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Bank Concentration and the Structure  
of Interest

by

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## A b s t r a c t

The Philippine financial system has failed to develop over the last three decades. M<sup>3</sup>/GNP ratio has not risen but has merely fluctuated around 22-25 percent. Wrong policies are blamed for the poor performance of the system. The current interest rate structure shows extremely wide differentials between saving and time deposit rates and between saving deposit and loan rates. The paper tries to explain these by the policies adopted by the Central Bank, especially those restricting bank entry and imposing high intermediation taxes. The paper analyzes how the policies effectively repress intermediation activities and result in high profits and intermediation cost. The effects of the current policies are compared to the effects of the more traditional forms of repression followed earlier, i.e., 1960 to 1980.

The gleaming high-rise bank offices in Metro Manila staffed with sleekly-dressed executives and clerks belie the poor performance of the financial system in its primal role of mobilizing saving. The level of intermediation relative to the output of the economy has remained low, while the cost of intermediation continued to be high.  $M_3/GNP$  ratio has stagnated at just above 20 percent in the last three decades. Access to financial services is highly unequal, as their location is concentrated in Manila and other big cities. The financial system has a weak structural base. It consists of too many weak small banks, an underdeveloped securities market and a few strong, big banks. The latter have assumed an increasingly dominant position that permits them to exercise monopoly power. Many small banks, including the majority of rural banks and a few commercial banks, are in arrears with the Central Bank (CB) and/or have acquired very bad loan portfolios. [The CB policy of restricted entry and exit has sheltered both the big and the small banks from competition, allowing the former to earn abnormal profits and the latter to operate at high cost]

The poor performance of the financial system could be explained by bad policy. From the founding of the CB in 1948 up to 1980, [a regime of repressed interest rates and extensive intervention in credit supply has prevailed.] This was followed by a regime of intermediation taxes and restricted bank entry.

The paper briefly reviews the intermediation performance of the banking system. It describes the major features of the past and the present policy regimes and explains how they tended to slow down financial development. We focus on banks, since they comprise the bulk of the financial sector, and we give special attention to the sector's increasing degree of concentration. The following sections cover successively: a) financial development in the Asian context; b) a brief discussion of the policy regimes; c) the structure of the banking industry and measures of its concentration; d) analysis of the likely behavior of the large banks with regard to interest rates and intermediation margin and <sup>✓</sup>d) the effect of the various taxes on these variables.

## 2. Financial Development in the Asian Context

Financial market development in the Philippines lagged behind its neighbors. Table 1, Panel A shows the trend of  $M_3$ /GNP ratio over 1970 to 1987 period in East Asia ( $M_3$  consists of core deposits = demand + saving + time deposits). This ratio indicates the rate of savings mobilization. All the countries reported here excepting the Philippines experienced a continuous upward trend. Indonesia started late as its ratio in 1970 was only 8 percent. This has since risen to 21 percent. Thailand started at 23 percent and now has a 62 percent  $M_3$ /GNP ratio. The Philippines had an initial ratio of 20 percent. The ratio merely fluctuated at around 25 percent during the 1970-83 period, rising to a high of 31 percent in 1983 following the interest rate

TABLE 1

## M / GNP IN SELECTED ASIAN COUNTRIES

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| Country                                                   | 1976 | 1975 | 1974 | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 | 1987 | 1988 |
|-----------------------------------------------------------|------|------|------|------|------|------|------|------|------|------|------|
| Panel A, M <sub>3</sub> = Demand + saving + time deposits |      |      |      |      |      |      |      |      |      |      |      |
| Indonesia                                                 | 0.08 | 0.10 | 0.10 | 0.11 | 0.12 | 0.13 | 0.13 | 0.16 | 0.19 | 0.21 | n.a. |
| Malaysia                                                  | n.a. | 0.37 | 0.45 | 0.51 | 0.55 | 0.57 | 0.57 | 0.64 | 0.74 | 0.86 | n.a. |
| Philippines                                               | 0.20 | 0.18 | 0.28 | 0.26 | 0.28 | 0.31 | 0.26 | 0.24 | 0.22 | 0.22 | 0.23 |
| Singapore                                                 | 0.54 | 0.56 | 0.66 | 0.71 | 0.73 | 0.72 | 0.68 | 0.72 | 0.77 | 0.83 | 0.85 |
| Thailand                                                  | 0.23 | 0.29 | 0.32 | 0.34 | 0.39 | 0.43 | 0.52 | 0.54 | 0.59 | 0.62 | 0.62 |
| Korea, Rep. of                                            | 0.29 | 0.26 | 0.19 | 0.30 | 0.34 | 0.34 | 0.33 | 0.43 | 0.38 | 0.47 | 0.50 |
| Taiwan                                                    | n.a. | 0.31 | 0.19 | 0.32 | 0.36 | 0.39 | 0.42 | 0.49 | 0.54 | 0.59 | 0.66 |
| Panel B, M <sub>3</sub> = M <sub>1</sub> + quasi-money    |      |      |      |      |      |      |      |      |      |      |      |
| Indonesia                                                 | 0.15 | 0.18 | 0.19 | 0.19 | 0.21 | 0.23 | 0.26 | 0.30 | 0.31 | -    | -    |
| Malaysia                                                  | 0.46 | 0.54 | 0.58 | 0.63 | 0.63 | 0.62 | 0.67 | 0.81 | 0.75 | -    | -    |
| Philippines                                               | 0.17 | 0.21 | 0.22 | 0.24 | 0.25 | 0.21 | 0.21 | 0.22 | 0.22 | 0.23 | 0.23 |
| Singapore                                                 | 0.60 | 0.66 | 0.70 | 0.72 | 0.70 | 0.66 | 0.70 | 0.78 | 0.85 | 0.84 | 0.84 |
| Thailand                                                  | 0.34 | 0.39 | 0.39 | 0.45 | 0.50 | 0.56 | 0.60 | 0.63 | 0.67 | 0.66 | 0.66 |
| Korea, Rep. of                                            | 0.31 | 0.34 | 0.35 | 0.39 | 0.39 | 0.37 | 0.39 | 0.40 | 0.41 | 0.43 | 0.43 |
| Taiwan                                                    | 0.56 | 0.64 | 0.64 | 0.75 | 0.86 | 0.92 | 1.08 | 1.17 | 1.32 | 1.44 | 1.44 |

Source: Key Indicators of Developing Member Countries of ADB Vol. XVII-July 1987; Vol. XIV-April 1985; Vol. XV-III-July 1988, Vol. XVI, July 1989.

