THE PHILIPPINE REVIEW OF ECONOMICS
VOL. XL NO. 1 JUNE 2003

Trade in banking services and the role of GATS

*Ernando S. de Leon and Teodora I. San Pedro**

Abstract

The General Agreement on Trade in Services (GATS), which was concluded by participating countries in the Uruguay Round of negotiations, is the first multilateral effort to establish rules governing the conduct of international trade in services, including financial services. The GATS also provides the framework for multilateral negotiations on improved market access for foreign services and service suppliers.

This article aims to clarify the issues regarding the consequences of liberalizing trade in banking services and the obligations assumed by member countries in the context of negotiations under the GATS. It argues that the benefits of liberalizing trade in banking services arise primarily from greater competition and better financial intermediation. It also points out the interdependence between sound macroeconomic management, appropriate financial regulation and supervision and a liberal trade regime in banking services.

JEL classification: G20, F13, O19
Keywords: Trade in services, WTO, Philippine financial sector

1. The role of GATS in the liberalization of banking services

In general, there are four ways in which central banks/monetary authorities intervene in the market to affect the activities of financial institutions. First, central banks institute measures for macroeconomic policy management. The conduct of open market operations of a central bank, for instance, affects financial market conditions through the impact of such measure on domestic liquidity, interest rates and exchange rates. This aspect of government intervention is, however, beyond the purview of the GATS.

Second, central banks maintain and introduce measures aimed at ensuring the soundness and stability of the banking system, in the process protecting, the interest of consumers. Typical prudential measures include compliance with predetermined capital adequacy ratios, requirements for preserving asset quality, liquidity ratios, controls on market risks, management controls, disclosure, reporting requirements

*The authors are, respectively, Deputy Director, Macroeconomic Policy Research Group, Department of Economic Research, Bangko Sentral ng Pilipinas; and Manager-II, Supervisory Reports and Studies Office, Bangko Sentral ng Pilipinas.

and limits on DOSRI[1]. GATS commitments do not preclude monetary authorities from adopting prudential measures. Paragraph 2(a) of the Annex on Financial Services stipulates that:

> "Notwithstanding among other provisions of the Agreement, a Member shall not be prevented from taking measures for prudential reasons, including for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier, or to ensure the integrity and stability of the financial system."

However, there is also a provision in the Annex which states that when prudential measures run counter to certain provisions of the GATS, these must not be used to avoid commitments or obligations under the Agreement.

Third, monetary authorities can maintain other regulations that could affect operations and competition in the financial market. For instance, a country can adopt a measure that mandates banks to allocate a certain proportion of their loanable funds to a specific industry. Moreover, monetary authorities can further require that such lending be extended at preferential interest rates in pursuit of a particular industrial policy. In economic theory, these types of measures, though not prudential in nature, are not an efficient way of allocating the scarce financial resources of a country. They may also pose a risk to the soundness of the banking system, if pursued in excess. Whether these measures run contrary to the GATS obligations or not, however, depends on whether they actually constitute limitations on market access and national treatment[2].

The fourth policy intervention of monetary authorities that could affect the operations of suppliers of banking services pertains to the trade regime. Monetary authorities can impose trade restrictions that may prevent the establishment of foreign service suppliers and impede the flow of foreign services through cross border supply. The reduction and elimination of this type of measure is the main focus of trade liberalization efforts in the GATS.

> Article XIX states, "To pursue the objective of the GATS to expand trade in services under conditions of transparency and progressive liberalization and as a means of promoting the economic growth of all trading partners and the development of developing countries, members shall enter into successive rounds of negotiation to achieve progressively higher level of liberalization."

Negotiations[3] within GATS, shall be directed toward the reduction and elimination of measures that impede market access and national treatment of foreign

---

[1]DOSRI is the acronym for directors, officers, stockholders and related interests. Regulation on DOSRI accounts prohibits the grant of credit to individuals with direct and indirect interest in the bank where the loan is being sought.

[2]It is the WTO principle that the global trading system should be without discrimination. That is, a country should not discriminate between its own and foreign products, services or nationals (they are given "national treatment"), and a country should not discriminate between its trading partners (they are all, equally granted "most-favored-nation" or MFN status).

service suppliers. Moreover, members are encouraged to promote the increasing participation of developing country members by helping them strengthen their domestic service sectors and improve their access to distribution channels and information networks. Priority is accorded to liberalization in sectors of interest to developing country members, and the four modes of supply of services, namely: (1) cross-border supply, which means a service can be delivered by mail, by telecommunications facilities or as embodied in a goods (e.g., after-sale service); (2) consumption abroad, which means residents of one country are free to purchase services in another country; (3) commercial presence, which means foreign service suppliers can establish an office or branch in another country; and (4) movement of natural person, which means personnel who are themselves suppliers or employees of service suppliers may travel to other countries.

2. Importance of binding commitments in the GATS

Undertaking multilateral commitment under the GATS results in a more predictable and certain national policy environment. This also helps the affected sectors put in place the measures necessary to adjust gradually to time-bound liberalization commitments.[4] Multilateral commitments for future liberalization also infuse additional urgency for the authorities to put in place the reform process required by a liberalized environment. Finally, undertaking liberalization commitments under the GATS provides foreign investors additional security, thereby encouraging investment flows while reducing the cost of attracting foreign capital by offering various kinds of fiscal incentives.

