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# Philippines

*Cesar Saldaña*

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## Executive Summary

The Philippine economy underwent sustained growth of 3.8 percent per year from 1986 until the 1997 Asian financial crisis. The Government did not meet target fiscal deficits in the 1980s, but delivered a creditable performance from 1992 to 1996. In the past, interest payments accounted for a large part of deficits and a substantial proportion of expenditures were not oriented to economic growth.

The Government relies on the domestic debt market to finance deficits and on foreign borrowings when it wants to avoid exerting upward pressure on domestic interest rates. However, the Philippines does not have much more room for foreign financing because of its high foreign debt stock as a ratio of GDP. The Government recognizes the importance of a developed bond market and high domestic savings rates for attaining low long-term interest rates. Domestic savings rates are low, however, and this constrains the growth of the bond market.

Commercial banks control 70 percent of the resources of the financial system (90 percent of *Bangko Sentral ng Pilipinas* (BSP)—the central bank, is excluded from the financial system). Nevertheless, the banking system is in good condition, with nonperforming loans (10.4 percent at the end of 1998) and capital-to-risk-assets ratio (17.6 percent as of October 1998) being some of the best in Asia. The banking system appears to be the base upon which the Government can build its bond market development program.

In the next five years (2000–2004), the Government aims for an expansionary fiscal policy and a prudential monetary policy. Low long-term interest rates will help bond market development. The Government intends to pursue fiscal stability through growth in revenues, reforms in expenditures, and a financing mix that minimizes interest cost. It will support this by reforming its policies on contractual savings to achieve a positive real rate of return for savers. Reducing short-term debts and lengthening the maturity structure of public debts will reduce refinancing

risk and upward pressure on domestic interest rates. The Government reduced its short-term debts from 69 percent in 1985 to 55 percent of total debts in 1998. Targets rely heavily on domestic debt markets to finance deficits up to 2001 and finance net repayments of foreign loans during planned fiscal surplus years after 2001.

BSP aims to control inflation and long-term interest rates through open-market operations (OMO). However, its actions may have detrimental effects on short-term interest rates, which are the immediate concerns of the Bureau of Treasury (BTr) when it issues bonds in the primary market. BSP has a credible instrument in its overnight interest rates, given the large amount of Treasury securities that it can move in the secondary market at any time. Its reverse repurchase agreement (RRP) rates serve as a floor for interbank call rates and effectively guide movement in bank interest rates. BTr can also influence base money through its primary market operations. Except for periods of serious dislocation and adjustment, such as the Asian crisis, BTr's auction rates have moved together with BSP's policy rates. Current coordination mechanisms appear to serve BTr and BSP reasonably well. Through participation in the Development Budget Coordinating Committee (DBCC), BSP understands BTr's financing plans. As a member of the Auction Committee, BSP provides BTr with interest rate forecasts and scenarios that it can use to set its own expectations. BTr's concerns about high interest rates probably influence BSP's choice of policy instruments to control inflation. During the Asian crisis, for example, BSP used moral suasion and later reduced reserve requirements to make banks bring down their lending interest rates. BTr stood to benefit from both lower interest rates and an improved potential for the economy, and revenues, to grow again.

**Objectives of Bond Market Development.** Its experience of domestic and regional crisis means the Government, instead of relying on foreign borrowing, wants to develop the domestic bond market to achieve flexibility in raising funds and create a benchmark yield curve for the domestic debt market.

BTr issues government bonds. However, current laws on transactions and capital gains taxes are biased against bonds. Reforms for implementation in 2001 will eliminate transaction taxes, but capital gains tax remains. BTr sets and implements policies in the primary and secondary markets, operating auctions through accredited dealers whose number has expanded under its "open dealer network" policy. BTr recently issued small-denominated T-bonds through underwriters to retail investors under its Small Investor Program (SIP). This expanded the possibilities for disintermediation by BTr, but entails high administrative

costs. The large savers that account for the bulk of bank deposits are already being offered rates that are responsive to T-bill rates, and may shift to Small Denomination T-bonds (SDTs) if BTr continues to offer favorable interest rates intended for small savers. Also, the efficiency of SIP in broadening the investor market is not clear when compared with less institutionally-costly policy options, e.g., offering tax incentives for savings and relaxing regulatory restrictions on institutional investors (insurance companies, pension funds, etc.) to invest in bonds. There are also questions about whether BTr has a mandate to broaden the investor market.

**Size, Growth, and Structure of the Bond Market.** Treasury securities are a dominant and growing component of the bond market. Corporate debt securities made up only 3.3 percent of the market in 1998 and consisted mostly of long-term commercial papers. Since 1992, the government successfully shifted from predominantly T-bills to floating rate T-notes and then to fixed rate T-bonds. Since 1996, it has established the nucleus of a true bond market, but this came at a cost of a possible diminution of the 91-day T-bill as a benchmark security. There was a decline in volume of 91-day T-bills and a concentration of tenors in two and five years for T-bonds. Financial institutions dominate the demand market for bonds, and private investors have limited influence. Analysis of intermediation spreads shows that increasing competition in the banking system eliminated the high intermediation profits of banks from 1987 to 1992. Since 1994, banks have been able to earn spreads only by investing in long-term bonds, i.e., by assuming higher liquidity risks. Bank savings rates, at least for large savers, became very responsive to T-bill rates after 1994. Along with relative macroeconomic stability during that period, this explains the success of BTr in introducing fixed-rate T-bonds.

In international terms, the Philippines has one of the lowest levels of financial depth (ratio of financial assets to GDP) among emerging Asian economies. It is also the only country whose corporate sector does not have a significant share in the bond market, suggesting the existence of serious regulatory and tax biases against corporate bonds. Inflation rates are the biggest reason for the high interest rates on T-bonds, and constrain bond market development.

**Features, Conduct, and Efficiency of the Philippine Bond Market.** BTr issues securities through a dealer system using an electronic auction. Current rules allow the Auction Committee, headed by the BTr under the Department of Finance (DoF), to unilaterally reject bids, which makes DoF a nonprice-taker, and enables it to influence interest rates during

auctions. The Auction Committee does not always allot the preannounced offers to bring down interest rates. Fully-awarded auctions averaged only 75 percent of all auctions for T-bills and 64 percent in T-bonds between November 1995 and October 1999. In the rest—usually less competitive auctions—allotments were denied to some winning bidders or entire auctions were cancelled. This could retard bond market development. Weak implementation of participation rules is another problem, e.g., giving dealers all the benefits of being exclusive dealers of Treasury securities without enforcing their market-making obligations. The result is an absence of market makers, weak secondary markets, and one-way trades to buy-and-hold investors in the primary market.

The secondary market for bonds is an over-the-counter (OTC) system dominated by Treasury securities. Trading volume is surprisingly high, although a large volume may be due to informal repos motivated by avoidance of tax and liquidity reserve requirements set by BSP. At present, there are two clearing and settlement systems—one for corporate and another for Treasury securities. For government bonds, BTr's present system of "netting with same day settlement" still presents settlement risks compared to delivery-versus-payment (DvP). The trading of corporate debt securities lacks a central clearing and settlement system, with consequent risks from current practices like issuance of "certificates of participation".

**Developing the Yield Curve.** The Government has issued longer maturity T-bonds to develop a benchmark long-term yield curve, but the effort has so far failed because the secondary market is not developed. The primary markets reflect current market rates, except for contrary signals generated by nonfully-awarded auctions. A yield curve results only from two-way quotes and trades of benchmark bonds with different times remaining to maturity. In the absence of a liquid secondary market, wide gaps exist between yields of securities of different nominal tenors. A key constraint is the issuance policy of spreading out issues among many different tenors and series. Fragmentation of issues to 171 series (as of 8 October 1999), also makes it more difficult for dealers to market the securities and use them as underlying securities for developing derivatives.

### **Recommended Development Policies and Strategies for the Philippine Bond Market**

To build a truly competitive market, the Government needs to resolve policy issues, improve market infrastructure, set rules and procedures, and promote participation by reputable players. It should also prepare a blueprint for development of the bond market to achieve (i) a consensus on goals and policy agenda; (ii) an efficiently functioning primary market; (iii) an efficiently functioning secondary market, and (iv) an active corporate bond market. The recommended policies and strategies are directed at four market reform components: (i) policy and regulatory framework, (ii) market infrastructure, (iii) supply of bonds, and (iv) demand for bonds.

**Policy and Regulatory Framework.** The Government should rationalize the regulatory framework of the bond market, adopt a market development-oriented issuance policy and management, and build a benchmark yield curve. It should expand its present role as issuer and regulator by adopting the roles of promoter and catalyst. As promoter, it should broaden the range of bond instruments and the participation of investors and dealers. As catalyst, it should innovate in market infrastructure, bond instruments, and incentives to trading and holding bonds. In the secondary market, it should promote liquidity and provide incentives to bond trading. For corporate bonds, current tax and regulatory burdens should be reduced and distortions removed without further delay.

**Market Infrastructure.** The Government, through BTr, should drive a policy consensus on a blueprint for developing world-class market infrastructure, ranging from preannouncement of the offer to clearing and settlement systems. In the primary market, BTr should consider setting up a primary dealer (PD) system with strong market-making obligations and a minimum level of participation. A PD system carries the risk of further narrowing of the market, possibly leading to oligopolistic practices. Improving secondary market infrastructure, particularly by amending the BSP rule to consider repos as securities rather than deposit substitutes, may induce more competition in the present “open dealer network” system.

The Government should also amend the present policy of rejecting bids in a valid auction, which diminishes confidence in the trading system, and address concerns about the lack of competition in some auctions by resetting bidding rules. BTr could achieve this through minimum percentage dealer participation, requirement of two-way quotes for PDs, and a mandated ceiling on bid rates. In the secondary market, a critical

recommendation is for BSP to review its regulations on reserve requirements for repurchase agreements (repos). As sovereign debts, Treasury securities may require a lower provision for capital loss based on Basle Agreement criteria. In settlement of secondary trading, BTr should shift from “netting with same day settlement” to DvP, by installing an electronic link with BSP, supporting the public listing of large bond issues, and ensuring that the infrastructure is accessible to investors at low cost. BTr should also monitor PDs’ market-making obligations (two-way quotes) in the secondary market. For corporate bonds, the Securities and Exchange Commission (SEC) should install facilities for the timely release of information regarding the creditworthiness of issuing companies. SEC and BSP should also push for the adoption of a central depository, clearing, and settlement system. A study is needed to consolidate the BTr’s and corporate bond market’s systems for the facilitation of the clearing and settlement for secondary trading of all types of bonds, while still enabling BTr to fulfil its role as fiscal agent and record keeper of the Government.

**Supply of Bonds.** The Government should provide a steady supply of domestic bonds and improve the liquidity of bond issues. It could continue issuing bonds even with its target of a balanced budget after financial year 2001/02, because a large stock of bonds need to be refinanced, including substantial foreign debts. Developing the municipal bond (LGU) market will enhance the supply of government bonds, which should be underpinned by sound macroeconomic management and inflation control. Because of the devolution of responsibility from national to local governments, LGUs have a large backlog of projects that need financing. LGUs may issue bonds to finance revenue-generating projects, while government-controlled corporations could also issue bonds to finance infrastructure projects.

To develop the primary market, BTr should manage future bond issues to improve the liquidity of certain target benchmark maturities and issues, adopting the 91- and 364-day T-bills and the five-year T-bond as benchmark securities. Specific recommendations are to (i) identify and announce the benchmark securities; (ii) increase the issue size and frequency of these benchmark securities; (iii) make “jumbo” issues of the five-year bond to build up its liquidity; (iv) conduct a reissuing program for the 364-day T-bill and the five-year T-bond; and (v) open repo facilities for trading with benchmark securities as support. In the secondary market, repo facilities should be developed. In the corporate market, the main impediment is the capital gains tax on bonds. DoF should make this comparable to similar tax on equities.

**Demand for Bonds.** The main issue is the size and diversity of the investor base. On the policy front, BTr should promote the participation of heterogeneous investors in the bond market. In the primary market, the Government should stimulate demand for Treasury securities by selecting dealers with a wide network of retail investors, and by setting up grassroots bond investor programs. In the secondary market, it should grant tax breaks to targeted investor groups. To promote the growth of the corporate bond market, BSP and SEC should demand transparency and disclosure in the OTC market. Acceptable trading practices should be developed and questionable ones sanctioned. The Government should also set up a market price information system for trades of key bond issues that will provide accurate, reliable, and timely information for investors.

## **I. Fiscal Policy and Management**

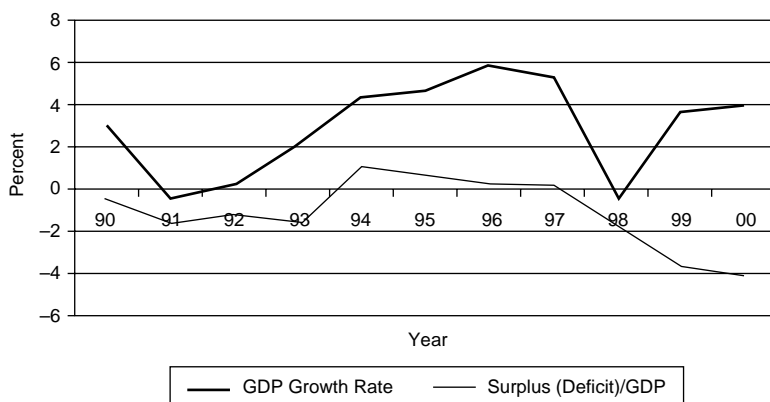
### **A. Broad Economic Overview**

Following the political and economic crisis in the early 1980s and political instability of 1991–1992, the Philippine economy experienced sustained growth, with average real GDP growth of 3.8 percent per year from 1986 to 1997. This was a result of private sector investments and a platform of structural reforms, primarily liberalization and regulatory reforms. During the 1993–1998 economic plan period, the Government implemented a macroeconomic stabilization program that successfully reduced the chronic fiscal deficit. GDP grew at an average rate of 4.3 percent from 1993 to 1996, in line with the plan's target economic growth rates. Investments and exports, encouraged by political and economic stability, boosted economic growth. The Asian financial crisis that started in July 1997 put the brakes on this growth, however. GDP grew 5.2 percent in 1997 but declined to just 0.5 percent in 1998 (Figure 1).

The effects of the Asian crisis were most severely felt in the manufacturing and construction sectors, which continued to contract in 1999. Agriculture recovered in 1999 from a steep decline in the previous year. The services sector, benefiting from new entrants and deregulation in transportation and telecommunications, was the only sector that grew in 1998, and it continued to lead economic growth in 1999.

Interest rates were comparatively low between 1993 and 1996, ranging from 11.3 percent to 13.6 percent for the bellwether 91-day Treasury-bill. At the height of the crisis, BSP raised bank reserve requirements as part of its Monetary Stabilization Program. By December 1998, 91-day T-bill rates were down to precrisis levels. Inflation rates, at 8 percent, remained at around the target single-digit rate from 1993 to

**FIGURE 1**  
**Fiscal Position and GDP Growth Rates (1990–2000)**  
 (percent)



Sources: ADB, *Key indicators of Developing Asian and Pacific Countries 2000*; ADB, *Asian Development Outlook 2001*; *Philippine Statistical Yearbook*, 1997 and 1999.

1998. While the country managed to weather the crisis of 1998, it still needed to revive the economy. In 1999, the Government implemented an economic recovery package of investment in infrastructure, agriculture, and industry, which led to modest growth of about 3 percent—but also the highest budget deficit in almost a decade.

