ENHANCEMENT OF INSURANCE RESERVES TARGETING FRAMEWORK

Report prepared for the Philippine Deposit Insurance Corporation (PDIC)

Consultant: Steven A. Seelig
World Bank: Nataliya Mylenko, Claire McGuire
First: Sebnem Sener

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Preface

We would like to thank the management and staff of the Philippine Deposit Insurance Corporation (PDIC) for their assistance, cooperation, feedback and hospitality during the course of this project. Both staff and management were forthcoming with their views and factual information and data that greatly assisted in the formulation of the recommendations contained in this report.

The assessment and recommendations contained in the report reflect the expert opinions and are shaped by best international practice as well as the specific situation faced by the PDIC. The growing international literature on deposit insurance practices and the relevant statutes and procedures relied on by the PDIC, were reviewed. Aside from work done in Washington DC, the team made three visits to Manila in June and November, 2011 and in January 2012.

Executive Summary

Deposit Insurance exists to provide depositors with protection against losing all or a portion of their deposits in the event a bank fails and thus provides the public with confidence in the banking sector. The Philippine Deposit Insurance Corporation (PDIC) provides depositors up to PHP 500,000 of coverage on deposits held in each bank. For depositors to have confidence that they will be paid, should their bank fail, it is important that where an ex ante fund exists that it be adequately capitalized to meet the likely demands resulting from bank failures during periods of stress.

This study assesses the adequacy of the PDIC fund, relying on the recent historic experience with bank failures in the Philippines. In determining the minimum level of funding needed by the PDIC, the study relies on the guidance of the International Association of Deposit Insurers that states the insurance fund "should be sufficient for serious difficulties in the banking sector but not for systemic crisis." In the absence of a stress testing capability at PDIC that would provide probabilities of default for situations of serious difficulty in the banking sector, an analysis was performed on data for the past 15 years with a goal of arriving at a fund target ratio that could be compared to the current fund balance.

Based on the experience of the past 15 years, it is recommended that a fund target of 5 percent of insured deposits be established. Such a fund ratio would allow the PDIC to readily absorb the losses associated with bank failures during a two year period of stress, including the failure of a larger bank. The target ratio is expressed in terms of insured deposits, rather than total deposits to reflect the risk of the additional exposure resulting from an increase in deposit insurance coverage, as recently occurred in the Philippines and other countries in response to the global financial crises.

Utilizing the recommended 5 percent target as a benchmark indicates that the PDIC is under funded. At end 2010 the ratio of fund balance to insured deposits was 4.5 percent and is estimated to have risen to almost 4.7 percent at year-end 2011 (before any year-end provisions). It is therefore recommended that the PDIC board examine whether there is a need to increase revenues, either by increasing the assessment rate (not currently an option since the rate is set by law) or alternatively seeking authority for a special assessment.

Many countries have established statutory target rates for their deposit insurance funds and have linked the ability of the deposit insurer to increase premiums to this target. Others have not established statutory targets but have given the governing body of the deposit insurer the ability to raise premiums when it determines that it is underfunded.

There is a need for legislation to give the PDIC board greater discretion to increase premiums when the fund is below target. Such legislation should allow for the following:

- **Ability of the PDIC board to increase premiums above 20 bp to achieve the target ratio.** It could mandate a lowering of premiums when the target is hit, preferably through rebates to the banks. The 5 percent target could be put in the law as a trade-off for the board receiving greater premium setting flexibility. It also should be given the authority to maintain the 20 bp premium if in its judgment economic or banking conditions warrant maintaining premiums at 20 bp, even if the fund has just reached its target ratio. Such judgment would tie economic uncertainties to projections of increased number of failures.

- **The PDIC board should be given the authority to make special assessments when the fund is below target and it believes a rapid recapitalization is warranted.** The PDIC board should be given the authority to require prepayment of assessments as a means of supplementing PDIC's liquidity position.

- **Once the fund ratio falls below the target, the PDIC must undertake an analysis of what measures, if any, are necessary to return the fund to its target level within a five year period.**

In addition to these measures that relate to setting of premiums, there are several additional measures that could be taken that would improve the financial performance of the PDIC. The financial performance of the PDIC can be improved if it had a broader range of resolution options and if the closing and resolution of an insolvent bank could be speeded up. Measures that would address these include:

- **The government of the Philippines should cease treating the PDIC as a state owned enterprise and requiring it to pay dividends to the government.**

- **Reducing the cost of bank failures by introducing a broader range of resolution techniques such as purchase and assumption transactions and bridge bands, as has been proposed by the PDIC.**

- **Legal protection needs to be provided to central bank supervisors and PDIC staff and managers.** Such protection is necessary because the current exposure to shareholder suits against supervisors personally has served as a deterrent to quick closings of insolvent banks, thus increasing the cost to the PDIC.

- **Shareholders should not be allowed to stay the actions of the supervisor in closing the bank, nor halt the receivership under a claim of having the bank restored to them.** Rather if they can prove that a closing was improper they should be entitled to monetary damages for the loss of their equity and the franchise value of the bank. In this manner they would have legal protection from arbitrary or improper actions by the supervisor.

- **The proposal by the central bank for a 90 day period, after capital reaches zero, to allow the shareholders to recapitalize their bank should be rejected.** While this measure may provide defenses for supervision officials if sued

personally, it comes at the expense of the PDIC and will surely lead to asset stripping and the exit of uninsured depositors; both of which would increase the cost of bank failures to the PDIC.

Legislation and other measures are needed to speed up the liquidation of banks and the payment of dividends to the PDIC on the subrogated claim. Measures to accomplish this include:

- **The 90 day receivership period to allow shareholders yet another opportunity to rehabilitate a bank should be eliminated.**

- **Judicial recognition that general creditor claims are subordinated to the subrogated claim and thus likely will have no value**. Consequently earlier payment of dividends should be allowed.

- **The PDIC should be given authority to access deposit records of banks prior to their failure.** The PDIC needs sufficient time to either plan for a speedy pay-out or to conduct an alternate resolution of a failed bank and this necessitates it having access to deposit records well before the closure of the bank.

- **PDIC should take steps to speed up the liquidation of assets at banks in receivership.** More aggressive and innovative approaches to asset sales and collections are required.

The Adequacy of the PDIC Insurance Fund And Related Issues

Steven A. Seelig[+]

Introduction

Deposit insurance is about maintaining public confidence in depository institutions so as to avoid runs on financial institutions. In the Philippines this is accomplished by the Philippine Deposit Insurance Corporation ("PDIC"). The PDIC provides depositors with protection up to 500,000 pesos per depositor in an insured institution in the event that the institution is declared insolvent.[1] In the Philippines commercial, rural, and thrift banks' depositors are covered by PDIC insurance. In general, depositors are aware that banks/banking institutions are covered by PDIC deposit insurance due to stringent notice requirements imposed on banks by Section 21 of the PDIC Charter.

The PDIC has been in existence for 49 years and has had extensive experience dealing with failed banks. The Philippine banking sector is characterized by a large number of small institutions and a relatively small number of larger commercial banks. At end-2010 the system consisted of 758 insured depository institutions with 8,132 banking offices. Of these, the 38 commercial banks had more than half of the banking branches and 88 percent of the total assets of the industry. During the last five years, PDIC has on average dealt with 22 banks per year that were closed by the Monetary Board of the Banka Sentral ng Philipinas (BSP). This stands in sharp contrast to the experience of most of the world's deposit insurers who have either closed no banks or only a few.[2]

Confidence in a deposit insurer comes from it having adequate capital, sufficient liquidity, and the operational capacity to assure that depositors can access their funds quickly. Adequate capital for a deposit insurer implies that the deposit insurer's net worth is sufficient to cover probable potential losses that could be incurred by the deposit insurer in resolving an insolvent bank. A deposit insurer's capital serves as the buffer that covers the difference between the funds advanced and the recoveries on the assets of the failed bank. Having sufficient liquidity implies that the deposit insurer has liquid assets, cash and government securities sufficient to meet its cash needs to satisfy

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[+] Financial Stability Associates and a World Bank consultant.

