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BASEL III IMPLEMENTATION AND MSME LENDING: A TIGHT BALANCING ACT

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Access to finance remains to be a major challenge for micro, small, and medium enterprises (MSMEs) in the Philippines despite the implementation by government of several policies and projects to address it. In 2016, MSMEs account for 99.6 percent of the total 911,768 establishments and produced 4.9 million jobs or 63.3 percent of total jobs in the Philippines. Within this sector, 90 percent are micro enterprises—those with assets of up to PHP 3 million; 9.5 percent are small enterprises—those with assets valued from PHP 3,000,001 to PHP 15 million; and 0.4 percent are medium enterprises—those with assets valued from PHP 15,000,001 to PHP 100 million. In other economies in Southeast Asia as well as in the rest of developing Asia, MSMEs also comprise the majority of registered firms, an average of 96 percent in 2015.

The Bangko Sentral ng Pilipinas (BSP), on the one hand, has always had an active role in finding solutions to the financing problem. Speaking at a conference in Manila in October 2017, BSP Governor Nestor Espenilla, Jr. told banks to facilitate credit access to MSMEs, emphasizing the sector's significant contribution to the national economy. The plan involves the reduction of the level of statutory reserves (or money set aside by financial institutions to remain solvent) available in BSP in order to release more money into the economy.

On the other hand, BSP is also eager to fully implement Basel III, the latest issuance from the Basel Committee on Banking Supervision[1] (BCBS) that aims to further strengthen the banking industry. Many observers believe that these reforms will apply more pressure to local banks and could possibly hinder the improvement of MSME lending in the Philippines.

Basel III implementation

The BCBS introduced the Basel III reforms in December 2010. Like its precursors—Basel I and Basel II, Basel III reforms want banks to keep an adequate capital to enhance their capacity to absorb losses and risks and in effect to prevent them from becoming bankrupt.[2] Guidelines on improving risk management and governance and on strengthening bank transparency and disclosures were also maintained.[3] In the Philippines, BSP started the implementation of Basel III reforms in 2014. The first set of reforms, covering capital adequacy, was fully implemented in January 2014. These rules that require banks to hold a minimum level of capital have already appeared in earlier Basel accords. The BCBS strengthened the capital requirements in Basel III by introducing capital buffers and in so doing increased the capital base to 10.5 percent from Basel II's 8 percent. The BSP has set a higher regulatory minimum of 13.5 percent as the Philippine banking system is said to be in a strong capital position.

The BSP also rolled out liquidity and leverage requirements, which were fully implemented in May 2015 and March 2016, respectively. Minimum liquidity coverage ratio has already been set at 100 percent, while implementation of leverage ratio not lower than 5 percent will begin on 1 July 2018. The liquidity rules will ensure that a bank has adequate cash or assets that can be easily converted to cash for use during market stresses. The leverage rules will ensure that a bank can pay the debts it incurred at any given time.

In the Philippines, Basel III reforms are applicable only to universal and commercial banks (U/KBs) and their subsidiary banks and quasi-banks. There are 21 universal banks and 22 commercial banks out of the 585 banks currently supervised or regulated by BSP. By the end of 2017, the country's banking system held total assets amounting to PHP15.17 trillion, PHP 13.8 trillion (91 percent) of which are held by U/KBs. Its gross total loan portfolio was PHP6.14 trillion, PHP 5.29 trillion (86.1 percent) of which come from U/KBs. Meanwhile, the 55 thrift banks and 487 rural and cooperative banks will continue to comply with Basel 1.5 capital adequacy requirements, wherein capital reserves should not go below 10 percent.

Basel III and impact to MSME lending

Why is access to finance an obstacle that continues to encumber MSME development in the Philippines? Several factors cause these impediments to lending. Most banks require MSMEs to provide collateral before credit is given. MSMEs also suffer the consequences resulting from lack of credit information and lack of bank and government guidance in preparing compliance documents. These factors are worsened by other non-financial challenges which include rising business costs, difficulty in finding sustainable quality labor, intense business competition, unstable consumer demand, and complicated government regulations.

