Chapter 26

Asia
The Philippines

An innovative insurance program is critical in starting a local government bond market.

John Petersen

Lessons

In the Philippines the Local Government Code of 1991 ushered in a new framework for intergovernmental relations, extending more responsibilities and decisionmaking power to local governments. It established a system of transfers that has been stable and predictable and that contributes a large share of local budgets. The law also opened prospects for local government financing from private sources, with relatively few restrictions. Despite growing capital spending needs, however, substantial barriers remain. Perhaps most important is the restriction of depository banking to government-owned banks, which has effectively limited local governments to two such banks for their credit needs.

Nevertheless, efforts have been made to expand access to private financing. The desire of the private banking system to enter the local government credit market, coupled with earlier

efforts by the Department of Finance, contributed to the formation of a small but energetic municipal bond market toward the end of the 1990s. This development was largely made possible by the creation of a specialized bond insurer, the Local Government Unit Guarantee Corporation, with joint public and private ownership. The corporation, which insures investors for a fee, has instituted proprietary credit ratings used to determine eligible credits and set insurance fees.

Despite early successes, continued growth in the Philippine municipal bond market will remain difficult as long as the government banks retain their dominant depository and lending relationships with local governments. The vision formed by the Philippine government in the mid-1990s foresaw the government financial institutions limiting their lending to short-term financing and small projects that did not qualify for municipal bonds. However, these banks have found local government loans, backed by the assignment of transfer payments, very profitable and are not anxious to have the local government market made competitive.

Another impediment is the availability of concessionary loans through the Municipal Development Fund or through concessionary loan programs routed through government-owned banks. These loans create a risk for private lenders, which might develop local government projects only to see them picked off by government financial institutions able to lend on concessionary terms.

The municipal securities market in the Philippines, fueled by the innovative insurance provided by the Local Government Unit Guarantee Corporation, will remain an "infant industry" for some time, needing active steps to make private underwriting of bonds competitive. The Local Government Unit Guarantee Corporation has provided a focal point for increasing the competition for such lending and for building the foundations of a market. At the very least the competitive advantages bestowed on government lenders should be reduced, as should the tax advantages given to investments routed through banks.

During the 1980s the Philippines underwent turbulent political change that led to a powerful movement toward greater democracy, a more open economy, and political devolution. Beset with economic difficulties and heir to a large government sector, persistent trade deficits, and heavy international debt from the despotic Marcos years, the reform-minded nation steered a course toward political decentralization, trade liberalization, and debt repayment.

The keystone of the political reform was the passage of the Local Government Code of 1991, which shifted resources and responsibilities to local governments. Implementing the new code has been a challenge, as the legacy of central government primacy and involvement in local affairs has continued and the national government's deficits have persisted.

A largely peaceful popular revolt occurred in 2000, in response to the corruption of the Estrada regime and poor economic performance, bringing a change in national leadership. Overall, the country has made steady if slow progress, and it suffered less from the East Asian crisis than did its neighbors. However, it continues to be dogged by a sluggish economy and difficult political situation.

Structure and Finances of Local Governments

The Philippines is a unitary state with a hierarchical system in which local governments are directly under the control of the national government, though with certain constitutional protections. The local sector consists of three levels: the provinces and major cities, the municipalities, and the *barangays* (essentially neighborhood organizations). The country has more than 1,600 local governments (in addition to the 42,000 barangays), including 78 provinces, 82 cities, and 1,525 municipalities.

The Local Government Code of 1991 assigned greater responsibilities for service provision to local governments and also entitled them, under the internal revenue allotment (IRA) scheme, to receive 40 percent of the state's income and value added tax revenues, which are distributed on the basis of a formula. The code also gave local governments expanded powers for setting local tax rates and collecting own-source revenues. The mainstays of local revenues are the property tax, the business tax, and taxes on vehicles.

The program of formula-based revenue sharing led to local governments largely substituting the new revenues from the central government for own-source revenues, especially the local property tax. In 1990–96 local

own-source revenues declined from 50 percent of total local revenue to 30 percent, while local governments' share of total government spending grew from 6 percent to 16 percent. (With spending at 3 percent of GDP, the size of the local sector remains modest.) The aggregate revenue numbers mask big differences among the local jurisdictions. Cities derive about 50 percent of their revenues from own sources, compared with only about 30 percent for provinces.

One motivation for the new intergovernmental structure was to get local governments to assume a greater share of the burden of financing infrastructure. It was thought that this might be accomplished by permitting local governments broad powers to borrow without the approval of the national government. To that end the Philippine Department of Finance, with considerable donor support, led the way on initiatives to expand local governments' access to credit, following a policy articulated in 1996 (Llanto and others 1998).

The Power to Borrow

Although the Local Government Code provides substantial borrowing powers to local governments, there are some restrictions. Section 324 imposes a limit on local governments' borrowing capacity, stipulating that their appropriations for debt service should not exceed 20 percent of their regular income. In addition, a local government must budget for all contracted-for debt service; otherwise its budget is considered void, and it cannot lawfully spend funds.

Regulation of bond issuance is indirectly implied by section 296 of the Local Government Code, which subjects such debt to regulation by the Securities and Exchange Commission and the Central Bank. Until recently these regulatory provisions were not energetically exercised, however. The Securities and Exchange Commission has held that local government bond issues were exempt from its registration procedures, but in late 2000 the Department of Finance requested the commission to "delegate" its approval powers to the department for purposes of developing a registration procedure.

