The corporate bond market in the Philippines

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Introduction

"Expanding, but still nascent" would be a good way to characterise the corporate bond market in the Philippines. From the late 1980s until 1996, the market grew at a steady pace, but declined in the wake of the Asian financial crisis, and even more following a major political event in 2001. Although the downward trend was reversed in 2004, when issuance of short- and long-term commercial paper reached more than three times the level in 2003, the present bond market remains largely one for government debt.

Corporate bond trading lacks transparency, as it is done bilaterally and over-the-counter (OTC). However, as the Fixed Income Exchange, a major market infrastructure reform project, becomes fully operational before the end of 2005 improved transparency by way of corporate bond listings is expected to be achieved.

I. Sound macroeconomic backdrop

The growth potential of the Philippine corporate bond market is supported by improving macroeconomic fundamentals.

In the last quarter, despite the challenging political situation, the domestic economy continued to grow amid a relatively low core inflation rate. Domestic interest rates also continued to ease due to adequate liquidity in the system combined with some decline in the risk premium on public debt arising from improvements in fiscal conditions. To address emerging inflation risks, the Monetary Board recently tightened the monetary policy stance by way of hikes in the reserve requirement ratios and policy rates. The peso continues to strengthen against the US dollar on the back of sustained dollar remittances from overseas Filipino workers and higher portfolio capital flows. For its part, the national government has consolidated efforts to improve its fiscal position by way of additional revenue collections, administrative reform measures and the implementation of a revised and expanded value-added tax.

On the corporate side, the financial performance of the country's major companies during the first half of 2005 was generally strong. In the banking sector, key performance indicators show asset expansion, improvements in loan and asset quality, double-digit growth in deposits, profitable operations, adequate liquidity and sufficient capitalisation.

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II. Corporate debt issuance expanding, but still small

The levels of short- and long-term commercial paper issuance (which by legal definition includes corporate bonds) by Philippine companies has also exhibited an increasing trend recently. However, it still remains diminutive compared to the well-established government bond market (See Table 1).

Table 1

Outstanding corporate bonds in the Philippines

(PHP billions)

	2002	**2003**	**2004**	**End-June 2005**
Total outstanding STCP[1] and LTCP[2]	7.860	12.280	43.597	23.561
Registered with the SEC	5.200	10.800	11.960	5.000
Rated corporate issues	20.972	112.980	121.178	120.307
Government securities - domestic	1,046.731	1,673.285	1,941.420	1,975.743

Notes: [1]STCP, or short-term commercial paper, is debt with a maturity of 365 days or less. [2]LTCP, or long-term commercial paper, is debt with a maturity of more than 365 days. The term includes, but is not limited to, bonds and notes. Only includes securities issued by residents of the Philippines and excludes those issued by the national government and the central bank.

Sources: Bondware; SEC; BIS.

The difference in statistics in the first three categories in Table 1 above is due to the exemptions allowed by the Securities and Exchange Commission (SEC) on registration and ratings of securities. Furthermore, since trading at present is bilateral among private parties, there is no repository of reliable consolidated data for commercial paper issuance that includes issues sold to the public and those sold to selected private investors under a negotiated placement basis (which current statistics may not easily capture).

According to Bondware, 19 issuers had paper outstanding at end-June 2005. The Bondware data do not include the paper of four corporations that have been registered with SEC and the securities issued by MRT Funding Corporation worth PHP 98 billion which was rated by PhilRatings - the only domestic credit rating agency in the country.

The Bondware data, which showed aggregate issuance in the Philippines of USD 1,537 million at end-June 2005, also showed that 55% of corporate issuance was by the private sector; 31% by public corporations; and 13% by commercial banks. Total corporate bond issuance grew by 56% in 2003 and 255% in 2004.

The bulk of private sector issuance is by companies engaged in property development, with the remainder by the communications (telcos) and power generation sectors. Three commercial banks issued bonds worth a total of PHP 11,000 million. Only one corporation issued dollar-denominated bonds, while three foreign-owned corporations operating in the Philippines issued paper amounting to PHP 4,950 million. Overall, the single biggest issuer was the National Power Corporation, which issued bonds worth PHP 17,613 million, or roughly USD 316 million.

