

Deepening and Diversifying the Financial System

A vulnerable banking sector and an underdeveloped domestic corporate bond market are undermining the sustained expansion in credit necessary for attaining a higher level of economic growth. The issues and options relating to ensuring market integrity, limiting systemic risks, and diversifying choices for investors, savers, and borrowers have been well identified and extensively reported. The challenge, though, is to implement a systematic and coordinated implementation of actions that translate recommendations into concrete results.

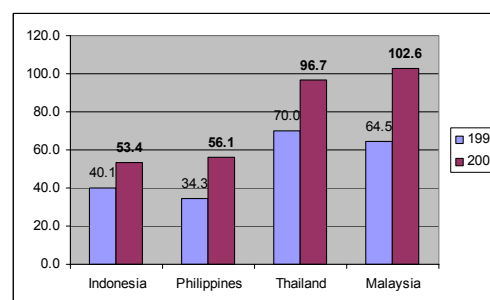
Background

The Philippines financial sector is underdeveloped compared to other countries in the region. The depth of the financial system—as indicated by the ratio of broad money (M2) to GDP—remains low relative to others in the region (see figure 1). Despite a significant increase during the 1990s, this ratio currently stands at around 56%, comparable to Indonesia but significantly below the level of around 100% for Thailand and Malaysia. The ratio of total assets of the banking system to GDP in the Philippines is among the lowest in East Asia.¹ Non-bank, market-based financing also remains underdeveloped. Corporate bonds, for example, account for only 2% of GDP, compared to 10% and 30% for Thailand and Malaysia, respectively. The underdeveloped financial system is likely to be an important reason contributing to the Philippines' lower propensity to invest and its poorer growth performance.

The banking system, which dominates the financial sector, also remains fragile. The ratio of distressed assets stood at 27% at the end of 2003.² Authorities have been taking measures to address these problems. The Bangko Sentral ng Pilipinas (BSP) began implementing Bank of International Settlements (BIS) capital standards in 2001

and requiring banks to report their accounts on a consolidated basis since 2001. Provisioning requirements were tightened in 2002 with banks required to reappraise foreclosed assets every two years. The Special Purpose Vehicle (SPV) Act was passed in 2003 to facilitate the removal of nonperforming assets from bank balance sheets. However, much remains to be done to strengthen the supervisory and regulatory regime to address the fragilities present in the banking system. This task is complicated by the inadequate legal protection provided to regulators and supervisors and the fact that financial intermediaries are often part of larger conglomerate structures. Measures are also needed to develop bond markets to reduce the dependence on bank financing and lay down the longer term foundations for a deepened and diversified financial system.

Figure 1 – Financial depth – M2:GDP in selected countries



Source: IMF International Financial Statistics database

¹ Economist Intelligence Unit, Philippines Country Profile 2003.

² BSP

Issues

The banking system continues to be fragile and is ineffective in its intermediation role, despite efforts at overhauling the legislative and regulatory framework.

Drop in bank lending. Lending from banks has been stagnant and the ratio of total gross commercial bank loans to GDP dropped from nearly 65% in 1997 to around 40% in 2003.³ The intermediation capacity of the banking system remains constrained by a high level of nonperforming assets, insufficient provisioning, and a low capital base. Because of this, banks prefer holding government paper to seeking out viable lending propositions in the private nonfinancial sectors. This is in sharp contrast to other countries within the region where determined and concerted efforts to resolve the problems on bank balance sheets stemming from the Asian crisis is now leading to a resumption of bank lending to the real sectors of the economy. These concerns are reflected in the negative outlook assigned by international credit rating agencies for Philippine banks.

Slow progress in resolving nonperforming loans (NPLs) and distressed assets. Notwithstanding the Special Purpose Vehicle Act, which provides tax breaks and other incentives to encourage financial institutions to clear their books of bad assets, progress in disposing of the stock of distressed assets has been minimal. The large pricing gap on these assets between banks and investors has made banks reluctant to accept large losses from selling off these assets. Insufficient regulatory pressure and continuing ad hoc forbearance on the part of regulators have also muted incentives for banks to restructure their balance sheets. Both stem to a great extent from inadequate protection for bank supervisors and weaknesses in the powers of the regulatory authorities to intervene.

