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Preconditions for an Active Municipal Bonds Market in the Philippines

by John Earle Petersen

A chapter in *Information Paper #2: Local Government Credit Finance and Private Commercial Banks, Development Banks, Investment Houses, and Government-Financed Banks and Programs*

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ANNEX I

VIII. PRECONDITIONS FOR AN ACTIVE MUNICIPAL BOND MARKET IN THE PHILIPPINES

There are several component parts that need to be addressed in forming an active Philippine municipal bond market. The first is defining what is meant by the characterization "active market". By active market, is meant a continuing flow of investment funds from both private and public sources into a marketplace where new and outstanding issues of Local Government Unit (LGU) securities compete with other investments and are actively underwritten and traded. Such a market, once established, should have sufficient size to provide it with continuity and a variety of instruments that will appeal to private investor needs. Access to that market by LGU issuers should be on the volition, reasonably unfettered by restrictions and approvals, and economical.

Creating and sustaining such a market for LGU securities requires numerous preconditions. These may be conveniently categorized into the following four major brackets:

* the investment needs of investors (the demand for securities)
* the financing needs of local government issuers (the supply of securities)
* the mechanics of and participants in the operations of the securities market (issuance and trading processes) and,
* the regulatory oversight and institutional infrastructure of the market (the advisors, overseer, regulators and trainers and others interested in the market)

While I have had but limited exposure to the Philippine situation, I have had the benefit of background papers by participants in the LDAP/ARD Credit Finance Study and other resource documents. At points in the following discussion I will parenthetically reference those and other papers by name and page number (please see sources listing at the end of this paper). The frame of reference is typically how things are done in the U.S. market (this is described in the preceeding section). But the U.S. way of doing things, while timetested, is not perfect and there surely will be approaches to building a market that could be unique to the Philippines.

1. Investor Needs

Private institutional and individual investors are the key to creating a market in that they provide the capital needed by the localities. Private investors require financial rewards to do this and they are constantly involved in a risk versus return calculations among competing froms of investment. In a market environment it is up to the middlemen in the market and the issuers to develop products (types of instruments and security) that will entice investors to invest in LGU securites. In the absence of any past history, special efforts are needed to attract private capital to LGU investment. The discussion below will talk about steps along the path that seeks to introduce LGUs into the market (really, to build such a market).

In the Philippines, the challenge is to devise credit instruments that will permit the untested LGU credits to compete for private funds in what has been a high and volatile interest-rate market which exhibits a high time-preference for investment and a paucity of long-term debt investment. Three major problems need to be addressed: 1) paying competitive yields in what has been a high-yield and volatile market; 2) providing sufficient protections against risk, especially that of default, and 3) designing securities that will be of sufficient maturity to support large scale projects that have fairly slow payout.

The market will not spring forth full blown overnight, and the operating assumption must be that existing credit assistance programs in many cased will need to foster the transition into more private-sector involvement. At the same time, there appear to be projects that can get the ball rolling in that direction. Creditwothiness, is of particular importance given the high incidence of nonpayment under previous GFI loans made to LGUs. My perspective is that great care needs to be taken that securities are of high credit quality and that the chance for default in remote. Yet, there needs to be a systematic weaning away from central government control, guarantees, and concessionary rates which foster LGU queuing for credit. This will require instilling discipline in borrowers and the structuring of private-sector safeguards to promote timely repayment of debt obligations.

1.1. High Interest Rate Environment

The high interest rates, currently ranging in the mid-teens to low twenties for short-term government securities, are the relative cost of capital in the Philippine economy and present an opportunity cost for the use of capital in public versus private sectors. It appears that the long-term payoff of certain public investments will need to swim up an exceedingly steep stream, given the obvious high time-preference of money and the pressure for immediate consumption. Nonetheless, the costs of capital in the public sector, including that of LGUs should stay in touch with the rates in the market and subsidies of capital costs should be explicitly recognized. otherwise, there will be misallocations and a continuing inducement for potential LGU issuers to queue up waiting for low-interest loans or grants (Llanto, p.45). In a high-rate environment, interest rates, if not fully offset, can be bought down by the creative use of instrument design, the use of investible reserves and the impact of tax exemptions.

