Philippines—Update

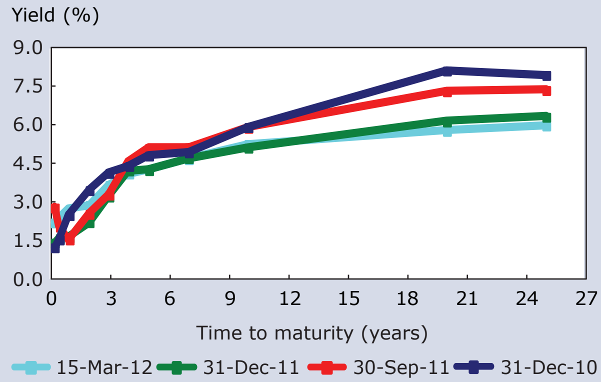
Yield Movements

The Philippines' government bond yield curve flattened between end-2010 and end-2011 as inflation fears dissipated and concerns over weakening growth heightened, leading to calls for a more accommodative monetary policy and aggressive fiscal stimulus measures. In 2011, the yields on tenors of less than 1 year increased between 5 basis points (bps) and 18 bps, while the rest of the curve fell between 17 bps and nearly 200 bps **(Figure 1)**.

The yield curve continued to flatten between end-December and 15 March, as yields in most tenors across the curve rose—with maturities of 3 years or less rising more than the others. Yields for maturities between 3 months and 3 years increased between 45 bps and 110 bps, while tenors of 5 years and 10 years rose 3 bps and 15 bps, respectively. Meanwhile, yields in other tenors declined between 4 bps and 37 bps. Yield spreads between 2- and 10-year tenors narrowed to 238 bps in 15 March from 291 bps at end-December.

The gross domestic product (GDP) of the Philippines grew 3.7% year-on-year (y-o-y) in 2011 after expanding 3.7% y-o-y in 4Q11. GDP growth in 2011 failed to meet the government's target of 4.5%–5.5% and was well below 2010's growth rate of 7.6%. Spillover effects from the eurozone debt crisis and a slowdown in the United States (US) and Japan weighed heavily on the country's export sector in 2011. Cumulative exports for the full-year 2011 stood at US$48 billion—a contraction of 6.9% from 2010. Merchandise exports showed signs of recovery in the first two months of 2012—generating $8.6 billion receipts or 8.8% higher than same period of 2011. Remittances from overseas Filipinos buoyed the country's economy, reaching a record-high US$20.1 billion in 2011 or annual growth of 7.2%. Remittances in January–February 2012 reached US$3.1 billion—5.6% higher than the same period in 2011.

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



LCY = local currency.
Source: Bloomberg LP.

Average consumer price inflation in the Philippines was 4.8% in 2011, based on 2006 consumer price index (CPI) data, which was well within the government's target range of 3.0%–5.0%. (Inflation averaged 4.4% based on 2000 CPI data.) Benign inflation continued in 1Q12 as inflation in January, February, and March eased to 3.9%, 2.7%, and 2.6% y-o-y, respectively. Bangko Sentral ng Pilipinas (BSP) has set an inflation target range for 2012–2014 of 3.0%–5.0%. Year-to-date average is at 3.1%.

With inflation risks well within manageable levels and growth lagging in 2011, BSP shifted its monetary policy stance from neutral to accommodative by slashing key interest rates 25 bps in both January and March. The overnight borrowing (reverse repurchase) and lending (repurchase) rates were lowered to 4.0% and 6.0%, respectively. Policy rates have thus reverted to their historic lows last seen in March 2011. BSP also reduced its reserve requirement ratio by 3 percentage points from 21% to 18%—for commercial and universal banks—effective 6 April. In 19 April, BSP kept its policy rates unchanged—pausing from its easing monetary stance—as (i) oil prices remain elevated leading to upside risks to inflation outlook and (ii) gains from previous rate cuts have yet to be assessed.

