

## REVISED FRAMEWORK FOR MONETARY OPERATIONS UNDER THE BSP INTEREST RATE CORRIDOR (IRC) SYSTEM

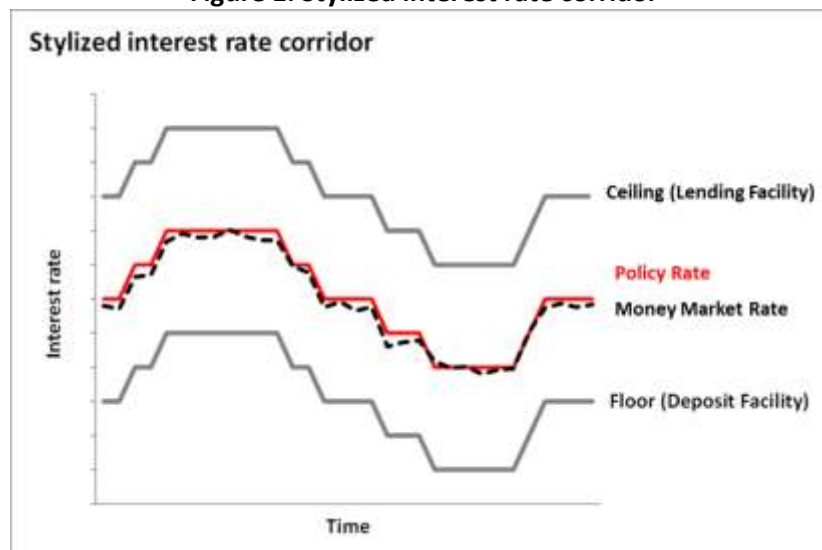
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### 1. The Interest Rate Corridor (IRC) system

An interest rate corridor (IRC) is a system for guiding short-term market interest rates towards the central bank (CB) target/policy rate. It consists of a rate at which the CB lends to banks (typically an overnight lending rate) and a rate at which it takes deposits from them (deposit rate). In a standard corridor, the lending rate will be above the CB target/policy rate (thereby forming an upper bound for short-term market rates), and the deposit rate will be below the CB rate, thereby forming the lower bound (Figure 1).

The IRC system is intended to help ensure that money market interest rates move within a reasonably close range around the BSP's policy rate. The close relationship between the policy rate and market interest rates provides the fundamental basis for monetary policy transmission. Through the IRC system, the BSP is able to generate a more effective policy signal as market rates closely track the policy target rate.

**Figure 1. Stylized interest rate corridor**



While there is no consensus on the width of the corridor, international central banking practice suggests the use of a narrow and symmetrical corridor. The choice of corridor width is determined largely by the importance assigned by the central bank to the amount of interest rate volatility, the central bank's preferences on the extent of counterparties' reliance on CB liquidity facilities, and degree of interbank market activity.<sup>1</sup> In the case of the

<sup>1</sup> Bindseil, U. and Jablecki, J. (2011), "A Structural Model of Central Bank Operations and Bank Intermediation," ECB Working Paper Series No. 1312.

Philippines, a narrow corridor allows the BSP to provide clearer guidance to the market and limit interest rate volatility particularly in the initial stages of IRC implementation.

## 2. Objectives of the IRC system

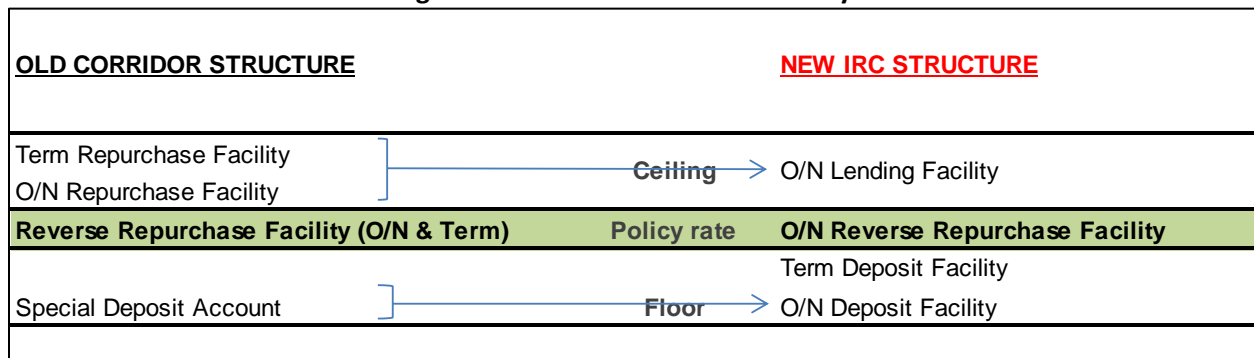
Upon implementation of the IRC system, the use of a narrow corridor combined with auction-type liquidity operations will help the BSP to influence short-term market interest rates to move closely with the BSP policy rate, in the process strengthening the transmission of changes in the monetary policy stance to the rest of the economy.

