Amando M Tetangco, Jr: Recent market volatility – implication for the Philippine economy and banking system

Remarks by Mr Amando M Tetangco, Jr, Governor of the Central Bank of the Philippines (Bangko Sentral ng Pilipinas), at the Public Hearing of Senate Committee on Banks, Manila, 29 September 2008.

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Mr. Chairman, members of the Committee, Senators. Good morning. The Bangko Sentral ng Pilipinas is thankful for the opportunity to discuss what is undoubtedly the most talked-about issue in the world today. Indeed, the international financial architecture has been irrevocably remodeled by events over the past two years. To understand what all of these events mean and to situate the Philippines in all these, it is quite important that we undertake a clinical diagnosis of what exactly has transpired and outline a roadmap, if you will, of where the drifts of change may take us.

In today's briefing Mr. Chairman, we share with your Committee our analysis, beginning with a brief discussion of the events that led to what is now euphemistically referred to as the Sub-prime mortgage crisis. After presenting the broad outline of the current turmoil, we go directly to how all these are affecting the Philippines. It is in this section, Mr. Chairman, that we reiterate our earlier pronouncements that our exposures are limited and that our hard-earned financial market stability continues. At the request of the Chairman, we have also prepared a separate short presentation of the more technical details of the typical transactions and the financial instruments involved.

The genesis of the current financial difficulties in the US market

Allow me Mr. Chairman to raise 4 themes that in our view give context to what is currently transpiring in the market – The Great Moderation, Market Psychology, Financial Innovation and Globalization. The "Great Moderation" refers to the period where there was low volatility in inflation and output. By the early part of this decade, this was supported as well by an environment of low interest rates. This is an essential development since it fueled the boom in mortgages, aided no doubt by the traditional market psychology that real estate prices – particularly housing values – would perpetually rise. The same market psychology encouraged investors to seek new avenues to enhance portfolio yields within this low interest rate environment.

The financial market responded to this by introducing so-called structured products. These instruments are designed to repackage the traditional risks related to mortgage out of the balance sheet of banks while providing newer means to handle the financing of the mortgage. These structured products were made available to a wide spectrum of investors across different jurisdictions allowing for new opportunities in a more diversified portfolio. Unfortunately, Mr. Chairman, when mortgage defaults became prevalent, the same links that diversified risks to a broader web of stakeholders are precisely the very same links through which we find some contagion effect that is now reflected by the present difficulties.

The role of information, Mr. Chairman, in all of these simply cannot be understated. When times are good, there is the overwhelming tendency to ride the bandwagon, oftentimes sacrificing the need to validate all information as prudence dictates. However, when times are bad, it is precisely the dearth of information that drives institutions and the general public towards panic.

To see this in better detail, we begin with what is arguably one of the most followed market rate, the Effective Fed Funds rate. Soon after the onset of the new millennium, the Effective Fed Funds rate was moving downwards, eventually reaching its lowest levels in the 3rd quarter of 2003. The low interest rate regime was intended to spur lending and indeed one sector that benefited was the mortgage markets.

Housing prices were experiencing a pronounced appreciation and the low interest rate regime served to further fuel a boom in mortgages. In ages past, banks simply took the tenor mismatch of short-term liabilities funding long-term assets such as mortgages. This business model however exposes the bank to considerable long-term risks. Under the Basel Accord framework – the de facto international best practice for bank supervision – these risks must be mitigated by corresponding capital charges. It is the long-term nature of the mortgage that makes it relatively "expensive" to maintain from the standpoint of allocating a fixed amount of bank capital.

The process of securitization offers an alternative since US financial institutions could take out much of the traditional mortgage-related risks from their balance sheet. Essentially, this is what occurred as housing equity loans (HELs) were securitized, providing FIs both fresh funds and balance sheet leeway to extend new loans, particularly mortgages. The securitized HELs became what is referred to as mortgage-backed securities (MBS) and, with further structuring, eventually fed into another instrument which is called Collateralized Debt Obligations or CDOs.

The conversion of mortgages into Mortgage-backed securities (MBS) and Collateralized Debt Obligations (CDOs) may seem complicated but in reality these are fairly straightforward transactions. To provide the Committee a rough schematic, we start with those who take out amortizing housing loans from banks. For the bank, this is a long-term asset which ties up resources and is prone to market and credit risks. To mitigate these risks, the bank may pool the amortizations expected from the mortgage and create a security which can be sold to investors. The coupon payment of the new security is funded by the amortizations of the housing loan. This security is referred to as the MBS and the transaction is oftentimes is handled through a Special Purpose Vehicle.

