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A Status Report on the Philippine Financial System

Second Semester 2002

Bangko Sentral ng Pilipinas
Manila, Philippines

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GLOSSARY OF TERMS

A. SELECTED ACCOUNTS

1. ***Total assets*** refer to the sum of all assets, adjusted to net off the accounts "Due from Head Office/Branches/Agencies" and "Due to Head Office/Branches/ Agencies" of foreign bank branches.

2. For purposes of computing the average, one period covers 12 months
   a. ***Average assets*** refer to the sum of total assets for two periods divided by 2.
   b. ***Average capital*** refers to the sum of total capital accounts for two periods divided by 2.
   c. ***Average earning assets*** refer to the sum of earning assets for two periods divided by 2.
   d. ***Average interest-bearing liabilities*** refer to the sum of interest-bearing liabilities for two periods divided by 2.

3. ***Total capital*** refers to the sum of paid-in capital of locally incorporated banks, assigned capital and the qualified capital allowable component of the net "Due To/Due From Head Office/Branches/Agencies" accounts of branches of foreign banks plus surplus, surplus reserves, undivided profits and appraisal increment reserves.

4. ***Distressed assets*** refers to NPAs and current restructured loans.

5. ***Earning assets*** refer to the sum of loans (gross of allowance for probable losses) and investments (gross of allowance for probable losses), exclusive of equity investment (gross of allowance for probable losses).

6. ***Fee-based income*** refers to the sum of bank commissions, service charges/fees, and other fees/commissions.

7. ***Gross assets*** refers to total assets, net of reserves plus loan loss reserves (LLR) plus provision for ROPOA.

8. ***Interest-bearing liabilities*** refer to the sum of deposit liabilities and borrowings.

9. ***Net income before tax*** refers to the sum of net operating income and extraordinary credits/(charges).

10. ***Net interest income*** refers to the difference between total interest income and total interest expense.

11. ***Net operating income*** refers to the difference between operating income and operating expenses.

12. ***Non-interest income*** refers to the sum of fee-based income, trading income, trust department income and other non-interest income.

13. ***Non-performing loans (NPL) under Circular No. 202*** refer to past due loan accounts whose principal and/or interest is unpaid for thirty (30) days or more after due date (applicable to loans payable in lump sum and loans payable in quarterly, semi-annual or annual installments), including the outstanding balance of loans payable in monthly installments when three (3) or more installments are in arrears, the outstanding balance of loans payable daily, weekly or semi-monthly installments when the total amount of arrearages reaches ten percent (10%) of the total loan receivable balance, restructured loans which do not meet the requirements to be treated as performing loans under existing rules and regulations, and all items in litigation.

14. ***NPL under Circular No. 351*** refers to NPL under Circular No. 202 excluding loans classified as Loss in the latest BSP examination which are fully covered by allowance for probable losses and applicable to a bank which has no unbooked valuation reserves and other capital adjustments required by the BSP.

15. ***Non-performing assets (NPA) under Circular 202*** refer to the sum of non-performing loans (NPL) under Circular No. 202 and real and other properties owned and acquired (ROPOA).

16. ***NPA under Circular No. 351*** refers to the sum of NPL under Circular No. 351 and ROPOA

17. ***Operating expenses*** refer to the sum of bad debts written off/provisions for probable losses, overhead costs and other expenses.

18. ***Operating income*** refers to the sum of net interest income and non-interest income.

19. ***Overhead costs*** refer to the sum of non-loan related operating expenses such as compensation/fringe benefits, depreciation and amortization, etc.

20. ***Trading income*** refers to the sum of trading gains/(losses), foreign exchange profits/(losses), gold trading gains/(losses) and profit/(loss) on sale of redemption of investments.

B. FINANCIAL AND OTHER RATIOS

1. ***Capital adequacy ratio (CAR)*** refers to the ratio of capital to risk weighted assets computed in accordance with the new risk-based capital adequacy framework (patterned after the 1998 Basle Capital Accord) which has been formally adopted effective 1 July 2001.

2. ***Cost-to-income ratio*** refers to the ratio of operating expenses (exclusive of bad debts written off/provisions for probable losses) to operating income.

3. ***Density ratio*** refers to the ratio of the total number of domestic banking offices to the total number of cities/municipalities in the Philippines.

4. ***Earning asset yield*** refers to the ratio of total interest income to average earning assets.

5. ***Funding cost*** refers to the ratio of total interest expense to average interest-bearing liabilities.

