

Bangko Sentral ng Pilipinas



Bangko Sentral ng Pilipinas Modernization

A Policy Perspective

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*Disclaimer: the views expressed here belong to the authors
and do not necessarily reflect those of the BSP.*



I. Background

- **Objective:** identify modernization challenges facing monetary authorities so that more detailed investigation, if warranted, can be pursued.
- **Scope:** Issues identified are far from being “complete list”, though they are, in our humble opinion, at the forefront of challenges to BSP’s policymaking and regulatory powers.



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II. Aspects of Modern Central Banking

Features	Issues
<ul style="list-style-type: none"> • Clear objectives and effective tools 	<ul style="list-style-type: none"> • Hawk or dove? <ul style="list-style-type: none"> (a) Returning inflation to the target within the shortest period vs. real sector stabilizations. (b) Supporting internal value vs. external value of the currency (c) Weight of movements in asset prices vs. prices of goods and services in achieving the inflation target
<ul style="list-style-type: none"> • Legitimate policy objectives 	<ul style="list-style-type: none"> • Clear undertaking between monetary and fiscal authorities
<ul style="list-style-type: none"> • Effective use of markets in monetary policy implementation 	<ul style="list-style-type: none"> • Clear transmission mechanisms of policy instruments to the real economy
<ul style="list-style-type: none"> • Transparency and accountability 	<ul style="list-style-type: none"> • Clear reporting procedures to the authorities and the general public



III. Modernization Challenges

- A. Economic and technological innovations
 - (i) Monetary transmission mechanisms and controllability of targets in a liberalized environment
 - (ii) Payment system
 - (iii) Financial products: derivatives and e-money
 - (iv) Financial supervision
- B. Risk management
- C. Financial crimes
- D. Analytical tools for policy analysis and decision-making
- E. Organizational development



A. Economic and Technological Innovations

A.1 Monetary transmission mechanisms and controllability of targets 1

Monetary Transmission Channel	Issue(s)
Interest Rate Channel	Extent to which policy propagates through the yield curve
Credit Channel	Recent crisis experiences amidst a more liberal global financial system may have induced fragility in the financial sector



A.1 Monetary transmission mechanisms and controllability of targets 2

Monetary Transmission Channel	Issue(s)
Asset Price Channel	<ul style="list-style-type: none">• The propagation of the policy rate changes to asset prices alters the net worth of households and firms• Identifying fundamental-driven asset price movements versus unsustainable bubbles
Exchange Rate Channel	Relative price effect and balance sheet effect on spending



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Challenge: Identifying the transmission channels

BSP StratPlan 2005: Development of Dynamic Stochastic General Equilibrium (DSGE) model for the Philippines in the medium term



A.2 Payment and Settlement System

Challenges	Future Directions
<ul style="list-style-type: none">Limited powers of BSP in applying the Core Principles for Systematically Important Payment Systems to systems outside its jurisdiction	<ul style="list-style-type: none">Proposed Payment and System Act <i>Added Benefit:</i> Potential for facilitating greater remittance flows
<ul style="list-style-type: none">Credit and liquidity risks in event of system breakdown or severe economic distress	<ul style="list-style-type: none">Reliable back-up system
<ul style="list-style-type: none">Future risks arise from operational dependencies on technology platforms that support multiple payment systems of financial markets	<ul style="list-style-type: none">Multilateral approach to risk mitigation of the payment and settlement system



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A.3 Financial Products: Derivatives

Issues	Challenges
<p>No consensus on net impact of derivatives on monetary policy and financial stability</p> <p>Fender (2000): Hedging by firms weaken the broad credit channel</p> <p>Rule (2001): Allows the banking sector to concentrate on what it does best: originating and allocating credit</p> <p>Instefjord (2005): Potential threat to bank stability</p> <p>IMF (2006): Information from credit derivatives market are useful for financial sector surveillance and for instilling market discipline</p>	<p>Mitigate systemic risk by mitigating information asymmetry through:</p> <ul style="list-style-type: none"> (a) Disclosure mechanisms (b) Investor education (c) Corporate governance



