The Philippine financial system: issues and challenges[1]

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1. Introduction

Driven by aggressive economic policy and structural changes in the 1980s and 1990s, the complexity of the Philippine financial system has gradually increased. The sustained thrust of the reform process in the 1990s facilitated the rapid expansion and eventual integration of the local financial system with the rest of the world. The structural reforms that allowed freer entry of foreign capital paved the way for healthy competition and increased efficiency with the introduction of new technology, greater transparency and broader opportunities for growth.

Notwithstanding these gains, increased financial integration has also heightened the country's vulnerability to external shocks and exposure to risks. The 1997 Asian financial crisis exposed the country's vulnerability to shocks. While a number of policy measures were put in place to address these weaknesses, the emergence of new risk would require constant recalibration of such measures and the evolution of new ones.

2. The Philippine financial system

Resources continue to increase

In the last ten years, the financial sector has benefited from a number of liberalization and deregulation initiatives as globalization has taken root more strongly in the Philippines. As a result, the Philippine financial system's underlying fundamentals have posted steady progress since 2000. As of November 2005, the total assets of the Philippine banking system amounted to P 4.4 trillion, more than double the amount recorded in 1996 (Table 1). Commercial banks (KBs), which are further subdivided into universal and regular commercial banks, continued to be the dominant players in the industry, accounting for more than 90 percent of the total assets.

Banking system attempts consolidation

The ongoing restructuring of the banking system, which involves the consolidation and closure of weak banks, resulted in a reduction in the number of banking institutions from a peak of 1,003 in 1997 to 881 as of end-September 2005 (Table 2). The total number of banks comprised 42 KBs, 84 thrift banks (TBs) and 755 rural banks (RBs). However, the operating network of the banking system increased slightly to 7,653 as of end-September 2005, from 7,624 at end-June 2005, reflecting the increase in rural banks' branches/agencies.

The Bangko Sentral ng Pilipinas (BSP, the central bank) offered a package of incentives to set in motion the consolidation of the banking industry. A moratorium on the establishment of new banking offices/branches was likewise issued to hasten the creation of larger and stronger banks. The increase in minimum capital requirements of banks also provided the impetus for mergers and acquisitions. Banks which are unable to meet capital build-up requirements have the option to merge or consolidate with other institutions.

[1] Presented by Deputy Governor Diwa C. Guinigundo, in charge of the Monetary Stability Sector of the Bangko Sentral ng Pilipinas during the BIS Meeting of Deputy Governors from Emerging Market Economies on 8-9 December 2005 in Basel, Switzerland.

Table 1

Total assets of the banking system

	1996	1997	1998	1999	2000	2001	2002	2003	2004	Nov 2005
In billions of pesos										
Banks										
KBs	1,876.2	2,513.0	2,512.2	2,722.3	3,013.6	3,070.5	3,250.2	3,425.6	3,760.6	3,968.2
TBs	185.1	208.4	216.4	223.5	245.8	259.0	274.7	292.8	317.9	342.4
RBs	48.0	57.6	60.0	61.5	67.4	73.8	83.5	92.4	104.5	115.5
Specialized government banks[2]	0.2[1]	–	–	–	–	–	–	–	–	–
Grand total	**2,109.5**	**2,779.0**	**2,788.6**	**3,007.3**	**3,326.8**	**3,403.3**	**3,608.4**	**3,810.8**	**4,183.0**	**4,426.1**
Growth, in %										
KBs	39.25	33.94	–0.03	8.36	10.70	1.89	5.85	5.40	9.78	4.11
TBs	29.17	12.59	3.84	3.28	9.98	5.37	6.06	6.59	8.57	10.34
RBs	44.14	20.00	4.17	2.50	9.59	9.50	13.14	10.66	13.10	10.53
Specialized government banks[2]	–99.71									
Grand total	**32.49**	**31.74**	**0.35**	**7.84**	**10.62**	**2.30**	**6.03**	**5.61**	**9.77**	**4.73**

[1] Consisted only of one specialized government bank. [2] Beginning February 1996, specialized government banks were consolidated with commercial banks.

Source: Bangko Sentral ng Pilipinas.

Table 2

Total number of financial institutions[1]

	1996	1997	1998	1999	2000	2001	2002	2003	2004	Sep 2005
Commercial banks[2]	3,647	4,078	4,230	4,326	4,250	4,320	4,265	4,296	4,329	4,322
Head offices	49	54	53	52	45	44	42	42	42	42
Branches/agencies	3,598	4,024	4,177	4,274	4,205	4,276	4,223	4,254	4,287	4,280
Thrift banks	1,171	1,389	1,474	1,478	1,391	1,351	1,278	1277	1,280	1,279
Head offices	108	117	117	118	112	104	94	92	87	84
Branches/agencies	1,063	1,272	1,357	1,360	1,279	1,247	1,184	1,185	1,193	1,195
Rural banks	1,514	1,715	1,942	1,885	1,912	1,914	1,911	1,921	2,003	2,052
Head offices	804	832	826	806	790	781	776	765	764	755
Branches/agencies	710	883	1,116	1,079	1,122	1,133	1,135	1,156	1,239	1,297
Total	**6,332**	**7,182**	**7,646**	**7,689**	**7,553**	**7,585**	**7,454**	**7,494**	**7,612**	**7,653**
Head offices	961	1,003	996	976	947	929	912	899	893	881
Branches/agencies	5,371	6,179	6,650	6,713	6,606	6,656	6,542	6,595	6,719	6,772

[1] Excludes BSP. [2] Includes Land Bank of the Philippines; with Development Bank of the Philippines starting February 1996; and with Al Amanah Islamic Bank of the Philippines starting June 1996 (SRSO Concept).

r Revised.

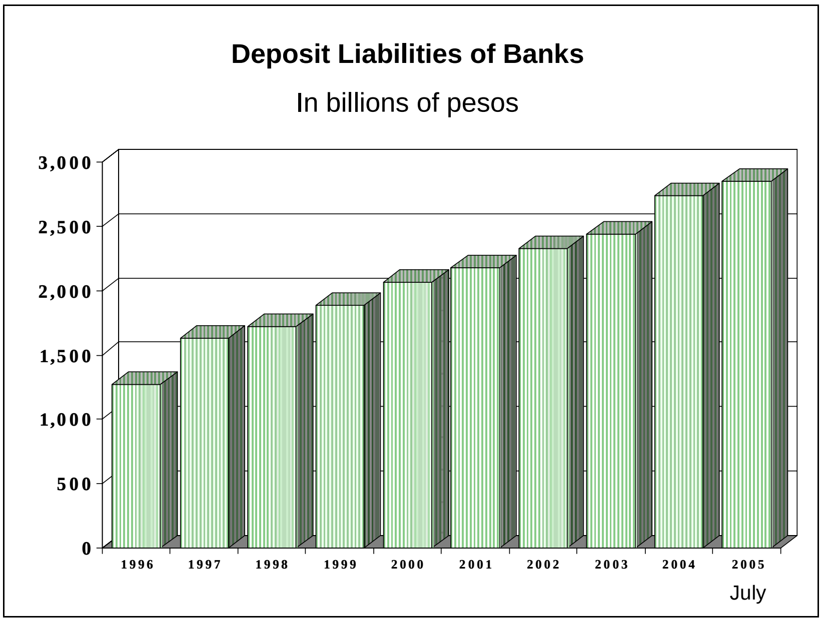
Despite the steady decline in the number of banks, there is still room for further consolidation in the banking system.[2] The mergers and consolidations did not generally involve big banks; only five such mergers involved banks of significant size. One major deterrent to large-scale consolidation is the structure of ownership in the banking system. About 23 percent of total banking assets is owned by 15 families. Another possible reason cited for the slow consolidation process is that only a few banks are publicly listed. In the Philippines, only universal and commercial banks are required to have their stocks offered to the public, and only 10 percent of their required minimum capital must be listed.

