



The PEACe Bonds



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by JUDE ESGUERRA

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CODE-NGO'S PEACE BONDS

Financing Civil Society's Fight Against Poverty

by DANILO A. SONGCO

National Coordinator, CODE-NGO

centavo from this project. We set out in this project with a clear objective to raise funds for poverty eradication projects. We believe that the accomplishment of this objective will redound to the benefit of the poor and marginalized in our country and will lead to the strengthening of a vibrant yet financially beleaguered civil society.

sion (NPAC) and the Department of Finance will each have one representative as ex-officio, non-voting members of the board. As the term of office of the six trustees from CODE-NGO expires, they will be replaced by other prominent NGO leaders who are not from CODE-NGO. In time, the Peace and Equity Foundation will be fully independent from CODE-NGO.

Having heard a lot of arguments about the PEACe bonds, it seems that there are two underlying reasons for the controversy. The reason behind the Senate investigation was unraveled through the confirmation process of Sec. Lito Camacho. The PEACe bonds was a potent reason to block his confirmation because of his family relation to CODE-NGO's chair and because the project went through government agencies that he either supervised or are related to his department. The fact that he has hurdled the most difficult part of the confirmation process does not seem to indicate that the Senate investigation will be aborted. Unfortunately, the PEACe bonds have become a political issue.

The other underlying reason seems to be the discomfort of some of our civil society colleagues in our participation in the capital market, one of the bastions of capitalism. Some civil society activists do not trust the market because they believe there is no such thing as a free market. As such, they probably conclude that the funds that we raised (particularly since they are quite huge) was the product of manipulation of the market.

However, when CODE-NGO decided to tap the capital market for funds, we knew we had to engage the market. The capital market has its own rules that one needs to follow if one wants to benefit from it. We played by these rules while making sure at every step of the way that we did not break any law or government procedure. Still we stand firm in our conviction that the funds that we raised were obtained legally and morally. The funds that we raised are fully accounted for and neither Marissa Camacho-Reyes nor I earned a single

Smarter Than Others?

The RCBC and CODE-NGO PEACe Bonds¹

by **JUDE ESGUERRA**
DEVELOPMENT WATCH
Institute for Popular Democracy (IPD)

¹ An excellent companion reading to this piece is "Zero-Sum Game: Myths and Facts," published as a seven-part series in the *Manila Tribune*, Jan. 14-20 2001.

CODE-NGO wishes the public to believe that it received P1.4 billion for its PEACe and Equity foundation because of an innovative idea.

It lobbied for a new kind of indebtedness for the Philippine government (10-year treasury zeroes in which the interest earnings are capitalized semi-annually into the value of the bond) and then got the Rizal Commercial Banking Corporation (RCBC) to lend the government P10.17 billion through these new instruments of indebtedness. RCBC then sold the bonds to CODE-NGO at cost, but only so CODE-NGO can turn around and sell the bonds at a markup of P1.4 billion to RCBC's subsidiary – RCBC Capital.

Instead of handshakes, CODE-NGO's revelation of its transaction with government and RCBC only raised more questions, not to mention eyebrows.

PHILANTHROPY AWARD FOR RCBC?

At first glance, at least, this is not at all about CODE-NGOs ingenuity, but an inexplicable act of philanthropy on the part of RCBC. For why would a bank part with an amount of money that was three times its anticipated net profit for 2001? Why did RCBC not buy directly on behalf of its affiliates to avoid having to part with P1.4 billion? The answers one would get from the parties concerned are at best evasive.

CODE-NGO and its financial advisers explain that RCBC did not come out empty handed from this deal. According to CODE-NGO, RCBC Capital, which became the only owner of these government bonds right after the auction, stood to earn from reselling or lending out these government bonds to other banks and to insurance companies. P1.4 billion was only the first part of the profit, CODE-NGO explains that it left some to keep RCBC shareholders happy as well.

If this is so, one cannot be wrong in saying that if RCBC did not have to transfer P1.4 billion to CODE-NGO's foundation, then a more aggressive bid – that would nevertheless still have

be auctioned in order to ensure transparency in its sale and in order to discover the real price of these bonds in the market. Had CODE-NGO lost in the auction, it would have lost everything that it worked for.

Where is the money now?

