

Financial Services Integration and Consolidated Supervision: Some Issues to Consider for the Philippines

Melanie R.S. Milo



Philippine Institute for Development Studies
Seaside Center, Alabang, Muntinlupa City, Philippines

The author is a Senior Research Fellow at the Philippine Institute for Development Studies (PIDS). She obtained her Ph.D. in Economics from the Australian National University and specializes in money and banking, and international macroeconomics. She acknowledges the excellent research assistance of Allelie Sobreñañas.

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Please address all inquiries to:

Philippine Institute for Development Studies
NEDA sa Makati Building, 106 Amorsolo Street
Legaspi Village, 1229 Makati City, Philippines
Tel: (63-2) 893-5705 / 892-4059
Fax: (63-2) 893-9589 / 816-1091
E-mail: publications@pidsnet.pids.gov.ph
Website: <http://www.pids.gov.ph>

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Table of Contents

List of tables and figures	<i>iv</i>
Foreword	<i>v</i>
Abstract	<i>vi</i>
I. Introduction	1
II. Trends in financial services integration and consolidated supervision	3
III. Financial sector consolidation in the Philippines	28
IV. Some issues to consider for the Philippines	45
Appendix	50
References	54

List of Tables and Figures

Tables

1	Sources of market failure and their regulatory implications	13
2	Bank regulators (as of 1999)	14
3	The location of banking supervision (as of 1999, in percent)	14
4	Regulatory agencies (as of 1999)	15
5	Countries that have either moved toward unified financial supervision (partially or fully) or are considering doing so	16
6	Indicators of institutional framework (mid-1997, unless otherwise indicated)	26
7	The structure of the Philippine financial system, 1972 and 1979	31
8	Limits on equity investments of banks	33
9	Summary of commercial banks' subsidiaries and affiliates	34
10	Degree of restrictiveness of regulatory restrictions on bank activities and the mixing of banking and commerce of selected Asian countries	36

Figures

1	Three alternative bank structures for delivering integrated financial services	4
2	Distribution of 123 countries by degree of restrictiveness of regulatory restrictions on bank activities and the mixing of banking and commerce	6
3	Regulatory approaches	9
4	Integrated supervision decision tree for emerging and transition economies	22
5	Measures of financial deepening, 1977-2001	37
6	Supervision and regulation of a universal bank and its subsidiaries and affiliates	41

Foreword

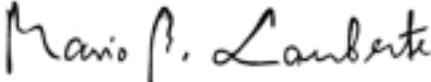
The Philippine Institute for Development Studies (PIDS) celebrated its silver founding anniversary in 2002. In this connection, various activities were held to highlight the contribution and significance of policy research in governance as well as to commemorate more than two decades of providing competent research.

One of these activities is the Perspective Paper Symposium Series where the PIDS research fellows presented a perspective of the development and evolution of issues and concerns over the past 25 years in their respective fields of specialization such as infrastructure, banking and finance, science and technology, human resources development and labor markets, competition policy, poverty analysis and housing development. The 11 papers covered most of the themes in the PIDS research agenda and presented reviews of specific policy issues from where policy debates can proceed with greater focus.

Such outputs, however, are best disseminated in book formats so as to widen the reach of the excellent observations, analyses and recommendations put forward by the Institute's inhouse pool of researchers. Thus, the Institute presents 11 commendable titles under the *Perspective Paper Series* as its contribution to Philippine policy research.

It is with confident expectation that this *Series* will provide the essential answers to the concerns and gaps in various policy issues which the Institute has been trying to address in the last 25 years.

This book examines the trends in Philippine banking regulation in the past 25 years. In particular, it notes that the Philippines has followed a policy of despecialization in the banking sector by widening the range of permissible activities and bank products to enhance competition and efficiency, beginning with the introduction of universal banking in 1980. However, there has been no corresponding adjustment or change in the regulatory framework until very recently. The book then raises the issue of the appropriate institutional structure for financial sector regulation.


MARIO B. LAMBERTE, Ph.D.
President, PIDS

Abstract

This paper examines the trends in Philippine banking regulation in the past 25 years. In particular, it notes that the Philippines has followed a policy of despecialization in the banking sector by widening the range of permissible activities and bank products to enhance competition and efficiency, beginning with the introduction of universal banking in 1980. However, there has been no corresponding adjustment or change in the regulatory framework until very recently. Expectedly, financial services integration or convergence has affected the effectiveness and efficiency of financial sector regulation. Thus, the paper raises the issue of the appropriate institutional structure for financial sector regulation. The structural aspects of regulation as presented encompass the reasons for recent interest in the subject, the pros and cons of single versus multiple regulators, the international experience, and the developing countries' perspective. The paper then discusses the issues for consideration for the Philippines.

1

Introduction

When banks operate without difficulty, bank regulation and supervision¹ typically do not receive much attention. But when large banks or a large number of banks fail and the system itself is threatened, regulation and supervision then become a major point for criticism and reform. Institutional changes may also be deemed important together with the “improvement” of regulation and supervision (Shull 1993). Thus, much of the regulatory system in many banking sectors, including the Philippines, has developed in response to various financial crises.

The literature on the Asian financial crisis typically contends that financial liberalization and the removal of obstacles to foreign borrowing by banks and the corporate sector, coupled with poor and inadequate prudential supervision, gave rise to the risk of moral hazard and the resulting financial crisis. Consequently, and not surprisingly, the enhancement of prudential regulation and supervision of banks through the adoption of international standards or “best practices” was among the recommendations and prerequisites for the recovery of the Asian economies. The architecture of financial supervision and any need for change also became an important issue to be addressed. Thus, strengthening the supervisory mechanism under the IMF programs for the crisis economies, namely, Indonesia, Korea and Thailand, also required the establishment of integrated prudential regulators (Gochoco-Bautista et al. 1999).

The Philippine financial sector fared relatively well compared to the crisis economies, not having experienced large financial failures. This has been partly attributed to the reforms that had been implemented in the financial sector beginning in the early 1980s, including the strengthening

¹ In its strictest sense, banking regulation refers to the framework of laws and rules that govern banks' operations, while banking supervision refers to the monitoring of banks' financial conditions and the enforcement of banking regulation (Spong 1994). This paper follows the practice of viewing regulation and supervision in a more general sense, and uses the terms interchangeably.

of prudential regulation and supervision of the banking system. Two commercial banks did fail in the aftermath of the Asian crisis—Orient Bank in 1998 and Urban Bank in 2000 although in both cases fraud/insider abuse was the ultimate cause of failure. The case of Urban Bank is especially noteworthy because its failure had been attributed to problems in its investment house subsidiary, Urbancorp Investments, Inc. Failure to detect problems in Urbancorp, in turn, had been attributed to some lapse in supervision/regulatory oversight that arose from confusion in the proper assignment of regulatory function over investment houses between the Bangko Sentral ng Pilipinas (BSP) and the Securities and Exchange Commission (SEC). Two other commercial banks with links to investment houses suffered financial difficulties but were acquired by foreign bank subsidiaries.

In the aftermath of the Asian crisis, the General Banking Law of 2000 (RA 8791) was passed. It aimed to address weaknesses in the regulatory framework governing banks, including the problem of insider abuse. An important element of this Act was the adoption and incorporation of internationally accepted standards and practices into the BSP's supervisory processes. But what the string of bank and investment house failures also highlighted was the need to close regulatory gaps that resulted from the integrated or conglomerated nature of financial institutions but with a fragmented regulatory system in the Philippines. This is the focus of this paper.

This paper examines some key trends in Philippine banking regulation in the past 25 years. In particular, it notes that the Philippines has followed a policy of despecialization in the banking sector by widening the range of permissible activities and products of banks to enhance competition and efficiency, beginning with the introduction of universal banking in 1980. However, there has been no corresponding change in regulatory framework until very recently. Expectedly, financial services integration or convergence has affected the effectiveness and efficiency of financial sector regulation. Thus, the paper raises the issue of the appropriate institutional structure for financial sector regulation.

The following section presents the structural aspects of regulation, including the reasons for the recent rise of interest in the subject, the pros and cons of single versus multiple regulators, the international experience and the developing countries' perspective. Section 3 reviews the Philippines' policy with respect to financial services integration. The paper then discusses some issues for consideration in identifying the appropriate regulatory structure to further strengthen prudential regulation of the Philippine financial sector in Section 4.

2

Trends in Financial Services Integration and Consolidated Supervision

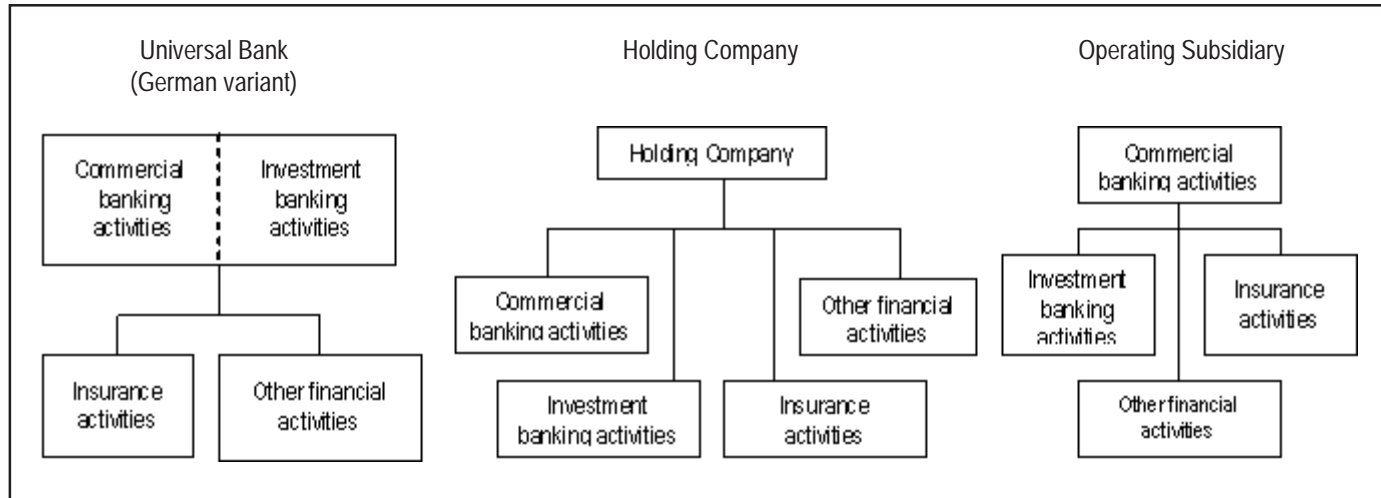
Financial services integration

Financial services are traditionally classified into three major sectors—banking, insurance and securities. Financial services integration or financial convergence refers to the production or distribution of a financial service traditionally associated with one of the three major financial sectors by service providers from another sector. Some common terms that connote financial services integration include bancassurance, universal banking, and financial conglomerates, with the degree of integration ranging from shallow to deep (Skipper 2000).

Figure 1 presents three alternative structures for the undertaking of nontraditional activities by commercial banks: 1) the universal bank, in which the nontraditional activity is consolidated within the same corporate unit as the bank; 2) the holding company affiliate, in which the bank is in one subsidiary of a holding company and the nontraditional activity is in another subsidiary of the holding company; and 3) the operating subsidiary in which the nontraditional activity is located in a subsidiary of the bank (Shull and White 1998).

A pure universal bank is one that manufactures and distributes all financial services within a single corporate structure, while the German variant combines commercial and investment banking within a single corporation but conducts other financial activities through separately capitalized subsidiaries. A universal bank can also be considered a financial conglomerate, which is defined as consisting of firms under common control that provide services in at least two financial sectors. Bancassurance, a marketing arrangement in which banks sell insurance products and usually vice versa, involves affiliated firms and meets the definition of a financial conglomerate. The structure that a bank adopts in delivering integrated financial services is influenced primarily by regulation. Other influencing factors include the historical development of a country's financial markets, market power, and economies of scale and scope (Skipper 2000).

Figure 1. Three alternative bank structures for delivering integrated financial services



Source: Shull and White (1998); Skipper (2000).

Financial services integration also occurs through the blurring of product lines because of innovation, that is, when firms in one sector create and sell products containing significant elements traditionally associated with the products of another sector. For instance, variable (unit linked) annuities and life insurance combine elements of insurance and securities, while the securitization of banks' asset cash flows (e.g., mortgages, credit card balances, and other debt portfolios) combines elements of investment and commercial banking. Money market mutual funds offered by investment banking firms are effectively demand deposit accounts. This trend toward product convergence can drive commercial banks, securities firms, and insurers toward operational integration (Skipper 2000).

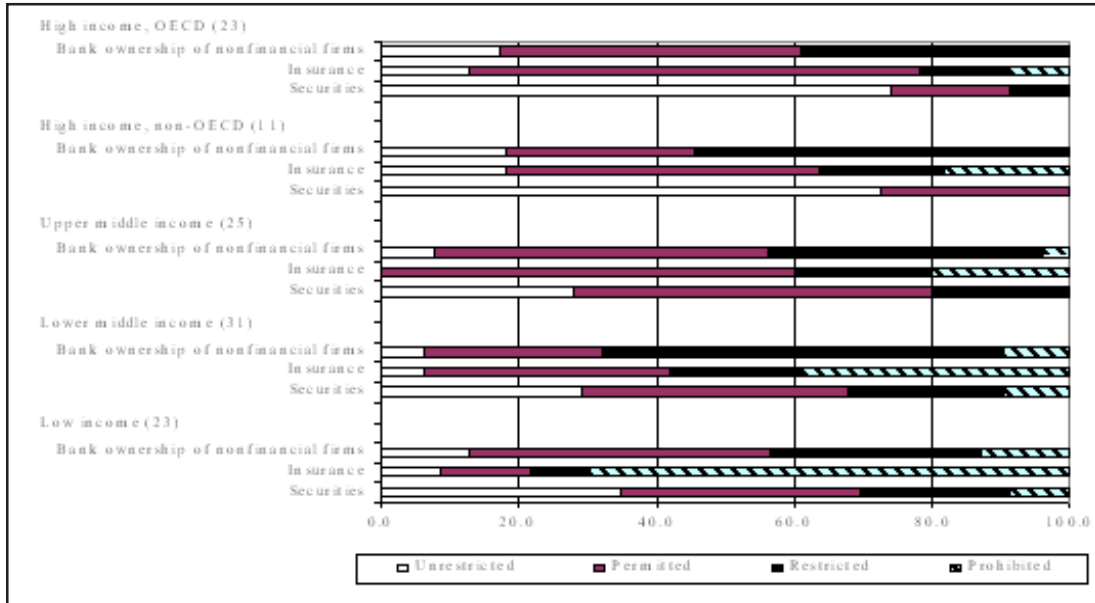
Financial services integration or financial convergence has become a feature of the financial landscape in many developed and developing countries. Several factors have contributed to this trend: regulatory arbitrage; the liberalization and deregulation of the financial sector; the greater use of financial engineering techniques and models, facilitated by significant advances in information technology and telecommunications; and changing consumer preferences. In particular, deregulation and liberalization policies are having a significant impact on the traditional structure of the financial services industry worldwide. Because such policies have induced greater competition and tighter profit margins, banks and other intermediaries have been forced to seek new business models and other sources of income. Technology has also significantly affected the way financial products and services are produced and consumed. For instance, innovations in self-service delivery include ATMs, telephone-based transactions, and web-enabled services through Internet portals (Egan and Ng 1999).

