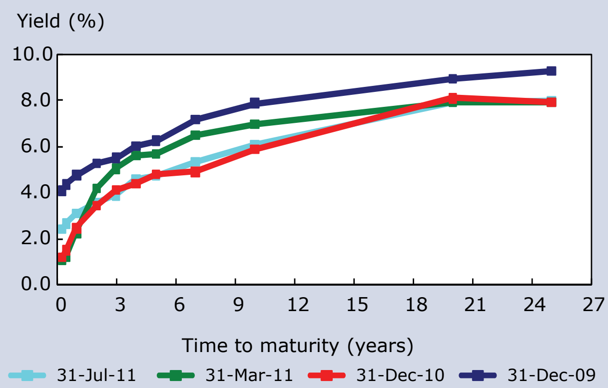
Philippines—Update

Yield Movements

Yields in the belly of the Philippine government bond yield curve rose between end-December 2010 and end-March on the back of inflationary concerns and monetary tightening **(Figure 1)**. The curve then flattened between end-March and end-July as yields at the short-end rose and yields in the belly of the curve fell. During this period, yields for 3- and 6-month tenors rose 139 basis points (bps) and 143 bps, respectively, while yields for 1-, 20-, and 25-year tenors rose 83 bps, 3 bps, and 7 bps, respectively. Yields in the belly of the curve fell between 61 bps and 117 bps from end-March to end-July. Yield spreads between 2- and 10-year tenors narrowed to 250 bps in July from 280 bps in March after a 90 bps drop in the 10-year yield. Overall, the Philippine yield curve flattened between end-December 2010 and end-July.

Figure 1: Philippines' Benchmark Yield Curve—LCY Government Bonds



LCY = local currency.
Source: Bloomberg LP.

Consumer price inflation accelerated in 2Q11, rising to 4.6% year-on-year (y-o-y) in June from 4.5% in May, based on National Statistics Office (NSO) inflation series data from 2000. The NSO's more recent 2006-based data reflected higher inflation rates in both June (5.2%) and May (5.0%). Year-to-date inflation levels through June were 4.3% using the 2000-based data and 4.7% using the 2006-based data. Both rates fall within the government's target range of 3%–5% for full-year 2011.

Rising commodity prices have emerged as a threat to the price stability objective of the Bangko Sentral ng Pilipinas (BSP), which has tried to contain the secondary effects of inflation by maintaining a relatively hawkish policy stance. BSP raised both of its policy rates 25 bps following Monetary Board meetings in March and again in May. BSP's overnight borrowing facility stands at 4.5%, while the overnight lending facility is 6.5%. In its June and July meetings, BSP kept its policy rates steady but followed steps taken by its Asian counterparts in hiking the reserve requirement by 100 bps each. Given the possibility that the current inflation trend might exceed BSP's annual target, the central bank has said it will remain vigilant for any potential build up of inflationary expectations and is ready to tighten monetary policy as needed.

Gross domestic product (GDP) growth in the Philippines fell to 4.9% y-o-y in 1Q11 from 6.1% in 4Q10, based on 2000 price levels. (Until 2011, the National Statistical Coordination Board [NCSB] had used 1986 as its base year.) Reduced government spending, slowing exports, and consumption weakened by escalating consumer prices contributed to lower GDP growth in 1Q11.

Size and Composition

The local currency (LCY) bond market continued to grow modestly in the first half of 2011. Growth in the issuance of treasury and corporate bonds overshadowed the contraction in treasury bills and other government debt issuances, resulting in the continued overall expansion of the Philippine LCY bond market.

