Deposit Insurance and Its Role in the Financial Safety Net Framework in the Philippines

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I. INTRODUCTION

It is said that "banking, in the modern sense of the word, can be traced from medieval and early Renaissance Italy, to the rich cities in the north like Florence, Venice, and Genoa."[1] In addition, "[t]he word 'bank' is commonly regarded as derived from the Italian word banco, a bench, given that the Jews in Lombardy typically had benches in the market place for the exchange of money and bills."[2] "When a banker failed, his bench was

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1. Banking 2012, Banks and Banking — An Overview, *available at* http://banking-2012.info/ (last accessed Feb. 25, 2011). *See* NOBLE FOSTER HOGGSON, BANKING THROUGH THE AGES — FROM THE ROMANS TO THE MEDICIS, FROM THE DUTCH TO THE ROTHSCHILDS 39-71 (2007 ed.).
2. THOMAS HERBERT RUSSELL, BANKING, CREDITS AND FINANCE 51 (1916).

broken by the populace [— *banco rotto* — and it is] from this circumstance" that the word "bankrupt" emerged.[3]

From market places to financial markets, from benches to local and global branches, the business of banking has evolved into a far more complex undertaking, deeply entwined with the financial landscape. The various roles that banks perform in the economy today include:

(a) They act as intermediaries and ameliorate the information problems between investors and borrowers by monitoring the latter and ensuring a proper use of the depositors' funds.[4]

(b) They share the risk in the economy by diversifying and smoothing fluctuations over time and shield depositors against unexpected consumption shocks.[5]

(c) They contribute to the growth of the economy by providing the resources that funds various enterprises.[6]

(d) They perform an important role in corporate governance as delegated monitors who ensure that firms use the resources allocated to them effectively.[7]

Although the importance of the different roles of banks varies substantially, banks will always play a vital role in the financial system.[8] The relation becomes significant when one begins to consider how a sound financial system can spur a country's economic growth.[9] A reduction in the efficiency of monetary policy and prolonged economic decline may be some of the results of problematic financial systems, and in cases where these problems are in the larger scale, these may cause capital flight or create large

3. *Id.*

4. Franklin Allen & Elena Carletti, The Roles of Banks in Financial Systems, A Discussion on the Various Benefits of Banks in Financial Systems Abstract, *available at* http://fic.wharton.upenn.edu/fic/papers/08/0819.pdf (last accessed Feb. 25, 2011). This study was prepared for the Oxford Handbook of Banking and edited by Allen Berger, Phil Molyneux, and John Wilson.

5. *Id.*

6. *Id.*

7. *Id.*

8. *Id.*

9. International Monetary Fund, Financial System Soundness, *available at* http://www.imf.org/external/np/exr/facts/banking.htm (last accessed Feb. 25, 2011).

expenses relating to the rehabilitation of troubled financial institutions.[10] Also, if the recent global financial crisis is any indication, the financial troubles in one country can rapidly create a contagion that recognizes neither territorial boundaries nor economic status.[11] Hence, the stability of a country's banking and financial system is paramount both at the domestic and international fronts.[12]

This Essay puts into context the function performed by a deposit insurer, specifically the Philippine Deposit Insurance Corporation (PDIC), in the financial safety net framework of the Philippines. It illustrates how the PDIC's performance of its mandate, consistent with international best practice, directly affects the stability not only of our banking system, but the financial system as well. Lastly, this Essay highlights two Core Principles of Effective Deposit Insurance Systems to emphasize international standards against which any intended reform or policy affecting the PDIC should be measured.

II. FINANCIAL SAFETY NET DESIGN

Financial safety net frameworks are intended to maintain the stability of the financial system.[13] In comparing a financial safety net to a circus safety net, Edward J. Kane, a noted author, has this to say:

> In a circus, a safety net serves two purposes. Its immediate function is to protect acrobats from splattering themselves against the ground when they make a mistake and to protect a paying audience from the trauma of witnessing such a disaster. Its deeper purpose is to encourage acrobats to practice and perfect stunts that are challenging enough to thrill an audience.
>
> Stunts must be perfected, because audiences will not pay to watch acrobats fall repeatedly into a net. Carrying out a relatively simple trick is more entertaining than botching a difficult one. From an economic point of view, safety nets are erected not to inspire wild risk-taking, but to embolden performers enough to free their minds to analyze and undertake risks in prudent and skillful ways.[14]

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10. *Id.*

11. *Id.*

12. *Id.*

13. Edward J. Kane, Financial Regulation and Bank Safety Nets: An International Comparison, *available at* http://www2.bc.edu/~kaneeb/FINANCIAL%20REGULATION%20AND%20BANK%20SAFETY%20NETS.doc (last accessed Feb. 25, 2011).

14. *Id.* at 2.

In the same way, there is a two-fold purpose to a financial safety net. Firstly, it is a risk-containment measure.[15] The business of banking is a relatively sensitive and inherently risky endeavor.[16] As Kane puts it, a government's financial safety net consists of the measures it takes to limit the risky positions that institutions take and to limit the damage that customers, employees, and stockholders endure when a disaster ensues.[17]

Secondly, a financial safety net is a framework that shores up confidence in the financial system and encourages stakeholders to participate and undertake reasonable risks that keep the show going, so to speak.[18] Without such confidence in the stability of the financial system, financial institutions become vulnerable at the slightest sign of trouble.[19] In banks, for example, a *banco rottto* may trigger one or several bank runs, which can bring about a liquidity crisis and a potential contagion effect in the banking system. The 2008 global credit crunch is a prime example of this crisis contagion.

