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A NOTE ON
CENTRAL BANK REGULATIONS
OF THE FINANCIAL SYSTEM

by

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The Central Bank recently issued a series of circulars directed at investment houses. They cover new ceiling interest rates, minimum size of placements, reserve requirements and various portfolio ratios. Additional regulations are being considered, in particular a tax on interest rate on money market instruments. These regulations were imposed as a consequence of very legitimate concern over serious weaknesses in the money market particularly its instability as reflected in very wide fluctuations in the rate of interest on money market instruments. Since this market has been served by investment houses, the regulations of the Central Bank were directed to the operation of investment houses.

The regulations are tabulated in Table 1.

Table 1

NEW CB REGULATIONS

CB Circular 492 - sets the maximum interest rate on bank deposits, 730 days or less as follows:

demand deposits - no interest

savings deposits -

commercial banks - 7 per cent
thrift institutions - 7 1/2 per cent

time deposits (minimum of P100 and 90 days)

commercial banks -

90 days - 8 1/2 per cent
180 days - 9 per cent
360 days - 10 per cent
540 days - 11 per cent
730 days - 12 per cent

thrift banks and rural banks

90 days - 9 per cent
180 days - 9 1/2 per cent
360 days - 10 1/2 per cent
540 days - 11 1/2 per cent
730 days - 12 1/2 per cent

CB Circular 493 - sets the maximum rate of interest for deposit substitutes with a maturity of 730 dyas or less at 17 per cent per annum. Prescribes no interest rate ceiling on time deposits and deposit substitutes with a maturity period of more than 730 days.

20/10

Table 1 (Con't.)

CB Circular 494 - sets the maximum interest rates and yields on loans and purchase of instruments by banks and non-bank financial intermediaries authorized to engage in quasi-banking functions as follows:

17% - for purchase of receivables and other obligations with a remaining maturity of 730 days or less.

19% - for loans with maturity of more than 730 days.

no ceiling - for purchase of receivable and other obligations with a remaining maturity of more than 730 days.

CB Circular 495 - sets the minimum size and maturity of deposit substitute transactions as follows:

minimum lot

effective April 1, 1976

₱100,000 - for maturities of 730 days or less

50,000 - for maturities of more than 730 days

effective July 1, 1976

₱200,000 - for maturities of 730 days or less

100,000 - for maturities more than 730 days

Table 1 (Con't.)

minimum maturity

7 days - effective April 1
April 1, 1976

15 days - effective
July 1, 1976

CB Circular 496
and 497

- sets the reserves against deposit substitutes of banks and non-banks authorized to engage in quasi-banks as follows:

effective April 1, 1976 -
5 1/2 per cent and shall be
raised at the rate of 1/2
percentage point every
month thereafter until 20%
requirement is reached.

composition of reserves
effective April 1, 1976

- At least 25 per cent in the form of deposit balances with the CB for banks and cash on hand and in banks for non-banks.
- Up to 75 per cent in the form of cash in vault and/or government securities.

CB Circular 498 - sections for violation of CB circular nos. 492-497.

This paper tries to analyse the regulations in terms of their effectiveness in achieving the objectives for which they were set and in terms of their over-all impact on the whole capital market. The objectives of the CB are to reduce instability in the market and to develop the long term market. An understanding of the working of the financial market is necessary for the analysis. Section 1 provides this background.

Before such an analysis can be done, three arguments will be developed to review the regulations. First, the chronological order, the stated objectives and the nature of the regulations governing commercial banks and investment houses seem to reflect a segmented view of the financial market. Secondly, it is likely that the new regulations would not achieve the objectives for which they were imposed, especially in the longer-run. Third, there is a need to consider a different approach to influencing and developing the financial market. The Monetary Authority has used control as a solution to most problems in the market. There are situations when

the problems were created by the controls themselves. For such a problems, the obvious solution is to remove the controls, not to impose new ones. [The new approach suggested is to rely more on market forces except in cases where interference is clearly necessary.]