The yields on the issues ranged from a low of 6.8% to a high of 15.4%, depending on the tenor and issuer. Most of the bonds carried a fixed-rate coupon.

Given the Bondware data, the Philippine corporate bond market is apparently among the most underdeveloped in the region (Table 2). Going forward, we believe that the various capital market reform initiatives that are underway will ultimately create a more conducive environment to the development of a corporate bond market.

Table 2

Estimated value of outstanding bonds in the region

(USD millions)

	Amount	% of total
Australia	117,240	9.9
China	180,186	15.3
Hong Kong SAR	5,625	0.5
India	6,706	0.6
Indonesia	22,096	1.9
Japan	629,763	53.6
Korea	155,292	13.2
Malaysia	23,863	2.0
New Zealand	3,660	0.3
Philippines	**1,537**	**0.1**
Singapore	14,700	1.3
Thailand	14,812	1.3
Total	1,175,480	100.0

Source: Bondware.

III. Unique characteristics of the market

The Philippine domestic corporate bond market has a number of unique features.

a. Commercial paper includes corporate bonds

The existing Philippine laws define commercial paper to include corporate bonds as follows: "a means of evidence of indebtedness of any person with a maturity of more than three hundred sixty-five (365) days. The term shall include, but not be limited to, bonds and notes".

The same registration procedures (and exemptions) apply to both types of commercial paper, which includes corporate bonds. In fact, both have a stiff stockholder approval requirement of a two thirds majority, which is founded on existing provisions of the Philippine Corporation Code.

b. Registration with the SEC is not required for all bond issues

The general rule is that all securities sold or distributed by any person or entity within the Philippines be duly registered with the SEC. However, the following categories are exempted from registration:

1. Any evidence of indebtedness *issued by* a bank, or non-bank financial institution with a quasi-banking licence.
2. Evidence of indebtedness *issued to* the BSP under its open market and/or rediscounting operations.
3. Evidence of indebtedness *issued to* banks, investment houses, financing companies, investment companies, insurance companies, pre-need companies and other primary institutional lenders *(a pre-need company is a SEC registered corporation which sells pre-need plans that are essentially contracts or agreements that provide for the performance of*

future services, payment of monetary considerations at the time of actual need or agreed maturity).

4. Bills of exchange arising from sale of the goods and services distributed and/or traded by banks or investment houses through an organised market.

5. Evidence of indebtedness, eg. short- or long-term commercial paper, meeting the following conditions:
   – issued to not more than 19 non-institutional lenders;
   – payable to a specific person;
   – neither negotiable or assignable and to be held to maturity; and
   – in an amount not exceeding PHP 50 million.

The sale of securities exempt from registration requires full disclosure to the investor that such securities have not been registered with the SEC. In addition, an issuer of commercial paper under any of the above exempt transactions must file a notice of exemption with the SEC.

c. Ratings are not required for all bond issues

A rating by an accredited credit rating agency[2] is required in the registration of commercial paper. However, exemption from the rating requirement is allowed when:

1. the issue amount is not more than 25% of the issuer's net worth; or
2. there is an irrevocable committed credit line with a bank covering 100% of the proposed issuance.

Commercial paper or bonds that are exempt from registration are also exempt from the rating requirement.

d. Manner of trading

Currently, trading in corporate bonds is OTC and bilateral or privately negotiated by buyers and sellers. The appointed bookrunner, lead manager and co-manager are under no obligation to make secondary markets for the securities. Furthermore, there is no available trading platform where bonds are listed, although the Fixed Income Exchange will list corporate bonds in 2006. Because trading is not transparent, we cannot ascertain trading volumes, turnover or trading depth.

e. No market conventions

There are no market conventions governing the issuance, pricing, distribution, trading and settlement of commercial paper and corporate bonds that give the details of agreed practices by industry players implementing minimum provisions of regulations imposed by the SEC and the BSP.

f. Registration of debt securities not fully computerised

The registration of commercial paper (including bonds) has yet to be computerised. Some securities are still issued in certificate form, although for recent issues are already in scripless format.

