

DEVELOPING A PHILIPPINE LOCAL GOVERNMENT BOND MARKET

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Background

The Local Government Code of 1991 (R.A. No. 7160, referred to as the "Code" in this paper) initiated comprehensive changes in Philippine public administration, namely, decentralization and greater local autonomy for local government units (LGUs) in the planning, implementation and financing of public services. Consistent with the new approach, the Code gave greater responsibilities to LGUs and a correspondingly greater authority for them to raise revenues and to borrow capital.

Among other things, the Code's provisions on credit financing allowed LGUs, subject to the rules and regulations of the Bangko Sentral ng Pilipinas (BSP) and the Securities and Exchange Commission (SEC) "to issue bonds, debentures, securities, collaterals, notes and other obligations to finance self-liquidating, income-producing development or livelihood projects pursuant to the priorities established in the approved local development plan or the public investment program."

Until recently, the Philippine macroeconomic picture has been characterized by a volatile inflation rate, foreign exchange rate, and

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interest rate. There were times when the inflation rate exceeded the interest rate. All these discouraged investors and savers alike from long-term investing or borrowings and made them favor short-term instruments. Thus, during much of the 1980s, a 30-day money instrument was, more often than not, all that was available. With greater economic stability, a strong peso and a stable interest rate, confidence has rebounded and many companies are now able to raise substantial amounts in long-term funds.

This paper looks into issues that affect the market development for LGU bonds.

Government Regulation of Bond Issues

The Code allows the issuance of LGU bonds with or without the guarantee of the Republic of the Philippines. The extension of a national government guarantee commits the national government to service the loans obtained by the LGU when the latter, as principal borrower, is unable to pay the principal, interest or other charges under the covering credit arrangement.

The first step, after the necessary project identification and development, is for the LGU to pass "a[n] ordinance or resolution approved by the majority of all its Sanggunian members declaring and stating the terms and conditions of the bonds, the purpose for which the proposed indebtedness is to be incurred and [stating] that the project to be financed by the proposed flotation is among those in the priority areas of approved local development plan[s] or the public investment program, together with details of the development or livelihood project to be financed by the bond flotation particularly with respect to any foreign exchange purchases of raw materials/ services, intermediate and capital goods" (BSP Circular Nos. 41s 1994 and 44s 1994).

The LGU then secures the approval of the Secretary of Finance in the case of bond issues for which a guarantee of the Republic of

the Philippines is sought. To secure the necessary BSP endorsement, the LGU should present the guarantee approved by the Secretary of Finance, the Sanggunian Resolution and other documents as may be required by the BSP. A bond issue without a national government guarantee need not have the corresponding approval of the Secretary of Finance. Upon the rendition of a favorable opinion by the BSP, the bond proposal should then be submitted for final approval by the respective authority exercising supervision over the proponent LGU as provided for in Sec. 25, Chapter 3, Article One of the Code. With such final approval, the LGU is then authorized to coordinate with its underwriter, trustee or other agents for implementation of the bond flotation.

The SEC has not issued any regulations specifically applicable to LGU bond issues. Existing rules and regulations, designed to be applicable to corporate bond issues, therefore apply.

The more significant conditions for registration of unsecured bonds are as follows: net worth of registrants should be at least P25 million at the time of filing; the registrant must have been in operation for at least three years; and certain financial standards should be met, in terms of current ratio, debt to equity, debt to average earnings, debt to cash flow, fixed assets to long-term liabilities, interest coverage, and others as may be prescribed by the SEC. A preliminary prospectus of the issue, which would include pertinent information, as well as the audited financial statements for the preceding three years, a long-form audit report, projected cash flows, and other information as may be required by the SEC, are to be submitted. Subsequent to the issuance of the SEC Certificate of Registration, the registrant is required to submit the Trust Indenture, Underwriting Agreement, Printed Prospectus, and other documentary requirements.

Specified minimum collateral coverage is required in the case of secured bonds. Acceptable collaterals are as follows: listed securities (which must have a current market value of at least 200 percent of

the face value of the bond issue), registered real estate (appraised value of at least 150 percent), registered heavy equipment and motor vehicles (appraised value of at least 200 percent), government securities (aggregate current market value of at least 100 percent), and other assets acceptable to the SEC. Documents as evidence of the collaterals (e.g., Certificates of Title) should be delivered to the indenture trustee and, where applicable, covered by pledges, real estate or chattel mortgages.

