

NOTE

BANK SECRECY LAW: A HISTORICAL AND ECONOMIC ANALYSIS

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I. INTRODUCTION

Historically, the common law tradition has served as the legal framework for all English speaking countries. In the common law tradition, judges developed traditions serving as precedents for adjudicating cases. Throughout the Middle Ages up to the dawn of modern history, common law was practiced in Great Britain. Influenced by the emergent Natural Science, legal scholars, most notably Christopher Columbus Langdell sought to apply "scientific principles" to the study of law.¹ With such application, doctrinalism was born.

Doctrinalism asserted that from individual knowledge, it is possible to decide individual cases through the use of syllogistic reasoning from precedent principles set forth in the previous cases.² Not all legal scholars, however, were swayed by the tenets of doctrinalism. Justice Benjamin Cardozo, a noted American jurist, argued that law cannot be understood outside the social context.³ Thus, legal realism arose from the opposition to strict doctrinalism. Ultimately, the law and economics approach emerged from the larger philosophical school of legal realism

Law and economics methodology examines the formation, the structure, the process and the economic impact of law and legal institutions.⁴ Historically, classical economists such as Adam Smith, Karl Marx and Max Weber observe the close relationship between economic relations and the complexity of the legal system.⁵ Only recently, however, did the economic analysis of laws become more

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¹ NICHOLAS MERCURO & STEVEN MEDEMA, *ECONOMICS AND THE LAW* 1, 51 (1997).

² *Id.*

³ *Id.*

⁴ *Id.*

⁵ KATHARINA PISTOR & PHILIP WELLON, *THE ROLE OF LAW AND LEGAL INSTITUTIONS IN ASIAN ECONOMIC DEVELOPMENT 1960-1965*, 33 (1999).

widespread.⁶ Traditionally, economic analysis of laws was confined to the domains of anti-trust, regulation and taxation. With the pioneering works of Ronald Coase,⁷ Guido Calabressi,⁸ Gary Becker⁹ and Richard Posner,¹⁰ the scope of economic analysis now transcends such traditional domain. The “law and economics” approach now includes the study of legal procedures, the handling of sentences, and even the existence of the legal institutions themselves. In fact, Bruce Ackerman of Yale Law School says, “the economic approach to law is the most important development in legal scholarship in the twentieth century.”¹¹

This paper examines the “Law on the Secrecy of Bank Deposits” (Republic Act No. 1405), popularly known as the “Bank Secrecy Law,” from the traditional domain of economic analysis as well as from the perspective of the emergent law and economics discipline. Before analyzing the law proper, it will give the reader a historical background as well as the economic rationale of the passage of the Bank Secrecy Law. In analyzing such law, it will use the Theory of Portfolio Allocation and theories from the Economics of Information. Finally, it will recommend some amendments for the law and will give directions for further research.

II. HISTORY AND RATIONALE OF THE BANK SECRECY LAW

A. HISTORICAL CONTEXT OF THE LAW

The Bank Secrecy Law was passed in September 1955, exactly ten years after the end of Second World War. The war had devastated the economy and recovery was just beginning. Low income naturally resulted in low savings rate. During this time, majority of the Filipinos were engaged in agriculture and thus the population was concentrated in the rural areas.¹² Because of neglect and widespread illiteracy, farmer income grew rather slowly.¹³

⁶ RICHARD COOTER & THOMAS ULEN, *LAW AND ECONOMICS* 1 (1997). GABRIEL CALABRESSI, *On the General State of Law and Economics Research Today and Its Current Problems and Prospects in Law and Economics* in REPORT FROM A SYMPOSIUM IN SWEDEN 1 (1977).

⁷ RONALD COASE, *The Problem of Social Cost*, 3 JOURNAL OF LAW AND ECONOMICS 1 (1960).

⁸ GUIDO CALABRESSI, *Some Thoughts on Risk distribution and the Law of Torts*, 70 YALE LAW J. 1 (1961).

⁹ GARY BECKER, *Crime and Punishment: An Economic Approach*, 76 JOURNAL OF POLITICAL ECONOMY 169 (1968).

¹⁰ RICHARD POSNER, *THE ECONOMIC ANALYSIS OF LAW* 5 (1980).

¹¹ COOTER & ULEN, *supra* note 6.

¹² FRANZ DAVID LIM, *A Historical Analysis Between Food Prices and Agricultural Investments: A Comparative Study of Philippine and Taiwan Experience* 30-33 (2000). Unpublished A.B. Thesis, Ateneo de Manila University.

¹³ *Id.*

Massive poverty, in turn, fermented social discontent and unrest. With considerable peasant support, the *Hukbalahap* (Huks), the military arm of the *Partido Komunista ng Pilipinas* (PKP),¹⁴ threatened to topple the young Philippine Republic. To finance the campaign against the Huks and to build rural infrastructures, the Magsaysay government issued bonds. Incidentally, the issuance of the bonds coincided with the passage of the Bank Secrecy Law. In fact, House Bill No. 3977, the forerunner of the Bank Secrecy Law, lumped the bond issuance and the bank secrecy provisions together.

During that time, the Philippine banking system was still at its infancy. There were only five Filipino-owned banks operating at that time, most of them founded during the period 1950-55.¹⁵ These banks catered to the needs of the booming Philippine industry and were urban in orientation.

