Innovations in Corporate Securities in the Philippines: 1987 - August 1992

By *Bienvenido M. Aragon*

The paper presents innovations in long term corporate securities in the Philippines over the period 1987-August 1992. While innovation may simply have been a response to the difficult market conditions that prevailed in the latter part of that period, they do demonstrate a receptivity to innovate and this augurs well for further development of the market. For investors innovation imply a wider array of choice to improve risk-return profiles of their portfolios. For issuers it opens up new possibilities for generating long term funds and reducing capital cost. However, innovation is not without risk for both investor and issuer. Investors will have to be more sophisticated in evaluating new securities. Issuers are not guaranteed that innovative issues will always succeed.

I. INTRODUCTION

This paper reviews and analyzes innovative features of local corporate securities for the period 1987 to August 1992. This period saw many Philippine firms offer their shares to the public. The number of issues actively traded in the stock exchanges increased significantly and most of these were in the commercial-industrial sector. It was also a period when the business sector and government renewed their efforts to develop the capital market. During the period, the stock market had severe ups and downs but even this may have a role to play in financial innovation.

The study is limited to innovations in long-term capital market securities. Not all of the securities reviewed were issued. However, it is just as important to study them since they still convey current thinking; they may be revived and issued; and it is interesting to know why certain issues didn't take off. Leads on innovations were found mainly from articles in the **Business World** and **Business Day**. This follows the procedure of William Silber in tracking down innovations in the United States. Prospectuses and term sheets were examined to verify and clarify information. Sources of information for each security are presented separately in the references.

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The following section reviews literature on financial innovation in the US. There appears to be no published studies on financial innovation in the Philippines. The main body of the paper follows where innovations are discussed under four categories: Warrants and Options, Equity-linked and Convertible Securities, Floating Rate or Adjustable Rate Securities, and Asset Backed Securities. The final section presents the study's conclusions.

II. REVIEW OF LITERATURE

Financial innovation may involve a new product or a new process. Most financial innovations involve the modification of an existing product or process [10].

There is sufficient agreement on the nature of genuine financial innovation. Van Horne [10] says that an innovation is viable only if it makes markets more efficient and/or more complete. Efficiency here means reducing the cost of financial intermediation while completeness signifies that demand for a particular type of security is satisfied. Merton [5] says innovations improve economic performance in three ways: by meeting investor or issuer demand for new securities; by reducing transactions cost and enhancing liquidity; and by reducing agency costs arising from information asymmetries. Moore [7] distinguishes two effects of financial innovation. The *intermediation effect* increases savings relative to current income and increases the potential rate of growth of capital and income. The *asset transmutation effect* enables diverse asset preferences to be satisfied

and leads to a higher rates of real wealth to current income. Attractiveness of assets result in lower required rates of return and encourages more investment.

Finnerty [3] makes a distinction between innovations that are lasting and those that are temporary. Those that endure respond to fundamental economic demands. These demands are similar to those mentioned by Merton [5]. Temporary innovations arise as a circumvention of regulations and disappear when the regulations change. Miller [6] says that any innovation's contribution to welfare can be subjected to a simple test: Are people willing to pay money for it? He says that by this test the innovations have proven their worth.

Silber [8] disputes the view that innovation is often simply a response to regulation. He proposes a more general hypotheses that innovations arise to lessen the constraints imposed on the firm. External constraints arise from government and the market place but internal constraints may arise from the firm's own goals and policies. He proposes a programming framework where innovation becomes the response to the cost of meeting constraints. A less formal approach simply lists factors that may have stimulated innovation. Silber [8] and Van Horne [10] list almost identical factors.

Silber	*Van Horne*
1. Inflation	1. Volatile inflation rates and interest rates
a. Level of Interest Rates	2. Regulatory changes and circumvention of regulation
b. General Price Level	3. Tax changes
c. Tax Effects	
2. Volatility of Interest Rates	4. Technological advances
3. Technology	5. Level of economic activity
4. Legislative Initiative	6. Academic work on market efficiency and inefficiencies
5. Internationalization	
6. Others	

Finnerty [3] has a longer list but he seems to confuse cause and effect. For example technology and reduced transaction cost are listed as separate factors. But indeed this may be a chicken and egg question.

