‘Provincial’ banking in the Philippines: Strategic Priorities and Opportunities

This research note has been prepared as part of an investigation by Bridge into provincial banking in South and South East Asia. The objective of this research is to identify strategic priorities and provide investment to increase banks’ growth and developmental impact.

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Investment attractiveness	
Market opportunity	★★★★★
Balance sheet	★★☆☆☆
Profitability trends	★★☆☆☆
Sector structure	★☆☆☆☆

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Summary

This paper reviews the ‘provincial financial services market’ in the Philippines to understand managements’ strategic and investment priorities. We predict that provincial banks’ ROEs will fall over the coming years – as profits fall and regulatory capital requirements increase. This will force family owners to re-evaluate their position in the market.

The ‘provincial banking sector’ (rural and thrift banks) was founded in the 1950s under a government policy to expand lending to agriculture and small-scale industry in rural areas. This approach to rural development has not met the expectations of the Philippine government or provincial consumers and businesses—lack of financing to SMEs and farmers is still a major barrier to job creation. Two factors have contributed to this inability to meet the policy objectives: Firstly, the policy created a large number of sub-scale banks which has generated an unstable and undercapitalized sector that required considerable government assistance in the 1980s, and may require more government assistance in the near future. Secondly, provincial banks have been very conservative lenders, only lending to a few sectors of the rural economy. As a result, many people turn to high cost alternatives, such pawn shops for their financing needs. There is still considerable unmet demand for credit in provincial areas.

Over the next 5 years, provincial banks will face a combination of falling profits and calls for additional capital. As a result, we predict that average ROEs will fall to less than 4% in rural banks and less than 1.5% in independent thrift banks. We also predict that provincial banks will not be able to pay significant dividends from 2010 to 2014. As a result, provincial banks will find it hard to raise capital. The major issues facing the banks over the next 5 years will be:

- *Increased competition, from commercial banks, non-banks and NGOs, attracted by the high spreads in provincial banking.* Provincial banks will find it difficult to compete with the superior product sets and efficiency of the commercial banks.
- *Major investments in technology, innovation and skills to meet customer expectations will be required.* This will be led by investment in I/T systems and ATMs. More progressive banks will invest in alternative channels such as mobile banking. Banks will seek to introduce new credit and payments products, which will require investment in skills. These changes will change provincial bank’s scale economics, favoring larger banks.
- *Falling profits across the sector, caused by increased competition, higher relative costs due to sub-scale operations and adverse publicity forcing banks to lower margins.* Most likely, more provincial banks will collapse, further damaging the sector’s reputation.

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Building better banks

- *Increased need for capital injection, due to falling profits, need for investment and regulatory requirements*. This will further lower returns on equity.
- *Increased difficulty in raising capital*. Family owners will become reluctant to increase investment, since dividend payments will fall and owners will realize that it will be difficult to sell their shares. Few banks will be able to raise capital from institutional investors.

There is a risk that falling profits and low levels of capitalization will result in more insolvencies. In order to avoid this outcome and to ensure the provincial banks deliver on their policy mandate, regulators will seek to restructure the sector over the next 5 years, including increased pressure for mergers and consolidations to reduce the number of provincial banks.

Provincial banking is potentially highly profitable, due to large unmet demands and high margins. Scale banks in Indonesia, such as BRI and Danamon, show the provincial bank business model is viable. We predict the emergence of several 'Regional champions', who will grow organically or through mergers. This trend is beginning, for example through the development of One Network Bank, 1st Valley Bank and Green Bank in Mindanao. Furthermore, these Regional champions may consolidate into 'National champions'.

The trends in the sector will force every family owner to rethink its participation in the banking sector and answer:

1. What scale do we require to survive long-term?
2. What new skills are needed to compete? What new I/T systems will be required? How can we bring in new management?
3. How much capital will we need to invest? Where are we going to source this level of capital? Would we be willing to accept external (non-family) investors?
4. Is this the best use of family money? Could our capital be better deployed to other industries? If so, who could we sell to, and how can we protect our interests through the sale?

External investment is needed, both to meet the capital requirements (~Php20bn, or $500m, over 3 years) and to catalyze reform. However, the small size of today's provincial banks and their governance structure precludes direct investment from institutional investors. Investors will seek vehicles that allow investment in a number of banks and promote consolidation.

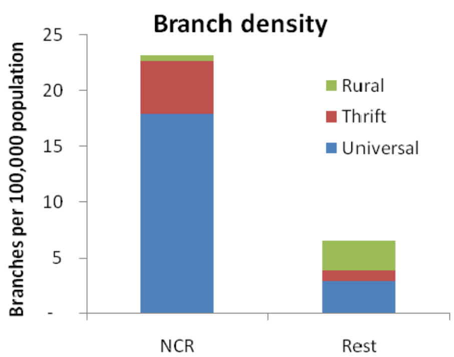
Summary projections

PhP (Bn)		2006 A	2007 A	2008 A	2009 E	2010 E	2011 E	2012 E	2013 E	2014 E
Operating Income	Top 20 rural banks	3.8	5.2	7.2	8.5	9.8	10.9	12.3	13.9	15.6
	Other rural banks	8.3	9.2	9.1	10.0	10.3	10.7	11.0	11.2	11.1
	Independent thrift banks	9.9	12.2	13.2	14.5	15.0	15.2	15.7	16.0	16.2
Net profit	Top 20 rural banks	0.7	0.7	0.9	1.1	0.9	0.7	0.8	0.9	0.9
	Other rural banks	1.6	2.0	1.9	1.9	1.2	0.7	0.4	0.1	-0.2
	Independent thrift banks	-0.6	-0.4	0.1	0.5	0.4	0.0	0.2	0.1	0.0
Assets	Top 20 rural banks	28.2	44.1	48.2	58.3	70.5	81.1	93.3	107.3	123.4
	Other rural banks	98.4	105.4	97.9	105.3	113.1	120.8	127.9	134.0	139.2
	Independent thrift banks	123.4	136.0	134.9	148.4	157.3	163.6	168.5	173.5	178.7
Return on Average Capital	Top 20 rural banks	19%	13%	14%	14%	9%	5%	5%	5%	5%
	Other rural banks	14%	14%	12%	12%	6%	3%	2%	1%	-1%
	Independent thrift banks	-4%	-3%	0%	3%	2%	0%	1%	0%	0%
Capital injections (% of total capital)	Top 20 rural banks	27%	22%	11%	15%	19%	16%	14%	9%	10%
	Other rural banks	7%	4%	-3%	3%	5%	8%	6%	2%	2%
	Independent thrift banks	7%	5%	-1%	12%	11%	9%	7%	1%	1%
Dividend (% of total capital)	Top 20 rural banks	19%	8%	12%	3%	2%	1%	1%	1%	1%
	Other rural banks	12%	9%	1%	4%	1%	1%	0%	0%	0%
	Independent thrift banks			0%	1%	0%	0%	0%	0%	0%
Average annual ROE	Top 20 rural banks	7%								
	Other rural banks	4%								
	Independent thrift banks	1%								

Market Participants

This paper analyses the providers of financial services to lower middle and lower income people, and for micro, small and medium-sized enterprises (MSMEs) in the Philippines to areas outside Manila. We have focused on this sector as currently penetration is low and the sector is served by many small, specialized banks. This section describes these banks.

The formal banking sector in the Philippines comprises commercial and universal banks, thrift banks and rural banks. In addition there are a number of non-bank providers of financial services, both regulated and un-regulated, including pawn shops, cooperatives and informal money lenders.



Commercial and universal banks are currently minor players in the provincial banking market. They have low branch density outside Manila (see left) and traditionally focus on more wealthy clients, since minimum account size limits exclude lower income groups.

Commercial banks are, however, starting to enter the middle income market. Some commercial banks have bought rural banks (e.g. RCBC and AUB). Some are using new technology such as m-banking to reduce distribution costs and go down-market (e.g. BPI). Others are reducing minimum account limits.

