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OFFSHORE BANKING AND THE PHILIPPINE ECONOMY

By

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Abstract

Offshore banking in the Philippines was allowed after 1976. This has led to the establishment of offshore units of banks actively engaged in international banking, which prospered especially in the 1970's.

This paper discusses the rationale of the establishment of offshore banks in the perspective of the country's financial and banking policies, the benefits foreseen from their establishment, the future of the operations of the offshore banks, and their contributions to the Philippine economy. The establishment of the offshore banks has given rise to new financial policy issues. Commenting on the current financial crisis facing the Philippine economy, it is suggested that offshore banks face a difficult period ahead.

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Offshore banking is better described than defined. With the growth of international banking in the immediately preceding decades, it became a matter of convenience and expediency for the banks engaged in international finance to rely on booking centers which offer the best facilities in terms of cost and other tax advantages. Regional location also mattered a great deal, since specific geographic advantages also serve particular countries more effectively. Moreover, these regions present benefits that relate to the timing of funds placement and generation and contribute to the increase in the efficiency of the international capital market. With international communications technology allowing the speed of seconds for transactions to be made, funds transactions can be effectively undertaken over different time zones during a large part of the 24-hour working cycle for the world. These factors have contributed

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to the sophistication of the business of banking and have given rise, phenomenally, to what are known as "offshore" banking centers. As the term implies, offshore banks differ from domestic banks. In countries where offshore banks have been encouraged to be established, the offshore banks are not allowed to undertake business which is normally reserved to domestic banking. However, offshore banks are free from interest rate and other reserve requirement controls that domestic banks are subject to.

Before 1976, there were no offshore banks in the Philippines. Therefore, Philippine experience in offshore banking units is limited. But in relation to the modest aspirations in this regard, it seems that the initial targets have been fulfilled. This experience poses a number of interesting issues for financial policy-making and therefore are of unique interest in that respect. In discussing this subject, it is useful to review the rationale for the creation of offshore banks in the Philippines, the benefits derived from them, the future of their financial operations, and most important, from a Philippine viewpoint, to assess their contributions to the progress of the Philippine economy. The establishment of offshore banks have further given vent to new financial issues confronting the Philippine policy on banking. However, the current financial crisis facing the Philippine economy poses a threat to the further growth of offshore banks at least in the near future.

Background to the birth of offshore banks

The emergence of political independence in 1946 brought in central banking and the passage of the commercial banking law in 1949. The Philippine banking scene as a result saw the rapid development of banking and the multiplication of domestic banks. The keystone of commercial banking policy was to reserve domestic banking to Philippine banks. Further, there was a policy preference for the development of private banking. Thus, domestic private banks became not only inevitable but were actively promoted.

No foreign banks were allowed to operate in the domestic economy. Except for the four banks that were already operating in the country at the time of the adoption of the commercial banking law, no further foreign branch banking was permitted. This explains the preeminent locations of Citibank, Bank of America, the Hongkong and Shanghai Bank, and Chartered Bank in Philippine commercial banking. These banks had licenses to operate as branches in the Philippines before the enactment of the national commercial banking act.

Years of development within the financial sector, however, indicated some weaknesses in the progress of the domestic economy. For one thing, while many domestic banks had emerged in the banking scene, they were undercapitalized. Therefore, the capacity of these banks to finance a growing economy was limited. Inadequate exposure to more advanced banking practices as well as isolation of contacts with the more dynamic international banks were surely the result of limited capitalization and the limited sphere of market objectives of the private domestic banks. Hence, these banks tended to be insular in outlook and their full potentials could not be harnessed. From a national viewpoint, however, it was essential that the banks be made to play a more active role in the financing of domestic economic activities.

Following the report of a study group which surveyed the needed reforms in the financial sector in 1972, the enlargement of the capital base of the banking system was recommended. To implement this program, the capitalization of the commercial banks was required to be raised to a minimum prescribed ceiling. One technique which was allowed in order to provide for a capital build up was the liberalization of the participation of foreign interests in the equity ownership of domestic commercial banks. Such equity ownership was, however, only up to minority participation of no more than 40 per cent of total capital. This program led to the enlargement of the capital base of the domestic commercial banks and the entry of some foreign banks in a minority basis in some Philippine banks.

Still concerned that the country could not tap the international financial markets effectively without the participation of the foreign banks, a thorough study of the option of establishing offshore banks in the Philippines commenced. An offshore banking system was perceived to yield benefits to the Philippines by improving the country's access to the world's major financial institutions. It would also provide an invaluable experience in the field of international finance to the financial community as well as training for young bankers. This was conceived as an effective vehicle for providing transfer of banking technology and practice to the domestic banking sector through its direct contact with offshore banks. It was further conceived that offshore banks would assist in facilitating the growth of Manila into an important satellite among financial centers in the region of Southeast Asia and the Pacific. The government was conscious of the fact that other cities have grown significantly as centers of finance in the region and that there would be room for more areas, as there is not only an element of competition in this growth, but more important, that of complementarity of the various centers not only in the region but also in the world.

Offshore banks were allowed to be established in the Philippines in 1976. The law allowing their establishment recognized many factors that were needed to make offshore banking an attractive operation in the Philippines. To begin with, policy-makers were aware of the inherent disadvantages of Manila, compared to existing centers, which had to be overcome to make it marginally more attractive. This had to be done in the form of certain tax incentives. There will be more space to discuss these advantages and disadvantages below.

The Central Bank prepared the guidelines for attracting foreign banks to establish offshore banks in the country. The offshore banking law was timed during a period when a quantum expansion of international banking was happening. The Eurodollar market had been very liquid because of the large petrodollar surplus. In order to ensure the liquidity of the offshore banking units (henceforth referred to as OBU's), each OBU was required to maintain at least a minimum net fund of US$1 million. The incentives structure for OBU's was so designed and has evolved over time as to progressively make the operating environment attractive to them. To ensure that Filipinos are trained properly in this new financial activity, the OBU's were also required to employ Filipino nationals while allowing them to employ expatriate personnel. Eventually and after some learning process, it was believed that Philippine nationals would become actively engaged in the profession.