During the fifties, the government embarked on the Import Substitution Program.¹⁶ Abetted by the slapping of exorbitant tariffs on imported goods and by the restriction of imports through quotas, the elite began investing in industries.¹⁷ To finance such investments, they borrowed from the banks, and, from then on, the banking industry gradually prospered.

The Philippine capital markets were not fully developed then. Poorly developed capital markets, in turn, hindered economic growth. In order to expand the capital markets and ultimately to generate economic growth, the House and the Senate passed House Bill No. 3977¹⁸ and Senate Bill No. 351, respectively. Both bills intended to generate savings. The preambles of both bills clearly and explicitly stated this intention. For instance, the preamble of House Bill No. 3977 read,

One of the major roadblocks on the path of our economic progress is lack of capital and credit facilities. Banks and other credit institutions have been established by the government to expand the credit facilities in the country, and to private enterprise to establish banks and other credit institutions, but all these steps have not solved the problem of providing adequate capital to propel more speedily our economic development.

¹⁴ The Partido Komunista ng Pilipinas (PKP) was spearheaded by Luis Taruc and had Leninist orientation. On the other hand, the Communist Party of the Philippines (CPP), founded by Jose Ma. Sison in the sixties, has Maoist orientation.

¹⁵ The Second World War obliterated the infant Philippine banking industry consisting of seven banks, five of them foreign owned (by the Chinese and the Americans). The two Filipino banks were Philippine Bank of Commerce (private), Philippine National Bank and Industrial and Agriculture Bank (both government-owned).

¹⁶ PAUL HUTCHCROFT, *BOOTY CAPITALISM: THE POLITICS OF BANKING IN THE PHILIPPINES* 71 (1998).

¹⁷ *Id.*

¹⁸ Authored by Rep. Jose P. Laurel Jr. of Batangas.

In both Houses, the lawmakers cited hoarding and capital flight as reasons for the passage of the Bank Secrecy Law. In a privilege speech before the Congress, Representative Gonzales encapsulated the rationale of such law by saying:

I wish to inform the gentlemen that the newspapers are carrying reports that money is being smuggled abroad. I believed that the gentleman from Manila will bear me out that in our airport, MIA (Manila International Airport), there have been many people caught smuggling money, or silver, or gold bullions... We like to induce investments¹⁹

B. THE HOUSE AND THE SENATE VERSIONS

Both House and Senate bills recognized the problem of hoarding. Both bills intended to protect the depositors' privacy and thus to encourage savings. But there were also considerable differences; for instance, the House version wittingly or unwittingly allowed banks to be a "safe haven" for potential tax evaders. In a privilege speech before the house, Representative Jose P. Laurel justified the passage of the bill by stating:

And yet there is plenty of money hoarded in homes all over the country... Many people do not deposit their money in banks or invest in bonds for fear that the tax collection agencies might make inquiries about their bonds and deposits for purpose of taxation. Many of these people are not guilty of tax evasion and would be able to explain that they are not guilty of tax evasion, but they would rather hoard their money at home and forego the returns of investments in bonds or deposits in banks than be made to face the inconvenience of and trouble of facing inquiry or investigations for possible tax evasion. While it is true that many tax evaders will evade liability for tax evasion if this bill is approved, it is believed that *the benefits that will accrue to our economy in enacting this bill into law will counter-balance the losses of Government from such tax evasion*. It is believed that the approval of this measure will inject into the bloodstream of our anemic economy the capital which we need for greater agricultural and industrial production.²⁰ [Emphasis supplied]

By allowing the banks to become "tax evaders' haven," the bill's author displayed superficial understanding of economics. Such allowance only makes enforcement of tax law expensive since more resources must be devoted to the prosecution of the tax evaders. As an alternative, the congressmen could have just proposed to lower tax rates.

Both Houses of Congress debated the merits of the bills. Unfortunately, the debates in both Houses were rather lackluster as both parties exhibited a shallow

¹⁹ CONGRESSIONAL RECORDS 3RD CONGRESS 2ND SESSION (HOUSE OF REPRESENTATIVES) VOL. 2 NOS. 69-74. 374-380 (1955).

²⁰ *Id.*

understanding of economics. In both Houses, the bills were met with some opposition. Some congressmen proposed amendments to allow the Congress to examine bank accounts. Others suggested that the accounts of public officials be made open to scrutiny. But, both proposals were defeated in both Houses. After the debates, 58 representatives voted to pass the Bill while 17 senators voted in favor of the Senate version. In both Houses, nobody voted against the bill. Nor did anyone abstain deliberately.

C. HOW THE SUPREME COURT INTERPRETED THE BANK SECRECY LAW

The cases decided by the Supreme Court on the Bank Secrecy Law can be characterized as falling into one of two categories: (a) cases relating to violations of the Anti-Graft and Corrupt Practices Act (Republic Act No. 3019); and (b) cases relating to garnishments. Both categories involve exceptions to the Bank Secrecy Law.

As to graft and corruption cases, the first test case of the Bank Secrecy Law came in 1963. In the case of *Tatalon Barrio Council v. Chief Accountant of the Bank of the Philippine Islands*,²¹ the court ruled that the bank accounts being subpoenaed were considered confidential and that the case of the petitioners did not fall into any of the exceptions stated in Section 2 of the law. Hence, the court sustained the act of the chief accountant of the bank in not disclosing the accounts of the defendant in a graft and corruption case.

