

**ASSESSMENT OF THE PROBLEMS OF
THE FINANCIAL SYSTEM:
THE PHILIPPINE CASE**

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ASSESSMENT OF THE PROBLEMS OF THE FINANCIAL SYSTEM: THE PHILIPPINE CASE

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I. INTRODUCTION

The Philippine formal financial system has already achieved a certain degree of sophistication. Financial institutions, quite varied in kind, include, among others, universal banks, commercial banks, thrift banks, rural banks, investment houses, finance companies, and pawnshops, and are scattered all over the country. The bank density ratio is fairly high for the country as a whole, although it is significantly higher in urban than in rural areas (Table 1). At present, banks package a relatively wide variety of loans and other banking services, although most of them are still short-term, and offer different deposit and investment instruments. The latest investment instrument developed by a few leading banks in the country is the so-called "capital funds." A hybrid of the unit trust and common trust, this medium- to long-term investment vehicle assures that investors' funds are intact and keep on growing.

This degree of sophistication, however, cannot hide the fact that the Philippine financial system is still underdeveloped relative to those of neighboring countries such as Korea, Taiwan, and Malaysia. As may be seen from Table 2, financial deepening that occurred between 1977 and 1983 appeared to be only temporary and unsustainable. Indeed, the problems that have persistently plagued the financial system have unduly impeded its development to the fullest.

The Philippine banking history, since the establishment of the Central Bank (CB) in 1949, is littered with bank runs and bank failures. As the number of banks increased substantially in the 1960s, banking problems became more pronounced. In 1981, the financial system experienced a severe liquidity crisis that had greatly shaken the public's confidence in the financial system. But this turned out to be only a prelude to a much bigger problem that emerged in 1983 when the economy was struck by a balance-of-payments crisis. It is by far the worst balance-of-payments crisis in Philippine history, and it occurred at a time when political situation had reached its lowest ebb.

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Table 1
NUMBER OF BANKING OFFICES AND BANK DENSITY RATIOS,
URBAN VS. RURAL, 1977-1986

Year	a/ No. of Banking Offices			b/ Bank Density Ratio		
	Phils.	Rural	% Rural	Phils.	Urban	% Rural
1977	2,660	1,957	74	16.8	7.6	20.0
1978	2,888	2,132	74	15.9	7.3	18.9
1979	3,188	2,343	73	14.8	6.8	17.6
1980	3,411	2,479	73	14.2	6.4	17.1
1981	3,538	2,506	71	14.0	5.9	17.3
1982	3,689	2,577	70	13.8	5.7	17.2
1983	3,822	2,635	69	13.6	5.5	17.3
1984	3,791	2,633	69	14.1	5.8	17.7
1985	3,594	2,525	70	15.2	6.5	18.9
1986	3,581	2,492	70	15.6	6.6	19.6

a/

Year-end totals.

b/

In thousands of inhabitants per banking office; the denominator is the year-end number of banking offices.

Source: Blanco and Meyer (1988).

Table 2
FINANCIAL DEEPENING INDICATORS, URBAN VS. RURAL,
1977-1986

Year	PHILS.	URBAN	RURAL
A. Loan: GDP Ratio			
1977	0.36	0.94	0.12
1978	0.39	1.03	0.12
1979	0.42	1.15	0.12
1980	0.44	1.19	0.12
1981	0.44	1.15	0.13
1982	0.45	1.15	0.13
1983	0.49	1.28	0.13
1984	0.40	1.14	0.09
1985	0.31	0.91	0.07
1986	0.30	0.83	0.08
B. Deposit: GDP Ratio			
1977	0.25	0.63	0.08
1978	0.27	0.68	0.09
1979	0.29	0.74	0.08
1980	0.31	0.81	0.08
1981	0.32	0.80	0.09
1982	0.33	0.82	0.11
1983	0.34	0.81	0.12
1984	0.27	0.68	0.08
1985	0.25	0.65	0.09
1986	0.25	0.60	0.11

Source: Blanco and Meyer (1988).

This paper attempts to describe and analyze the extent of problems in the Philippine financial system, their causes, regulatory and supervisory responses to such problems, and the incidence of the cost of bank failures. It is hoped that results of this study can provide lessons useful in formulating policies and measures to deal with the problems of the financial system.

The next section briefly discusses the economic and political developments in the Philippines since 1970. Section III provides a description of the development of the Philippine financial system and the major financial reforms. The extent of the problems of the financial system from 1970 to the present is examined in Section IV. This is followed by an analysis of the causes of banking problems in Section V. Section VI describes the supervisory and regulatory responses to the banking system's problems, while Section VII analyzes the incidence of the cost of bank failures. The last section concludes and discusses major lessons that can be drawn from the study.

II. ECONOMIC AND POLITICAL DEVELOPMENTS

This section briefly discusses the economic and political developments in the country during the period 1970 to 1987.

Politics and economics are closely intertwined in the Philippines. In either field, personality counts a lot. There are political dynasties as well as economic dynasties. In most cases, they support each other to ensure their survival and to further their interests. Although the Philippines copied practically all the democratic institutions from the US, democratic processes are often short-circuited just to serve the narrow interest of certain economic groups.

In 1972, about a year before the President's second term should have ended, Marcos declared martial law, abolished Congress, and detained a number of well-known political opponents. He sought to destroy the dominant political dynasties by denying them access to political exercises. All local government officials were appointed by him and could be replaced at his pleasure. He also tried to eliminate economically powerful dynasties. Thus, land reform was more extensively implemented in areas where landlords were known to oppose him. In industry, Marcos saw banking as the launching pad for other businesses. He then issued a law which was smartly incorporated in banking reform, limiting bank ownership of individuals and family members.¹ Interestingly, friends and relatives of Marcos tried to replace the old captains in the industry with his blessing and encouragement. It was not uncommon for Marcos to issue decrees and letters of instructions conferring monopoly power to his so-called "cronies". For instance, monopolistic trading arrangements controlled by Marcos' "cronies" were set up to control the country's two top agricultural exports, namely sugar and coconut.

1. Of course, there are some merits to this, such as ensuring the quality of good management.

Swift economic reforms came too easily under Marcos' dictatorial regime. In the financial system alone, two major reforms were introduced in less than ten years. It is noteworthy that not even a single reform was instituted over 20 years before the declaration of martial law. Even President Aquino who had legislative powers under the brief Revolutionary Government refused to initiate a major reform when she was handed by the CB a set of proposed amendments to the Central Bank Act and the General Banking Act.

Table 3 presents some economic indicators which summarize the developments of the country during the period 1970 to 1987. Total population was estimated at 57.4 million in 1987. Although the annual population growth rate of the country, which now stands at 2.4 percent, has been declining over the years, it is still considered high by international standards. Since growth of the economy in real terms was pretty sluggish, especially in the 1980s when the average annual growth rate was only one percent, underemployment rate, which is a better measure of labor absorption than unemployment, were alarmingly high.

The fiscal sector has had a dismal performance. Tax effort never went beyond 13 percent in any given year. It is the lowest among neighboring Asian countries. Meanwhile, the national government has been saddled with huge budget deficits. The debt service burden of both the national government and government-owned and/or controlled corporations has grown very rapidly since 1982. This is mainly due to government's take over of a number of private corporations that failed during the 1983-84 balance-of-payments crisis and further aggravated by its assumption of publicly-guaranteed debts. In 1989 alone, the national debt service burden takes up 44 percent of the total government budget.

The huge budget deficit has been partly financed through CB borrowing. The CB has been able to maintain a high level of lending to the national government by keeping its lending to banks at low levels. In fact, CB's net credit to banks had been negative for most of the years between 1970 and 1987.

Except for four years, the Philippines has obtained a negative current account balance since 1970. External debt shot up after 1979 when the government pursued a "countercyclical policy" to offset the adverse impact of the second oil shock on the domestic economy. As external debt piled up each year, the debt service burden became heavier. In 1987, the foreign debt service ratio already reached a staggering level of 48 percent.

Inflation rate has been high but at a manageable level, except for two years when, in 1974, it skyrocketed to 34 percent and again in 1984 to 50 percent per annum. Before the interest rate decontrol, real savings and time deposit rates were severely negative. After 1981, when ceilings

Table 3
SELECTED DEMOGRAPHIC AND ECONOMIC INDICATORS

Indicators	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987
A. Demographic																		
1. Population (M)	36.9	37.9	38.9	40.0	41.1	42.3	43.4	44.6	45.8	47.0	48.3	49.5	50.8	52.1	53.4	54.7	56.0	57.4
2. Unemployment (%)	7.6	5.9	0.6	1.6	4.6	4.2	5.2	4.5	4.1	4.2	5	5.3	8	4.4	7.3	7.1	6.7	9.1
3. Underemployment (%)		15	13.3	12.1	10.1	13.3	10.6	17.4	19.6		20.9	23.9	25.5	29.6	36.4	22.2	28.4	24.2
B. Income																		
1. GNP, real (P B)	40.9	53.1	55.9	61.1	64.5	68.3	73.3	78.0	82.5	88.2	92.5	95.7	97.5	98.8	91.6	87.9	89.5	94.8
2. GNP growth rate (%)		6.5	5.4	9.3	5.6	5.8	7.4	6.3	5.8	6.9	5.0	3.4	1.9	1.1	-7.1	-4.1	1.9	5.9
3. Per Capita Income (P)	1952.9	1401.7	1437.0	1527.6	1569.5	1615.9	1688.5	1749.1	1801.1	1874.2	1915.1	1932.8	1920.7	1894.5	1717.8	1607.3	1568.2	1632.8
C. Monetary Sector (in billion pesos)																		
1. Money Supply	4.7	5.2	6.5	7.3	9.0	10.3	12.1	14.9	16.9	18.8	22.5	23.5	23.5	32.5	33.8	35.8	42.7	52.1
2. Total Liquidity	9.4	10.5	11.8	13.1	24.2	28.9	35.8	43.8	51.8	57.4	67.8	82.1	95.3	113.0	121.2	132.8	141.1	158.2
3. Reserve Money	3.2	3.5	4.4	5.0	8.1	7.0	7.9	9.8	12.1	14.6	16.2	17.8	18.6	27.7	33.4	38.0	50.0	56.9
4. CB Net Credit to Banks	0.97	0.58	0.98	-1.15	-0.02	-0.01	-1.17	-2.51	-3.44	-1.90	3.86	7.18	9.04	4.94	-2.65	-12.87	-10.85	7.26
5. CB Net Credit to National Government	1.63	1.57	1.44	0.24	-1.23	0.95	1.81	2.24	2.41	3.25	5.13	8.63	12.01	12.99	8.75	13.02	5.18	-32.22
D. Fiscal Sector																		
1. Budget Deficit (% to GNP)						1.23	1.75	1.86	1.22	0.18	1.26	4.00	4.29	1.86	1.66	1.87	5.60	2.31
2. Tax Effort (%)						12.02	11.42	11.06	11.56	11.90	11.54	10.35	10.07	10.44	9.46	10.24	10.70	12.22
E. External Sector																		
1. Current Account Balance (\$ B)	-0.05	0.00	0.01	0.54	-0.18	-0.88	-1.05	-0.75	-1.10	-1.50	-1.90	-2.08	-3.20	-2.75	-1.12	-0.08	1.00	-0.59
2. International Reserves (\$ B)	0.25	0.38	0.55	1.04	1.50	1.36	1.64	1.53	1.88	2.42	3.16	2.57	1.71	0.96	0.87	1.08	2.46	1.98
3. External Debt (\$ B)	2.30	2.39	2.73	2.86	3.76	4.84	6.77	8.07	10.89	13.35	17.25	20.89	24.68	24.82	25.42	26.25	26.26	28.65
4. Debt Service Ratio (%)	28.02	24.48	24.23	17.19	13.01	17.31	18.17	19.26	28.50	25.34	19.00	24.53	37.17	36.02	37.88	43.28	43.74	47.97
F. Prices																		
1. Inflation Rate (%)	14.85	21.80	8.23	16.50	34.16	6.78	9.23	9.89	7.29	16.51	17.60	12.39	10.21	10.17	50.35	23.10	0.75	3.78
2. Treasury Bill Rate (%)	19.135	11.948	11.918	9.425	10.047	10.342	10.168	10.901	10.888	12.254	12.141	12.608	13.811	14.173	30.534	26.808	14.439	11.39
3. Lending Rate (%)	12.000	12.000	12.000	12.000	12.000	12.000	12.000	12.000	12.000	14.000	14.000	16.000	17.128	21.278	38.103	26.300	17.300	13.300
4. Savings Deposit Rate (%)	6.000	6.000	6.000	6.000	6.000	6.000	7.000	7.000	7.000	8.000	9.000	9.812	9.811	8.730	8.655	10.842	7.683	4.530
5. Time Deposit Rate (%)	6.500	6.500	6.500	6.500	6.500	6.500	6.500	6.500	6.500	7.000	7.511	7.900	6.540	11.113	16.989	18.907	20.366	20.566
6. Exchange Rate (P/\$)	6.025	6.432	6.675	6.758	6.788	7.248	7.440	7.403	7.368	7.378	7.511	7.900	6.540	11.113	16.989	18.907	20.366	20.566

Sources: Philippine Statistical Yearbook (various years); National Income Accounts (various years); and Central Bank Quarterly Report to the President (various years)

on deposit rates were already removed, real time deposit rate has been positive in all the years except in 1984. In contrast, real savings deposit rate has remained negative except in 1986 and 1987. The gross spread between lending and deposit rates has been extraordinarily high. This is accounted for by the various intermediation taxes imposed by the CB and government (i.e., gross receipts tax, high reserve requirements, agri/agra loan requirement) and the considerably high profit margin enjoyed by banks.

The 1983-84 balance-of-payments crisis had practically put the economy ten years back. According to the *Medium-Term Philippine Development Plan, 1986-1992*, the per capita income will be restored to the 1981 level only in 1992 assuming that the economy will be growing at an average rate of 6.5 percent per year in real terms from 1986 to 1992.

Prospects for the economy have greatly improved since President Aquino took over the reins of the government in early 1986. The high growth rate achieved in 1987 was mainly consumer-led. In 1988, demand shifted towards the investment side which is a good indication that the economy is on the road towards sustainable recovery.

III. DESCRIPTION OF THE PHILIPPINE FINANCIAL SYSTEM

The modern-day Philippine financial system has a long history. It began during the Spanish colonial era as a direct result of the lucrative Manila-Acapulco galleon trade. The very first institution which was not actually a bank but functioned like one was the Church-operated *Obras Pias* founded in 1594. It provided funds for the galleon trade and to planters of export crops. In 1814, English, American, German and French merchants were permitted by the Spanish colonial government to set up trading houses. Soon after, *Obras Pias* began losing their business to the trading houses.

The first real bank was established in 1851 by Spanish laymen and religious orders. It was named Banco Español-Filipino de Isabel II, the forerunner of the Bank of the Philippine Islands (BPI) which today remains the biggest privately-owned commercial bank. The British merchants tried to retain their interest in the economy by setting up two banks, namely the Chartered Bank of India, Australia and China, and the Hongkong and Shanghai Bank in 1873 and 1875, respectively. Both banks are still operating today. Monte de Piedad, the first savings bank, was established in 1882. Its funds came from the *Obras-Pias*. It is one of the biggest savings banks in the country today.

During the American colonial period which started in 1898, American-owned banks entered the domestic scene. In 1902, the International Banking Corporation of New York, the precursor of Citibank, opened a branch in Manila. Forty-five years after, the second overseas branch of Bank of America was set up in Manila. Both branches are still operating in the country today.

Chinese merchants also established their own banks. Most notable among them were the China Banking Corporation (CBC) and the Mercantile Bank of China which were set up in the 1920s.

Not to be outdone, the government also created its own banks. The First Agricultural Bank was established in 1908, but it was absorbed in 1916 by the Philippine National Bank (PNB), the biggest commercial bank in the country today. Again, in 1935, the government created the Agricultural and Industrial Bank, but only to be taken over in 1947 by the Rehabilitation Finance Corporation, the predecessor of the Development Bank of the Philippines (DBP).

To mobilize savings in the rural areas, the Postal Savings Bank was established in 1904. All post offices in the provinces were considered branches of this bank. The Postal Savings Bank was closed by the government in 1975 when the widespread presence of rural banks in the countryside made it irrelevant.

Table 4 enumerates the banks which had been operating before the establishment of the CB in 1949. Note that aside from government-owned banks, only two of these were owned by Filipinos.

The establishment of the CB in 1949 ushered in a new era for the Philippine financial system. Up until 1965, the CB vigorously encouraged entry of Filipino businessmen into the banking system. On the other hand, only four branches of foreign banks were allowed to continue their operation, and they were prohibited to open new branches anywhere in the country.

With a very low minimum capital requirement of only P8 million and the cheap CB credit provided to banks, the number of commercial banks mushroomed to 40 in 1960 from a mere 11 in 1949. Leading Filipino-owned banks such as Far East Bank and Trust Company (FEBTC), Metropolitan and Trust Company, Merchants Banking Corporation, Rizal Commercial Banking Corporation (RCBC), and others were established during the period. The rapid increase in the number of commercial banks occurred at a time when the Philippines were going through the import-substituting industrialization. As Patrick and Moreno (1984) noted:

"Wealthy families began to move into industrial activities, and they recognized the benefits of controlling a bank. In other instances, a banking family moved into industry. Almost all bank owners were involved in one of the industrial groups. This is not surprising. It took some capital to start a bank; perhaps equally important were built-in deposit and lending relationships" (p. 103).

No less than the then CB Governor Gregorio Licaros himself said that the "average Filipino banker is in the banking business not for banking profits; he uses his bank for allied business" (FEER, 7 April 1978, p.80).

Table 4
BANKS OPERATING BEFORE THE ESTABLISHMENT OF THE
CENTRAL BANK OF THE PHILIPPINES (1949)

Name of Bank	Ownership
A. Commercial Bank	
1. Bank of the Philippine Islands	Ecclesiastical
2. China Banking Corporation	Chinese
3. Peoples Bank and Trust Company	American
4. Philippine Bank of Commerce	Filipino
5. Philippine Bank of Communications	Chinese
6. Philippine Trust Company	Ecclesiastical
7. Philippine National Bank	Government
B. Savings Bank	
1. Monte de Piedad	Ecclesiastical
2. Philippine Postal Savings Bank	Government
3. Banco Hipotecario de Filipinas	Filipino
C. Agricultural Bank	
1. Agricultural and Industrial Bank	Government
D. Foreign Branches	
1. The Chartered Bank of India, Australia, and China	British
2. The Hongkong and Shanghai Banking Corporation	British
3. Yokohama Specie Bank	Japanese
4. National City Bank of New York	American
5. Bank of Taiwan, Ltd.	Japanese
6. Nederlandsch Indische Handelsbank	Dutch
7. The Bank of America, NT and SA	American

Source: Lirio (1985).

Doherty (1980) noted that the Philippine industries are characterized by interlocking directorates. An interlocking directorate is defined as the simultaneous holding of a position in the board of directors of several companies. Figure 1 depicts the extent of interlocking directorates among financial institutions, while Figure 2 gives a specific example of interlocking directorates of the RCBC and CBC.

Lending to directors, officers, stockholders, and related interests (DOSRI) served as the main channel in diverting bank funds to affiliated companies. A CB regulation restricted DOSRI loans but only up to an amount not exceeding their respective outstanding deposits and the book value of the share of their paid-in capital. In addition, loan to a single borrower was mandated not to exceed 15 percent of the net worth of the investing bank. However, as will be discussed later, the CB had difficulty enforcing these regulations.

Seeing the need to provide banking services to rural areas, the government enacted the Rural Banking Act in 1952. Rural banks were established as small unit banks allowed to operate only within a limited service area, say a town. To encourage potential investors to go into rural banking, the government provided rural banks with substantial subsidies and a number of tax exemptions and privileges. Moreover, the government matched every peso put up by owners of rural banks as equity. They were placed in preferred shares which earned only two percent per annum.

