

## The Philippines growth dialogues: Kristine Romano, Nestor A. Espenilla Jr., and Nestor Tan

June 2018

In the third installment of this series, business leaders discuss important recent trends in the banking sector.

**The Philippines growth dialogues**, a collaboration between McKinsey and *BusinessWorld*, is a video series presenting the ideas of influential leaders in the public, private, and social sectors about key opportunities to promote economic growth in the Philippines. This third installment focuses on the banking sector.

Despite the global financial crisis, the Philippine banking system has made impressive strides in recent years: loans have quadrupled and deposits nearly quadrupled since 2005, and the number of ATMs and bank branches rose by 14,000 and 4,000, respectively, during the past decade. Reforms of the banking system have strengthened balance sheets, governance, and risk management.

---

<sup>1</sup> This statistic is based on the World Bank's standardized definition of small and medium enterprises (5–19 employees and 20–99 employees, respectively), which is different from the Philippine-specific definition (<100 and <200 employees, respectively).

As the sector becomes more integrated globally, additional growth lies in store, but so do two challenges. The first is innovation. In ten years, two-thirds of the Filipino workforce won't know what life was like before the internet. Are banks ready to meet the needs of these women and men, who will command the largest share of the country's purchasing power by the coming decade? The second challenge is inclusive growth. Only 32 percent of Filipinos have a bank account, and only 31 percent of the small and midsize businesses get financing from banks.<sup>1</sup> Can the Philippines create incentives so that its financial institutions serve these segments and turn the gaps into growth opportunities?

Kristine Romano is the managing partner in McKinsey's Manila office. Nestor A. Espenilla Jr. is the governor of Bangko Sentral ng Pilipinas, the country's central bank. Nestor Tan is the president and CEO of BDO Unibank, the largest bank in the Philippines.

***The following transcript has been edited for clarity and concision.***

**Kristine Romano:** Digital is on everyone's mind. Today, four in ten Filipinos in the workforce are digital natives. Technology is changing the way banks do business. Artificial intelligence, advanced analytics, blockchain, and the Internet of Things—all of these are blurring the

traditional lines between financial services and other industries. Hundreds if not thousands of fintechs are trying to disrupt the banking sector. While all this is happening, Philippine banks still seem to be in a wait-and-see mode. How do we encourage our banks to adopt these new technologies and how can they use them to promote financial inclusion?

### Financial inclusion

**Nestor A. Espenilla Jr.:** We see a very strong connection between innovation and financial inclusion. The reason is that financial exclusion has existed for some time, notwithstanding the fact that there is opportunity. Demand from small and midsize companies and from consumers is strong. We have a young population that's upwardly mobile, looking for financial services to meet their needs. About 47.0 percent of the adult population has loans, but only 4.4 percent borrow from banks. A major reason is that these markets are hard to serve using the traditional, conventional bricks-and-mortar approach. The last couple of years have seen all kinds of products, but they essentially don't connect to one another.

**Nestor Tan:** Let me give you a concrete example. If I want to do electronic payments, there has to be an originating account and a destination account. If one is absent, you cannot digitize. So we try our best to create digital products for customers, but we have been lagging behind in trying to convert recipients or merchants. In my view, financial inclusion will precede digitization, not the other way around.

### Fintech

**Nestor A. Espenilla Jr.:** Fintechs have come in to, basically, strengthen the backroom operations of banks. Many of our banks still lack scale, but scale is an issue that will be solved over time. That's also where competition comes in and forces strategic decisions. Bigger scale creates more efficient services. We are seeing our domestic banks adopting new technology; gearing up for a more digital world; introducing more products, credit, savings, and investment products; and distributing insurance products through a bancassurance platform.

**Nestor Tan:** I do believe that our banks, as an industry, are still relatively subscale compared with the region. I don't know if it still holds, but if you combine the top three banks here, it would only be ranked number six in the ASEAN<sup>2</sup> or maybe number seven, so we're relatively subscale. The question, then, for us is will we be able to achieve the right scale or penetration before the market opens up. If we can, maybe we can build our industry from the ground up. If we can't, we will be vulnerable to regional competition.

We're vulnerable in the consumer-lending side of the business, particularly to those that are financially included—salaries, employees, formal-sector businesses, large corporates. We're also vulnerable in areas like asset management. We are vulnerable in payments. Competitors will get market share. We will still be there, but the margins will be affected. It's a game of scale and cost efficiency. However, other sectors are still untapped. The challenge for local banks is how do you compensate for a loss of market share or margins in some products by building up other areas?

---

<sup>2</sup> Association of Southeast Asian Nations.

## Digital infrastructure

**Nestor A. Espenilla Jr.:** There are still also issues of infrastructure, the reliability of channels. We're talking about digital technology. If we are hampered by unreliable services or speed, then that's also an issue.

**Nestor Tan:** Are banks ready for digital? Probably not yet, but they're getting there. We want to get our utilities in order. As I mentioned, in a lot of areas, the banking community has to work together. The country is in the process of creating an ID registry using biometrics as the base for identifying individuals. It's just a registry, I think, but consider the potential. We will be avoiding the use of ATM cards, which is expensive. We will be minimizing fraud if we can use fingerprints or facial recognition to identify the account holder. We're also trying to upgrade our utilities—the clearinghouse, the Bancnet ATM exchange, and the credit bureau—so we can be of better service to our members.

## Digital ecosystem

**Nestor A. Espenilla Jr.:** There's homework to be done in terms of creating a digital financial ecosystem that can be trusted by people. Our approach is to work with the private sector, and today we have embarked on a project for the national retail-payment system. The big idea is that we want to create a digital platform that will allow an ecosystem of financial products to be efficiently distributed throughout the economy. What we hope to see is that any one of us, from a chosen account—a bank account or a wallet account—will be able to transact business with anyone. You can transfer a value person-to-person. You can transfer a value to government, paying taxes or fees. Or government can transfer value to you: benefits, subsidies, conditional cash transfers. Et cetera. So it's an ecosystem. And digitization enables the design of credit products, savings products, investment products, and insurance products that are easier to distribute. You can also break this down into smaller amounts. The Philippine economy operates on the *tingi*<sup>3</sup> system, so you'll be able to save in little amounts. It is easier to do that electronically.

---

<sup>3</sup> Buying in smaller amounts.

**Nestor Tan:** If you do something unique and try to keep it to yourself, the usual competitive behavior is that others will try to do something and outdo you on innovation. Then you will be competing on innovation, which is not our core competency. However, if a group of us decide that we will level the playing field, then we compete on what we know best, which is banking.

*This video also appears on the BusinessWorld site and is republished here by permission. □*

**Kristine Romano** is a partner in McKinsey's Manila office, **Nestor Espenilla Jr.** is the governor of Bangko Sentral ng Pilipinas, and **Nestor Tan** is the president and CEO of BDO Unibank.