Two years later, in an almost similar case, the court departed from its previous interpretation of the Bank Secrecy Law. In *Philippine National Bank v. Gancayo*,²² the court ruled that the accounts of Ernesto Jimenez (former administrator of the Agricultural Credit and Cooperative Administration), accused of having unexplained wealth, can be opened. In its decision, the court reconciled Section 2 of Bank Secrecy Law with Section 8 of R.A. No. 3019 or the Anti-Graft and Corrupt Practices Act, which states,

If in accordance with the provisions of Republic Act 1379, a public official has been found to have acquired during his incumbency, whether in his name or in the name of other persons, an amount of property and/or money manifestly out of proportion to his salary and to his other lawful income, that fact shall be a ground for dismissal or removal. Properties in the name of the spouse and unmarried children of such public official may be taken into consideration, when their acquisition through legitimate means cannot be satisfactorily shown. Bank deposits shall be taken into consideration in the

²¹ G.R. No. L-18360. 7 SCRA 171 (1963).

²² G.R. No. L-18343. 15 SCRA 91 (1965).

enforcement of this section, notwithstanding any provision of law to the contrary.

The Supreme Court said:

The truth is that these laws are so repugnant to each other that no reconciliation is possible. Thus while Republic Act No. 1405 provides that the bank deposits are absolutely confidential and [therefore] may not be examined, inquired or looked into, except in those cases enumerated therein, the Anti-Graft Law directs in mandatory terms that bank deposits *shall* be taken into consideration in the enforcement of this section, notwithstanding any provision of law to the contrary. The only conclusion possible is that Section 8 of the Anti-Graft Law is intended to *amend* Section 2 of Republic Act No. 1405 by providing an additional exception to the rule against the disclosure of bank deposits.

Indeed, it is said that if the new law is inconsistent with or repugnant to the old law, the presumption against the intent to repeal by implication is overthrown because of the inconsistency or repugnancy reveals an intent to repeal the existing law. And whether a statute, either in its entirety or in part, has been repealed by implication is ultimately a matter of legislative intent.²³

Then, the court ruled that cases of unexplained wealth are similar to cases of bribery and dereliction of duty. Thus, it allowed the opening of accounts of the holders being prosecuted for the above-mentioned offenses.

In *Banco Filipino Savings and Mortgage Bank v. Purisma*,²⁴ the Court affirmed the decision in *Philippine National Bank v. Gancayco*.²⁵ It also ruled that the accounts of people being prosecuted for violation of R.A. No. 3019 hidden under other people's name can be also investigated.

As regards cases involving garnishments, the Supreme Court, basing its decision on the House deliberations, in *China Banking Corporation v. Ortega*²⁶ ruled that the Bank Secrecy Law does not preclude the bank deposits from being garnished to satisfy a judgment. The court reiterated this ruling in the later case of *Philippine Commercial and Industrial Bank v. Court of Appeals*.²⁷

Nevertheless, in all the aforementioned cases, the court has upheld the "absolutely confidential nature" of bank deposits, subject to certain specific exceptions. In *Tatalon Barrio Council v. Chief Accountant of Bank of Philippine Islands*²⁸, the court ruled that the documents called for by the petitioners are privileged documents

²³ *Id.*

²⁴ G.R. No. L-56429. 161 SCRA 577 (1988).

²⁵ *Id.*

²⁶ G.R. No. L-34964. 49 SCRA 355 (1973).

²⁷ G.R. No. 84526. 193 SCRA 453 (1991).

²⁸ *Supra* note 23

protected by the Bank Secrecy Law. In *Philippine National Bank v. Gancayco*,²⁹ the court again upheld the confidential nature of bank accounts. Its ruling on the opening of bank accounts, however, is based on the principle that a public office is a public trust.³⁰ The court affirmed the exceptions to the absolute secrecy of bank accounts, not on the basis of principles of sound banking practices, but rather on society's expectations on public officials. The court followed a similar line of reasoning in *Banco Filipino Savings and Mortgage Bank v. Purisma*.³¹ In *China Banking Corporation v. Ortega*³² and in *Philippine Commercial & Industrial Bank v. Court of Appeals*,³³ the court ruled that garnishment does not constitute inquiry on bank accounts.

In summary, the court ruled that bank accounts may be examined in the cases where the defendant is accused of violations of Graft and Corrupt Practices Act. It also ruled that Bank Secrecy Law does not bar garnishment of accounts in satisfaction of judgment.

D. THE ECONOMIC RATIONALE OF THE LAW

The early theories on economic development, developed during the forties and the fifties, influenced the policy behind the law. There was a strong emphasis on industrialization. For instance, economists Paul Rosenstein-Rodan and Ragnar Nurske advocated the "big-push industrialization."³⁴ In 1950, Arthur Lewis emphasized the superiority of the industry over agriculture.³⁵ In 1957, Albert Hirschman, by expressing the need for sufficient infrastructures, extended the theories of earlier development economists.³⁶ Certainly, industrial investments required massive inflows of capital. Thus, these theories implied the need to generate savings for industrialization.

