Amando M Tetangco, Jr: Financial stability through collaboration and understanding

Speech by Mr Amando M Tetangco, Jr, Governor of the Central Bank of the Philippines (Bangko Sentral ng Pilipinas), at the Insurance Congress of Developing Countries (ICDC) 2009, Makati City, 25 March 2009.

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Atty. Eduardo Malinis, Insurance Commissioner and Chairman of the Organizing Committee of the Insurance Congress of Developing Countries 2009, other distinguished speakers, distinguished delegates to this Insurance Congress, ladies and gentlemen, good morning.

To our visiting delegates, Welcome to Manila! Welcome to the Philippines! I hope you've had or you will have the chance to partake of the many options to help further "stimulate" our domestic economy. I am sure all of us in this room have heard about the different financial stability and fiscal stimulus packages, being pursued by economies across the globe, to help stem the impact of the current global financial and economic crisis. I am certain the organizers of ICDC Manila 2009 have also put together their "own" version of a post-meeting stimulus package to complement the many interesting conference breakout sessions. For my part, I'd like to encourage all of you to participate as actively in that endeavor as you would in the different sessions in the next three days.

Let me begin my remarks this morning by thanking Commissioner Ed Malinis and the Congress organizers for inviting me to speak before you today. At first blush, the keynote message for a gathering of insurers to be delivered by the governor of a central bank that supervises only the banking sector, may be a bit peculiar. But if one seriously looks at the situation, it is indeed quite reflective of the theme of the Congress, which is Financial Stability through Collaboration and Understanding.

Ladies and gentlemen, at no other time than now has the need for promoting financial stability been more imperative. As we are all keenly aware, the current financial turmoil has gone beyond the borders of the epicenter of the financial crisis – the US and the major economies – and has reached the shores of emerging markets. More importantly, the global financial turmoil has transcended the bounds of the financial realm and has crossed over to the real sector of most economies, including several represented here today.

You will be pleased to know that my remarks this morning will be brief. I only have two messages that I wish to bring across, in light of our desire for financial stability. First is that, information efficiency must be created and maintained among financial regulators. As we have witnessed in this current crisis, the lines delineating the financial institutions that make up the financial system have become at times blurred, making improved collaboration among financial regulators exigent. Second, there must be a conscious effort among regulators to devote more resources to the regulation of the conduct of business. There is often the temptation during a large-scale (global) crisis, such the one we are in at the moment, to speak only about systemically important institutions. Ladies and gentlemen, I believe we must be careful not to forget the public that ultimately we serve. We must remember that the financial sophistication of the investing public may not necessarily coincide with the pace of financial innovation. This creates a gap that could result in the public not fully appreciating the products and new structures that they are investing in, thereby unduly exposing them to risk.

I. The need for information efficiency

In discussing my first point, which is the need for information efficiency, I'd like to highlight two recent developments in the global financial markets. First, the convergence among

different types of financial institutions. And second, the convergence in the framework for financial regulation and supervision.

A. Convergence among different types of financial institutions

The financial crisis in the US, as we now understand it, is partly explained by the relatively loose regulation of entities heavily involved in financial innovation, including the oversight of the sale of these products to the wider public. Financial markets have developed in recent years so that the same financial products are sold across different financial sub-sectors – from banks to insurance companies, to securities firms, with several cross-combinations thereof. In addition, the emergence (through common ownership) of financial conglomerates that encompass the different types of financial institutions has eroded the long-standing barriers that kept these business lines apart. With these changes, it has become important that financial regulators clearly understand the mechanisms for passing on of risks among these different sub-sectors.

Let me illustrate. The distress certain insurance companies currently face can be directly traced to their exposure to risks that originated in the banking system, including structured products and derivatives whose underlying assets were sub-prime mortgages. This further highlights the fact that the risks to financial soundness of insurance firms may now also arise from the asset side of their balance sheets, a clear departure from the traditional insurance firm risk management practice that focused exclusively on the underwriting risks associated with insurance liabilities.

Indeed, the barriers that used to separate the analysis of risks in different lines of business have slowly been breaking down.

To give you another example, unlike in their old (standard) business models, banks are now paying more attention to the adequacy of pricing risk exposures so as to at least cover expected losses. In many business models, this is called the probability function for loss given default. Curiously, this is central to and is a long-standing practice among insurance firms.

As we are now able to appreciate, this product and financial structure convergence has been driven by financial liberalization and advances in information and financial technology. Developments in risk management and in valuation methodologies also helped to heighten convergence. These factors nurtured convergence, particularly during the extended low-interest rate environment – referred to as The Great Moderation – when market participants sought to enhance yield and “offload” or spread risk.

B. Convergence in the framework of prudential regulation and supervision

A second major development in the financial market, which makes information efficiency among regulators urgent, is the convergence in the framework of prudential regulation and supervision. Just as in banking, for instance, a set of core principles now lays out the broad prudential framework in insurance too. The International Association of Insurance Supervisors (IAIS) has released just two weeks ago an Issues Paper on Group-Wide Solvency Assessment and Supervision. This sets out the future IAIS work on the development of a comprehensive suite of supervisory papers on group-wide solvency assessment and supervision. One could look at this as the international insurance industry’s version of the capital adequacy framework under Basel II for banks.

It is not only, however, the framework for prudential regulation and supervision that has converged. At the national level (counting over 30 countries now), there has also been a physical convergence of the different financial supervisory bodies – more specifically the establishment of “integrated supervisors” (i.e., supervisors that are responsible for at least two (2) types of financial institutions).

