FINANCIAL EXECUTIVES INSTITUTE OF THE PHILIPPINES (FINEX)

2016 FINEX National Conference Report

The 2016 FINEX National Conference kicked off with the theme "Sustaining Economic Growth Throough Financial Inclusion." Five technical sessions provided participants with a broad appreciation of how financial inclusion pays an important role in fostering economic development.

The Philippines in 2050: A Global Economic Leader

The first technical session, titled "The Philippines in 2050: A Global Economic Leader," opened the technical sessions. Joseph Incalcaterra, Asia Economist of HSBC, presented a compelling thesis that the bank has had since 2012 – that the Philippines would grow to become the 16th largest global economy by the year 2050.

Incalcaterra highlighted the large role that demographic destiny plays in the country's drive to grow. With more than 103 million people as of 2015, the country will see population grow at about 1% p.a. through 2050. On top of the growth, the population median age is among the youngest in Asia.

This demographic boom imbues the Philippines with many natural advantages. By 2050 the working age population will comprise about 67% of the total population. This also means that the country will still sport a very healthy dependency ratio because the younger, working age population will be able to support the senior age group.

The key demographic of working adults from 35-64 years old will continue to power consumption as their numbers expand. Currently, more than 73% of GDP is driven by consumption and this is unlikely to change much in the future.

However, there is still much for the country to do in order to fulfill that potential.

Job creation takes priority – with a large and growing population, the Philippines will need to step up its investments in human capital so that the private sector will be able to hire better-trained talent right out of the universities.

The creation of jobs will also require a more welcoming environment for domestic and foreign direct investment. Interest in the country among investors remains high, particularly in the BPO industry.

However, the consensus among the foreign chambers is that the country can do more to make it easier for inbound direct investment. The ease of doing business, the sanctity of performance in contracts, and consistency of equitable taxation, have been cited as areas where the Philippines can improve.

Another area that has hampered growth due to a lack of sustained investment in capital formation, is infrastructure. The bottlenecks in infrastructure have artificially restrained trade in the past.

With the Duterte administration pledging to spend from 5-6% of GDP on infrastructure every year until 2022, the country remains hopeful that the government will be able to remove the infrastructure bottlenecks.

The Philippines remains primarily a service-based economy. This plays to the country's strengths in having a relatively young workforce, which is fairly fluent in English, with the technical and communication skills to deal with customer complexity.

Nevertheless, the higher investment in infrastructure, particularly in roads, bridges, airports, ports, and telecommunications, is seen to bring back solid interest in the country's manufacturing and exporting base.

The discussion after the presentation featured Incalcaterra, and also included Alexander B. Cabrera, Chair and Senior Partner of PwC Isla Lipana & Co.; and Emilio Neri, Jr., Vice President and Lead Economist of the Bank of the Philippine Islands. Malou Cristobal, President of Multinational Bancorporation, moderated the discussion and Q&A.

Incalcaterra highlighted possible reforms in the constitution as key factors in spurring more foreign direct investment into the country. Should the government be able to liberalize the rules on foreign investments in industries that are currently restricted to outside capital, this may spur a wave of new investment and a build out of better capability to spur growth going forward.

The consensus among the panelists was that the country indeed has the raw ingredients and the potential to reach its growth targets by 2050.

In particular, Cabrera noted that the people are very resilient and this resiliency will be a major factor as to why the economy weathered major shocks in the past.

The discussion also highlighted the importance of investing in people, who are the primary actors in any economy. It is the people who are the students that become the backbone of the labor force; it is people who have families that become the consumer market that powers the economy; it is the growing, working population that becomes the engine that supports the aging population going forward.

Neri pointed out that while the country is working on addressing its weaknesses in infrastructure in particular, the Philippines should still let the market play to its strengths. If the country is primarily a service based economy because that is where it is strongest, then that does not necessarily have to change. Balance in the achievement of growth is good, but the country does not have to sacrifice the areas where it is the strongest.

In closing, the panel reached a consensus that things look good for the Philippines, but many areas still need attention to reform and progress.

