CHAPTER 3

CAPITAL MARKET DEVELOPMENT IN THE PHILIPPINES: PROBLEMS AND PROSPECTS

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At the end of World War II, the Philippines was one of the more promising developing countries in Asia, but that promise has remained unfulfilled until the present time. The same may be said of the capital market. In 1966 the Philippines was the first country in Asia to introduce Treasury Bills and to organise a formal association of money market dealers, but since then its capital market has developed at no more than a snail's pace.

Some underlying trends in the financial sector of the Philippines since 1980 provide background for examining the development of the capital market. First, the importance of the financial sector in the economy is virtually unchanged over these two decades (Table 3.1). The ratio of financial sector assets to GNP, at 102.8 percent in 2001, is barely one percentage point higher than it was in 1980. The ratio climbed to 133.3 percent in 1997, but subsequently dropped, apparently reflecting the disintermediation effect of the 1997 Asian crisis.

TABLE 3.1
Amount and Composition of Financial Assets by Type of Institution, year-end 1980-2001

	1980		1985		1990		1995		2000		2001	
	Amount	Share	Amount	Share	Amount	Share	Amount	Share	Amount	Share	Amount	Share
	bil. pesos	%	bil. pesos	%	bil. pesos	%	bil. pesos	%	bil. pesos	%	bil. pesos	%
Banking system	188.8	76.2	395.2	78.6	609.5	76.1	1,595.6	78.6	3,326.8	80.4	3,259.3	79.7
Commercial banks	138.4	55.9	283.3	56.4	539.7	67.4	1,347.4	66.4	3,013.6	72.8	3,070.5	75.1
Thrift banks	10.6	4.3	15.1	3.0	37.6	4.7	143.3	7.1	245.8	5.9	259.0	6.3
Specialised gov't banks	34.2	13.8	88.0	17.5	18.5	2.3	68.2	3.4	--	--	--	--
Rural banks	5.6	2.3	8.8	1.8	13.7	1.7	36.7	1.8	67.4	1.6	73.8	1.8
Non-bank financial institutions	58.9	23.8	107.3	21.4	191.8	23.9	434.4	21.4	810.3	19.6	829.2	20.3
Government	20.1	8.1	60.6	12.1	107.8	13.5	277.2	13.7	473.4	11.4	506.7	12.4
Private	38.8	15.7	46.7	9.3	84.0	10.5	157.2	7.7	336.9	8.1	322.5	7.9
Total	247.7	100.0	502.5	100.0	801.3	100.0	2,030.0	100.0	4,137.1	100.0	4,088.5	100.0
Total Assets/GNP	101.6%		90.4%		74.3%		103.6%		117.3%		103.3%	

Notes: For non-bank financial institutions data for 2001 are projections and data for 2000 are 1999 estimate.
Source: BSP *Statistical Bulletin*, *Selected Philippine Economic Indicators*.

Second, the banking sector has gained in importance. In particular, commercial banks increased their share of financial system assets sharply from 55.9 percent in 1980 to 75.1 percent in 2001 (Table 3.1). The concentration of financial assets in commercial banks, which deal in government securities, have stock broking, investment bank, and thrift bank subsidiaries, and manage unit trust or mutual fund accounts, means that the diversity of institutions and instruments narrowed and that the market power of commercial banks increased.[1] The Bankers Association of the Philippines (BAP), the formal association of the commercial banking sector, was one of the most powerful lobbies in the country and was instrumental in limiting the entry of foreign banks, which was liberalised in 1994.

The other side of the picture is that non-bank financial institutions (NBFIs) decreased in importance over this period. More than banks, NBFIs tend to be the main buyers and sellers in the capital market. While NBFIs represented 23.8 percent of the financial system's resources in 1980, their share was estimated at only 20.3 percent in 2001.

Pension funds are the most important non-bank financial institution, with government pension funds accounting for 45.1 percent of the sector's assets in 1999 (Table 3.2). Pension funds are followed by insurance companies (19.6 percent) and then by investment houses and finance companies which together account for 17.3 percent of NBFI assets. Securities dealers and brokers account for only 1.6 percent of NBFI assets. (Nevertheless, the stock market is a growing component of the capital market, with market capitalisation of 55.5 percent of GNP, up from only 2.8 percent in 1984.) The Philippines' other, small, non-bank financial institutions together constituted only two percent of the total resources of the system in 1999 (Table 3.2).

One type of financial institution does not appear in these tables, that is pre-need companies. Unique to the Philippines, the pre-need industry started during the 1960s. Like insurance companies, pre-need companies promise to cover the cost of a future service (typically, education, pension, death-related services, or memorials) for a fixed premium during a person's lifetime. Pre-need plans are categorised as securities and regulated and supervised by the Securities and Exchange Commission (SEC), but there is little public data available.[2] The pre-need industry's assets grew rapidly during the 1990s from P27.7 billion in 1993 to an estimated P150 billion by 2001, nearly the same as the insurance industry. This dramatic growth has put pressure on insurance companies to put up their own pre-need subsidiaries.

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1. Trust accounts of commercial banks are kept off-book, and are not reflected in Table 1.
2. The minimum capital required to set up a pre-need company was P50 million at the end of 2000. The SEC licenses each company for an annual volume of sales for pre-need plans and imposes penalties for exceeding the approved volume. Pre-need companies are required to set-up a trust fund and make deposits according to a schedule issued by the SEC. The choice of trustee and trust agreement must be submitted to the SEC for approval. Currently, there are no rules on disclosure to plan participants nor are there clear investment rules apart from a 10-percent liquidity requirement and a 20-percent limit on investments in real estate.

TABLE 3.2
Amount and Composition of Non-bank Financial Institution Assets, 1991-99

	1991		1995		1999	
	Amount billion pesos	**Share %**	**Amount billion pesos**	**Share %**	**Amount billion pesos**	**Share %**
Government	133.7	55.2	250.3	55.2	389.8	54.4
Pension funds	106.1	43.8	186.7	41.1	322.8	45.1
Others	27.6	11.4	63.6	14.0	67.0	9.4
Private	108.3	44.8	203.4	44.8	326.4	45.6
Investment houses	31.2	12.9	40.7	9.0	93.3	13.0
Finance companies	14.8	6.1	27.6	6.1	30.6	4.3
Securities dealers/brokers	2.9	1.2	8.4	1.9	11.2	1.6
Insurance companies	45.2	18.7	100.3	22. 1	140.2	19.6
Non-bank thrift institutions	5.2	2.1	13.5	3.0	33.4	4.7
Others	9.0	3.7	12.9	2.8	17.7	2.5
Total	242.0		453.8		716.2	
Total Assets/GNP	19.2%		23.2%		22.8%	

Notes: Other private NBFIs include pawnshops, lending investors, venture capital corporation and fund managers.
Source: BSP *Statistical Bulletin*, *Selected Philippine Economic Indicators*.

This chapter focuses on three components of the capital market--pension funds, the equities market and the fixed-income securities market. We highlight these components because pension funds mobilise savings that could be a source of demand for capital market instruments and equities and fixed-income securities markets must function efficiently to channel domestic savings and foreign investment to further economic growth and development. The remainder of the chapter analyses problems in each of these sectors that have slowed the development of the capital market, describes recent reforms, and suggests changes that still need to occur.

THE PENSION SYSTEM

Contractual Savings for Capital Market Development

Overall, the Philippine financial sector is rather underdeveloped. The primary sources of long-term domestic financing are the stock market and the contractual savings sector, which includes pension funds and the insurance industry.[3] With increased participation, the contractual savings

3. The insurance industry accounts for one-fourth of contractual savings assets, and almost 60 percent of insurance industry assets are in life insurance companies. Life insurance companies are subject to a

sector has the potential to become a vehicle to support capital market development. The resources available to the contractual savings sector can provide an effective primary and secondary market for government and private securities, expand the capital market, and generate demand for professional investment and fund managers which will help establish a fund management industry (World Bank 1992).

The contractual savings sector in the Philippines has grown significantly. Total contractual savings increased at an average annual rate of 17.3 percent during the period 1985-2000 (Table 3.3). Nevertheless, this sector is less important in the Philippines that in many other developing economies. Contractual savings has hovered around 17 percent of GDP since 1998. This is about the same ratio as in Brazil, but it is far below the ratio in Chile, Singapore, and Malaysia, where contractual savings surpasses 50 percent of GDP.