1. The Financial Market

The economy usually has one financial market where financial assets of various forms are issued and bought. As in the commodity market, firms specialize in particular lines of business. In the financial market, we have ~~commercial~~ banks, ~~savings~~ associations, ~~investment~~ houses, the stock exchange, ~~consumer~~ finance companies, and others. They issue and transact in particular types of financial instruments: bank deposits, loans, under-writing, portfolio packages and so on. The instruments vary by liquidity and risk; by denominations and other conditions. These instruments are all forms of indebtedness. Primary securities are the issues of debt instruments (in the form of bills, bonds and equities) by spending units such as corporations

and the government. Then we have a wide variety of secondary issues - debt instruments of financial intermediaries - such as bank deposits, investment house bills and portfolio packages. These instruments are close substitutes of each other so that a change in the rate of return and other conditions in one instrument is likely to have repercussions on the rate of return on other instruments. The substitutability of financial instruments has been the basis of limiting government control over the financial system to control of commercial banks. Commercial banks are creators of money. Changes in money supply will determine the demand for other financial instruments, thus the rate of interest and the level of intermediation. Hence CB control over commercial bank money creation extends though indirectly to the whole system. In like manner any change in the supply of or demand for any one instrument, say government securities or corporate equities, would have an impact on the other instruments. The role of the financial authority vis-a-vis non-bank intermediaries need only be supervisory in order to prevent fraud and instability in the

market.

The Philippine Central Bank exercises extensive control over the financial market which goes beyond contraction and expansion of the supply or credit. It consists of regulations on rates of interest of specific instruments and the allocation of funds of particular types of intermediaries. Such regulations have affected the process of intermediation and the pattern of growth of the financial system. In the following section, the effects of these regulations on the pattern of development of the market is discussed.

2. Financial Market and the Investment Houses

The capital market in the Philippines developed rather fast over the last decade and a half as seen from the rate of growth of the value of assets of financial institutions (see Table 2). At the same time the market grew not in a pattern that might be considered along normal structures. The usual pattern of development is as the market increases in size, it also offers an increasing

variety of debt instruments. Through time bank assets diminish in importance.

Clients have to be educated to institutionalized lending and borrowing. Since banks have the longest history of existence and offer what could be considered the most rudimentary forms of lending and borrowing processes, they tend to dominate the financial market in its early stages of development. As the economy grows, larger business organization are established and wealth and the volume of accumulated savings increase. All these could be served more efficiently by a variety of financial services of which banking services are but a part. The financial market offers an increasing variety of claims: equities, bonds, bills and various forms of secondary issues. And intermediaries tend to be dispersed geographically resulting in increasing participation of the population in financial transaction. We find in Tables 3 and 4 for instance how the volume and variety of financial assets grew thru time in Western countries. Commercial bank issues and assets declined in proportion to

Table 2
AVERAGE ANNUAL RATES OF GROWTH OF ASSETS
OF THE FINANCIAL SYSTEM*
(in %)

Assets	Growth Rates			Annual Average 1960-74
	1960-65	1965-70	1970-74	
Cash	33	24	59	38
Due from CB	-2	107	40	48
Loans, Discounts	35	21	30	29
Investments	65	36	34	45
Others	50	29	37	38
Total Assets	35	24	34	31

Source: CB Statistical Bulletin

*excludes insurance and consumer finance companies.

the non-bank issues and assets. In the U.S. we see the relatively faster growth of corporate stock; government securities, claims against financial institutions, and other assets and the relative decline of money holdings and savings deposit. (Table 4). In the Philippines deposits have remained dominant asset with corporate equities and government debts not increasing in proportion to other assets. Banks continue to dominate the market. The securities market has remained a very thin market. The financial market remains concentrated in Metro Manila. Moreover, the term structure of interest exhibit a perverse direction, i.e., the longer the term the lower the rate. The deviation from the usual pattern of Philippine financial development can be traced in part to the financial policies adopted here. The following section tries to explain these developments and characteristics.

