Forum for Asian Insolvency Reform (FAIR)

MAXIMISING VALUE OF NON-PERFORMING ASSETS

Seoul, Korea
10 - 11 November 2003

Philippine Trends in Addressing Distressed Assets and Vehicles for Maximising Value

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The tight financial situation of the Philippine Government has prevented it from setting up of super funds to bailout the financial sectors from the ill-effects of the Asian Financial Crisis, and much less from setting-up a super agency that would handle the NPL problems of the financial sector. The Philippine approach has been to improve the key legal structures within the economy to allow basically private sector the opportunity to sort out its way from the financial morass. The strategy has pursued the following paths:

a) To upgrade to world-class standards the country's corporate rehabilitation and insolvency systems, with the setting-up of special commercial courts to handle the various proceedings;

b) To improve the country's credit transaction infrastructure;

c) Passage of a Special Purpose Vehicle Act to provide tax and other incentives for the financial sector to sell and dispose of their nonperforming assets to asset management companies;

d) To pass a Securitization Act and other component pieces of legislations.

I. Upgrading the Philippine Corporate Insolvency Regime

With the onset of the Asian Financial Crisis, it became important for the country's political, financial and business leaders to assure both local and foreign creditors clear and transparent structures that ensure the collection or eventual realization of their investments and credit extension into the country, preferably under a regime which conforms to world-class standards and overseen by tribunals who have the competence to decide on difficult issues covering corporate rehabilitation and dissolution.

Certified to the Philippine Congress as urgent legislation is the bill entitled "Corporate Rehabilitation and Insolvency Act" (CRIA) which is aimed at overhauling and consolidating the entire system governing corporate rehabilitation, dissolution and liquidation, and containing provisions on such important matters such as cross-border insolvency, etc. The bill is still with the technical committee of the House of Representatives, and has been pending for more than two years.

The bill seeks to provide speed and efficiency in the reselution of rehabilitation and insolvency cases, but at the same time achieve a balance between the rights of creditors and debtors, all in accordance with international standards.

Pending the passage of CRIA, the Judiciary has taken-up the cudgels to bring about an interim modernization of laws and practice pertaining to corporate rehabilitation and insolvency.

The obscure Insolvency Act (Act 1956, enacted way back in 1906), was up-graded using the provisions of the charter of the Philippine Securities and Exchange Commission (SEC) under Pres. Decree No. 902-A, to usher into the country a system of corporate rehabilitation. By was of special provision in the Securities Regulation Code (R.A. 8799), the exclusive jurisdiction to act on corporate rehabilitation proceedings was transferred and consolidated in special commercial courts. Pursuant to its constitutional power to promulgate rules of procedure (Section 5(5), Article VIII of the 1987 Constitution), the Supreme Court did not waste time nor the opportunity to assume leading role in pushing forward the development on the whole body of corporate rehabilitation. Using the experience of the SEC as laid out in the *SEC Rules in Corporate Recovery*, the Supreme Court invoking its "procedural law" making power under the Constitution, promulgated the "*Interim Rules of Procedure on Corporate Recovery*" which not only contained rules and procedure, but contained key provisions that bordered into substantive laws, since such provisions created substantive rights which previously did not exist, or which have the effect of supplanting or adversely affecting existing property rights. It

is argued that those are areas in the *Interim Rules* that are considered to be beyond mere "rules of procedure" and are deemed to be encroachment by the Supreme Court on the Legislative prerogatives.

The *Interim Rules* themselves represent a great experiment on the part of the Supreme Court embodying officially "cutting-edge judicial technology," in that:

a) The proceedings under the *Interim Rules* are mandated to be *in rem:* through compliance with publication requirements, the results of the proceedings are binding on creditors and other affected person even when they do not participate in the proceedings;

b) The proceedings are declared "summary", "non-adversarial", and "technology friendly," such that there are prohibited pleadings that unduly delay, causes of actions and oppositions are established based of sworn statements filed, attaching thereto the actionable documents when necessary, and that service of pleadings may be effected by fax or e-mail;

c) The proceedings are strictly "time-bound" and the whole process cannot exceed 18 months; and

d) The orders of the courts are immediately executory, even on appeal, unless enjoined by the Court of Appeals or the Supreme Court.

II. Special Purpose Vehicle Act of 2002

The Special Purpose Vehicle (SPV) Law was enacted into law in January, 2003, and became effective in April of the current year.

The SPV Act seeks to provide the legal framework for the establishment of SPVs on asset management companies that will acquire the non-performing assets (NPAs) of the covered financial sector, and whereby the participants in such SPVs would be able to avail of the tax, VAT and capital gains tax exemptions for transactions involving the transfer of the NPAs from Financial Institutions (and specifically qualified individuals) to SPVs.

The SPVs could then rehabilitate the acquired assets and sell them off for a profit in the future, but within five years, although the window period to avail of the SPV should only be two years.

If one were to look into the essence of the SPV Act, it essentially constitutes a "bail-out" for the financial sector of the Philippine economy: that because of the seriously high level of NPAs of the financial sector, there is a need to undertake a restructuring by which the financial sector would be "pressured" to book the losses sustained from their NPAs but under the auspices of the SPV Law which would afford them a cushion in the process and allow the maximization of the "realization value."

