The Feasibility of Establishing a Secondary Mortgage Market in the Philippines

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Abstract

This thesis will assess the "readiness" and analyze the factors that will lead to the development of an effective secondary housing mortgage market in the Philippines. We will use secondary mortgage market models from the United States and other countries with well-established secondary mortgage institutions (SMIs) as a lens through which to analyze the readiness of the Philippine market. In the course of our assessment, we will examine the following four key issues:

1. The primary and secondary fixed income securities market;
2. The mortgage origination process;
3. The securitization and trading process; and
4. The regulatory, legal and tax environment.

We will offer recommendations and alternatives with regard to the Philippine market's further development.

Thesis Advisor: W. Tod McGrath
Title: Lecturer

Acknowledgements

"*Arrows in the air*"

In a fledgling attempt as a campus journalist, I brazenly swiped my college mascot's trademark quiver as the title of an editorial column. Fueled by the idealism of a brash college student, the title of the column served as a metaphor to "strike" at the proverbial issues that affected not only the school community, but the Philippine-wide issues as well. A pseudo-pulpit, if you will, to ramble on aimlessly, proselytizes to, and inflames the student community. The column lasted for a good issue. But the idealism, I would like to think just went into hibernation.

Six years later, I went into my mental closet to see if the quivers were still sharp. And I made a makeshift bulls eye out of the state of Philippine housing finance. Needless to say, this is much longer than the half page column that I had to eke out.

"If you build it, they will pay" was the quote former Finance Undersecretary Romeo Bernardo overheard from an anonymous developer that he used for a column decrying the state of Philippine housing finance. As a member of the Philippine real estate development community, you would think that there would be nothing more soothing for me than to hear the sound of "*ka-ching*" lining up my pockets.

But the sound of "*ka-ching*" could be distracting me from the bulls' eye being tattooed onto my chest.

The establishment of a sustainable housing finance system in the Philippines is an issue that has, for better or worse, been laid out on a political grandstand of competing ideas and vested interests that has rendered housing finance worse for the wear. Given the right amount of rhetoric, smoke and mirrors, and the political push and pull, taking up the "cudgels" for housing finance wins votes and makes money. Unfortunately, these arrows took aim at the sustainability of housing finance.

Let us aim those arrows at the right bulls' eyes. And if you want to find out what those bulls' eyes are, I invite you to read this monster of a thesis.

Firstly, I would like to thank all the magnanimity of the Philippine interviewees who candidly and passionately shared their views with us on the state of Philippine housing finance. These include the following:

Professors Juan Miguel Luz and *Victor S. Limlingan* of the Asian Institute of Management, *Winston L. Peckson*, Vice President of Global Financial Markets ABN-AMRO, *Atty. Cynthia Roxas-del Castillo*, Dean of the Ateneo de Manila University Law School, *Andres I. Rustia*, Managing Director of the Asset Management Department of the *Bangko Sentral ng Pilipinas* (Central Bank of the Philippines), *Leonilo G. Coronel*, Executive Director of the Bankers Association of the Philippines, *Atty. Manuel M. Serrano*, Founding Chairman of the Chamber of Real Estate and Builders Associations (CREBA), *Assistant Secretary Jeremias N. Paul, Jr.* of the Finance Department, *Senen L. Matoto,* President of the Investment Houses of the Philippines (IHAP) and Executive Director of the Financial Executives of the Philippines (FINEX), *Luis R. Ymson, Jr.,* First Vice President of First Metro Investment Corporation *Arthur Tan*, Executive Vice-President and General Manager of the Home Guaranty Corporation (HGC*), Deputy Secretary Lucille Ortille* of the Housing and Urban Development Coordinating Council (HUDCC), *Norman H. Macasaet*, Principal Transactions Group of Lehman Brothers, *Peter D. Maquera*, Chief Operating Officer of Lighthouse Credit Technologies Corporation, *Monico Jacob*, Former Home Development Mutual Fund (HDMF)/*Pag-Ibig*, Chairman and Conference Chairman of the Philippine Conference on Securitization and Managing Director of CEOs Inc., Eduardo T. Manicio, Vice-President of the Funds Generation Group of the National Home Mortgage Finance Corporation (NHMFC), *Manuel C. Crisostomo*, President and Chief Executive Officer of Home Development Mutual Fund (HDMF)/*Pag-Ibig, Erlinda M. Henson*, First Vice-President of the Audit and Investment Division and *Paul Q. Reprado*, Assistant Vice-President of the Investment Department of PET Plans, *Romeo L. Bernardo*, former Finance Undersecretary and Managing Director of Lazaro, Bernardo, Tiu & Associates, *Santiago F. Ducay*, Executive Director of the Subdivision and Housing Developers Association (SHDA), *Andrew D. Alcid*, Executive Vice President, Investment Banking Division of United Coconut Planters Bank, and *Dr. Renato S. Reside*, *Jr.*, University of the Philippines College of Economics.

I also tip off my hat to *Dr. Timothy Riddiough*, who put us through the wringer with two terms of real estate finance. Professor Riddiough not only drilled Modigliani and Miller propositions one and two were was the real Eminem, but also taught us that vasectomy, just like development, is irreversible.

Special mention also goes out to Tim Berners-Lee, founder of the World Wide Web. Mr. Berners-Lee, you make it almost impossible for us graduate students to imagine what it was like writing a thesis ten years ago. I lay the blame squarely on you as well for becoming an Internet junkie.

Or course, I cannot fail to mention our esteemed thesis adviser Tod McGrath. Tod was our first and last word on Real Estate Finance, serving as our lecturer for real estate finance orientation and as our adviser

on the thesis. Tod's larger than life personality, punctuated by his uncanny resemblance to Bill Murray, his snakeskin boots and his serrated wit, helped add color to the classroom discussion. Tod, there's a good time waiting for you in Manila when you find it on the map.

This thesis also goes out to the next Real Estate graduate student who actually pores through these pages and finds the crisp twenty-dollar bill lodged within this mammoth piece of work. There's "securitization" working for you my friend.

Last but not the least, I have to thank those who will forcibly read this thesis under threat of continuous nagging: my family. First of all, to my mom's sisters in the United States, *Tita Medit* and *Tita Ellen*, who have been so generous with their love, time and resources. I am forever indebted to both of you. My brother and sister, who grudgingly admit their love for me, right? Right? And of course, to my parents, who taught me that it's not about the *ka-ching*. It's about enriching the lives of our fellow Filipinos with the cup we are given. Thanks for helping me start to fill the cup, mom and dad.

Oh, and after putting Tod's jaw back in place after he had painstakingly read through our 800-pound gorilla of a thesis, I dropped by a friend's house to pay a little gratitude. Let me tell you what I told him, "*I will continue, oh my God, to do all my actions for the love of you.*"

Hanna and I are patiently waiting for the book deal.

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1 *INTRODUCTION*

Background

"Housing is a postponeable expenditure," he lamented, on the priority that the government had placed on the housing sector, despite government's proclamations to the contrary[1]. Despite the government's promises to prioritize shelter programs, only P11.5 Billion ($217 Million) out of the mandated P38.5 Billion ($726 Million) housing fund has been released over the last six years[2]. Tell that to the those who live in Manila's shantytowns, who thought they would finally have a corrugated steel roof over their hastily-constructed shelters.

In June 1998, *Joseph Ejercito Estrada*, a former B-movie action star turned politician, rode on a massive populist vote to win the presidency of the Republic of the Philippines. In his movies, "*Erap*" (which means "friend" spelled backwards) played the role of the Filipino robin hood, a "thug with a heart of gold", whose gangster-like ways, albeit Machiavellian, helped uplift the Filipino everyman from the clutches of poverty. However, his ability to uplift the lives of the Filipino people remained to be cinematic fiction.

Celluloid thugs don't seem to always have the best-laid plans when assuming the presidency. Case in point: the housing sector had been in turmoil since Estrada assumed office due to the lack of strong leadership behind the government's mass housing program.[3] *Initially, the goal of the Estrada administration was to pursue reforms that would develop a more stable and longer-term sources of financing for the housing sector.* In fact, "Erap's" administration was about to "reconfigure" the housing finance system- the driving force of the shelter sector[4]. One of President Estrada's earliest announcements was that housing, along with agriculture, would be the government's priority program. While the shelter sector has always been considered an important engine of growth given its multiplier effect, this was the first time it had been accorded this level of attention under any administration.

The government's lead housing agency, the Housing and Urban Development Coordinating Council (HUDCC), under the progressive leadership of Prof. Karina Constantino-David, a long-time advocate of

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[1] Limligan, Victor. Professor at the Asian Institute of Management. Personal Interview. June 2001. Makati City, Philippines.
[2] Aquino, Norman P. Gov't shelter program woefully underfunded. Businessworld Publishing Corporation. March 12, 2001. Makati City, Philippines.
[3] Bancod, Ed and Ladrido, Bonnie. BNP Prime Peregrine Property Sector Philippines. BNP Prime Peregrine. April 10, 2000. Makati City, Philippines.
[4] Tenorio, Arnold S. Housing program back to square one. Businessworld Publishing Corporation. February 8, 2001

poor people's housing, instituted tougher credit policies and market-oriented (versus subsidized) interest rates which were met with stiff opposition by private developers who had benefited from the less stringent policies of the previous administration.

But everything started to turn awry when Estrada buckled under the pressure from the private developers. He relieved the forward-looking HUDCC chair of her duty, scrapped his own development plans, created a Presidential Commission on Mass Housing (PCMH) and dubbed himself the self-styled "housing czar". The thinking behind this move was to group all of the financial institutions under his belt to expedite funding for his mass housing project, a reversion to the policies of old. The PCMH got off on the wrong foot when the appointed vice-chairman appeared to have questionable credentials. Thus, it came as no surprise the vice-chairman hastily resigned (in less than a month's time) due to negative publicity. These types of political appointments were, unfortunately, characteristic of the Estrada administration.

Fast forward a mere thirty (30) months later: In January 2001, after successive bouts of political and economic mismanagement, Estrada was ousted in a peaceful and orderly transition of power (which the Filipino people have dubbed "People Power 2", a "sequel" to the 1986 revolt that ousted late strongman *Ferdinand E. Marcos*). Former Vice-President and now President *Gloria Macapagal Arroyo*, an economist by training, has assumed the reins of power as the country trudges its way towards political and economic stability.

Although President Arroyo has communicated the development of the secondary mortgage market as a priority, there are still institutional obstacles in place, which are inimical to the development of this market. Moreover, there are still developers groups for whom securitization is a bitter pill to swallow because of the stringent measures it imposes. Thus, the measures they lobby for unwittingly deter not only securitization, but also capital market development.

This only seeks to illustrate that housing can make or break a presidential administration as it has been and continues to be one of the thorniest, and most misunderstood, issues to plague successive presidential administrations. In a developing country like the Philippines, housing finance is a politically charged issue because of the dual nature of housing itself: Housing serves as both a commercial good and as a social need. In a country debilitated by poverty (40% of the country's 76.5 million-strong population live below the national poverty line[5]), basic needs such as shelter have yet to be sufficiently met by the government. Thus, a sound housing finance policy can literally make or break an administration.

As part of the major policy reforms undertaken by former President Corazon C. Aquino[6], she issued Executive Order (EO) 90 in December 1986, which created the National Shelter Program (NSP), the cornerstone of current Philippine housing policy. The NSP was established primarily to implement provisions and development programs targeted at providing adequate housing facilities for the lowest 30% of the economic class[7].

One of the key institutions integral to the implementation of the NSP was the National Home Mortgage Finance Corporation (NHMFC). The NHMFC, roughly patterned after the United States' Federal National Mortgage Association (FNMA or "Fannie Mae"), was mandated to become the Philippines' publicly-owned and managed Secondary Mortgage Institution (SMI). Thus, the NHMFC was tasked to generate a critical mass of mortgages that would eventually be securitized and sold to public and private institutional funds. The development of the NHMFC as an SMI was viewed as a solution to housing finance in the problem.

Despite the laudable intentions of the NSP, the execution of the program failed to be sustainable in nature and long-term in character. Through the NHMFC, the government tried to address housing as both a social need and a commercial good. A confluence of factors, including lax underwriting guidelines, a production- versus finance-driven construction incentive, poor collection efficiency, and subsidized interest rates (which will be elaborated on in the later chapters of the thesis), resulted in large pool of non-performing loans. In 1996, The NHMFC was eventually relegated to a mere collection agency, to catch up on its delinquent mortgages. This move effectively waylaid the development of the SMI. After sending NHMFC to the wayside, the government has since entered into remedial stopgap measures to continue supporting housing finance for the lower socio-economic classes.

Underlying the aborted development of NHMFC were the shortcomings of the other 'cogs' that would lubricate the secondary mortgage market: an extremely thin secondary bond market, a highly prohibitive

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5 www.Inq7.net. More than 30 million Filipinos living in poverty: census. July 25, 2001. Makati City, Philippines.

6 Corazon Aquino succeeded ousted strongman Ferdinand Marcos in a peaceful and orderly transition of power which restored democracy to the Philippines in February 1986.

7 Tan, Edward L. Real Estate in the Philippines. Solar Publishing Corporation. 1999. Mandaluyong City, Philippines.

tax regime for bonds and asset-backed securities (ABS), and a legal and regulatory structure unfriendly to securitization.

However, in her first State of the Nation Address, recently installed President Gloria Macapagal Arroyo has apparently renewed calls for the establishment of an SMI as a means to encourage long-term savings. Aside from promising to establish a secondary housing mortgage market by the end of 2002, President Arroyo has also asked Congress to fast track the implementation of the Securitization Act and the amendments to the Securities Regulation Code[8]. Again, an SMI is being touted as the solution to a sustainable housing finance solution in the Philippines.

President Arroyo's proclamations augur well for the housing industry, which has been in a financing glut since the 1997 regional financial crisis. But there are still questions which are left unanswered with regard to the SMI: Will the NHMFC be rehabilitated into a working SMI or do we need to set up an altogether new SMI? In the event of a new SMI, will it be privately- or publicly-led? Is an SMI the best solution to developing a long-term market structure to address housing finance? Moreover, another set of questions arises that involve the 'cogs' of the secondary mortgage market such as: Is the secondary bond market still too thin to introduce mortgage-backed securities (MBS)? Have the tax, regulatory and legal structures evolved to become more conducive for securitization?

Purpose

The government's renewed call for a secondary housing mortgage market is a timely opportunity to re-look the feasibility of establishing such a market in the Philippines.

The process of securitizing, issuing and trading mortgage-backed securities (MBS) has been likened to an 'alignment of the planets' given that are several moving parts need to fall into place before the secondary mortgage market can be truly viable. *Thus, the purpose of this thesis is both to assess the "readiness' of, and opportunities for, the different 'moving' parts that will lead to the development of a vibrant and effective secondary housing mortgage market.* Moreover, we will use secondary mortgage market models from the United States and other countries with well-established secondary mortgage institutions (SMIs) as a lens through which to analyze the readiness of the Philippine market. In the course of our assessment, we will examine the following four key issues:

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[8] Inq7.net. *President Macapagal's State of the Nation speech.* July 23, 2001. Quezon City, Philippines.

1. The primary and secondary fixed income securities market;
2. The mortgage origination process;
3. The securitization and trading process; and
4. The regulatory, legal and tax environment.

Finally, we will offer recommendations and alternatives with regard to the Philippine market's further development.

Organization of the Thesis

This thesis comprises seven chapters. Since Mortgage Backed Securities (MBS) are structured similar to other fixed-income securities, and will eventually be underwritten, traded, cleared and settled in the same manner as regular securities in the wholesale capital market, the development of the Philippine secondary mortgage market is contingent on the state of the fixed-income securities market. Chapter 1 will provide an overview of the Philippine Fixed Income Securities market. Chapter 2 will review the current state of the Philippine residential real estate market. Chapter 3 will analyze the primary and secondary residential mortgage markets in the Philippines. Chapter 4 will provide an overview of government housing policies. Chapter 5 will discuss the current state of the primary and secondary mortgage backed securities market in the Philippines and make comparisons to the U.S. market. Chapter 6 will analyze the securitization process of mortgage-backed securities and make comparisons to more developed MBS markets in the U.S., Europe, and Asia. Chapter 7 will discuss the structural and regulatory framework related to the securitization process, including tax and legal issues. Chapter 8 will offer recommendations as to the market's further development.

Methodology

This thesis is based on a review of existing literature and articles in this field as well as one-on-one interviews with industry participants.

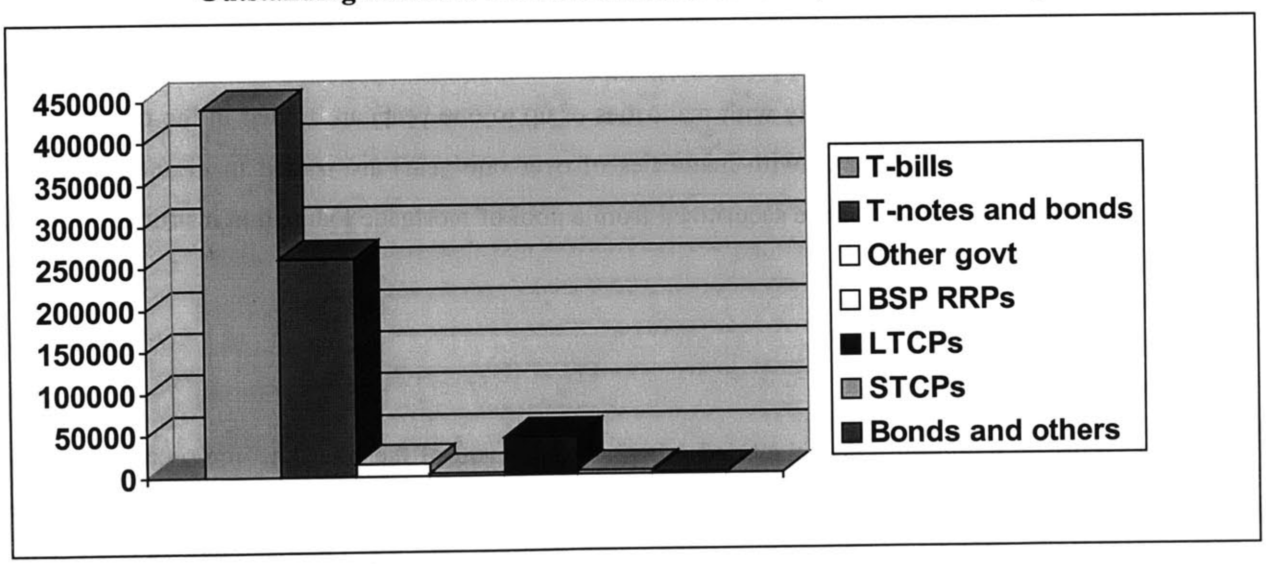
Since Mortgage Backed Securities (MBS) are structured similar to other fixed-income securities, and will eventually be underwritten, traded, cleared and settled in the same manner as regular securities in the wholesale capital market, the development of the Philippine secondary mortgage market in contingent on the state of the fixed-income securities market.

Primary Fixed Income Securities Market

Current State

Overview of Market. As of 1998, the Philippine fixed income securities market was approximately P766 Billion (US$ 14.5 Billion)[9]. There are two primary fixed-income instruments in the Philippines, namely government securities and corporate debt securities. However, government securities control the lion's share of the fixed income securities market (93.5%) with the balance accounted for by corporate securities (6.4%)[10].

Outstanding Domestic Debt Securities as of 1998 (Millions of Pesos)



Source: Asian Development Bank
** BSP RRPs = Reverse Repurchase Papers*
*** LTCPs = Long-term commercial papers*
**** STCPs = Short-term commercial papers*

The table below displays the characteristics of the Philippine fixed income securities market, and the corresponding money market and capital market subcomponents:

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[9] For thesis purposes, we will use the conversion rate of US$1 to P53.
[10] Saldana, Cesar G. Development of the Government Bond Markets in the Philippines. Asian Development Bank. March 2000. Manila, Philippines.

Characteristics of the Philippine Fixed Income Securities Market

Sector	Short-term money market	Long-term capital market
Public	• 91-, 182-, and 364-day T-bills issued by the Bureau of Treasury (BTr)	• 2-, 5-, 7-, 10-, and 20-year bonds issued by the national government, public corporations (i.e. public utilities, industrial companies, government owned and controlled corporations (GOCC)), and local governments. • Mortgage-Backed Securities backed by Home Development Mutual Fund (HDMF)/*Pag-Ibig* mortgages
Private	• Short-term commercial papers of varying maturities, issued by private corporations, of up to one year • Certificates of deposit • Money market certificates (i.e. promissory notes, repurchase agreements) • Interbank loans	• Long-term commercial papers of varying maturities, issued by private corporations, of more than one year but less than seven years • Preferred stock* issued by public utility companies • Convertibles** issued by companies • Mortgage-backed securities backed by mortgages of private banks

Source: Asian Development Bank

* *While a form of equity, preferred stock is considered fixed income instruments because the level of their current income is fixed. Also, the claims of holders of preferred stock are superior to the holders of common stock.*
** *Convertibles are securities that are initially issued as commercial papers, bonds, or preferred stocks that are convertible to shares of the issuing company's common stock.*

The difference between the money market and the capital market lies in the maturities of the instruments traded. Short-term securities (usually with maturities of up to one year) are traded in the money market while long-term securities (usually with maturities of over one year) are traded in the capital market. Since mortgage backed securities are securitized from a pool of mortgage loans, this instrument is traded in the capital market.

Government Securities

Treasury securities represent a dominant and growing component of the fixed income securities market, with Treasury bills (58%) comprising the single largest market for debt instruments in the Philippines. This market for the T-bills comprises the primary and secondary markets for 91-, 180-, and 364-day T-bills, as well as shorter-maturity cash management bills issued by the Treasury in the event of unusually tight monetary conditions. The national government finances its temporary cash gaps in its operations and for budget deficits by issuing treasury securities[11]. As a result of the chronic budget deficits, a significant proportion of proceeds from treasury issues go to refinancing of the government's maturing debts.

[11] Saldana, Cesar G. Development of the Government Bond Markets in the Philippines. Asian Development Bank. March 2000. Manila, Philippines.

In an effort to develop the capital market, the national government started issuing floating-rate Treasury notes (FRTNs) in 1991 whose yields were set quarterly at a fixed spread over 91-day T-bills. The economic stability of the Southeast Asian region encouraged when the country achieved relative macroeconomic stability in 1992, the government was encouraged to standardize longer-maturity Treasury issues and to issue them more gradually lengthening the maturity profile of government debt.

The issuance of floating-rate Treasury notes paved the way for longer-term issues of fixed-rate Treasury notes (FXTNs), with 2-, 5-, 7-, 10-, and 20-year maturities, and, in turn, provided the basis for pricing longer-term private-sector debt. The government hopes to increase the liquidity of the market for long-term government securities by further standardizing the tenor and regularity of issues.

Issuance. The Bureau of Treasury (BTr)[12] sells the Treasury bills via a weekly Swiss auction to 45 primary government securities eligible dealers (GSED), who bid competitively for the issues. The auction is electronic to allow for transparency, speed in handling large-scale issues averaging P15 Billion ($230 Million) a week, and the ability to secure competitive, market-determined yields. The Bureau of Treasury issues securities through either competitive or non-competitive bids. Competitive bids use the electronic auction while electronic bids use either the Over-the-Counter (OTC)[13] or tap method. Prior to the auction, a committee comprising representatives of the Bureau of Treasury, the Department of Finance (DoF), and the Bangko Sentral ng Pilipinas[14] (BSP) meet to consider the government's financing needs and agree on the amount of securities to be offered. Under the Swiss auction system of competitive bidding, bids tendered by the dealers are ranked according to their yield, from the highest to lowest. The committee accepts the bids, which offer the lowest yields, and the total volume of awards is subject to the amounts that meet the required volume of financing. However, current rules allow the Auction Committee to accept or reject any, or part of, or all of the tenders (i.e. The committee can award less than the offer or reject all bids).

Demand. There are three major investors in government securities, namely the investors, commercial and thrift banks, and the Bangko Sentral ng Pilipinas (BSP). The Bangko Sentral holds the government

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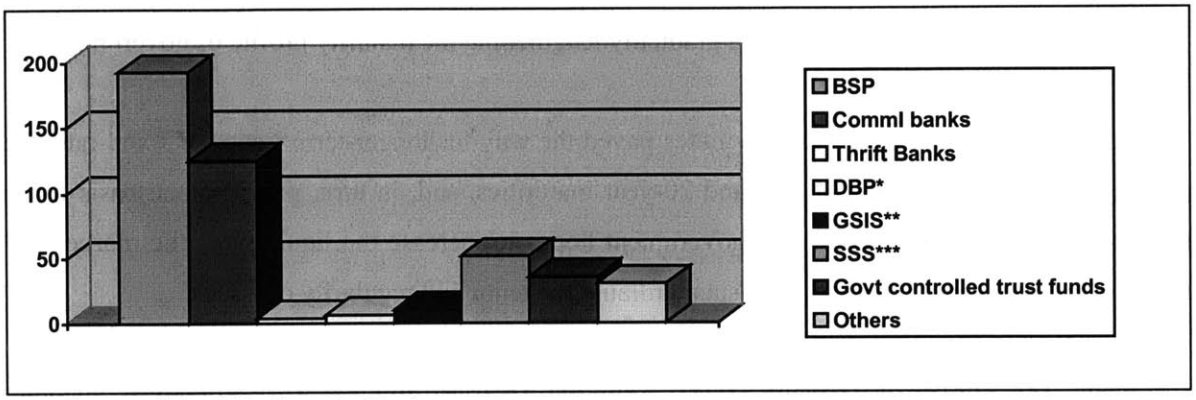
[12] The Bureau of Treasury is an attached agency of the Department of Finance (DoF). The Bureau of the Treasury's functions include (1) the auction of government securities and; (2) the accreditation and evaluation of government securities dealers.

[13] An OTC issuance occurs when the BTr negotiates an offering of securities to government owned and controlled corporations (GOCC), tax-exempt institutions and local government units (LGU). This is tantamount to a negotiated sale of treasury securities to government institutions for possible conversion of T-bills, as they mature, to T-bonds.

[14] Central Bank of the Philippines

securities as part of its open market operations. Meanwhile, the banks hold government securities are part of their statutory liquidity reserves and for their trading accounts. Investors are government contractual savings institutions and non-bank private investors.

Composition of Holders of Government Domestic Securities as of 1998 (in Billion Pesos)



Source: Asian Development Bank

* *DBP = Development Bank of the Philippines*
** *GSIS = Government Service Insurance Corporation*
*** *SSS = Social Security System*

T-bills have often been oversubscribed[15] because of the lack of acceptable private investment channels coupled with the flight to quality riskless assets that commonly characterize periods of economic uncertainty, similar to the Asian regional financial crisis. Investor demand shifted away from riskier private investments and channeled their funds into riskless government securities instruments, while lower-tier firms resorted to borrowing solely from short-term bank lending[16].

[15] Oversubscribed T-bills occur when winning bids are substantially less in volume than the bids tendered.
[16] Reside, Renato S. Mortgage-Backed Securities in Asia. Asian Development Bank. 1999. Pasig City, Philippines.

Corporate Debt Securities

Corporate debt securities have always been insignificant in size as private companies have relied on bank loans for short-term financing. As of 1998, the total corporate debt securities consisted mostly of long-term commercial papers, and were equivalent to only 3.3% of the outstanding loans to companies by commercial banks[17].

Companies issue debt securities under the Revised Securities Act (RSA), which is administered by the Securities and Exchange Commission (SEC). The objective of the Securities and Exchange Commission is to ensure that the potential investor has sufficient information to evaluate the issuer's underlying financial capacity to pay the interest and to redeem its debt securities. Thus, under the RSA, the SEC reviews whether the issue or the security has sufficiently disclosed its financial condition, credit standing and management aspects, and fulfillment of management requirements.

There are two main types of private money-market transactions – bank-related and corporate commercial-paper transactions. Bank-related money market transactions comprise the market for interbank call loans, promissory notes and repurchase agreements. Interbank call loans represent bank-to-bank lending of reserves. Repurchase agreements (repos) are short-term borrowings of banks against government securities of equal value. Commercial paper securities comprise both the short-term commercial paper (STCP) and the long-term commercial paper (LTCP), issued by blue-chip corporation to fund their business growth.

There was substantial growth in this small segment during the economic boom in the early 1990s, as commercial paper issuances, particularly from real estate development and construction companies, were growing in importance (relative to the stock market) among firms raising primary finance. However, the Asian regional currency crisis caused a decline in the private securities market because of the net redemption of commercial paper in this sector.

There is a dearth of Philippine bond issues because corporations prefer to issue commercial paper instead of bonds. Under the Philippine Corporate code, long-term bond issues require approval by at least two-thirds majority of the corporation's shareholders, while commercial paper issues merely require the consent of the board of directors. Nonetheless, long-term commercial paper, which has a term to maturity

[17] Saldana, Cesar G. Development of the Government Bond Markets in the Philippines. Asian Development Bank. March 2000. Manila, Philippines.

of 3 to 5 years, is nevertheless considered a de facto bond in the Philippines. Short-term commercial papers is usually issued by finance companies because their businesses require them to raise short-term funds for re-lending at longer terms and for maintaining liquidity. However, due to the Asian currency crisis, the supply of long-term commercial paper and the corresponding investor demand for such instruments disappeared because of economic uncertainty.

Sale of Long-term commercial paper from 1992 to 1st Quarter 1998 (Million pesos)

Year	No. of Issues	Total Amount Sold
1992	14	6,693
1993	3	1,300
1994	8	9,700
1995	10	13,725
1996	15	34,300
1997	5	5,000
1st Quarter 1998	0	0

Source: Securities Exchange Commission (SEC); Asian Development Bank (ADB)

Issuance. Private money or capital market issues may be sold through a public offering or private placement. After registration with the Securities and Exchange Commission (SEC), the lead underwriter distributes the commercial paper or the long-term commercial paper through a network of brokers and dealers. Presently, there is no central clearing and depository for corporate debt securities. The underwriter keeps the security and underwriting agreement and allocates the commercial paper to the dealers. In turn, the dealers sell the commercial paper by issuing "certificates of participation" (CoP) in the issue to the investors. The dealer cannot sell the commercial paper outright because the investor usually prefers a term to maturity that is shorter than the term of the original maturity.

The dealer may issue a Certificate of Participation with or without recourse. A Certificate of Participation with recourse means that it is not considered a deposit substitute, thus the dealer doesn't need to put up the required liquidity reserves. A Certificate of Participation without recourse means that the Certificate of Participation is backed up by the dealer's guarantee of payment in case of default by the issuer. In practice, a dealer may waive the "without recourse" term of the Certificate of Participation and pay for the dishonored Commercial paper.

The weaknesses in the structure for the primary corporate debt market are evident in such aspects as[18]:

[18] Saldana, Cesar G. Development of the Government Bond Markets in the Philippines. Asian Development Bank. March 2000. Manila, Philippines

1. Absence of a central clearing institution that can authoritatively validate (and, if necessary, guarantee) that Certificates of Participation are supported by an underlying debt security;
2. Settlement risks since the Certificates of Participation aren't tied to the validation of the underlying security and are done with different banks.
3. Absence of a central electronic trading system that can enable the dealers to view, in real time, not only their securities inventories but also he outstanding balance of their clients.

In the case of private placements, arrangers seek out the investors. Although regulatory approval is relatively faster versus public offering, because there are fewer investors, the sale can take longer to complete since negotiations take place with individual investors.

Demand. Investors in corporate securities are usually large contractual savings institutions (CSI) like the Social Security System, Government Service Insurance System, and AFP-RSBS[19], and the private insurance companies. Commercial banks and investment houses, through their money market departments, trade in the corporate bond market.

Secondary Fixed Income Securities Market

As can be gleaned from the primary fixed income market, the secondary market for fixed income securities is dominated by government securities with corporate securities capturing a small proportion of the potential secondary market.

Composition of Outstanding Bonds as of 1998

Instrument	Percent Control
Treasury bills	58.9%
Treasury notes/bonds	34.5%
Private corporate securities	6.6%

Source: Asian Development Bank

Government Securities

Trading. The secondary trading of government securities is generally liquid because of the large volume of securities that have been issued under each maturity to finance chronic budget deficits and the generally high demand from the private sector for risk-free short-term government securities.

[19] Armed Forces of the Philippines-Retirement Separation and Benefits System

The Bureau of Treasury's electronic trading system is used, and trades are recorded in the Registry of Scriptless Securities (RoSS). The process is as follows[20]:

1. Prospective purchasers (investors or dealers) request a government securities eligible dealer for a selling rate quote for a specific bill or bond[21]. An investor/dealer can get quotes from several government securities eligible dealers through the Dow Jones Market Network.
2. If the government securities eligible dealer has the requested securities in its inventory, then the dealer makes a sell quote based on the prospective investment amount and the prevailing market conditions.
3. Once the investor decides to purchase, the government securities eligible dealer closes the sale and issues a confirmation of sale to the investor. The dealer then sends an electronic instruction to Bureau of Treasury's Registry of Scriptless Securities to transfer the securities from an account under the securities client's name.
4. At the end of trading, the Registry of Scriptless Securities sends the government securities eligible dealer a statement, which contains the securities account balance.

The government securities eligible dealer usually gives a sell quote that achieves a target spread relative to its buying rate to be compensated for both holding on to an inventory of securities as well as its services as a dealer. During tight liquidity conditions, the eligible dealer often needs to sell a portion of its securities portfolio to raise cash at lower quotes, since it is based on a thin spread. According to Ymson, the spread is partly determined by the market's liquidity. During times of political instability, the spreads widened considerably[22]. Current accounting rules require that trading account securities be periodically revalued to current market values ("mark-to-market"), which affect the pricing of the securities in the secondary market.

Saldana, in his paper on Philippine bond markets, posits that the reason behind the high volume of trading in government securities is the common practice of banks to executing an "outright sale" of such securities to a buyer accompanied by a "side agreement" to repurchase the security at an agreed date. This practice allows dealers to avoid Documentary Stamp Taxes (DST) and liquidity reserve requirements

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[20] Saldana, Cesar G. Development of the Government Bond Markets in the Philippines. Asian Development Bank. March 2000. Manila, Philippines

[21] Philippine practice continues to use yield quoted for ease of comparison with interest rates on Certificates of Deposit (CD) (versus the universal of quoting debt securities at a price per unit of 100)

[22] Ymson, Luis, Jr. R. First Vice President of First Metro Investment Corporation. Personal Interview. August 2001. Makati City, Philippines.

for instruments that the Bangko Sentral considers deposit substitutes. This practice of "informal repos" allows banks to address asset-liability gaps, thus a substantial number of secondary trades at Registry of Scriptless Securities probably consisted of informal repos. These appear as outright sales twice when they shouldn't have been counted as a "secondary trade" at all, which implies that secondary trading data is likely to be overstated.

Clearing and Settlement. The Bureau of Treasury is the central clearing of all transactions through its Registry of Scriptless Securities. The outright sale/purchases require verification at the Registry as to whether or not the seller has sufficient balance (inventory) in its securities holder account. Upon the seller's authorization, the Registry transfers the security to the securities account of the buyer. Only securities dealers who are government securities eligible dealers can electronically confirm and authorize transfers with the Registry of Scriptless Securities.

Settlement of treasury securities is done through a "netting with same day" settlement. This involves offsetting the sell and buy transactions of each government securities eligible dealer at the end of each day and using only the net balance to adjust its deposit account with the *Bangko Sentral*[23]. The absence of an electronic link between the Bureau of Treasury and the *Bangko Sentral* impedes the real time settlement of secondary trades. To coordinate the settlement with *Bangko Sentral*, the Bureau of Treasury manually submits a document to the *Bangko Sentral* at the end of the day, which contains settlement information. The "netting system" is prone to settlement risks as there could be an "unwinding" of trades with the buyer if the buyer doesn't have sufficient funds to pay the net debit to his account. In the event that the seller has already transferred the security to the buyer, the seller can incur a loss. Despite the fact all parties can avoid a loss by "unwinding" the transaction, the "netting system" loses credibility. Moreover, "netting" allows government securities eligible dealers to engage in speculative transactions within the same day, especially when there are wide intra-day variations in interest rates.

Private Securities

Trading. Due to the lack of a structured mechanism for secondary trading, investors (including government securities eligible dealers) hold their privately issued debt securities until maturity. Thus, there is no real active secondary trading.

[23] Saldana, Cesar G. Development of the Government Bond Markets in the Philippines. Asian Development Bank. March 2000. Manila, Philippines.

The secondary market for commercial debt securities is an over-the-counter system with trades conducted through government securities eligible dealers and other licensed securities dealers[24]. The trading begins with the securities' underwriters, usually the independent investment houses and investment bank departments of universal banks. For both government and corporate securities, secondary transactions are usually one-way transactions to institutional investors such as insurance companies, pension funds, and treasury departments of commercial banks and industrial companies. There are only a limited number of individual investors in the debt securities market.

In August 2000, The Bankers Association of the Philippines (BAP) and the Investment Houses Association of the Philippines (IHAP) launched the secondary trading of commercial paper[25] to help investment houses to liquefy their holdings. The BAP and IHAP appointed Prebon Philippines Inc., an international foreign exchange broker, as the sole broker for the secondary trading of commercial papers. A sole broker was needed to provide a more transparent venue for the buying and selling of commercial paper and prevent unscrupulous investment houses from engaging in (reported cases of) fraudulent transactions such as double-selling of securities.

Clearing and Settlement. An over-the counter secondary market operates with the settlement done directly between the buyer and seller on a delivery-versus-payment (DvP) basis. There is no central clearing and settlement for secondary trading. Since there is a lack of a central clearing system, consequent risks arise due to the current practice of issuing certificates of participation. Moreover, since the settlement is not centralized, the costs are high. The Philippine Central Depository, Inc. (PCD), a private corporation, operates a computer-based depository system for the equities market called "FinTracs". The Capital Markets Development Council (CMDC) has determined that this system can be used for debt securities trading as well.

Obstacles to the Development of the Fixed Income Securities Market

The obstacles that prevent the development of the fixed income securities market are a) macroeconomic instability; b) absence of market makers who buy and sell securities with bid-offer spreads to provide the market with liquidity; c) lack of a reliable benchmark pricing mechanism; d) the taxation of financial intermediaries and transactions and; e) the separation of the clearing and settlement for government and corporate securities.

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[24] Ibid.
[25] Reyes, Carmina E. Secondary trading of commercial papers launched. Philippine Daily Inquirer. August 16, 2000. Manila, Philippines.

Macroeconomic instability

Macroeconomic stability is a fundamental requirement for the fixed income securities market. Thus, the development of the fixed income securities market hinges on dependent on sustained economic growth, low inflation and a credible fiscal policy and performance. This was evidenced prior to the 1997 regional financial crisis, wherein fiscal condition moved with GDP, which showed that macroeconomic growth and stability were integral to fiscal performance[26].

Despite the relatively developed nature of the Philippine bond market versus other Southeast Asian economies, its growth has been stunted by periods of macroeconomic instability, which spurred a flight to quality. In particular, investor demand shifted away from riskier private commercial debt instruments and into government debt instruments[27]. Thus, the restoration of macroeconomic stability should hopefully reduce the uncertainty and the consequent risks involved in purchasing long term commercial debt instruments, including MBSs.

Absence of market makers who buy and sell securities with bid-offer spreads to provide the market with liquidity

According to Saldana, the present primary fixed income securities market has no real market makers[28]. The Bureau of Treasury's present policy of an "open dealer" network has expanded the number of dealers, but unfortunately did not improve the competitiveness of dealer participation especially in the wake of unfavorable market conditions. The Bureau doesn't stringently enforce the market-making obligations of the government securities eligible dealers, which allow these dealers to enjoy the privileges of a dealer but not the obligations of one. This resulted in weak secondary markets and one-way trades to buy-and-hold investors.

The Banker Association of the Philippines (BAP), in conjunction with several financial agencies and organizations[29], had developed a trading and market making 'best practices' manual, in line with the development of the local financial structure to create an atmosphere for a "deep a liquid secondary

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[26] Saldana, Cesar G. Development of the Government Bond Markets in the Philippines. Asian Development Bank. March 2000. Manila, Philippines.
[27] Reside, Renato S. Mortgage-Backed Securities in Asia. Asian Development Bank. 1999. Pasig City, Philippines.
[28] Saldana, Cesar G. Development of the Government Bond Markets in the Philippines. Asian Development Bank. March 2000. Manila, Philippines.
[29] the Investment Houses of the Philippines (IHAP), the Bangko Sentral ng Pilipinas (Central Bank of the Philippines), the Investment Houses Association of the Philippines (IHAP), and the Trust Officers Association of the Philippines (TOAP).

market". Presumably, these manuals will be distributed to all local banks that would like to eventually sell their mortgage loans to a Secondary Mortgage Institution, or perhaps would like to securitize their own mortgages[30].

Lack of a reliable benchmark pricing mechanism

An efficient trading system that sets up benchmark prices for securities of various maturities and structures is integral to the development of a well-functioning primary and secondary fixed-income securities market[31]. A benchmark security is a government security of a certain term to maturity that is liquid enough so that it has a market-determined yield at any time. A benchmark yield curve is the schedule of yields generated by active trading of an entire set of benchmark government securities. The benchmark yield results from the two-way quotes and trades in the secondary market of government bonds with different remaining time periods to maturity[32].

Benchmarks are important because they help market participants to gauge their expectations of a) future interest rates, b) inflation, c) risk premiums, and d) to identify the portion of yields that correspond to default risk. Moreover, benchmarks help market participants hedge interest-rate risks more accurately. Since investors are exposed to several risks in connection with provision of credit, a long and well-defined market-based yield curve for riskless securities helps in developing a benchmark for pricing private securities of comparable maturity. The government has extended the maturity of T-bonds in an effort to develop a benchmark long-term yield curve. However, the effort has fallen short of achieving its goal since the secondary market has not been given priority. The primary markets appear to reflect the current market rates except when contrary signals are generated when auctions do not award the entire pre-announced offer to the winning bidders[33].

Since 1995, the government has adopted a bond issuance policy that was intended to create a benchmark yield curve. However, the benchmark yield can only develop with a two-way quote system and trades in the secondary market of benchmark bonds with different remaining time to maturity. The Bureau of Treasury has been issuing longer-term fixed-rate T-bonds (FRTNs) to lengthen the benchmark risk-free

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[30] Bankers Association of the Philippines. Market Reforms Project BAP Briefing to the Media. April 4, 2001. Makati City, Philippines.

[31] Ibid.

[32] Saldana, Cesar G. Development of the Government Bond Markets in the Philippines. Asian Development Bank. March 2000. Manila, Philippines.

[33] Saldana, Cesar G. Development of the Government Bond Markets in the Philippines. Asian Development Bank. March 2000. Manila, Philippines.

yield curve. In April 1997, the Bureau issued its first (and only) 20-year bond[34]. In November 2000, the Bureau issued a 25-year T-bond, which is the longest term to maturity issued by both government and corporations. Philippine laws limit long-term bonds to maturities of only 25 years. However, since current National Treasurer Sergio Edeza assumed office in February 2001, the Bureau of Treasury has purposely not issued bonds with maturities longer than 5 years. Edeza found the current 10-, 15- and 20-year Treasury bond yields to be too high, thus rendering the yield curve too steep[35].

Without a liquid market, wide gaps will exist between the yield of securities of different nominal term to maturities. A key constraint to liquidity is also the present issuance policy of spreading out issues among many different term to maturities and series[36]. The resulting structure of the outstanding securities is fragmented, which contributes to the problem of liquidity in the secondary market and, consequently, making it more difficult to build benchmark securities.

Mortgage loans in the Philippines are priced on the basis of T-bill yields. However, the basic problem with using T-bill rates to price loans in the primary mortgage market is the large mismatch in maturities since T-bills are short-term securities while mortgages are long-term securities. Nonetheless, the debt market continues uses the 91-day T-bill as the benchmark security for loan pricing. Furthermore, lack of liquidity and secondary trading of fixed-rate T-bonds has made the current market value of such securities uncertain, and the establishment of a true long-term yield curve even more difficult.

However, the 91-day T-bill doesn't always serve as an accurate benchmark security for pricing loans. A prime example of this occurred in the 1997 regional currency crisis when the financial markets were left in disarray. Bank treasurers said that the 91-day T-bill ceased to be a credible barometer against which loans were priced because they no longer reflected the real market sentiment in terms of interest rates. These sentiments were expressed as a result of the Bureau of Treasury keeping the yield of the 91-day T-bill "artificially low" through either lowering its offering or rejecting bids which it deemed too high, during the volatile exchange situation[37].

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34 Tirona, Jesus Michael A. Government to issue P6.2-B 20-year bonds this year. Businessworld Publishing Corporation. August 13, 1997. Makati City, Philippines.

35 Ymson, Luis, Jr. R. First Vice President of First Metro Investment Corporation. Personal Interview. August 2001. Makati City, Philippines.

36 Ibid.

37 Tirona, Jesus Michael A. Change in benchmark for interest rates urged. Businessworld Publishing Corporation. August 13, 1997. Manila, Philippines.

The private sector, through the Bankers Association of the Philippines (BAP) and/or the Financial Executives of the Philippines (FINEX), has proposed alternative benchmark yields for use in term instruments:

1. *Philippine Inter-bank offer rate* (PHIBOR). The PHIBOR, formed in early 1996, would reflect the rate at which banks would be willing to lend to each other for terms of one week to one year[38]. These lending rates would be based on accessible funding costs of banks, which would reflect differences in tax and reserve costs compared with other instruments. During the regional turmoil, banks strongly urged the 91-day T-bill to be shelved in favor of benchmark alternatives like the PHIBOR, but the BOT took a neutral stand on the issue, saying it is up to banks to decide how to price their loans[39].
2. *Philippine Interbank Reference Rate* (PHIREF). The PHIREF will be a "peso-interest rate benchmark" based on completed one-, two, three-, and six-month transactions in the peso-dollar swap market. This is similar to the PHIBOR, except that this is based on completed transactions. The PHIREF planned to capture all peso-dollar swap transactions electronically, the same way foreign exchange trades are captured in the Philippine Dealing System, the country's electronics currencies exchange[40].
3. *Secondary trading of 91-day T-bills*. Senen Matoto, president of the Financial Executives of the Philippines (FINEX) recommended benchmarking against the secondary 91-day T-bill, using a NASDAQ-style system to know what deals are being made with regard to the T-bill[41]. However, this requires that banks and dealers publicize their secondary transactions of 91-day T-bills. However, with the lack of data on secondary transactions, it will be difficult to convince issuers of financial instruments that the secondary 91-day T-bill is a credible benchmark.

Taxation of financial intermediaries and transactions

The primary fixed income securities market relies heavily on the potential of secondary trading. Thus, the taxes levied on the financial instruments constitute the biggest hindrance both for the development of the primary and secondary fixed income securities market. The current tax rules cause distortions in the yields of the capital markets, and consequently, create disincentives on the holding and trading of debt

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[38] Reside, Renato S. Mortgage-Backed Securities in Asia. Asian Development Bank. 1999. Pasig City, Philippines.
[39] Falgui, Raymond G. Benchmark rate up to banks – Treasury Businessworld Publishing Corporation. August 18, 1998. Manila, Philippines.
[40] Duplito, Ma. Salve I. BAP to create another benchmark for loans (91-day T-bill rate now'unacceptable' - BSP chief). Businessworld Publishing Corporation. September 3, 1999. Manila, Philippines.

securities. Taxes impact the relative yields of debt securities across different types and terms to maturity, relative to the equity securities and bank loans[42]. There are different types of taxes that are charged to debt securities:

Taxes on Long-Term Notes, Bonds and Debentures

Security	Tax on Issuance	Tax on Income generated in holding	Tax on Sale/Secondary Trading*
Public Bonds			
Documentary Stamp Tax	P0.30 per P200 (US$0.06 per US$3.77)	None	None
Withholding tax	None	20% final tax	None
Gross Receipts Tax	None	Graduated GRT taxes**	None
Income Tax	None	None	None
Private Bonds			
Documentary Stamp Tax	P0.30 per P200 (US$0.06 per US$3.77)	None	None
Withholding tax	None	20% final tax if considered deposit substitute	None
Gross Receipts Tax	None	Graduated GRT taxes**	None
Income Tax	None	None	32%***

Source: Asian Development Bank

* *Taxes on disposal/secondary trading are capital gains taxes*
** *Graduated Gross Receipts Taxes are as follows (as per Section 121 of Republic Act 9424)*
*** *Income tax rate is 32% effective January 1, 2000 as per Section 27 of Republic Act 8284.*

Graduated Gross Receipts Taxes

Short-term maturity (not more than 2 years)	5%
Medium-term maturity (over 2 years but not more than 4 years)	3%
Long-term maturity	
Over 4 years but not more than 7 years	1%
Over 7 years	0%

Income-related taxes. The income-related taxes are the final withholding tax of 20% of interest income and graduated gross receipts tax of 5% of interest income (for institutions). Bonds with a maturity over five years are exempt from income tax and the 20% withholding tax[43]. Withholding taxes and the gross receipts taxes are costs that financial intermediaries can choose to shoulder or pass on to the other parties in the financial transactions, which will discourage potential Mortgage-Backed Securities investors.

Capital gains tax.. Capital gains tax is 32% of net capital gains for corporate holders, and graduated rates for individuals except for those who hold bonds and certificates of indebtedness with a maturity of at least

[41] Matoto, Senen. President of the Financial Executives of the Philippines (FINEX). Personal Interview. June 2001. Makati City, Philippines.
[42] Saldana, Cesar G. Development of the Government Bond Markets in the Philippines. Asian Development Bank. March 2000. Manila, Philippines.
[43] Ruling 016-200 of the Bureau of Internal Revenue (BIR)

5 years. The capital gains tax on bonds is much higher versus the 0.5% transactions tax for the stocks traded in the Philippine Stock Exchange (PSE).

Documentary stamp tax (DST). The greatest obstacle to the development of the primary and secondary fixed income securities market is the documentary stamp tax on bonds and commercial papers. The documentary stamp tax acts as a "transaction cost" because it is levied for each issuance. In effect, the documentary stamp tax becomes a disincentive for trading fixed income securities, and instead, encourages a buy-and-hold policy[44].

Commercial banks could easily raise liquidity by issuing repurchase agreements versus its asset pool, but the documentary stamp tax serves as a disincentive[45]. The prohibitive cost of issuing repurchase agreements against government securities is the reason for the reportedly common practice of bankers to "sell" securities with an "informal arrangement" to buy back the same government security[46]. Secondary trading is NOT subject to the documentary stamp tax. Separation of the clearing and settlement for government and corporate securities.

There are still two parallel systems for clearing government securities and private commercial securities. The absence of an organized system for secondary trading of both government and private securities has forced market players to proxy the missing infrastructure on a bilateral basis[47]. In effect, market players needed to resort to individualized solutions, which are acceptable to both parties. This has resulted in "fragmentation", wherein there is a lack of a common standard in such processes as trading, which impedes the development of the market.

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[44] Saldana, Cesar G. Development of the Government Bond Markets in the Philippines. Asian Development Bank. March 2000. Manila, Philippines.

[45] For example, a bank with a weekly turnover of repurchase agreements pays the equivalent of 7.8% per year in documentary stamp tax (DST) alone. DST is computed as P0.30 per P200 or 0.15% per transaction. A week's average holding period would translate to 0.15% x 52 trades = 7.8% per year.

[46] Saldana, Cesar G. Development of the Government Bond Markets in the Philippines. Asian Development Bank. March 2000. Manila, Philippines.

[47] Bankers Association of the Philippines. Market Reforms Project Media Presentation. April 2001. Makati City, Philippines.

The Bankers Association of the Philippines (BAP) and the Investment Houses Association of the Philippines (IHAP) announced efforts to improve the system infrastructure for secondary trading of fixed income securities exchange before year end-2000. The fixed income exchange plans to use the delivery-versus-payment scheme versus ("netting the same day" settlement for government securities) for both government and corporate securities to avoid any notable fall-outs from settlement risk[48].

The fixed exchange will carry both corporate and government securities, and eventually asset-backed securities (including Mortgage-Backed securities), bank issues and fixed income funds. Moreover, as part of the Bankers Association of the Philippines (BAP)-led market reforms project, the expanded Philippine Dealing System (PDS) will allow additional bank-dealt products to be captured electronically and be viewed in the form of the Philippine Interbank Reference Rate (PHIREF) and the secondary trading of government securities. This is intended to increase trading efficiency, transparency, create the appropriate benchmarks, and allow the public to access critical information[49].

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[48] This refers to an incident of a secondary securities dealer called Bancapital Development Corporation that apparently sold the same government securities a number of times for future delivery, by issuing its own "confirmation of sale" documents.

[49] Bankers Association of the Philippines. Market Reforms Project Media Presentation. April 2001. Makati City, Philippines.

3 *OVERVIEW OF THE RESIDENTIAL REAL ESTATE MARKET*

Background

The number of housing units in the Philippines grew by 30% during the 1980s, and has since shown no signs of abating[50]. Prior to 1995, the growth rate for housing even accelerated as evidenced by the rise in applications for housing permits by 6.1%. Despite a slowdown in the real estate development due to the 1997 regional currency crisis, there have been signs that the residential market has started to pick up. As of 1999, the decline in ownership of dwellings is down by only 0.4%, versus a 23% in the same period from the previous year.

However, in spite of the rapid growth of units, there remains a significant unmet demand for additional and improved housing. The World Bank paints the following picture of the dire need for housing: Of the 11.4 million dwellings counted in the 1990 Census of Population and Housing, just under half had durable roofs and external walls, 6% had floor areas of less than 30 square meters, and occupancy rates were almost 97%, with a large number of households doubling up under one roof.[51]

As mentioned in Chapter 1, it is easy to see why the government perceives rightly housing as a social need: Approximately 35 to 40% of the 8 million population of Metro Manila do not own a house. A number of them live in unsanitary makeshift shanties, congested apartments and even dump sites. The large housing backlog not only leads to the rapid increase of informal settlers (or politically incorrectly referred to as slum or squatter colonies) but presumably a corollary increase in social issues as well[52].

To address the shortfalls in housing supply, particularly for the low- and middle-income families, the government instituted several socialized housing programs to produce, finance and ensure housing units and sites. Under the National Shelter Program (NSP), more than 500,000 units for low- and middle-income housing were built or financed with public support between 1992 and 1996[53]. However, there is still grave concern as to whether government-led efforts can keep up with the pace of ever-increasing housing demand. Or is it housing backlog? Or is it housing need? A fundamental problem the government faces in addressing the housing problem is, quite frankly, "getting their numbers right".

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[50] World Bank. Philippines Housing Finance: Reforming Public Provision and Promoting Private Participation. June 1997
[51] Ibid.
[52] Tan, Edward L. Real Estate in the Philippines. Solar Publishing Corporation. 1999. Manila, Philippines.
[53] World Bank. Philippines Housing Finance: Reforming Public Provision and Promoting Private Participation. June 1997

Housing Backlog

There have been conflicting estimates as to what constitutes the actual housing backlog. The Housing and Urban Development Coordinating Council (HUDCC) acknowledges that the housing statistics are in poor condition, as there is a need for government to clearly differentiate among effective housing demand from housing need and housing backlog[54]. The inability to deliver more realistic estimates of the total housing backlog presumably impedes the ability of policymakers, developers, and the housing agencies themselves from making sound government programs and business decisions. Developers have claimed that, due to the perceived huge demand, this has resulted in an oversupply of housing[55].

Presently, the housing agencies report that they measure housing demand in determining the housing backlog[56]. Earlier reported estimates from the government have pegged the number to be approximately 3.7 million new housing units, at least for the period of 1993 to 1998[57]. During the same period, renovation and upgrading of old housing units was placed at another 1.3 million units. Meanwhile, housing demand was expected to grow by 600,000 to 650,000 units annually[58].

For the period of 2000 to 2004, another report pegged housing "need" at 3.36 million units based on 100% household growth. Of the total housing need, more than 1.12 million make up the backlog[59]. To address this housing demand, the previous Estrada administration aimed to construct 350,000 housing units per year until 2004 or a total of 1.4 million new houses. However, the Housing and Urban Development Coordinating Council (HUDCC) figures indicate that the Estrada administration fell short of its target as it was able to provide only 274,727 shelter units from 1999 to October 2000.

However, in the October 1999 Philippine Conference on Securitization, the housing backlog was reported to be 800,000 to 1,000,000 units[60] (although it was not specified if this backlog was an annual period or

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[54] Ortille, Lucille. Deputy Secretary-General of the Housing and Urban Development Coordinating Council (HUDCC). Personal Interview. June 2001. Makati City, Philippines.

[55] Philippine Conference on Securitization. Mobilizing the Markets for Housing: The Case for Asset-Backed Securities. October 1999. Makati City, Philippines.

[56] Ibid. ff

[57] Llanto, Gilberto M., Aniceto Orbeta, Jr., Ma. Teresa C. Sanchez and Marie Christine G. Tang. A Study of Housing Subsidies in the Philippines. Philippine Institute for Development Studies. November 1998. Makati City, Philippines.

[58] STAT-USA on the Internet US Department of Commerce 1999

[59] Adversario, Patricia L. What ails the gov't socialized housing program. Businessworld Publishing Corporation. February 7, 2001, Manila, Philippines.

[60] In the minutes of the roundatable discussion of the 1999 Philippine Conference on Securitization, the Housing and Urban Development Coordinating Council retracted an earlier statement that the housing backlog was approximately 3 to 4 million units.

for the period of 1998 to 2004[61]). Yet, Colliers Jardine Research estimates that the housing "demand" at 1,730,898 from 1999 to 2004[62]. Meanwhile, the Chamber of Real Estate and Builders Association (CREBA), a private real estate development association, recently estimated the housing backlog for the country at 4.5 million units and growing[63].

Despite the discrepancy in estimates, let us assume that 800,000 to 1,000,000 are the estimate of the annual housing backlog. If so, the percentage breakdown of units is as follows:

Percentage breakdown of housing units

Location	Percentage
Metro Manila	24%
Provincial Cities	11%
Urbanizing Areas	44%
Rural Areas	21%

Source: HUDCC[64]

The impression communicated by the various projections for housing "backlog" appear to be target production-driven estimates versus utilizing other more "market-driven" housing production factors. The 1997 World Bank study on Housing Finance, four determinants were identified that influence demand[65], namely:

a) demographics;
b) affordability (a function of incomes, housing prices, and access to loans and subsidies);
c) acceptability (a function of tastes, construction designs, and the alternatives open to buyers) and;
d) security of tenure.

In the event that these determinants were used in estimating the housing backlog, then there would presumably be a year-to-year variance in the government's official projections, driven primarily by affordability and demographic considerations.

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61 The total housing 'backlog' is presumably computed based on the six-year presidential term. In this case, 1998 to 2004 was the presidential term of ousted President Estrada, who served a total of thirty months.

62 Colliers Jardine Research. Philippine Property Market. Colliers Jardine Philippines, Inc. 2000. Makati City, Philippines.

63 Gorayeb, Charlie V. National President of the Chamber of Real Estate and Builders Association (CREBA). CREBA national convention: GMA's 'healing mission'. Philstar.com. July 23, 2001. Manila, Philippines. The article doesn't specify from where CREBA generated their housing backlog estimates.

64 Housing and Urban Development Coordinating Council (HUDCC) estimates as reported to Edward L. Tan's book, "Real Estate in the Philippines". Percentages based on an estimate of roughly 3.8 Million units.

65 World Bank. Philippines Housing Finance: Reforming Public Provision and Promoting Private Participation. June 1997

Market Segmentation

The housing finance market in the Philippines is highly segmented. As a result of government policies on interest subsidies, the housing market has been divided into three distinct market segments based on loan sizes and the borrowers income levels[66].

Market Segmentation of Housing Finance by Income Level and Loan Size

Income Decile/s	Housing Category	Price Range	Interest Rate	Gov't programs
1-4	Socialized	Up to P150,000 (Up to US$2,830)	9% p.a. fixed	CMP *Abot-Kaya**
5-8	Low income	P150,000-P225,000 (US$2,830-US$4,240)	12% p.a. fixed	UHLP*/MWLS**
5-8	Low/Low-medium income	P225,000-P375,000 (US$4,240-US$7,070)	16% p.a. fixed (for 25 year loans)	UHLP*/MWLS**
5-8	Low-medium/Medium income	P375,000-P500,000 (US$7,070-US$9,430)	17% p.a. (only from HDMF****)	HDMF****
8-10	Middle/Low-high income	P500,000-P800,000 ($9,430-$15,100)	Market Rates	Commercial banks
8-10	Middle-high income	P800,000-P1,000,000 (US$15,100-US$18,870)	Market Rates	Commercial banks
8-10	High income	P1,000,000 and above (US$18,870 and above)	Market Rates	Commercial Banks

Source: World Bank 1997, Real Estate in the Philippines

* *The Community Mortgage Program (CMP) is a low cost lending to organized beneficiaries for lot purchase and development for lot purchase development with interest support from the Abot-Kaya (Extending capacity), administered by the National Home Mortgage Finance Corporation (NHMFC).*
** *Unified Home Lending Program*
*** *Multi-Window Lending Scheme*
**** *Home Development Mutual Fund/Pag-Ibig (Love)*

The Housing and Urban Development Coordinating Council recently released an updated category classification for the income categories under the Home Development Mutual Fund (HDMF)/Pag-Ibig[67]:

HUDCC Market Segmentation by Loan Size

Income Decile	Category	Price Range	Interest Rate
1-4	Socialized Housing	P180,000 and below	9%
5-8	Economic Housing	P180,000 to P500,000	12%
8-10	Middle Housing	P500,000 to P2,000,000	16%/18% p.a.*
8-10	Open Housing	P2,000,000 to P5,000,000	18% p.a.*

Source: Home Development Mutual Fund (HDMF)/Pag-Ibig, author's estimates

[66] World Bank. Philippines Housing Finance: Reforming Public Provision and Promoting Private Participation. June 1997

[67] Home Development Mutual Fund (HDMF)/Pag-Ibig Circular 187. Implementing Guidelines of the Pag-Ibig Housing Loan Program for Middle-Income and Overseas Pag-Ibig Members. 2001. Makati City, Philippines.

** Available to HDMF/Pag-Ibig members only. If the loan is repaid via salary deduction scheme where the employer shall guarantee collection of the amortizations due on the housing loan, the loan shall bear an interest rate of 14% p.a. for the entire term of the loan*

However, the previous category classification for income categories, which were used for the Unified Home Lending program, was as follows:

Interest Rates under the UHLP

Loan Tier	Category	Yearly Interest Rate (for life of loan)
Up to P150,000	Socialized housing	9%
Over P150,000 – P225,000	Low Income housing	12%
Over P225,000 – P375,000	Low Income housing	16%
Over P375,000 – P500,000*	Low Income housing	17%*

**Loan bracket amount only applicable for Pag-Ibig.*
Source: Asian Development Bank

The following are the income deciles in the Philippines:

Average Income of Families by Decile in Current 1998 Prices

Decile	Current Income per year	Income Group*
1	P23,449 (US$440)	Very low income
2	P35,261 (US$660)	Very low income
3	P44,094 (US$830)	Very low income
4	P55,108 (US$1,000)	Very low income
5	P67,537 ($1,270)	Low income
6	P83,331 ($1,570)	Low income
7	P105,201 (US$1,980)	Low to middle income
8	P138,430 (US$2,600)	Middle income
9	P192,466 (US$3,630)	Middle to high income
10	P423,953 (US$8,000)	High income

Source: 1997 Family Income and Expenditures Survey; 1998 Annual Poverty Indicator Survey. Author's estimates

Sources of Home Financing

Overview

The prospective homebuyer has two basic sources of financing to pay the owner/developer for the house/house and lot: from government housing/sub-housing agencies or from private commercial banks/private financing. However, middle-income homebuyers have had the option of borrowing from both the government housing agencies and commercial banks.

Sources of Home Financing

Government	Private
GSIS HDMF/Pag-Ibig SSS	Private banks Commercial banks Private financial institutions Relatives (i.e. Overseas/Expatriate Filipino workers) Personal resources Housing cooperatives Private company loans In-house developer loans

Source: Real Estate in the Philippines

The Philippine economy, including home financing and residential development, was perilously dragged down in last quarter of 2000 due to an illegal gambling scandal involving ousted President Joseph Estrada[68]. This was reflected in the decrease of the licenses to sell (LTS)[69], where in the Housing and Land Use Regulatory Board (HLURB) reported issuing 139,989 licenses to sell, which was a 16.3% decline versus the previous year. The decline was more pronounced in Metropolitan Manila, with only 13,298 licenses to sell issued, a 36.2% decline versus the previous year. The impact of the illegal gambling scandal, and the subsequent impeachment case against the President, that not a single license was submitted for approval in December for Metropolitan Manila[70].

Housing and Land Use Regulatory Board (HLURB) License to Sell

Units	2000	1999	Percent Change
Socializes Housing	23,502	30,482	(22.9%)
Low cost Housing	13,926	14,228	(2.1%)
Middle Income Housing	26,695	27,731	(3.7%)
High Rise Residential	2,631	4,788	(45.1%)

Source: Colliers Jardine Research

In reference to the market segmentation, these are the sources of home financing available to each income segment:

Socialized and Low Income-Housing

Overview. The Chamber of Real Estate and Builders Association (CREBA) has estimated that low-income housing will grow at 5% per year. The socialized and low-income housing rely primarily on government housing agencies for home financing. The lowest income households are part of the "socialized housing" market. The low-cost housing market was originally governed by Executive Order (EO) 90, which was signed into law in 1986. This established the Unified Home Lending Program (UHLP), which created the present system of housing finance in the Philippines. Under the system that

[68] Former President Joseph Estrada was accused by former confidante and erstwhile Ex-Governor Luis "Chavit" Singson of being on the take for jueteng, an illegal numbers game. This led to an eventual impeachment trial in October 2000, and Estrada's hasty resignation on January 2001.
[69] Number of transactions.

existed from 1986 to 1996, public contractual savings institutions such as the Social Security System (SSS), Government Service Insurance System (GSIS), and the Home Development Mutual Fund (HDMF)/Pag-ibig agreed to set aside a portion of their annual investable reserves to be lent to the National Home Mortgage Finance Corporation (NHMFC)[71], which was designated as the sole "take out window". Under what was dubbed a "formula lending" approach, property developers originated the housing loans from borrowers and then submitted the mortgage papers to the National Home Mortgage Finance Corporation (NHMFC) for take out. However, the Unified Home Lending Program (UHLP) was eventually deemed to be unsustainable due to:

- poor underwriting guidelines;
- moral hazard of allowing developers to originate loans;
- sloppy accounting guidelines and poor collection efficiency and;
- unsustainability of the interest rate subsidies

(These issues are discussed in-depth in Chapter 4). When the National Home Mortgage Finance Corporation (NHMFC) was relegated to a mere collection agency for its delinquent loans, the Home Development Mutual Fund (HDMF)/Pag-Ibig took over as the sole "lending window". However, developer groups complained of the stricter guidelines imposed by the HDMF/Pag-Ibig, as developers were no longer allowed to originate the loans.

The current Arroyo administration carries out a Multi-Window Lending Scheme (MWLS), where government financial institutions[72] engage in institutional lending to accredited-private banks for low-income borrowers. However, it has been reported that loan availability has been generally low under the MWLS, presumably due to the tight credit policies that the banks continue to maintain as a result of the currency crisis[73]. Since the banks are in charge of the collection efforts, they approve the housing projects before the government financial institutions can provide financing.

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[70] Colliers Jardine Research. Philippine Property Market. Colliers Jardine Philippines, Inc. 2000. Makati City, Philippines.

[71] The National Home Mortgage Finance Corporation (NHMFC), via legislation, was intended to be the future Secondary Mortgage Institution (SMI) through accumulating a critical mass of mortgage loans for eventual securitization. However, in an effort to 'speed up' lending, the NHMFC was made to do primary mortgage lending, a function it was not 'built' to perform.

[72] Contractual savings institutions such as the Government Service Insurance System (GSIS), Social Security System (SSS), Home Development Mutual Fund (HDMF)/Pag-Ibig and government owned and controlled financial institutions such as the Land Bank of the Philippines (LBP), Development Bank of the Philippines (DBP), and the Philippine National Bank (PNB).

The private sector does not generally lend to the socialized and low-income sector because they cannot compete against the fixed interest rates offered by the government financial institutions. Furthermore, the administrative costs of lending to low cost housing are the same as the costs of lending to middle income housing. Given the larger profits generated from middle-income housing, commercial banks have a lending bias for this sector[74].

Loan types. The terms for the loans generated under the National Home Mortgage Finance Corporation (NHMFC) included fixed interest rates, longer maturity periods, and higher loan-to-value ratios (sometimes 90% and even up to 100%). These comprise the "informal settlers" who receive loans of up to P80,000 ($1,500) at 6% to 9% fixed interest rates under the Community Mortgage Program (CMP). Low-income clients who receive socialized housing loans under the Multi Window Lending Scheme (MWLS) receive loans of up to P180,000 (US$3,400) at 9% to 12% fixed interest rates[75]. The market segment of loans from P150,000 to P375,000 (US$2,830-US$7,070) is referred to as "economic housing". Loans at these low-middle income segments are at 12% to 16% fixed income rates.

Loans above P375,000 (US$7,070) no longer quality for interest subsidies. However, in the event that the loan is originated by commercial banks, the loan carries Home Guaranty Corporation (HGC) guaranty that confers an implicit subsidy, through under-pricing the guarantee and a tax break to lenders[76]. On top of that, the Government Service Insurance System (GSIS) and the Home Development Mutual Fund (HDMF)/*Pag-Ibig* have in-house programs that make loans above P375,000 (US$7,070) available to members at 17% to 18% fixed-interest rates loans for 25 years[77].

Under the brief, but progressive, term of Karina Constantino-David, former chairperson of the Housing and Urban Development Coordinating Council (HUDCC), the government adopted market-oriented interest rates (versus subsidized interest rates) to entice the private sector to lend to the low income

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[73] Businessworld Publishing Corporation. SS housing loan availments drop despite bigger budget. September 12, 2000.
[74] Jacob, Monico. Former Home Development Mutual Fund (HDMF)/Pag-Ibig Chairman and Conference Chairman of the Philippine Conference on Securitization. *Personal Interview*. June 2001. Makati City, Philippines.
[75] According to the World Bank, as of April 1996, the maximum loan size for "socialized housing" under the Unified Home Lending Program (UHLP) are P180,000 (US$3,400) in Metropolitan Manila and other key provincial cities, and P150,000 (US$2,830) elsewhere. The first P150,000 (US$2,830) of all socialized housing are at 9% fixed rate, with any excess over P180,000 (US$3,400) at 12% fixed rate.
[76] This will be covered under the discussion of credit guarantees in the succeeding chapter.
[77] Commercial banks do not like to assume the liquidity and interest rate risks on loans for these term-to-maturities.

sector[78]. However, pressure from developer groups who had benefited from the Unified Home Lending Program (UHLP) versus these market-oriented polices resulted in a return to the "formula lending" and subsidized approach[79].

Obstacles to Private commercial bank lending. The private commercial banks have been wary of lending to the low income borrowers, at market rates, because of the perception that:

a) Low income borrowers have higher default rates (versus mid income borrowers)
b) Difficulty in collection efforts among low income borrowers and;
c) The government's lack of political will to foreclose on low income housing properties.

The perception that low income borrowers have higher default rates presumably stem from the high default rates for state-originated versus privately-originated mortgages. The default rate of the National Home Mortgage Finance Corporation (NHMFC) is 49%, versus the commercial bank's default rate of 3.1%[80]. However, the reason behind the high default rates among low-income borrowers was primarily driven by:

a) Poor underwriting guidelines[81] and;
b) Poor collection efficiency.

In effect, these mortgage loans were arguably perceived by low-income borrowers as government dole-outs. This further disincents the borrowers to make regular payments. Nonetheless, poor government policy has shaped private sector perception. Thus, the regional currency crisis and the subsequent contraction in mortgage lending limits[82] set by the *Bangko Sentral*, has put a credit squeeze on the low income housing market.

