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OPTIONS FOR PHILIPPINE BOND MARKET REFORM

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1. Introduction

The regional financial crisis which commenced in July of 1997 has mired many Asian economies in a period of recession, and social, political and economic uncertainty. For the most part, diagnosis of the problem has focused on a number of fundamental causes, including inappropriate exchange rate policies, bad corporate governance, moral hazard in the banking sector, excessive expansion of domestic credit, weak financial regulation, lack of transparency in financial reporting, and underdeveloped domestic bond markets. The last factor has been cited as reason why many domestic corporations in Asian countries chose to take on large amounts of foreign debt in the first place. Circumstances in domestic capital markets encouraged large amounts of foreign borrowing: high transactions costs; high rates of taxation; lack of primary and secondary bond market liquidity, etc.

With these pitfalls in mind, this paper was written with the objective of providing an initial examination of Philippine capital markets, a review of issues crucial to its development, and recommendations for further reform.

2. The Philippine Bond Market

Table 1 lists the characteristics of the two components of the Philippine bond market, the money market and the capital market:

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Table 1
Characteristics of the Philippine Bond Market

Term/ Institution	Long-Term Money Market	Long-Term Capital Market
Public	90-, 180-, and 360-day T-Bills issued by the National Government	2-, 5-, 7-, 10-, and 20-year bonds issued by the National Government, as well as public corporations and local governments Includes mortgage-backed securities (MBS) backed by Pag-Ibig mortgages.
Private	Short-term commercial paper of varying tenors issued by private corporations. Interbank lending, promissory notes and repurchase agreements	Long-term commercial paper of varying tenors issued by private corporations Includes MBS backed by mortgages of private banks

The money market and capital market in the Philippines

The distinction between the money market and the capital market lies in the tenor of the instruments traded in each market. The money market is the market for short-term securities (usually with tenors of one year or less), while the capital market is the market for long-term securities (with tenors of over one year). Note that mortgage-backed securities (MBS) are considered capital market instruments by virtue of their standard long-term tenors.

The market for money market instruments in the Philippines can be divided into the market for public and private securities. The same distinction can be made for the capital market.

Public money market and capital market securities

The market for public money market instruments, or treasury bills, is the single largest market for debt instruments in the Philippines (See Tables 2 – 3). The market for T-bills has been a very liquid market because of the historical need to

Table 2
Volume of Government Securities
(in Billion Pesos)

Issue	1990	1991	1992	1993	1994	1995	1996	1997	1998Q[1]
91-day	127.1	112.6	77.3	103.9	10.0	83.3	60.1	57.5	23.1
182-day	106.1	94.3	72.7	103.2	103.2	84.6	81.9	63.3	19.7
364-day	86.3	67.7	72.0	98.9	86.1	88.4	116.5	85.4	16.0
Total T-Bills	319.5	274.5	222.1	306.0	289.3	256.3	258.5	206.2	58.8
FRTN's		7.8	23.8	64.8	36.3				
FXTN's									
2-year					5.0	23.4	35.5	28.4	3.0
5-year						21.0	19.7	7.5	2.0
7-year							19.6	5.3	
10-year							2.0	10.3	
20-year								2.0	
Total 63.8 Securities	all	319.5	282.3	245.9	370.7	330.6	300.7	335.3	259.7

Table 3
Weighted Average Interest Rates (WAIR)
for Government Securities

Issues	1991	1991	1992	1993	1994	1995	1996	1997	1998Q[1]
91-day	24.00	21.67	15.92	12.68	12.65	11.89	12.35	13.1	17.5
182-day	25.63	23.79	16.78	13.34	13.40	12.73	12.82	13.0	18.4
364-day	26.24	25.19	18.01	14.09	14.10	13.57	13.36	13.6	20.0
WAIR T-Bills	25.15	23.27	16.87	13.36	13.60	12.75	12.95	13.28	18.48
FRTN's		n.a.	n.a.	n.a.	n.a.				
FXTN's									
2-year					13.25	13.98	13.99	13.04	17.8
5-year						14.98	14.6	12.77	19.6
7-year							15.18	16.3	
10-year							16.00	15.5	
20-year								14.4	
WAIR 18.48 Securities	all	25.11	22.63	n.a.	n.a.	n.a.	13.42	12.9	13.40

raise finances for the Philippines' chronic budget deficits. The treasury bill market is comprised of primary and secondary markets for 91-, 180-, and 364-day treasury bills, as well as cash management bills of shorter maturity issued by the Treasury when monetary conditions are unusually tight.[1]

In line with its goals of reducing its reliance on short-term debt and the goal of capital market development through the provision of a benchmark to be used for pricing private debt securities, the Philippine government started issuing Floating Rate Treasury Notes (FRTN's) in 1991. The yields of FRTN's were set on a quarterly basis at a fixed spread over 91-day treasury bills. The issuance of FRTN's paved the way for longer-term issues of Fixed Rate Treasury Notes (FXTN's), in tenors of 2-,5-,7-,10-, and 20-years, which developed a longer yield curve for public sector debt, and provided the basis for pricing longer-term private sector debt. The pace of issuance of FXTN's has been temporarily slowed down by the regional financial crisis, as tight monetary conditions reduced the demand for long-term instruments.

Apart from the BSP, banks and non-bank private investors, such as insurance companies and wealthy individual

Table 4
Holders of Outstanding Government Securities (holdings as a percentage of total outstanding government securities held)[a]

Holder	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994
Central Bank	12.8	8.9	6.1	3.7	4.6	3.4	2.4	9.0	36 8	31.4
Commercial Banks	18.9	19.6	13.0	16.2	23.5	22.9	23.0	16.6	12.2	20.4
Thrift Banks	1.9	1.5	1.2	1.5	1.4	1.1	1.6	1.4	0.6	0.6
Trust Funds	7.7	6.3	6.7	5.8	4.4	3.2	3.5	5.5	4.8	5.8
Semi-Government Entities	14.8	12.2	13.7	13.1	11.9	23.8	26.6	27.2	13.0	16.0
Non-Bank Private	43.9	51.5	59.3	59.5	54.4	45.6	42.8	39.4	31.1	26.0

Source: BSP
[a] These are the latest available figures from the BSP.

[1] The Bureau of the Treasury last issued Cash Management Bills at the height of the regional financial crisis.

investors are the largest holders of short-term government securities such as T-bills (see Table 4). Semi-government contractual savings institutions, such as the Social Security System (SSS) and the Government Service Insurance System (GSIS), are also large investors in government securities.[2] The private life insurance sector, only recently fully liberalized in terms of foreign entry, is another potential source of investment funds for capital market securities. However, they have not yet made a substantial impact on investments in private money- and capital-market securities, as the Insurance Commission has acknowledged.

It has long been proposed that government securities be sold in smaller denominations in the primary and secondary market to broaden their ownership base. However, high transactions costs are often cited as reasons why primary and secondary dealers prefer high minimum investments. Nevertheless, the GSIS recently launched a program, open to all citizens of legal age, offering mutual fund shares in T-bill and T-bonds in relatively small denominations.

The primary and secondary market for public securities

The Bureau of the Treasury[3] sells treasury bills on a weekly basis via Swiss auction to 45 primary market dealers[4], who bid competitively for the issues. Prior to each auction, a committee comprised of representatives from the Bureau of the Treasury, Department of Finance, and BSP consider the current financing needs of the government, and agree on the amount of securities to be offered. Under the Swiss auction system of competitive bidding, bids tendered by the dealers are ranked according to yield from the highest to the lowest. The committee accepts the bids with the lowest yields, with the total volume of awards subject to amounts which satisfy

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[1] The Bureau of the Treasury last issued Cash Management Bills at the height of the regional financial crisis.