[1] Pursuant to Section 30 of the Central Bank Act, banks may be closed due to: (1) inability to pay liabilities as they become due, (2) having insufficient realizable assets to meet its liabilities, (3) inability to continue in business without involving losses to depositors or creditors, or (4) having willfully violated a cease and desist order that has become final.

[2] The U.S. FDIC is a notable exception having closed a substantially larger number of banks per year during the same period.

potential depositor claims over the coming year. Operational capacity implies that the deposit insurer has the tools at its disposal to be able to assure depositors have access to their insured deposits relatively quickly after a bank has failed. The inability to accomplish this, either using resolution techniques (e.g. purchase and assumption transactions) or by paying off depositors, can undermine confidence in the deposit insurer and the banking sector, and potentially have macroeconomic implications.[3]

Core principle 11 of the Core Principles for Effective Deposit Insurance Systems requires that a deposit insurer should have funding mechanisms available to ensure prompt reimbursement of depositor claims. These principles were issued by the International Association of Deposit Insurers and the Basel Committee on Bank Supervision. The principle goes on to state that the primary responsibility for the cost of deposit insurance should be borne by banks, and indirectly their customers. The Philippines, as do most deposit insurers in the region, maintains an ex-ante funded deposit insurance fund. The PDIC follows this principle by charging banks premiums. It also has a back-up line of credit with the central bank (Bangko Sentral ng Philipinas) and per Section 19 of the Charter, the PDIC, with the approval of the President of the Philippines, is authorized to issue bonds, debentures, and other obligations for liquidity purposes. [4]

The International Association of Deposit Insurers (IADI) has stated that a deposit insurance fund "should be sufficient for serious difficulties in the banking sector but not for systemic crisis."[5] According to the core principles this has been defined by IADI as meaning that a " deposit insurance system can deal with a limited number of simultaneous bank failures, but the resolution of a systemic banking crisis requires that all financial safety-net participants work together effectively". IADI goes on to recognize that there are two approaches to assessing the adequacy of a deposit insurance fund: a statistical based model that estimates probabilities of default or expert opinion of target reserve ratios. However, they warn that target reserve ratios must accommodate changes in coverage, otherwise they risk understating the exposure of the fund.

This report provides an assessment of the adequacy of the PDIC insurance fund by focusing on its capital position and its liquidity. The methodology currently used by the PDIC in setting its reserve target is reviewed and alternative methodologies suggested. The analysis will examine the determinants of the PDIC's cash flows and the policy levers that can be used to influence these. As part of this analysis, the level and framework for deposit insurance assessments will be examined as will the experience of

[3] See Kaufman, George and Steven Seelig. "Post-Resolution Treatment of Depositors at Failed Banks: Implications for the Severity of Banking Crises, Systemic Risk, and Too Big To Fail." *Economic Perspectives* vol.26.2002. Federal Reserve Bank of Chicago.

[4] Section 18 of the PDIC Charter provides that the PDIC is authorized to borrow from the BSP under such terms as may be agreed upon by the BSP and the PDIC. PDIC is likewise authorized to borrow money, obtain loans or arrange credit lines or other credit accommodations from any banks designated as depository or fiscal agent of the Philippine Government, in case fund is not sufficient to provide for an emergency or urgent need.

[5] International Association of Deposit Insurers, *Evaluation of Deposit Insurance Fund Sufficiency On the Basis of Risk Analysis,* Discussion Paper. November 2011. p. 7.

the PDIC in handling failures. The limitations, both legal and policy, facing PDIC in implementing changes to its reserve targeting framework are discussed. Of particular note is the limitation on increasing in the assessment rate. Not only is an opinion rendered on the adequacy of the fund as of end-2010 but policy issues and levers affecting the financial viability of the fund are identified.

The report concludes with a series of recommendations to improve the financial capacity of the PDIC. These include operational and legal changes required to increase the likelihood that the PDIC is able to honor its commitment to depositors while enhancing financial stability in the Philippines without becoming a drain on fiscal resources.

Drivers of the PDIC's Cash Flow

The major sources of funding for the PDIC are assessments and income from investments. In 2010 PDIC had assessment income of PHP 9.2 billion, or 59 percent of its total revenues, and income on its investment portfolio of PNP 5.8 billion, or 38 percent of total revenues. Effectively, these two sources of revenue are the only drivers of cash inflows to the fund. The PDIC was initially capitalized by the government at a level of PHP 3 billion and this amount is referred to as the "Permanent Insurance Fund"

The revenues of the fund and other sources of cash flow are the source of funding that PDIC relies on to address its deposit insurance responsibilities when a bank becomes insolvent. PDIC has either paid off insured depositors, primarily when rural banks fail, or has entered into open bank assistance agreements. In either of these approaches, the PDIC is called upon to lay out cash to fulfill its obligation to insured depositors. Open bank assistance transactions may involve the PDIC purchasing troubled assets, granting a loan on favorable terms, or a combination of these.[6] When a bank is placed under receivership, the PDIC pays off insured depositors up to the insurance limit of PHP 500,000, and in turn receives a subrogated claim against the receivership that is booked as an asset.

The other sources of cash inflows to the PDIC result from its handling of insolvent banks. When a bank has been placed into receivership/liquidation the PDIC will receive payments on its subrogated claims as assets are liquidated and dividends are declared. This traditionally has been a protracted process. The other sources of cash flows are the recoveries on the open bank assistance agreements. These include the repayment of the loans made by the PDIC and the interest income earned on these loans (PHP 423.7 million in 2010). PDIC also receives cash flows from the proceeds from the sale of purchased/acquired assets associated with assistance transactions.

Given that increasing the risk profile of a deposit insurance fund is not advisable, the major controllable variables affecting the adequacy of the fund are the assessment framework and outflows for bank failures. Assessment income is determined by two variables: the assessment rate and the assessment base. These will be discussed below. The magnitude of cash outlays to address failures is a function of the health of the banking sector, the resolution tools available to the deposit insurer, the speed of closing, and the effectiveness of the asset liquidation process.

[6] Under Section 17(d) of the PDIC Charter, the Corporation is authorized to make loans to, or purchase the assets of, or assume liabilities of, or make deposits in a bank determined to be in danger of closing and which continued operation is deemed essential to the banking community/economy. Terms and conditions of the open bank assistance are prescribed by the PDIC Board, and may involve as well, purchase of good assets and liquidity loans at market rates.

Adequacy of the PDIC Fund

The first step in assessing the adequacy of a deposit insurance fund is to determine whether the financial statements properly reflect existing liabilities and exposures. The purpose of these calculations is not to modify the accounting framework used by a national authority, but rather to come up with an adjusted level of capital as a starting point to assess the adequacy of a deposit insurance fund.

In the case of the PDIC, the major potential liability not reflected on the balance sheet would be any commitments by PDIC to incur losses over time as part of its open bank assistance agreements. The income assistance agreements involve the PDIC borrowing funds from the central bank and on-lending these funds to the assisted bank. The PDIC has also, in the past, provided open bank assistance by purchasing distressed assets from banks and over time suffering a loss on these assets. To mitigate credit risk to the PDIC, the bank is required to invest the funds in government securities. The income assistance derives from a differential in the interest earned on the securities portfolio and that paid to the PDIC. The PDIC incurs future losses on these transactions if the interest rate it pays to the BSP exceeds the amount it receives from the assisted bank. While the amount of loss is determined at the time the assistance is granted, and is limited by the cost of closure, it is not reflected in the capital account of the PDIC. Similarly any commitments for future asset purchases from banks under assistance agreements, or banks where such agreements are in the process of negotiation, should be reflected in the calculations of available capital to support future failures. This is typically measured by taking the present value of either the expected loss on assets, or the stream of negative carry using the deposit insurer's opportunity rate, typically the government securities rate.

