AN ASSESSMENT OF POLICIES AFFECTING THE FINANCIAL SECTOR, 1986-1988

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AN ASSESSMENT OF POLICIES AFFECTING THE FINANCIAL SECTOR, 1986-1988*

Mario B. Lamberte and Julius P. Relampagos**

I. INTRODUCTION

This paper assesses the performance of the Aquino government in the financial sector. The first section presents the major policies and strategies outlined by the government. This is followed by a section that describes and analyzes the actions taken by the government in relation to the policies and strategies earlier spelled out. The third section assesses quantitatively the results of the policies and strategies adopted by the government in the financial sector. The fourth section discusses some policy issues that need to be addressed by the government.

II. MAJOR POLICIES AND STRATEGIES IN THE FINANCIAL SECTOR

The government's policies and strategies in the financial sector are clearly spelled out in the Medium-Term Philippine Development Plan, 1987-1992. The updated version of the Plan that was presented to the public in several hearings essentially retains the major policies and strategies with some minor modifications and additions. The following presents in toto the

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*This is Chapter IV of a larger study conducted by PIDS that reviews the performance of the Aquino Government on selected policy areas from 1986-1988. The assistance of Ms. Merle Gonzales and Ms. Nitz Tolentino for typing the draft is gratefully acknowledged.

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government policies and strategies in the financial sector as indicated in the Plan. We will indicate in the footnote whether the policy statements are based on the original or updated version of the Plan.

A. Improvement of the Financial Structure

Central Bank supervision and regulation of financial institutions shall be improved to promote a stronger and more stable financial system. To effectively pursue this, the Central Bank's independence from the executive branch shall be safeguarded. Freer entry into all areas of banking and finance shall be allowed to enhance efficient financial intermediation through competition, subject to prudent requirements for the protection of depositors. Furthermore, the Central Bank's responsibility to stabilize interest rates, prices, and the exchange rate shall be emphasized.

Consistent with the policy to cut down the overall size of the public sector in the financial system, the size and scope of operations of government financial institutions (GFIs), particularly the Development Bank of the Philippines (DBP) and the Philippine National Bank (PNB), shall be reduced by 1988. To further enhance the efficiency of these institutions through greater market competition, special privileges extended by the National Government and the Central Bank shall be eliminated. Steps shall be undertaken to increase private sector participation in the management of these institutions to ensure greater public accountability. In addition, the government shall completely divest itself of at least the majority stockholdings of the former privately-owned commercial banks by the end of 1988. 1/

B. Improvement of the Rural Credit Market

The development of the rural financial markets, in tandem with initiatives to improve the viability of the rural sector, shall be given emphasis. This will involve, in the immediate term, the rationalization and strengthening of the rural banking system to enable it to generate locally-sourced funds to support its lending and other financial functions in the rural areas, thus performing its lead role in agricultural development.

The transition towards a viable and self-sustaining rural financial structure which is capable of performing efficient intermediation functions will require an extensive review and possible modification of policies that hinder the expansion of financial services in the rural sector.

1/ This last statement is taken from the Updated version of the Plan.

In addition, the strengthening of countryside banking shall be accompanied and supported by adequate technical and infrastructure support and other feasible and cost-efficient mechanisms to reduce the risk and uncertainty of agri-oriented endeavors, as well as to create a resurgent market for agricultural loans. As a complementary measure, agricultural research and the strengthening of market intelligence systems will be pursued.

C. Rationalization of Government Regulations Affecting Intermediation Cost

An environment conducive to investments and growth shall continue to be encouraged. Government regulations affecting banks' intermediation costs shall be rationalized, i.e., gradual reduction in the reserve requirements when circumstances so warrant. Moreover, further reduction in intermediation costs through the repeal of the agri-agra requirements shall be endorsed for legislative action. On the other hand, the gross receipts tax shall be abolished within the Plan period, pending the successful implementation of the value added tax. 2/

D. Continued Adoption of a Market-Determined Interest Rate Policy

To enhance efficiency in financial intermediation, the determination of interest rates shall continue to be left to market forces. A positive real deposit rate will be maintained to encourage holding of surplus funds to channel an increasing portion of these funds to the banking system. 3/ The allocation of credit to sectors through the imposition of interest rate ceilings shall be resisted. All remaining forms of interest rate subsidies to specific sectors (including the government) through the Central Bank credit facilities shall be eliminated by 1987.

E. Development of the Domestic Capital Market

The intermediation and allocation of medium- and long-term financial resources for economic growth shall be improved through the development of the domestic capital markets. A favorable climate for the increased volume of medium- and long-term savings in the financial system will be provided by offering investors a varied choice of financial instruments and investment opportunities. In particular, the securities markets shall be strengthened to effectively mobilize savings and channel them into productive enterprises.

2/ This paragraph is taken from the Updated version of the Plan.

3/ This was mentioned on p. 385 of the original version of the Plan.

To stimulate long-term capital market development, the government shall foster conditions conducive to a market determination of interest rates. The shift in Central Bank policies towards a market orientation in interest rates and away from credit allocation or development financing subsidies and fixed rates shall be continued.

The development of a secondary market for government securities shall be actively pursued through improvements in trading securities and the continued market determination of the yield on government issues. The revival of the auction system for the marketing of publicly-offered issues will ensure that government securities are sold in an orderly but competitive environment and that interest rates are really market-determined. Interest-bearing bills of the Central Bank shall be gradually withdrawn from the financial system in favor of market competitive government securities that shall serve as the main instruments for open market operations.

To achieve efficient placement and active trading of marketable securities, accredited government securities dealers shall be strengthened to ensure effective marketing at the primary level, institutionalize secondary trading, and sustain secondary market development.

F. Prudent Monetary Management

The movement of monetary aggregates shall continue to be managed and closely monitored to help ensure consistency with broad macroeconomic targets. Open market operations and adjustments in reserve requirements shall be the major tools for monetary management.

III. ACTIONS TAKEN BY THE MONETARY AUTHORITIES/EXECUTIVE BRANCH AND LEGISLATIVE BRANCH OF THE GOVERNMENT

With the reconstitution of the Congress, the monopoly of the Monetary Authorities/Executive Branch in formulating monetary and credit policies has ended. 4/ As may be gathered from the numerous bills being filed in both the Senate and House, Congress has definitely taken an aggressive stance as far as formulation of economic policies in the country is concerned.

Reforms that require legislative actions have to be initiated by Congress. For their part, the Monetary Authorities/Executive Branch can initiate reforms only within the

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4/ The Monetary Authorities and Executive Branch of the government are lumped together because at present, the Monetary Board is dominated by government representatives acting on an *ex-officio* basis.

limits of existing laws. It should, however, be noted that the two bodies are independent from each other. Thus, under this setup, divergence in views and policy prescriptions could arise.

Laws always prevail. Under this ball game, however, Congress can change laws, while the Monetary Authorities/ Executive Branch are limited only to executing them. In assessing the actions taken by the government with respect to policy reforms in the financial sector, it is therefore necessary to separate those that are initiated by the Monetary Authorities/Executive Branch from those that emanate from Congress.

A. Improvement of the Financial Structure

1. Actions Taken by the Monetary Authorities/Executive Branch

The rash of bank failures in the wake of the balance-of-payments crisis, despite massive Central Bank assistance, prompted regulatory agencies to institute more measures to prevent such failures and at the same time, strengthen the banking system. Interestingly, most of the recently instituted measures are designed to minimize mismanagement and insider abuse. This is a tacit admission of the view that bank failures were mainly caused by fraud or insider abuse.

There were actually two types of measures that have been instituted - one that could be done within existing laws and another one that required changes in the charter, particularly the Central Bank Act and the General Banking Act. As regards the first set, the Central Bank effected some regulatory changes through the issuance of circulars (See Table 1). One of the changes was the expansion of the coverage of the single borrower's limit. In particular, the new regulation requires the 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 on single borrowers and the ceiling on outstanding guarantees a bank can issue 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 Central Bank requires the condition that the loan documents include a waiver on the part of the depositor of his right under

Table 1

SUMMARY OF CHANGES IN CENTRAL BANK REGULATIONS, 1986-1989

Circular No.	Effectivity Date	Supervision/Control	Deregulation
1093	Feb. 26, 1986	Requiring RBs to post within their premise a copy of their quarterly Statement of Condition.	
1104	May 26, 1986		Reducing required reserve from 23% to 22% against KBs: demand deposits savings deposit NOW accounts time deposit (730 days or less) deposit substitute (730 days or less) Thrift banks: demand deposits deposit substitute (730 days or less) NBFIs: deposit substitutes (730 days or less)
1112	Aug. 4, 1986		Reducing further the required reserves from 22% to 21% for the same accounts stated in Circular 1104
1113	Aug. 14, 1986	Prohibiting banks to re-discount loans granted from Special Time Deposits (STD) provided by the government for the Gulayan sa Kaunlaran Program.	

(Table 1 cont'd)

Circular No.	Effectivity Date	Supervision/Control	Deregulation
1114	Sept. 1, 1986	Setting the loan value of 80% and rediscount rate of 11.75% p.a. for the rediscount facility of the CB for eligible papers in agricultural production, cottage and small industries credits, general purpose working capital financing and other short-term credits.	
1115	Sept. 16, 1986	Prohibiting concurrent officerships between banks or between a bank and a non-bank financial intermediary except with prior approval of the Monetary Board.	
1119	Oct. 10, 1986	Requiring all banking institutions, including banks with expanded commercial banking authority to maintain a 21% reserve against deposit substitute liabilities with original maturities of 730 days or less, except short-term borrowings from banks and non-bank financial institutions for which the reserve requirement shall be 1%. A 6% reserve against deposit substitute liabilities with original maturities of more than 730 days for NBQBs shall also be maintained.	
1122	Nov. 23, 1986		Reducing the required reserves for time deposits from 6% to 5% for all banking institutions (i.e., KBs, Thrift banks, RBs) and non-bank financial intermediaries. Likewise, required reserves against deposit substitute liabilities with original maturities of more than 730 days is reduced from 6% to 5%.

(Table 1 cont'd)

Circular No.	Effectivity Date	Supervision/Control	Deregulation
1123	Dec. 5, 1986	Provides for the inclusion in the determination of the single borrower's loan limit under Section 23 of R.A. 337 the outstanding foreign and domestic standby and deferred letters of credit less marginal deposits and outstanding guarantees, except those fully secured by cash, hold-out on deposits/deposit substitute or government securities. Likewise, aggregate ceiling on issuance of guarantees is provided whereby a bank may not issue more than 50% of its unimpaired capital and surplus standby letters of credit foreign and domestic, including guarantees, except those fully secured by cash, hold-out on deposits/deposit substitutes or government securities. For NBQBs, it must not exceed 50% of their networth.	
1124	Dec. 5, 1986	Requiring each bank to cause an annual financial audit to be conducted by an external independent auditor not later than 30 days after the close of the calendar year and reports of such audit shall be submitted to the CB not later than 90 days after the start of the audit.	
1125	Dec. 15, 1986		Reducing the rediscount rate to 10% p.a. from 11.75% p.a. as previously provided in Circular 1114 for the same eligible papers.

(Table 1 cont'd)

Circular No.	Effectivity Date	Supervision/Control	Deregulation
1133	Feb. 9, 1987		Exempting from legal reserve requirement special time deposits and deposit substitutes arising from the lending operations of IGLF and ALF.
1135	Feb. 23, 1987	Requiring the lending bank to keep a complete record of all pertinent loan documents which shall be made available for inspection and/or examination by the CB.	
1143	April 24, 1987	Setting the guidelines for the rehabilitation of rural banks through a capital build-up consisting of a prerequisite fresh capital infusion and a subsequent conversion and/or plan of payment of all arrearages with the Central Bank which are past due and unpaid as of Dec. 31, 1986.	
1147	June 19, 1987	Prohibiting the account of interest income of the loans or loan installments have matured or have become past due. Also interest income shall not be accrued for unmatured loans/receivables with indications (i.e. bankruptcy, insolvency, cessation of operations, or such other conditions of financial difficulties to meet financial obligations as they mature) that collectibility has become doubtful. Accrued interest earned but not yet collected shall not be considered as profits and/or earnings eligible for dividend declarations and/ or profit sharing purposes.	

(Table 1 cont'd)

Circular No.	Effectivity Date	Supervision/Control	Deregulation
1151	Aug. 27, 1987	Provides that ALF facility may be extended to finance both seasonal production credit and medium and long-term subloans for fixed assets and permanent working capital, except for the acquisition of land. Likewise, the interest rate on the subsidiary loans shall be market oriented. Different rates may be provided for production and longer-term credit.	
1158	Oct. 5, 1987	Amending Circular 1143 regarding the fresh capital infusion. In cases where capital infusion exceeds the amount of P500,000.00, the excess may be paid into the rural bank by its stock-holders and investors in monthly installment, provided that the first installment on the fresh capital infusion shall not be less than the amount required to fullfill the minimum 10% risk asset ratio. Participating rural banks are not qualified to avail of rediscounting unless the required capital infusion is completed.	
1166	Dec. 16, 1987	Requiring all banks and non-bank financial intermediaries to adopt the Statements of Financial Accounting Standards (SFAS) in their financial statements and reports to the CB which are purported to be prepared in accordance with generally accepted accounting principles.	

(Table 1 cont'd)

Circular No.	Effectivity Date	Supervision/Control	Deregulation
1172	March 29, 1988		With the exception of rural banks whose applications have already been approved under Circular 1143, as amended by Circular 1158, all rural bank with arrearages are eligible to participate under the program except those with serious irregularities based on examination findings of the CB. Rural banks with supervised credit arrearages where the required capital infusion exceeds the amount of P500,000, the excess may be covered by the RB's availing itself of the conversion scheme provided that the alternative should not be construed as preventing the stockholders, if they so desire for the interest of the rural bank, from infusing more than P500,000. A rural bank may have the option of sourcing the payments to the CB from its cash resources provided such option will not reduce the liquid funds necessary to meet the deposit reserve requirements and day-to-day operations of the bank.
1183	Sept. 15, 1988		Requiring branches, agencies, extension offices, etc., and/or head offices of commercial banks, and specialized government banks in a particular regional grouping outside the National Capital Region to invest therein as a means to develop that region 75% of total deposit liabilities and provisions for "till money." "Deposits" shall exclude:

(Table 1 cont'd)

Circular No.	Effectivity Date	Supervision/Control	Deregulation
			(1) government deposits subject to 75% liquidity floor requirement (2) deposit of banks maintained for clearing purposes in areas where there are no CB clearing units However, the twelve regional groupings have been reduced to three enlarged groupings namely Luzon, Visayas and Mindanao. The enlarged groupings shall be used for purposes of determining the regional retention of deposits. This policy shall be deemed complied with if, in a particular region, the bank's lending for the financing of agricultural and export industries aggregated 60% of its deposits.
1188	Oct. 28, 1988		Eliminating the pre-requisite investment in government securities for purposes of establishing/opening branches and other banking offices by banks.
1191	Nov. 23, 1988	Provides for the formulation and monitoring of the "new" Manila Reference Rates (MRRs) which will be based on the weighted average of the interest rates paid during the immediately preceding week by 10 commercial banks with the highest combined levels of outstanding deposit substitutes and time deposits on promissory notes issued and time deposits received by these banks, of P100,000 and over per transaction account, with maturities corresponding to the interest periods for which such	

(Table 1 cont'd)

Circular No.	Effectivity Date	Supervision/Control	Deregulation
		reference rates are being determined.	
1200	May 16, 1989	The CB shall, therefore refrain from sustaining weak banks except in times of general financial emergency or when specific banks face problems of liquidity rather than of solvency. There is no bar to granting new licenses and, accordingly, the establishment of new banks in the future shall be allowed, with the CB determining the qualifications such as but not limited to compliance with all requirements of existing laws, capitalization, direction and administration as well as the integrity and responsibility of the organizers and administrators. The CB has lifted the requirement to purchase special five-year government securities as a condition to open new branches. In rural areas that are classified under categories IV and V, all restrictions on opening new branches are hereby removed. In urban and particularly metropolitan areas, the Central Bank shall obtain its discretionary policy on branching, but allow a bank to open a new branch as long as the bank's market share in that area would not create any market concentration problems.	
1204	June 23, 1989	Raising the reserve requirement on deposit liabilities and deposit substitutes with original maturities of more than 730 days from 5% to 7% for all financial institutions (i.e. KBs, Thrift banks, and rural banks) including non-bank financial intermediaries.	

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 reduce wholesale bank anomalies, the Central Bank has required all banks, whether government-owned or controlled or private, to be subject to an annual financial audit by independent auditors. The board of directors of concerned banks, in a regular or special meeting, shall consider and act on the financial audit report and shall submit, within 30 days after receipt of the report, a copy of its resolution to the Central Bank. The resolution shall show, among others, actions taken by the board of directors on the findings and recommendations of the independent auditor. To further facilitate its job in supervising banks, the Monetary Board has required the lending banks to keep a complete record of all pertinent loan documents which shall be made available for inspection and/or examination by the Central Bank. In another circular, the Monetary Board has decided to prohibit concurrent officerships between banks or between a bank and a non-bank financial intermediary except with prior approval from the Board. This is one of the measures taken to reduce conflict of interest and also to strengthen bank management since being a bank officer requires a full-time job.

The latest Central Bank circular dated May 16, 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 takeover of weak banks.