TABLE 2

SELECTED CREDIT AVAILABILITY RATIOS OF COMMERCIAL BANKS  
1970-1988

|                                                                        | 1970   | 1975   | 1980    | 1981    | 1982    | 1983    | 1984    | 1985    | 1986    | 1987    |
|------------------------------------------------------------------------|--------|--------|---------|---------|---------|---------|---------|---------|---------|---------|
| Total assets                                                           | 14,066 | 53,172 | 138,417 | 164,614 | 190,977 | 247,928 | 289,150 | 283,347 | 248,526 | 274,499 |
| Bank loans outstanding                                                 | 8,433  | 40,173 | 77,198  | 86,505  | 98,239  | 111,387 | 116,382 | 87,513  | 83,087  | 96,936  |
| Investment in bonds and securities                                     | 1,762  | 6,180  | 13,453  | 16,205  | 20,225  | 21,443  | 29,678  | 27,253  | 30,587  | 29,312  |
| Other assets                                                           | 582    | 3,746  | 10,575  | 15,557  | 19,400  | 31,849  | 45,930  | 39,862  | 42,164  | 39,059  |
| Change in bank loans<br>Gross investments                              | 0.662  | 3.085  | 0.106   | 0.087   | 0.110   | 0.120   | 0.060   | -0.356  | -0.054  | -       |
| Investments<br>Total assets                                            | 0.110  | 0.116  | 0.097   | 0.098   | 0.106   | 0.086   | 0.103   | 0.098   | 0.123   | 0.107   |
| Other assets<br>Total assets                                           | 0.041  | 0.070  | 0.076   | 0.093   | 0.103   | 0.128   | 0.159   | 0.141   | 0.170   | 0.142   |
| Bank loans<br>Total assets                                             | 0.600  | 0.756  | 0.558   | 0.526   | 0.514   | 0.449   | 0.402   | 0.309   | 0.334   | 0.353   |
| Loans to private<br>Total assets                                       | 0.549  | 0.745  | 0.513   | 0.485   | 0.483   | 0.423   | 0.368   | 0.269   | 0.305   | 0.335   |
| Loans to individuals<br>Loans to private                               | 0.379  | 0.184  | 0.210   | 0.223   | 0.214   | 0.217   | 0.244   | 0.231   | 0.230   | 0.283   |
| Monetary credit in 1970 prices<br>(GDP Deflator)<br>(in Billion Pesos) | -      | 47.8   | 71.0    | 76.3    | 81.3    | 91.2    | 59.1    | 44.9    | 39.2    | 40.9    |

Source: CB Philippine Financial Statistics and unpublished CB statistics for 1988.  
ADB Key Indicators of Developing Member Countries, 1989 for outstanding credit and GDP deflator.

liberalization in 1981. It declined to 22 percent during the subsequent recession. In Panel B we have  $M_3'/GNP$  available from 1973 onward.  $M_3' = M_1 +$  quasi money. The trends are similar.

For the Philippines, other statistics show an even worse picture than the  $M_3/GNP$  trend. The real supply of credit to the economy or outstanding credit declined very drastically from ₱ 91.2 billion to ₱ 46.1 billion in 1983 to 1987. Investment financed by loans as roughly indicated by the ratio of change in outstanding loans to gross investment was 0.106 in 1980; it gradually declined to negative levels in 1985 and 1986. The ratio has since risen but remains low at 0.177 in 1988. Of the loans granted, a decreasing proportion was going to the private sector, 0.549 in 1980 and 0.348 in 1988. Government corporations, government securities and foreign assets absorbed the remaining balance. Credit going to agriculture (in spite of the Agri-Agra portfolio requirement<sup>1</sup>) was only 9.3 percent in 1981 and declined to 7.8 percent in 1988. The level of real loans and deposits fell by 51.7 and 23.4 percent, respectively in 1980-87.

### 3. Policy Regimes and Intermediation

In the first monetary policy regime lasting from 1950 to 1980, the CB intervened extensively and directly in financial intermediation. It set deposit and loan rate ceilings at

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Banks are required to allocate 25 percent of the loans to agriculture and agrarian reform beneficiaries but are allowed to buy government securities instead.

generally below market levels. The real rates frequently turned negative especially from mid-1960 onwards when inflation rates reached double digit levels. Bank entry was encouraged with the CB making equity contributions to new rural banks (RB) and private development banks (PDB). Generous rediscounting facilities at extremely low discount rates were made available to all banks. CB credit became a regular source of loanable funds for all banks especially RBs. A complex scheme of rediscounting was adopted where discount volumes and discount rates were set for many types of activities and borrowers such as for rice production and small scale industrial loans. In 1970, the CB assisted the larger banks, specially a number of commercial banks and the Development Bank of the Philippines, in obtaining foreign loans on terms that generally ignored foreign exchange risks. Large amounts of subsidized credit were therefore being made available to the different types of banks. All these measures worked against the growth of intermediation activities and the stability of the financial system. Deposits were crowded out by the rediscounting facility and foreign loans and repressed by the deposit rate ceilings. The loan ceiling predictably led to excess demand for loans. For some banks, especially the state banks, credit rationing became a rent-seeking activity, in turn creating inefficient loan portfolios. Direct demands for loan accommodation from the President's Office<sup>2</sup> further weakened the

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<sup>2</sup> These loans were classified as "behest loans" by the last Marcos regime's DBP chairman in order to identify who was responsible for them.

quality of bank portfolios in these banks. The larger banks who obtained foreign loans suffered substantial losses from the drastic devaluations in the 1983-85. The rediscounting facilities entrapped the more myopic banks in cheap CB credit. Consequently they neglected to develop a solid deposit base. The facility, moreover, allowed imprudent loan decisions for after all the cost of loanable funds were perceived to be low. One may reasonably conclude that the wrong policies and abuse of power caused the financial crises of the first half of the 80s. A large segment of the financial system failed--the two state banks, PNB and DBP, which happened to be the largest intermediaries in the system; the three largest investment houses--PDCP, Bancom and PISO; majority of the rural banks numbering 1,030 in 1980, 6 commercial banks and the largest savings bank, Banco Filipino.