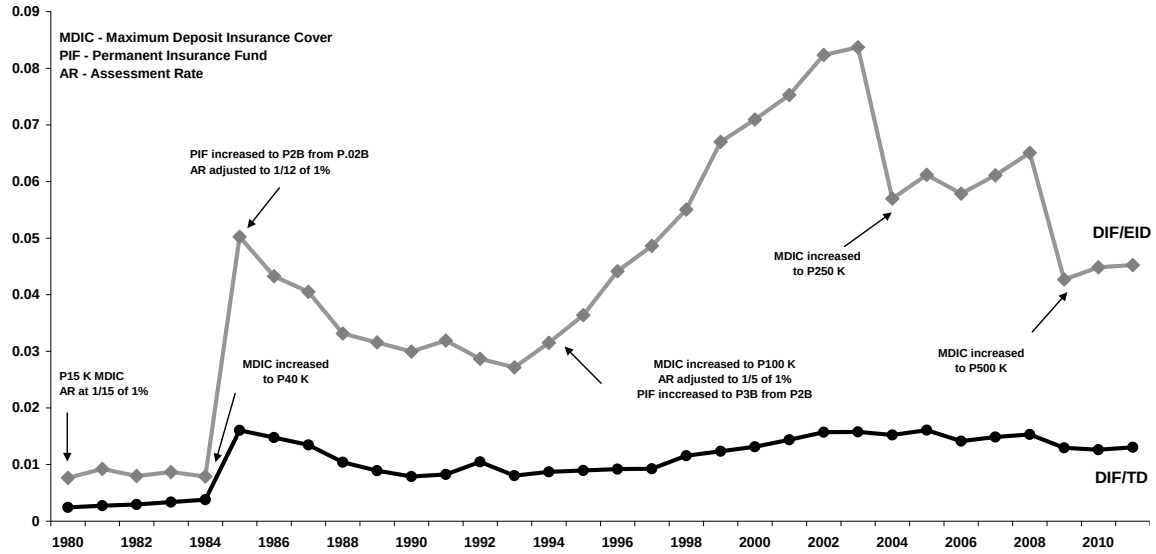
Inasmuch as the PDIC has structured most of its outstanding assistance loans to result in a positive spread the adjustments to capital from these transactions are relatively small at about PHP 1 billion. There are currently three outstanding agreements with negative spreads between the rates charged to the banks and that paid to the BSP.[7] The present value of the losses on these transactions for their remaining maturities is approximately PHP 1 billion (using a 4 percent discount rate). Also at present there are no commitments for future purchases of assets that need to be reflected in assessing capital. Hence the starting point is to assess the adequacy of a PDIC insurance fund of PHP 63.6 billion. (This is arrived at by reducing the year-end 2010 fund balance of PHP 64.6 billion by one billion.)

[7] This is based on data provided to the author. It should be noted, that the analysis assumes that any necessary provisions for credit risk connected to assistance transactions have been reflected on the balance sheet.

What should be the Fund Target?

The Philippine Deposit Insurance Fund (DIF) at year-end 2010 was 4.5 percent of estimated insured deposits and one percent of total deposits. (See Figure 1.) As of end-September 2011, the ratio stood at 4.6 percent. The DIF reached its peak in 2002 when it stood at eight percent of estimated insured deposits and two percent of total deposits. It subsequently declined when the insurance coverage was increased first to PHP 250,000 in 2004 and to PHP 500,000 in 2009. These increases in coverage were not accompanied by any increase in the assessment rate, thus leading to a downward shift in the ratio of the DIF to insured deposits.

Figure 1: Ratio of Deposit Insurance Fund (DIF) to Estimated Insured Deposits (EID) and Total Deposits*



Source: Philippine Deposit Insurance Corporation.

While in some countries a deposit insurance fund target rate is set out in statute, the Philippines, as is the practice in many other countries, leaves it to the PDIC board to determine the adequacy of the fund. The PDIC sets an internal target for the size of the deposit insurance fund based on its view of the condition of the banking system. As of year-end 2010, the PDIC estimates that the reserves of the DIF stood at 86 percent of the target level. The guiding principle for assessing the adequacy of the fund is that reserves should be maintained at a level sufficient to assure that the PDIC has adequate capital to absorb losses from bank failures under non-systemic conditions. This approach is consistent with international practice. However, to assess whether this is an adequate reserve requires that the deposit insurer be able to take a forward looking view of risks developing in the banking sector and also develop a margin of error for unanticipated events.

The Canadian deposit insurer, the CDIC, has recently published a consultation paper that looks at the adequacy of their premium income and the target fund level.[8] Currently, the CDIC has a target fund of between 40 and 50 basis points of insured deposits. In their examination of their premium rates, the CDIC determined that the ex ante fund and premium rates should be calibrated to reduce the likelihood that it will experience a deficit for a prolonged period of time. They concluded that if they were willing to settle for a probability of losses exceeding the fund size of 1.25 percent (a 98.75 percent confidence level) they would need a fund size slightly in excess of $20 billion. (At end-March 2010, the CDIC fund was about $3.1 billion.) This would equal 350 bp of insured deposits. Hence they have concluded that they should grow the fund beyond its current target range[9].

An assessment of the adequacy of a deposit insurance fund should capture risks to the fund coming from both anticipated and unanticipated losses. In addition, decisions/assumptions need to be made about banks that are "too-big-to-fail", inasmuch as the burden will fall on the supervisor to develop resolution outcomes for these banks rather than closing them.

The current PDIC framework relies on data for the previous year to develop its reserve target based on two sets of calculations. PDIC staff estimate a general reserve target and a specific target and combine these to arrive at the overall target. The banking sector is divided into two groups: banks at risk of failing and the rest of the system. Estimates of insured deposits for both groups of institutions are made. For the banks not deemed at risk, the reserve target is arrived at by multiplying the estimated insured deposits (EID) by a target rate set as that used by countries with similar credit ratings. In practice the target rate for the general reserve is the statutory rate used by Indonesia, namely 2.5 percent of total deposits. Identification of "banks at risk" hinges on the use of peer group ratio analysis of balance sheet and income statement data, as well as significant qualitative information such as information from BSP Reports of Examination, PCA list, etc. Once these banks are identified, PDIC staff projects the EID for these banks and multiplies the EID by the most recent loss rate on subrogated claims on outstanding receiverships. The loss rate used in 2010 was 75 percent and 80 percent is applied to 2011 targets. Summing the general and specific reserve targets yields a reserve target of PHP75.5 billion for 2010 and PHP76.9 billion as of March 2011.

The current approach suffers from several significant deficiencies. Most significant, it does not provide a meaningful measure of the short-term exposure of the deposit insurance fund. The specific reserve covers significantly more banks than actually fail in a given year and, being so broad, calls into question the need for the general reserve. The approach relies on data that only is available with a significant lag, thereby failing to provide PDIC with a current view on the health of the banking sector. The approach used is backward looking and does not reflect changes in economic conditions or shifts in banking strategies. There are methodological issues associated with the setting of the

[8] Canada Deposit Insurance Corporation. Consultation Paper "Premium Assessment Approach and Target Fund Level." June 2011.
[9] It should be noted that Canada, as compared to the Philippines, as experienced very few bank failures.

general reserve and it does not appear to adequately reflect the risks associated with the structure of the Philippine banking system. It also, does not include any allowance for possible future losses on financial assistance transactions.

