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Growth of Universal Banking in the Philippines: A Correlational Study with Economic Growth

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Abstract

The purpose of this paper is to determine whether universal banks' profitability performance impact GDP growth in the Philippines, from 2010 to 2018. Banks are believed to instrumental to economic growth because it provides the financial backbone needed to spur economic development through business creation and expansion. A healthy and resilient banking sector signals economic growth and development that is sustainable. The efficient transfer of funds from those that has surplus of them towards those that need them has been made possible due to the intermediation of banks. In the Philippines, banking formally started in 1851 with the establishment of the Bank of the Philippine Islands, which up to this day, stands to be one of the country's biggest and most stable universal bank. This study analyzes how universal banks grew over the years, and determines whether a correlation exists between universal bank growth and economic growth, using the variable of GDP growth rate as proxy for economic growth. The study showed that at the most recent periods, universal banks' ROE and ROA are weakly and negatively correlated with GDP growth rate.

Key words: *Universal banks, History of banking, Economic growth of the Philippines, GDP growth*

JEL classification*: G23; G32; G21*

Introduction

Banking is considered the backbone of economic growth of any country because it provides financial aid to government and the private sector (Gulzar, 2018). Economic growth is measured using gross national product [GNP] and gross domestic product [GDP] with the latter as the more realistic measure since it represents all economic activities and standard of living in the country of interest. Banks are responsible for capital creation, which in turn are borrowed by businesses to fuel resources needed for production. In addition, banks perform intermediary functions in trade activities because it act as payment centers for traders and buyers, both domestically and internationally (Nipun, nd). Economic theory even suggested that efficient financial systems, composed mainly of banks, stock markets, and bond markets, used for channeling of capital are advantageous for sustaining growth in developing economies in Asia (Estrada, Park & Ramayandi, 2010). It is said that growth in the banking sector leads to economic growth of a country because of its ability to influencey important economic sectors such as agriculture, industry, and trade (Abusharbeh, 2017).

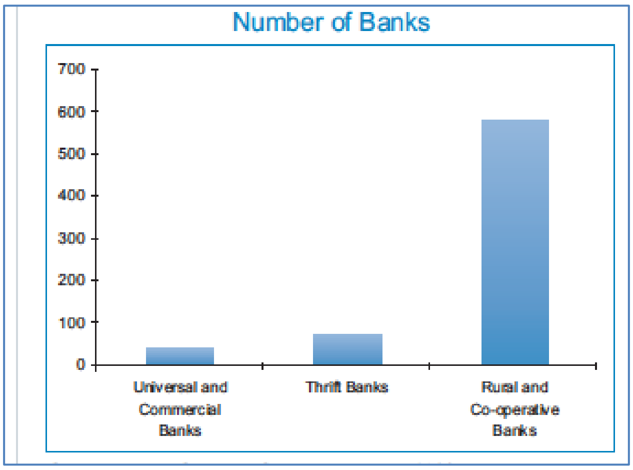
In recent years, universal banks have become significant in enhancing performance of banks because of the economies of scale and income diversification developed that generates higher return and qualitative asset that protects interest of banks' stakeholders (Saunders & Walter 1994 as cited in Miko, 2012). These banks have been acknowledged as vital in economic growth because of their role in stimulating growth through intermediation function, and ability to extend non-bank services like insurance and security trading (Miko, 2012). Because universal banks have significantly grown in the Philippines, it is assumed that its growth helped spur GDP growth of this country. This paper seeks to prove if this premise holds true.

Brief History of Banking in the Philippines

The Galleon Trade was the means of transporting goods from the Philippines to Acapulco, Mexico as early as the 16th century, when Spain colonized the Philippines. To finance the trade, the Obras Pias, a charitable organization run by friars and donated on by the wealthy, was utilized. This became the first evidence of the banking function, where only the friars and the rich participated. In 1851, El Banco Espanol Filipino de Isabel II was established until its name was changed to Bank of the Philippine Islands, and was recognized to be the first bank in the whole of Southeast Asia. Establishment of other banks soon followed such as the: Monte De Piedad Savings Bank which was a bank and a pawnshop; Rodriguez Bank which was more of a loan association; British Orient Bank which expanded the Philippines' trading with Europe; Hong Kong Shanghai Banking Corporation [HSBC] which was the first foreign bank that operated in the country in 1872, Philippine National Bank which was the first agricultural bank in 1916 and the first universal bank in 1980, among others. The latter years saw the rise of full service banks or universal banks which dominated the banking sector of the Philippines.

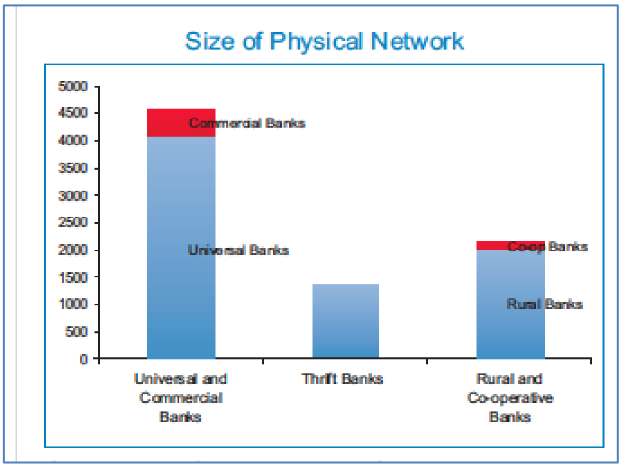
The Philippine banking system was able to weather financial crises, such as the global financial crisis in 2008 to 2009 because of its minimal exposure to the U.S. sub-prime markets, inherent resilience, strong balance sheets, and conservative banking policies and risk management systems (Kolar, 2011).