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

	Amount (billion)								**Growth Rate** (%)							
	Sep-11		**Oct-11**		**Nov-11**		**Dec-11**		**Sep-11**		**Oct-11**	**Nov-11**	**Dec-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	3,276	75	3,321	78	3,368	77	3,391	77	3.2	0.3	1.4	1.4	5.9	3.5	0.7
Government	2,867	65	2,902	68	2,936	67	2,956	67	2.4	0.7	1.2	1.2	4.9	3.1	0.7
Treasury Bills	330	8	313	7	296	7	295	7	(43.0)	(13.5)	(5.2)	(5.5)	(44.1)	(10.5)	(0.2)
Treasury Bonds	2,420	55	2,472	58	2,524	58	2,547	58	15.8	3.1	2.1	2.1	17.9	5.3	0.9
Others	117	3	117	3	117	3	113	3	(11.2)	(1.7)	–	–	(13.5)	(3.1)	(3.1)
Corporate	409	9	419	10	432	10	436	10	8.9	(2.2)	2.8	3.0	13.4	6.5	0.9

– = not applicable, 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 bonds issued by government agencies/instrumentalities/corporations with which repayment was guaranteed by the National Government. These include issues of Power Sector Assets and Liabilities Management (PSALM), National Food Authority, and others.
5. Peso Global Bonds (PHP-denominated bonds but payable in US$) and multi-currency Retail Treasury Bonds are not included. As of 31 December 2011, the Government of the Philippines and Petron Corporation have an outstanding PHP98.9 billion and PHP20.0 billion of Peso Global Bonds, respectively.

Source: Philippine BTr and Bloomberg LP.

Size and Composition

As of end-December, LCY bonds outstanding stood at PHP3.4 trillion for an increase of 3.5% quarter-on-quarter (q-o-q). Growth in treasury and corporate bonds led the robust expansion. Fixed-Rate Treasury Notes (FXTNs) stood at PHP2.96 trillion at end-December, rising 5.3% q-o-q; corporate bonds ended at PHP436 billion for a 6.5% q-o-q increase. Treasury bills, meanwhile, shrank 10.5% q-o-q to PHP295 billion **(Table 1)**.

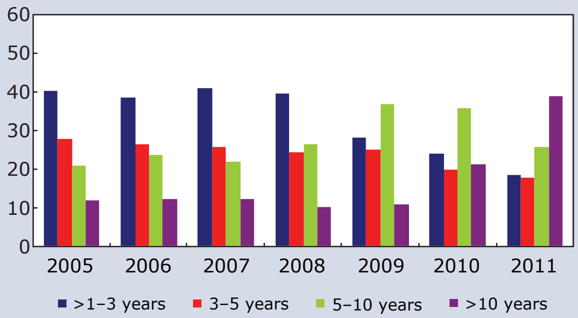
On an annual basis, total LCY bonds outstanding surged 5.9% in 4Q11, led by y-o-y growth of 17.9% and 13.4%, respectively, in treasury and corporate bonds. The growth figures are a result of the government and private issuers taking advantage of massive liquidity in the financial system and the low interest rate environment to issue long-term bonds.

In October, the Bureau of the Treasury (BTr) issued PHP110 billion of Retail Treasury Bonds (RTBs) with maturities of 10 years and 15 years. The 10-year RTBs, totaling PHP54.9 billion, carry a coupon of 5.75%; the 15-year RTBs, totaling PHP55.1 billion, have a coupon of 6.25%. RTBs are FXTNs that are sold primarily to individual investors and pay coupons on a quarterly basis.

Consistent with its strategy of lengthening its debt maturity profile, BTr offered only 7-, 10-, and 25-year bonds in 4Q11. BTr was able to sell PHP7.8 billion of 7-year bonds, PHP9.0 billion of 10-year bonds, and PHP18.8 billion of 25-year bonds.

The maturity profile of government FXTNs continued to lengthen in 2011. The average term of FXTNs increased to 9.7 years in 2011 from 7.6 years in 2010. Noticeably, the share of FXTNs with maturities between 1 year and 3 years fell to 18.3% in 2011 from 23.9% in 2010. The share of FXTNs with maturities between 3 years and 5 years decreased to 17.4% from 19.5%.The share of FXTNs with maturities between 5 years and 10 years fell to 25.5% from 35.5%. In contrast, the share of FXTNs with maturity terms of more

Figure 2: LCY Government Securities Maturity Profile, 2005–2011 (individual maturities as % of total)



LCY = local currency.
Note: Treasury bills and bonds with maturities of 1 year or less are excluded in the calculation of the LCY government securities maturity profile.
Source: Philippine BTr.

than 10 years rose to 38.8% in 2011 from 21.1% in 2010 **(Figure 2)**.