Total LCY bonds outstanding rose to PHP3.26 trillion (US$75.1 billion) at end-June, up 6.0% y-o-y **(Table 1)**. On a quarter-on-quarter (q-o-q) basis, LCY bonds increased 3.1% on the back of 4.6%

Table 1: Size and Composition of the LCY Bond Market in the Philippines

	Amount (billion)								**Growth Rate** (%)						
	Mar-11		**Apr-11**		**May-11**		**Jun-11**		**Mar-11**		**Apr-11**	**May-11**	**Jun-11**		
	PHP	US$	PHP	US$	PHP	US$	PHP	US$	y-o-y	q-o-q	m-o-m	m-o-m	y-o-y	q-o-q	m-o-m
Total	3,160	73	3,161	74	3,222	75	3,257	75	5.7	(0.7)	(0.2)	1.9	6.0	3.1	0.6
Government	2,758	64	2,774	65	2,825	65	2,840	65	4.5	(2.1)	0.6	1.8	5.4	3.0	0.0
Treasury Bills	400	9	385	9	385	9	381	9	(31.0)	(24.2)	(3.6)	0.1	(32.8)	(4.6)	0.0
Treasury Bonds	2,236	52	2,269	53	2,320	54	2,340	54	14.8	3.5	1.5	2.2	17.2	4.6	0.0
Others	122	3	119	3	119	3	119	3	9.5	(6.7)	(2.7)	0.0	(9.7)	(2.7)	0.0
Corporate	402	9	387	9	397	9	417	10	14.4	10.7	(5.1)	2.6	10.9	3.6	5.0

LCY = local currency, m-o-m = month-on-month, q-o-q = quarter-on-quarter, y-o-y = year-on-year.
Notes:
1. Calculated using data from national sources.
2. Bloomberg end-of-period LCY–US$ rates are used.
3. Growth rates are calculated from LCY base and do not include currency effects.
4. "Others" includes government-guaranteed bonds such as National Power Corporation and Power Sector Assets and Liabilities Management.
Source: Philippine Bureau of the Treasury and Bloomberg LP.

and 3.6% growth in treasury bonds and corporate bonds, respectively. Treasury bonds surged to PHP2.34 trillion at end-June, a 17.2% y-o-y increase. Corporate debt expanded 10.9% y-o-y to close out the first half of the year at PHP417 billion.

Government securities still dominated the Philippine LCY bond market in 2Q11, but the share of treasury bills notably decreased while treasury bonds gained as a result of the government's policies of fiscal consolidation and debt maturity restructuring. Treasury bills outstanding shrank to PHP400 billion in March, a decline of 31.0% y-o-y, and fell further to PHP381 billion in June, a 32.8% y-o-y decline.

Corporate and government issuance in 1H11 supported growth in the LCY bond market. Retail treasury bonds (5- and 10-year tenors) totaled almost PHP104 billion in March, representing the most significant government borrowing in 1H11. Meanwhile, corporate issuance was led by Ayala Land Inc. (January) and Ayala Corporation (May), which each sold PHP10 billion worth of bonds. Two companies owned by retail industry leader Henry Sy, Banco de Oro Unibank, and SM Investments, sold bonds worth PHP8.5 billion in June and PHP7.0 billion in February, respectively.

Corporate Bond Market Development

Total outstanding LCY corporate bonds stood at PHP417 billion at end-June. In total, there were less than 50 firms with corporate bonds outstanding, while the top 30 issuers accounted for more than 93% of the total. Among the top issuers, 28 were listed companies on the Philippine Stock Exchange, suggesting that it is easier for listed companies to borrow publicly due to greater financial and operating transparency. San Miguel Brewery led the roster of borrowers with PHP38.8 billion of issued debt. Banco de Oro Unibank was the second-largest with PHP36.5 billion and Ayala Corporation was next with PHP26.0 billion **(Table 2)**.