The two trust funds were established from the net proceeds of P 1.48 billion from sale of the PEACe bonds are all in the bank. Since it was established in November, 2001, the Peace and Equity Foundation has received 120 project proposals. Currently, the Peace and Equity Foundation limits itself to supporting **projects that can demonstrate impact on the poor family within 3 – 6 months.**

To date it has approved 11 projects ranging from P 200,000 to P 7,500,000. The total amount of approved projects is P 16,653,000. Most of these projects are located in the four priority areas of the foundation (e.g. ARMM, Eastern Visayas, Bicol and urban poor areas of Metro Manila). NGOs and POs who may be interested to access the Peace and Equity fund may send their project proposals to: 2/F CCS Bldg., Social Development Complex, Ateneo de Manila University, Loyola Heights, Quezon City. Tel nos. 4266001 (local 4624 and 4625) and 4265938. This is the CODE-NGO National Secretariat office which is the temporary home of the Peace and Equity Foundation.

The Board of Trustees of the Peace and Equity Foundation is made up of an eminent person (Fr. Noel Vasquez, S.J., former provincial and currently Treasurer of the Society of Jesus who is the Chair of the foundation), one from the business sector (Senen Bacani, former agriculture secretary who is the Treasurer), one from the basic sectors (Mercedes Nicolas, chair of a national organization of market vendors and other workers in the informal sector) and six individuals from CODE-NGO, (Marcia Feria-Miranda; Marissa Camacho-Reyes, Guillermo Cua from a nationwide confederation of cooperatives, Marietta Paragas from the Cordilleras, Martiniano Magdolot from Mindanao and myself). The National Anti-Poverty Commis

the fund-raising project to ALL interested and qualified NGOs and POs. It would not be exclusive to its members. From that standpoint there was no compelling reason to open the project to other civil society groups.

Did the Secretary of Finance interfere in the process to enable CODE-NGO to raise this money? Did CODE-NGO use its connections in obtaining the “sweeteners” of the PEACe bonds?

Certainly not. CODE-NGO started the project in March 2001 even before Sec. Camacho was appointed to the Department of Energy. When he was appointed to the DOF, Sec. Camacho inhibited himself from the project in order to prevent a conflict of interest since his sister, Marissa Camacho-Reyes, is the chair of CODE-NGO, the proponent of the PEACe bonds. Marissa Camacho-Reyes also inhibited herself from the project in the same vein. Sec. Camacho did not make any decision related to the PEACe bonds, he assigned Undersecretary Cornelio Gison to attend to the project in behalf of the DOF and National Treasurer Sergio Edeza in behalf of BTr.

All the decisions of government agencies that CODE-NGO dealt with in this project were done on arms length basis. The government agencies involved made decisions independently in responding to CODE-NGO’s requests at the initial stages of the project when it sought exclusive sale of the bonds. As far as the Monetary Board (MB) was concerned, CODE-NGO sought three eligibilities for the PEACe bonds but only got one. In the end, when the BTr decided to auction the zeroes, MB ruled that the secondary reserve eligibility that it granted shall go to whoever wins the bonds in the auction. It is not exclusive to CODE-NGO.

If indeed CODE-NGO used its influence in the process, it should have obtained the PEACe bonds through an exclusive sale. We worked hard to obtain the requirements of the BTr for the sale of the zeroes thinking that having completed such requirements, the zeroes would be sold to us. Contrary to our desire, the National Treasurer decided that the PEACe bonds

satisfied its shareholders required earnings from the secondary market – would have delivered an additional P1.4 billion in bond issuance proceeds for the national treasury. If RCBC and RCBC Capital had no deal with CODE-NGO but went directly to the government securities markets for these bonds, RCBC shareholders would not be less happy than they are today. The only difference is that the government, rather than a private foundation, would be holding an extra P1.4 billion. Government would still be repaying the bond holders P35 billion in the year 2111, the difference is that it would have gotten at least P11.54 billion in proceeds today instead of only P10.14 billion. This conclusion cannot be wrong if the auction that transpired on Oct. 16, 2001 for these bonds was one that forced bidders to reveal their best bids. There is reason for believing that the auction was not competitive.

If the national treasury’s auction system were competitive, there would be something illogical about expecting that RCBC will be able to turn around and sell these bonds to other financial institutions. After all, neither these prospective buyers nor their customers in the secondary markets were willing to match RCBC’s acquisition cost at the auction. One would also think that once one factors in the added cost due to the endowment to CODE-NGO’s foundation, the price that the secondary market must face becomes even steeper than the original acquisition cost. How could RCBC have made any money?