As of January, 1983, the Philippine Central Bank has already approved the applications of 28 banks to establish OBU's. Twenty-six of these are already operating. Among the more prominent of these institutions are Banque Nationale de Paris, Manufacturers Hanover, Chemical Bank, Bank of Tokyo, Barclays, Credit Lyonnais, and Chase Manhattan Bank.

OBU Operations

As with similar systems elsewhere, Philippine-based offshore banks can engage in offshore funds generation and placements in foreign currency. They may also make the same said transactions with each other and the Foreign Currency Deposit Units (FCDU's) of Philippine banks and engage in foreign currency-denominated lendings to Philippine residents subject to Central Bank approval. They have also been allowed to handle the importations of residents with a minimum of US $1 million but to be funded term by the same OBU and to render financial advisory and related services. The OBU may also trade in foreign exchange, discount bills and invest in foreign securities and debt instruments of non-residents and other OBU's. There is no limit placed on their loans to offshore accounts.

OBU's in the Philippines are also empowered to handle foreign exchange remittances, a service field that is important to the Philippine economy because of the rapidly increasing number of Filipino workers abroad, especially in the Middle East. OBU's are indirectly also operating in the peso lending market because their placements with domestic bank's FCDU's are converted by the latter into pesos for on-lending. However, this facility is available only on the basis of currency swaps approved by the Central Bank for OBU lending to onshore accounts. (This facility became an important element in financing domestic liquidity as well as providing the Central Bank with external liquidity during the balance of payments crises in the Philippines. To the extent that the facility gave additional leg room for maneuver of the financial position, they have helped in financing the Philippine economy. An outside critic might argue, however, that this provided for an element of instability in the handling of the Philippine balance of payments, because while it stretched the possibilities for external finance management, it became also a source of very large short-term instability, once funds even on this end would dry up.)

The OBU's are not allowed to accept local currency deposits, something which is allowed in two other financial centers in the region, HongKong and Singapore.

Factors Affecting Positioning of Financial Offshore Centers

There are several factors that affect the relative positioning among the financial centers. In relation to the offshore centers located in Singapore and Hongkong, Manila is only a small center and will probably remain so for many years. There are inherent factors that help as well as inhibit its present growth and any one institution that has set up its OBU operation in Manila would be most aware of it.

It may be useful to list a few of these factors which are as follows: (1) relative cost and tax incentives; (2) infrastructure, in particular telecommunications; (3) time zone difference; (4) resource endowments and commercial base of host country; (5) depth of the financial market; and (6) sovereign risk consideration.

Of these factors, the Philippines cannot claim advantage in many of them. In particular, some advantages (for instance, tax incentives and potential economic and commercial base) are outweighed perhaps by some disadvantages (such as relatively poor telecommunication and lack of financial depth) and, lately, by considerations of sovereign risk occasioned by factors that have been associated with the recent financial crisis.

(1) Relative cost and tax incentives.

Trade-offs between cost of operations and income opportunities exist to the financial institutions. Manila represents the widest concessions in terms of tax incentives and is further supplemented by low housing cost for expatriates and inexpensive salary level for local talent. However, Manila also provides the least number of commercial banking activities possible between the three centers and this reduces the opportunity for trading and commercial opportunities.

Tax incentives for Philippine OBU's compare favorably with those of HongKong and Singapore. Income from onshore transactions is taxed at 16.5 per cent in HongKong based on net income and at 40 per cent in Singapore while Philippine OBU's pay only 10 per cent withholding tax on gross onshore income.

Income from offshore transactions is not taxed in both HongKong and Manila. In Singapore, the offshore income tax was previously set at 10 per cent but this tax was suspended recently for five years with proviso for the possible extension of this tax-exemption period. This might be a reaction to the competitive nature of the tax environment, so that it may be designed to enhance her (Singapore's) strong position in the region.

(2) Infrastructure, especially telecommunications

Singapore and HongKong have telecommunications which are equal to any developed country while in the Philippines the situation is still much to be desired, whether in the form of transport and utility infrastructure. Most critical among these is telecommunications. As a result, it is not only costly but more importantly, sometimes unreliable. As bank dealers very well know, communications, especially the factor of "speed of access" to it is one of the prime ingredients for successful dealing operations.

(3) Time zone difference

Tokyo virtually starts the trading day as the US West Coast closes. If Honolulu, Sydney and Melbourne were to bridge the period between the closing of trading hours in the West Coast and the opening of trading hours in Tokyo, the world would be literally trading in foreign exchange around the clock.

Manila, HongKong, and Singapore all start at the same time. Singapore has consciously moved its official time thirty minutes ahead which precludes any previous advantage of HongKong and Manila. Bahrain starts 5 hours later, bridging a lull between Asia's closing and Europe's openings.

(4) Resource endowments and commercial base

Manila is the capital city of a country with a population base which is 20 times larger than that of either HongKong and Singapore. It has various natural resources ranging from agricultural land to offshore petroleum and geothermal power, while HongKong and Singapore are city states. In terms of the depth of commercial development, the city states are, however, much more developed. The entrepot nature of these two cities make them virtually main port cities for the international traffic of goods, services and capital. Manila, on the other hand, is only basically an international port for the Philippines. The strategic geographical locations of the two city states and the level of high success of their recent economic growth, propelled by very favorable internal policies for foreign and domestic capital, have made them realize their important links to trade between the Asia-Pacific area and the rest of the world.

Therefore, multinationals based or doing business in Singapore and HongKong far exceed the business of multinationals in Manila. This is basically because of the trade values going through the ports of these two city states. Their relative geographic smallness and the concentration of their trading and manufacturing activities has enabled them to improve their telecommunications and other infrastructure much more effectively than countries with a bigger hinterland in the region, like Thailand and the Philippines. The infrastructure in place also enhances the attractiveness of these financial centers in a sort of virtuous circle.