Major issuers of corporate bonds in 4Q11 were banks, investment houses, and a telephone company. BDO Unibank Inc. sold PHP6.5 billion of Tier 2 notes with a coupon of 6.375% and a maturity date of 7 January 2022. First Metro Investment Corporation, the investment banking arm of Metrobank Group, sold PHP5 billion worth of retail bonds with a coupon of 5.675% and a maturity date of 25 February 2017. Rizal Commercial Banking Corporation (RCBC) sold PHP3.85 billion of long-term certificates of deposit due on 29 June 2017 with a coupon of 5.25%. Philippine National Bank (PNB) issued PHP3.1 billion of 5.25-year long-term certificates of deposit with a coupon rate of 5.18% and a maturity date of 17 February 2017.

Corporate Bond Market Development. Total LCY corporate bonds outstanding in the Philippines reached PHP435.8 billion at end-December. San Miguel Brewery Inc. (SMB) remained the top corporate issuer with PHP38.8 billion worth of outstanding bonds **(Table 2)**. Recently, SMB gained approval from the majority of its bondholders to change several covenants in its existing bonds and was given the authority to raise another PHP20 billion through the issuance of 5- and 10-year bonds.

The four next largest borrowers in the bond market in 4Q11 were (i) BDO Unibank, Inc. with PHP38.0 billion of debt; (ii) Ayala Corporation, a holding company, with PHP26.0 billion; (iii) Philippine National Bank with PHP24.4 billion; and (iv) SM Investments Corporation with PHP21.1 billion.

Among the top 30 bond issuers, 27 companies were listed on the Philippine Stock Exchange. Only Manila North Tollways Corporation; Tanduay Distillers, Inc.; and Philippine Phosphate Fertilizer Corporation were privately-owned companies. Meanwhile, 14 out of the 30 issuers have bonds listed with the Philippine Dealing and Exchange Corporation (PDEx), the sole fixed-income exchange in the country. (The Power Sector Assets and Liabilities Management Corporation [PSALM] has PHP30 billion worth of bonds listed with PDEx; however, *AsianBondsOnline* classifies these as government bonds.)

Banking and financial services institutions remained the dominant issuers of bonds in 4Q11, accounting for 36% of the total market **(Figure 3)**. The share of banks and financial institutions was up from 34% in 3Q11 as BSP-supervised institutions enhanced their capitalization (Tier 2) and deposit bases (long-term certificates of deposit) in anticipation of the adoption of Basel III provisions by 2014, based on the latest guidance from BSP (See **Policy, Regulatory, and Institutional Developments**). In a low interest rate environment, banks have been tapping the bond market to protect existing lending franchises, expand operations, and ensure liquidity.

Holdings companies' share represented 16% of the total in 4Q11 and real estate companies accounted for 13%. A brewery and other companies selling alcoholic beverages comprised 11% of the total corporate bond market, while electricity and telecommunications companies accounted for 9% and 8%, respectively.

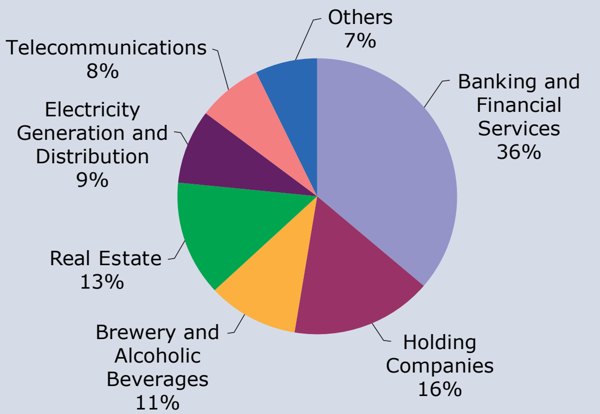
Foreign Currency Bonds. In January, the government took advantage of favorable market conditions to issue a 25-year US$-denominated benchmark bond designed to meet the country's