At present, there is really no active domestic long-term debt market in the Philippines. Aside from a couple of utility issues, the only long-term securities in the market are Central Bank issues, which are required to meet statutory reserve requirements and which were issued at submarket rates (Saldana, p.8). Long-term credit available to the LGUs has been solely supplied by the Municipal Development Fund (MDF) or the various Government Financial Institutions (GFIs) at sub-market interest rates and for maturities (and with grace periods) that have no counterpart in the private markets. Even at that, the great bulk of lending has been done to the national government, the deficit financing needs of which have swamped the domestic market. Thus, creating an intermediate longer term market in LGU securities will be a pathbreaking effort for all would-be debt issuers in the Philippined capital markets.

1.2. Tax-Exemption of Interest

Among the advantages that LGUs might offer would be the exempstion of their interest income from income taxation. On the basis that the top marginal tax rates (a 20 percent withholding and what I understand to be approximately 25 to 30 percent for corporations and individuals), the yields on the LGU securities should approximately 80 percent those available on fully taxable obligations. U.S. experience is that the tax-exemption feature is most effective in lowering rates in the shorter-term maturities where people are certain of their tax status. There are cogent arguments against tax-exemption in a developed economy; but in the case of starting a new market, the counter-arguments in favor of such an inducement are compelling. Tax-exemption of interest income could establish a niche in the market and provide a general relatively efficient subsidy to public works financing beneficial to fostering investment in infrastructure.

Unfortunately, there is no longer a tax exemption granted to LGU securities to be issued under 1991 Local Government Code, unlike the provisions in PD 752 (Saldana, p.17). Under that former law, the only LGU bond deal to occur has been the Cebu province capital issue of 3 years with a stock payout. The "bonds" were sold at 16% interest which were a tax-exempt (Saldana, Appendix Materials). The issue appears to be a highly specializes transaction that has only limited applicability to more conventional LGU offerings. However, the issuance illustrates that at this point in time offerings are likely to be "tailored"; and that actual offerings may be the best way to promote a clarification of borrowing requirements under the new Local Government Code.

1.3. Potential Investors in LGU Securities

Potential investment demand for LGU securities is a largely theoretical issue, but the indications based on the Credit Finance surveys are promising. For a developing country, World Bank figures indicate that the Philippines has a credible rate of personal savings, but these are largely absorbed in financing the national deficit. At present, it appears that individual savings go into stock sissues or into pass-book savings and time deposits and savings certificates at banks. I believe that these pay interest in the area of 8 to 10%. There would appear to be a niche in the personal investment area that might be met by small-denomination LGU paper or by shares in a LGU fund (as are discussed below).

Banks and insurance companies have virtuallu all the financial capital for investment in the market (Sanchez) and are heavily committed to government and government corporation securities. According to the surveys of banks and individuals reported by Sanchez, each sector is willing to acquire LGU paper, but evidently they are most interested in tax-exempt "clones" of short-term national Treasury bills. I will return to the role of banks in the discussion below, because it would appear they are of major interest in developing a LGU security market in the Philippines as once they were in the U.S.

1.4. Credit Risk

The record of creditworthiness if the LGUs has not been good. There has been a high level of default and loan forgiveness of loans made by the Government Financial Insitutions (GFIs) to LGUs (Llanto, p.45). If we accept that this outcome was due to a lack of information for assessing the underlying riskiness of projects, the conclusion must be drawn that the projects financed were not economic in the first place and that better information or more critical lending criteria would have curbed as much lending as was done. The opposite explanations are that the local governments were largely victims of exogenous situations which were disrupted the economy, or that the programs were poorly planned and administered, or that the local officials did not feel obligated to repay the "loans" which they believed to be grants. Whatever the explanation, the history is poor and the precedent needs to be rejected if private sources are to finance future capital needs.

