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

Policy Notes

ISSN 1656-5266 No. 2008-10 (December 2008)

Lessons for the Philippines from the US financial crisis

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September 2008 can be considered as the most dramatic period in recent financial history, with shocking events witnessed and recorded one after the other. US government-sponsored enterprises, Fannie Mae and Freddie Mac, going into conservatorship. The American International Group, Inc. (AIG) appealing to the US Federal Reserve Bank for a bailout. Wall Street stock prices plummeting. Financial titans like Merrill Lynch and Bear Stearns seeking cover from white knights, Bank of America and JP Morgan Chase, to avoid bankruptcy. Lehman Brothers disappearing from the financial map. And the US government committing approximately $1.4 trillion so far to bail out the financial sector (Table 1). Although there is greater confidence now that the crisis had abated, the economic condition would nonetheless remain moribund, at least, until next year.

How do all these affect the Philippines? This *Policy Notes* attempts to understand the potential economic implications to the Philippines of this US crisis and distill important policy lessons especially for financial regulation.

Channels of crisis impact

So far, the Philippines has not yet felt the effect of the financial mayhem in the US in any major way. To start with, the Philippine banking system has minimal exposure to structured financial products.[1] But because

[1] News accounts of Philippine banks' exposure to the Lehman Brothers' collapse put it at approximately 0.11 percent of total banking assets, or PhP5.5 billion. Individual banks with market losses from the derivatives securities have already allocated increased loss provisions in their capital.

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Table 1. Summary of current financial intervention

Beneficiary	Action	Financial Commitment
Bear Stearns (March 14, 2008)	Credit line for asset purchase	$28.8 billion
Fannie Mae and Freddie Mac (September 7, 2008)	Senior preferred stock purchase	Initial commitment: $100 billion each; no set limit
	Purchase of mortgage-backed securities	No set limit
	Credit facility	No set limit
AIG (September 16, 2008)	Purchase of preferred shares	$40 billion
	5-Year Loan	$110 billion
Citigroup (December 2008)	Purchase of bad assets and preferred shares; credit guarantee	$247.5 billion
Troubled Asset Relief Program (TARP)	Purchase of bad assets and company shares	$700 billion

Source: Various news articles

the United States is a large economy with major effects on the global economy, the Philippines will eventually also feel the pinch. There are several channels through which this can take place.

One is through the potential decrease in investment. The US is the major source of investments in the Philippines. In 2007, it accounted for 33 percent of new foreign direct investment (FDI). With capital being scarce and Main Street suffering the cold wind from Wall Street, potential new investments or expansion plans of foreign subsidiaries might temporarily be shelved. Among the major US investments are those in the business process outsourcing (BPO) industry. With an increase in US unemployment and the potential decrease in average wages, US corporations might give aggressive investment expansion of offshore outsourcing a rethink, if only out of political sensitivity or concern for potential backlash on what is perceived as employment export.

Another channel is through decrease in remittances. With the US recession bringing down the global economy, jobs of overseas Filipino workers (OFWs) may also be at risk. Already, the *New York Times* reported that many rich people in New York have terminated nanny jobs. Today, it may be nanny jobs; tomorrow, it might be other types of jobs in which Filipinos are usually employed. Thankfully, the demand for nurses has not yet declined in the US and elsewhere; but with a weakening economy, many other professions will experience poor demand.

A third channel is through decrease in tourism receipts. With a recession looming, many will likely shelve vacation plans to distant places and will instead substitute going to nearby destinations to save money. This means that less US and European tourists might be expected to visit Asia. Unless this gap is filled up by increased domestic tourism or other tourists from Asia, tourism services

which comprised 58 percent of total services exports in 2007, will take a dive in the short term.

Finally, the most predictable channel is the decline in exports as a result of weak demand in the US and other parts of the world.

Lessons from the crisis

Notwithstanding the potential downward spiral which the US crisis can cause in the economy, there are significant lessons to learn from this crisis experience. Understanding the cause of the crisis and the noteworthy response of the authorities is thus important to draw important policy lessons.