6. ***Interest spread*** refers to the difference between earning asset yield and funding cost.

7. ***Net interest margin*** refers to the ratio of net interest income to average earning assets.

8. ***NPA coverage ratio**** refers to the ratio of allowance for probable losses on non-performing assets (NPA) to total NPA.

9. ***NPA ratio**** refers to the ratio of NPA to total assets, gross of allowance for probable losses.

10. ***NPL coverage ratio**** refers to the ratio of allowance for probable losses on non-performing loans (NPL) to total NPL.

11. ***NPL ratio**** refers to the ratio of non-performing loans (NPL) to total loans (gross of allowance for probable losses), inclusive of interbank loans.

12. ***Population-to-banking offices ratio*** refers to the ratio of the total population to the total number of domestic banking offices.

13. ***Return on assets*** refers to the ratio of net income after tax (NIAT) to average assets.

14. ***Return on equity*** refers to the ratio of NIAT to average capital.

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*The numerator and the denominator for the ratios under (1) *Circular No. 351 shall exclude* and (2) *Circular No. 202 shall include* the loans classified as Loss in the latest BSP examination which are fully covered by allowance for probable losses and applicable to a bank which has no unbooked valuation reserves and other capital adjustments required by the BSP.

PROLOGUE

Financial institutions (FIs) supervised or regulated by the Bangko Sentral ng Pilipinas (BSP) at end-year 2002 had expanded further to 6,304 head offices up by 111 new entities from 6,193 at end-year 2001. The operating FIs consisted of 912 banks with 6,542 branches and other offices, 5,381 non-bank financial institutions (NBFIs) with 4,959 branches and 11 offshore banking units (OBUs) with one other office (Schedule 1).

The expansion in the number of BSP-supervised and regulated entities mainly came from NBFIs, as more pawnshops were opened during the year. The contraction, on the other hand, of banking institutions from 929 at end-year 2001 to 912 at end-year 2002 were due to 9 cases of merger involving 7 commercial banks, 5 thrift banks and 6 rural banks, and 13 bank closures involving 2 thrift banks and 11 rural banks. The moratorium on the establishment of new banks, limited the entry to only 5 banks consisting of one (1) foreign bank branch replacing another foreign bank branch which converted into a foreign bank subsidiary and four (4) rural banks exempt from the moratorium as either a micro-finance bank or located in an area without a bank.

Effective 3 July 1998, the supervision and regulation over non-banking entities were turned over to the Securities and Exchange Commission (SEC) for corporations and partnerships and to the Department of Trade and Industry (DTI) for single proprietorships in accordance with Section 30 of R.A. No. 7653 (The New Central Bank Act), except the following: non-banks with quasi-banking functions and/or with trust or Investment Management Account (IMA) license, non-banks which are subsidiaries/affiliates of banks and quasi-banks, non-stock savings and loan associations, pawnshops and venture capital corporations. Likewise, the supervision and regulation over building and loan associations were transferred to the Home Guarantee Corporation effective 7 February 2002 in accordance with Section 94 of R.A. No. 8791 (The General Banking Law of 2000).

THE PHILIPPINE FINANCIAL SYSTEM: AN ASSESSMENT

The Philippine Financial System continued to perform steadily in 2002 amid a prolonged tough and uncertain environment. The banking system in particular kept its focus on strengthening basic financial soundness. All indicators point to recovery taking hold: steady growth of deposits, increasing capitalization, and resumption of lending growth. However, the momentum of these improvements will need to be carefully nurtured.

The rapid growth of microfinance was noteworthy. In the last couple of years, microfinance has made progress towards the mainstream. Through various joint initiatives, mechanisms have been created to bridge banks, NGOs and cooperatives in credit delivery. Since 2000, there were 49 additional banks that have joined the 71 participating banks in microfinance. This brings the number to 120 banks participating in microfinance. The total microfinance loan portfolio amounted to ₱2.1 billion reaching 386,431 borrowers as of end-year 2002.

As the BSP remains committed to its legal mandate of taming inflation, the past year's inflation rate has plummeted further to a benign 3.1 percent at end-2002, thus fostering a low-interest rate regime. On balance, this should be conducive to a lower risk financial environment and the further implementation of structural reforms.