The Philippine Government's economic program calls for control of inflation, stabilization of the exchange rate, and maintenance of a positive external current account. Current plans address the decline in manufacturing and other economic sectors due to the Asian crisis, and the precarious external position aggravated by slow inflows of private foreign capital. The economic policy aims to stimulate output growth in an environment of macroeconomic stability.

## B. Fiscal Management Structure

The Government coordinates its investment and operating budget and fiscal management processes through an interagency group called the Development Budget Coordinating Committee (DBCC). DBCC is nominally composed of secretaries from the Presidential Cabinet Department of Budget and Management (DBM), Department of Finance (DoF), and

National Economic Development Authority (NEDA), with the Governor of the BSP and the Treasurer of the Philippines representing BTr. Operationally, the Committee works with undersecretaries and their senior technical staff. DBCC regularly meets to forecast revenues and expenditures, the cash position, and financing requirements of the national Government. With the exception of NEDA, officials from these agencies are members of the Auction Committee for government securities, and are thus directly involved in financing the operations of the Government. Each agency has a role in fiscal management and in the process of issuing government securities. DoF reviews, approves, and manages public sector debt to ensure effective utilization of borrowed funds and their prompt servicing and payment. BTr, as a bureau under DoF, performs all operating functions such as the issuing, servicing, and redemption of all national government-issued securities. BSP, under its old charter, performed these functions until November 1995, when the new Central Bank Law took effect, transferring this so-called “fiscal agency” role to BTr.

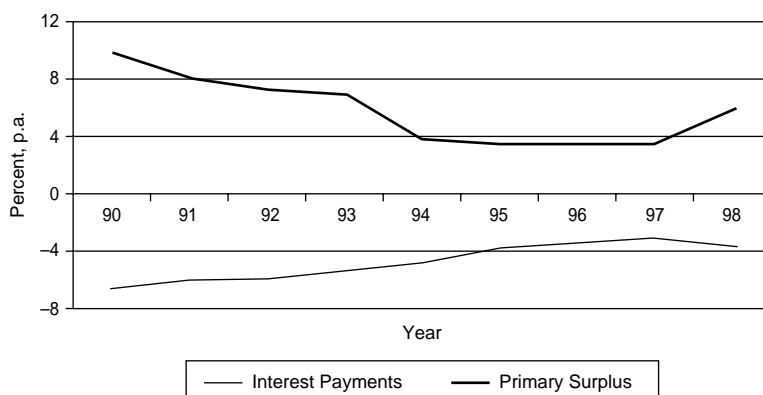
DBM formulates the national expenditure budget according to specified socioeconomic goals. When actual expenditure exceeds national budget targets, DoF’s role is to locate sources of financing. In times of budget surplus, DoF programs the net repayment of foreign or domestic debts. NEDA formulates social and economic policies and plans, including public investment programs. It reviews the fiscal and financing program for consistency with the overall macroeconomic program of the country.

### **C. Government Expenditure**

The main components of expenditure are operating expenses, capital outlays, and interest payments. Due to the high levels of foreign and domestic debts accumulated from chronic deficits in the past, interest payments were as high as 6.6 percent of GDP in 1990, as shown in Figure 2. The Government’s primary fiscal positions (budget position before interest payments) since 1986 were actually surpluses, and as high as 10.1 percent in 1990. The significance of interest payments relative to the overall fiscal deficit explains DoF’s desire to see lower interest rates at auctions and its willingness to access foreign debts that carry lower interest rates (but a corresponding currency exchange risk) when the domestic market is tight.

Expenditure has remained basically on target, but favored current operating expenses (averaging 81 percent of the total), rather than capital outlays (19 percent of the total). Such a bias of expenditure against growth-oriented capital outlay, especially in periods of deficit, does not strengthen the revenue potential of the economy. Further, the Government

**FIGURE 2**  
**Interest Payments and Primary Fiscal Position (1990–1998)**  
 (percent of GDP)

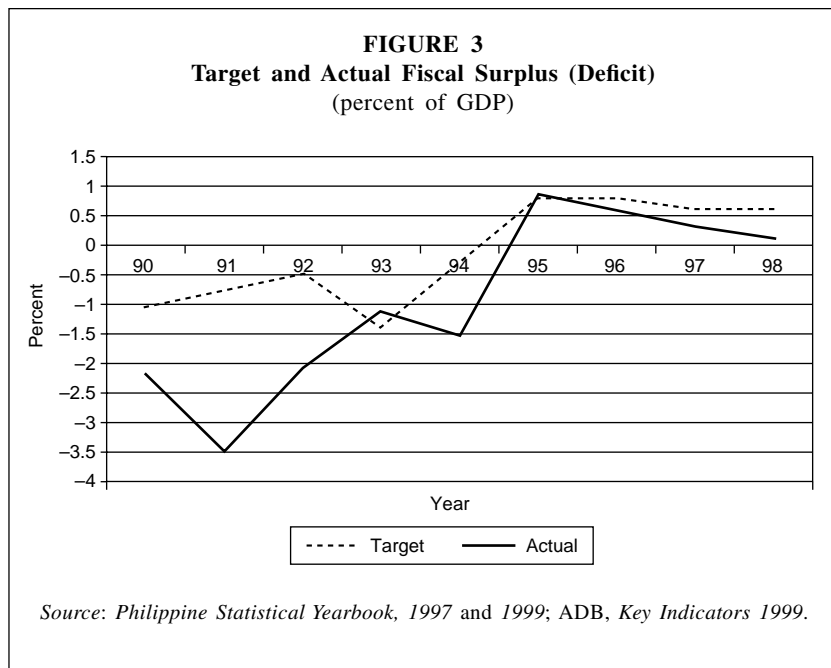


Sources: Philippine Statistical Yearbook, 1997 and 1999; ADB, Key Indicators 1999.

has a disturbing tendency to cut back capital outlay instead of operating expenditure when there is an impending deficit. In 1998, for example, the Government cut about P87.5 billion of planned capital outlay, but allowed operating expenditures to increase by about P26.7 billion over 1997 figures.

#### D. Fiscal Performance

The credibility of the Government's fiscal policy and performance affects the development of the bond market. Comparing the target and actual fiscal position of the national Government from 1986 to 1998, and its targets from 1987 to 2004, it expected to incur deficits from 1986 to 1994 (Figure 3). Actual deficits turned out to be very high in the years 1986–1991. The national Government generated budget surpluses from 1994 to 1997 of up to 0.9 percent of GNP, in most of those years exceeding target surpluses. It accomplished this by increasing and stabilizing revenues to an average of 18.7 percent of GNP and by holding expenditure to the target average of 18.2 percent of GNP. The surpluses during this period were partly due to privatization of some government-owned corporations and reduction of subsidies to the remaining government-controlled corporations.



In 1998, the Government incurred a budget deficit of 1.8 percent of GNP or about P50 billion, as a result of the Asian crisis and a consequent P100 billion shortfall in tax revenues, particularly indirect taxes, as a result of the slowdown in the economy. The 1999 budget deficit was expected to reach P90 billion.

### E. Development Planning

Among the major aims of the 1999–2004 development plan are macroeconomic and fiscal stability, strengthening of the financial and corporate sectors, and increasing long-term domestic savings. Macroeconomic stability entails generating sustained growth in exports without creating an imbalance in the current account, and attracting long-term capital such as foreign direct investments. Fiscal stability requires sustainable growth in revenues, reforms in expenditure, and a financing mix that minimizes interest costs and pressure on domestic interest rates.

Growing development requirements call for an increase in the household savings rate, currently one of the lowest in Asia. The Government plans to achieve this by reforming its policies on contractual saving, ensuring

a positive real rate of return for savers and, on this basis, assessing the efficiency of intermediation in the financial system.

The plan specifies major policy areas and public debt management goals, which are (i) to stop providing guarantees on private foreign loans; (ii) to reduce short-term debt and lengthen the maturity structure of public debt to reduce the refinancing problem and the upward pressure on domestic interest rates; (iii) to balance the national government budget by 2002, and (iv) to reduce the disincentive to local currency intermediation and increase the efficiency of the financial system.

Fiscal stimulus programs from 1999 onwards will involve consolidating the Government's fiscal position and even generating a small surplus when the economy recovers, estimated for financial year 2001/02. The success of this depends on consistent achievement of revenue targets, continuing control of public expenditure (with focus on growth-oriented expenditure), and access to a strong domestic debt market that taps into rising domestic savings.

There has been a substantial growth in medium- and long-term government debt since 1993, with the national Government reducing its dependence on short-term financing from 69 percent in 1986 to 55 percent of outstanding debts in 1998. From a target fiscal deficit of P68.4 billion in 1999, the Government is aiming for a fiscal surplus of P36.8 billion in 2004. A balanced fiscal position requires the Government to raise revenue from 16.6 percent of GNP in 1999 to 19.3 percent in 2004. Budget deficits and other budgetary requirements add up to total financing requirements ranging from P86.7 billion in 1999 to P12.3 billion in 2004, or an average of P55.4 billion. The plan envisages moving from a consolidated public sector deficit of 2.2 percent of GNP in 1999 to a surplus of 0.7 percent of GNP in 2004, with an average public sector borrowing level of 0.7 percent of GNP.

## **F. Financing Fiscal Deficits**

It is evident that the Government, as a matter of policy, wants to develop the domestic bond market. After the stabilization of the economy in the early 1990s, it could easily access international capital markets to finance its fiscal deficits. However, in the 1980s such dependence had led to a credit crunch, a unilateral moratorium, and political pressure to repudiate its debts. The Asian crisis also demonstrated that foreign debt markets can quickly dry up. By developing the domestic government bond market, the Government would achieve flexibility in raising funds, and create a reference yield curve for the local debt market.

Deficit financing came predominantly from foreign sources only in

1992 and 1993, while in years of surplus, the Government paid off foreign debts rather than reducing its domestic debts. To finance the 1998 deficit, it resorted to domestic rather than foreign financing, on a 75:25 ratio. As a matter of policy, the Government thus resorts to foreign financing during tight liquidity conditions when its Treasury auctions exert upward pressure on domestic interest rates.

The Philippines does not have much room for more foreign debt financing, however. It already has one of the highest levels of foreign debt as a ratio of GDP in Asia. The ratio rose during the high fiscal deficit years in the 1980s, rapidly declined during fiscal surplus years in the mid-1990s, and rose again after the Asian crisis. The ratio averages 69 percent, compared with 59 percent in Indonesia and 43 percent in Thailand. A comparatively low foreign debt ratio of 55 percent in 1997 allowed the Government to access more foreign debts to finance its deficits in 1998 and 1999.

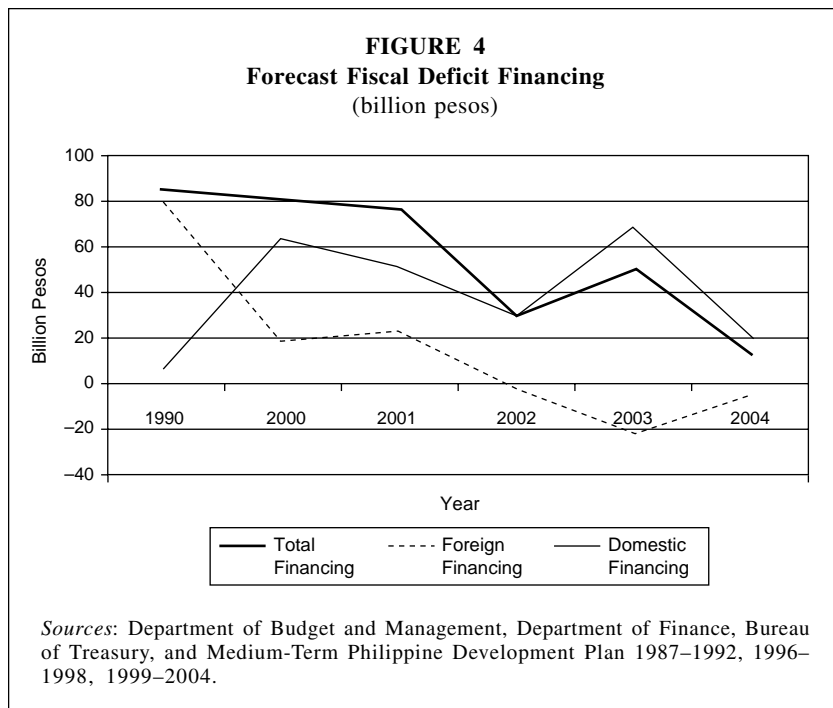
Figure 4 shows the pattern of target deficits and intended financing for the 1999–2004 plan period. The plan envisages financing from 2000 onward by an average ratio of 113 percent domestic and negative 13 percent of foreign financing. It supports development of the bond market, because supply of government bonds will continue even if the Government achieves its target of a balanced budget by financial year 2001/02. Past deficits assure the Government of a large stock of bonds to be refinanced, including a substantial amount of foreign debt. The feasibility of the plan depends on achievement of GDP growth, stability in currency exchange rates, and a deeper domestic bond market. If the additional financing does not materialize, the Government has committed itself, under the plan, to reduce expenditure.

If the bond market does not efficiently harness domestic savings, the Government's financing of its fiscal deficits from domestic debt markets will crowd out the private sector, resulting in high interest rates, even higher future fiscal deficits, and difficulties in issuing fixed rate long-term bonds.

## **II. Monetary Policy and Management**

### **A. Monetary Policy of the Bangko Sentral ng Pilipinas**

BSP carries out monetary policy, which aims to control inflation and stabilize the value of the local currency to reduce nominal interest and encourage growth. BSP's implementation of its interest policy, using extensive OMO, requires it to be financially strong. BSP's role in developing the capital market is to enhance the efficiency of financial intermediation. Intermediation costs depend on BSP's reserve requirements



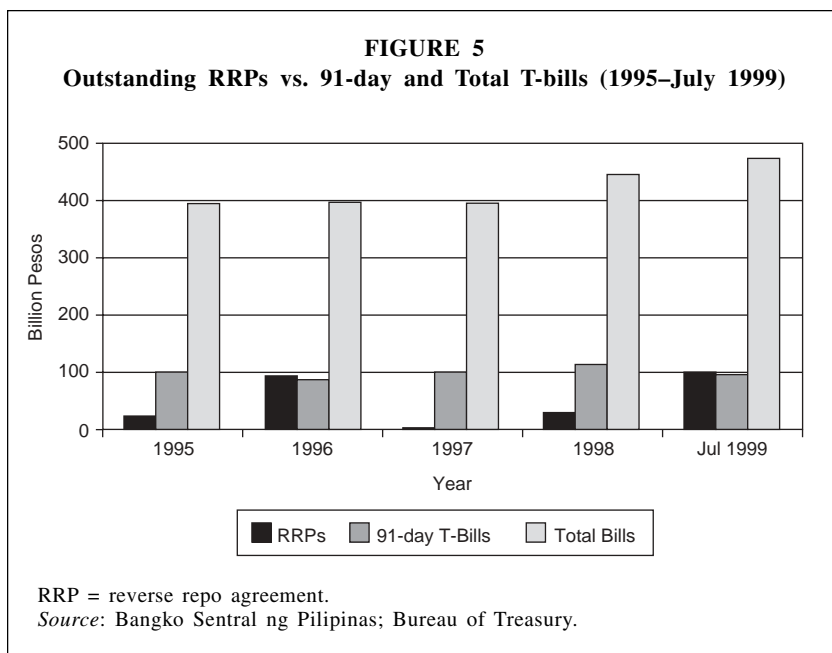
and transaction costs such as the documentary stamp tax (DST) and gross receipts tax (GRT). The comprehensive tax reform program (CTRP), to be introduced in 2001, will eliminate the DST and GRT and replace them with tax on the profits of financial institutions.