## 5. The New Regime

The worldwide criticisms of interest rate repressions and the bad experience of the first regime led to a reversal of policy at the turn of this decade. Interest rates were liberalized in 1981 and the rediscounting privileges were subsequently reduced. Excepting for agriculture, export and small-scale enterprises which continue to receive special privileges, the rediscount rates are now set in relation to the cost of competing sources of loanable funds, i.e. the Manila

reference rate (MRR).<sup>3</sup> Foreign currency deposits with minimal restrictions have been allowed as part of the liberalization movement. These reforms were, however, countered by new forms of financial repressions. CB imposes implicit barriers to entry and exit of banks and changes two types of taxes on intermediation--a 5 percent gross receipt tax on banks (GRT) and a 20 percent final tax on deposit earnings. Required reserves have been raised to all time high of 20 percent or more. The reserve ratio in the earlier regime was generally below 15 percent. The bank taxes were imposed as a revenue measure to reduce budget deficit, the reserve ratio for controlling money supply. They were handy measures for meeting IMF fiscal deficit and monetary targets dictated in the series of debt restructuring from 1978 onwards.

The interest rate liberalization did not have the expected results, as shown in the trend of the  $M_3$ /GNP and loans/investment ratios. It was being countermanded by other measures. The two taxes and the high reserve requirement raise the intermediation margin, lower the net yield on deposits and raise the loan rate, therefore discouraging bank deposits and bank loans. Moreover, the liberalization move was badly timed. It coincided with the onset of recession in 1980-81 and the political uncertainty that followed the Aquino assassination. Gyrating inflation and interest rates and the massive bank failures increased uncertainty that likely led to further outflow

of funds from the system. The liberalized capital market facilitated capital flight estimated by Boyce (1989) to amount to reach US\$8 to US\$13 billion between 1980 and 1986. Table 1 shows that the M/GNP fell from 31 percent to 26 percent in 1983 to 1984 and continued falling till 1985. In real terms, deposits declined by 28 percent in 1983-1984, and 10 percent in the following year. Loans fell even faster, 31 percent and 29 percent in the same period.

The series of bank failures changed the structure of the financial system. The relative importance of the two state banks (PNB and DBP) which dominated the system in the 60s and 70s was slashed down.<sup>4</sup> Their nonperforming assets were transferred to the Asset Privatization Trust. Otherwise they would have been weighed down by the high cost of servicing their liabilities. Within the private sector, a total of 173 banks were closed between 1981 and 1988, including 138 RBs, 28 thrift banks, 3 KBs and 4 private development banks. Of the 846 remaining RBs in 1988, 522 applied for rehabilitation, meaning that at least this number were in difficulty [Lamberte, 1989]. Deposit clients moved away from the weak, insolvent banks to the relatively strong ones. Table 3 shows that between 1982 and 1988, Far East Bank grew in nominal terms at 349 percent, PCIB 226 percent, Metro bank 204 percent, BPI 188 percent and UCPB 149 percent.

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<sup>4</sup> The value of the assets of DBP was slashed down from ₱ 72.0 billion in 1985 to ₱ 9.5 billion in 1986 or to 13.2 percent, that of PNB from ₱ 76.2 billion to ₱ 26.9 billion or to 35.3 percent, same years.

With few exceptions, the other banks virtually stagnated considering the inflation rate of 137 percent between 1982 and 1988. (See the change in the ranking of banks by size.) FEBTC rose from No. 6 to No. 1. Consequently, the industry became highly concentrated with five private commercial banks effectively dominating the industry. The financial system that resulted from all these events may be characterized in the following: a) it is a reduced system in terms of total assets; b) it consists of many small, weak and still inoperative rural banks and private development banks, much reduced state banks, a number of relatively small troubled commercial banks and a dominant set of five large universal and commercial banks.

There is no explicit policy about restricted bank entry. The policy is expressed as a concern by the CB Governor about 'proliferation' of banks and the danger of entrusting banking responsibilities to new bankers. In practice no new bank has been established since 1980. Instead mergers and investment in existing banks, including those in difficulty, are encouraged. Branching is also restricted to areas that are not "overbanked".

#### 6. Bank Structure and Measures of Concentration

Table 3 depicts the present structure of the financial system. Here, we see the relative importance of the commercial banks (KBs). In 1988, KBs share in total assets amounts to 63.1 percent, RBs share 2.1 percent and the other thrift banks (PDBs and savings banks) 12.7 percent as compared to 55.9 percent, 2.3 percent and 21.6 percent respectively in 1980. The RBs have an

TABLE 3

FINANCIAL SYSTEM ACCORDING TO ASSET SHARE  
1980, 1983, 1985-1988

| Banks Grouping                  | Millions of Pesos |         |         |         |         |         |
|---------------------------------|-------------------|---------|---------|---------|---------|---------|
|                                 | 1980              | 1983    | 1985    | 1986    | 1987    | 1988    |
| 1. Commercial banks             | 138,417           | 247,928 | 283,347 | 248,542 | 274,499 | 328,848 |
| 2. Thrift and savings bank      | 17,910            | 23,548  | 21,929  | 25,777  | 30,092  | 39,098  |
| 3. Rural banks                  | 5,642             | 9,500   | 8,022   | 9,351   | 9,960   | 11,019  |
| 4. Private development banks    | 1,621             | 4,613   | 5,084   | 5,425   | 5,473   | 6,699   |
| 5. Specialized government banks | 34,107            | 65,524  | 87,989  | 26,556  | 26,288  | 27,247  |
| 6. Nonbanks                     | 60,520            | 96,170  | 110,405 | 116,902 | 124,929 | 135,158 |
| Total                           | 247,770           | 430,934 | 502,499 | 417,099 | 451,685 | 523,135 |
| Banks Grouping                  | Percentage Share  |         |         |         |         |         |
|                                 | 1980              | 1983    | 1985    | 1986    | 1987    | 1988    |
| 1. Commercial banks             | 55.9              | 59.3    | 56.7    | 59.7    | 60.8    | 63.1    |
| 2. Thrift and savings bank      | 7.2               | 5.6     | 4.4     | 6.2     | 6.7     | 7.5     |
| 3. Rural banks                  | 2.3               | 2.3     | 1.7     | 2.2     | 2.2     | 2.1     |
| 4. Private development banks    | 0.6               | 1.1     | 1.0     | 1.4     | 1.2     | 1.3     |
| 5. Specialized government banks | 15.6              | 15.7    | 17.6    | 6.9     | 5.8     | 5.2     |
| 6. Nonbanks                     | 24.4              | 23.1    | 22.0    | 28.0    | 27.7    | 26.0    |
| Total                           | 100.0             | 100.0   | 100.0   | 100.0   | 100.0   | 100.0   |

Source: DBR-Domestic. Central Bank, from Lamberte, 1989, Table III 10.