Financially Inclusive Growth: Our Country's Imperative

The second technical session featured Anna Charlotte Schou-Zibell, Technical Advisor, Sector Advisory Service Division, Sustainable Development and Climate Change Department, of the Asian Development Bank.

Schou-Zibell's presentation, titled "last Mile Access for Inclusive Growth," delved into the challenges of getting more people to use the formal financial system. The basic thesis is that financial inclusion matters to economic growth because more people will be able to make payments, avail of credit, save, invest, and create a virtuous cycle. The pick up in economic activity will increase the pace and magnitude of economic transactions, and propel further growth.

Many barriers still exist. Fully 1/3 of the global population are financial excluded because they do not have access to financial services. Financial inclusion is important because it unlocks opportunity.

At the policy-making level, the National Strategy for Financial Inclusion sees digital finance as a low-cost, deeper penetration solution, with a wide scalable reach compared to traditional financial services.

Digital finance has to offer advantages to consumers and service providers. For consumers, digital finance has to make their every day lives more convenient. It can make payments more friction-free, allow more convenient access to deposits, and provide small scale access to credit in order to even out income and consumption, which has always been a challenge to economically-challenged households.

Businesses also benefit from digital finance. All types of businesses that embrace digital finance can reap the benefits from lower costs through decreased handling of cash, and reduce turn around times because prior vetting of customer accounts will occur, rendering credit evaluations redundant. In far-flung areas where the stock of cash can be spotty, digital finance eliminates the opportunity costs of cash and yet still facilitates even the smallest of transactions.

The World Bank estimates that the marginal benefits of embracing digital finance and financial inclusion are significant. Globally, more than 1.6 billion more individuals will be able to join the formal financial system, resulting in $2.1 trillion in new credit, $4.2 trillion in new deposits, and $3.7 trillion in incremental GDP growth.

To hit these goals, the challenge of the private sector is to cross that last mile to the customer. The value proposition that business has to provide is that while technology is good and enables many useful activities, it is only as useful when people use it to solve specific problem in their lives.

Financial service providers must upend their point of view and imagine services from the perspective of the financially excluded customer. To meet this end, providers need to understand and overcome barriers so that they can reinvent services which customers will actually use. On top of that, service quality and usability have to be top-notch so that customer use will be sustained.

Navigating the barriers are not as simple. Identity verification is a crucial step because interlinked markets now demand that "know your customer" requirements are in place to prevent money laundering. Not many know that an estimated 1.5 billion worldwide cannot prove their identity because of the lack of birth records. Proving identity is a big step towards joining the formal financial system.

The availability of access points is another significant barrier to reaching the last mile to the customer. Providers will have to come up with new solutions to connecting rural areas far from urban infrastructure. These solutions have to ensure a robust connection to a sturdy transactions platform. New customers in the formal financial system will abandon the services if the platforms are not reliable.

The services on these platforms don't have to be complex – we are talking about new entrants into the formal financial system, after all. What people need most are access to payments, savings, and credit. From these basic services, are built the incremental growth of all economic activity.

Romeo Bernardo of Lazaro, Bernardo, & Tiu moderated the panel discussion and Q&A. The panelists included the following:

1. Dr. Bernardo M. Villegas, Economist from the University of Asia and the Pacific
2. Jaime Garchitorena, CEO of the Credit Information Corporation
3. Rochelle Tomas, Inclusive Finance Advocacy Staff of the Bangko Sentral ng Pilipinas
4. Nataliya Mylenko, Senior Financial Sector Specialist, Finance and Markets Global Practice, the World Bank Group.

The panel discussed the challenge of financial inclusion on several levels.

Garchitorena noted that reliable credit information on companies and individuals is still a challenge due to the paucity of reliable data in an emerging market economy. He talked about the steps that the CIC is taking to improve data quality and data capture so that a central repository of reliable data is created to ensure the desired high quality of credit information.