Other economists were even more explicit about the role of savings. In 1950, Roy Harrod and Evesy Domar postulated that economic growth is positively related with the level of savings.³⁷ In 1955, Walt Rostow, in his *Stages of Economic Growth*, asserted that 20% annual savings is necessary to achieve the stage of mass

²⁹ *Supra* note 25

³⁰ *Id.*

³¹ *Supra* note 25.

³² *Supra* note 27.

³³ *Supra* note 28.

³⁴ RAGNAR NURSKE, PROBLEMS OF CAPITAL FORMATION IN UNDERDEVELOPED COUNTRIES 28 (1953). PAUL ROSENSTEIN-RODAN, *Problems of Industrialization of Eastern and Southeastern Europe*, 53 ECONOMIC JOURNAL 202 (1953).

³⁵ ARTHUR LEWIS, *Economic Development with Unlimited Supplies of Labor* 22 MANCHESTER SCHOOL OF ECONOMIC AND SOCIAL STUDIES 139 (1953).

³⁶ ALBERT HIRSCHMAN, THE STRATEGY OF ECONOMIC DEVELOPMENT 50 (1957).

³⁷ DEBRAJ RAY, DEVELOPMENT ECONOMICS 51 (1997).

consumption.³⁸ Two years later, Robert Solow refined the Harrod Domar Model by linking savings to short-run growth up to the steady state.³⁹

The above-mentioned models dominated economic thinking in the post-colonial era. These certainly influenced the policymakers to formulate policies that raise savings rate. In fact, the House and the Senate bills and the debates in both Houses clearly manifested such influence.

III. THE THEORETICAL FRAMEWORK

A. THE PORTFOLIO ALLOCATION THEORY IN A WORLD OF PERFECT CAPITAL MARKETS

People maximize wealth.⁴⁰ Not all wealth, however, is used in buying consumer goods. People forego current consumption in order to enjoy greater consumption in the future. In foregoing current consumption, they maximize returns to their wealth by investing in interest bearing assets.⁴¹ In the world of perfect information, investors will invest in the asset yielding the highest returns. In the world of risk and uncertainty, people maximize not the returns but the expected returns [EX].⁴² Also, the presence of uncertainty compels the investor to invest in a wide array of assets (X_1, X_2, \dots, X_N) as to minimize the potential loss. Mathematically,

$$\begin{aligned} \text{Max. EX} & & (1) \\ \text{EX} = P_1X_1 + P_2X_2 + \dots + P_NX_N & & (2) \end{aligned}$$

The P's are the probabilities associated with each asset.

Aside from the expected returns, transaction costs such as brokers' fee and consultancy fees play an important role in one's portfolio decision. The transaction

³⁸ WALT ROSTOW, *The Stages of Economic Growth* in *ECONOMICS OF UNDERDEVELOPMENT* 84 (1958), A.N. Agarawala and S.P. Singh (eds.). According to Rostow, twenty percent savings is a necessary but not sufficient condition. Infrastructures such as roads, education, and health are needed before the twenty percent savings rate can be materialized.

³⁹ ROBERT SOLOW, *A Contribution to the Theory of Economic Growth*, 70 *QUARTERLY JOURNAL OF ECONOMICS* 65 (1956). For Solow, technology or technical progress is the long run determinant of growth.

⁴⁰ To make the analysis simple, we consider nominal wealth only. In times of hyperinflation (more than 10%), the paper uses the real wealth instead of nominal wealth. Mathematically, $RW = W/P$ (where RW = Real Wealth, N = Nominal Wealth and P = Price Level).

⁴¹ GLENN HUBBARD, *MONEY, THE FINANCIAL SYSTEM, AND THE ECONOMY* 94 (2000).

⁴² M. FRIEDMAN & J. SAVAGE, *The Utility Analysis of Choice*, 56 *JOURNAL OF POLITICAL ECONOMY* 279 (1948).

costs are also directly proportional to the risk of the asset. For instance, the transaction cost in making deposits is far less than that in buying or selling shares of stocks. Transaction costs need not be monetary only. Time constitutes another form of transaction cost. For instance, bank depositors do not often monitor interest. In contrast, stock market investors spend considerable time monitoring stock prices.

Recently, modern technology has sharply reduced transactions cost. For instance, the use of Automated Teller Machines means that people living far from banks need not go to the bank to withdraw their money. Also, the internet allows investors to monitor stock prices anytime and anywhere.

Finally, there is the liquidity factor. The more liquid (less liquid) the asset is, the more attractive (less attractive) it is to the investors.

In a nutshell, the Portfolio Allocation Theory describes how savers distribute their savings across alternative investments so as to maximize returns on investments.⁴³ Mathematically,

$$X_1 = f(W_1, RET_1, R_1, L_1, CI_1, TC_1) \quad (3)$$

$$X_2 = f(W_2, RET_2, R_2, L_2, CI_2, TC_2) \quad (4)$$

$$\cdot \quad \cdot \quad \cdot \quad \cdot \quad \cdot \quad \cdot \quad \cdot$$

$$X_N = f(W_N, RET_N, R_N, L_N, CI_N, TC_N) \quad (5)$$

Thus, *relative* increase in wealth (W), returns (RET), liquidity (L) makes investment attractive while Risk (R), transaction costs and the cost of acquiring information (CI) make investments less attractive.