It should be pointed out, however, that while governments may have undertaken binding commitments under the GATS, the authorities retain their flexibility to deal with unforeseen events. In particular, the GATS allows members to take additional prudential regulations and measures to safeguard the viability of the balance of payments. Article X of the GATS also stipulates that there shall be multilateral negotiations on the question of emergency safeguard measures[5] based on the principle of non-discrimination. These discussions on the modalities of the emergency safeguard measures are ongoing in the WTO and are expected to be concluded by early 2003.

3. GATS liberalization and financial sector reform

There is no agreed view on the extent of contribution of the GATS liberalization process to the actual liberalization of financial services in member countries of the WTO (Sorsa [1997]). It was observed that multilaterally bound financial sector

[3]These negotiations shall take place with due recognition for members' national policy objectives and the level of development of individual members.

[4] Under the WTO, member countries could inscribe in their schedule of specific commitments the timing of implementation of future liberalization.

[5]In the context of WTO, these broadly refer to actions that may be taken to protect a specific domestic industry from serious injury arising from an unforseen development.

policies do not necessarily correspond to applied policies in member countries of the WTO. At most, WTO commitments by member countries represented a consolidation of existing policies. This notwithstanding, it is important to assess the extent of multilateral liberalization undertaken by a country under the GATS in relation to its unilateral financial liberalization from its own economic viewpoint. That is because GATS liberalization may not always take into account the economic rationale behind financial liberalization. Some member countries may have considered other factors (apart from the economic rationale) in making binding commitments under the GATS or their bindings reflect more mercantilistic bargaining than economics.

The pace and sequencing of financial sector reform require careful consideration. It should be noted that there are important links between the financial sector, macroeconomic policy management and the potentially systemic costs of a banking crisis. An assessment of a country's GATS commitments in relation to its financial sector reforms could be useful in ascertaining if its multilateral commitments may be sustained. Likewise, a comparison between the degree of WTO liberalization commitments under the GATS, and the actual indicators of the degree of openness and financial sector developments of a country could help in assessing whether that country has the potential for making further multilateral (or unilateral) commitments, in addition to those already made under the WTO.

3.1 Financial sector reform: opportunities and challenges

A number of empirical studies have shown that the liberalization of the financial sector in conjunction with other reforms can boost income and growth. Levine [1997] and King and Levine [1993] demonstrated that both developed and developing countries with open financial sectors have typically achieved a faster rate of economic growth than those with closed financial sectors. However, the growth-stimulating effect of liberalization is likely to be largest in the developing countries with less sophisticated financial systems (World Bank [1997]). Improved investment in terms of volume and quality is often the main link between liberalization and growth. Kireyev [2002] concluded that liberalization of trade in financial services under the WTO has generally been conducive to financial stability because of the mutually reinforcing nature of existing international rules and practices. Knight [1998] observed that imperfect competition in the banking sector has resulted in a lower level of bank credit relative to GDP than that supplied by a competitive banking sector. This is because, intermediation is less efficient when there is imperfect competition. A smaller stock of loans is supplied at a higher cost to borrowers, while depositors receive a lower rate of interest compared with the competitive case. Finally, an imperfectly competitive banking system responds to bad loan problems by reducing lending and raising intermediation spreads.

As the stock of bank credit declines and interest rate on bank lending rises, more borrowers may begin to default; as deposit rate declines, some depositors' expectations may change which could lead to shifting of assets to overseas markets. As the ratio of non-performing loans rises in an oligopolistic banking system, the intermediation of financial savings becomes less efficient and the level of monetization of the economy declines. This is because the ratios of both bank deposits and bank credit to GDP tend to fall.

In general, financial sector reform has four elements (Galbis [1994]), namely: (1) liberalization of interest rates and credit regulations, (2) adoption of measures to develop financial markets (money markets, treasury bills, payments system and shift to indirect monetary policy instruments), (3) strengthening the prudential framework and the supervisory system, and (4) strengthening competition in the financial markets.

The competition brought about by the entry of banking service providers, including foreign sources, lowers the cost and increases the quality of services to consumers. Foreign banking service providers can introduce more advanced management practices, credit quality and risk diversification techniques that could help make the financial market more stable. The infusion of new capital by banking service providers, including foreign banks, also strengthens the capital base of the financial system. Finally, competition among service providers increases as clients demand greater transparency and an improved flow of financial information. This will reduce market imperfections and enhance further the stability of financial markets.

Care, however, should be taken in liberalizing the financial sector. Lack of prudence in the liberalization process can lead to financial crises that may erode public confidence in the financial system and lead to policy reversals. Rapid liberalization may result in excessive growth of bank assets, unsustainable borrowings and asset price bubbles, which in turn, could weaken the balance sheets of banks. Against this backdrop, the effectiveness of monetary policy may be undermined, as the banking system is constrained to respond to price signals (i.e., interest rate). The potential cost of bank failures may also exert pressures on government finances. Meanwhile, a liberalized foreign exchange regime can increase the volatility of the exchange rates and complicate macroeconomic management.

Several studies have recommended a pragmatic case-by-case approach to financial liberalization (for instance, Galbis [1994] and Johnston, Lindgren, Garcia and Saal [1996]). The sequencing of the liberalization process should be considered alongside the state of development of the economy and the financial sector. As a general rule, financial sector reforms tend to succeed if preceded by macroeconomic stabilization supported by evolving prudential measures (Sorsa [1997]).

