Rural Bank Perception Survey 2010 – Summary results

This research note has been prepared by the Rural Bankers Research & Development Foundation with the support of Bridge Advisory Services.

The Rural Bankers Research & Development Foundation is a sister organization to the Rural Banker's Association of the Philippines (RBAP) which researches the status of and issues facing rural banks in the Philippines.

Bridge Advisory Services is a consulting and investment company currently investigating provincial banking in South and South East Asia.

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Summary

Rural Bankers expect their sector to change significantly and fast. They believe increased competition, especially from other rural banks, tougher regulation and poor reputation are all major issues. They predict the recent wave of consolidation and concentration will continue, implying there will be approx 50 rural bank closures per year for the next 5 years.

Larger rural banks appear ready for the new market conditions. They are the strongest competitors in the rural areas, plan to launch new innovative products and plan to grow. If they can access the capital and expertise they seek, they should thrive.

Smaller banks will have a more difficult time. They are already seen as the weakest competitors in rural areas and plan to focus on 'getting their house in order'. They want to build their expertise and install new I/T, which will require capital, but will find it difficult to retain staff, afford new I/T or attract investors. Smaller banks also see less urgent need for change. Smaller banks may increasingly be left behind as the sector develops.

Given the need for expertise, new I/T and capital, rural banks need to ask:

- How can we build expertise? Can we simply buy experts in the local market, or do we need to find partners who can supply this expertise?
- Is it economic to build new I/T systems independently, or would it be more cost efficient to join forces with other rural banks?
- How much capital do we need to build new systems and meet CAR requirements? How much additional capital do we need to accelerate our growth, to achieve scale and competitive advantage? Where can we get this capital from?

It is likely that many rural banks will decide that the best way to answer these questions is to either buy other banks (to build scale) or to sell (if it will not be possible to compete). Most banks already believe these types are deals will be common in the next 5 years.

Approach

The Rural Bankers Research and Development Foundation, working with Bridge Advisory Services, conducted a survey of rural bankers in January & February 2010. 85 rural banks responded, including ~35% of the rural banks with assets of more than PhP1bn. A follow-up survey probed some issues further. This report gives a summary of the results. The full data is available from the Rural Bankers Research and Development Foundation.

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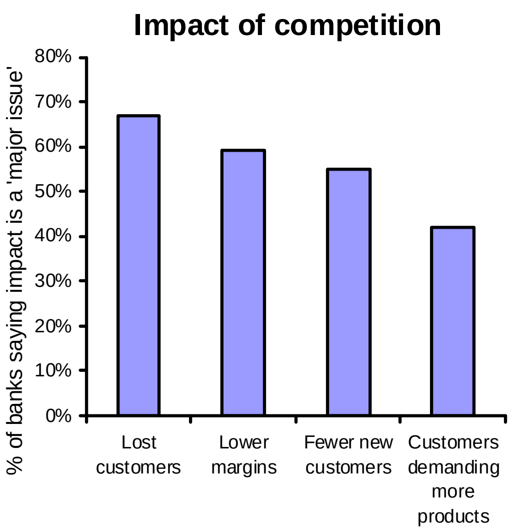
Challenges are increasing, banks expect faster change

Rural banks agree on their major challenges and that these challenges are becoming more significant. Increased competition, a more rigorous regulatory environment and poor reputation are all judged to be significant issues that are already impacting growth and profits. These challenges are going to increase the pace of change in the sector and ultimately lead to faster consolidation.



Increasing competition

Increasing competition important for rural banks. 66% consider it a major issue and only 10% say that increasing competition from commercial banks is not an issue. Competition is already impacting rural banks; the most common impact is lost customers (see left), followed by lower margins. All banks are impacted, irrespective of size and location.

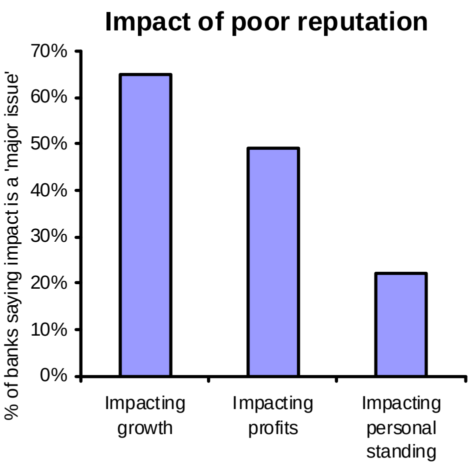
Rural banks realize that 'scale' rural banks are likely to be the most successful in their markets; they judge large rural banks their most aggressive competitors, followed by commercial banks. They smaller rural banks to be the least aggressive competitors.