[2] Only recently have SSS and GSIS corporate charters been amended and liberalized to relieve them of the burden of using their reserves for compulsory purchases of government securities. The SSS has the largest stock of government securities in its portfolio.

[3] The Bureau of the Treasury (BTr) is another attached agency of the Department of Finance.

[4] Accredited Government Securities Dealers (AGSD's) consist of commercials banks and investment banks.

the required volume of financing. Due to the dearth of acceptable private investment conduits, T-bill auctions have historically suffered from the problem of oversubscription,[5] as a flight to quality riskless assets often occurs in times of economic uncertainty.

Treasury bonds are auctioned off every other week. Unlike T-Bills, treasury bonds are auctioned using the Dutch auction system. Under the Dutch system, all accepted bids with yields higher than the winning (lowest) bid are awarded with the same yield as the winning bid. Like T-bill auctions, T-bond auctions have also been oversubscribed in the recent past.

Treasury bills and bonds have been issued in book-entry, or scripless form by the BSP since 1989. Secondary trading of treasury bills is generally liquid because of the large historical volume of securities issued under each tenor to finance chronic budget deficits, and because of the historically high private demand for risk-free short-term government securities. At present, clearing and settlement of secondary trades in T-bills is done through the Registry of Scripless Securities (R.O.S.S.) system developed and operated by the Bureau of the Treasury.

Private money market and capital market instruments

Table 5 lists the volume of money market transactions from 1990-1996. As these figures refer to the volume of transactions, they are a good indicator of money market liquidity. Note that banks tap the money market most frequently for short-term financing. Private money market transactions in the Philippines can be divided into bank-related transactions and corporate commercial paper transactions. From Table 5, bank-related transactions include the market for interbank call loans, promissory notes, and repurchase agreements. Government securities also have a substantial share of money market transactions, while private corporations have a small, albeit growing, share of money market transaction volume through the issuance and trading of commercial paper.

[5] The volume of winning bids is substantially smaller than the total volume of bids tendered.

Interbank call loans represent bank-to-bank lending of reserves. From Table 5, the increase in interbank transaction volume in 1995 was due to the entry of 10 foreign banks and a slew of new domestic banks, under more liberalized entry policies of the BSP. Promissory Notes (PN's) are mostly in the form of short-term corporate debt.

Table 5
Volume of Money Market Transactions
(in Billion Pesos)

	1990	1991	1992	1993	1994	1995	1996	1997
Banks	**798**	**965**	**988**	**1,330**	**1,557**	**2,394**	**2,816**	**2,070**
% to Total	62	58	47	47	44	59	64	57
Interbank Call Loans	731	851	889	1,259	1,438	2,295	2,761	1,987
Promissory Notes	63	81	76	70	56	78	51	79
Repurchase	4	33	23	1	63	21	4	4
Commercial Paper	**26**	**36**	**69**	**113**	**178**	**250**	**375**	**385**
% to Total	2	2	3	4	5	6	8	11
Government	**465**	**653**	**1,021**	**1,381**	**1,783**	**1,400**	**1,174**	**1,174**
% to Total	36	39	49	49	51	35	27	32
Treasury Bills	425	544	852	1,063	1,125	807	723	734
Other Government	40	109	169	318	658	593	451	135
Total	**1,289**	**1,654**	**2,078**	**2,824**	**3,518**	**4,044**	**4,365**	**3,629**
Growth		**28**	**26**	**36**	**35**	**15**	**8**	**–17**

Source: BSP

Repurchase agreements (RP's) represent short-term borrowings by banks, with government securities equivalent in value to the loan serving as collateral.[6] From the point of view of the creditor, such transactions are known as reverse repurchase agreements (RRP's). RP's may be transacted on a bank-to-bank basis, or by a bank with the BSP. As RRP's and RP's have become an instrument of the BSP in borrowing or lending

[6] i.e., the debtor agrees to "repurchase" the securities originally obtained by the creditor as collateral.

funds from or to banks, they have become an important tool of monetary policy. Recently, the BSP has ruled that RP's effectively constitute deposit substitutes, and are therefore subject to reserve requirements. The Department of Finance has also recently ruled that interest earnings by banks on repo transactions are subject to a 20 percent withholding tax. This has significantly reduced the use of repo transactions by banks, as evidenced by the figures in Table 5.

Commercial paper securities in the Philippines are usually issued in the form of short-term commercial paper (SCTP) and long-term commercial paper (LTCP) by blue-chip corporations. Both SCTP and LTCP issues require registration with the Securities and Exchange Commission (SEC). Tables 6 and 7 indicate that a term transformation occurred from 1994-1996, with commercial paper issuers displaying a greater propensity to issue long-term commercial paper (LTCP). In general, downward trends in the proportion of SCTP's issued relative to LTCP's can be observed from 1990-1992 and 1994-1996. The proportional rise in the issuance of short-term commercial paper by domestic corporations in 1993 occurred because the bull run in the stock market that year

Table 6
Sale of Commercial Paper
(In million pesos)

Year	Total	No. of Issuers	Long-Term CPs	% of Total	No. of Issuers	Short-Term CPs	% of Total
1990	6,140	4	1,000	16	16	5,140	84
1991	13,700	6	6,575	48	17	7,125	52
1992	10,743	14	6,693	62	13	4,050	48
1993	5,040	3	1,300	26	8	3,740	74
1994	21,190	8	9,700	46	21	11,490	54
1995	26,000	10	13,725	53	20	12,275	47
1996	44,600	15	34,300	77	17	10,300	23
1997	11,900	4	4,500	38	11	7,400	62
July - Dec 1997	2,400	1	500	21	2	1,900	79
Jan-Mar 1998	1,126	0	0	0	5	1,126	100

Source: SEC

Table 7
Outstanding Year-End Balances of Commercial Papers
(In million pesos)

Year	Total	L-T CPs	% to Total	S-T CPs	% to Total
1990	6,782	3,675	54.2	3,107	45.8
1991	10,589	7,615	71.9	2,974	29.1
1992	9,371	6,828	72.9	2,543	27.1
1993	12,491	9,717	77.8	2,774	22.2
1994	26,072	22,165	85.0	3,907	15.0
1995	28,896	24,977	86.4	3,919	13.7
1996	46,786	40,856	87.3	5,930	12.7
1997	27,136	23,505	86.6	3,631	13.4

Source: SEC

encouraged firms to favor the stock market over the commercial paper market for as a cheaper source of raising long-term capital. The regional financial crisis likewise reduced investor appetite for long-term financial instruments in 1997, and this is particularly evident after July 1997.

Tables 6 – 7 reflect two important trends in the market for commercial paper that were stalled by the onset of the regional financial crisis in July 1997: (a) the growing importance of the commercial paper market relative to the stock market, as it is tapped by firms for raising primary finance; and (b) the term transformation in private commercial paper issuance since 1993, indicating that firms tapping the commercial paper market for financing were increasingly tapping it for long-term funds. While the government has been a major catalyst in encouraging the use of the commercial paper market for long-term funding, there is evidence that the Philippine commercial banking system has been attempting to reduce its gap and duration risks by shifting a greater proportion of their lending activities to short-term loans.

