RECOVERIES OF CREDITORS' CLAIMS AGAINST CLOSED BANKS UNDER PHILIPPINE SETTING

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ABSTRACT

Bank closures happen globally due to legal grounds that vary among countries. The adverse effects common to all bank closures include loss of employment, disruptions in the payment and settlement system, loss of public confidence in the stability of the banking system, bank runs, systemic risks and losses imposed on uninsured depositors and other creditors. The researcher's goals are the minimization of losses imposed on the uninsured depositors and other creditors and expeditious recoveries of their claims. Indicators of bank insolvency and their impact on the recoveries of creditors' claims against the assets of closed banks under PDIC liquidation have been examined. Using the Pearson correlational analysis, findings reveal significant statistical link between the liabilities and realizable assets to recoveries of 577 closed banks as of yearend 2011. Findings also show that high debt ratios of 386 or 67% of the 577 closed banks indicated that their liabilities exceed the value of their realizable assets. Thus, these banks cannot pay all their debts, thereby, imposing losses on uninsured depositors and other creditors. To conclude, the researcher recommends that bank regulators should jointly prepare draft bills to be presented to the government legislative branch for reforms in the traditional bank closure practices and in the implementation of the liquidation processes that are detrimental to the best interest of uninsured depositors, creditors and the general public.

Key Words: *systemic risk, bank run, insolvency, realizable asset, liquidation*

Introduction

Bank closures are not unique to the Philippines. They happen globally. Some of the significant Philippine bank closures in recent years include Banco Filipino Savings and Mortgage Bank and Urban Bank. The grounds for closing a bank vary among nations due to different laws, culture, customs and beliefs. However, the common adverse effects of such closures are economic and financial crises which include disruptions in the payment system, unemployment, loss of public confidence in the stability of the banking system, bank runs and losses suffered by uninsured depositors and creditors. It is the minimization of losses imposed on the uninsured depositors and other creditors and the expeditious recoveries of their claims on the closed bank assets that prompted the writing of this paper. To attain the objectives, the paper should be convincing enough to rouse bank regulators to prepare draft bills for presentation to the Philippine Senate and House of Representatives. The main thrust of such bills are reforms of traditional practices which are detrimental to the best interest of uninsured depositors and other creditors, namely: 1) Closing a bank when its realizable assets are already insufficient to pay all its debts; 2) Granting the Monetary Board (MB) of the Bangko Sentral ng Pilipinas (BSP) the option to close or not to close a bank despite the presence of legal ground(s) placing a bank under receivership explicitly provided for under the New Central Bank Act (Republic Act No. 7653) and the General Banking Law of 2000 (Republic Act No. 8791); 3) Filing with the regional trial court, whose dockets are clogged, a petition for assistance in the liquidation of the bank due to the absence of a Liquidation Court exclusively tasked to decide on liquidation issues; and 4) Implementing bank liquidation without a law governing the takeover, liquidation and winding up operations of banks ordered closed by the Monetary Board.

A preview of the Philippine Banking System is briefly discussed. Banks are entities engaged in the lending of funds obtained in the form of deposits (Republic Act No. 8791). The structure of the Philippine Banking System consists of 1) universal banks (UBs), also known as expanded commercial banks (EKBs), which are authorized to exercise the powers of a commercial bank, investment house and the power to invest in non-allied enterprises (Republic Act 8791); 2) Commercial Banks (KBs) have the general powers incident to corporations and such powers as accepting drafts and issuing letters of credit, accepting deposits and extending credit, to name a few (Republic Act No. 8791); 3)Thrift banks (TBs) include savings and mortgage banks, private development banks and stock savings and loan associations organized under RA No. 7906 or Thrift Banks Act of 1995 for purposes, among others, of providing short term working capital, medium and long term financing, to businesses engaged in agriculture, services, industry and housing and providing diversified financial and allied services for its chosen market and constituencies specially for small and medium enterprises and individuals; 4) Rural banks (RBs) are created under Republic Act No. 7353 or the Rural Banks Act of 1992 for the purpose of providing adequate credit facilities to farmers, merchants cooperatives and to the people of rural communities; 5) Cooperative banks (Coop Banks) are organized by cooperatives pursuant to Republic Act 6938 or the Cooperative Code of the Philippines primarily to provide financial and credit services to cooperatives; 6) Islamic banks are created under Republic Act No. 6848 or the Charter of the Al-Amanah Islamic Investment Bank of the Philippines to promote and accelerate the socio-economic development of the Autonomous Region by performing banking, financing and investment operations and to establish and participate in agricultural, commercial and industrial ventures based on the Islamic concept of banking (Republic Act No. 6848); and other classifications of banks as determined by the Monetary Board of BSP.