Pension funds are the primary players in the contractual savings sector in the Philippines, with over 75 percent of contractual savings assets (Table 3.3).[4] Total assets in public sector pension funds were estimated at P473.4 billion in 2000. This is a sizeable pool of long-term resources, equal to 58.1 percent of the assets of non-bank financial institutions and 10.6 percent of the assets of the entire financial system. The generation of savings by the pension systems can be measured in terms of gross contributions and net income, which is investment income less the costs of running the system and benefits paid. In the Philippines, savings through pension contributions (public and private systems) reached an all-time high of 2.6 percent of GDP in 2000 (Table 3.4) and net income of the public pension system increased from P11.8 billion in 1989 to P35.6 billion in 2001 (Table 3.5).

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documentary stamp tax (DST) of 0.25 percent of the face value of each policy (Sunley et al 1997). The Financial Taxation Reform Program is seeking to reduce this tax to encourage efficient allocation of life insurance assets and equalize the DST on forms of savings instruments to level the playing field. Control by local, small family-owned businesses, which are often undercapitalised and have low retention capacity, hampers the non-life insurance segment.

4. This does not count the assets of the pre-need industry, which have been growing considerably but have no public data.

TABLE 3.3
Contractual Savings by Type of Asset, 1985-2000
(Billion pesos)

	1985	1990	1995	1998	1999	2000	2001	Avg. annual growth 1985-2000 (%)
Pension funds total assets	43.1	183.5	272.1	442.1	518.6	563.4	601.6	13.9
% of nominal GDP	7.5	17.1	14.3	16.6	17.4	17.1	16.5	
Public plan assets								
SSS investment funds	26.3	62.5	114.4	136.0	163.0	165.0	164.4	11.7
GSIS investment funds	16.8	36.1	72.2	131.6	163.7	181.1	205.5	16.4
Pag-IBIG assets	na	19.9	85.5	83.6	97.4	113.8	123.2	
AFP-RSBS assets	na	na	na	15.9	14.5	13.5	13.6	
Private plan assets	na	20.0	40.0	75.0	80.0	90.0	95.0	
Insurance assets	18.1	45.5	70.0	126.0	148.2	169.0	173.0	15.2
Total contractual savings	61.2	164.0	342.1	568.1	666.8	732.4	774.6	17.3
% of nominal GDP	10.7	15.3	18.0	21.3	22.4	22.2	21.3	

Note: These figures were obtained directly from each institution and may differ from Table 1 because of delays or omissions in information reported to the BSP.
Source: SSS, GSIS, Pag-IBIG, RSBS, Insurance Commission, WB, NSCB, UA&P.

TABLE 3.4
Pension Fund Contributions as a Share of GDP 1989-2000
(Percent)

	Public Sector Employer-Employee Contributions	Private Sector Employer-Employee Contributions	Total Public and Private Sector Contributions
1989	1.20	0.07	1.27
1990	1.42	0.11	1.53
1991	1.47	0.19	1.66
1992	1.48	0.15	1.77
1993	1.61	0.42	2.03
1994	1.71	0.56	2.27
1995	1.75	0.63	2.38
1996	1.71	0.48	2.19
1997	2.02	0.49	2.51
1998	1.81	0.54	2.35
1999	1.89	0.54	2.42
2000	1.98	0.58	2.55

Notes: Public member contributions came from annual reports of SSS and GSIS. Total income of private occupational funds was obtained from a survey by the Strategic Business and Economic Consultancy Group and company statements filed with the SEC. Total contributions are the sum of public contributions and the generated private member contributions
Source: Calculated by authors based on *SSS, GSIS, WB, NSCB, UA&P.*

TABLE 3.5
Net Income of Public Pension Funds, 1989-2001
(Million pesos)

	SSS	GSIS	Total
1989	8,237	3,545	11,782
1990	10,557	6,331	16,888
1991	13,598	7,013	20,611
1992	12,657	7,016	19,673
1993	12,555	8,738	21,293
1994	12,182	11,608	23,790
1995	13,898	14,113	28,011
1996	14,649	16,168	30,817
1997	16,829	18,515	35,344
1998	14,978	20,945	35,923
1999	13,397	30,568	43,965
2000	12,340	20,568	32,908
2001	9,793	25,813	35,606

Source: SSS and GSIS.

Pension savings can be significant sources of long-term capital because of their assured cash flows and long-term liabilities. Our ordinary least squares regression estimate indicates that the ratio of employee pension contributions to household savings is positively related to GDP (Appendix A). Thus, we can expect that the Philippines will have a growing pool of pension savings as economic development proceeds. In principle, by mobilising long-term savings, social security institutions can make non-inflationary long-term financing available to sectors that can use it most efficiently. The long-term maturity structure of their liabilities also creates a demand for matching financial assets, in the nature of equities and fixed income securities. The process of accumulation and investment of retirement reserves can stimulate creation of new financial institutions and more efficient mechanisms for allocating capital. In this way, the pension system itself can serve as an engine for increasing future earnings.

At present, however, only a small fraction of pension fund assets in the Philippines supports capital market development, because the investments are allocated primarily to loans and to non-traded government securities. The Philippine pension fund industry has a long way to go to match its neighbours. For instance, public pension spending in the Philippines was 0.6 percent of GDP, way less than Malaysia's 1.9 percent and Singapore's 2.5 percent (World Bank, 1985). Also, the pension system suffers from the absence of a pool of investment professionals, underdeveloped long-term financial markets, and a still-evolving relationship between pre-need companies and savers. Moreover, structural changes in the economy and society will increase the funding requirements of the formal social security system. Recently, the Philippines has begun to seriously consider reforms to strengthen the pension system.

Structure of the Public Pension System

As in most Southeast Asian economies, Filipinos relied more on extended families or informal, community-based support than on formal public pensions to provide for their social security needs. Strong ties among members of the extended family are a part of traditional Filipino culture and they provide a continuous and significant mechanism for assuring economic security into old age. Nevertheless, the Philippines introduced a formal public pension system for government employees as early as 1936.

Now, the formal social security system has two tiers (Asher 1998). The first tier comprises the mandatory, publicly managed system, including the Government Service Insurance System (GSIS), the Social Security System (SSS), the Armed Forces of the Philippines-Retirement and Separation Benefit System (AFP-RSBS), and the Home Development Mutual Fund (Pag-IBIG) (See Box 1). The GSIS primarily administers the social security program, including pension, workman's' compensation, and medical programs, for public-sector employees. The SSS, started in 1957, is responsible for employees of private companies and self-employed persons. The AFP–RSBS is to provide Filipino soldiers and their beneficiaries with living pensions and complementary welfare benefits, but it is still building up its fund and has yet to pay out any pension benefits. These three public systems are defined-benefit programs. The Pag-IBIG is the only defined contribution pension system in the Philippines.

The second tier is comprised of privately managed voluntary occupation pension plans of large private-sector companies. Unlike the first tier formal social security system, there is little published information on the private pension plans. Most employer-sponsored retirement plans have tailored their benefit schemes to satisfy the minimum requirements established by the

Employee Compensation Act of 1972. Typically, they pay a lump sum, calculated at 1.5 times the member's final salary times years of service with the company (Asher 1998). The private pension sector, while relatively young, is becoming an important source of retirement benefits for Philippine workers and one of the very few sources of long-term domestic capital.

Box 1

Basic Elements of the Retirement System

Pension funds are provided through both formal and informal planning. The formal retirement income support system includes five major elements:

- The Social Security System (SSS) provides retirement, survivor and disability benefits to workers in the private sector financed by employer and employee contributions totalling 8.4 percent of the first P11,000 of monthly earnings. Monthly retirement benefits are calculated by multiplying the average of the workers' most recent 60 monthly salary credits by 2 percent for each year of credited service and adding P300 to the total. Full retirement benefits are available at the age of 60.
- The Government Service Insurance System (GSIS) provides public sector workers with similar, though somewhat more generous, protections and is financed by employer and employee contributions totalling 21 percent of the first P16,000 in monthly earnings and 14 percent of earnings above this ceiling. GSIS, retirement benefits are calculated by multiplying the average of the workers' most recent 36 months of salary credits (with certain adjustments) by 2.5 percent per year of credited service. Benefits are available at the age 60.
- Pag-IBIG is a mandatory savings program financed by contributions totalling 4 percent for monthly earnings between P4,000 and P5,000. Accumulated funds are used primarily to finance housing loans. Accounts balances are available to participating workers at death, disability, retirement, or after 20 years of contributions. Participation is voluntary for low earners.
- Mandatory Retirement Pay (RA 7641) requires private sector employers to pay a lump sum equal to one-half month's pay for each year of service upon the retirement of an employee with more than five years of service. RA 7641 also provides for involuntary separation and disability benefits. Small employers in services, agriculture, and retail trade are exempt. This benefit does not have to be pre-funded. We estimate that pre-funding would cost employers about 2.5 percent of their cash wage bill if the average worker retired with tenure of 15 years and 6 percent of their cash wage bill if the provision were fully portable and average tenure at retirement were 35 years.
- Voluntary occupational pensions have tax preferences but their vesting, funding and benefit provisions are unregulated.

