CHAPTER IV
THE BANKING SYSTEM IN THE PHILIPPINE SETTING: PAST EXPERIENCE AND IMPLICATIONS

by

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1. INTRODUCTION

1993 marked a new beginning for the new Bangko Sentral ng Pilipinas (formerly known as the Central Bank of the Philippines). The change in name of the former Central Bank was just a culmination of several financial reforms that have been initiated by the government since 1981 in the Philippine banking system.

The last decade was the "lost decade" for the whole Philippine economy. Literally, this was the decade wherein the country's banking system practically lost the trust and confidence of the people in them and all other existing financial intermediaries until 1991.

Shortly after the second oil crisis in 1979, many non-financial enterprises in the Philippines encountered severe slacks in their business and went into insolvency. The Dewey Dee caper wherein a fly-by-night Chinese Filipino businessman fled the country in 1981, and left behind a tremendous amount of debt caused an ensuing financial disintermediation from 1983 onward. This was the beginning of a lingering financial depression which lasted until 1991. To arrest a possible debacle of the country's financial system, the government took massive rescue operations to bail out banks and other enterprises facing liquidity problems. Thus, government financial institutions such as the Development Bank of the Philippines (DBP), the Philippine National Bank (PNB), the Government Service and Insurance System (GSIS) and the Social Security System (SSS) had the presidential behest to do rescue operations.

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The unstable political climate that prevailed in the Philippines in 1983 caused severe capital flights which brought about the worst balance-of-payments crisis that ever happened in the entire history of the country.

The financial liberalization scheme was launched to eradicate the worsening Philippine financial system. Upon her assumption to office in 1986, then president Corazon Aquino went on with the implementation of the credit and banking reforms that were earlier initiated in the 1980s. These reforms were categorized into policy and institutional reforms. However, this paper is only concerned with the institutional reforms and will seek to clarify the cause and effect of the financial depression in the "lost decade." Section 2 of this paper provides an overview of the Philippine banking system, while Section 3 provides the institutional features inherent in the Philippine banking system. Section 4 will derive certain implications of financial liberalization based on a simple model with or without complete information. Recent institutional reforms and the backgrounds of the different financial intermediaries under the Bangko Sentral ng Pilipinas like commercial banks, thrift banks, rural banks and specialized government banks are discussed in Section 5. The concluding remarks are provided in the final section.

2. OVERVIEW OF THE PHILIPPINE BANKING SYSTEM

The last decade saw a dramatic experience in the country's banking system. The experience was a drastic financial disintermediation which has left disturbing after-effects on the financial system to date.

2-1. Transition in the Philippine Banking System

The banking system in the Philippines consists of commercial banks, thrift banks, rural banks, and specialized government banks. These banks are categorized by the banking laws. The definition, coverage and authorized functions for the said banks are described in detail in Section 5 of this paper.

Commercial banks are multi-purpose banks that serve the financial needs of individual and corporate entities.

Recently, upon the accomplishment of certain requirements set by the Monetary Board, commercial banks, to be known as expanded commercial banks or universal banks, have been authorized to conduct activities such as underwriting, securities dealership, and equity investment which only investment houses had the sole power to deal with. To date, the number of universal banks has reached almost half of the total number of commercial banks.

Thrift banks consist of savings and mortgage banks, private development banks, and stock savings and loan associations. The savings and mortgage banks accept and accumulate deposits and invest them in bonds, mortgages, agricultural loans, home building or personal loans. The private development banks go about their banking actitivities to meet the needs of industry and agriculture for medium- and long-term loans. The stock savings and loan associations are limited to the acceptance of savings deposits and the granting of small personal loans.

Rural banks are community types of banks that provide credit facilities to small farmers and merchants. They accept savings and time deposits upon the approval of the Monetary Board. They also act as an official depository of municipal, city, and provincial funds.

Commercial banks stand out overwhelmingly in the country's banking system in terms of their total assets which comprised more than 60 percent of the country's total assets from 1975 to 1990 (see Table 1). Other financial institutions playing a relatively significant role in the financial system are Non-bank Financial Institutions (NBFIs) whose assets contributed around 20 percent of the total assets in the Philippines over the same years above. However, a study of the NBFIs is not included in this paper.

Thrift banks' share of the total assets in the country remained within 2 percent to 5 percent from 1975 to 1990 (Table 1). Rural banks are actively performing their banking functions all over the country; thus they have the largest number of offices. However, since their banking business is restricted only in its location, their contribution to the country's total assets is rather limited within the range of 2 percent to 3 percent from 1975 to 1990 (Table 1). Table 1 also shows the following: there has been a clear-cut transition in the country's financial structure in terms of resource availability of the said banks from 1975 to 1990; and the concentration of financial resources in favor of commercial banks is still being pursued in the Philippines through the years, whereas rural banks' percentage share in the financial resources showed a declining trend from 3.3 percent in 1975 to 1.8 percent in 1990.

To get a clearer picture of the structural changes the country's banking system has undergone in the past decade, we have to take a closer look at the liability account of the banks which represents the source of funds of banks.

The main sources of bank funds are those of demand, savings and time deposits, as well as bills payable. Bills payable covers obligations and borrowings of the bank arising from the availability of rediscounting facilities from the CB, interbank loans, including call loans and other borrowings from banks, borrowings from non-bank financial institutions, deposit substitutes, private firms and individuals, and others. Deposit substitutes represent all types of money market borrowings of the bank, which include the following:

a. Promissory Notes Issued

These represent borrowings from private firms and individuals, evidenced by promissory notes issued by the bank in connection with its quasi-banking functions.

b. Repurchase Agreements — Commercial Papers and Securities

These represent borrowings incurred from the sale of commercial papers, promissory notes and government securities which are part of the bank's trading accounts. The sale of these is covered by an agreement to buy back the said securities at a specific future date.

c. Repurchase Agreements with the CB

These represent borrowings incurred from the sale to the CB of CB Certificates of Indebtedness (CBCIs) and other government securities, whose sales are covered by an agreement to buy back the said securities at a stipulated future date.

Table 1

Percentage Distribution of Assets

	1975	1980	1985	1990
KB	62.7	64.8	69.5	68.9
TB	2.4	5.0	3.5	4.8
RB	3.3	2.6	2.1	1.8
NBFs	31.6	27.6	24.9	24.5
	100.0	100.0	100.0	100.0

KB: Commercial Banks.

TB: Thrift Banks.

RB: Rural Banks.

NBFI: Non-Bank Financial Institutions.

Sources: National Statistical Coordination Board, *Statistical Yearbook 1980, 1985, 1992.*

d. Certificates of Assignment/Participation with Recourse

These represent borrowings incurred under the certificates of assignment/participation with recourse in connection with the bank's quasi-banking functions.

e. Other Borrowings of the Bank from the Money Market.

In a nutshell, bills-payable is the accounting item of the bank's borrowings from the money market, private firms and individuals, and the Central Bank in the form of repurchase agreement with the CB and availments of rediscounting facilities from the CB. The financial resources obtained by the bank through its borrowings are added up as bills payable, and this item of liability account becomes less available when money market becomes tight due to contractional monetary policies and or financial disintermediation and vice versa.

The most important sources of funds for thrift banks are deposits, which exceeded 80 percent of the thrift bank's total liabilities from 1975 to 1990, with 1985 as the exceptional year (Table 2-1). Bills-payable have had a minor contribution in the thrift bank's liabilities through the years. On the other hand, rural banks relied largely on bills-payable to generate income and to finance their assets (Table 2-2). The bills-payable as source of funds for the rural banks has, however, been gradually superseded by deposits from time to time since 1975. The percentage contribution of bills payable to rural banks was 52.2 percent in 1975 while that of deposits was 47.8 percent in the same year. In 1991, the percentage contribution of bills-payable diminished to 20.3 percent and that of deposits increased to 66.4 percent.

Other sources of funds have become very essential in the last decade and to date. These include items of liability accounts such as: dues to banks, treasurer's and manager's checks, accounts payable, overages, dividends payable, withholding tax

Table 2-1

Percentage Distribution of Total Liabilities of Thrift Banks

	Total Deposit	Bills Payable	Other Sources
1975	88.9	7.2	3.9
1980	84.9	70.5	7.6
1985	78.9	12.0	9.1
1990	84.1	4.9	11.0

Sources: Central Bank, *Statistical Bulletin Annual Report 1985, 1991.*

payable, dormant credits, etc. Dues to banks include dues to the CB representing all payments of taxes, and Peso Differential MAAB 43 (which are further discussed in Section 5 of this paper), together with the sale of Central Bank Certificate of Indebtedness (CBCIs) and other government securities. Dues to local banks represent credit balances of local banks arising from interbank claims and of foreign correspondent banks maintained as working funds in local currency. Treasurer's and Manager's checks represent the aggregate amount of checks drawn by the bank upon itself payable to the payees named in the check. Accounts payable represent obligations of the bank under open account arrangements, such as (a) deposits made by loan applicants for various expenses in connection with pending loan applications; (b) payments on loans pending liquidation; (c) interest rebates on loan accounts which have not yet been claimed by clients; (d) proceeds of collections pending remittance to clients/payees; (f) balances of current accounts closed due to improper handling and so forth. Overages represent the amount of overages found in the teller's daily transactions and or accountability of offices and other employees.

Because of the nature of these sources, other sources of funds are apt to be bloated when the financial system becomes depressed and vice versa.

The pattern of distribution of the bank's liabilities and its transactions appears to be a common trend among rural and commercial banks to a certain extent (Table 2-3).

In 1975, the major sources of funds among the commercial banks were those germane to bills payable and other sources which when placed together contributed 57 percent of total resources of the banks (Table 2-3). Deposits of the banks became the main source of funds for banks in the latter half of the '80s, contributing more than 60 percent to the bank's resources.

Nowadays, deposits accepted by all the banks serve as the most important resources for the country's banking system. In 1990, deposits contributed 84.1 percent to the thrift banks, 63.1 percent to the rural banks, and 65.0 percent to the commercial banks.