My perception is that the framework for ensuring that debt service will be collected and paid out is weak, especially in smaller, unsophisticated LGUs. A way to immediately improve capacity and establish discipline is to remove the project construction and financing from the immediate oversight of the local elected official. This can be done by BOT transactions (private sector) or through the use of trusts and trustees (public sector). In the latter case, the trustee would not only collect monies directly from the project but in the case of tax-supported issues would have a deed of assignment for IRA distributions. This form of security has evidently been available to the Government Financial Institutions (GFIs) but not the private sector. Also, it evidently was not enforced by the GFIs. The use of trusts, trustees and intercepts is very common in the U.S. and appears vital to develop confidence in the LGU private market. In fact, a review of the Sanchez paper indicates that where there have been bank loans to LGUs, the banks have attempted to behave in that capacity and wish powers in that direction (Sanchez, pp.27-30). In the case of direct loan, this type of monitoring is feasible; but for securities sold in the markets, the service must be contracted for.

Ideally, there should be a test case on the use of the intercepts or an opinion out of the proper national legal authority (Attorney General, or its counterpart).

2. LGU Financing Needs

It is unwise to generalize about the need for LGU credit financing; but the objectives of encouraging use of drecit can extend beyond the immediate need to raise capital. Borrowing not only accelerates the provision of capital, it also ties up a commitment of funds in the future to repay principal and to pay interest. That, in turn, diverts money from going into current operating outlays, which tend to become embedded in local budgets. In periods of rapid growth revenue growth, encouraging capital spending through the use of credit may hold down the growth in the operating side of the public sector and foster infrastructure improvements as opposed to immediate consumption.

2.1. Issues

Revenue-based, self-liquidating borrowing has dominated what limited LGU (bank) lending that has been done. Under PD 752, LGUs could only issue bonds for revenue-generating projects (no general tax-supported securities were allowed). Nonetheless, there were limitations on total debt as a ratio of total taxable assessed value (AV) of 5%, which in view of assessment practices works out to more like 0.5% of real market value (Saldana, p.12). In the U.S., the debt to AV ratio usually runs in the range of 5 to 15 percent and onlu tax-supported debt is subject to it. The LGU debt limitation under PD 752 was very restrictive, and should the question of limits arise again, alternatives must be explored such as limiting debt service as a percentage of revenue collections from own sources, etc. However, with the repeal of 752, there appears as of now to be no specific restraint on indebtedness, except the cap on LGU annual paying capacity. That is, it cannot exceed loan repayments of 20% on annual regular income including the IRA.

This issues on code restrictions of bonds to revenue-generating projects needs to be clarified. Particularly in connection with the status of general obligation (tx-supported) securities (Saldana, p.18). My recommendation would be that it and other issues be clarified not in theory but in the paractice of actuallu bringing some "deals" to market and using them as test cases to establish precedents.

According to the Local Government Code, the Central Bank and the SEC are to regulate LGU debt issuances and the DOF is supposed to provide technical assistance in the use of the new LGU credit provisions. If test cases are brought to market now this could help focus Central Bank attention on its proper role in the past. Under PD 752, the Central bank (CB) was not only a trustee and transfer agent. It also approved bonds. PD 752 clearly viewed the LGU issue as a subset of the national bond market, bonds being approved by the DOF and President and they carried the national government an exception is guarantee. The Cebu securities which were issued without a guarantee and on a tax-exempt basis. Evidently, it was not considered to be a debt instrument (Saldana, p.32) and not limited by the debt to AV restrictions.

2.2. Credit Analysis and Ratings

There is a need to establish the basics of municipal credit analysis. Reportedly, the DOF has fairly uniform for each LGU which use standard chart of accounts and are audited by the national government aud tor. According to Sanchez, those banks that have lent to LGUs use standard commercial type loan criteria, which corresponds to the revenue-supported projects (markets, waterworks) that they have been financing and the requirement for collateral. In the United States, general obligation (GO) and the revenue bond analyses are fundamentally different, the latter being a matter of individual contract and the former dependent on the overall tax-raising powers of the government. One suggestion made by Saldana is that the DOF make available collected LGU information in an easy to use form for preliminary credit evaluation purposes.