Source: SSS, GSIS, Pag-IBIG and World Bank.

At the end of 2001, the two main public social security programs (SSS and GSIS) had combined assets of P369.8 billion or 10 percent of GDP and accounted for almost 50 percent of contractual savings. Almost three-fourths of the combined total net income of these two schemes was in the GSIS system (Table 3.5). The surge in GSIS assets, which grew at an average annual rate of 16.4 percent from 1985 to 2000, was a major factor in the growth in contractual savings over the same period.

Problems

Three emerging trends in the economic landscape of the Philippines are creating the need to restructure the formal social security system and make it more efficient (Asher 1998). First, with increased urbanisation and industrialisation of rural areas, fewer people will be able to rely on informal, community arrangements to support their retirement, placing greater demands on the formal system to provide adequate benefits. Second, stronger purchasing power brought about by economic recovery will increase demand for economic security. Last, the size of the retiree population relative to the size of the workforce is projected to rise significantly in the next 30 years. A confidential World Bank report cited in the newspaper projects the possibility that SSS benefit payments will exceed its income by the year 2020. Heavy investment losses incurred during the Estrada administration and the low percentage of member contributions may put the SSS in this situation a decade sooner than the World Bank projected. These trends represent structural changes to which the formal pension system must adapt.

Although both the SSS and GSIS programs are partially funded, their investment policies and practices have serious shortcomings. For example, the reserves are not earning market returns, they are, for the most part, not held in liquid securities, and they are not managed in a way that encourages the growth of financial markets. A solution to hire a professional fund manager has been proposed but it is still very much in the conceptual stage.

Moreover, regulatory constraints on the allocation of pension fund assets to long-term securities have kept the public social security institutions from playing a significant role in developing the capital market. In 2000 long-term investments represented only 23 percent of total assets for the SSS and 32 percent for GSIS. This can be explained by the previous volatility of interest rates, which made even the private pension system maintain a fairly short-term investment profile, and to lean toward avoiding risk.

One negative aspect of public-sector controlled pension funds is the high probability of politically motivated (therefore, inefficient) investments. Indeed, there are allegations that investment of public sector pension assets in the Philippines has fallen under political influence. The former heads of the SSS and GSIS admitted that former President Estrada benefited from transactions involving the gaming firm, Belle Corp., and there are suspicions that he also profited from other deals such as the 1999 merger of Philippine Commercial International Bank (PCIBank) and Equitable Banking Corp. Equitable, then the country's tenth largest lender, was able to acquire 72 percent of PCIBank, the third largest bank, because the SSS and GSIS each contributed P7.5 billion to the P31.9 billion deal. While it was unusual for one bank to gobble up another bank more than twice its size, what was truly questionable was that this transaction was financed with the pension and other retirement contributions of private and state employees. Had the SSS and GSIS profited they could have defended the investment by pointing to the boost it gave to fund earnings, but in fact the merged bank has run into one financial problem after another, especially since the owners' connection with Estrada was exposed during the former president's impeachment trial.

Reforms

Reforming the pension institutions can improve retirement benefits and make the pension system more equitable. At the same time, if structured carefully, reform of the current retirement income system can raise the prospects for economic growth and development in the Philippines through improvements in the capital and financial markets.

The regional financial crisis stimulated the government to undertake some changes in the public pension system. Over-reliance on foreign financing along with excessive term transformation by financial institutions and excessive dependence of enterprises on short-term debt papers as opposed to long-term debt and equity finance were factors in the regional financial crisis. Recognition of these factors highlighted the need for the Philippines to develop domestic sources of financing. To this end, the government enacted two major pieces of legislation soon after the onset of the crisis to strengthen the public pension institutions. These and subsequent reforms have expanded their coverage and compliance and attempted to halt investment malpractice of public pension funds.

Both the Government Service Insurance System Act of 1997 (RA 8291) and the Social Securities Act of 1997 (RA 8282) raised the maximum amount of earnings on which pension contributions are based. This will increase the amount of money that pension funds could potentially put into the capital market. The Social Security Act of 1997 also gave the SSS new administrative authority. Before the act was passed, companies that complied with the pension funding requirements accounted for less than one-third of the employees who should have been covered by the program. Moreover, there is evidence that the contributions reported for a given worker in a given year often did not reflect the worker's full annual earnings. These compliance problems created financial difficulties for the SSS. They can be traced to the combination of economic incentives and administrative weaknesses to evade the law. The 1997 law gave the SSS greater powers to enforce compliance. For example, since the 1997 Act, the SSS can cross-check local business license applications with its own employer lists, making a more transparent environment. Compliance is an important challenge to the retirement income system. Without greater compliance, the system may never generate the adequate level of retirement income for beneficiaries that it should be able to provide. The main thrust of reforms seems to be compliance, i.e., actually collecting a greater proportion of the contributions that are legally required. This would have a positive impact on the pension saving rate in the long run.

Pending Issues

A number of problems and issues remain to be addressed to strengthen the public pension system as a social security institution and as a contributor to the capital market.

Over-pensioning

Under the GSIS benefit formula, many workers with long service may enjoy pensions that equal or exceed their pre-retirement net pay, given the current tax treatment. The GSIS is undertaking an analysis of benefits to long career workers. Administrators are presently comparing the combined total of pension benefits to pre-retirement earnings and they will recommend appropriate adjustments in the total compensation package for government employees.

Portability of Benefits

Workers moving from public to private sector employment are likely to suffer losses because benefits are not adequately portable between the GSIS and SSS programs. Several strategies could be adopted to remove the barriers to job mobility produced by the employer mandates under RA 7641. One approach is to require the previous employer to provide retirement pay and to adjust the benefit amount to reflect any increase in wages from the time the worker left each employer until retirement. A second approach is to require employers to set aside the potential benefits for workers who depart prior to retirement age. These funds would accrue interest in an investment account from the date of separation to the date of retirement. GSIS and SSS still need arrangements that allow workers to combine credits under the two schemes to establish their eligibility for benefits. Effecting this will require legislation, but GSIS and SSS are conducting preparatory discussions.

Privatisation

Some countries have responded to political and demographic pressures threatening the financial stability of their public pension systems by privatising them. A handful of countries have converted their pension systems from pay-as-you-go to partial- or full-funding and at the same time they have transferred management of contributions, in part, to the private sector. In the Philippines, discussion of privatising the SSS and the GSIS has been initiated either by the institutions themselves or by established fund managers. These discussions link privatisation to the objective of trimming the size of the government bureaucracy and improving investment returns. Conflicting political interests, however, may make it infeasible to accomplish privatisation of the Philippine pension system in a single step. If privatisation is to succeed, it is likely that it would only cover contributions in addition to present plan contributions.

THE EQUITIES MARKET

Besides improving the pension system, development of the capital market is a means to increase domestic savings to support long-term and sustainable development. Savings mobilisation requires a capital market that provides accessible instruments—both equities and fixed-income securities—to encourage savings and lower the cost of financial transactions. As intermediaries of such savings, efficient capital market institutions will improve the allocation of funds to alternative productive investments in the corporate sector. In the current global environment, with rapid development in information technology, innovations in financial products and services, integration of markets, and liberalisation of capital flows every economic player has to be competitive in order to survive. To compete for investors and channel investments properly in the rapidly changing global environment, the Philippine capital market needs technical and financial assistance to improve its analytic capability, to adopt international best practices, to build institutional capacity, and to upgrade infrastructure, particularly through IT-enabled support systems. The Philippines also needs to build a larger pool of investment capital by broadening public participation and attracting foreign investors to its equities and securities markets.