In addition, the Central Bank Act (Act 7653) requires that, as a condition of borrowing, the monetary board render an opinion on the impact of the borrowing on monetary aggregates, the price level, and the balance of payments. For a sovereign guarantee there is a more rigorous test and approval is required from the secretary of finance. No local government has borrowed with such a guarantee, nor has any borrowed in foreign currency.

Lending to Local Governments

The Local Government Code of 1991 appeared to open several avenues for local governments to access credit finance from bank credits and "other similar forms of credits" and also from bonds and "other securities." Local governments can use credit financing for two purposes—liquidity and capital projects. Meeting liquidity needs involves credit financing of a local government's current spending in advance of expected releases of intergovernmental (primarily IRA) payments or the receipt of taxes. Borrowing by local governments has been modest, accounting for only 3 to 5 percent of their receipts.

A review of access to credit by local governments should start with lending activity by the government financial institutions, by far the most important source of loan funds. Local governments naturally made initial credit requests to government financial institutions, since these hold their cash accounts. As these financial institutions regained confidence in local governments, they began to finance their capital projects. Today the main sources of non-donor-based credit financing are two government financial institutions, the Landbank of the Philippines and the Development Bank of the Philippines, and two specialized on-lending institutions, the Local Water Utilities Administration and the Municipal Development Fund. The Local Water Utilities Administration channels development assistance to local water supply projects and has offered long loan terms that match those of the underlying development assistance loans.

In the early years after the Local Government Code was implemented, the Philippine National Bank and the Landbank were the largest providers of credit to local governments. In 1995 the Philippine National Bank held about 5.9 billion pesos (P) in loans to local governments, the Landbank about P 4.7 billion, and the Development Bank about P 0.2 billion (Llanto 1996). The Municipal Development Fund had P 1.8 billion in loans, and the Local Water Utilities Administration about P 8 billion in water sector loans.

The government financial institutions, reopening their lending windows to local governments after the defaults of the 1980s, focused on those with higher incomes, as shown by the large average loan size in their local government loan portfolios. Interest rates on these loans were about the same as those on their prime commercial loans, suggesting that they assign a low risk premium to local governments. The average tenors were longer than those for commercial loans, at about two to four years.

After 1995 the growth of lending accelerated for the Landbank and the Development Bank, in part because of the rapid withdrawal of the Philip-

pine National Bank from the local government credit market following the bank's privatization. By the end of 2000 these three financial institutions had total outstanding loans to local governments of around P 16.5 billion (table 26.1).[1] The Landbank has been the most aggressive in lending to local governments and securing deposits from them. It had more than P 22 billion in approved loans to local governments at the end of April 2000, of which about P 10 billion had not been availed. The Development Bank and the Philippine National Bank are also actively soliciting local government business, although their loans to local governments are smaller and growing less rapidly.

The Landbank has the largest share of local government loans in its loan portfolio, at 9.6 percent in mid-2000. This share is smaller for the Development Bank and the Philippine National Bank. However, since default rates on local government loans are extremely low, and since large shares of the commercial loans held by the government financial institutions are nonperforming, local governments account for a much larger share of performing loans.[2]

The loans by the government financial institutions to local governments are equal to about 40 percent of their deposits with these banks, although the share varies. Thus at first glance it appears that the banks value local governments more for their depository relationship than for the ability to earn returns on lending to them.

The government financial institutions use the depository relationship and government reporting to create credit and investment instruments. They base credits for capital projects on the IRA and revenue flows of the local government rather than on the revenue flows of the project. They make available short-term credit facilities tied to future budget releases that allow local governments to draw funds in advance of revenues. And, moreover, they enable local governments to arbitrage on interest rates and on financial reporting by, for example, granting loans secured on their deposits, allowing the local governments to earn spreads on their investments and still report high deposit balances. These practices help the government financial institutions manage the risk of lending to local governments, while enabling the local governments to venture into commercial borrowing and financing of capital projects.

For the Local Water Utilities Administration, ongoing structural problems prevented it from expanding its participation in financing local water supply projects. Lending by the Municipal Development Fund also grew slowly, reaching P 2.7 billion in 1999. Among other possible sources, the

Table 26.1. Local Government Loans and Deposits with Selected Financial Institutions, Philippines, 2000

Financial institution	Local government loans outstanding, December 2000 (billions of pesos)	Local government loans as a share of total loans, June 2000 (percent)	Local government deposits, late 2000 (billions of pesos)
Landbank of the Philippines	11.9	9.6	28
Philippine National Bank	3.0	2.8	8
Development Bank of the Philippines	1.6	4.3	7
Total	16.5	—	43

— Not available.
Source: ARD, Government Finance Group 2001, pp. 56–57.

government pension funds, which had shown early interest, were content to invest in high-yield government obligations and made heavy commitments to the commercial property sector and equity investments. These factors impeded their participation in the growing local government credit market.

Private commercial banks carry out almost no direct lending to local governments. A regulation restricting local governments' depository accounts to government financial institutions as well as other impediments have precluded their access to private banks. (However, private banks are the main purchasers of the municipal securities that have been issued.) Thus policy and institutional factors have led to a de facto duopoly by the Landbank and the Development Bank in local government deposits and credits.

Like many emerging markets, the Philippine bond market is dominated by the central government and its need to finance its deficit. There are also a few corporate bonds. There is an active treasury bill market in which short-term bills are sold competitively at maturities ranging from 31 days to one year. Small-denomination bonds to attract individual savers were introduced in 1999. The treasury bill rates serve as the benchmarks for loans, which are typically sold in a variable rate format with 182-day adjustments.

