

Amando M Tetangco, Jr: Trust reforms – positioning the business for growth

Speech by Mr Amando M Tetangco, Jr, Governor of the Central Bank of the Philippines (Bangko Sentral ng Pilipinas), at the First General Membership Meeting of the Trust Officers Association of the Philippines (TOAP) for the year 2007, Manila, 30 March 2007.

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Distinguished directors and members of the Trust Officers Association of the Philippines; fellow bankers, special guests, friends. Good evening.

The invitation of TOAP President Ma. Lourdes de Vera declared that you are adopting the Hawaiian theme tonight. I was also advised that if I chose to come in my usual business attire, I will be given a lei.

Naturally, I became curious.

I remembered this wise woman who said: When a man brings his wife flowers for no reason, ... there's a reason.

Tonight, you chose to bring the full bloom of flowers to this ballroom. Clearly, this is a celebration!

Well ..., if the practitioners in our trust and fund management industry are celebrating, then we at the Bangko Sentral are here to congratulate you.

TOAP has been ... and continues to be... a dependable partner of the Bangko Sentral in promoting the development of our financial system...and in upgrading the quality and variety of financial services to the public.

This is the reason why I readily accepted your invitation for me to join you in your first general membership meeting this year. In particular, I appreciate the fact that our trust practitioners specifically requested that I discuss banking reforms as they relate to the trust industry.

But first, I shall give you an overview, so that you can appreciate the context of our reform agenda.

Economic prospects and financial stability

We are all witnessing a markedly more positive sentiment on our economy as manifested in higher investment flows from abroad into both direct equity and portfolio securities. Not surprisingly, domestic investor activity has likewise perked up. These developments have re-energized our domestic financial markets.

To a major extent, the phenomenon is being driven by global liquidity conditions, relatively benign global capital markets and generally stable world economic conditions. These factors have made international investors more willing to look at a broader array of investment opportunities, outside of the traditional favorites.

But it is also true that smart money does not get into markets if the fundamentals are not right. So, what are the positive things that investors are seeing in the Philippines today?

Well, you and I know that foremost of these is the sea-change in our fiscal management. Fiscal discipline, prudence and political will....have made a fiscal turnaround possible and a balanced budget attainable within two years.

Investors also appreciate our ability to keep the lid on inflation and maintain expectations well anchored....even in the face of challenges posed by volatile oil prices, unpredictable weather conditions affecting food supply, and periodic shifts in global market sentiment.

Already, headline inflation has dropped to less than 3 percent, boosting our credibility to achieve our medium-term inflation targets in a consistent manner.

The significant strides in micro-level structural reforms have also not gone unnoticed in such critical sectors as power, transport and communications, agriculture, and of course, services including banking and financial services.

In banking, much progress has been made to clean up the stock of non-performing assets that built up since the 1997 Asian financial crisis.... and banks have stepped up the pace in their re-capitalization efforts.

Operational improvements have likewise been introduced to strengthen risk management processes and to achieve more efficient operations. As a result, domestic bank balance sheets are stronger than they have ever been since 1997 and profitability has been restored.

All of these developments are generating a positive chemistry that goes hand-in-hand with windfall gains from our ever-growing remittance flows and robust merchandise exports.

This combination has resulted in unprecedented surplus in both the current account and overall balance of payments, record-setting international reserve levels, and.... external debt pre-payments.

If we continue to play our cards right, I believe there is a good chance that we can sustain this happy convergence.

For BSP, the emerging challenge to monetary management and prudential supervision is the steady delivery of financial stability, even as domestic liquidity growth may temporarily accelerate under benign fundamentals that we now have.

We realize that the economy itself is undergoing structural change. Therefore, we are conscious that our policy reaction should not be dogmatic.

The financial community that watches every move of the BSP must understand this evolving dynamic, carefully analyze the situation, and not irrationally contribute to any potential instability.

Having said that, there are guideposts that remain clear. One is the principle of avoiding conditions of prolonged negative real interest rates that distort investment and consumption signals. The BSP is very focused on this issue and is committed to adjust its policy settings, its instruments, and its tactics with agility..... as circumstances warrant.

I hope these general remarks on emerging economic prospects and the challenges they pose to BSP.... are useful to your own decision-making processes.

As professional managers and advisers to the public on the management of their steadily growing stock of financial savings, you play critical economic roles, in your own right.

As interest rates moderate to lower level equilibrium, they will be in search of alternative ideas with acceptable return.... versus risk profile.

This is apparent in the way deposits have grown vis-à-vis trust accounts in the last five years: a growth rate of 47% for trust accounts versus 61% for deposits. As of end-2006, banks reported P3.8 trillion deposits liabilities vs. P860 billion trust accountabilities.

In that sensitive role, you share the responsibility to educate the investing public on the nature of their potential choices and to uphold the integrity and stability of our evolving domestic financial markets. After all, this is the ultimate foundation of investor confidence in these markets.