A. Components of a Financial Safety Net

Key components of a financial safety net may vary from country to country.[20] But, by and large, an effective financial safety net to support the banking industry generally has certain common components.[21] In its Report on Deposit Insurance,[22] the Financial Stability Forum Working Group identified three elements: (1) prudential regulation and supervision; (2) a

15. *Id.* at 3.

16. *Id.* at 1.

17. *Id.*

18. Sebastian Schich, Financial Crisis: Deposit Insurance and Related Financial Safety Net Aspects, A Note on Financial Safety Nets Particularly on Deposit Insurance 4, *available at* http://www.oecd.org/dataoecd/36/48/41894959.pdf (last accessed Feb. 25, 2011). This Article was prepared for the meeting of the Organization for Economic Cooperation and Development's (OECD) Committee on Financial Markets which was held last Nov. 13, 2008.

19. *Id.*

20. International Association of Deposit Insurers, General Guidance To Promote Effective Interrelationships among Financial Safety Net Participants 5, *available at* http://www.iadi.org/docs/Guidance_Interrelationship.pdf (last accessed Feb. 25, 2011) [hereinafter General Guidance].

21. *Id.*

22. Financial Stability Forum, Guidance for Developing Effective Deposit Insurance Systems, *available at* http://www.financialstabilityboard.org/publications/r_0109 b.pdf (last accessed Feb. 25, 2011).

lender of last resort; and (3) deposit insurance.[23] The Report concluded that if a country has established a well-developed mechanism in only one or two of these three areas, it shall still be expected to face difficulties in finding efficient and real solutions for preventing or solving serious troubles in its banking system.[24]

There are those, however, who propose a slightly expanded definition of financial safety nets.[25] Particularly, "it is suggested that financial safety nets consist of four key elements, which are the three (minimum) elements already mentioned above, [together with] failure resolution mechanisms for financial institutions." The advantage of this more expansive definition is that it permits one to put the issues discussed in the current sphere into a broader context.[26] Each element is discussed below.

1. Prudential Regulation and Supervision

According to the General Guidance to Promote Effective Interrelationships among Financial Safety Net Participants,[27] the regulatory framework and prudential supervision are intended to

> [advance] improved stability performance in the banking system as they [try] to offset the [damaging] consequences of the market failure present in the industry. Prudential regulation and supervision include … the chartering (e.g., licensing) function which [requires] capital and character (fit and proper) and disclosure requirements, [limitations not only] on the types of assets that banks may hold [but also] on the activities in which they may [participate in].[28]

Regulation is intended to lessen unwarranted or unmitigated risks.[29] It is designed to monitor banks and to ensure that they are observing the regulations that will guarantee the safety and reliability of the banking system.[30]

23. General Guidance, *supra* note 20, at 4.
24. Schich, *supra* note 18, at 13.
25. *Id.* at 4.
26. *Id.*
27. General Guidance, *supra* note 20.
28. *Id.* at 5.
29. *Id.*
30. *Id.*

2. Lender of Last Resort

Lender-of-last-resort policies are said to typically have three primary objectives: (1) to protect the integrity of the payment systems; (2) to avoid runs that spill over from bank to bank and develop into a systemic crisis; and (3) to prevent illiquidity at an individual bank from unnecessarily leading into its insolvency.[31]

3. Failure Resolution Mechanisms

An essential part of any country's financial safety net is a timely and effective strategy for handling problems of failed banks.[32] Thus, "even in a healthy economy, banks may become troubled. When a bank is no longer a viable business, the financial safety net should provide [a process] for that bank's resolution and asset liquidation."[33] An effective and efficient failure resolution mechanism also prevents the trouble from exploding into a full-blown crisis. In this way, the adverse effects of a bank's failure are contained with substantially reduced costs and effects on the banking industry, the government, and the economy.[34]

4. Deposit Insurance

Well-functioning deposit insurance is described to lend stability to the financial system and aid in the reduction of the possibility of a banking crisis.[35] It offers stability mainly by reducing potential bank runs.[36] As a side benefit, an effective deposit insurance system also protects small depositors from loss if their banks fail.[37] Overall, a more stable economy, spawned by a less volatile financial system, is the foremost effect of a successful deposit

31. David Folkerts-Landau & Carl-Johan Lindgren, Toward a Framework for Financial Stability 27, *available at* http://www.imf.org/external/pubs/ft/wefs/toward/pdf/file05.pdf (last accessed Feb. 25, 2011).

32. Rosalind L. Bennett, Failure Resolution and Asset Liquidation: Results of an International Survey of Deposit Insurers, *available at* http://www.fdic.gov/bank/analytical/banking/2001sep/article1.html (last accessed Feb. 25, 2011).

33. *Id.*

34. *Id.*

35. Gilberto M. Llanto, Deposit Insurance: Role, Limitations, and Challenges (Philippine Deposit Insurance Corporation, Occasional Paper No. 1), *available at* http://www.pdic.gov.ph/files/PDIC_Occasional_PaperNo1.pdf (last accessed Feb. 25, 2011).

36. *Id.*

37. *Id.*

insurance system.[38] The role of the deposit insurer as an integral part of the financial safety net shall be discussed in further detail later on.

