Amando M Tetangco, Jr: Promoting the safety and efficiency of the financial system – a steady commitment to reforms

Speech by Mr Amando M Tetangco, Jr, Governor of the Central Bank of the Philippines (Bangko Sentral ng Pilipinas), at the International Conference on the Safety and Efficiency of the Financial System, Mandaluyong City, 27 August 2007.

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UP College of Business Administration Dean Dr. Erlinda Echanis; banking and finance educators from the University of Limoges, the University of Poitiers and the University of Birmingham, University of the Philippines; Prime Minister Virata; other distinguished members of the academe; colleagues from BSP, guests, ladies and gentlemen: A pleasant morning to all of you!

I am deeply honored to be invited to this conference and keynote the discussion on the theme, “The Safety and Efficiency of the Financial System.” But first, let me commend the conference organizers for putting together this event that touches on a broad spectrum of issues on the financial system. I would also like to give credit to the team of university professors and researchers representing the four aforementioned universities who will walk us through the various topics covered in this conference. In fact, one of them happens to be a BSPer – Ms. Thea Josefina Natalia Santos.

I would also like to acknowledge the presence of the panel of experts led by Bankers Association of the Philippines’ President Mr. Ramon Sy, UP Diliman Chancellor Dr. Sergio Cao and First Philippine Consultants, Inc. President Dr. Conchita Manabat all of whom will join us later in the session. I am certain we can look forward to a meaningful and engaging dialogue.

The promotion of the safety and efficiency of the financial system forms part of our mandate at the Bangko Sentral ng Pilipinas to uphold the integrity and stability of banks and other financial institutions that we supervise. Admittedly, this is no simple task, particularly since we have to contend with the challenges brought about by globalization which has significantly altered the course of the international financial system. To respond to this challenge, we have intensified our structural reform efforts to ensure that banks and other financial institutions continue to operate safely and efficiently.

It is this steady commitment to financial reforms that has helped contribute to a stable and resilient financial system.

The banking system, in particular, has managed to perform creditably amidst a complex and rapidly changing environment.

Performance of the banking system

In more concrete terms, key financial indicators as of end-June 2007 reflected overall soundness of the banking system.

- Bank resources sustained expansion, posting a growth of 8.6 percent to reach P4.9 trillion from the end-June 2006 level of P4.5 trillion.
- Asset expansion was underpinned by increased deposit mobilization and buildup in capital. Deposit liabilities grew by 11.0 percent to P3.6 trillion. Capital accounts, on the other hand, grew by 11.6 percent.
- The banking system’s capitalization remained more than adequate relative to international norms and the statutory floor. As of end-December 2006, the system’s capital adequacy ratio (CAR) stood at 16.9 percent on a solo basis and 18.1 percent

on a consolidated basis. These ratios are well above the BSP's 10 percent regulatory floor and the international benchmark of 8 percent.

- The banking system has achieved notable gains in cleaning up their bad assets, helping bring down the NPL ratio to 5.7 percent as of end-June 2007 from its peak of around 18 percent at end-December 2001. For universal and commercial banks, the NPL ratio was recorded at 5.2 percent. This is much closer to the pre-crisis level of about 4.0 percent.
- With a healthier balance sheet, banks have also now been able to post a steady uptick in loan growth. As of end-June 2007, total loans, gross (exclusive of interbank loans) stood at P2.0 trillion (vs. P1.9 trillion at end-June 2006) or a growth of 5.1 percent.
- Profitability is also returning to the banking system. Net income after tax (NIAT) increased by an estimated 10.2 percent for the first six months of 2007 over the same period last year. Annualized return on equity (ROE) and annualized return on assets (ROA) also recovered to a respectable 11.1 percent and 1.3 percent, respectively.

Notwithstanding its resilience and efficiency, the Philippine banking system cannot afford to be complacent and rely on these sound fundamentals alone if it is to continue to stand its ground amidst a challenging financial environment. It needs to sustain the path to reforms.