The Philippine banking industry plays a major role in the sustenance of the country's economic growth (Credit BPO, 2017). The banking landscape remains variegated as shown in Figures 1 and 2.



Source: Kolar, 2011

Figure 1: Number of banks per type



Source: Kolar, 2011

Figure 2: Size of physical network per type

Rural and cooperative banks have the most number of branches nationwide but in terms of size of physical networks, universal banks dominate. Universal banks possess more than 90 percent of the Philippine banking system's total resources, as well as the lion's share of the industry's total deposits (Infosys, 2011). To this date, there are 21 universal banks in the Philippines, 11 of which are listed in the Philippine Stock Exchange. Other universal banks are foreign banks that were allowed to join the Philippine banking system under Republic Act [RA] 7721 in 1995, which was an act that liberalized the entry of foreign banks in the country but only to a maximum of 10. Prior to RA 7721, no foreign banks were allowed to operate in the country until May 1994. In 1995, RA 7721 took effect and there were 10 out of 25 foreign banks that were allowed to operate, such that when 1 bank pulls out, that was the only time that a new foreign bank may come in. In 2014, then President Benigno Aquino removed the cap of 10 banks by issuing Republic Act 10641.

The entire banking sector of the Philippines is under the full supervision of the Bangko Sentral ng Pilipinas, the country's central bank.

The rest of the paper is structured as follows: literature review, research and methodology, results and analysis, and conclusion and recommendation.

Literature Review

On the impact of the banking sector on economic growth

Monnin & Jokipii (2010) examined the relationship between banking sector's degree of stability and subsequent growth in real output and inflation using a sample of 18 OECD countries from 1980 to 2008. The study revealed a positive link between real output growth and banking sector stability, but no clear link between banking sector stability and inflation (Monnin & Jokipii, 2010)

The study of Petkovski & Kjosevski (2014) investigated whether banking sector development promote economic growth using empirical analysis of selected 16 transition countries in Central and Southern Europe from 1991 to 2011. Banking sector development was measured in terms of banking credit to the private sector, interest rates, and ratio of quasi money, and the study found credit to private sector and interest margin to be negatively correlated to economic growth while ratio of quasi money was found to positively relate to economic growth (Petkovski & Kjosevski, 2014). The underlying cause of the negative relation could be attributed to the large amount of non-performing loans and banking crises at the beginning of the transition period and the global financial crisis of 2008 (Petkovski & Kjosevski, 2014)

The study of Dehnabi (2014), investigated the relationship between economic growth and banking sector using a panel data of effects of labour and physical capital factors of four European and four East Asia countries. The study revealed that economic growth in the selected European and East Asian countries are in long-term equilibrium relationship, with banking sector having a long-term significant impact on economic growth, with economic growth converging to their levels of long-term growth through the channels of labor and capital (Dehnabi, 2014). The study further showed that Europe is more successful in using money supply and domestic credit compared to East Asian countries; while East Asian countries are more succesful in labor and capital policies adoption in its banking sectors compared to European counterparts (Dehnabi, 2014).

Hamza & Khan (2014) used measures of bank performance such as deposits, advances, profitability, interest earnings, and investments to analyze relationship with economic growth using GDP. The study used a sample of 10 commercial banks in Pakistan from 2008 to 2012 and the research found that all the variables mentioned are positively and significantly related to economic growth (Hamza & Khan, 2014).

The study of Tripathy & Pradhan (2014) analyzed the short-run and long-run relationship, and causal relationships between banking sector development and economic growth of India from 1960 to 2011 that covered 52 years of post-independence for the country. There is strong evidence than development in the banking sector cause economic growth in the economy of India (Tripathy & Pradhan, 2014).

The study of Diallo (2015) analyzed the role of the banking sector and financial markets in the economic development of 125 countries from 1980 to 2010 using the Schumpeterian model and the study's empirical analysis showed that bank concentration has a negative and significant effect on average per worker GDP growth rate, which becomes more negative and significant when the country is close to the worldwide technological frontier (Diallo, 2015).

The study of Abugamea (2016) investigated the relationship between banking sector development and economic growth in Palestine from 1995 to 2014. The study found a weak relationship between development of the banking sector and economic growth as evidenced by a negative but significant impact of banking size (Abugamea, 2016).

The study of Adekola (2016) explored the impact of banks profitability on the economic growth of Nigeria using the annual report of five selected banks in the Nigerian banking industry from 2005 to 2014. The study found that banks profitability has a significant effect on Nigeria's economic growth (Adekola, 2016).

The study of Abusharbeh (2017) examined the impact of banking sector indicators in Pakistan such as credit facilities, depositors fund, number of branches, and interest rate on GDP from 2000 to 2015. The study revealed that banking credits is signficantly related to GDP growth while interest rates, customer deposits, and number of deposits are not significantly related (Abusharbeh, 2017).

The study of Puatwoe & Piabuo (2017) investigated the impact of financial development on economic growth, using three common indicators of financial development namely broad money, deposit to GDP ratio, and domestic credit to private sector in the country of Cameroon from 1980 to 2014. The study found a short-run positive relationship between monetary mass, government expenditure and economic growth, and a short-run negative relationship between bank deposits, private investment, and economic growth (Puatwoe & Piabuo, 2017). All indicators of financial development though, have a positive and significant impact on economic growth (Puatwoe & Piabuo, 2017).

