ECONOMIC POLICY
REFORM & ADVOCACY

Issues, Policies and Proposed Reforms in Philippine Financial Markets Development

A Market for Reforms

The country needs an effective financial market system for sustainable and broad-based economic growth to happen. An effective financial system should be able to mobilize resources in the economy for productive investment, and channel resources to activities that will promote growth, allow businesses to produce more goods and hence, generate more jobs. This paper is an attempt to identify the problems, existing policies and proposed reforms that affect the workings of the Philippine financial sector.

The Philippine Financial Market

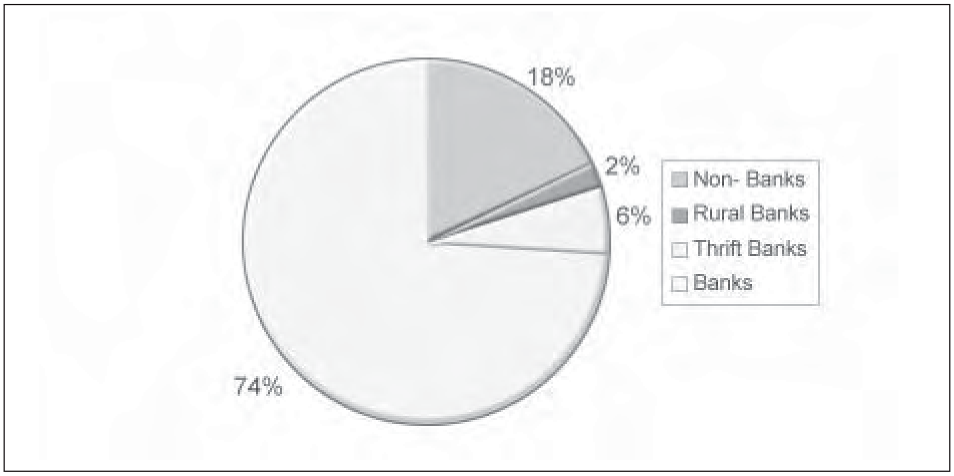
The Philippine financial sector comprises a variety of institutions, including banks (commercial banks whose operations include investment banking, thrift banks, rural banks, and development banks) and non-bank institutions (insurance companies, finance companies, pension funds, and the securities markets). The sector is highly dominated by banking, which itself is highly concentrated, with the six largest commercial banks controlling around 60% of all bank assets.

The big commercial banks are most often parts of family-owned business conglomerates and tend to operate as in-house banks for the non-bank business and commercial operations of the controlling families. The contractual savings sector, which is composed of public and private pension funds and insurance companies is another very small segment of the financial system. Capital markets are even much smaller in size and as a source of financing for private businesses, since they cater primarily to government domestic borrowing.

The Philippine financial system is far from effective. As defined, financial markets are said to be effective when they are efficient and deep.[1] Efficient financial markets are those that can mobilize funds from savings with the lowest opportunity cost and distribute these funds to investments that offer the highest potential returns, or what we call allocational efficiency. Financial markets are also efficient if they mobilize and allocate funds at minimal cost, or what we call operational efficiency. In terms of savings mobilization or efficiency, the Philippines' gross domestic savings ratio of 21% as of 2003 is one of the lowest among neighboring countries (see Table 1). The country's low savings rate is due to declining household savings since the 1980s, spawned primarily by lack of income (or low growth rate in income), and policies that do not promote savings growth (e.g., interest rates, bank availability and effective real exchange rates, etc.). Moreover, certain policies on interest rate ceilings; branch opening and entry rites have resulted in a strong informal sector that has negatively affected the returns to savings in the country.

[1] USAID Policy Paper "Financial Markets Development", Bureau for Program and Policy Coordination, August 1988

Figure1. Resources of the Philippine Financial System
(From the Presentation of Dr. Manny Esguerra to EPRA, anuary 21, 2005)



Depth, on the other hand, is characterized by the system's strength, with deeper financial markets believed to be less fragile than shallow financial markets. An indicator of financial depth is the ratio of broadly defined money or M2 (currency plus demand deposit) to gross domestic product (GDP). The table below shows that the Philippines' financial system with a ratio of 39.5% is shallower than most Asian countries, the third lowest in Asia after Laos and Cambodia. One reason for this is that the Philippines has high intermediation costs, which in turn, results in a wide disparity between savings and lending rate.

