Amando M Tetangco, Jr: Managing risks in a financial stability world – how different is this prudential world?

Speech by Mr Amando M Tetangco, Jr, Governor of Bangko Sentral ng Pilipinas (the central bank of the Philippines), at the Joint General Assembly of ACI Phils, FMAP, IHAP, MART, NASBI and TOAP, Makati City, 19 September 2012.

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The Officers and Members of ACI Phils led by Coco Martin, FMAP led by Mike Ferrer, IHAP led by Manny Tordesillas, MART led by Raul Victor Tan, NASBI led by Roderick Dones, and TOAP led by Raffy Ayuste, colleagues from the BSP, ladies and gentlemen, good evening.

It is a pleasure to be joining here tonight six (6) organizations… Since your last General Membership Meeting, I am told two organizations have been added to the Meeting. In other words, the "Clan" has gotten bigger.

Among your six organizations, you cover a very broad spectrum of the market activities which we oversee… from the cash market, to the foreign exchange market, to securities underwriting and brokering and then to trust.

This gathering is impressive for its sheer breadth of operating interests, all falling under the purview of the banking regulator…This Assembly therefore presents a unique opportunity for the BSP to share its views with several different organizations at the same time. I would therefore like to thank you for the invitation.

The operating environment

As I have done for a few years now during your General Membership Meeting, I shall begin my remarks by touching on our targets and expectations over our policy horizon.

If you attended our Mid-Year Economic Briefing last Monday (17 September) at the PICC, I think you would agree with me that, as in the immediately preceding Economic Briefing hosted by the BSP-IRO, the public's interest in our economy is palpable. The excitement about our economic prospects remains high. The presenters on the government side were optimistic, while the reactors on the private sector side were upbeat.

Our current growth rate is already at the doorstep of the National Government's announced real GDP growth target for 2013 of 6–7 pct…Inflation is expected to be benign with the targets for headline inflation still set at 3–5 pct through 2014… The country's external position is seen to remain robust. In fact, our current BOP and GIR are already at levels where they are forecast to be by 2013, if not higher.

Indeed, it would seem that the economic policies and reforms we have invested in over the years are converging towards solid high economic performance…But, in taking all these in, we need to be prudent… Let us not overvalue these better prospects lest we become complacent… You in the markets, of all, are most familiar with the still fragile global environment we operate in.

Over the past two weeks, both the ECB and the Fed announced new asset purchase programs – the OMT (although with some conditionality) and the QE3…Central bankers do know how to use acronyms also, don't we? Both of these were much awaited by the market…both seemingly open-ended… both signalling prolonged easy monetary policy in the advanced economies…And, your reaction has so far been, as expected… To take on added risk, as layers of policy uncertainty are peeled away.

At the BSP, we are watchful of these developments. If these programs still don't produce the desired effects on growth and unemployment in the US and Europe, the risks are clearly to the downside. Of particular concern to us is the adverse feedback loop between the financial sector and the real sector due to 1) the interlocking sovereign debt and banking crisis in the euro zone…2) the overhang of the fiscal cliff in the US, and…3) the softening Chinese economy.

The 2007/08 financial crisis graphically illustrated to us that this feedback loop can be very strong and could take a non-trivial length of time to unwind…It also taught us that although focus on price stability is necessary, it is not a sufficient condition to protect economic growth… Furthermore, we should remember the lesson that looking only at the health of individual financial entities would not safeguard the system as a whole…Indeed, the recent crisis has taught us many things – but most importantly, it taught us that policies to ensure monetary stability and financial stability must go hand in hand.

I know that when market players listen to a speech from the BSP Governor, you have your radars up, hoping to hear "directionals"… On the peso you hope to hear about where the peso is going. Have we hit the top yet?... On interest rates, you hope to hear where these are headed. Have we hit the bottom yet?... Are we at the top? bottom? Is the BSP holding steady?... These are important concerns, of course, because where the peso is and where interest rates are, feed directly and quite concretely into the everyday lives of Filipinos.

But, I don't have to speak about directionals tonight… Everyday you come across some quote from me on these financial prices… So I am certain you already know the stance of the BSP… One, that, the exchange rate will remain market-determined… although, Folks, be very aware that the BSP is watching how you conduct yourselves in the market… Two, that the policy interest rates will always primarily be dictated by the inflation outlook…but balanced off against concerns on excesses in other segments in the market such as real assets and capital flows.

You know that our current assessment is – that inflation over the policy horizon will remain well within our target range of 3–5 percent. You must also know that the implication of this on interest rates is that interest rates will remain low over this period.

Many of you already have a good handle on how the BSP conducts monetary policy and our exchange rate policy. I can say that we have had some success in communicating monetary policy to the market. But we still need to work on conveying the nuances when it comes to financial stability.

So, instead of one-dimensional directionals, I would like us to spend the next few minutes discussing financial stability.

In the BSP, we believe it is important to pursue financial stability because financial stability makes the transmission of other policies (including monetary policy) more effective… Moreover, we pursue it because financial stability helps financial institutions better allocate resources. When the risk/return tradeoffs are known and steady, returns are more "predictable" even when the risks are relatively higher. In other words, financial stability benefits both the policy makers and the market.

So what's new about financial stability?

The original draft of this speech contained the BSP financial stability framework…Our definition of financial stability…The governance framework in the BSP…And how we are pushing the agenda to go past the BSP borders.

But in the interest of time, let me just focus on a couple of points (well, five points to be precise) to help you better appreciate what we mean in the BSP when we talk about financial stability, and hopefully along the way, this discussion will help you also understand what all these mean for you and the institutions you represent.

