Amando M Tetangco, Jr: Assessment of the thrift banking system

Keynote address by Mr Amando M Tetangco, Jr, Governor of the Central Bank of the Philippines, at the Annual National Convention of the Chamber of Thrift Banks, Baguio City, 17 March 2006.

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Good morning!

I send my warmest greetings and congratulations to the membership of the Chamber of Thrift Banks (CTB) on the occasion of your National Convention, the high point of the annual celebration of the Thrift Banking Week.

You have chosen the theme of responding to the challenges ahead. As both banking supervisor and monetary authority, we welcome your cooperative and constructive approach to the many issues confronting the banking system. Indeed, we continue to face many challenges ahead even as we have also made considerable progress.

Assessment of the thrift banking system

As I survey the thrift banking system today, I believe it has proven its resilience in the face of all the many challenges.

In 2005, total resources of the industry grew by a very respectable 13.3 percent. Deposit level also continued to post double-digit growth of 16.8 percent, indicating strong confidence in the industry.

Meanwhile, the industry remained adequately capitalized with capital adequacy ratio (CAR) averaging at 16.8 percent as of end-June 2005. This is well above the prescribed minimum ratio of 10 percent and more than double the international benchmark of 8 percent.

Non-performing loans (NPL) ratio favorably declined to 8.9 percent as of end-December 2005 from 11.0 percent last year and from a peak of 13.4 percent at end-September 2002. Likewise, NPA ratio went down to 12.5 percent from 15.9 percent last year.

The industry's strengthening balance sheet also reflected a steady increase in the loss provisioning for bad assets. The industry posted a better NPA coverage ratio of 23.4 percent at end-December 2005 from 17.2 percent the previous year. However, this is still much lower than the 42.1 percent total NPA coverage ratio in universal/commercial banks. The whole banking industry should actually be striving for at least 50 percent coverage. And the best way to do that is to rapidly get rid of your remaining non-performing assets that continue to impose a drag on your performance. Indeed, your profitability remained marginal with return on equity and return on assets ratios at just 0.2 percent and 0.03 percent, respectively. As an industry, thrift banks continued to be the least profitable.

BSP reform agenda

The BSP is determined to pursue a banking reform agenda to shield the banking system against critical threats that may undermine its stability and integrity.

Specifically, we are intensifying the reform process aimed at addressing core aspects of banking operations and enhancing the regulatory framework for the effective conduct of banking supervision.

First of all, we must bear in mind that high NPAs are a fundamental threat to the safety and soundness of the banking system. We must therefore act decisively to remove this threat.

So far, we have been successful in trimming down the stock of NPAs in the banking system especially through asset disposition under the Special Purpose Vehicle Law (SPV) Law. Consequently, both NPL and NPA ratios of the banking system are currently at record lows.

The imminent approval of a two-year extension of the SPV Law by congress will boost the momentum for further disposal of banks' NPAs. I hope the industry will now more aggressively utilize this opportunity. This is the last chance.

In a related development, the Monetary Board (MB) also recently approved the guidelines that would allow banks to enter into Joint Venture Agreements (JVA) with property developers to provide an additional channel for banks to reduce their NPA holdings by helping convert bad assets into readily marketable or income producing assets.

However, to prevent abuses, certain safeguards were adopted. In the first place, all JVAs under the program are subject to prior MB approval. Only pre-existing non-performing assets are eligible under the program to guard against potential moral hazard. Banks are also prohibited from providing funds to the joint venture either as a loan or capital contribution. However, banks may extend financing to JV partners or to buyers on arms length commercial basis. Lastly, banks are not allowed to recognize income out of the properties they contributed to the joint venture regardless of the agreed valuation of said properties in the JVA. They are only allowed to recognize income upon receipt of the proceeds from the sale of the developed properties. Proper accounting is also required.

Moving on, we also continue to seek closer alignment of existing regulations with international standards to make regulatory policies more responsive to the growing competitiveness and sophistication of the financial services industry.

In particular, we are focusing on strengthening corporate governance, risk management, and capital adequacy in our banks. This will be complemented with effective and efficient enforcement.

In pursuit of this objective, we have recently issued major regulations covering:

- The new Financial Reporting Package (FRP);
- The guidelines on supervision by risk;
- The guidelines on information technology (IT) risk management; and
- The amendments to the fit and proper rule
- The prompt corrective action framework.