There are two bank regulators in the Philippines, namely: 1) Bangko Sentral ng Pilipinas (BSP) and 2) Philippine Deposit Insurance Corporation (PDIC). BSP acts as the primary regulator of banks. Under the BSP Charter, it is tasked to provide policy directions in the areas of money, banking and credit and shall have supervision over the operations of banks. The Monetary Board of BSP is the policy making body (RA No. 7653). The supervising and examining department head, personally or by deputy, examines the books of every bank once a year using a CAMELS Rating System which is an acronym for Capital Adequacy, Asset Quality, Management, Earnings, Liquidity and Sensitivity to Market Risk, wherein 5 is highest and 1 is the lowest. MB also prescribed a minimum capitalization for all banks according to classification. Details are shown in Table 1. On the other hand, PDIC was created by virtue of RA No. 3591. It has three mandates, namely: 1) As co-regulator of banks – examines banks subject to prior approval of the Monetary Board, issues rules and regulations and extends financial assistance to distressed banks; 2) As state deposit insurer – pays the insured depositors in the event of bank closure up to the maximum statutory limit. Table 2 shows the history of MDIC; 3) As Mandatory Receiver and Liquidator – upon the receipt of the Monetary Board Resolution appointing PDIC as receiver of a bank forbidden by MB to do business in the Philippines, PDIC takes over the closed bank. It is tasked to gather and control assets, records, liabilities and affairs; preserves and administers these assets and liabilities for the benefit of the creditors and within ninety days from takeover, it shall recommend to the Monetary Board whether to rehabilitate or to liquidate the bank. When the Monetary Board finds the receiver's recommendation to liquidate the bank as meritorious, it will appoint PDIC as liquidator of such bank. Hence, it has the following functions: 1) files with the Regional Trial Court a petition for assistance in the liquidation of the bank; 2) converts bank assets into cash; and 3) pays the bank's debts under order of the Court, in accordance with the rules on concurrence and preference of credit under the Civil Code of the Philippines (RA No. 386).

The main problem sought to be answered by this study is to determine the impact of insolvency on the recoveries of creditors' claims against closed banks under Philippine setting. To resolve this problem, answers are also sought on these sub-issues: 1) To determine the number of MB-ordered closed banks under PDIC receivership and liquidation as of end December, 2011 classified as to type of banks, year of closure and status; 2) To specify the legal grounds for placing a bank under receivership and to identify which one significantly affects the recovery of creditors' claims against closed banks under Philippine setting; 3) To find the mean interval between bank closure date and the date of approval of the project of distribution (POD) by the Liquidation Court; 4) To determine the significant impact on the recoveries of creditors' claims of selected indicators of bank insolvencies: i) Capital to Estimated Realizable Value of Assets Ratio, ii) Capital to Book Value of Assets Ratio, iii) Debt to Assets Ratio and iv) Capital Adequacy Ratio.

Table 1: Minimum Capitalization Requirement for Each Bank Type

BANK TYPE	MINIMUM CAPITAL REQUIREMENT
a. UBs	Php 4.95 billion
b. KBs	Php 2.4 billion
c. TBs with Head Office in:	
(1) Metro Manila	Php 1.0 billion
(2) Cities of Cebu and Davao	500 million
(3) Other areas	250 million
d. RBs with Head Office in:	
(1) Metro Manila	Php 100 million
(2) Cities of Cebu and Davao	50 million
(3) All other cities	25 million
(4) 1st to 4th class municipalities	10 million
(5) 5th to 6th class municipalities	5 million
e. Coop Banks	Php 10M

