



Philippine Institute for Development Studies  
*Surian sa mga Pag-aaral Pangkaunlaran ng Pilipinas*

## Integrated Financial Supervision: An Institutional Perspective for the Philippines

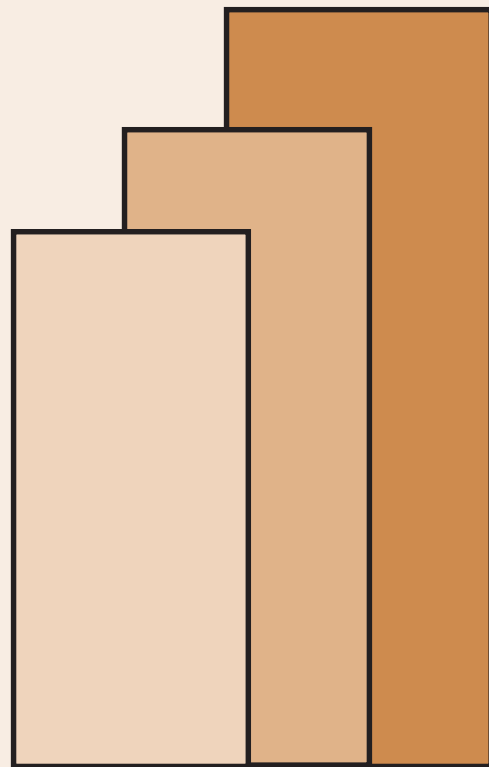
*Melanie S. Milo*

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**“Integrated Financial Supervision:  
An Institutional Perspective for the Philippines”**

Melanie S. Milo, Ph.D.<sup>1</sup>

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<sup>1</sup> Senior Research Fellow, Philippine Institute for Development Studies. This paper was written while the author was a Visiting Researcher at the Asian Development Bank Institute, Tokyo. Ms. Fatima del Prado and Mr. Don Yasay provided excellent research assistance. The usual caveat applies.

# **“Integrated Financial Supervision: An Institutional Perspective for the Philippines”**

Melanie S. Milo, Ph.D.

## **Abstract**

This paper looks at the issue of reforming financial regulatory structures from the New Institutional Economics perspective. In particular, it examines how the broader institutional environment prevailing in developing countries like the Philippines may affect the institutional arrangements for financial regulation, and how these might be taken into consideration when designing or reforming financial regulatory structures. The paper argues that the state of financial conglomerates in the Philippines does not warrant a shift toward integrated financial supervision. Instead, any effort to reform the financial supervisory structure must explicitly address the country’s most fundamental need, which is to strengthen institutions and governance structures. Key institutional characteristics must already be in place to undertake such a reform successfully, including sound political and legal systems and enforcement mechanisms. That being said, properly structured independent regulatory agencies in the financial sector can play a part in strengthening the overall regulatory environment.

JEL classification: G20, G28, H11, O16, P16

Key words: financial sector, financial development, financial services regulation, regulatory agencies, regulatory structure, integrated supervision, institutions

## **Glossary**

ASEAN	Association of Southeast Asian Nations
BCP	Basel Core Principles for Effective Banking Supervision
BSP	Bangko Sentral ng Pilipinas (Philippine Central Bank)
CBFA	Central Bank as Financial Authority index
EFW	Economic Freedom of the World
FAC	Financial Authorities Concentration index
FMA	Financial multi-authorities
FSA	Financial supervisory authority
FSF	Financial Sector Forum
GDP	Gross domestic product
GSJ	Global standard institution
GSIS	Government Service Insurance System
IAIS	International Association of Insurance Supervisors
IC	Insurance Commission
ICP	Insurance Core Principles
IMF	International Monetary Authority
IOSCO	International Organisation of Securities Commissions
NBFI	Non-bank financial institution
NIE	New Institutional Economics
OCC	Office of the Comptroller of the Currency
OECD	Organisation for Economic Cooperation and Development
SEC	Securities and Exchange Commission
SSS	Social Security System

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# Integrated Financial Supervision: An Institutional Perspective for the Philippines

Melanie S. Milo, PhD<sup>2</sup>

## I. INTRODUCTION

The literature on the Asian financial crisis typically contends that financial liberalization and the removal of obstacles to foreign borrowing by banks and the corporate sector, coupled with poor and inadequate prudential supervision, gave rise to the risk of moral hazard and the resulting financial crisis. Consequently and not surprisingly, the enhancement of prudential regulation and supervision<sup>3</sup> of banks through the adoption of international standards or “best practices” was among the recommendations and prerequisites for the recovery of the affected Asian economies. The architecture of financial supervision and any need for change also became an important issue to be addressed. Thus, strengthening the supervisory mechanism under the International Monetary Fund (IMF) programs for Indonesia, the Republic of Korea, and Thailand also required the establishment of integrated prudential regulators (Gochoco-Bautista *et al.*, 1999). However, to date, only the Republic of Korea has managed to completely undertake such a reform. In fact, the desirability of unified regulatory agencies—that is, agencies that supervise two or more of the traditional financial services sectors—has in itself become the focus of significant research recently. The primary reason has been the trend towards the forming of financial conglomerates.

This paper examines the issue of reforming financial regulatory structures from the New Institutional Economics perspective. That is, it investigates how the broader institutional environment prevailing in a developing country like the Philippines may affect the institutional arrangements for financial regulation, and how these might be taken into consideration when designing or reforming financial regulatory structures.

The paper has six sections. Section II describes the state of financial conglomerates in the Philippines and how they are currently supervised to determine whether any significant reform in the financial regulatory structure is warranted. Section II also discusses how the Philippine experience compares to those in other countries in the region. Section III discusses the supervisory implications of financial conglomeration, and the various regulatory approaches that have been adopted to address them. In Section IV, the role of institutions in economic development is discussed, particularly as seen through the New Institutional Economics (NIE) paradigm. The overall institutional environment of the Philippines is also discussed. Drawing on the NIE perspective, alternative approaches taking an institutional perspective to view financial sector issues and policies are then presented in Section V. In particular, the issue of reforming financial regulatory structures is analyzed from the new political economy perspective. Finally, Section VI presents some recommended modifications to the financial regulatory framework in the Philippines.

This paper does not cover the theoretical arguments for and against financial conglomerates or the historical rationale, evolution, and supervision of financial conglomerates in the Philippines. Neither does it analyze the various regulatory approaches, including the trend towards having a single financial regulator model. These approaches have been discussed

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<sup>3</sup> As traditionally defined, regulation refers to the set of rules and standards that govern the operation of financial institutions, while supervision refers to the oversight/monitoring of the application of those rules and standards. For the purposes of this paper, the two terminologies are used interchangeably.

in an earlier paper.<sup>4</sup> Current regulatory problems in individual financial sectors that are not directly related to financial conglomerates are mentioned to highlight the key issue with respect to the Philippine financial regulatory framework.

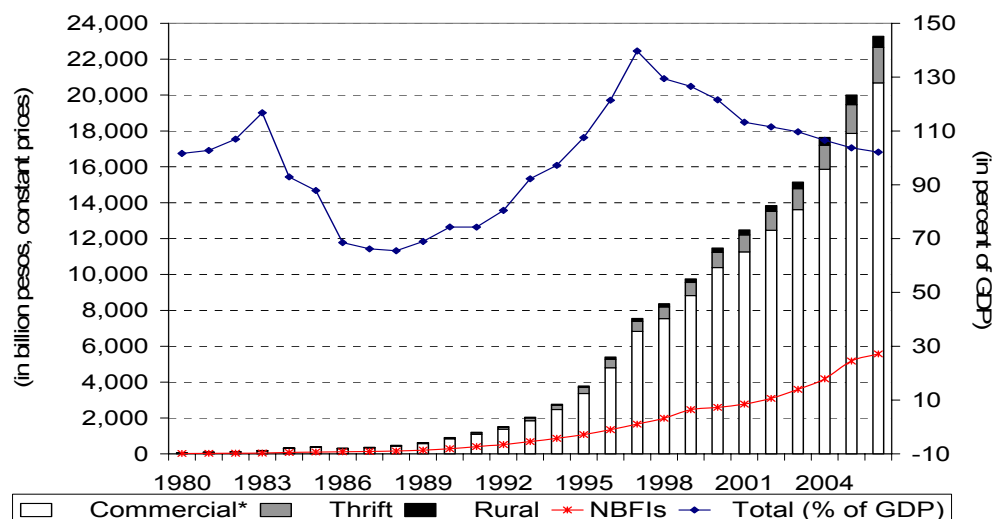
## II. TRENDS IN FINANCIAL CONGLOMERATION

### A. Overview of the Philippine Financial Sector

The Philippine financial system consists of banks and nonbank financial institutions (NBFIs). Banks are classified into the categories of universal banks (or expanded commercial banks), commercial banks, thrift banks (savings and mortgage banks, stock savings and loan associations, and private development banks), rural banks, cooperative banks, and Islamic banks. NBFIs include insurance companies, investment houses, financing companies, securities dealers and brokers, fund managers, lending investors, pension funds, pawn shops, and nonstock savings and loan associations.

Figure 1 shows the total assets of the Philippine financial system from 1980 to 2006. Total assets of the financial system as a percentage of GDP rose from around 102% in 1980 to 117% in 1983, and then continuously declined to 66% in 1988 as a result of the financial and economic crises in the mid-1980s. The ratio in 1988 was around the same level as that in 1970. The ratio then steadily rose to around 140% in 1997. But the trend was again reversed in the aftermath of the Asian financial crisis, with the ratio falling to its 1980 level of 102% in 2006. Thus, there has been no significant and consistent growth in the size of the Philippine financial sector in the past 35 years.

**Figure 1: Assets of the Philippine Financial System, by Type of Institution, 1980–2006 (In Billion Pesos, Constant Prices)**



Note: \*Commercial includes commercial bank and universal banks.

Source of basic data: Bangko Sentral ng Pilipinas; National Statistical Coordination Board.

The Philippine financial system has consistently been dominated by banks, particularly commercial banks.<sup>5</sup> In fact, the importance of commercial banks has increased over time.

<sup>4</sup> Milo (2002).

<sup>5</sup> Commercial banks refer to both commercial banks and universal banks, unless otherwise specified.



The banking system accounted for 81% of total financial assets in 2006, compared to around 76% in 1970. The asset share of commercial banks also increased from around 57% in 1970 to 72% in 2006. Total assets of commercial banks grew significantly in the 1990s due to the successive increases in minimum capital requirements, the upgrading of the specialized government banks into universal banks, and the entry of new local and foreign banks. In particular, universal banks dominate with an asset share of 80% of total commercial banking assets in 2006. In contrast, the asset share of rural banks fell from around 3% in the 1970s to 2% in 2006, while the asset share of thrift banks only slightly rose to 7% in 2006 from 4% in 1970. In contrast, the share of NBFIs in total financial assets fell from a high of 28% in 1975 to 19% in 2006. The dominant sector under NBFIs is the insurance sector. In fact, the share of the insurance sector in total NBFIs assets significantly increased over the past two decades, from 47% in 1980 to almost 80% in 2005. However, around 60% of the assets of the insurance sector were in turn accounted for by two government insurance corporations: the Government Service Insurance System (GSIS) and the Social Security System (SSS).

Thus, there has been no significant structural change in the Philippine financial sector. A bank-dominated financial system is not necessarily bad. The issue is whether such a structure is a market outcome or the result of government regulation. In the case of the Philippines, it was clearly the latter. The banking sector has historically been the focus of financial sector policy, development, and reform. In contrast, efforts to reform and develop the other sectors of the financial system began only in the mid-1990s. A theory on the relationship between financial development and economic development in a market-oriented economy posits that the banking system, which initially leads financial development, declines in importance as real growth and financial development continue (Goldsmith, 1969). One observed characteristic of the process of economic development over time in a market-oriented economy is an expansion and elaboration of the financial structure (institutions, instruments, and activities). On the other hand, economic development is retarded if financial intermediaries do not evolve (Patrick, 1966). This theory has been borne out by recent empirical literature.<sup>6</sup>

The dominance of banks in the financial system is not unique to the Philippines. Banks continue to be the biggest sector in most financial systems in East Asia, although there has been progress in diversifying financial markets especially after the 1997 Asian financial crisis. In particular, the focus of policymakers in the region has been to develop the equity and bond markets (Ghosh, 2006). Table 1 shows the structure of financial systems in East Asia. Overall, financial development in the Philippines lags behind other comparable countries in the region, particularly Thailand and Malaysia.

**Table 1: Structure of Financial Systems in East Asia (% of GDP)**

	Bank assets		Equity market capitalization		Bonds outstanding	
	1997	2005	1997	2005	1997	2005
China, People's Rep. of	124.6	163.1	11.2	17.8	12.9	24.4
Indonesia	31.1	49.8	12.2	28.9	1.9	19.6
Korea, Republic of	37.9	93.5	8.1	91.2	25.2	76.2
Malaysia	100.9	159.4	93.2	138.0	57.0	88.0
<b>Philippines</b>	<b>56.1</b>	<b>63.2</b>	<b>37.7</b>	<b>40.4</b>	<b>22.4</b>	<b>36.7</b>
Singapore	122.0	185.4	110.8	220.4	26.0	68.2
Thailand	79.7	103.6	15.1	70.1	7.1	40.8

Source: Ghosh (2006): Table 1.1, p. 27.

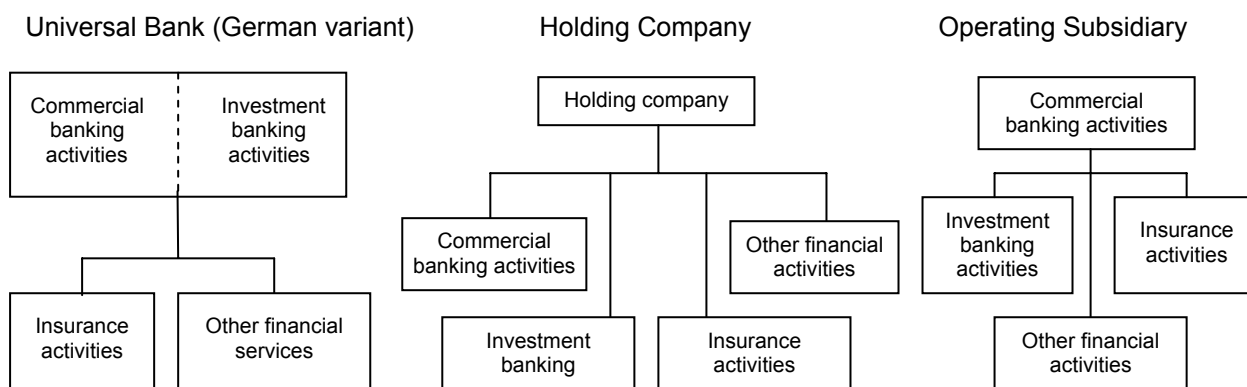
<sup>6</sup> See Levine (2003) and Demetriades and Andrianova (2003) for recent overviews of the literature.

Given the dominance of universal banks in the Philippine financial sector, the next section discusses Philippine and worldwide trends in financial conglomeration.

## B. Overview of Financial Conglomerates in the Philippines

Figure 2 presents three alternative structures for the undertaking of nontraditional activities by commercial banks: the universal bank, in which the nontraditional activity is consolidated within the same corporate unit as the bank; the holding company affiliate, in which the bank is in one subsidiary of a holding company and the nontraditional activity is in another subsidiary of the holding company; and the operating subsidiary, in which the nontraditional activity is located in a subsidiary of the bank (Shull and White, 1998). A pure universal bank is one that manufactures and distributes all financial services within a single corporate structure, while the German variant combines commercial and investment banking in a single corporation but conducts other financial activities through separately capitalized subsidiaries. A universal bank can also be considered a financial conglomerate. The Joint Forum on Financial Conglomerates<sup>7</sup> defines financial conglomerates as “any group of companies under common control whose exclusive or predominant activities consist of providing significant services in at least two different financial sectors (banking, securities, insurance)” (Joint Forum, 1995: 1). Bancassurance, a marketing arrangement wherein banks sell insurance products, that involves affiliated firms also meets the definition of a financial conglomerate. The structure that a bank adopts in delivering integrated financial services is influenced primarily by regulation. There are also other factors, including the historical development of a country’s financial markets, market power, and economies of scale and scope (Skipper, 2000).

**Figure 2: Three Alternative Bank Structures for Delivering Integrated Financial Services**



Sources: Shull and White (1998), Skipper (2000).

The Philippines introduced extended commercial banking or the German variant of universal banking as part of the initial financial liberalization program in 1980. A universal bank was allowed to perform the functions of an investment house either directly or indirectly through a subsidiary. Table 2 shows the number of commercial and universal banks from 1980 to 2006. In contrast to previous decades, the period after 1995 was characterized by significant movement in terms of new entries and consolidations. In particular, the number of foreign bank branches and subsidiaries increased as a result of deregulation of foreign entry in 1994. The number of private domestic banks also increased in the first half of the 1990s as a

<sup>7</sup> The Joint Forum was established in 1996 under the aegis of the Basel Committee on Banking Supervision, the International Organisation of Securities Commissions (IOSCO), and the International Association of Insurance Supervisors (IAIS), in order to take forward the work of the Tripartite Group on a range of issues relating to the supervision of financial conglomerates.

result of deregulation of entry, and then decreased towards the latter half of that decade due to mergers and acquisitions.

**Table 2: Number of Commercial Banks by Type, 1980–2006**

Type of commercial bank	1980	1990	1995	1997	2000	2006	% Share in total KB assets (2006)
Total	32	30	48	54	45	39	100
Universal banks	1	11	19	21	17	17	82
Private domestic		10	15	18	12	11	63
Government	1	1	4	3	3	3	14
Branches of foreign banks					2	3	5
Commercial banks	31	19	29	33	28	22	18
Private domestic	27	15	15	15	11	8	8
Subsidiary of foreign banks				4	6	3	1
Branches of foreign banks	4	4	14	14	11	11	9

Source: Bangko Sentral ng Pilipinas.

Thus, in contrast to other developing countries, the Philippines has had a long history of universal banking. In addition, the country has continued to follow a policy of despecialization by allowing banks to further widen their range of permissible activities and products. Table 3 presents the current ceilings on equity investments of banks. Cross-selling was also allowed under the new General Banking Law of 2000, and bancassurance was formally introduced in 2002. Initially, Bangko Sentral ng Pilipinas (BSP) planned to allow universal and commercial banks to sell only their subsidiaries' financial products, such as mutual funds and life insurance. A subsidiary is defined as a firm in which a bank has at least a 51% stake. The Monetary Board later decided to include banks' affiliates, which were then liberally defined as financial allied firms in which banks had at least a 5% stake, after foreign insurance companies argued that the subsidiary requirement favored only two universal banks. The Philippines' relatively unrestrictive stance on banks' allowable activities is further highlighted when compared to other countries in the region (Table 4).

**Table 3: Limits on Equity Investments of Banks**

Investee company	Equity ceilings of investing banks (%)			
	UB	KB	TB	RB
Allied				
Financial allied				
KBs <sup>a</sup>	100	49	49	49
TBs	100	100	49	49
RBs	100	100	49	49
Insurance companies	100	Not allowed	Not allowed	Not allowed
Venture capital corps	60	60	60	60
Others	100	100	100	100
Non-financial allied	100	100	100	49
Non-allied	35	Not allowed	Not allowed	Not allowed

**Notes:** UB = Universal banks (or expanded commercial banks); KB = commercial banks; TB = thrift banks; RB = Rural banks.

<sup>a</sup>In only one bank.