A plurality of the top 30 bond issuers were banks (34%), followed by real estate developers and operators (14%), holding companies (13%),

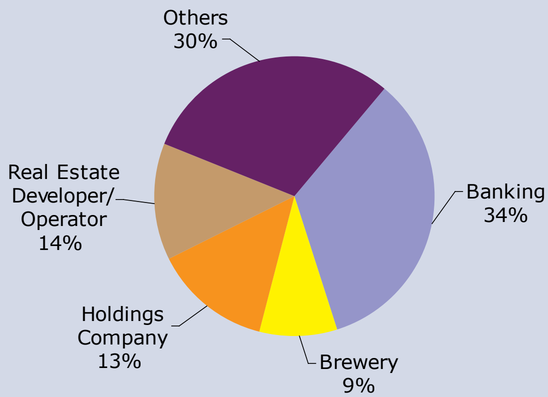
Table 2: Top 30 Issuers of LCY Corporate Bonds in the Philippines (as of June 2011)

Issuers	Outstanding Amount		State-Owned	Privately-Owned	Listed Company	Type of Industry
	LCY Bonds (PHP billion)	LCY Bonds (US$ billion)				
1. San Miguel Brewery, Inc.	38.80	0.89	No	Yes	Yes	Brewery
2. Banco De Oro Unibank, Inc.	36.50	0.84	No	Yes	Yes	Banking
3. Ayala Corporation	26.00	0.60	No	Yes	Yes	Diversified Operations
4. Philippine National Bank	21.25	0.49	No	Yes	Yes	Banking
5. Rizal Commercial Banking Corporation	21.00	0.48	No	Yes	Yes	Banking
6. Manila Electric Company	18.84	0.43	No	Yes	Yes	Electric-Distribution
7. Metropolitan Bank & Trust Company	18.50	0.43	No	Yes	Yes	Banking
8. Ayala Land, Inc.	17.34	0.40	No	Yes	Yes	Real Estate Developer/ Operator
9. SM Investments Corporation	16.40	0.38	No	Yes	Yes	Diversified Operations
10. Petron Corporation	16.30	0.38	No	Yes	Yes	Oil Refining & Marketing
11. Robinsons Land Corporation	15.00	0.35	No	Yes	Yes	Real Estate Developer/ Operator
12. JG Summit Holdings, Inc.	13.31	0.31	No	Yes	Yes	Diversified Operations
13. Globe Telecom, Inc.	12.72	0.29	No	Yes	Yes	Telecom Services
14. Philippine Long Distance Telephone Co.	12.50	0.29	No	Yes	Yes	Telephone-Integrated
15. Energy Development Corporation	12.00	0.28	No	Yes	Yes	Electric-Generation
16. Bank of the Philippine Islands	10.00	0.23	No	Yes	Yes	Banking
17. SM Development Corporation	10.00	0.23	No	Yes	Yes	Real Estate Developer/ Operator
18. First Philippine Holdings Corporation	8.49	0.20	No	Yes	Yes	Electric-Integrated
19. Allied Banking Corporation	8.00	0.18	No	Yes	Yes	Banking
20. Aboitiz Power Corporation	6.88	0.16	No	Yes	Yes	Electric-Generation
21. Megaworld Corporation	6.38	0.15	No	Yes	Yes	Real Estate Developer/ Operator
22. Metrobank Card Corporation	6.30	0.15	No	Yes	Yes	Diversified Financial Services
23. Manila North Tollways Corporation	5.28	0.12	No	Yes	No	Public Thoroughfares
24. China Banking Corporation	5.00	0.12	No	Yes	Yes	Banking
25. Filinvest Land, Inc.	5.00	0.12	No	Yes	Yes	Real Estate Developer/ Operator
26. Tanduay Distillers, Inc.	5.00	0.12	No	Yes	No	Beverages-Wines/Spirits
27. United Coconut Planters Bank	4.52	0.10	No	Yes	Yes	Banking
28. Manila Water Company, Inc.	4.00	0.09	No	Yes	Yes	Water Distribution
29. SM Prime Holdings, Inc.	3.99	0.09	No	Yes	Yes	Real Estate Management Services
30. Union Bank of the Philippines, Inc.	3.75	0.09	No	Yes	Yes	Banking
Total Top 30 LCY Corporate Issuers	**389.06**	**8.97**				
Total LCY Corporate Bonds Outstanding	**417.04**	**9.61**				
Top 30 as % of Total LCY Corporate Bonds Outstanding	**93.3%**	**93.3%**				

LCY = local currency.
Source: Bloomberg LP.

and a brewery (9%) **(Figure 2)**. Bond sellers from various other industries accounted for the remaining 30%.

