

Chapter 8

Financial Sector

I. SITUATIONER

The development of the financial system is important to mobilize domestic savings and finance investments as growth accelerates.

The Philippines' gross domestic savings to gross domestic product ratio has changed little through the past decade from 18.4 percent in 1990 to 20.9 percent in 2003. The depth of the financial system is shallower compared with other Asian countries, with (money supply to GDP) ratio of 39.5 percent, the third lowest in Asia after Laos and Cambodia. One reason for this is the high intermediation cost, which creates a wedge between the interest rates on savings and loans. Government debt papers also dominate the capital market, accounting for almost 93.1 percent of total outstanding issues. In other countries, the private sector issues account for a more significant percentage such as in Malaysia (41.5%), Thailand (17.9%) and Korea (39.1%). The domestic equities market also remains small compared to other Asian countries. The country's stock market capitalization to GDP ratio stood at 28.8 percent in 2003 compared with Hong Kong's 456.2 percent, South Korea's 49.3 percent, Malaysia's 156 percent, Singapore's 162.6 percent, and Thailand's 83.1 percent.

Meanwhile, a weak regulatory framework has undermined the growth of the preneed market.

Table 8-1 Domestic Capital Market

	Savings-to-GDP^{1/}	Broad Money (M2)-to-GDP	Domestic Market Capitalization^{2/}	Government Securities-to-Outstanding Debt Issues^{3/}
	(2003)	(2003)	(% to GDP)	(2004)
Philippines	20.9	39.5	28.83	93.11 (Aug 31)
Malaysia	42.9	108.7	156.04	58.51 (Sep 27)
Singapore	46.7	122.4	162.58	n.a.
Thailand	32.8	95.0	83.12	82.10 (Sep 27)
Indonesia	21.5	53.5	26.24	n.a.
Korea	32.8	124.5	49.27	60.94 (Sep)
Hong Kong	31.6	312.6	456.17	n.a.
China	42.7	189.2	n.a.	n.a.

^{1/} Source: ADB; Philippine data: NEDA

^{2/} World Federation of Exchanges, 2003

^{3/} Country statistical websites

A major concern that emerged in the wake of the 1997 Asian crisis is the country's slow reduction in the level of nonperforming loans (NPLs) compared with other Asian countries. The latter have strong fiscal positions and were therefore able to set up asset management companies that were able to absorb the nonperforming assets using public funds. As of June 2004, the Philippine banking system ratio of NPLs to total loans stood at 13.97 percent, higher than Thailand's 12.4 percent, Malaysia's 7.7 percent, Indonesia's 7.6 percent, and Korea's 2.2 percent. To encourage banks to unload their NPLs, the Special Purpose Vehicle Act was passed in 2002. However, only a few banks have consummated deals to dispose of their assets, as banks have not been willing to sell their assets at steep discounts offered by buyers. The banking system continued to be saddled with its pool of nonperforming assets. Nonperforming assets as a share to total assets amounted to 12.85 percent as of end 2003, slightly unchanged from 14.31 percent in 2001.

Another major concern, which impinges on fiscal sustainability, is the poor financial health of the public pension system. If not rectified, this will eventually translate to a national government bailout, with serious repercussions on fiscal consolidation efforts.

II. GOALS, STRATEGIES AND ACTION PLANS

The primary goal of reforms in the domestic financial system is to mobilize savings to achieve a savings to GDP rate of 25 percent to 30 percent. This will support an increase in investment ratio to 28 percent of GDP, with an increasing amount of resources channeled to support the development of agribusiness, including lending to micro, small and medium enterprises.

Key reforms in the financial market shall focus on: (a) ensuring macroeconomic stability through prudent monetary and fiscal policy (see Chapter 7 for fiscal reforms); (b) promoting a stronger, stable, and deeper financial system; (c) reforming the pension system; and (d) providing easier access to funds by SMEs to achieve the target of tripling lending to SMEs and support their development.

A. Ensure stable macroeconomic environment to reduce long-term risk by managing inflation

Prudent monetary policy is important for price stability. However, inflationary pressures, especially those which arise from supply cost factors cannot be addressed by monetary policy alone since controlling supply and cost shocks through tight monetary policy can undermine growth and ultimately affect inflation itself. Thus, inflation management will necessitate pursuing both monetary policy and measures to ease supply constraints and cost build-up.

1. ***Manage inflationary expectations by announcing inflation target and intensifying information dissemination on the concept of inflation targeting and core inflation.***
2. ***Mitigate impact of cost-push pressures on the economy:***
 - a. Ensure ample supply of commodities in the domestic market by improving agri-industry productivity; reducing postproductive costs through improvement in logistics and transport system; and timely and adequate importation of necessary basic food items and agricultural inputs (*Chapters 2 and 6*).

- b. Strengthen coordination among public and private stakeholders under the umbrella of the National Price Coordinating Council.
- c. Lessen the impact of imported fuel and energy prices by shifting to least cost source of energy and reducing dependence on imported energy sources. In addition, the government shall promote the use of energy-saving devices and time-of-use demand management practices in the consumption of electricity by industries (*Chapter 10*).

B. Promote a stronger, stable and deeper financial system

1. *Accelerate reduction of nonperforming assets*

The Bangko Sentral ng Pilipinas (BSP) will accelerate financial sector restructuring by pushing for the intensified implementation of the SPV law to facilitate the offloading of idle assets from the books of banks and other financial institutions. This will significantly pare down the banks' nonperforming assets.

