Amando M Tetangco, Jr: Recent market developments – impact on the Philippine banking and finance sector

Speech by Mr Amando M Tetangco, Jr, Governor of the Central Bank of the Philippines (Bangko Sentral ng Pilipinas), at the Joint Membership Meeting of MART, TOAP, ACI and IHAP, Makati City, 3 October 2008.

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Distinguished officers and members of the Money Market Association of the Philippines (MART), Trust Officers Association of the Philippines (TOAP), Association Cambiste Internationale (ACI) Philippines, the Financial Markets Association, Investment House Association of the Philippines (IHAP), esteemed guests, ladies and gentlemen, good evening.

Thank you for inviting me to be your guest speaker at tonight's joint general membership meeting. It's always good to engage the prime movers of the country's financial markets in an open discussion such as this. But especially during these times of great financial turmoil in major markets overseas. I would certainly welcome the questions and your comments during the open forum after my brief talk. As you are well aware, the BSP's approach to supervision and reform has always been consultative.

About the same time last year, if you recall, I was also your guest speaker at your general membership meeting. At that time, I spoke about the increase in global liquidity and the temptations that it introduced. I alluded to the changing nature of financial risk and how in this era of financial globalization, risks have transcended national borders. I also said that the international rules of the game are changing.

Ah... the time we live in is indeed interesting, isn't it? The rules of the game are further evolving. This time around, there seems to be a crunch in global dollar liquidity as the US market has rapidly de-leveraged. And events are showing that the magnitude of financial risks that have crossed national borders has been beyond most market participants' and regulators' expectations. Stunningly, we are witnessing rapid turnover in some of the marquee names in the global financial stage.

In fact, the market developments are moving so fast that the observations that I will be sharing with you tonight are not the same as those that I would have shared with you, had I delivered my talk on Tuesday as was originally scheduled.

But I want to assure all of you here tonight, that my overarching message remains the same – that is,

- First, our financial system is fundamentally sound and relatively insulated given its more largely domestic orientation,
- Second, our exposure to the troubled foreign financial institutions is minimal and quite manageable from a capital and liquidity standpoint, and
- Third, our past investments in banking and other financial reforms have helped shield us from catastrophic fallouts that the other jurisdictions have seen.

How did I come to these conclusions? Let me quickly run through the following points with you: a) What has just happened? b) How's our banking system faring? c) Is our macro stability sustainable? d) What are the BSP's thrusts going forward?

I. Recent market developments

We are all in the market, although coming from different perspectives, so I won't delve too much into the details of the events since mid-September. We have all witnessed that our domestic markets have followed, albeit somewhat mutedly, the movements in the global financial markets. What is interesting to note, however, is that our markets' reactions have at times merely been "knee-jerk". On quite a few days over the last 2 weeks, we saw the peso and the stock market, for instance, recovering most of any day's trading losses by the close of the day's trading session.

What I would like to highlight with you, is this – "The rules of the game are changing."

1) Financial markets have become very closely interrelated allowing for contagion to be easier and speedier;

2) The financial transactions that we thought would diversify risk may be the very same ones that have led to unhealthy risk concentrations;

3) Information is most critical, when you are least mindful of it ; and

4) As much as many would not want to believe it, regulation and markets must coexist – the trick is to craft good regulations that would allow markets to work.

Financial integration has allowed the movement across borders not only of goods but also of funds. The funds market has indeed become global. Yield-seeking by investors as well as capital raising activities of users of funds ceased to be confined to their own borders because of globalization. So called "securitization structures" have made it easier to transfer traditional on-books risks of banks to off-books accounts, therefore freeing up capital which allowed banks to lend more. "Structured products" have also allowed the enhancing of yield on traditional investment instruments. With these financial innovations, the objectives of the investors and the users of funds were therefore seemingly "happily married". But alas, the party has abruptly ended and the music has stopped playing.

In the flurry of these financial innovations, the value of transparency seemed to have been understated or even casually brushed aside. And as the market in the US was largely deregulated, the market grew larger and larger.

Some are predicting that what we may see, as an aftermath of this turmoil, is a highly concentrated and increasingly regulated financial system in the major economies. Policy makers and regulators in emerging markets, including in the Philippines, will then have to evaluate their own market structures to see how they can best position themselves in this changing environment.

II. The Philippine banking system

Against the backdrop of recent events, how have our banks fared?

You have heard me say that our banks' collective exposure to the failed Lehman Brothers was 0.3-0.4 percent of the banking system's total assets. We hope that there will be no other Lehman's type problems down the road, and this seems to be a fair hope given that US and even European authorities have now boldly stepped in to rescue the other large and potentially systemic financial institutions in their jurisdictions. Nonetheless, our latest survey of banks shows the exposure of Philippine banks to potentially "at risk" international financial institutions is only around 1 percent of total assets at most. And this level of exposure by a few banks is definitely well within the ability of these banks to absorb should they become actual losses given their strong capital base and liquidity.