Reforms and policy directions

In the pursuit of these objectives, we will carry on with our work in the following areas: reinforce asset cleanup through asset disposition under the amended SPV Law; improve the risk management process through effective enforcement of risk-based supervision; promote better governance and market discipline; and establish an appropriate capital adequacy framework for banks.

At this point, let me give you an overview of where we are now in the reform process and what still remains to be done.

Ongoing asset cleanup

The asset cleanup process remains a priority. Here, we expect banks to unload more bad assets under the amended SPV Law.

The BSP has so far approved Certificates of Eligibility (COE) amounting to P31.7 billion SPV-related transactions under phase II of the amended SPV Law. Combined with the P97 billion worth of NPAs disposed under Phase I, this brings the total amount of NPAs sold to roughly P128.7 billion. We expect this to reach up to P200 billion.

Full implementation of risk-based supervision

We are also fostering a strengthened environment through full implementation of consolidated and risk-based supervision.

To keep pace with the increasing sophistication and complexity of the financial environment, we have directed our policy thrust toward acceptable risk management practices that enable financial industry participants to better assess and manage risks without unduly hampering the ability to innovate.

In effect, we have assumed a more liberal approach to bank supervision in the sense that we do not instruct banks to avoid risks that seem too high, which is the way traditional bank supervision is done. Instead, the approach being used is to favor assessment of the quality of risk management practices by giving banks greater flexibility to respond to changing opportunities and allowing them to take risks so long as they demonstrate the ability to manage and price for those risks.

This is being complemented with enhanced regulations on risk management as a way of developing appropriate standards suited to banks' risk-taking activities.

More recently, we have issued general guidelines on supervision by risk, setting forth the broad expectations of the BSP with respect to the conduct of risk management by financial institutions under its jurisdiction. We followed this up with the issuance of specific guidelines on technology risk management, one of many envisaged to cover strategic areas, which is aimed at ensuring effective management of technology-related risk by financial institutions. We have since come up with specific guidelines on market risk management and liquidity risk management, which set forth BSP's expectations on the management of these key risks by banks.

Another related issuance of the BSP is the strengthening of the prompt corrective action (PCA) framework. This was done to compel banks to take pre-emptive action against what may constitute as emerging threats to their financial viability and thereby, ensure that they continue to operate in a safe and sound manner. As part of the PCA framework, banks are guided to align capital with actual risk exposures, implement business improvement measures, and institute corporate governance reforms.

Corporate governance and disclosure

To complement the above initiatives, the BSP has also been keen on promoting a culture of good corporate governance in the banking system. We have correspondingly issued appropriate regulations anchored on effective corporate directorship, sound audit and compliance systems, and enhanced disclosure in financial reporting.

Shift to IFRS/IAS

A related initiative is our move toward the adoption of prescribed International Financial Reporting Standards (IFRS) and International Accounting Standards (IAS) in 2005. This was a major step that we had to take in order to firmly establish meaningful and reliable standards for financial reporting in the banking system.

With the implementation of the Philippine Financial Reporting Standards (PFRS) and the Philippine Accounting Standards (PAS), we expect to derive benefits in terms of improving the quality of financial information to be disclosed to market participants. This should contribute to enhanced risk disclosure and better market discipline in the banking system.

Risk-based capital adequacy framework

In the time that we are building on these reform initiatives, we are simultaneously working on strengthening the risk-based capital adequacy framework.

Essentially, the shift to risk-based capital adequacy framework is much more than the application of mechanical risk weighting rules. The real challenge and benefit is actually greater in motivating banks to more deeply understand their risk exposures, develop models to capture the essence of those risks, and, consequently, fine-tune their business models to manage their risks to maximize value. We expect our domestic banks to rise to this challenge, particularly now that we are implementing tougher standards under Basel II.