Tomas described the BSP's programs on financial inclusion and how this has become a major imperative for the monetary and financial regulator. More than 70 million Filipinos remain unbanked and the BSP is working with the private sector on advocacy programs to bring easier access to financial services to the unbanked.

Villegas discussed the importance of bringing financial services to particular underserved sectors of the economy, in particular agriculture. The country's farmers have struggled for decades to build and preserve a way of life that has not enjoyed the most support from public and private stakeholders.

Despite its smaller than services and manufacturing contribution to the Philippine GDP, agriculture still remains a way of life and a profession for millions of people in the provinces. Bridging financial services to this industry will provide a much needed shot in the arm for incremental growth and efficiency.

Mylenko discussed the huge opportunity for incremental GDP growth that can be brought about by the full realization of using technology to increase financial inclusion. The consensus is that globally, we are at just the beginning of a wave of change that will have far reaching effects once that change accelerates.

Pursuing Shareholder Value by Pursuing the Consumer

The third technical session featured a presentation by Paolo Maximo F. Borromeo, Head of Corporate Strategy for the Ayala Corporation.

The Ayala Corporation has long been a vanguard in real estate. Since the 1990's it has pursued a growth strategy that has seen it consolidate its strengths in several consumer-targeted industries: banking, telecommunications, residential real estate, automobile dealership, healthcare, and even education.

Borromeo's presentation talked about the aspirations of the Filipino consumer, the archetypes of that earning and spending class, and how companies can create value by targeting that class.

First, the country with its population has long been powered by domestic consumption. With a per capita GDP of US$2,899, Borromeo noted that the country is an inflection point – consumer demand will boom in certain industries. These are driven by the oft-cited growth in BPO jobs and income, and the inbound remittances from overseas Filipino workers, which makes up more than 8% of GDP.

The key message is that the middle income market is still a huge untapped opportunity. This market segment shares a sense of entitlement in discretionary spending, with an emphasis on getting value for money, in the context of aspiring for more for the family. Business who find the formula for tapping this demand will create a significant amount of shareholder value in the future.

The middle income market represents more than 24 million Filipinos, or about 5.4 million households. This group is growing by about 600,000 every year.

Borromeo pointed out that across consumer archetypes there is a theme to how they spend their hard earned income – to make life easier. These major spends include internet use; recreation and leisure, with vacations to destinations in the Philippines; brand migration to higher brands in fast moving consumer goods; with an eye towards building savings for the future. These families prioritize spending on well being and learning.

These consumers have discernment because they seek to get value for money, and yet at the same time for certain aspirational expenditures (education and healthcare), they are willing to bear the cost. They work hard and save.

Borromeo identified three distinct categories of spending for this consuming class: everyday spending, long-term assets, and quality of live investments.

Everyday spending accounts for 51% of the share of the consumer wallet, with growth seen in restaurants, retail, and travel. The behaviors seen include active evaluation of value for money; a move towards buying more premium brands in FMCG; a migration from sachet consumption; and increased knowledge of how using technology can uncover convenience and lead to better bargains.

Long term assets mean buying the family residence. Vertical residential development in the middle market is growing, with a 60% year on year growth in housing application licenses nationwide noted. While the middle income class sees condominiums as an entry level alternative, most aspire to own their own house and lot.

Quality of life investments include education and healthcare. Middle income consumers want the best education they can afford for their children, and are willing to make sacrifices for it. They also recognize the importance of health and the need for high quality and yet affordable care.

The growth in middle income consumers remains a significant market and the potential has not yet been exhausted. As new innovations are implemented across consumer facing industries, companies will be able to offer financially sustainable solutions to Filipino consumers and improve their daily lives.

Raoul A. Villegas of PwC Isla Lipana moderated the discussion and Q&A session. The other panelists included Daniel Dy from Security Bank, Medel Nera, CEO of the House of Investments, and Joselito Orense, CFO and Treasurer of Metro Retail Stores Group Inc.

Nera discussed the torrid growth experienced in automobile sales, up more than 25% year on year. One of the aspirations of up and coming Filipino families is to own their own car. Low gas prices, affordable credit, and rising wages from employment have empowered families to fulfill this key aspiration.