The growing institutional investor base is led by government-owned contractual savings institutions. The Social Security System and the Government Service Insurance System had combined assets of about P 290 billion at the end of 1999. Prudential requirements and the high rates on treasury bills have precluded much diversification away from government securities, although the funds have recently invested in equities and real estate.

The Philippine banking system at first appeared to come through the East Asian financial crisis of the late 1990s relatively unscathed. However, the slow growth of the economy, recurring fiscal problems, and political instability have taken their toll on the condition of banks. Several factors contributed to Philippine banks' early resistance to the Asian downturn: the banks' generally prudent lending policies (especially with respect to real estate), high reserve requirements, good accounting and transparency practices, high profitability, and a penchant for holding large amounts of government debt rather than direct loans.[3] Nonetheless, commercial loan payment difficulties emerged as the economy continued to lag in the early 2000s. While the overall ratio of non-performing loans has not exceeded 20 percent, many loans had to be restructured by mid-2000. Meanwhile, banks have been kept busy financing the large and continuing deficit of the national government.

One result of the economic slowdown at the end of the 1990s was that it made the local government loans held by the government financial institutions look better and better. With their nearly flawless repayment record during the 1990s, as is discussed below, these loans have come to be recognized as a lucrative form of lending for the government financial institutions and have taken precedence over much riskier private sector loans. Banks can lend to local governments at 2 to 6 points above the treasury bill rate (the same as commercial loan rates) and typically pay savers rates that are 3 points or more below that rate. Thus banks enjoy a huge interest spread, one that an effective capital market should be able to shave through disintermediation.

Early Development of a Municipal Bond Market

Municipal bonds have a history in the Philippines. Sections of the Local Government Code of 1991 replaced the Marcos Executive Order 725 of 1975 that had permitted local governments to issue tax-exempt municipal bonds. These sections of the code authorize local governments to issue taxable, revenue-based municipal bonds subject to any applicable rules issued by the Securities and Exchange Commission and the Central Bank. Such bonds are specifically the obligation of the local government, not of the national government. Local governments must use bonds for self-liquidating, revenue-generating purposes (section 299). However, they may create debt and use other credit facilities for any "infrastructure and other socio-economic development purpose" as long as it accords with the local devel-

opment plan (section 296). Local governments were also granted considerable latitude to enter into public-private arrangements.

Municipal bonds were expected to become a major source of infrastructure capital, substituting economically responsive local decisionmaking and rate setting for central government provision of capital funds. Adoption of the new law on revenue-based municipal bonds was followed by an extensive orientation effort to inform officials of local governments, private commercial banks, the investment houses, the Securities and Exchange Commission, the Central Bank, the Department of Finance, the Central Office of Audit, and other national entities about the opportunities and requirements associated with developing and issuing municipal bonds. The Securities and Exchange Commission and Central Bank formulated rules to facilitate rapid review and clearance of proposed revenue-based municipal bonds.

Despite heavy promotion, in the ensuing years of the mid-1990s only five small municipal bond issues took place. These were very small (P 8 to 26 million) and of short maturity (two to three years) (Petersen 1998). Four of the issues, as government-guaranteed bonds sold for housing projects, were partially tax-exempt, and only one issue was unenhanced and fully taxable.[4] Early interest shown by the investment houses in municipal bonds after the passage of the Local Government Code of 1991 faded away.

A variety of institutional and economic factors led to the lethargy in starting up the municipal bond market. Four "environmental" impediments had a particularly important effect in abating private market interest in municipal bonds:

- *The greater appeal of private sector financings for finance professionals in the Philippines.* The equity markets and private banking, both domestically and abroad, attracted the top Filipino talents.
- *Ignorance and caution.* Both sides of the credit market were faced with the new phenomenon of local governments raising money in securities markets that were inexperienced in lending to them. Potential lenders and investors continue to have grave doubts about local political units' fiscal discipline and willingness to pay.[5] Local governments were used to obtaining grants or concessionary loans from Manila and generally are unskilled in planning for and raising capital funds on their own.
- *The small number (and small scale) of viable projects and the rigors and costs of bond issues.* Marketing bond issues involved large costs that neither the public nor the private sector could profitably absorb.

Good revenue-producing projects were few in number and, once they surfaced, subject to being "poached" by government lending institutions on concessionary terms.

- *Oligopolistic behavior by the government financial institutions.* With origins in a centralized and nationalized banking system that met all the banking needs of local governments, the government financial institutions dominate the provision of credit and other banking services to local governments, which are familiar and valuable clients.

Creditworthiness of Local Governments

Despite these impediments, the local government credit market has continued to tantalize many private bankers because, as a group, local governments appear to be a very good credit risk. Creditors' experience with local governments over the past decade has been excellent. Local government debt has been secure and profitable, and creditors have had relatively few problems in achieving high rates of timely payment on loans. Of course, this experience is almost exclusively that of government-owned institutions, which alone have the ability to hold local governments' deposits. The Landbank reported that only 0.18 percent of its outstanding local government loans were past due at the end of 2000. The Development Bank reported no past-due local government loans at the end of November 2000. The Philippine National Bank indicated that its portfolio had a couple of "defaults" but virtually "no losses," although some earlier loans had been restructured. The Municipal Development Fund claimed a similarly good repayment record, reporting defaults of less than 1 percent in the late 1990s (see World Bank 1999b).[6]

This strong debt repayment performance by local governments is the result of a mix of factors. Many local governments are prudent about going into debt and do not overextend themselves. Others have limited capital needs and prefer to use IRA payments or grants to fund these needs, usually restricted to small projects. The relative prosperity and political stability of the 1990s also helped. The most important factor may have been the conditions enforced by the government financial institutions: rapid payback periods on loans, a conservative lending stance (for a period in the 1980s the government financial institutions did not lend to local governments), and the strong security provided by the ability of government financial institutions to intercept the IRA payments.