B. The Central Bank

Central banks are regarded as the most important feature of most financial systems today.[39] They play a fundamental role in implementing an effective monetary policy, which is necessarily linked to financial stability.[40] According to Dr. Aslim Tadjuddin, Deputy Governor of Bank of Indonesia:

> [i]f monetary policy is mismanaged, inflation may soar and have adverse impact on the performance of financial institutions and financial markets. For instance, soaring inflation reduces real income and this has contagious effect to the quality of bank loans. While on the other hand, very tight monetary policy also possesses risk to financial stability.
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> ...
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> On the flip side of the coin, it can be shown that financial stability also has significant implications to monetary policy. For example, more effective bank supervision will reduce the probability of bank failures and increase public confidence on banking system. This condition will prevent a flight from broad money and improve the rate of inflation in the short run through variety of mechanisms. In practice, a stable banking system contributes significantly to a long-run effective monetary policy.[41]

He identifies the five primary roles of a central bank towards financial stability, to wit:

> (1) *First*, central banks are the sole authority for establishing a financial stability because it has comprehensive information on the threats to financial stability through *research and surveillance function*. ... The ultimate products of research and surveillance are recommendations for relevant authorities to promptly combat the unfavorable development in financial sector and prevent a stifling crisis.[42]

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38. *Id.*

39. Sam Vaknin, Bankers' Banks — The Role of Central Banks in Banking Crises, *available at* http://ezinearticles.com/?Bankers-Banks--The-Role-of-Central Banks-in-Banking-Crises&id=32548 (last accessed Feb. 25, 2011).

40. Aslim Tadjuddin, Deputy Governor of Bank Indonesia, Address at the APEC Financial Annual Forum in Shanghai, China (Oct. 15, 2003), transcript *available at* http://www.afdc.org.cn/upload/191/downloads/Aslim%20Tadjuddin.pdf (last accessed Feb. 25, 2011).

41. *Id.*

42. *Id.*

(2) *Second*, central banks have vital roles in fostering the soundness of financial institutions, especially banks, as it has the powers of *supervision and regulation*. ... Evidence shows that economies possessing sound market discipline traditionally have strong financial stability[.][43]

(3) *Third*, central banks have tools primarily intended for maintaining price stability; these are *interest rate* and open market operations. These tools are effective instruments for influencing financial stability via intermediary processes as well as for influencing demand in the economy[.][44]

(4) *Fourth*, central banks have a financial safety net function through its function as *lender of the last resort*. The lender of the last resort is the most traditional roles of a central bank for dealing with financial instability and crisis management. It includes both the provision of liquidity in normal times as well as during crisis. This tool has primarily focused on banks and is justified by the vulnerability of banks to liquidity crises that often trigger systemic crises. Illiquidity of a bank has negative impact for the financial system as a whole through inter-bank markets or payment system[.][45]

(5) *Fifth*, central banks have statutory power for payment system oversight. ... As the oversight authority of payment systems, central banks have the information and expertise to identify potential disrupting risks in the payment system that may cause an overall financial instability.[46]

In the Philippines, these tasks are performed by the Bangko Sentral ng Pilipinas (BSP), which, pursuant to its charter,[47] is authorized to administer the monetary, banking, and credit systems of the Philippines.[48] The BSP's primary objective is to "maintain price stability conducive to a balanced and sustainable [economic] growth" and to "promote and maintain monetary stability and the convertibility of the peso."[49] It is the BSP that provides policy directions "in the areas of money, banking, and credit."[50] It also

43. *Id.*

44. *Id.*

45. *Id.*

46. Tadjuddin, *supra* note 40.

47. The New Central Bank Act, Republic Act No. 7653 (1993).

48. *Id.* § 3.

49. *Id.*

50. *Id.*

supervises operations of banks and exercises regulatory powers over non-bank financial institutions with quasi-banking functions.[51]

Relevant to our discussion are the functions performed by the BSP in relation to banks and the banking system, thus:

(1) *Liquidity Management.* The BSP formulates and implements monetary policy aimed at influencing money supply consistent with its primary objective to maintain price stability.

(2) *Lender of Last Resort.* The BSP extends discounts, loans, and advances to banking institutions for liquidity purposes.

(3) *Financial Supervision.* The BSP supervises banks and exercises regulatory powers over non-bank institutions performing quasi-banking functions.

(4) *Other Activities.* The BSP functions as the banker, financial advisor, and official depository of the Government, its political subdivisions and instrumentalities and government-owned-and-controlled corporations.[52]

From the foregoing, it is plain to see that the BSP performs a crucial part in the financial safety net framework of the country. It is the institution that primarily implements the State's interest and policy in ensuring the stability of the financial system, particularly the banking system, as summed up by a provision of the General Banking Law of 2000,[53] to wit:

> SECTION 2. Declaration of Policy. — The State recognizes the vital role of banks in providing an environment conducive to the *sustained development of the national economy and the fiduciary nature of banking* that requires high standards of integrity and performance. In furtherance thereof, *the State shall promote and maintain a stable and efficient banking and financial system* that is globally competitive, dynamic[,] and responsive to the demands of a developing economy.[54]

Indeed, even the Supreme Court has recognized that the "banking system is an indispensable institution in the modern world and plays a vital

51. *Id.*

52. Banko Sentral ng Pilipinas, Overview of Functions and Operations, *available at* http://www.bsp.gov.ph/about/functions.asp (last accessed Feb. 25, 2011).

53. An Act Providing for the Regulation of the Organization and Operations of Banks, Quasi-banks, Trust Entities and for Other Purposes [General Banking Law of 2000], Republic Act No. 8791 (2000).