A.3 Financial Products: e-money

Issues	Policy Questions for BSP
<ul style="list-style-type: none">● e-money affects demand for coins and currency and consequently, on seignorage income● Even if the information technology revolution is to eliminate demand for currency, central banks can pay interest on its own liabilities such as reserves at market rates● May weaken impact of policy, hence, providing further impetus for strengthening the interest rate channel	<ul style="list-style-type: none">● Pros and cons of reserve requirement for e-money● Persuade DOF to commit to volumes on auction● Inflation-indexed bonds



A.4 Financial Supervision

- Challenges arise from
 - rapid pace of financial products innovation,
 - rise of financial supermarkets,
 - incentives to engage in regulatory arbitrage
- Financial Sector Forum: increasingly well-coordinated and consolidated supervision
- Factors to consider in assessing regulatory frameworks
 - Bank-dominated nature of Philippine financial system
 - Increasing vertical/horizontal integration in the financial sector
 - Advantages of keeping bank supervision and monetary policy under one roof
 - Resources and institutional credibility of the BSP



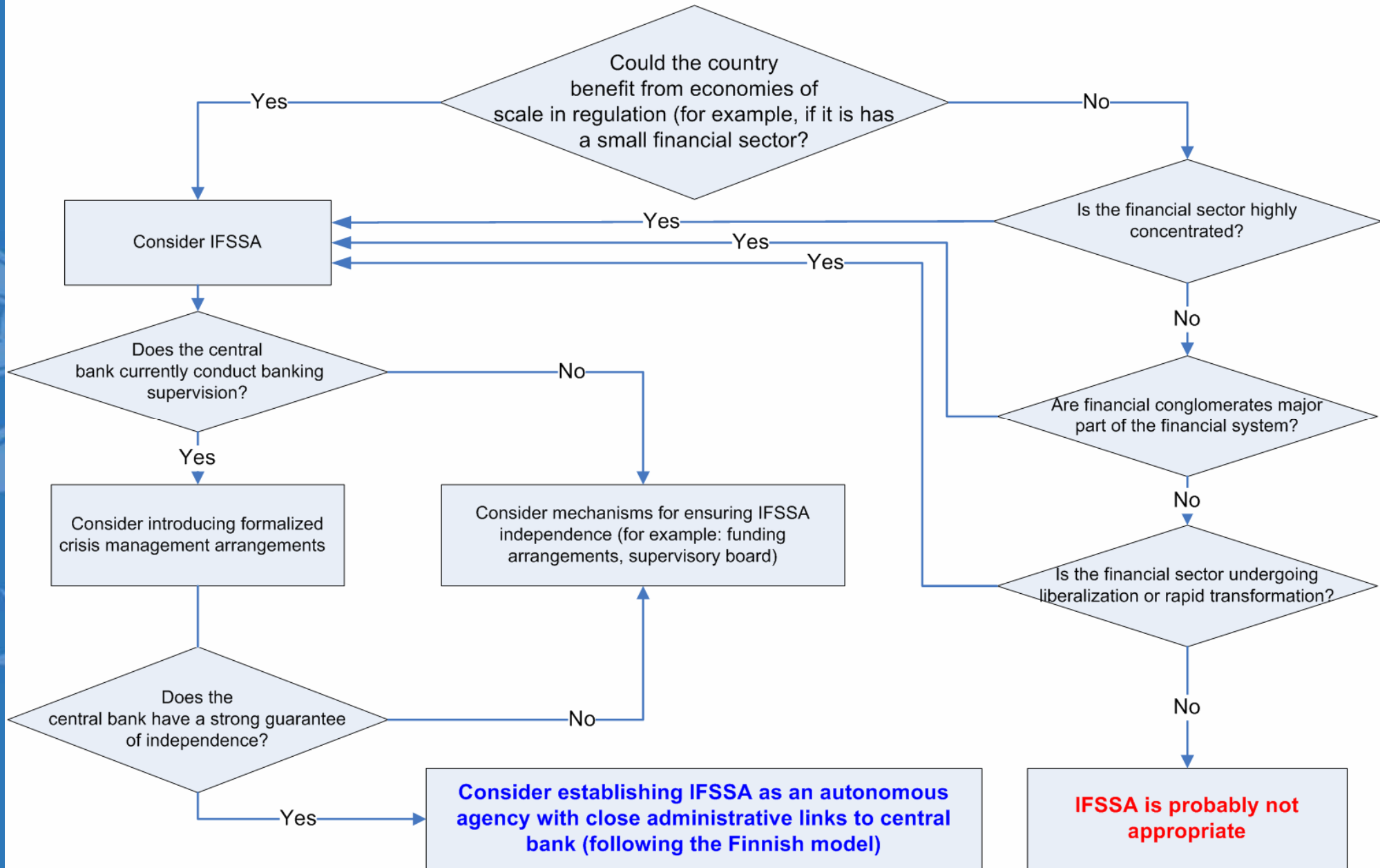
A.4 Financial Supervision

Jurisdiction	Philippines	England	Singapore	Finland	Australia
Monetary Policy	BSP	Bank of England	Monetary Authority of Singapore (MAS)	European System of Central Banks (ESCB)	Reserve Bank of Australia (RBA)
Banking Supervision	BSP PDIC	Financial Services Authority (FSA_E)	MAS	Bank of Finland	Australian Prudential Regulation Authority (APRA), Australian Securities & Investments Commission (ASIC), Australian Competition & Consumer Commission (ACCC)
Capital Markets Supervision	SEC	FSA_E	MAS	Financial Supervision Authority (FSA_F)	ASIC, ACCC
Insurance Supervision	IC	FSA_E	MAS	ISA	APRA, ASIC, ACCC