Source: Manual of Regulations for Banks, Bangko Sentral ng Pilipinas

Table 2: History of Maximum Deposit Insurance Cover (MDIC) per Depositor per Bank

LEGAL BASIS	MDIC per Depositor per Bank	
Republic Act (RA) No. 3591; June 22, 1963	Php	10,000.00
Presidential Decree (PD) No. 1451, June 11, 1978		15,000.00
Presidential Decree (PD) No. 1897; January 11, 1984		40,000.00
Republic Act (RA) No. 7400; April 13, 1992		100,000.00
Republic Act (RA) No. 9302; August 12, 2004		250,000.00
Republic Act (RA) No. 9576; June 1, 2009 (up to present)		500,000.00

Source: PDIC, Republic Acts, Presidential Decrees

Research disclosed that there is a dearth of foreign and local literature dealing with the impact of insolvency on the recoveries of creditors' claims against closed banks under PDIC liquidation. Hence, this paper serves as a pioneering study in the field of bank liquidation under Philippine setting. Moreover, the results of this study are deemed beneficial to end-users: 1) Philippine legislators and bank regulators; 2) creditors of banks under receivership and liquidation; 3) incumbent and potential depositors and creditors of operating banks; 4) academe; and 5) future researchers.

Foreign journals supported the theories of Capital Structure by showing the significance of having an adequate bank capital. In the article of Kaufman (2004), banks are considered "failed" when their assets are less than their liabilities. Bank capital serves many functions, to wit: 1. Provide protection to depositors-creditors; and 2. Provide funds to finance the operation of banks including the acquisition of assets (Samad, 2011). Capitalization results in self – protection by reducing the probability of insolvency. Maintaining solvency is needed to protect the interests of creditors especially the depositors (Morris and Shin, 2008). A well capitalized bank faces lower costs of going bankrupt (Vyas, et. al, 2008). The study of Moore (2011) provides support that capital adequacy is used as an early warning system by both bank management and regulators. It was used to predict distressed banks and minimize the impact of their failure. In the study of Davis and Karim (2008), an effective Early Warning System (EWS) should show heightened risks of bank runs and failures so that a sound banking policy will be developed to avoid potential crisis or mitigates its effects. Hogan and Sharpe (1990), explored the provisions on capital adequacy established by the Reserve Bank of Australia (RBA) and probed its purpose to three major Australian banks; namely: Australia and New Zealand Banking Group (ANZ), National Australia Bank (NAB) and the Westpac Banking Corporation RBA emphasized the importance of having adequate capital for each individual banks commensurate with its size, quality and diversity of business (Hogan and Sharpe,1990; Samad, 2011; Moore, 2011; Morris and Shin, 2008). RBA adopted the Basel Accord minimum capital requirement providing adjustments to tailor fit its financial system. Australia's minimum capital adequacy ratio is set to eight percent (8%). It also abided with Tier 1 and 2 capital, paid up ordinary shares and supplementary capital, respectively. The imposition of capital adequacy requirement can be a substitute to regulate market discipline and to alleviate the potential moral hazard problems.

The above mentioned banks complied strictly with the minimum prescribed capital adequacy ratio of 8%. However, the basis of computing the capital adequacy ratio of RBA was the historical cost accounting. Hogan and Sharpe indicated in their study that using such will be misleading towards the interpretation of the accurate bank condition. These were further strengthened by Laux and Leuz, 2010; Hovakimian, et.al, 2001; Linsmeier, 2011. They emphasized that a bank is economically insolvent, although not necessary insolvent as declared by law (Hogan & Sharpe, 1990; Lastra, 2008). Using the descriptive research and comparative analysis, the authors founded that the reliance on historical cost accounting techniques provides misleading measure of total bank risk and are likely to distort the allocation of credit (Hogan & Sharpe, 1990). They recommended the use of market value accounting to protect depositors. Market to book ratio is used as a supplement for managing the company's assets (Hovakimian, Opler and Titman, 2001 and Rajan and Zingales, 1995). Once a bank is ordered closed by the regulator, the realizable value of its assets significantly drops. Given this issue, the proponent would probe on the significant difference between historical cost and realizable value of the banks' balance sheet accounts and its impact on the soundness of financial policies and regulations. In the local literature, while Rigayen (2006) discussed the significant impact of environmental and industry indicators on the operational performance of banks in the Philippines by providing a model, the proponent's research will focus on the impact of insolvency on the recoveries of creditors' claims against closed banks in the Philippine setting.