	Thrift banks	Rural banks	Pawn shops
Assets ($bn)	10.7	3.2	0.47
CIR	86%	70%	91%
ROA	0.19%	1.9%	4.5%
ROE	1.65%	12.7%	9.6%
Outlets	1,296	2,148	14,784

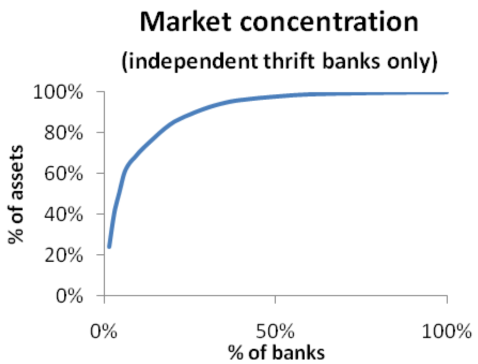
Thrift and **rural banks** focus on the ‘lower mass’ consumer market, and provide most bank lending to Micro, Small and Medium Enterprises (MSMEs)[i]. There are 83 thrift banks and 690 rural banks. Rural banks account for 2.6% of the banking sector assets in the Philippines; thrift banks account for 8.5%. (Throughout this paper, all data refers to year end 2008 and an exchange rate of PhP45:$1 has been used)

Rural banks were first formed in the 1950s and grew through the 1970s, supported by government initiatives in poverty alleviation which focused on direct credit provision and guarantee programs. These programs, which were channeled through the rural banks, provided significant credit subsidies to bring down the cost of borrowing for target sectors. These programs were not fully effective: credit decisioning was poor, funds were diverted and, rather than follow-up bad debts, banks frequently rolled over the subsidized loans for up to 6 cycles, which led to a bad-debt crisis in the 1970s and 1980s. The government was forced to re-capitalize the sector at significant cost and a large number of rural banks closed. Credit provision to rural areas did not significantly increase.

The policy was reviewed in the mid 1980s, leading to the implementation of a market-orientated credit approach in 1987. 43 subsidized rural credit programs were consolidated into one agricultural credit guarantee program (CALF) and a government supported agency, the PCFC, was set up to lend funds to rural banks and MFIs at market rates.

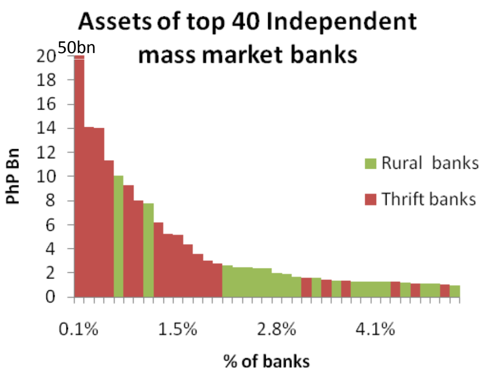
Academic studies have, however, indicated that the rural banks have not responded to the market opportunity well. Few have expanded outside of their traditional clientele and credit models. Since the 1980s, most rural banks have been in a 'low-stationary equilibrium' position: following conservative lending practices, growing slowly, not expanding to lower income groups[ii]. The change to a 'market orientation' did not lead to a reform of the institutions, so there has been little increase in lending.

The rural banks were typically founded up by businessmen based in the local area and most are still owned by their founding families, frequently the second or third generation.



Many thrift banks were founded at the same time as rural banks, with the aim of supporting investment in industry and agriculture, and the development of a long-term savings culture in individuals. Some of the thrift banks do not provide branch banking, but focus on car financing, credit cards or housing loans. Others are focused on urban upper-middle class customers. Typically these are owned by commercial, universal banks or foreign banks. 17 banks owned by local of international banking groups account for 70% of the thrift banking sector's assets. The remaining 57 'independent thrift banks' have assets of PhP140bn ($3.1bn) – the same size as the rural banking sector.

By design, thrift banks focus more on urban areas and lending to industry and larger enterprises, while rural banks lend to farmers and MSMEs. Many thrift banks still focus on urban areas, including Manila, and on business lending. Increasingly, however, the difference between rural banks and independent thrift banks is blurring; some thrift banks focus on microfinance, while the largest of the rural banks is larger than 93% of the independent thrift banks. Hence we classify the independent thrift banks and rural banks together as the 'independent provincial banks'. These 750 banks have total assets of PhP255bn ($6.4bn), total capital of PhP40.7bn ($904m), outstanding loans of PhP175bn ($3.9bn) and revenues of PhP3.4bn ($75m). Rural banks have approx 6 million deposit customers and independent thrift banks approx 3 million customers.



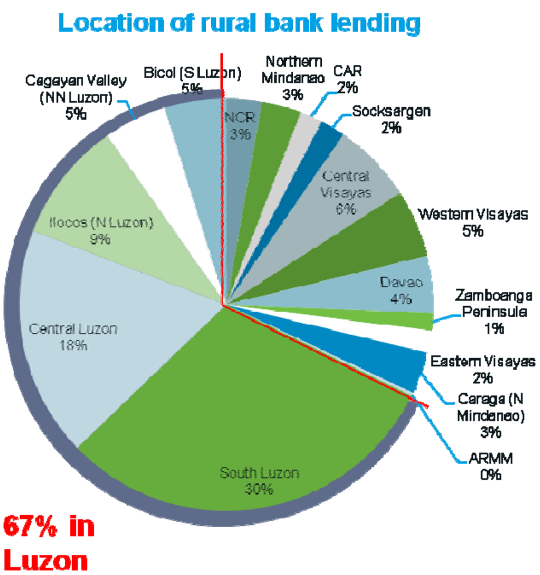
In recent years, a small number of the independent provincial banks have grown rapidly and these fast growing banks now comprise a majority of the sector's assets. The 40 largest banks (7% of the sector) all have assets over PhP1bn and account for 63% of the sector's assets (PhP180bn, or $4.0bn). They range from the Planter's Development Bank, with PhP50bn in assets, which focuses on SME lending, to CARD Rural Bank, which has PhP1bn and focuses on microfinance. 19 are thrift banks, 21 are rural banks. These banks have branch networks of up to 100 outlets, many are developing on-line I/T systems, some offer ATM services, etc.

The majority of rural and thrift banks are much smaller. There are, for example, 28 thrift banks with assets of less than PhP500m ($11m) and very many very small rural banks: there are 574 rural banks with 4 or fewer branches, which comprises 44% of the network. These banks will often only have 1 or 2 branches, dos-based I/ T systems and a very limited product set.

Within the 'independent provincial banks', 4 business models can be identified:

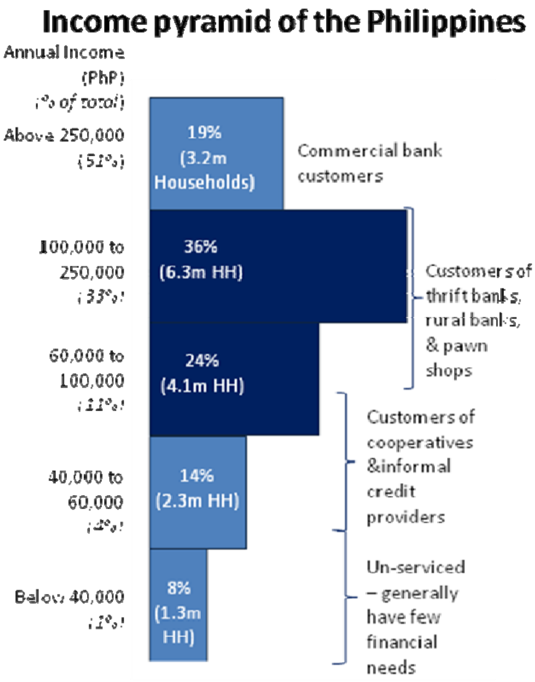
- Most of the banks operate as '**MSME Lenders**'. They provide secured loans of $1,500 - 3000 to local businesses, traders and farmers, charging interest rates of 40-45%. Loans to salaried staff, offered in partnership with the employer (Salary loans) are also common. Total lending approximately equals savings, so there is no need for external borrowing. This business model is relatively low risk and requires few skills, so is suitable for small rural banks. Both lending markets are, however, becoming more competitive, especially as some banks are introducing cash-flow analysis allowing higher LTVs.
- Recently, some specialized '**MFIs**' have formed, taking both rural and thrift bank licenses. CARD is a good example. These institutions offer un-secured loans of $50 to $300, either to individuals or through groups, at interest rates of 50-70%. Few MFI lenders require a history of saving from customers and frequently lending significantly outstrips deposits, requiring external liquidity funding. Many use a 'hub-and-spoke' delivery model, with large numbers of community mobilization officers, leading to a high staff-to-asset ratio. Although the MFIs are typically highly profitable, there are relatively few at the moment, 3 thrift banks and 6 rural banks fall into this category.
- The MFIs' success has motivated a number of rural banks to start offering microfinance services in addition to their MSME and salary lending, creating a '**Mixed model**'. 180 rural banks and 18 thrift banks now offer MFI loans, many supported by a USAid project. Although rural bank management often report that their MFI portfolio is highly profitable, un-secured lending rarely comprises more than 20% of their total book.
- Finally, some banks focus on '**deposit raising**', using the excess liquidity to buy government securities, resulting in a low loan to deposit ratio. This has been a profitable strategy in a number of recent years, since the interest rate offered on government securities has been high and staff-to-asset ratios are low in this model.

