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Deregulation of Bank Entry and Branching: *Impact on Competition*

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Regulations restricting market entry are among those that have a very direct impact on competition. In the Philippine banking sector, such regulatory restrictions have had adverse effects on the sector's structure, conduct and performance while the liberalization of these restrictions have led to a more competitive banking sector.

This *Policy Notes* provides a brief review of the impact of regulatory restrictions on entry and branching on the commercial banking sector in the Philippines and argues that *deregulation* of such policies is a key element in fostering a more competitive atmosphere.

Regulation of bank entry and branching in the Philippines: a review

Philippine government policy on domestic bank entry was initially lax in the 1950s and early 1960s, as the Central Bank of the Philippines (CBP) actively promoted the development of the banking system to finance the reconstruction of the economy after the war. It became very restrictive, however, beginning in the mid-1960s as the rapid expansion of the banking system led to increased instability. By that time, the CBP became increasingly concerned over the large number of small banks. It then decided to raise minimum capital requirements and essentially prohibited new bank entry. It also imposed tighter restrictions on bank branching, especially in areas identified as heavily or overbranched. Meanwhile, the moratorium on the entry of new foreign banks had been imposed since the time the CBP began operations in 1949 for nationalistic reasons. These entry and branching restrictions remained throughout the 1970s and 1980s. Minimum capital requirements were also consecutively raised during these periods. Thus, it was pointed out that the Philippines' financial liberalization program in the early 1980s did not enhance competition because interest rate liberalization was not accompanied by the complementary measure of deregulation of entry restrictions (Tan 1989).

It was only in 1992 that restrictions on new domestic bank entry and branching began to be effectively relaxed. In 1995, they were further simplified and made uniform across

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banks. Geographical restrictions on domestic bank branching were lifted in 1993, enabling branches to be established anywhere subject to certain prudential requirements. The moratorium on foreign banks was lifted in May 1994 with the passing of RA 7721 which partially liberalized the entry and scope of operations of foreign banks albeit retaining tight branching restrictions. In the aftermath of the 1997 Asian crisis, the *Bangko Sentral ng Pilipinas* (BSP) once again imposed a moratorium on the establishment of new banks and the branch expansion of existing banks, except for microfinance-oriented banks. It also mandated consecutive increases in banks' minimum capital requirements. The new General Banking Law of 2000 (RA 8791) formalized a three-year moratorium on new bank entry even as it allowed foreign banks to acquire up to 100 percent of the voting stock of (only) one domestic bank for a period of seven years from the effectivity of the law.

On the whole, government barriers to bank entry, e.g., direct entry restrictions and higher capitalization requirements, were imposed primarily to limit and reduce the number of banks as well as to increase their average size. Bigger and fewer banks were seen to promote the safety and soundness of the country's financial system. However, as shown in the next section, barriers to entry also had an adverse impact on the banking sector's structure, conduct and performance.

Structure, conduct and performance: some indicators

Banking structure. In general, one will note that there has been no significant structural change in the Philippine financial sector in the last 30 years. Banks, particularly commercial banks, have consistently dominated the Philippine financial system. In fact, the importance of commercial banks even increased over time, with the asset share of commercial banks increasing from around 57 percent in 1970 to 73 percent in 1999. In contrast, the asset share of rural banks fell from around 3 percent in the 1970s to less than 2 percent in 1999 and that of thrift banks slightly rose from 4 percent in 1970 to 6 percent in 1999.

The number of banking offices operating in the Philippines have particularly grown in the 1990s when restrictions, especially on bank branching, were eased as gleaned from Table 1. Compared to just 0.5 percent in the 1980s, the number grew by 8.7 percent in the 1990s, with all bank categories posting significant growth. Furthermore, the rapid growth took place across all regions. Thus, it shows that deregulation of branching, in particular, had a significant impact on regional access to basic banking services in terms of deposits and loans.

The period after 1995 was also characterized by significant movement in the commercial banking sector in terms of new entries and consolidations as seen in Table 2. In particular, the number of foreign bank branches and subsidiaries increased as a result of the partial deregulation of entry. The number of domestic private banks initially increased in the first half of the 1990s as a result of deregulation of entry, then decreased in the latter half due to mergers and acquisitions. Although the BSP especially encouraged mergers and acquisitions among the small banks to meet the higher capital requirements, the mergers and acquisitions primarily took place among the biggest banks.