Barth et al. (2001) present and discuss a new and comprehensive database on the regulation and supervision of banks in 123 countries.² Figure 2 shows a summary of the survey with respect to regulations on bank activities and the mixing of banking and commerce. In particular, it shows that a large number of countries across income groups now allow joint banking and securities and insurance activities, either within the bank itself or through subsidiaries or affiliates. Around 50 percent of the countries surveyed also allow bank ownership of nonfinancial firms.

In particular, financial services integration is advanced in Europe, where universal banking has been well established and bancassurance models have enjoyed a measure of success. The creation of the European Monetary Union has provided additional impetus for financial

² The database includes various aspects of banking regulation, like entry requirements, ownership restrictions, capital requirements, activity restrictions, external auditing requirements, deposit insurance scheme characteristics, loan classification and provisioning requirements, accounting/disclosure requirements, troubled bank resolution actions, and the "quality" of supervisory personnel and their actions.

Figure 2. Distribution of 123 countries by degree of restrictiveness of regulatory restrictions on bank activities and the mixing of banking and commerce (in percent)



Note: Unrestricted = full range of activities can be conducted in the bank; bank may own 100 percent of equity.
 Permitted = full range of activities can be conducted, but all or some must be conducted in subsidiaries; bank may own 100 percent of equity but ownership is limited based on the bank's equity capital.
 Restricted = less than full range of activities can be conducted in the bank or subsidiaries; bank can only acquire less than 100 percent of equity.
 Prohibited = activity cannot be conducted in either the bank or subsidiaries; no equity investment allowed.

Source of basic data: Bank Regulation and Supervision Database, World Bank (2001).

conglomeration and consolidation, which has been identified as a priority for the European Commission. Financial services integration is also fairly advanced in Canada and Australia (Skipper 2000). In contrast, the US was one of the most fragmented markets for financial services until recently. The Glass-Steagall Act of 1933 imposed strict legislative restrictions on affiliations between commercial banks, securities dealers, and insurance. Despite the legislative impediments, the barriers were eroded over time partly because of product innovation and the loosening of application of regulations. Proposals for liberalizing limitations on banking activities were developed in the 1980s and early 1990s, in line with worldwide deregulation efforts at the time. But it was only in 1999 that the US successfully enacted legislation to move financial institutions toward a system of conglomeration that has long existed in continental Europe and other countries. The Gramm-Leach-Bliley Financial Modernization Act established a new framework for affiliations among commercial banks, insurance companies, and securities firms through “financial holding companies” and “financial subsidiaries,” as well as guidelines for entry into merchant banking (Shull 2000).

The International Monetary Fund (IMF 2001) noted that the trend toward consolidation of bank with nonbank financial activities is also beginning to gain ground in emerging markets. Most emerging markets have followed the universal banking paradigm. Furthermore, banks typically dominate local capital markets, which means that they directly share in the growth of these markets.

In Asia, while financial services integration is at an early stage, Palmer (2002) argues that there is a significant scope for convergence across the region. Universal banking models incorporating commercial banking, insurance and securities activities already exist in many Asian countries and the remaining restrictions on financial conglomerates operating across sectors are bound to diminish. Bancassurance is also slowly taking hold. The Asian crisis has also spurred liberalization and deregulation efforts, which can accelerate integration. In addition, banks in Asia have been designated a key role in the development of the region’s capital markets. Commercial banks already play a major role in corporate bond markets as issuers, underwriters, investors and guarantors. This development reflects banks’ dominance of their financial markets, their high reputation, and the informational advantages they enjoy. Thus, it has been recommended that banks be further encouraged to foster corporate bond market development and pursue a complementary role. In addition to securities and derivatives businesses, banks may also be encouraged to engage in other nonbanking activities such as insurance underwriting (Shirai 2001; Yoshitomi and Shirai 2001).

Because of the underlying factors driving it, financial convergence is expected to continue. The speed and extent of convergence, though, will

not be the same for every country. It will depend on various factors, including the needs of the local market, the stage of development of the economy, various macroeconomic factors, and the extent to which regulatory reforms allow banks to diversify. But the common issue is how regulators can best respond to financial services integration (Palmer 2002). In particular, the emergence of financial conglomerates adds at least two new dimensions to the supervision and regulation of such entities in emerging markets: a) the issue of consolidated supervision, and b) the architecture of the institutions in charge of supervision (IMF 2001). The ultimate question is, if financial sectors are integrating, should regulators do the same? To be effective, Abrams and Taylor (2000) contend that the structure of the regulatory system must reflect the structure of the markets being regulated.

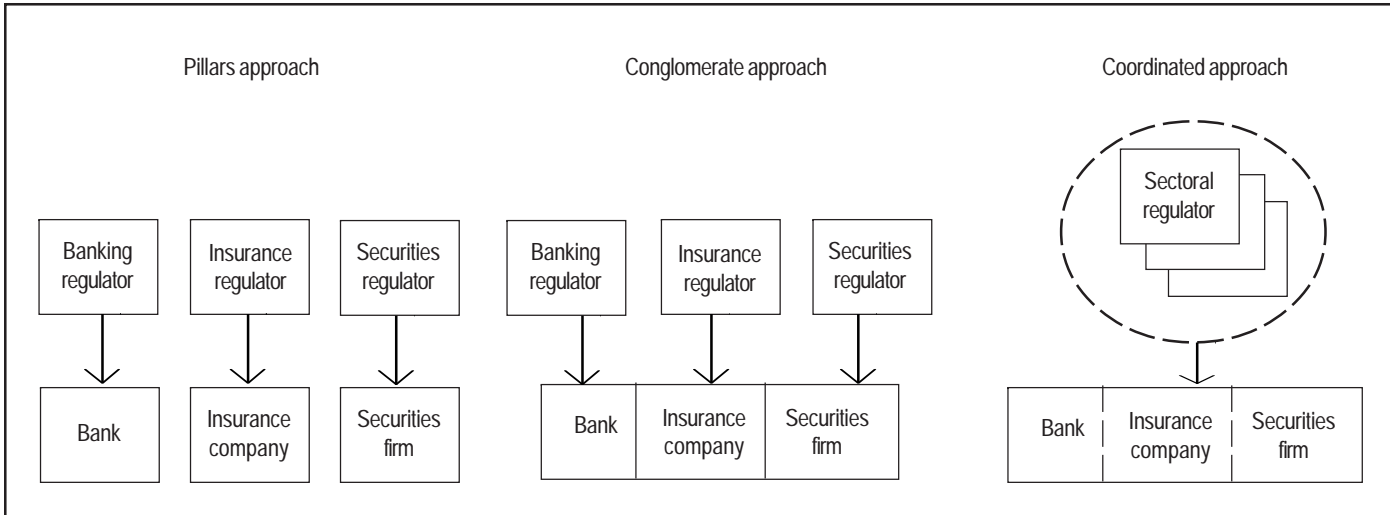
Consolidated supervision of banks

The traditional regulatory approach applied to the three major financial sectors is the “pillars” approach, that is, each “pillar” is regulated by its own distinct regulator enforcing its own laws (Figure 3). There are also lines-of-business and ownership restrictions to prevent competition in each other’s markets. A second approach is the “conglomerate” approach, wherein separate and distinct regulatory regimes for the three sectors still exist, but liberalization and deregulation of lines-of-business and ownership restrictions have permitted the formation of financial conglomerates. However, the formation of conglomerates has challenged the traditional demarcations between regulatory agencies and has made industry-specific supervision inadequate. Thus, in the third approach, the separate and distinct regulatory regimes for the parts of the conglomerate still exist but they are augmented with regulatory and supervisory practices that explicitly take into account the conglomerate nature of the regulated institution. For instance, separate sectoral oversight is combined with intersectoral coordination and cooperation (OECD 1998).

Banking regulators now generally accept that banking groups or financial conglomerates need to be supervised on both a solo and consolidated basis to take into account supervisory concerns that may be overlooked at the entity level (Palmer 2002). Prudential and market conduct concerns that result from financial services integration include transparency, contagion, regulatory arbitrage, conflicts of interest, double and multiple gearing; fit and proper requirements; and unregulated group entities, which are interrelated (Skipper 2000).

Transparency relates to the availability of accurate, complete, timely, and relevant information about the financial group to regulators and other interested parties. Thus, regulators must be authorized to collect relevant information from the group and/or from other regulators. However, the presence of an unregulated entity can lead to additional information problems. In particular, regulators should be familiar with management,

Figure 3. Regulatory approaches



Source: OECD (1998)

ownership, and legal structures to come up with a full assessment either of the risks faced by the group as a whole or the risk posed by the group's nonregulated entities to the regulated entities. Ensuring the fitness, propriety, and other qualifications of the top management of regulated entities can also be complicated by the organizational and managerial structure of financial conglomerates, especially if they can be influenced by managers or directors of the unregulated entities. Market conduct deficiencies could arise from possible internal conflicts of interest (agency problems), which are endemic to financial services integration. Finally, the proper assessment of a financial conglomerate's consolidated capital is complicated by double or multiple gearing,³ which could lead to an overstatement of group capital derived directly from each entity's solo capital.

Contagion occurs when one entity's financial difficulties adversely affect the entire group's financial stability, which could further lead to a market-wide contagion. Contagion can be due to intragroup exposures such as credit extensions or lines of credit between affiliates, cross-shareholdings, and intra-group guarantees and commitments. Contagion can also arise just from public perception. To minimize the risk of contagion, there should be adequate transparency and close coordination among regulators.

Tax treatment, accounting standards, investment restrictions, capital adequacy requirements, and other regulations typically differ across financial intermediaries, thus creating opportunities for regulatory arbitrage. One way to address this issue is to eliminate such differences by moving toward consolidated financial regulation. Otherwise, sectoral regulators must fully cooperate with one another to jointly identify instances of regulatory arbitrage and deal with them if necessary.

Thus, the case for consolidated supervision of banks is both compelling and obvious. Consolidated supervision has been deemed as an essential tool of supervising banks that conduct some of their business through their subsidiaries and affiliates. In the case of a bank that belongs to a group headed by a holding company, supervisors also need to take account of the activities of the holding company and fellow subsidiaries of the bank. Thus, consolidated supervision involves a comprehensive approach to banking supervision by evaluating the strength of an entire group and taking into account all the risks that may affect a bank, regardless of whether these risks are carried in the books of the bank or related entities (MacDonald 1998).

³ Double gearing or leverage occurs when one entity holds regulatory capital issued by another entity within the same group, and the issuer is allowed to count the capital in its own balance sheet. Multiple gearing occurs when the subsidiary firm in the previous instance itself sends regulatory capital downstream to a third-tier affiliate.

It could be argued that such an approach is unnecessary if a bank only holds fully paid shares in its subsidiaries (and has not guaranteed their liabilities vis-à-vis third parties) because of the principle of shareholder limited liability. However, the bankruptcy of a subsidiary could seriously damage the bank's reputation and weaken depositor confidence. Banks then have usually no alternative but to underwrite the losses of all entities under their control. A bank that is a subsidiary company within a wider business grouping may also be exposed to "upstream" risks arising from its owners or from "parallel" entities within the group (MacDonald 1998). Thus, Principle 20 of the "Core Principles for Effective Bank Supervision" identified by the Basle Committee on Banking Supervision states that: "An essential element of banking supervision is the ability of the supervisors to supervise the banking group on a consolidated basis" (BCBS 1997). Furthermore, "Banking supervisors should also have the ability to coordinate with other authorities responsible for supervising specific entities within the organisation's structure" (BCBS 1997).

But effective banking supervision is only part of a public infrastructure that should be well developed, and which should also include well defined rules and adequate supervision of other financial markets and their participants (BCBS 1997). Thus, the international regulatory community has also attempted to understand the differences between prudential rules for different industries and is studying ways of narrowing the differences. In particular, the Joint Forum on Financial Conglomerates was established in early 1996, composed of the Basle Committee on Banking Supervision, the International Organisation of Securities Commissions, and the International Association of Insurance Supervisors, which are responsible for setting international standards in their respective sectors. The Joint Forum has supported the development of core principles and the enhancement of risk-based supervision and capital requirements across the three sectors. It has also reviewed various means to facilitate the exchange of information between supervisors, enhance supervisory coordination (including the appointment and role of a lead coordinator), and develop principles toward more effective supervision of regulated firms within financial conglomerates. The Joint Forum's focus has been primarily on diversified financial firms with complex organizational and management structures whose large-scale activities cross national borders and sectoral boundaries. However, it is deemed that the lessons drawn and the guidance prepared could also apply to smaller conglomerates or conglomerates that only operate domestically (Joint Forum 1999).

It should also be noted that there are preconditions for the effective implementation of consolidated supervision, which include the legal framework, independence of the supervisory agency and commitment to the process. The components of consolidated supervision are consolidation of accounts, quantitative consolidated supervision (includes prudential

requirements such as capital adequacy, large exposures and connected lending) and qualitative consolidated supervision (includes management and organizational structure, group-wide business plans and strategies and consolidated internal controls and risk management) (MacDonald 1998). Thus, it requires a high degree of coordination, cooperation and harmonization, which is very difficult to achieve because important distinctions in the three major financial industries still exist even with financial services integration. Duplication of regulatory effort is also very likely under the coordinated approach. Thus, in developing an effective framework for consolidated supervision, supervisory agencies will inevitably face a number of policy and practical issues, some of which will be very difficult to resolve because of significant differences in regulatory frameworks. A related supervisory challenge of convergence then is the need to move to functional rather than industry-specific supervision.

Many countries still regulate financial conglomerates on an institutional basis, with some designating a lead regulator based on the conglomerate's principal activity. Thus, if the main activity is commercial banking, the lead regulator is the bank regulator, who has the added responsibility of overseeing the entire group's operation and ensuring coordination of responses but without usurping the power of other regulators (Skipper 2000). An important trend in recent years is the implementation of consolidated financial services regulation along functional lines particularly in several developed countries.