3.2 Internal financial sector reform and GATS liberalization

The state of development of a country's financial sector can be linked to the country's commitments to the various modes of supply in the GATS. WTO members with less developed financial sectors should first ensure that basic policies in internal reform are in place (Sorsa [1997]). Binding financial sector reform in GATS mode 3 (commercial presence), can take place during the later stages of internal financial sector reform. Meanwhile, modes 1 (cross-border supply), and 2 (consumption abroad) commitments, can be undertaken after putting in place some external opening measures, and adopting appropriate prudential regulations.[6]

3.3 Measures of the degree of liberalization of the financial sector

The financial depth of an economy[7] is an indicator of the level of development of a country's financial sector. The measures generally used to ascertain financial depth are the proportion of monetary aggregates to GDP and the share of private credit to GDP. Meanwhile, the level of real interest rates is used as an indicator of the policy framework in the financial sector. It should be noted that liberalization of interest rates and elimination of credit rationing are often the first stage in financial sector reform. Thus, a positive real interest rate can be viewed as an indicator of the stage of development of the financial sector.

Other performance indicators used to measure the openness of a financial sector are the return on assets and equity. They measure the efficiency of resource allocation while the interest margins provide an indication of the cost of traditional banking. Other indicators of openness are the share of foreign liabilities to the total banking sector in the balance sheet, as well as the gross return to assets of banks and their concentration ratios.

The succeeding sections will focus on the nature of Philippine commitments under WTO in relation to the actual financial sector developments in the country.

4. The Philippines' WTO commitments on trade in banking services

The Bangko Sentral ng Pilipinas (BSP) has participated in various rounds of negotiations on trade in financial services sector under the WTO. The latest liberalization commitments in the WTO were undertaken by the BSP during the

---

[6] Under the GATS, there are four modes of supply of services, namely: (1) cross-border supply, which means that a service can be delivered by mail, by telecommunications facilities or as embodied in goods (e.g., after-sale service); (2) consumption abroad, which means that there will be freedom for a country's residents to purchase services in another country; (3) commercial presence, which means that foreign service suppliers can establish an office or branch in the territory of another country; and (4) movement of natural persons, which means that personnel who are themselves services suppliers or are employees of service suppliers can travel to other countries to provide the service.

[7] Financial depth is a term used to describe the extent to which an economy relies on a formal banking sector in financial intermediation.

extended round of negotiations on financial services which was concluded on 12 December 1997. The specific commitments agreed upon by the negotiating parties, which entered into force on 1 March 1999, are embodied in the Fifth Protocol to the GATS. It has two parts, namely: (1) the framework agreement containing 29 articles and a number of Annexes and (2) the national schedules of specific commitments undertaken by each member government. The protocols to the GATS (numbering five, so far since 1995) provide for the annexation of the national schedules of specific commitments agreed upon in the various rounds of negotiations. The Second and Fifth Protocols to the GATS pertain to specific commitments in the financial services sector undertaken by member countries. The Philippines has yet to accede to the Fifth Protocol, pending concurrence by the Senate to these commitments. The Philippine commitments in the banking and investment houses sub-sectors of the financial services sector under the Fifth Protocol to the GATS are summarized as follows:

a. Each foreign bank shall be allowed to establish a maximum of six branches, with the first three of these branches at locations of its choice and the remaining three of these branches at locations designated by the Monetary Board;

b. Acquisition of up to 51 percent of the voting stock of an existing domestic bank by a foreign bank. Existing voting stocks of foreign banks beyond the 51 percent level will be maintained at their current level;

c. Investment of up to 51 percent of the voting stock of a new locally incorporated banking subsidiary. Existing investments of foreign banks beyond the 51 percent level will be maintained at their existing levels; and

d. Investment houses shall be organized as stock corporations, subject to foreign equity limitation of 51 percent. Majority of the members of the board of directors shall be citizens of the Philippines. Investment houses are not allowed to engage in banking operations. Prior authority is required for the performance of quasi-banking functions.

The scope of the Philippines' exemptions to the MFN principle of the WTO has also been narrowed. This means the reciprocity requirement, which ran counter to the MFN principle of the GATS, was revised to make it apply only to the establishment of commercial presence by foreign providers of financial services to the Philippines.[8] It may be mentioned that under the Second Protocol to the GATS, the MFN exemption sought by the Philippines pertaining to reciprocity requirement covered both the establishment of commercial presence and the expansion of existing operations.

---

[8] Reciprocity means that the grant of authority to foreign providers of financial services to establish commercial presence and expand operations in the Philippines is subject to the reciprocal favorable treatment by their country of origin to Philippine financial service providers. This is contrary to the MFN principle of the GATS since such requirement effectively discriminates some WTO members from the market opening measures committed by another member country.

The Philippines' commitments under the Fifth Protocol to the GATS allow for a minimum compliance by the country to the overall objective of the WTO to progressively liberalize the global conduct of trade in financial services. The Philippines did not offer more than what was provided under the law. In fact, the committed extent of foreign ownership of banks and investment houses was less liberal relative to the relevant provisions of Republic Act (R.A.) No. 7721, otherwise known as "*An Act Liberalizing the Entry and Scope of Operations of Foreign Banks in the Philippines and for Other Purposes*" and R.A. No. 8366, entitled "*An Act Liberalizing the Philippine Investment House Industry, Amending Certain Sections of Presidential Decree No. 129*".