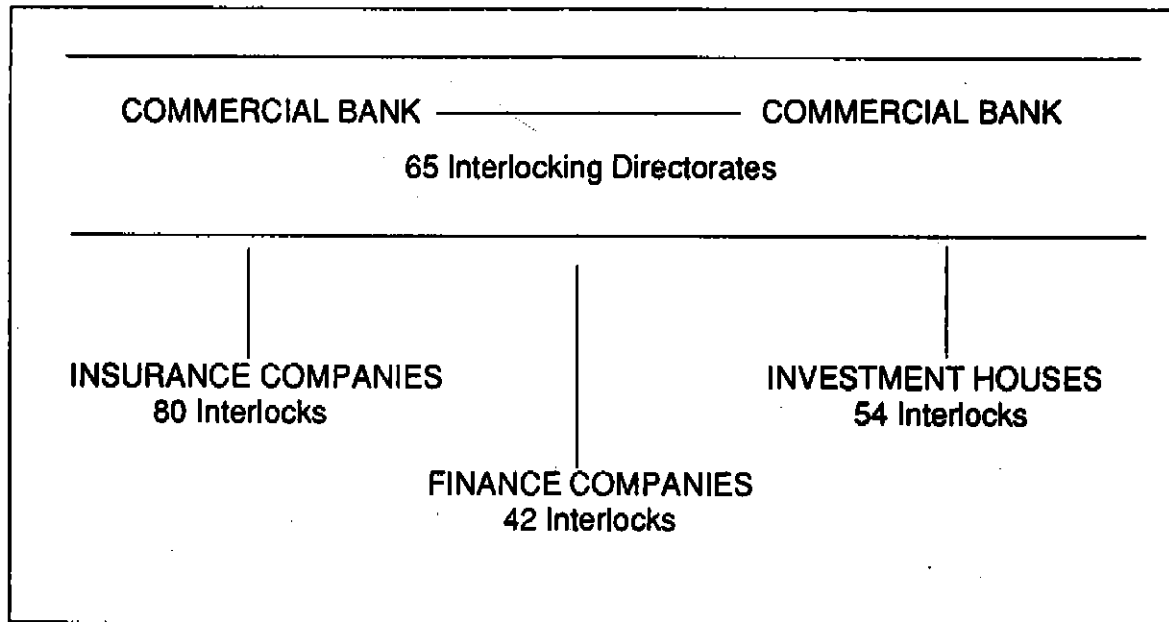
The deluge of small banks into the system was a cause for concern to the monetary authorities who consequently applied a brake on the growth of banks, specifically commercial banks, in 1965. Bank entry was prohibited and the minimum capital requirement for commercial banks was raised from P8 to P20 million.

While entry into the banking system was tight, other forms of financial institutions which did not fall within the purview of CB regulations rapidly proliferated. They competed intensely with banks both in the deposit and loan markets. The money market that started to develop in the mid-1960s provided surplus units and borrowers with more attractive savings instruments and an alternative source of funds, respectively.

In 1972, Marcos who just placed the country under martial law issued two important Presidential Decrees, i.e., P.D. No. 71 which amended the General Banking Act and P.D. No. 72 which empowered the CB to overhaul the banking system. These paved the way for the introduction of the first major reforms in the Philippine financial system. The reforms were based mostly on the recommendations of the joint International Monetary Fund (IMF)-CB Banking Survey Commission which, in 1971, conducted an evaluation of the Philippine financial system. Beginning in 1972, all lending institutions, receivables purchasers, and non-bank financial intermediaries except insurance companies, were placed under the regulation of the Monetary Board.

Figure 1

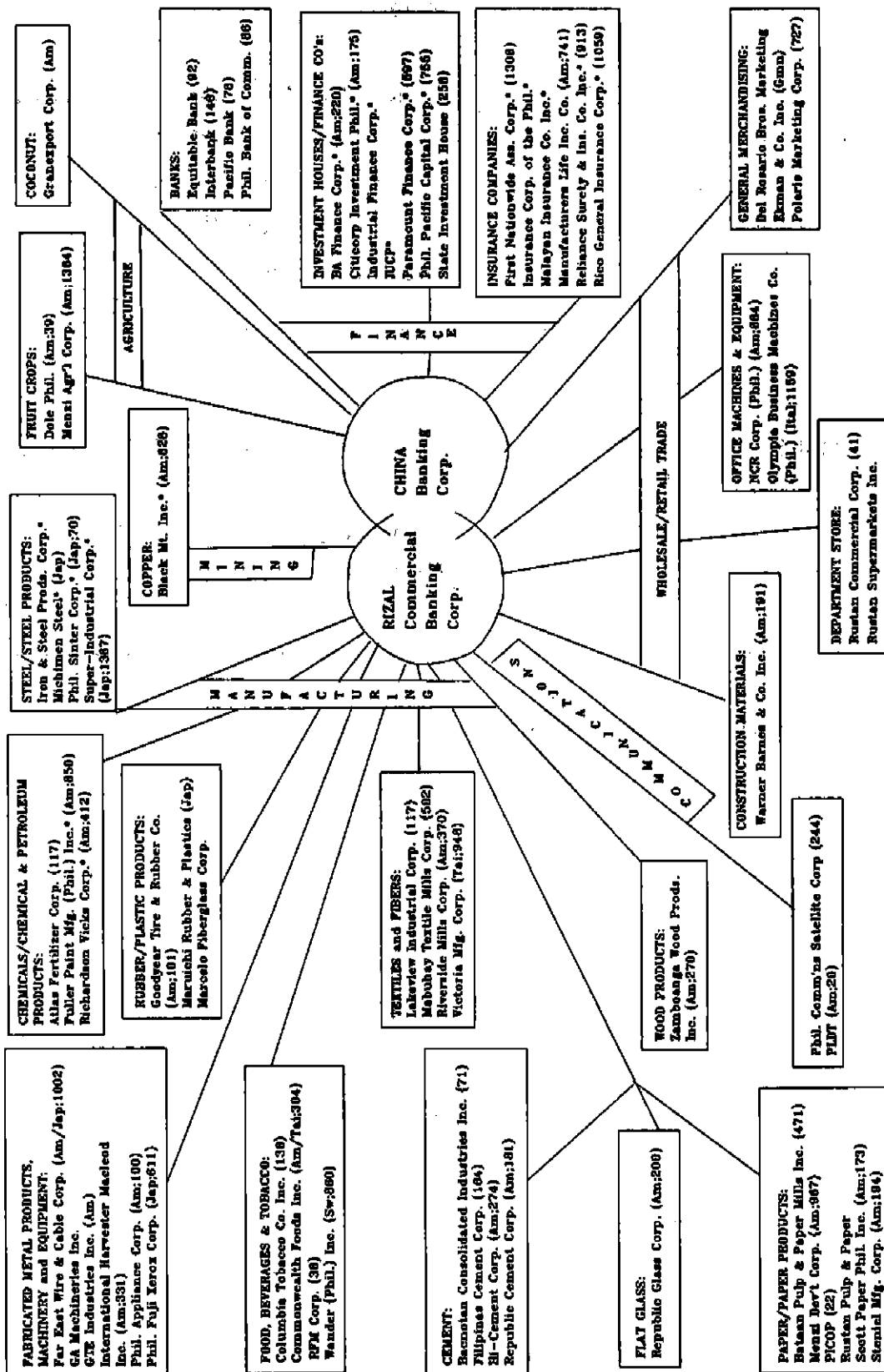
INTERLOCKING DIRECTORATES AMONG FINANCIAL INSTITUTIONS



Source: IBON Primer Series (1983)

Figure 2

THE WEB OF INDUSTRY AND FINANCE:
Interlocking Directorates of the RCBC-China Banking Group
with Financial/Industrial Corporations



Source: IBON Primer Series (1983).

Notes on Figure II

1. An interlocking directorate is defined as the simultaneous holding of a position in the Board of Directors of more than one company. In this case, the interlocking directorates referred to are those of the Board of Directors of RCBC and China Banking.
2. An asterisk (*) indicates whether the company is controlled by the RCBC-China Group, or if the RCBC-China Group is the principal local investor in the company.
3. The figures in parentheses following each corporation state:
 - (a) whether there is a foreign tie-up or foreign investor in the corporation; wherever there is such, nationalities are indicated as follows: Am (American), Gmn (German), Ital (Italian), Jap (Japanese), Sw (Swiss), Tai (Taiwanese).
 - (b) if the company is among Business day's Top 1000 in 1981. If so, the numbers represent the company's Gross Revenue Rank in 1981.
4. The chart is derived from data provided by John Doherty, S.J., in his article "Who Controls the Philippine Economy: Some Need Not Try as Hard as Others," (University of Hawaii Center for Asian and Pacific Studies, Philippine Studies Occasional Paper No. 5, August 1982). Fr. Doherty also provides data on which companies have foreign participation. Other sources used to determine foreign participation are: UP Law Center on TNCs in the Philippines, and BD's List of Multinationals in the Top 1000 in 1981.

A significant part of the 1972 financial reforms was the raising of the minimum paid-in capital of commercial banks from P20 million to P100 million to rationalize the banking system and to increase bank resources available for long-term loans. The minimum paid-in capital for development banks, savings banks, and rural banks were likewise increased to P10 million, P5 million and P0.5 million, respectively. To satisfy the new requirement, merger and consolidation among banks were encouraged and equity participation by foreign entities in domestic banks up to 40 percent was allowed for the first time. Several commercial banks did merge, resulting in a reduced number of private domestic commercial banks from 34 to 27 by 1980. Moreover, 11 commercial banks received substantial foreign capital infusion (Table 5).

Concerned about the quality of management especially in banks owned either by families or a small group of businessmen, the CB tried to disperse bank ownership by reducing the maximum ownership share of an individual to 20 percent and of a corporation to 30 percent.

The 1972 financial reforms enforced specialization among various types of financial entities. Investment banking activities, reserved solely to investment houses, were separated from regular banking activities. Rules and regulations regarding the establishment and operation of investment houses were issued in 1973 through CB circulars. These circulars defined a new class of activity as quasi-banking, delineated the institutions which would be allowed to engage in this activity, and established rules on their operations. Quasi-banking was defined as borrowing from 20 or more lenders, by issuing or accepting deposit substitutes (i.e., promissory notes, certificates of assignment or participation with recourse, and repurchase agreements), for the purpose of relending or purchasing receivables or other obligations.

In the mid-1970s, the CB introduced more reforms to cope with the challenge posed by the rapidly growing deposit substitutes and other high-yielding, short-term money market instruments which used to be unregulated. Interest ceiling of 17 percent on deposit substitutes was imposed. A 35 percent transactions tax was also slapped on all primary borrowings in the money market. Furthermore, a reserve requirement of 20 percent on deposit substitutes of commercial banks and non-bank financial institutions was introduced. All these dissipated the relative attractiveness of money market instruments over the traditional deposits whose rates were, then, administratively set.

Less than a decade later, another set of major reforms were introduced in the financial system. The reforms were mainly based on the recommendations of the joint IMF-World Bank (WB) Mission. A key aspect of the 1980 financial reforms was the removal of interest rate ceilings on both deposits and loans.

The new policy framework calls for a reduction in differentiation among categories of banks and non-banks authorized to perform quasi-banking and the promotion of large banks, called universal banks, offering broader range of financial services including those used to be reserved

Table 5
BANKS DURING THE POSTWAR PERIOD AND THEIR RANKS
BY ASSET SIZE, 1980

Name of Bank (by size of total Assets) 1980	Common abbreviation	Bank History	Controlling group (latest avail- able date)	Foreign equity		
				Name of foreign investor	Equity	Nationality
1. Allied Banking Corporation	Allied	Takeover of assets and liabilities of General Bank & Trust Co.; opened June 1, 1977 after Genbank was declared insolvent and ordered closed by the Central Bank on March 25, 1977	Lucio Tan Willy Co.			
General Bank & Trust Co.	Genbank	Established September 7, 1973	Clarence Yujico	Grindlays (subsequently sold)	40.0%	British
2. Bank of the Philippine Islands	BPI	Established August 1, 1951; merged with People's Bank May 20, 1974	Ayala-Zobel	Morgan Guarantee Trust Company (New York)	20.0%	American
People's Bank and Trust Co.	People's	Established November 1, 1926	J. Antonio Alarico			
3. Metropolitan Bank & Trust Company	Metrobank	Established September 7, 1962	George S.K. Ty			
4. Republic Planters Bank	RPB	Formerly Republic Bank; name changed after equity acquired by sugar bloc May 16, 1978	(Elizalde) Benedicto			
Republic Bank	Republic	Established January 5, 1961	Pablo Roman, Chairman			
5. Philippine Commercial & Industrial Bank	PCIB	Merger of PCIB, Merchants Banking Corporation and Philippine Bank of Commerce, March 23, 1978; PCIB estab- lished February 6, 1980	First Holdings			
Merchants Banking Corporation	Merchants	Established September 3, 1953	Rutino			
Phil. Bank of Commerce	Commerce	Established July 8, 1938	Juan Cojuangco			
6. United Coconut Planters Bank	UCPB	Formerly First United Bank; name changed to UCPB August 12, 1975 after the Philippine Coconut Producers Federation acquired equity in the bank pursuant to Presidential Decree No. 755	Ramon Cojuangco			
7. First United Bank	FUB	Established May 19, 1963	Josa Cojuangco			
Far East Bank & Trust Co.	FEBTC	Established April 4, 1960	Jose B. Fernan- dez, Jr. Barcelon Gokongwei Yulo Palencia Quimson Bancroft Soriano Trinidad Sixto Roxas	Chemical Bank of New York Mitsui Bank of Japan	12.0% 12.0%	American Japanese
8. Traders Royal Bank	Traders	Formerly Traders Commercial Bank; name changed to Traders Royal Bank, April 1, 1974 after Royal Bank of Canada acquired equity in the bank	Benedicto Africa	Royal Bank of Canada (subsequently sold)	30.0%	Canadian
Traders Commercial Bank	Traders Commercial	Established June 18, 1963	Jose Africa, Chairman Monty- libano			
9. Rizal Commer- cial Banking Corporation	RCBC	Established January 20, 1963	Yushengco Valdez Siguan-Reyna SyCip Tantoco	Continental International Financo Corp. Ltd. Sanwa Bank of Japan	30.0% 10.0%	American Japanese
10. China Banking Corporation	China	Established August 18, 1920 Reopened July 23, 1945	Deck-Chong Syco	Sanwa Bank of Japan	33.0%	Japanese

(con't of Table 3)

Name of Bank (by size of total Assets) 1980	Common abbreviation	Bank History	Controlling group (latest avail- able date)	Foreign equity		
				Name of foreign investor	Equity	Nationality
11. Pacific Banking Corporation	Pacific	Established June 23, 1955; merged with Progressive Com- mercial Bank, December 24, 1975	Babst Chua			
Progressive Commercial Bank	Progressive	Established May 3, 1962	Pastor Eudencio Jorge Araneta			
12. The Manila Banking Corp.	Manilabank	Established January 20, 1961	Cabarrus Jose P. Fernandez Puyat			
13. Consolidated Banking Corp.	Solidbank	Established July 16, 1963	Madrigal			
14. Equitable Banking Corporation	Equitable	Established September 20, 1950	Trinidad Tomulo	Cibank	40%	American
15. Philippine Bank of Communications	PBCom	Established September 4, 1939	Nubla- Ang Sang Lin			
16. Insular Bank of Asia and America	ISAA	Merger of Bank of Asia and First Insular Bank of Cebu, January 1, 1974	Kalaw	Bank of America (subsequently sold) Daichi Kangyo Bank	21.8% 10.0%	American Japanese
Bank of Asia	Asia	Established October 15, 1963	Kalaw			
First Insular Bank of Cebu	First Insular	Established January 23, 1961	Aboliz			
17. Security Bank & Trust Co.	Security	Established June 18, 1951	Cy. Ang	The Bank of Nova Scotia	28.5%	Canadian
18. Commercial Bank & Trust Company	Comtrust	Established September 20, 1954	Ayala (purchased from Marquet)	The Chase Manhattan Bank, N.A. (subsequently sold)	30.0%	
19. Philippine Banking Corp.	Philbanking	Established September 2, 1957	Laura Ortega Villa- nuova			
20. Prudential Bank	Prudential	Established July 2, 1952	Santos			
21. International Corporate Bank	Interbank	Formerly Continental Bank; reopened September 10, 1977	Herdis Group			
Continental Bank	Continental	Established April 17, 1963; its closure was authorized by the President of the Philippines upon Central Bank recommend- ation on June 24, 1974 with takeover of its assets by the Central Bank	Munoz Chairman			
22. Associated Citizens	Associated Citizens	Merger of Associated Banking Corp. and Citizens Banks October 14, 1975	Leonardo K. Ty			
Associated Banking Corporation	Associated	Established February 8, 1965	Ty Recto			
Citizens Bank & Trust Co.	Citizens	Established October 4, 1962	Arambulo, Presi- dent			
23. City Trust	City Trust	Formerly Feati Bank & Trust Company	Madrigal Brimo	First National City Bank	32.3%	American
Feati Bank & Trust Company	Feati	Established November 7, 1961	Araneta			
24. Producer's Bank of the Philippines	Producers	Established July 6, 1971	Co Bun Chun Henry L. Co			
25. Filipinas	Filipinas	Merger of Filipinas Bank and Manufacturers Bank December 29, 1975; name changed May 7 1980 from Filipinas Manufac- turers	Silverio, PNB majority share- holders from 1980			
Filipinas Bank Trust Co.	Filipinas	Established October 6, 19	Echaus, Chairman			
Manufacturers Bank & Trust Co.	Manufacturers	Established August 30, 1957	De las Alas, Chairman			
26. Philippine Trust Co.	Phil. Trust	Established June 1, 1964	Enrillo Yap Ramos			
27. Overseas Bank of Manila	Overseas	Established January 6, 1964 under Central Bank supervision starting November 1967 until operations suspended by CB Monetary Board August 1, 1988				

Source: Patrick and Moreno (1984).

solely for investment houses. universal banks were allowed for the first time to go into equity investments in both allied and non-allied activities, although with some restrictions. Restrictions with regard to the operations of other financial institutions were likewise removed. For example, rural banks may now engage in branch banking. This aspect of the 1980 financial reforms completely reversed the policy of financial specialization set out in the 1972 financial reforms.

The recent financial reforms emphasize bigness as may be gathered from the minimum capital requirement for each type of financial entity shown in Table 6. It is thought that a sizeable resource base helps ensure the stability of a financial institution.

While rules regarding interlocking directorships and/or officerships except the case of concurrent officerships in financial intermediaries were relaxed, rules governing DOSRI credit accommodations were tightened. For instance, the unsecured credit accommodations to each DOSRI is no longer allowed to exceed 30 percent of the total credit accommodations.

Table 7 presents the structure and growth of the Philippine financial system from 1976 to 1986. Commercial banks have had a nationwide branching network, with almost all of them located in cities and first class municipalities. Thrift banks have been operating in a limited geographic area, say a province and, therefore, have only fewer branches. Most rural banks have remained unit banks but have become more visible in almost every town in the country.

Between 1976 and 1980, a year before a major liquidity crisis struck the financial system, total assets grew by 123 percent in nominal terms or 43 percent in real terms. These dipped to 24 percent in real terms between 1980 and 1986 as a result of the 1981 liquidity crisis and the economy-wide crisis in 1984 and 1985. Even with the economic recovery that has been going on for the past three years, the financial system today has not yet re-established itself to the 1980 level in real terms.

The commercial banking system has been dominating the financial system, and its relative share in the total assets of the financial system has been increasing between 1976 and 1986. It should be noted that while the commercial banking system did experience a great difficulty during the crises, other types of financial institutions, such as investment houses, financing companies, rural banks and specialized government banks suffered more.

A notable characteristic of the Philippine banking system is the strong presence of government banks. The combined assets of the specialized government banks (i.e., DBP, Land Bank of the Philippines (LBP) and Philippine Amanah Bank) and PNB comprised about one-fourth of the total assets of the financial system in 1986. If the assets of the six government-acquired private banks were added, then the share of government banks would reach one-third of the total assets of the banking system.

Table 6
MINIMUM CAPITALIZATION OF PRIVATE DOMESTIC BANKS
AND NON-BANKS AUTHORIZED TO PERFORM QUASI-BANKING
ACTIVITIES (NBQB)

Type of Institution	Minimum Capitalization (in million pesos)
1. Universal Banks	500
2. FCDUs	150
3. Commercial Banks	100
4. Thrift Banks	
(a) New Thrift Banks	
(i) Metro Manila	20
(ii) Other Places	10
(b) Existing Banks	
(i) Metro Manila	10
(ii) Other Places	5
5. Rural Banks	
<p>Rural banks to be established must have P0.5M before they can operate. Existing rural banks are allowed to increase their capital within a period of time depending upon their number of years of operation.</p>	
6. Non-Bank Quasi-Banks	
(a) Investment Houses (IH)	20
(b) New NBQBs other than IH	20

Source: Central Bank Circular No. 739 (1980).