3. Explanation of the structural pattern of development of the financial market.

~~The~~ set of policies adopted by the Central Bank and other agencies of the government help explain

Table 3
RATIO OF NET ISSUES OF COMMERCIAL BANKS
TO TOTAL ISSUES AND ASSET OF FINANCIAL INSTITUTIONS

	Issues		Assets	
	Advanced Countries	LDC	Advanced Countries	LDC
1861 - 1880	42.8	54.0	45.9	-
1881 - 1900	38.3	-	42.2	-
1901 - 1913	42.4	54.8	43.2	59.2
1914 - 1929	35.5	97.9	40.2	64.1
1930 - 1938	15.7	49.9	29.7	49.3
1939 - 1948	30.8	37.5	34.8	39.8
1949 - 1963	26.9	44.7	28.8	43.5

Source: R.W. Goldsmith: Financial Structure and Development,
T.5.4, p.225.

FINANCIAL INSTRUMENTS OUTSTANDING IN THE UNITED STATES, 1963 and 1900

Amount ^a 1900 of dollars (2)	Distribution 1963 (3)	1900 (4)	Relation to National Wealth		New Issues ^b Ratio 1901-63 (per cent) (7)
			1963- (per cent) (5)	1900 (6)	
7.6	7.8	12.6	9.8	8.5	2.0
3.7	10.7	6.1	13.3	4.1	2.7
1.6	8.2	2.6	10.1	1.8	2.1
0.0	1.9	0.0	2.4	0.0	0.5
0.0	0.4	0.0	0.6	0.0	0.1
12.9	29.0	21.3	36.2	14.4	7.4
1.0	2.6	1.7	3.3	1.1	0.7
1.3	0.6	2.2	0.7	1.4	0.2
3.9	3.0	6.5	3.7	4.3	0.7
2.6	6.8	4.3	8.5	2.9	1.7
1.8	1.8	3.0	2.3	2.0	0.5
2.3	0.6	3.8	0.8	2.6	0.1
1.2	11.6	2.0	14.4	1.3	3.0
2.0	3.3	3.3	4.1	2.2	0.8
5.2	3.8	8.6	4.7	5.8	0.9
5.7	3.8	9.5	4.8	6.3	0.9
6.5	6.0	10.6	7.9	7.1	1.5
33.5	44.0	55.6	55.2	37.1	11.0
46.4	73.0	76.9	91.4	51.5	18.4
13.9	27.0	23.1	33.5	15.5	0.9
60.3	100.0	100.00	124.9	67.0	19.3

for claims

1 product 1901-63, except for Col. 20 (Stock issues from R.W. Goldsmith, Princeton University Press, 1955) 1,482-3; for 1939-63 from Federal

the development of the financial system. The policies which have important implications on the pattern of development are as follows:

1. Interest rate policy covering
 - a) low ceiling rate on saving deposit
 - b) low ceiling rate on loans
 - c) relatively low loan rate by government financial institutions
 - d) fixed rate on long-term government debts at relatively low levels
 - e) low discount rate especially for public and semi-public banking institutions
2. Development incentives

✓ The set of interest regulations imposed by the CB directly affects banks. On the whole the regulations are favorable to them. They borrow (through deposit liabilities) at very low rates of interest and supplement their funds by discounting at also low discount rate. They keep their reserves in the form of government securities which earn stipulated rates. These rates are higher than or

at least equal to the deposit rates.

✓ The low deposit rate discourages the institutionalization of savings and the dependence of banks on the discount window. Such dependence is a peculiar characteristic of Philippine banking for in other countries the discount window is a source of last resort to help banks meet reserve deficiencies and not a regular source of funds. When banks use the discount window as a regular source of funds, they may not be able to use it to fill their reserve deficiencies.