In terms of foreign participation, there are 14 foreign bank branches with six foreign bank subsidiaries in the Philippines as of the first semester of 2005. The number of foreign banks operating in the Philippines increased from four in 1994 to 20 as of June 2005 with the relaxation of regulations governing the entry and operation of foreign banks. As a result of the liberalization of foreign bank entry, the share of the foreign bank branches and subsidiaries in the total resources of the country's banking system doubled, from 6.2 percent at end-1995 to 13.8 percent at end-2004.

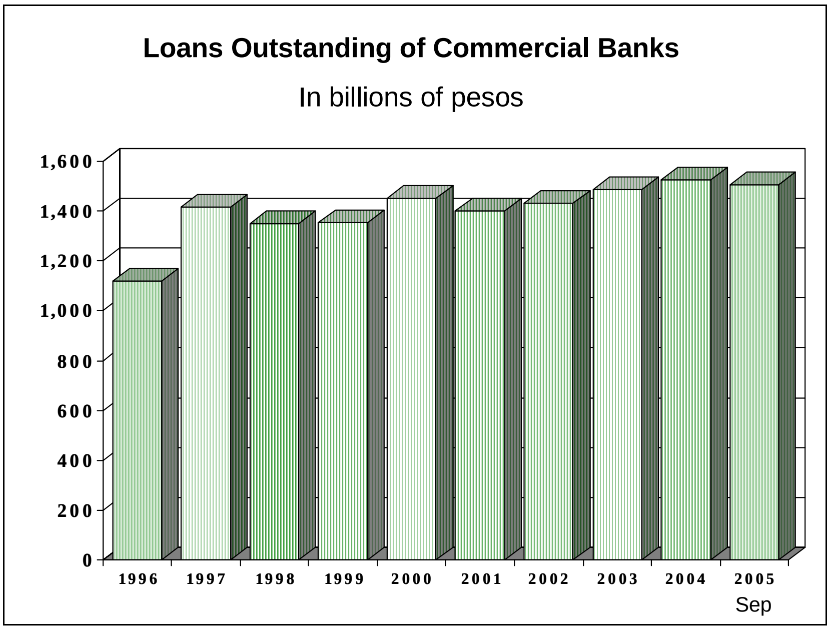
Deposits and loans continue to grow

The banking system's deposit liabilities expanded by 124.2 percent as of end-July 2005 to ₱2.849 trillion, compared to the 1996 level of only ₱1.271 trillion. Savings deposits still comprised more than half of banks' stable funding base. Deposit mobilization activities of banks include relocation of new branches and installation of automated teller machines in new sites.

KB loans outstanding grew by 34.4 percent compared to the 1996 level. The more modest growth in lending compared to the growth in deposits was due in part to the rise in the non-performing loan (NPL) ratio of banks after the Asian financial crisis.

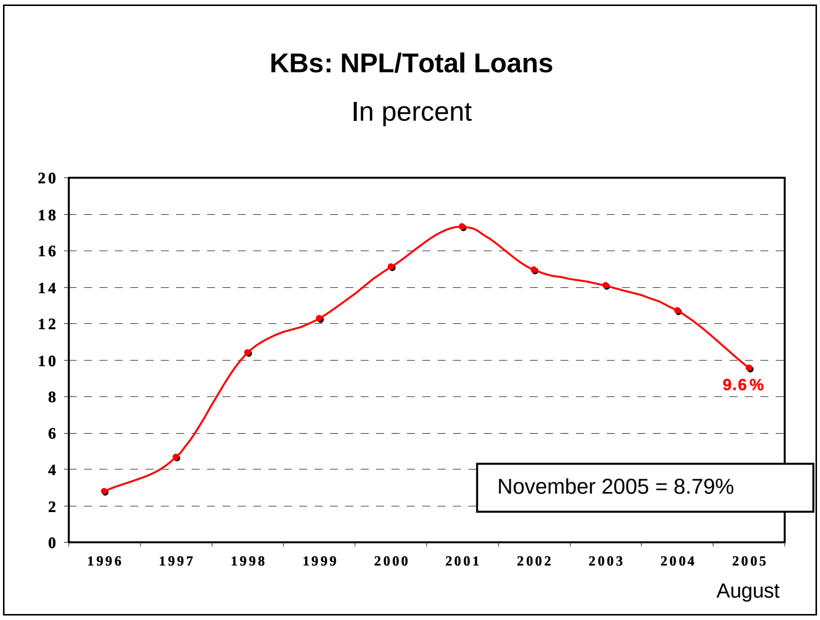


[2] Espenilla, Nestor A., "Banking Foreign Direct Investments and Consolidation: The Philippine Experience", presented during the SEACEN-BIS Seminar in July 2004.



Asset quality continues to improve

The NPL ratio of the commercial banking system rose from 4.7 percent in 1997, before the crisis. to reach a peak of 17.3 percent in 2001. However, the NPL ratio was back to a single-digit level in June 2005. The decline reflected the steady progress in banks' disposition of their idle assets since the implementation of the Special Purpose Vehicle (SPV) Act in 2002 and the sustained though modest rise in total loans of banks. Disposal of idle assets in the Philippines was private sector - led while that of other Asian economies was public sector - led with asset management companies funded by the government. The SPV Act offered fiscal incentives such as exemption from documentary stamp tax and capital gains tax. About 17.8 percent of banks' non-performing assets were disposed of under the SPVA.

