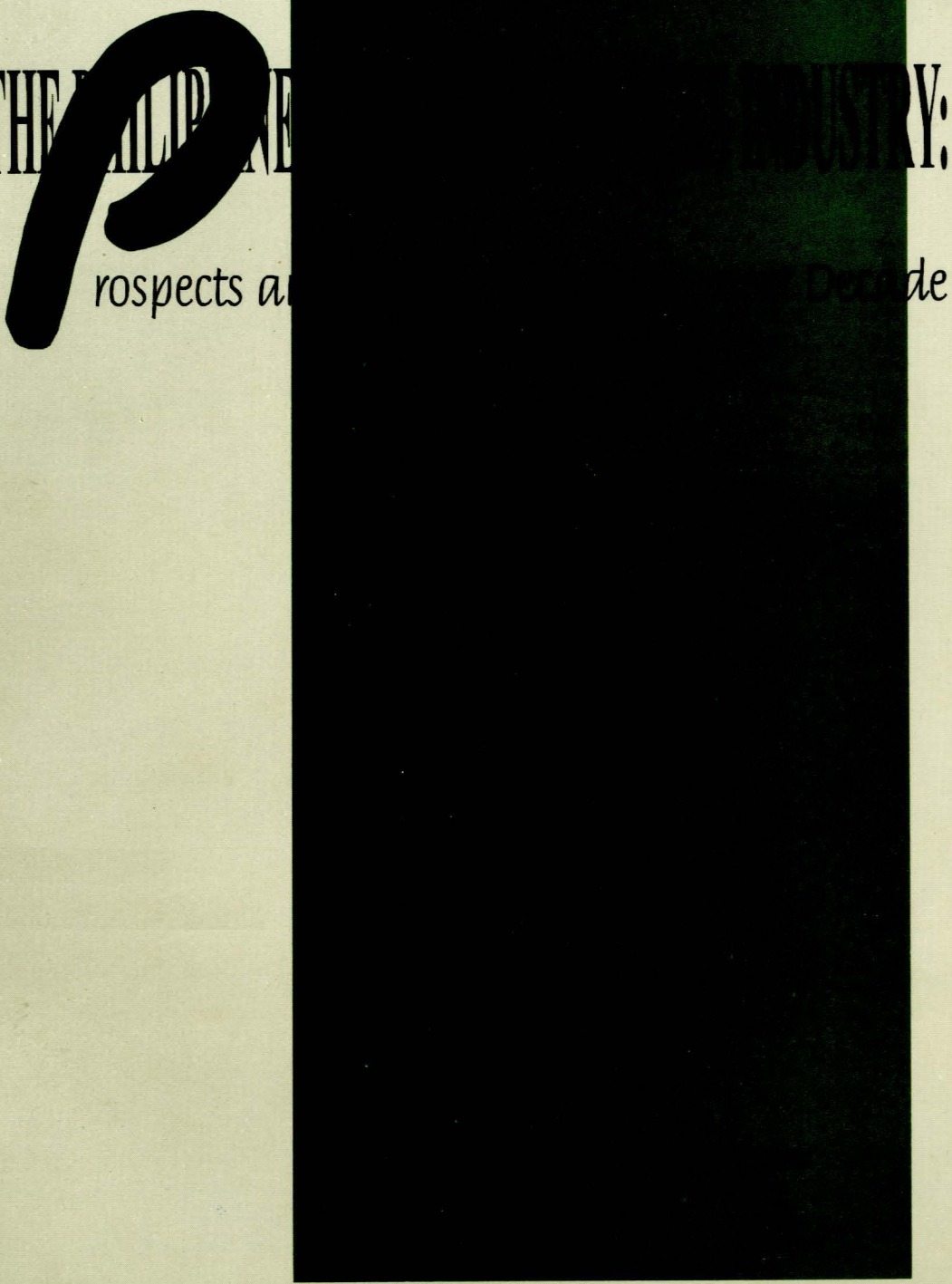


THE PHILIPPINE [redacted] INDUSTRY:

Prospects at the Dawn of the [redacted] Decade

University of the Philippines Press
UP Center for Integrative and
Development Studies
and the
UP College of Business Administration



UP ASSESSMENT PROJECT ON THE STATE OF THE NATION

THE PHILIPPINE FINANCIAL SERVICES INDUSTRY:

Prospects and Challenges in the next Decade

Papers Presented at the October 28, 1995 Symposium
Shangri-la's EDSA Plaza Hotel, Mandaluyong City

Gerardo Agulto, Jr.
Eduardo de los Angeles
Carlos C. Bautista
Dante B. Canlas
Jose R. Facundo
Manuel V. Pangilinan
Cesar E. A. Virata
Roy C. Ybañez

Rafael A. Rodriguez
EDITOR

University of the Philippines Press
UP Center for Integrative and Development Studies
and the
UP College of Business Administration

Published by
The University of the Philippines Press
University of the Philippines
Diliman, Quezon City

The University of the Philippines
Center for Integrative and Development Studies
Diliman, Quezon City

and
The UP College of Business Administration

Copyright 1995 by UP-CIDS
All rights reserved.

ISBN No. 971-8797-83-1
December 1995

Cover Design: Michael Arciga, Bella Lucas and Stretch Payawal
Report Design and Layout: Michael Arciga, Ellen Cometa, Nanie Domingo, Bella Lucas, and Stretch Payawal

Text composed in Galliard BT
Typeset using Aldus Pagemaker 5.0 ®

Printed in the Philippines by
University of the Philippines Printery
UP Campus, Diliman, Quezon City

FOREWORD

This volume puts together the speeches and papers presented at the October 28, 1995 Symposium on the Philippine Financial Services Industry. The symposium, held at Shangri-la's EDSA Plaza Hotel, was jointly sponsored by the University of the Philippines (UP) College of Business Administration, the UP Business Research Foundation and the UP Center for Integrative and Development Studies (UP-CIDS).

Taken together, the papers draw, albeit in broad strokes, a clear picture of the state of the financial services industry today and its prospects in an era of globalization and rapid technological change. The discussions of the challenge facing the industry leave the general reader with a sense of optimism regarding its capacity to innovate and adjust to external demands. But while the technical skills required of the people working in the industry in the 1990s are more sophisticated, this volume ends aptly with Dr. Cesar E.A. Virata's reminder that in at least one sense, the financial system of the 21st century will be no different from that of this millenium. Underpinning the financial systems of different historical epochs is a value as basic as trust.

The UP-CIDS is publishing this volume as part of the UP Assessments of the State of the Nation Monograph Series. The publications under the series include proceedings of roundtable discussions/conferences and research reports that hope to raise issues and generate reasoned criticisms and sound policy options concerning eight vital areas of Philippine society: Population, Resources, Environment and Sustainable Development; Values, Culture and Communication in Relation to Nation-Building and Development; Education, Learning and Development; Science, Technology and Development; Basic Human Needs; The National Economy, Public Welfare and Global Interdependence; Governance, Public Welfare and Social Justice; and The Well-Being, Welfare and Development of People.

The UP-CIDS wishes to acknowledge the UP College of Business Administration (UP-CBA) and the the UP Business Research Foundation for conceptualizing and organizing the symposium which made this publication possible; the Alfredo Velayo Research Chair in Business Policy for supporting the UP-CBA research on the commercial banking industry from 1980 to 1994, which was featured in the symposium; Mr. Satur Ocampo and Ms. Victoria Tinio for their editorial assistance; and Bella Lucas and Joy Aparis for seeing this volume through its publication with the technical assistance of Ellen Cometa, Nanie Domingo, Stretch Payawal and Michael Patrick Arciga.

As in all our publications, the views presented in this monograph are those of the authors whose academic freedom is upheld by the University.

Maria Cynthia Rose Banzon Bautista
Executive Director
Center for Integrative and Development Studies
University of the Philippines

Table of Contents

FOREWORD/*Maria Cynthia Rose Banzon Bautista*

EDITOR'S NOTE/*Rafael A. Rodriguez* **1**

A CORPORATE FUND USER'S VIEW **3**
Manuel V. Pangilinan

THE BEHAVIOR AND PERFORMANCE OF THE PHILIPPINE COMMERCIAL BANKING INDUSTRY, 1980-1994
A Study of the Relationship Between Economic Growth and Financial Development **13**
Carlos C. Bautista, Roy C. Ybañez and Gerardo Agulto, Jr.

FISCAL, MONETARY AND FINANCIAL INTERMEDIATION POLICIES
Impact on Fund Needs and Sources **34**
Dante B. Canlas

THE STOCK MARKET AS FINANCING SOURCE **42**
Eduardo de los Angeles

PROSPECTS OF AND CHALLENGES TO THE COMMERCIAL BANKING SECTOR **60**
Jose R. Facundo

END NOTE **72**
Cesar E. A. Virata

List of Tables

Bautista, Ybañez and Agulto

Table 1: Per Capita GDP, US Dollars **15**

Table 2: Selected Macroeconomic Indicators, 1975-1993 **17**

Table 3: Simulation Results of Monetary Expansion from 1985 Onward (in percentage point difference from base values) **21**

Table 4: Growth Rates in the Commercial Banking Sector **29**

Table 5: Return on Equity of Major Categories of Banking Institutions (Gross of Income Taxes) **31**

de los Angeles

Table 1: Initial Public Offerings (IPO), 1994-1995 (as of September 30, 1995) **45**

Table 2: Foreign Portfolio Investments, 1990-1995 (as of June 1995) **45**

List of Figures

Bautista, Ybañez and Agulto

Figure 1: Liquid Liabilities/Gross Domestic Product (GDP) **15**

Figure 2: Macro Indicators of Banking Industry Performance **18**

Figure 3: Historical Simulation Results of a Simple Macro Model with a Banking Sector **19**

Figure 4: Simulation Results of Monetary Expansion from 1985 Onward **20**

Figure 5: Return on Equity (in percent) **24**

Figure 6: Percent Changes of Financial Ratios: ROE, ROA and Leverage **24**

Figure 7: Percent Changes of Financial Ratios: ROE and Cost Control **25**

Figure 8: Percent Changes of Financial Ratios: ROE and Revenue Generation **25**

de los Angeles

Figure 1: Philippine Stock Exchange Market Capitalization **46**

Figure 2: Distribution of Petron Shares by Area **48**

List of Appendices

de los Angeles

Appendix A:	Initial Public Offerings for 1995	**53**
Appendix B:	Initial Public Offerings for 1994	**54**
Appendix C:	Rights Offerings for 1995 (as of September 30, 1995)	**56**
Appendix D:	Rights Offerings for 1994 (as of end December 1995)	**57**
Appendix E:	Philippine Stock Exchange Market Capitalization	**59**
Appendix F:	Number of Initial Public Offerings from 1990 to 1995	**59**

Editor's Note

Rafael A. Rodriguez
Dean
College of Business Administration
University of the Philippines, Diliman

In capital short countries such as the Philippines, the development of strong financial intermediaries that can mobilize both domestic and foreign savings for investment is a continuing concern. This concern has heightened in the last decade because of fundamental changes which have taken place in global financial markets as a result of the telecommunications and computer revolutions and the widespread deregulation of the industry in many parts of the world. Today, there is greater capital mobility across countries in what has become a truly global financial system, as well as greater competition and innovativeness among the financial institutions involved.

Foremost among the issues which surround the development of the Philippine financial services industry today is the question of whether it has kept pace with the development of new forms of financial products and services which have emerged in the world's leading financial centers and institutions. The paper of Mr. Manuel V. Pangilinan, Chief Executive Officer (CEO) of the diversified and regional First Pacific of Hongkong, provides insights into the new services capabilities which domestic financial institutions need to acquire to be at par with global competitors. From a macroeconomic standpoint, there is also a question of whether Philippine financial markets have grown in size to match the needs of an expanding Philippine economy, and a related issue on the level of intermediation efficiency that has been achieved in the country's changing regulatory environment. The presentations of Professors Carlos C. Bautista, Roy C. Ybañez, and Gerardo Agulto, Jr. provide some indicators on these questions for the last ten-year period of 1984-1994.

A central factor in the stability of Philippine financial markets is government's management of the macroeconomy. The paper of Dr. Dante B. Canlas of the National Economic and Development Authority (NEDA) outlines the Philippine's liberalization and stabilization programs in the medium term. Attorney Eduardo de los Angeles's presentation on the recent growth of the Philippine equities market and the development programs of the Philippine Stock Exchange gives the reader an appreciation of the efforts at

enhancing market efficiency as well as access for investors outside of Metro Manila and Luzon. The paper of Mr. Jose R. Facundo of City Trust, on the other hand, calls for a rethinking on the human power development needs of the sector that ongoing changes in the banking environment and in bank strategy and operations necessitate. Finally, former Prime Minister and Finance Minister Cesar E.A. Virata, who moderated the symposium proceedings, ends with a summary and a note on the most basic requirement in all financial systems.

Two sponsors of the symposium, namely the University of the Philippines-College of Business Administration and the UP Business Research Foundation, have profited from this symposium in terms of a broader insight into the contemporary developments and needs, particularly in terms of new inputs for training the future managers and technical staff of Philippine financial institutions. On the other hand, the third sponsor, namely the UP Center for Integrative and Development Studies, hopes that a broader public including the national leadership will benefit from the publication of the proceedings of this symposium on a key Philippine economic sector.

A Corporate Fund User's View

Manuel V. Pangilinan
Managing Director
First Pacific Company, LTD

No doubt, there is rising goodwill toward this country around the world. The September 1995 World Bank Report on the Philippines is generally positive. Moreover, there is potentially a huge market here where the demand and supply for finance will create tremendous opportunities for all types of financial intermediaries.

Notwithstanding the good news, there are difficult challenges ahead of us.

Examples of these challenges include a low domestic savings rate estimated at only 15 to 18 percent of gross domestic product (GDP); rising inflation; intense competition for funds from our neighbors in the region; a continuing perception overseas that ours is a difficult country in which to do business: the recent adverse international publicity surrounding the sale of the Manila Hotel and the lingering legal case hanging over the Fort Bonifacio Project. Certainly these factors do not help boost our country's competitiveness in the financial field.

Let me begin by talking about the broad requirements of corporate capital users from a First Pacific perspective. After this, I will address the various sources of funding and how we have made use of these. I will then conclude with a few prescriptive remarks about the contemporary financial markets in our country.

Demands for Funds

Three basic financial standards describe how we determine our demand for funds:

First, the preponderant financial objective for all businesses is to achieve sustainable and above average growth in earnings per share and cash flow per share. We will not invest in a business -

either an existing business or a new one - if the returns from that investment, net of financing cost, do not enhance our per share earnings and cash flow. Because our commitment to our various stakeholders is to develop quality recurring profits on an accounting and cash-flow bases, our per share numbers are calculated at the pre-exceptional and fully diluted levels.

Second, a further key driver in our investment decision does not rest - at least not initially - on the apparent availability or lack of availability of funds. Rather, the final determinants which lead us to raise the requisite financing are that: (a) the business has, or could have, the critical mass in terms of market leadership, earnings potential, and cash flow contribution; (b) the funding fairly prices the risk; and (c) most important, the opportunity raises our earnings and cash flow per share on a net basis.

Third, internal rates of return (IRR) are useful but not necessary tools in our investment analysis. The calculation of IRR can take into account up to 10 years' worth of hypothetical numbers, including terminal values. But there are other factors to consider: the rapid changes we are now seeing in markets, in competition, and in values which could erode the validity of one's assumptions; the observation that IRR figures are not reflected in profit-and-loss accounts; and the fact that shareholders' expectations afford one a lot less slack than the usual 10 years taken in the calculus for accounting and cashflow returns. Given all these, we view IRR simply for what it is: a hypothetical financial measure.