Under R.A. No. 7721, for instance, foreign equity ownership was allowed up to 60 percent. Similarly, R.A. No. 8366 authorizes foreign ownership of investment houses up to a level of 60 percent. The Philippine GATS commitments were lower than these statutory limits to allow the country's negotiators greater flexibility in both their negotiating stance and enhance the economy's ability to adjust to any developments in the financial system.

The binding of specific commitments in banking under the GATS will promote predictability of the regulatory regime in banking. In turn, this is expected to help in attracting foreign investments into the country. This is the underlying philosophy behind the BSP's endorsement of the Fifth Protocol to the GATS.

5. An overview of the Philippines' financial liberalization process

The Philippines has a long history of extensive financial reforms highlighted by appropriate and timely implementation of regulatory changes. These reforms were aimed at promoting a stronger, more efficient and globally competitive banking system.

The Philippine financial system's regulatory regime evolved from a protective one that insulated the financial market from outside competition in the 1950s to one that promoted selected industries in the 1970s. Measures to promote efficient financial intermediation were undertaken subsequently. Through the implementation of phased liberalization measures in the 1980s culminating in financial deregulation in the 1990s, a sound and stable banking system was allowed to evolve.

5.1 Pre-WTO developments

Early attempts at financial liberalization were undertaken by the monetary authorities early in the 1970s. In particular, a joint International Monetary Fund-Central Bank of the Philippines Banking Survey Commission was constituted to conduct an overall review of the financial sector of the Philippines. The recommendations of the Commission, which were more popularly known as the

financial reforms of 1972, resulted in the amendments of various banking statutes relating to the structure of the banking system. In particular, the financial reforms of 1972 saw the issuance of regulations requiring banks to increase their paid-in capital and the passage of laws increasing the allowable equity participation of foreign entities in domestic banks, separating "investment banking activities" from "regular banking activities". Underwriting activities were explicitly limited to investment houses. Moreover, the former Central Bank of the Philippines was given the authority and responsibility to supervise and regulate not only the monetary system but the entire financial and credit system of the country.

The financial reform process in the Philippines continued in the 1980s, easing up restrictive policies that had constrained market competition and domestic savings mobilization. The policy reforms in the early 1980s were focused on dismantling the administrative ceilings on interest rates on deposits and loans. The liberalization of interest rates was completed in January 1983 with the removal of the remaining interest rate ceilings on short-term loans. The universal banking (unibank), or expanded commercial banking, concept was introduced to enhance market competition and financial efficiency. The unibank concept increased the efficiency in the delivery of banking activities, enhanced banking competition, and widened the scope of banking activities. The former Central Bank of the Philippines (CBP) likewise lifted the moratorium on the establishment of new banks and relaxed the restrictions on the establishment of bank branches, promoting in the process bank mergers and consolidations.

The subsequent round of reforms focused on further strengthening prudential regulations. Among others, these involved the issuance of measures that reinforced the ability of the CBP to monitor closely the activities of banks through improved reportorial requirements, proper asset valuation, recognition of loan losses, as well as upward adjustment of banks' minimum capital requirements.

The early 1990s witnessed the advancement of institutional reforms in the Philippine financial sector, namely:

- Passage of R.A. No. 7353 (otherwise known as the *Rural Bank Act of 1992*) that rehabilitated the rural banking system;
- Signing into law of R.A. No. 7653 in July 1993, which created an independent Bangko Sentral ng Pilipinas (BSP) to replace the old CBP; and,
- Rehabilitation and strengthening of government financial institutions.

Policy reforms were also initiated to facilitate further deregulation of the financial system, as follows:

- Relaxation of rules on loan-to-deposit ratio requirement in 1990;

- Lifting the condition that off-site automated tellering machines (ATM) should be opened only in service areas where a bank has an existing branch and deleting the requirement of prior Central Bank approval for the establishment of ATMs in 1991;
- Relaxation of rules on the establishment of mobile ATMs in 1993; and
- Gradual reduction by the BSP of reserve requirements on deposits and deposit substitutes/liabilities of banks to lower banks' intermediation costs.

Measures were also put in place to promote the development of the capital market through the following:

- Elimination of double taxation on dividend income;
- Issuance of rules and regulations governing investment companies in October 1989;
- Easing of rules and regulations covering foreign investments in BSP-approved securities;
- Expansion in the dealership network of Treasury bills; and
- Unification of stock exchanges in the country.

These financial reforms were accompanied by foreign exchange liberalization measures that allowed the quoted exchange rate to reflect the true scarcity value of foreign exchange. The fundamental policy change in the country's foreign exchange regime consisted of lifting all quantitative purchase restrictions on current account transactions. For instance, the mandatory surrender requirement[9] of foreign exchange earned by resident firms was abolished. Sales and purchases of foreign exchange outside the banking system were allowed while foreign exchange receipts by residents were allowed to be deposited in their foreign currency accounts in the Philippines or overseas. Full and immediate capital repatriation and interest/dividend remittance privileges were also extended to all registered foreign investments in the country.

These changes renewed foreign investors interest in the country and contributed to the flow of overseas funds in the domestic capital market.

