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A Legislative Agenda for the Banking and Finance Sector (BPI Position Paper)

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CORPORATE PLANNING

The Bank of the Philippine Islands (BPI) fully appreciates the wisdom of recasting the financial system. We agree in principle with institutional and policy reforms as a means of achieving the broad objectives of increasing competition, enhancing market orientation, and strengthening financial intermediation.

As a leading bank in the private sector, BPI has never hesitated to position itself in the forefront when supporting reforms of the government in the area of banking and finance.

With the same spirit of concern, BPI has taken upon itself the task of suggesting a legislative agenda which we hope Congress, and ultimately policymakers, will consider in formulating a set of laws and regulations implementing changes in policy and institutional framework of the monetary sector. Thus, the bank addresses itself to a package of monetary and fiscal regulations and incentives in line with the thrust of restructuring the financial system. We believe that the agenda for financial reforms should be specifically aimed at achieving the following:

1. An institutional setting that ensures the independence of the Central Bank (CB) from political interference in the pursuit of its responsibilities of maintaining stable prices, interest rates, and competitive exchange rates, while sustaining the growth of the economy.
2. Increased efficiency and expansion of financial intermediation to encourage savings mobilization towards productive private investments.
3. A more stable financial system that allows fair and free competition among banks.
4. An active capital market that ensures availability of long-term investment opportunities.

The achievement of these goals will require the following: (a) changes in the role and organization of the Central Bank; (b) changes in the orientation and conduct of monetary policy; and (c) more effective supervision of financial institutions. In addition, certain monetary and fiscal incentives may have to be considered to stimulate the expansion of credit towards the rural areas and to encourage the transformation of short-term funds into long-term credits.

ROLE AND ORGANIZATION OF THE CENTRAL BANK

We subscribe in principle to the passing of a law implementing an independent monetary authority as provided for in Sec. 20, Article XII, of the new Constitution. The proposed Senate Bill (SB) 264, establishing an

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independent Central Monetary Authority (CMA), is a step in the right direction. However, instead of replacing the existing CB with a new institution called CMA, as proposed in the bill, BPI asks Congress to retain the CB organization but to incorporate an amendment of the existing CB charter that would provide for a reorganization of the Monetary Board. The suggested composition would limit government representation to only one membership (possibly the Finance Secretary), sans existing seats for the NEDA and DTI Secretaries. As we do not advocate the left-wing view of Central Banking in its extreme form comparable to the United States Federal Reserve Board, we also regard a certain degree of coordination of fiscal and monetary policy to be essential in the transition stage from a development - to a stabilization-oriented Central Bank. The chairmanship of the CMA should remain with the Governor, while the other members should come from the private sector. The proposed composition of the Board should inhibit its domination by any individual interest, including government. With the exception of the Finance Secretary, who shall be allowed to hold an executive office and a Monetary Board position in a concurrent capacity, membership in the Board should be given a full time status. The staggered appointment of its members with terms exceeding (and not coterminus with) that of the Chief Executive is likewise a basic precondition of its independence. We fully endorse a six-year time frame for the Chairman and members of the Board.

Since the CB's power over money and credit is a public trust, appointed members shall have the proven integrity, track record, and expertise in banking and monetary affairs. Further, they are to divest themselves of all holdings in financial institutions, and disclose their assets and liabilities periodically.

The role of the CB should primarily be stabilization and not development financing. Thus, the CB's main responsibility is the maintenance of stable prices, interest rates, a sustainable BPO, and regulation of financial institutions. The raising of development money, including the financing of the budget deficit, should be the primary responsibility of the executive branch and the private sector. Further, since the CB is not designed to manage special credit programs, it should get out of supervised credit schemes which could be better handled by development oriented institutions.

EFFICIENCY OF FINANCIAL INTERMEDIATION AND MONEY SUPPLY MANAGEMENT

The inefficiency of the savings- investment process as reflected in the very high spreads and real lending rates of banks may be attributed to a large extent to the excessive taxation of intermediation. Thus, to raise the efficiency of intermediation, we propose the revision of policies to permit an immediate, but gradual reduction in reserve requirements from the current 21 percent to 18 percent. Further, we endorse for legislative action the repeal of the agri-agra requirement and the eventual abolition of the GRT, a long standing concern of both the banking and business community alike. Reform of reserve requirement and loan portfolio rules will remove the tax on savings and investment and encourage intermediation activity.