As regards regulatory changes that required amendment of certain provisions of the Central Banking Act and General Banking Act, the Central Bank wasted no time in submitting proposals to this effect to the new government under the leadership of President Aquino who could have acted on all or a number of them before the newly-reconstituted Congress would have convened. It proposed 17 major amendments to the Central Bank Act which included among others, making the powers of supervision of the Central Bank 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 Central Bank 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 only on two of them - one pertaining to the role and powers of the receiver and liquidator and the other

one, on interbank settlements. As regards interbank settlements, an Executive Order signed by President Aquino intends to curb abuses usually practised by banks, especially the weaker ones. In particular, the new law provides that the Central Bank 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 Central Bank should either convert these into an emergency loan or advance with a plan of payment, or settle said overdrafts with the Central Bank.

The Central Bank also submitted to President Aquino for her approval 14 major proposed amendments to the General Banking Act. Most of the proposed amendments have focused on curbing insider abuse. 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 bank loans without proper documents. This would stop banks' previous practice of approving DOSRI loan applications even if the documentation is incomplete. Another proposed amendment being advanced is to authorize 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. Another important proposed amendment is the empowering of the Central Bank to issue "cease and desist" order. This is an additional regulatory and enforcement instrument of the Central Bank. However, not one of the 14 proposed amendments to the General Banking Act was acted upon by President Aquino. Thus, the burden of overhauling the Central Bank Act and the General Banking Act now rests with the Congress.

The World Bank Mission which visited the country last year has picked up most of the Central Bank-initiated proposed amendments to the Central Bank Act and General Banking Act and has incorporated them in the set of conditions attached to the Financial Sector Adjustment Loan.

While measures to improve the stability of the financial system through a more effective system of bank supervision have been instituted, some measures have also been adopted to enhance competition in the system. One of the measures was the relaxation of the deposit retention scheme. Previously, bank branches were required to invest 75 percent of the total deposit liabilities in their limited service area designated by the Central Bank. The new measure has expanded the definition of service area into only three major island groupings: Luzon, Visayas and Mindanao. 5/ In addition, the Monetary Board has significantly reduced barriers to entry. More specifically, it

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5/ See Circular 1183 on page 11.

has terminated its moratorium of giving new bank licenses, eliminated the prerequisite investment in government securities for purposes of establishing/opening branches and other banking offices by banks, and has allowed entry into all areas in the country, except in certain areas of the urban centers perceived by the Central Bank as "overbanked." 6/

The Philippine Deposit Insurance Corporation (PDIC) has been playing a passive role in the financial system. Its function is merely relegated to paying insured deposits of failed banks and occasionally, helping package a rehabilitation scheme for troubled banks. It has been perceived to be a mere adjunct of the Central Bank. This is not without reason. First, one of the deputy governors of the Central bank was the President of PDIC. And secondly, due to lack of funds, PDIC depends heavily on borrowings from the Central Bank to pay insured deposits of failed banks.

There is now a plan to make PDIC play an active role in the financial system. One major step so far taken by authorities was to appoint a full-time president who came from the private sector. Other plans for PDIC include increasing its capital and personnel complement and making it the receiver and liquidator of failed banks, thereby allowing the Central Bank to concentrate its efforts on bank supervision and management of liquidity.

As regards PNB and DBP, the government has opted for their rehabilitation. The first task that was done was to revise their respective charters. The second task was to transfer non-performing assets of these two institutions to the National Government which created the Asset Privatization Trust that takes care of disposing such assets. In 1986, DBP transferred to the National Government its non-performing assets amounting to ₱61.4 B and certain liabilities and related accounts amounting to ₱62.2 B. This resulted in the drastic reduction in DBP's total assets to ₱9.5 B in 1986 from a high ₱72 B in 1985. Recently, DBP has changed its lending procedure to make itself resistant to behest loans. This is done by including regional bank authorities in the process of making decision on loan requests.

Under its new charter, the authorized capital of PNB has been reduced from ₱25 B to ₱10 B. In 1986, PNB transferred to the National Government ₱47 B worth of non-performing assets and ₱55.4 B worth of liabilities. In addition, it had written off ₱5.2 B and booked ₱0.9 B as additional valuation reserve. With the rehabilitation program, PNB's total assets were substantially

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6/ The adverse impact of the previous regulation on deposit retention scheme and bank entry on the efficiency of the banking system is thoroughly discussed in Lamberte and Lim (1987) and Relampagos and Lamberte (1988).

reduced to ₱27 B in 1986 from ₱76 B in 1985. Starting on June 30, 1989, PNB no longer receives special treatment from the Central Bank beyond the normal rediscounting facility available to all commercial banks.

2. Actions Taken by the Legislative Branch

In response to the Constitutional provisions of creating a truly independent Central Monetary Authority, two separate bills have been filed in Congress (See Tables 2a and 2b). The House version introduces some amendments to the present Central Bank Act while the Senate version proposes an entirely new charter for the Central Bank. Both bills focus on the membership of the Monetary Board majority of which are supposed to come from the private sector and on strengthening the supervisory function of the proposed Central Monetary Authorities. A third bill simply proposes the decentralization of the country's Central Banking Authority, responsibilities and facilities on a regional basis. This is akin to the system in the US.

Concerned with the previous practice of using government to distribute political patronage and rampant insider abuse that caused several banks to fail, a bill filed in the House proposes to prescribe limits on loans or accommodations which government banks and other financial institutions may grant to borrowers. The proposed ceilings are substantially lower than the existing ones.

The PDIC has received much attention from lawmakers judging from the number of bills seeking to amend its present charter. The major provisions of the bills include, among others, increasing the permanent insurance fund, assessment rate, and maximum deposit insurance coverage; expanding the coverage of assessable deposits; requiring prompt payment of insured deposits; and increasing the participation of the private sector by including three representatives in the five-man board of directors of PDIC.

Increasing the maximum deposit insurance coverage from ₱40,000 per depositor to ₱60,000 or ₱80,000 or equivalent to full value of deposits may bring very little benefits to small depositors. As may be shown in Table 3, 96 percent of the total number of deposit accounts of the banking system are already covered by the existing maximum insurance coverage. However, increasing the insurance fund of PDIC may bring more benefits to all depositors, especially to small ones because it would enable PDIC to promptly pay insured deposits of failed banks. As may be gathered from Table 4, PDIC was still paying in 1987 insured deposits of closed banks in earlier years. Interestingly, one of the bills proposes to deny PDIC of receivership and liquidation power. This is inconsistent with the current plan of the government to transfer the receivership and liquidation power of the Central Bank to PDIC.

Table 2a

SENATE BILLS RELATED TO BANKING AND CREDIT POLICIES
(As of April 1989)

No.	Authors	Brief Description
Unnumbered	Aquino	"An Act to Promote Financial Intermediation in the Agricultural and Rural Areas" - exempt from purchasing any government securities whatsoever. - unrestricted entry. - at least 80% of the funds generated shall be retained in the rural areas. - Allowed to invest or lend not more than 15% of its net worth. - the total amount of equity investments shall not exceed fifty percent of its net worth. - exempt from the gross receipts tax and from the EO No. 37 imposing a twenty percent withholding tax on interest income. - free from Central Bank imposed interest rates on loans, deposits, deposit substitutes and trust funds. - market determined interest rates on loans, deposits, and trust funds.
19	Romulo and Herrera	"An Act Providing for Credit Assistance For Overseas Workers" - provides interest-free fund advances to be repaid via monthly wage/salary deduction.

No.	Authors	Brief Description
159	Alvarez	"An Act Creating the Cooperative Development Authority to Promote the Viability and Growth of Cooperatives as Instruments of Social Justice and Economic Development, Defining its Powers, Functions and Responsibilities, Rationalizing Government Agencies with Cooperative Functions, Transferring the Registration and Regulation Functions of Existing Government Agencies on Cooperatives as Such and Consolidating the Same with the Authority, Appropriating Funds therefor, and for Other Purposes."
171	Alvarez	"An Act Providing for Credit to Agrarian Reform Beneficiaries through the Banking System and the Mechanism and Incentives thereto" - provides that all banking institutions shall set aside at least 25% of their loanable funds for agricultural credit to be distributed as follows: a) 15% of loanable funds for agricultural credit in general; and b) 10% of loanable funds for agrarian reform beneficiaries (ARBs) c) alternatively, to invest these funds in certain government securities. - loans granted directly to ARBs to be credited at two hundred percent (200%) - exemption of interest income on loans to ARBs from Gross Receipts Tax (GRT). - losses on loans to ARBs deductible up to one hundred fifty percent (150%).

No.	Authors	Brief Description
202	Mercado	"An Act to Provide Maximum Rates of Interest to Loans Up to the Amount of Ten Thousand Pesos" - Progressive interest rate for pure and simple loans up to the amount of ₱10,000.00. - Maximum rates of interest for simple, personal loans: a) 1.50% per month if the sum lent does not exceed ₱2,000.00. b) 1.75% per month if the sum lent does not exceed ₱4,000.00 c) 2.00% per month if the sum lent does not exceed ₱6,000.00. d) 2.25% per month if the sum lent does not exceed ₱8,000.00 e) 2.50% per month if the sum lent does not exceed ₱10,000.00.
268	Maceda	"An Act Amending Presidential Decree Numbered One Hundred Fourteen by Revising and Incorporating therein the Rates of Interest and other Charges Collected by Pawnshops and for other Purposes" - Pegged interest rate at three (3) percent per month when the sum lent is not more than one hundred pesos; two and one-half (2 1/2) percent per month when the sum lent is more than one hundred pesos but not exceeding five hundred pesos; two (2) percent per month when the sum lent is not exceeding one thousand pesos; and fourteen (14) percent per annum when it is more than one thousand pesos. (150%).

No.	Authors	Brief Description
		- No interest shall be collected at any time before maturity, if said loans is only of three months duration or less. Advance interest payments may be required on loans with a period of more than three months provided that no collection shall be made on the first three months and that only interest for a total period of six months may be collected in advance. - A service charge of ₱5 for loans not exceeding five hundred pesos or a maximum of one (1) percent of the principal loans if exceeding that amount. - Loans not more than three thousand five hundred (₱3,500.00) pesos are free from documentary stamp tax. - The basis of interest due after maturity shall be the sum of the principal of the obligation, and interest earned at the time of maturity.
368	Romulo and Guingona	"An Act Repealing Sections 220, 221, and 222, under Title VIII, of the National Internal Revenue Code of 1977, as Amended by Presidential Decree No. 1739 and further Amended by Presidential Decree No. 1994" - abolition of the Gross Receipts Tax imposed on interest incomes of banks.
614	Romulo	"An Act Repealing Presidential Decree Numbered Seven Hundred Seventeen as Amended `Providing an Agrarian Reform Credit and Financing System to Agrarian Reform Beneficiaries through Banking Institutions'."

No.	Authors	Brief Description
		- abolishing the 25% agri/agra loan quota.
681	Maceda	"An Act Directing the Monetary Board or the Central Monetary Authority, as the Case might Be, to Program and Eventually Implement the Appropriate Decentralization of the Country's Central Banking Authority, Responsibilities and Facilities, on a Regional Basis Commencing Initially with Full Central Banking Capability Respectively for Luzon, Visayas and Mindanao"
743	Shahani, Laurel, Mercado and Pimentel	"Magna Carta for Small Enterprises" - Collateral-free or less collaterally burdened loans for small enterprises - Preferential interest rates on loans obtained under the credit program. - Exemptions from import taxes, fees or duties on imported machineries or equipment. - A fair share of at least 15% of total procurement value of goods and services supplied to the government
880	Romulo and Alvarez	"An Act Strengthening the Rural Financial System of the Philippines, Designating the Land Bank of the Philippines as the Apex Bank and Providing the Funds therefore, and for other Purposes" - 60% of the amount representing the fresh government equity infusion shall be used for agricultural loans and 40% of it for other countryside entities.

No.	Authors	Brief Description
		- Banks should maintain a risk-asset ratio of not less than ten percent (10%) after infusion - Members of the rural financial system are exempted from payment of the Gross Receipts Tax while rural banks shall be exempted from the payment of all taxes and fees for a period of 15 years from the approval of this account. - LBP shall have equity interest of up to 49% in these Regional Agricultural Banks.

Table 2b

HOUSE BILLS RELATED TO BANKING AND CREDIT POLICIES

No.	Author/s	Brief Description
2	Puyat-Reyes, Coseteng, Verano-Yap, Aquino-Oreta, Isidro, Lopez, Fugoso, Bagatsing (A.), Bagatsing (R.), Ocampo, Yap, Aquino, Mathay, Jr., Angeles, Webb, Javier, Tinga, Zamora, Serapio, Aguilar, and Dragon	"An Act to Amend Republic Act No. 3591, otherwise known as The Philippine Deposit Insurance Corporation Act, as Repealed further by Republic Act No. 6037, and Amended by Presidential Decree Nos. 120, 653, 1094, 1451, 1897, 1940, 1985 and Executive Order No. 890,and for other Purposes" - Maximum assessment rate is increased to 1/5 of one (1) percent per annum. - Coverage of assessable deposits is expanded to include the liabilities of the bank for cashier's, manager's and other officer's checks, demand drafts, telegraphic transfers, and other payment orders payable. - The assessment rate will be applied to the gross assessment base without any deductions. - Interest shall be charged on all unpaid assessments. - Receivership and liquidation power of PDIC is abolished. - The permanent insurance fund is increased to ₱5 billion. - Interest rates on PDIC loans from the CB is the prevailing rediscount rate or at similar rate as may be determined by the CB.
239	Real, Jr. and Gonzales	"An Act Requiring Prompt Payment of Insured Deposits of Closed Banks, and Amending for this Purpose Section 10 (c) of Republic Act No. 3591, otherwise Known as the Charter of the Philippine Deposit Insurance Corporation, as Amended"

No.	Author/s	Brief Description
		- Appropriates ₱5,000,000 from the General Fund as permanent insurance fund. - Maximum amount of the insured deposit of any depositor shall be ₱40,000. - In case of closure on account of insolvency, the corporation shall extend payment of the insured deposit, within a period of thirty days, either by cash or by making available to each depositor a transferred deposit in another insured bank in an amount equal to the insured deposit.
325	Romualdo, Pilapil, Romero, Camasura, Jr., Unico, del Mar, Garcia (P.), Ozamis, Amante, Amatong, Chavez, Pelaez, Tevez, Agana, Labaria, Almario, Lobregat and Puyat-Reyes	"An Act Establishing the Government Machinery to Promote the Growth and Expansion of Cooperatives as The People's Organizations for Creating, Sustaining and Increasing their Economic Opportunities, otherwise Known as The Cooperative Law of 1987" - Exemption from all government taxes, duties, levies and fees of whatever name and nature, - Exemption from payment of income, sales and lending investors tax, - Exemption from the payment of fees and charges for services in connection with any document or paper required in the organization. - Exemption from the payment of fees for services of a register of deeds in connection with any deed of sale, conveyance, transfer, or exchange of real property or any deed or instrument in connection with any loan. - Exemption for the payment of all court and sheriffs' fees

No.	Author/s	Brief Description
		- Exemption from the payment of documentary stamp tax, residence tax, and taxes on banks and insurance companies - Preferential right to supply agricultural and marine products to state agencies. - In appropriate cases, exemption from the application of the minimum wage law.
1291	Real, Jr., Cainglet, Pandon, Jr., Agana, Valencia, Bagatsing, Jr. Garduce, Amatong, Andolana, Monfort	"An Act Prescribing limits on Loans or Accommodations which Government Banks and other Financial Institutions may Grant to Borrowers" - Limits financial accomodations to an amount not exceeding 5% of lender's net worth and not exceeding 100% of the borrower's net-worth.
1524	Real Jr., Dureza, Cainglet, Montejo, Amatong, Plaza, Bacunawa, Agana, Garduce, Alfelor, Dragon	"An Act Converting all Past Due Loans of Rural Banks with the Central Bank of the Philippines into Government Equity and for other Purposes."
1676	Bautista	"An Act Requiring all Government and Private Banks to Set Aside at Least One Percentum (1%) of their Yearly Liquid Assets to Help Finance the Projects and Livelihood Program of Fisheries all over the Country Utilizing the Local Banks to Service Said Financing"
1724	Bautista	"An Act Directing all Government and Private Banks to Set Aside at Least One Percentum (1%) of their Yearly Loanable Funds Exclusively for Funding the Drivers all over the Country."

