REPUBLIC OF THE PHILIPPINES

FISCAL RISKS REPORT 2013

FOREWORD

The strides that the Philippine Government has taken towards strengthening its capacity to assess and manage fiscal risks have been gaining traction. The government has been able to foster growth in the face of continued uncertainty and weakness in global and regional economies owing to its prudent management of resources and proactive liability management. Alongside the drive for growth is the equally important task of safeguarding against risks that could materialize due to internal and external factors.

The 2013 Fiscal Risks Statement (FRS) builds upon the advances gained in managing fiscal risks as the National Government continues to be vigilant in recognizing possible risks to its fiscal operations. Aside from reporting recent fiscal developments, the FRS explores possible vulnerabilities emanating from the various sectors that comprise the economy.

The 2013 FRS highlights the following:

1. The continuing uncertainty in the global economy has made it particularly difficult to project macroeconomic parameters vis-à-vis actual outturns. Moreover, weak global economic prospects continue to pose a key risk to Philippine macroeconomic performance.
2. Fiscal performance continues to improve as measures are implemented that address revenue collection as well as resource mobilization.
3. The Government's active liability management has generally improved the sustainability of public debt even when taking into account continuing fiscal consolidation as well as various risk scenarios.
4. The financial system continues to be robust with adequate prudential measures in place to minimize risks particularly from the global financial system.
5. The government continues to monitor the performance of Government-owned and-Controlled Corporations and has put in place reforms to improve the management of the Government corporate sector.
6. Initiatives are continuing to better understand risks emanating from Public-Private Partnerships as these play a crucial role in alleviating low public investment levels while also possibly posing long-term risks to fiscal sustainability.
7. The country's high exposure to natural disasters and calamities has prompted it to exert efforts in strengthening risk mitigation and response mechanisms.

Cognizant of the key risks inherent in its operations, the FRS outlines the key programs and measures put up by the Government. It is with this in mind that the publication of the FRS seeks to better inform the public of how the Government dynamically manages risks to maintain its momentum for growth and development.

List of Acronyms and Abbreviations

ADB	Asian Development Bank
ASEAN	Association of Southeast Asian Nations
BESF	Budget of Expenditures and Sources of Financing
BIR	Bureau of Internal Revenue
BLGF	Bureau of Local Government Finance
BOC	Bureau of Customs
BOT	Build-Operate-Transfer
BPM5	Balance of Payments Method 5
BSF	Bond Sinking Fund
BSP	BangkoSentralngPilipinas
BTr	Bureau of the Treasury
CAR	Capital Adequacy Ratio
CARP	Comprehensive Agrarian Reform Program
CCC	Climate Change Commission
CFG	Climate Finance Group
CO	Capital Outlays
COA	Commission on Audit
CLM	Contingent Liability Management
DBCC	Development Budget Coordinating Council
DBM	Department of Budget and Management
DBP	Development Bank of the Philippines
DepEd	Department of Education
DFA	Department of Foreign Affairs
DIF	Deposit Insurance Fund
DILG	Department of Interior and Local Governments
DND	Department of National Defense
DOF	Department of Finance
DOH	Department of Health
DPWH	Department of Public Works and Highways
DRMD	Debt and Risk Management Division
DSA	Debt Sustainability Analysis
DSWD	Department of Social Welfare and Development
DTI	Department of Trade and Industry
ERC	Energy Regulatory Commission
eTAILS	Electronic Transparency and Accountability Initiative for Lump Sum Funds
FPPO	Fiscal Policy and Planning Division
GAA	General Appropriations Act
GCG	Governance Commission for GOCCs
GDP	Gross Domestic Product
GFIs	Government Financial Institutions

GIFMIS	Government Integrated Financial Management System
GOCC	Government-Owned and Controlled Corporations
GRT	Gross Receipts Tax
GSIS	Government Service Insurance System
HGC	Home Guaranty Corporation
ICC	Investment Coordination Committee
IMF	International Monetary Fund
IRA	Internal Revenue Allocation
LBP	Land Bank of the Philippines
LGU	Local Government Unit
LIBOR	London Inter-Bank Offer Rate
LRTA	Light Rail Transit Authority
LWUA	Local Water Utilities Administration
MENA	Middle East and North Africa
MFIs	Multilateral Financial Institutions
MIAA	Manila International Airport Authority
MNFGCs	Major Non-Financial Government Corporations
MOOE	Maintenance and Other Operating Expenditures
MWSS	Metropolitan Waterworks and Sewerage System
NCCAP	National Climate Change Action Plan
NDC	National Development Company
NDRRMF	National Disaster Risk Reduction Management Fund
NEA	National Electrification Administration
NEDA	National Economic and Development Authority
NFA	National Food Authority
NG	National Government
NHA	National Housing Authority
NIA	National Irrigation Administration
NPC	National Power Corporation
NPL	Non-Performing Loan
NSCB	National Statistical Coordination Board
ODA	Official Development Assistance
OF	Overseas Filipinos
OSS	One-Stop Shop Center
PAGASA	Philippine Atmospheric, Geophysical and Astronomical Services
PAGCOR	Philippine Amusement and Gaming Corporation
PCF	Performance Challenge Fund
PCOICOP	Philippine Classification of Individual Consumption Expenditure According to Purpose
PDAF	Philippine Development Assistance Fund
PDIC	Philippine Deposit Insurance Corporation
PDP	Philippine Development Fund
PERA	Personal Equity and Retirement Account
PEZA	Philippine Economic Zone Authority
PFM	Public Financial Management
PHIC	Philippine Health Insurance Company
PhilGEPS	Philippine Government Electronic Procurement System
PNOC	Philippine National Oil Company

PNR	Philippine National Railways
PPA	Philippine Ports Authority
PPP	Public-Private Partnership
PS	Personal Services
PSALM	Power Sector Assets and Liabilities Management Corporation
PSCC	Philippine Standard Commodity Classification
PSIC	Philippine Standard Industrial Classification
PTAP	Public Transport Assistance Program (PantawidPasada Program)
Quedancor	Quedan and Rural Credit Guarantee Corporation
REIT	Real Estate Investment Trust
SBGFC	Small Business and Guarantee Finance Corporation
SEC	Securities and Exchange Commission
SMV	Schedule of Market Values
SNA	System of National Accounts
SSIs	Social Security Institutions
SSS	Social Security System
SPUG	Small Power Utilities Group
SUCs	State Universities and Colleges
TCC	Tax Credit Certificate
TIDCORP	Trade and Investment Development Corporation
TransCo	National Transmission Corporation
UNESCAP	United Nations Economic and Social Commission for Asia and the Pacific
VAT	Value-Added Tax
ZBB	Zero-Based Budget approach

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FISCAL RISK STATEMENT

I. INTRODUCTION

1. **The continued uncertainty and weakness of global and regional economies stress the need to fortify fiscal resilience against shocks not only from within but also from external sources.** It is therefore prudent for the National Government to strictly abide by its medium term deficit and debt targets to allow ample fiscal space in the event of a slowdown in economic activity. This depends in part on the success of the Government's strategy of aggressively pursuing tax administration reforms to improve tax compliance and expand its revenue base.

2. **The recent experience in budget underutilization prompted the Government to implement measures to improve budget execution and at the same time ensure that expenditure ceilings provided will be well utilized.** Ongoing reforms in public expenditure management will be sustained and deepened to strengthen the links between planning, programming and budgeting to maintain the focus on results.

3. **Episodes of crisis in other countries connected to the mismanagement of contingent liabilities prompt the Government to continue strengthening its own capability to accurately assess and mitigate associated risks.** The Government has introduced new systems and practices to manage fiscal risks emanating from state owned enterprises, partnerships with the private sector, the financial system, local government, as well as natural disasters.

II. MACROECONOMIC RISKS AND BUDGET SENSITIVITY

A. MACROECONOMIC ASSUMPTIONS AND PERFORMANCE

4. **The country's macroeconomic performance showed sustained improvement.** Even as the global economy slowed down, the Philippine economy still managed to grow modestly under a low inflation environment.

5. **The accuracy of macroeconomic assumptions was affected by sudden shifts in the global economy.** Economic growth in 2011 was lower than expected due to external factors. The combined effects of the protracted European sovereign debt and banking crisis and the disruption of global supply chains due to the incidence of tsunami in Japan and the flooding in Thailand dampened growth. On the domestic front, natural calamities and delays in government spending

also affected economic growth. As growth in developed economies slowed down, LIBOR rates have remained consistently low, hitting the low end of the assumptions for the three year period. Meanwhile, the peso appreciated in nominal terms and averaged below the assumed ranges in 2010-2011. There was considerable volatility in international oil prices due largely to geopolitical tensions in the Middle East and North Africa (MENA) region. Meanwhile, the slowdown of the global economy caused weaker-than-expected performances of exports and imports during the period. On the other hand, prices were stable and inflation rates fell within the government target from 2009-2011. The fiscal balance improved over the years, which, together with low inflation, contributed to a low interest rate environment.