2-2. Financial Depression and Disintermediation in the Philippines

The financial depression in the country took place in the early 1980s. The deposits accepted by rural banks declined from 47.8 percent in 1975 to 41.7 percent in 1980. Other sources made up for the reduced share of deposits in 1980 (Table 2-2). Thrift banks faced the same situation in the same year. The contribution of deposits to the thrift banks' resources decreased by 4 percent which was made up for by the increase in the other sources by 4.3 percent (Table 2-1). Commercial banks also experienced a decrease in the deposits accepted by them from 56.9 percent in 1980 to 52.6 percent in 1981, a year after the financial depression

Table 2-2

Percentage Distribution of Total Liabilities of Rural Banks

	Total Deposit	Bills Payable	Other Sources
1975	47.8	52.50.0	
1980	41.7	52.1	6.2
1985	43.0	48.6	8.4
1986	48.0	41.6	10.4
1987	55.6	34.6	9.8
1988	57.8	30.0	12.2
1989	60.1	24.5	15.4
1990	63.1	22.5	14.4
1991	66.4	20.3	13.3

Sources: Central Bank, *Statistical Bulletin Annual Report 1985, 1991.*

Table 2-3

Percentage Distribution of Total Liabilities of Commercial Banks

	Total Deposit	Bills Payable	Other Sources
1975	43.0	37.9	19.1
1980	56.9	25.7	17.4
1981	52.6	29.7	17.7
1982	53.4	27.3	19.3
1983	50.9	29.0	20.1
1984	50.9	24.6	24.5
1985	54.7	26.2	19.1
1986	63.0	13.6	23.4
1987	62.5	13.3	24.2
1988	66.4	13.2	20.4
1989	67.7	12.8	19.5
1990	65.0	13.3	21.7

Sources: Central Bank, *Statistical Bulletin Annual Report 1985, 1991.*

plagued the thrift and rural banks. In facing this financial situation, the commercial banks concentrated more on the country's money market in beefing up their resources. The percentage contribution of bills payable for the commercial banks increased by 4 percent, simultaneous with a 4 percent decrease in the distribution of their deposits (Table 2-3).

The financial depression that happened in 1980 to 1981 was just a prologue to the most dramatic financial disintermediation that the Philippine banking system was to have.

The Philippines went through a political and economic turmoil that started with the Aquino assassination in 1983 and the declaration of moratorium to foreign creditors in the ensuing year. A devastating uncertainty pervaded the air that time. Massive runs on the banks plagued the rural and thrift banks as an aftermath.

Savings and time deposits withdrawn from the rural banks amounted to 124.1 million pesos (60 percent) in 1983 and 145.2 million pesos (96 percent), in 1984 (Table 3-1). The more severe run on the banks terribly hit the thrift banks on the same year, resulting in a drastic drawdown in the levels of their savings and time deposits by 1,751.60 million pesos (32.1 percent down) for the former and 2,356.30 million pesos (42.9 percent down) for the latter from the previous year's levels (Table 3-3).

Since 1984, there has been a shift in depositor's preference of deposit portfolios in favor of savings deposits over time deposits. It was not until 1988 that the 1983 value of time deposits was achieved by the thrift and rural banks (Table 3-1 and Table 3-2). On the other hand, commercial banks managed to minimize the bank run on their deposits. A shift, however, occurred in their saver's preference from time deposits to savings deposit in 1986. The value of their time deposits decreased by 22,959.80 million pesos (30 percent down) in 1986 and further by 2,863 million pesos (5.5 percent down) in 1987. While time deposits have been shrinking for two consecutive years, the value of savings deposits, on the contrary, increased by 15,763.30 million pesos (27.0 percent up) in 1986 and by 10,236.80 million pesos (13.8 percent up) in 1987. The 1985 value level of time deposits recovered between 1988 and 1989 (Table 3-3).

Table 3-1

Rural Banks
(Million Pesos)

	Demand Deposit	Savings Deposits	Time Deposits
1983	23.5	2,063.1	1,504.8
1984	17.6	1,939.0	1,359.6
1985	17.1	1,966.9	1,143.0
1986	20.5	2,407.2	1,339.4
1987	22.7	3,011.4	1,482.2
1988	31.3	3,519.1	1,718.6
1989	31.9	4,224.6	1,997.4
1990	38.5	4,710.6	2,318.1
1991	40.6	5,477.8	3,028.9

Source: Central Bank, *Statistical Bulletin Annual Report 1991.*

Table 3-2

Thrift Banks
(Million Pesos)

	Demand Deposit	Savings Deposits	Time Deposits
1983	230.4	5,457.1	5,495.7
1984	214.2	3,705.5	3,139.4
1985	238.3	5,472.5	4,767.9
1986	411.0	7,639.0	4,914.7
1987	395.9	9,827.0	4,824.2
1988	487.8	12,620.0	5,999.0
1989	658.0	16,600.8	8,051.1
1990	659.1	17,295.5	9,631.1
1991	777.4	22,551.8	11,309.8

Source: Central Bank, *Statistical Bulletin Annual Report 1991.*

Table 3-3

Commercial Banks
(Million Pesos)

	Demand Deposit	Savings Deposits	Time Deposits
1983	19,289.8	42,286.4	57,457.4
1984	15,458.2	48,475.6	73,284.7
1985	14,888.5	58,485.7	75,279.9
1986	19,808.4	74,249.0	52,320.1
1987	22,966.3	84,485.8	49,457.1
1988	23,555.0	110,039.0	65,153.0
1989	29,525.0	136,714.0	86,152.0
1990	32,607.0	181,070.0	97,066.0
1991	38,796.0	211,170.0	122,666.0

Source: Central Bank, *Statistical Bulletin Annual Report 1991.*

The detrimental effect of the 1984 financial crisis on the country's banking system is evident in the changes in the number of bank offices (Tables 4-1 and 4-2). The destructive effect of the 1984 financial crunch experienced by the banking system lingered until 1992. A reduction in the number of bank offices arose from the bankruptcy/merger of the banks. In 1984, the number of head offices of thrift banks was reduced to 121 from 136 in 1983. Among the thrift banks, savings and mortgage banks (SMBs) have, however, shown how their robust financial base withstood the run against them almost through 1984 up to 1991 (Table 4-4), except the year 1985

Table 4-1

Number of Banks' Offices By Institution

	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992
Commercial Banks	1904	1922	1744	1766	1727	1746	1754	1813	1923	2254
of which HO[a]	3434	30	30	29	29	29	29	30	31	32
BO[B]	1,554	1,577	1,491	1,516	1,526	1,547	1,555	1,624	1,760	2,117
TB	708	650	671	665	658	664	675	634	663	718
of which HO	136	121	118	116	112	110	106	103	101	98
BO	353	322	373	372	369	378	403	382	433	505
RB	1,157	1,157	1,117	1,082	1,058	1,048	1,043	1,045	1,063	1,140
of which HO	949	940	904	875	850	840	824	804	784	787
BO	94	109	109	107	109	109	118	142	182	253

[a] Head office.
[b] Branch office.

Sources: Factbook, Philippine Financial System 1984, 1986, 1989, 1992.

Table 4-2

Changes in the Number of Banks' Office by Institution

	1984	1985	1986	1987	1988	1989	1990	1991	1992
KB[a]									
of which HO[b]	0	-4	0	-1	0	0	1	1	1
BO[c]	23	086	25	10	21	8	69	136	357
TBD									
of which HO	-15	-3	-2	-4	-2	-4	-3	-1	-3
BO	-31	51	-1	-3	9	25	-21	51	72
RB[a]									
of which HO	-9	-36	-29	-25	-10	-16	-20	-20	3
BO	15	0	-2	2	0	9	24	24	71

[a] Commercial banks.
[b] Head offices.
[c] Branch offices.
[d] Thrift banks.
[e] Rural banks.

Calculated from Table 4-1.

Table 4-3

Number of Offices of Thrift Banks

	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992
Savings Mortgage Banks (SMB)	209	211	226	231	243	250	277	270	285	316
HO	8	8	7	7	8	8	8	7	7	7
BO	140	142	179	184	195	203	231	225	258	289
Private Development Banks (PDB)	218	209	225	213	205	205	206	211	202	218
HO	45	43	45	43	42	41	41	40	38	37
BO	101	93	107	101	94	95	96	105	102	127
Stock Savings & Loan Association (SSLA)	281	230	220	221	210	209	192	172	176	184
HO	83	70	66	66	62	61	57	56	56	54
BO	112	87	85	87	80	80	76	66	73	89

Sources: Fact Book, Philippine Financial System 1984, 1986, 1989, 1992.

Table 4-4

Changes in the Number of Offices of Thrift Banks

		1984	1985	1986	1987	1988	1989	1990	1991	1992
SMB		2	15	5	12	7	27	-7	15	31
	HO	0	-1	0	1	0	0	-1	0	0
	BO	2	37	5	11		28	-6	33	31
PDB		-9	16	12	-8	10	1	5	-9	16
	HO	-13	-4	0	-4	-1	-4	-1	0	-2
	BO	-25	-2	2	-7	0	-4	10	7	16

Calculated from Table 4-3.

when one of the SMBs collapsed. Many of the private development banks (PDBs) also managed to survive the 1984 financial disintermediation and its ensuing financial depression from 1984 to 1991. With prolonged after-effects on the banking system, the PDBs lost ten head offices until 1992. The most severely affected financial institution among the thrift banks was the stock savings and loan associations (SSLAs). They lost 13 head offices and 25 branch offices in 1984, with the loss of the former further increasing to 29 from 1984 to 1992 (Table 4-4). Among rural banks, only nine head offices were closed in 1984. This was, however, just the beginning of massive and consecutive bankruptcies of rural banks. In 1985, they lost 36 head offices, 29 in 1986, and 25 in 1987 (Table 4-2). The growing casualties for rural bank head offices went on until 1991, totalling to 165 from 1984 to 1991 (Table 4-2).

Regarding commercial banks (Table 4-1), the number of head offices closed down was four in 1985 and one in 1987. These five commercial bank head offices were acquired by government financial intermediaries like the Philippine National Bank (PNB), Development Bank of the Philippines (DBP), Government Service and Insurance System (GSIS) and the Social Security System (SSS) until 1987. However, commercial banks showed a rather brisker recovery since 1990, with new commercial banks being established yearly since then.

The year 1991 marked an epochal turn for the country's banking sector, which saw each banking institution's expansion. Commercial banks opened 136 new branch offices in 1991 and 357 in 1992. The corresponding number for thrift banks was 55 in 1991 and 72 new branch offices in 1992. Even rural banks opened 24 new branch offices in 1991 and 71 in 1992. However, the question remains whether this development could serve as an assurance of a more robust banking system. Whether it has become sturdy enough to be able to withstand any financial depression and disintermediation in the future remains to be seen.

3. JUXTAPOSITION OF DOSRI LOANS WITH INTERLOCKING DIRECTORSHIPS IN THE PHILIPPINES

A bank, whether commercial, thrift or rural, is allowed to lend its resources to the director, officer, stockholder, and other related interests (DOSRI) of the bank.

The Monetary Board also allows a person to concurrently hold the position of director or officer in a bank and a non-bank financial institution, or a venture capital corporation *inter alia*. The interlocking directorates prevail not only between financial sectors in the Philippines. Juxtaposing these interlocking directorates with the DOSRI loans, it is obvious that an availment of the DOSRI loan encourages further interlocking of directorships between non-financial and financial sectors in the Philippine setting where loanable funds are restrictive.

