Technical Report

The Philippine Capital Market Reform Agenda Module 1: Financial Market Core Principles and an Enabling Environment

by Johnny Noe E. Ravalo, Ph.D.

Prepared for

Bangko Sentral ng Pilipinas,
Bankers Association of the Philippines, and
Philippine Dealing and Exchange Corporation
Republic of the Philippines

Submitted for review to

USAID/Philippines OEDG

November 2005

Economic Modernization through Efficient Reforms and Governance Enhancement (EMERGE)
Unit 2003, 139 Corporate Center, 139 Valero St., Salcedo Village, Makati City 1227, Philippines
Tel. No. (632) 752 0881 Fax No. (632) 752 2225

Preface

This report is the result of technical assistance provided by the Economic Modernization through Efficient Reforms and Governance Enhancement (EMERGE) Activity, under contract with the CARANA Corporation, Nathan Associates Inc. and The Peoples Group (TRG) to the United States Agency for International Development, Manila, Philippines (USAID/Philippines) (Contract No. AFP-I-00-00-03-00020 Delivery Order 800). The EMERGE Activity is intended to contribute towards the Government of the Republic of the Philippines (GRP) Medium Term Philippine Development Plan (MTPDP) and USAID/Philippines' Strategic Objective 2, "Investment Climate Less Constrained by Corruption and Poor Governance." The purpose of the activity is to provide technical assistance to support economic policy reforms that will cause sustainable economic growth and enhance the competitiveness of the Philippine economy by augmenting the efforts of Philippine pro-reform partners and stakeholders.

This technical report was written by Johnny Noe E. Ravalo, Ph.D., who was concurrently serving as the EMERGE Team Leader for Banking and Capital Markets. It was requested by Governor Rafael B. Buenaventura, Bangko Sentral ng Pilipinas, by letter dated March 28, 2005, and by Mr. Leonilo G. Coronel, Executive Director, Bankers Association of the Philippines, by letter dated April 1, 2005. The author would like to express his utmost appreciation to Gov. Buenaventura, Mr. Coronel and Mr. Cesar Crisol of PDEx for their unwavering support throughout this engagement.

Attached to the technical report is a slide presentation of its findings prepared by the author for a discussion workshop held with members of the Capital Market Development Council (CMDC) and its guests on October 24, 2005.

Financial Market Core Principles and an Enabling Environment

Johnny Noe E. Ravalo Ph.D.

Prepared for:

Bangko Sentral
ng Pilipinas

Bankers Association
of the Philippines

Philippine Dealing and
Exchange Corporation

Economic Modernization Through Efficient Reforms and Governance Enhancement (Project EMERGE)
U.S. Agency for International Development
Contract No. AFP 1-00-00-03-00020 Task Order 800
Task 4.1.1.2: Capital Market Reform Agenda Module 1

ACRONYMS

BAP	Bankers Association of the Philippines
BIS	Bank of International Settlements
BOP	Balance of Payments
BSP	Bangko Sentral ng Pilipinas
CIS	Collective Investment Schemes
CSI	Contractual Savings Institutions
CMDC	Capital Market Development Council
DOF	Department of Finance
DVP	Delivery-versus-Payment
FI	Financial Institution
FINEX	Financial Executives Institute of the Philippines
GBL	General Banking Law of 2000
IAIS	International Association of Insurance Supervisors
IC	Insurance Commission
IFRS	International Financial Reporting Standards
IHAP	Investment House Association of the Philippines
IOSCO	International Organization of Securities Commission
ISA	International Standards of Audit
LCY	Local currency
OTC	Over-the-Counter
PSE	Philippine Stock Exchange
RTGS	Real-Time Gross Settlements
SEC	Securities and Exchange Commission
STP	Straight-Through-Processing
SRC	Securities Regulation Code
SRO	Self-Regulatory organization
YC	Yield curve

TABLE OF CONTENTS

EXECUTIVE SUMMARY

This is the first of a 3-part initiative which collectively delineates a ***"Capital Market Reform Agenda" (CMRA)*** for the Philippines. The choice of nomenclature deliberately exemplifies the two facets that are being examined from a different perspective. Unlike previous efforts in this area, the scope of this initiative is broader. Specifically, we revert to the more traditional definition of "capital market" as referring to that "segment of the financial system that mobilizes and intermediates long-term funding without delimiting the source of these funds" [para 6]. The reference to an "reform agenda", on the other hand, acknowledges that to make a discernable impact in developing this market there is a need to go beyond an inventory of desirable reforms. Instead, the approach is to craft a cohesive plan that delegates accountabilities across stakeholders, instilling in the process a shared commitment with shared responsibilities.

We introduce the notion of ***Competitive Parity*** to describe the unique interplay of interests in the financial market. This is a novel approach because it argues that the different sectors in the financial market are *simultaneously* substitutes and complements. This recognizes that the interests in the financial market are inherently competing with one another in the context of attracting resources within a risk-for-return environment. However, these interests are also offering themselves to be complements so that the added value of the collective market is larger than the sum of the sectors on a stand-alone basis.

This view has a profound impact on the reform initiative. Limited resources and finite opportunities in the short-term suggest that the dynamics between financial institutions is defined as a ***zero-sum game*** i.e., resources and opportunities are fixed in the short-run so that the gain of one entity must be a redistribution that comes at the direct expense of another. Recognizing that interests are inherently competing in this market allows the use of the basic economic construct of the Edgeworth Box which shows that no solution common to all stakeholders is possible under these conditions. In practical terms, stakeholders are not likely to find common ground on how to move forward on issues that directly affect their business interests if they are left to independently maximize their profits and/or market share. This is a serious breach in the reform initiative because the very notion of a common reform agenda is in fact nebulous. This is the direct result of interests competing within a zero-sum environment.

Financial markets, however, present themselves to be a value-added to savers, borrowers as well as the intermediaries themselves. This is possible because the above-mentioned short-run constraints need not be binding over longer periods. What is found is a virtuous cycle where an efficient financial system feeds into higher economic growth, improves public welfare, increases cashflows and wealth which subsequently heightens the demand for further financial services. This level of efficiency is clearly the policy target.

Thus, the challenge is to overcome short-run constraints in order for the *possibility* of long-run gains to be an option. Specifically, stakeholders need to define a means for addressing the limitations of a zero-sum game at the microeconomic level before the economic gains at the macroeconomic level can accrue. This is certainly not a trivial exercise particularly when business interests are at stake. However, it remains the only way for previously agreed upon reform results to effectively manage the reform process and not the other way around.

In the context of all of these, the reform agenda therefore is as much an issue of handling the gains and losses in the transition as it is about identifying the idealized end-results. Stated differently, the underlying challenge is to induce a high level of ***cooperative competition*** which can deepen the complementarities across sectors while taking full cognizance of the return-cum-risk motive of the individual sectors & its participants.

To address these difficulties, this initiative takes the approach that the critical first step is for stakeholders to consolidate their collective interests around fundamental concepts which can lead to a common reform platform. To this end, a set of eight (8) Core Principles are proposed. These principles are not meant to simply articulate desirable-but-nonetheless-self-evident features. Instead, they provide for an ***incentive-compatible framework*** that can address the competing interests in this market while remaining consistent with a vision of a developed Philippine financial market. In this way, they can be also used to provide specific guidance for aligning current and future reform initiatives.

These Core Principles are the focus of this component of the CMRA. We introduce ***Competitive Parity*** as the basic structure of the market and suggest that the way out of the dilemma is to consider the market as a ***public good***. There is no intention to rely on the stakeholders' sense of altruism to improve the market. Instead, the case is made that everyone is better off — including the current dominant players — once an efficient financial system is attained consistent with a vision proposed in this module. Towards this end, ***financial policy*** espoused by regulators must take a clear developmental orientation which in turn will impact the way we approach financial taxation, benchmark setting and infrastructure design issues. On the market side, the ***management of risk*** is explicitly highlighted as the value-added of the financial market. By arranging financial products along a continuum of risk, we are able to create a relative measure that positions any particular product both against other products and to specific market participants who are well-situated to use this product. The basic rules for propagating the public good are then delineated by a ***financial governance*** structure that encourages market creativity but delimits behavior that is considered incongruous to the public interests. ***Information & transparency*** as well as ***consumer welfare*** provide the needed support to the governance structure. And in line with the desire to institutionalize the paradigm of market-based monitoring, the ***integrity of the price system*** is relied upon to be the performance benchmark under a specific criterion of efficiency.

The Core Principles are subsequently applied in outlining an enabling environment for the development of a self-sustaining capital market. An appreciation of where the market is relative to the proposed enabling environment defines a transition path for the reform initiative. More importantly, the enabling environment creates a specific incentive structure within which specific "design issues" can be filled in at a later point in time by the collective decisions of stakeholders.

Both the Core Principles and the accompanying Enabling Environment are positioned to cut across the different components of the financial market. There is a deliberate effort then to keep the discussion at the strategic — rather than tactical — level since the objective is to generate an agreement of the fundamental concerns that apply to all stakeholders. This means that the main focus is on structural issues and impediments that affect the financial market as a whole, with specific reference to the capital market. With this foundation in place, subsequent contending views can be addressed relative to the tenets of this collective agreement.

This document concludes with an initial assessment of key policy initiatives that have helped the capital market to take roots. This is important because it is the first step in determining the courses of action that need to be taken to move the capital market forward in a direction that is consistent with the shared principles. The subsequent modules of the CMRA will focus on these next steps in greater detail by looking into the prospects and bottlenecks of the market (module 2) and subsequently crafting the appropriate sector-specific roadmap (module 3).

A. Defining a Way Forward

1. The Philippine financial market has gone through significant structural changes since the country returned to the voluntary capital markets in the early 90s.[1] Yet despite all of these reforms, the impression however is that there is still a lot of unfinished work. For example, deposit-driven banking institutions are still the primary and dominant source of term funds. This literally suggests that the bulk of "developmental finance" is actually leveraged from short-term funds. This is not the most efficient market arrangement but the reality is that bank credit has long been the most likely funding option. Stated differently, a well-functioning capital market — one where innately long-term funds are mobilized and intermediated — has not yet really developed and this has been identified as an urgent policy objective.

2. The absence of a conventionally-defined capital market is by no means an indication that stakeholders have not recognized the need for reforms. An inventory of these reforms has been defined by the Capital Market Development Council (CMDC) whose mandate is precisely to identify impediments to the growth of the capital market and to recommend the requisite reforms & policy measures.[2] What many find daunting however is that the inventory is perennially lengthy and appears to be continuously expanding.

3. This has led many to believe that the reform initiative has stalled. However, it does not take much to concede that generating results from this reform initiative will have to be a protracted process and not just an event. From the perspective of contemporaneous financial market architecture, market reforms are inherently quite complex in substance and, at least in the Philippine context, the bulk of these requires some form of legislative action. For both of these reasons, having an appreciation of what should be done is necessary but is not by itself sufficient to guarantee the desired results.

---

[1] These changes would include, for example, the creation of the Philippine Stock Exchange (PSE) and its subsequent demutualization. The regulatory framework for the securities industry (through the Securities Regulation Code or SRC) and the banking industry (via the General Banking Law of 2000 or GBL) respectively have been significantly revised, allowing for the formal adoption of a risk-based supervisory framework, among others. At the level of infrastructure, DVP has been institutionalized through an RTGS system. An inter-dealer platform has recently been launched shifting fixed income trading from a very loose OTC market to the more formal controls under an exchange-based market.

[2] The CMDC was created in November 1991 through a Joint Manifesto between financial sector regulators (SEC and the central bank), private sector organizations (BAP, FINEX, IHAP, the Manila & Makati Stock Exchanges) and the Executive branch (DoF). Its membership has since been expanded to include the insurance and pre-need sectors.

4. The reality of it is that reform initiatives are driven by the interplay of competing interests and their need to seek a workable consensus. More importantly, we have to recognize that in the short-run resources are limited and thus business opportunities are finite. As a result, the working dynamics between stakeholders at any given point in time is defined as a ***zero-sum game***.[3] This is a significant point because one basic insight of the economic construct of the ***Edgeworth Box***[4] is that no convergent solution is possible if stakeholders are able to independently maximize their respective objective functions. In practical terms, stakeholders are not likely to find common ground on how to move forward on issues that directly affect their business interests if they are left to independently maximize their profits and/or market share. This is a serious breach in the reform initiative because the very notion of a common reform agenda is in fact nebulous. This is the direct result of interests competing within a zero-sum environment.

5. Moving forward, the challenge therefore is to transform the inventory of desired reforms into a cohesive agenda that has clear stakeholder support. This is possible only if stakeholders can first address the limitations of a zero-sum game at the microeconomic level before the economic gains at the macroeconomic level can accrue. This is certainly not a trivial exercise particularly when business interests are at stake. Thus, the reform agenda must delegate accountabilities across stakeholders so that it is unambiguously a shared commitment with shared responsibilities. It must also parlay these same accountabilities to instill a sense of urgency through the expedient and equitable resolution of any outstanding issue. In so doing, reform results can effectively manage the reform process and not the other way around.

6. This module delineates such an "reform agenda" for the Philippine capital market. It is the first in a 3-part series of initiatives and focuses on the structural underpinnings of the agenda. There is a deliberate effort to keep the discussion at the strategic — rather than tactical — level since the objective is to generate a general agreement of the structural design of the market. Specifically, we outline in this document the core principles that apply to the financial market in general and define an enabling environment for the capital market in particular. To mitigate the risk that these "principles" merely reflect irrefutable

---

[3]In game theory, a ***constant sum game*** is where the sum of all players' payoff is the same for any outcome. A ***zero-sum game*** is a special case of a constant-sum game in which all outcomes generate a combined payoff of zero across all players. In this specific context, resources and opportunities are fixed in the short-run so that the gain of one entity must be a redistribution that comes at the direct expense of another.

[4]The ***Edgeworth Box*** is a graphical tool used in economic theory to show the allocation of finite resources.

tautologies, corollary precepts are identified for each of these eight principles. These provide clearer substance to these principles, particularly in interpreting their consequence and how they can be applied.

7. While there have been previous initiatives in crafting a plan for the capital market, this current endeavor is different in two key respects. First, the capital market is defined in its traditional meaning as the segment of the financial system that mobilizes and intermediates long-term funding without delimiting the source of these funds.[5] Thus, this will include both debt and equity instruments (as well as hybrids) literally with an original tenor in excess of one year but preferably much longer (i.e., at least exceeding 5 years, optimally exceeding 10 years).[6] In terms of specific market participants, the capital market basically covers those in the [a] Securities industry, [b] Stock market, and [c] Banks, at least to the extent that they provide long-term funds or participate in the fixed income market. Concern over the investor base will invariably raise the role played by contractual savings institutions (CSI), collective investment schemes (CIS) and other funds-management participants since they all perform intermediary functions and generate activity in the long-term funds market.

8. The second key difference is that this agenda is envisioned to execute a defined consensus plan that is specifically anchored on shared core principles. Instead of suggesting reforms directly, an effort is made to first define the basic principles to which market stakeholders uniformly agree. These core principles are a critical element because differentiated financial products & services guarantee directly competing interests. In an open market, these competing interests do not necessarily lend themselves to any voluntary convergence or may be resolved involuntarily through market dominance. These principles help mitigate the possibility of reform deadlocks by providing a benchmark against which policy recommendations and market behavior can always be appraised. Although principles are inherently broad in scope, the corollary precepts that arise provide

---

[5] Previous assistance from various donor agencies for the Philippine "capital market" have actually focused on different facets of the market. The capital market study completed by the World Bank (WB) in February 1992 looked into government securities and contractual saving institutions. The US Agency for International Development (USAID) funded a USD13.5 million Capital Market Development Project beginning September 1992 for capacity-building and infrastructure improvements in trading, clearing, settlements and depository services, among others. The Asian Development Bank (ADB) subsequently provided USD75 million to the Republic of the Philippines (Loan 1363-PHI) in 1995 for the Capital Market Development Program, focusing heavily on the equities market. More recently, the ADB has provided assistance for the development of the non-bank financial sector while the International Monetary Fund (IMF) capital market workshops discussed several aspects of the securities market.

[6] The tenor cut-off of one-year recognizes the standard distinction between money market instruments like treasury bills and capital market instruments such as bonds.

a guideline for specific courses of action.[7]

9. This module also delineates how these principles apply to the capital market in particular. This gives more specificity to the agenda and provides a clearer view of the general issues and broad concerns that must be addressed moving forward. The objective is not to provide product-specific recommendations. The recommendations that go into a collective "roadmap" will be the focus of subsequent modules but only after the building block have been sufficiently covered. Instead, we outline in this module specific conditions under which the Philippine capital market can develop and thrive on a sustained basis in a manner that is consistent with — and reflective of — the shared principles.

10. Much like the core principles, this enabling environment is meant to cut across the different sub-components of the financial market. While this generates (and limits us to) some amount of generality, it also means that the main focus is on structural issues and impediments that affect the financial market as a whole, with specific reference to the capital market . Again the purpose is to consolidate around basic concepts that market stakeholders can agree upon and to set a common reform platform arising from these agreements. Only with this foundation in place can contending views be addressed relative to the tenets of this collective agreement.

11. This document concludes with an initial discussion of selected policy initiatives that have helped the capital market take roots. This is important because it is the first step in determining the courses of action that need to be taken to move the capital market forward in a direction that is consistent with the shared principles. The subsequent modules of the CMRA will focus on these next steps in greater detail by looking into the prospects and bottlenecks of the market (module 2) and crafting the appropriate sector-specific roadmaps thereafter (module 3).

---

[7] We state categorically that the existence of competing interests is not pejorative upon market participants. It merely reflects the fact that there is relative scarcity of resources in financial markets at any given point in time. Furthermore, different financial instruments react differently to the same stimuli so that a change in any market parameters will invariably cause gains & losses to accrue to various stakeholders. This scarcity and the different structure of financial products underpin the existence of competing interests.

B. Measuring Financial Market Performance

12. For reasons already stated, core principles play a central role in this agenda. The substance of the principles however are not totally absolute because they should also reflect our relative expectations of our own financial market and in which direction stakeholders choose to take this market. This requires a clear understanding of financial market dynamics and the bar against which we hold its performance.

13. In this context, it is important to appreciate that the financial market is inherently different from other markets in the real economy. The primarily difference is the manner in which the products are generated and delivered. All other firms have a clear delineation of what constitutes inputs and outputs as well as the production process that converts inputs into an output. Financial institutions (FIs) on the other hand are unique because the underlying product (i.e., managing risks) and its production process are inherently fungible. Specifically, FIs are differentiated in this respect because they:

- ***offer an array of products and services that can be classified either as a liability or an asset in their balance sheet***. To the extent that products offered by these FIs include obligations of the FIs themselves (i.e., bank deposits, insurance policies), the traditional distinction between an input and an output is blurred.[8]

- ***create liabilities for themselves in order to create their assets.*** This goes to the matter of how highly leveraged FIs are in contrast to non-financial firms. Effectively, the majority of funds deployed by these FIs are actually those that they manage under a fiduciary responsibility. This institutionalizes the concern over systematic risk and its consumer welfare considerations.