We continue to favor a market-oriented policy on interest rates as a principal means of allocating and channelling credit to productive investments. In line with this policy objective, the redemption of all low-yielding reserve eligible securities for eventual phase-out or replacement/rollover at market-determined rates should be continued. By repricing these securities at market-determined rates, intermediation costs could be reduced further, while the volume of trading in governments in the secondary markets can continue to expand.

To effectively manage money supply and inflation while avoiding a repetition of excess practices in the past, Congress may consider a provision in the law that sets a cap on the size of the CB credit associated with the financing of the budget deficit linked to the expansion of the money supply and GNP as an independent control mechanism.

Again, as a way of enhancing monetary control while at the same time minimizing the crowding-out effect of open market borrowings on the availability of private sector credit, there should be a provision for a comprehensive debt management program which specifies a targetted level, instrumentation and maturities mix of the outstanding public debt.

STABILITY AND DEVELOPMENT OF THE BANKING SYSTEM

An expanding financial market requires not only increased efficiency of intermediation but also a system resilient to shocks. History of the banking system shows significant individual and industry-wide vulnerability to crisis. This is hardly conducive to savings mobilization and term transformation of loanable funds into productive investments. We, therefore espouse a set of recommendations which we envision will provide a stronger foundation for a sustained growth of the financial system:

a) First, as a priority issue, the supervision and regulation of financial institutions must be strengthened to assure financial stability, minimize bankcruptcy, and prevent insolvency of individual banks. The Central Bank should be mandated via legislation to develop and publicize an early warning system for problem banks. Their ratings done by an independent credit rating agency should be disclosed to the public, consistent with standards and guidelines of prudent banking practice as set by the Monetary Board. While the CB has played an important role in maintaining financial stability during recent crisis, its interventions to stabilize specific institutions have almost always taken place too late. Its intervention should occur before an institution is on the brink of bankcruptcy and requiring emergency assistance. If one of the financial yardsticks is violated, the CB should intervene immediately. Penalty enforcement for erring banks and officials should be strengthened, particularly those involving cases of fraud, DOSRI violations, and sound financial management practices. An effective CB supervisory role is a prerequisite for the long run stability of the financial system. In addition to enforcing financial control ratios (loan to deposit/deposit substitute liabilities, network to risk assets, DOSRI rule), the Central Bank may have to guide the commercial banks in improving their profitability and capital reserve positions. The ratios which could be used as targets can include (a) dividend payout ratio, and (b) gross expenditures to gross reserves ratio. Maintaining the latter ratio at a low level would lead banks to improve their efficiency and productivity. The CB could consider guidelines to reduce the ratio over time. Lower dividend payout ratios could likewise contribute to increasing the internal reserves and strengthening the capital base. This would induce resilience of banks under unusual adverse conditions.

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b) Second, the PDIC should be strengthened via increased capitalization from the government. Its functional coverage must also be expanded to give it an active role in monitoring and risk assessment of individual banks and other financial intermediaries. Further, we feel that added protection can be afforded against depositors' banks by raising the existing floor on insured deposits, initially to ₱ 100K. The size of individual bank premiums should be flexible, and should be allowed to exceed the floor.

The insurance premium to be paid by each bank should be adjusted according to its financial position and the risk rating provided by PDIC. Further, the PDIC assessment of individual bank risk should be used as supplement to overall CB supervisory responsibilities.

c) Third, a policy of deregulation, market initiative and increased competition among banks should be pursued. Subject to the controlability and prudent requirements for the protection of the investing public, free entry into all areas of banking and finance, including the opening of new branches, regardless of the geographic area, should be allowed. When they can foster competition and introduce new banking practices that would raise the efficiency of their domestic partners, foreign commercial banks should be allowed to come in within the existing constraint of the 40 percent ceiling on equity.

d) Fourth, consistent with the policy of reducing government's overall size and competitive presence in the private sector, a program for the orderly reprivatization of government-acquired banks should be implemented within a two-year time frame. Further, the listing of these banks in the stock market should be pursued.

e) Fifth, to support rural development, the rural financial/credit market should be developed via the accelerated rehabilitation of rural banks, and stronger interlinkages among the non-government organizations (NGOs), cooperatives, formal and informal credit institutions and government agencies in the rural credit delivery system. Further increased incentives should be given to cooperatives (such as tax deductible expenses) involved in savings mobilization and credit delivery. In this regard, we favor a legislative action relaxing the regional loan/investment dispersal and agricultural credit for unibanks, the geographic restrictions on branch banking and the deposit retention scheme. BPI also feels that measures to set aside loanable in the economy may run contrary to enhancing competition and efficiency of intermediation.