BSP determines the general direction of interest rates, which set investors' expected required rates of return in the government bond market. Through its OMO, BSP influences the availability and rate of return of debt securities.

## B. Monetary Policy Tools

**Inflation and OMO.** BSP monitors and controls the level of domestic liquidity or base money (M3) to control inflation. Reserve money and base money are the operational targets of monetary policy. BSP's main monetary policy instrument is OMO, in which it purchases or sells government securities to move monetary conditions toward specific targets in order to control inflation. BSP does this under a repurchase (repo) agreement, which involves the purchase of government securities with a commitment to sell on a specified future date at a pre-determined interest

yield. In a reverse repurchase (RRP) agreement, BSP sells a security with a commitment to purchase the same security on a specified future date priced at a fixed interest yield. Such OMO indirectly affects the level of reserve and base money levels by either removing domestic currency from, or releasing it into, the financial system. An increase in domestic liquidity increases domestic demand, which could increase inflation rates if not immediately met by higher supply through either increased domestic production or higher imports. By contrast, contraction in domestic liquidity reduces domestic demand, slows down domestic activity and reduces inflationary pressures. The extent of BSP's OMO is shown in Figure 5.



BSP's other instruments include rediscounting, reserve requirements, government deposits, special savings deposits, and moral suasion.

**Interest Rate Management.** The substantial volume of RRP is indicative of BSP's significant influence on market yields. In certain years, such as 1996 and 1999, outstanding RRP even exceeded outstanding 91-day T-bills. BSP sets RRP interest rates to influence interest rates in the debt market, particularly the interbank call loan (IBCL) rate. BSP's

overnight RRP rate represents the floor or lower limit of IBCL, because banks with surplus funds can lend to either BSP or other banks. BSP's repo rate reflects BSP's policy regarding the upper limit of interest rates. However, the repo rate is not a powerful policy instrument, as it cannot enforce a rate ceiling in the market.<sup>1</sup> BSP signals its interest rate policy in the interbank market through its RRP rates. Except for the highly volatile period from August to December 1997, BSP's OMO has effectively guided movements in IBCL rates. To bring down corporate lending rates, BSP successfully guided IBCL rates downward from August 1998 to October 1999, at a time when the Government was incurring its highest fiscal deficit in years.

BSP and BTr interact in the debt securities market. BSP controls base money by operating in the secondary bond market. BSP's policy rates influence the interest rates of government securities in the primary market and investments through a chain of actions. An increase in BSP's policy rate increases the yield on T-bills issued in primary auctions. The banks' corporate lending rates rise because they use the 91-day T-bill rate as a benchmark. The rise in the cost of capital then dampens economic activity through lower investments. The reverse process holds in case of a cut in BSP policy rates. On the other hand, BTr influences base money by operating the primary auction for the government bond market. To the extent that securities dealers hold T-bills and Treasury bonds (T-bonds) to maturity, they do not significantly impact on high-powered money (M1). There is a historical relationship between BSP's policy rates and BTr's auction rates. RRP rates were significantly higher than 91-day T-bill auction rates when BSP was combating inflationary pressures from late 1995 to early 1996 and currency speculation from May to October 1997 and in September 1998. Meanwhile, the 91-day T-bill auction rates were significantly higher than RRP rates from late 1997 to August 1998, when BTr was financing the budget deficit from the domestic debt market. Except for these periods, BTr's auction rates closely followed BSP's policy rates.<sup>2</sup> In spite of the large fiscal deficit in 1999, BSP decreased its policy rates, and the 91-day T-bill rates followed suit. At one time, BSP implemented the Government's mandate to bring down lending rates to encourage businesses to start borrowing and investing again.

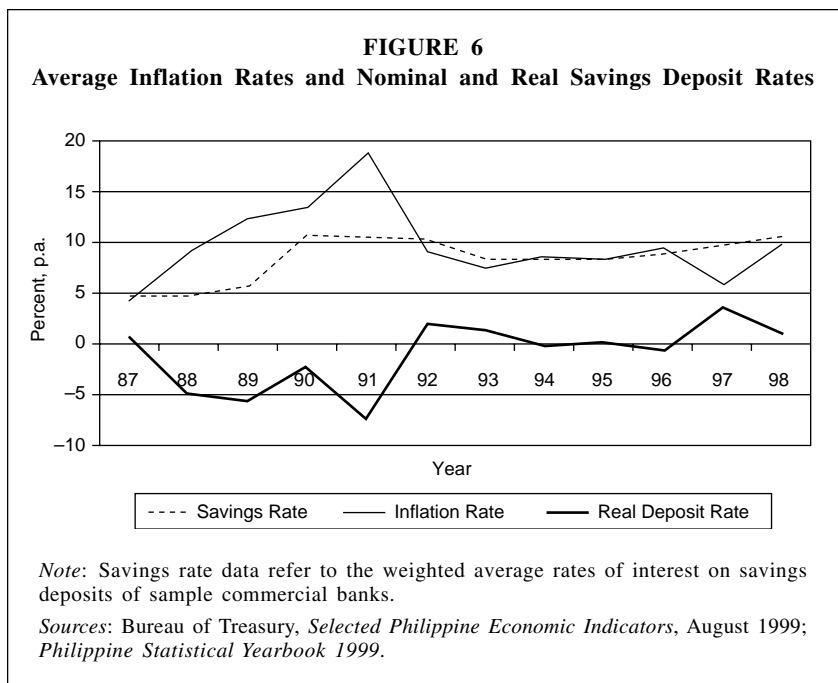
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1. Notably, it is in allotment of offers to winning bidders at auctions that BTr influences interest rates in the government securities market.

2. A regression analysis using the BSP overnight borrowing rate as predictor and 91-day T-bill auction rate as dependent variable is significant at 5 percent. Constant (std error)=9.1 (0.77);  $t=11.7$ ; BSP borrowing rate (std error)=0.29 (0.06);  $t=4.9$  ( $n=197$ ).

**Interest Rate Conflict.** Differences of opinion between BSP and BTr on interest rate policy surfaced when it became evident that the Government was going to incur large budget deficits in 1998. Interest rates are important to BTr, because it relies on the domestic debt securities market for financing deficits, or in periods of surplus for reducing outstanding debts. Such short-term fiscal concerns probably mask the importance to the Government of long-term solutions to the problem of high interest rates, i.e., a developed bond market and a high rate of domestic savings.

The rate of domestic savings is low because of disincentives to save in banks, even for large savers. Figure 6 compares actual and real bank savings deposit rates from 1987 to 1998. Average inflation rates of 9.4 percent exceeded the average yield on savings deposits of 8.3 percent, resulting in negative average real deposit rates of 1.1 percent. Most of the negative real deposit rates were from 1988 to 1991, and again in the economic boom years of 1994–1996. To the extent that BTr securities depend on intermediation by the commercial banks, negative real savings rates constrain the supply of savings and constitute an important limiting factor in the growth of the debt securities market.



**Current Account and Exchange Rates.** From 1987 to 1998, the country sustained a reasonable level of current account deficit, averaging 1.6 percent of GNP, and financed mainly by medium- and long-term loans. Foreign investment grew substantially from only US\$812 million in 1993 to a peak of US\$3.39 billion in 1996—an annual growth rate of 33 percent. Both foreign investments and loans fell in 1997, however, which was made up for with a steep rise in borrowing. A turnaround in the current account in 1998 due to the devaluation of the peso resulted in a surplus in the country's overall balance of payments. Foreign investments recovered from only US\$762 million in 1997 to US\$1.67 billion in 1998, about half of the 1996 level.

On the currency exchange front, the deregulation of foreign exchange transactions in 1993 increased the size of the foreign exchange market and led to an appreciation of the local currency. After the Mexican crisis of 1995–1997, the local currency remained stable at about P26:US\$1. When the Asian crisis resulted in a steep devaluation of the Philippine peso, the Government introduced policy measures and worked with the Bankers' Association of the Philippines (BAP) to stabilize the exchange rate. The depreciation of the US dollar and decline in interest rates in late 1998 eased the pressure on financial markets in Asia, allowing the local currency to strengthen and remain stable in the range of P39–P41 to US\$1 in 1999.

### **C. Policy Coordination vis-à-vis the Bond Market**

The experience of the past 15 years suggests that fiscal management requires close coordination between BSP and BTr. BSP's mandate is to manage base money by means of policy interest rate mechanisms in the secondary bond market, while BTr is essentially a price-taker in the primary bond market. Through its participation in the DBCC, BSP gathers information about the domestic financing plans of BTr and integrates them into its policies. Through its position on the Auction Committee, BSP provides BTr with future interest rate scenarios that BTr uses to set its own expectations. BTr communicates its concerns about high interest rates in a way that probably influences BSP's choice of policy instruments to control inflation. For example, during the Asian crisis, BSP enforced a reduction of lending interest rates by moral suasion on BAP and the reduction of statutory reserve requirements (SRR). BSP's immediate goals during the crisis were to control the nonperforming loans of banks and corporate bankruptcies. BTr benefited from the ensuing lower interest rates, with the result that potential for the economy, and for tax collections, grew again.

### **III. Overview of the Bond Market**

The Asian crisis reduced the value of the equities markets in all affected countries, including the Philippines. However, the size of the Philippine bond market, which consisted almost entirely of government issues, remained stable at about 20 percent of total financial assets.

The crisis increased the relative share of banks in the total financial assets of most Asian countries. In the Philippines, banks increased their share of total financial assets from 34 percent in 1995 to 44 percent in 1998, further increasing the already dominant presence of banks as financial intermediaries (Table 1). The flight of household savings to bank deposits could thus set back future government efforts to develop the bond market by issuing bonds directly to investors and bypassing intermediaries.

The Philippine bond market, as a ratio of GDP, is one of the largest among emerging Asian countries. However, the fact that it is the only country without a domestic corporate bond market suggests possible distortions and biases against private corporate bonds, including tight regulatory processes, and high transaction costs and interest rates.

In 1998, total domestic debt securities were about 86.2 percent of GDP and 61.7 percent of total equity market capitalization. Government securities accounted for about 93.5 percent of the total domestic debt market. Corporate securities accounted for only 6.4 percent, and total corporate debt securities were only equivalent to 3.3 percent of outstanding loans to companies by commercial banks.

It is evident that the Government, as matter of policy, wants to develop the domestic bond market to reduce its dependency on foreign debt markets. This would give the authorities flexibility in raising funds, and create a reference yield curve for the local debt market.

The Government finances temporary cash gaps in its operations, and more permanent ones such as budget deficits, by issuing Treasury securities. Government corporations also issue bonds to finance their projects, and the Government issued bonds to recapitalize the Central Bank, Philippine National Bank, and other state-owned banks as part of financial sector restructuring in 1987.

In all types of securities, a high proportion of the proceeds of new issues goes to redemption of maturing securities.

**TABLE 1**  
**Outstanding, Issued, and Redeemed Treasury and Corporate Debt Securities**  
(P Million, 1986–1998)

Year	Treasury Bills			Treasury Notes and Bonds <sup>b</sup>			Corporate Securities			Total Outstanding Treasury and Corporate Debt Securities
	Outstanding	Issued	Redemption <sup>a</sup>	Outstanding	Issued	Redemption	Outstanding	Issued	Redemption	
1986	55,419.6			31,267.0			3,799.0	5,209.8		90,486.3
1987	105,908.0	184,856.0	134,367.5	33,625.8			4,972.0	7,891.7	6,718.5	144,506.8
1988	142,614.0	207,619.0	170,912.3	43,011.3			4,805.0	6,358.9	6,526.7	190,431.2
1989	172,542.0	268,307.0	238,379.2	43,703.1			8,380.0	8,113.7	4,538.0	224,626.5
1990	192,589.0	351,171.0	331,124.2	41,762.5			12,280.0	18,800.4	14,900.8	246,632.3
1991	213,469.0	323,097.0	302,217.0	66,109.9			18,283.0	28,265.5	22,262.1	297,863.1
1992	336,019.0	434,072.0	311,522.1	97,103.3			14,018.0	22,075.6	26,341.0	447,141.0
1993	413,292.0	343,424.0	266,150.5	210,291.9			15,144.0	13,792.3	12,666.6	638,728.8
1994	368,231.0	345,891.0	390,952.0	237,178.1	5,000.0		26,997.0	26,405.9	14,552.2	632,407.7
1995	391,251.0	249,757.0	226,737.8	211,389.6	44,430.0	70,218.5	30,027.0	31,541.0	28,511.5	632,667.9
1996	392,730.0	263,265.0	261,786.0	226,296.6	79,795.0	64,888.0	53,603.0	35,885.0	12,309.0	673,167.7
1997	389,197.0	208,029.0	216,562.0	234,069.3	56,435.0	48,662.3	56,608.0	24,584.5	21,579.5	682,839.8
1998	439,971.0	219,768.0	168,994.0	259,280.5	42,983.0	17,771.8	49,427.0	6,162.0	13,342.8	751,828.7

<sup>a</sup> Data includes outstanding and issued. Redemption data was derived from data on outstanding and issued securities from data outstanding and issued securities;

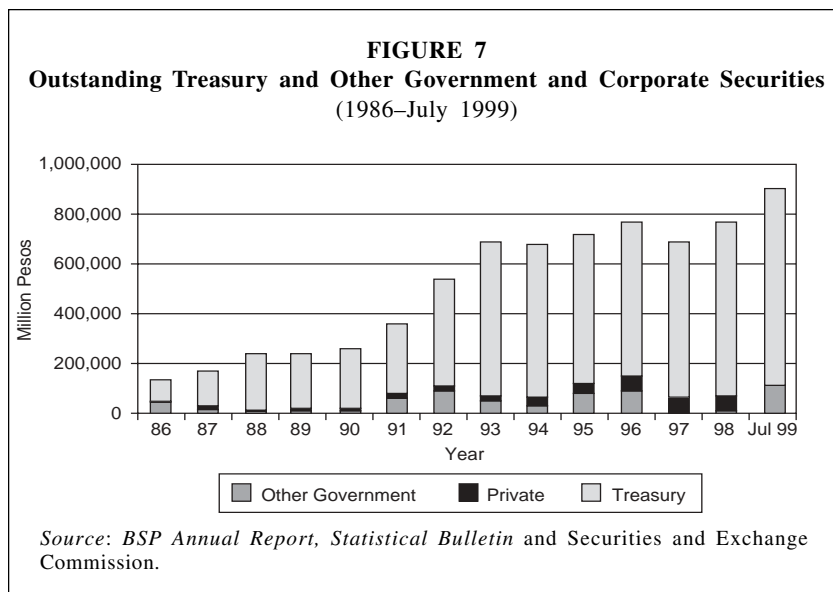
<sup>b</sup> No data on issues and redemption prior to 1995.

Sources: BSP Annual Report, Statistical Bulletin; Department of Economic Research (DER)-BSP and Bureau of Treasury.