Chart 1 is a graphical analysis of the impact on banking of the set of interest policies. Assume an aggregate demand and supply of funds as DD and SS. If the market is left to itself, equilibrium will be at A where the equilibrium rate will be at r_e and the funds supplied to banks by depositors and loaned to investors is F_e . When deposit rate is fixed at say r_d , and loan rate at r_1 , deposits are at d_1 and loan demand at l_1 . Assume the CB lends to banks d_1 d_2 at r_d so that loans = d_2 . Excess demand is reduced. Excess demand might even be reduced to zero. But banks are given the profit margin of $r_1 - r_d$. Moreover, their deposits are reduced from F_e to d_1 .

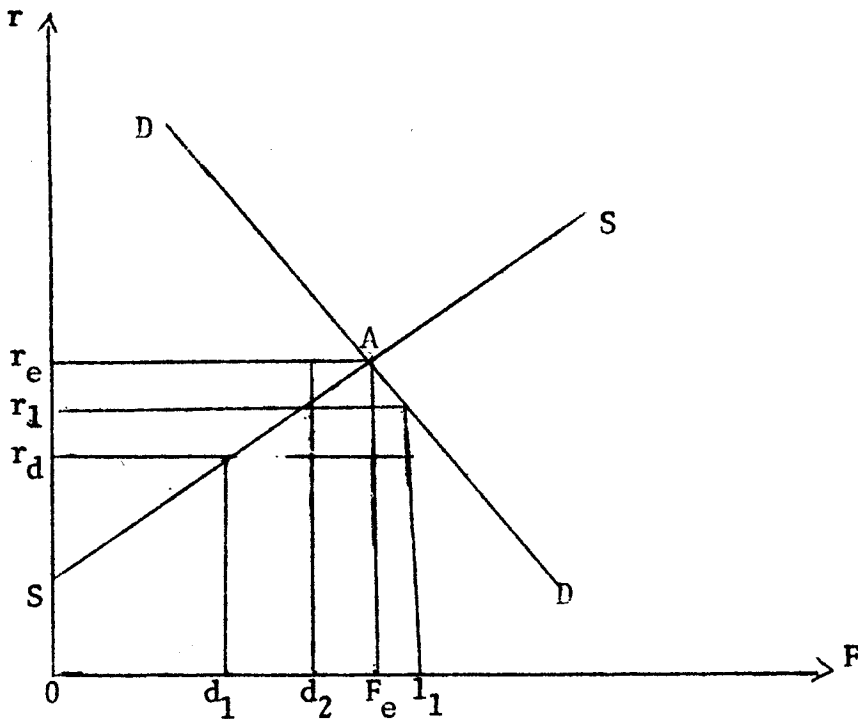


Chart 1

This banking policy has been in operation over the last two decades and a half. In the meantime, the economy was growing at moderately high rate. With this growth, the demand and supply of funds in alternative forms must have increased. So that left to its own forces the financial market should have developed in response to the growing demand and supply of financial assets. [Volume-wise the market expanded but its pattern of growth deviated from the usual or what we may consider the normal pattern.] Bank

✓assets continued to dominate total assets. The equity market lagged behind and its volume remained a very small portion of total claims. Transactions in government securities have remained a bilateral arrangements between financial institutions and the Central Bank. These securities have not been integrated into the total financial market.*

✓Philippine financial policy has been solely focused on commercial and rural banking. There has been no policy to encourage the development of the securities market whether private or public. On the contrary, reserve and interest rate policy related to government securities has been deleterious to the development of the security market since government securities failed to augment this small market.

The investment policies could also have had negative effects on the development of the security market. Credit, tax and tariff incentives have been granted almost indiscriminately in the sense that their distribution has not been based on any reliable social returns criteria.** Entrepreneurs

* New issues of government treasury bills are auctioned at discreet time period, not bought and sold the usual way equities or commodities are sold. Since they are attractive form of reserve with rates as high as 17 per cent, the subscriptions always end in excess of new issues.

