Philequity Corner (February 9, 2009)
By Valentino Sy

The US can learn from the Philippines

The issue of how to value distressed assets is one of the more contentious issues bogging down the bank rescue plan. As discussed last week, US authorities are contemplating on the creation of an "aggregator bank" that will absorb all the distressed assets in the system. But if the government buys some bad assets as part of the rescue, it could force banks to drastically write down billions of similar assets. That could create further instability unless changes in the mark-to-market accounting rule are made.

Pros and cons of mark-to-market

Mark-to-market accounting requires banks to regularly adjust the value of their assets based on the current market prices of those assets. This method of accounting relies on the notion that the market is an asset's best arbiter of value.

Over the past several months and mainly due to the ongoing crisis, there has been a considerable debate regarding mark-to-market accounting. Proponents of this methodology argue that mark-to-market reflects the true value of the balance sheets of financial institutions. This transparency, in turn, helps investors and policymakers better assess their risk profile and undertake more timely market discipline and corrective actions.

In contrast, the opponents claim that mark-to-market accounting leads to distressed prices in illiquid markets. The problem is that in rare circumstances (especially in times of crisis), the market becomes dysfunctional. Distressed selling and forced liquidations distort the market's ability to be determinative in measuring fair value. Thus, the volatility in asset prices directly affects the value of banks' assets. This, in turn, could force banks into insolvency even though they would be able to fully cover their commitments if they were allowed to continue until the assets mature.

Message from our Sage

The problems associated with mark-to-market bring to mind what Washington Sycip said in one of our board meetings. "Not everything the US does is correct. Therefore, the Philippines should not follow what they do all the time." In fact, Mr. Sycip has in the past often emphasized the pitfalls and dangers of the mark-to-market rules implemented by government.

Fortunately, the Philippines suspended the mark-to-market rules last year. Our regulators were ahead of their US counterparts in relaxing the mark-to-market rules for banks. The US was just contemplating scrapping the mark-to-market rule last week which was the reason why the markets rallied strongly.

Learning from the Philippines

As early as October 2008, the Bangko Sentral ng Pilipinas (BSP) allowed local banks to selectively reclassify their assets based on either mark-to-market or at amortized value. This move was aimed to help the local banks avoid booking paper losses and

depletion of capital at a time when asset prices were extremely and artificially volatile.

Clearly, it was a good move by the BSP, the Department of Finance and the SEC. By anticipating early and thinking ahead, our economic managers added stability, confidence and liquidity to the Philippine capital markets.

Too much "economic" democracy is irresponsible

Mr. Sycip is also often quoted as saying that "unbridled democracy is irresponsible." This certainly applies to financial markets and economy, as much as it does in politics. In fact, too much "economic" democracy is partly to blame for this unprecedented global crisis.

For one, too much derivates were allowed to be created and concentrated in too few hands. The "notional value" of the world's over-the-counter derivatives amounted to something around $596 trillion as of end-2007, according to the Bank of International Settlements. At the center of this current crisis are the credit default swaps, which alone were estimated to be worth $54 billion as of the same date.

Second, regulations were too lax with regard to naked short-selling or the practice of selling a stock short without first borrowing the shares. Recent investigations showed that abusive naked short-selling attacks had a hand in the failures of Bear Stearns, Lehman Brothers and other financial institutions.

And now, US regulators are allowing the proliferation of leveraged Exchange Traded Funds (ETFs). These are the ETFs labelled as Ultra, 2x, Double Long, Ultra-short, Inverse Double, 3x, etc. Not only do they increase the use of leverage among ordinary investors but they also add to the volatility in an already volatile market environment.

Unwittingly, while the US government is trying to save the financial system, the UltraShort Financials (symbol: SKF), with its huge volumes, is undermining the financial recovery by allowing huge short positions on US banks.

Rescue plan unveiled this week

This week, all eyes will be on US Treasury Secretary Geithner who is expected to unveil the rescue plan on US banks. While the outlines of the plan remain sketchy, we expect the government to find ways of liquefying the banks' toxic assets, in one form or another.

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