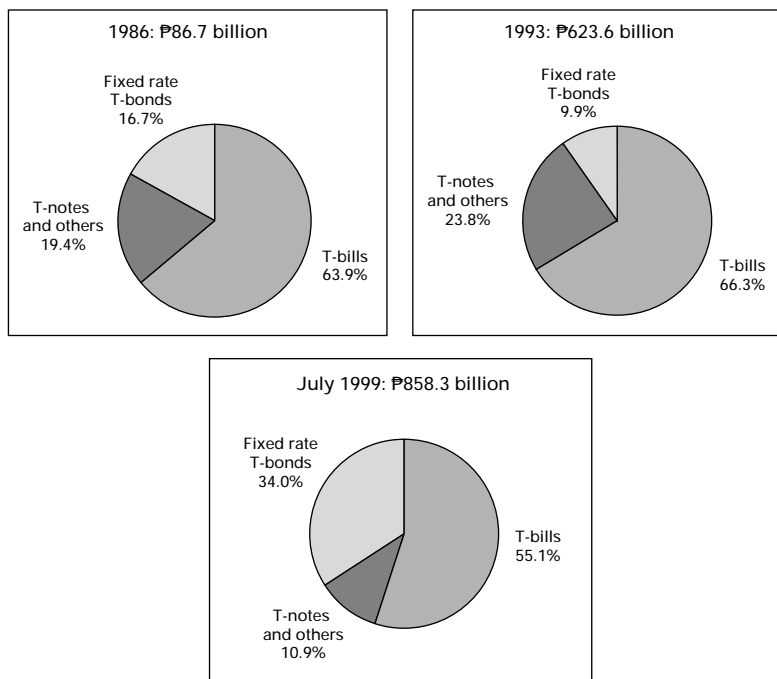
### A. Historical Overview

In the Philippines, a long period of large chronic deficits and high inflation from the 1970s to the early 1990s caused the Government to dominate the short-term debt securities market. The “lumpy,” highly predictable need of government for refinancing maturity issues created a negotiation-driven government securities market, with the Treasury and commercial banks, as a group, engaged in a zero-sum game.

This macroeconomic instability required the Government to finance its deficits primarily with 91-day T-bills. Completion of foreign debt restructuring in 1992 enabled it to increase its offerings of Treasury notes. Shifting from T-bills to T-notes addressed past problems of refinancing bunched maturities of T-bills. During the 1980s, the Government’s refinancing of maturing T-bills crowded out private sector securities in the market, and exerted upward pressure on interest rates. Although T-notes lengthened the maturity of government debt, they still carried variable rates that were benchmarked on the 91-day T-bill rates. When the country achieved relative macroeconomic stability in 1992, the Government issued fixed rate T-bonds that rose to outstanding levels of P61.8 billion in 1993, P188.4 billion in 1996, and P292 billion in July 1999 (Figure 7). The progressive shift from T-bills to floating rate T-notes and then to fixed rate T-bonds was a significant achievement, representing the beginnings of a true bond market in the Philippines.



**FIGURE 8**  
**Composition of Outstanding Treasury Securities**  
 (1986, 1993, and July 1999)

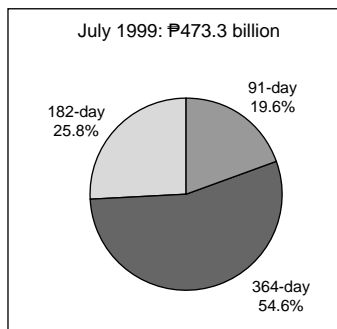
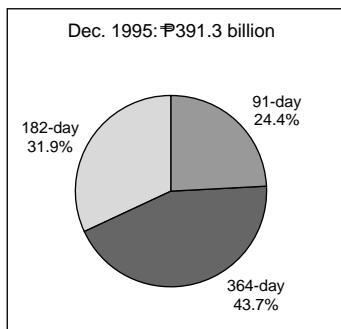


Source: BSP Annual Report, Statistical Bulletin.

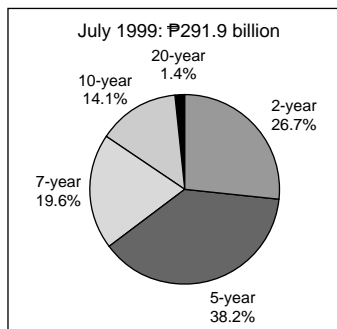
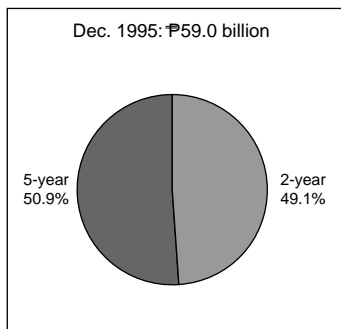
While total government securities increased at an annual rate of 15.7 percent from 1986 to 1998, fixed rate T-bonds grew annually by 26 percent, and T-bills by about 18 percent. Figure 8 shows the impact of these differential growth rates on the composition of government debt securities. In 1986, T-bills took up almost 64 percent of the total, compared to 17 percent for T-bonds. By 1999, the share of T-bonds had doubled to 34 percent of the total, and T-bills had fallen to 55 percent. The emergence of longer tenors in government securities led to a parallel growth of the corporate market, suggesting that the preconditions for the growth and development of a true corporate bond market are relatively stable macroeconomic conditions and a seasoned long-term Treasury bond market.

**FIGURE 9**  
**Maturity Composition of T-Bills and T-Bonds**  
 (1995–1999)

**Treasury Bills**



**Treasury Bonds**



Source: Bureau of Treasury.

The government bond market thus needs to develop in advance of its corporate counterpart. In 1995, the mix by security type was 82 percent for T-bills and 18 percent for T-notes and T-bonds. By July 1999, the mix had shifted to 55 percent and 45 percent. Terms are also lengthening within T-bills and T-notes. Figure 9 shows the distribution of maturity of Treasury securities from 1995 to 1999. In 1995, 91-day T-bills accounted for 24.4 percent of total T-bills outstanding compared to 43.7 percent for the 364-day tenor. The ratios were 19.6 percent for 91-day T-bills to 54.6 percent for 364-day T-bills in July 1999. The absolute amount of outstanding 91-day T-bills actually decreased from 1995 to 1999 while total T-bills outstanding increased. The decline in the volume of outstanding

91-day T-bills might threaten the liquidity of this bellwether security. For T-bonds, there is also a pattern of lengthening tenor. In 1995, BTr started to issue fixed-rate T-bonds, with the two-year tenor accounting for 49 percent of the total. In 1999, five-year T-bonds took 38.2 percent, while 7- and 10-year T-bonds together accounted for 33.7 percent of the total. This is a notable achievement, considering that fixed rate T-bonds of tenor longer than five years did not exist prior to 1995. Nevertheless, from 1995 to 1999, T-bonds were concentrated in two- and five-year tenors, suggesting that most investors still preferred to stay within the five-year tenor.

**Yield.** Historically, there has been a wide variation in yields of government securities at primary auctions. Conceptually, bond yields are investors' compensation for inflation risk and other risks related to liquidity and market factors. Yields on bellwether 91-day T-bills at auctions ranged from 11.4 percent in 1987 to 24 percent in 1990. It was not feasible to issue fixed-rate long-term bonds at reasonable rates because of high interest rates in the early 1990s, so there were no fixed rate T-bonds issued before 1994. Actual yields moved with inflation rates. Yields were lowest in 1987 and in the five years from 1993 to 1997, when the country posted strong economic growth with low inflation. Fixed-rate T-bonds in various tenors came out after 1995 with a peak yield of more than 19 percent for 7- and 10-year bonds.

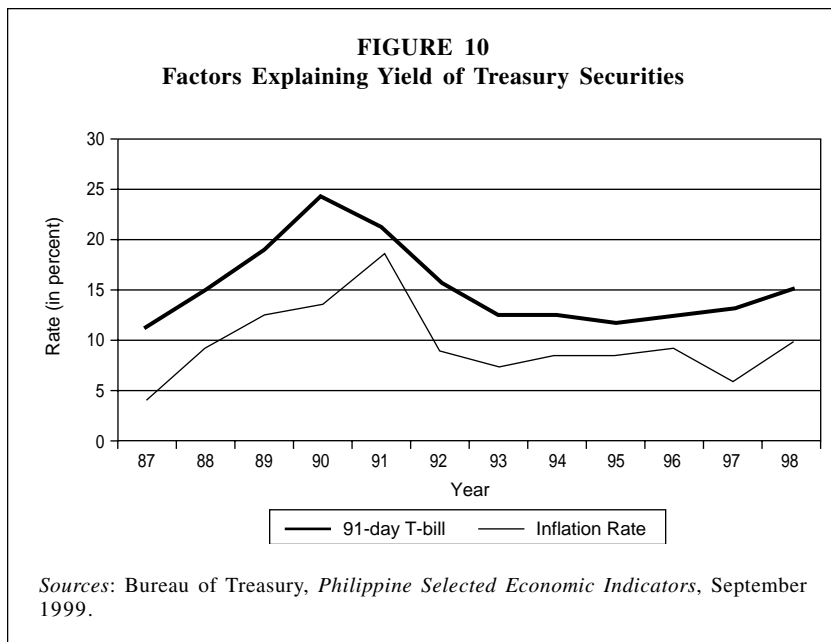
Figure 10 shows that inflation is the most important factor determining bond yields, accounting for an average of 61.4 percent of nominal yields of 91-day T-bills.<sup>3</sup> The high yields even for a risk-free security of the shortest maturity are not conducive to development of the Philippine bond market. Inflation rates averaged 9.4 percent from 1987 to 1998, accounting for about two thirds of the average 91-day T-bill yields of 15.3 percent. This means that yields on T-bonds are likely to exceed 10 percent. When yields on T-bills of the shortest maturity are near double-digit levels, T-bonds become too costly as a source of financing for government. Yields on corporate bonds are certain to be even higher, because they benchmark on the 91-day T-bill and add a risk premium. The Government needs to reduce inflation and achieve economic growth targets. A bond market, whether government or corporate, cannot flourish when investors require double-digit yields.

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3. Inflation rate is a significant factor (at 5%) .

Constant (std error) = (6.78 (1.8) t = 3.8.

Inflation rate (std error) = 0.910 (0.18) t = 5.1 (n = 11).

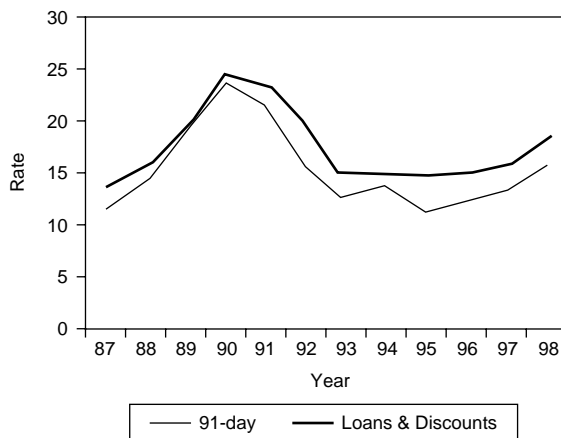


The yield on 91-day T-bills works as a bellwether rate with respect to the bank credit market. Bank lending rates follow the 91-day T-bill rate, as shown in Figure 11. The average risk premium over the 91-day T-bill rate that banks require on their loans was about 2.2 percent. Government securities eligible dealers (GSEDs) in primary auctions also benchmark their bids on Treasury securities with respect to the 91-day T-bill. Figure 12 presents actual yield on Treasury securities for auctions in two sample months. Interest rates in the primary auction appear to reflect current market rates (which were higher in December 1998 than July 1999), with a premium for longer maturities. Due to the absence of an established and active OTC, it is not possible to verify whether yield at auctions is equal to prevailing market rates.

## B. Corporate Market and Financing Behavior

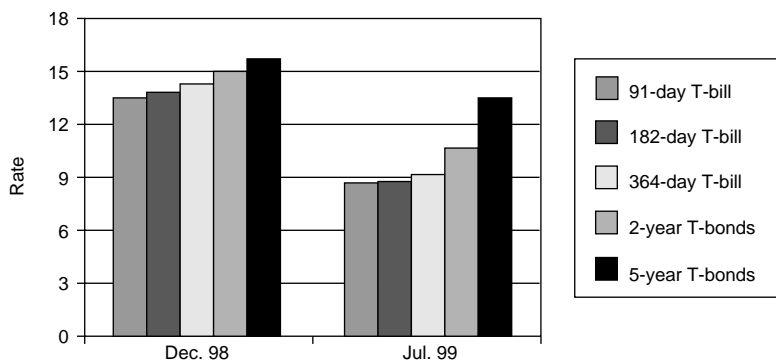
**Primary Market.** The primary bond market's infrastructure for primary trading and its recording systems meet international best practice standards for allotment of government securities through electronic auctions. Nevertheless, there are weaknesses. BTr has increased the number of dealers through an "open dealer network" policy, but not necessarily the quality of bids, and BTr still does not have an assurance of sufficient

**FIGURE 11**  
**Average Interest Rates of 91-day T-Bills and Loans and Discounts**



Sources: Bureau of Treasury; ADB Key Indicators.

**FIGURE 12**  
**Gross Yield for Treasury Securities of Various Tenors**



Sources: Bureau of Treasury; ADB Key Indicators.

subscription in every auction. As BTr does not strictly enforce market-making obligations, GSEDs can purchase and hold Treasury securities to maturity without giving realistic bid and offer quotes. In addition, a policy of allowing arbitrary rejection of winning bids by the Auction Committee distorts the market process, impeding bond market development, by (i) sending negative signals to market participants, reducing their confidence in the primary auction system; (ii) constituting a loss of transparency by relying on the subjective judgment of the Auction Committee rather than the high objectivity of the automated debt auction processing system (ADAPS); and (iii) creating an atmosphere of “auctioneer vs. dealers,” enabling the regulator to arbitrarily intervene in a supposedly competitive auction system.

The secondary market for debt securities is dominated by government securities. Corporate securities are a small proportion of the potential secondary market, with only 6.6 percent of total debt securities in 1998. In reality, GSEDs and commercial banks tend to hold government securities to maturity because of the absence of a secondary market—which also means there is no benchmark yield curve for the bond market.

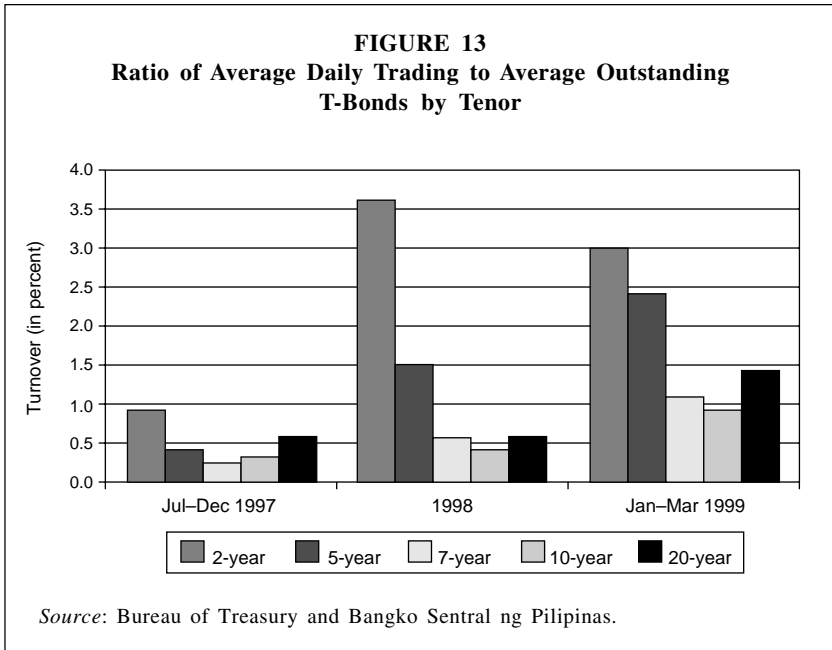
The figures seem to tell a different story, however. Between July 1997 and March 1999, there was a significant rate of growth in secondary trading in T-bills of 8.7 percent per month, or more than 104 percent per year. Likewise, for bonds, the growth rate was 0.7 percent per month or 80 percent per year. T-bills are the most heavily-traded, averaging 43.5 percent of the outstanding amount in the first quarter of 1999. The two- and five-year T-bonds were the next most traded securities, at 60 percent and 49 percent per year of outstanding balances, respectively. Average trading volumes increased significantly for T-bonds of all tenors from 1997 to 1999.