RCBC WAS SMARTER THAN THE OTHERS

What RCBC may have had going for it is that (just as in their original plan) no other financial institution was able to secure a supply of the treasury zeroes. The value of RCBC Capital’s holdings of these assets rises or falls depending on the ability of other groups to get their own supply when government issues more of these instruments. The Auction Committee’s decision to limit the award of zeroes to P35 billion in face value, even if P40 billion could have been awarded

on the basis of the benchmark that they themselves used,² is also instrumental to the eventual monopoly ownership by RCBC Capital of the Treasury Zeroes. Upon the discretion of the authorities, it is also possible that the first issue of zeroes was also the last one for a long time to come. RCBC will then have control of the only supply. Institutions that need a supply of the bonds will have no recourse but to get them at the price set by RCBC Capital. Still one hopes that the national treasury will not allow RCBC such undue advantage.

If it is true that RCBC did not come out empty-handed after this transaction, plausible narratives such as this one are needed to show how RCBC could have made money out of this deal. The integrity of CODE-NGOs explanation cannot stand on the claim that RCBC was merely being altruistic.

Marissa Camacho-Reyes, CODE-NGOs chairperson almost comes close to a plausible explanation. She says that banks like RCBC are also capable of using these bonds as the underlying basis for new kinds of financial assets that can be very attractive to small investors.³ Investors and fund managers are supposedly willing to pay very good money if a bank can design and offer assets with term and risk-and-return attributes that are tailor-made for the requirements of entities that sell life insurance and preneed plans. She says that RCBC could afford to honor the deal with CODE-NGO and still be confident of being a competitive participant in the auction because it intended the bonds to be raw materials for high-value financial products they planned to manufacture.

This is most probably true, except that it cannot possibly be true just for RCBC and its affiliate companies. RCBC's exposure in the insurance and financial businesses are probably not as idiosyncratic as Reyes has been led to

Fifteen universal banks, five of which are multinational banks, participated in the auction of the PEACe bonds. The BTr offered between P 30 - 50 billion worth of zeroes but P 137 billion or almost four times the amount awarded worth of the bids were received. The PEACe bonds were **oversubscribed**. If indeed there was information asymmetry or if the auction was rigged, the bidders had two days to make their complaints and demand a re-bidding. Not one of the bidders raised a complaint. Since all of those who participated in the auction are expert traders, they would not have participated if the playing field was not level. . Logic dictates that the bidders are the best witnesses to testify if the bidding was fair or not. They have not been invited up to this day.

As a matter of fact, in a forum sponsored by the Makati Business Club (MBC) last February 11, the Executive Director of the Bankers' Association of the Philippines and the President of the Money Market Association of the Philippines (both associations being authorities in capital market transactions) hailed the auction of the PEACe bonds as fair and transparent. They also said none of their members have come forward to complain about irregularities in the Oct. 16 auction of the PEACe bonds. Other leaders of the business community from MBC, the Management Association of the Philippines and the Bishops Businessmen's Conference who were present in the forum agreed that the PEACe bonds were sold in a fair and transparent manner.

Was CODE-NGO's desire to have the PEACe bonds sold to them exclusively a violation of the law and a way of keeping the deal secret? Not at all. The National Treasurer himself admitted in the second hearing of the Senate investigation that the Bureau of Treasury sometimes sells government securities on a negotiated basis to a single buyer. There have been several of these negotiated sales in the past.

CODE-NGO was the originator of the project and its members made up a large constituency that supported it. It likewise intended to open whatever funds it would obtain from

² Interview with Deputy Treasurer Mendiola of the National Treasury.

³ e.g., investment instruments where the real value of the original capital of the investor is insulated from risks.

is still not payable until 15 April of every year for the next ten (10) years. To conclude therefore that government will lose such a huge tax revenues is premature to say the least.

This project DID NOT add P 35billion to the debt stock of government. The ten-year zeroes that were issued by the BTr are part of the borrowing program of government to finance its budget deficit. In short, the BTr would have had to borrow to begin with.

Government only got P 10 billion yet it has to pay P 35 in ten years? The BTr borrowed P 10.168 billion (present value) from the capital market at an interest rate of 12.75% payable in ten years. If one multiplied P 10.168 billion by 12.75% over a ten year period (compounded semi-annually) the product would be P 35 billion (face value). The difference with zeroes is that government does not pay the semi-annual interest, it makes a balloon payment of the face value at maturity.

In fact government saved money in interest payment from the sale of the PEACe bonds because it fetched a lower price than the prevailing market rate for ten-year fixed interest bonds on the day of the auction.