B. THE EFFICIENCY AND THE LIMITS OF FINANCIAL MARKETS

So far, section A above described how efficient capital markets work. The efficiency of the capital markets hinges on several assumptions.⁴⁴ Among them is the availability of perfect information. If, however, information is unavailable or so costly as to exclude certain people from acquiring it, then sub-optimal decisions are made.⁴⁵ In such situations, *information asymmetry* arises. The presence of information

⁴³ *Supra* note 42.

⁴⁴ Other assumptions are: (1) freedom of entry and exit for producer; (2) Charging of price equals marginal cost; and (3) Both consumers and producers are price takers.

⁴⁵ JOSEPH STIGLITZ *The Role of State in Financial Markets* in PROCEEDINGS OF THE WORLD BANK ANNUAL CONFERENCE ON DEVELOPMENT ECONOMICS 1993, 1 (1994).

asymmetry reduces transactions since people are generally risk averse. In fact, it can lead to extinction of certain markets.

Information asymmetry can be classified into two categories: moral hazard and adverse selection.⁴⁶ *Moral hazard* occurs when there is imperfect information concerning the *actions* that the individual undertakes.⁴⁷ For example, in banking, a depositor cannot know how his or her deposits are used. *Adverse selection*, in turn, occurs when there is imperfect information concerning the *characteristics* of the goods or services being bought or sold.⁴⁸ For example, banks cannot perfectly distinguish good borrowers from the bad ones. Thus, they may lend money to bad borrowers.

Problems of moral hazard and of adverse selection plague both the developed and the developing countries. In both types of countries, information carries a cost. Nevertheless, information asymmetry is more widespread in the developing countries. For one, because of advances in technology, information is less costly to gather in developed countries. Another, because the legal system, especially with regard to the enforcement of both contracts and law, is less developed in the developing countries, the cost of information verification is also more expensive. Different degrees of information asymmetry arise from the dissimilarity in both the technology and the efficiency of the legal system.⁴⁹

The problem of information asymmetry necessitates government intervention. The government, through the enforcement of contracts and the mandatory disclosure of certain information, safeguards the people from fraudulent information. Government intervention occurs in several forms like taxes, subsidy and regulation.⁵⁰ It, however, cannot substitute the initiatives of the private sector. Like markets, the government can also fail. It is not immune to both corruption and inefficiency. Thus, it must intervene to the extent that it can enhance the operations of the market. Otherwise, non-intervention may be a better solution.

C. THE ROLE OF MARKET AND GOVERNMENT IN THE FINANCIAL MARKETS

The credit market is not immune from market failures arising from information asymmetry. In fact, the problems of information asymmetry pose a

⁴⁶ JOSEPH STIGLITZ, *The Causes and Consequences of the Dependence of Quality on Price*, 24 JOURNAL OF ECONOMIC LITERATURE 1 (1987). JOSEPH STIGLITZ, *Information and Economic Analysis: A Perspective*, 95 ECONOMIC JOURNAL (SUPP.) 21 (1985).

⁴⁷ *Id.*

⁴⁸ *Id.*

⁴⁹ *Supra* note 38.

⁵⁰ These three can vary in degree. This paper, however, will just focus on prudential regulation.

greater threat to the banking sector.⁵¹ Banks, by nature, deal with risk and information. Risk, in turn, is inversely proportional to the availability of *correct* information.⁵² As implied in the Theory of Portfolio Allocation, excessive riskiness of the banking sector results in the withdrawal of bank deposits and ultimately in the weakening of the banking industry.

Certainly, the use of market forces in combating information asymmetry is worth considering. If, however, private cost exceeds private gains, there is no incentive for the private sector to provide such goods or services. Hence, the state must intervene. Aside from market failure, only the government can carry out effective prudential regulations for two other reasons. First, only the government has the power to compel both the disclosure of confidential documents such as bank records and the membership in bank insurance.⁵³ Furthermore, only the government can handle the risk associated with macroeconomic disturbances caused by bank failures.⁵⁴ Thus, government intervention stems from both necessity and feasibility.

Intervention consists of establishment of state or development banks,⁵⁵ market regulation⁵⁶ and prudential regulation.⁵⁷ Prudential regulation includes regulation-making and bank supervision. Regulation-making means the codification of policies to insure the soundness of banking system.⁵⁸ It covers the setting of limits for DOSRI loans, the capital requirements and the risk management system.⁵⁹ This usually involves the three branches of the government: executive, legislative and judicial branches.⁶⁰ On the other hand, supervision consists of examining the veracity of bank documents and balance sheets, the risk behavior of managers and of enforcing law and regulations.

Government intervention, however, is not always free from politics. For instance, assessing a certain bank's health is subjective.⁶¹ Hence, political considerations may enter into the picture. Furthermore, there is always the possibility of

⁵¹ *Supra* note 46.

⁵² *Id.*

⁵³ *Id.*

⁵⁴ *Id.*

⁵⁵ DIMITRI GERMINDIS, DENNIS KESSLER & RACHEL MEGHIR, FINANCIAL SYSTEMS AND DEVELOPMENT: WHAT ROLE FOR THE FORMAL AND INFORMAL SECTORS? 40 (1991).

