The debt restructuring process by CDRC is expected to be accelerated with changes that were made to the debt restructuring framework during 2001. The changes included the setting of specific timeline to ensure effective implementation of the restructuring and enhanced disclosure and reporting requirements to improve corporate governance. More importantly, borrowers must undertake operational restructuring alongside debt restructuring because debt restructuring on its own may not bring about long term solution for the problems faced by the large corporates, to ensure the viability of the company over the longer term. The criteria for the acceptance of loans under CDRC was also amended to borrowers with aggregate borrowing of RM100 million with exposure to at least five creditors banks compared to a minimum amount of RM50 million and two creditor banks previously.

As at 8 March 2002, 12 cases with debts totaling RM18.8 billion remained outstanding. This included one case that was previously resolved but had to be revised. For cases in which the creditors and borrowers are unable to reach a consensus on the terms of the restructuring exercise, the cases would be removed from the purview of CDRC. Any further negotiations between the creditors and borrowers will be conducted outside the auspices of CDRC. To date, CDRC has rejected or discharged 12 cases from its purview. CDRC is on course in its target to ensure that all workout proposals of borrowers under its purview are approved and implemented by end-July 2002.

## 5. Concluding Remarks

The process of bank and corporate restructuring has proceeded steadily with Danaharta and the CDRC having done a good job within the parameters under which they operate. Thillainathan (2000) attributed the substantial restructuring to the following factors. First, there was political will. Second, the scale of the restructuring problem was more manageable. Third, the domestic resources available to finance the restructuring was plentiful and finally, the required legal infrastructure to correct the failing economy was already in place or quickly put in place. A main issue with the restructuring is that it was more government-financed and government-facilitated and less market-based. While this was justified during the crisis, there should be increased reliance on market-based approach to restructuring as the economy got stronger.

The development of the financial sector should be aligned with the envisaged direction for the development of the economy. This objective is incorporated in the formulation of the Financial Sector Masterplan (FSMP) by the central bank that was launched in March 2001. The FSMP outlines the medium and longer term agenda to build a financial sector that is responsive to the changing economic requirements and that is resilient, efficient and competitive. The recommendations that were outlined in the FSMP focused on enhancing domestic capacity and capability before progressing towards more competitive environment in the second phase and finally towards greater international integration. The FSMP identified three key objectives in its implementation phases. Firstly, to enhance domestic capacity by building the capabilities of domestic banking institutions and increased deregulation in certain areas to increase competition; secondly to promote financial stability through strong, risk-adjusted regulations and supervision; and finally, to meet the socio-economic objectives of Malaysia, which includes increasing the level of consumer activism.

Other developments in the financial system include the introduction of various capital market measures to promote efficiency, transparency, resilience and competitiveness of the capital market. Additional measures were concurrently introduced to improve corporate governance and minority shareholder position. The key measures include first, the launching of the Capital Market Master Plan (CMP) by the Securities Commission on 22 February 2001. The CMP seeks to ensure that the capital market is able to play its role in supporting national economic growth needs and aspirations, meeting the challenges of globalisation and tapping value-added opportunities within areas of comparative and competitive advantage. The second measure relates to the consolidation of the stockbroking industry, where the 53 stockbroking companies which existed as at end-August 2001 are expected to be reduced to 36. The Kuala Lumpur Stock Exchange introduced the new Listing Requirements to further enhance efficiency in capital market activities, corporate governance and transparency as well as strengthen investor protection and promote investor confidence. Both the Kuala Lumpur Options and Financial Futures Exchange (KLOFFE) and the Commodity and Monetary Authority of Malaysia (COMMEX) have been integrated to become the Malaysian Derivatives Exchange (MDEX) in order to attain economies of scale, offer a wider range of products to investors and enhance cost efficiency.

With all these reforms and measures, Malaysia should be stronger and more resilient in meeting the vagaries of the global business cycle. Although critics indicate that what have been done may not be sufficient in certain aspects, particularly the existence of moral hazard in the banking industry enhancing corporate governance and transparency, they have said that Malaysia was successful in containing its bad-debt situation, and hence preventing an erosion of consumer and corporate confidence. These need to be dealt with as the country faces bigger challenges ahead, particularly the rise of China and the implementation of AFTA and WTO agreements.

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**Table 1**
**Composition and Growth Rate of the Gross Domestic Product and Employment Share By Industry of Origin (In 1987 Prices)**

| GDP Share (Employment Share) | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001[1] |
|---|---|---|---|---|---|---|---|---|---|
| Agriculture, Forestry and Fishing | 12.9 (22.6) | 11.6 (19.6) | 10.3 (19.0) | 9.8 (17.7) | 9.2 (16.7) | 9.6 (16.3) | 9.1 (16.0) | 8.5 (15.2) | 8.4 (14.8) |
| Mining and Quarrying | 7.5 (0.5) | 7.3 (0.5) | 8.2 (0.5) | 7.7 (0.5) | 7.3 (0.5) | 7.9 (0.5) | 7.2 (0.5) | 6.9 (0.4) | 6.8 (0.4) |
| Manufacturing | 26.2 (23.4) | 26.7 (25.1) | 27.1 (25.7) | 29.1 (26.5) | 29.9 (26.9) | 27.9 (26.5) | 29.9 (26.4) | 33.4 (27.6) | 32.8 (27.4) |
| Construction | 3.8 (7.3) | 4.0 (7.9) | 4.4 (8.9) | 4.7 (9.4) | 4.8 (9.9) | 4.0 (9.4) | 3.6 (8.5) | 3.3 (8.1) | 3.4 (8.2) |
| Services<br>(Non-Govt.)<br>(Govt.) | 50.6 (46.2)<br>42.7 (34.6)<br>7.9 (11.6) | 51.1 (46.9)<br>43.4 (35.4)<br>7.7 (11.5) | 51.2 (45.9)<br>44.1 (35.1)<br>7.1 (10.8) | 50.7 (45.9)<br>44.2 (35.6)<br>6.5 (10.3) | 51.9 (46.0)<br>45.3 (36.1)<br>6.6 (9.9) | 55.7 (47.3)<br>48.4 (37.1)<br>7.3 (10.2) | 55.1 (48.6)<br>47.8 (37.8)<br>7.3 (10.8) | 53.4 (48.7)<br>46.5 (38.1)<br>6.9 (10.6) | 54.6 (49.2)<br>47.4 (38.6)<br>7.2 (10.6) |
| Import Duties – Imputed Bank Service Charges | -1.0 | -0.7 | -1.2 | -2.0 | -3.1 | -5.1 | -4.9 | -5.4 | -6.0 |
| Unemployment :% | 3.0 | 2.9 | 2.8 | 2.5 | 2.4 | 3.2 | 3.4 | 3.1 | 3.9 |
| Per Capita GDP (RM) | 7235 | 7548 | 8050 | 8646 | 9065 | 8245 | 8493 | 8899 | 9167 |
| **Average Growth Rate (%)** | | | | | | | | | |
| Agriculture, Forestry and Fishing | -3.1 | -1.9 | -2.5 | 4.5 | 0.7 | -2.8 | 0.4 | 0.6 | 1.2 |
| Mining and Quarrying | -4.0 | 6.0 | 22.9 | 2.9 | 1.9 | 0.4 | -2.6 | 3.1 | 0.9 |
| Manufacturing | 14.6 | 11.4 | 11.4 | 18.2 | 10.1 | -13.4 | 13.5 | 21.0 | 0.2 |
| Construction | 10.8 | 15.1 | 21.1 | 16.2 | 10.6 | -24.0 | -4.4 | 1.0 | 4.9 |
| Non-Government Services | 16.0 | 11.1 | 11.9 | 10.2 | 10.5 | -0.5 | 4.4 | 5.3 | 4.0 |
| Government Services | 7.2 | 5.4 | 1.4 | 1.7 | 8.6 | 1.1 | 7.7 | 1.4 | 7.1 |
| **Total** | **9.9** | **9.2** | **9.8** | **10.0** | **7.3** | **-7.4** | **6.1** | **8.3** | **2.0** |
| Average Per Capita Growth Rate (%) | 5.9 | 4.3 | 6.7 | 7.4 | 4.8 | -9.0 | 3.0 | 4.8 | 3.0 |
| Per Capita Income (Nominal) (RM)<br>(US$) | 8299<br>3073 | 9042<br>3447 | 10072<br>4016 | 11228<br>4446 | 12314<br>4377 | 12135<br>3093 | 12305<br>3238 | 13,361<br>3516 | 13,333<br>3508 |
| **Population (Million)** | **19.2** | **20.1** | **20.7** | **21.2** | **21.6** | **22.1** | **22.7** | **23.3** | **23.8** |

Note 1: Estimate by the Ministry of Finance.

