Reaction Paper on Aragon's "Innovations in Corporate Securities in the Philippines: 1987 - August 1992"

By *Norberto C. Nazareno*

As Associate Professor Bienvenido M. Aragon pointed out, there have been no published studies on financial innovation in the Philippines. His paper thus serves as a good introduction to this topic. It should sensitize capital market participants, specially individuals and institutional investors to the realization that financial instruments can be innovated. It should also give our colleagues in the financial field a good overview of what other well known professors of finance have written on the matter, and a good summary of some innovative products launched in the Philippine financial market in the past five years.

My reactions focus on the following:

a) The study's general approach to the topic;
b) The author's review of various literature on the subject;
c) The review of features of selected innovative products; and
d) The study's conclusions.

ARAGON'S APPROACH

Aragon limited his study to innovations in long term capital market securities, developing and reviewing four categories: 1) Warrants and Options, 2) Equity-linked and Convertible Securities, 3) Floating Rate or Adjustable Rate Securities, and 4) Asset Backed Securities.

While Aragon had to put order into his paper by developing his discussions around the above four categories, innovations in corporate securities should really have no bounds. I would best capsulize this topic by just showing a balance sheet and saying: "There, you can innovate in both sides of the balance sheet. And, it all depends on what you need. Necessity is the mother of financial innovation".

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I start off with this reaction primarily because a creative financial mind should not be stifled by four categories. I have been involved in a number of financial innovations and I would be one of those who would highly encourage financial creativity and innovation since the maturity of our capital market is determined by the kinds of products available to investors. My approach will be different. I will simply give the financial mind a block of raw marble and ask him to chisel and free up the angel entombed within the marble. So, I will give him the balance sheet and let him see where and how he can innovate. If there is a need for a more distinctive classification to emphasize the product of innovation, I would call innovative products on the left side of the balance sheet "Asset Securitization" and innovative products on the right side of the balance sheet "Equity Derivatives". This is the raw marble I will give the financial mind to work on - to chisel out the angel that can satisfy his needs.

DISCUSSION ON VARIOUS LITERATURE

One of the points cited by Aragon is the observation that financial innovation should not occur in isolation. It is best however, that this point be stated more categorically and emphatically. I earlier referred to the angel entombed within a block of raw marble. A financial mind needs to be as creative and imaginative as a sculptor. However, unlike the sculptor who would perhaps not care as to who would appreciate the work created within his poetic license, the financial mind should be more pragmatic in addressing specific needs of specific market segments. Thus the term "financial engineering." The sculptor's angel may eventually remain only a monument for people to stare at and admire. On the other hand, the innovated financial product must be demanded and "consumed" by the market to serve

the purpose for which it was created. This is perhaps why Aragon referred to excesses in innovation, when products are developed not for public consumption and with "little or no economic substance." I will term this as "narcissistic innovation" which I would not encourage.

Financial products are more sensitive compared to consumer products because in the former, we may still need to create demand to succeed. In both cases, however, it is basic to first know the needs of the market. We take more risks in creating something in isolation. Innovation is costly in terms of executive time and professional fees. One financial innovation I was involved in took a lot of man hours from a team of 10 executives. It took nine months for the team to complete the task, albeit not on a full-time basis. And we spent more than ₱200,000 in professional fees to external lawyers and auditors.

The investor is "King." We should try to understand what he wants. Aragon did not stress this. Perhaps it is because we have taken the investors for granted, or perhaps we already generally know what they want, i.e., high return at no risks, with the chance to get out at anytime. There may be other attractions to appeal to the investors' ego. But otherwise, it is as simple as 1) returns, 2) risks, and 3) liquidity. In the end, the investors are the ones who spell the success or failure of an innovative financial product.

Finally, it should be good to mention that specially in the Philippines, innovations are seldom created by investors. This is also implied in the literature Aragon cited. Innovations are created by issuers or by financial intermediaries. Innovations do not emanate from investors because they do not have the resources to do so. They are happy just to select from the smorgasbord of financial instruments available in the market.

FEATURES OF INNOVATIVE PRODUCTS

Aragon discussed four product categories: Warrants/ Options, Equity-linked and Convertible Securities, Floating Rate or Adjustable Rate Securities, and Asset Backed Securities. In addition to describing the features of the various products, he would every now and then discuss the strengths and weaknesses of each category, from the point of view of investors and issuers.

On Warrants

Warrants are synonymous to Options. And, Options can either be a "Call" or a "Put". They can be written by anybody and not necessarily the original issuers of the securities. Nor should they be issued only during the Initial Public Offerings (IPOs). Furthermore, they can be issued for a single security as well as for a basket of securities.

Portfolio managers can enhance their assets by writing options while awaiting the proper time for selected shares to reach certain strike prices. The fees that the option writers receive (the writers are the ones that earn the fees) are earning enhancements themselves as they are not refundable. On one hand, they allow buyers of "call" options to take positions on shares without investing the full value of the shares. The flip side is that they allow buyers of "put" options to sell to them at a given strike price irrespective of market conditions. The price of options is normally a fraction of current or anticipated future price. Investors who are bullish in the market will tend to buy "call" options. Investors who are bearish in the market will tend to buy "put" options.

Issuers or investors of warrants or options are those that anticipate the future with the hope that positions now taken, whether in "puts" or "calls", will end up to their financial benefit. Only those who invest in the future will in fact consider this innovative product called warrants or options as "sweeteners".