In assessing alternative types of funding we look to:

* Price, preferably with pricing in the spread rather than in high "frontend fees;"
* Tenor and scheduling of principal repayments;
* Security required;
* Tax efficiency; and
* Foreign exchange and interest rate exposure.

Sources of Funds

Let me now turn to the sources of funds.

In considering potential providers of funding, we favor institutions which offer:

* Placement capability;
* Operational reliability;
* Long-term relationship;
* A local presence; and
* Ideas and innovations to meet the specific needs of our circumstances at the time.

I cannot overemphasize the last point: While pricing may be a key component in selecting a fund provider, the vital component of success is often the ideas and innovations that lead to an effective financing solution. For this to work well, the provider must fully understand our business and our objectives and be prepared to innovate to meet these objectives.

By way of example, First Pacific recently succeeded in raising $US230 million for the expansion of our telecommunications businesses. The funds were raised through the private placement of new ordinary shares in a book-building exercise led by Merrill Lynch.

Our objective was to broaden the Company's investor base without diluting the financial and equity interests of existing shareholders. To do this, we have had to ensure that equity was raised at fair value and that, in particular, there would not be downward pressure in the share price as a result of the placement. This was a daunting challenge to throw at our banker.

Merrill Lynch was willing to innovate. It came to us with the idea for the first "book-building" approach to equity raising by a Hong Kong listed company. Investors and institutions were targeted directly and a reasonable price for the shares set accordingly. Merrill Lynch had the apt idea and so it got the deal.

Types of Funds

As to types of funds, we have considered, or used, in recent years each of six broad categories:

* Traditional bank credit;
* Asset financing;
* Export financing;
* Corporate debt securities;
* Asset securitization;
* and of course, Equity.

Let me comment on some of these.

Traditional bank credit, such as money market lines and trade finance, have historically been a mainstay of Philippine corporate financing. However, bank credits must increasingly expand into what I call investment financing, which can be divided into two classes:

First, senior debt investment financing, in which less emphasis is placed on the assets or capital of the borrower, with repayment premised on the future cash flows generated by the investment; and

Second, mezzanine debt financing which is the preferred route to raising expensive funds emitted by venture capitalists. The finance in this case is subordinate to that of senior debt but receives an enhanced return through equity warrants.

In asset-based financing, consumer finance represents a large untapped market here. Balance Sheet size, diversity of consumer-driven instruments, and geographic reach of finance companies in this country compare poorly, say, to Thailand.

One of the most exciting areas of financial innovation and potential is Corporate Debt Securities and of course, the global bond market.

Those of you who read *The Economist*'s survey of The World Economy in its October 7th 1995 issue may be familiar with the story of an advisor to United States President Bill Clinton who

summed up many people's views of the bond market by saying: "I used to think that if there was reincarnation, I wanted to come back as the President or the Pope. Now I want to come back as the bond market: you can intimidate everybody."

Indeed there is much discussion about the "power of the bond market" and how this impinges on Government's ability to manage its domestic finances. From the perspective of a corporate fund user today, the potential of the bond market is enormous. To put this in perspective:

In the 13 years from 1982 to 1995, the outstanding volume of international bonds jumped from $US259 billion to $US2 trillion. While much of this growth has been fueled by Government debt issues, the growth in corporate issues has also been significant. At the same time, international portfolio diversification is in its infancy. As pension funds in America and Europe seek more investment opportunities abroad, so have corporate fund users in Asia been able to slowly secure competitively priced funding for their ongoing needs through international bonds.

In the Philippines, approximately $US1.3 billion of corporate bonds were issued in one year (August 1994 - August 1995). Only an insignificant amount of this was raised and carried by our domestic financial institutions.

First Pacific and our Dutch subsidiary, Hagemeyer, have already made significant use of the bond market. In so doing, we were seeking to:

* Reduce our funding costs;
* Diversify our funding base away from traditional bank credits and access insurance companies and pension funds;
* Extend final maturities at attractive fixed rates; and
* Obtain less onerous covenants than with medium-term bank credit facilities.

With regard to securitization, there have been signs that the financial markets in Asia are gradually recognizing its potential. There have been deals done for securitizing credit card debts in

Hong Kong, royalty streams in Japan, and telecommunications earnings in Thailand. Mortgage securitization has been attempted in Hong Kong with some success.

Finally, in dealing with equity, the singular piece of advise I would offer is to regard it as your most precious resource and, perhaps in a perverse way, to consider equity as your least desired manner to raise finance. In the context of what I have set out before as our paramount financial goal, that is, enhancement of earnings per share, it follows that one should be parsimonious about issuing new shares simply because the fewer shares you have in issue, the better your per share earnings and cash flow performance will be in the long-term.

It is clear that with financial innovations currently available, the range of funding options for corporate fund users is enormous. Appropriately used, financial derivative products such as interest rates and foreign exchange swaps extend these options still further. Today, any credible business operating with access to the global financial markets should be able to achieve an ideally tailored financing solution.

Prescriptions

I would like to turn now to the Philippine financial markets and offer three basic observations:

First, the challenge to the Philippine financial services industry is to bring to corporate fund users the broad range of financial products currently available throughout the world at competitive prices. Nothing less should do. Our products and services must compete with global players, both domestically and in our export markets. We need every aspect of our business to be competitive, including funding arrangements. After all, the object of the whole financial system is to induce and mobilize resources - externally and internally - so that these can be made available at appropriate terms to end-users in pursuit of economic activities essential to national development.

Second, to achieve this, we need to do two things: (a) undertake a fundamental reevaluation of the structure and performance of the current financial system in order to broaden the variety of financial instruments, encourage the growth of specialized financial intermediaries, and lower the cost of financial intermediation; and (b) further liberalize the financial sector.

With regard to the process of reevaluation, we need to revitalize the domestic money market so that it can become a more efficient mechanism with which commercial banks can manage their primary and secondary liquidity reserves, and serve as an effective transmitter of central bank credit and interest rate policies through open market operations. We should encourage the development of fund managers who can pool and co-mingle funds for specific investment purposes on a long-term basis. We have to develop a mortgage market system that makes it possible for homeowners to get mortgage terms for as long a maturity and as low an interest rate as possible. Finally, our capital market has to be broadened to allow a more efficient exchange for the secondary trading not only of shares but also of other capital market instruments such as mortgage-backed securities.

With respect to liberalization, without detracting from the progress made to date, commercial banks in this country are still one of the most protected industries from external competition or from tough application of prudential regulations found elsewhere in the region.

Why should we open up some industries like telecommunications but leave the finance business comparatively closed? The benefits of deregulating the telecommunications sector are now increasingly becoming palpable: more dial tones, wider geographic coverage, and affordable prices. And, as consolidation in the telecommunications industry will occur ultimately, I would wish to see affirmative action being taken to encourage consolidation of banks so that they can be truly competitive and thus provide better service and deliver funds more cheaply to end-users.

The ambit of deregulation should be widened as well to embrace a network of support services to financial providers. As the sophistication and complexity of financial markets evolve, so must the level of skills of lawyers, merchant bankers, and even

printers of prospectuses rise *pari passu*. We should encourage such evolution by opening up our market to such foreign service providers and raise, as a consequence, the standards of accounting practice and disclosure closer to international measures.

Third, while the concept of the cost of capital may be a useful analytical tool especially at the level of abstraction, its utility to managers can be rather low in developing a strategy for raising finance in the magnitude and on terms that are user-friendly. That is because capital is specific.

There is capital required to finance natural resources and convert their potential into usable and marketable form.

There is capital required to finance land, plant, and equipment producing industrial and consumer goods.

There is capital required to finance inventories and receivables and the handling, transport, storage, and distribution of products.

There is capital required to finance the import of capital goods, raw materials, and even finished products.

There is capital required to finance real estate.

And finally, there is capital required to finance investments in manpower at various levels of technical, managerial, and administrative competence.

My point here is that capital will not come to you just because one has need of it. Capital has to be sought, and in that seeking, we have to sell ourselves in what some merchant bankers refer to colorfully as a beauty contest. This is simply because there are many attractive corporate fund users out there.

CONCLUSION

There is no doubt that significant changes in financial institutions both here and abroad are being made today. Against this backdrop, the preponderant questions are how to cope, how to

manage, how to turn the ebbs and flows of financial resources to optimize values to the corporation's many constituents and, ultimately, to the service of our society.

In this dynamic situation, corporate borrowers play both an active and a passive role. New financial requirements emerge and, in response, so do new practices, new institutions, and new instruments. In the face of such dynamism and competition, it is imperative that financial institutions adapt. If they do not, they are liable to become irrelevant.

Michael Crichton's latest book, *The Lost World*, is instructive. He writes:

> *On our planet there are currently fifty million species of plants and animals. We think this is a remarkable diversity yet it is nothing compared to what has existed before. We estimate that there have been fifty billion species since life began. That means that for every thousand species that ever existed on earth, only one remains today. Thus, 99.9 percent of all species that ever lived are extinct. Natural disasters account for only five percent of that total. The overwhelming majority of species died one at a time.*

But why? The answer is that our planet is more continuously active than is generally recognized; this leads to changes in environment which cause most plants and animals to expire. But complex animals like dinosaurs and Man are another matter because they have insulated themselves against such changes.

What Crichton proposes is that complex animals became extinct because they either did not change their behavior against those changes or if they did, it was not for the better. In either case, behavior ceases to be responsive to the environment and eventually leads to decline and death. The ability to adapt therefore is vital for Man as indeed it is for financial systems.

Notwithstanding the need to be adaptive, I accept that financial systems being inherently conservative must strike a balance between the imperative to change and the condition for order. To flourish, complex systems should gravitate toward what

Crichton calls the "edge of chaos." This is a place where there is enough innovation to keep a living system vibrant, and enough stability to keep it from falling into anarchy. It is a zone of conflict and upheaval.

Thus, finding the point of equilibrium is the critical matter. If a living system drifts too close to the edge, it can fall into incoherence and dissolution; if it shifts too far from it, it becomes rigid and frozen. Both conditions lead to extinction. Too much change is as destructive as too little.

The Behavior and Performance of the Philippine Commercial Banking Industry, 1980-1994

A Study of the Relationship Between Economic Growth and Financial Development*

*Carlos C. Bautista, Roy C. Ybañez and Gerardo Agulto, Jr.***
College of Business Administration
University of the Philippines, Diliman

There exists extensive literature on the importance of the financial system in stimulating economic activity. Some studies (Shaw, 1973; McKinnon, 1973, among others) contend that differences in the growth rates of economies are explained by differences in the levels of sophistication of services offered by the financial sector. More recent studies, both theoretical and empirical (see for example, King and Levine, 1993), likewise emphasize the crucial link between finance and growth. Influenced in part by recent developments in growth theory which emphasize the importance of innovative activities, these studies further suggest that the links between finance and growth are not limited to the former's resource mobilization and risk diversification functions. Equally important, according to these studies, is the financial sector's entrepreneurial evaluation function to effectively screen innovative activities that are most likely to succeed. The more efficiently the financial sector performs its functions, the more it contributes to the rate of growth of the economy through its impact on resource mobilization and innovation.

The study on which this presentation is based is an attempt to document and analyze the relationship between Philippine financial development and economic growth. In particular, we tried

---

*This presentation summarizes the highlights of a study supported by the Alfredo Velayo Research Chair on Business Policy of the Philippine financial system, specifically the commercial banking industry from 1980 to 1994. The full text of the report will be a forthcoming publication of the Center for Integrative and Development Studies, University of the Philippines.

**Associate Professor, Professor and Associate Professor respectively of the College of Business Administration, University of the Philippines, Diliman, Quezon City, Philippines.

to validate the hypothesis that financial development and economic growth are positively correlated. While we hope to determine the magnitude of this correlation, establishing causality is beyond the scope of our research. Furthermore, this study will focus on the largest sector in the financial system, the commercial banking industry, to provide possible explanations for our preliminary observations regarding the relationship between finance and growth. In so doing, we will also examine the effects of macroeconomic adjustment policies on the economy, on the one hand, and on the behavior and performance of commercial banks, on the other.

Finance and Development: A Comparison Across ASEAN[1]

One traditional measure of financial development is the ratio of liquid liabilities[2] to gross domestic product (GDP).This ratio is basically a measure of the size of the financial system. It reflects how extensively money is used in the economy and thus the level of development of the financial sector. On the other hand, economic development can be measured using per capita GDP in US dollars, which basically indicates the level of well-being in the economy.

Figure 1 and Table 1 show the ratio of liquid liabilities of the financial system to GDP, and per capita GDP in US dollars, respectively, for the five countries of the Association of Southeast Asian Nations (ASEAN) from 1970 to 1992.

Based on the ratio of liquid liabilities to GDP, it is clear that Singapore's financial sector is the largest among ASEAN countries. The Philippine financial system, on the other hand, did not seem to have grown compared to that of neighboring countries, with the exception of Indonesia whose financial system is almost identical in relative size to the Philippines. Throughout the 22-year period

---

[1] All the basic data used in this section came from various issues of the International Financial Statistics, unless otherwise specified.

[2] Liquid liabilities are defined as the sum of M1 or narrow money, interest bearing liabilities of the banking system, and demand and interest bearing liabilities of non-bank financial intermediaries. This was used because of its availability for all countries under study and because it is the broadest monetary aggregate that can be used to measure relative financial system size.

Figure 1: Liquid Liabilities/ Gross Domestic Product (GDP)

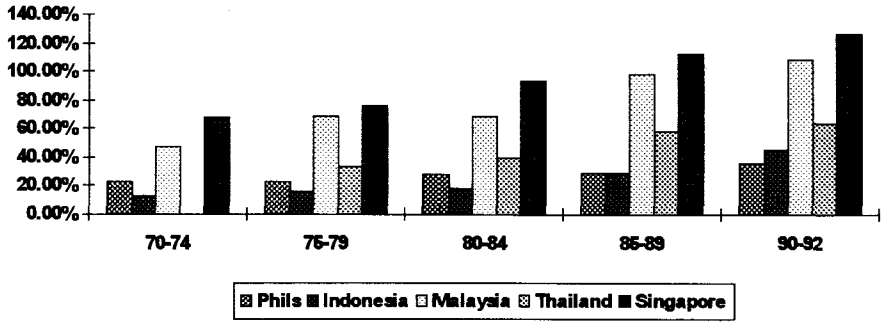


Table 1: Per Capita GDP, US Dollars

	70-74	75-79	80-84	85-89	90-92
Philippines	241	480	612	583	734
Indonesia	111	291	537	464	610
Malaysia	556	1,124	1,969	1,968	2,681
Thailand	242	465	722	964	1,446
Singapore	1,536	3,085	6,212	8,840	15,763

under consideration, the ratio for the Philippines never exceeded forty and by the 1990s, it was the lowest in ASEAN. Likewise, judging by absolute levels of per capita income, the Philippines and Indonesia seem to be exhibiting the same development pattern.

Using data presented above, economic development as measured by per capita GDP was regressed on financial development as measured by the ratio of liquid liabilities to GDP. Results of this regression validate the hypothesis that indeed there exists a strong positive relation between the two variables. The next section examines in greater detail these preliminary observations, specifically by studying the effects of macroeconomic policies on both economic growth and commercial bank profitability.