Table 1. Philippines: Macroeconomic Performance, 2010-2012[a/]
(in percentage points, unless otherwise specified)

	2010		2011		2012		2013
Particulars	**BESF**	**Actual**	**BESF**	**Actual**	**BESF**	**Actual**	**BESF**
Real GDP growth	2.6-3.6	7.6	5	3.9	5.5-6.5	6.6	7-Jun
Inflation	3.5-5.5	3.9	5-Mar	4.6	5-Mar	3.2	5-Mar
91-day T-bill rate	7-May	3.7	6-Apr	1.4			
364-day T-bill rate [b/]			5-Mar	2.4	5-Mar	1.97	5-Mar
Exchange rate[c/] *(PhP/USD, period average)*	46-49	45.11	45-47	43.3	42-45	42.23	42-45
LIBOR (6 months)	1.5-3.5	0.52	3-Jan	0.51	0.5-1.5	0.69	0.5-1.5
Dubai crude oil price *(USD/barrel)*	60-80	78.04	75-95	106.19	90-110	109.08	90-110
Exports growth[d/]	7-May	34.9	13	-6.9	12	7.9	12
Imports growth[d/]	14-Oct	32.9	18	1.6	18	2.2	14

Sources: NEDA, NSO, NSCB, BSP, BTr

a/ Macroeconomic assumptions are those adopted by the Development Budget Coordination Committee (DBCC) on June 26, 2012 as published in the Budget of Expenditures and Sources of Financing (BESF) submitted by the executive branch to Congress for the preparation of the General Appropriations Act.

b/The DBCC decided to shift to 364-day Treasury bill rate from 91-day Treasury bill rate beginning 2011 to better capture the composition of NG debt and interest payments.

c/ For the exchange rate, a positive value implies that the currency was stronger (appreciated) than budgeted.

d/ Based on the Balance of Payments Manual 5 (BPM5) concept.

6. **Philippine macroeconomic performance in 2012 was broadly in line with assumptions.** Growth surged in 2012 as GDP expansion outpaced Government forecasts while inflation remained at the low end of the Bangko Sentral ng Pilipinas'(BSP) estimates for the period. Other indicators were within assumed ranges which, given the fragile external environment, is testament to the country's strong macro-fundamentals.

B. MACROECONOMIC RISKS

7. **Economic activity is expected to remain robust in 2013 as the government continues to implement policies to stimulate and support growth.** The improved fiscal operations of the National Government as well as a benign inflation environment allows for accommodative policies and programs. Other growth drivers have remained resilient despite adverse economic conditions and would continue to do so. Nevertheless, external risks could significantly affect the country's economic performance.

8. **There is concern that China's growth will significantly decelerate to levels lower than what the country had experienced in the last 30 years unless it is able to rebalance growth.** China's economic growth decelerated from 10.4 percent in 2010 to 9.2 percent in 2011. This trend has carried forward to 2012, with real GDP growth recorded at 7.8 percent. However, estimates from the National Economic and Development Authority (NEDA) show that a delay in China's rebalancing policy and a slowdown in China's economic growth may just result in a minimal decrease in the real GDP growth rate of the Philippines.

9. **The European sovereign debt and banking crisis poses a continuing threat to global economic stability and has far reaching repercussions.** While immediate risks arising from the Euro-zone have subsided, it will have to struggle through the effects of reforms and future policy decisions to keep the common currency afloat. So far, the leadership of the European Union (EU) as well as the European Central Bank (ECB) has shown great resolve in alleviating the crisis that has gripped the region.

10. **Fiscal uncertainty in the US poses a new risk to macro-stability**. Although the US was able to settle the immediate concern regarding tax cuts engendered in the Fiscal Cliff, the issue of automatic budget cuts and slow growth still lies ahead. Given the size of the US economy and its ties to the region, specifically the Philippine economy, the risk of a US recession would have a significant impact in the country's fiscal, financial and economic performance.

C. FISCAL PERFORMANCE

11. **In 2012, the National Government incurred a budget deficit of P242.8 billion equivalent to 2.3% of GDP**. Revenues grew by 12.9%, with tax effort improving to 12.9% of GDP from 12.4% in 2011. Expenditures expanded 14.1%, much faster than the 2.3% growth registered in 2011.

12. **The accuracy of underlying macroeconomic assumptions used in projecting the annual budget affects fiscal outturns.** Variations from macroeconomic parameters feedback to revenues, expenditures and the fiscal balance through several channels. Table 3 reflects the sensitivity of fiscal accounts to various macroeconomic variables.

Table 2. Philippines: Differences between Fiscal Targets and Outturns, 2010-2012a/

(as percent of budget, unless otherwise specified)

Particulars	2010	2011	2012
Total Revenues	-9.56	-3.55	-2.14
Tax revenues	-8.54	-5.56	-5.84
Non-tax revenues	-18.61	14.93	41.27
Total Expenditures	-2.98	-8.37	-4.14
Current expenditures	-4.51	-5.39	-3.91
Capital and equity expenditures[b/]	6.42	-22.35	-6.56
Net lending	-38.28	20.67	19.22
Balance	34.7	-31.81	-2.11
Financing	37.9	-62.43	80.11
Net Domestic	7.31	-75.09	146.55
Net Foreign	159.4	3.4	-35.69

Source: BESF

a/ Positive values indicate that actual figures are higher than budgeted and vice versa

b/ Capital and equity expenditures include Capital Transfers to LGUs and CARP-Land Acquisition and Credit

Table 3. Philippines: Fiscal Sensitivity to Key Macroeconomic Variables, 2013

(in billion Pesos per annum)

Particulars	Revenues	Disbursements	Budget Balance
1 percentage point increase in Real GDP growth	15.2		15.2
1 percentage point increase in Inflation rate	14.6		14.6
1 percentage point increase in Merchandise Imports	4.7		4.7
1 percentage point (100 bps) increase in T-bill rate, all maturities	8.2	3.2	5
1 Peso appreciation in foreign exchange rate	-8.6	-2.6	-6

Source: DOF, BTr

Revenues

13. **The tax effort increased to 12.9% in 2012 from 12.4% in 2011,** as a result of continued implementation of administrative measures by both the Bureau of Internal Revenue (BIR) and the Bureau of Customs (BoC).

14. **Non-tax revenues grew by 10.2% and was P51 billion more than target.** Collections of fees and charges in 2011 benefited from a huge one-time payment of Malampaya proceeds amounting to P30 billion. For 2012, investment income and dividend payments received by the Bureau of the Treasury (BTr) reached P84.1 billion outpacing the P51.6 billion program.

Table 4. Philippines: Revenue Program, 2012-2013
(in billion pesos)

Particulars	2012 Full Year Program	2012 Actual	2013
Total Revenues	**1,568.50**	**1,534.90**	**1,780.10**
Tax Revenue	**1,445.50**	**1,361.10**	**1,651.30**
BIR	1,066.10	1,057.90	1,238.60
BOC	365.1	289.9	397.3
Other Offices	14.2	13.3	15.4
Non-Tax Revenue (net of Privatization)	**121**	**165.4**	**126.9**
BTr Income	34	84.1	35.6
Privatization	**2**	**8.3**	**2**

Source: BESF

15. In 2013 the National Government will raise total revenues of P1.78 trillion, equivalent to 14.9% of GDP and a 14.1% increase from the revised program for 2012. Tax effort in 2013 is expected to reach 13.8%, 0.5 percentage points higher than the expected 13.3% for 2012. Tax revenues are expected to grow by 14.2% with contributions from the BIR and the BoC expected to grow by 16.2% and 8.8%, respectively. Non-tax revenues will be lower this year at P126.9 billion despite lower expected dividends from government corporations.

16. **Several programs were instituted and are being implemented in support of the government's thrust on fiscal sustainability and anti-corruption advocacy.** Under the Aquino Administration, the Revenue Integrity Protection Service (RIPS), the anti-corruption arm of the Department of Finance (DOF), has filed 38 cases and charged 48 personalities. At the BIR, the Run After Tax Evaders (RATE) program aims to investigate and prosecute individuals and/or entities engaged in tax evasion and other criminal violations of the National Internal Revenue Code (NIRC) of 1997, while generating the maximum deterrent effect. There were 117 cases filed from July 2010 to June 2012. At the BoC, Run After the Smugglers (RATS) and the re-launch of the informant's rewards system enabled the agency to comply with the directive of President Aquino for the BoC to file at least two cases against smugglers per month. As of June 2012, 88 of the 189 cases were filed under the Aquino Administration. These cases filed under the RATE and RATS program are in various stages of prosecution before various courts i.e., Court of Tax Appeals or regular courts, Court of Appeals and the Supreme Court.

17. **The Department of Finance continued to support the passage of various tax measures that will help enhance the country's tax collection. These include:**

a. RA 10251, signed into law on December 20, 2012, restructures excise taxes on alcohol and tobacco products. The law simplifies tax administration, introduces buoyancy, levels the playing field, and ensures compliance with World Trade Organization requirements by: (a) reducing the number of tax tiers towards a unitary rate; (b) removing the prize freeze at 1996 levels; and

(c) providing automatic tax rate adjustments. It also allocates revenues for the universal health care program of the government and for the promotion of economically viable alternative livelihood programs for tobacco farmers and workers.

b. In the area of fiscal incentives, two (2) reforms are being pursued. One is the rationalization of fiscal incentives. Another is the establishment of a mechanism for monitoring and reporting tax expenditures in line with the government's objective of promoting transparency and accountability.