54. *Id.* § 2 (emphasis supplied).

role in the economic life of every civilized nation."[55] The Court has held in many of its decisions that, "whether as mere passive entities for the safekeeping and saving of money or as active instruments of business and commerce, banks have attained a ubiquitous presence among the people, who have come to regard them with respect and even gratitude and, above all, trust and confidence."[56]

Thus, the Court explained in *Philippine Savings Bank v. Chowking Food Corporation*[57] that the banking business is deemed

> impressed with public interest. Of paramount importance is the trust and confidence of the public in general in the banking industry. Consequently, the diligence required of banks is more than that of a Roman *pater familias* or a good father of a family. The highest degree of diligence is expected.[58]

Likewise, the High Tribunal ruled that "the banking business is properly subject to reasonable regulation under the police power of the State because of its nature and relation to the fiscal affairs of the people and the revenues of the State."[59] Further, "[b]anks are affected with public interest because they receive funds from the general public in the form of deposits."[60] Finally, the Court stated that it is the government's responsibility to ensure that the financial interests of those who deal with banks and banking institutions as depositors or otherwise are protected.[61]

55. *See, e.g.*, Simex International (Manila), Inc. v. Court of Appeals, 183 SCRA 360, 366 (1990).
56. *See* Security Bank and Trust Company v. Rizal Commercial Banking Corporation, 577 SCRA 407, 417 (2009). *See also* Bank of the Philippine Islands v. Roxas, 536 SCRA 168 (2007) & *Simex International*, 183 SCRA 360.
57. Philippine Savings Bank v. Chowking Food Corporation, 557 SCRA 318 (2008).
58. *Id.* at 330 (citing Bank of the Philippine Islands v. Court of Appeals, 326 SCRA 641 (2000); Philippine Bank of Commerce v. Court of Appeals 269 SCRA 695 (1997); & Philippine Commercial International Bank v. Court of Appeals, 350 SCRA 446 (2001)).
59. Central Bank of the Philippines v. Court of Appeals, 208 SCRA 652, 684 (1992).
60. *Id.*
61. *Id.*

III. THE DEPOSIT INSURANCE SYSTEM

Exercising complementary functions with the Central Bank in the financial safety net framework is the deposit insurer.[62] The most important role of the deposit insurer is the protection it provides "depositors from market imperfections by guaranteeing the liquidity of deposits, thus, lending stability to the financial system."[63] To a certain degree, "depending on the coverage, deposit insurance [guarantees the] depositors that their hard-earned savings would be [protected, secured,] and demandable (subject to claims processing) [regardless of] the performance of their depository institution."[64]

It is said that "[a] deposit insurance system provides [specific, albeit] limited protection for [qualified] depositors in the event of a bank failure."[65] Deposit insurance can achieve a number of objectives.[66] The most common of which, however, include contribution to the stability of financial systems, and protection of less financially secured depositors from losses.[67] Absent a credible deposit insurance system, there subsists a possibility that "depositors might 'run' by removing their deposits from a bank, and/or other banks, in response to difficulties at a single bank."[68]

In the Philippines, it is solely the PDIC that performs this function. Created in 1963, it was mandated to protect, through deposit insurance, the depositors of commercial, savings, mortgage, rural, and development, cooperative banks, stock savings and loan associations, branches, and agencies in the Philippines of foreign banks, and all other corporations authorized to perform banking functions in the Philippines.[69]

62. Llanto, *supra* note 35, at 13.

63. *Id.* at 5.

64. *Id.*

65. David K. Walker, Deposit Insurance in Selected Asian Countries: Before and After the Financial Crisis (Philippine Deposit Insurance Corporation, Occasional Paper No. 2) 5 *available at* http://www.pdic.gov.ph /files/Occasional_Paper_No2.pdf (last accessed Feb. 25, 2011).

66. *Id.*

67. *Id.*

68. *Id.* at 6 (citing D.W. Diamond & P.H. Dybvig, *Bank Runs, Deposit Insurance, and Liquidity*, 91 J. POL. ECON. 401-19 (1983)).

69. An Act Establishing the Philippine Deposit Insurance Corporation, Defining Its Powers and Duties and For Other Purposes, Republic Act No. 3591, As Amended, § 4 (b) (1963).

It is to be highlighted that the PDIC Charter, as amended, gives basis for its three-fold function, as enumerated below.

1. The PDIC as Deposit Insurer

The PDIC is the sole insurer of deposits in the Philippines. Under its original charter, deposit insurance coverage is left to the discretion of each bank or banking institution.[70] That is, unless a bank applies for coverage and such application is approved, the deposits held or accepted by such institution will not be protected by the deposit insurance system. Recognizing the difficulty of this setup, and to further emphasize the protection provided by the PDIC, the government made deposit insurance coverage mandatory and automatic on all banks operating in the country.[71] Thus, under the present system, the deposit liabilities of any bank or banking institution, which is engaged in the business of receiving deposits, as defined by the PDIC Charter, shall be insured.[72]

The PDIC reported that the total insured deposits in the banking system, as of June 2010, amounted to ₱1.41 trillion, with 96.9% fully insured at the MDIC of ₱500,000.00 and 3.1% partially insured.[73]

2. The PDIC as Statutory Receiver

The PDIC Charter provides that whenever the Monetary Board of the BSP shall deem it necessary to appoint a receiver for any banking institution, the PDIC shall be appointed as the statutory receiver.[74] As such, the PDIC, as

70. An Act to Amend Certain Sections of Republic Act Numbered Three Thousand Five Hundred Ninety-One Entitled "An Act Establishing the Philippine Deposit Insurance Corporation, Defining Its Powers and Duties and for Other Purposes", Republic Act No. 6037, § 3 (1969).