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[2] Credit rating agencies are required to have a minimum capital of PHP 10 million. Currently, there are two credit rating agencies recognised by the BSP. The Philippine Rating Services Corporation (PhilRatings) was recognised by the BSP as a domestic credit rating agency for bank supervisory purposes under BSP Circular no 404 dated 19 September 2003. Fitch Singapore PTE, Ltd, a subsidiary of Fitch Ratings, an international credit rating agency with representative office in the Philippines, was recognised by the BSP for bank supervisory purposes under BSP Circular no 473 dated 1 February 2005.

g. Market participants

Participants in a bond issue may include:

- underwriter;
- bookrunner;
- lead manager and co-manager(s);
- trustee;
- registrar and depository;
- paying agent;
- legal service provider; and
- credit rating agency.

A bank may perform a combination of the above functions.

h. Issuance costs

The issuance of debt securities is associated with high fixed costs relative to bank loans. In Table 3 below, we outline the estimated issuance costs for commercial paper and bonds.

Table 3

Estimated issuance costs

Stage/participant	Estimated fee
SEC registration	0.10% to 0.75% on maximum aggregate price of the securities offered
SEC legal fees	1% of registration fee
Documentary stamp tax	.005% of issue amount
Underwriter	25 bp to 40 bp
Credit rating fee	1/20th to 1/10th of 1% of the issue amount
Registry	Upfront fee for primary issuance or approx. 1/200 of 1% of issue size
	Maintenance fee - fixed charge on a periodic basis
	Transfer fee - fixed charge per transfer transaction
Lead manager(s)	Approx. 1% of the gross proceeds if inclusive of underwriting and selling responsibilities

Sources: SEC; various banks.

IV. The role of banks in the Philippine corporate bond market

The Philippine financial system is dominated by banks. At end-June 2005, the total resources of the banking system were PHP 4.4 trillion, or approximately 85% of 2004 GNP. The breakdown of banking resources is as follows: private domestic unibanks - 56%; private domestic commercial banks - 7%; government banks - 11%; foreign banks - 16%; and domestic and foreign thrifts - 10%.

In bond issuance, banks may participate as issuers, underwriters, lead managers, selling agents, registries, paying agents or settlement banks. Under Philippine laws, only universal banks/commercial banks and investment houses can act as underwriters. In 2004, banks held an aggregate investment portfolio in government, private and foreign securities of PHP 1.0 trillion.

Aside from fee-based income, banks earn profits from trading. In 2004, trading gains from private equities and commercial paper amounted to PHP 1.7 billion, versus trading gains from government securities of PHP 6.1 billion.

V. Issues and concerns

a. Legal

The stiff stockholder approval requirement (two thirds majority) for corporate bond financing stipulated by the Corporation Code, as well as the unfavourable taxation environment, have dampened corporate bond issuances in the Philippines. There is an urgent need for the passage of important legislation (eg. to update bankruptcy laws, amend the BSP Charter, create a credit bureau) that will spur the development of the domestic bond market.

b. Transparency

The following has contributed to a lack of transparency in the Philippine corporate bond market:

1. Exemptions from rating and listing requirements.
2. Absence of competitive pricing information using benchmark government debt prices.
3. No readily accessible monitoring and surveillance methods/tools for use by regulators.
4. Absence of data consolidation on completed transactions.
5. No access to reliable information on creditworthiness of issuers, except for sophisticated institutional investors.

c. No organised trading

The corporate bond market in the Philippines is bilateral and conducted OTC. Currently, there is no true picture of secondary market liquidity, and it is not clear whether there are repo or derivatives markets. The lack of pricing and distribution information has dampened the demand for corporate bonds.

d. High issuance costs

Because of high issuance costs, only top-tier corporations can issue bonds. Indeed, most Philippine companies, including small and medium-sized enterprises, would rather obtain their funds via bank loans than via the capital market.