Macroeconomic Policy and the Banking Sector

The Philippine economy appears to be trapped in the so-called boom-bust cycle. This is evident in its low growth average and the large variability in its growth pattern (see Table 2.) Beginning in 1976, the Philippines experienced a gradual decline in economic growth that culminated in the balance-of-payment (BOP) crisis of 1983. From a high of 8.81 percent in 1976, the gross domestic product (GDP) bottomed out at negative growth levels in 1984 (-7.32%) and 1985 (-7.31%), during which the full effects of the BOP crisis were felt. From 1986 to 1989, however, the economy grew at an average of 5.13% but this level of growth was not sustained into the 1990s. In 1990, GDP increased by 2.7 percent but declined by .39 percent in 1991 and almost did not move (.10%) in 1992. In 1993, GDP rose by 1.7 percent.

In general, the method of macroeconomic adjustment adopted by policymakers from 1983 up to the present strongly emphasize the control of total spending to limit the growth of the general price level rather than the adjustment of the BOP deficit through a depreciation of the currency. It was particularly important for monetary authorities during the first half of the post-crisis period between 1986 and 1989—in large part due to the conditionalities imposed by the Bretton Woods agencies as a prerequisite for loan approvals—to avoid wild fluctuations in the exchange rate. This meant that international reserves had to be maintained at visibly high levels while at the same time making domestic assets such as treasury bills sufficiently attractive to portfolio holders to dampen possible speculation in the foreign exchange market. By 1988, however, monetary policies had become less restrictive. This was one of the factors that allowed for the reasonable growth of the economy. Nonetheless, interest rates continued to rise as a result of increased economic activity. But fear of inflation and currency

Table 2
Selected Macroeconomic Indicators, 1975-1993*

Year	GDP Growth	Inflation Rate	Liquidity Growth	91-Day TB Rate	Depre-ciation	*GIR***	*Bud Def/* GDP	*ROE* of *KBS****
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
1975	5.57%	9.32%	19.31%	10.34%	6.78%	1,361	1.440%	*NA*
1976	8.81%	8.31%	24.43%	10.19%	2.65%	1,642	1.993%	*NA*
1977	5.60%	8.27%	22.30%	10.90%	-0.50%	1,525	2.085%	*NA*
1978	5.17%	9.33%	17.77%	10.89%	-0.50%	1,883	1.549%	*NA*
1979	5.64%	14.84%	10.65%	12.25%	0.16%	2,423	0.993%	*NA*
1980	5.15%	14.25%	18.21%	12.31%	1.92%	3,155	1.473%	16.11%
1981	3.42%	11.70%	21.07%	12.80%	5.36%	2,574	4.988%	13.06%
1982	3.62%	8.70%	16.05%	14.03%	8.19%	1,711	4.548%	11.49%
1983	1.87%	14.22%	19.90%	15.38%	28.26%	865	3.295%	12.87%
1984	-7.32%	53.34%	7.20%	42.39%	49.51%	886	6.225%	5.90%
1985	-7.31%	17.63%	9.87%	16.46%	13.12%	1,061	4.496%	-19.39%
1986	3.42%	2.95%	7.31%	9.55%	10.17%	2,459	5.595%	-10.81%
1987	4.78%	7.38%	12.12%	13.59%	0.42%	1,959	3.976%	14.19%
1988	6.25%	10.25%	22.57%	16.74%	2.66%	2,059	2.691%	17.41%
1989	6.06%	8.69%	27.98%	20.45%	3.16%	2,324	1.234%	20.14%
1990	2.70%	12.71%	18.36%	26.52%	11.59%	1,993	1.758%	26.85%
1991	-0.39%	16.66%	15.48%	21.11%	12.91%	4,470	0.977%	19.63%
1992	0.10%	8.05%	11.03%	14.48%	-7.76%	5,218	1.187%	16.61%
1993	1.69%	6.49%	24.56%	15.94%	7.34%	5,801	1.177%	15.18%

Source of Basic Data: National Statistical Coordinating Board (NSCB), Bangko Sentral ng Pilipinas (BSP), Department of Finance (DOF).

* All the basic data used are end-of-period values.
** Gross International Reserves (GIR) of the BSP, in million US dollars.
***Return on equity of commercial banks.

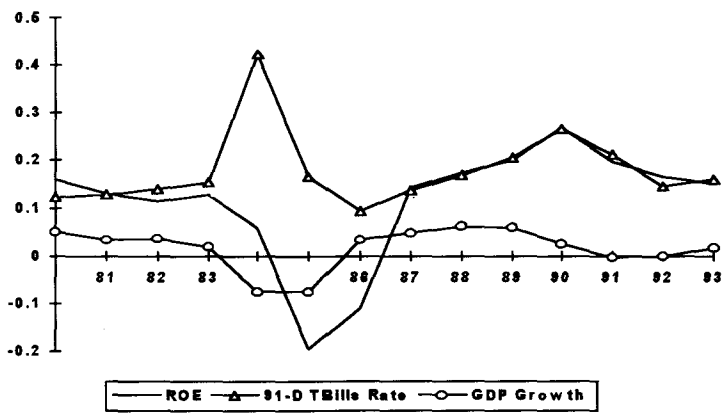
depreciation as economic activity heightened resulted in the tightening of monetary policies once again as the country entered the 1990s. In turn, although inflation was indeed controlled, this unfortunately was achieved at the expense of output growth.

In this study, we hypothesized that overall bank behavior and performance in the Philippines is responsive to both changes in economic activity, represented by GDP growth, and the cost of

funds, approximated by the end-of-period rates of 91-day treasury bills. Bank behavior and performance may be represented by the commercial banking system's return-on-equity (ROE) or the relationship between net profit and the amount invested by bank owners. Figure 2 plots data on the ROE of the commercial banking industry, the 91-day treasury bills (T-bills) rate and GDP growth. By inspection, one can see a generally positive association between ROE, on the one hand, and the T-bill rate and GDP growth, on the other. This relation is verified by regression analysis. Furthermore, beginning 1987, ROE rose and fell **consistently** with T-bill rates. This possibly has significant implications on bank profitability as Tbill rates are presently declining.

Figure 2

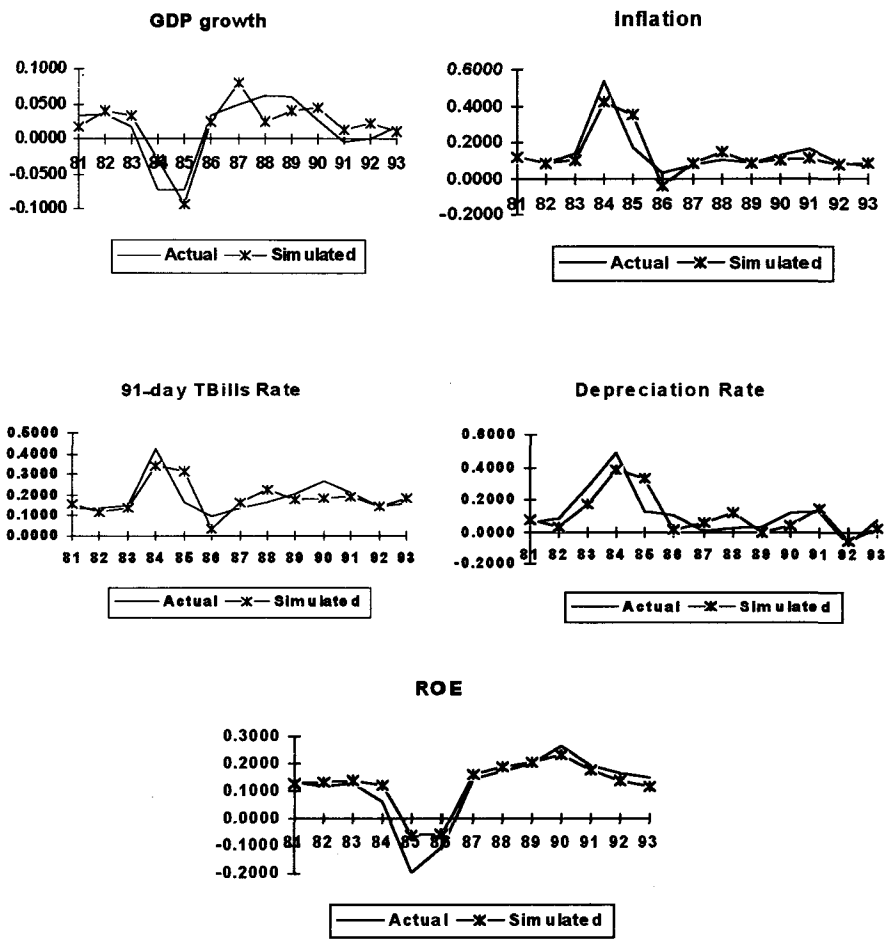
Macro Indicators of Banking Industry Performance



To further quantify the effects of policy on both economic growth and bank performance, we posed an alternative scenario wherein a more relaxed monetary policy is pursued during the post-crisis period and onward. Using data from the National Statistical Coordinating Board (NSCB) and the Bangko Sentral ng Pilipinas (BSP), we constructed a forecasting model. To gauge the tracking ability of the model, we performed some dynamic simulations as shown in Figure 3.

Figure 3

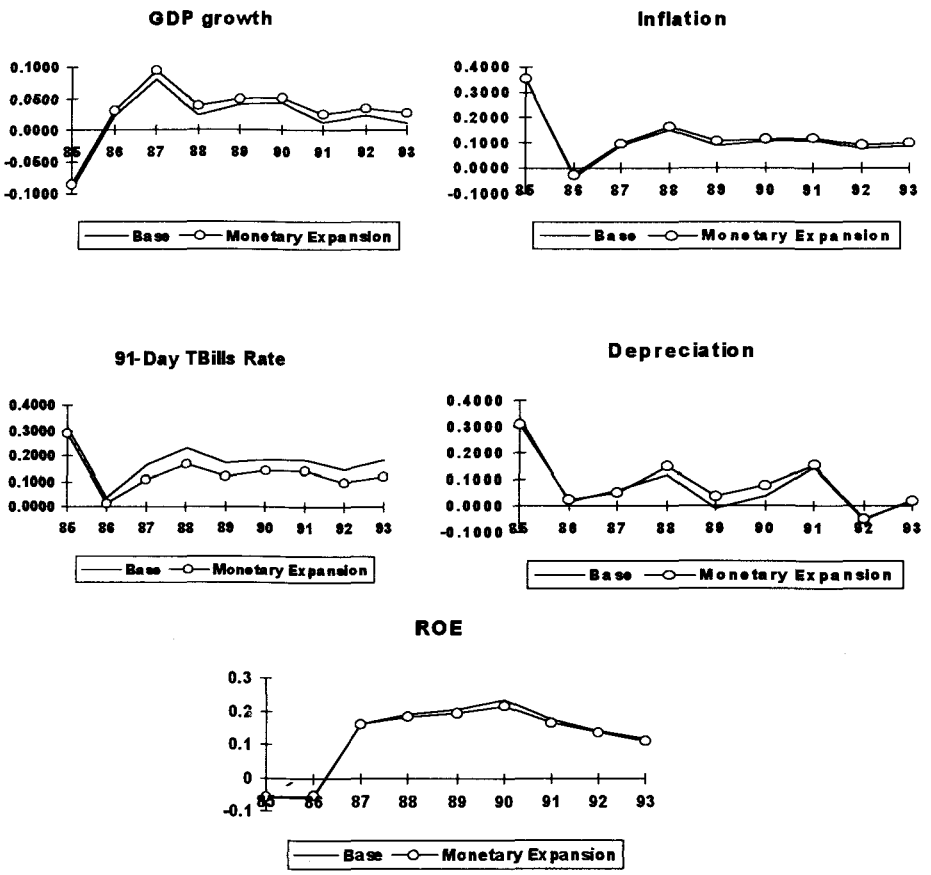
Historical Simulation Results of a Simple Macro Model with a Banking Sector



Next, we conducted a policy experiment that assumed total liquidity growth at a constant rate of 19 percent onward starting in 1985. This in effect tries to simulate an expansionary monetary policy. The results of these experiments are shown in graphical form in Figure 4.

Figure 4

Simulation Results of Monetary Expansion from 1985 Onward



From Figure 4, it is clear that if monetary expansion was pursued beginning 1985, output growth, and inflation and depreciation rates would have been higher while interest rates would have been lower. For the simulation period, the average growth rate of the economy is higher by 1.13 percent from the base case. On the average, inflation is higher by one percent; the 91-day treasury bills rate is lower by 4.7 percent; and the peso depreciation rate is higher by an average of 1.15 percent (see Table 3).

Table 3

Simulation Results of Monetary Expansion from 1985 Onward (in percentage point difference from base values)

	GDP growth	Inflation	91-day T-bills Rate	Depre-ciation	ROE
1985	0.81%	0.00%	-2.53%	-2.34%	0.32%
1986	0.66%	0.86%	-2.49%	1.22%	0.15%
1987	1.48%	0.70%	-5.80%	-1.06%	-0.08%
1988	1.42%	1.57%	-5.93%	3.19%	-0.43%
1989	1.00%	1.51%	-5.50%	4.35%	-1.34%
1990	0.73%	1.07%	-4.28%	4.16%	-1.70%
1991	1.18%	0.78%	-4.59%	1.08%	-1.03%
1992	1.26%	1.25%	-4.57%	0.40%	-0.47%
1993	1.68%	1.34%	-6.48%	-0.63%	-0.38%
Ave	1.13%	1.01%	-4.69%	1.15%	-0.55%

The simulation results on GDP growth and the interest rate were used on the regression equation previously alluded to, to derive the effects of monetary policy on banking industry performance. Notice that with monetary expansion, the ROE of commercial banks is lower by less than one percentage point on the average—a seemingly negligible change. Nonetheless, this has significant implications. Looking back at Table 2, output growth and interest rates are shown to be moving in opposite directions at least up to 1990. In the model, an increase in money supply has a liquidity effect stronger than the positive effects of inflation on the interest rate. The net result is a decline in the interest rate that raises aggregate (overall) demand for goods in the economy and leads to higher output growth. The effect on the banks ROE thus is the net effect of (1) a decline in the interest rate; and (2) the increase in output growth caused by monetary expansion. A decline in ROE of banks when Tbill rates fall means that this lowering of Tbill rates (a price effect) dominates the effect on loan demand of an increase in output growth (a quantity effect).

To summarize the results of the simulation, the tighter the credit conditions, the higher the interest rate, the lower the output growth and the higher the ROE of banks. Such results are seemingly inconsistent with results of regression analyses previously done in our study that revealed (1) a highly positive relation between economic development (measured by per capita GDP) and financial development (measured by the ratio of liquid liabilities to GDP); and (2) a positive relation between ROE, on the one hand, and Tbill rates and GDP, on the other. How is it possible then for bank profitability to increase without a corresponding increase in economic growth? The next section discusses the changes in the structure of the commercial banking industry—a reaction in part to the changing macroeconomic environment—which may serve to partly explain this apparent paradox.

The State of Commercial Banking in the Philippines[3]

Although the Philippines has lagged behind her Asian neighbors in terms of financial development for the past 15 years, and despite its generally poor economic performance, some degree of financial deepening is evident in the country. This appears to have started in 1989, with the M3 to gross domestic product (GDP) ratio[4] rising from 20 percent in 1988 to 29.4 percent in 1994 (although coming from a previous high of 26.4 percent in 1978). To specify the nature and dynamics of this deepening, we focused on the commercial banking system whose behavior and performance, given its share in the financial system, may be indicative of the behavior and performance of the finance industry as a whole.