Consolidated financial sector supervision

Recently, significant attention has been focused on the structural aspects of financial regulation, particularly the desirability of unified regulatory agencies—that is, agencies that supervise two or more of the traditional financial services sectors. The primary reason has been the trend toward financial conglomerates. Reddy (2001) notes that even if a compartmental approach is taken with respect to financial institutions and activities and risks can be separated, the linkages are such that contagion is inevitable. Countries are therefore seeking more effective modes to supervise financial conglomerates. On the other hand, smaller countries are seeking ways to achieve economies of scale in regulation through better management of regulatory resources (particularly personnel) and infrastructure support (Mwenda and Fleming 2001).

Regulatory structure refers to the way in which a country organizes the various agencies in charge of financial sector regulation. In principle, there are two fundamentally different models of regulatory structure—one based on institutional groups (as discussed in the previous section) and the other based on regulatory functions. Regulatory functions refer to the underlying functions of regulation, namely, addressing the various sources of market failure (Carmichael 2002). Table 1 presents the four main sources

Table 1. Sources of market failure and their regulatory implications

Market Failure	Regulation	Regulatory Institution
Anticompetitive behavior	Merger, antitrust rules, free entry, and exit to markets	Consumer protection or conduct of business agencies. In some cases, these are part of other supervisory authorities.
Market misconduct	Information disclosure, business conduct, licensing, governance and fiduciary responsibilities, financial strength	Banking Supervision Authority, Securities Commission, Insurance Regulatory Authority. These could all be under one integrated authority.
Asymmetric information	Prudential regulation: entry requirements, capital requirements, balance sheets restrictions, liquidity requirements, customer support schemes (e.g., deposit insurance)	Banking Supervision Authority, Securities Commission, Insurance Regulatory Authority. These could all be under one authority.
Systemic instability	Maintenance of suitable macroeconomic environment, lender of last resort facility, direct regulation of the payments system	Ministry of Finance, Central Bank, Banking Supervision Authority (in many cases part of the Central Bank) and Deposit Insurance Agency. In the case of an independent Banking Supervision Authority, these functions are separated.

Source: Dammert (2000)

of market failure in the financial system—anticompetitive behavior, market misconduct, asymmetric information and systemic instability—as well as the corresponding regulations needed to address them and the regulatory institutions capable of implementing them.

In the purest form of the institutional model, a single regulator responsible for correcting all four sources of market failure is assigned to each institutional group. In the purest form of the functional model, correcting each of the four sources of market failure is assigned to a single regulator that will be responsible for all institutions that are subject to that particular failure. In practice, regulatory structures around the world typically involve a mixture of functional and institutional divisions. On the other hand, the global trend toward integrated financial regulation can be viewed as a trend toward restructuring regulatory agencies along functional lines, particularly with respect to prudential regulation (Carmichael 2002).

In a separate survey of the structure of financial regulatory institutions in 123 countries in 1999, Llewellyn (1999, as cited in Llewellyn 2001)⁴ showed

⁴ The author advises caution in interpreting the results of the survey as the practice is not always as precise or straightforward as might be suggested by the formal structure.

that for nearly three-quarters of countries in the sample, the central bank is still the one responsible for the supervision of banks. Furthermore, the most common model of banking supervision, which made up around 50 percent of supervisory structures, is for the central bank to supervise only banks (Table 2). Developing countries are also much more likely to entrust responsibility for banking supervision with the central bank (Table 3). More generally, it is still most common to have separate and dedicated supervisory agencies for banks, insurance companies and securities firms (Table 4). However, there has been a significant reduction in the number of countries with dedicated and specialist regulatory institutions since 1996.

There are only three countries (Netherlands Antilles, Singapore and Uruguay) where the central bank is responsible for banks, securities firms, and insurance companies. Ten countries have a single prudential regulator for all financial institutions and markets that is not the central bank (Llewellyn 2002). These are Australia, Austria, Denmark, Iceland, Japan, Korea, Malta, Norway, Sweden and the UK. The number has significantly increased since 1996. The notable additions to this group of countries since 1996 are Australia, Iceland, Republic of Korea, Japan and the UK. In three countries (Chile, South Africa and the Slovak Republic), banks are regulated alone while securities and insurance are regulated by the same agency. In nine countries, banks and securities are supervised by the same agency

Table 2. Bank regulators (as of 1999)

	Central Bank	Non-Central Bank	Total
Banks alone	63	7	70
Banks and securities	7	6	13
Banks and insurance	16	13	29
Banks, securities and insurance	3	8	11
Total	89	34	123

Source: Llewellyn (2001)

Table 3. The location of banking supervision (as of 1999, in percent)

	Central Bank	Outside the Central Bank
Industrial countries	35	65
Developing countries	78	22

Note: The table shows what institutions have primary responsibility. Central banks may still be significantly involved in prudential supervision issues without having primary responsibility.

Source: Llewellyn (1999) in Hawkesby (2000)

while insurance is regulated by a specialist agency. In 13 cases (Austria, Canada, Colombia, Ecuador, El Salvador, Guatemala, Malaysia, Nigeria, Pakistan, Paraguay, Peru, Venezuela and Zambia), banks and insurance are combined within the same agency while securities firms are supervised by a specialist agency (Llewellyn 2001). Thus, while there are only few practitioners of the unified model, almost all of which are developed economies, partial consolidation of financial regulatory institutions is more widespread and includes a number of emerging and transition economies. More countries are also in the process of either adopting or considering moving toward partial/full unified financial services supervision (Table 5).

Carmichael (2002) discusses the experience of nine countries with integrated regulators—Australia, Canada, Denmark, Japan, Korea, Norway, Singapore, Sweden and the United Kingdom—that compose an informal grouping called the Integrated Regulators Group.⁵ The basis for membership when the group was created in 1999 was that the agency be responsible for prudential regulation of both banks and insurance companies. While most group members have a wider range of responsibilities than this, the combination of responsibilities for banking and insurance regulation was taken as a working definition of ‘integrated regulation.’ Carmichael (2002) observes the one area in which there was a high degree of consensus was the motivation for establishing the integrated agency, namely, a) convergence in financial markets and the need for a more consistent approach to regulating financial conglomerates; b) the need for greater consistency in the application of policy across different industries; and c) the ability to use scarce regulatory resources more efficiently.

Table 4. Regulatory agencies (as of 1999)

	No. of Countries
Single Agency	
Central Bank	3
Other	10
Separate agencies for each	35
Banks alone; Securities and Insurance combined	3
Banks and Securities combined, Insurance alone	9
Banks and Insurance combined; Securities alone	13
Total	73 ^a

^a Countries where agencies are identified
Source: Llewellyn (2001)

⁵ Iceland joined the group in 2000.

Table 5. Countries that have either moved toward unified financial supervision (partially or fully) or are considering doing so (as of June 2001)

Unified supervision (partial or full) that includes supervision of the banking sector		Considering or mooting the idea of a unified regulator
Australia	Malaysia	Bulgaria
Austria	Malta	Germany
Canada	Netherlands Antilles	Ireland
Colombia	Nigeria	Kazakhstan
Denmark	Norway	Mauritius
Ecuador	Pakistan	Poland
El Salvador	Paraguay	Slovakia
Estonia	Peru	Slovenia
Guatemala	Singapore	South Africa
Hungary	Sweden	Turkey
Iceland	Trinidad and Tobago	Ukraine
Jamaica	United Kingdom	
Japan	Uruguay	
Korea	Venezuela	
Latvia	Zambia	

Source: Mwenda and Fleming (2001)

On the other hand, there is a broad range of responsibilities, powers, and organizational and operational structures among the members of the Integrated Regulators Group. What they do have in common is that all major forms of prudential regulation have been brought together under one roof. Some integrated agencies also included part or all of market conduct regulation. Only the Monetary Authority of Singapore combined these two regulatory functions with systemic stability regulation through oversight of the payments system and monetary policy. Finally, competition policy was not incorporated in any of the integrated agencies. Thus, the majority of the integrated regulators can be considered as differing versions of the functional approach to regulation because they assign one regulator to each source of market failure, at least in principle. The main variation is that some go beyond the pure functional model by combining two or more of these functional regulators into the integrated agency.

The most extreme case of regulatory approach would be the single regulator supervisory model, which has only one control authority, separate from the central bank, with responsibility over all financial markets and intermediaries, and concerned with all the objectives of regulation. The concern with this model is the potential conflict of interest in pursuing different objectives. It could also lead to excessive concentration of regulatory powers. It is interesting to note that this model characterized

the early stages of financial system development when the central bank was the only regulatory body (Di Giorgio and Di Noia 2001). This is why the integrated model is being adopted, for instance, by a number of transition economies.

In many emerging markets, the supervisory and regulatory frameworks have been considerably improved, especially through the adoption of internationally accepted core principles. However, consolidated supervision is significantly less developed (IMF 2001). In particular, effective consolidated supervision is hindered by legislative barriers and different accounting and regulatory regimes for the different financial sectors. High levels of expertise in risk-areas common to all financial service industries also need to be developed by the regulators. In particular, regulators need a thorough understanding of the differences that still exist between industries, as well as the converging financial market as a whole. Finally, at least one supervisor has to have comprehensive oversight (Palmer 2002).

The trend toward a universal banking paradigm in many emerging markets may indicate that consolidation of regulatory agencies in charge of banks, securities, and insurance companies would also be appropriate to reflect the industry structure's evolution (IMF 2001). But does the same balance of argument hold for the emerging economies as for the developed economies?

Implications for developing countries

With respect to the applicability of consolidated financial sector supervision to developing countries, the literature cites two key lessons that they can learn from the experience of developed country practitioners. One is that simply changing the structure of regulation cannot guarantee effective supervision, and integrated regulation per se is not a solution to regulatory failure. Correcting regulatory failure requires better regulation, that is, setting more appropriate prudential and market conduct standards, improving surveillance, and strengthening enforcement. Integrated regulation may help facilitate this process, but it cannot cause these changes to occur by themselves. Indeed, the countries that adopted the consolidated financial sector supervision approach did so to enhance the supervisory process.

The second lesson is that there is no single best form of integrated regulatory agency. Unified financial services supervision has been adopted differently in many countries, that is, its application has varied from country to country and there is no single right way of introducing or implementing unified models of financial services supervision. Factors that accounted for the differences revolved around starting points, industry structures, and objectives. Clearly, the decision of whether or not to integrate financial services supervision should be taken after full consideration of the circumstances of each individual country.

In view of the foregoing, a number of experiences shared by countries may well be instructive vis-à-vis the benefits and costs of integrated regulation. A number of general principles and key lessons have also been identified, which can inform the discussion about the appropriate institutional structure in developing countries (Abrams and Taylor 2000; Bain and Harper 1999; Briault 2002; Carmichael 2002; Llewellyn 2002; Mwenda and Fleming 2002; Reddy 2002; Skipper 2000; Taylor and Fleming 1999).

The arguments in favor of a single regulator are summarized as follows: First, there are economies of scale for the regulator, since unification may permit cost savings on the basis of shared infrastructure, administration and support systems. Second, the regulated units also benefit from this scheme, since unification mitigates the costs, which supervised firms with diverse activities (i.e., financial conglomerates) bear for dealing with multiple regulators. Third, accountability is enhanced, since complexity of the multiple supervisory system could lead to lack of clarity of roles and consequently lack of accountability. Fourth, regulatory arbitrage can be avoided. In a multiple regulatory regime, fragmentation of supervision could lead to competitive inequalities as different units, possibly offering similar products or services, are supervised differently. Fifth, reducing the number of regulators could allow scarce supervisory resources, especially in specialist areas to be pooled. Sixth, a single regulator can respond more effectively to market innovation and development, as there would be no regulatory gray areas. Finally, unification aids in international cooperation, as there is a single contact point for all regulatory issues (Reddy 2001).

Not surprisingly, Reddy (2001) also observes that the arguments against the idea of a single regulator are equally strong. First, unification could lead to lack of clarity in functioning, as multiple regulators tend to have different objectives. This objective may be depositor protection for banks versus investor protection for capital markets versus consumer protection for other financial firms. Second, concentration of power could vitiate democratic policies. Third, there may actually be diseconomies of scale, since monopolistic organizations can be more rigid and bureaucratic than specialist agencies, being typically large and too broad-based structures for effective regulation of the entire system. Fourth, there may be unintended consequence of public tending to assume that all creditors of supervised institutions will receive equal protection. Finally, the focus of banks, securities, and insurance supervisors being different, pooling of skills and objectives, pooling of resources may not produce the synergy that is expected.

Arguments like the above have brought to the fore an umbrella approach, in which separate regulatory authorities are established and coordinated, and which has been deemed desirable for Asian developing countries because they typically do not have sufficiently strong prudential

regulations or banking sector supervision. In such a situation, integrating nonbanking regulators with bank regulators could weaken the regulatory capacity of the latter if human and financial resources are limited, which could in turn reduce confidence in the overall financial system. Furthermore, independent regulatory regimes that protect central banks from policy intervention are mostly lacking. Thus, integrating the various regulators without ensuring independence may weaken the quality and credibility of the overall regulatory regime. Instead, the priority should be the strengthening of bank regulation while improving regulatory capacities for nonbanking business (Shirai 2001).

Abrams and Taylor (2000) maintain that developing regulatory capacity should precede the issue of regulatory structure, which becomes a major concern only if it will help to achieve the former. Particularly in many developing and transition economies, where banks and hence banking supervision are central to their financial systems, unification of financial sector supervision must not compromise banking supervisory capacity or independence. However, they also note that changing the structure of regulation could eliminate gaps in regulatory coverage. In some countries that suffered financial crises, for instance, the presence of a systematically significant unsupervised group of financial institutions was a contributing factor.

The other factor that they consider crucial in assessing the unified model is that the institutional structure of regulation should mirror the institutional structure of the industry being regulated. Thus, in countries where the financial system includes universal banks, or where banks are significant players in the securities markets, combining banking and securities regulation will be most appropriate. Combining banking and insurance regulation will be most appropriate in countries with strong linkages between banks and insurance companies. Finally, combining the regulation of all three sectors will be most appropriate when distinctions between different financial intermediaries have become blurred or the financial services industry is composed of diversified, multi-activity groups.

Other general guidelines include the following. In developing countries where banks dominate insurance and securities business, there may be a case for unified regulation (Reddy 2001). Skipper (2000) contends that the larger the financial services market of a country, the greater the complexity and difficulty in moving to consolidated regulation. Conversely, the more modest in size a country's financial sector is, the easier it should be to move to consolidated approaches. McDowell (2001; in Mwenda and Fleming 2001) also argues that smaller states, by necessity, cannot afford to have very complex or costly regulatory institutions and systems. In financial terms, the burden of regulation has to be kept under control. If there are economies of scale in regulation, Llewellyn (2001) posits that a single agency might be especially appropriate for small countries. Thus, the move of a

number of transition economies toward unified financial services regulation has been justified by the relative smallness of their financial sectors and the economies of scale in regulation that could be achieved (Mwenda and Fleming 2001).