However, Coronel claims that it is a misperception that banks are not willing to lend to low cost housing. But he is careful to add that a) there must be an alignment of incentives among the developers and banks and the government to encourage the private sector to lend to low cost housing and; b) there must be an

[78] Under the Unified Home Lending Program (UHLP), commercial banks found it hard to compete versus public institutions because of the distortive interest rate subsidies of government loans.
[79] Llanto, Gilbert M. and Leilanie Q. Basilio. Housing Policy: Developing a Market-Based Housing Finance System. Philippine Institute of Development Studies. December 1999. Makati City, Philippines.
[80] World Bank. Philippines Housing Finance: Reforming Public Provision and Promoting Private Participation. June 1997.
[81] Above-standard loan to value ratios of 90% and even up to 100%.
[82] Banks are limited to a 20% exposure on real estate.

ACTUAL demand for the housing units that are built for the low cost housing sector. Coronel cites that the quality of certain previous low cost housing projects left much to be desired. Given this, he cites certain considerations prior to lending to low cost housing, such as a) the property must be livable, b) the location must be accessible by public transportation, and c) there must be livelihood projects within the low income housing community[83].

Moreover, private commercial banks are crowded out by government housing programs such as the Multi-Window Lending Scheme (MWLS)[84] because of a) the banks' reluctance to lend below a price threshold (i.e. P250,000/US$4,270); b) the subsidized interest rates which the banks cannot compete against and; c) the difficulty to match the current loan terms set by the public institutions (i.e. 5 years term-to-maturity for private banks vs. 25 years term-to-maturity for public institution). Thus, low-income homebuyers usually have no choice but to approach contractual savings institutions for home financing[85].

Middle Income Housing

Overview. The Chamber of Real Estate and Builders Association (CREBA) estimates that middle income housing will grow at 2% per year[86]. Alcid adds that there is still vibrant demand for the low middle-to-middle income-housing sector[87]. The middle-income market is usually the domain of private banks. However, some borrowers are able to finance their loans from both the public institutions and the private banks. In this case, 50% of the loans usually come from private banks, while the balance comes from the contractual savings institutions (CSI)[88].

These "second real estate mortgages" come in the form of in-house developer loans, wherein the buyer pays a portion of the down payment on installment terms to the developer for a certain number of years[89].

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[83] Coronel, Leonilo G. Executive Director of the Bankers Association of the Philippines. *Personal Interview.* June 2001. Makati City, Philippines.

[84] Llanto, Gilbert M. and Leilanie Q. Basilio. *Housing Policy: Developing a market-based housing finance system.* Philippine Institute of Development Studies. December 1999. Makati City, Philippines.

[85] Philippine Conference on Securitization. *Mobilizing the markets for housing: The Case for Asset-Backed Securities.* October 1999. Makati City, Philippines.

[86] According to Reside, author of Mortgage-Backed Securities Markets in the Philippines, this growth rate is generally consistent with household growth estimates obtained from the Philippine census and other independent sources.

[87] [87] Alcid, Andrew D. Executive Vice President, Investment Banking Division of United Coconut Planters Bank. *Personal Interview.* June 2001. Makati City, Philippines.

[88] Social Security System (SSS), Government Service Insurance System (GSIS), and the Home Development Mutual Fund (HDMF)/Pag-Ibig

[89] Tan, Edward L. Real Estate in the Philippines. Solar Publishing Corporation. 1999. Mandaluyong City, Philippines.

The rest of the contract price was loaned, previously, from the National Home Mortgage Finance Corporation (NHMFC) (and presumably from one of the various Government Financial Institutions (GFI) or their accredited banks under the Multi-Window Lending Scheme (MWLS)). Government loans will usually cover house and lot properties/condominiums up to P600,000 (US$11,320) (since the usual maximum loanable amount from the Home Development Mutual Fund (HDMF)/Pag-Ibig is P500,000 (US$9,430)) In this case, the down payment is approximately P100, 000 (US$1,890)[90].

Both real estate developers and real estate consultants believe in the strong upside potential of the middle-income housing sector[91]. Prior to the 1997 regional currency crisis, banks and developers had been taking advantage of the recent growth in purchasing power of middle-class Filipinos by stepping up the development of middle-class housing development. Property developers attract clients with creative in-house buyer financing schemes, such as staggered equity payments and direct credits by developers to home-buyers, while obtaining short-term bridge financing from banks for their own financing needs.

The demand for middle-income housing continues to grow as suburbanization pressures remain strong, particularly in the urbanizing areas south of Metropolitan Manila[92]. The mid-income segment appears to be in a recovery phase[93], after high interest rates and economic uncertainty during the 1997 regional currency crisis drastically decreased the demand for middle-income loans. Improved mortgage rates of roughly 13% in 2000, have made the home-purchase decision more palatable, versus the nearly 30% per year which occurred during the 1997 regional financial crisis[94].

House prices in middle-income estates started at P500,000 ($9,430), while the upper-middle-income segment started at P3 Million ($56,600). Well known high-end developers, such Ayala Land, have entered the mid-income housing segment, with an almost 100% sold ratio in their projects[95]. This can be partly attributed to banks, which have been reluctant to lend on real estate, in general, but favor lending in the form of residential mortgages to the middle-income bracket. This is further confirmed by the Bankers Association of the Philippines (BAP), as mortgage lending to this sector is considered "recession-

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90 A downpayment greater than P100,000 (US$1,890)would be difficult for regular Social Security System (SSS) and/or Home Development Mutual Fund (HDMF)/Pag-Ibig members to come up with.

91 Colliers Jardine Philippines. Philippines Report Residential Sector Update. March 2001. Makati City, Philippines.

92 Urban Land Institute. ULI Market Profiles 2000 Pacific Rim. 2000. Washington, D.C.

93 Colliers Jardine Philippines. Philippines Report Residential Sector Update. March 2001. Makati City, Philippines.

94 Urban Land Institute. ULI Market Profiles 2000 Pacific Rim. 2000. Washington, D.C.

95 These "pocket" residential developments (dubbed pocked developments because of their proximity to work coupled with the middle class affordability) range from P1.5 – P5 Million (US$28,300 – US$$94,300).

proof"[96]. "The last thing you will have is homeowners reneging on their loans," stated Leonilo Coronel, executive director of the BAP, "unless there is a deep-seated recession."

In 2000, the mid-income housing sector experienced the least decline, due to the presidential scandal and impeachment case, which only experienced 1 3.7% decline versus the other income housing segments. Colliers Jardine Research noted that there were nascent signs of recovery in the mid-income housing segment up to the third quarter of 2000, which were truncated by an abrupt hike in mortgage rates (12.6-21.0%)[97]

Sample Computation for Middle Income Housing

	Amount
Total Contract Price	P1,500,000
Down Payment (30%)	P450,000
Balance (70%)	P1,050,000
Loan Term	10 years
3rd Quarter 2000 Average Mortgage Rate	12.58%
Monthly Amortization	P15,418
Peak November 2000 Mortgage Rate	21.04%
Monthly Amortization	P21,022
Additional Mortgage Burden	P5,604

Source: Colliers Jardine Research

Loan types. Commercial bank residential mortgages are usually 15-year loans characterized by adjustable rates, with rates revised annually (and in some cases, semi-annually). The longest fixed rate period before resetting the loan is five years, at a premium of 400 basis points over the one-year adjustable rate mortgage (ARM)[98].

While the private commercial banks continue to finance this market, the government owned banks has since stopped because their allotted funds for the housing have dried up. Loan packages for middle income housing charge market rates and are domain of private banks. These private banks have variable interest rates and lower loan-to-value ratios (typically 60%). For Home Development Mutual Fund (HDMF)/*Pag-Ibig* members whose incomes fall under middle-income housing segment, they can borrow amounts ranging from P500,000 to P2,000,000 for a maximum term of 20 years, with a loan-to-value ratio of 70%.

[96] Coronel, Leonilo G. Executive Director of the Bankers Association of the Philippines. Personal Interview. June 2001. Makati City, Philippines.
[97] Colliers Jardine Research Philippine Property Market. Colliers Jardine Philippines, Inc. 2000. Makati City, Philippines.

High-Income Housing

Overview. High-income housing is primarily the domain of commercial banks. We have found no clear indicators as to the growth of the high-income sector in the Philippines. This is presumably because new upscale housing, such as high-end residential condominiums, are perceived as "investments", big-ticket spending items with a high price elasticity of demand, versus being actual residences. Thus, as a result of economic uncertainty and high interest rates, the demand for such housing has dramatically decreased. In fact, high-income housing exhibited the highest decline in terms of licenses to sell (45.1%)[99]. Other reasons cited for the decline in the high-income residential units, usually characterized by high-rise residential condominiums, were the increased competition from new supply which were depressing property prices, and a limited number of incoming expatriates[100].

High-end, high-rise residential and office buildings will take more time to recover[101]. In fact, high-rise property developers are facing serious cash flow problems, and some of them are even technically bankrupt[102]. Property developers in this segment, mostly dominated by large firms, borrowed heavily from abroad, issuing long-term bonds to finance their domestic expenditure, and are thus among the hardest hit in the regional financial crisis. To further compound matters, the high-income market has been saddled with a growing volume of inventories.

In 2000, developers were finding it difficult to dispose of residential condominiums, especially condominiums priced at P5,000,000 (US$94,300) per unit, particularly given the oversupply of luxury condominiums. For perspective, the high-rise residential condominium sector stock grew by an average of 12% per year as of end-1999, while vacancy rate was estimated at 12%. An immense supply is expected to come online in the luxury residential market, which is expected to push up vacancies to 20% at the end of 2001[103]. There have been reports that developers in the emerging Central Business District (CBD) areas were offering their condominiums at 20% to 30% discount from their price list[104]. Aside from offering discounted values, developers were luring in investors through creative in-house financing techniques.

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98 World Bank. Philippines Housing Finance: Reforming Public Provision and Promoting Private Participation. June 1997.
99 Colliers Jardine Research Philippine Property Market. Colliers Jardine Philippines, Inc. 2000. Makati City, Philippines.
100 Urban Land Institute. ULI Market Profiles 2000 Pacific Rim. 2000. Washington, D.C.
101 US Department of State FY2000 Country Commercial Guide.
102 STAT-USA on the Internet US Department of Commerce 1999
103 Urban Land Institute. ULI Market Profiles 2000 Pacific Rim. 2000. Washington, D.C.
104 Colliers Jardine Philippines. Philippine Property Market. Colliers Jardine Philippines, Inc. 2000. Makati City, Philippines.

The high-rise residential appears to be at the tail end of the down cycle, as capital values remain low from the supply overhang of residential condominiums[105]. Established high-end developers such Ayala Corporation, have reported a recovery in their high-end residential developments[106].

Loan types. Presumably, the loan types are similar in structure to middle-income housing. However, since most of the high-end developers are saddled with large inventories, almost all of their sales are driven by more flexible terms and in-house financing[107].

Residential Developer

Overview. In a developing country like the Philippines, the private sector plays an important role in property development, particularly due to the lack of government funding. It is quite noticeable that urban precincts which are developed and managed by corporations or by private consortiums succeed much better than others do[108]. Key to note as well, is that although most of the major real estate development companies in the Philippines are publicly listed, they are still primarily owned, controlled and managed by landed families[109].

Prior to the 1997 regional currency crisis, the business strategy employed by many development companies was to acquire large tracts of land and park them in their balance sheets over a period of time until they were 'ripe for development' (sometimes extending to twenty years)[110]. This strategy worked well initially for ten years prior because land values basically increased from next to nothing at the end of the Marcos era to exponentially high levels right before the crisis. As a result, "land banking" was not a problem because the rate of increase of land values was always greater than a company's cost of capital, thus creating value for the company. Thus, most real estate development companies had actively pursued a strategy of land banking based on speculative development or trading purposes. For perspective, the

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[105] Colliers Jardine Philippines. Philippines Report Residential Sector Update. March 2001. Makati City, Philippines.
[106] Colliers Jardine Philippines. Philippines Report Residential Sector Update. March 2001. Makati City, Philippines.
[107] Mortgage loans are paid to the developers directly, who in turn, discount their receivables for these luxuruy residential units with the commercial banks to generate liquidity.
[108] Cornelio-Pronove, Monique and Chemerie Cheng. Cities in the Pacific Rim Planning Systems and Property Markets. 1999. Makati City, Philippines.
[109] Among the more well known families are the *Zobel de Ayalas* (Ayala Land), the *Lopezes* (Rockwell Land Corporation), and the *Ortigases* (Philippine Realty). Key to note as well is that several of the large development companies are owned by ethnic Filipino-Chinese, which include SM Prime (*Henry Sy*). In fact, much of the earlier equity financing for these companies came from family-based fortunes that were made from other business ventures.
[110] Ladrido, Bonnie. Philippine Property Sector Analysis. BNP Prime Peregrine. 2000. Makati City, Philippines.

'rule of thumb' holding period for raw land is two years, which provides enough time to plan out the development and to obtain the necessary licenses.

However, after 1997, there has been a dramatic decline in companies purchasing raw land as developers are rechanneling funds to either complete developments or repay debts to commercial banks. Market data and economic trends now play a larger role in the developer's decision process to minimize speculation risk. Prior to this, developers would often aggressively proceed with residential developments buoyed by a "build it and it will come attitude". The research-oriented strategy pursued by larger companies such as Ayala Land, which purchases raw land and land banks based on an assessment of development potentials through market research[111].

Revenue. The primary profit driver of local real estate companies is development income[112]. As a result, the marked slowdown in the revenue of development companies is due to the drastic cut in development income. In fact, pure real estate development companies suffered the most due to the 1997 regional financial crisis because of little or no sources of recurring income.

Sources of development financing. Because of the difficulty developers have had in financing their projects, developers have been 'forced' into the role of financial engineers[113]. The inability of development companies to source financing from commercial banks have compelled developers to come up with creative financing schemes to continue with their projects, which has seriously affected their core competence of building houses. During the Philippine Conference on Securitization, developers voiced their support for mortgage-backed securitization to allow them to focus more on the efficient and cost-saving production methods for housing. Given these limitations, there are two primary means of raising development funds in the Philippines.

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[111] Cornelio-Pronove, Monique. Research Manager at Jones Lang LaSalle Philippines. Interview. April 2001, Makati City, Philippines.
[112] Ladrido, Bonnie. Philippine Property Sector Analysis. BNP Prime Peregrine. 2000. Makati City, Philippines.
[113] Philippine Conference on Securitization. Mobilizing the Market for Housing: The Case for Asset-Backed Securities. October 1999. Makati City, Philippines.

Debt Financing

Commercial bank financing. The main financing source for developers, prior to the 1997 currency crisis, was local commercial banks. During the economic 'boom years' (1993-1996), developers easily secured development financing[114]. However, due to the increased systemic risk in real estate, the *Bangko Sentral ng Pilipinas* (Central Bank of the Philippines) issued a circular in June 1997 setting a 20% regulatory limit on bank loans to the real estate sector. Meanwhile, all real estate loans could not exceed 30% of the bank's total loan portfolio[115].

Developers groups are claiming that the 20% cap on real estate has not yet been reached because it combines the developmental loans made to developers, foreclosed properties, and mortgage loans to homebuyers. Thus, developers are pushing that these loan types not be lumped together with the objective to free up debt financing for development[116].

Coronel appears to support the developers groups argument with regard to the overarching definition of the banks' real estate exposure. According to Coronel, the definition of real estate exposure should cover properties that generate cash flow. Given this, foreclosed properties as a result of *dacion et pago* (payment in kind – via property settlement), should not be considered as part of real estate exposure. If this definition held true, then Coronel believes that real estate exposure is well below 20%[117]. However, Limlingan says that given that the non-performing loans (NPLs) of the banks' real estate exposure lie with development loans and not with the mortgage loans, the banks' will be hesitant to lend to developers even if these loan types are segregated[118].

However, due to defaults from several property developers from speculative property acquisition/developments during the height of the currency crisis, banks non-performing loans increased dramatically. Presently, a lot of large developers are over leveraged[119]. Since then, local commercial banks have been very conservative and cautious, due to their large non-performing loans, composed

[114] Coronel, Leonilo G. Executive Director of the Bankers Association of the Philippines. *Personal Interview.* June 2001. Makati City, Philippines.
[115] Reside, Renato S. *Mortgage-Backed Securities in Asia.* Asian Development Bank. 1999. Pasig City, Philippines.
[116] Limlingan, Victor S. Professor at the Asian Institute of Management. *Personal Interview.* June 2001. Makati City, Philippines.
[117] Coronel, Leonilo G. Executive Director of the Bankers Association of the Philippines. *Personal Interview.* June 2001. Makati City, Philippines.
[118] Limlingan, Victor S. Professor at the Asian Institute of Management. *Personal Interview.* June 2001. Makati City, Philippines.
[119] Alcid, Andrew D. Executive Vice President, Investment Banking Division of United Coconut Planters Bank. *Personal Interview.* June 2001. Makati City, Philippines.

mostly of properties, and the large amount of properties they are reluctantly acquiring through "*dacion en pago*" cases. In effect, many banks have become larger land banks than most property developers[120]. According to Alcid, banks are hesitant to lend out financing for new development loans primarily because the current development loans in their portfolio have gone into default[121].

Before the crisis, a majority of the large developers also had foreign currency loans as international banks became active when the real estate market was strong. However, development companies suffered tremendously when the peso was devalued to 25% of its original value in 1998. A number of mid sized developers who availed of this loan have since gone bankrupt.

Although there is still development financing available, banks are more selective of the developers. Coronel claims that are certain developers that have built in stability into their cash flows that banks are willing to lend to[122], such as Megaworld and Ayala Land. For developers who are still able to avail of development financing, the arrangement is usually for the bank to purchase their mortgage loan receivables[123], at a discounted price, with recourse[124]. This effectively provides liquidity for developers to engage in new development projects. However, if the mortgage loan receivables have been sufficiently seasoned (i.e. 2 year period), the banks will purchase the receivables, at a discounted price, without recourse[125].

Other debt financing sources. Aside from commercial bank loans, developers also secured financing from insurance companies, international banks with local offices, and through floating long-term commercial papers. For property firms, the long-term commercial papers made sense due to the long gestation period of their projects. Some companies, such as Insular Life, Sun Life of Canada, and

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[120] Cornelio-Pronove, Monique. Research Manager at Jones Lang LaSalle Philippines. Interview. April 2001. Makati City, Philippines.

[121] Alcid, Andrew D. Executive Vice President, Investment Banking Division of United Coconut Planters Bank. *Personal Interview*. June 2001. Makati City, Philippines.

[122] Coronel, Leonilo G. Executive Director of the Bankers Association of the Philippines. *Personal Interview.* June 2001. Makati City, Philippines.

[123] Matoto, Senen L. President of the Investment Houses of the Philippines. *Personal Interview*. June 2001. Makati City, Philippines.

[124] In this case, recourse means that the developer retains ownership interest over the contracts-to-sell (CTS) that they discount with the bank, and thus are required to provide liquidity in the event that the a homebuyer defaults on the contract-to-sell (CTS). Contracts-to-sell (CTS) are discussed under financial instruments in the primary mortgage market in Chapter 5.

[125] In this case, without recourse means that the banks acquire complete ownership of the contract-to-sell (CTS) through an absolute deed of sale from the developer to the banks. Thus, the banks acquire all the risks, particularly the default risks, that were borne by the developer.

Citibank are involved in property development particularly for their own buildings, which they then strata-title[126].

Pre-selling. As mentioned earlier, developers often have to resort to creative in-house financing scheme, such as pre-selling, because of the difficulty in securing financing from private commercial banks. During the real estate economic boom in 1995, pre-selling was the key source of financing developers. Unlike Hong Kong and Singapore, there are no restrictions on the sales period. The market then was very speculative and the rule of thumb was for developers to start excavation upon receipt of around 40% of construction cost via pre-selling. Property ownership in the Philippines is characterized by long-term ownership by a developer or a joint venture partner. The pre-selling provided a more lucrative alternative versus costly bank financing. This development-funding scheme is a double-edged sword: the developers have greater latitude to defer or stop construction progress to reflect market conditions. However, they also run the risk of not delivering the 'finished goods' to clients at the promised date[127].

Equity Financing

Stock market. When the Philippine stock market was on an upswing (circa 1993), many estate companies with a small capital base went public to secure cheaper capital. Initially, real estate values increased tremendously as foreign institutional investors invested heavily in real estate stocks. However, in the later half of 2000, the Philippine stock market has not been performing well due to the political uncertainties (coupled with its gradual recovery from the crisis). Moreover, property investment has been very limited, if at all active, since the 1997 regional financial crisis[128].

Challenges faced by Developers. Developers have been unable to focus on their primary task of producing houses as they are saddled with several finance-related concerns.

a. 'Forced' social component for development.

Since the development of residential communities and condominiums fall under the Urban Development and Housing Act or Republic Act 7279, an area for socialized housing equivalent to 20% of the total gross area of the proposed project or 20% of the total project cost is required to be developed. This socialized housing component can be met by:

[126] Cornelio-Pronove, Monique. Research Manager at Jones Lang LaSalle Philippines. Interview. April 2001. Makati City, Philippines.
[127] Ibid.
[128] Ibid.

1. *New settlement.* The development of an entire 'new settlement' or a portion as certified by the National Housing Authority (NHA) of by the respective municipality.
2. *Slum upgrading.* The development, upgrading and improvement of a slum or blighted area to be certified by the NHA or the respective municipality.
3. *Community Mortgage Program.* The financing of the acquisition, development, and subdivision of an identified 'Community Mortgage Program' project duly accredited by the National Home Mortgage Finance Corporation (NHMFC).
4. *Joint Venture projects.* Entering into a joint venture project with the respective municipality or any housing agency to develop a socialized housing project where the developer's participation is equivalent to 20% of the project area or cost.

Arguably, this social component 'forces' the developer to take on an additional responsibility for a role that should lie primarily with the government.

b. High interest rate environment.

Prior to the regional currency crisis, the strength of the primary housing markets brought a concomitant rise in the provision of primary housing credit by the banking sector to all segments of the housing market. However, the Central Bank, alarmed at the increasing systemic risk in the housing sector, has attempted to control bank exposure by limited credit to this sector. Furthermore, the poor investment climate, due to the banks' negative experience in non-performing real estate loans and the political uncertainty, there is still a high interest rate environment which has discouraged developers to progress on either their stalled property developments or their land banked properties.

c. Low profit margins on low income housing units.

As far back as 1997, the World Bank paper on housing finance said that there was emerging evidence that it was increasingly difficult to construct dwellings that met the P150,000 (US$2,830) ceiling for the lowest subsidized interest rate group[129]. The reason behind the continued development under this housing category is related to the fiscal incentives allotted to the developer[130]. Land values are already included in the P150,000 (US$2,830) cap on housing, which has steadily risen to 50% (and higher) of the total value of the property. Interviews by the World Bank suggested that profit margins of 10%-20% are easily eroded either when contingencies or construction costs rise.

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[129] World Bank. Philippines Housing Finance: Reforming Public Provision and Promoting Private Participation. June 1997.

[130] The World Bank suggested that developers cut corners on secondary infrastructure (i.e. inadequate sewerage or electrification) and on construction (i.e. poor quality of concrete or piping for foundations and infrastructure) in ways that violated building codes. This was driven primarily by income tax exemptions for the construction of low-income homes that have been linked to a mortgage loan ceiling of P150,000 (US$2,830) since the late 1980s without being indexed. Thus, the combination of both rising construction costs and a fixed tax exemption ceiling has

Recently, an Australian-based manufacturer of non-traditional housing materials, James Hardie, claimed that it could construct socialized housing units worth P100,000 (US$1,890) each using Hardiflex, a proprietary technology which used fiber cement material to construct walls[131]. Although this would presumably be a boon to developers, it still does not address the issue or rising land values as a component of the P150,000 (US$2,830) price cap.

Developers Associations. There are two notable developers associations which have been able to influence government policy in the past with regard to housing finance, namely: the Chamber of Real Estate and Builders Associations (CREBA), and the Subdivision and Housing Developers Association (SHDA).

Chamber of Real Estate and Builders Association (CREBA)

CREBA is a private umbrella organization of various professionals in the real estate industry, which include builders, brokers, appraisers, manufacturers, suppliers, private funders, architects, and engineers, which number approximately 4,500. The Chamber of Real Estate and Brokers Associations (CREBA) actively lobbies for policies they believe will support the growth of the real estate industry. The Chamber has claimed that the government has failed to provide adequate incentives to developers in addressing the housing shortage[132]. In fact, the Chamber of Real Estate and Brokers Association (CREBA) CREBA, ran for three congressional seats in the recently concluded May 2001 elections under the party list system. Aside from running for a Congressional party-list seat, the Chamber has lobbied for the following policies in relation to housing finance:

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contributed to a steady deterioration of the size and quality of low-income homes. In 1997, newly constructed socialized housing was an average of 35% smaller versus ten years ago.

[131] Bandal, Desiree M. Housing material manufacturer sees potential in mass housing program. Businessworld Publishing Corporation. July 14, 2000. Makati City, Philippines.

[132] Junia, Catherine C. CREBA bats for P100-B seed fund for housing. Businessworld Publishing Corporation. May 9, 2001. Makati City, Philippines.

1. *The implementation of a Centralized Home Financing Program (CHLP),* a mass housing financing program developed by the Chamber of Real Estate and Builders Association (CREBA). Their program involves:
    a. Creation of a P100-billion permanent revolving seed fund from one-time lump-sum investments by the Social Security System (SSS), the Government Service Insurance System (GSIS), and the Home Development Mutual Fund (HDMF)/Pag-IBIG Fund;
    b. Subsidized and fixed interest rates for socialized housing over a period of 25 years;
    c. Cap on the interest rate spreads of 3% charged by banks on loans for socialized housing;
    d. Yearly securitization of the subsidized mortgage loans to ensure continuous funding.

The Chamber of Real Estate and Builders Association (CREBA)'s proposal will be covered in Chapter 5.

2. *Re-institutionalization of the Unified Home Lending Program (UHLP)*[133]. CREBA member companies had benefited from the failed Unified Home Lending Program. In the event that the government transitioned to the World Bank sponsored program (i.e., funding bias against non-socialized housing projects) there income streams were jeopardized[134]. On behalf of its members, CREBA complained that their member-developers were experiencing difficulty in obtaining take-outs from a) the Home Development Mutual Fund (HDMF)/*Pag-Ibig*, when it was the sole take-out window that replaced the National Home Mortgage Finance Corporation and b) presumably, the HDMF and the other Government Financial Institutions (GFI) through their accredited banks, under the current Multi-Window Lending Scheme (MWLS).
3. *Active lobbying against former Housing and Urban Development Coordinating Council (HUDCC) Chairperson Karina Constantino David's market-based housing finance program under the ousted Estrada administration*, which called for market-oriented interest rates (versus cross-subsidized interest rates[135]) to encourage private lending institutions to lend to the socialized and low income segments[136].

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[133] Aquino, Norman P. and Reena J. Villamor. CREBA seeks 3% limit on housing loan spreads. Businessworld Publishing Corporation.

[134] Tenorio, Arnold S. Housing program back to square one. Businessworld Publishing Corporation. February 8, 2001. Makati City, Philippines.

[135] Developers favored the cross-subsidy scheme under the Unified Home Lending Program (UHLP), wherein those paying higher interests at 12% or 16% would subsidize those paying the lower rate of 9%.

[136] Tenorio, Arnold S. Whereto for the Government's Housing Program: Overhaul of funding scheme may not sound good under new program. Businessworld Publishing Corporation. October 22, 1999. Makati City, Philippines.

The housing finance program of former Housing and Urban Development Coordinating Council (HUDCC) Chairperson will be discussed in Chapter 4.

Subdivision and Housing Developers Association (SHDA)

The Subdivision and Housing Developers Association (SHDA) is a private organization composed of registered national private subdivision and housing developers. The SHDA serves as the political lobbying arm of these developers with regard to issues affecting the real estate development and housing industry. Recently, the Subdivision and Housing Developers Association has worked closely with the Home Development Mutual Fund (HDMF)/*Pag-Ibig* to develop developer risk-sharing schemes with the provident housing fund agency:

1. *Implementation of the Developer Contract to Sell (CTS) Scheme*[137]. The scheme is a risk-sharing arrangement between the contractual savings institution (CSI)[138] and developer where the developer guarantees a 100% collection efficiency on its end-buyer accounts for the first 2 years of the loan repayment period in exchange for a more expedient take out of the loans. In June 2000, the Home Development Mutual Fund (HDMF)/*Pag-Ibig* issued Circular 182, which provided the release of loan proceeds to developers within seven working days and contained the rules governing the HDMF take-out window under the developer's contract to sell (CTS) financing scheme earlier worked out by SHDA with HDMF[139].
2. *Implementation of the Subdivision and Housing Developers Association (SHDA) Guaranty Fund*[140]. The SHDA guarantee fund serves to complement the Contract to Sell (CTS) scheme. The primary objective of the guaranty fund is to provide a stand-by back up guaranty protection to the Home Development Mutual Fund (HDMF)[141] and other contractual savings institutions in the event of failure on the part of any guaranteed developer to comply with their individual undertaking to buy back defaulting homebuyers loans within the first 2 years of the housing loan repayment period under the developer contract to sell (CTS) scheme.

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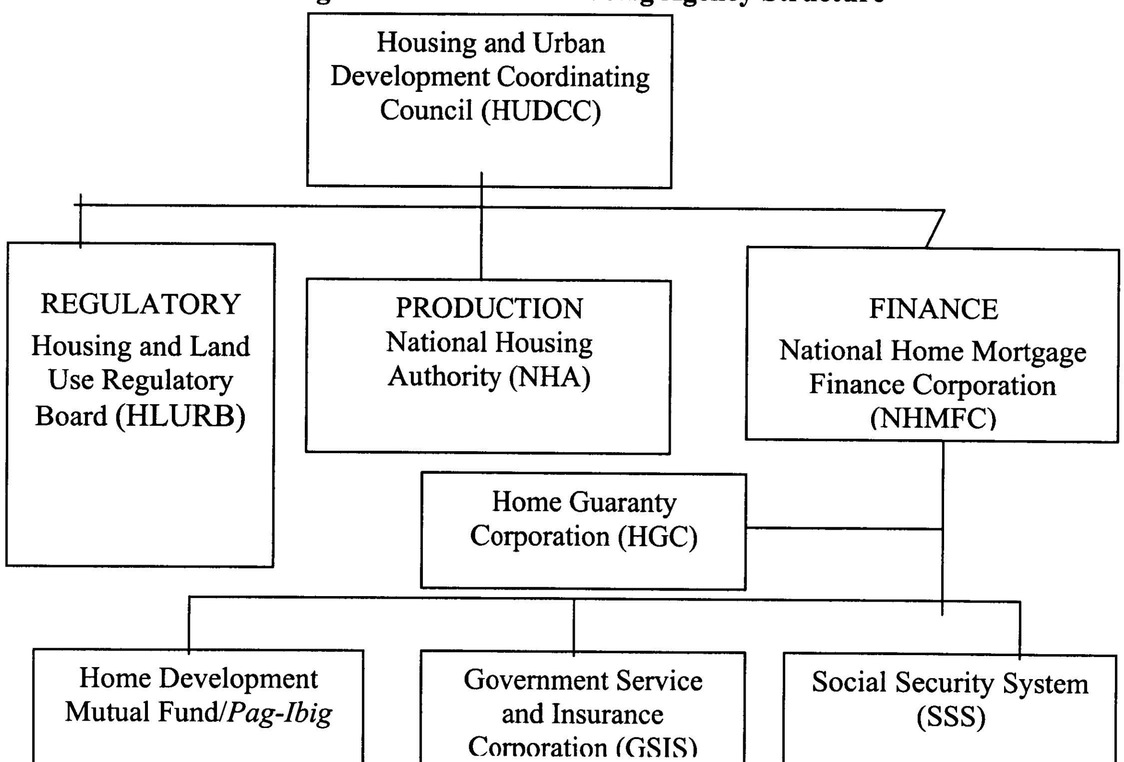
[137] Subdivision and Housing Developers Association. Concept Paper SHDA Guaranty Fund, Inc. December 2000. Makati City, Philippines.
[138] Government Service Insurance System (GSIS), Social Security System (SSS) and the Home Development Mutual Fund (HDMF)/Pag-Ibig
[139] Businessworld Publishing Corporation. Developers laud new home financing rule. June 27, 2000. Makati City, Philippines.
[140] Subdivision and Housing Developers Association. Concept Paper SHDA Guaranty Fund, Inc. December 2000. Makati City, Philippines.

[141] The Subdivision And Housing Developers Association (SHDA)is initially working with the Home Development Mutual Fund (HDMF) before expanding the schemes to the other contractual savings institutions.

Government Infrastructure

Overview. In a bid to rationalize housing finance and development, the then newly installed Aquino administration created *the Housing and Urban Development Coordinating Council* (HUDCC), through Executive Order 90, which was directly under the Office of the President (OP). The HUDCC was the highest policy-making body established to coordinate and monitor all government projects and agencies related to housing and urban development. The HUDCC is an umbrella organization of multisectoral representatives from the private and public sector.

Original Government Housing Agency Structure



Source: Real Estate Development in the Philippines

The Housing and Urban Development Coordinating Council is an umbrella organization of multi-sectoral representatives from the private and public sector. The public sector representatives come from:

a. The *contractual savings institutions* (i.e. Social Security System (SSS), Home Development Mutual Fund (HDMF)/Pag-Ibig, and the Government Service Insurance System (GSIS));
b. *Government housing agencies* (i.e. National Home Mortgage Finance Corporation (NHMFC), National Housing Authority (NHA), Housing and Land Use Regulatory Board (HLURB) and the Housing Guaranty Corporation (HGC)) and;

c. Various *government support agencies* (i.e. Department of Finance (DOF), National Economic and Development Agency (NEDA), Development Bank of the Philippines (DBP))

The private sector representatives come from the developers, banks, contractors, brokers, and low-income housing programs.

Housing sub-agencies. The two key relevant housing sub-agencies[142], with regard to the development of the secondary mortgage market are:

Agency	Original objective/thrusts	Current objective/thrusts
National Home Mortgage and Finance Corporation (NHMFC)	The NHMFC was ***originally envisioned to be the government's secondary mortgage institution, the equivalent to Fannie Mae.*** The NHMFC coordinates the activities of the three sub-agencies, which are the major sources of home mortgage funds. The three sub-agencies are the Social Security System (SSS), the Government Service Insurance System (GSIS), and the Home Development Mutual Fund (*Pag-Ibig*) Originally, the NHMFC was supposed to develop systems that would attract private institutional funds via securitization of long-term housing mortgages.	In 1996, the NHMFC was ***relegated to a mere collection agency for its delinquent accounts.*** The NHMFC continues to administer the Community Mortgage Program (CMP), the Social Housing Development Loan Program, and the *Abot-Kaya* Mortgage Program.
Home Guaranty Corporation (HGC)	The HGC was ***originally envisioned to be the explicit government guarantee for the NHMFC, similar to the United States' implicit government guarantee of Fannie Mae.*** The HGC processes loan applications and approves the release of money to applicants. It assists and encourages private developers and commercial lenders to develop and finance low and middle income mass housing through a system of guarantees, loan insurance and other incentives.	Aside from its previous mandate, the HGC has been vested with the mandate to "pursue the development of a secondary market for housing mortgages, bonds, debentures, notes, and securities."[143]

[142] The other two agencies are the Housing and Land Use Regulatory Board (HLURB) and the National Housing Authority (NHA). The HLURB is the sole regulatory body for housing and urban development. Its three main functions are: rules making, enforcement, and adjudication. These functions cut across three programs, namely real estate management, town planning and zoning assistance and review, and urban land reform. The NHA directly builds and sells housing units. It also assists in the lowest 10% of urban income earners through slum upgrading, squatter relocation. The NHA also provides technical assistance to private developers undertaking low-cost housing projects.

[143] Loosely interpreted, this could imply that Home Guaranty Corporation (HGC) could become an alternative Secondary Mortgage Institution (SMI) since the National Home Mortgage Finance Corporation (NHMFC) can no longer realistically pursue secondary mortgage market operations.

The Contractual Savings Institutions (CSI) which contribute to housing finance are:

Agency	Original objective/thrusts	Current objective/thrusts
Home Development Mutual Fund (HDMF)/*Pag-Ibig*	Pag-Ibig administers provident fund contributions collected from member employees and employers, utilizing funds not required for provident benefits for housing loans for members. Pag-Ibig is also charged with the development of savings schemes for home acquisition by private and government employees.	Same
Social Security System (SSS)	The SSS provides social safety nets through providential loans and other benefits to privately employed income earners. As of December 2000, the SSS had 26% of its investments in housing loans[144]. The agency, by mandate, directs its investments particularly towards low-income housing[145].	Same
Government Service Insurance System (GSIS)	The GSIS is the primary provider of funds for long-term individual real estate and mass housing loans for middle and low-income government employees, respectively[146].	Same

Key to note is that, in an ideal secondary housing mortgage market, *all these contractual savings institutions, with the exception of the Home Development Mutual Fund (HDMF)/Pag-Ibig, should be investing in Mortgage Backed Securities (MBS) instead of engaging in primary mortgage market operations* (i.e. lending to the homebuyer). Nonetheless, all these agencies were directed to use their funds for primary lending through: investing their funds in the National Home Mortgage Finance Corporation (NHMFC) under the Unified Home Lending Program (UHLP) or setting aside funds to be lent out through accredited banks for primary lending under the Multi-Window Lending Scheme (MWLS) (This will be discussed in later portions of the Chapter).

144 http://www.sss.gov.ph/

145 Section 26 of the Social Security Act of 1997 states that the SSS shall invest "(e) In bonds, securities, promissory notes or other evidence of indebtedness of shelter agencies of the National Government or financial intermediaries to finance housing loans of members; and in long-term direct individual or group housing loans giving priority to the low-income groups, up to a maximum of ninety percent (90%) of the appraised value of the properties to be mortgaged by the borrowers;"

146 http://www.gsis.gov.ph/vindex.html.

Housing finance agencies. The agencies involved in housing finance are the National Home Mortgage Finance Corporation (NHMFC), the Social Security System (SSS), the Government Service Insurance System (GSIS), and the Home Development Mutual Fund (HDMF)/*Pag-Ibig*. These agencies provide mortgage loans to low and middle-income borrowers. Prior to 1996, the NHMFC provided take-out funding to the public and private institutions using funds provided by GSIS, SSS and HDMF/*Pag-Ibig*. While previously channeling funds to the NHMC, the 3 contractual savings institutions (CSI) were also providing housing loans to their respective members[147].

Recent history. The brief term of ousted president Joseph Estrada was turbulent for the mass housing sector due to the lack of a clear government program[148]. The Estrada administration had initially set off on the right foot by attempting to reform the housing finance system to bring about stable and longer-term sources of financing. The president's first appointee as chairperson of the Housing and Urban Development Coordinating Council (HUDCC), Karina Constantino-David, made strides to reform the system by instituting tougher credit policies and market-oriented reforms which developers had to meet[149]. This had met stiff opposition from private developers groups, particularly the Chamber of Real Estate and Developers Association (CREBA)[150].

President Estrada buckled under pressure from the private sector and created a Presidential Commission on Mass Housing (PCMH), of which he appointed himself chairman[151]. In what appeared to be a major policy shifts, he effectively changed a previous plan that he himself launched, the Medium-Term Philippine Development Plan for Shelter (MTPDP-S), and duplicated the role and functions of the Housing and Urban Development Coordinating Council (HUDCC) tasked to oversee the housing program. This led to the resignation of Housing and Urban Development Coordinating Council (HUDCC) chief Karina Constantino-David. The new ambiguous thrust of Estrada's housing program was unclear,

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[147] Llanto, Gilberto M., Aniceto Orbeta, Jr., Ma. Teresa C. Sanchez and Marie Christine G. Tang. A Study of Housing Subsidies in the Philippines. Philippine Institute for Development Studies. November 1998. Makati City, Philippines.

[148] Ladrido, Bonnie. *Philippine Property Sector Analysis.* BNP Prime Peregrine. 2000. Makati City, Philippines.

[149] The policies under the term of former Chairperson Karina Constantino-David will be discussed under Government Housing Policy.

[150] The Chamber of Real Estate and Builders Associations (CREBA) were so opposed to former Chaiperson David's leadership that Manuel Serrano, founding chairman of CREBA, said "Anyone but Karina (David)." A Businessworld article entitled "Whereto for the Government's Housing Program: Overhaul of funding scheme may not sound good under new program" (October 22, 1999) claimed that developers from CREBA claimed that David stood in the way of their participation in the government's housing program. She allegedly dashed developers' hopes that the government would revive the Unified Home Lending Program (UHLP).

[151] In the media, he was known as "housing czar".

which resulted in a World Bank Loan meant to facilitate the implementation of the Medium Term Development Plan for Shelter (MTDP-S) to be put on hold.

The Presidential Commission on Mass Housing (PCMH) essentially grouped the government financial institutions (GFI) under one roof to supposedly make it easier to source funding for mass housing projects[152]. The PCMH got off to a rocky start when the president's appointed vice-chairman, Jose Luis "Sel" Yulo, turned out to have less than a desirable track record[153]. The resignation of the vice-chairman, after barely a month in office, set back the Estrada administration's mass housing program once more. The program that was eventually set up under the PCHM was *Pabahay sa Bagong Siglo* (Housing for the new Century), which appeared to be another Unified Home Lending Program (UHLP) under a new name[154].

Under the newly installed Arroyo administration, bold moves have been initiated to restore confidence in the government housing program. President Arroyo has since a) abolished the Presidential Commission on Mass Housing (PCMH)[155]; b) announced the replacement of the Housing and Urban Development Coordinating Council (HUDCC) with a Department of Housing[156], to be headed by the current Chairperson, Michael Defensor, and; c) re-initiated talks with the World Bank (WB) and the International Finance Corporation (IFC) to support a reinvigorated housing program[157].

The Arroyo administration has yet to reveal whether or not it plans to return to the original Medium Term Development Plan for Shelter (MTDP-S) that was in place in the earlier part of the Estrada administration, implement a revised version of the plan, or to embark in a new housing policy plan altogether.

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152 In a Businessworld article entitled, "Focus: A Secondary Market for Housing", former Finance Secretary Edgardo Espiritu had made statements tacitly admitting the need to continue former Housing and Urban Development Coordinating Council (HUDCC) chair's Karina Constantino-David's initiatives to pursue a market-oriented approach to housing finance, especially in light of the ballooning budget deficit.

153 In a Businessworld article entitled, "Whereto for the Government's Housing Program: Overhaul of funding scheme may not sound good under new program" the article referred to Yulo as 'portrayed as the Trojan horse of real estate developers, particularly the 4,000-strong construction industry organization Chamber of Real Estate and Builders' Associations Inc. (CREBA)'. Yulo enjoyed CREBA's support as he was a private developer himself who had interests in 10 realty companies. After his appointment as the new Presidential Adviser on Mass Housing and the resignation of Ms. David from the HUDCC, CREBA sent out paid advertisements and press releases congratulating Mr. Estrada for the creation of the PCMH, and "extend(ing) the glad hand of partnership" with Mr. Yulo as co-chairman of the commission.

154 Contractual savings institutions were again asked to put funds into housing finance that would be lent out at subsidized rates.

155 www.abs-cbnnews.com. Mass housing body abolished. July 18, 2001. Quezon City, Philippines.

156 www.abs-cbnnews.com. GMA set to create housing department. July 20, 2001. Quezon City, Philippines.

157 Philippine Star. March 5, 2001. Manila, Philippines.

Government Housing Policies

Overview. The National Shelter Program (NSP) was a program pursued by both the Aquino (1986-1992) and Ramos (1992-1998) Administrations that embodied the government's comprehensive strategy to address the housing problems of the Philippines. The NSP was based on three principles namely: a) reliance on the initiative and capability of the of beneficiaries to solve their housing problem with minimum assistance from the government; b) the use of the private sector as the principal player in providing decent and affordable housing and; c) the role of the government as enabler, facilitator and catalyst in the housing market. Although there will still be subsidies provided, they would be targeted to provide adequate housing facilities for the lowest 30% of the economic class[158].

The National Shelter Program (NSP) had 4 major programs: a) production of housing units; b) mortgages; c) development loans and; d) community programs. These programs targeted either direct end-beneficiaries/households or private developers/private commercial banks. The NSP invests the Housing and Urban Development Coordinating Council (HUDCC) with oversight responsibility over four major housing programs for low-income beneficiaries:

Low-Cost and Socialized Housing Programs

PROGRAM	DESCRIPTION
Resettlement	• Resettlement of families displaced by public infrastructure projects or Mt. Pinatubo eruption or in danger areas, managed by National Housing Authority (NHA) with minimal monthly payment for a 60-sq-m lot
Community Mortgage Program	• Low-cost lending by National Home Mortgage Finance Corporation (NHMFC) to organized groups of beneficiaries for lot purchase and development with interest support *from Abot-Kaya Pabahay* Fund.
Direct Housing Provision	• Direct financial assistance to target beneficiaries of National Shelter Program (NSP) who are Social Security System (SSS)/Government Service Insurance System (GSIS) and Home Development Mutual Fund (HDMF)/*Pag-ibig* members usually for purchase of lot and/or construction of new dwelling unit. • Unified Home Lending Program (UHLP) managed by National Home Mortgage Finance Corporation (NHMFC) from 1986 to 1996. The Expanded Home Lending Program (EHLP) managed by Home Development Mutual Fund (HDMF)/*Pag-Ibig* managed by Pag-Ibig from 1996 to 1999. The Multi-Window Lending Scheme (MWLS) managed by the contractual savings institutions (SSS, GSIS and HDMF), and the government financial institutions (Development Bank of the Philippines (DBP), Land Bank of the Philippines (LBP)) from 1999 to ongoing. • Regular Home Development Mutual Fund (HDMF)/ *Pag-ibig programs* • Special projects of the Housing and Urban Development Coordinating Council (HUDCC), Department of Public Waterworks and Highways (DPWH)
Indirect housing provision	• Mobilizes financing for shelter through direct developmental loans, local governments. • Home Guaranty Corporation (HGC) Guaranty Program (retail guaranty, developmental guaranty, mortgage-backed securization) • Home Development Mutual Fund (HDMF)/*Pag-ibig* (*Pag-ibig* programs, developmental loans local government *pabahay*, other housing-related loans)

Source: Asian Development Bank

The Housing and Urban Development Coordinating Council (HUDCC) has to meet annual housing targets based on estimated housing demand and supply. However, the satisfaction of targets for flawed programs revealed that the existing modes of housing finance to be unsustainable. Thus, this prompted the government in mid-1996 to commission a World Bank (WB) Study of potential reforms in the housing finance system. Initial studies that were released convinced the government of the need to sustain the socialized and low –cost housing finance system with more transparent, explicit, and time-bound budgetary transfers, and also to establish a more market-determined housing finance system for the middle income to upscale markets[159]. These study findings initially found its way into the Medium Term Development Plan for Shelter (MTDP-S).

Under the Estrada administration, the National Shelter Medium Term Development Plan for Shelter (MTDP-S) (1999-2004) was launched. The major policy thrusts of the MTDP-S were: a) situating shelter within the broader national urban policy framework wherein shelter is both a component of social policy and an instrument for economic growth; b) distinguishing between housing subsidy[160] and housing finance such that sources of housing subsidies are "on-budget" and kept separate from transactions in the housing market and; c) directing public resources to a ratio level of 80%/20% in favor of socialized housing[161]. Key to note is that the MTDP-S was a plan that was to have been funded by the World Bank to facilitate its implementation[162].

Unfortunately, in a major policy shift by the Estrada administration, the MTDP-S was apparently shelved with the creation of the Presidential Commission on Mass Housing (PCMH). In an Executive Order (EO) which created the PCMH, the EO stated that the PCMH was created "to fast-track the implementation of mass housing projects, stimulate economic activity, and provide for the needs of the poor." The new body's functions include formulating "the overall framework and implementation plan (to include targets and timetables) of the centerpiece program, including its components," and the "strategies and incentives to encourage private financial institutions to provide for the financial backbone."[163]

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159 Reside, Renato S. Mortgage-Backed Securities in Asia. Asian Development Bank. 1999. Pasig City, Philippines.

160 Subsidies are defined as "non-market, direct or indirect transfers of resources by the government to a particular sector. A common form of subsidy is an interest rate subsidy where the government provides housing funds that are lent at below market interest rates." (Philippine Institute of Development Studies (PIDS)).

161 Medium-Term Philippine Development Plan 1999-2004 Executive Summary.

162 Tenorio, Arnold S. Whereto for the Government's Housing Program: Overhaul of funding scheme may not sound good under new program. Businessworld Publishing Corporation. October 22, 1999.

163 The EO merely paralleled the tasks that the Housing and Urban Development Council (HUDCC) was already performing the same tasks have also been assigned to the HUDCC under the government's MTPDP-S, leading to what former HUDCC Chairperson David's resignation which cited "parallel structures" that "create confusion."

The de-facto government mass housing policy is the Multi-Window Lending Scheme (MWLS), a derivative of the Unified Home Lending Program (UHLP), which was a carryover from the Estrada administration[164]. Thus, we will initially discuss the UHLP, followed by the Medium Term Development Plan for Shelter (MTDP-S), a plan that was scrapped by the Estrada Administration, despite World Bank-support. We will conclude with a discussion of the Multi-Window Lending Scheme (MWLS).

Unified Home Lending Program (UHLP)

The UHLP is the homebuyers financing component of the National Shelter Program (NSP) which integrated the respective housing programs of the Social Security System (SSS), GSIS (Government Service Insurance System) and the Home Development Mutual Fund (HDMF)/*Pag-Ibig*. There are three levels of transactions[165]:

1. The SSS, GSIS and HDMF negotiate with the National Home Mortgage Finance Corporation (NHMFC) on an annual funding commitment to the Unified Home Lending Program (UHLP) based on their annual investible funds.
2. The NHMFC re-lends the funds to eligible homebuyers through accredited originators which include financial institutions, developers, and corporate employers. Prospective originators apply for a Purchase Commitment Line (PCL) with the NHMFC. Once the PCL is approved, the NHMFC will purchase up to the granted commitment line the mortgage deliveries of the originators following an agreed upon draw down schedule. Through this arrangement, the originators were able to undertake more housing projects because they were able to immediately swap cash for their mortgage investments. The mortgages taken out from the originators were then assigned to the funders.
3. The NHMFC collects from the borrowers their monthly loan payments which are then turned over to the funders. The NHMFC was obligated to pay the funders the yearly loan amortizations arising from the loan originations made by the private developers/banks, regardless of whether or not it collects from the borrowers. Thus, the whole lending, relending, mortgage take-out and loan repayment revolved around the NHMFC.

Loan terms. There were three loan packages offered under the Unified Home Lending Program (UHLP), with fixed interest rates and a maximum loan-to-maturity of 25 years.

[164] The Multi-Window lending system (MWLS) followed the unsuccessful Presidential Commission on Mass Housing (PCMH) program.
[165] Llanto, Gilberto M., Aniceto Orbeta, Jr., Ma. Teresa C. Sanchez and Marie Christine G. Tang. A Study of Housing Subsidies in the Philippines. Philippine Institute for Development Studies. November 1998. Makati City, Philippines.

Interest Rates under the Unified Home Lending Program (UHLP)

Loan Tier	Category	Interest Rate	Term-to-maturity
Up to P150,000 (US$2,830)	Socialized housing	9% p.a.	25 years
Over P150,000 (US$2,830) – P225,000 (US$4,250)	Low Income housing	12% p.a.	25 years
Over P225,000 (US$4,250) – P375,000 (US$7,080)	Low Income housing	16% p.a.	25 years
Over P375,000 (US$7,080)– P500,000 (US$9,430) *	Low Income housing	17% p.a.	25 years

**Loan bracket amount only applicable for Home Development Mutual Fund (HDMF)/Pag-Ibig.*

The interest rates were supposed to give the National Home Mortgage Finance Corporation (NHMFC) an average return of 12.25% to cover both its cost of funds and its administrative costs. The Unified Home Lending Program (UHLP) was designed to operate on the principle of cross-subsidization, wherein the borrowers of the higher loan packages would subsidize the buyers or the lowest loan package[166].

Origination guidelines. The National Home Mortgage Finance Corporation (NHMFC) did not have any initial contact with the borrowers because only the originators screened the borrowers. The NHMFC used a "formula lending" system where borrower eligibility was based solely on the borrower's monthly income, but no effort was made to determine the capacity to pay.

Gross Income Required for Loan

Loan Amount	Amortization + 5% origination fee[167]	Required Gross Income
P150,000 (US$2,830)	P1,321.73 (US$25)	P3,777.00 (US$71)
P225,000 (US$4,250)	P2,488.24 (US$47)	P7,110.00 (US$134)
P375,000 (US$7,080)	P5,350.63 (US$101)	P15,289.00 (US$288)

Source: Real Estate Development in the Philippines

The "formula lending" approach, used by the originators, would based the loan amount on the borrower's monthly income multiplied by 30, with monthly amortizations not to exceed 1/3 of his/her monthly income[168]. Key to note is that the loans made under the original Unified Home Lending Program (UHLP)

[166] Llanto, Gilberto M., Aniceto Orbeta, Jr., Ma. Teresa C. Sanchez and Marie Christine G. Tang. A Study of Housing Subsidies in the Philippines. Philippine Institute for Development Studies. November 1998. Makati City, Philippines.

[167] Under the Unified Home Lending Program (UHLP), the originators are allowed to charge a maximum origination fee of 2.5% of the loan amount. The origination cost to the borrower would be 5%, with the balance 2.5% going to the National Home Mortgage Finance Corporation (NHMFC).

[168] The UHLP allowed for a housing loan to be obtained based on the combined salary of the principal and the co-borrower if both are active members of the supporting agencies. For example, if a principal borrower wants to borrow P375,000 (US$7,080) but only has a salary of P10,000 (US$190) a month, he/she can *merely* have his wife or any relative of either party within the second degree of consanguinity or affinity to act as a co-borrower.

under the National Home Mortgage Finance Corporation (NHMFC) were not guaranteed by the Home Guaranty Corporation (HGC) because of the leniency of the "formula lending" policy[169].

In 1996, after the National Home Mortgage Finance Corporation (NHMFC)'s mortgage function was suspended and it was relegated to a mere collection agency for existing portfolio, the Home Development Mutual Fund (HDMF)/Pag-Ibig was assigned NHMFC's original take-out role until a new multi-window lending system could be put into place[170].

Medium Term Development Plan for Shelter (MTDP-S)

The Medium-Term Development Plan for Shelter (MTDP-S) was hailed as a breakthrough in housing finance in the Philippines as it moved away from a production-oriented mindset for the Housing and Urban Development Coordinating Council (HUDCC) towards a market/finance-oriented one[171]. Based on the plan, the government expected to have established by 2004 a housing program that had "a viable market-oriented housing finance system with sufficient sources of long-term mortgage finance."

Under the previous administration, the previous "formula lending" approach led to the bankruptcy of the government's housing program because of a) the inability to collect loan repayment; b) the unsustainable nature of lending practices, and c) an existing subsidy mechanism that led to substantial leakage of government support for the non-poor[172]. Crucial to reforming the finance system was the elimination of unsustainable lending policies and of an existing subsidy mechanism that led to substantial leakage of government support to the non-poor[173].

Under former Housing and Urban Development Coordinating Council (HUDCC) Chairperson Karina Constantino-David's leadership, the HUDCC redefined the government's role in the housing market via

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[169] In an interview with Arthur Tan, Vice-President of the Home Guaranty Corporation (HGC), the HGC had actually approved a guarantee facility for the National Home Mortgage Finance Corporation (NHMFC). However, the NHMFC could not avail of the guarantee because of the strict conditions.

[170] However, developers who found it easier to originate loans under the Unified Home Lending Program (UHLP) complained about the stricter rules, and consequently, the slowdown in takeout of Home Development Mutual Fund (HDMF)/Pag-Ibig loans.

[171] In an interview with Romeo Bernardo, former Finance undersecretary during the Ramos administration (1992-1998) said that the Housing and Urban Development Coordinating Council (HUDCC) and the Department of Finance (DOF) would often be at loggherheads because the HUDCC perceived housing as a production, not finance problem. "It didn't matter if the financing for their targeted number of houses was not sustainable," he said "They (HUDCC) would twist the arms of the pension funds and then get the money, without worriying if the collections were good."

[172] This will be discussed in more detail under the failures/shortcomings of Government Housing Policies.

[173] Tenorio, Arnold S. Housing program back to square one. Businessworld Publishing Corporation. February 8, 2001. Makati City, Philippines.

the Medium Term Development Plan for Shelter (MTDP-S). The major changes versus the previous National Shelter Program (NSP) consisted of a) tapping the private mortgage market to finance the housing demand of low income groups and; b) targeting housing subsidies to low income households[174]. The rationale for the 'market-based' housing finance approach under the leadership of former Chairperson Constantino-David was to integrate socialized housing into the mainstream financial markets.

One of the key innovations introduced by the Medium Term Development Plan for Shelter (MTDP-S) was to give due attention to the rental housing market, which has been a long ignored segment of the housing sector that degenerated under the housing control law[175]. The MTDP-S corrected a 'false premise' of earlier government housing programs which equated shelter provision to home ownership.

Public Sector Role. In this approach, the government would pursue an 'enabling' role where its primary role would be to create an environment conducive to private sector participation in the housing market[176]. Thus, the Constantino-David led housing team, in a radical turnaround, declared that it was devoting 80% of its funds to support socialized housing, with no more than 20% funneled into economic housing.

There is also a separate on-budget subsidy mechanism targeted to the poorest 30% of beneficiaries, but which is complementary to the market-oriented system. The on-budget subsidy would replace the existing off-budget subsidy mechanism that was implicit in below-market interest rates on mortgage loans, and, thus, susceptible to leakage to the non-poor[177]. Such a revision, according to the plan, was seen to "ensure a better distribution of responsibilities and risks (between government and) the private sector." By making the cost of housing to the poor "on subsidy", it appears in the annual government budget, versus the interest subsidy approach of the Unified Home Lending Program (UHLP), where the amount of subsidies was "hidden" from public scrutiny[178].

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[174] Llanto, Gilbert M. and Leilanie Q. Basilio. Housing Policy: Developing a Market-based housing finance system. Philippine Institute of Development Studies. December 1999. Makati City, Philippines.

[175] Bernardo, Romeo L. Revisiting housing finance. Philippine Daily Inquirer. March 12, 2001. Makati City, Philippines.

[176] It is interesting to note that the Medium Term Development Plan (MTDP-S) for Shelter and the previous National Shelter Program (NSP) had basically the same principles; namely a) involving the private sector in housing finance and; b) the government playing an enabling role. However, the difference in implementation (at least, if the MTDP-S) of both programs radically diverge.

[177] Tenorio, Arnold S. Housing program back to square one. Businessworld Publishing Corporation. February 8, 2001. Makati City, Philippines.

[178] Bernardo, Romeo L. Revising housing finance. Philippine Daily Inquirer. March 12, 2001. Makati City, Philippines.

As part of the on-budget subsidy, the Medium Term Development for Shelter (MTDP-S) recommended the establishment of a Housing Assistance Fund (HAF), with a set of transparent target mechanisms. The HAF, which would have been funded through bond proceeds, was meant to hand out capital grants to poor households applying for a mortgage loan, and facilitate a multi-window home mortgage loan system run primarily by the private sector.

Private Sector Role. The three primary roles of the private sector would be to a) strengthen its role of primary lending to the low income sector (since it is no longer competing with government subsidized interest rate loans), b) provide liquidity as institutional investors of Mortgage-Backed Securities (MBS), and c) establish a private sector-managed secondary mortgage institution (SMI) that would serve as catalyst for a viable secondary mortgage market[179].

Key Highlights of the Medium-Term Development Plan for Shelter

Objectives	• Formulate a comprehensive shelter program in accord with a defined national urban policy. • Develop a sustainable, market-oriented housing finance system that will encourage maximum private sector participation. • Design a system that will focus and address the need of the bottom 30% of the society. • Facilitate a decentralized shelter delivery system that will bolster valuable community support, thus making it demand-responsive.
Strategies	• Initiate reforms in the housing finance system to enable private sector participation in housing finance and production improvement of institutional infrastructures in the primary mortgage market, as well as the development of a secondary mortgage market through securitization review and rationalization of the shelter agencies' operations. • Institute the Housing Assistance Fund (HAF), an "on-budget" subsidy fund, and a corresponding transparent targeting mechanism. • Provide unambiguous support to the low-end sector via explicit, nominal grants versus distortive interests and tax subsidies to mortgage loans. • Encourage involvement of private institutions in socialized housing finance by allowing the sector to operate within the market interest rates. • Enable efficient rental market to augment shelter for less affluent, more mobile households. • Render accessibility to developmental, cooperative-led and community-based lending through decentralized housing delivery via the local government units (LGU).
Private Sector Role	• Private developers and lending institutions. Handle the origination and channeling of funds to homebuyers. • Banks. Engage in enhanced investment in mortgage-lending especially in socialized housing; undertake financial advising and intermediation in the securitization program. • Private investors. Provide liquidity through investments in Mortgage-Backed Securities.
Contractual Savings Institutions (CSI) Role	• Provide liquidity as institutional investors in Mortgage-Backed Securities (MBS) and in primary markets. This was expected to ease pressure on the CSIs from directly lending out funds to an unsustainable socialized housing program (i.e. Unified Home Lending Program (UHLP)) and, instead, increase their viability and indirectly help the housing sector through the development of the capital market.
Housing	• Housing and Urban Development Coordinating Council (HUDCC). Undertake effective

[179] Tenorio, Arnold S. Housing program back to square one. Businessworld Publishing Corporation. February 8, 2001. Makati City, Philippines.

Agencies	supervision and coordination of all agencies. • National Home Mortgage Finance Corporation (NHMFC). Possible 'rationalization' of the NHMFC (i.e. closure) or possible reversion into its unfulfilled mandate as a SMI. • Home Guaranty Corporation (HGC). Enhance risk management capability. • Home Development Mutual Fund (HDMF)/Pag-Ibig. Develop asset-liability management.
Primary Mortgage Market	• The proposed Plan for Shelter and Urban Development principally adopted the framework of the previous primary mortgage program of the National Shelter Program (NSP) (i.e. Resettlement, Community-based lending, retail lending, guarantees, etc.) but not the ailing and structurally flawed programs which will be discontinued. • There will be an explicit prioritization for socialized housing (i.e. 80%/20% allocation of aggregate public resources in favor of low cost hosing programs, specified target share of developmental lending including guarantee provisions). • An innovative "on-budget" subsidy (Housing Assistance Fund) will be established to complement the regular low-cost programs under the housing agencies and promote greater room for private bank low-cost lending. Banks and other lending institutions are unable to compete under the former strategy because of the distorted interest subsidies that the government loan offers. • Under the Housing Assistance Fund (HAF), the subsidization period of loan amortization for qualified borrowers will be reduced from 25 years to 10 years. This is due to the consideration of the rising capability of the borrowers to service their loans over time[180]. • Effective implementation (i.e. adequate fund releases and collection efficiency should, however, be installed to avoid the pitfalls of the previous programs, namely the Unified Home Lending Program (UHLP)) • Development of auxiliary infrastructure should also be achieved to help ensure the program's success.
Secondary Mortgage Market	• The other important component of the Plan for Shelter and Urban Development is the development of the secondary mortgage market through asset securitization.

Source: Philippine Institute of Development Studies, Businessworld, Philippine Daily Inquirer.

World Bank Recognition. It is noteworthy to mention that the World Bank (WB), after staying away from the Philippine housing sector for almost a decade, had not only regained confidence but also (and more importantly) was willing to finance the new housing finance program under Chairperson Constantino-David.

The World Bank (WB), in a report issued earlier this year pointed out, in no uncertain terms, that the key to drawing in private sector funding and making shelter finance sustainable was a) setting market rates of interest for low-income housing loans and; b) instituting a carefully targeted and transparently budgeted upfront subsidy program for poor homebuyers[181]. The report read that, "This is the vision embodied in the Medium Term Philippine Development Plan for Shelter. It would seem to recommend itself over any attempt to resurrect directed lending under another guise." In fact, the Medium-Term Development Plan for Shelter (MTDP-S) was based largely from the recommendations of the 1997 World Bank Study on

[180] While amortization remains constant in nominal terms, nominal income increases due to inflation and income improvements. Thus, the problem of loan affordability then is re-assumed to exist only for a maximum of ten years.

"Philippines Housing Finance: Reforming Public Provision and Promoting Private Participation"[182]. As early as April 1999, the World Bank announced that it was providing technical assistance in the effort to restructure the housing sector's financing system. An assistance project amounting to $4.6 million was in the works and was ready to begin by the following month[183].

The project, entitled Housing Finance Technical Assistance (HFTA), which was to be handled by the Housing and Urban Development Coordinating Council (HUDCC), was supposed to help attract private financing to support the socialized housing program for the next six years. The World Bank (WB) was ready to finance the implementation of the MTDP-S, but it was shelved shortly after President Estrada set up the Presidential Commission on Mass Housing (PCMH)[184].

The Multi-Window Lending Scheme (MWLS)

The Multi-Window lending scheme (MWLS) appears to be a combination of the Unified Home Lending Program (UHLP) and the Medium Term Development Plan for Shelter (MTDP-S). The Housing for Urban Development and Coordinating Council (HUDCC), claimed that the MWLS was a "two-pronged program" – one a market-based, demand-driven, private sector led program, and the other a government-led program.

The Multi-Window Lending System (MWLS) not only brought back the contractual savings institutions[185] into primary lending at below-market interest rates, but also other government owned and controlled financial institutions as well, which include Land Bank of the Philippines (LBP), the Development Bank of the Philippines (DBP), and the Philippine National Bank (PNB).

The Multi-Window Lending Scheme (MWLS) engages in wholesale or institutional lending to private banks and to other government owned and controlled financial institutions[186]. These private banks and government owned and controlled financial institutions will serve as conduits, and lend money to the

[181] Tenorio, Arnold S. Political will needed to reform weak housing sector. Businessworld Publishing Corporation. February 9, 2001. Makati City, Philippines.
[182] The World Bank study has been incorporated into several portions of this thesis.
[183] Tenorio, Arnold S. Housing program back to square one. Businessworld Publishing Corporation. February 8, 2001. Makati City, Philippines.
[184] Tenorio, Arnold S. FOCUS: A secondary market for housing. Businessworld Publishing Corporation. December 1, 1999. Makati City, Philippines.
[185] Government Service Insurance System (GSIS), Social Security System (SSS), and the Home Development Mutual Fund (HDMF)/Pag-Ibig
[186] Businessworld Publishing Corporation. Property sector airs views on new scheme. March 27, 2000. Makati City, Philippines.

homebuyer under, presumably, the same uniform lending guideline set up by the government under the Unified Home Lending Program (UHLP).

Interest Rate Scheme under the Multi-Window Lending Scheme (MWLS)

	Interest rates from funders to		Interest rates to homebuyers from	
Category	GFI*	Private Banks	GFI*	Private Banks
Socialized housing (P180,000 (US$3,400) and below)	6%	9%	9%	12%
Low cost to Open Housing (P180,000 (US$3,400) and above)	6%	9%	Market rates**	Market rates**

Source: Businessworld
**Government Financial Institution*
*** From a technical standpoint, these are also fixed interest rates. For example, if the loan is contracted at a market rate of 16%, the loan will stay at 16% for the whole period*[187].

Although Businessworld reported that the low cost to open housing rates under the Multi-Window Lending Scheme would be at market rates, a cursory review of the respective websites of all the contractual savings institutions reveals that the program continues to maintain the same three-tiered interest rate scheme that was used in the Unified Home Lending Program (UHLP). The loan terms and interest rate schemes used in the Multi-Window Lending Scheme (MWLS) are discussed in depth in Chapter 5. Presumably, the maximum term to maturity of these mortgage loans was 25 years, similar to the Unified Home Lending Program (UHLP).

It must be noted that at the time these 'subsidized' interest rates were being pegged, the market rates for mortgages was 16%[188]. Similar to the Unified Home Lending Program, the Multi-Window Lending Scheme (MWLS) is supposed to generate an effective return of 12% through the principle of cross-subsidization[189].

Government support will include amortization support for the first five years on socialized housing loans, and the Home Guaranty Corporation (HGC) guaranty (which comes together with a tax incentive) for government financial institutions and private banks who lend at 11% per annum. Unlike the previous Unified Home Lending Program (MWLS), the loan guarantee and appraisal services will be provided by

[187] Ortille, Lucille. Deputy Secretary General of the Housing and Urban Development Coordinating Council. Personal Interview. June 2001. Makati City, Philippines.
[188] In a Businessworld interview, an SSS official was quoted as saying, "We'll just have to absorb the differential and look at it as a form of service."
[189] In the case of the Multi-window lending System (MWLS), the socialized housing loan rates would be subsidized by the 'market rate' loans of the low cost to open housing, to generate an effective return of 12%. However, the effective rate will be dependent on the prevailing 'market rates'.

the Home Guaranty Corporation (HGC). Supposedly, the 'market-driven' mechanism for the scheme was defined as assigning contractual savings institutions and government financial institutions to cater to particular market segments.

Market Segmentation under the Multi-Window Lending Scheme (MWLS)

Institution	Market Segment
Development Bank of the Philippines (DBP)	Developmental loans to Local Government Units (LGU)/Developers
Government Service Insurance System (GSIS)	Teachers and government employees
Home Development Mutual Fund (HDMF)	Armed Forces of the Philippines (AFP) and the Philippine National Police (PNP)
Land Bank of the Philippines (LBP)	Developmental financing, cooperative housing
Social Security System (SSS)	Overseas Filipino workers and trade union workers and other private sector workers

Source: Businessworld, HUDCC

Former Chairperson Leonora de Jesus[190] had made several modifications to the Multi-Window Lending Scheme (MWLS) which included: a) ensuring private sector participation and breakup of monopolies and cartels operating in the industry, b) Risk sharing through contract-to-sell (CTS) scheme with a buyback provision over a two-year seasoning period and c) support by a private sector-led guaranty fund (Subdivision and Housing Developers Association (SHDA) guaranty fund)[191].

The contractual and savings institutions had allotted P40 Billion (US$755 Million) for the Multi-Window Lending Scheme (MWLS). Meanwhile, the government also mobilized P22.65 Billion (US$427 Million) and a P14 Billion (US$ 264 Million) from the Home Guaranty Corporation (HGC). However, according to the Housing and Urban Development Coordinating Council, the utilization rate from the Contractual Savings Institutions (CSIs), as of June 2001, was at 17%[192].

The reasons posited by the contractual savings institutions (CSI) behind the low utilization rate were a) the stringent housing guidelines set by the accredited banks administering and servicing the loans and; b) the lingering effects of the 1997 regional currency crisis[193]. It is interesting to note that private sector developer groups under the umbrella organization of the Private Sector Consultative Council for Shelter

[190] Former Chairperson Leonora de Jesus was the former head of the Presidential Management Staff (PMS) of ousted President Estrada who replaced resigned Chairperson Karina Constantino-David.

[191] Businessworld Publishing Corporation. New HUDCC initiatives seen to perk up home access. October 27, 2000. Makati City, Philippines.

[192] Ortille, Lucille. Deputy Secretary General of the Housing and Urban Development Coordinating Council (HUDCC). Personal Interview. June 2001. Makati City, Philippines.

[193] Businessworld Publishing Corporation. SS housing loan availments drop despite bigger budget. September 12, 2000.

(PCCS)[194] have categorically supported the Multi-Window Lending Scheme, except for the Chamber of Real Estate and Builders Associations (CREBA). CREBA, instead continued to propose the establishment of a Centralized Home Financing program with a P120 Billion (US$ 2.3 Billion) seed fund, which was to be sourced from the government-mandated allocations of the contractual savings institutions (CSIs) commercial banks, insurance companies, and unused agri-agra[195] allocations from the banking sector through a proposed executive order[196].