Poor loan quality

One of the major factors in the US mortgage loan defaults that led to the 2008 financial panic is the rapid increase in subprime loans. Though the immediate crisis triggers came from the securities market, the core of the problem is the poor quality of loans from the originators of the traded securities. These mortgage originators were not only banks (operating under tight regulation) but also 'monoline' financial institutions that do not operate under a prudential regulatory framework. Issuances of below-investment grade, mortgage-backed securities ballooned between 2003 and 2006, from US$37.4 billion to US$114.3 billion in the first semester of 2006.[2] The increase in subprime loans has been aided by a glut of investible funds in the market and the prolonged low-interest environment that has fueled high economic growth. Under this environment, lax control on loan quality ensued, with so-called 'ninja' loans given to those with 'no income, no jobs, no assets' borrowers, and 'low- or no-docs' loans proliferated. Predatory lending was likewise prevalent, taking advantage of the lack of financial sophistication of subprime borrowers, providing many enticements for borrowers to refinance. Examples of these enticements are offers of 'teaser' interest rates or fresh loans with cash out, even as the fine prints say that interest rates will increase over the lifetime of the loan.

The relevant policy lesson here is the need for continuous watchfulness of financial regulators over the quality of loans in the financial system. The Asian crisis had already helped the Philippines establish many controls on banks that should help in this regard. However, should there be existing nonbank sources of loans in the domestic market that are beyond the prudential regulatory net of the Central Bank, this should warrant a closer look from regulatory authorities. For as long as they transact financial loans and/or securities, the lesson from the crisis is that it matters to know where such entities source their funds and how much "own capital" they have. Otherwise, the moral hazard incentive to loan out money they do not own without

[2] Taken from *Inside Mortgage Finance* as cited by Randall Dodd, "Subprime: tentacles of a crisis," *Finance and Development* Vol. 44, No. 4 (December 2007).

careful regard for quality can, as the US and Asian financial crises have shown, lead to future trouble.

'Cutting clean'

Another lesson from the current crisis is that sales of performing and nonperforming loans (NPLs) to another entity should be done 'cleanly'. Thankfully, the now expired Special Purpose Vehicle (SPV) Law had required 'true sale' for NPLs that want to benefit from the many tax and fee waivers. Yet, it is important to understand whether there are, indeed, no more trappings in those NPL transfers.

In the case of the US financial crisis, many banks or loan originators agreed to a 'put-back' option in the securitized loans, meaning that the arranger (of the securities) may or may not exercise the option to return the transferred assets to the banks, and thus be again reflected in banks' balance sheets. Other banks have also agreed to a contingent financing for the arranger in the form of credit lines to be able to fund the sale of the securities. Thus, when the short-term commercial credit market dried up as a result of concern over huge number of defaulting subprime loans, the 'securitizers' turned to the banks for credit lines, drawing banks again into the maelstrom of the subprime loans problem, and leaving many of them scrambling for additional capital to cover their increased risks.

The irony is that while the sale of loans to the arrangers or 'special investment vehicles' (SIVs) in the US should have preserved the banks' capital from further losses (in principle, the loans sale should have removed the risks from the banks' balance sheets, making them more strongly capitalized), it turned out that there were other entrapments for banks in the form of credit line commitments and put-back option. This is not to mention that the banks' own holdings of subprime securities were backed by the same subprime loans they sold to the SIVs.

Several policy lessons can be drawn from this. The most important is with regard to the treatment of asset-backed securities (ABS)[3] in the balance sheet of banks. The underlying reason for banks' purchase of ABS is that in terms of capital provisions for potential losses, these securities required far less capital than mortgages. ABS, particularly highly rated ones, contain much less risks than loans and would thus require lower capital requirement. Hence, buying ABS while disposing old loans freed up some of the banks' capital to fund additional businesses, e.g., more loans. The 'originate-and-distribute' model was a convenient way for banks to spread the risk to more people who are willing to hold on to the securities, leaving more of their capital free to do business with.

One of the ways in which this model went wrong is in the delegation of the regulatory role to the assessor of risks, e.g., credit rating

[3] There are many forms of asset-backed securities. Mortgage-backed securities (MBS) is one form of ABS.

agencies (CRAs). In the ideal world in which CRAs have no perverse incentives but to objectively assess the risk levels of ABS, the 'originate and distribute' model would have perhaps worked. But in the real world, the CRAs derive their income from the arrangers which seek their opinion. CRAs which give more favorable ratings would naturally be better sought than others that are more conservative. In many cases, in order to provide high rating, the CRAs themselves advise the arrangers to put additional 'enhancements' to the securities in order to give them a semblance of safety. Thus, securities backed by subprime loans can be rated triple A if they are imbedded with some credit default insurance and the like. This perverse incentive led to rating inflation, defrauding investors of the actual quality of the assets backing the securities. In turn, the triple A rating made it possible for erstwhile highly regulated financial institutions like insurance and pension funds to purchase subprime securities, something they would not have been allowed to under their respective mandates.