Our monitoring of banks' activities continues to reveal no abnormal actions by or against banks. In addition, the interbank market continues to function in an orderly manner given fairly stressed global conditions. Where we have seen some "friction" is in the swap market, possibly in step with tightness in global dollar liquidity. But as I understand it, that has abated in the last couple of trading days.

Ladies and gentlemen, our banking system remains fundamentally sound. Capital is still well above both the BSP 10% minimum prudential requirement and the BIS standard of 8%. Asset quality is as close to the lowest level seen since the Asian Crisis as it has ever been. Return on equity has also been improving. And there is ample liquidity system-wide.

This stable banking system has been critical in underpinning a stable macroeconomic environment. And sustained stability in our macroeconomic environment in the last few years has also avoided the build up of dangerous imbalances that could have led our banking system astray.

III. Macroeconomic stability

Now, a question that may be in your minds is this – Is the macroeconomic stability that we have so far enjoyed in danger, given the global financial turmoil further threatening world economic growth?

You can't have a more direct question than that, can you? Well, I will also try to be as forthright. As you aware, we have lowered our growth expectations to a range of 4.4 to 4.9 percent. I believe that given the unfolding environment, such a range would still be decent.

On inflation, our base scenario for a hump-shaped inflation path remains. The inflation peak may be nearing, if we haven't yet seen it. After that, we see some leveling off, then entry into single digit territory by Q1 2009. Now, if the downtrend in global oil and non-oil commodity prices is sustained, we should see the leveling off period shorter, and inflation being within the target range before the end of 2009.

We are cognizant that the global slowdown could further weaken our exports but possibly tempered by lower oil prices and other commodity imports. Remittances actually are very strong and above forecasts so far, but they may also be eventually affected. Prolonged risk aversion could also change the direction of capital flows. However, we are also keenly aware that the global economies are not all slowing down at the same rate. In addition, not all the economies are seen to grind to a halt. There will continue to be opportunities for growth. There will always be value investors, given all the liquidity that will have been shored up because of the ensuing "clean up" in the financial turmoil. We are thus expectant that markets such as the Middle East and China will be resilient. We see these markets as taking up much of the slack that will be created by the slowdown in the US and Europe. We therefore still consider our $2 billion BOP surplus target this year as reasonable and doable.

Given all these and as we sustain the reform effort, I believe our macroeconomy stands an excellent chance of maintaining its stable course.

IV. BSP thrusts going forward

What can you expect from the BSP going forward? We will remain focused on our mandate of price stability. We believe that inflation at manageable levels is essential to ensuring sustainable economic growth.

We will maintain our policy of a market-determined exchange rate, with official action only to keep volatilities at bay. We will stick to the policies that have allowed us to sustain a strong external position.

We will continue to review our banking reform agenda. The banking system strength that we have seen thus far has been made possible by the reforms that we have put in place. We will continue to enhance risk management standards, improve corporate governance and accelerate compliance with Basel 2 principles.

The recent events in the financial markets highlight the critical importance of efficient price discovery, transparency and investor protection. In line with this, our issuance of regulations aimed at further broadening the array of financial products available in the market will continue to include a review of existing rules to ensure that appropriate risk disclosure and client suitability procedures are in place for new risk-taking activities.

In addition, the BSP will continue to work together with the private sector and other government agencies to further enhance both the infrastructure and the regulatory framework for capital market transactions to further promote efficiency in trading, settlement and delivery of government securities.

Finally, we will pursue our legislative agenda. As you must be aware, the Credit Information System Act and the Personal Equity and Retirement Account Act have both recently been approved. These are two very important pieces of legislation, particularly as we face the challenges brought about the current financial turmoil. The CISA will help address the lack of comprehensive and credible credit-related information. This will in turn improve access to credit and reduce its cost. PERA, on the other hand, is expected to promote voluntary savings and therewith provide a new base for stepping up capital market development. It is also expected to be complementary to our public pension system.

The BSP will continue to work with Congress on key legislation that would further enhance protection for investors, improve BSP's oversight capabilities and minimize costs of resolutions.

Concluding remarks

Ladies and gentlemen, the challenges that we face are enormous. Although much has already been revealed in terms of the problem areas of the global financial market turmoil, we are very much aware that more could be forthcoming.

I said earlier, "the rules of the game are changing". Fortunately, at the UAAP, the rules have not changed, the best still prevails. I can almost hear some of you say underneath your breaths – if indeed that is the case, then we should "throw the playbook out the window." My advice to all of you – instead of doing that, be watchful. At this critical point, it is more important that we remain focused on the strategy and the reform agenda that have so far allowed us to be resilient.

On the part of the BSP, we will remain vigilant in our assessment of developments. We will ensure that we are flexible to promptly and decisively take action when necessary. We will be forthright in our communication to our stakeholders.

To steer the market from a further and deeper impact of this turmoil, the BSP continues to look to the active cooperation and support of all of you in the market. As they say, we are in this game together. I take note of the passionate and unwavering support pledged here by all the associations present tonight. In order for all of us to finish the course we laid out, we must work together as a team.

Magandang gabi po sa inyo, at maraming salamat. Mabuhay tayong lahat!