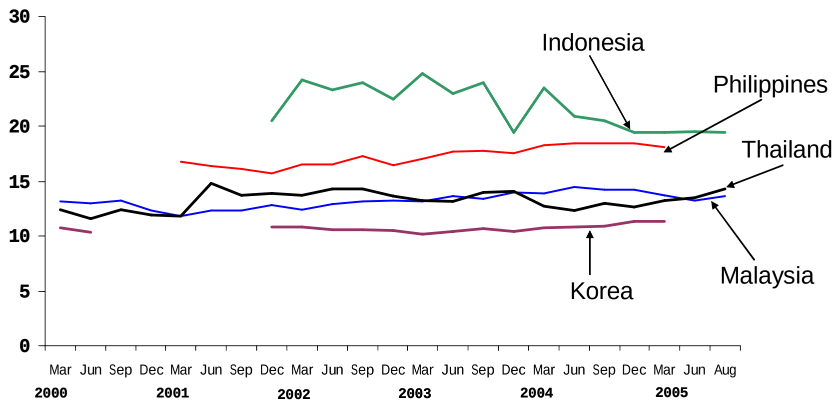


Capital position remains above prescribed norms

The banking industry continues to be well capitalized. The capital adequacy ratio (CAR) of banks on a consolidated basis was recorded at 18.1 percent as of March 2005. The ratio exceeds the 8 percent Basel I standard and the 10 percent set by the BSP.[3] Tier 1 capital comprised 99.4 percent of qualifying capital.[4] Compared with those of its counterparts in the region, the country's CAR remains above those of Malaysia, Thailand, and Korea, which showed CARs above the Basel I standard.

Capital Adequacy Ratio

Financial system



Source: ARIC Financial Indicators, ADB website. Commercial banks CAR: Malaysia (August '05); Thailand (August '05); and Korea (Commercial banks, June '05).

Loan provisioning affects profitability ratio

The industry's profitability weakened starting 1997, as reflected in the downtrend in both the return on assets and equity. There was some uptick in the profitability ratios in 2003 resulting mainly from the offloading of NPLs by banks. The general decline may be traced partly to increased loan provisioning of banks for their bad loans. The rise in provisioning has affected banks' profitability in the short term, but this is expected to recover in the long term. Bank earnings recovered in 2001 through 2003, but resumed their downtrend in 2004. The spike in profitability in 2003 resulted from a significant reduction in below-the-line items, particularly extraordinary credits as a commercial bank sold a substantial portion of its non-performing loans.

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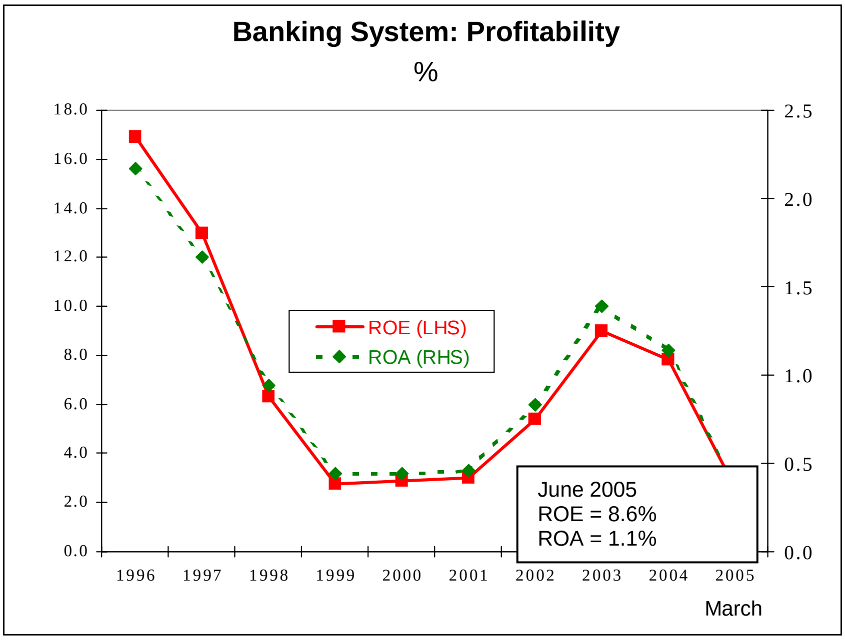
[3] The CAR is a risk-sensitive measure of a bank's solvency. It relates capital to risk assets weighted according to their relative riskiness. BSP Circular No. 280, dated 29 March 2001, and BSP Circular No. 360, dated 3 December 2002, both as amended, require all banks to maintain a CAR of at least 10 percent on a solo basis (i.e., head office plus branches) and on consolidated basis (i.e., parent bank plus subsidiary financial undertakings but excluding insurance companies) covering credit risk, and for universal and commercial banks, combined credit and market risks.

[4] Tier 1 capital refers to core capital, mainly shareholders' funds, while Tier 2 refers to supplementary capital such as preferred stocks and subordinated debt.



3. Financial stability issues and challenges

The domestic financial system has demonstrated resilience to external and domestic shocks since the 1997 financial crisis. However, some remaining issues need to be addressed to ensure that the financial system will remain stable and can fully exploit growth opportunities.

Improving asset quality

The most important task is to clear up the balance sheets of banks. The overhang in the non-performing assets (NPAs) of the banking system has declined in recent years but it still remains high relative to pre-crisis levels. With weak balance sheets, banks have been risk averse, resulting in reduced credit for investments. This renders the system vulnerable to shocks and contagion effects in the event of big bank failures.

From 3.5 percent of total loans in 1996, the NPL ratio of the banking system peaked at 17.1 percent in 2001. The rise in borrower default was brought about by the deterioration in corporate performance as many borrowers were caught in a confluence of sharply weaker exchange rates, interest rate spikes, and collapsing property and equity values, combined with the general slowdown in business activity during the period. Many of the NPLs were related to property bubble lending. Philippine banks have a credit culture that tends to be reliant on collateral based lending, and the burst in the property bubble during the crisis gave rise to structural NPLs.

The crisis also saw bank lending decline, reflecting both the deterioration in asset quality as well as the slowdown in economic activity. In particular, commercial bank lending deteriorated significantly from a year-on-year growth of 51.9 percent in 1996 to a 14.5 percent contraction in 1998, before showing slight expansion beginning in 1999. The modest lending activity can be traced to both demand and supply factors. On the one hand, demand for credit declined as consumption and investment were sharply reduced because of uncertainty and some over-capacity achieved in pre-crisis years. On the other hand, the weakening of borrowers' creditworthiness, combined with weakened bank balance sheets, resulted in a more cautious lending stance by banks that made them highly selective in their lending behavior even at higher interest rates.

In 2002, improving fundamentals and a more accommodative monetary policy stance saw asset quality begin improving, with the NPL ratio easing slightly to 14.9 percent from the 17.1 percent peak. The passage of a legislative bill (i.e., the Special Purpose Vehicle Act) to aid in the disposal of banks' bad assets helped sustain the improvement in the NPL ratio in the following years such that, by August 2005, the banking systems' NPL ratio had fallen to 9.8 percent of total loans.

