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Capital Market Development in the Philippines

Introduction

In the early 1960s, the Philippines as a developing country and its capital markets appeared to be of great promise. Its per capita income was higher than most Asian countries and its educational and political levels were at par with the United States (USAID, 1999). But that promise has remained unfulfilled.

Some underlying trends in the financial markets of the Philippines since 1980 emerge from Table 1. First, the importance of the financial sector in the economy has grown significantly. The ratio of the financial sector assets to GDP was 91.7% in 1980, fell after the Marcos era through the Asian Financial Crisis (AFC) and has reached 115.2% by 2015.

Second, the banking sector has gained more importance. Universal and commercial banks (UKBs) particularly increased their share of financial system assets from 55.9% in 1980 to 72.8% in 2015. Since the figures exclude trust assets (another 16.7% of bank assets), it means UKBs increased their market power, hindering the development of new financial products and institutions. (Antonio and Abola, 2005).

Thus, non-bank financial institutions (NBFIs) became relatively less important. This was unfortunate since NBFIs are big buyers and sellers in the capital market and developers of new financial products for it.

Among NBFIs, pension funds are the

Table 1: Amount and Composition of Financial Assets by Type of Institution, 1980-2015

	1980		1990		2000		2010		2015	
	Amount	Share	Amount	Share	Amount	Share	Amount	Share	Amount	Share
	Billion Pesos	%	Billion Pesos	%	Billion Pesos	%	Billion Pesos	%	Billion Pesos	%
Banking system	**188.8**	**76.2**	**609.5**	**76.1**	**3,326.8**	**80.4**	**7,230.2**	**79.9**	**12,406.3**	**80.9**
Universal and commercial banks	138.4	55.9	539.7	67.4	3,013.6	72.8	6,423.7	71.0	11,159.2	72.8
Thrift banks	10.6	4.3	37.6	4.7	245.8	5.9	626.4	6.9	1,034.1	6.7
Specialized gov't banks	34.2	13.8	18.5	2.3	-	-	-	-	-	-
Rural Banks	5.6	2.3	13.7	1.7	67.4	1.6	180.1	2.0	212.8	1.4
Non-bank financial institutions	**58.9**	**23.8**	**191.8**	**23.9**	**810.3**	**19.6**	**1,816.1**	**20.1**	**2,920.9**	**19.1**
Government	20.1	8.1	107.8	13.5	473.4	11.4	-	-	-	-
Private	38.8	15.7	84	10.5	336.9	8.1	-	-	-	-
Total	**247.7**	**100**	**801.3**	**100**	**4,137.1**	**100**	**9,046.3**	**100**	**15,327.1**	**100**
Total Assets/GDP	91.7%		67.1%		115.5%		100.5%		115.2%	

Note: Trust accounts also play a significant part in the financial sector as these account 24.3% and 16.7% of the total assets in 2010 and 2015, respectively. See BSP website for definition of NBFIs.
Source: Bangko Sentral ng Pilipinas (BSP)

most important segment, with government pension systems accounting for around 2/3 of the sector's total assets. The contractual savings sector helps expand the capital market and develop professional investment/fund managers (Antonio and Abola, 2005). Besides, total contractual savings have grown significantly to 10.3% of GDP in 2014.

Government-sponsored pension systems held total assets of P1.7 Trillion in 2014, the largest being the Government Service Insurance System (GSIS, for public sector employees with assets of P907 B), the Social Security System (SSS, for private sector employees and self-employed, P395 B), and the Home Development Mutual Fund (P379 B). The private sector, mostly life insurance firms, had P847.4 B in assets.

In 2008, the Personal Equity and Retirement Account (PERA) Law aimed to expand the retirement options of Filipinos, in addition to the GSIS and SSS. Membership in PERA is voluntary, and may include GSIS/SSS members. (Kilayko, 2014; Tiongson, 2015).

This paper focuses on the two major components of the capital market – the equities and the fixed-income securities markets.

The Philippine Equity Market

In 1996, the market capitalization to GDP ratio (MCG ratio) of the Philippines peaked at 97.3% before succumbing to the Asian Financial Crisis (AFC) and political problems. MCG had an upward trend from 2003 and reached 101.2% in 2015, breaking the 1996 record– interrupted only by the Global Financial Crisis (GFC). (Figure 1).