So how come CODE-NGO made a huge gain despite the fact that it did not invest a single centavo of its own money (*laway lang ang puhunan*)? Because its underwriter, RCBC Capital, agreed to advance the money to buy the bonds since it had a firm underwriting agreement with CODE-NGO. Apart from the obvious financial gain that RCBC would eventually make from trading the bonds in the market, it went into a partnership with CODE-NGO because it believes in the poverty alleviation objective of the project. This is an exercise of their corporate social responsibility. Likewise, this is not an unusual business practice because some underwriters do advance funds for their clients.

Was the sale of the PEACe bonds done in a manner that is transparent and above board? Were any government regulations broken in the process?

believe.⁴ Whatever makes the bonds attractive to RCBC must also make them attractive to others. This is surely one of the reasons why CODE-NGO was lobbying to acquire the bonds through negotiations, rather than through an auction (an auction introduces the risk that one may not acquire the goods one desires). That RCBC allowed itself to be saddled with a P1.4-billion-handicap made it quite unlikely that it would be able to match the bids of most other participants in an auction. What is most curious is that RCBC still managed to give the lowest bids and win the entire lot of bonds that was awarded on Oct. 16, 2001.

A plausible explanation does exist—if it were the correct one. It would be best if it were something that CODE-NGO never knew about. Otherwise, CODE-NGO would be an accomplice to a most unsavory maneuver by RCBC. Meanwhile, CODE-NGO got money that clearly could have gone to the national treasury. It will be shown later that certain facts are consistent with the theory that RCBC misled other members of the banking cartel that had intended to profit collectively from the auction of the zeroes.

Yet, even granting that there was more value to be made out of the bonds after and over and above the P1.4 billion that RCBC Capital forked over to CODE-NGO, the question remains: what was CODE-NGO's value-added effort to the transaction that gave it claim to P1.4 billion?

INNOVATIVENESS?

It is not even clear that CODE-NGO owns a “franchise” to the original idea of creating zeroes with the eligibilities that they now possess. At least one of CODE-NGO's advisers (Bobby Guevara) was selling the same idea to another institu-

⁴ When pressed for more detail RCBC and Code-NGO's financial advisers say that this is its corporate secret that the public need not know about.

tion in Quezon City on Apr. 24, 2001. This institution, however, rejected the idea not because it was implausible but because there was something improper about earning money out of nothing and preempting funds that could have gone into the national treasury. This leads one to ask if the idea was actually the franchise of CODE-NGO? It is possible – perhaps likely – that the idea belonged to a group of financial advisers on the lookout for institutions who can be valuable in the execution of their plan.

No one can possibly have a franchise on the idea of treasury zeroes, not even on treasury zeroes laced with sweeteners that CODE-NGO lobbied for.

The proponents themselves claim that the issuance of treasury zeroes was going to “deepen the financial markets.” It was something that the authorities themselves presumably also wanted to happen,⁵ although if this were true, it is unclear why it was taking a long time for government to come around to issuing them. This message was meant to disabuse critics of the notion that the treasury zeroes would not have been issued by the national treasury were it not for the lobby by CODE-NGO and RCBC. Supposedly, even without RCBC and CODE-NGO, there is already a meeting of minds (and of supply and demand) between the bankers in general and the monetary authorities. One wonders why CODE-NGO had to do any lobbying at all.

CODE-NGOs contribution was probably less about hastening the issuance of zeroes by the financial authorities. It seems more plausible that RCBC and the financial advisers saw CODE-NGO as an institution that possessed the political connections needed for RCBC to acquire the zeroes through negotiations. This was after all the original plan. RCBC could not induce the various government agencies to create Treasury Zeroes that would then go solely to a single commercial bank.

⁵ At the Dec. 12, 2001 briefing by RCBC, CODE-NGO and its financial advisers.

Internal Revenue Code states that gains from retirement of bonds (public and private) with a maturity of 5 years and more are exempt from payment of income tax, apparently to encourage long-term savings/ investments. CODE-NGO merely sought a ruling from the BIR to confirm this feature of the PEACe bonds. It did not ask for, nor it is granted special tax incentives. **There is no foregone tax revenue** because gains from the PEACe bonds are exempt from tax in the first place. One does not lose something that is not there in the first place.