⁵⁶ MCKINNON, RONALD, MONEY AND CAPITAL IN ECONOMIC DEVELOPMENT, 26 (1973).

⁵⁷ GERARD CAPRIO, JR., *Policy Uncertainty, Information Asymmetries and Financial Intermediation*, WORLD BANK POLICY RESEARCH WORKING PAPERS NO. 853, 9-10 (1992). DMITRI VITTAS, *Policy Issues in Financial Regulation*, WORLD BANK POLICY RESEARCH WORKING PAPERS NO. 910, 4-7, 19-21 & 33-35, (1992).

⁵⁸ *Id.*

⁵⁹ *Id.*

⁶⁰ ANNE KHADEMIAN, CHECKING ON BANKS: AUTONOMY AND ACCOUNTABILITY IN THREE FEDERAL AGENCIES 23 (1996).

⁶¹ *Supra* note 46.

collusion between the regulator and regulated.⁶² Even in the absence of collusion and of political considerations, technological advances and the evolution of financial markets impugn the rationale of active government intervention in the financial markets.⁶³ For instance, the merger of banking and securities markets makes regulation more difficult.

Historically speaking, the cost of regulation has soared markedly since the seventies.⁶⁴ Furthermore, the failure of regulations to prevent bank failures has led many economists to question their rationale.⁶⁵ Moreover, excessive regulations discourage managers to self-regulate.⁶⁶ Nevertheless, many of the calls for deregulation simply reflect the deregulation movements in other sectors of the economy.

With government inefficiencies in mind, economists generally advocate a mixture of regulation and market incentives in shaping desirable behavior.⁶⁷ Specifically, regulations must be incentive compatible.⁶⁸ For example, bankers must not be penalized for complying with the regulations. Moreover, the regulatory framework must encourage or even reward prudent behavior among the bankers. However, responding to new incentives takes time.⁶⁹

IV. ECONOMIC ANALYSIS OF THE BANK SECRECY LAW

A. THE BANK SECRECY LAW AND THE DEVELOPMENT OF FINANCIAL MARKETS

The stringent protection of the identity of the account holders has indeed made bank deposits attractive. Individuals and firms want secrecy for their accounts. Bank accounts, by nature, are private and confidential. Moreover, protecting the identity of the account holders will make them less vulnerable to kidnapping and to

⁶² *Supra* note 61.

⁶³ DIMITRI VITTAS & PATRICK HONOHAN, *Bank Regulation and the Network Paradigm: Policy implications for Developing and Transition Economies*, WORLD BANK RESEARCH WORKING PAPER NO. 163, 2-20 and 28-34 (1996). DIMITRI VITTAS & MILLARD LONG, *Financial Regulation: Changing the Rules of the Game*, POLICY RESEARCH WORKING PAPER WPS 803, 1-4 and 9-15 (1991).

⁶⁴ *Id.*

⁶⁵ MICHAEL BORDO, *Regulation and Bank Stability: Canada and the United States 1870-1980*, WORLD BANK RESEARCH WORKING PAPER NO. 1532, 1-14 (1995).

⁶⁶ *Supra* note 61.

⁶⁷ GERARD CAPRIO, JR., *Bank Regulation: The Case of Missing Model*, WORLD BANK POLICY RESEARCH WORKING PAPER NO. 1574, 15 (1996).

⁶⁸ *Supra* note 46.

⁶⁹ *Supra* note 68.

robbery. Finally, the law protects depositors' accounts from the scrutiny of the Bureau of Internal Revenue.⁷⁰ According to section 2, without a court order, bank accounts cannot be used as evidence against tax evaders. The penalties (the cost) in section 5 of the Bank Secrecy Law also deter outsider intrusion.

B. FAILURE OF THE LAW TO STIMULATE SAVINGS

The Bank Secrecy Law triggers problems of information asymmetry – moral hazard and adverse selection. Information asymmetry paralyzes the function of an otherwise perfect credit market.

1. The Problem of Moral Hazard

As mentioned earlier, prohibiting the examination of bank accounts protects the depositors' privacy. On the other hand, it also hampers prudential regulation. With ineffective bank supervision, banks undertake risky investments.⁷¹ Risky investments, in turn, increase the likelihood of bank insolvency. In the event of bank insolvency, the government often bails out insolvent but erring banks to avoid hyperinflation, capital flight and destabilizing exchange rate devaluation. Knowing that the government and the Central Bank will not allow large-scale bank failure, bank managers will continue to make risky investments. Taxpayers, not erring bankers, will ultimately shoulder the cost of bank rehabilitation.⁷² Thus, one moral hazard leads to another.

In the context of bank secrecy, rehabilitation might aggravate the problem of moral hazard. During the 1983-1984 financial crises, for instance, the Central Bank extended one billion pesos worth of emergency assistance to Banco Filipino.⁷³ Banco Filipino, in turn, siphoned millions of pesos of emergency rehabilitation funds. After its closure in 1984, the Central Bank sued Banco Filipino for fraud and mismanagement. The Bank Secrecy Law, however, prevented the prosecutors from gathering incriminating evidence against it. Ultimately, lack of evidence contributed to Banco Filipino's courtroom victory in 1991. Thus, in extreme cases, the law can perpetuate a *series* of moral hazard problems.

⁷⁰ *Supra* note 16.