Dy picked up from that discussion and noted that the growth in consumer credit has accelerated faster than even the economy. This consumer credit is fueling higher spending particularly on big ticket items like automobiles and appliances.

Despite the growth in credit, Dy notes that most Filipinos still do not have access to consumer credit. As more Filipinos acquire the means to avail of consumer credit, we can expect consumer spending to accelerate.

Orense echoed the optimism broadly felt in the consumer sector. Metro Retail group has benefited directly from the growth in consumer spending and they do not see signs of any slowdown. Metro Retail plans to expand its store footprint and add yet still more square meters of leasable space, a testament to the strong growth seen in the retail industry.

The Role of Technology in Fostering Financial Inclusion

David Margendorff, CEO of PawnHero, an online pawnshop disrupting the pawnshop industry, opened his presentation by noting that the majority of the world population is unbanked, and that out of this, 57% are in Asia and the Pacific.

The unbanked population presents a major opportunity for players active in digital disruption. Traditional banks have not been agile enough, and are hampered by a tight regulatory environment, to innovate quickly. High mobile penetration has enabled financial technology service providers to reimagine financial services from the ground up. Taken together, these 3 factors: unbanked population, slow adapting banks, and mobile phone penetration, have led to unprecedented levels of digital disruption in financial services.

One of the largest opportunities that Margendorff sees is that large banks have a large fixed cost base in terms of people and branches. A lot of these costs are driven by regulatory requirements. By using technology, alternative firms can effectively remove significant parts of the middle of the P&L and provide competitive financial services to the masses.

However, he observed that Philippine banks are opening more branches. This is not the fintech way of reaching out to more customers, who may not have access to branches in the first place.

Margendorff ended his presentation by talking about how PawnHero has disrupted the pawnshop industry by removing a significant amount of capital investment related to branching, and how it forged a partnership with a bank to offer digital financial services to its customers.

The moderator of the panel discussion and Q&A was Johnny Sy of Cloudtop. He was joined by Manny Ayala, Managing Director of Endeavor Philippines, and Christian Besler, Chief Digital Officer of Ayala Health.

Ayala discussed how digital has fundamentally changed how business is done, and how people live their lifestyle. These innovations are being felt at all levels of social strata, but the biggest marginal impact is felt at the bottom of the pyramid.

Besler talked about his experiences in leading the innovation effort in digital for Ayala Healthcare.

The Role of Capital Markets for Funding SME's

Kristine Romano, Associate Principal for McKinsey & Company, presented how capital markets can adapt to the unique funding requirements of small and medium scale enterprises.

There are about 87,000 small scale enterprises, typically characterized with each having less than Php3 million in assets and less than 100 employees.

Medium enterprises number about 4,000 or so nationwide, with each typically having less than Php 100 million in assets and more than 200 employees.

Together, the SME sector of the Philippine economy accounts for 36% of GDP and 61% of employment. Despite their outsize contribution to employment, these enterprises frequently struggle to raise capital.

More than 80% of their capital requirements are internally generated. External financing from debt or equity accounts for less than 9% of invested capital. How can SME's fund their growth in a tight market for capital?

Romano noted the competing interests of funders and users of capital. Capital funders are often concerned with liquidity issues, insufficient information on which to evaluate risk, and a limited appetite for the long term funding needs of SME's. SME's struggle with limited formal operational and financial reporting systems, limited credit history and financial information, and no patience for the record keeping and detail orientation required to raise capital from external sources.

There are three platforms of available capital in this country with the attendant challenges for raising them: stock exchanges and private equity markets; credit markets through banks and original issuance markets through underwriters; and the peer lending market and crowdsourcing.

Each of these channels of capital has advantages or disadvantages for the SME, and one size does not fit all. Four factors determine the fit for the SME when it comes to raising capital:

1. Are the interests of the SME and the investors mutually aligned?
2. How cheap is the capital?
3. What kind of institutional support is available?
4. What kind of momentum is being generated in the market for this type of funding source?