**There has been a long list of critiques of the incentives policy, among them G.P. Sicat on the import substitution policy and the ILO Report on the Philippines: Sharing in Development, Geneva, 1973.

of influence could more powerfully take advantage of these incentives than small scale unicorporated business. These incentives are substantial gifts so that it is natural for entrepreneurs to try to confine the subsidy within the family. Why would family corporations share the subsidy through equity sharing? It might be said, therefore, that the Filipino tendency of organizing business within familial boundary was exacerbated by the generous grant of credit, tax, tariff incentives thus discouraging equity financing.

As we see in the preceding paragraphs, most of the control decisions of the Central Bank have been unfavorable to investment banking, the more serious of which are those restricting the growth of the securities market including government securities. The restriction of the supply of marketted securities reduced the volume of assets which investment houses can manage for savers and under-write for issuers. Their investment portfolio management being thus restricted they went into the very volatile short market and later dominated it. Unfortunately, the weaknesses of this market were blamed on the investment houses. The new regulations intend to channel funds away from investment houses with the hope, it seems, of reducing the volatility or instability of the money market. It is doubtful these

regulations would achieve their objective since they are not directed at the root of the problem. It might be argued that the investment houses are passive players in this market. The market was not created by them and it would probably exist without them. There is a need, therefore, to have some understanding of the nature of this market so that the solution applied is addressed to the problem, not merely to its symptom.

4. Regulations affecting investment houses, would they do the job?

The Central Bank's objectives in imposing the set of regulations on investment houses were to encourage what it calls long-term instruments and to stabilize the rate of interest in the money market.

As argued earlier, it is not meaningful to take the stated maturity of an instrument to be its actual maturity. Very few asset holders buy long-term assets with the intention of holding them to maturity. Demand for each asset is determined

by the returns expected in the fairly near future over which period expectations can be formed. Beyond a year, expectations assume greater degrees of uncertainty. This fact plus that instruments can be easily sold and rebought as relative returns change render meaningless the stated maturity of long-term instrument as indicator of its actual maturity. It is the volume of the market that determines the amount of funds that can be used over longer period. It is only in loan instruments where the stated maturity matters.

Policies for the development of the market would have two effects on the supply of long-term funds. A larger volume provides greater degree of liquidity to any one instrument. Any issue or purchase would form but a small part of the market which can be transacted without a major impact on over-all level and structure of rates in the market. The liquidity of non-monetary instruments in turn, allows individuals to economize on their holdings of very liquid assets. More of their wealth can therefore be allocated to liquid but

longer-term papers. In contrast, policies that impose a price on short-term maturities will tend to direct funds to less liquid assets like time deposits but which are not necessarily for long-term uses. Such policies reduce the liquidity of assets in general, thus obstructing market development.

The Central Bank allows long-term instruments higher ceiling rates. Thus we have the following ceiling rate-maturity relation:

Rate (in per cent)	Type of Instrument/ Maturity
0	<u>demand deposits</u>
	<u>savings deposits</u>
7.0	Commercial banks
7.5	Thrift institutes
	<u>time deposits</u>
	Commercial banks
8.5	90 - day
9.0	180 - day
10.0	360 - day
11.0	540 - day
12.0	730 - day

	Thrift banks & rural banks
9.0	90 - day
9.5	180 - day
10.5	360 - day
11.5	540 - day
12.5	730 - day
	<u>deposits</u> <u>substitutes</u>
17.0 (maximum)	730 - day or less
no ceiling	over 730 days
	<u>discounting of</u> <u>receivables</u>
17.0 (maximum)	with remain maturities of 730 days or less
19.0 (maximum)	lending rate
19.0 (maximum)	lending rate for loans with maturity of more than 730 days

The first question to be asked is whether indeed this ceiling rate-maturity relation as imposed by the CB reflects realistically the ex-ante rate-maturity relation of asset holders. In other words, is the risk premium on the uncertainty of a two year versus a 3-month savings deposit as perceived by asset holders smaller or greater than

3.7 percentage points (difference in their ceiling rate of 12.5% and 8.5%)? If the risk premium is greater than 3.7%, then such a rate differential would not attract the holding of long instruments. Inflation alone, which in recent years have always exceeded 10 per cent, would render the expected effective rate on a one-year or two year paper lower than the short rate. This question is very basic to regulations of interest rate structure. Unless we have a priori knowledge of the responsiveness of people to interest rate differential and maturity, we cannot predict how effective such a regulation will be. Of course, there could be expected responses at the margin, but we do not know how weak or how strong that is going to be.