Managing risk exposures

Deregulation, technological progress, financial innovation, changing tastes and demographics, and increasing market competition have all combined to dramatically transform the financial services industry. This is a continuing and dynamic process. As a result, the banking industry has no choice but to reinvent its products and services and the way they are delivered to customers to stay competitive. However, while these developments have opened new doors of opportunities, they have also introduced credit, market, and liquidity risks that need to be properly managed.

Over the past decade, increased market volatility has raised the risk of a counterparty's failure to meet its obligation. In particular, the growth in bank credit card receivables (CCRs), which peaked at 41.2 percent in 2002, has raised some concern. The increased credit risks facing banks prompted the BSP to call for more stringent loan procedures to mitigate the threats this risk poses to financial stability. As a result, the growth of CCRs slowed down significantly from its peak in 2002 to 16.7 percent by 2004.

Similarly, banks have been exposed to increasing risks arising from higher volatility of interest rates and other market prices and the increasing use of customized products. Market prices, in particular, can move very rapidly and, on occasion, in unison, so potential loss to market risk exposure can be substantial. Subsequently, while most banks have the highest exposure to credit risk, market risk has become an important secondary risk factor. Therefore, the BSP has implemented a number of measures to mitigate market risk.

Basically, banks' weak risk management practices helped precipitate the wholesale souring of bank asset quality during the Asian crisis.

Developing the domestic capital market

Another major BSP goal is the development and deepening of the domestic capital market.

The capital market is an integral part of the financial system. For one, a robust domestic capital market complements the banking system in financial intermediation, providing alternative means of financing to ensure the efficient and sustainable funding of large-scale or long-term projects of government institutions and private entities. A developed capital market also ensures the availability of a wider array of financial instruments that help encourage higher levels of savings, which in turn translate into higher levels of investments to support a faster pace of economic growth.[5] Moreover, a strong capital market would provide the banking system greater flexibility in managing and redistributing its risk, particularly through securitization and hedging. Hence, developing the domestic capital market would contribute to the soundness of the country's financial sector. In turn, a well-functioning financial market supports the effective conduct of monetary policy, which is a major element in the achievement of price stability. For this reason, the BSP, as the sole monetary authority and supervisor of the banking system, has intensified its efforts to help accelerate the development of the Philippine capital market.

In its infancy, the Philippine capital market was synonymous with the loan market. The early 1990s, however, witnessed significant developments in the market, including the establishment of an independent central bank under a new charter, the gradual reduction in reserve requirements, the liberalization of foreign bank entry, and the relaxation of bank branching policies. Complementing the liberalization of the financial market were reforms that led to the emergence of the government bond market as a major venue for mobilizing long-term funds.[6] These, combined with the unification of the Makati and Manila stock exchanges into the Philippine Stock Exchange, saw the emergence of other financial intermediaries as channels for capital financing. Debt securities and equity markets became

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[5] According to comparative data from the ADB, the gross domestic saving rate in the Philippines as of 2003 was only 20.1 percent of GDP, behind Indonesia's 21.5 percent, and lower than Hong Kong's 31.6 percent, Thailand's 33.1 percent, Malaysia's 42.9 percent, and Singapore's 46.7 percent.

[6] These reform measures included the following: (a) government securities were made eligible as reserves against deposits; (b) the investor base was broadened with the granting of more licenses for primary dealers and the introduction of small-denominated securities that appeal to retail investors; (c) government securities with longer maturities were introduced from 1991-1996; and (d) the infrastructure of the government securities market was improved with the automation of the auction process and the introduction of the Registry of Scripless Securities (RoSS).

alternative sources of funds. Subsequently, while banks remained one of the dominant players in the capital market, investment houses, stock brokerage firms, money market funds, and other fund management institutions have steadily gained significance.

However, while the government securities market flourished (particularly with the national government registering chronic fiscal deficits), the absence of necessary market infrastructure - such as an organized venue for trading securities - has hindered the development of the corporate debt securities market, making private securities a less liquid instrument to hold, and at greater cost to trade. The onset of the regional financial crisis in 1997 further dampened private sector appetite and depressed the corporate debt securities market.

Today, the Philippines' debt securities market remains almost synonymous with the market for government securities, since public debt issues capture over 90 percent of the market for debt instruments. The corporate bond market is virtually non-existent. With the debt securities market mainly a fund-generating market for the government, and the equities market a virtual mirror of conditions from within and outside the system, the traditional loan market remains the market of choice for both providers and users of capital funds. Due to the underdeveloped state of the domestic capital market, the banking system has been bearing a disproportionately large part of the burden of financing economic development as well as fiscal deficits, which has rendered the system highly vulnerable to changes in interest rates

Other issues and challenges

There is a need to coordinate the regulation and supervision of the financial system (banking, securities, and insurance). Over time, innovation and globalization have given rise to new business structures and "hybrid" products that no longer fit squarely with the traditionally regulated institutions. This has created significant scope for regulatory arbitrage that has also encouraged conglomerated financial organizations. In other jurisdictions, this has led to the creation of an "integrated regulator". While discussions aimed at bringing this system about in the Philippines have started, its realization faces considerable legal and political obstacles and is therefore unlikely to be a factor for at least three more years.

In the absence of an integrated regulator, there is a need for the major regulators (the BSP, the Securities and Exchange Commission (SEC), the Office of the Insurance Commission (OIC), and the Philippine Deposit Insurance Corporation (PDIC)) to coordinate their policies and procedures more seamlessly and share information in order to effectively discipline financial markets and financial institutions. However, coordination is hampered by differences in institutional capacity among regulators. This can lead to a non-level playing field which can place banks at a competitive disadvantage as they are subject to increasingly more binding supervision by the BSP and, to some extent, by the PDIC.

There is a need to increase financial transparency. Lack of transparency has prevented market discipline from working in the most effective manner. Accounting and disclosure practices leave much room for improvement. External auditors appear to have difficulty striking the right balance between their public duty and their business interests. Also, due to poor appraisal standards, asset valuations are unreliable, leading to potentially overstated financial statements. Because of poor information disclosure, the system is also more prone to rumor-driven contagion (intensified by text messaging). However, given the already weakened state of the banking system, improvements in public disclosure have to be carefully managed and calibrated to avoid undue panic.

4. Financial policy response

Over the years, particularly in the aftermath of the 1997 Asian financial crisis, the BSP has been strengthening the banking system's ability to respond to the challenges brought about by globalization and the shocks posed by the global economic crisis. In particular, focus is geared towards strengthening the BSP's prudential regulatory standards and aligning them with international norms to enhance risk management, promote good corporate governance and greater transparency, and reduce moral hazard. At the same time, procedures were adopted to identify and deal with potential problems of solvent and nearly insolvent banks.

Improving asset quality

The Philippine government has had limited capability to help the banking system dispose of its NPAs, in contrast to other crisis-affected Asian countries. Out of fiscal necessity, therefore, the strategy was to mobilize private investment to clean up banks' balance sheets and rehabilitate the banking system.