Weak fiscal position. The Government has limited fiscal headroom to deal with a banking crisis or recapitalize the banking system using public funds. Liquidity support already provided through the Philippine Development Insurance Corporation (PDIC) and BSP is high and has increased significantly recently. Such support is unsustainable given mounting concerns about the Government's debt position and its contingent liabilities. At the same time, private financing to support bank restructuring has not been forthcoming on account of political uncertainties, insufficient incentives, and an inadequate regulatory framework. Thus it is urgent that immediate efforts are mounted by the regulatory authorities to strengthen the banking system so as to forestall any increase in fragility in the banking system, with its attendant negative economic consequences.

The bond market is weak and does not serve as an alternative to commercial bank financing, but a meaningful domestic market for corporate bonds is still years away. Other weaknesses include a lack of investors, most notably large domestic commercially driven institutions; a lack of appropriate issuers; and a weak market infrastructure.

Miniscule corporate bond market. The domestic bond market is heavily dominated by government debt. As of mid-2003, corporate bonds outstanding were less than 2% of GDP, while government bonds outstanding were around 21% of GDP. This is in sharp contrast to, e.g., Malaysia and Thailand, where corporate bonds outstanding were 30% and 10%, respectively. The range of nongovernmental debt instruments available to investors is limited, largely explained by the small size and low credit quality of most corporate issuers. The development of a healthy mortgage securities market has been hampered by the predominance of subsidized lending by special tax and pension funds.

³ BSP data

Weak market infrastructure. The network of primary dealers to make markets is inadequate, while settlement systems for bonds remain expensive and risky. The absence of bid and offer price quotations makes the price discovery function of the secondary market inefficient. The repurchase (or repo) market—to facilitate funding and liquidity management of market participants—remains underdeveloped as a result of the lack of a legal framework and tax issues.⁴ Limitations in regulations, including disclosure requirements and supervision, have discouraged the development of financial derivatives markets, which market participants could use to hedge their interest rate, foreign exchange, and credit risks. Generally, the market infrastructure needs strengthening to improve liquidity and transparency.

Contractual savings institutions have a muted role in fostering financial system efficiency. This stems from an inadequate supervisory framework and the weak financial position of these institutions. Sections of the pre-needs industry are in distress, and despite their relatively small size could lead to a crisis of confidence in the financial system. Also, as discussed in the Pension Funds policy brief, the state-run pension programs are in serious financial difficulties. Unlike the case in many Latin American countries, for example, the pension institutions have not served as catalysts in the process of financial system deepening and discipline.

Recommendations

The first and immediate priority is to facilitate bank balance sheet restructuring by implementing and strengthening reforms relating to supervision and NPL restructuring. There are a number of reasons to give highest priority to banking

⁴ For example, whether the repo transaction is deemed to be a secured loan or a sale (and repurchase) of the securities has income and capital gains tax implications.

sector reforms. First, the banking system, as the single largest component of the financial system, is currently and is likely to continue being the main source of finance to the private sector. Thus, it needs to be made more efficient and capable of lending to a broad range of entrepreneurs. Second, a strong and competitive banking system is, often, the basis for a robust domestic corporate debt market. Third, the general reform credibility of the Government largely hinges on demonstrating progress in reforming the banking system. Both domestically and internationally, there is a perception of growing problems in the Philippine banking system. This is undermining investor confidence.

Various reports, including the Financial Sector Assessment Program report jointly prepared by the International Monetary Fund and the World Bank, have recommended a number of actions to strengthen the banking sector. Immediate reform priorities include:

Strengthening the prompt corrective action framework for handling distressed institutions quickly. One critical weak link is the ability and independence of supervisors and regulators to enforce remedial measures on banks without fear of undue legal prosecution of supervisors and senior management of BSP and PDIC. Legislative amendments relating to the PDIC charter have recently been approved. The BSP charter amendments addressing these weaknesses and making them relatively less vulnerable to immediate political pressures need to be enacted and put into effective force immediately. They would go a long way in increasing incentives and pressures on bank managers and owners to take steps to strengthen their capital base and tackle NPLs as well as in facilitating a fast transition to consolidated supervision under a risk based framework. Limiting the use of frivolous temporary restraining orders to delay regulatory enforcement also needs to be addressed urgently. In this context the supervisory authorities may wish to learn

from the experience of countries such as Korea, Malaysia, and India where reforms were introduced limiting the capacity of vested interests to use the judicial system to delay enforcement efforts.