Another issue raised was that the government stands to lose tax revenues of PhP7,945,600,000.² That amount was arrived at by simply getting the difference between PhP35,000,000,000 (the face value of the zeroes, bonds) and PhP10,170,000,000, which is the price paid by RCBC for the zeroes, and multiplying the difference of PhP24,830,000,000 with the 32% corporate income tax rate. As pointed out by no less than the longest ever serving finance minister of the country, even assuming that indeed the income of the zeroes are taxable, the computation amounts to “gross over simplification” of the corporate income tax process. As every experienced tax practitioner will know, our income tax system is computed based on net income, meaning, any gross income made by RCBC on the zeroes, in this case, PhP24,830,000,000 is subjected to ordinary deductions for expenses and other deductions permitted to be made by a corporate tax payer. It is only the **net income after all deductions** that is subject to the 32% corporate income tax. In addition, we were advised that, for tax purposes, since the alleged gain will be made over ten (10) years, then the tax (as properly computed) is also spread over ten (10) years, if ever there will be any such tax.

Furthermore, every tax payer, whether an individual or a corporation, knows that income taxes are payable only on 15 April of every year. Assuming again that the income from the zeroes are subject to tax, then, its stands to reason that the tax

² As claimed by former Senator Juan Ponce Enrile

ted the difference of P 1.8 billion to CODE-NGO. After paying fees, CODE-NGO divided its net proceeds of P 1.48 billion into two. It established a trust fund of P 148 million for the sustainability of its network members and organized the Peace, Equity and Access for Community Empowerment Foundation (Peace and Equity Foundation) to manage a trust fund of P 1.3 billion as conceived.

While the fund raising objective was successful, the Peace bonds is now the center of controversy. It is the subject of a Senate investigation as well as intense public debate. The allegations against the PEACE bonds range from it being a scam, to it being a grand conspiracy among CODE-NGO and several government agencies, to CODE-NGO unethically using its influence to obtain the funds that it raised in the project.

In order to prevent readers who may not be keen about financial market transactions from being confused, I will confine our arguments to the major issues raised against the Peace bonds. There has been a lot of disinformation and misinformation about the PEACE bonds lately and these have created more heat than light in addressing the issues about this project.

From where we stand, there are four major points that should be established before making a conclusion about the PEACE bonds:

Did government lose money in this undertaking?

Definitely not.

The **P 1.8 billion gross margin is private funds**. The P 10.168 billion that was paid by RCBC to the BTr is the public fund but the gain of P 1.8 billion is a private fund because it is a trading gain realized from buying and selling government security. Money market traders make money this way. This happens as a normal course of business in the capital market on a daily basis.

There was no special tax exemption given to the PEACE bonds. The BIR merely confirmed that the gains from the retirement of PEACE bonds are tax exempt by their very nature as a ten-year bond. Section (32) B (7) g of the 1997 National

It is not easy to see how CODE-NGO can claim that the P1.4 billion endowment was the fruit of innovation. The CODE-NGO officials themselves admit that the most essential details of the transaction were proposed by the financial advisers and RCBC as the underwriter. Instead, what emerges is that though CODE-NGO may have thought that it was hiring financial advisers and RCBC for a project that it conceived, what may be no less true is that it was the financial advisers and RCBC that chose CODE-NGO to assist them in the execution of their plan. CODE-NGO got an endowment of P1.4 billion because it made itself useful to RCBC and the financial advisers. It is a fact that the financial advisers were hawking the same scheme to others who would agree to render their services. The next question is whether there is any public interest involved here. That is, did the government lose money as a result of the auction of 10-year treasury zeroes?

DUMB IF YOU DID!

If the original plan pushed through (where RCBC would acquire the treasury zeroes for CODE-NGO through a negotiated sale), CODE-NGO's complicity to a crime would be hard to deny. Quite a few things have already been said about *delicadeza* and about CODE-NGO being a crony of the Macapagal administration.⁶ Here, however, we merely point out that if the original plan pushed through, government would have lost money because CODE-NGO managed to convince the authorities to bend the rules.

In particular, CODE-NGO proposed and got initial approval that only RCBC would get the treasury zeroes and it would get these at the going price of ordinary 10-year treasury bonds, to wit: "We suggested that we use the Bloomberg rate for 10-year bonds on the day of the sale. Bloomberg publishes benchmark rates for different financial instruments everyday. The

⁶ Toby Monsod, Red Constantino,

capital market normally uses these rates in pricing their products.⁷

This is a revision of the rules on negotiated deals (through what is called the “tap facility”⁸). The existing rules say that in the case of negotiated deals, the rate that should apply is the lowest bid during the most recent auction for that particular instrument. The lowest previous bid is not the same as the prevailing market rate. Depending on its cash requirements, the national treasury regularly awards treasury bonds to those who bid above the lowest bidder. Market prices will not eventually tend towards the lowest bid. There is every reason to expect then that prevailing market interest rates that CODE-NGO proposed for the authorities to use will be higher than the lowest bid at the previous auction, as what the rules required. Had this proposal been implemented, the National Treasury would have been shortchanged in its transaction with RCBC and CODE-NGO.