Over time, the IRC is expected to aid in the further development of Philippine capital markets by fostering money market transactions and active liquidity management by Philippine banks. Increased trading in money markets will strengthen the price discovery process in money markets, by providing participants and monetary authorities alike with information on the prevailing cost of and demand for liquidity in the financial system. This, in turn, will promote the establishment of more accurate interest rate benchmarks that will help facilitate the effective and efficient pricing of financial products in the domestic market. The proposed reform in the monetary operations framework is also in line with international best practice in monetary policy operations.

## 3. Features of the BSP’s IRC system

The structure of the BSP IRC system is shown on the right-hand side of Figure 2. The interest rates on the standing overnight lending and the standing overnight deposit facilities form the upper and lower bounds of the corridor, respectively, with the policy rate located in the middle.<sup>2</sup>

**Figure 2. Structure of the BSP’s IRC System**



<sup>2</sup> The IRC implementation involved the following changes in the BSP monetary operations: modification of the RRP facility into a purely overnight facility, introduction of the term deposit facility (TDF), and conversion of standing facilities (SDA and RP) to overnight windows.

The interest rates for the two standing facilities that form the upper and lower bounds of the corridor have been set at  $\pm 50$  basis points around the target policy rate (the overnight RRP rate under the new IRC structure). Other changes are as follows:

- 1) The RP facility was replaced by a standing overnight lending facility (OLF);
- 2) The RRP facility was transformed into an overnight RRP offered at a fixed rate equivalent to the policy rate; and
- 3) The SDA term facility was replaced by a standing overnight deposit facility (ODF) and the auction-based TDF.

To ensure smooth transition, the BSP maintained the same set of qualified counterparties for the facilities under the IRC system (Table 1). Eligible counterparties for the RRP facility and the OLF consist of banks and non-banks with quasi-banking functions (NBQBs). Meanwhile, eligible counterparties for the TDF and ODF include banks, NBQBs and trust entities.

Similarly, the prohibition on non-resident funds in the BSP's facilities for monetary operations (TDF and ODF) shall be maintained. At the same time, the prohibition on the sale, discounting, assignment or negotiation of banks/quasi-banks of their credit rights in TDF, ODF and RRP with the BSP to clients either on a "with or without recourse basis" shall be upheld.

**Table 1. Eligible Counterparties**

<b>Instrument for Monetary Operation</b>	<b>Counterparties</b>
O/N Lending Facility	Banks and Non-banks w/ Quasi-Banking functions (NBQBs)
O/N Reverse Repurchase Facility	Banks and NBQBs
Term Deposit Facility	Banks, NBQBs, and Trust entities
O/N Deposit Facility	Banks, NBQBs, and Trust entities

The objective of using active monetary operations, through the TDF and RRP facility, is to bring market rates inside the corridor and nearer to the BSP policy/target rate.

The main benefit of active monetary operations is that the volume of operations can be adjusted depending on monetary authorities' assessment of how much liquidity will need to be siphoned or injected to ensure that market rates move in line with the policy rate. In principle, larger and more frequent operations can be undertaken depending on the needs of the market. The BSP, however, opted to start with small auction volumes in order to prevent any undue tightness in liquidity conditions as well as ensure that counterparties are sufficiently prepared to shift to the new operational framework.

- Standing liquidity facilities

The standing overnight liquidity facilities are available on demand to qualified counterparties. The overnight lending facility (equivalent to RP in the old system) is, in principle, not constrained in volume but, in practice, depends mainly on the available collateral held by BSP counterparties. Meanwhile, the overnight deposit facility is, likewise, unlimited in volume to help absorb any residual system liquidity and constrain market rates from falling below the corridor.

- O/N RRP facility

The existing RRP facility is transformed into an overnight facility and is offered using a fixed-rate and full-allotment method, where individual bidders are awarded a portion of the total offer depending on their bid size. Fixed-rate, full allotment allocation helps ensure that the overnight rate sits close to the BSP policy rate. Table 2 below lists the features of the O/N RRP facility.