---

[3] Annual figures involving balance sheet items are derived from monthly data of the Bangko Sentral ng Pilipinas. This was done so that the annual figures, as much as possible, are representative of performance for the whole year and to avoid potential biases in year-end data.

[4] Unlike the ratio of liquid liabilities to GDP used to measure financial deepening in the next section, the M3 is a narrower aggregate defined as the sum of money supply, savings and time deposits, and deposit substitutes of deposit money banks.

Commercial banks (KBs) continue to dominate the Philippine financial system. At the end of 1994, there were 34 KBs, including 18 with unibanking licenses and four foreign banks, accounting for 66.4 percent of total resources, up from 57.3 percent in 1980. Of these, domestic private banks constituted slightly over 70 percent of the industry, the two government banks—Philippine National Bank or PNB and Land Bank—22 percent, and foreign banks eight percent. For the period 1980 to 1994 the resources of the KBs have grown, on the average and in real terms, at an annual rate of 2.9 percent which is .67 percent higher than that of gross national product (GNP). This is notwithstanding the crisis years from 1984 to 1987 which saw the industry contract and experience a number of individual bank failures.

The Financial Performance of Commercial Banks

As a a benchmark measure of the financial performance of the commercial banking industry, the study used return on equity (ROE) of banks.

From 1980 to 1994, ROE averaged 15 percent, levelling off at this rate in the later years after swings that are reflective of the corresponding economic climates. The turbulence of the first five years of the 1980s was reflected in the decline of ROE, bottoming out in 1985 at negative 19 percent. The recovery period thereafter was mirrored by the industry ROE increasing, peaking at 27 percent in 1990. The last five years showed ROE stabilizing at 15 percent yearly (see Figure 5).[5]

Using the DuPont financial analysis model, we looked into the principal factors which influenced the behavior of ROE during the 15-year period between 1980 and 1994. Data show that the movement of ROE can be traced more to industry efficiency in managing its resources rather than its funding strategies. In other words, ROE behavior was affected more by return on assets (ROA) than financial leveraging (see Figure 6).

---

[5] After-tax profits of the industry averaged 6.5 billion pesos annually during the 15-year period, reaching its highest point in 1994 at almost 18 billion pesos. Equity investment in 1994 approached 120 billion pesos, averaging slightly more than 44 billion pesos during the 1980-1984 period.

Figure 5
Return on Equity (in percent)

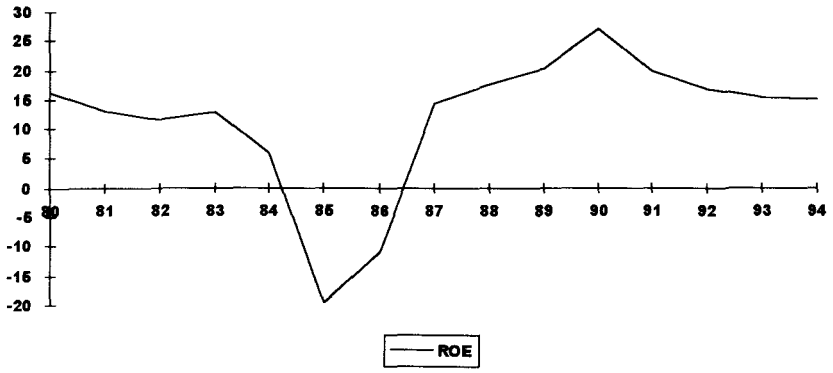
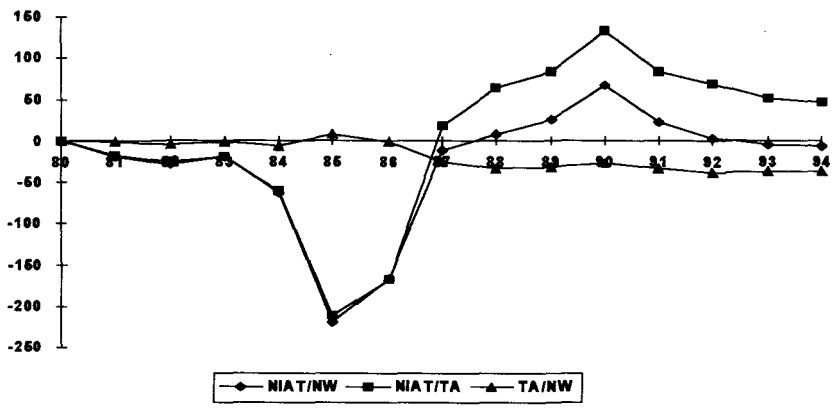


Figure 6
Percent Changes of Financial Ratios:
ROE, ROA and Leverage



By cascading the analysis further, we found that the behavior of ROA was influenced alternately by both of its direct subcomponents of revenue generation and cost control. Specifically, in the first half of the 15-year period under study, cost control (as reflected by profit margin) was the key activity affecting ROA and ROE. Revenue generation (as reflected by asset turnover) was the influential variable in the later half. Stated differently, the industry used cost control to shape returns during the harsh economic times and shifted to revenue generation during the more clement economic years that followed (see Figures 7 and 8).

Figure 7
Percent Changes of Financial Ratios:
ROE and Cost Control

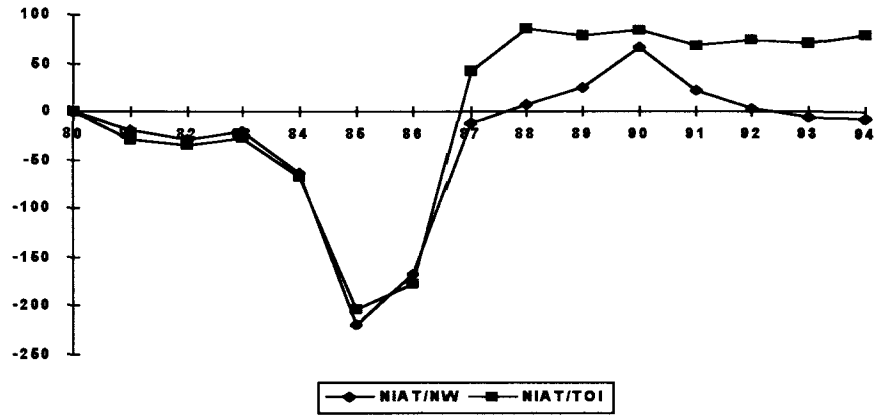
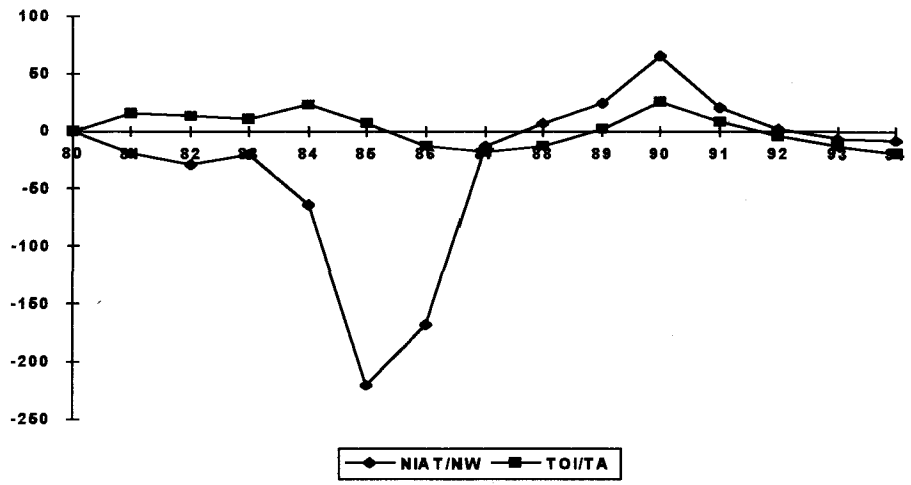


Figure 8
Percent Changes of Financial Ratios:
ROE and Revenue Generation



Structural Shifts in the Commercial Banking Industry

During the period under study, a number of significant changes in the structure of the commercial banking industry occurred, specifically in relation to liabilities and capital, assets, off balance-sheet activities, and profitability and lending spreads. An examination of these structural shifts may clarify further the cost control and revenue generation strategies employed by industry which eventually led to the stabilization of industry ROE despite the below average economic performance of the Philippines.

Liability and Capital Structure. There has been a significant shift in the liability structure of the commercial banking system to a much greater reliance on deposits and less dependence on borrowings. This is reflected in the sharp rise in the ratio of deposits to total liabilities, from 56 percent in 1980 to 73 percent in 1994. This shift has largely been toward savings deposits which, by year-end 1994, accounted for 66 percent of total deposits, up from only 32 percent in 1980. It is possible that, among others, liberalized rules on bank expansion and technology improvements (e.g., automated teller machines) have facilitated the rapid growth of deposits.

On the other hand, there has been a decline in bank borrowings or bills payable largely as a result of a decline in the use of deposit substitutes. By year-end 1994, the latter constitute less than one percent of total liabilities. Previous studies (*e.g.* Yap, *et al.*, 1990) suggest that this may be due in part to more stringent rules on deposit substitutes, on the one hand, and continuing concerns regarding the risk involved in investing in money market instruments after the money market crisis of the 1980s. Financial deepening has been mainly due to this growth in savings deposits and the corresponding decline in deposit substitutes. In fact, financial deepening may be moving faster than traditional measures suggest. For instance, deposit substitutes of nonbanks although still at low levels, are now larger than those of deposit money banks. Moreover, as is frequently argued, regulatory costs for Philippine banks are higher than those in other ASEAN countries. This may partly explain the shift in bank mobilization off the balance sheet to trust and investment management accounts.

The capital structure of the commercial banking industry has also changed. By the end of 1994, commercial banks (KBs) have become better capitalized. Bank equity has grown at a faster rate than either deposits or total liabilities. Thus, the ratio of debt to assets declined from 92 percent in 1980 to 87 percent in 1994. This is due in part to higher capital requirements imposed by the Bangko Sentral ng Pilipinas, on the one hand, and the transfer of liabilities of the government-owned Philippine National Bank to the national government in the mid-1980s.

Asset Structure. Loans have had, on the average, the slowest growth among the major balance sheet items for the period 1987 to 1994, appearing to mirror overall economic activity. This traditional channel of intermediation has been hampered by slow and erratic movements of economic activity and must be considered a serious problem for economic development. However, loans have been the fastest growing component in the past two years, reflecting improving economic conditions. Based on year-end 1994 figures, KB loans are predominantly short-term (75%), private sector (97%) loans oriented toward the manufacturing and trading sectors (57%, combined).

Investments have, on the other hand, grown significantly from 11 percent of total assets in 1980 to 16.2 percent in 1994. Of these, an average of 76 percent have been in government securities. In recent years, however, there has been a dramatic rise in foreign securities investments.

On the other hand, a decrease in loan demand as a result of a decrease in output growth would have less dominant effect on return on equity (ROE) since KBs have veered away from loan-based intermediation.

Off Balance-Sheet Activities. Previous studies (*e.g.* Zingapan *et al.*, 1990) have noted the potential benefits to banks of off balance-sheet activities as sources of additional income, particularly in so far as these activities are subject to less stringent regulation. Such activities consist mainly of trade-related guarantee services like letters of credits (LCs) and fiduciary services like pension trust funds and investment management services. These are mostly reflected in the contingent liabilities of banks.

Trust services increased at an annual (real) rate of 14.5 percent between 1984 and 1994, compared to 3.1 percent for total bank resources and 6.5 percent for deposits, accounting for about 43 percent of total industry contingent liabilities as of year-end 1994. In general, trust and fund management activities have provided bank clients with alternative vehicles for investment in government securities, direct loans and stocks (see Table 4.).

Furthermore, off balance-sheet intermediation has grown faster over the period 1984 to 1994 than traditional deposit-based intermediation. The ratio of trust accountabilities to deposit liabilities rose from 15.5 percent at year-end 1984 to 28.8 percent by year-end 1994. This ratio reached a high of 42.6 percent in February 1993. It has been argued that increasing off-balance sheet activities was a reaction to the high regulatory cost of deposit-based intermediation (Zingapan, *et al.*, 1990), chief among which are the 17 percent to 25 percent reserve requirement that prevailed during this period, the five percent gross receipts tax (GRT), and loan allocation restrictions such as the Agr-Agra. By shuttling funds generation and utilization activities off the balance sheet, KBs minimize exposure to these regulations and avoid their corresponding costs. Thus, it seems that KBs compensated for the slow growth of traditional lending activities by attempting to maximize the potential of off-balance sheet activities.

However, it seems that the imposition by the Central Bank of a reserve requirement on common trust funds in October 1993 reduced the attractiveness of this form of intermediation. With the shifts in the liability structure of KBs and the growth of loans in the past two years, a return to traditional deposit-loan based intermediation is foreseen. It would be interesting to see what implications this might have on the stability of ROE, especially given the downward trend in treasury bill rates.

Bank Profitability and Lending Spreads. Intermediation income from traditional banking activities[6] accounts for around half (47%) of the gross operating income of banks.[7] With the rise in loan

[6] This is roughly equivalent to net interest income.

[7] Gross operating income = net interest income + other sources of income, e.g. commissions, fees and charges, trading gains, foreign exchange profits, income from trust department.

Table 4

Growth Rates in the Commercial Banking Sector

Growth Rates: Nominal	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	Average
Resources	24.1	19.8	21.0	21.5	8.5	(1.6)	(8.8)	23.5	21.6	22.5	19.8	11.6	20.6	21.3	16.1
Deposits	19.1	13.9	23.2	17.6	13.7	(0.3)	2.7	27.9	27.4	23.5	19.9	13.1	24.8	23.2	17.8
Networth	26.1	23.8	17.1	28.2	(4.9)	7.6	20.2	39.7	17.9	16.6	28.5	21.1	18.3	19.6	20.0
Loans	16.7	18.6	23.1	17.8	(5.2)	(6.3)	(13.1)	18.9	20.1	20.3	18.6	17.8	26.9	27.3	14.4
Investments	9.9	20.8	25.5	15.2	13.5	3.7	(7.4)	63.8	17.1	27.2	35.5	23.3	15.2	22.8	20.4
Earning Assets	18.7	16.4	20.2	16.2	(1.2)	(5.7)	(9.1)	31.2	21.8	24.7	17.8	13.8	22.2	22.7	15.0
Contingent Accounts					(42.6)	4.0	57.4	17.2	9.5	16.1	14.4	17.7	18.3	18.2	13.0
Trust Accounts					20.2	31.3	18.8	35.2	19.9	18.6	36.3	52.4	25.3	4.3	26.2
Number of Offices	15.2	6.4	3.4	0.9	(8.8)	0.7	(1.8)	2.4	(0.5)	4.5	7.8	18.7	10.3	12.3	5.1
Growth Rates: Real (Adjusted for Inflation)															
Resources	9.8	8.7	10.0	(19.2)	(11.9)	(2.4)	(12.2)	13.6	10.0	7.0	0.9	2.5	12.0	11.3	2.9
Deposits	5.3	3.3	12.0	(21.8)	(7.6)	(1.1)	(1.0)	17.6	15.2	7.9	1.0	3.8	15.9	13.0	4.5
Networth	11.5	12.3	6.5	(14.7)	(22.7)	6.8	15.9	28.4	6.6	1.8	8.2	11.2	9.9	9.7	6.5
Loans	3.2	7.5	11.9	(21.6)	(23.0)	(7.0)	(16.2)	9.3	8.6	5.1	(0.1)	8.2	17.9	16.7	1.5
Investments	(2.9)	9.6	14.1	(23.3)	(7.8)	2.9	(10.8)	50.6	5.9	11.1	14.1	13.3	7.1	12.7	6.9
Earning Assets	5.0	5.6	9.3	(22.7)	(19.7)	(6.5)	(12.4)	20.7	10.2	8.9	(0.8)	4.5	13.5	12.5	2.0
Contingent Accounts					(53.3)	3.2	51.6	7.8	(1.0)	1.4	(3.7)	8.1	9.9	8.4	3.2
Trust Accounts					(2.4)	30.3	14.5	24.3	8.4	3.5	14.7	39.9	16.4	(4.4)	14.5

activities in recent years, this ratio reached a record high of 66 percent in 1994. No long-term trend is apparent as the ratio of net interest income to gross operating income has fluctuated significantly over the period from 1980 to 1994.