	SME lender	MFI	Mixed model	Deposit taker
Average loan size	$2000	$150	$500	$1500
Loan / deposit	110%	170%	120%	60%
Staff / asset (Pm)	12	30 - 50	15	7
Yield on portfolio	25%	60%	35%	25%



Rural and thrift banks are common throughout the country. The greater level of economic activity in Luzon is reflected in the lending profile: 54% of rural bank branches and 67% of rural bank lending is in Luzon. In the past, margins and ROEs of rural banks were significantly higher in Mindanao than other areas, but these margins have fallen and the difference is now small.

Market Opportunity & Impact



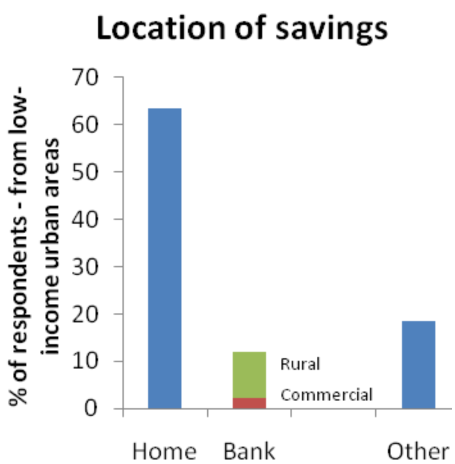
The Filipino provincial banking market is relatively undeveloped, compared to other countries. Increased lending in provincial areas would be the most effective way to accelerate employment creation.

Lower income people and smaller enterprises are poorly served by financial services in the Philippines. The Filipino lower middle income banking market is 54% of the size of the market in Indonesia, adjusting for the difference in rural GDP[iii].

Withiin consumer banking, there is a major gap in lower middle income banking for individuals. 75%-80% of the "potential (individual) market" do not use formal banking services[iv]. Middle and lower-middle income people rarely use deposit accounts, especially if they live outside of the major urban centers. Poorer people may have more access to credit, from informal and semi-formal sources of credit, such as cooperatives, self-help groups and MFIs.

Overseas Filipino Workers (OWFs) are a large and economically important group, which have been ignored by many provincial banks. Approximately 10% of the adult population works overseas, remitting $16bn per year to the Philippines, which provides approximately one third of the country's GDP. OFWs need specific products, such as remittance services, increased control over how their money is used, long-term savings products, housing loans that are repaid while the worker is overseas, and business development funding once the OFW has returned home. Initial investigation indicates that these services are rarely available in rural areas[v].

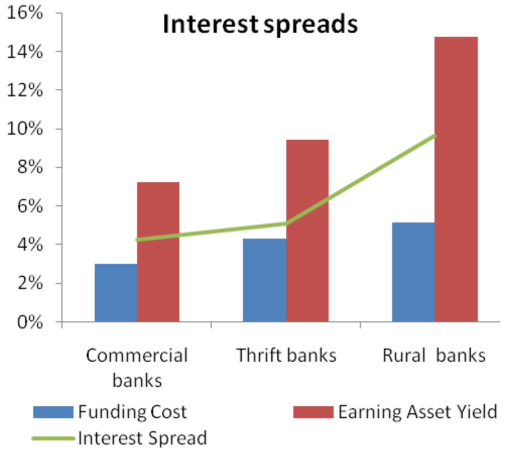
There are a large number of microfinance organizations in the Philippines, providing credit to lower income people. Many of these microfinance organizations are very small, are un-regulated and are focused on urban areas, where there are increasing reports of credit pollution, which indicates that some of these organizations may suffer from poor financial sustainability. Moreover, the target group of these organizations is narrow – typically focusing on the urban poor. Our interviews with microfinance providers confirm there is a shortage of credit in rural areas, and for middle income people.



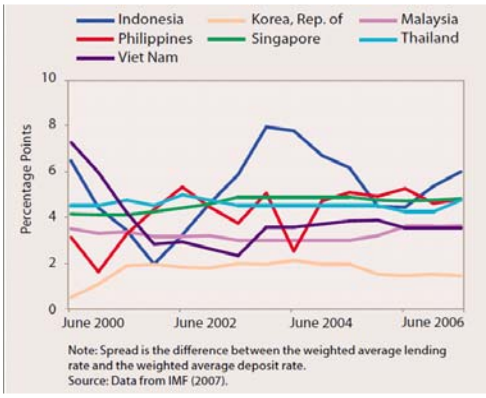
The availability of subsidized liquidity in the banking sector through the 1980s, and the availability of low cost liquidity from commercial banks in recent times, has resulted in a lack of deposit gathering and servicing. Studies of the proportion of savings mobilized from rural areas and customer surveys confirm a large unmet demand for savings products. A large proportion of lower income urban people keep their savings at home (see left)[vi]. Efforts to promote savings by rural banks have led to very rapid mobilization.

Micro, small and medium enterprises (MSMEs) also rarely use formal banks. The structure of the MSME sector in the Philippines would also indicate a large demand for credit: 20% of the Filipino population is involved in entrepreneurial activities of some kind – one of the highest proportions of the population in the world[vii]. MSMEs account for 70% of total employment[viii].

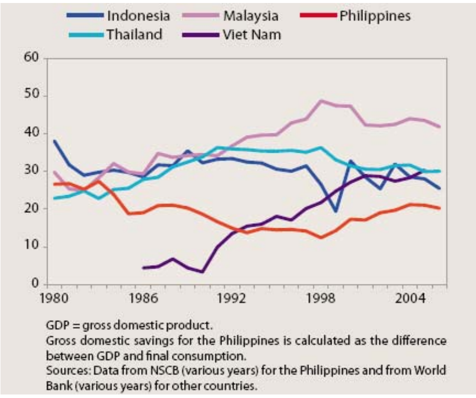
MSMEs report significant difficulties in obtaining credit. In 1991, the 'Magna Carta' for Small Enterprises took effect, which required banks to allocate a proportion of their lending to SMEs. Between 1991 and 2007, lending to SMEs



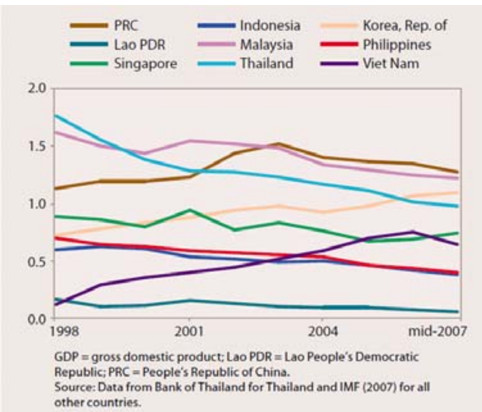
Lending and deposit spreads



Domestic saving as % of GDP



Domestic credit as % of GDP



increased from PhP17bn to PhP352bn, an increase of 21 times[ix]. However a survey of SMEs conducted in 2006 found considerable unmet demand – lack of access to finance was the biggest barrier for MSMEs across all sizes of enterprise[x]. Only 34% of these small-scale entrepreneurs had any relationship with a bank, either as a depositor or a lender. Only 5% had taken out bank loans, compared to 16% who had taken out loans from informal '5-6' lenders, 11% had used non-bank lending institutions and 6% who had used pawn-shops. A 2007 survey showed that bank loans across the SME sector only account for 11% - 21% of SME's total current funding, well below the usual benchmark of 30%[xi].

Rural banks were originally set up to increase the provision of lending to agriculture. While surveys indicate that the proportion of households with agricultural loans has increased to approx 60% of farmers, 60% of these loans are provided by informal providers (such as friends, traders, millers and landowners). Of the formal providers, most are provided by cooperatives, LandBank and pawn shops. Private commercial banks only provide 1.5% of the lending to farmers[xii], mostly to larger farm owners and those how have access to collateral, typically agricultural processors. Most farmers note that access to credit is difficult, and is becoming more difficult.

The low level of provision of financial services in provincial areas is also seen in the prices of simple banking services. Secured loans can cost 20-30% from rural banks outside of cities (whose cost of funds is 3-4%) and the average interest spreads in rural banks is double the average spread for commercial banks. Simple domestic payments can cost $2.50 from banks. However, since banks are rarely available, rural customers often use pawn shops, which charge 6% for a transfer. A similar transaction in Indonesia costs $0.2.

Poorly developed middle-class banking contributes to the low savings rate in the Philippines. The Philippines's domestic saving rate has fallen since the 1980s and is now 30% - 50% lower than comparable countries (see left). The Filipino banking system is, however, highly liquid, partially due to low levels of lending, especially to the MSME sector; lending as a proportion of GDP in the Philippines is one of the lowest in South East Asia. This failure of intermediation is a major barrier to growth in the Philippines, and especially hinders the growth of businesses that would employ lower income groups.