The Philippine equities market is one of the oldest in Asia. The Manila Stock Exchange (MSE) was founded in August 1927. The Makati Stock Exchange (MkSE) was established in May 1963. To consolidate logistics and hasten development, these two bourses agreed in principle to unify their operations under the Philippine Stock Exchange (PSE), which was incorporated on 14 July 1992. They continued to operate separately, however, until 4 March 1994, when the SEC granted the PSE a license to operate as a securities exchange and simultaneously cancelled the licenses of MSE and MkSE, making the PSE the sole exchange operating in the Philippines.

The PSE has remained relatively small since its formation. At the end of 2001, it listed only 230 companies and only a little over 300 issues. Of these, only 120 to 140 are actively traded issues. More importantly, most analysts consider only 30 to 50 of these issues to be investment grade. The 50 largest issues on the PSE account for almost 90 percent of its total capitalisation of $51.6 billion and the 50 most-traded securities account for over 80 percent of the total turnover value.

Moreover, the growth of the PSE seems to have stalled since the Asian financial crisis. In 1997, the year the crisis began, only six companies listed securities on the PSE, in 1998 four companies were listed, and in 2001 only a single company was listed. Total value turnover also dropped dramatically from a high of P669 billion (US$17 billion) in 1996 to only P357 billion (US$8 billion) in 2000 and to P160 billion (US$3 billion) in 2001. This post-crisis trend contrasts with the bright outlook for the PSE in the first two years after its formation, when IPOs boomed and market capitalisation was increasing.

The year 1994 was the busiest ever for IPOs in the Philippines, with 21 new issues generating gross proceeds of 37 billion pesos (Table 3.6). Between 1994 and 1996 there were 50 new company listings raising P95 billion. The 1994-96 surge in IPOs is probably attributable to the foreign exchange liberalisation in 1992, which paved the way for better a macroeconomic environment and the deregulation of the banking industry in 1994. Also, economic stability and political confidence during the administration of President Ramos meant that newly listed issues could realise average gains of 100 to 200 percent in one month's time. The rapid rise in prices of new issues might also suggest that underwriters under priced IPOs to guarantee success and to minimise their risk.

TABLE 3.6
Number and Proceeds of New Listings, 1987-2001

	Number of IPOs	Gross Proceeds million pesos
1987	2	156.5
1988	3	952.3
1989	6	3,702.2
1990	10	4,134.3
1991	10	5,658.3
1992	9	5,660.6
1993	11	8,713.9
1994	21	37,415.0
1995	16	31,028.5
1996	13	27,049.5
1997	6	10,073.6
1998	4	1,016.8
1999	5	756.5
2000	7	560.7
2001	3	242.0
Total	126	137,120.7

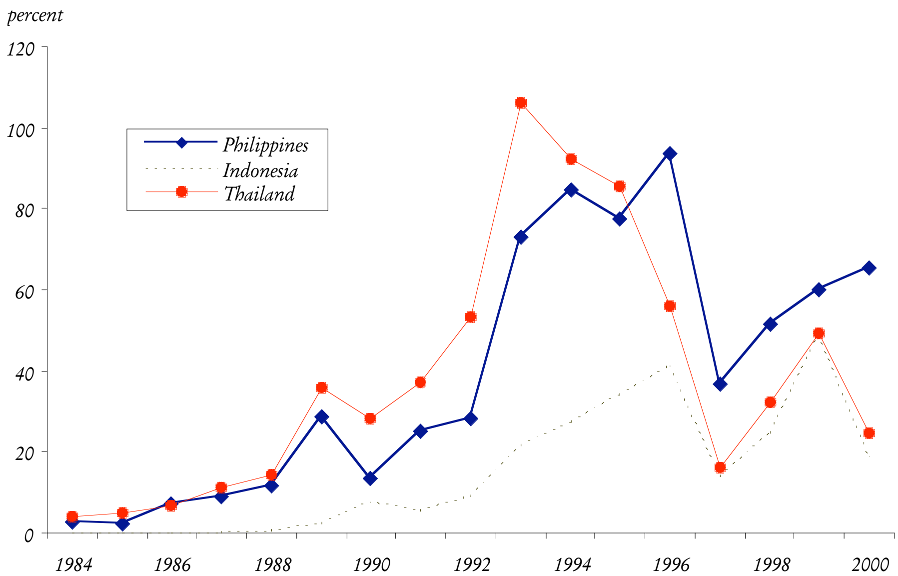
Notes: Number of IPOs is the number of firms that issued IPOs. Issues with A/B share classification are counted as one IPO. Gross Proceeds equals offer price times the number of shares offered to the public including both A and B shares.
Source: Philippine Stock Exchange

In 1994, stock market capitalisation in the Philippines reached 84.5 percent of GNP, compared to only 13.4 percent in 1990 (Figure 3.1). Market capitalisation peaked at 93.5 percent of GNP in 1996 before it fell drastically with subsequent external (the Asian financial crisis) and internal (political uncertainty) problems. Although it began to recover, in 2001 the market capitalisation-to-GNP ratio was still down by one-third from its peak. However, market capitalisation in the Philippines is larger in relation to GNP than in Thailand and Indonesia (Figure 3.2).

FIGURE 3.1
Ratio of Market Capitalisation to GNP, 1984-2000

Source: Emerging Stock Markets Factbook.

FIGURE 3.2
Market Capitalisation to GNP Ratios of Selected Asian Economies, 1984-2000



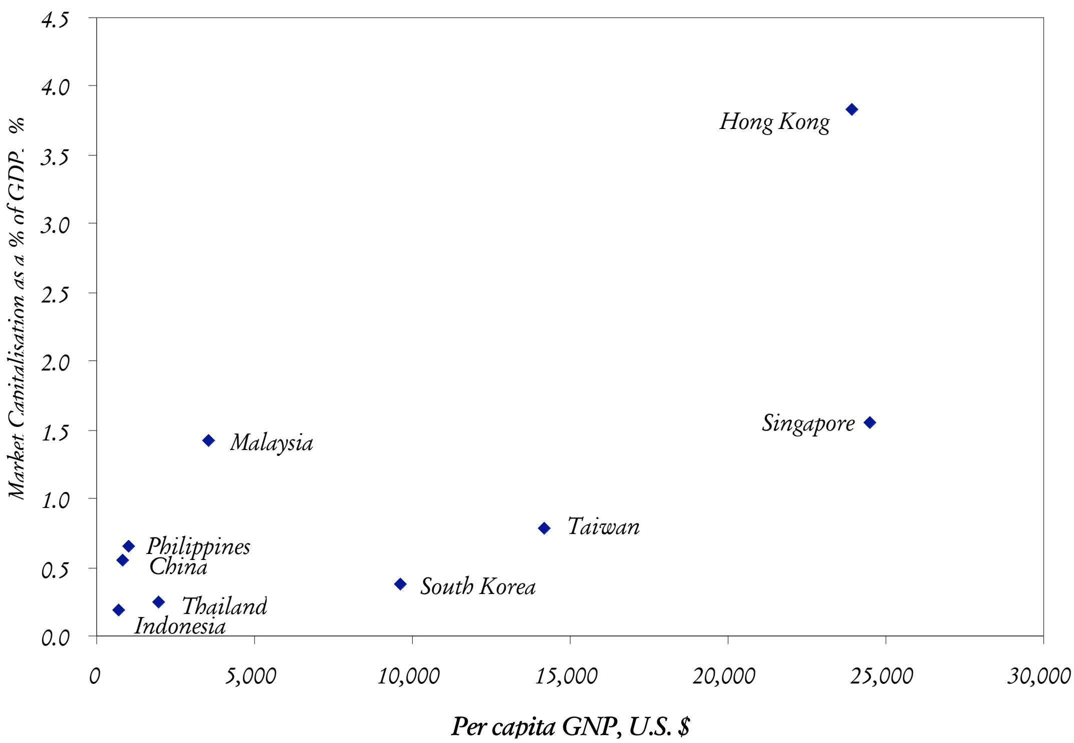
Source: Emerging Stock Markets Factbook.

Comparison with Other Asian Markets

This raises the question of how the size of the equities market in the Philippines relates to the economy's overall level of development. We answer this question by comparing the Philippines with neighbouring economies.

Figure 3.3 plots GNP per capita against the ratio of market capitalisation to GNP for nine Asian economies in 2000. It suggests a positive relationship between per capita income, or level of development, and the size of the stock market. For developed economies with high per capita incomes, like Hong Kong and Singapore, the value of stock markets is equal to or greater than total output, so the market capitalisation ratio is 1 or above. On the other hand, for emerging markets like the Philippines, China, Thailand, and Indonesia, that have lower levels of GNP per capita, the value of stock markets is generally less than the value of output. Malaysia is the exception among the emerging Asian economies with market capitalisation almost 1.5 times GNP.