Expenditures

18. **Actual National Government spending for 2012 amounted to P1.8 trillion, equivalent to 16.8% of GDP.** Expenditures were P62.0 billion lower than the program mainly due to underspending for infrastructure and other capital outlays amounting to P47.5 billion. This was due in part to the problems with project implementation encountered by the DPWH such as right-of-way acquisitions, realignment of funds or modification of projects and peace and order problems among others. There were also some procurement delays which resulted to low obligation of funds for airports, navigational facilities and PPP projects of the DOTC.

Table 5. Philippines: Expenditure Program, 2012-2013
(in billion pesos)

Particulars	2012 Full Year Program	2012 Actual	2013 Full Year Program
TOTAL EXPENDITURES	**1,854.50**	**1,777.80**	**2,021.10**
Current Expenditures	**1,468.40**	**1,411.00**	**1,585.10**
Personnel services	595.7	542.6	641.3
MOOE	269.7	256.7	298.8
Allotment to LGUs	218.6	218.6	241.8
Tax expenditures	33	38.1	26.9
Subsidies	18.2	42.1	42.3
Interest Payment	333.1	312.8	333.9
Capital Outlays[a/]	**363.1**	**339.3**	**409.6**
Infra and Other Capital Outlays	287.2	250.8	326.3
Equity	2.1	21.3	2
Net Lending	**23**	**27.4**	**26.5**

Source: BESF
a/ Includes Capital Transfers to LGUs and CARP-Land Acquisition and Credit

19. **Lower interest payments were a significant source of savings.** Interest payments were below Government estimates as average interest rates in 2012 fell to 2.0% against the 3.0% program in addition to the lower volume of government securities issued

20. **For the past four years, significant amount of savings for the National Government have come from interest payments.** For 2012, interest payments were below the revised program by 1.5 percent. Estimation of interest payments is made difficult by its dependency on certain macroeconomic variables particularly prevailing interest rates and foreign exchange rates. Given the volatility of these variables, forecasts usually come in ranges which have a bandwidth of about two percentage points. The mid-point of the forecast range is used for a conservative estimate of interest payments.

21. **As a response to the underspending incurred during the earlier parts of the year, the government funded quick-disbursing priority programs using additional dividends from government corporations and the discontinuation of slow-moving expenditures.** Similar to the previous year, savings from the discontinuation of slow-moving expenditure items were pooled to fund urgent expenditures that are expected to sustain macroeconomic stability, accelerate infrastructure development, bolster tourism, support reforms in local government and update defense capabilities among others.

22. **To strengthen budget execution capacities, the Department of Budget and Management (DBM) has created Account Management Teams (AMTs) to monitor the disbursement performance of key implementing agencies**. AMTs are composed of the planning and budget officers of implementing agencies along with concerned DBM Operations Units, staff from the Fiscal Planning Bureau and the Budget Technical Service. These teams monitor the status of agency budget utilization and identify problem areas where bottlenecks are encountered. Through this program, government agencies were able to revise their monthly cash programs to initiate a catch-up in the last quarter.

23. **The FY 2013 National Expenditure Program shifts the validity of appropriations from two to one year.** The shift aims to improve the predictability of the budget execution process by doing away with the previous policy that allows the carry-over of appropriations for MOOE and CO to the following fiscal year. In line with this, DBM has also reiterated the importance of the submission of monthly cash programs (MCPs) of department/agencies by end-November 2012. The submission of realistic MCPs as basis of the aggregate DBCC disbursement program will not only facilitate the timely release of funds, but will hopefully avoid the repeat of the underspending performance during the early parts of the year.

III. PUBLIC DEBT

24. **National government debt sustainability has steadily improved despite challenging global economic conditions (see Table 6)**. In 2012, the debt to GDP ratio went up from 2011 because the National Government borrowed to finance obligations of PSALM. Without this fiscal consolidation transaction, the debt to GDP ratio would have remained at 50.9% for 2012.

Table 6. Philippines: National Government Debt Indicators, 2010-2012 (in percentage points, unless otherwise specified)

Particulars	2010	2011	2012
National Government Debt			
% of GDP	52.4	50.9	51.4[a/]
% Share			
Domestic	57.6	58	63.8
External	42.4	42	36.2
Average Maturity (yrs)	8.8	10.2	10.9
Domestic	6.7	9.2	10.4
External	11.3	11.4	11.5

Source: BTr, DOF
a/ Includes P55.6 billion on-lending to PSALM, net of which results in NG debt/GDP ratio of 50.9%

Debt Sustainability Analysis

25. **Resilience against various risks has concurrently improved.** External debt as a proportion of NG debt is at 36.2 percent before deducting the GPN component, in which case the share is further reduced. The government has taken full advantage of favourable market conditions to extend the maturity of outstanding debt which lessens rollover risk without compromising cost considerations for debt amortization.

26. **Results of the most recent Debt Sustainability Analysis (DSA) carried out by the Debt and Risk Management Office (DRMO) highlights the improving trajectory of NG debt** (see Annex A). Assuming no major disruptions for all fiscal, macroeconomic and financial variables over the medium term (baseline scenario), the analysis indicates that the debt ratio will fall to38.5 percent of GDP by 2016 (see Annex A, Fig. 1).

27. **VAR analysis underscores the improving sustainability of NG debt** (see Annex A, Fig. 2). A stochastic VAR simulation, which takes into account the historical correlation between shocks to growth, interest rates and foreign exchange rates, infers the resilience of Government debt sustainability as the upper limit of the probability bands for NG debt in proportion to GDP consistently falls below the current level as well as sustainability thresholds.

28. **Lastly, the DSA reveals the impact of several simulated scenarios on the sustainability of public debt** (see Annex A, Fig. 3). Under a growth shock similar to the 2009 financial crisis, the simulation depicts a small but sustained increase in the ratio of NG debt to GDP over the baseline. A massive global downturn scenario further diverges from the baseline projections while maintaining the downward trajectory of NG debt in proportion to GDP. On the other hand, a small shock due to disasters present a low risk as reconstruction efforts presents a boon to growth over the medium term. Meanwhile, a massive calamity can adversely affect debt sustainability unless sufficient safety nets are put in place.

29. **Stress tests on the sensitivity of NG debt to changes in interest and exchange rates further illustrate the resilience of NG debt against shocks** (see Table 7). More specifically, the analysis shows that sensitivity to interest rate movements have been more or less maintained whereas foreign exchange risk exposure has improved.

a. Much like the previous year, a temporary 100 basis points (1%) increase in the average effective interest rate on NG debt would increase interest payments by 2.16% in the succeeding year. This is equivalent to 0.44% of revenues or 0.07% of GDP.

b. A 10% depreciation of the peso against major currencies pads outstanding debt by an amount equivalent to 1.76% of GDP. This is an improvement from the previous year's sensitivity estimate of 1.9%. Conversely, a 10% appreciation of the local currency diminishes the debt stock by the same amount (i.e. 1.76% of GDP).

Table 7. Philippines: Interest and Exchange Rate Sensitivity of NG Debt[a/]

Particulars	1 year impact *(in million pesos)*	1 year impact *(% increase in interest payment budget)*	1 year impact *(1 % shock & peso appreciation, in million pesos)*
Interest Rate Sensitivity (1 percentage point increase)			
Domestic Interest Rate			
Floating interest rate			
Rolled-over fixed rate	1,949.48	0.61%	1,949.48
Foreign Interest Rate			
Floating interest rate	2,807.49	0.88%	2,526.74
Rolled-over fixed rate	1,408.57	0.44%	1,267.71
Rolled-over debt amortization	689.46	0.22%	620.52
Plus: 10 percent depreciation/appreciation			
Of which against the US$	8,536.39	2.69%	-8,536.39
Of which against the JPY	981.08	0.31%	-981.08
Of which against the Euro	295.72	0.09%	-295.72
Combined interest rate hike and depreciation	16,668.20	5.25%	-3,448.74
Foreign Exchange Rate Sensitivity (10 percent depreciation/appreciation)			
Of which against the US$	135,108.33	-	-135,108.33
Of which against the JPY	47,758.67	-	-47,758.67
Of which against the Euro	6,470.31	-	-6,470.31
	(as % of GDP)		**(as % of NG revenue)**
Interest Rate Sensitivity *(1% increase)*	0.07	2.16	0.44
Combined Shock *(1% increase plus 10% depreciation)*	0.16	5.25	1.07
Foreign Exchange Rate Sensitivity *(10% depreciation)*	1.76		
Combined Shock *(1% increase with 10% appreciation)*	-0.03	-1.09	-0.22

Source: DOF

a/Based on NG debt outstanding as of December 2011; assumed roll-over rate/floating rates based on current market rates plus 1 percent shock

c. A combined shock wherein interest rates rise by 1% and the local currency depreciates by 10% increases NG interest payments by 5.25% (1.07% of revenues; 0.16% of GDP) Meanwhile, a 10% appreciation could offset a 1% increase in interest rates, effectively lowering interest payments by 1.09% (0.22% of revenues; 0.03% of GDP).

30. **The scenario and stress tests highlights the need to closely monitor recognized and emerging risks to public debt sustainability.** In spite of a declining debt ratio and an improvement in the fiscal stance for the past years, fiscal sustainability remains vulnerable to major shocks. It is necessary for the government to monitor these risks and to set-up contingent measures that will mitigate the associated adverse impacts in case these risks materialize.