Table 1. Selected Financial Markets in Asia

	Savings to GDP Ratio (2003)	Broad Money (M2) to GDP (2003)	Domestic Market Capitalization (% to GDP) 2003	Government Securities to Outstanding Debt Issues (2004)
Philippines	20.9	39.5	28.83	93.11
Malaysia	42.9	108.7	156.04	58.51
Singapore	46.7	122.4	162.58	N.A.
Thailand	32.8	95.0	83.12	82.10
Indonesia	21.5	53.5	26.24	N.A.
Korea	32.8	124.5	49.27	60.94
Hong Kong	31.6	312.6	456.17	N.A.
China	42.7	189.2	N.A.	N.A.

Sources : ADB, Philippine data (NEDA)
World Federation of Exchanges
Country Statistical Websites

While banks fail to mobilize enough savings, the capital market on the other hand, although one of the oldest in Asia, remains underdeveloped with government debt papers dominating and accounting for almost 93% of total outstanding issues (see Table 1). In other countries, the capital market is dominated by private issues (see Malaysia and Thailand, 41.5% and 17.9%, respectively.). Likewise, the equities market, as measured by the stock market ratio of 28.8%, is small compared to those of other Asian countries. Clearly, the Philippine capital market is inadequately developed, with virtually no corporate bond market existing.

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Non-bank institutions, such as insurance companies, including the state-owned Government Services and Insurance System (GSIS) and the private pension fund Social Security System (SSS), should have helped the banks in boosting savings. Sadly, however, weak regulations undermine the pre-need market. The Philippine mutual funds industry is miniscule, with a track record that began only in the late 1990s and remains dominated by subsidiaries of large insurance companies, Sunlife and Philam.

Policy environment in the financial sector

The Philippine financial markets remain highly underdeveloped because of the policies and regulatory environment that surround the sector. Ideally, governments of developing countries should provide a policy and regulatory environment that encourages competition, the use of a variety of debt and equity instruments, uphold the growth of institutions that offer varied instruments and services to potential savers and investors, and lastly, but more importantly, protect the interests of savers by reducing their risks. Such an environment would encourage the growth of strong financial markets.

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The Philippine government, throughout the history of financial development in the country, had formulated a number of policies, some of which hew close to the ideals mentioned above and some that do not. Although not exhaustive, this section will attempt to discuss the policy environment that has supported (or deterred) the development of the financial markets on the overall and those of its specific subsectors.

THE BANKING SECTOR

Issues

Various indicators on Philippine banking have deteriorated, despite the fact that the 1997-1998 crisis did not affect the Philippines as badly as other countries. Increasing volatility in the economy coupled with a general weakening in business activities contributed to the deterioration of the following indicators.

(1) While most banks report adequate capital, the sufficiency of this capital and if they meet international standards are questionable.

(2) Asset values are not clearly established and more and more foreclosed assets show up in the balance sheets of these banks.

These are the problems plaguing banks after the crisis:

1. Commercial banks' nonperforming loans (NPL) have steadily been rising, from 4-5% in 1997 to 13% in 1999 and 19% in 2001.
2. The widespread foreclosure of assets led to an increased ratio of real and other properties owned and acquired (ROPOA) and restructured loans in the banks' balance sheets. Overall, 35% of total loans are under some form of stress and non- performing assets as a proportion of total assets have reached 30% in 2002.
3. Two large banks—Philippine National Bank (PNB) and Equitable PCI, suffered deteriorating investor confidence, which resulted in an emergency funding scenario from Philippine Deposit Insurance Corporation (PDIC) and the *Bangko Sentral ng Pilipinas* (BSP).
4. There has been a decline in profitability ratios such as ROA from 2.2% to 0.6%, and ROE from 15.96% to 4.3% (2001).
5. Capital adequacy remains doubtful in the context of the overhang of distressed assets, and some under-reporting of problem assets, existing provisioning arrangements, and declining profitability.