In particular, according to Taylor and Fleming (1999), developing and transition economies can derive useful lessons from the Scandinavian experience with integrated financial supervision. Emerging markets share many of the features that have made the experiences of Norway, Denmark and Sweden with integrated financial supervision successful:⁶ they are relatively small economies with small financial systems that can exploit economies of scale and scope in supervision; they are still building human capital in the area; and they have banks that offer a wide range of financial services, particularly growing bancassurance businesses.⁷ Their rationale for bringing together banking, securities, and insurance regulation within a single organization was twofold. Firstly, integrated supervision would permit more effective supervision of financial conglomerates. Secondly, the merger would also permit economies of scale to be obtained in regulation, especially better leverage of resources in administration and infrastructure support. Another factor behind their creation of integrated financial sector supervisory agencies was the desire to improve the quality of supervision of other financial sectors. In particular, insurance regulation was criticized as being largely reactive. The influence of the more proactive approach of the banking supervisors was seen as a valuable benefit. Achieving regulatory neutrality, as well as better regulation of conglomerates, was also among the primary motivations for establishing integrated regulatory agencies among the members of the Integrated Regulators Group (Carmichael 2002). Integrated regulatory agencies have proven to be fertile ground for harmonization of prudential standards across different institutional groups (APRA 2000).

While there is some support for consolidated financial sector supervision in developing countries, a more contentious issue is whether the unified regulator should be separate from the central bank. Taylor and Fleming (1999) concede that this is a major difference between developing and the Scandinavian countries. None of the three Scandinavian integrated regulatory bodies was created by removing the banking supervision function from the central bank. The regulation of commercial banks in these countries had long been conducted by a specialist banking supervisory body. This difference has serious implications. One, the creation of an integrated

⁶ Norway, Denmark and Sweden integrated their regulatory agencies in 1986, 1988 and 1991, respectively.

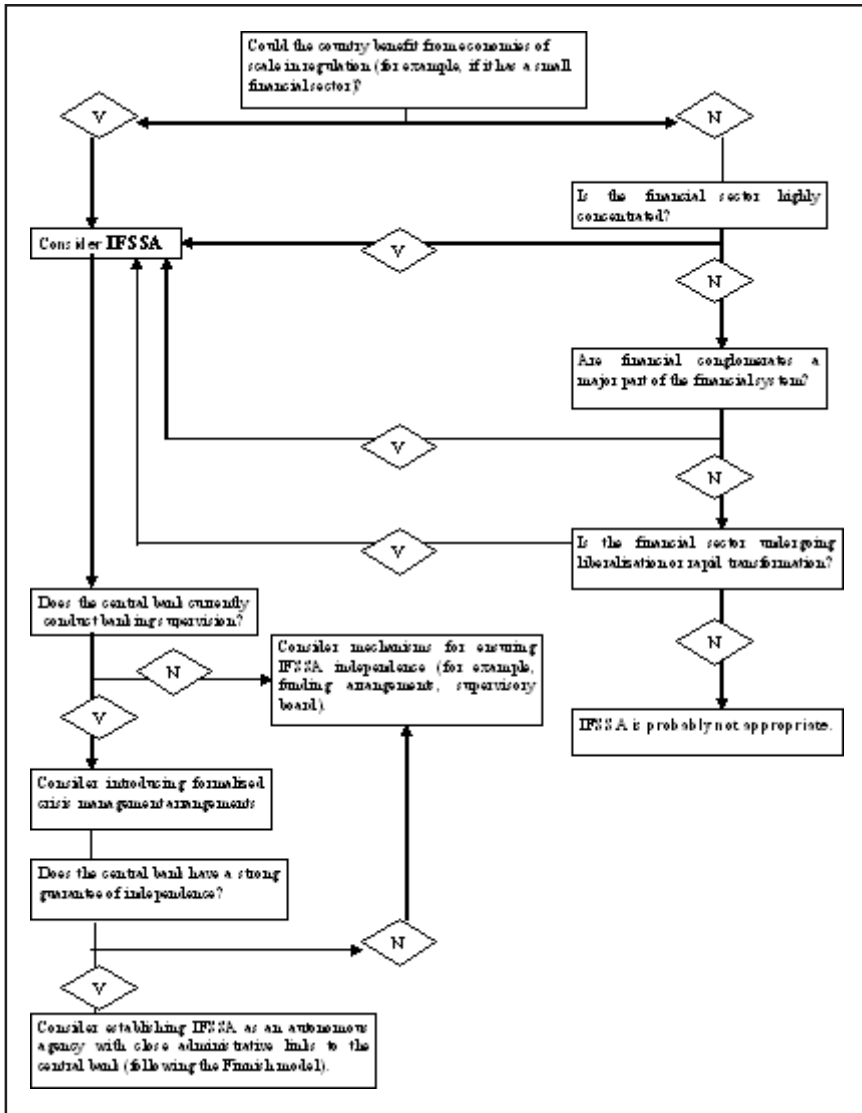
⁷ In fact, Norway, Denmark and Sweden all began integrated regulation by merging their banking and insurance regulatory agencies, as insurance companies played a more important role as investment brokers and there were signs of increased cooperation between banking and insurance businesses.

agency did not prove as contentious compared to other countries where a long-established bank supervisory function was removed from the central bank. Two, crisis management arrangements were not explicitly considered. Where the banking supervisory function was removed from the central bank, it was considered necessary to find a substitute arrangement similar to the type of liaison that banking supervisors and officials had when they worked within a single organization. In the three Scandinavian integrated authorities, regular meetings are held with their respective central banks and information about individual institutions is shared with them on request. But they do not have formalized crisis management arrangements. The latter is especially important in developing countries.

Thus, they also presented the case of Finland as an alternative model, short of the fully integrated approaches adopted in Denmark, Norway and Sweden. To a large extent the Finnish system of regulation followed that of these three countries until the late 1980s. Finland had also long regulated its banks through a Bank Inspectorate outside the central bank, which acquired the responsibility for the prudential regulation of nonbank securities firms in 1979. However, a fully integrated approach to regulation was not deemed appropriate because of the structure of Finland's financial system, particularly the relatively less developed bank-insurance linkages and a large compulsory private sector pension system. Furthermore, Finland saw the need to enhance the linkages between its banking supervisors and the Bank of Finland. Thus, it created the Financial Supervision Authority (FSA), which is independent in its decisionmaking but administratively connected to the Bank of Finland. That is, the FSA shares the support infrastructure of the central bank, which has enabled it to achieve significant scale economies as well.

Thus, integrated supervision is not the only way to achieve significant economies of scale, although that has not been the primary motivation. More generally, the authors caution that their arguments for integrated regulation do not automatically imply that this organizational form would be appropriate for transition economies or the emerging markets. They are in accord with the general conclusion in the literature that the organizational form of regulation should be adapted to the circumstances of particular countries. Of special importance is ensuring that the structure of regulation is adapted to the underlying structure of financial markets. Thus, they devised a "decision tree" to assist emerging markets in their choice of an appropriate organizational model (Figure 4). As is evident from their decision tree, they also advocate the gradualist, evolutionary approach to integration that was followed in the Scandinavian countries. In contrast, the United Kingdom adopted a "big bang" approach to integration, and integrated nine existing regulators with significantly different cultures and experience.

Figure 4. Integrated supervision decision tree for emerging and transition economies



Note: IFSSA stands for Integrated Financial Sector Supervisory Agency.
 Source: Taylor and Fleming (1999)

Lastly, Taylor and Fleming (1999) cite two critical issues that need to be addressed if an integrated agency is to be successfully established. One, it is important that the transition for the individual specialized agencies to the unified agency is managed effectively. This requires developing an

implementation plan that will dictate the path from the fragmented to the integrated model once a decision to shift to an integrated agency has been made. Two, once the integrated agency is in place, a range of administrative and personnel issues must be addressed in the context of a well managed change program.

Clearly, the transition from institutional regulation to functional regulation is a complex process. And it should be recognized that there are significant differences even among developing countries. As Skipper (2000) points out, there is something to be said for building on existing structures. The choice need not be made in extremes of single and multiple regulators because there are possibilities of hybrids and supplementing arrangements. Under any system, issues of information exchange and coordination are inevitable. In the final analysis, the regulatory objectives, coverage, skills, operational effectiveness, and credibility are important, and structures remain one element of financial regulation (Reddy 2001).

The East Asian experience

Emerging markets that have established a single supervisory agency for the banking, securities and insurance sectors include Hungary, Korea and Singapore (IMF 2001). The case of Korea is especially noteworthy because it reformed the institutional setup/regulatory structure of its financial sector as a result of the Asian crisis. In particular, a series of financial sector reforms formed part of the support program that Korea negotiated with the IMF in 1997. These reforms included the establishment of an integrated prudential regulator. Laws passed in December 1997 significantly strengthened the independence of the Bank of Korea, consolidated all financial sector supervision, and merged all deposit insurance protection agencies.

A new regulatory approach was deemed urgently needed to restore market discipline, strengthen prudential regulations and adapt to the worldwide trend of universal banking. The primary motivations for integrating the existing supervisors were financial services convergence and blurring distinctions between the different financial sectors. Achieving efficient cooperation among regulators in developing consistent supervisory policies to ensure competitive neutrality in the Korean financial sector proved difficult under the institutionally based system of financial regulation. This lack of unification led to widespread regulatory arbitrage and was seen to be a major contributor to the spread of the Asian crisis in Korea (Bain and Harper 1999).

Thus, the Financial Supervisory Commission (FSC) and the Financial Supervisory Service (FSS) were established in April 1998 and in January 1999, respectively, upon the passage of legislation consolidating the existing financial supervisory authorities by the National Assembly in December 1997. The FSS was created by integrating the four previously existing supervisory bodies—the Banking Supervisory Authority, Securities

Supervisory Board, Insurance Supervisory Board and Nonbank Supervisory Authority—into a single, consolidated organization. The FSC is broadly charged with policy formulation for the financial market, while the FSS is tasked with overseeing and supervising financial business entities and other participants in the financial market. Thus, as a wholly integrated regulatory body, the FSC/FSS has broad policy and enforcement authority to lead market reform and oversee activities taking place in the financial market (FSC/FSS 2001).

Japan also established an integrated prudential regulator in 1998, the Financial Supervisory Agency (FSA), separate from the Ministry of Finance and the Bank of Japan. Japan's FSA is responsible for the supervision of all private financial institutions, including banks, insurance companies and securities firms. Prior to the establishment of the FSA, prudential supervision was already integrated and separate from the Bank of Japan but part of the Ministry of Finance, which assigned a low priority to this function because of its primary focus on budgetmaking and taxation.

Indonesia also made a commitment to strengthen the independence of its central banks and unify financial sector supervision. In May 1999, Indonesia enacted a new Central Bank Act that conferred upon Bank Indonesia the status and position of an independent state institution. According to Article 34 of this Act, the banking supervision function will be separated from the central bank and carried out by an independent financial services supervisory institution that would be established before December 31, 2002. Besides supervising the banking sector, this institution will also supervise companies in other financial sectors, including insurance, pension fund, securities, venture capital, and other financial institutions that manage public funds (Bapepam 2000). Indonesia, though, has not been able to replicate the pace of the reform in Korea. This is not surprising considering the significant differences in their starting positions. The focus of Bank Indonesia to date (and rightly so) has been on amending and improving the supervision system and banking regulations to comply with international standards, and restructuring troubled financial institutions. Thus, reforming the institutional setup is not the priority. A gradual approach will also be more prudent and realistic. The target date of operation of Indonesia's single supervisory agency has been moved to January 2004.

Thailand has also drafted a new Bank of Thailand Act and a new Financial Institutions Act. The new Bank of Thailand Act aims to strengthen the independence and accountability of the Bank of Thailand (BOT), and limits its objectives to maintaining price stability and safeguarding the stability of the financial system. The new Financial Institutions Act would give the BOT the sole responsibility for supervising financial institutions (as opposed to sharing it with the Ministry of Finance under current laws) and will pave the way for universal banking in Thailand. It will also empower the BOT to supervise and monitor financial subsidiaries and conglomerates

on a consolidated basis, and will specify steps for prompt corrective action and exit procedures for unviable financial institutions. The Act also aims to eliminate redundancies and discrepancies between different laws applicable to different types of financial institutions. Specifically, it combines the Commercial Banking Act and the Act on the Undertaking of Finance Business, Securities Business, and Credit Foncier Business, thereby creating a uniform standard of supervision among these as well as specialized financial institutions. The draft Act has been passed by the House of Representatives and is now being reviewed by the new government (BOT 2001).

As noted earlier, Singapore is one of only three countries, together with the Netherlands Antilles and Uruguay, whose central bank is responsible for banks, securities firms, and insurance companies. In fact, the Monetary Authority of Singapore (MAS) was the first integrated supervisor, having acquired powers to regulate the insurance and securities industries in 1971 and 1984, respectively. Despite its almost 20 years of experience as an integrated regulator, the MAS continues to systematically review its regulatory and supervisory policies, and build expertise to better supervise both financial conglomerates and specialized firms. It is in the process of studying the desirability and feasibility of further harmonizing prudential regulation, where it is warranted, and removing rules that no longer have value. One of its key initiatives is the move toward risk-based capital frameworks for life insurers, and member firms of the Singapore Exchange. Such move is seen as a step to make regulatory requirements more comparable, consistent, and closely calibrated to the risk profile of an institution (Palmer 2002).

Malaysia, on the other hand, is one of 13 countries that combine banking and insurance supervision within the same agency while securities firms are supervised by a specialist agency. In particular, recent pieces of legislation have vested the Central Bank of Malaysia (Bank Negara Malaysia) with comprehensive legal powers to regulate and supervise the Malaysian financial sector. These include the Banking and Financial Institutions Act of 1989 (BAFIA); the 1994 revision of the Central Bank of Malaysia Act of 1958; and the Insurance Act of 1996, which was further amended in 1999. The BAFIA provides for the licensing and regulation of institutions undertaking banking, finance company, merchant banking, discount house, and money-broking businesses. It also requires the regulation of institutions carrying on scheduled business comprising nonbank sources of credit and finance, such as credit and charge card companies, building societies, factoring, leasing companies, and development finance institutions. Nonscheduled institutions engaged in the provision of finance could also be subject to certain provisions of the BAFIA. The Insurance Act, on the other hand, requires amendments to existing provisions dealing with the licensing of insurers, insurance brokers adjusters, and reinsurers; the setting

up of subsidiaries and offices; establishment of insurance fund, direction and control of defaulting insurers, the control on management and accounts of licensee; examination and investigating powers of the Central Bank; winding up and transfer of business of licensee; and matters relating to policies, insurance guarantee scheme fund, enforcement powers of the Central Bank, offenses, and other general provisions.