Sources: www.fsa.gov.uk; www.rba.gov.au; www.accc.gov.au; www.pdic.gov.ph; www.bsp.gov.ph; www.insurance.gov.ph; Jännäri (2001); www.bankofengland.co.uk; www.mas.gov.sg

Integrated Supervision Decision Tree

(Note: IFSSA denotes Integrated Financial Sector Supervisory Agency)



Source: Taylor and Fleming, 1999



B. Risk Management

- Allows bank management to assess risk exposures on a global basis and modify such accordingly in a timely manner
- Minimizes probability of systemic instability and need for central bank assistance
- Each bank could have unique risk management model



B. Risk Management

Issues	Policy Advocacy Areas
Require supervisors to keep pace with various risk models and have high degree of understanding of the firm being supervised -- Regulatory capture	Ensuring adequate safeguards for independent analysis of compliance with prudential and sound corporate governance standards (e.g. immunity of supervisors from lawsuits)
Inter-company comparison and industry analysis will not be easy	Credible credit rating agencies (accreditation process)
Impact on competition efficiency gains versus possible competitive edge for big banks	Both the BSP and FIs must recruit and harness human capital pool adept at risk management



C. Financial Crimes

Issues	Policy advocacy areas
Need to keep abreast with the increasing sophistication and ingenuity of perpetrators of financial crimes	Strong advocacy for good corporate governance
Financial fraud reflects weak controls and reporting system, and low level of public awareness	Public awareness campaigns
AMLA : Balance between benefits of catching money launderers and encouraging participation in the domestic financial system	



D. Analytical Tools: Inflation Forecasting

- Shift to inflation targeting has brought inflation forecasting to the fore of monetary policymaking.