2. *Prevent and minimize systemic risks by strengthening regulations in accordance with international standards for greater transparency and accountability*

- a. Amend the BSP charter to include immunity of supervisors from law suits, authority to compel banks to implement prompt corrective action and higher capital build-up, shift away from the strategy of forbearance and liquidity assistance, and stronger criminal and administrative penalties for violations of banking laws;
- b. Amend the Insurance Code to empower the Insurance Commission to preempt financial distress or intervene to help resolve financial problems of an insurance company;
- c. Provide the Securities and Exchange Commission (SEC) with adequate legal protection, access to bank records in an investigation, ability to obtain freeze orders, and visitorial powers over regulated companies and their auditors. Furthermore, SEC's enforcement actions shall be strengthened through effective coordination with the Department of Justice, the Supreme Court, the National Bureau of Investigation and the Philippine Judicial Academy by means of enhancing its law enforcements partners' capability to investigate and prosecute securities fraud cases;
- d. Strengthen the framework for quick resolution of financially-distressed enterprises through the passage of the Corporate Recovery Act;
- e. Enhance and rationalize the regulatory framework on investment companies and the sale of preneed plans through the government's support on the passage of the Revised Investment Company Act and the Preneed Code;

- f. Restructure the Cooperative Development Authority into a regulatory body through the amendment of the CDA charter to provide the regulatory framework for the development of cooperatives nationwide. In addition, capacity building for CDA and other stakeholders shall be pushed in order to implement an effective regulation and supervision of credit cooperatives;
- g. Introduce the risk-based capital adequacy framework for providers of financial services and products under SEC regulation and supervision;
- h. Strengthen consolidated supervision mechanisms via closer cooperation and coordination among financial services regulatory agencies. This is to rationalize the incentive structure for the financial sector and achieve competitive parity across bank and nonbank sectors. The government shall also ensure consistency of rules and regulations intended for promoting a level playing field and that overlaps/gaps in supervision are minimized;
- i. Intensify coordination and consultation among government agencies, market participants and private sector groups. This includes the creation of a Financial Governance Council, establishment of an organized forum to facilitate coordination activities and consultations, and conduct of consultation meetings, trainings, symposia and related activities on a periodic basis;
- j. Implement a coordinated disaster recovery plan to ensure undisrupted operations or timely reopening of financial sector institutions in the aftermath of a catastrophic event; and
- k. Implement a long-term development plan or blueprint for the Nonbank Financial Sector to promote growth and expand contributions to the economy.

3. *Improve market liquidity*

- a. Establish a Fixed-Income Exchange capable of providing a modern screen-based system for dealers of fixed-income securities. This includes the establishment of a competitive secondary market for corporate debt, a settlement mechanism that supports an appropriate delivery versus payment process, and firm legal ownership of bonds being traded recording of ownership to beneficial owner level;
- b. Encourage new listings of equities in the Philippine Stock Exchange (PSE). This includes listing of Board of Investments/Department of Energy -mandated companies, select government companies, SMEs, and bonds issued to retail investors and overseas Filipino workers. To promote listings, information campaigns and related investment-promotion activities shall be conducted from 2005-2010. Likewise, PSE's competitiveness shall be enhanced by improving liquidity for secondary market transactions and development of in-house "think tank" for new products that can be introduced in the exchange; and
- c. Develop and fasttrack mortgage-backed securities market encouraging the immediate securitization of housing loan portfolios of various government

institutions. This can also be done by developing a transition strategy toward nondistortionary housing support programs, standards and systems in lending, underwriting and servicing, and fast and effective collateral foreclosure regime for mortgage lending.

4. *Protect investor and creditor rights*

- a. Minimize investor risk by improving the settlement, clearing, and custodianship of instruments (e.g., centralized ownership records and elimination of physical certificates, and introduction of national identification numbers). A national financial market infrastructure shall be established that will seamlessly link market activities from trading, clearing and settlement to postsettlement disposition of equity and debt securities. This includes migration from checks to electronic payment system, expansion of delivery versus payment coverage to investor level and across all instrument types, development of custody activities for equity and debt securities, and dematerialization of all securities;
- b. Support amendments to the Corporation Code to enhance minority shareholder rights and provide remedies for corporate malfeasance;
- c. Sustain reforms in corporate governance by aligning corporate practices and financial reporting structures with international best practices. This includes strengthening the role of independent directors for public companies and adopting International Accounting Standards and International Standards for Auditing in SEC's rules and regulations. This also includes implementing certification procedures for at least one officer or director of financing companies, investment houses, fund managers, distributors and mutual fund/investment companies and preneed plan companies certified by examination as compliance officers;
- d. Support the passage of a Credit Reporting Bill. This would permit sharing of information to protect investors and lenders and reduce the cost of borrowings by investors and consumers; and
- e. Pursue amendments to the Consumer Act to include protection against fraudulent consumer financial products and services.

5. *Tap savings through new financial products*

Support the passage of the Personal Equity Retirement Account Act to improve the country's savings rate.

6. *Remove tax distortions*

Harmonize the tax treatment of financial instruments and institutions to support the development of the capital market. This shall include, among others, removing the double taxation of insurance products.

C. Rationalize government pension and retirement schemes

- 1. Allow increase of members' contribution to pension fund to narrow the funding gap. This will require the updating of actuarial study that shall be the basis for determining the increase in members' contribution to ensure that the financial condition of pension funds is actuarially sound.*
- 2. Introduce a clear set of credentials or qualifications that will become the basis for the appointments to the boards of main pension providers, namely SSS and GSIS.*
- 3. Designate an appropriate agency as the regulator to supervise the activities of pension funds and ensure their viability.*

D. Increase SME access to financing (Chapter 1: Trade and Investment)