RESEARCH NOTE

Recent Developments in Regulating "Too Big to Fail" Banks in the Philippines

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Abstract: This paper presents an overview of the recent developments in the financial regulation system that relates to the management of banks identified as "too big to fail" such that government response is needed to address the eventual failure of these institutions. First appeared in an announcement in the United States, the "too big to fail" clause is linked to the measures undertaken by the government to save large companies from apparent letdown, since their failure would result to economic fallout due to their interconnectedness with other entities for goods and services. The paper also provides an overview of the causes and implications of this clause such as the exposure of financial institutions to systemic risk and the moral hazard problem. In addition, the discourse sheds light on how global response takes action towards creating resolutions on these systemically important financial institutions, particularly in the Philippines, whose counterpart of "too big to fail" entities are identified as Domestic Systemically Important Banks (D-SIBs). Lastly, it presents alternative options that can contribute towards improving financial regulation without experiencing the trade-offs as a result of these actions.

Keywords: Too big to fail, macroprudential regulation, systemic risk, moral hazard

JEL Classification: E50, E52, E58, N22, N25, O53

Financial regulatory system seeks to ensure that markets are well-oiled to function effectively in promoting economic growth and development and can only take place if the markets are shielded against the negative effects of both endogenous and exogenous factors that expose them to systemic risk, thereby disrupting the financial system. In addition, every financial system should increase its ability to become resilient in absorbing shocks to strengthen their liquidity position and to effectively manage their capital flows. Maintaining this strong capability in credit intermediation and providing services to the general public would eventually contribute towards the ultimate thrust of fostering sustainable economic growth.

However, regulatory structures face tradeoffs. In the case of policies that attempt to reduce exposure to systemic risk, there is greater visibility of the presence of the moral hazard problem as a result of risk behavior. Hashmall (2010) argued that the regulatory structure should lead to the reduced exposure to systemic risk and to the moral hazard problem while maintaining market discipline. Her paper provided the case of establishing a

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new framework for regulating institutions that are identified as "too big to fail" (TBTF). TBTF institutions, according to Hashmall, are large and interconnected that their failure can pose threats on the financial system in its entirety.

The Philippines is of no exception with regards to the institutionalizing of reforms in the financial system. The implementing agency for monetary policy in the Philippines is the Bangko Sentral ng Pilipinas (BSP) that faces challenges in evaluating its regulatory structure, conduct of policy, as well as compliance with the traditional roles bestowed upon them, not to mention the internalization of effective governance mechanism to achieve effectiveness and efficiency in pursuing its mandates (Bagsic & Glindro, 2006). In addressing the ability of the banks to protect themselves from losses arising from their exposure to financial risk, the BSP, through its Monetary Board, issues guidelines that will minimize their risk exposure, thereby preventing significant disruptions to the financial system and the economy (Rivera, 2014). Such pronouncements find its great importance in dealing with banks that are susceptible to systemic risk exposure where implementation of reforms and increased macroprudential regulation are necessary when these banks are too big to fail. In retrospect, one might ask how the BSP deals with TBTF financial institutions in the country in the first place.

This research seeks to highlight recent developments in banking regulation in the Philippines with regards to the banks that are identified as TBTF financial institutions. Following the implementation of the Basel III accord, it will attempt to shed light on the efforts of the BSP to increase the resiliency of the Philippine economy by minimizing the negative consequences brought about by the actions of the TBTF financial institutions.

The paper is structured as follows: In the next section, it will provide an overview of the causes and implications of "too big to fail" resolutions that relates to systemic risk and the moral hazard problem. Next, this paper discusses the recent developments in the Philippines banking regulation that took place in the light of the TBTF resolution processes, while the last section provides a discourse on the future of TBTF banks given the developments in the banking regulation system in the country.

Causes and Implications of TBTF Resolutions

"Too big to fail" is an idea that a business has become so large and ingrained in the economy that a government will provide assistance to prevent its failure. This term first appeared in an announcement by Stewart McKinney, United States representative from Connecticut after a $4.5 billion government rescue plan was shaped for the now defunct Continental Illinois National Bank and Trust (Sorkin, 2009). According to Labonte (2015), as large companies are interconnected with other entities for goods and services, the failure of these large companies would bring forth economic fallout such that the government will undertake measures to save them from apparent failure. TBTF resolutions also refer to special insolvency resolution regimes whose insolvency will pose spillover effects on other firms and sectors that if no bypass of usual resolution regimes to protect counterparties against loss takes place, it will result to financial instability of the interconnected institutions (Kaufman, 2013).