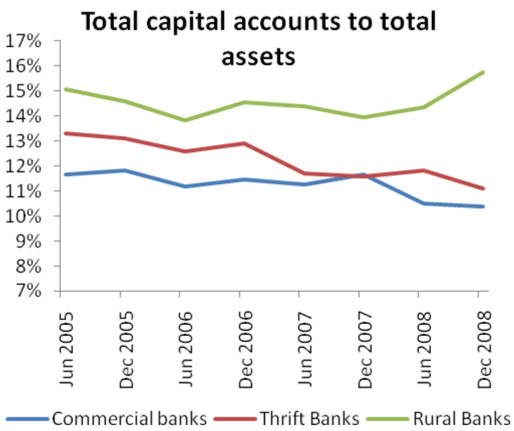
The Philippines's major developmental challenge over the next 20 years will be to create employment. The population of the Philippines is growing at 2.1% per year, one of the fastest in Asia. Approx 1.5m new jobs need to be created every year to meet the increased number of people entering the workforce. The MSME sector will need to contribute the majority of these new jobs. Increasing lending to MSMEs is the fastest way to increase employment, given the current low levels of capital formation in the sector and the higher employment impact of investment in the sector – average employment per unit of capital is 4 times higher for MSMEs in the Philippines than for large enterprises. Lending $300 to a MSME creates one additional job[xiii]. Increasing lending to MSMEs by PhP50bn (20% of the total assets of the independent provincial banking sector) would generate 3.7m jobs.

The next two sections evaluate the performance of the provincial banks to determine their ability to meet this demand for credit.

Balance sheet

Many independent provincial banks need to increase their capital considerably to meet capital adequacy requirements and to invest. The demands for capital are going to increase over the next 5 years.

Current position



The simple ratio of capital accounts to total assets indicates that the rural banking sector overall is well capitalized; for rural banks the ratio has increased to 15.8%. Although the figure for the overall thrift banking sector is considerably lower, the figure for independent thrift banks is 12.6%.

This positive position masks some issues that indicate that there are already many banks that need to increase their capital:

- **Many independent provincial banks have less capital than the minimum requirement.** Average levels of capitalization are distorted by some the very high levels of capital maintained by some banks. For example, 20 independent thrift banks have simple capital to asset ratios above 40%.

  The Philippine Deposit Insurance Corporation (PDIC) states that 103, or 15% of the rural banks, are currently undercapitalized. An additional 10% of banks fail to comply with regulations for other reasons, so that 25% of rural banks are in the PDIC's Prompt Corrective Action program. PDIC has earmarked PhP5bn, to supply 50% of the capital needs to bring currently undercapitalized banks to capital adequacy. PhP10bn is equivalent to 6.8% of the current total assets of the rural banks[xiv].

  Among the independent thrift banks, 12, or 18%, have simple capital adequacy ratios of less than 10%. Assuming that all independent thrift banks will need to raise their capital adequacy ratios to 11%, these banks will need to raise an additional PhP4.2bn in equity, or 2.7% of current assets.

  The existence of such a large number of undercapitalized banks creates a significant risk to the provincial banking system.

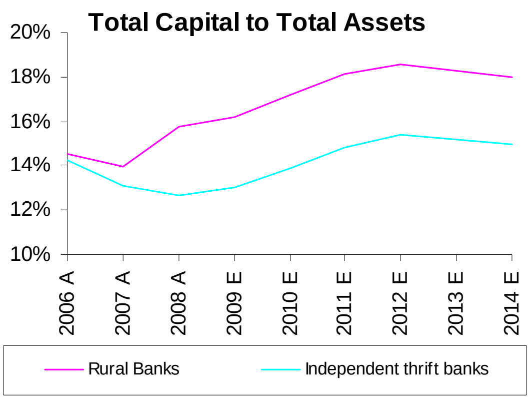
- **A number of banks may be over-reporting their current capital positions**. Without the benefit of I/T systems to monitor loan losses and experience in risk management, it is likely that many of the smaller independent banks are under-reporting their non-performing assets. Increased scrutiny from regulators may expose more bad debt and lower capital adequacy ratios.

Projection

We predict that provincial banks are going to need to raise additional capital, to allow growth and to meet increasingly stringent regulatory requirements.

- **Successful provincial banks will need increased capital to fund their organic growth**. Although the provincial banking sector as a whole has not grown fast in recently years, some banks have grown significantly faster than the market and as this growth continues and profit margins come under more pressure they will find that they are unable to fund future growth from retained earnings.

- **All provincial banks will need to invest heavily in skills and systems in the near future**. Maintaining capital has become the primary objective of many smaller banks, so that they have delayed investment in systems or capabilities. As explained below, the provincial banking market is becoming more competitive and customers are demanding more from the provincial banks, which means that many smaller banks are progressively falling behind their competition. To 'stay in the game', many of these banks will need to make significant investments which will reduce the capital of these banks.



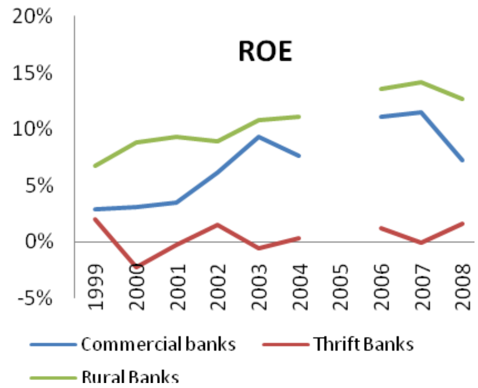
Capital requirements are going to become more stringent. Provincial banks are exposed to a number of risks that require them to maintain higher capital adequacy ratios. For example, the banks often have higher levels of operational risk, due to their reliance on out-of-date I/T systems and limited back-up or disaster recovery. They also have a higher proportion of un-secured lending than in other sectors.

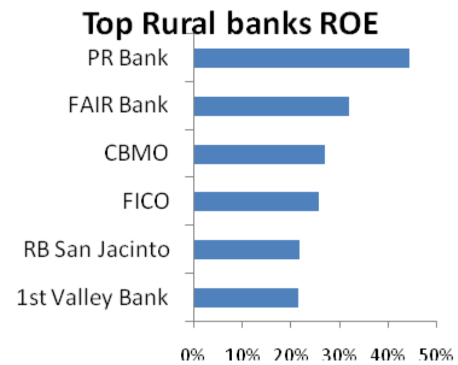
Additionally, most rural and thrift banks are exposed to considerable systemic risk. Rural and thrift banks typically concentrate on one type of lending, such as salary loans or agriculture, and are based in one location. This creates large systemic risk – a single event can undermine the whole of a loan book. For example, a typhoon in one area of the country can severely impact the whole of local economy, a fluctuation in the price of rice can undermine all agricultural loans, the loss of a single customer can result in the loss of all the bank's salary loans.

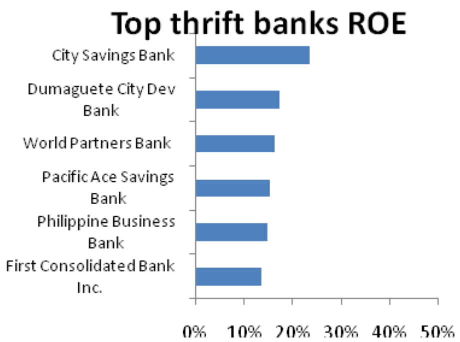
This indicates that smaller banks may need to maintain higher capital adequacy ratios than other banks, and pressure from the BSP to increase capital adequacy is likely to continue.

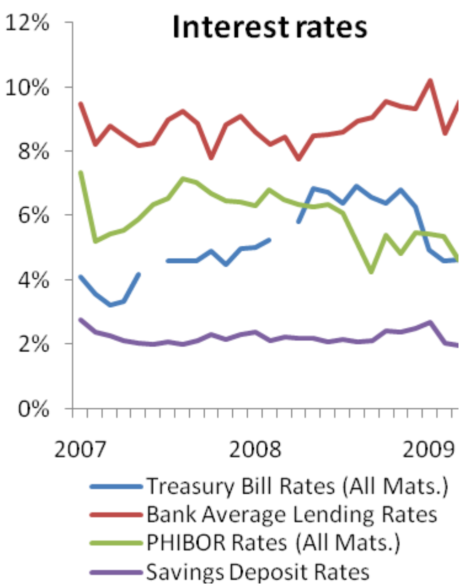
Recognizing this, the Bangko Sentral ng Pilipinas (BSP) is requiring rural and thrift banks to comply with Basel 1.5 capital regulations, which will raise the level of capital required and identify more banks that require recapitalization.

Hence, provincial banks are going to need to find considerably more capital over the coming 5 years. The next section evaluates if retained profits will be sufficient to supply this capital.