Thus, there is diversity in approaches to reforming the regulatory structure, even among the countries most affected by the Asian crisis. Developing and strengthening regulatory capacity was the priority, and the reform of the regulatory structure was deemed as necessary to achieve that. There was also a need to eliminate gaps in regulatory coverage, particularly over nonbanks, which was a contributing factor to the crisis.

Only the Philippines has not undertaken or considered consolidated financial sector supervision, whether partial or full. The Philippine financial sector fared relatively well compared to the crisis economies, in that there were no large financial failures in the Philippines. This has been partly attributed to the reforms that had been implemented in the financial sector, particularly banking sector ones that included significant improvements in prudential regulation and supervision. In fact, the banking sector's institutional framework prior to the crisis was rated fairly well compared to other countries in the region (Table 6).

Two commercial banks did fail in the aftermath of the Asian crisis—Orient Bank in 1998 and Urban Bank in 2000, primarily as a result of fraud/insider abuse. The case of Urban Bank is especially noteworthy because its

Table 6. Indicators of institutional framework (mid-1997, unless otherwise indicated)

Country	Bank Regulatory Framework	Bank Supervision Quality	Transparency	GS Fragility Score (0=best, 24=worst)	GS CAMELOT Score ^a (1=best, 10=worst)
Indonesia	Satisfactory, improving	Weak, improving	Satisfactory	15	4.6
Korea, Rep. of	Weak, improving	Fair	Fair, improving	18	n.a.
Malaysia	Satisfactory, improving	Weak, improving	Satisfactory	15	4.5
Philippines	Good	Fair	Satisfactory	13	3.7
Singapore	Very good	Very good	Poor	7	4.0
Thailand	Weak, improving	Weak	Poor, improving	22	5.2

Notes:

n.a. = not available

^a Goldman Sachs CAMELOT Score for domestic banks only. Weightings for calculation of overall score: 25 percent for asset quality; 20 percent for management; 15 percent for capital adequacy; 15 percent for earning; 5 percent for liquidity; 15 percent for operating environment; and 5 percent for transparency.

Source: Ramos (1997a, 1997b; in Gochoco-Bautista et al. 1999)

failure had been attributed to problems in its investment house subsidiary, Urbancorp Investments, Inc. Failure to detect problems in Urbancorp, in turn, had been attributed to some lapse in supervision/regulatory oversight that arose from confusion in the proper assignment of regulatory function over investment houses between the BSP and the SEC. Two other commercial banks with links to investment houses suffered financial difficulties but were acquired by foreign bank subsidiaries—Westmont Investment Corp. was a unit of Westmont Bank, which was acquired by United Overseas Bank; and the ASB group of companies had links with the Bank of Southeast Asia, which was acquired by the Development Bank of Singapore.

Unlike Korea, Indonesia and Thailand, the Philippines only entered into a two-year stand-by arrangement with the IMF in March 1998 as a precautionary measure. The memorandum for economic and financial policies (MEFP) included banking sector reforms in the light of the financial crises in the region. In particular, the MEFP identified four banking reforms for implementation, namely, raising capital and encouraging some consolidation; reducing bank risks by tightening provisioning requirements and strengthening regulatory oversight; leveling the playing field between different types of institution and instruments, especially with a view to reducing incentives to peso disintermediation; and the twin objectives of dealing expeditiously with any problem bank while safeguarding the soundness of the banking system. But the crisis also highlighted the need to close regulatory gaps that resulted from the integrated or conglomerated nature of financial institutions but with a fragmented regulatory system in the Philippines.

3

Financial Sector Consolidation in the Philippines

Trends in financial services integration and supervision

Financial services integration in the Philippines can be divided into two main phases. The first phase occurred in the 1960s and the 1970s as a result of regulatory arbitrage. That is, banks and other financial institutions circumvented regulatory requirements, taxes, and other restrictions on traditional deposit instruments through financial innovation. The second phase began in 1980 with the introduction of financial liberalization policy, and reinforced in the 1990s by further deregulation of the financial sector and advancements in information and communications technology (ICT).

The original Central Bank Act (RA 265), which was enacted in 1948, gave the Central Bank of the Philippines (CBP) supervisory and regulatory powers over the entire banking system. In 1971, a Joint International Monetary Fund-Central Bank of the Philippines Banking Survey Commission was created to review the country's overall financial system. The consensus was that the financial system had become unnecessarily complicated and fragmented. Also, the rise of new financial institutions had undermined the effectiveness of the CBP's monetary and credit policies. Thus, one of the recommendations of the Commission was for the CBP to be given authority and responsibility not only over the banking system but over the entire financial and credit system as well. In making this recommendation, the Commission noted the rapid growth of nonbank financial intermediaries (NBFIs), especially investment houses, trust funds, and finance companies, that were engaged in the extension of credit on terms beyond the scope of the statutory capability of the CBP. The Commission further noted that a growing number of NBFIs were obtaining funds from the public by issuing their own debt instruments. These operations were not subject to the kinds of regulation to which banking institutions were subject, such as interest rate ceilings, reserve requirements, and capital-to-risk-asset ratios. Thus, there was a need to close the regulatory gap to protect the interests of the holders of deposit substitutes.

RA 265 was then amended with the issuance of Presidential Decree (PD) No. 72 in November 1972, which promulgated most of the Commission's recommendations. The CBP then issued a series of circulars in 1973, which contained the rules and regulations that would govern particularly the establishment and operation of investment houses that were behind the remarkable growth of the money market from the mid-1960s. Investment banking activities, reserved solely for investment houses, were separated from regular banking activities. A new class of activity called "quasi-banking" was defined as borrowing from 20 or more lenders through the use of debt instruments with recourse other than deposits for the purpose of relending or purchasing receivables or other obligations. NBFIs with the authority to engage in quasi-banking functions or nonbank quasi-banks (NBQBs) were made subject to CBP rules and regulations. Non-NBQBs, which could issue commercial papers without recourse, fell under the supervision of the Securities and Exchange Commission (SEC), although they were required to submit reports of their operations to the CBP (Lamberte 1989). Instruments of the money market were officially recognized as "deposit substitutes."

Prior to the 1972 reforms, the money market was dominated by investment houses. As the demand for credit rapidly outstripped supply, and with banks constrained by low deposit rate ceilings that discouraged the institutionalization of savings, investment houses sought to fill the credit gap by developing the money market. Thus they began to deal in short-dated instruments of prime corporations. Since these debt instruments were unregulated, they carried interest rates significantly higher than the deposit rate ceilings. For instance, in 1972 the ceilings for savings and time deposits rates were 6 and 7 percent, respectively, compared to the 14 percent interest rate on deposit substitutes. Thus, the money market was able to draw funds away from traditional deposits (Lamberte 1989). Following the reforms that made the money market officially part of the financial system, commercial banks began to set up their own money desks. A number of commercial banks either formed their own investment houses or allied themselves with existing ones. Eventually, they came to dominate the money market, which became an important source of funds and investment opportunities (Licuanan 1986). By 1974, the level of deposit substitutes reached over 60 percent of total savings and time deposits of commercial banks.

However, given the very thin supply of prime commercial papers, most financial institutions ended up relending the funds that they borrowed from the money market. Investment houses in particular, which had sole authority to engage in underwriting business, opted to reduce their exposure in investments and increased their lending activity instead. The same was true for finance companies with quasi-banking functions. Thus, a mismatch in the sources and uses of funds of banks and NBQBs arose and deepened over the years (Licuanan 1986). This unstable form of financial

intermediation led to instability in the banking system in the mid-1970s. In particular, two commercial banks failed—Continental Bank in 1974 and General Bank and Trust Company in 1976, although the latter began having difficulties in 1974 but was bailed out by the CBP (Hutchcroft 1993).

Both Continental Bank and General Bank had affiliated investment houses, and long-term investments were being financed with short-term instruments. They borrowed heavily from the money market and then lent the borrowed funds to their other business affiliates through their affiliate investment houses. It became a way of continuously channeling funds to borrowers who had reached the single-borrower limit prescribed by the CBP. When the affiliate firms failed, the investment houses suffered severe liquidity problems. This translated to a run on deposits of the affiliated banks as depositors linked the former to the latter. The president of Continental Bank was convicted of misappropriation of funds, and this precipitated a bank run which spread to other medium and small banks including the General Bank. The CBP intervention in the form of emergency loans to banks suffering from liquidity problems and assurances of support quickly restored confidence in the banking system (Lamberte 1989; Hutchcroft 1993).

To counter the growing instability in the money market and encourage the growth of long-term instruments, the CBP issued a series of circulars in 1976, which sought to strengthen the regulation of the money market, particularly investment houses. The new set of regulations included an interest rate ceiling of 17 percent on short-term deposit substitutes; a 35 percent transactions tax on all primary borrowings; minimum size and maturity of deposit substitute transactions; and reserve requirements and other portfolio ratios. At the same time, the CBP increased the ceiling rates on savings and short-term time deposits (Tan 1976). All these worked to reduce the attractiveness of holding deposit substitutes relative to time deposits. As was intended, investment houses were the most adversely affected since they dealt mostly in short-term money market instruments. Thus, there was a significant decline in the growth of NBFIs after the reforms (Table 7). Although commercial banks' deposit substitutes also decreased, they were compensated by increases in savings and time deposits.

In 1979, another review of the Philippine financial sector was conducted, this time by a joint IMF-World Bank mission (World Bank/IMF 1979). The objective of the review was to determine how to increase the flow of longer-term savings and make such flows available for priority uses, particularly medium- and long-term finance for industry. The government also asked the mission to look into the possibility and consequences of expanding the functions of financial institutions, for instance, allowing commercial banks to undertake investment banking functions. One of the findings of the mission was the underdeveloped state of the long-term capital market. While the interest rate structure and tax regimes were cited as

Table 7. The structure of the Philippine financial system, 1972 and 1979

	Total Assets (in P billion, 1985 prices) ¹		Average Annual Growth Rate (percent)		Number of Offices	
	1972	1979	1972-75	1976-79	1972	1979
	Banking system	190.79	430.08	15.5	11.4	1,552
Commercial	142.54	329.75	17.7	11.6	743	1,423
Thrift	8.31	21.94	2.4	23.2	158	589
Rural	7.09	14.34	17.8	6.6	621	1,086
Specialized government banks	32.85	64.04	7.5	8.7	30	71
NBFIs	56.02	141.73	26.3	2.4	226	1,576
Total	246.81	571.80	18.0	8.9	1,779	4,746

¹ Price index used was the implicit GNP deflator.

Source of basic data: Central Bank of the Philippines (1991)

significant contributors to the preference for short-term finance, the legislated specialization of financial institutions was cited as another major factor.

The Philippine financial system was originally patterned after the US system of specialized institutions: different types of institutions, under different laws and regulations, with specific functions (Patrick and Moreno 1984). This tendency toward specialization was reinforced by the 1972 reforms, with the separation of regular banking from investment banking activities. Such specialization led to fragmentation and less competition among institutions, and reduced the ability of the system to respond to changing needs and demands. Thus, measures that would foster active competition in the system were deemed central to any reform in the financial structure.

Qualified approval was given to the proposed move toward universal banking. A commercial banking system that is less specialized, able to participate more actively in the trading of bonds and equities, and can underwrite issues could support the development of the securities market, increase competition, and enhance the efficiency of markets. But steps had to be taken to guard against potential dangers such as increased concentration of market power and conflicts of interest. Concentration in the financial sector would tend to create excessive market power for a few institutions. If banks were free to invest in equities and hold them in their own account, there would clearly be a danger of them obtaining controlling interest in other corporations. Thus, the need for safeguards to promote competition was also highlighted. More freedom of action for other financial

institutions was also recommended to ensure their competitiveness, and to further reduce specialization in the system.

The findings and recommendations of the mission formed part of a financial reform program that the Philippines embarked on in March 1980, which in turn was part of a wider structural adjustment program. The aims were to (a) promote competitive conditions to foster greater efficiency in the financial system; and (b) increase the availability of and access to longer-term funds, which were the major concerns raised by the reviewers (Remolona and Lamberte 1986).

The first objective of increased competition and efficiency was to be achieved by lessening the enforced specialization of financial institutions, and broadening the range of their services. This goal covered the introduction of extended commercial banks or universal banks authorized to offer a wider range of services, including those previously reserved for investment houses, such as underwriting and securities dealing; the elimination of all functional distinctions among thrift banks; reduction in differentiation across banks and nonbank financial intermediaries authorized to perform quasi-banking functions (NBQBs); and increase in the powers and functions of NBQBs. These institutional reforms allowed financial intermediaries to opt for voluntary specialization or to engage in a variety of financial services in response to changing demands and conditions. Regulations were revised such that competing entities were subject to the same conditions and restraints. The second objective of increasing the availability of longer-term funds through term transformation was to be achieved through interest rate deregulation.

Thus, in contrast to other developing countries, the Philippines has had a long history of universal banking. And over the years, the country has continued to follow a policy of despecialization by allowing banks to further widen their range of permissible activities and products.⁸ Table 8 presents the current ceilings on equity investments of banks, which had been further relaxed under the General Banking Law of 2000. The ceiling of 51 percent on a universal bank's equity investment in an insurance company was already lifted in 1999. Table 9 gives a summary of universal banks and commercial banks' various subsidiaries and affiliates.⁹ The Philippines' relatively unrestrictive stance on banks' allowable activities is further highlighted when compared to other countries in the region (Table 10). The result of such policy was a flexible and dynamic market structure. However, the resulting market structure also had an impact on the effectiveness of the regulatory structure.

⁸ See Appendix 1.

⁹ The full listing is available from the author.

Table 8. Limits on equity investments of banks

Investee Company	Equity Ceilings of Investing Banks (in percent)			
	UB	KB	TB	RB
Allied				
Financial allied				
KBs	100 ¹	49	49	49
TBs	100	100	49	49
RBs	100	100	49	49
Insurance companies	100	na	na	na
Venture capital corps	60	60	60	60
Others	100	100	100	100
Nonfinancial allied	100	100	100	49
Nonallied	35	na	na	na

Note: UB = universal (or expanded commercial, EKBs) banks; KB = commercial banks; TB = thrift banks; RB = rural banks
na = not applicable

¹ In only one bank

Source: Bangko Sentral ng Pilipinas

Thus, financial services integration has long been a feature of the Philippine financial system. Another key feature of the system is the dominance of domestic universal banks, which accounted for 64 percent of total banking assets and 53 percent of total assets of the financial system in March 2002. Finally, financial services integration also demonstrated the capacity of Philippine banks and other financial institutions to innovate to circumvent regulatory requirements, taxation and other restrictions, for instance, on traditional deposits.