Philippine Stock Market in General

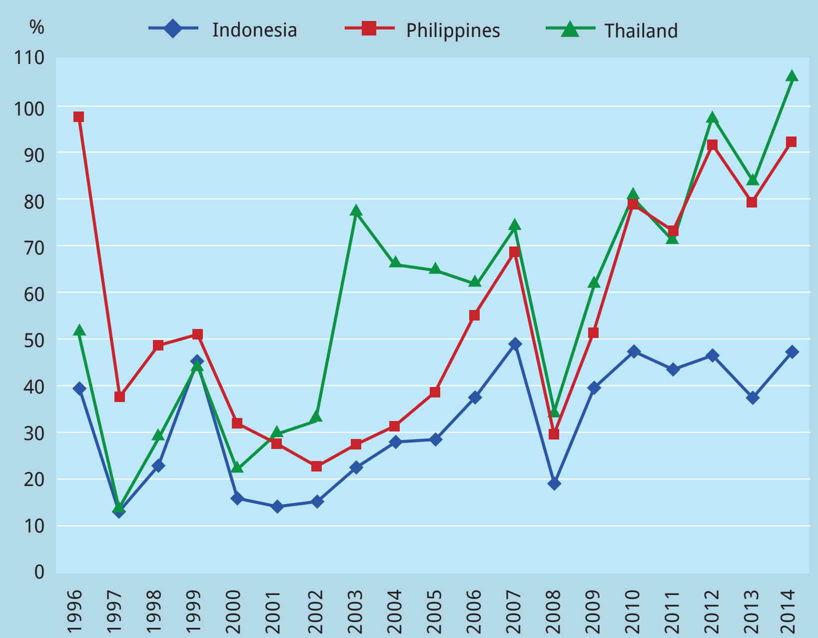
The Philippine Stock Exchange (PSE), housing 264 listed firms, is the main institution for initial public offerings and secondary market stock trading. It is a self-regulatory organization sanctioned by the Securities and Exchange Commission (SEC), the regulatory body overseeing corporations and stock market activity.

PSE provides the trading platform known as PSETrading (able to handle a million transactions daily), which was acquired from the New York Stock Exchange. Its regulatory division has been separated as a subsidiary (Capital Markets Integrity Corp). It provides audit, surveillance, and compliance oversight over the stock market participants/activities with the Total Market Surveillance System acquired from the Korea Stock Exchange in 2012.

Matching of trades is done electronically, with anonymity preserved. All trades, including online, pass through brokers who charge a minimum of 0.25% of trades. A 0.5% transactions tax on the sale is charged to the seller in lieu of capital gains tax.

Stock prices and market activity are

Figure 1: Market Capitalization to GDP Ratios of Selected ASEAN Economies, 1996-2014



Source: World Bank

Table 2: Compounded Annual Growth Rates PSEi, 2000-2015

	2000-05	2006-10	2010-15	2000-15
PSEi	7.0%	14.9%	10.6%	10.8%
Financial		3.7%	10.0%	7.2%
Industrial		16.3%	8.8%	12.1%
Holdings		18.3%	14.3%	16.0%
Property		5.4%	13.0%	9.6%
Services		1.6%	-0.8%	0.3%
Mining & Oil		32.1%	-5.7%	9.6%

Note: Sector indices started only in 2006.
Source: PSE

on real-time and summarized in two main stock price indices. One is the 30-share Philippine Stock Exchange Index (PSEi), and the other is the overall All Shares Index and six sectoral indices.

Settlement of trades is T+3 under a scripless system. PSE's subsidiary, Securities Clearing Corp. Of the Philippines acts as settlement coordinator, risk manager for broker transactions, and administrator of the trade guaranty fund.

While the country has no stock index futures market, PSE in 2013 teamed up with the Singapore Exchange to launch SGX-PSE MSCI Philippines Index Futures in Singapore.

Performance of PH Stockmarket

Table 2 shows the compounded annual growth (CAGR) of PSEi from 2000 to 2015 at 10.8%. If we start from 2006, the CAGR was more impressive at 12.6%. Sectorally, only the Services sector and Mining & Oil (due to falling commodity prices starting 2014) landed in negative territory. The Holdings sector performed best, in tandem with fast economic growth. The Industrial sector reflected the capacity/efficiency gains of energy firms, while strong residential demand and BPO-driven uptake of commercial space boosted the Property sector.