The trend towards greater corporate reliance on the CP market has recently been halted by the recent regional financial crisis and the precipitous rise in domestic interest rates (see Tables 8 - 9). Tight monetary conditions were the result of BSP tightening in order to reduce domestic liquidity available to currency speculators. Although the crisis sparked

Table 8
Weighted Average Interest Rates of Various Instruments

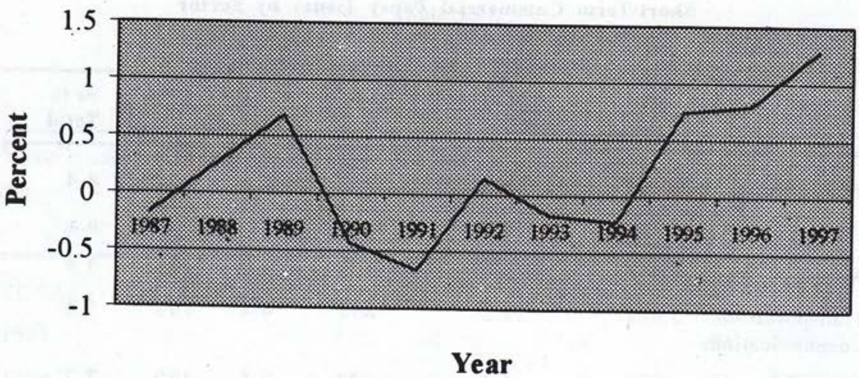
Variable/ Year		1988	1989	1990	1991	1992	1993	1994	1995	1996	1997
Lending											
Bank Lending	16.0	19.5	24.3	23.5	19.4	16.3	15	14.6	14 8	16 2	
CP Rate	13.5	17	21.2	19.5	15.6	12	9.7	11.6	12 5	12.7	
91-Day T-Bill	14.4	19.3	23.4	21.4	14.8	12.3	13.6	11.3	12.4	13 1	
Reverse RP	13.1	14.6	12.7	13.7	14.1	11.2	17.9	13.3	12 2	11.2	
ICBL	14.6	15.3	15.8	16.1	16.6	13.7	13.4	12.1	12.6	17.9	
Borrowing											
MRR 60	12.8	16.1	21.3	18.9	15	11.4	11.7	10.1 2	12	13 4	
MRR 90	10.7	15.7	21.4	17.7	14.2	11.2	11.4	9.6	10.9	11.1	
MRR 180	14.8	15.7	21.4	17.7	14.2	10.3	11.2	9.6	10 4	9.8	
Time Deposits	11.0	16.0	20.2	18.5	14.1	10.4	10.7	9.3	11.5	11 2	
Savings Deposits			5.2	5.0	10.6	8.3	8.0	8.0	8.0	9.1	

Notes: Manila Reference Rate (MRR) – the rate on short-term borrowings by banks via promissory note and time deposit transactions.
ICBL: Interbank Call Loan Rate
Reverse RP - Reverse repurchase agreement
Bank Lending Rate - on demand/time loans, bills discounted, mortgage contract, receivables and restructured loans.

Table 9
Monthly Interest Rates in 1997

Month	Commercial Paper	Treasury Bills	CP minus T-Bills	Interbank Call Loans	Money Market Average
January	10.686	10.425	0.26	11.280	10.944
February	10.432	10.136	0.29	10.651	10.490
March	10.022	9.647	0.37	10.400	10.153
April	9.872	9.523	0.34	10.183	9.943
May	10.549	10.044	0.50	13.191	12.152
June	10.776	10.278	0.49	13.531	12.668
July	13.852	12.317	1.53	22.967	19.077
August	13.400	12.597	0.80	16.645	15.113
September	14.285	13.483	0.80	16.178	15.312
October	15.598	14.382	1.21	31.397	25.524
November	15.444	14.475	0.96	17.126	16.264
December	15.659	14.859	0.80	14.820	14.944

Figure 1
Difference Between Commercial Paper Rate and T-Bill Rate
(Weighted Average)



Source: BSP, author's computations

Table 10
Registration/Licensing of Securities by Type
(Percent to Total)

Securities		1993	1994	1995	19961997	
Total	100	100	100	100	100	
Shares of Stock	68.3	78.8	72.8	62.3	39.5	
Bonds	0	0	0.1	0	0	
Commercial Papers	5.7	12.5	16.8	23.1	9.3	
Short-Term	5.7	6.8	7.9	5.3	6.3	
Long-Term	0	5.7	8.9	17.8	3	
Insurance, Pension, and Pre-Need	19.9	8.5	9.5	10.6	29.1	
Educational	8	2.9	3.1	2.7	14	
Life Insurance	2	1.1	0.7	0.9	1.5	
Pension	9.8	4.5	5.8	6.9	13.6	
Proprietary and Non-Proprietary Shares	0.4	0.1	0	3.4	21.9	
Asset-Backed Securities	1.2	0.1	0.3	0.5	0.1	
Asset-Participation Certificates		4.6	0	0	0	0
Warrants	0	0	0.4	0.03	0.2	

Source: SEC

Table 11
Short-Term Commercial Paper Issues by Sector
(in Million Pesos)

Sector	1994	% to Total	1995	% to Total	1996	% to Total
Manufacturing	2,247	12.4	847	4.5	1,223	8.4
Utilities	57	0.3	n.a.	n.a.	n.a	n.a.
Wholesale Trade	3,054	16.9	499	2.7	571	3.9
Transportation/ Communications	2,022	11.2	837	4.4	803	5.5
Holdings	720	4.0	1,277	6.5	390	2.7
Finance	9,256	51.3	15,407	81.9	10,109	69.4
Real Estate	700	3.9	n.a.	n.a.	1,469	10.1
Total	18,056		18,817		14,565	

Source: SEC; n.a. – Not Applicable

Table 12
Long-Term Commercial Paper Issues by Sector
(in Million Pesos)

Sector	1994	% to Total	1995	% to Total	1996	% to Total
Manufacturing	900	14.5	6,665	55.2	3,800	24.4
Utilities	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Wholesale Trade	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Transportation/ Communications	n.a.	n.a.	1,000	8.3	n.a.	n.a.
Holdings	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Finance	1,300	21	1,400	11.6	5,700	36.7
Real Estate	4,000	64.5	3,000	24.9	6,050	38.9
Total	6,200		12,065		15,550	

Source: SEC; n.a. – Not Applicable

a sudden surge in interest rates in general, corporate CP rates had already been gradually diverging from weighted average T-bill rates since 1995 (see Figure 1). Note that with the exception of 1992, weighted average CP interest rates were generally lower than weighted average T-bill rates from 1990-

Table 13
Registration, Insurance and Outstanding
Balance of Bonds, 1993-1997
(in millions of pesos)

Year	Registration		SalesOutstanding	Balance		
	No. of Corp.	Autho-rized Debt Ceiling	No. of Corp.	Amount	No. of Corp.	Amount
TOTAL	1	160	1	160	4	563.7
1993	0	0	0	0	4	2,262.8
1994	0	0	0	0	4	2,037.9
1995	1	160	1	160	4	631.2
1996	0	0	0	0	4	594.3
1997	0	0	0	0	4	563.7

Source: SEC

1994. This reflects the fact that most issuers in the private money and capital markets are prime corporations, and that these issuers could increasingly tap the wholesale credit market instead of the commercial bank-sourced retail credit market for cheap funds. This trend shows that raising funds in the CP market can be as cheap, or cheaper than borrowing regular loans from the banking system.