e. Problems besetting institutional investors

Some institutional investors, such as pre-need companies, non-life insurance and mutual funds, (which, because of their liability structures, represent the bulk of demand for corporate issues) currently have a poor reputation in the market, which is hampering their growth. Dealing with the problems of institutional investors may require a stronger regulatory environment.

f. Outmoded bankruptcy laws

There are significant gaps between existing bankruptcy laws and investor protection. The current corporate rehabilitation law is obsolete, and does not ensure the ability of investors to immediately recover investments in the event of default.

g. Need for increased regulatory supervision

There is a need for increased supervision of corporate bond issuance. Publication of post-trade information and other market data is required not only to promote trading in the secondary market, but also to ensure proper market monitoring and surveillance.

VI. Capital market reforms and initiatives

A series of capital market reforms is underway in the Philippine capital market, aimed at addressing the financing mismatches of private enterprises. Specifically, the initiatives are intended to foster an environment in which there is a link between investors willing to place funds on one hand, and corporates in need of longer-term financing on the other.

a. Delivery of securities

The BSP issued regulations that require securities sold by a bank or non-bank to be delivered either to the purchaser or to his designated third-party custodian. The proper delivery of securities by dealer banks and non-banks assures the investor of a validated transfer of title and ownership to the securities purchased, thereby guaranteeing that said securities have not been the subject of multiple sales and undocumented repurchase agreements. The BSP issued regulations in July 2003 but the full implementation of the delivery requirement will be in the first quarter of 2006 following the resolution of issues with another government agency. Prior to the issuance of the regulations requiring mandatory delivery to the purchaser or to his designated custodian, manipulative practices by banks such as multiple sales and undocumented repurchase agreements were noted by the BSP.

b. Accreditation of third-party custodians

In connection with the requirement to deliver securities, the BSP subsequently issued regulations on the prequalification criteria for banks and non-bank financial institutions (NBFIs) under BSP supervision that will operate as securities custodians or registrars, and defined the functions and responsibilities of each. Accreditation standards were raised to include a minimum CAMELS ratio of "4", minimum capital adequacy ratio of 12% and adequate technological capability to offer securities custodianship and registry.

c. Market infrastructure

The BSP has strongly supported efforts of the Bankers Association of the Philippines and other industry associations to establish a Fixed Income Exchange (FIE) in the country. The FIE actually started operating an inter-dealer platform in March 2005, posting daily average trading volume of PHP 200-300 million[3] since it opened. It will expand to accommodate the public market before the end of 2006 when the connectivity with the Registry of Scripless Securities of the Bureau of the Treasury has been accomplished. The FIE will also run a board for corporate issues on which transparency in pre- and post-trade prices will be quoted.

[3] 1,906 million as of 4 January 2006 (Source: Philippine Dealing and Exchange Corp.).