The requirements are straightforward, but LGU operations and accounting are different from those of private corporations and the former would be hard put to produce timely audited financial statements of a character that would be meaningful to financial analysts, let alone comply with announced criteria on current ratio, fixed assets, and so on.

In reality, compliance with the requirements both of approval and of payment are daunting. The issuance in 1990 by the Province of Cebu of its innovative Cebu Equity Bond Unit was preceded by about seven months of work and waiting to secure the necessary authorizations from the Department of Justice, the Monetary Board, the Commission on Audit, the Department of Finance, and the Office of the President, in addition to the Provincial Board approval. The process was understandably slow since all concerned had little precedent to follow. With more LGU debt issues, all concerned will gain experience and will have more models to follow, thus inevitably speeding up review and approval. However, the formulation of standard operating procedures and policies for the guidance of both the proponent and approving agency will be advantageous to all concerned.

Constraints in the Design of an LGU Bond Issue

Provinces, cities and municipalities are allowed to issue bonds under the following conditions:

- (1) The obligation will finance self-liquidating, income-generating development or livelihood projects. Accordingly, the proceeds of bond issues may not be used to finance, for example, recurrent expenditures and the general obligations of an LGU.
- (2) The projects concerned must be pursuant to the priorities established in the approved local development plan or the public investment program. The LGU concerned is therefore obliged to formally adopt a public investment program which would be expected to support the local development plan and which would in turn be consistent with the priorities and plan of the National Economic and Development Authority (NEDA).

Limits to LGU borrowing are imposed by the Local Government Code, which states that an LGU annual budget should provide in full for "... all statutory and contractual obligations ... provided that the amount of appropriations for debt servicing shall not exceed 20 percent of the regular income of the LGU concerned," with regular income defined as "estimates of regular income for the budget year as determined by the local finance committee."

Within these broad constraints, an LGU has the discretion to formulate the detailed terms and conditions of a bond issue, taking into account project cost and ability to pay, specifically the maximum amount available for debt servicing which is 20 percent of an LGU's regular income. In designing and marketing securities issues, it is normal to have a financial adviser to assist in the design of the issue and in negotiations with underwriters. Obviously, prevailing market conditions and practices would determine the coupon rate, term, denomination, selling price and effective interest rate, whether or not the bond is guaranteed by the national government. The formulation of the specifics of the bond indenture would likewise be in the light of prevailing practice.

A bond issue could be used to finance LGU's infrastructure projects (i. e., a commercial center or a new road improving access to areas with high potential), whose benefits would be realized mainly from an increase in property values and the corresponding increase in real estate taxes. Under the existing internal revenue allocation (IRA) sharing mechanism, the national and provincial governments would share in the incremental taxes thus generated by a municipality's project. This suggests the need for reviewing the IRA sharing formula such that an LGU that is responsible for servicing the debt incurred to realize the increase in property values could retain, for purposes of debt servicing, the incremental real estate tax proceeds from the LGU-financed project.

The Code is unclear as to what the consequences might be if the debt service requirements of the LGU happen to exceed the 20 percent ceiling. This has to be resolved, in order to dispel any uncertainty in the continuity of payment in the event of a violation.

The existing levels of training and experience of LGU planning and finance personnel are such that it may be difficult to expect them to design bond packages. Such personnel should be skilled in project identification, analysis and development, and in the preparation of an LGU plan and investment program. They should also be familiar with financial packaging, aided by detailed guidelines and examples of what can be done and how to accomplish them. This suggests a program of technical assistance to LGUs and the development of external consultancy expertise in these skills.

Marketability

The marketability of LGU bonds depends on the terms and conditions vis-a-vis competing public and private sector issues. In the continuum of risk and return, debt instruments of the national government would expectedly have the lowest risk and the least returns. Other things being equal, the next would be LGU and

government corporations, private corporation debt paper, preferred stock, and common stock. There would be gradations within each category: small LGU vs. large LGU, guaranteed and nonguaranteed LGU debt, banks as against nonbank financial institutions, public utilities as against ordinary corporations, and others.