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Despite the enforcement of Republic Act 9501 (or the Magna Carta for Micro, Small and Medium Enterprises), loans provided for MSMEs have continuously declined in the past five years, in the midst of the capital adequacy rule implementation. RA 9501 requires all lending institutions under BSP to set aside at least 8 percent of their total loan portfolio for micro and small enterprises and at least 2 percent for medium enterprises. The latest available data (fourth quarter of 2017) shows that the banking system has failed to reach the minimum for micro and small enterprises (MSEs), setting aside merely 3.32 percent. However, it performed exceptionally in terms of loans for medium enterprises as it lent 3.03 percent more than the minimum requirement. Looking at data, total loans for MSMEs slid from 12.11 percent in the first quarter of 2013 to 8.35 percent in the last quarter of 2017, which accounts for only 2.3 percent of the gross domestic product (GDP). More worrisome is the compliance rate of U/KBs, which hold about 85.2 percent of the total loan portfolio. Lending to MSMEs has declined in the past 20 quarters despite a loan portfolio growing at an average 3.96 percent. One factor that could have induced the steady decline is poor loan performance. Gross non-performing loans of U/KBs amounted to PHP 107.7 billion in October 2017, 9.4 percent higher than the amount of bad loans incurred in October 2016.

The full implementation of Basel III is feared to bring about further reduction in MSME loans allocated by U/KBs in the coming years so that U/KBs can always retain the required capital levels. Banks are predisposed to cut lending to MSMEs as they are regarded to bring in higher risk and lower returns. Basel III in particular is likely to assign greater risk weights to MSME loans. In effect, loans and other financial services will become more expensive as a result of higher interest rates and will even be harder to obtain as competition for deposits is expected to increase.

Coping with funding issues and Basel III

In response to low credit allocation given to them, MSMEs depend mostly on internal sources of financing and other alternative means[4], which are just sufficient to run their current business operation. Business expansion, e.g., producing higher value outputs or participating in the global value chain, and in turn, higher productivity, require greater financing that only U/KBs can offer.

As in the past, the Philippine government continues to find solutions to the problem of access to finance. The SME Plan 2004-2010 sought to provide reasonably priced loans to small enterprises. The succeeding MSME Development (MSMED) Plan 2011-2016 and the MSMED Plan 2017-2022 have picked up from where the previous plan left off. Its programs such as Pondo Para sa Pagbabago at Pag-asenso, Access to Small Entrepreneurs to Sound Lending Opportunities, and Credit Surety Fund offered loans with lower interest rates. The current MSMED plan has identified streamlining and simplifying loan processes and requirements as one of its priority goals. But the impacts of these plans and programs, which are alternatives to traditional lending (i.e., bank loans) to begin with, could soon peter out into stopgap solutions once Basel III reforms are fully rolled out. Permanent solutions primarily from BSP should be in place.

There is no doubt that changes resulting from Basel III will make banking in the Philippines safer and the system more resilient should another financial crisis take place. However, the attainment of these positive outcomes happens to be costly for MSMEs. With that, the question remains whether BSP can strike a balance between its eagerness to keep up with the Basel III timeline and its responsibility to execute RA 9501 directives and to help improve MSMEs' access to finance.

Endnotes

[1] The Basel Committee on Banking Supervision, with headquarters at the Bank for International Settlements in Switzerland, is an international group of central bankers from 27 countries and the European Union. Its primary purpose is to set banking regulation standards. The Philippines is not a member of the BCBS but has been keen in implementing Basel rules since 2001.

[2] The two main objectives of the Basel III proposals are: 1) to strengthen capital and liquidity standards so that the banking sector becomes more resilient against financial and economic stress; and 2) to improve the banking sector's ability to absorb shocks.

[3] The enhancements of Basel III over Basel II come primarily in four areas: 1) augmentation in the level and quality of capital; 2) introduction of liquidity standards; 3) modifications in provisioning norms; and 4) introduction of leverage ratios.

[4] Internal sources of financing usually refer to personal funds. Alternative sources of financing include among others capital leasing, supplier credit, equity financing, and grants.

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