Thus, it is advisable that first, banks be transparent about the actual nature of loans and asset transfer to an SPV or SIV. Particularly for loans that have benefited from government tax and fees waiver, it is ideal that there be no more 'trappings' connected with the sold loans/assets in the form of contingent financing or put-back options or similar commitments. Even for those that do not enjoy any special government financing, these additional entrapments should at least be made transparent for regulators to properly assess the continued risk carried by the banks with respect to those supposedly transferred assets. A thorough review would perhaps recommend a needed capital boost higher than what the bank books would show.

Second, regulators should do their own assessment of securities risk, if possible. That is, triple A securities should no longer enjoy the same forbearance they once enjoyed unless given by credit rating agencies that regulators trust. Otherwise, even triple A ABS should be required higher capital requirement and loss provision than what they have heretofore enjoyed.

Third, CRAs should build up their reputation once again and be more transparent with their ratings and downgrade criteria. Ideally, they should provide an explanation and a baseline mark, along with the final rating that takes additional enhancements into consideration. The idea is to provide more information for investors in securities to assess the risks they are taking on.

Are globalization and deregulation to blame?

Some pundits have raised the question on whether the US financial crisis came about as a result of a borderless financial world and the repeal of the Glass-Steagall Law which used to put boundaries on banks' and

nonbanks' cross-ownership and activities. They noted that as a consequence of globalization, the free flow of funds to the US contributed to the glut in funds that fueled the lending boom and the consequent deterioration in loan quality. Meanwhile, with deregulation, banks' activities multiplied far beyond their core competencies of providing loans. In fact, a huge portion of US banks' income come not from interest earnings but from fee-based activities, e.g., syndicated loan arrangement, investment banking, securitization, etc. The question is: might deregulation inadvertently allowed banks to venture into financial activities which, in retrospect, should not have been prudently permitted?

For sure, there will be many voices for and against these questions. However, as regards globalization, granted that globalization helped fuel the lending boom, the solution to the capital problems of banks when the crisis erupted nonetheless laid with globalization as well. What amazed many observers is how US banks could remarkably raise more than US$40 billion capital by September 2008 amidst the financial strains. Yet, raised capital they did, because somewhere in other parts of the globe, some investors remained confident that the US is still a good place for their investment and found good buys in the US financial sector when equity share prices plummeted. Of course, some eyebrows were raised in the capital injection coming from Sovereign Wealth Funds. But that is another story (see Table 2).[4]

As for deregulation, the repeal of Glass-Steagall Law, in fact, allowed the orderly acquisition of Merrill Lynch and Bear Sterns by Bank of America and JP Morgan Chase. Without the new regulation based on the Gramm-Leach-Biley Act, such acquisition arrangement would not have been possible. Allowing the two behemoth financial institutions to fail because there are no other nonbank institutions large enough to absorb them, given the existing economic environment, would have thrown the US

[4] For more discussion on Sovereign Wealth Funds and their role in the US financial crisis resolution, see Anna Paulson, "Raising capital: the role of Sovereign Wealth Funds," *Chicago Fed Letter* No. 258.

Table 2. Sovereign wealth funds investment in US financial firms

Firm	Sovereign Wealth Fund	Date of Investment	Investment (in billion US$)	Equity Stake (in percent)
Citigroup (Round 1)	Abu Dhabi Investment Authority	11/26/2007	7.5	4.9
Citigroup (Round 2)	Government of Singapore Investment Corp. and Kuwait Investment Authority	1/14/2008	7.9	5.2
Morgan Stanley	China Investment Corporation	12/19/2007	5.0	9.9
Merrill Lynch (Round 1)	Temasek Holdings (Singapore)	12/19/2007	5.0	9.9
Merrill Lynch (Round 2)	Kuwait Investment Authority and Korea Investment Corp.	1/15/2008	8.9	5.4

Source: Chicago Fed Letter, January 2009.

financial system at the edge of the precipice, if not at the abyss.