Existing policies

Admittedly though, the banking sector has gone through extensive reforms in the 1990s. In an effort to liberalize the industry, we had witnessed:

- Lifting of credit policies that led to market-determined interest rates;
- Liberalization of bank branching and entry
- Lifting of foreign exchange from substantial Central Bank control

  The financial crisis in 1997 and 1998 further legitimized a number of other reforms that aimed to strengthen regulation, supervision and transparency among players.
- The General Banking Act of 2000 improved the superseded 1949 law in terms of prudential regulation and supervision such as higher capital norms; tighter loan classification and provisioning rules, better consolidated reporting and more conservative value for real estate.

- The supervisory powers of the BSP were enhanced via on- and offsite supervision, basic early warning system, more frequent financial reporting, and public disclosure.

Coupled with a more stable economic environment in the 1990s (as compared to the 1980s), these policies brought forth the following positive developments in the system:

1. It was during this period that the financial system deepened, although admittedly still not as deep as the level of Indonesia, Taiwan or Thailand.
2. The importance of bank deposits as major sources of funds on borrowings was emphasized.
3. Banks assets rose significantly and the number of branches increased by more than 60%.
4. Competition became healthier as more players in the market vied for depositors via more attractive deposit products.

While there were positives, there were also negatives:

1. The liberalization was half-baked, with only a few foreign banks allowed entry and a limited number of branches set up. Hence, the level of competitiveness among the banks was also rather limited.
2. Liberalization during the Ramos time lacked decisive steps to strengthen the regulatory institutions in the banking sector. One clear example of failure of regulation was the Orient Bank fiasco.
3. Some dubious banks (small and medium-sized banks aside from Orient) were tolerated to operate by the Central Bank under the guise of a " a more liberalized environment."

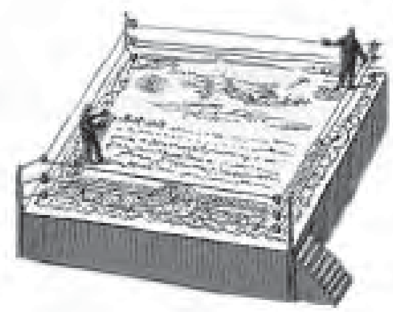
Proposed areas for reform/other issues

Given the lessons of liberalization efforts during the 1990s, the following areas should be the focus in the next wave of banking reforms for a more liberalized banking environment:

1. Bank consolidation or mergers should conform and meet prescribed capital adequacy ratios, loan/loss provisioning guidelines, etc.
2. Better-informed regulation and supervision.
3. Regulatory issues, transparency through surveillance, discipline and compliance should be key elements in the next reform agenda.
4. Explicit taxes such as the gross receipts tax of 5% on the banks' interest income and capital gains. Another tax adding to the intermediation cost is the 20% withholding tax on interest income.
5. Credit allocation policies that are imposed on banks, namely, the agri-agra law, the deposit retention scheme, and the mandatory credit to small scale enterprises deserve some review, as they contribute to banks' increased holdings of government securities (please see section on fixed income securities below).
6. The lack of adequate legal powers to address and resolve problem financial institutions continues to hamper BSP and PDIC. Particularly, the BSP needs legal power to suspend operations of a distressed institution and proceed with restructuring, merging or liquidating it without undue interference from the shareholders. Conversely, it also needs to be protected from possible litigation by an intervened bank's shareholders.
7. The conglomerate structure of banking in the Philippines needs to be addressed in future policy issues. Since the financial system is dominated by six commercial banks that also own trust, investment, securities, insurance, foreign currency deposit, thrift subsidiaries, corporations and real estate development projects, arbitraging of financial operations is facilitated. The fact that there are different regulatory bodies with existing capabilities that handle the various operations of conglomerates further makes arbitraging possible.
8. The conglomerate structure of commercial banks, although efficient in terms of profitability, is vulnerable to subsidiaries' problems. For instance, Urban Bank's funding problems originated from funding problems by the investment subsidiary that required the bank to provide liquidity and acquire its NPLs, but this eventually overwhelmed the bank that the BSP had to intervene.
9. The institutional structure of bank conglomerates is a roadblock to effective regulation and supervision. Some transactions of the intermediaries are supervised