These repayment records, though established exclusively with government financial institutions, provide evidence that at current levels of bor-

rowing and pledges of security, there is little reason to characterize local governments as weak or undependable credits. However, current levels of local government debt are low by international standards and the security pledged has always been general obligation, with a heavy reliance on IRA payments. Thus it is unlikely that the strong repayment records reflect financial management acumen on the part of the borrowers.

Role of Private Banks

Private commercial banks in the Philippines, though they would very much like to make loans, have been cautious (if not skeptical) about the possibilities of revenue-based municipal bond financing. They view local government lending as an unknown commodity, and without an explicit ability to hold local government deposits or intercept central government payments, they consider local governments to be high risk. Moreover, local governments offer poor income prospects compared with the nonrisk returns of 10 to 15 percent on treasury bills.

Private banks are similarly cautious about underwriting bond issues for local governments. The costs of preparing revenue-producing bond issues are relatively high, and private underwriters face a risk that government financial institutions will pick off local government bond issues by coming in late and offering attractive loan terms. For a time the roles were reversed, and the private sector was underwriting a growing number of local government bond issues. The slowdown in economic activity and political turmoil in the early part of the present decade appeared to abate the bond market's growth.

Still, circumstances are moving in the direction of greater private market access. One recent change has made municipal bonds more attractive to private banks. The Agri-Agra law (Presidential Decree 717) requires private banks to maintain 25 percent of their portfolio in loans to the agricultural and agribusiness sector. It has been difficult, however, for banks to develop loans of this type, and in the late 1990s there was reportedly a P 20 billion deficit in their holdings of Agri-Agra loans. A Central Bank ruling in 2000 now permits banks to use municipal bonds toward the Agri-Agra requirements, stimulating demand for such bonds.

Local Government Unit Guarantee Corporation

The Bankers Association of the Philippines had long been interested in developing mechanisms to insure against the risks to its member institutions

in dealing with local governments. In 1997 the Department of Finance, intent on developing a municipal bond market, began an initiative that culminated in the formation of the Local Government Unit Guarantee Corporation, a company that underwrites investor insurance of local government bonds. The company was capitalized at P 250 million (about $7 million) in March 1998 and began an extensive marketing campaign targeting both banks and local governments.

The Local Government Unit Guarantee Corporation added several interesting ingredients to the development of the Philippine bond market. To write guarantee policies and set its premiums, it had to develop credit criteria and a credit rating system (see section on credit ratings). The premium for the guarantee depends on the rating and the scale of the transaction, with around 1.0 to 1.5 percent of the outstanding principal being the target level for premiums. By March 2001, the corporation had closed on eight bond issues involving its guarantees.[7] As of mid-year 2003, Local Government Unit Guarantee Corporation–insured bonds amounted to about P 1.7 billion (about $33 million) in insured principal outstanding.[8] At its current level of capitalization the corporation could guarantee around P 2.5 billion in loans or bond issues and believes that it needs more capital.[9]

In 1999 the Local Government Unit Guarantee Corporation engaged in negotiations with the U.S. Agency for International Development (USAID) on the use of USAID's new credit enhancement program, which would allow U.S. government backup on its guarantees. USAID requested that the two government financial institutions holding equity in the corporation (the Landbank and the Development Bank) divest their interests in it. Concerned about possible government interference, it asked that the corporation divest itself of the bond rating function, if possible. (That decision will depend on the financial viability of the rating function.) In late 1999 the corporation entered into an agreement with USAID and has paid the fees to receive its 30 percent backup on qualifying bond issues.

The Local Government Unit Guarantee Corporation represents an innovation of international significance in local government finance. It has provided a way to involve private commercial banks in local government capital financing despite the barriers to establishing banking relationships. Its enhancements bring early homogeneity to a potentially disparate market and the promise of some liquidity to an otherwise comatose secondary market. If its selection of credits to insure proves dependable, it will go a long way toward building investor confidence. The corporation also oper-

ates an internal rating system that is unique in the scope and detail of its credit assessments. The rating system could become commercially viable if the volume of bond financing is sustained.

Multilateral and Bilateral Initiatives: The Municipal Development Fund and Technical Assistance

The Philippine Municipal Development Fund is an initiative of the World Bank and other donor institutions dating to 1984 (Gavino 1998). While the donor institutions set up the fund because of the underdeveloped capital market in the country, in the end it wants local governments to access the capital market. The fund uses different modes of assistance, combining loans and grants to correspond with the revenue-generating and non-revenue-generating (social and environmental) components of projects. For projects with large social and environmental components (relating to schools, dump sites, and public markets, for example), grants can cover up to 70 percent of the project cost. The loans are tied to the grants. There also has been a concerted effort to inject more private capital and managerial expertise into the financing and operations of infrastructure facilities.[10]

Working with the Development Bank of the Philippines, the World Bank has been experimenting in using the Municipal Development Fund to aid local government infrastructure projects. One example is the Local Government Unit Urban Water and Sanitation Project, which finances facilities that are not part of the water districts financed by the Local Water Utilities Administration. The project requires privatized operation under a design, build, and operate scheme in which lease payments from the operators are used to repay the local government's loan. Another example is the Water Districts Development Project, an initiative dating from 1993 that the World Bank has undertaken with the Landbank of the Philippines. This project has added sewage treatment to existing water districts. The project has had problems because of collection difficulties and changes in local government leadership. Yet another example is the flood control project in San Fernando, Pampanga. Because all these are inherently non-revenue-generating projects, they encounter difficulties when political problems arise, because the funds need to be allocated to the projects from the local governments' current operations.

