# Rafael Buenaventura: Laying the foundation for a progressive financial system

Speech by Mr Rafael Buenaventura, Governor of Bangko Sentral ng Pilipinas (Central Bank of the Philippines), at The Asset Forum, ASEAN Capital Markets Forum Series, Makati City, 20 October 2004.

*   *   *

Ladies and gentlemen, good morning.

## Introduction

We are indebted to the Asset Magazine, headed by its dynamic editor-in-chief, Mr.. Danny Yu, for organizing this forum on Philippine capital markets. This is an issue that should be high in our agenda for reform. Clearly it is critical for the government to immediately deal with a looming fiscal crisis but that should not distract us from the equally important task of accelerating the development of the domestic capital market. Indeed, these two reforms are closely linked. Fiscal stability is an important precondition to financial system stability. A well developed capital market enhances flexibility in fiscal management.

## BSP agenda

The BSP, as the monetary authority and supervisor of the banking system, is firmly committed to the prioritization of domestic capital market development. First, well-functioning financial markets support the more effective conduct of monetary policy that is key to achievement of price stability. Second, a robust domestic capital market complements the banking system in financial intermediation and can even relieve pressure especially during times of crises by providing alternative means of financing to the economy. Third, the banking system has greater flexibility in managing and re-distributing its risks via the capital market particularly through securitization and hedging.

An even more basic reason is the need to improve on the current low domestic saving rate. According to comparative data from ADB as of 2003, the gross domestic saving rate in the Philippines was only 20.1% of GDP compared with Hong Kong (31.6%), Thailand (33.1%), Malaysia (42.9%) and Singapore (46.7%). Even Indonesia is slightly higher at 21.5%. A low domestic saving rate is a basic constraint to achieving higher levels of investment needed to support a faster pace of economic growth. To promote savings, the Philippine financial market needs to offer a broader array of financial instruments beyond bank deposits and equity.

We are particularly keen on seeing the faster development of the domestic debt market. As of 2003, total outstanding domestic bonds accounted for just around 40 percent of GDP, compared with 85 percent for bank assets and 69 percent for equity. Most of these bonds are in the form of government securities. In developed countries, where capital markets are deep, the bond market size ranged from 88 percent of GDP in Euroland and 151 percent in the united states.

## Our initiatives

The BSP's most fundamental contribution to the development of financial markets is fully consistent with its primary mission - price stability. A low and stable inflation environment is a major factor that supports a healthy financial system that is less vulnerable to crises. Under our inflation targeting framework adopted since 2002, headline inflation is being kept within the 4-5 percent range. This range may be temporarily breached due to intense supply side pressures such as what we are seeing today due to abnormal oil markets, but we expect inflation to eventually revert to within the target range.

However, we realize that achieving price stability is not enough if we are to help fast track capital market development. More direct action is necessary. In this regard, our initiatives include advocacy of better corporate governance and transparency, widening of investor base, and promotion of sound market infrastructure.

We are championing better corporate governance and financial transparency so that investors will have more confidence in placing their funds and have more reliable financial information to guide their judgments. Although our natural starting point has been the banking system, the impact goes well beyond that as banks themselves enforce better standards of governance in their corporate clients that prepare them for the capital market.

In the same vein, we are demanding higher standards of conduct from external auditors so that reliable financial statements can be properly enforced. We are complementing the governance initiative by developing a program to promote improved financial literacy so that investors can impose proper market discipline.

You will also note that we have been enforcing more stringently mark-to-market regulations and looking at their further strengthening. Our aim is not just to improve financial transparency but also to promote more active secondary market trading.

In a further move to improve financial transparency, we are also gearing towards aligning local financial accounting standards with the International Accounting Standards (IAS). We are optimistic that adopting the standards will help promote fairness, accuracy and transparency in the financial statements of banks and other supervised institutions. This would help in strengthening market discipline, encouraging sound risk management practices, and stimulating the domestic capital market.

Other related initiatives aimed at improving transparency in the financial markets include the nurturing of domestic credit rating agencies and the establishment of a unified credit bureau. We expect to have the latter to be up and running by mid-2005.