The study of Al-abedallat (2017) explored the impact of the banking sector of Jordan on economic development using GDP as measure and credit facility size offered by banks, from 2000 to 2015. The study significant impact of the factors deposits of the banking sector and credit facilities on GDP, prompting the recommendation of expanding credit facilities to all sectors (Al-abedallat, 2017)

Mhadhbi, Terzi, & Bouchrika (2017) revisited the Granger causal relationship between development of the banking sector, and economic development of 40 developing countries from 1997 to 2012. According to the study, none of the banking sector development indices caused economic growth in about 57% of the sampled countries, while 62% of the countries showed a causal relationship between banking sector development and economic development (Mhadhbi, Terzi, & Bouchrika, 2017)

The study of Tongurai & Vithessonthi (2018) explored the impact of banking sector development in changes in economic growth and structure, using a wider sample consisting of all countries in the world from 1960 to 2016. The study found banking sector development has a negative impact on agricultural sector development among countries with high degrees of development in the banking sector; while banking sector development has no impact on industrial sector development (Tongurai & Vithessonthi, 2018). On the other hand, the study concluded that both agricultural and industrial sector growth has a positive effect on banking sector development (Tongurai & Vithessonthi, 2018). Findings of this study show a unidirectional relationship between banking sector development and industry-level economic growth, such that the development and growth of agricultural and industrial sectors drive banking sector development but not vice-versa (Tongurai & Vithessonthi, 2018).

The study of Klein & Weill (2018) analyzed the impact of bank profitability on economic growth using a sample of 133 countries from 1999 to 2013. The study concluded that a high current level of bank profitability positively impacts economic growth while the past level of bank profitability has a negative impact on economic growth (Klein & Weill, 2018). This means that the positive impact of bank profitability on economic growth is short-lived (Klein & Weill, 2018).

The study of Ahmed, Yousuf, & Lubna (2019) examined how economic growth is closely related to banking sector development. Using the proxies of money supply, domestic and private credit for banking sector development, the study analyzed the relationship of these variables with economic growth of Bangladesh using Per Capita GDP as proxy, from 1980 to 2016 (Ahmed, Yousuf & Lubna, 2019). The study substantitated a unidirectional and bidirectional causality between economic growth and financial development (Ahmed, Yousuf & Lubna, 2019).

The article of Khuda (2019) acknowledged the contribution of the banking sector in the economic growth of Bangladesh through the years however, the contribution could have been stronger if the challenges faced by the banking sector such as weak management, poor governance, lacking in strong leadership, and non-compliance with ethical standards were addressed. Non-compliance on ethical standards led to several kinds of banking scams like money laundering and increase in non-performing loans (Khuda, 2019).

Synthesis of Literatures Reviewed

Literatures confirmed the sound and significant impact of banking on economic growth and development. Even with various proxies used for banking growth, the results are common in different parts of the world, and that is, banking and the role of banks in economic growth cannot be argued. Even with various researches made around the world, very little was found focusing specifically in the Philippines, except for the study of Mhadhbi, Terzi, & Bouchrika (2017) which included Philippine's data in its roster of developing countries samples. This motivated this researcher to find out if universal banks growth in the Philippines which comprised more than 90% of the sector are significant in the economic development of the country, using the period 2010 to 2018.

Research and Methodology

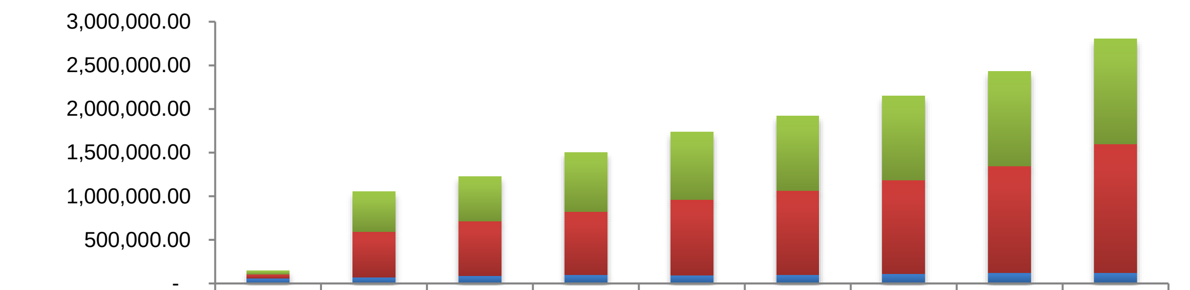
Research Method

The study utilizes bank assets and equity of eleven [11] listed banks out of the 21 universal banks in the Philippines. This 11 banks are owned in majority by Filipinos, making all its consolidated financial reports to be domestic in nature.

This paper mainly used graphical trend analysis and correlational analysis to determine if the universal banking sector performance is contributing to the Philippines' GDP growth rate from 2010 to 2018.