The market appears pricey, as the PSEi's Price-Earnings (PE) ratio also has been rising (ref. Figure 2). Dividend yields have been on the low side—usually from 0.3% to 2.5%, with some notable exceptions.

Fund-raising through IPOs and Stock rights offerings has been rising as detailed in Table 3. Notably, it raised $1 B or more since 2010, reaching a peak in 2012. The slowdown in IPOs may be due to the scarcity of candidates.

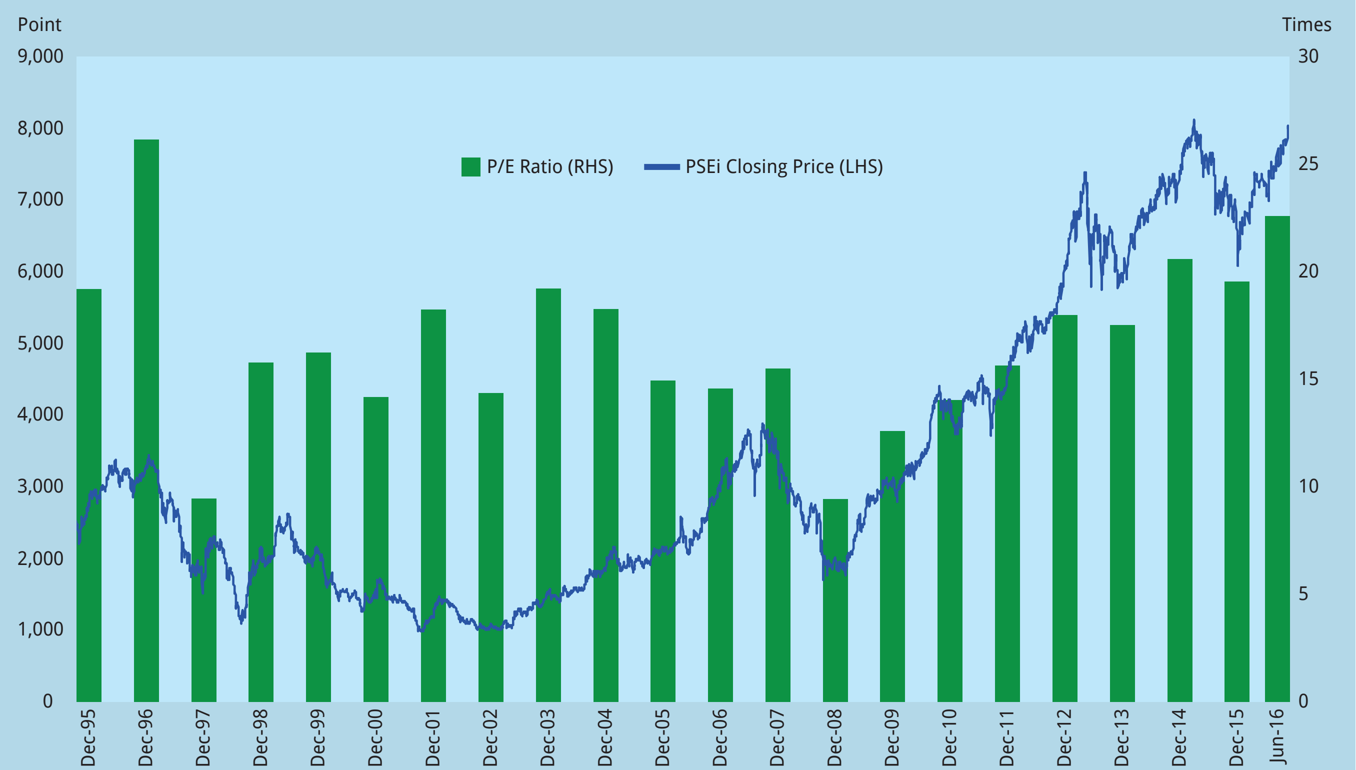
Valeroso (2012), studying 69 firm IPOs during 1997-2010, found average open-

Table 3: New Capital Raised in Stock Market, 2006-2015 (P Millions)