Strengthening the effectiveness of the SPV Act with supporting and complementary legislation—the Corporate Recovery Bill and the Securitization Bill. This will facilitate private financing and takeout of distressed assets. The costly and uncertain process of restructuring distressed assets and loan recoveries currently hinders the effectiveness of the SPV Act. This compels private financiers to demand a steep discount on the purchase price of distressed assets. Banks, on the other hand, are unwilling to offer such discounts because it would weaken their balance sheets and profitability. A sound bankruptcy and reorganization framework could reduce the gap between the bid and offer prices. Enactment of the Corporate Recovery Bill, which aims to provide an improved reorganization framework and mechanism for debt resolution and debt workout, could facilitate the needed restructuring.

Expediting passage of the Securitization Bill. A well-defined securitization framework would facilitate restructuring because it would permit asset management companies to fund their acquisition of distressed assets via capital markets and institutional investors—pension funds, insurance companies, and mutual funds. In this context it may be useful to learn from the experience of India where mutually reinforcing legislation introduced as a package—the equivalent of a combined SPV and Corporate Recovery and Securitization Act—enabled banks to aggressively restructure nonperforming loans and access capital market funds for restructuring. Similar comprehensive approaches were also adopted in Korea and Malaysia, and enabled the governments there to reduce somewhat the fiscal costs of banking system recapitalization.

Streamlining the respective roles of regulatory agencies, improving the coordination of the multiple financial regulatory agencies, and ensuring the consistency of the resulting regulations. Intermediaries that are often part of larger conglomerate structures dominate the financial system. This makes measurement of interconnectedness and concentration of risk complicated. There is a danger that problems within a conglomerate could spill over to its financial subsidiaries. Interconnectedness among different types of financial intermediaries also makes more difficult the task of strengthening bank balance sheets and enforcing prudential discipline because of the potential for regulatory arbitrage by taking advantage of laxer rules where possible. This argues for a substantial strengthening of consolidated supervision mechanisms via closer cooperation between the four key agencies: BSP, PDIC, Securities and Exchange Commission (SEC), and the Insurance Commission.

The second priority is to systematically develop domestic debt markets so that in the medium term, the corporate sector has access to an alternate source of finance.

Because the banking system is working its way through a process of rebuilding balance sheets, the corporate sector may need alternate sources of finance in the meantime. Further, given the short-term nature of customers' deposits, the ability of the banking system to finance a significant expansion of long-term investments in the real sectors of the economy is limited. Thus, a deep and liquid corporate bond market is essential. Alan Greenspan has noted, for example, that bond markets can act like a 'spare tire', substituting for bank lending as a source of corporate funding at times when banks' balance sheets are weak and banks are rationing credit. The challenge is to build a critical mass and diversity of issuers; broaden and deepen the investor base; improve information flows; and strengthen market making in the secondary market. The end point is a market with a high level of

liquidity that facilitates reliable and efficient price discovery. Key measures needed include:

Encouraging the use of securitization by expediting the enactment of the Securitization Law and accompanying implementing regulations. As demonstrated in other countries in East Asia, securitization can be an important tool to clean up banks' balance sheets and improve their capital ratios in a bank restructuring process. Securitization also contributes to the development of corporate bond markets by overcoming the problems of the small size and low credit quality of most issuers. When combined with credit enhancement and guarantee arrangements, the newly packaged securities can attain a credit rating high enough to meet the requirements of investment managers. Securitization, by enabling smaller firms to access capital markets, could also contribute to increasing competitive pressures on banks.⁵

Supporting the development of a mortgage-backed securities market by encouraging the immediate securitization of the housing loan portfolios of various government institutions. In the US, institutions such as Ginnie Mae, Fannie Mae, and Freddie Mac have played an important role in securitizing diversified pools of mortgages and offering them to a wide range of investors, thus creating a stable flow of financing to the housing sector. Besides supporting the public policy goal of encouraging home ownership, mortgage-backed securities are important in developing deep and liquid