This brings me to the subject of the reform agenda that we believe can move the trust industry to even greater heights.... and allow it to take its rightful place in our financial system.

The harsh lessons of the bond and equity market sell-off in May 2006 that hit hard UITFs should not be so readily forgotten. Yes....there has been significant recovery since then, for those who held their ground as markets rebounded as expected,.... but it cannot be denied that investors who panicked got hurt from that unfortunate episode.

On hindsight, the initial rapid expansion of UITFs amid the exuberance of the time....swept in investors who were not prepared for the higher attendant risks that are the natural corollary of higher returns.

Yes, all the essential warnings were there both in regulations and in customer documents that were duly signed. But it is equally clear, we still have some work to do in weaning "investors" from a depositor mind set and form more realistic expectations....if we are to develop the domestic capital market as the second major pillar of our financial system.

Recent developments make us more confident of a bright future for our domestic capital market and the important role to be played by the trust industry. This includes the final approval by Congress of the long-awaited PERA bill which provides generous tax incentives to encourage individuals to

voluntarily set-aside long-term savings: up to a maximum of P50,000 per year over their working life, up to at least age 55 to supplement their retirement income.

This is a great opportunity and challenge for the trust industry to design product choices that conform faithfully to the laudable objective of this new law.

Further, the improving economic prospects also set the stage for progressive liberalization of our foreign exchange regime to allow for greater flexibility in overseas investing. This should provide professional fund managers the necessary room to maneuver the diversification of their portfolios and to access a richer variety of qualified assets.... for the benefit of their customers.

Ladies and gentlemen. The reform agenda must be pursued vigorously.... if we are to secure the opportunities. At the financial market level, the BSP is closely collaborating with key market players through their respective industry associations, as well as with our fellow regulators particularly the SEC.....to achieve more transparent and investor-friendly markets.

It is in this context, that we welcome the recent launch of the new government securities benchmark system that can promote fair price discovery, more effectively. We expect the trust industry to work within this new system so we can achieve full transparency and comparability of performance.

The new benchmark should also assist in properly valuing debt securities and other financial products like derivatives, repos, as well as securities borrowing and lending arrangements... and thus promote their acceptability to the market.

As the galaxy of available domestic capital market assets expands and the market deepens....it is the trust industry that will be a clear winner.

We are also working hard to constantly improve the payments and securities settlement systems. It is basic that we aspire to fully achieve efficient DVP settlement in all securities transactions.... in line with global standards in the area. This is critical to both investor protection and market stability.

We also need to work closely to reform the trust industry itself. In that spirit, we are devoting dedicated resources at the Bangko Sentral... through our newly formed trust supervision group...to work closely with TOAP. Their priorities include (1) basic trust department operating standards; (2) risk management guidelines; (3) trust department rating system; (4) specialized examination procedures; and (5) improvements to UITF regulations.

At a more fundamental level, we are also reviewing the basic governance arrangements of the trust department....as an entity within the bigger banking organization....to minimize potential conflicts of interest, while preserving natural business synergies.

This includes a closer look at the composition of the trust committee and a clearer articulation of their duties and responsibilities for good governance. Also in scope are the qualifications of trust officers and the proper definition of their duties and responsibilities.

The basic operating standards are designed to ensure consistency in the administration and operation of trust and other fiduciary business and investment management activities to better promote investor protection. The standards cover significant areas of trust operations and set forth the minimum array of procedures – from account acceptance to termination, aimed at further professionalizing business conduct across all practitioners.

On the other hand, the risk management guidelines will be formulated to identify, manage, and control specific risks in the trust business. In tandem with the basic standards, the risk management guidelines will enjoin trust entities' total adherence to the cardinal principles of prudence and utmost care.

A rating system for the trust unit... analogous to the CAMELS rating system for bank proper....is being formulated to independently assess their performance, given their special fiduciary responsibilities.

To tie everything up, new specialized examination procedures are being drafted for trust operations.... to basically align these with the risk-based approach and to incorporate compliance with the basic standards and risk management principles.

Finally, the UITF regulatory framework will be reinforced to cover the following: (1) improved certification program for UIT marketing personnel; (2) additional guidelines to standardize UIT performance reporting for marketing purposes; (3) enhanced risk disclosures and client suitability profiling; (4) updating of major template documents like the declaration of trust to incorporate amendments to the regulatory framework; and (5) corporate governance structure of UITs such as the

possible separation of trustee and fund manager functions or alternatively, the strengthening of present combined function arrangement....as these matters have evolved in global best practice.

Ladies and gentlemen. All these trust reforms are building blocks that should help us nurture a truly competitive and dynamic trust industry that is responsive and supportive of a growing economy. This we owe to our country and our people.

Let us therefore take heart that even as we continue to face challenges...the opportunities ahead give much promise, especially to those who will adhere faithfully to the tenets of good governance. Remember: fairness, accountability and transparency.

On this upbeat note, I greet you all.... Aloha!

Thank you all and good evening.