While the ultimate aim in setting up the Municipal Development Fund was to have local governments access private capital, there appears to be

no clear mechanism for inducing them to do so. Implementing a credit program that features submarket lending terms while attempting to develop a private capital market for the more creditworthy borrowers poses major difficulties. Two types of moral hazard are present. For program administrators, there is a desire to lend to good projects and to show responsible use of funds by achieving good repayment records. Proponents of such projects are typically the more creditworthy local governments. For local government borrowers, there is a desire to qualify for the program so as to avail themselves of the preferential (submarket) terms. They understandably resist having to borrow at higher interest rates and for shorter periods.

The World Bank and others are also providing technical assistance aimed at improving access to credit, however. Part of the World Bank's Local Government Finance Development Fund (LOGOFIND) project is directed toward technical assistance and training programs to bolster local government financial administration. One objective is to develop more professional planning and analytical capacity at both the national and the local government level, which would enhance credit-related policies and implementation.

The GOLD (Governance and Local Democracy) Investment Promotion and Prioritization Program, sponsored by USAID, has worked for several years in five provinces (Bohol, Capiz, Lanao del Norte, Nueva Vizcaya, and Palawan). Although the program has provided no credit assistance, it has promoted better practices in capital budgeting and in accessing alternative credit sources. The project developed participatory methods for identifying and developing possible local government investment projects that could be financed through loans, joint ventures, build-operate-transfer (BOT) arrangements, and municipal bonds. Of 50 investment projects analyzed, only one emerged as a possible candidate for revenue-based municipal bond funding. However, several smaller projects might be candidates for bank loans or for loan pooling devices.

In a related effort in 2000, a project funded by USAID and undertaken by the Financial Executives Association of the Philippines prepared a comprehensive manual of practice in the municipal bond market (Financial Executives Institute of the Philippines 2000). The manual explains step by step how issues are developed and marketed and what roles different participants play. It includes copies of the typical documents needed in bond offerings and explains legal authorities and constraints. It also shows the range of costs that have been incurred in bond sales.

Appraisal of Local Governments' Access to the Credit Market

Loan funds from the government financial institutions appear to have been generally available to local governments, at least through late 2001. The constraints appeared to be in the development of bankable projects and the reluctance of local governments to borrow to finance projects at the rates and on the terms offered by the government financial institutions. Moreover, despite continuing perceptions to the contrary in the private sector, credit quality does not appear to be an issue, although this proposition has not been tested by widespread borrowing in large amounts. The bonds and bank loans have done well with respect to repayment, but borrowing is at very modest levels and well secured by the IRA payments.

The supply of projects that are good candidates for debt financing is constrained by the limited ability of local governments to formulate projects and put them into satisfactory technical shape for financing. This problem has many sources, including lack of skills among local government officials and the cost and difficulty of procuring professional services. Not surprisingly, smaller local governments normally give preference to small, simple capital projects and the purchase of equipment (such as earth-moving machinery). Moreover, the assignment of government responsibilities places the provision of major infrastructure facilities outside the purview of local governments, putting these facilities in special districts (such as water and sewerage) or leaving them with national agencies (ports and terminals). Thus, to be technically feasible, projects often require the cooperation of local governments in regional schemes and perhaps the cooperation of national agencies as well.

The capacity of local governments to pledge credible security is limited because of the reliance on IRA (which itself has proved to be a strong security) and the resulting weakness in own-source revenue raising systems. Creditors may nominally prefer self-supporting projects and physical collateral (and revenue-generating projects are supposedly required for bond issues).[11] As a practical matter, however, both government financial institutions and bond investors look to the IRA pledge for security. Thus there have been no local government loans that are pure revenue bonds—that is, bonds based solely on project earnings and assets. There are also some legal issues. The legal ability of local governments to have separate, restricted funds for debt service is unclear, and the existing accounting system used

in local governments does not recognize the separate fund doctrine nor do financial reporting formats facilitate separate reporting.

Political risk ("willingness to pay") continues to be the paramount concern among potential private sector lenders. Perhaps because of the institutional and regulatory barriers in dealing with local governments, private creditors are generally leery of extending credit to them. Private market investors see local politics as volatile and undependable and still subject to the national government's intrusion or to changes in the rules of the game. Without the private sector as a direct stakeholder (creditor) relying on the viability of local governments, the chances for such changes may be increased.

Private commercial banks, aside from their participation in the Local Government Unit Guarantee Corporation and their role as underwriters of municipal bond deals, have been effectively blocked from lending directly to local governments. The main constraint is the regulation restricting local governments' depository accounts to the two government banks, the Landbank and the Development Bank, and one private bank, the Philippine National Bank. Inability to hold these accounts means that private commercial banks cannot establish customer relationships, enjoy the economic benefits of holding deposits, or have the benefits of IRA intercepts and offsets against deposits as collateral against loans (though banks can enjoy the benefits of the IRA intercept if they hold bonds insured by the Local Government Unit Guarantee Corporation). Commercial banks have attempted to circumvent this restriction by underwriting and investing in bonds. Neither activity establishes broader relationships with local governments or provides the benefits of holding deposits. As long as the depository restriction remains in place, issuing securities will be the only way for local governments to tap private capital.