Failures/Shortcomings of the Government Housing policies

Production-Oriented Versus Finance-Oriented. The apparent shortcomings of all government housing programs, with the exception of the Medium Term Development Plan for Shelter (MTDP-S), is the populist logic that politicians adopt of building as many housing units as possible, without consideration for the financial consequences of this action. Thus, the short-sighted solution to this problem would be, as former Finance undersecretary Romeo Bernado put it, "throwing in good money after bad"[197]: pumping in more money through the use of member contributions in the contractual savings institutions (CSI), legislating budgetary appropriation for subsidized lending, and imposing loan quotas on financial institutions to force them to lend to target beneficiaries[198]. In effect, the National Home Mortgage Finance Corporation (NHMFC) performed the role of social welfare versus being a market-driven secondary mortgage institution.

This policy of constructing housing units goes all the way back to the dictatorial Marcos administration, where houses were built based on supply and not demand, and were carried over through to the Ramos

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194 The Private Sector Consultative Council for Shelter (PCCS) include the Subdivision and Housing Developers Association (SHDA), the Organization of Socialized Housing Developers of the Philippines, National Real Estate Association, Builders Alliance Towards Action, Women in Shelter and Its Environment, the Realty Service Council of the Philippines, the Philippine Association of Realtors Boards and the Real Estate Builders Association of the Philippines.

195 The Agri-Agra law (Presidential Decree 717), issued in May 29, 1975, It mandated banks to grant 25% of their loanable funds to agriculture (i.e. any kind of borrower engaged in agriculture). The law, whose implementation has since been amended through several circulars issued by the Bangko Sentral ng Pilipinas (Central Bank of the Philippines), mandates all banking institutions to set aside at least 25% of their loanable funds for agricultural credit in general. Of these, at least 10% should be made available for agrarian reform credit, or to farmers tilling land acquired under the agrarian reform program. Otherwise, the entire 25% may be used for agrarian reform credit,

196 Businessworld Publishing Corporation. New HUDCC initiatives seen to perk up home access. October 27, 2000. Makati City, Philippines.

197 Bernardo, Romeo L. Former Undersecretary of the Department of Finance (DOF). Personal Interview. June 2001, Pasig City, Philippines.

198 Llanto, Gilbert M., Aniceto C. Orbeta, Jr., Ma. Teresa C. Sanchez and Marie Christine G. Tang. A Study of Housing Subsidies in the Philippines. Philippine Institute of Development Studies. November 1998. Makati City, Philippines.

Administration[199]. This supply oriented housing policy led to the proliferation of thousands of units which the intended beneficiaries refused to occupy. Although the Estrada administration initially moved towards a more market-oriented approach, ousted President Estrada caved into private developers interests and returned to the supply-oriented approach.

The newly installed Arroyo administration, unfortunately, appears to be bent on taking the same approach. In her State of the Nation (SONA), President Arroyo promised to build 800,000 houses[200] by acquiring P20 Billion (US$377 Million) worth of financing from the government financial institutions[201]. This problem of supply is further exacerbated by the significant variances for the total housing backlog. It is troubling to note that the Housing and Urban Development Coordinating Council (HUDCC) claims that the total housing backlog is approximately 700,000 to 1,000,000 units, while the Chamber of Real Estate and Builders Association (CREBA) has estimated that this number to be at 4,500,000 units.

Unsustainability of subsidized interest rate housing programs. The unfortunate return to a subsidized interest rate mortgage loans via the Multi-Window Lending Scheme (MWLS) tell us that the government has not learned from the sins of the past. In 1998, the Philippine Institute of Development Studies (PIDS) had already performed a comprehensive analysis illustrating the unsustainability of a housing subsidy program. This is due to huge fiscal requirement of providing direct and indirect subsidies, the leakage of benefits to unintended beneficiaries (i.e. the middle and high income borrowers), and the distortions introduced in the financial markets which have prevented the private sector from financing the housing market.

Problems with the Unified Home Lending Program (UHLP)

a. National Home Mortgage Finance Corporation (NHMFC) subject due political pressure.

Since the National Home Mortgage Finance Corporation (NHMFC) is a government institution, it has succumbed in the past to political pressure[202]. Moreover, the NHMFC has been the victim of poor management given that the heads of NHMFC are usually government appointees. Thus, instead of

[199] Tenorio. Arnold S. Focus: A Secondary Market for Housing. Businessworld Publishing Corporation. December 1, 1999.
[200] For the remainder of her administration (2001-2004), President Arroyo promised that the government would build 100,000 for the low income class and 50,000 for socialized housing.
[201] www.inq7.net. President Macapagal's State of the Nation speech. July 23, 2001. Makati City, Philippines.
[202] Philippine Conference on Securitization. Mobilizing the Markets for Housing: The Case for Asset-Backed Securities Romeo Bernardo's presentation. October 1999. Makati City, Philippines.

developing policies that could have been market-driven, the government's production-driven focus arguably prevented this.

b. Lenient origination guidelines and poor servicing/collection efficiency of public institutions.

As can be gleaned from the description of the origination guidelines used for the Unified Home Lending Program, the lenient "formula lending" approach, based primarily on the potential homeowners' salary bracket, failed to distinguish among potential borrowers according to their capacity and willingness to pay. Consequently, the "formula lending" approach led to the poor asset quality of the mortgage loans that were intended for securitization. The lack of a rigorous screening process and poor collection efforts presumably led to the high level of defaults/non-performing loans (NPLs) originated by public institutions[203].

Alcid added that the intention of the National Home Mortgage Finance Corporation (NHMFC) was good, unfortunately the execution left much to be desired. He highlighted the key shortcomings of the program as the inability to both underwrite and properly service the loans[204]. Maquera chimes in with poor processing procedures for the loan, which include a) the failure to send a bill; b) the failure to properly post the payment of the mortgage loan which leads to an inability to track how much a homebuyer owes and; c) the need for a homebuyer to take a day off from work merely to pay the monthly amortization. The cumulative effect of these deficient processing procedures has resulted in the failure by the National Home Mortgage Finance Corporation (NHMFC) to determine good from bad homebuyers[205].

Moreover, since the Unified Home Lending Program (UHLP) was perceived by private commercial banks as catering primarily to low income borrowers, the poor origination and servicing guidelines have given the impression that the low income segment, as a whole, are poor borrowers.

In the initial stage of the Unified Home Lending Program (UHLP), banks served as the mortgage loan originators. These originating banks were institutions approved by the National Home Mortgage Finance Corporation (NHMFC). The banks were tasked to screen for qualified loan applicants, and issue the preliminary approval of the maximum loanable amount for the potential homebuyer. The originating

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[203] Social Security System (SSS), Government Service Insurance System (GSIS), Home Development Mutual Fund (HDMF)/Pag-Ibig, and National Home Mortgage Finance Corporation (NHMFC).
[204] Alcid, Andrew D. Executive Vice President, Investment Banking Division of United Coconut Planters Bank. *Personal Interview*. June 2001. Makati City, Philippines.
[205] Maquera, Peter D. Chief Operating Officer of Lighthouse Credit Technologies Corporation. *Personal Interview*. June 2001. Pasig City, Philippines.

bank would then receive a commission from the National Home Mortgage Finance (NHMFC). After that, the loan take-out will be given by the originating bank to the developer.

However, few banks were responsive to the loan origination process because of the retail nature of the loans. Since there was a political need to achieve a targeted number of housing units, the housing agencies allowed developers to originate loans to achieve their 'numbers'[206]. Given that loan origination is not their respective businesses' core competence, both the developers and the contractual savings institutions (CSI) (i.e. Social Security System (SSS)/Government Service Insurance System (GSIS), and Home Development Mutual Fund (HDMF)/*Pag-Ibig*) did not possess the capability to satisfy certain criteria when underwriting mortgage borrowers[207], which is reflected in the wide disparity in non-performing asset ratios between public and private institutions:

Arrears on Private Banks Total Loan Portfolios and on Selected Public Lenders Housing Portfolios

Institution	Ratio of Arrears to total housing loan portfolio (%)
Commercial Banks	3.1%
Thrift Banks	7.9%
Home Development Mutual Fund	12.7%
Rural Banks	17.0%
Social Security System	37.9%
National Home Mortgage Finance Corporation	49.0%

Source: World Bank, 1997
Although no estimate was provided for the Government Service Insurance System (GSIS), estimates by other agencies peg the ratio of arrears to 50%.

This indicates that the in-house underwriting and servicing capabilities of public originators hindered their ability to develop securitizable mortgage loans. According to Reside, this hypothesis is reinforced by claims made by the Social Security System (SSS) that there has so far been a zero default rate on mortgages under-written for SSS members by SSS-accredited private banks[208]. Thus, this suggests that the present system of bank accreditation had greatly enhanced the quality of mortgages. In fact, after

[206] Manicio, Eduardo T. Vice-President, Funds Generation Group of the National Home Mortgage Finance Corporation (NHMFC). Personal Interview. June 2001. Makati City, Philippines.
[207] The mortgage loans of the Social Security System (SSS)/Government Service Insurance System (GSIS) are the loans they provide directly to their members. However, Home Mortgage Development Fund (HDMF)/Pag-Ibig, given its mandate as a primary mortgage loan provider, appears to be doing a better job versus the two contractual savings institutions (CSI).
[208] Reside, Renato S. Mortgage-Backed Securities in Asia. Asian Development Bank. 1999. Pasig City, Philippines.

controlling for "cross-institutional" differences in underwriting and servicing[209], cross-sectional differences across the income-level of borrowers do not matter[210].

The liberal mortgage screening and servicing procedures adopted in low-cost housing programs such as the Unified Home Lending Program (UHLP) served as disincentive for timely repayment by any borrower, *regardless* of income level[211] Moreover, liberal screening and servicing procedures inadvertently strengthens the perception that these mortgage loans were government dole-outs, further weakening the homebuyers' credit discipline[212]. Alcid anecdotally related that the National Home Mortgage Finance Corporation (NHMFC) did not set up invoices nor did they follow up with the homebuyers[213].

Such adverse incentive distortions presumably accounted for the high rates of arrears among public originators[214], who generally cater to low-cost housing borrowers, versus private commercial banks, who generally cater to middle to high income homebuyers. In fact, data from the Philippine Institute of Development Studies (PIDS) strengthen this argument: The collection efficiency of developer-originated loans is lower than those loans originated by financial institutions (59% vs. 69%)[215].

c. Subsidized interest rates

As elaborated on in the origination guidelines under the Unified Home Lending Program (UHLP), low-income borrowers were offered below market interest rates and longer amortization terms by the public versus private institutions, which effectively discouraged private commercial banks to compete because of the distorted interest rate subsidies of the government-sponsored mortgage loans.

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[209] Cross-sectional differences in screening and servicing capacity refer to the cross-sectional differences in institutional capacity and readiness for securitization. Originators that are better underwriters and servicers will also tend to be better prepared to securitize their mortgages.

[210] There is a perception among private commercial banks that low-income borrowers are not good payors. However, proper screening of the loans disputes that perception.

[211] Reside, Renato S. Mortgage-Backed Securities in Asia. Asian Development Bank. 1999. Pasig City, Philippines.

[212] Philippine Conference on Securitization. Mobilizing the Markets for Securitization: The Case for Asset Backed Securities, Former Finance Undersecretary Romeo Bernardo's presentation. October 1999. Makati City, Philippines.

[213] [213] Alcid, Andrew D. Executive Vice President, Investment Banking Division of United Coconut Planters Bank. *Personal Interview*. June 2001. Makati City, Philippines.

[214] Social Security System (SSS), Government Service Insurance System (GSIS), Home Development Mutual Fund (HDMF)/Pag-Ibig, and National Home Mortgage Finance Corporation (NHMFC)

[215] Llanto, Gilbert M., Aniceto C. Orbeta, Jr., Ma. Teresa C. Sanchez and Marie Christine G. Tang. A Study of Housing Subsidies in the Philippines. Philippine Institute of Development Studies. November 1998. Makati City, Philippines.

On top of the distorted interest rates, the intended beneficiaries –the low-income sector - do not get the benefits of the subsidies. Weak targeting mechanisms, such as the one used in the Unified Home Lending Program (UHLP), often allow unintended beneficiaries (i.e. 'better educated', 'better politically connected') to present themselves as 'worthy' beneficiaries of the subsidy versus the targeted beneficiaries[216]. However, since the 'recognized beneficiaries' of the program are the low-income sector, they are unfortunately blamed for its nonperformance. The Unified Home Lending Program (UHLP)'s mortgage take-outs, amounting to P29.4 Billion (US$555 Million) from 1993-95 clearly illustrate this:

Mortgages taken out under the Unified Home Lending Program (UHLP) for 1993 to 1995

Loan Bracket	No. of beneficiaries/ unit	% of total		Average Loan Value	Average Income
		Beneficiaries /units	Loan Value		
P150,000 (US$2,830) and below	56,323	38.1%	26%	P135,513.60 (US$2,560)	P4,517.10 (US$85)
P150,000 to P225,000 (US$2,830 – US$4,250)	48,521	32.8%	32.8%	P198,625.40 (US$3,750)	P6,620.80 (US$124)
P225,000 to P375,000 (US$4,250 – US$7,080)	43,061	29.1%	41.3%	P281,699.90 (US%5,320)	P9,390.00 (US$177)
Total/Average	147,905	100%	100%	P198,778.40 (US$3,750)	P6,625.90 (US$125)

Source: Philippine Institute of Development Studies

Only 38.1% of the low-income borrowers were the beneficiaries of the units, versus the combined 61.9% of the middle (32.8%) and high-income borrowers. Corollary, the low-income borrowers only comprised 26% of the total loan value of the Unified Home Lending Program (UHLP) versus the combined 74.1% of the middle (32.8%) and high (41.3%) income borrowers[217]. The table makes clear that the interest rate subsidies went to the middle and high-income groups[218].

In fact, it is possible that people with the capacity to pay don't end up paying. The National Home Mortgage Finance Corporation (NHMFC)'s collection performance for high-priced loans (loans carrying

[216] Llanto, Gilbert M., Aniceto C. Orbeta, Jr., Ma. Teresa C. Sanchez and Marie Christine G. Tang. A Study of Housing Subsidies in the Philippines. Philippine Institute of Development Studies. November 1998. Makati City, Philippines.

[217] Llanto, Gilbert M., Aniceto C. Orbeta, Jr., Ma. Teresa C. Sanchez and Marie Christine G. Tang. A Study of Housing Subsidies in the Philippines. Philippine Institute of Development Studies. November 1998. Makati City, Philippines.

[218] The interest rate subsidies depended more on the loan size rather than on the level of the interest rate. Thus, higher income borrowers who availed of bigger loans captured a larger benefit of the subsidized interest rates. Although the low income groups should have benefited from the subsidized interest rates, the outcome is the opposite: because of the bigger loan sizes, the middle and high income group derive more of the subsidies. (Philippine Institute of Development Studies).

higher interest rates) were generally lower versus than low-priced loans (57% for 16% loans versus 73% for 9% loans)[219]. Since credit investigation was practically nonexistent with the Unified Home Lending Program (UHLP), potential applicants who deserved more government support in terms of the higher subsidy extended socialized loan packages were boxed out by applicants who could afford higher interest payments.[220]

This is further evidenced by a study by the Philippine Institute of Development Studies (PIDS) which revealed that the social costs of subsidizing housing loans and misdirecting the subsidies to nonporous borrowers were quite high[221].

Subsidy Incidence under the Unified Home Lending Program (UHLP) (1993-1995)

Subsidy Incidence	Income Group[222]		
	Low	Middle	High
% of Beneficiaries	38	33	29
% of Loan Value from UHLP	26	33	41
% of Delinquent Loans	11	36	53

Source: Philippine Institute of Development Studies

Only 38% of the intended low-income beneficiaries received the subsidy, versus the combined 62% of the middle (33%) and high (29%) income brackets. In terms of loan value, only 26% of the mortgages were availed of by the low-income group versus the combined 74% of the middle (33%) and high (41%) income groups. However, in terms of the delinquent accounts, the high-income borrowers, the "unintended" beneficiaries, have the highest delinquency rates (53%), followed by the middle-income borrowers (36%), then by the low-income borrower (11%)[223]. These results dispute the perception that low-income borrowers are not good payers (in fact, it appears to be the other way around).

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[219] Llanto, Gilbert M., Aniceto C. Orbeta, Jr., Ma. Teresa C. Sanchez and Marie Christine G. Tang. A Study of Housing Subsidies in the Philippines. Philippine Institute of Development Studies. November 1998. Makati City, Philippines.

[220] Tenorio, Arnold S. Housing program back to square one. Businessworld Publishing Corporation. February 8, 2001. Makati City, Philippines.

[221] Llanto, Gilbert M. and Leilanie Q. Basilio. Housing Policy: Developing a Market-based Housing Finance System. Philippine Institute of Development Studies. December 1999. Makati City, Philippines.

[222] Definition of income groups:
Low – Households with monthly income below P5,000 (US$94)
Middle – Households with monthly income P5,000 – below P7,500 (US$94 – below US$141)
High – Households with monthly income above P7,500 (US$141)

[223] Llanto, Gilbert M., Aniceto C. Orbeta, Jr., Ma. Teresa C. Sanchez and Marie Christine G. Tang. A Study of Housing Subsidies in the Philippines. Philippine Institute of Development Studies. November 1998. Makati City, Philippines.

This may have been further exacerbated the origination of the loans through the private banks. If the transfer of subsides occur through private commercial banks, there is usually a bias against the intended beneficiaries (i.e. low income group). Factors such as high transaction costs, information asymmetry, and perception of high credit risks prevent poor households from accessing the financial markets[224]. The Philippine Institute of Studies (PIDS) paper on Housing Subsidies points out that there is a tendency of banks or lending institutions to credit ration the intended beneficiaries, and to cater to the more creditworthy segment of the borrowing population (i.e. high income group).

Moreover, the subsidized interest rates were not transparent. This meant that opportunity costs of the housing subsidies and the government's budget constraints were not adequately considered in the design on these subsidies. The total amount (P25.4 Billion/US$479 Million) spent on housing subsidies from 1993-1995 appears to confirm the lack of transparency in the subsidy design mechanism. 90% of the subsidies to the housing sector are coursed into the home mortgage programs (i.e. Unified Home Lending Program (UHLP)). And among all the housing programs, the Unified Home Lending Program (UHLP) carried 74.1% of the total housing subsidies[225].

d. Moral Hazard with developers

An inherent conflict exists in having developers originate loans as their primary business concern is the production of housing units, and not loan origination. Since the Unified Home Lending Program (UHLP) program allowed developers to originate loans, and not the primary mortgage lenders, this led to the lenient selection of homebuyers as the originator-developers were more concerned with generating more income by seeking out more homebuyers regardless of the latter's capacity and willingness to pay[226]. Thus, it is not surprising that the estimates from the Chamber of Real Estate and Builders Association (CREBA) are much higher (4.5 million units) versus the Housing and Urban Development Coordinating Council (HUDCC) (700,000-1,000,000 units).

[224] Llanto, Gilbert M., Aniceto C. Orbeta, Jr., Ma. Teresa C. Sanchez and Marie Christine G. Tang. A Study of Housing Subsidies in the Philippines. Philippine Institute of Development Studies. November 1998. Makati City, Philippines.
[225] Llanto, Gilbert M., Aniceto C. Orbeta, Jr., Ma. Teresa C. Sanchez and Marie Christine G. Tang. A Study of Housing Subsidies in the Philippines. Philippine Institute of Development Studies. November 1998. Makati City, Philippines.
[226] Tenorio, Arnold S. Housing program back to square one. Businessworld Publishing Corporation. February 8, 2001. Makati City, Philippines.

This conflict was evident in the Unified Home Lending Program (UHLP), as real estate developers assumed the initial credit and financing risk by starting construction EVEN BEFORE entertaining applicants for the low-cost housing units. After screening applicants and obtaining the required documentation from them, the developers drew on the preset purchase commitment lines (PCLs) with the National Home Mortgage Finance Corporation (NHMFC) in amounts corresponding to the appraised value of the properties[227]. The National Home Mortgage Finance Corporation (NHMFC) reviewed the homebuyers' documentation and other proof of capacity to repay to ensure that it met the Unified Home Lending Program (UHLP) qualifications for borrowers. Amortizations after take-out out of the developer-originators were made by homebuyers directly to the National Home Mortgage Finance Corporation (NHMFC), who would then service of the loans. Moreover, since the loan the developers performed origination function, the National Home Mortgage Finance Corporation (NHMFC) was ill equipped to check on the actual paying capacity of loan applicants[228].

In effect, developers were 'incented' to qualify as many homebuyers as possible, despite the fact that developers were ill-equipped to screen homebuyer capacity and willingness to pay, otherwise these developers would be stuck with inventory. The take-out scheme virtually allowed developers to pass on all of their risks to the National Home Mortgage Finance Corporation (NHMFC). As a result of the flawed incentive structure, the 1998 Philippine Institute of Development Studies (PIDS) argues that private developers will only participate in the government's housing program, particularly the "socialized" programs, if there are continuing government subsidies[229].

More often than not, the production oriented policy of the Unified Home Lending Program (UHLP) led to unscrupulous developers putting up substandard housing units. Anecdotal evidence reveal that housing units were built in the most inhospitable (i.e. mountainous areas) or the most inaccessible (i.e. no access to public transportation nor main roads) of areas, since the developers were confident that they would eventually be 'taken out' by the National Home Mortgage Finance Corporation (NHMFC)[230].

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[227] The Purchase Commitment Line (PCL) served as the government's assurance that the originator-developers would get paid through the loans released by the National Home Mortgage Finance Corporation (NHMFC) to the member-borrowers of the Contractual Savings Institutions (CSI).
[228] Tenorio, Arnold S. Housing program back to square one. Businessworld Publishing Corporation. February 8, 2001. Makati City, Philippines.
[229] Their argument is further bolstered by the Chamber of Real Estate and Builders Association (CREBA) rejection of the market-oriented finance scheme of the Medium Term Development Plan for Shelter and lobbying for the return of the Unified Home Lending Program (UHLP).
[230] Alcid, Andrew D. Executive Vice President, Investment Banking Division of United Coconut Planters Bank. *Personal Interview.* June 2001. Makati City, Philippines.

The results of the adverse incentives were evident: housing developers who had built housing units even before entertaining housing applicants were left with a large stock of housing inventory and receivables that were not "taken out"[231]. When the Home Development Mutual Fund (HDMF)/Pag-Ibig took over the mortgage take-out function from the National Home Mortgage Finance Corporation (NHMFC), these developers could not pass the more stringent guidelines set up by the HDMF/Pag-ibig and were stuck with both the receivables and the inventory.

The generous stance that government has taken with regard to developers is characteristic of the policies of previous administrations, which encouraged developers to "raid" public financing for the shelter program. In an effort to address the housing backlog, previous administrations were held hostage to developers' demands that the government support the developers' production binge through liberal funding support, through end-user lending, developmental loans, or loan guarantees[232]. With reference to the previous Home Development Mutual Fund (HDMF)/*Pag-Ibig* example, the government was 'obliged' to assist developers who were caught with excess "housing" inventory that were not taken out by the National Home Mortgage Finance Corporation (NHMFC) through making the Home Development Mutual Fund (HDMF)/Pag-Ibig the new, albeit stricter, mortgage take out window[233].

The claim made the Chamber of Real Estate and Builders Association (CREBA) with regard to the failure of the Unified Home Lending Program (UHLP) was not the program "per se" but rather the people running it, according to Carlos Nocon, the Executive Vice-President of the Chamber or Real Estate Builders and Associations (CREBA)[234]. "The key success factors are in credit scoring, monitoring, collection and foreclosure or in efficiently managing the entire credit cycle before it becomes unmanageable." Nocon was quoted as saying. Nocon said that the P42 Billion (US$ 792 Million) Unified Home Lending Portfolio (UHLP) fund represented payments made to developers after a) constructing the house and lot packages; b) identifying and pre-qualifying the beneficiaries; c) all necessary documents were submitted and verified and; d) transferring ownership to individual beneficiaries. "It is not as if the developers "bled" the financing agency... but simply the end result of a contractual relationship between the agency and the developer under the National Shelter Program (NSP)" Nocon said.

[231] Manicio, Eduardo T. Vice President, Funds Generation Group of the National Home Mortgage Finance Corporation (NHMFC). Personal Interview. June 2001. Makati City, Philippines.
[232] Tenorio, Arnold S. Housing program back to square one. Businessworld Publishing Corporation. February 8, 2001. Makati City, Philippines.
[233] [233] Manicio, Eduardo T. Vice-President, Funds Generation Group of the National Home Mortgage Finance Corporation (NHMFC). *Personal Interview*. June 2001. Makati City, Philippines.
[234] Catherine C. Junia, Gov't lacks funds to finance socialized housing projects – CREBA. Businessworld Publishing Corporation. May 7, 1999. Makati City, Philippines.

Although Bernardo makes a similar claim with regard to poor management of the Unified Home Lending Program (UHLP), he asserts that this was not the root problem. The poor management was a result of the mismatch of personnel skills with the Unified Home Lending Program (UHLP)[235]. After all, the National Home Mortgage Finance Corporation was structured to be a Secondary Mortgage Institution (SMI), and not a primary mortgage lender. Moreover, the National Home Mortgage Finance Corporation (NHMFC) was subject to political pressure to hit a target number of housing units. In the end, the poor management only highlighted the "confused role" of the National Home Mortgage Finance Corporation (NHMFC): "Was it a Secondary Mortgage Institution (SMI) or was it a Department of Social Welfare and Development (DWSD)?" (Since the National Home Mortgage Finance Corporation acted more like a welfare agency distributing mortgage loans as dole-outs."

e. **Misuse of Contractual Savings Institutions.**

The ideal role of the contractual savings institutions (CSI) in a well-functioning secondary mortgage market is to provide liquidity through investments in Mortgage-Backed Securities (MBS). However, under the Unified Home Lending Program (UHLP), the National Home Mortgage Finance Corporation (NHMFC) paid the funders 10.25%. In effect, the Contractual Savings Institutions lost the opportunity to earn greater yields in alternative instruments (i.e., government securities)[236].

For perspective, Executive Order (EO) 90 consolidating the housing funds of the contractual savings institutions (CSIs) under the National Home Mortgage Finance Corporation (NHMFC) under a temporary loan agreement, until NHMFC could stand on its own financial footing. However, EO 90 did not specify a timetable as to when the NHMFC could eventually "stand on its own feet" and was viable enough to start a secondary mortgage institution (SMI). Thus, a 'temporary arrangement' became a relatively permanent one, as the lending arrangement between the National Home Mortgage Finance Corporation (NHMFC) and the contractual savings institutions (CSI) were continuously renewed, from 1988 to 1996 (when the National Home Mortgage Finance Corporation (NHMFC) was relegated to a mere collection agency for its past due accounts)[237]. As a result, 78% of the housing subsidy programs from 1993 to 1995

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235 Philippine Conference on Securitization. Mobilizing the Markets for Housing: The Case for Asset-Backed Securities Romeo Bernardo's presentation. October 1999. Makati City, Philippines.

236 Llanto, Gilbert M., Aniceto C. Orbeta, Jr., Ma. Teresa C. Sanchez and Marie Christine G. Tang. A Study of Housing Subsidies in the Philippines. Philippine Institute of Development Studies. November 1998. Makati City, Philippines.

237 Manicio, Eduardo T. Vice President, Funds Generation Group of the National Home Mortgage Finance Corporation (NHMFC). Personal Interview. June 2001. Makati City, Philippines.

were shouldered by the contractual savings institutions (CSI), with a bulk of the funding the interest rate subsidy component of the Unified Home Lending Program (UHLP)[238].

Problems with the Medium Term Development Plan for Shelter (MTDP-S)

a. Developers asserting moral hazard

As mentioned in the "Moral Hazard with Developers" shortcoming under the Unified Home Lending Program, the Philippine Institute of Development Studies (PIDS) posited that "private developers will only participate in the government's housing program, particularly the "socialized" programs, only if there are continuing government subsidies". In the case of the market-oriented Medium Term Development Plan for Shelter (MTDP-S), this is exactly what occurred.

In fact, the Medium Term Development Plan for Shelter (MTDP-S) did not have the chance to be 'tested' because it was shelved due to well-placed developers lobbying against the plan during the ousted Estrada administration[239].

The Chamber of Realtors and Builders Association (CREBA) had been at odds with the David-led housing team because of the Housing and Urban Development Coordinating Council (HUDCC)'s a) refusal to revive the National Home Mortgage Finance Corporation (NHMFC) as mortgage take-out window, b) plan to permanently discontinue the Unified Home Lending Program (UHLP) because of its flawed structure, c) plan to implement an 80%/20% allocation of the housing agency's resources in favor of low cost housing programs, and d) market-oriented (versus cross-subsidized) interest rates for low-cost housing loans. [240]. Thus, the Chamber of Real Estate and Builders Association (CREBA), whose member companies had benefited greatly from the failed Unified Home Lending Program (UHLP), lobbied against these plans otherwise it would deal a severe blow to their income.

[238] Llanto, Gilbert M., Aniceto C. Orbeta, Jr., Ma. Teresa C. Sanchez and Marie Christine G. Tang. A Study of Housing Subsidies in the Philippines. Philippine Institute of Development Studies. November 1998. Makati City, Philippines.

[239] The developer group was 'influential' enough to have the Medium Term Development Plan for Shelter (MTDP-S) plan shelved despite the fact that the World Bank (WB) was prepared to shell out $4.6 Million to facilitate the plan's implementation.

[240] The Chamber of Real Estate and Builders Association (CREBA) realized that it would be in

Former Chairperson Karina Constantino-David, in her resignation letter, cited the existence of "parallel structures without a clear center of accountability create(ing) confusion and instability," with reference to the sudden creation of the Presidential Commission on Mass Housing (PCMH), a superbody that virtually displaced the HUDCC from its mandated role as coordinator of government's housing program. On top of that, she also complained of a "large number of presidential advisers, consultants and assistants (who) only add disarray." Chief among the presidential advisers alluded to in the letter was a close presidential friend Estrada named Jose Luis "Sel" Yulo, whom private realty association[241] was pushing to replace Ms. David[242]. The World Bank (WB), upon resignation of the David-led housing team, had suspended talks pending the appointment of a new Housing and Urban Development Coordinating Council (HUDCC) Chairperson[243]. However, after the appointment of former Presidential Management Staff (PMS) chief Leonora de Jesus to the HUDCC, the World Bank discussions were not resumed, at least under the ousted Estrada administration.

[241] Although the Businessworld article decline to name the private realty association, this group has strongly been speculated to be the Chamber of Real Estate and Builders Associations (CREBA).
[242] Tenorio, Arnold S. Housing program back to square one. Businessworld Publishing Corporation. February 8, 2001. Makati City, Philippines.
[243] The World Bank (WB) team had already forewarned the government about letting politics getting in the way of official development assistance projects.

Primary Housing Mortgage Market – The Philippines

Overview. The Philippine banking system constitutes more than three-quarters of the total assets of the financial system[244]. However, except for the limited participation of the banks in the previous Unified Home Lending Program (UHLP) and the current Multi-Window Lending System (MWLS), the private commercial banks have not been actively involved in low-cost housing finance (versus their active participation in the middle and high-income housing market). Therefore, it might be insightful to briefly discuss the key patterns in the Philippine financial system and how they affect both the primary and secondary mortgage market.

Short-term investment orientation. In the Philippines, consumer's savings are largely captured in the financial system through deposits, and much of these deposits are in the nature of savings deposits and checking accounts[245].

Savings Channels in the Philippines (as of May 2000)

Savings Channel	Percentage
Savings Deposit	77%
Demand Deposits	17%
Time Deposits	6%
Deposit Substitutes	0%

Source: Bankers Association of the Philippines

The main reason that depositors place their funds into savings deposits and checking accounts is to allow them to draw against it as the need arises. Consequently, the banks must always be ready to honor any withdrawal from these accounts. This puts pressure on the banks to "protect" their dominant source of funds, which are "short-term" in nature. During periods where liquidity is most valued, this makes the yield curve[246] susceptible to inversion in times of crisis[247]. Thus, this gives rise to the "short-term orientation" of both the depositors and the bank.

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[244] Llanto, Gilbert M. and Leilanie Q. Basilio. Housing Policy: Developing a Market-based housing finance system. Philippine Institute of Development Studies. December 1999. Makati City, Philippines.

[245] Bankers Association of the Philippines. Market Reforms Project Presentation. April 4, 2001. Makati City, Philippines.

[246] The yield is the single interest rate that equates the present value of a fixed income instrument's payments to the instrument's price. Although interest rates may vary over time, the yield to maturity is calculated as the "average" rate that is applied to discount all of an instrument's payments. Thus, a yield curve is a graph of the yield to maturity as a function of time to maturity. In well-functioning capital markets, longer term instruments have higher yields, which reflect that future interest rates are higher than current rates. Given this, a normal yield curve is upward-sloping.

Another result of this "short-term" orientation is the difficulty in providing longer-term funds for borrowers. Since over 90% of the funds sourced have an effective maturity of less than one year, the need for longer-term loans (i.e. 5 to 10 years) creates "duration mismatch" problems for the bank.

When the need arises by banks to raise funds locally, most of these funds are raised through loans (versus commercial papers) and these loans are usually short (versus long) term in nature.

Loans Data from 1996 to end-May 2000 (Billions of Pesos)

Loans	1996	1997	1998	1999	2000
Short-term	P779B ($14.7M)	P965B ($18.2M)	P872B ($16.5M)	P821B ($15.5M)	P823B ($15.5M)
Medium-term	P204B ($3.9M)	P247B ($4.7M)	P233B ($4.4M)	P281B ($5.3M)	P290B ($5.5M)
Long-term	P138B ($2.6M)	P205B ($3.9M)	P248B ($4.7M)	P252B ($4.8M	P259B ($4.9M)
Commercial Papers	P375B ($7.1M	P385B ($7.3M)	P348B ($6.6M)	N/A	N/A

Source: Bankers Association of the Philippines

The demand by banks for long-term funds is, more often than not, financed by a supply of short-terms savings where the interest rate re-pricing takes on a critical role. From 1998 to 2000, interest rates – due to macroeconomic factors – have to be adjusted upwards or downwards. Since re-pricing for mortgage loans are usually done on a yearly basis, the volatility of interest rates discourages banks from engaging in long-term exposures. For example, during the height of the 1997 regional currency crisis, the 91-day treasury rates were kept artificially low by the government, thus not allowing the banks to price loans properly for risks.

Thus, we return to the discussion behind the reason why private commercial banks have not actively in low-cost housing finance. This can be partially explained by a) the negative effect to of the government subsidized programs (which we discussed extensively in Chapter 4), which have discouraged the development of the primary market for housing, and b) the short-term orientation of banks assets where the banks' short-term liabilities do not match the long-term nature of households' housing loans. The "duration mismatch" of borrowing short and lending long produces risks of term intermediation. The risks here lie in the relative illiquidity of the housing good and the opportunity costs of unadjustable interest rates. In the current market environment, if mortgage-backed securities (MBS) are issued to investors,

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[247] This occurs when when short-term deposit rates are higher than longer-term rates.

they need to be priced higher than current long-term financial instruments (which are presumably government securities).

Due to the lack of a secondary mortgage market, Jacob describes Philippine housing finance as a cyclical "feast and famine financial structure". This is characterized by the "feast" period, wherein the commercial sector are flush with liquidity and thus continuously lend to the point that they are carrying more mortgage loans than they can handle. The feast period is then followed by a "famine" period wherein the banks have over-lent, and thus merely earn interest from the mortgage loans until they are able to accumulate enough liquidity to lend again[248].

Interest rates. The private commercial banks have traditionally been 'crowded out' by the public lending sector via subsidized interest rates. Given this, it is instructive to find out how private commercial banks compete for mortgage loans. According to Coronel, these are the typical components built into the mortgage interest rate[249]:

Sample Computation of Mortgage Interest Rate

Cost	Approximate % Points	Description
Cost of funds	9.9*	Based on 91-day T-bill benchmark rate
Intermediation costs	1%-2%	Taxes paid on transaction, insurance costs
Administration costs	4%-5%	Back-office cost, Hedge against credit/interest rate risks, etc.
Total	14.9%-16.9%	Average market mortgage interest rate to homebuyer

Source: Leonilo Coronel, Bankers Association of the Philippines
** based on April 2001 91-day T-bill rate from Bankgo Sentral ng Pilipinas (Central Bank of the Philippines)*

The largest spread of the private commercial banks comes in the form of the administration costs. These spreads can vary from bank to bank. For perspective, the current market rates are closely approximated by the fixed interest rate for low-income housing by the public lending agencies:

[248] Jacob, Monico. Former Home Development Mutual Fund (HDMF)/Pag-Ibig Chairman and Conference Chairman of the Philippine Conference on Securitization. *Personal Interview.* June 2001. Makati City, Philippines.
[249] Coronel, Leonilo G. Executive Director of the Bankers Association of the Philippines. Personal Interview. June 2001. Makati City, Philippines.

Home Development Mutual Fund Market Segmentation by Loan Size

Income Decile	Category	Price Range	Interest Rate
1-4	Socialized Housing	P180,000 and below	9%
5-8	Economic Housing	P180,000 to P500,000	12%
8-10	Middle Housing	P500,000 to P2,000,000	16%/18% p.a.*
8-10	Open Housing	P2,000,000 to P5,000,000	18% p.a.*

Source: Home Development Mutual Fund (HDMF)/Pag-Ibig, author's estimates
** Available to HDMF/Pag-Ibig members only. If the loan is repaid via salary deduction scheme where the employer shall guarantee collection of the amortizations due on the housing loan, the loan shall bear an interest rate of 14% p.a. for the entire term of the loan*

However, using the sample computation for the mortgage interest rates, the past seven years were characterized by prohibitively high mortgage interest rates, particularly right after the 1997 regional currency crisis. For perspective, the largest spread between the highest market mortgage rate and fixed interest rates was in 1998, where the spread was 639 basis points (22.3% vs. 16%). However, mortgage interest rates have decreased of late, with the spread between market and fixed rates is currently at 90 basis points (16.9% vs. 16%):

Average Mortgage Interest Rates from 1995 to April 2001

Years	90-day T-bill interest rate	Approximate Mortgage Rates
1995	11.3%	16.3%-18.3%
1996	12.4%	17.4%-19.4%
1997	13.1%	18.1%-21.1%
1998	15.3%	20.3%-22.3%
1999	10.2%	15.2%-17.2%
2000	9.9%	14.9%-16.9%
April 2001	9.9%	14.9%-16.9%

Source: Author's estimates based on Bankers Association of the Philippines sample computation of mortgage interest rate
** from the Bangko Sentral ng Pilipinas (Central Bank of the Philippines)*

Coronel's sample computation appears to approximate current mortgage rates. The Bank of the Philippines[250] website reveals that mortgage loans within the P1 Million – P5 Million (US$19T-US$94T) with a fixed five-year term to maturity had an interest rate of 17.5%, which is slightly higher from our computation by 60 basis points. However, for a mortgage loan with same loanable amount and term-to-maturity but with a two-year fixed interest rate, the rate is 15.5%, well within the approximate mortgage range.

Loan types. The typical private bank loans are targeted for the mid- to high-income housing segment (P500,000/US$9,430 up to P5,000,000/US$94,340). These loans have a fixed one-year market interest rate, which is usually re-priced annually. However, some of these loans are also re-priced at a monthly, quarterly and even biannually. Loans which retain a longer fixed rate interest on their mortgage loans have higher interest rates.

Sample Mortgage Loan Interest Rates

Loan Amount	Interest Rate
Less than P1M (US$19T)	
Fixed for 1 year Fixed for 2 years Fixed for 5 years	15% 16% 18%
P1M (US$19T) to less than P5M (US$94T)	
Fixed for 1 year Fixed for 2 years Fixed for 5 years	14% 15.5% 17.5%

Source: Bank of the Philippines website (August 2001)

The term-to-maturity on these loans are usually fifteen years, but they can range from a minimum of five years to a maximum of twenty years. The following is a survey of bank mortgage loan terms from 1997 and 1998 (Note that the respective t-bill rates and approximate mortgage rates for those years were 13.1%/18.1%-21.1% and 15.3%/20.3% - 22.3% respectively).

Interest Rates on Retail Mortgage Loans

Bank	April 1997	September 1998	April 1997	September 1998*
Commercial Banks				
Active Bank	23%		5 years	
Asian Bank	17%	19.795%	15 years	15 years/monthly
Bank of the Philippine Islands	17%		15 years	
Bank of Commerce	20%	20%	15 years	10 years/monthly
Citytrust	17%		15 years	
Far East Bank	17.5%	19.795%	15 years	Variable/yearly
PCIBank	17%	18%	15 years	20 years/yearly
Rizal Comml Banking Corp.	17%	19%	15 years	15 years/yearly
Union Bank	17%	20%	15 years	20 years/semiannually
China Bank	17%		15 years	
Solid Bank	17%	19%	15 years	15 years/monthly
United Coconut Planters Bank	17%		15 years	
Equitable Bank	17.5%	19%	15 years	15 years/variable
Philippine Veterans Bank	18%		15 years	
Savings and Mortgage Bank				
BPI Family Bank	18%	17.75%	15 years	15 years/yearly
Keppel Monte	18%	22%	15 years	5 years/biannually
Philippine Savings Bank	17.5%	19.75%-22.75%	15 years	15-20 years/quarterly
Private Development Banks				
Asiatrust Development Bank	17%	17.75%	15 years	15 years/yearly
Planters Development Bank	18%	23.5%	15 years	15 years/yearly
RCBC Savings	19%		15 years	
PDCP Development Bank	17%		15 years	

Source: Asian Development Bank
* *the maturities are quoted along with the frequency of repricing (i.e. monthly, annually, quarterly)*

[250] Bank of the Philippine Islands (BPI) is one of the largest universal bank of the Philippines.

The typical public sector loans are targeted to the low- to mid-income housing segment (from less than P180,000/US$3,400 to P500,000/US$9,430). These loans have fixed interest rate loans over the life of the loan, with a term-to-maturity of twenty-five, and even up to thirty years. Presented below is a survey of the packages offered by the three contractual savings institutions (CSI):

Interest Rate and Term-to-Maturities of Public Sector Mortgage Loans(for 2001)

Institution	Interest Rate terms	Term-to-maturity
Multi-Window Lending Scheme (MWLS)	• For socialized housing (up to P180,000/US$3,400), 9% fixed rate for the life of the loan • For P180,000/US$3,400 up to P500,000/US$9,430, 12%/13% p.a., subject to review every five years • Rates include 0.5% Home Guaranty Corporation (HGC) guaranty	Multiples of five years with a maximum of thirty years
Home Development Mutual Fund (Expanded Housing Loan Program)	• For P250,000/US$4,720 – P500,000/US$9,430, 16% fixed rate for the life of the loan. • For socialized housing (up to P180,000/US$3,400), 9% fixed rate. • For economic housing (P180,000 to P250,000) 12% fixed rate. • For socialized housing and lot packages (9%) (P180,000/US$3,400 – P250,000/US$4,720) • For socialized and economic housing, the subsidy period for socialized and economic housing will depend on the loan term.	Multiples of five with a maximum of twenty five years
Social Security System (Individual Housing Loans)	• For socialized housing (up to P180,000/US$3,400), 9% fixed rate for the life of the loan. • For P180,000/US$3,400 up to P500,000/US$9,430, 13% p.a., subject to review every five years.	Multiples of five years with a maximum of thirty years
Government Service Insurance System (GSIS)	• For socialized housing (up to P180,000/US$3,400), 9% fixed rate for the life of the loan. • For P180,00/US$3,400 to P250,000/US$4,720, 12% fixed rate for life of loan. • For P250,000/US$4,720 to P375,000/US$7,080, 14% fixed rate for life of loan. • For P375,000/US$7,080 to P500,000/US$9,430, 16% fixed rate for life of loan.	Multiples of five years with a maximum of thirty years for loans up to P180,000/US$3,400. Multiples of five years with a maximum of twenty five years for loans P180,000/US$3,400 – P500,000/US$9,430

Source: Home Development Mutual Fund (HDMF) website, Social Security System (SSS) website, Government Service Insurance System (GSIS) website

Size of primary housing mortgage market. There have been conflicting reports as to the actual size of the Philippine mortgage loan market. The 1997 World Bank housing study pegged the market at roughly 11% of Gross Domestic Product (GDP) of P312 Billion (US$5.9 Billion)[251]. Given this, Bernardo believes that

[251] Versus 20% of GDP in Malaysia, 30% of GDP in Hong Kong, 50%+ of GDP in both the UK and the US. However, note that all these countries have secondary mortgage markets.

the Philippine mortgage market is large enough to need the liquidity provided by a Secondary Mortgage Institution (SMI)[252].

Global comparisons for mortgages outstanding as % of GDP

Country	Mortgages Outstanding (US$B)	% of GDP
United States	3,600	54
Japan	1,500	33
Malaysia	4	23
Korea	44	14
Thailand	16	13
Philippines	6	11
Indonesia	7	5

Source: Romeo Bernardo Presentation at Philippine Conference on Securitization

However, Kotecha[253] believes that the mortgage loan market accounts for less than 5% of Gross Domestic Product (GDP). Thus, similar to the housing 'backlog' issue, the government in conjunction with the private sector, should reconcile their mortgage loan estimates in preparation for the development of a secondary mortgage institution (SMI). Nonetheless, similar to Bernardo, Kotecha believes that despite the small percentage of the market versus GDP, primary mortgage lending can grow rapidly with an effective secondary mortgage market[254].

[252] Philippine Conference on Securitization. Mobilizing the Markets for Securitization: The Case for Asset Backed Securities, Former Finance Undersecretary Romeo Bernardo's presentation. October 1999. Makati City, Philippines.
[253] Mahesh Kotecha is the President of the Structured Credit International Corporation (SCIC), a consulting and advisory firm that provides specialized financial advisory services in the area of debt capital markets to financial institutions and other business entities particularly in emerging markets. Kotecha was commissioned by the Financial Executives of the Philippines (FINEX) to draft a business plan on a Philippine Secondary Mortgage Institution (SMI) in the last quarter of 2000.
[254] Kotecha, Mahesh K. Secondary Mortgage Institution (SMI) Philippines – Draft Business Plan. Structured Credit International Corporation. 2000. New York, New York.

Volume of mortgage loans. According to Kotecha, the total mortgage volume is roughly P151 Billion (US$2.8 Billion)[255]. The following is the breakdown of the mortgage volume and their major characteristics:

Estimated Volume of Mortgage Loans

Loan	Category	Characteristics
P100B (US$1.9B) P40B (US$755M) with NHMFC* P55B (US$1B) with HDMF**	Public sector	Low to mid income housing loans, low fixed interest rate loans
P50B (US$943M) P31B (US$585M) with commercial banks P15B (US$283M) with thrift banks	Private sector	Middle to high income housing loans, floating rate interest rate loans re-priced annually
P20B (US$377M)	Developers	Estimated developers contract to sell for houses priced within the mid income bracket (P400,000 /US$7,550-P1,000,000/US$18,870) sold to first time homebuyers, including overseas Filipino workers

Source: Structured Credit International Corporation
Note: Amounts have been rounded off for the estimated total of the loans. Thus the aggregate amount may not equal the breakdowns. * *National Home Mortgage Finance Corporation (NHMFC)*
** *Home Development Mutual Fund (HDMF)/Pag-ibig*

However, of these loans, Kotecha only considers P71 Billion as eligible mortgage that can be considered for securitization. These include the private sector and the developer's mortgages (via Contract to Sell), but exclude the public sector loans.

Financial Instruments in the Primary Mortgage Market

Certain financial instruments in the Philippine mortgage market have evolved in favor of the developer versus other financing alternatives available to the developer.

Reservation Agreement. As the name implies, the reservation agreement merely reserves the chosen property for the potential homebuyer with a nominal reservation fee (in some cases, about 5%) made on the property. In the event that the homebuyer fails to meet his obligations in the reservation agreement (i.e. down payment and submission of requirements), the reservation and additional payments made are considered forfeited. The policy of forfeiture and cancellation of the payments remitted to the developer are usually contained on the reservation agreement[256].

[255] P151 Billion (US$2.9 Billion) is roughly 4.7% of Gross Domestic Product (GDP). GDP, as estimated by the International Institute of Finance was roughly P3,233 Billion (US$ 61 Billion) in 2000.
[256] Tan, Edward L. Real Estate in the Philippines. Solar Publishing Corporation. 1999. Manila, Philippines.

Contract to sell (CTS). Contracts to sell (CTS) enable developers to obtain bridge financing at market rates for housing construction from private commercial banks until the credits are taken out by the contractual savings institutions (CSI). The title subsequently passes on to the homeowner, and the mortgage passes to the contractual savings institution (CSI), who assumes the role of creditor. The Contract to Sell (CTS) can also be structured like a lease-purchase transaction, where the developer or the contractual savings institution (CSI) retains title to the property until all amortizations are paid[257].

The contract to sell (CTS) is the formal and legal agreement between the homebuyer and the developer. In a Contract to Sell (CTS), unlike a regular mortgage, the title to the property does not immediately pass to the homebuyer, but merely a mutual promise to sell and buy. The homebuyer binds himself to fulfill his obligations in terms of paying his monthly amortization fees to the developer. While the developer, in turn, binds himself to deliver what he has promised to the homebuyer (i.e. housing unit, quality of development, amenities)[258].

The Contract to Sell (CTS) has been deliberately structured to serve developers, who are given a certain degree of flexibility in dealing with delinquent clients without being subject to the Foreclosure Law[259]. However, although the Contract to Sell (CTS) isn't covered by the foreclosure law, it is covered under the Maceda Law (Republic Act 6522), which requires a developer or any financing institution to reimburse the defaulting borrower if the latter has completely paid at least two years' worth of amortization[260].

Regular mortgage instruments. In lieu of the contract to sell (CTS), banks use regular mortgage instruments when granting housing loans, which are governed by the Foreclosure Law (Republic Act 3135).

Deed of Absolute Sale. The deed of absolute sale signifies that the buyer has fulfilled all financial obligations to the seller[261]. With the deed of absolute sale, the title of the property is now transferred to the homebuyer's name. However, the seller may still have unfulfilled obligations, in terms of development, to the homebuyer. In some cases, only partial developments are completed in the residential subdivision, and some buyers have already paid their property in full to avail of some discounts.

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[257] Reside, Renato S. Mortgage-Backed Securities in Asia. Asian Development Bank. 1999. Pasig City, Philippines.
[258] Tan, Edward L. Real Estate in the Philippines. Solar Publishing Corporation. 1999. Manila, Philippines.
[259] The Foreclosure Law will be discussed in Chapter 7.
[260] The Maceda Law will be discussed in Chapter 7.

Primary Housing Mortgage Market – The United States

Overview. The US Government provides stability in the early stages of the market development in the following ways. First, they provide tax subsidy by allowing for deductibility of mortgage interest. Second, they provide insurance for loans. Third, they create agencies to buy loans on the secondary market and create secondary mortgage market instruments. They also create incentives for support of affordable housing in developed markets. There is one key government housing agency within the U.S. primary housing mortgage market.

Federal Housing Administration (FHA)

The Federal Housing Administration, a wholly owned government corporation, was established under the National Housing Act of 1934 to improve housing standards and conditions; to provide adequate an adequate home financing system through insurance of mortgages; and to stabilize the mortgage market. FHA was consolidated into the newly established Department of Housing and Urban Development (HUD) in 1965.

FHA provides mortgage insurance on single-family and multifamily mortgage loans to low- and middle-income families. FHA bears the risk that a borrower will default and that the lender will convey to FHA either a property or a loan in exchange for payment of an insurance claim.

Through mortgage insurance, FHA helps lenders reduce their exposure to risk of default. This allows lenders to make money available to a broader range of income earners, some of whom would otherwise fail to qualify for loans. Mortgage insurance has made financing available in neighborhoods and geographic areas facing economic uncertainty, and to individuals and families not adequately served by the conventional mortgage market. FHA spreads and manages risk through geographically dispersed loan insurance activity and a portfolio that is diverse in borrowers and products.

Secondary Housing Mortgage Market – The Philippines

Overview. In well-functioning capital markets such as the United States, mortgage securitization has evolved to a point where the mortgage-backed securities can be 'tailored' to meet the investment risk preferences of institutional investors and accommodate the financial interests of private mortgage lenders. Thus, in the United States, the reason behind mortgage-backed securitization has become almost wholly

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[261] Tan, Edward L. Real Estate in the Philippines. Solar Publishing Corporation. 1999. Manila, Philippines.

financial in nature: improve Return on Equity (ROE), satisfy capital adequacy requirements, increase fee-based income, and improve liquidity and asset-liability management[262].

However, in developing countries such as the Philippines, not only are the capital markets still in a stage of 'infancy' (versus the mature United States capital market), but mortgage securitization is only part of an overall housing policy (which includes finance, production, and regulation) and, consequently, the national development strategy[263]. For perspective, the National Home Mortgage Finance Corporation (NHMFC) was originally set up and mandated by the government, via Executive Order (EO) 90 in 1986, to serve as the Secondary Mortgage Institution (SMI)[264].

However, the government has recently expressed its desire to play a catalytic role (vis-à-vis the regulatory and legal environment) in housing finance, and instead, allow the private sector to develop the secondary housing mortgage market in the Philippines[265]. In fact, the private sector, through the efforts of the Financial Executives of the Philippines (FINEX) had organized a conference on securitization in 1999 with the objective of mobilizing private funds for housing through a secondary mortgage institution (SMI)[266].

Given this, there are several differences between mortgage origination between the United States and the Philippines. In the United States, mortgage loans are mostly privately originated. In the Philippines, a large portion of the national mortgage portfolio is quasi-publicly originated[267]. These quasi-publicly-originated mortgages are targeted to improve housing finance for the poor in the form of subsidies[268]. The rationale behind these subsidies in the housing markets is the belief that the majority of the

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262 Reside, Renato S. Mortgage-Backed Securities in Asia. Asian Development Bank. 1999. Pasig City, Philippines.

263 For example, the aborted Medium Term Development Plan for Shelter (MTDP-S) is part of the 1999-2004 Medium-Term Development Plan of the ousted Estrada administration.

264 The National Home Mortgage Finance Corporation (NHMFC), in 1996, has been relegated to a mere collection agency of its past-due accounts.

265 Although a market-oriented housing finance scheme, wherein the government would have played more an 'enabling' role and the private sector would initiate the development of a secondary mortgage institution (SMI), was outlined under the Medium Term Development Plan for Shelter (MTDP-S), these plans were abruptly set aside with the establishment of the now-defunct Presidential Commission on Mass Housing (PCMH).

266 The results of the FINEX-organized October 1999 Philippine Conference on Securitization appear in several portions of the thesis.

267 According the 1997 World Bank study on housing finance, as of December 1995, at least 30% of the total formal construction and mortgage lending is being undertaken by the public agencies. However, this statistic most likely understates the role of the government in the Philippine residential mortgage market since a large proportion of private sector lending is related to the commercial rather than the residential real estate sector.

population will not be able to afford housing units unless some form of subsidy is made available to them[269].

Secondly, since Mortgage-Backed Securities (MBS) as an alternative financial instrument to government securities is relatively new in the Philippines, regulatory, taxation and legal authorities are still unfamiliar with the laws that encourage securitization. Given this, the laws governing Mortgage-Backed Securities (MBS), and securitization as a whole, are still in its infancy. These include the rules on mortgage valuation, pricing, servicing, foreclosure, accounting, and risk-based capital treatment.

Thirdly, the Philippines have yet to develop the supporting infrastructure for mortgage-backed securitization, which include bond and mortgage insurance, credit information bureaus, centralized titling systems and title insurance.

Fourth, given the 'infant' stage of the Philippines in terms of capital market development, there are some features of the underdeveloped market which constrain the development of Mortgage-Backed securities (MBS). These include a) maturities for privately-originated, market-rate mortgages have a term-to-maturity of ten years (publicly-originated, fixed-interest rate mortgages have a term-to-maturity of twenty-five years); b) since no clear yield curve exists, the average interest rates on Mortgage-Backed securities (MBS) are based primarily on the underlying mortgages and the benchmark 91-day T-bill rate, and c) credit channeled by the government to low cost-housing is an implicit subsidy to that segment of the market[270].

Secondary Housing Mortgage Market Models

United States

The U.S. Government also adds stability to the developed secondary mortgage market. They provide full faith and credit guarantee on secondary market instruments securitizing mortgage loans for low and middle-income households.

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[268] Llanto, Gilberto M., Aniceto Orbeta, Jr., Ma. Teresa C. Sanchez and Marie Christine G. Tang. A Study of Housing Subsidies in the Philippines. Philippine Institute for Development Studies. November 1998. Makati City, Philippines.

[269] The subsidies can come in the form of lowering the cost of production of housing units or bringing down the cost of the housing unit for the end-user.

[270] Reside, Renato S. Mortgage-Backed Securities in Asia. Asian Development Bank. 1999. Pasig City, Philippines.

Ginnie Mae. Ginnie Mae is a wholly owned government corporation within the Department of Housing and Urban Development that supports federal housing initiatives by providing liquidity to the secondary mortgage market and by attracting capital to the residential mortgage markets. Ginnie Mae securities are backed by the full faith and credit of the US Government ensure uninterrupted flow of capital to housing markets even in the adverse economic conditions.

Ginnie Mae programs help increase the supply of affordable housing by guaranteeing securities issued by private lenders backed by pools of residential mortgages insured by the Federal Housing Administration. Ginnie Mae securities provide lenders with a vehicle for originating, funding and servicing mortgages in a highly structured and liquid market. At the same time, the securities provide investors with an investment that offers safety of principal, liquidity and attractive yield.

Ginnie Mae securities are one of the most widely held and traded mortgage-backed securities in the world. Ginnie Mae has guaranteed more than $1 trillion in mortgage-backed securities. Historically, 95% of all FHA and VA mortgages have been securitized through Ginnie Mae.

Ginnie Mae is a guarantor. It does not issue, sell, or buy mortgage-backed securities, or purchase mortgage loans.

Government Sponsored Enterprises (GSEs): Fannie Mae and Freddie Mac. Fannie Mae and Freddie Mac, the nation's largest housing finance institutions, are government sponsored enterprises (GSEs). The Congress created Fannie Mae and Freddie Mac to fulfill specific public policy objectives but they are, nonetheless, private firms owned by stockholders. According to their federal charters, the mission of both Enterprises is to provide stability in the secondary market for residential mortgages and to promote nationwide access to mortgage credit by increasing the liquidity of mortgage

GSE's are publicly traded organizations under government oversight. These organizations guarantee the full and timely payment of principal and interest on mortgage loans in amounts established by the U.S. Congress. They also have to guarantee the timely payment of principal and interest on mortgage-backed securities backed by eligible conventional loans or by government insured or guaranteed loans. The guarantee is not backed by the full faith and credit of the U.S. They also have to buy mortgage loans, mortgage backed securities for their own portfolios to stimulate secondary market activity.

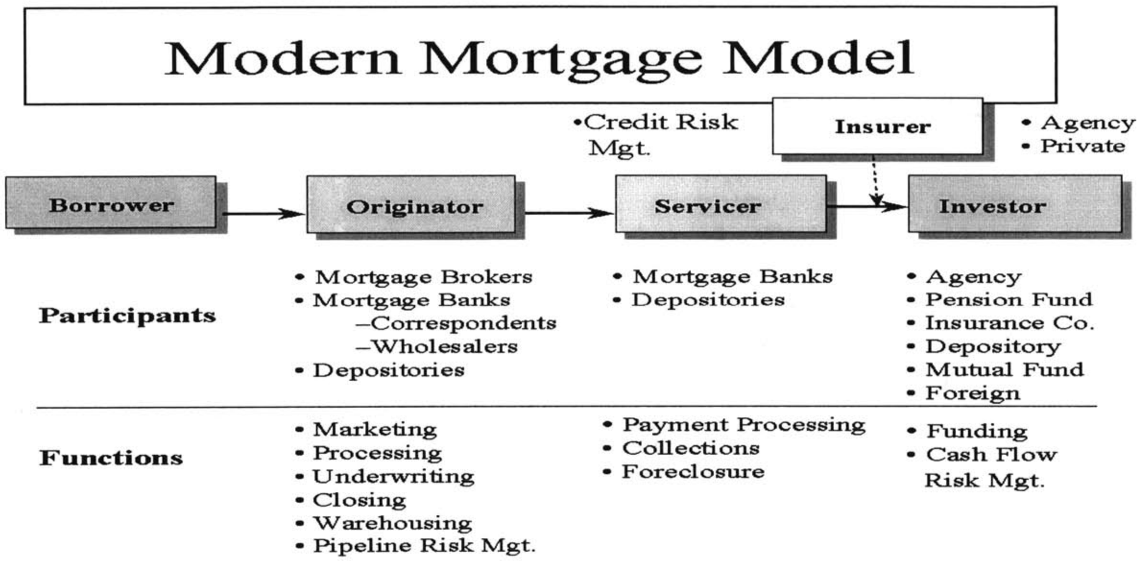
Freddie Mac played a significant role to find new ways of securitizing mortgages that would make them attractive to more investors. In 1983, Freddie Mac introduced the first multi-class mortgage backed security—the Collateralized Mortgage Obligation (CMO). The unique thing about CMOs was that the investors in a pool of mortgages did not all receive the same pro-rata share of cash flows. Rather, cash flows from the pool of mortgages were allocated to investors based on a set of rules, enabling us to target investors whose portfolio needs were more suited to a particular profile of cash flows. Rather cash flows from the pool of mortgages were allocated to investors based on a set of rules, enabling them to target investors whose portfolio needs were more suited to a particular profile of cash flows. In the early years there were limits to what multi-class mortgage securities could accomplish as issuers faced complex tax, accounting and regulatory obstacles.

Federal Home Loan Banks (FHLBs). FHLBs are government-sponsored enterprise owned by member banks and funded by debt issued into the capital market.

The mortgage backed securities market second only to U.S. Treasuries as the largest segment in the fixed income securities market has provide to be a more effective and efficient means to manage the interest rate risk associated with home loans. However, the transfer of mortgage credit risk to the capital markets has developed more slowly.

Freddie Mac and Fannie Mae have positioned GSE debt as one logical alternative to help meet investors' needs. That is because both firms issue debt in very large volumes and with regularity, and trade closer to Treasury yields than other credit instruments because of their high credit quality, liquidity and institutional integrity.

Models of Secondary Mortgage Markets. Whereas the traditional model of housing finance was based on specialized institutions performing all or most of the functions of mortgage lending, the modern model of housing finance is one in which the various functions (origination, servicing, risk management, funding) are unbundled and done by specialized entities.

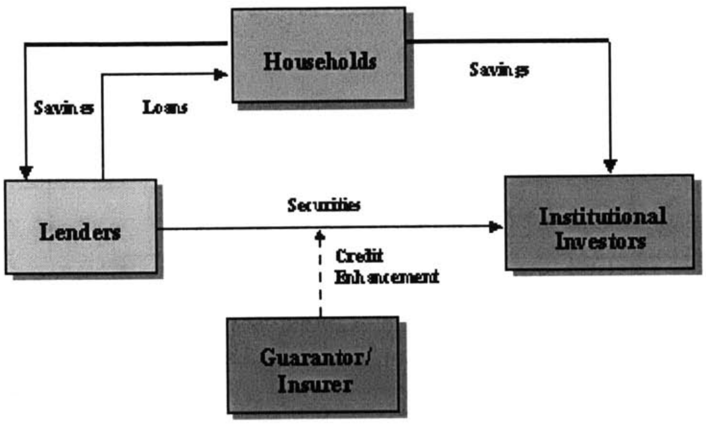


Source: International Housing Finance

The modern model of housing finance is based on a secondary mortgage market where mortgage loans are sold and securitized. Loan sales come from either traditional mortgage lenders or mortgage companies that specialize in the origination and servicing of the mortgage assets. Mortgage companies may operate on a retail (dealing directly with the borrowers or brokers) or wholesale basis (buying loans from other lenders, packaging them and re-selling or securitizing them. There are two primary secondary market models:

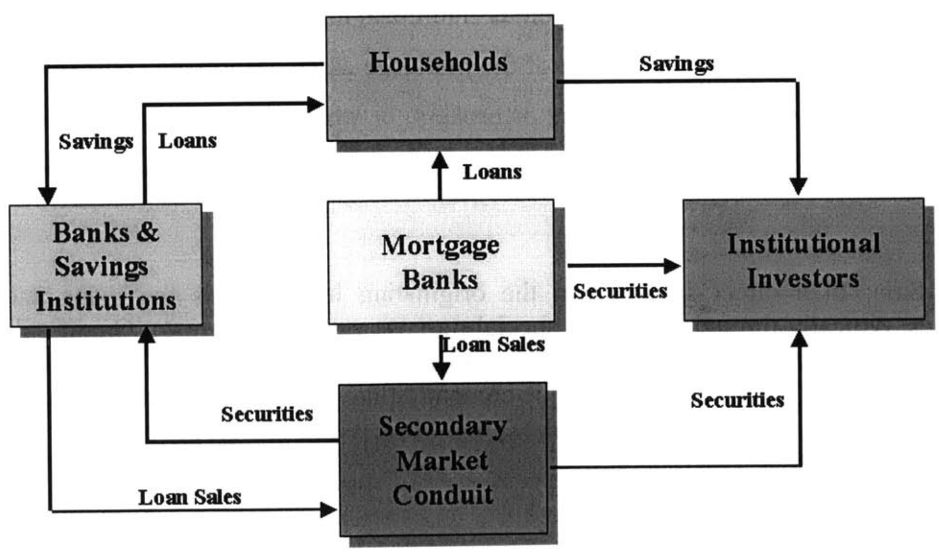
- **Direct Sale**: In a direct sale system the originating lender pools the loans and issues the securities, typically through a trust or special purpose vehicle (Figure 4). Credit enhancement is done by a third party (government agency as with Ginnie Mae in the US), pool insurer (mortgage insurance (like MGIC) or bond insurance company (like MBIA), or by structuring the securities (e.g., senior-subordination, reserve funds). Most MBS issued in Europe have been direct sales by originating lenders.

Secondary Market: Direct Sale



- **Conduits**: Conduits are specialized institutions that purchase mortgages from a number of different lenders, contract with those lenders or other institutions to service the mortgages and issue MBS backed by pools of mortgages (either from a particular lender or a number of lenders). Credit enhancement may be as above or by the conduit itself (e.g., Fannie Mae and Freddie Mac in the US). Conduits may be government supported (Fannie Mae, Freddie Mac, Banco Hipotecario in Argentina, Hong Kong Mortgage Corp.), or private (US, Australia, UK). Figure 5.

Secondary Market with Conduit



The origins of securitizations date back to the founding in 1938 of the Federal National Mortgage Association (FNMA), popularly known as Fannie Mae, which was established by the U.S. government following the Great Depression to buy and sell federally insured residential mortgage loans made to lower income individuals. In the late 1960's, due to the federal government's increasing concern for the availability of housing and mortgage credit, the mortgage backed securities (MBS) market was greatly expanded. In 1968, the Government National Mortgage Association (GNMA or Ginnie Mae) was created as part of the U.S. Department of Housing and Urban Development.

Its guarantee represents the further obligation of the U.S. government on pools of loans guaranteed by two government agencies, the Federal Housing Administration and the Veterans Administration. In 1970, Freddie Mac was established to insure securities backed by pools of non-government (conventional) mortgages. Both FHLLMC and FNMA now have this mandate. Their mission is to provide stability in the secondary market for residential mortgages and to promote access to mortgage credit throughout the U.S. by increasing the credit quality and liquidity of mortgage investments.

The market views both FNMA and FHLMC as equivalent to triple-A credits based on the implicit support of the U.S. government, although there is no record of the need for actual government financial support in recent history. These two agencies purchase and securitize conventional mortgages. Unlike Ginnie Mae, which is a government owned and operated entity, Fannie Mae and Freddie Mac are publicly owned, traded on the NYSE and privately managed. FNMA is one of the largest issuers of the U.S. dollar denominated debt after the Department of the Treasury, with $606 billion outstanding in MBS at mid-year 1996, representing roughly 25% share of the U.S. residential mortgage market. It enjoys an excellent credit performance with a delinquency rate at half of the industry average and loan losses at about 0.06% of its total mortgage loans.

The establishment of these federally sponsored agencies has led to the development of securitization and the growth of an active secondary mortgage market for U.S. government guaranteed mortgage securities. Nearly 50% of the over $3.6 trillion of the total mortgage debt outstanding by year-end 1995 had been securitized. In addition, over $70 billion of the outstanding home equity loan (HEL) market (which is dominated by private lenders with virtually no role for the secondary mortgage agencies) has been securitized since 1990. Pricing of MBS is much more efficient owing to the implied government support in addition to the underlying collateral cash flows. Standardization of mortgage types and documentation, and homogenization of underwriting to conservative standards have been additional benefits. Some market participants have estimated that the mortgage rates for consumers might have been 25 to 60 basis points higher in the U.S. without development of the MBS market.

The savings and loan crisis during the 1980's provided an opportunity for new types of lenders, the U.S. mortgage banks, who originate and warehouse loans for a short period before reselling them. In 1990, the mortgage banks were responsible for around 35% of residential mortgage originations; by 1996 the figure had risen to around 55%. The following table summarizes the key characteristics of the U.S. mortgage market.

Characteristic	Consequence
The US mortgage market is dominated by mortgage banks.	US mortgage markets limited own funds to do their business as large parts of their mortgages are sold to government sponsored enterprises.
The rise of mortgage banks was triggered by the *Savings & Loans* crisis where the lack of capital induced institutions to remove loans from the balance sheet through securitization.	Risks are sold to third parties (investors)
Mortgage banks sell their loans into secondary market, primarily to US government sponsored enterprises who benefit from lower capital-to-assets ratios than banks.	Risks are outside supervisory scrutiny
The mortgage bank does not need to be successful in funding in order to create the conditions necessary to be successful in lending.	

Source: International Housing Finance

The Implicit Guarantee of the US Government Agencies. In the US, central government agencies play a central role. They buy individual packages of mortgage loans from lending institutions and either hold them on balance sheet or securitize them, selling them into the secondary mortgage market. There are three such agencies active in the secondary market in the U.S. The Government National Mortgage Association (GNMA), guarantees pools of loans originated by mortgage banks. The loans are insured by the Federal Housing Administration (FHA) and are targeted toward lower and moderate-income homebuyers. GNMA is backed by the full faith and credit of the U.S. government, which guarantees the timely receipt of principal and interest. U.S. institutions buying GNMA mortgage securities do not need to allocate capital to back these purchases, *as GNMA paper enjoys a zero percent risk weighting, the same as U.S. Treasury bills.* There are two other federal agencies active in the market, the Federal Home Loan Mortgage Corporation, FHLMC or Freddie Mac, and the Federal National Mortgage Association, FNMA or Fannie Mae. In many cases, it can be advantageous for a lending institution to sell loans to one of the federal agencies and repurchase credit-enhanced securities backed by the original loans.

Public Guarantee: The Important Role of the US Government Agencies

Characteristic	Consequence
The US central government sponsored enterprises (Ginnie Mae, Fannie Mae and Freddie Mac) buy mortgage loans from mortgage banks and sell them into the secondary market.	There is an element of state aid in American mortgage funding
These enterprises enjoy implicit government guarantees which reduce funding costs by about 50 Bp.	This advantage reduces funding costs by about 50 bp.
They have an emergency credit line from the Treasury of $8.5 billion (so far unused)	
Fannie and Freddie have roughly $0.032 of debt for each dollar of capital (compared to $0.115 of debt per dollar at private banks)	
The sheer size of the enterprises allows economies of scale. 50% of all outstanding residential mortgages at the end of 1997 were securitized. This amounted to about $2 trillion out of a total market of $4.1 trillion.	

Source: International Housing Finance

Capital Adequacy Implications. These agencies enjoy an implicit U.S. government guarantee; there is a belief, so far untested, that if the agencies failed they would be bailed out, in one way or another, by the U.S. government. They are, however, in other respects, conventional shareholder-owned institutions, with widely traded equity. Bonds and mortgage backed securities issued by Freddie Mac and Fannie Mae *carry only a 20% risk weighting for U.S. banks, compared to the internationally agreed 50% weighting for conventional residential mortgages.* Fannie Mae holds about 17% of all outstanding mortgages (and therefore about 34% of securitized mortgages), Freddie Mac holds 14% (28%), and Ginnie Mae, about 13% (26%). About 8% of outstanding mortgages (20% of securitized loans) are in pools issued by private conduits, not backed by the federal agencies. This provides us with an indication of why the secondary market in the United States is so large and attractive.