IV. CONTINGENT CENTRAL GOVERNMENT OBLIGATIONS

A. FINANCIAL SECTOR

State of the Philippine Banking System

31. **The Philippine banking system registered a healthy and solid performance for the first semester of 2012.** The resilience of the banking system is evidenced by continued asset growth, ample liquidity, strong core earnings, improved asset quality and higher capitalization during the period.

32. The banking system's resources grew by 5.5 percent to P6.6 trillion as of 30 June 2012. Steady year-on-year growth was also registered in other key areas such as core lending [1] (14.9%), and deposit generation (3.5%). Bank liquid assets remain at a comfortable level of 57.8% of deposits. Net income for the first six months of 2012 continued to be positive at P55.2 billion, and represents an 18.7% increase from P46.5 billion during the same period in 2011.

33. The banking sector's asset quality improved as both non-performing loan and non-performing asset ratios as of end-May 2012 fell to 2.8% (vs. 3.4% a year ago) and 3.3% (vs. 3.8% a year ago), respectively.

34. Bank capital position remains robust with a risk-based capital adequacy ratio of 16.6% on a solo basis and 17.6% on a consolidated basis as of end-December 2011. Said ratios are in excess of minimum international and regulatory standards. [2]

35. **Although the banking system's strong fundamentals are expected to provide adequate cushion from adverse shocks, fiscal and financial fragilities prevailing in the global environment, particularly from the Euro area, poses a risk to the banking sector.** Despite minimal exposure to the Euro zone, the banking system

[1] Core lending refers to total loan portfolio net of interbank loans and reverse repurchase with BSP and other banks.
[2] Solo basis refers to the combined financial statements of the head office and branches/other offices. Consolidated basis refers to the combined financial statements of parent bank and subsidiaries consolidated on a line by line basis.

may experience lower bank profits from lending activities should domestic growth turn out weaker-than-expected and exports earnings perform below the National Government's assessment. Significant volatility in global financial markets could also result in banks' experiencing losses on their investment portfolio. Banks' investment portfolio of P1.6 trillion constitutes 23% of the banking system's total assets. Investments are primarily in the form of government securities such as issuances of the National Government (P1.0 trillion), 35% of which is denominated in foreign-currency, traded in foreign markets, benchmarked against other international issuances and vulnerable to changes in global market prices.

36. **Thus far, the Philippines has also experienced strong capital inflows which have supported market activity.** The increase in capital flows could fuel imbalances in the credit and asset markets and threaten financial stability. On the other hand, loan growth has slowed down from its peak of 22.5% year-on-year growth last September 2011 to 16% in July 2012. Furthermore, real estate loans of universal and commercial banks as a percentage of total loans stood at 13.5% as of 12 March 2012, below the 20% ceiling prescribed by the BSP.

37. **A reversal of capital flows could tighten foreign exchange liquidity conditions and pose difficulty in sourcing foreign currency funding abroad for the banking system.** Rising borrowing costs could also exert downward pressure on banks' profitability and liquidity. However, as of end-June 2012 the banking system has mostly relied on funding from deposits by residents rather than from off-shore markets.

<u>Risks from the Banking Sector</u>

38. **Fiscal risk arising from the financial sector is deemed to be minimal as the exposure of the National Government to the Philippine banking system[3] is limited.** As of end-June 2012, the bulk (94%) of the Philippine Government's exposure to the banking system is in the form of deposit placements amounting to P600billion which comprise 13% of aggregate deposit liabilities of the banking sector of P4.7 trillion. It bears noting that banks are required to maintain a 50% liquidity floor on deposits and borrowings from the National Government in the form of transferable government securities which acts as a liquidity buffer to service withdrawals and payments on their borrowings from the NG.

39. **The banking system's deposits are insured through the Philippine Deposit Insurance Corporation (PDIC), a GOCC attached to the DOF.** The PDIC charges banks an insurance premium, part of which is set aside in a deposit insurance fund. As of end-February 2012, the PDIC's Deposit Insurance Fund (DIF) have grown to P72.6 billion in spite of increased payouts in 2011 for insured deposits of closed banks. [4]

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[3] Philippine banking system in this report refers to universal and commercial banks (U/KBs). U/KBs generally account for 90 percent of the total assets of the Philippine banking system as of end-June 2012.

[4] Source: www.pdic.gov.ph.

40. **The National Government also extends foreign exchange risk cover on foreign currency denominated borrowings of government banking institutions.** This can be availed for loans from multilateral agencies that are intended for relending to specific sectors. As of end-June 2012, the notional amount of such cover granted to government banks is estimated to be USD2.3 billion.

<u>Risk Mitigation Measures</u>

41. **The Bangko Sentral ng Pilipinas (BSP) recognizes the need to put in place measures to address risks emanating from the financial sector.** The BSP remains committed to pursuing wide-ranging reforms in the banking sector with the broad objective of ensuring financial stability. The reforms which have been implemented focus on areas that are crucial to upholding good governance, risk management and market conduct for banking groups and individual banking institutions.

Provision of Liquidity

42. In the event of a liquidity squeeze in the banking system, the BSP stands ready to provide liquidity in order to maintain the stability of financial markets. In addition to the BSP's standing loan facilities, the BSP could adopt similar liquidity measures which were implemented during the height of the 2008-2009 global financial crisis to ensure the continued access to funds by the public for their operating and capital requirements. The set of measures includes liberalized access to BSP's peso repurchase and rediscounting facilities and an increase in the BSP's peso rediscounting budget.

43. The country's Gross International Reserves (GIR) remain sufficient reaching USD83.6 billion as of end-February 2013. The level of GIR is enough to cover 11.9 months of imports of goods and payments of services/income. It is also equivalent to 10.9 times the country's short-term external debt based on original maturity and 6.7 times based on residual maturity.[5] If warranted, the BSP can also avail of the Chiang Mai Initiative Multilateralization (CMIM) facility to augment its foreign exchange reserves.

Strengthening Bank Supervision

44. Guidelines have been issued by the BSP on the adoption by universal and commercial banks, including subsidiaries and quasi-banks, of the Basel III capital adequacy standards effective 1 January 2014. Banks are also required to comply with international accounting standards consistent with the tenets of fairness, transparency and comparability in financial reporting.

[5] Original maturity refers to the amount of time from the issue date to the final contractual maturity date of the performing financial asset and financial liabilities while residual maturity refers to the amount of time remaining from the report date until the final contractual maturity of the performing financial asset and financial liabilities.

45. The BSP has further enhanced its off-site surveillance toolkit through the implementation of a macro-surveillance framework for off-site supervision and a time-bound prompt corrective action framework for dealing with problem banks.

46. The BSP approved an enhanced version of the Strengthening Program for Rural Banks (SPRB) or the SPRB Plus to improve financial services in rural areas. The SPRB Plus widens the scope of eligible strategic third party investors to include strong and well-managed thrift banks and commercial banks as well as provide for a broader array of financial and regulatory incentives.

Capital Market Development

47. The BSP works with other financial regulators and the industry on capital market-related policies on benchmark rates, derivatives, amendments to the Securities Regulation Code and offshore investments. The BSP also actively supports initiatives aimed at developing domestic corporate bond markets and regional integration to provide an alternative source of financing in the economy.

Ensuring of Financial Stability

48. The Financial Stability Coordinating Council (FSCC), a national-level body composed of the BSP, Securities and Exchange Commission (SEC), Insurance Commission (IC), DOF and the PDIC, was created in April 2012. The Council serves as a venue for financial regulators and the fiscal authority to discuss matters relating to financial stability to come up with a coordinated response in the mitigation of system-wide risks. The tasks of the FSCC include undertaking system-wide vulnerability assessments, formulation of well-coordinated policies on the adequate mitigation of system-wide risks and the proper communication of such policies to the public.

B. GOVERNMENT-OWNED AND/OR-CONTROLLED CORPORATIONS

49. **The DOF continued to closely monitor the contribution to the public sector deficit or surplus, and other financial indicators, of the fourteen major non-financial government corporations (MNFGCs), three governmental financial institutions (GFIs), and three social security institutions (SSIs)** (see Table 8). DOF, through the Corporate Affairs Group (CAG), actively monitors the financial position of government corporations and their impact on the fiscal position, in line with DOF's mandate to generate financial resources and ensure sound and efficient management of such resources. The DOF-CAG also complements the role of the Governance Commission for GOCCs (GCG) which was created as the central advisory, monitoring and oversight body in the government corporate sector, pursuant to RA 10149 (GOCC Governance Act of 2011). Some of the GCG functions are to review and determine which GOCCs should be reorganized, merged, streamlined, abolished or privatized, establish performance evaluation systems and adopt government corporate governance standards.