⁵ The key issues in securitization that require attention are: (i) clear accounting and capital adequacy rules relating to off-balance sheet treatment of securitized assets; (ii) accounting valuation of residual assets held by originators; (iii) prudential capital held by banks and securitization companies holding different classes of asset-backed securities; (iv) a legal framework that establishes clear legal status of Special Purpose Vehicles; clarity in the assignability of receivables, and the definition of "true sale" of assets; and (v) tax neutrality.

bond markets and facilitating a stable flow of funds to the construction and housing industry. Cagamas Berhad, the National Mortgage Corporation in Malaysia, is another example of the catalytic role of mortgage markets in supporting capital market development.⁶ Therefore, it is in the Government's interest to push for the immediate securitization of the housing loan portfolios of various government institutions, such as the National Home Mortgage Finance Corporation, Pag-Ibig Provident Fund, Housing Guaranty Corporation, Social Security System, and the Government Service Insurance System. Even a modest development of mortgage-backed securities would return immediate benefits by promoting professional mortgage credit standards, inducing lenders to better manage their risks, and facilitating competitiveness among lenders by broadening the access to long-term finance to both banking and nonbanking originators. The key tasks are developing a transition strategy toward nondistortionary housing support programs; improved mortgage lending, underwriting, and servicing standards; and an effective and fast collateral foreclosure regime for mortgage creditors. An interagency working group could facilitate the process of developing a roadmap for primary and secondary mortgage market development.

Completing the process of building the necessary debt market financial infrastructure. A number of reports have examined actions required to strengthen the issuing, trading, clearance and settlement, market surveillance, and enforcement structures in Philippine debt markets. The key action points are:

- Review, discussion, and implementation of key proposals

⁶ Cagamas Berhad was established in 1986 to promote the secondary mortgage market in Malaysia. It borrows money by issuing debt securities and uses the funds to purchase housing loans from financial institutions to encourage further financing of houses.

made by the Bankers Association of the Philippines with regard to setting up a fixed-income exchange (FIE). The FIE initiative is comprehensive and covers all aspects of the market infrastructure including functioning money, repo and derivatives market. Implementing this initiative will go a long way in enabling the Philippines to develop a world-class infrastructure for financial markets operations. As part of this initiative, the BSP has approved a private-sector led company to act as custodian of government securities for the general public.

- Continue implementation of international standards and recommendations on best practices standards and recommendations on best practices and regulations (Basel II, Committee on Payments and Settlements Systems, a forum under the auspices of the Bank for International Settlements, and International Organization of Securities Commissions (IOSCO). It is vital to ensure that clearance and settlements systems are established to meet IOSCO-recommended standards and practices.
- Standardize bond contracts, underwriting standards, and clearance and settlement procedures.
- Review taxation of capital market issuances and trading and ensure tax neutrality for bond issuance and investment. Bond market development does not require tax exemptions or subsidies, only a neutral system with respect to debt decisions by companies and investment decisions by financiers. A comprehensive review of existing tax regime is required. It may also be useful to learn from the experience of Singapore and the manner in which it used tax regulations to systematically

promote issuance, underwriting, and marketing activities.

In the medium term, give high priority to the development of institutional investors. International experience shows the importance of the role played by institutional investors in the demand for corporate bonds. These institutions can provide liquidity to the bond market if regulations and financial infrastructure provide opportunities for them to trade frequently. They can also contribute to improve company corporate governance, which facilitates the development of both bond and stock markets. Lastly, they can be conduits for tapping funds from international and regional investors. In Philippines, such institutions outside the public sector are still in a nascent stage of development. Experiences from Chile and Mexico have shown that pension reforms have over a period of time played a key role in developing local bond markets. Similar reform efforts in the Philippines pension system are required (the specifics have been covered in a separate note).⁷ As regards the pre-needs industry, the key challenge is to improve the financial soundness of the industry through introduction of prescriptive actuarial standards and funding levels and establishment of adequate actuarial reserves. In the case of the insurance sector the immediate priority is adoption of a risk-based approach to supervision and empower the Insurance commission with powers to pre-empt financial distress or intervene in the event of financial disturbance or mismanagement in the affairs of an insurance company.

⁷ See note on “Pension Funds.”