The common predicament of the banking industry is to compete with other financial institutions to survive. Hence, corrupt bank owners adopt more aggressive strategies coupled with lax management by placing depositors' money to high-yielding risky investments to gain large profit not minding the results thereof. Risk management has become part of the strategic planning process of bankers (Vyas, et al., 2008). This is supported by the portfolio theory wherein there is a tradeoff between risk and return. Any losses that resulted from taking the risk should be borne by the bank itself thru its capital (Vyas, et al., 2008). Financial crisis have become more frequent because of moral hazards (Kane, 1989). Banks choose risky asset portfolio to gain more profit (Stiglitz, 1985). With sufficient competition and with the presence of deposit insurance, bank management finds it desirable to gamble.

Research Methodology

This study made use of a combination of descriptive, causal and correlational research designs. The secondary data obtained from Bangko Sentral ng Pilipinas and Philippine Deposit Insurance Corporation were statistically treated in the following manner: percentages, ratio analysis, graphs, frequency distributions, time series technique called moving average and Pearson product-moment correlation coefficient.

Results and Discussion

Sub-issue No. 1: What is the number of MB-ordered closed banks under PDIC receivership and liquidation management as of December 31, 2011 classified as to type of banks, year of closure and status?

Type of Banks

As of December 31, 2011, the total number of banks under PDIC Receivership and Liquidation stood at 577. Results show that out of the five hundred seventy seven (577) closed banks under PDIC Receivership and Liquidation as of yearend 2011, two (2) were commercial banks, sixty seven (67) thrift banks and five hundred eight (508) rural banks.

Year of Closure

Results show that there are five hundred seventy seven (577) banks that were ordered closed by the Monetary Board of the Central Bank of the Philippines (CBP)/ Bangko Sentral ng Pilipinas (BSP) for the period 1961 to 2011 or a span of fifty (50) years. These banks have been transferred to PDIC by CBP/BSP and directly taken over by PDIC as mandatory state receiver and liquidator. The highest concentration of bank closures in a single year occurred in 1998 with forty (40) closed banks or 6.93% of total closed banks as of yearend 2011. This number was closely followed by 39 or 6.76% in 1985. Data show that the oldest bank under PDIC liquidation as of December 31, 2011 was a rural bank forbidden to do business in the Philippines by the Monetary Board in 1961 or 50 years ago. Data also show that the Monetary Board never closed a single bank during the years 1962 to 1967, 1970, 1974 to 1976 and 1992 and only a single bank closure per year occurred in 1961, 1968, 1971-1972 and 1977 – 1979.

Status

Results show that out of the five hundred seventy seven (577) closed banks under PDIC receivership and liquidation as of yearend 2011, twenty two (22) banks or 3.81% were under receivership and five hundred fifty five (555) were under liquidation or 96.19%.

As of December 31, 2011, closed banks under PDIC liquidation reached five hundred fifty five (555). The number of banks under PDIC liquidation with no Final Project of Distribution (FPOD) / Final Project of Distribution still pending approval by the Liquidation Court stood at two hundred ninety six (296) or 53.33% of the total number of closed banks under PDIC liquidation. The 296 banks consist of one (1) KB or .34%, 40 TBs or 13.51% and 255 RBs or 86.15%. With regards to banks under PDIC liquidation with LC-approved FPOD, the number reached 259 consisting of 1 KB, 24 TBs and 234 RBs.

Sub-issue No. 2: What are the legal grounds for placing a bank under receivership and which one significantly affects the recovery of creditors' claims against closed banks under Philippine setting?

Forbidding a bank from doing business in the Philippines and designating Philippine Deposit Insurance Corporation (PDIC) as mandatory receiver of the banking institution is vested exclusively with the Monetary Board. In the exercise of such authority, its action shall be based on any or combination of the grounds for placing a bank under receivership cited under two Philippine laws: 1) Sec. 30 of the New Central Bank Act or Republic Act 7653; and 2) Sec. 53 of the General Banking Act of 2000.