The local government bond market appears capable of sustained growth, although potential obstacles have arisen. Recent events have caused uncertainty about what procedures are to be followed in the municipal bond market operation, and the central government may be having second thoughts about allowing the market to develop without active oversight. The Department of Finance indicated that it would issue an executive order regulating the municipal bond market. The Central Bank, by resolution, referred requests for its waiver on a proposed municipal bond sale (Caloocan) to the Department of Finance, seeking prior "endorsements" from the department before granting the waiver.[12] Still, the Department of Finance showed a willingness to discuss and negotiate the bond regulation and approval process with the private underwriters and financial advisers.

In the long term the national government needs to follow through on implementing its capital access plan for local governments. That plan argued that credits for commercially viable local governments should be financed by private capital sources (private commercial banks and the bond market). Progress was made in improving access to the capital markets for local governments, primarily through the Local Government Unit Guarantee Corporation. The Municipal Development Fund intends to tighten its focus on smaller, less creditworthy local governments, but private commercial banks continue to be excluded from the local government loan market by their inability to hold local government deposits except under exceptional circumstances.

The market should include participation by commercial banks (as both direct lenders and investors in securities) and other private and public investors that local governments can best access through a domestic bond market. The direct lending and on-lending systems, funded by development assistance and operated exclusively by the government financial institutions and the Municipal Development Fund, inhibit growth in the domestic markets and the tapping of domestic private capital.

Credit Ratings

There has been interest in the Philippines in creating a system of credit ratings and an independent rating agency to rate local government securities, to help create investor confidence, and to provide criteria for setting price differentials. Two independent rating agencies operate in the Philippines, but neither of these rates local government credits. Specializing in rating corporate obligations, these private rating agencies have no particular competence in rating local government credits and are too expensive. Philippine financial institutions, including the two government financial institutions, use internal rating systems to classify the creditworthiness of local governments, but no entity publishes credit scores or bond ratings for local governments (see ARD, Government Finance Group 2001, section 3). However, the Local Government Unit Guarantee Corporation has indicated that it would like to spin off its rating activity if the service can be made financially viable, to make it independent of the company's insurance business (Tirona 2001).

The rating system used by the Local Government Unit Guarantee Corporation is the most developed one. The system is based on a two-step approach. First, an indicators screen based on secondary data is used to screen

potential candidates for guarantees (the screen has data for about 160 of the largest local governments). This produces scores. Second, a full-blown credit analysis is performed on applicants for insurance coverage. This provides a rating for the local governments. The company also judges the creditworthiness of projects to be financed by bond proceeds, although it does not assign ratings to such projects.

By early 2001 the Local Government Unit Guarantee Corporation had rated eight local governments for purposes of insured bond sales. These ratings are not made public, but the requirement is that the local governments be "investment grade" to secure insurance.[13] The costs of preparing ratings (approximately P 40,000–50,000) have been incorporated into the insurance premium.

To be effective and credible, a credit rating system must meet four criteria:

- *Sound methodology.* The system must be logically sound in what it measures, and the analysis used must be relevant to judging ability and willingness to pay.
- *Competent and professional administration.* The system must be applied rigorously by individuals who have the necessary skill and judgment and the required data.
- *Objectivity and independence*. The system must be free of political and economic pressure. It will earn no respect if it is manipulated for political or financial ends.
- *Financial sustainability.* The system must be financially viable to meet the first three criteria. That means that it must be self-supporting or subsidized in a way that protects its independence and at a level enabling it to pay for the professional skills required.

Meeting these four criteria is difficult for the Philippines when it comes to rating local government securities because there is insufficient demand to support an independent, professionally run rating agency. There are few bond issues, they tend to be small, and the ratings now given are a tie-in of the bond insurance, which all recent bond issues have used. Moreover, the government financial institutions, which make all bank loans to local governments, have their own internal systems (and yet still rely mostly on the IRA assignment). There is no requirement for investors or issuers to be rated. The rating system of the Local Government Unit Guarantee Corporation is in place only because of an internal prudential requirement, reinforced by a reinsurance require-

ment by USAID. Thus a rating agency would need to be founded on direct or indirect regulatory requirements.

The most successful route, however, may be the credit ratings "cart" following the credit market "horse." Published credit ratings are most important to current and potential holders of securities—passive investors that do not have direct lending relationships with the borrower like those that a bank has. Until the securities market, consisting of many passive investors with substantial holdings, becomes more important as a source of capital to local governments, there will be little effective demand for published external ratings.

Rating systems, whether internal or proprietary, will be greatly helped by improvements in the data on local governments made available by the national data gathering agencies, the Bureau of Local Government Finance and the Central Office of Audit. Without better data, particularly on debt service payments and self-balancing funds for local government enterprises, quantitative analysis will continue to have severe limitations.

Other Impediments to Local Governments' Access to the Credit Market—and Possible Remedies

The main obstacles to expanding local governments' access to private capital markets have been discussed—difficulties surrounding the banking depository relationships, perceptions of credit quality, and lack of credit ratings. There are other institutional and regulatory impediments as well, some of which are intertwined.

Exclusive Rights of Assignment of Central Government Payments

Only the government financial institutions and the Municipal Development Fund are permitted to use IRA deeds of assignment as security on loans extended to local governments. This privilege allows the government financial institutions to dominate the local government credit market and restricts competition on loans, deposit rates, trustee relationships, and other measures that help local governments better manage their fiscal resources and strengthen their creditworthiness.

The government financial institutions are reluctant to give up this competitive advantage. However, the same rights of assignment and interception of funds should be extended to private banks and investment houses, though perhaps constrained by prudential limits allowing such rights only to qualifying private banks.