These high volumes and growth rates of secondary trading of government securities are not consistent with the observation that GSEDs either hold government securities to maturity or sell to investors that hold to maturity. The daily secondary trading volumes of 3 percent and 2.4 percent of outstanding for two- and five-year T-bonds are comparable to more developed bond markets such as the Republic of Korea.

A possible explanation is the common practice<sup>4</sup> by banks of executing an “outright sale” of government securities to a buyer accompanied by an undocumented “side agreement” to repurchase the same security at an agreed date. Through this practice, securities dealers avoid DST and liquidity reserve requirements for instruments considered by BSP as deposit

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4. As recently cited in “BSP to plug loopholes in lending, buybacks and swaps,” *Business World*, 20 December 1999.



substitutes. The incentives for this practice were heightened with the liberalization of banking after 1992, when average spreads between T-bills and savings deposits dropped to zero from 4.9 percent between 1987 and 1991. Banks earned spreads on savings deposits only if they purchased T-bonds and assumed a negative asset-liability gap. Thus, the practice of “informal repos” allowed banks to address the asset-liability gap. A substantial number of secondary trades recorded at Registry of Scriptless Securities (RoSS) probably consisted of informal repos. Since they appeared as outright sales/purchases twice when they should have not been counted as a “secondary” trade at all, secondary trading data is likely to be grossly overstated. If de facto repos were excluded, the true secondary trading volumes for government securities is likely to have been significantly smaller.

**Factors Promoting Development of the Secondary Market.** The electronic trading system provided by Dow Jones or Reuters allows GSEDs to form a network of OTC traders that serves as a secondary market. With the support of the RoSS and BSP in settlement, this can form the infrastructure for a modern core OTC market. Present volumes of secondary trading gathered from RoSS are impressive. Even if secondary trading turns out to have a significant component of de facto repos, it still

demonstrates that the primary auction infrastructure and RoSS can handle active OTC trading. Secondly, mark-to-market accounting rules encourage secondary trading because they require periodic recognition of gains and losses, eliminating deferred recognition of losses on trading securities as a reason for not selling a security. The active role of BSP in the secondary market through its OMO broadens the participation of banks. BSP also has a central role in facilitating the settlement system for the secondary market, because most securities dealers are banks.

**Impediments to the Development of the Secondary Market.** The present primary market does not have real market makers. BTr's present "open dealer network" policy gives GSEDs the privileges of a dealer with none of the obligations. Meanwhile, transaction taxes such as DST and GRT make secondary trades far too costly, inhibiting frequent trading and encouraging holding of securities to maturity. Since the nature of their business is to hold liquid assets, banks are severely affected by this distortion in incentives to hold securities. Under CTRP, the Government will discontinue DST and GRT only in 2001. Also, reserve requirements for repos backed up by government securities are a disincentive to using government securities for liquidity purposes. The presence of two parallel systems for clearing—one for government securities and another for corporate securities—causes inefficiencies, because securities dealers need to go through two separate clearing and settlement process. In addition, the use of DvP for corporate securities and "netting with same day" settlement for government securities<sup>5</sup> results in two standards of settlement risk in the secondary market. Learning from the lessons of a well-publicized case involving failure in settlement of government securities in 1994,<sup>6</sup> the Government wants to eliminate all risks and promote maximum transparency in transaction settlement.

Fragmentation of the market is another trouble area. On 8 October 1999, the government securities market had 112 T-bond series and 49 T-bill series for a total of 171 security series that security dealers could potentially trade. This is too big a number for dealers to track and market to retail investors. Many series are too small even in absolute amount. The average outstanding amounts per series as of 8 October 1999 were

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5. All Treasury securities issued after 1995 are on RoSS except for some securities issued by BSP and other government institutions.

6. This incident involved a secondary securities dealer called Bancapital Development Corporation, which apparently sold the same government securities a number of times for future delivery by issuing its own "confirmation of sale" documents.

P2.95 billion for T-bills (US\$73.8 million) and P1.93 billion (US\$48.3 million) for T-bonds. These average amounts per series represent only 2 percent of total outstanding T-bills and 0.9 percent of total outstanding T-bonds, respectively. The average issue sizes per series are too small to promote sufficient liquidity in the market.<sup>7</sup>

### C. Small Investor Program

In 1999, BTr embarked on a new policy direction for bond market development, launching a P50 billion SIP by issuing small denomination T-bonds (SDTs) with a minimum of P5,000 and maximum of P500,000 per investor.

The issue was made via an underwritten public offer, with quarterly coupon interest payments. BTr plans to list SDTs in the Philippine Stock Exchange (PSE) to provide liquidity support for investors. As an underwritten public offer, SIP-SDT is a parallel primary market process to the present dealer system. BTr controls the pricing of SIP-SDT but incurs underwriting fees, unlike in the dealer system, where GSEDs set prices by marking up their bids.

The Government is aiming to develop the bond market by disintermediation through SIP-SDT by issuing Treasury securities directly to investors to reward and encourage savings. Whether BTr should distribute government bonds in this way depends on whether small savers are truly not served by the banking system, the interest rates of SIP securities relative to the market, and whether the administrative mechanisms for prequalifying “small investors” can prevent leakage.<sup>8</sup>

BTr needs to determine the capacity of small savers to absorb substantial amounts of these issues. The P50 billion SIP is an important test for identifying whether small or large investors benefit from disintermediation. Small depositors (P15, 000 and below) account for 75 percent of the total number of bank deposit accounts, but only 3 percent of the total amount of deposits. In terms of deposits insured by Philippine Deposit Insurance Corporation (PDIC) from 1992 to 1998, the average

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7. If equally distributed among the 45 GSEDs, the outstanding T-bills per series imply only P66 million for each GSED and for T-bonds, P43 million for every GSED.

8. For example, SIP allows a maximum purchase of P500,000, a limit clearly much higher than capacities of “small savers.” Leakage is a potential concern whenever offered yields on SIP exceed those for Treasury bonds of comparable tenors. Underwriters tend to recommend interest rates in the higher end of the market to ensure the market success of an offering.

balance of small deposit accounts came down from P4,000 per account in 1992 to P2,000 per account in 1998. With the total of small deposits only about P30 billion in 1998, SIP's target small depositors do not appear capable of absorbing P50 billion of SIP-SDT. Large depositors have less than 5 percent of the total number of accounts but hold about 84 percent of total bank deposits. This group has the capacity to absorb SIP-SDT, and may already have participated in the initial issues of SDT due to their yields, which are high even relative to T-bills. Overall, BTr's apparent initial success in issuing SDTs needs to be reexamined in certain areas of costs, targeting and efficacy relative to other means of savings mobilization. Heightened competition among banks has made them offer interest rates to depositors that are responsive to T-bill rates. For large savers, banks offer a wide range of savings instruments. The often quoted wide spread between savings passbook rates and lending rates is irrelevant in the market for large savers. The entry of SDTs offering higher than T-bill rates might simply rechannel existing large savers to SDTs. In addition, BTr's efforts to service small savers entail high administrative costs (as SDT issues accumulate) and involve leakages (to nontarget beneficiaries like large savers). It is also not clear that SIP is an efficient way of broadening the investor market, or that BTr has this mandate. Such direct participation in markets may be less popular than policy and tax reforms intended to encourage savings. Policy options aim for the same goals but do not entail imposing institutional costs on government, for example offering tax incentives for savings and relaxing regulatory restrictions on institutional investors (insurance companies, pension funds, etc.) to invest in bonds.

A measure of the incentive to disintermediation is the spread between yield on government securities and bank deposit rates. There is an apparent wide spread between T-bills or T-bonds and interest on savings accounts before considering reserve requirements and withholding tax on interest income. The large nominal spread of banks, being visible to the public, explains why the public, and possibly regulators, often views banks' profitability in a negative light. However, real economic incentives to disintermediation narrow sharply when one calculates net spread, i.e., inclusive of tax and intermediation costs. From 1987 to 1991, there was a wide average net spread of 4.9 percent between the average yield on 91-day T-bills and savings deposit rates, allowing banks to earn by gathering deposits and investing them in T-bills. With relative economic stability and the liberalization of banking from 1992 to 1997, spreads between the 91-day T-bills and savings deposits thinned out to an average of less than 0 percent. In that environment, the only way banks could earn via intermediation on savings deposits was by

purchasing T-bonds. Banks then faced a liquidity gap when financing two- and five-year T-bonds with savings deposit. Under tax laws enforced since 1998, interest income from five-year bonds or longer is exempt from tax. Such selective tax exemption widened the differences between after-tax yields on five-year T-bonds and savings deposits and all Treasury securities with tenor shorter than five years. In sum, liberalization in banking increased competition and eliminated intermediation spreads in the shorter end of Treasury securities. Interest rates on the savings of large savers closely shadow T-bill rates. Banks can still enjoy wide spreads between large savers rates and bond yields, especially due to tax exemption for tenors of more than five years. It reflects a possible inefficiency in the longer-end of the bond market that largely explains why the savers served by disintermediation efforts like SIP-SDT are the large savers. BTr needs to redesign the program if it is to reach small savers.

#### **D. Types of Securities**

**Treasury Securities.** These represent sovereign obligations of the Philippine Government, while securities issued by government agencies, local government units (LGUs), and government-owned or controlled corporations (GOCCs) carry their institutional name rather than “Treasury.” Unless they are guaranteed by the national government, they are corporate or local government obligations. The Government issues Treasury securities in scriptless form. T-bills are sold on a discounted basis, i.e., interest is deducted from the face amount upon issuance. T-bonds are issued on coupon basis, i.e., interest is paid periodically. Interest paid through discount or coupons is subject to 20 percent final tax that is withheld upon issue of T-bills or payment of the coupon for T-bonds. No other tax is imposed in secondary market transactions for outright sale or purchase of Treasury securities.<sup>9</sup> T-bills come in various tenors of less than one year. The tenor, in number of days, follows the universal practice of ensuring that bills fall due on a business day. Quotes for T-bills are either by yield rate, which is the discount, or by price based on 100 points per unit. T-bills with tenors of 35, 42 or 63 days are called Cash Management bills (CMBs). During periods of high interest rates, the Government issues CMBs instead of T-bonds. T-bonds are securities of more than one-year tenor with yield equal to the sum of any discount or premium, and the coupon rate expressed as a percentage of face value

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9. A sale of a Treasury security with agreement to repurchase is technically an repo and subject to DST under current (2000) tax regulations.

on a per annum basis. The Government pays interest on fixed rate bonds semi-annually. A recent issue of small-denominated bonds carried interest payable quarterly.

### *1. International Bonds*

Since the return of the Philippines to the international bond market in February 1993, both public and private companies have issued a series of foreign currency-denominated bonds. Government bond issues accounted for 52 percent of total international issuances in 1993, but by 1995, 78 percent of issuance came from private companies. Issues dropped in 1997 due to a rise in the risk premia charged by foreign investors on emerging markets issues. Bond yields became prohibitively high after the Asian crisis.

**Corporate.** Private companies mainly issued convertible bonds in the international capital market in the first half of the 1990s. Foreign investors purchased these convertible bonds as a way of participating in the growth potential of the region. There was a steep decline in the number of issues and amount of funds raised through private convertible bonds in 1997. The steep plunge in the Asian equities markets reduced the value of the equity conversion option on existing convertible bonds, sending bond prices into a steep decline. The downside risk of corporate equities after the crisis negated the value of the equity conversion option. However, in 1998, with a recovering economy and stock market, there were three corporate bond issues in the international market: a telecommunications company, Bayan Telecoms, Inc. (US\$130 million), a real estate developer, Alsons Corporation (US\$11.5 million), and a public utility holding company, First Philippine Holdings (US\$90 million).

**Government.** The Government issued three bonds in the international bond market from 1990 to 1998: a US\$150 million fixed-rate credit offering in 1993, a US\$690 million Brady bond exchange in 1996, and a twin-tranche US\$500 million yankee bond offering in 1998. In early 1999, the Philippine Government launched a split US\$1 billion 10- and 20-year global bond issue. In February, it launched a 20-year US\$200 million bond followed by a second US\$400 million issue, and in March, Asia's first Euro-denominated offering of Eu300 million on a five-and-a-half-year term. The Government used the proceeds from these issues to refinance the country's maturing US dollar obligations for the period, and shore up gross international reserves depleted during the Asian crisis.

## **E. Investor Base**

There are three major sectors constituting the aggregate demand for government debt: investors, commercial and thrift banks, and BSP. BSP holds government securities as part of its OMO. Banks hold them as part of their statutory liquidity reserves and for their trading accounts. Investors are wholesale retirement funds administered by trust departments of banks. The BSP, banks and government-controlled pension funds accounted for about 74 percent of total government securities in 1994, rising to 77 percent in November 1999, while private institutions and individuals accounted for 26 percent in 1994, falling to 23 percent in November 1999.

The dominance of financial institutions suggests that influence of private institutional investors is weak. Private investors held a high proportion of the total from 1986 to 1992, with a shift back to banks in 1993/94 and 1999. Pension funds and private investors could be directly accessed by Government, and pension funds are large enough to be a major influence if they benefit from reforms in government policies on savings. However, retail investors are still not in a position to influence the total demand for bonds, and the Government is likely to continue its dependence on intermediation by banks.

BTr is currently undertaking a P50-billion SIP to distribute securities directly to retail investors in an effort to expand this sector. This could be seen as being in conflict with the role of GSEDs. However, BTr points out that GSEDs are not presently serving small investors. The question over whether to pursue both primary dealership and direct issuance to investors in the primary bond market is clearly a major policy question for BTr.

Investors in corporate securities are mainly large institutions like the Social Security System (SSS), Government Service Insurance System (GSIS), Retirement and Separation Benefits Program (RSBS), and private insurance companies.

## **IV. Bond Market Infrastructure**

### **A. Primary Dealer System**

Only accredited GSEDs, i.e., those appointed by the DoF Secretary, can participate in primary issues.

BTr prequalifies GSEDs based on certain criteria, such as (i) prior license granted by either BSP, the Insurance Commissioner or the SEC as securities dealer; (ii) compliance with statutory capital requirements in the pertinent financial services industry; (iii) electronic interconnection in a network with the BTr; and (iv) capacity to meet obligations.

The number of GSEDs increased from 23 in 1995 to 45 by the end of 1998 as BTr sought to increase competition in primary auctions. Some 41 of the 45 are banks, consisting of 29 domestic and 12 foreign banks.

The practice among GSEDs and commercial banks of holding government securities to maturity, due to the absence of a secondary market, implies that GSEDs do not perform their obligations of “position-taking and market-making in government securities” and “regular participation in auctions at reasonable and current market bid rates” as specified in the guidelines.