The policy lesson for the Philippines is not to easily blame globalization and deregulation. Certainly, these two are no panacea, but to make them scapegoats for troubles in the financial sector is barking on the wrong trees. The lesson from the US financial crisis is that adverse incentives of stakeholders in the industry are to blame for the mayhem.

Another important lesson is the crucial role of domestic laws that make possible the speedy and orderly transfer of ownership in financial institutions. Without this, huge government resources have to be spent just to shore up failing banks or pay for deposit liabilities.

Central Bank response

The Federal Reserve Bank's response to the crisis was three-pronged. It has lowered interest rates in an exceptionally rapid and proactive way since September 2007 to reduce strains on credit conditions. It facilitated the orderly ownership transfer or capital support of systemically critical financial institutions like Merrill Lynch, Bear Stearns, Citigroup, and AIG. Lastly, when many traditional funding sources for financial institutions have dried up, the Federal Reserve provided liquidity through the use of the discount window.

What is noteworthy in the Fed's moves is its aggressiveness and surgical targets. Through the discount window, it infused liquidity where it is needed while tethering inflation expectation by not making more changes in the federal funds rate. It allowed access to nondepository institutions like investment banks, primary government securities dealers, and insurance companies to the discount window which, until then, had been reserved only for banks. It opened facilities to purchase highly rated commercial papers and provide backup liquidity for money market mutual funds. By its targeting of temporarily dysfunctional parts of the financial system like the commercial paper market, the Fed prevented further impairment of the financial market.

The lesson for the Philippines is the need to have the central monetary authority, the Bangko Sentral ng Pilipinas (BSP), possess the capacity to act and act decisively. In the Fed experience, the mandate to lend to nondepositories under unusual and exigent circumstances, provided they are backed by sufficient collateral, armed them with the necessary flexibility to act. And act they did. Is the BSP endowed with the same scope for flexibility in case of extraordinary financial turmoil? This question should be important enough to merit a reexamination of the BSP mandate.

At the same time, the fiscal authority must also have the wherewithal to back the moves of the central bank. The Fed, on its own, would not have moved as aggressively as it did, were it not assured of being refunded by

the Treasury. The lesson here is the need to maintain sound fiscal position in government to acquire the necessary muscle to flex in an adverse situation.

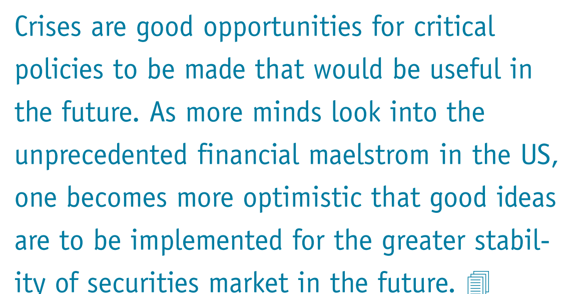
A peek at the future of financial regulation

There is a positive and negative side to having an underdeveloped capital market. The negative side is, obviously, the limited funding sources from the banking system. Securitization, after all, provides the opportunity for relatively cheap financing for investment and commercial expansion. The positive side, on the other hand, is that we can look at the experience of other more advanced markets and avoid the pitfalls of excess.

On the regulatory side, considering the converging businesses of banks and nonbanks, there is a great need for a more coordinated regulation and intervention. A turf mentality would have resulted to greater catastrophe in the US financial market. The turf mentality which bedevils many government agencies in the Philippines is something that Philippine policymakers must truly reflect upon and seek to prevent, both in normal and adverse times.

Forbearance of banks' use of securities for regulatory arbitrage should now receive greater scrutiny. Not only would credit ratings for those securities be stricter and more transparent but capital provisions for securities risk might need to be reexamined to see if the current requirement is sufficient.

In advanced markets, over-the-counter trade of derivative securities had fallen short in providing market liquidity during crisis situations. It is likely that the existing bilateral counterparty agreements will change into a more central counterparties scheme akin to that in the equity markets. In this way, counterparty risks, which proved the downfall of critical financial securities, are mitigated.



Crises are good opportunities for critical policies to be made that would be useful in the future. As more minds look into the unprecedented financial maelstrom in the US, one becomes more optimistic that good ideas are to be implemented for the greater stability of securities market in the future.

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