The data relied upon for the reserve target analysis is only available with a significant lag and may not be sufficiently complete. The PDIC relies on financial reports submitted by banks on a quarterly basis and information from examination reports and the PCA list provided by the BSP. Typically, balance sheet and income report data is provided by banks to regulators with a several month lag. The data must then be checked and processed by regulators and frequently this will result in revisions by the banks.[10] This process in developed countries typically takes 6 weeks to two months and in emerging market countries can take three months. Hence, the PDIC board receives estimates of a reserve target, as of year-end, the following May or June. By the time decisions on the reserve target are taken the risk profile of the industry may have changed.

The general reserve target is set based on the statutory rate of Indonesia. There is no conceptual basis for the use of this rate, other than Indonesia's credit rating which bears little relationship to the risks faced by the deposit insurer. Moreover, to use another country's target rate, one would have to assume that the risks in the banking sector are the same for both countries and that the reference rate accurately reflects the risks. In the case of Indonesia the rate was set in law when the Indonesian deposit insurance scheme was put in place and was set at twice the then U.S. rate of 1.25 percent, under the assumption that the banking sector in Indonesia was at least twice as risky as the U.S. The way the target is calculated by the PDIC, by definition, will always result in a higher target than Indonesia, since the PDIC applies the 2.5 percent target rate to the healthy banks and applies a much higher loss rate to banks it views at risk. The only time the two targets will be the same is if there are no "banks at risk" in the Philippines and thus no specific reserve. The PDIC should set its own rate for a general reserve and this rate should be much lower than an overall rate that includes losses on banks likely to fail.

The analysis used to set the reserve target is relatively static. While the staff relies on indicators that are decent predictors of institutions likely to encounter problems and updates the loss rate applied to "banks at risk" to reflect the most recent data, the analysis does not allow for dynamic changes to either the banking sector or the economy. Both of these could significantly affect the risks faced by the PDIC and affect the adequacy of the fund. Moreover, the staff assumes that all banks that are at risk will fail (a probability of default of 100 percent) which is unlikely. In addition, the approach suffers from a risk that staff fails to identify a bank that will fail during the coming year, based on its condition and changes to its risk profile and also possible failures caused by changes in economic conditions.

An alternative preferred approach would be to use stress testing to estimate, or as a supplement to the current approach, the risks to the PDIC balance sheet. Such an

[10] Despite the checking that is done, there may also be a problem with the reliability of the data reported by banks and thus this alone would compromise the usefulness of the current approach.

approach could be used to supplement the estimate for banks that are likely to close by identifying those banks that are "at risk." Stress testing starts with the current condition of the banks, including estimates of the probability of default, and applies economic and financial shocks to examine the impact on bank capital and liquidity and to provide a more forward looking view that reflects the risk of economic disruption. The shocks need to be plausible and reasonable. They should not be designed with an eye towards bringing down the system. Stress testing of the banking system as a whole as well as the larger banks is part of the IMF/WB Financial Sector Assessment Program and has proved useful for identifying vulnerabilities in countries' financial sectors. Moreover, IADI has recently published a discussion paper recommending the use of various types of models to assess the adequacy of a deposit insurance fund. It is therefore recommended that PDIC develop both stress testing and failure prediction models.

The results of various stress tests, combined with traditional financial analysis of the current state of the sector, could be used by the Board of Directors of the PDIC in assessing the adequacy of the target fund size and the current condition of the fund. Even when a statutory ceiling exists, deposit insurers have used stress testing and other empirical tools to augment the decision process of the governing body and to determine the level of premiums that need to be charged when increases are legally mandated.[11] It also could be used as a planning tool to allow staff and the board to better understand the linkages between economic and financial events and rapid deterioration in banks' financial condition. Under this approach the board of the PDIC would be the body setting the DIF target and then taking steps to meet the target. These might include raising premiums, adjusting the risk-based schedule were risk based premiums to be adopted, or, if the DIF significantly exceeded the target either provide rebates to banks or reduce premiums.

Consultant's Assessment of PDIC Fund Adequacy

In the absence of a robust stress testing model, and estimates of probabilities of default for individual banks, the adequacy of the fund can be assessed by relying on historical data in periods of stress. Inasmuch as PDIC has a history of regularly honoring insurance claims on banks that have failed, such an analysis can be used to establish a target fund ratio that can be benchmarked against the existing fund balance. The underlying analysis herein will need to be reassessed on a regular basis, preferably with the use of stress testing.

For the purpose of this analysis, data from the past 15 years was relied upon because it both encompassed the Asian Crisis period and the recent global financial crisis.[12] A purely statistical approach was rejected since increases in deposit insurance

[11] Examples of countries using such techniques include the United States, and Canada. Indonesia is working on developing such a capacity as are other countries in the region.

[12] Canada, the United States, and most recently the EU in its proposed draft directive on bank resolutions, have relied on failure experiences in a recent period, or the countries risk appetite to set a target rate. The

coverage in recent years, heavily skewed the losses and exposure of the insurance fund to the most recent period, reflecting very low losses in most of the earlier period. Hence, it was decided to use a more qualitative approach by setting the following criteria:

- *The fund should be sufficient to cover actual losses on failed banks for the worst two contiguous years*.

- *It should be able to address the failure of at least one large bank that under ordinary market conditions would not be considered systemic.*

- *An additional margin of comfort can be obtained to cover unanticipated risks by providing sufficient funds to cover an additional year's failures and/or an additional commercial bank .failure*.

While these criteria for assessing the adequacy of the PDIC fund are somewhat arbitrary, they are grounded in both the experience within the Philippines during the period since the Asian crisis and the approach used by countries where the governing body of the deposit insurer must make determinations as to the adequacy of the fund and/or the premium structure. If one were to require that the PDIC fund be at a minimum level to cover additional years' failures or the failure of more than one large bank, by definition the fund would have to be larger and the target rate would be higher. The criteria chosen for this analysis strike a reasonable balance between prudence, cost to the banking sector, and providing confidence to the public that they will have access to their insured deposits. However, it needs to be recognized, as is the case in the United States, there will be a need for some discretion by the PDIC board in implementing a reserve target and tying it to the premiums charged. In the U.S. the FDIC staff conducts similar exercises, supplemented by more sophisticated empirical analysis, in making recommendations to the board as to whether changes in the assessment rate are called for.

It is recommended that the deposit insurance fund target for the PDIC be tied to insured deposits rather than total deposits. Ratios relating the fund size to total deposits suffer the risk that they do not reflect the additional exposure of the insurance fund to an increase in coverage. For example, if ceteris paribus deposit insurance coverage was doubled the ratio of the fund balance to total deposits would not change. Whereas, if linked to insured deposits the target ratio would be reduced by 50 percent. Hence, the recommended target ratio for the PDIC should continue to be set in terms of insured deposits. If a statutory target ratio is established, as discussed below, then all other things equal, an increase in deposit insurance coverage might result in the fund falling below the target ratio; thereby possibly necessitating an increase in the assessment rate. Consequently, the PDIC would have to monitor and assess the impact of proposed changes to deposit insurance coverage on the capacity of the fund to meet the target ratio.

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approach used here is customized to fit the relatively unique experience of the PDIC in dealing with a relatively large number of insolvencies, even during periods when economic stress is minimal.

Given the criteria spelled out above it is recommended that the target reserve ratio be set at 5.0 percent of estimated insured deposits.[13] This target would fulfill the criteria set out above for assessing the adequacy of the fund. From an empirical perspective, looking at the period 2008–2010 were the PDIC fund capitalized at this level it would have been able to cover losses associated with the failure of rural and thrift banks, the cost of failures of these banks during 2008-2010, plus the failures of two large largest commercial banks, ranked by deposits. Underlying, this conclusion are the assumptions that the PDIC will continue to suffer losses on its subrogated claims on smaller institutions of 80 percent and that it will lose 50 percent on its claims on the commercial banks, primarily because of the large volume of lower status claims at these banks.