On Equity-linked and Convertible Securities

Convertibles have a certain attraction to investors, specially those who require regular income streams (from the coupon) and would hope for an incremental bonanza (from capital appreciation) in the performance of the share price in the market. On the other hand, convertibles are not attractive to issuers as the coupon paid are not tax deductible and the exercise of conversion has a diluting effect. A happy compromise for corporate issuers to attract stable funds needed for balance sheet and cash flow management is to price the coupon at lower than the market price with positive indication that the future price of the underlying shares will compensate for or outperform the conversion price.

On Floating Rate or Adjustable Rate Securities, Aragon says:

> *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 . . . 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.

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."

Contrary to the impression given above, the rate risks might be solved for the investors but not for the issuer when the market is volatile. The issuers are just able to solve their liquidity risks by being assured of availability of funds. But, they have to pay the investors the prevailing market price.

In some developed financial markets, the two product categories are combined into one product: floating rate concept with equity linked securities (notes). The Equity-linked Notes provide an acceptable fixed coupon and a share of the upswing in the share price of the issuer in the market based on a given formula.

On Asset Backed Securities

I think a more accurate term for this product is not Asset Based Securities (ABS), but rather Cash Flow Based Securities. While there are assets behind the product, what are being sold directly to investors are the cash flow behind the assets. The ABS are rated on the consistency and quality of the cash flow. A tripe "A" rated ABS will command a better price for the issuer than a "B" rated ABS.

BEYOND THE DESCRIBED FEATURES

Beyond the descriptions of the features of each product category and the analyses of the strengths and weaknesses for both the investors and issuers, I would add that the fundamental desires of both the investors and issuers are really at odds with each other. The ideal objectives of issuers are: to use stable non-interest bearing funds which are willing to take risks *pari passu* with existing shareholders without dilution of ownership. On the other hand, the ideal objectives of investors are: to get the highest return on their available funds without taking risks while retaining the flexibility to get back their funds almost at will.

The challenge is for the financial mind to strike a happy balance and to innovate. Funds are not unlimited. Acceptable and attractive issues are likewise few and selective. As in the case of initial public offerings of equity issues, the normal strong temptation is for issuers to get the highest price/earning (P/E) multiple in pricing their issues. They want to sell at the price the market can bear. On the other hand, investors are just waiting for "bargains" - for issues which are priced at less than market or industry P/E. The happy balance is to allow investors to hold on to newly issued shares that will see capital appreciation as the price approaches its full value in the market, and to allow issuers to use much cheaper and more stable funds to support their productive endeavors.

Also, Aragon very aptly discussed that innovation can be a response to new and more efficient technology, or to create flexibility, or to reduce friction costs brought about by regulatory constraints. As the product matures and the market becomes sophisticated and competitive, margins become thinner. Competition rises to the level of efficient delivery. Then, there is a need to reduce friction costs in delivering the financial product. This includes efficient tax management within the limits allowed by law.

Lastly, it might be good to know the tools financial minds need to innovate. They must have a working knowledge of the Revised Securities Act, BIR rules, regulations, pertinent taxes, and underlying accounting entries for both the issuers and the investors. The balance sheet impact of any financial product is very important. It is difficult for one person to have a command of all these disciplines. It is more convenient to create a team composed of a tax expert, an accountant, and a lawyer. In the end, the innovated product is translated into legal documents that embody the product itself.

ADDENDUM TO ARAGON'S CONCLUSIONS

Aragon's paper has four simple conclusions:

a) The past 5 1/2 years were receptive to innovation which will contribute to the development of the capital market.
b) Innovations were most likely the result of difficult market conditions requiring "sweeteners" to sell securities during the period. And, innovations are part of market evolution which suggests a slower process.
c) In depressed market, even innovative securities may be hard to sell.
d) The market needs to mature for investors to accept innovative products. Unfortunate experience of the market on some innovative products is a set back to innovation which can perform a vital function in capital market development.

I would like to supplement Aragon's conclusion; viz

a) Financial innovation is dynamic, bounded solely by the creativity of the financial mind who is challenged to balance the desires of the investors and the issuers.
b) The number and complexity of innovative securities are barometers of the maturity of the financial market.
c) While innovation is an initiative of the issuers, the success or failure of innovative securities is determined by the market of investors. The challenge, therefore, is for innovation to be as simple as possible: for investors to immediately understand, appreciate, evaluate and buy the financial product.

Innovation inherently means moving out from that which is ordinary. This means moving out from traditional centers of finance, namely, the banks. We will see that most innovations will tend to make issuers directly access the market of investors.

Without innovation, our financial market will stagnate. There is always the desire as we move ahead to continue to reduce cost, increase yield, lessen risks, and improve liquidity. The challenge to the financial mind, as it chisels on the raw marble, is not only to balance the opposing needs of the issuers and the investors but equally important, to innovate within allowable rules and regulations, accounting standards and tax laws.

There may be no need to start from scratch nor to reinvent the wheel. Many innovative products have matured in developed financial markets. The first task may be as easy as adaptation within local rules and regulations. But patience still is needed. It took more than one year to launch Asset Backed Securities, a very mature product in the US. For one, new rules and regulations had to be written by domestic regulatory agencies.

I am a proponent of innovative products so that we can give the investors a better smorgasborg of securities to choose from. It is both fun and challenging. But one needs to be patient, always probing with an open mind, no matter how ridiculous an initial idea may sound.

Let the financial minds be challenged to innovate and develop our capital market. ■