However, BTr has not monitored and seriously enforced these requirements on GSEDs—partly because there are too many of them to all serve as market makers given the present market volume. Fiscal agents in other Asian countries, such as Malaysia and Singapore, limit dealers to a few large investment banks, but require them to bid for a high minimum volume in every auction. Large dealers hold inventory and are positioned to make markets. In the last few years, rapid consolidation in the banking industry indicates that strong forces of economies of scale are at work in the industry, especially the core banking service of securities trading. The “open dealer network” policy of BTr may not be consistent with bond market development vis-à-vis the ongoing consolidation of banks.

## **B. Issuance Methods and Procedures**

The Government issues debt securities through a fiscal agent, which was the Central Bank prior to 1995 and thereafter the BTr. BTr issues securities on a scriptless basis in a primary auction through a network of dealers. Primary auctions used to be physical, sealed-bid auctions. Under BTr’s current auction system, authorized officers of GSEDs directly bid at their remote terminals. This is supported by the Dow Jones Market Network and a book-entry registry system, the RoSS. RoSS maintains records of Treasury security issues and holders in its central electronic system, located at the BTr. It maintains updated accounts of securities holders at all times by recording purchases, transfers, and redemption of Treasury securities. The electronic system is fully confidential and anonymous, reducing opportunities for possible collusion. It is designed for transparency and speed in handling large-scale issues averaging P15 billion (US\$375 million) a week, and its ability to elicit competitive, market-determined yields.

BTr conducts competitive bids through the electronic auction and noncompetitive issuances through either OTC or tap methods.

It can issue Treasury securities directly to investors through securities underwriters. Debt securities may be in script form, or on a book-entry basis (scriptless). With the latter, a central record-keeping system keeps an updated book of current holders of securities at all times.

**The Auction Process.** This starts with a notice of public offer to sell Treasury securities. The Secretary of Finance, by public notice and through BTr, offers to sell T-bills and T-bonds under specified terms and conditions and invites tenders. BTr electronically transmits the public notice of offering through the ADAPS which is BTr's electronic linkage with GSEDs, indicating any additional information about the specific offer. In response to the public notice of offering, GSEDs electronically submit their tenders to BTr through authorized officers who key in their bids using their remote terminals, usually by 10:00. GSEDs confirm their bids before cutoff time at 13:00, to ensure that their bids reflect current market sentiments. A GSED may submit any number of competitive bids and one noncompetitive bid. Tenders are unconditional and for a minimum amount of P10 million (US\$250,000) in maturity value for GSEDs and P1 million for non-GSEDs.

Bids for T-bills are quoted to three decimal places, while bids for T-bonds are in multiples of one eighth of a percent. Noncompetitive tenders are accepted at the weighted average yield of the accepted competitive tenders for the specific auction. The Dow Jones platform at BTr takes note of bid yield rates and total amount of bids as they come in. After cutoff time, the system sets out all bids from the lowest to highest yield for review by the Auction Committee, which then immediately deliberates upon all tenders.

The Auction Committee is composed of the Secretary of Finance as Chairman, the Treasurer as Vice-Chairman, SEC Commissioner, Assistant Secretary of the Domestic Finance Group of DoF, Deputy Treasurer for Operations of BTr, Deputy Treasurer for Planning and Policy of BTr, and the Managing Director for Research of BSP as members. BTr acts as the Secretariat of the Auction Committee.

T-bills follow English auction rules. The Committee accepts all tenders, starting with the lowest bid, up to the amount of preannounced offer, after deducting the total amount of noncompetitive bids. Winning bidders get their allotment at their bid yield rates.

T-bonds follow Dutch auction rules. The Committee identifies all winning bidders, starting with the lowest bid rate up to the amount of the preannounced offer. All winning bidders pay the same yield rate as the last winning bidder. At the cutoff level, if the same bid rate appears in two or more tenders, and the Committee wants to sell only the publicly announced offer, it allocates the appropriate amount pro rata to the tied bidders. The rate for noncompetitive bids is equal to the average rates tendered by accepted competitive bids.

Current rules allow the Auction Committee to accept or reject any, all, or parts of tenders, i.e., it may award less than the offer or reject all bids. It does not always allot the preannounced offers, because it wants

to keep interest rates on government debts low. Once it has decided on the amount and allotted the offer, notices are electronically sent to winning GSEDs through ADAPS. The Committee then downloads information on awarded securities to the principal securities account of the winning GSEDs in RoSS. To close out the award process, members of the Committee sign a printout of the summary of auction results.

If primary auctions are classified into two groups: fully-awarded auctions (allotment equals preannounced offer) and not fully-awarded auctions (total allotment is less than preannounced offer), the fully-awarded auctions made up 75 percent of the total number of auctions from November 1995 to October 1999, but distributed 86 percent of the total amount of T-bills offered. This suggests that full awards tended to be made in auctions that were larger in terms of amount of preannounced offers. For T-bonds, 64 percent of auctions resulted in full awards of preannounced offers, i.e., more competitive auctions, distributing 77 percent of the total amount offered. The five-year T-bond auctions appeared to be most efficient among the T-bonds auctions, because fully-awarded auctions accounted for 88 percent of the total, and distributed 93 percent of the amount offered. The efficiency of fully-awarded auctions for the other T-bond tenors were much lower. For example, only about half of seven-year T-bond auctions resulted in full award of preannounced offers, and those awards distributed only 63 percent of the amount of total offers.

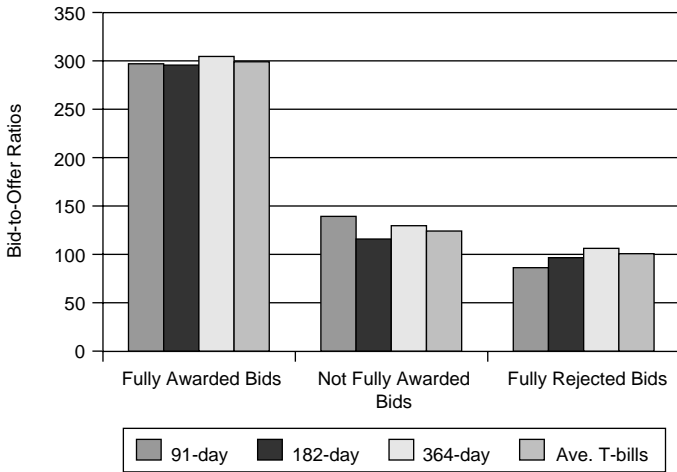
Non-full awards per se count as failed auctions and imply a serious flaw of the primary auction system. One reason is dealers' failure to fulfil their obligations to participate in all auctions and submit reasonable bids. The two figures below present the rates of oversubscription in auctions classified as to the degree of awards relative to preannounced offers. Occasions where the Auction Committee rejected all bids can be explained by adverse market conditions and resultant low dealer participation.<sup>10</sup> For T-bills, fully-awarded auctions from 1995 to October 1999 were oversubscribed by an average of almost 200 percent. By comparison, the oversubscription rate for not fully-awarded auctions averaged 22 percent, and only 1 percent in auctions where all bids were rejected. T-bond auctions exhibit the same pattern.<sup>11</sup> Fully-awarded T-bond auctions were oversubscribed by 137 percent, compared to only 9 percent for not-fully awarded auctions.

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10. A univariate analysis of variance using the ratio of total bids to offer as dependent variable yielded significant differences for the three T-bill categories ( $F = 9730$ ) at 5 percent level.

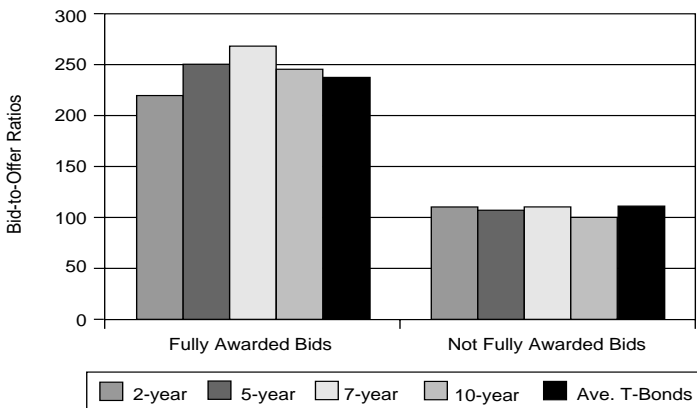
11. A similar univariate analysis of variance of bids-to-offer ratios for the four types of T-bonds showed statistically significant differences ( $F = 9484$ ) at 5 percent level.

**FIGURE 14**  
**Comparative Bid-to-Offer Ratios of T-Bill Auctions by Degree of Awards**



Source: Bureau of Treasury.

**FIGURE 15**  
**Comparative Bid-to-Offer Ratios of T-Bond Auctions by Degree of Awards<sup>a</sup>**



<sup>a</sup> There was no auction where the Committee rejected all bids.

Source: Bureau of Treasury.

On one hand, the findings justify BTr's refusal to fully award offers when bids do not reflect "true market" conditions, i.e., when auctions are relatively undersubscribed. However, the significant number of failed auctions reflects the weaknesses of the GSEDs, and BTr's failure to properly monitor them.

It undermines the benefits of the modern primary auction infrastructure and shows that the primary auction system is governed by an administrative, rather than market, mechanism. This seriously affects credibility, and can distort the pricing of bonds to the extent that interest rates in the primary auction are systematically lower than in the secondary market.

**OTC Issuance.** In OTC, BTr negotiates an offering of securities to GOCCs, tax-exempt institutions (TEIs), and LGUs. In effect, it is a negotiated sale of Treasury securities to government institutions. The Secretary of Finance, with the approval of the President, and in consultation with the Monetary Board, authorizes the OTC sale of government securities. An OTC sale is usually negotiated for institutions that want to invest their excess funds, or that hold T-bills they want to convert, as they mature, into T-bonds. Settlement on awarded issues occurs on the following Wednesday for T-bills and Thursday for T-bonds. On settlement date, based on a prior automatic debit authorization from GSEDs, BTr sends a debit instruction to BSP for the total amount of securities allotted to each winning GSED. BSP debits the demand deposit accounts of GSEDs and makes a consolidated credit to the account of the TOP. BSP then sends a credit advice to BTr. On the maturity or redemption date of a security, BTr instructs BSP to debit the account of the TOP and to credit the account of the holder of record. BTr pays interest for T-bonds in arrears every semester following the same settlement process.

**Corporate Issuance.** Companies issue debt securities either through public issue or private placement. After SEC registration, the lead underwriter distributes the CP or LTCP through a network of brokers and dealers, who are members of the Investment Houses Association of the Philippines (IHAP) and Money Market Association of the Philippines (MART). The underwriter keeps the security and underwriting agreement and allocates the CP to dealers. Dealers then sell CPs by issuing "certificates of participation" (CoP) to investors in the issue. Dealers cannot sell the CP outright, because investors usually want tenors that are shorter than the tenor of the original security. A dealer may issue a CoP with or without recourse. CoPs issued without recourse are not considered as deposit substitutes and the dealer (usually a bank) does not need to put

up the required liquidity reserve. CoPs issued with recourse are backed up by the dealer's guarantee of payment in case of default by the issuer. In practice, a dealer may waive the "without recourse" term of the CoP and pay for a dishonored CP.

Clear weaknesses in the primary market for corporate debt are (i) the absence of a central clearing institution to authoritatively validate (and if necessary, guarantee) that CoPs are supported by an underlying debt security; (ii) risks in settlement, being not tied to validation of the underlying security and done with different banks, and (iii) absence of a central electronic trading system that can enable dealers to view in real time their securities inventories and the outstanding balances of their clients.

### C. SIP – Issuance Conflict?

BTr is currently undertaking a P50-billion SIP. BTr considers the policy of expanding SIP as its contribution to capital market development. SIP could be seen as being in conflict with the present policy of relying on wholesale deals with GSEDs and letting them distribute Treasury securities to retail investors. BTr points out that GSEDs are not presently serving small investors, however. Whether BTr should distribute government bonds in wholesale and retail channels at the same time depends on whether small savers are truly not served by the banking system, the interest rates of SIP securities relative to the market, and whether the administrative mechanisms for prequalifying "small investors" can prevent leakage.<sup>12</sup> The question over whether to pursue both primary dealership and direct issuance to investors in the primary bond market is clearly a major policy question for BTr.

#### *Frequency, Lot Size and Allotment*

Income tax collections peak in the second quarter of the year, so the Treasury consequently issues less debt securities at this time. Changes in actual market interest rates, patterns in growth of GDP and the tax base, as well as government public expenditure programs also affect timing.

BTr conducts auctions every Monday for T-bills, every month on

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12. For example, SIP allows a maximum purchase of P500,000, a limit clearly much higher than capacities of "small savers." Leakage is a potential concern whenever offered yields on SIP exceed those for Treasury bonds of comparable tenors. Underwriters tend to recommend interest rates in the higher end of the market to ensure the market success of an offering.

the second or third Tuesday for two-year T-bonds, and every quarter for the 5-, 7- and 10-year bonds. BTr pre-announces its offer at least three days before the auction via the Dow Jones Market Network terminals. The public offering is for a definite amount for each tenor. Currently, the pre-announced offers are in lot sizes of P2 billion for 91-day T-bills and 5-, 7- and 10-year T-bonds, P3 billion for two-year T-bonds and P1 billion for 182- and 364-day T-bills. The policy on frequency of issuance and lot size partly explains the limited secondary market liquidity of securities of longer tenors because, except for the 91-day T-bill, other tenors are either too infrequently-issued or issued in small lot sizes.

Present policy implies quarterly amounts of issues for each tenor of P24 billion for 91-day T-bills, P12 billion for 182- and 364-day T-bills and two-year T-bonds, and only P2 billion for 5-, 7- and 10-year T-bonds. Among T-bond tenors, only the two-year seems large and liquid enough to attract secondary trading. The efforts of BTr to lengthen tenors have apparently resulted in smaller issues for each tenor. In addition, BTr tends to break up its preannounced offers into several issue series of even smaller total amounts, resulting in fragmentation of securities which exacerbates liquidity problems in the secondary market.

#### **D. Secondary Trading Systems**

**Government Securities.** Secondary trading uses BTr's electronic trading system and is recorded in the RoSS. The process begins with the prospective purchaser (who may be an investor or another dealer) asking a GSED for a selling rate quote for a specific bill or bond.<sup>13</sup> The GSED, if it has an inventory of the requested securities, then makes a sell quote based on the prospective investment amount and prevailing market conditions. A GSED usually gives sell quotes to achieve a target spread relative to its buying rate, to be compensated for holding an inventory of securities, and for its service as dealer. When liquidity conditions are tight, a GSED often needs to sell part of its securities portfolio to raise cash, and at lower quotes, being based on a thin spread. The rules on reporting trading account securities can affect the pricing of securities in the secondary market. An investor (or a dealer building a trading securities portfolio) can get quotes from several GSEDs through the Dow Jones market network. Once it makes a decision to purchase, the GSED closes the sale and issues a confirmation of sale to the investor.

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13. While the universal practice is to quote debt securities at a price per unit of 100, Philippine practice still uses yield quotes for ease of comparison with interest rates on certificates of deposits.

It receives either the investors' check, a debit authority for its account with the GSED or other similar forms of payment. The GSED then sends an electronic instruction to BTr's RoSS to transfer the securities from an account under the securities' client's name. When there is a securities certificate, securities dealers need a depository and custodian for the certificate.