5.2 Post-WTO developments

In 1994, after the country's accession to the WTO as one of its founding members, financial sector reforms continued to be pursued actively. In particular, the rules governing the entry and operations of foreign banks in the country were liberalized with the passage into law of R.A. No. 7721, otherwise known as "*An Act Liberalizing the Entry and Scope of Operations of Foreign Banks in*

[9]This pertains to the rule that required exporters to surrender their foreign exchange earnings to the central bank.

the Philippines and for Other Purposes", on 18 May 1994. The regulatory regime on the entry of foreign banks in the country was further liberalized following the passage of the *General Banking Law of 2000* (R.A. No. 8791, dated 23 May 2000). Under this law, a foreign bank may be authorized to acquire up to 100 percent of the voting stock of only one bank organized under Philippine laws, within seven years from the effectivity of the law and subject to the provisions of R.A. No. 7721. However, the control of 70 percent of the resources or assets of the banking system should at all times be held by banks that are majority-owned by Filipinos.

Complementing the deregulated environment is the provision of safeguards to ensure market discipline and integrity of the financial system. Improvements in the legal and supervisory framework of the financial environment were undertaken in order to discourage mismanagement and fraud.

Rules on investments in banks were also eased to promote consolidation of bank resources while rules defining the scope of derivatives trading among banks and other financial institutions were issued in order to encourage prudent behavior in managing risks associated with derivatives.

Reserve requirements against bank deposits and deposit substitutes/liabilities of banks were also gradually reduced to lower banks' intermediation cost and consequently influence a reduction in interest rates. From 24 percent in end-1993, reserve requirement on bank deposits trended downward to the current 16 percent.

Moreover, capitalization requirements for commercial banks, thrift banks, rural banks and investment houses were increased several times over the years to strengthen these institutions' capability to face the challenges of a deregulated and increasingly globally integrated financial environment.

6. Financial sector development in the Philippines

The series of policy reforms put in place by the monetary authorities, along with improvement in the country's economic fundamentals, have contributed significantly to the continued soundness and stability of the Philippine financial system. At the same time, the financial system grew gradually in size and sophistication.

6.1 Total resources of the Philippine banking system

The total resources of the Philippine banking system grew almost two-fold from ₱592.0 billion at end-1990 to ₱1,606.6 billion by end-1995 (Table 1). The growth of the banking system's aggregate resources continued reaching ₱3,475.1 billion by end-2002. The increased deposit mobilization and continued capital build-up underpinned the growth of the banking system.

Table 1. Total Resources of the Philippine Banking System
(In Billion Pesos)

Year	*Banking System*	*Commercial Banking System*	*Foreign Bank Branches and Subsdiaries*	*Share of Foreign Banks (in percent)*
2002 P/	3,475.109	3,141.412	485.828	13.98
2001	3,259.272	2,942.772	499.782	15.33
2000	3,234.453	2,935.976	474.911	14.68
1999	2,954.843	2,679.564	382.728	12.95
1998	2,769.696	2,501.124	369.974	13.36
1997	2,769.936	2,509.133	320.025	11.55
1996	2,119.690	1,888.345	203.961	9.62
1995	1,606.644	1,429.711	99.371	6.19
1994	1,264.913	1,133.283	76.626	6.06
1993	1,015.205	919.056	n.a.	n.a.
1992	798.554	720.772	n.a.	n.a.
1991	681.371	618.838	n.a.	n.a.
1990	592.000	541.258	n.a.	n.a.

p Preliminary
Source: Supervisory Reports and Studies Office

Table 2. Network of the Banking System

Year	**All Banks**			**Foreign Bank**		
	Head Office (1)	*Branches (2)*	*Total (3)*	*Head Office (4)*	*Branches & Subsdiaries (5)*	*Total (6)*
2002 P/	912	6,542	7,454	20	175	195
2001	929	6,656	7,585	20	220	240
2000	947	6,606	7,553	20	235	255
1999	976	6,713	7,689	20	242	262
1998	996	6,650	7,646	18	116	134
1997	1,002	6,179	7,181	18	89	107
1996	961	5,371	6,332	17	16	33
1995	937	4,632	5,569	15	6	21
1994	920	4,176	5,096	4	5	9

p preliminary
Source: Supervisory Reports and Studies Office

Commercial banks, which accounted for 90 percent of the total resources of the banking system as of end-June 2002, drove the expansion of the banking system's total resources. Their total assets grew by 164.1 percent from ₱541.3 billion at end-1990 to ₱1,429.7 billion by end-1995. This growth was sustained as total resources reached ₱3,141.4 billion by end-2002, representing an expansion of 119.7 percent from 1995.

6.2 Increased share of foreign banks in the total resources

As a result of the liberalization of the entry of foreign banks through the passage of R.A. No. 7721 on 18 May 1994, the share of the foreign bank branches and subsidiaries to the total resources of the country's banking system grew from 6.2 percent at end-1995 to 14.0 percent by end-2002. This arose as total resources of foreign bank branches and subsidiaries expanded by almost four times from ₱99.4 billion in end-1995 to ₱485.8 billion by end-2002. The share of foreign banks to the total resources of the banking system, however, remained substantially below the 30 percent cap stipulated under the law.

6.3 Wider network of banks

The liberalization of branch banking and the entry of foreign banks contributed not only to the significant rise in resources but to the widening of the operating network of the banking system. From 5,569[10] at end-1995, the number of banking offices increased to 7,454[11] at end-2002 (Table 2). The number of offices of foreign bank branches and subsidiaries, in particular, increased from 21 by end-1995 to 195 by end-2002.