Source: Ragayah and Saadiah (2002)

**Table 2**
**Malaysia: Key Macroeconomic and Financial Indicators**

| Indicators | June 1997 | Dec. 1997 | June 1998 | Dec. 1998 | June 1999 | 1999 | 2000 | 2001[p] | 2002[f] |
|---|---|---|---|---|---|---|---|---|---|
| Real GDP growth (annual, %) | 8.4[1] | 5.6[2] | -5.2[1] | -10.3[2] | 4.1[1] | 6.1 | 8.3 | 0.4 | 3.5 |
| Gross national Savings (% of GNP) | n.a. | 39.4 | n.a, | 41.9 | n.a. | 41.1 | 39.5 | 34.9 | 33.8 |
| CPI growth (%) | 2.2 | 2.9 | 6.2 | 5.3 | 2.1 | 2.8 | 1.6 | 1.4 | 1.8 |
| Unemployment rate (quarterly, %) | 2.3 | 2.0 | 3.3 | 3.4 | 3.3 | 3.4 | 3.1 | 3.7 | 3.6 |
| Federal Government Overall Balance (% of GDP) | n.a. | 2.5 | n.a. | -1.9 | n.a. | -1.8 | -3.2 | -5.8 | -5.5 |
| Current account balance (% of GNP) | n.a. | -5.9 | n.a, | 13.7 | n.a. | 17.1 | 10.2 | 8.9 | 7.9 |
| External debt (% of GNP) | 43.2 | 64.0 | 64.7 | 60.2 | 57.7 | 57.6 | 50.5 | 55.4 | - |
| Net international reserves | | | | | | | | | |
| **RM billion** | 70.7 | 59.1 | 58.2 | 99.4 | 118.3 | 117.2 | 113.5 | 117.2 | - |
| US billion | 28.0 | 21.7 | 20.5 | 26.2 | 31.1 | 30.8 | 29.9 | 30.8 | - |
| Months of retained imports | 4.3 | 3.4 | 3.8 | 5.7 | 6.7 | 5.9 | 4.5 | 5.1 | - |
| M3 growth (%) | 21.8 | 18.5 | 7.3 | 2.7 | 7.7 | 8.3 | 5.0 | 2.8 | - |
| 3-month interbank rate (%) | 7.5 | 8.7 | 11.2 | 6.5 | 3.3 | 3.18 | 3.25 | 3.27 | - |
| BLR (commercial banks, %) | 9.5 | 10.3 | 12.3 | 8.0 | 7.2 | 6.79 | 6.78 | 6.39 | - |
| Banking system loans (annual growth, %) | 28.2 | 26.5 | 10.2 | 1.3 | 1.6 | 0.1 | 5.5 | 3.6 | - |
| RWCR of banking system | 12.0 | 10.5 | 11.2 | 11.8 | 12.7 | 12.4 | 12.4 | 12.8 | - |
| Net NPL of banking system (% of total loans) (6-month classification) | 2.2 | 4.7[3] | 8.9[3] | 7.5 | 7.9 | 6.4 | 6.3 | 8.1 | - |

Notes: p = preliminary; f = forecast; n.a. = not available; [1] Refers to 2nd quarter, [2] Refers to 4th quarter [3] 3-month classification.
Source: Bank Negara Malaysia 1999a for June 1997-June 1999; 2001, 2002 for 1999-2001.

Table 3
Retrenchment of Workers According to Sector, 1996-1998

| Year | Total | % Change |
|---|---|---|
| 1996 | 7,773 | |
| 1997 | 18,863 | 143 |
| 1998 | 83,865 | 345 |
| | | % of Total |
| 1998 | | |
| Agriculture | 5,108 | 6.1 |
| Mining | 877 | 1.1 |
| Manufacturing | 45,151 | 53.8 |
| Construction | 9,334 | 11.1 |
| Electricity, gas and water | 1 | 0.0 |
| Transport, storage and communications | 2,007 | 2.4 |
| Wholesale and retail trade, hotels and restaurants | 10,434 | 12.4 |
| Finance, insurance, real estate and business services | 6,596 | 7.9 |
| Social services | 4,242 | 5.1 |
| Others[1] | 115 | 0.1 |
| **Total** | **83,865** | **100.0** |

Note: [1] Includes unclassified sectors.
Source: Malaysia 1999.

Table 4
Malaysia: Inflation Indicators Annual Growth Rate (%), 1997-2001

| | Weights | 1997 | 1998 | 1999 | 2000 | 2001 |
|---|---|---|---|---|---|---|
| | | Annual Change (%) | | | | |
| Consumer Price Index (1994=100) | 100.0 | 2.7 | 5.3 | 2.8 | 1.6 | 1.4 |
| Of which : | | | | | | |
| Food | 34.9 (33.8) | 4.1 | 8.9 | 4.6 | 1.9 | 0.7 |
| Beverages and tobacco | 3.6 (3.1) | 1.3 | 4.3 | 7.9 | 2.8 | 4.8 |
| Clothing and footwear | 3.6 (3.4) | -0.5 | 0.4 | -2.0 | -1.7 | -2.6 |
| Gross rent, fuel and power | 21.1 (22.4) | 3.2 | 4.4 | 1.6 | 1.5 | 1.4 |
| Furniture, furnishings and household equipment and operation | 5.6 (5.3) | 0.1 | 3.9 | 1.3 | 0.0 | 0.1 |
| Medical care and health expenses | 1.9 (1.8) | 3.6 | 6.2 | 3.1 | 2.0 | 2.9 |
| Transport and communication | 17.9 (18.8) | 0.6 | -0.1 | 0.5 | 2.1 | 3.6 |
| Recreation, entertainment, education and cultural services | 5.8 (5.9) | 0.4 | 3.3 | 2.6 | 0.5 | -0.1 |
| Miscellaneous goods and services | 5.6 (5.5) | 4.6 | 7.1 | 1.5 | 0.9 | 0.7 |
| | | | | | | |
| Consumer Price Index by Region: | | | | | | |
| Peninsular Malaysia CPI | 100.0 (81.6) | 2.8 | 5.5 | 2.9 | 1.7 | 1.5 |
| Sabah CPI | 100.0 (8.9) | 2.0 | 4.3 | 2.4 | 0.6 | 0.6 |
| Sarawak CPI | 100.0 (9.5) | 1.7 | 4.2 | 1.6 | 1.5 | 0.8 |
| | | | | | | |
| Producer Price Index (1989=100) | 100.0 (100.0) | 2.7 | 10.7 | -3.3 | 3.1 | -5.0 |
| of which | | | | | | |
| Local Production | 79.3 | 2.5 | 11.2 | -3.9 | 3.6 | -6.1 |
| Imports | 20.7 | 2.8 | 9.2 | -0.6 | 1.1 | -0.3 |
| | | | | | | |
| House Price Index (1990=100) | | 1.9 | -9.4 | 2.3 | 4.7 | 0.9[1] |
| of which | | | | | | |
| Klang Valley | | 4.4 | -11.2 | -10.2 | 12.4 | 0.4 |
| Johor Bahru | | 0.1 | -21.9 | -8.7 | 2.8 | -2.3 |
| Penang Island | | 1.3 | -11.5 | -8.2 | 8.3 | -3.7 |

Notes: [1] January-June
Weights in parentheses are for 2000-2001.
Source: Bank Negara Malaysia (2000, 2002).

**Table 5**
**NPLs Acquired and Managed by Danaharta**

| | 31 December 1999 | | | 31 December 2000 | | | 31 December 2001 | | | 30 June 2002 | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Gross Value (RM mil) | Value Paid (RM mil) | Discount % | Gross Value (RM mil) | Value Paid (RM mil) | Discount % | Gross Value (RM mil) | Value Paid (RM mil) | Discount % | Gross Value (RM mil) | Value Paid (RM mil) | Discount % |
| NPL acquired form : | | | | | | | | | | | | |
| Commercial Banks | 11,062.4 | 4,020.4 | 64 | 11,542.1 | 4,461.1 | 61 | 11,417.1 | 4,434.8 | 61 | 11,412.0 | 4,434.4 | 61 |
| Finance Companies | 3,938.7 | 1,938.5 | 51 | 4,312.4 | 2,049.5 | 52 | 3866.9 | 1,889.4 | 51 | 3867.0 | 1889.5 | 51 |
| Merchant Banks | 3,024.3 | 1,677.3 | 45 | 3,211.9 | 1,811.8 | 44 | 3,211.9 | 1,811.8 | 44 | 3211.8 | 1811.7 | 44 |
| Development Finance Inst. | 935.7 | 565.6 | 40 | 1,161.2 | 749.2 | 35 | 1,161.2 | 749.2 | 35 | 1161.2 | 749.1 | 35 |
| Offshore Banks | 123.1 | 104.7 | 15 | 123.1 | 104.7 | 15 | 123.1 | 104.7 | 15 | 123.1 | 104.7 | 15 |
| Others | 42.7 | 42.7 | 0 | 42.7 | 42.7 | 0 | 42.7 | 42.7 | 0 | 42.7 | 42.7 | 0 |
| TOTAL | 19,127.0 | 8,349.1 | 56 | 20,393.4 | 9,219.0 | 55 | 19,822.9 | 9,032.7 | 54 | 19,817.8 | 9032.1 | 54 |
| NPLs under Management : | 26,393.7 | | | 27,094.5 | | | 27,896.0 | | | 27,944.1 | | |

Sources: Danaharta, Operations Reports: Six months ended 31 December 1999, 2000, 2001 and Six months ended 30 June 2002.

