

Philippines: Report on Observance of Standards and Codes—Payment Systems

This Report on the Observance of Standards and Codes on Payment Systems* for the **Philippines** was prepared by a staff team of the International Monetary Fund as part of the Financial System Stability Assessment and included in the background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on **September 16, 2002**. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of the **Philippines** or the Executive Board of the IMF.

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INTERNATIONAL MONETARY FUND

PHILIPPINES

SUMMARY ASSESSMENT OF THE OBSERVANCE OF FINANCIAL SECTOR STANDARDS AND CODES

I. INTRODUCTION AND SUMMARY

1. This section contains summaries of the reviews of compliance and consistency with key principles and standards applicable to the financial sector. Specifically, it reviews compliance with (a) the Basel Core Principles for Effective Banking Supervision; (b) the Committee on Payment and Settlement Systems' (CPSS) Core Principles for Systemically Important Payment Systems; (d) the International Organization of Securities Commissions' (IOSCO) Objectives and Principles of Securities Regulations; (e) the International Association of Insurance Supervisors' (IAIS) Supervisory Principles; and the Code of Good Practices in Transparency in Monetary and Financial Policies. The detailed assessments for each of the standards and codes formed an integral part of the FSAP and an input into the Financial System Stability Assessment (FSSA).

2. The assessment confirms that the infrastructure for effective supervision has improved considerably in recent years and that while important gaps exist, compliance is overall quite high. The weaknesses that exist are however critical and derive in part from a supervisory structure and its enforcement capacities being out of line with key challenges. Among these are the needs to reorient the framework away from forbearance and liquidity support to one that is based on early problem identification, prompt corrective action and resolution.

3. The supervisory authorities are well aware of the concerns raised and have requested technical assistance to develop a comprehensive action plan to deal with the specific concerns as well as to ensure even higher levels of compliance with the relevant standards and codes.

4. The assessments were coordinated by Mr. Masayuki Tamagawa and prepared by:

Basel Core Principles for Effective Banking Supervision	Ms. Barbara Baldwin and Mr. Ronald McDonald (Banking Supervisor, formerly Bank of England), Mr. Marcel Maes (Banking Supervisor, formerly Commission for Banking and Finance, Belgium)
IAIS Core Principles on Insurance Supervision	Mr. Rodney Lester and Miguel Navarro, World Bank
IOSCO Objectives and Principles of Securities Regulation	Mr. Noritaka Akamatsu, World Bank
CPSS Core Principles for Systemically Important Payment Systems	Mr. Philip Woo, (Consultant, Monetary Authority of Singapore)

Code of Good Practices on Transparency of Monetary Policy	Mr. Charles Siegman (Consultant, IMF)
Code of Good Practices on Transparency of Monetary and Financial Policies-Banking Supervision	Mr. Charles Siegman (Consultant, IMF)
Code of Good Practices on Transparency of Monetary and Financial Policies—Deposit Insurance	Mr. Charles Siegman (Consultant, IMF)
Code of Good Practices on Transparency of Monetary and Financial Policies—Securities Market Supervision	Mr. Charles Siegman (Consultant, IMF)
Code of Good Practices on Transparency of Monetary and Financial Policies—Insurance Supervision	Mr. Charles Siegman (Consultant, IMF)
Code of Good Practices on Transparency of Monetary and Financial Policies—Payment System Oversight	Mr. Charles Siegman (Consultant, IMF)

II. OBSERVANCE OF CPSS CORE PRINCIPLES FOR SYSTEMICALLY IMPORTANT PAYMENT SYSTEMS

SUMMARY ASSESSMENT

A. General

5. The assessment has been based on the report “*Core Principles for Systemically Important Payment Systems*” (Jan. 2001) by CPSS and the FSAP Guidance Note (Aug. 2001) by the IMF, the World Bank, and the CPSS. Discussions were held with the central bank, bankers association, clearing house, key banks and service providers, and documents pertaining to the laws, regulations, rules and procedures, contractual agreements, system descriptions, published reports and responses to FSAP questionnaires were reviewed to assess the level of compliance. As a self-assessment exercise against the CPSIPS was not conducted prior to the FSAP mission, such a review has not been factored into this report.

Institutional arrangements and market structure

6. The Bangko Sentral ng Pilipinas (BSP), clearing house and major banks play important roles in the Philippines payment systems. The BSP takes a leading role in establishing interbank clearing facilities and their relevant policies and regulations. It is the primary settlement agent for Peso funds transfers, while the PCHC provides the infrastructure for the clearing, communications network and software for the transmission of settlement instructions between participating banks and BSP. For U.S. dollar payments, Citibank serves as the settlement bank, while PCD and PCHC are the system operators for the real-time and batch transactions of PDDTS.