Increasing regulation

A number of regulatory changes are judged to be 'major issues' by rural banks. The main issues are:

- The BSP's policy of consolidation: a major issue for 64% of rural banks.
- Implementation of Basel 1.5 regulations on capital: considered a major issue by 60% of rural banks. A number of respondents commented that Basel 1.5 is not suitable for community based banks and will increase the regulatory burden on the banks.
- The BSP's SPRB (the 'White Knight Investor program'): considered a major issue by 60% of rural banks.

A number of rural banks also commented that the regulatory system should be more predictable and slower to impose penalties.



Reputation

Poor reputation is also an important issue for rural banks. It is already impacting growth (65% of banks state this is a 'major issue') and profits (48%). Additionally, poor reputation impacts the personal standing of rural bank owners. Some banks are concerned more rural banks will close and all will suffer from a 'ripple effect'.

Impact

Rural bankers predict there will be 380 rural banks in 5 years

Many of the critical challenges identified by rural banks will shape industry structure; larger rural banks will thrive, regulators are catalyzing consolidation, etc. Rural bankers recognize these forces and predict that the number of rural banks will fall from 670 today to 380 in 5 years, a reduction of 43% in 5 years, or 58 banks per year.

Differing abilities to respond will create a greater divergence between small and large banks

Rural banks will respond to the increasing challenges differently depending upon their current position. Larger banks' strategies are focused on growth and innovation. Smaller banks are more focused on 'getting their house in order'. This difference in strategy will accelerate the structural changes already seen in the sector, with smaller banks stagnating and larger banks are taking a bigger market share.

We asked rural banks how they would respond to the increasingly competitive environment. The top 4 priorities, each considered high priority by two thirds of the rural banks, focused on credit and internal management (Introduce more lending products / increase lending, Strengthen credit processes / decision-making, Professionalize management and Lower costs / increase efficiency).

Which products will create growth?

Large banks	Medium & small banks
• Secured lending for housing	• Secured lending to farmers
• Individual micro-finance	• Secured lending to traders
• Secured lending to farmers	• Salary loans
• Secured lending to traders	• Secured lending for housing

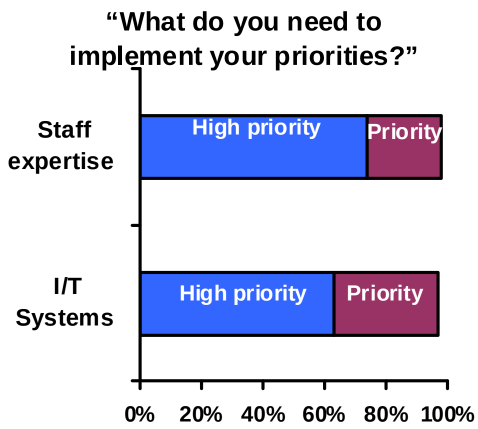
There were, however, significant differences in priorities according to the size of the bank. Larger banks are less concerned by 'core capabilities' since they are already strong competitors – they are more focused on growth and innovation. Having already expanded their salary and loans to SMEs / traders, they see most opportunity in housing loans, microfinance and lending to farmers. Larger banks have already proven that they have execution ability. They now need to ask how they will develop expertise and raise capital.

	Smaller banks	Mid-sized banks	Larger banks
Strategic focus	*Get the house in order*		*Growth / innovation*
Management priorities (from survey)	• Raise more deposits • Improve image • Introduce new credit products	• Professionalise management • Improve credit process • Improve image • Lower costs	• Innovate products • Grow via organic expansion • Attract new segments • Develop risk skills
Likely constraint	• Execution ability	• Affordability	• Expertise & capital
Critical questions	• Will getting the house in order be sufficient to survive? • Will smaller banks always be disadvantaged?		• Does the bank have the skills to manage a more complex organisation?

Smaller banks have more basic priorities. They plan to improve their capabilities to become competitive with the larger banks, focusing on image, growth through traditional products (such as SME lending and salary loans), deposit gathering, etc. Given their limited size and financial resources, they need to ask if they will be able to make these changes fast enough.

The difference in strategy between smaller / mid-sized banks and larger banks is likely to accelerate the structural change in the sector. Larger banks are going to continue to grow, while smaller banks are likely to stagnate. Most banks realize this impact of 'scale' – 94% of banks say they need to be bigger to be efficient. The question facing smaller banks is: will they be able to achieve this scale?