Foreign exchange (FX) profits constitute the next biggest source of income, averaging 21 percent from 1980 to 1994. Notably, FX profits served as buffer during periods of depressed loan demand, accounting for as much as 42.3 percent of gross operating income in 1984. Trading gains averaged 7.6 percent of gross operating income over the same period while other bank services, including trust services, averaged around 25 percent.

We also present some findings on bank lending spreads as indicator of the intermediation efficiency of commercial banks (KBs). While economists would argue that large spreads are indications of inefficiency, others would claim that these are not due to the exercise of monopoly power but rather the result of rising intermediation cost due to regulation, specifically the reserve requirement and the gross receipts tax (GRT).

The average gross spread, equal to the difference between the average lending rate and the blended cost of demand, savings, and time deposits, for the period 1980 to 1994 is 8.77 percent. Regulatory costs averaged 2.87 percent, broken down into 1.86 percent for the reserve requirement and 1.01 percent for the GRT. Net spread, or the net cost of the reserve requirement and GRT but gross of other bank costs and profits, is 5.9 percent.

In real terms, the gross spread averaged 7.66 percent while the net spread 5.18 percent. Also in real terms, spreads are generally more stable than either lending or deposit rates, suggesting the capability of KBs to adjust lending rates to changes in the cost of funds. Moreover, real spreads are somewhat higher in the second half of the period under study. This improvement may be attributable to a more bullish economy and the growth of loan demand.

Finally, Table 5 shows some comparative figures on the profitability of KBs and other types of banking institutions.

Table 5
Return on Equity of Major Categories of Banking Institutions*
(Gross of Income Taxes)

	Commercial Banks	Thrift Banks	Savings & Mortgage	Private Dev. Banks	Stock SLAs	Specialized Govt Banks	Rural Banks
1984	4.5	10.2	14.9	11.6	4.4	(74.7)	6.9
1985	(13.5)	4.4	4.8	8.2	(0.4)	(98.4)	5.6
1986	(8.8)	8.3	24.9	3.3	1.3	(37.7)	9.3
1987	13.6	4.0	23.0	(10.0)	(1.0)	19.3	10.3
1988	21.2	13.4	20.3	12.5	4.4	30.4	9.4
1989	24.9	21.1	31.6	17.8	5.7	19.4	12.0
1990	31.0	25.1	29.7	25.9	19.9	33.2	14.3
1991	25.5	22.7	31.7	18.8	15.3	23.6	11.4
1992	20.2	23.6	32.3	20.7	14.3	24.0	11.2
1993	16.7	20.4	27.1	18.4	13.2	16.5	12.8
Average	13.5	15.3	24.0	12.7	7.7	(4.4)	10.3

Source of Basic Data: Fact Book. Philippine Financial System, 1993.

* The rate of return data in this table is not comparable to the return on equity (ROE) estimates for the commercial banking system discussed elsewhere in this report not only because of the exclusion of income taxes but also because of differences in bank categories. The Fact Books groups the Land Bank under specialized government banks while the *BSP Statistical Bulletin* groups it under commercial banks.

In general, KBs are not the most profitable among the broad classes of banking institutions. Savings banks, with their orientation toward consumer finance, are the most profitable.

Risk Management. The study also evaluated the performance of the commercial banking industry in terms of the major risks involved in managing banks, namely credit, liquidity, capital adequacy and operational risks. No notable developments in terms of these risk dimensions were identified. However, given the significant influence of the government-owned Philippine National Bank on industry statistics, the findings on risk management — and of return generation — serve only as baseline data and thus must be supplemented through further research.

Summary

The study has shown that Philippine financial development, though lagging behind other countries in the region, is closely related to the overall macroeconomic performance of the country. On the performance of the commercial banking industry, the data suggest that the positive relationship between treasury bills (T-bills) rate and bank ROE (return on equity) is based on (1) the fact that banks price their loans in reference to the T-bills rate and (2) during the later part of the period under study, (where the relationship is most evident) savings deposits, which constitute the cheapest source of bank funds, increased substantially as a proportion of total bank fund sources.

The study has also shown significant changes in the asset and liability structure of the Philippine commercial banks during the period, possibly as a response to changes in the regulatory environment. The study also suggests that commercial banks adopted different management strategies, e.g., cost control versus revenue generation, depending on the favorableness of the credit conditions prevailing during the period.

References

King, R. and R. Levine. 1993. "Finance, Entrepreneurship and Growth," *Journal of Monetary Economics*, pp. 513-542.

McKinnon, R. 1973. Money and Capital in Economic Development. Brookings Institute.

Shaw, E. 1973. Financial Deepening in Economic Development. Oxford University Press.

Yap, Josef, Mariano Lamberte, Teodoro Untalan and Socorro Zingapan. 1990. "Central Bank Policies and the Behavior of the Money Market: The Case of the Philippines." Working Paper Series No. 90-24, Philippine Institute for Development Studies.

Zingapan, Ma. Socorro, Mario Lamberte and Josef Yap. 1990. "Off-Balance Sheet Activities of Commercial Banks in the Philippines." Working Paper Series No. 90-25. Philippine Institute for Development Studies.

Fiscal, Monetary and Financial Intermediation Policies

Impact on Fund Needs and Sources

Dante B. Canlas
Deputy Director-General
National Economic and
Development Authority

Introduction

In the past few years, the government has been implementing a structural economic policy reform program based on greater reliance on the coordinative ability of private markets guided by a decentralized price system. In line with this, several industries have been deregulated, such as the telecommunications and shipping industries; markets have been liberalized, including the financial and capital markets; and public enterprises have been privatized, like Petron and the Philippine National Bank.

In this deregulated and liberalized setting, the government's role is in the areas of fiscal, monetary, and financial-intermediation policies. These policies need to be coordinated with those on exchange-rate, trade and industry so that economic and business activities are not disrupted. We want to achieve stable prices and avoid undesirable fluctuations in the national output and employment. In journalistic parlance, this is referred to as avoiding the recurrence of boom-and-bust cycles.

I will present the directions of fiscal and monetary policy, and point out how the new thrusts of these macroeconomic policies help lead to a smooth functioning of the financial market. Since it defines the expenditure, revenue, and deficit programs of the government, fiscal policy determines the level of the public debt.

Any deficit has to be financed. Monetary policy determines how much of the deficit is to be financed by money creation, and therefore, is mainly responsible for the composition of the public debt. If, on one hand, the monetary authority fully accomodates the deficit, money supply rises, generally with inflationary consequences. Inflation, by interfering in the signals provided by the price system, always affects output adversely.

On the other hand, if the monetary authority does not accomodate the deficit and lets the government finance it by borrowing from the public through the issuance of Treasury bills and other eligible debt instruments, nominal interest rates rise. This step crowds out investments, eventually affecting output negatively.

In these two extreme cases, banks and other financial intermediaries suffer as a result of the overall economic slowdown. Moreover, inflation prevents banks and other financial intermediaries from coming up with efficient saver-investor matches, while high interest rates lead to higher default probabilities.

Recognizing, therefore, the output effects of fiscal, monetary, and financial-intermediation policies, the government is adopting the following strategies: (1) both revenue and government spending may increase but they should achieve balance over time; (2) money-supply growth is pre-announced in line with the target growth of the real gross national product (GNP) and a declining single-digit inflation rate; (3) the cost of financial intermediation is set for further reduction through the removal of distortionary taxes, fees and charges; and (4) the nominal exchange rate is market-determined, with central-bank intervention designed to maintain consistency with money-supply targets. In all of this, the goal is to provide a predictably stable setting for the private sector.

This approach is adopted in the light of the country's past experience with inconsistent macroeconomic policies. Under that old policy regime, the country was unable to overcome its savings and foreign-exchange constraints, thereby leading to a recurrence of serious balance-of-payments difficulties. Financial intermediation was greatly impeded, causing an economic slowdown and ultimately a contraction.

A deficit in the balance of payments (BOP) means that aggregate spending exceeds aggregate income receipts. To finance the deficit, the government resorted to foreign borrowing. As a result, claims of the rest of the world on the economy increased. When the deficits persisted, foreign borrowing eventually became unsustainable, erupting into a liquidity crisis. Consequently, the Philippines was not able to transact smoothly with the rest of the world.

Those BOP crises had fiscal and monetary roots. One of the major dissavers then was the public sector, in particular, the government corporate sector. The financing of those budget deficits was largely through money creation, which led to high domestic inflation. The relative price of imports went down; and consequently, an excess demand for dollars materialized.

At that time, the exchange-rate system in place was fixed. Under that fixed exchange-rate system, the central bank stood ready to sell dollars for pesos at a predetermined or targeted nominal exchange rate. Excess pesos were thus exchanged for dollars to finance the increase in the demand for imports whose relative price had fallen as a result of the high domestic inflation. The international reserve assets of the central bank decreased as a result. When the budget deficits persisted, more pesos were released. Eventually, the central bank ran out of foreign reserves, causing a liquidity crisis.

The 1983 BOP crisis was of the sort I just described. The central bank suspended servicing of foreign debts, causing failures on the financial intermediation functions of commercial banks. That BOP crisis triggered two years of recession, the first in the postwar economic history of the country.

Everytime a BOP crisis broke out, the government had to run to the International Monetary Fund for the needed foreign currency—the special drawing rights. The Fund's recommendation to any member-country client with a BOP problem is to practice austerity. Monetary and fiscal policy was thus tightened, and given the severity of the BOP problem, the peso was devalued by a significant magnitude. The short-run response of the economy to a belt-tightening was to slow down before growth resumed.

Given this background, let me turn to the current macroeconomic policies of the government designed for sustained economic growth with stable prices.

Fiscal Policy

The government is pursuing a deficit-reduction program in its medium-term development program. In 1995, the deficit is targeted to be only about .38 percent of gross national product (GNP). As of the first nine months of the year, the government is on track with this target. This consolidated public-sector deficit is set for balance in 1996.

Since 1993, the deficit has been declining. Success in this area is traceable to growing revenue collection, arising from improved efficiency of tax collection, higher fees and charges, implementation of new tax rates and adherence to privatization. The tax reform is by no means complete at this stage, but the present Congress is set to deliberate on the tax-reform package certified by the administration.

The government was able to put a lid on spending by streamlining the bureaucracy, and privatizing a good number of public enterprises. Spending was also contained by the privatization of government enterprises, as net subsidies to them were greatly reduced. Meanwhile, the macroeconomic policies in general have yielded a reduction in interest rates paid by the government. In addition, the reform of the special fiscal incentives program has led to a substantial reduction in government expenditures.

Monetary and Financial-Intermediation Policies

An important milestone in the reform of monetary policy is the act which created the new Bangko Sentral ng Pilipinas (BSP). It must be recalled that as a result of inconsistent fiscal, monetary, and exchange-rate policies, the old Central Bank became saddled with huge monetary liabilities which hampered the sound conduct of monetary policy.

The new BSP has a fair amount of independence from the fiscal authority. Only one cabinet member sits in the Monetary Board (MB) in an ex-officio capacity. With cabinet members in the majority in the old setup, the MB created perverse incentives. The deficits created by the fiscal authority were readily accommodated by the monetary authority. Consequently, the economy was not able to extricate itself from a high inflationary regime.

The new BSP has also ushered in a quite flexible exchange-rate system. As a result, the BSP has been able to maintain a healthy level of international reserves, sufficiently large to withstand any speculative attack. Base money, or the total liabilities of the BSP, adjusted for the prevailing peso-dollar rate, can be met by the level of its foreign reserve assets.

In relation to financial intermediation, the BSP continues to liberalize the financial market. This can be seen in the new rules on bank branching and in the act which permitted the entry of ten foreign banks in the commercial banking system. This has introduced more competition in the system resulting in better assessment of the default probabilities of potential borrowers. New savings and demand-deposit instruments are emerging to the benefit of savers and consumers. Competition prods banks and other deposit-taking intermediaries to continue coming up with financial innovations using advances in modern telecommunications, with salutary effects on savings and investments.

Of course, the continuous reduction in the minimum reserve requirements for deposits of varying maturities is a boon to banks and other deposit-taking financial institutions. This measure has released more loanable funds into the economy and reduced the cost of financial intermediation.

The liberalization of the capital account in the BSP is a further boost to financial intermediation. Return-capital among residents has been observed. Foreign savings flowing into the country for loan and equity finance are also on an uptrend.

The BSP is now concentrating on its price-stabilization mandate. This is unavoidable under the present enhanced capital-mobility regime. The BSP needs to preempt inflationary expectations to prevent capital outflow, particularly, the short-term speculative type. To succeed in this, the BSP must be credible as an inflation fighter. To help establish this credibility, the fiscal authority coordinates with the BSP to make sure that chronic deficits in the public-sector account are avoided. Any temporary deficit, caused by, say, unavoidable production disturbances, will be backed by future fiscal surpluses.

In this connection, the August and September 1995 inflation rates are not a cause for worry since they arise mainly from a temporary rice-price shock. As of September, the average inflation rate is still 7.2 percent. There is no macroeconomic shock that will cause a double-digit inflation rate, on the average, for the year. Note that the national government posted a fiscal surplus in September, while base money is well within the money supply programmed for the period.

Trade Policies

At this point, a few words about trade policies are useful in rounding up the structural policy reform program of the government. These are important for financial intermediation in so far as they permit the entry of quality investments seeking loan or equity financing.

The new trade policies are anchored on import liberalization and tariff reduction. These two complementary measures allow entrepreneurs to access least-cost raw materials, components, and technologies available in the world market. Competition from imports, meanwhile, is an incentive to domestic enterprises to invest in new capital equipment which embody new technologies. This raises the quality of investments, which could be financed by the increase in savings expected from greater competition in the capital and financial markets, and in the stabilization of key macroeconomic variables like interest rates, general price level, and the exchange rate.

The new trade environment opens up new opportunities for the insurance market. Foreign trade and its financing depend a lot on insurance markets being able to allocate risk bearing efficiently. In this connection, the government has to a great extent liberalized the insurance industry. In 1994, after being closed for 50 years, the insurance industry was opened to 100 percent-owned foreign companies. This certainly opens up a new source of funds for investments.

Concluding Remarks

The structural policy reform program of the government has made the Philippines a more open economy. As a result, the country is now linked with the rest of the world, not only through trade in goods and services but also through trade in national monies and securities.

To ensure a smooth functioning of financial and capital markets in this setting, the conduct of fiscal, monetary, and exchange-rate policies must be consistent to produce a stable environment for producers, consumers, and intermediaries.

The fiscal-policy stance is clear at this point. The consolidated public sector deficit is targeted for balance in 1996. Given the success of the government in reducing this deficit from 1993 to 1995, there is no doubt that this target can be achieved.