The new FRP effectively amends the Manual of Accounts (MOA) and revises the reportorial requirements for banks, in accordance with the provisions of the new Philippine Financial Reporting Standards (PFRS)/Philippine Accounting Standards (PAS). To the extent possible, we have also integrated into the new FRP the requirements of the Basel 2 Capital Adequacy Framework. The new FRP will greatly promote an enhanced level of financial transparency and also facilitate an enhanced off-site surveillance of banks and other financial institutions under our jurisdiction.

Banks are constantly exposed to various risks because of the increasingly complex financial setting. Rather than constrain product innovation and operational flexibility, we would rather espouse the adoption of appropriate internal risk management mechanisms to ensure that banks and other financial institutions continue to operate in a safe and sound manner. It is for this purpose that we have set out the guidelines on supervision by risks under Circular No. 510. Mainly, these guidelines specify BSP's expectations on how banks and other financial institutions should manage their risks. These are also designed to provide guidance on how the risk-focused supervision will be applied to these risks.

Meanwhile, the guidelines on I.T. risk management are intended to communicate to the banking industry BSP's expectations on how technology-related risks should be viewed in the context of bank risk management. We all know how pervasive information technology has become in our banking business. These guidelines will aid in effectively identifying, measuring, monitoring and controlling banks' technology risk exposure.

Building on previous initiatives to raise corporate governance standards, we recently came out with a stricter "fit and proper rule" encompassing all directors and senior officers of banks. This is to ensure that officials tasked to manage banks and other financial institutions possess the integrity and competence required for the job.

Very recently, the monetary board approved the Prompt Corrective Action (or PCA) framework. This basically communicates to the industry how the BSP will deal with potential problems in bank operations at a very early stage hopefully to forestall more serious problems from arising that would necessitate more drastic and painful measures. The key triggers for the initiation of PCA include substandard capital adequacy ratios and poor Camels performance. Whenever PCA is initiated, banks will be required to put forward an action plan to immediately correct the situation. The action plan will be in a memorandum of understanding to be executed between the bank board of directors and the BSP.

To promote healthy competition in the banking system and allow your greater flexibility to respond to market opportunities, we have also allowed the partial lifting of the moratorium on bank branching primarily to facilitate the expansion of financial services in underserved areas.

Likewise, we have opened up outsourcing possibilities and allowed an increasingly wide array of treasury, consumer and wealth management products.

All told, you can expect many more meaningful changes in the banking industry this year and in the coming years as we gear up for the full adoption of international best practices. I hope you will not see the recent changes as just more rules to cramp your style. On the contrary, by shifting to more strategic regulation of corporate governance, risk management, and capital adequacy, we hope to give banks much greater flexibility to pursue businesses that are consistent with their skill, risk appetite, and capital position. Banks that are well-managed and well-capitalized will be fully liberated to pursue their corporate objectives in this evolving environment. In contrast, banks that are poorly run and undercapitalized will find themselves severely under pressure both from the market and the regulator.

We are also continuing our advocacy efforts in Congress for the passage of key legislative measures. Among others, we are seeking approval of the amendments to the BSP Charter which will make the BSP a more effective monetary authority and banking regulator. Another vital piece of legislation is the Credit Information System Act which will pave the way for the establishment of a truly comprehensive credit information system in the country. This is expected to lower the cost of credit, provide greater access to credit in general, and reduce the dependency on collateral-based lending.

Taking the long view, what is the significance behind all these developments in the banking system? How are they going to affect the thrift banking industry?

Essentially, these developments would alter the overall banking landscape. The change will be influenced mainly by the accelerated consolidation process in the banking system that is expected to take place within the next 3 years as a result of a combination of regulatory enhancements and the exacting standards posed by an increasingly complex financial environment.

The enhanced competition would naturally favor the stronger, more capable banks and financial institutions. On the other hand, the smaller banks would do well to harness their core expertise in order to better serve their respective market niches.

The highly global and complex banking scenario leaves no room for complacency for all banking industry players. To survive, thrift banks must enhance their financial strength, conform to sound corporate governance practices and boost their competitive advantage by honing excellence in specific target markets.

Concluding remarks

I would like to end my keynote speech by calling on all member institutions of the chamber to remain supportive of our policies and reform initiatives. The reform agenda that I have outlined to you today is a work in progress.

In the past, you have taken a proactive role in the pursuit of genuine reforms in the thrift banking system. Now is the time to reaffirm that commitment. There is a lot of work ahead of us, but with vision to guide us and with steadfast action, we can be assured of success in achieving our shared goal of building a stronger, more competitive banking system.

Thank you very much and more power to all of you!