## Loan Management Progress

| | | 31 December 1999 | | | 31 December 2000 | | | 31 December 2001 | | |
|---|---|---|---|---|---|---|---|---|---|---|
| No | | RM Billion | % | % | RM Billion | % | % | RM Billion | % | % |
| 1. | Restructured/Approved For Restructuring | 17.6 | 38 | | 35.83 | 74 | | 47.72 | 100 | |
| a. | Performing | 3.14 | | 18 | | | 9 | | | |
| b. | Fully Settled | 1.66 | | 8 | | | | | | |
| c. | Workout Proposal Approved | 12.59 | | 74 | | | | | | |
| d. | Plain Loan Restructuring | | | | | | 19 | | | 24 |
| e. | Special Administrators | | | | | | 8 | | | 11 |
| f. | Settlement | | | | | | 18 | | | 14 |
| g. | Scheme of Arrangement | | | | | | 16 | | | 18 |
| h. | Foreclosure | | | | | | 20 | | | 21 |
| i. | Legal Action | | | | | | 5 | | | 4 |
| j. | Others | | | | | | 5 | | | 8 |
| | | | | | | | | | | |
| 2. | Proposal Evaluated Pending Finalization | 2.51 | 6 | | | 3 | | | | |
| 3. | Proposal Submitted Pending Evaluation | 15.81 | 35 | | | 10 | | | | |
| 4. | Recovery Initiated Pending submission of Proposal | 4.14 | 9 | | | 11 | | | | |
| 5. | Recovery to be Initiated | 5.68 | 12 | | | 2 | | | | |
| | | | | | | | | | | |
| | TOTAL | 45.52 | 100 | 100 | 47.49 | 100 | 100 | 48.03 | 100 | 100 |

Sources: Danaharta, Operations Reports: Six months ended 31 December 1999, 2000, 2001.

Notes:

1. **Plain Loan Restructuring (PLR)** refers to restructuring which may include rescheduled loans,.partial cash settlement or asset disposal.
2. **Settlement** refers to cases where loans are disposed outright, or full and final settlement has been agreed and payment has been received or its pending
3. **Scheme of arrangement (SOA)** refers to a scheme under section 176 of the Companies Act 1965, a voluntary scheme of arrangement or a scheme under the CDRC.
4. **SA-scheme approved (SA)** refers to a Special Administrator scheme
5. **Foreclosure** refers to foreclosure of property under section 57 of the Pengurusan Danaharta Nasional Berhad Act 1998, and foreclosure of share collateral.
6. **Others** refer to cases of partial resolution, involving primarily redemption of collateral to reduce the amount outstanding pending final resolution.
7. **Legal action** refers mainly to accounts where all other recovery methods have been exhausted.

Table 7

**Expected Recovery from Loans Restructured and Loans Approved for Restructuring**

| | 31 December 1999 | | | 31 December 2000 | | | 31 December 2001 | | |
|---|---|---|---|---|---|---|---|---|---|
| | Loan Outstanding | Expected Recovery | Recovery Rate (%) | Loan Outstanding | Expected Recovery | Recovery Rate (%) | Loan Outstanding | Expected Recovery | Recovery Rate (%) |
| Performing Loans | 3.14 | 3.14 | 100 | 2.57 | 2.57 | 100 | | | |
| Plain Loan Structuring | 4.38 | 3.88 | 88.5 | 7.06 | 6.54 | 93 | 11.60 | 8.04 | 69 |
| Settlement | 3.57 | 2.57 | 72.0 | 6.34 | 4.86 | 77 | 6.87 | 5.19 | 76 |
| Scheme of Arrangement | 1.73 | 1.41 | 81.3 | 6.08 | 5.07 | 83 | 9.15 | 6.95 | 76 |
| SA –Scheme Approved | 0.37 | 0.19 | 50.7 | 2.50 | 1.54 | 62 | 5.55 | 2.46 | 44 |
| Foreclosure | 1.85 | 0.89 | 47.8 | 7.63 | 2.12 | 28 | 11.58 | 3.37 | 29 |
| Others | | | | 2.02 | 1.10 | 55 | 4.14 | 2.50 | 60 |
| Legal Action | | | | 1.63 | | | 2.05 | - | - |
| SA Pending Approval | 2.56 | | | | | | | | |
| | 17.61 | 12.08 | 68.6 | 35.83 | 23.80 | 66 | 50.94 | 28.51 | 56 |

Sources: Danaharta, Operations Reports: Six months ended 31 December 1999, 2000, 2001.

Table 8
Cumulative Progress of CDRC as at 31 December 2001

| | 31.12.2001 | | | |
|---|---|---|---|---|
| | RM mil | % | No of cases | % |
| Cases discharged | | | | |
| - Withdrawn cases | 7,427 | 11 | 13 | 11.6 |
| - Rejected cases | 2,642 | 4 | 10 | 15.1 |
| Subtotal | **10,069** | **15** | **23** | **26.7** |
| Cases accepted | | | | |
| - Outstanding | 18,038 | 27 | 12 | 14.0 |
| - Revised | 1,747 | 3 | 3 | 3.5 |
| - Resolved | 34,489 | 51 | 37 | 43.0 |
| - Transferred to Danaharta | 2,470 | 4 | 11 | 12.8 |
| Subtotal | **56,744** | **85** | **63** | **73.3** |
| Total referred to CDRC | 66,813 | 100 | 86 | 100.0 |

Source: CRDC 2002.

International Conference on
Economic Recovery and Reforms

# The Philippines

# Bank Performance and Rate of Economic Recovery: The Philippine Case

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## ABSTRACT

The paper sees imprudent lending by a weak banking system as an important and common cause of the East Asian crisis. The crisis-hit economies' banking systems had not put in place prudential rules and practices and their organization was subjugated to power politics and big business control. Many of their member banks engaged in imprudent connected lending which later turned up as non-performing loans, NPL. These have real and financial costs. Bad investments produce smaller or even zero value added thus slowing down growth. Banks' fund supply falls when loans do not get repaid. NPL also reduce banks' interest income and raise their collection and other transactions costs. The health of the Philippine banking system is analyzed in terms of aggregate and cross-section performance indicators such as sources and uses of funds, NPL/loan ratio, NPL/equity ratio and capital/asset ratio. Performance, as gauged from these ratios, varied widely across banks. NPL ratio ranged from 8% to 69%. Six banks had serious NPL ratio exceeding 20% and NPL/equity ratio much exceeding unity. Bank performance is not explained by size or state-private ownership. Two of the problematic banks were large state banks and four were private of varied sizes. The problematic banks composed a relatively small segment of the system so that their insolvency did not cause a systemic bank run. A core group of fairly strong private banks had existed and withstood the turmoil of the past three decades including the 1983-1985 economic crisis, the 1989-1991 recession and the Asian crisis. They had acquired a reputation of good banking. It appears that their presence had preserved the people's confidence in banking so that a systemic bank-run was avoided. Depositors did not react in a herding manner, they were discriminating in their response to the crisis and to the news of specific bank failure. NPL has contributed to the slow recovery of the economy as the banks are unable to increase credit and lower interest cost.