Findings

Figure 3 describes how the total assets, total equity and net income of the 11 listed universal banks grew from 2010 to 2018



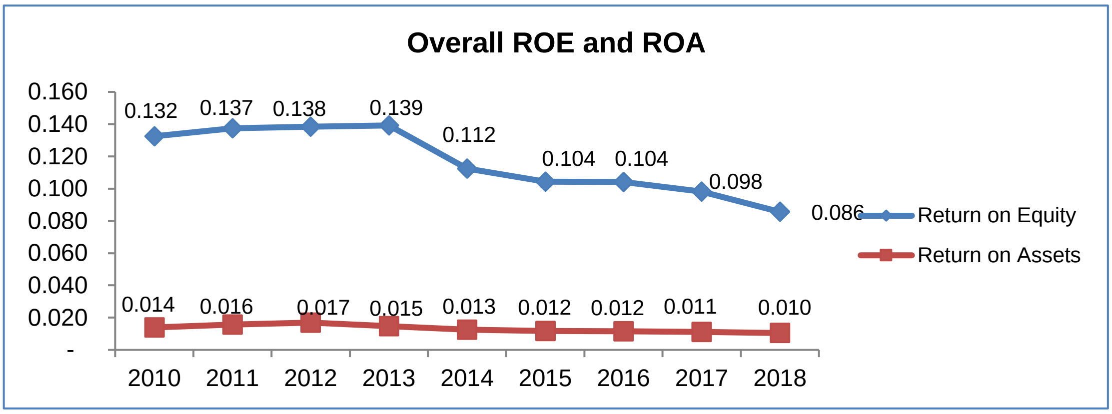
	2010	2011	2012	2013	2014	2015	2016	2017	2018
Accumulated Total Assets	42,955.36	455,897.67	512,669.65	681,047.57	775,532.88	852,973.92	966,516.85	1,084,366.8	1,204,411.8
Accumulated Equity	45,194.62	523,068.88	626,928.76	721,909.83	862,515.79	965,419.54	1,072,198.9	1,225,001.2	1,471,443.5
Accumulated Net Income	59,868.87	71,851.37	86,761.16	100,486.22	96,946.60	100,790.13	111,729.18	120,274.16	125,939.12

Source: Researcher's own calculation

(Note: Accumulated total assets was scaled to ÷10 for better graphical representation)

Figure 3: Growth in total assets, equity and net income in absolute amounts (in Php '000)

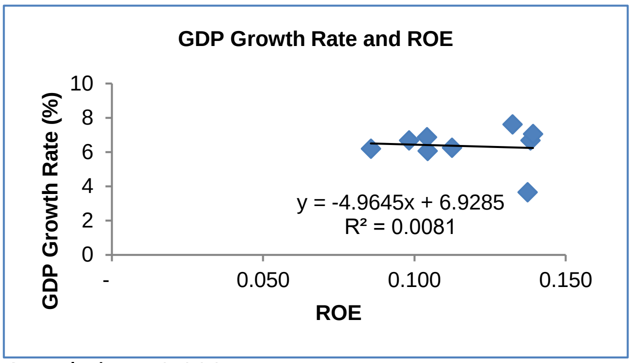
Even with growth in assets and equity, net income growth is stagnant. This results to unremarkable performance of return on asset and return on equity as shown in Figure 4



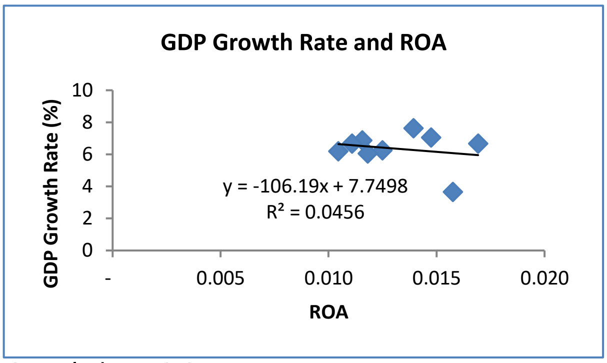
Source: Researcher's own calculation

Figure 4: Overall ROE and ROA of the 11 universal banks

ROE is declining which signals that even with increasing amounts of equity, net income generation is getting weak. Figures 5 and 6 show the scatter plot of ROE and ROA with GDP growth rate.



Correlation: -0.090



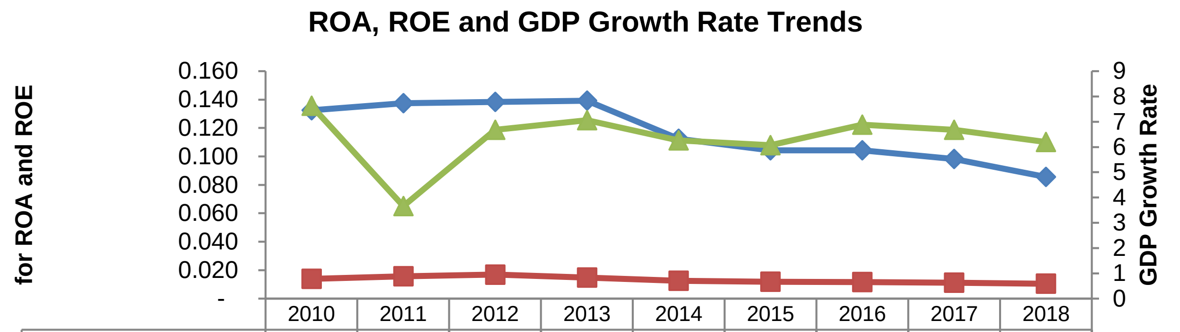
Correlation: -0.214

Source: Researcher's own calculation

Figure 5: GDP Growth Rate and ROE

Figure 6: GDP Growth Rate and ROA

Based on Figure 5, a 1 point increase in ROE decreases GDP growth rate by -4.97, however, the correlation is very weak at -0.90 and model fit that is low at 0.0081. In figure 6, a 1 point increase in ROA reduces GDP growth rate by -106.2, however the correlation is weak at -0.214 and model fit that is also low at 0.04561. From these results, it appears that universal banks' profitability using ROE and ROA as proxies do not impact economic growth, as summarized in figure 7.