As it is government backed and enjoys implicit government guarantees, the secondary market is able to provide a less expensive source of funding than other mechanisms. Informal estimates suggest that the federal backing for Fannie Mae and Freddie Mac, for example, *reduces their funding costs by about 50 basis points.* Moreover, the sheer size of the institutions allows them to develop significant scale economies. Also, the *agencies are allowed to operate with significantly lower capital-to-assets ratios than banks.* The did not become subject to specific capital adequacy regulation until the mid-1990s.

U.S. Standardization. The size of the federal agencies enables them to impose homogeneity on the market. Fannie Mae, for example, has developed standardized software to assist lenders in the underwriting processes. The federal agencies can insist on loans have particular characteristics before they purchase and they are able to publish uniform, widely available mortgage rate benchmarks in order to facilitate comparison shopping by borrowers.

Fixed versus variable rate mortgage products. The U.S. market is dominated by fixed-rate mortgages. Almost two-thirds (65%) of loans held by the federal agencies are 30-year fixed-rate loans and a further 15% are 15-year fixed rates. Just 10% of the loans are adjustable-rate mortgages and the rate charged by the mortgage lending institution is linked to an index.

Pre-payment Risk. In the U.S., pre-payment risk is a very important consideration. In the US borrowers typically take out a 30-year fixed rate mortgages, but there are no, or minimal, redemption penalties. The secondary market – which operates under a risk of not receiving the expected return from the borrower if he pre-pays – offers an effective mechanism for pricing that risk. This means that he prepayment irks is mutualised among the borrowers t and that borrowers who do no prepay effectively pay for other borrowers' mobility. On early repayment penalties, there are significant differences in national laws.

Products and techniques, which operate in the US market, are not yet transferable to the Philippine market, not least because of the dominant role of the federal agencies. However, conditions in the Philippines and Asian markets are changing rapidly. Intense competition, greater focus on the need to use capital efficiently, changing funding conditions created by historical low inflation and interest rates, and an acceleration of already trends towards specialization may drive the creation of a much larger secondary market.

Other Models

Malaysia (Cagamas). Cagamas was incorporated in December 1986 to support the Malaysian Government's policy of encouraging house ownership, particularly of the lower income group, by providing liquidity to the financial institutions, and at the same time, to develop the private debt securities market. The company has established itself as the leading issuer of private debt securities in Malaysia. Cagamas had securitized 23.8% of the outstanding housing loans of the financial institutions.

Hong Kong (HKMC). The corporation was established in 1997 with the primary objective of promoting the development of the secondary mortgage market in Hong Kong. A liquid secondary mortgage market will help the authorized institutions to address three funding risks, namely maturity mismatch, the liquidity risk and the concentration risk.

Hong Kong started securitizing mortgage sin 1994, thereby developing Asia's first private mortgage market. In recent years there has been a strong appreciation of Hong Kong property values, contributing to the growth of this market. Hong Kong's residential mortgage market is estimated at over US$30 billion and offers ample opportunities for securitization with supportive legal and regulatory regimes. Banks and property developers will need to sell mortgage assets because of balance sheet constraints. Consequently, the government is spearheading the establishment of a Fannie Mae-type institution in Hong Kong.

Mortgage-Backed Securities (MBS) Supply Issues

Overview. Technically, there are two types or mortgage loans that have the potential to be currently securitized:

1. *Securitization of the nonperforming loans (NPLs) for liquidation.* Theses are mortgages from both the public and private sector, which can partially be rehabilitated through the introduction of improved collection and servicing efforts[271] (notwithstanding such issues as fixed vs. market interest rates and term-to-maturity of the loans). Currently, these are the non-performing mortgage loans from the National Home Mortgage Finance Corporation (NHMFC) from the defunct Unified Home Lending Program (UHLP), the contractual savings institutions (Social Security System

[271] The assumption on the rehabilitation of residential non-performing loans is based on an estimate provided by Norman Macasaet, Principal Transactions Group of Lehman Brothers. In an interview with Norman Macasaet, Brothers was able to rehabilitate an estimated 8,000 of 15,000 residential loans (53%), that the Thai government foreclosed on from private finance companies, for securitization.

(SSS), Government Service Insurance System (GSIS), Home Development Mutual Fund (HDMF)/Pag-ibig), and the banks (commercial, thrift and rural). These type of loans are usually sold to an Asset Management Company (AMC), at a steep discount, by the mortgagees.

2. *Securitization of the 'Performing loans'*. These are mortgages from both the public and private sector (notwithstanding such issues as fixed vs. market interest rates and term-to-maturity of the loans). These loans cover the 'utilized loans' from the Housing and Urban Development Coordinating Council (HUDCC)'s Multi-Window Lending Scheme (MWLS), the contractual savings institutions (Social Security System (SSS), Government Service Insurance System (GSIS), Home Development Mutual Fund (HDMF)/Pag-ibig), the developers Contracts to Sell (CTS), and the banks (commercial, thrifts, and rural). These type of loans are usually sold to a Secondary Mortgage Institution (SMI).

The third type of mortgage loans are for new loan origination that have the potential to be securitized. These mortgage loans include the unutilized portion of the Multi-Window Lending Scheme (MWLS), the new loans to be originated by the contractual savings institutions (CSIs) to their members and employees, the new loans to be originated by the banks (commercial, thrifts, rural), and the new Contracts-to-sell (CTS) to be originated by the developers. These type of loans are usually sold to a Secondary Mortgage Institution (SMI).

The following two tables are the author's estimates and projections for the performing and non-performing loans that can be currently securitized:

Assumed non-performing loans (NPLs) for rehabilitation and securitization

(Please refer to end of chapter for computational details)

Sector	Institution	Amount	Issues
Public	National Home Mortgage Finance Corporation (NHMFC)	P10.9B (US$205.8M)	Fixed rate loans with a composite interest rate of 13%[272] and a term to maturity of 25 years.
	Multi-Window Lending Scheme (MWLS)	P1.4B (US$25.8M)	Fixed rate loans with a maximum term to maturity of 30 years. HGC guaranteed
	Home Development Mutual Fund (HDMF)	P3.7B (US$69.8M)	Loans to members Fixed rate loans with a maximum term to maturity of 25 years.
	Social Security System (SSS)	P61M (US$1.2M)	Loans to members and employees Fixed rate loans with a maximum of term to maturity of 30 years.
	Government Service Insurance System (GSIS)	P221.5M (US$4.2M)	Loans to members and employees Fixed rate loans with a maximum of term to maturity of 30 years.
Total Public		**P16.3B (US$307M)**	
Private Sector	Commercial bank	P492.9M (US$9.3M)[273]	Adjustable rate market loans with a term to maturity of five to twenty years.
	Thrift Banks	P628M (US$11.9M) (Figure 6 (end of chapter)	Adjustable rate market loans with a term to maturity of five to twenty years.
	Rural banks	No data available	Adjustable rate market loans with a term to maturity of five to twenty years.
Total Private		**P1.12B (US$21M)**	
Total		**P17.4B (US$328.8M)**	

Assumed 'performing' loans for securitization

272 This was the estimate provided by Deputy Secretary General Lucille Ortille as the composite interest rate for the fixed interest rates of 9%, 12% and 16% under the previous Unified Home Lending Program (UHLP).

Sector	Institution	Amount	Issues
Public Sector	National Home Mortgage Finance Corporation (NHMFC)	P10-P12B (US$189–US$226M)[274] (out of a possible P42B (US$792M)[275]	Fixed rate loans with a composite interest rate of 13% and a term to maturity of 25 years.
	Multi-Window Lending Scheme (MWLS)	P4.2B (US$79.7M) Figure 7 (end of chapter)	Fixed rate loans and a maximum term to maturity of 30 years. HGC guaranteed
	Home Development Mutual Fund (HDMF)	P48.015B (US$906M)	Loans to members and employees Fixed rate loans with a maximum of term to maturity of 30 years.
	Social Security System (SSS)	P189.4M (US$3.6M)	Loans to members and employees Fixed rate loans with a maximum of term to maturity of 30 years.
	Government Service Insurance System (GSIS)	P418M (US$7.9M)	Loans to members and employees Fixed rate loans with a maximum of term to maturity of 30 years.
Total Public Sector		P52.8B – P54.8B (US$997M-US$1.03B)	
Private Sector	Commercial Bank	P30.07B (US$567M)	Adjustable rate market loans with a term to maturity of five to twenty years
	Developers Contracts-to-sell (CTS)	P20B (US$377M)[276]	Adjustable rate market loans/Fixed higher than prevailing market rate loans with a term to maturity of five to twenty years (need to confirm)
	Thrift banks	P13.8B (US$261M)[277]	Adjustable rate market loans with a term to maturity of five to twenty years
	Rural banks	No data available	Adjustable rate market loans with a term to maturity of five to twenty years
Total Private Sector		**P63.87B (US$1.21B)**	
Total		**P126.7B – P128.7B (US$2.39B-US$2.43B)**	

[274] This was a ballpark estimate given by Deputy Secretary General Lucille Ortille of the Housing and Urban Development Coordinating Council (HUDCC) with regard to "cherry-picked" loans eligible for securitization from the total portfolio of the National Home Mortgage Finance Corporation (NHMFC). Note that this 'securitizable' amount is only 29% of the total loan portfolio. Ideally, the total amount of securitizable mortgages should be P21.4 Billion or 51% of the loan portfolio.

[275] This was the estimate provided by the Housing and Urban Development Coordinating Council. Note that it higher by P2B (US$38M) from the estimate of Mahesh Kotecha from the Structured Credit International Corporation (SCIC). (P42B/US$792M vs. P40B/US$754M).

These are the new mortgage loans that have the potential to be securitized:

New Loans for Securitization[278]

Sector	Institution	Amount	Issues
Public Sector	Multi-Window Lending Scheme (MWLS)	P33.2B (US$626M)	Fixed rate loans and term to maturity of up to 30 years. HGC guaranteed
	Home Development Mutual Fund (HDMF)/*Pag-Ibig*	P7.43B (US$140M)	Loans to members Fixed rate loans with a maximum of term to maturity of 25 years.
	Social Security System (SSS)	P97.8M (US$1.8M)	Loans to members and employees Fixed rate loans with a maximum of term to maturity of 30 years.
	Government Service Insurance System (GSIS)	P25.08M (US$473T)	Loans to members and employees Fixed rate loans with a maximum of term to maturity of 30 years.
Total Public Sector		**P40.8B (US$769M)**	
Private Sector	Commercial Bank	P930M (US$17.5M)	Adjustable rate market loans with a term to maturity of five to twenty years
	Developers Contract-to-sell	P600M (US$11.3M)	Adjustable rate market loans/Fixed higher than prevailing market rate loans with a term to maturity of five to twenty years (need to confirm)
	Thrift banks	P450M (US$8.5M)	Adjustable rate market loans with a term to maturity of five to twenty years
	Rural banks	No data available	Adjustable rate market loans with a term to maturity of five to twenty years
Total Private Sector		**P2B (US$37.4M)**	
Total		**P42.7B (US$806M)**	

276 Figure based on 2001 Structured Credit International Corporation study.

278 These are for mortgage loans generated in a year based on the performing loans, of both public and private institutions, in the previous year.

Mortgage-Backed Securitization (MBS) supply issues.

Difficulty to securitize public sector-originated loans. According to Kotecha, the only mortgage loans that are eligible for securitization are the aggregate private sector loans and the developers' contracts-to-sell (CTS), which amount to P71B (US$1.3B)[279]. Given this, Kotecha believes that public sector lenders can only do stand-alone mortgage-backed securitization (MBS), and cannot sell any of these mortgages to a secondary mortgage institution (SMI) for securitization[280]. Kotecha noticeably excludes the public sector mortgages of P100B (US$1.9B), which include P55B (US$1.04B) from the Home Development Mutual Fund (HDMF)/Pag-Ibig and P40B[281] (US$755M) from the National Home Mortgage Finance Corporation (NHMFC). Presumably, the reasons behind the 'ineligibility' of the public sector mortgages are a) the fixed interest rates on these loans and; b) the long term to maturities (25 years), thus making these mortgages difficult to securitize. In the event that these loans are securitized, these securities may not deliver higher yields as a long-term investment alternative versus government securities (i.e. treasury bonds) of similar maturities[282]. According to Ortille, the composite rate for the Unified Home Lending Program (UHLP) mortgage loans was 13%[283]. The only government security which trades at the same duration is the 25 year treasury bill, which is 303 basis points higher versus the composite mortgage rate (16.036%)[284].

In the event that publicly originated mortgages are securitized, Alcid added investors (i.e. the commercial banks) will be hesitant to purchase publicly originated mortgages, even if the mortgage backed security (MBS) has credit enhancements (i.e. guarantees), because of the underlying asset quality (i.e. the underwriting standards of the public mortgage loans are not of the same underwriting standard as those of the banks)[285].

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279 Kotecha, Mahesh K. Secondary Mortgage Institution (SMI) Philippines – Draft Business Plan. Structured Credit International Corporation. 2000. New York, New York.
280 Kotecha, Mahesh K. Secondary Mortgage Institution (SMI) Philippines – Draft Business Plan. Structured Credit International Corporation. 2000. New York, New York.
281 Note that Kotecha's estimate of the National Home Mortgage Finance Corporation (NHMFC) is $2B (US$38M) lower versus that of the Housing and Urban Development Coordinating Council's estimate.
282 For perspective, the logic behind the three tiered interest rate (9%/12%/16%) scheme pursued under the Unified Home Lending Program (UHLP) was to let the higher-tiered loans subsidize the lower-tiered loans, which was termed a "cross-subsidization".
283 Ortille, Lucille. Deputy Secretary General of the Housing and Urban Development Coordinating Council. *Personal Interview.* June 2001. Makati City, Philippines.
284 As of August 10, 2001. Source: Hong Kong Standard Chartered Bank Corporation Philippines.
285 285 Alcid, Andrew D. Executive Vice President, Investment Banking Division of United Coconut Planters Bank. *Personal Interview.* June 2001. Makati City, Philippines.

National Home Mortgage Finance Corporation (NHMFC) securitization issues. Aside from the other public lending institutions that used "formula lending" practices and subsidized/fixed interest rates to its members and employees, there are issues idiosyncratic to the National Home Mortgage Finance Corporation (NHMFC). The NHMFC, the sole take-out window during the Unified Home Lending Program (UHLP), which currently holds a P42B (US$792M) portfolio of past due loans, almost became insolvent for a third time before it was relegated to a collection agency function in 1996. The issues associated with the National Home Mortgage Finance Corporation (NHMFC) are:

1. *Questionable asset quality.* In the previous congress, Former Chairperson Karina Constantino-David said during a joint hearing of the House of Representatives committees on good government and on housing and urban development that there may have been "ghost loan applications"[286], [287] due to a collusion among the housing agencies, developers, employers and borrowers[288]. This was purported be one of the key factors that led to the collapse of the National Home Mortgage Finance Corporation (NHMFC).

   Even the private sector questions the integrity of the records of the NHMFC to support a credible asset-backed securitization[289]. Jacob relates that, due to the tarnished reputation of the National Home Mortgage Finance Corporation (NHMFC), investors will be hesitant to purchase any mortgage-backed securities (MBS) that the NHMFC issues[290]. As further anecdotal evidence, Benardo cites that the National Home Mortgage Finance Corporation (NHMFC) may have had intentionally had "sloppy" accounting systems to hide the "unholy alliance" between developers and the NHMFC[291]. Presently, there are roughly 50,000 unoccupied housing units nationwide due to these ghost beneficiaries[292]. Moreover, Alcid added that the inability to generate accurate and timely information with regard to the status

[286] Businessworld Publishing Corporation. Housing scam. September 17, 1999. Makati City, Philippines.
[287] Ghost beneficiaries are applicants for housing projects of government housing agencies who do not occupy or pay for the units. They cause the government to lose money because the housing agencies that pay the developers for the construction of the units are supposed to collect from the occupants.
[288] Businessworld Publishing Corporation. Accountability for bad loans Developers' accountability in real estate scams probed. September 16, 1999. Makati City, Philippines.
[289] Matoto, Senen L. Director of the Financial Executives of the Philippines. *Personal Interview.* June 2001. Makati City, Philippines.
[290] Jacob, Monico. Former Home Development Mutual Fund (HDMF)/Pag-Ibig Chairman and Conference Chairman of the Philippine Conference on Securitization. *Personal Interview.* June 2001. Makati City, Philippines.
[291] Bernardo, Romeo L. Former Undersecretary of the Department of Finance. *Personal Interview.* June 2001. Makati City, Philippines.
[292] Businessworld Publishing Corporation. *Developers in housing scam can't be charged.* September 5, 2000. Makati City, Philippines.

of the mortgage loans for the potential investor is another stumbling block to the securitization of National Home Mortgage Corporation (NHMFC)-originated mortgages[293].

2. *'Political issues' with selling mortgage loans at a discount.* Given the high default rate of the National Home Mortgage Finance Corporation (NHMFC), certain sectors have recommended that these mortgage loans be sold off to an Asset Management Company (AMC), at a discount, for liquidation. However, there is serious concern as to whether or not the government has the 'political will' to absorb such steep discounts. Recall that the contractual savings institutions (CSIs) lent money to the National Home Mortgage Finance Corporation (NHMFC), which in turn, was used for primary lending through loans originated by developers. When the NHMFC was shut down as a take-out window, these were the amounts lent by the respective contractual savings institutions (CSIs) to the National Home Mortgage Finance Corporation (NHMFC) for the Unified Home Lending Program (UHLP):

Breakdown of P42Billion loan portfolio of the National Home Mortgage Finance Corporation (NHMFC)

Institution	Approximate Amounts
Social Security System (SSS)	P30B (US$566M)
Government Service Insurance System (GSIS)	P6.5B ($123M)
Home Development Mutual Fund (HDMF)	P4.5B ($85M)

Source: National Home Mortgage Finance Corporation (NHMFC)

Obviously, the Social Security System (SSS) is the most concerned with regard to their 'exposure' in the National Home Mortgage Finance Corporation (NHMFC). In terms of investments, the P30 Billion (US$566) housing loan exposure constitutes roughly 18% of the total investments of the SSS, and 71% of total housing loan exposure[294]. In 1999, the Department of Finance received offers from Goldman Sachs and Lehman Brothers with regard to the sale of the assets. However, former Finance Secretary Edgardo Espiritu claimed that "the most we can get is 50%", which would be dependent on the due diligence on the assets[295]. However, the Commission on Audit (COA), which is not used to such steep discounts, expects that all government dealings will

[293] [293] Alcid, Andrew D. Executive Vice President, Investment Banking Division of United Coconut Planters Bank. *Personal Interview.* June 2001. Makati City, Philippines.
[294] Based on December 2000 Social Security System Investments and Assets. Total investments was P165B(US$3.1B) and total housing loans was P42.5B (US$802M).
[295] Calica, Dymphna R. US banks eye P43-B assets of NHMF. Businessworld Publishing Corporation. August 30, 1999. Makati City, Philippines.

generate a profit[296]. Thus, the COA may not approve of such a large loss unless there is presumably political will from the executive branch to "eat the losses". In the meantime, Limlingan believes that the government will just continue to postpone the "selling off" of these loans and "pretend" that everything is in working order[297].

Commercial banks don't want to give up their 'performing loans' to a Secondary Mortgage Institution (SMI). Due to the undesirable economic conditions in the Philippines, banks are hesitant to sell off their mortgage loan portfolios, which presumably consist of mid income housing loans, because there is an impression that the banks will have a hard time generating new mortgage loans[298]. As mentioned in Chapter 3, Coronel says banks consider these loans "recession proof". "The last thing that you will have is homeowners reneging on their loans unless it is a deep-seated recession" Coronel states[299]. Moreover, private banks are liquid right now, thus there is no pressing need for them to liquefy their assets through selling off their mortgages to a Secondary Mortgage Institution (SMI)[300]. This argument is strengthened by Matoto, who says that the banks' priority right now is to maintain a good portfolio, rather than to liquefy good assets[301].

Development and thrift banks are willing to securitize mortgages to gain liquidity. Development banks have a greater requirement for liquefying assets as their liquidity reach is limited versus universal banks[302]. Similarly, thrift banks, which are constrained by their portfolio, could benefit from selling their loans to a Secondary Mortgage Institution (SMI) to generate liquidity and originate more mortgages[303].

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[296] As an aside, former Home Development Mutual Fund (HDMF) President and Chair of the Philippine Conference on Securitization says that the Commission on Audit (COA) does not have a "commercial orientation" (i.e. the expectation that when engaging in commercial transactions, government entities cannot make a loss)

[297] Limlingan, Victor S. Professor at the Asian Institute of Management. *Personal Interview.* June 2001. Makati City, Philippines.

[298] Limlingan, Victor S. Professor at the Asian Institute of Management. Personal Interview. June 2001. Makati City, Philippines.

[299] Coronel, Leonilo G. Executive Director of the Bankers Association of the Philippines. Personal Interview. June 2001. Makati City, Philippines.

[300] Kotecha, Mahesh K. Secondary Mortgage Institution (SMI) Philippines – Draft Business Plan. Structured Credit International Corporation. 2000. New York, New York.

[301] Matoto, Senen L. Executive Director of the Financial Executives of the Philippines. Personal Interview. June 2001. Makati City, Philippines.

[302] Matoto, Senen L. Executive Director of the Financial Executives of the Philippines. Personal Interview. June 2001. Makati City, Philippines.

[303] Kotecha, Mahesh K. Secondary Mortgage Institution (SMI) Philippines – Draft Business Plan. Structured Credit International Corporation. 2000. New York, New York.

Developers want their current Contracts to Sell (CTS) to be liquidated. Because of the softness of the real estate market, developers have had to resort to 'in-house' financing[304] schemes to support their development efforts as they have experienced difficulty in borrowing development money from the banks[305]. For perspective, Alcid says that private commercial banks don't want to book any more real estate exposure as may real estate developers loan went into default as a result of the 1997 regional currency crisis[306].

Moreover, developers have also have difficulty in getting commercial banks to discount their mortgage receivables from in-house financing since most large banks are already liquid, and would presumably like to originate their own mortgage loans. Thus, most developers are capital constrained to engage in new development projects. Given this lack of alternative financing sources, it appears that certain developers groups look forward to the development of a secondary mortgage institution (SMI) to liquidate their mortgages. In fact, the Subdivision and Housing Developers Association (SHDA) appears to have thrown their support behind President Arroyo's initiatives to pass the securitization bill[307]. Limlingan adds that the Subdivision and Housing Developers Association (SHDA) are in favor of mortgage-backed securitization as they are confident in the asset quality of their mortgage loans[308].

Commercial banks want to liquidate non-performing real estate loans. Since most commercial banks are liquid, there concern is oriented towards securitizing their non-performing real estate loans (versus securitizing their 'good' mortgage loan portfolio)[309]. Recent reports[310] have said that Lehman Brothers has forged separate deals with Metropolitan Bank and Trust Corporation, the country's biggest bank in terms of assets, and Equitable PCIBank, the third largest bank, to establish their respective Asset Management Companies (AMC) to dispose of their nonperforming loans (NPLs)[311] (which presumably include a sizeable portion of real estate loans).

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304 In some cases, developers require as little as a 5% to 10% downpayment on the property.

305 Ducay, Santiago F. Executive Director of the Subdivision and Housing Developers Association. Personal Interview. June 2001. Makati City, Philippines.

306 Alcid, Andrew D. Executive Vice President, Investment Banking Division of United Coconut Planters Bank. Personal Interview. June 2001. Makati City, Philippines.

307 Aquino, Norman P. GMA says gov't to prioritize mass shelter programs. Businessworld Publishing Corporation. June 28, 2001. Makati City, Philippines.

308 Limlingan, Victor S. Professor at the Asian Institute of Management. *Personal Interview.* June 2001. Makati City, Philippines.

309 Matoto, Senen L. Executive Director of the Financial Executives of the Philippines. Personal Interview. June 2001. Makati City, Philippines.

310 Yap, Cecille E. Lehman, Metrobank, Equitable, step up efforts to create AMCs. Businessworld Publishing Corporation. July 18, 2001. Makati City, Philippines.

311 For perspective, as of end-2000, Metrobank's Non-performing loans (NPLs) have reached P29 billion, while Equitable PCI's is worth P24.8 billion, representing 15% and 19% of the their total loan portfolio, respectively.

Computational Details For

1. **Assumed non-performing loans (NPLs) for rehabilitation and securitization**
2. **Assumed 'performing' loans for securitization**
3. **Assumed new loans for securitization**

Figure 1. Computation for National Home Mortgage Finance Corporation (NHMFC)

Amount	Assumptions
P42B (US$792M)	Estimated number of mortgage loans (Source: Housing and Urban Development Coordinating Council (HUDCC)) Note that there is a P2B (US$38M) difference between the HUDCC estimate and Structured Credit International Corporation (SCIC) (P42B/US$792M vs. P40B/US$754M)
Multiplied by 49%	Ratio of arrears of to total housing portfolio of HDMF (Source: World Bank)
Multiplied by 53%	Based on rehabilitated loans of Lehman Brothers in Thailand for residential loans.
(US$205.8M)	Total 'rehabilitated' loans for securitization

FIGURE 2. Computation for Multi-Window Lending Scheme (MWLS) that can be rehabilitated

Amount	Assumptions
P6.8B (US$128.3M)	17% (Utilization rate of MWLS) X P40B/US$755M (Total amount budgeted for MWLS) = P6.8B/US$128.3M Source: Housing and Urban Development Coordinating Council (HUDCC)
Multiplied by 37.9%	Since there is no more National Home Mortgage Finance Corporation (NHMFC), we will assume that the ratio of arrears to total housing portfolio is the documented highest ratio of arrears for a public originator, which is the Social Security System (SSS). Source: World Bank
Multiplied by 53%	Based on rehabilitated loans of Lehman Brothers in Thailand for residential loans.
P1.4B (US$25.8M)	Total 'rehabilitated' loans for securitization

Note: This assumes that there will be a default as well for the MWLS, similar to the Unified Home Lending Program (UHLP) because of similar "formula lending" practices.

FIGURE 3. Computation for Home Development Mutual Fund (HDMF)/ Pag-Ibig that can be rehabilitated

Amount	Assumptions
P55B (US$1B)	Estimated number of mortgage loans (Source: Structured Credit International Corporation (SCIC))
Multiplied by 12.7%	Ratio of arrears of to total housing portfolio of HDMF (Source: World Bank)
Multiplied by 53%	Based on rehabilitated loans of Lehman Brothers in Thailand for residential loans.
P3.7B (US$69.8B)	Total 'rehabilitated' loans for securitization

FIGURE 4. Computation for Commercial Bank that can be rehabilitated

Amount	Assumptions
P31B (US$585M)	Estimated number of mortgage loans (Source: Structured Credit International Corporation (SCIC))
Multiplied by 3%	Ratio of arrears of to total housing portfolio of commercial banks (Source: World Bank)
Multiplied by 53%	Based on rehabilitated loans of Lehman Brothers in Thailand for residential loans.
P492M (US$9.3M)	Total 'rehabilitated' loans for securitization

Figure 5. Computation for Thrift Bank performing loans

Amount	Assumptions
P15B (US$283M)	Estimated number of mortgage loans (Source: Structured Credit International Corporation (SCIC))
Multiplied by 92.1%	1 – Ratio of arrears of to total housing portfolio of thrift banks (Source: World Bank)
P13.8B (US$261M)	Total performing loans

Figure 6. Computation for Commercial Bank New Loans

Amount	Assumptions
P31B (US$585M)	Estimated number of mortgage loans (Source: Structured Credit International Corporation (SCIC))
Multiplied by (1.03%)	Estimated base case growth rate per year compounded over two years (Source: Structured Credit International Corporation (SCIC))
P930M (US$17.5M)	Total performing loans

Mortgage Origination

Overview. In the Philippines, there are two sources of mortgage origination: public and private origination.

The public institution originators are the government owned and controlled contractual savings institutions (CSIs)[312] that provide in-house primary mortgage lending to their members and funding for the Multi-Window Lending Scheme (MWLS) program[313]. During the Unified Home Lending Program (UHLP), which ran from 1986 to 1996, the contractual savings institutions pooled their funds together to purchase mortgages generated by the National Home Mortgage Finance Corporation (NHMFC).

The private institution originators are the private banks. Although developers can be classified as originators as well, this was more prevalent under the Unified Home Lending Program (UHLP). The UHLP allowed developers to originate loans from homebuyers which would then be 'taken out' by the National Home Mortgage Finance Corporation (NHMFC). However, some developers continue to originate mortgage loans as well via "in-house" financing schemes.

Recent history and current state of public mortgage origination. Technically, the largest originator for public loan originators from 1986 to 1996 was the National Home Mortgage Finance Corporation (NHMFC). Although the NHMFC was originally envisioned to become a public sector secondary mortgage institution (SMI), the NHMFC became involved in primary mortgage lending for low to mid income housing. Obviously, given the original mandate of the National Home Mortgage Finance Corporation (NHMFC), primary mortgage lending was not a function that the company was "structured" to perform.

Nonetheless, the mortgage origination guidelines (which were dubbed "formula lending" approach" used in the Unified Home Lending Program (UHLP) was drafted and approved by the Housing and Urban Development Coordinating Council (HUDCC) and the National Home Mortgage Finance Corporation (NHMFC).

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[312] Social Security System (SSS), Government Service Insurance System (GSIS), and the Home Development Mutual Fund (HDMF)/Pag-Ibig.
[313] This was discussed in-depth in Chapter 4.

The National Shelter Program (NSP) mandated the National Home Mortgage Finance Corporation (NHMFC) to meet the housing target of 1.2 Million housing units. At the initial phase of the Unified Home Lending Program (UHLP), banks were used as the originators for the primary mortgage loans. Private banks and savings and loans banks which originated loans from the National Home Mortgage Finance Corporation (NHMFC), and received a commission from the NHMFC for screening and bringing qualified buyers on the release of the loan. However, few banks were originating the Unified Home Lending Program (UHLP) loans. Presumably, the reasons for the low originations by the banks for these loans were a) few potential homebuyers could pass the screening guidelines of the bank; b) the private banks would prefer to focus on their privately originated mortgage loans[314]. According to Manicio[315], very few banks were originating loans because of the retail nature of the mortgage loans[316].

Nonetheless, since the National Home Mortgage Finance Corporation (NHMFC) needed to "show" that they were meeting a targeted number of housing units, they allowed developers to originate loans as well. Developers dominated the loan originations of the Unified Home Lending Program (UHLP)[317], because of an arrangement, which made it virtually "risk-free" for them to originate loans. The National Home Mortgage Finance Corporation (NHMFC) merely had to take out mortgages, which were originated and initially financed by property developers. Real estate developers negotiated for purchase commitment lines (PCLs) with the National Home Mortgage Finance Corporation (NHMFC) wherein the NHMFC agreed to take out the housing loans from the developer upon appraisal and after the homebuyer submitted the proper documentation[318]. Because of this production target orientation for housing units, this 'incents' developers to start construction even before entertaining applicants for the low-cost housing units[319].

When the National Home Mortgage Finance Corporation (NHMFC) mortgage purchase function was suspended, the take out function was transferred to the Home Development Mutual Fund (HDMF). The current Multi-Window lending scheme (MWLS), which is an "evolution" of sorts from the Unified Home Lending Program (UHLP), was discussed in depth under Chapter 4.

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314 The administrative costs of handling the Unified Home Lending Program (UHLP) loans might have outweighed the commissions the banks received from screening the loans.

315 Manicio, Eduardo T. Vice-President, Funds Generation Group of the National Home Mortgage Finance Corporation (NHMFC). *Personal Interview.* June 2001. Makati City, Philippines.

316 Manicio asserted that commercial banks were more inclined to make loans that were a) wholesale and; b) short-term in nature.

317 Manicio, Eduardo T. Vice-President, Funds Generation Group of the National Home Mortgage Finance Corporation (NHMFC). *Personal Interview.* June 2001. Makati City, Philippines.

318 Technically, the developer did not even need to shell out equity to build housing units. The construction loan for the housing units was taken out from a bank while securing the purchase commitment line (PCL) ensured that the National Home Mortgage Finance Corporation (NHMFC) would take the developer out.

319 Again, this is all tied up to the production-oriented policy of the government.

Recent history and current state of private mortgage origination. As of 1998, the largest primary mortgage lenders were the thrift banks.

Top Private Bank Originators as of 1997

Name of Bank	Estimated share of total mortgages or CTS originated	Type of bank
1. BPI Family Bank	16.0	Thrift
2. Union Bank	12.0	Thrift
3. PS Bank	9.3	Commercial
4. PCI Bank	8.3	Commercial
5. Bank of the Philippine Islands	5.4	Commercial
6. China Trust Banking Corporation	4.5	Commercial
7. Banco Filipino	4.0	Thrift
8. China Banking Corporation	3.5	Commercial
9. Solid Bank	2.8	Commercial
10. Rizal Commercial Banking Corp.	1.5	Commercial

Source: Asian Development Bank

Prior to the regional 1997 currency crisis, commercial banks had been steadily increasing their real estate loans as proportion of their total loan portfolio. From 1995 to 1997, the real estate exposure of banks had exhibited the highest growth rate over the past two years. In 1996, bank exposure to real estate and financial services expanded 97.2% to P244.41 Billion (US$4.6 Billion) from P123.94 Billion (US$2.3 Billion). These two sectors also enjoyed a greater share of the banks' portfolio, increasing to 21.8% from 16.8% in 1995[320].

Real Estate Loans of Commercial Banks, 1995 to June 1997

Year	Real Estate Loans	% of total loan portfolio
1995	44,802	5.17
1996	86,492	7.08
June 1997	159,285	11.23

Source: Asian Development Bank

In 1997, the *Bangko Sentral* (Central Bank of the Philippines) reported that the outstanding real estate loans of commercial banks stood at P159.3 Billion (US$3 Billion), which was 16.5% higher than the previous quarter. Metropolitan Manila had the highest concentration of real estate loans (P127.3 Billion (US$2.4 Billion), which is 79% of the total) and where 95.3% of the total outstanding real estate loans of trust departments were made[321]. The "aggressive growth" the Philippine real estate property market

[320] Garcia, Elisha R. and Dulce J. Castillo. *Stricter limits on real estate loans seen to prolong boom, curb speculation*. Businessworld Publishing Corporation. May 1, 1997. Makati City, Philippines.

[321] Reside, Renato S. *Mortgage-Backed Securities in Asia.* Asian Development Bank. 1999. Pasig City, Philippines.

began to exhibit the symptoms of the Korean and Thai property markets as property gluts drove them into a real estate crisis[322].

Thus, the *Bangko Sentral* (Central Bank of the Philippines), prodded by the property crisis in the nearby Asian economies, acted to restrain the local banks' 'over eagerness' in financing real estate projects, particularly speculative projects[323]. Thus in April 1997, the monetary board, the policy-making body of the *Bangko Sentral* (Central Bank of the Philippines), set the real exposure limit for banks to 20% of their respective loan portfolios[324]. When the ruling was made, the *Bangko Sentral* (Central Bank of the Philippines) claimed that real estate exposure was at 9.2%[325]. Prior to this, banking rules allowed banks to extend loans to any single industry of up to 30% of their total loan portfolios which the *Bangko Sentral* (Central Bank of the Philippines) enforces "moral suasion". On top of the limits to real estate exposure, the Monetary Board also directed banks to reduce the loan value of real estate extended as collateral for any bank loan to not more than 60% (versus the previous 70% of the appraised value) of the collateral.

Low-cost housing loans made under the National Shelter Program were exempted from the restrictions on real estate exposure. However, banks were still wary to lend to low-cost housing due to the perceived high default rate of this sector[326]. Moreover, the private sector could not compete with the subsidized interest rates being offered by the Unified Home Lending Program (UHLP) to low income borrowers.

Origination Issues

a. Public sector mortgage origination issues

Continued use of a modified "formula lending" scheme and subsidized interest rates under the Multi-Window Lending Scheme. Under the Unified Home Lending Program (UHLP), the National Home Mortgage Finance Corporation (NHMFC) used a "formula lending" system where borrower eligibility was based solely on the borrower's monthly income, but no effort was made to determine the capacity to

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[322] Ducanes, Geoffrey M. *Moody's warns of traces of Thailand in RP banks (BSP figures on property exposure of banks doubted).* Businessworld Publishing Corporation. April 18, 1997. Makati City, Philippines.
[323] Garcia, Elisha R. and Dulce J. Castillo. *Stricter limits on real estate loans seen to prolong boom, curb speculation.* Businessworld Publishing Corporation. May 1, 1997. Makati City, Philippines.
[324] Garcia, Elisha R. and Dulce J. Castillo. ... *as Monetary Board limits to 20% banks' exposure to real estate sector.* Businessworld Publishing Corporation. April 30, 1997. Makati City, Philippines.
[325] However, Moody's was in doubt with regard the claimed figure. Moody's said that (based on its experience with other banking markets such as those in Thailand and Japan), "The statistics compiled and reported by central banks regarding the composition of the commercial banks' loan portfolios frequently lack sufficient detail to identify particular concentrations or give reporting banks significant latitude in how they classify their exposures." (Businessworld Publishing Corporation)

pay. The maximum loanable amounts were subject to fixed interest rates and a term-to-maturity of 25 years.

Under the Multi-Window Lending Scheme (MWLS), a modified version of the "formula lending" scheme is used to lend money to a targeted homebuyer segment[327]. The MWLS has taken measures to ensure better repayment and an improved determination of capacity to pay versus the Unified Home Lending Program (UHLP), such as a) having accredited banks screen the potential homebuyers for mortgage loans[328]; b) monthly salary deductions for the mortgage loan. However, despite these measures, the continued use of the subsidized interest rates does not render these mortgage loans more 'palatable' for securitization.

Moreover, the utilization rate for the Multi-Window Lending Scheme is only 17%. Perhaps one of the reasons behind the low rate is that the administrative costs of handling the 'low income segment' is not worth the effort for the banks, who would rather focus on market-rate, mid to high income loan packages[329]. For perspective, these were the sample eligibility requirements used to determine capacity-to-pay for members of the Philippine National Police (PNP) and teachers (serviced by the Home Development Mutual Fund (HDMF)/Pag-Ibig):

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[326] Recall at this point that National Home Mortgage Finance Corporation had already been reporting high levels of default among its homebuyers, who were perceived to be low income borrowers.
[327] Recall in Chapter 4 that each contractual savings institution (CSI) or government financial institution was assigned to cater to different market segments. For example, the Social Security System (SSS) handles the Filipino overseas workers, trade union workers and other private sector workers.
[328] The Social Security System (SSS) has claimed that there has so far been a zero default rate on mortgages underwritten for SSS members by SSS-accredited private banks, which suggests that bank accreditation enhances the quality of mortgages.
[329] Tan, Arthur, Executive Vice-President and General Manager of the Home Guaranty Corporation. *Personal Interview*. June 2001. Makati City, Philippines.

Eligibility	Active HDMF/Pag-Ibig member[330] Must have passed prior screening and pre-processing of the Philippine National Police (PNP) Housing Board/Department of Education, Culture and Sports (DECS) National Housing Secretariat as to capacity to pay[331] Must not be more than 65 years old at loan maturity and must be insurable. Must have legal capacity to acquire and encumber real property. Must have no outstanding Pag-IBIG housing loan, either as principal or co-borrower.
Loanable amount basis	Capacity to pay Loan-to-collateral ratio
Loan Payment	Monthly amortizations over the term of his loan thru salary deduction
Loan Insurance	Mortgage Redemption Insurance (MRI) and Property/Fire Insurance (P/FI)

Source: Home Development Mutual Fund (HDMF)/Pag-Ibig website

Private Mortgage Origination Issues

Lack of borrower credit information. To determine borrower quality in the primary mortgage market, it is crucial to have information on a potential homebuyers' credit history. Credit-providing companies, such as local banks and credit card companies, gradually build up credit histories.

However, there is a general lack of data with regard to shared credit histories of consumers due to the lack of cooperation among data providers[332]. In the existing credit information structure, private banks have invested substantial amounts to develop proprietary systems in building credit histories and, thus, are unwilling to share the information with other banks. Banks are wary of the 'free rider' problem, where sharing the information will "level the playing field", without another bank having to spend money to acquire the information. The hesitance to share credit information eventually leads to high spreads that are built into mortgage loans. According to Reside, the exchange of such personal information further impeded by cultural biases against what are deemed to be invasions of personal privacy[333].

[330] For a teacher, this must be evidenced by as evidenced by the inclusion of the borrower's name in the Department of Education, Culture and Sports (DECS) Payroll List, and a certification that the borrower is a regular DECS employee/teacher with a permanent appointment.
[331] The Home Development Mutual Fund (HDMF)/Pag-Ibig website did not specify the screening requirements of the Philippine National Police (PNP) housing body or Department of Education, Culture and Sports (DECS) National Housing Secretariat.
[332] Coronel, Leonilo G. Executive Director of the Bankers Association of the Philippines. *Personal Interview.* June 2001. Makati City, Philippines.
[333] Reside, Renato S. *Mortgage-Backed Securities in Asia.* Asian Development Bank. 1999. Pasig City, Philippines.

Nonetheless, there has been some progress in sharing "negative" credit information with regard to consumers (i.e. defaults, delinquencies), credit providers are hesitant to provide "positive" credit information (i.e. where money is spent by consumer)[334].

With reference specifically to mortgage loans, the structural deficiencies of the Unified Home Lending Program (UHLP) (i.e. "formula lending" practice, high default rates which are mistakenly attributed to low-income borrowers) has led to a "credit rationing" by primary mortgage creditors. Thus, while credit has been for middle- to high-income primary borrowers, primary creditors in the low-cost housing market have tried to delay take-outs until such time that lending guidelines are improved to facilitate crosschecking of borrower information[335]. Reside argues that with the increased awareness of the acute problems in lending to low-cost housing, potential home-buyers in this sector have become victims of adverse selection because the lending guidelines and the funding institutions (i.e. the National Home Mortgage Finance Corporation (NHMFC)) themselves failed to distinguish good from bad credit risks[336].

Lack of standardized origination documents and procedures. The standardization of loan documents is a necessary prerequisite for securitization. Moreover, the standardization of bank documents will lessen the private banks' administration costs, by lessening the number of forms that need to be filled out, which in turn will drive down mortgage loan rates[337].

According to Coronel, each bank has its own set of standards in terms of originating mortgage loans[338]. Moreover, mortgage rates, which may be similar across private commercial banks[339], continue to be based on a bank's own reference lending rates[340]. Among the lack of standardized documents and processes include a) documents of conveyance and reconveyance (i.e. deeds of sale with mortgage, contracts to sell, lease purchase agreements, etc.), b) lack of standardized appraisals for properties, c) a lack of common

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[334] Coronel, Leonilo G. Executive Director of the Bankers Association of the Philippines. *Personal Interview.* June 2001. Makati City, Philippines.
[335] This was primarily the case when the Social Security System (SSS) and Government Service Insurance System (GSIS) pooled funds to lend to the Home Development Mutual Fund (HDMF) when it took from National Home Mortgage Finance Corporation (NHMFC) as the take out window.
[336] Reside, Renato S. *Mortgage-Backed Securities in Asia.* Asian Development Bank. 1999. Pasig City, Philippines.
[337] Coronel, Leonilo G. Executive Director of the Bankers Association of the Philippines. *Personal Interview.* June 2001. Makati City, Philippines.
[338] Coronel, Leonilo G. Executive Director of the Bankers Association of the Philippines. *Personal Interview.* June 2001. Makati City, Philippines.
[339] Recall the chart in Chapter 4 which contained the tables on Mortgage Interest Rates as of 1998.
[340] Reside, Renato S. *Mortgage-Backed Securities in Asia.* Asian Development Bank. 1999. Pasig City, Philippines.

base criteria for due diligence standards and; d) improved disclosure standards[341]. Aside from the lack of these documents/processes, the Philippine Conference on Securitization also reiterated the need for a title insurance system, due to rampant cases of fake land titles that have been in circulation[342]. However, Matoto believes that the "players" in securitization can initially live with the lack of the title insurance system[343].

Tan cites that efforts to standardize loan documentation via an interagency committee of the Housing and Urban Development Coordinating Council (HUDCC) started as far back as the Aquino administration (1986-1992)[344]. However, the major impediment to standardization were the private banks' legal counsel who each held fast to their own belief as to what constitutes primary mortgage documents.

As part of the organization's new mandate to "ensure its active involvement in the development of the secondary mortgage market for housing mortgages, bonds, debentures, bonds, debentures, notes and securities"[345], the Home Guaranty Corporation attempted to spearhead the development of standardized underwriting documents in preparation for securitization. However, the banks appear to be have their own set of mortgage documents and are reluctant to work on a cooperative basis. Although banks want to securitize, they each appeared to want to securitize on their own terms.

The Multi-Window Lending Scheme (MWLS) was supposed to facilitate the standardization of primary mortgage documents. However, banks continue to have issues with the proposed standardized documents, which include a) the number of documents that the potential homebuyer must fill out and; b) certain provisions of the documents[346].

One of the 'outgrowths' of the lack of standardized documentation is that developers have had to serve as impromptu financial engineers by attempting to combine the different documents that banks require for loan take-outs. In effect, developers lose focus on their primary responsibility of ensuring the quality of housing projects as they are grow more concerned over the guarantee that the banks will purchase their

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341 Philippine Conference on Securitization. *Mobilizing the Markets for Securitization: The Case for Asset Backed Securities*. October 1999. Makati City, Philippines.
342 Title insurance will be discussed in Chapter 7.
343 Matoto, Senen L. Director of the Financial Executives of the Philippines. *Personal Interview*. June 2001. Makati City, Philippines.
344 Tan, Arthur, Executive Vice-President and General Manager of the Home Guaranty Corporation. *Personal Interview*. June 2001. Makati City, Philippines.

345 Home Guaranty Corporation. *Charter Change 2000.* March 2000. Makati City, Philippines.

mortgage loans. Low cost housing developers have made their appeal during the Securitization conference to develop a mechanism that would allow for a more comprehensive assessment of granting housing loans[347].

The Banker Association of the Philippines (BAP), in conjunction with several financial agencies and organizations[348], had developed an origination and underwriting 'best practices' manual, in line with the development of the local financial structure to create an atmosphere for a "deep a liquid secondary market". Presumably, these manuals will be distributed to all local banks who would like to eventually sell their mortgage loans to a Secondary Mortgage Institution, or perhaps would like to securitize their own mortgages[349].

Lack of originator education on securitization. Since there appear to be issues with regard to developing the primary mortgage lending infrastructure in preparation for mortgage securitization, an issue raised in the Securitization conference was the general lack of understanding among originators with regard to securitization as a financing tool. In fact, Matoto adds that the lack of knowledge about securitization, which is reflected in the financial infrastructure related to securitization, is not due to the lack of "bright people", but rather the lack of securitization deals in the country[350]. Jacob seconds this argument, saying that there is an abundance of Filipinos with the financial skills to structure a securitization transaction. Unfortunately, because of a confluence of factors, the government not providing enough support behind the development of the secondary mortgage market and the heavy tax burden related to secondary trading of the instruments), these financial experts have chosen to focus on other finance-related priorities[351].

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346 Tan, Arthur, Executive Vice-President and General Manager of the Home Guaranty Corporation. *Personal Interview.* June 2001. Makati City, Philippines.

347 Philippine Conference on Securitization. *Mobilizing the Markets for Securitization: The Case for Asset Backed Securities.* October 1999. Makati City, Philippines.

348 the Investment Houses of the Philippines (IHAP), the *Bangko Sentral ng Pilipinas* (Central Bank of the Philippines), the Investment Houses Association of the Philippines (IHAP), and the Trust Officers Association of the Philippines (TOAP).

349 Bankers Association of the Philippines. *Market Reforms Project BAP Briefing to the Media.* April 4, 2001. Makati City, Philippines.

350 Matoto, Senen L. Director of the Financial Executives of the Philippines. *Personal Interview.* June 2001. Makati City, Philippines.

351 Jacob, Monico. Former Home Development Mutual Fund (HDMF)/Pag-Ibig Chairman and Conference Chairman of the Philippine Conference on Securitization. *Personal Interview.* June 2001. Makati City, Philippines.

Securitization

The securitization of primary mortgages involves several issues which overlap with regulatory, legal and taxation-related matters. These include issues on recourse/non-recourse, accounting treatment, and secondary mortgage institution structure (i.e. trust or corporation). Given this, we will focus on the mortgage pool valuation.

Mortgage pool valuation. Since there is no active secondary mortgage market in the Philippines, where mortgages can be sold at market interest rats, the selling price of the mortgages sold to a Secondary Mortgage Institution (SMI)[352] or to an Asset Management Company (AMC)[353] will generally be equal to the present discounted value[354] of the outstanding principal of the mortgages[355]. However, the appropriate discount factor to be used in valuing private sector-originated mortgages, prior to selling it to an SMI should take into consideration the following factors:

1. *Market interest rates for long-term financial instruments that have similar maturities.* The "discount rate" or the market interest rates that should be used to discount the mortgages will be problematic as there is no pronounced long-term yield curves for long-term financial instruments[356].
2. *General asset quality of the mortgages for sale to a Secondary Mortgage Institution (SMI).* According to Reside, it is reasonable to assume that higher privately-originated mortgage quality will be associated with mortgages that have lower loan-to-value ratios (i.e. 60% loan to value) and longer seasoning (i.e. 2 to 3 years)[357]. On the other hand, lower quality mortgage will be associated with mortgage that has higher loan-to-value rations (i.e. 70% loan-to-value) and shorter seasoning (i.e. below 2 years).

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[352] A secondary mortgage institution (SMI) is ideal for the current performing mortgage loans and the new mortgage loans to be originated by the private sector. Presumably, only these loans will be acceptable for securitization because they are pegged at market rates, thus rendering them "eligible" for securitization.

[353] An asset management company (AMC) is ideal for the current nonperforming loans originated by the private sector. These loans are sold to an AMC at a discount, which are then rehabilitated, securitized and sold at a profit. Presumably, only these private mortgage loans will be acceptable for securitization (once they are rehabilitated) because they are pegged at market rates, thus rendering them "eligible" for securitization.

[354]The discount rate is determined by the rates of return prevailing in the capital markets. If the future cash flow is absolutely safe, then the discount rate is the interest rate on safe securities such as government debt (as is the case in the United States). If the size of the future cash flow is uncertain, then the expected cash flow should be discounted at the rate of return offered by equivalent-risk securities. (Brealey, Richard A. and Stewart C. Myers. Principles of Corporate Finance. Sixth Edition. Irwin McGaw-Hill. 2000. United States of America)

[355] Reside, Renato S. *Mortgage-Backed Securities in Asia.* Asian Development Bank. 1999. Pasig City, Philippines.

[356] The only real player in the long-term securities market is the government through the issuance of treasury bonds. However, the issuances of such long-term securities, that match the tenor of private mortgage loans (i.e. 15 years) is infrequent.

[357] Reside, Renato S. *Mortgage-Backed Securities in Asia.* Asian Development Bank. 1999. Pasig City, Philippines.

3. *Originator integrity.* A primary mortgage originator with a history of poor screening and servicing standards (which consequently leads to inferior asset quality), will be in no position to demand a good price for its mortgage pool, regardless of the quality of the assets in the pool. Conversely, primary mortgage originators with well-established screening and servicing standards will probably be able to demand a good price for their mortgage pool. In fact, some private banks have engaged in their own mortgage-backed securitization efforts, as the institutional investors rely on the bank's reputation and credibility to guarantee the quality of the mortgage pool.

The valuation of non-performing privately originated mortgage pools to be sold to an Asset Management Company (AMC) is usually the result of a) the due diligence performed by the Asset Management Company (AMC) and; b) the negotiations between the private bank and the Asset Management Company (AMC). Based on the experiences of other countries, where private banks sold their nonperforming loans (NPLs) to an Asset Management Company (AMC), the discounts reached as much as 50% of the asset's value[358]. The sale of both the performing and non-performing publicly originated mortgage loans present a problem because of the following:

1. *Subsidized and fixed interest rates hamper securitization efforts.* Loans sold to a Secondary Mortgage Institution (SMI) should be priced at appropriate market rates. However, the problem lies in the fixed composite market rate of 13% for the publicly originated mortgage loans[359]. Although there is no pronounced yield curve for the long-term instruments, the next best alternative would be to use treasury bonds of similar maturities to discount these mortgages. Obviously, the treasury must offer high interest rates to attract long-term funds. In the event that treasury bond rates are higher than the composite interest rate (which presumably will be the case), no reasonable Secondary Mortgage Institution (SMI) would purchase the mortgage pool at a discounted value of 13% if the treasury bond rate was higher. The other alternative for these public originated mortgages would be to sell these mortgages at a discount (i.e. higher than both the composite interest rate and treasury bond rate) to the Secondary Mortgage Institution (SMI), but this would mean that the primary mortgage lenders would always sell these mortgages at a loss.

[358] Yap, Cecille E. *Lehman, Metrobank, Equitable, step up efforts to create AMCs.* Businessworld Publishing Corporation. July 18, 2001. Makati City, Philippines.
[359] The composite rate of 13% was provided by Deputy Secretary Lucille Ortille of the Housing and Urban Development Coordinating Council (HUDCC)

2. *Lack or originator integrity.* As mentioned in Chapter 5, the integrity of the National Home Mortgage Finance Corporation (NHMFC) loan portfolio is of questionable quality due to a possible collusion between developers and the NHMFC. A Secondary Mortgage Institution (SMI) or Asset Management Company (AMC) will presumably have difficulty in conducting due diligence on these mortgage loans as the accounting system were deliberately "sloppy" to hide the "unholy alliance" between certain developers and employees of the National Home Mortgage Finance Corporation (NHMFC)[360].

According to Reside, it would appear that privately originated, market-oriented mortgages would probably receive better interest rates once securitized[361]. Meanwhile, publicly oriented, subsidized and fixed interest rate mortgages would probably receive high interest rates to compensate for the risks involved[362].

Secondary Mortgage Institution (SMI)/Asset Management Company (AMC)

Overview. There are basically two types of mortgage loans that can be securitized: The pool of performing mortgage loans are sold by an originator to a Secondary Mortgage Institution (SMI) at the present discounted market rate value of the outstanding principal of the mortgages. Meanwhile, the non-performing loans (NPLs) are sold to an Asset Management Company (AMC) at a deep discount of the outstanding principal of the mortgages. Aside from these options, banks have also performed "in-house" or "stand-alone" mortgage-backed securitization wherein they securitized their own mortgages, which were then pre-sold to institutional investors.

In the Philippines, there is no functioning Secondary Mortgage Institution (SMI). Therefore, we will review the various public and private institutions, which have attempted to perform the functions of a Secondary Mortgage Institutions (SMIs). On top of that, we will briefly review various in-house securitization efforts.

As a result of a) the private banks' sizable pool of non-performing real estate loans from the 1997 regional currency crisis and; b) the large arrears on the publicly-originated loans, there have been both private and public led efforts to establish an Asset Management Company (AMC) to liquidate these

[360] Bernardo, Romeo L. Former Undersecretary of the Department of Finance. *Personal Interview.* June 2001. Makati City, Philippines.
[361] Reside, Renato S. *Mortgage-Backed Securities in Asia.* Asian Development Bank. 1999. Pasig City, Philippines.

mortgages and generate fresh funds. Thus, we will discuss current efforts of both sectors to establish Asset Management Companies (AMCs).

Public Secondary Mortgage Institution

National Home Mortgage Finance Corporation.

Overview. In 1986, Executive Order No. 90 was issued by President Aquino, which mandated that National Home Mortgage Finance Corporation (NHMFC) as the Secondary Mortgage Institution (NHMFC). Thus, similar to "Fannie Mae" the NHMFC was supposed to accumulate a "critical mass" of mortgage loans that it would eventually securitize. The National Home Mortgage Finance Corporation would then use the funds generated from Mortgage-Backed Securities (MBS) issues to purchase more mortgages, providing a long-term and sustainable source of housing finance. However, instead of performing the mortgage-purchase function, the National Home Mortgage Finance Corporation (NHMFC) was tasked to engage in primary mortgage lending, a task it was not "built" to perform. How did this come about?

When E.O. 90 was drafted, the government had established that 3.7 million new housing units would be needed for the period of 1993 to 1998. Given the production orientation of the government with regard to housing, there was a need to "jump start" housing production, and the National Home Mortgage Finance Corporation (NHMFC) was used as the vehicle to promote this end.

Thus, E.O. 90 had a portion of the investible funds from the contractual savings institutions (Social Security System (SSS), Government Service Insurance System (GSIS), Home Development Mutual Fund (HDMF)/Pag-Ibig) to be administered by the National Home Mortgage Finance Corporation (NHMFC) [363] to be lent out directly to homebuyers at subsidized and fixed interest rates and a 25 year term-to-maturity[364]. The provision of the E.O. 90 was translated into a "temporary loan arrangement" between the NHMFC and the funders, until the NHMFC could finally stand on its "financial" feet. However, E.O. 90

[362] Of course, this is in the event that these publicly originated mortgages can be securitized at a fixed composite rate of 13% (without the benefit of credit enhancements).

[363] The National Home Mortgage Finance Corporation (NHMFC) administered the Unified Home Lending Program (UHLP), one of the four mortgage-lending programs of the National Shelter Program (NSP)[363]. The other programs were the Home Development Mutual Fund (HDMF) Expanded Housing Loan Program, the Home Insurance and Guaranty Corporation (HIGC) Retail Guaranty Program, and the housing programs of the Social Security System (SSS) and the Government Service Insurance System (GSIS). For perspective, all the programs under the National Shelter program were largely subsidized and intended for the production of housing units and ownership.

did not provide for a timetable and a strategy as to when the National Home Mortgage Finance Corporation (NHHMFC) would eventually stand on its own feet and be viable enough to begin its Secondary Mortgage Institution (SMI) function. Thus, what was supposed to be a "temporary loan" arrangement between the NHMFC and the contractual savings institutions (NHMFC) was renewed "continuously" from 1986 to 1996. Moreover, since E.O. 90 focused on housing production, there was no "solid structure" to recycle the loans nor was there a provision to provide for bad mortgage loans[365].

For a time, the National Home Mortgage Finance Corporation (NHMFC) functioned as the sole-lending window of the Unified Home Lending Program (UHLP). The NHMFC used the low-cost funds lent to it by the contractual savings institutions (CSIs) and "took out" or purchased mortgages originated by low-cost housing developers[366]. (Please refer to Chapter 4 for a discussion on the take out transaction process for developers with the National Home Mortgage Finance Corporation (NHMFC)).

However, the contractual savings institutions (CSIs) couldn't sustain their large subsidies to low-cost housing (in some cases, the loan-to-value ratio was 100%), which was further compounded by the relatively inferior quality mortgage portfolios these funders[367] held versus those of private mortgage lenders[368].

Eventually, the volume of transactions being passed on to the National Home Mortgage Finance Corporation (NHMFC) from the originator-developers grew too large for them to handle administratively. The NHMFC could neither properly screen all the transactions according to UHLP guidelines nor adequately handle these transactions. Moreover, the sloppy accounting and record keeping by the NHMFC[369] made it initially difficult to ascertain the true extent of the stock losses of the contractual savings institutions (CSIs).

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[364] The loan was to be used to either purchase a residential lot, finance the purchase of a lot and house construction, or purchase a newly constructed residential unit or construct a new house. Home repairs and improvement are also included in the program.

[365] Manicio, Eduardo T. Vice-President, Funds Generation Group of the National Home Mortgage Finance Corporation (NHMFC). *Personal Interview*. June 2001. Makati City, Philippines.

[366] Although private banks would screen and originate potential homebuyers for the Unified Home Lending Program (UHLP), for which they would receive a commission from the National Home Mortgage Finance Corporation (NHMFC), the UHLP was dominated by developer-originators.

[367] All the mortgage loans that were purchased by the National Home Mortgage Finance Corporation (NHMFC) were pledged to the funders. (Source: Manicio, Eduardo T. Vice-President, Funds Generation Group of the National Home Mortgage Finance Corporation (NHMFC). *Personal Interview*. June 2001. Makati City, Philippines)

[368] Reside, Renato S. *Mortgage-Backed Securities in Asia*. Asian Development Bank. 1999. Pasig City, Philippines.

[369] Former Undersecretary Romeo Bernardo asserts that such "sloppiness" was intentional to hide the collusion between certain developers and the National Home Mortgage Finance Corporation (NHMFC).

A number of factors: the poor screening guidelines, interest-rate subsidies[370], the lax collection efforts, and the disincentive for borrowers to repay their loans in due time due to the above standard loan-to-value ratios contributed to the substantial amount of non-performing loans in the NHMFC portfolio[371]. (The structural deficiencies of the Unified Home Lending Program (UHLP) were discussed extensively in Chapter 4).

Thus, in mid-1996, the government suspended the loan purchase facility of the National Home Mortgage Finance Corporation (NHMFC) due to the poor asset quality of its mortgages. Except for the administration of the Abot Kaya amortization program and the Community Mortgage Program (CMP) the NHMFC has since been relegated to merely collecting on its past-due loans.

Current State. While the National Home Mortgage Finance Corporation (NHMFC) continues its collection activity, the government has mulled several options with regard to this troubled housing agency. However, among all these options, none of them appear to be 'restoring' its status as a Secondary Mortgage Institution (SMI). According to Kotecha, the National Home Mortgage Finance Corporation (NHMFC) has lost is opportunity to become a Secondary Mortgage Institution (SMI) as it will now have great difficulty in gaining investor acceptance as an SMI[372], a sentiment echoed by many financial and housing experts. Rustia put it succinctly, "Nobody looks at NHMDC as an efficient institution, and there must be another institution."[373]

The lone voice of opposition comes from the Chamber of Real Estate and Builders Associations (CREBA), which vehemently opposes the possible dismantling and selling off of the receivables of the National Home Mortgage Finance Corporation (NHMFC) supposedly due to the role of the NHMFC in the government's housing program[374]. Serrano argues that it "doesn't matter whether or not it (National Home Mortgage Finance Corporation) is an effective institution or not, but it was designated to be there.

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[370] The interest rate subsidy was credit subsidy where the government allocates housing funds that were lent at interest rates way below market rates. For example, the 9% interest rate for socialized housing –which was below both current mortgage rates and even the inflation rate – was a significant, long-term subsidy to borrowers.

[371] This eventually led to the widespread perception that investment lending for low-cost housing is extremely risky. Thus, private banks have been wary of lending to this sector, and are even more wary to securitize the low-cost housing loans.

[372] Kotecha, Mahesh K. *Secondary Mortgage Institution (SMI) Philippines – Draft Business Plan*. Structured Credit International Corporation. 2000. New York, New York.

[373] Rustia, Andres I. Managing Director of the Asset Management Department of the Bangko Sentral ng Pilipinas (Central Bank of the Philippines). *Personal Interview*. June 2001. Manila, Philippines.

[374] Businessworld Publishing Corporation. *Fund managers eye NHMFC.* September 13, 1999. Makati City, Philippines.

CREBA sees no reason why it should not be used". In fact, Serrano believes that "it can be restored to what it once was before" by putting in "the right people, since it just a fictional entity after all."[375]

The entire loan portfolio of the National Home Mortgage Finance Corporation (NHMFC) currently stands at P42 Billion (US$ 792 Million), which is comprised of 180,000 accounts. According to Manicio, the collection efficiency, across-the-board, for the NHMFC loans is 50%. The balance 90,000 non-performing loans (NPLs) are due for litigation[376].

For the National Home Mortgage Finance Corporation (NHMFC) loans that are still considered performing: the NHMFC manages to collect P350 Million (US$6.6 Million) a month, where the maximum collectible per month should be P450 Million (US$8.5 Billion)[377]. Thus, the NHMFC is in arrears of approximately P100 Million (US$ 1.9 Million) a month[378].

The National Home Mortgage Finance Corporation (NHMFC) implemented several schemes to improve their collection efforts, which included a) auctioning of all delinquent properties, b) outsourcing of collections services to the private sector, c) computerization of the billing and collection systems; d) developing new affordable repayment schemes for account re-activation and, e) developing new programs to facilitate borrowers, such as the sale of mortgage rights[379]. However, the outsourcing option was not approved by National Home Mortgage Finance Corporation (NHMFC)'s internal auditors. One of the agency's statutes maintained that if the function was currently being performed by the institution itself, the function could not be outsourced. Meanwhile, despite the phenomenal response to the sale of mortgage rights[380] program, there were problems with regard to the program's implementation[381] and was thus discontinued.

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[375] Serrano, Atty. Manuel M. Founding Chairman of the Chamber of Real Estate and Builders Associations (CREBA). *Personal Interview*. June 2001. Makati City, Philippines.

[376] Manicio, Eduardo T. Vice President, Funds Generation Group of the National Home Mortgage Finance Corporation (NHMFC). *Personal Interview*. June 2001. Makati City, Philippines.

[377] This assumes a level payment of a loan over 25 years, the term-to-maturity of the Unified Home Lending Program (UHLP) mortgage loans.

[378] Manicio, Eduardo T. Vice President, Funds Generation Group of the National Home Mortgage Finance Corporation (NHMFC). *Personal Interview*. June 2001. Makati City, Philippines.

[379] Businessworld Publishing Corporation. *NHMFC deputizes second batch of housing rights sellers*. February 8, 2001. Makati City, Philippines.

[380] The sale of mortgage rights involves the assigning, transferring, disposing or alienating to another person (natural or juridical) National Home Mortgage Finance Corporation's (NHMFC) rights, or interests or participation in the mortgage loans NHMFC had earlier financed either under its Unified Home Lending Program (UHLP) or the Community Mortgage Program (CMP). Manicio related that the monthly collections went from a low of P320 Million (US$6 Million) to a high of P450 Million (US$ 8.5 Million).

[381] From an implementation standpoint, there were reports of "double sales" of mortgage rights, potential homebuyers moving into housing units even before documentation was completed, litigation from prior

Presently, the National Home Mortgage Finance Corporation (NHMF) uses a) loan condonation programs[382] to incent delinquent homebuyers to update their loans and, b) a relaunched collection program wherein management teams are divided into accounts by regions. In 1998, under former Housing and Urban Development Coordinating Council (HUDCC) Chairperson Karina Constatino-David's leadership, there was a policy move to rationalize the housing agencies, which included privatizing the National Home Mortgage Finance Corporation's (NHMFC) collection activity and winding down its lending activity[383]. However, these plans were apparently aborted when David resigned from the HUDCC due to the set-up of the (now defunct) Presidential Commission on Mass Housing (PCMH).

In 1999, the Estrada administration planned to securitize the National Home Mortgage Finance Corporation's (NHMFC) assets. The government had gone to the extent of hiring Goldman Sachs and Lehman Brothers as underwriters for the National Home Mortgage Finance Corporation (NHMFC) issues. However, the planned securitization did not materialize due to the lack of a market for the securities and problems with the valuation of the assets[384].

In May 2001, the newly installed Arroyo administration again revived plans to securitize the National Home Mortgage Financing Corporation's (NHMFC) mortgage loans. The Department of Finance (DOF) lined up the assets of NHMFC as a priority for securitization this year. The government plans to sell of an estimated P42 Billion (US$ 792 Billion) worth of National Home Mortgage Finance Corporation's (NHMFC) assets in the form of securities. The government's objective in NHMFC securitization is now primarily to raise funds for the government and keep its budget gap within target[385].

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homeowners who had not paid their loans for a long time, etc. Moreover, the National Home Mortgage Finance Corporation (NHMFC) failed to secure the concurrence of the funders prior to starting the program. (Souce: Manicio, Eduardo T. Vice President, Funds Generation Group of the National Home Mortgage Finance Corporation (NHMFC). *Personal Interview*. June 2001. Makati City, Philippines.)

382 Delinquent housing loan borrowers, whose accounts have been published in major newspapers prior to sale through public bidding, have until a specific date to update their payments in order to save their accounts from auction sale by the National Home Mortgage Finance Corp. (NHMFC). (Source: Businessworld Publishing Corporation. *NHMFC extends loan condonation scheme to Apr. 30.* April 10, 2000, Makati City, Philippines)

383 Tenorio, Arnold S. *Housing program back to square one.* Businessworld Publishing Corporation. February 8, 2001. Makati City, Philippines.

384 Calica, Dymphna R. *US banks eye P43-B assets of NHMFC.* August 30, 1999. Manila, Philippines.

385 Calica, Dymphna R. Gov't readies sale of P40-B securitized NHMFC assets. May 7, 2001. Manila, Philippines.

Home Guaranty Corporation (HGC).

Overview. After the National Home Mortgage Finance Corporation (NHMFC) was relieved of its mortgage-origination function, the Home Guaranty Corporation (HGC) actively stepped up its government owned and controlled 'explicit' guaranty corporation, actively stepped up its guarantee loans to encourage the private sector, via the commercial banks, to securitize their own assets. Thus, instead of becoming a Secondary Mortgage Institution (SMI), it initially encouraged private banks to engage in their own stand-alone mortgage securitization.

In 1995, HGC has already approved the request of three commercial banks, namely Philippine Commercial and Industrial (PCI) Bank, Bank of the Philippine Islands (BPI), and Solidbank Corp. to issue MBS. PCIBank planned to issue P1 Billion (US$18.9 Million) worth of Mortgage-Backed Securities (MBS) while BPI and Solidbank planned to issue P500 Million (US$9.5 Million) each of Mortgage-Backed Securities (MBS)[386].

However, the 1997 regional financial crisis of 1997, which spurred high interest rates due to the peso devaluation, coupled with the high transaction costs and the lack of a clear mechanism for securitization, hampered the banks' securitization efforts.

Current State. Due to the sidelining of the National Mortgage Finance Corporation (NHMFC) as the public Secondary Mortgage Institution (SMI), the Home Guaranty Corporation (HGC) was touted as the alternative government-sponsored SMI. Lending credence to this idea is the new charter of the Home Guaranty Corporation (HGC), signed into law in March 2000 (Republic Act 8763 or the Home Guaranty Corporation Act of 2000). Among the amended corporate functions is HGC's "new mandate to pursue the development of a secondary market for housing mortgages, bonds, debentures, notes and securities"[387]. Loosely interpreted, this could mean that Home Guaranty Corporation (HGC) could pursue

[386] Home Guaranty Corporation (HGC)-guarantee instruments are exempted from the registration requirements of the Securities and Exchange Commission (but subject to a case-by-case *Bangko Sentral ng Pilipinas* (Central Bank of the Philippines) approval since bank assets were involved), thus reducing the transaction costs involved in Mortgage-Backed Securities (MBS) issuance. Further, tax exemption is granted up to a maximum of 10% of interest earnings. Despite the incentives, banks, as issuers, have still been wary of the risks involved in the transaction.

[387] Home Guaranty Corporation. The Implementing Rules and Regulations of the Home Guaranty Act of 2000 (With Republic Act 8763). March 2001. Makati City, Philippines.

mortgage-backed securitization. This is further strengthened by the expansion of the Home Guaranty Corporation's (HGC) capital base[388], the prioritization of lower-cost packages[389] and an extended term[390].

However, Bernardo expressed his concern with regard to the Home Guaranty Corporation (HGC) being 'strongly urged' by congressional supporters to go into direct low-cost financing given its new mandates[391]. In particular, Bernardo fears that the Home Guaranty Corporation (HGC) might be compelled to make a "politically popular but financially disastrous" decision to replace the Contractual Savings Institutions (CSIs) in terms of funding the Multi-Window Lending Scheme (MWLS) or to become the new primary mortgage originator (akin to the National Home Mortgage Finance Corporation (NHMFC)). Limlingan supports Bernardo's concern that the Home Guaranty Corporation (HGC) might be transformed into the next National Home Mortgage Finance Corporation (NHMFC). He believes that the increased capitalization of the Home Guaranty Corporation (HGC) was a Chamber of Real Estate and Builders Associations (CREBA) initiative to create a new take-out window for developers, since the National Home Mortgage Finance Corporation (NHMFC) was no purchasing mortgages[392].