As a result of the crisis and the ensuing scramble for short-term liquidity amidst very tight monetary conditions, the demand for short-term debt instruments rose relative to long-term debt instruments. As a result of the drastic reduction in the supply of long-term wholesale credit due to the regional financial crisis and the gradual decline in long-term retail credit from the banking sector, the supply of long-term financing in the Philippines has been abruptly cut off. This has adversely affected the manufacturing sector, and more severely, the property sector, which are both increasingly reliant on long-term financing. In the meantime, the dearth of regular corporate CP issuance paved the way for pre-need and pension firms to issue their own securities, the total of which increased dramatically in 1997, as evidenced by data on securities registration in Table 10. Note that the issuance of proprietary shares, or ownership shares in exclusive golf clubs and resorts, also rose dramatically in 1997.

Table 11 lists short-term CP issues by sector. Note that, at present, finance companies are the largest corporate short-term CP issuers.

Table 12 lists the long-term CP issues by sector. Note that manufacturing, finance, property and real estate firms are the largest corporate long-term CP issuers. That property and real estate firms are the largest long-term CP issuers is consistent with the long gestation periods of real estate projects. Also note that finance firms are increasing their reliance on long-term commercial paper to finance their activities.

The dearth of Philippine bond issuance is very much evident in Table 13. Corporations prefer to issue CP's in lieu of bonds because under the Philippine Corporate Code, issuance of the latter requires approval by a majority of at least 2/3 of the corporation's shareholders, while the former merely requires the consent of the board. Nevertheless, in the Philippines, long-term CP's are traditionally considered de facto bonds.

The primary and secondary market for private securities

Private money, or capital market issues, may be sold in the primary market in either of two methods: through the underwriting process or through private placement. If sold through the underwriting process, such primary issues are sold by underwriting syndicate to their investor-clients. On the other hand, private placement may take longer to consummate, since the issuer negotiates with investors individually. Either way, both methods require registration of commercial paper with the SEC, which subjects each transaction to review. There are separate SEC rules for short-term CP's and long-term CP's. The former require the issuer to establish a credit commitment line (CCL) in an amount equal to at least 20 percent of its approved debt ceiling, usually in the form of a standby letter of credit. However, if the issuer satisfies standard financial ratios set by the SEC, the issuer gets an exemption from this requirement. On the other hand, long-term CP issuers are exempted from CCL provided they meet SEC standards regarding debt-to-equity ratios, collateral, and other financial ratios.

Once issued in the primary market, long-term CP's are normally repriced every quarter based on the terms of the issue. Secondary trading in commercial paper is very thin compared to government securities because of high transactions costs such as payment of documentary stamp tax (DST).[7]

Unlike government debt securities, trading in private corporate debt securities is not scripless, and is substantially less liquid. No automated central registry exists, as the purchase and exchange of securities is done manually. The Philippine government has plans to establish a scripless secondary market trading mechanism for private debt, but pursuit of this project is being postponed until after the elections in May of 1998.

Regulatory structure of the fixed income securities market

There are three important public regulatory institutions in the fixed income securities market: the SEC, the Bureau of the Treasury (BTr), and the BSP.

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[7] Documentary stamp taxes on bonds amount to P0.30 for each P100 face value, which is 0.3 percent, relatively higher compared to our ASEAN neighbors.

Securities and Exchange Commission (SEC)

The SEC is endowed with jurisdiction, and tasked with supervision and control over all corporations, partnerships, and associations in the Philippines. The SEC functions include licensing, registering, supervising, and regulating companies, as well as keeping public records filed by companies. The laws which endow the SEC with these powers are the Corporation Code, the Revised Securities Act, the Financing Company Act, the Investment Houses Law, the Omnibus Investments Code, and the Foreign Investments Act of 1991. The SEC has oversight functions over the Philippine Stock Exchange, as well as all over-the-counter securities trading,.and all other participants in the securities industry such as brokers and dealers. Only government-issued and guaranteed securities are exempt from SEC registration.

Table 14
Outstanding Credit Rated by CIBI
(as of December 31, 1997)

Type of Security	Issuers	Issues	Outstanding Credit Rated Line (in P Million)
Short-Term Commercial Paper	11	11	7,900
Long-Term Commercial Paper	33	43	50,015

Source: CIBI

Analytical Process

1) Interviews
2) Site/plant visits
3) Qualitative analysis of issuer's
   - Core business and industry risk
   - Market position and operations
   - Management
   - Ownership structure
4) Quantitative analysis of
   - Accounting quality
   - Profitability
   - Cash flow
   - Capital adequacy and debt structure
   - Funding and liquidity
   - Asset quality
   - Benchmarking vs. other similar firms
   - Stress test and sensitivity analysis

Source: CIBI

Bureau of the Treasury (BTr)

By June 1998, all of the fiscal functions previously carried out by the BSP in the trading of government securities will be transferred to the BTr. This includes the auction of government securities, as well as the accreditation and evaluation of government securities dealers.

Bangko Sentral ng Pilipinas (BSP)

Because the New Central Bank Act mandates the transfer of the fiscal functions of the BSP to the Bureau of the Treasury, the only type of security with the potential to come under purview of the BSP are securities issued by banks and institutions under their supervision. Such securities may include asset-backed securities issued by banks acting as originator/trustee/issuer.

Credit rating agency

Credit Information Bureau, Inc. (CIBI), the Philippines' first and only credit rating agency, was established in April 1992 through the joint efforts of the BSP, the SEC and the Financial Executives Institute of the Philippines (FINEX). CIBI's establishment, however, has thus far failed to spur bond market development because of perceptions of lack of independence from corporations being rated, as well as insufficient institutional capacity to conduct credit ratings. The void in domestic ratings development has piqued the interest of a number of foreign rating agencies who have approached the Philippine government with proposals of setting up new rating firms or purchasing an equity stake in CIBI.

CIBI presently rates the following peso-denominated publicly-issued debt securities: 1) short-term commercial paper; 2) long-term commercial paper; 3) ABS; and 4) MBS. In the future, CIBI plans to offer the following additional services: 1) corporate bond ratings; 2) bank ratings; 3) municipal bond ratings; 4) indicative ratings; and 5) company ratings.

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[8] Under the previous legislation, finance companies without quasi-banking functions were restricted to a most 19 sources of funds. Abolition of this restriction implies wider dispersion of CP investors and potentially greater demand for credit ratings.

Table 14 lists the total outstanding credit currently rated by CIBI. CIBI uses the following standards for its rating process (see box).

Credit ratings for commercial paper issues are not required in practice by regulatory authorities, although with the recent move by the SEC to disclosure-based regulation, the prospects for greater reliance on and market-driven demand for credit ratings appears good. The recent passage of the Financing Company Act liberalizes the funding sources from which finance firms, important potential issuers of CP's, can obtain debt financing.[8]

Clearing and settlement

By assuring financial market investors that trading of securities by all market players is properly accounted for and consistent with the volumes actually transacted and consummated, adequate clearing and settlement systems enhance the integrity and credibility of securities markets. To meet the requirements of an internationally acceptable system for securities trading, a system must generally meet the following requirements:

(1) True delivery versus payment (DVP) settlement – True DVP implies that there is a simultaneous, final and irrevocable exchange of cash for securities during a transaction. The system must ensure that there are sufficient securities and cash available to be exchanged.

(2) Security features should meet banking standards – Given the huge volume of trades transacted at any given moment, this feature is critical to protect the interests of market participants from unauthorized use.

(3) On-line data entry of settlement instructions by participants – This feature enables support of rapid growth of trading volumes by eliminating the need to prepare physical forms for delivery to the clearing and settlement institution.