On the other hand, Manila still has to break bottlenecks in capital requirements for telecmmunications and infrastructure, in spite of the country's large economic potentials. Multinationals in Manila are concentrated more towards those long-term fixed investments in the country in natural resource development or import substitution industries. It is only recently that new enterprises with a large degree of foreign trade activity, including exports, have arisen in the manufacturing sector. Experience has it that international commercial banks much prefer the trade financing documentary type of credit business instead of project or country lending.

(5) Depth of financial market

The greater the depth, variety, and volume of the commercial transactions, the more sophisticated the array of financial transactions and instruments possible. This factor, of course, is dependent on the degree of a country's economic development. The level of economic development allows the growth of the financial markets as well. HongKong and Singapore are well-developed markets because of this edge in economic levels. The licensing and regulatory framework likewise plays a major role in the development of the financial market.

Because of their relative newness, the Philippine market allows at the present time the least variety of transactions. Perhaps the fact that the relatively large but still underdeveloped Philippine economy has to be protected and gradually introduced to the offshore system becomes a disadvantage. HongKong's depth of financial markets extend over China, Taiwan, South Korea, and other parts of the region.

(6) Sovereign risk

Sovereign risk is a factor that comes high in the estimate of banks. That this is a factor of importance is shown in the case of Singapore, where there is a long line of applicants wishing to set up offshore banks in that country. Because of a record of political stability without major disruptions especially since the late 60's, Singapore enjoys a high reputation. The uncertainties over HongKong's future may have resulted in the wait and see attitude of some bankers when the issue of sovereignty and the year 1997 came into definite head, but it is also a mark of the maturity of this market that financial institutions with long term commitments have not been much fazed by these developments.

Manila's future is partly held suspect at the present time because of the aftermath of recent political developments which were followed by adverse economic news. The resolution of political issues, which surely plays an important role in sovereign risk calculation of potential banks and investors, are less intricate in the case of the Philippines to the extent that the present issues could be resolved internally. When external political factors are not within direct influence within the country as would presently appear in the case of HongKong, there may be greater long term uncertainty. The bilateral negotiations between Britain and China would certainly determine the parameters of HongKong's future. And China's position is in the upperhand. Hence, the degree of control by HongKong over its future destiny is dependent at this time on external factors that are not within great control.

In reviewing all these factors, it is to be noted that Manila's role as a financial offshore center is still in its formative stage and that it will most certainly continue to trail behind the more developed and sophisticated markets in Singapore and HongKong. Manila has some inherent disadvantages which play a role in the future growth of offshore banking. One of these is the level of economic development, in spite of the much larger potential economic base of the Philippines. A difficult obstacle to this is the relatively poor communications which continue to hamper Manila's role. In recent years, the improvement programs to provide better telecommunications will be realized. The natural growth of the economy will also surface from the present maze of economic difficulties that have beset the country in recent years, especially in 1983, when an external debt crisis of crippling proportions emerged. The complementary developments within the financial system, including that of the offshore banks, will certainly be affected by these new problems. The infrastructure in banking which is already presently in place will provide some basis for the growth of offshore banking. But certain important issues that need attention are offshoots of the entry of offshore banks and of the debt crisis. The resolution of these problems and issues could affect the character of offshore banking in the Philippines.

Performance of OBU's

The system of offshore banks in the Philippines has reasonably met the modest expectations at the start. The total assets of OBU's have increased from US $757 million in 1977 to US $4.47 billion as of June 1983. This means a growth of about 490 per cent over this period. Compared to the level of assets in HongKong and Singapore, these amounts are however still modest.

The Philippine offshore banks have generated onshore transactions that have assisted in financing the inflow of external resources to the economy. From 1979 to June 1983, this amounted to a total of US $15 billion. The lendings in recent years have averaged about US $3.5 billion. About 56 per cent of these transactions were interbank lendings, the rest to nonbank customers. The Philippine OBU's have also been involved in the syndication of US $8 billion worth of loans for Philippine borrowers during the period 1977 to 1981.

The relationship of Philippine OBU's to Philippine banks has been more complementary than competitive as far as funds marketing is concerned. As already revealed, the offshore banks have lent interbank for much of its transactions. This actually ranged from 54.5 per cent to 57.9 per cent, or an annual average of 56 per cent, of the total placements and loans involving all customers.

More than 50 per cent of the corporate clients of the Philippine OBU's are giants in the Philippine corporate scene. They belong to the top 200 Philippine corporations and at least 35 per cent of these are multinational companies. This may simply reflect the fact that bigger firms have greater credit requirements. To some extent, it also reflects the bias on the side of the OBU's for wholesale and bigger business clients, hence against the small and medium scale enterprises which are being promoted by government. This situation can of course be seen as having created a larger competitive base for the domestic banking sector in the financing of the blue chip corporate, large clients. However, since the domestic banking sector is not a surplus foreign currency holder and the offshore banks are raising largely foreign currency funds to meet the needs of the domestic corporate sector, the competition between multinational companies and other corporate fund users is probably more limited and therefore more imaginary than real. In the case of the larger domestic banks and financial institutions, however, the operations of the Philippine offshore banks have provided some stimulus for competition. The large corporate clients are, of course, the prime clients sought after by the domestic banks. To the extent that these corporations have found finance locally through the offshore banks which they would normally have coursed through Philippine banks, some competition does exists.

It is essential to look at the situation on a system wide basis, however. Even with the possibility that some credit displacement has occurred for the domestic funds, with the bigger firms sourcing their finance from the OBU's, the small and medium scale industries are less crowded out of the domestic funds market. Hence, given limited credit resources, more financing is made available to the small and medium scale and other enterprises by virtue of the availability of larger financial resources emanating from the OBU's.