The insured deposits at banks that failed in the specified years, which were the peak years for new subrogated claims from failures, were examined and the PDIC loss experience on small banks was utilized. A range of assumptions about loss rates for the larger commercial banks was used as a sensitivity analysis to arrive at a measure of fund adequacy. (See Table 1.) It should be noted that given the large volume of claims that would be subordinated to those of the PDIC in large banks, the actual loss to be experienced by the PDIC would be significantly lower than that shown in Table 1. In many of these banks insured deposits are less than 25% of total liabilities and most of the losses will be borne by uninsured depositors and other junior creditors, if the bank is subject to the receivership process.

Table 1. Target Fund Rates —Three Years of Failures
Plus a Large Bank

Target Rate*	Loss Rate Assumptions
6.91%	**100%**
5.53%	**80%**
4.22%	**80% + 50%**
3.47%	**80% + 33%**

*Target ratio of deposit insurance fund to insured deposits. Underlying data provided by PDIC.

Utilizing the 5 percent target, the PDIC is currently slightly underfunded. The current ratio of fund balance to estimated insured deposits is 4.59 percent, below the target of 5 percent. This implies that the fund is adequately funded to handle anticipated risks, but not fully funded to protect against the cost of unanticipated events.

[13] Consistent with best practice and the recognition that systemically important banks, those viewed as "too big to fail" are not included in the analysis,. Though, in fact PDIC could resolve one of the larger banks, if it limited its exposure to insured deposits and was able to use alternative resolution techniques such as a P&A with the transfer of only insured deposits.

It should be noted that with a broader range of resolution techniques, especially purchase and assumption transactions limited to insured deposits, that the losses on large banks will be considerably lower. Hence this reserve target ratio would accommodate the failure of some commercial banks..

Measures to Operationalize Target

Statutory Targets

While not necessarily considered best practice, a number of countries have set the target DIF ratio in their statute (see Table 2). This approach, in some countries, gives the deposit insurer greater flexibility to raise premiums to meet the target. In other countries the target ratio was established at the time deposit insurance was introduced so as to establish a goal for the DIF's governing body and to form a base level below which premiums would not be reduced. In many cases this was a policy compromise in return for limiting premium rates. It serves to protect the deposit insurer from political pressure from banks to lower premiums just because there have been no failures while there is still a need to grow the fund.

Table 2. Countries with Statutory DIF Reserve Targets

Country	DIF Target Ratio
Albania	5 percent of insured deposits
Argentina	5 percent of total deposits
Azerbaijan	5 percent of insured deposits
Bulgaria	5 percent of eligible deposits
Czech Republic	1.5 percent of insured deposits
Indonesia	2.5 percent of total deposits
Jordan	3 percent of total deposits
Kazakhstan	5 percent of insured deposits
Moldova	7 percent of insured deposits
Oman	2.7 percent of total deposits
Taiwan	2 percent of total insurable deposits
United States	1.35 percent of insured deposits
Yemen	3 percent of total deposits

Source: World Bank

One country in the region that has a banking structure similar to that of the Philippines, Indonesia, has a statutory reserve target and premium regime. Article 13 of the Indonesian Deposit Insurance Law establishes a flat premium system with premiums set at 20 bp per anum. In addition, it allows for changes in the premium if any one of three conditions is met: (a) a change in deposit insurance coverage;[14] (b) the accumulation of reserves has exceeded 2.5 percent of total system deposits; and (c) there is a change in the risk exposure in the banking industry. Any changes in premiums

[14] The increase in coverage in response to the global financial crisis did not result in an increase in premiums by the Indonesian deposit insurer.

desired by the board of the Indonesian Deposit Insurance Corporation must be done in consultation with parliament and implemented by regulation. With the exception of consultation with Congress, this type of a statutory structure, but with a different reserve target might be a useful legislative change, especially if removing the premium rate from the law is not politically feasible.

Other countries, especially in the region do not have statutory targets. In fact, a majority of the deposit insurers who have responded to an IADI survey in the summer of 2011 have indicated that they do not have statutory targets. Countries such as Canada, India, Hungary, Japan, Korea, Malaysia, Mexico, and Uruguay do not have statutory targets. Rather they use discretion in setting premiums to assure that the fund is, or will be in the future (for newer deposit insurers) sufficient to meet their likely obligations.[15] Deposit insurers in Singapore and Hong Kong, given the risks in their banking systems, have targets much lower than those in the Philippines, Indonesia and Taiwan. Some deposit insurers are locked into a flat rate statutory premium regime that limits flexibility while others have flexibility and use a risk based scheme to fine tune premium income.

Applying the range of targets in Table 2 to year-end 2010 data for the Philippine banking system and the PDIC fund suggests that the adequacy of the PDIC fund, using a 5 percent target rate, falls shy of meeting the target. As Table 3 shows, only if a very low target rate against insured deposits is adopted is the PDIC fund (including its paid in equity) adequate. This is not surprising given the relatively large number of failures dealt with by the PDIC and the high cost of dealing with those failures.

Table 3: Adequacy of the PDIC Fund Using a Sample of Statutory Targets
December 2010

Target Rate % of insured deposits	PDIC Fund As % of Target
1.35	334.0
5.0	89.6
7.0	64.0
Target Rate %of total deposits	
2.5	50.5
3.0	42.1
5.0	25.2

Regardless of the framework used to set a target the adequacy of a fund is determined by its ability to meet its obligations when banks fail. In assessing adequacy, a fund should have sufficient reserves (liquid assets in excess of liabilities) so

[15] For example, the DICJ (Japan's deposit insurer) sets premiums so as to ensure that its "general account" remains in balance over the long term in light of its expected expenses (deposit insurance cost of failures) and assuming that no bank is treated differently should it become insolvent.

as to meet its commitment if the higher end of a range of reasonably likely failures were to occur over a fixed period of time, usually 1-2 years. Such an estimate requires a forward looking methodology that captures both highly probable failures as well as unanticipated ones, such as rapid deterioration of some CAMEL category 3 banks.

Increasing the Fund Size

A deposit insurer faced with an inadequate fund should take measures to increase revenues and/or reduce outlays so as to build up the size of the fund over time. To increase revenues, most deposit insurers look to increase the assessments, or premiums charged. Another approach, only available to deposit insurers faced with a larger number of failing institutions, is to increase recoveries from failures and shorten the timing of these recoveries. It has also been suggested that deposit insurers could increase interest income if they broadened the range of allowable investments, though this is not considered to be a good policy option. Lastly, but beyond the direct control of the PDIC, would be a change in supervisory policy and enforcement that reduced the number of bank failures and assistance transactions.

Determinations of the time frame and changes to premiums that will be needed to bring the fund to its target will require analysis and a determination as to the PDIC's risk tolerance. Decisions will need to be made as to what time frame is acceptable within which to grow the fund. Once this is agreed upon, an analysis must be undertaken to determine whether the existing premium structure will achieve the fund target within the time frame; if not, decisions will need to be made on increasing assessment rates.

Increasing the Assessment Rate

The most direct way to increase deposit insurance fund revenues is to increase the premium/assessment charged. There are two ways this can be done: (1) increase the assessment rate or (2) increase the assessment base. Inasmuch as the assessment base in the Philippines is total deposits, there is little scope to increase revenues by increasing the base. Internationally, the assessment base is typically defined as insured deposits or total deposits. Only recently has the U.S. recognized that other secured liabilities can increase the loss to the insurance fund and thus the assessment base has been revised to add these to total deposits.