Let me begin with capital. The BSP is now more "focused" on capital adequacy – but from the perspective of strengthening the ability of capital to absorb losses. Lest I be misunderstood, I want to emphasize that our regulations in the past were never just simply about exacting compliance to a specific ratio. What is different today is the focus. Now the goal is to make capital more efficient in mitigating potential losses from the type of bailouts we saw in other jurisdictions. Today, we are (in a sense) being "stricter" about what goes (or does not go) into both the numerator and the denominator of that ratio. By doing this, we are broadening the risks that are accounted for by such capital. This is the BSP view on CAR from a financial stability perspective.

The CAR should not keep only your compliance officer awake at night… It should concern everyone here, including you who are in the confines of your trading rooms…. Ladies and gentlemen, the types of transactions and risks you can undertake will now be defined by the amount and kind of capital your institutions have… But you already know that… from the example of the 15pct risk weight on NDF.

It is this kind of policy framework that drives the new regulations we have been putting out… And this is my second point…We now view regulation using the "systemic" lens. After the additional NDF risk weight, you must have noted that the BSP has become more visibly concerned with issues that have systemic implications. These are reflected in, among others, the refinements to SDA trading, which have been intended to contain possible carry trades funding SDAs, and initiatives to improve reporting on real estate exposures, which are expected to ensure that all possible exposures are contained in the net and accounted for in the limits set.

These reforms are some of the most recent that we put out… but many more lie ahead – from the money market to the capital market and to the derivative market. Some in the pipeline are 1) defining the benchmark yield curve so that pricing is transparent and independent of one large market participant's rejections (I meant actions) in the auction market, 2) awakening the moribund repo markets so that liquidity is improved and one-sided quotes will be a thing of the past, 3) standardizing OTC derivatives so that structured products would have more legs to stand on, and 4) obtaining the components of shadow banking so that the unregulated activities are brought to the surface.

While I am listing forthcoming reforms, let me also share with you that there are talks in the regulatory circle that consumer protection will be elevated to a core banking function and not simply an advocacy… You should keep this in mind because when this happens, it would materially impact your product development, disclosure practices and marketing efforts, on one hand, and trading and settlement infrastructure, on the other.

This brings me to my third point. Market infrastructure … The perennial elephant in the room… Friends, new international guidelines are being introduced. Let me rattle off a few more acronyms. I am afraid it's not only central bankers who love acronyms. Regulators have an even bigger penchant for these!… CSDs (for central securities depositories), SSS (for securities settlement systems), CCPs (for central counterparties) and TRs (for trade repositories). I am not saying BSP will take all these in…. But once these guidelines are in place, we will have to consider how we can adopt these best practice guidelines to our domestic operating context. I assure you, the BSP will be consultative in rolling out the guidelines... but at the same time, the BSP will not allow parochial motivations to cloud what is best for the market and financial stability.

Moving on to my fourth point… In considering financial stability, the BSP has pushed changes in the financial governance framework so it starts with the financial institution itself. I realize this point may seem at odds with what I just said about parochial motivations…. But having solid governance structures in the banks would precisely help the institution veer away from such insular thinking.

Governance was never meant to be the reactive function of the regulator. Our recently released revised compliance framework highlights the accountability of banks with actions and processes that they undertake. We have also just issued the new corporate governance and risk management guidelines for trusts (I am told the latter had undergone considerable discussion and coordination…Is this is indicative of how tough Trust practitioners are?)

Finally, it would be a serious oversight if I do not touch on the monetary policy aspects of financial stability. Our calibration of monetary policy rates is towards price stability but it clearly will have real economy implications. In addition, the interest rate benchmarks that monetary policy sets will directly impact the cost of leverage and the volume of credit exposures. Obviously, the use of one policy lever (in this case, policy interest rates) would not always be able to address – at the same time – two policy objectives (price stability vs. financial stability) without conflict. Hence, the use of enhanced policy tool kit and policy coordination are imperative.

To operationalize all these at the BSP, we have recently created the BSP Financial Stability Committee (or FSComm) in addition to the BSP Advisory Committee (which recommends monetary policy to the Monetary Board).

From the five items I enumerated earlier, it is clear that financial stability crosses the three pillars of central banking. To close that "divide", the FSComm is set at the highest level at the BSP, with the main committee manned by the three deputy governors and 3 of the most senior officers of the BSP… I have the pleasure of directly overseeing this committee.

Closing remarks: market conduct ensures reform success

I have given you some of the guideposts, or mile markers on the road to financial stability – as we see it in the BSP.

The BSP can put out regulations and create the enabling regulatory environment… but, after everything is said and done, it is the market that will execute transactions.

A wise man once warned that when dealing with the market, one should anticipate that it is not so much about the destination, as it is about the ride itself. Financial targets tell us where we want to go but it is risk-taking and risk management that get us there. No doubt, the ride can be enjoyable and give you a high, but if you don't manage the risks well, then you – dragging everyone else with you – might end up in one big traffic jam, if not in the gutter.

Ladies and gentlemen, I am not about to ask everyone here – for lack of a better term – to "behave"… As Michael Corleone said to Sonny, "It's not personal, it's strictly business."

Acceptable behaviour is a given because that is what collective responsibility requires. And our collective responsibility are prudential concerns. Turned on its head, prudential concerns are our collective responsibility because the gains (as well as the losses) are always shared.

This applies as much to the cash market, to the foreign exchange market, to securities underwriting and brokering, to trusts and other fiduciary activities and certainly to banking.

I therefore ask the organizations and institutions here tonight, let us effectively partner with one another because... the stakes are far too great for the bottom line of any single balance sheet… the stakes far outweigh the high of the ride.…

Ladies and gentlemen, we are in this together.