As Figure 5 shows, financial deepening, as measured by the M2 to GDP ratio, was fairly modest from 1977 to 2001. In the mid-1960s to the mid-1970s, there was significant growth in deposit substitutes because these instruments were relatively unregulated, as was discussed earlier. Thus, M3 to GDP significantly rose until deposit substitutes were subjected to similar regulatory requirements as deposits in the late 1970s. Significant financial shallowing occurred in the 1980s as a result of a series of financial, economic, and political crises. In the 1990s, there was a sharp increase in off-balance sheet activities of commercial banks, which was facilitated by the easing of banking regulations. These included the use of foreign currency deposits to extend foreign currency loans, and trust accounts for securities investment.

Philippine commercial banks still exhibit economies of scale and scope (Okuda 1999). As such, they could achieve more efficient production if they broadened the scope of their operations. The current regulatory framework is highly supportive of such move toward diversification.

Table 9. Summary of commercial banks' subsidiaries and affiliates (as of the year indicated in parentheses)

Commercial Bank	Bank	Insurance	Investment House	Stock Exchange	Other Financial Institutions ¹	Nonfinancial Enterprises	Share of Financial Subsidiaries in Banks' Total Assets (in percent)
Universal banks							
Al-Amanah Islamic Investment Bank of the Philippines	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Allied Banking Corp. (2000)	☐				☐		15.2
Banco de Oro Universal Bank (2000)		☐	☐		☐		0.6
Bank of the Philippine Islands (2002)	☐	☐	☐	☐	☐	☐	12.1
China Banking Corp. (2000)		☐			☐	☐	0.1
Development Bank of the Phils. (2002)						☐	n.a.
Equitable Banking Corp. (2000)	☐	☐	☐	☐	☐	☐	3
Land Bank of the Philippines (2002)		☐			☐	☐	0.3
Metropolitan Bank and Trust Co. (2002)	☐	☐	☐	☐	☐	☐	16.9
Philippine National Bank (2000)		☐	☐	☐	☐	☐	0.6
Prudential Bank (2000)	☐		☐		☐		0.1
Rizal Commercial Banking Corporation (2002)	☐		☐	☐	☐	☐	16.2
Security Bank Corp. (2002)			☐	☐	☐	☐	0.4
Union Bank of the Philippines (2000)		☐	☐	☐	☐	☐	n.a.
United Coconut Planters Bank (2002)	☐	☐		☐	☐	☐	7.9

Table 9 (cont'd.)

Commercial Bank	Bank	Insurance	Investment House	Stock Exchange	Other Financial Institutions ¹	Nonfinancial Enterprises	Share of Financial Subsidiaries in Banks' Total Assets (in percent)
Regular commercial banks							
Asia United Bank Corporation (2002)					☐		n.a.
Bank of Commerce (2002)		☐	☐			☐	n.a.
EastWest Bank (1998)			☐			☐	n.a.
Export and Industry Bank (1999)					☐		n.a.
Global Bank	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
International Exchange Bank	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Philippine Bank of Communications (2002)					☐	☐	4.4
Philippine Trust Co.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Philippine Veterans Bank (1999)						☐	n.a.
TA Bank of the Philippines (merged with ABN Amro) (1998)				☐		☐	n.a.

¹ Other financial institutions include foreign exchange corporations, leasing and finance operations, and venture capital corporations.

n.a. means not available.

Source: Commercial banks' Published Consolidated Statement of Condition and Annual Reports, various years

Table 10. Degree of restrictiveness of regulatory restrictions on bank activities and the mixing of banking and commerce of selected Asian countries (as of 1999)

	Securities	Insurance	Bank ownership of nonfinancial firms
Indonesia	permitted	prohibited	prohibited
Korea, Rep. of	permitted	permitted	restricted
Malaysia	permitted	permitted	restricted
Philippines	unrestricted	permitted	permitted
Singapore	unrestricted	permitted	permitted
Thailand	permitted	permitted	restricted

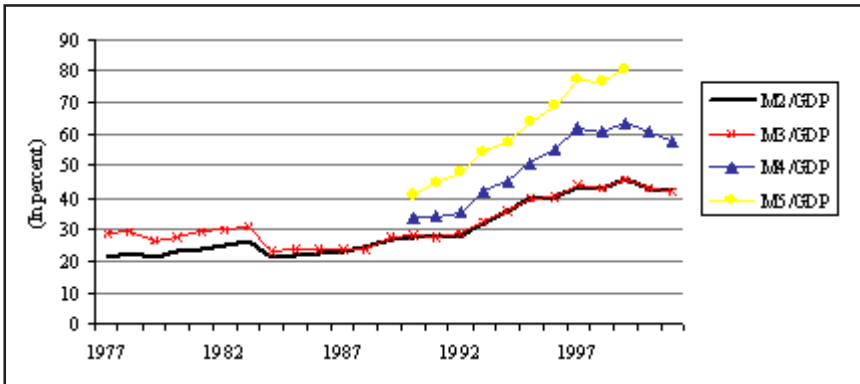
Source of basic data: Bank Regulation and Supervision Database, World Bank (2001)

Furthermore, new technology has allowed the unbundling and repackaging of individual products in various ways. This makes it easier to circumvent regulations that prohibit an activity through product innovation to produce a close substitute (Herring and Santomero 1995).

A recent policy pronouncement that will further increase financial services integration in the Philippines is the introduction of bancassurance.¹⁰ Initially, the BSP planned to allow universal and commercial banks to sell only their subsidiaries' financial products, such as mutual funds and life insurance. A subsidiary is defined as a firm in which a bank has at least a 51 percent stake. The Monetary Board later decided to include banks' affiliates, which were then liberally defined as financial allied firms in which they have at least a 5 percent stake, after foreign insurance companies argued that the subsidiary requirement favored only two universal banks. In fact, the BSP was originally reluctant to allow cross-selling, which was provided for under the General Banking Law of 2000, because of the string of bank and investment house failures in 2000. Thus, an important issue that needs to be addressed is supervision and regulation in the context of financial services integration. While the evolution of policy has been toward increasing financial services integration, there has been no corresponding change in the regulatory framework in the Philippines until very recently.

¹⁰ BSP Circular No. 357, dated 8 November 2002, presents the guidelines on the use of the head office and/or any or all branches of universal banks and commercial banks as outlets for the presentation and sale of financial products of their allied undertakings (subsidiaries and affiliates) or of its investment house units. In the case of sale of insurance products of insurance company affiliates, said affiliates must be accredited or pre-cleared by the Insurance Commission to ensure that only stable and reputable insurance companies can sell their products through banks.

Figure 5. Measures of financial deepening, 1977-2001 (in percent)



Note: M3 = M2 + deposit substitutes; M4 = M3 + foreign currency deposits; M5 = M4 + trust accounts of banks

Source of basic data: Bangko Sentral ng Pilipinas; National Statistical Coordination Board

Financial sector regulation

As in other countries, the Philippines began with the traditional “pillars” approach to regulating and supervising the three major financial sectors—SEC for the securities market, the Insurance Commission (IC) for the private insurance sector, and the CBP for the banking sector. Needless to say, each agency operated under different sets of rules, principles and standards.

The SEC regulates and supervises the securities market, and also acts as the registrar for all companies. Established in 1936, the SEC was abolished during the Japanese occupation and reactivated in 1947. In September 1975, the SEC was organized as a collegial body and given quasijudicial powers. Administratively, the SEC is under the Department of Finance. The Securities Regulation Code (RA 8799) was enacted in July 2000 to address areas of institutional weaknesses in the securities market, which included the role of the SEC and its mandate, lack of confidence in the integrity of the market, and the adequacy of investor protection. In particular, the Code updated and toughened up the penalties on securities fraud, particularly insider trading. The Code also enforced a “full disclosure” approach for public offerings to ensure that investors had enough information to make informed investment decisions. It also focused on strengthening the role of the SEC as regulator/overseer by transferring its quasijudicial functions, such as settlement of intracorporate disputes and suspension of debt payments, to the regular courts. Finally, RA 8799 also required the reconstitution of the board of the Philippine Stock Exchange (PSE), a nonstock, nonprofit organization composed of member-brokers, and its demutualization within one year to broaden its ownership base.

In particular, there are three departments under the SEC's Capital Market Development and Regulation: a) Market Regulation Department (composed of the Exchange Division, Brokers/Dealers Division, and Investment Houses Division), which is responsible for developing the licensing criteria for all market participants; licensing market participants to ensure their compliance with licensing guidelines; and referring suspected licensing infractions to the Enforcement Department; b) Corporation Finance Department (composed of the Financing Companies Division, Mutual Funds Division and Securities Registration Division), which is responsible for authorizing new securities issued by Philippine enterprises and assuring adequate information is available about securities traded in public markets; and c) Nontraditional Securities and Instruments Department (composed of Registration and Licensing Division, Actuarial Review Division, and Monitoring and Audit Division), which is responsible for overseeing nontraditional securities and instruments, including pre-need companies operating in the Philippine capital market (also includes other instruments such as commodity futures contract, propriety or nonpropriety membership certificates, and other similar instruments).

Insurance firms, excluding government-owned insurance corporations that are governed by their respective charters, are regulated and supervised by the Insurance Commission of the Philippines (IC). The IC was set up as an autonomous body in 1949, when it was split from the CBP. It falls under the jurisdiction of the DOF, the role of which is not well defined and considered weak, especially with respect to its oversight functions (World Bank 1992). The IC is a powerful government agency, with licensing, regulatory, and adjudicatory functions. The Insurance Code of 1978 is the overall regulatory framework of the industry. Changes to the 1978 Code have been very few. A recent and major reform was the deregulation of entry, including the entry of foreign insurance companies, in the 1990s.¹¹

The original Central Bank Act, which was enacted in 1948, gave the CBP supervisory and regulatory powers over the entire banking system. In a package of financial reforms implemented in 1972-73, the CBP was given authority and responsibility not only over the banking system, but over the entire financial and credit system as well. Finally, in June 1993, the New Central Bank Act, which called for the creation of a new, independent Central Monetary Authority called the *Bangko Sentral ng Pilipinas* (BSP), was signed into law. The Act redefined the scope of the BSP's supervisory and regulatory powers to include banks, quasibanks, and institutions performing similar functions (Sec. 3). The Act also provided for the transfer of regulatory powers over finance companies without quasibanking functions

¹¹ Milo (2000) reviews the regulation and structure of the private insurance sector.

and other institutions performing similar functions from the BSP to the SEC, within five years from the effectivity of the Act (Sec. 130).¹² On the other hand, the Act also gave the BSP authority to supervise and examine, not just banks and quasibanks, but also their subsidiaries and affiliates engaged in allied activities (Sec. 25).¹³ Two specific departments in the BSP used to carry out its supervisory function—the Supervision and Examination Sector, which was the operating department; and the Supervisory Reports and Special Studies Office, which received the regular financial reports, generated the statistical reports for the use of the operating departments, and reviewed systems and procedures related to supervision.

The Philippine Deposit Insurance Corporation (PDIC) also monitors the activities of banks, although it primarily relies on information gathered by the BSP. Finally, the SEC registers banks' articles of incorporation, but only if they are accompanied by a certificate of authority to operate issued by the Monetary Board.

A major law that the Philippines passed in the aftermath of the Asian crisis was the General Banking Law of 2000 (GBL). The goal was to “promote and maintain a stable and efficient banking and financial system that is globally competitive, dynamic and responsive to the demands of a developing economy” (Sec. 2). An important element of the GBL was the adoption and incorporation of internationally accepted standards and practices into the BSP's supervisory processes. In particular, Section 5 allowed the Monetary Board to “... prescribe ratios, ceilings, limitations, or other forms of regulation on the different types of accounts and practices of banks and quasibanks which shall, to the extent feasible, conform to the internationally accepted standards, including those of the Bank for International Settlements (BIS).” This provision finally allowed the adoption of a risk-based capital adequacy framework. The decision to shift to this new framework for measuring capital adequacy was actually made by the Monetary Board in June 1993,¹⁴ but its implementation was subject to the amendment of the old General Banking Act.

Section 4 of the GBL defines the supervisory powers of the BSP. In particular, the BSP's “supervision” of banks' operations and activities was defined to include both “regulation” and “supervision,” as traditionally defined. It also granted the BSP supervisory and regulatory powers over

¹² Likewise, the Act mandated the transfer of the BSP's fiscal agency functions to the Department of Finance. These two measures aimed to sharpen the BSP's focus on its central banking functions (Lamberte 2002).

¹³ A subsidiary was defined as “...corporation more than 50 percent of the voting stock of which is owned by a bank or quasibank. The Act also gave the Monetary Board considerable leeway in defining a bank affiliate, that is, “...a corporation the voting stock of which, to the extent of 50 percent or less, is owned by a bank or quasibank or which is related or linked to such institution or intermediary through common stockholders or such other factors as may be determined by the Monetary Board.”

¹⁴ Resolution No. 544 dated 25 June 1993

quasibanks, trust entities, and other financial institutions, which are subject to BSP supervision under special laws. Universal banks and commercial banks were also given authority to engage in quasibanking functions (Sec. 6). Section 7 also gave the BSP authority to examine an enterprise that is wholly or majority-owned or controlled by a bank. This provision is consistent with the provision in the New Central Bank Act which gave the BSP authority to supervise and examine banks, quasibanks, and their subsidiaries and affiliates engaged in allied activities (Sec. 25). It is also more general in that it allows the BSP to also examine a nonallied enterprise as long as it is at least majority-owned or controlled by a bank.

The GBL also increased the allowable limits on the equity investments of universal and commercial banks in financial allied and nonallied enterprises. In addition, the GBL provides for cross-selling. Section 20 states that "... bank may, subject to prior approval of the Monetary Board, use any or all of its branches as outlets for the presentation and/or sale of the financial products of its allied undertakings or of its investment house units." However, Section 54 expressly prohibits banks from directly engaging in insurance business as the insurer.