(4) On-line real time matching of transactions – This feature is necessary to ensure completeness and correctness of information on transactions *prior* to settlement. Thus, parties should be able to view both currently unsettled and previously settled trades on-line. This reduces the incidence of failed settlements.

(5) On-line access to securities holdings – Allows participants to continuously reconcile their securities positions with those of the depository. This reduces the probability that discrepancies are not immediately addressed in order to avoid situations where participants sell securities they do not have.

In addition, an adequate clearing and settlement system must be cost effective and must comply with the requirements of regulatory agencies. With these parameters in mind, the CMDC commissioned a study in mid-1997 to determine which among the two existing clearing and settlement systems was superior.[9]

At present, there are two clearing and settlement systems for securities in the Philippines. The Registry of Scripless Securities (R.O.S.S.) is the clearing and settlement system for government securities, including T-Bills and T-Bonds. R.O.S.S. has been maintained and operated by the BTr since 1996 when it inherited from the BSP the responsibility of being the government's fiscal arm.[10] The Central Bank Act gave the BSP five years from July 1993 to divest this function, but BTr managed to assume this role two and a half years in advance of the statutory sunset requirement.

The clearing and settlement system used by Philippine Central Depository, Inc. (PCD) is presently being utilized in the equities market for trades in the Philippine Stock Exchange.

[9] A description of the controversy over which system was superior is described in the next chapter.

[10] As mandated by the Central Bank Act of 1993 (R.A. 7653).

The PCD system is based on the Australian computer system FINTRACS, which is presently used in Australia, New Zealand and Western Canada. PCD added enhancements for the program to suit the Philippine environment. PCD started operating its scripless trading system in late-1996, reducing settlement from 27 days to 4 days.

Underwriters and dealers/brokers

In the Philippines, investment banks or investment houses are the primary underwriting agents for securities issues. The underwriter assists in the structuring and offering of private securities through: (1) the creation of an underwriting syndicate to help broaden the market for corporate securities; (2) the registration of the bonds or commercial paper with the SEC; and (3) acquisition of a credit rating from CIBI. Underwriters normally earn a spread of between 1 percent to 1.5 percent of the total value of the issuance.

Securities dealers or brokers may purchase, sell or resell securities. They earn a spread from the selling and purchasing price of the securities. Depending on the transaction, dealers or brokers may purchase and sell securities on their client's behalf, or for their own account. The bull run in the stock market in 1993 brought hefty profits for the securities industry. However, the regional financial crisis has forced many brokerages and investment houses into retrenchment.

Recent developments in securities markets

In 1995, the Philippine government was the recipient of a 15-year $150 million Technical Assistance (TA) Loan for Capital Market Development from the Asian Development Bank (ADB). The objective of the project was to promote a diversified, competitive, and vibrant capital market to raise allocative efficiency of long-term savings and accelerate economic growth. The goals of the program included: (1) introducing internationally accepted standards in the conduct of business in the stock market; (2) Restablishing the capital market coordination committee to foster increased government to capital market concerns; (3) strengthening the regulatory and enforcement capability of the SEC; and (4) improving stock exchange operations.

Because the TA loan encompasses a very broad range of activities, it has had a profound effect on the functioning of Philippine capital markets.

Based partly on studies on the capital market conducted under an earlier TA granted by the ADB, the United States Agency for International Development (USAID) initiated a Capital Market Development Project (CMDP) which ran from 1993–1997. Under the CMDP, the Philippines received a $13.5 million grant to implement reforms in the SEC, as well as in private sector institutions involved in capital markets. An offshoot of the CMDP was the establishment of the Capital Markets Development Council (CMDC), a committee comprised of senior public and private sector representatives tasked with coordinating inter-agency activities to promote capital market development. Once established, the CMDC became a forum for public-private debate on financial market development.

A recent innovation in public capital market instruments is the development of a municipal securities market. Under Republic Act 7160 (The Local Government Code), local government units (LGU's) were permitted to borrow to finance capital investment projects and income-producing development livelihood projects, and to stabilize public finances. The BSP issued guidelines for bond floatation by LGU's in 1994, and a number of cities and provinces have issued securities under these guidelines. Notable municipal bond issues to date include the Cebu bonds issued in 1991, as well as the housing-related bonds floated by the municipality of Claveria, Misamis Oriental, and the city of Legaspi in 1995. The market for municipal bonds is a nascent market, with underwriters confined to small financial advisory firms and investors mostly comprised of local citizens of the bond-issuing municipalities.

Partly responsible for the relative dearth in domestic corporate bond issuances in the years 1993-1997 was the re-entry of the Philippine government and prime private corporations to international capital markets. Improved sovereign credit ratings, as well as lower external debt ratios prompted the Philippine government to tap international debt markets again with the innovative Brady Bond exchanges in 1995 and 1996. Private corporate issuers soon followed, and private corporate foreign debt rose quickly, from just 13.26 percent of total foreign liabilities in 1990 to about one-fourth of the total in late 1997. However, the rash of international corporate debt

Table 15
Summary of Taxes on the Financial Sector

Type of Tax	Tax Base	Tax Rate
Income Taxes		
Corporate tax	Net income	34% in 1998 33% in 1999 32% in 2000
Withholding tax	Interest Income	20%
Gross Receipt Tax (GRT)		
Commercial banks	Gross income	0-5%
Thrift banks	Gross income	0-5%
Rural banks	Gross income	Exempted for 5 years
Leasing companies	Gross income	0-5%
Life Insurance companies	Premiums	0-5%
Documentary Stamp Tax		
Bonds and stocks	Face value	0.75-1%
Bank checks and drafts	Number of checks and drafts	P1.50 per check
Life insurance	Amount insured	0.25%
Non-life insurance	Premium	12.5%
Value-Added Tax (VAT)		
Dealers of securities	Gross income	10%
Non-life insurance Companies	Premiums	Exempted
Pre-need companies	Gross receipts less contributions to trust funds	10%

Source: World Bank (1997) and updates from The Tax Reform Act of 1997 (R.A. 8424)

issuances is more reflective of structural impediments in the domestic bond market.

Another innovation in Philippine securities markets is the nascent market for mortgage backed securities or MBS, are securities backed by cash flows from mortgages originated by banks and non-bank financial institutions. The Philippine government is actively encouraging the development of MBS markets in the Philippines as it aims to reinvigorate housing markets. Among the promising programs for MBS development is the proposal by Urban Bank to securitize mortgages originated by Pag-Ibig, the state-owned provident fund for housing.

Table 16
Structure of Taxation of Financial Instruments

Kind of Tax on Disposal/ Securities	Tax on Issuance/ Acquisition	Generated in Holding	Tax on Income Secondary Trading[b]
Short-Term and Long-Term Notes, Bonds and Debentures			
A. Public			
	P0.30/P200.00	None	None
Withholding Tax	None	20% Final Tax	None
Gross Receipts Tax	None	Graduated GRT Rates[c]	None
Income Tax	None	None Tax Rates[d]	Graduated Income
B. Private Bonds, Commercial Paper, and Asset-Backed Securities			
1. Bonds and Asset-Backed Securities			
Documentary Stamp Tax	P0.30/P200.00	None	None
Withholding Tax	None	20% Final Tax	None
Gross Receipts Tax	None	Graduated GRT Rates[1]	None
Income Tax	None	None	Graduated Income Tax Rates[2]
2. Commercial Paper			
Documentary Stamp Tax	P0.30/P200.00	None	None
	None	20% Final Tax	None
Gross Receipts Tax	None	Graduated GRT Rates[1]	None
Income Tax	None	None	Graduated Income Tax Rates[2]

[b] Taxes on disposal or secondary trading are capital gains taxes.