According to Tan[393], general manager of the Home Guaranty Corporation (HGC), the corporation is studying the possibility of making HGC the Secondary Mortgage Institution (SMI) and will probably commission a study to look at this in more depth. However, there were no concrete plans to actively pursue Secondary Mortgage Institution (SMI) plans.

Home Development Mutual Fund (HDMF)/Pag-Ibig.

Overview. The Home Development Mutual Fund (HDMF)/*Pag-Ibig* has engaged in a) limited mortgage-backed securitization efforts, which include mortgage-backed securities (MBS) issuances of P500 Million

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388 The Home Guaranty Corporation's (HGC) authorized capital stock was increased from P2.5 Billion (US$47 Million) to P50 Billion (US$943 Million) with an initial equity infusion of P7.5 Billion (US$142 Million) by the National Government upon approval of the Act.

389 Republic Act 8763 compels the Home Guaranty Corporation (HGC) to give preferential attention and incentives to socialized and low-cost housing. The Law provides that 70% of its guaranty portfolio must be allocated to this sector. Moreover, attractive incentives are given to funders of socialized housing – premium fees are lower, tax shield is higher and the guaranteed portion of the interest earnings is higher.

390 The Home Guaranty Corporation (HGC) was given a fresh 50-year mandate to operate a stronger and improved guaranty system for housing.

391 Bernardo, Romeo L. Former Undersecretary of the Department of Finance (DOF). *Personal Interview.* June 2001, Pasig City, Philippines.

392 Limligan, Victor. Professor at the Asian Institute of Management. *Personal Interview.* June 2001. Makati City, Philippines.

393 Tan, Arthur, Executive Vice-President and General Manager of the Home Guaranty Corporation. *Personal Interview.* June 2001. Makati City, Philippines.

(US$ 9.4 Million) in 1994 and P430 Million (US$ 8.1 Million) in 1997[394] and, b) a mortgage-backed bond (MBB) issuance of P4 Billion (US$ 75.5 Million), tax exempt, Home Guaranty Corporation (HGC) guaranteed bonds in March 2000 at 8.25%, equivalent to 14% on a grossed-up basis[395].

Kotecha believes that the Home Development Mutual Fund (HDMF)/*Pag-Ibig* could securitize its performing middle-income loans, which comprise 40% of its business volume (30% is evenly divided between the socialized and low income housing segments). Moreover, Mortgage-Backed Securities (MBS) could help increase the Home Development Mutual Fund (HDMF)/*Pag-Ibig*'s liquidity position given that over the next 5 years, its payment liabilities will outstrip its cash flow[396].

Although the Home Development Mutual Fund (HDMF)/*Pag-Ibig*'s underwriting standards could stand improvement, Kotecha asserts that they may be sufficient enough to securitize the middle-income loans. Among the standards Kotecha highlights are: a) loan-to-value rations are typically less than 90% (versus previous National Home Mortgage Finance Corporation (NHMFC) loans which had 100% loan-to-value rations), b) income checking is performed and the Home Development Mutual Fund (HDMF)/*Pag-Ibig* has asked the government to use direct debits against salary payments and, c) in-house appraisers are used.

Current State. The Home Development Mutual Fund/*Pag-Ibig* has a total portfolio of P55 Billion (US$ 1.04 Billion)[397], with a World Bank-estimated default rate of 37.9%. Out of the Home Development Mutual Fund (HDMF)/*Pag-Ibig*'s 300,000 mortgage loans, an estimated 80,000 are delinquent. Lehman Brothers reportedly made an offer to securitize the entire portfolio, but it was rejected because of the steep discount they offered.

Originally, former Home Development Mutual Fund (HDMF)/*Pag-Ibig* president, Ramon Palma-Gil, estimated that Pag-Ibig the Home Development Mutual Fund (HDMF)/*Pag-Ibig* would only be able to securitize an estimated P500 million worth of performing loans. However, securitization on an individual loan basis would result in "cherry-picking" by investors, depriving Home Development Mutual Fund

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394 Philippine Conference on Securitization. *Mobilizing the Markets for Housing: The Case for Asset-Backed Securities*. October 1999. Makati City, Philippines.

395 Kotecha, Mahesh K. *Secondary Mortgage Institution (SMI) Philippines – Draft Business Plan*. Structured Credit International Corporation. 2000. New York, New York.

396 The Home Development Mutual Fund (HDMF)/*Pag-Ibig* is a member-owned provident fund, with more than 5 million members in the fund. The members expect annual compounded dividends of 3.5% to 4%.

(HDMF)/*Pag-Ibig* of its most attractive loans. And in the process, it will make it harder for the agency to securitize its remaining loans in the future.

Instead of "cherry-picking" mortgage loans to securitize, which would admittedly be difficult as the Home Development Mutual Fund (HDMF)/*Pag-Ibig* would have to review over 240,000 accounts, the Home Development Mutual Fund (HDMF)/*Pag-Ibig* planned to securitize on a per housing project, with the objective of developing the infrastructure (i.e. increased participation in the planning and development of the project prior to financing or lending for take-out) to improve collection efficiency and make the securitized pool more attractive to investors[398].

In an apparent change of plans, Palma-Gil re-looked into securitizing the P54 Billion (US$1.01 Billion) Home Development Mutual Fund (HDMF)/*Pag-Ibig* loan portfolio by tapping the services of an independent company, Lighthouse, a joint venture of former investment bankers and the United Coconut Planters Bank (UCPB), to look into the records of existing mortgages[399].

Lighthouse was supposed to conduct a free pilot project to help Home Development Mutual Fund (HDMF)/*Pag-Ibig* improve the quality of its portfolio, using proprietary technology to reviewing and reprocess the Home Development Mutual Fund (HDMF)/*Pag-Ibig* and improve collection efforts. As of this writing, the deal has yet to push through. Manuel Crisostomo, the current Home Development Mutual Fund (HDMF)/*Pag-Ibig* Chairperson, says that, in retrospect, HDMF should be primarily involved in direct lending to the members of the provident fund, instead of securitizing their mortgages, as this is one of their main functions[400].

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[397] Note that there is a discrepancy between the claims of P1B (US$ 19M) between Kotecha's estimate of the Home Development Mutual Fund (HDMF)/*Pag-Ibig's* portfolio (P55 Billion (US$1.04 Billion)) and that the Home Development Mutual Fund (HDMF)/*Pag-Ibig's* estimate of their portfolio (P54 Billion (US$1 Billion)).

[398] Falgui, Raymond G. *Pag-IBIG Fund mulls new tack on housing debt (... after ditching Lehman Brothers).* Businessworld Publishing Corporation. November 30, 1999. Manila, Philippines.

[399] Leilani M. Gallardo. *Pag-Ibig sells P4-B bonds Thursday.* Businessworld Publishing Corporation. March 20, 2000. Makati City, Philippines.

[400] Crisostomo, Manuel C. President and Chief Executive Officer of Home Development Mutual Fund (HDMF)/*Pag-Ibig. Personal Interview.* June 2001. Makati City, Philippines.

Chamber of Real Estate and Builders Associations (CREBA)-Proposed Housing Finance Program

The Chamber of Real Estate and Builders Association's (CREBA) proposed Centralized Home Financing Program (CHFP) technically does not focus on the development of a secondary mortgage institution (SMI), although the proposal calls for the revival of the National Home Mortgage Finance Corporation (NHMFC). Rather, it appears to be a comprehensive proposal by the Chamber of Real Estate and Builders Association (CREBA) to develop a "sustainable" housing finance program. The Centralized Home Financing Program (CHFP) is the alternative housing program that the Chamber of Real Estate and Builders Association (CREBA) has been batting for in lieu of both the shelved Medium-Term Development Plan for Shelter (MTDP-S) and the current Multi-Window Lending Scheme (MWLS).

The Chamber of Real Estate and Builders Association (CREBA) proposes executive orders[401] and legislation to implement the Centralized Home Financing Program (CHFP). Although several of the "securitization enhancement" measures, such as tax exemptions for mortgage backed securities (MBS) and the exemption from the Maceda Law[402], several aspects of the Centralized Home Financing Program (CHFP) are similar to the structurally deficient, and now defunct, Unified Home Lending Program (UHLP). Key to note is that although the Chamber of Real Estate and Builders Association (CREBA) claims to support securitization, they still continue to propose initiatives that are inimical to securitization, such as proposing subsidized interest rates under the Centralized Home Financing Program (CHFP)[403].

Businessworld reports that a number of Housing and Urban Development Coordination Council (HUDCC) officials believe that the reason behind the Chamber of Real Estate and Builders Association's (CREBA) clamor to revise the present housing finance system and revive the Unified Home Lending Program (UHLP) or any similar program is because a number of its members benefited greatly from the formula-lending system[404].

Nonetheless, the key features of the Centralized Home Financing Program are the following:

"Seed fund" from the contractual savings institutions. The fund pool will come from the following government agencies:

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[401] Executive Orders only pass through the Office of the President and not through the upper and lower houses of congress.

[402] The Maceda Law is discussed under legal issues in Chapter 7.

[403] Limlingan, Victor S. Professor at the Asian Institute of Management. *Personal Interview.* June 2001. Makati City, Philippines.

[404] Junia, Catherine C. *Gov't lacks funds to finance socialized housing projects – CREBA.* Businessworld Publishing Corporation. May 7, 1999. Makati City, Philippines.

Agency	Amount
Government Service Insurance System (GSIS)	P15 Billion (US$283 Million)
Home Development Mutual Fund (HDMF)*Pag-Ibig*	P25 Billion (US$472 Million)
Social Security System (SSS)	P25 Billion (US$472 Million)
Agri-Agra Funds[405]	P35 Billion (US$660 Million)
Total	P100 Billion (US$1.9 Billion)

Source: Chamber of Real Estate and Builders Associations (CREBA)

According to the Chamber of Real Estate and Builders Association (CREBA), the amounts for the respective contractual savings institutions (CSIs) were derived by getting the full extent of each of their investible funds for a year[406]. Thus, instead of placing their investible funds in other financial instruments (i.e. government securities), the contractual savings institutions (CSI) are supposed to put all their money into the seed fund for the Centralized Home Financing Program (CHFP). The Chamber of Real Estate and Builders Associations (CREBA) argues that since the contractual savings institutions (CSI) are mandated to provide housing finance under their respective charters, that these funds be effected in a one-time lump sum basis versus annual installments, under the Centralized Home Financing Program (CHFP).

Similar to the Unified Home Lending Program (UHLP), the contractual savings institutions (CSIs) are made to invest in primary mortgage lending, instead of developing the capital markets by investing in mortgage-backed securities (MBS). Instead, the Chamber of Real Estate and Builders Association (CREBA) recommends banks (via their housing credit allocation and statutory reserves) as the primary investors in the mortgage backed securities (MBS).

Key to note is the financing scheme that the Chamber of Real Estate and Builders Association (CREBA) developed for the Centralized Home Financing Program (CHFP):

1. A swap of the National Home Mortgage Finance Corporation's (NHMFC) outstanding loans at face value (P42 Billion/US$792 Million) with the contractual savings institutions (CSIs) in exchange for promissory notes or housing bonds from the National Home Mortgage Finance Corporation (NHMFC) of an equivalent amount.

[405] The Agri-Agra Law (Presidential Decree 717) mandates that banks set aside 25 %of their loan portfolio (15% for agriculture and 10% for agrarian reform lending) to help spur growth in both these sectors. The law has since been amended to allow socialized or low-cost housing as one form of alternative compliance to the Agri-Agra Law.

[406] According the Chamber of Real Estate and Builders Association (CREBA), full investible funds of each of the Contractual Savings Institutions is 70% for the Home Development Mutual Fund (HDMF)/*Pag-Ibig*, 30% each for the Government Service Insurance System (GSIS) and the Social Security System (SSS).

2. The National Home Mortgage Finance Corporation (NHMFC) promissory note/housing bond will have a term-to-maturity of 10 years. The term-to maturity presumably corresponds to the median maturity of the outstanding mortgage portfolios of the National Home Mortgage Finance Corporation (NHMFC).
3. The National Home Mortgage Finance Corporation (NHMFC) promissory note/housing bond yield will be set at an average rate of the outstanding National Home Mortgage Finance Corporation (NHMFC). However, the yield will be less 2%, to allot for the overhead, collection and related costs of the National Home Mortgage Finance Corporation (NHMFC) in servicing the mortgage for the contractual savings institutions. For perspective, the Housing and Urban Development Coordinating Council (HUDCC) reports that the average yield of the mortgage loans under the Unified Home Lending Program (UHLP) was 13%. Thus, the contractual savings institutions will be receiving only 11% over a period of ten years. As of August 8, 2001, the 10-year treasury bill was trading at 15.7886%.
4. The National Home Mortgage Finance Corporation (NHMFC) promissory note/housing bond will be amortized annually for a period of ten years.

The proposal assumes that the total investment of the contractual savings institutions (CSIs) will be liquidated on the 10^{th} year, with all interest accruals being paid yearly.

Production oriented housing target. The Centralized Home Financing Program (CHFP) expects to build 350,000 housing units a year over a 10-year period. According to the Chamber of Real Estate and Builders Association (CREBA), this production target will "eliminate the problem of homelessness and squatting within 20 years". Moreover, this will allow developers to undertake long-term programming of housing activities such as land banking. For perspective, the production oriented objectives of the previous housing programs resulted in a) 'financially disastrous' consequences, as evidenced by the failure of the Unified Home Lending Program (UHLP) and; b) the proliferation of thousands of units which the intended beneficiaries refused to occupy.

Revival of the National Home Mortgage Finance Corporation (NHMFC) as a primary mortgage lender and sole take out window. Although the National Home Mortgage Finance Corporation (NHMFC) has already been relegated to a collection agency of its P42 Billion (US$792 Million) loan portfolio, the Centralized Home Financing Program (CHFP) proposes reviving its primary mortgage lending and mortgage take out function[407]. In the Chamber of Real Estate and Builders Association (CREBA) proposal, the National Home Mortgage Finance Corporation (NHMFC) will simultaneously undertake BOTH primary mortgage lending and securitization activities[408]. However, in the Centralized Home Financing Program (CHFP), the National Home Mortgage Finance Corporation (NHMFC) will be engaged in wholesale collection efforts from the developers. Presumably the reason why Serrano[409] argued that it "doesn't matter whether or not it (National Home Mortgage Finance Corporation) is an effective institution or not, but it was designated to be there. CREBA sees no reason why it should not be used...it can be restored to what it once was before" by putting in "the right people, since it just a fictional entity after all"[410] was because the Chamber of Real Estate and Builders Associations (CREBA) planned to use it for their proposed Centralized Home Financing Program (CHFP).

Decentralized lending. Mortgage origination for the Centralized Home Financing Program (CHFP) will be undertaken either through participating banks or through developers via Contract-to-Sell (CTS) origination. Under the previous Unified Home Lending Scheme (UHLP), mortgages versus contracts-to-sell (CTS) were provided to the homebuyers. For perspective, mortgages are covered under the foreclosure law, which allows the homebuyer up to a year to redeem his/her foreclosed property[411]. Under the Contract-to-sell (CTS), the title of the property will not pass to the homebuyer until full payment of the property. In the Centralized Home Financing Program (CHFP), the National Home Mortgage Finance Corporation (NHMFC) will "take-out" the Contract-to-sell (CTS) from the developers.

Developer origination. After the National Home Mortgage Finance Corporation (NHMFC) takes out the developer's Contract-to-Sell (CTS), the National Home Mortgage Finance Corporation (NHMFC) will

[407] Unlike the Unified Home Lending Program (UHLP) where the sole mortgage take out window was the National Home Mortgage Finance Corporation (NHMFC), the current Multi-Window Lending Scheme utilizes several government financial institutions (via their accredited banks) for primary mortgage lending and take out.

[408] Again, the National Home Mortgage Finance Corporation (NHMFC) is being used to perform primary mortgage lending, an activity that the organization was not structured to perform. Presently, the National Home Mortgage Finance Corporation (NHMFC) has since refocused and correspondingly restructured its activities to collect on its loan portfolio.

[409] Serrano, Atty. Manuel M. Founding Chairman of the Chamber of Real Estate and Builders Associations (CREBA). *Personal Interview.* June 2001. Makati City, Philippines.

[410] The Chamber of Real Estate and Builders Association (CREBA), through Serrano, appears to be the lone voice endorsing the use of the revival of the National Home Mortgage Finance Corporation (NHMFC), although all other key players in securitization agree that the National Home Mortgage Finance Corporation (NHMFC) can no longer serve as an effective secondary mortgage institution (SMI).

[411] Presumably, the Contract-to-sell (CTS) is used versus mortgage origination to avoid the foreclosure law.

release 90% of the balance of the Contract-to-Sell (CTS). The retention of the 10% of the balance of the housing unit is suppose to a) 'alleviate' the risk burden that was shouldered by the National Home Mortgage Finance Corporation (NHMFC) under the Unified Home Lending Program (UHLP), where the UHLP paid out 100% of the property to the developers; b) render unnecessary the Home Guaranty Corporation (HGC) guaranty because it already incents the developer to ensure that payments are made on the contract-to-sell (CTS) and; c) prevent delays in "take outs" to developers because the National Home Mortgage Finance Corporation (NHMFC) does NOT have to undertake a lengthy process of credit evaluation of individual loan applications.

The developer shall a) take collect the first 2 years of the Contract-to-sell (CTS) for the National Home Mortgage Finance Corporation (NHMFC), and; b) have a 100% warranty in writing to back up the collection of mortgage receivables. After the first 2 years, the developer will deliver an absolute deed of sale to the National Home Mortgage Finance Corporation (NHMFC), effectively transferring its ownership to the NHMFC.

Use of purchase commitment lines. Similar to the Unified Home Lending Program (UHLP), the Centralized Home Financing Program (CHFP) will draw up purchase commitment lines (PCLs) for the developers and participating banks that will "take out" the Contracts-to-Sell (CTS) and mortgages. For perspective, the purchase commitment lines (PCLs) created incentives for developers, who were also originating the mortgage loans, to build housing units even before entertaining applicants for the low-cost housing.

Standardization of lending parameters. The proposal calls for the standardization of lending terms, conditions, and documentation, as a means of reducing costs and ensuring marketability. The Centralized Home Financing Program (CHFP) appears to use the same uniform lending guidelines/borrower eligibility that were characteristics of the Unified Home Lending Program (UHLP), namely all income-earning citizens who are non-members of the Home Development Mutual Fund (HDMF)/Pag-ibig, Government Service Insurance System (GSIS), and the Social Security Service (SSS) under the Urban Development and Housing Act (Republic Act 7279) or members of the contractual savings institutions (CSI) who have not previously availed of government housing assistance

Subsidized interest rates. Similar to the Unified Home Lending Program (UHLP), the National Home Mortgage Finance Corporation (NHMFC) will administer the three-tiered fixed interest rates of 9% for socialized housing, 12% for low income housing, and 16% for mid income housing. For perspective, the unsustainability of subsidized interest rates for the mortgage loans was identified as one of the shortcomings of the Unified Home Lending Program (UHLP).

"Full" securitization program. The subsidized mortgage loans will be recycled through a continuous securitization program. Presumably, this implies that all mortgage-backed securities (MBS) from the Centralized Home Financing Program (CHFP) will be purchased to maintain the liquidity of the seed fund. Moreover, the Chamber of Real Estate and Builders Association (CREBA) believes that the program will be successful behind proposed securitization enhancement measures by raising the net yields WITHOUT correspondingly raising the mortgage rates.

The Centralized Home Financing Program (CHFP) proposed the use of the Home Guaranty Corporation (HGC) as a credit enhancement on the securitized pool of mortgages. For perspective, a guarantee facility was not extended by the Home Guaranty Corporation (HGC) to the Unified Home Lending Program (UHLP) because or the lenient borrowing guidelines. Presumably, this would be the case for the Centralized Home Financing Program (CHFP) since it uses similar lending parameters. For perspective, the lending requirements for the program would be developed by the National Home Mortgage Finance Corporation (NHMFC) BASED upon the lending parameters that the Chamber of Real Estate and Builders Association (CREBA) drafted for the proposed Executive Order on the Centralized Home Financing Program (CHFP).

The Chamber of Real Estate and Builders Association (CREBA) asserts that the securitization program will be high-investment grade because of the a) strong hold on the collateral property and; b) 100% collection of receivables and; c) proposed exemption from the Maceda Law[412].

The Chamber of Real Estate and Builders Association (CREBA) defines "strong asset hold" as the use of contracts-to-sell (CTS) versus mortgage origination, because the title of the property doesn't transfer to the homebuyer until the property is fully paid. Thus, the developer, acting on the National Home Mortgage Finance Corporation's (NHMFC) behalf, can cancel the contract-to-sell (CTS) and re-sell the property.

Furthermore, the Chamber of Real Estate and Builders Association (CREBA) claim that the possibility of defaults is rendered remote because of the a) the "low" loan-to-value ratio which increases the homebuyers' stake in the contract-to-sell (CTS) (For perspective, the Chamber of Real Estate and

Builders Association (CREBA) uses the loan to value ratio of 95% for socialized housing and 90% for non-socialized housing. For perspective, commercial banks have a 60% to 70% loan to value ratio) and; b) the use of the contract-to-sell (CTS) to incent homebuyers to fully pay the housing unit before the property is transferred to their name.

The 100% collection of receivables is backed up by what the Chamber of Real Estate and Builders Association (CREBA) termed as a 'developer warranty' scheme. In the event that an account falls in arrears for more than 2 months, the developer will be required, within a 1-month period, to either update the account or buy it back. However, if the developer fails to comply, the National Home Mortgage Finance Corporation (NHMFC) merely cancels the developers' collection agreement and forfeits the 10% retention. On top of that, the National Home Mortgage Finance Corporation (NHMFC) will have to take up the collection efforts.

The following are the securitization "enhancement" measures the Chamber of Real Estate and Builders Association (CREBA) to "enhance" the yields on the mortgage backed securities without having to increase the mortgage rate to homebuyers. These measures are proposed in the bill that the Chamber of Real Estate and Builders Association (CREBA) drafted to create a Department of Housing.

1. Exemption from the 20% withholding tax/final tax on interest income for savings depositors of banks whose investments in housing bonds is not less than 20% of their investible funds;
2. Exemption from the 20% final tax on income, documentary stamp tax (DST), gross receipts tax (GRT), and Value Added Tax (VAT), for transactions involving the purchase and sale of housing bonds/securities;
3. Use of housing bonds/securities as statutory and/or liquidity reserves of banks and insurance reserves of insurance companies;
4. Use of investments in housing bonds/securities as alternative compliance with the loan-to-deposit ratio of requirement of banks;
5. Use of investments in housing bonds/securities as alternative compliance with the social housing quota under the Urban Development and Housing Act (Republic Act 7279).

Other "securitization" enhancement measures to be included in the bill are the a) exemption of housing units sold under the Contract-to-sell (CTS) from the Maceda Law; b) Reduction of the mortgage period for foreclosures from 1 year to 3 months; c) Summary ejectment by the Housing and Land Use

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[412] The Maceda Law is discussed under legal issues in Chapter 7.

Regulatory Board (HLURB) to facilitate the turnover of defaulted loans/cancelled accounts and; b) establishment of a 20% credit allocation for housing.

Current State. In an article that came out in the Philippine Star, Charlie Gorayeb, the national president of the Chamber of Real Estate and Builders Associations (CREBA) seemed to imply that the Centralized Home Financing Program (CHFP) was finally pushing through under the administration of newly installed President Arroyo[413]. Gorayeb said that the P20 Billion (US$377 Million) that the President had earmarked for the development of housing units during the State of the Nation Address (SONA) would form part of the seed money to start of their proposed Centralized Home Financing Program (CHFP)[414]. Moreover, Gorayeb stated that the centralized house financing program (CHFP) would be part of proposal that they would submit to congress seeking to establish a Department of Housing and Urban Development. Meanwhile, he adds that the both the mechanics of the common housing fund and the infrastructure to pursue the Chamber of Real Estate and Builders Associations (CREBA) proposed housing program would be mapped out by the government.

Issues with the Centralized Home Financing Program (CHFP).
Another version of the Unified Home Lending Program (UHLP)?. The Centralized Home Financing Program (CHFP) appears to carry the same structural flaws of the Unified Home Lending Program (UHLP). Since most of these deficiencies are similar to the Unified Home Lending Program (UHLP), these issues were discussed extensively under the shortcomings of the aforementioned program in Chapter 4. However, it is also instructive to understand the possible rationale behind the Chamber or Real Estate and Builders Association (CREBA) aggressive push for the Centralized Home Financing Program (CHFP).

Key players in securitization have asserted that developers in the Chamber of Real Estate and Builders Association (CREBA) want to maintain the housing finance structure under the Unified Home Lending Program (UHLP) because it has worked to the Chamber of Real Estate and Builders Association's

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413 Gorayeb, Charlie V. *Government-private sector housing policy to be forged in summit.* Philippine Star. August 6, 2001. Manila, Philppines.

414 Gorayeb said that the P20 Billion (US$377 Million) will be The fund will be combined with the P50 Billion (US$943 Million) coming from the unused portions of the Agri-Agra Fund, and the P10 Billion (US$189 Million) contribution from the Home Development Mutual Fund (HDMF)/*Pag-Ibig*, and a P5 Billion (US$94 Million) contribution each from the Social Security System (SSS) and the Government Service Insurance System (GSIS). The aggregate amount will total P90 Billion (US$1.7 Billion), which will start of their proposed Centralized Home Financing Program (CHFP).

(CREBA) financial advantage[415]. Under the Unified Home Lending Program (UHLP), developers groups under the Chamber of Real Estate and Builders Association (CREBA) were able to pass on sub-par mortgage loans to the National Home Mortgage Finance Corporation (NHMFC) via the purchase commitment loans (PCLs). Similarly, the Chamber of Real Estate and Builders Association (CREBA) has been successful in a) securing government subsidy for the development projects and; b) persuading the government to purchase the debt papers of their members' projects. Thus, it would appear to be in the Chamber of Real Estate and Builders Association's (CREBA) best interests to continue this type of relationship. This assertion is strengthened by the discussion on the 'moral hazard for developers' shortcomings under the Unified Home Lending Program (UHLP), wherein the developers has already built the housing units even before they had qualified potential homebuyers for the low-income units.

Moreover, the desire to maintain a government sponsored housing program may explain why the Chamber of Real Estate and Builders Associations (CREBA) favors a publicly- versus privately-led secondary mortgage institution (SMI). The developer groups in the Chamber of Real Estate and Builders Associations (CREBA) may have concluded that the 'quality' of their current receivables[416] isn't up to par. Thus, if a private-led secondary mortgage institution (SMI) is established, developer groups under the Chamber of Real Estate and Builders Associations (CREBA) will not be able to sell off their mortgage loans because they are not eligible for securitization (i.e. poor asset quality)[417]. Presumably, the Chamber of Real Estate and Builders Association (CREBA) would be in a better position if the government merely allocated funding for housing versus having their mortgage origination process undergo the stringent underwriting guidelines required prior to securitization. This belief tends to be strengthened by the proposed 10% retention scheme of the total contract-to-sell (CTS) balance of the National Home Mortgage Finance Corporation (NHMFC) under the Centralized Home Financing Program (CHFP). The rationale of the Chamber of Real Estate and Builders Association (CREBA) behind the retention is to prevent delays in "take outs" to developers because the National Home Mortgage Finance Corporation (NHMFC) does NOT have to undertake a lengthy process of credit evaluation of individual loan applications.

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[415] Limlingan, Victor S. Professor at the Asian Institute of Management. *Personal Interview*. June 2001. Makati City, Philippines.

[416] These receivables are presumably mortgage receivables from the loans that were not taken out by the National Home Mortgage Finance Corporation (NHMFC) under the Unified Home Lending Program (UHLP). Moreover, these receivables are presumably pegged under the fixed interest rate scheme of the Unified Home Lending Program (UHLP).

[417] Limlingan, Victor S. Professor at the Asian Institute of Management. *Personal Interview*. June 2001. Makati City, Philippines.

For perspective, key players in securitization have argued that most of the developers whose mortgage loans had become non-performing loans (NPLs) were members of the Chamber of Real Estate and Builders Associations (CREBA). Again, this assertion appears to be strengthened by a) the revival of the National Home Mortgage Finance Corporation (NHMFC) as the secondary mortgage institution (SMI) under the Centralized Home Financing Program (CHFP) and; b) Serrano's insistence to revive the National Home Mortgage Finance Corporation (NHMFC) because it is the only institution with the public mandate to securitize[418].

In the event that the National Home Mortgage Finance Corporation (NHMFC) could not be revived as a primary mortgage take out window, Limligan says that the Chamber of Real Estate and Builders Association (CREBA) has been influencing the government to let the Home Guaranty Corporation (HGC) become a) the new primary mortgage take out window for developers or; b) to serve as a guarantor for the mortgage loans of that Chamber of Real Estate and Builders Association (CREBA) developers in the event that they are able find new sources of financing[419]. He argues that the that Chamber of Real Estate and Builders Association's (CREBA) initiatives was the primary reason behind the increased capitalization of the Home Guaranty Corporation (HGC).

The National Home Mortgage Finance Corporation (NHMFC) and contractual savings institution (CSI) 'swap' is financially unfavorable for the funders. There are several concerns with regard to this proposal. First, the revolving seed fund calls for a 'swap' of the outstanding loan portfolio of the National Home Mortgage Finance Corporation (NHMFC) with a one-time seed fund from the investible reserves of the contractual savings institution (CSI). However, the outstanding loans of the National Home Mortgage Finance Corporation are already technically owned by the three funders. In effect, this proposal charges the contractual savings institution (CSI) to purchase their 'investments' in the National Home Mortgage Finance Corporation, which does not appear to make financial sense for the funders.

In the event that this 'swap' pushes through, it still appears be financially unfavorable for the contractual savings institutions (CSI). The total National Home Mortgage Finance Corporation (NHMFC) outstanding loan portfolio is P42 Billion (US$ 792 Million). However, the National Home Mortgage

418 Serrano, Atty. Manuel M. Founding Chairman of the Chamber of Real Estate and Builders Associations (CREBA). *Personal Interview.* June 2001. Makati City, Philippines.

419 Limlingan, Victor S. Professor at the Asian Institute of Management. *Personal Interview.* June 2001. Makati City, Philippines.

Finance Corporation (NHMFC) reports that only 50% of loans are non-performing[420]. Despite this, the Chamber of Real Estate and Builders Association (CREBA) recommends a "face value" swap of the loan portfolio for the seed fund from the contractual savings institutions (CSI). Given this arrangement, the more financially sensible alternative for the funders would be to "absorb" the loans from the National Home Mortgage Finance Corporation (NHMFC) and collect the mortgages themselves instead of buying out their own investments.

On top of this, the Centralized Home Financing Program (CHFP) swap requires a P100 Billion (US$1.9 Billion) seed fund with the P42 Billion (US$792 Million) loan portfolio. The proposal was silent with regard to where the seed fund would source the additional P58 Billion (US$1.09 Billion).

Subsidized interest rates will continue to render the Centralized Home Financing Program (CHFP) mortgages ineligible for securitization. The Centralized Home Financing Plan (CHFP)'s recycled seed fund hinges on the continuous securitization of the mortgage pool from their receivables. However, similar to the subsidized interest rates on the mortgage loans of the Unified Home Lending Program (UHLP), the subsidized interest rates on the mortgage loans of the Centralized Home Financing Program (CHFP) fail to make these potential mortgage backed securities (MBS) more lucrative versus higher yielding long-term government securities (i.e. treasury bills). In Chapter 5, we discussed how Kotecha already discounted all mortgage loans originated under fixed interest rates as being ineligible for securitization[421]. Furthermore, the use of subsidized interest rate will continue to "crowd out" commercial banks from participating in low cost housing since the banks cannot compete against these rates[422].

The use of the total investible funds of the contractual savings institutions (CSI) for the Centralized Home Financing Program (CHFP) prevents the growth of the capital markets. The contractual savings institutions (CSI) are the ideal institutional investors for mortgage-backed securities (MBS) because of the asset-liability duration match[423]. However, as discussed in Chapter 4, the contractual savings lose out on the opportunity to invest in long-term financial instruments with higher yield (i.e. government securities).

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[420] Manicio, Eduardo T. Vice-President, Funds Generation Group of the National Home Mortgage Finance Corporation (NHMFC). *Personal Interview.* June 2001. Makati City, Philippines.
[421] Kotecha, Mahesh K. *Secondary Mortgage Institution (SMI) Philippines – Draft Business Plan.* Structured Credit International Corporation. 2000. New York, New York.
[422] Llanto, Gilbert M., Aniceto C. Orbeta, Jr., Ma. Teresa C. Sanchez and Marie Christine G. Tang. *A Study of Housing Subsidies in the Philippines.* Philippine Institute of Development Studies. November 1998. Makati City, Philippines.

The Chamber of Real Estate and Builders Association (CREBA) recommends that the 'potential' investors in mortgage-backed securities are the banks[424]. However, Bernardo claims that banks are not ideally suited for providing long-term financing for housing due to the short-term nature of their liabilities (i.e. deposits)[425].

Private Secondary Mortgage Institution.

Home Corporation

Overview. The Home Corporation would have been the first privately led Secondary Mortgage Institution (SMI) in the Philippines. In September 1998, Urban Bank created Home Corp., a financing company owned by UrbanCorp Investments[426]. Through Home Corp., Urban Bank expected to syndicate loans backed by the mortgages of Home Development Mutual Fund (HDMF)/*Pag-Ibig* Fund members, in the process helping Pag-Ibig's middle-income contributors get homes and acquire financing. In fact, Urban Bank was even in talks with the International Finance Corporation (IFC), the World Bank's private sector arm, to invest in Home Corp. and allow it to eventually increase its paid-up capital.

The Home Development Mutual Fund (HDMF)/*Pag-Ibig* estimated that the middle income group's funding demand at P10 Billion (US$ 180 Million) a year considering a rate of 5,000 to 10,000 housing units built per year, with a value of P1 Million (US$19,000) to P2 Million (US$38,000) per loan. These middle-income groups would be the target of Home Corporation's securitization program since the families were the target of the program since the Home Development Mutual Fund (HDMF)/*Pag-Ibig* catered to lower loan ceilings. Under the program, the Home Development Mutual Fund (HDMF)/*Pag-Ibig* would originate loans of between P500,000 (US$9,400) to P3.5 Million (US$66,000), higher than the present maximum loanable amount of P500,000 (US$9,400) to its qualified members. Home Corporation would, in turn, purchase the mortgages and securitize them via the issuance of Mortgage Backed Securities (MBS). The Home Development Mutual Fund (HDMF)/*Pag-Ibig*, at the time, estimated that

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[423] The discussion on contractual savings institutions as the ideal investors for mortgage backed securities is discussed extensively under the Investors section of this chapter.
[424] The Chamber of Real Estate and Builders Association (CREBA) identified the following potential mortgage backed securities (MBS) sources: a) banks 20% housing credit allocation; b) banks 9% statutory reserves; c) 50% of 75% loan to deposit ratio of banks; d) 50% of the remaining deposits of banks and; e) 50% of the 20% quota for socialized housing projects.
[425] Bernardo, Romeo L. *Revisiting Housing Finance.* Philippine Daily Inquirer. March 12, 2001. Makati City, Philippines. The short-term investment horizon of Philippine commercial banks is discussed extensively in Chapter 5.
[426] Reside, Renato S. *Mortgage-Backed Securities in Asia.* Asian Development Bank. 1999. Pasig City, Philippines.

they would have approximately 15% of the fund's membership of 5 million who would qualify for the loan under the program

Meanwhile, the Home Development Mutual Fund (HDMF)/*Pag-Ibig* would handle the administrative such as retail loan servicing and loan collection. Qualified banks under the program would charge an interest rate based on prevailing market rates for the first two years of the loan and a fixed interest rate of 18% from the third year until its maturity.

The Mortgage-Backed Securities (MBS) would have had a 20-year term with semiannual payment of principal and yield. The Mortgage-Backed Securities (MBS) would be in denominations of as low as P10,000 (US$190), to make it accessible to retail investors as well as institutional investors. Urban Bank said that members will have to qualify based on commercial bank-based credit standards, theoretically making the loans creditworthy and bankable assets in their own right. Urban Bank and the Home Development Mutual Fund (HDMF)/*Pag-Ibig* drew up the mortgage origination, lending and servicing guidelines for securitizable loans to minimize credit risk.

The Home Guaranty Corporation (HGC) was to have guaranteed the mortgages, and not the securities themselves. Since the HGC guarantee is the equivalent of a sovereign guarantee, the pass-through interest earnings of Mortgage-Backed Securities (MBS) investors up to 8.5% of the market-determined interest rate would have been exempt from the regular 20% withholding tax on interest income. In addition, the Mortgage-Backed Securities (MBS) did not have to be registered with the Securities and Exchange Commission (SEC).

To support the securitization process, Urban Bank was going to electronically link originating banks with Home Development Mutual Fund (HDMF)/*Pag-Ibig*'s regional offices. On top of this, Equitable Card Network had been tapped to facilitate the loan collections through credit card in addition to payments through ATM cards, the branch network of banks and mail check payments. The securities would have been underwritten and sold to financial institutions and capital market investors, listed on the Philippine Stock Exchange (PSE), and enrolled in the Philippine Central Depository, Inc. for scripless trading.

During its first year, Urban Bank hoped to generate P10 Billion (US$189 Million) to fund the same amount of housing loans. However, even up to 1999, there was a failure to list the first ever publicly listed MBS at the PSE due to the lack of inventory of mortgage loans to back up the securitization. In turn, the lack of inventory build-up was due to the sluggish economic activity and shrinking interest rate margins discouraged developers from turning over their receivables to Home Corporation. In fact, of the P5 Billion (US$94 Million) earmarked for the securitized housing loan program, only P1 Billion (US$19 Million) had been used up, which was a far cry from P10 billion a year the bank was initially projecting.

Current State. According to Crisostomo, the Urban Bank/Home Corporation never pushed through for two key reasons[427]. Firstly, Urban Bank/Home Corporation wanted the Home Development Mutual Fund (HDMF)/*Pag-Ibig* to play the role of originator for Urban Bank/Home Corporation's mortgage-backed securities (MBS), a role which the provident housing fund was not keen on performing[428]. The intention of Urban Bank/Home Corporation was to "short cut" the system (i.e., despite not having a sizable pool of mortgages, they already wanted to securitize) and engage in secondary mortgage institution (SMI) operations. In fact, the Home Development Mutual Fund (HDMF)/*Pag-Ibig* had still been processing the loans (i.e. mortgage loans had not yet been lent out), but Urban Bank/Home Corporation had already been selling the mortgage backed securities (MBS) for mortgages that had not yet been created[429].

Crisostomo's statements appear to strengthened by preliminary reports on the collapse of Urban Bank[430]. Government investigations of Urban Bank revealed that the bank's misfortune stemmed from the financial trouble of its investment house subsidiary, Urbancorp Investment. Early reports said Urbancorp has possibly engaged in "Wincorp-like" transactions, referring to another cash-strapped investment house, Westmont Investment Corp., which brokered securities deals but was caught by liquidity problems when investors suddenly preterminated their holdings[431].

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[427] Crisostomo, Manuel C. President and Chief Executive Officer of Home Development Mutual Fund (HDMF)/*Pag-Ibig. Personal Interview.* June 2001. Makati City, Philippines.

[428] The current retail lending of Home Development Mutual Fund (HDMF)/*Pag-Ibig* was intended to provide housing loan access to low income borrowers (up to P500,000 (US$9,430)). However, Urban Bank/Home Corporation had wanted Home Development Mutual Fund (HDMF)/*Pag-Ibig* to originate middle income loans of P500,000 to P3.5 Million (US$9,430 to US$66,000).

[429] According to Crisostomo, it had been made to appear that the Home Development Mutual Fund (HDMF)/Pag-Ibig had been reneging on its agreement.

[430] Urban Bank collapsed in May 2000 after experiencing a severe bank run (which led to a bank holiday and its eventual closure). Preliminary investigation by government agencies on the Urban Bank 'fiasco' indicate that the bank's management had broken the rules of sound banking. Preliminary findings by the task force investigating the case showed that the bank, among others, violated the revised securities act and the law on commercial papers. (Source: Boras, Eric. S. *Second Quarter Banking Report: Some hard lessons from the Urban Bank collapse (What Happened and Can it Happen Again?).* Businessworld Publishing Corporation. August 16, 2000. Makati City, Philippines.)

[431] Boras, Eric. S. Second Quarter Banking Report: Some hard lessons from the Urban Bank collapse (What Happened and Can it Happen Again?). Businessworld Publishing Corporation. August 16, 2000. Makati City, Philippines.

Metrobank, Equitable Non-performing loan securitization

Lehman Brothers has recently forged separate deals with Metropolitan Bank and Trust Company, the Philippines' biggest bank in terms of assets, and Equitable PCI Bank, the third largest bank, for the establishment of their respective Asset Management Companies (AMC)[432].

Businessworld reports that Lehman Brothers is currently performing due diligence on the Non-Performing Loans (NPLs) and acquired assets of Equitable PCI Bank. However, there was no mention as to the percentage of the non-performing loans (NPLS), which were residential loans. For perspective, as of end-2000, Metrobank's Non-Performing Loans (NPLs) have reached P29 Billion, while Equitable PCI Bank's Non-Performing Loans (NPLs) have reached P24.8 Billion, representing 15% and 19% of the their total loan portfolio, respectively.

Thrift Bank Securitization

Thrift banks claimed that they have already begun the process of securitization by purchasing asset-backed (ABS) or mortgage-backed securities (MBS) among themselves[433]. According to thrift bank representatives at the Philippine Conference on Securitization, their experience revealed that Asset Backed Securities (ABS) have higher yields compared to other financial instruments.

Other securitization efforts. There have been previous attempts by other local and foreign banks to securitize mortgage loans. However, structural deficiencies in the financial capital markets prevented these banks from further pursuing securitization efforts. It is interesting to note that both of these proposals mortgage securitization efforts occur right before the 1997 regional currency crisis.

Lighthouse Credit Technologies Corporation Securitization. Lighthouse is an independent third-party loan servicer founded by former real estate financial experts and investment bankers from the United States. Lighthouse plans to be a fully integrated company that engages in all the processes leading towards mortgage-backed securitization[434]. These include mortgage origination up to securitization

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[432] Yap, Cecille E. *Lehman, Metrobank, Equitable, step up efforts to create AMCs.* Businessworld Publishing Corporation. July 18, 2001. Makati City, Philippines.
[433] Philippine Conference on Securitization. *Mobilizing the Markets for Securitization: The Case for Asset Backed Securities.* October 1999. Makati City, Philippines.

[434] Maquera, Peter D. Chief Operating Officer of Lighthouse Credit Technologies Corporation. *Personal Interview.* June 2001. Pasig City, Philippines.

process, utilizing global best standards practices. Lighthouse has a) been in negotiations with the National Home Mortgage Finance Corporation (NHMFC) to purchase their total loan portfolio at par value and; b) won the bid to service 60,000 accounts for the Home Development Mutual Fund (HDMF)/*Pag-Ibig* but which did not push through because of the unstable political environment in 2000 (i.e. the impeachment of President Estrada) which consequently led to economic instability.

Bankers trust. In 1997, The Hong Kong unit of Bankers Trust was involved in negotiations with Philippine banks for the possible securitization of mortgages where peso-denominated mortgage prices would be swapped with dollars. Bankers Trust had been in talks with foreign institutions, such as the Financial Securities Assistance, to serve as a credit guarantor to help enhance the creditworthiness of the securities. However, Bankers Trust mentioned that securitization in the Philippines would only be successful if the country's credit rating would be upgraded to a notch below investment grade[435].

Bankers Association of the Philippines/Citibank N.A. In January 1997, the Department of Finance (DOF) wanted to forge a partnership with the private sector, particularly Citibank N.A., the Bankers Association of the Philippines (BAP) and the multisectoral Capital Markets Development Council (CMDC), to create a Secondary Mortgage Institution (SMI) that would facilitate mortgage securitization[436].. The Department of Finance (DOF) envisioned the Secondary Mortgage Institution (SMI) to be an organization that would buy mortgages from banks and selling the Mortgage Backed Securities (MBS) to thrift banks with a guarantee from the Home Guaranty Corporation (HGC). The original motivation for the Department of Finance (DOF) to spearhead this move was because the contractual savings institutions (CSIs) were already hard-pressed in funding the government mortgage lending programs. However, the plan failed to push through supposedly due to the high costs of securitization (which was further exacerbated by the sluggishness of the housing sector given that proposal came amidst the 1997 regional currency crisis).

Issues with foreign ownership of Asset Management Companies (AMC)/Secondary Mortgage Institutions (SMI). Macasaet of Lehman Brothers cites that one of the key issues hampering the development of the secondary mortgage market in the Philippines is the inability of foreign companies to establish and maintain virtually full control of their asset management companies (AMC)/secondary mortgage

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[435] Castillo, Dulce J. *Bankers Trust in talks with KBs on securitization.* Businessworld Publishing Corporation. January 29, 1997. Manila, Philippines.
[436] Duplito, Ma. Salve I. *BAP, Citibank eye secondary mortgage firm.* Businessworld Publishing Corporation. October 30, 1997. Manila, Philippines.

institutions (SMI)[437]. In Thailand, Lehman Brothers was able to establish an asset management company that successfully liquidated roughly 7,000 to 8,000 medium to high-income residential mortgage loans (from a purchased mortgage portfolio of 15,000 loans) that were absorbed by the Thai government from 52 different finance companies. The asset management company (AMC), 99% owned by Lehman Brothers, and 1% owned by the Thai government, introduced world class servicing facilities to rehabilitate the loans. When the rehabilitated loans were issued with Lehman's credit enhancements, the mortgage backed securities (MBS) generated strong demand from domestic Thai investors.

Maquera, of Lighthouse Technologies, adds that investment banks such as Lehman Brothers or Goldman Sachs will have a) the experience and expertise; b) financial capital and; c) international credibility to establish and run an asset management company (AMC)[438]. However, the current laws on foreign ownership serve as a disincentive to foreign companies from setting up such institutions in the country. For perspective, in the event that the secondary mortgage institution (SMI) is considered a quasi-bank, the Foreign Investments Act of 1991 allows only 60% foreign equity for an investment house or financing company. In the event that the secondary mortgage institution (SMI) is considered a corporation, it may possibly be limited to 40% foreign equity on land ownership[439].

Guarantees

Overview. An investor in mortgage- backed securities (MBS) requires some level of assurance that he will receive a regular stream of cash flows originating from the securitized pool of mortgage loans. This necessarily means that the investor should be 'insulated' from the risks that occur in the primary mortgage market, such as default risks of the homebuyer[440]. These "assurances" take the form of guarantees, which is suppose to provide the risk cover that will make the Mortgage Backed Security (MBS) competitive with other investment options.

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[437] Norman Macasaet, Principal Transactions Group of Lehman Brothers. *Personal Interview.* June 2001. Makati City, Philippines.
[438] Maquera, Peter D. Chief Operating Officer of Lighthouse Credit Technologies Corporation. *Personal Interview.* June 2001. Pasig City, Philippines.
[439] Land ownership is presumably transferred to the secondary mortgage institution through the non-recourse purchase of mortgages and contracts-to-sell (CTS).
[440] This assumes that the Secondary Mortgage Institution (SMI) is an entity separate from the originating institution (i.e. a private bank securitizing its own mortgage loans).

The assurance provided to the Mortgage-Backed Security (MBS) is crucial in increasing demand for the financial instrument. In the United States, the three Secondary Mortgage Institutions (SMIs)[441] all carry the implicit guarantees of the U.S. government (i.e. U.S. Treasury), thus rendering their Mortgage-Backed Securities extremely liquid.

Home Guaranty Corporation. In the Philippines, the guarantee is explicit, and comes in the form of the Home Guaranty Corporation (HGC, formerly the Home Insurance Guaranty Corporation). The HGC, a government owned and controlled corporation, is the 'de facto' guarantee for mortgage backed securities (MBS) issued in the Philippines. Theoretically, most mortgage-backed securities (MBS) are regarded as having the same risk profile as sovereign debt, and thus are exempt from Securities and Exchange Commission (SEC) registration[442]. The Republic of the Philippines guarantees the Home Guaranty Corporation's (HGC) borrowings and guaranty obligations both as to the principal and interest subject to certain limitation. However, unlike the U.S., the Home Guaranty Corporation doesn't necessarily guarantee the mortgage loans of the Secondary Mortgage Institution (SMI)[443].

For example, the mortgage loans lent out through the National Home Mortgage Finance Corporation (NHMFC) for the Unified Home Lending Program (UHLP) were not guaranteed by the Home Guaranty Corporation (HGC) [444]. Although the Home Guaranty Corporation (HGC) had actually approved a guarantee facility for the National Home Mortgage Finance Corporation (NHMFC), the "formula lending" guidelines of the Unified Home Lending Program (UHLP) were too lenient, that the NHMFC could not secure the guarantee.

For perspective, the Home Guaranty Corporation (HGC) guaranteed the first Home Development Mutual Fund (HDMF)/*Pag-Ibig* home lending program in 1981 (prior to the Unified Home Lending Program (UHLP) in 1986). The shortcoming of the program was that upon a mere 3 months worth of default by the homebuyer, the National Home Mortgage Finance Corporation (NHMFC) could draw - upon mere notification – the entire homebuyer's mortgage loan balance from the trust fund of the Home Guaranty Corporation (HGC)[445].

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[441] Federal National Mortgage Association ("Fannie Mae"), Government National Mortgage Association ("Ginnie Mae"), and the Federal Home Mortgage Corporation ("Freddie Mac")
[442] Reside, Renato S. *Mortgage-Backed Securities in Asia.* Asian Development Bank. 1999. Pasig City, Philippines.
[443] In the Philippines' case, this would have been the National Home Mortgage Finance Corporation (NHMFC).
[444] Tan, Arthur, Executive Vice-President and General Manager of the Home Guaranty Corporation. *Personal Interview.* June 2001. Makati City, Philippines.
[445] Tan, Arthur, Executive Vice-President and General Manager of the Home Guaranty Corporation. *Personal Interview.* June 2001. Makati City, Philippines.

The current Multi-Window Lending System (MWLS) carries a Home Guaranty Corporation (HGC) loan guaranty line approval of P14 Billion ($264 Million)[446], and the use of the Home Guaranty Corporation (HGC)'s appraisal services. But it is of concern to note that the Multi-Window Lending System (MWLS) continues to use a "uniform lending" guideline, which was rejected by the Home Guaranty Corporation under the Unified Home Lending Program (UHLP)[447]

The Home Guaranty Corporation (HGC) is the government agency mandated to operate a viable guaranty system to mobilize funds for housing. The Home Guaranty Corporation provides guaranty for a) development loans (guaranty facility covering loans extended for the development of subdivisions, townhouses, dormitories, apartments, and other residential dwellings) and; b) retail loans (i.e. guaranty coverage on loans/credit facility extended for the purchase/acquisition or lease of a single-family residence).

The Home Guaranty Corporation (HGC) guarantees are full faith and credit of the Philippine Government. Thus, one of the agency's programs is the guaranty facility covering asset-backed securities (ABS). Given this, the Home Guaranty Corporation (HGC) has been the primary provider of Mortgage-Backed Securities (MBS) insurance in the Philippines. HGC guarantees have been widely used. For example, in March 2000 it guaranteed the Home Development Mutual Fund (HDMF)/*Pag-Ibig* issue of P4 Billion (US$75 Million) in March 20000, and the Bank of the Philippine Islands Mortgage Backed Security (MBS) issue.

In the securitization process, the Home Guaranty Corporation (HGC) extends its guaranty on housing securities to enhances the creditworthiness of the instrument. Housing securities, real properties, housing mortgages, and contract receivables from the sale of units and housing projects are assets that may be securitized. In particular, banks and other financial institutions may avail of Home Guaranty Corporation's (HGC) guaranty for purposes of issuing Mortgage Backed Securities (MBSs) backed up their portfolio of housing mortgage loans or contract receivables[448].

The guaranteed entity may claim for the guaranty benefits upon default by the mortgagor or borrower. The events guaranteed for Mortgage Backed Securities (MBS) include: a) failure to redeem securities at

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446 Businessworld Publishing Corporation. *New HUDCC initiatives seen to perk up home access.* October 27, 2000. Makati City, Philippines.

447 Businessworld Publishing Corporation. *Property sector airs views on new scheme.* March 27, 2000. Makati City, Philippines.

maturity, b) failure to service guaranteed interest on the securities, and c) off-mark wind-up[449]. Since the Home Guaranty Corporation (HGC) bears the risk of guaranteeing the retail loans, they have the opportunity to help improve the origination standards for primary mortgage lending. The Home Guaranty Corporation (HGC) currently offers a new product line to evaluate a banking institution's lending guidelines before they extend a guarantee line. Although this product line was meant to be a "double check" of the banks for their underwriting guidelines, this product line has made the Home Guaranty Corporation (HGC) a "de facto" source of improving bank underwriting guidelines[450].

Previously, the Home Guaranty Corporation (HGC) guaranteed individual mortgage loans that are pooled and conveyed to the Special Purpose Vehicle (SPV) or Trust Fund. A 100% recovery of outstanding principal loan plus interest to the extent of 8.5% is guaranteed, and an exemption from withholding taxes of 20%. Thus, from an investor standpoint, the total cash flow of the Mortgage Backed Security (MBS) is not guaranteed. Also, the guaranteed interest portion is tax-free to the insured or beneficiary of the guaranty. However, the new law governing the Home Guaranty Corporation (HGC) was further 'skewed' to incent lending to the low-income sector. For example, the law extends 100% recovery only to the socialized and low cost housing, guarantees a larger portion of the interest and provides higher tax exemptions for socialized and low cost housing.

Guaranty Cover and Tax Exempt Features for Retail Dwelling Units

Housing type	Loan to Value ratio (% of appraised value)	Guaranty Cover		Tax Exemption
		Principal Obligation	Interest	Interest or Yields Earned
Socialized housing	100%	100%	11%	11%
Low cost housing	90%	100%	10%	10%
Medium cost housing	80%	90%	9.5%	9.5%
Open Housing	70%	85%	8.5%	8.5%

Source: Home Guaranty Corporation (HIGC)

Furthermore, the net worth of the Home Guaranty Corporation (HGC) has been skewed as well to guarantee low-income housing packages:

448 Reside, Renato S. *Mortgage-Backed Securities in Asia*. Asian Development Bank. 1999. Pasig City, Philippines.
449 An off-mark wind-up shall be deemed to have occurred in the following instances: a) if there is a 25% slippage on each of the following: construction timetable/cost/quality; marketing in terms of units sold; or cash inflows in terms of equity payments and/or buyers takeout or; b) if the slippage items above reaches 50%.
450 Tan, Arthur, Executive Vice-President and General Manager of the Home Guaranty Corporation. *Personal Interview*. June 2001. Makati City, Philippines.

Allocation of Guaranty Capacity

Type of Housing Package	% of Guaranty Capacity
Socialized housing (P180,000/US$3,400 and below)	40%
Low cost housing (P180,000/US$3,400 to P500,000/US$9,430)	30%
Medium cost housing (P500,000/US$9,430 to P2M/US$38T)	20%
Open housing (P2M/US$38T to P5M/US$94T)	10%

Source: Home Guaranty Corporation (HIGC)

The guaranteed entity for the retail/single-family dwelling unit has the option to choose the type of guaranty coverage as follows:

1. *Standard Coverage.* Home Guaranty Corporation (HGC) shall pay in the form of debenture bonds should default occur within the first five years of guaranteed obligation, and in the form of cash if the default occurs after the first five years of the guaranteed obligation.
2. *Pure Bond Coverage.* Home Guaranty Corporation (HGC) shall issue debenture bonds as payment for any retail guaranty claims regardless of when default occurs during the term of the guaranteed obligation.

The guaranty premium, as well, reflects the bias for low-income housing. The guaranteed entity is suppose to pay the annual premium upon enrollment or renewal of the guarantee coverage. The payment may either be in cash or in debentures issued by the Home Guaranty Corporation (HGC).

Guaranty Premium

Housing Type	Premium Payment (% of outstanding obligation)
Socialized housing	½ of 1%
Low cost housing	¾ of 1%
Medium cost housing	1%
Open housing	1.5%

Source: Home Guaranty Corporation (HIGC)

In March 2000, Republic Act 8763 of the Home Guaranty Corporation Act of 2000 was signed into law[451], which renewed the charter of the Home Insurance Guaranty Corporation[452]. Among the key highlights of the Law which were relevant to mortgage backed securitization (MBS) were the following:

SALIENT FEATURES OF REPUBLIC ACT 8763

1. *Extending Life Term.* The Home Guaranty Corporation (HGC) was given a 50-year mandate to operate a guaranty system for housing.
2. *Expanding Capital Base.* The Home Guaranty Corporation (HGC)'s authorized capital stock was increased from P2.5 Billion (US$47 Million) to P50 Billion (US$943 Million), with an initial equity infusion of the P7.5 Billion (US$142 Million) by the National Government.
3. *Amending Corporate Function.* The Home Guaranty Corporation (HGC) has been vested with a new mandate to pursue the development of secondary mortgage market for housing mortgages, bonds, debentures, notes, and securities[453].

[451] Among other things, the corporation was renamed Home Guaranty Corporation (HGC) from the Home Insurance and Guaranty Corporation (HIGC).
[452] Home Guaranty Corporation. The Implementing Rules and Regulations of the Home Guaranty Corporation Act of 2000 (with Republic Act 8763). March 2000. Makati City, Philippines.
[453] The new mandate of the Home Guaranty Corporation (HGC) was tasked to "pursue the development and sustainability of a secondary mortgage market as the *primary strategy* to encourage private sector participation in

4. *Instituting Safeguards.* The charter provides for mechanisms to ensure the Home Guaranty Corporation (HGC)'s mandate is carried out with prudence. These include:
   a. *National Government Guaranty.* The Republic of the Philippines will guarantee the Home Guaranty Corporation (HGC)'s borrowings and guaranty obligations both as to principal and interest subject to the following limitations:
      - Guaranty obligations, not to exceed twenty times (20X) the Home Guaranty Corporation (HGC)'s capital and surplus[454].
      - Corporate borrowings, not to exceed the aggregate amount of obligations of all accounts guaranteed.
   b. Sinking Fund. 5% of the annual net operating revenues would be set-aside as reserves for guaranty calls.
   c. Prioritizing lower-cost packages. The new law compels the Corporation to give preferential attention and incentives to socialized and low-cost housing. The law provides that 70% of its guaranty portfolio are given to funders of socialized housing – the premium fees are lower, the tax shield and risk cover on the interest earnings are higher.

Issues with the Home Guaranty Corporation.

The Home Guaranty Corporation (HGC) served to increase, not reduce risk, in the primary mortgage market. According to Toby Monsod, former Secretary General of the Housing and Urban Development Coordinating Council (HUDCC) under former HUDDC Chairperson Karina Constantino-David noted in a paper that instead of 'catalyzing' the private mortgage market, the Home Guaranty Corporation (HGC) crowded out, rather than, crowded in, the private sector[455]. "Perversely, it may have increased, rather than reduced risk." Monsod's paper stated.

Prior to the new Home Guaranty Corporation (HGC) charter, the basic guarantee was 100% of the outstanding principal of the loan plus 8.5% of the interest cost and a tax shield of 10% of interest income. This rendered the mortgage loans a risk-less asset, which was not subject to the single borrower's limit, to the 20% ceiling on real estate exposure (for banks) and to capital asset requirements, giving it a virtual 'no capital, no taxes'.

However, Monsod claims that the same guarantee inhibited the development of the primary mortgage market. The Home Guaranty Corporation (HGC) guarantees discouraged financial institutions from undertaking proper credit checks or acquire information essential for underwriting primary mortgages. As a consequence, the ancillary services such as credit reporting bureaus and insurance failed to evolve

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housing finance. The Corporation shall undertake such measures using the guaranty cover as *enhancement* trading by the public in a secondary market for housing mortgages, bonds, debentures, notes and securities".

[454] This means that capital of the Home Guaranty Corporation (HGC) P50B can be leveraged 20 times

[455] Tenorio, Arnold S. *FOCUS: Secondary mortgage market expected to boost housing.* Businessworld Publishing Corporation. December 3, 1999. Makati City, Philippines.

because private banks did not need them given the 'sovereign guarantee' of the Home Guaranty Corporation (HGC).

In fact, Monsod argues that the Home Guaranty Corporation (HGC) should be downgraded from a sovereign guarantee into a mere corporate guarantee to instill market discipline. In a corporate guarantee, the Home Guaranty Corporation would be forced to "to properly price its services, streamline its activities, maintain adequate reserves and observe proper disclosure."

The recommendation to downgrade to a corporate guarantee appeared to be coming from the perspective that a private led secondary mortgage institution (SMI) could not provide comparable credit enhancements for its mortgage backed securities (versus presumably a public led secondary mortgage institution (SMI) which had a 'no capital, no taxes' offer from the Home Guaranty Corporation (HGC)). However, Monsod's argument doesn't appear to take into consideration that a) the private led secondary mortgage institution (SMI) purchasing the Home Guaranty Corporation (HGC) guarantee to enhance the demand for their Mortgage Backed Securities (MBS) and, b) the U.S. Mortgage Backed Securities (MBS) from the Secondary Mortgage Institutions (SMIs) have both an implicit guarantee from the U.S. government (although these SMIs are already privately owned) coupled with credit enhancements.

Nonetheless, the argument that the Home Guaranty Corporation (HGC) guarantee has prevented the development of credit discipline is supported by Alcid[456]. Alcid asserts that banks have become reliant on the guaranty rather than relying on the quality of the cash flow of the underlying mortgages. In fact, in some unscrupulous deals, the "first way out" is through the Home Guaranty Corporation (HGC) guaranty because those who initiate the deal are aware that the cash flows are not enough to cover the principal and interest.

The Home Guaranty Corporation (HGC) doesn't totally insulate the Mortgage Backed Securities (MBS) investor from default risks in the primary mortgage market. Firstly, the current Home Guaranty Corporation (HGC) guaranty for retail/single family home loans is not a full guarantee of market rates, but have corresponding interest rate caps, which decrease as the housing package increase. Thus, the Mortgage Backed Securities (MBS) investor is subject to the risk between the gap of the Home Guaranty

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[456] Alcid, Andrew D. Executive Vice President, Investment Banking Division of United Coconut Planters Bank. *Personal Interview.* June 2001. Makati City, Philippines.

Corporation (HGC) guaranty on interest rates and market rates, especially if the securitized pool of mortgages consists of medium cost and open housing.

Second, the current structure of the guaranty cover attempts to incent private banks to lend to the low-cost housing sector through a higher guaranty cover for both principal obligation and interest, higher tax exemptions, and a lower guarantee premium. Moreover, the allocation of the guaranty capacity has been skewed as well towards the socialized and low-income housing sector. This has two implications:

The Home Guaranty Corporation (HGC) encourages private banks to lend to homebuyers at an 11% mortgage interest rate[457]. As per Coronel's sample computation of mortgage interest rates in Chapter 5, the banks will be hesitant to lend at this rate as it fails to cover the bank's administration costs. The interest rate of 11% 400 basis points lower versus the Bank of the Philippine Islands (BPI) 1 year fixed interest rate for 5 year loans below P1 Million (US$19,000). The low interest rate coupled with private banks' hesitance to lend to the low income housing sector (and being the housing sector least likely to be securitized) will presumably lead to the failure to use up the guaranty allocation for the socialized and low income sector.

The mid-income sector, which is the most likely candidate for securitization, will conceivably avail of the Home Guaranty Corporation (HGC). Given this, there is the distinct possibility that the guaranty allocation for this sector will be quickly used up. Consequently, the lack of guaranty allocation for the mid income may stifle securitization of the mid income-housing sector.

The Home Guaranty Corporation (HGC) guaranty is not necessarily a liquid guarantee. Recall that for a retail/single-family mortgage loan, the Home Guaranty Corporation (HGC) will a) for standard coverage, pay in the form of a debenture bond if the default occurs within 5 years of the guaranteed obligation and, b) for pure bond coverage, and pay in the form of debenture bonds regardless when the default occurs. According to Tan, prior to the re-capitalization of the Home Guaranty Corporation (HGC) in March 2000, the cash coverage has posed a liquidity problem for the company as it covers both retail and development loans. The Home Guaranty Corporation (HGC) had come to a point where they did not have liquidity to service calls, thus they issued bond guarantees, subject to the authorized bond ceilings[458]. However, according to Kotecha, the bond guarantees of Home Guaranty Corporation (HGC) are illiquid, trade

[457] Businessworld Publishing Corporation. *Property sector airs views on new scheme.* March 27, 2000. Makati City, Philippines.
[458] Tan, Arthur, Executive Vice-President and General Manager of the Home Guaranty Corporation. *Personal Interview.* June 2001. Makati City, Philippines.

poorly and at significant discounts[459]. In fact, there have been instances that when the Home Guaranty Corporation (HGC) bond guarantee matured, it was replaced with another bond guarantee[460]. Thus, the Mortgage Backed Security (MBS) investor is faced with the prospect of receiving an illiquid bond versus cash.

The Home Guaranty Corporation (HGC) is subject to political pressure. As a government owned and controlled corporation (GOCC), the Home Guaranty Corporation (HGC) has been 'coerced' to guaranty financially unsound projects. Thus, the guarantees have been subject to much abuse, particularly by unscrupulous developers who use "government connections" to secure a cash guarantee[461]. For example, under the Ramos administration, the Home Guaranty Corporation (HGC) had extended a controversial P500 Million (US$ 9.4 Million) guaranty for the construction of the APEC (Asia Pacific Economic Cooperation) Villas for the heads of state during the APEC Summit in November 1996[462]. The government ended up shouldering P488.3 Million (US$ 9.2 Million) of the APEC Villas when the private corporation that constructed the villas defaulted on its loan to the Development Bank of the Philippines and the ING Bank[463].

The Home Guaranty Corporation (HGC) has been 'persuaded' to support the government's primary mortgage programs despite their structural deficiencies. Under the Unified Home Lending Program (UHLP), the Social Security System (SSS) required that the Home Development Mutual Fund (HDMF) secure a Home Guaranty Corporation (HGC) guaranty each time the Social Security System (SSS) released funds to the Home Development Mutual Fund (HDMF) to fulfill its annual funding commitment[464]. However, the Home Guaranty Corporation only covered 22% of the loans that the Social Security System (SSS) extended as a funder.

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[459] Kotecha, Mahesh K. *Secondary Mortgage Institution (SMI) Philippines – Draft Business Plan.* Structured Credit International Corporation. 2000. New York, New York.
[460] Jacob, Monico. Former Home Development Mutual Fund (HDMF)/Pag-Ibig Chairman and Conference Chairman of the Philippine Conference on Securitization. *Personal Interview.* June 2001. Makati City, Philippines.
[461] Alcid, Andrew D. Executive Vice President, Investment Banking Division of United Coconut Planters Bank. *Personal Interview.* June 2001. Makati City, Philippines.
[462] Garcia, Cathy Rose A. and Yasmin Lee G. Arpon. *Palace belittles possible delay in WB loan for housing study.* Businessworld Publishing Corporation. November 12, 1999. Makati City, Philippines.
[463] The loan guarantee supposedly ignored Presidential Decree 385, which mandated government financial institutions to foreclose all loans with arrears amounting to at least 20% of the total outstanding loan obligation.
[464] This occurred after the Home Development Mutual Fund (HDMF) took over the role of sole take out window from the National Home Mortgage Finance Corporation (NHMFC) under the Unified Home Lending Program. (Source: Reside, Renato S. *Mortgage-Backed Securities in Asia.* Asian Development Bank. 1999. Pasig City, Philippines.)

Similarly, the Home Guaranty Corporation has extended a P14 Billion ($264 Million) guaranty line for the Multi-Window Lending Scheme (MWLS), which uses a "formula lending" scheme which did not originally pass the Home Guaranty Corporation's (HGC) guidelines under the Unified Home Lending Program (UHLP).

Subdivision and Housing Developers Association (SHDA) Guaranty Fund. The Subdivision and Housing Developers Association (SHDA) Guaranty Fund complements an arrangement that the Subdivision and Housing Developers Association (SHDA) forged with the Home Development Mutual Fund (HDMF)/*Pag-Ibig* called the Developer Contract-to-Sell (CTS) scheme[465]. The scheme is a risk-sharing arrangement between the funder and the developer, where the developer guarantees a 100% collection efficiency of the homebuyer for the first 2 years of the loan repayment period. However, given that the Home Development Mutual Fund (HDMF)/*Pag-Ibig* is still exposed to the risk of the developer failing to comply with the buy back guaranty within the 2 year credit seasoning period[466].

The Subdivision and Housing Developers Association (SHDA) Guaranty Fund will provide a stand-by backup guaranty protection to the Home Development Mutual Fund (HDMF)/*Pag-Ibig* and other funders in the event of the failure on the part of any guaranteed developer to comply with its buy back of defaulting buyers within the first 2 years of the scheme of the housing loan repayment period under the Developer Contract-to-Sell (CTS) scheme.

The guaranty fund is composed of a) the cash bond posted by developers to cover 5% of the value of the housing loan takeout and b) a one-time non-refundable guaranty fee equivalent to 2.5% of the loan value to be charged from the developer to cover the two-year seasoning period[467].

According to Tan, the Subdivision and Housing Developers Association (SHDA) Guaranty Fund complements the Home Guaranty Corporation (HGC) guaranty efforts (in the event that a Home Guaranty Corporation (HGC) guaranty is purchased on top of the Subdivision and Housing Developers Association

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[465] On the part of the Home Development Mutual Fund (HDMF)/*Pag-Ibig,* the funder commits to fast-track the loan take out and put in place a funding commitment line system to facilitate the matching of housing production with that of funds available and to adopt a set of lending rules that will be relevant to the needs and capacity of the intended mass housing beneficiaries. The arrangement is expected to improve both the collection efficiency of the funder and the cash flow and profit generation capability of the developer.

[466] Subdivision and Housing Developers Association. *Concept Paper SHDA Guaranty Fund, Inc.* December 1, 2000. Makati City, Philippines.

[467] Businessworld Publishing Corporation. Pag-IBIG and housing developers sign guaranty deal. December 22, 2000. Makati City, Philippines.

(SHDA) Guaranty Fund) [468]. In a Contract-to-Sell (CTS), the Home Guaranty Corporation (HGC) does not guarantee the first 2 years of the loan, as this risk is borne by developers[469]. Within the first 2 years of the guaranty, a defaulting account will be substituted with 'an account of current status' by the Home Guaranty Corporation (HGC)[470].

Issues with the Subdivision and Housing Developers Association (SHDA) Guaranty Fund. The Subdivision and Housing Developers Association (SHDA) Guaranty Fund is a guaranty fund for loans with fixed interest rates. Although the Home Development Mutual Fund (HDMF)/Pag-Ibig default rate may significantly decrease due to both the Developer Contract-to-Sell (CTS) scheme and the Subdivision and Housing Developers Association (SHDA) Guaranty Fund, these mortgage loans are presumably not eligible for securitization due to their fixed interest rates. Thus, it will have no impact on the development of Mortgage-Backed Securities (MBS) in the Philippines.

In the event that the 16% fixed interest rates mortgage loans of the Home Development Mutual Fund (HDMF)/*Pag-Ibig* are securitized, then the investor of the Mortgage-Backed Security (MBS) is still not insulated from default risks in the primary mortgage market. This is because the capacity of the Subdivision and Housing Developers Association (SHDA) Guaranty Fund is limited by the number of developers who sign up with the fund. The Fund currently has an initial authorized capitalization of P20 Million (US$377,000) and a paid-up capitalization of P1.25 Million (US$24,000)[471]. However, Mariano Martinez, president of the Subdivision and Housing Developers Association (SHDA) believes that the fund will reach P5 Billion (US$94 Million) after roughly a year in operation[472].