Table 7
**PHILIPPINE FINANCIAL SYSTEM: NUMBER OF INSTITUTIONS,
TOTAL ASSETS AND PERCENTAGE DISTRIBUTION OF ASSETS**

Institutions	1976				1980				1986			
	No. of Institutions		Total Assets		No. of Institutions		Total Assets		No. of Institutions		Total Assets	
	Head Office	All Outlets a/	Amount (P M)	% Distribution	Head Office	All Outlets	Amount (P M)	% Distribution	Head Office	All Outlets	Amount (P M)	% Distribution
TOTAL	2,065	3,793	99,301	100.0	2,580	5,067	219,633.5	100.0	3,002	5,979	331,586	100.0
A. Banks	934	2,459	80,360	81.8	1,164	3,364	186,813.3	86.0	1,024	3,614	286,397	87.3
Commercial Banks b/	31	1,107	59,357	60.4	32	1,503	138,417.1	63.0	30	1,786	237,055	71.5
Thrift Banks	95	392	9,021	3.1	144	673	10,547.1	4.8	116	665	17,547	5.3
PDAs	33	99	480	0.4	43	154	1,618.3	0.7	43	213	5,579	1.7
SMBs**	10	162	2,042	2.1	10	268	4,352.6	2.0	7	231	6,097	2.4
SSLAs***	52	132	499	0.5	91	251	1,576.2	0.7	66	221	3,871	1.2
Rural Banks	805	867	9,018	3.1	985	1,096	5,642.2	2.6	875	1,083	9,103	2.7
Specialized Gov't Banks	3	73	14,984	15.2	3	82	34,206.9	15.6	3	100	25,693	7.8
B. Non-Bank Financial Institutions	1,056	1,259	17,785	18.2	1,396	1,693	30,820.0	14.0	1,997	2,283	40,995	12.4
Investment Houses	12	49	4,825	4.9	12	62	8,607.3	3.9	13	40	7,519	2.3
Financing Cos.	219	348	4,644	4.7	342	531	11,902.1	5.4	210	334	5,627	1.7
Securities Dealers/ Brokers	126	126	1,092	1.1	141	141	1,035.5	0.5	124	124	945	0.3
Investment Cos.	59	59	3,751	3.8	62	62	4,978.7	2.3	62	82	10,154	3.1
Fund Managers	178	176	3,307	3.4	12	12	1,658.1	0.8	11	11	1,268	0.4
Lending Investors	30	31	17	0.0	57	61	50.0	0.0	288	300	237	0.1
Pawnshops	430	472	149	0.1	544	588	280.5	0.1	1,143	1,367	1,011	0.3
Money Brokers	2	2			5	5			5	5		
Gov't Non-Bank Financial Institutions c/					6	6	2,296.8	1.0	3	3	14,068	4.2
Venture Capital									17	17	126	0.3
C. Non-Bank Thrift Institutions	75	75	136	0.1					81	82	1,194	0.3
MSLAs d/	7	7	24	0.0					7	7	16	0.0
NSLAs e/	68	68	112	0.1					74	75	1,178	0.3

* Private Development Banks
 ** Savings and Mortgage Bank
 *** Stock Savings and Loan Association

a/ Includes head offices (HCOs), branches or sub-branches, field offices, extension office, moneyshops, savings agencies, overseas offices (33%) of local banks.

b/ Includes nine (9) banks authorized to operate as universal banks.

c/ Includes National Development Company (NDC), National Home Mortgage Finance Corp., and the Phil. Veterans' Dev. Corp. (PHIVEDEC).

d/ Mutual Savings and Loans Associations.

e/ Non-stock Savings and Loans Associations.

f/ Data from CB, as of June 1987.

Sources: CB Fact Book, Philippine Financial System (various years)

The four branches of foreign banks also occupy an important place in the banking system. They accounted for about 15 percent of the total assets of the financial system in 1986. Two of them are among the ten largest banks in the country today.

While some privately-owned commercial banks realized modest growth during the period 1976 - 1986 through capital build-up, merger/consolidation and intensive deposit mobilization, others achieved phenomenal growth through special favors obtained from the government. For example, Allied Bank received P889 million in loans and advances from the CB in 1978 which was about 24 percent of its total assets and 321 percent of its net worth (Patrick and Moreno 1984). Almost two-thirds (which is more than P1 billion) of the total casino trust fund had been deposited in trust and savings accounts with the Traders Royal Bank (TRB). The extraordinary rapid growth of United Coconut Planters Bank (UCPB) and Republic Planters Bank (RPB) was mainly due to the deposit of large revenues from coconut and sugar export levy (Tan 1981).² In addition, RPB obtained substantial assistance from the CB in the form of rediscounts and overdrafts especially after a new management headed by a close friend of Marcos took over in 1978.

IV. EXTENT OF THE PROBLEMS OF THE FINANCIAL SYSTEM

This section attempts to describe the extent of the banking problems in the Philippines from 1970 to the present. While the analysis starts in 1970, it does not mean that banking problems started to emerge only in the 1970s. In fact, bank failures in the 1960s prompted Congress to enact a law in 1969 authorizing the Philippine Deposit Insurance Corporation (PDIC) to immediately pay depositors of banks forbidden to do business by the CB, of up to P10,000 for each individual depositors' total deposits in these banks in order to restore confidence in the banking system. Towards the second half of the 1960s, the CB closed eight banks, one of which is the Overseas Bank of Manila, a private commercial bank.

The Philippine financial system experienced three major crises since 1970: the first in the mid-1970s; the second in 1981; and the third in 1983-1984. A detailed description of these problems follows. More attention will be given to failures of large banks.

Table 8 presents the number of closed PDIC member banks from 1970 to 1987. During the period 1970 to 1980, the CB closed a total of 48 banks, 42 of which were rural banks. Failures of rural banks hardly create a ripple on the banking system for at least two reasons. First, they are typically small unit banks; thus, runs in their case are usually localized. Second, they relied more

2. The coconut levy fund was deposited with UCPB as demand deposits. In the Philippines, demand deposits (checking account) are non-interest bearing deposits.

Table 8
NUMBER OF CLOSED PDIC MEMBER-BANKS

Bank Group	1970-1980	1981	1982	1983	1984	1985	1986	1987	1981-1987	1970-1987
Commercial Banks	3 ^{a/}	-	-	-	-	2	-	1	3	6
Savings and Mortgage Banks (SMBs)	1	-	2	-	-	2	-	-	4	5
Private Development Banks (PDBs)	-	1	-	-	2	-	-	1	4	4
Stock Savings and Loan Associations (SSLAs)	2	3	-	1	14	4	-	2	24	26
Rural Banks	42	27	9	6	10	36	25	25	138	180
Specialized Government Banks (SGBs)	-	-	-	-	-	-	-	-	-	-
All Banks	48	31	0	7	26	44	25	29	173	221
% to Total Member-Banks		2.5	0.9	0.6	2.3	4.0	2.4	2.8		

^{a/} Includes Overseas Bank of Manila which was closed in 1968.

Sources: PDIC Annual Reports (various years).

on special credit programs of the government for their sources of funds and less on deposits. In contrast, commercial, savings and development banks have a branching network and a relatively larger deposit base; thus, their failures are usually felt by the banking community.

The failure of the Continental Bank on 25 June 1974, which ranked 19th in terms of assets and 26th in terms of deposits out of 40 commercial banks as of March 1974, was particularly disturbing since it precipitated a run on some medium-sized and small banks. As a result, large deposits moved into the branches of foreign banks while medium- and small deposits, to large private commercial banks and to the government-owned PNB. For instance, the deposit accounts of BPI more than doubled between March 1974 and June 1974 from 193,466 to 388,239, while PNB gained 175,456 new deposit accounts during the same period and another 261,944 between June 1974 and September 1974.

To prevent a systemic bank run, CB intervened by giving emergency loans to those that suffered liquidity problems and assuring the financial community that it would cover all problems of liquidity drain. Confidence in the banking system was restored within that year as may be seen from the 23 percent rise in deposits in nominal terms, although in real terms, it went down by six percent because of the 34 percent inflation rate mainly caused by the quadrupling in the price of oil (Table 9).

At the time of its closure, Continental Bank had 60,128 deposit accounts amounting to P121.2 million which was less than one percent of the total outstanding deposits of the financial system in 1974 (Table 10). PDIC paid a total of P28.8 million or 24 percent of the total outstanding deposits up to the time when Continental Bank resumed operation in 1977 under a new management who assumed all the assets and liabilities of the closed bank. The CB's advances to the closed bank were converted into a support fund which formed a major component of the rehabilitation package. The support fund accounted for about 46 percent of the total resources of the bank in 1977 and 39 percent in 1978 (Licuanan 1986).³

One medium-sized bank that was hit by a severe liquidity crisis at about the time when Continental Bank was closed by the CB was General Bank and Trust Company (Genbank). The timely intervention of the CB weathered the crisis of the bank; but this proved to be only temporary for in 1977, Genbank experienced another serious run. The CB found it insolvent and finally closed it on 25 March 1977.

3. The Central Bank support fund is separate from the PDIC payments. The latter were paid directly to insured deposits.

Table 9
TOTAL OUTSTANDING DEPOSITS OF THE FINANCIAL SYSTEM
1970-1987

Year	Nominal (P M)	b/ Real (P M)	Annual Percentage Change	
			Nominal %	Real %
1970	8,886	10,853	-	-
1971	10,693	11,442	20.34	5.44
1972	12,634	12,633	18.15	10.41
1973	17,452	14,774	38.14	16.95
1974	21,499	13,894	23.19	(5.96)
1975	27,571	16,450	28.24	18.40
1976	34,082	18,623	23.62	13.21
1977	42,834	21,795	25.68	17.03
1978	54,952	25,602	28.29	17.47
1979	70,180	28,375	27.71	10.83
1980	90,364	31,608	28.76	11.39
1981	100,132	31,567	10.81	(0.13)
1982	116,662	33,922	16.51	7.46
1983	140,049	36,466	20.05	7.50
1984	152,239	26,455	8.70	(27.45)
1985	166,278	24,442	9.22	(7.61)
1986 a/	144,122	20,984	(13.32)	(14.15)
1987 a/	153,954	20,748	6.82	(1.12)

a/
Data reflect the transfer of selected assets/liabilities
of DBP and PNB to the National Government.

b/
Deflated by the GNP deflator (1972 = 100).

Source: Central Bank.

Table 10
LARGE BANKS CLOSED BY THE MONETARY BOARD
OF THE CENTRAL BANK

Bank	Date of CB Takeover	No. of Deposit Accounts	Deposits (In million pesos)
a/ Overseas Bank of Manila	8-02-68	13,061	49.40
b/ Continental Bank	6-25-74	60,128	121.20
c/ General Bank and Trust Co.	3-25-77	157,977	199.60
d/ Royal Savings Bank, Inc.	7-06-84	302,580	350.70
Banco Filipino Savings & Mortgage Bank	1-25-85	2,413,000	897.00
Philippine Veterans Bank	4-10-85	no data	1,600.00 ^{e/}
Pacific Banking Corp.	7-05-85	no data	3,058.00 ^{f/}
PISO Development Bank	2-04-87	20,068	206.30
Manila Banking Corp.	5-25-87	633,614	1,905.20

a/

Resumed operation on January 8, 1981 under the name Commercial Bank of Manila.

b/

Resumed normal operation on May 31, 1977 under the name Allied Banking Corporation.

c/

Resumed normal operation on September 19, 1977 under the name International Corporate Bank.

d/

Resumed normal operation on September 11, 1984 under the name Commercial Savings Bank, a subsidiary of COMBANK (now renamed Boston Bank of the Philippines).

e/

Data pertain to end-1984. Note that P1.4B of the P1.6B deposits were government deposits.

f/

As of December 1984. In 1987, Far East Bank and Trust Co. (FEBTC) won the bid to operate Pacific Bank's 43 branches all over the country and, since then, has been servicing all depositors of the closed Pacific Bank.

Sources: PDIC Annual Reports and Central Bank.

At the date of its closure, Genbank had 157,977 deposit accounts amounting to about P200 million. This was less than one percent of the total deposits of the financial system in 1979. Three months later, Genbank was sold to a new group of investors who assumed all the assets and liabilities of the closed bank. The P310 million CB advances to Genbank formed part of the rehabilitation package. This accounted for roughly 112 percent of the total net worth of the Allied Bank, the new name of Genbank, in 1978. As already mentioned in the preceding section, CB's continued support to Allied Bank largely explains its rapid growth after being rehabilitated.

While the banking problems in the 1970s were brought about by sporadic failure of some banks, the banking problems in the 1980s were systemic. Between 1981 and 1987, the CB closed 173 banks, accounting for 78 percent of the total bank closures during the period 1970 to 1987. It must be noted that the ratio of bank failures to the total PDIC-member banks appears to be very low, with the highest ratio at four percent in 1985. However, this hides the true picture of the banking problems since it does not consider the extent of the CB and the national government's intervention in averting the crisis.

In the early part of 1981, Consolidated Bank and Trust Company (Solidbank) experienced a one-day run. Its heavy exposure to the failed Consolidated Mines, Inc. prompted depositors to withdraw their deposits from the bank. The timely CB intervention, certifying Solidbank's viability, saved the bank. However, a few days later, the financial system encountered a full-scale liquidity crisis precipitated by the Dewey Dee caper.⁴

Filmanbank which belonged to the Silverio Group of Companies suffered a continuing decline in its liquidity position. The bank had been granting unsecured loans which it could not collect. To prevent the bank from failing, PNB infused P200 million worth of equity, eventually taking control of the ownership and management of the bank.

Philfinance, a finance company also with the Silverio Group, suffered a liquidity crunch. This was aggravated by uncollected loans made mostly to several companies of the Silverio Group which at that time were also suffering from a market slump. Subsequent investigation showed that Philfinance violated certain regulations. In particular, it engaged in "kiting" and took in deposits from more than 19 investors.⁵ It was closed by the authorities in 1981.

Atrium Capital Corporation (Atrium), the largest investment house in the country with assets of P1.6 billion as of 1980, and Asia Pacific Capital Corporation (APCOR), a finance company, suffered similar fate. Both companies were affiliates of the Herdis Group of Companies. They

4. See next section.

5. "Kiting" means borrowing from the money market using three or four times the same commercial papers of reputable firms for different sets of investors.

were known to have lent huge sums to Dewey Dee and to their affiliates with funds mostly sourced from the money market. Although the placements were on a "without recourse" basis, Atrium honored the preterminations upon encouragement of the CB. To pay off its investors, it obtained an emergency loan from the CB to the tune of P800 million. The rehabilitation package imposed by the CB included a merger of Atrium, Apcor, and Interbank-- all of which were affiliates of the Herdis Group. Interbank, the surviving company, received P420 million capital infusion from DBP. Later on, the remaining 20 percent ownership share of the Herdis Group was acquired by National Development Corporation (NDC), a government-owned holding company, thus making Interbank a fully government-owned commercial bank.

Combank which was formerly the Overseas Bank of Manila and rehabilitated in the early part of 1981 under the aegis of the Herdis Group, encountered similar difficulties as the other financial institutions under that Group. In 1982, the Government Service Insurance System (GSIS) acquired majority ownership and control of the bank.

Bancom Development Corporation, the fourth largest investment house in the country with assets of P923 million as of 1980 was one of the biggest casualties of the 1981 liquidity crisis. And with it, the whole Bancom Group of Companies which included affiliates in other Asian countries was brought down. Bancom responded to the demand of its investors for payment of the money market placements by borrowing P400 million from the CB. It tried to regain its posture by merging with three other financial institutions of the Bancom Group and then converting it into a commercial bank to be named Union Bank of the Philippines (UBP). However, the resulting capital base was way below the P300 minimum capital requirement for a new commercial bank to obtain a license; so it invited LBP and the Social Security System (SSS) to provide the rest of the capital. LBP contributed 47 percent and SSS, 33 percent of the required capital. In addition, SSS deposited with UBP P500 million on a three-year basis (i.e., it can be withdrawn only after three years). A little later, it was found out that the liabilities of the Bancom companies absorbed by UBP exceeded their assets. The write-off practically dissipated the interest of the Bancom Group in UBP; thus, the government, through LBP and SSS, ended up owning UBP.

Associated Bank, a small private commercial bank with assets of P1.6 billion at the end of 1980, encountered a liquidity crisis in 1981. The government stepped in by providing the bank with assistance in the form of CB advances, paid-in capital and deposits of DBP which amounted to about P190 million. In the following year, DBP acquired Associated Bank for its inability to pay its debts to DBP.

The Philippine Veterans Bank (PVB), a government-owned commercial bank, also experienced a run in 1981. But the bank run was much milder compared to those experienced by other banks simply because government deposits comprised about 86 percent of its total deposits. It lost P5.1 million in its operation in 1981; the following year, the losses went up to P32.6

million. Although PVB had been encountering solvency problems since 1982 on account of substantial uncollectibles, nevertheless, it was allowed to continue operation.

The extent of the effect of the 1981 liquidity crisis on the financial system may be seen in Table 9. The annual nominal growth rate in deposits declined sharply in 1981 and 1982 to below 20 percent, whereas in the past 10 years, the annual growth rate had steadily been above 20 percent. In real terms, deposits shrank by 0.13 percent in 1981 despite the fact that inflation rate declined to 12.4 percent from the previous year's 17.6 percent.

The impact of the crisis on bank profitability is much more visible. For government banks, the return on capital precipitously declined from 7.2 percent in 1980 to five percent and 3.1 percent in 1981 and 1982, respectively, as they became more involved in holding non-performing assets. In the same manner, private commercial banks' profit rate went down from 14.8 percent in 1980 to 10.9 percent and 9.5 percent in 1981 and 1982, respectively. The narrowing in the profit margin of commercial banks could be attributed to two factors. First, there had been a substantial increase in loan delinquency from 13.4 percent of commercial banks' loan portfolios in 1981 to 14.8 percent in 1982 which was already close to the 15 percent critical ratio for any particular bank.⁶ Second, in response to the Dewey Dee scandal, banks became more conservative in their lending policy. More specifically, they lent only to prime borrowers.

After the painful effects of the 1981 liquidity crisis for two consecutive years, optimism began to rise in the first quarter of 1983, but only to be frustrated by the political and economic uncertainty precipitated by the assassination of Senator Benigno Aquino in August and the balance-of-payments crisis that struck towards the last quarter of that year. The banking problem that emerged was far worse than that during the 1981 liquidity crisis. Between 1983 and 1987, CB closed down a total of 131 member banks including six large banks.

On 29 June 1984, Royal Savings Bank (RSB), one of the leading thrift banks with 23 branches in Southern Tagalog closed shop without CB approval after losing P100 million in deposits in less than one month. CB officially closed it on 6 September 1984. The closure of RSB was significant for at least three reasons. First, RSB was operating in one of the richest areas in terms of deposits. At the time of its closure, RSB had 302,580 deposit accounts with deposits amounting to P350 million. Second, the owners of RSB were close to then President Marcos. And third, RSB was operating in the home province of then Prime Minister Cesar Virata who was also a member of the Monetary Board at that time. Depositors took the closure of RSB as a signal that the authorities mean business this time. This incident agitated the banking community in an atmosphere of general economic and political instability. Depositors thus, started moving their funds into safer and more liquid banks.

6. Delinquent or past due loans are those not paid upon maturity in case of lump sum payment or upon the designated schedule of payment in case of installment payment. They are immediately booked as past due loans a day after the maturity date. Delinquency or past due ratio is the ratio of past due loans to total loans outstanding.

A few days after CB closed RSB, Banco Filipino Savings and Mortgage Bank (BF), the second largest thrift bank in terms of assets with 83 branches/offices distributed all over the country, unilaterally declared a "bank holiday" when CB refused to grant assistance to stop the run it had been experiencing for the past few days. A little later, President Marcos ordered CB to provide BF with P3 billion emergency loan that nonetheless, failed to reverse the rapidly deteriorating financial situation of BF. Finally, CB closed it on 25 January 1985. At the time of its closure, BF had more than two million deposit accounts amounting to P897 million.