Van Horne [10] concludes that for product innovations the dominant stimuli are volatile inflation and interest rate while process innovations are caused mainly by technological advances. Silber [8] ranks technology and legislative initiative as the important factors.

Finnerty [2,3] analyses innovation in corporate securities, viz: debt, preferred stock, convertibles and common stock. He lists thirty nine debt innovations, eight preferred stock innovations, ten convertible innovations and seven common stock innovations. For each security, he identifies the innovative or distinguishing feature and its impact on risk reallocation, liquidity, transactions costs and tax, and other benefits. Finally he offers corporate treasurers advice in the form of questions regarding the issuance of innovative securities. He tells them to check whether the new security will benefit the shareholders or simply enrich the investment bankers who designed and sold it. Black and Scholes [1] describe the institutional and regulatory rigidities that impede innovation and McConnell [4] presents a case study of a successful financial innovation.

The issue of financial innovations turns a full circle on the issue of whether the innovations have been excessive. Van Horne [10] comments that in the drive to generate more profits, innovations of little or no economic substance are introduced. One is immediately reminded of Miller's simple test and Van Horne himself raises the question: "Are not the financial markets rational and competitive?" He says that irrationality prevails at times but does not recommend tighter regulation. The market must discipline itself. Miller [6] addresses the issue that reduced trading costs has encouraged too much short term trading and shortened time horizons. He says that trading is the process by which information is collected, aggregated and disseminated. As an example, Miller cites the low cost of trading index futures which makes that market the natural entry point for new information. It is wrong to conclude that trading index futures per se causes volatility. In short, don't mistake the messenger for the message.

Despite the excesses, Van Horne [10] is optimistic that innovations will continue into the future. Deregulation, technology, international events and research will continue to fuel innovation. Writing seven years later, Merton Miller [6] is not as optimistic. He says that the revolutionary innovations in the last 20 years will be replaced by slow, evolutionary change. In his view the cutting edge is not as sharp as it was in the 60s and 70s when economic and finance literature were rich in ideas and concepts that would later bear innovations.

In the Philippines, research on capital market development has tended to focus on the broader aspects of components, structure, size, and developmental and regulatory policy. There appear to be no published studies on financial innovation in general and the specific forms of innovation in particular.

III. INNOVATIONS IN CORPORATE SECURITIES

A. Warrants/Options

Options may be attached to a security as a "sweetener" in a public offering of the security. The more common form is a warrant attached to a security that entitles the holder to purchase shares for so many warrants held at a certain pre-set price. Warrants may be also issued with a rights offering and have been issued separately in other countries.

A warrant represents a call option on an underlying security. A call option gives the holder the right (but not the obligation) to buy the security at a pre-set price. What the option is worth depends on a number of factors. The principal ones are the current price of the underlying security, the volatility of that price, the exercise or strike price, the time to expiration and interest rates. Warrants would be valuable if the price of the underlying security has good upside potential and if the price exceeds the exercise price. The value of warrants also increase with longer expirations and higher interest rates. From the issuer's point of view, warrants may result in a better price or a lower cost for a security issue.

Another form of option that may be embedded in a security is a put option. A put option gives the holder the right (but not the obligation) to sell the security at a pre-set price. In other words it is a "puttable" security. If the put option is attached to a bond, it protects bondholders against a deterioration in the issuer's credit standing. It reduces agency costs because the holder has the right to sell the bonds back if there is a material adverse change in the company's condition. If the put option is attached to common shares, it assures investors that they can sell the shares back at a pre-set price. According to Finnerty [3/], this reduces the information "asymmetry" related to new share issues especially when the issue's success is highly uncertain.