The increase in the operating network of the banking system led to greater accessibility of the population to banking services. Bank density ratio, which is defined as the ratio of the population to total number of banking offices, improved from 11,442 persons per bank in end-1996 to 10,736 in end-2002.

6.4 Financial deepening

The expansion in the total resources and operating network of the banking system occurred against the backdrop of greater financial deepening brought about by financial reforms and the liberalization process. The broad money indicator (M3/GDP) rose from 27.9 percent at end-1990 to 42.0 percent by end-2002. This reflected increased monetization of the Philippine economy (Table 3). It is also indicative of an increasing reliance on the banking system relative to capital markets.

[10] 937 head offices and 4,632 other offices.

[11] 912 head offices and 6,542 other offices

6.5 Positive real interest rate

Meanwhile, real interest rate (savings deposit rate minus the inflation rate) also improved. From a negative 0.3 percent in 1994, the real interest rate turned positive at 3.2 percent in 1997 (Table 4). As of end-2002, the real interest rate remained positive at 1.1 percent.

6.6 Improved contestability of the market

The contestability of the market (defined as openness of the market to foreign competition) also showed favorable trends. The share of foreign bank branches and subsidiaries to total loans (net of allowance for probable losses) expanded from 6.9 percent at end-1995 to 15.7 percent by end-2002 (Table 6). Their share to total deposit liabilities rose from 4.1 percent at end-1995 to 12.7 percent by end-2002 (Table 5). The bulk of loans granted by foreign bank branches and subsidiaries as of end-2002 went to financial intermediation (36.2 percent), manufacturing (20.9 percent), and other community, social and personal activities (15.9 percent).

6.7 Narrower interest spread of banks

The increasing presence of the foreign bank branches and subsidiaries in the Philippine banking system has exerted competitive pressure on the domestic banks. This, together with the more difficult economic environment has contributed to the narrowing of interest spreads (defined as earning assets yield minus funding cost) from 5.8 percent in 1997 to 3.9 percent by the first semester of 2002 (Table 7). The net interest margin (defined as the ratio of interest income to average earning assets) also declined from 5.9 percent in 1997 to 3.7 percent by the first semester of 2002.

6.8 Increased concentration of banks

The concentration ratio (defined as the ratio of the total assets of the top 5 banks to the total assets of the banking system) dropped initially during the pre-Asian crisis years from 39.8 percent at end-1995 to 34.6 percent by end 1998 (Table 8). However, it started to move up and has risen to 43.0 percent at end-2002, as the banking system began its consolidation process partly in response to the Asian crisis and, on a long term basis, to create a nucleus composed of a few big and strong banks that can compete in an increasingly globalized economic environment.

6.9 Decline in non-performing loans

The non-performing loans (NPLs) of the banking system traced an uptrend in the aftermath of the Asian crisis. From a low of 5.4 percent at end-1997, the ratio

Table 3. M3/GDP

Year	GDP (In billion pesos)	M3 end-period (In billion pesos)	M3/GDP (In percent)
2002	3,974.074	1,669.662	42.0
2001	3,639.980	1,525.032	41.9
2000	3,308.318	1,427.397	43.1
1999	2,976.905	1,365.098	45.9
1998	2,665.060	1,144.552	43.0
1997	2,426.743	1,066.017	43.9
1996	2,171.922	881.404	40.6
1995	1,905.951	761.430	40.0
1994	1,692.932	607.614	35.9
1993	1,474.457	480.329	32.6
1992	1,351.559	385.385	28.5
1991	1,248.011	347.079	27.8
1990	1,077.237	300.541	27.9

Source: Department of Economic Research

Table 4. Real Interest Rate (In Percent)

Year	Savings Deposit Rate	Inflation Rate	Real Interest Rate
2002	4.2	3.1	1.1
2001	7.5	6.1	1.4
2000	7.4	4.4	3.0
1999	7.3	6.7	0.6
1998	11.0	9.7	1.3
1997	9.1	5.9	3.2
1996	8.0	9.1	-1.1
1995	8.0	8.0	0.0
1994	8.0	8.3	-0.3

Source: Department of Economic Research

Table 5. Total Deposits Liabilities of the Banking System (In Billion Pesos)

Year	*Banking System*	*Foreign Bank Branches and Subsidiaries*	*Share of Foreign Banks (in percent)*
2002 P/	2,353.048	299.316	12.72
2001	2,199.522	308.161	14.01
2000	2,085.200	293.372	14.07
1999	1,919.522	221.684	11.55
1998	1,754.244	152.494	8.69
1997	1,674.366	120.683	7.21
1996	1,293.330	58.505	4.52
1995	1,018.647	42.059	4.13

p preliminary

Source: Supervisory Reports and Studies Office

Table 6. Total Loans of the Banking System (In Billion Pesos)

Year	*Banking System*	*Foreign Bank Branches and Subsidiaries*	*Share of Foreign Banks (in percent)*
2002 P/	1,704.542	267.325	15.68
2001	1,672.944	279.242	16.69
2000	1,686.883	260.427	15.44
1999	1,651.752	217.504	13.17
1998	1,646.121	177.472	10.78
1997	1,713.634	193.912	11.32
1996	1,358.166	129.389	9.53
1995	963.682	66.821	6.93

p preliminary

Source: Supervisory Reports and Studies Office

Table 7. Interest Spread
(In Percent)