The next one to fall was the PVB which was closed by CB on 10 April 1985. The losses it incurred since 1981 kept piling up, resulting in a drastic decline in its assets to P2.1 billion in 1984 from P2.7 billion in 1981. The P60 million emergency loan provided by CB to PVB in 1983 failed to ease the bank's tightening finances. Its cumulative losses already reached P150 million in February 1985. At the time of its closure, PVB had deposits of P1.6 billion; however, 88 percent of it belonged to the government.

Pacific Banking Corporation, a medium-sized commercial bank with deposits of about P3 billion as of December 1984 was hit by heavy withdrawals in the early part of 1985. CB tried to save it by extending emergency advances amounting to P2.2 billion, but to no avail. Pacific Bank was closed on 5 August 1985.

The financial crisis prompted the government to provide additional assistance to its six acquired banks to keep them afloat. The huge amount of additional assistance indicates the magnitude of the problems these banks were encountering. For instance, government financial assistance to Associated Bank increased by 1,250 percent in 1984 while that to Union Bank increased by 466 percent after the government takeover. The nature of financial assistance to the six acquired banks as of December 1984 is indicated in Table 11.

Bank failures continued on to 1987 under the Aquino administration. PISO Development Bank, the largest privately-owned development bank in the country and one of the conduits of foreign currency loans from multilateral institutions such as the WB and the Asian Development Bank (ADB), lost heavily on its foreign currency loan of more than P500 million during the crisis when the value of peso fell sharply against the dollar. Then, in January 1987, it was hit by massive withdrawals for two consecutive weeks when it failed to clear its checking transactions with a commercial bank as required by the Monetary Board Resolution No. 131 which took effect on 19 January 1987. The CB assistance to PISO Bank failed to reverse its deteriorating financial condition. The bank was later found insolvent and closed by the CB on 4 February 1987. At the date of its closure, PISO Bank had 20,088 deposit accounts with a total value of P206 million.

Just three months after the closure of PISO Bank, a universal bank collapsed. This somehow shattered the view that size connotes stability. Manila Bank actually suffered from a bank run in 1984, rapidly depleting its deposits which stood at P4.1 billion at the end of 1983. CB continued

Table 11
FINANCIAL ASSISTANCE TO ACQUIRED BANKS
 (As of December 1984, in million pesos)

Bank	Total	Government Equity	Government Deposits	Parent Advances	Central Bank Advances
Associated	745.3	407.0	16	24.9	297.4
Commercial	747.8	322.0	97	174.0	154.8
Inter Bank	576.9	530.0	3	-	43.9
Pilipinas	2,149.3	240.0	92	150.4	1,666.9
Union	2,170.4	309.0	987	850.0	24.4

Source: GFI Study (October 1988).

propping up the Manila Bank until the latter's overdrafts with the CB swelled to P6.1 billion in May 1987. It eventually closed Manila Bank in that month. As of the date of its closure, Manila Bank had 633,614 deposit accounts valued at P1.9 billion.

The magnitude of the problems of private banks taken as a whole appears minuscule when compared to the problems experienced by DBP and PNB. It should be noted that these two government financial institutions were heavily involved in rescuing not only ailing financial institutions but also non-financial institutions since 1979 when several large corporations collapsed. The 1983-1984 balance-of-payments crisis further aggravated their already badly contaminated loan and investment portfolios.

DBP used to be the second largest financial institution in the country. Between 1980 and 1984, its total assets more than doubled from P27 billion to P67 billion (Table 12). Its lending activities mainly financed by time and savings deposits, were largely sourced from the national government and government-owned corporations such as SSS, and long-term borrowings. The proportion of foreign borrowings to total long-term borrowings markedly increased during the 1983-1984 balance-of-payment crisis as a result of the sharp devaluation of the peso *vis-a-vis* the dollar. DBP's problems became more pronounced in 1984 when it suffered a substantial loss of P6.6 billion; the huge losses piled up to P17.9 billion at the end of three years. In 1986, DBP underwent a rehabilitation program which involves the transfer of its non-performing assets totalling P61.4 billion and certain liabilities and related accounts amounting to P62.2 billion to the national government. This resulted in the drastic reduction in DBP's total assets to P9.5 billion in 1986 from a high P72.0 billion in 1985.

PNB has been the largest commercial bank in the country. Just like DBP, its assets more than doubled during the period 1980 to 1984 from P38.6 billion to P87.2 billion (Table 13). It mobilizes deposits from the private sector; however, its reliance on deposits from the national government and semi-government agencies has been fairly high. PNB's vast branching network throughout the country enables it to act as the government's main depository financial institution. Before the new management took over in 1986, PNB also relied heavily on borrowings from the CB to sustain its operations.

PNB lost heavily during the period 1984 to 1986, with cumulative losses amounting to P11.8 billion. In 1986, the new management launched a rehabilitation program for the bank. Transferred to the national government were P47 billion worth of non-performing assets and P55.4 billion worth of liabilities. It had written-off P5.2 billion and booked P0.9 billion as additional valuation reserve. Under the new Charter, the authorized capital of PNB was reduced from P25 billion to P10 billion, P2.5 billion of which was subscribed by the national government. With the rehabilitation program, PNB's total assets were sharply pared down to P27 billion in 1986 from P76 billion in 1985.

Table 12
SELECTED FINANCIAL STATISTICS OF DBP
 (in million pesos)

	1980	1981	1982	1983	1984	1985	1986	1987
Resources								
Total Assets	27,086.2	34,706.8	43,988.5	54,934.0	66,800.2	72,043.0	9,503.6	10,531.8
Loans	15,933.8	18,516.5	22,875.4	30,919.7	35,827.6	24,758.0	5,271.1	4,384.5
Time and Savings Deposits	4,603.9	6,627.6	7,068.5	4,672.3	978.3	1,518.0	561.5	531.8
Long-term Borrowings								
Foreign	6,333.8	7,635.2	11,459.3	18,860.9	28,653.2	32,285.9		
Domestic	8,242.7	10,016.1	11,871.1	14,175.7	14,854.6	12,704.6	2,025.7	1,340.0
Equity	4,060.1	4,534.8	5,305.9	5,427.7	4,422.5	4,470.8	2,878.2	3,460.8
Income and Expenses								
Earnings	2,873.7	3,419.7	4,368.6	5,369.8	2,448.0	3,140.2	2,138.5	1,777.2
Expenses ^{a/}	2,435.7	3,315.9	4,288.0	5,272.0	8,907.5 ^{b/}	8,776.7	8,776.4	965.4
Net Profit (Loss)	223.1	103.7	117.3	110.2	(6,640.8)	(5,636.5)	(5,636.2)	762.6

a/
 Net of taxes

b/

P5.48 billion was funded by the National Government.

Sources: DBP Annual Reports (various years).

Table 13
SELECTED FINANCIAL STATISTICS OF PNB
(in million pesos)

	1980	1981	1982	1983	1984	1985	1986	1987	1988
Resources									
Total Assets	38,652.1	44,866.3	58,709.8	70,502.3	87,196.1	76,156.9	26,913.2	31,267.6	38,758.1
Loans and Discounts	24,419.7	27,410.3	32,894.4	44,502.3	47,893.5	35,319.1	8,668.2	12,406.4	15,124.7
Deposits Outstanding									
Government	4,953.8	6,465.0	6,280.0	11,382.7	6,589.6	5,408.7	4,470.8	6,698.2	7,968.7
Semi-Government	1,708.2	1,604.3	2,624.5	2,624.7	3,435.6	5,518.1	796.1	1,233.2	1,346.4
Private	13,069.4	10,935.4	11,375.0	11,128.6	10,178.9	12,512.9	11,590.6	10,998.8	16,637.5
Total	19,731.4	19,004.7	20,279.5	25,136.0	20,204.1	23,439.7	16,857.5	18,930.2	25,952.6
Bills Payable									
Central Bank Borrowings	2,552.9	4,059.9	4,139.7	1,881.9	11,142.5	9,940.7	11.6	0.0	4.2
Equity	2,289.0	2,868.8	3,332.1	4,016.6	6,935.8	1,253.7	2,539.5	3,550.0	5,009.3
Earnings and Expenses									
Earnings	3,310.3	5,655.6	6,586.4	7,738.3	9,170.8	5,176.1	3,941.2	3,398.1	4,998.3
Expenses	3,099.3	5,425.4	6,427.8	7,503.6	10,272.2	12,393.4	7,511.3	2,387.6	3,151.0
Net Profit (Loss)	211.0	230.1	158.6	234.7	(1,102.4)	(7,217.3)	(3,570.2)	1,010.5	1,847.3

Sources: PNB Annual Reports (various years).

The extent of the problems of the rural banking system deserves some comments. By year-end of 1986, only 880 remained in operation, down from a peak of 1,046 in 1982. Of these remaining rural banks, 80 percent had rediscounting arrearages with the CB totalling about P3.6 billion; 72 percent had portfolios with over 25 percent of loans already past due; 36 percent had operations in the red; 47 percent had deficiencies in their legal reserve requirements; and 13 percent had negative capital networth and by law should have already been closed. Only 232 rural banks were actually performing well.

The extent of the problem of the entire financial system since the 1983-1984 balance-of-payments crisis may be seen in Table 9. The nominal growth rate of deposits of the financial system plunged to less than 10 percent starting in 1984 and even became negative in 1986. In real terms, deposits shrank by substantial amounts during the period 1984 to 1987, indicating severe disintermediation taking place in the system.

It is to be noted that during the 1983-1984 balance-of-payments crisis, government financial institutions were not called upon anymore to help ailing banks for two reasons. First, the government had already acquired six banks during the 1981 liquidity crisis that continued to suck more government resources in the subsequent years. Second, PNB and DBP found themselves in acute financial difficulty during the 1983-1984 balance-of-payments crisis. Thus, the task of helping ailing financial institutions during this crisis could not be delegated to them.

The extent of CB's assistance to financial institutions is shown in Table 14. It had been rising since the third quarter of 1983 and reached a peak during the first quarter of 1986, the most turbulent quarter ever experienced by the financial system. Shortly after the presidential election in February 1986, the opposition which contested the results of the election urged depositors to withdraw their deposits from banks owned by cronies and close allies of Marcos. By the same token, when the new government took over in the same month, cronies and political allies of Marcos withdrew their deposits from banks for fear of sequestration.

CB appears to be responsive to bank runs. For instance, when a bank run, triggered by the unilateral closure of Royal Savings Bank and Banco Filipino occurred in the third quarter of 1984, CB increased by threefold its assistance to financial institutions to prevent the bank run from developing into a major crisis. Again, during the first and second quarter of 1987 when the PISO Bank and Manila Bank were closed, CB increased its assistance to financial institutions, thus reversing the declining trend in the level of CB assistance to financial institutions established in the immediate past four quarters.

Between 1984 and 1986, the loan portfolio of the financial system shrank both in nominal and real terms (Table 15). The economic and political instability during this period made banks very conservative in their lending activities. They took in highly liquid position by investing in short-term CB and Treasury Bills. With this position, the profit rates of banks had remained low.

Table 14
RESERVE MONEY AND CENTRAL BANK ASSISTANCE TO
FINANCIAL INSTITUTIONS
(in billion pesos)

Period Year (Quarter)	Reserve Money (1)	Assistance to Financial Institutions (2)	(2)/(1) (in %)
1983 (II)	16.1	-	-
1983 (III)	17.6	0.1	0.5
1983 (IV)	27.7	1.2	4.3
1984 (I)	24.8	1.9	7.7
1984 (II)	27.1	3.2	11.8
1984 (III)	28.7	9.4	32.8
1984 (IV)	33.4	10.9	32.6
1985 (I)	30.5	12.2	40.0
1985 (II)	31.6	12.5	39.6
1985 (III)	32.6	13.3	40.8
1985 (IV)	38.0	13.8	36.3
1986 (I)	40.4	19.1	47.3
1986 (II)	38.0	13.9	36.6
1986 (III)	39.5	13.8	34.9
1986 (IV)	50.0	12.7	25.4
1987 (I)	48.1	14.3	29.7
1987 (II)	49.0	15.5	31.6
1987 (III)	49.7	15.4	31.0
1987 (IV)	56.9	15.4	27.1
1988 (I)	53.8	15.3	28.4
1988 (II)	53.4	15.1	28.3

Note: Central Bank's assistance to financial institutions includes emergency loans and overdrafts.

Source: Central Bank, Quarterly Economic and Financial Report.
(Various quarters).

Table 15
TOTAL LOANS OUTSTANDING OF THE FORMAL FINANCIAL
SYSTEM, 1970-1987 ^{a/}

Year	Nominal (P M)	Real (1972=100) (P M)	Annual Percentage Change	
			Nominal %	Real %
1970	13513.1	16504.0		
1971	16023.2	17147.2	18.58	3.90
1972	18490.3	18490.3	15.40	7.83
1973	23235.3	19671.7	25.66	6.39
1974	33527.0	21668.5	44.29	10.15
1975	43665.3	26054.6	30.24	20.24
1976	52643.0	28767.3	20.56	10.41
1977	63197.3	32157.6	20.05	11.79
1978	80986.3	37733.1	28.15	17.34
1979	103524.0	41858.4	27.83	10.93
1980	124936.0	43701.5	20.68	4.40
1981	148470.5	46806.9	18.84	7.11
1982	167236.7	48629.7	12.64	3.89
1983	219617.1	57184.7	31.32	17.59
1984	214327.2	37437.4	(2.41)	(34.53)
1985	188366.1	27965.7	(12.11)	(25.30)
1986	184895.0	26921.2	(1.84)	(3.74)
1987	203344.0	27406.1	9.98	1.80

a/

Loans include items in litigation and past due.

Source: Central Bank.

Table 16
SAVINGS AND INVESTMENT
(in % of GNP)

Year	Investment	Domestic Savings	Foreign Savings
1971	21.1	19.2	1.9
1972	20.8	19.0	1.8
1973	21.6	24.9	-3.3
1974	26.8	20.0	2.8
1975	31.2	24.1	7.1
1976	30.9	23.5	7.4
1977	29.5	25.2	4.3
1978	29.5	23.5	6.0
1979	31.2	25.9	5.3
1980	30.7	24.8	5.9
1981	30.7	24.7	6.0
1982	28.9	20.7	8.2
1983	26.9	19.5	7.4

Source: Remolona et al. (1985).

For private commercial banks, the average rate of return on capital went down further to 8.8 percent in 1983 from 9.5 percent in 1982, and hovered around 10 percent for the next three years. The extraordinarily high rates on CB and Treasury Bills prevented their profit rates from further falling down during this period. Meanwhile, profit rates of government-owned banks had been severely negative between 1984 and 1986.

V. CAUSES OF THE PROBLEMS OF THE FINANCIAL SYSTEM

This section examines the causes of the financial system's problems. It is important to sort out causes which are external to or beyond the control of financial institutions (i.e., sudden changes in overall economic and regulatory environment) and those internal to financial institutions (i.e., poor management and fraud).

The seeds of the present problems of the financial system were actually planted in the 1970s; thus, our analysis of the causes of the financial system's problems starts with the 1970s.

The Philippines entered the decade of the 1970s fresh from the balance-of-payments crisis that erupted towards the latter part of the 1960s. In fact, the peso was devalued in February 1970 from P2 to P3.9 per dollar. Despite two major oil shocks--one in 1973 and the other one in 1979 --the Philippines achieved a remarkable growth rate, averaging 6.4 percent during the period 1971 - 1980. Real income per capita was consistently rising from P1,353 in 1970 to P1,915 in 1980. Investment expenditures posted a yearly increase of about 10 percent. But one has to look closely at how the high growth in the 1970s was attained. Table 16 shows that investment ratio had been rising quite rapidly from 21 percent in 1971 to 31 percent in 1980; however, domestic savings did not keep pace with the growth in investment. The gap was, therefore, filled up by foreign borrowings; thus, growth in 1970s can be largely described as a debt-driven one.

The international financial environment was at that time on the Philippines' side. Foreign commercial banks, awashed with "petro" dollars, were recycling them by dramatically increasing their lending to the Third World. The Philippines did not let this opportunity pass as may be seen from Table 17. In particular, changes in external debt outstanding were very high between 1975 and 1980. Despite the huge current account deficits which increased 11 times from 1971-1975 and from 1976-1980, the government neglected the required adjustment in the exchange rate which had been appreciating most of the time during that period (Table 18) because of the easy access to external financing.

In the face of an appreciating exchange rate, the real lending rate had been negative most of the time during the 1973-1980 period.⁷ This has a serious implication on resource allocation.

7. The ceiling on the nominal lending rate was still in force during this period.

Table 17
NET FLOW AND NET TRANSFER, 1970-1986
(in US\$ M)

Year	Change in External Debt Outstanding a/	Interest Payments b/	Net Transfer
1970	470	116	354
1971	90	91	-1
1972	340	115	225
1973	160	119	41
1974	870	146	724
1975	1180	223	957
1976	1830	246	1584
1977	1300	236	1064
1978	2620	439	2181
1979	2660	625	2035
1980	3900	975	2925
1981	3640	1378	2262
1982	3790	1993	1797
1983	140	1988	-1848
1984	600	2328	-1728
1985	830	2219	-1389
1986	2010	2048	-38
Total	26430	15285	11145

a/
Including gross external liabilities of the
banking system.

b/
Investment income debits other than earnings on
direct investment.

Sources: Balance of Payments Statistics Yearbook, various issues

Table 18
 REAL EFFECTIVE EXCHANGE RATE, REAL INTEREST RATES
 ON DEPOSITS, REAL LENDING RATES, AND INFLATION RATES
 (in %)

Year	Real Effective Exchange Rate-Index a/ (1973 = 100)	Lending b/ Rate	Interest Rates on Deposits		Inflation Rate
			Savings Deposits	Time Deposits c/	
1973	100.00	(4.5)	(10.5)	(9.5)	16.5
1974	83.69	(22.2)	(28.2)	(24.7)	34.2
1975	92.17	(5.2)	(0.8)	2.7	6.8
1976	95.64	(2.8)	(2.2)	0.8	9.2
1977	98.04	2.1	(2.9)	0.1	9.9
1978	105.32	4.7	(0.3)	2.7	7.3
1979	93.72	(2.5)	(7.5)	(4.5)	16.5
1980	88.10	(3.6)	(8.6)	(3.6)	17.6
1981	85.91	4.7	(2.6)	3.2	12.4
1982	83.13	8.0	(0.4)	4.0	10.2
1983	102.36	9.2	(0.5)	4.2	10.2
1984	100.03	(23.2)	(38.8)	(17.9)	50.4
1985	88.37	5.1	(12.3)	(1.3)	23.1
1986	112.03	16.6	7.2	14.0	0.8
1987	118.81	9.5	0.7	6.0	3.8
1988	122.54	6.9	(5.0)	4.1	9.1

a/ An increase means a move towards a more competitive exchange rate.

b/ Based on the secured loans of commercial banks.

c/ Weighted average for transacted rates.

Sources: Lamberte et al (1989) and Central Bank.

Table 19
 TERM STRUCTURE OF EXTERNAL DEBT, 1970-1986
 (Distribution in %)

Year	Medium and Long-term ^{a/}	Short-term ^{b/}	Monetary Sector ^{c/}
1970	65	13	21
1971	64	13	23
1972	61	11	28
1973	60	10	30
1974	55	9	36
1975	53	9	38
1976	60	11	30
1977	65	12	23
1978	58	12	31
1979	53	14	33
1980	50	15	36
1981	47	18	35
1982	45	18	37
1983	50	16	33
1984	51	17	32
1985	52	14	34
1986	55	10	35

a/ Debt with maturities of one year or more.

b/ Debt with maturities of less than one year.

c/ Gross external liabilities of the banking system
 (Central Bank and commercial banks).

Source: Central Bank.

The 1979 oil shock was more disturbing to the domestic economy than the 1973 oil shock because it was followed by a prolonged recession in the Organisation for Economic Co-operation and Development (OECD) countries and a sharp rise in real interest rates in the international markets. The government launched stabilization measures by obtaining more foreign loans; thus, external debt expanded more rapidly from 1979 to 1982. However, there was a remarkable shift in the term structure of external debt. The share of short-term non-monetary debt and gross monetary sector liabilities in the total outstanding external debt rose from 35 percent in 1977 to 55 percent in 1982 (Table 19). An increasing proportion of this short-term external debt was used to replace maturing longer-term debts and to finance working capital requirement. The sudden acceleration of short-term external debt was indeed a sign of the deteriorating creditworthiness of the country.