**Source:** Bangko Sentral ng Pilipinas.

**Table 4: Degree of Restrictiveness of Regulatory Restrictions on Bank Activities and the Mixing of Banking and Commerce in East Asia (as of 2005)**

	Securities	Insurance	Real estate	Bank ownership of non-financial firms	Ownership of banks by nonfinancial firms	Ownership of banks by nonbank financial firms
Cambodia <sup>a</sup>	unrestricted	unrestricted	prohibited	restricted	unrestricted	unrestricted
China, People's Rep. of	prohibited	restricted	prohibited	prohibited	permitted	permitted
Indonesia	prohibited	prohibited	prohibited	prohibited	permitted	permitted
Japan	permitted	permitted	prohibited	restricted	permitted	permitted
Korea, Rep. of	restricted	restricted	restricted	permitted	restricted	restricted
Malaysia	permitted	restricted	restricted	restricted	restricted	restricted
Philippines	unrestricted	permitted	permitted	permitted	restricted	restricted
Singapore	unrestricted	restricted	restricted	restricted	permitted	permitted
Thailand	prohibited	restricted	restricted	restricted	restricted	restricted
Viet Nam <sup>b</sup>	prohibited	prohibited	prohibited	permitted	restricted	restricted

**Notes:** <sup>a</sup>As of 2001; <sup>b</sup>As of 1999.

Income group: 1—Low income; 2—Lower middle income; 3—Upper middle income; 4—High income/non-OECD; 5—High income/OECD

For securities, insurance and real estate activities:

Unrestricted: full range of activities can be conducted in the bank/bank may own 100% of equity.

Permitted: full range of activities can be conducted, but all or some must be conducted in subsidiaries/bank may own 100% of equity but ownership is limited based on bank's equity capital.

Restricted: less than full range of activities can be conducted in the bank or subsidiaries/bank can only acquire less than 100% of equity.

Prohibited: activity cannot be conducted in either the bank or subsidiaries/no equity investment allowed.

For regulatory restrictiveness of bank ownership of nonfinancial firms (ownership of banks by nonfinancial/nonbank financial firms):

Unrestricted: a bank (nonfinancial/nonbank financial) may own 100% of the equity in a nonfinancial firm (commercial bank).

Permitted: a bank (nonfinancial/nonbank financial) may own 100% of the equity in a nonfinancial firm (commercial bank), but prior authorization or approval is required.

Restricted: limits are placed on ownership.

Prohibited: cannot own any equity investment whatsoever

**Source of basic data:** Bank Regulation and Supervision Database, World Bank (2007; 2003 for Cambodia and 2001 for Viet Nam).

In 2004, BSP undertook a conglomerate-mapping exercise to facilitate its supervisory work. The focus of the exercise was on private domestic banks and their subsidiaries and affiliates. The exercise showed that nine universal banks and one commercial bank could be considered as constituting the core financial conglomerates, according to the definition of the Joint Forum on Financial Conglomerates. The 10 banks accounted for 58% of the total assets of the commercial banking system.

The average number of subsidiaries and affiliates was 27. The nine universal banks, which are the only banks allowed to have non-allied subsidiaries or affiliates, could be considered mixed conglomerates. The average number of non-allied subsidiaries and affiliates was six. These ten financial conglomerates are still primarily banking in nature. On average, total assets from the parent bank to the consolidated group increased by only 6%. Furthermore, lending activities are still conducted in their parent bank. The average increase in total loans was only 8%, from the parent bank to the consolidated group (Yuvienco 2007).

Table 5 gives a summary of various subsidiaries and affiliates of the universal banks in 2005 or 2006. The results show that only four banks have diversified holdings – the two biggest banks (Metropolitan Bank and BPI) and two smaller-sized banks (Allied and RCBC).

**Table 5: Summary of Private Domestic Universal Banks' Subsidiaries and Affiliates (as of 2005)**

	Bank	Insurance	Investment house	Stock brokerage	Other fin'l institutions <sup>a</sup>	Non-fin'l enterprises	% Share of subsidiaries/affiliates in consolidated assets	% Share of parent bank in total KB assets (2006)
Allied Banking Corp.							17.5	2.9
Banco De Oro							7.7	6.5
Bank of the Philippines Islands (BPI)							19.0	10.9
China Banking Corp.							0.1	3.6
Equitable Banking Corp. <sup>b</sup>							5.6	7.5
Metropolitan Bank and Trust Co.							15.8	12.4
Philippines National Bank							0.5	5.6
Rizal Comm'l Banking Corp. (RCBC)							15.5	4.4
Security Bank Corp.							0.9	2.8
Union Bank of the Philippines							0.0	4.3
United Coconut Planters Bank							7.1	2.5

**Note:** <sup>a</sup>Other financial institutions include foreign exchange corporations, leasing and finance operations, venture capital corporations; special purpose asset vehicles/asset management companies; and credit card companies.

<sup>b</sup>As of 2006.

**Source of basic data:** Commercial banks' Published Consolidated Statement of Condition and Annual Reports, various years.

An alternative way of measuring commercial banks' range of services is to assess the extent to which they are providing fee- and non-fee based services, based on their income statements (Ghosh 2006). In particular, the income diversification index (IDI) measures the importance of traditional banking services relative to nontraditional banking services. That is,

$$IDI = 1 - \text{abs}[(\text{net interest income} - \text{other operating income})/\text{total operating income}] \quad (1)$$

A score of one denotes perfect diversity; that is, interest income and other sources of operating income are exactly equal. A score of zero, on the other hand, denotes specialization in one line of activity. The index will be reduced by imbalances of income (Ghosh 2006; Corbett 2007).

Table 6 presents measures of consolidation and diversification of banking sector activities in selected East Asian economies. The results show that significant consolidation has taken place in the region since the Asian financial crisis, as indicated by the large rise in the median size of banks. This is also true in the Philippines, but Philippine banks are considerably smaller compared to banks in similar economies such as Malaysia and Thailand. Although it is not easy to systematically measure the range of services being provided by the banks, the income diversification index indicates that banks have broadened

their range of services as well. This is especially true in Malaysia, the Philippines and Thailand (Ghosh 2006).

**Table 6: Measures of Consolidation and Diversification of Banking Sector Activities in Selected East Asian Economies**

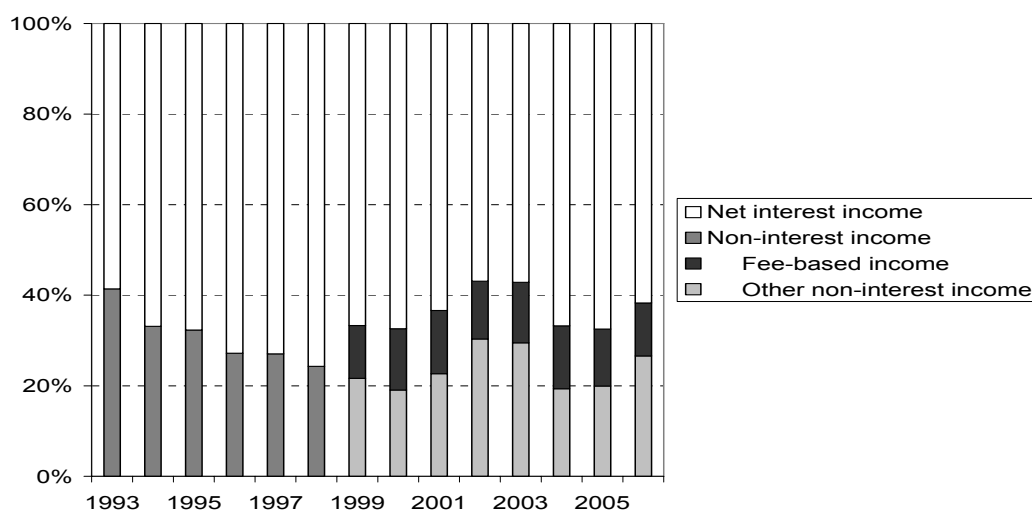
	Median size of assets (US\$bil)		Median market share of assets (%)		Income diversification index	
	1998	2004	1998	2004	1998	2004
Indonesia	0.2	0.8	0.4	0.7	0.46	0.45
Korea, Rep. of	16.7	61.9	4.0	5.8	0.65	0.61
Malaysia	1.9	7.4	1.3	2.7	0.53	0.64
<b>Philippines</b>	<b>0.4</b>	<b>1.3</b>	<b>0.8</b>	<b>2.4</b>	<b>0.57</b>	<b>0.65</b>
Singapore	2.2	0.8	0.8	0.2	0.40	0.41
Thailand	4.4	13.4	3.9	6.9	0.41	0.61

**Source:** Ghosh (2006): Table 4.4, p. 82.

**Note:** To ensure the comparability of the banks in the sample, it is limited to banks identified by Bankscope as commercial banks, savings banks, and bank holding companies with major commercial banking operations.

Figure 3 shows the distribution of total operating income of commercial banks in the Philippines. Net interest income is still the dominant source for commercial banks. Its share steadily increased from 1993 to 1998. Non-interest income became more important in the years following the Asian financial crisis. During that period, fee-based income accounted for around 12% of total operating income, and other non-interest income accounted for 20–30%. Table 7 presents the income diversification index by type of commercial bank in the Philippines. The results show a similar pattern and indicate a high level of income diversification particularly for domestic and foreign banks. The government universal banks are the least diversified in terms of income source.

**Figure 3: Distribution of Total Operating Income of Commercial Banks, 1993–2006 (%)**



**Source basic data:** Bangko Sentral ng Pilipinas.

**Table 7: Income Diversification Index by Type of Bank, 1993–2006**

	All commercial banks	Domestic universal	Domestic commercial	Foreign	Government
1993	0.83	0.82	0.93	0.84	0.59
1994	0.66	0.67	0.59	0.94	0.51
1995	0.65	0.66	0.66	0.99	0.33
1996	0.54	0.58	0.56	0.59	0.30
1997	0.54	0.48	0.63	0.90	0.43
1998	0.49	0.47	0.54	0.73	0.30
1999	0.67	0.68	0.57	0.74	0.57
2000	0.65	0.74	0.67	0.74	0.20
2001	0.73	0.84	0.64	0.81	0.37
2002	0.86	0.98	0.81	0.80	0.42
2003	0.86	1.00	0.78	0.80	0.43
2004	0.66	0.80	0.58	0.47	0.42
2005	0.65	0.71	0.67	0.62	0.44
2006	0.77	0.83	0.81	0.77	0.45

**Source of basic data:** Philippine Deposit Insurance Corporation.

**Note:** Score of 1 for the income diversification index indicates perfect diversity between traditional banking and nontraditional banking activities, while a score of 0 denotes specialization in one line of activity.

Ghosh (2006) also undertook a cross-country regression analysis on a sample of the largest publicly listed and private commercial banks to determine the impact of these structural changes on banking sector efficiency. Included in the analysis were the economies of Hong Kong, China; Indonesia; the Republic of Korea; Malaysia; the Philippines; Singapore; and Thailand. These results indicate that larger banks and banks that are undertaking a broader range of activities are not yet enjoying economies of scale and scope. That is, banks' operating income would be much higher if they were broken up into financial intermediaries specializing in individual activities, rather than if they were engaged in multiple activities. This result does not augur well for the Philippines, given its high level of consolidation and diversification of banking sector activities.

### C. Worldwide Trends in Financial Conglomeration

The Philippine experience is similar to other developing and emerging markets, where financial conglomeration is typically discussed in the context of banks. However, De Nicoló *et al.* (2003) note that this is not dissimilar to the case of industrialized countries where the reasons for conglomeration are often the same albeit with different catalysts. In particular, macroeconomic pressures and banking crises in the 1990s led governments to undertake deregulation. This, combined with higher capital requirements caused banks to be more competitive as their profit margins declined. In countries where there was no prohibition on universal banking, banks moved towards nontraditional banking activities. Other countries explicitly introduced legislation to allow banks to broaden their range of activities.

De Nicoló *et al.* (2003) documented worldwide trends in financial conglomeration by examining firm level data from the *Worldscope* database for the top 500 financial institutions according to total assets. Financial institutions are classified as conglomerates if they undertake at least two of the three major lines of business or activity (i.e., banking, insurance, securities investment). Table 8 presents some summary statistics of worldwide financial conglomeration in 1995 and 2000.

**Table 8: Worldwide Trends in Financial Conglomeration,<sup>a</sup> 1995 and 2000**

	1995				2000			
	Total		Conglomerates		Total		Conglomerates	
	No. of institutions	Assets (US\$bil)	No.	Asset share (%)	No. of institutions	Assets (US\$bil)	No.	Asset share (%)
US	102	5,327	43	78.9	109	9,624	67	73.0
Canada	18	884	11	87.4	14	1,221	10	89.6
Japan	127	10,012	9	44.0	119	9,327	25	57.3
Australia	9	449	6	81.8	9	670	9	100.0
Western Europe	201		124		119		119	91.6
Europe		15,634		89.4	162	22,437		
Eastern Europe							4	100
Latin America	5		2		4	61.8	15	96.3
Asia		180		64.6	16	454		
Africa <sup>b</sup>	32	971	10	31.2	51	1,784	33	68.4
	6	144	4	55.3	16	456	16	100
Total	500	33,601	209	72.1	500	46,036	298	80.1
Banks	360	26,063	156	75.1	360	34,273	243	86.5

**Source:** De Nicoló *et al.* (2003): Table 8-9, p. 21-22.

**Notes:** <sup>a</sup>Based on a sample of top 500 financial institutions ranked by total assets.

<sup>b</sup>Includes Middle East in 2000.

These results indicate that there has been a significant increase in financial conglomeration between 1995 and 2000, both in terms of the number of financial conglomerates and their asset share. In 1995, 42% of the top 500 financial institutions were classified as conglomerates. This increased to 60% in 2000. In terms of asset share, financial conglomerates accounted for 80% of total assets in 2000, a slight increase from the 72% asset share in 1995. The study also found that the rate of conglomeration rises with the asset size of financial institutions. For instance, in the top 50 institutions in 2000, 92% were classified as conglomerates with an asset share of 94%.

Not surprisingly, the study found that industrialized countries dominated the sample, although their performance differed according to region. For instance, Western Europe has quite a long history of conglomeration. In contrast, restrictions on allowable activities of financial intermediaries have only been recently lifted in the US and Japan. The trend is also increasingly becoming a feature of emerging markets. The 38 financial institutions included in the sample in 1995 came from only a few emerging market countries (Brazil; Greece; the Republic of Korea; Malaysia; South Africa; Taipei, China; and Thailand). The number rose in 2000 due to the substantial growth in asset size of financial institutions in the emerging market economies of Eastern Europe, Asia, Latin America, and the Middle East.

Finally, in terms of industry type, the results show the dominance of financial institutions classified as banks. The number of banks represented around 72% of the sample, with an asset share of more than 70%. In particular, the number of banks classified as conglomerates significantly increased from 43% of the total number of banks in the sample in 1995, to 68% in 2000. Asset share of banks classified as conglomerates also increased from 75% of total bank assets in 1995 to 86% in 2000.

The IMF (2001) also noted that the trend toward consolidation of bank with nonbank financial activities is beginning to gain ground in emerging markets. Most emerging markets have followed the universal banking paradigm. Furthermore, banks typically dominate local capital



markets, which mean they directly share in the growth of these markets. In Asia in particular, while financial services integration is at an early stage, Palmer (2002) argued that there is significant scope for convergence across Asia. Universal banking models incorporating commercial banking, insurance and securities activities already exist in many Asian countries and the remaining restrictions on financial conglomerates operating across sectors are bound to diminish. Bancassurance is also slowly taking hold. The Asian financial crisis also spurred liberalization and deregulation efforts, which can accelerate integration. In addition, banks in Asia have been designated a key role in the development of the region's capital markets. Commercial banks already play a major role in corporate bond markets as issuers, underwriters, investors, and guarantors. This reflects banks' dominance of their financial markets, their high reputation, and the informational advantages they enjoy. Thus, it has been recommended that banks be further encouraged to foster corporate bond market development and pursue a complementary role. In addition to securities and derivatives businesses, banks may also be encouraged to engage in other nonbanking activities such as insurance underwriting (Shirai, 2001; Yoshitomi and Shirai, 2001).

Due to underlying factors driving it, financial convergence and conglomeration is expected to continue. The speed and extent of convergence, though, will not be the same for every country. It will depend on various factors, including the needs of the local market, the stage of development of the economy, various macroeconomic factors and the extent to which regulatory reforms allow banks to diversify (Palmer, 2002). But the common issue is how regulators can best respond to financial conglomeration. In particular, the emergence of financial conglomerates adds at least two new dimensions to the supervision and regulation of such entities in emerging markets: one is the issue of consolidated supervision, and the other is the architecture of the institutions in charge of supervision (IMF 2001). The ultimate question is, if financial sectors are integrating, should regulators do the same?

#### **D. Current Supervision of Philippine Financial Conglomerates**

The Philippines essentially follows the traditional "pillars" approach in regulating and supervising the three major financial sectors—the Securities and Exchange Commission (SEC) for the securities market, the Insurance Commission (IC) for the private insurance sector, and BSP for the banking sector. Needless to say, each agency operates under different sets of rules, principles and standards, resulting in differing qualities of supervision that proved problematic especially in the aftermath of the Asian financial crisis.<sup>8</sup>

The Philippines does not currently have a legally embedded definition of financial conglomerates. With respect to supervising financial conglomerates, that is, universal banks, the regulatory framework is fragmented. BSP has supervisory authority over banks and quasi-banks and their subsidiaries and affiliates engaged in allied activities. Non-allied entities are subject to BSP examination only if they are at least majority-owned or controlled by a bank. However, some of these subsidiaries and affiliates of banks (including investment houses, securities dealers and brokers, finance companies and insurance companies) are primarily regulated by the Securities and Exchange Commission and the Office of the Insurance Commission under relevant laws. BSP moved towards consolidated supervision of banking groups beginning in the late 1990s, but it concedes that its application is still rudimentary because existing laws preclude its full implementation.

To somewhat address the fragmented nature of financial supervision of a universal bank, the three financial supervisors plus the Philippine Deposit and Insurance Corporation (PDIC) formed the Financial Sector Forum (FSF) in 2004. The FSF is not a financial regulatory

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<sup>8</sup> Milo (2002) discusses the evolution of financial sector supervision in the Philippines more fully, including its fragmented nature and the resulting difficulties.

body. The aim of the FSF is to provide the four financial agencies a mechanism for cooperation, coordination, information sharing and harmonization to address inconsistencies in the supervision and regulation of the different financial entities within the conglomerate that could lead to regulatory arbitrage. Financial regulatory issues that the group has sought to address include: (i) harmonization of regulation of products offered by banks, securities dealers and insurance companies that are similar in nature; (ii) comparison of capital adequacy requirements; and (iii) making the requirements and procedures for accrediting reputation agents, such as making external auditors more uniform (Yuvienco, 2007).

The FSF is certainly a step in the right direction in terms of making the quality of supervision across the different components of a universal bank more consistent. However, the FSF is not a formal organization, and therein lies its weakness. Participation in the group is voluntary, so, technically, agreements reached are legally nonbinding. The group primarily operates through moral suasion. But the group is bound to face some policy and practical issues that may be very difficult to resolve due to significant differences in regulatory frameworks. The question is whether the group would be able to withstand such pressures and maintain its cohesion. One option would be to formalize the FSF and appoint a lead regulator. Since financial conglomerates in the Philippines are still largely banking in nature, then BSP is the natural lead regulator. BSP then becomes responsible with the added duty of overseeing the entire banking group's operation and ensuring coordination of responses, without usurping the power of other regulators. The next section discusses the supervisory implications of financial conglomeration more fully.

### **III. FINANCIAL SUPERVISORY IMPLICATIONS OF FINANCIAL CONGLOMERATION**

Regulatory structure refers to the way in which a country organizes the various agencies in charge of financial sector regulation. In principle, there are two fundamentally different models of regulatory structure—one based on sectoral groups (i.e., banking, insurance and securities), and the other based on regulatory functions. Regulatory functions refer to the underlying functions of regulation, namely, addressing the various sources of market failure. Carmichael (2002) identifies four main sources of market failure in the financial system, and how to address them—anti-competitive behavior (competition law), market misconduct (conduct of business regulation/consumer protection), asymmetric information (prudential regulation) and systemic instability (macroeconomic surveillance and stabilization).

In the purest form of the sectoral model, a single regulator responsible for correcting all four sources of market failure is assigned to each sectoral group. In the purest form of the functional model, correcting each of the four sources of market failure is assigned to a single regulator that will be responsible for all institutions that are subject to that particular failure. In practice, regulatory structures around the world typically involve a mixture of functional and sectoral divisions. The most extreme case of regulatory approach would be the single regulator supervisory model, wherein there is only one control authority, separated from the central bank, with responsibility over all financial markets and intermediaries, and concerned with all the objectives of regulation.