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The crisis-hit economies of Asia are recovering and exhibiting positive growth rates. However, the rate of recovery in most cases has been slow with the prospect for resuming their high pre-crisis growth path uncertain. All the affected economies are experiencing great difficulties in solving structural defects of their financial systems and the large non-performing loans of their major banks. We see the crisis as the expected consequence of very inefficient allocation of financial resources by financial systems that had not as yet instituted many of the basic elements of the Basle financial architecture. The architecture includes regular use of international accounting and auditing standards, legal framework for protecting property rights and enforcing financial obligations, prudential rules for banks and appropriate role and powers of central banks. Among Asian economies, only the Philippines, Malaysia and Singapore had adopted and applied international accounting standards before the crisis. At the same time, the crisis-hit economies' important financial institutions particularly banks were subjugated to the dictates of the governing power in politics and/or business. Connected banking of various forms was practiced by connected banks. In Indonesia, the Suharto government exercised direct influence on the state banks which dominated the system. In Korea, the chaebols had financial institutional arms. In Thailand, Malaysia and the Philippines, big business conglomerates also included banks and other financial institutions which functioned as their financial arm. The connected banks tended to make bad loans to the investment projects of their affiliate businesses. In many cases the projects were not chosen on the basis of their marginal rate of return and risk. The capital inflow into their economies merely increased the supply of resources of the connected financial institutions and powerful business groups. Foreign capital which was seen as a sign of approval by the international financial community was welcomed by their governments. That the massive foreign capital inflow overvalued the currency and penalized exports was generally ignored. By supporting the currency, the capital flow stabilized the nominal exchange rate and over-rated the expected rate of return on domestic assets. This further encouraged capital inflow, at least for a time.

The imprudent lending by connected banks meant fund allocation to bad investments which later on manifested themselves as non-performing loans. The reckoning of the true state of the economy instigated a capital flow reversal that resulted in very large devaluation of the currency and the crisis. The devaluation inflated the liability of the financial institutions and other sectors that borrowed from abroad. This worsened the ability of firms to pay their loans thus worsening the NPL problem. The banks which borrowed abroad likewise incurred losses. The NPL reduced the banks' supply of loanable funds, profits and net worth. The NPL also diminished their reputation or goodwill making them less attractive to depositors. Solving the NPL problem has proved difficult for all the affected Asian economies. Stiglitz (2001) discussed a number of issues related to NPL. There are management problems of how to minimize the cost of disposing NPL. Viable projects have to be distinguished from non-viable ones with the intent of saving the former and preventing fire sales for the latter. The assets have to be correctly valued. The agent for managing NPL has to be chosen, should it be a government agent, an independent private group or the affected bank itself. There are also refinancing issues - which banks to close, which to be refinanced and where to obtain the funds. The recession has reduced both tax and private saving sources for refinance. Foreign capital still hesitates to come back to the affected economies. The third issue relates to moral hazard that government assistance and policies might foster.

The needed financial reforms are proving to be difficult and slow to implement. Putting in place the Basle financial architecture is a slow process as it starts with learning and putting into extensive practice international accounting and auditing standards, legislating corporate and banking legal structure including developing judicial capability for enforcing and settling financial conflicts, reorienting central banking and strengthening its capability for enforcing prudential banking rules and practices. Solving defective and non-competitive structure of the banking system and large NPL has been a difficult and complex challenge. It has taken Korea four years to finally solve the insolvency of its banking system. Japan, Thailand and Indonesia have not settled the NPL of their major banks. The Philippines has settled only one of four insolvency bank cases.

The paper analyzes the financial turmoil, especially the NPL problem, that the Philippines experienced following the Asian crisis. It is noted that at the onset of the crisis, the Philippines appeared to be in a relatively strong position to withstand contagion for it had already undertaken major structural reforms in the banking sector. The experience with a deep crisis in 1983-1985 of a similar depth and causes as the 1997-1999 Indonesian crisis had prodded the government to adopt major reforms. The crises in both countries involved the toppling of an authoritarian and rapacious president. Major reforms in trade and industry, the public sector and the banking system had been undertaken by the new Philippine administrations over the 1986- 1995 period. The banking system had been tremendously strengthened. Most indicators in 1995-1996 were favorable. The NPL ratio was only 2.8%, the banks' asset/capital ratio was 12%, the current account to GDP ratio was -4%, the national budget had a small surplus. However, the statistics did not reveal the imprudent connected lending that a number of banks had made. The unproductive investments which they financed later revealed themselves as NPL. The large devaluation that accompanied the crisis worsened the NPL problem as the firms which borrowed abroad suffered losses from the inflation of their foreign liability. At the same time interest rate rose as the central bank adopted a deflationary policy and as the short-term capital flow reversed its direction and reduced the level of domestic credit. The NPL ratio doubled the following year and has continued to rise since 1996 reaching 18.4% in May 2001 (Philippine Daily Inquirer, July 8, 2002). The NPL are pulling down the rate of recovery. While GDP growth quickly turned positive from -0.6% to 3.3% in 1997-1998 to 1998-1999 it has remained at less than 4% since then. The downturn in Japan and the US, the country's most important trading partners, contributes to the economic slack. The banking system has stagnated with its loans growing at virtually zero rate. The stock market fared even worse with prices and value of transactions continuing to fall.

The paper traces the movement of key financial variables during the post-Marcos period from 1986 to 2001. We looked into the response of the financial market to the structural reforms undertaken during the period and how imprudent bank lending had crept up again. A cross-section analysis of banks shows significant variation in their performance. There were prudent banks and very imprudent ones. The economy was fortunate to have a core group of private banks that have behaved prudently through various political regimes. They sustained the banking system by preventing a mass bank run through the two crises. The paper also discussed central bank policies relating to the crisis and the remaining weaknesses of prudential rules.

The paper is organized as follows: Section 2 briefly analyzes the real cost of imprudent lending. Section 3 gives a brief history of structural reforms and their impact on intermediation activities of banks. Section 4 looks at the performance of individual banks and assesses the health of the banking system as whole. It also illustrates cases of imprudent lending by specific banks. Section 5 gives the dimension of the NPL problem and its implications on the recovery of the banking sector and its competitiveness. The concluding remarks in the last section discusses policy issues.

## Section 2 - The Real Cost of Imprudent Lending and Speculative Portfolio Investment

Inefficient lending and financing imply inefficient allocation of real resources. Imprudent lending of connected banks has real counterparts in bad investments. The real impact on the economy is seen in Figure 1 below. Consider an aggregate investment opportunity curve AB with a competitive domestic saving-investment equilibrium at point X, with a rate of return = marginal rate of time preference equal at r(1). Let us assume a liberalized capital market with foreign interest rates being lower than domestic rate. Capital inflow would push the level of domestic investment to point Y where the marginal rate of return equals foreign interest rate $r_f$ All is still well and the economy realizes consumption in year 2 at $C_{23}$, from $C_{22}$. In a competitive system, capital inflow will stop at this level. Sovereign guarantees and irrational exuberance on the part of foreign investors may lead to a larger capital inflow than the optimal level. The misallocation would be exacerbated if the capital flow is channeled to connected banks and their businesses. Their privileged access to funds leads to a concentration of fund in their businesses, hence a lower marginal rate of return. This tendency is observed in the crisis-hit economies particularly Korea and Indonesia. It is also the case in Japan.

Financing bad investments inevitably results in NPL and slower economic growth. Bad investments would not generate sufficient income to pay for the user cost of capital - interest costs and depreciation or even the amortization of principal. From the national accounting framework, bad investments contribute little or zero to GDP growth. The negative impact of inefficient financing may not manifest itself in the short-run during which the positive multiplier effect of the investments is operating. The multiplier effect may be prolonged when the current growth of income further attracts new investments. But in the long-run, the low or negative returns on investment will manifest themselves as NPL. The Japanese and Korean recessions are the long-run reckoning of the cumulating bad investments in the past.

The presence of foreign capital complicates the results as the distribution of losses may be biased against domestic investors. It appears that the burden or cost of the currency crisis was born largely by the domestic party to the foreign transactions and less by the foreign sources of the capital. There are four types of capital flows - FDI, long term loans, short-term loans and portfolio investments. Clearly profits and loses are directly borne by the FDI source. Because of implicit sovereign guarantees on loans, asymmetric stock market information and asymmetric currency hedge, domestic agents tend to bear most of the risk or burden of losses from foreign capital inflows. Consider stock price changes. Stock price changes may arise from changes in corporate performance or from speculative attacks. An increase in the profitability of a corporation raises its stock price, losses have the opposite effect. The stock holder gains or losses from the real changes. Price changes due to speculative attack in the market results in wealth redistribution between buyers and sellers. The huge portfolio inflow into the rather small and underdeveloped stock markets of the crisis-hit economies resulted in large losses for many domestic financial investors. The large foreign institutional investors have a comparative advantage in obtaining information and economies of scale in diversifying their portfolios. They manage very large funds. It is likely, therefore that they gained at the cost of domestic investors. Or if they lost, their losses would not have been as much as the losses of the small domestic investors. In the case of the short-term loans, the foreign lenders lost less since their loans were denominated in foreign currency. The domestic borrowers were left to bear the currency losses that inflated their foreign liabilities. They also faced higher interest rates for their loan repayment.