As external debt mounted, the share of the public sector in total external debt increased tremendously. The figures in Table 20 could have understated the public sector's share since a significant proportion of private sector external debt was guaranteed by government financial institutions. A WB study (1984) reported that the share of private medium and long-term debt which was publicly guaranteed was 34 percent in 1975; it fell to 20 percent in 1980, and then rose to 29 percent in 1982. Interestingly, many of the projects that received foreign loans guaranteed by the national government and government financial institutions failed, and the government eventually took over them. Tables 21 and 22 show the magnitude of publicly-guaranteed foreign loans assumed by the national government and CB under the first and second round Paris Club debt rescheduling programs.

What is more disturbing insofar as the financial system is concerned is that a substantial fraction of foreign borrowing appears to have financed capital flight from the Philippines (Boyce 1988). Montes (1987) estimated that the capital flight from 1970 to 1982 was about 38 percent of the total foreign debt outstanding in 1983.

The 1970s witnessed the sudden rise of conglomerates whose interests include trading, manufacturing, mining and services. Examples are Construction and Development Corporation of the Philippines (CDCP), Delta Motor Corporation (DMC), Herdis Group of Companies (HGC), and others. The prevailing mood at that time was instant bigness and instant profit. In achieving these goals, the new corporate giants abandoned the traditional method of growing followed by old corporate giants such as San Miguel Corporation (SMC), Ayala Corporation, and others, by highly leveraging themselves. For instance, CDCP had a debt to equity ratio of 6-to-1 and DMC, 12-to-1 (*Business Day* 1983). This is actually a formula for disaster. The extent of the dependence of the various sectors of the economy on debt is shown in Table 23. As pointed out earlier, the appreciating exchange rate brought about by foreign borrowings and negative real lending rates could have led to serious misallocation of resources.

Table 20
EXTERNAL DEBT OF THE PHILIPPINES, 1970-1986
(in US\$ million)

Year	Total Outstanding ^{a/}	Borrowing Sector	
		Public	Private
1970	2.30	1.10	1.20
1971	2.39	0.92	1.47
1972	2.73	1.11	1.62
1973	2.89	1.15	1.74
1974	3.76	1.57	2.19
1975	4.94	2.33	2.61
1976	6.77	3.52	3.25
1977	8.07	4.03	4.04
1978	10.69	5.69	5.00
1979	13.35	7.65	5.70
1980	17.25	10.25	7.00
1981	20.89	12.80	8.09
1982	24.68	15.43	9.25
1983	24.82	16.73	8.09
1984	25.42	17.55	7.87
1985	26.25	19.12	7.13
1986	28.26	21.83	6.43

^{a/}

End-of-year estimates of external debt outstanding
including gross banking system liabilities

Source: Central Bank.

Table 21
**OUTSTANDING BALANCE OF FIRST ROUND PARIS CLUB
 RESCHEDULED DEBT**
 As of December 31, 1988
 (in US\$ Equivalent)

Particulars	Amount
Grand Total	974,418,905.05
I. Republic of the Philippines as Assuming Obligor	790,535,260.22
A. Public Loans	537,908,482.09
1. Direct RP Loans	232,364,151.74
a. Loans Utilized by Government Agencies	161,470,550.17
1. United States Agency for International Dev't. (USAID)	2,355,868.71
2. Overseas Economic Cooperation Fund (OECF)	30,360,950.26
3. Loans Under PL 480	9,696,309.91
4. Export-Import Bank Loans (Japan Eximbank)	36,146,305.20
5. Belgian Loans	139,869.20
6. German Loans (KFW)	513,031.35
7. Japanese Loans (MITI)	14,656,725.03
8. Other Loans	67,601,490.50
b. Loans Relent to Government Corporations	70,893,601.57
1. United States Agency for International Dev't. (USAID)	6,233,427.42
2. Overseas Economic Cooperation Fund (OECF)	58,592,536.09
3. Export-Import Bank Loans (US EXIMBANK)	3,105,189.87
4. Belgian Loans	250,580.00
5. German Loans (KFW)	1,327,876.76
6. Other Loans	1,383,991.43
2. RP-Guaranteed Gov't. Corporate Loans	296,699,505.31
1. United States Agency for International Dev't. (USAID)	798,604.75
2. German Loans (KFM)	6,317,100.92
3. Export-Import Bank Loans	121,878,526.70
4. Japanese Loans (MITI)	93,669,442.53
5. Other Loans	74,035,830.42
3. Other RP-Guaranteed Gov't. Corporate Loans	8,844,825.04

(con't. of Table 21)

Particulars	Amount
B. Other Publicly Guaranteed Loans	238,832,836.12
1. DBP Guaranteed	110,222,093.52
2. NDC Guaranteed	7,639,843.48
3. NIDC Guaranteed	2,861,586.37
4. PDCP Guaranteed	2,394,756.09
5. PHILGUARANTEE Guaranteed	10,013,188.92
6. PNB Guaranteed	77,499,441.16
7. Others (Original Obligor)	26,757,873.03
C. Private Loans	13,793,942.01
II. Central Bank of the Philippines as Assuming Obligor	183,883,644.83
A. Public Loans	76,009,185.99
1. Direct RP Loans	5,519,831.96
a. Loans Utilized by Government Agencies	545,867.91
1. Denmark Loan	61,547.82
2. Other Loans	484,320.09
b. Loans Relent to Government Corporations	4,973,964.04
1. Denmark Loan	4,037,277.50
2. Other Loans	936,686.55
2. RP-Guaranteed Gov't. Corporate Loans	70,489,354.03
1. Other Loans	70,489,354.03
B. Other Publicly-Guaranteed Loans	103,893,571.74
1. DBP Guaranteed	39,529,885.19
2. NIDC Guaranteed	6,283,601.17
3. PHILGUARANTEE Guaranteed	1,517,819.34
4. PNB Guaranteed	4,401,249.12
5. Others (Original Obligor)	52,161,016.92
C. Private Loans	3,980,887.09

Source: Bureau of the Treasury.

Table 22
**OUTSTANDING BALANCE OF SECOND ROUND PARIS CLUB
 RESCHEDULED DEBT**
 As of December 31, 1988
 (in US\$ Equivalent)

Particulars	Amount
Grand Total	1,037,837,019.76
I. Republic of the Philippines as Assuming Obligor	984,292,874.11
A. Public Loans	722,769,594.23
1. Direct RP Loans	257,937,150.20
a. Loans Utilized by Government Agencies	144,940,651.46
1. United States Agency for International Dev't. (USAID)	3,943,493.79
2. Overseas Economic Cooperation Fund (OECF)	35,463,666.12
3. Loans Under PL 480	9,535,163.56
4. Export-Import Bank Loans	9,710,122.81
5. Belgian Loans	134,026.80
6. German Loans (KFW)	523,880.38
7. Japanese Loans (MITI)	25,323,822.78
8. Denmark Loans	64,135.36
9. Other Loans	60,242,339.86
b. Loans Relent to Government Corporations	112,996,498.74
1. United States Agency for International Dev't. (USAID)	9,430,787.02
2. Overseas Economic Cooperation Fund (OECF)	71,942,169.15
3. Export-Import Bank Loans	1,483,600.00
4. Belgian Loans	349,070.00
5. German Loans (KFW)	1,484,747.88
6. Denmark Loans	1,144,138.64
7. Other Loans	27,161,986.05
2. RP-Guaranteed Gov't. Corporate Loans	456,159,223.05
1. United States Agency for International Dev't. (USAID)	829,105.87
2. German Loans (KFM)	6,471,541.96
3. Export-Import Bank Loans	124,614,585.03
4. Japanese Loans (MITI)	84,581,884.66
5. Other Loans	239,662,105.53

(con't. of Table 22)

Particulars	Amount
3. Other RP-Guaranteed Gov't. Corporate Loans	8,673,220.98
1. Other Loans	8,673,220.98
B. Other Publicly Guaranteed Loans	261,523,279.88
1. DBP Guaranteed	194,073,896.65
2. NDC Guaranteed	7,344,708.60
3. NIDC Guaranteed	742,047.41
4. PHILGUARANTEE Guaranteed	10,392,061.31
5. PNB Guaranteed	25,939,243.34
6. Others (Original Obligor)	23,031,322.57
II. Central Bank of the Philippines as Assuming Obligor	53,544,145.65
A. Public Loans	471,375.80
1. Direct RP Loans	150,723.44
a. Loans Utilized by Government Agencies	150,723.44
1. Other Loans	150,723.44
2. RP-Guaranteed Gov't. Corporate Loans	320,652.36
1. Other Loans	320,652.36
3. Other Publicly-Guaranteed Loans	53,072,769.84
1. Others (Original Obligor)	53,072,769.84

Source: Bureau of Treasury.

Table 23
DEBT EQUITY RATIO

Earlier Industry Classification	Year											Present Industry Classification			
	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980		1981	1982	1983
Agriculture	1.91	2.45	2.69	2.48	2.19	1.61	2.04	1.62	2.02	Agric. Fish & Forestry	1.75	2.07	2.4	2.15	4.18
Manufacturing	1.56	1.67	1.80	1.69	2.44	1.77	1.82	1.98	2.16	Manufacturing	2.17	2.51	2.17	2.13	2.43
Mining	0.59	0.48	0.53	0.66	0.82	1.02	1.19	1.42	1.59	Mining & Quarrying	0.88	1.14	2.09	3.47	4.26
Services	1.20	1.53	1.53	1.3	1.69	1.94	1.3	1.98	2.04	Construction	3.00	2.98	3.49	4.15	2.4
Utilities	2.54	2.64	2.86	2.47	2.25	2.09	2.31	2.27	1.97	Elec., Gas & Water	1.21	0.97	1.32	1.42	1.97
Commercial	1.96	1.97	1.96	2.05	2.42	2.50	3.54	2.41	2.38	Transpo, Stor & Commn	2.47	2.75	3.16	3.69	6.5
Unclassified	1.90	1.90	0.40	0.47						Wsale & Retail Trade	3.04	3.5	3.92	3.97	3.78
										Comm, Soc, & Per Serv.	2.26	1.56	1.67	1.78	1.12
										Fin, Ins, REst & Bus Serv.	8.16	0.32	10.46	9.86	10.3
All	1.56	1.64	1.72	1.61	2.05	1.77	1.94	1.99	2.09	All	3.64	3.96	4.65	4.56	5.83

Sources: Top 1000 Corporations, Business Day, various issues.

The supply of finance had not kept pace with the demand during the 1970s. For instance, Roxas (1976) estimated that, by the end of 1974, commercial banks were able to supply only 67 percent of the credit requirements of the top 1,000 corporations. One of the reasons for this was that the Philippine financial market was severely repressed. The ceilings on the interest rates had constrained banks to tap the savings potential of the country. As shown in Table 18, the real interest rate on savings deposits had been negative in all the years between 1973 and 1980, while that on time deposits was positive for only two years. Non-bank financial institutions, like investment houses, tried to pick up the slack by developing the money market. They started buying and selling short-dated instruments of prime corporate names, and since they were unregulated, the debt instruments carried interest rates much higher than those of traditional deposits, thereby causing a portfolio shift on the part of large surplus units. Soon after, commercial banks also started their own money desks. Since the supply of prime commercial papers was very thin, most financial institutions which were borrowing from the money market engaged themselves in lending. More specifically, investment houses which were given exclusive authority to engage in underwriting business reduced their exposure in investment, and instead significantly increased their lending activity (Licuanan 1986). The increasing loan portfolio of investment houses was financed by buying funds from the money market. For instance, the money market supplied an average of 76 percent of investment houses' resources between 1977 and 1982. Finance companies with quasi-banking functions followed the same trend established by investment houses in their asset composition and sources of funds. The mismatch in the tenor between loans and sources of funds of investment houses and finance companies and even some banks became more pronounced over the years.

The sudden emergence and rapid growth of highly-leveraged corporate giants in the 1970s was partly aided by the growth of the money market. Firms which were turned down by commercial banks because they were either considered highly risky or that they had already exhausted the single borrower limit as per CB regulation, turned to investment houses and finance companies for credit. Thus, financial institutions had been carrying loan portfolio that had become riskier over the years. They should have been perceived by investors as risky issuers of money market instruments. This was not the case, however.

In 1976, CB imposed a uniform ceiling on all money market instruments. Interest rate could not be used anymore by investors as a signal of the degree of riskiness of the issuers of money market instruments. Investors at that time were also not sophisticated enough to know the difference between sales of instruments on a with and without recourse basis. They viewed investing in money market instruments as something similar to depositing money in a bank which can be withdrawn anytime they wish. Furthermore, there was no public credit rating agency in the Philippines; hence, the prime and risky borrowers were lumped together.

Some newly-emerging corporate giants saw the need to acquire financial institutions in making their strategic leaps. One example was the Herdis Group. To meet its financing needs, it acquired a savings bank, an insurance firm, an investment house (Atrium), a finance company (Apcor), a leasing company, and a commercial bank (Interbank). Not yet contented, it still acquired, through its investment house, another commercial bank (i.e., the inactive Overseas Bank of Manila which was renamed Commercial Bank of Manila). These financial institutions largely depended on funds bought from the money market.⁸ Aside from lending to their own affiliates, Atrium and Apcor were known to have lent large amounts to and underwritten several commercial papers of Dewey Dee's Continental Manufacturing Corporation.

Another example is the Silverio Group. It acquired Filmanbank, a commercial bank, and Philfinance, a finance company. Philfinance was actively involved in the money market to finance other subsidiaries of the Silverio Group.

Government financial institutions also provided fuel to the rapidly-growing corporate giants. They either directly gave huge loans or granted quite liberal guarantees to foreign loans contracted by private corporations. Foreign banks which were busy recycling "petro" dollars granted loans to Philippine corporations on the strength of guarantees provided by government financial institutions without even looking at the viability of projects being financed. Thus, the usual prudent practice of granting loans was even dispensed with by foreign creditors because of government guarantees.

Government exposure in the form of equity, loans and guarantees to corporate giants was not inconsequential. DBP alone had an exposure of over P7 billion in 122 companies as of 1981 (*Business Day* 1983). Government financial institutions' exposure to CDCP which had a paid-in capital of P1.2 billion as of 1981 amounted to P3.9 billion.

Looking back, it can be said that the financial system was sitting on an active economic volcano that could erupt any time. Foreign debt was increasing rapidly; the fast growing conglomerates were highly leveraged; and a mismatch in the tenor between assets and liabilities of financial institutions which were very active in the money market was pervasive. Indeed, the problem first erupted in 1979 when the economy was struck by the second oil shock which resulted in a prolonged deceleration in economic growth. A number of corporate giants started to fail in a domino-like fashion. Thinking that the market slump was only temporary, the government adopted a "countercyclical policy" which included taking over ailing corporations to

8. The Central Bank started to publish data on money market in 1976. The volume of money market was P190.4 billion in 1976, rising to P462.8 billion in 1982. Since then, it declined due partly to the stringent regulations imposed by regulatory authorities in response to the Dewey Dee caper and partly to the interest rate deregulation which started in 1981. At present, the volume of money market transactions ranges between P30 to P40 billion.

be rehabilitated and then sold as soon as the economy improves. Since the government tax effort was considerably low, and in fact, was declining since 1979 (Table 16), the "countercyclical policy" resulted in huge budget deficits (Table 24).

The mounting government budget deficits were financed through borrowings from the CB and foreign loans. Thus, net credit of the CB to the national government almost quadrupled between 1979 and 1982 (Table 3). As regards foreign loans, the notable shift towards short-term borrowing was accompanied by a more pronounced dependence on commercial bank, variable interest and accommodation starting in the early part of 1980.

The effort of the government to contain the effects of the 1979 oil shock and the recession in OECD countries that stirred the domestic economy seemed to have worked. In particular, confidence in the financial system remained high despite its inherent weaknesses, as described above, and the growing number of ailing corporations. But this proved to be short-lived. While the government was busy cleaning up the mess created by a number of distressed corporations, a liquidity crisis precipitated by the Dewey Dee caper struck in 1981. Worse, it occurred at the time when the economy started to absorb the impact of the 1979 oil shock.

Dee was a prominent businessman who left the country on 9 January 1981, leaving behind unpaid debts of about P635 million, mostly to 16 commercial banks, three offshore banking units and 11 investment houses. When news of his departure broke out, investors in the money market and bank depositors started withdrawing their funds. Commercial banks, investment houses and finance companies which depended heavily on the money market were hardest hit by the massive wave of preterminations.⁹ The CB and government financial institutions (i.e., DBP, PNB, LBP, SSS, and the GSIS) were involved in the massive rescue operation--an unprecedented move in Philippine banking to restore confidence in the banking system.

The Dewey Dee caper did not cause the liquidity crisis. It merely provided the spark that ignited the crisis. There were already a number of distressed corporations since the market started to slump in 1979, but were kept alive by rolling over their short-term money market loans. Interestingly, they were able to hold financial institutions by the neck. If their loans were not rolled over, then they would declare a default which could precipitate a run on those lending institutions that had large exposure to them. It is to be noted that most of the ailing firms were those that rapidly grew in the 1970s by highly leveraging themselves. The 1981 liquidity crisis that shook the people's confidence in the financial system finally caught up with them. A massive wave of preterminations ensued, and financial institutions could not collect from these firms simply because their loans had turned sour.

9. That is, investors recalled their money market placements before maturity date. Before the liquidity crisis, there was no clear regulation regarding pretermination. Depositors were even allowed to withdraw their time deposits before maturity date.

Table 24
EFFECT ON THE BUDGET DEFICIT OF CONTRIBUTION TO
GOVERNMENT CORPORATIONS

Year	Budget Deficit (P M)	Total Contribution to Government Corporations a/ (P M)	Contribution to PDIC, DBP and PNB b/ (P M)	Hypothetical Budget Surplus (Deficit) without Contribution	
				Level (P M)	As % of GNP
1975	1,403	807	n.a.	(596)	(0.5)
1976	2,349	2,196	799	(153)	(0.1)
1977	2,852	2,498	737	(354)	(0.2)
1978	2,167	2,877	212	710	0.4
1979	342	3,869	171	3,527	1.6
1980	3,397	5,371	205	1,974	0.8
1981	12,145	9,334	1,322	(2811)	(0.9)
1982	14,405	12,183	1,258	(2222)	(0.7)
1983	7,431	8,715	202	1,284	0.3
1984	9,828	14,581	6,820	4,763	0.9
1985	11,187	16,791	10,471	5,604	0.9
1986	30,593	27,484	21,240	(3109)	(0.5)
1987	17,745	11,638	n.a.	(6107)	(0.9)
1988	20,272	7,738	n.a.	(12534)	(1.5)

a/ Includes transfers, net lending and equity to financial and non-financial government corporations. The figures from 1975 to 1979 were obtained from Montes (1987).

b/ Includes equity and net lending.

N.A. = not available.

Sources: Department of Budget and Management.

The first ones to fall in the wake of the 1981 liquidity crisis were the so-called "in-house" financial institutions of the fast-rising conglomerates. As already mentioned above, these were financial institutions acquired or set up by conglomerates primarily to service their own financing requirements by borrowing funds from the money market or underwriting commercial papers issued by their own affiliates. These include Filmanbank and Philfinance of the Silverio Group; Atrium, Apcor, Interbank and Combank of the Herdis Group; and Bancom Development Corporations of the Bancom Group. The run spilled over into small banks and revealed the weaknesses of some of them. One case was the PVB which had been unable to collect loans incurred by some of its officers. Another case was the Associated Bank which had been showing poor profit performance. The ongoing managerial problems between its two ownership groups further aggravated its problem (Patrick and Moreno 1984).

The 1979 "countercyclical policy" of the government was extended to 1983 when the number of company failures increased tremendously in the wake of the liquidity crisis. Essentially, the government did not want any major corporation to be closed because of its adverse employment effects. A dictatorial government whose popularity had already seriously declined could not allow such thing to happen. Government exposures to the ailing private corporations were converted into equity and additional funds were infused to keep them afloat. The government through its various financial institutions, especially PNB and DBP, eventually ended up controlling a big number of ailing corporations. Overnight, the government-owned NDC which was supposed to venture into highly capital-intensive industries became a holding company for distressed companies. It took over many corporations belonging to the Herdis Group and CDCP (*Business Day* 1983).

The same policy was extended to the financial system. No major bank was allowed to fold up so as not to undermine further the already weakening confidence in the financial system. The CB even successfully persuaded investment houses to honor preterminations even if the placements were on a without recourse basis by offering them assistance. Mergers and consolidations especially among financial institutions belonging to the same conglomerate were encouraged. The large exposure of the government to six ailing commercial banks eventually led to government takeover of these banks.