In consonance with monetary policy, the future thrusts of the banking sector policy seek to provide a strengthened financial environment to support economic growth with financial stability. Specifically these include, among others, the amendments to the BSP Charter as well as the PDIC Charter; support for legislative initiatives such as the proposed Asset Securitization Law and the proposed Corporate Recovery and Insolvency Law to help banks manage their balance sheets; support for the continuing restructuring of the banking industry; implementation of the consolidated supervision of financial enterprises; and continued implementation of other reforms to further strengthen the banking system such as better corporate governance.

The BSP accords particular importance to the expediency and dispatch in disposition of the non-performing assets (NPAs) of the banking system. The overhang of large NPAs on the books have been keeping banks in a bind, hampering more vigorous progress in lending activity. The BSP has been at the forefront of the joint government-private sector effort to secure the passage of the appropriate enabling legislation, which will encourage/facilitate private investment in the NPAs of Philippine banks through the creation of asset management companies. Finally, the Special Purpose Vehicle (SPV) Act was approved by Congress in December 2002 and was signed into law by the President on 10 January 2003 (Box1).

Box 1

THE SPECIAL PURPOSE VEHICLE (SPV) ACT 2002

As guardian of banking stability, the Bangko Sentral ng Pilipinas' main function is to ensure the presence of a sound regulatory and supervisory environment conducive to a more efficient and competitive banking system. One of the more recent legislative initiatives of the BSP is its strong advocacy for the establishment of a legal framework for the creation of special purpose vehicles (SPV) that would buy banks' non-performing assets[1] (NPA) and encourage private sector investments.

The large overhang of NPAs in the banking system has been an overriding concern of the BSP. As of end-year 2002, the banking system's gross assets reached ₱3.6 trillion while total loan portfolio (TLP) amounted to ₱1.9 billion. Around ₱286.6 billion of these loans are non-performing, while another ₱217.5 billion comprises ROPOA, bringing the total NPA portfolio to ₱504.2 billion or 13.9 percent of the banking system's gross assets or 27.1 percent of TLP. Although NPLs declined by 6.3 percent or ₱19.1 billion from ₱305.8 billion at end-year 2001, NPL ratio still remained high at 15.4 percent. On the other hand, acquired assets grew by 13.7 percent, down from last year's growth of 20.8 percent.

The accumulated stock of NPAs needs to be trimmed substantially from banks' balance sheets as it constrains lending and impairs profitability. Data on loan growth indicate subdued lending activity. TLP increased by a slight 2.5 percent at end-year 2002 and such increase would have been 1.4 percent only if interbank loans (IBL) were excluded. By getting rid of its bad assets, a bank is able to undertake new lending, thus leading to an improved balance sheet, enhanced asset quality and stronger profitability.

In a bid to cut back on banks' bad debts and spur lending activity, the BSP has fully backed the creation of privately funded SPVs which would acquire, manage and dispose of impaired assets. This move is in line with the Government's thrust of promoting a sound financial sector for the country. Government support came in the form of an enabling law with accompanying incentives. On 23 December 2002, Congress passed Republic Act (R.A.) No.

1/ *NPAs refer to the sum of non-performing loans (NPL) and real and other properties owned and acquired (ROPOA).*

On 23 December 2002, Congress passed Republic Act (R.A.) No. 9182 [The Special Purpose Vehicle (SPV) Act of 2002], which was signed into law on 10 January 2003 by President Gloria Macapagal-Arroyo. This laid down the legal and regulatory basis for the setting up of private SPVs.

Salient features of the SPV Act of 2002

The SPV Act of 2002 primarily seeks to encourage private sector investment in NPAs, eliminate existing barriers to the acquisition of NPAs, and improve the liquidity of the financial system.

The Act and its Implementing Rules and Regulations (IRR) also specifies the taxation framework for the sale by banks and other financial institutions (FIs) of their NPAs with fiscal incentives and some regulatory relief. The Philippine model is essentially a market-based private sector-driven model. As such, the role of government is limited to the grant of incentives through the removal of so-called "friction costs" on transactions such as capital gains tax, documentary stamp tax, mortgage registration, fees, and other similar fees. Some regulatory relief, subject to full disclosure, is also provided to allow selling financial institutions especially banks, time to adjust their capital positions after taking potentially substantial losses on sale of NPAs at discounted prices.