It is now generally accepted by banking regulators that banking groups or financial conglomerates need to be supervised on both a solo and consolidated basis to take into account supervisory concerns that may be overlooked at the entity level (Palmer, 2002). In fact, this forms part of the core principles identified by the Basle Committee on Banking Supervision. Prudential and market conduct concerns that result from financial services integration include transparency, contagion, regulatory arbitrage, conflicts of interest, double

and multiple gearing; fit and proper requirements; and unregulated group entities, which are interrelated (Skipper, 2000).

Recently, significant attention has been focused on the structural aspects of financial regulation, particularly the desirability of unified regulatory agencies—that is, agencies that supervise two or more of the traditional financial services sectors (i.e., banking, insurance and securities). The primary reason has been the trend towards financial convergence or blurring of product lines, and the rise of financial conglomerates, hence the need for more effective modes to supervise them. Smaller countries are also seeking ways to achieve economies of scale in regulation through better management of regulatory resources (particularly personnel) and infrastructure support (Mwenda and Fleming, 2001).

The debate on financial supervisory structure focuses on two issues: sectoral approach versus functional approach, and the single financial supervisor model (FSA) versus multi-financial authorities model (FMA). However, in the context of increasing financial convergence or conglomeration, the first issue seems to have become moot because the relevance of the sectoral approach rests precisely on the separability of the banking, securities and insurance markets. This is confirmed by the adoption or consideration of various models (“pure” or “mixed”) of the functional supervisory approach in an increasing number of countries (Masciandaro, 2003). Table 9 presents a summary of the pros and cons of integrating financial sector supervision, which Čihák and Podpiera (2006) discuss in greater detail.

**Table 9: Summary of Pros and Cons of Integrating Financial Sector Supervision**

Potential Pros	Potential Cons
Easier to achieve efficiency in supervising financial conglomerates	If objectives not clearly specified, may be less effective than sectoral supervisors
Possible economies of scale	Possible diseconomies of scale if too large an organization that is difficult to manage
Possibly improved accountability	If objectives not clearly communicated, possibility to extend moral hazard problems across the whole financial sector
Easier to eliminate duplicities, turf wars	Process of integration may lead to politically or special interest motivated changes in supervisory framework
Easier to ensure level playing field across market segments	Process of integration, if not managed properly, may lead to loss of key staff or to other problems

**Source:** Čihák and Podpiera (2006), Table 3.

The global trend towards integrating financial regulation can be viewed as a trend towards restructuring regulatory agencies along functional lines, particularly with regard to prudential regulation (Carmichael, 2002). At least 46 countries had adopted unified or integrated supervision by 2002, with around half of them creating a single regulator for the entire financial sector and the other half merging two of the main supervisory authorities (Table 10).<sup>9</sup>

<sup>9</sup> Carmichael (2006; in Corbett, 2007) differentiates integrated agencies from unified ones. Integrated agencies supervise all types of financial institution and activity in one agency, although they may be limited in terms of the aspects of business that they cover. On the other hand, a unified agency is one that covers prudential regulation and “conduct-of-business” supervision.

**Table 10: Countries with a Single Supervisor, Semi-integrated Supervisory Agencies and Multiple Supervisors in 2002<sup>a</sup>**

Single supervisor for the financial system	Agency supervises two types of fin'l intermediaries			Multiple supervisors (at least 1 each for banks, securities firms and insurers)		
	Banks & securities firms	Banks & insurers	Securities firms & insurers			
1. Austria	12. <b>Japan</b>	23. Dominican Republic	29. Australia	40. Bolivia	47. Argentina	64. Jordan
2. Bahrain	13. Latvia	24. Finland	30. Belgium	41. Chile	48. Bahamas	65. Lithuania
3. Bermuda	14. Maldives	25. Luxembourg	31. Canada	42. Egypt	49. Barbados	66. Netherlands
4. Cayman Islands	15. Malta	26. Mexico <sup>b</sup>	32. Colombia	43. Mauritius	50. Botswana	67. New Zealand
5. Denmark	16. Nicaragua	27. Switzerland	33. Ecuador	44. Slovakia <sup>b</sup>	51. Brazil	68. Panama
6. Estonia	17. Norway	28. Uruguay	34. El Salvador	45. South Africa <sup>b</sup>	52. Bulgaria <sup>b</sup>	69. <b>Philippines</b>
7. Germany	18. <b>Singapore</b>		35. Guatemala	46. Ukraine <sup>b</sup>	53. <b>Cambodia</b>	70. Poland <sup>b</sup>
8. Gibraltar	19. <b>Republic of Korea</b>		36. Kazakhstan <sup>b</sup>		54. <b>China, People's Rep. of</b>	71. Portugal
9. Hungary	20. Sweden		37. <b>Malaysia</b>		55. Cyprus	72. Russia
10. Iceland	21. Taipei, China <sup>c</sup>		38. Peru		56. Egypt	73. Slovenia <sup>b</sup>
11. Ireland	22. UAE		39. Venezuela		57. France	74. Sri Lanka
	23. UK				58. Greece	75. Spain
					59. Hong Kong, China	76. <b>Thailand</b>
					60. India	77. Turkey
					61. <b>Indonesia<sup>b</sup></b>	78. USA
					62. Israel	79. <b>Viet Nam</b>
					63. Italy	

**Notes:** <sup>a</sup>Sample includes only countries that supervise all the three types of intermediaries (banks, securities firms and insurers).

<sup>b</sup>Countries reported to be considering adopting partial or full integrated supervision as well.

<sup>c</sup>Established in 2004.

**Source:** de Luna Martínez and Rose (2003); Corbett (2007).

Recent surveys of the experience of countries with integrated regulators indicate a high degree of consensus in terms of the motivation for establishing the integrated agency, namely: (i) convergence in financial markets and the need for a more consistent approach to regulating financial conglomerates; (ii) the need for greater consistency in the application of policy across different industries; and (iii) the ability to make more efficient use of scarce regulatory resources (Carmichael, 2002; de Luna Martínez and Rose, 2003).

With respect to its applicability to developing countries, the literature cites two key lessons that can be learned from the experience of developed country practitioners (e.g., Abrams and Taylor, 2000; Bain and Harper, 1999; Briault, 2001; Carmichael, 2002; de Luna Martínez and Rose, 2003; Llewellyn, 2001; Mwenda and Fleming, 2001; Reddy, 2001; Skipper, 2000; Taylor and Fleming, 1999). One is that simply changing the structure of regulation cannot guarantee effective supervision, and integrated regulation per se is not a solution to regulatory failure. Correcting regulatory failure requires first and foremost better regulation: that is, setting more appropriate prudential and market conduct standards, improving surveillance, and strengthening enforcement. Integrated regulation may help facilitate this process, but it cannot cause these changes to occur by themselves. Indeed, the countries that adopted the integrated financial sector supervisory approach did so to enhance the supervisory process.

The second lesson is that there is no single best form of integrated regulatory agency. Unified financial services supervision has been adopted differently in many countries; its application has varied from country to country and there is no single right way of introducing or implementing unified models of financial services supervision. Factors that accounted for the differences include differences in starting points, differences in industry structures, and differences in objectives.

While there is some support for consolidated financial sector supervision in developing countries, a more contentious issue is whether the unified regulator should be separate from the central bank. The latter, in turn, partly stems from the issue of whether central banks should be (or continue to be) involved in banking supervision. Barth *et al.* (2002) noted that there are reasonable arguments both for and against this structural issue in the literature. In particular, the main point of contention is its impact on the safety, soundness and systemic stability of the financial system. In particular, arguments for central bank supervision of banks point to the informational advantage that it affords the central bank, which facilitates its conduct of monetary policy. On the other hand, those who argue against central bank supervision of banks typically cite the resulting conflict of interests between its monetary policy function aimed at price stability and bank supervision function aimed at financial stability.

Table 11 shows the distribution of 151 developed and developing countries according to the location of bank supervision as of 2002.

**Table 11: Location of Bank Supervision Function**

Region	Central Bank Only (69 countries)			Central Bank Among Multiple Supervisors (21 countries)	Central Bank Not a Supervisory Authority (61 countries)		
Africa	Botswana Burundi Egypt Gambia Ghana	Guinea Lesotho Libya Namibia Rwanda	South Africa Sudan Swaziland Tunisia Zimbabwe	Morocco Nigeria	Algeria Benin Burkina Faso Cameroon Central African Republic Chad Congo Côte d'Ivoire	Equatorial Guinea Gabon Guinea Bissau Kenya Madagascar Mali Niger Senegal	Togo
Americas	Argentina Brazil	Guyana Suriname	Trinidad and Tobago Uruguay	United States	Bolivia Canada Chile Colombia Costa Rica	Ecuador El Salvador Guatemala Honduras Mexico	Nicaragua Paraguay Peru Venezuela
Asia/Pacific	Bhutan Cambodia Fiji Hong Kong, China India Israel Jordan Kuwait	Kyrgyzstan Malaysia New Zealand Pakistan Papua New Guinea Philippines Qatar Russia	Samoa Saudi Arabia Singapore Sri Lanka Tajikistan Tonga Turkmenistan United Arab Emirates	China, People's Rep. of Taipei, China Thailand	Australia Japan Korea, Republic of Lebanon		
Europe	Armenia Azerbaijan Belarus Bulgaria Croatia Greece	Ireland Italy Lithuania Moldova Netherlands Portugal	Romania Serbia & Montenegro Slovenia Spain Ukraine	Albania Czech Republic Germany Macedonia Slovakia	Austria Belgium Bosnia and Herzegovina Denmark Estonia Finland France	Hungary Iceland Sweden Switzerland Turkey Latvia Luxembourg Norway	Poland United Kingdom
Offshore Financial Centers	Aruba Bahrain Belize	Macau, China Mauritius	Oman Seychelles	Anguilla Antigua and Barbuda Commonwealth of Dominica Cyprus Grenada Montserrat Saint Kitts & Nevis Saint Lucia Saint Vincent & The Grenadines Vanuatu	British Virgin Islands Gibraltar Guernsey Isle of Man	Jersey Liechtenstein Malta Panama Puerto Rico	

Source: Table 3.3 (pp. 90-91) in Barth *et al.*, (2006).

The table shows that banking supervision continues to be assigned to the central bank in most countries—about 60% of the countries surveyed, with around 45% assigning banking supervision solely to the central bank. This model of banking supervision is also more common in developing countries, including those in Asia.

Clearly, there are strong conceptual arguments both for and against the central bank's combined functions of banking supervision and monetary policy, which can be supported by the diversity of global experience. However, the empirical work that has been done on this structural issue is still limited. Barth *et al.* (2002) noted several studies that support a narrower focus for the central bank that does not include bank supervision, but the results are far from conclusive. Again, the general consensus in the literature so far is that there is no “one right answer,” and that the answer will largely depend on country-specific circumstances and capacities. These include prevailing conditions in the financial system, the political environment, and the preferences of the public (Haubrich, 1996). Thus, the effects of monetary policy on banking supervision and vice versa should be explicitly examined before a country decides on whether to retain or remove bank supervisory duties from its central bank.

Another key issue that relates to the central bank's supervisory function is whether it should supervise other financial service sectors as well, such as securities and insurance. Overall, the arguments in the literature reviewed by Barth *et al.* (2002) weigh more heavily against it because: (i) it will lead to excessive concentration of power; (ii) the conflict of interests would be more extensive; and (iii) it could unduly extend the financial safety net if the central bank's lender of last resort function is seen as extending across all financial institutions, thereby worsening the moral hazard problem.

Meister (2001: 1; in Barth *et al.*, 2002) very rightly emphasized that the “... design of regulatory and supervisory responsibilities is one of the most important matters affecting the future course of financial market policy. There is, however, no universally valid answer to the question of *how* this should be done.” Furthermore, he noted that the answer cannot be derived from theory. Unfortunately, while there is significant literature discussing the pros and cons of having a single versus multiple regulators, there is very little empirical analysis addressing this issue. Čihák and Podpiera (2006: 3) claim to be the first to come up with a “...comprehensive, cross-country analysis of the emerging experience with integrated financial supervision.” Using cross-country data on quality of supervision and on supervisory staffing, they examine whether fully integrated supervisory agencies<sup>10</sup> are better than other structures, in terms of quality of supervision across sectors and cost efficiency.

Quality of supervision is measured by the degree of compliance with internationally accepted standards in banking, insurance, and securities regulation, that is, the Basel Core Principles for Effective Banking Supervision (BCP), the International Association of Insurance Supervisors (IAIS) Insurance Core Principles (ICP), and the International Association of Securities Commissions (IOSCO) Objectives and Principles of Securities Regulation, respectively. They use a database of assessments derived from the IMF and the World Bank's Financial Sector Assessment Programs, which have been made publicly available by the countries involved. In particular, the relationship between observance of international standards and the organization of the supervisor (whether fully integrated or not) is examined in two ways—based on BCP compliance, and based on compliance on all three standards.

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<sup>10</sup> Čihák and Podpiera (2006) define a fully integrated supervisory agency as an agency that is in charge of (micro) prudential supervision of at least the three main segments of most financial sectors (i.e., banking, insurance, and securities markets). Such agency may or may not be in charge of consumer protection. They do not consider agencies, which are in charge of prudential supervision of two of the three main financial sectors, as integrated supervisors.

There were 65 available assessments for the BCP, which consisted of 13 advanced economies, 19 emerging market countries, and 33 developing countries. Twelve of these countries had fully integrated supervisors at the time of the assessment. They constructed an index of overall BCP compliance and regressed this on an integrated regulator dummy (1 for fully integrated; 0 otherwise). They noted that integrated supervisors are more common in developed economies where overall regulatory environments are also better, which could bias the result. Thus, they added two other variables to the regression to correct for this bias—a variable to measure the quality of the general regulatory environment and per capita GDP. The variables were added one at a time and simultaneously, although they noted that the latter regression had to be interpreted carefully since quality of regulatory environment and GDP per capita are positively correlated. Their results showed that, with just the integrated regulator dummy as explanatory variable, the coefficient was positive and highly significant. That is, fully integrated supervisory agencies tend to have higher quality of banking supervision. However, its impact and level of significance were significantly reduced when overall quality of the regulatory environment was added into the regression, and more so when GDP per capita was added as an explanatory variable. In fact, income level was a more powerful explanatory variable, while the integrated regulator dummy became insignificant.

Indices for compliance based on all three standards were also constructed using a sample of 36 countries which had complete assessments for all three sectors. The sample consisted of 10 industrialized countries, 12 emerging market countries, and 14 developing countries. In particular, compliance in each sector was broken down into the four components of good regulation: (i) regulatory governance; (ii) prudential framework; (iii) regulatory practices; and (iv) financial integrity/safety. Indices were then constructed for each component. Per capita GDP was also included as a control variable. For the indices of BCP compliance, results were similar to the earlier results; that is, income level was a more powerful explanatory variable, while the integrated regulator dummy had the expected positive sign but was insignificant. For the indices of ICP and IOSCO compliance, income level was again highly significant. The integrated dummy variable also had the expected positive sign, but was significant in only two components for each sector—regulatory practices (ICP), prudential framework (IOSCO) and financial integrity/safety net for both.

They also tried to distinguish integrated regulators in central banks from those outside, but they noted that the estimated coefficients were insignificant. One of the supposed benefits of integrated supervision is more consistent regulation across financial sectors. Čihák and Podpiera (2006) tested this by regressing the variation coefficient across the three sectors of each of the four component indices on the integrated dummy variable. They again included per capita GDP as the control variable, which was also highly significant. Their results indicated that overall quality of supervision was more consistent across the sectors being supervised by integrated supervisory agencies. In terms of individual components, only the estimated coefficients for regulatory practices and financial integrity/safety net were significant.

To test the argument that integrated supervision may lower costs, they used available data on the number of supervisory staff. Their results showed that integrating supervision did not lead to substantial supervisory staff reduction. They then tried to explain the number of supervisory staff by country population, area, the level of development (approximated by per capita GDP), and the size of the financial sector (approximated by M2/GDP). They found that population and the country's level of development mattered. However, the dummy variable for integrated regulators was not statistically significant, although it had the expected negative sign. They attributed the latter result to the following: (i) the time since integration was in most cases not yet sufficient for the cost savings to materialize; (ii) looking just at supervisory staff numbers and not total staff numbers might not have captured some

savings in support staff; (iii) the integrated regulator could have taken on new responsibilities that resulted in little change in the number of supervisory staff; and (iv) there were no true synergies among the sectors that would lead to supervisory staff savings.

The authors deserve to be commended for coming up with the first systematic empirical assessment of the impact of integrated financial supervision. They did caution that their regression results should not be interpreted as indicating causality in any way. Thus, Corbett (2007) rightly notes that while their results are suggestive, they cannot be taken as robust since both their data quality and econometric methods are rudimentary, and the specification of the regressions is problematic. She concludes that, “The main impression is that we still know little about the effect of integrated supervisors. This partly explains why there is no consensus view about what system works best” (Corbett, 2007: 24).

With regard to the data, Das and Quintyn (2002) note that the Financial Sector Assessment Program’s assessment of financial sector governance issues is based mainly on qualitative measures of governance prescribed under the various financial sector standards. Also, a key message coming out of the FSAPs is that where regulation is failing, it is due to failure of implementation (Carmichael and Kaufmann, 2001). That is, having best practice prudential and market conduct standards on paper does not mean the agencies involved also have the wherewithal and the willingness to implement them.

Čihák and Podpiera (2006) noted the positive relationship/correlation between the general regulatory environment and the degree of compliance with internationally accepted standards, and between the quality of regulatory environment and per capita GDP. Add to this the overwhelming result of their paper, which is the strong positive relationship between the various measures of compliance and level of income. Compliance with internationally accepted standards can be seen as a subset of the overall regulatory environment, which in turn is a key component of a country’s institutional framework. Thus, their result of a strong correlation between compliance with internationally accepted standards and income level confirms the very basic argument of New Institutional Economics. That is, “Institutions matter for economic performance.”

## **IV. INSTITUTIONS AND ECONOMIC DEVELOPMENT**

### **A. New Institutional Economics**

Simply put, New Institutional Economics (NIE) endeavors to integrate a theory of institutions into economics. Ronald Coase, who explicitly introduced transaction costs into economic analysis (Coase, 1937), is cited as a central figure for the field. The term was introduced by Oliver Williamson in a paper he wrote in 1975. It has since become a standard or banner uniting a diverse group of economists who shared one common intellectual ground: institutions matter, the relationship between institutional structure and economic behavior requires attention, and the determinants of institutions can be analyzed with the aid of economic theory (Richter, 2005). NIE is inherently an interdisciplinary field of study (Williamson, 1998). It includes work in property rights analysis, the economic analysis of the law, public choice theory, constitutional economics, the theory of collective action, transaction cost economics, the principal-agent approach, the theory of relational contracts, and comparative economic systems. The commonality of all these approaches is that, unlike neoclassical economics, the institutional framework is not assumed as given but is explicitly treated as an object of research, and the implications of any given institutional arrangements for economic behavior are taken into account (Richter, 2005).



According to Douglass North, another seminal contributor to or primary proponent of NIE, institutions “form the incentive structure of a society, and the political and economic institutions, in consequence, are the underlying determinants of economic performance” (North, 1994: 360). He defines institutions as “the humanly devised constraints that structure human interaction. They are made up of formal constraints (such as rules, laws, constitutions), informal constraints (such as norms of behavior, conventions, self-imposed codes of conduct), and their enforcement characteristics” (North, 1994: 360).

North then defines organizations as “groups of individuals bound together by some common purpose to achieve certain objectives. Organizations include political bodies (political parties, regulatory agencies), economic bodies (firms, trade unions), social bodies (churches, clubs), and educational bodies (schools, universities)” (North, 1994: 361). Thus, he refers to institutions as the rules of the game, and to organizations and their entrepreneurs as the players. These are the institutions of foremost interest to NIE—the institutional environment (or North’s rules of the game—the polity, judiciary, laws of contract and property), and the institutional arrangement that deals with the institutions of governance (or play of the game—the use of markets, hybrids, firms, bureaus) (Williamson, 1998).