My own belief is that while the private sector will need to devise its own methods of analysis, there can be a leadership in working through how these might be formulated. For example, if the DOF elects to put its (MDF) lending operation on a more commercial basis (petersen Memorandum of March 20, 1992), it could provide a starting point for criteria to be used in judging affordability. As LGU bond issues approach the market, analysts will have their own priorities among factors that determine creditworthiness. While the LGU credit market is small, it will be a one-at-a-time exercise. The formal use of credit ratings will await there being some volume of new issues. Any rating agency operation should be outside of the government sector to maintain its independence... nobody would follow a government-instituted guide, is my guess, although the private sector may not fare much better.

2.3. Current LGU Finance Policies

There is a need to know the financial situation of LGUs and their investment policies and assets. This can be very important in evaluating their needs and resources. In the U.S., for example, the ability of banks to attract deposits and investments from local governments and to provide other services (such as payroll, trust activities, etc.) have been important in cementing bank-LGU credit relationships (just like with private sector firms). These are bargaining levers in securing credit. In the Philippines, much of this money management has been determined by the central government and routed through the GFIs and government-owned banks. How much savings (idle balances) do the LGUs have? Do they mainly use pay-as-you-go financing from current receipts? There are a variety of related issues that need to be examined in assessing how strong a credit is and its bargaining position in achieving good terms and conditions.

3. The Market: Processes and Instruments

The municipal market in the U.S. is very large and, while national in scope, it is very active on the local and regional levels in the case of smaller issuers. Large issues have a national appeal and are focused on the New York bond market hub, while smaller issues get the greatest interest out of the regional market centers. It is also an Over-The-Counter market (OTC), with individual securities not being listed on the echanges, but rather with traders calling around bids and offers on individual bonds. It also has a large component of competitively auctioned issuances. That form of sales, is inlikely in the Philippine market, where competitive negotiation with prospective underwriters would appear the better model (in the U.S., the negotitated sale accounts for about 75% of all issuances).

In the case of the Philippines, there are potentially only a few larger issuers that would have regularly traded issues, but a restructured MDF fund, such as described to Mr. Pardo of DOF (Petersen Memo) would have a better prospect for listing and trading. The fund could consist of smaller to intermediate issues (maybe, big ones too) and shares (certificates of participation) could be listed at the Manila and Makati exhanges. This would build liquidity and perhaps institutional support for LGU borrowing.

3.1. Instrument Types and Funds

Debt instrument types should be employed that allow for longer maturities, but also allow for a refixing of interest rates to conform with the changing level. The variable-rate security seems especially useful here. Because of the mechanics involved might be best done on a pool or fund security that would allow for the interpositioning of an intermediary between the underlying LGU borrower and the investor. For example, there might be a floor/ceiling restriction (8% to 20%) on interest rates on LGU fund securities, which would pay interest rates geared to 80% of the average rate (WAIR) on Treasury Bills for the investment period (calculated retrospectively).

What interest rate ratio of tax exempt to taxable rates would evolve to clear the market would depend on first making certain that LGUs can issue tax exempt and the effectiveness of tax exemption (e.g., are corporations and individuals paying at the top marginal brackets and, if so, how much do they represent in total investible funds?)

The annual amount of the debt service might be fixed for the underlying borrower and then the maturity could be varied depending on the levels of interest rates (high rates would lead to a stretching of maturities, low rates would shorten them). This is called an extendable/retractable security and it gives the borrower assured debt service, but allows the repayment period to vary.

Obligations of the fund would help develop a secondary market in either of two ways: as a debt obligation (or asset sale, where the underlying obligations to the fund are securitized and resold to private investors) or a stock with a dividend dependent on interest payments from the underlying loans. The fund share approach would allow them to be traded on the stock exchange as shares of other funds. Another idea, that of small denomination securities is discussed elsewhere below.