Profitability trends

Currently, provincial banks are making returns comparable to the rest of the Filipino commercial banking sector, but profits are already low for a number of banks. Returns on equity are likely to fall in future years, due to falling profits and higher capital requirements. Retained profits are not going to be sufficient to meet the capital needs in the sector.

Current position

Comparing the reported profitability of provincial banks and commercial banks gives an ambiguous result. Rural banks have a higher ROE and ROA than the commercial banks.

Thrift banks, however, have much lower profitability – often only just breaking even (see left)[xv]. In recent years, independent thrift banks have not been profitable. We estimate that the ROE of the independent thrift banks was between -2.5% and -3.5% in 2006 and 2007. In H1 2009, thrift banks considerably improved their performance, averaging 10.5% ROE across the sector. Independent thrift banks, however, only achieved an ROE of 3.3%[xvi].

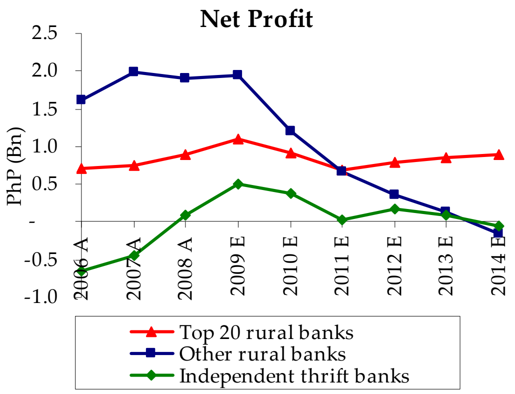
Again, it is useful to understand the variation across the sector, since some of the larger provincial banks distort the averages. Both within rural banks and thrift banks, some banks are achieving strong ROEs. 5 of the larger rural banks are achieving ROEs above 20% and the top 5 independent thrift banks average an ROE of 17%. The 'top performers' contain examples of all business models and all sizes, banks that are located in more remote locations and banks that focus on microfinance are over-represented.

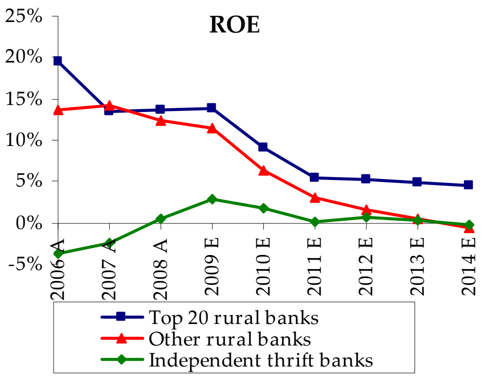
At the same time, there are a number of provincial banks experiencing weak profitability. Within the independent thrift banks sector, 46 out of 54 banks, representing 81% of the assets of the sector, have ROE of less than 10%. 15 are already making a loss. A similar breakdown is not available for rural banks, but anecdotal evidence indicates that a number are being supported by their family owners.

Projection

In the short-term, we project that profits of provincial banks will fall. Market interest rates favored rural banks during 2008[xvii]. It was possible for banks to borrow from the interbank market at relatively low interest rates, driven by the excess liquidity in the Filipino banking market, favoring banks that had high loan to deposit ratios. At the same time banks with excess liquidity were able to buy government securities that offered higher than average interest rates.

This favorable situation allowed rural banks to maintain profitability despite some significant head-winds, including a reduction in lending caused by the global recession, and the need to keep a larger proportion of assets liquid which was necessary to re-assure depositors that they would be able to recover their deposits following the well-publicized collapse of a fraudulent rural bank – some rural banks maintained a 40% liquidity ratio for much of the year.





The unusual interest rate conditions have now reverted to normal and profitability of independent provincial banks has started to fall. We expect profits to continue to decline during 2009 and 2010, and continue to be under pressure in the next 5 years, due to the following trends:

- **Competition will increase, from commercial banks and non-banks**. Commercial banks are starting to focus on middle-income customers and smaller enterprise lending. While this may not directly impact provincial banks in the short-term – few commercial banks are offering services in microfinance or small-enterprise lending – it will gradually compress the market available to provincial banks and many will be forced to address lower income groups, for which they do not have a suitable business model. In addition, an increased number of non-bank competitors, such as specialized lending companies and pawn-shops, will further compete for the provincial bank's customers. This will lead to a reduction in the currently wide interest rate spreads.

- **Independent banks will continue to suffer from a poor reputation.** As mentioned above, a large rural bank group failed in late 2008, which forced rural banks to keep a large proportion of their assets liquid to protect against a run on their deposits. It has also forced many rural banks to raise deposit interest rates to maintain their balance sheet – a number now offer 'double money in 5 years' offers, which is considerably higher than the commercial banks. It is likely that some of the banks are offering these rates will not be able to honor them and may enter receivership: at least one major rural bank has failed this year. This may create a vicious circle of low trust and low profitability which would further impact customer confidence.

- **Bad-debt levels may rise.** There are early indications that bad-debt levels may rise in the near future. In some urban areas borrowers are able to access credit from a number of providers and are starting to borrow from multiple lenders – which is possible as there is no credit-bureau or centralized credit black-list. Additionally salaried workers, who are an important customer group for many rural banks, now often have high levels of debt and some appear to have over-borrowed.

- **The cost of 'staying in the game' will rise.** Understandably, given the recent history of failure in the sector and the highly fragmented industry structure, the BSP is demanding that the rural and thrift banks comply with progressively more rigorous regulation. Additionally, banks will need to invest in new I/T systems to enable them to comply with check-clearing requirements and customer's demand for new channels (such as mobile-banking). Meeting these demands will be costly for smaller banks.

Independent thrift banks that focus on urban markets are likely to face a difficult future. They need to increase their net margins to retain their profitability, but this will be difficult due the increasing competition from more efficient commercial banks. Hence loan growth will slow, margins will remain relatively low and we predict that the banks will again become un-profitable in 2012.

Industry and corporate structure

The current provincial banking industry structure is a barrier to the sector's development and limits bank's ability to access external capital. Consolidation is a priority.

Returns on equity in the provincial banking sector are likely to fall due to decreasing profits and increasing capital demands unless the sector undergoes significant structural change. A comparison with Indonesia indicates the direction of this change. In Indonesia two large banks address the provincial sector; BRI and Bank Danamon. These banks earn between 35% and 50%[xviii] from their provincial banking. To achieve these types of return, provincial banks need to address the following issues:

- **Most rural and thrift banks are sub-scale.** Most rural banks and many thrift banks are stand-alone or in networks of less than 10 branches. As a result, they cannot afford to invest in the capabilities required to compete. Many of the smaller banks, which were set up in the 1950s and 1960s when banking was simpler, now recognize that "banking is no longer a Mum and Pop business".

  There are a number of obvious disadvantages from being sub-scale, such as an inability to balance liquidity across branches, develop I/T systems or offer payments products. These all undermine competitiveness.

  Other less evident factors have greater impact. Small organizations cannot attract or retain staff skilled in I/T, marketing or risk management. They are unable to build a brand and so find it expensive to raise deposits. Funding costs are higher and smaller banks need to keep a higher proportion of their assets liquid. They are difficult to regulate and, since they have less developed controls, are higher risk, so will always be under pressure from regulators to consolidate. All of the independent provincial banks, even those in the top 40 banks, face these issues and will have a long-term competitive disadvantage compared to larger banks.

- **Governance structure not suitable for growth.** Most rural and thrift banks are owned by a family and the board is largely comprised of family members. Some banks state that as the bank has grown, the board's capabilities have not kept up. Many of these banks have started a program to professionalize their boards but this process is slow since the current board members are also the bank's owners.

  Most rural and thrift banks are now 30-40 years old, and are transferring to a second or a third generation. In many cases there is no obvious successor, since the family has emigrated or moved away from the rural area.

- **Ownership structure is a barrier to investment**. Most thrift banks and all rural banks are owned by families. This has been a strength in the past, but in the future, rural banks are likely to find that owners are reluctant to inject additional capital, since they will realize that exits are difficult due to a lack of buyers and dividends are unlikely. Owners will also realize that in the long-run, sub-scale banks will not be able to compete and so will be reluctant to invest further.

Strategic response

The long-term success of the rural banking sector is dependent upon structural change in the sector. The regulatory environment supports these changes. Provincial bank owners now need to decide what role they want to play in the sector, which is going to involve some difficult choices.

The current market structure, of a large number of small, family owned banks, has led to inefficiency, low profitability and limited ability to raise capital. These issues are going to increase over the next 5 years with increased competition, leading to further reduction in margins and more failures of provincial banks. The strategic priorities given below are clear. Regulators, investors and bank owners need to identify a path to implement these priorities.

