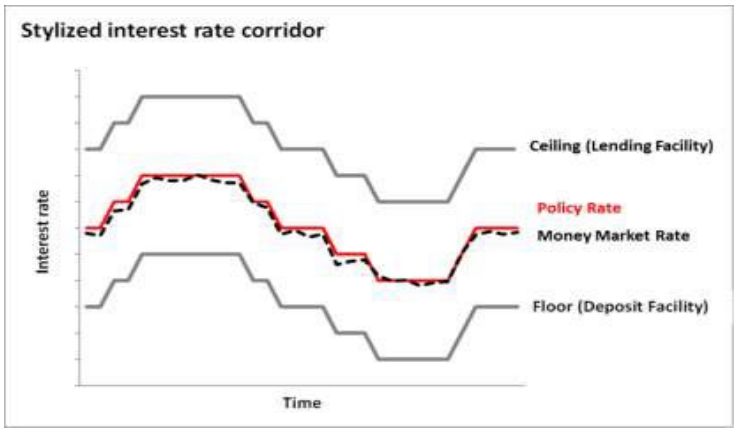
REVISED FRAMEWORK FOR MONETARY OPERATIONS UNDER THE BSP INTEREST RATE CORRIDOR (IRC) SYSTEM

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.[1] In the case of the Philippines, a narrow corridor allows the BSP to provide

[1] Bindseil, U. and Jablecki, J. (2011), "A Structural Model of Central Bank Operations and Bank Intermediation,"

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.[2]

Figure 2. Structure of the BSP's IRC System

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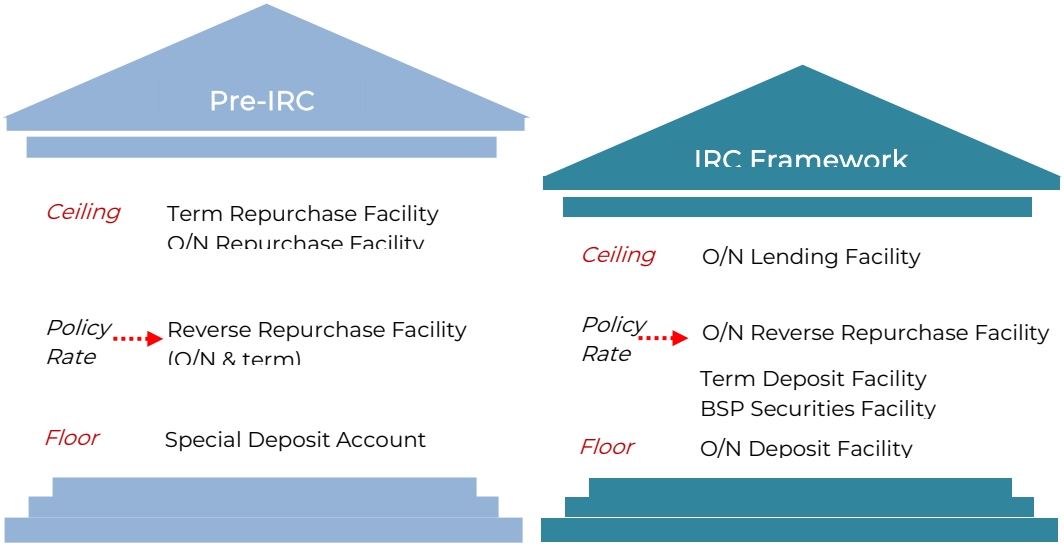
[2] The IRC implementation involved the following changes in the BSP monetary operations: modification of the RRP facility into a purely overnight facility, introduction of the term deposit facility (TDF), and conversion of standing facilities (SDA and RP) to overnight windows.



The interest rates for the two standing facilities that form the upper and lower bounds of the corridor have been set at ± 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;
3) The SDA facility was replaced by a standing overnight deposit facility (ODF);
4) The BSP introduced an auction-based term deposit facility (TDF); and
5) Starting in September 2020, the issuance of BSP Securities was included in the standard monetary operations of the BSP.

To ensure smooth transition, the BSP maintained the same set of qualified counterparties for the facilities under the IRC system. Eligible counterparties for the auctions for the RRP facility, TDF and BSP Securities Facility (BSP-SF), as well as in the OLF and ODF consist of banks and non-banks with quasi-banking functions (NBQBs). Effective 10 December 2021, digital banks were included in the set of eligible counterparties.

At the start of the IRC implementation, trust entities were eligible counterparties in the TDF and ODF. Starting 1 July 2017, access of trust entities to BSP deposit facilities was completely phased out. On the other hand, effective 10 December 2021, trust entities have been included as eligible participants for BSP Securities in the secondary market.

The prohibition on non-resident funds in the BSP's facilities for monetary operations (TDF, BSP-SF, and ODF) is maintained. At the same time, the prohibition on the sale, discounting, assignment or negotiation of banks/quasi-banks of their credit rights in TDF, BSP-SF, ODF and RRP with the BSP to clients

either on a "with or without recourse basis" shall be upheld.