TABLE 4

## MARKET SHARE AND MEASURES OF CONCENTRATION

| Rank  |      | Firm Name                      | Total Assets<br>(TA) |         | Market Share<br>(in terms of<br>(TA)) |        | Growth Rate<br>of TA<br>1982 - 88% | Remarks                 |
|-------|------|--------------------------------|----------------------|---------|---------------------------------------|--------|------------------------------------|-------------------------|
| 82    | 1988 |                                | 1982                 | 1988    | 1982                                  | 1988   |                                    |                         |
| 1     | 2    | Bank of the Philippine Islands | 9,119.6              | 26,282  | 0.0773                                | 0.1232 | 188.0                              |                         |
| 2     | 3    | Metro Bank                     | 8,453.1              | 25,729  | 0.0717                                | 0.1206 | 204.4                              |                         |
| 3     | 6    | Allied Bank                    | 8,012.8              | 9,470   | 0.0679                                | 0.0444 | 18.1                               |                         |
| 4     |      | Republic*                      | 6,576.3              | 7,879   | 0.0558                                | 0.0369 | 19.8                               |                         |
| 5     | 5    | UCPB                           | 6,493.9              | 16,173  | 0.0551                                | 0.0758 | 149.0                              |                         |
| 6     | 1    | Far East Bank and Trust Co.    | 6,260.4              | 28,093  | 0.0531                                | 0.1317 | 348.8                              |                         |
| 7     | 4    | PCIB                           | 6,012.6              | 19,676  | 0.0511                                | 0.0922 | 226.1                              |                         |
| 8     | 12   | Interbank                      | 5,309.2              | 7,274   | 0.0450                                | 0.0341 | 37.1                               | Investment from ANEL    |
| 9     |      | Manilabank                     | 5,286.9              |         | 0.0448                                |        |                                    | Closed                  |
| 10    | 17   | Traders*                       | 4,934.9              | 3,851   | 0.0418                                | 0.0181 | -22.0                              |                         |
| 11    |      | Family Bank                    | 4,600.8              |         | 0.0390                                |        |                                    | Merged with BPI         |
| 12    | 11   | RCBC                           | 4,448.2              | 7,604   | 0.0377                                | 0.0356 | 71.0                               |                         |
| 13    | 13   | China Bank                     | 4,131.4              | 6,015   | 0.0350                                | 0.0282 | 45.6                               |                         |
| 14    | 15   | Security Bank                  | 3,912.6              | 4,666   | 0.0332                                | 0.0219 | 19.3                               |                         |
| 15    | 12   | IBAA                           | 3,636.5              |         | 0.0308                                |        |                                    | Bought by PCIB          |
| 16    |      | Pacific                        | 3,619.0              |         | 0.0307                                |        |                                    | Closed                  |
| 17    | 7    | Solidbank                      | 3,267.8              | 8,837   | 0.0277                                | 0.0414 | 170.4                              | Investment from Nova S  |
| 18    | 14   | PBCom                          | 3,049.8              | 5,010   | 0.0259                                | 0.0235 | 64.3                               |                         |
| 19    | 8    | Equitable                      | 2,908.0              | 8,190   | 0.0247                                | 0.0384 | 181.6                              |                         |
| 20    |      | Prudential                     | 2,894.2              |         | 0.0245                                |        |                                    |                         |
| 21    | 18   | Philbanking                    | 2,620.4              | 3,699   | 0.0223                                | 0.0173 | 40.7                               |                         |
| 22    | 19   | Union Bank                     | 2,575.1              | 3,690   | 0.0218                                | 0.0173 | 43.3                               |                         |
| 23    | 20   | Producers*                     | 2,474.2              | 3,121   | 0.0210                                | 0.0146 | 26.2                               |                         |
| 24    | 21   | Associated*                    | 2,191.3              | 2,518   | 0.0186                                | 0.0118 | 14.9                               |                         |
| 25    | 9    | City Trust                     | 2,118.8              | 8,098   | 0.0180                                | 0.0379 | 182.2                              |                         |
| 26    | 16   | Philtrust                      | 1,283.1              | 3,938   | 0.0109                                | 0.0185 | 206.9                              |                         |
| 27    | 23   | Pilipinas                      | 1,145.3              | 1,425   | 0.0097                                | 0.0067 | 24.4                               | Investment from Bank of |
| 28    | 22   | ComBank now Boston Bank        | 587.3                | 2,150   | 0.0050                                | 0.0101 | 266.3                              | Investment from Boston  |
| Total |      |                                | 117,954.5            | 213,386 |                                       |        |                                    |                         |

Herfindahl Index (HI)\* 0.0452 0.0741

Comprehensive Concentration Index (CCI)\*\*\* 0.1157 0.2470

\*Government-acquired or in difficulty, now in process of privatization or rehabilitation.

\*HI is calculated by squaring and summing the share of industry size accounted for by every firm in the industry.

\*\*HI is calculated by multiplying each firm's share of industry size by the firm's rank, with firms ranked in descending order of size.

\*\*\*CCI is calculated by adding the market share of the largest firm in the industry to a summary index covering the remaining firms in the industry.

Source: SGV - A Study of Commercial Banks in the Philippines, 1982, unpublished CB statistics, 1989.

average asset size of ₱10 million, savings banks ₱ 36 million, PDBs ₱ 130 million and the KBs ₱6,960 million. The commercial banks, in turn, are dominated by five private KBs whose combined assets comprised 54 percent of the private commercial banking system in 1988. The Far East Bank and Trust Co., the largest private KB, has assets exceeding the total for all rural and savings banks combined--₱28 billion versus ₱17 billion.

In 1982, the five largest private KBs had a share of 32.8 percent of the total domestic private KB assets. In 1988, their share rose to 54.4 percent. Mergers and closure reduced the number of banks from 28 to 23 from 1982 to 1988.