Table 2: Top 30 Issuers of LCY Corporate Bonds in the Philippines (as of end-December 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. BDO Unibank Inc	38.00	0.87	No	Yes	Yes	Banking
3. Ayala Corporation	26.00	0.59	No	Yes	Yes	Diversified Operations
4. Philippine National Bank	24.35	0.56	No	Yes	Yes	Banking
5. SM Investments Corporation	21.10	0.48	No	Yes	Yes	Diversified Operations
6. Rizal Commercial Banking Corporation	19.85	0.45	No	Yes	Yes	Banking
7. Manila Electric Company	18.82	0.43	No	Yes	Yes	Electricity Distribution
8. Metropolitan Bank & Trust Co	18.50	0.42	No	Yes	Yes	Banking
9. Philippine Long Distance Telephone Co	17.50	0.40	No	Yes	Yes	Telecommunications
10. Ayala Land Inc	15.51	0.35	No	Yes	Yes	Real Estate
11. Robinsons Land Corporation	15.00	0.34	No	Yes	Yes	Real Estate
12. Petron Corporation	13.60	0.31	No	Yes	Yes	Oil Refining and Marketing
13. JG Summit Holdings, Inc	13.31	0.30	No	Yes	Yes	Diversified Operations
14. Globe Telecommunications	12.72	0.29	No	Yes	Yes	Telecommunications
15. Energy Development Corporation	12.00	0.27	No	Yes	Yes	Electricity 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
18. First Philippine Holdings Corporation	8.49	0.19	No	Yes	Yes	Electricity Generation and Distribution
19. Allied Banking Corporation	8.00	0.18	No	Yes	Yes	Banking
20. Filinvest Land, Inc	8.00	0.18	No	Yes	Yes	Real Estate
21. United Coconut Planters Bank	7.67	0.17	No	Yes	Yes	Banking
22. Aboitiz Power Corporation	6.87	0.16	No	Yes	Yes	Electricity Generation
23. Megaworld Corporation	6.38	0.15	No	Yes	Yes	Real Estate
24. Metrobank Card Corporation	6.30	0.14	No	Yes	Yes	Diversified Financial Services
25. Manila North Tollways Corporation	5.28	0.12	No	Yes	No	Public Thoroughfares
26. China Banking Corporation	5.00	0.11	No	Yes	Yes	Banking
27. First Metro Investment Corporation	5.00	0.11	No	Yes	Yes	Investment Banking
28. Tanduay Distillers Inc	5.00	0.11	No	Yes	No	Alcoholic Beverages
29. Philippine Phosphate Fertilizer Corporation	4.50	0.10	No	Yes	No	Agricultural Chemicals
30. Manila Water Company Inc	4.00	0.09	No	Yes	Yes	Water Distribution
Total Top 30 LCY Corporate Issuers	**405.55**	**9.25**				
Total LCY Corporate Bonds	**435.80**	**9.94**				
Top 30 as % of Total LCY Corporate Bonds	**93.1%**	**93.1%**				

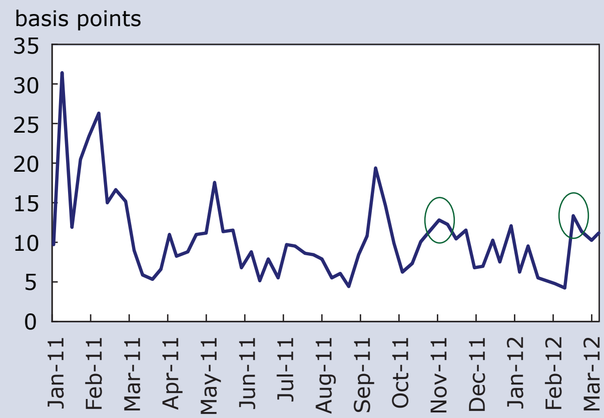
LCY = local currency.
Source: Bloomberg LP.

Figure 3: LCY Corporate Bond Issuers by Industry (as of end-December 2011)



LCY = local currency.
Source: Bloomberg LP.