Provided that developers sell their contracts to sell (CTS), which have secured guarantees from both the Subdivision and Housing Developers Association (SHDA) Guaranty Fund and the Home Guaranty Corporation (HGC), to a private secondary mortgage institution (SMI), the guarantee to the investor is still limited by the guaranty capacity of the Subdivision and Housing Developers Association (SHDA) Guaranty Fund during the first two years of the payment by the homebuyer.

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[468] Tan, Arthur, Executive Vice-President and General Manager of the Home Guaranty Corporation. *Personal Interview*. June 2001. Makati City, Philippines.
[469] The first 2 years are considered to be the most 'critical' period as seasoning established the whether or not the loan is good.
[470] An account of current status will signify that the title of the property was not transferred to the buyer.
[471] Subdivision and Housing Developers Association. *Concept Paper SHDA Guaranty Fund, Inc*. December 1, 2000. Makati City, Philippines.
[472] Businessworld Publishing Corporation. Property developers put up guaranty fund for industry. June 16, 2000. Makati City, Philippines.

Potential to use Subdivision and Housing Developers Association (SHDA) guaranty fund to sell contracts-to-sell (CTS) to private banks. Limlingan says that if and when the Subdivision and Housing Developers (SHDA) Guaranty Fund expands its scope to include private commercial banks, banks would be willing to purchase their receivables as long as there is a guarantee[473]. Moreover, these market rate loans would be eligible for securitization. However, the guarantee to the investor continues to be limited by the capacity of the Subdivision and Housing Developers Association (SHDA) Guaranty Fund during the first two years of the payment by the homebuyer

Credit Enhancements

Overview. Credit enhancements are used to protect Mortgage Backed Securities (MBS) investors from the losses that may arise from the deterioration of the mortgage pool. Given the dearth of long-term public and private long-term financial instruments in the Philippines, Kotecha believe that credit enhancements, such as multilateral guarantees and Home Guaranty Corporation (HGC) guarantees will enhance the viability of mortgage backed securities with terms longer than 5 years[474].

There are basically two types of credit enhancements: external (i.e. letter of credit from a bank or a guarantee from a financial insurance company) or; internal (i.e. structural enhancements like tranches or over collateralization)[475].

To clarify, the Philippines has no equivalent implicit "sovereign guarantee" attached to its Mortgage Backed Securities (MBS), whether they are publicly- or privately-originated mortgages[476]. Thus, any sort of guarantee attached to a Mortgage Backed Security (MBS) will be lumped together with "credit enhancements". The closest equivalent that the Philippines have to a pseudo-"sovereign guarantee" is the Home Guaranty Corporation (HGC). However, the Home Guaranty Corporation (HGC) guarantee is not instantly "attached" to a public or private mortgage backed security (MBS), but rather the mortgage loans should qualify under Home Guaranty Corporation (HGC) and the guaranty must be purchased. Thus, in reference to the previous section, former Secretary General Monsod of the Housing and Urban

[473] Limlingan, Victor S. Professor at the Asian Institute of Management. *Personal Interview.* June 2001. Makati City, Philippines.
[474] Kotecha, Mahesh K. *Secondary Mortgage Institution (SMI) Philippines – Draft Business Plan.* Structured Credit International Corporation. 2000. New York, New York.

[475] Reside, Renato S. *Mortgage-Backed Securities in Asia.* Asian Development Bank. 1999. Pasig City, Philippines.
[476] Recall that Home Guaranty Corporation (HGC) did not guarantee the mortgage loans under the Unified Home Lending Program (UHLP).

Development Coordinating Council (HUDCC), the Home Guaranty Corporation (HGC) could be lumped together with the other "credit enhancements".

As per the *Bankgo Sentral ng Pilipinas* (Central Bank of the Philippines) circular on Asset Backed Securities (ABS), these are the following enhancements that can be used[477]:

1. Standby letter of credit issued by a commercial bank other than the originator/seller or its subsidiary/affiliate, its parent bank or the parent bank's subsidiary/affiliate, and Trustee or its subsidiary/affiliate.
2. Surety bond issued by any insurance company other than the originator/seller's subsidiary or affiliate, the subsidiary or affiliate of the originator/seller's parent bank and the trustee's subsidiary or affiliate.
3. Guarantee issued by any entity other than the originator/seller or its subsidiary/affiliate, its parent bank or the parent bank's subsidiary/affiliate, and Trustee or its subsidiary/affiliate.
4. Over collateralization provided by the originator/seller wherein the assets conveyed to the Special Purpose Trust (SPT) exceed the amount of securities issued. Losses arising from overcollaterization shall be recognized by the Originator/seller upfront. Such losses shall be treated as capital charges.
5. Spread account wherein the income from the underlying pool of receivables is made available to cover any shortfall in the repayment of Asset Backed Securities (ABS). The spread account shall be handled by the Trustee, which shall account for it separately. If not needed, the "spread" generally reverts to the holder of the residual certificate.
6. Subordinated securities that are lower ranking, or junior to other obligations and are paid after claims to holders of senior securities are satisfied.
7. Other credit enhancements as may be approved by the Monetary Board.

Current State. Previous securitization efforts in the Philippines have relied heavily on structural enhancements such as over collateralization and subordination.

Over collateralization. Over collateralization occurs when the mortgage pool has a peso value in excess of the value of the securities being used against the pool[478]. By doing this, more income flows into the pool from the larger amount of mortgages relative to the required coupon payments to investors. Defaults would have to be approximately equal to the amount of over collateralization before investors would suffer losses. The extent of the over collateralization in a mortgage backed security (MBS) is usually based on the desired debt coverage ratio (i.e. the number of mortgages needed to provide a sufficient amount of income relative to the interest payment) to investors in the pool.

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[477] *Bangko Sentral ng Pilipinas* (Central Bank of the Philippines). Circular No. 185 (Series of 1998). December 4, 1998. Manila, Philippines.

[478] Brueggeman, William B., Ph.D. and Jeffrey D. Fisher, Ph.D. Real Estate Finance and Investments. Irwin McGraw-Hill Tenth Edition. 1997. United States of America.

Issue with over collateralization. Matoto says that the *Bangko Sentral* (Central Bank of the Philippines) circular on asset backed securities (ABS) discourages underwriters to put a deal together because over collateralization requires the seller of the mortgages to take a capital charge[479]. This occurs when the assets conveyed to the Special Purpose Trust (SPT) exceed the amount of securities to be issued. The *Bangko Sentral* (Central Bank of the Philippines) rules of the conveyance state that[480],

The seller shall be under no obligation to provide additional assets to the Special Purpose Trust (SPT) to maintain a "coverage ratio" of collateral to the outstanding Asset Backed Securities (ABS). A breach of this requirement will be considered a credit enhancement and shall be charged against capital.

Subordination. Essentially, a mortgage-backed security (MBS) is a claim on the cash flows of a collection of individual mortgage loans that are pooled together. These cash flows are subsequently re-allocated to investors based on the rules governing the priority of principal and interest payments.

There are several investment classes within a subordinated mortgage backed security structure[481]. The allocation of the pooled cash flows can vary substantially among the alternative investment classes. These allocations follow a set of pre-specified rules that are set out in the investment prospectus. The rationale behind securitization is that the *value of the sum of the parts exceeds the value of the whole.* This occurs when partitioned cash flows from particular investment classes offer certain benefits that, when considered as a whole, exceed the value of the non-partitioned (non-pooled) cash flows.

The general approach of subordination is to create mortgage-backed securities (MBS) where investment risk is shifted down the structure. This is commonly referred to as a "waterfall" structure. The higher quality investment classes represent "high quality" bonds in terms of (virtually nil) default risks and the expected receipt pattern of cash flows. However, as one moves downward through the security structure, investment class risk characteristics represent the risks of the mortgage loans that are used to collateralize the mortgage-backed security (MBS).

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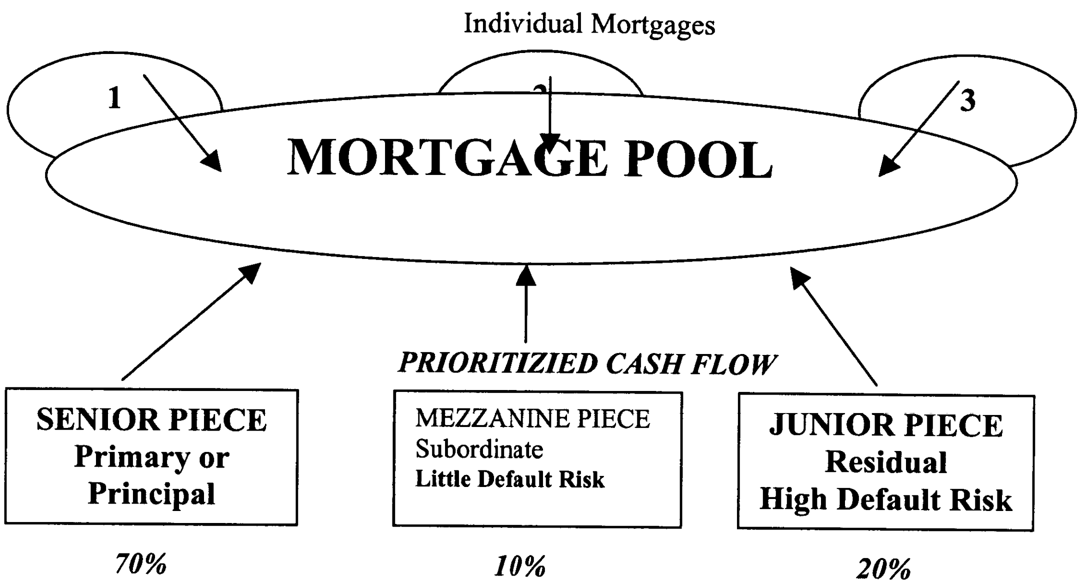
479 Matoto, Senen L. President of the Investment Houses of the Philippines. *Personal Interview.* June 2001. Makati City, Philippines.
480 *Bangko Sentral ng Pilipinas* (Central Bank of the Philippines). Circular No. 185 (Series of 1998). December 4, 1998. Manila, Philippines.
481 Riddiough, Timothy. Real Estate Capital Markets Course Reader. Massachusetts Institute of Technology. Spring 2001. Cambridge, Massachusetts.

Representation of Mortgage Pooling and Cash Flows



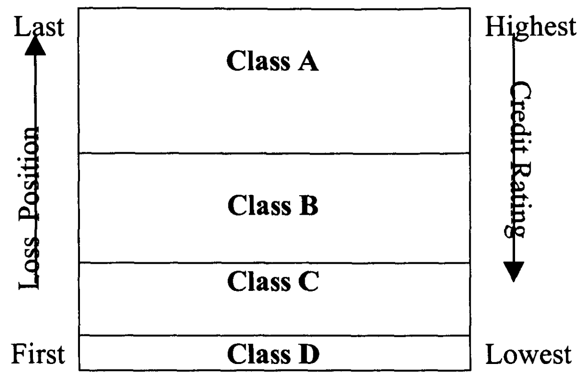
Source: Timothy Riddiough, Massachusetts Institute of Technology

Because of the default risk, the Mortgage Backed Security (MBS) is designed to shift default risk down through the various security classes. This is typically done through prioritizing the return of the total pool principal payments wherein the "senior" tranches have priority on the principal that is returned through either loan amortization or through default/foreclosure recoveries. Meanwhile, the lower priority tranches have to wait until the senior classes are fully repaid before they can receive a return on principal. Thus, the principal is allocated "top down".

Losses from defaults/foreclosure, on the other hand, are allocated in a "bottom up" fashion. This means that the face value of the lowest-rated tranches decline by the realized default loss[482].

[482] For example, net recovery of P80 on a face value loan amount of P100 results in a P20 loss that is subtracted from the face value of the lowest Mortgage Backed Security (MBS) tranche.

Principal and Default loss allocation structure



Source: Timothy Riddiough, Massachusetts Institute of Technology

Thus, the subordinated structure ensures that investment risk increases as tranches become less and less protected from the loss of principal due the default risk.

Credit Enhancements: U.S. System

Securitization is the method by which loans or mortgages are pooled and enhanced in order to be converted into investment grade securities. The process makes it possible for firms to separate otherwise non-marketable assets from their balance sheet and, often with the help of credit enhancement, turn them into negotiable instruments.

Financial Guarantees. The "originator" of the assets, such as the mortgage lender with a pool of mortgage loans) sells these assets to a Special purpose Vehicle (SPV). The SPV is a legal entity that is designed to segregate the ownership of the asset pool and associated cash flow in case of the originator's bankruptcy. Working with a financial guarantee company, the SPV purchases the assets from the originator and structures the pool to a level acceptable to the international rating agencies, investors and the financial guarantor. The SPV then issues securities that are bought by investors with the pool of assets becoming the collateral that supports principal and interest payments on the securities. These payments of principal and interest to investors are guaranteed by the financial guarantor, and carry its high investment grade rating.

The use of financial guarantees, a form of third party credit enhancement, has proven a cost-effective way for borrowers to tap domestic and international debt capital markets to satisfy their funding needs. The use of a financial guarantee to enhance the rating of a securitized transaction can lower the cost of funding for the issuer and provide other advantages, including diversification, off-balance sheet treatment, effective asset utilization, ease of documentation and stable funding, all while limiting risks and offering an attractive yield for the investor.

Mortgage Insurance. The secondary market GSEs require credit enhancement, which is usually in the form of private mortgage insurance for all loans purchased over 80% LTV. For securities backed by loans not purchased by the GSEs, additional credit enhancement comes in the form of pool insurance or senior subordination. The costs of credit enhancement will be a function of the characteristics of the mortgage loan collateral as well as the past performance of the servicer. For loans sold to the GSEs, the guarantee fee they charge will also be a function of the loan characteristics and servicer performance.

Lenders (investors) can protect themselves from some losses in the lending process by requiring insurance. Mortgage insurance at least partially protects the investor against loss from a subsequent foreclosure that results in sale proceeds that are insufficient to cover the unpaid principal, interest and foreclosure costs. In the United States, there are three primary sources of default insurance:

1. Federal Housing Administration (FHA): provides 100% coverage of principal loss and foreclosure processing costs.
2. Veterans Administration (VA): provides partial insurance for a specified percentage of the loss.
3. Private Mortgage Insurance (PMI): provides top loss insurance (e.g., 20% coverage of the outstanding balance greater than 70% LTV.

Credit Ratings Agencies

Overview. On top of credit enhancements, Mortgage Backed Securities (MBS) in developed financial markets rely on the use of credit ratings agencies (i.e. Standard & Poors, Moody's) to assess the quality of a Mortgage Backed Security (MBS)[483]. The credit rating serves as a benchmark that allows the Secondary Mortgage Institution (SMI) to determine how much credit enhancement is needed to achieve a particular rating for the issuer.

In a developed financial market, the rating obtained by a fixed income security is crucial because of its effect on the price. The assignment of a high rating to the issue means that the debt costs are lower (and issuance proceeds are higher) versus when a low rating is assigned. As a result, the ratings agencies have

[483] Reside, Renato S. *Mortgage-Backed Securities in Asia.* Asian Development Bank. 1999. Pasig City, Philippines.

gained enormous power and serve as de facto regulators of entities who want to secure debt capital through the public markets[484].

The rating assigned by a rating agency to a particular investment class is an assessment of the default or credit risk. The commonly used ratings categories are AAA, AA, A, BBB, BB, etc. The ratings that fall below BBB are referred to as "non-investment grade", which implies that there is a significant default risk that comes with the ownership of these securities. In a subordinated debt structure, each particular tranche that is carved out of the mortgage pool and sold is assigned a rating based on that tranche's perceived riskiness. For some tranches within a single issuance, it is possible to have all the ratings assigned to the various tranches. However, the credit rating can also be used to assess the creditworthiness of an institution issuing a specific financial obligation[485] or a specific class of obligations[486].

The ratings take into consideration measures such as the properties in the pool, the loan to value ratios, the debt service coverage ratio, mortgage pool size and mortgage pool diversification, and the creditworthiness of guarantors, insurers, or other forms of credit enhancements on the obligation (and in the event that it is an international issuance, takes into account the currency in which the obligation is denominated).

[484] Riddiough, Timothy. Real Estate Capital Markets Course Reader. Massachusetts Institute of Technology. Spring 2001. Cambridge, Massachusetts.
[485] For example, a private bank might issue its own mortgage-backed securities (MBS), and the credit ratings the issuance receives is the rating of the creditworthiness of the bank.
[486] www.bondtalk.com. *Standard & Poor's Ratings Definitions*. 2000. United States of America.

Standard & Poors Long-term Issue Credit Rating

Ratings	Definition
AAA	An obligation rated AAA has the highest rating assigned by Standard & Poor's. The obligor's capacity to meet its financial commitment on the obligation is extremely strong.
AA	An obligation rated AA differs from the highest-rated obligations only in small degree. The obligor's capacity to meet its financial commitment on the obligation is very strong.
A	An obligation rated A is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than obligations in higher-rated categories. However, the obligor's capacity to meet its financial commitment on the obligation is still strong.
BBB	An obligation rated BBB exhibits adequate protection parameters. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the obligor to meet its financial commitment on the obligation.
Obligations rated BB, B, CC, CC, and C are regarded as having significant speculative characteristics. BB indicates the least degree of speculation and C the highest. While such obligations will likely have some quality and protective characteristics, these may be outweighed by large uncertainties or major exposures to adverse conditions.	
BB	An obligation rated BB is less vulnerable to nonpayment than other speculative issues. However, it faces major ongoing uncertainties or exposure to adverse business, financial, or economic conditions which could lead to the obligor's inadequate capacity to meet its financial commitment on the obligation.
B	An obligation rated B is more vulnerable to nonpayment than obligations rated BB, but the obligor currently has the capacity to meet its financial commitment on the obligation. Adverse business, financial, or economic conditions will likely impair the obligor's capacity or willingness to meet its financial commitment on the obligation.
CCC	An obligation rated CCC is currently vulnerable to nonpayment, and is dependent upon favorable business, financial, and economic conditions for the obligor to meet its financial commitment on the obligation. In the event of adverse business, financial, or economic conditions, the obligor is not likely to have the capacity to meet its financial commitment on the obligation.
CC	An obligation rated CC is currently highly vulnerable to nonpayment.
C	The C rating may be used to cover a situation where a bankruptcy petition has been filed or similar action has been taken, but payments on this obligation are being continued.
D	An obligation rated D is in payment default. The D rating category is used when payments on an obligation are not made on the date due even if the applicable grace period has not expired, unless Standard & Poor's believes that such payments will be made during such grace period. The 'D' rating also will be used upon the filing of a bankruptcy petition or the taking of a similar action if payments on an obligation are jeopardized.
Plus or Minus	The ratings from AA to CCC may be modified by the addition of a plus or minus sign to show relative standing within the major rating categories.
P	The letter p indicates that the rating is provisional. A provisional rating assumes the successful completion of the project financed by the debt being rated and indicates that payment of debt service requirements is largely or entirely dependent upon the successful timely completion of the project.
L	The letter L indicates that the rating pertains to the principal amount of those bonds to the extent that the underlying deposit collateral is federally insured, and interest is adequately collateralized. In the case of certificates of deposit, the letter L indicates that the deposit, combined with other deposits being held in the same right and capacity, will be honored for principal and pre-default interest up to federal insurance limits within 30 days after closing of the insured institution or, in the event that the deposit is assumed by a successor insured institution, upon maturity.
*	Continuance of the ratings is contingent upon Standard & Poor's receipt of an executed copy of the escrow agreement or closing documentation confirming investments and cash flows.
R	The r is attached to highlight derivatives, hybrids and certain other obligations that Standard & Poor's believes may experience high volatility or high variability is expected returns as a result of noncredit risks. Examples of such obligations are securities whose principal or interest return is indexed to equities, commodities or other instruments. The absence of an 'r' symbol should not be taken as an indication that an obligation will exhibit no volatility or variability in total return.
NR	Not rated.

Source: www.bondtalk.com

Implications of Ratings to Key Players. A credible and independent rating agency plays a critical role in the sound functioning of capital markets as it:

- Provides investors with objective and unbiased opinions of relative credit risk (conveyed through simple rating symbols), which are essential tools for making sound investment and financing decisions;

- Performs the functions of information searching and monitoring, analysis and dissemination, and helps to level the playing field by providing transparency and disclosure to all investors (small private individuals as well as large institutional investors) of credit rated securities;

- Maintains a continuously updated body of opinion (databank) on the credit quality of debt issuances and issuers; and,

- Does market development and promotion work to popularize public debt securities. (A rating agency disseminates rating information through press releases and rating publications, enhancing market awareness on a rated institution's profile and financial capability, while helping to promote its debt issuance to a wider pool of investors.)

Issuers. Ratings benefit the issuers in the following ways:

- **Wider access to capital** – Ratings are now widely used and clearly understood by institutional investors. Also, rating information is disseminated to capital markets in areas where the rate may not be well known, thus exposing the rate and its rated debt issues to a larger number of potential investors.
- **Financing flexibility** – A wider market access often translates into reduced funding costs.

- **Efficient new issuance** – Pricing structures linked to ratings can facilitate planning of new debt issues by providing ratees, dealers and investors with acceptable benchmarks.

- **Improved counter-party relationships** – Prospective business partners or clients are provided with a certain degree of confidence as indicated in the ratings. Banks and corporations use ratings to guide their decisions on trade finance, swap agreements, money market transactions, and other counter-party risk situations.

Investor. Ratings benefit the investor in the following ways:

- **Reduced uncertainty** – Ratings reduce investment uncertainty as they enhance transparency and disclosure. Less uncertainty means greater confidence, which encourages capital market growth and greater market efficiency and liquidity.
- **Portfolio diversification** – Through ratings, investors get to know the various potential debt investments available to them across industries and securities types.
- **Risk premium assessment** – Rated instruments in the market can be compared based on their level of riskiness as implied in the ratings.

- **Portfolio monitoring** – Surveillance or monitoring of ratings is part of a rating agency's credit rating process. Movements in ratings (upgrades or downgrades) could indicate that an investor's portfolio may require adjustment.

Intermediary. Ratings benefit the intermediary in the following ways:

- **Facilitate pricing and underwriting** – Investment bankers and other intermediaries active in the fixed income markets also find ratings useful in the planning, pricing, and placement of securities. Ratings can help place new issues with a broader investor base and also mitigate uncertainties about the credit quality of the issue and the issuer.

- **Monitor counterparty risk** – Ratings also help intermediaries monitor their risk exposures, either on behalf of clients or for their own accounts.

- **Assist in capital allocation** – Ratings are often used in capital models and so-called "haircut" rules that require securities brokers and dealers to maintain capital against securities in a portfolio.
- **Marketing** – Often ratings have proven useful in marketing various forms of pre-packaged bond or short-term funds to both institutional and retail investors.

Current State. Previously issued Mortgage Backed Securities (MBS) were not rated by the former Credit Information Bureau, Inc. (CIBI) (now Philratings), which at the time was the only domestic credit-ratings agency. Presumably, these were stand along Mortgage Backed Securities (MBS) were issued by private banks or government financial institutions and sold to private or public institutional investors, who had to rely solely on the reputation and trustworthiness of the institution making the issue.

Philippine regulatory authorities do not require credit ratings for commercial paper issues. However, since the Securities and Exchange Commission (SEC) has moved towards more disclosure-based regulation, this has encouraged more prime corporations to rely on credit ratings and market-driven demand for such ratings. The passage of the Financing Company Act (Republic Act 5980) has liberalized the sources of debt financing for finance firms, who are the primary issuers of the commercial paper (CPs)[487].

The Securities and Exchange Commission (SEC) currently requires only the privately originated mortgage backed securities (MBS) to undergo credit ratings as publicly originated mortgage backed securities are exempted from Securities and Exchange Commission (SEC). However, Matoto believes that even the publicly originated mortgages should undergo credit rating as well since the ratings affect

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[487] Reside, Renato S. *Mortgage-Backed Securities in Asia.* Asian Development Bank. 1999. Pasig City, Philippines.

the credibility of an issue[488]. Moreover, ratings for both the public and private mortgage backed securities (MBS) provide the potential investor an opportunity to make an "apples-to-apples" comparison and reduce investment uncertainty between the investment alternatives.

Previously, the sole local credit ratings agency in the Philippines was the Credit Information Bureau, Inc. (CIBI). Prior to the equity investment of Standard & Poor's (S&P) into the bureau, the Credit Information Bureau, Inc. (CIBI) was hindered by the lack of skilled technical staff to perform the ratings, as well as the poor availability, accuracy, timeliness, and regularity of corporate and government data.

The low capacity for ratings reduced both primary and secondary market liquidity by preventing second-tier firms with below-prime ratings to issue long-term debt to tap capital markets. Consequently, these second-tier firms become credit-constrained during periods of economic uncertainty, such as the 1997 regional currency crisis. Thus, the money and capital markets reduce the capacity to transfer risks efficiently.

In the Philippines, there are currently two local credit ratings agencies that are affiliates of international ratings agencies: Philratings, an affiliate of Standard & Poor's (S&P), Thomson Financial Philippines. These agencies have mostly focused on rating commercial paper given the dearth of mortgage-backed securities (MBS) in the country[489]. According to Coronel, credit ratings agencies are merely "waiting in the wings" to start rating mortgage backed securities (MBS)[490].

Philratings. PhilRatings evolved from Credit Information Bureau, Inc.(CIBI), which started in 1982 through the joint efforts of the *Bangko Sentral* (Central Bank of the Philippines), the Securities and Exchange Commission (SEC) and the Financial Executives Institute of the Philippines (FINEX). The Credit Information Bureau, Inc.(CIBI) was set up primarily to serve as a business and credit information center.

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488 Matoto, Senen L. Executive Director of the Financial Executives of the Philippines. *Personal Interview.* June 2001. Makati City, Philippines.

489 Matoto, Senen L. Executive Director of the Financial Executives of the Philippines. *Personal Interview.* June 2001. Makati City, Philippines.

490 Coronel, Leonilo G. Executive Director of the Bankers Association of the Philippines. *Personal Interview.* June 2001. Makati City, Philippines.

The Credit Information Bureau, Inc.(CIBI) was eventually given the mandate to implement the Government's policy of establishing and maintaining an efficient credit evaluation and monitoring process in the financial system. In 1985, the company, through its Ratings Group, began credit rating commercial paper (CP) debt issues of Philippine companies. However, the Credit Information Bureau, Inc.(CIBI) was once perceived to lack independence from the corporations it rated as well as the institutional capacity to conduct credit ratings.

In 1998, the Credit Information Bureau, Inc.(CIBI) spun off its two major business units, transforming the Ratings Group into CIBI Ratings, Inc. and the Information Group into CIBI Information, Inc. CIBI Ratings, Inc., which has since been renamed Philratings, is aggressively involved in capital market development initiatives[491].

Philratings has already signed a mutual cooperation and assistance agreement with Standard & Poor's (S&P) to develop issuer credit ratings, create enhanced information products, and actively market the ratings system. For the ratings process, Standard & Poor's (S&P) will provide criteria and analytical assistance to Philratings. Philratings adopted a new national ratings scale, with definitions and symbols correlated with Standard & Poor's (S&P).

Philratings Long-term credit ratings

Rating	Description
Prs Aaa	Smallest degree of investment risk. Interest payments are protected by a large or by an exceptionally stable margin and principal is secured. While the various protective elements are likely to change, such changes as can be visualized are most unlikely to impair the fundamentally strong investment characteristics of such issues.
PRS Aa	Margins of protection may not be as large as in PRS Aaa issues. Fluctuations of protective elements may be of greater amplitude or there may be other elements present which make the long-term risks appear somewhat larger than for PRS Aaa rated securities.
PRS A	With favorable investment attributes and are considered as upper medium grade obligations. Factors giving security to principal and interest are considered adequate, but elements may be present which suggest a susceptibility to impairment some time in the future.
PRS Baa	Neither highly protected nor poorly secured. Interest payments and principal security appear adequate for the present but certain protective elements may be lacking or may be characteristically unreliable over any great length of time. Such issues lack outstanding investment characteristics.
PRS Ba	Judged to have speculative elements. The issuer's capability to pay for such issues in the future cannot be considered as well-assured. Often the protection of interest and principal payments may be very moderate, and thereby not well safeguarded during both good and bad times over the future.
PRS B	Generally lacks characteristics of a desirable investment. Assurance of interest and principal payments or maintenance of other terms of the contract over any long period of time may be small.
PRS Caa	Poor standing. High possibility of default and there may be danger with respect to principal or interest.
PRS Ca	Very poor standing; has other marked shortcomings. The issue may be in default.
PRS C	In default.

Source: www.philratings.com

[491] www.philratings.com

Although Philratings has rated more than 350 short- and long-term commercial paper (CP) issues[492], they have only started to take steps towards developing ratings for asset and mortgage backed securities.

Thomson Financial Philippines. Thomson Ratings Philippines entered the credit ratings game in June 1999. The International Finance Corporation, the private sector investment arm of the World Bank made a 15% equity investment of up to US$75,000 in Thomson Ratings Philippines which planned to offer a full range of high quality independent ratings services to the Philippine domestic market using internationally accepted standards[493].

Thomson Ratings Philippines, which was capitalized at approximately $500,000, was to rate both corporations and financial institutions. Short-term and long-term commercial paper (CP) will be the primary instruments rated, but other instruments such as bonds, municipal government issues, and securitized papers would have been rated as these markets develop[494].

According to Matoto, Thomson Financial Philippines has since closed shop due to the lack of deals to rate. However, he believes that Thomson will possibly return as more local deals come into play[495].

Underwriting/Issuance and Sale of Mortgage Backed Securities (MBS)

Underwriters.

Overview. In the United States, newly issued mortgage backed securities (MBS), similar to its other fixed-income counterparts, are marketed to the public by investment banker through the primary securities market. The purchase and sale of the already-issued securities among private investors takes place in the secondary securities markets[496].

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[492] The short-term commercial paper (CP) issues that Philratings rated ranged between P25 Million (US$472,000) to P2 Billion (US$38 Million), while long-term commercial paper (CP) issues have ranged from between P75 Million (US$1.4 Million) to P6 Billion (US$113 Million). For perspective, the total outstanding credit-rated short and long-term commercial papers (CPs) amounted to P51.3 Billion (US$968 Million) as of end-1999.

[493] International Finance Corporation. *IFC Invests in Credit Rating Agency in the Philippines.* IFC Press Release. April 29, 1999.

[494] Juntilla, Judith S. *1st Annual Philippine Local Debt Conference: Thomson Ratings enhances credibility of RP debt market.* Businessworld Publishing Corporation. February 17, 2000. Manila, Philippines.

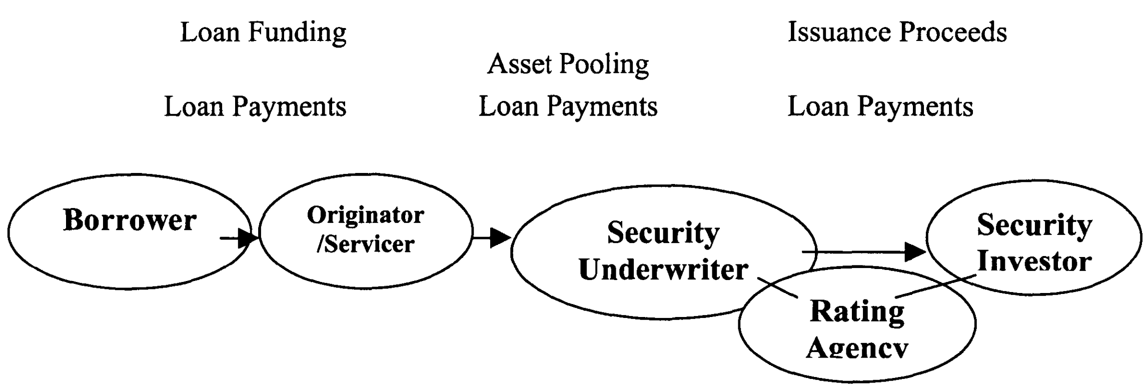
[495] Matoto, Senen L. Executive Director of the Financial Executives of the Philippines. *Personal Interview.* June 2001. Makati City, Philippines.

[496] Bodie, Zvi Ph.D., Alex Kane and Alan J. Marcus, Ph.D. *Investments 4th Edition.* Irwin McGraw-Hill. 1999. United States of America.

The public offering of securities is typically marketed via an underwriting by investment bankers. In most cases, more than one investment banker markets the securities. A lead firm forms an underwriting syndicate of other investment bankers to share the responsibility for the stock issue.

In the case of a mortgage-backed security (MBS), a loan originator provides mortgage origination services and secures fees from origination. The underwriter, who often directly coordinates a network of loan originators, pools the mortgage loans together and determines the appropriate cash flow allocation rules for securities that are carved out of the pool[497]. The income earned by the underwriter is the spread differential between the weighted average mortgage yield on the pooled loans and the weighted average securities yield. The ratings agencies earn fees for determining the subordination levels needed to secure particular credit quality ratings and also for monitoring the post-issuance asset pool performance. These fees are paid directly by the underwriter, since the free-rider problems prevent the fees from being passed on directly to the investors. Although the ratings agencies exert control over the security design and monitoring of the issuances, they do not take investment positions in the securities themselves.

Loan Production and Securitization Process



Source: Timothy Riddiough, Massachusetts Institute of Technology

The investment banks advise the originator regarding the terms at which it should attempt to sell the securities. A preliminary registration statement is filed with the Securities and Exchange Commission (SEC) describing the issue and prospectus of the company. When the statement is finalized by the Securities and Exchange Commission, it is called the prospectus. The prospectus contains the price at which the securities will be offered to the public.

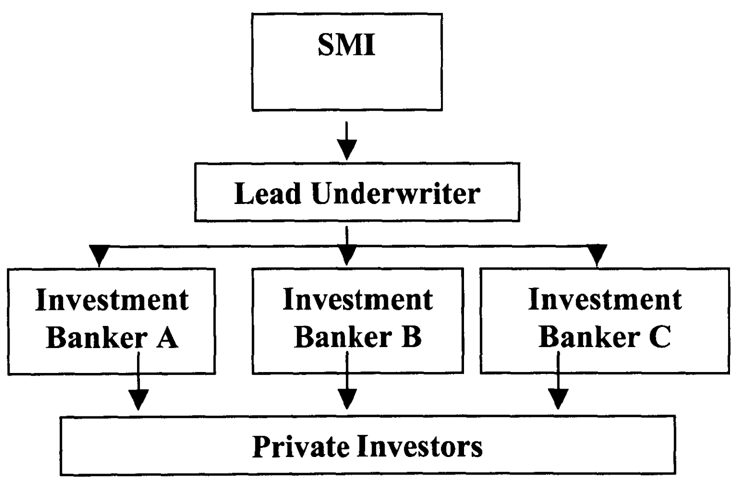
[497] Riddiough, Timothy. Real Estate Finance and Investments Course Reader. Massachusetts Institute of Technology. Spring 2001. Cambridge, Massachusetts.

In the United States, investment bankers manage the issuance of new securities to the public. After the Securities and Exchange Commission has critiqued the registration statement and a preliminary prospectus has been distributed to potential investors, the investment bankers organize "road shows" where they publicize the upcoming offering.

The "road shows" are performed for two reasons. First, it attracts potential investors and provides them information about the offering. Second, the investment bank is able to collect information for the Secondary Mortgage Institution (SMI) and its underwriters information about the price at which they will be able to market the securities.

In the United States, there are two methods of underwriting a security[498]. The first method is a firm commitment, where the underwriting arrangement is for the investment bankers to purchase the securities from the issuing company. In the case of the mortgage-backed securities (MBS), the issuing company is the Secondary Mortgage Institution (SMI), and then resells them to the public. The Secondary Mortgage Institution (SMI) sells the securities to the underwriting syndicate for the public offering price, less a spread that serves as the compensation for the underwriters. This arrangement makes the underwriters bear the full brunt of the risk if the shares cannot be sold to the public at the stipulated offering price.

Relationship among firm issuing securities, the underwriters, and the public



Source: Investments 4th Edition

[498] Bodie, Zvi Ph.D., Alex Kane and Alan J. Marcus, Ph.D. *Investments 4th Edition*. Irwin McGraw-Hill. 1999. United States of America.

The second method of underwriting is known as the best-efforts agreement. In the best-efforts agreements, the banker agrees to help the Secondary Mortgage Institution (SMI) to sell the issue to the public, but the investment bank does not necessarily purchase the securities. The investment bank simply acts as an intermediary between the public and the firm. Thus, the bank does not bear the risk of being unable to resell the purchased securities at the offer price.

Current State. In the Philippines, local investment banks, which are subsidiaries of private commercial banks, and investment houses serve as the primary underwriting agents for securities issues. According to Matoto, the 53 members of the Investment Houses of the Philippines (IHAP) are ready to underwrite the mortgage-backed securities (MBS) once the proper regulatory infrastructure and incentives are in place[499].

The role of a local underwriters is to structure private securities issues and offer them to investors through a) creating an underwriting syndicate to broaden the market for a corporate security; b) registering the security with the Securities and Exchange Commission (SEC) and; c) obtaining a credit rating from either Philratings or Thomson Financial Philippines.

Local underwriters normally earn a spread of 1 to 1.5% of the total value of the issue. The securities dealers or brokers may purchase, sell, or resell securities for clients or for their own account, earning a spread between the sale and the purchase price of the securities.

Secondary Trading

Overview. There are two types of primary securities market issues: a public offering, which is a security issue sold to the general public that can then be traded on the secondary market; and a private placement, which is an issue that is sold to a few high net worth individuals or institutional investors and usually held until maturity[500].

In the United States, public securities offerings that are traded in secondary markets can be bought and sold in the a) national and local exchanges, b) over-the-counter market (OTC) and, c) direct trading between 2 parties.

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[499] Matoto, Senen L. President of the Investment Houses Association of the Philippines. *Personal Interview.* June 2001. Makati City, Philippines.
[500] Bodie, Zvi Ph.D., Alex Kane and Alan J. Marcus, Ph.D. *Investments 4th Edition.* Irwin McGraw-Hill. 1999. United States of America.

Although there are several stock exchanges in the United States, only the New York Stock Exchange (NYSE) and the American Stock Exchange (Amex) are national in scope. The New York Stock Exchange (NYSE) is the largest single exchange and preferred by large traders. Meanwhile, the American Stock Exchange (Amex) focuses on listing smaller and younger firms. The exchange provides a facility for its members to trade securities, and only members of the exchange may trade there.

The Over-the-Counter (OTC) market trades securities, but it is not a formal exchange. There are no membership requirements for trading, nor are there listing requirements for the securities. In the Over-the-Counter (OTC) market, thousands of brokers register with the Securities and Exchange Commission (SEC) as dealers in Over-the-Counter (OTC) securities. A broker in the Over-the-Counter (OTC) market can execute a trade by contacting the dealer listing an attractive quote.

The National Association of Securities Dealers Automated Quotation System (NASDAQ) stock market has a computer-linked bid and asked prices for securities offered by the various dealers. The bid price is the price at which the dealer is willing to purchase the security. Meanwhile, the asked price is the price at which the dealer will sell the security. In the United States, the third market is referred to as the trading of exchange-listed securities in the Over-the-Counter (OTC) market. The fourth market is refers to direct trading between investors in exchange-listed securities without the benefit of a broker.

Current State. In the Philippines, all previous mortgage backed securities (MBS) issues were sold either through private placement or through underwriting syndicates. Since the mortgage backed securities (MBS) markets in the Philippines are neither deep nor liquid enough to warrant secondary market trading, investors hold most mortgage backed securities (MBS) issues until maturity. However, according to both the Home Development Mutual Fund (HDMF)/*Pag-Ibig* and several thrift banks who have started the sale and purchase of Asset Backed Securities (ABS), there appears to be a lucrative market for mortgage backed securities (MBS)[501].

A concern raised by key players in the securities markets with regard to the secondary trading of mortgage backed securities (MBS) was the lack of a central trading organization for secondary bond trading and the concomitant infrastructure that central trading offers: a 2 way-quote system to provide for an appropriate security pricing mechanism, absence of defined custodianship and clearinghouse for scripless trading and settlement, and lack of established trading conventions. Without the central trading

[501] Philippine Conference on Securitization. *Mobilizing the Markets for Securitization: The Case for Asset Backed Securities*. October 1999. Makati City, Philippines.

system, it was doubtful as to whether the issuance of mortgage-backed securities (MBS) would eventually create liquidity for housing finance as the securities would not be actively traded.

To address these concerns, Chapter 2 discussed the Bankers Association of the Philippines (BAP)-led market reforms project which was to set up a fixed income exchange to be up and running by end-2000. Matoto supports the establishment of the fixed income exchange as it a) allows for more transparency in trading, b) allows the investor to access a larger market (and is not longer constrained to re-sell the security back to the dealer), and c) drive market prices for the mortgage backed securities (MBS).

However, prior to the fixed bond exchange, there were previous plans to list the mortgage backed securities (MBS) of Home Corporation (the Secondary Mortgage Institution (SMI) set up by Urbancorp Investments), worth P2.5 Billion (US$47 Million) in the Philippine Stock Exchange (PSE)[502]. Initially, the Philippine Stock Exchange (PSE)[503] planned to fast-track the formulation of the rules and regulations governing the trading of mortgage backed securities (MBS), with an interagency task force composed Urban Bank, the Philippine Stock Exchange (PSE), the Securities and Exchange Commission (SEC) and the Philippine Central Depository (PCD). A manual of rules and regulations was being drawn up as well that would cover listing requirements, trading procedures, and regulation.

According to the Philippine Stock Exchange (PSE), the Philippine Stock Exchange (PSE) member-brokers would be entitled to as much as 25% of the mortgage-backed securities (MBS) underwritten by syndicate that would be formed semiannually. Philippine Stock Exchange (PSE) members would also participate not only in the secondary trading of the mortgage backed securities (MBS) but also in the primary offering as well.

However, as discussed under the Secondary Mortgage Institution (SMI) section on Home Corporation, Home Corporation's mortgage backed securities (MBS) never took off due to lack of market demand for the securities.

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[502] Businessworld Publishing Corporation. *Mortgage-backed securities to debut at PSE by October.* March 25, 1998. Manila, Philippines.

[503] On March 4, 1994, President Ramos ordered the Securities and Exchange Commission (SEC) to grant the Philippine Stock Exchange, Inc. (PSE) its license to operate as a securities exchange. Although there is one virtual exchange, achieved through computer link-up, there are two existing trading floors.

Demand Issues and Potential Investors for Mortgage Backed Securities (MBS)

Demand Factors.

Market participants are knowledgeable with regard to mortgage-backed securities (MBS). Although the October 1999 Philippine Conference on Securitization outlined the need for further investor education with regard to mortgage backed securities (MBS), Kotecha believes that the major investors (i.e. institutional investors such as contractual savings institutions (CSIs), trust departments of commercial banks) are sufficiently knowledgeable about mortgage-backed securitization[504]. Kotecha supports this argument behind the previous stand alone mortgage backed securitization efforts in the Philippines which have an aggregate value of P2 Billion (US$ 38 Million). These mortgage backed securities include Citibank in 1992, Home Development Mutual Fund (HDMF)/*Pag-Ibig* in 1993, Home Guaranty Corporation (HGC) in 1996[505], Bank of the Philippine Islands (BPI) Family Bank, Solid Bank, Ayala Life and Home Corporation. Furthermore, private sector-led efforts (i.e. the Philippine Conference on Securitization) have helped push for institutional reforms (i.e. passage of the law exempting the secondary trading of fixed-income instruments from documentary stamp tax (DST)), albeit slowly.

Lack of investor education may dampen demand for mortgage-backed securities (MBS). Unlike Kotecha, there is still a sentiment among various stakeholders in the mortgage backed securitization process that investor education is a paramount concern. In the 1999 Philippine Conference on Securitization, the a) lack of investor understanding behind securitization as a financing tool and, b) lack of market information on mortgage backed securities (MBS) were cited as key reasons for the failure of securitization in the country. The conference pointed out that even individuals in the finance and investment sector are unfamiliar with securitization. According to Finance Assistant Secretary Jeremias Paul, investors need to be aware of the sort of instrument they are dealing with, as well as its costs, and its risks and returns for mortgage backed securities (MBS) to gain a foothold as a long-term financial investment[506].

Matoto adds that among retail investors, there is demand for long-term financial instruments, as evidenced by the strong demand for government-issued retail bonds worth P5 Million to P6 Million

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[504] Kotecha, Mahesh K. *Secondary Mortgage Institution (SMI) Philippines – Draft Business Plan*. Structured Credit International Corporation. 2000. New York, New York.

[505] According to Arthur Tan, Executive Vice-President and General Manager of the Home Guaranty Corporation (HGC), HGC securitized a portion of their loan portfolio to run through the process and a) evaluate how the Home Guaranty Corporation (HGC) would work for mortgage backed securities (MBS) and; b) better understand what sort of requirements they will require from clients who would request for their services.

(US$94,000 to US$113,000) issued in April 2000. However, this retail demand may not necessarily translate into demand for mortgage-backed securities (MBS) as these type of investors are used to simple financial instruments and may not understand complexity of instrument[507].

Alcid uses anecdotal evidence of the previous administration's desire to securitize 'idle land' as proof of the lack of understanding behind securitization[508]. Alcid points out, rather obviously, that securitization occurs when there is an underlying stream of cash flows coming from the property, which is not the case with idle lands.

Lack of potential market depth for mortgage backed securities (MBS). Peter Maquera, Chief Operating officer of Lighthouse Credit Technologies, believes that there is no 'critical mass' of mortgage loans that can be securitized[509]. Maquerra cites the critical mass of commercial properties of the United States Resolution Trust Corporation (RTC) that required liquefaction, which gave rise to the commercial mortgage backed securities (CMBS) market[510]. In the case of the Philippines, the P100 Billion (US$1.9

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506 Paul, Jeremias N. , Jr. Department of Finance Assistant Secretary. *Personal Interview.* June 2001. Manila, Philippines.
507 Matoto, Senen L. President of the Investment Houses of the Philippines. *Personal Interview.* June 2001. Makati City, Philippines.
508 Under the previous Estrada administration, the government wanted to transfer state-owned lots to the National Home Mortgage and Finance Corporation (NHMFC) to increase the agency's capital to P50 Billion (US$ 943 Million) from P2.5 Billion (US$47 Million). They wanted to use these lands as collateral for loans to develop them for commercial and socialized housing purposes. According to the former Finance Secretary Edgardo Espiritu, they were "assigning future earnings to secure the loans." (Source: Serapio,
509 Maquera, Peter D. Chief Operating Officer of Lighthouse Credit Technologies Corporation. *Personal Interview.* June 2001. Pasig City, Philippines.
510 One of the key factors which led to the birth of the commercial real estate capital market in the United States was banking deregulation and. In the early 1980s, bank deregulation occurred in response to the high inflationary environment of the 1970s. The problem with encouraging a "survival of the fittest" atmosphere resulted in deposits remaining insured (i.e. deposit insurance became more generous) while bank regulation decreased. This allowed both banks and the Savings & Loans (S&Ls) to borrow money at rates that were not commensurate with the investment risks. As a result, huge amounts of debt capital were allocated to commercial real estate at extremely "competitive" prices. The outcome resulted in a moral hazard. By the end of the 1980s, bankruptcies became commonplace and the traditional capital sources had dried up.
The public markets for capital emerged when the US federal government, through the Resolution Trust Corporation (RTC) owned large quantities of commercial real estate debt that needed liquefication. The RTC could not hold on to the distressed properties for political reasons while selling the debt on an asset-by-asset basis was too slow and inexpensive. Thus, the most politically (and arguably economically) feasible alternative was to sell the assets in bulk. Securitizing the assets and dividing the cash flows into different securities turned out fairly well. Moreover, since the federal government were more concerned with disposing of the properties quickly (rather than getting the highest price), Wall Street was able to incorporate their start-up costs into the security pricing (i.e. buying from the Resolution Trust Corporation (RTC) at low prices and selling to public bondholders at significantly higher prices). This process was further helped by the lack of private debt capital for origination, which rendered public debt capital a viable alternative. This led to the emergence of the capital markets for commercial mortgage backed securities (CMBS). (Source: Riddiough, Timothy. *Real Estate Capital Markets Lecture Notes.* Spring 2001. Massachusetts Institute of Technology. Cambridge, Massachusetts.)

Billion)[511] worth of publicly originated mortgages could have provided a critical mass for a secondary mortgage market. However, given the poor asset quality of publicly originated mortgages coupled with the fixed interest rates, Maquera believes that only P10 Billion (US$189 Million) to P12 Billion (US$226 Million) of these mortgages are securitizable.

Kotecha, on the other hand, believes that a secondary mortgage market could rapidly develop, but it can only be sustained by selling efforts of professionals who are able to execute deals and offer a range of products. For example, mortgage backed securities (MBS) that are complemented by whole loan trading and purchases with recourse[512].

There is a short-term versus long-term investment orientation among local investors. As discussed in Chapter 5, there is a "short-term" investment orientation among banks and investors (due to the nature of the deposits), thus preventing banks from investing in long term instruments such as mortgage backed securities because of an asset-liability duration mismatch. Assistant Finance Secretary Paul related the short-term orientation to the general level of macroeconomic instability of the country. Given the volatility of interest rates (and consequently the yield curve), investors would rather place their funds into short-term instruments and refinance periodically, rather than place their funds in long-term financial instruments such as mortgage-backed securities[513].

Private banks liquidity dampens demand for mortgage-backed securities. A majority of local commercial banks are generally liquid and do not require mortgage-backed securities (MBS) in their portfolio[514]. Given this, Jacob feels that banks may not be interested in developing the secondary mortgage market[515]. In fact, banks can probably earn more by holding on to their mortgages[516]. Matoto adds that some private banks may want to purchase mortgage-backed securities (MBS) as a matter of strategy, but is unsure as to

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[511] The P100 Billion (US$1.9 Billion) comprises P40 Billion (US$758 Million) from the National Home Mortgage Finance Corporation (NHMFC) and P55 Billion (US$1.04 Billion) from the Home Development Mutual Fund (HDMF)/*Pag-Ibig*.

[512] Kotecha, Mahesh K. *Secondary Mortgage Institution (SMI) Philippines – Draft Business Plan*. Structured Credit International Corporation. 2000. New York, New York.

[513] Paul, Jeremias N. , Jr. Department of Finance Assistant Secretary. *Personal Interview*. June 2001. Manila, Philippines.

[514] Philippine Conference on Securitization. *Mobilizing the Markets for Housing: The Case for Asset-Backed Securities*. October 1999. Makati City, Philippines.

[515] Jacob, Monico. Former Home Development Mutual Fund (HDMF)/*Pag-Ibig* Chairman and Conference Chairman of the Philippine Conference on Securitization. *Personal Interview*. June 2001. Makati City, Philippines.

[516] Jacob estimates that these banks carry mortgage loans worth between P1.5 Million (US$28,300) to P3 Million (US$ 56,600), for an average period of 5 to 7 years.

whether the volume purchased will merit the establishment of a Secondary Mortgage Institution (SMI)[517]. Most private banks would consider purchasing mortgage-backed securities (MBS) when it is economically justified, especially since these securities provide better asset and liability matching as they fund mortgages with short term liabilities. However, Matoto believes that there is still strong institutional demand for long-term financial instruments (i.e. government securities). However, there has been interest expressed by lenders such as United Coconut Planters Bank, the Bank of the Philippine Islands, and insurance companies such as Philippine-American Life.

Contractual savings institutions plan to shift funds into securities. Both state pension funds have declared that they will "dramatically" shift their investments to fixed-income securities and reduce their exposures in the stock market[518]. The Social Security System (SSS) said it plans to channel its investments to "risk-free" government securities and loans to members. Meanwhile, the Government Service Insurance System (GSIS) said the fund will continue to invest in the stock market, but will increase its exposure in fixed-income investments such as long-term bonds with higher returns. Presumably, these long-term investments will include mortgage-backed securities (MBS) once these instruments are introduced in the market, as these funds have been mandated to invest in housing finance.

Mortgage backed securities (MBS) from privately originated loans are a financially attractive option for investors of long-term instruments. Private sector originated mortgage loans are attractive to institutional investors for several reasons. First of all, there is a low default risk (3.1% for commercial banks, 7.9% for thrift banks according to 1997 World Bank study) associated with private bank originated loans. This is further strengthened by the impression among bankers that middle income mortgage loans, the target home loan clients of banks, are "recession-proof" and will not renege on their loans unless it is a deep-seated recession. Second, according to Kotecha, the mortgage backed securities (MBS) based on private bank mortgages can remain competitive with government securities because they are at market rates, re-priced annually and pay interest of roughly 20%[519]. Third, according to Alcid, mortgage backed securities (MBS) are more appealing financial investments versus long-term commercial papers (LTCPs) because the default risk is spread out over the mortgages. Alcid's argument is strengthened by a spate of

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517 Matoto, Senen L. Executive Director of the Financial Executives of the Philippines. *Personal Interview.* June 2001. Makati City, Philippines.

518 Yap, Cecille and Ma. Elizabeth L. Sanchez. *State pension funds eye shift to securities investments.* Businessworld Publishing Corporation. April 4, 2001. Makati City, Philippines.

519 Kotecha, Mahesh K. *Secondary Mortgage Institution (SMI) Philippines – Draft Business Plan.* Structured Credit International Corporation. 2000. New York, New York.

long-term commercial papers (LTCP) that have gone into default[520]. Among these companies were C&P homes, a well-known low cost housing developer[521], the Trust International Paper Corporation (TIPCO)[522], and a partial default by the Bonifacio Land Corporation[523].

Conversely, mortgage backed securities from publicly originated loans are a risky option. Presumably, in the event that these public mortgages are to be securitized, these loans will have to be "cherry picked" (i.e. finding "performing" loans with preferably a 16% interest rate). According to both Deputy Secretary General Lucille Ortille and Lighthouse Chief Operating Officer Peter Maquera, the mortgage loans that can be securitized range from P10 Billion (US$189 Million) to P12 Billion (US$226 Million). The risk in these loans lies in their fixed interest rate.

Although the fixed 16% interest rate closely approximates current market rates, local interest rate volatility (i.e. similar to the interest rate swings during the 1997 regional currency crisis) has the potential to "burn" the investor, especially if the Bureau of Treasury (BOT) offers higher yields on long-term instruments in times of crisis. Furthermore, the yield for a publicly originated mortgage should be higher versus government securities (i.e. treasury bonds) which carry a "sovereign guarantee"). However, the 25 year treasury bond (which has the same "maturity" as the government originated loans) is currently traded at an average of 16.34%[524], which is already 34 basis points higher than the fixed mortgage rate. Unless credit enhancements such as over collateralization and subordination, coupled with other government incentives, enhance the value of the publicly originated mortgage backed securities (MBS), it is doubtful if this security will be more attractive versus treasury bonds.

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[520] Many corporations issued long-term commercial papers during the "economic boom" years preceeding the 1997 regional currency crisis.

[521] In May 2000, PhilRatings downgraded C&P Homes, Inc.'s outstanding P3 Billion (US$ 57 Million) long-term commercial paper debt issue (LTCP) from "PRS Ca" to "PRS C", which means the loan is in default. PhilRatings noted that, due to liquidity problems, C&P Homes had stopped paying interest on their paper since November 1999, which was issued in November 1996 (right before the 1997 regional currency crisis). C&P Homes is now negotiating with LTCP holders to restructure its debt obligations, possibly through asset-for-debt swap arrangements. (Source: www.philratings.com)
It is interesting to note that C&P *topped the housing loan releases of mortgage takeouts* under the government's Unified Home Lending Program (UHLP). (Source: Businessworld Publishing Corporation. *Villar's companies top list leading participants in Government's UHLP.* November 17, 1994. Makati City, Philippines.

[522] In August 2001, Philratings rated "Trust International Paper Corporation's (TIPCO) outstanding P200 Million (US$3.8 Million) long-term commercial papers (LTCPs) was rated PRS Caa, meaning "Poor standing. High possibility of default and there may be present elements of danger with respect to principal or interest." (Source: www.philratings.com)

[523] Flores, Shirley L. *Bonifacio Land partly defaults on bond payments.* Businessworld Publishing Corporation. June 7, 2001.

[524] Average rate that 25-year treasury bond was traded from January 2, 2001 to August 10, 2001. The treasury bond traded at a high of 19.11% and a low of 15.42%. (Source: HSBC Bank Philippines)

Lastly, although these mortgage backed securities have already been "cherry picked" loans, due to information asymmetry, potential investors will have the general impression that these loans have high default rates. Thus, they will tend to shy away from these securities despite reassurance to the contrary. Moreover, it must be noted that if the mortgage loans to be securitized are from the Unified Home Lending Program (UHLP), they do not carry a Home Guaranty Corporation (HGC) guaranty.

Properly structured mortgage backed securities (MBS) will be the key to generate investor demand. According to Matoto, a properly structured deal will compel institutional investors to purchase mortgage-backed securities. In particular, Matoto referred to contractual savings institutions (CSIs), which are mandated to invest in long-term financial instruments[525]. Arguably, whether the mortgages are publicly or privately originated, the proper credit enhancements (i.e. Home Guaranty Corporation (HGC) cash guarantees for both private and public mortgage backed securities (MBS), subordinated structures where "risky" mortgages as the most junior tranche) can enhance their appeal to potential investors.

Aside from properly structuring the mortgage-backed securities (MBS), there must be adequate information provided on the transaction in the prospectus to reinforce the security and integrity of the underlying mortgages. These include information on homebuyers, originator, servicer, secondary mortgage institution, guarantors, credit enhancers, and all other institutions that participated in the transaction. Inadequate information will undermine mortgage backed securities (MBS) development[526]. In the case of privately originated mortgages, information on the credit history of the homebuyer loans may be readily available for the investor. However, the credit history might be more difficult for publicly originated mortgages given the "sloppiness" and "questionable integrity" of the records of certain public institutions, such as the National Home Mortgage Finance Corporation (NHMFC).

Potential Investors

Local investors. Since mortgage-backed securities (MBS) are securitized from a pool of mortgages extending from 5 to 25 years, the ideal investors for these instruments would be those who need to match the 'duration' of these mortgages with their long-term liabilities. For example, a pension fund purchases mortgage-backed securities (MBS) because its maturity matches with their obligation to pay their client's dividends. Thus, the ideal investor for mortgage-backed securities (MBS) is investors whose long-term liabilities match the long-term funding needs of housing.

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[525] Matoto, Senen L. Executive Director of the Financial Executives of the Philippines. *Personal Interview.* June 2001. Makati City, Philippines.
[526] Reside, Renato S. *Mortgage-Backed Securities in Asia.* Asian Development Bank. 1999. Pasig City, Philippines.

Reside says there are a few available statistics on previous mortgage-backed securities (MBS), as most of these were done through private placement[527]. However, underwriters of previous issues (i.e. Citibank) have indicated that the typical mortgage-backed securities (MBS) investor is a long-term investor, usually an institutional investor such as a pension fund or insurance company.

Kotecha identified the following institutions as potential investors for mortgage backed securities (MBS)[528]:

1. Contractual savings institutions (Government Service Insurance System (GSIS), Social Security System (SSS),and the Home Development Mutual Fund (HDMF)/*Pag-Ibig;*
2. Private Insurance companies;
3. Pension funds;
4. Banks (particularly the trust departments and the money markets of commercial banks[529]) and Quasi-banks;

According to Bernardo, banks are not ideally suited for providing long-term financing for housing due to the short-term nature of their liabilities (i.e. deposits)[530]. Among all these institutions, the contractual savings institutions (CSI) are the touted as the ideal anchor investor because they are able to channel vast long-term resources into the housing markets without sacrificing their viability. The contractual savings institutions (CSI) would benefit from the better matching of assets and liabilities, a wider selection of investment grade securities, and better returns on investments.

For perspective, the assets of the contractual savings institutions (CSI) were P422.6 Billion (US$8 Billion) in 1995, which comprised 18% of the assets of the financial system. The public contractual savings institution (CSI) alone dominated the contractual savings sectors at 66.3%[531]. According to Monico Jacob, the former Chairman of the Home Development Mutual Fund (HDMF)/*Pag-Ibig,* contractual savings institutions (CSI) already have the mandate to provide financing to the housing sector, albeit on an unsustainable basis, through providing a portion of their annual investible reserves for primary lending to both the Unified Home Lending Program (UHLP) and the Multi-Window Lending

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527 Reside, Renato S. *Mortgage-Backed Securities in Asia*. Asian Development Bank. 1999. Pasig City, Philippines.
528 Kotecha, Mahesh K. *Secondary Mortgage Institution (SMI) Philippines – Draft Business Plan*. Structured Credit International Corporation. 2000. New York, New York.
529 Alcid, Andrew D. Executive Vice President, Investment Banking Division of United Coconut Planters Bank. *Personal Interview*. June 2001. Makati City, Philippines.
530 Bernardo, Romeo L. *Revisiting Housing Finance*. Philippine Daily Inquirer. March 12, 2001. Makati City, Philippines.

Scheme (MWLS). However, he said that the contractual savings institutions (CSIs) should compel the development of the secondary mortgage market and stop primary lending[532]. These investible reserves need to be rechanneled into mortgage backed securities (MBS) so as a) to provide better "returns" to these institutions versus primary mortgage lending[533] and; b) to provide long-term, sustainable financing for housing.

Issues with Contractual Savings Institutions (CSI) as potential mortgage backed securities investors.

Continued misuse of contractual savings institutions (CSIs) annual investible reserves in housing finance. Manuel Crisostomo, current President and Chief Executive Officer of the Home Development Mutual Fund (HDMF)/*Pag-Ibig*, said that the role of HDMF/*Pag-Ibig* should be to invest in mortgage-backed securities (MNS) and not to be a loan originator as they are "a provident fund and not a bank". The provident fund should be investing in long-term financial instruments that guarantee a fair amount of dividend earnings to members, and objective not currently met through primary lending[534]. However, the current funding system of direct lending by the contractual savings institutions are not only damaging to the capability and viability of the contractual savings institution, but it also stunts the growth of the capital markets.

First, direct lending to housing prevents the capability of contractual savings institution (CSI) to make financially sound investments (i.e. government securities) which are suppose to deliver fair amounts of dividend earnings to its members. This is clearly not the case in primary mortgage lending. Under the Unified Home Lending Program, the contractual savings institutions were earning 10.25%, a rate below that of government securities. The Philippine Institute of Development Studies (PIDS) estimated that the contractual savings institutions (CSIs) lost a total of P8 Billion (US$151 Million) from 1993 to 1995 by lending to the Unified Home Lending Program (UHLP) instead of investing in other higher return, long-term financial instruments

[531] World Bank. Philippines Housing Finance: Reforming Public Provision and Promoting Private Participation. June 1997.
[532] Jacob, Monico. Former Home Development Mutual Fund (HDMF)/*Pag-Ibi*g Chairman and Conference Chairman of the Philippine Conference on Securitization. *Personal Interview.* June 2001. Makati City, Philippines
[533] Under the Unified Home Lending Program (UHLP), the contractual savings institutions (CSIs) were making 10.25% on their primary mortgage lending, which is lower versus government securities.
[534] Crisostomo, Manuel C. President and Chief Executive Officer of Home Development Mutual Fund (HDMF)/*Pag-Ibig. Personal Interview.* June 2001. Makati City, Philippines.

As a consequence of primary lending to the Unified Home Lending Program (UHLP), the viability of the contractual savings institutions (CSI) is affected. The liquidity of these institutions investment is locked away for 25 years instead of allowing the money to be recycled for other investments[535]. This is further exacerbated by the fact that these institutions have to "eat the losses" from a structurally inefficient housing finance program. For perspective, the government is having difficulty selling off the P42 Billion (US$792 Million) loan portfolio held by the National Home Mortgage Finance Corporation (NHMFC) because of the losses that the contractual savings institutions will book due to the poor investment[536].

Moreover, the continued investment of contractual savings institutions (CSIs) into the primary mortgage market, instead of the secondary mortgage (or secondary fixed income) market, retards the development of long-term financial instruments. Long-term investors will continue to have limited financial alternatives, save for government securities. Only the introduction of the large financial resources of the contractual savings institutions (CSIs) into mortgage-backed securities (MBS) can provide an impetus for a secondary mortgage institution (SMI) to securitize. Moreover, the investment of contractual savings institutions (CSI) will allow other relatively smaller investors to follow suit, paving the way for a vibrant secondary market.

However, the newly installed Arroyo administration continues to use contractual savings institutions (CSI) for primary lending purposes. In her recent state of the nation address, President Arroyo promised to build 800,000 houses[537] by acquiring P20 Billion (US$377 Million) worth of financing from the government financial institutions[538]. This effort is already on top of the P40 Billion (US$755 Million) allotted by the contractual savings institutions for the Multi-Window Lending Scheme (MWLS), a derivative of the failed Unified Home Lending Program (UHLP).

Lastly, it is quite alarming to note that the Chamber of Real Estate and Builders Associations (CREBA) claimed that the P20 Billion (US$377 Million) appropriation as part of seed money that will start the Chamber of Real Estate and Builders Associations (CREBA) -developed Centralized Home Financing Plan (CHFP). The fund plans to appropriate P10 Billion more from the Home Development Mutual Fund

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535 Alcid, Andrew D. Executive Vice President, Investment Banking Division of United Coconut Planters Bank. *Personal Interview*. June 2001. Makati City, Philippines.

536 The default rate of the P42 Billion (US$792 Million) loan portfolio is 50%. The Social Security System (SSS) hold P30 Billion (US$566 Million) of the portfolio, followed by the P6.5 Billion (US$123 Million) of the Government Service Insurance System (GSIS), and the P4.5 Billion (US$ 895 Million) of the Home Development Mutual Fund (HDMF)/*Pag-Ibig*.

537 For the remainder of her administration (2001-2004), President Arroyo promised that the government would build 100,000 for the low income class and 50,000 for socialized housing.

(HDMF)/*Pag-Ibig*, and P5 Billion (US$94 Million) each from the (SSS) and the Government Service Insurance System (GSIS) as seed fund for a housing program[539]. Note that this is the same Centralized Home Financing Plan (CHFP) that CREBA was offering as an alternative to both the Medium Term Development Plan for Shelter (MTDP-S) and the Multi-Window Lending Scheme (MWLS).

Issues with potential investors.

Foreign investors

The foreign exchange risks render local mortgage backed securities (MBS) unattractive to foreign investors. According to Limlingan, foreign investor demand will shy away from Philippine (and Southeast Asian) securities because of the foreign exchange risk associated with these securities[540]. Since these mortgage backed securities (MBS) are peso-denominated, coupled with the volatility of the peso against the US dollar, only foreign investors who have the "appetite" for this sort of foreign exchange risk will venture into purchasing these securities. However, Matoto doubts that local mortgage backed securities (MBS) will attract foreign investors[541]. Limlingan adds that the only companies securitizing their future earnings are those with dollar assets such as airline and telecommunication companies.

[538] www.inq7.net. President Macapagal's State of the Nation speech. July 23, 2001. Makati City, Philippines.
[539] Gorayeb, Charlie V. *Government-private sector housing policy to be forged in summit.* Philippine Star. August 6, 2001. Manila, Philippines.
[540] Limlingan, Victor S. Professor at the Asian Institute of Management. *Personal Interview.* June 2001. Makati City, Philippines.
[541] Matoto, Senen L. President of the Investment Houses of the Philippines. *Personal Interview.* June 2001. Makati City, Philippines.

Mortgage-Backed Securitization (MBS) Process – United States

Standardization

Standardization of the mortgage instrument is a key factor in secondary market development. Mortgage should be pooled with similar characteristic to facilitate larger pool size and more liquidity and to reduce the due diligence costs of investors and rating agencies. There can be many types of mortgages present in the housing finance system, but only those with sufficient volume are candidates for sale and securitization.

Investors and rating agencies must be able to do due diligence with reasonable cost. The more heterogeneous the terms and documentation of the loans, the greater the cost of due diligence and the less competitive is sale through securitization. In order to reduce the transaction costs of evaluating mortgage loans and the processing costs of issuing and administering MBS, the characteristics (e.g., rate adjustment, amortization schedule, term) of the mortgages should be uniform.

The degree of uniformity depends on the characteristic involved. In the U.S. residential market, almost all pools will be restricted to 1-4 family residential properties. Loan size may be restricted (for example, Fannie Mae and Freddie Mac are constrained by law to maximum loan size for 1-4 family loans of $275,000, a limit which is changed annually according to an external index). Geographic restrictions may apply for certain pools of non-conforming loans (loans not eligible for purchase by the government-sponsored enterprises).

Constraints on loan adjustment features are common. For example, fixed; rate mortgages (FRMs) are not pooled with adjustable-rate mortgages (ARMs) and ARMs with different indices will not be pooled together. Loans with deferred interest or negative amortization are not pooled with fully amortizing loans. There will be an allowed range of loan maturities and loan coupon rates. These limits allow investors to more accurately predict prepayments and pool cash flows. A wider range allows for more loans in a pool (enhancing liquidity) but more uncertainty in estimating prepayments. An important constraint in pooling is that no loan in the pool can have a coupon rate less than the security coupon rate. This constraint ensures that the servicer always has a financial incentive to service the loans. There may be constraints on loan purpose or LTV in order to achieve certain ratings or credit enhancement objectives.

Documentation. In addition, standardized documentation must be available for all loans. Typical documentation includes the mortgage note (document describing the mortgage obligation) and deed (document conveying ownership to lender as security for the repayment of the mortgage. Because the U.S. is comprised of 50 states, there is variation in the security for the loan, which can be in the form of a deed of trust, mortgage or deed to secure debt. A key legal perquisite is the timely and cost effective registration of title and lien. A barrier that exists in many developing countries is the imposition of transfer taxes or stamp duties on title and lien registration or transfer. Long delays in the registration process can also increase the risk of primary market and secondary market transactions.

A loan file will contain the application, property appraisal and borrower credit report. Lenders use standardized application and disclosure forms, the format of which has been determined by the U.S. Department of Housing and Urban Development. The appraisal determines the value of the property through examination of the sales prices of similar properties construction costs of new properties, and market conditions and trends. Since January 1995, a uniform residential appraisal report has been used for nearly all lenders, including those intended for sale to Fannie Mae or Freddie Mac and those insured by the FHA and VA. In addition to the implicit oversight of investors, financial institution regulators have established appraisal guidelines for the institutions they supervise.

The credit report is a key document that is required for all loans. There are no specific guidelines regarding credit reports but they have become increasingly important in underwriting. The information compiled by credit bureaus is used to compute credit scores, such as the FICO score, which have become the basis of loan decisions, in some cases even supplanting the appraisal. Additional credit requirements include employment verification, income verification (pay stubs, in some cases income tax returns) and asset/liability information (e.g., bank accounts, loans etc.)

The final major document requirement is the title report or title insurance policy. A title search verifies that the mortgagee owns the property being pledged as security for the lien. The title insurance policy insures against the risk that the mortgagee may not have clear title or may have encumbered the property with other liens (which could exceed the value of the property or have a priority to the loan being applied for). Lenders also require property and casualty insurance. A key aspect of the secondary market is the representations and warranties given by loan originators. In all loan sales transactions, the seller will warrant that all documents are present and completed to the standards of the investor.

Information Requirements

Investors are dependent on the servicer to collect and remit payments. The servicer must have good systems for accumulating and remitting cash and performance information on a timely basis and a good track record in collections.

Home mortgage servicing is characterized by low revenue per loan and potentially high expenses for difficult-to-service loans. As a result, loan quality and efficiency of operations is critical to a servicer's success. Servicing in the U.S. has become increasingly automated. This trend reflects demand of investors for more timely and comprehensive information, profit opportunities in marketing and cross selling, and their own needs for improved risk management. As a result there has been an increased consolidation of servicing in the U.S.

Information processing and real time transmission have become increasingly important in the U.S. secondary market. Historical performance data on mortgage payments (e.g., default and prepayment) is a major factor in risk assessment and pricing. Because of the importance of data in the assessment of risk, the demands on servicers are potentially great. Servicers must be able to process and disseminate large amounts of information. Thus, they must develop effective, automated management information systems.

Secondary Marketing

Functions. Secondary marketing is the function of financing and, subsequently, selling the originated mortgage to institutional investors. This activity includes the warehousing of the mortgage between the time the mortgage is closed and subsequently sold to an investor. It is arguably the most critical function in the secondary market. More mortgage bankers fail as a result of failure to manage the risks of secondary marketing than for any other reason.

