Capital Market Development in the Philippines --Problems and Prospects

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Outline

- Introduction
- Pension Funds
- Equity Market
- Commercial Paper & Bonds Market
- Concluding Remarks

Introduction

- **Capital markets started in 1966 (T-bills)**
- **Development stunted by a**
  - Banking & BOP crisis in 1981-1985 &
  - Asian financial crisis of 1997

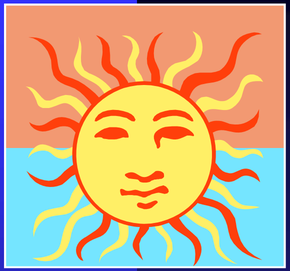
Total Assets of Financial System

	1980		1990		2001	
	Amount	Share	Amount	Share	Amount	Share
Banking System	188.8	76.2	609.5	76.1	3,381.5	82.7
NonBank Fis	58.9	23.8	191.8	23.9	707.2	17.3
Total	*247.7*		*801.3*		*4,088.4*	
% of GNP	*101.6*		*74.3*		*105.9*	

Excludes Trust Funds managed by Banks

Introduction

- **Banks, especially commercial banks, have become even more important**
- **Non-bank Financial Institutions (NBFIs)**
  - NBFIs have been declining in importance:
    - 1980 – 23.8% of total financial sector
    - 2001 – 17.1%
  - Government pension funds & private non-bank financial intermediaries approximately equal in size



I. Pension Funds

- **Assets up from 11% in 1980 to 17% in 2000**
- **Pension Funds - Contributions have reached all-time high of 2.6% of GDP in 2000**
  - Public Pension Funds (65%)
  - Private Pension Plans (35%)

I. Pension Funds

- **Insurance Industry –**
  - 60% life 40% non-life
  - 55% foreign-owned-and-controlled
- **Pre-need Industry – (not included)**
  - Unique, Spectacular growth
  - P27B in 1993 to around P160B in 2001 or nearly as big as insurance industry
  - Probable cause: banks offer poor rates due to market muscle.

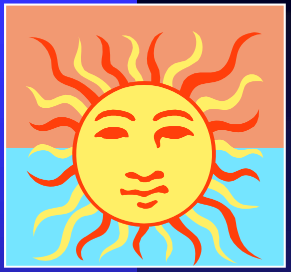
I. Pension Funds: Problems & Reforms

- **Inadequate funding by 2012.**
  - Losses due to Pres Estrada
  - Low compliance
- **Non-hermetic transfers from public to private sector systems**
- **Privatization**

- **Use of professional fund managers**
  - Ability to cross-check with local gov’t units
  - Coverage of self-employed
  - Still awaiting raising of contributions
- **Still under study**
- **Unlikely to cover existing plans**