Thus, the Philippine banking system continued to be characterized by the presence of a few large commercial

Table 1. Number of banking institutions, 1980-99

	1980	1985	1990	1995	Jun '99
Banking Institutions	3,419	3,632	3,638	5,569	7,689
Head offices	1,209	1,055	940	938	976
Branches/Agencies	2,210	2,577	2,698	4,631	6,713
A. Commercial banks	1,501	1,744	1,813	3,047	4,326
Head offices	32	30	30	46	52
Branches/Agencies	1,469	1,714	1,783	3,001	4,274
B. Thrift banks	671	671	653	925	1,478
Head offices	144	118	103	99	118
Branches/Agencies	527	553	550	826	1,360
C. Rural banks	1,155	1,117	1,045	1,346	1,885
Head offices	1,030	904	804	790	806
Branches/Agencies	125	213	241	556	1,079

Source of basic data: Bangko Sentral ng Pilipinas.

banks and a lot of very small thrift and rural banks. Tan (1989) had argued that the ultimate effect of the policy of restricted entry into the banking sector had been to shield both the big and small banks from competition. This allowed the big banks to earn abnormal profits and the small banks to operate at high costs.

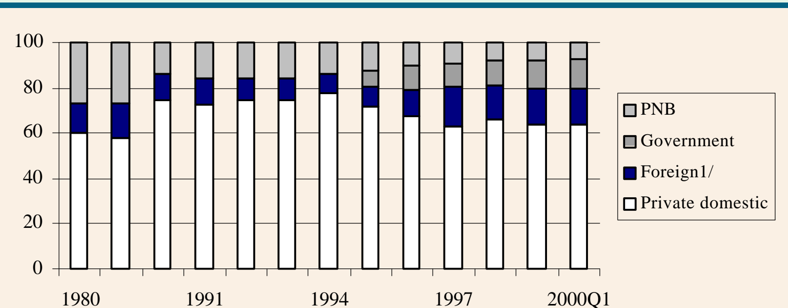
Measures of concentration. In terms of the distribution of commercial bank assets according to ownership of banks, Figure 1 shows that private domestic banks consistently accounted for over 60 percent of total commercial bank assets. Private domestic banks' share rose to as high as 77 percent in 1994, before subsequently falling to around 67 percent in 1999, with the entry of the ten foreign banks in 1995. If the share of the Philippine National Bank (PNB), which passed into majority private ownership in 1995, is included, the share rises to around 76 percent in 1999. On the other hand, the asset share of foreign bank branches and subsidiaries rose from around 9 percent in 1995 to 17.5 percent in 1997, which indicates a decreasing dominance of the domestic commercial banks. As to the share of government-owned commercial banks, it declined from less than 27 percent in 1980 (accounted for by PNB) to 12.6 percent in 1999.

Table 2. Number of commercial banks by type of bank, 1980-2000

Type of bank	1980	1985	1990	1995	1999	2000[1]
Total	32	30	30	46	52	47
Private domestic banks	27	25	25	30	30	25
Foreign bank branches	4	4	4	14	13	13
Foreign bank subsidiaries			6	6		
Government banks	1	1	1	2	3	3

[1]Data for 2000 are only for the first quarter and incorporated the approved mergers and acquisitions.
Source of basic data: Bangko Sentral ng Pilipinas.

Figure 1. Distribution of commercial bank assets by type of bank, 1980-2000Q1 (in percent)



1/Includes branches and subsidiaries of foreign banks.
Source of basic data: Bangko Sentral ng Pilipinas.

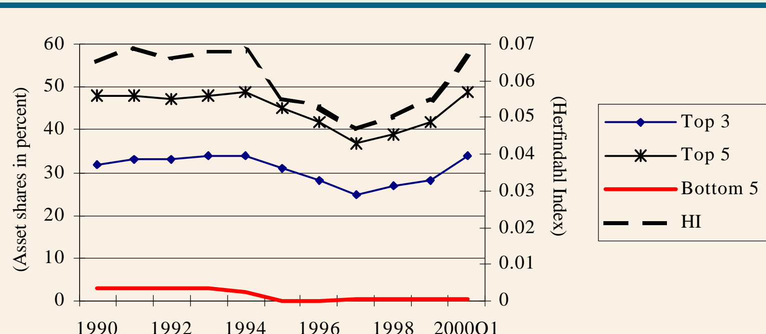
Figure 2 presents some measures of asset concentration in the Philippine commercial banking system. Although the actual value of the Herfindahl index (HI)[1] may not be indicative of undue concentration given its very low values, it would also be useful to look at the trend. The HI was fairly stable from 1990-94. It began to decline beginning in 1995 with the entry of the new foreign banks, indicating that the system was becoming less concentrated. However, this trend was reversed beginning in 1998, which means that the mergers and acquisitions also resulted in increasing concentration.