FIGURE 3.3
Per capita GNP vs. Market Capitalisation as a Percentage of GNP, 2000



Source: Emerging Stock Markets Factbook.

We examined this relationship more closely by means of OLS regression of per capita GNP on the market capitalisation ratio for these nine economies using data for 1991 and 2000 (Appendix B). We found that there was a structural change in the relationship during the 1990s.

Specifically we found that for a given level of per capita income the market capitalisation ratio was higher in the more recent period. In other words, equities markets have grown in importance for economies at all levels of development. Besides, this has meant that despite the Asian crisis, stock market capitalisation in the Philippines is above average in relation to per capita GNP.

Problems

Dependence on Foreign Capital

Historically the Philippine stock market has not had a bull run without strong foreign participation. This was demonstrated quite clearly during the years between 1994 and 1996. Furthermore, in 1997 it was foreign funds fleeing the local market that caused its collapse. Strict monitoring of foreign capital, like the Malaysian model, can be a solution to the problem of volatile flow of funds.

High Transactions Costs

Another factor holding the equity market back is costs. The Philippine stock market has the second highest transaction costs among Asian equities markets (Table 3.7). In fact, at over US$2 billion commissions, fees, and taxes in the Philippines are significantly higher than in other Asian markets. The most significant contributor to these costs is taxes, specifically taxes on transfers, closely followed by commissions. If not for the very high market impact cost in South Korea, the Philippines would have the highest total cost among Asian equity markets.

TABLE 3.7
Equities Market Transaction Costs in Selected Economies, 1997 Q4
(US$ billions)

	Commissions, Fees and Taxes	Market Impact	Total Cost
Hong Kong	1.16	0.24	1.40
India	0.52	1.24	1.76
Indonesia	1.95	0.58	2.53
South Korea	1.52	3.97	5.49
Malaysia	1.78	0.41	2.19
Philippines	2.60	0.17	2.77
Singapore	1.38	0.42	1.80
Taiwan	1.31	0.53	1.84
Thailand	1.67	0.52	2.19
Asia Average	1.54	0.90	2.44
New York Stock Exchange	0.31	0.55	0.86
World	1.11	0.68	1.79

Notes: Market Impact compares the trade price to the "underlying price," and indicates execution skill and market liquidity. Normally, the larger the trade, the more the impact. Here, the underlying price is estimated by averaging the daily high, low, open, and close.
Source: Ekins/McSherry Co., Inc.

High taxes on transactions are almost certainly restricting volume and liquidity in the Philippine market. Low liquidity reduces the attraction of the stock market for investors and issuers. Experience elsewhere suggests that cutting very high transaction taxes leads to substantial increases in trading and tax revenue (Wells 1998). However, given the tight fiscal situation, Philippine tax authorities should study the likely impact that reducing transactions taxes would have on overall volume and on tax revenue.

Loss of Credibility

Finally, the Philippine equity market has suffered because the PSE and the SEC, as the final watchdog, lost public investor credibility, particularly during the Estrada Administration (1998 - 2001). One example, was the Best World Resources (BW) scam, the biggest fraud in Philippine stock market history. BW's stock price rose to a record level in October 1999 with an announcement that Macao casino tycoon, Stanley Ho, was to invest heavily and become Chairman of BW. This did not materialise and the price plunged a week later. The exhaustive Investigation Report of the PSE's Compliance and Surveillance Group concluded that Dante Tan, who controlled BW, and other brokers were manipulating BW stock through fraudulent "wash sales," in which the seller and buyer are one and the same person. The objective is to create the illusion of an active market in a particular stock.

Former President Estrada also allegedly played a role in the dramatic changes in BW's stock price. Tan was a friend of the President, and in July 1999 through the government Philippine Gaming Corporation (PAGCOR) the Office of the President gave the nationwide on-line bingo franchise to Best World Gaming and Entertainment Corp., a wholly owned subsidiary of BW. Under the Constitution, only Congress can grant a franchise to operate a gambling activity; without a congressional franchise, a gambling activity is a criminal act.

The BW scam was so massive and so glaring that it scared away all investors, foreigners and locals alike. This uncertainty caused the stock market to fall in late 1999 and 2000. Despite evidence presented during Estrada's impeachment trial in late 2000, the criminal cases against the parties involved have hardly moved.

Reforms

A positive offshoot of the BW scandal was the passage of the Securities Regulation Code (RA 8799), or the Securities Act of 2000, in July 2000. The enactment of the Code sends a clear signal to both local and foreign investors that the Philippine government is firmly committed to developing the local capital market and protecting investors. The reforms in the Code aim to develop the capital market, promote self-regulation in the securities industry, ensure protection for all investors, encourage full and fair disclosure, and eliminate fraud and manipulation which create market distortions.

Significant features of the Code include:

- *Reorganisation of the SEC into an effective market regulator.* The Code allows the SEC to completely reorganise, including paying higher salaries, which will enable it to attract the better trained staff that it needs to restore credibility as an effective market regulator. The Act also gives the SEC additional powers to enforce the law and address market abuses.
- *Full-disclosure approach to regulation of the securities market.* The law codifies a new approach to regulation, which aims to ensure that investors are provided with material information to enable them to make informed investment decisions. The SEC's role in public offerings is to review disclosure documents to make sure that they comply with disclosure requirements. The issuer, corporate secretary, persons who sign the registration statement, underwriters, and directors are liable for the accuracy the disclosure documents.
- *Credibility of the securities market.* The law requires the Philippine Stock Exchange to de-

mutualise and become a publicly held corporation with diverse ownership within one year, to immediately be governed by a majority of non-broker members, and to be managed by an independent and professional group. De-mutualisation is a way to restore investors' perception that the stock market is fair and transparent. The Code also gives the SEC power to regulate other types of markets, including "innovative trading" markets to reflect new market realities.

- *Protection of minority shareholders*. The law provides better protection to minority shareholders. Such protection is essential to attract new investors to the stock market where ownership is highly concentrated. Under the Code, mandatory tender offers are required if any person or group of persons intends to acquire 15 percent of the equity securities of a listed or other public company, or intends to acquire at least 30 percent of such equity over a period of 12 months.
- *Prevention of market abuses*. The law contains new prohibitions on insider trading and affiliated transactions by brokers and dealers, and it generally segregates the broker and dealer functions to prevent market abuse and fraud. Moreover, the Code provides the SEC with a flexible framework to regulate such markets, to enable it to resolve cases more expeditiously during an investigation.

There are two major items on the reform agenda that have yet to be carried out. The first is to remove the stamp tax on secondary transactions. This item had been given priority on the legislative agenda. The government is willing to reduce the DST on secondary transactions, but it wants to raise the DST on other items to compensate for the loss in revenue.

The second item is to achieve convictions in the BW scandal. The SEC does not appear to be seriously pressing the criminal cases on this issue. Achieving convictions will go a long way to restoring credibility in the integrity of equities market institutions among investors and the general public.

Future reform of the equity market should address the issues of information availability, profitability, and fairness. Investors put their capital where they believe it will yield the highest returns. The confidence of investors to go into the stock market depends both on the availability of information to guide their decisions and manage risks and on their perception of market profitability and fairness.

Lastly, the SEC must take very concrete steps to improve the credibility and image of the institution and its employees and to establish procedures and systems that remove, where possible, discretion on the part of SEC personnel over decisions and transactions. Among these are transparent rules and procedures, automation of some processes, closer monitoring of cases to determine delays and backlogs, and transferring discretion to parties that have a greater stake in the outcome, particularly in corporate recovery cases. These are some of the administrative reforms that remain to be carried out to complement the recent legislative reforms.

THE MARKET FOR FIXED-INCOME SECURITIES

The fixed-income securities market is the largest part of the capital market in the Philippines. Debt instruments are issued by the government and private companies and they are held by banks, insurance companies, pension funds, and pre-need companies. The government securities market is much larger and more highly developed than the private debt market.

Market for Government Securities

The market for Philippine Treasury bills is one of the oldest active securities markets in Asia, having been established in 1966 concurrent with the formation of the Money Market Accredited Dealers Association (MART) to handle its transactions. Despite its age, it has not fully developed, and much-needed improvements remain to be effected.