	No. of IPOs	Avg IPO Size	IPO	Stock Rights	Total New Capital Raised	in US$
2006	4	6,382.24	25,528.96	2,283.98	27,812.94	542.01
2007	10	2,503.71	25,037.08	16,640.43	41,677.51	903.12
2008	2	5,081.21	10,162.41	6,276.52	16,438.93	369.63
2009	1	20.01	20.01	4,315.15	4,335.16	91.00
2010	3	9,362.70	28,088.11	51,888.26	79,976.37	1,772.93
2011	5	2,057.76	10,288.82	40,608.74	50,897.56	1,175.11
2012	5	5,408.13	27,040.66	52,068.21	79,108.87	1,873.34
2013	8	7,082.65	56,661.20	2.43	56,663.63	1,334.95
2014	5	2,637.51	13,187.57	45,603.39	58,790.96	1,324.26
2015	4	1,299.42	5,197.67	48,404.00	53,601.67	1,177.98

Source: Technistock, PSE

Figure 2: Performance of PSEi, 1995-2016



Source: Bloomberg

ing-day returns at 8.05% and the one-year aftermarket returns at -0.10%. These were much lower than those for 1987-1997. Using multiple regression analysis of IPO returns and analysis of variance, the following–offer size, firm age, industry, underwriter reputation, and the 91-day T-bill rate—were statistically insignificant. Only the number of IPOs in the previous 30 days appeared negatively related to underpricing.

Improvements Since the AFC

Antonio and Abola (2005) stated several challenges to the equities market in the aftermath of the AFC, including: heavy dependence on foreign capital, high transaction costs and loss of credibility.

First, foreign capital had been historically important to the market with the severely negative impact of the massive outflow of foreign funds during and after the Asian Financial Crisis. However, this dependence has diminished significantly, attested to by the local stock market's continued rise despite the exit of foreign funds after the GFC.

Second, in the late 1990s the Philippines had the second highest transaction costs after South Korea, due to elevated documentary stamp taxes (0.10%). In 2008, this tax was removed.

Third, credibility of the stock market had been damaged during the Estrada Administration by the Best World Resources (BW) scam, one of the biggest frauds in local stock market history. Thereafter, a more professionalized PSE, a strengthened SEC under President Benigno Aquino III, and strong economic fundamentals enabled the country to weather the GFC relatively unscathed, and to revive foreign investor interest.

Boosters and Drawbacks in the Stock Market

Congress enacted in 2008 and 2009 two laws that would directly benefit the stock market. The PERA law (earlier discussed) took effect in 2008. The following year, the Real Estate Investment Trust law aimed to incentivize placing income-generating properties like office, retail, etc. in a listed trust fund, provided the company that owns them is listed in the stock market and distributes 90 percent of net operating income as dividends. The Bureau of Internal Revenue finally issued the Implementing Rules and Regulations for the PERA law only in July 2016, and a revised one for the REIT law also in the same month.

In addition, the Credit Information System Act (CISA) of 2008 established the Credit Information Corporation which would house the database of all borrowers of financial institutions. The Financial Rehabilitation and Insolvency Act became law in 2010. It provided special privileges to financial market transactions (as well as fairer policies and procedures for bankruptcy actions) (Lim, 2016).

Some issues, however, remain to be resolved: (a) disallowance of short-selling, (b) high brokers' fees relative to other ASEAN countries, (c) limited analytical capabilities of the PSE electronic platform, and (d) the preponderance of poorly capitalized small brokers generally averse to ASEAN integration.