Two alternative measures of concentration for the private domestic banking sector were calculated, the Herfindahl or H index and the Comprehensive Concentration Index or CCI index. (Please see table for the formula.) The H index rose from .045 to .074 in 1982 to 1988. This may be read in terms of the equivalent number of equally-sized banks (firms) to comprise an industry. An H index of .045 means 22.2 banks and an H index of .074 means 13.5 banks comprising the industry. The index rose by 64 percent in six years, a rather fast rate of concentration.

The CCI index directly gives the share of the largest bank (firm) plus some weighted average H-index for the rest of the banks. In 1982, the CCI index was .156, in 1988 it was .247. This index gives a greater weight to the top firm and seems to be more appropriate for industries that are dominated by only one firm. The five largest banks have assets in the range of ₱ 16

billion to P 28 billion while the rest have assets below P 10 billion including eight with assets below P4 billion.

These indexes might appear small and indeed do not capture the institutional setting which likely enhances the power of the dominant banks in the industry. First, all the banks are located in Manila. Second, their owners/managers live in one loosely-knit social group and in a geographically proximate environment, that of Makati. In a number of cases, their business interdependence extends beyond banking and includes banking conglomeration in production and trade, and most importantly, a sharing in political power.

Collusion is difficult to document. There are many ways by which the larger banks can make implicit agreements on interest rates and service fees. What are observable are the predictable outcomes of these agreements. Interest rates are likely to be sticky, abnormal profits tend to persist, and competition via interest rates is usually avoided. In lieu of price or interest competition, advertisement or product differentiation is used. There is some evidence for these practices.

#### 1. Performance, Policy and Concentration

The intermediation margin, profit rates and the interest rate structure are briefly examined here.

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Well-known bank affiliation with political power or business are Gokongwei-PCIB, CB Governor-Far East Bank, Ayala-San Miguel groups-BPI, Lucio Tan-UCPB.

10 a) Intermediation margin. Reproduced here are the  
calculations of commercial bank intermediation cost made in the  
World Bank 1988 Financial Sector Study using "basic" CB data  
(which unfortunately are not accessible to the public). It  
decomposed the gross margin, i.e., interest earnings net of tax  
minus the effective cost of loanable funds expressed as a percent  
of loans. These are reproduced below.

The total margin (or the rate paid by borrowers minus the  
rate received by depositors) has been very large and showed an  
increasing trend. The average margin in 1986 was 8.76 percent (=  $14.62 - 5.86$ ) as compared to 6.99 percent in 1983 ( $15.01 - 8.02$ ).  
Of the average loan rate of 14.62 percent, only 40 percent went  
to pay depositors, 26 percent went to the various taxes (final  
tax, GRT, the reserve requirement and Agri-Agra rule) and 34  
percent to bank margin, i.e., bank operating expenses and  
profits. Profits before taxes comprised about one-third of bank  
margin for 1984-86 or about two percentage points of the total.  
By international standards this is fairly high. Panel E shows  
that of eight countries which include developed and developing,  
all excepting Morocco have a much lower profit margin than the  
Philippines. Because of our low wage scale, our staffing cost is  
relatively low, however our administrative and depreciation costs  
are significantly higher. Within the country, however, domestic  
bank staffing cost is at least 50 percent higher, on average,  
than among foreign banks, despite the high salaries paid to  
expatriate personnel. These data seem to imply that our domestic  
banks are less efficient in their operation. The palpable

TABLE 3

## INTERMEDIATION MARGIN, 1983, 1986

| A.                                          | Intermediation margin,<br>as % of earning assets | 1983   |      | 1986   |  |
|---------------------------------------------|--------------------------------------------------|--------|------|--------|--|
|                                             |                                                  |        |      |        |  |
| 1.                                          | Average cost of deposit                          | 10.02  |      | 7.32   |  |
| 2.                                          | Net of 20% final tax                             | 8.02   |      | 5.86   |  |
| 3.                                          | Cost of loanable funds                           | 12.67  |      | 8.92   |  |
| 4.                                          | Average lending rate                             | 15.01  |      | 14.62  |  |
| 5.                                          | (4) net of 5% GRT                                | 14.26  |      | 13.89  |  |
| 6.                                          | Bank margin (5) - (3)                            | 1.59   |      | 4.97   |  |
| 7.                                          | Total margin to clients (4) - (2)                | 6.99   |      | 8.76   |  |
| B. Composition of the total margin (7) in % |                                                  |        |      |        |  |
| 1.                                          | Depositor                                        | 53.40  |      | 40.05  |  |
| 2.                                          | 20% of final tax                                 | 13.35  |      | 10.01  |  |
| 3.                                          | Reserve cost                                     | 17.67  |      | 10.96  |  |
| 4.                                          | GRT                                              | 5.00   |      | 5.00   |  |
| 5.                                          | Bank margin                                      | 10.57  |      | 33.97  |  |
|                                             | Total                                            | 100.00 |      | 100.00 |  |
| C. Components of bank margin                |                                                  |        |      |        |  |
|                                             | (% of total assets)                              | 1984   | 1985 | 1986   |  |
| 1.                                          | Intermediation margin                            | 5.04   | 6.02 | 5.07   |  |
| 2.                                          | Staffing cost                                    | 1.06   | 1.23 | 1.38   |  |
| 3.                                          | Administrative cost                              | 1.48   | 1.50 | 1.57   |  |
| 4.                                          | Depreciation                                     | 0.83   | 1.08 | 0.86   |  |
| 5.                                          | Total cost                                       | 3.37   | 3.81 | 3.80   |  |
| 6.                                          | Profits before taxes                             | 1.67   | 2.21 | 1.90   |  |

D. Staffing Expenses as % of total assets

|                         |     |     |     |
|-------------------------|-----|-----|-----|
| 1. All banks            | 0.9 | 1.0 | 1.4 |
| 2. Sound domestic banks | 1.0 | 1.2 | 1.4 |
| 3. Foreign banks        | 0.4 | 0.7 | 1.0 |