The secondary mortgage in the U.S. is dominated by the Government Sponsored Enterprises (GSEs). The two U.S. GSEs that perform these activities are Fannie Mae and Freddie Mac. The GSEs guarantee mortgage-backed securities and the seller servicer acts as the custodian holding the mortgage loans as collateral for the securities.

FHA-insured and VA-guaranteed loans are pooled and sold as mortgage-backed securities guaranteed by a U.S. agency called the Government National Mortgage Associate (Ginnie Mae or GNMA). Other mortgages are sold to private mortgage conduits that use them as collateral for MBS. In recent years, the private secondary market (in which non-conforming loans ineligible for purchase by the GSEs are sold) has been rising in importance.

- Risk management: The function of secondary marketing is to find investors to purchase the loans from the mortgage bank and for managing the financial risks involved in making loans with an established interest rate in a changing interest rate environment, as well as other risks associated with the process. Although referred to as pipeline risk, there are in fact four major risks the seller must manage as part of the secondary marketing function.
- Commitment risk: The risk than an interest rate commitment ("rate lock") offered to a home buyer for a loan is made and the firm is unable, generally due to market forces, to earn an adequate sales price to cover the costs of providing the commitment. This risk may be reduced or offset by purchasing offsetting commitments (i.e. committing in advance to sell a loan or pool of loans at a particular rate).
- Pipeline risk: The risk that a closed loan will change in value between the time of closing and shipment to an investor. This risk is often hedged using forward, option or futures contracts.
- Documentation risk: The risk that a closed loan is underwritten improperly and does not conform to the investor's requirements. These loans are known as "lame loans" and frequently can be converted into acceptable loans for delivery, but usually after months of seasoning and additional documentation. The delays in delivery, or inability to deliver, produce costs for the originator.
- Liquidity risk: The risk that certain types of mortgage loans may face large buy price-sell price (bid-ask) spreads.

This can happen if the firm buys loans wholesale (i.e. from other lenders) and is unable to generate a sufficient volume to securitize or sell the loans at a profit. Problems in reselling the loans may produce losses for the firm. Most mortgage lenders in the U.S. have highly developed data processing systems that track loans during the commitment phase in order to ensure that there is sufficient volume to meet future sales obligations and that loans are pooled according to the precise characteristics demanded by investors. One of the main prerequisites of a secondary market is availability of such data and the means to manipulate it.

Servicing

Functions. The servicing of mortgages is a critical component of a viable secondary mortgage market. The collection of mortgage payments and the periodic remittance of these payments to the investor (or conduit) is the major task of servicers (whether they are originators or third parties). In addition, servicers are the primary repositories of information on the mortgage loans. Thus, they must maintain accurate and up-to-date information on mortgage balances, status and history and provide timely reports to investors. Mortgage loan servicing involves all the activities related to:

- collecting mortgage payments
- accounting for all financial transactions
- collecting past due accounts
- remitting payments to investors
- foreclosing on seriously delinquent properties
- disposing of foreclosed real estate

Collections and Default Management. An important part of the servicing function is establishment of clear guidelines for the collection of mortgage payments. The documents must spell out payment obligations and procedures to be followed in the event of default. Although lender discretion in working with borrowers is an important part of the collection process, third party investors must know what those procedures are before making their investment (in order to assess the degree of default risk) and what latitude exists in dealing with the borrower (e.g., forbearance or restructuring). Servicers also must make decisions about and implement procedures leading to foreclosure and repossession in the case of defaulted loans.

The servicer has the primary responsibility of default management. When loans become delinquent, it costs the servicer more for which they receive no additional revenue. A delinquent loan may also require an even more costly foreclosure process. The Mortgage Bankers Association of America (MBA) reported that as of March 31, 2000, the overall seasonally adjusted delinquency rate on one-to-four family unit homes was 3.82%. The 90+ days past due rate was 0.54%. Foreclosure refers to a legal process by which a mortgagee obtains title to the property from a mortgagor in default for purposes of disposing of the property to provide funds to pay off the loan. The MBA reported that the foreclosures started for all types of loans were 0.85% on March 31, 2000. Investors expect servicers to be pro-active in default management. The typical actions that a loan servicers will take at various stages of delinquency are:

- 30-60 days: Reminders to delinquent borrower through mail or phone and/or provide counseling.
- 90 days: consider loan restructuring such as forbearance (reduced payments) or lower interest rate.
- 120+ days: commence foreclosure process

7 *STRUCTURAL ISSUES*

The biggest obstacle that faces mortgage backed securitization issuance in the Philippines is the government's lack of familiarity with regard to the securitization process. The Philippines is just starting to develop well-defined rules for mortgage-backed securitization[542]. However, due to the lack of sophistication in the local financial markets and the lack of regulatory experience, each regulator has historically insisted on drafting their own set of rules[543].

The lack of familiarity with securitization manifests itself in the regulatory, taxation and legal structure which is hardly conducive to mortgage-backed securities (MBS) development. Thus, Limingan argues that entrepreneurial-minded private sector entities will need to take the risk to engage in mortgage-backed securities (MBS)[544]. The Home Corporation, a subsidiary of UrbanCorp, was the first private sector secondary mortgage institution to venture into mortgage-backed securities (MBS) development despite the unsure regulatory, taxation and legal environment it would face. Expectedly, the company's failure highlighted the lack of clear regulatory guidelines form the government agencies that were supposed to monitor the company. Therefore, it is integral that we understand how the regulatory, taxation and legal environment affect the development of mortgage-backed securities (MBS) in the Philippines.

Regulatory Issues

Overview. There are two government institutions that directly impact the development of the mortgage backed securities (MBS) industry in the Philippines, namely the *Bangko Sentral ng Pilipinas* (Central Bank of the Philippines) and the Securities and Exchange Commission (SEC). Market players have complained of inconsistent provisions with regard to the regulatory guidelines issued by both these organizations as one of the primary reasons behind the failure of securitization.

These concerns came to the forefront after the collapse of Urban Bank, which owned Home Corporation, a secondary mortgage institution (SMI) that was purchasing mortgage loans for securitization from the

[542] Reside, Renato S. *Mortgage-Backed Securities in Asia.* Asian Development Bank. 1999. Pasig City, Philippines.
[543] The two government regulatory agencies, the *Bangko Sentral* (Central Bank of the Philippines) and the Securities Exchange Commission (SEC) recently drafted a Memorandum of Agreement (MOA) on June 7, 2001 to carify their respective roles in mortgage backed securitization.
[544] Limlingan, Victor S. Professor at the Asian Institute of Management. *Personal Interview.* June 2001. Makati City, Philippines.

Home Development Mutual Fund (HDMF)/*Pag-Ibig*[545]. Right after the collapse, both government regulators initially "pointed fingers as to who was to blame for the Urban Bank fiasco"[546]. The Securities and Exchange Commission (SEC) had claimed that regulatory supervision of investment houses rested solely with the *Bangko Sentral* (Central Bank of the Philippines). The *Bangko Sentral* (Central Bank of the Philippines), on the other hand, asserted that their responsibility over Urban Corp, which was considered an investment house, was merely to ascertain if it had violated banking laws (versus complete oversight). However, the *Bangko Sentral* (Central Bank of the Philippines) has admitted to the ambiguity of the law over which government regulator has supervisory responsibility over quasi-banking institutions such as Urban Corp.

Thus, it is instructive to understand the respective regulations of the *Bangko Sentral ng Pilipinas* (Central Bank of the Philippines) and the Securities and Exchange Commission (SEC) in light of our review of the establishment of a secondary mortgage institution (SMI) and the issuance of mortgage backed securities (MBS).

Securities and Exchange Commission (SEC)

Overview. The Securities and Exchange Commission (SEC) is the government regulator that has jurisdiction over all corporations, partnerships, and associations in the Philippines. The Securities and Exchange Commission (SEC) licenses, registers, supervises, and regulates companies and keeps their public records.

Currently, the Securities and Exchange Commission (SEC) also has oversight functions over (1) the Philippine Stock Exchange (PSE); (2) Over-the-counter securities trading, as well as over all other participants in the securities industry, which include brokers and dealers. Only government-issued and – guaranteed securities are exempt from SEC registration[547]. Given this, the mortgage backed securities

[545] Investigation by the government officials revealed that the collapse of Urban Bank stemmed from its investment house subsidiary, Urban Corp (which, in turn, owns Home Corporation.). Government reports revealed Urban Corp had brokered securities deals but was caught by liquidity problems when investors suddenly preterminated their holdings. Apparently, Urban bank supported Urban Corp's investments that turned sour. An official from the Central Bank said that Urban Bank may have actually been sound, but it was the liquidity problems of Urban Corp when clients preterminated their investments. Most withdrawals serviced by Urban bank were then said to be pretermination of placement by investors of Urbancorp. (Source: Eric S. Boras. *Second Quarter Banking Report: Some hard lessons from the Urban Bank collapse (What Happened and Can it Happen Again?).* Businessworld Publishing Corporation. August 16, 2000. Makati City, Philippines.)

[546] Eric S. Boras. Second Quarter Banking Report: Some hard lessons from the Urban Bank collapse (What Happened and Can it Happen Again?). Businessworld Publishing Corporation. August 16, 2000. Makati City, Philippines.

[547] Reside, Renato S. *Mortgage-Backed Securities in Asia.* Asian Development Bank. 1999. Pasig City, Philippines.

(MBS) that would have been issued by the National Home Mortgage Finance Corporation (NHMFC), and those that were issued by the Home Guaranty Corporation (HGC) and the Home Development Mutual Fund (HDMF)/*Pag-Ibig* were exempt from Securities and Exchange Commission (SEC) registration.

Securitization concerns. The Securities and Exchange Commission's (SEC) concern with regard to securitization is the need for full disclosure of the Asset Backed Securities (ABS) prior to its release to investors. Since the financial concept of securitizing (what are essentially) "future receivables" is relatively new in the Philippines, regulators require full disclosure to ensure potential investors are fully knowledgeable and understand that they are purchasing[548]. Moreover, the regulators as well are also still grappling with concept of securitizing, which manifests itself in the rules and regulations that have been released by the Securities and Exchange Commission (SEC).

The guidelines that the Securities and Exchange Commission (SEC) uses with regard to securitization are a) the Rules on the Registration and Sale of Asset Backed Securities, which was implemented on March 25, 1991 and; b) a Memorandum of Agreement between the Securities and Exchange Commission (SEC) and the *Bangko Sentral ng Pilipinas* (Central Bank of the Philippines) with regard to the supervision of institutions issuing Asset Backed Securities (ABS), which was implemented on June 7, 2001. The Securities and Exchange Commission (SEC), as well, has released proposed amendments to the Rules on Asset Backed Securities (ABS) that appears to be more conducive to the development of a Secondary Mortgage Institution (SMI) and the mortgage backed securitization[549].

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[548] Reside, Renato S. *Mortgage-Backed Securities in Asia.* Asian Development Bank. 1999. Pasig City, Philippines.
[549] The *Bangko Sentral ng Pilipinas* (Central Bank of the Philippines) and the Securities and Exchange Commission (SEC) rules will be compared in later parts of this section.

KEY HIGHLIGHTS OF THE PROPOSED CHANGES THE RULES ON THE SEC RULES ON THE REGISTRATION AND SALE OF ASSET BACKED SECURITIES (ABS)

<table>
<tr><td>Definition of “Asset Pool”</td><td>A group of physically segregated or otherwise particularly identified assets originally owned by the originator, conveyed to, held, and owned by the issuer.</td><td>A group of identified, self amortizing assets that comprise the specific assets underlying the asset backed securities (ABS), and are either conveyed to the special purpose trust (SPT) issuing the asset backed securities (ABS), or pledged by the special purpose vehicle (SPV) owning the assets to secure performance of the asset baked securities (ABS).

Two or more originators or sellers may form a common asset pool for the purpose of issuing asset backed securities (ABS).</td></tr>
<tr><td colspan="3">Rationale: All assets in the asset pool must be specifically identified and either conveyed to the trustee of the security of pledged by a special purpose vehicle (SPV) to secure performance of a debt security.

Also, this rule allows for two or more originators or seller to combine assets in a common asset pool for the purpose of issuing a single security. This ability to combine assets originated by several sellers into a single asset pool may improve asset quality and minimize financing costs for small issues.</td></tr>
<tr><td>Definition of “Asset Backed Securities”</td><td>Trust certificates issued by a trust created pursuant to the rules representing undivided ownership interests in the assets forming the pool.</td><td>Securities that represent undivided ownership interest in the assets forming the asset pool and; represent the right to of the holder to receive payments from the proceeds expected to be derived from the assets forming an asset pool owned by a Special Purpose Vehicle (SPV) and pledged by the SPV to secure payment to holders of the securities. Asset-Backed Securities (ABS) may be issued in series. An ABS may include a credit enhancement.</td></tr>
<tr><td colspan="3">Rationale: The rule is intended to clarify that either “pass through” or “pay through” structures are acceptable organizational forms for asset-backed securities (ABS). Under the existing rules, only the “pass through” structure, in which the asset pool is actually held by the Special Purpose Trust (SPT) is permissible. With either structure, however, there must be a Special Purpose Trust (SPT) administered by an independent trustee.</td></tr>
<tr><td>Scope of Credit enhancements</td><td>These include sinking funds[550] and separate bank accounts.</td><td>These include subordinated structures, over collateralization, sinking funds, third party guarantees, standby letters of credit, swaps, spread accounts or reserve funds.</td></tr>
<tr><td colspan="3">Rationale: Under the current rules, the only permissible credit enhancements are “sinking funds” and separate bank accounts, which are too restrictive and often uneconomical. Under the new definition, it is permissible to create any type of credit enhancement intended to increase the likelihood that investors in asset-backed securities (ABS) receive payment of the amounts due to them. The credit enhancement need not provide a 100% coverage or guarantee payment until maturity of the enhanced security. A credit enhancement may be established by the seller, originator or issuer, it may be built into the structure of the security, or provided by a separate entity for a fee, or comprised of a combination of structure and outside entities.</td></tr>
</table>

[550] Sinking fund is defined as the proceeds of collection from the asset pool including all income therefrom, set aside in an account with a custodian bank to be used by the issuer to redeem the issued securities.

Definition of "Originator", "Seller" and "Servicer"	Originator is the original obligee of the assets, such as the financial institution that grants a loan or a corporation in the books of which the assets were created. Seller conveys to the issuer the assets forming the pool. *The seller may also be the originator.* Servicer is the corporation appointed by the issuer to perform the servicing of the asset pool. Servicing shall mean primarily collecting and recording payments received on the assets and remitting such collections to the issuer.	Same. Seller conveys assets to the issuer of the Asset Backed Security (ABS). *The seller may also be the originator.* Servicer has the contractual responsibility to administer the assets in the asset pool. These functions include, but are not limited to, collecting and recording of payments received on the assets in the pool and remitting of such payments to issuer, compiling data on the assets in the pool and reporting such information to the issuer and trustee, monitoring of delinquencies and instituting legal actions to recover collateral, and any other functions covered in the servicing contract. A servicer may have one or more subservices. *The seller or originator may also be the servicer.*

Rationale: Although asset servicing is often transferable, usually the originator or seller will already be servicing the assets at the time the asset backed security (ABS) is issued, and under this definition may continue to do so. In most cases, it would be efficient for the originator to also be the servicer. The originator is more familiar with the assets than an unrelated third party and may be able to collect payments on the assets more effectively than a new servicer. *Additionally, if the originator maintains an economic interest in the cash flows from the asset pool – its incentives to service the assets effectively align its interests with those of the security holder.*

Definition of "Special Purpose Trust"	Trust constituted solely to purchase assets (the trustee of such trust must be trust department of a commercial bank), owning or holding the asset pool for a definite period of time until all Asset Backed Securities (ABS) are redeemed.	Trust administered by a trustee independent of the seller, originator, servicer or any underwriter of the Asset Backed Security (ABS), or any affiliate/subsidiary, or director/officer and relatives to the 4^{th} degree, and created solely for issuing or administering an ABS.
Definition of "Special Purpose Vehicle"	No equivalent.	Special purpose corporation, limited partnership, or other person created solely for the purpose of formation, issuance, and administration of Asset Backed Securities (ABS). Special Purpose Vehicles may own the assets in the asset pool, but shall not engage in any activities or incur any indebtedness not connected to the formation, issuance or administration of the ABS.

Rationale: Sale of the assets to a Special Purpose Vehicle (SPV) protects the assets from inclusion in any subsequent insolvency of the seller or originator. *While in many asset backed securities (ABS) issues the SPV will ultimately transfer ownership of the assets to the Special Purpose Trust (SPT), in the "pay though" structure it continues to own the assets in the asset pool and itself issues ABS in the form of debt, pledging the assets and their cash flow to secure the payment of the debt.*

The Special Purpose Vehicle (SPV) must be created "solely" for the issuing asset backed securities (ABS) and thus cannot engage in any activity or incur any indebtedness other than in connection with the formation or administration of the ABS, since other activities may lead to claims against assets in the asset pool.

Special Purpose trust functions	The issuer of the Asset Backed Security (ABS) must be created solely for owning and holding the asset pool. It may only hold one asset pool at a time.	Each Asset Backed Security (ABS) must be administered by the Special Purpose Trust (SPT), created solely for administering the ABS. The trust must terminate upon final distribution of the proceeds of the last series of the ABS. The trustee of the SPT must be independent from and not affiliated with the seller, originator, issuer or any underwriter of the ABS, or any affiliate/subsidiary, director/officer or their relatives up to the 4th degree. The trustee of the SPT can be, but is not required to be, the trust department of a commercial bank.
Duties of the trustee (Special Purpose Trust)	The issuer of the Asset Backed Security (ABS) a) must be a trust' b) should own the asset pool and; c) issue the ABS.	Form and administer the Asset Backed Security (ABS). These duties include holding the assets in the asset pool or the ABS, collecting principal and interest payments from the servicer of the assets and making principal payments to holders, and monitoring the performance of assets in the pool

Rationale: The trustee, in the event of default, must be prepared to act in the best interests of the holders of the asset backed security (ABS). *The rules thus require that the trustee be wholly independent of the other parties involved in the formation, issuance and administration of the ABS.*

Typically, asset backed securities (ABS) trustees have been the trust departments of large commercial banks because of their expertise in performing this function. *The proposed rules allow banks to continue to act as trustees, but does not require the trustee to be a bank trust department, as long as the trustee's independence is not compromised.*

Conveyance	Conveyance to the issuer of the assets forming the asset pool shall be absolute and on a without recourse basis.	Conveyance of the assets to the asset pool shall transfer ownership of those assets to the trust or special purpose vehicle. Conveyance shall be accompanied by an opinion from an independent Certified Public Accountant (CPA) that the transfer constitutes a true sale under generally accepted accounting principles (GAAP). *An agreement requiring the seller/originator of the assets to repurchase/substitute the assets contained in the asset pool for breach of representations or warranties made in the agreement shall not affect the non-recourse nature of the original conveyance.*

Rationale: The transfer of assets *must constitute a "true sale" to ensure that the asset is "bankruptcy remote" and available to support the Asset Backed Security (ABS) as intended, even if the originator or seller of the assets becomes insolvent.*

Additionally, *a provision in the sales agreement that requires the seller or originator to repurchase the or substitute particular assets for bona fide breaches or representations or warranties on the nature or quality of the asset (in contrast to simple default), should not transform the transaction into a recourse transaction.* Repurchase is not a general recourse requirement: for example, repurchase is not generally required upon default and does not reflect retention of credit risk by the seller. Instead, it is usually triggered by the discovery that a particular asset is not what it was promised to be, or occasionally by breach of servicing warranties. The ability of the trustee of special purpose vehicle (SPV) to require repurchase or substitution is necessary to facilitate high volume asset sales.

Credit Enhancements	No equivalent.	Originator/seller/issuer of an Asset Backed Security (ABS) may at any time create a credit enhancement designed to increase the likelihood of payment, if part or in full, of the amounts due to the holders of the security. *The credit enhancement may be provided by the seller, originator, issuer or third party.* More than one type of credit enhancement may be used to support a single ABS.

Rationale: The seller, originator, or issuer of asset-backed securities is given wider latitude to provide a variety of credit enhancements to the security. Credit enhancements may be built into the security structures, or provided by an outside entity. *Enhancements may be provided by the originator or seller*, based on its own creditworthiness, or by an independent third party for a fee. There may be more than one enhancement supporting a security, so that a series of credit enhancements may offer tiers of support for the asset backed security (ABS).

Credit enhancements are not required to ensure that all payments due on the securities are paid on a timely basis: *enhancements may cover non-payment "in full" or "in part"*. Through this, the parties can allocate the credit risks of the transaction in a manner that best suits their particular needs. In addition, *credit enhancements can be created at "any time", which permits an Asset Backed Security (ABS) to be credit enhanced at the time of issuance or any time afterwards.*

Liquidity supports	No equivalent.	Seller/originator of the assets in the pool may agree to make advances to the holders of the Asset Backed Securities (ABS) to cover late payments on the assets, or otherwise compensate holders to compensate for decreased returns caused by late payments.

Rationale: Sellers or originators can provide liquidity supports, and advance or otherwise compensate (i.e. discount adjustments) security holders for shortfalls due to late payments on the assets.

Source: Securities and Exchange Commission (SEC)

Bangko Sentral ng Pilipinas (Central Bank of the Philippines)

Overview. The *Bangko Sentral ng Pilipinas* (BSP) handles the securities issued by banks and institutions. These securities include asset- or mortgage-backed securities issues where the bank plays the role of the originator, the trustee, or the issuer.

Current State. The guidelines of the *Bangko Sentral* (Central Bank of the Philippines) with regard to securitization are a) Circular (No. 185) governing the origination, issuance, sales and servicing of asset-backed securities by any bank or non-bank with quasi-banking functions, including its subsidiaries and affiliates engaged in allied activities and, b) a Memorandum of Agreement between the Securities and Exchange Commission (SEC) and the Bangko Sentral ng Pilipinas with regard to the supervision of institutions issuing Asset Backed Securities (ABS). For perspective, under the Philippines' General Banking Act, the Bankgo Sentral (Central Bank of the Philippines) supervises nonbank financial institutions that engage in quasi-banking activities such as the

Securitization Concerns. The *Bangko Sentral*'s (Central Bank of the Philippines) main concern with regard to mortgage backed securities are a) possible conflicts of interest within banks who have subsidiaries/affiliates that securitize the mortgage loans, b) possible risks to the originating banks, and c) possible risks of mortgage backed securities (MBS) to potential investors. From a macroeconomic perspective, the Bangko Sentral is concerned about the monetary policy implications that will result from wide scale securization initiatives.

The primary concern of the *Bangko Sentral*'s (Central Bank of the Philippines) circular on asset backed securities (ABS) appears to be to keep the loan originator completely distinct and separate from the secondary mortgage institution to avoid a conflict of interest. In particular, this concern appears to be targeted to a) commercial banks that sell their mortgage loans to their investment banks/investment house subsidiaries or affiliates or b) secondary mortgage institutions (SMI) that are subsidiaries of commercial banks, and not towards the development of a private secondary mortgage institution (SMI) that has no affiliation with a particular commercial bank.

KEY HIGHLIGHTS OF BANGKO SENTRAL NG PILIPINAS (CENTRAL BANK OF THE PHILIPPINES) CIRCULAR 185 ON ASSET BACKED SECURITIES

Issue	Bankgo Sentral requirements
Conveyance of Assets	The conveyance of the Assets comprising the Asset Pool shall be done within the context of a "true sale" and, for this purpose, the Seller[551] may not retain in its books the asset backed securities (ABS), except the residual value, if any. The Seller shall have no obligation to repurchase or substitute an asset, or any part of the Asset Pool at any time, except in cases of a breach of representation or warranty. The Seller shall be under no obligation to provide additional assets to the Special Purpose Trust (SPT)[552] to maintain a "coverage ratio" of collateral to outstanding Asset Backed Securities (ABS). A breach of this requirement will be considered credit enhancement and should be charged against capital. Losses of the originator/seller from over collateralization shall be recognized upfront. Securitized assets shall be considered the subject of a true sale between the seller and the Special Purpose Trust (SPT). Sold assets shall be taken off the books of the seller and shall be transferred to the books of the Special Purpose Trust (SPT). For accounting purposes, the transfer shall only be considered a true sale if a) the transferred assets have been isolated and put beyond the reach of the seller and its creditor; b) the Special Purpose Trust (SPT) has the right to pledge or exchange its interest in the assets and; c) the seller does not effectively maintain control over the transferred assets by any agreement.
Third Party Review	A due diligence review by an independent entity mutually agreed upon by the seller and the issuer[553] shall be done before the assets are sold.
Originator and Seller	The Seller may itself be the Originator[554] and may likewise be designated as the Servicer[555].
Trustee and Issuer	The trustee[556] shall be the trust department of a bank licensed to do business in the Philippines. The trustee shall have the right to manage or administer the asset pool. The trustee shall see to it that necessary measures are taken to protect the asset pool.
Underwriter[557]	An expanded commercial bank or investment house shall have written policies and procedures on the underwriting of an Asset Backed Security (ABS). An Underwriter may deal in Asset Backed Security (ABS), except those administered by its trust department, the trust department of its subsidiaries/affiliates, the trust department of its parent bank or the trust department of its parent bank's subsidiaries/affiliates. An expanded commercial bank/investment house may act as an underwriter, on a firm basis, of Asset Backed Securities (ABS) except those administered by its trust department, the trust department of its subsidiaries/affiliates, the trust department of its parent bank or the trust department of its parent bank's subsidiaries/affiliates. The underwriter may not extend credit for the purpose of purchasing the Asset Backed Security which the expanded commercial bank/investment house or its subsidiaries/affiliates underwrite.
Guarantor	Only an entity whose regular business is that of guarantee issuance or similar undertaking can

[551] The Seller is defined as the entity with conveys to the Special Purpose Trust (SPT), or in our case the Secondary Mortgage Institution (SMI), the assets that constitute the asset pool.
[552] The Special Purpose Trust (SPT) is defined as trust administered by a trustee and created solely for the purpose of issuing and administering an Asset Backed Security (ABS).
[553] The Issuer is defined as Special Purpose Trust (SPT) that issues the Asset Backed Security (ABS).
[554] The Originator is defined as the bank, non-bank with quasi-banking functions, and/or its subsidiary or affiliate engaged in allied activities that grants or purchases loans or receivables and assembles them into a pool for securitization.
[555] The Servicer is defined as the entity designated by the issuer primarily to collect and record payments received on the assets, to remit such collections to the issuer and to perform such other services as may be specifically required by the issuer excluding asset management or administration.
[556] The Trustee is defined as the entity designated to administer the Special Purpose Trust (SPT).
[557] The Underwriter is defined as the entity engaged in the act or process of distributing and selling of the Asset Backed Security (ABS) either on guaranteed or best effort basis.

	act as a guarantor.
Credit enhancement	Standby letters of credit, surety bonds and guarantees can be used, other than those issued by the Originator/seller or its subsidiary/affiliate, the Originator/seller's parent bank or subsidiary/affiliate, or the Trustee or its subsidiary/affiliate. To be consistent with the concept or true sale, subordinated securities shall be sold to third party investors other than the originator/seller's parent company or its subsidiary/affiliate or, if held by the seller, capital charges shall be booked upfront. Otherwise, the subordinated securities shall be treated as deposit substitutes subject to legal reserves.
Prohibited Activities	The seller may not, under any circumstances, designate its trust department, the trust department of its subsidiaries/affiliates, the trust department of its parent bank or the trust department of its parent bank's subsidiaries/affiliates as trustee. The trust indenture shall not contain any stipulation whereby the seller, its subsidiaries/affiliates, its parent bank or the parent bank's subsidiaries/affiliates shall commit to extend any credit facility to the issuer and/or trustee. The Asset Backed Security (ABS) shall not be eligible as collateral for a loan extended by a bank/non-bank with quasi-banking functions which originated/sold the underlying assets of such Asset Backed Securities (ABS). The trustee may not designate its subsidiary affiliate, its parent or the parent's subsidiaries/affiliates as servicer or vice-versa.

Source: Bangko Sentral (Central Bank of the Philippines)

Regulation of the Secondary Mortgage Institution (SMI)

The recent memorandum of agreement (MOA) signed by the Securities and Exchange Commission (SEC) and the *Bangko Sentral ng Pilipinas* (Central Bank of the Philippines) states,

> "That while the Securities and Exchange Commission (SEC) has jurisdiction over the sale or offer of asset backed securities (ABS), the *Bangko Sentral ng Pilipinas* (Central Bank of the Philippines) shall regulate the origination, issuance, sale, servicing and administration of asset backed securities (ABS) by any bank/quasi-bank, including its subsidiaries and affiliates engaged in allied activities as well as securitization schemes where the originator/seller is not supervised by the *Bangko Sentral ng Pilipinas* (Central Bank of the Philippines) and the trustee/issuer of the asset backed securities (ABS) is the trust department of a bank or a non-bank financial institution under *Bangko Sentral ng Pilipinas* (Central Bank of the Philippines).[558]"

In the event that both the Secondary Mortgage Institution (SMI) and an Asset Management Company (AMC) are considered quasi-banks by the *Bangko Sentral ng Pilipinas* (Central Bank of the Philippines), then the rules and regulations that will govern the issuance of mortgage backed securities (MBS) will fall under the *Bangko Sentral ng Pilipinas'* (Central Bank of the Philippines) Circular No. 185. Otherwise, if the secondary mortgage institution (SMI) is considered a corporation, then it falls under the regulation of, potentially, the Securities and Exchange Commission's (SEC) proposed rules on the issuance of Asset Backed Securities, which appears to be more favorable to mortgage backed securities (MBS).

[558] Memorandum of Agreement between the Bangko Sentral ng Pilipinas (Central Bank of the Philippines) and the Securities and Exchange Commission (SEC). June 7, 2001. Manila, Philippines.

However, the *Bangko Sentral ng Pilipinas* (Central Bank of the Philippines) has reservations over allowing the secondary mortgage institution (SMI) to be a corporation because securitization creates a multiplier effect in capital markets and money supply with the creation of credit and with the turnover of liquidity. If the secondary mortgage institution (SMI) is under the control of the *Bangko Sentral ng Pilipinas* (Central Bank of the Philippines), the *Bangko Sentral ng Pilipinas* (Central Bank of the Philippines) feels that it will limit the scope of their monetary authority, and hence undermine their constitutional mandate to provide policy direction in banking and credit for the purpose of attaining monetary stability[559].

Given this, it would appear that the *Bangko Sentral ng Pilipinas* (Central Bank of the Philippines) will insist that secondary mortgage institutions (SMI) fall under their rules and regulations. This appears to be the case for investment banks/houses that are subsidiaries of commercial banks or investment houses as Matoto confirmed that the *Bangko Sentral ng Pilipinas'* (Central Bank of the Philippines) Circular 185 has made it difficult for them to put together mortgage backed securities (MBS) deals[560]. In the event that a private secondary mortgage institution (SMI) that is not particularly affiliated to any commercial bank is established, it would seem likely that the *Bangko Sentral ng Pilipinas'* (Central Bank of the Philippines) would insist that it fall under its rules and regulations.

Recourse. In theory, there are two methods by which mortgage loans are sold to a Secondary Mortgage Institution (SMI)[561]: on a non-recourse or a recourse basis. For mortgage loans sold on a non-recourse basis, the secondary mortgage institution (SMI) a) acquires complete ownership over all the future cash flows arising from the mortgage pool and b) assumes all the risks, particularly the default and credit risks, that were borne by the loan originator[562].

When the originator transfers all the ownership rights and thus relinquishes all its claims to the mortgage pool to the secondary mortgage institution (SMI), the SMI is deemed to be "bankruptcy remote". A non-recourse sale of mortgage loans insulate the mortgages from claims by the originator's owners and creditors in the event that the originator goes bankrupt. Given this, a secondary mortgage institution (SMI) is desirable because it is a bankruptcy-remote vehicle that isolates the mortgage from undue claims on the cash flow and protects the interests of investors. For mortgage loans sold on a recourse basis, the

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[559] Reside, Renato S. *Mortgage-Backed Securities in Asia*. Asian Development Bank. 1999. Pasig City, Philippines.
[560] Matoto, Senen L. President of the Investment Houses of the Philippines. *Personal Interview*. June 2001. Makati City, Philippines.
[561] Or for the case of nonperforming mortgage loans, sold to an Asset Management Company (AMC).
[562] Reside, Renato S. *Mortgage-Backed Securities in Asia*. Asian Development Bank. 1999. Pasig City, Philippines.

loan originator chooses to retain some ownership interest, rights, or credit risk in the pool, or is otherwise is required to provide liquidity or insurance for any or all of the secondary mortgage institution's (SMI), risks over the mortgage pool. According to Reside, recourse transactions don't make the assets bankruptcy remote[563]. Under both the *Bangko Sentral ng Pilipinas'* (Central Bank of the Philippines) circular and the Securities and Exchange Commission's (SEC) proposed rule on asset backed securities (ABS), they both require that the conveyance of assets to be a true sale[564], thus without recourse. However, the *Bangko Sentral ng Pilipinas'* (Central Bank of the Philippines) circular and Securities and Exchange Commission's (SEC) proposed rule on asset-backed securities (ABS) appear to diverge with regard to the "scope" of non-recourse. Unlike the Securities and Exchange Commission's (SEC), the non-recourse for the *Bangko Sentral ng Pilipinas* (Central Bank of the Philippines) appears to extend to the credit enhancements as well.

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[563] *Reside, Renato S. Mortgage-Backed Securities in Asia. Asian Development Bank. 1999. Pasig City, Philippines.*
[564] *The Bangko Sentral ng Pilipinas (Central Bank of the Philippines) states that "Securitized assets shall be considered the subject of a true sale between the seller and the Special Purpose Trust (SPT). Sold assets shall be taken off the books of the seller and shall be transferred to the books of the Special Purpose Trust (SPT). For accounting purposes, the transfer shall only be considered a true sale if a) the transferred assets have been isolated and put beyond the reach of the seller and its creditor; b) the Special Purpose Trust (SPT) has the right to pledge or exchange its interest in the assets and; c) the seller does not effectively maintain control over the transferred assets by any concurrent agreement". Meanwhile, the Securities and Exchange Commission's (SEC) proposed rules states that "a) the conveyance of the assets to the asset pool that transfer ownership of those assets to the trust or special purpose vehicle (SPV) and; b) the conveyance shall be accompanied by an opinion from a Certified Public Accountant (CPA) that the transfer constitutes a true sale under generally accepted accounting principles (GAAP)."*

COMPARISON OF RECOURSE/NON-RECOURSE RULES BETWEEN THE BANGKO SENTRAL (CENTRAL BANK OF THE PHILIPPINES) AND THE SEC

Issue	Bangko Sentral	SEC
External credit enhancements	Standby letters of credit, surety bonds and guarantees can be used, *other than* those issued by the Originator/seller or its subsidiary/affiliate, the Originator/seller's parent bank or subsidiary/affiliate, or the Trustee or its subsidiary/affiliate.	Originator/seller/issuer of an Asset Backed Security (ABS) may at any time create a credit enhancement designed to increase the likelihood of payment, if part or in full, of the amounts due to the holders of the security. *The credit enhancement may be provided by the seller, originator, issuer or third party.*
Internal credit enhancements	To be consistent with the concept or true sale, subordinated securities shall be sold to third party investors other than the originator/seller's parent company or its subsidiary/affiliate or, if held by the seller, capital charges shall be booked upfront. *Otherwise, the subordinated securities shall be treated as deposit substitutes subject to legal reserves.* The seller shall be under no obligation to provide additional assets (over collateralization) to the special purpose trust to maintain a "coverage ratio" of collateral to outstanding asset backed securities (ABS). A breach of this requirement will be considered a credit enhancement and should be charged against capital.	As above.

Since there is no functioning private secondary mortgage institution (SMI), the organizations that would be most inclined to engage in mortgage backed securities (MBS) transactions are the local investment banks. However, since the *Bangko Sentral*'s (Central Bank of the Philippines) non-recourse scope seems to include 'credit enhancements', this has made it difficult for investment banks to put together mortgage backed securities (MBS) deals.

In the Philippines, most of these investment banks/houses are either affiliates or subsidiaries of commercial banks. If the conveyance of the mortgage loans to the secondary mortgage institution (SMI)[565] was considered a non-recourse arrangement, then theoretically there would be no issue for these investment banks with regard to offering their own credit enhancements or securing credit enhancements from their parent commercial banks. However, this is not possible under the *Bangko Sentral*'s (Central Bank of the Philippines) rules, as a) all external credit enhancements need to be secured from third parties and; b) investment banks can't invest in subordinated structures[566] otherwise the securities will be considered deposit substitutes and subject to legal reserves.

The *Bangko Sentral*'s (Central Bank of the Philippines) insistence to keep credit enhancements as part of the "non-recourse" scope possibly stems from the *Bangko Sentral*'s (Central Bank of the Philippines) suspicion that commercial banks may use mortgage backed securities (BSP) to create another "informal" repurchase agreements with their buyers to avoid liquidity reserve requirements. Recall that in Chapter 2, Saldana elaborates on the practice of commercial banks to execute "informal" repurchase arrangements with a buyer to repurchase government securities at an agreed date[567]. This practice allows dealers to avoid Documentary Stamp Taxes (DST) and circumvent liquidity reserve requirements for instruments that the *Bangko Sentral* (Central Bank of the Philippines) considers deposit substitutes.

The *Bangko Sentral* (Central Bank of the Philippines) securitization rules seem to imply this. Under the rule of conveyance, it states that "the seller does not effectively maintain control over the transferred assets by any concurrent agreement". Moreover, anecdotal evidence appears to prove that the 'distrust' of

565 Which in this case, is the investment bank/house of the commercial bank.
566 An investment bank's investment in the subordinated structure can be construed as a confidence-building measure for the investor because it gives the impression that the bank stands behind the mortgage backed security (MBS).
567 This "informal" practice was discussed extensively in Chapter 2.

the *Bangko Sentral* (Central Bank of the Philippines) with regard to the 'misuse' of commercial papers will extend to mortgage backed securities (MBS)[568]. According to Limlingan, the Investment Houses Association of the Philippines (IHAP) wanted to securitize assets, and classify these assets as an off balance sheet transaction. However, the group was berated by the *Bangko Sentral* (Central Bank of the Philippines) governor who said he did not want a repeat of the commercial paper case[569].

Matoto says that, as a result of the *Bangko Sentral's* (Central Bank of the Philippines) securitization rules that 'anticipate' the circumvention, is not only clearly prejudicial on the part of the *Bangko Sentral* (Central Bank of the Philippines), but it has also effectively "killed" securitization. For perspective, Matoto points out that no securitization deal has been put together yet since the circular was put out in 1998[570], presumably due to the stringent rules on credit enhancements.

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568 Limlingan, Victor S. Professor at the Asian Institute of Management. Personal Interview. June 2001. Makati City, Philippines.

569 With reference to having informal repurchase agreements for mortgage backed securities (MBS) to avoid liquidity reserve requirements, which was being done with commercial papers.

570 Matoto, Senen L. President of the Investment Houses of the Philippines. Personal Interview. June 2001. Makati City, Philippines.

571 Which in this case, is the investment bank/house of the commercial bank.

572 An investment bank's investment in the subordinated structure can be construed as a confidence-building measure for the investor because it gives the impression that the bank stands behind the mortgage backed security (MBS).

collateralization) to the investment bank for over collateralization. The *Bangko Sentral* (Central Bank of the Philippines) prefers that credit enhancements be provided by a third party rather than by the originator to avoid the recourse issue[573].

The *Bangko Sentral*'s (Central Bank of the Philippines) insistence to keep credit enhancements as part of the "non-recourse" scope possibly stems from the *Bangko Sentral*'s (Central Bank of the Philippines) suspicion that commercial banks may use mortgage backed securities (BSP) to create another "informal" repurchase agreements with their buyers to avoid liquidity reserve requirements. Recall that in Chapter 2, Saldana elaborates on the practice of commercial banks to execute "informal" repurchase arrangements with a buyer to repurchase government securities at an agreed date[574]. This practice allows dealers to avoid Documentary Stamp Taxes (DST) and circumvent liquidity reserve requirements for instruments that the *Bangko Sentral* (Central Bank of the Philippines) considers deposit substitutes.

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Moreover, anecdotal evidence appears to prove that the 'distrust' of the *Bangko Sentral* (Central Bank of the Philippines) with regard to the 'misuse' of commercial papers will extend to mortgage backed securities (MBS)[575]. According to Limlingan, when the Investment Houses Association of the Philippines (IHAP) wanted to securitize assets, and classify these assets as an off balance sheet transaction. However, the group was berated by the *Bangko Sentral* (Central Bank of the Philippines) governor who said he did not want a repeat of the commercial paper case[576].

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[573] Reside, Renato S. *Mortgage-Backed Securities in Asia.* Asian Development Bank. 1999. Pasig City, Philippines.
[574] This "informal" practice was discussed extensively in Chapter 2.
[575] Limlingan, Victor S. Professor at the Asian Institute of Management. *Personal Interview.* June 2001. Makati City, Philippines.
[576] With reference to having informal repurchase agreements for mortgage backed securities (MBS) to avoid liquidity reserve requirements, which was being done with commercial papers.

Matoto points out that no securitization deal has been put together yet since the circular was put out in 1998[577], presumably due to the stringent rules on credit enhancements.

Perceived conflict of interest. Directly related to the issue of non-recourse is the insistence of the *Bangko Sentral* (Central Bank of the Philippines) to keep each "process" leading towards mortgage backed securitization as "arm's length" as possible. Similar to the non-recourse issue, the difficulty of investment banks to control the entire securitization process as the Bankgo Sentral (Central Bank of the Philippines) requires them to 'frame out' specific functions to different entities makes it difficult to progress with mortgage backed securities (MBS) issuance.

In contrast, the proposed rules of the Securities and Exchange Commission (SEC) are not as stringent with regard to the "processes" leading towards mortgage-backed securitization. Thus, in the event that a private led secondary mortgage institution (SMI) is established, that is not particularly affiliated to a local commercial bank, and it will arguably undergo an easier mortgage backed securitization process versus investment banks.

PROCESS TRANSACTION OF THE BANKGO SENTRAL WITH THE SEC FOR ASSET-BACKED SECURITIES (ABS)

	Bangko Sentral	SEC
Asset Backed Security (ABS) dealing	An underwriter[578] cannot deal with asset-backed securities administered by its trust department, the trust department of its subsidiaries/affiliates, the trust department of its parent bank/parent bank's subsidiaries/affiliates.	No equivalent.
Asset Backed Security (ABS) underwriting	An underwriter cannot administer asset-backed securities (ABS) of its trust department, the trust department of its subsidiaries/affiliates, the trust department of its parent bank/parent bank's subsidiaries/affiliates.	No equivalent.
Asset Backed Security (ABS) credit extension	An underwriter *cannot* extend credit for the purpose of purchasing the asset backed securities (ABS) which it underwrites or is underwritten by	No equivalent.

[577] Matoto, Senen L. President of the Investment Houses of the Philippines. *Personal Interview.* June 2001. Makati City, Philippines.
[578] The underwriter can be an expanded commercial bank or an investment house.

	its subsidiaries/affiliates or its parents bank/parent bank's subsidiaries/affiliates.	
Designation of trustee	Seller[579] *cannot* designate its own trust department, the trust department of its subsidiaries/affiliates, the trust department of its subsidiaries/affiliates, trust department of its parent bank/parent bank subsidiaries/affiliates as trustees.	The special purpose trust (SPT) must be a trustee independent of the seller, originator, servicer, or any underwriter of the asset backed security (ABS), or any affiliate/subsidiary, or director/officer and their relatives up the 4th degree.
Purchase of asset backed securities (ABS) by a trust department	The trust department of a bank that has discretion in the management of any trust or investment account *may not* purchase asset backed securities (ABS) administered by the trust department of the same bank, the trust department of its subsidiaries/affiliates, trust department of its parent bank/parent bank subsidiaries/affiliates as trustees.	No equivalent.

Source: Bangko Sentral (Central Bank of the Philippines), Securities and Exchange Commission (SEC)

Trust or corporation structure

Prior to understanding the benefits of a trust structure or corporate structure with regard to a Secondary Mortgage Institution (SMI), it is instructive to understand the difference between a pass-through and a pay-through structure.

Under a pass-through structure, the mortgage-backed securities (MBS) issued by the secondary mortgage institution (SMI) represent an undivided ownership interest in the asset pool. Thus, the mortgage backed securities (MBS) holders are treated as beneficial owners of the assets. Under a pay-through structure, the mortgage-backed securities (MBS) issued by the secondary mortgage institution (SMI) takes on the form of debt of the issuer rather than ownership interest in the asset pool. A pay-though structure allows the cash flow from the mortgage pool to be structured like a fixed-income security. Thus, the mortgage-backed securities (MBS) are not paid immediately to investors once the mortgage loans in the pool are paid by the homebuyer, but instead on a monthly or quarterly basis to suit investor preference[580]. Given the ability to structure payments according to investors preferences, a pay-through structure is preferred for a secondary mortgage institution (SMI).

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579 The seller can also be the originator and may likewise be designated as the servicer.

The Securities and Exchange Commission's (SEC) proposed rules for asset-backed securities (ABS) allow the special purpose vehicle (SPV) to be either a pass through or pay through organizational structure[581]. The ownership of the assets will be transferred to the special purpose vehicle (SPV) that shall a) own the assets in the asset pool; b) issue mortgage backed securities (MBS) in the form of debt, and; c) pledge the assets and their cash flow to secure the payment of the debt[582].

However, *Bangko Sentral's* (Central Bank of the Philippines) circular only allows a pass through structure for banks and non-bank entities with quasi-banking functions that plan to issue mortgage-backed securities (MBS)[583]. Given that investment banks are presumably the organizations keenest on issuing mortgage backed securities (MBS), these banks will presumably be under the *Bangko Sentral*'s (Central Bank of the Philippines) supervision. If the investment bank is structured as a pay through, the mortgage-backed security (MBS) will be considered a deposit substitute[584]. As a deposit substitute, the security becomes subject to reserve requirements, which effectively increases the intermediary costs of issuing a mortgage-backed security (MBS)[585]. Moreover, the secondary mortgage institution (SMI) will be required to secure a quasi-banking license to issue an asset backed security, a license that the *Bangko Sentral* (Central Bank of the Philippines) has not issued in many years[586]. However, it is yet undetermined if a secondary mortgage institution (SMI) that is not affiliated with any particular commercial bank will fall under the supervision of the *Bangko Sentral* (Central Bank of the Philippines) or the Securities and Exchange Commission (SEC). Although Rustia admits that the treatment of the pay through structure de-motivates securitization, he recommends that the "private sector package something

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580 Reside, Renato S. *Mortgage-Backed Securities in Asia*. Asian Development Bank. 1999. Pasig City, Philippines.

581 The Securities and Exchange Commission's (SEC) proposed rules states that the securities shall be "administered by an independent trustee which (i) represent an undivided ownership in the assets forming the asset pool, or (ii) represent the right of the holder to receive payments from the proceeds expected to be derived from the assets forming the asset pool owned by the special purpose vehicle (SPV) to secure payment to holders of securities."

582 Securities and Exchange Commission. *Commission release proposing rules governing the issuance, sale and administration of asset backed securities*. 2001. Mandaluyong City, Philippines.

583 The *Bangko Sentral's* (Central Bank of the Philippines) circular states that "asset backed securities (ABS) shall refer to certificates issued by a special purpose trust (SPT) representing an undivided ownership in the asset pool."

584 A deposit substitute is defined as an alternative form of obtaining funds from the public other than deposit through the issuance, endorsement, or acceptance of debt instruments for the borrower's own account for the purpose of relending or purchasing of receivables. This would require the secondary mortgage institution (SMI) to secure a quasi-banking license because the contracting of debt to purchase receivables constitutes a quasi-banking activity under Philippine law.

585 Alcid, Andrew D. Executive Vice President, Investment Banking Division of United Coconut Planters Bank. *Personal Interview*. June 2001. Makati City, Philippines.

586 Philippine Conference on Securitization. *Mobilizing the Markets for Securitization: The Case for Asset Backed Securities*. October 1999. Makati City, Philippines.

where the provision of the law is not violated"[587] but presumably offering the same benefits of a pay through structure (i.e. structuring payments on a periodic basis versus paying the security holder every time a mortgage loan in the pool is paid.)

Taxation

The whole process of mortgage-backed securitization in the Philippines is marked by a high incidence of taxation. From the investor's standpoint, the cascading taxes that accrue to the purchaser of mortgage-backed securities (MBS) are such that the potential income that can be derived from the transaction is drastically reduced. From an issuer's standpoint, the aggregate amount of taxes strongly discourage mortgage backed securities (MBS) development as they eventually add to the large transaction costs behind these securities. The prohibitive amount of taxes is further exacerbated by the prevailing uncertainty of the regulatory authorities with regard to the tax treatment of mortgage-backed securities (MBS). Thus, the 1999 Conference on Securitization stated that mortgage-backed securitization would not take off with such an onerous and burdensome tax regime[588].

Thus, conference attendees have batted for a reduction or elimination of these taxes, which they argue would not result in a significant revenue loss or shortfall for the government since the taxes derived from these transactions are very minimal. The following table illustrates the high incidence of taxation involved in mortgage-backed securitization:

Transaction	Details	Applicable taxes	Tax Rates
Constitution of real estate mortgage	Purchase of mortgage on real property from original seller (based on appraised value as transfer value). Constitution of mortgage by mortgagor to mortgagee bank (based on allowed loan value of appraised property)	National taxes Capital gains tax Documentary stamp tax (DST) Municipal taxes Register of Deeds fee Documentary stamp tax (DST)	 6% 1.5% maximum of 0.5% variable 0.2–0.4%
Transfer or assignment of loans secured by the mortgage	–	Documentary stamp tax (DST)	1.5%

[587] Rustia, Andres I. Managing Director of the Asset Management Department of the Bangko Sentral ng Pilipinas (Central Bank of the Philippines). *Personal Interview.* June 2001. Manila, Philippines.
[588] Philippine Conference on Securitization. *Mobilizing the Markets for Securitization: The Case for Asset Backed Securities.* October 1999. Makati City, Philippines.

Mortgage backed securities (MBS) issuance	Issuance of mortgage backed securities (MBS) certificate in the primary Market Interest income earned on such securities Secondary trading of Mortgage backed securities (MBS)	Documentary stamp tax (DST) Final withholding tax Documentary stamp tax (DST)	1.5% 20% no longer taxed[589]
Foreclosure of property	Extra judicial Foreclosure	National taxes Capital gains tax Documentary stamp tax (DST) Municipal taxes Register of Deeds fee	 6% 1.5% maximum of 0.5% variable
Credit enhancements	Home Guaranty Corporation (HGC) guarantee Fidelity bonds Indemnity/Surety bond	Tax break on interest Earnings Documentary Stamp Tax (DST) Documentary Stamp Tax (DST)	Up to 11% of interest on socialized housing[590] earnings are tax free 12% 7%

Source: World Bank 1997; updates from the Tax Reform Act of 1997 (R.A. 8424), Home Guaranty Corporation (HGC)

The following section will discuss the taxes that are involved in the transformation of a mortgage loan into a mortgage-backed security (MBS).

Documentary Stamp Tax (DST). Taxes on financial intermediaries and transactions constitute one of the greatest impediment towards the development of mortgage-backed securities (MBS) in the Philippines. Primary among these taxes is the documentary stamp tax (DST), which hinders both the development of the primary and secondary mortgage market[591]. The documentary stamp tax (DST), which raises the transaction costs of issuing and purchasing the mortgage backed security (MBS), is the most pervasive tax that is imposed on almost all transactions in the securitization process. The documentary stamp tax (DST) is a 1.5% tax that is:

a) Imposed on real estate mortgage;
b) Imposed on deed of sale when purchased by the originator. The total value of the documentary stamp tax is based on the value of each the mortgages conveyed to the

[589] Secondary trading of mortgage backed securities (MBS) has since been exempted from documentary stamp tax (DST). House Bill 12564, passed in December 2000, removing the documentary stamps tax (DST) on the secondary trading of financial instruments and those to be traded at the stock exchange.
[590] Up to 10% of interest for low cost housing, 9.5% for medium cost housing, and 8.5% for open housing.
[591] Reside, Renato S. *Mortgage-Backed Securities in Asia*. Asian Development Bank. 1999. Pasig City, Philippines.

secondary mortgage institution (SMI) (i.e. If 100 mortgages are pooled, each one is hit with a documentary stamp tax (DST));

c) Imposed upon initial issuance of the mortgage-backed security (MBS) from the issuer to the investor.

It is also key to highlight certain gray areas that continue to exist with regard to the tax treatment of mortgage-backed securities. Firstly, mortgage backed securities (MBS) are neither strictly debt or equity, thus there is some a gray area with respect to its tax treatment[592]. Under Philippine tax laws, it is important as to whether or not the security is treated as a debt or equity. In his paper, Reside says that Philippine regulatory authorities will treat mortgage backed securities (MBS) as debt instead of equity, making primary and secondary issues subject to documentary stamp tax (DST)[593] and the gross receipts tax (GRT). However, the treatment of mortgage backed securities (MBS) as debt appears to run counter to the pass-through structure currently allowed by the *Bangko Sentral* (Central Bank of the Philippines), which represents an undivided interest in the asset pool.

According to Finance Assistant Secretary Paul, one of the Department of Finance's (DOF) initiatives is to propose the removal of documentary stamp taxes (DST) on presumably all related processes which lead to mortgage backed securities (MBS) issuance as part of a financial sector tax reform package in the current congress[594]. However, Jacob believes that this might be difficult to remove as the documentary stamp tax (DST) continues to be a revenue generating mechanism for the government[595].

The 1999 Philippine Conference on Securitization succeeded in partially removing the burden of documentary stamp taxes (DST) on secondary trading of mortgage-backed securities (MBS). House Bill 12564 was passed in December 2000, removing the documentary stamp tax (DST) on the secondary trading of financial instruments and those to be traded at the stock exchange[596]. The House Bill amended

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[592] Reside, Renato S. *Mortgage-Backed Securities in Asia.* Asian Development Bank. 1999. Pasig City, Philippines.

[593] Secondary trading of mortgage backed securities (MBS) has since been exempted from documentary stamp tax (DST). House Bill 12564, passed in December 2000, removing the documentary stamps tax (DST) on the secondary trading of financial instruments and those to be traded at the stock exchange.

[594] Paul, Jeremias N. , Jr. Department of Finance Assistant Secretary. *Personal Interview.* June 2001. Manila, Philippines.

[595] Jacob, Monico. Former Home Development Mutual Fund (HDMF)/*Pag-Ibig* Chairman and Conference Chairman of the Philippine Conference on Securitization. *Personal Interview.* June 2001. Makati City, Philippines.

[596] Philippine Conference on Securitization. *Mobilizing the Markets for Securitization: The Case for Asset Backed Securities.* October 1999. Makati City, Philippines.

Section 198 of the National Internal Revenue Code on "the stamp tax on assignments and renewals of certain instruments and treatment of derivative instruments."

The amended bill states: "No documentary stamp tax (DST) shall be collected on the said assignment, transfer, renewal or continuance if there is no change in the maturity date or remaining period of coverage from that of the original instrument, provided further that no documentary stamp tax (DST) shall be collected on asset-backed securities and any other derivative or secondarily traded instrument of which the underlying asset or primary financial instrument was already subjected to a documentary stamp tax (DST) on primary issuance."

Double taxation of the Secondary Mortgage Institution (SMI). A privately led secondary mortgage institution (SMI) established in the Philippines may be subject to double taxation under Philippine tax laws[597]. According to Reside, large and mature secondary mortgage institutions (SMI) typically have large flows of expenditures and revenues pass through their books through a variety of instruments. Given this, the tax authorities might excessively tax the operations.

For example, the secondary mortgage institution (SMI) will have a significant amount of (interest) income and (interest) expenditure flowing through its books. In the event that the tax authorities a) treat the interest income generated by the secondary mortgage institution (SMI) (through the secondary mortgage institution's (SMI) pass-through spreads) as taxable income and b) does not consider the interest expense incurred by the secondary mortgage institution (SMI) (in regularly paying out coupons to the mortgage backed securities (MBS) holders), then this will constitute double taxation which would significantly hamper securitization efforts.

Capital gains tax. For the mortgage loan originator, one of the key issues is the tax implication of the conveyance of the mortgages to the secondary mortgage institution (SMI) in the secondary mortgage markets[598]. If the mortgage loans are considered as conveyed through the normal course of business, any capital gains from the transfer may be construed as the tax authorities as taxable revenue. However, if the mortgage loans are conveyed at a loss or at a discount, the tax authorities may argue that the sale of the mortgages is not in the ordinary course of business and, thus, is not considered tax-deductible. Reside argues that to simplify tax administration, the mortgage loans should be transferred at book value to make the conveyance from the originator to the secondary mortgage institution (SMI) tax neutral.

[597] Reside, Renato S. *Mortgage-Backed Securities in Asia*. Asian Development Bank. 1999. Pasig City, Philippines.
[598] Reside, Renato S. *Mortgage-Backed Securities in Asia*. Asian Development Bank. 1999. Pasig City, Philippines.

Other Taxes

For the homebuyer. The other taxes levied on mortgage backed securities, such as withholding taxes, income tax, and gross receipts tax (GRT), are costs that the financial intermediaries may choose to pass on to the potential homebuyers in the primary mortgage market. Effectively, this would run counter to the objective of mortgage backed securitization, which is to bring down the costs of borrowing money for a mortgage loan for a homebuyer.

For the investor. There are two key disincentives for potential investors in mortgage backed securities (MBS): the withholding tax from the interest income as a result of holding a mortgage backed security and the capital gains taxes levied on the disposal of the mortgage backed securities (MBS) in the secondary mortgage market[599]. Moreover, the *Bangko Sentral* (Central Bank of the Philippines) has ruled that bank-originated mortgage backed securities (MBS), will not be considered as deposit substitutes. Thus, mortgage backed securities (MBS) investors will be exempt from paying a withholding tax, but will have to pay corporate income tax.

For perspective, the following is the income tax scale that will be levied on investors from any gain from the sale of mortgage-backed securities (MBS):

a) 33% on net for domestic and resident foreign corporations;
b) 33% on gross for non-resident foreign corporations;
c) Graduated rates of 5% to a maximum of 33% on net for citizens, resident aliens and non-resident aliens engaged in trade or business and;
d) 25% on gross for non-resident aliens not engaged in trade or business (These rates are subject to the provisions of the applicable tax treaty).

For the secondary mortgage institution (SMI). In the event that mortgaged property[600] conveyed to a secondary mortgage institution (SMI) undergoes foreclosure, the following are the taxes involved[601]:

[599] Reside, Renato S. *Mortgage-Backed Securities in Asia.* Asian Development Bank. 1999. Pasig City, Philippines.
[600] A mortgaged property that is an ordinary asset.

a) Expanded Withholding Tax of 1.5% to 5% of selling price if the seller is habitually engaged in the real estate business; otherwise the withholding tax is 7.5%[602];

b) Documentary Stamp tax (DST) of P15.00/US$0.28 for every P1,000.00/US$19 consideration, based on the highest bid price and;

c) Transfer of real property ownership tax of 0.5% of 0.75% of consideration of fair market value, whichever is higher.

Summary of taxes for both the loan originator and the mortgage backed securities (MBS) investor. The following table traces the incidence of taxation and clarificatory taxation issues for the aforementioned parties, based on a presentation during the 1999 Philippine Conference on Securitization[603]:

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[601] Philippine Conference on Securitization. *Mobilizing the Markets for Securitization: The Case for Asset Backed Securities*. October 1999. Makati City, Philippines.

[602] If we are to assume that the secondary mortgage institution (SMI) is not considered as habitually engaged in the real estate business, the expanded withholding tax would be 7.5%.

[603] Philippine Conference on Securitization. *Mobilizing the Markets for Securitization: The Case for Asset Backed Securities*. October 1999. Makati City, Philippines.

Step	Tax/es	Issue
Assignment/sale of assets (receivables) by the Originator to the Secondary Mortgage Institution (SMI)	Income tax	This is not usually the subject of income tax because the originator will sell the receivables at either face value or at a discount. However, if the receivables sold/assigned are installment receivables, of which the sale and the corresponding receipt of payment will trigger income realization. The discount is a deductible business loss
	Gross Receipts tax (GRT)	If the originator is a bank, then the receipt of payment from the Secondary Mortgage Institution (SMI) will trigger Gross Receipts Tax (GRT) liability.
	Value Added Tax (VAT)	The sale of receivables is not subject to Value-Added Tax (VAT).
	Documentary Stamp Tax (DST)	It is not subject to Documentary Stamp Tax (DST) because it is not a borrowing transaction, being without recourse. The assignment of mortgages is presently subject to Documentary Stamp Tax (DST).
Issuance by the Secondary Mortgage Institution (SMI) of the Asset-Backed Security (ABS)	Documentary Stamp Tax (DST)	The issuance is not subject to Documentary Stamp Tax (DST) under Section 180 of The National Internal Revenue Code of 1997[604] because it is not considered a depository substitute. However, the Department of Finance (DOF) has claimed that, whether it is a pass through or pay through, the initial issuance of asset-backed security (ABS) will be subject to documentary stamp taxes (DST).

[604] "SECTION 180. *Stamp Tax on All Bonds, Loan Agreements*, Promissory Notes, Bills of Exchange, Drafts, Instruments and Securities Issued by the Government or Any of its Instrumentalities, Deposit Substitute Debt Instruments, Certificates of Deposits Bearing Interest and Others Not Payable on Sight or Demand. - On all bonds, loan agreements, including those signed abroad, wherein the object of the contract is located or used in the Philippines, bills of exchange (between points within the Philippines), drafts, instruments and securities issued by the Government or any of its instrumentalities, deposit substitute debt instruments, certificates of deposits drawing interest, orders for the payment of any sum of money otherwise than at sight or on demand, on all promissory notes, whether negotiable or non-negotiable, except bank notes issued for circulation, and on each renewal of any such note, *there shall be collected a documentary stamp tax of Thirty centavos (P0.30/US$0.0057) on each Two hundred pesos (P200/US$3.73), or fractional part thereof, of the face value of any such agreement*, bill of exchange, draft, certificate of deposit, or note: Provided, That only one documentary stamp tax shall be imposed on either loan agreement, or promissory notes issued to secure such loan, whichever will yield a higher tax: Provided, however, That loan agreements or promissory notes the aggregate of which does not exceed Two hundred fifty thousand pesos (P250,000/US$4,720) executed by an individual for his purchase on installment for his personal use or that of his family and not for business, resale, barter or hire of a house, lot, motor vehicle, appliance or furniture shall be exempt from the payment of the documentary stamp tax provided under this Section."

[605] SECTION 178. *Stamp Tax on Certificates of Profits or Interest in Property or Accumulations*. - On all certificates of profits, or any certificate or memorandum showing interest in the property or accumulations of any association, company or corporation, and on all transfers of such certificates or memoranda, *there shall be collected a documentary stamp tax of Fifty centavos (P0.50/US$0.0094) on each Two hundred pesos (P200/US$3.77)*, or fractional part thereof, of the face value of such certificate or memorandum.

		It is doubtful if the Secondary Mortgage Institution (SMI), if it considered a trust, will be subject to Section 178 of the Code[605] because it is not an association, company or corporation.
Investment of Funds/Administration of the Secondary Mortgage Institution (SMI)	Withholding tax	The income of investible funds from investments in Government Securities or deposit substitute instruments consisting of discounts from issuance wise subject to a 10% withholding tax. However, this is a tax on the investors holding an undivided interest in the Asset Pool of the Secondary Mortgage Institution (SMI), not a tax on the Secondary Mortgage Institution (SMI).
Distribution to Investors	Withholding tax	The distribution of income by the Secondary Mortgage Institution (SMI) to investors is subject to a 20% final withholding tax imposed on yield and other monetary benefits from the trust fund and similar arrangements. The rate is increased to 25% and 33% if the recipients are non-resident aliens not engaged in trade or business and non-resident foreign corporations, respectively.
	Income tax	However, the mortgage backed security (MBS) is not subject to income tax if: Distribution of income has already been subjected to a 20% final withholding tax Distribution of income to individual investors where the mortgage backed security (MBS) qualifies as a long-term deposit or investment certification. Distribution of income where mortgage backed security is guaranteed by the Home Guaranty Corporation (HGC), up to 11% of the interest income distributed[606]. Distribution to tax exempt investors such as employee retirement funds, Government Service Insurance System (GSIS), Social Security System (SSS), foreign governments, financial institutions owned, controlled or enjoying refinancing from foreign governments, and international or regional financing institutions established by foreign governments.

Source: October 1999 Philippine Conference on Securitization

Summary of taxes for the secondary mortgage institution (SMI). The following table describes specific income tax related issues that directly impact the operations of the secondary mortgage institution (SMI), based on a presentation during the 1999 Philippine Conference on Securitization[607].

[606] Up to 10% of interest for low cost housing, 9.5% for medium cost housing, and 8.5% for open housing.

Step	Tax/as	Issue
Assignment/sale of assets (receivables) by the Originator to the secondary mortgage institution (SMI)	Income Tax	There is no income tax levied because it is only an outright purchase of mortgages. The discount of mortgage loans is not considered interest income to the secondary mortgage institution (SMI) because sale of receivables is not a borrowing transaction.
Distribution to mortgage backed securities (MBS) investors	Income Tax	The Secondary Mortgage Institution (SMI) is not subject to income tax or Gross Receipts Tax (GRT) on the interest income derived because it is a pass-through security.

Source: October 1999 Philippine Conference on Securitization

Legal Issues

Maceda Law. The *Maceda* Law (Republic Act 6552) governs residential property loans that are amortized in installments. Both mortgages and contracts-to-sell (CTS) are covered by the *Maceda* Law. Homebuyers in default whose contracts have been canceled, but who still have two years' worth of installments, are entitled under the *Maceda* law to a full refund of the cash value of payments made up to the fifth year, and 5% every year thereafter[608].

Furthermore, the *Maceda* Law entitles the homebuyer to a grace period of one month for each year of installment payments made to pay for the unpaid installments without additional interest. If less than two years of installments have been paid, the grace period shall be two years, within which the homebuyer may sell his rights or assign them to another person. The *Maceda* Law becomes an impediment towards securitization because it creates an uncertain cash flow stream on the mortgage-backed security (MBS). The uncertain cash flow can prevent potential investors from purchasing mortgage-backed securities (MBS) due to the 'uncertainty' risks involved.

However, Jacob does not perceive the Maceda Law to be a barrier, but rather as an advantage for mortgage-backed securities (MBS)[609]. Firstly, Jacob presumes that if a homebuyer has been amortizing over the past two years, the probability of default will already be highly unlikely. Second, in the event that the trustee of a secondary mortgage institution (SMI) recovers the property from the homebuyer, the

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[607] Philippine Conference on Securitization. *Mobilizing the Markets for Securitization: The Case for Asset Backed Securities*. October 1999. Makati City, Philippines.
[608] Reside, Renato S. *Mortgage-Backed Securities in Asia.* Asian Development Bank. 1999. Pasig City, Philippines.
[609] Jacob, Monico. Former Home Development Mutual Fund (HDMF)/*Pag-Ibig* Chairman and Conference Chairman of the Philippine Conference on Securitization. *Personal Interview.* June 2001. Makati City, Philippines.

trustee can re-sell the property at a higher price given that the property has presumably increased in value. Nonetheless, although these measures to mitigate uncertainty of cash flow, the potential mortgage backed securities (MBS) investor is still subject to the uncertainty risk.

SUMMARY OF MACEDA LAW

Action	Description
Complaint	To be filed in court; if there are grounds for foreclosure, court orders principal, interest, and other costs to be paid to mortgagee.
Sale	Property can be sold if mortgagor is still in default 90 days from date of judgment. Sale of foreclosed property is subject to capital gains tax of 6% of gross selling price or current fair market value, as well as documentary stamp tax of 1.5%. Estimated total cost of foreclosure to the seller: around P30,000/US$566 per property.

Source: Asian Development Bank

Extra-Judicial Foreclosure Law. The Extra-Judicial Foreclosure Law (Republic Act 3135) governs regular mortgages. The foreclosure law entitles the debtor and his successors in interest to redeem foreclosed property within one year from the date of sale[610]. Similar to the Maceda law, the foreclosure law creates an uncertain cash flow for the potential mortgage backed securities (MBS) investors because a) there is no guarantee for the secondary mortgage institution (SMI) that there will be complete and certain recovery of the value of the foreclosed assets and; b) the prohibitive costs and length of time associated with foreclosure.

SUMMARY OF EXTRA-JUDICIAL FORECLOSURE LAW

Action	Description
Notice of sale	Property can be sold if mortgagor is still in default 90 days from date of judgment. Sale of foreclosed property is subject to capital gains tax of 6% of gross selling price or current fair market value, as well as documentary stamp tax of 1.5%. Estimated total cost of foreclosure to the seller: around P30,000/US$566 per property.
Sale	By public auction, under the direction of the sheriff, justice, or auxiliary justice of the province. Sale of foreclosed property is subject to capital gains tax of 6% of gross selling price or current fair market value, as well as a documentary stamp tax (DST) of 1.5%. Estimated total cost of foreclosure to the seller: around P30,000/US$566 per property.
Debtor's rights	Right to redeem property within one year of sale. Right to petition that sale be set aside and writ of possession canceled should courts later determine that mortgage was not violated.
Obligation of purchaser of foreclosed property	Bond equivalent to 12 months' use of property to indemnify debtor in case it is proven that sale violated mortgage or requirements of Foreclosure Law.

Source: Asian Development Bank

[610] Reside, Renato S. *Mortgage-Backed Securities in Asia.* Asian Development Bank. 1999. Pasig City, Philippines.

Prohibitive costs of foreclosure. In the cases of both the Maceda law and the Extra-judicial foreclosure law, the prohibitive foreclosure costs serve as a disincentive for institutions (in the case of secondary mortgage institutions (SMI), their trustee) owning the non-performing assets to dispose these assets in a timely manner. However, the costs of foreclosure appear to be more onerous for publicly- versus privately originated mortgages. Given the scope of non-performing loans (NPLs) of the National Home Mortgage Finance Corporation (NHMFC)[611], the average costs of P30,000 (US$566) per foreclosure (i.e. inclusive of foreclosure-related taxes and publication of sale of foreclosed properties) are prohibitive[612]. On the other hand, Limlingan reports foreclosure is relatively easier for private banks on their middle-income housing portfolio as the banks have already made previous arrangements with both the lawyers and the sheriffs. Limlingan relates that it usually takes a week to foreclose on these defaulting loans. Rather, the high cost housing (i.e. above P50 Million (US$943,000)) are those that are more difficult to foreclose on as these homebuyers can afford to hire lawyers to delay foreclosure proceedings[613].

Lack of title insurance

Overview. To provide a better understanding behind the lack of title insurance in the Philippines, there is a need to explain the legal documents that signify proof of ownership. The principal proof of ownership of a title that a homebuyer owns the lot/house and lot that he/she purchased is the Transfer Certificate of Title (TCT) registered in his/her name. These are the titles issued under the Torrens system of registration by the government, through the Register of Deeds. Under the Torrens system of registration, the rights acquired by the registrant are guaranteed by the government[614]. However, title verification is necessary because there have been numerous cases of titles being sold by unscrupulous developers or being resold where the titles have liens or encumbrances, title defects, forgery, falsification and other similar legal defects. The scale of the widespread title falsification came to light during a fake land-titling racket that was brought to the attention of Congress in March 1999[615]. Anecdotally, Manicio relates that even the National Home Mortgage Finance Corporation (NHMFC) has had to backtrack 2 or 3 times to verify the genuineness of the title insurance (and despite the backtracking, there are still fake titles)[616]. The massive faking of land titling was found to be prevalent not only in Metro Manila, but also in the

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611 Approximately 50% of their P42 Billion (US$792 Million) portfolio are non-performing loans.
612 Manicio, Eduardo T. Vice-President, Funds Generation Group of the National Home Mortgage Finance Corporation (NHMFC). *Personal Interview.* June 2001. Makati City, Philippines.
613 Limlingan, Victor S. Professor at the Asian Institute of Management. *Personal Interview.* June 2001. Makati City, Philippines.
614 Tan, Edward L. *Real Estate in the Philippines.* Solar Publishing Corporation. 1999. Manila, Philippines.
615 Manila Bulletin. *Solons act on fake land titles.* March 29, 1999. Manila, Philippines.
616 Manicio, Eduardo T. Vice-President, Funds Generation Group of the National Home Mortgage Finance Corporation (NHMFC). *Personal Interview.* June 2001. Makati City, Philippines.

other parts of the country as well. Thus, the Torrens system has since been reduced to an unreliable guarantee of ownership of real property.