II. Equities Market

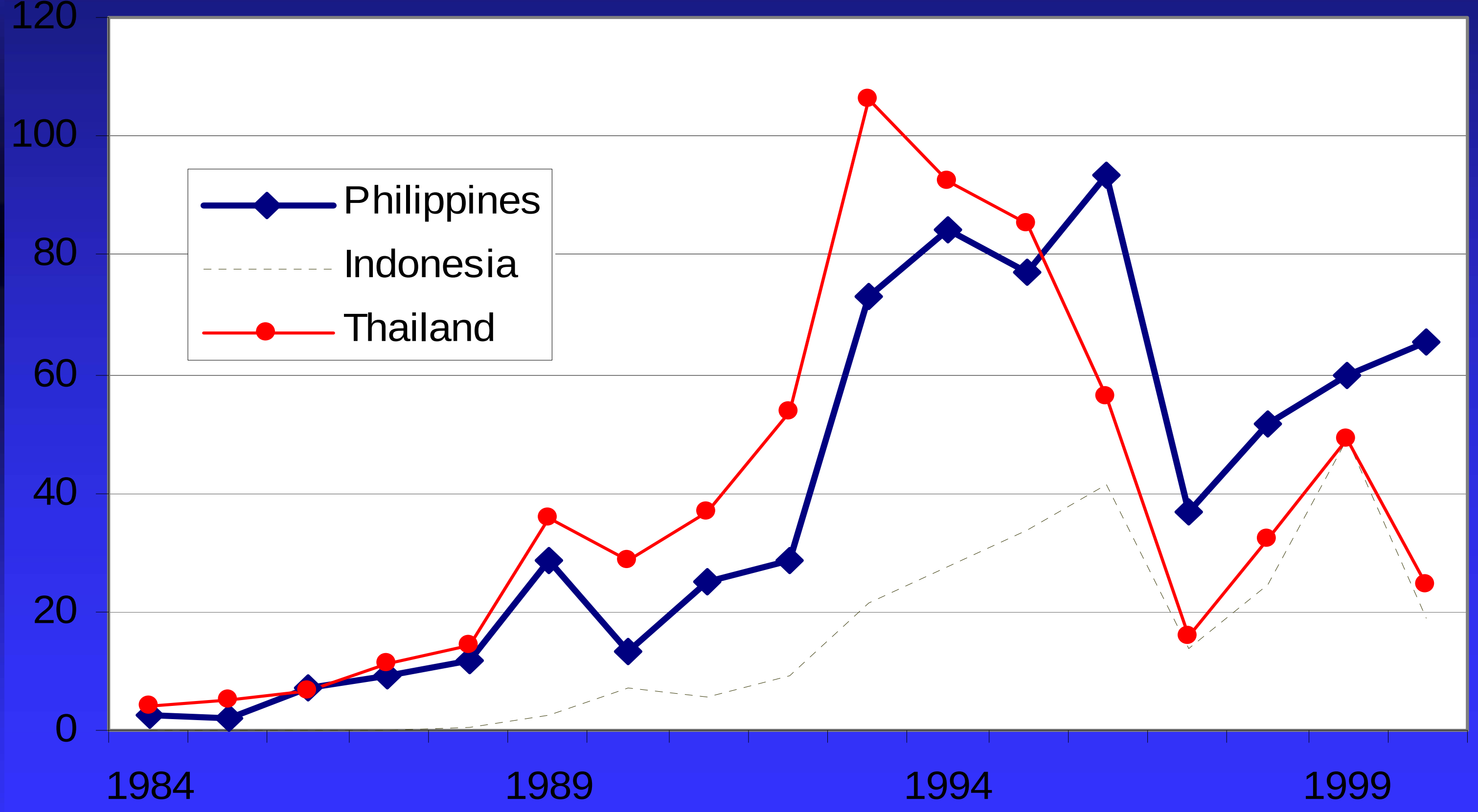
- Manila exchange started in 1927, Makati exchange in 1963, unified into Philippine Stock Exchange in 1994.
- 233 companies listed in 2001.
- Less than half of issues are actively traded
- 50 largest issues account for 90% of market capitalization
- Market cap in 2001 was $42B or 55.5% of GNP



II. Equities Market

- **IPOs**
  - Boomed in 1994-1996, with 50 companies listed, raising P95 billion
  - Became negligible by 2001.
- **Market Cap**
  - Reached high of $81 billion or 94% of GNP
  - Down by one third in 2001, but better than Indonesia and Thailand

Market Cap to GNP Ratios



II. Equities Market: Problems

- Dependence on foreign capital
- High transaction costs (including taxes)
- Loss of credibility of the Exchange and SEC (during Estrada administration)

II. Equities Market: Reforms

- **Securities Act of 2000**
  - SEC reorganized, salaries upgraded, and more focused as market regulator
  - Additional enforcement powers
  - More stringent requirement on “full disclosure”
- **Better protection of minority shareholders**
  - Appointment of independent directors
  - Code of Corporate Governance in place

II. Equities Market: Reforms

- **PSE**
  - Demutualized
  - Independent and professional management group in majority in place
- **Still to be done**
  - Remove stamp tax on secondary transactions (priority in legislative agenda)
  - Convictions in BW scandal

III. Fixed-Income Securities Market

- **Corporate - $1 bil. or 1.3% of GNP**
- **Government - $16 bil. or 20% of GNP**
  - Long-term bonds now dominate, almost 70% of regular issues.
  - Primary auctions – on-line; follow English system for T-bills and Dutch system for T-bonds (long-term)
  - Electronic system for registry/settlement

III a. Government Securities: Problems

- **Primary Market**
  - Some inefficiencies – because T-bill rates are higher than equivalent CDs
  - Monoposonist position of commercial banks
  - Linear programming models show yields can be lowered by changing rules