E. Comparative bank margin

|                                   | Staffing<br>Cost | Adm.<br>Cost | Depr. | Total<br>Cost | Profit<br>before<br>taxes | Total<br>Margin |
|-----------------------------------|------------------|--------------|-------|---------------|---------------------------|-----------------|
| Phil. (1986)                      | 1.4              | 1.6          | 0.9   | 3.9           | 1.9                       | 5.8             |
| Selected<br>countries ca.<br>1980 |                  |              |       |               |                           |                 |
| Belgium                           | 2.2              | 0.5          | 0.3   | 3.1           | 0.3                       | 3.4             |
| Denmark                           | 2.0              | 0.9          | 0.7   | 3.6           | 0.7                       | 4.3             |
| Finland                           | 1.6              | 1.6          | 0.7   | 3.9           | 0.4                       | 4.4             |
| Morocco                           | 2.2              | 0.8          | 0.7   | 3.7           | 1.9                       | 4.8             |
| Norway                            | 2.1              | 1.4          | 0.5   | 4.0           | 0.3                       | 4.5             |
| Pakistan                          | 1.7              | 0.8          | 0.1   | 2.6           | 0.7                       | 3.3             |
| Portugal                          | 2.0              | 0.7          | 1.5   | 4.2           | 0.3                       | 4.5             |
| Spain                             | 2.8              | 0.8          | 0.6   | 4.2           | 1.5                       | 5.7             |
| Average                           | 2.1              | 0.9          | 0.6   | 3.7           | 0.7                       | 4.4             |

luxurious offices and lifestyles of bank owners/executives whose cost is generally charged as office expense may possibly explain part of the high administrative and depreciation cost of domestic banks.

b. The structure of interest. The preceding section accounts for the rather wide average deposit loan rate differential (Table 6). Very large differentials exist between types of deposits and between types of loan. Up to 1980 when interest ceilings were in force, the deposit rate differentials set by the CB were relatively narrow; in 1970 the range in deposit rates was 6.0 to 9.5 percent and just before interest rates were freed in 1980, the range was 9.0 to 14.0 percent for savings deposit (SD) and 1 year time deposits (TD). The SD-TD differential widened increasingly from the time of interest rate liberalization. The SD rate fell more rapidly than TD from their peak in 1983-84 when inflation reached the historical rate of 50 percent. The 1989 first quarter rates were 4.08 percent for SD, 12.95 percent for 6-month TD, and 13.94 percent for 12 month TD. Note the differential for the first six month-maturity differential for SD and TD of 8.87 percentage points in contrast to a differential of only 1.0 percentage points for the next six month-maturity differential, i.e., 6-month to 12-month TD. In the case of foreign currency deposits, the term structure is quite flat where the equivalent rate differential is less than one percentage point for all available maturities. The current (September 21, 1989) FCDU rates for 1 month maturity to one year maturity ranges from 7.75 to 7.25 percent. As the WB study

TABLE 6  
NOMINAL INTEREST RATES IN ASEAN COUNTRIES  
1975, 1980-88

|                    | 1975  | 1980           | 1981  | 1982  | 1983  | 1984  | 1985  | 1986  | 1987  | 1988  |
|--------------------|-------|----------------|-------|-------|-------|-------|-------|-------|-------|-------|
| <b>INDONESIA</b>   |       |                |       |       |       |       |       |       |       |       |
| Loans              | n.a.  | 9.00           | 9.00  | 9.00  | 9.00  | 12.00 | 12.00 | 21.40 | 21.67 | n.a.  |
| Savings deposit    |       | 15.00          | 15.00 | 13.00 | 15.00 | 15.00 | 15.00 | 15.02 | 15.00 | n.a.  |
| Time deposit:      |       |                |       |       |       |       |       |       |       |       |
| 6 months           | 12.00 | 6.00           | 6.00  | 6.00  | 19.77 | 18.40 | 16.88 | 15.33 | 17.03 | n.a.  |
| 12 months          | 15.00 | 9.00           | 9.00  | 9.00  | 18.04 | 19.11 | 18.74 | 15.72 | 16.82 | n.a.  |
| Treasury bills     | n.a.  | n.a.           | n.a.  | n.a.  | n.a.  | n.a.  | n.a.  | n.a.  | n.a.  | n.a.  |
| <b>MALAYSIA</b>    |       |                |       |       |       |       |       |       |       |       |
| Loans              | n.a.  | 7.75           | 8.50  | 8.79  | 11.08 | 11.35 | 11.54 | 10.80 | 8.19  | 7.25  |
| Savings deposit    | 5.97  | 5.25           | 6.33  | 6.58  | 6.25  | 6.50  | 6.65  | 6.09  | 4.94  | n.a.  |
| Time deposit:      |       |                |       |       |       |       |       |       |       |       |
| 6 months           | 6.21  | 6.54           | 9.67  | 9.94  | 8.35  | 9.52  | 9.06  | 7.17  | 4.00  | n.a.  |
| 12 months          | 8.01  | 7.42           | 9.90  | 10.42 | 8.75  | 9.64  | 9.27  | 7.42  | 4.50  | n.a.  |
| Treasury bills     | n.a.  | n.a.           | n.a.  | n.a.  | n.a.  | n.a.  | n.a.  | n.a.  | n.a.  | n.a.  |
| <b>PHILIPPINES</b> |       |                |       |       |       |       |       |       |       |       |
| Loans              | 21.00 | 21.09          | 18.68 | 19.24 | 28.27 | 28.61 | 17.53 | 13.34 | 15.92 | 16.8  |
| Savings deposit    | 9.00  | 9.14           | 9.80  | 9.70  | 9.90  | 10.80 | 8.00  | 4.50  | 4.10  | 4.08  |
| Time deposit:      |       |                |       |       |       |       |       |       |       |       |
| 6 months           | 14.00 | 10.2-<br>17.00 | 14.50 | 13.40 | 20.16 | 18.80 | 11.00 | 7.40  | 11.51 | 12.95 |
| 12 months          | 14.00 | 10.5-<br>18.00 | 13.90 | 14.20 | 17.40 | 19.30 | 11.50 | 10.00 | 11.91 | 13.94 |
| Treasury bills     | 11.87 | 12.55          | 13.78 | 14.23 | 18.53 | 20.73 | 16.04 | 12.89 | 16.23 | -     |
| <b>SINGAPORE</b>   |       |                |       |       |       |       |       |       |       |       |
| Loans              | n.a.  | 11.72          | 13.65 | 10.23 | 9.05  | 8.97  | 7.93  | 6.82  | 6.10  | 5.96  |
| Savings deposit    | 3.50  | 8.03           | 9.83  | 7.20  | 6.24  | 6.95  | 5.66  | 4.25  | 3.06  | n.a.  |
| Time deposit:      |       |                |       |       |       |       |       |       |       |       |
| 6 months           | 4.96  | 9.28           | 10.82 | 7.54  | 6.49  | 7.05  | 5.23  | 4.06  | 3.09  | n.a.  |
| 12 months          | 5.79  | 9.83           | 10.80 | 7.95  | 6.77  | 7.16  | 5.57  | 4.25  | 3.47  | n.a.  |
| Treasury bills     | 3.34  | 6.78           | 2.38  | 2.57  | 2.59  | 2.91  | n.a.  | n.a.  | n.a.  | n.a.  |
| <b>THAILAND</b>    |       |                |       |       |       |       |       |       |       |       |
| Loans              | n.a.  | 18.00          | 19.00 | 19.00 | 17.63 | 18.75 | 19.00 | 17.00 | 15.00 | n.a.  |
| Savings deposit    | 4.50  | 8.00           | 9.00  | 9.00  | 9.00  | 9.00  | 9.00  | 7.25  | 7.25  | n.a.  |
| Time deposit:      |       |                |       |       |       |       |       |       |       |       |
| 6 months           | 7.00  | 10.00          | 11.00 | 11.00 | 11.00 | 13.00 | 13.00 | 9.50  | 9.50  | n.a.  |
| 12 months          | 8.00  | 12.00          | 13.00 | 13.00 | 13.00 | 13.00 | 13.00 | 9.50  | 9.50  | n.a.  |
| Treasury bills     | n.a.  | 9.16           | 11.57 | 11.64 | 9.35  | 10.00 | 11.02 | 6.76  | 3.63  | n.a.  |