To the bank, the effect is an improvement in the asset quality of its balance sheet because the traditional mortgage risks are mitigated. Investors welcome this because it affords them another instrument that they can consider for their portfolio. The SPV earns from being a conduit while the mortgagor is unaffected because he/she has already received the proceeds from the original loan.

Taking this a step further, Collateralized Debt Obligations may also be created and likewise offered to investors. There are technical differences between CDOs and MBS but for purposes of situating the current market conditions, it is perhaps sufficient to suggest that the two instruments are similar in that they pool underlying assets and sell an instrument that represents these underlying assets.

The Effective Fed Funds rate subsequently reversed course. Housing prices also began to fall significantly and mortgage defaults began to rise. Since the home was typically the collateral of the mortgage, falling housing prices also eroded the value of the collateral supporting the loan. In the past, a loan default would have simply meant foreclosing on the home. However, since the mortgage was already "converted" into a security (MBS and CDOs) held by investors worldwide, the combination of rising mortgage defaults and falling collateral values translated into losses for the MBSs and the CDOs (either through outright defaults, missed coupon payments and loss in market value of the security).

These factors sparked the widespread dilemma that we now find ourselves in. If memory serves us right, it was in February 2007 that the term "subprime mortgage" was publicly alluded to in a disclosure by an international financial institution.

The subprime difficulties began to take explicit shape as mortgage institutions take their losses into their financial books. In April 2007, New Century Financial files for Chapter 11 protection and less than a year after, Bear Stearns is acquired with Fed support.

The Philippine situation

You may wonder Mr. Chairman what this unfortunate situation has to do with a small archipelagic economy half-way across the globe.

If they are affected, why are we? The answer to that Mr. Chairman is the realities of macro-financial economics. The funds market is indeed global; investors seek the most competitive terms without necessarily being confined within national borders while issuers are free to raise capital across different jurisdictions and under different currencies. Exchange rates are always bilateral in nature but eliminating arbitrage requires that adjustments are inevitable once bilateral rates are linked, i.e., from euro to pound to dollar to peso. On top of this, there is our longstanding economic ties with the US and this would easily manifest itself in many of our mainstream economic indicators such as the BOP (both current and financial accounts), inflation, employment and OFW remittances.

It is also important to bear in mind Mr. Chairman how innovation plays a role here. With funding markets more global than any other point in history, new products and new transactions are routinely developed to address evolving needs. We earlier provided a schematic that essentially converted housing loans from long-term illiquid assets held by banks and into marketable securities held by the investing public. Without altering the basic cash flows (i.e., the amortization of the loan), the market has altered the character of the instrument and allowed the product to be available to the public. This is intrinsic to the changes in the market landscape and as we will see later, is essential to understanding how our own banks became involved with Lehman Brothers exposures.

The extent of exposure of Philippine banks

Going to the actual exposures of Philippine based banks to Lehman Brothers, we have already stated publicly that the magnitude is roughly 0.3 percent to 0.4 percent of total assets. In other words, the extent is less than one-half of 1 percent of total assets. This marginal exposure is spread over a limited number of banks and involves transactions arising from Special Purpose Vehicles as well as the direct investment in Lehman-issued financial instruments.

Banking market remains stable

Apart from the limited exposure, we find that our market's reaction has been contained as well. The Peso, for example, depreciated when talk of Lehman's difficulties took center stage. This is evident the day after Lehman filed for bankruptcy protection as market uncertainty set in. Yet in the same vein, that uncertainty abated and the peso appreciated once the rescue plan of the US Fed and Treasury was announced.

Looking at check clearing activity for that particular week, we find no evidence of either abnormal or sharp reactions. In fact among universal and commercial banks, there was a net check deposit of roughly Php970 million on the 16th and 17th of September – the period of Lehman's filing for Chapter 11 – followed by a net check withdrawal of basically the same amount on the 18th. In effect, resources were not withdrawn on balance as a result of Lehman's difficulties and commercial/universal banks even closed the week with further additions.

Over at the interbank market, average rates remained relatively the same as well throughout the same period.

Where the market response was most evident was in the pricing of the credit risk. One can see from the chart that the EMBI+ indices, both Global and for the Philippines, rose immediately after September 16. The same pattern is evident in our 5-year Credit Default Swaps, suggesting that it became more expensive to hedge against the possibility of a

Philippine default. However, we would like to stress that those spikes have likewise abated, again once the market absorbed the information on the rescue plan.

Assessing our market landscape

What we are suggesting Mr. Chairman is that our own market's reaction has been relatively subdued despite the otherwise historic developments offshore. We attribute this to our own structural make-up specifically.

