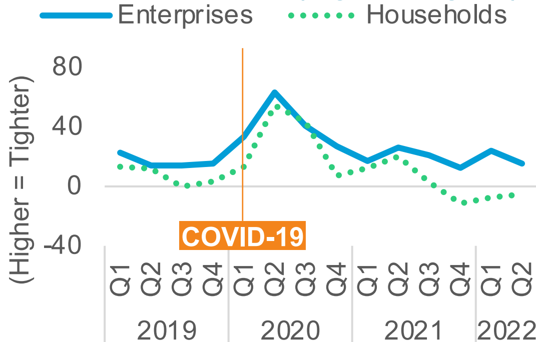
Cashing In

Ready to roll

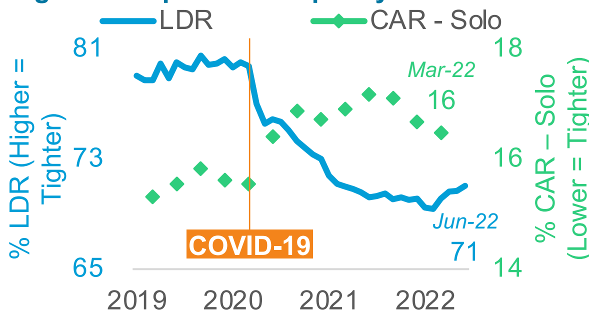
Banks generally become more conservative in lending during crises. As banks tightened credit standards and were reluctant to lend at the onset of the pandemic *(Figure 1)*, capital and liquidity ratios improved *(Figure 2)*, with higher capital adequacy ratio (CAR) and lower loans-to-deposits ratio (LDR) initially. This provided banks with a trusty warchest that they eventually deployed as economic conditions started to bounce back and allowed for the easing of their credit standards.

Figure 1. Change in Banks' Credit Standards, versus Previous Quarter (Higher = Tighter)



Source: Bangko Sentral ng Pilipinas (BSP)

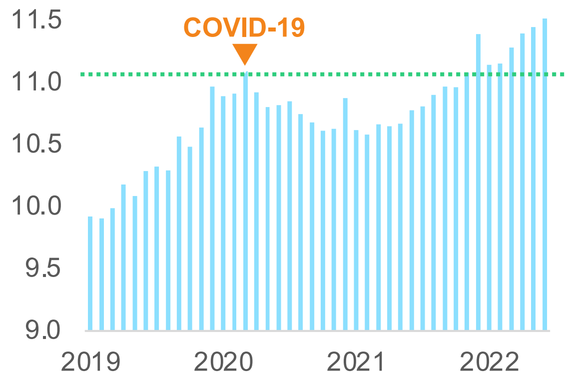
Figure 2. Capital and Liquidity Ratios



Source: BSP

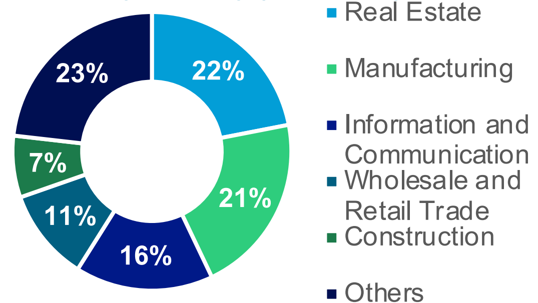
Two years into the pandemic, total loans of the Philippine Banking System (PBS) had already recovered to pre-pandemic levels *(Figure 3)*. With the wider economic reopening, better prospects were seen in industries like manufacturing, real estate, information and communication, wholesale and retail trade, and construction, evidenced by their combined 77% contribution to the annual change in loans as of June 2022 *(Figure 4)*.

Figure 3. Total PBS Loans, Gross of BSP RRP, Inclusive of Memo Items (PHP Trillions)



Source: BSP

Figure 4. June 2022 PBS Annual Loan Increase, by Industry (% of Total)

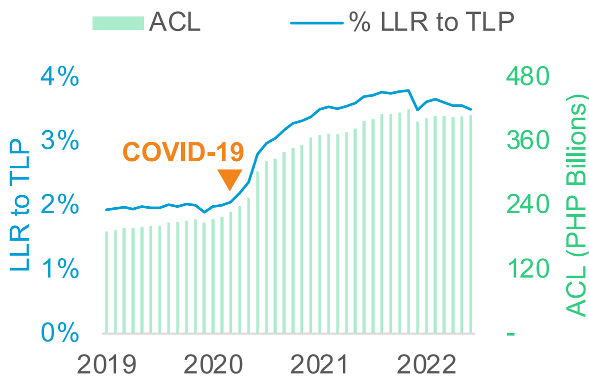


Sources: BSP, MBT TBG-PSAD estimates

Strengthened fortress

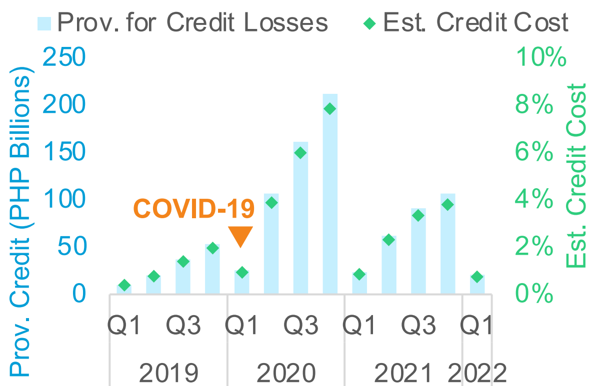
Alongside the initial tighter credit standards, banks also beefed up allowance for credit losses (ACL) at unprecedented levels, augmenting their loan loss reserves (LLR) to TLP for potential deterioration of asset quality *(Figure 5)*. Although already lower than pandemic highs, provisions for credit losses remained above pre-pandemic levels *(Figure 6)*. While asset quality is not an issue at this point, this buffer provides banks some level of comfort when giving out loans as the country transitions to the new normal.