The PDIC is currently limited in its discretion to raise premiums. Under its statute, the maximum the PDIC can charge is 20 basis points. This maximum was put in place in 1992 when deposit insurance coverage was set at PHP 100,000 and has remained at this level despite a five fold increase in marginal coverage. While not best practice, many countries have chosen to put a maximum rate on premiums, in part to provide banks with some certainty as to their expenses for deposit insurance and to prevent the deposit insurance fund from growing ex ante to an excessive level. However, having a statutory ceiling rate significantly limits the ability of the PDIC or the government to assure that the deposit insurance fund has adequate resources to meet its responsibility and shifts the

ultimate cost of deposit insurance to the taxpayers, should the PDIC become significantly underfunded.

Inasmuch as the PDIC assessment base is total deposits and insured deposits are only about 28 percent of these, the effective premium on insured deposits is about 71 bp.[16] By international standards, this rate appears on the high side. For example, Canada now charges an average rate of 4.2 bp on insured deposits, well below its high rate of 16.7 bp that it charged between 1994 and 1999, when it introduced risk based premiums. In 2009, Japan's deposit insurer set its premium rate for demand deposits at 10. 7 bp and retained the rate on "general deposits" at 8.1 bp and the overall effective rate at 8.4 bp. In terms of developing countries, Vietnam charges a rate of 15 bp and Malaysia, with its risk based premium system had an overall effective rate of 5.1 bp., with a maximum premium for the riskiest banks of 24 bp. Consequently, it would be difficult to argue for an increase in the maximum rate, without a shift to a risk based system.

Imposing a Special Assessment

If there is little scope to raise the maximum premium rate, PDIC should consider seeking authority to impose special assessments when the Fund falls below a specified level. Such a special assessment could take two forms. It could be a one time premium charge, using the existing assessment base or an expanded one or it could take the form of a prepayment of assessments. A special assessment can be a useful tool to recapitalize the deposit insurance fund if it becomes undercapitalized from dealing with a larger than normal number of failures resulting from economic stress. However, imposing such a charge while the banking sector is under pressure could be counter productive. Ideally it should be imposed when the banks have recovered from the economic downturn and used as a means to replenish the deposit insurance fund's capital. It should be noted that the former approach of charging an additional premium to recapitalize the fund results in a one-time boost to capital without impairing future earnings of the banking sector. Such an assessment could also take on the form of an "add-on" to the existing premium structure and spread over a couple of years.

In contrast, the prepayment of premiums provides no long term capital relief to the deposit insurer but rather provides liquidity support and potentially additional investment income. Hence, the choice of approach, special assessment or prepaid premiums, should be driven by the financial condition of the fund. If there is a meaningful capital shortfall then a one time supplemental assessment is appropriate. However, if the problem is one of a cash flow shortage leading to a liquidity problem facing the deposit insurer that could possibly raise the specter of a loss in confidence in deposit insurance by the public, requiring banks to prepay several years worth of assessments may be appropriate. It should be noted that banks would have to be allowed to amortize the cost of this payment over the prepayment period (e.g. if the PDIC were to require a three year prepayment of premiums, banks would need to amortize this expense over three years) to avoid harming their financial position.

[16] The PDIC currently assesses insured banks at a rate of 20 bp of total deposits.

While special assessments are not commonly used by deposit insurers, when it is accepted that banks should bear the cost of deposit insurance, rather than taxpayers, special assessments have been used. In the second quarter of 2009 the U.S. FDIC charged banks a special assessment with the purpose of replenishing the deposit insurance fund, which had been depleted by numerous bank failures, including some rather large ones. Initially the FDIC had proposed a 20 bp special assessment on total deposits at all banks. However, as a result of extensive lobbying by banks, and especially small banks, the final rule implemented was a 5 bp special assessment on total assets of banks minus their tier 1 capital. Effectively, for the purpose of the special assessment the assessment base was increased to total liabilities. Also in 2009, the FDIC required banks to prepay their 2010, 2011, and 2012 assessments. This provided the FDIC with a cash infusion and banks were allowed to amortize the expense over the three year period. Inasmuch as many other deposit insurers are relatively new, especially in Asia, they have not been faced with a wave of failures similar to that encountered by the FDIC. During the Asian crisis, the taxpayers bore the cost of blanket guarantees that were put in place in several countries and more recently the cost of such guarantees has been borne by taxpayers in European countries such as Ireland.

Other Issues

The PDIC is relatively unique in that it is exposed to a negative assessment from the government in the form of mandatory dividend payments. The PDIC as a state corporation is required by the Philippine government to pay it 50 percent of its annual earnings in the form of dividends (only if it generates net income). Thus the PDIC is forced to maintain higher assessment rates than it otherwise would need, in effect taxing banks on behalf of the government. Also the loss of this income has hindered the fund from reaching its target level. While many countries in the region, such as Indonesia, have mandatory dividend payout policies for state owned companies, this does not apply to deposit insurers who are part of the government. Inasmuch as the PDIC would invest the cash that it pays in dividends in Philippine sovereign bonds or other government paper, from a public funding perspective there is no benefit to the government. The only benefit to the government is that these dividends provide a source of revenues to reduce the deficit. However, this comes at the expense of creating a contingent liability for taxpayers if the PDIC fund is not adequate to deal with bank failures. Given that the public purpose for having a government sponsored deposit insurance fund is to provide confidence to depositors and thus avoid bank runs, the policy of the Philippine government of requiring dividend payments, especially when the fund is undercapitalized, is counter productive.

Consequently there is a need to clearly establish PDIC's exemption from remitting dividends to the national government. Ideally this exemption should be expressly specified in law. An alternative might be for the Department of Finance to issue a clarification that the PDIC is exempt from the requirements of the Dividend Law based on its status as a governmental entity.

Reducing the Cost of Failures

Speedier closings

There is a clear and pressing need to achieve quicker declarations of insolvency by the supervisors. Under the current system, depository institution owners are given an extended period of time to recapitalize a bank that has reported capital below the required level. During this period, moral hazard increases and thus the risk that the owners will gamble for redemption increases, albeit at the ultimate expense of the PDIC. Given the fragilities in the system and the large number of insured institutions supervisors need to be more aggressive in enforcing capital orders and taking actions.

One of the major impediments to quicker and more forceful supervision is the lack of legal protection for supervisors. Supervisors in the Philippines are exposed to the risk that the owners of a bank that is declared insolvent will sue them personally and have a freeze put on their personal assets. Internationally the lack of protection for supervisors has been found to have a chilling effect in dealing with severly undercapitalized bankd and is a major deficiency in the bank supervisory framework as defined by the Basel Committee. Hence, the Philippines is non-compliant with the Basel Committee for Effective Bank Supervision Core Principles, specifically Principle 1. The absence of this protection not only weakens supervision but also dramatically increases the cost of bank failures by leading to delays in closing banks or recognizing insolvency.

Consideration should be given to both providing legal protection to supervisors and enactment of a prompt corrective action regime. Proposed amendments to the BSP's Charter include the indemnification of Monetary Board members and BSP officials/personnel against the costs and expenses reasonably incurred in connection with any civil or criminal action, suit or proceedings to which they may be made a party by reason of performance of functions/ duties. Other countries, notably the U.S., provide protection against civil suits to all federal government employees from actions stemming from their carrying out their authorized official duties, unless it can be shown that these actions were a violation of criminal law.

Prompt corrective action (PCA) legislation has been adopted in a number of western hemisphere countries (e.g. United States and Colombia) to provide assurance that supervisors will take corrective actions when capital falls below a certain level and that the bank is closed when capital falls to that specified level that may exceed zero. The basis for a declaration of insolvency, even when reported capital is positive, is that by the time a determination is made that a bank has zero capital in all likelihood its capital is significantly negative with the consequence that the deposit insurer suffers greater losses.[17] In the Philippines, setting a capital insolvency threshold greater than zero would require legislation.