	2010	2011	2012	2013	2014	2015	2016	2017	2018
Return on Equity	0.132	0.137	0.138	0.139	0.112	0.104	0.104	0.098	0.086
Return on Assets	0.014	0.016	0.017	0.015	0.013	0.012	0.012	0.011	0.010
GDP Growth Rate	7.632	3.66	6.684	7.064	6.265	6.067	6.876	6.685	6.2

Figure 7: ROA, ROE and GDP Growth Rate Trend

Source: Researcher's own calculation

Conclusion and Recommendation

This research concludes that the profitability performance of the 11 banks taken in aggregate using ROE and ROA do not represent a remarkable picture. Even with expanding bank sizes in terms of assets and equity, the aggregate net income do not grow in proportion. Although banks have different performances and, majority of the sampled universal banks have declining ROE performance, and lack luster ROA performance (see Appendix 1). The result of this study is in contrast with the findings in literature, since most have empirical evidences that banking sector growth are positively related with GDP growth. Even with other factors influencing GDP performance and growth, universal banks are presumed to be significant growth drivers and this expectation has to be closely aligned with the overall bank profitability performance. The result of this study will become valuable to these banks for them to closely look at how well income is generated by their expanding size, as well as banking policies in the Philippines that may need to be reviewed in as much as profitability and its impact in GDP is concerned. This study though is limited only on the direct impacts of the banking sector, not including the indirect impacts in the form of support to economic players (e.g. agriculture, manufacturing, service, etc.).