3-1. DOSRI Loans

Bank directors duly hold their positions in accordance with the corporate charter. Bank officers include the President, Vice Presidents, and others whose duties are defined in the by-laws, or are generally recognized or designated as officers of the bank. "Stockholders and their related interests" are those individuals who have stockholdings in the lending bank, individually or together with their spouses or relatives within the first degree of consanguinity or affinity, or legally adopted heirs.

Loans and other credit accommodations to the DOSRI are categorized as either direct or indirect borrowings from the bank. A loan to a DOSRI is referred to as direct borrowing if the director, officer, or stockholder of the lending bank is a party to any of the covered transactions for himself, or is the representative or agent for others, or if he acts as a guarantor, endorser, or surety for loans from the banks, or if the loan or credit accommodation to another party is secured by property interest or right of the director, officer, or stockholder. A borrowing of DOSRI from the bank is indirect if the borrower, guarantor, endorser, or surety is a: 1) spouse or relative within the first degree of consanguinity or affinity, or relative by legal adoption of a director, officer, or stockholder of the bank; 2) partnership of which a director, officer, or stockholder and the related interests is a general partner; 3) co-owner with the director, officer, stockholder, or their related interests of the property or interests or right mortgaged, pledged, or assigned to secure the loans or credit accommodation; 4) corporation, association, or firm by which a director, or officer of the bank, or his spouse is also a director or officer of such corporation, association, or firm; 5) corporation, association, or firm of which any or a group of directors, officers, stockholders of the lending bank and or their related interests hold or own more than twenty percent of the subscribed capital of such corporation, or of the equity of such association or firm.

With regards to the regulations on loans to DOSRI, total outstanding direct credit accommodations to each of the bank's directors, officers, or stockholders are restricted under the new financial reforms not to exceed, at any time, or at an amount equivalent to his outstanding deposit and book value of his paid-in capital contribution in the lending bank. If credit accommodations to each of the bank's directors, officers or stockholder are unsecured credits, the credit accommodation is allowed to amount to 30 percent of his total credit accomodations. This regulation is known as individual ceiling.

On the other hand, there is an aggregate ceiling on unsecured loans to the DOSRI. Without permission of the Monetary Board, the total outstanding borrowings of directors, officers, or stockholders are allowed to reach only 15 percent of the total loan portfolio of the bank or 100 percent of combined capital account of the net of the deferred income tax expenses or provision for losses not currently deductable for income tax purposes. The Monetary Board also provides a provision for exclusions from aggregate ceiling for the following credit accommodations to directors, officers, or stockholders of the bank:

a. Credit accommmodations covered by a hold-out on deposit substitutes, or covered by cash marginal deposits or secured by evidences of indebtedness of the CB or by other indebtedness or obligations the servicing and repayment of which are fully guaranteed by the national government. A loan is considered as secured by a hold-out on or assignment of deposit or deposit substitute account if it is covered by a hold-out agreement or deed of assignment signed by the depositor or investor/ placer in favor of the bank and maintained in the lending bank:

b. Credit accommodations to a corporate stockholder which meet all the following conditions:

1. the corporation is a non-financial institution;
2. its shares are listed and traded in the big board or commercial and industrial board of domestic stock exchanges;
3. its stockholdings in the lending bank do not exceed 30 percent of the voting stocks of the bank; and
4. no person or group of persons related within the first degree of consanguinity or affinity holds/owns more than 20 percent of the subscribed capital of the corporation.

c. Credit accommodations to government owned or controlled corporations, in cases where a director, officer, or stockholder of the lending bank is a representative of the government in the borrowing corporation and does not hold any proprietary interest in such corporation.

Individual and aggregate ceilings to the DOSRI loans apply to the commercial and rural banks, but it is not known if it applies to thrift banks.

3-2. Interlocking Directorships and Officerships

The banking laws in the country are only concerned with interlocking directorships within the financial system. We take up first the regulations and rules for interlocking directorships within the financial system stipulated in the laws under the new reforms.

Regulations are intended to govern interlocking directorships within the financial system in order to safeguard against the exercise by the same person or group of persons of undue influence over the policymaking and or management functions of similar financial institutions. Such influence could have an adverse effect on competition or could result in conflict of interests.

The concurrent directorships between banks or between a bank and a non-bank financial institution are prescribed in principle, except as may be authorized by the Monetary Board. This is so because the concurrent directorships may prejudice the various relationships within the financial system to the interests of the institutions involved or to their disadvantage. Concurrent directorships are allowed in the following cases: (1) banks not belonging to the same category; (2) a non-bank financial intermediary other than an investment house not undertaking quasi-banking functions; (3) a bank not performing quasi-banking functions and a non-bank financial intermediary, other than investment house, performing quasi-banking functions and; (4) a universal bank or a commercial bank and one or more financial institutions other than an investment house where majority interests are held by the bank.

Quasi-banking functions include the following as their essential elements:

(a) borrowing accounts for the borrower's own account;
(b) twenty or more lenders at any one time;
(c) methods of borrowings are issuance, endorsement or acceptance of debt instruments of any kind, other than deposits, such as acceptance of promissory notes, participations, certificate of assignment or similar instruments with recourse;
(d) purpose for quasi-banking may be for re-lending or purchasing receivables or other obligations which refer to the acquisition of claims collectible in money, including interbank borrowings or borrowings between financial institutions, or of securities, etc.

Besides the interlocking directorships within the country's financial system, another type of interlocking directorships is well known among businessmen and economists. They point out that this type of interlocking directorships characterizes one important conglomerate structure of large business in the country. The question is whether the Monetary Board places restrictions on the concurrent directorship position in a financial and non-financial sector. Since the banking laws do not elaborate on this matter, there may be a tacit agreement with the Monetary Board that a concurrent position of directorships between a financial intermediary and a non-financial corporation are not unlawful and unregulated.

In the case of Japan, a large business creates a conglomerate including a wide range of diversified business entities in the manufacturing and service sectors. Within the conglomerate, it is well known that a bank plays an important role to support the financial needs of the conglomerate. This is called the main-bank. The main-bank usually acts quite independently of the conglomerate and is not considered as an in-house bank for the members of the conglomerate. The interlocking directorships within the financial system are strictly prohibited by the Central Bank of Japan. The directors of the bank are also kept from holding concurrent directorship positions in a non-financial corporation. There are no interlocking directorships in terms of concurrent positions of directorships within the conglomerate banks in the Japanese banking system. The main-bank in Japan is not the in-house bank for the conglomerate because the policy-making of the main bank is not influenced by any individual or group of individuals other than the bank whose respective directors belong to the same conglomerate. On the other hand, the companies within the same conglomerate are often influenced by their main banks in their management decisions. The main-bank, however, sometimes gets into financial trouble when it over-commits the company's capital. These cases sometimes occur in Japan due to keen competition in the financial sector; when the risk is high, aggressive bank officers are often apt to snap at high returns offered by other companies, without careful scrutiny of the risks involved.

Filipino finance and banking experts argue that banks in the Philippines are treated as in-house banks for the conglomerate to which they belong and they use the DOSRI institution to advance their respective interests in favor of the conglomerate. The DOSRI institution, together with interlocking directorships prevalent in the Philippine setting, tends to provide hotbeds of bank fraud, which further weakened the country's financial system in the last decade. (For more details, see Lamberte's paper, 1989.)

Tan (1993) sketches a comprehensive picture of the extensive interlocking of directorates between the large commercial banks and firms in various Philippine sectors. Tan describes it thus: "An application of these concentrated industry firms is that commercial banks tend to have specialized control on industries: BPI (Bank of the Philippine Islands), for example, tends to operate on the food and beverage industry as well as the manufacturing of soap, cleaning preparations, perfumes, cosmetics, and other toilet preparations. Another point to consider is that even if a certain competitive industry exists, the firms behave in such a way that there is collusion." To the extent that Tan's observation is valid, the country's commercial banks therefore becomes the hub of policy-making and management for various industries which are placed under their bank's control. The bank's commitment to the decision making of the firm or firms as affiliates within the same conglomerate implies that the bank should be saddled with the responsibility of credibility risks which the firm or firms assumed for their own in principle. In connection to this, Lamberte (1989) states the following:

"Why is it that the loans to DOSRI and bank affiliates could lead to severe bank problems? One reason is that the loan application does not pass through the rigors of loan processing applied to unaffiliated borrowers. It is highly probable that the DOSRI accommodations are granted on terms disadvantageous to the bank. More often than not, the loans are used to fund risky ventures which normally a bank refuses to finance if they were proposed by unaffiliated borrowers. The saying, "heads, I win...tails I lose," applies here. That is, if the project succeeds, the DOSRI and or affiliates reap all the extra profits for taking high risks; if the project fails, depositors and Philippine Deposit Insurance Corporation (PDIC) will bear the costs. Another reason is that loans to DOSRI and or affiliates are either not fully secured or lacking in collateral, thus, in the case of bankruptcy, the bank has nothing to collect." Lamberte's assertion is very much evident in the case of rural bank failures.

The total number of violations committed by 847 rural banks examined by the Central Bank during the years from 1984 to 1986 amounted to 674. Some 462 of the total violations were related to DOSRI loans. The cases of Banco Filipino and Manila Bank suggest that failure in the diversification of their risky assets led to their liquidity problem when their affiliated borrowers went bankrupt. These were surprisingly committed in the banking system that, through backed up by PDIC and government rescue operations, was beset by a moral hazard introduced in the country's financial system through the DOSRI and interlocking directorships. This nightmare in the last decade should provide lessons to the Monetary Authority.

4. EXAMINING THE STRUCTURE AND POLICY REFORMS IN THE PHILIPPINE BANKING SYSTEM

The foremost concern of the Philippine banking system is the attainment of stability and robustness, as it tries to provide the economy with efficient financial intermediation. Basically, the system has to establish its credibility among the different types of depositors and creditors in their daily transactions. Thus, when the bank's credibility is lost, the financial system immediately encounters a destructive run on the banks. Massive bank runs result in the prolonged and severe deterioration of the banking system. In this case, the size or number of banks does not necessarily help avert liquidity drain from its deposits, despite the rescue efforts of the Central Bank. This was all too clear in the experience of the Philippine banking system in the last decade.

Bank runs can be compared to a heart attack wherein the blood ceases to be effectively distributed within the human body. As in a heart attack, the bank ceases from doing its role of effectively distributing money and credits in the banking system during a bank run. Thus, the issue of robustness and stability of financial intermediation must take precedence over any other monetary policy issue in a country. Financial liberalists, as presumed by Mckinnon (1973) and Shaw (1973), often tend to play down or overlook this point. Bautista (1992) wisely perceives this point and argues: "thus, while financial liberalization represents an important step towards enhancing economic development, it is not sufficient. Moreover, as various country experiences indicate, financial development entails more than de facto liberalization of interests rates. More fundamentally, unless the underlying institutional structures are in place, the perceived benefits may even turn out to be disturbing to put in proper perspective the role of money and banking policies in development."