No.	Author/s	Brief Description
1808	Bautista	"An Act Establishing a Farmers and Fishermen Bank in every Municipality Throughout the Country, and Providing Funds therefor." - A minimum authorized capital of ₱500,000.
2578	Bautista, Sr., Del Mar and Monfort	"An Act Directing the Central Bank of the Philippines to Provide Specific Lending Guidelines to Help Consumers and Marketing Cooperatives, and Appropriating Funds thereof as Seed Capital" - Appropriated One Billion Pesos (₱1,000,000,000) as "Seed Money" for lending.
2943	Ty and Monfort	"An Act further Amending Republic Act Numbered 3591 entitled `An Act Establishing the Philippine Deposit Insurance Corporation Defining its Powers and Duties and for other Purposes', as Amended" - Increases the maximum deposit insurance coverage in the banking system from ₱40,000 to ₱80,000. - The assessment rate shall not exceed one-tenth of one per centum per annum. - The permanent insurance fund is further increased to three billion (₱3,000,000,000) pesos.
7640	Real, Jr., Puyat-Reyes, Ty, the members of the Committee on Banks and Currency, Coseteng, Verano-Yap, Aquino-Oreta, Isidro, Lopez (J.),	"An Act further Amending Republic Act Number Three Thousand Five Hundred Ninety One, otherwise Known as the Charter of the Philippine Deposit Insurance Corporation, as Amended, and for other Purposes"

No.	Author/s	Brief Description
	Fugoso, Bagatsing (A.), Bagatsing (R.), Ocampo, Yap (R.), Aquino (A.), Mathay, Jr., Angeles (D.), Webb, Javier (R.), Tinga, Zamora, Serapio, Aguilar, Dragon, Gonzales and Monfort	
9126	Javier (E.) and Bagatsing, Jr.	"An Act Amending Republic Act No. 265 as Amended to Establish the Central Monetary Authority, Defining Its Role, Responsibilities, Objectives and Powers in the Administration of the Monetary, Credit and Banking System and for other Purposes"
10787	Romualdo, Teves, Dayanghirang, Andaya, Pilapil, Romero, Camasura, Jr., Unico, del Mar, Garcia (P.), Ozamis, Amante, Amatong, Chavez, De Pedro III, Pelaez, Del Rosario, Dominguez, De Venecia, Jr., Cojuangco, Jr., Sarmiento, Sr., Laguda, Bagatsing, Jr., Mercado (R.M.), Concepcion, Jr., Monfort, Nuñez, Lingad, Durano III, Espinosa (M), Sison, de Guzman, Jr., Javier (E.), Joson, Jr., Veloso, Payumo, Estrella, Jr., Tuzon, Escudero III, Bandon, Jr., Orbos, Martinez, Jr.,	"An Act to Promote the Growth and Development of Cooperatives as Instrument for National Development and Creating the Cooperatives Development Commission to Coordinate and Rationalize all Government Policies and Agencies Supporting Cooperatives Development, Appropriating Funds therefor and for other Purposes"

No.	Author/s	Brief Description
	Cerilles, Mastura, Tinga, Rivera, Jr., Abines, Agana, Labaria, Almario, Lobregat, Puyat-Reyes, Roa, and the Members of the Committee on Economic Affairs, Committee on Government Reorganization and Committee on Appropriations	
16926	Orbos	"An Act Exempting from Taxes the Receipts And Income of Loans Used to Finance Agriculturally Based, Related and/or Located Activities and Businesses" - Receipts and income of loans shall be exempted from all taxes, including gross receipts tax and income tax.
16927	Orbos	"An Act Exempting the Interest Income of Certain Types of Deposits from Tax" - Exempted are the following: a) income of deposits with rural banks, private development banks, savings banks, savings and loans associations whose main office and principal operatives are or are not located in the countryside; b) income of deposits of commercial banks and savings banks with rural banks, private development banks and loan associations, whose main offices and principal operations are located in the countryside.

No.	Author/s	Brief Description
17848	Orbos, Adaza, Dragon, Pardon, Joaquin, Aquino, Florante, Jaime, Lopez, Guanzon, Laguda, Puey, Lacson, Yulo, Abines, Garcia (P.), Martinez, Durano, dela Serna, Del Mar, Paras, Romero, Teves, Montejo, Dorca, Velozo, Locsin, Loreto, Mercado (R.G.), Daza, Ong, Roño, Garduce, Ramirez, Dauz, Tan, et.al.	"Magna Carta for Small Enterprises" - Exempted from all kinds of taxes ; - Exclusion of any and all income receipts from the computation of the individual income tax; - In lieu of all taxes and other business taxes, CBEs shall pay a yearly CBE tax to the municipality or city where they are registered.
19782	Tinga, Paras, Yap (R), Garcia (E.), Bengson (III), Zarraga, Bagatsing, Jr., Tanjuatco, Lopez (J.), Sarmiento, Sr., Dragon, Aquino (H.S.), Aquino (A.), Bagatsing (A.), and Monfort	"An Act to Develop the Philippine Securities Market, Create a Capital Market Development Commission, Define its Powers and Duties, Amend Pertinent Provisions of Relevant Laws, and for other Purposes" The following are incentives given to listed corporations: - Tax deductible dividend payments - Exemption from documentary stamp tax on every original issue of certificate of stocks - Reduced income tax to 30% of any closed corporation which converts into listed corporation - Free listing of long-term debt securities or instruments - Documentary stamp tax on long-term securities or instruments is reduced to fifty centavos (50¢) for each two hundred pesos or fraction thereof, of their face value

No.	Author/s	Brief Description
		- The above incentives are subject to the following conditions: a) any corporation shall list unissued shares representing at least thirty-three and one-thirds percent (33-1/3%) of its voting stock in any securities exchange. b) the aggregate par value of the listed shares shall not be less than ten million pesos (₱10,000,000) or such larger amount as may be fixed by the Commission from time to time. c) any such corporation shall lose all the shares representing its authorized capital stock within a period of fove (5) years from the date of its initial listing application. The following are incentives given to investors: - Tax deductible investments equalling the full amount invested in original issues of shares of listed corporations provided that it shall not in any one year exceed five percent (5%) of the investor's net income before the investments for that year, or ten percent if the investments are in shares of listed corporations in less developed areas. - Exemption from documentary stamp tax on sales of listed shares and other securities - Exemption from documentary stamp tax of original issue of certificates of stock.

No.	Author/s	Brief Description
		- Indirect income from listed debt securities shall be subject to the following rates of witholding taxes: a) twenty percent (20%), if the security has a maturity of one (1) year or less; b) fifteen percent (15%), if the security has a maturity exceeding one year but less than five (5) years; c) ten percent (10%), if the security has a maturity of five years or longer but less than seven (7) years; d) five percent (5%), if the security has a maturity of seven years or longer but less than ten (10) years; and e) no tax, if the security has a maturity of ten (10) years or longer.
21063	Calingasan	"An Act Increasing the Amount of Insured Deposits to Eighty Percent (80%) of the Total Deposits of Each Depositor Amending for the Purpose Republic Act Numbered Thirty Five Hundred and Ninety-One, as Amended, Entitled `An Act Establishing the Philippine Deposit Insurance Corporation, Defining its Powers and Duties and for other Purposes'" - Provides twenty-million pesos for the permanent insurance fund, the amount of fifteen million pesos is appropriated from the General Fund.

No.	Author/s	Brief Description
22354	Bagatsing	"An Act Exempting Interests Derived from Philippine Currency Bank Deposits from being Taxed Amending for the Purpose Section 2, Paragraph (c) of Executive Order No. 37, in Relation to Section 21, Paragraph (d) of the National Internal Revenue Code, as Amended"
22362	Ty and Labaria	"An Act Revising Our Monetary System by Phasing out the Present Currency from Circulation and Replacing it with Currency which has Gold and/or Silver Reserve for other Purposes" - Transfers monetary policies from the control of the Central Bank of the Philippines to the Treasury of the Philippines.
24375	Javier	"An Act Providing that Insurace Coverage of Bank Deposits of an Individual Depositor be the Total Amount of his Deposits Amending for the Purpose Republic Act Numbered Thirty-Five Hundred and Ninety-ONe, as Amended, Entitled `An Act Establishing the Philippine Deposit Insurance Corporation, Defining the Powers and Duties and for other Purposes'" - Provides five billion pesos for the permanent insurance fund, the amount of three billion pesos is appropriated from the General Fund.

Table 3

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

	NO. OF BANKING OFFICES 1/	NUMBER OF ACCOUNTS			PERCENT OF ACCOUNTS	
		Total	Up to P40,000	Over P40,000	Up to P40,000	Over P40,000
Commercial Banks 2/	31	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 (DBs):						
Private DBs	42	707,887	697,692	10,195	98.56	1.44
Development Bank of the Philippines (DBP)	1	86,509	85,065	1,444	98.33	1.67
Stock Savings & Loans Assn. (SLAs)	63	2,041,198	2,031,606	9,592	99.53	0.47
Rural Banks 4/	505	2,787,566	2,776,605	10,961	99.61	0.39
TOTAL	649	18,013,534	17,381,417	632,117	96.49	3.51

	DEPOSITS (In millions of pesos)						
		INSURED DEPOSITS			UNINSURED DEPOSITS	PERCENT OF DEPOSITS 3/	
	Total Deposits	Total Insured	Up to P40,000	Over P40,000		Insured	Un-Insured
Commercial Banks	163,976	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	58.86	41.15
DBP	636	184	126	58	452	28.93	71.11
Stock SLAs	2,639	1,838	1,454	384	801	69.65	30.34
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

1/ Head offices only.

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

3/ Percentages were computed before rounding.

4/ Reporting rural banks only.

Source: PDIC 1987 Annual Report.

Table 4

PAYMENTS MADE BY PDIC IN 1987

	No. of Accounts	Amount Paid (P M)
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: PDIC 1987 Annual Report.

B. Improvement of the Rural Credit Market

One of the major drawbacks in the government's effort to implement a full rural development policy is the underdeveloped rural financial markets. This may be seen from the inability of big formal financial institutions to provide a more sustained flow of credit for agriculture-based economic activities. With the thrust of the present government to pursue a rural-based, export-led development strategy, rural financial institutions will therefore play an increasing role in meeting this challenge.

There is a problem, however, of creating a truly viable rural financial market that will complement the government's efforts in effecting rural development. The present trend of less active involvement among bigger financial institutions in rural finance leaves rural banks as the only active participants in the formal rural credit market. In the long run, this trend must be corrected in order for the rural financial market to meet the growing financial requirements of a rural sector in progress. But in the immediate term, there is a need to strengthen the rural banking system being the most important channel of formal credit to small enterprises in the rural areas.

This section reviews banking policies instituted by the Monetary Board/Executive Branch and the Legislative Branch that directly bear on the improvement of the rural financial markets. Specifically, policies on rural bank rehabilitation, deposit retention scheme, and free entry of banks will be emphasized.

1. Rural Bank Rehabilitation

Actions Taken by the Monetary Board

Past policies had induced rural banks to become mere conduits of government-supported credit programs designed to boost economic activities in the rural sector. There was a failure to emphasize the need to mobilize deposits for their lending operations. Rural banks became increasingly more dependent on the rediscounting window which in effect, led to the accumulation of over ₱2 B arrearages with the Central Bank as of December 1986. When massive farmer-borrower defaults occurred during the 1983-84 economic crisis, a significant number of rural banks discontinued their operations and many experienced deteriorating financial conditions. The sad plight of the rural banking system handicapped the operations of small production units which do not have access to bigger banks, and would therefore place a severe strain on the government's effort to stimulate rural development.

In response, the present administration implemented the rural bank rehabilitation program through CB Circular 1143 issued in 1987. This is not the first time that the rural banking system has undergone a rehabilitation program. During the

previous regime, the rural banking system underwent at least two massive rehabilitation programs. But unlike the previous regime's programs, the current rehabilitation program emphasizes the need to strengthen the financial viability of rural banks through the latter's own initiative. Specifically, the present program aims to strengthen the rural banking system through a capital build-up and conversion scheme and/or plan of payment for rural banks experiencing financial difficulty. The latter provides for the conversion of arrearages into paid-in capital of the government in the form of shares of stock of a rural bank issued in the name of the Land Bank of the Philippines in the case of a conversion scheme. But in the case of a plan of payment, a rural bank shall enter into an arrangement with the Central Bank involving the amortization of arrearages within a period of not exceeding 10 years. As contained in the original program, a prerequisite to the approval of application in the program is a requirement for the private stockholders to infuse into the rural bank fresh capital in cash equal to at least 10 percent of supervised credit arrearages with the Central Bank including accrued interest but excluding penalties, or an amount equal to the deficiency in capital of the bank required to achieve the 10 percent minimum risk asset ratio, whichever is higher.

Many rural banks expressed willingness to reopen and continue their operation, but only a few have been able to qualify in the program. Some stockholders find it difficult to comply with the fresh capital infusion requirement considering that only existing owners (i.e., family groups) are willing to infuse more capital in a rural bank. Though rural bankers acknowledge the risk involved in allowing one family to control a bank, they still find it the most practical way to build up capitalization during the rehabilitation period.

The developments taking place in the rehabilitation of rural banks prompted the Monetary Board to amend the fresh capital requirement portion to include an alternative mode of payment for rural bank capitalization. As contained in the revised program through Central Bank Circular 1158, stockholders have the option of paying into the rural bank in monthly installments within a period not exceeding six months the amount in excess of ₱500,000 fresh capital infusion. However, rural bankers seek further reduction in the fresh capital infusion from ₱500,000 to ₱300,000.

Many rural bankers perceive that the program primarily aims to make rural banks, especially those with bigger loan arrearages, settle their accounts with the Central Bank. Considering that a bigger portion of the rural banks' arrearages with the Central Bank is due to borrower loan defaults, most of them are seeking further refinements of the program to include condonation of accrued interest, liquidated damages and other charges on such loan arrearages. Rural banks are willing to pay

the principal given enough time, but condonation of accrued interest which is supposed to be collected from borrowers who have defaulted would speed up their rehabilitation.

To improve the participation rate among rural banks, the program was further revised. Under the revised program contained in Central Bank Circular 1172, all rural banks with arrearages with the Central Bank which are past due and unpaid as of December 31, 1986 are qualified to join (except those with serious irregularities and those whose applications have been approved under the original program contained in Central Bank Circular 1143 and 1158). These arrearages also include emergency loans, overdue special time deposits and CB-IBRD accounts.

Actions Taken by the Legislative Branch

There are several bills being filed in Congress seeking to improve financial intermediation in the rural sector (See Tables 2a and 2b). One particular point related to rural bank rehabilitation is a Senate bill exempting rural banks from the payment of all taxes and fees for a period of 15 years. This is in line with the Legislative Branch's efforts to strengthen the rural financial system by, among others, exempting rural financial institutions from payment of the gross receipts tax. This move could be one of the steps to improve the financial status of rural banks during the rehabilitation period but may be open to abuses of non-payment of other obligations with the Central Bank not covered by this particular bill. Exempting banks from all taxes is certainly a significant policy reversal.

Another bill seeks to convert all past due loans of rural banks with the Central Bank into government equity to be held by the Land Bank of the Philippines in the form of preferred stocks. This is inconsistent with the rural bank rehabilitation program currently implemented by the Central Bank. The financial sector reform program calls for a reduction in government involvement in the operations of the financial system and greater participation of bank owners in rehabilitating their banks. The same bill proposes that rural banks shall devote 50 percent of their loanable funds for lending to small farmers, fishermen and other land reform beneficiaries, but enjoins the Central Bank to open its rediscounting window to rural banks. The bill, however, does not specify the mode of rediscounting for rural banks. This is a retrogression to the past policies on rural bank lending operations and could run counter to the rehabilitation program as rural banks would become dependent again on Central Bank funds.

Similarly, a bill filed in the Senate calls for fresh government equity infusions for new issues of capital stock of rural banks, cooperative rural banks and even private development banks operating in rural areas. This is designed to develop financial linkages between these rural financial institutions and the Land Bank of the Philippines (LBP) in order to expand the

financial resources of the rural sector for small farmer-borrowers. In effect, LBP becomes the Apex bank. If the intention is making LBP a conduit of government funds to rural financial institutions, then the Apex bank concept may not be a good one.

2. Deposit Retention Scheme

Actions Taken by the Monetary Board

The continuous drain of rural financial wealth into the urban areas remains a major factor deterring the emergence of an improved rural credit market. The fact that there are a number of prospective investors in the rural sector should serve as an impetus for financial institutions to increase the flow of credit to the rural areas. With the rural sector serving as the backbone of Philippine development in the medium term, the problem must be addressed with appropriate policies consistent with the objective of improving the rural financial market.

The policy response of the Monetary Authorities to correct this problem was to implement the deposit retention scheme. Initially, the scheme requires branches outside the National Capital Region to invest at least 75 percent of their total deposits, net of required reserves, on the same service areas where these deposit resources were generated. Several criticisms, however, have been aired by the banking group as well as by some independent policy planners. Deposit retention policy produces both distortionary effects on private and social profitabilities. Banks are forced to finance less worthy investments just to satisfy this requirement. This poses obstacles in mobilizing deposits and also endanger the viability of rural financial intermediaries since institutionally-fixed portfolio composition held by banks as a result of this regulation may not be optimal.

These developments were taken into account in the revised version of the scheme contained in CB Circular 1183. Although the 75 percent retention policy is still enforced, regional groupings have been reduced to three enlarged groupings (i.e., Luzon, Visayas and Mindanao) from the previous twelve regional groupings. This is an improvement over the previous policy since financial institutions face a greater array of investment choices in a wider market within the designated region.

Actions taken by the Legislative Body

A Senate bill calls for the retention of at least 80 percent of the funds generated by financial institutions in the rural areas. This is one of the steps through which this bill hopes to promote financial intermediation in the rural areas.

It is not mentioned in the bill that funds should be invested in the same service areas but allowed instead the transfer of funds from one rural area to another through branches of LBP, PNB and DBP preferably at the areas nearest the funding source. Nevertheless, this is consistent with the Central Bank policy on restraining the flow of locally generated funds to the National Capital Region from other regions. Additional provision prohibits any rural financial intermediaries to furnish, directly or indirectly, to any multinational enterprise the funds generated from the rural areas.

3. Bank Entry and Branching

Actions Taken by the Monetary Board

Past policies designed to create a more progressive Philippine banking system through bigger capitalization, mergers and consolidations, and restricted branching in certain areas have created bottlenecks in the physical growth of banks and branches opened. For instance, the Central Bank's policy on minimum capital requirement for a newly-opened bank discouraged the opening of new rural banks which could not meet such requirement.