71. An Act Increasing the Maximum Deposit Insurance Coverage, and in Connection Therewith, to Strengthen the Regulatory and Administrative Authority, and Financial Capability of the Philippine Deposit Insurance Corporation (PDIC), Amending for This Purpose Republic Act Numbered Three Thousand Five Hundred Ninety-One, As Amended, Otherwise Known as the PDIC Charter, and for Other Purposes, Republic Act No. 9576, § 1 (2008).

72. R.A. No. 3591, § 5.

73. Philippine Deposit Insurance Corporation, Bank Deposits Hit ₱4.75-T in H1, *available at* http://www.pdic.gov.ph/index.php?nid1=8&nid2=1&nid=498 (last accessed Feb. 25, 2011).

74. R.A. No. 3591, § 10 (a).

receiver of closed banks, has the duty to hold, manage, and preserve the assets of the bank in trust for all creditors and/or stockholders with due diligence, reasonable skill, sound discretion, and good faith. It is given the control, management, and administration of the affairs of the closed bank and can exercise a broad range of authorities.[75]

3. The PDIC as Co-Regulator of Banks

The BSP remains to be the primary regulator and supervisor of banks in the country.[76] Nevertheless, consistent with its function as deposit insurer and statutory receiver/liquidator, the PDIC is made a co-regulator of banks. Through the amendments to its Charter, PDIC's responsibilities as co-regulator were expanded accordingly. The PDIC is now vested with authority to conduct a special examination of banks upon a finding of unsafe and unsound banking practices.[77] It may also look into deposit accounts and transactions in the event of threatened or impending closure.[78]

4. Government Instrumentality

It must be emphasized that the PDIC is neither a stock nor a non-stock corporation like government-owned-or-controlled corporations (GOCCs). Rather, it is a government instrumentality defined under the Administrative Code[79] as:

> (10) Instrumentality refers to any agency of the National Government, not integrated within the department framework, vested with special functions or jurisdiction by law, endowed with some if not all corporate powers, administering special funds, and enjoying operational autonomy, usually through a charter.[80]

In light of the decision of the Supreme Court in *Manila International Airport Authority v. Court of Appeals*,[81] the PDIC can be considered "a

75. *Id.* § 10 (b).

76. Bangko Sentral ng Pilipinas, Banking Supervision, *available at* http://www.bsp.gov.ph/banking/overview.asp (last accessed Feb. 25, 2011).

77. R.A. No. 3591, § 8.

78. *Id.*

79. Instituting the "Administrative Code of 1987," Executive Order No. 292 (1987).

80. *Id.* § 2 (10).

81. Manila International Airport Authority v. Court of Appeals, 495 SCRA 591 (2006).

government instrumentality vested with corporate powers to perform efficiently its governmental functions."[82] The Office of the Government Corporate Counsel, in Opinion No. 008, Series of 2007,[83] has affirmed the same, to wit:

> On the first query, our review of the PDIC Charter in relation to the guidelines laid down in said MIAA case, indicates that *PDIC is a government instrumentality which is endowed with corporate powers. PDIC is not a government-owned or controlled corporation because it is not organized as a stock or non-stock corporation.* Under Section 13 of Republic Act (R.A.) No. 9302, it has no capital stock divided into shares, nor does it have stockholders or voting shares.
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> ...
>
> Thus PDIC, being a government instrumentality, is not a taxable person because it is not subject to taxes, fees or charges of any kind by local government units save only when its real property is leased to a taxable person in which case, the said property is subject to real estate tax.[84]

That the PDIC is an instrumentality created by the government for public welfare was supported by the Department of Finance (DOF) in proposing the grant of a tax subsidy.[85] The DOF sustains Bureau of Internal Revenue (BIR) Ruling No. 074-86[86] where the BIR recognized that the PDIC is "an instrumentality created by the government for the public welfare and is, therefore, not organized for profit whose functions and objective for which it was created do not come within the purview of doing an insurance business."[87]

Unlike GOCCs, the PDIC does not exist and operate for profit. Its primary purpose is to discharge the governmental function of promoting and safeguarding the interests of the depositing public by way of providing permanent and continuing insurance coverage on all insured deposits.[88] While it is not integrated within the departmental framework of the national

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82. *Id.* at 617.

83. Office of the Government Corporate Counsel (OGCC) Opinion No. 008, Series of 2007 [OGCC Opinion No. 008] (Jan. 9, 2007).

84. *Id.* (emphasis supplied).

85. Tax subsidy and exemptions for PDIC approved, *available at* http://www.congress.gov.ph/committees/commnews/commnews_det.php?newsid=1064 (last accessed Feb. 25, 2011).

86. Bureau of Internal Revenue, BIR Ruling No. 074-86 (July 17, 1986).

87. *Id.*

88. OGCC Opinion No. 008.

government, it is nonetheless attached to the DOF by virtue of Section 3.2 of Executive Order No. 149[89] for "policy and program coordination and/or administrative supervision."[90]

IV. THE PDIC AS AN INTEGRAL PART OF THE FINANCIAL SAFETY NET FRAMEWORK

As part of the financial safety net, the PDIC contributes to the stability of our financial system, complementing the work of the BSP, through the following:

(1) Assuring depositors that they will have access to their insured deposits even if their bank fails. This builds up the public's trust and confidence in our banking system. Given the vulnerability of our financial markets, the confidence in the banks and the banking system prevents panic from spreading throughout the financial system in times of trouble. Such panic adversely affects both healthy and troubled banks if not immediately contained.[91]

(2) To a certain extent, sharing the lender-of-last-resort function of the BSP when it grants, under certain conditions, financial assistance to open banks that run into liquidity or capital inadequacy problems.[92] The assistance can come in the form of capital infusion, loans, asset purchases, or assumption of liabilities. Such assistance keeps the banks operating and may help avert the spread of financial instability in the banking industry.