OBU's have directly contributed to the raising of government revsnues through the taxes that they have paid. Philippine OBU's have paid a total of US $12.5 million in taxes since they started operations up to June 1983. Of course, this has been made possible by the fact that the offshore banks have become net profit institutions. Their total earnings after tax have grown from a loss of US $1 million in 1977 to profits of US $25.4 million in 1982 and a projected US $27.6 million in 1983 based on first semester earnings. Of course, considering their numbers, these amounts may not be large. As proportions of assets, these only accounts for an average of 0.56 per cent return on assets after tax, although there are reports of some OBUs making about 0.6 to 0.75 per cent returns on assets. Perhaps part of this profitability has been pushed by foreign exchange operations and by the increase in the documentary credit and letter of credit business. The bulk of OBU's net income is derived largely from interest earnings on loans, with fees contributing about 2 to 4 per cent. Foreign exchange operations and, more recently, the growth of documentary credit business (basically the opening of own account letters of credit) may have contributed partly to these earnings. It may be stated that such rates of return on assets are still below the American standard of 1 per cent.

Issues Confronting Philippine OBU's

The offshore banks have indicated that their operations are not yielding sufficient profitability and are requesting for more banking powers as a result. Even abstracting from the financial crisis in the Philippines which has reduced prospects of future growth, on the basis of the restrictions on their present operations, their prediction of the future is not very bright. Their position in the Philippine offshore picture is seen by them as an anchor for greater participation in domestic banking. In fact, among the reasons for establishing offshore units in Manila, the profit opportunities foreseen for onshore foreign currency lending and the prospect of having a foot on the door prior to further banking liberalization may have played the critical roles. To some extent, this is seen as a foot in the door in one ASEAN country, with implications for future growth, should ASEAN's economic prospects escalate brightly.

The nature of the request of the offshore banks up to now is not well-defined, largely because they themselves are trying to make a feel of what is feasible and opportune. They have organized into an Offshore Banking Units Association which they have used as a forum for making their requests united. Naturally, their position has elicited opposition from the Banker's Association of the Philippines. The latter has been wary of the possible competition and loss of market to the more established foreign banks especially in matters in which they have since 1949 been preeminently protected.

The OBU's are initially asking for an authority to go into full foreign trade financing, without the current limitations placed on their letter-of-credit business. Eventually, however, full branch banking powers, including peso deposit-taking and lending, would be most desired by them, including the capability to undertake foreign exchange transactions like the local banks. As present rules allow, the offshore banks are limited to sourcing and packaging of foreign currency loans and imports of local borrowers only for amounts of more than US $1 million at least and that they commit to finance the L/C negotiation for a medium term period of 5 to 8 years. The offshore banks can trade in deposits and foreign exchange, bank and fund loans to offshore companies, countries and other banks but so can their branches in other offshore centers.

Some of the requests of the offshore banks can be granted by the regulatory authorities, for they are within the powers of the Monetary Board of the Central Bank. But this is not the case with the granting of full branch banking powers. The authority for this must rest with the national legislature since that would require the amendment to the general banking law, which limits domestic banking to Philippine domestic banks. It is to be recalled that the need for offshore banks arose out of the judgment that the present system of domestic banking was not capable of raising sufficient resources, especially external, because of the limited capacities of the domestic banks in tapping foreign exchange resources. The offshore banking system, therefore, was some form of compromise with the system of participation of foreign banks in domestic banking activity. Concededly, foreign branch-banking in the Philippines would have solved the problem of raising external resources more effectively. The policy of establishing offshore banks provides a more contained approach towards solving this problem of external resource generation, without disturbing the domestic banking picture.

From a Philippine national perspective, the offshore banks are outposts that provide the country with financial links abroad. This promotes the increased integration of the local economy with the external world, especially at the financial level. The country's present needs to finance the balance of payments gap require, among others, the maintenance of credit lines with international financial institutions. The physical presence of some offshore banks may be good reason to provide larger credit lines for the country than would otherwise be the case.

From the viewpoint of the offshore bank, the link provided for the country and its corporate institutions to foreign finance is an invaluable service and therefore it would seem appropriate to seek government support and recognition through reciprocity. They believe that in this way they can be more effective in providing these foreign exchange needs, aside of course from winning a niche in Philippine banking in order to earn profits. By receiving these concessions, they would be placed relatively at par with the same institutions in Singapore and HongKong, which have greater leeway in taking local currency deposits and lending. It would take more than license liberalization to bring Manila at par with HongKong and Singapore for reasons already discussed earlier, but the situation would improve immensely from where they are as a result.

The opposition to the grant of full banking powers and even some of the increased activities may be summarized on three related grounds. The first is the ground related to the enactment of the general banking law which was to reserve domestic banking only to Philippine banking corporation. "Market reservation" is justified on restrictive nationalistic arguments. The experience in domestic banking and the reforms related to increased capitalization and the participation of minority foreign equity have so far been the area of concessions in this field.

One consequence of this argument is that it restricts Philippine banking activity only largely to Philippine shores. It is not possible to extract reciprocity to commitments for Philippine banks to undertake branch-banking abroad and has limited therefore the growth of Philippine banks. In banking as in diplomacy, reciprocity is a rule. And without access to the powers and opportunities of undertaking full branch-banking in foreign shores, the growth of Philippine banking is restricted. More can be said about the missed opportunities of Philippine banking in foreign shores, but it is sufficient to state that the Philippine National Bank and, of course, other Philippine domestic banks have been unable to set up a wider network of international branches largely because of this restrictive provision in Philippine domestic banking. In contrast, some banks from ASEAN countries, notably Thailand, Singapore, and Malaysia, have found foreign branch banking an integral part of their financial development.

So, banking is a two-way street. For the country to maximize its benefits from the opportunities of banking in the international community, some domestic concession to branch-banking by foreign banks, if only in terms of one foreign bank branch per nationality, is a required modicum for the country's expansion into international banking. One can argue that the presence of at least one Philippine bank in a major financial center, if tapped fully, could create immense benefits for the country's efforts in mobilizing trade and finance. The practice in other developing countries, even among ASEAN countries, is to allow foreign branch banking on the basis of strict reciprocity. On this basis alone, it is the Philippines which has been most restrictive. No foreign branch had been granted a license to operate a Philippine branch since the creation of the Philippine Central Bank in 1949. + update - ....

foreign tariff approach

The second ground against the increased banking powers of the offshore banks is competition from foreign banks. This is related to the market reservation for Philippine nationals. Competition should be welcome to bring down the price of banking services, the mobilization of funds, and the efficacy of banking services overall. Hence, the direction of benefits would accrue to the general public. The argument then is revised that competition in banking is desired, but that competition against big multinational banks would place the local smaller banks at a competitive disadvantage. In any case, Philippine domestic banks are in a fairly competitive business. This argument is reminiscent of local arguments for high tariff protection in industry.