[17] In the U.S. the insolvency threshold is set at 2 percent by legislation. This was done to reduce the cost to the deposit insurance fund resulting from supervisory delay in closing banks.

Adding to the costs of the deposit insurance fund is the requirement that the owners be given 90 days after the closing to rehabilitate the bank. This period is known as the 90 day receivership period during which the receiver is prohibited from disposing/selling the assets of the bank and using the cash to make distributions to creditors. Instead the receiver is mandated by law to gather all the assets for safekeeping. The receiver thus incurs expenses in the administration of these assets while not gaining sufficient cash to cover these costs. In virtually no instances have the owners satisfactorily recapitalized a bank after it has been closed. Nor would one expect them to, given that they have had a lengthy period of time to add less capital while the bank's position was weakening and it was placed under corrective demands from the central bank. While loan collection efforts by the receiver are not impacted during this period, and may even be enhanced over what the bank was doing, the high loss rates on PDIC receiverships suggest that this period of delay has had significant negative consequences.

During this 90 day period assets, particularly performing ones, lose market value. Performing borrowers stop paying, collateral disappears, and borrowers transfer assets to family members. International experience suggests that the deterioration in asset value on the performing loans results in a loss in value of 35-75 percent, depending on whether there is collateral and whether the bank failures are part of a broader economic recession. It also should be noted that if the PDIC were to receive legislative authority to carry out additional resolution strategies for handling failed banks, the requirement for a 90 day receivership period would seriously inhibit the use of such tools.

Potentially adding to the costs of the deposit insurer is the proposed legislation from the BSP that would give financial institution owners an extra 90 days to recapitalize an insolvent bank before it is declared insolvent and turned over to the PDIC. While this legislation is designed to provide supervisors with greater protection when making an insolvency determination, it will impose significant additional costs on the PDIC. If the owners of a depository institution have failed to put up sufficient capital during the period when the capital ratio fell from 9 percent to zero, it is highly unlikely that they would be able or willing to suddenly provide a substantial amount of capital within 90 days after a bank reaches zero capital. What is more likely, as has been the experience in other countries throughout the world is that the owners will take advantage of this 90 day reprieve to enhance their own position by engaging in asset stripping. The implications for the deposit insurer are significant, including the loss of uninsured depositors leaving the deposit insurer with 100 percent of the subordinated claim (and losses) and a decrease in the value of the assets, increasing the loss rate on the claim.

An additional delaying factor that contributes to excessively lengthy liquidations and receipt, by the PDIC, of dividends on its subrogated claims is a lengthy and complex set of judicial approvals that are necessary for the receivership to function effectively. Policies allowing escrows while litigation is proceeding, and most importantly judicial recognition that, given that the PDIC has insured depositor preference, general creditor claims arising from litigation will not receive any recovery unless the PDIC recovers 100 percent, should be implemented so as to allow for speedier payment of liquidation dividends, despite there being litigation against the liquidation.

Enhanced Resolution Techniques

Currently the PDIC is limited in its resolutions to either paying off insured deposits and liquidating banks or providing open bank assistance. In order for the PDIC to provide open bank assistance the bank must either be determined by the central bank to be "systemically important" or the PDIC may grant open bank assistance when it determines that the continued operation of the bank is essential to provide adequate banking service in the community or maintain financial stability in the economy. A systemic finding is only required if the cost of the assistance exceeds the cost of paying off insured depositors. In all other instances the transaction must cost less than a deposit payout. The latter test is easy to meet since the loss rate on liquidations over the past few years has run between 75 and 80 percent. To date, open bank assistance has been primarily limited to commercial banks since they are significantly larger than rural banks; however, there is no legal barrier to offering it to rural banks and thrifts. Most failures have been rural banks and these have been handled with payouts. However, insured deposit payouts, with the accompanying liquidation of all the assets of the failed bank, can be both disruptive to the public and more costly to the deposit insurance fund.[18] Consequently, authorities need a broader range of resolution techniques.

The PDIC has submitted legislation to broaden its resolution capabilities, including for purchase and assumption transactions. This effort is consistent with the G-20 call for countries to broaden their resolution capabilities and thus the parliament should grant the PDIC the powers it is requesting. Given that a P&A involves another bank purchasing the good assets (or potentially at a discount some of the bad assets) of a failed bank and assuming the insured or all the liabilities of the failed bank the outlays for the deposit insurer are much less than for a pay-out. Also, since typically the good assets are purchased at par, the liquidation receives more for these assets than it would recover in a straight liquidation, thus reducing the cost of the resolution compared to the recovery rate experienced in liquidations.[19] The transaction is less disruptive to depositors since they receive almost immediate access to their funds as deposits at another bank. If PDIC gets authority for P&A transactions it will have to develop a protocol for doing them and will have to train staff so that execution will be quick and smooth.

Another power sought by the PDIC is to be able to establish bridge banks. These institutions, that are owned and operated by the deposit insurer, are typically only used for very large banks. Bridge banks were designed to be used to allow sufficient time for an acquirer of a closed bank to perform due diligence. In this context they could be a more cost effective alternative than open bank assistance for larger insolvent banks. However, bridge banks can involve the deposit insurer in the complexities of operating a bank and can open a whole new range of legal exposures. These risks can be addressed by retaining experienced retired bankers to manage the bridge bank and a combination of

[18] See Kaufman, George and Steven Seelig. "Post-Resolution Treatment of Depositors at Failed Banks: Implications for the Severity of Banking Crises, Systemic Risk, and Too Big To Fail." *Economic Perspectives* vol.26.2002. Federal Reserve Bank of Chicago.

[19] During the mid-1980s the U.S. FDIC adjusted the cost test to favor P&A transactions by recognizing a 10 percent greater recovery in these transactions compared with those where a pay-out and total liquidation had been pursued.

retired PDIC executives and others to serve as board members of the bridge bank while looking out for the PDIC's interest. In a country such as the Philippines, where neither the staff of the deposit insurer or the supervisor have adequate legal protection great care should be exercised before taking the decision to create a bridge bank.

The PDIC currently is restricted in its access to deposit records of a bank prior to its failure. This both can delay the speed with which depositors of a larger or multi-branch bank can be paid their insured amounts and hinder the ability of the PDIC to implement more effective bank resolution techniques. Many countries have imposed some form of cost test on the resolution agency that requires them to demonstrate that an alternate resolution is less costly than an insured depositor pay-out. Since one of the principle advantages of P&A and bridge bank transactions is the speed with which they can be carried out, performing such a cost test will be impossible if the deposit insurer does not have access to sufficient deposit information. Hence, it is imperative that the PDIC be given authority to access deposit records prior to the bank being declared insolvent. Protection for depositors, under bank secrecy laws can be applied to the PDIC while the bank is open.

Asset Liquidation Practices

The PDIC has experienced higher than typical losses on liquidations it manages. The low rate of recovery by the liquidations has resulted in greater losses from bank failures and thus a relatively high cost to the deposit insurance fund. This high loss rate reflects the poor quality of the assets at the time their liquidation begins and the delays discussed above, in the start of the liquidation process. (While it can be argued that a slower liquidation process may result in gains if collateral, such as real estate, appreciates in value over time; however, the present value of such returns over the life of most liquidations is likely to be lower, especially if one uses a risk adjusted discount rate rather than the government bond rate.) Moreover, these losses influence the calculations of the adequacy of the fund. Hence, measures that can increase recoveries and speed up collections will improve the health of the PDIC fund. As mentioned above, P&A transactions will help tremendously in this regard. However, such transactions will not be possible for some rural banks since there will be no interested acquirers.