Figure 5. ACL (PHP Billions) and Loan Loss Reserves (% of Total Loan Portfolio, TLP)



Source: BSP

Figure 6. PBS Provisions for Credit Losses (PHP Billions) and Estimated Credit Cost

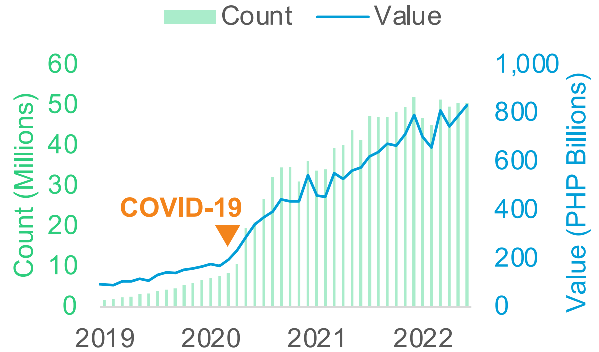


Sources: BSP, MBT TBG-PSAD estimates

Digitalization and new competition

The pandemic changed the way individuals and businesses do their banking transactions. The share of digital to total transactions doubled from 10% in 2018 to 20% in 2020, achieving BSP's initial 20% target. Part of this digital revolution is the prevalence of online interbank fund transfers through InstaPay and PESONet *(Figure 7)*. Encouraged by the accelerated digital adoption, the BSP further boosted their goal to 50% digital of total transactions by 2023.

Figure 7. InstaPay + PESONet Transaction Count (Millions) and Value (PHP Billions)



Source: BSP

The vibrant market of the Philippines attracted more competition through financial technology (fintech) companies and digital banks. Fintech companies like GCash (Mynt - Globe Fintech Innovations, Inc.) allowed for seamless online fund transfers especially for the unbanked population. Meanwhile, digital banks enabled account opening even without going to a physical branch of a bank. To date, the BSP has only granted six digital banking licenses. The convenience offered by these innovations is what is mostly enticing customers.

Looking Ahead

We are ***optimistic*** on the sector, given the following considerations:

Wider economic reopening will benefit banks. As pandemic restrictions continue to be lifted, economic activity will be spurred and so will loans.

Higher policy rates will produce better margins. In general, banks gain from higher rates as their margins initially expand with higher lending rates, before borrowing costs increase to offset this.

Digitalization is the new norm and may result in more efficient operations. With the newfound convenience in digital transactions, most customers will likely not revert back to the traditional way of banking, and banks may find pockets of cost saving opportunities by utilizing new technologies.

Glossary

Allowance for credit losses (ACL) refers to the cumulative amount set-up against current operations to provide for losses, which may arise from the non-collection of loans and receivables, interbank loans, etc. *Higher ACL provides more cover for potential losses.*

Capital adequacy ratio (CAR) is a BSP-regulated ratio of total qualifying capital to total risk-weighted assets. *Higher CAR implies stronger balance sheet and more capacity to deploy to risk assets like loans.*

Estimated credit cost is the ratio of annualized provisions for credit losses to the average gross TLP. *Higher credit cost infers a more conservative stance.*

Loan loss reserves (LLR) to TLP is equal to ACL divided by gross TLP. *Higher ACL to TLP denotes safer and more conservative lending standards.*

Loans-to-deposits ratio (LDR) is obtained by dividing gross TLP by deposit liabilities. *Higher LDR indicates tighter liquidity*.

Provisions for credit losses refers to the impairment loss on loans and receivables and other financial assets, which shall be debited to set up the allowance for losses on the said financial assets. *Higher provisions suggest conservatism and/or more uncertainties.*

Annex

Competition. The banking sector is faced with heightened competition from the emerging fintech companies amid growing acceptance of digital financial services. The risk that banks may not be able to adopt easily or keep pace with rapid technological developments could impact efficiency of banks or render some financial services obsolete which could put pressure on in its ability to compete in the financial service space.

Highly Regulated Industry. Banks operating in the country are required to comply with regulations and guidelines issued by various local regulatory authorities, such as but not limited to the BSP, AMLC, PDIC, SEC, NPC, and BIR, and international bodies, including the FATF. Failure to comply with regulations and guidelines issued by these regulators could have a material adverse impact on the overall standing of financial entities as this

may result to increase in cost to operate, present legal challenges, payment of penalties or even having the license to operate revoked by regulators and restricting financial entities from doing business.

Economic Downturn. Uncertainties surrounding global markets may hamper economic growth and as a result pose a significant challenge to the banking sector – given its impact on profitability, credit, liquidity and asset quality. The effects of slowdown or stagnation in growth of the economy may lead to a spike in loan defaults, liquidity problems and difficulty in meeting capital adequacy requirements, which in turn could threaten the stability of the whole sector.

Market Risk. Banks are vulnerable to fluctuations in market interest rates and any changes in the liquidity position of the Philippine market. As a result, volatility in interest rates could have a material adverse effect on the bank's financial position, liquidity and results of operations.