5. Portfolio Ratios and Size of Placements

Let us next consider the regulations on portfolio ratios and the minimum size of placements in the money market. The same question as in the interest rate structure may be raised with respect to the portfolio ratios. Are these desirable

ratios? If the growth of the volume of assets is restricted as a consequence of such a regulation, liquidity and stability will also be negatively affected since both qualities are determined by market size and variety.>

The regulation on the minimum size of placement is a very serious one. Funds supplied to investment houses will be drastically reduced since the regulation excludes small wealth-holders from the market. In the past large placements form the bulk of the supply of funds. In the case of one investment house in 1975, only seven (7) per cent came in placements of P200,000 or less; the rest (93%) in much larger placements which averaged P450,000. The large size of placements might reflect monopoly power among the few lenders which can easily lead to greater fluctuations in the interest rate. Investment houses should be encouraged to widen their clientele to include small lenders. Such a policy would help diminish monopoly power and increase the volume of funds in the market,. Regulations imposing minimum placement for any asset would tend to reduce the

supply of funds to this asset,>

We can, therefore, say that the objective of expanding the long-term market is not likely to be achieved by the instruments that the CB has adopted. It is possible that the opposite of what they try to achieve results, that is, the discouragement of the growth of long-term instruments.

6. Would the regulations help stabilize the rate of interest?

(The Philippine money market is a small segment of the financial market. The average volume of transactions per week is about six (6) per cent of the total volume of credit transacted.*** Secondly, this market operates as if apart from the rest of the financial market. It is a market for very short, emergency needs of banks and large corporations suffering from temporary cash

***outright sales of commercial papers

From C. 2

flow problems. In fact about 73 per cent of transactions in 1975 were by banks and 12 per cent by corporations. Two elements here seem to contribute to the fluctuations in rates. First is the small size of the market and second the nature of the demand for funds by its borrowers. In a small market, a shift in demand or supply function would tend to have a large price effect in comparison to the same shift in a large market. A withdrawal of funds by a large lender, or an additional demand by a large borrower would be felt in the market. On the other hand, there seems to have been monopoly-like lending to banks and corporations which are known to be in special difficulties as seen from large placements in the market. Furthermore, the fact that reserve deficiencies are penalized by a 40 or higher rate of interest sets the opportunity cost of borrowing in the money market. Thus when a lender happens to be in a monopoly position, he can charge a rate that approaches the penalty rate. In a less tight situation, competition among big lenders would tend to lower the rate.

Problems of cash flow and temporary reserve deficiencies will always occur in any market. If the market is large, monopoly power will not develop. Intermediaries in large numbers can draw on an equally large number of lenders. On the other hand, if the penalty rate on reserve deficiency were not so high, banks may not be charged such high interest rate when they borrow to meet reserve requirements. This matter deserves attention.

Banks inevitably incur reserve deficiencies every now and then even if they are faithful in keeping adequate reserves. The flow of funds in the market is not perfectly predictable hence there would tend to be some fluctuations in the actual reserves/deposit ratios. If this fluctuation is inevitable (unless unnecessarily high excess reserves are kept) then regulations on reserve levels have to be more flexible. Banks should be provided a warning system or secondary sources before they are penalized for not meeting the requirements. Such a system would reduce the

opportunity interest cost of bank reserve deficiency and possibly the wide rate fluctuations. As of now the required level of reserves must be kept on a day to day basis.