Under Section 3 of the SPV Act, participating FIs shall be limited to the following:

1. the BSP;
2. a bank as defined under The General Banking Law of 2000 (R.A. No. 8791);
3. a financing company as defined under The Financing Company Act of 1998 (R.A. No. 8556);
4. an investment house as defined in The Investment Houses Law (Presidential Decree No.129);
5. government financial institutions (GFIs), which shall be limited to the Philippine Deposit Insurance Corporation (PDIC), Land Bank of the Philippines (LBP), and Development Bank of the Philippines (DBP);
6. government-owned or –controlled corporations (GOCCs); and
7. other institutions licensed by the BSP to perform quasi-banking functions.

SPV Rule 3 (b) of the IRR defines the scope of authority of the following agencies or Appropriate Regulatory Authority (ARA) which shall have jurisdiction over the FI's operations:

1. Department of Finance (DOF) – in the case of the PDIC and GOCCs, in consultation with other agencies that have primary jurisdiction over the said FIs whenever appropriate;
2. Bangko Sentral ng Pilipinas (BSP) – in the case of banks, including LBP and DBP, and financing companies and investment houses with trust and quasi-banking functions licensed by the BSP;
3. Securities and Exchange Commission (SEC) – in the case of financing companies and investment houses, except their trust and quasi-banking functions or any qualified entity not under the DOF or BSP.

Following are some of the key provisions in the SPV Act:

- Application for the establishment and registration of an SPV
- Recognition of the extent of the powers of the SPV
- Submission of SPV Plan which shall include, among others, the SPV's investment policies, features of the Investment Unit Instruments (IUIs), and rights of the holders of the IUIs
- Prior certification of eligibility [2/] as NPA by the ARA
- Requirement of a true sale nature in the transfer of assets to SPV
- Basis for the grant of tax exemptions and fee privileges
- Promulgation of rules and regulations governing the treatment of loss as a result of the transfer of NPAs
- Enforcement of penalties in cases of abuse of tax exemptions and privileges

The Congressional Oversight Committee (COC) approved the IRR on 19 March 2003, which became effective on 9 April 2003. This effectively starts the clock for eligible transactions. Under the SPV Act, FIs have two years to transfer their NPAs.

A steering committee within BSP has been formed to oversee the implementation of the transfer of NPAs of banks and non-bank FIs, as well as coordinate the implementation of the Act with the different supervising and examining departments of the Supervision and Examination Sector (SES) of the BSP and with the other regulatory agencies.

[2/] *The BSP is presently making an inventory of banks' NPLs and ROPOA to determine their eligibility as an NPA based on a list of NPAs as of 30 June 2002, as specified in the IRR. For the record, total NPAs for the said period stood at ₱520 billion or 14.9 percent of the system's gross assets of ₱3.5 trillion*

The BSP also intends to strengthen its efforts to spur the development of the domestic capital market through the creation of a favorable environment for a wide-range of asset-backed securities, rationalization of the taxation of transactions in the capital market, promotion of new debt and equity instruments, and expansion of institutional players. In this regard, the BSP supports the proposed bill on securitization as well as the elimination of the documentary stamp tax (DST) on secondary trading. In addition, the BSP is closely cooperating with the private sector to build the basic market infrastructure necessary to an efficiently functioning capital market such as the proposed Fixed Income Exchange and its supporting settlement and clearing systems and custodial arrangements.

The BSP continues to improve its supervisory framework for the banking system by formulating the remaining implementing rules and regulations of the General Banking Law of 2000. The shift to consolidated supervision of financial conglomerates as well as the shift from a compliance-focused supervisory approach to one that focuses on risk and its management is being implemented vigorously to enable a more proactive approach. This will also involve the enhancement of coordination with other local regulatory agencies (e.g., Securities and Exchange Commission (SEC) and Insurance Commission (IC) and international supervisory authorities. Meanwhile, the BSP is advocating proposed amendments to the New Central Bank Act of 1993, which aim to promote greater stability in the banking system, further strengthen supervisory capability and generally enhance the effectiveness of the BSP. Major reforms being proposed in this regard involve the following: (1) providing the BSP sufficient flexibility to conduct banking examinations depending on bank risk profile; (2) implementing prompt corrective action in the case of problem/distressed banks; and (3) imposing stronger criminal and administrative penalties for violation of banking laws and regulations.

In sum, these are important efforts that can be expected to be followed through with an array of specific measures over time. To be sure, greater stability can be attained only if there is a continuity in efforts to strengthen the economy's achieving resilience against vulnerabilities that could undermine growth. The BSP needs to proceed energetically, keeping focus on its mandate to deliver price stability conducive to the promotion of a strong and efficient financial sector that will serve as an efficient channel to intermediate funds and manage financial risks.