Box 1

The Philippine Fixed Income Exchange

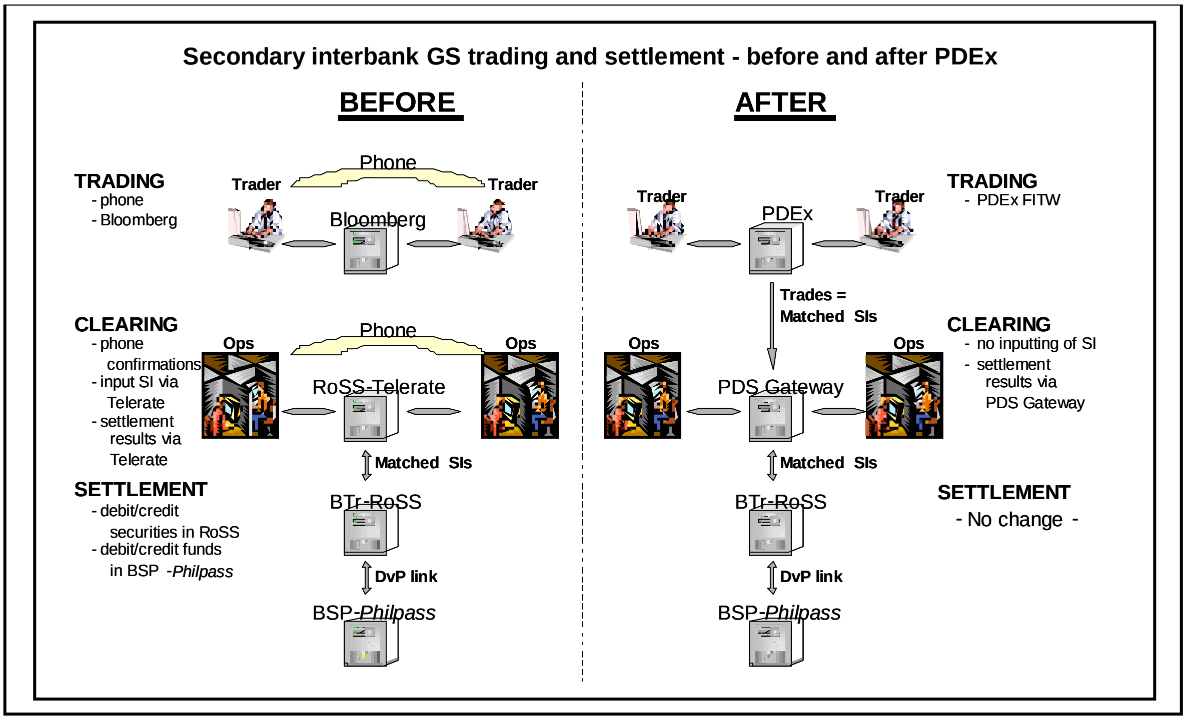
For purposes of infrastructure, the Philippine Dealing System (a holding corporation) owns three corporate entities that ensure direct and cohesive processing of securities transactions from trading to settlement and on to custody. These are 1) the Philippine Dealing and Exchange Corp. (PDEx) that acts as virtual trading floor for government and corporate issues; 2) the Philippine Securities Settlement Corporation (PSSC) that handles clearing and settlement of completed trades at the PDEx; and 3) the Philippine Depository and Trust Corp. (PDTC) that functions as the repository for securities on behalf of public investors for the purpose of providing proper disposition and accounting of securities holdings, as well as wider customer access to markets.

The FIE was established to accomplish three principal objectives. First, it will ensure that securities are properly delivered either to the purchaser or to the purchaser's appointed third-party custodian. Second, it will institutionalise third-party custodians - first introduced in 2004 to promote investor protection by separating the functions of dealing and custody of securities. Finally, the FIE will facilitate the migration from the current bilateral OTC trading to a formal trading arrangement that will achieve transparency and efficient price discovery.

Pre-FIE

In particular, the FIE will address the undesirable features of the current market, such as:

- market fragmentation, whereby pockets of investors exist;
- limited entry and exit for investors, who have usually been locked in to arrangements with their original securities dealers;
- inefficient price discovery, reflecting the fact that data and statistics have been readily available only to dealers and large institutional investors; and
- virtually no securities lending transactions.



Post-FIE

The creation of the FIE is expected to bring about the following improvements in the trading of securities:

- centralised market with exchange participation rights;
- segregation of dealing and brokerage (sales) activities;

- freedom for investors to choose their executing broker;
- transparent pricing;
- efficient price discovery; and
- securities lending capability.

Currently, the Fixed Income Exchange provides for participation rights for brokers, dealers or combination broker-dealers. There is also segregation of dealing and brokerage activities, which should result in a shift from dealers trading against the public to brokers executing on behalf of the public. Thanks to this measure, investors will have a wider and better choice of brokers to execute their transactions.

At this point, transparent pricing has been achieved for the interbank market, as quotations are available on a per security basis, and executions are at the best bid and offer. Going forward, we hope to achieve efficient price discovery for the common investor in the public market phase, as price and trading data will be made available on a real-time basis by subscription and on a delayed basis for free.

d. Legal and regulatory framework

The Documentary Stamp Tax Law. To partly address the taxation burden, R.A. no 9243 dated 17 February 2004 (*An Act Rationalising the Provisions of the Documentary Stamp Tax of the National Internal Revenue Code of 1997, as Amended, and for Other Purposes*) was passed exempting secondary trading of securities from documentary stamp taxes.