To improve the repayment performance of outstanding borrowers, the BSP sought to *maintain a stable inflation and domestic interest rate environment,* even before the formal adoption in 2002 of inflation targeting as the framework of monetary policy. Given the emerging macroeconomic environment, from December 2000 to March 2002, the BSP reduced policy rates by 800 basis points to 7.0 percent for overnight reverse repurchase rates (RRP) and 9.25 percent for overnight repurchase rates (RP). Since then, however, the monetary stance was characterized by caution, allowing past interest rate cuts to work their way into the economy while keeping a look-out for prospective threats to price stability.

The BSP also *set provisioning requirements for banks' loan portfolio accounts*. All institutions are required to maintain an adequate level of allowance for probable losses. These requirements are applied uniformly for all types of loans, whether corporate or government lending.

- General loan loss provision was set up. This is not linked to any individually identified uncollectible accounts required to be set up under existing regulations. The structure is as follows: 5 percent of the unclassified restructured loans; and 1 percent of the unclassified loans other than restructured.
- Allowance for probable losses for specific loan and other risk assets accounts was also established. This is implemented based on the following schedule:

Loan Classification	Allowance
Unclassified	0%
Loans especially mentioned	5%
Substandard	
Secured	6-25%
Unsecured	25%
Doubtful	50%
Loss	100%

With the BSP *pushing for the passage of key legislation aimed at providing the legal framework to facilitate the creation of private-led asset management companies to hasten the off-loading of banks' NPAs*, the Philippine Congress enacted Republic Act No. 9182, or the SPV Act of 2002, in January 2003. Republic Act No. 9267, or the Securitization Act, was also signed into law in March 2004. That signaled the authorities' determination to institutionalize the strengthening of the banking system.

The *SPV Act* of 2002 sets out the legal, regulatory, and taxation framework for banks and other financial institutions to sell non-performing and acquired assets. The law aims to help institutions securitize their assets by granting tax incentives to asset management companies or special purpose vehicles.

- The primary purpose of the SPV Act is to enable Philippine banks to unload their non-performing loans and foreclosed assets to special purpose vehicles (SPVs), in the hope of further strengthening the banking sector.
- Under the Act, an SPV is required to be a stock corporation with a minimum paid-up capital of ₱31,250,000.00. The selling bank is permitted to own up to 5 percent of the outstanding capital stock of the SPV. An SPV is allowed to issue Investment Unit Instruments (IUIs) to finance its acquisition of non-performing loans and foreclosed assets. These IUIs are to be registered with the SEC prior to being sold or distributed to permitted investors within the Philippines. To encourage the transfer of the non-performing loans and foreclosed assets to the SPV, certain tax reliefs are granted.

On the other hand, the *Securitization Act of 2004*, the companion bill to the SPV Act, aims to: (a) improve the legal standing of securitized issues; (b) promote securitization for the development of the capital market; and (c) pursue the development of the secondary market for asset-backed securities and other related financial instruments.

- Under this securitization law, assets may be sold with recourse to a special purpose entity (SPE), which then issues securities backed up by a pool of similar assets. Several taxes will be granted to encourage financial institutions to transfer housing mortgages to SPEs. While SPEs will still have to pay income taxes like any other corporation, transfers of assets will be exempt from value added and documentary stamp tax. SPEs will also be exempt from the 5 percent gross receipts tax applicable to a bank/financial intermediary and will be given a 50 percent discount on all applicable registration and annotation fees. Property transfers, through *dacion en pago* [7] will similarly be exempt from the 6 percent tax on capital gains. The revenues foregone from these tax incentives are expected for to be minimal since the government is not presently collecting those taxes from which the SPEs are exempted.
- Other provisions include: prohibiting the national and local governments from securitizing receivables arising from future expectations of revenues (such as royalties, fees, internal revenue allotments, etc.) at the expense of their successors; and requiring each securitization plan to be prior registered with the Securities and Exchange Commission (SEC).

The implementing rules and regulations (IRR) of the SPV law were approved in March 2003. Significant reductions in banks' NPLs began to be felt in the latter part of 2004 as bulk sales of bad assets to SPVs were made, although the market remained generally thin due to the deep discounts quoted by investors, making banks reluctant to dispose of these assets. As of 26 June 2005, 343 certificates of eligibility (COEs)[8] have been issued under the SPVA. The amount of NPAs transferred under the said law totaled ₱96.7 billion, involving various transactions. Of the total peso transactions, ₱79.1 billion involved a sale to an SPV. The remaining amount involved the sale of real and other properties owned and acquired (ROPOA) to individuals and *dacion en pago* transactions. The total amount of NPAs transferred under the SPV Act represents 18.6 percent of the ₱520 billion worth of NPAs as of 30 June 2002.

However, the two-year effectivity for the filing and disposal of NPAs under the SPV Act ended in April 2005. To give the banking system more time to dispose of non-performing and repossessed assets at discount, a bill has been filed in the Congress to extend the privileges under the said law by another two years. The unloading of an additional ₱100 billion worth of NPAs is expected with the extension of the effectivity of the law.

Meanwhile, Congress approved and released the IRR of the Securitization Act in May 2005. With the release of the law's long-awaited IRR, the government expects to harness the bond market's tremendous potential in generating long-term funds, not only for housing but for other priority development programs.

To force asset disposal, the BSP implemented the following measures: (a) asked banks whose NPL ratios have surpassed industry levels to submit measures that are being taken to reduce their NPL levels; and (b) increased the risk weight on NPLs from 100 percent to 125 percent and announced a further increase to 150 percent by 2007 (Circular No. 475, dated 17 November 2005).

Enhancing risk management

In the past ten years, the BSP has implemented several major improvements in Philippine banks' risk management practices. The BSP's effort to focus on risk management is ultimately intended to give banks greater flexibility to respond to changing opportunities under a more deregulated environment and at a time of rapid technological advances. Traditional bank supervision tended to instruct banks to avoid taking highly risky undertakings. The new approach to supervision favors assessment of the

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[7] Refers to "payment in kind", whereby property, whether real or personal, tangible or intangible, is alienated in favor of the creditor.