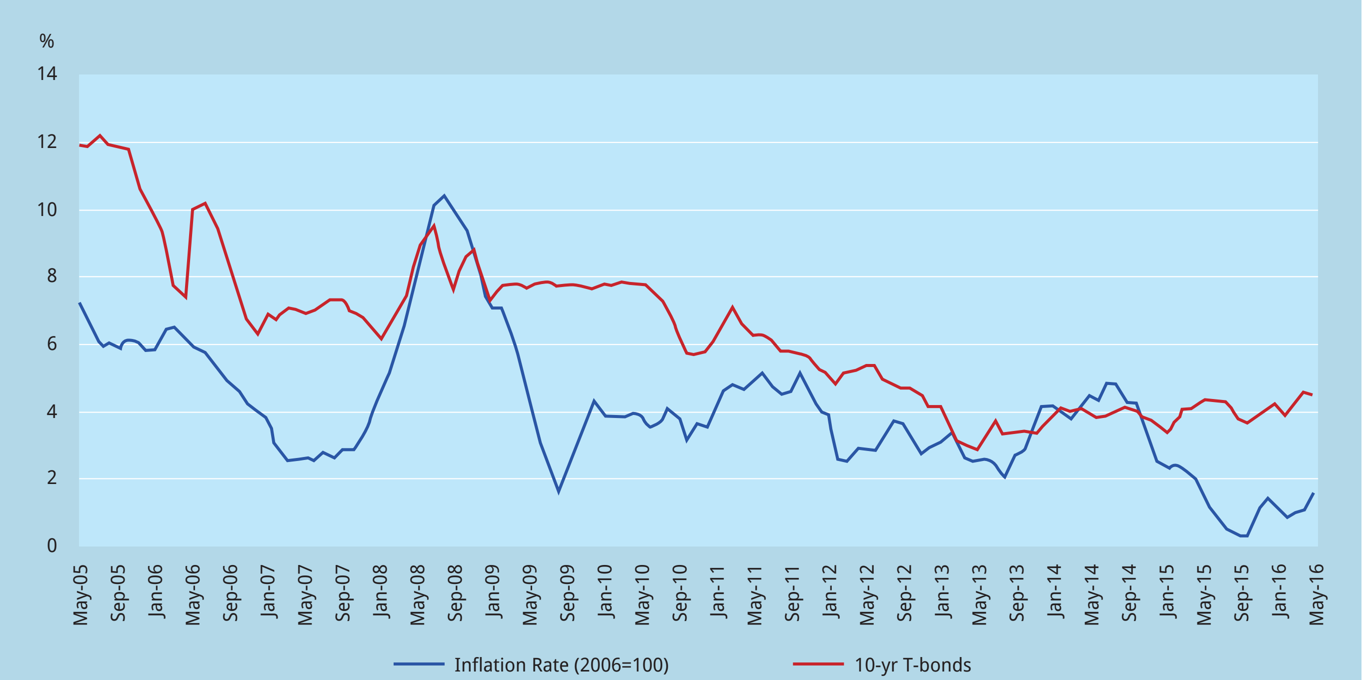
Despite these issues, the positive legal developments, improved corporate governance and stricter government regulations, should add more years to the stock market boom since the GFC.

Fixed-Income Securities Market

General Features of Market for Government Bonds

The market for Treasury bills (T-bills) opened in 1966 to enable the National Government (NG) to finance its deficits through the money market instead of

Figure 3: 10-yr T-bond Yields and Inflation Rate, May 2005 to May 2016



Source: Bangko Sentral ng Pilipinas, PDeX, PSA through the country's central bank. Since 1994, the Bureau of the Treasury (BTr) handles issuances of government securities (GS)—for both T-bills and Treasury bonds (long-term T-bonds or FXTNs) with tenors up to 25 years. BTr auctions are open to 37 Government Securities Eligible Dealers (GSEDs), which bridge the issuances from the government to public investors. (BTr website)

Philippine Dealing and Exchange (PDeX) handles all transactions since 2006 together with the Registry of Scripless Securities (ROSS). Settlements are at end-of-day net offsetting of GSED accounts with the BSP. A 20% final withholding tax on interest income is imposed even on GS.

The nearly fivefold growth of the GS market from 1995 to 2015 may be seen in Table 4. Prior to 2000, T-bills dominated the issuances. In 2001, NG began issuing retail treasury bonds (RTBs) to provide small retail investors' access to GS with P5,000 as the smallest denomination and limiting GSED's holdings of RTBs.

Moreover, as interest rates were falling (Figure 3), the government issued more T-bonds which now account for 93.2% of the outstanding value of regular issues of GS and 2.33x the value of RTBs. Dispo and Abola (2015) noted that with more T-bond issuances NG cash flows improved.

In 2006 BTr introduced bond exchanges/swaps to smooth and lengthen its debt maturity profile and to establish liquid benchmarks for long-term financing to support government/private sector initiatives, e.g., PPP for infrastructures, etc. (Asian Development Bank, 2012) The first bond exchange in 2006 involved bonds maturing until 2009 which swapped for Php 490 B of fresh 3-, 5-, and 7-year T-bonds. Thereafter, bond exchanges became more frequent (Dispo & Abola, 2015).