Improved bank competition is essential in the provision of low-cost financial services especially in the rural areas where the risk factor is a big cost component in lending. Thus, the Central Bank's policy of eliminating the prerequisite investment in government securities for purposes of establishing/opening branches and other banking offices through Circular 1188 is an open invitation to expand banking services in rural areas. A more liberal branching policy eliminates the possibility of a single bank monopolizing the provision of financial services in rural areas. Likewise, free bank entry provides a wider array of portfolio choices for borrowers, and a more varied financial instruments which can be maintained by the surplus units. Lamberte (1987) has found that the "institution" elasticity is significantly greater than one. That is, more financial savings can be mobilized by increasing the number of financial institutions in the country.

Actions Taken by the Legislative Body

In Congress, there is a similar move that calls for the unrestricted entry of financial intermediaries in the rural areas. This means that the problem of shortage of financial institutions in the rural areas is currently addressed. In particular, a Senate bill seeks to exempt from Central Bank's minimum capital, personnel and office facilities requirements financial intermediaries operating in the rural areas, provided that these intermediaries be subject to the minimum 10 percent debt-to-equity ratio and other CB financial ratios. At the House, a bill has been filed seeking to exempt from taxes

interest income of certain types of deposits with rural banks, private development banks, savings banks, savings and loan associations and even commercial banks, whose main offices and principal operations are located in the countryside. Both these bills serve as an open invitation for financial institutions to expand their operations in rural areas which could help improve the performance of rural financial market.

C. Rationalization of Government Regulations Affecting Intermediation Cost

1. Actions Taken by the Monetary Board

The existence of high bank intermediation costs could hamper the growth of rural financial market. Aside from the fact that rural enterprises may be discouraged from availing themselves of formal credit due to the high cost of lending, bankers would rationalize the "flow-out" of rural resources in search of the highest marginal return which urban-based projects offer in order to maintain a certain profit margin level.

The policy response of the Monetary Authorities to reduce banks' intermediation costs has been the gradual reduction in reserve requirements. Throughout the 1986-1988 period under the new administration, the Monetary Board has reduced twice the required reserves against deposit liabilities with original maturities of 730 days or less for all banking institutions from 23 percent to 21 percent. For deposits with maturities over 730 days, the reserve requirement has been reduced to five percent from six percent in 1986. This means that funds for lending operation will be made more available especially in rural areas. However, CB Circular 1204 issued on June 23, 1989 raises again the reserve requirement of deposits with original maturities of more than 730 days from five percent to seven percent.

As regards the agri/agra requirement and gross receipts tax, there is nothing that the Monetary Authorities can do since they were introduced through legislative actions except to endorse to Congress the proposal to remove them.

2. Actions Taken by the Legislative Branch

Several bills have been filed in Congress seeking to reduce bank intermediation cost by eliminating both the gross receipts tax and the agri-agra scheme. In particular, S.B. 368 calls for the abolition of the gross receipts tax on interest income of banks, while S.B. 614 seeks to repeal P.D. 717 by abolishing the 25 percent agri/agra loan quota. These complement the Monetary Authorities' effort to reduce the intermediation costs.

There are bills now being filed in Congress that suggest either to modify existing loan portfolio requirements or to introduce more loan portfolio requirements to favor certain

sectors of the society. In particular, a Senate bill seeks to revive the required lending for agrarian reform beneficiaries equivalent to 10 percent of a commercial bank's loanable funds as originally set in P.D. 717. Recognizing the little impact of the agri-agra scheme in ensuring the flow of credit to the intended beneficiaries, S.B. 171 allows alternative compliance only by buying Land Bank Agrarian Reform Credit Bonds, and the proceeds of which shall be exclusively used for credit to agrarian reform beneficiaries. Banks, however, will be penalized in holding low-yield assets since these bonds carry an interest rate of four percent per annum which could increase banks' intermediation costs.

Required lending for financing projects and livelihood programs of fishermen all over the country equivalent to one percent of the local bank's yearly liquid assets is also being sought in Congress through H.B. 1676. For microenterprises lending, the requirement to set aside three percent of the lending institution's total loan portfolio is endorsed in the Senate through S.B. 743. Similarly, the House has proposed through H.B. 1724 to direct all government and private banks to set aside one percent of their yearly loanable funds for lending programs of drivers all over the country.

As pointed out earlier, attempts to fix the loan portfolio of banks may be detrimental to the present efforts of the government to deregulate and improve the performance of the financial system especially in the rural sector.

D. Continued Adoption of a Market-Determined Interest Rate Policy

1. Actions Taken by the Monetary Authorities/Executive Branch

In the past, the rediscounting facility of the Central Bank was used to allocate credit to high priority sectors. The rediscount rate for the priority sectors ranged from three to eight percent per annum with a prescribed ceiling on the lending rate of banks between 12 to 14 percent per annum (See Table 5). The rediscount value was between 50 to 100 percent. While the lending rates were below the market rates, the huge spread between rediscount and lending rates was very attractive to banks.

Starting in November 1985, the rediscounting window of the Central Bank has been used more for stabilization purposes rather than for allocating credit to priority sectors. This policy has been maintained today. Specifically, the proportion of the loan value that the Central Bank rediscounts has been standardized for

Table 5
CENTRAL BANK REDISCOUNTING POLICY
(% p.a.)

Year	Date	Circular Number	CB Rediscount Rate High	CB Rediscount Rate Low	Loan Value High	Loan Value Low	Lending Rate a/ (Secured Loans)
	05-19-78	CLR 610	9.00	1.00	100	50	
1980	09-24-80	CLR 762	9.00	1.00	100	50	14.00
1981	02-27-81	CLR 784	8.00	3.00	100	80	16.00
	03-10-81	CLR 786	8.00	3.00	100	80	
	06-18-81	CLR 803	8.00	1.00	100	80	
1982	05-23-82	CLR 930	8.00	1.00	100	80	17.13
1983			8.00	1.00	100	80	21.28
1984	01-23-84	CLR 991	LR-6	1.00	100	80	39.10
	03-12-84	CLR 994	MRR-6	MRR-12	90	80	
1985	05-30-85	CLR 1063	MRR-3	MRR-12	90	80	28.30
	11-22-85	CLR 1086	12.75	12.75	80	80	
1986	09-1-86	CLR 1114	11.75	11.75	80	80	17.30
	12-15-86	CLR 1125	10.00	10.00	80	80	
		AV	12.27	12.27			
1987		CLR 1125	10.00	10.00	80	80	13.30
1988		CLR 1125	10.00	10.00	80	80	15.92

MRR - Manila Reference Rate
LR - Lending Rate

a/ - Weighted Average for all maturities
b/ - Weighted Average for Transacted Rates
c/ - Weighted Average for 91-day T-Bill rates

SOURCES : CB Review (various issues)
CB Annual Report (various issues)
IMF International Financial Statistics (various issues)
IMF Survey (March 1989)

all eligible papers at 80 percent. 7/ And more importantly, a uniform rediscount rate that is aligned with the market rate has been applied. It is based on the MRR90 which is re-evaluated and, if necessary, adjusted every quarter. The method for determining the MRR90 has recently been changed. Whereas the old MRR90 was based on the interest rate on the promissory note with a 90-day maturity, the new MRR90 which appeared starting in January 1989 is based on the weighted average of the interest rates on promissory notes and time deposits with a 90-day maturity. The reason for changing the formula in determining the rediscount rate is that the relative share of promissory note has substantially declined vis-à-vis time deposits over the most recent past. Recently, banks base their marginal cost of funds on time deposit rate.

Under the previous regime, numerous special credit programs proliferated. Some of them were managed by financial institutions, while others, by non-financial institutions. Under the Department of Agriculture alone, there used to be forty-six separate loan funds for various commodity programs. All of them were lent at highly concessionary rates. In 1986, twenty out of the forty-six separate loan funds were merged to create the so-called Comprehensive Agricultural Loan Fund (CALF). The pooled CALF funds are now being used to beef up the resources of the following four guarantee programs: Philippine Crop Insurance Corporation; Guarantee Fund for Small and Medium Enterprises; Quedan Guarantee Fund Board; and Bagong Pagkain ng Bayan (guarantee funds for loans to local government units). The remaining twenty-six separate loan funds could not be consolidated with the CALF mainly because they are covered by existing agreements between the government and donor countries/ multilateral agencies. Most of the non-CALF agricultural lending programs carry non-market rates (See Table 6), whereas CALF's special lending programs follow the market rates (See Table 7).

There are also special lending programs for other sectors other than the agricultural sector that are still being maintained by non-financial government institutions (See Table 8). Interestingly, three of these six credit programs were created only recently. Two of the six credit programs still carry rates that are below market rates.

Under the IGLF program, the interest rate charged on loans to participating banks is based on the average rate of time deposits with maturities of two years or more during the preceding six months if the fixed interest rate is applied, or the average rate of time deposits with maturities of up to six

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7/ Eligible papers include agricultural products credits, cottage and small industries credits, general purposes working and capital financing, and other short-term credits.

Table 6
NON-CALF SPECIAL CREDIT PROGRAMS

	Programs	Interest Rates a/	Past Due b/ Ratio (%)	Repayment c/ Rate (%)
(1)	GFSME	Prevailing bank rate	20	73
(2)	Quedan Financing Program			
	- Grains Businessmen	Prevailing bank rate	12	99
	- Farmers' Groups	15% per annum for QGFB direct lending prevailing bank interest rate	5	99
	- Food Market Retailers	10% p.a. for daily amortization 12% p.a. for weekly amortization 14% p.a. for monthly amortization 16% p.a. for quarterly amortization	26	98
	- Food and Agricultural Market Enterprises	Lending conduits to end borrower 12% p.a. for weekly amortization 14% p.a. for monthly amortization 16% p.a. for quarterly amortization	58	81
(3)	Bagong Kilusang Kabuhayan at Kaunlaran sa Bayan	16% p.a. (fund source to lending conduits)*	0	d/ 20
(4)	Land Bank: Cotton Financing Program	15% p.a. (LBP to ultimate borrower) * 12% (LBP to Coop RBs) * 15% (CRBs to ultimate borrowers)	63	67
(5)	Agricultural Loan Fund Project	11.8% CB to PFIs effectively July-Sept. 1989 (market-oriented)	0	100
(6)	Palawan Integrated Area Development Project	3% (short-term from fund-source to lending conduits)* 7% p.a. (Medium/Long-term from fund-source to lending counduts) 10% p.a. (Short-term from lending conduits to end borrowers) 14% p.a. (Medium/Long-term from lending conduits to end borrowers)	2	100
(7)	Agro-Industrial Technology Transfer Program	8.75% p.a. (direct lending)*	2	72
(8)	Private Sector Modernization Program	11% p.a. (direct lending)*	7	83
(9)	Aquaculture Development Project	14% p.a. (lending conduits to end borrowers)	1	100
(10)	Northern Palawan Fisheries Development Project	7.5% p.a. + .75% commission charge (fund source to lending conduit) * 12% p.a. (lending conduits to end borrower)*	0	73
(11)	Northern Samar Integrated Credit Financing Program	18% p.a. (lending conduits to end-users) *	10	80

a/ Figures are based on interests rate as of March 31, 1989.
b/ Loans past due over loans outstanding
c/ Loans collected over loans matured
d/ Loans collected over loans granted
* Fixed interest rates
Source: Agricultural Credit Policy Council.

Table 7

CALF SPECIAL CREDIT PROGRAMS

Programs	Interest Rate	Past Due Rates (%	Repayment Rate (%)
(1) Integrated Rural Financing Program	Prevailing bank rate	6	97
(2) Quedan Financing Program for Allied Products	Prevailing bank rate	0	100
(3) Cooperative Marketing Project	Prevailing bank rate	39	70

Source: Agricultural Credit Policy Council

Table 8

SOME FEATURES OF THE LENDING PROGRAMS

PROGRAM	START OF OPERATION	RESOURCES	SOURCES OF FUNDS	IMPLEMENTING ORGANIZATION/ OFFICE	ELIGIBILITY	LOAN PURPOSE
a) TST	1987	P100M $8.8M	Govt. ADB	DTI	NGO	1) fixed assets 2) production 3) advance to contractors and sub-contractors
b) IGLF	1952	$321M a/	USAID IBRD	Industrial Guarantee and Loan Fund, Central Bank	Manufacturing and Service industries with total assets from P500,000-P20M	1) working capital 2) fixed assets acquisition 3) packing 4) production
c) EIMP	1980	P165.5M	OECF	Technology Livelihood Resource Center	Resource-based Export Manufacturing and Processing Enterprises	1) fixed assets acquisition
d) EDAP	1987	P20M	KKK	Technology Livelihood Resource Center	Export Manufacturing and Processing Enterprises	1) working capital
e) PITC	1988	P10M	PITC	Philippine International Trading Corporation	Export Manufacturing and Processing with Assets not more than P10M	1) working capital 2) raw-materials
f) TF	1984	P16.5	KKK	Livelihood Corporation	Manufacturing Enterprises with L/Cs, POs	1) working capital 2) raw-materials

a/ starting January 1989.

(Table 8 cont'd)

PROGRAM	LOAN REQUIREMENTS	LOAN CEILING	INTEREST	MATURITY	PRIORITY PRODUCTS	OTHER HIGHLIGHTS
a) TST	real estate, buildings machineries	P1 M per borrower	Market rate	5 years	garments, gifts, and housewares, furniture, metal-working footwear, leather goods	
b) IGLF	D/E - 80:20 Collateral - real estate, government securities Project Study	a) cottage P150,000-P.4M b) small P150,000-P.4M c) medium P 50,000-P16M	Market rate	1) 7 years 2) 12 years 3) 180 days 4) 1 year	none	provides optional guarantee coverage 1) collateral short - max. of 25% of loan 2) credit risk - 60% of loan for small
c) EIMP	Collateral - project assets	P 5M	10%	10 years	woodworking, building component - related products, food processing, garments, light metals	
d) EDAP	D/E - 80:20 Collateral - unincumbered personal/project assets, L/C, inventories of raw materials and finished goods	P2M	12%	Term loans: 1 year Credit line accomodation: expiry date of L/C or as negotiated	non-traditional export-products	
e) PITC	Collateral - L/C	70% of L/C value or P200,000 whichever is higher	Market rate	Expiry date of L/C	non-traditional export-products or all priority products of ITG	
f) TF	Collateral - unincumbered real estate, personal/project assets, chattel mortgage	80% of L/C and/or PO not to exceed P750,000 (domestic) P1,000,000 (foreign)	18%	6 months	none	

months if the variable interest rate is applied. Banks may charge the market rate to end-user borrowers. However, borrowers located in underdeveloped areas of the country are supposed to be charged a rate that is two percentage points below the market rate. The main reason for instituting such policy is that borrowers in depressed areas usually have higher transaction costs in accessing the IGLF facility due to distance and poor infrastructure facilities. IGLF encourages banks to follow the policy by differentiating its lending rate to banks located in various areas of the country. The lending rate structure of IGLF loans to participating banks for the period 23 January 1989 to the present is shown in Table 9.

2. Actions Taken by the Legislative Branch

There are several bills now being filed in Congress that have direct bearing on interest rate policy (See Tables 2a and 2b). They may be classified according to the following: (1) those that espouse the free market view of interest rate determination; (2) those that recommend limiting the bank spread; (3) those that espouse a ceiling on the rates; and (4) those that recommend preferential rates for certain sectors of the economy.

Lawmakers recognize the need to improve access of certain sectors of the society to the formal credit system. The most common mechanism proposed is to require banks to allocate a certain percentage of their loanable funds to target groups. Except for one bill, all bills that recommend a loan portfolio requirement leave the interest rate determination of these loans to the market. This is a marked improvement over the past wherein loan portfolio requirement was often associated with concessionary rates.

An important bill now being deliberated is House Bill No. 19740. Specifically, it limits the effective intermediation spread (EIS), which is the difference between the nominal interest rate on a loan and the specific financial institution's composite cost of funds, according to the following schedule:

1. For loans maturing within 360 days - 6 percent

2. Loans with maturities of 361 to 720 days - 7 percent

3. Loans with maturities of 721 to 1080 days - 8 percent

4. Loans with maturities of 1081 to 1440 days - 9 percent

5. Loans with maturities of 1441 days or more - 10 percent

This proposed legislation is different from the one of fixing the interest rates. While it fixes the intermediation spread, nevertheless, it allows the lending rate to vary in

Table 9

INTEREST RATES ON IGLF AVAILMENTS OF PARTICIPATING FINANCIAL INSTITUTIONS
(For the period 23 January to 30 June 1989)

Location of Project	Interest Rate Per Annum (%)	
	Fixed	Variable
National Capital Region (NCR)	14.1	12.1
Region I	12.1	10.1
Region II	12.1	10.1
Cordillera Autonomous Region (CAR)	11.1	9.1
Region III	14.1	12.1
Region IV (except Quezon, Aurora, Romblon, Marinduque, Palawan, and Mindoro)	14.1	12.1
Region V	11.1	9.1
Region VI (except Antique, Aklan and Capiz)	13.1	11.1
Region VII (except Bohol, Negros Oriental and Siquijor)	14.1	12.1
Region VIII	11.1	9.1
Region IX	11.1	9.1
Region X (except Camiguin)	13.1	11.1
Region XI	13.1	11.1
Region XII	12.1	10.1
Quezon, Palawan, Capiz and Aklan	12.1	10.1
Bohol, Antique, Siquijor, Mindoro, Aurora, Rombolon, Marinduque, and Camiguin	11.1	9.1
Negros Oriental	13.1	11.1

Source: CB Circular No. 89-01 (January 1989).

accordance with the cost of funds for a certain term loan. However, the lending rate of a particular term loan which is determined by the proposed formula may not reflect the market rate since it is constrained by the spread. Thus, the formula may yield results that squarely contradict the proposed bill's declaration of policy i.e., ".... allowing a regime of market-oriented determination of the cost of money." Additionally, average cost pricing will always result in inefficiencies compared with marginal cost pricing except at the point where the average cost is equal to the marginal cost.