- ***are not bound by the physical limits of a production process that takes fixed amounts of inputs to generate fixed quantities of output***. For FIs, financial expertise and market information are critical production ingredients and these are used in developing several types of financial products and

---

[8] In economics, the theory of the firm has a long-standing tradition. It should be noted that there is no equivalent firm-level theory for financial institutions. In fact, banks and non-banks are often segregated as a focus of research. The homogeneity of the “nonbank sector” also needs to be re-examined since the nature of the securities, insurance and pre-need business can be difficult to consolidate into a single model.

services simultaneously. This capacity to take advantage of scale and scope economies allows FIs substantial leeway in both size and depth not normally possible with non-financial firms.

- ***purposely expose themselves to "mismatches" (i.e., gaps) in tenor and currency denomination, among others, as part of their normal business operations.*** Contrary to the popular criticism after the 1997 crisis, FIs are inherently in the business of parlaying and creating gap positions. While these gap positions are patently risky, FIs are also intrinsically risk managers. The objective is not to avoid all risks but instead to identify & manage acceptable risks within prudential norms.

- ***have the ability to provide a value-added product or service to a customer increasingly without physical delivery.*** The availability of technology has defused the limits of geographical and physical boundaries, making funds much more fungible. This fungibility is driven by the means that underlie the handling of risks (i.e., funds) and the infrastructure of the system. This has altered the market landscape and the manner by which consumer protection is evolving.

- ***must execute a completed financial transaction over a period of time.*** A transaction in the real economy is consummated at the point of exchange between the commodity and its payment. For FIs, at least two such transactions must occur (i.e., a security matures, a loan is repaid, insurance benefits are availed etc) over varying lengths of time. This is a critical differentiation between financial and non-financial markets and raises the matter of how risk is endemic to financial markets.

14. Despite all of these complexities, the financial market is often succinctly seen as providing savers the venue to accumulate surplus funds at an expected premium while offering borrowers a mechanism for accessing these funds at a realized cost. As a result, the effectiveness of this market is customarily judged by its ability to cultivate saving (i.e., saving mobilization) and its capacity to intermediate this saving in various desired funding maturities (i.e., term transformation).[9]

---

[9] The gross interest rate spread, defined as the loan rate minus the deposit rate, has also become a popular measure of the efficiency of intermediation *vis-a-vis* mobilization. However, unless risk and regulatory costs are accounted for and deducted from the gross spread, this measure is more misleading than useful.

15. This agenda recognizes that saving mobilization and term transformation are important policy considerations. However, these two can also be seen as more by-products of other policy considerations rather than end-objectives in and of themselves.[10,11] Consequently, this agenda looks at saving mobilization and term transformation as contributory to the overall effectiveness of the financial market but these do not necessarily provide the conclusive barometer of performance.

16. ***The preferred measure of financial market performance in this agenda is the ability of financial prices to provide "relevant signals"***. These signals include the behavior of past prices and all publicly available information, including the risks inherent in the underlying product. This is consistent with the standard economic definition of ***semi-strong market efficiency*** which argues that the market cannot be outperformed, on average, unless there is systematic failure in information dissemination.[12] The qualifier "on average" does not rule out that investors may do better than the collective market from time to time but it should preclude this possibility of above-normal returns from occurring on a consistent basis.

17. There are two clear advantages in using this performance measure. First, there is a basic attraction in allowing financial prices to clear the market. Instead of weighing upon an array of relevant considerations, there is considerable convenience for stakeholders — regulators, regulated institutions & agents as well as the general public — to focus only on a composite indicator in making their financial decisions. This re-states the problem of allocating resources across time and across instruments in terms of relative prices, just as it is done in the real economy. From a regulatory standpoint, it also emphasizes that any intent to intervene through prices-setting policies without addressing the underlying problems will be misplaced. This is because the price system is primarily just the venue for the valuation of information rather than a remedial policy of structural and operational weaknesses.

---

[10]Saving by definition is the residual of income over consumption. Since consumption is proportional to income but at a less than one-to-one basis, the primary stimuli to saving is income. The primary policy consideration in this case is the generation and distribution of income, not saving directly.

[11]The current structure of the Philippine financial market finds savings deposits being leveraged into long-term loans. In this sense, term transformation is occurring and there is notional availability of term funds. However, this is clearly not adequate, suggesting that term transformation is a necessary consideration but not a sufficient condition of preferred financial market performance.

[12]These so-called failures" come about either from the persistence of actionable information that are privately-held or from bottlenecks in the dissemination of and access to relevant information that is otherwise publicly made available.

18. The second advantage is more critical. Focusing on the pricing/valuation system allows all the unique features of the financial market to be fully captured and contained in only one indicator. As the indicator gains wide access, all of its embedded information are then presented in a standardized and calibrated unit of measure, in this case interest rate per annum. The capture of all relevant information and the subsequent standardization of its units of measure are critical because there is very high premium in reflecting risks in financial market transactions. ***More risks must necessarily be reflected in higher financial returns. This trade-off is central to the nature of the financial market because it creates the relative price from which the allocation of fixed resources (i.e., savings) and the funding of unrealized objectives (i.e., borrowings) emanate.***

Box 1
Contrasting Levels of Market Efficiency

The efficiency of the market — where prices move randomly and cannot be consistently predicted — has been the standard paradigm since Eugene Fama formulated the so-called Efficient Market Hypothesis in 1970. Within this paradigm, markets are classified into 3 levels of efficiency.

- ***Weak efficiency*** refers to the case where the current price already reflects all past prices. This suggests that technical analysis on its own cannot "beat the market".

- ***Semi-strong efficiency*** has the current price reflecting all publicly available information. The implication is that neither technical nor fundamental analysis can generate consistently better results than the random market.

- When both public and private information are fully embedded in current prices, this is classified as ***strong efficiency***. Since all information is already accounted for, there will be no room even for so-called insider information to create any advantage.

19. Non-price indicators typically highlight structural and operational limitations (for example, low saving rate or weak term transformation). These can be captured easily into financial prices through the appropriate premiums. However, non-price indicators often stop at identifying these limitations without making explicit the underlying risks. Thus, using a semi-strong efficiency criterion is not only convenient but is also more holistic, particularly in monitoring system gaps & weaknesses.

C. A Vision for the Philippine Financial Market

20. This agenda's vision for the Philippine financial market is necessarily aligned with our expectation of what the financial market provides and our preferred measure of performance. What we envision specifically is an ***open market which is responsive to the varied needs of its public who in turn have the power of choice over differentiated but equally viable alternatives***. These choices — and the power to make those choices when needed — underpins robust market activity. All of these are fundamentally driven by the ***capacity of financial prices to fully capture all relevant information*** since a well-functioning price system not only provides valuation but also acts as the market's signaling mechanism.

21. Moving forward, the development of the Philippine financial market must start from within, providing for the needs of its stakeholders, maximizing the resources available from among participants and tapping opportunities that present themselves. A developed Philippine financial market:

- ***provides a venue for mobilizing and intermediating funds productively***. Mobilization requires a clear delineation between saving and investment. Those who seek to postpone consumption need to have convenient and continuous access to savings instruments. For those who wish to use their surplus funds for monetary gains, the financial market should have a menu of investment options with differentiated risk-return profiles.[13] To maintain the required balance in the flow of funds, the financial market must also be effective in intermediating the mobilized funds. This is only possible when it provides a viable platform for raising different forms of capital funds out of both domestic and foreign saving.

- ***consciously takes on risks in order to generate returns***. Financial returns in excess of the intrinsic value of time are justifiable only in the context of financial risks. This is the very nature of financial markets since collectively avoiding risk will invariably degenerate it into a barter system *ipso facto*. Developed financial markets deliberately nurture such risks but only within the context of specific fiduciary responsibilities. It does so by tolerating risks that can

[13]Saving is fundamentally an intertemporal allocation of resources. There is a return for this ability to postpone consumption which augments liquidity across periods. Investment on the other hand goes beyond the pure compounding effect of time. There is a conscious initiative to take added risks with the intent of generating added returns but this initiative also puts the principal at risk.

be prudentially managed by stakeholders. [14] This means avoiding those that are systematically unnecessary or those that cannot be effectively mitigated.

- ***adheres to an effective system of financial governance***.

Financial governance defines what constitutes acceptable risk-taking and is central to a responsive financial market. Competing interests require that a fiduciary responsibility be instilled upon market agents to balance the inherent drive for returns and its implicit exposure to risks.[15] This fiduciary responsibility is effected through a framework of supervisory standards and prudential regulations. This governance structure is most effective when it cultivates market creativity without sacrificing accepted international best practice. The same financial governance system must take cognizance that the transition to notional goals is often just as important as the goals themselves. Market arrangements, conventions as well as the code of conduct of practitioners must reflect this transition and the desired sequence of reforms.

- ***invests in the required support infrastructure***.

Financial market activity is as much defined by its governance structure as it is delimited by its information technology backbone.[16] To properly address the needs of market participants, physical infrastructure such as payment systems, trading platforms, exchanges and its auxiliary services are all mandatory. These represent significant expense but the investment must be made by stakeholders irrespective of monetary consideration if financial market transactions are to be efficiently executed. Furthermore, this infrastructure support has also become a competitive factor considered by foreign investors as financial markets continue to liberalize. While positioning foreign saving to augment domestic resources raises prudential norms, the potential opportunity they present cannot be ignored in further developing a holistic financial market.

---

[14]It is understood that this creates a moral hazard problem. If additional returns are systematically possible only by taking systematically more risks, there must be a way to identify those “risks that can be prudentially managed”.

[15]Unlike other firms in the “real sector”, financial institutions are inherently much more leveraged. This is the source of the fiduciary responsibility since public funds are involved and problems could degenerate into systemic difficulties.

[16]The “commercialization” of information technology in the last 2 decades has increased market turnover but at the added onus of faster response. Investing in the support infrastructure is therefore as much a collective commitment among stakeholders as it is another area that could nurture the seeds of contagion.

- ***achieves all these through a price system***.

It is central to this agenda that financial prices remain unimpeded by artificial policy intervention and neutral of friction costs.[17] This keeps it consistent with our preferred measure of efficiency. More importantly, it recasts the allocation problem into the singular dimension of risk versus return which remains the most basic tenet of financial markets. Absent this, market participants will allocate scarce resources by maximizing incentives that are not directly embedded in financial prices. This will be difficult to monitor and nearly impossible to manage. It is likely to spawn economic rents, contravening the broad and balanced development of the market. To move the market forward, financial prices must reflect their intrinsic economic value. The choices that arise are then premised only on this full valuation and the transparency of this valuation keeps the choices viable and sustainable.

22. These five facets epitomize the proposed vision for the Philippine financial market. The ability to efficiently mobilize and intermediate funds is tantamount to the choices that are provided to stakeholders. The prudential handling of acceptable risks recognizes the wisdom of tolerating some but not all risks. This allows the system to generate its added-value which accrues to stakeholders. A governance structure must necessarily be defined to provide substance to the risk-taking and market-making functions undertaken within this market. This requires a specific infrastructure to effect the flow of funds and exchange-for-value transactions. Having all of these evident in financial prices makes this vision self-sustaining through the broadcast of relevant information and the development of a transparent valuation system.

23. This vision also purposely avoids positioning an idealized Philippine financial market in the context of its potential standing among the world's financial systems. We retain our perspective of ***nurturing the developmental agenda from within***, responding first to the needs of local market stakeholders without overlooking the opportunities beyond our shores. The strategy is more "inward-looking" in the sense that a developed Philippine financial market is expected to "pull" resources (both domestic and foreign) into its fold.[18]

---

[17] The mechanisms for the capture and broadcast of market prices is to be part of the market infrastructure, covering physical/electronic components and the market arrangements that underlie the operations of the physical/electronic components.

[18] The use of the term "pull" is taken from the capital flows literature. One explanation has recipients being attractive destinations of these capital flows that they "pull" resources towards them. The analogy to the financial market is not insignificant since it suggests that the market provides a broad range of financial instruments that are commensurately priced and the necessary support infrastructure for handling funds & the management of risks.

24. The ability to "pull" resources will be indicative of its success in offering economic value. This is the desired competitive advantage which will eventually elevate the local financial system into the upper echelons in the world market. In our strategy, the premium attached to the needs of market participants — regardless of personal nationality or corporate domicile — is deliberate because it uniquely ensures that the financial market is unambiguously contributory to the development of the local economy itself.

D. Shared Core Principles

25. The vision is crafted in a manner where its five tenets intentionally reflect the structural core of the market that we aspire for. They provide the ideal state of affairs where the fundamental concerns of all stakeholders are addressed equitably and productively. However, the agenda recognizes that the transition from where we are to where we want to go is of critical importance. The existence of so-called best international practice provides a useful starting point. However, these do not guarantee that the local market will convergence to its desired state. There are currently deviations from these international best practices and the transition to the desired standards is not a unique and automatic path. The transition will necessarily generate costs on various stakeholders and these need to be carefully managed in the context of pursuing reforms and maintaining the wherewithal for reforms.

26. To better define this transition path, we provide eight core principles that will essentially govern the initiatives that move the market towards its envisioned state. Four of these are referred to as macro-prudential principles because they provide guidance for the system as a whole. Three others are

Box 2
International Best Practice on Supervision

There are separate supervisory "core principles" that apply to the banking, securities and insurance industries.

The Basel Committee on Banking Supervision introduced its Core Principles for Effective Banking Supervision in 1997. Prior to this, the 1988 Basel Accord epitomized the standard that was applied to banks. Although the 1988 Accord was to voluntarily apply to internationally active banks, it has become the *de facto* standard for the banking community regardless of the extent of cross-border activity. The new accord — Basel II — was completed in June 2004 and provides a 3-pillar approach namely, minimum capital requirements, supervisory review process and market discipline. With the strong link between the banking system and the economy, the Basel Accord has always had a heavy emphasis on managing the risks that may lead to systemic instability.

The International Association of Insurance Supervisors (IAIS) first issued their core principles document in October 2000. The 2003 revision provides for 28 ICPs on the regulation and supervision of the insurance sector. Specific principles are provided for the supervisory framework, the insurance firm, prudential requirements, markets & consumers as well as on anti-money laundering.

The principles espoused by the International Organization of Securities Commission (IOSCO) are embedded in Objectives and Principles of Securities Regulation. A total of 30 principles are in the document based on the 3 core objectives of securities regulation: (1) investor protection, (2) market fairness, efficiency & transparency and (3) the reduction of systemic risks.

referred to as micro-foundation principles as they pertain to specific market participants. The 8th principle integrates the previous principles and reflects our preferred measure of market performance. These eight principles necessarily complement one another and therefore give the agenda one added critical level of substance. Taking this further, so-called corollary precepts are also outlined for each of these principles to provide operational content.

27. There is a fundamental difference between these eight Core Principles and those espoused by the BIS, IAIS and IOSCO. The international principles inherently focus on the supervision of their respective sectors, providing guidance on the oversight of either the particular financial institution and/or its specific market. In contrast, the principles proposed by this reform agenda are intended to provide a framework for institutionalizing a cooperative solution among inherently competing interests. These competing interests arise not only in the context of the oversight of regulators over regulated entities but also across all entities and across all sectors. The focus then is not delimited to supervision but rather on crafting a framework where known impediments to reforms are addressed by stakeholders as a collective body. These difference in focus and scope then account for the very minimal overlaps between the proposed eight Core Principles and those provided independently by BIS, IAIS and IOSCO.[19]

28. We reiterate that the following principles are meant to be strategic in nature. These principles are structured to elicit general conformity across stakeholders. This is designed to be the key stimulus for further cooperative efforts in the reform process. To a great extent, the value of these principle lie in their collective insights, merging specific concerns in the course of providing more substance to the tenets of the proposed vision. The corollary precepts that accompany these principles provide a fair indication of the tactical content of how to proceed with the reform agenda.

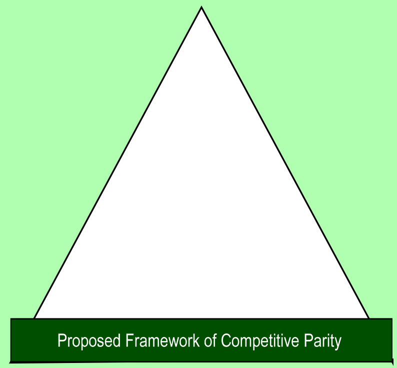
[19] There is an on-going effort where economies voluntarily submit themselves to an evaluation both of their adherence to international standards (Review of Standards and Codes or ROSC is undertaken by the World Bank) and of the stability of their financial sector (Financial Sector Assessment Program or FSAP is performed by the IMF). The proposed eight Core Principles do not present themselves to be an alternative to the international standard. Instead, the eight principles provide a complementary framework that is meant to focus on issues prevalent in the Philippines.

D.1 Macro-Prudential Principles

PRINCIPLE #1

Structure: Competitive Parity

Financial products & services complement each other while competing for resources that are fixed at any point in time. This duality is what we refer to as *Competitive Parity*



Corollary Precepts

- The financial system is made whole if and only if the delicate balance between financial sectors as both substitutes & complements is maintained
  - The flow of funds between sectors must be seen in the context of the strength of the recipient sector and the weaknesses of the other sectors
- Complementarity between sectors suggests:
  - Constructive competition cannot exist with monopoly profits
  - The financial system's ability to manage risks is more than what the respective sectors can do put together
  - Financial market "development" cannot be defined as a "collective concept" (i.e., there should be no break in the risk continuum)
  - Cost and stability issues argue for the sharing of the financial infrastructure to the full-extent possible

29. We begin with an appreciation of the working relationship across sectors. This agenda accepts as a basic premise that the interests of the different sectors are inherently competing with one another. However, we do not see this as derogatory upon the motives of the market participants. Instead, this agenda takes these competing interests as a natural feature of a market that competes for fixed resources from the public by offering differentiated instruments that can handle varied risks.[20]

30. ***We have coined the term "Competitive Parity" to describe the unique condition where different financial market sectors are both substitutes to and complements with each other***. The former arises because there are only finite resources

---

[20] The market exists precisely because different instruments react differently to changing market conditions. As interest rates rise, for example, the gain of savers comes at the expense of borrowers. Similarly, holders of "floaters" gain but fixed income products take a revaluation loss.

which can be deployed at any point in time to address the financial objectives of stakeholders. When funds are incrementally directed into one sector, the other sectors have effectively lost out on these resources as well. In this sense, the sectors are substitutes vying for the same resources and this subsequently creates a competitive environment among themselves.

31. What actually triggers the allocation of funds is how one sector fares relative to another. Positive developments in one sector will naturally improve the sector's attractiveness *vis-a-vis* the limited resources and at the relative expense of other sectors. On this basis, it is neither possible nor appropriate to evaluate one sector in isolation. Instead, the dominance or weakness of any sector should be seen in the context of what it does & does not offer versus what is available in the alternative sectors. Stated differently, differences across sectors must be taken in relative terms rather than absolute.