(3) The PDIC likewise shares in the prudential supervision and regulation functions of the BSP. Through periodic examinations of and required reports from banks, the PDIC is able to monitor the financial and operational soundness of banks. Through regulatory issuances, the PDIC likewise lays down rules and policies that deter the commission of unsafe and unsound banking practices, which can be detrimental to

89. Office of the President, Streamlining of the Office of the President, Executive Order No. 149, § 3.2 (Dec. 28, 1993).

90. *Id.*

91. Llanto, *supra* note 35, at 5 (citing Rikki Tigert Helfer, *What Deposit Insurance Can and Cannot Do*, 36 FIN. & DEV. (1999)).

92. R.A. No. 3591, § 17 (d).

the institution, its depositors, and creditors, and the entire financial system in general.[93]

(4) As the statutory receiver or liquidator, the PDIC ensures the timely and appropriate resolution of closed banks. It takes charge of the closed bank's assets and converts these into cash for the settlement of the closed bank's obligations to depositors and creditors alike.[94] By conducting the liquidation process in an efficient and cost-effective way, the PDIC is able to minimize further disruptions in the banking industry and reduce costs for the closed bank itself.

From the foregoing, it is clear that the PDIC performs a crucial role in making sure that the country's financial safety net works. It functions side by side with the BSP to secure and to maintain the stability of our banking and financial systems.[95] In particular, the PDIC's operations redound to the benefit of the depositors, whose hard-earned savings are protected from bank failures; to the banks, whose operations are kept stable and trusted; and to the bank creditors, who are assured a prompt and straightforward settlement of their claims.

In addition, the PDIC's operations benefit the National Government. The Government cannot afford to allow banks to fail at the risk of depositors losing their money and a contagion spreading among banks.[96] When a bank is in trouble, the PDIC saves the Government from the task of directly bailing out the institution with its own funds. When the bank fails, the Government is able to pay the depositors the amount of their insured deposits through the PDIC and the Deposit Insurance Fund (DIF).

Thus, it is not surprising that it is an avowed policy of the State to "strengthen the mandatory deposit insurance coverage system to generate, preserve, maintain faith and confidence in the country's banking system" and to protect it from unlawful plots and schemes.[97] Towards this end, the Government takes it upon itself to extend all means and mechanisms

93. Llanto, *supra* note 35, at 11.

94. R.A. No. 3591, § 4.

95. Llanto, *supra* note 35, at 9.

96. Norberto C. Nazareno, The Philippine Deposit Insurance Corporation (PDIC): A Key to Banking Stability, *available at* http://www.pdic.gov.ph/index.php?nid1=11&nid2=5&rid=4 (last accessed Feb. 25, 2011). This Article was originally published in the Philippine Banking Almanac IV.

97. R.A. No. 9576, § 1.

necessary for the PDIC to fulfill its vital task of promoting and safeguarding the interests of the depositing public by way of providing permanent and continuing insurance coverage on all insured deposits, and in helping develop a sound and stable banking system.[98]

V. CORE PRINCIPLES FOR EFFECTIVE DEPOSIT INSURANCE SYSTEMS

In the aftermath of the recent global financial crisis, the Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience[99] pointed out "the importance of effective depositor compensation arrangements in giving depositors confidence, thereby reducing the likelihood of a run on the bank, and in supporting confidence in the financial system as a whole."[100] Thus, the Report emphasized the need to assess, and where essential, to reinforce deposit insurance arrangements.[101] The Report also stressed the need for authorities to come up with a clear international benchmark against which the national deposit insurance systems can judge the efficiency of their own system.[102]

In response to the Report, the Basel Committee on Banking Supervision (BCBS) and the International Association of Deposit Insurers (IADI) decided to collaborate to develop an internationally agreed set of core principles using the IADI Core Principles for Effective Deposit Insurance Systems as a basis.[103] The resulting 18 Core Principles are reflective of, and intended to be adaptable to, a wide range of conditions, state of affairs, and settings.[104]

Of the 18 Core Principles, emphasis will be given to two principles against which any reform or new policy affecting the organization and operations of the PDIC will be measured against. The first Principle is on Governance, which states that, "[t]he deposit insurer should be operationally

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98. *Id.*

99. Financial Stability Forum, Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience, *available at* http://www.financialstabilityboard.org/publications/r_0804.pdf (last accessed Feb. 25, 2011).

100. *Id.* at 50.

101. *Id.* at 51.

102. *Id.*

103. Basel Committee on Banking Supervision & International Association of Deposit Insurers, Core Principles for Effective Deposit Insurance Systems, A Consultative Document Published by Bank for International Settlements, *available at* http://www.dictt.org/documents/JWGDI_CBRG_core_principles_BS0911_final.pdf (last accessed Feb. 25, 2011) [hereinafter Core Principles].