[c] Graduated GRT Rates are defined in Section 121 of R.A. 8424 as:

Short-term maturity (not in excess of 2 years)		5%
Medium-term maturity	(over 2 years but not exceeding 4 years)	3%
Long-term maturity	(1) Over 4 years but not exceeding 7 years	1%
	(2) Over 7 years	0%

[d] Graduated Income Tax Rates are defined in Section 27 of R.A. 8424 as:

Up to December 31, 1997	35%
Effective January 1, 1998	34%
Effective January 1, 1999	33%
Effective January 1, 2000	32%

Table 16 (cont.)
Structure of Taxation of Stocks

Kind of Securities	Tax on Issuance/ Acquisition	Tax on Income Generated in Holding	Tax on Disposal/ Secondary Trading
1. Shares listed in PSE			
Documentary Stamp Tax	P2.00/P200.00	None	P1.50/P200.00
Withholding Tax	None	None	None
Gross Receipts Tax	None	None	None
Income Tax	None	Tax on dividends 6% by 1/1/1998 8% by 1/1/1999 10% by 1/1/2000	Capital gains are excluded from the computation of gross income
Other Taxes	If up to 25% of out-standing shares is issued, 4% of gross value If from 25% to 33.33% of outstanding shares is issued, 2% of gross value If above 33.33% of outstanding shares is issued, 1% of gross value	None	Tax on exchange of $^1/_2$ of 1% of gross selling price
2. Shares not listed in PSE			
Documentary Stamp Tax	P1.50/P200.00	None	P1.50/P200.00
Withholding Tax	None	None	None
Gross Receipts Tax	None	None	None
Income Tax	None	Tax on dividends 6% by 1/1/1998 8% by 1/1/1999 10% by 1/1/2000	If capital gains are less than or equal to P100 K, then 5% of capital gains If capital gains are greater than P 100 K, then 10% of capital gains
Other Taxes	None	None	None

Once issued, the Mortgage-Backed Securities (MBS) will be listed and traded in the Philippine Stock Exchange in book entry (scripless) form, while clearing and settlement will utilize the Philippine Central Depository's (PCD) automated Financial Transactions System (FINTRACS) system, which is presently being used for equities transactions by the PSE members.[11] To encourage demand by smaller investors in MBS, Urban Bank proposes to sell MBS in minimum denominations of P10,000. The target launch of this project is in mid-October of 1998. In order to diversify the risk in its securitization operations, Urban is presently looking for other banks to join its endeavor. The Department of Finance of the Philippines has expressed its approval for the Pag-Ibig-Urban Bank securitization, on the grounds that it will be a catalyst and help facilitate further MBS development.

3. Options for Future Reforms to the Philippine Bond Market

As Figure 1 demonstrates, it is entirely possible for the weighted average interest rate (WAIR) for commercial paper to fall below the WAIR for T-bills. This is a very fortunate circumstance for bond issuers (especially blue chip issuers), and demonstrates the potential of the Philippine bond market to become a low-cost source of funding for private corporations.

Table 15 presents a cross-country comparison between the Philippine bond market relative to bond markets in neighboring ASEAN countries. Table 16 summarizes several important issues presently facing Philippine capital markets. Some of the issues constitute key impediments to primary and secondary markets for short-term and long-term commercial paper (i.e., bonds).

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[11] The PCD's FINTRACS system is capable of carrying debt securities in addition to equities. While banks have been encouraged to use FINTRACS, a row has developed over the insistence of the Bureau of the Treasury that banks continue to use its own R.O.S.S. system, notwithstanding studies showing the latter to be inferior, as well as endorsement by the CMCC of the FINTRACS system. Thus, while banks utilize R.O.S.S. for trading government securities, equities are presently traded using FINTRACS. The continued use of two separate systems constitutes a hindrance to further development of a more liquid private bond market, because banks presently participating in PCD cannot have access to the trading of public debt securities, for which they still have to register an account with R.O.S.S.

Prior to strengthening regulations governing financial markets and establishing competitive market mechanisms for bond market development, there is a more fundamental need to strengthen corporate governance.

International comparisons of bond market development among developing countries indicate that a fundamental problem in capital markets in such countries is the lack of liquidity in domestic bond markets. This lack of liquidity is at the same time a supply-side and demand-side problem. The problem coming from the supply-side is usually due to the insufficiency of the volume of debt that has been issued for a particular security (also at a particular maturity). The problem coming from the demand-side is usually due to the small and limited number of investors or regulatory constraints on eligible investments by potential investors. Both of these problems conspire to discourage or provide disincentives for secondary market trading. Thus, most economists writing on the causes of capital market underdevelopment point to the need to liberalize capital market regulations on securities and investors to increase primary and secondary market liquidity.

The arguments for liberalizing regulations notwithstanding, it appears that strengthening corporate governance is the key fundamental prerequisite for developing domestic bond markets, and the same will be true for the case of the Philippines. Corporate governance is the key to bond market development because the demand for a bond issue is ultimately dependent on the credibility of the issuer to deliver payment. Thus corporate issuers should be able to operate in an environment that provides them with incentives to perform well, minimizes moral hazard, and maximizes incentives to strengthen transparency in financial reporting and incentives to strengthen the principal-agent relationship between managers and bondholders/investors.

Good corporate governance is also required from the other institutions guaranteeing that the investor will be paid on a particular time. Thus, bond market development hinges not only on the issuing corporation, but also on the underwriter(s), the bank that may provide the financial guarantee, the credit rating agency, the organized exchange in which the bond is traded, and other institutions. One reason why it is so difficult to develop bond markets in the first place is the need fo proper governance and incentives in so many institutions other than the issuer. Good governance in these other institutions must also be complemented by discipline coming from market forces. This is because market distortions in the provision of financial guarantees, credit rating and underwriting all provide weak links from the issuer to the investor from where risks can be amplified. Bond market development relies on the concomitant workings of a system that can accurately recognize, assess, and price risks. In addition, transparency in financial reporting and accurate information about firms is also crucial to assess risk. The presence of a weak link in the process significantly reduces demand for fixed income securities. All of these factors then hinge delicately on the ability of the regulatory bodies to enforce rules and ensure the existence of an efficient market-oriented mechanism of bond issuance and trading. Thus, the strength of regulations and regulatory agencies constitute the backbone of any bond market.

In this regard, recent initiatives to amend the Corporation Code, and to pass the proposed Securities Regulation and Enforcement Act (SREA) of 1998, the Revised Investment Company Act (RICA), as well as the Revised Insurance Code, are very welcome developments. However, scrutiny of these pieces of legislation still leave some room for improvement from the bond market perspective, and are left as a separate topic for another paper.

The implementation of good corporate governance in turn hinges on the technical and institutional capacities of our regulatory institutions — the SEC, the BSP, and the Insurance Commission. Upgrading regulatory and supervisory skills in these institutions will constitute a great boon to our financial markets in general, not just the bond market. Skills here must keep pace with the abilities of the private sector.

The bond market is shallow and lacks liquidity (i.e., there are very few investors, and very few classes and types of securities). The market is dominated by government securities and there is a lack of variety in private bond issues.