Putting a limit to the effective intermediation spread assumes that the EIS enjoyed by banks is way beyond what society should allow. This may be an unfair assumption. If the EIS is indeed very high at all times, it is necessary to analyze first why it is too high before offering a sweeping solution. The way to do it is to examine the following major components of EIS:

(1) regulation-induced intermediation cost (e.g., reserve requirement, gross receipts tax, agri-agra loan requirement, etc.);

(2) transaction costs of banks; and

(3) net spread.

Understanding these components of EIS can help us formulate rational policies. In a separate study (See Lamberte 1987), the adverse impact of some regulations on intermediation costs have been analyzed. The recommendation arrived at from the results of the study is to lower the reserve requirement and abolish the GRT and agri-agra requirement.

As regards transaction costs, the latest study by Untalan (1988) shows that the cost per peso loan outstanding for all sample banks is about three percent. The lending cost of banks is affected by at least two factors. One is inefficiency. Usually, banks have no drive to improve efficiency if there is lack of competition. In this regard, the proper policy is to encourage more competition among banks. The other one is information cost. In an imperfect market, banks can greatly reduce default rates by gathering more information about the client and his/her projects. Information is costly to obtain, however. In this regard, there is some scope for government intervention by producing those information needed by banks in evaluating loan applications. Risk-pooling and risk reducing programs can also greatly help reduce banks' transaction costs.

As regards net spread, it has been shown in an earlier study (See Lamberte 1983) that the commercial banks were enjoying a very comfortable net spread. Considering the widening of the gross spread in the recent past (See Lamberte 1987), the net spread realized by banks at present could be the same as when the

earlier study was conducted. However, there is no reason at all to rush to legislation limiting the net spread to be realized by banks if they are seen to be enjoying huge net spread. It could be that the net spread currently enjoyed by banks is the optimal one considering returns of alternative investment opportunities. If this were the case, then putting a cap on the net spread may force banks to move out of the banking industry, thus further aggravating our problems with having a weak intermediation system. However, if the huge net spread is brought about by the oligopoly power of banks, then either of the following two alternative policies can be done: (1) put a limit to the net spread but allow banks to continue exercising their oligopoly power; or (2) reduce the oligopoly power of banks by encouraging more competition. New banking regulations discussed earlier seem to favor the second option.

Having a uniform EIS for all loans of the same maturity is tantamount to asking banks not to lend to small borrowers. It is known that the per peso cost of a small loan is higher than that of a large loan. Moreover, banks that specialize in lending to small borrowers could close shop. Untalan (1988) has shown that the cost of maintaining each peso of loan outstanding is six percent for rural banks, three percent for private development banks and two percent for commercial banks.

Another thing that must be considered is inflation expectations. In another study (See Lamberte 1985), it has been demonstrated that given a 20 percent reserve requirement, and forcing banks to obtain zero net profits, the spread or difference between nominal and lending rates could vary depending on inflation expectations. For example, if we were to obtain a real deposit rate of five percent per annum, then the nominal intermediation spread for a one-year loan should be 1.25 percent, 3.75 percent and 6.75 percent for an inflation rate of zero percent, 10 percent and 20 percent, respectively. This just goes to show that fixing the financial intermediation spread would be distortionary.

Interest rates on all types of loans with formal institutions have been deregulated since 1983. At present, however, some lawmakers are seriously considering of reimposing an interest rate control on selected types of financial institutions. In particular, a bill has been filed in the Senate seeking to fix the lending rates of pawnshops. This may be unfair to pawnshops since other types of financial institutions are not subjected to any interest rate ceilings. Moreover, it could frustrate the rapid growth of one of the alternative sources of funds for households and small entrepreneurs. Lamberte (1988) has discussed the role played by pawnshops in the development process. With liberal licensing policy and absence of interest rate control, pawnshops have proliferated recently not only in urban areas but in rural areas as well. The recently stiffer competition among pawnshops has brought down the lending rates.

Another bill seeks to formalize the informal credit market but subject it to interest rate ceilings. Aside from heavy administrative burden to be shouldered by a regulatory agency which will monitor all small credit transactions, the proposed interest rate ceilings for different loan sizes in the informal credit market would have adverse consequences on the supply of credit, thus further aggravating the plight of small borrowers who do not have access to the formal credit markets. In addition, those occasional lenders who are not charging any interest on their loans to their friends/relatives will now be forced to charge a rate to compensate for the extra cost they will incur in keeping records of the loans and issuing receipts.

IV. DEVELOPMENTS IN THE FINANCIAL SECTOR

This section assesses quantitatively the results of the policies and strategies adopted by the Aquino administration in the financial sector. Admittedly, some of the policies have been installed only very recently, e.g., an end to the moratorium on giving new bank licenses, and therefore their results cannot be captured within the period of analysis. Moreover, effects of certain policies take some time, and the lags could vary among them. These factors should be taken into consideration in interpreting results.

A. Structure and Performance of the Financial System

The growth of the total resources of the financial system in real terms was arrested in 1983 when a balance-of-payments crisis struck the economy (See Table 10 and Figure I). It rebounded in 1987 but registering only a very slight percentage increase in real terms of 0.96 percent. The 1988 real growth rate of 5.53 percent is still much lower than the 13.84 percent registered in 1983. Although signs of improving performance are becoming visible in the financial system, the 1988 real assets are still much lower than the pre-crisis period.

The Philippine financial system has always been dominated by the commercial banking system. The relative shares of the different types of financial institutions in the total resources of the financial system have been fairly stable even during the 1986-88 period. The notable exception, however, is that of specialized government banks. Its share in the total assets of the financial system was pared down by one-half which was mainly brought about by the transfer of the huge amount of non-performing assets of DBP to the National Government. In terms of deposit generation, the entire financial system reached the highest annual real growth rate of 10.52 percent in 1982 (See Table 11). But in 1984, heavy peso withdrawals hit the deposit-taking activities of banks placing the growth rate of deposits in real terms at negative 28 percent. The negative annual real growth rates of the financial system's deposit liabilities

Table 10

TOTAL RESOURCES OF THE PHILIPPINE FINANCIAL SYSTEM
BY TYPE OF INSTITUTION
Year-Ends 1980-1988
(In Million Pesos)

	1980	1981	1982	1983	1984	1985	1986	1987	1988
Commercial Banks	138417.1	164614.6	190977.4	247928.2	289150.9	283347.1	248542.3	274499.0	328847.5
	(0.56)	(0.55)	(0.56)	(0.58)	(0.59)	(0.56)	(0.60)	(0.61)	(0.63)
Thrift Banks	10557.6	11631.1	12585.6	16149.0	14967.8	15081.3	17652.3	19557.4	24932.7
	(0.04)	(0.04)	(0.04)	(0.04)	(0.03)	(0.03)	(0.04)	(0.04)	(0.05)
Savings Banks	7352.4	6930.5	5872.4	7399.4	7613.8	6847.2	8124.4	10534.1	14165.4
	(0.03)	(0.02)	(0.02)	(0.02)	(0.02)	(0.01)	(0.02)	(0.02)	(0.03)
Private Dev't.Banks	1620.6	2631.4	3703.0	4613.2	4525.3	5084.2	5624.5	5474.5	6698.6
	(0.01)	(0.01)	(0.01)	(0.01)	(0.01)	(0.01)	(0.01)	(0.01)	(0.01)
Stock Savings and Loans Assn.	1584.6	2069.2	3010.2	4136.4	2828.7	3149.9	3903.4	3548.8	4068.7
	(0.01)	(0.01)	(0.01)	(0.01)	(0.01)	(0.01)	(0.01)	(0.01)	(0.01)
Specialized Gov't.Banks	34206.9	43179.6	53315.9	65323.9	78614.9	87989.4	28555.7	26287.5	27246.6
	(0.14)	(0.14)	(0.16)	(0.15)	(0.16)	(0.18)	(0.07)	(0.06)	(0.05)
Rural Banks	5642.2	6631.2	8136.5	9499.7	9023.3	8821.7	9350.5	9960.8	11018.8
	(0.02)	(0.02)	(0.02)	(0.02)	(0.02)	(0.02)	(0.02)	(0.02)	(0.02)
Non-Banks	58945.7	63302.2	74154.6	92033.4	95480.8	107259.3	112998.3	121380.4	131089.6
	(0.24)	(0.21)	(0.22)	(0.21)	(0.20)	(0.21)	(0.27)	(0.27)	(0.25)
TOTAL ASSETS: Nominal	247769.5	298358.7	339170.0	430934.2	487237.7	502498.8	417099.1	451685.1	523135.2
Real	186013.1	201866.5	211584.5	240879.9	181737.2	158516.9	129413.3	130658.1	137884.8

Note: Figures in parentheses are the corresponding ratios to the total nominal assets

Source: DER-Domestic, Central Bank

Figure 1: Phil. Financial System

Total Assets Nominal vs. Real (1978)

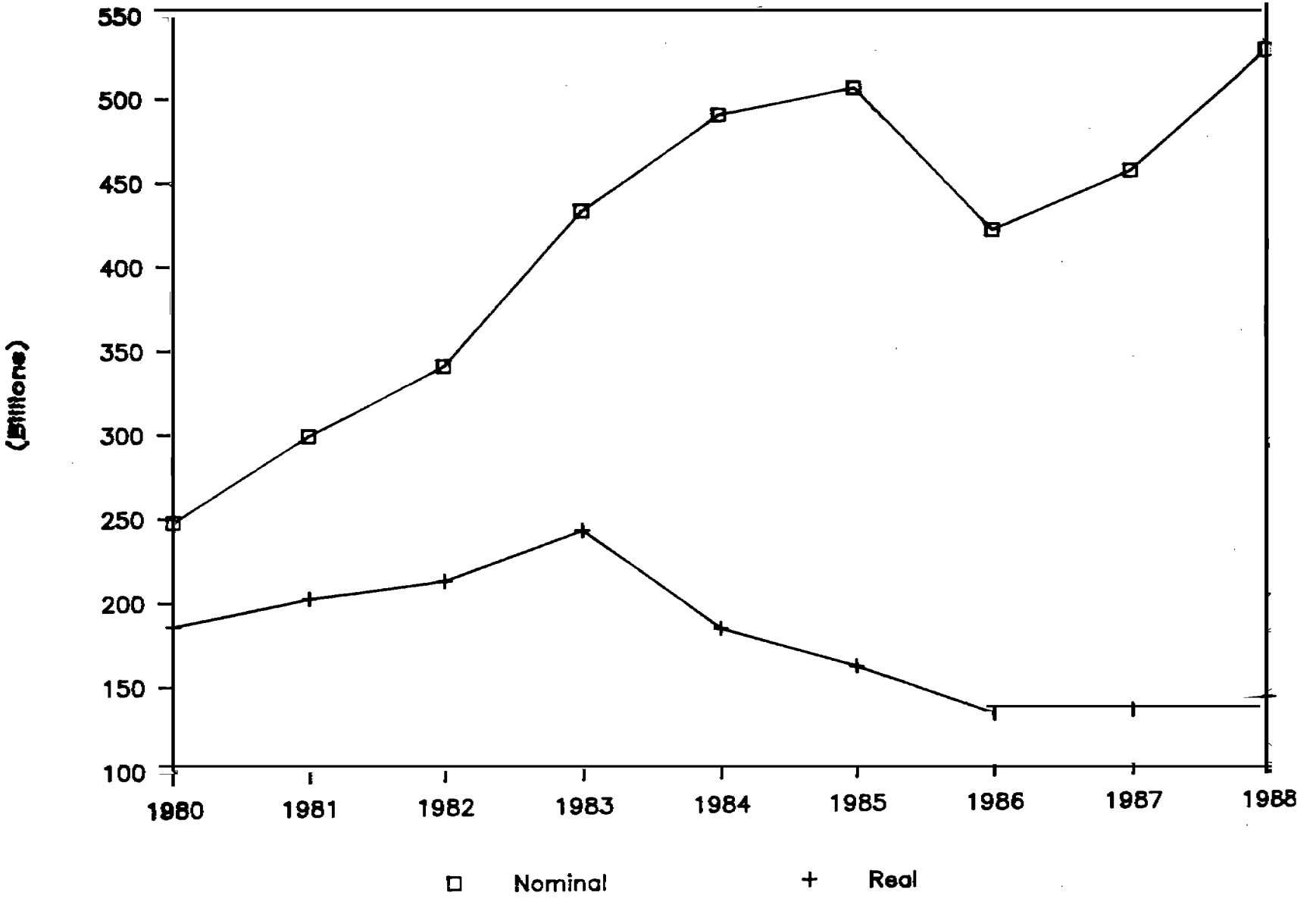


Table 11

PHILIPPINE FINANCIAL SYSTEM
DEPOSIT LIABILITIES AND LOAN PORTFOLIO
1980-1987
(In Million Pesos)

	Deposit Liabilities		Loan Portfolio	
	Nominal	Real	Nominal	Real
1980	89538	67221	141978	106590
1981	99641	67416	159067	107623
1982	119436	74508	186714	116478
1983	142275	79528	239172	133690
1984	153569	57280	247077	92159
1985	164435	51872	209067	65952
1986	166469	51650	156455	48543
1987	178079	51513	178039	51501

Source: Philippine Financial System
1987 Fact Book

continued up to the second year of the Aquino rule though there was a big improvement compared to the last year of the Marcos rule. In 1986, real growth rate was placed at negative 0.43 percent as compared to negative 9.44 percent in 1985, and improved further to negative 0.26 percent in 1987. The real levels attained, however, under the new administration are still much lower to the pre-1985 period despite the recently rising trend of nominal deposit liabilities.

The same is true with the lending operations of the financial system. In 1984, real growth rate registered at negative 31 percent which continued all the way up to the first year of the Aquino rule. Lending operations began to go up again in 1987 registering a growth rate of six percent in real terms. However, demand, short-term and intermediate-term lending largely account for the improvement in the lending operations in 1987. They were used mainly to finance temporary (i.e., consumer-led) increases in aggregate output (See Table 12). Long-term lending lagged behind and even deteriorated from the previous year's level reflecting the failure to develop the long-term capital market that could sustain long-term investment. It should however be noted that in 1987, a comfortable level of political stability was not yet achieved. During the 1986-88 period, there was a marked improvement in the financing of lending activities through the use of deposit resources (See Table 13). Throughout the 1980-85 period, deposit generation continued to lag behind the lending operations which means that other sources (i.e., CB rediscounting, government subsidies, etc.) could have been widely utilized by the financial system. This was due to the active involvement of the Central Bank and other government agencies in lending operations through several highly subsidized credit programs which made some banks, especially rural banks, mere conduits of these funds. Thus, this dependence failed to emphasize among financial institutions their deposit-taking activities. During the 1986-87 period, loans-to-deposit ratio went below unity suggesting that banks are becoming less dependent on borrowings, or conversely becoming more dependent on deposits. Similarly, there was an improvement in the use of deposit resources in financing the increase in the assets of the financial system. Beginning the first year of Aquino rule, close to 40 percent of the financial system's total resources had been financed through deposit liabilities which remained almost in the same level the following year. Thus, as a whole, it can be said that financial intermediation has visibly improved in the most recent years.

B. Central Bank Rediscounting

Liquidity management is one of the major functions of the Central Bank. This is anchored on the classical hypothesis of a strong inflation rate-money supply-monetary base linkage. Once an inflation rate target for a certain period is decided on, the Central Bank then determines the level of monetary base that is

Table 12

DISTRIBUTION OF LOANS BY MATURITY
1980 - 1987
(In Million Pesos)

Year-End	Demand	Short-term	Intermediate-Term	Long-term	Total
1980	10,458.2 (0.13)	49,843.3 (0.65)	7,746.8 (0.10)	9,149.3 (0.12)	77,198.1
1981	10,667.3 (0.12)	52,823.4 (0.61)	14,976.2 (0.17)	8,038.3 (0.09)	86,505.2
1982	9,307.8 (0.09)	58,478.0 (0.59)	17,778.3 (0.18)	12,675.5 (0.13)	98,239.6
1983	10,433.8 (0.09)	66,792.1 (0.60)	16,858.2 (0.15)	17,303.6 (0.15)	111,387.7
1984	8,322.1 (0.07)	62,651.7 (0.54)	28,226.5 (0.24)	17,181.9 (0.15)	116,382.2
1985	8,060.5 (0.09)	50,038.4 (0.57)	14,667.9 (0.17)	14,806.5 (0.17)	87,573.3
1986	10,529.1 (0.13)	46,869.5 (0.56)	15,042.1 (0.18)	10,646.7 (0.13)	83,087.4
1987 a/	17,212.3 (0.18)	52,524.4 (0.55)	19,183.9 (0.20)	5,966.7 (0.06)	94,887.3

a/ As of September, 1987.

Note: Figures in parentheses are the corresponding ratios to the total loans.

Source: Central Bank Statistical Bulletin, 1987.

