documents in Appendix 2).

Problem Tree for the Finance Sector



Roadmap Results Framework (Finance)

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 financial sector	Share of nonbank financial sector assets to exceed 30% by 2016 Investment ratio at 22% of GDP by 2015 (baseline: 15% in 2009) M2-to-GDP ratio above 55% (baseline: 51% in 2009).	Comprehensive, coordinated, and widely supported capital market development plan implemented Enabling policy and regulatory environment created Investor confidence strengthened Institutional demand increased	Level of outstanding debt securities as % of GDP and frequency of turnover Number of issues of debt and equity securities SEC and IC achieve administrative and fiscal autonomy Number of PERA accounts % of population with private life insurance policy	**Pipeline projects with estimated amounts** Capacity Development of Financial Regulators ($1.0 million) **Ongoing projects with approved amounts** Financial Market Regulation and Intermediation Program ($200 million)	**Pipeline projects with estimated amounts** Support development and implementation of new capital market development plan Capacity development of nonbank financial regulators **Ongoing projects with approved amounts** Policy dialogue on capital market planning, market functions, and supervision/regulation particularly in non-bank sector. Capacity development activities for CDA and credit and savings cooperatives Advice on regulatory environment for micro-insurance
Increased and sustainable access by poor and low-income households to savings, lending, and microinsurance services	Increase in number of active microfinance borrowers from 5.5 million in 2009. Microfinance loan accounts opened (number). Increased number of poor and low income households covered by microinsurance products.	Increased financial literacy and capacity of poor and low- income households to utilize lending and insurance products Improved and greater coverage of cooperative financial services Sustainable microinsurance system based on market principles	Number of poor women and men completing financial literacy training in rural and urban areas Financial institutions providing micro finance loans (number). Number of institutions providing microinsurance products.		

CDA = Cooperative Development Authority, GDP = gross domestic product, IC = Insurance Commission, M2 = broad money, PERA = personal equity retirement account, SEC = Securities and Exchange Commission, TA = technical assistance.
Source: Asian Development Bank.