⁷¹ FREDERIC MISHKIN, *Understanding Financial Crises: A Developing Country Perspective* in ANNUAL WORLD BANK CONFERENCE ON DEVELOPMENT ECONOMICS (B. Pleskovic and J. Stiglitz, eds.) 1 (1997).

⁷² The Philippine Deposit Insurance Corporation (PDIC) will insure only up to a certain amount. Thus, bank failures will hurt more the large depositors than the small ones. The small depositors, however, will bear the brunt of macroeconomic instability.

⁷³ *Supra* note 16.

Aside from encouraging risky and fraudulent investments, the Bank Secrecy Law makes DOSRI (Directors Officers and Related Interest) loans difficult to detect.⁷⁴ DOSRI, in itself, is not harmful.⁷⁵ Nevertheless, most financial economists recommend the limitation of DOSRI.⁷⁶ In most DOSRI loans, the loan limits are generally far higher, the interest rates generally far lower and the repayment period far longer. In the absence of effective prudential regulations, the banks may not even assess the risk in making DOSRI loans.

In the Philippines, the problem of DOSRI is made doubly serious because of the prevalence of interlocking directorates. Although good for the entrepreneurs, such interlocking directorates create serious moral hazard problems. Depositors do not know where the money is being diverted or whether such money is used to finance related firms' sour investments.

In summary, the Bank Secrecy Law not only does not solve the problem of moral hazard but also aggravates such problem.

2. The Problem of Adverse Selection

As mentioned earlier, the privacy provisions of the Bank Secrecy Law attract savers. Savers, however, are not aware that the same provisions also tend to restrict prudential regulations. They are also not aware that the secrecy provisions encourage the banks to take excessive risks. On the contrary, they may feel more secure about their deposits. Thus, by placing their money on a riskier banking system, they make an adverse selection.

Also, the law increases transactions cost in the event of bank insolvency. Because the state often fails to successfully prosecute errant bankers, the depositors will be compelled to sue banks on their own. Thus, bank secrecy adds a hidden contingent transaction cost – the litigation cost. Since such cost is not obvious to the ordinary depositors, they will continue to deposit their money. Meanwhile, taxpayers bear the cost of failed prosecutions.

The Bank Secrecy Law also makes criminal investigations on banks difficult. Of course, bank examination is still possible.⁷⁷ But one has to go through several time-consuming (in most cases, time-wasting) processes. For instance, bank examination requires the Monetary Board's approval, which is given only when the

⁷⁴ *Supra* Note 16.

⁷⁵ *Supra* Notes 64 and 68.

⁷⁶ *Id.*

⁷⁷ FRANZ DAVID LIM, *The Social Cost of Bank Secrecy Law* 10-13 (2001). Unpublished paper, University of the Philippines School of Economics.

evidence of fraud is indeed strong. Ascertaining the strength of such evidence, however, is expensive in terms of both time and money.

The cost of obtaining evidence substantiating bank fraud is also enormous as result of the Bank Secrecy Law. Because bank documents and audit reports obtained *prior* to court-sanctioned examination are inadmissible as evidence, bank supervisors must rely on witnesses and on other indirect evidence. Corroborating those testimonies with the available shreds of evidence is extremely difficult and costly. Also, witnesses need protection. Witness protection involves expenses on food, on safehouses and on security personnel.

Moreover, the Bank Secrecy Law makes it possible for banks to misrepresent their financial positions by bloating their assets and understating their liabilities. Such misrepresentation is not necessarily fraudulent. The story of the Republic Bank is an interesting example.

The Republic Bank was founded on 1953. In span of eight years, it stood as the eleventh largest bank in the Philippines. In 1961, the government legalized the deposit of public funds in private banks. Because the Republic Bank's owner, Pablo Roman, enjoyed close ties with the Macapagal Administration, public funds flowed into its vaults. By 1963, it held a quarter of public fund deposited in commercial banks. Not surprisingly, its ranking jumped from eleventh to the third largest bank by 1963.

Such meteoric rise, of course, attracted depositors. Depositors, because of the Bank Secrecy Law, were not aware that bulk of the funds had come from the public sector. Neither did they know such deposits were made by political connections, not by sound financial analyses. Thus, the politically propped-up growth led the public to make an adverse selection, mistaken as to the actual financial strength of the bank.⁷⁸

C. REEXAMINING SECTION ONE OF THE LAW

The Bank Secrecy Law failed to take information asymmetry, both moral hazard and adverse selection, into account. Arguably, policy makers had a limited set of theoretical and empirical models to guide them. After all, the theories on information asymmetry only came out in the seventies, i.e., decades after the enactment of the law. Moreover, the role of financial markets in economic development was not yet properly understood at that time. Only after the publication of

⁷⁸ Interestingly, the Republic Bank failed because of massive DOSRI loans.

Ronald McKinnon's *Money and Capital in Economic Development*⁷⁹ did the role of credit market in economic development become widely appreciated.

Interestingly, the House and the Senate bills as well as the congressional deliberations clearly showed that policymakers were not aware of the necessity of prudential regulations and of the problems of information asymmetry. For instance, in the debate about the Bank Secrecy Law, nobody mentioned the need to maintain prudential regulation. Also, section 4 renders the Bank Secrecy Law superior to all regulations, regardless of their content. None of them ever foresaw the negative consequences, both economic and legal, of such law.