Current State. In September 2000, both houses of Congress attempted to pass a bill[617] to that would solve the fake land-titling problem through the institution of land title insurance, by amending the Insurance Code to include land titles[618]. The bill proposes the creation of a land title insurance system that would protect landowners from fly-by-night real estate developers. The policy was to protect the insured from title defects, forgery, falsification and similar unlawful acts. The land insurance policy is supposed to guarantee real estate buyers some form of compensation should a defect in their land titles be discovered later. The bill would task the Insurance Commission to issue guidelines specifying the risk premiums to be charged by insurance firms for different insurance contracts. The measure also allows companies not otherwise disqualified by law to engage in the title insurance business.

To complement the title insurance initiatives, another pending bill in Congress is the Special Procedures for the reconstitution of Torrens Certificate of Title lost or destroyed (HB 6580). Among other this, this bill proposes that the faking of land titles be considered as a heinous crime[619]. Businessworld reported that the American National Financial, Inc. (ANFI), one of the larger outfits involved in underwriting land title insurance in the United States, is reviewing the possibility of lending their expertise in any transfer of technology that the venture would require for land titling[620]. There is also a private sector initiative to provide title insurance which is centrally administered to protect innocent buyers. Jacob proposed that a central deposit for titles and mortgages assumed to have gone through a due diligence process with the banks, originators and then upload them to a central depository. This can be modernized or computerized. Through this process, securitization can be performed and can be easily attached with a title insurance. Moreover, this can be done even without legislation[621]. However, the private sector led title insurance has yet to materialize[622]. Despite the lack of title insurance, Matoto says that the key players are willing to live with this risk when they securitize mortgage loans[623].

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617 Lower House bill 11974 and Upper House Senate Bill 1689.

618 Manila Bulletin. *Bill to stop fake land titling pushed.* September 4, 2000. Manila, Philippines.

619 Manila Bulletin. *Solons act on fake land titles.* March 29, 1999. Manila, Philippines.

620 Aquino, Norman P. *Bill proposes land title insurance.* Businessworld Publishing Corporation. August 24, 1999. Manila, Philippines.

621 Philippine Conference on Securitization. *Mobilizing the Markets for Securitization: The Case for Asset Backed Securities.* October 1999. Makati City, Philippines.

622 Paul, Jeremias N. , Jr. Department of Finance Assistant Secretary. *Personal Interview.* June 2001. Manila, Philippines.

623 Matoto, Senen L. Executive Director of the Financial Executives of the Philippines. *Personal Interview.* June 2001. Makati City, Philippines.

8 *RECOMMENDATIONS FOR THE DEVELOPMENT OF THE SECONDARY MORTGAGE MARKET IN THE PHILIPPINES*

Primary Mortgage Market

If broadening access to housing finance is the main objective in creating a secondary market, then great attention must be paid initially and on an ongoing basis to primary market issues. These include loan product design, origination channels and credit risk, as opposed to other financial risks. Unless these issues are addressed adequately, then the primary market will not produce a sufficient volume of loans or sufficient credit quality to allow sustainable secondary market development.

In a presentation by former Finance Undersecretary Romeo Bernardo in the October 1999 Philippine Conference on Securitization, he said that studies indicated that the Philippine mortgage market is large enough to need the liquidity provided by a Secondary Mortgage Institution (SMI). In the development of the secondary mortgage market, we must take into consideration the idiosyncrasies of the local primary mortgage market:

Primary Mortgage Market Considerations in Developing a Secondary Mortgage Institution

Factors Affecting the Primary Mortgage Market	Low-cost housing	Middle- to upper-class housing
Mortgage quality	Many low quality mortgages due to poor origination standards and low collection efficiency by contractual savings institutions. Private sector proposes to improve Standards for securitization purposes.	Better-quality mortgages and stricter origination and servicing by banks.
Interest rates	Three-tiered fixed interest rate system based on loan amount. Floating rates mulled by government to attract private sector funding.	Floating Rates
Tenor	Up to 25 years	Up to 10-15 years
Mortgage Insurance	None	Provided by HGC
Political economy of reform	Government is trying to shift away from a system where it bears all the risks to a system where risks are shared by public and private sectors. Some opposition to stricter lending standards from developers.	

Source: Mortgage-Backed Securities in Asia

Improvement in origination and servicing of mortgage loans. This includes improving underwriting and screening processes, which needs to be strengthened industry-wide, particularly in the public institutions. Capital markets will rely on the ability of borrowers to pay their debts, and originating and servicing institutions to pass on such payments to investors in a timely manner with attractive rates of return. In a securitization transaction, the capital market participants (investors, financial guarantee firms, and the SPV that issues the MBSs) shoulder much of the credit risk. Since none of these parties is expected to come face-to-face with the actual borrower, they will mostly rely on the integrity of the underlying mortgages when deciding whether or not to purchase MBSs.

Origination and servicing standards may be improved through prudent investments in human capital and technology. A wide geographic dispersion of collecting agents facilitates servicing. Appraisal standards also need improvement.

Recent initiatives by primary mortgage lenders to crosscheck borrower credit histories with other institutions should continue when the MBSs market is developed. Also laudable is the system of rewards instituted by Pag-ibig for developers who succeed in reducing nonperforming assets and arrears. Much more creativity is needed to design incentives that reward good behavior throughout the MBSs process. It is important that there is adoption of minimum standards in the documentation process. Standardization will create a more efficient process towards mortgage-backed securitization. But more importantly, it will also bring down transaction costs from origination to securitization.

The October 1999 Philippine Conference on Securitization recommended that:

- Trade organizations for both housing and finance should coordinate with regulatory agencies to adopt minimum or common standards for documentation, due diligence, and disclosure.
- Push legislation for reforms/computerization of the Land Registration Administration (LRA) and the various Registers of Deeds.
- Solicit developer support for origination
- Low-cost housing developers, through the October 1999 Philippine Conference on Securitization, recommended that they were willing to share the risks with banks on housing projects to improve the credit risk rating.

B. Secondary Mortgage Market

Our thesis has covered a broad range of topics relating to the feasibility and viability of establishing a secondary mortgage market in the Philippines.

- Mortgage origination process;
- Investor, rating agency and credit enhancement issues;
- Role of the public and private sector;
- Role and development of the Secondary Mortgage Institution (SMI);
- Legal, tax and accounting issues; and
- Prerequisites for secondary mortgage market development; and
- Benefits of Securitization

1.1 Mortgage Origination Process

Standardization. A key primary market characteristic is standardization of the mortgage instrument. There can be many types of mortgages present in the housing finance system, but only those with sufficient volume are candidates for sale and securitization.

In order to reduce the transactions costs of evaluating mortgage loans and the processing costs of issuing and administering MBS, the characteristics (e.g., rate adjustment, amortization schedule, term) of the mortgages should be uniform. In addition, standardized documentation must be available for all loans.

Along with standardization of mortgage instrument and design, the underwriting of mortgages should be performed in a comprehensive and consistent manner. The underwriting process establishes guidelines ensuring that a borrower has the ability and the willingness to repay the debt and that the property provides sufficient security for the mortgage.

Assessment of the ability to pay generally consists of relating borrower income, assets, liabilities and net worth to proposed mortgage payments and overall housing expenses. Debt-to-income guidelines help to standardize underwriting. Willingness to pay is based on the down-payment (borrower investment in the property) and credit history. The appraisal determines the value of the property through examination of the sales prices of similar properties construction costs of new properties and market conditions and trends.

The servicing of mortgages is a critical component of a viable secondary mortgage market. The collection of mortgage payments and the periodic remittance of these payments to the investor (or conduit) is the major task of servicers (whether they are originator or third parties). IN addition, servicers are the primary repository of information the mortgage loans. Thus, they must maintain accurate and up to date information on mortgage balances, status and history and provide timely report to investors.

Ultimately, the attractiveness of mortgages and MBS depends on the ability of investors to understand the instruments and quantify their risk and return potential. Standardization of mortgage instruments is an important step in reducing the information costs to investors. In addition, historical performance data on mortgage payments (e.g., default and prepayment) is important in risk assessment. Because of the importance of data in the assessment of risk, the demand on servicers (and conduits) are potentially great. These institutions must be able to process and disseminate large amounts of information. Thus, they must develop effective automated management information systems.

An important part of the servicing is establishment of clear guidelines for the collection of mortgage payments. The documents must spell out payment obligations (dates, amounts, terms of adjustments, obligations for taxes and insurance) and procedures to be followed in the even of default. Although lender discretion in working with borrowers is an important part of the collection process, third party investors must know what those procedures are before making their investment (in order to assess the degree of default risk) and what latitude exist in dealing with the borrower (e.g., forbearance or restructuring). Servicers also must make decisions about and implement procedures leading to foreclosure and repossession in the case of defaulted loans.

Install the appropriate infrastructure such as (1) adopting delivery versus payment clearing and settlement system; (2) posting transactions on a real-time basis on a public medium (i.e. stock exchange) and; (3) having a credible and reliable bond rating system. Have large institutional investors, such as the contractual savings institutions, as market makers. Remove the tax disincentives, particularly the DST.

The newly installed Arroyo administration has prioritized the passage of an Investment Company Act for congress when it begins sessions in end-July 2001 to promote a fair, orderly, and efficient capital market in order to provide the private and public sectors with access to funds vital to the development of the national economy. Among the other bills she plans to prioritize are a personal equity requirement bill, the investment company bill, and the securitization bill. The objective of these bills is to promote long-term savings, mobilization through mutual funds, common trust funds, and other such forms of unit trust investment in a bid to expand long-term fixed income market.

Where should the origination guidelines emanate from?
Origination guidelines should be set and emanate from the SMI. Again, banks will 'follow the money'. If selling their mortgage loans to the SMI is a lucrative proposition versus the option of keeping the loans on their portfolio or securitizing themselves, then they will adopt the underwriting guidelines.

1.2 Investor, Rating Agency and Credit Enhancement Issues

Credit Ratings. Attracting investors will be a major task for the Philippine securitization markets. Ratings and credit enhancement are important means to attract investors as they provide independent assessments of the credit risks of MBS and provide a measure of investor protection. As securitizations are issued from vehicles with no track record, investors look to ratings to get reassurance that they will get their principal and interest on time. Therefore, obtaining high credit ratings from credible rating agencies should be a major objective for Philippine securitizations. Such ratings can be obtained if a number of rating agency concerns can be met. These include: availability of asset performance and issuer portfolio performance information, legal and regulatory isolation of the transaction structure from bankruptcy of the seller, presence of quality servicers and the ability to change them if necessary, availability of credit enhancement, and the ability to pierce the sovereign ratings of the Philippines.

One key constraint for the Philippines is the fact that its domestic rating agency CIBI is still struggling to establish its reputation and its ratings do not yet affect significantly the pricing of securities. We encourage efforts to strengthen CIBI in any way possible. In addition, we believe that domestic investors should have additional rating opinions available to help them make prudent investment decisions. We recommend the following:

1. SEC encourages foreign rating agencies to establish a presence in the Philippines by easing capital and domestic ownership requirements for this purpose.
2. SEC permit the use of non-Philippine ratings from overseas rating agencies for domestic MBS.

Credit Enhancements. Another means to attract investor interest is to use third party guarantees. We believe that financial guarantees would benefit domestic investors and other market participants. We recommend the following:

1. Leverage the use of the Asian Development Bank's capital for partial credit guarantees. A combination of multilateral and private sector guarantees, such as from the ADB and another private sector guarantee, to achieve triple-A international ratings. Borrowers in non-investment grade countries need partial credit guarantees from multilateral institutions to achieve triple-A ratings because financial guarantee companies can typically guarantee only those transactions which are rated investment grade -- triple-B or better -- before the guarantee, a level which such borrowers cannot easily achieve for international financings.

Investor Regulations and Education. Another means to attract investors is through regulations that facilitate investments in MBS. To attract major domestic investors, make regulations more clear and helpful for investing in MBS. From discussions with some investors, we found that they were not sufficiently familiar with the deals in the market and had many concerns, some of which may be possibly address with regulatory clarifications or better information. We also found that some investors were not sufficiently familiar with deals in the market and had many concerns, some of which may be possible to dispel with regulatory clarifications or better information. Such observations lead us to believe that in the Philippines, a process of investor education on securitizations is necessary. We recommend the following:

1. The government should help the government foster investor confidence by encouraging the industry to promote investor education through seminars, discussion groups, and other educational events or informal exchanges.

One of the resolutions from the October 1999 Philippine Conference on Securitization was the need for "investor" education with regard to MBS as both an investment and a financing tool. Thus, there was a recommendation for a concerted effort by such groups as the Bankers Association of the Philippines (BAP), the Investment Houses Association of the Philippines (IHAP), and the Financial Executives of the Philippines (FINEX), the Capital Markets Development Council (CMDC) and other concerned agencies to support and conduct institutional advocacy and investor education programs for MBS. Moreover, there is also a need to get funding support for advocacy/education programs from multilateral institutions such as the World Bank/IMF.

Changing short-term orientation. Aside from educating the investors, the Department of Finance (DOF) is also trying to create an investment atmosphere that is more conducive to long-term financial investments. Thus, it has initiated a shift from short-term bills in the effort of developing the long-term bond market, according to the October 1999 Philippine Conference on Securitization.

According to former Finance Undersecretary Romeo Bernardo, banks provide most of the capital for housing. But banks are not suited for this due to the short-term nature of their liabilities. On the other hand, contractual savings institutions (i.e. pension funds, insurance companies) have long-term liabilities to match the long-term funding needs for housing. Thus, for the SMI to be viable, the anchor investors should be the contractual savings sector. Investments in MBS are ideal for contractual savings institutions because of:

- Better matching of assets and liabilities.
- Better quality and more varied investment-grade securities
- Better rates of return on CSI's loans and investment portfolios.

Working with Rating Agencies, Credit Enhancers and Investors. Rating agencies, credit enhancers and investors need detailed information on the performance of residential mortgage assets on a historical and an on-going basis. Seller/servicers and others in the Philippines generally tend to be reluctant to share such information. The reasons are understandable: high costs of gathering the data from internal files, long time it may take to gather the information, concerns that disclosure of poor asset quality might damage a lender's competitive position, and concerns about protecting the privacy of borrowers.

This situation presents the SMI a unique opportunity. If it can gain market confidence and access to the originator information required by investors, rating agencies and credit enhancers by offering to provide useful aggregate information while protecting the confidentiality of lenders and borrowers, it can provide a very important impetus to the growth of securitization in the Philippines. Hong Kong Monetary Authority (HKMA) has shown the way by conducting an exemplary study of the territory's residential mortgage market and making it publicly available, fostering development of secondary mortgage markets. We recommend the following:

1. The government should give priority to developing and disseminating mortgage loan asset performance information for the industry, as lack of such information is a fundamental constraint to developing rated MBS in the Philippines. We recommend that SMI become the agency responsible for gathering and disseminating such information for the markets on a regular basis. As a secondary market begins to develop, we recommend that SMI take the lead, in developing and disseminating relevant information about past and prospective MBS for the investing public.

Working with Capital Markets Intermediaries. While the SMI needs to cultivate financial intermediaries, its need for funding will be limited at the outset. Therefore, it needs to exercise leadership in other ways. It should focus on a major risk management objective in designing MBS, namely, mitigating basis risk, and take lead in pursuing meaningful market solutions. Interest rates on mortgage loans are set on the basis of the selling lender's minimum lending rates (MLR), which is not a market index.

Therefore, if MBS backed by such mortgages were sold and financed with securities which are priced on the basis of any market index, the issuer would face basis risk arising from the mismatch between the rate charged by investors in the MBS and the rates payable on the mortgage loans. This risk cannot currently be hedged in the Philippines markets and results in a significant structural problem that needs to be addressed with product innovations in the mortgage loans and creation of useful capital market indices. We recommend the following:

1. The SMI work with the intermediaries in the capital and money markets to help develop a short term index that can be used for term financing in the capital markets, which could be used to price seven- to ten-year MBS so that basis risk is reduced on adjustable rate mortgage loans. It is also recommended that pass though structures are considered as they pass along the variability in the mortgage rate to the investors.
2. Finally, securitization markets depend on a great deal of operational support provided by specialized bond trustees, servicers, and others.
3. The SMI be encouraged to assume the role of centralized MBS administrator for all domestic MBS, but recommend that such a role not be fixed by regulation. Competition should be allowed

so that the market can strive for better solutions and so that competitive pressures keep the SMI on its toes.

Developing a Presence in Capital Market. The SMI's long term competitive strength will come from its ability to raise long term funds at better rates than those available to major mortgage lenders. Therefore, the SMI should chart out a long-term strategy to gain progressively lower cost funding from a diverse range of sources. In time, it should develop a program of MBS issues in the domestic markets and enter the international capital markets, when they are more receptive to domestic borrowers. Such MBS issues, if brought regularly and in reasonable size, could become liquid and provide additional long-term yield curve benchmarks. We recommend the following:

The SMI should develop and implement a carefully considered, intense and sustained investor marketing program which conveys a clear message that SMI is a government-sponsored secondary market agency with conservative credit underwriting standards, appropriate operational expertise and a sensible business strategy. It will be important to indicate clearly and credibly that the SMI has strong moral and material support of the government, either through an explicit guarantee as recommended or otherwise, to achieve investor acceptance of the SMI as a blue chip, state owned enterprise.

The SMI should obtain domestic and international credit ratings for use initially in the domestic markets so as to be able not only to raise funds at better rates but also to function effectively as a guarantor. This will give an SMI guarantee an independent imprimatur from credible third parties and will also impose external market discipline on SMI.

The SMI should develop and implement a strategy, perhaps in concert with an experienced offshore, private sector technical partner, to act as a financial guarantor in the mortgage sector. This will foster the development of SMI as an effective secondary mortgage market promoter / facilitator and enhance its reputation and contribution to the housing sector.

Fixed and floating rate MBSs certificates to meet investor preferences. The SMI should consider offering both fixed- and floating-rate MBSs certificates. Offering a broad class of securities would attract a broader range of investors, enhancing the liquidity of the MBSs market.

Furthermore, by being able to match the interest stream on the MBSs certificate with that of the underlying instrument, the SPV, the issuing and pass-through agent, reduces its own interest-rate risk.

Pay through versus pass through securities. Under Philippine laws, the SMI would be considered a quasi-banking institution under the jurisdiction of the BSP. The SMI would issue pass-through mortgage-backed securities. Pay-through MBSs would be more flexible, since cash flows from the underlying assets or mortgages can be structured to meet scheduled principal and interest payments to investors, whereas the timing of payments to investors in pass-through securities corresponds to the timing of payments by mortgagors.

1.3 Role of the Public and Private Sector

You need a supportive public infrastructure but privately run framework. What it does is provide based on merit guarantees for local governments on their own borrowings from the financial system.[624]

Government Housing Policy

Interest Rate Subsidies[625]. Subsidization of interest rates in the primary market negates the development of a strong secondary market. Almost all of the people interviewed stated that we should do away with the interest rate subsidy, which is an off budget subsidy, and go for a transparent subsidy. For example, Professor Victor S. prefers capital subsidy to an interest rate subsidy. There are ways to make it more affordable: for capital subsidy, you can increase the down payment, so that the amount to amortize at market rates will be smaller. [626]

Make social assistance targeted and transparent. [627] The only group that is opposed to this is CREBA, (which is strange given that the dept of finance and the NHFMC believe that the subsidies should be transparent, instead of being interest rate subsidy, as they want to 're-implement' a three-tiered interest rate scheme with their centralized housing finance program.

The government should separate housing as a commercial good and housing as a social need. These two concepts should not be mixed up. Socialized and Low income needs to be serviced by the govt. treated separately. That's where you need government subsidy. Even if the government guarantees low

[624] Bernardo, Romeo L. Former Undersecretary of the Department of Finance. *Personal Interview.* June 2001. Makati City, Philippines.
[625] Subsidies are non-market, direct or indirect transfers of resources by the government to the housing sector.
[626] Limlingan, Victor S. Professor at the Asian Institute of Management. *Personal Interview.* June 2001. Makati City, Philippines.

[627] Bernardo, Romeo L. Former Undersecretary of the Department of Finance. *Personal Interview.* June 2001. Makati City, Philippines.

cost housing, banks be hesitant to buy papers because of underlying asset quality, not up to same standard as banks.[628]

Incentive Problems. Under the National Shelter Plan, the government has four major programs that are largely subsidized and intended for production of housing units and ownership. These programs target either direct end-beneficiaries or private developers/institutions which are encouraged to mobilize their own resources to meet the demand for housing.

The negative effect of government-subsidized programs which have discouraged the development of the primary market for housing, and by the short-term orientation of bank assets where the banks' short term liabilities do not match the long term nature of households' housing loans. This mismatch of borrowing short and lending long produces risks of term intermediation. These term risks are inherently associated with the relative illiquidity of the housing good, the opportunity costs of unadjustable interest rates, and exposure to currency risks, if housing loan programs are financed by foreign loans.

In the low cost housing sector, banks face not only high transaction costs but also information asymmetry. The lack of information on creditworthiness, relative credit risks and other risks can discourage bank lending to low income households. The offset could be high interest rates that will cover risks and generate some profit for the lender. However, adverse selection and moral hazard problems arise, making this approach untenable. Thus, in the absence of information, collateral and substantial equity from the low-income borrower, and the lack of long-term funds, banks rarely take on mortgage loans of low-income households. Incentive compatibility problems in existing subsidy programs

The present subsidy schemes are meant to give the low-income group access to adequate and decent housing. However apart from the fiscal costs and the ineffectiveness of the present subsidy schemes, incentive compatibility problem arises on the part of various players in the housing market. Given the present structure of incentives motivated by the subsidies, these agents choose the best action for themselves which results in the achievement of their respective goals at great fiscal burden to the government. Their strategic behavior that maximizes their self-interested goals threatens or undermines the achievement of society's stated housing policy objectives.

> **Borrowers.** Under the formula approach, borrowers take a housing loan on the basis of their monthly incomes and contributions to the pension funds and not on their capacity to repay that loan. The creditworthiness criterion for a loan has been set aside by the government and the private sector in the desire to increase home ownership. Thus, borrowers who might not normally have qualified for a loan, do get a loan and end up not repaying it. Delinquent borrowers perceive that the housing loan is a typical government loan which need not be repaid at all or whose repayment can be delayed or postponed. In addition, condonation of penalties, the high cost of foreclosure and the lack of effective

[628] Alcid, Andrew D. Executive Vice President, Investment Banking Division of United Coconut Planters Bank. *Personal Interview.* June 2001. Makati City, Philippines.

monitoring of loans encourage loan delinquencies. In time, the loan arrears and the condoned penalties become effectively income transfers mostly to the high-income groups who get the bigger loans.

Banks. At present, private commercial lenders do not provide financing for low cost housing. The transaction cost and information problem associated with relatively small loans deter their active participation in this market. The situation is aggravated by the design of housing finance for socialized housing. The loanable funds are sourced from the pension funds and to some extent from government's budgetary appropriation which are lent at subsidized rates. This discourages the private commercial lender's participation. Even if they were willing to lend for low cost housing purposes, they would not because they cannot compete with the subsidized loans provided by the government. The private commercial lenders have been enlisted simply as credit conduits for a fee and thus, take no credit risks for lending to the sector. The origination fee of 5 percent of the outstanding loan for underwriting, approving and channeling public loanable funds to the target clientele seems to be very high. The end result is that they get rents from the sure income provided by the high origination fees and the subsidies from HIGC's 100 percent retail guarantee and special tax exemption.

Private Developers. The formula lending finance scheme allows private developers to produce houses and market them to eligible, but no necessarily credit worthy, borrowers. Their loan exposure is immediately extinguished by the take-out agreement with the government's housing agencies. They also earn sure income and do not have credit risk exposure except in so far as there are delays in getting reimbursement from the housing agencies through the take-out mechanism. IN this case, they incur opportunity losses. On the other hand, the lack of credit risk, the ability to exploit information asymmetry in the production of houses and auxiliary infrastructure such as sewerage, piping, etc., and the guaranteed take-outs by the government's housing agencies create incentives for supplying sub-standard housing units and defective infrastructure to the most number of borrowers who could be persuaded to have housing loans.

Public housing agencies. The funders (HDMF, SSS and GSIS) are caught in a bind. The government which has taken a social responsibility to provide people with affordable homes is using the funds accumulated from member contributions and managed by those agencies to support and finance a public policy objective. In other words, the government is to some extent appropriated funds. Thus, there is little cause to wonder at the insufficiency of resources deployed.

Legislators/policy makers. As long as government views its role as providing low cost housing to almost everyone household, a populist Congress will have a simplistic look at the housing

We recommend the following:

1. Eliminate the formula approach to lending.

The established securitization markets in the U.S., Europe, and perhaps Hong Kong can provide an appreciation for complexities of the MBS markets and illustrate how ratings, credit enhancements, and other market mechanisms provide sensitive and flexible checks and balances to complement official rules and regulations.

The development of the United States' Primary and Secondary Mortgage Markets has been significantly enhanced by the active role of the Federal Government. Without the active participation of the Federal Government, affordable housing for lower to moderate income Americans, arguably would not exist. The United States experience indicates that with proper risk management techniques, important social goals can be achieved, while at the same time creating profit opportunities for both private sector, as well as government.

The Philippines must carefully evaluate the proper role of their governments in the development of their housing sectors, taking into consideration of all risks identified and quantified, where possible

Private or Public.

"We need to have a cohesive, coherent housing policy. It is difficult to have this if the policies are always subject to politicking."[629]

"That's why it has to be private sector led." [630]

The politics should be brought out of it. It is too political. It is mostly a public sector market with inadequacies in the infrastructure for servicing so that the private sector does not want to participate. But because it is public, and shelter for masses is such a highly politicized issue, especially for getting elected, shackled from acting in a commercial for-profit way.

How do we address the lower income population?

Our read on the market is that if you apply best practice underwriting criteria, what the housing agencies lent on argue is that 2/3 could afford a market rate loan. He thinks it can be market rate, can be securitized, but need to put house in order. The other third will need some kind of assistance. "Call a spade a spade". If you choose to lend to them, well that's a subsidized social housing program. Don't pretend its market rate, recognize for it. (my opinion: thus, remove it from funding from pag-ibig, sss, gsis, as this is not a profitable investment. Put it under another funding window. As a social need, it needs to be funded by another agency). [631]

There should be separate housing assistance for the poor from the commercially viable.[632] When you mix these groups up, you see it as a production problem, you cannot bring in the private sector, because the subsidy elements are unclear. Poor efficiency in collection. "Sorry, we can't collect because we are

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[629] Coronel, Leonilo G. Executive Director of the Bankers Association of the Philippines. *Personal Interview.* June 2001. Makati City, Philippines.

[630] Maquera, Peter D. Chief Operating Officer of Lighthouse Credit Technologies Corporation. *Personal Interview.* June 2001. Pasig City, Philippines.

[631] Maquera, Peter D. Chief Operating Officer of Lighthouse Credit Technologies Corporation. *Personal Interview.* June 2001. Pasig City, Philippines.

[632] Bernardo, Romeo L. Former Undersecretary of the Department of Finance. *Personal Interview.* June 2001. Makati City, Philippines.

trying to help the poor" these are how they couch those terms. Even those who can afford, they don't pay because it is perceived as a government dole-out. Since this was almost a 100% LTV ratio, this further gave the low-income incentive to think that it was a government incentive. Let the commercial portion of real estate be market driven. There should be no direct government lending for the commercial part. Allow that to be taken care of by the private sector. Government's role should be to develop institutions and develop capital markets.

Why don't you consider rental housing as an option?

Low cost and socialized housing – forcing Filipinos to become homeowners, not every Filipino is ready to become homeowner. Separate program to build low-income units.[633] People who are transient will most likely be renters.

The housing problem is not simply a funding issue. A number of reforms must take place and includes:

1. rationalize the government's housing programs and institutions
2. promote a market-based housing finance system as a mechanism for financing low cost housing.
3. target subsidies, e.g., one-time capital allowance, to well-identified low-income households.
4. require targeted households to mobilize savings as equity contribution in the low-cost housing program of government.
5. stimulate the private rental housing market by lifting rent control and providing on-site (upgrading) and off-set (new developments) services to localities outside the major metropolises.
6. provide infrastructure that will lead to the opening of new lands for low-cost housing
7. review zoning regulations, building codes and other regulations, e.g., development permits, land conversion, and others, to eliminate high transaction cost.
8. introduce reforms in the pension funds to make more long-term funds available for housing.
9. review/amend the comprehensive shelter and finance act and the urban development and housing act to make them more consistent with a market based housing finance system.
10. provide a legal, institutional and regulatory infrastructure for the efficient functioning of the primary and secondary mortgage markets.
11. maintain a stable macroeconomic condition characterized by low inflation and low interest rates.

It is critical from the public policy standpoint to review the housing subsidy program of government for several reasons. First the fiscal resources used in subsidy programs, especially those targeted to a very large segment of the population, are non-trivial. Those resources have competing, alternative uses and thus, any misallocation of resources imposes costs to society. Scarce fiscal resources have their alternative demand and appropriate public policy requires that the social benefits from the housing subsidies exceed the social cost of those subsidies. In this study, the social cost is measured by the total

[633] Alcid, Andrew D. Executive Vice President, Investment Banking Division of United Coconut Planters Bank. *Personal Interview.* June 2001. Makati City, Philippines.

fiscal resources devoted to subsidies given their alternative uses. The social benefits are indicated by the magnitude of the subsidies and their intended compared to actual incidence.

Second, the housing subsidies target the relatively poor members of society. It is important to find out whether indeed the target beneficiaries are the actual beneficiaries of the subsidies. Third, apart from the determination of the fiscal cost or burden and the incidence of benefits of housing subsidies, it is equally important to assess how the incentive structure created by the subsidy schemes has affected the behavior of economic agents, i.e., borrowers, private banks, private developers, public housing agencies, policy makers, legislators, relative to the objective of making housing markets more efficient. Efficiency refers to the larger market role of private agents in the production, financing and distribution of housing units, with the government and the housing agencies providing a favorable environment for private sector participation in the housing market.

Role of Originators and Developers. Originators should remain separate and distinct from developers due to the prevailing moral hazard that exists in collapsing the function into one entity. Developers' expertise remains in development and not underwriting. Each should stick with their respective expertise. From an anecdotal standpoint, developers were left with inventory which they made prior to even underwriting any claims.

The developer community must also receive education on the benefits of the secondary mortgage market. Perhaps a lack of understanding behind securitization is the reason that developers may be hesitant to actively support this initiative. Case in point: the Central Housing Fund continued to support the use of subsidized interest rates, and left origination in the developers' hands.

It is necessary to develop aligned incentives for developers that will encourage them to strengthen the development of the secondary mortgage market. Show them that the Central Fund is not sustainable. Continued insistence on subsidized interest rates is not sustainable and will not bring about the creation of a secondary mortgage market.

Housing Demand.

Where do we get targeted housing numbers from? Are they accurate?

A more accurate computation of housing demand will also help developers rationalize development. Instead of being production oriented, we must separate the socialized income from the low and mid-income who can pay.

We should be wary of following target production numbers or we fall again into the trap of producing inventory. Developers also need a clear number to work against, and a number provided by third-party, instead of developers, to avoid conflict of interest.

The socialized income may require government assistance through a transparent subsidy. Also, we must look at the possibility of rent-to-own for the socialized income. Since banks don't want to look at socialized income housing, then it might be time to look for more creative solutions for this, such as micro financing, which has a high repayment rate of 98%. Moreover, with proper underwriting guidelines, these can still be securitized and bought by the CSIs, who are mandated to support housing.

The low to mid income can adopt either a cooperative housing/mixed-income housing scheme similar to the US model. You can also align developers here as well. They can build mid income projects with a component of low-income housing integrated into the project. In effect, they get tax incentives, or tax shelters in return.

1.4 Role and Development of the Secondary Mortgage Institution (SMI)

The newly installed administration of President Gloria Macapagal Arroyo will push for four key economic reforms when congress opens in end-July 2001. Among these measures will be the passage of a securitization bill. Although there is not much information with regard to this, newspapers claim that it wants to securitize mortgage payments to develop a secondary trading market.

According to Prof. Reside of the University of the Philippines School of Economics, the SMI and the regulatory authorities should set prudential limits on the volume of MBSs issues while the operating procedures and monetary management of SMI-issued MBSs are being fine-tuned. There are three reasons for this recommendation.

First, automating the origination and servicing systems of the SMI would increase substantially the volume of purchased mortgages and MBSs issues and therefore also the SMI's operating risks. Thus, the SMI should ensure that it has adequate staff capacity to process and manage the increased volume of transactions.

Second, MBSs provide originating banks with additional reserves and additional liquidity. MBSs proliferation, if left unchecked, may therefore inhibit effective monetary management by the BSP, aside from creating asset bubbles in property prices.

Third, as an efficient mechanism for risk transfer, MBSs development may also provide a mechanism for the financial sector to evade prudential limits on bank lending to real estate. These limits, initially imposed by the BSP in 1996, were designed to reduce excessive risk taking by banks in lending to a single industry. Thus, for example, if a bank sells a mortgage to an SPV and takes the loan off its books, it can provide the same borrower with another loan. In this regard, automating the originating and servicing process in stages may be wise given the central bank's uncertainty about the macroeconomic effects of securitization.

Minimization of SMI transaction costs. To achieve the lower spreads between the primary mortgage market and MBS yields, efficiency measures must be undertaken. There have been private-sector proposals to automate mortgage origination and servicing is an important first step in lowering the transaction costs of issuing MBSs. Assuming the existence of a critical mass of borrowers, automation and the use of electronic communications systems will lower average origination and servicing costs. The initially large lump-sum investments in technology by an SMI also justify providing it with fiscal incentives at the start.

Initial Securitization of Performing Loans. SMI may initially consider securitizing mortgages with values slightly above the socialized housing class. Thereafter, it should gradually strengthen linkages with the low-cost housing market.

The current tightness in low-cost housing finance is primarily due to systemic weaknesses stemming from the inadequacy of current lending guidelines in ascertaining the creditworthiness of borrowers. While the financial squeeze felt by potential homeowners, funders, and developers in the low-cost housing market will be compounded by the inability to securitize mortgages in their segment, the major players, such as the SSS/GSIS and the HDMF should take immediate steps to improve origination and underwriting standards.

Given the current severe asset quality problem in the low-cost housing industry, the *SMI might consider purchasing only housing loans above the socialized housing limit, where collection efficiency appears to be better, to ensure the quality of mortgages.*

In the event of new loan origination, Pag-Ibig/HDMF, in the October 1999 Philippine Conference on Securitization, recommended that socialized and low-cost housing should be brought into the commercial financial system to rein in more private capital, but subjected to the same market standards and practices to ensure the same level of asset quality and collection efficiency.

We should start securitizing mid-income loans.[634] Limlingan says that we should start with securitizing mid income housing. Also, explore the possibility of having mid income developers securitize their own loans as this is one way to get the ball rolling.[635] Do not worry about high-end people, they can take care of themselves. Focus initially on the mid income to be securitized, then later go to socialized (socialized is a substrata of low income) income. "The problem is not housing finance for the poorest, their problem is poverty and no financial solution can solve that and by putting that as a

[634] Asian Institute of Management

[635] Matoto, Senen L. President of the Investment Houses of the Philippines. *Personal Interview.* June 2001. Makati City, Philippines.

responsibility of a financial institution simply pollutes the commercial viability of the financing institution."[636]

Underwriter/Trading. The SMI should be listed in the stock market and should be allowed to raise funds by issuing either MBSs or shares of stock. Private-sector sources have expressed interest in using the clearing and settlement facilities of the Philippine Central Depository (PCD) and the Philippine Stock Exchange (PSE) for scripless trading of MBSs in the primary and secondary markets. Allowing MBSs to be traded in the stock market enhances their visibility and attracts more investors. It also diversifies potential ownership and the funding sources of the SMI, which can thus issue both MBSs and equity, in amounts to be determined by its optimal MBSs-equity mix.

Since the SMI is vested with a sovereign guarantee, a flight to quality in times of economic distress could raise demand for, and prices of MBSs, and lower yields, as in the recent case of Cagamas bonds in Malaysia.

In the October 1999 Philippine Conference on Securitization, the Department of Finance (DOF) claimed that it had forged an agreement with the Philippine Stock Exchange to set up the tradability of long-term bonds as a step to encourage secondary trading of MBS.

Custodian Institutions. Use previously existing institutions to serve the custodianship and clearing functions for the MBSs. Adoption of market-driven approaches to determine the levels of underwriting/issue costs.

Development of trading rules/conventions. The PSE, IHAP, BSP and SEC to coordinate in crafting trading rules and conventions. These include:

- Trader licensing
- Delivery Conventions
- Settlement conventions
- Trading hours, etc.

We will attempt to identify areas where the government needs to take a step back and play a catalyst through a regulatory role. Then there are also times when the government needs to have a more "hands-on" approach. In the government's haste to provide housing for the lowest sub-strata of Philippine society, they gloss over underwriting procedures and ambiguous policies to hit targeted housing numbers. Delinquency or failure to pay appears to be a natural consequence of serving the poor. Thus, the private sector has shied away from lending money to the low-income sector. However, *serving the poor, both from the public and private sector standpoint, should not be a losing proposition.* There is a very simple

[636] Bernardo, Romeo L. Former Undersecretary of the Department of Finance. *Personal Interview.* June 2001. Makati City, Philippines.

guideline that needs to be followed. Peter Maquerra of Lighthouse Credit Technologies phrased succinctly, *"You aren't going to lend, unless you think you are going to get paid back*"[637].

The reasoning that government offers behind the high default rate among the poor is that they have a social need to fulfill. However, the reasoning behind this must be put into question. Is it because the poor cannot afford to pay? Or are the high delinquency rates related to the poor collection efficiency and lenient lending standards which don't incent the poor to pay.

In the book *Mortgage-Backed Securities in Asia* released by Asian Development Bank, several developing Asian countries were surveyed, including China, India, Indonesia, Korea, Malaysia, Pakistan, the Philippines and Thailand. Among all these countries, only the Philippines and Pakistan had considerable amounts of non-performing mortgage loans while the default rate in other countries were manageable[638]. The problem in both countries was traced to public institutions that used inadequate borrower screening regulations.

Guidelines and incentives can be put into place that correct the situation which effectively renders housing finance more sustainable, even for the lowest economic sub-strata, instead of maintaining its "feast and famine[639]" cycle for all potential homeowners.

"The problem, as most of us see it, is ideology," Mr. Nocon said. "We feel that Ms. David's orientation has always been left of center, and we, as businessmen have always been capitalists," he added.[640] However, despite their orientation, they were asking for banks to reduce lending rates while Karina David pursued a market-rate interest rate policy even for low income housing, as per the World Bank recommendation.

There are two types of securitization- securitize bad assets to liquidate and securitize the good assets. For the securitization of bad assets, which is accomplished through an AMC, he believes the Philippines will adopt the Korean model.[641] There should be an Asset Management Company (AMC) for the bad loans.[642]

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[637] Maquera, Peter D. Chief Operating Officer, Lighthouse Credit Technologies Corporation. *Personal Interview.* June 2001. Pasig City, Philippines.

[638] Reside, Renato, S. Ghon Rhee, and Yutaka Shimomoto. *Mortgage-Backed Securities Markets in Asia.* Asian Development Bank. 1999. Manila, Philippines.

[639] Jacob, Monico V. Conference Chairman on Philippine Conference on Securitization. *Personal Interview.* June 2001. Makati City, Philippines.

[640] Junia, Catherine C. `Zero' output in gov't housing program noted (No direction from the administration, say developers). Businessworld Publishing Corporation. March 26, 1999.

[641] Ortille, Lucille. Deputy Secretary General of the Housing and Urban Development Coordinating Council. *Personal Interview.* June 2001. Makati City, Philippines.

[642] Limlingan, Victor S. Professor at the Asian Institute of Management. *Personal Interview.* June 2001. Makati City, Philippines.

Lehman Brothers suggested that HUDCC put up an AMC that will spin off into an SMI and buys off all the old loans at a discounted value. It will start initially with the bad loans. After that, you can take in better mortgages. [643] Bring in a Goldman Sachs or Lehman Brothers, in some form of partnership with the government, to show them how to run a for-profit mortgage company. And do that for a number of years. Try securitization and other liquefaction techniques, and enter into exit strategies with Lehman or Goldman. At least you know it can be done.

1. Not the NHMFC. Investors are wary on NHMFC because of track record, bailed out three times. People known to be corrupt, a lot of contingent liabilities associated.

    - Lehman has had models to do this in the past.
    - Devise public private partnerships
    - (Refer to the example given by Lehman Brothers Thailand).

We cannot do it ourselves because it is too political.[644] An AMC can be the precursor to an SMI. An AMC, empowered by private charter to securitize assets and real estate owned (ROPOAs). A lot of banks have ROPOAs that can be liquefied. Use ABS to develop specific securities of the bank.

Nearly all of the people interviewed for this thesis agreed that the SMI should be private sector led. However, you need government participation in the private led SMI. You need government participation to influence policy. The government should have sensible policies. It can be a joint venture with private sector money. But the government needs to put in some money as well. But it has to be privately owned. [645]

SMI may need to be spearheaded by the private sector. NHMFC – more practical if you got people to put money into private sector led initiatives. IFC and major banks have expressed strong sentiment in investing. The government should not own more than 30%, preferably CSI, GFIs with a developmental and long-term view. A certain percentage is made available to foreign, multilateral organizations (IFC). Local market should be provided some shares as well (banks, private insurance companies, developers). Then after some time, eventually the public should be able to invest in SMI.[646]

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[643] Maquera, Peter D. Chief Operating Officer of Lighthouse Credit Technologies Corporation. *Personal Interview.* June 2001. Pasig City, Philippines.

[644] Jacob, Monico. Former Home Development Mutual Fund (HDMF)/Pag-Ibig Chairman and Conference Chairman of the Philippine Conference on Securitization. *Personal Interview.* June 2001. Makati City, Philippines.

[645] Coronel, Leonilo G. Executive Director of the Bankers Association of the Philippines. *Personal Interview.* June 2001. Makati City, Philippines.

[646] Crisostomo, Manuel C. President and Chief Executive Officer of Home Development Mutual Fund (HDMF)/*Pag-Ibig. Personal Interview.* June 2001. Makati City, Philippines.

Is the NHMFC still a viable institution? If the government runs the SMI, the problem is that it remains dependent on government policies. This is a problem because policies change as administrations change, and therefore the SMI will be influenced by the somewhat unstable political climate in the Philippines. Also, policies need to be consistent at least for the medium term, 6-10 years, because the maturities of mortgages are also 6-10 years. The SMI should be isolated from frequent changes.

Almost all interviewed agree that the NHMFC should sell off their loans.

- "We aren't used to deep discounts, but let's face it. Let's give it up if we need to."[647]
- "The government has to bite the bitter pill and swallow the losses. It doesn't have very good options."[648]

Forget about NHMFC and start a new SMI. Government relegated to regulatory role. Let shareholder employ professional managers. Private sector alone cannot do it. They need government to push certain things. Regulatory, legal, and tax structures cannot be reformed without government support. NHMFC no longer has credibility because of large amount of non performing loans. The Department of Finance, wanted to wind down NHMFC operations, but it wasn't pursued under the Estrada administration. [649]

NHMFC – it already has a bad reputation, it has deteriorated, if it securitizes, people will not touch it. It is gone, it has been sidetracked by the fact that when EO 90 in 1986, and government pooled funding "rationalized funding" all CSIs then mandated NHMFC to do primary lending. Mandate is to be SMI. Any other institution? Time the private sector took over.[650]

What we should do with the bad loans of NHMFC?

- To have an RTC, separate totally from NHMFC, contract out to another company.
- Sell it to buyers at a discounted price.
- Sell it off if it is in public interest. But he is unsure if the government can take the hit. [651]

[647] Coronel, Leonilo G. Executive Director of the Bankers Association of the Philippines. *Personal Interview.* June 2001. Makati City, Philippines.

[648] Alcid, Andrew D. Executive Vice President, Investment Banking Division of United Coconut Planters Bank. *Personal Interview.* June 2001. Makati City, Philippines.

[649] Bernardo, Romeo L. Former Undersecretary of the Department of Finance. *Personal Interview.* June 2001. Makati City, Philippines.

[650] Jacob, Monico. Former Home Development Mutual Fund (HDMF)/Pag-Ibig Chairman and Conference Chairman of the Philippine Conference on Securitization. *Personal Interview.* June 2001. Makati City, Philippines.

[651] Bernardo, Romeo L. Former Undersecretary of the Department of Finance. *Personal Interview.* June 2001. Makati City, Philippines.

Is there a market for several SMI's? Once you start something with government support, but it shouldn't preclude a private group, the opportunity is there for several entities. There is a logical progression of the market, similar to in the U.S.

Who can be an effective SMI? It still has to be created, and feel that it should be private sector led with government participation to temper for policies that will be benefit lower income. Otherwise, you see people only within the 2-3MM range, and the lower income households are once again ignored.[652]

Nobody looks at the NHMFC as an efficient institution, there must be another institution. Even though those interviewed in government agencies believe that the NHMFC can still be revived as a secondary mortgage institution, it may not be in the best interest to keep this institution. Preferably a private run business, it will operate more efficiently versus a government institution. The government cannot hope to be at par with the private sector.[653] Come up with a private sector led SMI. [654] Privately managed and owned. Maybe government should be a part of it at the start, then gradually withdraw.

The Asian Institute of Management (AIM) still believes that the NHMFC should be the SMI. It doesn't matter if they are capable or not, the point is that they are the only ones with the mandate. However, the rationale behind CREBA's wanting to keep the NHMFC around is because CREBA has probably concluded that the quality of their receivables isn't that good. That is why they are probably adamant about keeping all the old structures in place because they can work it to their advantage. They have really been throwing to the government their bad loans. CREBA doesn't seem to be in favor of developing a private led SMI. They would rather continue with NHMFC because it is the only one with the public mandate, "which truly baffles me". Although CREBA claims to be on the side of securitization, they still continue to do things inimical to it, such as proposing subsidized interest rates. However, there is a suspicion that the receivables of the CREBA members cannot be securitized because they are of poor quality. Most of the mortgage loans which became non-performing loans that developers took out came from CREBA. In contrast, groups like SHDA, which has a much better reputation, are in favor of securitization because they are confident in the quality of their receivables.

The SMI has a challenging role to play as a "change agent" to influence the primary markets for residential mortgage loans. It must develop powerful funding machinery to gain leverage with the primary market. It should aim to set industry standards based on intellectual capital and technical assistance to

[652] Rustia, Andres I. Managing Director of the Asset Management Department of the Bangko Sentral ng Pilipinas (Central Bank of the Philippines). *Personal Interview.* June 2001. Manila, Philippines.

[653] Paul, Jeremias N. , Jr. Department of Finance Assistant Secretary. *Personal Interview.* June 2001. Manila, Philippines.

[654] Tan, Arthur, Executive Vice-President and General Manager of the Home Guaranty Corporation. *Personal Interview.* June 2001. Makati City, Philippines.

gain a large following in the residential mortgage markets in the Philippines in a number of strategic areas which include origination, mortgage loan design, risk management and securitization. The SMI can influence origination only indirectly, through its purchase guidelines and design of mortgage loan products that would be easier to securitize.

The SMI's secondary market activities, if successful, will influence origination of loans, gradually leading to standardization in the underwriting process, documentation, servicing and enforcement. This will lead to greater predictability of residential mortgage assets and to greater capital market access for the housing sector through MBS, increasing availability of longer-term funds and reducing costs for homeowners. Achieving such long-term benefits will require that SMI impose strict loan purchase standards, which may initially be more stringent than the common industry practice.

We believe that it is important for the SMI to gain investor confidence, it should exercise strict discipline, especially when credit quality has generally deteriorated. Securitization of mortgage loans can be done on a larger scale only when mortgage loans are designed with secondary markets in mind. The current mortgage loan products, not being designed for the secondary mortgage markets, are difficult to securitize. We recommend the following:

1.5 Legal, Tax, and Accounting Issues

Legal, regulatory, tax and accounting issues have a significant impact on the feasibility and attractiveness of securitizations. For the benefits of MBS to be achieved in the Philippines, there is a need for a clear framework in these areas, which affect not only the likelihood of high credit ratings for MBS but also the economic costs to the issuer. Changes in the legal framework need to balance a respect for existing laws and practice with the need to perfect security interests, achieve a true legal sale and limit additional costs. For the primary and secondary mortgage markets to develop, however, there is a need to develop the legal, institutional and regulatory infrastructure that will minimize risks in origination of primary mortgage loans and securitization, ensure market pricing of mortgage assets and provide credit enhancement mechanisms.

Regulatory authorities must balance their concerns for financial soundness with the need for fair, prudent and transparent rules on off balance sheet treatment for capital adequacy purposes. Without tax neutrality to minimize additional costs, the economics of securitization can be unattractive relative to on-balance sheet funding. The accounting profession must set out reasonable rules on off balance sheet treatment for GAAP purposes to fairly reflect the company's operations as analysts may use financial reports to compare and rate the company, thereby affecting its access to capital markets.

Legal Issues. A successful housing finance system is premised on a well-developed legal and regulatory structure. The primary concern for investors it the security interest. In other words, how enforceable is the claim the investor has on the collateral in the even to default. The answer depends on the clarity of land title, the ability to establish priority of liens on the collateral (i.e. an effective title and lien registration system) and the ability to enforce foreclosure and repossession over a reasonable time period.

Enforceable security interest is a necessary but not sufficient condition for a successful housing finance system. For transactions involving asset sale or pledging (i.e. collateral), security interests must be transferable and investors must have the ability to perfect their security interest after transfer. The transfer of interest must be at a relatively low cost. An additional legal concern is the borrowers, servicers, or other third parties.

- The possibility of a "true" sale and perfection of a security interest.
- The feasibility of establishing a Special Purpose Vehicle that is bankruptcy remote.
- The legal right to transferred assets upheld even in the even of bankruptcies.

In the October 1999 Philippine Conference on Securitization, the Department of Finance state that it was actively going to support housing securitization through: proposing securitization in terms of technical and financial assistance via Accelerated Growth in Liberalization with Equity (AGILE) by proposing a bill regarding reforms in financial sector taxation.

The DOF is also pushing for the swift passage of a revised Securities Act, and has also reinforced its support for the RICA or the Revised Investment Companies Act. The newly installed President Arroyo has said that she plans to prioritize the passage of (1) an investment company bill and; (2) a securitization bill.

The objective of the investment company bill is to promote a fair, orderly, and efficient capital market in order to provide the private and public sectors with access to funds vital to the development of the national economy. As of this time, it is unsure as to whether or not the securitization bill the President plans to prioritize is similar in nature to the one developed during the Philippine Conference on Securitization.

During the October 1999 Philippine Conference on Securitization, there were several proposals forwarded with regard to the development of the secondary mortgage market in the Philippines.

- *The Revised Securities Act.* The proposal was to consider securitization as an exempt transaction. The reason behind this would be to rationalize the cost of registration and the purpose of securitization.

- *Revision in foreclosure proceedings.* Inclusion through both separate legislation and amendments to the General Banking Act that all foreclosures done by the SPV shall be considered as payment of obligation. Thus, not subject to a one-year redemption period.

- *Title insurance.* In September 2000, Sen. Aquilino Pimentel Jr. and Rep. Dante Liban of Quezon City proposed the other day a lasting solution to the prevailing problem of fake land titles through the institution of land title insurance, amending the Insurance Code to include land titles. Liban authored House Bill 11974, while Sen. Pimentel filed in the Upper House counterpart which is Senate Bill 1689.

This proposes the creation of a land title insurance system that would protect landowners from fly-by-night real estate developers. The policy was to protect the insured from title defects, forgery, falsification and similar unlawful acts.

Senator Pimentel said that the land insurance policy would guarantee real estate buyers some form of compensation should a defect in their land titles is discovered later.. SB 1689 would task the Insurance Commission to issue guidelines specifying the risk premiums to be charged by insurance firms for different insurance contracts. The measure also allows companies not otherwise disqualified by law to engage in the title insurance business.

So far, the American National Financial, Inc. (ANFI), one of the larger outfits involved in underwriting land title insurance in the US, are reviewing the possibility of lending their expertise in any transfer of technology that the venture would require.

However, in the October 1999 Philippine Conference on Securitization, there was also a private sector proposal to initiate/provide title insurance which is centrally administered to protect innocent buyers.

- *Maceda Law alternatives.* The October 1999 Philippine Conference on Securitization, there was a proposal to specify in the plan of securitization or in separate legislation that property buyers should go after the originator and not the SPV.

Regulatory and Accounting Issues. It is critical that any transaction involving the originator and the SPV cannot be attacked on the subsequent insolvency of the originator, as otherwise the transaction will not provide any benefits of isolating the assets from the credit of the originator.

- Authorities' willingness to consider the use of securitization.
- Viability and feasibility of off-balance sheet and non-recourse financing.

In the October 1999 Philippine Conference on Securitization, participants outlined the need to "harmonize" and align the inconsistent provisions in the regulatory guidelines issues (or to be issued) by the BSP and the SEC.

There was also a need to rationalize the regulatory framework to promote the further development of the Philippine ABS market. These are key proposals/resolutions to address regulatory issues as raised in the Philippine Conference on Securitization:

Issue	Resolution
SPV/SMI Structure: Only Special Purpose Trusts (SPT) are allowed by law	Regulators has agreed to look further into the possibility of: - including future receivables as a type of "securitizable" asset, and; - allowing Special Purpose Corporations to issue ABS. An industry position paper was being prepared to help regulators in their evaluation of these two proposals.
Securitizable Assets: Future Receivables and Financial Derivatives not included	Regulators are still not comfortable with including financial derivatives as a type of asset that can be securitized. However, the BSP said that it is amenable to expanding the coverage, but it cautious in it's the definition of *securitizable assets*. Also, the BSP would prefer to wait until the market has matured and this activity has gained acceptance of the investing public before taking any more steps.
Credit Enhancements: Upfront recognition of losses from over collateralization Upfront recognition of capital charges for subordinated securities held by seller.	The treatment of credit enhancements needed to be discussed further with the BSP. The DOF has said that
Perceived Conflicts of Interest Seller may not use its own trust department as trustee for ABS issues. Trust department cannot purchase ABS which it administers. Underwriters cannot deal in ABS issues which are administered by its trust department.	BSP not keen on changing their position; they need to be assured that all banks have the ability to fully comply with Chinese Wall* requirements between the bank proper and their respective trust departments. The primary reason behind prohibiting originator banks from using its own trust department as SPT issuer is intended to insulate the SPT from the originator and remove the possibility that the originator will be pressured to support a securitization structure backed-up by its assets when this has deteriorated or has become non-performing.

** Chinese Wall. A Chinese Wall is an internal 'wall' between two departments of a bank of other financial institution which is meant to ensure that conflict of interest do not arise and, in particular, there is no inside dealing in the shares of a client.*

During the 1999 Philippine Conference on Securitization, the Conference Participants drafted an Executive Order and Draft Bill in Congress that would:

- Urge the SEC to revise the rules on securitization to recognize the creation of a Special Purpose Vehicle. The SEC is currently looking into the best practices and the special requirements of SPCs in developed countries.
- Urge the BSP to not to classify the SPV as either a bank or a quasi-bank, and not to have the securities issues deemed as deposit substitutes.
- Urge the Insurance Commission to include asset-backed securities as investible assets for insurance companies. The Insurance Commission has drafted some rules and regulations for the approval of investments on ABS and will discuss this further with the BSP and SEC.

Tax Issues. On taxes, progress has been made in all areas other than taxation at the level of the issuer, where it is important to avoid double taxation. Tax neutrality at the level of the issuer can be addressed most readily through modifications that permit use of mutual funds as SPVs and through other reforms in the existing laws and regulations. This is the approach we favor. For a securitization to be effective, some tax considerations are crucial. The transaction must not lead to a greater tax burden than if the originator had not done the transaction, and potential tax liabilities must not make the SPV insolvent.

In the October 1999 Philippine Conference on Securitization, proposed Executive Orders and a Bill on Securitization were developed to govern the tax treatment of securitization-related transactions. In drafting these proposals, the conference wanted to convince the government of the following:

- Securitization will not take off on an onerous and burdensome tax regime and, therefore, there will be no substantial loss incurred in removing taxes from securitization-related transactions.
- If the government believes it will lose revenue by exempting securitization-related transactions, it will be more than offset by the increased activity in the primary market, where the transactions are still subject to tax. In fact, the originator will even be forced to accelerate the recognition of income tax where the securitization of installment receivables is involved.
- The government must recognize that securitization is primarily a transfer of obligation from one creditor to another and the additional income to the parties will be taxed.

The DST has been mentioned as one of the largest and most onerous obstacles to the MBS. In the October 1999 Philippine Conference on Securitization, the Department of Finance (DOF) proposed to harmonize rates for documentary stamp tax (DST) by establishing a single rate for financial sector instruments and trade documents. However, the DOF argued that the DST cannot be eliminated, primarily for the reason that it is a major source of revenue for the government. As a compromise, the DOF is considering the removal of the DST on secondary trading, in order to encourage a vibrant secondary market for bonds, stocks, and derivatives.

In reference to the earlier table on taxes to the originator/investor that appeared under taxation issues, these were the recommended solutions by the Philippine Conference on Securitization:

Step	Tax/es	Issue	Solution
Assignment/sale of assets (receivables) by the Originator to the Special Purpose Trust (SPT)	Income tax	This is not usually the subject of income tax because the originator will sell the receivables at either face value or at a discount. However, of the receivables sold/assigned are installment receivables, of which the sale and the corresponding receipt of payment will trigger income realization. The discount is a deductible business loss	
	Gross Receipts tax (GRT)	If the originator is a bank, then the receipt of payment from the SPT will trigger Gross Receipts Tax liability.	This will be covered by the Financial Institution Tax (FIT), which will replaced the GRT. The FIT would be imposed on financial intermediation services which are equivalent to the spread between the interest received and the interest expense based on the 91-day Treasury bill rate.
	Value Added Tax (VAT)	The sale of receivables is not subject to Value-Added Tax.	There is a need to request the BIR to issue a clarificatory ruling to ensure that this is not subject to VAT.
	Documentary Stamp Tax (DST)	It is not subject to DST because it is not a borrowing transaction, being without recourse. The assignment of mortgages is presently subject to DST	Recommend removal of the DST since the underlying document has not been subject to DST.
Issuance by the SPT of the Asset-Backed Security (ABS)	Documentary Stamp Tax (DST)	It is not subject to DST under Section 180 of The National Internal Revenue Code of 1997 because it is not considered a depository substitute. Doubtful is subject to Section 178 of the Code because a trust is not an association, company or corporation.	To remove any gray areas, it should be clarified that even If the SPV is a corporation, as proposed in the draft bill, it should not be subject to DST.
Investment of Funds/Administration of the SPT	Withholding tax	The income of investible funds from investments in Government Securities or deposit substitute instruments consisting of discounts from issuance which is subject to a 10% withholding tax. However, this is a tax on the investors holding an undivided interest in the Asset Pool of the SPT, not a tax on the SPT	
Distribution to Investors	Withholding tax	The distribution on income by the SPT to investors is subject to a 20% final withholding tax imposed on yield and other monetary benefits from the trust fund and similar arrangements. The rate is increased to 25% and 33% if the recipients are non-resident aliens not engaged in trade or business and non-resident foreign corporations, respectively	
	Income tax	However, the MBS is not subject to income tax if:	

		Distribution of income has already been subjected to a 20% final withholding tax Distribution of income to individual investors where the ABS qualifies as a long-term deposit or investment certification Distribution of income where ABS issue is guaranteed by the HGC, up to 8.5% of the interest income distributed. Distribution to tax exempt investors such as employee retirement funds, GSIS, SSS, foreign governments, financial institutions owned, controlled or enjoying refinancing from foreign governments, and international or regional financing institutions established by foreign governments.	

Elimination of the Documentary Stamp Tax (DST). We recommend the elimination of stamp taxes on all servicing fees, including excess servicing fees at the end of the transaction, in order to achieve tax neutrality for securitizations. The government should consider eliminating DST on MBSs. This should stimulate primary and secondary market liquidity of MBSs. As the volume of securitization issues increases in the long run, the government may wish to review pass-through spreads, to examine the extent to which any publicly provided subsidy is retained by an SMI or any other party to an MBSs transaction. This is done to ensure that SMIs can afford to purchase mortgages from originators at higher prices (leading to lower primary mortgage market interest rates); at the same time MBSs can be sold to investors with more attractive yields.

8.1.1.1 Other

Prerequisites for Secondary Mortgage Market Development[655]

The success of the secondary market in the US has led both private and public sector officials in many countries to recommend its creation as a way of enhancing the flow of funds to housing. However, what is often overlooked in such discussions in the readiness of the primary market. True and sustainable secondary market development cannot proceed unless and until the primary market is able to produce a sufficient volume of high quality mortgages that meet the servicing and performance requirements of investors.

[655] Summary from "Prerequisites for a Successful Secondary Mortgage Market: The Role of the Primary Mortgage Market" by Michael Lea, Housing Finance International, 15, 2, December 2000

The role of the primary mortgage market. True and sustainable secondary market development sufficient volume of high quality mortgages that meets the servicing and performance requirements of investors. The importance of the primary market is magnified with the introduction of a secondary market. This is due to the fact that there is a separation of functions in a secondary market. This leads to functional specialization and dependence of one party on the actions of others. The functions of origination, servicing, risk management and funding are unbundled and managed by different specialized entities. Originators may be traditional depositories, mortgage companies or mortgage brokers. The institution may be traditional depositories, mortgage companies or mortgage brokers. The dependence of one functional entity on another means that mistakes are more difficult to hide in a secondary market system. Origination specialists also must be more cognizant of pipeline risk because their loans are sold soon after origination. Pipeline risk is the risk that between the time a lender makes a binding commitment to a borrower and the time the loan is either sold or placed in portfolio, the value of the loan will decline. If a loan is mis-priced, the lender takes an immediate loss. Even if the loan is properly priced, incomplete or erroneous documentation can lead to a lender having to repurchase a loan at a future date. Thus the quality of mortgages produced by the primary market becomes much more important in a secondary market.

What are the major primary market prerequisites for secondary market development? There are at least 8 major prerequisites:

1. <u>Stable Macroeconomic Environment</u>

The state of development of the Philippine's mortgage market will depend in large part upon the degree of macroeconomic stability and past government policies affecting housing finance. Macroeconomic stability is very important for several reasons. First, it has a major effect on the demand for mortgages. High rates of inflation and nominal interest rates are typical features of volatile economies. These features have the effect of reducing the affordability of conventional mortgages. A volatile economy also affects the supply of funds and the characteristics of mortgages offered by lenders. In a volatile environment, lenders are reluctant to offer long-term loans. This may lead them to not offer mortgages or only offer short maturity loans that in turn are less affordable for consumers. A volatile macroeconomic environment also creates difficulties for investors. Like lenders they may prefer short-term assets, in part because of the difficulties of forecasting inflation and interest rates. Investors must be able to forecast cash flows with a tolerable level of variance in order to price and evaluate the risk of their investments.

A volatile economy also affects the supply of funds and the characteristics of mortgages offered by lenders. In a volatile environment, lenders are reluctant to offer long-term loans. This may lead them to not offer mortgages or only offer short maturity loans that, in turn, are less affordable for consumers. Pipeline risk (the risk that market rates and prices change between the loan commitment is mad and the loan is funded) is also much higher in a volatile market rate of return. Thus, the mortgage rate must be sufficient to cover the investor's marginal funding cost (both debt and equity), the risks of mortgage investment (i.e., credit, interest rate and liquidity risk) and the administrative cost of servicing mortgages (and MBS).

2. Developed Legal Environment

A well functioning title and lien registry are important underpinnings of both the primary and secondary market. Without good title, borrowers cannot use their homes as effective collateral for loans and investors will not view securities backed by such loans as safe. A key legal prerequisite is the timely and cost effective registration of title and lien. A barrier that exists in many developing countries is the imposition of transfer taxes or stamp duties on title and lien registration or transfer. Long delays in the registration process can also increase the risk of both primary market and secondary market transactions. A workable foreclosure and repossession system is an important although not essential component of an effective legal environment.

3. Competitive Market Structure

Mortgages must be attractive investments. The interest rates on the mortgages must be market determined and provide investors with a positive, real, risk-adjusted rate of return. The spread must compensate the investor for the risks of the investment including credit risk, liquidity risk and interest rate risk. The more competitive is the mortgage market the greater the potential for secondary market development. This is particularly the case if the market environment will support the entry of mortgage companies that rely on securitization (off-balance sheet finance) for funding. In countries in which the dominant lenders are depository institutions with abundant capital and access to relatively cheap retail funds, securitization is often not a cost effective form of finance and it is difficult to create a secondary market. There must be a significant volume of loans to justify the up-front costs of developing the secondary market infrastructure.

Government policies determine the competitive e environment in which mortgage lending is done. In the past, special circuits for housing finance have prevailed in many countries. A special circuit is characterized by specialized lenders that dominate the mortgage market, supported by government incentives, both financial and regulatory. Their preferences often lead to the offering of mortgages at rates less than that necessary to provide acceptable risk-adjusted returns for investors. This leaves out those lenders with nonsecuritizable portfolios, unless the government augments the return on the mortgages for investors.

For secondary market development, mortgage rates must provide a return that is attractive relative to their alternative investment opportunities. For banks or institutional investors that are typically the major investors in MBS, this means a positive spread over comparable duration government bonds. The yields on such bonds provide a default-risk free pricing benchmark for investors. The spread must compensate the investor for the risks of the investment including credit risk, liquidity risk and interest rate risk.

The more competitive the mortgage market, the greater the potential for secondary market development. This is particularly the case if the market environment will support the entry of mortgage companies that rely on securitization (off balance sheet finance) for funding. In countries in which the dominant lenders are depository institutions with abundant capital and access to relatively cheap retail funds, securitization is often not a cost of effective form of finance and it is difficult to create a secondary market. This has been the case in Europe where secondary mortgage markets have been slow to develop.

4. Mortgage Instruments

The cash flows from mortgages must be predictable. There must be relative standardization of the instrument, documentation, and underwriting. Standardization of the mortgage instrument is a key factor in secondary market development. Mortgages should be pooled with similar characteristics to facilitate larger pool size and more liquidity and to reduce the due diligence costs of investors and rating agencies.

5. Proper Origination Techniques

Solid and consistent underwriting is key to secondary mortgage market development. Investors must have confidence that lenders are properly judging risk and using a consistent set of criteria in evaluating loans. A degree of standardization is necessary to lower costs of due diligence and allow investors, rating agencies, guarantors to quantify credit risk. An accurate assessment of the value of the property is fundamental to determining whether, in the event of borrower default, the lender could recoup enough from the sale of the home to cover losses. A repository for credit information that can be used to ascertain a borrower's track record of handling credit is an important component of underwriting. Credit bureaus can provide lenders with detailed credit files; they also can provide a credit-bureau score, which summarizes the information into one number reflecting an individual's expected credit performance.

6. Secondary marketing expertise

Secondary marketing is the function of financing and, subsequently, selling the originated mortgage to institutional investors. This activity includes the warehousing of the mortgage between the time the mortgage is closed and subsequently sold to an investor. There are at least 3 major risks the seller must manage as part of the secondary marketing function:

- *Commitment risk*: The risk that an interest rate commitment ("rate lock") offered to a home buyer for a loan is made and the firm is unable, generally due to market forces, to earn an adequate sales price to cover the costs of providing the commitment.
- *Pipeline risk*: The risk that a closed loan will change in value between the time of closing and shipment to an investor. This risk is often hedged using forward, option or futures contracts.
- *Documentation risk*: The risk that a closed loan is underwritten improperly and does not conform to the investor's requirements. These loans are known as "lame loans" and frequently can be converted into acceptable loans for delivery, but usually after months of seasoning and additional documentation. The delays in delivery, or inability to deliver, produce costs for the originator.

7. Proper Servicing techniques

The servicing of mortgages is a critical component of a viable secondary mortgage market. The collection of mortgage payments and the periodic remittance of these payments to the investor (or conduit) are the major tasks of servicers (whether they are originators or third parties). In addition, servicers are the primary repositories of information on the mortgage loans. Thus, they must maintain accurate and up-to-date information on mortgage balances, status and history and provide timely reports to investors. The ability to collect payments on delinquent loans and institute timely foreclosure, repossession and collateral sale in the interest of the investor is necessary to safeguard the investor's interest.

There are undoubtedly other important factors in developing a secondary mortgage market for the Philippines. The prerequisites listed above are necessary but not necessarily sufficient conditions. The lack of these prerequisites does not mean that securitization is impossible as it may be possible to do a few transactions with a narrow range of collateral in the form of private placements. But a sustainable secondary market involves generating an on-going flow of transactions that will develop liquidity in the market, enhance investor and regulatory understanding and comfort and achieve the desired increase in availability of funds and decreased relative cost of mortgage credit. This can only be done if there is a sufficient volume of attractively priced, well-documented and underwritten mortgage loans that are serviced by competent and reputable organizations.

There is of course an element of which comes first, the chicken or the egg. Some will argue that creating a secondary market is necessary to provide the proper incentives and guidelines for standardization, processing and management in the primary market. A well-developed secondary market can indeed have these benefits. But there are clearly minimum requirements regarding the economy, instrument and institutions that must be met before a viable secondary market can be created.

8.1.1.2 Benefits of Securitization: Implications for the Philippines

The benefits of securitization are summarized as follows:

- Interest rates for borrowers are lower compared with interest rates through traditional lending.
- The amount of capital available through capital market is significantly larger than capital available through traditional lending.
- Efficiencies in intermediation and market size reduce transaction costs. Lending institutions include liquidity premiums in the pricing of loans.
- Capital markets provide better risk diversification and pricing mechanisms than are available to any individual lending institution.
- Access to a vast wholesale funding market is available to all lenders that securitize.
- Lenders can utilize their origination capabilities to the full.
- Greater lending to the sub-prime and non-conforming segments of the market is facilitated with the credit risk being passed to the wholesale market.
- As margins become tighter, fee income becomes more attractive than net interest income.
- An efficient flow of information is generated to support the securitization process.
- Standardization of products is also encouraged to ease the complexity of that information.
- Capital efficiency is improved as assets are moved off the balance sheet.
- Competitive pricing might be improved if institutional funding rates are partly passed to consumers.
- Credit risk is substantially reduced.

Realistic Expectations. It is unrealistic to expect that a sustainable secondary market can be developed in a short period of time. Even the most developed secondary systems such as the U.S. have taken decades to evolve; and the more successful emerging market examples such as the Home Mortgage Bank of Trinidad and Cagamas of Malaysia have been in business for over a decade.

Scale. Ultimately, a sustainable secondary market is a numbers game. Unless certain debt issuance size thresholds are crossed, the instruments are unlikely to be liquid, and without liquidity in the instruments, a sizeable premium is likely to be paid in higher interest rates: higher even than the marginal cost of funds for primary mortgage banks, which reduces the incentive to sell any loans into the secondary market. Most secondary market institutions start life much smaller in asset size than many of their bank clients, hence need to leverage their initial size rapidly to achieve critical mass. The core value proposition of a multi-lender secondary market conduit is that the whole is more than the sum of the parts: if it is not, its reason for existence will sooner or later be threatened by larger lenders who can and will go it alone.

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