**Corporate Securities.** The secondary market for corporate debt securities is an OTC system, with trades conducted through GSEDs and other licensed securities dealers. However, the market is not active because most investors, including GSEDs, purchase and hold securities to maturity. The process starts with underwriters of the securities, which are independent investment houses and investment bank departments of universal banks. For both corporate and government securities, transactions are mostly one-way sales to institutional investors such as insurance companies and pension funds, and to the treasury departments of commercial banks and industrial companies. There are only a limited number of individual investors.

### *1. Stock Exchange*

In February 1999, the SEC approved the listing guidelines and trading procedures for debt securities proposed by PSE. The system had not been implemented by March 2000. Issuers preferred to issue CPs rather than long-term bonds because of the relative ease in bringing CPs and long-term commercial papers to the market. The Philippine Corporation Code requires approval of corporate CP issues only by the issuing company's board of directors, but by two thirds of stockholders for bond issues.

### *2. Marking-to-Market*

Current accounting rules called "marking-to-market" require that trading account securities be periodically revalued to current market values.<sup>14</sup> The difference between current market value and the previous book value is recorded as an income or loss in the income statement. BSP requires banks to follow mark-to-market rules for their trading account portfolios.

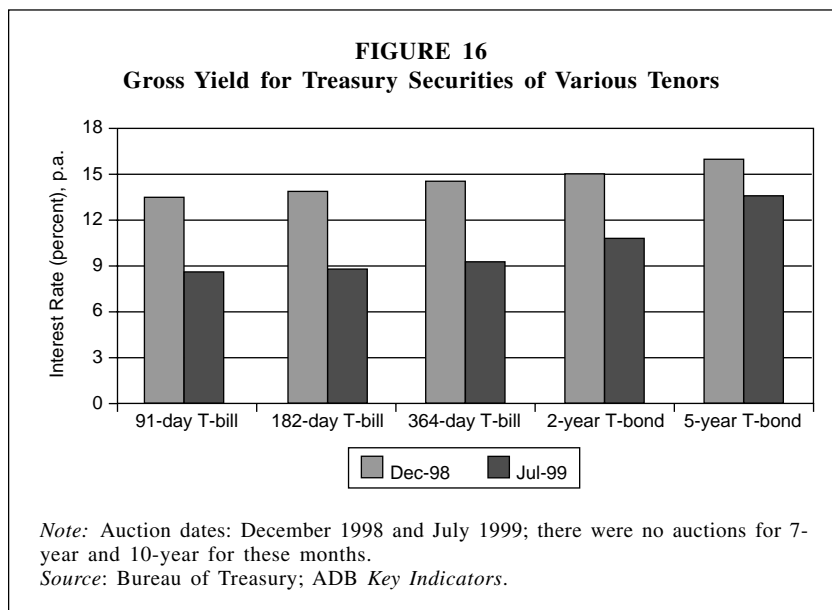
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14. The procedure is actually a revaluation because the securities are still held as inventory.

## E. Other Aspects

### 1. Benchmark Yield Curve

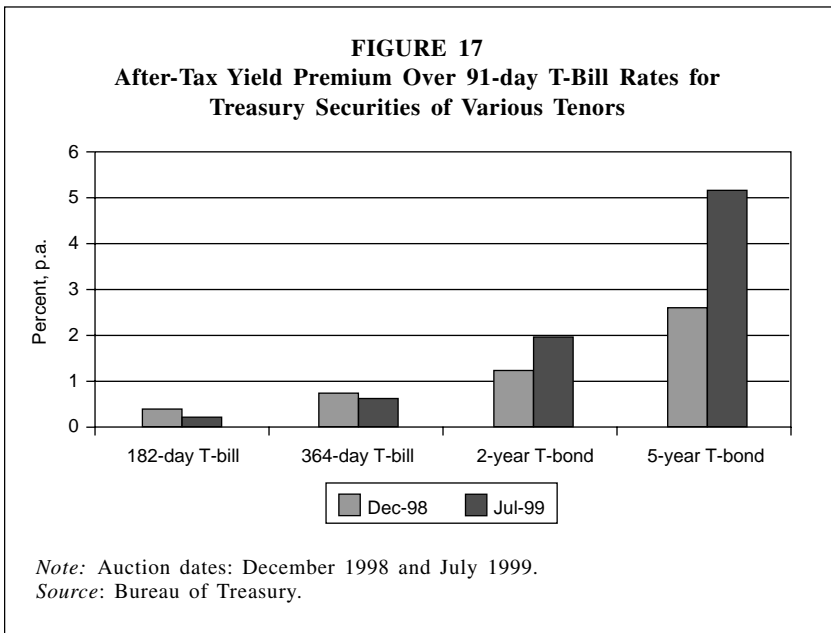
A benchmark security is a government security of a certain tenor that is so liquid that it has a market-determined yield at any point in time. A benchmark yield curve is the schedule of yields generated by active trading of an entire set of benchmark government securities. A benchmark yield curve comes out of two-way quotes and trades in the secondary market of government bonds with different remaining time periods to maturity. Based on the observed practice of loan-pricing, the Philippine debt market considers the 91-day T-bill as a benchmark security.



In order to support the benchmark securities that are to form the long-term yield curve, BTr successfully phased out long-term floating rate notes and introduced fixed-rate T-bonds almost as soon as it assumed its fiscal agency role in 1995. The volume of issues and bonds outstanding has continued to grow, and DoF and BTr have issued T-bills and T-bonds with longer maturity over the past five years (Figure 16), and decreased dependence on T-bills and CMBs in financing fiscal deficits. However, without a secondary market for government securities, there is

no benchmark yield curve for the bond market. Yields for T-bonds on auction dates are likely to reflect true market rates at that time. However, once outstanding, current yield-to-maturity quotes for T-bonds are not available. Thus it is not possible to fill in the yield curve for various interim maturities, and the credit market still uses the 91-day T-bill rate as the bellwether rate, even for long-term loans.

Figure 17 shows how GSEDs priced government securities of different tenors relative to the 91-day T-bill during auctions in two given months. The different yield rates do not necessarily form a “yield curve” unless the yields represent current market yields (rather than yields-at-auction date) and there is an active, liquid discounting (for bills) or quote-driven (for bonds) market for each security for the time period remaining to maturity in order to fill in the gaps between nominal tenor. Yields during auctions show increasing premia on the 91-day T-bill as the tenor lengthens. On an after-tax basis, the average premium for five-year T-bonds over 91-day T-bills at auction was as high as 5.1 percent in July 1999. The apparently high premium is probably due to the tax-free status of five-year T-bonds and their limited liquidity.



## 2. Tax Treatment

Income-related taxes on debt securities are the final withholding tax of 20 percent of interest income (for individuals) and GRT of 5 percent of interest income (for institutions). Capital gains tax is 35 percent of net capital gains for corporate holders and at graduated rates for individuals, except for bonds and certificates of indebtedness with maturity of at least five years. DST works like a transaction cost, because it is levied for each issuance at a flat amount depending on the amount of issue. Secondary trading of securities is not subject to DST.

Current tax rules cause distortions in yields on capital market securities, creating disincentives for holding and trading them. Capital gains tax on bonds is much higher than the 0.5 percent transactions tax for stocks traded in the PSE. Requiring DST<sup>15</sup> on every issue is a strong disincentive for trading securities, and encourages a buy-and-hold mentality. Commercial banks could raise liquidity by issuing repos against the vast pool of government securities, but do not because of DST. For example, a bank with a weekly turnover of repos pays the equivalent of 7.8 percent per annum in DST tax alone. The prohibitive cost of issuing repos against government securities is the reason for the reportedly common practice of “selling” a government security with an undocumented commitment to repurchase it,<sup>16</sup> in effect an underground repo market. The Government has responded with tax reforms under CTRP that will eliminate DST and GRT, leaving income and capital gains taxes as the remaining taxes on debt securities from 2001.

## 3. Credit Rating

The Philippines was the first of the study of Asian developing countries (ADCs) to establish a local credit rating agency, setting up the Credit Investigation Bureau, Inc. (CIBI) in 1982 through the efforts of the Central Bank, SEC and the Financial Executives Institute of the Philippines (FEIP). Recently, CIBI was reorganized as the Philippines Ratings Services Corporation (PhilRatings) with technical assistance from Standard and Poor's. In 1999, a second rating agency, Thomson Ratings

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15. DST is currently P0.30 per P200 or 0.15 percent per transaction. For a week's average holding period, this is equivalent to 0.15 percent  $\times$  52 trades = 7.8 percent per year. Another disincentive for repos is BSP's reserve requirement.

16. “BSP to Plug Loopholes in Lending, Buybacks, Swaps,” *Business World*, 20 December 1999.

Philippines, was established, with the help of Thomson Watch and the International Finance Corporation (IFC). These are steps in the right direction.

#### *4. Clearing and Settlement*

At present, there are separate clearing and settlement systems for corporate and government securities. For corporate debt securities, settlement is done directly between buyer and seller on a delivery-versus-payment basis. There is no central clearing and settlement for secondary trading. A private company, Philippine Central Depository, Inc. (PCD) operates a computer-based depository system for the equities market called "Fintracs." It has been evaluated by the Capital Markets Development Council as potentially adaptable for use in debt securities trading.

For government securities, BTr is the central clearing point for all transactions through its RoSS. Outright sales/purchases require verification at RoSS as to whether the seller has sufficient balance (inventory) in its securities holder account. Upon authorization by the seller, RoSS effects a transfer of the security to the securities holder account of the buyer. Only securities dealers that are also GSEDs can electronically confirm and authorize transfers with RoSS.

Settlement of Treasury securities auctions and trading is done through a system known as "netting with same day" settlement. This involves offsetting sell and buy transactions of each GSED at the end of each day and using only the net balance to adjust its deposit account with the BSP. This system meets the standard recommended by the Group of 30 (G-30) countries of T+0 (same day) settlement, following the stock market crash of 1987. The absence of an electronic link between BTr and BSP impedes real time settlement of secondary trades. To coordinate settlement with BSP, BTr submits a document to BSP at the end of the day, by hand, containing settlement information. It is recognized among modern bond markets that "netting" is not the best system, because it still involves settlement risk. For this reason, large financial institutions may hesitate to deal with smaller institutions, because if the buyer does not have sufficient cash to pay the net debit to its account at the end of the day, all trades with that buyer will be unwound. If the seller has already transferred the security to the buyer, it can incur a loss. Even if all parties avoid a loss by unwinding the transaction, the trading system still loses credibility. Further, "netting" still allows a GSED to engage in speculative transaction on the same day, particularly when there are wide intra-day variations in interest rates. BTr officials want to improve the present settlement system by moving toward a Real-Time Gross Settlement

(RTGS) system, or DvP, used in advanced trading systems such as Hong Kong, China. This discourages speculative transactions, because a GSED needs to fund each transaction and can no longer count on the next transaction to fund the previous one. With zero settlement risk, any dealer can deal with any other dealer. However, DvP requires more dealer liquidity, so some GSEDs might therefore oppose its adoption.

## **V. Regulatory Structure**

The DoF Secretary has the authority to regulate the terms, methods and conditions of issue of Treasury securities. The Secretary pre-announces public offerings, specifies terms and conditions of offerings, and invites tenders. Only accredited GSEDs, i.e., those appointed by the DoF Secretary, can participate in primary issues. Other institutions designated by the DoF can participate in specific auctions. The Treasurer of the Philippines, under the authority of the DoF Secretary, prescribes the minimum qualifications, duties and responsibilities of GSEDs. Similarly, BTr regulates, supervises and monitors the process of issuing, holding and administration of Treasury securities. BTr develops its regulatory procedures in a manner consistent with the Government's efforts to develop the capital markets and with those of other regulatory institutions, primarily BSP for banks and SEC for the corporate issuers.

Corporations issue debt securities under the Revised Securities Act (RSA) administered by SEC.<sup>17</sup> Under the RSA, SEC reviews whether an issuer has made sufficient disclosure of its financial condition, its credit standing and management aspects, and its fulfillment of administrative requirements. SEC aims to ensure that investors have adequate information to evaluate an issuer's underlying financial capacity to pay interest and redeem its debt securities. As part of the Government's capital market development efforts, SEC has been coordinating with a private sector-led multisectoral body, called the Capital Market Development Council (CMDC), to identify institutional and regulatory constraints to development, and has shifted from a policy of merit-based to disclosure-based regulation. In the past, SEC evaluated the specific financial capacities of an issuer mainly as a means of determining its capacity to redeem the securities it intends to issue. Under the RSA, SEC still reviews an issuer's financial capacity, but its new focus is on whether information disclosed by the issuer is sufficient to enable investors to make sound decisions. SEC administers the Corporation Code and its provisions regarding issuance

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17. The Revised Securities Act is expected to be passed by Congress in the first quarter of 2000.

of debt securities. For example, the Corporation Code only requires approval by the board of directors if a corporation issues a commercial paper, but requires approval by two thirds of the shareholders if it issues long-term bonds.

The SEC licenses and supervises securities dealers who need to maintain statutory capital requirements and submit financial statements and other reports.

## VI. Major Policy Issues and Recommendations

In the last five years, the Philippine Government has generated initial impetus for the development of the bond market in terms of market infrastructure, actual bond issues and institutional expertise. A truly competitive bond market remains some way off, however.

The Government needs to resolve policy issues, improve market infrastructure, reform rules, and promote participation by reputable market players, and should proceed in a phased manner using a building-block approach. Consistent with the recommendations of the Asia-Pacific Economic Cooperation (APEC) Collaborative Initiative on Development of Domestic Bond Markets,<sup>18</sup> the milestone achievements in sound bond market development are (i) consensus on a goals and policy agenda for government bond market development (Phase 1); (ii) an efficiently-functioning primary market (Phase 2); (iii) an efficiently-functioning secondary market (Phase 3), and (iv) an active corporate bond market (Phase 4). The secondary government bond market and corporate bond market could develop simultaneously, because secondary market players are also involved with, or are themselves, corporate issuers. This study submits key recommendations designed to tackle these development milestones, classified into four key components: (i) policy and regulatory framework, (ii) market infrastructure, (iii) supply of bonds from issuers, and (iv) demand for bonds by investors. These recommendations are summarized in a policy matrix, as shown in Table 2.

### A. Policy and Regulatory Framework

**Consensus Building.** The Government needs to define the objectives of its development program, and should make a policy statement to (i) lay out its policy and regulatory framework for bond market development;

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18. "Compendium of Sound Practices: Guidelines to Facilitate the Development of Domestic Bond Markets in APEC Member Countries," APEC, August 1999.

(ii) rely upon its authority to issue and trade government bonds as the basis for development of the entire domestic bond market; and (iii) set the goal of bond market development policy as that of generating a benchmark long-term yield curve. Fiscal, monetary and bond market development policies must be coordinated to promote stability in the market. The Government should use the DBCC and Auction Committee to coordinate the policies and operations of key government institutions involved in bond market development.

**Primary Market Development.** The Government should play an active role in the primary market as an issuer, regulator, promoter and catalyst. It should minimize interest costs and design a suitable maturity schedule, ensure that participants in the market follow the rules, review and reform the rules of primary market operations, ensure a broad range of instruments and wide participation from investors and dealers, and improve and innovate in such areas as market infrastructure and incentives to trading and holding bonds. It should broaden the types of government securities available in the primary market by promoting the issuance of LGU bonds.