Table 8. Philippines: Consolidated Public Sector Financial Position, 2009-2011
(as percent of GDP, unless otherwise specified)

Particulars	2009	2010	2011
Consolidated public sector financial position	-3	-4	-1.8
Non-financial public sector financial position	-4.1	-4.2	-2.3
Financing position of 14 major MNFGCs	-0.2	-0.7	0.2
in billion pesos	-19.25	-66.93	-19.84
Financing position of GFIs	0.9	0.1	0.1
in billion pesos	10.78	9.45	9.76
Financing position of SSIs	0.5	0.4	0.5
in billion pesos	39.06	40.12	47.97

Source: DOF

50. **In 2011, the consolidated net financing deficit of the 14 MNFGCs amounted to P19.84 billion, a 70% decrease from the previous year's level.** This is primarily due to lower importation by the National Food Authority in 2011 in view of substantial stock overhang from heavy importation during previous years. Other GOCCs which contributed to narrowing the deficit were the National Housing Authority (NHA), Local Water Utilities Administration (LWUA), National Electrification Administration (NEA), and the National Irrigation Administration (NIA). These improvements were more than sufficient to negate the higher deficit of the Power Sector Assets and Liabilities Management Corporation (PSALM) due to the tapering of privatization proceeds.

51. **SSIs and GFIs downplay the deficit of the 14 MNFGCs to a great extent.** As against the MNFGCs average consolidated deficit of P35.3 billion for the years 2009-2011, SSIs and GFIs posted an average cash surplus of P42.4 billion and P10.0billion, respectively, for the same period.

52. **SSIs posted a cash surplus of P48 billion in 2011, a 20% increase from the 2010 surplus of P40 billion.** The significant improvement was mainly due to substantial proceeds from the sale of the share of the Government Service Insurance System (GSIS) in one of its major investments. The two other SSIs are the Social Security System (SSS) and the Philippine Health Insurance Corporation (Philhealth).

53. **Challenging times and strong competition in the banking industry hampered the financial performance of GFIs.** GFI surplus for 2011 amounted to P9.76billion, a 3% increase from the 2010 cash position of P9.45 billion. GFIs include the Development Bank of the Philippines, Land Bank of the Philippines, and the Trade and Investment Development Corporation of the Philippines (formerly Philippine Export and Foreign Loan Guarantee Corporation). The GFIs' major revenue drivers are their managed loans and investment portfolio. To curb potential ill-effects, some innovative measures were planned by the GFIs to remain competitive.

Activities Undertaken and Progress Achieved in Pursuit of GCG Mandates

The GOCC Governance Act of 2011 (R.A. No. 10149) is the cornerstone in the government's resolute march to initiate and institutionalize a paradigm shift in the governance of GOCCs. In just a year after its creation, the GCG has already accomplished the following in pursuit of its mandate:

1. Cleaned up and reclassified the official list of GOCCs for monitoring and evaluation purposes.

2. Began implementing the following organic documents as approved by the President:
   a. Ownership and Operations Manual Governing the GOCC Sector;
   b. Code of Corporate Governance for GOCCs; and
   c. Fit and Proper Rule for Appointive Directors and CEOs of GOCCs.

3. Initiated coordination/consultation efforts and partnership with key government agencies in addressing: (a) the GOCCs' Rationalization Plans and Applications for Salary Adjustments (with DBM); (b) the development and harmonization of the Compensation and Position Classification System (CPCS) for GOCCs with Civil Service laws, rules and regulations (with the Civil Service Commission or CSC); (c) the Commission on Audit's (COA) fiscal issues and operational management of specific GOCCs; (d) the initial mechanics of the transfer of the privatization functions of the Privatization and Management Office (PMO) to GCG for GOCCs under its care; and (e) surrendered corporations under the GCG's coverage currently under the care of the Presidential Commission on Good Government (PCGG).

4. Prepared the GCG Information Systems Strategic Plan (ISSP), which covers the GCG's key IT projects, namely: the Integrated Corporate Reporting System (ICRS) and the GOCC Leadership Management System. Development of the ICRS is already underway and is set to be completed by the end of the first quarter of 2013.

5. Reviewed the appointments of all incumbent Appointive Directors/Trustees and submitted to the President shortlists of nominees for appointment/reappointment to the various GOCC Governing Boards for the term beginning 01 July 2012 and ending 30 June 2013.

6. Began reviewing, in collaboration with Towers Watson Philippines, Inc., the various compensation and position classification systems in the GOCC Sector with the view of harmonizing and aligning the same to be competitive with the private sector.

7. Discontinued anomalous and excessive compensation practices among certain GOCCs.

8. Implemented an interim Performance Evaluation System complimented by a Performance-Based Incentive program for 2012 in order to both monitor and motivate/drive organizational performance in the GOCC Sector.

Moving Forward in Pursuit of GCG Mandates

Cognizant of the role of GOCCs as significant tools for economic development, the GCG intends to fulfil the following:

1. Rationalize the GOCC sector to its optimum size by evaluating the performance and relevance of GOCCs.

2. Evaluate GOCCs that have regulatory and/or commercial functions to move towards privatization of commercial and/or transfer of regulatory functions to the appropriate regulatory agencies to avoid conflicts of interest.

Source: GCG

54. **Total liabilities of the government corporate sector[6] amounts to P3.2trillion according to the 2010 COA audited report** (see Table 9). The liabilities of the 14 MNFGCs account for 49% of the total liabilities and is by itself equivalent to 17.4% of GDP.

Table 9. Philippines: Liabilities of the Government Corporate Sector and 14 Major Non-Financial Government Corporations (MNFGCs), 2010
(in billion pesos, unless otherwise specified)

Particulars	Total Liabilities	% of GDP
TOTAL GOCCs	3,177.91	35.3
Share of 14 MNFGCs (%)	49%	
TOTAL 14 MNFGCs	1,567.91	17.4
NPC/PSALM/TransCo[a/]	1,132.00	12.6
NPC	66.07	0.7
PSALM	891.65	9.9
TransCo	174.28	1.9
NFA	178.41	2
LRTA	69.23	0.8
NIA	41.89	0.5
HGC	25.52	0.3
PNR	24.96	0.3
MWSS	21.71	0.2
PPA	16.01	0.2
NEA	14.84	0.2
LWUA	12.22	0.1
NHA	9.62	0.1
NDC	9.47	0.1
PNOC and Subsidiaries	10.5	0.1
PEZA	1.56	0

Source: 2010 COA Audited Report except PNOC and Subsidiaries figures which are based on unaudited financial statements, comprising 123 GOCCs.
a/ NPC, PSALM and Transco are counted as one corporation.

55. **A majority of GOCC liabilities are guaranteed by the National Government made possible through the charter of the GOCCs or RA 4860, as amended (Foreign Borrowing Act)**(see Table 10). GOCCs are often directed to bear the cost of social programs which are not recoverable and therefore should ideally be funded out of the budget, but are instead funded through borrowings.

[6] Excluding the Bangko Sentralng Pilipinas.

Table 10. Philippines: Outstanding Government Guaranteed Debt to GOCCs, 2011
(Unaudited, in million pesos)

	Amount in Million Pesos	% of GDP
MNFGCs		
PSALM	338,110	3.47%
NFA	143,670	1.48%
HGC	16,274	0.17%
LRTA	11,043	0.11%
MWSS	10,461	0.11%
PPA	9,219	0.09%
NIA	6,631	0.07%
LWUA	4,553	0.05%
NDC	3,525	0.04%
PNR	2,065	0.02%
NPC	929	0.01%
NHA	755	0.01%
PEZA	180	0.00%
NEA	114	0.00%
GFIs/SSIs		
DBP	85,460	0.88%
LBP	31,835	0.33%
TIDCORP	1,350	0.01%
PHC	-	0.00%
Others		
NHMFC	34,615	0.36%
BCDA	32,278	0.33%
SBMA	9,733	0.10%
MIAA	5,522	0.06%
NLRC (NORTHRAIL)	3,954	0.04%
SBGFC	2,038	0.02%
TIEZA (formerly PTA)	521	0.01%
PDA	386	0.00%
TOTAL	**755,220**	7.76%

Source: DOF

56. **The National Government extends advances for the debt servicing of guaranteed GOCCs obligations to avoid defaulting on guaranteed commitments** (see Table 11). This is often the case where GOCC cash flows are insufficient to pay debt on its own, either because they are operating at a loss or are only marginally profitable because tariffs or charges do not allow full cost recovery.

Table 11. Philippines: Outstanding NG Advances to GOCCs, 2009-June 2012
(in billion pesos)

Particulars	2009	2010	2011	As of June 2012[a/]
Of the 14 MNFGCs				
NIA[b/]	34.2	39.84	43.68	45.9
LRTA	16.51	20.41	22.99	24.66
PNR	18.97	20.09	21.07	21.52
NEA	19.55	19.78	19.92	19.97
NPC/PSALM[c/]	9.26	11.57	13.6	24.73
NFA	3.87	4.03	12.16	12.24
NDC	1.83	2.14	3.83	3.95
Other GOCCs	**16.36**	**17.46**	**17.47**	**18.33**
TOTAL	**120.54**	**135.33**	**154.73**	**171.3**

Source: BTr.Includes interest on NG advances.

a/ As of June 2012, outstanding NG advances corresponding to interest on NG advances amount to P38.14 billion.

b/ Represents Casecnan-related accounts

c/ Includes Casecnan-related accounts

Government Support for GOCCs

GOCCs often perform functions in support of social objectives. As such, Government support to marginally profitable GOCCs in distress is often necessary in view of the public interest.