It is strongly recommended that universal banks in the Philippines consider not only growing in size (assets and equity) but focus must be made on how this growth in size could contribute to higher and faster net income generation. The country's GDP growth rate is slowly declining from its 2013 level, and universal banks can aggressively embark on measures that will accelerate business expansion, and increase in productivity in the country's agriculture sector, since these are the two of the largest areas where the country can gain competitive advantage due to its natural terrain for farming, and educated labor force. Universal banks may extend its product and service offerings to the agriculture sector to reduce the country's reliance on imports of agriculture products. Universal banks, most especially those listed in the Philippine Stock Exchange may need to uplift and strengthen their roles by improving on each bank's individual bottom lines and drive ROE and ROA higher, or in alignment with growth in assets and equities.

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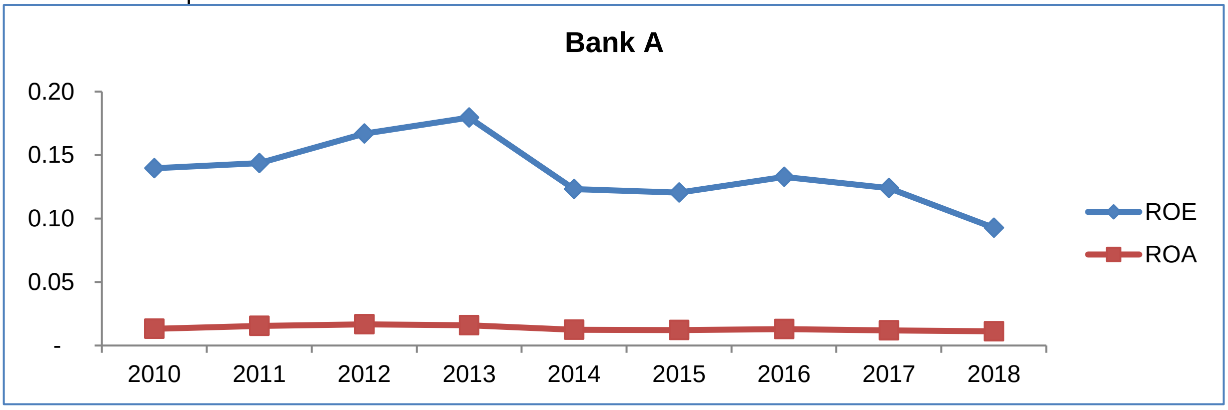
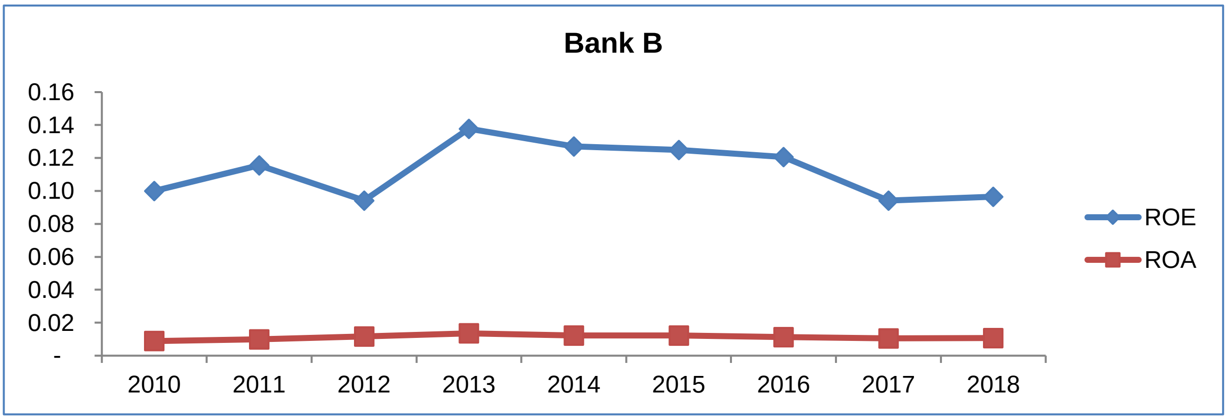
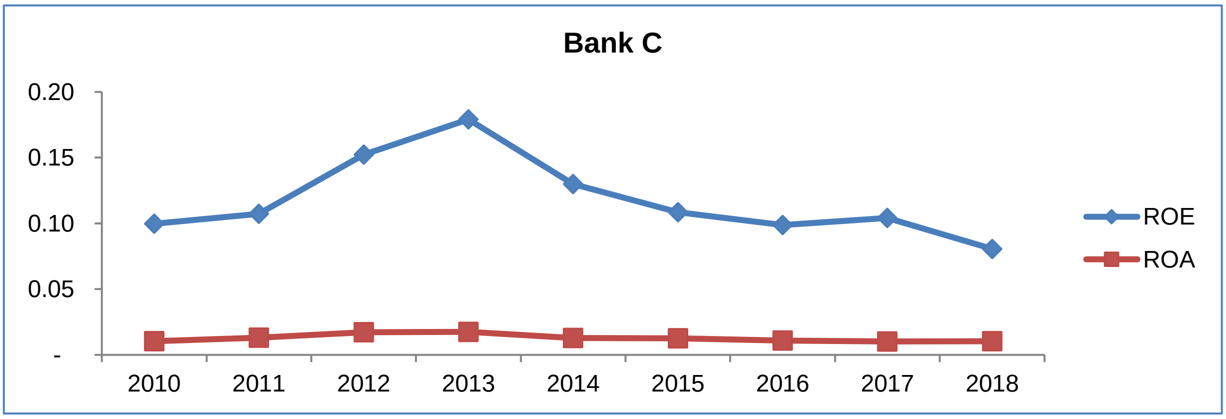
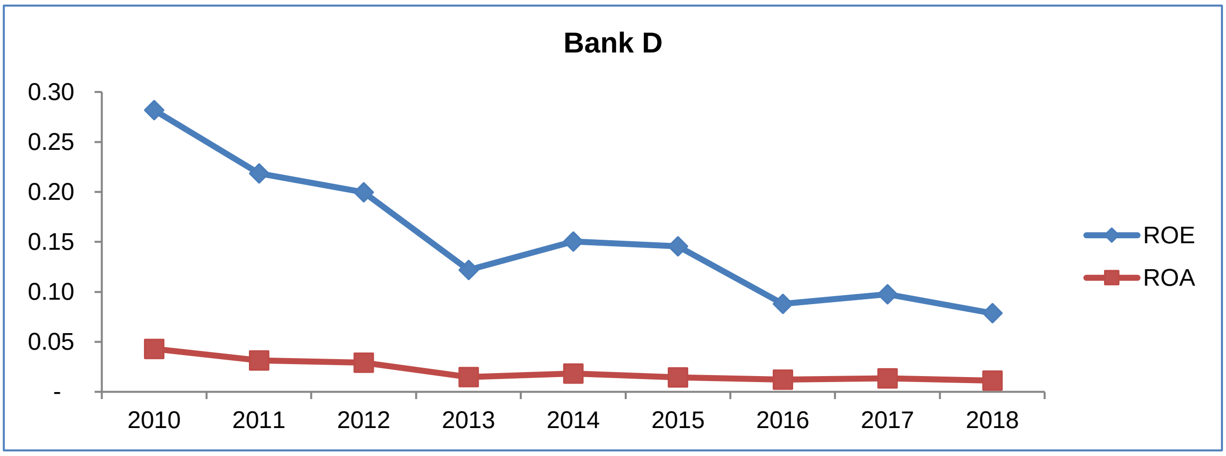
Appendix