Private companies have started to issue long-term commercial papers with maturities ranging from one to seven years. As of March 1994, there were 21 companies authorized by SEC to issue long-term commercial papers with an aggregate face value of P36.8 billion. It is common for long-term papers to have an interest rate that floats with Treasury Bill rates. As of this writing, the thinking in the financial community is that there would be market acceptance of an instrument with a five-year maturity and interest at about 50 basis points above 91-day Treasury Bills, with a corresponding resetting of interest rates. A seven-year issue could be similarly salable, but possibly at about 75 basis points above the 91-day Treasury Bill rate.

The Philippine capital market is still in the early developmental stage and it would be unrealistic to expect immediate market acceptance of LGU bond issues. During the necessary period of transition, it may be advisable to design instruments that initially have relatively small amounts, short maturities, attractive interest rates that preferably float with Treasury Bill rates, a national government guarantee, a mechanism that assures prompt payment, and where possible, added features such as convertibility to an attractive security, as was done in the Cebu Province debt issue. As LGU issues gain market confidence, terms could become more favorable to the issuer.

LGU debt issues no longer have tax exemption privileges and, like Treasury debt instruments, enjoy mainly the advantages of being eligible as reserve assets of banks and other financial institutions and of interest payments being subject to a lower income tax rate to holders (20 percent rather than the 35 percent imposed on interest earned on private corporate debt). Accordingly, LGU bonds might be of particular interest to certain sectors, in the following instances :

- (1) Cash-rich LGUs might be persuaded (or directed by the authorities concerned) to buy bonds issued by other LGUs rather than placing all or most of these funds in private fixed income instruments;
- (2) The funds of insurance companies and pension funds which are necessarily long-term in character could be partly invested in LGU bonds. The large portfolios of government-controlled pension funds logically include LGU bonds; the sizable ones are those of the Government Service Insurance System, the Social Security System, and the Armed Forces of the Philippines Retirement and Separation Benefits System;
- (3) Government securities, including LGU bonds, are eligible as reserve assets of bank and nonbank financial institutions. This warrants a focused marketing approach; and
- (4) The Code provides that, "preferably," LGUs should use government banks as depository banks, but the Commission on Audit (COA) has ruled that where there are government banks in the vicinity, the LGUs must deposit their funds therein. A revision of the COA ruling would provide leverage in marketing LGU debt issues. Government deposits, however, are subject to a 50 percent reserve requirement (vs. 15 percent for other forms of deposits). At the same time, banks enjoy a longer-than-average float on government deposits. As matters stand, leverage could be exercised on banks authorized to receive deposits under the existing policy.

The Province of Cebu issued the highly successful and pathbreaking Cebu Equity Bond Unit (CEBU) in July 1990. However, it has yet to be followed by other LGUs. It had the following highlights:

- (1) A total of P300 million was issued, had a term of three years, earned tax-free interest of 16 percent per annum, and called for

- principal repayments in five equal semi-annual installments in the form of class "A" shares of Cebu Property Ventures and Development Corporation (CPVDC), a joint venture of Cebu Province and Ayala Land, Inc. The province contributed real property while Ayala contributed cash for their respective shares in CPVDC. The conversion between CEBU and CPVDC shares was according to a formula based on the current market value of the latter's security shares; and
- (2) The issue was successful. Interest rate was, in effect, a high 20 percent before tax and there was a likelihood of capital appreciation in CPVDC shares. The tax-free feature, which is no longer allowed under the provisions of the Local Government Code, had the advantage of allowing investors to earn 20 percent while the cost to the province was only 16 percent, with the national government in effect shouldering the difference in terms of tax revenue foregone.

Government financial institutions (GFIs) presumably can be counted on to protect the interests of LGUs since they are both in government. As such, they can be appointed as financial advisors to LGUs in the design of debt issues, the selection of underwriters, and in other decisions needed in such transactions. The wholly government-owned and controlled Land Bank of the Philippines and the Development Bank of the Philippines as are the partly privatized Philippine National Bank and Philippine Veterans Bank would help make sure that LGUs do not pay too much for debt funds.