DEVELOPING THE CAPITAL MARKET

A major issue in banking reform is the development of long term financial markets. The increase in long term markets to finance private investment is critical in maintaining economic recovery. In addressing the problem of mobilizing medium and long term financial resources, the Bank addresses itself to a package of regulations and incentives, in addition to the complementary measures already indicated above.

1. *Fiscal Incentives*

In addition to the abolition of GRT, there must be added incentives for the lender to offer long term instruments to their depositors on more attractive terms. This involves reforming the tax structure to increase the demand for long term placements/sourcing from potential investors. With this in mind, the fiscal activities may want to consider the following.

1.1Graduated reduction of the 20 percent withholding tax on interest income, with preferential treatment according to long term placements. A graduated final tax schedule based on maturity structure should be considered as a step to an eventual tax-free status on long term (over 2 years) instruments over the next 5 years.

1.2Additional tax incentives to encourage the listing and broadening of the ownership of shares of closely-held private, reprivatized and private joint venture companies via the stock market.

1.3Provision for deductibility from taxable income of a certain amount of equity or long term bond (corporate/government), including those investments in private trust funds for small savers. BPI feels that the securitization of debt and equity markets should increase the supply of long term securities and widen the spectrum of papers available for investors. However, we also recommend that tax breaks be given to increase the demand for these securities. In particular, a liberal tax treatment on mutual funds invested in long term governments could be considered as an incentive.

2. *Consistent Fiscal and Monetary Stance*

The willingness and confidence of investors to hold long-term instruments depends on their perception of future market conditions in terms of liquidity, inflation, interest rate structure, and the underlying fiscal and monetary conditions. These market perceptions should be conducive to lengthening investment horizons. Policy-makers must, therefore, shape an environment consistent with this thrust. Specifically, BPI addresses the need for the following systematic preconditions:

a. A stable interest rate structure to maintain a forward sloping yield curve across all securities, including Central Bank open market instruments. The volatility of short-term interest rates creates uncertainty over the general direction of yields, thereby discouraging medium and long-term placements.

Recent observations in the Philippine setting confirms empirically that interest rates are being used to support a given exchange rate objective. This has engendered erratic movements in interest rates. This conduct of monetary policy is worrisome, since it is not conducive to long-term investment.

b. Management of monetary and fiscal policy consistent with stable prices. High and volatile inflation rates are a primary cause of financial shallowing. A reduction in the inflation tax on financial intermediation will lead to a fall in bank spreads. Likewise, placements in long term assets are sensitive to inflation and real returns. Thus, a policy mix that aims to stabilize inflation should enhance long-term lending and borrowing activities.

3. *Product and Marketing Considerations*

In addition to the proposed reduction of reserve requirements and relaxation of statutory ratios on agri-agra portfolios, there are other factors that could "incentivize" commercial banks to lengthen the tenure of assets and liabilities:

a. Encouraging co-financing activities with development finance institutions. This should enhance their project appraisal capabilities.

b. Introducing long-term sourcing instruments such as financial debentures, capital notes, and negotiable CDs at competitive terms. Given an active secondary market, they should be able to replace deposit substitutes which are mostly short-term instruments.

c. Strengthening the government securities placement and secondary market dealership network. The improvement of the procedures for marketing and servicing government securities is a priority issue.

d. Introducing regulatory measures to promote discipline and professionalism in the securities markets, particularly the disclosure of inside information on publicly-offered issues.

Finally, BPI feels that as a transitory measure, it may be worth considering an incentive to support the term to transformation of short-term bank funds into term loans. To "incentivize" banks for added risk, we feel that banks lending loans beyond 3 years should be given guaranteed access under a clearly established rule or formula to a long-term lender of last resort liquidity facility, and possibly, a gradual phasing-out of the reserves on long term (over 2 years) sourcing (which are utilized for term loans) over a period of time.

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