[8] Refers to the certificate issued by the appropriate regulatory authority as to the eligibility of the NPL or ROPOA for purposes of taking advantage of the tax exemptions and privileges, pursuant to the provisions of the SPV Act.

quality of risk management practices, and generally allows banks to take risks so long as they demonstrate their ability to manage and price those risks. In particular, the *risk management initiatives* have included the following:

- The BSP recognized the greater risk exposure in the system brought about by derivatives activities and the need to mitigate it. Hence, BSP Circular No. 102 was issued in December 1995 prescribing the minimum standards for risk management of derivatives. This was the first BSP regulation that specifically focused on banks' risk-taking activities and risk management practices.
- In 1997, in response to the higher risk environment, the BSP started to move from a compliance-focused supervisory approach to the risk-based approach that focused bank supervision on the measurement of banks' risk exposures and on risk management, instead of mainly concentrating on financial audit and compliance review. The purpose of this change in approach is to adapt to the evolving structure of the banking system and evolving international best practices.
  - The on-site examination process was reoriented to a more forward-looking and risk-based approach with the adoption of CAMELS (capital adequacy, asset quality, management, earnings, liquidity, and sensitivity to market risks) and the Risk Assessment System (RAS).
  - The BSP developed an Early Warning System (EWS) which uses statistical modeling techniques to enhance its ability to supervise the banking system.
  - In 2001 the BSP adopted the risk-based capital adequacy ratio along the criteria of Basel I, with some modifications to take into account special local conditions and practices.
- In March 2001, the BSP adopted the original Basel I framework through Circular No. 280. This circular provided guidelines for the computation of risk-based capital for credit risk. The BSP's risk-based capital adequacy framework was further enhanced with the issuance of Circular No. 360 in December 2002, which required banks to measure and apply capital charges against their market risk, in addition to their credit risk. The market risks addressed by this regulation are the risks pertaining to interest rate-related instruments and equities in the trading book, and foreign exchange risk throughout the bank.
  - On the implementation of the Basel framework, the BSP imposes a minimum capital adequacy ratio (CAR) of 10 percent on domestic and foreign banks. This minimum required ratio of 10 percent was set higher than the Basel I or Basel II recommended ratio of 8 percent to take account of other risks not captured in the current framework, e.g. operational risks. This requirement is applied on both a solo and a consolidated basis. It is also applied uniformly across all types of banks, except that the capital charge for market risk is applied only to universal and commercial banks. Subsidiaries of foreign banks are treated in the same manner as domestic banks. Branches of foreign banks have the same minimum capital adequacy ratio requirement, except that the bases of their qualifying capital are "assigned capital" and "net due to head office, branches and offices abroad" - up to three and four times the "assigned capital" for universal and commercial banks, respectively.
  - The calculation of capital charge for market risk is the same as the 1996 Amendments to Basel I. Banks may, subject to prior BSP approval, use the internal value-at risk (VaR)[9] model approach in lieu of the standardized approach for calculating the capital charge for market risk. The calculation of qualifying capital is also the same as that prescribed in Basel I. It consists of Tier 1 and Tier 2 capital, where total Tier 2 capital should not exceed Tier 1, and lower Tier 2 should not exceed 50 percent of Tier 1.

[9] Refers to a technique which uses the statistical analysis of historical market trends and volatilities to estimate the likelihood that a given portfolio's losses will exceed a certain amount; measures the worst expected loss over a given time interval under normal market conditions at a given confidence level.

Unsecured subordinated term debt instruments may, depending on terms and conditions, qualify under upper or lower Tier 2 capital.

– The credit risk weights used are as follows:

  - 0 percent risk weight on cash, claims on or claims guaranteed/collateralized by securities issued by the Philippine National Government/BSP and multilateral development banks, as well as central governments and central banks of other countries with the "highest credit quality", defined as a rating of AA- and above by recognized credit rating agencies';
  - 20 percent risk weights on checks and other cash items, claims on Philippine/foreign incorporated banks and private enterprises with the "highest credit quality";
  - 50 percent risk weight on loans for housing purposes secured by real estate mortgages (REM) that are not past due;
  - 75 percent risk weight on loans to small and medium-sized enterprises and non-performing loans for housing purposes secured by REM;
  - 125 percent risk weight on all non-performing loans (except housing loans secured by REM); and
  - 100 percent risk weight on all other claims.

– The BSP, on 13 December 2004, announced its implementation plan for Basel II. The BSP believes that the adoption of Basel II and its three component pillars, i.e., minimum capital requirements, supervisory review process, and market discipline, would compel banks to further strengthen their risk management system and corporate governance if they are to remain competitive and viable. This require, however, a significant upgrading of technical skills on the part of both supervisors and banks. It will also require setting up an infrastructure supportive of the framework, e.g., more credible credit rating agencies, reliable credit information bureaus, etc.

– As stated in the plan, universal/commercial banks are expected to comply with the standardized approach for credit risk, and the basic indicator or standardized approaches[10] for operational risk by 2007. By 2010, these banks may move to the foundation internal ratings based (IRB) or advanced IRB approaches[11] for credit risk, and advanced measurement approaches for operational risk. TBs and rural/cooperative banks are expected to be subject to an enhanced Basel I-type approach by 2007, except for TBs affiliated with universal banks (UBs)/ KBs, which should use the same approach used by their parent UBs/KBs. The exposure draft for the new risk-based capital adequacy framework was issued on 19 April 2005 for comments by the banks concerned.

- The BSP required all banks to set up a comprehensive risk management system which should already cover liquidity risk management. Maturity gap analysis is required at every regular examination, but there are no specific limits on maturity gaps. There are also specific rules for particular liabilities like long-term negotiable certificates of deposit, repurchase transactions and total issuances of unsecured subordinated debt. The reserve requirement is a total of 21 percent for demand deposits, NOW accounts, savings deposits, and time deposits. The reserve for long-term negotiable certificates is only 2 percent.
- Placing limits and creating policies over material areas of exposure is a significant step in managing the combined effect of various market risks. For this reason, the BSP has set

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[10] Refers to an approach proposed by the Basel Committee to calculate credit risk capital requirements for domestic banking institutions using risk indicators for each of their business lines.

[11] Refers to an approach proposed by the Basel Committee to determine the required buffer capital by breaking credit risk into its constituent elements and dealing with each in turn.

several exposure limits for banks, scaled as a proportion of capital or total loan portfolio. These include:

- large exposure limit: 5 percent of qualifying capital;
- related party credit limit: 100 percent of the book value of capital contributions and 100 percent of unencumbered deposits, but not to exceed the single borrower's limit (25 percent of unimpaired capital);
- specific sector (real estate): 20 percent of total loan portfolio; and
- single borrower's limit (SBL): 25 percent of unimpaired capital.

- In 2004, the BSP issued guidelines to help manage large exposures and credit risk concentrations. In particular, the BSP:
  - required the boards and senior management of banks to ensure that adequate systems and controls are in place to identify, measure, and monitor and report large exposures and credit risk concentrations of banks in a timely manner;
  - amended the SBL to achieve more comprehensive coverage on a consolidated basis of bank exposure to related parties;
  - tightened rules governing bank exposure to directors, officers, staff and related interests (DOSRI). The new rules set more binding limits on the grant of loans, credit accommodations, and other guarantees to DOSRI and imposed stiffer sanctions on violators;
  - required universal and commercial banks to develop and implement an internal credit risk rating system, and to develop and maintain an appropriate, systematic and uniformly applied process in determining the amount of reserves for bad debts and doubtful accounts; and
  - implemented a more stringent policy on credit card operation, particularly in the customer application process.