The stabilization measures adopted by the government in the aftermath of the 1981 liquidity crisis had further resulted in larger budget deficits (Table 24). Villegas (1985) noted that during 1981-1983, corporate equity investments¹⁰ became the single most important capital outlay, surpassing even infrastructure spending. Accordingly, about 30 percent of equity disbursements in 1981-1982 was allocated to government financial institutions which, in turn, used these funds

10. Corporate equity investments are real equity stakes of the government in financial and non-financial government corporations. Government advances to these entities are separately booked in the item called "net lending."

mostly for bailing out or subsidizing the operations of the "lemon" companies. The burgeoning budget deficits were financed through CB borrowings and foreign loans. Foreign borrowings alone financed 49 percent of the budget deficits (Lamberte 1987). This had further contributed to the balance-of-payments crisis that struck towards the latter part of 1983.

The 1983-1984 balance-of-payments crisis brought with it all the ingredients of a financial crash. The peso was devalued by almost 50 percent in less than one year; inflation rate skyrocketed to 50 percent in 1984; the economy contracted by about 11 percent in two years' time; the government did not have much elbow room anymore to bail out ailing banks; and political uncertainties prevailed. This was further exacerbated when the government pumped in around P5 billion into the economy through election-related spending activities a few months before the National Assembly election of May 1984, thus lessening CB's capability to provide financial assistance to banks experiencing temporary liquidity problems.

An atmosphere of nervousness prevailed during the balance-of-payments crisis period, prompting depositors to move their deposits to more liquid banks. Note that with a sizable proportion of the resources taken out of the country, general disintermediation ensued (Montes 1987), and the weak financial position of several banks¹¹ was revealed. Despite substantial CB assistance that was quickly given to these banks, their financial conditions continued to deteriorate. The CB had no other recourse but to close them.

In view of the sharp devaluation of the peso vis-a-vis the dollar, banks with liabilities in the foreign currency were troubled. One case was the PISO Bank which used to be a sound bank with substantial financial support from the WB and the ADB.

The big losers in the currency adjustment were DBP and PNB. For instance, DBP's foreign exchange losses amounting to P1.35 billion in 1984 and P920 million in 1985 was further aggravated by the steep rise in the domestic interest rate on time deposits and borrowings. Worse still, PNB and DBP were saddled with an increasing number of non-performing assets; thus, they were unable to derive normal interest income from a large part of their loan portfolio while they continued servicing their debts. In other words, they were firmly squeezed from both sides and had to gasp for breath. Efforts to sell non-performing assets, at the time when the economy was down, resulted in huge losses for these banks. For example, DBP lost P1.2 billion from the sale of the Galleon Shipping account,¹² just one of the big non-performing accounts of DBP.

11. These banks have been cited in the earlier section.

12. Galleon Shipping was owned by one of Marcos' cronies. Its foreign loan was guaranteed by DBP.

Surprisingly, majority of the private commercial and thrift banks were able to weather the crisis primarily because with the 1981 liquidity crisis, banks became more conservative in their lending policy. That is, they lent only to prime clients and tried to minimize any mismatch in the tenor between their assets and liabilities. They sacrificed income in order to achieve a conservative balance sheet position.

The degree of the conservativeness of commercial banks during the crisis period may be gleaned from Table 25. All private domestic banks except Manila Bank which, later on folded up, had loan-to-deposit ratios for the year 1985 well below 80 percent, the level considered as normal. For foreign banks, a high loan to deposit ratio is not surprising since these banks depend more on the resources contributed by their head offices rather than on deposits mobilized from the domestic market. It is noteworthy that PNB and four government-acquired commercial banks obtained ratios well in excess of 100 percent. This indicates that these banks remained unstable during the crisis.¹³

All the aforementioned facts suggest that the failures of some financial institutions cannot be solely attributed to the generally unfavorable condition of the economy.

Another possible cause of bank failures is fraud.

There is a general perception that bank failures are always associated with bank fraud or insider abuse. Yet, no banker in the Philippines has ever been prosecuted and imprisoned for plundering their own banks at the expense of depositors since the establishment of the CB. Perhaps, the most popular form of bank fraud in the Philippines is granting loans to bank directors, officers, stockholders, and related interests (DOSRI), in such case where a bank is a part of a conglomerate which uses the proceeds in very risky ventures, or just dissipates the funds. If the investment succeeds, then the DOSRI and/or affiliates reap all the benefits. If it fails, the bank may not report the losses so that the bad loans will not be reflected, or it may understate the losses arising from such loans in order to prevent a bank run. In any case, the bank would not be reporting anymore its real financial position. The role of fraud in bank failures along this line will be examined by citing specific cases.

Continental Bank presents a classic case of imprudent management in the Philippines. It borrowed heavily from the money market, lent on a long-term basis through its affiliate Continental Finance to other business affiliates without credit investigation, supporting papers or collaterals and financed real estate projects (Patrick and Moreno 1984). It was hit by a massive

13. It should be noted that in 1984, 29 commercial banks set up a P/395.5 "liquidity resource fund" for the purpose of assisting any of the participating banks to cover temporary liquidity needs arising from overdrafts with the Central Bank or a deficiency in reserve requirements. They recognized the serious impact of a run on one bank and on the rest of the system at a time of general political and economic instability.

Table 25
LOAN TO DEPOSIT RATIO, 1985

Bank	Loans/Deposits (%)
A. Private Commercial Banks	
1. Allied a/	46.3
2. BPI a/	47.8
3. China	63.2
4. City Trust a/	65.9
5. Consolidated	50.1
6. Equitable	48.8
7. Far East	50.2
8. Manila Bank a/	121.5
9. Metro Bank a/	58.4
10. Communications	59.2
11. Phil. Banking	80.2
12. PCIB a/	58.9
13. Phil. Trust	43.5
14. Producers	NA
15. Prudential	50.2
16. RCBC	72.2
17. Security	31.2
18. Traders	55.4
19. UCPB a/	70.5
B. Foreign Banks	
20. BA	NA
21. Citibank	100.9
23. Hongkong	349.3
24. Chartered	215.4
C. Government-Acquired Banks	
24. Associated	81.8
25. Combank	104.9
26. Interbank	189.2
27. Pilipinas	115.7
28. Republic	210.2
29. Union	78.7
D. Government-Owned Bank	
30. PNB	154.8

NA - not available

a/ Universal banks as of 1985.

Source: Business Day, Top 1000 Corporations, 1985.

bank run when news broke out that its president was arrested and charged with misappropriation of deposits and other irregularities. Unfortunately, the case has never been settled up to the present time. In fact, the original owners of Continental Bank which has been renamed Interbank under a new management have been trying to recover the bank by filing charges against the CB and the present owners of Interbank.

Genbank, the second bank that was closed in the 1970s, had been lending heavily to its investment house affiliate, Filcapital Development Corporation. When the latter closed down in 1976 due to severe liquidity problems, depositors began withdrawing their funds with the Genbank.

The owners of RSB had been borrowing huge amounts more than the limit on DOSRI accommodation allowed by law without sufficient collateral from their own bank. When hit by a massive run, the bank opted to close shop because much of its resources were tied up to unsecured loans obtained by its owners. Later on, CB found it insolvent, and subsequently closed it. CB shelved its plans to investigate the bank's owners and top executives when the latter agreed to a CB-PDIC-GSIS proposed rehabilitation program for the bank which included the acquisition by GSIS of the insolvent bank and the owners' promise to return over P200 million worth of assets. This is unfortunate especially since up to this time, the original owners of RSB, now renamed Comsavings, never kept their promise, and instead filed a case in court against the present owner of Comsavings alleging that the bank was grabbed from them by the former management of GSIS. The government could not move ahead with its plan to privatize Comsavings due to the many court cases filed against the bank, GSIS and former owners. In fact, it was left out in a deal that involved the sale of COMBANK, the mother bank of Comsavings, to private investors.

The Banco Filipino (BF) had been lending to its owners and affiliates who were engaged in real estate development. In particular, the CB found out that outstanding loans to the Aguirre Group of Companies amounted to P2.1 billion representing 57 percent of the total loan portfolio of BF which stood at P3.6 billion as of July 1984. Problems started to crop up when the real estate business experienced a market slump during the 1981 liquidity crisis. Like other banks, it suffered heavy withdrawals during the last quarter of 1983. When BF unilaterally declared a "banking holiday" on 23 July 1984, it claimed that it was solvent. CB refused to grant BF's request for additional cash assistance because of certain anomalies committed by the bank (*Business Day* 1984). Accordingly, BF was already insolvent as of July 1984 (Villegas 1985). President Marcos intervened in the controversy by pressuring the CB to bail out BF. The CB succumbed to the pressure, and it subsequently appointed a conservator for BF and extended a credit line of P3 billion which was roughly equivalent to the total volume of deposits of the bank. Despite this massive assistance, BF continued to suffer a run when it reopened. Later on, CB came up with a report showing that as of 25 January 1985, BF's realizable assets of about P3.9 billion after providing for bad debts, depreciation, and decline in value of properties owned or

acquired were already way below its total liabilities of about P5.2 billion. This was the basis of CB's decision to liquidate BF. As it turned out, BF's claim of solvency when it unilaterally declared a "banking holiday" was based on a financial statement that did not provide sufficient valuation reserves. At present, several cases have been filed by the owners and employees of BF against the CB. One of their main contentions is that the CB acted arbitrarily and in bad faith on the closure of BF.

The PVB did not have any affiliate. However, its officers who were mostly military personnel exploited the opportunity of obtaining unsecured loans from the bank. Despite its huge losses which kept piling up since 1981, the bank was allowed to operate by the erstwhile government for obvious reasons. In 1985, the deterioration in the financial position of PVB had reached to alarming proportion. Paid-up capital had been reduced to only P28 million as of February 1985 which was lower than the P100 million minimum paid-up capital for an existing commercial bank. Possible losses in its loan portfolio and other assets could further reduce the bank's assets to negative P483 million. Just a few days before the closure of PVB, no less than President Marcos ordered all the members of the PVB board of directors to stop a continuous drain of funds (*Business Day* April 11, 1985). Even with this, no legal action had ever been initiated to prosecute bank officers for committing bank fraud.

Pacific Bank presents another case of bank fraud. It was considered by the banking community as a solid medium-sized bank. In 1985, a foreign bank wanted to purchase 27 percent of the shares of Pacific Bank. Later on, it withdrew its offer after finding out that the Pacific Bank's financial statements were bloated and certain expense items were deferred or underreported to reflect profits when in reality it was losing. When news of this anomaly leaked out, depositors started withdrawing their funds from Pacific Bank. The CB's huge emergency cash advances of over P2 billion to Pacific Bank failed to stave off the massive run.

Like other closed banks, Manila Bank lent heavily to its agribusiness affiliates. Many of these affiliates went bankrupt during the balance-of-payments crisis. Manila Bank refused to recognize the huge losses stemming from these loans by not providing sufficient valuation reserves which the CB estimated to have already reached P600 million as of October 1984. In 1987, the CB found Manila Bank to be severely insolvent and closed it.

The case of the so-called "in-house" financial institutions of the conglomerates were already thoroughly discussed above. It suffices to say that failures of these financial institutions largely stemmed from loans they made to affiliates that went bankrupt.

As regards rural banks, the results of the examination conducted by the CB covering 847 rural banks indicate that commission of fraud was pervasive (Table 26). This was the main cause for the weakening of the financial position of a large number of rural banks.

Table 26
DISTRIBUTION OF BANKS ACCORDING TO TYPES OF VIOLATIONS

Type of Violation	No. of Banks
Fictitious/indirect/questionable loans (DOSRI and other loans)	137
Misapplication/misappropriation of bank funds (including temporary borrowings)	146
Past due DOSRI/DOSRI in excess of ceiling	325
Manipulated bank records and reports	29
Willful non-compliance with Monetary Board directions	37

Note: The examination was done by the Central Bank during the period 1984-86. Several rural banks committed more than one type of violation.

Source: Rural Bank Rehabilitation and Review Committee (1986).

Why is it that loans to DOSRI and bank affiliates could lead to severe bank problems? One reason is that the loan application does not pass through the rigors of loan processing applied to unaffiliated borrowers. It is highly probable that DOSRI accommodations are granted on terms disadvantageous to the bank. More often than not, the loans are used in risky ventures which normally a bank refuses to finance if they were proposed by unaffiliated borrowers. The saying "Heads, I win; tails, you lose" applies here. That is, if the project succeeds, the DOSRI and/or affiliates reap all the extra profits for taking high risks; if the project fails, depositors and PDIC will bear the costs. Another reason is that loans to DOSRI and/or affiliates are either fully unsecured or lacking in collateral; thus, in case of bankruptcy, the bank has nothing to collect. The losses, once recognized by the bank to have been carried by bad loans to DOSRI and/or affiliates, could easily trigger a bank run, hence, the reluctance of banks to recognize such losses by not providing adequate valuation reserves. In contrast, loans to unaffiliated borrowers are usually highly collateralized. The typical loan-to-collateral ratio in the Philippines is 50 percent which can very well cover losses due to loan default.

While fraud was committed by private bankers in the case of failures of commercial banks, fraud was committed at the highest level in government in the case of the financial difficulties experienced by PNB and DBP. These financial institutions were saddled with behest loans and guarantees that went sour. Behest loans and guarantees were accommodations which could have not been granted by these banks to President Marcos' relatives, "cronies" and associates were it not for his pressure and/or personal endorsements. The government even violated the law when it allowed PNB to grant CDCP a loan worth more than P2 billion which was subsequently converted into equity in view of the inability of CDCP to repay the loan. This amount already represented 60 percent of PNB's total net worth which was well in excess of the 15 percent single borrower limit rule. Furthermore, banks' total investments in equities were not supposed to exceed 50 percent of its net worth.

The inescapable conclusion that may be drawn from the above is that, to a large degree, fraud committed by owners and officers of banks had contributed to bank failures and/or banking problems. The CB's inability to closely monitor DOSRI accounts could have invited more abuses. Moreover, the reluctance of the monetary authorities to investigate the real cause of bank failures and to prosecute erring bankers may have encouraged many bank owners and officials to commit fraud..

VI. SUPERVISORY AND REGULATORY RESPONSES TO THE FINANCIAL SYSTEM'S PROBLEMS

This section discusses the responses of the supervisory and regulatory agencies to the financial system's problems. Some measures such as changing regulations to pre-empt or to prevent the recurrence of certain problems affected the entire system. Others were specific to a financial institution encountering some problems, as in the case of rehabilitation or closure. The first type of measures will be discussed followed by the second type.

The CB tried to maintain stability and soundness of the financial system by raising the minimum capital requirement. This was done three times since 1950: the first in the mid-1960s; the second in 1972; and the third in 1980. The CB seemed to be willing to trade-off size for capital-to-risk asset ratio. For instance, a universal bank may have a risk asset ratio of as low as six percent provided that its capital is not less than P700 million.

The CB reinforced its minimum capital requirement with a moratorium on new bank entry. Although this policy was introduced in the mid-1960s, it is still being maintained today. An exemption which is provided for in the 1980 financial reforms is the case where a small financial institution, say a thrift bank, graduates to another type, say a commercial bank, and assumes all the functions and privileges of a bigger financial institution. While branching is being encouraged by the CB in lieu of giving license to new banks, it is highly restrictive in the sense that it does not allow new branches in the so-called "over-branched" areas. This is to prevent overcrowding in one area which could lead to bank failure or bank run. In the end, this policy would have achieved a more balanced distribution of financial institutions in the country (Chan 1988).

Some regulations were effected in response to financial innovations. In the mid-1960s, new types of financial institutions emerged. They had certain advantages over banks since they operated outside the purview of CB regulations such as interest rate ceiling and reserve requirement. The 1972 financial reforms essentially restructured the financial system and gave the CB the authority and responsibility not only over the monetary system, but over the entire financial and credit system as well. The reforms heralded the birth of the so-called non-bank financial intermediaries with authority to engage in quasi-banking functions (NBQBs), as distinguished from those which have no such authority (non-NBQBs). The former are authorized by the CB to borrow from 20 or more lenders using debt instruments with recourse other than deposits at any one time for relending purposes. Since they are allowed to issue deposit substitutes, NBQBs are subject to the rules and regulations of the CB just like other banks, whereas non-NBQBs which may issue commercial papers without recourse are only required to submit to the CB reports of their operations. Their supervision rests with the Securities and Exchange Commission (SEC).

In the 1970s, the money market became very active. The major participants were banks and NBQBs such as investment houses and finance companies. Having unregulated yields on its various instruments, the money market was able to attract more funds away from the traditional deposits. Concerned about the impact of high interest rate on investment, the increasing emphasis on direct lending by NBQBs and possible insider abuse as demonstrated in the case of the Continental Bank that failed in 1974, the CB issued in 1976 new regulations covering the money market operations of banks and NBQBs. These regulations included interest rate ceilings, higher minimum trading lot size, reserve requirements on deposit liabilities or commercial paper of NBQBs and banks and 35 percent transactions tax on all primary borrowings in the money market-- all of which effectively reduced the interest rate differential between money market instruments and traditional deposits.

Interestingly, non-NBQBs were spared from such regulations. At that time, however, they were already accepting money market placements on a without-recourse basis and brokering direct placements by attaching their own post-dated check to the transactions on a paying-agency basis and offering a verbal commitment to buy back the paper. This was actually a quasi-banking function. Indeed, the attachment of a post-dated check, verbal commitment to buy back the paper, unregulated rate, SEC permit and the primeness of the paper placed non-NBQBs in a better competitive position than NBQBs and banks whose money market operations were tightly controlled by the CB. To survive the cutthroat competition, NBQBs also engaged themselves in without-recourse transactions by attaching their own post-dated checks under a paying-agency agreement and reinforcing it with a verbal commitment to buy back the paper. Since NBQBs are not legally liable for the repayment of the commercial paper, these transactions are outside of the CB regulations. This is one classic case of financial innovation devised to evade repressive financial regulations. More specifically, both NBQBs and non-NBQBs were able to circumvent CB rules on the money market - NBQBs for having borrowed from the public on a without recourse basis and non-NBQB for undertaking quasi-banking functions.

As already discussed above, most of the NBQBs and non-NBQBs lent heavily to their affiliates, many of which performed badly. In effect, NBQBs and non-NBQBs were already pushing non-prime papers, but investors kept on buying them because of the promised high yields, the attachment of post-dated checks to the transactions and the verbal buy-back guarantee of the issuing financial institutions. It should also be noted that the various regulations governing the money market transactions had unnecessarily increased the cost of commercial paper. As a result, companies of highest credit rating which had alternative sources of credit were driven out while companies with lower credit ratings had no choice but to remain in the market (Licuanan 1986). This is a classic case of "adverse selection" process which attracted only risky borrowers.

The severity of the 1981 liquidity crisis prompted regulatory agencies to immediately institute measures in order to regain the public's confidence in the financial system as quickly as possible. In view of the imminent threat by financial institutions not to honor preterminations of papers

sold on a without-recourse basis which could further aggravate the runs that were going on, the CB ruled that commercial papers issued on a without-recourse basis be considered as on a recourse basis. This, in effect, legalized the transfer of the liability of commercial paper issues to financial institutions. To be able to honor preterminations, financial institutions which were hardest hit by a run were given CB financial assistance. However, this assistance was limited only to NBQBs because by law, the CB can extend its lender-of-last-resort facility only to banks and NBQBs.

In the early part of 1981, CB set up the Industrial Fund to assist firms crippled by the Dewey Dee caper. The initial amount of P1.5 billion was fully availed of by large distressed firms, such as CDCP, Alfa Integrated Textile Mills, Bancom Realty Corporation, Asia Industries of the Herdis Group, and others. The following year, the Industrial Fund was replaced by a new rediscounting facility with a capital of P2 billion which could be availed of by the six selected commercial banks authorized to receive loan applications from industrial firms that qualify for the rescue assistance.

Some changes in the regulations on financial institutions' operations were introduced. CB issued four circulars governing the issuance of commercial paper. The measures being adopted were intended to enhance the soundness of the market, in general, and to protect investors, in particular. Among the important measures contained in the circulars are the following:

- any proposed issue shall be supported by a committed credit line agreement with a qualified bank;
- to preserve the integrity of commercial paper issues, commercial paper instruments shall be printed with a standard format, serially pre-numbered and denominated by the CB Security Printing Plant;
- a stipulation in commercial paper disallowing the lender the right or option of pretermination;
- the total outstanding liabilities or borrowings inclusive of any outstanding commercial paper issue of a corporate issuer under ordinary registration shall not exceed 300 percent of its net worth;
- CB may extend a loan to any bank which provides a committed credit line facility to a corporation proposing to issue commercial paper; and
- the institutions selling without recourse shall indicate or stamp in conspicuous print on the instruments as well as on the confirmation of sale of the phrase "without recourse," otherwise they will be subject to CB regulations governing issuances with recourse.