104. *Id.* at 2.

independent, transparent, accountable, and insulated from undue political and industry influence."[105]

The BCBS-IADI explanation and supporting guidance for this Core Principle states that:

> [g]overnance refers to the processes, structures, and information used in directing and overseeing the management of an organisation. It concerns *the relationship between the organisation and the authority from which it receives its mandate or to which it is accountable.* The four major elements comprising sound governance are: operational independence, accountability, transparency and disclosure, and integrity. All are equally important, and they reinforce each other in supporting sound governance.[106]

Several authors make the argument for establishing adequate independence arrangements for financial regulatory entities such as the PDIC.[107] They contend that "to be effective, regulatory agencies must enjoy independence in four areas,"[108] namely:

> (1) *Regulatory independence* — which is critical for effective rule making — means that agencies should have an appropriate degree of autonomy in setting prudential regulations, within the broader legal framework. Supervisors who can define regulations are in a better position to respond quickly and flexibly to changing needs and trends in the international markets. Supervisors will also be more motivated to implement and enforce regulations if they have been closely involved in the rule-making process.
>
> (2) *Supervisory independence* is critical to enforcing rules, imposing sanctions, and managing crises. To be effective, supervision must be largely invisible, but this very invisibility makes supervision vulnerable to interference from both politicians and supervised entities. To protect their integrity, supervisors should enjoy legal protection when carrying out their responsibilities so that they cannot be sued personally for their actions — which can paralyze the supervisory process. *Appropriate salaries should help agencies attract and retain competent staff and discourage bribe taking.* Introducing rules-based systems for sanctions and interventions could also discourage improper interference.

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105. *Id.* at 3.

106. *Id.* at 10 (emphasis supplied).

107. Udaibir S. Das, et al., Financial Regulators Need Independence, An Article Originally Published in Finance & Development, *available at* http://www.imf.org/external/pubs/ft/fandd/2002/12/das.htm (last accessed Feb. 25, 2011).

108. *Id.*

(3) *Institutional independence* is guaranteed by clear arrangements for appointing and dismissing senior personnel, the agency's governance structure, the roles and responsibilities of board members, and transparency in decision-making.

(4) *Budgetary independence* is needed so that *the agency has the freedom to determine its staffing, training, and remuneration needs.* Budgetary autonomy is generally better established in countries where supervisors are part of the central bank, because of the latter's budgetary autonomy, and in countries that recently established an integrated (unified) supervisory agency. Many countries are increasingly using an industry levy to fund regulation, and this can reinforce autonomy by freeing regulators from the government's direct budgetary control.[109]

Consistent with the Core Principle of Governance, the same Authors also add that independence for regulatory agencies must be accompanied by accountability, transparency, and integrity to prevent any abuse.[110] Further, they claim that independent agencies must be accountable not only to the executive or legislative branches of government, but also to the public in general.[111]

This Core Principle has been highlighted to emphasize the internationally recognized need to grant a regulatory agency, such as the PDIC, with a certain degree of insulation, not only from the influence of the entities or industry it regulates, but also from the undue interference of politics in the government.[112] If the PDIC is to effectively perform its tasks in the financial safety net framework, it must be accorded a certain measure of insulation from these influences.

Funding, the second Principle, means that:

Principle 11 — Funding: A deposit insurance system should have available all funding mechanisms necessary to ensure the prompt reimbursement of depositors' claims including a means of obtaining supplementary back-up funding for liquidity purposes when required. Primary responsibility for paying the cost of deposit insurance should be borne by banks since they and their clients directly benefit from having an effective deposit insurance system.[113]

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109. *Id.* (emphasis supplied).

110. *Id.*

111. *Id.*

112. *Id.*

113. Core Principles, *supra* note 103, at 4.

The need for adequate funding is evident. In order to perform its mandate as deposit insurer, the PDIC must possess sufficient capital to cover the deposit liabilities of member banks. The Deposit Insurance Fund is the capital account of the PDIC, from which it pays deposit insurance.[114] Under R.A. No. 9576, it has been declared a State policy "that the DIF shall be preserved and maintained at all times."[115]

The composition of the DIF is broken down under Section 13:

> SECTION 13. The Deposit Insurance Fund shall be the capital account of the Corporation and shall principally consist of the following: (i) the Permanent Insurance Fund; (ii) assessment collections, subject to the charges enumerated in Section 6 (d); (iii) reserves for insurance and financial assistance losses; and (iv) retained earnings: *Provided*, That the reserves for insurance and financial assistance losses shall be maintained at a reasonable level to ensure capital adequacy.[116]

in relation to Section 6 (d), of the PDIC Charter, to wit:

> (d.) All assessment collections and income from operations after expenses and charges shall be added to the Deposit Insurance Fund under Section 13 hereof. Such expenses and charges are: (1) the operating costs and expenses of the Corporation for the calendar year; (2) additions to reserve to provide for insurance and financial assistance losses, net of recoverable amounts from applicable assets and collaterals, during the calendar year; and (3) the net insurance and financial assistance losses sustained in said calendar year.[117]

Apart from the Permanent Insurance Fund (PIF) of ₱3 billion[118] that was appropriated to fund the system in 1992, no further capital infusion has been made by the National Government. Since then, it has been the banks, through the mandated assessments, and the PDIC, through its fund-investment efforts, which have borne the burden of building up the DIF.[119]

Still, the DIF is nowhere near the target, which the PDIC had computed to be sufficient to provide protection in case of bank failure.

114. Ernest Leung, Bank Deposit Insurance System in the Philippines, *available at* http://www.pdic.gov.ph/index.php?nid1=11&nid2=5&rid=5 (last accessed Feb. 25, 2011).

115. R.A. No. 9576, § 8.

116. R.A. No. 3591, § 13.

117. *Id.* § 6 (d).