Table 1. Eligible Counterparties

Instrument for Monetary Operation	Counterparties
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 and NBQBs
BSP Securities A. Primary auction B. Secondary market	 Banks and NBQBs Banks, NBQBs and Trust Entities
O/N Deposit Facility	Banks and NBQBs

The objective of using active monetary operations, through the TDF, BSP-SF, and RRP facility, is to keep market rates aligned with 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	Weekly
Submission of bids	4:30 - 5:00 PM
Eligible counterparties	Banks and NBQBs
Type of allocation	Pro rate based on bid size
Minimum bid amount	₱10 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 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 three tenors—seven days, 14 days, and 28 days—in its term deposit. The 7-day and 28-day tenors were initially offered. The BSP started offering a 14-day tenor during its 14-February 2018 TDF auction in response to the strong interest of counterparties. 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 14-day and 28-day tenors after a 7-day holding period at the appropriate pre-termination rate.

The TDF auction is 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, 14 days, 28 days Flexible to offer deposits with other tenors
Auction type	Variable-rate tender, multiple price (English) auction
Pricing	Based on bids
Auction size	Determined by liquidity forecast
Announcement of auction size	Indicative calendar released quarterly; auction offer released two (2) business days ahead
Submission of bids	9:30 - 10:00 AM
Eligible counterparties	Banks and NBQBs
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
Pretermination	Not allowed for 7-day TDF, allowed for 14-day and 28-day TDFs after suitable holding period at the appropriate pretermination rate
Announcement of results/settlements	Same day

- BSP Securities Facility (BSP-SF)

  Under Republic Act No. 7653 as amended by R.A. No. 11211 in February 2019, the BSP is granted the authority to issue negotiable securities as part of the BSP's instruments for regular monetary operations, in line with the international central bank practices.

  The inclusion of BSP Securities issuance in the standard monetary operations of the BSP in September 2020 provides an additional monetary tool for implementing monetary policy and promotes greater flexibility in managing liquidity in the financial system under the IRC framework. Particularly, the issuance of BSP Securities will be useful for absorbing excess financial system liquidity that are structural in nature.

  At the same time, BSP securities issuance will help in guiding market interest rates along the short end of the yield curve, thereby strengthening the transmission of BSP's monetary policy stance to the rest of the economy.

Table 4. Features of the BSP Securities

Feature	Details
Frequency of operations	Once a week
Maturity	28 days No limit on tenor; conditional on market and liquidity conditions
Auction type	Variable-rate tender, multiple price (English) auction for bills Uniform price (Dutch) auction for bonds (original issuance)
Pricing	Based on bids
Auction size	Determined by liquidity forecast
Announcement of auction size	Indicative calendar released quarterly; auction offer released two (2) business days ahead
Submission of bids	9:30 - 10:00 AM
Eligible counterparties	Banks and NBQBs
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
Buy-back Operations	Yes
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 during the implementation. In conducting monetary operations, the BSP will continue to calibrate carefully its monetary operations setting, guided by the BSP's assessment of market developments and liquidity conditions.

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 further 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

Since the formal adoption of IRC in June 2016, the BSP has been generally successful in achieving its primary goal in implementing the IRC system in terms of enhanced traction of the BSP policy rate on short-term market interest rates.

Consistent with the IRC objective of improving the BSP's ability to guide market interest rates, the interbank call loan rate has risen steadily above the ODF rate and is generally moving in line with the BSP's policy rate or the O/N RRP rate, with activity in the IBCL market has also increased over time.

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.

6. Operational refinements since IRC implementation in June 2016

The BSP has introduced several refinements to the IRC framework to ensure effective implementation. Said enhancements include changes in the timing of daily RRP operation and announcement of weekly TDF auction offer volumes,[3] additional tenor offered in the TDF,[4] and adjustments in the term deposit auction offer volume when necessary.[5] The process of placing funds in the ODF was likewise automated starting on 25 August 2017.[6] Meanwhile, the set of eligible counterparties in the TDF and ODF was also modified.[7] In September 2020, the issuance of BSP Securities has been included in the standard monetary operations of the BSP. Moreover, in November 2021, the set of eligible counterparties in the secondary market for BSP Securities was expanded to include trust entities as well as the inclusion of digital banks as eligible participants in the BSP's monetary operations.

[3] For greater operational flexibility, beginning with the 3 May 2017 TDF auction, the details on the offer volumes per tenor are posted one (1) week before the scheduled auction instead of a two-week lead time as previously practiced. However, starting 3 July 2019, lead time for posting was changed from seven (7) days to two (2) days to ensure that the offer volume will be based on the latest information available on market liquidity conditions.

[4] The BSP started offering 14-day tenor on 14 February 2018, consistent with the BSP's assessment of liquidity conditions.

[5] As opposed to having fixed weekly offer amounts for a given month at the early stage of IRC implementation.

[6] ODF operations are now being conducted via the Monetary Operations System (MOS), a web-based platform developed in-house to support the BSP's monetary operations. When the MOS was launched in May 2016, only the RRP and TDF auctions were conducted via the MOS while the ODF and OLF operations were operated using existing arrangements.

[7] While strictly not part of the envisioned operational refinements to the IRC system, access to BSP deposit facilities is now limited to banks and non-banks with quasi-banking functions (NBQBs) after the discontinuance of access of trust entities by end-June 2017.