Year	*Return on Assets*	*Return on Equity*	*Interest Spread*	*Net Interest Margin*
Jun-02	0.7	4.8	3.9	3.7
2001	0.4	3.2	4.0	3.8
2000	0.4	2.6	4.2	3.9
1999	0.4	2.9	4.6	4.5
1998	0.8	5.9	5.6	5.7
1997	1.7	13.0	5.8	5.9

p preliminary
Source: Supervisory Reports and Studies Office

Table 8. Share of Top 5 Banks in the Total Resources of the Banking System

	Total Resources		
Year	*Banking System (In Billion Pesos)*	*Top 5 Banks (In Billion Pesos)*	*Share of Top 5 Banks (In Percent)*
2002[P/]	3,475.109	1,492.507	42.9
2001	3,259.272	1,439.300	44.2
2000	3,234.453	1,428.530	44.2
1999	2,954.843	1,163.000	39.4
1998	2,769.696	957.104	34.6
1997	2,769.936	964.024	34.8
1996	2,119.690	778.041	36.7
1995	1,606.644	640.012	39.8

p preliminary
Source: Supervisory Reports and Studies Office

of the NPLs to the banking system's aggregate loans rose to 16.9 percent at end-2001 (Table 9). This uptrend in the NPL ratio (17.6 percent) continued in the second quarter of 2002, but reversed starting the third quarter. As of end-2002, preliminary data indicated that the NPL ratio of the banking system was held to 15.4 percent. Similarly, the ratio of non-performing assets (NPAs)[16] to total assets of the banking systems climbed from 4.3 percent at end-1997 to 14.6 percent at end-2001. As of end-2002, the NPA ratio was down 13.9 percent. The NPL and NPA ratios were even lower based on the new definition of NPLs[17] at 14.7 percent and 13.5 percent, respectively, as of end-2002. The new definition also allowed banks to exclude from the non-performing loans classification, those which were fully provisioned.

Even as the level of NPLs rose relative to pre-Asian crisis levels, the same was covered by adequate loan loss reserves. Finally, loan loss reserves of the banking system as a percentage of NPLs remained high at 53.2 percent, while that for NPAs stood by 32.6 percent at end-2002.

6.10 Capital adequacy of banks

The Philippine banking system remained adequately capitalized. The capital adequacy ratio (CAR) of the banking system by end-2001 stood at 14.5 percent on a solo basis (head office and branches) and 15.6 percent on consolidated basis (parent bank and subsidiary financial allied undertakings, excluding insurance companies). Commercial banks, in particular, showed CARs of 15.6 percent and 16.8 percent on solo and consolidated basis respectively by end-September 2002. These CARs were way above the BSP prescribed minimum ratio of 10 percent and the BIS standard ratio of 8 percent.

7. Prospects for further liberalization within the WTO framework

The financial sector reforms undertaken by the monetary authorities in the past years have contributed significantly to the development of the Philippine economy. In particular, the deregulation of interest rates, the liberalization of rules on bank branching, and the entry of foreign banks have played a crucial role in the monetization of savings in the country which have resulted in a more efficient allocation of scarce financial resources in the economy. In recent years, the competition posed by new players in the Philippine banking system has also contributed to the narrowing of interest spread of banks—an indication of greater efficiency in fund intermediation. More importantly, this development suggests the ability of the banking system to adjust to a more competitive environment. This, along with the continuing efforts of the monetary authorities to align the regulatory framework and prudential measures in the Philippine banking system with best international practices, helped reinforce its ability to endure shocks related to the globalization of banking services. The Philippine banking system is also

[16] NPL plus real and other properties owned or acquired (ROPOA).

[17] As provided under Circular No. 351 dated 19 September 2002, loans classified as loss but fully covered by allowance for losses are excluded from the NPL definition.

Table 9. Selected Ratios of Non-Performing Loans and Non-Performing Assets (In Percent)

	All Banks				Commercial Banks			
Year	*NPL Ratio*	*NPA Ratio*	*NPL Cover*	*NPA Cover*	*NPL Ratio*	*NPA Ratio*	*NPL Cover*	*NPA Cover*
2002 P/ 1/	14.7	13.5	50.2	30.1	15.0	13.1	51.2	31.7
Sept-02 1/	16.2	14.4	47.4	29.5	16.4	14.0	48.1	30.9
2002 P/	15.4	13.9	53.2	32.5	15.8	13.5	54.1	34.1
Sept-02	16.7	14.7	49.5	31.1	17.0	14.3	50.2	32.6
Jun-02	17.6	14.9	47.0	30.5	18.1	14.5	47.3	31.8
Mar-02	17.6	15.2	44.4	29.1	18.0	14.8	44.6	30.2
2001	16.9	14.6	45.3	29.6	17.3	14.3	45.2	30.6
2000	14.9	12.7	43.7	28.6	15.1	12.4	43.6	29.4
1999	12.7	11.3	45.4	30.0	12.3	10.7	46.6	31.4
1998	11.0	8.9	36.4	27.9	10.4	8.1	38.3	29.9
1997	5.4	4.3	42.1	33.6	4.7	3.7	47.2	38.4
1996	3.5	3.0	39.5	31.0	2.8	2.4	44.3	35.0
1995	4.0	3.3	42.5	32.7	3.2	2.7	48.9	37.3
1994	4.7	3.7	42.8	32.3	3.9	3.1	47.9	35.5

p preliminary

1/ Based on new definition of NPL under BSP Circular No. 351 dated 19 September 2002.