The third argument then unfolds. Domination by foreign banks is possible. The resources of foreign banks are unlimited since they have a global network of offices. They have, moreover, the longer experience in the field and their international contacts are extensive. Aside from competing in the peso loan market, they would also bite into the corresponding peso deposit market, thereby making the competition for funds much harder. On account of their larger international size and bigger volumes, the foreign banks can probably afford to lower their spreads and thereby charge lower L/C fees, by simply disposing the charges of the correspondent banks, something which the local banks make use of to channel their L/C business. The effect of this will be to reduce the collateral business of domestic banks. One effect of this development is to reduce the cost of banking services to the general public and may contribute to the financial efficiency of the system to the benefit of the producing sectors. In any case, such development could accelerate the improvement of the efficiency of the service sectors to the main producing sectors of the economy. This should be a welcome development if only to promote a more efficient flow of international trade. The impact of this on the producing sectors will certainly feed back on the financial system in the form of increased business.

It is not often appreciated that the domestic banks generally have the bigger volume and established overhead vis-a-vis the domestic business. Domestic banks can have unlimited capacity to establish local branches, subject of course to Central Bank regulations. Moreover, they have a greater insight into local business conditions, including perhaps those noneconomic attributes, such as cultural and personal touch. Moreover, for the foreign banks to engage in domestic business, the incremental cost of doing such business should be higher for them. So, the foreign banks have a comparative disadvantage in this area. Based on the business practiced by the four foreign bank branches so far, their concentration has been less on the retail side as on multinational business and on larger corporate financing. To the extent that their presence enables an enlargement of funds made for domestic business, then the contributions of these banks to the credit facilities available within the economy is enhanced.

In general, the geographic presence of the foreign banks is in Metropolitan Manila. No thought is given to the possibility of branch-networking on a geographic basis. Since Metro Manila accounts for about 75 per cent of the deposits in the entire country, there is a fear that the foreign banks could capture part of that deposit base into the foreign branch banks. To the extent that (1) retail deposits are probably not the kind that would attract foreign bank activity, (2) the domestic private banking sector is in fact also part of the conglomerate of enterprises of many domestic corporations and enterprises, (3) the large amounts of deposits of government institutions are forbidden to place their funds in other than government banks, the fears of domination by the foreign banks is misplaced. It is difficult to find examples of any country today in which a foreign branch bank or the totality of foreign branch banks having been able to penetrate dominantly the banking market of a country. The regulatory powers of the Central Bank can certainly play a role in reducing any possibility of domination while at the same time promoting domestic banking.

The other side of the balance sheet is that the foreign branches may be in the best position to channel foreign exchange lending to domestic enterprises which would otherwise be provided by access to lines of domestic banks and the central bank, through relending to conduit banks. If they operate their branhes, the foreign banks are forced to take a direct risk position. It is so much better for the foreign banks as foreign enterprises taking a domestic risk position based on their operations than for them being safeguarded as offshore ventures from these risks, which are then passed on to domestic banks and government entities that may borrow to finance the requirements of domestic enterprises.

In any case, to the foreign banks, lending foreign exchange needs rather than in peso needs would be their probable principal market target because this is the area in which their comparative advantage lies. This could have a significant impact on the expansion of the domestic economy. It is in consonance with the gradual liberalization of foreign trade and the domestic economy that such moves could be helpful. The finance of foreign trade for a rapidly developing economy has to be supplemented with external funds, so that the domestic needs for project financing would not be competing with foreign trade financing. One lesson to be learned from the recent (1983) balance of payments crisis emanating from the debt rescheduling problem is the recognition that a significant amount of the country's sustenance to maintain the factories and to keep consumption at some desired past level is that the finance of foreign trade is an essential day-to-day activity. Such normal financing had to be put into motion by competing requirements, such as fuel imports and other necessities, including the payment of the necessary interest servicing on existing loans, not to mention the more logical need to import major consumption goods if only to maintain the standard of living.

Perhaps one could view the problem either from a restrictive or liberalizing atmosphere. The restrictive solution would provide maximum protection from external competition of the domestic banking sector. This has the benefit to the banking sector of creating a monopoly position for them in servicing the requirements of the domestic economy for finance. In this case, the domestic banks are assured of growth and their contacts with other foreign banks would be established through a network of correspondents. Under this more limited climate, the growth of some domestic banks will be much more than other domestic banks. And if there are economies of scale in banking, there could still be some domination of the banking sector by some larger domestic banks. This may come about not even as a result of the government promotion of public sector banking as the case has been in the past. In fact, the past trends in Philippine banking is for the private banking sector to grow much more than the public banks. Under this setup, the gap in providing the finance for normal economic activity will be wider. While the local banks may always borrow from foreign banks some of their requirements, either through the interbank transactions with the existing offshore or from their lines from other foreign banks, the risk exposure of the domestic banking sector is confined largely to the Philippine banks.

In contrast, under a more liberalized setting for banking, the opportunities for growth could even be larger for the whole economy and perhaps even for the domestic banking sector as a result. There is wider participation of foreign banks in the economy, either by virtue of the operation of "reciprocity" in banking or by allowing a greater participation by the foreign offshore banks in some aspects of domestic banking. Two significant effects may follow. The first would be a more rapid internationalization of the Philippne economy, with stronger linkages to finance from abroad. This is in consonance with the measures related to the liberalization of the rest of the economy, in which the basic framework of policy is to promote enterprises that are able to earn exports as a means of survival. The presence of foreign banks in this scene would promote the improvement of banking services much faster.