Finally, the GBL requires banks, quasibanks, and trust entities to submit and publish financial statements that show the actual financial condition of the institution submitting the statement, and of its branches, offices, subsidiaries, and affiliates.¹⁵

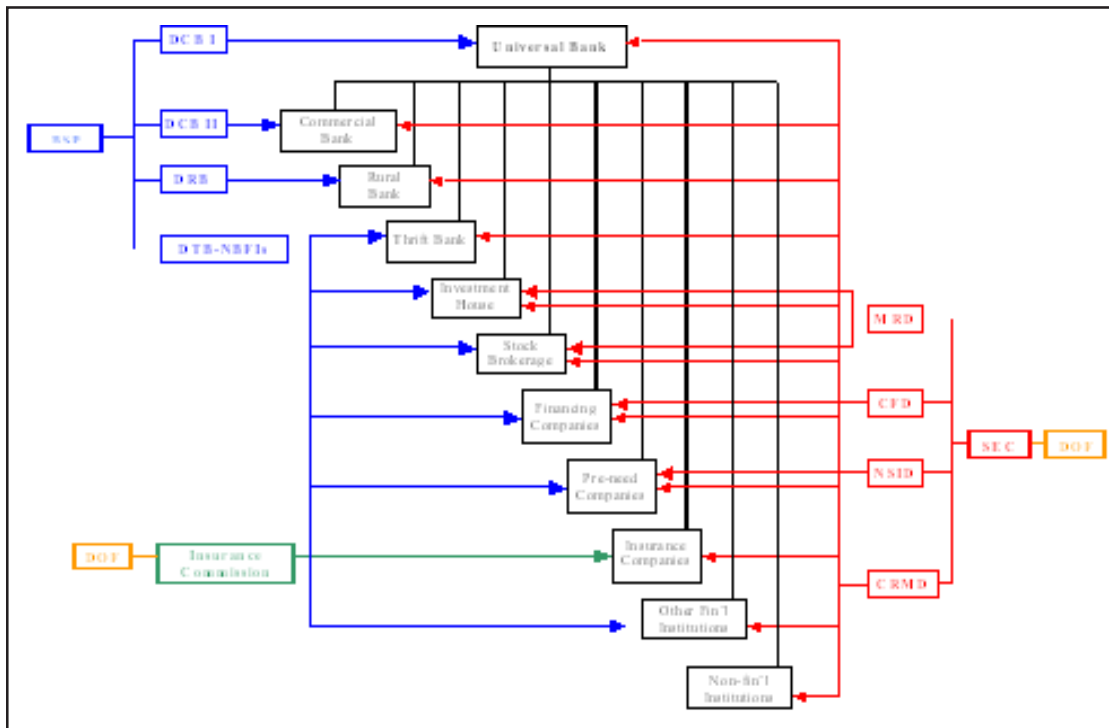
Supervision of financial conglomerates

The regulatory system governing line-of-business restrictions in the Philippines shifted from the "pillars" to the "conglomerate" approach, as the country undertook financial liberalization and deregulation beginning in the 1980s.

With respect to supervising financial conglomerates, particularly universal banks, the BSP has supervisory authority over banks and quasibanks and their subsidiaries and affiliates engaged in allied activities. However, some of these subsidiaries and affiliates of banks (including investment houses, securities dealers and brokers, finance companies, and insurance companies) are primarily regulated by the SEC and the Insurance Commission under relevant laws. The integrated or conglomerated nature of financial institutions but with a fragmented regulatory system in the Philippines is illustrated in Figure 6. In particular, under the original setup, examination of a banking group was conducted separately and without any coordination by several departments under the Supervision and Examination Sector of the BSP and the SEC's Capital Market Development and Regulation Department, according to type of financial institution.

¹⁵ Other provisions of the GBL are discussed in Milo (2000).

Figure 6. Supervision and regulation of a universal bank and its subsidiaries and affiliates



BSP - Bangko Sentral ng Pilipinas
 SEC - Securities and Exchange Commission
 DCB I - Department of Commercial Banks I
 DCB II - Department of Commercial Banks II
 DOF - Department of Finance

DRB - Department of Rural Bank
 DTB-NBFIs - Department of Thrift Banks
 and nonbank Financial Institutions
 NSID - Nontraditional Securities
 and Instruments Department

MRD - Market Regulation Department
 CFD - Corporation Finance Department
 CRMD - Company Registration and Monitoring Department
 (handles the registration and monitoring of all
 domestic corporations and partnerships)

As was pointed out earlier, the risks of a fragmented regulatory system, particularly the presence of regulatory gaps and absence of coordination between regulatory agencies, became evident, particularly in the failure of Urban Bank in 2000. Urban Bank was one of the smallest commercial banks before it was downgraded to a thrift bank in March 2000, unable to meet the new capitalization requirement. Investment house subsidiary Urbancorp operated as an investment house without quasibanking functions and engaged in trust operations. The latter, which had significant real estate exposure, suffered liquidity problems when its investors preterminated their holdings due partly to the failure of other investment houses with banking ties.¹⁶ Urban Bank, in turn, suffered heavy withdrawals due both to the pretermination of placements by its subsidiary's investors and loss of public confidence following its downgrade. The simultaneous weakening of these two financial institutions was clearly interlinked, similar to the banks failures that resulted from the failure of their affiliated investment houses in the 1970s.

Failure to detect problems in Urbancorp has been attributed to some lapse in supervision/regulatory oversight, which in turn arose from confusion in the proper assignment of regulatory function over investment houses between the BSP and the SEC. As noted earlier, the New Central Bank Act provided for the transfer of regulatory powers over finance companies without quasibanking functions and other institutions performing similar functions from the BSP to the SEC, within five years from the effectivity of the Act (Sec. 130). At the same time, it gave the BSP authority to supervise and examine banks' subsidiaries and affiliates engaged in allied activities. However, these provisions were not yet operational at that time.

Recently, there have been some moves to shift to a "coordinated" approach and consolidated supervision of banks. The BSP adopted some elements of consolidation of accounts of banking groups in 1998. It also imposed a common cutoff date for examination of banks and their subsidiaries and affiliates under BSP supervision. That is, subsidiary/affiliate banks and quasibanks are examined, but not subsidiaries and affiliates that are not banks or quasibanks. The latter are only required to submit financial statements, which form part of the consolidated report.

Reportorial requirements on the banking group are also limited to (a) the required publication of quarterly consolidated statement of condition (parent bank and its subsidiaries engaged in financial allied

¹⁶ Westmont Investment Corp., a unit of Westmont Bank, was reported to have had between P5 and P7 billion in unpaid instruments and the ASB group of companies about P3.5 billion in unpaid instruments that went through the Bank of Southeast Asia. Westmont Bank and BSA Bank were merged with foreign bank subsidiaries United Overseas Bank and Development Bank of Singapore, respectively.

activities) side-by-side with the combined quarterly statements of condition (head office and branches) as of the call date; and (b) the required submission of annual audited financial statements of the bank, which, under the Philippine accounting standards, should be prepared both for the banking group and the parent bank (Circular 339 dated 18 July 2002).

The imposition of prudential regulations (such as the single borrower's limit and ceilings on DOSRI loans, etc.) are currently applied only on a solo basis, except for the required compliance with the risk-based capital ratio and the limit on net open foreign exchange position. The former is applied both on solo and consolidated basis, while the latter is applied only on a consolidated basis. However, insurance companies are excluded in computing for the consolidated risk-based capital adequacy ratio, which also only covers credit risks (Circular 280 dated March 29, 2001).

In addition, the BSP and the SEC signed a Memorandum of Understanding (MOU) in July 2002 outlining cooperative arrangements to more efficiently share supervisory responsibilities and information for those entities that fall under the jurisdiction of both agencies. In particular, the MOU gave the BSP full regulatory powers over investment houses that are subsidiaries and/or affiliates of banks. Similar MOUs are being drafted between the BSP and the Insurance Commission and the Philippine Deposit Insurance Corporation. Strong coordination and cooperation between the BSP and the Insurance Commission will also be critical following the lifting of the limit on a universal bank's equity investment in an insurance company in 1999 and the recent introduction of bancassurance. In fact, the BSP was initially reluctant to allow cross-selling because of the string of bank and investment house failures in 2000. Thus, the BSP has also been very careful to remind banks about to sell life insurance products that they must indicate to their clients that these products are not guaranteed by the PDIC. The issue is how to operationalize these MOUs, and whether they will prove adequate.

In August 2002, the BSP announced the reorganization of its Supervision and Examination Sector. Under the new setup, there will be four departments, each of which will supervise a specific group of banks according to size and complexity of organizational structure. Thus, there will be a Banking Group Supervision Department to supervise the largest banks and their subsidiaries. The other departments will focus on other large banks with less complex organizations (including some large foreign banks), midsize banks (including some foreign bank subsidiaries) and nonbank financial institutions, and rural and microfinance banks.

The BSP's recent actions are certainly steps in the right direction. Clearly, it recognizes the need to upgrade its supervisory capacity, given the increasing complexity of the banking groups' organizational structure and business activities. In particular, its efforts to move toward a consolidated supervision of banking groups and a "coordinated" approach to supervising

financial conglomerates are in line with the core principles identified by the Basle Committee on Banking Supervision (1997). But it also concedes that its current application of consolidated supervision is still rudimentary because existing laws preclude its full implementation.

The BSP has proposed further amendments to the New Central Bank Act, but other financial legislation may need to be amended as well. The Basle Committee notes that effective banking supervision is only part of a public infrastructure that should be well developed by having, among others, well defined rules and adequate supervision of other financial markets and their participants. Thus, in addition to strengthening banking regulations in the Philippines, there is also a need to improve regulatory capacities for nonbanking business. The question then is, can the consolidated financial sector supervision approach help strengthen the overall regulatory capacity and ensure consistent regulation in the Philippine financial sector?

4

Some Issues to Consider for the Philippines

In considering what regulatory structure is appropriate in an integrated financial world, the underlying issue is what regulatory structure minimizes the chances of government failure in ameliorating market imperfections and does so most efficiently (Skipper 2000). With respect to consolidation of financial sector supervision, there is as yet no international consensus. The literature is generally cautious, especially in the application of the approach to developing countries. That is, each country must conduct a full assessment of the pros and cons of adopting a particular model. There is consensus, however, on the key factors that need to be considered in such an assessment. The literature highlights two factors: a) changing the regulatory structure must be undertaken only if it will maintain and enhance supervisory capacity and the effectiveness of supervision; and b) the change in the institutional structure of regulation must reflect the change in the market structure.

The relative resilience of the Philippines to the ill effects of the Asian crisis was partly attributed to the banking sector reforms that had already been implemented, particularly the significant improvements in prudential regulation and supervision. Thus, the banking sector's institutional framework prior to the crisis was rated fairly well in comparison to other countries in the region. The BSP continues to seek ways of improving and upgrading its regulatory capacity, particularly the consolidated supervision of banking groups. But what also needs to be done is to improve regulatory capacities and eliminate gaps in regulatory coverage of other financial services sectors.

The different standards of regulation and supervision over financial institutions by other government agencies have also become more problematic recently. In particular, a number of investment houses and preneed companies under the direct supervision of the SEC have run into financial difficulties. The SEC has also undertaken moves to tighten their regulation and supervision. The case of the preneed industry, which provides for the performance of future service or payment of monetary

considerations for health, education, pension, interment and other needs, is noteworthy. Because preneed plans are classified as securities, the preneed industry falls under the jurisdiction of the SEC (and the Department of Health for health maintenance organizations, or HMOs). In fact, the emergence of this industry was attributed to the Insurance Commission's tight and conservative regulation of the insurance industry (World Bank 1992). Thus, it grew rapidly since it operated under a less restrictive regulatory environment. For instance, total assets of the private insurance industry in 2000 amounted to less than P212 billion, while total assets of the preneed industry already amounted to around P148 billion. In recognition of this disparity in regulation, the SEC undertook measures to tighten the regulation of the preneed industry. For instance, the SEC issued a circular in June 2000 that set limits on the investment portfolio of preneed companies. Considering the similar nature of the two industries, calls have been made to place the preneed industry under the Insurance Commission to ensure consistent regulation and strengthen the protection offered to preneed plan holders.

But the private insurance sector's regulatory framework also needs to be upgraded, especially with the entry of more foreign insurers and the introduction of new products that resemble bank and securities instruments, including dollar-denominated products. Unlike other economies in the region such as Indonesia, Malaysia, Singapore and Thailand, the Philippines has not issued an updated Insurance Code. And changes to the prevailing Insurance Code of 1978 have been very few. Historically, the regulatory framework governing the insurance industry was marked by conservatism and risk aversion. Although this resulted in overall financial soundness, it was also deemed overly cautious and thus constrained the growth of the industry (World Bank 1992). A major reform undertaken beginning in the mid-1990s was the deregulation of entry, but other regulations remain stringent and outdated. Developing the insurance sector is also important because it can play a more significant role in mobilizing long-term savings and developing the capital markets.

With all the regulatory changes taking place in the different financial services sectors and other reforms being proposed, there is also a need to ensure that they are consistent and deal with the issue of regulatory arbitrage. Clearly, the public requires comparable disclosure and protection for similar products. The BSP's efforts to coordinate and cooperate with the other financial regulatory agencies should help narrow the differences in regulatory regimes. But the process has to be institutionalized rather than just relying on MOUs and other ad hoc arrangements. As financial services integration continues and distinctions between financial products continue to narrow due to financial innovation and financial deregulation, coupled with demands for further financial deregulation under the General Agreement on Trade in Services, and increasing globalization of financial

markets, what is needed is a broader perspective on financial sector supervision and regulation to ensure and enhance supervisory capacity and the effectiveness of supervision.

The institutional structure of financial regulation and the market structure clearly suffers from a mismatch that needs to be addressed. If one looks at the country's current financial structure, the dominance of universal banks and the introduction of cross-selling such as bancassurance, then the consolidated financial sector supervision approach would be appropriate for the Philippines.

Thus, at the very least, consolidated financial sector supervision should be seriously considered. How to undertake it is the bigger issue. The literature also makes it clear that the transition from institutional to functional regulation is a complex process and will take time to implement. Martinez (2002), for instance, estimates the time required to merge supervisory agencies to be around eight years, although the developed countries took considerably less time than that. Consolidation can be done gradually and by building on existing structures and reform initiatives, especially since the country is not in a crisis situation. The BSP is already taking steps toward a consolidated supervision of banking groups, which includes reforming its supervisory structure. Consolidated financial sector supervision can be a natural extension of that policy. That is, it can serve as a framework within which to view or situate current financial reforms and to shape or direct future regulatory reforms, including strengthening regulatory capacity over NBFIs. Reviewing the experience of other countries in the region will prove instructive.

Whether the Philippines opts to stick with institutional regulation or move to integrated/functional regulation, someone has to have an overview of the financial sector. The question is whether this should be the BSP or some other agency. The 1987 Constitution expressly assigns the supervision of banks to the BSP,¹⁷ thus according it a major, if not dominant, role in financial sector supervision. In fact, the creation of the BSP augurs well for our capacity to undertake major institutional reforms and create a powerful and independent institution. Under the New Central Bank Act, the BSP has to some extent become the *de facto* "super regulator" of the financial system, with its authority to supervise and examine banks' subsidiaries and affiliates engaged in allied activities (Sec. 25). Designating the BSP as the lead regulator makes sense because of the dominance of banks in the financial system. Another advantage is that the BSP is the most experienced

¹⁷ Section 20, Article 12 of the 1987 Constitution states that: "The Central Bank of the Philippines, which shall function as the central monetary authority, shall provide policy direction in the areas of money, banking and credit. It shall have supervision over the operations of banks and exercise such regulatory powers as may be provided by law over the operations of finance companies and other institutions performing similar functions."

regulator in the financial sector, especially in a deregulated environment. It could then set the standard for the other regulators in the sector.