Banks are profit-making firms. They borrow to lend and they generally borrow short at some interest cost and lend long at a higher interest rate. The interest rate differential provides them with a margin of profit. The balance sheet of a bank consists of assets, principally loans, liabilities from funds borrowed in the form of deposits and other liabilities and equity. The supply of loanable funds comes from funds flowing in from new deposits and other liabilities and repayment of loans. When a loan turns bad, its amortization and interest income stop. Fund supply falls. The problem worsens if the bank's reputation suffers because of the presence of NPL for it will be less able to attract new deposits or retain outstanding deposits.

**Section 3 - The Philippine Experience**

There were marked differences in the economic performance and the conditions prevailing at the onset of the crisis between the Philippines and the three crisis-hit economies - Korea, Thailand and Indonesia. The Philippine had had a much inferior economic performance with lower and more volatile growth rates which made it less attractive to foreign capital. Capital inflow was not as massive as in the other economies. (Table 1) Political uncertainty and poor governance had prevailed through two decades of the Marcos dictatorship, from 1965 to 1985. The regime was as repressive as it was rapacious, taking capture of both public and privately owned resources and businesses. The people power revolution toppled the dictatorship in

February 1986 but the achievement was followed by great hardship. The new government of Cory Aquino was challenged by a series of coup attempts from Marcos followers with the last one in December 1989 almost succeeding. The economy inherited large foreign debts and insolvent government financial institutions (GFI). It had to recover from a deep recession when GDP annual growth dropped by -7.3% in two successive years from 1983 to 1985. The recovery from the 1983-85 crisis was fast and appeared strong until it was reversed by the 1989 coup attempt. It created political uncertainty which was exacerbated by major calamities - a strong earthquake and the eruption of Mt. Pinatubo, and the Gulf War. Again a recession set in with growth dipping from 6.2% to 3.0% to -0.6% over the 1988-1991 period. Recovery was slower this time and before growth could stabilize at its long-run level of 5-6%, the Asian financial crisis spread to the country, once again pulling down growth rate to a negative level, -0.6% in 1997-1998. Growth turned positive the next year but it has remained at a relatively low level, 3.3%, 3.9% and 3.7% in the next three years. The country's growth fundamentals particularly the saving rate and the population rate have not been very strong, averaging less than 20% and 2.3%, respectively, in the 1990s.

The last recession was not as deep as had happened in the neighbors. When the Asian crisis started, there was much optimism that the economy would be able to avoid its contagion. Macro fundamentals and financial indicators were encouraging.[1] Moreover, the country had already undertaken substantial and fairly comprehensive structural reforms covering trade and industry, industrial organization, and banking. The historically high and highly differentiated tariff râtes were drastically lowered and simplified and almost all non-tariff barriers were abolished. The more than 300 government corporations created during the Marcos dictatorship were privatized. Some important monopolies, especially in transportation and communications, were dismantled. Major banking reforms were undertaken.

[1] Tan, E. wrote in 1999 that the Philippine crisis could have been prevented if the central bank and the national government did not follow the IMF prescription of adopting recessionary monetary and fiscal policies which exacerbated the effects of the capital flow reversal. At the time of writing, the NPL problem had not yet emerged.

The banking reforms were instigated by the very palpable fraudulent financial transactions made during the Marcos regime that left the country with a large external debt, unproductive investments and large NPL in the then dominant government financial institutions, GFI. The GFI included the Development Bank of the Philippines (DBP), the Philippine National Bank (PNB), the Government Service Insurance System (GSIS) for state employees and the Social Security System (SSS) for private employees. The two banks were the largest in the banking system and the GSIS and SSS, the largest in the insurance industry. Marcos directly made demands on the GFI to provide financing for his and his cronies' projects, hence the term "behest loans". Many of the behest loans were never intended to finance projects but were simply ways of appropriating funds. The practice became known as "front-ending" i.e., propose a project with little or no collateral upon the behest of the President, pocket the loan proceeds and invest a small fraction for show. The state banks' loanable funds were largely sourced from the central bank's rediscount window and foreign borrowing. Government agencies, including the central bank, were the main foreign borrowers then. The funds indirectly financed capital flight estimated to have reached $10billion in 1986, the equivalent of a year's export at the time. The GFI loans inevitably ended up as NPL. There remained many failed businesses. At the time of reckoning under the new government of Cory Aquino, the NPL ratio of PNB was 35%, GSIS, 50%, DBP, 65%.[2] Their NPL comprised the bulk of the system's NPL. Additionally, many small private unit banks consisting of rural banks and individual development banks which had been dependent on central bank rediscounting window also acquired relatively large NPL. The policy then was for the central bank to rediscount their loan papers at minimal interest rates. The window provided a good opportunity for financial capture so that many small rural and development banks were established in order to have access to it. A few crony private commercial banks which also obtained favorable central bank credit also failed.

[2]The SSS was headed by a man of strong will and integrity who negated the President's behest. SSS was the only GFI that preserved its solvency during the Marcos years.

It is noteworthy that in this profligate environment, a core group of private commercial banks separated themselves from the abusive system and functioned as regular banking intermediaries. The group had developed a fairly solid reputation of good banking and formed a segment that was large enough to preserve confidence in the banking system, thus preventing a massive bank run. The insolvency of the state and crony banks did not endanger collapse of the system for being dependent on central bank funding, they had little deposits to run away with. In 1985 the loan deposit ratio was 850% for state banks, 230% for rural banks and 110% for private commercial banks. Government deposits comprised the bulk of the GFI deposits. Since they undertook marginal intermediation functions they were perhaps viewed by the public as merely a source of privileged credit. While they did not cause a bank run, their bad loans entailed real losses to the economy for the funds could have been allocated to productive investments.

A series of major banking reforms were undertaken over the 1986-1995 period. The Cory government was faced with the choice of closing the insolvent state banks or restructuring their portfolio to their net worth. The latter was chosen with a proviso that henceforth they were to mobilize their own funds and no longer rely on central bank credit. Central bank development lending and currency swaps were stopped. The Asset Privatization Trust was created to take over and manage the GFI's NPL. The resources and net worth of DBP and PNB were reduced by the removal of the NPL. This decision had the important result of reducing the relative importance of state banks; their share in the total assets of the banking system fell from 19.9% in 1985 to 3.2% in 1987; their total resources dropped from P77 billion to P25 billion. Entry of domestic banks and branching was relaxed.

The Ramos administration completed the reforms though the sequence may be questioned. It fully liberalized currency and capital transactions quite early. (1992). In 1993, the central bank was made independent of the executive by limiting the representation of cabinet members in the Monetary Board from 5 to 2 out of 7. The new central bank called Bangko Sentral ng Pilipinas, BSP was to be responsible mainly for maintaining price and exchange stability. Its economic development role, which had been abandoned earlier, was officially removed by the law. In 1994, foreign bank entry and branching were relaxed. Previously only four foreign banks which obtained their licenses in the 1950s and 1960s had been allowed to operate. They could not expand their branches beyond a handful located in Metro Manila. The new law allowed 100% foreign equity in banks which in the beginning were to be limited to 10. Foreign banks could establish more branches, merge with domestic banks and have controlling interest in any of them. Bangko Sentral was concerned about the large number of banks and their small sizes. It raised minimum equity levels for different bank categories several times: universal banks from P1 billion in 1990 to P2.5 billion in 1995, to P5 billion in 1999. The corresponding figures for other commercial banks are P500 million, P1.25 billion and P2.4 billion.

The reforms had many positive impact: entry of a large number of foreign banks and branches, an acceleration in intermediation activities, reduction in deposit-loan margins and introduction of modern technology in bank services and clearing. (Table 2) The number of foreign bank branches increased by 7 between 1995 to 2000. In addition to the branches are 5 subsidiaries of foreign banks. M2/GNP[3] ratio which stagnated at around 20% from the mid 1960s to 1985 began to rise and reached 43.3% in 1997. The recent crisis reversed its upward trend and pulled it down to 39.4% in 2001. The financial asset/GNP ratio rose from 70.9% in 1986 to 134.1% in 1997; it also fell afterwards dipping to 106.3% in 2001. The insolvent small rural banks and private development banks were closed down, and the rest encouraged to merge or be taken over by larger and solvent commercial banks and thrift banks. Bank capital grew at two-digit rate over the 1986-1997 period. The number of banks fell slightly so their average equity rose while their branch network expanded. The intermediation margin decline initially in 1986-1990 but the 1990's financial turmoil has disrupted positive developments in the system. Unite and Sullivan (2002) found the margin declined only in the conglomerated banks in1990-1998.

[3] $M_2 = M_1$ + saving deposits + time deposits. Deposit substitutes comprise less than 5% of total deposits and when added to the $M_2$ equals $M_3$. The $M_2$ and $M_0$ definitions are not as expansive as those in the US which has more diversified liquid assets.