The National Food Authority's (NFA) policy mandate of stabilizing prices for both producers and consumers make it difficult to generate sufficient funds to pay off its own debt. While the level of increase in NFA borrowing was minimized to a certain extent, DOF has requested NFA to further revisit its role under the Food Staples Sufficiency Program with the end objective of further decoupling its mandate – so that functions requiring subsidy are performed by government agency/ies and NFA performs responsibilities which are based on the principle of financial viability.

Other GOCCs requiring assistance whose low tariffs and collection rates do not allow them to cover operating expenses as well as contractual and debt obligations include the National Irrigation Administration(NIA), Philippine National Railways' (PNR), and the Light Rail Transit Authority (LRTA).

The power corporations remain a key source of fiscal risks. EPIRA envisioned that any losses [7] suffered by PSALM would be recovered through universal charges for stranded debt and stranded contract costs. [8] Although PSALM first filed for such recoveries in 2009 with the Energy Regulatory Commission, it has yet to be granted the authority to collect the universal charge. Until these are approved and collected at the rates sufficient to cover the actual costs, PSALM's financial condition and dependence on NG support will remain and it will continue to borrow. From 2012 onwards, the DOF envisions the NG to be the one to borrow and lend directly to PSALM for its funding requirement, rather than issue a guarantee for PSALM's borrowings - this arrangement will result in lower all-in borrowing costs.

57. **As of June 2012, the National Government has been able to realize net inflows from GOCCs amounting to P4.13 billion owing to dividends, fees and revenue shares** (see Table 12). Steps have been taken in accounting for and pursuing the collection of dividend arrears and close monitoring of the financial performance of GOCCs, including their subsidiaries.

7 Pursuant to EPIRA, NPC's assets and liabilities (except the Small Power Utilities Group or SPUG-related assets and other assets) were transferred to PSALM. The transferred debts to PSALM were supposed to be paid off from the proceeds of the privatization of the generation assets, concession fees from the private company's operation of the transmission grid, power generation income from the operations of the unsold generation plants, revenues from contracts with IPPs and IPPAs, and collection of universal charge.

8 Section 4 of the EPIRA: Stranded debt refer to any unpaid financial obligations of NPC which have not been liquidated by the proceeds from the sales and privatization of NPC assets. Stranded contract cost refers to the excess of the contracted cost of electricity under eligible contracts over the actual selling price of the contracted energy output of such contracts in the market. Such contracts shall have been approved by the ERB as of December 31, 2000.

Table 12. Philippines: Net Budgetary Flows to GOCCs, 2009-June 2012
(as percent of GDP, unless otherwise specified)

Particulars	2009	2010	2011	As of June 2012
NG Flows from GOCCs	**0.4**	**0.3**	**0.5**	**0.3**
(in billion pesos)	**35.72**	**26.99**	**46.95**	**28.97**
Dividend	0.2	0.1	0.3	0.2
Interest on NG Advances	0	0	0	0
Guarantee Fees Collected	0.1	0	0	0
Forex Risk Cover Fee	0	0	0	0
NG Share on Net Income	0.2	0.1	0.1	0.1
Airport Terminal Fee	0	0	0	0
NG Flows to GOCCs	**0.3**	**0.4**	**0.9**	**0.2**
(in billion pesos)	**23.86**	**32.41**	**84.65**	**24.84**
Subsidy[a/]	0.2	0.2	0.6	0.1
Equity	0	0	0.1	0
Net Lending	0.1	0.1	0.2	0.1
Net NG Flows to GOCCS (I-II)	**0.1**	**-0.1**	**-0.4**	**0**
(in billion pesos)	**11.85**	**-5.42**	**-37.7**	**4.13**

Source: BTr

1/ Subsidy excludes tax subsidies totaling to P160,472 million for 2008 to 2011. Effect of tax subsidy is neutral since it is considered as both revenue and expenditure of the government. Difference in total is due to rounding.

C. PUBLIC-PRIVATE PARTNERSHIPS

58. **Public-Private Partnerships (PPPs) entail an assignment of roles and allocation of risks between the government and private sector proponents.** Fiscal risks stemming from PPP contractual agreements pertain to commitments made by government line agencies during the execution of major projects which may be covered by performance undertakings or guarantees by the national government. Some of these eventualities translate to actual liabilities and budgetary outlays when they materialize and can affect fiscal objectives and sustainability.

The government's approach in managing contingent liabilities in relation to PPPs is summarized in the following policy directions:

1. The government is implementing a framework for the monitoring and management of contingent liabilities in PPP projects that will ensure economic efficiency and fiscal sustainability.

2. At the project level, the government pursues an optimal assignment of roles and risks such that contingent liabilities in each project are equitable and consistent with fiscal prudence and significant Value-for-Money. These criteria are incorporated in the project approval process in the NEDA ICC and are reflected in the terms and conditions of each project agreement.

3. At the aggregate level, the government will ensure exposure to contingent liabilities is consistent with fiscal sustainability. The DOF, DBM, and NEDA, working within the DBCC process, will determine the prudent ceiling for total contingent liabilities.

4. The government is pursuing budgetary programs for provisioning and maintaining reserve funds for an orderly financing of contingent liabilities that may materialize. The government will incorporate a line appropriation item for contingent liabilities in the GAA based on the estimated outstanding level from legacy projects and projections from new PPP projects.

The government is adopting a framework for managing contingent liabilities consistent with these policy directions which consists of:

1. Regular analysis and quantification of contingent liabilities;

2. Recognition of existing contingent liabilities from legacy projects and a formal process for approving contingent liabilities associated with pipeline PPP projects;

3. A process for regular monitoring and updating of contingent liabilities for each project, and for aggregating the total amount at the macro level;

4. A process for the disclosure of contingent liabilities in the FRS and in the GAA as well as in investor reports; and

5. A process for provisioning and funding contingent liabilities.

59. **As reported in the General Appropriations Act of 2012, existing "legacy" projects consist of 38 major operational projects with an aggregate original project cost of USD 16.38billion** (see Annex B).The largest projects are the MWSS privatization of the two Metro Manila water concessions, and the BOT IPP projects.

60. **Estimates suggest that fiscal risks from legacy contingent liabilities are manageable and will not significantly affect fiscal sustainability.** Contingent liabilities from legacy projects primarily consist subsidies covering shortfalls in approved tariffs from contractual agreements and

buyout provisions, which are mitigated by the fact that most have already been operating for a number of years. Furthermore, some contingent obligations are already covered by NG advances to concerned agencies.

61. **Two new PPP projects are expected to begin execution in 2012: the DaangHari interconnection tollway and the PPP for School Infrastructure Project (PSIP) BLT.** The DaangHari project is valued at P1.96 billion while the PSIP has a total project cost of P10.4 billion.

62. For 2013 onwards, Table 13 details some of the PPP projects expected to be executed with their corresponding project costs:

D. LOCAL GOVERNMENT UNITS (LGUs)/ SUBNATIONAL GOVERNMENT

Table 13. Philippines: 2013 New PPP Project Pipeline
(in million pesos)

Project Title	Estimated Cost
LRT 1 South extension/O&M	59,200
New Centennial Water Supply Source	25,000
NLEX-SLEX Connector	20,191
CALA Expressway	19,690
NAIA Expressway	15,770
Mactan Cebu Terminal	10,150
Panglao Airport	8,000
Philippine OrthopedicCenter	5,000
Automatic Fare Collection System	1,800
Laguindingan Airport O&M	1,800
Angat Hydro Electric	1,600
Vaccine Self-Sufficiency Project	453
2013 onwards	168,654

Source: NEDA PPP Center

63. **Low revenue generation and overreliance on Internal Revenue Allotments (IRA) is a lingering concern for Local Government Units (LGUs).** The Local Government Code (LGC) makes LGUs broadly responsible for raising and mobilizing local revenues. Likewise, various modalities were identified in conjunction with the exercise of the LGUs' corporate powers under the LGC from public-private partnerships, build-operate-transfer, privatization, and other schemes, to availing of loans and grants from both local and international sources. However, a majority of LGUs still rely on National Government transfers, particularly the Internal Revenue Allotment (IRA), due to low income generation and low revenue base. Moreover, poor economic stewardship diminishes the net revenue effect of local enterprises. Lastly, the 20-year old rules and procedures governing local government borrowing may be ill-equipped to ensure long term fiscal sustainability in the face of financial development and rising financial complexity.

64. **Local revenue generation is hampered by outdated and undervalued property valuations, which effectively diminishes the real property tax base.** Despite the LGC mandate for general valuation reassessments every three years, substantial efficiency shortcomings constrains collection to only 20-30% of potential real property taxes. BLGF records reveal a steady decline in compliance with general revisions from 83% in 1992 down to only 25% in 2008. Technical capacity is another issue as some LGUs appear to have problems collecting the RPT, even at the low assessed values.

65. **LGUs have been largely prudent in their borrowings with no more than half having fully utilized their estimated borrowing capacities.** Preliminary figures indicate total LGU project borrowings from financial institutions have reached P66.49 billion as of September 2011.

66. **Potential LGU borrowings as gauged by intention to borrow, is still limited but growing to include barangays during the past 5 years.** Data on LGU applications for debt capacity certification form the Bureau of Local Government Finance (BLGF) from 2002-2011 indicate that an average of 34 provinces (43.0% of 80 provinces), 53 cities (38.3% 0f 138 cities)302 municipalities (20.2% of 1,496 municipalities) and 27 barangays (0.1% of 42,027 barangays) have applied for a debt capacity certification per year. On average, 22.7% of LGUs, excluding barangays, annually apply for a debt capacity certificate from BLGF.