Prior to the adoption of a pro-rata system for awards in the RRP window, the existing stock of term RRP placements were allowed to mature without rolling over. This entailed winding down the term RRP facility over a specified transition period by allowing all the outstanding term RRPs to mature.

**Table 2. Features of the O/N RRP facility**

Feature	Details
Frequency of operations	Daily (5 days a week)
Maturity	Overnight
Auction type	Fixed-rate, full-allotment
Auction size	Based on BSP liquidity forecast
Announcement of auction size	Same day
Submission of bids	2:00 - 2:30 PM
Eligible counterparties	Banks and NBQBs (same set of counterparties as present)
Type of allocation	Pro rata based on bid size
Minimum bid amount	P10 million
Maximum bid amount	20 percent of auction size
Maximum no. of bids	One (1)
Announcement of results/settlements	Same day

- Term Deposit Facility (TDF)

The Term Deposit Facility is a key liquidity absorption facility, commonly used by CBs for liquidity management. The TDF is used to withdraw a large part of the structural liquidity from the financial system to bring market rates closer to the BSP policy rate. Table 3 presents the features of the TDF.

The BSP offers two tenors—seven days and 28 days—in its term deposit. The possibility of offering longer tenors can be considered in the future, depending on the liquidity needs and preferences of the market.

Pre-termination is prohibited for the 7-day tenor but is allowed for the 28-day tenor after a 7-day holding period at the appropriate pre-termination rate.

The TDF auction will be operated using a variable-rate, multiple-price tender (English auction) in order to bring short-term interest rates within a reasonably close range to the policy rate.

**Table 3. Features of the TDF**

Feature	Details
Frequency of operations	Once a week
Maturity	7 days, 28 days Flexible to offer longer-dated deposits in the future
Auction type	Variable-rate tender, multiple price (English) auction
Pricing	Based on bids
Auction size	Determined by liquidity forecast; small at first but to be scaled up gradually over time
Announcement of Auction size	Indicative calendar released quarterly; auction offer released two weeks ahead
Submission of bids	9:30 - 10:00 AM
Eligible counterparties	Banks, NBQBs and trust entities; similar set of counterparties as in SDA facility
Minimum bid amount	₱10 million
Maximum bid amount	20 percent of auction size per tenor
Maximum no. of bids	Two (2) bid amounts per tenor at different rates
Pre-termination	Not allowed for 7-day TDF, allowed for 28-day TDF after suitable holding period at the appropriate pretermination rate
Announcement of results/settlements	Same day

#### **4. Impact on the monetary policy stance**

The shift to the IRC system does not represent a change in the BSP's stance of monetary policy. The IRC reforms are primarily operational in nature and are not intended to materially affect prevailing monetary policy settings upon implementation. In the initial stages, the TDF is expected to have a rate between that of the RRP and overnight deposit facility such that the weighted rate for monetary operations will remain broadly the same. Moreover, the interest rate at the floor of the corridor, where the bulk of the BSP's liquidity absorption with the market currently takes place, is being kept steady at the launch of the IRC system. At the same time, short-term liquidity conditions are expected to remain broadly unchanged as funds will continue to be absorbed through monetary operations under the IRC system. In conducting monetary operations, the BSP will calibrate carefully the volume of the TDF offerings to achieve a smooth transition to the new system.

It should be emphasized that the IRC system is not a multiple interest rate regime. The BSP's main policy rate continues to be the overnight RRP rate.

Over time, the implementation of the IRC system will allow for recalibrations in other monetary policy tools, including the possible adjustments in reserve requirements in line with international norms.

#### **5. Impact on money market and market interest rates**

Money market activity is expected to increase over time as the scale of BSP active monetary operations, through the TDF, expands in the course of IRC implementation. The rise in TDF volumes and the resulting adjustment in money market rates along with increased activity in the money markets will in turn help support the price discovery process and the establishment of more accurate interest rate benchmarks, thus allowing the yield curve to adjust appropriately.

The transition to the new monetary operations regime is expected to be gradual. Money market rates are not expected to rise significantly in the early phase of IRC implementation, given the ample liquidity in the financial system. Over time, however, as the scale of BSP's active monetary operations (i.e., auction volumes in the TDF) increases, short-term money market rates are expected to rise gradually, tracking the BSP policy/target rate more closely. Interest rates in the primary T-bill market over time are also expected to gradually align with short-term market rates.

The BSP believes that, in the long term, the interest rate corridor system will support capital market development by encouraging more interbank transactions as well as facilitating price discovery and providing benchmarks for short-term interest rates. These developments in turn can also serve to improve the overall market conditions for funding by the corporate sector.