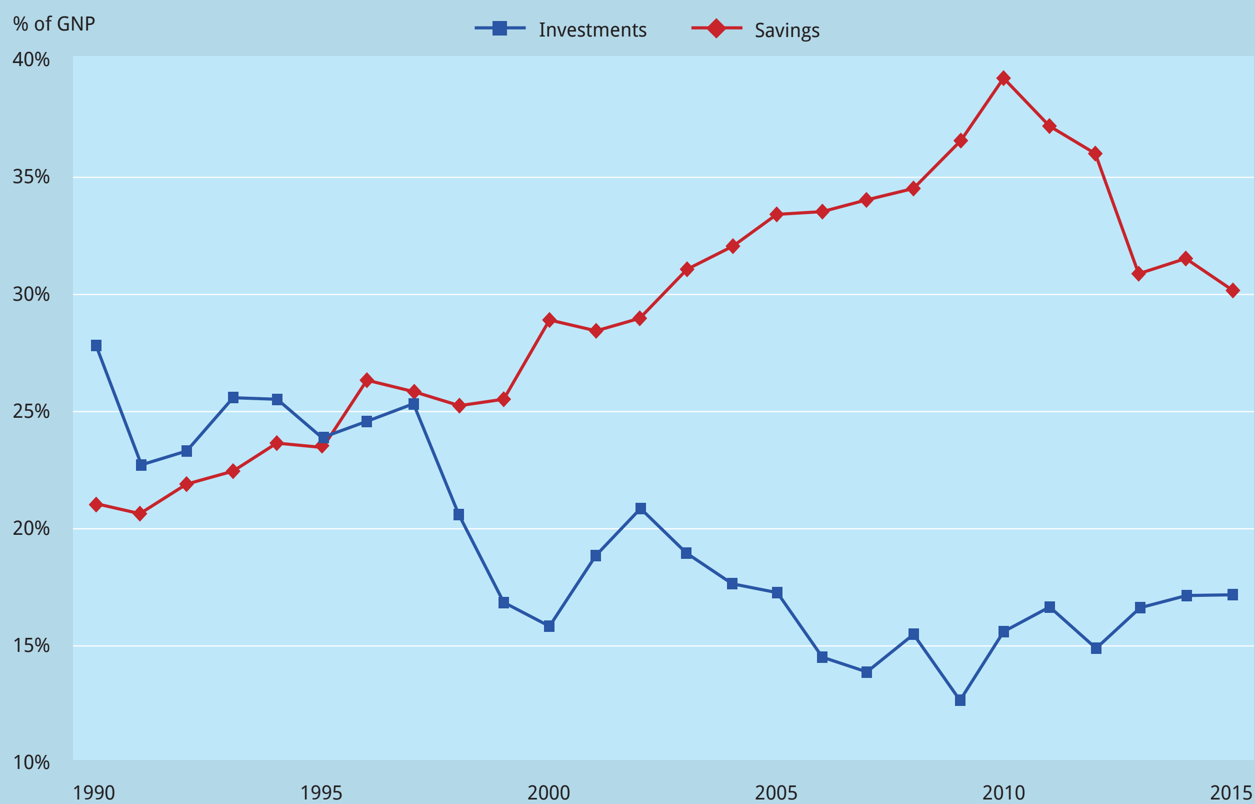
In a 2010 initiative, NG issued multicurrency retail treasury bonds (MRTB) to help overseas Filipino workers (OFWs) and migrant Filipinos safeguard their for-

Table 4: Outstanding Value of Regular Issue Government Securities, 1995-2015 (in Billion Pesos)

	1995	2000	2010	2015
TOTAL	**667.26**	**1,043.85**	**2,809.41**	**3,916.78**
I. National Government Issues	**661.95**	**1,033.54**	**2,709.10**	**3,883.78**
Regular Issues	**450.24**	**901.74**	**1,395.05**	**2,019.03**
A. T- Bills	391.25	467.28	527.41	264.44
B. Fixed Rate T- Bonds	58.99	434.47	867.64	1754.59
3-yr	-	-	108.63	145.55
4-yr	-	-	3.35	-
5-yr	30.00	116.57	49.54	226.40
7-yr	-	99.64	193.06	469.13
10-yr	-	98.45	235.96	379.12
20-yr	-	9.84	137.71	298.33
25-yr	-	5.79	139.30	235.98
Special Issues	**-**	**38.25**	**1,314.05**	**1,864.75**
A. Retail T- Bonds	**-**	**-**	**292.15**	**753.20**
3-yr	-	-	58.87	-
5-yr	-	-	148.19	27.49
7-yr	-	-	61.31	49.35
10-yr	-	-	23.78	74.71
10-yr	-	-	-	194.03
15-yr	-	-	-	95.81
20-yr	-	-	-	132.68
25-yr	-	-	-	179.13