The other side of the coin is that Philippine domestic banks will have the opportunity to link much more directly with other banks which are much better managed in the sense of professional management. This experience could have lasting impact on the professionalization of domestic banking. More important is the opening of greater opportunities for Philippine domestic banks to operate abroad, which through reciprocity, would likely enable them to set up foreign ope... ons which enhance their capability as banks to service the requirements of their clientele in the Philippines. The effects of interaction with a broader base of foreign banks in the country, whether offshore or foreign branchs, is dealt with in the last section.

The Future of Offshore Banks

Offshore bank operations have grown in the 1970's and the early 80's. This was a natural consequence of the growth of the Eurodollar market and the supplementary Asian dollar, basically developed in Singapore and Hongkong. The growth of offshore banking had been immensely helped by the liquidity derived from the petrodollars that were in surplus for sometime. However, the developments consequent to the sovereign debts, first experienced in Eastern Europe but which spread by 1982 to the Latin American countries has reduced the amount of lending being made available to developing countries. These developments have been felt in Asia, and the decrease of offshore banking activity has already been critically observed in the market for loan funds in 1983 as compared to the previous years in the Asian markets.

The syndication market in Hongkong is said to be less than half the size of 1982 levels. The growth of Singapore's offshore banks -- Asian currency units or ACU's -- has levelled, with much of their dealing business being directed to Europe and the United States rather than towards Asian markets as in the past. Within Tokyo, where before a serious thought had been given to the establishment of offshore bank units, there is less enthusiasm for the idea. However, Taipeh has recently approved a law which will establish offshore banking units.

The contraction of the market has been less marked in the Asian markets because of the relative prosperity enjoyed by Asian countries compared to other areas for sometime. Certainly, the problems in the Asian region have been aggravated by the nervousness about developing country debt that had been most worrisome since the Mexican debt crisis of 1982, followed by the problems of Brazil which became very difficult in early 1983. To tack on to this is a list of many countries having difficulties with their external debt accounts, the countries in Latin America accounting for a sizable chunk of this debt, Brazil being by far the highest debtor with about US $90 billion of debts.

Naturally, such nervousness has reached the Asian front, since some countries have already achieved some record in levels of debts. The attitude of some lenders is to withdraw slowly and to be cautious about new indebtedness. The entry of the Philippines into the picture in October 1983, with a debt rescheduling request, has made the region of Asia geographically affected. These developments are but the outward causes of the contraction of the offshore banking volume in Asia. The market is still there, but now there is a much more reduced level of activity.

The debt problem in the Philippines has a natural effect on the volume of business activity of the offshore banks, at least in relation to funding Philippine activities. The fact that rollovers and continued commitments have to be met within the context of the debt rescheduling program as well as the economic stabilization program both contribute to a foreseen but less buoyant atmosphere for Philippine finance for at least a few years. Many factors will determine the support of the stabilization program, but the IMF standby credit which has yet to be approved in mid-1984 is critical component needed to secure favorable reaction of the international financial community. Of course, the offshore banks are operating on an international basis and to the extent that the market dealings continue to be done in that context, the offshore banking activities will continue as they are in a reduced market context. The lull in onshore lending except in the context of the debt restructuring will surely hurt the offshore banks whose entry into Manila has been largely based on optimism on this account.

Hence, it is inevitable that a squeeze on profitability among offshore banks will result. This is a reflection of the contraction in loan dealings as a result of the worldwide debt problems and the regional loan market contraction. Specifically, for the Philippine offshore banks, added squeeze results from not being able to fund an increasing market for onshore loans as expected at the beginning for at least a few years to come until confidence in credit standing normalizes. So, as the market for loans and syndications contract or stay at relatively weak levels for the near future in the context of the Asian offshore banking scene, there will be a corresponding cost and profit squeeze on the banks.

A complicating aspect of the present financial squeeze on the operations of offshore banks is an offshoot of developments arising from the Philippine financial crisis. Obviously, a prolonged financial crisis will only reduce the operational attractiveness of offshore bank operations whose main activities could be reduced towards servicing only their existing portfolio of loans and deposits. So long as such state of affairs continue, the profit squeeze would prolong and could make the margin of continued operations within the Manila offshore center open to doubt.

A more serious component of the implication of the financial crisis is related to the "sovereign risk" question which has arisen from the freezing of some foreign exchange deposits placed from the international interbank market on the domestic branches of international banks operating in Manila. The issue is highlighted by the case of Citibank Manila branch, which froze the foreign currency deposits in compliance with the order of the Philippine monetary authorities as a result of the moratorium on foreign debts. Therefore, the maturing liabilities could not be met, except for payment of interest. The Citibank branch has operated as a domestic branch with a foreign currency deposit unit (FCDU) and therefore was bound by domestic regulation. Because of its prominent role as an international bank, Citibank has received foreign currency placements in the interbank market booked in its Manila FCDU.

When the moratorium on payments was called on the Philippine external debt by the monetary authorities on October 17, 1983, Citibank decided to freeze the foreign currency assets deposited in Manila, in conformity with the local regulation. Other foreign branch banks were affected, including the Bank of America, but Citibank's net position was larger by magnitude and naturally attracted the more international attention. Citibank's position highlights the difference in the legal position of an offshore bank (whose foreign currency placements were not affected by any local regulation) and the domestic branch bank of a foreign bank, with an FCDU.

One effect of this action nevertheless emphasizes the question of "sovereign risk". The Citibank has linked its action to the principle that the placement of deposits in their Manila branch carried with it the assumption by the depositors of a sovereign risk. The deposits, they contend, were accepted at premium rates above the London interbank rate which already reflected the associated country risk. Because of the relative position of Citibank in international banking and the size of the foreign currency deposits (placed at about US $800 million), this action has created greater nervousness on an already nervous international banking community. The third world debt crisis, of which the Philippine case is a component, has already created some contractionary effects on interbank lending, as discussed earlier.