Inadequate Financial Accounting and Reporting

The system of financial record-keeping and reporting prescribed by the Central Office of Audit for local governments does not lend itself to the financial statement reporting required by banks, investment houses, and investors in municipal bonds. The Central Office of Audit, in consultation with private banks and investment houses, should develop guidelines for financial record-keeping to support the analysis of debt obligations. The existing local government accounting system, an adaptation of that used by the central government, reports only highly aggregated results. Revamping the system to allow for self-balancing and freestanding enterprise funds and to shift the focus from ensuring legal compliance to reporting financial condition would do much to aid bond financing techniques.

High Front-End Costs of Bond Issuance

To prepare revenue-based municipal bond packages for marketing, local governments must invest in preliminary project identification, prefeasibility and feasibility studies, and financial preparations. Some of this work can be done in-house, but in every case there comes a time when the local government must engage external specialists (financial analysts, bond underwriters, and the like). However, the procurement process presents a problem. Many local governments lack the capacity to put out competitive solicitations for underwriting services—and as a result are not allowed to hire experts to help them. Moreover, the costs of preparing and floating bond issues are high relative to the amounts borrowed, especially for small issues.

Private banks and investment houses generally will not put up these front-end costs unless the project has very large potential (P 250 million and above). Even in these cases local governments will have to finance some of the costs, a process complicated by the procurement laws. Because of the high front-end costs, local governments are reluctant to explore major development projects.

Taxation of Securities Transfers

The documentary stamp tax (levied on legal documents and associated financial transactions, such as stock or bond certificate transfers) hampers the development of an investor market in stocks and bonds by creating a disincentive for investors to take risks. Continuing the tax will further dampen the chances for developing a vigorous capital market, including municipal bonds. The present tax system favors continued intermediation

through banks, since investments made through banks (such as certificates of deposit or savings accounts of more than five years' maturity) are exempt from the documentary stamp tax.

Lack of a Secondary Bond Market

Establishing a secondary market for municipal bonds would encourage more individual and institutional investors to invest in such bonds, particularly those wanting options on how long they remain invested in a single bond. A secondary market cannot emerge until there is a primary market supplying a volume of tradable securities. Even so, the first steps toward developing a secondary market for municipal bonds need to be taken. The Philippine Securities and Exchange Commission, in collaboration with the Philippines Stock Exchange, is exploring the start-up of trading operations in bonds, including revenue-based municipal bonds. This might be aided by establishing a "bond pool" that would combine small local government loans into packages of sufficient size to attract investor interest and an active secondary market. The existing tax law is not conducive to secondary trading, however.

Lack of Procedures for Financial Emergencies of Local Governments

There is little guidance on what procedures to follow in the event of a financial emergency at the local level. Section 531 of the Local Government Code of 1991, which deals with debt relief for local government units, might have been adequate for debt management problems encountered in the Marcos era. However, the expanded use of credit finance by local governments today calls for a comprehensive procedure for dealing with local governments that run into serious financial difficulty.

The procedure should be designed so that it does not intrude on the fiscal autonomy granted to local governments under the Local Government Code but does hold them accountable for willful actions of default. It should be structured to lend comfort to investors on economic and natural calamities *(force majeure)* beyond the control of local governments but not on political succession problems at the local level (where trust accounts and legally enforceable contracts can provide protection).

Tax Treatment of Local Government Interest Payments

The government treasury bill market and investor practices have favored short-term maturities and high interest returns, and there are no incentives designed to foster investment in longer-term maturities at somewhat lower

interest rates. This situation inhibits the wide adoption of revenue-based municipal bond financing by local governments. Revenue-producing projects often need several years of gestation for design, construction, operation, and cash flow generation. They need the bond-created funds at interest rates lower than those prevailing in the regular bank loan market and with maturities much longer than the usual two- to five-year loan period.

There are several ways to attack this impediment. One way is to set up tax exemption incentives for long-term bonds with maturities of, say, four to five years. Individual investors, given current credit finance practices in the market and the absence of a secondary market, probably would not wish to tie up their funds in such long-term maturities. Major institutional investors, such as the Social Security System and the Government Service Insurance System, however, have expressed interest in reserving small slices of their portfolios for investment in sound revenue-based municipal bonds, given appropriate incentives.

Two possible options are giving a blanket tax exemption to all revenue-based municipal bonds or setting up a graduated system of exemptions for bonds with maturities of 7 to 15 years. Although always controversial, tax exemption is used extensively by sovereigns to enhance the market for their bond issues. Applied surgically, it might be good "bait" for drawing investor funds out to longer maturities.

Weak Incentive for Investor Due Diligence

The ability to intercept IRA payments is a mixed blessing. It enhances the credit of local governments, but it can lead investors to rely on the intercept mechanism as the only source of security and remove the incentive to conduct due diligence to ensure that projects are self-supporting. One possible cure is to exempt projects that are self-supporting from the ceiling on debt service, discussed next. The idea would be to ensure that projects are self-supporting and kept apart from any pledged support from general revenues. Without such a tax pledge, there would be no need to restrict project borrowing by the availability of general tax revenues, as is now done.

Ceiling on Local Government Debt Service

Section 324(b) of the Local Government Code imposes a limit on the debt incurred by a local government by restricting annual appropriations for debt service to no more than 20 percent of its regular income. For some provinces and large cities, this cap is reportedly beginning to constrain development initiatives.

Municipal bonds are restricted to "revenue-producing" activities. Precisely how that phrase is to be interpreted is unclear, since the revenues produced may well be insufficient to pay operating expenses and debt service. For activities that generate sufficient revenue to cover operating expenses and debt service, the debt service might be exempted from the ceiling. This is customary practice in the United States. Similarly, in the European Union the debt of self-supporting government-owned utilities is not counted against the national debt ceiling.