32. Some of the sectoral differences are quite beneficial but must still be kept within limits. For example, product offerings are always oriented towards their sector of origin. This diversity is central to constructive competition because it creates choices for users. [21] However, ***to generate the envisioned public good, the system must ensure that this competition remains constructive rather than destructive.*** Left to its own, dominant sectors can increasingly build upon its market control if this generates added returns at the margin. What would prevent a sector from completely monopolizing the financial market is the realization that no single product group can effectively address all the risks in the market. Rather than stake a full claim on a delimited — if not ineffective — financial market, each sector has an incentive to parlay complementarities between product offerings to develop a broader financial market. Thus, ***the issue of shared commitments and shared responsibilities need not be premised on altruistic behavior alone as it is still consistent with the pursuit of business interests.***

33. All these suggest that there are important complementarities to consider across financial sectors. The reference we make to "parity" points to a certain balance among the sectors which arises because the value of the whole must depend on the contribution of the parts. In this situation in fact, the ability of the system to manage risks is more than what the respective sectors can do when put together. This is not a figurative proposition but one that functionally reflects the manner by which simple and complex risks can be better

---

[21] These choices arise from the better matching of cash flows between users (both the providers and users of liquidity) and the different instruments. Ultimately, this matching can be seen in the context of the risk tolerance of the investor/borrower versus the risk profile of the instruments.

managed through combinations of products or hybrids of product features.[22]

34. With sectors needing to complement each other, it should *not* be possible to define the financial market as "developing" if at least one component sector is having difficulties. This rigid benchmark necessarily follows from the notion of the risk continuum which would not be defined if there is any "break" between components. This break is a literal disconnect between a sector & the rest of the continuum and effectively delimits what the system can provide. Specifically, the composite second-best is certainly going to be inferior to the notional first-best case where all the component sectors are themselves flourishing. This must be the case since the different sectors are producing "economic goods" and the absence of any of these "goods" implies a reduction in the system's value-added.

35. This corollary must extend to the flow of funds. ***It should no longer be sufficient that incremental funds are being mobilized and intermediated at the aggregate. Instead, the distribution of the flows across sectors matters as much as the volumes generated***. A re-distribution of funds from one sector to another, for example, will have an impact on the system even if the total amount of funds generated remains the same. This impact arises because one sector lost resources while another gained the same resources. This re-balancing has created a real effect because one cannot simply offset gains with losses. Instead, the financial landscape has been altered because economic opportunities have also changed in the process.

36. An exception is possible when the financial system re-balances away from a skewed distribution of resources towards a better balance. To the extent, for example, that long-term credits are currently funded by very short-term deposits, the system can gain when capital is raised from non-intermediated sources. Whether these non-intermediated funds are in the form of equity or bonds would then depend on the risk-return preference of long-term investors. The "gain" to the system — despite the increased volume in the equity or bond market that is offset by the decease in long-term loans — would be the reduction in outright costs that comes about from not having to price such extensive term transformation in the intermediated market.[23] This redistribution would also have a developmental impact in deepening a nascent capital market and in nurturing a more robust yield curve. Clearly, both of these have social benefits that may not necessarily be evident immediately but should ultimately be reflected in the price structure.

---

[22] This is one context wherein an efficient financial market and a vibrant economy mutually reinforce each other.

[23] Stated differently, there is a reduction in the price risk faced by those raising capital and a reduction in the gapping risk faced by the intermediary.

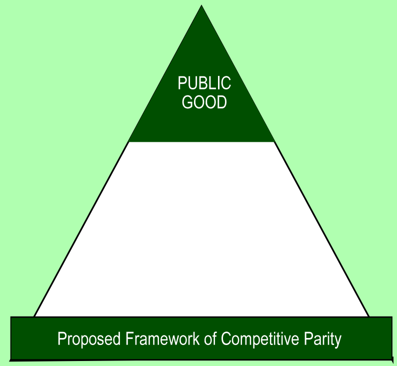
37. The extent to which the sectors complement each other is also evident in the development of the needed infrastructure. These infrastructures — institutional arrangements that relate to as well as the physical design of trading platforms, clearing & settlement systems, depository & custody services, even risk engines — require a significant amount of initial investment and subsequent maintenance cost. These costs are difficult to justify if they were to be the sole purview of some particular sector. Fortunately, there is significant complementarity across sectors to allow for a shared infrastructure. This complementarity arises from similarities in exchange-for-value systems regardless of the specific product line involved. For developing markets, the lack of extensive depth would render specializations in infrastructure counter-productive. From these perspectives, economies of scale and scope give very strong reasons for consolidating the market's infrastructure needs.

38. Beyond outright cost considerations, however, the more fundamental justification for sharing the financial infrastructure is systemic stability. This infrastructure inextricably connects different facets of the financial market in order to provide the desired transaction. The payments system and a securities settlements system, for example, are mirror images not only in terms of exchanging one commodity for the other (i.e., exchange-for-value) but also in terms of making collateral available while extending credit to a counterparty (i.e., under a repo agreement). This level of complementarity makes the system whole and bigger than the sum of its parts. However, as markets broaden, transaction values increase and retail payments become more active, the risks faced by an inter-connected national infrastructure are also inherently larger. Therefore, complementarity improves the delivery of financial products & services through the financial infrastructure but this national system must also be designed appropriately to address the incremental systemic risks that arise.

PRINCIPLE #2

Value: Public Good

An efficient financial market contributes directly to economic growth and is indispensable to the national interest



Corollary Precepts

- An efficient financial market is a "public good".
  - Developing the financial market is a shared commitment and a shared responsibility.
- The development of the financial market must play a prominent and explicit role in the country's economic program.
  - Conflicts should be resolved in favor of social interests since they outweigh private interests

39. This principle establishes the symbiotic relationship between the real economy and its financial market. With the distribution of resources highly uneven and interests inherently competing, the financial market plays the heightened role of providing borrowers with economic opportunities through leverage and/or parlaying private saving into personal investments. This suggests that an efficient financial market — one that delivers its upside, minimizes its inherent downside and responds to the needs of stakeholders — should be treated as a ***"public good"***.[24] By its very nature, it should be deemed to be ***indispensable to the national interest*** and it is clearly in everyone's interest to attain financial market efficiency.

40. Formally treating the financial market as a public good is the only way for competing interests to be effectively managed. As noted previously, competing interests within a zero-sum game leads to the conclusion that stakeholders cannot possibly arrive at a common solution where all interests are coincidentally and independently maximized. The public good principle designates that common social purpose towards which individual interests are subsumed and subordinated. This is necessary because the overarching objective is to define a means for addressing the limitations of a zero-sum game at the microeconomic level in order for the economic gains at the macroeconomic level to accrue.

---

[24] Public goods are defined in terms of 2 features: (a) non-rivalrous and (b) non-excludable. The first says that once the good is produced/made available, everyone can benefit from it. The second feature states that everyone will have access to the public good once it is produced/made available. The use of the term "good" is not accidental and literally suggests that the collective benefits to be derived more than offset any intrinsic cost.

41. ***The offshoot of all these is that developing the financial market towards our desired structure must play a prominent and explicit role in the country's economic development program.*** This calls for more than an inventory of desired and pending initiatives. What is needed is a cohesive agenda with a organized plan for executing clear courses of action under defined accountabilities. We again take cognizance that interests are inherently competing in the financial market and because of which stakeholders are not likely to converge to a common solution. Thus, the agenda must reflect the collective judgement of stakeholders on how these competing interests are to be managed. Furthermore, since the reform process is hardly predictable, it helps to phase in the end-objectives so that deliverables can be expected sequentially within a reasonable period.

42. Reflective of the public good feature, the responsibility and commitment towards the development of the financial market must be for the account of all stakeholders. Regulatory authorities must clearly delineate their framework of what is allowed and disallowed, cultivating creativity and value-added products & services within the limits of what end-users need and what the system can tolerate. Intermediaries are accountable for their professional conduct by striking a prudential balance between their business interests and their fiduciary responsibilities to their clients. End-users must also do their share by being transparent with information pertinent to their operations to which some form of financing has been applied. And to the extent that legislation is required, our legislators are called upon to enact these statutes as expeditiously as possible within the realm of productive cooperation with other stakeholders.[25]

43. Invariably however, varied interests will compete for fixed resources and/or regulatory incentives. This poses the biggest dilemma in crafting an agenda since the courses of action that will be chosen will necessarily create "winners" and "losers". However, this is to be expected of a market that thrives on product differentiation and the allocation of scarce resources. This notwithstanding, these competing interests should not cause a gridlock in the reform initiatives by themselves. Being a public good, conflicts should be resolved in favor of social interests. These interests in turn are embedded in our defined vision for the financial market and our benchmark of performance.

44. It should be of interest that this agenda elevates the entire financial market to the

[25] It is appreciated that in the interest of transparency and consensus-building, the legislative process makes the effort to hear all views on a particular issue and can be protracted. These Core Principles may aid this process by formulating the agreements-in-principle in advance and providing a reference & input in aid of legislation.

level of being indispensable to the national interest.[26] This reiterates the virtuous cycle between an efficient financial market and economic growth. Following the Competitive Parity principle, this efficient financial market is defined only in the holistic sense, covering all subsectors without exception. This collective and uniform treatment of subsectors creates choices for financial market users, matching specific financial needs (i.e., timing of cash flows/repayments, maturity considerations, etc) with specific product offerings. This, in turn, feeds into the real sector, allowing the financial market to mutually reinforce the macroeconomy, increasing the demand for financial services and extracating itself from the limitations of the zero-sum game.

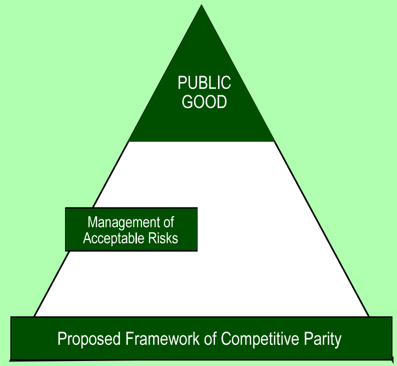
45. When sectors are designated as "indispensable to national interest", there is a necessary reference to the rights of workers. While this point needs to be reviewed and resolved to the mutual satisfaction of all parties, we also emphasize that principle #2 focuses primarily on the fiduciary responsibility of financial market operators in managing the interests of the saving/investing public. *Ipso facto*, this does not suggest guaranteeing maximum return on every opportunity but rather the prudential handling of risks consistent with the needs of the saver/investor.

[26]Republic Act 8761 explicitly identifies the banking industry as indispensable to the national interest. Parallel jurisprudence for the securities and insurance industries do not make the same distinction.

PRINCIPLE #3

Product: Managed Risks

The primary product transacted in the financial market is the management of acceptable risks.



Corollary Precepts

- The financial market is inherently risky and stakeholders agree to abide by a risk-based system for monitoring conduct & stability
  - A developed & efficient financial market will manage risk at various levels of aggrupation
  - There are significant differences in the ability of stakeholders to tolerate and manage risk
  - Stakeholders must make a deep commitment to the math, methods & metrics of managing risks — m^3 **of Risks** — to effectively mitigate these risks
- Financial instruments should be explicitly categorized along a continuum of risk
  - The saving/investing public can make better informed choices by using the relative ranking of the continuum
  - FIs address the moral hazard of incompatible risks by delimiting themselves to the appropriate segment of the continuum
- It is not in the public interest to offer a product and/or service to a counterpart who is not in a position to tolerate & manage the attendant risks

46. Financial markets are inherently risky to varying degrees.[27] There is always the possibility that counterparts may default, market prices may move disadvantageously or that operational flaws can lead to unexpected losses. Yet, even after due consideration of the risks involved, the public continues to take part in this market on the belief that it is still the most efficient way of addressing our respective financial objectives. Thus, ***potential private gains in using the financial market outweighs the possible costs that come with the inherent risks.***

[27] Risk and uncertainty are distinguished because only under the former can probabilities of possible outcomes can be assigned. Thus the management of risk must lend itself to the methods of statistical inference and quantitative techniques.

47. This principle takes explicit cognizance of financial risk and argues that the net gains expected by individuals is also true for the system as a whole i.e., the gains to some individuals do not come at the expense of other individuals thus creating a gain to the system as a whole. This is far from being a tautology. Since resources and opportunities are limited in the short-run, it is not clear why individual gains in mitigating risk do not come at the expense of others. More importantly, although there are potential net gains at the level of an individual, risks are known to increase geometrically when combined and the collective burden of these risks can offset the potential of additive gains.[28] ***What this principle then suggests is that a developed financial market provides the means for effectively managing financial risks at various levels of stakeholder aggrupation***. This is its value added and this is why it is a public good.

48. To further this point, it is important to appreciate what financial markets ultimately trade. Most view this market simply as the venue for transacting financial instruments that can move funds across time, across market participants and across currency denominations. At closer inspection however, financial instruments are merely the means for conducting the needed transactions. The "product" is not the funds themselves. Instead, these provide valuation in response to one's financial objectives. What is in fact ultimately being transacted are the alternative ways of addressing these financial objectives, whether it is saving, financing, investing, equity participation or hedging. In turn, these financial objectives represent various tasks in managing specific financial risks, quantified in monetary terms and denominated in some chosen currency. In this context, the financial market provides different risk tools for various risky undertakings in support of varied financial objectives.[29]

49. To productively parlay the presence of risk, it is critical that stakeholders accept that there are significant differences in their ability to tolerate and manage risks. This acceptance however can mean different things for different stakeholders. For supervisory institutions, they would be most concerned with putting in place a system that readily signals the changing tides of risks in line with their stability mandate. Valuation standards such as mark-to-market and mark-to-model are particularly useful in capturing price

---

[28] Collective risks are additive only when (the return from) instruments are perfectly correlated. However, if this were the case, then this effectively is a single-asset portfolio which would not qualify as a market.

[29] *Ipso facto*, the product offering needs to be more than a single-asset portfolio. This brings us back to the issue of how the financial market can be a value-added if collective risks exceed the sum of stand-alone risks. The risk management principle cannot be a tautology if the public good principle is already established.

fluctuations for trading and investment positions. These must go hand in hand with compliance to the accounting and audit standards espoused respectively under the International Financial Reporting Standards (IFRS) and International Standards of Audit (ISA) so as to eliminate gaps in valuation both across instruments and across economies. Imposing risk-based capital charges would be an integral component of this monitoring system, in this case to mitigate credit risks and the evolving facet of operational risk.

50. While this supervisory framework has become largely best international practice, we should also point out that there are policy and practical difficulties in its application. ***There is the danger that risk management standards are approached as an issue of compliance rather than for its core principles.***[30] This makes the practice of managing risk more superficial than effective. Furthermore, there is the concern over so-called financial conglomerates and cross-bred product lines. This may be compounded by a supervisory system that is drawn along so-called "functional" lines but allows for overlapping oversight.

51. For the other participants, knowing that there are differences in risk capacity means that it is important to evaluate the risk content of each financial product and service. The expected outcome may look obvious in many respects but in practice there is always considerable discussion on how the products compare versus one another.[31] The intention is not to measure the amount of risk that underlies each instrument since these values can change from time to time. ***Instead, it is more important to position each instrument vis-a-vis other instruments along a generalized continuum of risk.*** This provides a quantum of risk per instrument that is relative to the other instruments rather than an absolute measure.

52. This relative risk ranking is useful to the consuming public for them to be made aware of the products, the respective risks that arise with each instrument and how each instrument fares along the risk continuum. The choices that the public makes in terms of saving and investment instruments is often delimited by the amount and quality of information that they have on the product lines. This defeats the purpose of the financial market since these choices are made on the basis of incomplete and imperfect information rather than on the basic issue of risk. Developing an informed public is a concrete way of

[30] Since risk involves statistical inference and technical analysis, mitigating risk requires the proper grounding in the Math, Methods and Metrics of risk. We refer to this paradigm as $\boldsymbol{m}^3$ **of Risks**.

[31] There is always an incentive for each product/service provider to suggest that their product is not as risky as others and is thus more attractive. This is a natural consequence of competing interests.

re-aligning the decision process back towards its risk foundations.

53. The same ranking of relative risk is beneficial to financial intermediaries (FIs) because it provides a basic reference for delimiting their operations. Since different FIs have different capacities towards risk, this process of delimiting operations within its risk tolerance will have to be intrinsic to the firm. This creates a moral hazard problem because the natural business motive for higher systemic profits must come by taking more risks. Prudential regulations often set the floor for a risk management framework but the cap on individual & compound risks is a matter that is decided internally by the FI itself. Capital charges help to set the outer limit for risk-taking but this capital allocation scheme is itself not without is complications.[32]

54. To properly address the moral hazard problem, FIs need to make a real commitment to appreciate and work with risk. It should be clear to FIs that "risk management" is neither just another buzzword nor a matter of compliance that invariably increases the cost of doing business. Instead, ***risk management is a foundation of what makes the financial market a public good and thus should be approached as a structural component of the business***. This requires a top-down appreciation, from the board to the various operating units. A clear and explicit risk strategy must be defined, combining experience and stylized behavior into highly technical models that are the domain of specialists. So-called risk engines have also become necessary to properly monitor and report on these risk dynamics. All of these resources require a significant investment in time and funding just to put in place.

55. The commitment though must extend beyond outright financial cost. As a result of the well-documented complications brought about by the inappropriate handling of financial risks, there has been a very strong policy interest with standardizing risk *methodologies.* This has invariably led to the use of statistical and econometric models which can formally represent risk patterns. Unfortunately, there is often resistence in using these formal models because they are *ipso facto* more complex than internally-set limits and because they often lead to more stringent prudential standards. The added complexity arises because there are additional insights that these models generate in the course of the analysis. However, this is often neither appreciated nor fully valued. And since there is always the natural predisposition towards what is already understandable and what may be

[32] The ability of capital charges to contain risk-taking is also dependent on whether the quantitative model is properly specified. Current international models have standardized parameters to provide a basic reference. There is a clear gain to re-calibrating the parameters to best approximate local conditions.

more convenient, the reform process may find itself estopped. This is where commitment must take a stand against this reform trap.

56. The objective is not the purity of the math but rather the need to standardize risk ***methodologies***. This emphasis on “methodologies” is not accidental; the intent is to identify the consequences of risk-taking without necessarily dictating the specific transactions that participants may want to enter into. The parameters of these methodologies certainly need to be calibrated to local conditions and therefore this adds another layer of technical complication. This is not to be confused however with a passion for technical depth for its pure pleasure. Rather, the desire is to standardize the rules of the game as a matter of financial governance. Certainly, change will always be costly but this should not take away from the prudential supervision of risk. It should also not take away from the basic fact that markets today are much more complex than in the past. ***This gives rise to the urgent need for a standard methodology, precisely because it is a collective benefit to avoid the costs of inappropriately managed risk.*** Thus, convenience, on its own merit is necessary but not sufficient. The commitment required of FIs is to appreciate the need for delimiting risk-taking within prudential norms that is decided on public — not private — terms, no different from reserve requirements, prudential haircuts or money laundering prohibitions.

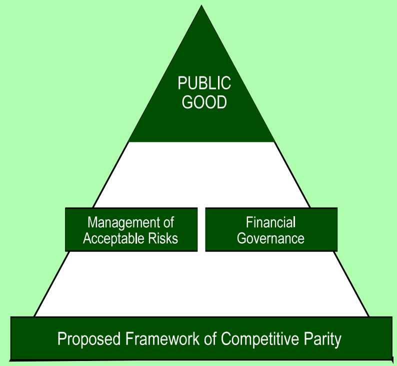
57. Beyond their own needs, FIs have another critical responsibility in line with managing risks. Since they are expected to know the risk content of the various products and have a deeper appreciation of market dynamics, their direct dealings with their clients puts them in the best position to assess the risk capability of the same clients. This is not to suggest that they should actively make the financial decisions for all their clients all the time. Instead, they are well equipped to suggest the limiting set of products and services that would likely suit their clients’ needs consistent with the risks that these clients are willing & capable of taking. In some case, this may mean flagging the inconsistency between the client’s financial objective, his/her risk capacity and the extent of risk the client is willing to take.