A major project being implemented currently is the institutionalization of a system of independent securities custodians. This is primarily aimed at protecting investors from fraudulent acts of multiple securities sales and to discourage undocumented transactions. More positively, the custodian system will support the eventual growth of securities borrowing and lending that will help promote market liquidity.

We have systematically tightened prudential and risk management standards. This will definitely strengthen the banking system. In the process, risk-based capital requirements based on the Basle framework have stimulated the issuance of tier 2 subordinated debt as part of the recapitalization process. Down the road, as the stock market recovers, banks should be issuing more equity to bolster tier 1 capital.

We intend to bring the banking system in compliance with Basle 2 by 2007. In preparation, we are now requiring universal and commercial banks to formally set up a minimum internal credit risk rating system for the underwriting and ongoing administration of corporate credit exposures. This is embodied in Circular No. 439 which also requires that in rating corporate clients, banks use only financial statements audited by sec-accredited external auditors.

Moreover, in quick succession, we have issued tougher standards on the management of large exposures, on single borrower limits, and on DOSRI lending. These will likely spur corporate borrowers to diversify their funding sources beyond the usual friendly banks and in the direction of the capital market.

But not all regulatory initiatives have been towards tightening. We have also introduced changes to remove obstacles to capital market development and create opportunities for banks with respect to capital market related business. These include selective lowering of reserve requirements for repo transactions that meet certain standards as well as for other financial products. Over the medium-term, we hope to effect a phased generalized lowering of reserve requirements to be more competitive with low reserve requirement regimes found in most other countries.

We have likewise allowed the introduction of new and innovative financial instruments in the domestic market, including complex structured products under appropriate regulatory arrangements.

Recently, we have launched an initiative to reform the common trust fund (CTF) and replace it with a better product called the unit investment trust fund (UITF). It will be better in the sense that its assets will be marked-to-market daily so that investors will not be misled as to the real performance of their investments. These should avoid any residual risks to the bank as asset manager. As an investment product, UITFs will be more competitive as it will no longer be subject to reserve requirements as these are no longer effectively considered as deposit substitutes. We expect UITFs to eventually evolve into major institutional investors in the capital market competing against mutual funds and other collective investment schemes.

We are also intensifying our coordination efforts with other financial regulators so that we can achieve a more level regulatory playing field. In July 2004, a Memorandum of Agreement was signed by the BSP, the Securities and Exchange Commission (SEC), the Insurance Commission (IC) and the Philippine Deposit Insurance Corporation (PDIC) to formally establish a Financial Sector Forum (FSF). This further enhances coordination arrangements among the concerned agencies, particularly with regard to more effective supervision of financial conglomerates, to information exchange, and to consumer protection.

Aside from developing a more conducive regulatory environment, we are helping develop appropriate market infrastructure. In this regard, we are strongly supporting the private sector initiative, led by the BAP, to establish the fixed income exchange and its related infrastructure to ensure efficient and safe clearing and settlement of securities transactions.

Finally, our reform initiatives are benefiting from the support of Congress which has decisively acted on certain vital pieces of legislation including the elimination of DST on secondary trading, the SPV Law and the Asset Securitization Law. All of these measures will help spur the domestic capital market. The BSP has worked hard with other interested partners to get these laws enacted and we will continue to do so for other pending legislation that support capital market development.

Although much progress has already been made, the work is still far from over. The BSP will continue to push for more reforms in the financial system, specifically: (1) a special legislation to support a strong credit reporting system; (2) the enactment of a more balanced bankruptcy resolution framework; and (3) the enactment of the proposed changes to the BSP Charter to strengthen our ability to clean up the banking system and properly enforce prudential standards.

We particularly attach great importance to the amendment of the BSP Charter. Unless we are able to properly police the banking system with sufficient powers, we will be constantly plagued by a vulnerable banking system. A vulnerable banking system will not be responsive to our financing needs. And because banks play important roles in support of the capital market whether as investors, underwriters, managers, market makers, issuers and guarantors, a weak banking system will also hamper their development of the domestic capital market.

## Conclusion

The financial sector reform agenda is a truly major task. We need to move boldly across a broad front. Neither the BSP nor the government as a whole can do the job alone. We need to work together, the public and the private sector, to build a truly progressive financial system.

Thank you very much. I hope my remarks will stimulate a lively discussion that should move us to action.