In March 1992, Easy Call announced that it would issue shares with warrants. Twelve million shares will be issued at ₱18 per share and one warrant will be issued for every 5 shares. The warrants entitle the holder to buy a share at ₱18 per share and can be exercised between July 1, 1993 to June 30, 1994. Easy Call warrants were first traded on July 8, 1992 at the Manila Stock Exchange. It was steady at ₱7.00, while the underlying Easy Call stock was also steady at ₱25.00. In other words the warrant was trading at its intrinsic value. The most recent price of Easy Call shares was ₱23.50 on August 21, 1992 and the stock appears to be infrequently traded. The last time the warrants were quoted was on July 14 and the price was still ₱7.00. It is not clear why quotations on the warrants have not appeared since then.

In August 1991, General Milling Corporation announced a possible issue of 40 million stock options attached to 200 million shares to be offered in its ₱1 billion initial public offering (IPO). The options allow the holder to purchase one share for every five shares bought in the IPO at the initial offering price of ₱5 per share. The option can be exercised within 18 months commencing four weeks after the listing date. However, due to adverse market developments the issue was temporarily shelved.

In December 1990, First Philippine Holdings Corporation (FPHC) announced a plan to issue detached warrants, i.e., warrants not attached to a bond or share of stock. FPHC would issue warrants to 14 million shares broken down into 10.1 million B shares and 3.9 million A shares at a price of ₱2 to ₱3 per warrant. The exercise price of the warrant was not stated although at that time FPHC shares were selling for ₱10 each. These warrants were never issued but with FPHC stock recently trading at ₱37 and ₱48 for A and B shares, respectively, they would have been valuable.

In September 1990, Union Glass and Container Corp (UGCC) announced a public offering of shares with a put option. 2.4 million ₱1 par value shares would be sold at an initial subscription price of ₱4 per share plus a sell back charge of ₱0.02 per share for A shares, and ₱4.45 per share plus a sell back charge of ₱0.03 per share for B shares. The put option could be exercised within the first 180 days following the listing of the stock. The commitment to buy back the shares at the offering price was made by Metro Drug, Inc. which had undertaken to purchase 80% of UGCC's outstanding shares. According to an officer of the underwriting firm, it would have been difficult to underwrite the issue without the put option. However, in November 1990, the issue was shelved.

Warrants and put options work differently but in both cases their attractiveness depends on market conditions. In a depressed market, warrants may not be attractive to investors because the prospect of a profitable exercise of the warrant may be highly uncertain. In a depressed market, a put option may be attractive to investors. However, it will be risky for the company writing the puts. It may end up buying back the securities it issues. On the other hand, it can be argued that in a buoyant market, "sweeteners" are unnecessary. The upshot is that the use of attached options is rather tricky. Another difficult aspect is the pricing of options. The sell

back charge on the UGCC put options, for instance, appears to be very attractive because only a very small decline in share price is necessary to cover the sell back charge. The Easy Call warrants traded at a price equal to its intrinsic value (market price less exercise price). In theory the price of an option should be above its intrinsic value.

B. Equity Linked and Convertible Securities

Convertibility is added to enhance a security's marketability and lower the cost of funds. The value of the conversion feature depends on the degree by which share prices are expected to rise. For this reason convertible securities are often issued by companies that can sustain their growth and profitability. There are risks from a "hung convertible", i.e., a convertible issue that is not converted. It conveys a message to investors that the company did not perform as well as expected. Unconverted debt may hamper additional debt financing as debt capacity is not freed up by conversion.

Finnerty [3/] says that another advantage associated with a convertible is risk neutrality. Any increase in the risk of the value of the bond is offset by the increase in the value of the embedded option since option values are positively correlated with volatility. This has to be understood in the context of agency costs and the asset substitution problem. The problem refers to a troubled and levered firm that takes a gamble on a highly risky investment. If the investment succeeds, the payoff to equity holders will be high, given the thin equity they have provided. If the investment fails, equity holders lose little. Creditors may not prevent firms from taking on risks but they could at least partake of the payoff if it succeeds.

Although there have been many convertible security issues in the past, some recent issues are worth noting.