The SPAV Law. R.A. No. 9182 (*Special Purpose Asset Vehicle Law*), enacted in January 2003, was passed to address the non-performing asset (NPA) problem of Philippine banks by providing tax incentives for their sale.

The Securitisation Law. R.A. Act no 9267 (*Securitisation Act of 2004*) was promulgated to promote the development of the capital market by supporting securitisation; providing a legal framework for securitisation; and creating a favourable market for a range of asset-backed securities.

Other laws that will affect the corporate bond market in particular and the capital market in general are now in various stages of review by the Philippine Congress. These are:

1. **Credit Information System Act.** This bill provides for the creation of a central credit information bureau as a reliable source of information to allow lenders to accurately evaluate risks and select between creditworthy and poor-quality borrowers, thus improving discipline in the credit process.

2. **SPAV II (Special Purpose Asset Vehicle II).** This bill seeks to extend the original SPAV Law (above) for another two years to complete the NPA clean-up process.

3. **PERA, or Personal Equity Retirement Account.** This legislation seeks to establish a provident personal savings plan, which sponsors hope will be accepted as an essential and valuable instrument for long-term retirement savings. Specifically, PERAs are designed to achieve a comfortable and financially secure retirement through planned savings, sound investment and tax deferral.

4. **RICA, or Revised Investment Company Act**. This bill seeks to establish a comprehensive regulatory framework to enable investment companies to play a key role in capital formation, and promotes fiduciary principles in the management and administration of investment companies. In particular, it aims to protect the investing public and, in particular, prevent misuse of customer funds.

5. **Pre-Need Code**. This bill is intended to provide a sound legal and regulatory framework for the pre-need industry, for the protection of investors and pre-need plan holders.

6. **Corporate Recovery Act.** This bill is intended to modernise the bankruptcy code by providing a more expeditious way of rehabilitating ailing corporations with corporate recovery rules aligned with international best practice.

e. Implementation of International Financial Reporting Standards (IFRS)

The main goals of the BSP and SEC are to strengthen market discipline, encourage sound risk management practices and stimulate the domestic capital market. Both authorities recognise the importance of fairness, accuracy and transparency in financial statements to the achievement of all these objectives. Accordingly, the Philippines will require banks to adopt International Financial Reporting Standards for financial statements as of December 2005.

f. Credit rating agencies

BSP regulations cover the recognition of credit rating agencies for bank supervision purposes. This complements a more general recognition process enforced by the SEC. The reviews and rating changes issued by these credit rating agencies are used to fine-tune the opinions of lenders, investors and regulators about institutions and/or instruments. The two rating agencies operating in the Philippines are PhilRatings, the country's only home-grown agency, and Fitch Singapore PTE, Ltd, a subsidiary of Fitch Ratings.

g. Financial Sector Forum

The BSP has launched an inter-agency cooperative body called the Financial Sector Forum, comprising of the BSP, the SEC, the Insurance Commission and the Philippine Deposit Insurance Corporation. Its primary aim is to coordinate the efforts of its member agencies in the areas of supervision and regulatory policy; reporting, information exchange and dissemination; and consumer protection and education. The creation of the Forum is expected to aid in the development of the capital market by ensuring that initiatives are conceptualised and implemented using a common framework.

h. Capital market reform agenda: a joint effort

The Capital Market Development Council (CMDC), a joint public-private body, bringing together representatives of industry associations and regulators, is drafting the road map for capital market development in the Philippines, with technical assistance from various international agencies.

Conclusion

Although we have embarked on an ambitious programme of capital market reform, we are aware that much remains to be done to develop our domestic corporate bond market. We are mindful of the lessons of the Asian financial crisis, and recognise, in particular, that a well-functioning bond market reduces the vulnerability of the corporate sector and contributes to the overall financial health of the country.