7. As shown in the table below, the major interbank clearing systems are the cheque clearing, MIPS2-IBCL and the PDDTS-U.S. dollar Gross. Over 92 percent of all interbank funds transfers are transmitted through these systems. The daily funds settlement (net) of

securities transactions averaged PHP 176.5 million, and these are settled via the cheque clearing system.

8. The main means of consumer payments are still via paper cheques and cash. Electronic transactions involving ATMs (~1,250 transactions a day in 1999), credit cards (2.8 percent of population in 1997) and EFTPOS (~1,600 transactions a day in 2000) are relatively small on a per capita basis. Multi-purpose pre-paid card instruments were only recently introduced, like the BPI express cash and smart money card, by a bank and cellular phone company respectively.¹

Table 1. The Philippines: Comparative Table of Interbank Payment Systems

	Daily Average	
	Values (PHP Mil.)	Volume
Cheque clearing 1/	62,436.69	455,749
MIPS2-IBCL 2/	52,483.94	169
PDDTS-U.S. dollars gross 3/	30,354.38	835
EFTIS 2/	6,776.25	177
Peso netting 4/	4,210.52	1,927
ROSS 2/	1,119.28	15
Securities settlement 5/	876.00	5,200
PDDTS-U.S. dollars netting 3	37.99	32

1/ Estimated figures from PCHC (Jan.–Sep. 2001).

2/ BSP figures (until Oct. 2001).

3/ Citibank figures (until Aug. 2001), using US\$1=PHP50.8134 (BSP, Oct. 2001).

4/ PCHC figures for Y2000.

5/ PCD Annual Report 2000 (gross trades).

9. The most significant payment system developments are the enhancement of MIPS to MIPS2 from a net to a gross settlement system in July 2001 and the on-going RTGS project spearheaded by BSP. The RTGS project was initiated in Jan. 2001, and at the time of assessment, BSP was evaluating the submitted proposals from four companies for such a solution. In October 2001, the PCHC assumed the responsibility to clear inter-regional cheques, while BSP continued to clear the 27 local regional ones.

10. The core interbank payment systems are either in place or would be established soon. With the future RTGS system, more securities transactions can be settled on a gross delivery-vs. -payment basis via electronic means, which will significantly improve the processing efficiency and reduce settlement risk. The recent enactment of the Electronic Commerce Act (RA No. 8792) and Rules on Electronic Evidence (July 17, 2001) will also support future developments of the electronic payment systems. There have been several fraudulent cases involving cheques, and the arbitration procedures recently established by PCHC would be

¹ Source: PIDS discussion paper Nov. 2001 on Philippines Payment System.

helpful as a mechanism for resolving cases amicably and not through the courts. It will take some time before clear trends are observed on the effectiveness of arbitration. Although PCHC has made many improvements on the processing of paper cheques, the predominance of paper-based instruments in the consumer payment space might limit the efficiency gains in the future. The Peso-Netting system, an electronic funds transfer facility similar in concept to a GIRO system, is apparently under-utilized as a means to settle low-value interbank payments.

B. Main findings—Summary

11. The identified Systemically Important Payment Systems (SIPS) are MIPS2, cheque clearing and the PDDTS-U.S. dollar gross systems. As most of the issues identified across the three systems are similar, the findings are presented in a general way, while issues that are specific to a particular system are highlighted.

Legal foundation (CP I)

12. The legal and regulatory framework for the establishment of interbank clearing facilities by BSP is in place, but the finality of settlement for both public and private systems is inferred through contractual obligations and does not have as strong a legal underpinning as compared to a central bank law or directive. This may make the enforceability tied to the judicial processes, which may complicate the effectiveness of systemic risk reduction. Absolute clarity on this matter is especially needed when there is an insolvency of a major payment system participant.

13. The specific oversight responsibilities and central bank powers over payment system operators (e.g., PCHC, PCD) is unclear, particularly in the case of private-sector established interbank clearing systems (PDDTS). The manual unwinding process for clearing items may pose some risk given the high overall values through the cheque clearing system, and this is compounded by the long float times for inter-regional clearing and incidences of fraudulent transactions.

Understanding and management of risks (CPs II–III)

14. The rules and procedures for all systems are comprehensive and clear, but their general encapsulation as contractual agreements may weaken their enforceability, although in practice, they are unlikely to be strongly contested. The tools and incentives to manage credit and liquidity risks are generally available, although limited, and the settlement banks (BSP and Citibank) may face certain exposures by implicitly guaranteeing settlement of transactions. For BSP, the current design specifications of the RTGS system would allow participants to manage their liquidity more effectively.

Settlement (CPs IV–VI)

15. The settlement of MIPS2 and cheque clearing transactions is achieved through central bank money in a real-time and end-of-day manner respectively. The move towards an actual

RTGS system would strengthen these processes. In the case of PDDTS, U.S. dollar payments are settled in real-time but across the books of a commercial bank (Citibank). As mentioned in CP 1, the manual unwinding process for cheques raises some concerns, especially in the event of the inability to settle by the participant with the largest single settlement obligation.