Figure 2: LCY Corporate Bond Issuers by Industry
(as of June 2011)



LCY = local currency.
Source: Bloomberg LP.

Foreign Currency Bonds

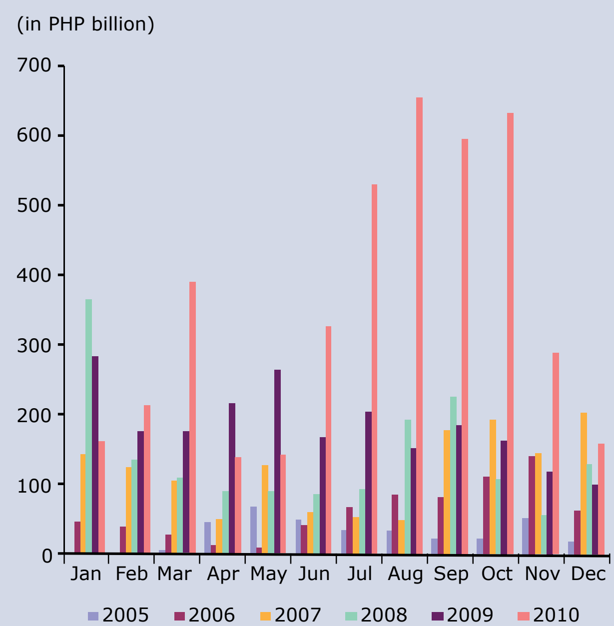
In March, the government sold US$1.5 billion of 15-year US$-denominated global bonds with a coupon rate of 5.5%. The sovereign raised US$2.8 billion from international markets in 1H11, led by a US$1.3 billion 25-year global peso bond issued in January. The Development Bank of the Philippines (DBP) also sold US$300 million worth of 10-year bonds at a coupon rate of 5.5%. DBP has a program of foreign borrowing that will reach US$1.2 billion in 2011.

In May, San Miguel Corporation—a diversified conglomerate with businesses in a number of sectors including food and beverage, power, mining, infrastructure, and telecommunications—sold 3-year US$600 million exchangeable bonds with a coupon rate of 2.0%. The bonds can be converted into common shares to be sourced from the treasury stock of the company with a 25% premium on the offer price. The bonds are listed on the Singapore Exchange.

Trading Volume Trends

According to the sole fixed-income exchange and reporting platform in the country, PDEx, the liquidity of government securities, particularly Fixed-Rate Treasury Notes (FXTNs), improved dramatically between 2005 and 2010. The trading volume of FXTNs increased by a factor of 12 over this period, from PHP357 billion in 2005 to PHP4.25 trillion in 2010. Monthly trading volume averages rose from PHP 35.7 billion in 2005 to PHP354 billion in 2010. Assuming an average of 20 trading days per month, daily trading volume soared from PHP1.8 billion in 2005 to PHP21.3 billion in 2010. The highest recorded trading volume in a single day was PHP122 billion in October 2010. A number of factors have contributed to the increased trading of government securities including improved transparency in market activities, growing capitalization of the banking system, and improving regional and domestic economic indicators **(Figure 3)**.