67. **LGU borrowings constitute only a small fraction of total outstanding loans and investments averaging 1.4% of total outstanding loans and investments from 2002-2009.** Preliminary September 2011 figures indicate that LGU borrowings are just 2.6% of the P3.222 trillion outstanding loans of the banking system. Thus, it has very little effect on the supply of financial credit resources.

Risk Mitigation Measures

68. **Two important memorandum circulars are now implemented to facilitate LGU exercise of their fiscal autonomy**. JMC No. 2010-01 enjoins LGUs to regularly revise the Schedule of Market Values (SMVs) and property assessments and classification while JMC No. 2010-02 reinforces the imposition of "additional ad valorem tax on idle lands to promote productive and responsive land ownership. These initiatives will not only mitigate potential risks but also empower LGUs in managing their resources and strengthen their fiscal position making them less dependent on the IRA. Technical assistance is also available through trainings

and workshops covering reform areas in improving collection of real property, business taxes and other receipts.

69. Another step is the adoption of a course book on Revenue Generation and Updating the Local Revenue Code to help LGUs in developing new strategies and exploring innovative ways in enhancing their financial capabilities. Lastly, there are mainstream and rollout reforms initiated under the LAMP2 Component 4 such as the Philippine Valuation Standards (PVS), Mass Appraisal Guidebook, Valuation Database Information Systems (VDIS), local tax studies as well as continued advocacy for the Valuation Reform Act, tax reforms, and professionalization of practitioners in the valuation sector.

70. The LGC can be amended to incorporate revenue capacity and human development indicators in addition to population and land area in the IRA formula to address inequities in the system. Adding revenue capacity considerations to the IRA formula would provide incentives for LGUs to mobilize own source revenue. Under such an arrangement, as recommended by an IMF Team, the part of the IRA pool allocated to LGUs with lower revenue capacities would increase.

71. The BLGF is pursuing several key initiatives to effectively manage risks emanating from LGU loans and borrowings:

a. Strict implementation of the BLGF Debt Certification and Creditworthiness Rating System to minimize the risks of having bad LGU Loans.

b. Development of an LGU Debt Management and Monitoring System to ensure manageable and prudential limits on local indebtedness and provide a better measure of the impact of proposed borrowings on the finances of LGUs. The system would require all relevant information on existing and new local indebtedness as a condition for granting of loans or bond issuance.

c. Drafting of BLGF instructional manual on assessment of LGU loans/borrowings capacity and statistical information analysis.

d. Release of an LGU guide on managing loans/borrowings that will contain discussions on risks, debt service management, LGU best practices in the Philippine setting, and other relevant debt mechanisms.

e. Publication of a national registry of local government debt that is freely accessible on the DOF web page. This will enable the public to know how much their respective LGUs borrow and to check whether the proceeds are utilized for intended developmental projects.

f. Proposed Technical Assistance from the World Bank would cover the following:

i. Review and assessment of existing policies, guidelines and mechanism on contracting loans and borrowings, including the effectiveness of the existing Debt Service Formula and the process of issuance of Certification of Borrowing Capacity.

ii. Establishing efficient and appropriate tools and systems to manage, monitor, record and publish local governments' loans and borrowings for transparency and greater accountability.

E. NATURAL DISASTERS

72. The Philippines is one of the most vulnerable countries to natural disasters. The country ranked 3rd in the 2011 World Risk Report published by the United Nations University Institute for Environment and Human Security (UNU-EHS). In 2011, the country saw 33 disaster events with tropical storm Sendong (international name: Washi) alone claiming 1,000 lives in Northern Mindanao.

73. In 2011, weather disturbances, floods, tremors, and landslides have resulted in total direct and indirect losses of P59.23 billion, representing 0.63% of GDP. Tropical storm Pedring (international name: Nesat) resulted in total losses of P9.33 billion, representing 0.1% of nominal GDP. Meanwhile, severe tropical storm Washi alone caused P14.1 billion worth of total damage, representing 0.15% of GDP and is estimated to have reduced real GDP growth rate by 0.09 percentage points. In total, it was estimated that annual real GDP growth rate may have been reduced by 0.4 percentage points through resulting damages to inputs and interruptions to work and business. This reduction in GDP was most likely shared between 2011 and 2012. However, the government assistance to affected sectors as well as reconstruction efforts can boost real GDP growth by 0.002 percentage points.[9] More recently, NEDA estimates that typhoon Gener (international name: Saola) and the Southwest Monsoon may have reduced the country's economic growth rate by 0.051 to 0.053 percentage points, which is likely to be shared between 2012 and 2013.[10]

74. The Government recognizes the severe impacts of natural disasters and has made progress in the following areas: (a) Prevention and mitigation, (b) Preparedness, and (c) Risk transfer.

<u>Prevention and Mitigation</u>

75. Government agencies are undertaking steps to assess disaster susceptibility and preparedness. The Department of Education (DepEd) and the Department of Transportation and Communication (DOTC) have begun risk mapping initiatives, which allows them to assess vulnerable assets. Meanwhile, the Department of Health (DOH) is currently implementing its "Safe Hospitals in Emergencies and Disasters" program funded thru a European Union grant. The program involves a disaster risk assessment of existing health facilities covering all types of risks including the structural resilience of hospitals.

[9] Based on NEDA's economic outlook as of December 26, 2011
[10] Based on NEDA's estimates as of August 22, 2012

76. The Department of Public Works and Highways (DPWH) has introduced a comprehensive master plan for effective flood management in Manila and outlying provinces up to 2035. The plan calls for at least P352 billion in infrastructure spending, covering a total of 11 projects. The "high priority" projects are the Manila core area drainage improvements (P27.2 billion); East Manggahan Floodway and improvement in Cainta and Taytay rivers (P26 billion); Malabon-Tullahan river improvements (P21.6 billion); Meycauayan river improvements (P14.04 billion); Valenzuela-Obando-Meycauayan river improvements (P8.631 billion); land-raising for small cities around Laguna lake (P7.15 billion); and improvement of inflow rivers to Laguna lake (P637 million).

77. For 2012, the Metro Manila Development Authority (MMDA) has a budget of P279.2 million for various flood control initiatives which includes the Pasig, San Juan and Marikina River systems. A part of the budget is also allocated to improving the drainage system, as well as dredging in various areas of Metro Manila such as Makati and Quezon City.

<u>Preparedness</u>

Improved Response Systems

78. To enable better coordination and efficiency on the ground during disasters, the Armed Forces of the Philippines (AFP) trains personnel from service provider agencies such as health services, water, power, transport, etc. in disaster preparedness. Meanwhile, the National Food Authority (NFA) is undertaking the emergency food development program that seeks to find ways to increase the shelf life of various kinds of food such as rice, meat, etc. It also offers microbial, chemical and physical analysis of rice and other crops to test for damages.

79. In 2012, the Department of Agriculture (DA) allocated P31.48 million to establish agro-meteorological stations in highly vulnerable agricultural areas. These are meant to provide early warnings to make the necessary preparations to save as much produce as possible and/or give ample time for evacuation if needed.

Disaster Risk Financing Strategy

80. Thru the Global Facility for Disaster Reduction and Recovery (GFDRR), the World Bank is providing assistance to DOF in the formulation of the Government's Disaster Risk Financing Strategy. The strategy aims to outline reform areas and key actions that could be undertaken by the Philippine Government in the short, medium, and long-term horizon to mitigate the fiscal and economic effects of the recurrent impacts of natural disasters.

81. The Disaster Risk Financing Strategy will include the design of appropriate risk financing instruments and mechanisms. International and local consultants have been called in to assist with the drafting of the strategy. Currently, a stock-taking

exercise of disaster-related initiatives as well as an initial list of all assets held by the National Government has just been completed by the local consultant as an initial step in this initiative.

Risk Transfer

82. The Government is interested in improving its capacity to assess ex-ante, potential impacts of natural disasters. To that end, GFDRR is also financing the development of a catastrophe risk model for the Philippines. This is expected to increase the resilience of the country to natural disasters through:

a. A geo-referenced catalogue of past natural disasters, along with financial and economic losses;
b. A database for government assets and their associated vulnerabilities to natural disaster;
c. A quantitative risk profile for the Philippines which cover weather/ precipitation risks, as well as seismological risks; and
d. Design of a parametric insurance scheme.

83. Using risk transfer instruments like the abovementioned parametric insurance will allow the government to leverage available resources by using a portion to pay insurance premiums. Parametric insurance is a type of insurance which compensates policy holders based on a triggering catastrophe event (e.g. an 8.0 magnitude earthquake). It is extremely quick-disbursing, requiring only confirmation of the triggering event (not an assessment of losses suffered which can take months).

84. The Philippine government has always absorbed the impacts of natural disasters to its own balance sheet, and to defer the full reconstruction and rehabilitation of affected infrastructure. Such deferment inevitably lowers economic growth as damaged infrastructure cannot adequately support rapid economic expansion. Throughout the years, resources dedicated to immediate relief, reconstruction and rehabilitation have been increasing as seen in the Table 14.