Cebu Equity Bond Units or CEBUs are securities issued by the provincial government of Cebu in early 1991 to raise funds for infrastructure projects. The issue is divided into 300 million units at ₱1.00 per unit. There are several noteworthy features of CEBUs.

a. It is the first local government bond issued in the Philippines. As such the 16% interest the bonds pay is tax free.

b. The other significant feature is that the principal will not be paid in money but in Class A shares of Cebu Property Ventures and Development Corporation (CPVD). CPVD is a joint venture between the Cebu provincial government and Ayala Land Inc. to undertake real estate development projects in Cebu. In June of 1990, the Cebu government transferred three parcels of prime land in Cebu City in exchange for shares in CPVD. It is these shares in CPVD that will repay the principal of the Cebu Equity Bond Units.

Principal payments shall be made in five equal semi-annual amortizations beginning at the end of the second semester from issue date. The formula for determining the number of shares of CPVD is:

$$\text{No. of shares} = \frac{\text{MPA}}{\text{RV} + (\text{AMP} - \text{RV}) \times .50}$$

where MPA = maturing principal amount
RV = reference value of the stock which is set at P1.00
AMP = average market price based on the closing price for the previous 10 trading days preceding D-date (determination date is 15 calendar days before maturity date)
.50 = sharing ratio between the Cebu government and the CEBU holders on the stock's capital appreciation

If the market price of Class A CPVD shares is less than its par value, the formula shall be:

$$\text{No. of shares} = \frac{\text{MPA}}{\text{AMP}}$$

However, it is only good up to a maximum of 1.25 shares pledged per unit.

The pricing formula enables the CEBU holder to buy CPVD shares at less than market price if the latter rise significantly above ₱1.00 and at market price if the shares trade below their par. The attractiveness of CEBUs therefore is closely tied to the performance of CPVD.

In early 1992, CPVD shares were offered and subsequently listed. 50 million A shares and 250 million B shares were offered at ₱1.25 per share. There were three objectives in this initial public offering: to raise funds for the province, to privatize CPVD and to provide market price for the conversion formula of CEBUs. As of August 28, 1992, CPVD shares closed at ₱1.04 and ₱1.10 for A and B shares, respectively.

Strictly speaking CEBU are not convertible in the usual sense that the holder has the choice of whether to convert or not. In the case of CEBU, the conversion into shares is mandatory. Except where the limit of 1.25 shares is exceeded, holders of CEBU get in shares a value equivalent to the maturing principal amounts which is as if they held the bond to maturity and were paid the principal. However, if CPVD A shares fall below ₱0.80 per share in the market, then CEBU holders will sustain losses. CEBUs appear to have the upside potential of convertibles but not the full downside protection of the latter. Of course, in extreme cases of financial distress, there is also no guarantee that the face value of a convertible debt will be repaid.

In April 1990, Engineering Equipment, Inc. was reported to be planning an issue of ₱200 million worth of 10-year subordinated convertible debentures with a coupon rate of 12 3/4%. The notable features of this issue are:

a. It will be issued at a discount of 35%.
b. It is subordinated which means it has a lower ranking vis-a-vis other creditors.
c. It is convertible into common on a par value-per-par value basis starting on the fourth year. On the fourth year, 35% of an investors' bondholdings may be converted on a one-for-one basis regardless of market price, followed by another 35% on the fifth year and the balance on the sixth year.

In October 1990, this offering was shelved by the company because the depressed share price (it was below the par of ₱1 per share.) made the issue "impractical and unacceptable," according to the EEI chairman and CEO. Still it is instructive to analyze its features.

The sizable discount of 35% can be described as a deep discount. In the US, deep discount bonds or junk bonds are often associated with high risk start up companies. Such companies have to raise funds at very high yields but may not have the stable cash flows needed to service regular interest payments. However, deep discount bonds or zero coupon bonds (ZCB) were also issued by companies that were not high risk but simply wanted to exploit tax arbitrage opportunities in the amortization of discounts as a tax deductible expense. ZCB also serves investors' needs in that it avoids the reinvestment risk associated with the interest received[5/].

The deep discount in the EEI bond can be partly explained by the high interest rate levels at that time. Treasury bill rates were in the range of 25-30%, around twice the coupon rate EEI was offering. It may have been difficult for EEI to service a high level of interest payments because it wasn't performing very well. The perceived riskiness of EEI is probably the other reason for the deep discount. In the four-year period 1986-1989, it only posted a profit in 1988. During that period, it was also investigated by the SEC for a significant amount of unreported losses.