Source: Bureau of the Treasury (BTr)

Figure 4: Savings and Investments Gap, 1990-2015



Source: Philippine Statistics Authority

eign currency savings. The first tranche amounted to USD400 M and EUR75 M. As incentive to OFWs, NG assumed the 20% final withholding tax on the bonds' interest income. (Asian Development Bank, 2012)

Antonio and Abola (2005) noted the challenge of T-bills commanding yields higher than similar tenored time deposits. They cited market imperfection due to buyers' side weakness coupled with strong market power of UKBs as a possible cause.

Table 5: Yields on Long-term PH Government Bonds

	Sep-02	Apr-16
1-year	7.17	2.33
2-year	9.2	3.23
5-year	11.78	3.52
10-year	12.58	4.63

Source: Asian Wall Street Journal & Philippine Dealing Exchange

Secondary Market Development

Philippine GS secondary market is relatively small compared to ASEAN's more developed bond markets but is already large enough at USD84 B to be sufficiently deep and liquid (Dispo and Abola, 2015).

After PDeX became fully operational in 2006, liquidity in the GS bond market greatly improved as indicated by the huge jump in the bond turnover ratio, (i.e., the volume of transactions as a percentage of total outstanding debt) to 98% in 2013 from 30% in 2005, besting Malaysia and Singapore, albeit with much smaller volumes. The large drop in average bid-ask spreads to 3.4 bps in 2015 from 47.5 bps in 2000 (ibid.) confirm better liquidity.

Considering that tax-exempt institutions (TEIs, e.g., GSIS and SSS) hold more than P500 B of GS, BTr allowed TEIs to trade in the ordinary secondary market starting May 2015. The move sought to deepen the secondary market since previously TEIs could only trade with one another, over-the-counter (Dispo & Abola, 2015).

Yields for all tenors trended sharply downward (Figure 3) since 2005. Yields have fallen due to slower inflation which averaged 3.35% in 2010-2016, and greater domestic savings (Figure 4) due to OFW remittances. Table 5 illustrates the plunge in yields from 2002 to 2016.

Antonio and Abola (2005) cited several reasons why the secondary market remained fairly illiquid viz: (1) propensity of banks to hold on to existing issues; (2) inefficient trading system; (3) lack of market makers; (4) heavy taxation of secondary market transactions; and (5) lack of investor interest.

The first has remained a concern since banks still hold large amounts of GS, and this may decline only with the emergence of a much bigger corporate bond market.

Secondly, inefficient trading system occurred at that time with one-on-one, barter-like trading system. Largely solving this, PDeX's electronic trading platform, albeit imperfect, has improved efficiency and lessened transaction costs.

The third is no longer an issue since large banks have sizeable GS holdings and often act as *de facto* market makers.

As seen earlier, documentary stamp taxes on secondary trading of debt and equity instruments have been scrapped.

The earlier problem of lack of investor interest, due to high and volatile interest rates, market illiquidity and lack of market knowledge, is being addressed given the rising number of retail buyers. Besides, the rapid increase of mutual funds and Unit Investment Trust Funds has provided greater understanding and demand for bond investments.

Corporate Bond Market

The Philippine corporate bond market includes long-term corporate bonds and notes. The latter (classified as commercial papers) are originally issued to no more than 19 buyers, but are later tradable. This enables firms to avoid an initial 20% final withholding tax, and certain registration requirements (e.g., prospectus, etc.). Since 2015 SEC allows shelf registration (including both short-term and long-term debt papers).

Long-term corporate bonds/notes outstanding rapidly grew from negligible levels in 2000 to US$ 17B or 5.9% of GDP by 2015.

In November 2007, PDeX opened a trading board for corporate securities with the listing of a 5-year fixed-rate corporate bond. In 2008, PDeX allowed the public to trade through accredited brokers. This led other large corporations, including government corporations, to issue more bonds. From 2006 to 2015, 89 firms, mostly listed in PSE, issued bonds (Dispo and Abola, 2015). Nonetheless, secondary trades remained low with a bond turnover ratio of 4.9% in 2015.