Strategic priorities

- **Consolidate, either through mergers or rapid organic growth** – to achieve economies of scale, attract more skills to the sector and to reduce risk through diversification

- **Innovate**
  - **products**
    to deepen the relationship with existing customers and ensure branches are relevant to all people in their catchment area
  - **distribution**
    to reduce costs and to allow provincial banks to service lower income people
  - **credit processes and collections**
    to allow more lending while limiting losses from credit
  - **I/T systems**
    to facilitate the above
  - **branding and image**
    to rebuild trust in the sector

- **Raise additional capital** – to fund growth and innovation, and strengthen balance sheets

- **Develop executive management and board members** – since running a large network is a very different task to running a small number of branches

Banks that follow this strategy are likely to start to diverge from the majority of provincial banks, achieving greater efficiency, being able to command higher interest margins and generating sufficient profits to fund growth. We predict the emergence of 'Regional Champions', which in time are likely to consolidate into 'National Champions'.

This movement is already being seen, with the rapid growth of a few, larger, rural banks which have been expanding into new forms of lending and rapidly opening new branches. We have surveyed the finances of 10 of the top rural banks, and found that their loan book averaged 42% annual growth from 2006 to 2008, compared to 14% annual growth in the overall sector. Their net interest margins are significantly higher (25%, vs. 11% for other rural banks), partially because of their stronger presence in microfinance and higher margin lending. They have invested in new branches, yet profits per branch are already 13% higher than average. Within the rural banking sector, we predict that the market share of the largest 20 rural banks will grow from 33% now to approx 50% in 2014.

Regulators

Regulators have two main priorities. They need to increase the performance of the provincial banking sector, which will require banks to scale-up. This will also reduce the regulatory burden. They also need to increase the stability of the sector, which in the short-term requires recapitalization of some banks and in the medium-term, reform to the corporate structure of provincial banks so that they are able to raise capital themselves.

The BSP and the PDIC, have already put in place a number of significant programs to support recapitalization, consolidation and improved management, including:

- **'Framework for Matching'** – an on-line service help owners of banks that wish to divest to find suitable buyers.
- **'Strengthening program for Rural Banks'** – a 'White Knight' investor program that will supply funding in the form of equity and direct loans to a strategic investor to assist it to buy undercapitalized rural banks and so to encourage mergers, consolidations and acquisitions of rural banks. Funds of up to PhP5bn have been earmarked for this scheme which will run for two years from Dec 2009.
- **Continued monitoring and implementation of the Prompt Corrective Action program**. The BSP is introducing additional requirements for rural banks, including Basel 1.5 capital calculation methodology.
- **Continued development of regulatory structure for microfinance and SME lending**. The BSP has implemented programs, in partnership with the ADB, IFC and GTZ, to make the regulatory framework more suitable for SME and microfinance lenders.

These programs constitute a significant effort to re-capitalize and develop the provincial banking sector. We predict that regulators will continue to use all the mechanisms that they can to catalyze consolidation.

Institutional investors / external equity providers

The structural changes envisaged will require considerable additional equity. The following table estimates the amount of additional capital required in the provincial banking sector over the following 3 years. This comprises:

- **Recapitalization of undercapitalized banks**. Many banks have CARs below required levels and already need to raise additional capital. RBAP estimates that the implementation of Basel 1.5 will require rural banks to increase their capital by 3% of assets. The PDIC has set aside PhP5bn for recapitalization of rural banks that are currently undercapitalized, assuming that 50% of the capital contributions will come from private sector partners; Php10bn equates to 6.8% of current rural bank assets. We have assumed that rural banks will need to raise their CARs by an average of 5%. Additionally, we have identified the level of capital required to lift all independent thrift banks to a CAR of 11%, which is equivalent to 2.7% of the current independent thrift banks' assets.
- **Funding for growth**. Retained earnings will not be sufficient to fund the projected growth of provincial banks, especially as margins are being squeezed at the same time. We have assumed that rural and provincial bank owners leave a large portion of the profits in the banks, but additional capital will be required.
- **Funding for mergers and acquisitions**. We assume that 15% of the rural and independent provincial banks will be sold in the next 3 years at book value. Interviews with existing owners indicates that many provincial bank owners would prefer to completely sell their bank, rather than do a share-swap, which will require purchasing bank to raise additional capital.

Estimated capital needs within the Provincial Banking Sector

	PhP (Bn)			USD (M)		
	2010 E	2011 E	2012 E	2010 E	2011 E	2012 E
5% increase in CARs of rural banks (50%, assuming 50% from PDIC fund)	1.5	1.4	1.4	34.0	30.3	30.3
Capital injections (above retained profits) to fund growth	1.0	2.0	2.1	22.9	45.3	45.7
Funds required for buy-out of 10% of rural banks per year	1.6	1.8	2.1	35.0	40.7	45.7
Total (Rural Banks)	**4.1**	**5.2**	**5.5**	**91.9**	**116.3**	**121.7**
2.7% increase in CARs of independent thrift banks	1.4	1.5	1.5	31.5	32.7	33.7
Capital injections (above retained profits) to fund growth	0.7	0.6	0.1	16.6	12.9	3.1
Funds required for buy-out of 10% of independent thrift banks per year	1.1	1.2	1.3	24.3	26.9	28.8
Total (Independent Thrift Banks)	**3.3**	**3.3**	**3.0**	**72.4**	**72.5**	**65.6**
Overall Total	**7.4**	**8.5**	**8.4**	**164.3**	**188.8**	**187.3**

In total, over 3 years, rural banks will need to raise capital equivalent to 47% of current capital and independent thrift banks will need to raise capital equivalent to 44% of existing capital.

Current provincial bank owners are unlikely to provide this capital. Individual investors will increasingly avoid the sector, due to concerns on level of return and exit opportunities. External capital will be required. There are, however, some significant barriers to external investment at the moment.

- **Deal size**. Almost all of the provincial banks are too small for the returns to cover the costs of the transaction for an institutional investor.
- **Unrealistic expectations.** Given the margin trends, increasing capital requirements, small size and limited growth of provincial banks, investors are likely to only accept conservative multiples of book value. Rural banks appear to have had over-inflated expectations in the past. We estimate that in order to generate an average 20% return on equity, a smaller rural bank should be valued at 60% of book, while a smaller thrift bank should be valued at 40% of book.
- **Family holding structure.** Many external investors will be concerned that the governance structure is not sufficiently transparent to allow normal standards of corporate governance. A bank seeking external investment is likely to need to change its board structure.
- **Financial transparency**. Provincial banks accounts may not reflect the true situation of the bank, especially the loan book position.
- **Legal barriers.** There are legal restrictions on foreign investment directly into rural banks. Investors need to use a holding company structure.
- **Limited exits.** Given the small size of deals at the moment, few exits appear possible, especially for an ownership stake that does not confer managerial control. This again limits attractiveness for an external investor.
- **Limited impact on sector restructuring.** Unless the structure of the sector changes, investment will not lead to a significant increase in efficiency or better provision of banking services to provincial areas. Investors who are focused on a public benefit will be unlikely to support an investment approach that does not catalyze to sector reform.

Institutional investors need a 'vehicle' to allow them to invest in the sector. A vehicle would need to allow investment in a number of provincial banks to increase the total invested amount, and consolidate these banks to increase their efficiency, which requires it to bring experience of managing a larger financial services entity. This consolidation should also create an organization that can operate and grow independently to allow an exit. Finally, the vehicle would need to implement more transparent governance structures.

Provincial bank owners

The family owners of provincial banks are both the bank's capital providers and the senior management. Both roles are going to change in the next few years.

Provincial bank owners, and especially rural bank owners, have received a good return from their investment in recent years, with ROEs in rural banks of 13-14% in 2006 to 2008 and good dividend payments. In future years this will change in two ways. Firstly returns will fall. The average annual return on capital in rural banks from 2009 to 2014 will equal 4.7%, driven by falling profits and increased capital requirements. Secondly, rural bank owners will not be able to withdraw profits through dividends for a number of years, as capital will need to be retained to meet capital adequacy requirements. This trend has already started as provincial bank owners were not able to pay as large dividends in 2009 as they paid in 2008, to lift CARs from 13.9% to 15.8%. In future, 70% to 90% of profits will need to be retained in the banks to build up capital.

There is significant difference in capital movements across the different sectors of the provincial banking market.