Romano observed that successful capital markets allow fit for purpose products to be exchanged, pointing to examples in Canada (TMX Venture Exchange); China (CHINEXT); and Germany. These capital markets typically allow more streamlined requirements for issuers to make the compliance process easier and faster.

Comparing the burden of compliance, bank loans for SME's require about 15 separate documents for a successful loan (in addition to passing the credit evaluation.

Listing on the main board of the Philippine Stock Exchange requires complying with 40 documentary requirements. To list on the secondary board of the Philippine Stock Exchange, which is really geared towards SME's, one has to comply with an even 43 document requirements! This flies in the face of conventional wisdom that capital raising for SME's should follow a more streamlined process.

However, Romano did show that the lower capitalization requirements of SME board in Thailand, Malaysia, and China allowed SME's with lower capital thresholds to list and raise funds for growth.

Working together, stakeholders in the financial system can effectively encourage a more frictionless capital raising process.

First, fees must come down. It is ironic that for entities that can least afford it, SME's bear a disproportionate level of fees to access debt or equity financing.

Second, stakeholders must realize that what is good for the SME is good for the market. Other countries like China, Thailand, and Great Britain pioneered networks of advisors for SME's to mentor the latter, and provide better information to investors and funders.

A large amount of cost and effort is spent on narrowing the information gap. China, Thailand, and Great Britain realized that lowering the costs of information asymmetry would go a long way towards increasing the pace of growth in the SME sector.

Further, Romano noted that regulators have a role to play in helping SME's raise capital easier grow faster. Such regulatory breaks include lower marginal tax rates for SME's, exemptions from listing and registration fees, and SME tailored loan packages with smaller sizes, and a more limited fee structure.

The panel discussion and Q&A session was moderated by Senen Matoto, President of Vicsal Investment Inc. The panel included:

1. Rabonni Arjonillo, President of First Metro Investment Corporation
2. Reginald Cariaso, Managing Director and COO of BPI Capital Corporation
3. Gabriel Lim, Senior Vice President and Head of Equity Capital Markets for BDO Capital and Investment Corp.

The panel composed of seasoned investment bankers were one in agreeing with the merits of enabling SME's have access to the capital markets. However all contend that there are hard realities in the local market to contend with that accompany such an endeavor.

What are these?

The capital market is essentially a virtual marketplace where sophisticated and knowledgeable investors are matched typically with corporate high grade securities issuers effectively disinter-mediating the banking system of depositors and lenders thus theoretically reducing the cost of funding for borrowers . By this definition it suggests that SME's would not qualify. The guardians of this marketplace, i.e., the government regulators and the stock market and fixed income exchanges, zealously protect the interests of the investing public through various stringent disclosure regulations and audited financial information required of securities issuers. Given the relatively high cost of compliance, this becomes a significant stumbling block for SME's.

What then are the alternatives for the SME's?

The typical SME's would likely be in business as suppliers of raw materials or distributors of finished products or service providers or retailers for large corporations. The assets particularly the receivables that are created would be viable instruments for trading in the capital market through a fixed income exchange thus releasing working capital for the SME's. For the equity requirements, private equity capital particularly for technology driven SME's is available from high net worth investors and venture capital hedge funds.

How can SME's access these funds?

An investment bank could provide the guidance necessary to prepare and season SME's for the capital market. However it will require determination and resources on the part of SME's. Corporate governance standards would have to be elevated. Willingness to disclose heretofore "confidential "financial and strategic business information would be a necessity. Dealing with regulators would have to be learned. The support of government through BSP mandated credit allocations for the SME's similar to the agri-agra would also be a helpful tool. Creation of specialized guarantee institutions providing wrap-around guarantee facilities could accelerate debt securities issuances. A step in the right direction is the government mandated creation of the Credit Investment Corporation that could facilitate evaluation the financial worthiness of SME's. Re-orienting rating agencies to cover SME's is another valuable guide for would be investors.

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