Liquidity is a fundamental prerequisite for bond market development. Without liquidity, or the ability to exchange assets for cash, secondary markets for bonds would be non-existent, and most trading activity would be concentrated in short-term securities which are quickly redeemable. There would be little or no demand for long-term securities, thus potentially credit-constraining projects and pursuits with long gestation periods (such as infrastructure projects). In this light, the sure sign of lack of liquidity in a bond market is the ensuing scramble for short-term securities during a crisis period.[12] The absence of liquidity in the bond market may be magnified by the lack of variety in investors and instruments, as well as to the type and number of eligible investors in the already narrow range of eligible instruments. Ultimately, these circumstances contribute to the "buy and hold" culture that stunts the development of secondary markets.

Once corporate governance is strengthened, regulatory constraints on the type and number of eligible investors and securities may be addressed. In the Philippines, the number of eligible investors is constrained by a number of factors, most importantly by some institutional constraints on eligible investments imposed by regulators and/or legislation.[13]

One characteristic of the Philippine bond market that contributes to its shallow nature is the domination of the market by government securities (see Table 5). The dearth of private sector issues is probably due to supply-side constraints, such as the inadequate number of blue-chip firms which are current and potential issuers of fixed income securities. The inherently small number of potential blue-chip issuers makes the need for strengthening corporate governance all the more crucial, for without established reputations, smaller firms must rely on their own integrity and transparency of operations to be able to lower the costs of issuance.[14]

[12] At the height of the financial crisis in 1997 and early 1998, the Philippine government faced a situation where there was no demand for T-bonds, but overwhelming demand for cash management bills with tenors shorter than those of regular T-bill issues.

[13] Examples include limits or exclusions of certain types of securities eligible as insurance company, SSS, or GSIS investments. For example, it is not clear whether asset-baccked securities and other derivative instruments are considered as admitted assets not eligible investments under the current and proposed revisions to the Insurance Code.

[14] Addressing this problem implies that the CIBI, in addition to the investors and other participants in the bond market, must have the capacity to assess small and medium scale firms.

Table 17
Cross-country bond market comparisons

	Philippines	Thailand	Indonesia	Malaysia
Size of domestic bond market in 1997 (% of GDP)	11% (about 10% comprised of government securities)	11% (mostly corporate securities)		
Special secondary trading mechanism for corporate bonds	None	Thai Bond Dealing Center (TBDC)	Over-the-Counter Fixed Income Service (OTC-FIS)	Bond Information and Dissemination System (BIDS) facilitates over-the-counter secondary trading
Clearing and Settlement	Government securities cleared and settled via Registry of Scripless Securities (ROSS)	Scripless over-the-counter trading with real time gross settlement and true delivery versus payment system available soon	Scipless trading available since 1998	SPEEDS scripless trading system
Credit ratings	Not mandatory (Credit Information Bureau, Inc. – CIBI)	Mandatory (Thai Rating and Information Services – TRIS) TRIS international partner; Standard and Poors	Mandatory (PEFINDO) PEFINDO international partner: Duff and Phelps	Mandatory (Rating Agency Malaysia Berhad – RAM, and Malaysian Rating Corporation Berhad – MaRC) RAM international partner: Duff and Phelps MaRC international partner: Thomsom BankWatch

Table 17 (cont.) - Cross-country bond market comparisons

	Philippines	Thailand	Indonesia	Malaysia
Stamp tax for bond trading	0.15% based on face value	15% stamp tax levied only on primary purchase of securities No withholding and capital gains	Information not available	Trading in Cagamas securities subject to exemption from stam duties
Other taxes	20% withholding tax on interest earnings	taxes for domestic investors No benchmarks available. Some domestic bond investors use the		Interest income on investments in private debt securities by domestic investors exempted from
Benchmark reference rate for pricing long-term credit	Short-term treasury bill rates are usually used to price long-term credit. However, the Philippine government is trying to establish liquidity in the market for Treasury Bonds	rate of return on stock investments and deposits as benchmark. Others derive a synthetic yield curve using the convered interest parity condition.	Various synthetic rates have been created to serve as benchmarks, but there no benchmarks based on government securities	Benchmark bonds were issued by Khazanah Holdings, the Malaysian govern-ment's investment arm

While there appears to be enough liquidity in the government securities market, it is only present over shorter maturities, such as the Treasury Bill market. Liquidity is still not sufficient over longer-term issues. This has contributed in part to the absence of a reliable benchmark reference pricing mechanism, with T-bill rates still being used as a reference to price private sector long-term debt. To address this, the government must continue to increase the regularity and volume of long-term T-bonds, and to stimulate secondary market trading in them.

In addition to the lack of liquidity in longer-term securities, there is a crucial lack of information on secondary market trading activity in T-bills. The latest figures available from the government on the breakdown of investors in T-bills is from 1994. Without sufficient investor information, both the government and the private sector have very little idea of the potential demand for both public and private securities. Further development of the bond market is curtailed when regulators are not aware of the size of the potential market.

The absence of additional financial sector infrastructure that encourages bond market development.

Financial sector infrastructure would include financial guarantee firms and institutions, such as banks, that are willing to provide additional security (be they additional guarantees or standby letters of credit) for structured bond issues. They also include credit bureaus, corporate research firms and other information-producing institutions.

The housing sector in the Philippines is rather fortunate to have a financial guarantee firm (the Home Insurance Guaranty Corporation or HIGC). The presence of a state-run guarantee firm has helped spur the recent development of the market for asset-backed securities (ABS) in the Philippines. In securitizing domestic mortgages originated by private banks and other public sector housing institutions, HIGC provides a guarantee on the mortgage-backed securities (MBS), increasing their attractiveness to domestic investors. The HIGC guarantee is treated as a sovereign guarantee, and in addition, carries with it a tax break of up to 8.5 percent on interest earnings to MBS investors. The presence of a private financial guarantee firm to provide additional protection for bond investors may provide an added boost to bond market development.

In addition, the establishment of additional institutions, such as credit bureaus and institutions engaged in domestic corporate research, all augment public and private corporate information sources and enhance the transparency of reporting on corporate activities. Transparency of financial reporting is also facilitated by adoption of internationally accepted disclosure and accounting standards. These are all within the purview of financial and corporate regulators. Therefore, institutional capacity to implement such standards must also be strengthened.

Absence of a formal trading venue for bonds and other fixed-income securities

Among the challenges facing Philippine bond markets, the absence of a formal, organized venue for trading fixed income securities is one which has contributed to its underdevelopment. The Philippine Stock Exchange has for some time contemplated the idea, but no action has been taken thus far. In contrast, Indonesia and Thailand have initiated the establishment of formal bond exchanges (see Table 17).[15]

Establishment of a formal bond exchange spurs bond market development by creating a unified venue for primary bond issuance and secondary trading. The association of bond dealers and investors ensures that the interests of the bond market are protected.

Absence of proper benchmark reference mechanism for pricing credit

Benchmark bonds serve as a reference not only for pricing credit at similar tenors, but also for pricing new bond issues in the primary market. In this regard, the yield curve from sovereign bonds usually serve as benchmarks because of their lower risk and high liquidity profile.

The general absence of a benchmark reference pricing mechanism has a number of adverse effects on credit markets in general. First, there are no accurate methods of pricing any private sector debt beyond one year in maturity. The current standard practice is to use the current yield on 90-, 180-, or 360-day T-bills, which are inappropriate benchmarks for any debt beyond one year in maturity.

The Philippine government has recently begun to address the need for a benchmark pricing mechanism by gradually introducing zero-coupon Treasury bonds in 3-, 5-, 7-, 10-, and 20-year maturities (see Tables 2 - 3).[16] Unfortunately, the efficacy of this practice is undermined during periods of financial distress, such as the regional financial crisis, when there is a scramble for short-term securities.