But there is an even more important manner in which CODE-NGO’s proposal would have caused the national treasury to bend the rules to the detriment of the tax-paying public. The rule on the national treasury’s tap facility of granting banks an interest on their money that is no more than the lowest bid at the previous auction, quite logically, applies to bonds that have been regularly issued by the National Treasury. It would be the height of fiscal irresponsibility for the government to sell high quality *denorado* rice at the reference price of *wag-wag*. But that would have been the inescapable result of CODE-

⁷ Marissa Camacho-Reyes and Dan Songco of CODE-NGO, “Response to Action for Economic Reform’s Statement on the PEACe Bonds.” Manuscript, Jan. 22, 2002.

⁸ This “tap facility” itself was being phased out during the term of national treasurer Valdehuesa because despite the rules that were in place, the banks have already discovered a strategy for playing with the rules rather than by the rules. According to Prof. Felipe Medalla, the economist Elli Remolona has done an astute analysis of the game that bankers have been playing.

bonds) project was conceptualized. As National Coordinator, I was her alter ego in this project.

The idea behind the PEACe Bonds project was to raise P 1 billion from the capital market, a potent source of funds. The target amount had to be big in order to make a significant impact on a colossal problem. CODE-NGO would buy bonds from government and sell them in the secondary market. The profit from this sale would be used to establish an independent foundation that would manage a trust fund (only the interest would be spent) to finance NGO/PO projects to fight poverty. The fund would be made available to all legitimate NGOs and POs - not just to CODE-NGO members.

Since CODE-NGO is not a Government Securities Eligible Dealer (GSEDs, the only ones authorized to buy government securities), it contracted the services of Rizal Commercial Banking Corporation (RCBC), to act as its agent to purchase the zero coupon bonds or zeroes. It was also able to obtain the services of an underwriter, RCBC Capital, who agreed to purchase from CODE-NGO all the zeroes that it would buy from government (through RCBC) at a pre-agreed price. In capital market parlance, this is referred to as a firm underwriting agreement.

CODE-NGO proposed to government to sell the ten-year zeroes. It also worked to secure eligibilities from certain government agencies to make these bonds marketable in the secondary market for a profit. Although CODE-NGO initially tried to obtain the zeroes on an exclusive sale basis, the Bureau of Treasury (BTr) decided to auction them off. Thus, on October 16, 2001, RCBC was able to obtain P 35 billion worth of zeroes from this auction in behalf of CODE-NGO. The winning bid was 12.75% per annum which meant that RCBC would pay P 10.168 billion as its current value and government would redeem the bonds at P 35 billion in ten years. Following the firm underwriting agreement, RCBC sold the bonds to RCBC Capital at 11% per annum or P 11.9 billion. They reimbursed themselves the P 10.168 billion that they paid BTr and remit-

shown that all the bidders had the same information at the time of the auction. Between a bank that had five months to accumulate several billions in liquidity and another that had only a week's notice, the cost of capital of the latter would significantly be much higher. This cost of quickly liquefying assets contributed to the costs and the consequent weaker ability of the other banks to bid aggressively even if they intended to.¹²

Second: If the initial bidding was uncompetitive and the bidders could have been subsequently induced to bid lower, the National Treasury should have declared the auction a failure. Did the members of the Auction Committee at the National Treasury know that the banks could have given the treasury more proceeds from the auction? There are two reasons for believing that they did:

1. the faxed bids were not sealed bids, the Auction Committee required the bidders to reveal the institutions on whose behalf they were bidding. When the auction committee saw that CODE-NGO's bidder (RCBC) won all of the zeroes, it immediately knew that RCBC could have bid lower – it had at least P1.4 billion to spare. The auction committee should have been under no impression that it had to award bids that would enable RCBC to honor its commitment to CODE-NGO.
2. One member of the Auction Committee is a representative of the Bangko Sentral ng Pilipinas (BSP). This person knows that when BSP requires banks to put a percentage of their deposits on reserve instead of lending these funds out, BSP pays banks only 9 percent (pre-tax or 7.2 percent after tax) for these (secondary) reserves that they need to keep in their vaults. If a bank has treasury zeroes, these can take the place of the BSP's mandatory reserves. Instead of being required to hold on to

an asset that brings a return of only 9 percent, banks can use the zeroes that have a much higher yield. (In the case of RCBC, it is tax-exempt yield of 12.75 percent.)