Table 13

PHILIPPINE FINANCIAL SYSTEM
SELECTED RATIOS
1980-1987

	Deposits-to-Asset Ratio	Loans-to-Deposit Ratio
1980	0.3614	1.5857
1981	0.3340	1.5964
1982	0.3521	1.5633
1983	0.3302	1.6811
1984	0.3152	1.6089
1985	0.3272	1.2714
1986	0.3991	0.9398
1987	0.3943	0.9998

Source: Philippine Financial System
1987 Fact Book

deemed consistent with that target. It does this by manipulating the components of the monetary base over which it has greater control.

The major components of the monetary base are the Net Foreign Assets (NFA) and Net Domestic Assets (NDA). The latter can be more readily controlled by the Central Bank. NDA can be further decomposed into net credits to the public sector (NCPS), net credit to the deposit money banks (NCDMB), and others (NDAOTHERS). The action of the Central Bank with respect to its rediscounting window is reflected in the NCDMB. For instance, if the Central Bank increases its rediscounting of export loans, then NCDMB increases, ultimately resulting in an increase in the monetary base, assuming other things being equal. However, increases in the monetary base arising from the rediscounting window may be completely offset by conducting an open market operation. The Central Bank may do this by selling either its own liabilities (e.g., CB bills, reverse repos) or National Treasury's liabilities (i.e., Treasury bills). In the former case, NCDMB is literally kept constant, while in the latter case, NCDMB is allowed to increase, but the increase is offset by an equivalent decline in the NCPS.

The rediscounts of the Central Bank to commercial banks dropped sharply during the 1983-84 balance-of-payments crisis (See Tables 14 and 15). Stabilization measures implemented by the Central Bank and greatly reduced demand for credit during the crisis period accounted for the sharp decline in rediscounts. The level of rediscounts (both outstanding and granted) in 1988 has not yet been restored to the pre-crisis period, although demand for credit has picked up quite fast as may be gathered from the figures on the loans outstanding of commercial banks (See Table 14). In 1988, banks were still liquid, although less liquid than the previous years, hence there was less demand for rediscounts.

The Central Bank seems to be pursuing an export-oriented rediscounting policy. This is understandable since the Philippines has been confronted with a balance-of-payments problem in the last few years. Indeed, it is easier for banks to obtain rediscounting on export loans than on non-export loans. Within the export sector, the non-traditional sector is given priority over the traditional sector as may be gathered from the amounts of rediscounts (outstanding and granted) going to the former.

Currently, the Central Bank sees to it that the export sector's access to the rediscounting window will not be grossly affected by any change in the monetary policy (i.e., a change from easy to tight monetary policy). This is reflected in the way it manages liquidity. The Central Bank makes a forecast of exports every quarter. This forms the basis for determining the net increase in the rediscounting of export loans that the

Table 14
OUTSTANDING REDISCOUNTS OF THE CENTRAL BANK, LOANS OUTSTANDING OF COMMERCIAL BANKS, AND COMMODITY EXPORTS

Year	Year	Average Exchange Rate (P/$)	(a) Total Rediscounts to Commercial Banks		(b) Export Rediscounts					
					Total		Traditional		Non-Traditional	
			(P M)	(US$ M)	(P M)	(US$ M)	(P M)	(US$ M)	(P M)	(US$ M)
1980	1980	7.51	9079	1208.9	3969	528.50	2259	300.80	1710	227.70
1981	1981	7.90	11383	1440.9	2736	346.33	1234	156.20	1502	190.13
1982	1982	8.54	12963	2400.6	2583	302.46	950	111.24	1633	191.22
1983	1983	11.11	8504	765.4	1955	175.97	72	6.48	1883	169.49
1984	1984	16.70	4533	271.4	2092	125.27	1446	86.59	646	38.68
1985	1985	18.61	5121	275.2	2162	116.17	1077	57.87	1085	58.30
1986	1986	20.39	3167	155.3	1174	57.58	886	43.45	288	14.12
1987	1987	20.57	3609	175.4	1736	84.39	1035	50.32	701	34.08
1988	1988	21.09	3559	168.7	1983	94.00	1026	48.64	957	45.37

Year	(c) Total Loans Outstanding of Commercial Banks		(d) Commodity Exports		(b)/(a)	(b)/(c)	(b)/(d)
	(P M)	(US$ M)	(P M)	(US$ M)			
1980	77198	10279.4	43467.9	5788	0.437	0.051	0.091
1981	86505	10950.0	45203.8	5722	0.240	0.032	0.061
1982	98240	18192.6	42879.3	5021	0.199	0.026	0.060
1983	111388	10025.9	55605.6	5005	0.230	0.018	0.035
1984	116382	6969.0	90029.7	5391	0.462	0.018	0.023
1985	87573	4705.7	86145.7	4629	0.422	0.025	0.025
1986	83087	4074.9	98748.8	4843	0.371	0.014	0.012
1987	96936	4717.1	117660.4	5720	0.481	0.018	0.015
1988	115392.4 a/	5470.2	149139.5	7070	0.557	0.017	0.013

a/ As of Sept. 1988

SOURCE : Central Bank

Table 15

LOANS GRANTED BY THE CENTRAL BANK TO COMMERCIAL BANKS
(In ₱ M)

	(a) Total 1/	(b) Traditional Exports	(c) Non-Traditional Exports	b + c / a	b / c	c / a
1980	38,707	20,000	11,607	0.82	0.52	0.30
1981	46,096	19,571	13,884	0.73	0.42	0.30
1982	39,121	15,459	10,833	0.67	0.40	0.28
1983	28,229	8,256	12,028	0.72	0.29	0.43
1984	14,392	1,568	10,805	0.86	0.11	0.75
1985	7,040	575	5,787	0.90	0.08	0.82
1986	9,696	2,251	6,322	0.88	0.23	0.65
1987	5,173	1,485	3,493	0.96	0.29	0.68
1988	9,582	2,150	6,959	0.95	0.22	0.73

1/ Includes other loans.

Source: Central Bank

Central Bank could allow for the reference quarter. Aside from this, the Interagency Study Group on External Trade Statistics and Projections Foreign Operations Committee which is headed by the Central Bank meets with exporters twice a year to validate its medium-term forecast of exports. Thus, going back to the liquidity management approach followed by the Central Bank which was discussed earlier, the projected net increase in the rediscounts of export loans will cause an increase in NCDMB, which in turn will exert an upward pressure on the monetary base, other things being equal. If the projected increase in the monetary base arising from the net increase in the rediscounting of export loans exceeds the level that is thought to be consistent with the inflation rate target, the Central Bank will not adjust downwards its rediscounting of export loans, but rather will engage itself in open market operation to bring down the increase in the monetary base to its targeted level.

Table 16 shows that the interest rates on reverse repos and Treasury bills have consistently been above the Central Bank's rediscounting rate, except in 1988 for reverse repos. It suggests that rediscounted loans have been subsidized by Central Bank, in the case where reverse repos were used to mop up liquidity, and by the national government, in the case where the Treasury bills were used. This subsidy could partly neutralize the penalty on exports arising from trade policy biases (See Medalla 1989).

C. Stability of the Financial System

The financial system has always been under stress. It suffered a severe liquidity crisis in 1981 that resulted in the closure of some large investment houses and thrift banks. Six financially distressed commercial banks ended up in government's hands. Just as the financial system started to recover from the 1981 liquidity crisis, a balance-of-payments, the worst by far in Philippine history, struck the economy in 1983 and 1984. Between 1981 and 1985, the Central Bank closed a total of 119 banks, of which two were commercial banks (See Table 17).

The occurrence of bank failures has continued during the Aquino Administration. During the 1986-1987 period, the Central Bank closed a total of 54 banks of which 50 were rural banks. However, all these were due to the unsustained losses incurred by banks during the 1983-84 balance-of-payments crisis. Note that nine relatively large banks had collapsed since 1968, and two of them occurred in 1987 (See Table 18). PISO Development Bank, the largest privately-owned development bank in the country which was one of the conduits of foreign currency loans from multilateral institutions, such as the World Bank and Asian Development Bank, lost heavily on its foreign currency loans of more than ₱500 M during the crisis as 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

Table 16

COMPARISON OF REDISCOUNT RATES, TREASURY BILL RATE AND REVERSE REPURCHASE RATE
(In % per annum)

Year	CB Rediscount Rate 1/	Treasury Bill Rate 2/	Reverse Repurchase Rate
1980	9.00	12.14	-
1981	8.00	12.55	-
1982	8.00	13.79	-
1983	8.00	14.23	13.93
1984	MRR-6	27.16	29.25
1985	MRR-3	19.65	24.18
1986	12.27	16.90	13.25
1987	10.00	11.50	11.64
1988	10.00	13.59	9.85

1/ The highest rate is presented here (see also Table III.).
2/ Weighted average for 91-day T-bill rate.
3/ Weighted average for transacted rates.

Sources: Central Bank Circulars (various issuances).

Central Bank Review (various issues).

Table 17

NUMBER OF CLOSED PDIC MEMBER BANKS

Bank Group	1981-1985	1986-1987	Total
Commercial Banks	2	1	3
Savings and Mortgage Banks	4	-	4
Private Development Banks	3	1	4
Stock Savings and Loan Associations	22	2	24
Rural Banks	88	50	138
All Banks	119	54	173

Source: PDIC Annual Reports (various years).

Table 18

LARGE BANKS CLOSED BY THE MONETARY BOARD
OF THE CENTRAL BANK

	Bank	Date of CB Takeover	No. of Deposit Accounts	Deposits (In PM)
(1)	Overseas Bank of Manila 1/	8-02-68	13,061	49.40
(2)	Continental Bank 2/	6-25-74	60,128	121.20
(3)	General Bank and Trust Co. 3/	3-25-77	157,977	199.60
(4)	Royal Savings Bank, Inc. 4/	7-06-84	302,580	350.70
(5)	Banco Filipino Savings & Mortgage Bank	1-25-85	2,413,000	897.00
(6)	Philippine Veterans Bank	4-10-85	no data	1,600.00 5/
(7)	Pacific Banking Corp.	7-05-85	no data	3,058.00 6/
(8)	PISO Development Bank	2-04-87	20,088	206.30
(9)	Manila Banking Corp.	5-25-87	633,614	1,905.20

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

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

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

4/ 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).

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

6/ 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.

Source: PDIC Annual Reports and Central Bank.

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 Central Bank's assistance to PISO Bank failed to reverse its deteriorating financial condition. The bank was later on found insolvent and closed by the Central Bank on 4 February 1987. At the date of its closure, PISO Bank had 20,088 deposit accounts with a total value of ₱206 M.

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 ₱4.1 B at end-1983. The Central Bank continued propping up the Manila Bank until the latter's overdrafts with the Central Bank reached a staggering level of ₱6.1 B 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 ₱1.9 B.

It appears from these new developments that the Central Bank is intensely pursuing its policy of weeding out weak banks to restore confidence in the system.

The deposit insurance system plays a vital role in the financial system. In the US, confidence in the banking system has never been diminished despite several bank failures since the establishment of the Federal Deposit Insurance Corporation which has been promptly paying insured deposits of failed banks. The Philippine Deposit Insurance Corporation (PDIC) was established in 1969 with the aim of protecting small depositors as well as of developing a strong and progressive banking system. Although PDIC regularly assesses banking development and conducts examinations on member banks, it remains powerless in averting bank failure.

PDIC has been slow in paying depositors of insured deposits. As Table 19 shows, it was still servicing 39,095 deposit accounts of banks which were closed prior to 1987. In some cases, it resorted to paying depositors by installment. For instance, depositors of PISO Bank and Manila Bank were paid only ₱10,000 initially instead of the ₱40,000 coverage.

The low capitalization of PDIC has been the main cause for its inability to promptly pay depositors. It has been heavily borrowing from the Central Bank to pay insured deposits. Its borrowings from the Central Bank to support heavier disbursements for payoff went up from ₱920 M in 1986 to ₱1.54 B in 1987. PDIC's accrued interest payable in 1989 greatly exceeded its gross income of ₱189 M for the same year. With the past record of PDIC, it can be said that it has never been a factor in maintaining stability and confidence in the financial system.

Table 19

PAYMENTS MADE BY PDIC IN 1987

	No. of Accounts	Amount Paid (P M)
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: PDIC 1987 Annual Report.

The Central Bank appears to be responsive to bank runs. For instance, when a bank run occurred during the third quarter of 1984 which was triggered by the unilateral closure of two large savings banks, the Central Bank increased by threefold its assistance to financial institutions to prevent it from developing into a major crisis (See Table 20). To contain the run during the first and second quarter of 1987 when the PISO Bank and Manila Bank were closed, the Central Bank increased its assistance to financial institutions, thus reversing the declining trend in the level of Central Bank assistance to financial institutions established in the immediate four quarters.

The economy is now on the road to recovery; so is the financial system. It is worthwhile noting, however, that the level of Central Bank assistance to financial institutions still appears to be very high (See Table 20). Indeed, this leaves the Central Bank very little elbow room to avert a major crisis without going back to the period of high interest rate. The presently high ratio of Central Bank assistance to financial institutions to reserve money suggests that the financial system is not yet over the hump.

DBP used to be the second largest financial institution in the country. Between 1980 and 1984, its total assets more than doubled from ₱27 B to ₱67 B (See Table 21). Its lending activities were mainly financed by time and savings deposits, which came mostly from the National Government and government-owned corporations, and long-term borrowings. The proportion of foreign borrowings to total long-term borrowings markedly increased during the 1983-84 balance-of-payments crisis as a result of the sharp devaluation of the peso. DBP's problems became more pronounced in 1984 when it suffered a substantial loss of ₱6.6 B. The huge losses went on for three consecutive years. The new management team took over DBP and successfully rehabilitated it. In 1987, DBP made a turnaround and earned a profit of ₱783 M. Realized profit increased to ₱1.6 B in 1988. It has now restored its normal lending operations with more focus on wholesale banking.

PNB has been the largest commercial bank in the country. Like DBP, its assets more than doubled during the period 1980 to 1984 from ₱38.6 B to ₱87.2 B (See Table 22). Although it mobilized deposits from the private sector, it also relied heavily on deposits from the National Government and semi-government agencies. It also borrowed heavily from the Central Bank to sustain its operations. PNB incurred huge losses during the period 1984-1986 amounting to ₱11.8 B. Having cleansed of its non-performing assets in 1986, PNB realized hefty profits of ₱1 B and ₱1.8 B in 1987 and 1988, respectively. It has already started implementing its privatization program by successfully selling to the public 30 percent of its total outstanding shares last July 1989. The public's response to the sale of

Table 20

RESERVE MONEY AND CENTRAL BANK ASSISTANCE
TO FINANCIAL INSTITUTIONS
(in P B)

Period	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 assistance to financial institutions includes emergency loans and overdrafts.

Source: Central Bank, Quarterly Economic and Financial Report

Table 21

SELECTED FINANCIAL STATISTICS, DBP
(In ₱M)

	1980	1981	1982	1983	1984	1985	1986	1987	1988 3/
A. Resources									
Total Assets	27,086.2	34,706.8	43,988.5	54,934.0	66,800.2	72,043.0	9,503.6	10,531.6	11,432.5
Loans	15,933.8	18,516.5	22,875.4	30,919.7	35,827.6	24,758.0	5,271.1	4,394.5	na
B. Time and Savings Deposits	4,603.9	6,627.6	7,068.5	4,672.3	978.3	1,519.0	561.5	531.6	na
C. Long-term Borrowings									
Foreign	6,333.8	7,635.2	11,459.3	18,860.9	28,853.2	32,295.9			
Domestic	8,242.7	10,016.1	11,971.1	14,175.7	14,954.6	12,704.6	2,025.7	1,340.0	na
D. Equity	4,060.1	4,534.8	5,305.9	5,427.7	4,422.5	4,470.8	2,678.2	3,460.8	na
E. Income and Expenses									
Earnings	2,673.7	3,419.7	4,369.6	5,369.8	2,648.0	3,140.2	2,138.5	1,777.2	2,569.3
Expenses 1/	2,435.7	3,315.9	4,298.0	5,272.0	8,607.5 2	8,776.7	8,776.4	965.4	920.0
Net Profit (Loss)	223.1	108.7	117.3	110.2	(6,640.9)	(5636.5)	(5,638.2)	782.6	1,649.2

1/ Net of taxes

2/ P5.48 was funded by the National Government.

3/ Obtained from Philippines' Best 1000 Corporations (1989).

Sources: DBP Annual Reports (various years).

Table 22

SELECTED FINANCIAL STATISTICS, PNB
(In ₱M)

	1980	1981	1982	1983	1984	1985	1986	1987	1988
A. 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
B. Depósits 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
C. 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
D. 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
E. 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).

PNB's stocks has been enormous judging from the fact that the stock offering had been oversubscribed. This reflects the public's confidence in the financial health of PNB. It is interesting to note that its borrowing from the Central Bank was practically nil in 1987 and 1988.

D. Performance of the Rural Banking System

During the final years of the previous regime, the financial status of rural banking system had seriously deteriorated. In fact, the greatest number of rural bank failures for the past fifteen years was recorded in the year preceding the turnover of government (See Table 23). The closure of 40 rural banks in 1985 resulted in the negative 17.3 percent real growth rate in the assets of the rural banking system. In 1986, the real growth rate jumped to 4.2 percent reflecting the improvement of the financial conditions of some rural banks. After almost three years of the launching of the rural bank rehabilitation program, rural bank failures have been kept minimal at four head office closures in 1988. It is to be noted that rural bank failures during the 1986-88 period have not been associated with declining rural banking assets in nominal terms unlike in the previous period. In real terms, however, assets of rural banking system have registered positive growth rates in 1986 and 1988 (See Table 24).