Bond Ratings

The SEC requires that commercial papers be rated by the Credit Information Bureau, Inc. (CIBI) prior to authorization. Of the 21 long-term commercial papers authorized as of March 1994, five were rated CIB Aa and the rest rated CIB A. Ratings are issued after a

thorough analysis of the papers and the company. The CIBI ratings appear to have gained the confidence of investors, to the extent that some have limited their portfolios to papers with highest ratings and are content to charge a lower interest rate than those charged by papers with lower ratings.

The rating of LGU debt issues is a fairly well-defined discipline in the more developed countries. As more LGUs float debt papers, a rating mechanism becomes more and more of a necessity to guide investors and LGUs alike. In broad terms, such rating of municipal bonds would necessarily call for an analysis of factors such as the project to be financed by the proceeds and the anticipated benefits and cash flows arising from it, the operating revenues and expenses of the LGU, the magnitude, disposition and trends of the LGU's share of national government support or Internal Revenue Allocation (IRA), the presence of a national government guarantee to the proposed issue, the level of outstanding debt and commitments for annual interest and principal repayment, and subjective considerations regarding LGU leadership and management, plans and programs, and other relevant issues.

The financial statements of LGUs and of the government in general are not always revealing or timely. Government accounting is entirely different from private accounting and analysts are often at a loss in comprehending these statements. Proper monitoring would require at least the preparation of some special purpose reports or, possibly, changes in the recording and summarizing of LGU accounts.

Liquidity Mechanism

Bond holders need a ready market for their holdings in case of cash need. Ordinarily, holders of long-term debt papers would look to banks (for their own or trust accounts), insurance companies, corporate treasuries, pension funds, and other financial institutions as immediate buyers. As matters stand, there may not be a sufficient

number of ready buyers particularly if the volume of LGU bond issuances increase substantially. The development of an adequate liquidity mechanism would call for the reconciliation of often conflicting concerns of issuers, sellers and potential buyers on such matters as the quality and characteristics of LGU bonds, as well as investment standards, existing government regulations, and other requirements imposed by law.

LGU bonds can be used as the underlying security of repurchase agreements and other forms of deposit substitutes and money market instruments. In this, however, they are on the same footing as the papers issued by the Treasury and private corporations which may in fact have a more active secondary market. Other things equal, investors would naturally tend to buy money market instruments without attaching particular importance to the underlying security.

Some financial institutions, particularly GFIs, could create a market for LGU bonds. But since they would not wish to hold these instruments until maturity, they would do so only once there is broad acceptance of the said instruments and once the institutions concerned can find ready buyers.

The ideal solution for liquidity would be for LGU bonds to be listed in the Philippine Stock Exchange (PSE). The Exchange is reportedly studying this matter. Such listing would help enlarge the market and thus ensure maximum liquidity to bond holders. As in equity listings, however, applicants for listing would have to measure up to applicable standards. Tax considerations, described elsewhere in this paper, would also have to be resolved before trading can materialize.

Adjusting to Bond Trading Mechanics

Government regulations would need a careful review vis-a-vis the mechanics of bond marketing and administration. With a fixed coupon rate that is not necessarily identical to market interest rate

on the date of bond issue, chances are that the initial sale of the bond would not be at face value. (Nonetheless, an early draft of government rules and regulations required the selling of LGU bonds at no lower than face value.)

The issue would necessarily be at a discount in case the coupon rate is lower than the market rate, and at a premium if the opposite happens to be the case. Unless appropriate measures are taken, all concerned are likely to be charged with graft if the issue is sold at a discount. The alternative of setting a high coupon rate would not necessarily solve the problem either, since a higher-than-market coupon rate would likewise render the decisionmakers vulnerable.

Repayment of the principal on the basis of face value could also be questioned and stopped by an auditor or accountant who might notice that the bond was originally sold at a discount.

A fall in market interest rate would mean an increase in the market value of a fixed coupon bond. All concerned would likewise be charged with graft by an alert prosecutor who notices a lower issue price, particularly if the bond was floated not too long before the fall in interest rate.

Questions about pricing could delay the release of debt service payments at any number of cautious decisionmakers, including budget, accounting, auditing, and cashier's offices. Categorical rulings from the Office of the President, Department of Justice, Department of Finance, Department of Interior and Local Government, COA, and other agencies such as the Ombudsman, would help assure all those concerned. Appropriate policies and a standard mechanism for the approval of the original issue and prompt remittance of debt service payments would also have to be designed and implemented.