The controversy will likely have an impact on the continued profitability of offshore banking, although the issue is only indirectly attributed to offshore banking operations as explained above. The effects of such financial nervousness will lead to a greater selectivity of the placement of interbank deposits at the expense of small and growing financial offshore centers which expanded especially in the 1970's. One effect of this is the reduction of placements of foreign currency deposit funds away from banking centers where the perceived sovereign risks are high and the return of funds to the established and large financial centers. That this affects Philippine offshore banking operations is already a foregone conclusion. But it will further have an aggravating effect on other financial centers in Asia, the Carribean and the Middle East. The legal question is docketed in the United States, where one domestic bank (Wells Fargo) is suing another (Citibank) on the recovery of deposits in a foreign branch operation of the latter. The ruling on this issue in a US court will have large impact on offshore banking. But even before this is settled, the economic effects -- that of reduction of deposits -- would have already been felt by offshore banking units in places where sovereign risk is perceived to be relatively high.

If the prospects for offshore banking is much reduced as a consequence of these developments, the only role open for offshore banks is to weigh the relative advantages of having a foot on the door towards a larger share of activity in Philippine domestic banking. As long as the financial crisis in the Philippines constricts the nature of foreign trade for a few years, during the period of serious belt-tightening, the prospects of trade financing gains would be relatively low. Hence, only a long term outlook on the part of the offshore banks will make them continue operations, where these have become very marginal. On the other hand, because of the difficult market situation internally, the Philippine domestic banks will probably be expected to wage an even more concerted effort to contain these advances. The local banks are themselves facing a severe profit squeeze, resulting from the effects of the financial crisis, which among others, carry with it a tight monetary policy and a difficult period for domestic firms. Hence, credit will be much more scarce, and as a result bank operations will be severely constrained for some years while the stabilization program is under way.

Offshore Banking and Domestic Banks

The presence of offshore banks may influence domestic banks and other financial enterprises at the institutional level through business interaction and at the level of banking technology and improvement of human resources. The offshore banks have to deal through direct contacts with financial institutions (domestic banks) by making available some onshore loans for the foreign exchange requirements of the latter's clientele. Of course, they may also do so directly to lend dollar needs to domestic enterprises. The placement of foreign currency deposits with the foreign currency deposit units (FCDU's) of the domestic banks creates liquidity for the domestic banks so long as these deposits convert into peso funds that can be used to finance the credit needs of domestic borrowers whether for peso or foreign exchange. Hence, the mechanism of foreign currency swaps, which have to be approved by the Central Bank. In this case, the dollar funds are made available for a specific period and they may be availed of by the Central Bank for reserve and other purposes.

Since the entry of OBU's, the domestic banking system has experienced some improved organization. The law creating foreign currency deposits led to the unique activities associated with the FCDU's which enable domestic banks to create or deposit base for some of their foreign exchange requirements. Those domestic banks that undertook expansion in this direction also developed contacts with the offshore banks to fund part of their financial requirements. Such direct business contacts facilitate an extension of the horizons of domestic banking. While in the past, it was necessary for domestic banks to work out reciprocal arrangements with foreign banks to undertake their normal trade and documentary business actively through their international departments, the direct contact with the OBU's made that contact much more direct. Arrangements for onshore financing on an interbank basis were presumably made much more quickly, mainly on the theory that the presence of operations of foreign banks, supplemented by the network of representative offices of foreign banks, gave greater leeway for supporting financial needs. Thus, at the level of increased resources available to domestic banks, it can be said that benefits have been derived from the entry of offshore banks.

Another level of benefits related to the domestic banks is the direct learning experience. Through the interaction of the offshore bank units with the domestic banks, the management capability of the latter can be influenced effectively. Hence, there is a more effective transfer of banking technology. Sometimes this is accomplished because the former employees of the offshore units, midway or through their careers, find new jobs in the traditional domestic banks. In fact, it can be expected that the domestic banks will look towards the managerial pools already trained in the offshore and foreign branch banks in order to improve their own competitive edge. In this sense, the foreign banks will provide substantial side benefits to the economy through their training of domestic bankers. Through this experience, as well as the traditional exchange of desk officers among correspondent banks, new technology and methods are transferred to the local banks. The learning process can be in all phases of banking, but more particularly in the operations of the international departments where major transactions are undertaken to fund the various micro lending requirements of banks. This experience would vary, depending on the size and orientation of the domestic bank. But certainly, since in due time, the nation's development would require an increasing sophistication in the application of the technology of banking, the sooner this is learned, the better from the viewpoint of the nation.

The Philippine National Bank is certainly the largest Philippine domestic bank accounting for a little less than one-fourth of the total assets of the Philippine domestic banking system. From this viewpoint, because of the normally large demands on its resources by its various programs as a banking institution, it has to seek the funding from various sources. One of its direct benefits from the entry of OBU's and its exposure to other financial centers also as an OBU is the acquisition of expertise in reducing the cost of borrowings. The key is in personnel and in the trading skills needed in the competitive area of finance. By learning the art of the "two-way" quote, for instance, it has been able to reduce the margins on the cost of funds enormously in the trading of foreign exchange, when raising funds for particular short-term operations. Before, the single quote system in bidding for deposit funds had led to a higher cost of funds. The second quote enables a dealer either to accept deposits or to place it in other institutions. Within the bank, the cost of funds have been cut by as much as 1/4 of one per cent on short-term indebtedness, from 3/8 to 1/8 of one per cent. To a bank raising millions of dollars at given times, such cost cutting results in significant savings for internal operations. Unfortunately, these operations have been affected by the sudden drop in the country's credit standing, thereby affecting at least temporarily PNB's effectiveness in the international trading market, because of the debt restructuring. Such methods of reducing the costs of liabilities is critical to bank survival in a competitive setting.

At the same time, improvements in asset management techniques could be learned from foreign banks, because of their longer experience in banking. Offshore banking is however basically a wholesale operation and little in the management and monitoring of individual accounts can be learned from them directly. The learning process is in the asset management of domestic banking operations where foreign banks may have an equity or, in some cases, where they have a full branch banking operation. Other banks do not necessarily learn to improve their operations in this case. But the transfer of technology is through the personnel employed, because these are the persons more directly involved in the implementation of accounts monitoring. As these bankers grow in their profession, they may transfer to other banks and therefore their influence on the improvement of overall banking would be enhanced.