As regards the rehabilitation program, the number of rural banks which were given approval to participate increased eightfold in 1988 from the 1987 level (See Table 25). Close to 62 percent or 295 of the approved applications as of end-December 1988 have fully complied with the rehabilitation program requirements with 224 availing themselves of the fresh capital infusion, while 71 opted to settle 10 percent of total arrearages with the Central Bank. Fifty-one more rural banks have partially infused capital bringing a total of 275 rural banks, or roughly 58 percent of the approved applications, availing themselves of the fresh capital infusion requirement. The increase in rural bank capitalization due to the fresh capital infusion could be seen from the increase in nominal terms the capital accounts of the rural banking system. In real terms, however, capital accounts have exhibited positive growth rates during the 1986-1987 period and negative in 1988. But compared to the last two years of Marcos rule, capital accounts of the rural banking system have performed better under this government.

Other signs of improving performance of the rural banking system are becoming visible under the present administration. The efforts of the government to strengthen rural banking operations in order to improve its lending activities in the rural sector elicited a positive response. Rural banks' loan portfolio began to grow in 1986 at 0.6 percent in real terms which is an improvement from the negative real growth rate recorded the previous year (See Table 24). But a negative

Table 23

NUMBER OF OPERATING RURAL BANKS
1984-1988

Year	Head Office	Branches	Extension Offices and Money Shops	Total
1984	940	109	118	1157
1985	904	108	104	1117
1986	875	109	101	1084
1987	850	109	101	1060
1988	846			

Source: SRO, Central Bank.

Table 24

SELECTED ACCOUNTS OF THE RURAL BANKING SYSTEM
1984-1988
(In Million Pesos)

Year	Assets		Loan Portfolio		Deposit Liabilities		Capital Accounts		Total Borrowings		Deposit-to-Borrowings Ratio
	Nominal	Real	Nominal	Real	Nominal	Real	Nominal	Real	Nominal	Real	(%)
1984	9023.3	3365.6	7022.5	2619.4	2867.2	1069.5	1305.8	487.1	3937.7	1468.7	72.8
1985	8821.7	2782.9	6636.5	2093.5	3018.7	952.3	1360.5	429.2	3835.3	1209.9	78.7
1986	9350.5	2901.2	6790.5	2106.9	3767.1	1168.8	1451.9	450.5	3416.4	1060.0	110.3
1987	9960.8	2881.3	7226.9	2090.5	4516.3	1306.4	1574.7	455.5	2759.6	798.3	163.6
1988	11018.8	2904.3	7970.2	2100.7	5218.3	1375.4	1712.6	451.4	2682.4	707.0	194.5

Source: SRO, Central Bank.

Table 25

RURAL BANK REHABILITATION PROGRAM
(CB Circulars 1143, 1158 and 1172)

	As of Dec. 14, 1987	As of Dec. 31, 1988
No. of Applications Received	480	522
No. of Applications Approved	59	476
No. of Applications Denied/Withdrawn/ Disqualified	2	27

Source: Agricultural Credit Policy Council

real growth rate was experienced again in 1987. Although agricultural loans extended by rural banks grew in absolute terms, however, its ratio to total loans declined throughout the 1986-1988 period. Likewise, the effort of the Monetary Authorities to make the rural banking system less dependent on Central Bank funds has prompted rural banks to mobilize deposits to finance their lending operations. Deposit liabilities of rural banks have exhibited impressive real growth rates of 22.7 and 11.8 percent in 1986 and 1987, respectively. In 1988, real growth rate went down to 5.3 percent but still much higher than the levels achieved in 1984-85 period. More importantly, rural banks have reduced their borrowings from the Central Bank, which is a reversal of their situation before 1986 when they were heavily dependent on government financial support through the various subsidized credit programs. The deposit-to-borrowings ratio for the past three years never went below 100 percent, suggesting that rural banks have recently intensified their effort to mobilize deposits.

The relatively good performance of the rural banking system in 1986 and 1987 is reflected in the improvement of their net income from the levels realized in the 1984-1985 period (See Table 26). Thus, the return on total assets almost doubled between 1985 and 1987. The return on bank equity achieved a similar improvement during the same period. But in real terms, it was in 1986 that rural banks realized the highest growth rate in net income under the new administration.

Since rural banks are supposed to be the primary source of formal credit in the rural areas, strengthening the financial conditions of the rural banking system would serve as an impetus to increase the loans extended to the agricultural sector. Although agricultural loans granted by the formal financial system increased in absolute terms during the first two years of Aquino administration, however, its share to total loans has declined. As of the third quarter of 1988, a slight increase in the share of agricultural loans to total loans has been recorded, but still much lower than the levels achieved during the pre-1986 period (See Table 27). Since the dominant economic activity in the rural areas is still agriculture-based, the declining share of agricultural loans could create bottlenecks in the government's present efforts to implement a full rural development policy.

E. Interest Rate, Inflation Rate and Exchange Rate

The domestic currency depreciated vis-à-vis the dollar by only 4.4 percent between February 1986 and February 1989 (See Figures 2 and 3). This is indeed a remarkable achievement by the Aquino government since it gives some semblance of stability to the economy. However, one must closely examine how this was achieved. The build-up of gross international reserves and low inflation rates in 1986 and 1987 largely contributed to the

Table 26

FINANCIAL RATIOS OF THE RURAL BANKING SYSTEM
1984-1988
(In Percent)

Year	Return on Total Assets	Return on Equity	Net Income to Gross Income
1984	1.1	7.6	9.3
1985	1.0	6.2	7.5
1986	1.7	10.5	13.2
1987	1.9	11.6	15.1
1988	1.7	10.7	13.9

Source: SRO, Central Bank.

Table 27

LOANS GRANTED BY THE FINANCIAL SYSTEM
TO THE AGRICULTURAL SECTOR
1981-1988
(Billion Pesos)

Year	Agricultural Loans	Total Loans	Share of Agriculture (%)
1981	25.725	275.817	9.3
1982	28.443	304.513	9.3
1983	29.294	365.005	8.0
1984	30.271	366.434	8.3
1985	28.355	287.985	9.8
1986	22.589	298.580	7.6
1987	27.786	379.000	7.3
1988 a/	27.127	347.800	7.8

a/ January - September, 1988.

Source: Central Bank Statistical Bulletin, Vol. II, 1986.

Figure 2: NOMINAL EXCHANGE RATE (₱/US$)

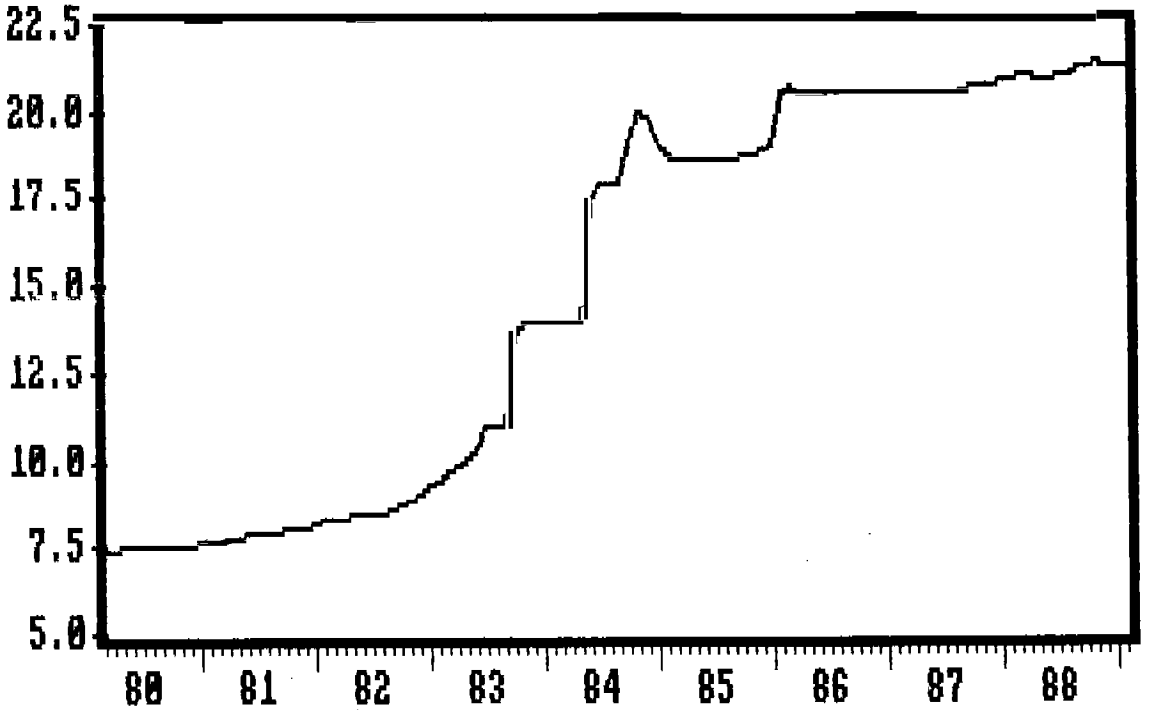
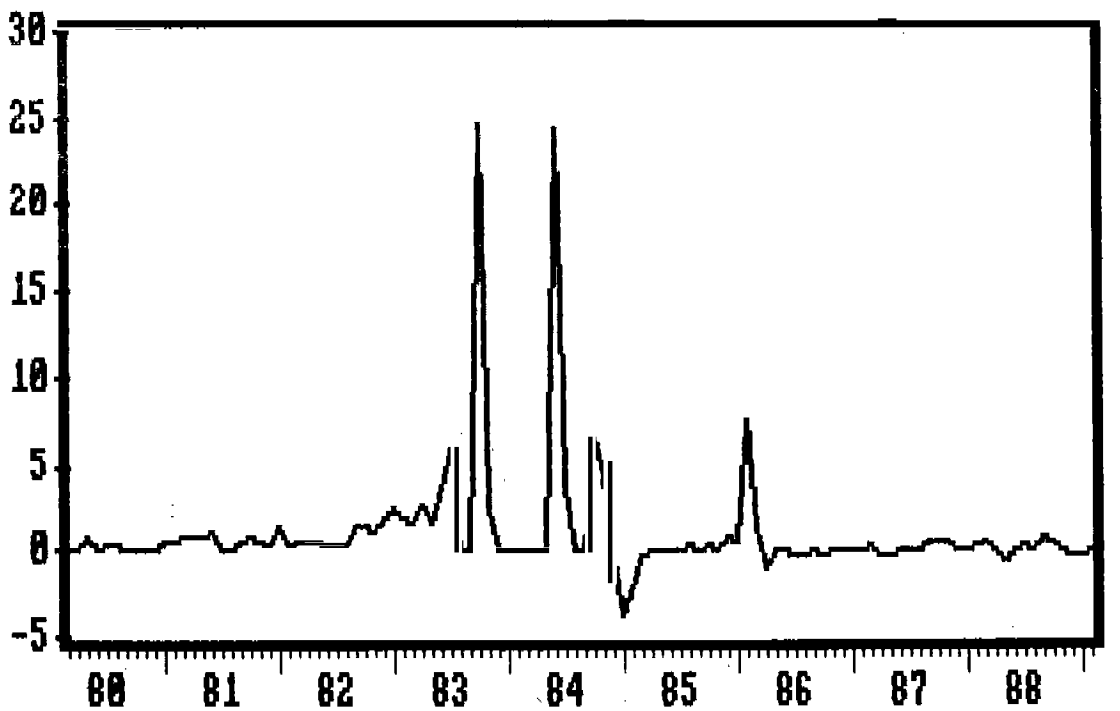


Figure 3: PERCENT CHANGE IN THE NOMINAL EXCHANGE RATE



stability of the exchange rate during these years (See Figures 4 and 5). In 1988, however, pressures on the exchange rate had mounted. Inflation rate went up to about nine percent while the gross international reserves rapidly deteriorated. Since reserves were already at critical levels, the Central Bank started to use interest rate as an instrument to defend the domestic currency. As a result, the 91-day treasury bill rate went up to 16.7 percent per annum in December 1988 from a low 9.1 percent in January 1987 (See Figure 6). The recent borrowings from the IMF and the World Bank and part of the new money currently being negotiated with private bank creditors are intended to build up the reserves.

As stated in the Plan, a positive real deposit rate will be maintained to mobilize savings. This objective was met for all investment instruments in 1986 and 1987 (See Figure 7). In 1987, however, the real rate on savings deposits was negative although those on time deposits and treasury bills were still positive. This has a serious implication on savings mobilization. As shown in Table 28, savings deposits comprise about 57 percent of the total deposits of deposit money banks in 1987. While inflation rate went up in 1988, the interest rate on savings deposits even went down. Interestingly, the nominal interest rate on savings deposits of 4.1 percent per annum in 1988 was much lower than the nominal interest rate of six percent per annum enjoyed by depositors in the early 1970s when it was still administratively fixed by the Central Bank.

V. SOME POLICY ISSUES

This section discusses some policy issues that must be addressed by the government.

A. Threat of Policy Reversal

The Monetary Authorities/Executive Branch of the government has already introduced substantial policy reforms in the financial sector. In particular, most policy statements contained in the Plan have already been translated into concrete policy actions. There is no doubt, therefore, that the financial sector is now moving towards a more liberal environment.

Further policy reforms currently being contemplated pertain to those that require legislative actions. In this regard, the Monetary Authorities/Executive Branch is fortunate enough to find support from some lawmakers who are willing to carry the task of further reforming the financial sector in the halls of Congress. Admittedly, however, while there are lawmakers who are sympathetic to the ongoing policy reforms, others have introduced bills that tend to reverse the policy reforms. The proposed policies in these bills bear the familiar hallmarks of a repressed financial system, viz, ceilings on lending rates, loan

Figure 4: GROSS INTERNATIONAL RESERVES
(In US$ M)

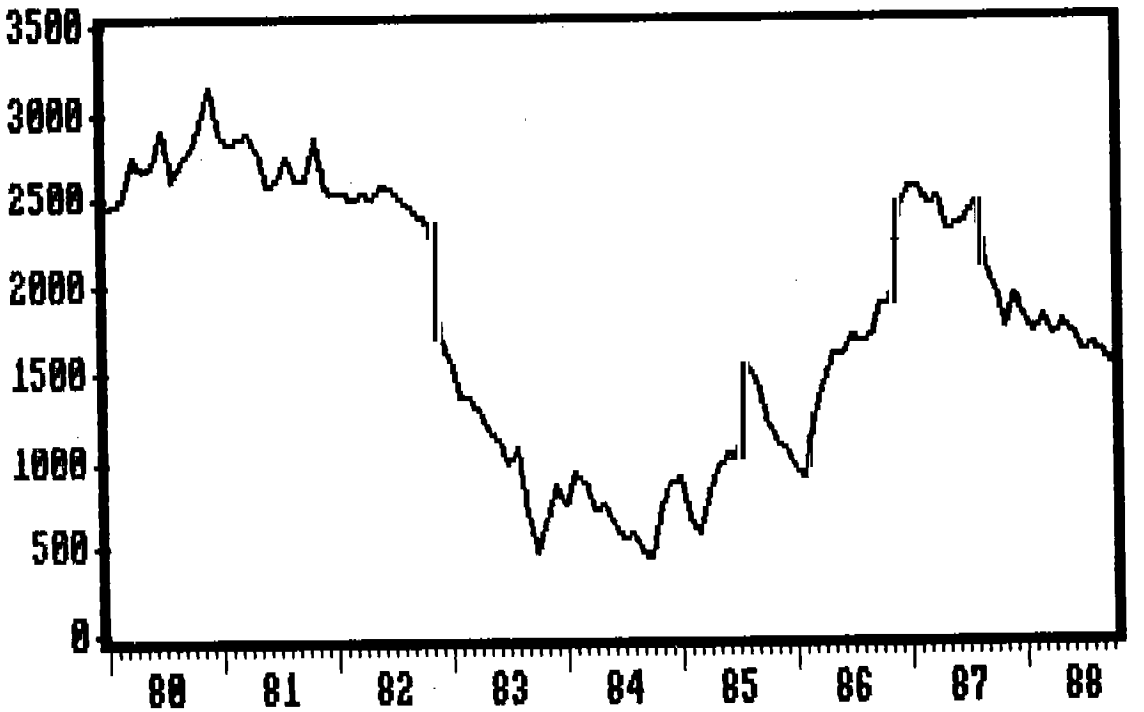


Figure 5: INFLATION RATE
(In % p.a.)