Source: Supervisory Reports and Studies Office

adequately capitalized to face competition. This is reflective of the continuing efforts of the monetary authorities to ensure sufficient bank capitalization by encouraging mergers and consolidation, among others. This policy, however, has led to a rising concentration ratio in the Philippine banking system in recent years. At the same time, it should be noted though that the liberalized rules on the entry and operations of foreign banks ought to encourage the entry of new players in the Philippine banking system, including the establishment of commercial presence of leading foreign banks. All these ought to reduce the concentration ratio in the Philippine banking system over the medium term.

Meanwhile, the Philippines commitments under the Fifth Protocol of the GATS allow for a minimum compliance by the country with the overall objective of WTO to liberalize progressively the global conduct of trade in financial services. As mentioned earlier, the Philippines did not offer more than what was provided under the law. In fact, the Philippines' undertakings in the WTO on the extent of

foreign ownership of banks and investment houses were more conservative tha the relevant provisions of laws in the country.

Given the country's unilateral liberalization efforts in recent years and th nature of its GATS commitments under the Fifth Protocol, the country is in a positio to participate in the WTO's future round of negotiations and make furthe undertakings to assure the international financial community of the predictabilit of the country's regulatory regime. The monetary authorities should, however, b given time and space to undertake these commitments in the context of the refor measures the country has unilaterally implemented in earlier years. Proceedin on the basis of domestic policy is important because if actions taken are perceive as a response to external stimuli, i.e., WTO trading partners, the process could b susceptible to public cricticism and could be stalled or even suffer some reversal

The commitment to an open financial market (whether unilateral o multilateral), however, entails the continuous review of existing prudentia measures to ensure the sustained soundness of the Philippine banking system i the face of a globalized financial market. In this regard, the recent Asian financia crisis highlighted the need to craft prudential policies so that resilience is built u in times of economic boom, allowing banks to deal more easily with inevitabl economic downturns. To this end, the monetary authorities should continuousl upgrade the monitoring and supervision systems through, among others, the trainin of bank examiners, the tightening of prudential practices, the building of stron risk management mechanisms and by establishing early warning mechanisms fo detecting bank failure. In this regard, the recently enacted General Banking La of 2000 aims to further strengthen banking regulatory oversight, raise prudentia standards to international norms, foster greater competition and enhance th supervisory capability and independence of the Bangko Sentral.

To complement the ongoing restructuring of the banking industry, the Bangk Sentral in coordination with the Department of Finance, the Securities and Exchang Commission of the Philippines and the Philippine Stock Exchange, will pus vigorously for the rapid development of the local capital market. One of the ke lessons of the Asian crisis is the danger of over-reliance on the banking system t provide for the massive financing requirements of development. This has led t systemic vulnerability, with a banking crisis tending to quickly translate into major setback for the real economy.

The reform of the taxation framework on financial transactions and instrument would also be critical in the development of the Philippine capital market. In thi respect, reforms that ease the tax burden of financial intermediation and promot a more level playing field should be put in place.

Finally, on the multilateral front, the WTO should complete the task o formulating a standard set of rules governing the imposition of emergenc safeguard measures in services. Under the GATS, a member country invokin

emergency safeguard measures would be allowed to temporarily withdraw or modify its GATS specific commitments. These measures are important in order to safeguard its domestic industry against serious injury or threat emanating from the entry of foreign service suppliers in the domestic market.

Table 10. Capital Adequacy Ratio (CAR) (In Percent)

All Banks	*Solo*	*Consolidated*
2001	14.5	15.6
Commercial Banks	*Solo*	*Consolidated*
Sept-02 P/	15.6	16.8
Jun-02	15.6	16.8
Mar-02	15.6	16.8
Dec-01	14.1	15.3

p preliminary

Source: Supervisory Reports and Studies Office

References

Fry, M. [1988] *Money, interest and banking in economic development.* Baltimore: Johns Hopkins University Press.

Galvis, V. [1994] *Sequencing of financial sector reform: a review.* IMF Working Paper 94/101, International Monetary Fund, Washington.

Gelb, A. [2002]. *Financial policies, growth and efficiency.* World Bank Policy Research Working Paper 2002, World Bank, Washington.

King, R.G. and R. Levine [1993] "Finance and growth: Schumpeter might be right" *Quarterly Journal of Economics,* 108: 717-738.

Kireyev, A.P. [2002] *Liberalization of trade in financial services and financial stability (empirical approach),* IMF Working Paper 02/139, International Monetary Fund, Washingron.

Knight, M. [1998] *Developing countries and the globalization of financial markets,* IMF Working Paper 94/101, International Monetary Fund, Washington.

Levine, R. [1997] "Financial development and economic growth: views and agenda" *Journal of Economic Literature,* 34:988-726.

Lindgren, C., G. Garcia, and M. Saal [1996] *Bank soundness and macroeconomic policy,* International Monetary Fund, Washington.

Masamichi, K., P. Low, M. Luanga and L. Schuknarht n.d.. *Opening markets in financial services and the role of GATS,* World Trade Organization, Geneva.

Sorsa, P. [1997] *The GATS agreement on financial services — a modest start to multilateral liberalization,* IMF Working Paper 97/155, International Monetary Fund, Washington.

World Bank [1997] *Private capital flows to developing countries: the road to financial integration.* Oxford: Oxford University Press.