President Ramos (1992-1998) was able to foster political stability and a sense of a competent government. This encouraged capital inflow. From a low base of only $81 in 1986, net inflow rose quite rapidly starting in 1989. (Table 3) Large-scale capital inflow started only in 1994 as the net inflow rose from $4.4billion to $11.1billion in 1995 to 1996. Previously, the net inflow comprised mostly of medium and long term loans and FDI. In 1996, the latter comprised only 30% of the total inflow. The short-term flows in 1996 consisted of portfolio investments, short-term loans by non-bank and bank borrowing (reported as commercial bank net foreign account). The net foreign assets of banks (NFA) jumped from $1.6 billion to $4.2 billion. Portfolio investments were first reported in 1996 at $2.101 billion. The reversal in 1997 and 1998 in the short-term accounts was drastic - from a positive $7.714 billion to -$.416 billion, then to -$5.820 billion and -$2.038 in 1998 to 1999. Bank borrowing comprised the bulk of the short-term flows. They included foreign currency deposits (FCD) by residents and foreigners. Previously FCD could not be lent out but beginning in 1992, banks were allowed to lend them, partly in domestic currency. These loans entailed currency risk on top of the ordinary credit risk. The drastic reversal of the short-term flows had had its expected impact - currency depreciation, reduced fund supply, high interest rate and inflation of liabilities of the foreign currency borrowers, all hurtful to the banks, their borrowers and the real sector.

The capital inflow substantially increased bank lending. Table 2 shows that the growth rate of commercial bank loans outstanding accelerated during the 1992 to 1996 period and drastically decelerated afterwards; in 1994-1995, growth was 40.7%, in 1995-1996, 61.9% and in 1996-1997, 26.5%. Growth was negative in 1997-1998, and only .4% in 1998-1999, high at 7.2% in 1999-2000 but fall to -1.5% in 2000 -2001. Portfolio investments from abroad intensified the rising activities in the stock market. Table 2 shows a rapid rise in the value of transactions and stock price during the 1990-1996 period. The value of transactions jumped by 77% and the price level by 22% in 1996 to 1997. The reversal of the portfolio flow had the expected negative effect on the stock market with both the value of transactions and prices falling substantially. The stock market, like the banking system has not recovered until now (July 2002)

**Section 4 - Non-Performing Loans Across Banks**

Non-performing loan and non-performing asset ratios (NPL/total loans and NPA/total assets) are used here to gauge the health of banks. Bangko Sentral uses a rather strict definition of non-performing loans (NPL), i.e., loans whose principal and/or interest has not been paid 30 days or more after its due date (BSPa). The NPL ratio was quite low in 1996, 2.8%, but has continuously increased since then. It nearly doubled to 4.9% in 1996-1997, then again in the following year when it reached 10.3% in 1998. The ratio was 16.9% at the end of year 2001 and is now 18.4%. The current rate is still low relative to the other last Asian economies though its continuing rise is worrisome. The NPL ratios were about 80% in Korea, 40% in

Thailand but only 10% in Malaysia (Dekle and Fletzer 2002)

It is helpful to see the problem at the micro level, i.e., at individual banks. We find the NPL problem to be non-systemic but isolated in specific banks. The wide variation in the condition of banks including their NPL ratio seems to reflect differences in behavior particularly in their business identity and objectives. Some banks seem to see themselves primarily as banking enterprises that aim to develop and survive as banks. Such banks would have a long time horizon of operation, cultivating a reputation as reliable trustees of the people's saving and wealth. This core group of banks had withstood three decades of economic and political turmoil. They did not join the political banks in the capture of central bank development funds and other privileges. The presence of these banks had exerted a great stabilizing influence on the banking system, preserving depositors' trust in the system and preventing a systemic bank run. Nevertheless the core banks also suffered from the crisis, they also incurred high NPL though these are sufficiently covered by their networth.

The annual growth of deposits and outstanding loans averaged 23.8%% and 33.1% respectively in 1990-1996. (Table 2) In these years, all the commercial banks had capital-asset ratio greater than the Basle level of 8%, ranging from 10.0% to 15.0% (Table 4) The banks, however, had varying profitability rates as reflected in surplus to equity ratio and surplus to asset ratio which ranged, respectively, 12.5% to 39% and 4% to 12%. It is noted that the banks that became insolvent after the crisis did not show inferior surplus ratios. Ordinary balance sheet and income statements were unable to indicate quality of a bank assets and liabilities. The latter are not distinguished by currency and so do not indicate currency risk.

The bad loans made during the credit bubble of the first half of the 1990s manifested themselves as NPL after a lag of three- to- five years. The NPL ratio in end of 2001 ranged from 8.9% (China Trust) to 69% (Westmont Bank). (Table 4) Bank size and ownership structure do not seem to explain the NPL ratio for there were large and small banks and private and state banks that incurred high NPL ratio. The solvent banks include the same mix. Three small private banks became insolvent: Westmont Bank (United Overseas Bank, Philippines), Urban Bank and Orient Bank. The Philippine National Bank (PNB), with NPL ratio of 46%[4] was the sixth largest bank with equity of P186 billion. It was a state bank until 1996 when it was partially privatized. Then in 1998 its controlling interest was acquired by Lucio Tan, a crony of President Estrada. (He took over in July 1998 and was deposed in December 2000.) The Land Bank of the Philippines, a state bank and the fifth largest in the commercial banking system, had NPL ratio of 25.1%. The Equitable-PCI Bank, a large private bank had NPL ratio of 32.9%. Equitable Bank and Philippine Commercial and Industrial Bank were fairly strong banks that never had a problem until their politically assisted merger in 1998.

Anecdotal stories give some insights into the irregular lending made by the problem banks. The anecdotes were culled from business reports in major newspapers since

[4]The Banko Sentral website gives PNB's NPL ratio at 46% but the bank's published information gives a figure of 53% (Philippine Daily Inquirer, July 22, 2002).

official reports were unavailable. The reports show different forms of imprudent transactions including DOSRI loans (to directors, other officers and related individuals of the bank), politically connected loans and more ordinary frauds committed by bank officials.

1. PNB has had a checkered history of connected banking and insolvency. It is the oldest state bank founded in 1916 under the US colonial government to service the financial transactions of the government. It issued the Philippine currency which was convertible to the US dollar at P2/$1. From the 1950 to 1985 it had functioned as a development financing arm of the national government. As a state bank it was a depository of government funds. It had been a source of privileged credit for the country's political and business elite. ( Hutchscroft 1998). It appears that the bank had ingrained a habit of privileged or connected banking which its partial privatization in 1989, 1992 and 1998 failed to remove. PNB shares were first sold to the public in 1989 and again in 1992. The bank had rightly assumed central bank guarantee against closure because of its size and (partial) government ownership. It was not closed down in 1986 when it was found insolvent. It is not being closed down even if its NPL has exceeded its equity by 160%

In the first year of Estrada administration (1998) Lucio Tan, his crony, acquired controlling interest in the bank but with the government retaining about 16% of its equity. It is not clear how much Tan actually invested in the bank. Just before his acquisition, the bank issued new stocks. The bank lent to its Employees Retirement Fund in order to buy a block of the new issues. Through the President's help, Tan obtained the voting rights of the Retirement Fund shares which he used to gain controlling interest. (Torrijos, PDI May 23-24, 2001, Business World, June 4, 2000) Until 1996, the bank's condition appeared relatively strong. Its equity to asset ratio was 11%, its deposits and loans were growing at 21% and 24% annually on average from 1990-1996. These rates were comparable to the growth rates of the other large banks such as Metro, Bank of the Philippine Islands and RCBC. (Table 4). It reported profits until 1997, then losses afterwards. In year 2001, the bank declared losses of

P11 billion that reduced its equity by almost half. The losses have not been explained how these were incurred. They could be through front-ended DOSRI loans, a sophisticated form of looting. Tan's acquired Philippine National Airline was reported to owe PNB P9 billion (Villamor and Lucas, PDI). The central bank and the Philippine Deposit Insurance Corporation (PDIC) provided it with emergency loans of P15billion and P10 billion, respectively. The bank has remained open but its level of intermediation has been drastically limited by its NPL problem.

2. Three private commercial banks were declared in difficulty by the Bangko Sentral: Orient Bank, Westmont Bank and Urban Bank. Orient bank was placed on receivership after it was found to have reported investments in fictitious companies and made DOSRI loans that turned bad. It was closed down immediately with the case now in court. Westmont Bank made heavy investments in its sister investment company, the Westmont Investment Corporation which concentrated lending in property. The bank obtained emergency loans from the Bangko Sentral while negotiating its sale to United Overseas Bank of Singapore. The bank has been allowed to remain open pending the negotiation which had dragged on for four years. The Singapore bank was reported to have finalized Westmont Bank's full takeover. (Business World, July 4, 2002).