III a. Government Securities: Secondary Market

Problem

- Holding-on
- 2-way quotes
- Inadequate payment/settlement

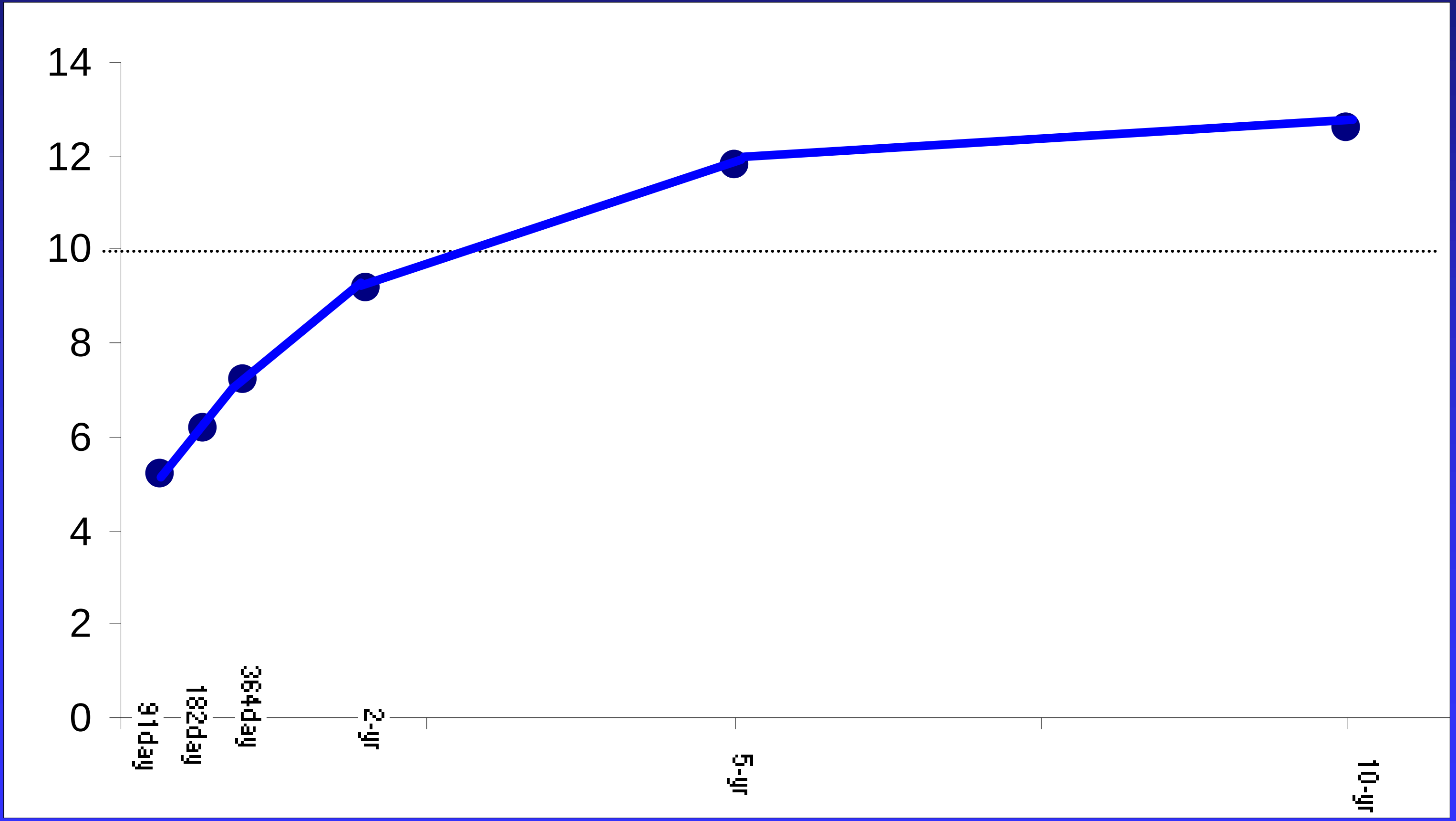
Solution

- Remove/reduce mandated lending to agri/portfolio
- BAP & PSE planned to add to existing system
- Software needs updating

III a. Government Securities: Problems and Solutions

Problem	Solution
Market Makers	Remove tax-exempt status of public pension funds and attract new players due to wide bank spreads
Heavy stamp tax	Tax removal part of priority legislative agenda
Lack of investor confidence	Solve with market liquidity

Yield Curve from T-bills to T-bonds (10-year) (Sep 2002)



Long-Term Gov't Bonds
10-Year T-Bonds (Sept. 02)

Tenor	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

III a. Government Securities: Some Conclusions

- Very steep yield curve unjustified by present and expected inflation rate
- Secondary market inefficiency calls for immediate solution
- Opportunity for flattening yields