Prospects for Developing the Private Credit Market

The Local Government Code, at least on paper, opened prospects for a market for local government obligations. It created a potential for local government financing from private sources both for expenditures in advance of revenues and for capital projects, but serious structural barriers remain. Particularly important is the restriction of depository banking to government financial institutions, which has effectively limited local governments to two such institutions for their credit needs. Nonetheless, local governments gained experience as borrowers in the 1990s and saw the development of a range of credit and security structures. This experience contributed to the emergence of municipal bonds toward the end of the decade.

Starting up the municipal bond market in the Philippines will remain difficult as long as the government financial institutions retain their dominant depository and lending relationships with local governments. The vision formed by the Philippine Department of Finance in the mid-1990s foresaw the government financial institutions limiting their lending to short-term financing and small projects that did not qualify for municipal bonds (Philippines, Department of Finance 1996). The problem is that the government financial institutions have found local government loans, backed by the assignment of government transfers, to be very profitable and are not anxious to have the local government loan market made competitive.

Another impediment to the development of the private capital market is the continued availability of concessionary loans from the Municipal Development Fund or through concessionary loan programs routed through the government financial institutions. These loans create a risk for private lenders, which might develop local government projects only to see them picked off by government financial institutions able to lend on concessionary terms. For a time the reverse was the case, with government financial institutions being undercut by aggressive bond issues. However, the most

recent evidence is that the government financial institutions, with funds to spare, have been refinancing outstanding local government bond issues at lower interest rates.[14]

The municipal securities market in the Philippines, fueled by the innovative insurance provided by the Local Government Unit Guarantee Corporation, will remain an "infant industry" for some time, needing active steps to make underwriting and trading of bonds competitive. The Local Government Unit Guarantee Corporation has provided a focal point for increasing the competition for local government lending and for building the foundations of a municipal bond market. At the very least the competitive advantages bestowed on government financial institutions should be reduced, as should the tax advantages given to investments routed through banks.

Notes

1. Although there are other government financial institutions, such as the Veterans Bank and Amanah Bank, they are small and do not offer the full range of services provided by universal banks such as the Landbank of the Philippines and the Development Bank of the Philippines.

2. On 30 June 2000 nonperforming loans for the Philippine National Bank were 35 percent of total loans; for the Landbank of the Philippines, 19 percent; and for the Development Bank of the Philippines, 9 percent (*Business World*, *Special Report for Q2 2000*, 16 August 2000).

3. For a discussion of the Philippine banking system and its good performance during the recent crisis, see Delhaise (1998).

4. Victorias Pabahay (P 8 million), Santo Domingo (P 10 million), Calavaria (P 20 million), Puerto Princesa (P 20 million), and Lagaspi Suerta (P 26 million). Santo Domingo's issue did not carry a guarantee or the partial tax exemption. The guaranteed bonds were guaranteed for principal and up to 8.5 percentage points of the interest rate, and 8.5 percentage points of the interest was exempt from the 20 percent withholding tax. The bonds ranged in final maturity from two to three years and carried interest rates of 14 to 16 percent. See Gavino (1998, pp. 27–28).

5. There has been a persistent negative perception in the Philippine municipal bond market of the 1991 Cebu bond deal, which briefly threatened default at the time of the changeover in governor of that province. There was no default, though there was a reduction in the land collateral pledged by the province. The political rhetoric of the time and selective memories overshadowed the actual outcome. While much is made about the terrors

of political succession and repudiation of debt, the repayment record for the few local government bonds issued has been spotless—and that for loans, nearly perfect—in the past decade.

6. The 15-year period of strong performance that began in 1985 followed an inglorious one in which there were widespread defaults on local government loans in the early 1980s. Burdened by loans from the Marcos era, local governments refused to pay debt service to the government financial institutions. They were largely relieved of that burden in the mid-1980s, when the central government forgave many of the debts.

7. The policies cover debt service insurance, which amounts to a guarantee of debt service payments. In any given year these are much less than the outstanding principal, but they will sum up to much more over the life of the bonds.

8. See Tirona (2003, p. 2). Thus far, the default rate has been zero. As of mid-2003, the Local Government Unit Guarantee Corporation anticipated P 2.5 billion in guaranteed local government debt by the end of the year.

9. The business plan of the Local Government Unit Guarantee Corporation includes a commitment by the 22 member banks to subscribe more capital when it is called for. With its roughly $7 million capitalization, the corporation is very small by industry standards. However, given the IRA-secured loans, its potential portfolio appears to be of high quality, though dependent on the stability of the country's intergovernmental payments system.

10. See Gavino 1998 for a discussion of various infrastructure financing initiatives, including build-operate-transfer and other privatization schemes. While much has been done at the national level, privatization projects have been slow to materialize at the local level.

11. Although projects to be financed are to be "self-liquidating, income-producing or livelihood projects," there is plenty of room to maneuver in interpreting these terms, none of which is defined. See Local Government Code of 1991, section 397.

12. Monetary Board Resolution 1442 (25 August 2000).

13. A condition of the USAID reinsurance is that the local government bond issues be for allowable purposes and occupy one of the top three rating categories (AAA, AA, A). The Local Government Unit Guarantee Corporation has insured bonds at a slightly lower rating grade (B), forgoing the USAID reinsurance in at least one case.

14. Jesus Tirona, president of the Local Government Unit Guarantee Corporation, correspondence, Manila, October 2002.