ROA and ROE performance of individual banks





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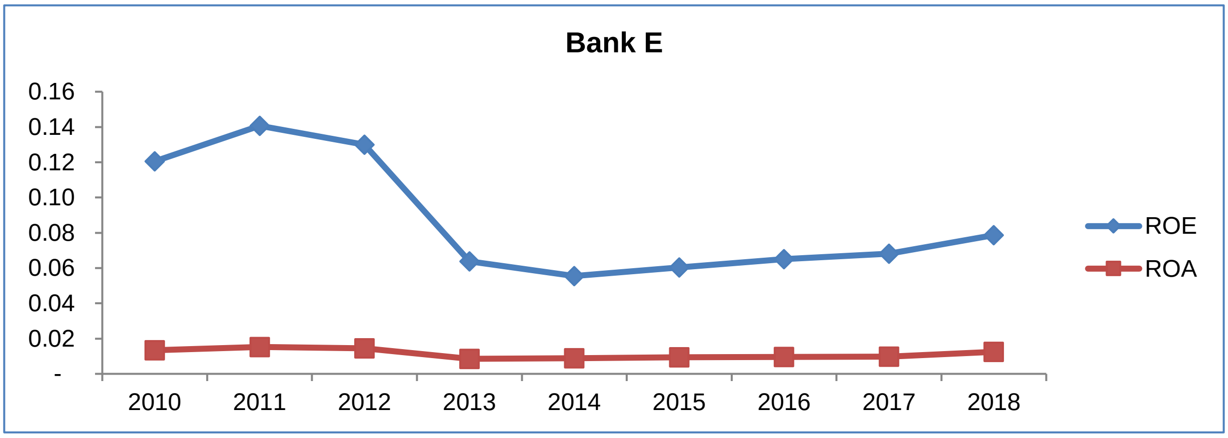
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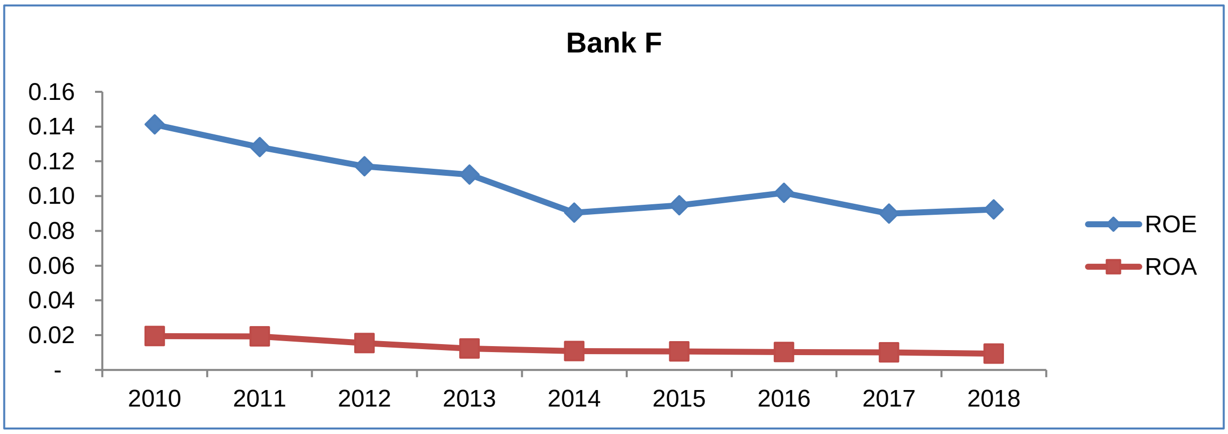
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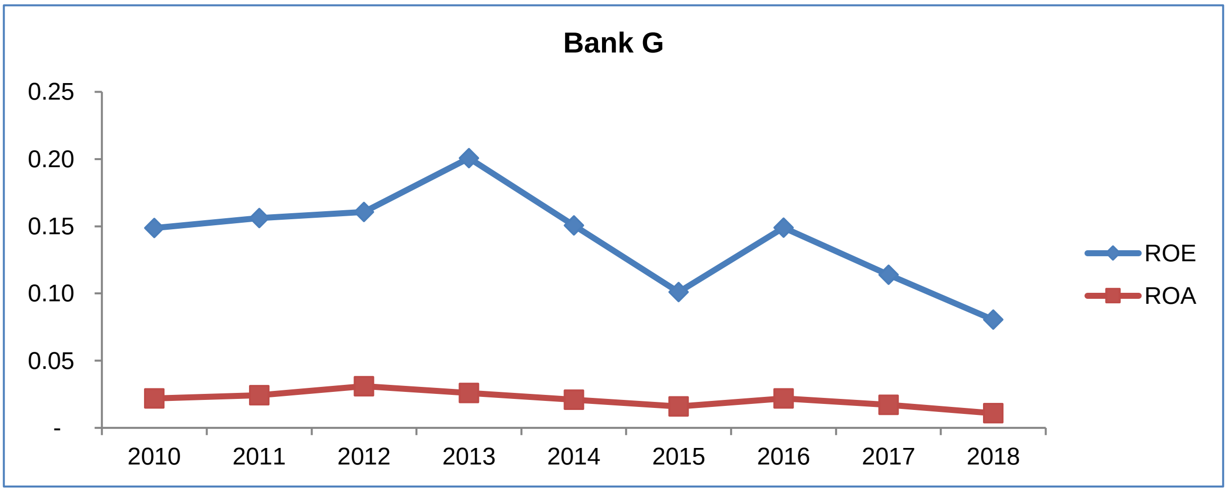
Bank G
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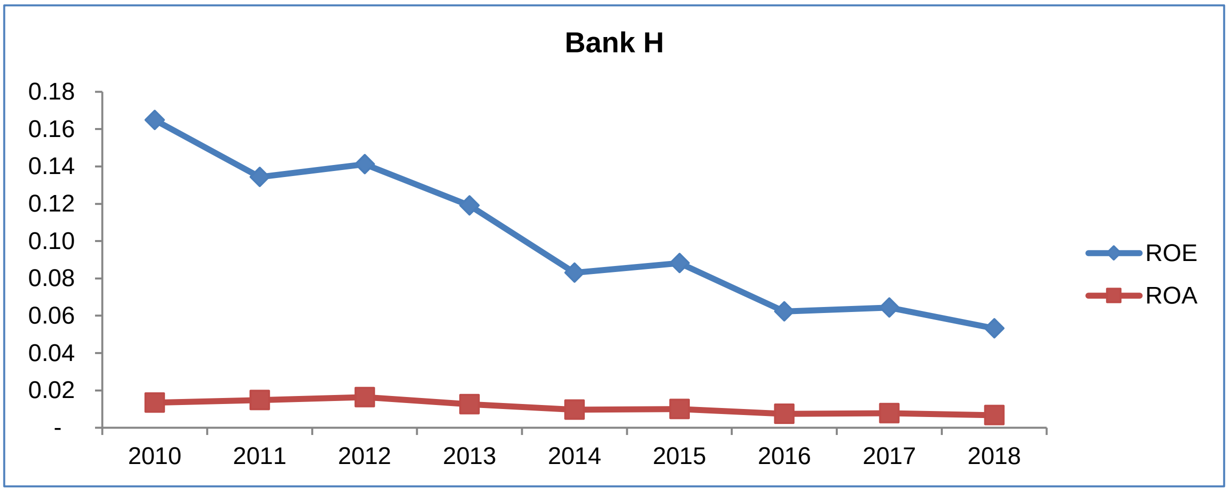