by the SEC, others by the Insurance Commission. Supervision is still undertaken by type of service/license type of institution (whether EKB, commercial bank, thrift bank, etc.) even when they are part of the same conglomerate and hence consolidated supervision should be the approach. Another constraint in supervision is the rigid depositor law secrecy legislation. Although the anti-money laundering act partially addresses the secrecy law, the effect of regulation is still compromised by the existing aspects of secrecy. Moreover, the institutional structure of banks of being conglomerates, further makes transparency and information disclosure difficult to implement

THE CAPITAL MARKETS



A. Stock Market

The Philippine Stock Exchange (PSE) is the oldest in Asia. The unification of the two bourses in 1992 had promised to hasten development but as of 2001, the PSE has remained relatively small since its formation, with only 230 companies and half of a little over 300 issues active. In 1994, the market was very active especially in the area of Initial Public Offerings (IPOs), with 21 new issues generating almost P37 billion (B). The growth however was stalled by the onset of the Asian financial crisis with only four newly listed companies in 1998 and only one single company listed in 1999. To date, IPOs have remained few and far between.

Issues

The following problems still plague the development of the Philippine equities market.

1. Dependence on foreign participants puts development at risk, if not temporary. Historically, bull runs have always been accompanied by strong foreign participation; hence, the market turned bearish when foreign funds fled in 1997.
2. High transaction costs, the second highest among Asian equities markets as of 1997, deter growth in volume and liquidity. Taxes (transfer tax) and commissions significantly comprise these transaction costs.
3. Poorly run regulatory bodies such as the SEC and the PSE, diminishes the market's ability to protect the interest of the investing public. The biggest fraud in Philippine market history, the BW scandal, which revealed anomalies on insider trading, and involved President Estrada's close friend Dante Tan, eroded the confidence of the local investors and scared foreign investors as well.

Existing policies

In response to the BW scandal, the Securities Regulation Code (RA 8799 or the Securities Act of 2000) was enacted to send a clear message to local and foreign investors that the government is serious in developing the equities market and providing security to investors. The significant features of the code are:

- Reorganization of the SEC—The law enabled the SEC to reorganize and offer better compensation to attract more qualified professionals and convince the public that it is more equipped to use its powers as an effective regulator. Additional powers to enforce the law and stop market abuses were also incorporated in the law.
- Policy of full disclosure—The law made the corporate secretary, underwriters, and directors liable for any failure to disclose to the public material information that will affect investors' decision. The premise is that more informed investors can make sound financial decisions and aid the process of regulation in the market.
- Credibility of the securities market—The law required the PSE to demutualize, be owned by mostly non-broker firms and be managed by an independent and professional group to gain back investors perception that the stock market is fair and transparent.
- Better protection of minority stockholders—The law requires mandatory tender offers from any person or group that intends to acquire 15% of the equities securities of a listed or public company or intends to acquire at least 30% of such equity over a period of 12 months.
- Prevention of market abuses—The law contains new prohibitions on insider trading and affiliated transactions by brokers and dealers. It segregates the broker and dealer functions

to prevent market abuse and fraud. Moreover, the Code provides the SEC with a flexible framework to regulate such markets, to enable it to resolve cases more expeditiously during an invitation.

Proposed areas for reform and other policy issues
There are some major items in the reform agenda that have yet to be carried out, as follows:

1. Removal of documentary stamp tax (DST) on secondary transactions. While this has been prioritized in the legislative agenda, as tradeoff, it is proposed that the DST on other items will be raised to increase legislative agenda.
2. Restore credibility of the SEC by convicting those involved in the BW scandal.
3. Concrete steps to ensure information availability, profitability and fairness.
4. There should be concrete steps toward improving the credibility and image of the SEC as an institution and its employees. This entails establishing procedures and systems that remove discretion made by SEC personnel over some processes or transactions.
5. The Capital Markets Development Commissions (CMDC) also recommended several legislative proposals to the government which include: (a) a Securitization Act to allow the creation of special purpose vehicles as the transferee of assets and issuer of securities (there is a law on this but there have been very few availments because of the disincentive for the sellers to write down the value of the foreclosed assets); (b) a revised Investment Company Act to create an environment more conducive to the development of the Philippine Mutual Fund industry while strengthening investor protection; and (c) a Personal Equity Retirement Account Act (PERA) which would created a new form of long-term savings.