All banks need expertise, new I/T and capital to implement their strategies, but not all can secure them



Banks recognize their need for expertise and new I/T to achieve their priorities. They are also likely to need more capital than they appreciate at the moment. Many banks, especially smaller ones, will find it difficult to attract expertise and capital. Those that do will thrive.

All types of rural banks state that they need expertise and new I/T systems to implement their strategies.

The surveys indicate that banks especially need expertise in credit and collections processes, executive management, new product development and I/T systems. Larger banks are especially focused on expertise: 100% saying this is a high priority.

New I/T systems are a 'high priority' for 68% of banks. Banks that recently replaced their core system are as likely to prioritize I/T as other banks, indicating systems development is a continuous process, not a one-off project. Priorities are: replace core banking system (urgent for 25% of banks, preferable for 49% of banks), implement ATMs (urgent for 14%, preferable for 71%) and implement m-banking (planned by 31%).

The need to raise capital is not as widely appreciated, with only 62% of banks stating that they will need to raise additional capital in the next 5 years. Given that banks will need capital to implement their strategies, meet new BSP requirements and achieve 'scale', it is likely that more banks will find they need additional capital – those that do not risk finding it hard to grow and being left behind.

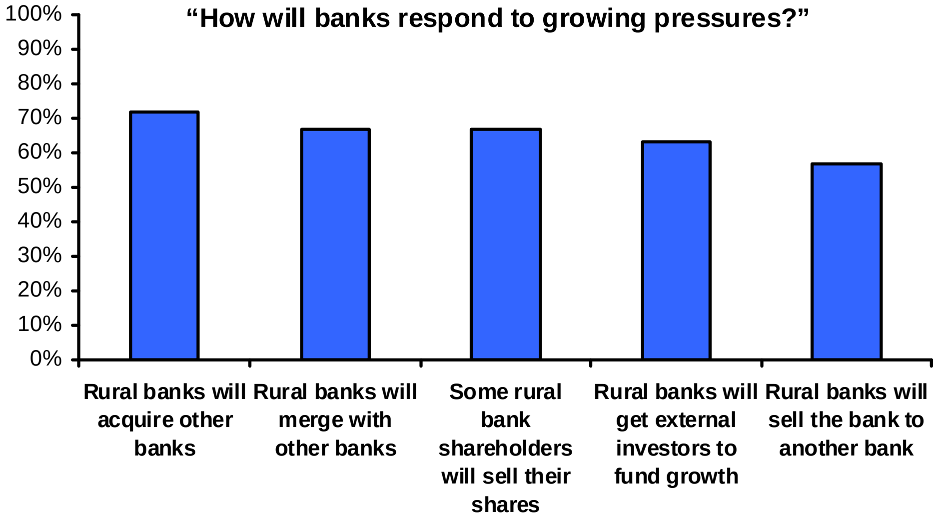
The difficulty of raising capital is, however, well understood. 39% of banks have found it hard to raise capital in the past, and of those who found it easy, 65% expect to find it difficult in future. In total, 79% of banks have found it hard to raise capital, or expect to find it hard to raise capital in future.

Rural banks need to ask themselves why they find it hard to build expertise, improve I/T systems and raise capital. These issues have been critical for rural banks for a number of years, and yet few banks are confident that they can resolve them. The results of the survey indicate that banks need to ask:

- What is the best way to build staff expertise? Can we hire expertise from the local market, or will we need to look further afield to build skills? Can we afford this expertise?
- Why has it been difficult to develop I/T systems? Given our size, can we build up I/T systems independently, or should we join larger networks to build I/T? In the medium-term, will the need for I/T investment change the economics of banks, favouring larger banks?
- Have we been realistic in our estimates of the need for capital, given the need to increase capabilities to compete, desire for growth and changing regulation? If we need to raise capital, where will this come from?

Possible futures: likely to see more transactions

Given the need for expertise, I/T investment and capital, it is likely that many banks owners will seek to merge or sell. Most banks believe this will become common in the next 5 years.



There is a commonly held belief that rural bank owners are very conservative in their approach and very loyal to the idea of stable family ownership. To test this belief, the survey asked banks what the impact of the growing pressures in the market would be. Overall, we found most respondents believe that corporate changes are going to be common over the next 5 years. More than 70% believe that rural banks will acquire other banks, although some banks also commented that banks have unreasonable expectations of valuation

There is again a considerable difference in perception between different sizes of bank. Larger banks are more open to corporate changes. 100% of larger banks believe rural banks will get external investment. Larger banks believe acquisition will become common, rather than mergers, while the opposite is true for smaller banks. Again, a picture emerges of larger banks being more dynamic and open to change.