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

<table>
<thead>
<tr>
<th></th>
<th>1980</th>
<th>1990</th>
<th>2001</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>Amount</td>
<td>Share</td>
<td>Amount</td>
</tr>
<tr>
<td>Banking System</td>
<td>188.8</td>
<td>76.2</td>
<td>609.5</td>
</tr>
<tr>
<td>NonBank Fis</td>
<td>58.9</td>
<td>23.8</td>
<td>191.8</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>247.7</strong></td>
<td><strong>101.6</strong></td>
<td><strong>801.3</strong></td>
</tr>
<tr>
<td><strong>% of GNP</strong></td>
<td><strong>101.6</strong></td>
<td></td>
<td><strong>74.3</strong></td>
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</tbody>
</table>

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

- 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

Phippines
Indonesia
Thailand
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
  - Monopsonist position of commercial banks
  - Linear programming models show yields can be lowered by changing rules

**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
- Market Makers
- Heavy stamp tax
- Lack of investor confidence

Solution
- Remove tax-exempt status of public pension funds and attract new players due to wide bank spreads
- Tax removal part of priority legislative agenda
- Solve with market liquidity
Yield Curve from T-bills to T-bonds (10-year) (Sep 2002)
<table>
<thead>
<tr>
<th>Tenor</th>
<th>Philippines</th>
<th>Australia</th>
<th>India</th>
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<tbody>
<tr>
<td>1-year</td>
<td>7.17</td>
<td>4.89</td>
<td>5.94</td>
</tr>
<tr>
<td>2-year</td>
<td>9.20</td>
<td>5.01</td>
<td>5.94</td>
</tr>
<tr>
<td>5-year</td>
<td>11.78</td>
<td>5.31</td>
<td>6.34</td>
</tr>
<tr>
<td>10-year</td>
<td>12.58</td>
<td>5.56</td>
<td>7.18</td>
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</tbody>
</table>
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 fully implemented
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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