PEACe Bonds and the Numbers Game
(value in billion pesos)

Yield	Value after 10 years	Acquisition cost at the auction
14.14 ^A %	35.000	8.927
13.20 ^B %	35.000	9.748
12.75 ^C %	35.000	10.169
9.00 ^{AD} %	35.000	14.513

- a - Benchmark of the Auction Committee.
- B - The benchmark yield rate used by CODE-NGO. This is the comparable non-taxed rate of the most recent auction of 10-year Treasury Notes prior to the Oct. 16 auction.
- C - Yield for the zeroes awarded on Oct. 16 through the dutch auction.
- D - Competitive yield, based on the yield on the secondary reserves of banks.

If the treasury were to use a benchmark interest rate above which the auction was to be declared a failure, that figure should have been very close to 7 percent.¹³ If the yield at a competitive auction were a little above 9 percent, for instance, RCBC would have needed to turn over about P14 billion instead of just P10.17 billion (*see above table*). In other words, even if RCBC gave the lowest bid, it could not have been left empty-handed. This also means that CODE-NGO's endowment was only a small portion of what RCBC stood to gain from transac-

¹²Discussions with Dr. Felipe Medalla.

¹³Instead, the Auction Committee used a benchmark rate of 14.14 percent. In a telephone interview, deputy treasurer Mendiola, a member of the Auction Committee, acknowledged that the reserve eligibility of the zeroes that was granted by the monetary board was valuable. But he said that they "did not know how to cost it."

tion in the secondary markets and from RCBC's own utilization of the zeroes as secondary reserves.

The facts can be interpreted in a number of ways. The kindest interpretation is that the National Treasury committed mistakes out of incompetence. Another interpretation that others can plausibly make is that these mistakes were committed on behalf of RCBC and CODE-NGO. What is certain is that without these mistakes, it would have been difficult for RCBC to generate a return that would make its shareholders happy.

If the National Treasury used the correct benchmark—as suggested in this section—and insisted on this, perhaps fewer banks would have participated in the auctions. There were some that would have gotten the issues of 10-year treasury zeroes if the treasury's stance induced them to reveal their true willingness to pay. But RCBC would not have been willing to bid with a P1.4-billion-handicap and CODE-NGO would not be embroiled in the controversy that it now finds itself in.

Unfortunately, for the National Treasury, it is the weakest link in this scheme of things.

percent withholding tax. The secondary reserve eligibility was mentioned in the Treasury Notice that was released on Oct. 15, 2001, one day before the auction. On the day of the auction, the National Treasury gave further clarification on the tax exemption and secondary reserve eligibility features of the PEACe Bonds. We do not know what time this memo was released to the dealers, considering that the cutoff time for submitting bids was 12 noon.¹⁰

Despite official communications that should have equalized the information held by RCBC with that of the other bidders, the other banks at the time of the bid may not have been equally confident about the properties of the bonds. They were unsure about what the regulatory authorities (e.g., the Monetary Board and Insurance Commission) were willing to allow.¹¹ The lead time of several months enjoyed by RCBC and CODE-NGO should not be dismissed as irrelevant even if it can later be

¹⁰ Based on the "Annex to the Statement" of the Freedom from Debt Coalition.

¹¹ For instance: one other implicit eligibility of the zeroes was the use of their face value as cover for non-performing loans (NPLs). Any government security can of course be used as a reserve for NPLs. However, treasury zeroes (depending on the regulator) can be used for window-dressing NPL reserve adequacy ratios. A bank may claim that the face value, rather than the going market value today, is the amount that should be used in assessing the value of the zeroes as a reserve cover for NPLs. RCBC itself made presentations before some members of the monetary board and this may have been a topic that was discussed. Thus, although other prospective bidders may have known of the window-dressing possibilities for those who held zeroes, non-RCBC bidders did not know how the monetary authorities were going to tolerate the use of zeroes for window-dressing. RCBC may have gotten implicit signals that the regulators would simply look the other way. Even if everyone knew of the formal properties of the bonds, other things that would affect the value of the bonds—possible reversal of the tax-exempt status, regulatory forbearance—could have been contingent on whether RCBC would win at least some of the bids.

been the National Treasury's benchmark and why the auction committee should have rejected the bids on the basis of a realistic expectation that the proceeds should have been greater. It would be incorrect to say that there is no public issue involved just because RCBC was the lowest bidder anyway. The auction may not have been competitive.