IIIb. CPs and Bonds

- **Outstanding papers are mostly long-term**
- **Market issuances practically nil**
  - Due to flight to quality
- **Problems**
  - Same as govt securities +

IIIb. CPs and Bonds: Problems and Solutions

Problem

- Credit Rating
- Mixed accounting standards
- Lack of standards for good governance

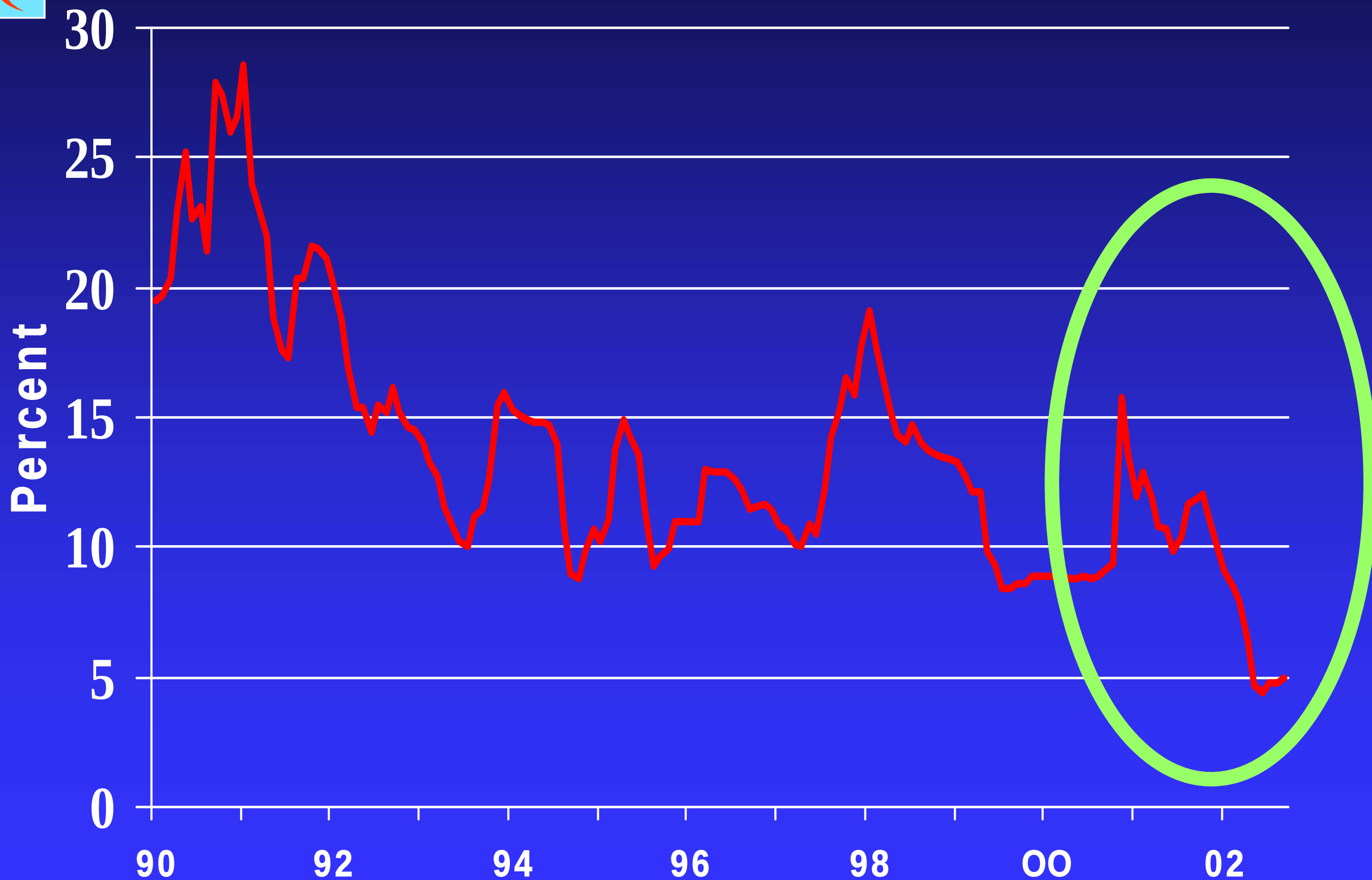
Solution

- Entry of second rating agency & revitalized first agency with foreign help
- Adapt USGAAP or IASC & impose sanctions
- Best practices, duties & responsibilities of directors in place, still to be <u>fully implemented</u>