The essence of achieving a sound and firm banking structure is to keep on achieving and maintaining people's confidence in the banking system. Thus, people's confidence must not be jeopardized by the bank's abuses in seeking profits. Banks must be very careful not to commit any moral hazard that will instantly dissipate people's confidence and trust in them. But in reality, many banks still commit moral hazards simply because private financial intermediaries are not non-profit organizations. To elaborate on this more clearly, let us use two simple models with and without complete information.

The most difficult task for a banker or creditor is determining whether the borrowers or loan applicants are well qualified and credible, i.e. that these applicants are doing good business and have no pending financial troubles. If a borrower company faces a critical level of overleverage in its debt-equity structure, it may have difficulty establishing its credibility since the lending bank will entertain fears that the loan it grants, which is fungible by nature, may be channelled off its proper use, thus affecting the borrower's new projects. It has been a common practice among loan applicants to misdeclare their financial situation to attain good terms or to have their loan applications approved. This results in asymmetry of available information between borrowers and creditors.

Table 5

Specifications of the Projects

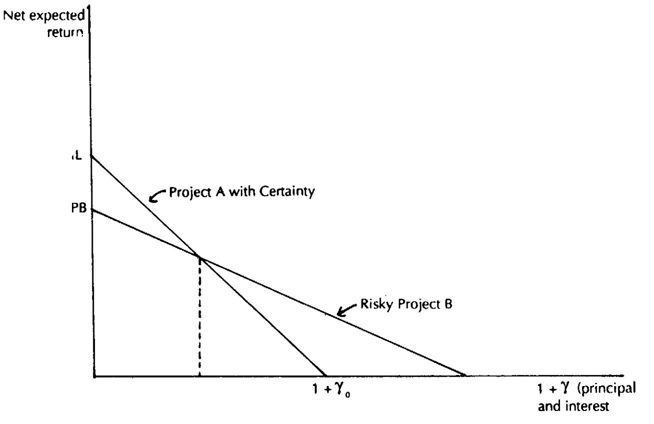
	State S_1	State S_2
Probability of occurrence	P	1 – P
Gross return to Project A	α	α
Gross return to Project B	ß	0

Suppose that two projects A and B were submitted to the banker/creditor, as indicated in Table 5. Table 5 shows that the probability of occurrence of state of economy S_1 is *P* and 1-*P* for that of state of economy S_2. Project A yields a gross return of α in the occurrence of either state of the economy S_1 or S_2 . On the other hand, project B yields a gross return of ß in the occurrence of state S_1 and zero in state S_2. The gross returns to project B is larger than that to project A, α, i.e., ß $>\alpha$.

Case 1 : With asymmetry of information, the banker is not sure that Project A and B are properly carried out by enterprise A and B, respectively. Hence, he has no incentive to offer a differential rate of interest on the unit amount of his lending to projects A and B. Instead, he applies the same lending rate, γ to both projects.

Based on the specifications of the projects submitted to him, he finds the expected rate of returns to project A to be α -1-γ peso worth with zero risk and p(ß-1-γ) peso worth to project B, ß>1+γ. From the banker's point of view, the expected return to its lending to project B is $p(1+\gamma)$. The size of the risk associated with this return is $p(1-p)(1+\gamma)^2$. On the other hand, a borrower's expected repayment of principal and interest rate is also $p(1+\gamma)$. The size of the credibility risk that the borrower will have to assume is also given by $p(1-p)(1+\gamma)^2$. The credibility risk is

Figure 1
With Asymmetric Information



obviously a monotone function of interest rate, γ. Therefore, from the points of view of both creditor and borrower, the higher risk is necessarily concommitant to the higher interest rate with lower net return to the risky project. The lower the probability, *p*, the higher the risk of project B. We will not take up the trivial case of project B with sufficiently high probability of *p*. Figure 1 indicates our concern where α is larger than $p\beta$. Under high lending rate of interest, there is no other way for enterprise A but to back out of project A with lending rates exceeding the level of γ_0 in Figure 1. Project B becomes a viable project only under a high interest rate regime ($r > \gamma_0$). Therefore, despite the banker's wish to be prudent, he has no other choice but to approve loans to projects with high-risk returns.

Hence, although project A is preferable over project B from the banker's point of view, the banker has no other choice but to grant a credit to project B.

The implications of this simple model are the following:

1. As the country's banking system has experienced, financial lending tends to adopt a high interest rate regime when financial repression gives way to financial liberalization. Theoretically, a possible danger arises when the banks' assets are dominated by high-risk ones due to adverse selection of their assets which in turn, could undermine the Philippine banking system as a whole.

2. Taking high risk return projects connotes that the bankers are committing moral hazards at the expense of the PDIC and depositors since this provides fertile ground for bank runs. Therefore, utmost caution should be observed since too much emphasis on deregulation of interest rates or an over-committment to the market mechanism might cause another liquidity crisis in the Philippine banking system if high interest rates persist for a long period.

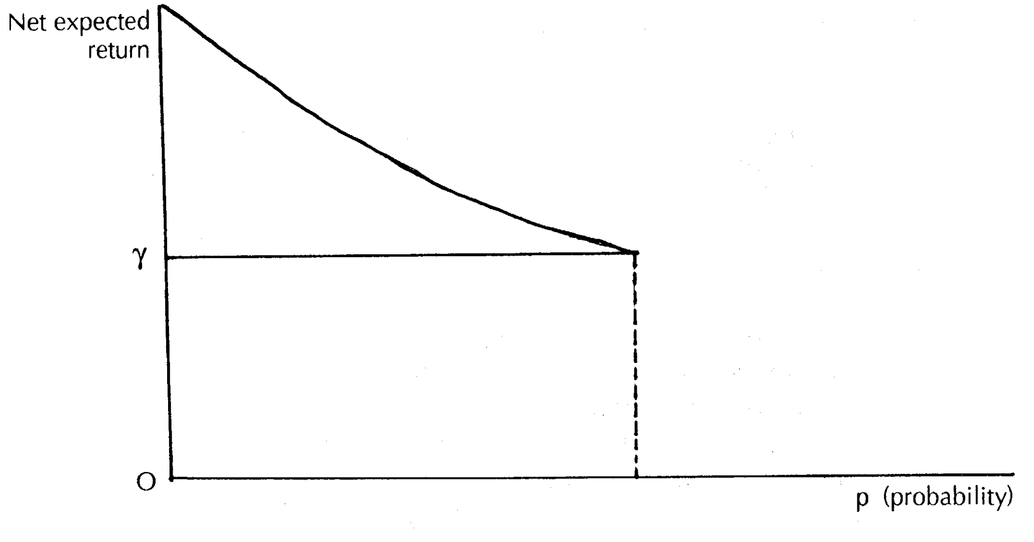
3. Interlocking directorships between the banking sector and non-financial sector, to some extent, could be an effective means to minimize the skewness of information available between bankers and non-bankers provided that it does not lead to collusion which results in giving higher lending rates to their unaffiliated borrowers.

4. If financial liberalization tends to promote an oligopolistic industrial organization in the Philippine banking system, which may result in the furtherance of high interest rate regime by collusion with bankers, the Monetary Board should intervene in the market to minimize the risks bankers face. The deregulation on the foreign banks' entry to the country's financial market may be another potent measure to help achieve a competitive market, thereby lowering the level of interest.

Case 2 : With complete information/symmetry of information.

This is the case wherein the banker has complete information of the borrower's qualifications and financial positions. From the vantage point of the banker, he may place interest rate differentiation to project A and B. Because the loan to project B is risky, he is likely to ask enterprise B to pay an equivalent level of expected interest rate to the interest rate, *r*, which is obtained from lending to the enterprise A with certainty. In this case, the expected rate of interest on the lending to project B is given by $1\text{-}p + r/p$. It is obvious from Figure 2 that the expected rate of interest always exceeds the rate of interest, *r*, on loans to the non-risky project. Implications from this model are the following:

Figure 2
With Complete Information



1) In the conglomerate with which the bank is affiliated, interlocking directorships may be executed between the bank and those undertaking project A and B. If both projects are carried out, interest rate differentiation is likely to be applied in the different enterprises within the conglomerate.

2) If there is no interest rate differentiation inside the conglomerate, credit rationing must take place in the allocation of the bank's resources according to the different specifications of the project. Unless the application of allocative criteria is evident, there is room for loopholes where the DOSRI privilege is abused and is inimical to the bank's interest. If the Monetary Authority finds it difficult to curb these abuses, the DOSRI institution should either be abolished or be enforced with stringent or strict conditions such as requiring the submission to the Monetary Authority of all the necessary documents and a complete justification and valid reason for the availment of the DOSRI loan.

3) The 1970s saw the mushrooming of large conglomerates in the Philippines. This was made possible by taking advantage of relatively easy loans backed by the government and the implementation of public investments and related projects. In spite of the repeal of the Anti-Usury Act in 1973, interest rates were still administratively fixed at their level below market rates. One can presume that with virtually a fixed-rate regime, a conglomerate was provided the leeway not to implement the interest rate differentiation in its projects which further resulted to misallocation of bank resources inside the conglomerates.

Aside from the above scenario, other important issues pertaining to the stability of the banking system must be examined. A bank encounters money market interest risks when it is involved in a mismatch in the term transformation between its borrowings from the money market or depositors, and lending to investors for the purpose of real estate acquisition, home building, etc. As we saw in Section 2, the fund sources of banks in the 1980s were mainly in the form of borrowings from the money market and savings deposits. Although time deposits have become an important source of funds for every bank nowadays, the borrowings from the money market as deposit substitutes are by nature very short term transactions as compared to those from lending investors which have a longer maturity term. The loan market operated by banks and non-bank borrowers is characterized to be a forward contract market where the banks take a long position to facilitate a hedge for borrowers taking a short position. Therefore, banking business requires specialized skills in scrutinizing the granting of loans. On the other hand, non-bank borrowers hedge the money interest risk concomitant with their borrowings by clamoring for longer maturity term as much as possible, while concurrently covering a part of their long-term borrowing costs by lodging their funds in short-term deposits with the bank.

The objectives of the 1980 financial reforms were stated in the joint IMF-World Bank report (1979) to be the following:

1) to promote greater efficiency by means of more competitive conditions; and

2) to increase the availability of and access to longer term funds.