Sources: ADB. Key Indicators of Developing Member Countries, July 1989.

TABLE 7  
REAL INTEREST RATE IN ASIAN COUNTRIES  
1980-88

|                             | 1980  | 1981 | 1982 | 1983 | 1984  | 1985  | 1986 | 1987 | 1988 |
|-----------------------------|-------|------|------|------|-------|-------|------|------|------|
| <b>INDONESIA</b>            |       |      |      |      |       |       |      |      |      |
| Loan                        | -10.1 | -1.2 | 1.1  | -    | 0.6   | 3.3   | 25.2 | 6.3  |      |
| Savings deposit (SD)        | -14.1 | 3.6  | 6.2  | -    | 3.6   | 8.9   | 18.7 | -0.4 |      |
| Time deposit (TD) 12 months | -10.1 | -1.2 | 1.1  | -    | 11.3  | 12.6  | 19.4 | 1.4  |      |
| Inflation rate              | 29.1  | 10.2 | 7.9  | -    | 11.4  | 6.1   | -3.7 | 15.4 | 6.9  |
| <b>MALAYSIA</b>             |       |      |      |      |       |       |      |      |      |
| Loan                        | 0.9   | 7.3  | 6.2  | 5.9  | 5.8   | 13.0  | 20.2 | 0.5  | 3.5  |
| SD                          | -1.7  | 5.3  | 4.0  | 1.1  | 0.9   | 8.2   | 15.4 | -3.7 | -    |
| TD 12 months                | 0.5   | 8.9  | 7.8  | 3.6  | 4.0   | 10.8  | 16.8 | -3.2 | -    |
| Inflation rate              | 6.9   | 1.0  | 2.6  | 5.2  | 5.6   | -1.5  | -9.4 | 7.7  | 3.8  |
| <b>PHILIPPINES</b>          |       |      |      |      |       |       |      |      |      |
| Loan                        | 5.5   | 7.7  | 10.8 | 16.7 | -21.1 | -0.9  | 12.4 | 8.0  | 8.0  |
| SD                          | -6.5  | -1.1 | 1.3  | -1.7 | -38.9 | -16.4 | 3.6  | -3.8 | -5.6 |
| TD 12 months                | -5.1  | 2.9  | 5.8  | 5.8  | -29.0 | -6.9  | 9.1  | 4.0  | 4.2  |
|                             | 2.4   |      |      |      |       |       |      |      |      |
| Inflation rate              | 15.6  | 11.0 | 8.4  | 11.6 | 49.7  | 18.4  | 0.9  | 7.9  | 9.7  |
| <b>SINGAPORE</b>            |       |      |      |      |       |       |      |      |      |
| Loan                        | 0.3   | 7.0  | 6.0  | 5.2  | 8.3   | 9.1   | 3.2  | 5.1  | 3.0  |
| SD                          | -3.4  | 3.1  | 3.0  | 2.3  | 6.1   | 6.9   | 0.7  | 2.1  | -    |
| TD 12 months                | -2.4  | 4.2  | 3.6  | 2.9  | 6.5   | 6.8   | 0.7  | 2.5  | -    |
| Inflation rate              | 11.4  | 6.7  | 4.2  | 3.9  | 0.7   | -1.2  | 3.6  | 1.0  | 3.0  |
| <b>THAILAND</b>             |       |      |      |      |       |       |      |      |      |
| Loan                        | 5.5   | 10.5 | 15.3 | 14.1 | 18.9  | 19.7  | 13.7 | 11.0 |      |
| SD                          | -4.5  | 0.5  | 5.3  | 5.5  | 9.2   | 9.7   | 4.0  | 3.3  |      |
| TD 12 months                | -0.5  | 4.5  | 9.3  | 9.5  | 13.2  | 13.7  | 6.2  | 5.5  |      |
| Inflation rate              | 12.5  | 5.5  | 3.7  | 3.5  | -0.2  | 0.7   | 2.3  | 4.0  | 7.0  |

Note: Real rate is assumed to be nominal rate minus the growth rate of GDP deflator.

Source: ADB. Key Indicators of Developing Member Countries, July 1989.

pointed out, deposit maturity hardly means anything here since minimal penalty is imposed by banks for pretermination of time deposits. The explanation for this wide differential must be sought elsewhere.

The interest rate structure is compared with the structures in other Asian countries given in Table 6. In Indonesia: SD-TD rates ranged from 15.00 to 17.03 percent, Malaysia: 4.04 to 4.50, Singapore: 3.06-3.47 percent, Thailand: 7.25-9.50 and South Korea: 10.00-10.00 percent in contrast to 4.10 to 12.89 for the Philippines, in 1988. The range in the Philippines remained as wide to 1989. Saving deposits composed almost 60 percent of total bank deposits here. The SD-loan rate differential is 4.08 to 16.8 percent or a crude margin of about 300 percent. In the other countries the crude margin is about 100 percent.