Internationally though, the convergence has not really been physical but only intellectual, with the creation of the Joint Forum. The Joint Forum is composed of international financial supervisory organizations, namely, the Basel Committee on Banking Supervision (BCBS), the International Organization of Securities Commissions (IOSCO), and the IAIS. The Forum has been performing a valuable role in identifying differences in prudential arrangements across sectors and in considering the ever larger set of issues of common interest across the different supervisory communities.

C. The Philippine case

In the Philippines, we do not have an integrated supervisor for the financial system although, as I will explain later, there are existing collaborative arrangements among the different financial supervisory agencies in order to achieve our goal of a stable financial system. Supervision of the Philippine financial system follows a "silo" approach, i.e., each supervisory agency is responsible for supervision of a certain segment of the system – (1) the Bangko Sentral ng Pilipinas (BSP) for banks and quasi-banks, their financial allied subsidiaries and affiliates; non stock savings and loan associations, and pawnshops; (2) the Securities and Exchange Commission (SEC) for investment houses, financing companies, securities dealers/brokers, investment companies, and pre-need companies; and (3) the Insurance Commission (IC) for insurance and reinsurance companies, insurance brokers, and mutual benefit associations.

While the BSP supervises the largest financial groups holding the bulk of the financial system's resources, in some instances, the existing mandates of the three supervisory agencies result in overlaps in supervisory jurisdictions. These overlaps are, however, remedied by our continuous collaborative efforts. Most notable of these collaborative efforts is the establishment in 2004 of the Financial Sector Forum (FSF), which is similar to the Joint Forum but only on a national scale. The FSF is comprised of the three supervisory agencies – the BSP, the SEC and the IC – together with the Philippine Deposit Insurance Corporation (PDIC). The members of the FSF are the heads of the four member agencies, with the BSP Governor as the Chair. FSF is essentially a cooperative effort without any legal mandate lest it be construed as being an integrated supervisory body.

A quick survey among the participants in this Congress will show that there is no clearly identifiable single optimal model for supervision. There are motivations commonly cited for establishing consolidated supervision, although no standard has been established for its design. These motivations include 1) regulatory consistency and coordination to harmonize rules and standards, 2) the difficulty that hybrid financial instruments and presence of financial conglomerates pose to separate regulators, and 3) the value of economies of scale given limited financial and human resources.

What is evident in all discussions, however, is the need to share information efficiently, regardless of the form of supervision structure present in the economy. Ladies and gentlemen, what is incumbent among financial supervisors in order to facilitate and strengthen financial stability at this time, is to create and maintain an information sharing structure that will allow all to react swiftly and preemptively to changes in the operating environment. This will certainly help prevent the occurrence of a crisis of the magnitude and breadth we're seeing today.

II. Conduct of business supervision

Let me now move on to my second message which, I believe is an issue that is of particular interest to developing countries.

One characteristic of developing countries is the relatively weaker financial sophistication of their consumers, which makes the customers quite vulnerable to financial scams, including relatively simple ones. I believe therefore that financial supervision in developing countries

should not only focus on setting prudential standards, but also on strengthening conduct of business oversight of financial institutions (i.e., supervision of the business practices, including dealings with customers). The increased globalization of the financial industry presents a further complication as globalization improves the availability of and access to complex financial products across developing countries, without necessarily discriminating among levels of sophistication of the target markets.

Ensuring that financial institutions conduct their business in a proper and transparent manner should therefore be a primary concern for financial supervisors in developing countries. Failure to ensure proper business conduct by financial institutions would have adverse implications on market confidence, which, in turn, could threaten the viability of the financial markets as source of funds that could support the productive capacity of the economy.

This point could not be more apparent in the developments in the global financial markets we are witnessing right now. The fallout from the global financial crisis left many investors in financial products with substantial losses, and exposed some investment schemes as economically unsound if not totally fraudulent. The immediate impact was the weakening of confidence in financial markets, which played a key role in stoking the crisis. Restoring market confidence through conduct of business supervision is therefore essential in order to restore the smooth functioning of financial markets.

In the Philippines, financial supervisors, independently and in collaboration with the Financial Sector Forum, have already undertaken initiatives and issued rules to improve the conduct of business by financial institutions, especially those relating to complex products and services. The BSP, for instance, came out with circulars requiring banks and trust entities to take a more pro-active responsibility in marketing their derivative and trust products by conducting client suitability tests. Under these rules, the bank/trustee shall perform a client profiling process under the general principles on client suitability assessment to guide the client in choosing investment outlets that are best suited to his objectives, risk tolerance, preferences and experience. In addition, the BSP has tightened disclosure requirements covering the interest structure on credit cards, fees paid on loans and deposits, and the management and custody fees for trust funds. The FSF, for its part, has also intensified the release of advisories against fraudulent and unsound corporate financial practices.

Concluding remarks

Ladies and gentlemen, allow me to conclude my remarks this morning by recapping my two points.

The increasing convergence of the different types of financial institutions and financial products calls for closer collaboration among the different financial supervisory agencies or units in order to ensure financial stability. For the developing countries, however, another important issue is the refocusing of financial supervision to include not only the oversight role of supervisors in the safety and soundness of financial institutions, but also the oversight role of supervisors in the conduct of business of these institutions.

I trust that these would be food for thought among you, as you consider the many different issues that surround financial stability during these very difficult and challenging times.

I wish you all a productive and meaningful Congress.

Thank you very much for your attention, and good day.