Formal rules must be securely nested in hospitable informal norms for them to function well, since it is the latter that legitimizes the former. Also, appropriate political institutions must be supportive of economic institutions (Chu, 2003). Economic performance is influenced by polities since they define and enforce the economic rules of the game. Thus, the formation of polities that will create and enforce property rights is a critical component of development policy (North, 1994). Fukuyama (2006) also noted that formal institutions are embedded in a political culture, that is, the matrix of informal norms, values, traditions, and historical path-dependencies. Even the best institutions will not work well in the absence of a supportive political culture. Alternatively, seemingly less optimal formal institutions can often be made to work given the right leadership, judgment, and political will. There are times when it is preferable to work within the context of imperfect existing institutions, rather than use up political capital on long-term institutional reforms.

Although there is now a consensus that institutions “matter,” the process of integrating institutions and institutional change into economic theory is still fairly new (Aron, 2000). Thus, the causality of the various links and channels of influence between the institutional set-up and development outcome is still not well or fully understood (Jütting, 2003).

**Institutions and economic performance.** Only efficient institutions are growth-promoting. They encourage individuals to engage in productive activities by providing appropriate incentives and establishing a stable structure of human interactions, which reduce uncertainty. Posner (1998; in Chu, 2003) defined two types of efficiency: substantive efficiency (i.e., a rule promotes allocative efficiency), and procedural efficiency (i.e., a rule is designed to reduce the cost or increase the accuracy of using the system of rules). Thus, Chu (2003) argues that affluence in developed countries is a cumulative result of efficient institutions; poverty in poor countries is a result of inefficient institutions. According to Greif (2005; in Carden, 2005), successful institutions are both contract-enforcing and coercion-constraining; that is, they reward production and exchange rather than expropriation and redistribution. However, the institutional frameworks in developing countries “overwhelmingly favor activities that promote redistributive rather than productive activity, that create monopolies rather than competitive conditions, and that restrict opportunities rather than expand them” (North, 1990: 9; in Hasan *et al.*, 2006).

Thus, NIE posits that countries need two distinct and not necessarily complementary sets of institutions to meet the challenge of development: (i) those that promote exchange by lowering transaction costs and promoting trust, and (ii) those that induce the state to protect

rather than expropriate private property. Included under the first set of institutions are contracts and contract enforcement mechanisms, commercial norms and rules, and habits and beliefs favoring shared values and the accumulation of human capital. Constitutions, electoral rules, laws governing speech and education, and legal and civic norms are among those under the second set of institutions (Shirley, 2005).

Identifying the institutions that significantly explain observed disparities in living standards across countries has also become the focus of recent development and growth literature (Aron, 2000). There has been a huge growth in empirical literature that measures the impact of institutions on development outcomes, particularly growth.<sup>11</sup> Easterly and Levine (2003) and Acemoglu *et al.* (2002), for instance, have shown that resource endowments are important for growth only as mediated through institutions, for instance by providing more or less favorable conditions for the emergence or survival of certain types of institutions. Fukuyama (2006) argues that the proximate causes of growth are still the institutions, which can be shown in many cases to be exogenous to the material conditions under which a given society develops. However, serious problems with data, methodology, and identification plague the growth literature (Aron, 2000). That being said, while studies may define “institutions” differently, the results are consistent and strong overall: “institutions explain economically and statistically significant differences in per capita incomes across countries” (Eicher and Leukert, 2006: 2). The literature typically examines either the global sample or developing countries. The consensus institutions that have been associated with economic performance commonly relate to measures of government risk of expropriation, rule of law, bureaucratic quality, corruption, government repudiation of contracts, civil liberties, and openness to trade (Eicher and Leukert, 2006).

**Institutional development/reform.** In previous years, the issue of institutional development or “governance reform” has become more prominent (Chang, 2005). If developing countries are poor because their current institutions provide a weak basis in terms of incentives that promote growth, this raised the question not only of what type of institutions they should acquire, but more importantly of how they could develop such institutions. There is more agreement in the literature on former rather than on the latter (Hasan *et al.*, 2006).

As Shirley (2005) concedes, NIE has had less to say about institutional change, except that it is hard to accomplish. This is due in particular to the complex interactions between the different typologies of institutions (i.e., interaction between formal and informal institutions, between different levels of institutions, and between economic and political institutions), which have different horizons for change and are therefore subject to very different evolutionary dynamics. Institutional reforms typically deal with formal institutions, which can be changed immediately. But informal institutions that serve to legitimize any set of formal rules, such as beliefs and norms, change only gradually. Thus, if a country chooses to adopt the formal rules of another country, it will have very different performance characteristics compared to the original country if both the informal norms and the enforcement characteristics are different. This implies that transferring successful western market economies’ formal political and economic rules to developing economies is not a sufficient condition for generating good economic performance (North, 2002). Another reason why underdevelopment cannot be overcome by simply importing institutions that were successful in other countries is institutional path dependency. That is, those who make policy and design institutions have a stake in the framework they created, and will therefore resist changes that may rob them of power or property (Shirley, 2005). North (1992) does note that

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<sup>11</sup> See *inter alia* Knack and Keefer (1995, 1997); Barro (1997); Hall and Jones (1999); Kaufmann *et al.* (1999); Acemoglu *et al.* (2001, 2002); Easterly and Levine (2001, 2003); Rodrik *et al.* (2004); Beck and Laeven (2005); and Hasan *et al.* (2006). For extensive reviews of the literature, see Aron (2000); Jütting (2003); and Shirley (2005).

path reversal is possible, and has occurred. However, it is a difficult process given that too little is still known about the dynamics of institutional change, especially the interplay between economic and political markets.

Taken to its logical conclusion, then, the focus on institutions could be debilitating for those advocating policy reforms. Since institutions are naturally deeply embedded in society, and if growth truly necessitates major institutional transformation in such areas as rule of law, property rights protection and governance, among others, then the prospects for growth would seem to be dismal in poor countries (Rodrik, 2006).

But institutions are brought into the analysis precisely to expose the limits of the “one-size-fits-all” argument deployed by orthodox economists regarding economic policy. Even the World Bank and the IMF have started emphasizing the role of institutions in economic development. But according to Chang (2005), this should be seen as an attempt to contend with the continued failures of orthodox policies in the real world. In explaining why “good” economic policies based on “correct” economic theories have so consistently failed, orthodox economists now invoke institutions. That is, the countries that implemented their policies did not have the right institutions, which is why they did not work and not because they were wrong to begin with. As a result, the original Washington Consensus of “stabilize, privatize, and liberalize” has now been augmented by a long list of so-called “second-generation” reforms that are heavily institutional in nature (Rodrik, 2006).

Chang (2005) points out the importance of making a clear distinction between the forms and functions of institutions. Citing the compilation of major “governance” indexes (or the indexes of institutional quality) by Kaufmann *et al.* (1999, 2002, 2003), he noted that the indexes often mixed up variables that capture the differences in the *forms* of institutions (e.g., democracy, independent judiciary, absence of state ownership) and the *functions* that they perform (e.g., rule of law, respect for private property, enforceability of contracts, maintenance of price stability, the restraint on corruption). He also argues that the orthodox literature is overly fixated with particular forms of institutions, as shown in the so-called “global standard institutions” (GSIs) argument.

According to the proponents of the GSI argument, particular forms of institutions (mostly Anglo-American) must be adopted by all countries in order to survive in an increasingly globalized world. They include “political democracy; an independent judiciary; a professional bureaucracy, ideally with open and flexible recruitments; a small public-enterprise sector, supervised by a politically independent regulator; a developed stock market with rules that facilitate hostile mergers and acquisitions; a regime of financial regulation that encourages prudence and stability, through things like the politically-independent central bank and the Bank for International Settlements capital adequacy ratio; a shareholder-oriented corporate governance system; labor market institutions that guarantee flexibility” (Chang, 2005: 6). But this transforms the discussion on institutions into another “one-size-fits-all” paradigm. It becomes more problematic if the preferred institutional forms are propagated through what Kapur and Weber (2000) refer to as “governance-related conditionalities” of the Bretton Woods institutions and the donor governments. Thus, Chang (2005) calls for some balance between forms and functions—the importance of institutional forms should not be ignored, but institutional diversity should not be denied either.

Rodrik (2006) also pointed out that institutional form is not uniquely determined by institutional function. This is very much apparent even in the developed countries where important institutional differences persist. But he also points out that this does not mean that economic principles work differently in different places. A distinction needs to be made between economic principles and their institutional embodiment. Most first-order economic principles, such as incentives, competition, hard-budget constraints, sound money and property rights, come institution-free. They do not map directly into institutional forms. For

instance, it is possible to implement property rights through common law, civil law, or even Chinese-type socialism. Furthermore, policymakers always operate in second-best environments. So even in apparently straightforward cases such as price reform, optimal reform trajectories cannot be designed without considering prevailing conditions. The bottom-line is that there is still a lot to be learned about what improving institutional quality means on the ground (Rodrik *et al.*, 2004).

This is not to say that developing countries cannot learn from the experience of developed economies. Just that pure institutional imitation is rarely enough. Making imported institutions work would require some degree of adaptation. Some institutional innovation would also be required, that is, coming up with “unique” institutions (Chang, 2005). This is where local knowledge is vital, since good institutions are heavily dependent on local context, traditions, habits, and political culture. Without local knowledge, it would be difficult to even understand how existing institutions actually work, much more how to reform them (Fukuyama, 2006). Thus, for institutional reforms to be successful, what is required is what Levy and Spiller (1994; in Shirley, 2005) refer to as “goodness of fit” between the specific innovation and the country’s broader institutional environment. In particular, Shirley (2005) describes a “good fitting” institutional innovation as one that is not dependent on absent or weak institutions, and is as much as possible insulated from or adapted to perverse institutions. The successful developing countries such as the People’s Republic of China, the Republic of Korea, and Taipei, China, which have almost always combined unorthodox elements with orthodox policies (Rodrik *et al.*, 2004), bear this out.

This was also another key theme that Rodrik (2003) identified from a collection of analytical country narratives. That is, “Good institutions can be acquired, but doing so often requires experimentation, willingness to depart from orthodoxy, and attention to local conditions” (p. 12). Ignoring the role of local variation and institutional innovation would be adequate at best, and harmful at worse. Since institutional and governance shortcomings vary across national contexts, the focus of institutional reform agendas must be on the most binding local constraints.

This is closely related to the third theme identified by Rodrik (2003: 15): “The onset of economic growth does not require deep and extensive institutional reform.” According to conventional wisdom on institutional reforms, they have to be pursued simultaneously because they are complementary by nature. Fortunately, there are successful reform experiences that show otherwise; that is, kick-starting growth does not require an ambitious agenda of complementary institutional reforms. This has been the case in the People’s Republic of China and India, the world’s largest two developing economies, where modest changes in institutional arrangements and in official attitudes towards the economy have produced huge growth payoffs. Their experience also accords with the earlier point on focusing reform efforts on the most binding domestic constraint on growth. Thus, their “transitional institutions” are also very different.

Turning to the role of policy, it is also as important as institutions. Kolodko (2005) points out that it is not enough just to undertake market-economy institution building. Without confusing the means with the aims, the other necessary component is an appropriately designed and implemented economic policy. Even the best institutions will not automatically lead to good policy. Conversely, when there is a shortage of institutional capital, a policy will fail to better utilize existing social, human, financial and fixed capital. A dual approach is therefore necessary. The evolution of institutions must be kept on the desired path at all times, even as the process is facilitated for the moment by sensible policies to maintain momentum.

Rodrik *et al.* (2004) concurs with this point, arguing that the primacy of institutional quality in explaining income levels around the world does not signify policy ineffectiveness. They also note the murky distinction between institutions and policies. For instance, institutional

reforms that were undertaken by Japan, the Republic of Korea, and People's Republic of China could be characterized as "policy innovations that eventually resulted in a fundamental change in the institutional underpinning of their economies" (p. 156). To delineate the two, policies can be seen as a flow variable, and institutions as a stock variable; institutions then are the cumulative outcome of past policy actions. Quibria (2002; in Hasan *et al.*, 2006: p. 3) defines institutions as encompassing "the formal and informal rules and customs within which individuals and firms operate," and policies as "the various strategies and measures a government adopts to achieve its goals and objectives within a country's institutional framework." Viewed in this context, policies then become government's instruments to change the "rules of the game." Policies can therefore have a significant impact on a country's institutions, which is what efforts at policy reform in developing countries are all about (Hasan *et al.*, 2006).

Finally, Rodrik (2006) proposes a practical approach for formulating growth strategies consisting of three sequential elements: first, a diagnostic analysis must be undertaken to identify the most significant constraints on economic growth in a given setting; second, a creative and imaginative policy design needs to be formulated to suitably target the identified constraints; and third, the process of diagnosis and policy response must be institutionalized to make sure the economy remains dynamic and growth is sustained. The requirements for growth to be sustained should not be confused with the requirements to initiate it, since the nature of the binding constraint will expectedly change over time. If the concern of a policymaker is to ignite economic growth, targeting the most binding constraints on economic growth—where the return would be highest—may be better than investing scarce political and administrative capital on large-scale institutional reforms. It would be necessary to undertake institutional reform eventually to sustain economic growth. But doing that would be easier and more effective with an already growing economy, so its costs can be spread over time. Rodrik's caution is against any obsession with comprehensive institutional reform that could lead to an overly ambitious policy agenda that is virtually impossible to fulfill.

## **B. Overview of the Philippines' Institutional Quality and Economic Performance**

In a collection of selected analytic country narratives that examined the respective roles of microeconomic and macroeconomic policies, institutions, political economy, and initial conditions in determining technological convergence and accumulation patterns, Rodrik (2003) questioned why the Philippines and Bolivia "continue to stagnate despite a sharp improvement in their 'fundamentals' since the 1980s" (p. 2). According to Pritchett (2003), the paradox is that the Philippines, whose policies and institutions best fit today's conventional wisdom, is doing poorly. He then contrasts the Philippines to Vietnam, which has divergent institutions and yet is doing very well.

According to David (2004), "A strong republic is a political order that rests on strong institutions rather than on charismatic or benevolent leaders. It draws its life from the participation and submission to authority of mature citizens rather than from any ability to buy or coerce the loyalty of powerless subjects. It is a system of rational administration based on legal authority." That is, modern governance is rule of law and not rule of the patron. Therein lies the root of the Philippine debacle.

Simply put, the Philippine state is weak. This stemmed from its lack of relative autonomy from the vested interests of dominant Filipino social classes, powerful political families and clans, an influential landed elite, and wealthy Filipino capitalists.<sup>12</sup> The result of a weak Philippine state was "politics of privilege" (Hutchcroft, 1997; in Banloi, 2004), a rent-seeking activity that causes corruption and mismanagement of the Philippine political economy.

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<sup>12</sup> For a fuller discussion, see Banloi (2004), Hutchcroft (1997, 1998), and Magno (1992).

Hutchcroft (1998; in Banloi, 2004) describes this as “booty” or “crony” capitalism, in which private interests are pursued using public resources, and the apparatus of the state is exploited by economic and political oligarchs. Not surprisingly, a premature and weak Philippine state has produced weak institutions of governance. Weak institutions and governance structures, in turn, have contributed to the poor economic performance of the country, and its lagging behind its Southeast Asian neighbors.

Pritchett (2003) noted the dramatic improvement in Philippine institutions after Marcos. Elections are free and reasonably fair, and there are more civil rights and press freedom. These have presumably led to improved “transparency” and “accountability.” Then why is the Philippines’ per capita GDP lower than it was in the last “pre-crisis” year 1982? The democratic governments following Marcos have not only failed to achieve rapid growth like other economies in the region, but have failed to restore per capita output to levels prevailing during Marcos’ time. Lim and Pascual (2000) attribute this to the failure of post-Marcos regimes to qualitatively change state institutions and governance structures. There have been substantial improvements from the Marcos regime, but they did not explicitly deal with the institutions of governance and systemic roots of corruption and bureaucratic inefficiencies. Because the basic institutions and governance structures remained intact, patronage politics and clientelism were preserved.

While the state institutions and governance structures did not qualitatively change, Lim and Pascual (2000) noted that the post-Marcos governments significantly changed the economic program into domestic and external liberalization, deregulation and privatization under the aegis of the multilateral institutions. The aim was exactly to replace the state with the private sector and markets, thus reduce the state’s possible areas of intervention in the economy, and ultimately improve efficiency and productivity. But according to Lim and Pascual (2000), “The view that reducing the areas of state intervention, without initiating state and institutional reforms to reduce clientelism in governance structures, would at best be a valid short-term policy for a corrupt and inept state, ... but would definitely fail in the medium and long term” (p.13).

This is because economic liberalization demands more from the state: effective enforcement of property rights and contracts; ensuring competitive and fair market processes; market regulation to check socially undesirable activities (pollution, over-risky transactions, monopoly and predatory pricing, low quality and standards of goods, etc.); and to undertake or promote socially productive ones (infrastructure, access to quality education, research and development). The cooperation of more domestic and foreign players, who need to be convinced of fair play and adequate handling by the state of the macroeconomy, is also required under liberalization and deregulation. In the Philippine case, clientelism directly clashed with the post-Marcos governments’ economic thrust, and became a major stumbling block to the country’s economic development for the country. In particular, when the liberalization thrust of an economic sector went against vested interests, regulatory institutions became susceptible to reversals and flip-flopping of policies. When there is a high degree of arbitrariness in the political and legal spheres, instilling long-term investor confidence would be very difficult to achieve (Lim and Pascual, 2000).

De Dios and Hutchcroft (2003) also noted that the Philippines’ political system has not kept pace with the requirements of economic development. That is, the Philippines has not achieved the proper combination of political institutions to provide the required responsiveness to public interest on the one hand, and flexibility with respect to changing economic conditions on the other. That being said, they also point out that years of deregulation and liberalization have resulted in a more diversified economy and more participants in the policy arena. Large family conglomerates still exist and dominate the economy. However, monopolistic power has been tempered by external openness, which

has provided a fairer and more even test for new entrants in various activities like manufactured exports and information technology.

The most recent economic reforms undertaken in the mid-1990s transformed important sectors of the economy, particularly the services sector (i.e., telecommunications, public utilities, transportation, and banking), and induced a stronger pro-market orientation among many leading members of the business community. However, the weak character of the political and institutional foundations upon which the program of liberalization rested has again been affirmed by subsequent experience, particularly under the Estrada administration, and some would argue under the Arroyo administration. Even a sound policy agenda promulgated at the national level is not sustainable without careful and sustained nurturing of the country's institutional and political foundations (de Dios and Hutchcroft, 2003).

Pritchett (2003) concurs with the view that the post-Marcos governments have failed to create a credible alternative set of policies and institutions necessary to kick off a growth boom to a higher level of income. Pritchett further argues that, although there has been some improvement in institutional quality under democracy, there has also been an increase in "institutional uncertainty" (that is, the reliability with which economic actors can anticipate the rules of the game, whether those rules are considered good or bad). And it is this increase in institutional uncertainty that could account for the stagnation in the country's output level. Thus, a fundamental roadblock to sustained economic growth is uncertainty over the rules of the game that accompanies comprehensive, but poorly managed, institutional change.

**Indicators of institutional quality.** The index published in *Economic Freedom of the World* (EFW) by the Fraser Institute measures the degree to which the policies and institutions of countries are supportive of economic freedom. The components of economic freedom include personal choice, voluntary exchange, freedom to compete, and security of privately owned property. The EFW index measures the degree of economic freedom present in five major areas: (1) size of government; (2) legal structure and security of property rights; (3) access to sound money; (4) freedom to trade internationally; and (5) regulation of credit, labor and business.