Risk may also be the reason why the issue had to be subordinated. Existing creditors of companies that are facing difficulties may insist that any new indebtedness be subordinated to existing debts. Instead of standing on equal footing, subordinated creditors rank behind the senior creditors in the payment of claims. This makes subordinated debt more risky, and apart from the riskiness of the company itself, may also account for the deep discount.

Finally, the bonds are convertible into common on a par value-per-par value basis. This may appear to be generous since conversion prices are often set at a premium above par. However, at that time, EEI shares were trading at ₱0.80 per share and even fell to as low as ₱0.50 per share. Although a conversion feature should be evaluated in terms of future prospects and not in terms of current performance, it was probably very difficult to create positive expectations at that time. As of August 28, 1992, EEI closed at ₱1.30 per share.

In October 1991, Filsyn issued ₱400 million convertible bonds to three local banks and two foreign partners to raise funds for expansion and modernization. The notable feature of the bond is that it is payable only in the form of Filsyn shares, somewhat similar to CEBUs. Bondholders have to convert within the 5-year term on conversion dates set at six-month intervals. The conversion price escalates from ₱5.25 per share on the first conversion date and ₱7.50 per share at maturity. In the meantime that the bonds are not converted, interest of 18% will be paid. Recently, Filsyn applied for a change in the status of these bonds from *exempt* to *registered* to allow the bonds to be sold to the public.

The features are almost similar to CEBUs except that more leeway is given the investor in timing the conversion. The escalation of the conversion price is to induce an early conversion but it also means foregoing the interest income. The pricing formula of CEBUs has more flexibility since it is based on market prices at around the conversion dates. This does not imply that the conversion prices set on the Filsyn bond is bad for the investor. It would depend on the market price in relation to the conversion price. If the market price is higher than the conversion price, the investor benefits. However, because the bonds are required to be converted

into stocks and since the conversion price is pre-set, the bonds would offer even less downside protection than CEBUs.

The attractiveness of a convertible has been attributed to its good upside potential, low downside risk, and a regular income stream. Many small investors who may be keeping their money in savings and time deposits and other fixed income securities may find a convertible attractive. It promises them the fixed return and principal protection while giving them possibilities for capital gains. This may help draw funds away from the banking system and short term securities to the capital market. If there is this unserved market for convertibles, issuers should be able to raise funds at a lower cost using convertibles.

C. Floating Rate or Adjustable Rate Securities

Volatility of interest rates poses risks for investors and borrowers and usually results in a preference for short term financial instruments and underdevelopment of long term issues. Investors do not want to get "locked in" into rates that may quickly shoot up to high levels. Borrowers, on the other hand, fear the opposite. They do not want to borrow at high rates when these may subsequently fall. Floating rate or adjustable rate instruments provide yields that vary with some benchmark interest rate. In this manner the risk from rate volatility is shared among investors and borrowers. Borrowers, and for that matter investors, vary in their ability to absorb interest rate volatility. For example, banks may be in a better position to absorb the risk of floating rates since they may just pass this on to borrowers. On the other hand, property development firms would find it difficult since a period of high interest rates coincides with the period when its business is also slow, making the interest payments more difficult to service.

In April 1989, PLDT issued at ₱750 million worth of Series A floating rate debentures. The interest rate is the higher of 12% or 1.5% per annum over the applicable Base Rate. The Base Rate will be set on the first business day of each quarterly interest period, shall be the weighted (as to the amount of bids accepted by the Central Bank) average of the last two average auction results for 91 day T-Bills during the past two weeks. Investors are assured of earning at least 12% or a 1.5% premium over the 91 day T-Bill rate. This may be enticing enough for investors to commit their funds for a longer term. Although the debentures have a final maturity of six years, it has serial maturities that retire 10%, 20%, 30% and 40% of the issue each year starting at the third year from issue date.

While PLDT may not have an automatic mechanism for passing off higher interest charges, its revenue stream may be sufficiently stable to take on floating rate debt. Furthermore floating rate debt may be the only feasible way of raising funds on a long term basis consistent with its requirements for expansion and service improvements.