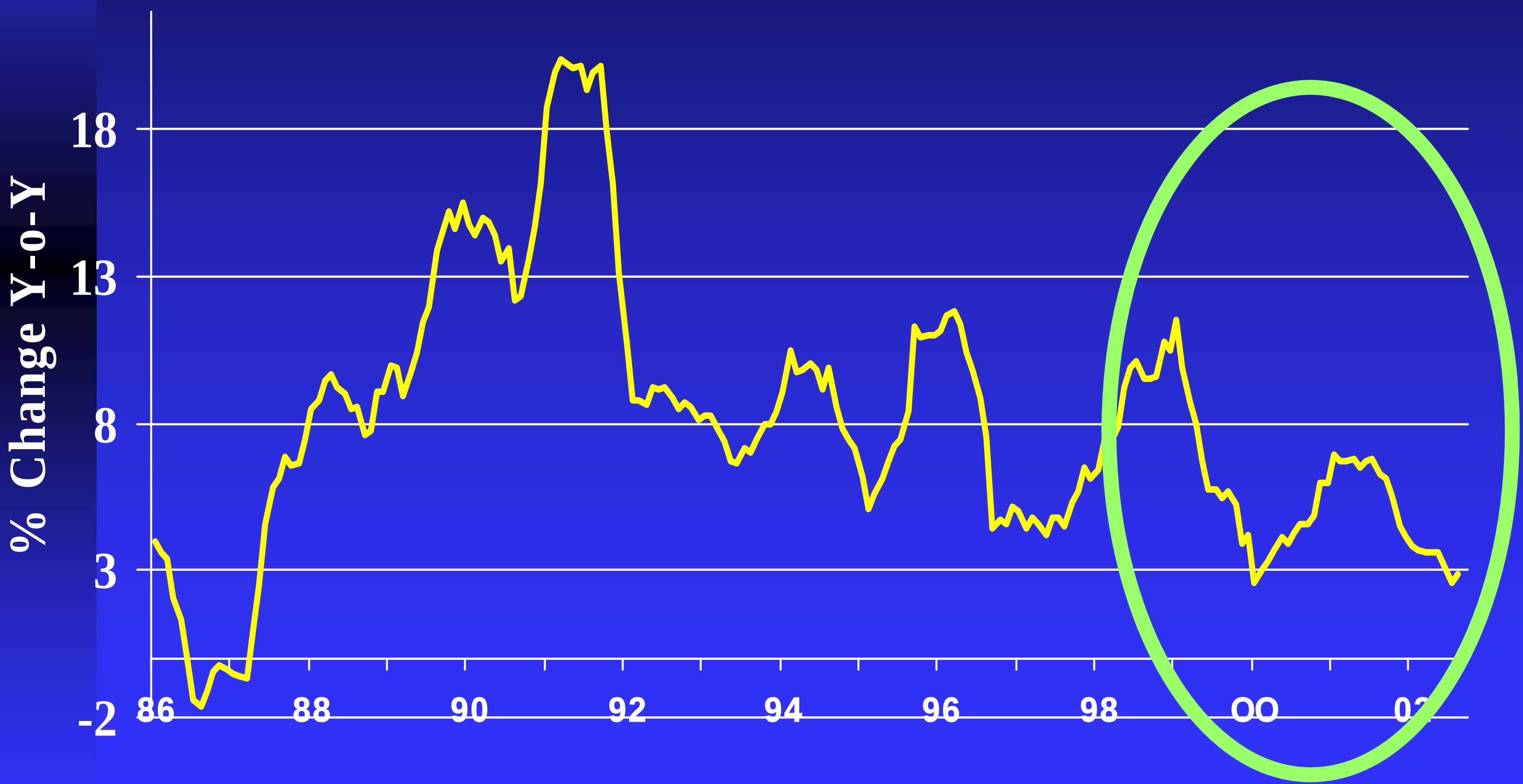
III c. Prospects for Gov't Securities and Corp Bonds

- Very high real interest rates on these fixed-income securities
- Inflation is on a downward trend and is expected to remain low
- No way but for spreads to narrow

91-day T-bill Rates on Long-term Decline



Inflation Rate—Low and on Downward Trend



IV. Concluding Remarks

- Early start was stalled
- Recent structural economic reforms removed many obstacles
- Problems remain but solutions have been given or being addressed
- Recent trends of economic stability, lower inflation and interest rates set the stage for major developments in capital markets.

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