Security and operational reliability, and contingency arrangements (CP VII)

16. The contingency plans are generally in place, but the resource capabilities and independent audit of the IT security and controls of BSP and PCHC systems, and particularly the offsite backup facilities and coordination of plans, would need to be improved to strengthen the operational robustness of MIPS2 and the cheque clearing systems. In the case of BSP, they had identified the deficiencies and have been actively addressing them. The remote backups for all three SIPS should ideally be in effectively distant but convenient locations, to minimize the concentration risks, especially after the events of September 11.

Efficiency and practicality of the system (CP VIII)

17. The systems are currently leveraging on existing infrastructures (MIPS2 on PCHC, PDDTS on PCD), which is a good sign of the practicality of all parties given the level of IT investments, pool of expertise and general readiness of participants. Except for PDDTS, the formal mechanisms to monitor operational cost-benefit trade-offs and efficiencies are only rudimentarily practiced. The efficiency aspects, of course, would require to be balanced by the cost and risk considerations, and this was generally observed.

Criteria for participation (CP IX)

18. The general criteria for participation in all three systems are not explicit, although there is an implicit understanding among the parties involved, and BSP provides the high-level regulatory safeguards through its banking supervision role. There are apparently no anti-competitive practices or methods that might compromise the safety, fairness or efficiency within the systems.

Governance of the payment system (CP X)

19. The availability of information, consultations among the various parties, communication of decisions and generally fine across all the systems. The governance structures were observed to be fairly effective, accountable and transparent, and could be strengthened by better clarity on the appropriate oversight authority and overlapping ownership/membership structures of the parties involved.

Central bank responsibilities in applying the CPs

20. The BSP's specific objectives, major policies and oversight of SIPS are implied through legislation, contractual agreements and its powers over the participants, which are all banks. However, payment system oversight in practice, especially over PCHC and private sector systems and operators, is unclear. A self-assessment of the three SIPS by BSP would

be useful, and developing the necessary expertise would enable it to encourage the design and operation of safe and efficient payment systems that form the cornerstone of Philippines' financial sector and economy.

C. Recommended Action Plan

Table 2. The Philippines: Recommended Actions to Improve Observance of CPSS Core Principles and Central Bank Responsibilities in Applying the CPS

Reference Principle	Recommended Action
Legal foundation <i>i.e., CP I</i>	<ul style="list-style-type: none"> Elevate settlement finality to a directive for better legal underpinning. Clarify the procedures within the system in cases of participant insolvency. Introduce explicit legal recognition of netting arrangements for better clarity.
Understanding and management of risks <i>i.e., CPs II–III</i>	<ul style="list-style-type: none"> Consolidate the rules and regulations of the systems into separate, comprehensive and readily available documents. Study feasibility of multiple clearing cycles within a day to reduce the load and risk at the end-of-the-day.
Settlement <i>i.e., CPs IV–VI</i>	<ul style="list-style-type: none"> Review and establish loss sharing or other appropriate measures to minimize systemic risks in instances of default. Clarify the settlement of U.S. dollar in Philippines vis-à-vis United States.
Security and operational reliability, and contingency arrangements <i>i.e., CP VII</i>	<ul style="list-style-type: none"> For clarity, develop comprehensive and coordinated contingency plans. Conduct regular end-to-end IT audits to ensure security policies and operational service levels are on par with market and technological developments. Establish remote backup facilities to remove the concentration risk.
Efficiency and practicality of the system <i>i.e., CP VIII</i>	<ul style="list-style-type: none"> Review the cost structures and establish policies to promote better efficiency. Conduct economic, technology and market impact analysis of the design of the systems and its procedures and propose improvements for a more robust and efficient system.
Criteria for participation <i>i.e., CP IX</i>	<ul style="list-style-type: none"> For clarity, make explicit the participation criteria. For clarity, specify the procedures on exclusion of participants from the system.
Governance of the payment system <i>i.e., CP X</i>	Publish information on the operations, the governance structure, the decision-making processes for greater transparency.

Reference Principle	Recommended Action
Central bank responsibilities in applying the CPs	<ul style="list-style-type: none">• Disclose payment system objectives, the role vis-à-vis different payment system operators and SIPS for clarity and transparency.• Conduct thorough self-assessments of the SIPS against the core principles to identify and rectify other weaknesses.• Establish a team of payment system specialists to coordinate internal payment system policies, operations and risk management, as well as liaise with other authorities, agencies and the industry to promote safety and efficiency.
<i>i.e., Responsibilities A–D</i>	<ul style="list-style-type: none">• Study the wider issues and implications of foreign currency settlement systems in Philippines and seek out relevant foreign authorities for consultations and cooperation.