B. Fixed Income Securities Market

The largest component of the Philippine capital market is the fixed income securities market, largely comprised of debt instruments issued by the government and private companies and held by banks, insurance companies, pre-need companies and pension funds.

The national government typically issues two kinds of instruments, treasury bills and treasury bonds, with maturity of lower than one year and longer than one year, respectively. The Treasury bill market was born because of persistent government deficits.

Issues
The government securities market has fundamental weaknesses stemming from the inefficiency of the primary auction market and the underdevelopment of a secondary market.

- **Inefficiency of the primary auction market**. Yes, we do have electronic bidding and award posting, yet the market is inefficient; proof of this is that the yields of T-bills are higher than time deposit of the same maturity. This may be because the largest market for T-bills are the commercial banks, which by sheer monopsonist power can influence the yields to their favor.
- **Lack of a secondary market**. The next fundamental problem is a non-existent secondary market that arises from the fact that primary buyers of treasury bills and treasury bonds opt to hold on to these instruments until they mature, thus, making the market illiquid. Part of the problem springs from the directive stating that if banks fail to comply with the mandated allocation for agriculture, another means by which they can comply is by purchasing government securities. Another reason for the illiquidity is the lack of any functioning market makers, which in the ideal situation could be an investment house that could ensure the public that despite the lack of market activity, there is liquidity as assured by their presence in the market. There are only a few investment houses in the country, and a number is owned by commercial banks (others are poorly capitalized). In fact the evolution of banks into universal banking systems in the 1980s has stymied the growth of the capital market since it allowed big banks to gain dominance over financial institutions.
- **Heavy taxation of secondary market transactions**. Since the docs stamp tax of 0.75% is based on the face value of the instrument, it is a significant additional cost to the cost of the transaction. This makes holders unwilling to unload their securities to

achieve liquidity and realize capital gains. Although the removal of the tax is part of the Department of Finance (DOF)'s Financial Sector Tax Reform Program, it has yet to be granted legislative approval.

- **Lack of investor interest**. Interest rate fluctuations, lack of market liquidity and lack of market knowledge continue to discourage investors to hold long-term instruments such as government bonds and securities. And since the market is very thin, the general public and even financial professionals lack knowledge about how the market works.

C. The Mutual Funds Industry

Despite various reforms, as of 2003, the industry can still be considered miniscule given its late development, with 25 mutual funds (or investment companies) and 14 investment company managers or advisers. Nine of the 25 funds however have stopped selling shares and of the remaining, eight belong to fund families and managed by insurance companies Sunlife and Philam. In fact, notwithstanding the existence of 25 mutual funds in the market, there are really only three major players in the industy: the BPI Management and Trust Group, PhilAm Asset Management, Inc., and Sunlife Asset Management Inc. In terms of transactions, investments in mutual funds pale in comparison to investments in common trust funds (CTFs). Peso common trust funds investments are over five times bigger than mutual fund investment. Mutual funds are only 2% of the amount invested in savings and time deposits as of December 2002.

Issues

One unique feature of Philippine mutual funds and in fact a major contributor to its lackluster progress is the fact that it has a strong resemblance to CTFs and hence, face strong competition from the latter. CTFs are managed by Central Bank licensed institutions, mostly commercial banks. The nature of operations of both CTFs and mutual funds are similar: that of pooling the contributions of individual and institutional investors and investing them in a portfolio of securities. CTFs are also non-guaranteed investments (no guaranteed return promised to the investor). Unlike mutual funds, however, CTFs are not separate incorporated entities, regulated by the BSP (versus mutual funds which is regulated by the SEC), and the relationship of the investor and the issuer of the CTF is that of trustor–trustee.