Similar trends are also evident when one looks at the asset share of the three and five largest commercial banks, all of which are domestic banks. Before the restriction on new foreign bank entry was eased in 1995, the five largest commercial banks consistently accounted for around half of the sector's total assets. Their share declined to around 37 percent in 1997. This trend, however, has since been reversed. Moreover, the gap between the five biggest and five smallest commercial banks is starklingly wide.

The continued dominance of a few, large commercial banks raises the issue of market power. Thus, there is a need to monitor the concentration process even in a deregulated environment to detect any further strengthening of the oligopolistic group in the commercial banking sector and to ensure that it does not lead to misuse of market power.

[1]*The Herfindahl index, which is a commonly used measure of industrial concentration, is calculated by squaring and summing the share of industry size accounted for by every firm in the industry, with a maximum value of 1 (or 10,000 where the market share is measured in percentage terms) indicating a monopoly.*

Figure 2. Measures of commercial bank asset concentration, 1990-2000Q1



Source of basic data: Published balance sheet statements of commercial banks.

Operational efficiency. Operational efficiency is a microeconomic concept. It is, however, also used to characterize a financial system. In particular, the market structure could be reflected in the spread between the cost of funds and the lending rate: a financial system is considered operationally efficient if the interest spread is low. The latter arises from two factors. One, on a microeconomic level, the more cost efficient banks are, the lower the spread will be under reasonably competitive conditions. And two, on a macroeconomic level, systemic risks also affect the spread. A more stable and confident environment will lead to a lower risk premium over lending, thus leading to a lower spread.

A high intermediation margin would imply a smaller intermediation activity. One of the structural weaknesses identified in the Philippine banking sector in the past was the large spread between commercial bank deposit and lending rates. This was attributed to high intermediation costs mainly in the form of taxes and reserve requirements as well as high profit margins. Tan (1989) also pointed out that the interest rate differential might not just be due to taxes but to some monopoly power of the large commercial banks as well. More recently, the World Bank (1998) noted that high intermediation costs continued to be a feature of the Philippine banking system in 1988-95, especially when compared to other Asian economies.[2] In addition to high reserve requirements and the mandated credit requirements, it attributed the Philippines' continued high intermediation costs to high operating costs and insufficient competition. In particular, it noted that the "high profits despite high costs indicate lack of competition, which is also evidenced by the fact that there is high concentration in the banking sector..." (World Bank 1998: p. 23).

The partial liberalization of foreign bank entry in 1994 precisely aimed to increase competition and improve efficiency in the domestic banking sector. Nevertheless, although it led to some changes in the banking structure, particularly the decline in concentration ratios, there has been no significant impact on bank spreads. Table 3 shows domestic commercial banks' average spread and rates of return both prior to and after the easing of the restriction on foreign bank entry took place. Both only slightly declined during the post-liberalization years prior to the Asian crisis.

Recent studies have examined the impact of the entry of more foreign banks on domestic banks' interest rate spreads and efficiency (e.g., Manzano and Neri 2001, Montinola and Moreno 2001, Unite and Sullivan 2001). Overall, their results indicate that foreign bank entry has had limited impact. Manzano and Neri noted that the effects on competition might not have been felt immediately because of a period of adjustment for the foreign banks and/or because liberalization did not go far enough. Ultimately, though, they attributed the persistence of high bank spreads to the government's macroeconomic policy mix which could have masked the impact of foreign bank entry on the domestic banks' interest spread. According to Montinola and Moreno, meanwhile, the scope of liberalization was limited, hence, its modest effects on competitiveness and efficiency.

While the entry of more foreign banks in 1995 has not had a visible impact in terms of reducing domestic banks' interest spread, this does not mean that foreign banks have had no impact whatsoever on domestic banks' operations and the level of competition in the banking sector. Focusing

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[2]The interest spread is often used for international comparisons of financial sector efficiency. But as Claessens and Glaessner (1998) noted, cross-country comparisons should be done with care because a number of country-specific regulatory, tax, macroeconomic and microeconomic factors affect the costs of financial intermediation.

on price or interest competition does not take into account the dynamic aspect of competition and efficiency. The latter refers to the structural response of banks to deregulation as reflected, for instance, in their balance sheets or changes in the structure of their assets and liabilities.