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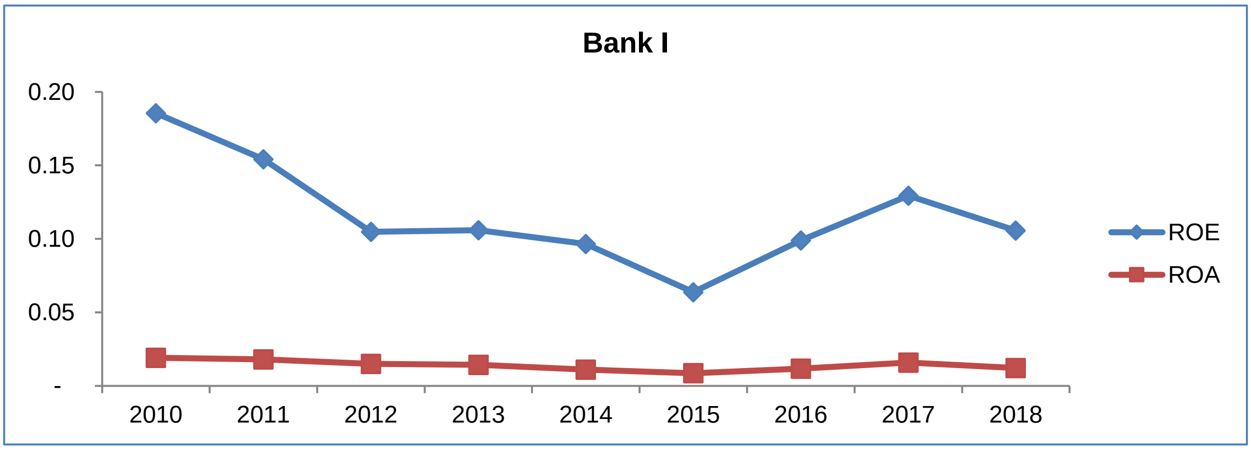
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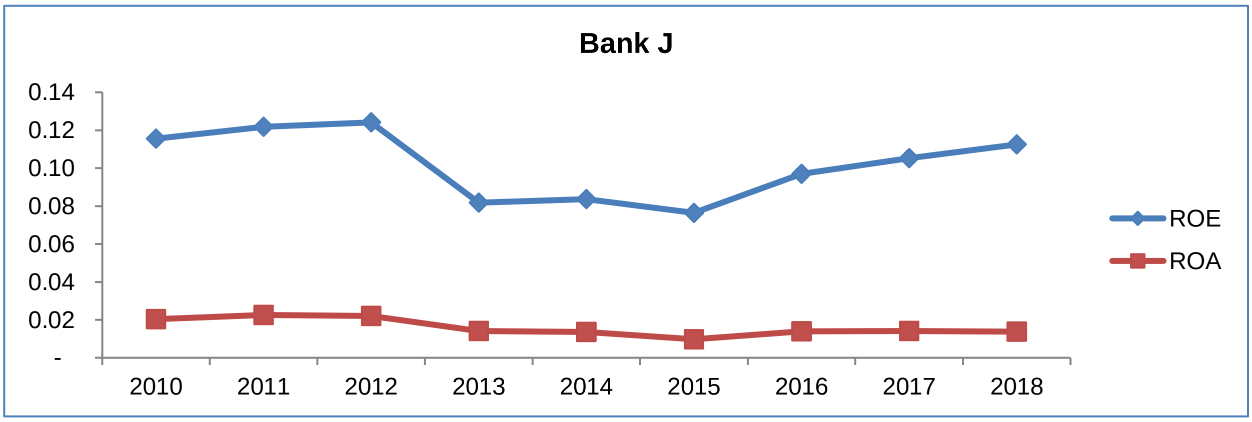
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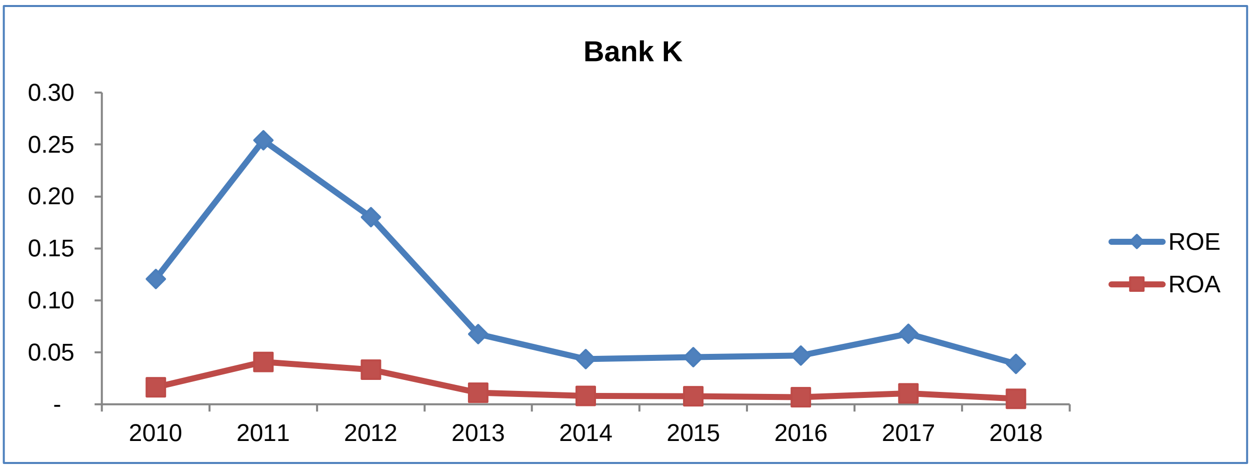
Bank K
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