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Investors' reluctance to go into mutual funds as opposed to other similar investments (pre-need plans, and CTFs, say) can be traced to its double taxation and lack of effective regulation. Similarities in the products or the high degree of substitution among products do not match the difference of regulation to the disadvantage of the mutual funds industry.

Existing policies

The Investment Company Act or RA 2629 is arguably the best piece of legislation that supported the emergence of the mutual funds industry. [Note: Can we know what year this RA was formulated?] However, despite two funds, Trinity Shares Inc. and Pacific Funds, Inc., which operated for a year in the late 1960s, the industry has been dormant until 1991. It was only when capital account liberalization in the country took off that the Philippine mutual funds industry expanded and has since grown despite the 1997 Asian crisis.

Reform areas

Although the mutual funds industry has grown significantly in recent years, the industry is still very much in its infancy. Investment companies have yet to achieve the popularity and familiarity that banks, trust and insurance products enjoy. In fact, even the more seasoned investors are unaware of the strong resemblance between mutual funds and CTFs.

Because of this, several initiatives for the industry are welcome:

1. **Investor education** is a top concern among industry players. Investment agents, those who play the role of disseminating information on the product are attracted to push more insurance and pre-need products as they offer more commissions.
2. **Market development** is another concern, which should be a responsibility shared by regulators and policy makers. The tax on dividends should be scrapped as this results in double taxation and severely restricts (if not terminates) the growth of

money market funds. The proposed measure to scrap documentary stamps will benefit not only mutual funds but also other financial participants in general.

3. **The dominance of bonds funds** in the stock market is a result of the lack of sophistication of both investors and the capital market in general. We hope that this is a temporary situation and will be reversed in favor of the mutual funds sector given the market development efforts by both the industry and financial policy makers.
4. **Mutual funds' ability (or inability) to compete with the CTFs**, its closest substitute. The differences in the regulatory policies between the *BSP* (for the CTFs) and the SEC (for mutual funds) may have been a result of the overall objectives of these two institutions. However, creating a uniform set of policies should solve the inequity of the regulations governing the two.

Future research

It will take time before the issues and problems discussed above are addressed and resolved especially since they come from a broad front of sectors—banking, capital markets, particularly stock, fixed income and mutual funds. In fact, the discussion of issues may be still expanded if other sub-sectors such as the pre-need and private fixed-income securities market are examined. The institutional reforms suggested, especially on financial transparency and strengthening of regulation should cut across all areas of the financial market.

The government and well-meaning groups that are involved in the sector have already undertaken initiatives. The next steps involve a prioritization of which among the earlier initiatives should be pursued aggressively given funding and resources constraint. For the TIERG project and in the financial markets group discussions organized by EPRA in January where most of the issues in this paper were also tackled, the following research areas were suggested. Subject to future discussion group meetings that are expected to further refine and expand the list, the following were identified:

1. A study on the saving behavior of the poor and their attitudes toward savings and investing. The group identified overseas Filipino workers (OFWs) as potential big savers hence, meriting an investigation on their spending and saving patterns. (The Philippine Center for Policy Studies [PCPS] will undertake this study in behalf of EPRA)
2. Best practices or state of the art policies in the financial markets of other countries;
3. A study on the existing saving instruments available (from the sellers' side) and how these can be maximized by the savers. (Maybe, a pamphlet can be made available to the middle and lower income class detailing easy to-follow steps and enumerating avenues where they can put their savings).
4. A study or survey on people's attitude on savings and investments including aversion to risk, to back the perception that there is a substantial amount of funds still untapped;
5. A study on savings but with a developmental approach, keeping in mind that most of the savings of the average Filipino go to educational plans and insurance;
6. A study that will determine the real benefits of savings to the public vis-à-vis keeping other real goods, to help effective savings mobilization. This is like a stakeholders study (which can also be undertaken in all of the reform areas of the project), which will analyze the effect on the stakeholders of the policy reforms being proposed in the project.
7. Finally, and more importantly, a study that will outline how best to embark on a "financial literacy program" in order to educate the investing public at large on the benefits of savings and investing and as a result mobilize more savings and develop the financial market in the country.

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