A prepayment provision allows PLDT to wholly or partially (minimum of ₱100 million) prepay the debentures with at least 45 days notice. This gives PLDT the option of prepayment if rates rise to prohibitive levels or cheaper financing becomes available.

In July 1992, Planters Development Bank successfully issued 2,000,000 shares of ₱100 par adjustable rate preferred stock (ARPS). These shares were subsequently listed in the stock exchange on August 3. The innovative features of this issue are:

a. Adjustable dividend rate - The regular dividend rate is given by the formula:

$$\text{Regular dividend rate} = \frac{(TB1 + TB2) * 80\%}{2} + 2\%$$

where TB1 = weighted average nominal rate of 91-day T-Bill for the last auction date of the immediately preceding calendar quarter

TB2 = weighted average nominal rate of 91 day T-Bill for the last auction date immediately preceding the auction date of TB1.

In other words, the dividend rate for a quarter shall be 80% of the average of the 91-day T-Bill rates in the last two auctions of the previous quarter plus 2%.

Excluding the effects of taxes, the nominal yield on the PDB ARPS would be lower than yields on Treasury Bills. If 91-day T-Bill rates average 20%, the ARPS divided rate will only be 18%. On an after tax basis, T-Bills will yield less because of the 20% withholding tax while dividends are not subject to tax. On an after tax basis, there will be a 2% yield difference in favor of ARPS. However, there is a provision that allows Plantersbank the option to redeem the shares if

interest rates rise to abnormally high levels as determined by its board of directors. This may dampen investor enthusiasm for the shares.

This redemption feature together with absence of a floor and only a small premium over T-Bill rates may render the issue unattractive. However, this may be offset by another feature: convertibility into common stock.

b. Conversion feature - The preferred shares are convertible into common at the option of the holders. A maximum of 50% of the shares held by each shareholder may be converted on the ninetieth day after the fifth anniversary of filing. The balance can be converted on the ninetieth day after the sixth anniversary of filing. The conversion formula is:

$$\text{Number of Common Shares} = \frac{PS}{(150\% \times ABV)} \times NCSO$$

where PS = Par Value of Convertible Preferred Share
ABV = Aggregate Book Value of All Outstanding Common Shares
NCSO = Number of Common shares Outstanding

Shares that are not converted may be redeemed by Plantersbank at par plus accrued dividends.

As mentioned earlier, banks are in a good position to issue floating rate instruments because they can pass it on by lending at floating rates as well. In addition, Plantersbank appears to be trying to reduce its funding cost by putting a conversion option at the same time placing a cap on dividends by reserving the option to redeem the shares. Conversion features are usually attractive for companies that are rapidly growing. This means that share prices will appreciate significantly over the near term making conversion attractive. The financial performance of Plantersbank may justify such expectations. Between 1987 to 1991, Plantersbank resources and earnings grew at an average annual growth rate of 36.5% and 72.3%, respectively. The 50% premium over book value in the conversion price does not seem unreasonable given that traded bank stocks like PNB and PCIB have even higher premiums. As of August 28, 1992, Plantersbank shares closed at P 100 per share.

There are many other issuers of floating rate long term commercial paper. Among them: San Miguel Corporation, Coca Cola, Interphil, Magnolia, Universal Robina Corp. The rates they offer are aligned to T-Bill rates. But by far the largest issuer of floating rate securities has been the national government. As part of its move to restructure its domestic debt profile into more medium-term and long-term maturities, it began issuing in mid-1991 P 10 billion worth of 3-year floating rate Treasury notes at a yield of 0.75% over the 91-day T-Bill rate.

Though there are other ways to hedge interest rate volatility, it is expected that floating rate securities will continue to be popular for as long as interest rates are volatile.* However, companies will vary in their ability to service floating rate debt and issuers will have to evaluate this carefully. In fact, in the US, there are so-called inverse floaters - the interest rate decreases as interest rate levels rise. This is good for companies whose business and cash flows suffer in a period of high interest rates.

