‘Provincial’ banking in the Philippines: Investment and change priorities

‘Provincial banks’ in the Philippines (rural and independent thrift banks, which share many characteristics) are facing a period of unprecedented change, opportunity and threat. Profits will fall and regulatory capital requirements increase in the next few years, leading to falling ROEs, demands for capital from family owners and limited dividends. This will force family owners to re-evaluate their position in the market.

The ‘provincial banking sector’ 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. As a result, many people turn to high cost alternatives, such pawn shops for their financing needs.

The primary factor conTTstraining the effectiveness of the provincial banking sector is the sub-scale nature of its participants. In the 1950’s, when these banks were formed, scale was not an issue because I/T and information management were not prevalent in the sector. Now, however, I/T drives efficiency and customer convenience and information management is critical to control and product innovation……and the Provincial Banking structure is too subscale to effectively invest in them.

Simply speaking, the intent behind the creation of the Rural and Thrift banks is still as relevant today as it was 50 years ago, but the structure of the sector needs to change to meet this intent. Over the next 5 years, unless addressed, the situation will likely deteriorate — further eroding the ability to create employment in the provincial areas of the country.

The sector will be under increased regulatory and competitive pressure which will lead to reduced profits and increased need for capital:

- *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.
- *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.

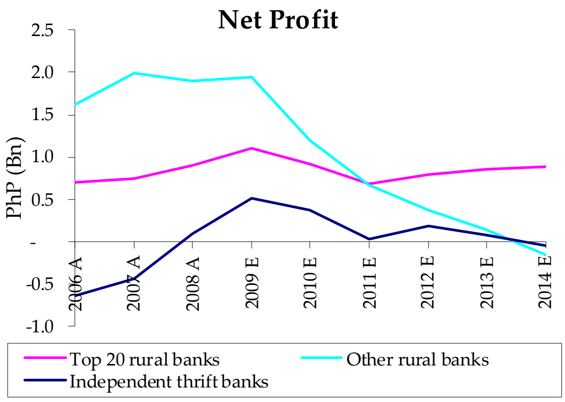
This combination of falling profits and need for additional capital will cause average ROEs will fall to less than 4% in rural banks and less than 1.5% in independent thrift banks. We also predict that provincial banks will not be able to pay significant dividends from 2010 to 2014. As a result, provincial banks will find it hard to raise capital.

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.

While the industry structure is now longer appropriate, Provincial banking is a 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. A new industry structure will evolve to meet both the policy needs and the financial needs of the industry participants. 'Regional champions', who will grow organically or through mergers, will become prevalent. 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'.

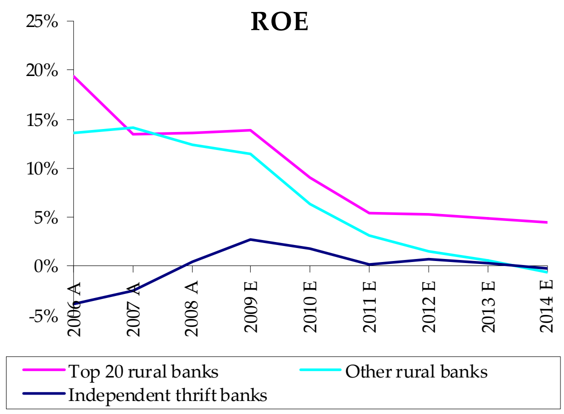
New challenges will need to be addressed by these Regional and National Champions. Management systems to manage much broader and more complex institutions will be required. Capital will be required to accelerate their growth.

A recent survey conducted by ourselves and the Rural Banker's Research and Development Foundation makes it clear that rural banks clearly understand the issues facing the sector, and recognize the need for additional expertise. It is not yet clear, however, how they will raise the additional capital required for growth and investment.



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?



This research note has been prepared as part of an investigation by Bridge Advisory Services into provincial banking in South and South East Asia. Bridge's Principals are

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