58. ***Simply put, FIs should be able to determine what their clients can & cannot do, based on their financial standing and risk tolerance.*** This is not yet the realm of funds management for specialized clients. Instead, it is still within the basic fiduciary function of the FI in the specific context of being a risk manager. This must follow from the first two principles, i.e., managing the risk tolerance of stakeholders is itself a public good. Offering products that are beyond the risk tolerance of clients is simply not in the public interest.

PRINCIPLE #4

Governance: Creating Signals and Moving Markets

The financial governance framework effectively creates a hierarchy among competing interests



Corollary Precepts

- Regulatory parity must be achieved as a condition for *constructive competition*
    - The financial governance structure shall reflect regulatory parity within an agreed period of time
    - The mantra of "leveling the playing field" is implementable only if stakeholders agree on a pre-determined transition path towards parity
    - All financial laws shall be continuously aligned with best international practice consistent with the country's developmental requirements
- Financial supervisors shall co-develop their expertise in monitoring and regulating the financial market
    - Common information about covered institutions and agents shall be gathered and shared among financial supervisors
    - Training programs shall be developed to provide financial supervisors a holistic understanding of various facets of the financial market as well as nurture their specialized requirements
- Stakeholders commit to institutionalize Risk Management principles beyond the perfunctory compliance of generalized standards
    - International standards and principles related to managing risks shall be harmonized across financial sectors and adapted to reflect the empirical regularity of local conditions
    - Market participants shall develop the required core competence — m^3 **of Risks** — to manage risks efficiently
    - Risk management standards shall not create arbitrage across sectors and shall cover the treatment of conglomerates & hybrid products

59. The Competitive Parity principle accepted that financial market interests naturally compete with one another but also need to reinforce each other to attain the higher goal. The public good principle established a target for this higher goal but requires that the

interests of the whole takes precedence over sectoral interests. The risk management principle argued that the output of this public good is its ability to manage risks through the products and services it offers. Since the different product offerings can be arranged according to a stylized progression of risk content, this risk continuum represents the value chain that premises the delivery of the public good i.e., ***for as long as there are no gapping holes & disconnects along the continuum, the array of product offerings can collectively address the various risks in the system which subsequently underpins the provision of the public good***.

60. The previous principles therefore focused on the competitive fabric, the economic importance, and functional contribution, respectively of the financial market. This 4th macro-prudential principle completes the broad structural components of this market by looking at the supervisory covenants between financial supervisors and covered institutions/agents. We refer to these covenants as "***financial governance***" ***and we use this term specifically to mean the collective practices of supervision across sectors and their corresponding prudential & regulatory standards***.

61. It is essential to include financial governance as a core component because of the Edgeworth result: ***left to its own, the financial market would normally not lend itself to a "cooperative equilibria"*** between regulators and covered institutions/agents on one hand and among market participants on the other hand. The basic pursuit for higher returns — which can only come by taking larger exposures of risk — necessarily puts the stakeholders at competing positions. The financial supervisor would like to contain risk-taking to avoid systemic instability while market players need to take advantage of every opportunity that comes along, often without regard to its systemic implications. Thus, the public good nature of the market is being challenged by the private interests that underpin the same market. To rein in the possibility of systemic collapse, defined supervisory oversight needs to be in place. However, if this oversight is too stringent, the ability of market participants to service the evolving needs of clients is also unnecessarily constrained. This brings us back to the policy challenge raised previously: how can competition be kept constructive without degenerating into a destructive non-cooperative situation.

62. Financial governance is the answer to this policy question and the burden of defining the covenants rests with the supervisory agencies. The basic reference for these covenants is the manner by which the system chooses to prioritize inherently competing interests. Thus from the outset, we laid down the public good principle, initially to illustrate the market's economic value but more so now to define its essential role in preventing a chaotic interplay of conflicted objectives. Effectively, this principle can be taken as offering

guidance on how financial supervisors nurture the creativity of market participants to provide products and services while installing the desired safeguards against deliberate abuse or inadvertent failure. This integrates the prior macro-prudential principles by providing a tangible and visible substance to the issues raised by the prior principles. The critical value-added then is that the covenants define the framework through which socially imprudent practices are delimited and as a result delineates what constitutes acceptable conduct in the context of a public good, managing risks to the users' benefit and the competitive structure among financial sectors.

63. Financial supervisors must therefore appreciate that the regulatory landscape directly affects the balance of competing interests across sectors. The chosen structure of financial governance itself molds market behavior because it defines what can and cannot be done by stakeholders. More importantly though, changes to the regulatory landscape sends signals as gains and losses are created. These signals define the pace and direction of market activity as one clearly expects funds to move at the margin towards "advantaged" sectors at the expense of "disadvantaged" sectors.

64. It is therefore critical that a policy review of the governance structure be periodically conducted. It can be reasonably expected that this review will highlight imbalances, largely brought about (a) by the desire of decision-makers to provide incentives to certain products and activities and (b) the breakdown of the traditional distinction across product categories.[33] The former is the "infant industry" argument which has been demonstrated to have its limitations. To sustain these subsidies, the impact is to penalize those who are not part of the targeted beneficiaries. The latter is borne by the cross-breeding of products and/or the unbundling of product distribution from production both of which increasingly reflect the market landscape. Thus, moving towards regulatory parity will have deep long-term benefits even if this transition comes at the expense of short-term costs.

65. ***We do recognize however that the mantra of "leveling the playing field" is an appealing advocacy but is difficult to implement in practice because change generally creates "winners" and "losers" in the process.*** As repeatedly pointed out above, the bigger challenge is managing the transition to a desired goal rather than identifying the goal itself. This is not to suggest that regulatory change is to be avoided just because there are costs in the transition. Such changes are actually critical to a healthy financial market as part of its natural evolution (*vis-a-vis* international standards and relative to domestic idiosyncratic needs) or when remedial action is necessary. It is also not to

---

[33] It is in this context that financial governance not only provides a framework for acceptable market conduct but also invariably defines a prioritization of the competing interests.

imply that financial supervisors should tolerate any imbalance in the structure of financial governance. These imbalances are literally the disparities that handicap some sectors at the expense of others, contravening our earlier principles on public good and competitive parity.

66. Clearly then, parity in financial governance is fraught with difficulties. However, it is also as clear that it remains the desired policy prescription because it induces the fundamental interplay of demand and supply without the added noise brought about by artificial (arbitrage) factors. In order to preserve parity, it is imperative that similar products must be governed by similar standards and practices. The difficulty with this is the reality that overlaps across product lines has become increasingly the norm. This makes it more difficult to determine the clusters towards which “reasonably similar” products can be classified. Hybrids are particularly difficult to handle in this regard because they combine features that are endemic to different product lines which are often regulated by different financial supervisory institutions. This raises an obvious classification problem for which there is no obvious solution.

67. One possible resolution to this conundrum is to rely upon the risk continuum as the means for classification. Instead of classifying products and services according to the similarities of their features, it is better to categorize them according to their risk profiles. This allows stakeholders (i.e. both the financial supervisors and the users) to focus on the probable upside & downside effects of the instruments and to identify who would bear such consequences. There is good reason for this inasmuch as we have already argued that managing risk is the primary product of the market and the various financial instruments are the means of providing for this deliverable. In effect, financial governance parity reinforces the risk management macro-prudential principle just as the latter feeds into the former.

68. To ensure the integrity of the continuum, all products and services must have their basis in law clearly defined. The speed and extent to which the international financial market has evolved in the last two decades alone suggest that there will be a number of statutes in the domestic economy’s financial market that would need to be aligned with international practice. This process though of monitoring and upgrading all financial laws will henceforth be a continuous process since the dynamics between international practices and the economy’s developmental requirements is itself evolving. Where the local statute is already ineffective in meeting current needs, expediency in crafting a more robust legal basis cannot be overstated.

69. Legislative work may also be required to clarify unclear provisions or to provide for those that are currently nonexistent. This will include re-thinking the legal standing and

economic function of products and/or institutions that may be unique to the country (i.e., pre-need plans, quasi-banks, quasi-deposits and lending investors). This review would be very useful for supervisory parity. In addition, providing the legal basis where there currently is none (i.e., ponzi schemes) not only plugs glaring loopholes but makes a stronger case for overall governance.

70. The broader issue of the last points is the existence of gaps and overlaps in the framework of financial governance. This is a real concern for the Philippines which has had a long history of product-specific oversight by supervisory bodies. However, this is not exclusively an issue of antiquated laws. ***It is often overlooked that current international practice allows for the "production" of financial products to be decoupled from the delivery of the same products.***[34] In such a case, financial institutions and financial products have increasingly been exposed to multiple regulators. This blurs the traditional lines of governance which affects the attractiveness of the same product across different providers and/or different products for the same provider. Clearly, this is not the end-objective of the desired parity.

71. The heightened complexity of financial instruments and the existence of supervisory gaps & overlaps therefore strongly argue for oversight bodies to streamline their supervisory initiatives. However, the difficulties of converging governance standards across supervisory institutions is also not often appreciated. In practice, traditional financial institutions (i.e., banks, securities firms and insurance companies) are prone to contrasting risks which require the different supervisory bodies to enforce differentiated standards of risk mitigation. The BIS Accord focuses more on the asset-side of the banks' balance sheet while the IAIS Principles necessarily emphasizes the liabilities incurred by insurance companies. IOSCO, on the other hand, espouses principles for the securities market as a whole and aligns its concern for covered institutions accordingly. Integrating such contrasting frameworks will therefore be quite a challenge, not only for so-called financial conglomerates but more so in maintaining consistency in signaling the desired governance.

72. In the light of the contrast in supervisory focus, it is important for supervisory institutions to coordinate their policy prescriptions at the minimum. This could be enhanced by the sharing of relevant information about covered institutions as a matter of due course. Preventive offsite monitoring and diagnostic onsite audit provide excellent opportunities for

---

[34] Some jurisdictions allow banks to be active participants in the securities business via universal banking. *Bancassurance* allows the retail network of banks to distribute insurance products while the model of *assurbanque* has insurance firms offering traditional bank products. Recently, the longstanding strict separation of banking and securities activity in the US under Glass-Steagall has been liberalized under the Gramm-Leach-Bliley Act.

cooperative action. The desired outcome however is not the coordination of efforts but in effecting coordinated actions. To maximize the potential for coordinated action, common training programs can be developed to provide for a more holistic appreciation of the different concerns across financial markets. These will supplement any training on specialized skills & core competence in the specific areas of specific supervisors.

73. The implicit presumption thus far is that the principle of managing risks has taken deep roots among stakeholders. This should not be taken as a given because of the moral hazard problem: since higher returns can be made systemically only by taking more risks, then covered institutions/agents would have a profit-incentive in relaxing the covenants for controlling risks.[35] As noted previously, this trade-off becomes unacceptable below a certain threshold which the financial authorities must prudentially define. This threshold is not likely to be absolute since the system's tolerance for risks invariably changes over time. However, it should be expected that supervisory institutions will prefer a higher threshold *ceteris paribus* while financial intermediaries would seek to push this to the lowest edge.

74. ***To ensure a cooperative situation, stakeholders need to commit to institutionalizing the very substance of risk management.*** The key perspective is that risk management is a core institution of financial market dynamics, no different from anti-money laundering or reserve requirements. The substance of this institution then rests on four facets (which we refer to as the ***baseline 4C's of Risk Management***):

- accepting the ***Concept*** that managing risks is the ultimate value-added of the financial market;
- going beyond the requirements of ***Compliance***;
- a ***Commitment*** to its principles, not its form and;
- building the requisite ***Core Competence*** to properly enforce the principles.

75. The first is our macro-prudential principle #3. The second is important because there is a real danger that participants may view risk management as a compliance issue concocted by the new international financial architecture. Since risk management can be seen as the task of controlling for risk exposures, it can be relegated to being classified as

[35]A complication arises once the Basel Accord approach of consolidating risk exposures across affiliates & subsidiaries is extended to so-called financial conglomerates. As a matter of practical policy enforcement, there needs to be some way to define consistency in risk management frameworks across industry classifications. This would then allow the parent company (for example, a bank) to consolidate its capital adequacy requirements to include its exposures in subsidiaries that may include investment houses, insurance firms, asset management companies and other financial service providers.

a "cost center" in the context of overall business operations. This will be a mistake. Thus, the third facet reinforces the point that regardless of the specific form of the risk standards, what is to be complied with is the underlying principle that risk management is tantamount to wealth maximization. In order to achieve this, it is essential that a core competence is properly developed, inclusive of the complex technical methods required to carry out the process and ingrain the perspective of maximizing stakeholder wealth.

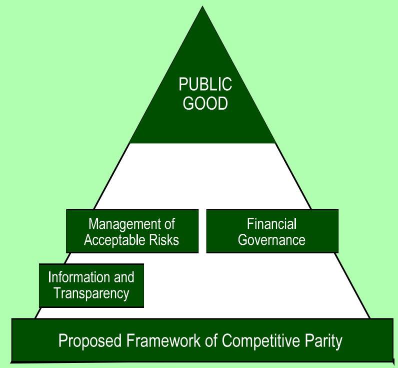
76. In practice, these facets must begin with the agreement among stakeholders that the international risk management standards provide suitable guidance on the principles but the exact numerical form of these standards are much more malleable. As the standards are converted into statistical & econometric models, there needs to be an appreciation that these models work best using localized parameters. These parameters can also be used to eliminate regulatory arbitrage across sectors, any imbalance for different providers of the same product or in consolidating the risk treatment of financial conglomerates. Invariably, however, these would require some specific skills in mathematical methods, models and the requisite metrics. This should be developed rather than avoided since it is the only way that *ad hocery* can be mitigated which in turn ensures consistency & parity.

D.2 Micro-Foundation Principles

PRINCIPLE #5

Information and Transparency

The availability, access, quality and timeliness of information are the key elements to financial market efficiency



Corollary Precepts

- Transparency and disclosure are key determinants of the ability of financial prices to reflect market signals
  - *Materiality* shall be defined *ex ante* within the framework of corporate governance
  - The financial governance structure defines the relative threshold of materiality, guided by international standards on disclosure to mitigate the moral hazard problem
- Market-based monitoring is propagated only when standards for the collection and processing of relevant information are well defined
  - Transparency & disclosure institutionalize the immediate impact of material information on financial prices
  - Contemporaneous market conditions are best reflected by information from actual (done) transactions
  - The greatest value of *Information processors* is to provide systemic indications of the future, reinforcing our emphasis on risk as a cornerstone of market-based monitoring of the financial market

77. This first micro-foundation principle focuses on the role played by information and how transparency is central in a market-based monitoring of the financial market. ***In prescribing an efficient financial market as a public good, we are institutionalizing that the benefits to be derived must be "public" in nature rather than "private".*** Since it is in the nature of public goods that there are no rivalries or exclusions from its benefits, information must be level to all stakeholders. Consequently, the same efficiency norms that define the public good would require that no stakeholder shall have any informational advantage over other stakeholders at any point in time.[36]

---

[36]Consistent with our prescribed vision of an efficient and developed financial market, the parity condition is limited to publicly-available information.

78. This goes well beyond the uniform access to all relevant information. What it effectively implies is that there are no asymmetries in the form of incomplete and imperfect information. Under present norms, this condition is not met. However, this does not prevent a number of actionable standards to be identified. For one, what constitutes "relevant information" must be pre-identified by stakeholders with subsequent accountabilities established for its timely & uniform provision. At the core of this disclosure regime is the concept of ***materiality***. This threshold defines the extent of transparency which subsequently determines the effectiveness of the market to self-monitor developments and reflect the same through the price system. Without the pre-determination of material information, the ability of financial prices to signal is also necessarily compromised.

79. It is interesting to observe that materiality is defined as the relevance of information which will affect the decisions of its users if the information is misstated or omitted. This is vulnerable to the criticism that what constitutes "material" can only be demonstrated *ex post facto*. To ensure the integrity of the price system, it is important that this threshold be determined *ex ante*. From a policy perspective, it is the market's financial governance structure which will effectively determine the threshold information required of covered institutions and other market agents. This minimum level shall necessarily be calibrated so that market conduct is delimited within the parameters deemed consistent with the nature of the public good. It would then be up to

Box 3
Materiality, Insider Information and Chinese Walls

Trading in the financial market ultimately boils down to an issue of the counterparties taking a position based on information they have about a particular security. This is often not just about the content of the information but it is increasingly more so about the timing of the release of the information to the public domain.

The issue of materiality is therefore inherently complex because material information always starts from within the company and can be transmitted in so many different ways to parties both within and outside the firm. The fact that financial gains can be accrued from these material information raises the need for preventive measures against conflicts of interest. This includes the prohibitions against ***insider trading*** and setting a ***Chinese Wall*** between the research side and the underwriting unit of securities firms.

It should be pointed out that arguments have been put forward suggesting that insider trading need not be detrimental to public interest. These arguments are basically premised on the idea that financial markets trade on information. Insider trading, according to the argument, allows information to be conveyed to the market through the purchase or sale of a security. It has also been argued that the trade, even if based on inside information, is between counterparties who are voluntarily conducting the trade. In effect, it is considered by those supporting this view that the trade is a "victimless act".

the covered institutions & agents to voluntarily provide supplemental information which it believes the public should be made aware in the context of transparency.

80. This disclosure process has the potential to be contentious since there is always the ***moral hazard*** that covered institutions and agents have a direct stake in the information that they disclose publicly. To minimize this moral hazard, international best practices have moved towards defining the appropriate covenants for effective transparency. Corporate Governance principles, for example, particularly cover the extent of the financial disclosure expected of market participants. To augment this broad standard, specific disclosure practices have also been crafted to cover (among others) loan accounting & credit risk of banks, the reporting of trading & derivatives activities of securities firms and standards specific to insurance companies.

81. As part of this disclosure and transparency regime, standards for "information processors" are just as equally important. The international effort to converge to IFRS is a necessary condition for the full globalization of the financial market to eliminate incompatibilities in the specific treatment of financial market products and activities. The parallel standards for audit and the exacting responsibilities of external auditors provide a needed validation of the information disclosed by the covered institution. Within this system of check and balance, penalties for malfeasance and the enforcement of these penalties play a key role (not only for purposes of jurisprudence but ultimately) for preserving the signaling capacity of the price system. This certainly must extend to credit rating agencies both because of their increasing role within regulatory standards and because of the price impact their ratings invariably generate.[37]

82. A related but often overlooked aspect is the matter of transactions information. In the equities market, these information are carried and provided by a ticker-tape type system. While this infrastructure is often just within the confines of the trading floor (i.e., both physical and increasingly in electronic platforms), there is nonetheless the opportunity to provide for real-time information to those who seek this information. This opportunity is much less common in fixed income markets to a large part because the trade is typically on an *OTC* basis. More recently however, there are infrastructures that provide for the capture of transactions data, both for OTC and *off-market transactions*. These include the

---

[37] This raises the issue of what value-added do credit rating agencies eventually provide. Currently, CRAs project the longer-term performance of firms and sovereigns. However, technology has increased market turnover and shortened the window of opportunity within which investors and traders have to react. Thus, the point has been raised whether CRAs should instead provide the means of anticipating "turning points". This shortens the forecast period but would make the credit information more valuable to traders.