The national government regularly issues two kinds of securities, Treasury Bills (which mature in less than one year) and longer term Treasury Bonds. Prior to 1990, the maximum maturity of securities issued by the national government was only one year. Gradually as inflation and interest rates declined, the government began to issue instruments with longer maturity. Beginning in 1986 it issued longer-term Floating Rate Treasury Notes (FRTNs). It discontinued these in 1994 and replaced them with fixed-rate semi-annual coupon bonds, called Treasury bonds (Table 3.8). Treasury bonds (T-bonds) are issued in a range of maturities, and by 2001 they accounted for 69.2 percent of outstanding government securities (regular issues only).

In addition to these regular government issues there are special issues, both short and long term, by the national government and other securities issued by local governments or government corporations. One long-term special issue was the Retail 10-Year Treasury bond issued in 2001 and 2002.

TABLE 3.8
Outstanding Value of Regular Issue Government Securities, 1995-2001
(Billion pesos)

	1995	1996	1997	1998	1999	2000	2001
Treasury bills	216.7	218.2	214.6	264.4	290.2	275.5	250.8
Fixed-rate Treasury bonds	59	186.4	227.6	253.5	330.5	434.3	563.3
2-year	29	76.6	85.8	72.9	84.4	104.1	159.8
5-year	30	62.5	69.8	90.9	110.2	116.6	146.1
7-year	0	37.7	45.8	53.2	68.9	99.6	132.4
10-year	0	9.6	23.8	32.4	61.9	98.4	107
20-year	0	0	2.4	4.1	5.1	9.8	9.8
25-year	0	0	0	0	0	5.8	8.2
Total	275.7	404.6	442.2	517.9	620.7	709.8	814.1
in US$ billions	10.72	15.43	15.00	12.66	15.88	16.06	15.96
% of GNP	14.1	17.9	17.5	18.5	19.8	20.3	20.2

Source: Bureau of Treasury.

Origins and Systems

The Treasury bill (T-bill) market was born because of persistent government deficits and ceilings on deposit interest rates. The Central Bank originally carried out weekly auctions, but this regime ended with the clearer dichotomisation of monetary and fiscal policy in 1993. The Bangko Sentral ng Pilipinas (BSP) was established to replace the bankrupt Central Bank and the auctions were to be transferred to the Department of Finance, Bureau of Treasury (BTr) within five years. The BTr actually started handling the auctions in 1995. A representative of the BSP occupies one seat on the new Auction Committee.

When the BTr took over the primary auction of T-bills and T-bonds, it adopted the privately developed Automated Debt Auction Processing System (ADAPS). The ADAPS is an electronic system for the auctioning government securities to a network of authorised government securities dealers (GSEDs) linked electronically to the BTr. As of March 2001, there were 38 GSEDs, only five of which were non-banks. Introduction of ADAPS raised confidence in government issues by dramatically speeding up the auction process, making it real-time.[5]

5. Leonor Magtolis Briones and Catherine Bool Nunez, E-Government and Information Technology. *Asian Review of Public Administration*, 13(1), Jan-June 2001. Downloaded from http://unpan1.un.org/intradoc/groups/public/ documents/eropa/unpan004145.pdf.

Longer-term T-bonds are sold in a competitive, uniform price Dutch auction while T-bills are sold in an English auction, where successful bidders pay the price that they have bid. For T-bills, the Auction Committee decides a cut-off yield below which it makes awards, based on the amount of securities to be auctioned. First, however, 40 percent of the T-bills in the auction are awarded to non-competitive bidders (i.e., those that do not specify any price or yield, but only an amount), at the weighted average of the accepted bids. Bidders may enter as many bids as they wish and also participate in the non-competitive bids. The Committee can reject all bids that are way off current market rates or award less than previously announced.

Clearing and settlement are done on-line through the BTr's Registry of Scripless Securities (RoSS) system. RoSS is a central electronic clearinghouse that monitors and officially records the sale and registration of all government securities. Secondary trading is carried out by GSEDs on a limited, over-the-counter basis. There are no two-way price quotes for market players to see, so trading is based on direct one-on-one contact between dealers.

Problems with the Government Securities Market

The two fundamental weaknesses of the government securities market in the Philippines are inefficiency in the primary auction market and underdevelopment of a secondary market.

Despite electronic bidding and award posting, the primary auction market is still inefficient in several respects. This is illustrated by the fact that the rate is higher on T-bills than on similar period time deposits. One source of the high yields is market imperfection on the buyers' side. Banks, especially the big banks, have too much market power. In the past, a single bank has been able to corner the entire issue of a given tenor, especially of 364-day T-bills. This problem was pointed out in the 1992 World Bank study of Philippine Capital Markets:

> "…in normal circumstances, a demand for T-bills larger than the available supply should depress the yields on T-bills. The commercial banks in the Philippines, however, hold a monopsonist position in the market for T-bills. At the end of 1989, commercial bank holdings on their own account and private investors of T-bills amounted to 81 percent of total T-bills outstanding." (World Bank 1992)

Although more up-to-date information on ultimate holders is not available, the situation is not likely to have changed, since banks' share of financial resources increased during the 1990s (Table 3.1).

Another source of high yields is the auction rules. Using linear programming on actual bids for 16 auctions, Leonor found that the government could lower yields on primary auctions by changing the rules. Specifically, she proposed adjusting the percentage of accepted non-competitive bids according to a formula that considers tenders for both competitive and non-competitive bids and awarding risk-averse non-competitive bids at a rate equal to the highest accepted bid (Leonor 2000, p. 56).

The government proposed a new set of regulations and bidding system and submitted it for comment by market players in late 2001. One part of the proposal was to switch from the English to the Dutch system for auctioning T-bills, which would promote competition. It is likely that the change can be effected before the end of 2003.

The second fundamental problem is the practical non-existence of a secondary market, even for much-sought-after government securities. There are at least six reasons for the illiquidity and lack of development in the secondary market. They are: (1) a propensity for primary auction dealers to hold on to securities for their own account; (2) the inefficiency of the trading system; (3) the absence of market makers, (4) prohibitive taxation of securities transactions; and (5) lack of investor interest.

Propensity to Hold on to Existing Issues

Rather than serving as intermediaries, primary buyers of T-bills and T-bonds tend to hold on to these instruments until maturity, making the market illiquid. On one hand, primary auction dealers appear to be extremely risk-averse, preferring to put a large portion of their portfolios into government securities rather than loans. This behaviour has been especially apparent after BOP and/or banking crises and it continued after the Asian crisis of 1997. At the same time, the central monetary authority's regulations on bank lending compound the propensity for primary buyers to hold on. Banks that fail to meet the required loan allocation to agriculture can comply by purchasing certain government securities.

To solve the holding-on problem and create liquidity in the secondary market, Abola (1998) suggests lowering, or removing altogether, mandated lending to agriculture and limiting the government securities holdings of banks and insurance companies to a reasonable percentage of either total assets or total earning assets.

Inefficient Trading System

Presently, dealers carry out secondary market transactions on actual buy/sell requests, which they seek to fill from their own accounts or among other dealers on a personal basis. This one-on-one, barter-like system is inefficient, resulting in high transaction costs that discourage trading.

To be more efficient, the system for secondary trading in government securities should allow public, two-way exchange of information on bids and quotes and impersonal matching and execution of trades. A public-access, on-line quoting and trading system would accomplish these goals. The Bankers Association of the Philippines has plans to add such a system to its electronic trading system for foreign exchange, while the PSE has its own plan to include it alongside its stock trading system. Regardless of which entity (or a joint entity as is also being considered) succeeds, these plans, together with the determination of the Bureau of Treasury to develop a secondary market, bode well for the realisation of this long-awaited development to become operational before the end of 2003.

Lack of Market Makers

A viable secondary market needs large financial intermediaries to act as market makers, taking up the slack in the market and feeding the public perception that their presence assures liquidity. At present, the Philippines lacks any significant market makers. There are many Philippine investment houses, but they are either owned by banks or are poorly capitalised; the former cannot really compete with their parent's banking business, while the latter have little muscle to become market makers. This situation developed out of the introduction of universal banking in the 1980s, which stymied the development of the capital market by allowing banks to gain such dominance over other financial institutions. Neither are the SSS and GSIS pension funds able to function as market makers. Because their T-bill holdings are tax-exempt, these big institutional investors are constrained to trade only with the BSP (Bernardo 1999, p. 14). Not only is this tax exemption distorting but also it is unfair to other holders of government securities.