The Monetary Board also issued regulations governing without-recourse transactions of financial intermediaries. More specifically, any of the following practices in connection with a without-recourse transaction were prohibited:

- issuance of post-dated checks of the financial intermediary whether for its own account or as an agent of the debt instrument sold, assigned or transferred without recourse; or
- issuance by the financial intermediary of any form of guarantee on sale transactions or negotiations or assignment of debt instruments without recourse; and
- payment with its own funds by the financial intermediary which assigned, sold or transferred the debt instrument without recourse unless the financial intermediary can show that the issuer has funds corresponding to the amount of obligation with the said financial intermediary.

As part of the measures to prevent the recurrence of the problems that led to the 1981 liquidity crisis, the Credit Information Bureau, Inc. (CIBI) was set up at the CB to coordinate information on all issuers of commercial papers. At present, it has collected data on some 25,000 companies and 6,000 individuals (World Bank 1985). Commercial banks have been the primary users of the services extended by CIBI (Lamberte *et al.* 1989).

The 1983-1984 balance-of-payments crisis presented two related major problems to restore the creditworthiness of the country and to regain the public confidence in the banking system. To deal with the first problem, the Philippines presented a financial program to her major foreign creditors which consisted of four components: debt restructuring, new credit, trade facility, and standby credit with IMF. Approval by the IMF of the said program was delayed for about a year due to some events that unfolded during the negotiation process and the failure of the government to meet the required prior actions. One was the embarrassing overstatement of the international reserves which prompted then President Marcos to replace the CB Governor. Another was the sudden surge of reserve money brought about by the government's heavy spending on election-related activities and, ironically, by the effort of the CB to save financial institutions, notably Banco Filipino, from the massive run.

In response to the previous years' heavy dependence on foreign loans which, to a large extent, was aided by the guarantees provided by government financial institutions, the government issued in November 1983 a guideline prohibiting all government financial institutions from extending any guarantee to secure foreign loans or obligations. This was followed by a decree requiring the approval of the President of the Philippines on all direct borrowing by all government-owned or -controlled corporations. Further, a tighter control on foreign guarantees provided by government and private financial institutions was instituted by the CB. In particular, bond payment guarantees issued by domestic private and government banks to

secure obligations of local contractors with overseas projects, foreign loan guarantees issued by domestic private and government banks and financial institutions to secure any foreign obligations, including those of their foreign subsidiaries or branches, and guarantees issued by foreign banks and financial institutions to secure both foreign and peso obligations of local firms require prior approval of the CB.

The monetary authorities were indeed walking on a tightrope in dealing with the balance-of-payments crisis. While it recognized the need to pursue contractionary policy to restore confidence in the Philippine economy which was not the case during the liquidity crisis, it also had to provide financial assistance to financial institutions experiencing massive runs to dispel any doubts about the stability of the financial system. The figures presented in Table 27 suggest the kind of actions adopted by the monetary authorities during the crisis. In the twelve-month period from June 1983 to June 1984, net credit to the public sector grew by 88.5 percent while those to the financial sector fell by 34.4 percent. The December 1982 level was recovered in September 1984 due to a substantial increase in net lending by the CB to "other financial entities," a category that includes thrift banks, but mainly, the DBP. The principal reasons for this increase were two: (1) the increase in the emergency loans to thrift banks in response to massive withdrawals by depositors; and (2) the effort to keep DBP functional.

Measures to control reserve money movements were likewise instituted by the CB. These included raising the reserve requirements on all deposit liabilities from 18 to 24 percent in less than a year, drastically reducing CB rediscount accommodations but giving high priority to exports and introducing high-yielding, short-term debt instruments called CB ("Jobo") bills to strengthen the CB open market operations.¹⁴

The impact on liquidity of the CB's massive financial assistance to financial institutions hard hit by runs was minimized through the issuances of CB bills (Table 27). Since funds deposited with relatively weak banks had moved partly into the hands of the public and partly into more liquid banks, the rescue operation was accomplished by borrowing funds from the public and more liquid banks using CB bills as the major instrument--a case of internal recycling of funds. This, however, proved to be costly to both ailing banks which had to pay a rate of 36 percent per annum for their emergency loans and the CB whose CB bill rates went up to as high as 40 percent per annum in September 1984. The high rates on CB bills had significantly contributed to the losses which currently amounted to about P34 billion on a cumulative basis. For stronger banks, the high-yielding, short-term CB bills and Treasury bills were attractive investment opportunities at the time when their loan portfolio had substantially contracted.

14. See Lamberte *et al.* (1985) for details.

Table 27
RESERVE MONEY, MAIN COMPONENTS
(in million pesos)

	1982		1983		1984	
	June	December	June	December	June	December
Reserve Money	15,675	18,664	16,064	27,723	27,082	28,664
Net Foreign Assets	(6,168)	(14,953)	(23,837)	(36,683)	(58,691)	(53,124)
Net International Reserve	(966)	(9,067)	(16,035)	(23,989)	(35,565)	(37,190)
Medium and Long-Term						
Foreign Liabilities	(5,202)	(5,885)	(802)	(10,641)	(15,226)	n.d.a
Blocked Peso Deposits				(2,053)	(7,900)	(10,930)
Net Domestic Assets	21,843	33,617	39,901	64,406	85,773	81,788
Net Credits to the						
Public Sector	7,438	7,505	7,465	11,621	14,068	11,945
Net Credits to the						
Financial Sector a/	15,142	16,262	14,480	14,895	9,502	16,314
of which						
CB Bills					(3,040)	(5,709)
Emergency Advances	3,142	3,137	3,051	3,787	3,431	4,044
Others Items	(737)	9,850	17,956	59,257	40,836	53,529
Revaluation	2,373	4,525	13,737	38,241	58,199	65,297
Net Domestic Assets						
Without Revaluation	19,470	29,092	26,164	26,164	27,574	28,259

a/ Net credits to deposit money banks plus net credits to other financial entities.
N.D.A. = not directly available

Source: Lamberte et al. (1985).

The rush of bank failures in the wake of the balance-of-payments crisis, despite massive CB assistance, prompted regulatory agencies to institute more measures to arrest such failures and at the same time, strengthen the banking system. Interestingly, most of these measures were designed to minimize mismanagement and insider abuses.

There were actually two types of measures: one that could be done within existing laws and another one that required changes in the charter, particularly the CB Act and the General Banking Act. As regards the first type of measures, the newly-appointed CB Governor created the Office of Special Investigation within the CB to prosecute those who caused losses to depositors, either through mismanagement or fraud.

The CB effected some regulatory changes through the issuance of circulars. For example, it expanded the coverage of the single borrower's limit. The new regulation requires inclusion of contingent liabilities in the determination of the limit to which banks can lend to a single borrower or a group of affiliated borrowers. It also limits the amount of standby letters of credit, both foreign and domestic, including guarantees which require a third party to assume the obligation in the event the borrower fails, and which can be issued by a bank or a NBQB. The regulation limits such guarantees outstanding at any given time to 50 percent of the bank's unimpaired capital and surplus except guarantees that are fully secured by cash, hold-out deposits, deposit substitutes or government securities. The loan limit and the ceiling on outstanding guarantees are intended mainly to protect banks, particularly government banks, which in the past had overextended funds principally to favored groups. As part of its effort to closely monitor DOSRI loans, the CB requires that the loan documents include a depositor's waiver of his right under existing law of the confidentiality of his deposits in case the same depositor obtained a loan secured by hold-outs or assignments of deposits. To make all transactions of banks more transparent and to reduce wholesale bank anomalies, the CB required all banks, whether private, government-owned or - controlled to be subjected to an annual financial audit by independent auditors. The board of directors of concerned banks shall consider and act on the financial audit report and submit within 30 days after receipt of the report, a copy of its resolution to the CB. The resolution shall show, among others, actions taken by the board of directors on the findings and recommendations of the independent auditor.

The latest CB circular dated 16 May 1989 spells out its policy towards improving the stability and soundness of the banking system. More specifically, it shall refrain from sustaining weak banks except in times of general financial emergency or when specific banks face problems of liquidity rather than of solvency. This is in sharp contrast to the policy followed during the 1981 liquidity crisis that led to the government's takeover of weak banks.

As regards regulatory changes that require amendment of certain provisions of the Central Banking Act and General Banking Act, the CB proposed 17 major amendments to the CB Act which included among others, making the powers of supervision of the CB effective in

preventing and penalizing the commission of irregularities and fraud through the instrumentalities of banks; clarifying the roles of the receiver and liquidator and their powers and privileges; imposing stiffer penalties for submitting false statements and violation of laws and regulations; and prohibiting banks with outstanding emergency advances from the CB from expanding the total volume of its loans or investments or granting new loans or renewals of existing loans. However, of the 17 proposed amendments, President Aquino acted on only two-- one that pertains to the role and powers of the receiver and liquidator and the other one, on interbank settlements. On interbank settlements, the Executive Order issued by President Aquino intends to curb abuses usually practised by weaker banks. In particular, the new law provides that the CB will not clear checks drawn against the bank's accounts to settle its interbank balances if it continues to overdraw for five consecutive days and fails to fully cover the overdrafts. Banks with existing overdrafts with the CB should either convert these into an emergency loan or advance with a plan of payment or settle said overdrafts with the CB.

CB also submitted 14 proposed amendments to the General Banking Act, most of which focused on curbing insider abuses. For instance, it has been suggested that additional requisites in the processing of loans be imposed to minimize, if not actually prevent, the grant of DOSRI loans without proper documents. Another amendment being advanced is the authorization of the Monetary Board to prescribe the conditions and limitations under which DOSRI loans can be granted by banks. Heavier penalties for violation of any provision of the General Banking Act were also proposed to deter bank irregularities and fraud. It was also proposed that the CB be empowered to issue "cease and desist" order. This is an additional CB regulatory and enforcement instrument. Unfortunately, none of these was acted upon by President Aquino; thus, the burden of overhauling the CB Act and the General Banking Act now rests with the Congress.

The World Bank Mission which visited last year has picked up most of the CB-initiated proposed amendments to the CB Act and General Banking Act and has incorporated them in the set of conditions attached to the Financial Sector Adjustment Loan. Thus far, several bills are being filed in Congress seeking to strengthen bank supervision and regulation. These include, among others, the following:

- cease and desist orders to be added to the CB's available enforcement instruments;
- addition of new appropriate criteria for appointment of receivers for distressed banks to provide the Monetary Board with more flexibility in dealing with insolvent banks;
- curbing insider abuse by eliminating secrecy accorded to deposits of DOSRI under certain circumstances; and

-giving protection to the regulatory staff against losses resulting from suits brought against them for action taken in performance of their duty.

The approach followed by the CB in dealing with ailing banks or banks that encountered severe financial difficulties depended, to a large degree, on the general economic policy and condition at the time when banks experienced financial difficulties. The personal crusade of the CB Governor also counted a lot. In general, it was averse to closing ailing banks because of the repercussions it might create on the entire banking system. Also, it might suggest that the CB is an inefficient supervisory agency.

During the 1981 liquidity crisis, the government saw to it that no commercial bank fails. Massive assistance in the form of CB emergency advances, government equity infusion through its financial institutions, and the grant of privilege to be a depository of government funds were accorded to ailing banks. The rehabilitation package also included the requirement to divest ailing banks of unrelated businesses and to merge it with other financial institutions belonging to the same conglomerate. As mentioned earlier, the massive assistance provided by government to ailing banks resulted in takeovers.

The 1983-1984 balance-of-payments crisis was entirely a different ballgame. Government resources were fairly limited, and PNB and DBP which played a prominent role in bailing out ailing banks during the 1981 liquidity crisis found themselves practically insolvent. Moreover, a new governor took over the reigns of the CB. He launched a crusade for sound and responsible banking and put more emphasis on quality rather than quantity of the banking system. Insolvent banks were, thus, allowed to go this time. However, closing insolvent banks was not that easy for the CB because of strong resistance from owners of insolvent banks. One case was the Banco Filipino owners who succeeded in reversing CB's earlier decision of not providing BF with additional financial assistance due to anomalies perpetrated by the bank owners. Nevertheless, the crusade of weeding out ailing banks was continued as may be seen from the number of insolvent banks already closed.

With regards to PNB and DBP, the government opted for their rehabilitation. Non-performing assets of both banks were transferred to the national government, and their respective charters were revised. In 1987, they made a turnaround which was not surprising since their loan portfolios were already cleansed of bad accounts. They now have restored their normal lending operations. Starting 30 June 1989, PNB has not been receiving special treatment from the CB beyond the normal rediscounting facility available to all commercial banks. It has already started privatizing itself by selling 30 percent of its total outstanding shares. The

public's response to this effort has been enormous. In fact, the PNB stock offering has been oversubscribed. Meanwhile, DBP has recently changed its lending procedure to make itself resistant to behest loans. Regional branch officers are now included in the process of deciding on loan requests. Overall, the six government-acquired banks have now been either fully or partially privatized. Their privilege as a special depository of government funds has been terminated.

One important measure adopted by the government in the wake of the balance-of-payments crisis was the launching of a rehabilitation program for the rural banking system. The program is selective since it focuses assistance on those banks that have a big chance of becoming viable and independent of government subsidies. It also aims to relieve rural banks of their burden of arrearages with the CB totaling almost P3.6 billion. This involves conversion of the arrearages to government equity in rural banks and a 10-year installment program on the unconverted arrearages. To qualify for the program, stockholders of rural banks must infuse additional capital into their bank, the amount of which depends on the individual rural banks' financial status. The bottomline, however, is that enough fresh capital must be infused so that the rural bank fulfills the legal, mandatory requirement of a minimum 10 percent risk asset ratio.

As of December 1988, the CB has approved applications for rehabilitation of 476 rural banks. Some 295 rural banks have fully complied with the requirements while 63 have only partially completed the necessary requirements. The rest have yet to respond to the notice of approval sent by the CB. About 79 percent of the participating banks have opted to infuse new capital in lieu of the alternative payment of 10 percent of their total arrearages with the CB.

VII. INCIDENCE OF THE COSTS OF BANK FAILURES

This section examines the incidence of the costs of bank failures. The incidence may fall on stockholders, depositors, the Philippine Deposit Insurance Corporation (PDIC), the CB and/or the national government. Indeed, it is difficult to quantify the incidence of the costs of bank failure, especially that part borne by the bank stockholders. It should be recalled that most bank failures were largely due to fraud or diversion of deposit funds to either bank affiliates or businesses owned by the bank stockholders. Thus, in cases of bank failure, stockholders may lose entirely their bank shares plus the market value of the franchise, but the amount of funds diverted could have more than compensated for these losses. Unfortunately, information about bank exposures to individual stockholders and affiliates are scanty and very sketchy. The analysis therefore, excludes those portions borne by bank stockholders.

PDIC was organized in 1963 but began its actual operation only in 1968. Its original permanent insurance fund was P5 million which was subsequently raised to P20 million in 1964, and then to P2 billion in 1985. Membership is compulsory for deposit-taking institutions registered with the CB. Table 28 shows the number of PDIC-member banks from 1980 to 1987.

Table 28
NUMBER OF PDIC MEMBER-BANKS

Bank Group	1980	1981	1982	1983	1984	1985	1986	1987
Commercial Banks (KBs)	32	33	34	34	34	30	30	29
Savings and Mortgage Banks (SMBs)	10	9	8	8	8	7	7	8
Private Development Banks (PDBs)	43	44	45	45	43	45	44	42
Stock Savings and Loan Associations (SSLAs)	91	87	84	83	70	66	65	62
Rural Banks (RBs)	1,030	1,040	1,046	960	955	905	880	850
Specialized Government Banks (SGBs) <i>a/</i>	3	3	3	3	3	3	3	3
All Banks	1,209	1,216	1,220	1,133	1,113	1,056	1,029	994

a/

Includes the Development Bank of the Philippines (DBP), Philippine Amanah Bank (PAB), and Land Bank of the Philippines (LBP).

Sources: PDIC Annual Reports (various years).

It has been declining during the indicated period because of the rush of bank failures in recent years and the CB's policy of not giving new bank licenses.

PDIC does not intend to cover the full value of individual deposits; thus, it stipulates a maximum amount of coverage for each depositor. Originally, the maximum amount of coverage was set at P10,000 per depositor. This was raised to P15,000 per depositor in 1978, and subsequently to P40,000 per depositor in 1985. As of September 1987, the total number of accounts reached 18 million, 96 percent of which had balances not exceeding P40,000 (Table 29). However, in terms of the total value of deposits which stood at P179.7 billion as of September 1987, only 33 percent or P59.9 billion was protected by the P40,000 maximum insurance coverage for each depositor. Deposits of commercial banks obtained the lowest protection rate since a significant proportion of their deposit accounts were large.

Table 30 presents the number of banks closed by the CB and the PDIC payments of insured deposits from 1970 to 1987. Note that the value of deposits reported here refers to the date of closure. PDIC need not pay the full value of the deposits of failed banks since only a portion of this was covered by insurance; thus, depositors could have lost a certain portion of their deposits in failed banks. An attempt was made to estimate the losses of depositors due to bank failures from 1970 to 1987 by multiplying the outstanding deposits of closed banks, as of the date of closure, by the proportion of insured deposits to total deposits per bank type, and the product was subtracted from the outstanding deposits of closed banks. With this procedure, there is a tendency to overestimate the losses of depositors. The reason is that some banks were bought by new owners who assumed all the deposit liabilities of the closed bank as in the case of Genbank and Continental Bank--an angle which was not taken into account in the calculation. The figures obtained in this study should, therefore, be taken with great caution.

The estimated losses of depositors due to bank failures from 1970 to 1987 are presented in Table 31. Out of the P7.6 billion outstanding deposits of closed banks cumulated from 1970 to 1987, only 46 percent or P3.5 billion were covered by insurance. Thus, for the same period, depositors lost about P4.1 billion or about 54 percent of the total outstanding deposits of closed banks--an indication that the cost of bank failures fell more heavily on depositors. The total loss borne by depositors was roughly 5.2 percent of the average total deposits of PDIC-member banks during the period 1970-1987 or 0.6 percent of the nominal GNP in 1987.

It must be noted, however, that the incidence of the cost of bank failures is unevenly distributed among depositors. More specifically, it fell more heavily on depositors of commercial banks than depositors of other types of banks. Out of the estimated losses of P4.1 billion, three-fourths belonged to depositors of commercial banks.

Some depositors of commercial banks and large thrift banks were businessmen and institutional investors. When their banks were closed, they must have encountered liquidity

Table 29
PDIC RISK EXPOSURE ON DEPOSIT LIABILITIES OF THE
PHILIPPINE BANKING SYSTEM
As of September 30, 1987

	No. of Banking Offices a/	Number of Accounts			Percent of Accounts	
		Total	Up to P40,000	Over P40,000	Up to P40,000	Over P40,000
Commercial Banks	31 ^{b/}	10,730,334	10,163,022	567,312	94.71	5.29
Savings Banks	7	1,660,040	1,627,427	32,613	98.04	1.96
Development Banks: Private DBs	42	707,887	697,692	10,195	98.56	1.44
DBP	1	86,509	85,065	1,444	98.33	1.67
Stock SLAs	63	2,041,198	2,031,606	9,592	99.53	0.47
Rural Banks	505 ^{d/}	2,787,566	2,776,605	10,961	99.61	0.39
TOTAL	645	18,013,534	17,381,417	632,117	96.49	3.51

Deposits (In million pesos)

	Total Deposits	Insured Deposits			Uninsured Deposits	Percent of Deposits c/	
		Total/ Insured	Up to P40,000	Over P40,000		Insured	Un- Insured
Commercial Banks	162,976	49,539	26,847	22,692	114,437	30.21	69.79
Savings Banks	7,187	4,579	3,274	1,305	2,608	63.71	36.29
Development Banks: Private DBs	2,280	1,342	934	408	938	58.66	41.34
DBP	636	164	126	58	472	25.93	74.07
Stock SLAs	2,639	1,838	1,454	384	801	69.65	30.35
Rural Banks	3,016	2,409	1,970	439	607	79.87	20.13
TOTAL	179,734	59,891	34,605	25,286	119,843	33.32	66.68

a/

Head offices only.

b/

Includes two special government banks (Land Bank of the Philippines and Philippine Amanah Bank)

c/

Percentages were computed before rounding.

d/

Reporting rural banks only.