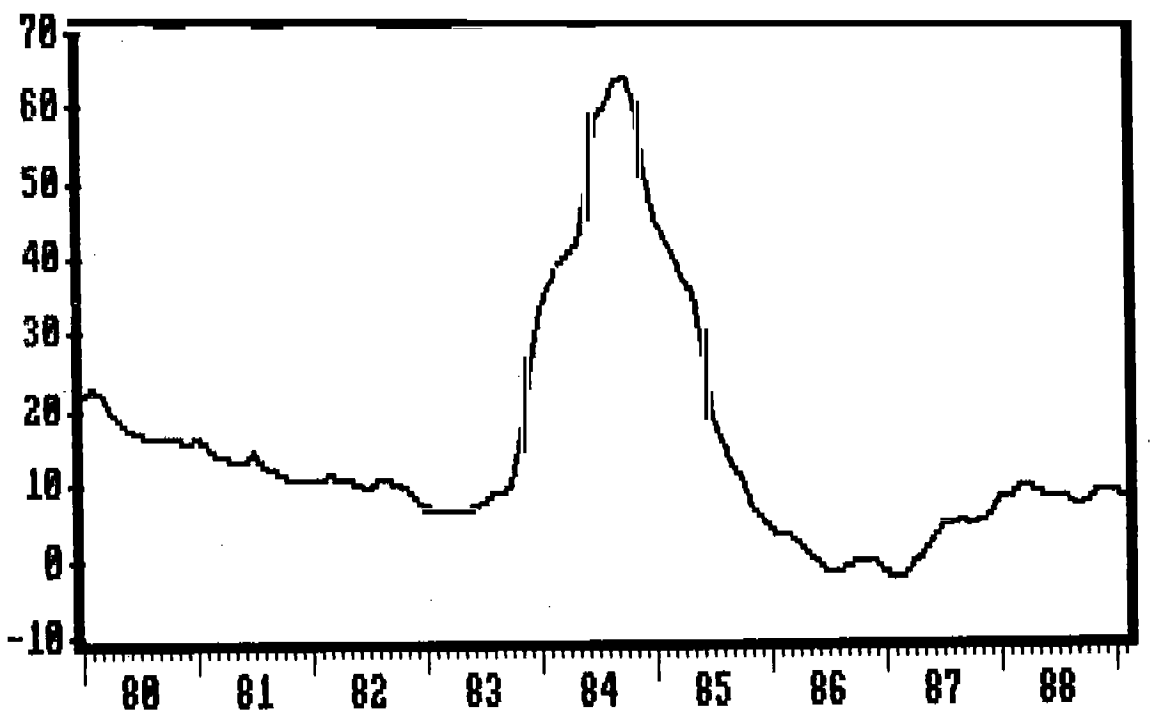


Figure 6: 91-DAY TREASURY BILL RATE
(In % p.a.)

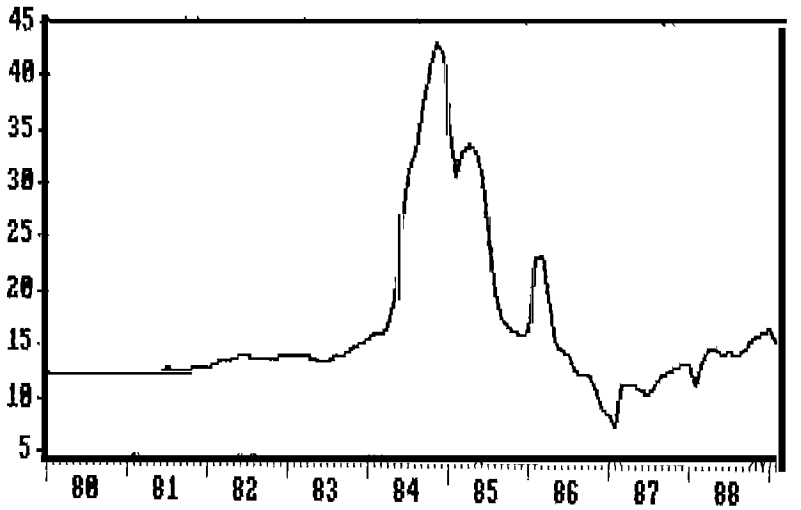


Figure 7: REAL INTEREST RATE ON SAVINGS DEPOSITS (RSDR), TIME DEPOSITS (RTDR) AND 91-DAY TREASURY BILL RATE (In % p.a.)

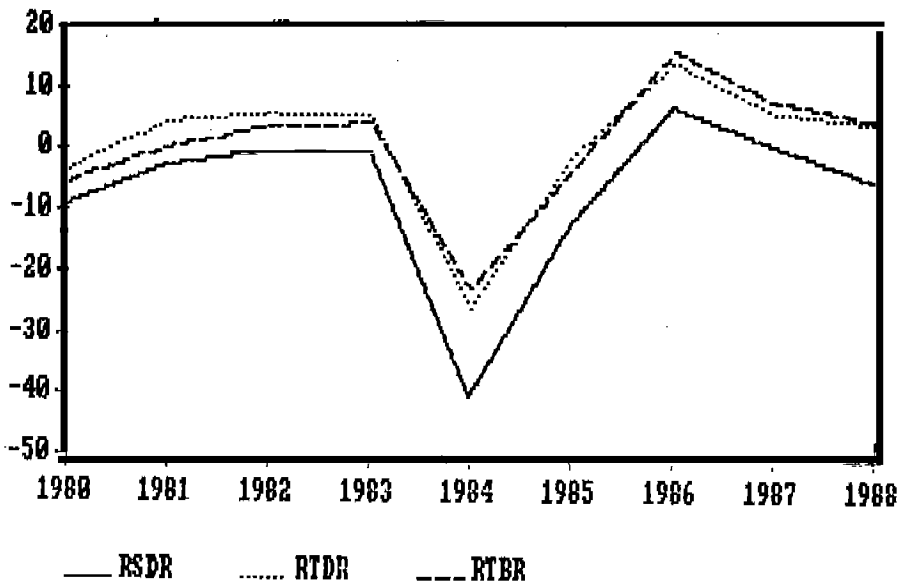


Table 28

PERCENT SHARE OF THE DIFFERENT TYPES
OF DEPOSITS TO TOTAL DEPOSITS

Year	Demand Deposits	Savings Deposits	Time Deposits	Deposit Substitutes	Total Deposits (PM)
1967	32.3	43.3	24.4	0.0	5790.2
1968	33.0	46.1	20.9	0.0	6121.1
1969	34.8	46.8	18.5	0.0	6827.9
1970	32.8	53.7	13.6	0.0	6977.9
1971	32.2	54.4	13.3	0.0	7843.6
1972	36.0	51.5	12.5	0.0	8436.5
1973	26.1	39.4	6.8	27.7	14610.6
1974	23.6	33.5	5.5	37.5	19931.0
1975	23.1	30.2	6.8	39.9	24137.0
1976	21.2	30.4	12.4	35.9	30245.6
1977	22.1	31.0	16.3	30.6	37203.5
1978	20.2	34.3	19.2	26.3	43702.2
1979	20.1	35.1	20.1	24.8	48178.3
1980	21.4	33.9	23.2	21.5	57628.6
1981	16.9	34.3	25.4	23.3	70465.5
1982	13.1	35.0	31.8	20.1	82588.6
1983	13.8	36.5	31.4	18.3	93354.8
1984	11.9	38.4	38.3	11.3	99417.3
1985	10.8	42.6	38.6	7.9	108816.4
1986	11.9	54.2	29.6	4.3	111828.9
1987	13.4	57.1	26.6	2.9	123780.4

Source of Basic Data: Central Bank

portfolio requirements for certain sectors of the economy, and tax exemptions. Records of congressional hearings of these bills indicate that the Central Bank has consistently expressed its objections to the bills that tend to halt or reverse the recently initiated financial policy reforms. However, instead of confining itself to commenting on bills that propose some policy reversals or defending its current policy reforms, it may well be for the Central Bank to take an aggressive stance without necessarily being confrontational. One way of doing it is to establish a permanent communication line with Congress that would serve as a venue for explaining the general financial policies and ongoing policy reforms pursued by the government and for commenting on bills being contemplated before they are formally filed in Congress.

B. Stability of the Banking System

There is an urgency to improve the stability of the banking system. Past experience suggests that the incidence of bank failure falls more heavily on depositors. As shown in Table 29, out of the ₱5.8 B deposits of closed banks from 1970 to 1986, only 42 percent or ₱2.4 B were insured. What is worse is that PDIC has yet to pay 23 percent of the total insured deposits of closed banks.

While the general economic condition has contributed to bank failures, insider abuse or fraud has played a much larger part (See Lamberte 1989). The current efforts to strengthen the supervisory function of the Central Bank with more focus on reducing insider abuse is a step in the right direction. While the Central Bank is now in the process of weeding out weak and/or mismanaged banks, it must be tempered with a liberal bank entry policy so as not to reduce people's access to banking services. Although the Central Bank has already announced the termination of its moratorium on the giving of new bank licenses, it still remains to be seen whether it is going to approve application for opening a new bank or branch in an area where there is no bank or the bank has been closed without necessarily compelling new entrants to buy the closed bank.

There is definitely a need to increase the insurance fund of PDIC so that it can promptly pay insured deposits *in toto*. Even if depositors cannot redeem entirely their deposits with closed banks, the knowledge that they can quickly claim their deposits covered by insurance can help strengthen their confidence in the banking system.

C. Interest Rate and Exchange Rate Policy

The use of interest rate to defend the exchange rate has induced more volatile and high domestic interest rate. This could produce a leftward shift of the aggregate supply curve - *à la* "structuralist approach" - that would eventually lead to

Table 29

DEPOSITORS' LOSSES DUE TO BANK FAILURES, 1970-1986
(In ₱ M)

Type of Bank	No. of Banks Closed	Outstanding Deposits 1/	Estimated Insured Deposits	Depositors' Losses	PDIC Payments	Depositors' Receivable from PDIC
Commercial Banks	5	3,029.4	280.2	2,749.2	118.9	161.3
Savings and Mortgage Banks	3	1,015.6	954.9	60.7	767.4	187.5
Private Development Banks	3	163.7	127.7	36.0	117.0	10.7
Stock SLAs	24	1,300.5	853.8	446.7	709.3	114.5
Rural Banks	154	266.9	185.2	81.7	135.3	49.9
Total	189	5,776.4	2,401.7	3,374.7	1,847.8	553.9

1/ As of the date of closure. Figures are on a cumulative basis.

Source of Basic Data: PDIC 1986 Annual Report.

higher inflation rate which is what the present policy of stabilizing the exchange rate is trying to avoid. Of course, the biggest casualty of having an overvalued currency and high domestic interest rate is the export sector. Although this measure is deemed temporary since reserves will be built up again which would relieve the pressure on the exchange rate, one must, however, examine closely the manner by which reserves are going to be increased. The present strategy of borrowing from multilateral agencies and private bank creditors may not be a good one. In the past, the availability of foreign loans had actually reduced the willingness to make the necessary adjustment in the exchange rate to correct the balance-of-payments problem.

The best alternative strategy to build up reserves is through increased exports. But this requires an adjustment in the exchange rate to a realistic level. In one of the chapters below, it is shown that the performance of the export sector is closely associated with movements of the real effective exchange rate.

D. Special Credit Programs

As discussed above, there are still a number of special credit programs being managed by non-financial government agencies. Some of them have appeared only recently and carry concessionary rates. The sad history of special credit programs in terms of repayment rates and its redistributive impact should have been enough to convince policymakers to discontinue and/or avoid creating such programs (See Lamberte and Lim 1987). In a separate study, Lamberte et al. (1989) have suggested that the funds allocated to these programs be consolidated and used to augment resources of the existing guarantee programs. The guarantee programs call for a cost-sharing between the government and private banks. Moreover, a high gearing ratio (i.e., about 5) of a guarantee fund would have a wider reach compared to a direct lending program.

Since credit is fungible, widening the scope of guarantee programs rather than maintaining numerous credit programs could be more effective in inducing the flow of credit to the rural sector. Thus, the consolidation of several separate loan funds for various commodity programs into the Comprehensive Agricultural Loan Fund is an achievement in streamlining the number of existing credit programs. Likewise, the gradual disengagement of government agencies from direct lending could help eliminate the "dole out" mentality among rural borrowers. It must be noted that the leniency shown by the previous administration in penalizing non-repayment of loans extended by government agencies has produced this kind of mentality, which now impairs the successful implementation of special credit programs. Lastly, the implementation of credit programs should be undertaken by financial institutions which have the facilities in determining credit-worthy projects and borrowers.

E. Rural Bank Rehabilitation

Both the Legislative Branch and the Monetary Authorities/Executive Branch have introduced substantial policy reforms that seek to improve the financial status of the rural banking system. Similarly, private sector involvement has been reflected in the significant number of rural bank owners which opted to infuse fresh capital as a requirement to the rural bank rehabilitation program. Thus, as a whole, the effort of the present administration to rehabilitate financially distressed rural banks has gained the support of the different sectors of society. But in terms of implementing policy reforms that are supposed to create an environment truly supportive of the operations of rural banks, there is still a great challenge that this administration needs to consider. For instance, some lawmakers in the Legislative Branch seek to reimplement past policies on rural lending which include loan fixing and even the use of CB rediscounting facility for rural banks. Though these policies aim to ensure a sustained flow of credit to the rural sector, experience shows that the results of such policies had caused the sad plight of rural banks during the previous regime. Most of them became dependent on highly subsidized credit and overlooked the other important function of a bank, i.e., deposit mobilization. Likewise, their dependence on government-supported credit has made them vulnerable to government budgetary deficit. Thus, when public funds dried up, many rural banks got into trouble.

In this regard, there is a need to examine thoroughly these proposed policies and find out how they could complement the present rural bank rehabilitation program in particular, and the improvement of the rural financial market in general. It is important to note that the recent performance of the rural banking system is quite impressive despite the absence of highly subsized credit and loan portfolio requirements. Thus, policies that make rural banks less dependent on Central Bank borrowings, or conversely, more dependent on deposits for their lending operations should be widely pursued by this administration. It has now become clearer that the rural areas have large untapped savings waiting for the right incentives to flow into the formal banking system.

As regards financial intermediation in the rural areas, the opening of a new rural bank should not be inhibited by rigorous requirements (i.e., minimum capital requirements, etc.). Thus, there is a need to pursue banking policies that facilitate the process of opening a new bank such as cutbacks in paper requirements, elimination of red tapes, etc. Likewise, previous stockholders/owners of closed rural banks who have anomalous records should not be permitted to operate a new rural bank to insure a more credible rural banking system. Finally, on the part of the government, a fair treatment should be extended to all rural banks in terms of enforcing standard requirements on

banking operations. Special treatment or favor accorded to certain individuals or groups by the government should be highly discouraged.

VI. SUMMARY

This paper assesses the performance of the Aquino administration in the financial sector. It discusses the reforms in the financial sector initiated by the present government as spelled out in the Medium Term Philippine Development Plan 1986-1992 and their impact on the performance of the financial sector.

This paper categorizes the individual policy reforms under six major groupings: improvement of the financial structure, improvement of the rural credit market, rationalization of government regulations affecting intermediation cost, continued adoption of a market-determined interest rate, development of domestic capital market, and prudent monetary management. Under each grouping, actual policy actions taken up by both the Monetary Authorities/Executive Branch and Legislative Branch are discussed separately. Each concrete policy action is evaluated in terms of its consistency (or inconsistency) with the reforms called for in the Plan. Thus, concrete policy actions that complement and/or contradict the planned policy reforms are equally highlighted.

One general result of the study shows that the Monetary Authorities/Executive Branch have already made substantial progress as far as implementing the desired policy reforms under existing laws. Congress has also responded to the call for policy reforms particularly those that require legislative actions. These actually complement the policy actions desired by the Monetary Authorities/Executive Branch. For instance, under the issue of improving the financial structure, both sides have taken up a similar stand to protect banks from overextending loans to favored groups. On the part of the Monetary Authorities, a CB circular has been issued putting a loan limit on single borrowers, while on the part of the Legislative Branch, a House bill has been filed prescribing limits on loans or accommodations which financial institutions including government banks may grant to borrowers. On another aspect, under the objective of improving the rural credit market, some lawmakers have filed bills seeking to provide incentives to financial intermediaries operating in rural areas to encourage bank competition. These complement the Central Bank's current policy of freer entry and branching in the rural areas by abolishing the requirement on prerequisite investment in government securities. Likewise, some lawmakers in Congress have proposed the abolition of the GRT and the repeal of agri-agra requirement to reduce bank intermediation costs.

Congress is not a monolithic institution, however. Some bills being filed suggest reversal of policies which have been recently initiated by the Monetary Authorities. One example pertains to the proposal in Congress, supported by a handful of lawmakers, to extend the loan portfolio requirements of financial institutions to other sectors other than agriculture and agrarian reform beneficiaries. Another bill recommends conversion of arrearages of rural banks with the Central Bank into government equity. This could undermine the current rural bank rehabilitation program which calls for greater participation on the part of bank owners/stockholders.

The efforts of the Aquino administration to deregulate and improve the performance of the financial system have produced some positive results. Total resources of the financial system have registered positive real growth rates beginning 1987 since it was hit by BOP crisis in 1983. However, real assets of the financial system in 1988 are still much lower than the pre-crisis period. In terms of deposit generation, although real growth rates are still negative, a marked improvement has been noted in 1986-87 from the 1984-85 growth rates. Likewise, real growth rate in lending operations of the financial system rebounded in 1987. But demand, short-term, and intermediate-term lending largely account for such improvement. Long-term lending lags behind and even deteriorated from the 1986 level reflecting the failure to develop the long-term capital market. The relatively better performance of the financial system can be gathered from the ratios of loans to deposits and deposits to assets. Beginning 1986, close to 40 percent of the total assets of the financial system were financed by deposits. The use of deposit resources in sustaining lending activities has also improved under this administration.

As regards the rehabilitation of GFIs, PNB and DBP realized impressive profits in 1987 and 1988 after the transfer of their non-performing assets to the National Government. Rural banks, likewise, have exhibited improvement in their performance during the 1986-1987 after the implementation of the rural bank rehabilitation program.

The remarkably slow depreciation of the domestic currency vis-à-vis the dollar could be taken as a symbol of stability in the economy. However, the manner by which this was achieved can be questioned. Pursuing a high interest rate policy and borrowing more from abroad to build up reserves could be more catastrophic in the long run than making the necessary adjustment in the exchange rate now in the face of an increasingly large current account deficit.

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