- **Larger banks** are likely to grow fast and have higher ROEs than the sector average. We predict the total average return will be 6.5%. However, as these banks are also growing fastest, they will have considerable demands for external capital, so investors are not likely to be able to withdraw significant dividends. We predict that capital injection requirements will be significantly higher than dividend payments every year to 2014.
- **Smaller rural banks** will not grow as fast but will need additional capital to cover current capital shortfalls. They will also see larger falls in profit due to greater margin squeeze and higher relative technology costs, with ROEs averaging just 3.5% to 2014.
- **Smaller thrift banks** have increased their profitability in the first half of 2009, but will soon face considerable margin pressure and slow growth due to increased competition from commercial banks, which will lead to a reduction in profits. Banks will both be unable to pay dividends and will need to increase their capital to meet regulator's requirements. We predict average dividend payments of less than 1% of capital and the need to raise significant amounts capital every year.

Many rural bank owners have maintained their banks out of a commitment to their local community and as it provides a position in their community. This benefit is under threat. The reputation of rural banking has already been impacted by recent scandals and the number of scandals is likely to increase due to poor financial performance across the sector.

These trends means that bank owners have to ask some fundamental questions:

1. **What scale do we require to survive long-term?**
2. **What new skills are needed to compete? What new I/T systems will be required? How can we bring in new management?**

   By comparing themselves against the capabilities of the competition, we believe banks will realize that the minimum economic size for an I/T enabled bank is considerably larger than their current size. Banks with less than 100 branches with assets of approx PhP100bn are unlikely to achieve full scale benefits.
3. **How much capital will that require that we invest? Where are we going to source this level of capital? Would we be willing to accept external (non-family) investors?**

   Banks need to plan for how they will source capital, both to meet requirements and to grow to the level of being efficient. Often banks will need to source this capital from outside the existing owning family. These families will need to ask if they are willing to become a partial owner of a bank. If so, families may want to place covenants on new owners to protect their heritage – this may include defining the structure of the advisory board, limiting name changes, giving formal positions to founders, etc.
4. **Is this the best use of family money? Could our capital be better deployed to other industries? If so, who could we sell to, and how can we protect our interests through the sale?**

A number of banks have already determined that, since banking has changed and provincial banks appear to be at their most valuable at the moment, this is a good time to capitalize on this position and sell. Selling now would ensure that the family is protected against a future decline in the industry. It could free up capital for other ventures, and free up family members to follow alternative careers. For many families, this is likely to be the best option.

This decision needs to be made soon. Many banks will need to replace their I/T systems over the next few years to allow them to continue to process cheques and to allow them to link to ATMs. They should define their longer-term vision before embarking on an investment program.

Ultimately, the owners and management of provincial banks need to chose between the following high-level options:

- **'Continue as is'** – Changes to the rural banking sector have started, but will continue to play out over the next 5 - 10 years. During this time, it will be possible for independent rural banks to continue in operation, although returns will reduce and capital invested by current owners will slowly be lost.
- **'Lead the change'** – A relatively small number of provincial banks are likely to thrive in the next 10 years, since scale economics make it difficult for smaller banks to compete and the pace of technology change is increasing. Banks that invest now and start to grow will position themselves for the future and will become one of these few 'National or Regional Champions' that thrive. Becoming a future leader will require the implementation of a number of changes at once and rapid growth. This will require both a strong management team with a strong vision and significant capital.
- **'Capitalize on current position'** – Rural and smaller thrift banks have achieved much, but are likely to start to decline in the next 5 years. For owners who are not willing to significantly invest, this may be the best time to release capital and sell to another bank. A number of rural banks have already done this and the numbers are likely to increase.

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Top 20 Rural Banks

P&L (PhP M)	2006 A	2007 A	2008 A	2009 E	2010 E	2011 E	2012 E	2013 E	2014 E
Interest income	3,916	5,941	8,334	9,699	11,245	12,724	14,367	16,216	18,296
Interest expense	1,189	1,710	2,485	2,820	3,455	4,134	4,684	5,375	6,213
Non Interest Inc.	1,046	962	1,377	1,646	1,975	2,317	2,664	3,064	3,523
Gross income	3,773	5,194	7,226	8,525	9,765	10,907	12,347	13,904	15,606
Op. Expenses	2,734	4,076	5,679	6,576	7,842	9,092	10,252	11,564	13,045
Provisions	102	154	273	466	689	891	1,025	1,178	1,355
Profit before tax	937	964	1,274	1,482	1,234	924	1,070	1,162	1,206
Taxes & except. items	232	219	374	385	321	240	278	302	314
Net Profit	705	745	900	1,097	914	683	792	860	893
Balance sheet (PhP Bn)	**2006 A**	**2007 A**	**2008 A**	**2009 E**	**2010 E**	**2011 E**	**2012 E**	**2013 E**	**2014 E**
Loans	16,072	25,110	29,890	35,868	43,041	49,498	56,922	65,460	75,280
Cash & due from banks	5,075	8,811	9,160	11,450	14,312	16,459	18,928	21,767	25,032
Other assets	7,049	10,132	9,160	10,992	13,190	15,169	17,444	20,060	23,070
Total Assets	28,196	44,053	48,209	58,309	70,544	81,125	93,294	107,288	123,381
Deposits	12,388	16,635	29,075	30,854	38,567	48,209	55,441	63,757	73,320
Bills payable & other liab	3,702	6,720	8,763	10,350	10,977	11,025	11,868	13,181	15,427
Total Liabilities	16,090	23,355	37,839	41,204	49,545	59,234	67,308	76,938	88,747
Paid in Capital Stock	2,640	3,715	4,406	5,445	7,112	8,888	10,881	12,432	14,217
Retained Earnings	2,200	2,500	2,600	3,320	4,198	4,928	5,475	6,109	6,797
Total Capital	4,840	6,215	7,006	8,765	11,309	13,817	16,356	18,541	21,014
Capital movements	**2006 A**	**2007 A**	**2008 A**	**2009 E**	**2010 E**	**2011 E**	**2012 E**	**2013 E**	**2014 E**
Dividend payments	705	428	779	219	183	137	158	172	179
… as % of total capital	19.5%	7.7%	11.8%	2.8%	1.8%	1.1%	1.0%	1.0%	0.9%
Change in paid-in capital	640	1,074	691	1,039	1,667	1,777	1,992	1,552	1,785
… as % of total capital	26.7%	22.2%	11.1%	14.8%	19.0%	15.7%	14.4%	9.5%	9.6%
Ratio (%)	**2006 A**	**2007 A**	**2008 A**	**2009 E**	**2010 E**	**2011 E**	**2012 E**	**2013 E**	**2014 E**
Loan Growth	52.5%	56.2%	19.0%	20.0%	20.0%	15.0%	15.0%	15.0%	15.0%
Deposit Growth	34.3%	74.8%	6.1%	25.0%	25.0%	15.0%	15.0%	15.0%	15.0%
Spread	24.7%	24.5%	25.3%	24.5%	23.2%	22.0%	21.5%	21.0%	20.5%
Equity to assets	17.2%	14.1%	14.5%	15.0%	16.0%	17.0%	17.5%	17.3%	17.0%
Income to assets	16.2%	14.4%	15.7%	16.0%	15.2%	14.4%	14.2%	13.9%	13.5%
Op. costs to assets	11.7%	11.3%	12.3%	12.3%	12.2%	12.0%	11.8%	11.5%	11.3%
CIR	72.5%	78.5%	78.6%	77.1%	80.3%	83.4%	83.0%	83.2%	83.6%
ROAA	3.0%	2.1%	2.0%	2.1%	1.4%	0.9%	0.9%	0.9%	0.8%
ROAE	19.5%	13.5%	13.6%	13.9%	9.1%	5.4%	5.2%	4.9%	4.5%

