Rafael Buenaventura: Deepening domestic financial reforms

Speech by Mr Rafael Buenaventura, Governor of Bangko Sentral ng Pilipinas (Central Bank of the Philippines), at the Financial Executives Institute of the Philippines (FINEX) forum on "Deepening reforms, strengthening core values" and Induction of FINEX Officers, Makati City, 19 January 2005.

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It is my great honor and pleasure to speak before the FINEX today, a stalwart partner and moving force, in shaping our domestic financial system. Indeed, I am happy to note that your incoming president is one of our own.

Today, allow me to focus on my presentation mainly on our efforts to strengthen our financial system and develop, in particular, our domestic capital market.

It is pleasing to note that 2005 started off with a slew of very good economic data. First of all, 2004 GDP growth is expected to reach more than 6% on account of increased private consumption and exports; robust services and agriculture growth despite increased inflationary pressures in the second half of the year.

The fiscal accounts are more or less in line with program. This has prompted recent declines in the bell weather 91-day Treasury bill rate. Our dollar reserves ended at a very comfortable level US$16.1 billion, at the high end of our target range.

The positive news have spilled over to our foreign exchange market, with rates averaging now well below the PhP56/US$ mark, and to the stock exchange. Year-to-date, the PHISIX has posted an 8% growth, easily making our exchange among the top ten performing markets in the world.

However, in order to sustain all of these positive developments in the long-run, we must continue our concerted efforts in further strengthening the financial system, particularly, the development of the domestic capital market. Without this, the whole package of reforms being shepherded will not be sustainable in the future and we will constantly be in a roller-coaster ride.

A more stable and stronger financial sector ensures a more efficient mobilization of capital and resources. These are in turn channelled to the best and most productive investment activities thereby supporting higher economic growth. With a stronger domestic financial system, the economy will become more resilient in coping with negative external shocks and disturbances and less vulnerable to contagion and reduced access to international capital markets. Furthermore, monetary policy will be able to operate more efficiently as a wider array of market-based tools become available for calibrating economic activity and maintaining price stability.

A fundamental initiative of the BSP to support capital market development is the shift to inflation targeting, and the higher level of policy transparency that it requires, as basis for the conduct of our monetary policy in achieving price stability. A stable price environment is a central pillar towards securing overall macroeconomic stability, in turn a necessary pre-condition to capital market development. Although recent acceleration in inflation has been mostly supply side driven, the BSP remains very cautious with its monetary policy stance while retaining the flexibility to support economic growth. This is the usual balancing act that is the traditional measure of the mettle of a central bank. But preserving price stability is really a cooperative endeavor and the government has responded with measures to mitigate supply-side pressures through increased price monitoring of staple foodstuff, ensure supply of commodities through higher productivity in agriculture and industry, and lessening dependence to imported fuel and energy prices.

The BSP has launched major reform initiatives in the banking sector where we have direct responsibility as its supervisor. Key initiatives include strengthening corporate governance and transparency, clearing-out non-performing assets and strengthening bank balance sheets through better liability management and recapitalization, upgrading risk management standards, and improving consumer protection. Consistent with these objectives, we have been systematically aligning our regulations with key international standards such as the Basle Committee recommendations on supervisory practices and on capital adequacy, the IAS/IFRS Standards for the proper accounting and disclosure of financial transactions, OECD principles on good corporate governance. We are likewise closely consulting with our peer central banks and bank regulators to learn from their rich experiences.

These have yielded a slew of regulatory changes and others yet to come that will radically change the rules of the game for our banking industry. For the better, we are convinced. We believe that the changes will also further hasten the long overdue consolidation in our banking industry that is essential to make it stronger. The rigors of international standards and the growing presence of international level competitions will inexorably hasten the exit of weak institutions that are unwilling to reform.

The proposed amendment of the BSP Charter is a very critical element in the banking reform agenda. We are particularly seeking changes to strengthen the institutional arrangements for banking supervision that will enable us to fully comply with best international practice. The most critical changes include strengthening the basic legal protection of bank supervisors in the course of performing their official duties and improving the ability of the BSP to resolve problem banks. Without these vital amendments, we will be unable to properly enforce the reforms embedded in the regulatory changes. These are very basic arrangements that are widely adopted internationally, precisely to achieve a healthy banking system.