The five major areas are in turn composed of 21 components, which in turn are made up of several sub-components. Counting the various sub-components, the EFW index comprises 38 distinct pieces of data. Each component and sub-component is rated on a scale from 0 to 10 (a higher index value represents a better quality of institutions) that reflects the distribution of the underlying data. The component ratings within each area are averaged to derive ratings for each of the five areas. Finally, the summary rating is the average of the five area ratings. A chain-linked summary index is also constructed to allow comparison over time (Gwartney and Lawson, 2006).<sup>13</sup>

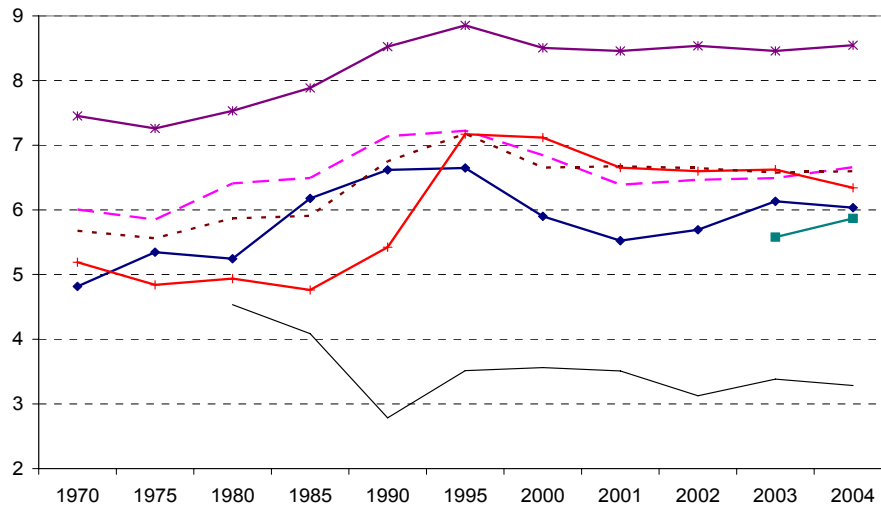
Figure 4 shows the evolution of some institutional variables since 1970 in selected ASEAN economies. In particular, it confirms the significant worsening of institutional quality in the Philippines during the 1970s under martial law; a reversal of trends with the restoration of democracy in the mid-1980s; and some weakening in recent years.

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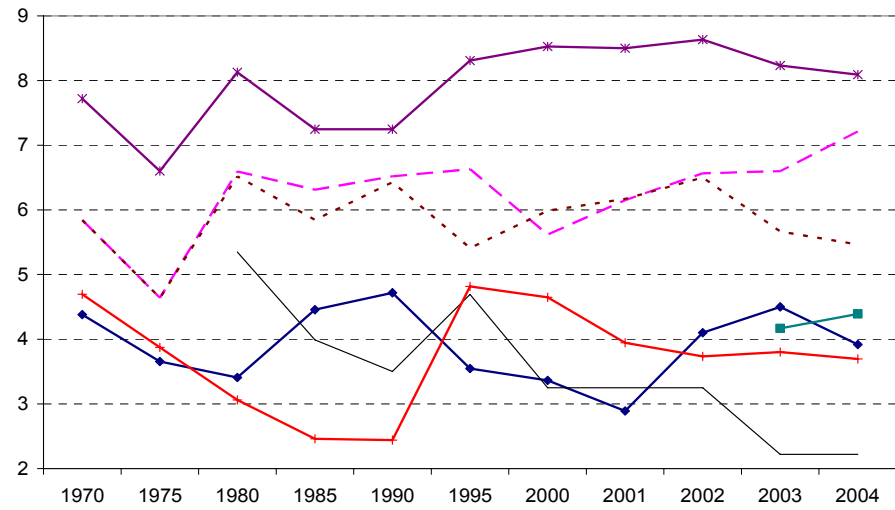
<sup>13</sup> See Appendix 1 for a list of the different components of the EFW index and a brief description of the chain-linked summary index.

**Figure 4: Quality of Institutions, Selected ASEAN economies (1970–2004)**

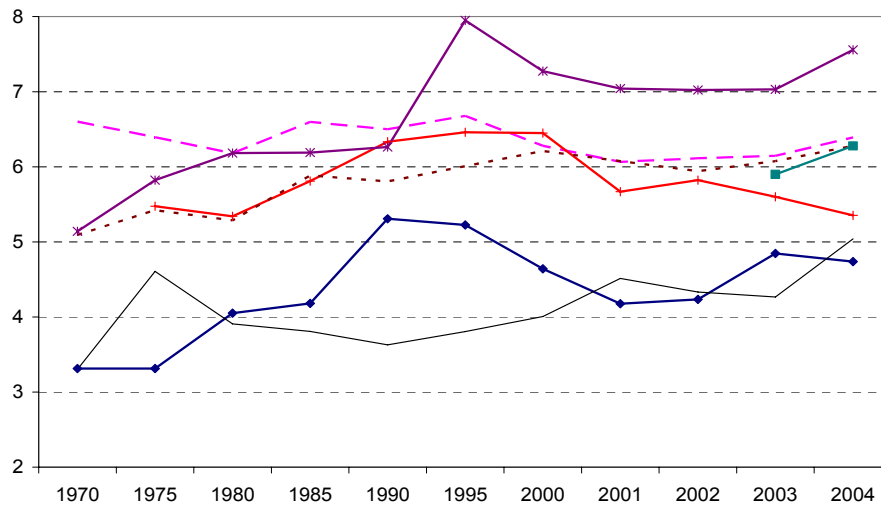
**Chain-linked EFW Summary Index**



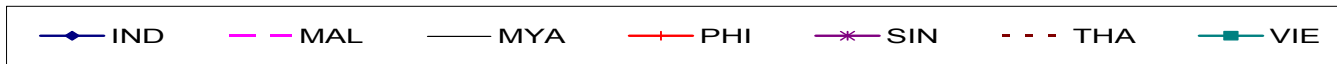
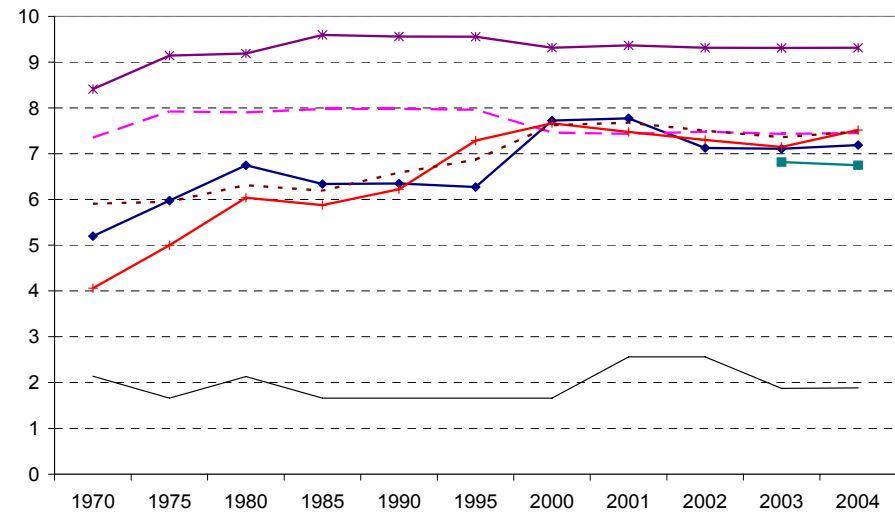
**Legal Structure and Security of Property Rights**



**Regulation of Credit, Labor and Business**



**Freedom to Trade Internationally**



Source of basic data: Gwartney and Lawson (2006).



The Heritage Foundation/Wall Street Journal *Index of Economic Freedom* measures countries against a list of 50 independent variables divided into 10 broad factors of economic freedom: (i) trade policy, (ii) fiscal burden of government, (iii) government intervention in the economy, (iv) monetary policy, (v) capital flows and foreign investment, (vi) banking and finance, (vii) wages and prices, (viii) property rights, (ix) regulation, and (x) informal market activity.<sup>14</sup> Each factor is graded according to a unique scale, which runs from 1 to 5: A score of 1 signifies an economic environment or set of policies that are most conducive to economic freedom, while a score of 5 signifies a set of policies that are least conducive to economic freedom.<sup>15</sup> Finally, the 10 factors are added and averaged, and an overall score is assigned to a country. The index is available from 1995 (Miles *et al.*, 2006).

Table 12 shows the scores of selected ASEAN economies in 2006. In particular, the Philippines scored poorly with respect to property rights and regulation. The variables for property rights included: freedom from government influence over the judicial system, commercial code defining contracts, sanctioning of foreign arbitration of contract disputes, government expropriation of property, corruption within the judiciary, delays in receiving judicial decisions and/or enforcement, and legally granted and protected private property. A score of 4 indicates a low level of protection; i.e., property ownership weakly is protected; court system is inefficient; corruption is present; judiciary is influenced by other branches of government; and expropriation possible.

**Table 12: Index of Economic Freedom, Selected ASEAN Economies, 2006**

Country	Rank (out of 157)	2006 Score	1	2	3	4	5	6	7	8	9	10	1995 Score
Cambodia	68	3.0	4.0	2.3	2.5	1.0	3.0	2.0	2.0	4.0	4.0	5.0	3.7
Indonesia	134	3.7	3.0	4.1	3.5	3.0	4.0	4.0	3.0	4.0	4.0	4.5	3.5
Lao PDR	149	4.1	4.5	3.8	1.5	4.0	4.0	4.0	4.0	5.0	5.0	5.0	4.5
Malaysia	68	3.0	2.5	3.3	3.0	1.0	4.0	4.0	3.0	3.0	3.0	3.0	2.5
Myanmar	155	4.5	5.0	3.6	3.5	4.0	5.0	5.0	4.0	5.0	5.0	4.5	4.4
<b>Philippines</b>	<b>98</b>	<b>3.2</b>	<b>2.5</b>	<b>3.8</b>	<b>2.0</b>	<b>2.0</b>	<b>4.0</b>	<b>3.0</b>	<b>3.0</b>	<b>4.0</b>	<b>4.0</b>	<b>4.0</b>	<b>3.4</b>
Singapore	2	1.6	1.0	2.1	3.5	1.0	1.0	2.0	2.0	1.0	1.0	1.0	1.7
Thailand	71	3.0	3.5	3.4	2.5	1.0	4.0	3.0	3.0	3.0	3.0	3.5	2.5
Viet Nam	142	3.9	4.5	3.9	3.5	2.0	4.0	4.0	3.0	5.0	5.0	4.0	4.6

**Notes:** Columns 1-10 (1) refer to the scores for the following broad factors of economic freedom: (1) Trade; (2) Fiscal Burden; (3) Government intervention; (4) Monetary policy; (5) Foreign investment; (6) Banking; (7) Wages and prices; (8) Property rights; (9) Regulation; and (10) Informal market.

Interpretation of scores: Free—countries with an average overall score of 1.99 or lower; Mostly Free—countries with an average overall score of 2.00 to 2.99; Mostly Unfree—countries with an average overall score of 3.00 to 3.99; and Repressed—countries with an average overall score of 4.00 or higher.

**Source:** Miles *et al.* (2006).

The report noted the Philippines' "slow judicial system, hampered by lack of funding and an insufficient number of judges to handle court cases ... and a series of contract reversals" (p. 320) especially from 2002 that further undermined the security of contractual arrangements. Both are viewed as serious disincentives to foreign investment. Also, its 2006 score represented a worsening compared to its 1995 score of 3.

<sup>14</sup> Appendix 2 lists the relevant variables for the 10 broad indicators of economic freedom.

<sup>15</sup> See Appendix 3 for the interpretation of scores for selected factors of the index of economic freedom.

The variables for regulation included: licensing requirements to operate a business; ease of obtaining a business license; corruption within the bureaucracy; labor regulations, such as established workweeks, paid vacations, and parental leave, as well as selected labor regulations; environmental, consumer safety, and worker health regulations; and regulations that impose a burden on business. A score of 4 indicates a high level of regulatory burden; i.e., highly complicated licensing procedures; regulations impose heavy burden on business; existing regulations applied haphazardly and in some instances are not even published by the government; corruption present and poses a substantial burden on businesses. In particular, the report noted the lack of transparency and haphazard enforcement of regulations by the country's regulatory agencies, extensive bureaucratic corruption. There has been no improvement in the country's score since 1995.

Finally, the World Bank also estimates worldwide governance indicators, which measure six dimensions of governance (Kaufmann *et al.*, 2006):

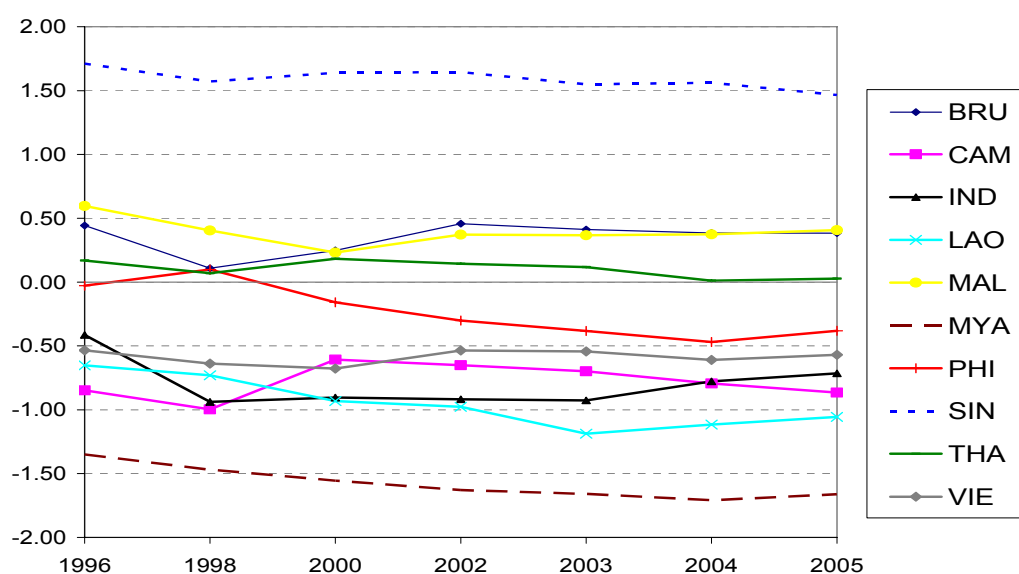
1. *Voice and accountability*, the extent to which a country's citizens are able to participate in selecting their government, as well as freedom of expression, freedom of association, and free media;
2. *Political stability and absence of violence*, perceptions of the likelihood that the government will be destabilized or overthrown by unconstitutional or violent means, including political violence and terrorism;
3. *Government effectiveness*, the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies;
4. *Regulatory quality*, the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development;
5. *Rule of law*, the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, the police, and the courts, as well as the likelihood of crime and violence; and
6. *Control of corruption*, the extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as "capture" of the state by elites and private interests; voice and accountability, political stability and absence of violence, government effectiveness, regulatory quality, rule of law, and control of corruption.

The indicators are based on a large number of individual data sources that provide information on perceptions of governance. These data sources consist of surveys of firms and individuals, as well as the assessments of commercial risk rating agencies, non-governmental organizations, and a number of multilateral aid agencies.<sup>16</sup> The six governance indicators are measured in units ranging from about -2.5 to 2.5, with higher values corresponding to better governance outcomes. Figure 5 shows the average of the six governance indicators for the ASEAN economies from 1996 to 2005. Again, the figure confirms some weakening in the Philippines' institutional quality in recent years.

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<sup>16</sup> It includes the Heritage Foundation/Wall Street Journal Index of Economic Freedom. Kaufmann, Kraay, and Mastruzzi (2004) contains a complete description of the statistical methodology underlying the indicators.

**Figure 5: Average Governance Indicator for ASEAN Economies, 1996–2005**



**Source of basic data:** Kaufmann *et al.* (2006).

Overall, the different institutional indicators show a positive relationship between economic performance and institutional quality in the ASEAN member countries. That is, the countries that have been doing well economically are also the ones that scored well in terms of institutional quality (e.g., Singapore, Malaysia, and Thailand). Also, it is noteworthy how Viet Nam has come close to, and even exceeded at times, the Philippine scores.

Therefore, de Dios and Hutchcroft (2003) argue that the most fundamental need in the Philippines is to improve the overall performance of government, insulate it from the plunder of oligarchic groups, and promote new types of private sector initiative. In particular, sustained economic growth requires significantly improving the quality of the bureaucracy. It is probably unlikely for the Philippine bureaucracy to achieve for instance Singapore’s level of coherence and capacity. But even incremental changes can enhance provision of the basic legal and administrative underpinnings necessary for the effective functioning of markets. In any institution building program, it is particularly important to concentrate on the enhancement of key agencies’ administrative capacity, including the new Central Bank, the Securities and Exchange Commission, and the Bureau of Internal Revenue. To date, economic reform efforts that merely remove restrictions on competition have been the most successful. Initiatives that would require sustained administrative capacity are more complex. For instance, simply liberalizing the banking sector does not resolve ongoing deficiencies in regulatory capacity. More generally, broader programs of economic reform do not obviate the need to address other political and institutional problems (de Dios and Hutchcroft, 2003).

Institutions can also be characterized according to the economic roles they perform. In particular, Tavares (2002) identified three different areas of institutional development, which affect the growth of an economy—the legal system, the governance of the firm and financial markets. The next subsection presents a broad diagnostic of the level of institutional development of financial markets and economic performance.

## V. INSTITUTIONAL UNDERPINNINGS OF FINANCIAL SECTOR DEVELOPMENT AND REFORM

### A. Financial Institutions and Economic Growth

The literature analyzing the impact of financial development on growth has provided strong evidence that financial development has a positive effect on long-run economic growth.<sup>17</sup> Thus, establishing well-functioning financial markets and financial institutions, which attract savings and channel them to productive investment projects, has been deemed a policy priority for governments. Recently, the research agenda has turned to the question of why many countries continue to be financially underdeveloped (Girma and Shortland, 2004). Although a broad consensus among economists has been reached on the positive relationship between a country's level of financial development and its rate of economic growth, there is less consensus on explaining the high degree of variance in financial development across countries (Haber, 2006).

The study of financial markets in the overall context of institutions in development is very new but growing. That is, financial development is not solely driven by differences in the general level of economic development (macroeconomic conditions), but also by differences in the rules pertaining to financial systems and their enforcement (regulatory/institutional conditions) (Asogwa, 2006).

In particular, there is a body of theoretical and empirical work that seeks to explain the persistent disparity in financial market development and economic performance across countries by relating it to the capacity of a country's institutions to protect private property, enforce contracts, and provide incentives for investment (Osili and Paulson, 2004). For instance, Shleifer and Vishny (1997) argue that weak contract enforcement creates incentives for debtors to default, thereby decreasing willingness to lend. Tavares (2002) notes that weak investor protection has significant negative effects opportunities for external finance, which leads to smaller capital markets. Levine (1999) and Levine *et al.* (2000) also find a relationship between countries that offer better investor protections and more developed financial markets.

**Institutional determinants of financial development.** According to Tavares (2002), a country's financial system and its institutional characteristics are deeply rooted in the country's history and political culture. For instance, the type of financial system that evolves over time is conditioned by the legal system. The comparative rights of individual investors vis-à-vis the state are emphasized differently under different legal traditions, with consequences for financial development. There is also a very close link between the legal and political influences on financial development (Tavares, 2002). Girma and Shortland (2004) classify the various potential explanations posited in the literature of why financial development has been slow in a large number of countries into three interrelated groups: institutional underdevelopment, legal and institutional heritage, and political economy.

According to the first group of studies, financial institutions do not operate in an institutional vacuum. The efficient functioning of a financial system requires respect for the rule of law, a low level of corruption and good contract enforcement. Thus, financial development, like economic development, also relies on good governance. The empirical literature also shows that the relationship between financial liberalization and financial crises strongly depends on the institutional environment in a country. The contention of this literature therefore is that booms and busts in the financial sector and the resulting financial underdevelopment result

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<sup>17</sup> See Levine (2003) and Demetriades and Andrianova (2003) for recent reviews of the literature.

from governments' inability to address institutional shortcomings or lack of understanding of the institutional foundations of a sound financial system that lead to badly sequenced reforms.<sup>18</sup>

The second group of literature specifically examines the links between law and finance, and identifies a more fundamental problem: some legal systems are simply not well suited to creating the preconditions for financial systems and institutions to successfully develop.<sup>19</sup> This explanation has a static and a dynamic perspective on why financial development, particularly arms' length finance, depends on how outsiders' property rights are enforced. Under the "static" view of law and finance, the focus is on the difference in legal traditions regarding the comparative rights of individual investors vis-à-vis the state—that is, common law versus civil law. Common law systems were designed to protect investor property against the Crown, thus creating an environment in which individuals could transact confidently. On the other hand, the state is set above the courts under civil law, and consequently interests of politically connected heads of firms above individual investors. According to this literature, countries that adopted British Common Law have larger financial systems compared to countries that adopted the French Civil Code due to the better protection given to investors under the former system. In this body of literature, either politics and political institutions do not matter (La Porta *et al.* 1998), or they matter but are less important than legal origin (Beck, Demirgüç-Kunt, and Levine, 2003) (in Haber, 2006).