Other rural banks

P&L (PhP M)	2006 A	2007 A	2008 A	2009 E	2010 E	2011 E	2012 E	2013 E	2014 E
Interest income	10,504	11,391	10,055	10,651	11,262	11,876	12,431	12,887	13,228
Interest expense	4,691	5,010	3,481	3,614	4,154	4,601	5,080	5,616	6,185
Non Interest Inc.	2,518	2,800	2,501	3,009	3,234	3,468	3,693	3,896	4,071
Gross income	8,331	9,180	9,075	10,045	10,342	10,743	11,045	11,166	11,114
Op. Expenses	6,636	6,498	5,771	6,445	7,275	8,145	8,638	8,946	9,190
Provisions	278	505	919	1,160	1,559	1,751	1,945	2,042	2,124
Profit before tax	1,417	2,177	2,385	2,441	1,509	847	462	179	-200
Taxes & except. items	-206	182	485	496	307	172	94	36	-41
Net Profit	1,623	1,995	1,900	1,945	1,202	675	368	142	-159
Balance sheet (PhP Bn)	**2006 A**	**2007 A**	**2008 A**	**2009 E**	**2010 E**	**2011 E**	**2012 E**	**2013 E**	**2014 E**
Loans	57,617	64,663	67,438	72,496	77,933	83,389	88,392	92,811	96,524
Cash & due from banks	18,007	18,524	17,041	18,405	19,693	20,874	21,918	22,795	23,479
Other assets	22,779	22,219	13,400	14,405	15,486	16,570	17,564	18,442	19,180
Total Assets	98,403	105,406	97,880	105,306	113,112	120,833	127,874	134,048	139,182
Deposits	64,246	72,371	79,033	65,885	71,156	76,137	80,705	84,740	88,130
Bills payable & other liab	12,668	12,453	11,747	13,048	16,383	16,760	17,325	18,362	20,286
Total Liabilities	76,914	84,824	90,779	78,933	87,539	92,897	98,030	103,103	108,416
Paid in Capital Stock	10,850	11,333	10,950	11,458	12,350	13,976	15,404	15,971	16,462
Retained Earnings	2,731	3,294	5,074	6,309	7,865	8,827	9,367	9,662	9,804
Total Capital	13,581	14,627	16,024	17,767	20,215	22,803	24,771	25,632	26,266
Capital movements	**2006 A**	**2007 A**	**2008 A**	**2009 E**	**2010 E**	**2011 E**	**2012 E**	**2013 E**	**2014 E**
Dividend payments	1,623	1,303	205	681	240	135	74	28	0
… as % of total capital	12.0%	9.2%	1.3%	4.0%	1.3%	0.6%	0.3%	0.1%	0.0%
Change in paid-in capital	944	484	-383	507	892	1,626	1,428	566	491
… as % of total capital	7.0%	3.6%	-2.6%	3.2%	5.0%	8.0%	6.3%	2.3%	1.9%
Ratio (%)	**2006 A**	**2007 A**	**2008 A**	**2009 E**	**2010 E**	**2011 E**	**2012 E**	**2013 E**	**2014 E**
Loan Growth	6.0%	12.2%	4.3%	7.5%	7.5%	7.0%	6.0%	5.0%	4.0%
Deposit Growth	12.6%	9.2%	-16.6%	8.0%	7.0%	6.0%	5.0%	4.0%	3.0%
Spread	13.6%	13.6%	11.5%	11.5%	11.1%	10.6%	10.2%	9.7%	9.3%
Equity to assets	13.8%	13.9%	16.4%	16.9%	17.9%	18.9%	19.4%	19.1%	18.9%
Income to assets	8.8%	9.0%	8.9%	9.9%	9.5%	9.2%	8.9%	8.5%	8.1%
Op. costs to assets	7.0%	6.4%	5.7%	6.3%	6.7%	7.0%	6.9%	6.8%	6.7%
CIR	79.7%	70.8%	63.6%	64.2%	70.3%	75.8%	78.2%	80.1%	82.7%
ROAA	2.0%	2.0%	1.9%	1.9%	1.1%	0.6%	0.3%	0.1%	-0.1%
ROAE	13.6%	14.1%	12.4%	11.5%	6.3%	3.1%	1.5%	0.6%	-0.6%

Independent thrift banks

P&L (PhP M)	2006 A	2007 A	2008 A	2009 E	2010 E	2011 E	2012 E	2013 E	2014 E
Interest income	13,252	15,759	17,210	18,388	19,614	20,349	21,060	21,436	21,816
Interest expense	4,897	5,448	6,003	6,050	6,863	7,501	7,805	8,010	8,285
Non Interest Inc.	1,501	1,848	2,008	2,114	2,281	2,394	2,478	2,552	2,628
Gross income	9,856	12,160	13,216	14,452	15,032	15,242	15,732	15,978	16,160
Op. Expenses	10,373	12,268	12,330	12,624	13,289	13,919	14,021	14,389	14,746
Provisions	553	634	743	974	1,127	1,269	1,408	1,450	1,494
Profit before tax	-1,070	-743	143	854	616	53	303	139	-79
Taxes & except. items	-428	-297	57	341	247	21	121	56	-32
Net Profit	-642	-446	86	512	370	32	182	84	-48
Balance sheet (PhP Bn)	**2006 A**	**2007 A**	**2008 A**	**2009 E**	**2010 E**	**2011 E**	**2012 E**	**2013 E**	**2014 E**
Loans	67,740	80,117	80,518	88,570	93,884	97,639	100,568	103,585	106,693
Cash & due from banks	17,565	17,959	15,805	17,385	18,429	19,166	19,741	20,333	20,943
Other assets	38,136	37,890	38,571	42,429	44,974	46,773	48,176	49,622	51,110
Total Assets	123,441	135,966	134,894	148,384	157,287	163,578	168,485	173,540	178,746
Deposits	67,950	86,349	94,807	100,060	110,066	116,670	121,337	124,977	128,726
Bills payable & other liab	12,596	19,548	23,369	17,729	19,007	18,732	18,009	17,594	18,469
Total Liabilities	80,546	105,897	118,176	117,789	129,073	135,402	139,346	142,572	147,196
Paid in Capital Stock	13,078	13,967	13,728	15,864	18,029	20,080	21,737	22,022	22,371
Retained Earnings	4,465	3,823	3,378	3,446	3,856	4,152	4,177	4,323	4,406
Total Capital	17,543	17,790	17,105	19,310	21,885	24,232	25,914	26,344	26,777
Capital movements	**2006 A**	**2007 A**	**2008 A**	**2009 E**	**2010 E**	**2011 E**	**2012 E**	**2013 E**	**2014 E**
Dividend payments	-642	0	0	102	74	6	36	17	0
… as % of total capital	-3.8%	0.0%	0.0%	0.6%	0.4%	0.0%	0.1%	0.1%	0.0%
Change in paid-in capital	1,202	889	-239	2,137	2,164	2,052	1,656	285	349
… as % of total capital	7.4%	5.1%	-1.3%	12.5%	11.2%	9.4%	6.8%	1.1%	1.3%
Ratio (%)	**2006 A**	**2007 A**	**2008 A**	**2009 E**	**2010 E**	**2011 E**	**2012 E**	**2013 E**	**2014 E**
Loan Growth	29.4%	18.3%	0.5%	10.0%	6.0%	4.0%	3.0%	3.0%	3.0%
Deposit Growth	27.1%	9.8%	5.5%	10.0%	6.0%	4.0%	3.0%	3.0%	3.0%
Spread	17.6%	17.2%	17.1%	17.5%	17.0%	16.4%	16.3%	16.1%	15.8%
Equity to assets	14.2%	13.1%	12.7%	13.0%	13.9%	14.8%	15.4%	15.2%	15.0%
Income to assets	8.9%	9.4%	9.8%	10.2%	9.8%	9.5%	9.5%	9.3%	9.2%
Op. costs to assets	9.4%	9.5%	9.1%	8.9%	8.7%	8.7%	8.4%	8.4%	8.4%
CIR	105.2%	100.9%	93.3%	87.4%	88.4%	91.3%	89.1%	90.1%	91.2%
ROAA	-0.6%	-0.3%	0.1%	0.4%	0.2%	0.0%	0.1%	0.0%	0.0%
ROAE	-3.8%	-2.5%	0.5%	2.8%	1.8%	0.1%	0.7%	0.3%	-0.2%

[i] 2006 Household income and expenditure survey, interviews with bank and other lenders

[ii] See Llanto, G. M. (2004), Rural Finance and Developments in Philippine Rural Financial Markets: Issues and Policy Research Challenges, published by PIDS

[iii] Bridge Advisory estimates, based on a sizing of the assets of major players in the Philippines and Indonesia, including commercial banks, rural banks and cooperatives.

[iv] Asian Development Bank, Low income household access to financial services, 2007

[v] See studies by ERCOF

[vi] Karman, D. S., N. Ahraf and Y. Wesley (2004), Market survey report

[vii] Global Entrepreneurship Monitor Report, 2006 - 2007

[viii] IFC: Scoping study for support to SME lending

[ix] BSP press release

[x] Global Entrepreneurship Monitor Report, 2006 - 2007

[xi] IFC: Scoping study for support to SME lending

[xii] Survey On Small Farmer And Fisherfolk Indebtedness 2001, Agricultural Credit Policy Council

[xiii] Based on current levels of fixed capital formation, as by the World Bank, estimates of annual depreciation data for the Philippines, from Bu, Y (2004), Fixed Capital Stock Depreciation in Developing Countries: Some Evidence from Firm Level Data, estimates of relative assets in SMEs and the rest of the enterprises in the Philippines, and assuming a multiplier effect of 3 times.

[xiv] In our modelling of the sector, we have assumed that the PDIC supported program will increase capital adequacy ratios in the sector by 5% over 3 years

[xv] Data from BSP web-site

[xvi] Data on individual thrift banks, taken from the BSP web-site

[xvii] Data on interest rates from BSP web-site

[xviii] Data from Mix-market.org and annual reports of Bank Danamon and BRI

[xix] Data from BSP web-site