**Secondary Market Development.** The Government should develop policies that promote liquidity and provide incentives to trade government bonds. Through DoF and BSP, it should review the compatibility of existing banking and corporate financing regulations in terms of development of the secondary market, focusing on policies impeding the development of a repo market, and the feasibility of setting up liquidity facilities for holders of government securities. Through DoF, it should consider providing incentives for institutional investors, e.g., a lower tax rate, in order to expand their participation in the bond market. The DoF, through BTr, should also support growth in OTC trading by providing benefits and privileges to market makers.

**Corporate Bond Market Development.** Once a secondary government market has been established, the Government should turn its attention to the primary and secondary corporate bond markets, reducing current tax and regulatory burdens and distortions. It should conduct policy dialogues with the corporate sector to coordinate the government and corporate sector bond market development efforts. An existing multisector institution, the CMDC, has coordinated capital market development efforts between government, private sector and international development institutions in the past, and could be harnessed again.

**TABLE 2**  
**Policy Recommendations for Growth and Development**  
**of the Philippine Bond Market**

Market Development Factor	Stages in Bond Market Development Government Bonds			
	Building a Consensus <i>(Phase 1)</i>	Primary Market Development <i>(Phase 2)</i>	Secondary Market Development <i>(Phase 3)</i>	Corporate Bond Market Development <i>(Phase 4)</i>
<b>Policy and Regulatory Framework</b>	<ol style="list-style-type: none"> <li>1. Attain the commitment of government to a statement of policy on BMD.</li> <li>2. Coordinate BMD policies with fiscal and monetary policies.</li> <li>3. Set benchmark yield curve as the goal of policy.</li> </ol>	<ol style="list-style-type: none"> <li>1. Support active role of government in the primary market.</li> <li>2. Promote LGU bond market.</li> </ol>	<ol style="list-style-type: none"> <li>1. Provide incentive policy for institutional investors.</li> <li>2. Coordinate BMD and fiscal and monetary policies that impact the secondary bond market.</li> </ol>	<ol style="list-style-type: none"> <li>1. Reduce tax and regulatory burdens and distortions.</li> <li>2. Conduct policy dialogues to coordinate corporate sector efforts toward BMD.</li> <li>3. Require full disclosure and high accounting standards.</li> </ol>

**Table 2 (cont.)**

Stages in Bond Market Development Government Bonds				
Market Development Factor	Building a Consensus (Phase 1)	Primary Market Development (Phase 2)	Secondary Market Development (Phase 3)	Corporate Bond Market Development (Phase 4)
<b>Market Infrastructure</b>	Set up the blueprint of a fully developed bond market infrastructure.	<ol style="list-style-type: none"> <li>1. Study the efficacy of setting up a primary dealer system vs. the current “open dealer network” system.</li> <li>2. Ensure transparency of allotment of offers.</li> </ol>	<ol style="list-style-type: none"> <li>1. Reduce regulatory burdens and distortions.</li> <li>2. Improve the clearing and settlement system.</li> <li>3. Monitor market practices and evaluate the performance of dealers.</li> </ol>	<ol style="list-style-type: none"> <li>1. Reduce regulatory burdens and distortions.</li> <li>2. Install facilities for timely release of corporate information.</li> <li>3. Improve credit rating facilities.</li> <li>4. Monitor market practices and evaluate dealers.</li> <li>5. Install a central depository, clearing and settlement system.</li> </ol>
<b>Supply of Bonds</b>	Assure a steady supply of domestic bonds regardless of fiscal condition.	<ol style="list-style-type: none"> <li>1. Manage issues to improve liquidity of target benchmark maturities.</li> <li>2. Build an accurate and reliable benchmark yield curve.</li> </ol>	<ol style="list-style-type: none"> <li>1. Develop facilities for repurchase market and securities lending.</li> <li>2. Monitor and enforce market-making obligations of primary dealers.</li> </ol>	<ol style="list-style-type: none"> <li>1. Keep transaction cost low by reducing tax burdens and distortions.</li> <li>2. Identify and differentiate bonds as to risk and quality of issues.</li> </ol>

BMD = bond market development; LGU = local government unit.

## B. Market Infrastructure

**Consensus Building.** The Government, in consultation with securities dealers, issuers and investors, should develop a game plan aimed at full development of market infrastructure to support the cycle of market operation, including rules and procedures. It should develop a blueprint for reforms, starting with the preannouncement of the public offer right up to clearing and settlement. The G-30 specifications could be a starting point, but should be expanded to meet the standards and specifications of market participants.

**Primary Market Development.** Strengthening the infrastructure of the current primary market is essential. Thus far, the Government has focused on its role as an issuer, and has not vigorously enforced the market-making obligation of GSEDs. The present policy of “open dealer network” does not seem to be working, and the DoF should study the feasibility of setting up a primary dealer system, whereby BTr would designate a core group of dealers among GSEDs. PDs would be required to bid for a minimum level, fulfil their market-making obligations, and would be rewarded with certain privileges. This designation should be done on a competitive basis, e.g., BTr could ask GSEDs to bid for only a few PD slots. This amounts to having a two-tier GSED system—market makers and ordinary dealers. It is recommended that market-maker GSEDs be required to make two-way quotes and bid for a higher minimum percentage of every preannounced offer. In recognition of their special role, they could be (i) allowed to exclusively participate in noncompetitive bids; (ii) given liquidity support by BTr or BSP; and (iii) closely consulted by BTr and members of the Auction Committee. GSEDs that are not market makers will be required to bid a lower minimum percentage of the total amount of preannounced offer and allowed to make one-way quotes. It is strongly recommended that BTr require a minimum participation limit in the primary auctions for each GSED, whether a PD or not, to facilitate monitoring by BTr of a GSED’s conduct and worthiness to retain its eligibility as a government securities dealer.

Allowing administrative overruling of auction rules is a major weakness in an otherwise efficient primary market infrastructure, because offers are allotted based on administrative rather than transparent market rules. The Auction Committee should review the auction rules to ensure transparency for awarding the preannounced offers. Although the Auction Committee may be justified in rejecting some or all of the winning bids when auctions are not competitive enough, this does not justify BTr’s practice of ignoring internationally-accepted auction rules. To ensure

competitiveness in every auction while avoiding less than full allotment of preannounced offers, BTr should (i) require dealers to subscribe a minimum percentage of the total offer with the sum of these minimum percentages being equal to a target oversubscription rate, e.g., 20 percent; (ii) specify a maximum rate acceptable for a bid to be valid; (iii) require dealers to participate in all auctions under all market conditions; and (iv) require PDs to give two-way quotes of a specified maximum spread. Without such safeguards, there is a serious danger that the PD system will result in further narrowing of the market, subjecting it to oligopolistic practices. Competitiveness, transparency, support by market-making dealers in every auction, and participation by dealers under all market conditions are essential.

**Secondary Market Development.** The Government bond market is an ideal base for developing the secondary market, because it has the most favorable tax rules and is free of the credit rating infrastructure necessary for the corporate bond market. Still, there are regulatory constraints when a holder of Treasury securities wants to raise liquidity through a repo agreement. BSP's requirement for liquidity reserves and DST costs inhibits the conduct of repo transactions and creates incentives for "off-books" approaches. The elimination of DST from 2001 will correct the disincentive for repos. Presently, BSP is using moral suasion to require banks to execute properly-documented repos. As a cause of the present distortion of the repo market, DST is probably more serious a disincentive than the required reserves. Its elimination may be a sufficient corrective measure. Nevertheless, BSP should review its regulations on reserve requirement for repos. While the principle of protecting bank capital from failed repos is valid in this case, the underlying security is a sovereign instrument and requires a lower capital loss provision following the Basle Agreement on risk-asset based capital adequacy measure. BSP should then consider the classification of repos as securities rather than deposit substitutes. A reduction of the reserve requirement would boost the repo market, because banks have substantial holdings of Treasury securities.

BTr should shift from its present system of netting with same day settlement to RTGS, or DvP. Netting meets G-30 standards, but is still riskier than DvP. Some market participants shun transactions with nonpeer institutions because of residual settlement risks under the netting arrangement. This is serious, because Philippine banks are of widely disparate size and reputation. The only missing element in the present system for achieving DvP is an electronic linkage with BSP for settlement. BTr should coordinate with BSP to enable it to shift to DvP without further delay to build confidence in the trading system of government securities.

BTr should monitor the market-making practices of dealers and their trading performance, and then exercise its authority to renew, cancel or enhance their accreditation. If the PD system is adopted, BTr should provide measured informational privileges to PDs, with the aim of allowing both parties a balanced assessment of current market conditions, especially the status of demand in the market, and leading to a consensus on the success of forthcoming bond issues.

**Corporate Bond Market Development.** A major impediment to the development of a corporate bond market is the capital gains tax. Being higher than comparable investments in equity shares, the DoF should consider realigning it in order to eliminate the disincentive to the trading of bonds. The valuation of corporate bonds is sensitive to the creditworthiness of the issuing company. For this reason, the Government, through the SEC, should install facilities for the timely release of information about the creditworthiness of issuing companies. The Government should encourage the entry of reputable credit rating institutions to provide rating services to corporate issuers. Recent entries of Standard and Poor's, in a technical service agreement with Credit Investigation Bureau, Inc.<sup>19</sup> and Thomson Rating Philippines in 1999,<sup>20</sup> are steps in this direction. The Government, through SEC, should also monitor the practices of securities dealers and evaluate them against their peers operating in more advanced Asian bond markets such as Hong Kong, China; Malaysia; and Singapore, and should work closely with CMDC, IHAP and MART in developing a code of best practice for securities dealers in order to define standards of conduct in the securities dealer industry.

The Government, through SEC and BSP, should push for the adoption of a central depository, clearing and settlement system. Initially, it can cover private sector and GOCC-issued debt securities through an existing system such as Fintracs. As a next step, RoSS and Fintracs could possibly be unified to facilitate clearing and settlement for all types of debt securities. Central clearing and settlement should serve dealers and investors better, while still allowing BTr to maintain an independent registry of issued Treasury securities. One possibility is the use of a technology that allows parallel book entry systems to be maintained at both RoSS and Fintracs, along with an expansion of the Dow Jones network to provide real-time information on price and volume to other non-GSED dealers.

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19. Under the technical service agreement, both parties have representatives when rating companies. The partnership falls short of a full sharing of technology arrangement.

20. Thomson Rating Philippines began operating in 2000.

### **C. Supply of Bonds**

**Policy Commitment.** The Government, through BTr, should provide a steady supply of domestic bonds under all fiscal conditions. This is not simple, however. As demonstrated in past periods of macroeconomic instability, it is too costly for the Government to issue bonds and even longer-term T-bills. In the 1999 to 2004 Economic Plan, the Government plans to move in the opposite direction, i.e., to issue domestic Treasury securities even in a period of fiscal surplus to pay off part of its existing foreign loans. This assumes the country can achieve a great degree of economic and exchange rate stability. Inability to meet planned economic targets inhibits bond market dealers and investors from forming reasonable expectations about future interest rates and bond prices. Commitment to regular issuance of bonds requires a corresponding commitment to manage macroeconomic fundamentals such as the fiscal position, inflation rate and exchange rate. The Government should focus on its role of establishing the credibility of its economic programs. Developing the municipal or LGU bond market would also expand and diversify supply. With the devolution of responsibility from national to local governments, LGUs have a large backlog of projects that need financing. A legal framework exists for the issuance of LGU bonds to finance revenue-generating projects, although national government guarantee of those bonds is precluded. GOCCs could also issue bonds to finance infrastructure projects.

**Primary Market Development.** BTr should manage future bond issues to improve the liquidity of certain target benchmark maturities and issues, and together with BSP should identify and build benchmark maturities aimed at eventually bringing down interest costs for DoF and easing the conduct of OMO for BSP.

In order to build a benchmark yield curve, the Government should (i) strengthen the 91-day T-bill as the prime short-term benchmark security by increasing the size of, and maintaining the frequency of, issues; (ii) identify the other benchmark securities to make up the benchmark yield curve (the 364-day T-bill and five-year T-bond are recommended); (iii) increase the size and frequency of Treasury issues around the three benchmark maturities while maintaining a significant presence in the other maturities to balance its fiscal requirements; (iv) make large (“jumbo”) issues for five-year T-bonds to build up the potential liquidity of this benchmark bond; (v) conduct a systematic re-issuing program for the two longer-term benchmark securities (364-day T-bills and five-year T-bonds); and (vi) focus any development policy initiatives, such

as repos and liquidity window for banks, on the three benchmark securities.

**Secondary Market Development.** This study supports the development of facilities for the repo market and securities lending. Because most dealers and holders of Treasury securities are banks, BSP holds the key to implementing this recommendation. The Government, through BSP, should (i) evaluate regulatory policy on repo agreements supported by Treasury securities, specifically the participants, benefits and risks involved, and implications on bank regulations, considering the differential risks of securities in relation to the risk-asset based capital provision required under the Basle Agreement; (ii) prepare regulations for conduct of repo transactions, including any required liquidity reserves, clearly defining acceptable practices and penalties for violation of rules; and (iii) consider opening a discount window for qualified government securities, following international practices, i.e., dealers paying market discount rates including provision for possible losses due to change in market interest rates (“haircuts”).

Another key recommendation is for BTr to monitor the activities of PDs in the secondary market and to enforce their market-making obligations. BTr should define standards of acceptable performance and specify sanctions. Because the secondary market is still limited, BTr indicators of performance for dealers should be market-based rather than based on absolute trading levels.

**Corporate Bond Market Development.** To promote corporate bond issues, taxes that increase transaction costs and act as disincentives to the trading of bonds must be removed. With the imminent phasing out of DST and GRT, the remaining task is to review the capital gains tax on bonds, as already discussed. The Government, through the SEC, should also facilitate the identification of risk and quality of corporate bonds relative to government Treasury securities. Such a continuum of risk-return categories is a required basis for developing a yield curve for the entire range of debt securities in the market.

#### **D. Demand for Bonds**

**Consensus Building.** Through BTr and BSP, the Government should promote the participation of heterogeneous groups of investors, and conduct systematic campaigns to increase public awareness about the rewards and convenience of investing in Treasury bonds. The quality of investors is also important. The present bondholders, mainly banks and other

financial institutions, are homogeneous, leading to movement in one direction when market conditions change, and creating imbalances in the market. The government should thus specifically target a diversified group of retail investors, such as pension funds, individuals, businesses and LGUs.

**Primary Market Development.** The Government can influence demand by managing the dealer system and setting up grassroots investor programs to support dealers at the retail level. Through BTr, it should expand the dealer system to include more non-bank dealers and other securities dealers with a wide network of retail investors and, through DoF and BSP, encourage dealers and other financial institutions to design and implement retail investor programs.

**Secondary Market Development.** The Government should give incentives, possibly financial, to heterogeneous investors to participate in the market. Also, through BTr and SEC, it should publicly list large issues of Treasury bonds in order to: (i) initiate a low transaction cost regime and simplified procedures that PSE will adopt for all subsequent public listing of Treasury bonds, and (ii) use the secondary market as a parallel market to the OTC for developing the benchmark yield curve.

**Corporate Bond Market Development.** To benefit investors in corporate bonds, the government, through BSP and SEC, should promote transparency in both the OTC market and PSE in trading of corporate bonds. Acceptable standards of trading should be developed, covering practices such as issuance of “certificates of participation” and other questionable informal practices. This should result in a code of standard practices that investors could use to assess the quality of their transactions to build their confidence in the bond trading system. A market price information system for trades of key bond issues should be set up to provide accurate, reliable and timely information to investors as a basis for their investment and trading decisions. Such a market price information service also plays a crucial role in developing the investor base.