What makes the new Basel II-based framework even more challenging is that it will not only focus on the computation of the appropriate level of capital given a certain level of exposure, but will also underscore the need for more market disclosures by banks on their risk exposures and management practices. The required disclosures to the public of bank capital structure and risk exposures are aimed at promoting greater market discipline in line with the so-called Pillar 3 of the Basel II recommendations. This is a challenge that our banks must not underestimate.

We are maintaining the prescribed minimum CAR of 10 percent. However, consistent with Basel II recommendations, we have begun implementing major methodological revisions to the calculation of minimum capital that universal banks, commercial banks and their subsidiary banks and quasi-banks should hold against actual credit risk exposures. This significantly amends BSP Circular No. 280 dated 29 March 2001 (for banks) and BSP Circular No. 400 dated 1 September 2003 (for quasi-banks).

Meanwhile, stand-alone thrift banks, rural banks and quasi-banks will continue to be covered for now by existing regulations (i.e., Circular Nos. 280 and 400) insofar as credit risk measurement is concerned. However, we are studying enhancements to make the applicable capital regulations more attuned to Basel II principles. Moreover, the guidelines for allocating minimum capital to cover market risk (BSP Circular No. 360 dated 3 December 2002) have also been amended to some extent, primarily to align specific market risk charges on trading book assets with the revised credit risk exposure guidelines.

A completely new feature is the introduction of capital charge for operational risk. This reflects recognition of the potentially significant costs emanating from this critical risk area that actually encompasses all facets of bank operations.

Complementary reform initiatives

On other key fronts, we will also carry on with our task of fostering the development of our financial markets through support for various legislative measures, such as the enactment of the Credit Information System Act (CISA) that will be pivotal in helping establish a reliable and comprehensive credit information system in the country.

We will also continue to foster the creation of stronger and globally competitive financial institutions that can be an asset to the financial system. Lately, we have been witnessing a growing trend toward mergers and consolidations among domestic banks and we expect this to further hasten in the next two years. This is driven in part by the increasing market competition as a result of liberalization and the adoption of more stringent global standards.

However, we are not discounting the role that smaller specialist banks play in the evolving financial landscape. Definitely, we need smaller specialist players that can more effectively cover important niche markets that have their own unique needs. Under this scenario, the smaller specialist players are able to complement the services offered by bigger banks.

Simultaneous with the ongoing process of reform in the banking system, the BSP has also actively engaged in initiatives to promote a deep domestic capital market that will complement the presence of a resilient banking system by having an alternative pillar to cushion against external shocks. We have pursued cooperative efforts to (1) improve the market infrastructure, particularly the establishment of the FIE to promote efficient and transparent price discovery of debt securities, (2) enhance securities and payment settlement mechanism to achieve DVP/PVP, (3) develop securities borrowing and lending and repo markets to deepen GS market, (4) develop the domestic derivatives market especially for interest rate, currency and credit products to support risk management, and redistribution of risk to those best able to bear them.

Final note

I have just presented to you the essential items in the comprehensive financial reform package.

The BSP will continue to take a proactive role in the pursuit of genuine reforms that will reduce vulnerability of the financial system in these complex times and contribute to the overall financial health of the country.

As pillars in the academe, you help build the foundation for excellence and integrity. I challenge you to let this spirit transcend to the community outside your own sphere. The academic community can make significant contributions in this area, not just in training (which is of course very important) but also in research and mass advocacy to broaden financial literacy. A key target for literacy are directors who serve in the boards of banks and other FIs. It is important that the culture of risk management be institutionalized at embraced at the corporate governance level. This means going beyond regulatory compliance and willingly embracing risk management principles as a value-creating and value-preserving undertaking just as important as earning profits.

With your continuing support and that of the other reform-minded professionals in the industry, we can collectively address the most fundamental challenge of achieving and maintaining a strong domestic financial system that can effectively respond to the demands of the times.

Thank you!