The "dynamic" view of law and finance focuses on the adaptability of the law to changing conditions, with flexible legal systems deemed as better suited to fostering financial development. Because common law emerges on a case-by-case basis, it can more quickly close the gap between an economy's needs and the law. This is in stark contrast to the seemingly immutable legal code of French civil law. The more difficult it is to undertake legal reform, the less investor protection there is at the cutting edge of financial innovation, thus tending to slow down financial development (Girma and Shortland, 2004). However, Tavares (2002) notes that country experiences do not entirely accord with this dichotomy—all countries, regardless of legal tradition, adapt to a greater or lesser extent to new economic and contractual realities.

Beck *et al.* (2001a, 2001b; in Tavares, 2002) empirically show that legal tradition does affect the level of overall financial development. But critiques of this literature also argue that there are some civil law countries that performed very well in terms of financial development in the early 20<sup>th</sup> century. And even within legal origins, a large discrepancy in terms of financial development exists (Tavares, 2002). Thus, other studies focus on the quality of legal systems, rather than legal origins per se. Results show that the level to which firms are financially constrained is higher when there is a high risk of expropriation, inefficient legal systems and high associated corruption. Modigliani and Perotti (1999; in Tavares, 2002) also argue that, in the absence of a strong legal system that can protect external investors, financial intermediaries with sufficient bargaining power to enforce their rights privately come forward and extract rents.

The third group of studies identified by Girma and Shortland (2004) focuses on the political economy of financial development, and presents a dissenting argument that legal origin has little effect on financial development or on economic growth more broadly. Instead, financial development is an outcome of specific laws and regulations, which in turn are the result of politics and political institutions (Haber, 2006).<sup>20</sup> This view also provides another way of

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<sup>18</sup> E.g., Demirgüç-Kunt and Detragiache (1998), Kaufmann *et al.* (1999), Hellmann *et al.* (2000), Andrianova *et al.* (2002).

<sup>19</sup> La Porta *et al.* (1997, 1998); see Beck *et al.* (2001a, 2001b) for a review of the literature.

<sup>20</sup> E.g., Rajan and Zingales (2003), Acemoglu, Johnson, and Robinson (2005), Lamoreaux and Rosenthal (2005).

looking at the divergent performance of countries with similar legal systems over time, by looking at the political system in which decisions about economic policies are made. In particular, Rajan and Zingales (2003) propose such a new political economy view to explain the u-shape pattern of financial development during the 20<sup>th</sup> century; that is, an interest group theory of financial development. They argue that financial underdevelopment may be the result of political circumstances—that is, to protect the interests of a narrow political/industrial elite. Since this group is served well by relationship banking, and potential competitors' access to finance is restricted by the absence of arms' length finance, such an elite may have little interest in developing well-functioning capital markets as an end in itself.

The latter two explanations of cross-country variance in financial development—i.e., law and finance and political economy—share two common characteristics. The first one is that they both emphasize that legal origins and political institutions were created through processes that occurred over long periods of time. The implication is that cross-sectional regression analysis is not the appropriate methodology to examine the way these mechanisms actually affect financial development. The second similarity, albeit with some exceptions, is that both explanations tend to focus on corporate governance and the growth of securities markets, i.e. arms' length finance. However, as Lamoreaux and Rosenthal (2005; in Haber, 2006) pointed out, it was not until the 20<sup>th</sup> century that firms in developed economies financed themselves through the sale of securities on organized exchanges; a more important source of finance in the 19<sup>th</sup> century was banks. And what was true for developed economies in the 19<sup>th</sup> century is true for developing and emerging economies today: few firms raise funds by selling shares on the market. Thus, any discussion of variance in financial development needs to focus at least as much on the development of banking systems as it does on the development of securities markets (Haber, 2006).

For instance, Haber (2006) traced the way the banking systems of the United States and Mexico developed from independence to 1913. His analysis indicates that political institutions—particularly those that created (or failed to create) institutionalized competition among political entities—played a significant role in determining the size and structure of the banking systems in these countries.

Zhang (2006a) used a similar approach in his study on Malaysia and Thailand; that is, he developed an institutional explanation of financial policy choices. In particular, he drew on theoretical studies on the policy impact of political parties to explain cross-national differences in Malaysia and Thailand's financial policy choices and the resulting capital market structures. His study showed how financial and regulatory policies have varied significantly in response to national configurations of political parties over time in the two countries. And it is this difference in the patterns of policy changes that has shaped financial market structures and development. He makes three major conclusions: (i) the significance of politicians and their preferences, as shaped by political party structures, in the process of policy formation and market development; (ii) political processes of policy formulation shaped by domestic political institutions still strongly influence market structures and development in small, open developing economies, even with the most intensive harmonizing pressures generated by global market integration; and (iii) political institutions in general and political party structures in particular matter significantly in the process of financial market development and governance. Thus, the paper confirms the tight linkages between political parties, incentives structures, and policy and market outcomes. Explaining national patterns of financial policy choice and performance, and the dynamics of capital market development, then requires that such linkages be explicitly addressed.

**Financial liberalization/reform.** Girma and Shortland (2005) also noted that the importance of countries' political regime characteristics has largely been ignored in studies on financial liberalization. Most studies have focused primarily on the effects of financial

liberalization on financial stability and economic growth, rather than its causes. Research on the political economy of financial liberalization, on the other hand, is mostly case studies: Finally, Girma and Shortland (2005) note that empirical research on the domestic and systemic causes of liberalization primarily relates to capital account liberalization. Thus, they conducted their own study on reasons for financial development or underdevelopment by empirically examining if regime characteristics such as a country's autocracy/democracy characteristics determine whether financial development is impeded through financial repression.<sup>21</sup>

Their results indicate that the countries most likely to have fully liberalized financial systems are the highly democratic countries. However, a regime has to be fully democratic to have a positive impact on liberalization. The results would seem to indicate that governments in intermediate regimes (that is, neither fully autocratic nor fully democratic) use financial intermediaries to pay off their supporters. In contrast, fully autocratic regimes would have more direct ways of dealing the opposition, rendering such policies unnecessary. Thus, the paper concludes that "elites, which are neither fully entrenched nor subject to intense electoral competition, act as a barrier to financial development. Governments appear to have deliberately used policies of financial repression in the banking system and controls on capital account transactions to control who receives financial resources and escape international scrutiny of their policies" (Girma and Shortland, 2005: 24).

Zhang (2003) also related political structures and liberalization in the Republic of Korea; Singapore; Taipei,China; and Thailand. He noted that these economies pursued different liberalization strategies during the 1980s and 1990s, which he attributed to differing domestic political structures. In particular, he argued that their divergent liberalization approaches and outcomes was due to fundamental differences in the organizational structures of the private sector, the bureaucracy and the party system, which shape social groups and state agencies' economic interests and political behavior in the policy-making process. As a result, they also had contrasting performance in the recent financial crisis. The growing capture of the policymaking process by the politically resourceful and structurally powerful industrial and banking groups led to the failure of market reform in the Republic of Korea and Thailand. In contrast, industrial fragmentation in Singapore and Taipei,China weakened private actors' capacity to organize effective group-based lobbying, and hence influence the reform process. The capture problem in the Republic of Korea and Thailand also reflected the inability of key state financial and regulatory agencies to insulate themselves from particularistic interests. Singapore and Taipei,China's respective central banks enjoyed a relatively high degree of political autonomy and organizational cohesion, which enabled them to manage financial market reform more effectively. Thus, Zhang underscored the importance not just of putting in place optimal policy and regulatory frameworks, but also of developing and improving in a sustained manner the political institutions that can bring about the desired public policy objectives. Again, the point is that without the appropriate political and institutional preconditions, financial market liberalization is likely to run counter to its proponents' objectives.

The political economy explanation for financial underdevelopment and the overall disappointing impact of financial liberalization also applies to the Philippines. In particular, Hutchcroft (1998) provides a detailed history of the Philippine commercial banking system from the American colonial period, when the combination of weak state and powerful oligarchy began to emerge, up to the Ramos administration in 1992–96 when important reforms to liberalize and privatize key sectors of the economy were undertaken. A crucial development in the banking system during the postwar years was the entry of a new "breed"

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<sup>21</sup> I.e., government controls on interest rates, credit controls and restrictions on deposits in foreign currencies in the banking sector; limits on foreign ownership and profit repatriation in the stock market; and limits on international capital flows.

of commercial bankers into the system. With the government's promotion of import substitution industrialization, prominent families began to move into various industrial activities. Ownership, or control of, or affiliation with a bank was seen as imperative to provide inexpensive credit for other parts of the conglomerate. As a result, almost all prominent families had ventured into commercial banking by 1965 (Patrick and Moreno, 1984; Hutchcroft, 1991). Furthermore, it was at their instigation that the government asked the IMF-World Bank mission, which was conducting a review of the Philippine financial sector in 1979, to look into the possibility and consequences of expanding the functions of financial institutions, for instance allowing commercial banks to undertake investment banking functions. Simply put, patrimonialism adversely affected national policy towards the banking sector, which in turn had adverse effects on financial intermediation and ultimately growth.

## **B. Institutional Underpinning of Financial Governance Reforms**

In the aftermath of the Asian financial crisis, the recommendation particularly of the international financial institutions was essentially domestic in nature: the upgrading of the domestic economic governance framework through convergence on international "best practice," as set out in the various international standards and codes. The Washington Consensus had emphasized the combination of macroeconomic stabilization, and trade and financial liberalization, with no mention of the institutional/governance requirements of financial openness. After the Asian crisis, there was significant emphasis on institutional and governance reforms, including the upgrading of prudential regulatory frameworks. However, this was not seen as a rejection of the Washington Consensus, but as a way of augmenting it. In particular, financial liberalization was still promoted as welfare enhancing, albeit with the additional proviso that an effective prudential regulatory framework must also be in place (Walter, 2002).

Mishkin (2001; in Walter, 2002) notes the wide coverage of the new consensus with respect to "governance requirements." For financial liberalization to work and to make financial crises less likely, the necessary institutional/governance prerequisites include: (i) adequate prudential supervision; (ii) high accounting and disclosure standards; (iii) effective legal and judicial systems; (iv) the facilitation of market-based discipline through entry and exit policies, competition policy, etc.; (v) reduction of the role of state-owned financial institutions; and (vi) elimination of too-big-to-fail in the corporate sector. The various structural conditionalities attached to the IMF-led rescue packages for Thailand, Indonesia and the Republic of Korea clearly reflected this new agenda (Kapur, 2001, Goldstein, 2001; in Walter, 2002).

**Governance and financial regulatory agencies.** Governance is a concept that has developed considerably since it emerged in discussions of development issues around the late 1980s. Most international organizations and bilateral agencies have developed their own definition of governance. Asian Development Bank (1998) defines the concept as the manner in which power is exercised in the management of a country's social and economic resources for development. The World Bank uses the same definition. The United Nations Development Programme (UNDP), on the other hand, defines governance as the exercise of political, economic and administrative authority to manage a society's affairs. A formal definition of governance was also presented in the recent European Commission White Paper on European Governance (Commission of the European Communities, 2001); that is, governance means "rules, processes and behaviour that affect the way in which powers are exercised at European level, particularly as regards openness, accountability, effectiveness and coherence" (p. 8).



Kaufmann *et al.* (2002: 10) define public sector governance as "the traditions and institutions that determine how authority is exercised in a particular country. This includes (1) the process by which governments are selected, held accountable, monitored, and replaced; (2) the capacity of governments to manage resources efficiently and to formulate, implement, and enforce sound policies and regulations; and (3) the respect of citizens and the state for the institutions that govern economic and social interactions among them." This definition is, by extension, also applicable to appointed bureaucracies and official agents, including financial sector regulators. Regulatory governance, which is a more specific concept, refers to the efficient and effective application of governance in the area of regulation. (Ferris, 2001). It encompasses the whole system by which regulation and competition are managed to achieve societal goals. (Cariño, 2002).

Das and Quintyn (2002) use the term regulatory governance to refer to "institutions that possess legal powers to regulate, supervise and/or intervene in the financial sector" (p. 7). They argue that good regulatory governance in the financial system is a critical component of financial stability. It is needed to promote effective competition in the companies being regulated, as well as facilitate the on-going process of change and provide the public with an efficient supply of services at reasonable prices. By failing to apply good governance principles, regulatory agencies lose credibility and moral authority to promulgate good practices in the institution under their oversight. This could create a moral hazard problem, contribute to unsound practices in the markets, and, ultimately, accentuate crises in the financial system. And a key aspect is that sound governance practices are also established and practiced by the regulatory agencies themselves. In fact, most of the financial crises of the past decade involved political interference in the regulatory and supervisory process, forbearance, and weak regulations and supervision. All these are symptoms of weak regulatory governance.

According to Das and Quintyn, good regulatory governance has four components— independence, accountability, transparency and integrity. Independence relates to independence from the political sphere and from the supervised entities. The issue has been raised as to why politicians would choose to delegate tasks related to economic and social regulation to an independent agency, rather than to a government agency, a specific ministry, or a local body. Das and Quintyn note two advantages of the former over the latter: expertise can be resorted to and relied on, especially when complex situations arise; and to safeguard market intervention from political interference, which would improve the transparency and stability of the outcome. That is, the possibility of making credible policy commitments would be enhanced by agency independence.

Credible policy commitments also have to do with the time-inconsistency problem. That is, political executives find it very difficult to credibly commit to long-term strategies and solutions due to the short-term cycles of elections and term limits. Another commitment problem that they are faced with is that they cannot bind a subsequent legislature and government. This makes public policies vulnerable to renegeing, and would therefore lead to a lack of credibility (Majone, 1997; in Das and Quintyn, 2002).

However, the need for political independence has also raised concerns that independent agencies would be outside political control, not be politically accountable, or pursue their own agendas that may go against the agenda of the political majority in democratic regimes. Independent regulators have sometimes been referred to as the "fourth branch of government," implying that they are outside the control of the traditional three branches that, through checks and balances, keep mature democratic systems in equilibrium. Such concerns are deemed as justified. Thus, it is also argued that independence should go hand in hand with accountability, particularly with respect to delegating authority (the government or the legislature), to those who fall under their functional realm, and to the general public. In practice, though, implementing it is more complex. If the agency's objective is clearly defined

and measurable, implementing accountability would be straightforward. But financial supervisors typically have several broad objectives, such as preserving financial stability or consumer protection. Thus, it would be more complicated to hold them accountable for achieving such objectives, compared to a central bank whose main objective is to meet an inflation target, for instance.

Transparency in monetary and financial policies refers to the way in which objectives, frameworks, decisions and their rationale, data, and other information, as well as terms of accountability are released to the public in a comprehensive, accessible, and timely manner. Finally, integrity means there are mechanisms to ensure that the staff of the agency does not compromise the pursuit of institutional goals in favor of their own behavior or self-interest. Integrity needs to be pursued and safeguarded in four levels: (i) the integrity of the board-level appointees (policy making body) in terms of procedures for appointment of heads, their terms of office, and criteria for removal; (ii) integrity of the agency's day-to-day operations; (iii) standards for the conduct of personal affairs of officials and staff to prevent exploitation of conflicts of interest; and (iv) the staff of the regulatory agency enjoys legal protection while discharging their official duties.

**Independent regulatory agencies.** The case for regulatory and supervisory independence has been well established in the case of public utilities, and other economic sectors where sector-specific oversight is required due to externalities. In the financial sector, the arguments are well established for central bank independence. On the other hand, the focus on financial sector regulatory and supervisory independence is fairly recent, and hence the discussion is not as extensive. Recent interest is due to two factors: (i) in most of the systemic financial sector crises that occurred in the 1990s, the lack of independence of supervisory authorities from political interference was cited as a contributing factor; and (ii) recent discussion on the most appropriate financial regulatory and supervisory structure.

In particular, Quintyn and Taylor (2002) make two contentions. The first is that a substantial degree of independence is needed by bank regulators and supervisors to fulfill their mandate and help to achieve and preserve financial sector stability. The second is that it is a complement to central bank independence in order to achieve and preserve the twin goals of monetary and financial stability. They also distinguished between “goal independence” (which refers to the regulatory agency’s mandated objective) and “instrument independence” (which refers to the actual formulation and implementation of supervisory and regulatory practices left to the discretion of specialist officials). They note that the politicians’ proper role is to set and define regulatory and supervisory objectives, but the regulators must be given the autonomy to determine how they should achieve those goals—and the accountability if they fail to achieve them. Finally, Quintyn and Taylor identify four dimensions of instrument independence—regulatory, supervisory, institutional, and financial or budgetary independence. The first two are characterized as the core functions, while the latter two are essential to support the execution of the core functions.

Regulatory independence means the agency has an appropriate degree of autonomy in setting technical rules and regulations, within the general confines of the law. Of the four dimensions, this is the most crucial but it is also the most difficult to implement in some countries because of the way it impinges on fundamental issues embedded in the constitutions and often rooted in long legal traditions.

The supervisory function is divided into four activities: licensing, supervision, sanctioning, and crisis management (Lastra, 1996; in Quintyn and Taylor, 2002). Ensuring the integrity of the supervisory function is typically undertaken through legal protection for bank supervisors/examiners, rules-based system of sanctions and interventions (e.g., prompt and

corrective action), and appropriate salary levels and clear career paths. Supervisory independence is also critical for financial sector stability, but it is also difficult to establish. Government interference, especially under the form of forbearance, is still common in many countries.

Institutional independence refers to the status of the agency as separate from the executive and legislative branches of government. It includes three critical elements: terms of appointment and dismissal of senior personnel; governance structure; and openness and transparency of decision-making. Finally, financial or budgetary independence refers to the role of the executive/legislature in determining the size and use of the agency's budget, including staffing of the agency and salary levels. Budgetary independence from government may enable financial supervisors to better withstand political interference, but it may lead to industry capture if the agency depends on the industry instead.

Quintyn and Taylor (2002) also note that arrangements for agency independence are by themselves not sufficient for effective regulation and supervision. Existing institutional arrangements and political culture are also significant. They highlight the need for checks and balances in the government system for independence to work. In particular, it would be relatively easy and less costly for authorities to override or undermine agency independence if there are few checks and balances. Some studies have shown this to be true in the case of central bank independence. Since this is the political reality in many developing countries, Quintyn and Taylor (2002) point out that governments need to be convinced through other means not to interfere with the financial sector. One such way would be through adherence to international standards and best practices. Carmichael and Kaufmann (2001) also argue that the Core Principles issued by the various international financial institutions are good guides, and they are the principles to which every regulator should aspire.

**Political underpinnings of financial market governance.** Walter (2002) described the core element of the IMF packages for the crisis economies in Asia as a move away from a system of financial regulation that is highly "relational-patrimonial" in nature towards a western-style "rules-based" system of prudential regulation and supervision. That is, under the former type of regulatory environment, banks typically constitute a kind of protected oligopoly. And given their centrality to the domestic financial and political system, they are deemed as too important to fail (Rosenbluth and Schaap, 2002). Close relationships between banks and bank regulators are also typical, making regulation more relationship-based than rules-based.

Thus, Walter argues that formally converging on international standards and codes is the easy part. But under this reform strategy, the likelihood of implementation failure is significantly underestimated because it does not take into account regulatory forbearance, which remains chronic in many of the East Asian countries undertaking such reforms. Implementation failures occur when politicians may have strong incentives to supply the regulatory forbearance demanded by weak banks and debtors. Thus, policy sequencing remains perverse mainly for political economy reasons, which leads to continuing financial vulnerabilities for these countries. In particular, real implementation failures mean that prudential regulation will dangerously lag the process of financial liberalization. Walter then illustrates this point by looking at bank capital adequacy in Indonesia, the Republic of Korea and Thailand as a specific area of regulatory forbearance. He then notes how non-transparent real bank capital is even in the best case scenario represented by the Republic of Korea. Thus, he concludes that while convergence towards western regulatory standards has formally taken place, in practice there is still significant divergence due to regulatory forbearance in countries with unresolved financial and corporate sector problems. Ultimately, the key obstacle to the upgrading of financial sector governance in most of East Asia is implementation failure, more than the blocking of key reform legislation.