OTC-FIS in Indonesia, BIDS in Malaysia and TRACE (the successor of FIPS) in the US. The importance of these data capture systems cannot be overstated. This is not only a matter of information but the bigger issue of mitigating execution risk in the capital market.

83. All of these are important but they must still nonetheless be tailor fitted to the requirements of the local regulators and the domestic market. Specifically, the intent is neither to create an overload of information nor to force covered institutions to unnecessarily reveal confidential & competitive information. The dividing line is ultimately defined by the minimum information required to efficiently supervise the market within the context of tolerable risks. Thus, this disclosure requirement falls within the gambit of pre-emptive monitoring of potential systemic risks brought about by the collective action of market participants whose primary business objective is return on investments.

84. ***The ideal upside of this disclosure is to institutionalize the immediate impact of information on financial prices***.[38] In this context, there is less reason for those who are in the business of processing information to provide an evaluation of *ex post* performance (since this should have been incorporated to the price already). Instead, the more urgent need is to anticipate the prospective condition of covered institutions and/or agents. This is much more consistent with ***risk analysis*** which concerns itself with what may transpire in the future based on available information today.

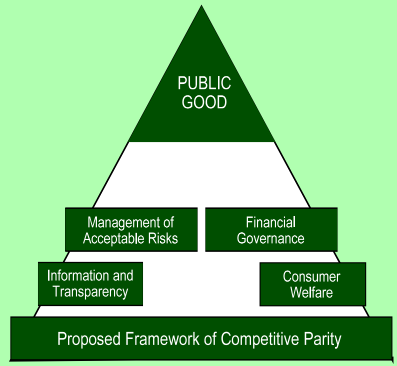
85. This particularly applies to accounting, audit as well as to credit rating institutions. The traditional "seal of good housekeeping" that these institutions provide is still important to the extent that it is an assurance that the presented information conforms to established norms at the minimum. That, in itself, poses a challenge because the integrity of this assurance has not always been prudently guarded. However, the greater challenge is to mine the data for systematic indications of what may be rather than what has been. Clearly, this goes beyond the traditional discussion of convergence and ventures into the territory of prognostication. It may be less important that a covered institution is rated (for example) BBB relative to the confidence that the institution's fortunes are not expected to change materially within a designated time interval. This reinforces this agenda's emphasis on risk analysis and provides a cornerstone for our information-centric view of a market-based monitoring of the financial market.

[38] The counterpart of this transparency is the possibility of increased price volatility.

PRINCIPLE #6

Consumer Welfare

Consumers are to be accorded general safeguards against abuse while recognizing that the financial market naturally generates risks in the pursuit of returns.



Corollary Precepts

- The possibility of abuse is endemic in a risk-for-return environment more so where consumers are neither equally informed nor equally equipped to deal with the nuances of the market
  - An equitable corporate insolvency framework, enforcement of creditor rights and the creation of alternative dispute mechanisms are critical for institutionalizing consumer protection
- Public awareness, as a continuing effort among stakeholders, is the most effective pre-emptive tool for mitigating the possibility of abuse
  - Regulators and market players shall establish the appropriate venues where pertinent issues will be discussed.
  - Regular workshops will be held for the media to develop and expand their understanding of the financial market

86. The 2nd micro-foundation revolves around the need for consumers to be accorded a minimum set of safeguards.[39] Unlike its parallel in the real economy, financial market transactions are unique because of the risks undertaken by the counterparties. To ensure a going concern, it is imperative that the accumulated risks do not surpass the system's capacity to bear them. This is consistent with the supervisors task of defining acceptable market conduct and part of this responsibility is to provide for a basic safety net for the consuming public and/or provide for remedial action when needed.

87. ***This micro-foundation principle can be seen as directly complementing the risk management macro-prudential doctrine. It recognizes that the prospect for abuse is endemic in a risk-for-return environment particularly where consumers are neither equally informed nor equally equipped to deal with the nuances of this market.*** As already mentioned, it is also an offshoot of macro-prudential #4 because the welfare of the consuming public is central to making the financial market a going concern

[39] This principle is fully consistent with one of IOSCO's three core objectives.

that perpetually provides a value-added. It also follows from the first micro-foundation since the availability of quality information is the most basic tool that can be provided to the general public to mitigate the potential for abuse.

88. All these do not suggest that the consuming public must be protected against all risks all the time. To do so is to suggest that the saving/investing public should not accrue any premium on any financial instrument as these bear no risk. What it does suggest however is that there should be a fundamental concern for customer protection/consumer welfare in terms of safeguards against financial crimes (i.e., fraud, money laundering), enforcement of prudential regulations, the conduct of market participants towards clients (both retail and wholesale), market abuses and other basic issues such as transparency and disclosure. This collective comfort level is quite central to the current paradigm of the international financial architecture. Not only is it part and parcel of effective governance, it should really be embedded in the broad fiduciary responsibility of financial intermediaries and financial markets towards the saving/investing public.

89. Rightfully, established international standards for banking, securities and insurance supervision raise the concern for customer protection to varying degrees. Beyond the faithful enforcement of these international standards, however, two more prominent aspects are particularly relevant to the Philippines as related corollaries. First, the country's insolvency law needs to be updated as quickly as possible. Dating back to the onset of the 20th century, there is an urgent need to bring the system's standards for corporate insolvency & creditor rights up to the international bar. While measures have been put in place in response to the 1997 crisis, a more structural revision would be quite beneficial. Second, recognizing that conventional legal action may be a protracted process, alternative dispute resolution mechanisms should be actively pursued. Arbitration is still in its nascent stages in the Philippines and putting a structure in place to formalize this option would likewise enrich a culture of consumer welfare.

90. Both of these mechanisms are clearly remedial in nature. Ideally, they are the fallback mechanisms that participants resort to once some form of failure has already transpired. To better provide for a going concern, the system is better positioned to emphasize measures that would mitigate, if not prevent, the occurrence of such failures. This is where public awareness is a critical component to alleviate entrenched asymmetries in information.

91. One easily actionable proposal is to create various fora which the different "publics" have regular and easy access where issues of general interest can be presented and discussed. The singular objective of these fora is to disseminate relevant information and

increase awareness so that financial decisions are made by better informed publics. Publications in the vernacular (often in cartoon or comics format), radio & TV programs and regular columns in the newspapers have been popular examples tried in various jurisdictions. At the more sophisticated end of the consuming public, internet access to specifically designed websites may be contemplated. Roadshows may also help for as long as they as "packaged" according to the specific intended audience. Overall though, the challenge is not in initializing these programs but rather in institutionalizing the concerted effort. We recognize that public awareness is a continuing process that is prone to fatigue and resource deprivation but the alternative is clearly much more counter-productive in the long-term.

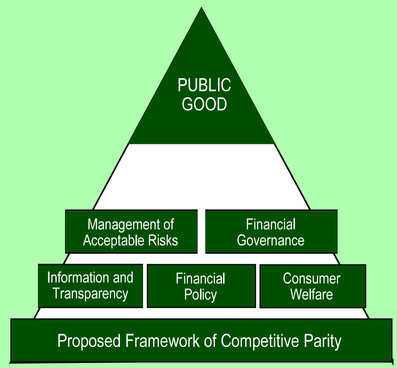
92. Public awareness however is not the exclusive domain of end-users. In practice, the majority of the consuming public base their information on what they read and hear from the tri-media rather than from the so-called practitioners themselves. Part of this is the "conflict of interest" aspect that is — fairly or otherwise — attributed to these market participants. However, the larger part of it is undoubtedly the comparative advantage of media professionals to package "byte-size" information. In our market, perceptions are determined much more by how the information is packaged rather than by the pure content of the news. In this regard, those who deliver the news must be well versed so that the innate practices of a risky market are put in their proper perspective.

93. A corollary arising from this is the need for and the value that regular media workshops may provide. In these workshops, media professionals are exposed to the various facets of the financial market. These obviously need not be structured at the level of an accreditation exam for a financial practitioner but should at least cover sufficient ground so as to develop a broader view and a deeper understanding of market dynamics. This type of endeavor is normally part of "continuing education" and would generally be left either as an individual and/or industry concern of the media professional. However, given the systemic impact that financial reporting can and does generate, developing and maintaining these workshops have a broad payoff that would be to the general interest of all stakeholders.

PRINCIPLE #7

Primacy of Development

The State recognizes that financial market development is its overarching objective in the conduct of its financial policy mandate



Corollary Precepts

- The economic costs of financial taxes cannot be greater, at the margin, than the social benefits derived from them
  - The efficiency of financial taxation is evaluated relative to its impact on the local economy
  - Taxes should be neutral across similar economic functions and/or activities
- Monetary authorities recognize that the chosen policy affects different stakeholders differently
  - Changes in benchmark rates shall consider the impact across competing interests
  - The design of the national payments system must specifically consider systemic stability and its impact on other financial sectors

94. This 3rd micro-foundation highlights the State's exercise of "***financial policy***" which this agenda takes as referring to fiscal and monetary policy as well as the critical nexus between these two. Specifically, this principle establishes that the individual decisions made and effected by the State under its financial policy prerogative must be for the expressed purpose of developing the financial market.

95. This may be misconstrued as a tautology since development is always the generalized objective of the State and particularly as a consequence of the public good principle (macro-prudential principle #1). However, ***Competitive Parity*** also alerted us that the financial market is an aggrupation of competing interests and in practice there are no interests more polar than those of the policymakers and the regulated institutions. At the very least, the divergence is because the for-profit motive of private interests in a *laisse faire* environment do not always conform to the established social objectives (macro-prudential principle #4). Beyond this however, there are basic instances where the State's exercise of financial policy directly contravene's the "bottom line" that private interests naturally seek. These competing interests need to be addressed in any agenda, not only to resolve any pending issues but more so to serve as a guide for policy initiatives moving forward.

96. Perhaps the most contentious issue between regulators and market participants is the inherent right of the former to impose taxes on the latter. It is problematic in itself that the tax will always be seen as a friction cost by the private sector. What truly complicates is that the cost to the private sector is a form of revenue for the public sector. This transfer of resources is a full offset: the gain of one comes at the equivalent expense of the other. This is where the interests are perennially in conflict.

97. This conflict of interest has real economic consequences. As the financial market is increasingly taxed, it necessarily raises the cost of intermediation. This incremental burden will be borne by the retail debtor and eventually by the general public. More importantly, taxes are being imposed on saving. Thus, the need of the State to generate tax revenues will manifest itself as higher interest rates, higher prices and an incremental constraint on broad economic growth.

98. It is not difficult to imagine then that ***beyond some critical level, additional financial taxes will be counterproductive for the economy as a whole as the economic burden more than outweighs potential social benefits.***[40] Several corollaries arise from this point. The most obvious would be the determination of the critical point that effectively caps the efficiency of imposing financial taxes. This gives us a clear picture of the level of the cap as well as where the system currently is relative to such cap. In many respects, league tables comparing cross-country tax rates do not really suggest the comparative burdens of taxation. They merely illustrate the outright rates but remain silent on the capacity of the respective economic systems — and its people — to bear them. In the absence of this determination, the debate on taxation will always fail to converge: the State needs tax revenues, the private sector sees this as a friction cost and both arguments are valid without any resolution in sight.

99. Aside from taxation of the system as a whole, there is also the matter of handling tax policy across financial markets. Following the ***Competitive Parity*** principle, tax-neutrality is the desired policy standard. This is simply to prevent the arbitrage in tax to be the stimuli for market transactions instead of the more fundamental demand and supply considerations. To attain neutrality, the immediate action agenda is to generate an objective inventory of the structure of financial taxation to identify any misalignments. The risk continuum would again play a critical role in this exercise because of the need to

---

[40] The imposition on financial taxes increases the cost of saving *vis-a-vis* consumption. The perverse effect on the economy arises when saving falls for given levels of income. This will then reduce domestically funded investments and decreases GDP *ceteris paribus*. The potential upside offset that can come from tax revenues is limited by the Laffer effect: as tax rates rise, taxpayers have an increasing incentive to avoid or evade taxes such that government tax collections actually decline.

categorize "similar economic functions and/or activities" across differentiated product lines or across different service providers.[41]

100. The transition from the current tax structure to one of neutrality will necessarily invite policy debates. If cases of tax arbitrage are identified, would the policy be to lower the higher rate, increase the lower rate or would it be some rate in between? How would these policy changes affect the expected tax collection of the government? These are not trivial questions and in fact are precisely those that have been left unresolved by previous tax reform initiatives. For this agenda, however, there are two clear limits that should be adhered to in resolving the issue. At one end, the efficiency of financial taxation caps the ability of the State to move the economy forward. At the other end, choosing the lower tax rate between differently-taxed-but-otherwise-similar products/functions would at least create parity albeit at some erosion to the government's current tax base. This creates an area between the two limits which is fertile ground for policy initiatives depending on the desired result and preferred incentive structure. In this context, the issue of tax-neutrality is less about the difficulties of the transition to the desired state but more of the empirical simulations that would outline the policy options. Stated differently, ***tax-neutrality cannot be dismissed solely on the grounds that the current tax revenues may be eroded***. Instead, it should be pursued with the commitment to undertake the necessary simulations which can provide the basis of the policy choice.

101. There is one final point on the fiscal policy side. While we have argued strongly for efficiency in tax policy and for tax parity across economic functions, it should also be accepted that the State should tax any product and/or activity which falls under the category of an "economic bad". In this case, the cost aspect of taxation is used by financial regulators as a potent factor for dissuading behavior and/or product use that is deemed outside the accepted limits of prudence. This is no longer under the gambit of parity but rather one of financial governance. This does not contradict any of the arguments presented in this section and instead should be taken as consistent with macro-prudential principle #4.

102. Monetary policy also has its share of issues between regulators and the covered institutions. For example, the tightening of monetary policy — in the context of reining the chosen policy target — is often described as either increasing the cost of doing business, decreasing competitiveness or both. However, unlike fiscal policy, there is no transfer of resources in monetary policy so that the "friction" is not between the regulator and the

[41] Tax arbitrage as defined here is limited to the uneven tax treatment of directly substitutable products. It does not cover issues such as "tax position" and cash/accrual accounting of tax liabilities.

regulated institutions. Instead, ***monetary policy affects the conduct of business by setting aside resources for prudential reasons (i.e., reserves and provisioning) or affecting market signals through central bank interest rate movements.***

103. The effect of these changes across different stakeholders is predictably differentiated. In this sense, the impact of monetary policy is just as real as outright taxation. As a corollary, the authorities must recognize how their policy actions — even when conducted strictly with prudential terms — can affect the development path of sectors which are inherently competing at any point in time for fixed resources.[42]

104. In the pursuit of the same monetary policy, the issue of the payments system must be raised. Previously, economies of scale and scope, in the context of *Competitive Parity*, argued for a cost-efficient shared infrastructure. Beyond the cost-efficiency issues, however, the payments system has a direct bearing on the developmental aspect of monetary policy. In particular, payment systems provide support for the conveyance of monetary signals through the money market (i.e., via repos) and raise a stability issue by creating a mechanism for the transmission of risks. These are not trivial matters and must be recognized in the context of institutionalizing a robust payment system.

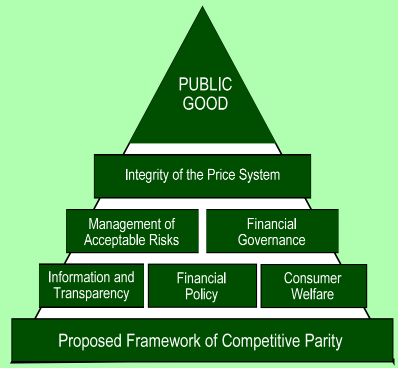
[42]Specifically, monetary policy decisions made by the regulator of banks necessarily impacts on the behavior and market conduct of non-banks. This raises the supervision issue of (a) separating monetary policy from bank regulation functions and/or (b) consolidating supervision over the financial market.

D.3 Integrating Principle

PRINCIPLE #8

Maintaining System Integrity

Consistency of financial prices and price discovery are central to attaining market efficiency



Corollary Precepts

- Distortions in financial prices create other distortions in resource allocation and resource distribution, contravening the fundamental contribution of the financial market to the real economy
- Stakeholders ensure that *price discovery* is continuously developed and unimpeded
    - The government ensures that benchmark issues will be managed to have sufficient depth
    - The yield curve for government issues must reflect the price (asset liquidity) and availability of funds (funding liquidity) at the respective tenors along the curve
    - Yield curves for other product lines shall be developed and made publicly available
- Systematic misalignments are to be eliminated by ensuring that financial prices fully reflect underlying risks

105. This concluding tenet is the logical last piece that integrates the seven preceding principles. Having established a view of the financial market, its key structural facets and what are expected of specific stakeholders, this agenda can then turn its attention to that one parameter that visibly drives the decision of market participants. This parameter is the array of financial prices that correspond to the various instruments, creating in the process an elaborate matrix of actionable signals (and thus incentives).

106. The signaling structure is much more complex than stand-alone prices because the relevant information transcends across instruments, across time and across currency-denominations. These inter-relationships are generated purely by each instrument's declared valuation, the pricing of risks and the simple supposition of "no-arbitrage" as a basic reference. Standard methods in financial mathematics allow for the derivation of this matrix of cross-effects upon which market decisions are based and made.

107. ***It is no exaggeration then that the integrity of the financial system rests on the vibrancy of its price system.*** If prices are distorted for whatever reason then the resource

allocation decisions that emanate from them cannot be reflective of the interplay between demand and supply forces (adjusted to an intrinsic tolerance to risk). The danger with this is that it does not necessarily manage the risks as required by stakeholders nor does it necessarily lead to a public good. The same distortion will likely favor some interests over others, causing a shift in the distribution of resources as well. Invariably, this has a risk consequence and it pushes financial supervisors to heighten their oversight to prevent an unwarranted build up of risk. These preventive policies, which will have to be in place until the distortions abate, necessarily come at the expense of the mandate to develop the financial market. Thus, distortions in financial prices create distortions in resource allocation and resource distribution, contravening the fundamental contribution of the financial market to the real economy.

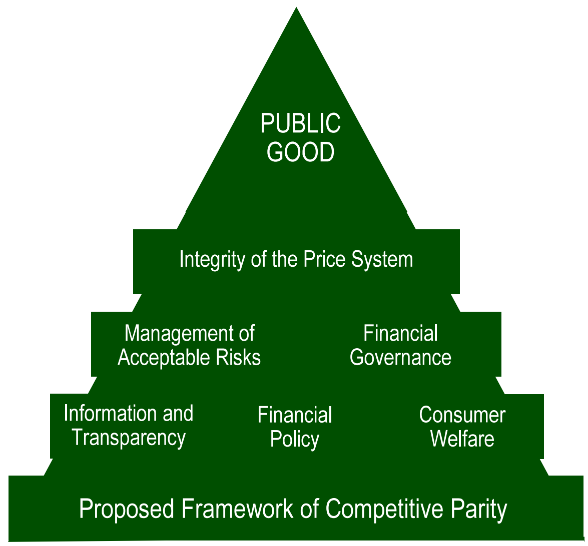
108. To nurture an open price system, market participants must develop a mindset towards ***price discovery***. This requires creating a price for funds of a specific form, for a specific tenor, a specific counterparty as well as other salient but specific details. The focus on specificity is deliberate as it creates a price for a specific case which forms part of the universe of possible permutations that require its value in a price. Effectively, this discovery migrates the system from its current tendency for a "base price plus" methodology to a yield-curve based pricing framework. We are however not constrained to only 1 yield curve. Just as the curve normally points upwards as the tenors increase, different yield curves can be constructed one over another to correspond to, i.e., differentiated credit risks. This network of yield curves not only visualizes the universe of possible benchmark prices but certainly allows for a more dynamic market activity, for example, by "riding a curve" or by undertaking "matrix trading".