In carefully loosening the regulatory grip on banks' risk-taking activities in order to give them more elbow room for success, the BSP must necessarily strengthen the responsibility of banks' boards of directors and senior management to ensure the soundness and stability of their respective banks. The regulators' role is primarily to evaluate the quality of oversight and management provided by these parties - that is, the quality of corporate governance. Hence, *strengthening banks' corporate governance* has been the theme of a number of BSP regulations.

- In June 1997, Circular No. 130 was issued requiring the boards of directors of banks to, among other things, adopt and maintain adequate risk management policies. A few months later, in October 1997, the BSP issued Circular No. 145 requiring banks to develop and implement a compliance system and to appoint/designate a compliance officer to oversee its implementation. In September 2001, the BSP issued Circular No. 296, which implemented the fit and proper standards for directors and officers of banks and non-banks. The same circular also prescribed a mandatory orientation program on corporate governance for banks' boards of directors. In October 2003, the BSP issued Circular No. 410, which provided the accreditation guidelines for banks' external auditors.
- The BSP issued a number of guidelines aimed at further enhancing governance practices in banks. In January 2004, the BSP issued the guidelines for the management of banks' large exposures (Circular No. 414). In March 2004, the BSP strengthened the DOSRI rules by expanding the definition of related interests (Circular No. 423). In May 2004, the BSP issued Circular No. 429, which is at aimed at further strengthening the banks' compliance function.
- In July 2004, the BSP issued the guidelines for the development and implementation of banks' internal credit risk rating systems (Circular No. 439). The guidelines emphasized the oversight function of the board of directors over these systems. In October 2004, the BSP required boards of directors to, in addition to an audit committee, a corporate governance committee and a risk management committee.

Developing the capital market

To help develop the domestic capital market, the BSP implemented or supported the following reform initiatives:

1. *Establishment of a private sector-led fixed income exchange (FIE).* Begun in 2001, this is intended to help institutionalize a liquidity and price discovery mechanism for secondary trading of fixed-income securities, provide the public with more investment options apart from traditional equities, and open up more avenues for private and public sector issuers to tap low-cost capital. Among other things, the BSP: allowed universal/commercial banks to invest in the FIE; created technical working groups to look into the legal issues surrounding the proposed FIE; and granted the Philippine Depository & Trust Corporation (PDTC) permit to operate as a non-bank financial institution with authority to perform quasi-banking functions, trust and other fiduciary business, and investment management activities. After several years of preparatory work, the first phase of the much awaited FIE, which consisted of a virtual inter-dealer trading platform that offers government securities ranging from one-month to 25-year tenors for secondary trading, was finally launched in end-March 2005. The second phase, which will allow retail investors to transact deals through their brokers, is also set to be launched this year.

2. *The institutionalization of third-party custodianship for securities.* Independent custodians for securities provide investors better protection from fraudulent acts of multiple securities sales by ensuring that all transactions are backed up by corresponding debt instruments. The custodian system also prevents price manipulation, as custodians record the buying and selling prices of securities. Third-party custodianship further complements the establishment of the FIE by paving the way for the creation of a repo and securities borrowing and lending market. Hence, to institutionalize a system of independent third-party custodians for securities, the BSP mandated the transfer of securities (used for quasi-banking functions) by banks under BSP supervision to BSP-accredited custodians in 2003.

Effectively, the regulation requires all buyers of securities to lodge their investments with an independent custodian who will have the sole responsibility in the registration and safekeeping of all debt securities sold, borrowed, purchased, traded, and transacted in the Philippines. BSP requirements for accreditation as a custodian include: a risked-based capital adequacy ratio not lower than 12 percent; a comprehensive risk management system; a CAMELS four rating standard; and adequate technological capability and technical expertise.

To date, the Monetary Board has approved the accreditation of six third party custodians: four foreign banks (Standard Chartered Bank, Deutsche Bank, Hong Kong and Shanghai Bank Corporation, and Citibank); one local bank, (Bank of the Philippine Islands); and a non-bank financial intermediary (Philippine Depository and Trust Corporation).

3. *Creation of unit investment trust funds (UITFs) to replace common trust funds (CTFs)*. As an investment product, UITFs will be more competitive as they will no longer be subject to reserve requirements, and will be exempt from the single borrowers' limit calculations. UITFs are also allowed to be offered in dollar-denominated forms for investors with independent dollar sources. However, UITFs have clearer safeguards that distinguish them from deposit substitutes.The safeguards include requiring assets held by UITFs to be marked to market daily and for them to be under third-party custody to protect investors from fund manager misconduct. Eventually, the BSP expects UITFs to evolve into major institutional players in the domestic capital market.

4. *Upgrading of the payment and settlement system into a real time gross settlement system (RTGS)* with a view to enhancing the operational efficiency, reliability, speed, and timeliness of payment transactions in the face of the rapidly increasing volume and large value of payment transactions. Initiated in 1998, the project required the BSP to install and manage a computerized facility that is able to process the payment and settlement of large-value fund transfers arising from the following transactions: trading of equities and government securities, money market placements, and foreign exchange market transactions. It is envisioned that with this new facility, the actual transfer of funds between the payer's bank and the payee's bank can be made individually within the same day that the instruction is made, provided the payer has sufficient covering balances or credit with the BSP. Thus, it will enable Philippine banks and their clients to settle on a "delivery versus payment" (DvP) or "payment versus payment" (PvP) basis.

In mid-July 2001, the Philippine RTGS began to be partially implemented to cover interbank loan transactions and the purchase of government securities under repurchase agreements between and among banks and the BSP. The Philippine RTGS, named the Philippine Payment System or PhilPass, was formally launched in December 2002.[12]

5. *Development of domestic rating capacity* to meet the growing need for credit rating services by both the financial industry and regulators. In pursuit of this goal, the BSP established minimum eligibility criteria for the recognition/derecognition of domestic credit rating agencies for bank supervisory purposes in 2003. In early 2005, the BSP approved a national rating agency system for the local banking industry that would allow international rating agencies to set up a national rating system for banks that would be applicable only to the Philippines. Subsequently, domestic banks assessed by rating agencies can now be given ratings higher than the sovereign credit rating.

Enforcing prompt corrective action

Banks with impending/potential problems are subject to the following:

- Intensive monitoring - problem banks are subject to close monitoring by the Prompt Corrective Action Units (PCAU) in each of the four supervising and examining departments of the BSP's Supervision and Examination Sector.
- Early intervention resolution - should early warning indicators[13] show deterioration of a bank's financial condition, the supervising and examining department-in-charge engages in early intervention initiatives before trouble spots get out of hand. These initiatives include the implementation of prompt and corrective action and the imposition of corresponding sanctions, depending on the severity of non-compliance with BSP-prescribed prudential regulations.