A banking system where institutions are well-capitalized relative to the risks they take on their balance sheet. Our latest Capital Adequacy Ratio (CAR) for universal and commercial banks is practically 50 percent higher than our prudential standard of 10 percent which is itself higher than the international standard of 8 percent set forth by the Basel Accord.

The continued asset clean-up of banks, accomplished through market-oriented schemes and without the use of public funds, has boosted the banking system's overall asset quality. The banking system's NPL ratio is now closer to the pre-crisis level of around 4.0 percent. Furthermore, Return to Equity continues to improve, currently at 10.8 percent as of end-2007

Investing in banking reforms

These strengths have been made possible because we have invested in previous reforms. While recognizing that change is itself difficult, we have nonetheless moved forward in putting in place a risk-based supervisory approach where minimum prudential standards are set, behavior and conduct are monitored but the day-to-day strategic & operational decisions are clearly vested on the banks in the context of their fiduciary responsibilities and their governance mandate as good corporate players. We have earlier shown the committee Mr. Chairman the capital adequacy position of our universal & commercial banks, setting the bar higher than the Basel Accord. Over and above that, we now have a core of dedicated specialists who are individually assigned to oversee specific institutions and have the technical expertise & training required for this critical function. We are instituting a new reportorial system – the FRP – that is fully compliant with International Accounting Standards. Perhaps most critically, we have regular and open discussions with our stakeholders so that issues can be thoroughly ventilated and a common understanding reached.

The broad overlying issues

All of these developments on the ground eventually mesh with the broad overlying issues. We have strengthened ourselves internally because we recognize that funding markets are irrevocably global where ups and downs necessarily cascade to everyone. The market no longer distinguishes where perturbations emanate; it only appreciates how the contagion may be transmitted. In this respect, the current problems in the United States are certainly not an isolated "US issue". There is no other stronger proof of this than the fact that various central banks have been working in concert to provide the necessary liquidity to prevent systemic dislocations. Moving forward though, information will always remain to be the key ingredient so that appropriate measures can be calibrated for differentiated difficulties. Information though is a two-way street: we will continue to oversee covered-institutions based on our risk-based supervisory framework while stakeholders need to remain faithful to the tenets of transparency and disclosure.

Macro-economic landscape

We would like to reiterate that the country's macro fundamentals remain sound and the economy has proven to be resilient. Despite a general slowdown worldwide and skyrocketing oil prices, we continue to generate growth. Our inflation numbers have indeed moved upwards and we recognize the difficulties that this brings. However, based on present commodity market conditions, we may soon see some relief. Our international reserves continue to rise, reaching $36.7 Billion as of end-August. This represents 6 months worth of imports and the payments of goods and services, doubling our previous norm. And considering all the external volatilities, our Balance of Payments position still shows encouraging news with a surplus of $2 Billion after the first 8 months. All these Mr. Chairman auger well for us.

The Bangko Sentral ng Pilipinas fully appreciates the historic implications of the most recent shock but we also note the very marginal exposures from our end. The good news then is not only the limited exposures but perhaps more so that it validates our prior collective investments in macro-financial reforms. This could only suggest that the financial stability that we have achieved can be expected to further continue.

Legislative landscape

On this note, we thank the Senate for its support and the passage of the PERA and CISA bills. These are essential tools as we move further in developing the capital market and institutionalizing credit information.

If there is a lesson from the current turmoil though, it must certainly be that markets are constantly evolving and that prudential oversight must likewise keep in step. Given the vast array of possible influences that bear upon market conditions, the general public must be afforded greater protection which is itself possible through more effective means of supervision. With the support of the Senate, we would like to move forward on existing proposals so that we can effectively institute the principle of consolidated supervision. Among others, the market conditions provide a compelling reason to consider the regulator's ability to direct existing shareholders to infuse additional capital, accept new investors or consolidate with qualified financial institutions when deemed necessary. This pro-active move would certainly minimize potential resolution costs. These, as well as others, are provided for in the proposed amendments to Republic Act No. 7653. Other legislative initiatives such as the Corporate Recovery Act, the Payments System Act and the Collective Investment Schemes Law are also essential in our on-going efforts to strengthen our market as well as in the light of the current market issues.

Mr. Chairman, the Bangko Sentral ng Pilipinas thanks you, the Committee and the Senate for this opportunity to provide our views and analysis on the issues at hand. We trust that we have comprehensively addressed your concerns and we look forward to our continuing collaboration to ensure that our financial market sustains its development.