Figure 3: Fixed-Income Treasury Notes Trading Volume, 2005–2010



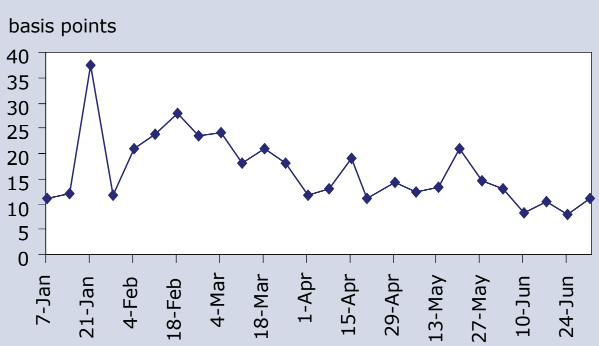
Note: PDEx reports one side of trades only.
Source: Philippine Dealing & Exchange Corporation (PDEx).

Bid–Ask Spreads

In 1H11, the bid–ask spreads of the five benchmark bonds were recorded using the data from the four voice brokers operating in the Philippines. The benchmark bonds are FXTN 5-67 (2.6 years remaining until maturity), FXTN 7-48 (4.6 years), FXTN 10-42 (5.2 years), FXTN 10-52 (9.5 years), and FXTN 25-08 (24.5 years). The lowest bid and the highest offer in terms of yield among the brokers at the close of a trading session (as reflected on their Bloomberg pages) are used to construct the market bid–offer spread. The weekly average market bid-offer spreads of the five benchmark bonds are presented in **Figure 4**.

The most that the market bid–offer spread widened in a single week was 37 bps during 17–21 January, when financial institutions began selling government securities as loss-limit stops were hit and inflationary fears signaled the onset of rising interest rates. Spreads narrowed at times in 1H11 on the back of better-than-expected data releases (e.g., a lower government budget deficit), higher liquidity (as reflected in auction tenders that were more than two times oversubscribed), more long-term maturities, and increased foreign and local corporate buying. The tightest weekly average was 8 bps recorded during 21–24 June after Moody's and Fitch upgraded their respective credit ratings for the Philippines, which was followed by the announcement of the government's debt swap scheduled for early July.

Figure 4: Benchmark Government Securities Bid-Ask Spreads, January–July 2011



Note: 1 basis point = 0.01 percent.
Source: *AsianBondsOnline*.

Among the five benchmark bonds, FXTN 25-08 posted the tightest market bid–offer spread with an average of 7.8 bps in 1H11. This was followed by FXTN 5-67 (10.0 bps), FXTN 7-48 (15.3 bps), FXTN 10-42 (16.6 bps), and FXTN 10-52 (33.3 bps).

Rating Changes

On 14 June, Rating and Investment Information Inc (R&I) affirmed the foreign currency (FCY) long-term bond rating of the government at BBB- with a stable outlook. The country's FCY short-term debt rating of a-2 was also affirmed. R&I highlighted the need to expand the revenue base and upgrade infrastructure conditions. Low public and private investment-to-GDP ratios and high (albeit declining) levels of debt were also factored into the ratings.

On 15 June, Moody's upgraded the FCY and LCY long-term bond ratings on debt issued by the government to Ba2, or two notches below investment grade, with a stable outlook for both. The upgrade was the result of the (i) progress made in fiscal consolidation by the current administration and (ii) sustained nature of macroeconomic stability on the back of a strong external payments position and economic growth.

On 23 June, Fitch Ratings upgraded the Philippines' long-term FCY issuer default rating to BB+ from BB. The long-term LCY issuer default rating and the country ceiling were also upgraded to BBB- from BB+. The outlook for all of these ratings is stable. The short-term FCY rating has been affirmed at B. The rating agency took note of the government's progress on fiscal consolidation, sustained macroeconomic stability and favorable prospects, and improving external finances.

On 29 July, Standard & Poor's (S&P) affirmed its BB/B (FCY) and BB+/B (LCY) sovereign credit ratings for the Philippines. The outlook for both is stable. The ratings reflect strong external liquidity and signs of improving growth prospects balanced against enduring fiscal weakness with high, albeit improving, debt ratios. The stable outlooks reflect S&P's expectation that remittances will continue to drive current account surpluses, while the weak fiscal profile will require more effort to address.