In response to this and to encourage banks to facilitate long-term financial needs for the country's development, the Central Bank lifted the interest rate ceilings on long-term loans in 1981 and on short-term loans in 1983. The lifting of interest rate ceilings on short term loans came after that on the long-term loans because the CB sought to allay a possible predicament that might be inflicted to banks in the event that the short term interest rate may shoot up over that on the long term loans. In other words, the CB tried to evade a possible risk of money interest among banks due to a mismatch in the term transformation between short- term borrowings of the banks and the long-term lendings to non-bank borrowers, more simply between the assets and liabilities of banks.

Other measures that the CB set up to encourage the banks to lend their funds to long-term loan seekers were:

1) The banks were allowed to avail of the facility for the medium- and long-term rediscounting window upon presentation of papers proving that the medium and long term loans were for the acquisition of fixed assets, working capital in connection with a proposed or ongoing expansion development program, investment in affiliates and other institutions, or for investment in high grade securities;

2) Under the lender-of-last-resort facility granted to banks, any paper irrespective of maturity is acceptable security so that banks are encouraged to engage in term transformation. Banks having temporary liquidity problems while in the cause of engaging in term transformation are also allowed to avail of this facility at a rate closer to the market rate.

An assessment of the effects of term transformations on the country's banking system was conducted by Remolona and Lamberte (1986) and reached the following conclusion:

> "Note that the interest rate on loans shot up in 1984. However, the estimated net rate of return is negative for the period 1983-84. This suggests that the increase in interest rate on new loans contracted in 1984 was not enough to compensate for the interest rate loss incurred on medium and long term loans contracted in the previous years, not to mention the losses due to loan default. Those who have heeded the CB's call for term transformation must have been badly hurt during the crisis."

To date, there is still a pervading fear that stock savings and loan associations and rural banks are still confronted with a mismatch in their term transformation which further weakens their banking bases. Theoretically, SSLAs grant credit to their members for the purpose of home building, real estate acquisitions, etc. These loans to the members require relatively longer term maturities while SSLAs accept short-term savings deposits from them. Rural banks, on the other hand, largely depend upon borrowings from the money market as their source of funds, while they facilitate financial assistance to small farmers and firms in their locality. RBs' confront risks not only with respect to interest but also in defaults on payment. However, data and documents required for an in-depth study are quite limited. So any further analysis on this matter should be postponed until such time as the needed data and documents are available.

Regarding the mismatch in term transformation, the following implications are derived:

(1) Alleviating the mismatch entails further encouragement of medium and long term time deposits — a tendency noted in the Philippine banking sector as pointed out in the preceding section. This reiterates the need to maintain people's confidence in the banking system to keep clients from shifting from medium and long term time deposits to short-term savings deposits as was observed in the last decade.

(2) Once the people's confidence is lost, the people's preference for deposits portfolios shifts from time deposits to savings deposits. When this occurs, banks prudentially seek to weather the riskier business ventures by going about their short-term lending only, thus jeopardizing the sustainable growth of the country's economy.

5. BACKGROUND AND RECENT INSTITUTIONAL REFORMS IN THE PHILIPPINE BANKING SYSTEM

The Philippine financial system has undergone a crucial test in the past decade as evidenced in the preceding sections. It is high time for the Central Monetary Authority to resolve the problems of the country's banking system. Reforming the Central Bank of the Philippines was just an initial step initiated by the Central Monetary Authority. The Central Bank was divested of the former function or role it played under the Marcos regime. Its new role is to maintain monetary stability and foster a financial environment conducive to economic growth of the country in strengthening the banking infrastructure. Deregulation and liberalization are the 1990s' key concepts of reform to foster greater competition in the banking system. And in line with the concept of deregulation and liberalization, the CB has lifted its restrictions and encouraged the entry of new banks and allowed an expansion and buildup of existing bank's branch offices. Thus, the moratorium on the establishment of new banks was lifted on May 16, 1989 and this was followed by an easing up on branch banking on April 15, 1991. According to the newly instituted auction system, minimum bids for franchises in Metro Manila as well as those cities considered as "over-banked areas," are priced twice as much as those in first-class cities and municipalities. Banks are also provided with incentives to open branches in those areas considered as "under-banked areas" in terms of economic activities and population. This means that franchises in these areas do not require minimum bids.

Under the existing banking laws, with the exception of four foreign banks already operating since the enactment of the General Banking Act in 1949, foreign banks are not authorized to operate in the country. In 1977, however, foreign banks were finally allowed to do off-shore banking in the country. They were authorized to furnish full foreign exchange services for all foreign currency non-trade remittance and inward export letters of credit. Recently, the new Central Bank or the Bangko Sentral ng Pilipinas started reviewing the restrictive policies on the entry of foreign banks in the Philippines and is recommending to Congress the liberalization of the restrictive policies on the entry of foreign banks. This section tackles the details about the institutional reforms intended for the banking system within the purview of the powers vested upon the Central Monetary Authority.

5-1. The Central Monetary Authority

The Central Bank of the Philippines (CB) was recently reformed to recover from its perennial deficit in the past decade. Republic Act No. 7656, or the New Central Bank Act was made effective last May 1993 to resolve the financial problem of the old CB, with the creation of a new Central Monetary Authority to be known as the Bangko Sentral ng Pilipinas (BSP).

The financial problem that the old CB faced reared its head during the years of the financial disintermediation[1] in the 1980s. For this, one could blame mismanagement and the inappropriate social and economic development strategies[2] and macroeconomic policies taken under the Marcos regime in the 1970s which saw the most severe internal political and economic disturbances to plague the country. The CB has operated in a deficit since 1983 and its losses have never gone below 10 billion pesos a year. With the losses 15 times more than CB's net worth, on the average, the CB books posted perpetually in the red since then.[3]

The CB losses could be traced to three factors namely: higher interest payments, forward cover losses, and swap arrangement which are elaborated on below:

[1] E.M. Remolona and M.B. Lamberte (1986); M.B. Lamberte (1989); J.T. Yap, *et al* (1990).
[2] H. Sakai (1989, 1990).
[3] M.T.V. Taningco (1993).

a) The debt service burden of both the national government and government-owned and or controlled corporations has grown very rapidly since 1982. This is mainly due to government's takeover of a number of private corporations that failed during the 1983-84 balance of payments crisis and was further aggravated by its assumption of publicly-guaranteed debts. The huge budget deficit was partly financed through CB borrowing. The gradual loss of confidence in the Philippine economy was further aggravated by the political events in 1983 and caused massive capital flight with a persistent imbalance in the external current account position. The Philippines faced severe foreign exchange outages with no other way out but a moratorium on capital repayments abroad. To arrest the capital flight, the CB implemented a tight monetary policy that saw interest rates on loans and CB bills soaring from 14.5 percent per annum before the start of the crisis in 1983 to as high as 40 percent in 1984. The CB bills which were issued to stem capital flights and finance a consolidated government budget deficit were known as the "Jobo Bills" named after then CB governor Jose "Jobo" B. Fernandez. While its interest payments ballooned, the CB continued to receive meager interest income on its low-yielding domestic assets.[4]

b) The forward cover, which refers to foreign exchange provided by the CB at a fixed exchange rate to importers of oil, grains, and other essential commodities, started in 1982. This was a national policy which allowed the economy to curb domestic inflationary pressure on the prices of those commodities. The losses due to the peso's depreciation were further aggravated by the importers' demand for the foreign exchange to be borne by the CB and not by the national government since the latter's function is to provide subsidies. Since the peso has been depreciating over the years, the CB has persistently been incurring forward cover losses.

c) The swap contract was needed to beef up the level of CB's foreign exchange reserves to maintain stability in the foreign exchange market. The CB received foreign exchange from the banks in exchange for pesos at prevailing exchange rates, which the CB would deliver back to them at an agreed future date at a predetermined exchange rate. The low level of CB's international reserves, however, made it difficult for the CB to deliver back the foreign exchange to the banks at the agreed date, and so these contracts had to be renewed repeatedly. As the contracts matured and were renewed, the CB recorded in its books the differentials resulting from the variations in the exchange rate. These peso differentials were placed in blocked peso accounts of blocked peso deposit and blocked peso differentials which were in effect treated as loans to the CB for which interest had to be paid at prevailing rates. Interest payments on these blocked peso accounts totalled 11 billion pesos in the six year period 1986-1991.[5]

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[4] M.T.V. Taningco (1993), *op. cit.*

[5] M.B. Suleik (1993), p. 36.

Faced with these extraordinary losses, the CB was provided by its Charter the authority to charge extraordinary expenses to three suspense accounts, specifically the Monetary Adjustment Account (MAA), the Exchange Stabilization Adjustment Account (ESAA), and the Revaluation of International Reserve (RIR).

RIR was organized because the CB engages in the buying and selling of foreign exchange in pursuance of its mandate to maintain the convertibility of the peso to be ready to freely buy or sell convertible foreign exchange offered to them or demanded from them by the banking system. The foreign exchange transaction of the CB does not contain any profits arising from its transactions. It therefore follows that any profits and losses arising from its transaction in foreign exchange should not be charged to its current income statement. The balance of payments crisis in the eighties caused the CB to charge the losses to the RIR account, with the net loss amounting to 1.8 billion pesos in 1982, increasing to a staggering 36.6 billion pesos in 1983, and to an even higher 88.4 billion pesos in 1985. The main items that accounted for these large increase in the RIR losses were the forward cover and swap contracts.

The MMA was provided in order for the CB to control the currency and coinage requirements of the economy. The costs of printing new notes and the minting of coins were charged to the MMA. More importantly, other costs charged to MMA include extraordinary expenditures arising from the issuance and service of instruments of monetary policies such as the Central Bank Certificates of Indebtedness (CBCI) and CB bills such as the "Jobo" or "Joey" bills, as well as payments on reverse repurchase agreement and on interest payments on bank reserves and deposits with the CB. These expenses have caused the outstanding balance of MAA to rise from some manageable level in 1980 to 66 billion pesos as of the end of 1992.[6]

The ESAA was created as a temporary account to which the following expenses are charged: (i) interest payments and commitment fees on foreign loans and other foreign obligations, and (ii) other expenses related to handling foreign loans and obligations such as expenses incurred in connection with negotiations, securing and servicing of foreign obligations. Because of acute shortage of foreign exchange in 1983, public and private sector borrowers were unable to amortize or repay their foreign debts even if they had enough pesos to be able to purchase foreign exchange. The CB allowed the domestic debtors to deliver or block the CB peso equivalent of their amortization at prevailing exchange rates. This meant that the CB assumed their foreign liabilities (principal debts and periodic interest due) which became the country's rescheduled debt. Because of the rapid and continuous depreciation of the peso in the eighties, the CB had to amortize the liabilities assumed by them at a later date with more pesos than it had received from the

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[6] M.B. Suleik (1993), p.42.

original debtors, which resulted in losses to the CB. The exchange rate adjustment to depreciate the value of the peso brought about extraordinary increases in the peso equivalent of the CB's foreign liabilities. Such expenses exceeded some affordable level and were temporarily deferred and lodged in the ESAA. The balance of ESAA amounted to 87 billion pesos as of the end of 1992.[7]

The huge deficit of the CB built up in the MAA, ESAA and RIR accounts, virtually crippled the CB that led them to take a macro management appropriate and needed for the country's economy to establish its growth and stability. This led to the passage of Senate Bill No. 1902 and House Bill No. 5652 creating the new Central Monetary Authority starting "clean" with a new equity position. Republic Act No. 7653 which is a consolidation of House Bill No. 7037 and Senate Bill No. 1235 was finally passed by the House of Representatives and the Senate on June 10,1993 and was signed by the President of the Philippines, Fidel V. Ramos.