It could be argued that ‘transition problems’ are inevitable and that the standards and codes exercise will eventually produce beneficial outcomes. But according to Walter, this view is complacent and does not take account of the political economy factors that are likely to produce a continued forbearance gap in many developing (and developed) countries. He also notes that even the international financial institutions, which have the responsibility to monitor and enforce the implementation of the standards and codes, may have mixed incentives to do so in practice.

Zhang (2006b) makes a similar argument. He notes how the IMF and the World Bank’s current reform agenda emphasize the role of institutions in promoting market discipline and getting the institutional mix right for financial systems to function smoothly, but still in the context of privatization and liberalization. According to Zhang, this financial market governance paradigm, which has achieved the status of a new orthodoxy in the international policy community, has three key components:

1. To ensure financial stability, the state is expected to play an active role in building strong legal and regulatory systems, while at the same time nourishing the financial market as an institution to maximize the scope for voluntary transaction. Thus, governments are urged to privatize state-owned banks, abstain from directing credit, and secure the rights of creditors and shareholders;
2. Free from government intervention, the financial market is supposed to encourage private actors to participate in market relations that stimulate financial development. This is to give significant scope for self-regulatory organizations and market regulations to “become a central institution of financial governance, a key institution for amplifying supervisory structures, facilitating information flow, allocating resources and managing risks.” That is, instead of depending on the state to fulfill these function, private participation and regulation are presented as the responsible market-based alternative; and,
3. Good governance must be predicated upon the building of concomitant institutions—credible legal systems, independent monetary agencies, active capital markets, and transparent and harmonized regulatory structures.

Zhang recognizes the new paradigm’s novel form of institutional rationality for the existence of efficient financial systems. That being said, he argues that it still has vital limits, particularly its failure to address the political dimensions of financial market governance. To wit:

The newly found state-friendly discourse has been framed in narrow economic terms as the supply of legal and regulatory institutions. It negates the much broader role of the state in market governance in developing countries and neglects the political process through which state actors create and regulate the financial system. Despite its emphasis on governance, the paradigm seldom confronts the issue of government and the politics that underlie it ... While the building of new institutions occupies the proscenium arch of the governance agenda, it has paid scant attention to the fact that institutional reforms would tamper with the existing political bargains that involve powerful interests ... Equally important, private participation and regulation has been promoted as a crucial institution of financial market governance without much discussion of the real and potential danger of private actors capturing the policy and regulatory process. To the extent that private capture is recognized as a legitimate concern, it is perceived as something that is to be resolved by governance (Kaufmann, 2002), not something that is likely to be a perpetual problem of the process (pp. 170-171).

According to Zhang, any attempt to improve the functioning of developing countries' financial markets must explicitly aim to enhance the role of state, tame powerful private interests, and promote distributive justice. To him, these are the issues that "constitute the essential political underpinnings of financial policy management and market governance in developing and emerging market countries" (Zhang, 2006b: 191). In particular, the role of the state needs to be strengthened, not only in terms of supplying the effective legal systems but, more importantly, in dismantling old market institutions and creating and keeping new and efficient financial markets and regulatory structures. A politically sustainable balance of power between private interests and public authorities has to be established. The challenge for public institutions then is how to employ private market agents to improve financial governance, and at the same time subject their behavior to the surveillance and control of democratic processes. Failure to fully consider these political and normative dimensions, Zhang concludes, could cause the prevailing governance paradigm, which is increasingly shaping the financial architecture of developing countries, to become politically unsustainable and hence fail.

In particular, the architecture of financial supervision and any need for change also became an important issue to be addressed in the aftermath of the Asian financial crisis. Thus, strengthening the supervisory mechanism under the IMF programs for Indonesia, the Republic of Korea and Thailand also required the establishment of integrated prudential regulators (Gochoco-Bautista *et al.*, 1999). However, to date, only the Republic of Korea has managed to undertake such a reform. Indonesia passed the reform legislation, but implementation has been moved several times. On the other hand, key financial reform legislations were proposed but were subsequently blocked in Thailand. As argued by Walter (2002), one explanation for the delay in the upgrading of prudential financial supervision was precisely that—political institutions allowed vested interests to block the reforms.

But it should also be noted that the feasibility of a unified financial regulatory body in the Republic of Korea (and even more so in the United Kingdom) was first subjected to in-depth studies, analyses and public debate, which then formed the basis for the proposed bill to consolidate all existing financial supervisory authorities. This was not the case in Indonesia or Thailand. That is, lack of understanding and hence appreciation for the reform would have played a part as well.

### **C. An Institutional Approach to Reforming Financial Regulatory Agencies**

**Traditional approach to reforming financial regulatory structures.** In considering what regulatory structure is appropriate in an integrated financial world, the underlying issue is what regulatory structure minimizes the chances of government failure in ameliorating market imperfections and does so most efficiently (Skipper, 2000). With respect to consolidation of financial sector supervision, some consensus is beginning to emerge. In particular, the literature highlighted two points: changing the regulatory structure must be undertaken only if it will maintain and enhance supervisory capacity and the effectiveness of supervision; and the change in the institutional structure of regulation must reflect the change in the market structure. Abrams and Taylor (2000), for instance, contend that the structure of the regulatory system must reflect the structure of the markets being regulated to be effective. If that is the case, then choosing between the single financial supervisor model (FSA) and multi-financial authorities model (FMA) seems to be straightforward, at least theoretically. *Prima facie*, the FSA model seems to be the optimal supervisory regime to meet the challenges posed by market-blurring and financial conglomeration. Although Masciandaro (2003) notes that the answer may not that simple.

The literature is generally cautious especially in the application of the approach to developing countries. Thus, each country is encouraged to conduct a full assessment of the pros and cons of adopting a particular model. In particular, the literature on the FSA model versus the FMA model highlights the need for countries to conduct some cost-benefit analysis to take into account specific institutional settings, in order to choose between alternative models. Hawkesby (2000), for instance, identifies a number of factors that policy makers have to take into account when assessing the costs and benefits of a supervisory structure, including: the cost of performing supervision, the efficiency of supervision, the effectiveness of supervision, and the impact of any choice on the conduct of monetary policy. He also cites some country-specific economic factors that may make a particular structure of financial supervision more appropriate compared to other structures. For example, the central bank may need to be responsible for prudential banking supervision for this function to be undertaken effectively and free of political interference in developing countries, especially if the central bank is already an independent one.

Abrams and Taylor (2000) also note that in countries where the financial system includes universal banks or where banks are significant players in the securities markets, then combining banking and securities regulation will be most appropriate. And there may be a case for unified supervision in countries where banks dominate in insurance and securities business. Finally, according to Skipper (2000), moving toward unified supervision would be more complex and difficult the larger the financial services market of a country, and vice versa. Thus, the adoption of integrated financial regulation by a number of transition economies has been justified by the relative smallness of their financial sectors, and hence the economies of scale in regulation that they could achieve (Mwenda and Fleming, 2001).

Hawkesby (2000) does recognize the difficulty of undertaking a cost-benefit analysis due to the degree of uncertainty surrounding the economic costs and benefits. Finally, he noted the significant role that political factors could play in the choice of supervisory structure. These in turn would be influenced by the country's recent history, public opinion, political inertia, or concern over the amount of power granted to the supervisory authority.

Masciandaro (2003) agrees that while an analysis of the expected costs and benefits from possible alternative structures would be important, it would not be enough to come up with a conclusive decision regarding an optimal supervisory regime. Estimating the real effects, instead of the potential effects, that the alternative supervisory models would have on key economic variables would also be problematic for 3 reasons: (i) measuring the degree of concentration of powers in order to attempt the quantitative description of a qualitative phenomenon would be problematic because of the diversification, from country to country, in the degree of centralization of financial supervisory power; (ii) the issue of the optimal degree of concentration of financial supervisory powers is fairly recent, so there is just a very short historical series available for analyzing the type of supervisory regime as an explicative or *exogenous* (though not unique) variable of any other economic phenomenon; and (iii) it would be difficult to completely and satisfactorily identify the key economic variables that would be affected by the supervisory structure, and/or how to measure them accurately.

Thus, Masciandaro (2003) concludes that a quantitative search for the effects of alternative supervisory structures is probably premature at this point. Instead, he raises the question of whether there are any common determinants in the decision each country makes to maintain or reform its financial regulatory structure. The answer to this question would help to interpret what has happened in the past, as well as project future scenarios of change. He then proposes an alternative approach to answer this question—that is, he applies to the financial supervision area the classic intuitions of the new political economy using a delegation approach.

**Political delegation approach to reforming financial supervisory structures.** As argued in the previous section on institutional reform, successful institutions are not easily transferred from one context to another because economic institutions must be supported by appropriate political institutions.

In line with this, Masciandaro (2003) argues that it is not possible to determine *a priori* the optimal degree of concentration in the financial supervision regime; rather it is an expected variable calculated by the policymakers that maintain or reform the financial architecture. Thus, the approach that he adopts is to treat the supervisory structure with one or more authorities as an *endogenous* variable, which is in turn determined by the dynamics of other economic and political structural variables that can summarize and explain the political delegation process. That is, what leads a country to either maintain or reform its supervisory structure is the *political* process.

In particular, his methodology involves combining new political economy and principal-agent/delegation approaches. The thesis that he tests is as follows: the optimal financial supervisory design in a given country depends on structural economic and institutional features. Policymakers then either maintain or reform the financial supervisory architecture, depending on the economic and institutional structure of their countries. The financial supervisory architecture can therefore be treated as an endogenous variable, which depends on a set of medium/long-term features. That is, it is a path-dependent variable.<sup>22</sup>

Masciandaro's methodology is similar to that applied to the study of central bank independence, which also represents a search for an optimal structure for the monetary agency. There is significant literature that endogenizes central bank independence, and tries to identify the conditions under which a given country might decide to modify its degree of independence. The various interpretative hypotheses proposed to explain the degree of central independence include the following: (i) financial interest group, i.e., the degree to which constituencies strongly averse to inflation are present as a political interest group, which drives policymakers to strengthen the status of the central bank; (ii) political interest group, which argues that features of the legislative and/or political system can influence the policymakers' decision to have a structure of monetary powers with an independent central bank; (iii) specific public interest, which argues that establishing an independent central bank may be due to policymakers' specific interest for reasons linked to political stability or international credibility; and (iv) general public interest, which emphasizes the role of the culture and of the tradition of monetary stability in a country or the importance of the citizen preferences.

Finally, Masciandaro (2003) uses the principal-agent approach to analyze the endogenization of the policymaker's choice of the optimal level of concentration in the supervisory architecture as a delegation problem. He notes that principal-agent models have also been applied to monetary policy studies. That is, to make the conduct of anti-inflationary monetary policy more effective, it is in interest of the policymaker (the principal) to delegate it to an independent central bank (the agent).

To apply the principal-agent approach to the issue of optimal financial supervisory model, Masciandaro (2003) proposes four steps: (i) identify the policymaker's objective in choosing to delegate the supervisory policy over the banking, securities and insurance system; (ii) explain why the policymaker wants to delegate this policy rather than directly implement it, and if his choice is motivated by general or specific interests; (iii) ask how many institutions the policymaker delegates this policy to; and (iv) which institution(s) he employs.

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<sup>22</sup> Masciandaro's political delegation approach in dealing with financial supervisory architecture issues is, to the author's best knowledge, the first to explicitly examine the relationship between political factors and financial supervisory architectures.

After defining the theoretical framework of the endogenous supervisory regime, Masciandaro then raises the following empirical question: are there common cross-border economic and/or institutional structural variables that explain why a country chooses or rejects a given supervisory model? If common economic and institutional endowments are associated with a given supervisory regime, then the probability that this model will be adopted in a specific country will depend on the presence of these endowments.

Masciandaro starts his analysis by constructing a Financial Authorities Concentration Index (FAC index), based on an analysis of which and how many authorities in 69 countries<sup>23</sup> are empowered to supervise the three traditional sectors of financial activity (banking, securities markets, insurance). A numerical value is then assigned to each type of authority: the higher the concentration of supervisory powers, the higher the value of the index value. This means the index reaches its maximum level if there is a single authority, and the minimum when there are more than three supervisors. The scores of the countries in his sample indicate that concentration of powers of financial supervision is more a feature of the developed countries than the developing or emerging states, particularly in Europe. However, he also notes that the score of four emerging economies involved in Europe's enlargement process (Estonia, Latvia, Malta and Hungary) reached the maximum level of FAC index.

He also calculates the Central Bank as Financial Authority Index (CBFA Index) to capture the involvement of the central bank in financial supervision by assigning a numerical value to the extent of the central bank's financial supervision function: the more sectors the central bank is involved in, the higher the index. This time, an analysis of the scores showed the central bank involvement in financial supervision is more characteristic of the developing and emerging countries. Taken together, the results showed that two polarized models are the most common: countries with a high concentration of powers with low central bank involvement (*Single Financial Authority Regime*); and countries with a low concentration of powers with high central bank involvement (*Central Bank Dominated Multiple Supervisors Regime*), which is consistent with a "leader-followers" framework.

Applying the political delegation approach to the results of the descriptive analysis indicates two things: (i) the policymakers around the world choose to delegate financial supervision rather than implement it directly; and (ii) the political choice on the degree of supervision consolidation seems to be negatively related to central bank involvement in financial supervision. Masciandaro posits two possible explanations for the trade-off between supervision consolidation and central bank involvement. One is the fear of over extension of the financial safety net if the central bank is also involved in the supervision of the securities and insurance sectors. Two is the fear of creating an overly powerful agency, which is a political economy explanation.

To determine the relationship between the policymakers' decisions regarding financial architecture and given country economic and institutional characteristics, Masciandaro then estimates a model of the probability of different regime decisions as a function of the following structural variables: (i) the structure of the financial systems itself (i.e., private governance factor); i.e., whether it is bank-based or market-based, and a measure of the size of the securities market size relative to GDP, to capture the size of the market and the role of financial conglomeration; (ii) the institutional environment (i.e. the public governance climate) to determines the ability of the policy makers to implement their choices, which is measured by a summary index calculated using the indicators proposed by Kaufmann *et al.* (2003); and (iii) the CBFA index, to capture the role of the central bank in the financial architecture.

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<sup>23</sup> Almost the same as the countries listed in Table 10, p. 13.



The expected sign of the relationship between the degree of supervision consolidation and the private governance factor is undetermined. The blurring process means potential changes in the nature and in the dimensions of intermediaries (the financial conglomerates effect). In a bank based regime, if the policymakers' choices depend on the features of their own regime, a positive relationship between the kind of regime and the degree of financial supervision consolidation, in the context of financial conglomeration, can be posited. At the same time, however, the blurring effects mean potential changes in the nature and in the dimensions of the financial markets (the securitization effects). Thus, in a market based regime, a positive relationship can be expected between the kind of regime nature and the degree of financial supervision consolidation, in face of the securitization effect.

The expected sign of the relationship between the degree of supervision consolidation and the public governance factor also cannot be determined *a priori*. If a policymaker, regardless of the financial regime of his country, can choose a higher degree of supervision consolidation to improve the capacity to deal with the effects of the blurring process, then a positive relationship between good governance indicators and financial supervision consolidation can be expected. However, if a policymaker prefers a single financial agency to improve his capacity to capture the financial supervisory structure, then a positive relationship can be posited between bad governance indicators and the financial supervision consolidation.

Finally, given the two possible explanations for the tradeoff between supervision consolidation and central bank involvement (i.e., the fear of over extension of the financial safety net and fear of creating an overly powerful agency), Masciandaro posits a negative relationship between central bank involvement and financial supervision consolidation.

The results show that the probability of a country moving towards a Single Financial Authority model, is higher: (i) the lower the involvement of the central bank in financial supervision; (ii) the smaller the financial system;<sup>24</sup> (iii) the more equity dominated the private governance model; and (iv) the more the public governance is good.

**Institutional quality and financial supervisory structure.** In particular, an institutional environment characterized by good governance seems to facilitate the choice of policymakers to unify supervisory powers. According to Masciandaro, a policymaker who cares about soundness and efficiency may prefer the single financial authority in the face of financial conglomeration. Another hypothesis that he posits is that good governance could be just a proxy of deeper institutional factors. This seems to be a very likely explanation. As the experience of the countries that have successfully adopted the single regulator model show, the transition from individual agencies is a complex costly process that has to be managed carefully and effectively. And a range of administrative and personnel issues must be addressed, which must be done again in the context of a well managed change program (Taylor and Fleming, 1999). This indicates that an effective government and high regulatory quality already have to be in place to manage the transition successfully. Or in the case of emerging markets that adopted the single regulator model, especially Estonia, the reform was part of a bigger reform to bring about a more effective government.

As a cursory exercise, one-factor analysis of variance was used to determine the correlation between financial supervisory structure and the various indicators of institutional quality discussed earlier. That is, institutional quality is the response variable while financial

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<sup>24</sup> Masciandaro notes that in the sample of countries with a single supervisor, only the UK seems to be the exception in the inverse relationship between the degree of financial supervision consolidation and the financial market dimension. He ran the same regressions without the UK, and found that all the results are confirmed, with a slight improvement.

supervisory structure is the factor variable with three levels based on Table 1: single supervisor; agency supervises two types of financial intermediaries; and multiple supervisors with at least one each for banks, securities firms and insurers. Appendix 4 shows the results using key components of the Index of Economic Freedom of the World (EFW) and the World Bank governance indicators as response variables. All the results indicate that there is a significant difference in institutional quality among countries depending on the financial supervisory structure. In particular, institutional quality among countries with a single supervisor is higher than those with agencies supervising two types of financial intermediaries, or those with multiple supervisors. On the other hand, there is no significant difference in institutional quality among countries with agencies supervising two types of financial intermediaries, and those with multiple supervisors.

For instance, using government effectiveness and regulatory quality, which are both components of the public governance index calculated by Masciandaro, as response variables indicate that the average index among countries with a single supervisor is higher by 0.73 and 0.59 compared to countries with an agency supervising two types of financial intermediaries and with multiple supervisors, respectively. Using the legal system and property rights component of the EFW index as response variables indicate that the average index among countries with a single supervisor is higher by 1.76 and 1.36<sup>25</sup> compared to countries with an agency supervising two types of financial intermediaries and with multiple supervisors, respectively. Comparable results when the overall EFW index is used are 0.55 and 0.48, respectively.

## **VI. INTEGRATED FINANCIAL SUPERVISION: THE WAY FORWARD FOR THE PHILIPPINES?**

Following Lim and Pascual (2001), the need for strong institutions and governance structures forms the basis of the study. As noted by de Dios and Hutchcroft (2003), the most fundamental need in the Philippines is to improve the overall performance of government, insulate it from the plunder of oligarchic groups, and promote new types of private sector initiative. This includes strengthening financial regulatory agencies, given the critical role that the financial sector plays in economic growth. Thus, any effort to reform the financial supervisory structure must explicitly address this most fundamental need.

Clearly the issue of oligarchic groups is very relevant to the banking sector, since the parent companies of most banks are mixed-activities conglomerates. In particular, many of the biggest private domestic universal banks also belong to the biggest holding companies in the country, which have significant holdings in such industries as manufacturing, construction, telecommunications, transportation and retail trade.<sup>26</sup> Under the current legal framework, BSP does not have the authority to examine non-bank parent companies. Will a single financial supervisor be able to enhance the role of state, tame powerful private interests, and promote distributive justice in the Philippines, which Zhang argues are the essential political underpinnings of financial policy management and market governance? This is likely only if the financial regulatory and supervisory agency is made independent, and it is empowered to regulate the ownership of a bank to guard against effective control by a party that has an interest in securing related party loans, e.g., a party that also controls a non-financial corporation. That was the case in the Republic of Korea. Of course, clear measures to ensure accountability also have to be put in place to guard against regulatory capture,

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<sup>25</sup> Recall that each component and sub-component of the EFW index is placed on a scale from 0 to 10 (a higher index value represents a better quality of institutions); while the World Bank's governance indicators are measured in units ranging from about -2.5 to 2.5, with higher values corresponding to better governance outcome.

<sup>26</sup> The issue of corporate structure of bank ownership will be addressed in a separate paper.

including accountability for the overall development of the financial sector and consumer protection.