118. Leung, *supra* note 114.

119. *Id.*

During the congressional deliberations for the enactment of reforms to amend the PDIC Charter, PDIC President Jose C. Nograles explained that the Corporation needed ₱24 billion for ample capitalization at the ₱250,000.00 MDIC:

> MR. NOGRALES. Your Honor, just to answer your question on the point of Congressman Villafuerte. The 24 billion is the reserve fund that we need to fund the 250, it's not to fund the one million. May I direct, Your Honor, to the board, this is as of December 2007. We have an estimated insured deposit base of ₱888 billion, '*no*. This require [sic], sir, based on our computation on risks and our risk modeling required insurance reserve of ₱73.2 [billion]. Our actual insurance reserve now is ₱49.2 [billion], *iyung* 54 *kanina* sir, if you add 49.2 plus 3 plus 2, *iyung sinasabi ninyong iyung three billion sir sa baba, iyung* permanent insurance fund[,] that is the fund given by the government and the retained earnings is ₱2.1 billion as correctly pointed out as been going over the years. [Our actual reserve now is ₱49.2 billion, the figure 54 mentioned earlier is derived from the sum of 49.2, 3, and 2. The three billion is from the PIF, that is…]
>
> So what we're saying, sir, if you take away the permanent insurance fund and the retained earnings and try to match what is need [sic] for an eight hundred eighty-eight billion insured deposit base we are short of twenty-four, that is how we derived, sir, the twenty-four, this is still at the two hundred fifty level.[120]

However, the patent problem of funding from the National Government surfaced soon enough as brought up by Representatives (Rep.) Roilo S. Golez and Luis R. Villafuerte, to wit:

> REP. GOLEZ. For example, the ₱24 billion being asked by the PDIC, how much of that is needed immediately? That will be coming from the National Government. So ₱24 billion on top of [a] ₱80 billion or a ₱40 billion deficit, expected deficit that may increase to a [sic] ₱100 billion, if we do not adjust the 1.4 trillion budget of the government, will add to the budgetary deficit and increase even the domestic interest rate because of that.
>
> …
>
> REP. VILLAFUERTE. But in the meantime, I think, Congressman Golez has pointed out—where is the government going to get that money? Now,

120. Transcript of Records, House Committee on Banks and Financial Intermediaries VII-5 (Nov. 11, 2008).

under the present GAA there is no way for the national government to provide that money.[121]

With the increase in the MDIC from ₱250,000.00 to ₱500,000.00 under R.A. No. 9576, Congress recognized the importance of a healthy and sufficient DIF by including financial strengthening measures aimed at ensuring the stability of the Corporation. These measures include: (1) the provision for the deposit insurance sharing between the PDIC and the National Government for a three-year period;[122] and (2) the charging of the tax obligations of the Corporation with the Tax Expenditure Fund (TEF) for a period of five years after which tax exemption takes effect.[123]

As explained by Rep. Jaime C. Lopez, Chairman of the House Committee on Bank and Financial Intermediaries:

> THE CHAIRPERSON. The idea was that PDIC will ... if and when there will be an increase from ₱250,000[.00] to ₱500,000[.00], PDIC will shoulder the first ₱250,000[.00]. In other words, payment made by PDIC to insured closed banks of ₱250,000[.00] shall be for the account of PDIC. Now, in excess of ₱250,000[.00] but below ₱500,000[.00] shall be for the account of the national government which shall appropriate the necessary fund thereafter. *In other words, the bill will not entail any transfer of fund and increase of the capitalization of PDIC. So you'll not benefit from any increase in capitalization. You will have only to be reimbursed, in other words, of payments in excess of ₱250,000[.00].*[124]

Similarly, the provision granting the PDIC the benefit of charging its tax obligations against the TEF is another concession to compensate for the financial constraints on the part of the National Government to directly infuse capital and to grant outright tax exemption.[125]

It must be pointed out that the PDIC does not receive any budgetary support from the National Government aside from the PIF allotted to it. On the contrary, it is the PDIC that regularly remits a significant portion of its earnings to the National Government annually.[126] That it is able to be self-sufficient in building up and preserving the integrity of the DIF and

121. *Id.* VIII-3.

122. R.A. No. 9576, § 4.

123. *Id.* § 8.

124. Transcript of Records, House Committee on Banks and Financial Intermediaries 1-3 (Feb. 11, 2011) (emphasis supplied).

125. R.A. No. 3591, § 17.

126. Leung, *supra* note 114.

exclusively funding its operations, all while performing its functions with complicity, should not take away the Government's interest in protecting the Corporation from threats to its financial capacity. After all, the Government itself benefits from the existence and operations of the PDIC.

VI. CONCLUSION

Without a doubt, the deposit insurance system plays a crucial part in creating and implementing an effective financial safety net framework. In the Philippines, the PDIC performs an even greater role than being the deposit insurer, as it is likewise a co-regulator of banks and the statutory receiver or liquidator. It complements the workings of the central bank, which is the BSP, in ensuring the stability of both the banking and the financial systems in the country. The existence and operations of the PDIC benefit not only banks and their depositors, but also the National Government, which is saved from the costly task of bailing out failed institutions and paying off depositors for lost deposits.

Given the significance of its functions, the deposit insurer must be able to operate efficiently and effectively. For this purpose, guidance may be had from international standards such as the Core Principles of Effective Deposit Insurance Systems. Special emphasis is given to the need for the proper amount of governance and independence in the operations of the deposit insurer as well as the utmost necessity to protect its financial capabilities.