Taxes

The tax issues pertaining to LGU bonds and bonds in general are rather complex, and a detailed study of such issues is beyond the

scope of this paper. It is clear, however, that tax laws need to be rationalized if an active bond market is to develop. Even if bonds were listed in the PSE, there is no assurance that active trading would follow unless tax questions are resolved.

There remain unsettled issues, but under the Tax Code, interest income on bank deposits, deposit substitutes and government securities is subject to a 20 percent final tax withheld at source. However, it appears that capital gains derived from the sale of bonds could be considered as ordinary income and taxed accordingly. In the case of a corporate investor, such gains on sale would be subject to a 20 percent withholding tax, creditable against the 35 percent corporate income tax.

The gain on the sale of a bond, even if this arose entirely from a change in market interest rate, is considered as ordinary income and therefore subject to a 35 percent tax. If an LGU bond was listed in the PSE, as is appropriate in a fully developed capital market, the applicable tax would be the 20 percent tax withheld on the coupon rate plus 35 percent on any difference between the original purchase price, which is likely to be at a discount, and the face value at redemption or market value upon sale.

On the other hand, a listed common stock is subject to a final tax of $\frac{3}{4}$ of 1 percent computed from the gross selling price, and deposit substitutes (including repurchase agreements with LGU bonds as underlying security) are taxed at 20 percent.

The Tax Code provision on wash sales would also apply. Any loss incurred on the sale of a bond would be nondeductible for income tax purposes when substantially identical securities are acquired by the seller within the 61-day period beginning 30 days before the sale and ending 30 days after the sale. In view of the normally high turnover of bond transactions in developed markets as traders take advantage of slight fluctuations in interest rate, the wash sale rule becomes both an economic disadvantage and an administrative nightmare.

Unlike shares of stock, bonds are normally bearer instruments and, therefore, need not be presented for reissuance when ownership changes. It seems unclear, however, if documentary stamp taxes would still be imposed. Similarly, there is uncertainty in the tax liabilities of a foreign investment in an LGU bond, specifically on the base of the withholding tax at the time of disposition (whether redemption or sale) of a bond investment.

The net impact of these provisions is to discourage the secondary trading of LGU (and other bonds) and limit the possibilities for an exit mechanism.

Payment Mechanics

Only a few LGUs have gone to the bond market. The bond issue of the Province of Cebu, described earlier, was successful. Unfortunately, a new administration came into power soon after the bond issue. Notwithstanding all the authorizations previously obtained, one of the first acts of the new administration was to attempt to dishonor the said bond. The attempt was overruled by higher authorities and Ayala restored "... cordial relations ... with the reconveyance of a 4,775 square meter property for a corresponding number of Treasury Shares." The affair ended happily, but damage was done, renewing the concern of investors about the continuity and seriousness of the financial commitments of LGUs.

It is necessary to design a mechanism that ensures prompt servicing of debt interest and principal. An approach could be built into the Trust Indenture, possibly along the following lines:

- (1) The LGU would routinely remit to the Trustee, that is, at the end of each month, all proceeds of the revenue-generating project financed by the bond;
- (2) The Department of Budget and Management would remit to the Trustee a predetermined amount or percentage of the IRA of

the LGU concerned. This would be estimated on the basis of the debt service requirement and the 20 percent of LGU revenue regularly allowed for purposes of debt service;

- (3) A committed credit line from an acceptable bank for the term of the bond, to enable the Trustee to obtain bridge financing so as to cover a shortfall from the first two sources above. In such cases, the short-term loan would be paid out of IRA allotments or a guarantee fund for such objectives to be established by the Department of Finance. If the credit line is large enough and if the LGU concerned is reliable enough, then even a direct IRA remittance would not be necessary. The source of the committed credit line would have to make the necessary arrangements to assure that any disbursements are eventually paid.

The principal of the Cebu Province bond issue was paid in installments over the life of the bond. In cases where a bond involves a balloon payment at maturity, it would be advisable for the LGU issuer to set up a sinking fund under the administration of the Trustee, calculated in such a manner as to build up the amount needed at maturity. A sinking fund would help assure that funds for repayment are set aside each year and that the LGU does not violate the 20 percent ceiling on each year's debt service.

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