109. All these seem straightforward but in practice face difficulties. The benchmark local currency yield curve (LCY-YC) must originate from the government since it is the government which has the least possibility of credit risk (by virtue of the printing press, if needed) and provides the ratings cap under current international best practice. The dilemma of course is that it is also the same government which is the largest borrower in the market. Thus, its interest is divided between lowering its own borrowing cost and its potential for developing the cost-of-borrowing benchmark. At worst, this gets manifested in frequent auction rejections or a significant gap between the primary and secondary rates. In addition, there is also often a tendency to borrow for specific purposes. The concern this raises in the market is the question of what can be funded within the calendar year (market absorption or supply risk) which invariably contributes to a shortened perspective.

110. To move forward on this dilemma, a viable "live rate" yield curve must be the accepted norm. The basic presumption in crafting such a yield curve is that there is

sufficient depth across benchmark issues. Initial evidence suggests that ***fragmentation*** is an issue for government securities benchmarks. Consolidation of the Philippines 12 benchmark issues — through ***buybacks*** and ***reopenings*** — will help in arresting the fragmentation and instilling depth in the desired benchmarks. With this depth in hand, the follow up task is the (auto) capture of secondary market trade upon which the yield curve is based. As the curve continues to pass the "market test", liquidity will develop, in principle, to lend further support to market activity, depth and viability. Either the absence of depth or the failure to pass the market test will ensure the irrelevance of any yield curve.

111. It has been presumed thus far that financial prices truly reflect their worth in risk. This is a necessary and sufficient condition for mitigating against systemic misalignments since it preserves the most basic tenet in financial markets: higher returns can systematically be achieved only by systematically taking larger risks. The absence of an open price system will certainly distort this risk-for-return trade-off with predictably abject results. This needs to be made explicit since the convenience & necessity of intervention often makes it easy to overlook such a basic tenet.



E. Enabling Environment for the Capital Market

112. Having defined the Core Principles that apply to the Philippine financial market as a whole, the task of delineating a normative environment for the capital market is much more straightforward. In particular, our policy concern is to craft a vision of the broad structural pillars and operating arrangements that would ideally make the development of this market self-sustaining. This broad vision is discussed in this section.

113. We reiterate that our concept of a "capital market" refers to [para 6]:

> *"the segment of the financial system that mobilizes and intermediates long-term funding without delimiting the source of these funds. Thus, this will include both debt and equity instruments (as well as hybrids) literally with an original tenor in excess of one year but preferably much longer (i.e., at least exceeding 5 years, optimally exceeding 10 years)."*

This is not synonymous to the term "***non-bank***". Since banks are presently the largest source of long term funds, excluding them paints an unrealistic view of the term-funds market. While we recognize that the dominance of banks in the financial market is itself a recurring reform initiative, including banks within the purview of the capital market does not preclude a policy reform of the structure of the financial market and its financing mix.

114. Our preference of tenor classification (i.e., 5-years or more) is strictly relative and *ad hoc*. However, we do note that shorter maturities are well within the reach of the banks and that the capital market is traditionally the domain of the market for bonds, notes and stocks. Thus, it is for the non-intermediated market to provide value by extending the maturity profile of the flow of funds while operating within a deep & liquid secondary market. This is not to say that banks are incapable of bridging the tenor gap between very short term deposits and long-term loans. Philippine banks already have this gapping expertise and have done so without the need for a vibrant secondary market.[43] However, it does come literally at a steep price reflecting the cost of liquidity and the corresponding refinancing risk.[44] Therefore, efficiently financing the needs of "development" will require

---

[43]With loans generally non-tradable, banks are effectively taking a position on credit risk and using a "price solution" to a tenor problem.

[44]The cost of borrowing cannot be disproportionate to the growth of the real economy. In principle, intermediation is unsustainable if the economy is growing — and business revenues are expanding — at a nominal rate equal to or lower than the annual cost of funds.

a financing mix oriented towards the traditional capital market. This should lead to a more cost-effective financing profile which in turn is possible if there is an innate market for long-term saving which can seamlessly fund the requirements of long-term intermediation. This is the capital market that we envision.

E.1 Macroeconomic Stability

115. Realistically, the capital market will develop and thrive to the extent that market participants are able to reasonably anticipate what may transpire in the future. This does not suggest that probabilistic expectations about the future need to accurately materialize. ***What is necessary is for participants to have the means to make educated guesses of future market possibilities — particularly on financial prices — and to recursively discount each of these possibilities in terms of the certainties of the present.*** This act of repricing the future in today's prices is a critical feature of a viable capital market because it is the basis upon which investment and borrowing decisions are made.[45]

116. To institutionalize this recursive process, the macroeconomy must be generally healthy. If instead there are vulnerabilities i.e., in the fiscal balance and/or its BOP position, the financing of these gaps will necessarily induce volatility in financial prices. This volatility is an anathema to the development of the capital market since it blurs expectations of the future.[46] Market participants will then take to the proverbial sidelines or at best delimit themselves to the short-term markets. In this context, macroeconomic vulnerabilities will effectively price long-term investment and borrowing opportunities beyond the risk-return frontier tolerable to participants.

117. It may seem ironical but the fact remains that before the capital market can contribute to the economy, the economy needs to be devoid of systematic difficulties to develop such a thriving capital market. In this sense, the pre-requisite of macroeconomic stability is tantamount to going beyond the myopia of private interests. While the overall macroeconomy is beyond the exclusive purview of capital market participants, it is precisely in this context that the 2nd macro-prudential principle advocates a ***public good*** approach to the financial market.

---

[45] This reiterates the importance of information and transparency, i.e., the 1st micro-foundation principle. The likely outcomes which stakeholders discount is necessarily based on the information that they have access to and the extent to which the object of material news are transparent in making them public.

[46] Alternatively, long-term financing cost may be too high (reflective of the increased volatility) to be a viable option.

E.2 Organized Market Structure

118. The positive state of the economy is a necessary condition but is not sufficient *ipso facto* to create a long-term market. Such ***a market needs to be methodically designed for processes and conventions that will dictate the transactions' workflow.*** Matching the interests of providers and users of liquidity requires that all unnecessary risks are obviated. This will bridge the gap between the demand for inherent long-term funds and the supply of liquidity which always has the default option of staying short-term. As this gap is increasingly narrowed, the system progressively migrates towards a "market of options".

119. An enabled capital market environment thus requires an organized venue for bridging this latent gap. This concept of a "venue" however goes beyond bricks and mortars. Instead, this ***venue is meant to provide the general public with a clear signal*** that a systematic platform exists for the flow and re-flow of long-term funds and any financial instrument attendant to the funds. Within this visible effort to organize, what is crucial is to:

- ***signal a concerted*** effort to mobilize & intermediate longer-term funds,
- ***allow access*** to funds and instruments to all interested parties,
- consciously provide an ***adequate payments infrastructure***,
- reinforce the payment system with ***adjunct services*** as needed,
- ***capture relevant information***

all of which must be undertaken ***within a defined financial governance framework***.

120. The signal that emanates from the concerted effort to develop an organized market is quite fundamental. It gives issuers viable choices to structure their balance sheet as they see fit (i.e., debt versus equity versus hybrids), matching their chosen financing method with their expected revenue flows. To investors, such an organized market extends the risk-return frontier, generating additional investment choices without necessarily increasing the risks. Coincidentally, the same improvement in the risk-return trade-off provides intermediaries more options in the market, either by taking open investment positions, improving hedging possibilities or in the general pursuit of profits through trading.

121. All of these are possible through various market structures that have specific roles to play. Primary markets are obviously necessary because they simulate exchange-for-value between funds and the financial instrument and thus between investor and issuer. It is, however, within a vibrant secondary market where the market value of the instrument is perpetuated since liquidity stimulates price discovery. A weak secondary market — because of liquidity constraints or due to an ineffective market structure — necessarily

erodes the viability of the primary market since potential investors are practically limited to a hold-to-maturity portfolio. This would be invariably a thin market since very few investors would be able to forego liquidity over long periods. In more sophisticated environments, the 3rd and 4th markets are important because they facilitate significant volumes per trade among institutional players.[47]

Box 4
Public Offerings, Private Placement and the Capital Market

The capital market creates an organized venue so that holders of excess liquidity who are open to long-term placements can link with those needing to raise longer-term funding. This will invariably include the pooling of retail excess funds so that larger blocks of long-term funds can be made available. In this context, the issue of ***distribution*** is important. While the definition of ***public*** differs from one jurisdiction to another, public offerings are subject to fairly common rules on registration and issuance of prospectus in line with both consumer welfare and financial governance issues.

The definition of "capital market" espoused by this module does not include any provision for public distribution to recognize that ***private placements*** have their role to play in this market as well. The securities involved in private placements need not be registered with the SEC (so-called exempt-securities) precisely because the transaction does not involve the public domain. This will expedite the raising of capital from institutional investors and the trade-off comes is that the transaction is held to a different standard of information and governance.

To prevent a possible segregation of the market that can lead to illiquidity, there are other provisions that allow holders of unregistered securities to sell these to the public (i.e., Rule 144 of the US SEC) or the buying/selling of unregistered securities within the 2-year period (i.e., Rule 144a) as originally prescribed in Rule 144.

In some cases, the tax treatment of exempt securities may differ from those under public offerings. This can be a problem of arbitrage but it is one that is defined by the tax structure rather than a problem of distribution.

122. There is however no intention to confuse effort with result. From the primary to the 4th market, the signals generated provide choices because the macroeconomy is stable and because a particular market framework is in place & enforced. The crux of providing for an explicit venue is that it institutionalizes these market arrangements & conventions. At the very least, this embeds a structure for operations and instills uniformity across transactions and participants. Beyond this, fragmentation in the market that arises from incomplete and imperfect information can be effectively addressed if the system can

[47] The 3rd market refers to over-the-counter trades between broker-dealers and large institutions. The 4th market refer to transactions among these large institutions.

provide uniform access to information to all participants. As such, these market arrangements & conventions consolidate interest towards the capital market by creating order through the enforcement of rules and laws. ***While a stable macroeconomy is the high-level pre-requisite, an organized venue premised on transparency thus gives the capital market its form***.

E.3 Creating Robust Benchmarks

123. Moving from form to substance, an enabled capital market environment must generate credible valuation through robust benchmarks. ***Pricing is the key component because it summarizes the relevant information needed to make investment and borrowing decisions***. This must be the case since all financial markets are distinguished, among others, by the fact that its pricing is not governed solely by historical cost but also incorporates *ex ante* valuation. This is certainly the case with the capital market where stakeholders are asked to value the uncertainties of the future *vis-a-vis* the certainties of the present. Activity in the capital market is therefore driven by investors being adequately compensated for voluntarily foregoing present consumption (and taking its corresponding risks) while issuers are able to raise capital at a cost that is reasonable to sustain viable economic opportunities.

124. The challenge is to quantify and effect what constitutes adequate compensation to investors which must simultaneously be deemed reasonable cost to issuers. The interests of these two parties are clearly in conflict and this is a classic case of ***Competitive Parity***. To address this impasse, we refer to the 8th principle which argues for the elimination of misalignments by requiring financial prices to reflect their true value in risk. In the process, this reinforces the 3rd macro-prudential principle and is in line with the preferred measure of performance for the financial system.

125. Financial prices, however, do not simply materialize. There must be a systematic means of generating these prices and ensuring consistency across various tenors.[48] This is where ***the government must take the lead in establishing benchmark rates***. The government has the unique standing to set these benchmarks because it has the best credit standing among local participants and issues a substantial volume into the market.

---

[48]Consistency can be defined in terms of the yield curve. The norm is for longer tenors to be priced higher and hence a persistently inverted yield curve would be inconsistent with the norm. Implied forward rates would be the central analytical measure for consistency across tenor buckets. If implied forward rates are systematically higher (lower) than future spot rates, the yield curve will logically maintain a long (short) term bias, eroding the viability of choices across tenor buckets.

In pricing these benchmark issues, it would be ideal to start from the longest end of the yield curve and subsequently price recursively backwards. This has the effect of setting a risk ceiling from which the shorter tenors can be aligned to enforce consistency. The converse approach (i.e., price-setting from the shortest-end and moving towards the longer-end) will not necessarily achieve this desirable result since the floor rate leaves longer-term rates open-ended without any guarantee that the divergent interests of providers and users of liquidity will converge.

126. To effect this valuation system, ***the government must manage the depth of benchmark issues***. It is well established that issuing benchmark securities in several tenor buckets may just lead to fragmentation. Within the G-10 economies, for example, benchmark issues are usually for 2, 5, 10 years with a terminal tenor that is typically at 30 years. Depth may then be cultivated through the normal aging of the original issues, complemented by a program of regular issuance and through buy-backs and re-openings.

127. We do recognize that a program of regular issuance of benchmark government securities is not common in East Asia since it obviously increases public debt. However, there is an incentive for the auctioneer — who also is the issuer of the benchmark issues — to reject "higher" benchmark rates in an attempt to reduce its borrowing cost.[49] However, we also take cognizance that the absence of liquid benchmark issues invariably raises the cost of funding. The only real difference between these two costs is the incidence of the implicit tax: the fiscal cost is borne by future generations while the funding cost is passed onto cohorts of the current generation. From this perspective, the added fiscal burden needs to be balanced with the public good (developmental) gains of market-making in an un(der)developed long-term fixed income market.

128. Caution must be exercised in succumbing to the temptation to reject higher bid rates in the primary market for government securities. If these rejections do not conform to the fair valuation of underlying risks, the rejections only serve to create a gap between primary and secondary market rates. This will be counterproductive since it sacrifices transparency and impinges on the continuity of pricing. In fact, credible valuation requires the yield curve to reflect both the availability of liquidity and the collective price of risk at a particular tenor. As a result of the later, there is considerable value to instilling transparency in the determination of market rates. Thus, at the early stages of the capital market, the

---

[49] This is another example of "competing interests" although in this particular situation, the contending interests of cost reduction and market development are nurtured within one and the same stakeholder (the government). The presence of a recurring budget deficit and/or a high debt-service burden are natural impediments to principle #7 and in enabling a robust benchmark.

developmental gains from signaling risk-adjusted rates will likely outweigh the first-round financial effects of higher borrowing rates to the government.

129. To preserve the credibility of the valuation framework, two features of the yield curve are highly desirable. First, it is important that rates of actual trades are captured and reported into the curve. Compared with indicative rates, these “done deal” rates are less susceptible to manipulation since they at least reflect the short-side of the market for which an equilibria has been established. Second, zero-rates are the preferred form since these directly reflect the price of time and the price of risk. Unfortunately, both of these features are often privileged access as a commercial service of data providers. While these have obvious strategic value to traders who are poised to pay for this advantage, there is still an overwhelming public good argument to making these information universally available.

130. The availability of credible benchmark rates spawns critical benefits.[50] On the side of those with a demand for term funds, the valuation of corporate debt (and subsequently equity as well) is best done as a markup over the benchmarks. Starting from the yield curve for government securities, different corporate credit curves can be constructed for different valuation purposes i.e., a curve for each credit rating category or a company specific curve over various tenors. Done systematically, matrix trading can arise to provide for a broader universe of options. Thus, corporates who are raising funds from the capital market can find comfort that their credit standing will be priced fairly and transparently because of the existence of robust benchmarks.

131. On the supply-side of this market would be the investor base. Regardless of whether these are institutional or retail investors, their appetite for capital investments must rely on the existence of a credible valuation mechanism. Marketability of these investments is a highly coveted feature which is only possible if the investor can appraise the expected value of the cash flows over the projected holding period. Deliberate strategies such as ***riding the curve*** must pre-suppose that there is a continuous market for the instrument and that there is a yield curve from which valuation emanates. Even for hold-to-maturity investors, such a yield curve will be indispensable since it is the only way to compare the gross returns from the investment versus the risk-adjusted price of time. In all of these contexts, a robust yield curve enhances the expansion of the investor base. The absence of such credible valuation makes capital investment *ad hoc* and solidifies the default

[50] There is an implicit presumption that stakeholders are properly informed about the yield curve. Otherwise, having robust benchmarks would itself not contribute to a self-sustaining capital market. In this sense, information about “done deals”, credit ratings and basic financial numerics are treated as “public” information.

preference for shorter-term opportunities.

E.4 Efficient Payments Infrastructure

132. ***If pricing gives substance to the capital market, the integrity of its transactions is influenced by the efficiencies of the payments infrastructure.*** The later governs how monetary claims are reconciled across parties and eventually settled. Since this settlement is done within the context of the final transfer of securities in exchange for the final transfer of irrevocable funds, then the credibility of the capital market to enforce the normal course of its transactions depends on the payments system to effect finality of settlement.

133. The absence of a well-functioning payments system will certainly be a drag on the capital market. At the minimum, there will be the inconvenience of operational delays in consummating the transactions. However, the more pertinent concern is that these delays raise a systemic issue. Delays in the final settlement of obligations increase ***counterparty risks (principally credit and liquidity risks)*** and thus raise the policy concern of instability. This is similar in nature to the previous concern over macroeconomic instability except that in this case the issue relates to the integrity of the transaction. The consequence then is for potential counterparties to either conduct the transaction purely on a bilateral basis or to incorporate such delays in the pricing. Neither of these are desirable as the former does not build into an organized market while the latter aggravates the gap between providers and users of liquidity.

134. Furthermore, an inefficient national payments systems increase the likelihood of execution risk. In this age of globalized opportunities and investments, this will be a significant concern for international investors and fund managers. Similar to the preceding point, this will invariably erode the investor base. Thus, operational gains that would have accrued from an efficient payments infrastructure are lost through these delays, moving the system further away from the desired workflow of a consolidated market.

135. The specific design of the payments infrastructure has been the subject of much attention. On the clearing side, there is a fair amount of variety in the infrastructure and the workflow of operations, particularly in the role played by the central bank. However, there is notable convergence on the design of (efficient) settlement systems. ***Real-time gross settlement*** (RTGS) is the overwhelming norm where settlement is done on ***delivery-versus-payment*** (DVP) basis. To effect this standard, ***dematerialization*** and ***immobilization*** of securities is necessary since the shortened settlement cycle reduces the corresponding settlement risk and execution risk.

136. The previous interest with the prospects of ***straight-through-processing*** (STP) has somewhat been curtailed of late. While shortening the time needed for processing and consummating transactions is important, speed alone cannot be the exclusive objective. The payments infrastructure provides gains by managing operations-related risks which includes the handling of delays but only relative to the limit by which information can be effectively managed. Corollary to this point, registry, depository and custody services are just as important to a well-functioning capital market architecture because they are complementary components of the payments infrastructure. Clearly, these adjunct services allow the technology platform of the payments system to operate as envisioned by international standards.