Challenges of the Corporate Bond Market

Antonio and Abola (2005) identified challenges to the corporate bond market, apart from those in common with the GS market mentioned earlier. They highlighted four factors, namely, (a) lack of mandatory listing, (b) lack of credible credit rating agencies, (c) misalignment of accounting and auditing standards to international standards and (d) lack of standards for good corporate governance.

The first two remain as challenges, while the last two have been resolved.

Since 2007, the country has been following International Accounting Standards (IAS) wherein the Philippine Financial Reporting Standards (PFRS) are essentially consistent with the International Financial Reporting Standards (IFRS).

After the AFC erupted, the private sector launched the Institute of Corporate Directors (ICD). ICD aimed to determine the key issues in governance and improve it among East Asian economies and to identify and spread the best practices in corporate governance. Moreover, it issued guidelines on Corporate Governance Reform, which are now in place.

Thereafter, BSP adopted the Basel rules and standards on corporate governance of 2010. PSE crafted a regularly updated handbook which contains guidelines and best practices. In 2009, SEC issued a revised code of corporate governance to companies involved in the stock and bond markets.

Besides, an ASEAN Corporate Governance Scorecard has been developed, in line with the OECD best practices and guidelines. Presently, listed Philippine companies have fared better, albeit with room for further improvement, (Asian Development Bank, 2014) since the 2016 awards to the top 50 ASEAN listed firms based on their Corporate Governance scores included 11 Philippine companies (ICD Website).

Current Challenges and Reforms Needed

Dispo and Abola (2015) discussed some challenges faced by the Philippine bond market for which they also offered detailed recommendations. They categorize these into: Market Infrastructure, Legal, Tax & Regulatory Aspects, Infrastructure & Institutional Aspects.

Regarding market infrastructure, the reforms they suggested include: (1) mandate all issuers to list all issuances in PDeX to enable the investing public to liquidate their bonds at their discretion; (2) modify the 19-lender Rule to apply only to small companies's tiny bond issuances enabling large issuances to be traded in PDeX to foster greater liquidity in the secondary market; (3) Benchmark setting of PDeX: Revise Rules as to (a) require to quote PRICE upon entering an order, (b) impose penalties on 2-way quotation violation, (c) provide for a successor benchmark/formula to PDST-F which is no longer a benchmark starting April 1, 2015 and (d) make bid-ask quotes binding and computerize matching of trades; (4) improve the PDST-R1 and PDST-R2 guidelines so that benchmark yields avoid being distorted by illiquid issues; and (5) improve the settlement system through the inclusion of settlement and/or funding advise and investment in infrastructure upgrade.

With regard to legal and regulatory issues, the policy recommendations include: (1) reduce SEC fees and documentary stamp taxes in line with international standards; (2) enforce stricter regulation of banks in which buying of bonds should not replace lending; (3) implement higher obligatory allocations of credit resources for government-owned banks and lower obligatory allocations imposed on private banks; and (4) craft a uniform tax rate (e.g., 10%) on all interest income and remove exemptions, thus levelling the playing field.

In terms of institutional issues, the recommendations include: (1) full implementation of the 19-lenders rules and sanctions as above; (2) lower the SEC registration fee schedule; (3) unify regulatory responsibility to one government body or at least release joint circulars from BSP and SEC to ensure uniform disclosure/compliance requirements; (4) enhance the credit rating system; and (5) avoid conflict of interest of UKBs by disenfranchising "universal banks" which have a blanket permission own thrift/rural banks, investment houses, and other NBFIs with quasi-banking functions.

Integration into ASEAN & the Future

Capital market integration within ASEAN will likely lead to greater market liquidity, lower transaction costs and equity/bond premiums because of subscale trading volumes and largely closed markets through capital account restrictions in the smaller markets. Besides, it will promote a more resilient and robust financial market to prevent the occurrence of another AFC like the 1997-98, crisis, provide access to a larger capital base, enhance economies of scale, and provide more diversification possibilities for investors/lenders.

Despite the varying development of local currency bonds and equities markets in the region, Park (2014) notes that integration is gradually happening. The markets are experiencing convergence since 2000 especially among the financial markets in emerging Asia, including ASEAN.

In sum, the Philippine GS bond market is practically ready for integration, while the corporate bond market is not. The stock market could be integrated if small brokers can be convinced to consolidate or significantly increase their capitalization.

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