Section I of the New Central Bank Act (Republic Act No. 7653) stipulates that a Central Monetary Authority shall function and operate as an independent and accountable corporate body in the discharge of its mandated responsibilities concerning money, banking and credit. Section 2 in the Act states that the capital of the Bangko Sentral shall be 50 billion pesos to be fully subscribed by the government. Ten billion pesos of this capital shall be fully paid for by the government upon effectivity of the Act and the balance shall be paid for within a period of two years from the effectivity of the Act. Section 3 of the new CB Act enumerates the responsibilities of the Bangko Sentral ng Pilipinas (BSP), namely, to provide policy directions in the areas of money, banking, and credit, supervise the operations of banks and exercise regulatory powers and other pertinent laws over the operations of finance companies and non-bank financial institutions performing quasi-banking functions. The primary objective of the BSP is also specified in Section 3 which states that the BSP shall maintain price stability conducive to a balanced and sustainable growth of the economy and also promote and maintain monetary stability and the convertibility of the peso.

In time with the provisions of the new CB Act, the old CB with huge liabilities shall be abolished completely and be replaced by the new Central Monetary Authority which starts with a clean slate. This is achieved through the transitory provisions in the New Central Bank Act. Section 129, Chapter VII of the Act stipulates that, in principle, the BSP shall, within a period of three years but in no case longer than five years, phase out all fiscal agency functions and transfer these functions performed by the old CB to the Department of Finance. Section 130 states that the BSP shall, within a period of five years, phase out its regulatory powers over finance companies without quasi-banking functions and other institutions perform-

[7] M.B. Suleik (1993), p.37.

ing similar functions and transfer these regulatory powers to the Securities and Exchange Commission (SEC).

All incumbent personnel in the CB as of the date of the approval of this Act continued to exercise their duties and functions as personnel of the BSP. Regarding the transfer of assets and liabilities, three members of the Monetary Board composed of the BSP Governor, the Secretary of Finance and the Secretary of Budget and Management and the Chairmen of the Committees on Banks of the Senate and the House of Representatives assumed the responsibility of determining the assets and liabilities of the CB which may be transferred to or assumed by the BSP. Section 132 designates the liquidation of the net liabilities of the CB such that the BSP shall remit seventy-five percent of its net profits to a special deposit account (sinking fund) until such time as the net liabilities of the CB shall have been liquidated through generally accepted finance mechanisms such as but not limited to write-offs, set-offs, condonation, collections, reappraisals, revaluation and bond issuance by the National Government or to the National Government as dividends. Any asset or liability of the CB not transferred to the BSP is to be retained and administered, disposed of and liquidated by the CB itself which shall continue to exist as the CB Board of Liquidators, but not later than twenty-five years, or until such time that liabilities shall have been liquidated.

To prevent the recurrence of the problems of the past, R.A. 7653 provides for the repeal of the Monetary Adjustment Account and the Exchange Stabilization Adjustment Account. Amounts outstanding are to be assumed by the CB Board of Liquidators. The Act also prohibits the Revaluation of the International Reserve Account (RIR) to be credited or debited for any purposes other than those specifically authorized under Section 45 of the Act.

5-2. Urban Commercial Banks

The scope of expanded commercial banking[8] authority includes, aside from commercial banking powers enumerated in the following paragraph, the authority to exercise the powers of investment houses to invest in the equity of non-allied undertakings and to own up to 100 percent of the equity of a financial intermediary other than a commercial bank or a bank authorized to provide commercial banking services.

A commercial banking corporation is authorized to carry on the business of commercial banking, by acceptance of drafts and issuance of letters of credit by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debts; by receiving deposits; by buying and selling foreign exchange, and by lending money against personal security or against securities consisting of

[8] *Manual of Regulations for Banks and other Financial Intermediaries*, Book I.

personal property or mortgages on improved real estate and the insured improvements. A commercial banking corporation may accept or create demand deposits subject to withdrawal by check; offer Negotiable Order of Withdrawal (NOW) accounts; invest to the extent allowed under existing applicable law and regulations in equities of allied undertakings, whether financial or non-financial; and acquire readily marketable bonds and other debt securities.

A commercial bank authorized by the Monetary Board to operate under an expanded commercial banking authority is referred to as a Universal Bank. It may perform the functions of an investment house either directly or indirectly through a subsidiary investment house; in either case, the underwriting of equity securities and securities dealing are subject to pertinent rules and regulations of the SEC. If the investment house functions are performed by the commercial banks, such functions are performed within the purview of the SEC regulations and undertaken by a separate and distinct department or other similar unit in the bank operating under an expanded commercial banking authority. If a bank avails of the option of exercising the powers of investment houses indirectly through its subsidiary investment house, the bank is not allowed to exercise the powers which are exclusively reserved for investment houses.

An investment house existing as of April 1, 1980 is also allowed to be converted into a commercial bank to operate under an expanded commercial banking authority. In the grant of this authority, the Monetary Board takes into consideration the capability of the applicant in terms of its past performance as a financial intermediary, its financial resources and technical expertise.

5-3. Thrift Banks

The scope of thrift banking authority[9] is related to those engaged in financial intermediation such as savings and mortgage banks, stock savings and loan associations, and private development banks, referred to as thrift banks.

The thrift banks perform any or all of the following services:

(a) to grant loans, whether secured or unsecured;

(b) to invest in readily marketable bonds and accounts receivables, drafts, bills of exchange, acceptances or notes, arising out of commercial transactions;

(c) to issue domestic letters of credit; and

(d) to undertake such other investments which the Monetary Board may determine as necessary in the futherance of national economic objectives.

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[9] *Manual of Regulations for Banks and Financial Intermediaries,* Book II.

Aside from these services, thrift banks, upon the approval of the Board, may undertake trust and other fiduciary business and may accept checking accounts, "NOW" accounts, government deposits and foreign exchange deposits.

A thrift bank with a paid-in-capital of at least 50 million pesos is allowed to apply an acceptance and a creation of demand deposit to the Central Monetary Authority through the appropriate supervising and examining department of the Central Bank. Officers and employees who have direct and immediate responsibilty in the handling of transactions and/or records pertaining to demand deposits are to be adequately bonded and or covered by an adequate blanket insurance.

The savings and mortgage banks accumulate deposits and invest them in bonds, mortgages, agricultural loans, home building or home development loans, or personal loans. The private development banks address their services in a manner by which they could meet the needs of industry and agriculture for medium and long term loans. The savings and mortgage banks and the private development banks are authorized to solicit and accept savings and time deposits, act as correspondents and collection agents and may rediscount paper with the BSP or other banks. On the other hand, stock savings and loan associations are limited to the acceptance of savings deposits and the granting of small personal loans.

Any activity of trust-licensed institutions resulting from a contract or agreement whereby the institution binds itself to render service or to act as a representative of an agency, or guardian or administrator of wills, properties and estates, or executor, results in a trusteeship. Transactions resulting from these activities are kept and recorded as fiduciary account. The investment management activity refers to any activity resulting from a contract or agreement primarily for financial return whereby the bank or an investment house (or the investment manager) binds itself to handle or manage investible funds or any investment portfolio in a representative capacity as financial or managing agent, advisor, consultant or administrator of financial or investment management, or any similar agreement which does not create or result in a trusteeship.

Engaging in trust and other fiduciary business requires a paid-in-capital of at least 100 million pesos. A bank or an investment house previously authorized to perform and is actually engaged in trust and other fiduciary business whose paid-in-capital is less than 100 million pesos is directed to build up its paid-in-capital in equal amounts annually over a three-year period from October 16, 1990 by way of fresh capital infusion or by stock dividends. In case an institution fails to comply with this requirement, the Monetary Board may order the institution to desist from accepting new trust and other fiduciary accounts and from receiving expiring trust and other fiduciary contracts.

Activities pertaining to the trust, other fiduciary business and investment business of an institution are carried out through a trust department which should be organizationally, operationally, adminstratively, and functionally separate and distinct from the other departments of the institution. These activities are conducted under the responsibilities of the board of directors, trust committee, and trust officer. The trust department, trust officer and other subordinate officers of the trust department are only directly responsible to the institution's trust committee which in turn is only responsible to the institution's board of directors. The trust committee must be composed of five members namely: (a) three directors who are appointed by the board of directors on a regular rotation basis and who are not operating officers of the institution; (b) the president; and (c) the trust officer as head of the trust department.

The typical trust transactions undertaken by the most prestigious universal banks in the Philippines, for example, include management of premium fund, and of institutional fund and investments in government securities and in the stock market. The premium fund is designed for the medium-term investors needing a steady source of tax-paid income derived from investing in a diversified portfolio of fixed income securities and instruments.The institutional fund is designed for the medium term to long term tax-exempt investors, such as qualified educational institutions, and retirement funds, needing a steady source of income derived from investment in fixed income securities and investments.

All earnings of the premium fund are subjected to the 20 percent final withholding tax, whereas all earnings of the institutional fund are not subjected to any form of final withholding tax, except when the said tax has already been withheld at source. The fund used for investing in government securities is referred to as government security fund. All earnings of this fund are subjected to the 20 percent final withholding tax. The fund designed for the medium-term investor targeting capital growth by investing in blue chip stocks is referred to as the capital fund. Earnings of this fund are subjected to the final withholding taxes, not with fixed tax rates.

All these types of funds except the institutional fund require minimum initial investment of 1000 units with par value per unit of 100 pesos, minimum maintaining balance of 1000 units, minimum additional contribution and minimum partial withdrawal of 100 units. On the other hand, the institutional fund requires minimum initial investment of 100 units with par value per unit of 100, minimum maintaining balance of 100 units, and minimum additional contribution and minimum partial withdrawal of 10 units.