137. ***On the whole then, the payments infrastructure is critical to the capital market because it obviates process-related risks.*** It does this by contributing to the organization of the market, developing transparency in the handling of the transactions, making the transactions as seamless as possible between counterparties and, in the process, cultivating market-based monitoring. The critical facet though in an enabled capital market environment is not the presence of the payments system but the gains from one that is ***efficient***. The mere fact that institutions are linked through the payments infrastructure raises the possibility of contagion. The irony then is that an efficient payment system can address certain risks but the presence of the same system creates added dimensions of risk. This is where the specific design of this infrastructure dictates the incidence (who bears) & mitigation (how to reduce) of risks and thus its overall contribution to the development of a thriving capital market.

E.5 Framework for Financial Governance and Financial Policy

138. Capital markets are particularly sensitive to the chosen framework of governance and policy. This is because this framework affects the structure of incentives — which in turn affects behavior — over a longer period of time. Furthermore, the same framework reflects the policy inclinations and priorities of the financial supervisors which itself outlines an actionable business agenda for market participants.

139. The challenge however is that the agenda of various market participants inherently diverge. As previously pointed out, there is no intrinsic mechanism within financial markets that would force a convergence of the competing interests of stakeholders. Volatilities in the economy, concerns over the credibility of the valuation mechanism and a less-than-mature financial infrastructure do not encourage a young capital market to take deep roots. The result is for the providers of liquidity to prefer shorter-term opportunities as a logical hedge against the uncertainties. Consequently, this rations out those needing additional

long-term liquidity or makes the funds available at significant added cost.

140. The governance & policy framework can bridge this gap. The intention is to furnish the providers of liquidity a level of comfort so that they can adjust their investment preferences to match the needs of the potential users of these liquidity in the capital market. This level of comfort arises from the understanding that, within reason, the governance & policy framework has provided for some recourse for every anticipated possibility. Stated differently, ***the governance & policy framework should deter abuse within a risk-for-return environment without impinging upon the creativity and innovation of market participants***.

141. All the issues raised in principle #4 (Governance) and principle #7 (Primacy of Development) apply here as well. However, in the specific context of the capital market, we reiterate that the governance & policy framework must be broad-based, capable of anticipating various supervisory and regulatory issues that may arise over an extended period of time. Since markets are constantly evolving, it is not likely that stakeholders can fully anticipate all possible scenarios for which rules and regulations would be required *ex ante*. Thus, the breadth of the framework must also include the mechanisms that would handle disputes between contending parties as well as the orderly enforcement of any decisions reached. The same framework must then be balanced so as to provide equal opportunities to these contending, if not competing, interests. Since competing interests are the norm rather than the exception, balance is not only desirable but is necessary to move markets forward. The real challenge then is to anticipate the oversight of an evolving structure where the interests of stakeholders inherently contend with one another. Addressing this challenge on a going-concern basis is the cornerstone upon which an effective framework for financial governance and financial policy is built.

142. At the risk of redundancy, we identify three specific components of the governance & financial framework which are particularly relevant to the capital market. First, there is the basic premise of the rule of law, the enforcement of contracts and the legal basis for all products, intermediaries & processes. Given the length of time involved in capital market transactions, legal and regulatory risks are central to this market. While international standards and codes have been defined as guidelines, the bar against which the local framework is held accountable is ultimately the faithful enforcement of these statutes. This covers not only the supervision & regulation of markets and institutions but also the key feature of protecting customers against abuse & illegal activities.

143. Second, the structure of supervision needs careful attention. Reporting lines from covered institutions and market activities to specific supervisory bodies require constant re-

assessment. The emergence of product hybrids and financial conglomerates suggest that the traditional lines of market classification — and therefore supervisory assignments — are obsolete. The unbundling of the production of a financial product and its distribution has also created supervisory ambiguities. None of these key issues should be left unresolved. In addition, the responsibilities of the covered institutions and agents must also be clearly delineated. This include corporate governance and more particularly disclosure practices. The generalized fiduciary responsibility of intermediaries under a public good approach suggests that the information derived from these practices are no longer the restricted private interest of covered institutions & agents but well within the public domain.

144. Third, the core principles on tax policy must be explicitly defined *ex ante*. This is a central issue for the capital market since tax incidence invariably has a larger impact over longer periods. Taxation would therefore tend to exacerbate, rather than resolve, the gap between the providers and users of liquidity in this market. More fundamentally, taxation will always be a contentious issue between stakeholders. The gains to the tax collector (i.e., the government) must always come at the expense of the taxpayer (i.e., issuers, investors and intermediaries in the capital market). Policy initiatives have frequently included tax incentives that are targeted for particular beneficiaries only. Thus, while it is clear that tax neutrality is the desired condition, the real challenge is handling the gains and losses that must accrue in the transition from the current system to the notional state i.e., those who have a favorable tax treatment are not likely to voluntarily give up such advantage and any mandatory reform towards parity will pit the emotions of losers against the sentiments of winners. By defining *ex ante* the core principles on tax policy, this transition path would have the benefit of clear strategic guidelines that are not influenced by the emotional baggage that must arise from gains & losses.

F. Moving Forward to a Thriving Capital Market

145. The Core Principles provide specific guidance to align current & future initiatives to the vision of the financial market defined earlier. The Enabling Environment that followed directly applied these principles towards the initiative of developing a self-sustaining capital market. Since capital market transactions are consummated only in the very distant future, the stylized Enabling Environment explicitly recognized the unique challenges this imposed upon the verbatim application of the Core Principles. The objective in all these was not the articulation of desirable-but-nonetheless-tautologous features. Rather, the task was to define an incentive-compatible framework that could address the inherently competing interests in this market. In so doing, this new framework could spur the momentum for a thriving capital market. Within this incentive structure then, specific "design issues" can be filled in by the collective decisions of stakeholders.

146. There are no illusions that the initiative for a thriving capital market will be less than challenging. Having both the Core Principles and a stylized Enabling Environment in place are necessary but insufficient for a detailed & specific roadmap for the reform agenda. The task of translating the strategic issues raised here into a consensus tactical plan is for future component (module 3) of this reform initiative. In the meantime, maintaining unanimity towards common basic tenets is the primary task at hand. This will undoubtedly demand persistence and a heightened sense of cooperation among stakeholders. And for this reason alone, an agreement among stakeholders to abide by the Core Principles would be a critical step forward.

147. Yet by the same token, the Philippine market for long-term funds is not at its raw inception. There is a significant amount of government securities already outstanding, there is access to term funds in the private market (albeit at a price) and a financial infrastructure is in place to handle the pure payment and exchange-for-value requirements. At this juncture, there is value to briefly highlighting some of the key developments in the last few years that are consistent with our vision of a stylized capital market. This is not meant to pre-empt the technical analysis that would be handled in module 2. Instead, we conclude module 1 by acknowledging key reform initiatives that were initiated in the last few years and would warrant unambiguous stakeholder support.

148. ***Arguably, the most critical initiative was the shift towards risk-based supervision***. Although instigated in the specific context of aligning the prudential norms of our banking industry with the original Basel Accord, its impact has gone well beyond banking. A similar risk-based monitoring framework has been introduced in the securities

market recently and one finds that the jurisprudence of financial products & services under legislative review now normally includes similar provisions. As a fundamental principle of governance, risk-based market monitoring has found pervasive acceptance across the traditional product categories and is now a minimum norm among international standards.

149. The key value added of risk-based supervision is that it re-scales market behavior into units of risk exposures instead of its nominal measure in currency. This makes it well suited for capital market development where the traditional gap between providers and users of liquidity has never been a monetary issue but rather that of risk mitigation. This approach forces the recognition of all identifiable risks and for market participants to necessarily take stock. These risks become evident then in setting yields (risk-adjusted pricing), in the periodic revaluation of trading positions (mark-to-market or, in some cases, mark-to-model) and in the capital structure prudentially required of intermediaries to conduct market activities (governance). All of these are key elements of a thriving capital market which relies on materiality to be conveyed publicly both through a transparent & efficient pricing system and its market-based supervisory structure. Conversely, had the risk-based approach not been introduced in 2000, there would be a very limited context within which we can conceptualize an incentive-compatible capital market.

150. ***Corollary to this would be the reforms in the area of information***. Principles of Good Corporate Governance have been actively espoused by the leadership of the BSP and SEC paving the way for increased transparency & disclosure, starting from the Board of Directors to all other levels in the organization. While the information requirements are not as far-reaching as those of the Sarbanes-Oxley Act in the United States, the fact that corporate disclosure has moved further in the last 6 years than at any other time in the past is the right stimulus needed by the capital market at the right time.

151. This is not only for the provision of material information but also its quality. The commitment to align with the International Financial Reporting Standards is not merely a compliance issue but one that provides the investor base with the needed information for comparing investment opportunities. The revised rules for external auditors delineate the specific accountabilities of these auditors when they attest to the information provided by the corporation and therefore delimits the moral hazard problem that has long developed. Along this line, the formal accreditation of credit rating agencies — both domestic and foreign — puts processed information into a standard which potential investors can readily take as an actionable insight. Taken separately, these are small reform steps. Yet collectively, they are complementary initiatives whose cumulative impact builds upon the quality of information which is most essential for capital market investors & regulators.

152. The introduction of an explicit framework for pricing risks and the improvements in information processing create significant complementarities in ***developing transparency***. These efforts have found renewed convergence in what is undeniably the most visible of the recent developments: the creation of an organized exchange-based fixed income market. This is a very significant step as it fundamentally alters the structure of this market, from an inherently OTC market to exchange-based. This move is geared to develop price discovery since trade-related transactions will be captured and universally provided. This should eliminate a substantial amount of arbitrage that is driven by information asymmetries among market participants. Furthermore, this initiative is also meant to provide for the stricter adherence to governance standards, guided by codes of best practice for various products & various facets of market activity. The intention to attain ***self-regulatory organization*** (SRO) status also has very deep implication on surveillance, its monitoring functions and the enforcement of market conduct provisions.

153. It is still too early to tell what the full effect of this initiative will be towards developing a self-sustaining capital market. What is already clear though is that this approach is the most far-reaching of all capital market initiatives heretofore. Beyond the fundamental shift in market structure, it is by far the most visible signal of an organized effort for fixed income products. There is an explicit interest to develop the public market, carving out the organized venue to the level of retail investors. The specific responsibilities of the various market intermediaries, among themselves and to the investor base, have also been defined to establish universal standards in lieu of bilateral arrangements. The link between this market venue and the needed infrastructure support has also been delineated. DVP is fully attained, for example, by complementing the exchange with the RTGS system of the BSP (PhilPaSS), eliminating the settlement risk that was clearly evident under the prior arrangement. Third-party custody arrangements are also available for those who prefer to avail of this service.

154. These are the most significant developments in recent years. We have highlighted these to recognize that some critical aspects of the reform agenda have already began in a manner that is consistent with tenets suggested by the Core Principles. It may not be as important right now to delve into the specific details of the desired action agenda as it is all but given that there will still be a fair amount of fine-tuning moving forward. The next step is to undertake a full technical review of contemporaneous market constraints & difficulties. Forming a consensus view of these difficulties, we can then refer to the Core Principles to craft a specific tactical reform agenda for each specific financial sector. Clearly, the tasks ahead are daunting but it is just as clear that the payoff to a thriving capital market is worth the realized burden of this initiative.

GLOSSARY

Buyback	Repurchase of bonds by the issuer prior to their maturity.
Chinese Wall	Provisions established within a financial institution to separate units or divisions that may have a conflict of interest in the use of non-public material information about a particular firm. This barrier is consistent with the prohibitions against insider information. A common example is the separation of the unit generating information about a client (i.e., investment analysts) and the one selling the securities of the firm in question.
CIS	Collective Investment Scheme is a form of investment vehicle that combines the funds of many investors and invests the pool into various instruments.
CMDC	Capital Market Development Council is a partnership between government agencies and private sector organizations. The council was established on the basis of a Joint Manifesto among the 8 founding members in 1991 and has since expanded to 11 member institutions and agencies. The council's mandate is to identify impediments to the growth of the Philippine capital market and recommend reforms and policy measures.
Competitive Parity	The framework proposed in this module where financial products & services are treated as both substitutes and complements.

CSI	Term used to refer to pension funds and insurance companies. These institutions provide a mechanism for saving based on some contractual agreement and in the process transfers risks.
Custody	The safekeeping & administration of securities and financial instruments in behalf of others.
Dematerialization	The elimination of physical certificates or documents of title which represent ownership of securities. The securities thus exist only in the accounting records.
Depository	An agent whose prime role is the recording of securities (either in physical or electronic form) and keeping records of ownership of these securities.
DVP	A standard which requires that the final transfer of one asset (i.e., securities) occurs if and only if the final transfer of another asset (i.e., cash) occurs.
Edgeworth Box	Is a graphical tool, named after Francis Ysidro Edgeworth, which depicts the ways that resources can be distributed among stakeholders.
Financial Governance	Term used in this module to specifically mean the collective practices of supervision across sectors and their corresponding prudential & regulatory standards.
Financial Policy	Refers to fiscal and monetary policy as well as the critical nexus between these two.
Fragmentation	Presence in a market of too many instruments to support active trading in any one instrument.

Immobilization	The placement of physical certificates of financial instruments in a central securities depository in order for subsequent transfers to be made on book-entry basis.
Insider Information	Material information about a particular firm that has not been publicly released but is known by individuals either inside the firm or those affiliated with them.
Leveling the Playing Field	The common phraseology used by market players and regulators to refer to the initiative to create parity among stakeholders. This parity may refer to specific regulatory issues (i.e., taxation) or to the general treatment of covered institutions and agents.
Liquidity	Asset liquidity refers to the ability of a financial instrument to command a price in the open market. Funding liquidity on the other hand is the availability of cash at the time (and currency) that it is required.
m^3 of Risks	The nomenclature used in this module to refer to the Math, Methods and Metrics of Risk.
Market, Capital	As defined in this module, the capital market is the *"segment of the financial system that mobilizes and intermediates long-term funding without delimiting the source of these funds. Thus, this will include both debt and equity instruments (as well as hybrids) literally with an original tenor in excess of one year but preferably much longer (i.e., at least exceeding 5 years, optimally exceeding 10 years)."*

Market Efficiency	The Efficient Market Hypothesis argues that financial prices reflect market information. A market's efficiency is then classified as either strong, semi-strong or weak depending on the type of information that is embedded in financial prices.
Market, Primary	The market for newly issued securities, provided directly by the issuer.
Market, Secondary	The market where investors purchase securities from other investors.
Market, 3rd	The market where broker/dealers trade with large institutional investors. The object of the trade are securities that are listed on exchanges but nonetheless traded on an over-the-counter basis.
Market, 4th	The market where trades are between institutional investors. The transactions are often large blocks of securities done via electronic communication instead of through an exchange.
Mark-to-Market	Practice of revaluing the price of a security on a daily basis to reflect the current market price. This will create gains and losses on a daily basis which will be reflected either in the income statement or balance sheet depending on the classification of the security.
Mark-to-Model	Practice of revaluing the price of a security based on the values generated by a model. Relying on models to generate a notional price is resorted to when there is no active trading market that would generate the market's price.

Materiality	Particular information which would affect the view of investors towards the security and its market price once it is made known.
Moral Hazard	In general, it is the risk that a contractual agreement will affect the behavior of the parties to the contract. This occurs because the contract includes provisions for compensation for negative outcomes. Thus, the party who is the beneficiary of the expected payout has the "incentive" to take more risks since failure is nonetheless compensated by the contract.
Payments System	Covers the institutional arrangements, processes and infrastructure that is used for transferring (and settling) monetary claims, including exchange-for-value transactions.
Private Placement	The sale of securities (equity, debt) by a firm to a limited group of investors whose number does not constitute a "public" based on local statutes. Private placements are held to a loose standard of governance since it is assumed that private investors are adequately knowledgeable of the transaction.
Public Good	An economic good that generates a benefit to all, once available, and is collectively "consumed". The private sector would not have any reason to produce such goods because relative scarcity cannot be enforced and a market price would be difficult to establish.

Public Offering	The sale of securities (equity, debt) by a firm to the public. For the consumer's general protection against fraud, public offerings must be registered with the local securities regulator and requires the firm to provide the appropriate information about itself & its intended use of the proceeds in a prospectus.
Rate, Implied Forward	The hypothetical rate that links two rates on the same yield curve.
Rate, Spot	The yield to maturity of zero coupon bonds for a particular tenor.
Re-opening	Issuance on more than one occasion of a bond in order to build the desired volume of the bond to a particular level.
Resource Allocation	Refers to the magnitude and prioritization by which resources are used.
Resource Distribution	In public economics, distribution refers to the issue of the rights over resources (who) and the timing of its use (when).
Risk	The exposure to an unknown result where possible outcomes can be assigned measures of likelihood (i.e., probability).
Risk-Based Supervision	The new approach to financial supervision where covered institutions explicitly reflect their risk exposures in their financial statements and relates these risk exposures to various prudential requirements (i.e., capital and/or liquidity).

Risk Management	The process where risk is mitigated through various means. *Ipso facto*, methods of statistical inference and quantitative techniques are used in formalizing and organizing the processes for the mitigation of risk.
RTGS	The continuous (real-time) settlement of funds or securities transfers on an order-by-order basis.
Rule 144	The US SEC regulation which governs the sale of unregistered securities to the public without the need to file a registration statement.
Rule 144a	An amendment to Rule 144 that provides for the resale and re-offers of unregistered securities to qualified institutional buyers (QIBs) within the 2-year holding period specified under Rule 144. This increases liquidity into the market.
Saving	The residual of income over consumption. Saving is a "flow" variable. The accumulation of saving is wealth (which is the stock variable).
Self-Regulatory Organization	SROs are organizations empowered by legislation to regulate its membership through the creation, issuance and enforcement of rules.
Straight-Through-Processing	The initiative to reduce the settlement cycle through the use of electronic facilities.
Uncertainty	In contrast to risk, this is the exposure to an unknown result where possible outcomes cannot be assigned measures of likelihood.

Zero Sum Game	A situation where the expected pay-off to one party comes at the expense of the other parties to the activity. The sum of all gains offsets all losses regardless of the actual outcome of the activity.

Legislation Cited:

General Banking Law of 2000	Republic Act 8791 replaced the 1949 General Banking Act. Among the key provisions of the new legislation is the shift by the monetary authorities to risk-based supervision and the clarification of the supervisory powers of the Bangko Sentral ng Pilipinas.
Glass-Steagall	Enacted in 1933 in response to the 1929 market crash, the Glass-Steagall Act insulated the activities of commercial banks from other financial institutions. The separation of commercial banks from securities firms became a hallmark of the international financial architecture until this was amended by the Financial Services Modernization Act.
Gramm-Leach-Bliley	Also known as the Financial Services Modernization Act, this law was signed into law in December 1999 and amended key provisions of Glass-Steagall. In particular, it facilitates the affiliation of banks, securities firms and insurance companies through the creation of a "financial holding company".

Insurance Code	Presidential Decree 612 institutes the Insurance Code of the Philippines and was passed into law in 1974. The 1978 amendments provides the last revision of this basic statute and revising the Code is the subject of on-going efforts.
Sarbanes-Oxeley Act	This law is officially known as the Public Company Accounting Reform and Investor Protection Act of 2002 and informally referred to as SOX or Sarbox. It aims to improve investor protection by increasing the reliability of corporate disclosures and the creation of the Public Company Accounting oversight Board.
Securities Regulation Code	Passed into law as Republic Act 8799, this Philippine legislation provides for the amended powers of the Securities and Exchange Commission to regulate the securities industry, including non-traditional securities such as Pre-Need Plans.