The issue of family-based commercial banks used to be addressed through strict limitations on the maximum ownership share of Filipino individuals, family/business groups and corporations, and limits on loans to directors, officers, stockholders and related interests (DOSRI). Previously, under the old General Banking Act, a Filipino individual and/or family group (individuals related up to the third degree of consanguinity or affinity) could not own more than 20% of the voting stock of a domestic bank, while the ceiling for domestic corporations (not wholly or majority owned by an individual or family group) was set at 30%. Under the new General Banking Law of 2000, the ownership ceilings were raised to 40% for Filipinos and domestic nonbank corporations. However, even such ceilings seem to be nonbinding in practice, in terms of who effectively controls banks in the Philippines. Clearly, the appropriate structure for bank ownership is an issue that needs to be further examined, particularly the desirability of imposing bank holding and financial holding company structures. It should be noted that the ownership pattern of banks has not led to any significant growth of the banking sector in the past 25 years, and has adversely affected the development of the equities and corporate bond markets as well.

In addressing the issue of reforming the financial regulatory/supervisory in the Philippines, it would be instructive to examine it both from the structural point of view and the institutional point of view.

From the structural point of view, the level and nature of financial conglomeration does not warrant a dramatic shift toward a single financial supervisor. Since financial conglomerates are essentially banking in nature, effective supervision of banking groups is the key. What is needed then is to ensure that BSP can adequately undertake this function, including expanding the scope of its authority if necessary. However, a bigger issue is the weak regulatory framework over nonbanks. Putting up an independent regulator for nonbanks as a complement to the already independent central bank may be considered but it should be seen as a preliminary step to further liberalize and deregulate the nonbanking sector to promote its development. Some coordination mechanism can then be designed with BSP, including assigning lead regulator functions to BSP over universal banks. But it should not be placed under BSP; the goal is to establish a regulatory agency that is at par with BSP, and hence able to inspire consumer confidence and promote the development of the nonbanking sector as a complement and alternative to banks.

On the other hand, transforming BSP into a single financial regulator as well would be ill-advised. Given the dynamics between the state and the dominant business groups, it would unduly extend the financial safety net because the central bank's lender of last resort function is likely to be seen as extending across all financial institutions, thereby worsening the moral hazard problem. A more important consideration is the potential negative impact of such a move on the safety, soundness and systemic stability of the financial system.

Finally, creating a single financial supervisor separate from the central bank is something that can be considered much later, after issues relating to the overall institutional environment have been dealt with. This would include amending the Constitution, which expressly assigns the supervision of banks to BSP as the central monetary authority. Such a reform would also be facilitated if the necessary expertise in regulating the different financial sectors has already been developed; that is, if upgrading of regulatory capacity and regulatory harmonization have been undertaken. The analyses in the previous sections indicate that key institutional characteristics must already be in place to undertake such a reform successfully, including sound political and legal systems and enforcement mechanisms. In particular, Barth *et al.* (2007) noted the dangers of strengthening official supervisory power without putting in place political and legal institutions that would induce

politicians and regulators to act in society's best interest instead of furthering their own interests. Given the overall quality of institutions in the Philippines and the time it would take to strengthen them, smaller scale reforms undertaken over time would be easier to manage, rather than a comprehensive institutional reform.

At this point, the issue with respect to financial regulatory/supervisory structure is not how many per se, but how strong, effective and competent are the financial regulators. In the Philippines, independence is important to safeguard the regulators against political intervention. At the same time, the emphasis must be on consumer protection and financial development to minimize the possibility of regulatory capture. Policymakers hesitant to support such a move towards independent regulators due to the fear of ceding power may be convinced to do so if a strong enough argument is made that the general public will ultimately benefit; that is, independence will lead to long-term benefits for financial sector soundness and stability. Strong public support for such a reform would also serve to neutralize opposition from the dominant family/business groups. Also, policymakers need to be persuaded that accountability arrangements should serve to bolster rather than rein in this independence, which is possible if the arrangements are well-designed (Quintyn *et al.*, 2007). Hence, the importance of subjecting any proposed reform to in depth studies, which should be made publicly available and subject to public debate, in order to promote understanding and hence appreciation for the reform.

As the literature concedes, every form of supervisory structure entails both benefits and risks. This accounts for the absence of a consensus on the best financial supervisory structure. But it is debatable whether coming up with such a consensus should be a goal in itself. After all, the whole point of bringing institutions into the analysis is precisely to capture country-specific factors in order to come up with the best form for a particular country. That being said, developing financial systems and deepening the reform process will ultimately rest on a clear understanding and appreciation of, and strong commitment to, strong regulatory frameworks as being in the national interest.

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## Appendix 1: The Areas and Components of the EFW Index

### 1: Size of Government: Expenditures, Taxes, and Enterprises

- A. General government consumption spending as a percentage of total consumption
- B. Transfers and subsidies as a percentage of GDP
- C. Government enterprises and investment as a percentage of total investment
- D. Top marginal tax rate (and income threshold to which it applies)
  - i. Top marginal income tax rate (and income threshold at which it applies)
  - ii. Top marginal income and payroll tax rate (and income threshold at which the top marginal rate applies)

### 2: Legal Structure and Security of Property Rights

- A. Judicial independence: the judiciary is independent and not subject to interference by the government or parties in disputes
- B. Impartial courts: A trusted legal framework exists for private businesses to challenge the legality of government actions or regulation
- C. Protection of intellectual property
- D. Military interference in rule of law and the political process
- E. Integrity of the legal system

### 3: Access to Sound Money

- A. Average annual growth of the money supply in the last five years minus average annual growth of real GDP in the last ten years
- B. Standard inflation variability in the last five years
- C. Recent inflation rate
- D. Freedom to own foreign currency bank accounts domestically and abroad

### 4: Freedom to Trade Internationally

- A. Taxes on international trade
  - i. Revenue from taxes on international trade as a percentage of exports plus imports
  - ii. Mean tariff rate
  - iii. Standard deviation of tariff rates
- B. Regulatory trade barriers
  - i. Non-tariff trade barriers
  - ii. Compliance cost of importing and exporting
- C. Actual size of trade sector compared to expected size
- D. Difference between official exchange rate and black market rate
- E. International capital market controls
  - i. Foreign ownership/investment restrictions
  - ii. Restrictions on the freedom of citizens to engage in capital market exchange with foreigners—index of capital controls among 13 IMF categories

### 5: Regulation of Credit, Labor, and Business

- A. Credit Market Regulations
  - i. Ownership of banks: percentage of deposits held in privately owned banks
  - ii. Competition: domestic banks face competition from foreign banks
  - iii. Extension of credit: percentage of credit extended to private sector
  - iv. Avoidance of interest rate controls and regulations that lead to negative real interest rates
  - v. Interest rate controls: interest rate controls on bank deposits and/or loans are freely determined by the market
- B. Labor Market Regulations
  - i. Impact of minimum wages
  - ii. Hiring and firing practices: hiring and firing practices of companies are determined by private contract
  - iii. Share of labor force whose wages are set by centralized collective bargaining
  - iv. Unemployment Benefits: the unemployment benefits system preserves the incentive to work
  - v. Use of conscripts to obtain military personnel
- C. Business Regulations
  - i. Price controls: extent to which businesses are free to set their own prices
  - ii. Burden of regulation
  - iii. Time with government bureaucracy: senior management spends a substantial amount of time dealing with government bureaucracy
  - iv. Starting a new business: starting a new business is generally easy
  - v. Irregular payments: irregular, additional payments connected with import and export permits, business licenses, exchange controls, tax assessments, police protection, or loan applications are very rare

For many countries, the index of economic freedom can be calculated back to 1970. One problem that arises, however, is that the underlying data are more complete in recent years than in earlier years. As a result, changes in the index ratings over time may reflect the fact that some components are missing in some years but not in others. The problem of missing components threatens the comparability of the index ratings over time. In order to correct for this problem, a chain-linked summary economic freedom index is constructed that is based on the 2000 rating as a base year. Changes to the index going backward (and forward) in time are then based only on changes in components that were present in adjacent years. The chain-linked methodology means that a country's rating will change across time periods only when there is a change in ratings for components present during both of the overlapping years. This is precisely what one would want when making comparisons across time periods (Gwartney and Lawson, 2006).

## **Appendix 2: Variables for the 10 Broad Factors of the Index of Economic Freedom**

- (i) Trade policy: weighted average tariff rate, nontariff barriers, and corruption in the customs service;
- (ii) Fiscal burden of government: top marginal income and corporate tax rates, and year-to-year change in government expenditures as a percent of GDP;
- (iii) Government intervention in the economy: government consumption as a percentage of the economy, government ownership of businesses and industries, share of government revenues from state-owned enterprises and government ownership of property, and economic output produced by government;
- (iv) Monetary policy: weighted average inflation rate from 1995 to 2004;
- (v) Capital flows and foreign investment: foreign investment code, restrictions on foreign ownership of business, restrictions on industries and companies open to foreign investors, restrictions and performance requirements on foreign companies, foreign ownership of land, equal treatment under the law for both foreign and domestic companies, restrictions on repatriation of earnings, restrictions on capital transactions, and availability of local financing for foreign companies;
- (vi) Banking and finance: government ownership of financial institutions, restrictions on the ability of foreign banks to open branches and subsidiaries, government influence over the allocation of credit, government regulations that inhibit financial activity, and freedom to offer all types of financial services, securities, and insurance policies;
- (vii) Wages and prices: minimum wage laws, freedom to set prices privately without government influence, government price controls, extent to which government price controls are used, and government subsidies to businesses that affect prices;
- (viii) Property rights: freedom from government influence over the judicial system, commercial code defining contracts, sanctioning of foreign arbitration of contract disputes, government expropriation of property, corruption within the judiciary, delays in receiving judicial decisions and/or enforcement, and legally granted and protected private property;
- (ix) Regulation: licensing requirements to operate a business; ease of obtaining a business license; corruption within the bureaucracy; labor regulations, such as established workweeks, paid vacations, and parental leave, as well as selected labor regulations; environmental, consumer safety, and worker health regulations; and regulations that impose a burden on business; and
- (x) Informal market activity: smuggling; piracy of intellectual property in the informal market; agricultural production supplied on the informal market; manufacturing supplied on the informal market; services supplied on the informal market; transportation supplied on the informal market; and labor supplied on the informal market).

## Appendix 3: Interpretation of Scores of Selected Factors of the Index of Economic Freedom

### Factor 6: Banking and Finance Grading Scale

Score	Restrictions on Banks	Criteria
1	Very low	Government provides financial sector with prudent regulatory supervision by an independent central bank; government may be active in some financial institutions but must comprise a very minor role in terms of total market share; credit allocated on market terms; foreign financial institutions able to operate freely and treated the same as domestic financial institutions; banks may engage in all types of financial services.
2	Low	Limited government involvement in financial sector beyond providing prudent regulatory supervision by an independent central bank; few limits on foreign financial institutions; credit allocated on market terms; government may be active in some financial institutions but must comprise a limited role in terms of total market share; banks may engage in all types of financial services.
3	Moderate	Substantial government influence in financial sector; regulatory supervision of financial institutions may be insufficient; government owns or controls banks that have a significant role in terms of market share; government influences allocation of credit; foreign financial institutions face restrictions; country may maintain some limits on financial services; bank information may face some barriers.
4	High	Heavy government involvement in financial sector; central bank not independent; regulatory supervision of financial institutions poor; banking system in transition or unstable; government owns or controls most of financial institutions; government directs allocation of credit; possible corruption; foreign financial institutions discourages; bank formation faces significant barriers.
5	Very high	Very heavy government involvement in financial sector; nearly all financial institutions owned or controlled by government; financial institutions in crisis or collapse, or banks operate on primitive basis; nearly all credit controlled by government; most credit extended to state-owned enterprises; corruption widespread; foreign financial institutions prohibited; bank formation virtually nonexistent.

### Factor 8: Property Rights Grading Scale

Score	Protection of Private Property	Criteria
1	Very high	Private property guaranteed by government; court system efficiently enforces contracts; justice system punishes those who unlawfully confiscate private property; corruption nearly nonexistent, and expropriation highly unlikely.
2	High	Private property guaranteed by government; court system suffers delays and is lax in enforcing contracts; corruption possible but rare; expropriation unlikely.
3	Moderate	Court system inefficient and subject to delays; corruption may be present; judiciary may be influenced by other branches of government; expropriation possible but rare.

4	Low	Property ownership weakly protected; court system inefficient; corruption present; judiciary influenced by other branches of government; expropriation possible.
5	Very low	Private property outlawed or not protected; almost all property belongs to the state; country in such chaos (for example, because of ongoing war) that property protection nonexistent; judiciary so corrupt that property not effectively protected; expropriation frequent.

### Factor 9: Regulation Grading Scale

Score	Levels of Regulation	Criteria
1	Very low	Existing regulations straightforward and applied uniformly to all businesses; regulations not much of a burden for business; corruption nearly nonexistent.
2	Low	Simple licensing procedures; existing regulations relatively straightforward, applied uniformly most of the time, but burdensome in some instances; corruption possible but rare.
3	Moderate	Complicated licensing procedures; regulations impose substantial burden on business; existing regulations may be applied haphazardly and in some instances are not even published by the government; corruption may be present and poses minor burden on business.
4	High	Highly complicated licensing procedures; regulations impose heavy burden on business; existing regulations applied haphazardly and in some instances are not even published by the government; corruption present and poses a substantial burden on business.
5	Very high	Government-set production quotas and some state planning; government regulations virtually impede creation of new businesses; corruption widespread; regulations applied randomly.

### Appendix 4: One Factor Analysis of Variance (ANOVA) Results

Factor variable: Financial supervisory structure

Levels: 1 Single supervisor

2 Agency supervises two types of financial intermediaries

3 Multiple supervisors with at least one each for banks, securities firms and insurers

#### A. Response Variable: Regulation of Credit, Labor and Business

Supervisory structure	Summary of Regulation of credit, labor and business		
	Mean	Std. Dev.	Freq.
1	6.9777777	.67436726	18
2	6.2772727	.92681317	22
3	6.1322581	.95860562	31
Total	6.3915493	.94032614	71

Source	Analysis of Variance			F	Prob > F
	SS	df	MS		
Between groups	8.55743932	2	4.27871966	5.45	0.0064
Within groups	53.3374883	68	.784374828		
Total	61.8949276	70	.884213252		

Bartlett's test for equal variances:  $\chi^2(2) = 2.5557$  Prob> $\chi^2 = 0.279$

Comparison of Regulation of credit, labor and business by Supervisory structure  
(Bonferroni)

Row Mean-		
Col Mean	1	2
2	-.700505 0.046	
3	-.84552 0.006	-.145015 1.000

**B. Response Variable: Legal System and Property Rights**

Supervisory Structure	Summary of Legal system and property rights		
	Mean	Std. Dev.	Freq.
1	7.35	1.6631826	18
2	5.5909091	2.2776155	22
3	5.9935484	1.5844948	31
Total	6.2126761	1.94407	71

Analysis of Variance					
Source	SS	df	MS	F	Prob > F
Between groups	33.2767011	2	16.6383506	4.89	0.0104
Within groups	231.281883	68	3.40120417		
Total	264.558584	70	3.77940835		

Bartlett's test for equal variances:  $\chi^2(2) = 3.6798$  Prob> $\chi^2 = 0.159$

Comparison of Legal system and property rights by Supervisory structure  
(Bonferroni)

Row Mean-		
Col Mean	1	2
2	-1.75909 0.011	
3	-1.35645 0.047	.402639 1.000

**C. Response Variable: EFW Summary Index**

Supervisory Structure	Summary of EFW Summary Index		
	Mean	Std. Dev.	Freq.
1	.80333334	.46073131	21
2	.25739131	.6983371	23
3	.35548387	.50540306	31
Total	.4508	.59716846	75

Analysis of Variance					
Source	SS	df	MS	F	Prob > F
Between groups	3.75187411	2	1.87593705	5.97	0.0040
Within groups	22.637278	72	.314406639		
Total	26.3891521	74	.356610164		

Bartlett's test for equal variances:  $\chi^2(2) = 4.3477$  Prob> $\chi^2 = 0.114$

Comparison of EFW Summary Index by Supervisory structure  
(Bonferroni)

Row Mean- Col Mean	1	2
2	-.545942 0.006	
3	-.447849 0.018	.098093 1.000

**D. Response Variable: Government Effectiveness**

Supervisory Structure	Summary of Government effectiveness		
	Mean	Std. Dev.	Freq.
1	1.1957143	.74770697	21
2	.46956521	1.0880319	23
3	.60483871	.73602025	31
Total	.7288	.90102938	75

Source	Analysis of Variance			F	Prob > F
	SS	df	MS		
Between groups	6.60020792	2	3.30010396	4.44	0.0152
Within groups	53.4769836	72	.742735883		
Total	60.0771915	74	.81185394		

Bartlett's test for equal variances:  $\chi^2(2) = 4.8015$  Prob> $\chi^2 = 0.091$

Comparison of Government effectiveness by Supervisory structure  
(Bonferroni)

Row Mean- Col Mean	1	2
2	-.726149 0.020	
3	-.590876 0.053	.135273 1.000

**E. Response Variable: Regulatory Quality**

Supervisory Structure	Summary of Regulatory quality		
	Mean	Std. Dev.	Freq.
1	1.1809524	.51157506	21
2	.45434783	.88096964	23
3	.60903226	.71018474	31
Total	.72173333	.77027614	75

Source	Analysis of Variance			F	Prob > F
	SS	df	MS		
Between groups	6.46665737	2	3.23332869	6.22	0.0032
Within groups	37.4394169	72	.519991901		
Total	43.9060743	74	.593325328		

Bartlett's test for equal variances:  $\chi^2(2) = 5.7270$  Prob> $\chi^2 = 0.057$



Comparison of Regulatory quality by Supervisory structure  
(Bonferroni)

Row Mean- Col Mean	1	2
2	-.726605 0.004	
3	-.57192 0.019	.154684 1.000

**F. Response Variable: Rule of Law**

Supervisory Structure	Summary of Rule of law		Freq.
	Mean	Std. Dev.	
1	1.1795238	.72446861	21
2	.27652174	1.1329672	23
3	.47548388	.78364465	31
Total	.61160001	.95216402	75

Source	Analysis of Variance			F	Prob > F
	SS	df	MS		
Between groups	9.93002324	2	4.96501162	6.25	0.0031
Within groups	57.1595849	72	.793883124		
Total	67.0896081	74	.906616326		

Bartlett's test for equal variances:  $\chi^2(2) = 5.3071$  Prob> $\chi^2 = 0.070$

Comparison of Rule of law by Supervisory structure  
(Bonferroni)

Row Mean- Col Mean	1	2
2	-.903002 0.004	
3	-.70404 0.020	.198962 1.000

**G. Response Variable: Control of Corruption**

Supervisory Structure	Summary of Control of corruption		Freq.
	Mean	Std. Dev.	
1	1.2671429	.85843545	21
2	.34826087	1.1490536	23
3	.4432258	.87074829	31
Total	.6448	1.026323	75

Source	Analysis of Variance			F	Prob > F
	SS	df	MS		
Between groups	11.4156355	2	5.70781773	6.18	0.0033
Within groups	66.5314367	72	.924047731		
Total	77.9470721	74	1.05333881		

Bartlett's test for equal variances:  $\chi^2(2) = 2.5602$  Prob> $\chi^2 = 0.278$

Comparison of Control of Corruption by Supervisory structure  
(Bonferroni)

Row Mean- Col Mean	1	2
2	-.918882 0.007	
3	-.823917 0.010	.094965 1.000

**H. Response Variable: Overall Governance Score**

Supervisory Structure	Summary of Overall governance score		
	Mean	Std. Dev.	Freq.
1	.80333334	.46073131	21
2	.25739131	.6983371	23
3	.35548387	.50540306	31
Total	.4508	.59716846	75

Source	Analysis of Variance				F	Prob > F
	SS	df	MS			
Between groups	3.75187411	2	1.87593705		5.97	0.0040
Within groups	22.637278	72	.314406639			
Total	26.3891521	74	.356610164			

Bartlett's test for equal variances:  $\chi^2(2) = 4.3477$  Prob> $\chi^2 = 0.114$

Comparison of Overall governance score by Supervisory structure  
(Bonferroni)

Row Mean- Col Mean	1	2
2	-.545942 0.006	
3	-.447849 0.018	.098093 1.000