3.2. Creation of and LGU Security-backed Fund

Many LGU projects are unlikely candidates in the near future for direct market issuance and would appear best served by a pool or bond bank that could combine issues and either sell its own securities or bundles of its loans (assets) into the securities market. This idea has been suggested in a memorandum to the DOF which is examining the lending policies of its Municipal Development Fund (Petersen Memo). A pooling approach provides for diversification and economies of scale. It also provides the pool with an element of control and oversight over the use of credit. There is also the opportunity to institutionalize a certain amount of loan development and technical assistance. Larger units and projects have the capability of going directly to the market, although the mechanics would appear to favor, for many, the rentention of the pool approach. Pool financing, which might be set up as a fund accessing several cources of capital, could have the following elements:

(a) An ability to provide package deals whereby the private sector could take a senior lien position (get paid first) and do the interim (early maturity) financing.

(b) A guarantee for a portion of the private loan, such as 80 percent of the debt service. This guarantee assumes that the pool would have access to intercept the IRA payments to borrowers if there was a debt service deficiency. This might be accomplished by the use of a trustee to whom the borrower would assign the first returns of the IRA to be placed in a debt service fund if that fund is inadequate to meet upcoming payments. Funds placed in the sebt service fund would be earning interest, which should be at least equal the cost of borrowing and might actually yield more than that cost were the LGUs able to borrow on a tax-exempt basis.

(c) Once a loan had seasoned, by having a track record for timely and complete payment of debt service on a regular schedule, it could be recycled by selling it our of the portfolio into the private sector. This securitization would free up more money for other lending. It is most economical to do this with tranches of securities and to provide greater protection by an over-collateralization of the underlying loans. In other words, P120 million in underlying performing debt might be pledged to the payment of the P100 million sold into the market.

(d) By combining public and private financing sources, the pool could vary the interest rate costs to borrowers. Over the long-run, there needs to be an incentive to run the LGUs and their enterprises on a cost-effective basis and with a realization of the actual cost of capital in the economy. The greater the per capita income of the borrower LGU, the larger its size, and more the extent of the enterprise activity, the larger should be the portion of private capital in the financing mix. As a rule of thumb, a 50/50 split would seem a desirable goal for general purpose (tax-supported) activities.

(e) The fund could borrow on its own in the market, using as security paying loans, the IRA intercept, and an invested reserve fund.

3.3. The Small Deonomination Security

In addition to the credit market instuments discussed above, the fund (or larger LGUs) could issue small denomination citizen bonds that would generate funds for particular projects in LGUs but would have the backing of the entire fund. Another reason for a fund involvement is that samll-denomination sales typically are best-efforts (not underwritten with the guarantee of receiving the amount of the bond issue). Thus, if not all the issue is sold, there is need for a back-up to take down the rest of the borrowing. As a result, most of the these issues have been sold as series of a larger issue. The small denominations could be distributed by the local banks, which might receive a small commission and/or credits for their 75 percent local retention requirement on the basis of bonds they sold plus a small commission. This inducement could encourage the banks to participate in the loans and to encourage citizen bond distributions.

The Sanchez survey work indicated that investors were hesitant about a direct issue from the LGU itself. This may reflect concerns about the competency of the local financial adminsitration (Lianto suggests this, pp 47-48). Of course, the idea of a small issue bond is applicable to any issuer, but it is preferable that it be used with the broader credit base of a fund to start with. (There is much risk in very small governments or projects issue citizen bonds since the risk of default could wipe out small local investors and discredit the program.) On the other hand, the enlistment of small individual and institutional savers to stimulate their domestic investment would appear to be a good overall policy objective in and of itself.