The existing wide spreads between loan and deposit rates at banks present a window of opportunity for active trading in government securities. In the first place, the amount of outstanding government indebtedness is large enough to supply the market with tradable instruments. Secondly, the private sector needs more efficient intermediation to maintain the momentum of the present recovery. Realising an active secondary market, however, also requires removing the impediments to participation by public pension funds and non-bank financial institutions, but that is unlikely to happen any time soon. Politicians are not apt to go against popular sentiment to legislate an end to the tax-exempt status of public pension fund holdings of fixed-income securities. Moreover, the powerful BAP is sure to mount stiff opposition to any attempts to unwind the universal bank model.

Heavy Taxation of Secondary Market Transactions

Every transfer of bonds and debentures is subject to a documentary stamp tax (DST) of 0.75 percent of the face value of the instrument. Since this tax is based on face value, it adds significantly to the cost of transactions in the secondary market, especially when interest rates are low as they have been trending in recent years. The high transactions cost discourages holders from unloading their securities to obtain liquidity or realise capital gains.

Both the private sector and the Department of Finance (DOF) have proposed removing the stamp tax for all secondary market transactions (including equities). Indeed, removal of the tax is part of DOF’s Financial Sector Tax Reform program, but it requires legislative approval. Passage of this and other financial sector reforms appear to be a priority of President Arroyo's administration.

Lack of Investor Interest

Finally, the secondary market for Philippine government securities suffers from a general lack of investor interest due to interest rate fluctuations and lack of market liquidity and market knowledge. Recent macroeconomic uncertainty and the resulting interest rate volatility have tended to make investors wary of long-term commitments such as bonds and government securities. Market illiquidity created by the structural problems cited above has discouraged retail investors from buying government securities. Moreover, Filipino investors and even finance professionals lack knowledge about the workings of such markets precisely because they are virtually non-existent in the Philippines. Past government policy did not help to encourage investors, either. For example, at one time Bancom was a pioneer in capital market development in East Asia and it actively promoted commercial papers and repurchase agreements for government securities, but the government allowed this large investment bank to collapse because of non-payment by a major paper issuer, Dewey Dee.

Except for the lack of liquidity in the market, the factors that have kept investors away from the secondary market for government securities seem to have been weakening. Evidence of this is the government's successful special issue of Retail Treasury bills/bonds in 2000 and 2001. These issues were sold directly to the public and in smaller denominations than regular issues of T-bills and T-bonds. The success of this special issue encouraged the government to repeat with another such issue in 2002. Retail investors would find such issues even more attractive if there were a secondary market to provide liquidity.

Overall Comments

The shortcomings of the primary auction market and the lack of a normal secondary market have meant that commercial banks can obtain economic rent in both markets. Evidence of this is the steep yield curve for government securities, which is unjustified by present or expected rates of inflation. Yields on Philippine government securities are also way out of line with yields in other developing countries such as India (Table 3.9).

TABLE 3.9
Yield on Long-term Government Bonds in Philippines, Australia, and India, September 2002
(Percent)

	Philippines	Australia	India
1-year	7.17	4.89	5.94
2-year	9.20	5.01	5.94
5-year	11.78	5.31	6.34
10-year	12.58	5.56	7.18

Source: *Asian Wall Street Journal.*

Indeed, the existence of these large yield spreads may also provide the solution to the inefficiencies of the primary and secondary markets for government securities in the Philippines. Such spreads create the incentive for other institutions and players to get into the act and to make substantial profits in the process.

Market for Private Fixed-income Securities

The fact that in 1996 domestic issues of commercial paper amounted to only half the volume of bonds floated on the international market by Philippine companies illustrates the weak state of the domestic market for private debt (Bernardo, p. 12). The market for private fixed-income securities in the Philippines is essentially a market for commercial paper. To issue bonds, corporations must prepare a prospectus and disclose much information, while to issue CP they simply need SEC approval. Prior to 1975, the issuance of commercial papers was unregulated. Financial disclosure started in 1975 and Registration and Eligibility Rules were adopted in 1981. Even prior to the banking crisis of 1984, the only private debt issues were short-term or commercial papers.

The market for commercial papers (CPs) was primarily short-term until 1991 when three-year commercial papers were first issued. These longer-term CP issues peaked in 1996, at P20.3 billion, and declined sharply from then until the present (Table 3.10). The market for short-term CPs followed a similar pattern, except that the fall has been precipitous since 1999. The Asian crisis severely impacted the private debt market in the Philippines. Due to a flight to quality, new issues of commercial paper fell from P24.6 billion in 1997 to only P8 billion in 1998 (Table

10). New issues for 2001 were practically nil (only P2 billion).

TABLE 3.10
Issues of Commercial Paper, 1995-2001
(Billion pesos)

	1995	1996	1997	1998	1999	2000	2001
Short term CP	18.8	15.1	13.2	7.3	2.0	1.8	1.0
Long term CP	12.1	20.3	11.4	0.7	6.7	7.0	1.0
Total	30.9	35.4	24.6	8.0	8.7	8.8	2.0
in US$ billions	1.20	1.35	0.83	0.20	0.22	0.20	0.04
% of GNP	1.6	1.6	1.0	0.3	0.3	0.3	0.0

Source: SEC.

Most outstanding private debt securities in the Philippines are long-term (Table 3.11). This is because recent tax changes partially or totally exempted long-term (5-year) issues on the part of the investor. Besides, with banks charging high lending rates when they are willing to lend, retail investors and corporate users would both benefit by issuing bonds. With inflation under control, there is promise for the corporate bond market to flourish during the coming decade.

TABLE 3.11
Commercial Paper Outstanding Year-end 1995-2000
(Billion pesos)

	1995	1996	1997	1998	1999	2000
Short term	3.9	5.9	4.7	3.4	2.0	1.6
Long term	25.0	46.0	50.2	44.3	45.5	43.0
Total	28.9	51.9	54.9	47.7	47.5	44.6
in US$ billions	1.12	1.98	1.86	1.17	1.22	1.01
% of GNP	1.5	2.3	2.2	1.7	1.5	1.3

Note: Data for 2000 are January to May only.
Source: SEC.

The private securities market suffers from most of the same problems discussed above with reference to the government securities market. At the same time, three additional factors specifically affect the development of the market for private fixed-income securities. These are (1) lack of mandatory ratings and credible credit rating agencies, (2) misalignment of accounting and auditing standards to international standards, and (3) lack of standards for good corporate governance.

Credit Rating Agencies

The private securities market in the Philippines would benefit from a more effective credit rating infrastructure to provide investors with objective, impartial information on the quality of debt issues. The need for credible rating agencies and mandatory rating of bonds is even greater since the Securities Act of 2000 gave the SEC a more regulatory role and the PSE has yet to prove its effectiveness as a self-regulating body.

The first credit rating agency in the Philippines, the Credit Information Bureau Inc, was set up in 1982 by the Central Bank, the SEC, and the Financial Executives Institute. Perhaps in response to criticisms in a 1997 study by the Asian Development Bank, the Credit Investigation Bureau was reorganised in 1998 with technical assistance from Standard and Poor's and renamed the Philippine Ratings Services Corporation, or PhilRatings (Saldana 2001). Thomson Watch and the International Finance Corporation (IFC) helped to establish a second agency, Thomson Ratings Philippines, in 1999 (Saldana 2001). These agencies maintain fairly good databases and they also gather information from other sources as well as from financial statements.

The revitalisation of the existing agency with foreign help and the entry of a second rating agency are welcome changes that will improve the quality of information and ratings in the Philippines. But, as in other developing countries, investors in the Philippines must pay special attention to obtain information not covered by financial statements and disclosures required by the SEC. A further step toward improving the private securities market by providing information essential for investors would be to make the rating of CP and bond issues mandatory.

Accounting and Auditing Standards

At one time, accounting and auditing standards in the Philippines were rated on a par with the rest of the region (Merrill Lynch 1998 cited in Abola et al. 2000, pp. 58-59). During the 1990s the Philippines moved away from strict adherence to the Generally Accepted Accounting Principles (U.S. GAAP) used in the United States by updating local accounting standards in accordance with the framework of the International Accounting Standards Committee (IASC).