One of the side benefits to multinational banking, be it offshore or branch-banking, is through human resources training. Among the larger, established banks with international network of branches, it is the practice to field their personnel recruited from a host country and then to make them work in their other branches abroad. Through this way, for instance, Citibank and other foreign banks have trained many young bankers in the Philippines through posting in their many international outposts. Such training is invaluable not only to the bank concerned (which of course has a self-interest in promoting its personnel's abilities so that they can contribute to company profitability) but to the country of which these bank professionals are nationals, for it increases the pool of personnel for national banking. Some exchanges of experiences and the exposure to different settings and cultural practices in banking, plus the fact that these banks are leaders in the technological advancement in banking, leads to the upgrading of skills and resources that are valuable to the nation. The same types of skills may not be obtained if a restrictive climate for banking participation were in operation. As in the case of industrial protection, where the protection becomes a device for stifling competition and national energies, excessive protection in the field of banking could only lead to insufficient and perhaps underdeveloped banking in a nation.

Table 1

A. LIST OF APPROVED OBUs BY YEAR

Year		Number
1977		16
1978		1
1979		3
1980		-
1981		5
1982		2
1983		1
	Total Approved	28
	Total Operational	26
	Total Non-Operational	2

B. LIST OF APPROVED OBUs

Name of OBU	Nationality	Date of Approval
1. American Express Int'l. Corp.	US	March 18, 1977
2. The Bank of Nova Scotia	Canada	-do-
3. Barclays Bank Int'l. Ltd.	England	-do-
4. Banque Indosuez	France	-do-
5. Banque Nationale de Paris	France	-do-
6. The Chase Manhattan Bank, N.A.	US	-do-
7. Crocker National Bank	US	-do-
8. European Asian Bank	West Germany	-do-
9. Lloyds Bank Int'l. Ltd.	England	-do-
10. Manufacturers Hanover Trust Co.	US	-do-
11. First Interstate Bank of California	US	-do-
12. The Bank of California, N.A.	US	May 6, 1977
13. The Bank of Tokyo, Ltd.	Japan	-do-
14. International Bank of Singapore	Singapore	-do-
15. Rainier National Bank	US	-do-
16. Security Pacific National Bank	US	-do-
17. Chemical Bank	US	June 9, 1978
18. Societe Generale	France	August 17, 1979
19. First National Bank of Chicago	US	November 9, 1979
20. Bankers Trust Company	US	December 14, 1979
21. Bank Credit and Commerce Int'l. (Overseas) Ltd.	Middle East (Multinational)	April 10, 1981
22. Credit Lyonnais	France	May 29, 1981
23. Bank of Hawaii	US	July 3, 1981
24. Middle East Bank, Ltd.*	UAE	October 9, 1981
25. First National Bank of Boston	US	November 6, 1981
26. Wells Fargo Bank, N.A.	US	July 9, 1982
27. Philadelphia Nationl Bank*	US	September 17, 1982
28. Korea Exchange Bank	South Korea	January 28, 1983

*not yet operational
updated as October 19, 1983

Source of Data: OBU Group, CB

Table 2

ONSHORE TRANSACTIONS
PHILIPPINE OFFSHORE BANKING SYSTEM
1979-1983
(In Million US Dollars)

Year	Loans To Non-Bank Customers	Interbank Transactions	Total	Growth Rate In Per Cent
1979	855	1,117	1,972	-
1980	1,231	1,693	2,924	48.3
1981	1,567	1,877	3,444	17.8
1982	1,528	2,048	3,576	3.8
1983 (June)	1,494	1,847	3,341	(13.2)
Total	6,675	8,592	15,257	

B.

ONSHORE TRANSACTIONS
PHILIPPINE OFFSHORE BANKING SYSTEM
PER CENT DISTRIBUTION OF TOTAL TRANSACTIONS BETWEEN
LOANS TO NON-BANK CUSTOMERS AND INTERBANK TRANSACTIONS
AND GROWTH RATES
1979-1983

	LOANS TO NON-BANK CUSTOMERS		INTERBANK TRANSACTIONS	
Year	% Share	Growth Rate In Per Cent	% Share	Growth Rate In Per Cent
1979	43.4	-	56.6	-
1980	42.1	44.0	57.9	51.6
1981	45.5	27.3	54.5	-10.9
1982	42.7	(2.5)	57.3	9.1
1983 (June)	44.7	(4.4)*	55.3	(19.6)*
Average	43.7	17.4	56.3	22.8

*Annualized

Source of Raw Data: Central bank of the Philippines

Table 3

PROFITABILITY OF PHILIPPINE-BASED OBUs
(In Million US Dollars)

	1981			1982		
OBU	Assets	Net Income	Income As % of Assets	Assets	Net Income	Income As % of Assets
1	109.95	.71	.65%	123.13	.81	.66%
2	270.64	1.53	.56	244.68	1.70	.69
3	303.68	.77	.25	306.76	.56	.18
4	174.54	1.23	.75	144.40	.91	.63
5	704.38	.89	.13	852.36	1.71	.20
6	288.24	.68	.24	240.05	(.93)	-
7	83.40	.31	.37	122.64	.26	.21
8	189.02	.07	.04	163.95	.33	.20
9	268.47	1.40	.52	282.55	1.62	.57
10	577.19	3.12	.54	427.63	3.52	.82
11	156.24	1.31	.84	156.07	1.02	.65
12	132.55	.55	.41	121.94	.56	.46
13	309.74	.41	.01	316.08	1.26	.40
14	46.35	.39	.13	48.61	.04	.08
15	98.62	.61	.62	112.09	1.03	.92
16	163.23	1.24	.76	174.98	1.27	.73
17	268.74	1.60	.60	380.54	2.48	.65
18	252.83	.89	.35	227.55	.61	.27
19	78.14	.01	.01	108.76	(.13)	-
20	161.25	1.54	.96	103.58	1.06	1.02
21	68.66	(.05)	-	129.51	.32	.25
22	-	-	-	305.36	.77	.25
23	-	-	-	42.46	(.22)	-

Source: SEC