4. Building a Market Infrastructure

The institutional infrastructure involves the "supporting" elements that set the playing rules and provide services into the primary participants (investors, issuers, and traders/underwriters). A lot of the concerns here are with information flows and rules and regulations. Two things merit further dicussion, however. One is pulling together professional groups into an orbit of concern over the market and the establishing of professional standards and training. The other is the need for technical assistance in providing disinterested and expert advice to issuers in particular.

4.1. Building Institutional Capacities

In the U.S. there is a cadre of private professionals that make the municipal market work. Key actors are the underwriters, financial advisors, and bond lawyers, and for revenue-generating enterprises, engineers. These professionals work with the finance officials who have more general skills and rely on them for the details. While this human infrastructure cannot be put in place overnight, it would appear vita' to having a strong noncentral government capacity.

It is suggested here that aside from bond issues by a few of the larger cities, a fund dedicated to private sector investment needs to be established that would act as a rallying point for promoting private domestic lending to LGUs. This entity should not be competitive with the existing GFIs, but should have the capability of packaging deals, supporting the development of institutional and human capacities, and co-ordinating government policies (including DOF, DILG, CB, and SEC policies). PD 752 had an unfortunate heavy hand when it came to regulation. It would be far more helpful if the central governments energies will bne directed to providing advice rather than mandating actions in the LGU borrowing area.

4.2. Technical Assistance

Aside from generating information as was discussed above in conjunction with credit analysis (Llanto, pp. 48-49; Saldana, p.54), there is need for overall, pro-active technical assistance in the area of capital financing. Help in the financial feasibility and design aspects and setting up the rudiments of debt administrative capacity. On the government side, these responsibilities would appear to be lodged generally with the Department of Interior and Local Government and, specifically, under the Local Government Code with the DOF. If, as is discussed above, the MDF moves into a broader, private-market involving stance, that capacity could be developed in conjunction with private-sector groups, such as the Bankers' Association of the Philippines and other like groups.

Public Finance, as a subject, is not well developed at the University of the Philippines and there is a lack of professionalism in LGU financial administration. Nevertheless, with curriculum development, specific extension work might be generated from there. Numerous models exist (Oregon, North Carolina, New York) where this approach has been used in the states.

5. Suggested Next Steps

Reviewing the above commentary suggests the following nearterm steps be taken:

5.1. There should be a continuation fo the dialogue that the LDAP Credit Finance project has fostered in the context of the Local Government Code. First-rate studies sponsored by the LDAP

5.5. Another step of the effort should actively involve those parties that can help establish the longer-term institutional infrastructure of an LGU capital market component. This requires education and technical assistance. Essentially this should involve rep resentatives from the U.S. legal, banking, credit analyst and state/local government communicties that could deal with their Filipino counterparts. Such groups include the Public Securites Association, the American Bankers Association (Corporate Trust Division), the Natinal Association of Bond Lawyers, Federation of Municipal Analysts, the International City Management Association, and the Securities and Exchange Commission. The idea would be not to graft a U.S-style municipal bond market into the Philippines, but to lend practical experience to the formation of a private capital raising market. An initial step to this might be a tour by select4ed Filipino officials to the U.S., to meet their counterparts and to spend an intensive few days seeing how the U.S. municipal market operates.

5.6. In terms of market mechanics, the above suggestions regarding a fund, most likely related to the existing MDF housed in DOF, has the most merit and should be pursued. It provides flexibility and size and mechanisms than can introduce LGU financing into the Philippine markets. The challenge is that this fund make a proactive effort to involve the private sources of capital and several ways to do that have been suggested. Direct borrowing by individual LGUs of suficient size and adequate credit quality, either as straight governmental borrowings or as related to BOTs should be encouraged in some cases.

5.7. lastly, the small-denomination bond has promise for enlisting savings and investment by individuals and the involvement of banks, which could act as distributing agents. While the largest LGU borrowers may be able to utilize the direct issue small denomination security, its use by the MDF fund as a collateral means to raise capital by appealing to small investors has merit. A variety of private lending and capital-raising approaches should be explored at this time; but at the same time central government-assisted efforts to enlist private capital should be focused on the MDF.