5-4. Rural Banks

The forerunner of rural banks was the Postal Savings Bank which was established in 1904. The said bank took an active part in mobilizing savings in the rural areas. All post offices in the Philippines were considered branches of this bank. The Postal Savings Bank was abolished in 1975 when rural banks in rural areas superseded the role of the Postal Savings bank.[10]

Rural Banks[11] are community type of banks designed to provide credit facilities to small farmers, fishermen, and merchants, including street and ambulant vendors. Rural Banks are organized upon the issuance of a certificate of authority to operate which allow them to: (a) grant loans and make investments; (b) accept savings and time deposits; (c) sell domestic drafts; (d) act as correspondent for other financial institutions; (e) receive in custody funds, documents, and valuable objects, and rent safety deposit boxes for the safeguarding of such effects; (f) act as financial agents and buy and sell upon the order of and or for the account of its customers, share evidences of indebtedness and all types of securities; and (g) make collections and payments for the account of others and perform such other services for its customers in line with the banking business.

Aside from the above-mentioned activities, a rural bank, upon approval of the Monetary Board, is allowed to perform any or all of the following services: (1) to open current or checking accounts or "NOW" accounts; (2) to act as trustee over estates or properties of farmers and merchants; (3) to act as official depository of municipal, city, or provincial funds in the municipality or city it is located; (4) to rediscount paper with the Philippine National Bank (PNB), the Development Bank of the Philippines (DBP), or other banks and their branches and agencies; and (5) to invest in allied undertakings.

The minimum capital requirement for a rural bank is the paid-in-capital of at least 500,000 pesos net of government capital contribution of which 300,000 pesos is to be paid-in at the start of operation and the balance within three years thereafter.

In recognition of the need for rehabilitation of rural banks, the Central Monetary Authority put forth a guideline to govern the implementation of the program to assist rural banks. This program is essentially a capital infusion and conversion plan of payment of all arrearages of rural banks with the old Central Bank (CB) which were post due and unpaid as of December 31, 1986.

The arrearages of a rural bank with the CB refer to the principal amount of all rediscounting obligations of the rural bank with the CB. The conversion refers to the conversion of arrearages on supervised credit papers into paid-in capital of the government in the form of shares of stocks of the rural bank, issued in the name of the Land Bank of the Philippines (LBP).

On fresh capital infusion, the Monetary Board provides two separate schemes. The rural banks with supervised credit arrearages are required to replenish new

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[10] M.B. Lamberte (1989), p.8, *op cit.*

[11] *The Manual of Regulations for Banks and other Financial Intermediaries*, Book III.

capital: a) in cash equal to at least ten percent of the total of the rural bank's supervised credit arrearages and accrued interest thereon; or b) an amount equal to the deficiency in capital of the bank required to achieve the ten percent minimum risk asset ratio, whichever is higher or: c) through contributions of stockholders which may include new and individual corporate stockholders or another banking institution. In case a rural bank has no supervised credit arrearages and is not deficient in capital, it may either increase its capital or pay the CB an amount equivalent to ten percent of the total of its arrearages and accrued interest, or 500,000 pesos, whichever is lower.

A rural bank may merge with one or more rural banks for purposes of meeting the paid-in capital requirement, increasing its resources, capital base, as well as effectiveness in the operations of the resulting bank. The merger or consolidation of two or more rural banks, or of one or more rural banks with a thrift bank or a commercial bank is encouraged by the Monetary Board.

The net worth of a rural bank is regulated to be not less than an amount equal to ten percent of its risky assets. The risky assets refer to the assets excluding the following: (a) cash on hand; (b) amount due from the CB which is the amount deposited with the CB; (c) loans to the extent covered by hold-out on or assignment of deposits maintained in the lending bank; (d) evidences of indebtedness fully guaranteed by the government; (e) bank premises; (f) balances maintained with the PNB; (g) the Agricultural Guarantee and Loan Fund (AGLF) portion of the CB:IBRD/ AGLF special financing program; (h) portion of special time deposit loans covered by the Industrial Guarantee and Loan Fund (IGLF) guarantee; (i) real estate mortgage loans insured by the Home Insurance and Guarantee Corporation; (j) loans secured by Central Bank Certificates of Indebtedness; (k) Masagana 99 loans covered by guarantee; (l) *Kilusang Kabuhayan at Kaunlaran* (KKK) loans; (m) deferred income tax expenses on provision for loss not currently deductible for income tax purposes.

On the liability side of a rural bank, an acceptance or creation of demand deposits is allowed, upon prior approval of the Monetary Board, for the bank with paid-in capital of at least 50 million pesos. A rural bank is allowed to accept NOW accounts as saving accounts from which funds may be withdrawn. Accepting NOW accounts requires the minimum paid-in capital of at least 5 million pesos. The privilege to maintain NOW accounts is limited to natural persons. These regulations imply that transactions carried out in the countryside are cleared in cash only.

Any rural bank may be considered as the depository of the accumulated savings in areas where the bank is located. All banks are eligible to participate in the *TIPID* movement[12] which solicits deposits of students within the premises of the school organizing the savings club. The *Samahang Nayon* (SN) funds consisting of barrio[13] savings fund and barrio guarantee fund are also lodged in rural banks.

[12] A savings club or thrift movement. *TIPID* is a tagalog word which means to save.
[13] A barrio is equivalent to a village in the Philippines.

Withdrawals from the Barrio Savings Funds are used for investing in the equity of the cooperative rural bank in the province where the depository rural bank is located or with the approval of the Department of Agriculture, for the projects of the *Kilusang Kabuhayan at Kaunlaran* (KKK).[14] Deposits of the barrio guarantee fund are treated like other deposits and allowed to be withdrawn in full with no restrictions, upon the approval of the Samahang Nayon Board of Directors and the authorized representative of the Department of Agriculture.

The Samahang Nayon is a pre-cooperative of farmers residing within the geographical limits of a village. A government project to promote the nationwide cooperative movement, the SN is a preparatory stage of the movement where the members learn the knowledge required to organize and maintain a full-fledged cooperative. On October 21, 1972, a month after the declaration of Martial Law, then President Marcos proclaimed the entire country under land reform. On April 14, 1973, the government issued Presidential Decree No. 175 to strengthen the co-operative movement. This decree was designed to use the cooperative programme in achieving the following objectives: to further emancipate the tenants from the bondage of traditional settling of the peasantry in the Philippines by providing them with a strong organization in the countryside; to attain a more equitable distribution of income; and to enhance the purchasing power of farmers. Under the cooperative movement, the following stages were set up as a nationwide scheme:

Stage 1: To organize pre-cooperatives to be known as Samahang Nayon (SN) in the villages.

Stage 2: To form full-fledged cooperatives referred to as the Kilusang Bayan (people's movement).

Stage 3: To organize consumer cooperative markets in key urban cities.

Stage 4: To integrate cooperatives into a whole system consisting of producers, marketing and banking cooperatives.

The Samahang Nayon includes a capital formation programme as one of its major functions. Members are required to participate in a forced-savings programme consisting of the barrio savings fund, the barrio guarantee fund, and the general fund. With the barrio savings fund, each member can acquire common stocks in existing rural banks and claim an equity fund as his own. Members have to place in advance five percent of each loan received from all institutional sources for the barrio savings fund. The barrio guarantee fund is a guarantee fund for land amortization payments pursuant to land transfer from landowner to tenant with a Certification of Land Transfer (CLT). Each member must contribute a cavan[15] of

[14] The *Kilusang Kabuhayan at Kaunlaran* is a government project to enhance farmers' livelihood in the countryside.

[15] A cavan is a volume measure equal to about 45 Kg of palay.

palay[16] per hectare each harvest to the barrio guarantee fund. Seventy percent of the fund is used to support the land amortization commitments of defaulting members, while thirty percent is reserved for insurance purposes.

Behind the beautiful veneer of the Samahang Nayon programme, many SNs were dissipated and became paper organizations only. The main reason for their failure is traced to the apathy of farmers toward the SN where it is located. Noel Vasques and Henedina Razon-Abad (1992)[17] point out the following:

> "Planning and framing of the programme policies were directed by a designated sector of the government bureaucracy. The programme itself did not allow for local initiative and participation. Efforts to participate were not appreciated. Farmers were cajoled and compelled to comply with the requirements of the programme. This process failed to take into consideration the feeling of distrust and suspicion of the peasantry towards the programmes which was a result of past failures and frustration they had experienced with the failed projects of the past and present administration."

5-5. Specialized Government Banks

The specialized government banks consist of the Development Bank of the Philippines (DBP), the Land Bank of the Philippines (LBP) and Al-Amanah Islamic Investment Bank of the Philippines (AAIIBP). These banks were formed primarily to provide credit facilities for specific projects in order to promote and expand agriculture and industry and accelerate socioeconomic growth and development.

The DBP is authorized under Executive Order No. 81 of the 1986 revised Charter of the DBP[18] to provide banking services principally to service the medium and long term needs of agricultural and industrial enterprises, particularly in the countryside and preferably for small and medium scale enterprises. The capital stock of the DBP is 5 billion pesos to be divided into 50 million common shares with par value of 100 pesos per share. The National Government subscribes to twenty-five million common shares of stock worth 2.5 billion pesos which is paid for by the government with net asset values of the DBP remaining after the transfer of assets and liabilities.

During the period of liquidity crises triggered by the Dewey Dee caper in 1981, the banking problems became systemic compared to the 1970s when banking problems were rather sporadic. The government was compelled to launch a rescue

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[16] Palay is paddy or unhusked rice.

[17] See the case study of Noel Vasques and Henedina Razon-Abad for a more comprehensive discussion on the Samahang Nayon programme in Barrio Santa Ines, Santa Monica area.

[18] Development Bank of the Philippines, *Annual Report for 1992*, p. 12, and the *1986 Revised Charter of the DBP*.

operation to stem financial disintermediation and prevent several large corporations from collapse. The DBP and the PNB, by virtue of being government financial institutions, had to bear the brunt of this rescue operation. The total assets of the DBP which grew from 27 billion pesos in 1980 to 72 billion pesos in 1985, plunged dramatically to 9.5 billion in 1986. DBP's losses piled up to 17.9 billion from 1984 to 1986. DBP underwent a rehabilitation program which involved the transfer of its non-performing assets amounting to 61.4 billion pesos and certain liabilities and related accounts amounting to 62.2 billion pesos to the national government. The main sources of its lending funds were contributed by the national government in the form of time and savings deposits of the government and the Social Security System (SSS) which is a government-owned institution. Thus, section 30 in the 1986 revised DBP charter states thus:

> The Bank (DBP) shall transter to the National Government some of its assets and liabilities as may be necessary to rehabilitate the bank and to start its operation under the Revised Charter on a viable basis, as determined by the appropriate authorities, such assets to include but need not be limited to its acquired assets and non-performing accounts and such liabilities to include real as well as contingent liabilities. The National Government is hereby authorized to accept the same under terms and conditions as may be mutually acceptable to the Bank and the national government.