Figure 4: Bid–Ask Spreads of the Philippines' Most Active Government Securities, 7 January 2011–15 March 2012



Source: *AsianBondsOnline*.

budgetary requirements. The government raised US$1.5 billion from the offering. The bonds carried an interest rate of 5.0% per annum. Investors comprised buyers from the United States (35%), Philippines (25%), the rest of Asia (25%), and Europe (15%). The government has a planned foreign borrowing program of US$4.02 billion in 2012 to be sourced from commercial borrowing (US$2.25 billion) and project loans (US$1.77 billion).

Benchmark Government Securities Bid–Ask Spreads

Bid–ask spreads for the most traded government securities between 7 January 2011 and 15 March 2012 are presented in **Figure 4**. Treasury bonds with daily or most frequent available bid–ask (two-way) quotes were gathered to monitor liquidity in the LCY secondary market. The data used to capture the bid-ask spreads for these securities were obtained from the Bloomberg pages of the money brokers operating in the Philippines.

During the period covered, average bid–ask spreads narrowed considerably. In 1Q11, average bid–ask spreads were 15.9 bps. In 2Q11, average spreads narrowed to 9.6 bps before falling further to 9.1 bps in 3Q11. Average bid-ask spreads rose marginally to 9.3 bps in 4Q11, then tightened again in the first several months of 2012, averaging 8.4 bps on expectations of monetary easing and a positive outlook for the country's economy.

Starting in the second half of 2011, less data are available on bid–ask levels for short tenors—such as FXTN 5-67, FXTN 7-48, and FXTN 10-42—as short tenors have been increasingly swapped-out for longer tenors and the government did not offer any notes with tenors of 2–5 years in 4Q11.

Some notable widening of average bid–ask spreads were recorded in 4Q11 and the first 2.5 months of 2012. During the two consecutive weeks of 8–11 and 14–18 November, average bid–ask spreads were 12.8 bps and 12.2 bps, respectively. Risk aversion sentiment crept into the LCY market as the eurozone's debt turmoil was perceived to be deepening on account of escalating European borrowing costs. In 2012, average bid–ask spreads were at their highest in the week of 20–24 February at 13.3 bps, when BTr set the coupon rates for its long-dated RTBs at least 25 bps higher than secondary trading of the same tenored treasuries.

The bonds posting single-digit bid–ask spreads during the period of observation were RTB 20-1 (1.9 bps), FXTN 20-17 (2.1 bps), RTB 15-2 (4.7 bps), FXTN 10-54 (6.1 bps), RTB 10-3 (7.1 bps), FXTN 10-53 (7.2 bps), FXTN 25-8 (7.3 bps), RTB 10-2 (7.4 bps), and FXTN 7-51 (8.1 bps).

Rating Changes

S&P raised its outlook on the Philippines' BB sovereign credit rating to positive from stable in December. The agency cited strong external liquidity and signs of improving growth prospects as reasons for the upgrade **(Table 3)**.

Table 3: Selected Sovereign Ratings and Outlooks for the Philippines

	Moody's	S&P	Fitch
Sovereign FCY LT Ratings	Ba2	BB	BB+
Outlook	Positive	Positive	Stable

FCY = foreign currency, LT = long term.
Source: Rating agencies.

Policy, Institutional, and Regulatory Developments

BTr Sells PHP179.8 Billion of Long-Dated RTBs

BTr sold a record-breaking PHP179.8 billion of 15- and 20-year RTBs in the last week of February. The 15- and 20-year bonds carry coupon rates of 5.375% and 5.875% per annum, respectively. The RTB coupons are payable on a quarterly basis. Of the total PHP179.8 billion worth of bonds issued, PHP44.1 billion were in the form of 15-year RTBs and PHP135.7 billion were 20-year RTBs. The RTBs were settled on 1 March. Previously, in October 2011, BTr raised PHP110 billion from the sale of 10- and 15-year RTBs.