Banks in the Philippines are particularly vulnerable to reserve fluctuations because they hold relatively small secondary reserves. Their investment in securities amounted to only 15% of total loans outstanding and 13 per cent of deposit liabilities in 1970. The figures for 1974 were 15 per cent and 19 per cent respectively. These secondary reserves formed only about 7-8 per cent of total assets in 1970 and 1974. In advanced economies, commercial banks hold substantial amount of secondary reserves consisting of liquid securities, particularly government securities. In the Philippines, in contrast, a large portion (about 75%) of government security holdings of banks forms part of the primary reserves. Only the residual is left as secondary reserves. Banks cannot rely on other securities since the supply of these is relatively thin. On the other hand,

the discount window, which in other countries accommodate banks in difficulties, might not be available to them when they suffer reserve deficiency. Here the discount window is a regular source of funds. The window is closed to banks under reserve deficiency if they happen to have already obtained the maximum loan from CB. The very regulations that assist banks in expanding their supply of funds - discounting privilege and applying government securities holding to their reserve requirements - reduce their secondary reserve position. Hence their recourse to the money market when they experience reserve deficiencies.

These arguments seem to be supported by Perez (1976) study where he shows that fluctuations in money market rates are caused by fluctuations in bank reserve position. In a study by Perez (1976), he found that of the various monetary variables, only changes in excess reserves explain significantly and with the expected sign changes in money market rates.

7. Concluding Remarks

The main point to this paper is that the financial market operates as one whole and not in segmented parts. Financial instruments are close substitutes of each other so that policies affecting interest rate, liquidity and the risk of default of any one instrument will have an effect on the demand and supply of the substitute instrument.

[The Central Bank adopted policies directed to parts of the market, apparently not considering their over-all impact.] There were policies (investment incentive and cheap credit) which made equity and corporate bond issues relatively unattractive forms of debt. Other regulations restricted the supply of funds to financial institution. [The CB has made small savings deposits unattractive by imposing low ceiling rates on them.] The market for government securities has not developed at all as a consequence of pegging their long rates and restricting their holdings to financial institutions. / Placements in investments houses have been restricted to big investments. There are other regulations that prevent the development of the

financial market such as many incentives given to investments. We can conclude that the policies on each part of the market did not consider their broader effects. Thus we obtain inconsistent policies. / For instance the CB wanted to develop the long market but it imposed regulations that were opposed to the development of long term instruments - corporate bonds and equities and government securities.

The set of regulations directed at investment houses are aimed at discouraging their money market transactions. These regulations hope to redirect funds away from investment houses into commercial banks by raising time deposit rates. It is doubtful that banks can attract substantial funds since these rates may not be high enough to compensate for the loss of liquidity in time deposits of one or two year duration. The rates do not seem to reflect the risk premium due to uncertainty and inflation of one-year or two year deposits.

The CB has neglected to consider the demand side of the market. As long as the penalty for reserve deficiency remains high, banks would continue to borrow at high rates whenever they incur reserve deficiencies. Problems of cash flows among business firms cannot be totally avoided. The demand, therefore, for short-term funds would always be there. Such demand is usually met by secondary reserves, banks here fail to hold substantial secondary reserve assets and CB regulations have not encouraged their large holding. Redirecting funds from investment houses to banks is almost irrelevant to the question of minimizing rate fluctuations.

The CB wants to see the investment houses flourish and for them to engage in transactions in long instruments. We have shown that this objective could be accomplished, not by any one specific regulation but by adopting a policy that is aimed at the long-run development of the whole financial system. A most drastic change in orientation seems called for and that is the holistic view of the system. On the other hand, there is an urgent need

(to raise, if not to remove, interest rate ceiling on bank deposits; to free the market for government securities, and to remove all floors on placements of any form. These proposed changes are expected to encourage a larger and freer flow of savings (or wealth) into financial forms, including the savings of the provincial areas. This movement is not to be confused with increasing the rate of saving out of current income which is determined by factors other than the rate of interest.

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