The BSP is likewise spearheading the initiative to establish a world-class credit information system. We have recommended a bill to congress creating such a system anchored by central credit information bureau that will have the ability to collect, consolidate, and distribute credit information to credit providers and analysts. World Bank studies and other independent studies have established that a good credit information system will significantly increase access to credit especially by small borrowers, lower credit transaction costs, lower cost of borrowing, and improve management of credit risk.

These are the two major pieces of legislation that the BSP is prioritizing in its advocacy with Congress. We hope that the FINEX collectively can help us in this effort that is so vital to strengthening the financial system.

There are other pieces of vital legislation that we should all be working closely together on to have enacted. One of these is an improved bankruptcy framework through the proposed Corporate Recovery Act. We are in critical need of a modern framework for orderly resolution of failed organizations that even-handledly settles potentially conflicting interests of borrowers and creditors. A bias for the former will lead to a weak financial system while a bias for the latter will sow the seeds of inequity and instability.

Other important pieces of legislation are oriented to furthering the development of the domestic capital market. These include the proposed RICA and PERA bills. Even more basic is the necessity to re-think the whole approach on the taxation of the various financial instruments to encourage a deep capital market that is able to offer a wide array of investment outlets catering to diverse risk preferences and investment objectives. I understand this is now the subject matter of a comprehensive study in preparation for a specific legislative proposal.

The high degree of interconnectedness of our financial system has compelled the BSP to play a more active role in developing the domestic capital market and to collaborate more closely with other financial regulators.

Let me mention a number of key initiatives. One initiative is to broaden the array of available capital market instruments such as Tier 2 Paper, LTNCDs, documented repos, structured debt, collateralized debt obligations, and credit derivatives. We have gone out of our way to overhaul our regulations to allow financial innovation but under appropriate risk management standards.

On the demand side, we have initiated a major reform of the trust business beginning with common trust funds that are being converted to a better product called the unit investment trust fund (UITF). Other managed funds are next in line primarily to create a wider domestic investor base where both sophisticated and unsophisticated investors can participate under adequate safeguards.

We are also encouraging the entry of high quality rating agencies, a critical actor in a capital market that is transparent and efficient in discovering fair prices commensurate to risk.

In the last few months, we have struggled to operationalize the fix income exchange [which FINEX and other organizations are major stakeholders] and to institutionalize an independent securities custody system that will improve investor protection, defeat market malpractices such as multiple selling of securities and undocumented transactions, and reduce systemic risk overall. Sad to say, we encountered fierce resistance from some market players and even government provider. Fortunately, that issue now appears to have been decisively resolved by the Department of Justice to allow

BSP-accredited third party custodians to finally operate. I hope all will now act with goodwill to achieve full implementation as soon as possible. We have already wasted too much time.

Why is the third party custody system so vital to the reform effort? It's really very simple. To an important extent, the root of current problems lie in the basic fact that securities already sold by dealers remain undelivered to investors and effectively stay under dealer control. By requiring delivery of securities directly to investors or their designated independent custodians, we hope to break the back of bad practices that rob our domestic capital market of its credibility to investors. The new system will also lead to greater investor empowerment by allowing them more flexibility to choose the best possible price from the market and break free from the stranglehold of potentially leonine dealer partnerships.

The financial system, being a large and complex sector, has necessitated the need for a stronger consolidated supervision mechanism among the different financial services regulators. One such initiative in this direction was the creation of the Financial Sector Forum or FSF last year. Composed of the BSP, SEC, PDIC and Insurance Commission, the FSF is currently undertaking its agenda of harmonizing supervisory and regulatory efforts, strengthening of the exchange of information among the different regulators and promotion of better consumer protection. We intend to continuously strengthen this coalition.

The road ahead for full financial system reform is indeed still long and complex. It is a historic struggle seemingly most genteel but no less tougher than military battles fought with real blood and tears. It is a struggle against entrenched interests that seek to preserve the mediocre status quo that has led our country's financial system to nowhere.

We appeal for the full support of our reform-minded financial professionals, the kind of professionals that FINEX has placed under its wing. Your authoritative and rational voices are badly needed both in advocacy for the reforms and for educating the broader public to understand the complex issues and changes. We should be working together to build an unbreakable coalition for deep reform in the financial sector.

My term, as Governor, is almost finished and there will be a major change at the Monetary Board. But I am confident that, with your support, the process of reform will march on relentlessly.

Thank you and good day!