In contrast to traditional static models' focus on price competition in analyzing industrial organization, more recent dynamic models argue that firms in reality are "engaged in a continuing dynamic competitive process, constantly creating and adopting new products and processes in order to gain advantage over their rivals" (Audretsch et al. 2001: p. 618). And in a dynamic economy, the latter may have a more significant effect on welfare than the former in the long run. The issue is especially relevant to financial markets as they operate in more deregulated and globalized environments and become increasingly characterized by technological advancements and product innovations.

In the Philippines, foreign banks traditionally competed with local banks primarily in corporate lending and nonbranch-based financial services. A survey of selected local banks on their reactions to the entry of more foreign banks in 1995 indicated that the latter has led to a more competitive environment particularly in wholesale banking (Hapitan 2001). The entry of more foreign banks further reduced the already thinning spreads from servicing corporate accounts because of the entry of more local banks in the early 1990s. This induced local banks to tap other segments of the market that would generate higher returns. Thus, local banks shifted their focus towards developing products and services for the middle and retail consumer markets, and to some extent the previously neglected small and medium-sized enterprises. Local banks also sought to improve existing product lines and services, especially by introducing technology-based enhancements such as phone banking, bills payment, point of sale transactions, and internet banking (AAC 1998). But as Hapitan (2001) also noted, re-engineering was undertaken by the domestic banks as a strategy in itself and not because of the entry of more foreign banks per se.

Local banks' greater focus on retail operations could also account for the persistence of high bank spreads, both from the cost and profit aspects. Banks whose services are directed more toward retail operations normally have higher operating costs compared to banks that are more oriented toward wholesale markets. This is due to the former's need for more branches, equipment and personnel to serve retail customers. Higher operating costs could then translate into a higher spread. The rapid expansion of branches of domestic commercial banks, especially in 1995-97, accounted for the increasing trend in their operating costs during that period.

The shift towards the more profitable retail lending could have also allowed banks to maintain their profit margins. The general declining trend from 1997 was due to the overall deterioration in economic and banking conditions as a result of the Asian crisis. The New General Banking Law has allowed foreign banks to fully own an existing local bank, thus relaxing the restriction on branching by foreign banks. In December 2000, for instance, Hong Kong Shanghai Banking Corporation (HSBC) acquired a local thrift bank, which could further enhance competition in the middle and retail consumer markets.

Table 3. Commercial banks' average spread and rates of return (in percent)

	Average Spread[1]	Average Rate of Return on Assets	Average Rate of Return on Equity
Pre-liberalization: 1991-94[2]	4.733	2.51	25.66
Post-liberalization: 1995-97	4.345	2.23	18.83

[1]Difference between lending and deposit rates adjusted for the gross receipts tax and changes in required reserves.
[2]1987-94 for Average rate of return.
Source: Lamberte (1999).

Some policy implications

- Government barriers to bank entry are being imposed primarily to limit and reduce the number of banks as well as increase their average size. Initially, the earlier restrictions were meant to address a situation where there was a weak structural base in the financial system consisting of too many weak small banks and a few strong, big banks. However, the focus should not just be the size of banks

but also their soundness, competitiveness and efficiency. Since entry barriers have clearly had a negative effect as shown in the previous sections, a policy on this aspect needs to be firmed up.

A balance needs to be struck between the potential costs and potential benefits of allowing greater competition. In particular, the potential adverse effects of enhancing competition through a lowering of barriers to entry can be addressed by properly applying prudential restrictions already in place, particularly the fitness and properness criteria for bank owners and managers.

✼ The continuing easing of entry of foreign banks may be helpful not only in rendering national banking markets more competitive and thereby more efficient but also in widening and eventually changing the nature of ownership of banks in the Philippines. Concentration of ownership of Philippine banks continues to be a concern essentially because of its adverse implications on allocation of credit, the worst case being DOSRI (directors, officers or stockholders and their related interests) abuses. A potential positive impact of greater foreign participation in the Philippine banking sector is therefore on the ownership structure and orientation of domestic banks.

✼ Finally, in addition to the policy on entry and branching, there are other key policy issues with respect to competition in the commercial banking sector that need to be examined further.[3] These include other unjustified regulatory restrictions on competition such as mandatory credit requirements; the effective treatment of the "exit problem"; competitive neutrality; mergers and acquisitions; and potential anti-competitive agreements as banks enter into more cooperative arrangements such as the interconnection of networks like ATMs, operation of international credit card systems and national debit transfer systems.

[3]*For a fuller discussion of these issues, see Milo 2000.*

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