As a result, the Philippines now has a mixed set of standards. While the U.S. GAAP is generally recognised as the more stringent standard, the Enron fiasco highlighted some of its deficiencies. Nevertheless, having a mixed set of standards is inefficient. It means that companies' financial statements are not readily comparable. Adherence to a single set of standards should be the norm. Since the Philippines followed U.S. GAAP in the past, it should continue to do so, and hope that U.S. GAAP and IASC will work out their differences in the future.

Not only are accounting standards in the Philippines now inconsistent, but also auditors are not held accountable. For example, a leading local auditing firm with ties to one of the top five U.S. auditing firms failed to detect the true state of insolvency of at least two listed companies. Neither the Board of Accountancy nor the Philippine Institute of Certified Public Accountants imposed sanctions on the auditors in these incidents or other cases.

The Philippines also needs to ensure that securities accounting is based on mark-to-market principles. BSP has mandated that banks follow mark-to-market, but the SEC has not imposed such a requirement on listed companies in general. There is great pressure for the SEC to issue such a directive and it should occur in due time.

Lack of Corporate Governance Standards

The Asian financial crisis of 1997 highlighted the lack of good corporate governance standards in the Philippines as elsewhere in the region. According to industry sources, before the crisis some Philippine banks were granting loans first and checking credit later, if at all. These banks continue to be saddled with high rates of non-performing loans, which stood at around 18 percent of total bank loans as of December 2001. The reckless lending to the real estate sector in 1994-97 could have been avoided if the Philippines had established norms for good corporate governance and sanctions for their violation.

Dr. Jesus P. Estanislao, former Secretary of Finance and President of the ADB Institute, spearheaded the establishment of the Institute of Corporate Directors in the Philippines. The

Institute worked with the World Bank and the Asian Development Bank to identify the key governance issues common to East Asian economies and to research and promote best practices in corporate governance. Workshops held in Manila in February, May, and November 2000 came up with a set of best practices in corporate governance and duties and responsibilities of corporate directors to recommend to the Pacific Economic Co-operation Council in the fall of 2001 (Institute of Corporate Directors 2000). The Philippines' group adopted these general principles.

In addition, through the SEC, the BSP, and public consultation, the Institute of Corporate Directors in the Philippines adopted a set of guidelines on Corporate Governance Reform. These guidelines cover rights and equitable treatment of shareholders, role of stakeholders in corporate governance, disclosure and transparency, responsibilities of board of directors, and appointment of two independent board members. The BSP requires all banks to follow these guidelines, while the SEC recommends that listed firms should follow them. At the end of May 2002, President Arroyo signed an Executive Order giving more teeth to the policy thrust. The BSP has been tough in implementing reforms and has mandated that members of banks' boards of directors take an accredited course on corporate directorship. The SEC is still working out final arrangements with the Philippine Stock Exchange to establish a similar requirement for directors of listed companies. Adoption of these guidelines and accompanying sanctions will mark a major step in realising a true private bond market. As is often the case in the Philippines, there is no shortage of laws or regulations on good governance—standards for best practice, duties, and responsibilities of directors are now in place—but what we need now is implementation and effective sanctions.

The Philippines is in the process of developing the necessary institutional framework for a bond market, but much work still has to be done soon to enable the financial system to be a contributor, rather than a deterrent, to sustained economic growth in the post-Asian crisis era.

CONCLUDING REMARKS

The capital market in the Philippines had a head start over the rest of East Asia, but it failed to develop. Recent structural reforms have improved the chances for the market to move ahead once more. We pinpointed the main obstacles in the way of developing the capital market, but we also showed that most of these obstacles have been or are in the process of being tackled. Reforms are being pursued to remedy imperfections in the primary market for government securities, and developing a liquid, electronically based (payments and settlement, and registry) secondary market is crucial.

With the recent trends of lower inflation, lower interest rates, and greater economic stability, the macroeconomic conditions are ripe for major development of the Philippine capital markets in this first decade of the new millennium.

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APPENDIX A
REGRESSION ANALYSIS OF PENSION FUND CONTRIBUTIONS

To show that pension contributions will be growing source of private savings for the Philippines in the future, we estimated a simple model of the determinants of pension fund contributions as a share of household savings during the 1990s. Pension contributions are a form of savings. Theoretically, when prices of goods and services are increasing very fast, households tend to decrease savings, while the other hand, when incomes are rising their savings increase. Furthermore, households are likely to reduce their current level of savings in the wake of natural disasters, wars, or financial upheavals, which make the future less certain. So like other savings, pension contributions should depend on the price level, income, and unforeseen shocks. As incomes rise, more enterprises join the formal sector of the economy and become subject to the pension scheme and as consumer prices move up, self-employed persons have less incentive to join the scheme. In recent years contributions from self-employed persons (which include overseas contract workers) have risen, because of the desire of these workers to take advantage of the housing loan benefit.

As independent variables we included the consumer price index (CPI) to reflect the price level; real gross domestic product (GDP) to proxy for household income; a dummy variable to capture the effect of natural calamities and the Gulf War in 1991; and a dummy variable to incorporate the impact of the aftermath of the Asian financial crisis in 1998. The data are annual for 1989 to 2000. The OLS regression results are:

Dependent variable: RATIO		
Variable	**Coefficient**	**t-statistic**
Constant	3.24190800	
CPI	-0.02498900	-7.582
GDP	0.00000653	6.026
DUM91	-0.30376600	-3.370
DUM98	-0.37293100	-4.128

R^2 = 93.4 ; Durbin Watson = 1.827

where:

RATIO = total member contributions / household savings
CPI = consumer price index (1994=100)
GDP = gross domestic product, at 1985 constant prices (in millions of pesos)
DUM91 = dummy variable with value of 1 in 1991
DUM98 = dummy variable with value of 1 in 1998

As expected, the consumer price index is negatively related to the pension savings ratio and higher gross domestic product means pension contributions are a larger share of savings. The uncertainties of 1991 and 1998 did dampen the rate of contribution to pensions out of savings. Other things equal, we can conclude that as the Philippines continues to develop and the general level of incomes rises, the pool of pension savings will also rise.

APPENDIX B
POOLED TIME SERIES ANALYSIS OF THE EQUITIES MARKET

To find out how economic development affects stock market capitalisation we estimated a simple regression of GNP per capita (PCY) on the ratio of market capitalisation to GNP (MKY) for the nine Asian economies, Philippines, Indonesia, Thailand, Malaysia, South Korea, Taiwan, China, Hong Kong, and Singapore. Analysis of the pooled data for 1991 and 2000 shows a positive relationship between PCY and MKY:

$$\begin{array}{llll} MKY = 0.231 & + 0.000083\ PCY & R^2 = & 0.552 \\ \quad\ (0.000019) & & S_1 = & 6.132 \\ \quad\ t = 4.44 & & df = & 16 \end{array}$$

In other words, market capitalisation rises along with an economy's per capita income and its level of development.

We used the Chow Test (Gujarati 1995) to test whether the relationship between MKY and PCY changed from 1991 to 2000. This test involves calculating a test statistic based on the sum of the squared residuals for the regression on the pooled time periods (S_1 above) and the sum of the squared residuals from regressions on each time period separately (S_2 and S_3 below):

1991

$$\begin{array}{llll} MKY = 0.229 & + 0.000067\ PCY & R^2 = & 0.538 \\ \quad\ (0.000024) & & S_2 = & 1.040 \\ \quad\ t = 2.86 & & df = & 7 \end{array}$$

2000

$$\begin{array}{llll} MKY = 0.306 & + 0.000085\ PCY & R^2 = & 0.536 \\ \quad\ (0.00003) & & S_3 = & 4.861 \\ \quad\ t = 2.84 & & df = & 7 \end{array}$$

Calculation of the test statistic:

$$F = \frac{S_5 / k}{S_4/(n_1 + n_2 - 2k)} = \frac{(12.033)/2}{(5.901)/[9 + 9 - 2(2)]} = \frac{6.0165}{(5.901)/14} = \frac{6.0165}{0.4215} = 14.3$$

where $S_4 = (S_2 + S_3) = 5.901$

$S_5 = (S_1 + S_4) = 12.033$

At the 5 percent level, the critical $F_{2,14} = 3.74$. Since the observed F value of 14.3 exceeds this critical value, we reject the hypothesis that the MKY function is the same in 1991 and 2000. In other words, we find that the structural relationship between MKY and PCY changed between 1991 and 2000. Two conclusions are worth noting. First, market capitalization is positively related to a country's development level as measured by per capita GNP. Second, despite the

Asian crisis, reliance on equity financing increased among the Asian countries in the sample.