Such gain comes at a cost because the TBTF resolution reduces market discipline, encourages moral hazard for excessive risk taking, and provides unfair competitive advantage over the healthy firms that lead to inefficient allocation of resources (Labonte, 2015). For financial institutions, these effects are the result of inadequate regulation and supervision because large banks assumed riskier positions wherein bailout becomes imperative for those banks that will fail (Shull, 2012). TBTF resolutions are driven by the presence of systemic risk among banks and financial institutions, the danger that the dissolution of a bank or any company will result to negative effects in the macroeconomy (Hashmall, 2010). Systemic risk can create loss of investor confidence where investors will resort to pull out investments and harm the economy by raising the cost of capital, thereby generating social costs of increased poverty incidence and unemployment.

Systemic risk has been addressed through regulation on financial intermediation to prevent bank runs and prevent the failure of depositary financial institutions. Deposit insurance, for example, provides a safety net to ensure the liquidity of deposits (Llanto, 2005), thereby insuring depositors and allowing them immediate access to their financial deposits even when banks fail. The biggest challenge for deposit insurance, according to Llanto, is that it has provided incentives for banks to

assume riskier positions, thereby imposing sanctions and market discipline to penalize them for their risky behavior that may lead to lack of trust in the financial institutions.

On the other hand, Shull (2012) also attributed the emergence of TBTF clauses to the way governments value the survival of large banks. Such relationship is apparently visible where large banks play a role in the allocation of financial resources that will bolster economic growth. The implied premium guaranteed by the government provides incentives for banks and financial institutions to engage in perverse regulatory behavior that compromises the interest of the general public and results to economic stability problems.

As a consequence of perverse regulatory behavior, the TBTF resolution creates a moral hazard problem because the guaranteed parties, knowing that the government will provide a bailout package for them, were given the incentive to undertake excessive risk, thereby sacrificing their market discipline. Mishkin (2006) argued that the moral hazard of safety nets like deposit insurance and implicit guarantee through bailouts is severe for large financial institutions due to the crisis of confidence that may spill over to other banks and financial institutions, causing a myriad of failures and financial crisis.

The 2008 financial crisis provides an excellent case of the causes and implications of TBTF resolutions using a different perspective. This economic downturn, resulting from the burst of asset bubbles in the subprime mortgage market, exposed the United States to the harsh effects of systemic risk because non-bank financial institutions produced much of the risk that allowing these institutions to fail will result in the bankruptcy of creditors and investors. Thus, in March 2008, the Federal Reserve (Fed) decided to bail out Bear Stearns using the TBTF clause to avoid larger costs that may impact the financial markets. Such action triggered the US government to provide implicit guarantee on other financial institutions. Come September 2008, the Fed refused to bail out the Lehman Brothers, leading to a massive crisis that hit other countries in the Middle East, Africa, and Europe, with Iceland being identified as the first country outside the US to have suffered the detrimental effects of the crisis such as a drop in GDP by 65%, bankruptcies, and threats of emigration (Danielsson, 2009). Such decision created uncertainty as policies resulted to the worsening of the financial markets. As such, the reliance on the TBTF resolution is a product of the inability to accurately predict and to quickly respond to the harsh effects of financial instability due to its connectedness with other institutions (Gutter, 2010).

The Response Towards TBTF Resolutions

In this section, I will highlight the response of the Philippine financial regulatory system to address the problems associated with the “too big to fail” resolutions. It provides a backgrounder on the response mechanisms implemented after the 2008 financial crisis, followed by the more stringent regulation as expressed in the Basel III accord, and how the Philippines localized the regulations to the domestic financial institutions.

The United States responded to the 2008 crisis through a legislative effort to exorcize TBTF. The Dodd-Frank Act, formally known as the Wall Street Reform and Consumer Protection Act, forbids bailouts and prohibits practices that results to taxpayer losses (Shull, 2012). Instead, it led to the creation of a more enhanced prudential regulatory regime administered by the Fed for non-bank financial companies designated as “systemically important” by the Financial Stability Oversight Council (FSOC) and banks with more than $50 billion in assets (Labonte, 2015).

These systemically important financial institutions (SIFI) were identified based on the criterion set by the FSOC, and shall be subject to the oversight of the Fed through prudent standards requiring higher capital balances and balance sheet constraints related to the systemic risk they are exposed to. According to Shull (2012), the Act also provides provisions on living wills, thereby permitting safe liquidation in the event of bankruptcy declaration, following SIFI’s establishment of credible liquidation plans. Moreover, it imposes stricter rules regarding debt aggregation for financial institutions involved in mergers and acquisitions, as well as a thorough review of the geographical concentration of risks that affects the financial stability of the United States and its financial system.