Earlier, we said that if the auctions at the treasury were competitive, the other banks would not have been willing to pay more than the acquisition price of RCBC. They would have had no regret and they would not knock at the doors of RCBC Capital for a share of the bonds. But soon after the Oct. 16 auction for the zeroes, other financial institutions that took part in the auction were willing to buy the bonds from RCBC Capital at a price that was much higher than RCBC's cost of acquiring them.

Sources who (for obvious reasons) will not be named, however, say that banks wanted to get hold of the zeroes at a significant profit for RCBC. Offers may or may not have been good enough to allow RCBC to fully recoup its "loss" of P1.4 billion due to the CODE-NGO endowment. But one fact is true: Those who wanted to get hold of the zeroes had no other supplier to run to. This implies several things.

First: The auction of the bonds did not induce some of the bidders to reveal their true subsequent willingness to pay. To explain this, at least one of the following will have to be true:

1. There could have been an attempted collusion among the buyers but RCBC bid more aggressively than the others expected.
2. Other bidders could have been signaled to "stay away" and "let RCBC to have this one."
3. An information game may have been played: The first written notice of the National Treasury to the GSEDs was dated Oct. 9, 2001, a week before the auction. This memo made no mention of secondary reserve eligibility. It said only that the bond issue was limited to the 19-lender rule and therefore was exempted from the 20

CODE-NGO's PEACe Bonds

*Financing Civil Society's
Fight Against Poverty**

by **DANILO A. SONGCO**
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Since the Caucus of Development NGO Networks (CODE-NGO) was created in 1991, one of the biggest challenges it has had to face is the problem of declining funds for NGO development projects. Money for development poured into the country when Cory Aquino became President owing to the desire of foreign governments to strengthen the new democracy in the Philippines. Since Mrs. Aquino adopted the policy that her government will work with NGOs and people's organizations (POs or grassroots organizations), a significant part of this development assistance went through them. In a study that CODE-NGO did in 1998, we determined that the average amount of funds that went to NGOs/POs from 1986 - 96 was P500 million a year¹.

These funds started to dwindle when the Philippine economy started to improve. Thus, in 1995 the United States Agency for International Development (USAID) and the Canadian International Development Assistance (CIDA) cut their NGO programs by 50% and continued to progressively reduce their NGO funds since then. (As this article was being written, we were informed that the Ford Foundation, one of the biggest donor agencies to Philippine NGOs and POs, will close down its Philippine operations by next year. The Ford Foundation gives around \$ 10 million a year to NGOs and POs). This has created a huge vacuum in development assistance and caused many NGOs and POs to close down or reduce their programs. This meant that the communities that they serve have also been deprived of their services.

Thus, in March of 2001, CODE-NGO incoming Chairperson Marissa Camacho-Reyes formally started a project that would significantly address this growing problem of NGOs and POs. Through the assistance of investment bankers, the Poverty Eradication and Alleviation Certificates (PEACE

NGO's plan to price the maiden issue of treasury zeroes at the price of plain 10-year treasuries that did not have the nice properties of the zeroes.

It is bewildering that even after controversy over the PEACE bonds has already erupted, CODE-NGO continues to use its proposed negotiated deal with the treasury as proof of its lily-white intentions.

Ultimately, finance secretary Isidro Camacho prevailed upon everyone⁹ to junk the idea of a negotiated deal and auctioned off the maiden issuance of the 10-year zeroes of the national treasury. By their own avowal, CODE-NGO, RCBC and the financial advisers say that they resented this turn of events. They continued to lobby for the authorities for a negotiated deal until September, long after a decision has supposedly been made by Camacho to use competitive auction.

But all ended well with CODE-NGO and company just the same. They pulled it off. A scheme that they at first intended to execute through direct dealings with the authorities was nevertheless consummated – against all odds and despite their P1.4-billion-handicap – via the auction that happened on Oct. 16, 2001. No bank outside of RCBC succeeded in acquiring the treasury zeroes.

WHY THE TREASURY SHOULD HAVE DECLARED THE AUCTION A FAILURE

If RCBC held on to the bonds, their up-front investment of P10.17 billion would have grown to P35 billion by 2011. To put it differently, their cache of zero bonds had a yield of 12.75 percent. Losing bids were those that would have generated smaller proceeds for the government. The treasury would have been satisfied if the yield were only P8.93 billion pesos or a yield of 14.14 percent. Here we show why that should not have

¹ Gonzalez, Raul. Official Development Assistance in the Philippines 1986 - 96. Caucus of Development NGO Networks. 1998.

⁹ Transcriptions of the dialogue between the Freedom from Debt Coalition and CODE-NGO's Marissa Camacho-Reyes and Dan Songco.