Findings indicated that 66.90% of banks that were closed have a negative capital or were declared insolvent. Whereas, the 33.10% of the banks closed were due to other grounds except insolvency. Hence, banks closed due to insolvency imply that not all claims of uninsured depositors and creditors will be paid since the realizable assets are not enough to cover their liabilities. On the other hand closed banks with positive capital have realizable assets greater than their liabilities. Therefore, all creditors' claims will be paid.

Sub-issue No. 3: What is the mean interval between the bank closure date and the date of approval of the project of distribution (POD) by the liquidation court?

The banks under PDIC liquidation management are classified into two: 1) those banks with no final project of distribution (FPOD) / FPOD still pending approval by the liquidation court; and 2) those banks with liquidation court-approved FPOD. Under the first type, the liquidator cannot start paying claimants because the law requires prior approval of the liquidation court before payment of debts (RA No. 7653).

Results show that 50% of creditors of closed banks awaiting Final Project of Distribution (FPOD) have been waiting for at least 12 years (median) and yet approval of the Project of Distribution is nowhere in sight. Results show that the longest waiting period for this category is forty two (42) years.

Results show that the long interval between bank closure date and the date of approval by the Liquidation court of the partial or final project of distribution may eventually yield to either of two things: 1) full or partial recovery of the creditors' claims against the assets of the closed banks; or 2) notice of zero recovery of some creditors' claims because the realizable value of the closed banks assets is insufficient to meet their liabilities. In both cases, this extraordinarily long waiting period or non-recovery of their locked-in deposits or investments caused great anxiety to all creditors and uninsured depositors.

Sub-issue No. 4: Do the following selected indicators of bank insolvencies, namely :i) Capital to Estimated Realizable Value of Assets Ratio, ii) Capital to Book Value of Assets Ratio, iii) Debt to Assets Ratio and iv) Capital Adequacy Ratio have significant impact on the recoveries of creditors' claims against closed banks under Philippine setting?

Using the Pearson Correlation, with data smoothened at 2-year moving average, findings reveal that the significant indicators that correlate with recovery are Capital to Estimated Realizable Value of Assets Ratio and Debt to Assets Ratio (in terms of ERVA). It is worth noting that the estimated realizable value and not the book value registered a statistical link with recovery at 5% significant level.

Conclusions and Recommendations

This study aims to determine the impact of insolvency on the recoveries of creditors' claims against closed banks under Philippine setting. While there is a dearth of foreign and local literature dealing with the recoveries of creditors' claims against banks under liquidation, the researcher pursued this subject to recommend reforms in the Philippine traditional bank closure practices to minimize the losses imposed on the creditors and the expeditious recoveries of their claims against closed banks assets. Findings show that as of December 31, 2011 rural banks topped the list of banks ordered closed by the Monetary Board (MB) of BSP. The minimum capital requirements for universal banks prescribed by the Monetary Board is the highest among all the categories of banks under the Philippine Banking System. Even if the grounds for closing a bank vary among nations, the adverse effects of such closures are common worldwide. The bulk of banks placed under receivership by the MB is due to insolvency, as a stand alone or in combination with unprofitability and/or illiquidity. Results show that the mean waiting time for recovery of creditors' claims against banks with Court-approved project of distribution was 17.9 years.

Whereas, the longest waiting period from bank closure date to date of approval of the Project of Distribution (POD) by the Liquidation Court (which grants authority for the liquidator to pay the bank's debts) is 48 years. Further, creditors of closed banks under PDIC liquidation with no project of distribution or with project of distribution still pending approval by the Liquidation Court have already waited for 12 years (median) and yet approval of the POD is still nowhere in sight. Some bank claimants falling under this category have already waited for 42 years and yet the POD's approval date is still contingent. Findings reveal that the significant indicators that correlate with recovery are 1) capital to estimated realizable value of assets (ERVA) ratio; and 2) debt to assets ratio (in terms of ERVA). ERVA and not book value registered a statistical link with recovery.

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