BSP Relaxes Rules on FX Transactions

BSP amended several foreign exchange (FX) regulations to provide easier access for both resident and non-resident FX users and to encourage investment in the country. The new measures aim to improve the data monitoring of private external debt and simplify procedures for FX transactions. The rule changes will

(i) allow, within a 3-month period (December 2011–February 2012), unregistered private sector foreign loans to be paid using FX purchased from authorized agent banks (AABs) and their subsidiary and/or affiliate FX corporations;
(ii) expand the list of non-trade current account transactions for which FX may be freely purchased from AABs or AAB FX corporations, without prior BSP approval, to include the following: (a) lease of foreign-owned equipment; (b) refund of unused foreign grant or aid funds, and foreign loan proceeds; (c) payment of underwriting expenses, fees, and commissions, including brokers' fees payable or due to non-residents for initial public offerings (IPOs) involving Philippine shares; and (d) settlement by the Philippine Deposit Insurance Corporation of Foreign Currency Deposit Unit (FCDU) claims against banks that have ceased operations;
(iii) allow AABs and AAB FX corporations to sell FX for advance payment of imports regardless of amount and without prior BSP approval, but subject to standard document requirements;
(iv) lift the requirements to (a) inwardly remit dividends, earnings, and divestment proceeds from outward investments funded by FX purchased from AABs or AAB FX corporations; and (b) reinvest these funds within 30 banking days from receipt;
(v) lift the requirement to convert to pesos the FX funding of foreign direct equity investments to qualify for registration with the BSP;
(vi) exempt from BSP approval foreign and FCDU loans that finance infrastructure projects included in the government's list of public–private partnerships (PPP), provided these are subsequently registered with BSP to qualify for servicing using FX to be purchased from AABs or AAB FX corporations, and include microfinance activities in the list of

projects eligible for foreign financing under Section 25 of the Manual of Regulations on Foreign Exchange Transactions;

(vii) lift the 3-day period within which FX purchased for import payments and deposited in FCDU accounts must be remitted to the offshore beneficiary; and

(viii) lift the BSP approval requirement for extensions beyond 1 year of the validity of letters of credit.

On 16 March, BSP further revised the FX rules by (i) raising the ceiling of undocumented importations from US$50,000 to US$500,000, (ii) lifting the requirement for submission of hard copies of daily investment registrations and outward remittance reports, and (iii) revising the list of regulated and prohibited products for export.

BSP Simplifies Reserve Requirement Rules, Cuts Ratios by 3 Percentage Points

Effective 6 April, BSP will adopt a simplified reserve requirement policy. Under the new rules, existing statutory and liquidity reserve requirements will be unified into a single reserve requirement, and BSP will not pay interest to the banks on the unified reserve requirement. Cash-in-vault (for banks) and demand deposits (for non-bank financial institutions with quasi-banking functions) will no longer count toward reserve requirement compliance.

Under existing rules, banks are paid interest rates of 4% on amounts up to 40% of their regular reserves. They are also paid on their liquidity reserves—a rate equivalent to comparable government securities less 50 bps. Upon adoption of the new rules, BSP will lower the reserve requirement ratio by 3 percentage points—to 18%—to offset the impact on banks' intermediation costs. Universal and commercial banks will maintain a reserve ratio of 18% from 21%.

BSP to Implement Basel III Provisions by 2014

In January, BSP announced that it would adopt all provisions of the Basel III Agreement effective 1 January 2014. While the Basel Committee on Banking Supervision allows for the staggered implementation of Basel III provisions up until January 2019, BSP decided to adopt all capital adequacy standards 5 years ahead of this timeline. Further, BSP will impose higher capital ratios than those suggested by the Basel Committee. **Table 4** provides a summary of the minimum capital requirements of Basel III compared with BSP's existing and proposed guidelines.

BSP will be conducting a quantitative study in 2Q12 to identify which banks are most susceptible to potential negative impacts from the implementation of its new guidelines.

Table 4: Capital Requirements under Basel III and BSP Guidelines (%)

Capital Requirements	Basel III		BSP Guidelines		
	Minimum Ratios	With Conservation Buffer	Existing Minimum Ratios	Proposed Minimum Ratios	Proposed Minimum with Conservation Buffer
Common Equity Tier 1 Ratio	4.5	7.0	None	6.0	8.5
Tier 1 Ratio	6.0	8.5	5.0 (6.0 trigger for PCA)	7.5	10.0
Capital Adequacy Ratio	8.0	10.5	10.0	10.0	12.5

PCA = prompt corrective action.
Source: Bangko Sentral ng Pilipinas.