More aggressive collection and sales practices are needed in the bank liquidation process. In this regard, a cursory review of PDIC policies suggests a number of areas where changes could be made that would have positive results. These include: (i) increasing delegations to staff so that deals can be consummated more quickly and counterparties will not need to add a discount for uncertainties; (ii) more aggressive marketing, including the use of bulk sales; and (iii) establishment of collection targets for liquidation staff. These techniques have been used successfully by other deposit insurers and they require a market based assessment of the value of a distressed loan portfolio.[20] Over time, a market for the assets of Philippine banks may develop independent of the sale of the bank. Consideration could be given to exploring an early sale of some of the

[20] The FDIC has used these approaches since the mid-1980s. IBRA, the Indonesian Bank Restructuring Agency also used sales targets and bulk sales to dispose of assets as did the deposit insurer in Uruguay.

assets of the failed bank, both performing and nonperforming loans. Such markets exist in the U.S. and sales are beginning to be seen in Europe.

Risk Based Premiums

The introduction of a risk based premium regime normally is viewed as revenue neutral to the deposit insurer. Its introduction typically means that the soundest banks will pay lower premiums and the riskiest banks will pay substantially more. Typically the weighted average rate under the risk based scheme is set at, or very close to the previous fixed rate. The benefits of such a scheme are clear, given that it both creates incentives for banks to be in the safest category (typically very well capitalized) and has an element of fairness in that the greater risk takers pay more for the coverage.

One approach that could be used by the PDIC to introduce a risk based premium framework would be to rely on its existing bank classification/rating regime. Alternatively, a two dimensional matrix approach that uses bank classifications as one dimension and the bank's capital ratio as the other could also be used. This has the benefit of recognizing that a bank's tier one capital is the buffer that protects the deposit insurance fund. Under such a framework those banks viewed as least risky would pay significantly lower premiums, while those banks, primarily rural banks, would have a substantial increase in their assessment rate.

However, it must be recognized that when a deposit insurer is currently charging a statutory maximum rate, as is the case with PDIC, the introduction of risk based premiums cannot be revenue neutral but will result in a reduction in assessment revenue. In this situation, the deposit insurer is left with two options, accept lower marginal revenues hoping that the benefits of a risk based scheme will outweigh the loss of revenue or, if there is rapid growth in the assessment base, characterized by uninsured deposits growing more rapidly than insured deposits, this may yield sufficient revenues without increasing the exposure of the fund.

If a deposit insurer does not have reserves great enough for the risks it faces, then policy driven reduction in revenues is counter productive. In the case of the PDIC, where the fund is slightly under capitalized, introducing risk based premiums would be counter-productive, unless the 20 bp statutory limit was lifted. To accomplish this, the sounder banks would clearly have to understand that they will pay minimally less than 20bp and the riskier banks would have to pay significantly more. However, given that uninsured deposits are more prevalent in the larger banks that are viewed as better than small rural banks, a reduction in the large bank assessment rate would have a significant impact on revenues. Thus, introduction of a risk based premium system would lead to an insignificant reduction in commercial bank premiums and therefore render the risk based framework impractical. Only when quality ratings are more uniformly spread against all categories of banks would it be feasible to consider risk based premiums, assuming the DIF was meeting its target rate.

Proposed Policy and Legislative Changes

The Government of the Philippines/PDIC should establish a deposit insurance fund target of 5 percent of insured deposits. Such a target, when met will allow PDIC to cover the likely cost of normally anticipated and unanticipated risks facing the fund. It should be recognized that this target explicitly does not assure adequate funding for a systemic banking crisis nor the ability to liquidate a bank viewed as "too big to fail."

The following are measures that should be taken to implement this policy and to improve the financial position of the PDIF fund, either through operational or resolution measures.

- **The PDIC should reflect an impairment charge on its balance sheet for those assistance agreements that involve a negative cost of carry or anticipated losses on asset purchases.** Such a charge should be the present value of the expected stream of losses.

- **PDIC should build up its analytical capacity to analyze large banks, develop a stress testing capability as well as develop a failure prediction model that allows predictions of the probability of failure.** The current PDIC approach to assessing fund adequacy is not sufficiently forward looking and does not allow management to assess the impact of economic and financial adversities on the fund. Having both of these modeling capabilities, as well as improved analysis capacity, will allow PDIC management to accurately, on an ongoing basis, assess its financial and operational capacity.

- **There is a need for legislation to give the PDIC board greater discretion to increase premiums when the fund is below target.** Such legislation should allow for the following:

    - **Ability of the PDIC board to increase premiums above 20 bp to achieve the target ratio.** It could mandate a lowering of premiums when the target is hit, preferably through rebates to the banks. The 5 percent target could be put in the law as a trade-off for the board receiving greater premium setting flexibility. It also should be given the authority to maintain the 20 bp premium if in its judgment economic or banking conditions warrant maintaining premiums at 20 bp, even if the fund has just reached its target ratio. Such judgment would tie economic uncertainties to projections of increased number of failures.

    - **The PDIC board should be given the authority to make special assessments when the fund is below target and it believes a rapid recapitalization is warranted.**

    - **The PDIC board should be given the authority to require prepayment of assessments as a means of supplementing PDIC's liquidity position.**

- **Once the fund ratio falls below the target, the PDIC must undertake an analysis of what measures, if any, are necessary to return the fund to its target level within a five year period.** This analysis will include projections of assessment revenues over a five year period as well as projections for likely failures during this period and their cost to the fund. Similarly, before a special assessment would be imposed a similar analysis would be undertaken by the board with the addition of an analysis of the liquidity position of the fund.

- **Given that the government of the Philippines has unlimited liability for the obligations of the PDIC it should cease treating it as a state owned enterprise and subjecting it to taxation and mandatory dividends.**

- **Legislation is needed to speed up the closing of insolvent banks.** The following measures are suggested:

  - **Legal protection needs to be provided to BSP supervisors and PDIC staff and managers.** Such protection is necessary because the current exposure to shareholder suits against supervisors personally has served as a deterrent to quick closings of insolvent banks, thus increasing the cost to the PDIC. Shareholders would still be allowed to sue the BSP or PDIC.

  - **Shareholders should not be allowed to stay the actions of the supervisor in closing the bank, nor halt the receivership under a claim of having the bank restored to them.** Rather if they can prove that a closing was improper they would be entitled to monetary damages for the loss of their equity and the franchise value of the bank. In this manner they would have legal protection from arbitrary or improper actions by the supervisor.

  - **The proposal by the BSP for a 90 day period, after capital reaches zero, to allow the shareholders to recapitalize their bank should be rejected.** While this measure may provide defenses for BSP officials if sued personally it comes at the expense of the PDIC and will surely lead to asset stripping and the exit of uninsured depositors.

- **Legislation is needed to speed up the liquidation of banks and the payment of dividends to the PDIC on the subrogated claim.**

  - **The 90 day receivership period to allow shareholders yet another opportunity to rehabilitate a bank should be eliminated.**

  - **Judicial recognition that general creditor claims are subordinated to the subrogated claim and thus likely will have no value and thus**

earlier payment of dividends allowed. Consideration to having a special set of judges handle all bank receivership matters might speed up matters since they would acquire knowledge of banking, PDIC, and receivership law.

- **The legislation submitted by the PDIC to enhance its resolution powers to include purchase and assumption powers and bridge bank authority should be passed.** At present the Philippines is not in compliance with the mandates established by the Group of 20 and the Financial Stability Board calling for countries to have broader and enhanced bank resolution regimes to allow for less disruptive closures at lower cost to the fiscal or deposit insurer.

- **The PDIC should be given authority to access deposit records of banks prior to their failure.** The PDIC needs sufficient time to either plan for a speedy pay-out or to conduct an alternate resolution of a failed bank and this necessitates it having access to deposit records well before the closure of the bank.

- **PDIC should take steps to speed up the liquidation of assets at banks in receivership.** More aggressive and innovative approaches to asset sales and collections are required.