D. Asset Backed Securities

Asset backed securities (ABS) are securities issued against a pool of assets, usually receivables. They represent fractional and undivided ownership in the receivables. The cash flow from the receivables are used to service the ABS. The receivables originate from mortgage loans, promissory notes, trust receipts, lease financing and even credit card receivables. These are booked as assets on the balance sheet of the bank or finance company and are transferred into a special purpose corporation, locally called a Special Purpose Trust. It is this Special Purpose Corporation that will issue the ABS. This process is called asset securitization. Offering assets as security or collateral is nothing new but the obligation was not securitized, i.e., not cut up into small pieces that could be traded.

The benefits of asset securitization are:

a) Interest rate risk and default risk are reallocated from the institution that originate the receivables to investorswho purchase the ABS. However, the risks investors bear is reduced because of risk diversification that results from pooling. As a result investors

*One way of hedging interest rate risk is through the use of interest rate futures. Interest rate futures contracts based on the 91 day Treasury Bill rate were introduced in the Manila International Futures Exchange in late 1990. It appears that the trading volume and open interest on this contract has not grown significantly.

demand lower yields on the ABS compared to yields on the individual receivables. In the US, asset backed debt is much cheaper than notes or bonds because they are rated highly by credit rating agencies 3/.

b) Liquidity is enhanced because the originators of the receivables can securitize and sell the receivables. Investors likewise can sell the ABS. Liquidity tends to lower required yields 3/.

c) The balance sheet of the originating bank or finance company is strengthened. The transfer of the receivables to the special purpose corporation and the resulting cash inflow can be used to reduce debts. Asset securitization is a way of shrinking and strengthening balance sheets.

A number of banks and finance companies have expressed their interest in issuing ABS and the SEC has issued the rules and regulations covering ABS. Among those that have expressed interest are Citibank, Urban Bank, All Asia Capital, BPI and the Home Insurance and Guaranty Corporation. Selling participation in a pool of receivables is not really new in the Philippines but the securities issued were not transferable and therefore not liquid. The ABS is designed to overcome this problem.

In July 1992, Citibank issued ₱354 million worth of ABS, the first time this type of security was issued in the Philippines. The asset backing in this case was provided by mortgage receivables. The securities carried an interest rate of 1.5% over the average yield of 91-day Treasury Bills. The bank announced that it plans to sell as much as ₱3.0 billion worth of receivables-backed securities over the next two years and would expand the asset backing with receivables from its credit operations.

Banks, in general, have resorted to asset securitization in order to liquefy their assets and strengthen their balance sheets. As they come under pressure to meet more stringent capital adequacy ratios (e.g., risk assets to net worth), they have to shrink their assets and one way is thru securitization. They have also come to realize that they can earn more even without enlarging their asset base. In fact, securitization enables them to earn even as they shrink.

Another example of ABS in the Philippines are Asset Participation Certificates (APC) that were issued by the rehabilitation receiver of the troubled property development company, BF Homes. The aggregate issue of APC would amount to ₱600 million divided into 120,000 units at ₱5,000 per unit. However, this amount is subdivided into smaller pools relating to specific properties under development. An example is the Garden Homes Pool based on long-term receivables from the sale of 523 Garden Homes residential units in Parañaque and Las Piñas.

The Garden Homes Pool Participation has a total face value of ₱155 million divided into 31,000 units of ₱5,000 each. It represents an investment in a pool of interest-bearing long-term receivables with a maximum term of 15 years, an interest rate of 18-21%, and amortized monthly by the buyers of the individual units. The notable features are:

a) 12% interest per year payable quarterly plus a 4% p.a. earnings increment beginning on the second year and also payable quarterly. Interest earnings of up to 8.5% may be tax exempt for certain qualified investors.

b) Maturity is five years from date of issue but may be called by the Trustee before maturity date.

c) The receivables in the pool are enrolled for credit insurance with Home Insurance and Guaranty Corporation. In the opinion of the Government Corporate Counsel, this is a virtual guaranty by the Republic of the Philippines.

d) The participations are fully and freely transferable by means of assignment.