Table 14. Philippines: Calamity and Quick Response Fund, 2006-2012
(in billion pesos)

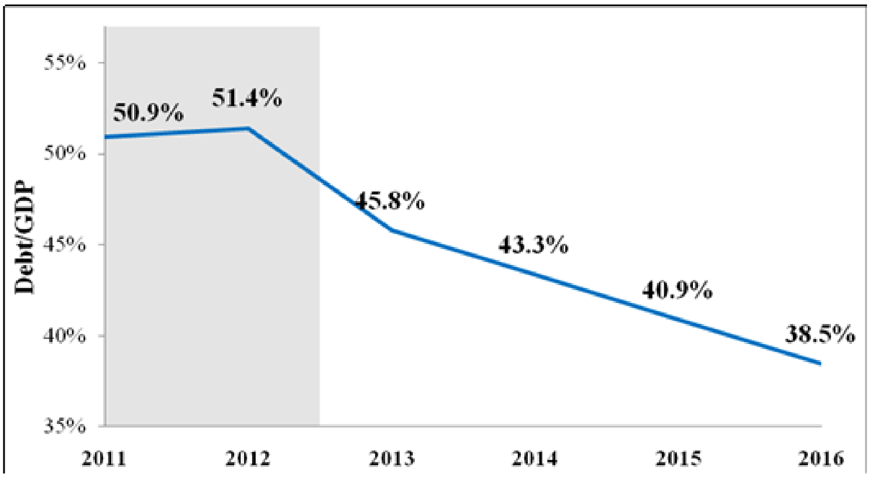
2006	2007	2008	2009	2010	2011	2012
2.76	9.2	4	4.9	4.4	6.88	10.65

Source: DBM

Annex A. Philippines: Public Debt Sustainability Analysis (DSA)

The most recent DRMO Debt Sustainability Analysis shows a declining trend for debt as a percentage of GDP. Baseline estimates indicate a debt-to-GDP ratio of 38.5% by 2016. The fan chart in Figure 2 shows the probable progression of NG debt as a percentage of

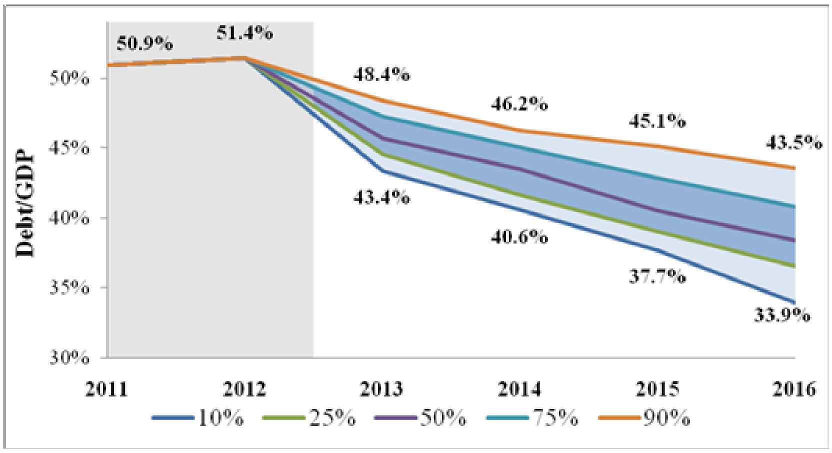
Figure 1. NG Debt to GDP Medium-Term Simulation



Source: DRMO staff estimates

GDP in the VAR analysis. The area in between the upper (90th percentile) and lower (10th percentile) limits of the chart indicate an 80% probability that debt-to-GDP will fall within that range for the given period.

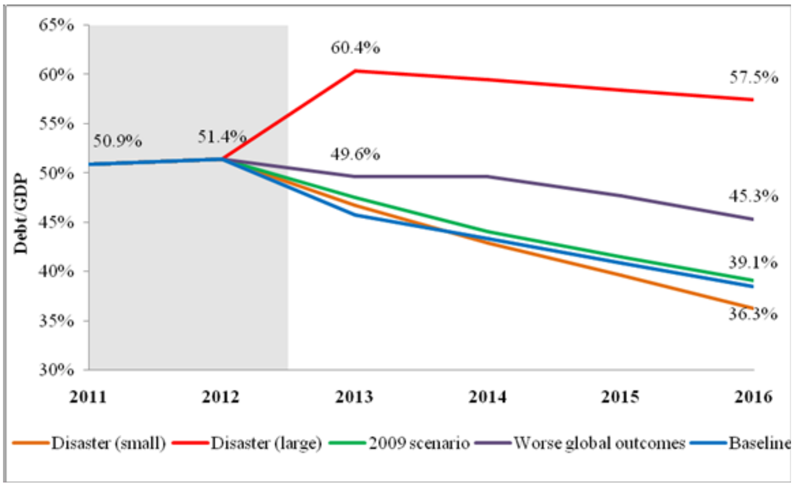
Figure 2. NG Debt to GDP Var Analysis



Source: DRMO staff estimates

Simulating various scenarios shows that large natural disasters have a lasting impact on debt levels while small scale disasters can even lower relative debt levels further due to economic growth from reconstruction efforts. Lastly, the scenario analysis reveals that a global economic downturn would have a manageable impact on debt sustainability given the composition of NG debt.

Figure 3. NG Debt to GDP Scenario Analysis



Source: DRMO staff estimates

Annex B. Philippines: Public-Private Partnership (PPP) Program

Summary List of Valid and Binding Contracts/Operational Projects

(Projected for end-December 2012)

Project Title	Estimated Cost (US$ millions)	IA/LGU	Scheme	
1 MWSS Privatization	4,593.0	MWSS	CAOM	
2 MWSS Privatization	2,406.0	MWSS	CAOM	
3 Sual Coal-Fired Thermal Power Plant	1,200.0	NPC	BOT-ECA	UC
4 San Roque Multi-purpose Project	1,141.0	NPC	BOT-PPA	
5 Ilijan Natural Gas Combined Cycle Power Plant	960.0	NPC	BOT-ECA	
6 Pagbilao Coal-Fired Power Plant	888.0	NPC	BOT-ECA	UC
7 Light Rail Transit Line No. 3 (MRT 3)	655.0	DOTC	BLT	
8 Casecnan Multi-Purpose Irrigation and Power Project	650.0	NIA	BOT	
9 Leyte-Luzon Geothermal Power Plant (Malitbog-Mahanagdong)	630.5	PNOC-EDC	BOO-PPA	No PU
10 Caliraya-Botocan-Kalayaan Power Plant Project	450.0	NPC	BROT	
11 Metro Manila Skyway (Stage 1)	419.0	PNCC/TRB	JV	
12 Pabahaysa Riles	400.0	PNR/NHA	DOT/BT	No PU
13 Manila North Luzon Tollway	370.0	DPWH/TRB	JV	
14 Mindanao Coal-Fired Thermal Power Plant	310.0	NPC	BOT-PPA	
15 Leyte-Cebu Geothermal Power Plant	305.5	PNOC-EDC	BOT-PPA	UC, No PU
16 Manila- Cavite Toll Expressway	131.0	PEA-TRB	JV	
17 Subic Water & Sewerage	120.0	SBMA	JV	No PU
18 Zamboanga Diesel Power Plant	110.0	NPC	BOO-ECA	UC
19 Bakun A/B and C Hydro Power Plant	83.0	NPC	BOT-PPAI	mmaterial
20 Mindanao I Geothermal Plant	79.6	PNOC-EDC	BOT-PPA	No PU
21 Database Infrastructure and Information Technology System	75.0	LTO	BOO	
22 Mindanao II Geothermal Plant	72.3	PNOC-EDC	BOO-PPA	No PU
23 Civil Registry System	65.0	NSO	BTO	
24 General Santos Diesel Power Plant	60.0	NPC	BOO-ECA	UC
25 Clark Water Supply & Sewerage	55.0	CDC	CA	No PU
26 Southern Tagalog Arterial Rd. (STAR)	53.0	DPWH	BTO	
27 Mandaluyong Marketplace	23.0	Mandaluyong City Gov't.	BOT	
28 Benguet Province Mini Hydro	22.0	NPC	under RA 7156	UC
29 Samal Island Resort Estate Dev't.	15.0	DOT	BOT	
30 Bohol Water Supply System	14.4	Bohol Prov'l. Gov't.	JV	
31 Bohol Provincial Electric System	5.0	Bohol /Prov'l Gov't.	JV	
32 Cogon Public Market	4.0	Cagayan de Oro City Gov't.	BT / BOT	
33 Slaughter House	3.0	Cagayan de Oro City Gov't.	BOT	
34 Alien Certificate of Registration(ACR) Smart Card Project	2.8	BI	BOT	
35 Carmen Public Market	2.4	Cagayan de Oro City Gov't.	BOT	
36 Dapitan Public Market	1.3	Quezon City Gov't.	JV	
37 Bocaue Public Market	1.2	Bocaue, Bulacan/ Mun. Gov't.	JV	
38 NKTI-Hemodialysis Center Project	1.0	DOH	PSP- Lease Contract	
Total for Valid and Binding Contracts (Operational Projects)	**16,377.92**			

Source: BESF