Table 3: Selected Sovereign Ratings and Outlook for the Philippines

	Moody's	S&P	Fitch	R&I
FCY Long-Term Rating	Ba2	BB	BB+	BBB-
Outlook	stable	stable	stable	stable

FCY = foreign currency.
Source: Rating agencies.

Policy, Institutional, and Regulatory Developments

Government Mulls New Global Peso Notes

The Philippine government is planning to issue Global Peso Notes (GPNs) and dollar bonds, possibly in September. The BSP has approved in principle the sale of up to US$1.5 billion of 15-year GPNs and as much as US$1.5 billion of new 25-year dollar bonds or the reopening of a US$1.0 billion bond due in October 2034. GPNs are PHP-denominated bonds that are sold offshore and payable in US dollars to investors. GPNs are tax-exempt. Principal and interest are converted into US dollars for payment. The US$ equivalent is calculated based on the prevailing PHP–US$ exchange rate on interest and principal payment dates. Under this scenario, investors bear the currency risk. The Philippines has sold a total of US$2.25 billion of GPNs in January 2011 and September 2010 **(Table 4)**.

Table 4: Philippine Global Peso Notes

Issues	Outstanding Amount (PHP billion)	Coupon (%)	Issue Date	Maturity Date
PHILIP 4.95 21	44.109	4.95	17-Sep-10	15-Jan-21
PHILIP 6.25 36	54.77	6.25	14-Jan-11	14-Jan-36

Source: Bloomberg.

BSP Raises Reserve Requirement Ratio to 21%

On 28 July, BSP raised the statutory reserve requirement for peso deposit liabilities and deposit substitutes of all banks and non-bank financial institutions with quasi-banking functions. The statutory reserves of universal and commercial banks increased from 9% to 10%. Including a liquidity reserve requirement of 11%, the latest adjustment raised the total level of required reserves to 21% from 20%. The reserve requirement hike was a preemptive move to counter inflationary pressures arising from excess liquidity driven by strong capital inflows given the favorable outlook for the Philippine economy. BSP, however, stated that inflation risks were still present and it remains ready to implement measures to ensure price stability.

BTR Conducts Another Domestic Debt Swap

On 13 July, the Bureau of the Treasury (BTR) completed its sixth domestic bond exchange program since 2006. The latest exchange received the highest level of participation to date, with PHP299.4 billion worth of bonds being offered in exchange for new 10.5- and 20-year bonds. On 19 July, BTR issued PHP67.6 billion of 10.5-year and PHP255.8 billion of 20-year bonds—a total of PHP323.4 billion of new benchmark bonds—in exchange for eligible bonds. It was also the first time that bonds were exchanged for 20-year bonds. The 10.5-year bond carries a coupon of 6.375%, while the 20-year coupon is 8.0%. The last debt swap lengthened the average maturity of government bonds outstanding by 2 years. The series of debt exchanges have resulted in fiscal consolidation and a lengthening of the country's debt maturity profile, allowing the government more flexibility in spending on infrastructure, social services, and public works.

BSP Amends Meaning of Qualifying Capital Instruments

BSP adopted the Basel III criteria for inclusion of non-common equity components in banks' capital base when determining capital instruments that can be counted as regulatory capital by Philippine banks, effective 1 January 2011. Basel III states that the majority of the capital base must be in the form of common equity elements and sets out minimum criteria for instruments to qualify in each of the sub-categories of capital. Instruments to be included as capital should not contain conditions that give the issuing bank an incentive to redeem the instrument. These conditions include step-ups of coupon rates on a call or maturity date, rights to accelerate the repayment of future scheduled payments except in liquidation, and a credit-sensitive dividend feature. Repayment of the principal of capital instruments requires prior supervisory approval and banks should not assume or create market expectations that supervisory approval will be given. BSP aims to implement other Basel III guidelines prior to earlier 2015—the year set by the international committee for compliance.