The writer argues here that in addition to the taxes the differential might likely be the result of interest rate discrimination in a monopolistic banking structure.

Banks possibly perceive two distinguishable groups of depositors--the small less-informed surplus units and the affluent modern surplus units. The former are scattered all over the country. The modern affluent surplus units are better read and experienced about financial opportunities in both the domestic and the international markets. The small (because short of surplus) savers likely have a less elastic supply of funds given that their financial asset choices are limited to the more familiar bank deposits. Additionally, their average wealth or

placement is generally small and their liquidity preference higher so that their preference for more liquid saving deposits is stronger than for the other groups. Given fewer alternatives, their reservation interest rate is lower and the supply of deposits less elastic. The big savers face the choice of the larger-denominated assets like time deposits, certificates of deposits, placements in trust funds and foreign currency legends. The modern affluent saver who can choose among this more varied set of financial assets including those with large denominations will tend to have a more elastic supply of funds for each type of deposits. Their reservation interest rate for domestic deposits would approximate the world rate adjusted for exchange rate risk. It is to the banks' interest to discriminate between these two groups. Discrimination would result in a lower interest rate for the group with the less elastic supply.

Figure 1 illustrates the likely interest rates for the two kinds of deposits. The less elastic savings deposit supply,  $S_{SD}$  and its marginal cost to the bank  $MC_{SD}$  are drawn. The large savers' supply of time deposits and close substitutes is  $S_{TD}$  at the reservation rate,  $\bar{r}_{TD}$  assumed to be equal to foreign time deposit rate plus premium (or loss) for expected exchange rate adjustment. Beyond point A, the supply curve is assumed to be positively sloped with the corresponding marginal cost,  $MC_{TD}$ . If the total demand for funds is  $D_1$ , the optimal interest rates and level of deposits are to the monopoly firm or cartel industry  $\bar{r}_1$  and  $r_1$  and  $F_1$  and  $F_1$ . With a larger demand at  $D_2$  which intersects the upward sloping part of the



total MC curve, the optimal rates are  $r_{SD}^2$  and  $r_{TD}^2$ . The rate differential is larger.

Bankers might rationalize the rate differential by transactions cost. But it is hard to imagine that the transactions costs involving bookkeeping, telling and clearing of small deposits while possibly higher than for small-sized deposits would amount to almost 10 percentage points (SD-TD differential). Also the differential is much lower in all the neighboring countries where the industry is experiencing rapid financial growth.

If indeed the large banks possess some monopoly power, this would be exercised over both the sources and uses of funds and other bank services especially those dealing with foreign exchange transactions. We may expect the loan rate for borrowers with a less elastic demand for funds to be charged a higher rate. Note that the reported loan rates are supposedly less than the effective loan rates. Casual observation shows that the effective rate ranges from 20 to 30 percent. Banks perhaps report their prime rates, not the average rates.<sup>6</sup> The reported loan rates differ minimally from the the rates on Treasury Bill (TD) which are the closer substitutes of prime loans than all other types of loans. The loan rate differentials of 20-30

<sup>6</sup>

The Manila Bulletin, the biggest Philippines daily, reports on 22 September 1989 that BPI "offers reduced rate" to borrowers of nontraditional export production and trading ranging from 17.25 percent to 21 percent as "compared with an industry going rule which ranges from 22 to 29 percent."

percent versus the reported 17 percent might reflect not just the premium for risk but also discrimination between borrowers.

Real rates on loans and deposits differ very significantly among Asean economies because both inflation rates and nominal interest rates differ (See Table 7). Over the 1986-88 period Philippine loan rates are relatively high exceeding the rates in Indonesia, Malaysia and Singapore. Its (Philippines) savings deposit rate is however the lowest and is negative in 1987 and 1988. Time deposit rates are fairly close to the Singaporean and Thai rates possibly reflecting the competitive market for these deposits.

#### 7. Concluding Remarks

A high intermediation margin whether arising from taxes or from bank inefficiency and profits imply a smaller intermediation activity. A low yield on deposit discourages savings flow into banks and a high loan rate discourages bank borrowing, therefore a low M/GNP ratio. The present policy regime of high intermediation taxes and restrictive bank entry is inimical to savings mobilization. We refer back to Tables 1 and 2 for the stagnation of financial development in the country. We have shown how the implicit policy on entry have allowed the increasing concentration of commercial banks which comprise the bulk of the financial system.

The Herfindahl and the Comprehensive Concentration Index rose from .045 to .074 and from .156 to .247, respectively. This

is a rather fast increase in concentration. The large banks presently enjoy tremendous advantage and will likely continue growing relatively faster than the rest of the banks. They have acquired a reputation for stability and good management having overcome the banking crisis of the early 80s. Between these banks and the group of small banks and rehabilitated banks which likely suffer from the stigma of bank failure, clients would tend to prefer banking with the former. The latter group is not likely to be in a position to compete against the big five with attractive interest rate offers. They can be 'killed' by the giants. Some have still carry-over losses from the past and have little surplus to support a fight with the giants.

Unless CB allows the entry of new banks with minimal entry cost, the concentration in the banking industry will likely worsen. Currently CB prefers the rehabilitation of insolvent banks. But this is disadvantageous to new investors since they are forced into banks that likely have bad portfolios and negative goodwill. These might be counted as entry costs. In rural banking this cost can be prohibitive, partly explaining the very slow rehabilitation of rural banks and the declining credit share in agriculture.

There is no rationale for the bank taxes especially since the tax on most physical assets is minimal. Real property tax is not only low but is very ineffectively collected. A 20 percent tax on deposit earning is therefore exorbitant and discouraging to saving mobilization.

CB has not paid attention to the effects of these policies on investment and growth. CB, moreover, has raised the interest rate as a means of protecting the currency via open market operations. Interest rates have also been allowed to fluctuate widely, creating uncertainty for both banks and their clients. As a consequence, speculations in government securities have become an attractive activity as compared to lending for investment. This may explain the declining share of bank loans in banks assets.

All these point to the necessity of monetary policy reforms.

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