One option would be to follow the Finland model and set up a Financial Supervision Authority attached to the BSP. Furthermore, the regulatory framework can be transferred to the BSP, thus enabling the SEC and the Insurance Commission to focus on the day-to-day regulation and supervision of the financial institutions and markets under their jurisdiction. Of course the objective is not and should not be to coordinate/harmonize all regulations but only those that are relevant to the overall stability of the financial system. That is, the focus should at least be on prudential and market conduct regulation. However, this will require high levels of expertise in risk areas common to all financial service industries.

Alternatively, as an interim measure, the Philippines can set up a council similar to the Federal Financial Institutions Examination Council of the US, composed of the heads of the various regulatory agencies. The Council was created in 1978 to promote consistency in the examination and supervision of financial institutions. Its primary task was to establish uniform principles and standards and report forms for the examination of financial institutions. Australia also set up a Council of Financial Supervisors in 1992, before it established an integrated prudential regulator in 1998. The key focus of the Council was the regulation of financial conglomerates, and its primary objective was to promote regular, high-level liaison among the various financial regulatory agencies. Its most significant contribution to the regulation of financial conglomerates was the development of a set of guidelines facilitating cooperation among its member financial regulators (Bain and Harper 1999). Such a council can then lay the groundwork for consolidated financial sector supervision in the Philippines. The Philippines can also learn much from other more experienced integrated regulators in the region, particularly Singapore and Malaysia.

Identifying the appropriate level and form of intervention is a serious challenge to government. Regulatory efficiency factors in overall economic performance. Inefficiency results in costs to the community through higher taxes and charges, poor service, uncompetitive pricing, or slower economic growth. To control costs and ensure effectiveness, regulation has to be placed within a consistent framework. This requires establishing clearly what needs to be regulated and why, and defining the principles for effective and efficient regulation (Wallis et al. 1997). A corollary to this would be the identification of the appropriate regulatory structure.

Financial systems in both developed and developing countries have typically been subject to substantial public regulation. The basic rationale for this is that both the payments system and public confidence in financial institutions and instruments, on which the financial system is built, bear the qualities of a public good. Hence, the need for some government intervention to achieve market-enhancing outcomes (Grimes 1999). But

the system of supervision and regulation must keep pace with a dynamic financial services industry. In many countries in recent years, including the crisis economies in Asia, that meant moving toward an integrated financial services regulation. Increasing financial services integration in the Philippines indicates that such a move is also appropriate and can serve as a framework in anticipating how the Philippine system of supervision and regulation must change so that it can accomplish its public purpose within the new financial landscape.

Appendix

Evolution of regulations on allowable activities of commercial banks

Year	Regulations (EKBs and KBs)
1970s	<ul style="list-style-type: none"> - Banks are allowed to invest in the equity of allied undertakings (but financial allied undertaking was limited to a minority in that enterprise). - KBs (commercial banks) may own up to 60 percent of the total voting equity and of the total equity of a venture capital corporation (PD 1688, April 3, 1980). - Prohibition against KBs' holding equity in nonallied activities
1980	<ul style="list-style-type: none"> - Authorized a KB, a bank authorized to provide commercial banking services as well as a government-owned and controlled bank, to operate under an expanded commercial banking authority (BP 61, April 1, 1980). - EKBs (expanded commercial banks) are authorized to own a majority or all of the equity of other financial intermediaries other than a commercial bank or a bank authorized to perform commercial banking services (BP 61, April 1, 1980). - KBs may own up to 60 percent of the total voting equity and of the total equity of a venture capital corporation (PD 1688, April 3, 1980). - Permits the total equity investment by EKBs in all fields of undertakings up to 50 percent of its net worth, although the single investment limit remains at 15 percent of net worth. - An EKB may hold as much as 35 percent of the voting stock of a nonallied enterprise, but not to exceed 35 percent of the total subscribed capital of the enterprise (Circular 739, July 3, 1980). - EKB may exercise the functions of an investment house directly or indirectly but they may not go directly into the finance company business or leasing directly but through subsidiary companies. - The combined investments of all banks, including EKBs, any other category of banks and quasibanks, together with the investments of their subsidiaries (except investments made by venture capital corporations under PD 1688) in a single enterprise should in aggregate remain a minority (BP 61), April 1, 1980). - Limits on investment by an EKB in the equities of financial allied undertakings (in relation to the total subscribed capital stock and in relation to the total voting stock of the allied undertaking) to a range of 30 percent to 100 percent. - An EKB may acquire up to 100 percent of the equity of a nonfinancial allied undertaking. Prior approval of the Monetary Board is required if the investments is in excess of 40 percent of the total subscribed capital stock or 40 percent of the total voting stock of such allied undertaking (Circular 739, July 3, 1980). - Nonallied undertaking eligible for investments by EKBs: agriculture, manufacturing, public utilities (Circular 739, July 3, 1980). - Total equity investments in a single nonallied enterprise of EKBs must be less than 50 percent of the voting stock of that enterprise (Circular 739, July 3, 1980). - EKBs and their wholly or majority-owned subsidiaries shall report to the Central Bank their outstanding equity investment in and outstanding loans to nonallied enterprises as of the end of that semester (Circular 739, July 3, 1980).
1983	<ul style="list-style-type: none"> - Requires all banks and NBQBs to adopt the Statements of Financial Accounting Standards (SFAS) in the preparation of their financial statements and reports to CB (Circular 951, Sept. 1983).

Appendix (cont'd.)

Year	Regulations (EKBs and KBs)
1984	<ul style="list-style-type: none"> - Limits the maximum total bank equity investment in and outstanding loans to any single enterprise (whether allied or nonallied) to 15 percent of the net worth of the investing bank (Circular 993, Mar 7, 1984). - Limits the maximum total credit exposure of banking institutions to affiliates/subsidiaries or corporate stockholders to the networth of such affiliates/subsidiaries or corporate stockholders (Circular 1019, July 16, 1984).
1985	<ul style="list-style-type: none"> - Requires nonbank financial institutions with quasibanking licenses (NBQBs) to publish its quarterly consolidated balance sheets within 30 days following the end of each quarter in any newspaper of general circulation (Circular 1083, Nov. 4).
1986	<ul style="list-style-type: none"> - Prohibiting concurrent officerships between banks or between a bank and a nonbank financial intermediary except with prior approval of the Monetary Board (Circular No. 1115, September 16, 1986).
1990	<ul style="list-style-type: none"> - Increases the number of nonallied activities in which EKBs may invest. Aside from agriculture, manufacturing and public utilities, they can now invest in mining and quarrying, construction, in certain activities in wholesale trade as well as community and social services, provided that within 30 days, they shall furnish the CB all the relevant information on their investments (Circular 1236, April 27). - Includes companies engaged in stock brokerage/securities dealership/brokerage among the allied financial undertakings in which KBs and EKBs may be allowed to invest (Circular 1237, May 7).
1991	<ul style="list-style-type: none"> - Includes insurance companies in the list of nonallied financial undertakings eligible for investment by EKBs provided that the equity investment of any director, officer or stockholder of an EKB shall be limited to a ceiling of 20 percent of the subscribed capital stock or equity of the investee insurance company (Circular 1289, June 6). - Includes insurance companies among the nonallied undertakings eligible for investment by EKBs but it shall not exceed the prescribed 35 percent of the equity of that undertaking (Circular 1297, July 16).
1992	<ul style="list-style-type: none"> - Includes foreign exchange dealership/brokering in the financial allied undertakings of banks with expanded commercial banking authority (Circular 1357, Oct. 8).
1994	<ul style="list-style-type: none"> - Discontinues the submission of some reports, changes the frequency of submission and adopts the diskette format of reporting for selected reports (Circular 29, June 2).
1995	<ul style="list-style-type: none"> - Includes the financial and commercial complex projects (including land development building constructed therein) arising from or in connection with the government's privatization program among the nonallied undertakings eligible for investment by EKBs (Circular 66). - Amends Circular 1289 by reclassifying equity investments of banks with expanded commercial banking authority in an insurance company from "investments in nonallied financial undertakings" to investments in allied financial undertakings, provided that said investments do not exceed 51 percent of the total subscribed capital stock and total voting stock of such insurance company (Circular 77, June 6). - Allows inclusion of investments in clearing house companies such as the Philippine Clearing House Corporation and the Philippine Central Depository, Inc., as nonallied financial undertakings (Circular 84, Aug 17).

Appendix (cont'd.)

Year	Regulations (EKBs and KBs)
	<ul style="list-style-type: none"> - Increases the limit on equity investments of an EKB, a KB or thrift bank, in financial allied undertakings to a range of 40 percent to 100 percent of total subscribed capital stock and voting stock of the allied undertakings (Circular 87, Sept 20).
1996	<ul style="list-style-type: none"> - Provides for the inclusion of a holding company as a financial allied undertaking of EKB (Circular 115, Oct 11).
1997	<ul style="list-style-type: none"> - Requires all banks to submit a report on the daily consolidated foreign exchange position of banks which shall include the foreign currency position against pesos of any of the banks' branches/offices, subsidiaries and affiliates, here and abroad (Circular Letter, Sept. 5).
1999	<ul style="list-style-type: none"> - Lifts the existing limit of an EKB's equity investments in an insurance company, previously set at 51 percent of total subscribed capital stock and of the total voting stock of such insurance company (Circular 219, Nov. 29).
2000	<ul style="list-style-type: none"> - Expanded the coverage of leasing companies that may qualify as financial allied undertakings of banks (Circular 263, Oct. 20). - The total investment of a universal bank in equities of allied and nonallied enterprises shall not exceed 50 percent of the net worth of the bank (RA 8791, May 23, 2000). - The equity investment in any one enterprise, whether allied or nonallied, shall not exceed 25 percent of the net worth of the bank (RA 8791, May 23, 2000). - A universal bank can own up to 100 percent of the equity in a thrift bank, a rural bank, or a financial allied enterprise (RA 8791, May 23, 2000). - A UB may own up to 100 percent of the equity in a nonfinancial allied enterprise (RA 8791, May 23, 2000). - Changes the report category and frequency of submission by NBQBs of certain reports from quarterly to monthly (Circular 255, Aug. 15). - Requires the submission of reports of NBFIs without quasibanking functions but which are subsidiaries/affiliates of banks and NBQBs and investment houses without quasibanking functions but which have trust authority (Circular 255, Aug 15, 2000).
2001	<ul style="list-style-type: none"> - The risk-based capital adequacy ratio of a bank as a percentage of qualifying capital to risk-weighted assets, shall not be less than 10 percent for both solo basis (head office plus branches) and consolidated basis (parent bank plus subsidiary financial allied undertakings, but excluding insurance companies) (Circular 280, March 29, 2001). - Banks shall submit a report of their risk-based capital ratio on a solo basis (head office plus branches) monthly and on a consolidated basis (parent bank plus subsidiary financial allied undertakings, but excluding insurance companies) quarterly (Circular 280, March 29, 2001). - Subject to prior approval of the Bangko Sentral ng Pilipinas (BSP), banks may invest in allied or nonallied undertakings, including corporate affiliations or structures. (Circular 295, Sept. 6, 2001). - All banking offices shall submit the required reports excluding the Quarterly Statement of Condition and Statement of Income and Expenses (original and duplicate) direct to the appropriate supervising and examining department of BSP Manila or to the nearest BSP Regional Offices, personally, by registered mail or by private courier (Circular 276, Mar 15, 2001).

Appendix (cont'd.)

Year	Regulations (EKBs and KBs)
2002	<ul style="list-style-type: none"> - With prior BSP approval, banks may invest in equities of financial institutions catering to small and medium-scale industries including venture capital corporation (financial allied undertaking) (Circular 316, January 29, 2002). - UBs/KBs/TBs may also invest in Service Bureaus provided that data processing companies may be allowed to invest up to 40 percent in the equity of Service Bureaus (Circular 317, January 29, 2002). - UBs may further invest in health maintenance organizations (Circular 317, January 29, 2002). - A publicly listed universal or commercial bank may own up to 100 percent of the voting stock of only one other UB or KB. Otherwise, it shall be limited to a minority holding (Circular 323, March 13, 2002). - All derivatives transactions between banks/NBQBs/FIs and their subsidiaries/affiliates (e.g., Forex Corporation) shall be with prior BSP approval (Circular 326, April 3, 2002). - The equity investments of UBs and KBs in any single enterprise shall not exceed 25 percent of the net worth of the investing banks (Circular 331, May 2, 2002). - The total amount of investments of EKBs in equities in all enterprises shall not exceed the following ratios in relation to the net worth of the investing bank: EKB-50 percent; KB-35 percent; TB-25 percent; RB-25 percent; COOP-25 percent (Circular 331, May 2, 2002). - In any single enterprise, the equity investments of universal and commercial banks in any single enterprise shall not exceed at any time 25 percent of the net worth of the investing banks (Circular 331, May 2, 2002). - The Consolidated Statement of Condition of a bank and its subsidiaries and affiliates shall be published side by side with the Statement of Condition of its head office and its branches/other offices. With regards to utilization and submission of audited financial statements (annual reports), banks with subsidiaries shall present the reports side by side on a solo basis and on a consolidated basis bank and subsidiaries (Circular 339, July 18, 2002). - UBs/KBs and TBs may also invest in equities of Fixed Income Exchange (nonfinancial allied undertakings) (Circular 338, July 18, 2002). - The BSP presents the guidelines on the use of the head office and/or any or all branches of universal banks and commercial banks as outlets for the presentation and sale of financial products of their allied undertakings (subsidiaries and affiliates) or of its investment house units. In case of sale of insurance products of insurance company affiliates, said affiliates must be accredited or precleared by the Insurance Commission to ensure that only stable and reputable insurance companies can sell their products through banks (Circular 357, November 8, 2002).

Source: Various circulars, Bangko Sentral ng Pilipinas

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This book examines the trends in Philippine banking regulation in the past 25 years. In particular, it notes that the Philippines has followed a policy of despecialization in the banking sector by widening the range of permissible activities and bank products to enhance competition and efficiency, beginning with the introduction of universal banking in 1980. However, there has been no corresponding adjustment or change in the regulatory framework until very recently. The book then raises the issue of the appropriate institutional structure for financial sector regulation.

Philippine Institute for Development Studies
Surian sa mga Pag-aaral Pangkaunlaran ng Pilipinas

NEDA sa Makati Building
106 Amorsolo Street, Legaspi Village
1229 Makati City, Philippines
Tel.: (63-2) 892-4059 / 893-5705 / 892-5812
Fax: (63-2) 893-9589 / 816-1091
E-mail: publications@pidsnet.pids.gov.ph
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