Also, the politicians both benevolently and malevolently invoke economic theories, such as the Rosenstein-Rodan⁸⁰ and Hirschman⁸¹ Models, to justify the heavy hand of government intervention. For those politicians, the palsied invisible hand of the market economy cannot coordinate investment decisions. Hence, for them, the visible feet of the government must step in. As history has shown very clearly, the visible feet of the government trample the creativity of the entrepreneurs and have led to various rent-seeking activities.⁸² Indeed, the Bank Secrecy Law is a showcase of harmful government intervention.

Finally, those oft-cited development theories fail to take the countries' institutions into consideration. The policy implications of the theories, however, require the presence of functioning institutions.⁸³ In the Philippine case, the Bank Secrecy Law needs an efficient legal system to speedily solve cases of fraud and mismanagement. Without such institutions, those policies will not work. Hence, in the Philippines, the dysfunctional legal system hinders the good intentions of the Bank Secrecy Law.

D. GAINERS AND LOSERS OF THE BANK SECRECY LAW

The bankers are the greatest gainers of the Bank Secrecy Law. Abetted by the porous legal system, they can [and many of them did] plunder the depositor's hard earned money. As mentioned earlier, the law makes prosecution and conviction of errant bankers difficult if not impossible. Moreover, the legal system tilts in favor of the bankers who can afford to hire competent but expensive lawyers. Conversely,

⁷⁹ *Supra* Note 57.

⁸⁰ ROSENSTEIN-RODAN (*supra* note 39b) advocates the need for greater coordination among industries.

⁸¹ HIRSCHMAN (*supra* note 41) calls for greater government investments in infrastructure.

⁸² ANNE O. KREUGER, POLITICAL ECONOMY OF POLICY REFORMS IN DEVELOPING COUNTRIES, 59 (1993).

⁸³ DOUGLASS NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE 120 (1991).

the depositor's are the greatest losers. The law offers them no protection from the depredation by the bankers. Neither does it offer compensation to the legitimate victims of bank plunder.

V. POLICY RECOMMENDATIONS

This paper recommends the amendment of the Bank Secrecy Law. Such amendments must recognize the paramount importance of prudential regulation. Of course, the degree of prudential regulation changes over time due to changes in technology and financial structures. Nevertheless, banking laws must not obstruct the imposition of prudential regulations.

To reduce litigation and the costs associated with them, specific powers for the bank regulators need to be included in the amendments to the Bank Secrecy Law. Such powers include the right to examine *certain* bank records, the right to verify those records, and the right to audit those records independently. Furthermore, the law must empower the regulators to take specific actions such as suspending errant bankers, obtaining documents without the need of prior judicial approval, imposing fines on recalcitrant banking institutions and shutting down banks for poor performance.

The law, however, must also put limits and checks to such powers. For instance, the law may require the examination of information and data *relevant to maintain bank stability*. Such, however, may involve the modification of document reporting format since current documents may contain irrelevant information. Thus, only relevant documents can be examined without prior court authorization. Furthermore, the law must dictate under what circumstances can the regulators discipline bankers. The regulators' examination power must certainly not affect the confidentiality of those deposits. To protect such privacy, the law must prohibit regulators from identifying and divulging the name and the occupation of the account holders without prior court approval. In other words, supervisors' access must be limited to the account numbers and the amounts in it (for auditing purposes). To prevent over-regulation and regulatory abuses, specific penalties for erring regulators need to be codified.

Furthermore, the law must delineate the roles of both the regulators and the courts. Specifically, the law must define their respective jurisdictions. Of course, overlapping is still possible. Nevertheless, the law must put a check on judicial activism. Otherwise, excessive intervention by the judiciary may obstruct the work of regulators. To protect regulators from abusive litigation, the law must provide

limited legal immunity to regulators. Specifically, it must provide circumstances where the Bank Secrecy Law cannot be invoked.

The reforms recommended above are indeed difficult to enact as well as implement. The beneficiaries of the *status quo*, both intended and unintended, will most likely block such reforms.⁸⁴ In fact, the Bankers Association of the Philippines and some members of the Congress, in the face of mounting pressure to pass the Anti-Money Laundering Law, adamantly opposed amending the Bank Secrecy Law.

VI. CONCLUSION

This paper examined the history and the economic bases of the Bank Secrecy Law. The historical study showed that the Bank Secrecy Law was passed haphazardly. Meanwhile, the economic analyses revealed that the Bank Secrecy Law generates problems associated with information asymmetry, as well as their concomitant social costs.

This paper showed the importance of examining historic laws within the context of the prevailing economic theories. Understanding the laws within the context of prevailing economic theories will enable legal scholars to understand the economic rationale behind those laws. Those prevailing theories can be best understood in the context of the social phenomenon they *tried* to explain. Hence, history matters in aiding the understanding not only of the context of the law but the context of the economic theories as well.

Also, laws are made in certain institutional context. Institutions, however, change, albeit slowly. With institutional change, the rationale of the law may or may no longer be tenable. Therefore, institutional change necessitates the comparison of the current and the historical contexts of the law. Historical analysis, however, does not supplant economic analysis of the law. Rather, it complements them.

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⁸⁴ *Supra* note 83.