Source: 1987 PDIC Annual Report.

Table 30
**NUMBER OF BANKS CLOSED BY THE CENTRAL BANK AND
 PDIC PAYMENTS OF INSURED DEPOSITS, 1970-1987**

Bank Group	No. of Banks	a/ Deposits		Insured Deposits Paid	
		No. of Accounts	Amount (P M)	No. of Accounts	Amount (P M)
Commercial Banks (KBs)	6	1,213,224	4,447.81	195,795	626.99
Savings & Mortgage Banks (SMBs)	3	2,541,840	1,016.14	437,268	776.27
Private Development Banks (PDBs)	4	137,620	298.40	30,831	164.28
Stock Savings & Loan Associations (SSLAs)	26 b/	996,434	1,581.82	198,294	747.04
Rural Banks (RBs)	180	721,499	290.88	131,790	176.10
TOTAL	219	5,610,617	7,635.05	993,978	2,490.68

a/
As of closure.

b/
Exclude RB of Jolo, Inc. which went into voluntary dissolution.

Source: 1987 PDIC Annual Report.

Table 31
**ESTIMATED LOSSES OF DEPOSITORS DUE TO BANK
 FAILURES, 1970-1987
 (in million pesos)**

Bank Type	(1) Percent of Insured Deposits to Total Deposits a/	(2) Outstanding Deposits of Closed Banks b/	(3) Estimated Insured Deposits c/	(4) Losses to Depositors d/	(5) PDIC Payments b/	(6) Depositors' Receivable from PDIC e/
Commercial Banks (KBs)	30.21	4,447.81	1,343.68	3,104.13	626.99	716.89
Savings Banks (SBs)	63.71	1,016.14	647.38	368.76	776.27	(128.89)
Private Development Banks (PDBs)	58.86	298.40	175.64	122.76	164.28	11.36
Stock Savings and Loan Associations (SSLAs)	69.65	1,581.82	1,101.74	480.08	747.04	354.70
Rural Banks (RBs)	79.83	290.88	232.21	58.67	176.10	56.11
TOTAL		7,635.05	3,500.65	4,134.40	2,490.68	1,009.97

a/ From Table 29

b/ From Table 30

c/ (1) x (2)

d/ (2) - (3)

e/ (3) - (5)

Source: 1987 PDIC Annual Report.

problems which severely affected or led to the closure of their businesses. Unfortunately, these losses could not be quantified due to lack of information. This is worth exploring in future studies.

PDIC has been very slow in paying insured deposits. Table 32 indicates the amount paid by PDIC within a certain timespan after a particular bank was closed. For instance, three years after Continental Bank was closed, PDIC paid only P28.8 million out of the estimated total insured deposits of P36 million. As of December 1987, PDIC was still paying insured deposits of banks closed several years ago (Table 33). In some cases, depositors did not get immediately the full amount of the insured deposits. For instance, depositors of PISO Development Bank and Manila Bank were initially paid P10,000 each. As Table 31 shows, depositors still have receivables from PDIC of about P1 billion or roughly 30 percent of what they should have received for their insured deposits.

One reason why PDIC cannot quickly pay insured deposits is that it is severely undercapitalized. Its total deposit insurance fund available for deposit insurance amounted to only P2.6 billion in year-end 1987, whereas its total risk exposure was estimated at P60 billion. The estimated losses of PDIC due to bank failures are presented in Table 34. While its total gross income for the period 1970-1987 amounted to about P1.2 billion, the estimated insured deposits payable for the same period reached P3.5 billion, yielding a loss of about P1.3 billion. Its assessment income and other income could not cover claims on deposit insurance and its operating expenses. In view of this, PDIC often resorted to borrowing from the CB. For instance, its borrowings from the CB to support heavier disbursements for payoff went up from P920 million in 1986 to P1.54 billion in 1987. PDIC's accrued interest payable of P315 million to the CB in 1987 greatly exceeded its gross income of P189 million for the same year.

At present, PDIC charges a uniform annual rate of 1/12 of one percent of total deposit liabilities of each member-bank. This has definitely subsidized the weaker banks. In fact, there is now a proposal to increase the maximum assessment rate for deposit insurance to 1/5 of one percent of the total deposit liabilities and to vary such rate on the basis of a bank's rating after examination. It was also proposed that the capital of PDIC be increased so that it can quickly reimburse depositors of their insured deposits in case of bank failures.

The transfer of non-performing assets and liabilities of PNB and DBP to the government suggests that the latter fully bears the cost of failures of these banks. As regards DBP, P61.4 billion of its liabilities have been transferred to the national government. Table 35 gives a detailed breakdown of these liabilities: About three-fourths of the P5.2 billion government deposits belongs to PNB and the national government; bills payable comprise the largest liability

Table 32
LARGE BANKS CLOSED BY THE MONETARY BOARD OF THE
CENTRAL BANK AND PDIC PAYMENTS

Bank	Date of CB Takeover	No. of Deposit Accounts	Deposits (P M)	Payments		
				Date	No. of Accounts	Amount (P M)
Overseas Bank of Manila ^{a/}	8-02-68	13,061	49.40	12-31-79	6,203	5.5
Continental Bank ^{b/}	6-25-74	60,128	121.20	9-15-77	24,307	28.8
General Bank and Trust Co. ^{c/}	3-25-77	157,977	199.60	5-31-77	16,536	11.8
Royal Savings Bank, Inc. ^{d/}	7-06-84	302,580	350.70	none	none	none
Banco Filipino Savings & Mortgage Bank	1-25-85	2,413,000	887.00	12-31-85	375,267	674.7
Philippine Veterans Bank	4-10-85	no data	1,600.00 ^{e/}	no data	no data	no data
Pacific Banking Corp.	7-05-85	no data	3,058.00 ^{f/}	no data	no data	no data
PISO Development Bank	2-04-87	20,088	206.30	12-31-87	5,163	46.8
Manila Banking Corp.	5-25-87	633,614	1,905.20	12-31-87	111,843	592.7

^{a/}

Resumed operation on January 8, 1981 under the name Commercial Bank of Manila.

^{b/}

Resumed normal operation on May 31, 1977 under the name Allied Banking Corporation.

^{c/}

Resumed normal operation on September 19, 1977 under the name of International Corporate Bank.

^{d/}

Resumed normal operation on September 11, 1984 under the name of Commercial Savings Bank, a subsidiary of COMBANK (now renamed Boston Bank of the Philippines)

^{e/}

Data pertain to end-1984. Note that P1.4B of the P1.6B deposits were government deposits.

^{f/}

As of December 1984. In 1967, Far East Bank and Trust Co. (FEBTC) won the bid to operate Pacific Bank's 43 branches all over the country and since then has been servicing all depositors of the closed Pacific Bank.

Sources: PDIC Annual Reports and Central Bank.

Table 33
PAYMENTS MADE BY PDIC IN 1987

	No. of Accounts	Amount Paid (PM)
25 Banks closed in 1984 and prior years	4,703	11.38
42 Banks closed in 1985	26,822	64.29
22 Banks closed in 1986	7,570	16.80
2 Banks closed in 1987	117,006	549.52
91 Banks Serviced	156,101	641.99

Source: 1987 PDIC Annual Report.

Table 34
ESTIMATED LOSSES OF PDIC DUE TO BANK FAILURES,
1970-1987
(in million pesos)

Particulars	Amount
^{a/} Gross Income	1,222.73
^{b/} Estimated Insured Deposits Payable	3,500.65
^{c/} Gain (Loss)	(1,267.46)

^{a/}
Composed of assessment income, interest income and other income.

^{b/}
Obtained from Table 31.

^{c/}
Operating expenses (i.e., personal services, management expenses, communications, interest expense, travel, and others) are not yet netted out from this figure.

Source: 1987 PDIC Annual Report.

Table 35

LIABILITIES OF DBP TRANSFERRED TO THE
NATIONAL GOVERNMENT
(in billion pesos)

Particulars	Amount
Total	61.4
A. Liabilities	
Peso Deposits	5.2
Private	0.0
Government	5.2
Bills Payable	50.3
Peso Borrowings	15.1
Fx Borrowings	35.2
Other Liabilities	6.4
B. Trust Funds	0.4
C. Contingent	23.0
Outstanding Guarantees	21.5
Unavailed of Guarantees	1.5

Source: Development Bank of the Philippines (1986).

item transferred to the national government; of the P15.1 billion local borrowings, SSS claims amount to about P6.5 billion; and foreign borrowings of about P35.2 billion come from 49 foreign loan accounts. Table 36 shows that of the US\$3.9 billion foreign liabilities of the DBP transferred to the national government, US\$1.4 billion have already been restructured with foreign creditors.

PNB's liabilities transferred to the national government is detailed in Table 37: The peso deposits of P6 billion belong to the national government, government corporations and private individuals; PNB still services withdrawals by government corporations and private individuals of these deposits on a reimbursable basis, i.e., the national government reimburses PNB equivalent to the amount withdrawn; and foreign borrowings comprise the biggest liability item transferred to the national government. Furthermore, of the US\$1.2 billion foreign liabilities of PNB transferred to the national government, US\$975 million have already been restructured with foreign creditors (Table 38).

The recent financial crisis had severely strained the resources of the CB. It lost heavily in its swap operations and forward exchange cover. It paid very high rates on its CB bills when it mopped up excess liquidity between 1984 and 1986 to stabilize the economy. It has been servicing foreign loans transferred to it by the national government, government corporations and private entities which collapsed during the height of the balance-of-payments crisis. Its total losses were estimated at P.18.2 billion, P10.9 billion and P16.9 billion in 1986, 1987 and 1988, respectively.¹⁵ These losses represent three percent, 1.6 percent and 2.1 percent of the nominal GNP in 1986, 1987 and 1988, respectively.

Recently, the Department of Budget and Management (DBM) came up with a detailed breakdown of the consolidated public sector deficits for the period 1986 to 1988. These are reproduced in Table 39. While these figures are still preliminary, they, nonetheless, give an indication of the magnitude of the contribution of government financial corporations' losses to the consolidated public sector deficit. In 1986 alone, the losses of the CB and government financial institutions (GFIs) plus the national government's financing to GFIs already amounted to P51.2 billion which was roughly 8.3 percent of the 1986 GNP. In 1987 and 1988, losses of the CB stood out prominently.

The huge consolidated budget deficits suggest that the financial losses incurred by financial and non-financial government corporations have exacted a heavy toll on the general public.

15. A detailed breakdown of these losses could not be obtained. Also, losses of the Central Bank in earlier years were not made available.

Table 36
**FOREIGN LIABILITIES OF DBP TRANSFERRED TO THE
 NATIONAL GOVERNMENT**
 (in US\$M)

Particulars	Restructured	Unrestructured	Total
Real			
Long-term	699.8	1,827.1	2,526.9
Short-term	149.4	0.0	149.4
Others	0.0	13.4	13.4
Contingent-Outstanding Guarantees	500.2	698.6	1,198.9
Grand Total	1,349.5 =====	2,539.2 =====	3,888.7 =====

Note: These are outstanding balances as of 31 December 1988 using 29 December 1988 exchange rate of the Central Bank.

Source: Bureau of Treasury.

Table 37
**LIABILITIES OF PNB TRANSFERRED TO THE NATIONAL
 GOVERNMENT**
 (as of November 1986)
 (in billion pesos)

Particulars	Amount
Total	53.0
Breakdown:	
Peso Deposits	6.0
FX Deposits	0.5
TCD* (Special financing)	4.9
Due to Treasurer of Philippines	0.0
Due to CBP	0.1
Bills Payable	36.7
Peso borrowings	16.4
FX borrowings	20.3
Marginal Deposits	0.1
Accrued Taxes and Other Expenses	2.4
Outstanding Acceptances	0.5
Other Liabilities	1.9

*TCD = Time Certificate of Deposit
 Source: Philippine National Bank (1987).

Table 38
FOREIGN LIABILITIES OF PNB TRANSFERRED TO THE
NATIONAL GOVERNMENT
(in US\$M)

Particulars	Restructured	Unrestructured	Total
Real			
Interbank Borrowings	108.7	0.0	108.7
Bankers-Acceptances	7.0	0.0	7.0
Bits Payable	371.1	108.6	479.7
Contingent	488.5	135.2	623.6
Grand Total	975.3	243.8	1,219.0

Note: These are outstanding balances as of 31 December 1988 using
29 December 1988 exchange rate of the Central Bank.

Source: Bureau of Treasury.

Table 39
BREAKDOWN OF PUBLIC SECTOR DEFICIT
(in billion pesos)

Particulars	1986	1987	1988
National Government (NG) Deficit	(31.2)	(20.1)	(25.5)
Monitored Corp. Deficit	(6.8)	(3.2)	2.1
Less: NG Financing to Monitored Corporations	11.7 ^{a/}	8.4 ^{a/}	5.4
Add: NG Transfers to PNOOC	-	-	(1.5)
Public Sector Borrowing Requirement (PSBR)	(26.3)	(14.9)	(19.5)
Local Government Units (LGU) Surplus	0.3	0.3	0.5
CB Deficit	(18.2)	(10.9)	(16.9)
Government Financial Institutions (GFI) Surplus b/	(12.0)	1.3	2.1
SSS/GSIS Surplus	5.5	5.1	4.7
Less: NG Financing to LGUs and GFIs	21.0 ^{c/}	0.3 ^{c/}	1.4
Consolidated Public Sector Deficit	(29.7)	(18.8)	(27.7)
As % of GNP	(4.8)	(2.7)	(3.4)

a/ Incorporates NPC capital transfer to LGUs.

b/ Includes DBP, PNB, PDIC, Philguarantee, Asset Privatization Trust, Home Financing Corporation, National Home Mortgage Finance Corporation and Philippine Crop Insurance Corporation.

c/ Incorporates PNB transfer to NG. Only a very small portion of this item went to local government units (LGUs).

Source: Department of Budget and Management (Preliminary Estimate).

VIII. CONCLUDING REMARKS

The Philippine formal financial system has already achieved a certain degree of sophistication. At present, banks package different types of loans and offer various types of deposit and investment instruments. However, this degree of sophistication cannot compare with those of her Asian neighbors such as Korea, Taiwan, and Malaysia.

The financial system experienced three major crises since 1970: the first in the mid-1970s; the second in 1981; and the third in 1983-1984. The banking problems that emerged in the 1970s were brought about by sporadic closures of some banks which caused a run on other banks. In contrast, the banking problems in the 1980s were deep and systemic. Between 1970 and 1987, the CB closed a total of 221 banks, 173 or 78 percent of which occurred during the last seven years.

The economy is now on the road to recovery, and so is the financial system. It must be noted, however, that the level of CB assistance to financial institutions still appears to be very high (Table 14). Indeed, this leaves the CB very little elbow room to avert a major crisis without going back to the period of high interest rates. It also suggests that the financial system is not yet over the hump.

The volatile situation of the financial system has a far-reaching implication on banks' intermediation function. Since banks have difficulty in attracting long-term funds from depositors who are still reeling from the traumatic effects of the 1981 liquidity and 1983-84 balance-of-payments crises, banks do not wish to lend long to the business sector. Their latest experience with term transformation indicates that it works against them during periods of instability (Remolona and Lamberte 1986).

There are several important lessons that can be drawn from the results of this study. They can be grouped into two general headings, namely, macroeconomic policy framework and banking supervision and regulations.

A. Macroeconomic Policy Framework

1. Erroneous economic policies had put the financial system under severe stress. The debt-driven growth accompanied by overvalued domestic currency in the 1970s produced the illusion that the real side of the economy was heading towards a robust economic growth. Financial institutions were running after fast-growing firms regardless of whether they were highly leveraged or not. It seems that they forgot that high leverage means high risk in normal conditions but deep trouble under the worst circumstances. For those who could not be accommodated by local financial institutions, the government's liberal guarantees provided them with

easy access to foreign loans. But when the real sector caved in, the financial system had to give in. Financial institutions such as PISO Bank, DBP and PNB, which had large foreign loan/guarantees exposure could hardly withstand a sharp adjustment in the exchange rate.

2. Countercyclical policy, an effective cushion to the impact of external shocks on the domestic economy, was used beyond its effective limits. Despite serious structural defects in the economy, the countercyclical policy initiated in 1979 was extended for five years. Government took over large ailing non-financial and financial corporations which required more capital infusion to keep them afloat, thus, diverting scarce government resources from productivity-increasing activities, such as infrastructure. Worse still, foreign loans were used to finance the implementation of countercyclical measures. Since this did not produce more foreign exchange, the countercyclical program only aggravated the balance-of-payments problem. The program would have yielded better results if it was preceded by structural adjustment in the economy.
3. Policymakers downplayed the harmful effects of financial repression on the economy. The rapid emergence of the money market in the early 1970s should have been taken as a cue to liberalize the financial markets; however, the reverse was done. Fearful of the negative impact of high interest rates on investments, policymakers imposed interest rate ceilings and reserve requirement on money market instruments. Financial institutions countered by introducing innovations that allowed them to evade such regulations. This made the supervisory functions of the CB more complicated.

B. Banking Supervision and Regulation

1. The CB's slow reaction to practices that tend to subvert its rules and regulations could lead to serious problems for the financial system. Fund sourcing through the sale and buy-back of without-recourse commercial paper is a classic example of how financial institutions beat CB rules and regulations. Such practice undermines the development of a true commercial paper market where trading is done on a without-recourse basis. Unfortunately, CB's measures such as prohibiting the attachment of a post-dated check to the without-recourse transactions, disallowing pretermination, and others, which were earlier proposed by some banks to counter malpractices came in too late when the money market already collapsed.

2. Most of the failures of financial institutions were associated with insider abuse and the monetary authorities seem helpless in eliminating or at least minimizing it. In spite of the regulation limiting the amount of DOSRI accommodations, CB examiners could not pinpoint any violation because they are prevented by the Deposit Secrecy Act from checking the deposit accounts of DOSRI. Inconsistent regulations seem to have rendered bank supervision ineffective. Moreover, the CB can only give notices, recommendations and warnings to concerned banks whenever results of bank examination indicate that some anomalies are being committed. Indeed, the lack of the power to issue "cease and desist" order has prevented the CB from quickly checking fraud before it can do more harm to the bank. The seeming helplessness of the CB in dealing with insider abuse can be further aggravated by political pressure such as the case of BF wherein President Marcos reversed the decision of the CB not to provide additional assistance due to anomalies.
3. The issue on insolvency is another stumbling block in the financial system. Under the CB Act, insolvency means that the realizable assets of a bank or non-bank financial intermediary performing quasi-banking functions as determined by the CB are insufficient to meet its liability. Thus, the size of loan loss reserves could make or break a bank. There were several cases wherein loan loss provisions recommended by the CB were contested by bank officers. For example, Manila Bank had been contesting the loan loss provision suggested by the CB up to the time of its closure. Those cases dragged on for a long time without any resolution. The CB should, therefore, devise a standard set of guidelines in determining loan loss reserves to avoid subjective assessment by CB examiners and bank officers.
4. The CB seems to be doing a good job in containing the effects of bank failures on the financial system and the economy by promptly giving emergency advances to banks hard hit by a run. However, there are no guidelines on the level of financial assistance the CB should give to each bank. This has actually led to unequal financial support to banks or unnecessary heavy exposure of the CB to banks with irreversible financial position. The CB should, therefore, institute measures to prevent itself from being heavily exposed to a seriously-ill bank.
5. While the CB remains alert in providing assistance to banks experiencing liquidity problems, it tends to waver when it comes to prosecuting bank owners and officers who mismanaged and plundered their bank. There were several cases wherein the CB had indicated that anomalies were committed by bank owners/officers, yet no case was filed against these erring individuals. With this stance, it can be said that the CB has virtually surrendered one important weapon in forestalling or minimizing insider abuse.

6. Political patronage in banking, especially in government- owned banks, can kill the banks themselves. This had happened to PNB and DBP wherein behest loans often led to the breakdown of financial and accounting controls. While government-owned banks should fulfill their special missions, they should, nevertheless, adhere to sound banking principles and practices. Independent board decisions and greater transparency in the operations are steps in the right direction.

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