The rehabilitation of the DBP has been successful to date. In 1992, DBP was included among the world's top ten banks by the internationally acclaimed business magazine, *The Banker,* in its July 1992 issue. DBP is the only Filipino bank to be included in the world's top ten banks in terms of soundness and performance with a capital asset ratio of 26.8 percent and profits on assets ratio of 5.6 percent, respectively.[19]

The Land Bank of the Philippines (LBP)[20] was created in 1963, through the Agricultural Land Reform Code, known as Republic Act No. 3844, to facilitate the implementation of the government's agrarian reform program. The legal existence of the LBP is for a period of fifty years from the date of approval as amended by Presidential Decree No. 251 dated July 21, 1973. The initial services provided by the LBP were limited to purchasing private lands for distribution to small farmers. In 29 years, since its creation, the LBP has expanded its operations that include a full range of commercial banking services from deposit acceptance and lending to trust management, money market participation, international transactions, and an extensive system of countryside banking. In 1973, the LBP was transformed into the first universal bank in the country for it was able to generate enough funds to sustain a land reform program with particular focus on rice and corn lands. In 1988, the Aquino administration embarked on the Comprehensive Agrarian Reform Program (CARP) as provided for in Republic Act No. 6557. The CARP covered all agricultural

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[19] Development Bank of the Philippines, *Annual Report 1992,* p.12; and the 1986 Revised DBP Charter.
[20] The Land Bank of the Philippines' Charter and *Annual Report 1992.*

lands, both private and public, regardless of tenurial arrangement and commodity produced. The cooperative movement was also given priority to ensure a collective support for CARP's beneficiaries. With these developments, the LBP expanded its services to include the following:

a. Financial assistance to small farmers and fishermen are extended mainly through 6,345 farmers/fishermen cooperatives and federations. A majority of its lending was released through rural financial institutions.

b. The 5:25:70 Countryside Partnership Scheme launched on October 2, 1992 is the improved version of the 5:15:80 Fixed Asset Financing Program for the acquisition of post-harvest facilities by the cooperatives. The program extended credit to cooperatives of farmers and fishermen for the acquisition of pre- and post- harvest faclities such as tractors, irrigation pumps, power rollers, hauling trucks, fishing vessels/gears and other fixed assets. The LBP tapped government agencies and private insititutions to act as its partners in the implementation of the 5:25:70 Countryside Partnership Scheme. Under the program, the LBP finances 70 percent of the project cost under its regular lending program for the fixed assets. The LBP's partners (program sponsor) put up a counterpart 25 percent by depositing a fund in the form of a trust to the LBP which will finance the fixed assets required by the cooperatives. This portion of the loan is interest-free. The remaining 5 percent is shouldered by the cooperatives as their equity. It could be in cash or in kind. As of December 1992, a total of 43 program sponsors, including 37 congressmen, four senators, and two government agencies have pledged a total commitment of 159 million pesos. The program is carried out as the ongoing livelihood project for farmers and fishermen.

Other ongoing livelihood projects include:

(i) a cattle financing program to stimulate the growth of the cattle industry while providing additional source of income to the farmers, and

(ii) marketing assistance to establish 41 additional market links by the LBP with manufacturing firms in order to extend technical and management assistance and to provide financial assistance to fishermen for the development of alternative livelihood projects that boost aquaculture production for domestic consumption. The fisheries sector program is provided by the LBP together with the Agricultural Credit Policy Council (ACPC) of the Department of Agriculture.

To help strengthen bank-assisted cooperatives, the LBP provides institution-building assistance with local trainor teams organized nationwide by the LBP. The LBP also set up the programs of rural financial institutions which include rural bank rediscounting program, liquidity pool program, and countryside financial enhancement program. However, active members in the countryside financial institutions are still very limited in number.

On land transfer operations, the LBP conducted ocular inspection of about 243,752 hectares in 1992. The LBP pays the cost of land approved to be transferred for agricultural production purposes.

The LBP extends assistance to landowners to engage in bond trading through the LBP's Bond Trading Board. Twenty-five year bonds are allowed to be converted to 10-year bond to improve their marketability and to enhance their acceptability as payment for various expenditures or even as investment instruments. The LBP has tie-ups with certain government and private institutions to accept the bonds as an alternative payment scheme. These are the Bureau of Internal Revenue for tax payments, state universities and colleges for the payment of tuition fees, government hospitals for the payment of hospital bills, and so forth.

The Islamic Bank Charter, Republic Act No. 6848, was passed by the Senate and the House of Representatives in 1989 and was approved by then president Corazon C. Aquino on January 26, 1990. The bank is known as the Al-Amanah Islamic Investment Bank of the Philippines (AAIIB). The primary purpose of the Islamic Bank is to promote and uplift the socioeconomic development of the Autonomous Region of Muslim Mindanao. The banking, financing and investment operations are subject to the basic principles and rulings of Islamic Shari'a. Operationally, the Islamic Bank is presently undergoing a transition period. It is in the process of establishing institutional infrastructures that will ensure the change from interest-based to profit-sharing operations. To offer advice and undertake reviews pertaining to the application of the principles and rulings of the Islamic Shari'a to the Islamic Bank's transaction, the Shari'a Advisory Council has been formed. It is composed of five members selected from among Islamic scholars and jurists of comparative law.

The banking services to be performed by the AAIIB are the following:

A. Open current and checking accounts;

B. Open savings account for safekeeping or custody with no participation in profits and losses;

C. Accept investment account placements and invest the same for a term with the Islamic Bank's Funds in transactions conforming to Islamic laws;

D. Other banking services based on Islamic principles and rulings.

Non-interest bearing placements are made under any of the placements of (a) savings accounts, (b) investment participation accounts and (c) current accounts and other deposit liabilities. Any deposit received by the bank without authorization to invest is treated as current account and savings account. All deposits received with authorization to invest form part of the general pool of placements allocated for the investment portfolios of the bank. The depositors or investors in joint investment participation accounts are entitled to a portion of the return on investment according to the deposit balances.

The Islamic Bank has an authorized capital of 1.0 billion pesos, 51 percent of which is made available for subscription by the national government, and 49 percent by Filipino and foreign individuals, institutions, or entities. The first Islamic Bank branch was launched in Cotabato City on February 11, 1991. The bank is still in its formative stage. The first five years of its existence are considered to be difficult and complex as the bank is currently establishing institutional infrastructure and developing its market.

6. SUMMARY AND CONCLUSION

The eighties was the "lost decade" for the whole Philippine economy. Literally, the country's banking system lost the people's confidence and many banking offices were either closed or merged with other financial institutions by the Central Bank of the Philippines. The financial liberalization program was launched amidst the socioeconomic turmoil in the early 1980s.

The financial depression in the country was triggered by bank runs in 1983 and 1984, which left lingering detrimental after-effects on the system until 1991. Several economists in the Philippines insist that the cause of this financial depression was due to bankers' involvement in bank abuses and commitment of moral hazards. Interlocking directorships and availment of DOSRI loans provided a fertile ground for banking anomalies.

With the lifting of financial repression through the deregulation of interest rate ceilings on short- and long-term lendings and savings under the financial liberalization scheme in 1981 onward, some economists have suggested that the institution of interlocking directorship in the Philippines could result to an oligopolistic collusion which in turn could bring about an artificial high interest rate regime in the banking system. It was shown based on the simple model with or without complete information that the high interest rate regime could undermine the country's financial base because the banks' assets might be dominated with high risk return portfolios. This may be brought about by the high interest rate regime caused by bankers' exposure to moral hazard at the expense of deposit insurance institutions and depositors, and their availing of the DOSRI loans which has become a hotbed of bank abuses.

Another factor weakening the country's financial base is a mismatch in term transformation between the lendings and borrowings of the banks. When the Central Bank gave in to the IMF/World bank recommendation to encourage the Philippine banking sector to provide medium and long term lending to industry and agriculture, many banks which heeded the CB's call suffered liquidity problems which was a result of money interest risk associated with the mismatch in term transformation.

Financial liberalization must be prudently implemented so that the country's financial system would not be undermined and weakened by the deregulation of interest rate ceiling. However, it is worthy to keep in mind that the market mechanism does not necessarily lead the market towards a competitive arena. This is the lesson that we have learned from the Philippine experience. Minimizing bankers' exposure to moral hazards entails bringing down the market rate of money interest which is made possible through achieving a keen competition among banks. Free entry of new banks and their branch offices would be a potent measure in this regard.

The importance of alleviating a mismatch in term transformation between the lendings and borrowings of banks suggests the following:

(1) People's confidence in the banking system must be maintained to encourage people's preference of medium- and long-term time deposits and keep them from shifting to short-term savings deposits – an experience from which the Philippine banking system suffered tremendously in the "lost decade."

(2) In the meantime, until the banking system will become sturdy enough to withstand any money interest risk arising from mismatch in term transformation, private banks should be judiciously advised to minimize the mismatch in their lending practices. However, the medium- and long-term facilities to furnish the financial needs for development of industry and agriculture are often considered to be key elements in sustaining the country's economic growth. In facilitating these needs, the specialized government banks should be fully utilized to play the key role.

It has became fashionable of late to put blind faith in the market mechanism such that government intervention bears the brunt of blames for distortions in the allocative efficiency of the resources in the country.

If a bank's role in the economy is analogous to that of the heart in the human body, a bank run can therefore be compared to a heart attack. As in the latter case where the heart ceases from effectively distributing blood in the human body, in a bank run, the bank malfunctions and ceases from doing its role of effectively distributing money and credit and rendering their services for day-to-day transactions in the economic system. Hence, the stability and robustness of the banking system should take precedence over any other banking and monetary issue. Often, a blind faith in the market mechanism leads even professional economists to play down or overlook this point. Needless to say, the regulations and government interventions are needed to see to it that the impaired markets will be supported accordingly, especially in most developing countries where impaired and incomplete markets pervade, as in the Philippines.

The institutional reforms that the Bangko Sentral ng Pilipinas (BSP) seeks to implement at present were put in place in line with the above considerations.

Reflecting on the lessons from the past experience with a view to solving the past problems suffered by the country's banking system, the BSP was divested of all fiscal agency functions. The functions of the old CB are mandated to be transferred to the Department of Finance within a period of three years beginning 1993, but in no case longer than five years. The BSP's role is restricted to that of an independent and accountable corporate body in the discharge of its responsibilities concerning money, banking and credit to maintain price and monetary stability and the convertibility of the peso.

The BSP sets the regulations on minimum paid-in capital and debt-equity ratio of the banks. The DOSRI loans and interlocking directorships are also regulated by the banking laws. However, the assessment of these new reforms was not attempted here but was instead postponed to a more appropriate time in the future.

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