Other prudential reforms/regulations

Other prudential regulatory standards have been continually strengthened and aligned with international standards.

1. In response to the increased blurring of distinctions between financial products, the BSP began *supervising financial conglomerates on a consolidated fashion in 1998*. A common cutoff date for examination of banks and their subsidiaries and affiliates under BSP direct supervision was put into place; the publication of the quarterly consolidated statement of condition (parent bank and its subsidiaries engaged in financial allied activities), side-by-side with the combined statement of conditions (head office and branches), was required; and the application, on a consolidated basis, of prudential limits on the required compliance with the risk-based capital ratio (applied on both a solo and a consolidated basis) and the limit on the net open foreign exchange position (applied only on a consolidated basis) were implemented.

2. In addition, as a step towards harmonizing the regulatory environment governing the financial services industry, the BSP, together with the SEC, the IC, and the PDIC, *formed the Financial Sector Forum (FSF)* in 2004. The FSF is expected to further enhance coordination arrangements among the concerned agencies, particularly with regard to the following: the harmonization and coordination of supervisory and regulatory methods and policies; reporting and information exchange and dissemination; and consumer protection and education to curb unlawful and unethical business practices.

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[12] Today, the following transactions are accepted for processing by the PhilPass: (a) interbank loan transactions among banks and non-bank financial intermediaries performing quasi-banking functions; (b) purchase and sale of government securities under outright and repurchase agreements, and between and among banks and non-bank financial intermediaries and the BSP in connection with the latter's open market operations; (c) settlement of the peso leg of foreign currency transactions and government transactions; (d) high-value customer payment instructions; (e) interbank settlement of ATM transactions; and (f) other payment instructions under DVP and PVP. In the near future, PhilP transactions will include bank settlements for government securities issued by the Bureau of the Treasury (BTr). The system may also be linked to the Philippine Stock Exchange (PSE) to allow the real-time settlement of stock transactions using the delivery versus payment mode.

[13] The early warning analysis uses econometric methods to produce a one-year ahead forecast of bank solvency from the financial data regularly submitted by reporting banks as well as from macroeconomic data.

3. The BSP *enhanced transparency* by requiring banks to disclose the following information in their quarterly published/posted statements of condition:

- amount of non-performing loans and ratio to total loan portfolio;
- amount of classified loans and other risk assets;
- general loan loss reserves;
- specific loan loss reserves;
- return on equity
- DOSRI loans/advances and ratio to total loan portfolio; and
- past due DOSRI loans/advances and ratio to total loan portfolio.

Additional information was also required in periodic reports submitted to the BSP, as well as in published reports and audited financial statements and all relevant financial reports: the staggered recognition of actual loss on sale/transfer of NPAs and/or impairment, if any, on the remeasurement of financial instruments at end of the first fiscal year following the sale/transfer of NPAs. Moreover, banks/FIs which received financial instruments issued by the SPVs as partial or full settlement of the NPAs transferred to the SPVs should disclose in the audited financial statements the method used and the significant assumptions applied in estimating the recoverable amount of the financial instruments, including the timing of the sale, the direct cost to sell, administrative expenses, and reinvestment rate of current market rate.

External auditors were likewise required to disclose adverse findings to the BSP, including: those involving fraud or dishonesty, which may jeopardize the interest of depositors and creditors; losses incurred which substantially reduce the capital funds of the bank; and inability of the auditor to confirm that the claims of creditors are still covered by the bank assets.

- To strengthen public confidence in the banking system and further foster financial stability, all peso and foreign currency savings deposit accounts, time deposit accounts, current or demand deposit or checking accounts in a bank are required to be insured with the PDIC. With the amendment of the PDIC's charter, the allowable insured deposit was raised from P100,000 to P250,000.

In December 2004, the BSP moved to align local financial accounting standards with international standards with the adoption by 2005 of new and revised Philippine Accounting Standards (PAS) issued by the Accounting Standards Council (ASC).[14] The standards are based on the new and revised International Accounting Standards (IAS) issued by the International Accounting Standards Board (IASB). The adoption of the new and revised IAS will help promote fairness, accuracy, and transparency in the financial statements of banks and other supervised institutions. Ultimately, all of these should help strengthen market discipline, encourage sound risk management practices, and stimulate the domestic capital market.

The BSP also imposes supervisors' guidelines, targets, codes of good practice, recommendations, etc., that do not have the full legal status of regulations. However, since these were issued as regulations by the BSP, banks are required to comply. These include regulations pertaining to the following: NPL ratios; returns on assets; returns on equity; loan to deposit ratios; liquidity; and sensitivity to market risk.

[14] Among the new standards is IAS 39 on financial instruments, which the BSP adopted in its rules and regulations governing the accounting treatment of investments in debt and equity securities. The BSP regulation provides general guidelines for classifying, recognizing, and measuring investments in debt and equity in accordance with IAS 39. In particular, it requires financial institutions to classify their outstanding investments in debt and equity securities based on their intention for holding or purchasing the securities.

5. Future direction

Policy directions in the banking sector will focus on two main policy objectives that are geared towards a flexible banking system and a deeper capital market. These objectives are to:

- promote a stronger and more stable financial system; and
- develop the domestic capital market to improve investments, protect investors, and provide easier access to funds by small and medium-sized businesses, both of which are essential to increasing growth.

On the financial supervision front, the BSP reform measures will be geared towards maintaining a healthy banking system. Initiatives include asset clean-up and capital base build-up through compliance with International Accounting Standards by 2005, and adoption of the Basle II Capital Adequacy Framework by 2007; improvement in the BSP's supervision technology and capacity through acceleration of the move to risk-based supervision; promotion of corporate governance; and improvement in the prudential regulatory environment at par with international standards and practices. The BSP will also advocate the passage of key legislation that includes extension of the effectivity of the SPV Law and amendments to the BSP Charter.

To further develop the domestic capital market, and thereby stimulate domestic savings and provide investment opportunities, the BSP will: continue to support the full implementation of the third-party custodianship system and the operation of the Fixed Income Exchange; facilitate the establishment of more credit rating agencies and support the creation of a centralized credit information bureau; widen opportunities for banks to tap the capital markets and continue trust reform for other managed funds; and support other enabling legislation for capital market development. In particular, the BSP will support calls for the passage of relevant amendments to the Credit Reporting Bill, the Corporate Recovery Act, the Pre-Need Code, and the Corporation Code.

In order to intensify the social dimensions of BSP policy, the BSP will also continue to advocate microfinance as the most effective tool for democratizing the access of the public to a portion of the nation's wealth, for empowering the poor and the economically challenged group of small entrepreneurs, and for scoring a dent on poverty alleviation. The BSP shall also pursue economic and financial literacy programs to reach out to consumers, investors, overseas Filipino workers and their beneficiaries, to help expand their investment options and ensure their economic future.