Monetary policy aims for a stable price setting. In this new open-economy environment, new challenges for stabilization policy have emerged. Fluctuations in the demand for money tend to be more pronounced in an open than in a closed environment. The task of the Bangko Sentral ng Pilipinas (BSP) is to predict changes in money demand, to determine whether they are temporary or permanent, and to act swiftly and decisively.

It can draw on a number of indicators for guidance in this regard. These include domestic interest rates, exchange rate, and the level of BSP foreign reserves. Inflationary expectations tend to get reflected immediately in the interest rates for debt instruments of varying maturities and in the exchange rate. The BSP must act early enough to extirpate inflationary expectations, given their self-fulfilling nature.

The tariff reduction program, meanwhile, is on track, set to achieve uniformity in the year 2004. By the year 2000, however, 85 percent of all tariff lines for industrial goods shall have been reduced to either three percent or 10 percent. By 2003, all industrial goods shall be subject to this two-tiered tariff rate. Meanwhile, the public consultation on the tariff reduction program for agricultural goods has just been completed; the draft executive order for the purpose will be written soon.

To sum up, the economic liberalization program has opened up new areas of investments, the users of funds. The set includes both export-oriented and import-substituting industries. The latter, however, have been rendered efficient by competition from imports and are decidedly different from the import-substituting industries of the Fifties, which thrived only on account of protection from high tariffs and import restrictions. On the savings side, the sources of funds, the stable macroeconomic policies together with the liberalization of financial, capital, and insurance markets are helping raise the savings level and its rate.

THE STOCK MARKET AS FINANCING SOURCE

Eduardo de los Angeles
President/Chief Executive Officer
Philippine Stock Exchange

Up to 1990, a 100 million pesos public offering was considered large for the stock market. That was the year when market capitalization stood at 161 billion pesos. Starting 1994, however, a public offering of less than one billion pesos was considered small. That was the year when market capitalization reached 1.39 trillion pesos.

Indeed, from the time the Philippine Stock Exchange (PSE) began to operate in April 1994 to September 1995 (see Table 1), it was able to raise 58.3 billion pesos for initial public offerings (IPO) broken down as follows:

P52.9 billion - for primary offerings
P5.4 billion - for secondary offerings

Furthermore, within the same period, the PSE was able to raise 46.3 billion pesos for additional offerings.

Notably, almost all, if not all of the IPOs from April 1994 to September 30, 1995, were fully subscribed. Some were even oversubscribed. Among the 31 companies that did IPOs between 1994 and 1995 (see Appendices A and B) were:

Company	**Work Program**
La Tondeña Dist., Inc.	Capital expenditures (bottling plant, mineral water project, alcohol aging facility, Vismin Bottling Plant)
MRC Allied Ind.	Expansion and upgrading of rubber processing plant in Makilala, North Cotabato; expansion of the rubber manufacturing operations; debt repayment; development of Cebu Industrial Estate; acquisition of real properties in Cebu; working capital

Company	Work Program
Security Bank Corp.	Branch expansion program; Automation program; investments; CAPEX
Piltel	Loan repayment; Cellular Mobile Telephone System expansion; Paging System expansion; Regional Telephone Service expansion
C & P Homes	Debt retirement; land acquisition; working capital
Southeast Asia Cement Holdings, Inc.	To embark on an expansion project involving FR Cement thru the installation of a new line (Line D)
Cosmos Bottling Corp.	To finance expansion program (Acquisition of glass shells, line refurbishing, fleet improvement) and repayment of debt
Swift Foods, Inc.	To finance capital expenditure, expansion of capacities and rehabilitation and upgrading of meat processing plant, and debt retirement
Petron Corporation	To finance its energy development program and its petrochemical project
Davao Union Cement	To partly finance its expansion project, corporate expenditures and related working capital requirements
Negros Navigation, Co., Inc.	For fleet expansion, port facilities development, existing debt retirement, working capital, temporary investments

During the same period, 47 companies benefitted from rights offerings (see Appendices C and D). Some of these were:

Company	Work Program
Republic Cement Corp.	To set up new production facilities - cement production operations
PCI Bank	To finance the bank's capital expenditures; branch expansion; acquisition of technology; construction of new building; investments in related undertakings to expand product lines and for strategic positioning
Metro Pacific	Expansion program and repayment of debt
Philrealty	To fund Tektite Tower II and to liquidate some present obligations
Sime Darby	Expansion and modernization of its production operations
Basic Petroleum	To support exploratory and development well projects, in which Basic Petroleum and Minerals, Inc. has a participating share

Funds were raised from foreign and domestic sources. As records at the Bangko Sentral ng Pilipinas show, in 1994 portfolio investments by foreign investors in the stock market amounted to US$2.97 billion; while portfolio investments by foreign investors from January to June 1995 amounted to US$1.93 billion (see Table 2).

Table 1
Initial Public Offerings (IPO)
1994-1995
(as of September 30, 1995)

	Total IPO	Primary Offering	Secondary Offering
1994	P 36,156,597,210	35,065,706,169	1,090,891,041
1995	22,134,769,988	17,806,543,488	4,328,226,500
TOTAL	P 58,291,367,198	52,872,249,657	5,419,117,541

Additional Offerings
Thru Rights Offerings
1994-1995
(as of Sept. 30, 1995)

1994	P 30,204,362,911
1995	16,047,644,912
TOTAL	P 46,252,007,823

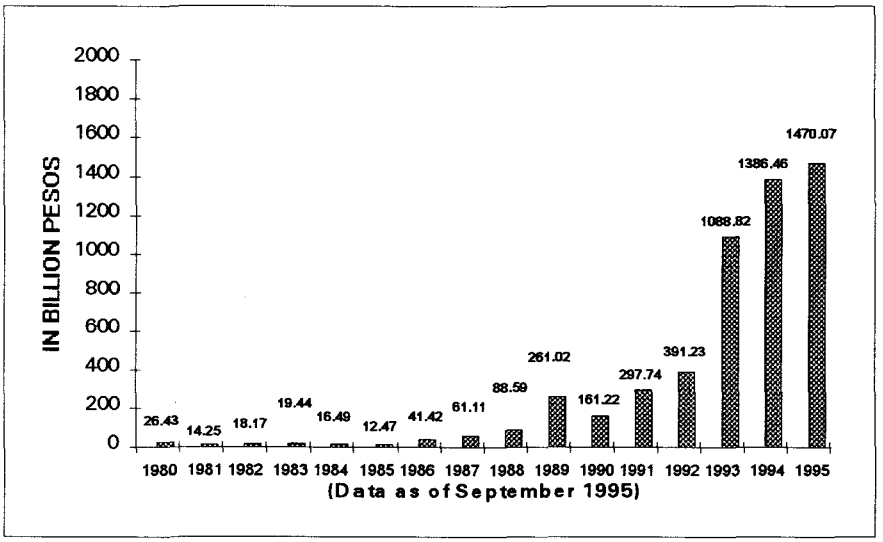
Table 2

Foreign Portfolio Investments, 1990-1995
(as of June 1995)

Year	Investments (in US dollars)
1990	US $ 152M
1991	US $ 227M
1992	US $ 566M
1993	US $2.257B
1994	US $2.979B
1995	US $1.938B
TOTAL	US $8.119B

In its first year of operations, the PSE has therefore fulfilled its fundamental role of attracting funds for investment in listed companies. Thus the market capitalization dramatically increased. (see Figure 1 and Appendix E)

Figure 1
Philippine Stock Exchange Market Capitalization



However, despite the significant growth of the stock market in the Philippines, we remain relatively small when compared to our Asian neighbors. We are barely one-third of the stock market of Thailand and one-fifth of the stock market of Malaysia. Our broker-members therefore insist on a queue for IPOs so that there is only one offering at a time.

Does this mean that the ability of the stock market to raise funds is still limited? Does this mean that we cannot rely on our stock market as a source of funds as we move toward the 21st century?

Quite frankly, I think that the stock market can raise the necessary funds for the operation and expansion of listed companies today and for the future. Take the case of Petron. In July to August

1994, it offered 600 million shares to the public at nine pesos per share under its fixed price tranche. This had a total market value of nine billion pesos. In sheer size alone, the Petron offering was about 18 times that of any other IPO in the past except for SM Prime Holdings and Universal Robina. The Petron offering was consequently branded as the mother of all IPOs.

There was anxiety among the underwriters and brokers. There was doubt on whether the market could sustain the Petron offering. Yet, in three weeks time, the demand for Petron shares was so high that the public had oversubscribed the offered shares. In three weeks time Petron was able to raise nine billion pesos.

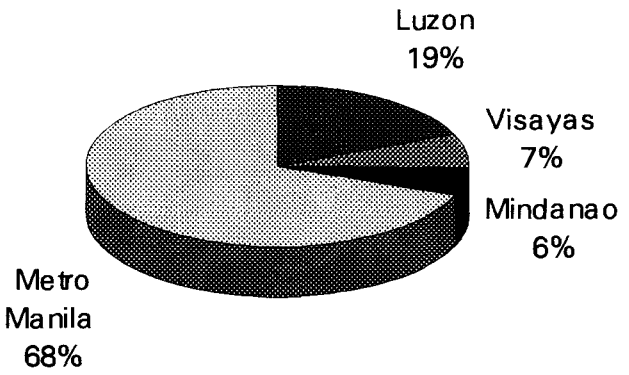
Subsequently, Aboitiz Equity Ventures offered its shares to the public and was able to raise 4.6 billion pesos. Next came William Lines which was able to raise 2.2 billion pesos, Piltel which raised 4.6 billion pesos, and C & P Homes which raised 5.7 billion pesos. Obviously, when the issue is "hot" and when the price-earnings (PE) ratio is right, the public shows interest in investing in the company.

From the Petron experience, we also have realized that funds from new investors are available. We now know that there are investors outside Metro Manila who are willing to put money into the stock market. Petron deliberately planned to distribute its shares as widely as possible, even providing for a scaling down of subscriptions. The result shows that out of the 600 million shares offered to the public: (see Figure 2)

68.5%	-	were subscribed by residents from Metro Manila
19%	-	were subscribed by residents from Luzon (outside of Metro Manila)
6.9%	-	were subscribed by residents from the Visayas
5.6%	-	were subscribed by residents from Mindanao

Figure 2

Distribution of Petron Shares by Area



Unfortunately, other IPOs did attempt as wide a distribution of their shares as Petron has. Instead, these IPOs were allotted almost equally between foreign investors and local investors from Metro Manila. Brokers in fact admit that their IPO allocation are offered mostly to old and selected clients in Metro Manila. This is why the investor base is still small. This is why the number of participants in the market is not larger than what it is now.

As we move toward the 21st century, and as the economy of the country improves, more and more infrastructure projects and expansion projects will need financing. This means that more funds must be raised through the stock market. Our stock market must attract more foreign and domestic investors. While our market capitalization has steadily increased from:

P1.09 trillion in 1993 to
P1.39 trillion in 1994 to
P1.45 trillion in 1995,

we expect the market to further grow to 1.6 trillion pesos by the end of 1995. Assuming a conservative growth of 15 percent per year thereafter, market capitalization will be:

P1.84 trillion in 1996,
P2.12 trillion in 1997,
P2.48 trillion in 1998,
P2.85 trillion in 1999, and
P3.28 trillion in 2000.

But this growth rate may not be enough. The Philippine Stock Exchange must introduce new and major programs for development commencing next year to keep up with the demands of a tigerish economy. Consequently, we must do the following:

First, encourage the top 1,000 corporations to go public. These companies that have proven track records of performance and profitability will prove more attractive to investors.

Second, allow simultaneous offerings, provided the offerings are from different sectors, in order to provide investors with more investment options and opportunities.

Third, introduce new products in the market. It is planned that by the second quarter of next year we can allow the trading of derivatives with respect to our index to provide investors with a hedging mechanism for their investments. Thereafter, as soon as Congress removes the capital gains tax on the sale of bonds, we shall immediately allow the listing of bonds in the Exchange.

Fourth, undertake a massive information campaign throughout the country on the mechanics of stock investments, and install facilities in key provincial areas for the dissemination of up-to-date quotations and corporate news.

In this connection, we intend to have syndicated columns in newspapers which shall familiarize the readers about investments in the stock market, forthcoming IPOs, and how analysts evaluate such issues. We plan to tap provincial newspapers to carry these columns in the local dialect. This will provide investors easy access to data and information.

Fifth, provide an effective distribution system for IPOs to enable prospective investors outside of Metro Manila to subscribe to new issues. Corollary to this, we shall urge more mutual fund companies to organize and mobilize savings from new investors.

Sixth, persuade more brokers to open branches in the provinces by offering them incentives, such as a reduction and/or exemption from payment of Exchange fees with regard to provincial transactions. We shall also facilitate the installation of trading materials outside Metro Manila.

Today, six cities in the North and South of Manila have been provided with trading terminals that are directly connected to the trading floor. Reports indicate a high degree of interest among investors in those cities. In fact, each trading terminal is able to generate approximately 7 million pesos worth of transactions per month. Corollary to this, we shall identify brokers who would like to service small investors and who can provide proper advice and counseling to new market participants.

Seventh, continue to improve our communication system in order to disseminate on time market data and news about listed companies. Thus, just six month ago, we were able to persuade Bloomberg to activate a comprehensive section on the Philippines which contains material and current information on listed companies and the market. The section includes price quotations of stocks as they are being actually traded, corporate news and current events in the Philippines.

We have also made arrangements with Reuters and Knight Ridder for information dissemination. We are negotiating with Internet to carry price quotations and information about forthcoming IPOs. For no one will invest in a market unless one has access to the material data that will enable him/her to decide what to buy and when to buy.

Eighth, organize marketing teams to visit investment bankers and fund managers here and abroad to promote our stock market.

Ninth, tap new markets for funds. There is a large Filipino community in the United States (US) which accounts for billions of dollars in remittances to the Philippines. This group is mostly

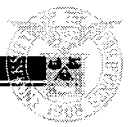
composed of professionals. During our roadshows, they expressed keen interest in investing in our stock market, particularly in IPOs. If timely and proper information about our market is made available to them and an efficient mechanism can be put in place, they can send orders and invest in Philippine securities in the near future.

After consulting our US lawyers, we were told that we can neither solicit nor sell securities that are not registered with the US Securities and Exchange Commission. However, if without solicitation but based on information, a US resident decides to invest in Philippine securities in the Philippine stock market and the order is executed in the Philippines, there will be no violation of US laws. The plan is to make our information available through Internet and through other data providers. Interested US residents can then be informed of duly licensed US brokers who have correspondent relationships with Philippine brokers. Orders could be made through US brokers who will communicate with their local counterparts for execution in the Philippines. Confirmation can then be made to the US broker who in turn will notify the US resident. Settlement could be done through banks or custodian organizations.

Tenth, pursue the establishment of a central depository system which will immobilize stock certificates and debt instruments, allow transfer by book entry and settle transactions at T + 4 (i.e., four days after the date of the actual transaction).

In the past, the bane of the market was the delayed delivery of stock certificates. It took transfer agents at least 28 days to issue new stock certificates. This caused investors much concern and anxiety. However, by February 1996, we shall begin to enjoy a central depository which can quickly and efficiently settle transactions in a way that meets international standards, and which can truly attract foreign investors to flock to the Philippine stock market.