On a global scale, the Basel Committee on Banking Supervision of the Bank of International Settlements issued the most recent accord, Basel III, in 2010, as a response to the never-before-seen changes in financial markets. Following the pillars of minimum capital requirements, supervisory review, and market

discipline that was established in Basel II, Basel III has incorporated guidelines on the regulation of new financial instruments and stimulated the creation of new financial vehicles reflecting the changes on the risk appetite of banks. Accordingly, Basel III was the best response to the global financial crisis, incorporating strengthening capital requirements and increasing their loss-absorbing capabilities (Azadinamin, 2012). While Basel I failed to incorporate the effects of risk other than credit risk and Basel II provided calculations for credit risk and weighting of different assets, Basel III came to the rescue to address the shortcomings of the previous two accords by strengthening the quantity and quality of money. Table 1 shows the evolution of Basel capital frameworks from I to III.

Azadinamin (2012) also cited the usefulness of additional provisions such as the leverage ratio to complement risk-based measures, the use of capital buffers, and the dynamic provisioning based on capital losses to deal with procyclicality issues that banks face in the aspect of reserve management. Furthermore, additional global rules by the Financial Stability Board (FSB) were set in consonance with holding much money to shield banks against losses. These rules will ensure that shareholders and bondholders will be the first in line to shoulder the burden of future losses and not the general public and governments who will rescue banks at the spur of the crisis ("'Too big to fail' bank rules," 2014).

Specifically in the Philippines, the BSP Monetary Board has approved the implementing guidelines for the revised capital standards under the Basel III accord for universal and commercial banks in the Philippines, which were implemented last January 1, 2014. To further strengthen the banking system, these banks, identified as Domestic Systemically Important Banks (D-SIBs) rather than "too big to fail" financial institutions, must meet specific minimum thresholds for Common Equity Tier 1 (CET1) capital at 6.0 percent and Tier 1 (T1) core capital at 7.5 percent in addition the capital adequacy ratio (CAR) set at 10.0 percent. Such thresholds are to be utilized in lieu of the hybrid instruments that were not successful in absorbing losses (Bangko Sentral ng Pilipinas, 2012).

Table 1. *Overview of Basel Capital Frameworks*

Accord	Year	Features
Basel I	1988	Standardized risk weights for credit and market risk exposures
Basel II	2004	Introduced risk-based capital calculations for credit, market, operational, and counterparty credit risk Standardized and model-based (with regulatory approval) Introduced concept of 3 Pillars: I, II, and III
Basel 2.5	2011	Addressed weaknesses in value at risk calculation for market risk (VaR) which did not capture tail risk through introduction of concept of stressed VaR
Basel III	2010	Focused on the liability side of the balance sheet Only major revisions to risk weighted asset calculations are for counterparty credit risk Key changes: Capital buffers Increased quantity and quality of capital, including stricter deductions from CET1 Liquidity coverage and stable funding requirements Leverage ratio requirement

Source: Moody's Investors Service (2014).

Table 2. *Comparison of Basel III Guidelines and the Proposed BSP Regulations as of 2012*

Capital requirements	Under Basel III		BSP Guidelines		
	Minimum ratios (%)	With conservation buffer (%)	Existing minimum ratios (%)	Proposed minimum ratios (%)	Proposed minimum with conservation buffer (%)
a. CET1 ratio	4.5	7.0	None	6.0	8.5
b. Tier 1 ratio	6.0	8.5	5.0	7.5	10.0
c. CAR	8.0	10.5	10.0	10.0	12.5

Source: Parcon-Santos & Bernabe (2012).

Table 2 provides a comparison of Basel III guidelines and the proposed BSP regulations.

The guidelines also introduce a capital conservation buffer of 2.5 percent that is made up of CET1 capital. This is an indicator that the Philippines have set the capitalization requirements over and above the required minimum percentage through a smooth transition process. In addition, the capital instruments issued by these banks from 2011 will be Basel III-eligible until the end of 2015. Furthermore, the thrift, rural, and cooperative banks will have to consider the geographical location and the size of physical network in the setup of capital adequacy requirements.

In 2014, the BSP Monetary Board has imposed additional guidelines for the D-SIBs or the TBTF banks in the country. In the article of Rivera (2014), these additional guidelines are aimed towards capitalizing on the strength that was already established in the past. In determining which banks are TBTF, banks will be evaluated based on the measures of size, interconnectedness, substitutability of financial institution structure, and complexity of transactions being dealt. No public announcement was made at that time to declare those D-SIBs, but the banks that will fall under this qualification are required to raise more capital by January 1, 2019. However, in 2015, the Bangko Sentral ng Pilipinas announced that it has completed the official list of 14 Philippine banks identified as D-SIBs, but it has refused to reveal their names (Montecillo, 2015). What is important, according to Tetangco (2015, as cited in Bangko Sentral ng Pilipinas, 2015), is that meeting the requirements expected for systemically important banks will strengthen the Philippine banking system by lowering the probability of failures.