∫∂ Noet E. Ravalo Ph.D.

Financial Market Core Principles

Dr. Noet E. Ravalo

Project EMERGE
U.S. Agency for International Development
Contract No. AFP 1-00-00-03-00020 Task Order 800
Task 4.1.1.2

Discussion Workshop
Executive Business Center, 5th Floor BSP Complex
Oct 24, 2005

1

∫∂ Noet E. Ravalo Ph.D.

Project Administration

- TA responds to the separate requests of BAP & Gov. Buenaventura first expressed in Dec 2004
  - EMERGE rec'd written requests in end-March
  - Overall TA structured into 3 parts
  - USAID approval for module 1 came in late May and began in June (48 day engagement)
  - Request transparent to CMDComm of Finex (Jan), CMDC pvt sector members (March) and CMDC *en banc* (May)

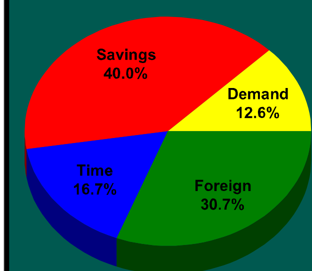
2

∫∂ Noet E. Ravalo Ph.D.

Working Perspectives

- Banks account for 81% of financial systemresources
- 31% of bank deposits are in foreign currency
- 76% of bank PHP deposits are in SA & DD/Now
- Short-term TDs (subject to roll-over) is common
- Loan-to-Deposit ratio ~1

Deposit Liabilities, June 2005



3

∫∂ Noet E. Ravalo Ph.D.

Working Perspectives

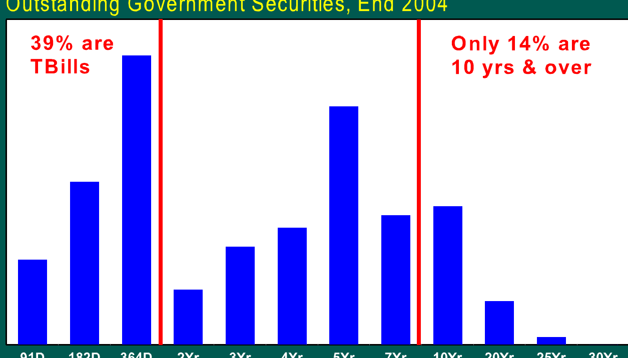
- More than 90% of FCDU deposits are owned by locals
- About 70% of $ROPs are owned by residents
- Financial account in the BOP has been negative since 2000
  - Bulk of these are classified under portfolio investments
  - Most likely, these investments are in US Treasuries

4

∫∂ Noet E. Ravalo Ph.D.

Working Perspectives

Outstanding Government Securities, End 2004

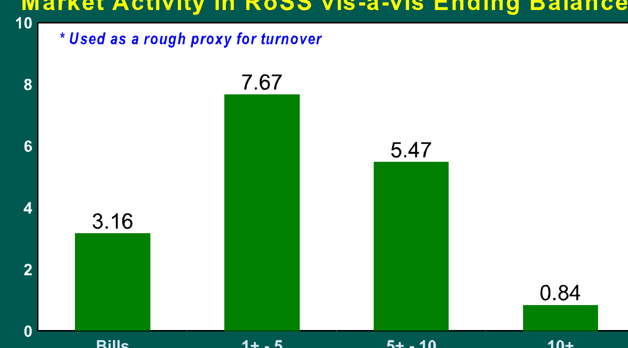


5

∫∂ Noet E. Ravalo Ph.D.

Working Perspectives

Market Activity in RoSS vis-a-vis Ending Balance



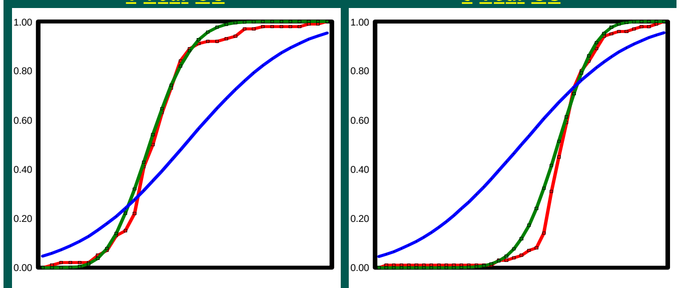
6

∫∂ Noet E. Ravalo Ph.D.

Working Perspectives

Daily Volatility of MART1 Series (Haircut Equivalent)

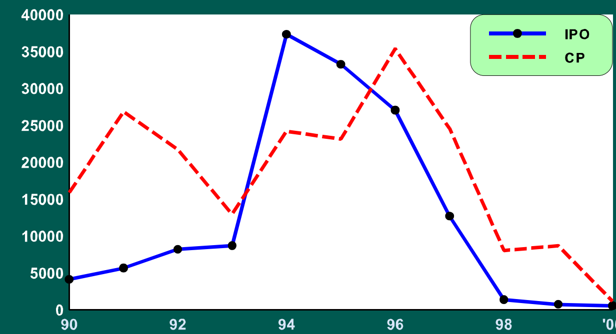
1 Year GS | 5 Year GS



7

∫∂ Noet E. Ravalo Ph.D.

Working Perspectives



8

∫∂ Noet E. Ravalo Ph.D.

Working Perspectives

- Capital market development has been on the radar screen for sometime now but . . .
- The challenge is to "build a better mouse trap"
- There are strong personal and sectoral positions on what needs to be done
- These views/positions are not Pareto-Improving

9

∫∂ Noet E. Ravalo Ph.D.

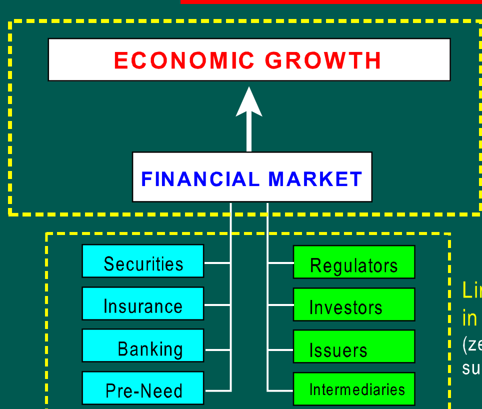
Basic Instincts, Rude Realities

- Premise of Finance
  - Financial market is inherently risky but presents itself to be a value-added
  - Finance is as much a service as it is a business
  - Systematically higher returns arise from systematically larger exposures to risk
  - FIs bear a fiduciary responsibility because of "*leverage*" .... and "*systemic stability*"

10

∫∂ Noet E. Ravalo Ph.D.

Basic Instincts, Rude Realities



Mutually re-enforcing (synergistic complementarity)

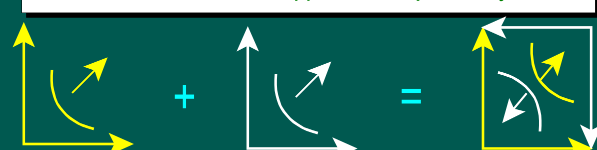
Limited resources in the short-run (zero-sum substitutability)

11

∫∂ Noet E. Ravalo Ph.D.

Basic Instincts, Rude Realities

- The Reality of Competing Interests
  - Competing interests do not lend themselves to a converging cooperative equilibria
  - Simple Edgeworth Box shows that we cannot maximize one's happiness independently



12

∫∂ Noet E. Ravalo Ph.D.

Basic Instincts, Rude Realities

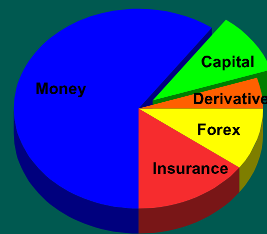
- **THEREFORE**, we have an ***incentive problem***:
  - ☞ Limited opportunities in ST (Zero-Sum Game)
  - ☞ The concept of reform (Adverse Selection)
  - ☞ Return-Risk trade off (Moral Hazard)
  - ☞ Pvt vs Public interests (Different Objectives)
  - ☞ Level Playing Field (Transition Dynamics)

13

∫∂ Noet E. Ravalo Ph.D.

The Approach We Take

Lengthy Legislative Process ??? Weakened Reform Appetite



- Financial market "works" only when there are viable choices
- Viable Choices imply that interests both compete and work together
- Thus, we need to agree on strategic issues before the analytical & tactical
- The strategic framework must be anchored on local requirements

14

∫∂ Noet E. Ravalo Ph.D.

The Approach We Take

International Best Practice

- **Financial Governance**
  - ☞ Risk Management
  - ☞ Corp Governance
- **Consumer Welfare**
  - ☞ Insolvency & Creditor Rights
  - ☞ Customer Protection
- **Information Management**
  - ☞ Accounting & Audit
  - ☞ Credit Rating

What we need at this stage of our market

How we can handle the transition

15

∫∂ Noet E. Ravalo Ph.D.

How this Differs from the Rest

- ***Traditional definition*** **of Capital Market**
  - ☞ Both for tenor and for participants
- ***Bottom-Up*** **Approach**
  - ☞ Uses first principles to anchor reforms
- ***Competing interests*** **are explicitly recognized**
  - ☞ Handling the gains & losses in transition
- ***Risk*** **as the over-riding premise**

16

∫∂ Noet E. Ravalo Ph.D.

All About Balancing Incentives

Regulators

Saving Public

Competitive Parity

- Interests compete w/ one another
- Risk-for-return creates incentive problems
- Need to handle winners and losers
- Desire cooperative solution

Investors

Issuers

Intermediaries

17

∫∂ Noet E. Ravalo Ph.D.

Vision of the Philippine FinMkt

". . . ***open market*** ... responsive to the varied ***needs of its public*** who in turn have the ***power of choice*** over differentiated but ***equally viable alternatives***. These choices ... underpin robust market activity ... driven by the capacity of financial prices to fully capture all ***relevant information*** ... ."

18

Landscape of Developed Fin Mkt

- Organized market for the flow & re-flow of funds that establishes benchmarks for product quality
- Prudential exposure to risks to earn fair returns
- Adheres to financial governance
- Invests in required infrastructure to instill certainty in execution and payment
- Allocation and distribution of resources is decided through price system

19

∫∂ Noet E. Ravalo Ph.D.

Managing the transition to the desired state . . .

20

∫∂ Noet E. Ravalo Ph.D.

Web of Correlated Tenets

Macro Prudential Principles

Value	Product	Structure	Covenants
Public Good	Managing Risks	Competitive Parity	Financial Governance
Info and Transparency	Consumer Protection	Financial Policy	System Integrity
Medium	Safeguard	Purpose	Valuation

Micro Foundation Principles

21

∫∂ Noet E. Ravalo Ph.D.

CP1: FinMkt is a Public Good

- The Edgeworth Box of competing interests makes a convergent solution unlikely

- FinMkt dev't is central to economic program
- Social interest (based on market vision) prevails over private interests
- Treat financial market as a public good
  - ☞ Non-rivalrous & Non-excludable
  - ☞ Economic good

22

∫∂ Noet E. Ravalo Ph.D.

CP2: RM is the Ultimate Service

- FinMkt is inherently risky and inadvertent lapses and/or abuse do occur

- Think in units of risk at all levels of aggrupation; risk continuum cannot have gaps to attain public good
  - ☞ Since risk is NOT linear additive, public good principle sets ultimate limit
  - ☞ Not in the public interest for all stakeholders to avail of all products all the time
  - ☞ Commit to m^3 *of Risk* to check moral hazard

23

∫∂ Noet E. Ravalo Ph.D.

CP3: Reality of *Competitive Parity*

- Mkt imbalance is incompatible with efficient growth

- Devt is a sub-additive concept, not aggregative
- Constructive competition is not viable under monopoly profits
- There are critical complementaries
  - ☞ Synergy in the RM capability of whole system
  - ☞ Complementaries in infrastructure are critical

24

∫∂ Noet E. Ravalo Ph.D.

CP4: *FinGov* Is A Core Issue

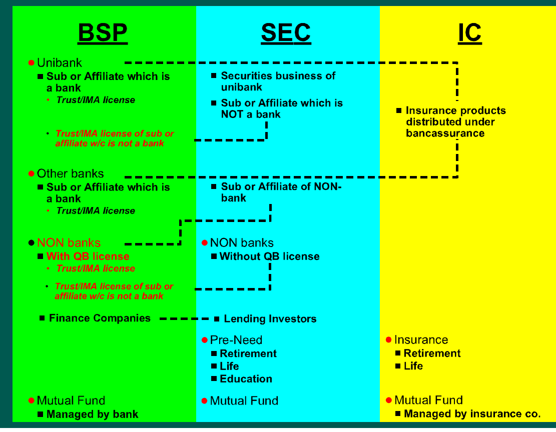
- Gaps in supervision create pockets of arbitrage

- Financial Governance prioritizes competing interests
- Challenge is HOW to attain parity, not WHAT is uneven
- Delimit imprudent practices & behavior
- Managing risk across porous sectoral/product borders requires developing a compatible framework

25

∫∂ Noet E. Ravalo Ph.D.

Lines of Control Have Webbed



26

∫∂ Noet E. Ravalo Ph.D.

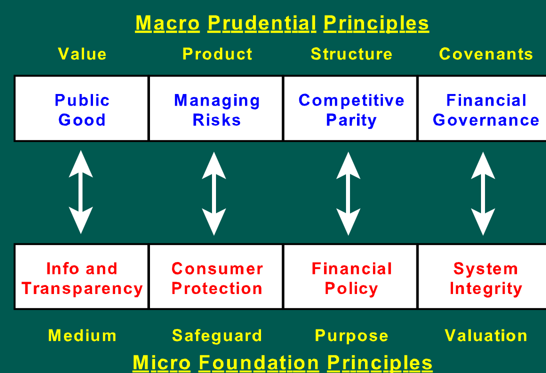
Convergence Is a Policy Issue

	Assets	Liabilities
Banks	Loans Investments Provisions (Contra)	Deposits
Securities	A/R (secured by securities) Investments	Payables (short position) Wholesale funding – repos – securities borrowing
Insurance	Investments	Technical provisions

27

∫∂ Noet E. Ravalo Ph.D.

Introducing Micro-Foundations



28

∫∂ Noet E. Ravalo Ph.D.

CP5: *FinInfo* as Building Blocks

- Information is incomplete & imperfect
- Materiality is defined *ex-post facto*

- Building a culture of market-based monitoring
  - ☞ Disclosure develops the integrity of the price system, not just for jurisprudence
  - ☞ Premium should be on done-transactions
- Info agents (audit, CRA) must be accountable for and pro-active with information

29

∫∂ Noet E. Ravalo Ph.D.

CP6: Safeguards to Consumers

- Risk-for-return environment can expose the public to the possibility of abuse and/or lapses

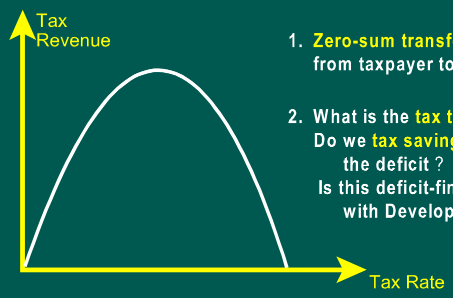
- Public awareness campaign as a preventive approach
- Established remedial measures
  - ☞ Insolvency framework
  - ☞ Creditor Rights
  - ☞ Alternative Dispute Mechanisms

30

∫∂ Noet E. Ravalo Ph.D.

CP7: Premium on Development

- **Financial taxation is innately contentious**



1. **Zero-sum transfer of resources from taxpayer to tax collector**
2. **What is the tax tolerance ?**
   Do we tax saving to pay for the deficit ?
   Is this deficit-finance consistent with Development ?

31

∫∂ Noet E. Ravalo Ph.D.

CP7: Premium on Development

- **Effect of monetary policy goes beyond inflation**

- **Monetary policy influences infrastructure**
  - ☞ **Payments system conveys signals through money market**
  - ☞ **Stability issue arises from the possible transmission of risks via connectivity**

32

∫∂ Noet E. Ravalo Ph.D.

CP8: *FinPrices* Make the Market

- **Fragmented market**
- **Noticeable gap bet. primary & secondary rates and along the yield curve**

- **Price Discovery is central to mkt monitoring**
  - ☞ **Move away from "base price +" to YC-based**
  - ☞ **Capture/Broadcast of trade transactions**
  - ☞ **Instill liquidity to support the YC**
  - ☞ **Encourage matrix trading**

33

∫∂ Noet E. Ravalo Ph.D.

An Enabling Environment for the Capital Market

34

∫∂ Noet E. Ravalo Ph.D.

Defining the Capital Market

". . . the segment of the financial system that provides long-term funding without delimiting the source of these funds. Thus, this will include both debt and equity instruments (including hybrids) literally with an original tenor in excess of one year but <u>preferably</u> much longer (i.e., at least exceeding 5 years, optimally exceeding 10 years)."

35

∫∂ Noet E. Ravalo Ph.D.

Foundations of Capital Market

- **Need to make educated guesses about the uncertain future and discount these into today's certainties**
- **Persistent macro vulnerabilities hinder this process**
  - ☞ **Impacts the volatility of financial prices**
  - ☞ **Blurs the future**

MACROECONOMIC STABILITY

36

∫∂ Noet E. Ravalo Ph.D.

Foundations of Capital Market

- K-mkt needs to be organized
  - Concerted effort on LT funds
  - Allow access
  - Adequate payments infrastructure
  - Capture relevant info

ORGANIZED MKT STRUCTURE

MACROECONOMIC STABILITY

37

∫∂ Noet E. Ravalo Ph.D.

Foundations of Capital Market

- Benchmarks are the crux of why we capture and discount financial prices
  - They translate what to make of our best guess of the future

ROBUST BENCHMARKS

ORGANIZED MKT STRUCTURE

MACROECONOMIC STABILITY

38

∫∂ Noet E. Ravalo Ph.D.

Foundations of Capital Market

- The payments infrastructure — both physical and market arrangement — govern the flow of resources

Payments Infrastructure

ROBUST BENCHMARKS

ORGANIZED MKT STRUCTURE

MACROECONOMIC STABILITY

39

∫∂ Noet E. Ravalo Ph.D.

Foundations of Capital Market

- Governance and Policy framework bridge the gap bet the providers & users of liquidity

Payments Infrastructure | FinGov FinPolicy

ROBUST BENCHMARKS

ORGANIZED MKT STRUCTURE

MACROECONOMIC STABILITY

40

∫∂ Noet E. Ravalo Ph.D.

Foundations of Capital Market

Menu of Choices

Payments Infrastructure | FinGov FinPolicy

ROBUST BENCHMARKS

ORGANIZED MKT STRUCTURE

MACROECONOMIC STABILITY

41

∫∂ Noet E. Ravalo Ph.D.

Taking Stock of Developments

- Shifting to a risk-adjusted mindset
  - Formal adoption of BIS Accord
  - Risk-based Net Liquidity model for NBFI
- Improvements in information mechanisms
  - Internal audit + Governance of the BOD
  - External auditors + CRAs
- Creating an organized venue
  - Creating signals + Capturing information

42