It will take from one to two years to capture all the shares of listed companies into the central depository. By that time, and assuming that the backroom offices of our brokers will be fully automated, the Philippine Stock Exchange will be able to expand trading from what it is today (9:30 a.m. to 12:30 p.m.) to 9:30 a.m.



to 5:00 p.m. That way, we will be able to increase the volume of transactions. It will also cover one hour of European trading time that should generate more funds for our market.

Finally, we shall relentlessly monitor the market, particularly with the aid of our new computerized surveillance system which is not only capable of detecting day-to-day aberrations in the market, but also discerning unusual activity over a period of time. With the help of a NASDAQ trained staff, we shall continuously monitor the market to detect and prevent price manipulations and insider trading. This is necessary to convince the public, particularly foreign investors, that we can provide them a fair and level playing field.

With these programs, we foresee that beginning next year, the Philippine stock market will be able to draw more interest, and therefore, raise more funds from foreign and local investors. The thrust is to be able to accumulate adequate capital to meet the funding requirements of the listed companies as we race to outpace our Asian neighbors toward the 21st century.

Appendix A

INITIAL PUBLIC OFFERINGS FOR 1995

Name of Corporation	Capital Raised	Work Program
1. Alaska Milk Corp.	398,807,337	Repayment of short term debt, working capital
2. Vitarich Corp.	1,100,000,004	CAPEX, working capital, long-term debt repayment
3. Waterfront Phil., Inc.	112,500,000	Partially finance the development of Phase I of the Airport Hotel Project
4. Bankard, Inc.	542,800,000	Debt retirement, modernization and automation of equipment & facilities, expansion of operations, working capital
5. La Tondeña Dist., Inc.	384,629,647	Capital expenditures (bottling plant, mineral water project, alcohol aging facility, Vismin Bottling Plant)
6. William Lines	2,274,642,850	Retirement of debts, to finance acquisition & re-engineering & refurbishing of the MV Ariake, working capital
7. MRC Allied Ind.	504,000,000	Expansion & upgrading of rubber processing plant in Makilala, North Cotabato, expansion of the rubber manufacturing operations, debt repayment, development of Cebu Industrial Estate, acquisition of real properties in Cebu, working capital
8. Security Bank Corp.	650,767,650	Branch expansion program, automation program, investment. CAPEX
9. Piltel	4,600,000,000	Loan repayment, Cellular Mobile Telephone System expansion, Paging System expansion, Regional Telephone Service expansion
10. Sinophil Corp. (4)	250,000,000	Oil and gas exploration
11. Ionics Circuits	584,375,000	Investment on Printed Circuit Board Mfg. Co.
12. C&P Homes	5,756,021,000	Debt retirement, land acquisition, working capital
13. Filipino Fund, Inc. (4)	648,000,000	Investment in fixed income securities
TOTAL	17,806,543,488	

Appendix B

INITIAL PUBLIC OFFERINGS FOR 1994

Name of Corporation	Capital Raised	Work Program
1. Cophil Exploration Corporation	98,048,000	To fund projects such as Payment of Rig, & Drilling of GSEC Nos. 69, 72, and 64
2. Southeast Asia Cement Holdings, Inc.	750,000,000	To embark on an expansion project involving FR Cement through the installation of new line (Line D)
3. Cosmos Bottling Corporation	2,515,625,000	To finance expansion program (acquisition of glass shells, line refurbishing, fleet improvement) and repayment of debt
4. 7-Seas Oil Exploration & Resources, Inc.	150,000,000	Shall be used for working capital requirements and payment of participating interests in designated oil exploration area
5. Aboitiz Equity Ventures, Inc.	4,682,471,363	To finance projects (substitute existing loan obligations, project financing investment in transport services)
6. Swift Foods, Inc.	456,450,120	To finance capital expenditure, expansion of capacities and rehabilitation and upgrading of meat processing
7. Liberty Telecoms Holdings, Inc.	1,083,437,260	plant, working capital requirements, and debt retirement
8. Phil. Savings Bank	602,390,360	To be used for investment in office automation, branch network expansion, & other capital expenditures
9. Mondragon Int'l. Phils., Inc.	536,820,000	Shall be used to retire corporate debts, partly finance the tourism estate project in Clark Air Base, capital expenditures, & supplement working capital
10. Petron Corporation	9,000,000,000	50% shall go to Philippine Government while the other 50% shall go to PNOC to finance its energy development program and its petrochemical project
11. Pacific Rim Oil & Resources Corp.	150,000,000	To be used for additional working capital requirements& partial payment of participating interests on designated oil exploration areas

Appendix B (cont.)

INITIAL PUBLIC OFFERINGS FOR 1994

Name of Corporation	Capital Raised	Work Program
12. Davao Union Cement A & B	721,373,584	To partly finance expansion project such as capital expenditures & related working capital requirements
13. SM Prime Holdings, Inc.	5,963,330,195	To finance expansion program particularly the development of existing properties
14. Selecta Dairy Products, Inc.	400,616,115	For expansion program & debt retirement
15. Negros Navigation Company, Inc.		For fleet expansion, port facilities development, existing debt retirement, working capital, temporary investments
16. Megaworld Properties & Holdings, Inc.	673,599,998	To finance ongoing & future projects (Central Business Park, One Lafayette Square, Brentwood Heights, Richmond Plaza, Acquisition of projects)
17. Universal Robina Corporation	6,527,834,174	To finance the expansion of existing projects, development of new projects, working capital purposes
18. South China Petro, & Explo., Inc.	125,000,000	To finance expenditures incurred in the operation & development of projects under GSEC Nos. 65,67, and 7; to invest in short-term GS, CPs and CDs.

Appendix C

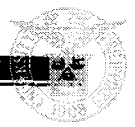
RIGHTS OFFERINGS FOR 1995
(as of September 30, 1995)

Name of Corporation	Capital Raised	Work Program
1. Urban Bank, Inc.	222,120,000	Capital buildup program to meet the minimum capital required for an expanded commercial bank
2. Republic Cement Corporation	480,000,000	To set up new production facilities - cement production operations
3. Belle Corporation	624,136,816	For the development of the Company's real estate projects
4. Robinson's Land, Inc.	600,000,000	For working capital purposes for the Company's real estate projects
5. Metroplitan Bank and Trust Co.	5,623,312,600	For branch expansion & working capital purposes
6. PCI Bank	5,000,000,000	To finance the Bank's capital expenditures; branch expansion; acquisition of technology; construction of new building; & to finance investments in related undertakings to expand product lines and for strategic positioning
7. Baguio Gold Mining Company	49,715,843	Payment of current liabilities; and working capital for evaluation and exploration of promising mining prospect - Dapitan Gold Project
8. Oriental Petroleum & Mining Corporation	719,111,579	For production, drilling, geology & geophysics
9. Philippine Telegraph & Telephone Coproration	650,000,000	Expansion of the Company; Buy-in of Philippine Wireless, Inc. & the retirement of selected debt
10. Shangri-la Properties, Inc.	39,184,242	Pay all outstanding bank debts; settle all obligations to contractors relating to the construction of the Shangri-la Plaza Mall; & pay all advances made by the stockholders.
11. Philippine Racing Club	475,195,080	Acquisition of land for track relocation; purchase of more offtrack sites and equipment; reserves for construction of racetrack facilities and stables at new site.
12. Negros Navigation Company	916,868,750	To fund the following: fleet expansion, working capital & debt repayment
13. Manila Wine Merchants, Inc.	648,000,000	Acquisition of office premises; investment in an investment house; and working capital
TOTAL	16,047,644,912	

Appendix D

RIGHTS OFFERINGS FOR 1994
(as of end December 1994)

Name of Corporation	Capital Raised	Work Program
1. Metro Bank	3,003,900,000	Branch expansion, automation & intensive lending
	1,975,000,000	Additional working capital & to support the bank's equity structure
2. Philbank	625,000,000	To comply with the 25% subscription requirement on the pending increase in Authorized Capital Stock
3. Union Bank	534,620,919	Forms part of the merger with Interbank wherein one Interbank share shall be converted into 25 Union Bank shares
4. Urban Bank	222,120,000	Increase in Capital Stock to support its application for an Expanded Bank License
5. Globe Mackay	1,500,000,012	
	999,999,990	
6. Mariwasa	122,422,387	1994 expansion program & to retire borrowings
7. Purefoods	184,700,000	To partially retire long term
	115,300,000	commercial papers
8. Cobertson Holding	270,000,000	
9. Dominion	248,020,909	Investments in Tagaytay, Sinophil, and others
10. First Phil. Holdings	1,248,000,000	To fund various power & infrastructure
	1,268,000,000	projects
11. House of Investments	525,000,000	
12. Mabuhay Holdings	1,000,000,000	Establishment of Mabuhay Capital Corporation
13. Metro Pacific	2,087,467,253	Expansion program & repayment of debt
14. Inter Phil	189,000,000	To finance the completion of the
	139,500,000	Corporation's Phase II Expansion Program & the acquisition of new equipment
15. Philtread	129,077,369	To retire debts & build up capital structure
16. Steniel	280,000,000	To pay bank loans
17. Belle	200,000,00	To fund investments & projects
18. Kuok	436,507,500	To finance prospective projects of the
	291,005,000	Company, development projects
19. Philrealty	2,291,170,700	To fund Tektite Tower II & liquidate some present obligations



Appendix D (cont.)

RIGHTS OFFERINGS FOR 1994
(as of end December 1994)

Name of Corporation	Capital Raised	Work Program
20. Shangrila Properties	1,211,586,422	To pay off outstanding debts & liabilities amounting to P1,250,770,664.29
21. Sime Darby	352,562,500	Expansion & modernization of its production operations
22. Integrated Chrome	62,998,296	To cover the cost of raw materials, payment of Nippon Denko Ltd. loan & payment of advances from stockholders
	41,998,864	
23. Itogon Suyoc	21,472,713	Exploration & development program
24. Lepanto	458,044,115	
	5,450,000,000	
25. Surigao Consolidated	250,000,000	
26. United Paragon	465,943,613	To retire high cost borrowings & advances & various exploration programs
	545,000,000	
27. Alcorn	120,000,000	To finance Alcorn's financial requirements for 1994 & 1995
	80,000,000	
28. Anglo Phil.	67,000	
29. Basic Petroleum	149,128,425	Exploratory & development well projects, in which Basic Petroleum & Minerals, Inc. has a participating share
30. Oriental Petroleum	77,410,546	To finance the exploration & drilling activities & maintenance expenditures for 1994 & future years
31. Philodrill	254,003,027	To finance oil exploration projects,
	169,335,351	dev't costs & finance debts incurred
32. Seafront	112,000,000	To cover several oil venture projects in which Seafront Resources Corporation has significant participating interest
	48,000,000	
33. Trans Asia	450,000,000	
34. Vulcan	0	
TOTAL	30,204,362,911	

Appendix E

PHILIPPINES STOCK EXCHANGE MARKET CAPITALIZATION

YEAR	MARKET CAPITALIZATION
1980	26,432,420,401.38
1981	14,254,972,492.00
1982	18,172,213,408.00
1983	19,445,131,740.00
1984	16,486,420,907.00
1985	12,740,936,501.96
1986	41,214,327,704.19
1987	61,108,374,939.48
1988	88,591,483,031.76
1989	261,021,551,503.18
1990	161,218,840,464.28
1991	297,743,365,108.27
1992	391,230,811,503.30
1993	1,088,819,743,691.82
1994	1,386,464,033,251.00
1995 (as of Sept. 29)	1,470,072,171,852.13

Appendix F

NUMBER OF INITIAL PUBLIC OFFERINGS FROM 1990 TO 1995

YEAR	NO. OF COMPANIES OFFERED
1990	9
1991	10
1992	10
1993	11
1994	22
1995*	13

*As of September 1995

Prospects of and Challenges to the Commercial Banking Sector

Jose R. Facundo
President
Cititrust Banking Corporation

There is no doubt that one of our greatest assets is our human resource. We recognize and thank the members of academe for their great contribution to the human resource base the country enjoys today. And on this national treasure we will rely to meet the challenges and demands of decades to come.

This recognition, on the other hand, carries with it the tremendous responsibility of ensuring that our schools and universities continue to meet the critical demand of the economy for well trained professionals. More important is their responsibility to supply our economy with a new breed of graduates attuned to the new realities of this world and well equipped with the mental framework and attitudes that will enable them to manage and adapt to the "explosions" we are seeing, and will continue to see, in all sectors of our society.

To help us fully appreciate the present state of the banking sector and to provide some degree of comparison, I would like to start by giving a brief history of the developments in the Philippine Banking Industry.

Decade of the 50s and 60s

Philippine banking as we know it today had its beginnings after World War II, when the General Banking Act was passed in 1948 and the Central Bank was created in 1949. Prior to the outbreak of the war there were 17 banks in the country, of which six were foreign. These 17 banks had 17 offices in Manila, 22 provincial branches and 54 provincial agencies. Banking then was dominated by a few large Philippine banks and the foreign banks.

The expansion of the domestic banking sector was pushed by government in the 1960s. With a minimum of capital requirements, 27 more commercial banks were set up, mostly small family-owned banks established to meet the banking requirements of family-related businesses.

This banking expansion in the 1960s created a shortage of qualified personnel similar to, albeit in a smaller scale, the severe shortage of banking staff we are experiencing today. The new banks met their human resource requirements through "piracy" of skilled clerical and supervisory staff from the older banks by offering attractive salary packages and promotion to senior management positions.

Government policies encouraged not only the expansion of the banking industry but also of financial institutions that performed highly specialized functions, such as savings banks, rural banks, development banks, finance companies and investment houses. Besides commercial banks, a large number of these financial institutions emerged in the 1960s.

Banking laws were patterned after United States (US) banking practices with a clear delineation between commercial and investment banking functions.

Banking then was highly regulated and was greatly influenced by a high degree of control and protection, as evidenced by:

1. foreign exchange and import controls;
2. interest rate ceilings: the Central Bank fixed interest rates on deposits and lending rates were fixed by the Usury Law of 1916; and
3. entry of foreign banks: the foreign banks were limited to the four branches existing then, and foreign equity in domestic banks was prohibited by law.

Decade of the 70s

The 1970s brought another wave of banking expansion and the beginnings of liberalization implemented through a comprehensive banking reform program. The banking reforms were much broader in context, covered a wider sector of the financial system, and involved basic change in direction and orientation.

Some of the key features of these reforms were the efforts to:

1. Encourage mergers and consolidation of banks to increase the effectiveness of the banking system and the financial resources of the numerous commercial banks. For this purpose, a fivefold increase in the minimum capital requirement for banks was mandated.

2. Place under the supervision of the Central Bank unregulated segments of the financial and credit markets.

3. Restrict the start-up of new banks and financial institutions.

4. Provide commercial banks with a broader franchise, to encourage them to venture into financial services other than the traditional deposit-taking and lending activities.

5. Entice the gradual entry of foreign banks by allowing foreign ownership in the equity of banks of up to 40 percent of voting stock;

6. Gradually lift the interest rate ceiling and shift from a fixed to a floating exchange rate system;

7. Allow the unlimited entry of offshore banking units (OBUs) of foreign banks;

8. Enact the Foreign Currency Deposit Act which allow banks to accept foreign currency deposits from local and foreign depositors and extend foreign currency loans. The wisdom of this move is clearly evident in the over $8 Billion in FCDU (Foreign Currency Deposit Unit) deposits of the domestic banking system.

I wish to point out that the relaxation of the rules on the foreign equity in banks, the entry of OBUs, and the foreign currency deposit system, served as a major force in the eventual globalization of the financial system. Foreign Currency Deposits and lending grew rapidly, and the forward exchange cover provided by the Central Bank induced the heavy use of swaps to fund loan requirements of Philippine industries.