Hence, these banks will be required to increase their minimum CET1 ratio by 1.5 to 3.5 percentage points depending on their classification. Such requirement will be imposed on top of the existing CET1 minimum of 6 percent and the capital conservation buffer set at 2.5 percent by the Monetary Board. In addition, D-SIBs whose capital ratio falls below their corresponding regulatory minimum will be subjected to constraints in income distribution through the channeling of profits. Moreover, as part of the intensive supervision activity of the BSP, all D-SIBs are required to include in their Internal Capital Adequacy Assessment Process (ICAAP) their concrete and reasonable recovery plans that might be implemented should they breach the capital requirements. This move, as stated by Parcon-Santos and Bernabe (2012), should prepare the Philippine financial system to mitigate the adverse macroeconomic effects as a benefit for the losses that may have incurred by the country during the financial crises faced in the past.

The Way Forward

Due to the presence of a more stringent macroprudential regulation in the Philippine financial system, our domestic banks are carrying the bigger challenge to sustain their growth despite the increased capital and liquidity requirements set by the Monetary Board of the Bangko Sentral ng Pilipinas. The KPMG report prepared by Williams, Low, and Topping (2013) recommended tougher regulatory requirements in the Philippines, like in the Asia Pacific region, might act as a constraint on the ability of the banks to grow their balance sheet that might affect economic growth, should bank customers fail to get the necessary

financing to support the growth of their entities. Thus, the situation creates a trade-off between financial stability and growth. Will that be worth it in the first place?

The Philippines, like its Asian counterparts, have more experience in the use of macroprudential tools dating back when the Asian Financial Crisis took place in 1997. However, structural restrictions are not that fully in place given the way banks operate in the country. In a country that continuously seeks for growth, a minor shortfall might take place as a result of the recent implementation of these tools (Williams et al., 2013). Such dampening could be attributed to the reduction, in part, of the availability of and the increased cost of financing. Thus, Philippine banks, while they are subject to the TBTF clause, should focus on addressing potential issues that may impact the availability and cost of financing, as well as economic growth. In this way, banks would have a better approach towards reviewing the phases involved in the gradual implementation of the recent pronouncements.

"Too big to fail" resolutions are quite challenging in the regulation of the financial system. As such, it would be necessary for the government to undertake actions that will efficiently manage these financial institutions, should they fail. Hashmall (2010) suggested that the Fed, or maybe the Bangko Sentral ng Pilipinas, in the case of the Philippines, should have the unilateral authority to authorize the deposit insurance commission to seize the banks towards rescuing them or instituting an orderly liquidation process. The BSP should be a stand-alone agency that can decide whether liquidation or bailout will be a viable option as long it will least likely affect the financial system and the economy as a whole. A social cost-benefit analysis might be a viable option to assess whether the cost of resolution is less than the cost of systemic effects to ensure transparency of the resolution process. This will aid in reducing risk without creating moral hazard as a single agency deliberately address the problem without interference from external agencies and institutions, thereby decreasing the uncertainty in stabilizing the financial regulatory structure and increasing the credibility of the BSP in its decision-making activities.

Given that the Philippines has yet to fully respond to the tall order of a more stringent financial regulation framework that addresses the concerns of systemically important financial institutions, Williams et al. (2013) suggested that the BSP and the Asian regulators should exercise flexibility in introducing Basel III, as well as creating a reasonable timeline to achieve the goals of the recent regulation. This was already done in the Philippines based on the report by Rivera (2014), with generic risk weightings to be recalibrated to minimize the cost of implementing regulation and thus, will foster sustained growth and development of the banks. In addition, further studies have to be undertaken to assess the cumulative effects of regulatory changes on economic growth. As an alternative to bank financing, calls are being made to strengthen the bond/capital markets that will bolster the securities market. Moreover, the BSP should legalize and encourage shadow banking mechanisms that will provide alternative source of financing for small and medium enterprises.

The response of Philippine banks in the light of new financial regulation, particularly on capital and liquidity standards, is determined by the length of time in which new requirements are fit into the system. Shorter transition periods may adjust asset holdings and may cause abrupt changes to the dismay of the financial institutions given the higher cost of penalties, but longer transition periods will enable banks and other financial institutions to mitigate the impact (Parcon-Santos & Bernabe, 2012). Towards the end, regardless of the length of time, the decisive action of banks to comply with new regulations could boost confidence in strengthening their capital and liquidity positions towards ensuring long-term financial stability. By mitigating the adverse effects and trying to keep as close as possible to the rudiments of current financial regulation, the economy will be in the best position to promote sustained growth and development as evidenced by the way the financial regulatory system oversees the behavior and activities of banks and other financial institutions.

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