Issue	Areas of Reform
Process and system and system for generating forecasts will have to be efficiently managed	Uncomplicated but privileged access to real-time data including nuances on methodological revisions
	Adequate hardware and software
	Specialized forecasting team



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D. Analytical Tools: Stress-Test

- Need for stress testing not only for individual institutions but also for the entire banking system as well as for the macro economy
- BSP has begun work in stress testing both at the macro and micro levels -- Early Warning Systems (EWS)

Macro Surveillance Tools	Micro Surveillance Tools
<ul style="list-style-type: none"> ● EWS on Macroeconomic Identification of Business Cycles 	<ul style="list-style-type: none"> ● Bank Performance Report System
<ul style="list-style-type: none"> ● EWS on Currency Crisis 	<ul style="list-style-type: none"> ● Comprehensive Bank Folders
<ul style="list-style-type: none"> ● Bank Distress Index 	<ul style="list-style-type: none"> ● Top Corporate Borrower Reports
<ul style="list-style-type: none"> ● EWS on External Debt Sustainability 	<ul style="list-style-type: none"> ● Bank Early Warning System



E. Organizational Development: Rationale

- Modern-day central bankers must be armed with:
 - Technical capacity to read financial markets and their correlations with the real economy;
 - Resources/ infrastructure to conduct market transactions and assess the impact of these transactions on central bank financial statements
 - Skills of a bureaucrat and a commercial banker



Corporate Structure

**BSP Knowledge
Workers**

- Leaner and flatter structure that rewards excellence and commitment
- Competency-based HR system
- Seamless communication flow
- Efficient databank
- Conducive physical set-up
- Commitment to outputs rather than inputs

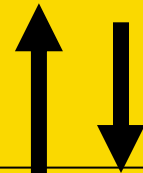


Middle-Up-Down Management Model

Top Management: What ought to be (grand vision)



Middle Management: Solving contradictions



Front-line: What actually is (reality)



Characteristics of middle managers as knowledge engineers

- Be highly capable in project coordination and management
- Be highly skilled at formulating hypotheses in order to create new concepts
- Be able to integrate various methodologies for knowledge creation



Characteristics of middle managers as knowledge engineers

- Have effective communication skills to encourage dialogue among members of the team
- Be proficient at employing metaphors in order to help others generate and articulate imagination
- Be capable of engendering trust among team members
- Be able to envision the future based on deep understanding of the past


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Human Resource Development

Challenges	Possible reform areas
<ul style="list-style-type: none"> ● Bottom-heavy organizational structure - The challenge has to do with considerable time lags in sharpening both institutional and industry knowledge and skills, deficiency in which impinges on management succession program 	<ul style="list-style-type: none"> ● Well-structured training programs ● Mentoring and coaching program
<ul style="list-style-type: none"> ● Corporate pay structure with security of tenure may also spawn perverse incentive of complacency 	<ul style="list-style-type: none"> ● Comprehensive skills and performance mapping vis-à-vis organizational competencies requirements <p>End goal: Strategic comprehensive HRD program that is responsive to individual career goals and BSP's modernization thrusts</p>



Suggestions for ensuring deep pool of human assets:

- Certificate courses (under the BSP Institute) on various and specialized aspects of finance/monetary/central banking for employees/outside in coordination with foreign or local professors/visiting scholars/industry practitioners
- Coordination with Economics, Finance, Mathematics, and Science departments of universities to include courses relevant to finance/central banking in their undergraduate/graduate programs



Suggestions for ensuring deep pool of human assets

- Dissertation and thesis grants for graduate students in monetary research
- Six-month training programs similar to those of other financial and multilateral institutions on a competitive-and-limited-slot basis
 - (a) Officer Development Program for MA/PhD degree holders; and
 - (b) Junior Officer/Specialist Program for BA/BS graduates



IV. Concluding Remarks

- The foregoing discussion highlights some of the pillars that support the conduct of monetary policy, the challenges that could weaken these pillars, and possible courses of actions that BSP might want to explore to turn these challenges into opportunities.
- Many of the reform areas within the BSP's control would necessitate continuous strengthening of its oversight functions, business processes, and HRD programs to stay ahead of the needs of a growing sophistication of the financial market.



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