Decade of the 80s

The reforms initiated in the 1970s were carried out more vigorously in the 1980s when two significant moves were instituted: first, the lifting of all interest rate ceilings on loans and deposits; and second, the passage of the expanded commercial banking law (Universal Banking Law), which gave banks meeting the minimum capital requirement a broad franchise to engage in both allied and non-allied undertakings. Unlike US laws, the new policies did not put a wall between commercial and investment banking activities.

In the 1980s the entire financial system was put to a severe test. It suffered from a crisis of confidence with the drastic downtrend in the economy, the foreign debt crisis, and the mounting portfolio problems of the financial system. We saw then the closure of a number of large commercial banks and financial institutions.

Developments in First Half of the 90s

Since the start of this decade, we have seen the following significant global and local developments, with a direct or indirect impact on the domestic financial system:

Global arena

1. Reunification of the two Germanys, the breakup of the Soviet Union, the end of the Cold War, and the emergence of China as a potential economic power;

2. Democratization moves in many parts of the globe, along with efforts to liberalize, globalize, deregulate and open up economies to the forces of the free market;

3. Recession in many of the major industrialized economies and political turmoil causing extreme volatility in interest rates, foreign exchange rates and the equities markets;

4. Ratification of the Treaty of Maastricht and the integration of Europe into one community;

5. Ratification of the Uruguay GATT (General Agreement of Tariffs and Trade) treaty and the eventual formation of the World Trade Organization;

6. Signing of the North American Free Trade Agreement (NAFTA) between the United States (US) and Mexico;

7. Establishment of the ASEAN Free Trade Area (AFTA) among the Association of Southeast Asian Nations (ASEAN) countries; and

8. Mega-mergers and consolidations of banks.

Local arena

1. Bold initiatives to accelerate the opening up of the domestic economy to free market forces and the privatization of government corporations. These moves were pursued to achieve greater global integration through deregulation and liberalization of all sectors of the economy;

2. Passage of the Foreign Investment Act of 1991;

3. Creation of a more independent Central Bank, the Bangko Sentral ng Pilipinas (BSP), with a clear mandate to maintain price and exchange rate stability;

4. Lifting of practically all foreign exchange regulations existing since 1949;

5. Resolution of the foreign debt crisis and the reentry of the Philippines into the international financial markets after the debt moratorium resorted to in 1983; and

6. Liberalization of the entire financial system by allowing the entry of additional 10 fully licensed foreign bank branches (first ever since 1949), and foreign bank ownership in domestic banks of up to 60 percent; as well as the liberalization of the insurance industry.

What is the Situation of the Financial System Today?

1. Today we have 48 commercial banks, many of which are now universal banks. Of the 48, we have 10 new foreign banks in addition to the previous four, all of which are among the biggest in the world and each of which has the potential to open six additional branches and become universal banks. Among the 48 banks, there are also newly opened banks with linkages to strong domestic and foreign partners.

   In addition, a number of new banks will be opened in joint venture partnership with large foreign banks that failed to obtain branch licenses. Foreign banks can now own up to 60 percent of a domestic bank. Furthermore, an increasing number of offshore banking units and representative offices of foreign banks are establishing a foothold in the Philippine financial market.

2. Commercial banks are rushing to increase their capital base over and above the new BSP minimum capital requirement for universal banks of 2.5 billion pesos (up from 1.5 billion pesos) by February 1996, and 1.25 billion pesos (up from 750 million pesos) for non-unibanks. You are most likely aware of the domestic bank that recently reached a capital of over 21 billion pesos surpassing the Philippine National Bank (PNB), which for a long time was the biggest. A number of banks are now calling for additional capital from their stockholders through rights issues.

3. Bank ads and press releases reveal that almost all banks are jumping into the consumer/retail banking business and a host of related businesses they have heretofore not engaged in. Majority of banks now have their own credit cards, offer 24-hour banking services in addition to ATMs (automated teller machines), enabling their customers to make enquiries and in some instances to pay their bills from the convenience of their homes or offices via the telephone. Some of the bigger banks now offer ATM facilities linked to foreign ATMs, enabling their customers to draw on their peso or FCDU (foreign currency deposit units) accounts while travelling abroad.

4. More banks are maximizing their unibank licenses and operating subsidiaries engaged in a broad array of non-commercial banking activities such as investment, banking, finance companies, stock brokerage, insurance brokerage, and leasing companies. In addition, we have more banks with direct investments in real estate companies, energy, telecommunications, mining, and other industrial and manufacturing companies.

5. There is a severe shortage of banking personnel, particularly in the areas of treasury, retail banking, credit/risk management, private banking and technology. Piracy of middle and senior management staff is rampant and compensation packages offering 100 percent premium are not uncommon.

6. Bank margins and fees have dropped dramatically. For example, the spread on large short-term FCDU loans to prime accounts have reportedly dropped to as low as 1/4 percent over the cost of funds.

Where Are We Heading For and What Are The Prospects and Challenges of the Next Decade?

During the first half of this decade, we have seen how the powerful forces of globalization, deregulation, liberalization and the opening up of the Philippine economy have caused "explosions" that have changed and will further dramatically change, the traditional contours not only of the financial system but also of many sectors of our society. If only to dramatize the situation, one can say that we have witnessed a global Pinatubo-like eruption of economies with corresponding lahars and fallouts whose eventual impact on financial systems is yet to be determined and assessed.

A number of things are however certain. We will all have to cope with the change. Each institution needs to determine how to manage the change process and reap its benefits. In the competitive free-market system we must operate in, there will definitely be winners and losers. The system will favor those who are strong and well-equipped to adapt and manage the change. It will be unkind

to those who are unable to discard the practices and habits they have been so used to under a protected and controlled economy - an outmoded system proven beneficial to a few but detrimental to the majority of the people.

What are the new realities that will critically influence the path we will take as we meet the challenges of global competition? Some of them are:

1. Our customers: they expect and demand more sophisticated products to satisfy their increasing needs. More significantly, customers have more options to choose from, not only in the domestic but also in global markets. They expect quality products and services at competitive prices. They look for convenience and safety of their investments;

2. Our stockholders and the investing public as a whole: they will increasingly demand returns on their investments which are competitive and commensurate to the risks. Capital will increasingly become a scarce resource and will freely flow to those areas which will provide safety and returns commensurate to the risks;

3. Human resource: there will be a scarcity of skilled personnel; and

4. The community at large: they will demand an equitable sharing in the fruits of the economic boom.

What are the Implications of These New Realities?

These new realities all lead to one glaring conclusion. We, specifically the banks, must all gear up for more intense competition where the competitive pressures will come not only from domestic sources but also from all over the world. The greatest challenge to bank management is choosing the path from the numerous options on hand to meet the new challenges. The strategy one chooses will determine if the institution will eventually be counted among the winners or the losers.

Some of the key resources and specific issues which will have to be addressed are:

1. Human resource base - A competent and skilled human resource base is one, if not the most, critical resource necessary to manage change and execute the strategies one adopts to meet the competition. In the "old days," when banking was relatively simple, the preoccupation was building a competence in operations and the skills needed to cope with the growth in business volumes. The number of bankers with this type of skills was abundant and could be easily sourced from the older, more established banks. Marketing, sales, account management, risk management, liquidity management, customer relations were not in the vocabulary of many bankers then. The new realities demand an entirely new breed of bankers.

2. Technology - The use of modern and state of the art technology will increasingly determine how each institution can successfully meet the processing requirements of increasing volumes, the need to process within the shortest time possible at the least cost the menu of products and services the market will demand, the information needed to monitor costs, risks, customer profiles, etc.

The good news is that the necessary hardware and software to satisfy the needs of banks are available. The bad news is that they cost a lot of money and require large investments. Furthermore, the choice of the right configuration to serve the needs of each institution is a difficult decision. You are certainly aware of huge investments made in technology which did not provide the expected benefits.

You will note that the ATM (automated teller machine) system is a technology-intensive service which requires huge investments. It is for this reason alone that banks have formed groups (Bancnet, Megalink, Expressnet) to spread out the investment costs of this banking convenience. It is also for this reason that you hear of merger talks among the three groups.

Auto financing as another example is a business most banks are now going into. You may not be aware that to compete in this business you must be able to approve a loan application within 24

hours, or you will most likely lose the business as the borrower has so many banks to choose from. This fast turnaround is not possible without the aid of automation.

3. Capital - The investments needed to develop a strong human resource and technology base alone will put tremendous pressures on the capital and financial resources of banking institutions. Consider as well the capital implications of the new risks arising from the rapid expansion in assets and product clusters, and the volatility of domestic and global markets.

You are all too familiar with the Barings case which brought down an old established financial institution; or the Daiwa Bank loss of $1 billion, or the recent Mexican crisis which was fortunately resolved quickly but which still had an impact on our financial markets, or something closer to home, the Bancap treasury bill scam last year.

It is obvious that the size of a bank's capital and financial resources will determine the capacity of each institution to compete. In this context, you will hopefully better appreciate the mega-mergers among banking institutions around the world and the rush among local banks to increase their capital bases far above what the Banko Sentral ng Pilipinas (BSP) has in fact mandated.

This issue alone will force banks to adopt appropriate strategies to achieve growth in the decade to come. The bigger and better-capitalized banks will mostly attempt to cover a broader area of financial and nonfinancial activities and a few will attempt to expand their operations in the Asian region or globally. The smaller banks will be forced to be more focused and find niches and segments of business where they will have some competitive advantage. One thing is clear though: each bank will have to achieve a minimum critical mass to at least justify the investments needed for technology and development of the required human resource base.

4. Productivity and costs - Open competition has two immediate consequences - it drives down margins and puts tremendous pressures on costs. The new entrants to the system will initially go for market share and sacrifice profitability. Under

this situation most banks will go for growth in assets and sales, which under an intensely competitive environment is easier said than done. For such a strategy has tremendous implications on the amount of capital required, one's appetite for risk and the operating capability of each institution. An alternative is to focus on cost management and achieve greater operating efficiencies and productivity.

These objectives could be addressed through automation, the market segmentation approach, and possibly through mergers with other institutions, or the building of alliances with strategic partners.

I have attempted to show a picture or a mosaic of the climate and environment we could possibly expect. In the process, I have attempted to describe the magnitude of future developments, issues, challenges and prospects of our financial system in the decade to come.

I have also tried to demonstrate how the powerful forces of globalization, deregulation and the opening up of our society to the disciplines of the free market have caused "explosions" in the financial system of the Philippines and of many centers in the world. These "explosions" will no doubt dramatically change our way of doing things.

I would like to be more specific and attempt to give an idea of what to expect from the banking sector in the next decade:

1. Banks will offer a broader array of financial/nonfinancial products to satisfy a wide range of needs: insurance, mutual funds, derivatives, options, credit cards, equities, real estate, private banking products, and countless others.

2. Highly sophisticated technology-based banking services will be accessed from the convenience of homes or offices either through the telephone, fax, computer terminal or TV monitor.

   Would you not wish you had these services now with the traffic problems we have? As of now we have one or two financial institutions abroad which have only one office and which deliver their banking services to their customers

ATMs. A number of our local banks are offering computer-telephone-linked services to handle enquiries, payment of monthly bills and similar fund transfers.

3. Mergers are likely as the forces of competition put real pressure on bank profitability and as stockholders demand reasonable returns on their investment. Banks will be under pressure to enter into alliances with other banking/non-banking institutions, both here and abroad, to achieve economies of scale in the delivery of products to customers.

4. Dis-intermediation: as interest rates drop and investors/depositors look for better returns, more funds will flow outside of the banking system into mutual funds, the equities market, commercial paper and other nonbank instruments. Likewise, to reduce costs, borrowers will source their funds to a greater degree from the equities market, the bond markets, insurance companies, and mutual funds, etc., here and abroad.

5. Closer alliance between banks and insurance companies is expected. More banks will go into insurance and more insurance companies will go into banking, as we already see now.

6. Nonbanking investments are bound to increase. The search for incremental revenues will drive the universal banks to optimize their unibanking franchises and increase their investments in nonallied undertakings, such as energy, telecommunications, tourism, and infrastructure projects, to name a few.

7. With regard to the capital market, as the interest rate drops and stabilizes, we will see a shift to longer-term instruments, both on the asset and the liability side of the balance sheet.

The implications and challenges of the new realities to our institutions of learning have hopefully become evident. For us to sustain the economic growth we have thus far achieved, the country will critically need a new breed of technology literate managers who are at ease with competition and the free market system, and who have the intellectual capacity and attitude to manage change, and exploit the tremendous potentials of the new system.

END NOTE

Cesar E.A. Virata
President
UP Business Research Foundation

The house of finance is built on trust. All the small pieces of paper, the handshakes, and the toasts attest to promises of delivery and payment.

The financial world today is characterized by growing specialization and competitiveness, as it adjusts to the rapid world-wide developments in transport and communications and the lowering of national barriers to allow the free flow of people, goods and services and money. The adjustments of the financial system to the imperatives of globalization are now shaping modern financial dealings.

In response, those who work in finance are becoming more adept to the changes in their environment. They are very innovative. They can invent, create, modify, derive, keep, hide, avoid or even evade; set up floors or ceilings, indices, fall away devices; offer spots, options, futures, anticipations, hedges, warrants, perpetuities, bullets; construct bridges, form syndicates, pools, mergers and consolidations; raid, buy and sell junk bonds, preferreds, convertibles, rights, guarantee, insure, certify, invest, create funds, have spreads, margins, commissions, success fees, etcetera.

The speakers, and representatives of financial institutions, government, and schools were the participants in this stimulating exchange of experiences and visioning of the future demands and requirements of a financial world without borders for the trustworthy. However, even if all borders were removed, levels of confidence will differ and, therefore, risks remain.

The managers of the system have presented the changes over the past, the current demands of the system and their projections of the future.

The demands to retool and carry on with the adjustment process is great. Even those who are in the field of finance now have to retrain and learn, and those who are still schooling and wish to join the profession have to foresee the waves of change and the challenges.

The symposium was a reckoning point for adjustment and change just like the launching of a rocket into space. At first it needs enough thrust to fight gravity but as the rocket gains altitude it has to use its side thrusters in flight to set its path to the objectives of the mission.

In the end, however, it is important for all of us to remember that while we can learn the mechanics of the financial system, all these collapse without **trust**. The word of honor, afterall is said and done, is still the foundation of finance.



The UP College of Business Administration

The College of Business Administration of the University of the Philippines was founded in 1916 as a pioneering institution in business education and research in the Philippines. Today, it offers programs for bachelor's, master's and doctorate degrees.

The faculty of the College are active in management consultancy, training and research. They offer practitioner oriented training in Finance through the Development Center for Finance (DCF), a non-stock, non-profit foundation organized jointly by the College and the FINEX Research and Development Foundation. Current faculty research interests include capital market development, technology policy and management, and sectoral policy and institutional development.

The UP Center for Integrative and Development Studies

The UP-CIDS was established in 1985 to promote interdisciplinary studies on critical topics that influence development policies and issues.

It initiates and supports research involving innovative methodological approaches and multi-disciplinary collaboration. While public policy questions are the primary concern of UP-CIDS, it also encourages basic research that is needed for informed formulation of policy.

The UP-CIDS functions under the Office of the UP President. Its four major programs are the UP State of the Nation Assessment Program; the Peace, Conflict Resolution and Human Rights Program; the Education Research Program; and the Special Programs.