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[15] The Indonesian bond exchange is the Over-the-Counter Fixed Income Service (OTC-FIS) located in the Surabaya Stock Exchange, while the Thai bond exchange is known as the Thai Bond Dealing Center (TBDC).

[16] The reason why zero coupon T-bonds are the appropriate instrument for creating a benchmark yield curve is that they eliminate the reinvestment risk posed by coupons from a coupon bond. Yields for T-bonds therefore accurately reflect the rate of return on a straight loan from the investor to the issuer to be paid only upon maturity.

Need for enhanced credit rating capacity

Insufficient ratings capacity constitutes a binding constraint to bond market development for two reasons. First, bond market development relies heavily on the creation of market liquidity within the same type of securities and across different types of securities. Should there be inadequacies in ratings capabilities, this would constrain the potential variety of securities issued and traded, confining activity to a small number of instruments. Second, insufficient ratings capacity raises the inherent risks in bond investments in general, reducing demand for bonds.

For this reason, bond market development in the Philippines should include a concomitant effort by Philippine capital market regulators to strengthen the credit rating industry. Recent debate on this issue has focused on the following issues: (1) allowing domestic ratings capacity to be enhanced through joint ventures with foreign partners; (2) facilitating the establishment of additional credit rating agencies; and (3) making ratings mandatory for all bond issues. The first issue is already being addressed by the Philippine government, which is actively encouraging CIBI in its pursuit of a foreign partner.[17] The second issue is under consideration for purposes of instilling market discipline in the domestic credit rating industry.[18] The third issue would induce demand for ratings services, making them more profitable ventures, and would also facilitate increased corporate transparency for all bond issuers.

Lack of facilities for financing inventories of securities

More well-developed financial regimes employ brokerages and investment banks to serve as market makers in the bond market. These market makers buy and sell securities for their own account, often, enhancing liquidity in the process. In order to encourage the taking of positions in securities, these market makers must have access to financing facilities (often, these are in the form of repurchase and reverse repurchase facilities). The absence of such facilities discourage market-making.

[17] CIBI has explored relationships with Standard and Poors, as well as Duff and Phelps.

[18] Countries such as Malaysia and India practice dual ratings.

Complicated system of taxation of financial transactions and intermediaries

Among the potential reforms facing Philippine capital markets, perhaps the most controversial, entail reforms to financial sector taxation. For lack of time, the reforms on financial sector taxation were not taken up during deliberations for the Comprehensive Tax Reform Program (CTRP). Tables 15 - 16 highlight the elaborate system of financial sector taxation in the Philippines for both institutions and transactions.

Based on comparisons with our ASEAN neighbors in Table 17, the 0.15 percent documentary stamp tax, as well as the 20 percent withholding tax on interest income on bond investments in the Philippines is still relatively high. In Thailand, secondary trading in bonds is exempt from stamp taxes and withholding taxes, while in Malaysia, secondary trading in Cagamas bonds, a widely traded government security, is exempt from stamp taxes and other duties, while interest earned from domestic investments in private debt securities are exempt from withholding taxes. Financial sector tax reform should consider these aspects of reform. The Philippine government has made it clear that it desires a tax-neutral financial sector tax reform. Thus, the argument for lowering taxes on secondary market trades, as well as lowering withholding taxes on interest income, depends on the price elasticity of demand for secondary market trades. This aspect of financial sector development should be explored in-depth.

4. Conclusion and Recommendations for Going Forward

Considering the issues taken up in the previous section, further development of the Philippine bond market will require strong commitment from all market participants: investors, regulatory agencies, and the Philippine government. A suggested blueprint for moving forward at this point consists of the following *more or less* sequential steps:

1) Though not emphasized in this paper, the most fundamental first step is to restore macroeconomic stability. Future reforms hinge on an environment of certainty. Macroeconomic stability also provides

a good foundation for economic growth and subsequent mobilization of domestic savings by primary investors in capital markets: insurance companies, pension funds, mutual funds, and pre-need firms. Strengthening such institutions comes under the purview of the SEC.

2) Second, continue the process of strengthening corporate governance. This enhances the integrity of the primary product — the corporate bond.

3) Third, ensure that financial institutions and markets operate in a competitive environment. This requires commitments on the part of the SEC, the BSP and the IC to improve rules and regulations, enforcement and monitoring. This also requires them to enhance their internal capacities for regulating such markets.

4) Fourth, competitive financial markets require transparency and timeliness in financial and corporate reporting. Thus, domestic credit rating capacity should be strengthened. Also, the establishment of bond market support structures, such as private credit bureaus and financial guarantee firms should be encouraged.

5) Fifth, an organized over-the-counter private and public bond exchange may be established, similar to the ones operating in Indonesia, Malaysia, and Thailand. A unified bond exchange could exploit scale economies in information-gathering, primary and secondary trading, and clearing and settlement, leading to lower transactions costs and ultimately, lower interest rates.

6) Within the framework of an organized bond exchange, other reforms may be implemented. Tax breaks for bond investors may now be explored further. However, it is recommended that the system in Thailand be adopted, where stamp duties are only levied on the primary issuance of a security.

And once their internal regulatory capacities are strengthened, financial regulators should consider liberalizing rules for eligible assets and investors. The bond exchange may now provide a more suitable venue for utilities, public sector corporations, local governments, and private sector infrastructure proponents to raise capital. Existing clearing and settlement systems should be strengthened. If possible, merging ROSS and PCD to facilitate trades across stocks and fixed income securities.

7) Finally, the government may continue enhancing liquidity and volume of treasury bond issues to facilitate creation of a benchmark yield curve.

Table 18
Key Issues Facing Philippine Capital Markets

Issues	Comments
Need to strengthen corporate governance and competitive market mechanisms governing the bond market. Also need to strengthen regime of transparency and accuracy of financial reporting. Strengthen regulatory system to specifically address issues related to bond and commercial paper market.	Strengthen institutional capacity of the Securities and Exchange Commission (SEC). The SEC is presently lobbying for amendments to the Corporation Code, and the Securities Regulation and Enforcement Act.
Bond market is shallow and lacks liquidity (i.e., there are very few investors, and very few issues). Bond market is dominated by government securities. There is lack of variety in bond issues.	Increase homogeneity and regularity of government security issues. Widen eligible assets that can be purchased by pension funds, insurance companies, and other financial institutions subject to prudential limits. Real time gross settlement (RTGS) system for government securities to be established to reduce trading risks.
Absence of financial sector infrastructure that encourages bond market development.	Encourage the practice of financial sector guarantees, standby letters fo credit, and other financial guarantee mechanisms subject to proper risk-adjusted pricing.
Absence of a trading venue for bonds.	Philippine Stock Exchange has delayed establishment of a separate trading board for fixed income securities. This is probably due to lack of issues due to the present financial crisis. Encourage mobilization of domestic savings to finance domestic infrastructure projects through the domestic bond market.

Table 18 (cont.) - Key Issues Facing Philippine Capital Markets

Issues	Comments
Absence of proper benchmark reference yield curve. Treasury bills rates are used to price debt greater than one year in maturity.	Government is presently phasing in regular issues of longer maturity government securities, but the market in them is not yet sufficiently deep or liquid to encourage secondary trading.
Need for enhanced credit rating capacity.	Credit Information Bureau, Inc. should enhance capacity to conduct ratings by establishing ties with foreign partners.
Lack of facilities for financing inventories of securities.	The Securities and Exchange Commission (SEC) and/or the central bank may consider such facilities for brokerage houses and investment banks.
Complicated system of taxation of financial transactions and intermediaries.	Simplified system of taxation required.