3. Urban Bank's trouble began when it bailed out its affiliate, Urbancorp, by buying more than P4.5billion of its loan receivables which BSP later considered to be 'garbage' receivables. Urbancorp used Urban Bank funds to invest in property. The property investments include Urban Bank Plaza, high-rise buildings in Fort Bonifacio, and Puerto Azul, a resort built during Marcos time that was already bankrupt at the time of Urban Bank purchase. (Dancel, PDI, May 8, 2001) Apparently Urban Bank had special relations with GFI. Land Bank's Provident Fund kept P400 Million deposits in Urban Bank and lent it P600 Million, half of it when Urban Bank was already in difficulty. The SSS Retirement Plan had P171 Million exposure to UB and owns 15% of its equity. The GSIS originally financed the Panlilio Group that invested in Puerto Azul. The loan had reached P14 billion (C.

Batino Business World May 5, 2000.) Note UB gave Puerto Azul P450 Million loan a day before UB declared a bank holiday. High government officials who were reported to be large depository clients of UB were allowed to withdraw their deposits a few days before the bank holiday. Despite all these doubtful transactions Bangko Sentral gave the bank an emergency loan of P30 billion. UB is still on receivership.

4. The SSS and the GSIS made loans and investments at the behest of President Estrada. (Dumlao, PDI June 11, 13, 2001, Business World, November 2, 1999) SSS' investment in Belle Corporation, the developer of Tagaytay Highlands, a luxury resort/real estate. It is illustrative of how SSS funds were misused to funnel funds to the President and his cronies. SSS was pressed to invest P745 Million in shares of stock of Belle Corporation. SSS' recorded purchase price was higher than the prevailing market price with the difference allegedly given to the President. In December 1998, SSS recorded a purchase of 149 million shares at P3.10 when it was trading at P2.10. On March 20, 2000, SSS held 476 million shares at average acquisition cost of P.69 though its closing price was P.59. The acquisition-market price differential in the two transactions amounted to P150 Million and P47.6 Million, respectively, or a total of P197.6 Million. This was the alleged commission of the President. Moreover, SSS was pressed to extend P375 million loan to the company. In 1999, SSS reported losses for the first time in its 44 year history. It had to borrow from the Land Bank, the Philippine Health Insurance and First Metro Investment Corporation, the first two being government institutions. SSS admitted it lost P813 million of its P50 billion investments in publicly listed stocks. In 2000, 28% of the investments were still locked in 24 corporations awaiting better prices. In the meantime they earn zero or minimal returns and have large paper losses. SSS and GSIS funds are also being eroded by high administrative cost. Scandalously high salaries and perks have been reported.

5. Both GSIS and SSS were pressured to provide funds to Equitable Bank to help it acquire Philippine Commercial and Industrial Bank (PCI). (Gaylican, PDI August 14, 1999) Equitable Bank and PCI were fairly strong banks that survived

and grew until their politically assisted merger in 1998. The assistance appears to be in exchange for money laundering services. Evidence in the impeachment proceedings against Presidetnt Estrada showed Equitable-PCI acted as a conduit of his loot from jueteng and other sources. The Bangko Sentral provided the merged bank with an emergency loan of P30 billion when it suffered a liquidity problem during the impeachment proceedings against President Estrada. There were increased withdrawals of deposits during the hearings when evidence of laundering of the President's deposits was being presented. The loan has been repaid and the bank has resumed normal operation.

6. Some banks including the more solid ones made large loans to projects of questionable social value. The Mondragon Leisure Resorts Corp. obtained a loan for P4.5billion for a tourist and gaming resort project in the abandoned U.S. Clark Airbase in Pampanga Province. (The 1986 Constitution prohibits foreign military basis in the country.) The airbase was badly damaged by the Pinatubo Volcano and its surrounding area is still covered by lahar or volcanic ash. Its only attractive feature is the presence of the abandoned US airport infrastructure. Pampanga has no natural scenic resources and the volcano is still active and can erupt again anytime. But four banks provided Mondragon with a colossal loan -Far East Bank, Asian Banking Corp., United Coconut Planters Bank and Metropolitan Bank and Trust Company. Three of these banks - FEBT, UCPB and Metro - are important banks in size and reputation. It appears that the company had intended to front-end the loan, i.e., immediately appropriate the loan proceeds and make token investment in the loan project. The company did not even pay the rental of the land and the gaming share to the government. According to the Clark Development Corporation President Rufo Colayco, Mondragon spent only about P2.0 billion of the loan proceeds. (G. Cabacungan, PDI, Jan. 8,1999) There were rumors the money was invested abroad. Another case that got to the papers was a P7 billion syndicated loan to Uniwide Retail Store. Important banks provided large loans - Equitable for P1.73 billion, RCBC for P1.34 billion, UCPB for P995 million, PNB for P611 million and Land Bank for P588 million. Six other banks

gave the balance. We have no report on how large property developments such as the Rockwell, the Fort Bonifacio, the Enrile Enterprises, the Villar Metropolis and the Amari Land Fill were financed. They must have absorbed a large fraction of domestic credit and account for a large share of the banking system's non-performing assets. Bangko Sentral reports that the bulk of the NPL came from only 161 large loans. (BSPa) The media recently reported a Senator owing PNB P300 million and the Lopez group that owns Rockwell a total of P30 billion to various creditors.

**Section 5 - Perspective of NPL**

As stated earlier, the problem banks did not form a large enough segment to cause a system-wide bank run and banking collapse. Confidence in the banking system was preserved as the anomalies were blamed on a small number of banks. By identifying the failing banks and discussing their problems, the news media helped put their relative importance in perspective, isolating them from the rest of the other banks. For this reason the threat of a bank run did not materialize. However, the high level of the NPL and their distribution across banks have implications on the future development of the banking system and its competitiveness.

The value of NPL was 7.9% of GNP and the NPA, 12.9% in 2001. (NPA = NPL + acquired assets from NPL.) (Table 5) It is reasonable to assume that actual losses in output would be a fraction of the NPL and NPA since some of the assets are possibly viable and majority have some market value. Some repayment of the NPL may be expected. The NPL are concentrated in 11 commercial banks which hold 51% of the banking system's NPL and 30% of its assets.[5] The problem banks comprise a minority in terms of numbers, 11 out of 44 commercial banks. Of the 11 troubled banks only four have not resolved their NPL problem - PNB, Orient Bank, Urban Bank and Land Bank. PNB's NPL to equity ratio was 260% at end of 2001. Its new President (Lorenzo Tan) reported in the papers that the bank is being rehabilitated and

[5] Table 4 does not include Urban Bank and Orient Bank which were closed down soon after their insolvency was confirmed by Bangko Sentral.

would start earning profits in four years time. Details on the rehabilitation plan were not spelled out in the papers. Its emergency loan of P25billion from the Bangko Sentral and the Philippine Deposit Insurance Company has not been repaid but is being extended in order to support the bank's rehabilitation. Two relatively large banks - Land Bank and UCPB also have equity to NPL ratios of 135% and 258% respectively. As a state bank, Land Bank might be viewed as possessing central bank guarantee against closure. Moreover, it can depend on a steady flow of deposits from government agencies and continue operating even with the heavy NPL burden. Government deposits comprised more than 69% of its total deposits in 2001. These guarantees will allow the bank to continue making imprudent lending. About six other banks with relatively high NPL ratio have been able to survive and function normally. All except UCPB have NPL/equity ratio of less than 1.0.

As discussed above, the NPL reduced the supply of funds, raised the cost of lending and reduced the profit rates of banks. The slowdown of the economy after the crisis had exacerbated the problem by also decreasing the level of saving and other excess funds that banks could intermediate. Table 2 thus shows how much the growth rate of deposits and loans have fallen since the crisis. The growth rate of loans outstanding of commercial banks dipped from 26.5% in 1996-1997 to -4.8% in 1997-1998. Loans had hardly recovered from the 1996-1997 crisis when their growth swung from .4% to 7.2% to -1.5% during the 1998-2001 period. Deposits performed better than loans, growing more steadily at 6.8% on average after the crisis. Expectedly the better performing banks or those with relatively low NPL ratio attracted more deposits and provided more loans than the problematic banks. Three banks stand out in terms of deposit growth - the Bank of the Philippine Islands, Banco de Oro and China Trust. Their NPL ratios were, respectively 15.1%, 11.2% and 8.9%, much lower than the average rate of 18.4%. But Metro Bank and Prudential Bank which have relatively high NPL ratios of 18.1% and 25.8%, respectively experienced high deposit growth of 16%. Metro Bank is the largest domestic bank that caters to Chinese Filipino businesses. Its NPL/Equity ratio was 62%. Prudential Bank NPL arose from an isolated case of fraud by its officials. It is owned by the Catholic hierarchy of Manila. It has a relatively low NPL/Equity ratio of -56%.