APCs had to be used in the rehabilitation of BF Homes because the usual approaches in rehabilitation, i.e., equity infusion or debt-equity conversion, did not give the appropriate relief. The owners of BF Homes did not have the funds for an equity infusion. Banco Filipino was ordered closed by the Central Bank, shutting off a source of funding for BF Homes. A debt-equity conversion would only provide relief from debt service but not new funds to carry out the projects. It would be difficult for a company under rehabilitation to raise funds thru a debt or equity issue because of perceived riskiness. Selling APCs in effect substituted the credit risk of numerous residential unit buyers for the credit risk of a company in rehabilitation.

This clearly demonstrates the benefits of risk diversification from pooling. It is not likely that all residential unit buyers will default on their amortization payments. This, together with the HIGC guarantee, reduces risk, lowers the cost of funding, and makes the project viable.

In the preceding examples, asset backing was in the form of receivables. In November 1990, the Asset Privatization Trust announced a possible issue of real estate backed APT Certificates (APTC). The APTCs will have an aggregate value of ₱2 billion divided into units of ₱10,000 each. The

proceeds will be used for the Philippine Leisure Estate project - a leisure and residential community complex. Holders of APTCs are entitled to capital gains but are not deemed owners of the land. Similarly, in August 1991, a little known company Millenuim Industrial Commercial Corporation announced its intention to float ₱2.4 billion of asset participation certificates. The asset pool backing up the issue is a large parcel of raw land situated in Mactan Island. The certificates entitle the holders to an undivided, pro rata, beneficial interest in the pool, its profits and final liquidation. Face value and earnings up to 8.5% are insured by HIGC. The certificates would have a 3-year maturity.

While these two securities were apparently not issued, some of its features are still worth noting. First, both are backed by undeveloped land. Second, the returns come in the form of profits or capital gains rather than fixed income. Third, there is some form of guarantee besides the asset backing. However, it seems doubtful whether this type of asset backing produces as much diversification as a pool of receivables. Moreover, the pool of receivables provide for a fairly predictable cash flow which is not present in property development projects. This is probably the reason why fixed returns are not promised. ABS may not be an appropriate funding mechanism for property development.

However, at the present time, there does not seem to be active secondary trading in ABS. Liquidity must be provided by repurchase agreements but the liquidity enhancing feature of ABS is not maximized in this manner. This may limit the growth of ABS.

IV. CONCLUDING REMARKS

Some tentative conclusions that can be drawn from this review of recent innovations in corporate securities are:

1. There have been significant innovations in corporate securities in the Philippines in the past 5 1/2 years. While these are still few in number and certain issues did not push through, it still demonstrates that issuers, investors, intermediaries and regulators are receptive to innovation. This will increase the array of securities available to issuers and possibly reduce the cost of capital. For investors, it may imply better risk-return trade offs and pay-off patterns and enhanced liquidity. This will contribute to the development of the capital market.
2. Most of the innovations appeared in the latter part of the period analyzed, i.e., 1990-1992. A number of companies offered their shares in 1987-1988, a period of strong economic recovery and generally buoyant stock market. Most of the offerings in this period were "plain vanilla" common stock. It could be that the innovations were simply waiting for their time to come as part of evolution of the market. More likely, however, the innovations were the result of difficult market conditions which made it hard to sell securities without "sweeteners" or enhancements.
3. Innovations may help make securities marketable but in a depressed market even innovative securities may be difficult to sell. This may explain why several issues did not take off. In other words,timing and market conditions are still important. It is not enough that a security offer innovation, it must offer value or at least a potential value. Convertibles and options are attractive only in an environment that holds out prospects for price gains. Asset backed securities are attractive only if there is real diversification of risk.
4. Investors will have to be more sophisticated in appreciating the risk-return trade-off involved with a particular security. This may not be a problem for institutional investors but may lead to individual investors being dazzled by high returns without mind to the riskiness of the investment. While the futures market is not part of this study, this seems to be happening to some investors who have traded in futures contracts. Apart from the alleged malpractices and irregularities in futures trading, unless one is hedging a pre-existing risk, futures trading is a highly speculative, highly levered, high risk game. The sad thing about this is the market may become discredited and fail to develop when it can, in the proper hands, perform a vital function. ■

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