The cross section data presented above lead us to conclude that the banking system has stabilized and that majority of the commercial banks have been able to manage their NPL. The NPL will, however, continue to drag down the growth of the system's intermediation activities. They will continue to slow down the flow of loanable funds from loan repayment and increase intermediation cost. Moreover, the variation across banks of the NPL ratio will dampen competition across them. Those with heavy NPL will not be able to compete well with those with low NPL ratio. The former would have a slower rate of repayment flow, higher cost and lower profit rate. As happened in the post- 1983-1985 crisis, rearrangement of the relative position or importance of the banks may be expected. The strong ones willl tend to attract more depositors, give more loans and offer better terms. This may results in a higher concentration ratio unless entry of new banks and new branches is able to counter the advantage of the existing strong banks.

**Section 6 - Bangko Sentral Policy**

The discussion raises several policy issues relating to a) prudential rules on disclosure and effective supervision and monitoring that set prompt signals of anomalous transactions, b) moral hazard fostered by BSP bailouts c) personal responsibility of bank officials for their portfolio decisions, and d) rationale for GFI. The anomalous transactions described above definitely reflect weaknesses of prudential rules and BSP-PDIC supervision. The anomalous transactions that reached billions escaped BSP supervisors. BSP failed to take note of the giant loans especially those going into property development, gaming and shopping centers. It did not question the large deposits that were flowing into selected and known crony banks. BSP has not instituted an electronics monitoring system which would allow it to promptly track irregular transactions. It inspects banks once a year at pre-announced schedule allowing them to produce good accounts. BSP looked into end of the year financial reports which can be beautified. Little can be read from balance sheet data since they do not reflect irregular transactions.

BSP has no definite stand on bailouts. Its bailout was selective favoring state banks and large connected banks – PNB, Equitable-PCI, Urban Bank. This practice fosters moral hazard of the worst kind encouraging corrupt officials and finance managers to connive to raid financial institution. While it condemned the so called garbage loans of Orient Bank and Urban Bank it was silent about the garbage loans of PNB and Land Bank. It continues to support the clearly bankrupt PNB and places no sanction on the high NPL of Land Bank. It is in fact insolvent with its NPL also exceeding its equity.

There is no clear accountability by bank officials for their portfolio decisions. Federico Pascual of GSIS and Renato Arellano of SSS admitted to succumbing to the pressure by President Estrada to provide loans to his cronies. They were entrusted with the pension funds of employees and ought to be accountable to them. The officers of PNB and Land Bank should be held responsible for their banks' high NPL. Narvasa, a former Supreme Court justice, was PNB board chair when many of its NPL were granted. His closeness to the President is reflected in his lawyering for him in the impeachment trial. The officers of Equitable-PCI agreed to service fraudulent deposits and other transactions of President Estrada. The officials of Urban Bank, Orient Bank and Westmont Bank clearly violated prudent banking principles. All the guilty bank officials have not been prosecuted. In fact no financial institution official has even been brought to court.

Finally there is the question of the economic value of having GFI and the partial privatization of PNB. The GFI no longer have a special role in the financial system since much of development financing has been abandoned. PNB and Land Bank are classified as extended or universal commercial banks and Land Bank's special access to government deposits sustains its lax lending decisions. The GSIS and SSS do not provide better service than private insurance. Because of the low rate of return on their investments and high administrative cost their pension funds earn below market interest rate. The government's minority interest in PNB, reported at 16%, allows it to appoint some of its directors.. Directorship in semi-government corporation is a lucrative privilege that the executive uses to grant favor all sorts of reasons. It is a source of corruption and an obstruction of efficient management. Partial state control confounds the objectives of the institution and blurs the accountability of its officers. To whom is a government appointed officer accountable - to the President or to the equity holders? President Arroyo has recently announced the government's retaking controlling interest in PNB. This is definitely a wrong move unless the intent is to refurbish its position until it can be sold and fully privatized at a fair price.

Much effort still has to be exerted to improve prudential rules and supervision of banks and the full privatization of GFI. Recent reforms are aimed largely at disclosure. Bangko Sentral now requires banks to make quarterly balance sheet reports. The Quarter 4, 2001 report contains risk indicators such as NPL and NPA ratios and sources of deposits, whether government or non-government. The information is however contained in the website to which only a very small proportion of the population largely in Metro Manila has assess. A new law on money laundering (2001) sets an extraordinary large deposit transaction of P4 million or $80,000 level for automatic reporting to the central bank. Few Filipinos have this wealth or business. BSP must make a thorough review of how it can effectively monitor large loans. As in the first crisis, it is the large privileged borrowers that caused the bank problems. The single borrower limit of 20% of equity will not prevent insolvency if the loans are really bad. A bank may lend to only 5 bad borrowers to wipe out its equity.

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## Tables and Figures

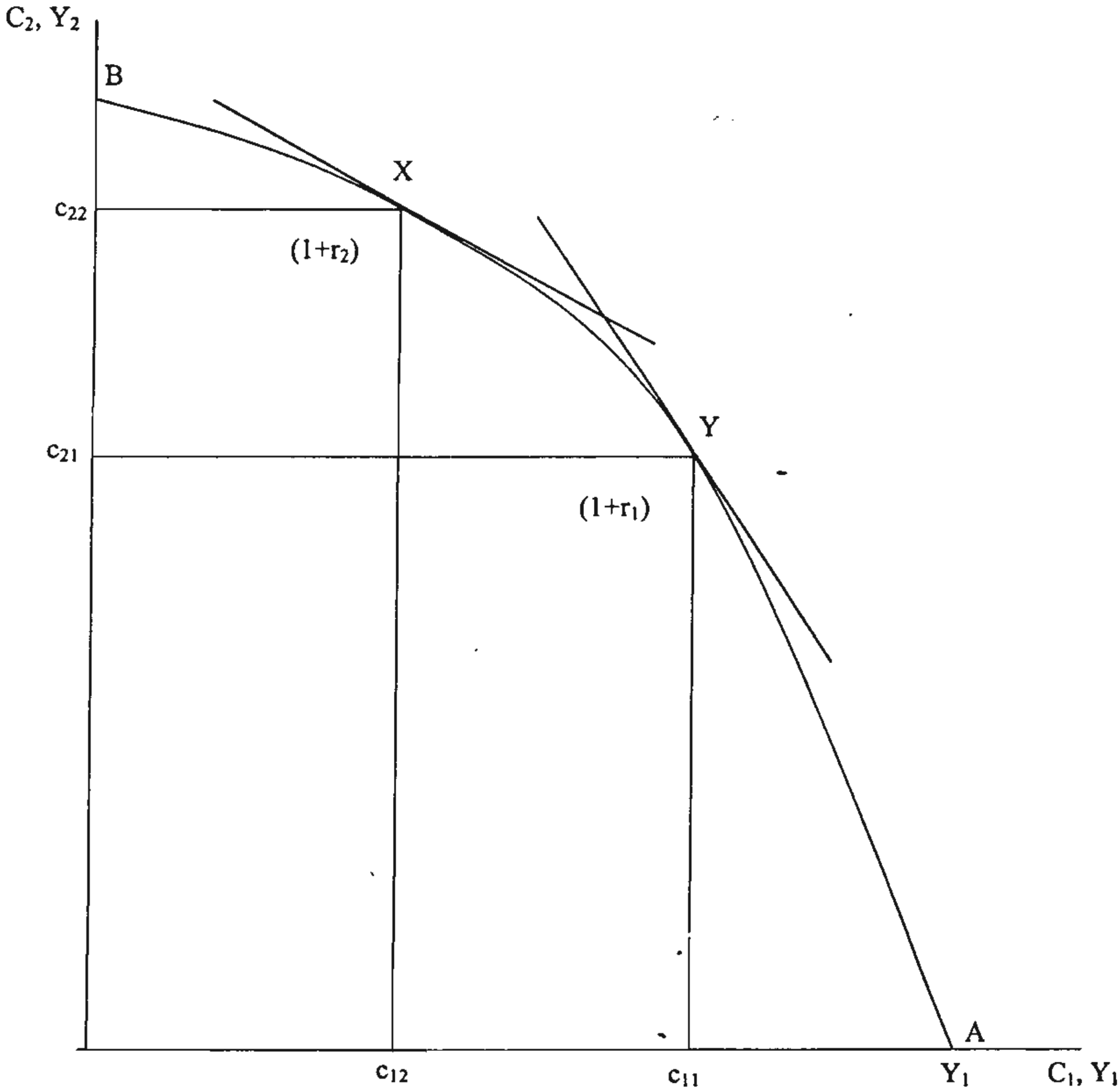


Figure 1