The tax incentives and privileges under the SPV Act may be classified into three (3) categories:

a) All sales or transfers of NPAs from the Bank to an SPV, or transfers by way of dation in payment (*dacion en pago*) by the borrower or by a third party to the Bank;

b) Transfers from an SPV to a third party of NPAs acquired; and

c) Transfers of individuals of a single family residential unit constituting as an NPA of a bank;

The above-enumerated transfers shall be exempt from the following taxes:

1. Documentary stamp tax (DST);

2. Capital gains tax imposed on transfer of lands and/or other assets treated as capital assets;

3. Creditable withholding income taxes imposed on transfer of land and/or buildings treated as ordinary assets; and

4. Value-added tax (VAT) or gross receipts tax (GRT) whichever is applicable.

In addition, the covered transfers enumerated above shall be subject to only fifty percent (50%) of the applicable fees imposable

Apart from the foregoing, the SPV shall, for a period of not more than five (5) years from the date of acquisition of NPLs by the SPV, be entitled to the following tax breaks and incentives:

a) The SPV shall be exempt from income tax on net interest income, DST and mortgage registration fees on new loans in excess of existing loans extended to borrowers with NPLs which have been acquired by the SPV; and

b) In case of capital infusion by the SPV to the borrower with NPLs, the SPV shall also be exempt from the DST.

Any loss that is incurred by the financial institutions as a result of the transfer of NPAs shall be treated as ordinary loss, subject to the following conditions:

a) Except for loss incurred by the Bank from the transfer of NPAs within two (2) years from the effectivity of the IRR which may be carried over for five (5) consecutive taxable years following the year of such loss, the accrued interest and penalties shall not be included as loss on said loss carry over from operations subject to the NIRC provisions on net operating carry-over loss (NOLCO);

b) For purposes of corporate gain or loss the carry-over shall be subject to pertinent laws; and

c) The tax savings derived by the Bank from the NOLCO shall not be made available for dividend declaration but shall be retained as a form of capital build up.

Preliminary Assessment of the Impact of the SPV Law. — Under the SPV Law, interested investors have until October, 2004 to set-up and register an SPV or asset management vehicle with the Philippine SEC, while the covered financial sector have until April, 2005, to transfer idle assets to any such SPV in order to avail of the tax incentives under the Law. In turn, the SPVs duly set-up have until April, 2010 to dispose of the NPAs they have purchased in order to avail of the Law's incentives.

More than ten months since the enactment of the SPV Law, no bank has availed of its provisions, and the anticipated influx of foreign funds to set-up SPVs has not materialized. The state of non-availment of the SPV Law has been diagnosed to arise essentially from the big gap between the rate of discounts that local financial institutions are willing to accept for the transfer of their NPAs to the SPVs and that rate that prospective buyers have dangled (ranging from 50% to 90% discount). Philippine financial institutions generally cannot absorb such large discounts being offered by foreign investors even when the Philippine Central Bank rule allows them to book the losses over a seven-year period.

More importantly, the local sentiment is that similar schemes adopted in the Asean region have yielded a worse-than-necessary consequences for local companies and provided great boon to foreign investors.

With the government's problem with its budget deficit, and the political and foreign exchange uncertainties prevailing in the country (especially with the May, 2004 Presidential, national and local elections), it is unlikely that the bid prices for Philippine NPAs would improve. The situation has been summed up rather well by a financial observer: "On the part of local banks, a discount of such

magnitude would be untenable. Their capital bases cannot possibly absorb the potential hit and the banks either have to infuse more capital, search for strategic investors, merge with rivals or go bankrupt. Or they can ignore the SPV Law and go on with their lives as if the law's perks never came about. This is the likely course that will be taken by the banks. It would be as if the SPV Law never existed."[1]

III. Proposed Legislations

1. Securitization Act

The current version of the Securitization Bill pending in the Philippine Congress provides for the following purposes sought to be achieved under the Act:

a) Promote securitization to support the development of the capital market:

- By establishing the legal and regulatory framework for securitization;
- Creating a favorable market environment for a wide range of asset-backed securities;
- More importantly, by rationalizing and streamlining the rules and taxes applicable to the securitization process;

b) Pursue development of the secondary mortgage market for asset-backed securities and other related financial instruments:

- As essential to its goal of generating investment; and
- Accelerating the growth of the housing finance sector, especially for socialized and low-income housing.

Unlike the SPAV Law which constitutes a one-time remedial measure to tackle a particular problem (*i.e.*, NPAs of the financial sector of the Philippine economy), and limits its tax breaks and incentives to specific sectors of the market, the Securitization Act aims to "institutionalize" Asset-Backed Securities (ABS) and Secondary Mortgage Institutions (SMI) in the Philippine economy in specific particular "patterns" mandated under the Act, as the condition to the granting of tax breaks and incentives.

One of the issues being addressed on the current version of the Securitization Bill is that since ABS and SMI schemes are actually market-driven institutions, it be unwise or even detrimental to the Philippine economic system that "particular patterns" be "mandated" by Government as the only accepted "schemes" by which tax breaks and incentives would be granted. Such "straight-jacketing" of the modules for ABS and SMI may tend to undermine developments and innovations in such sectors against the natural order of things in the commercial world, or would otherwise make them more expensive or costly to implement by trying to "fit" innovations within the parameter mandated by the Securitization Act.

The ABS and SMI systems are rather well-developed in modern economic jurisdictions, and fairly understood in Philippine jurisdiction and applied whenever the circumstances were auspicious. Concededly, it is not the lack of schemes or non-formal legislative acknowledgment of such schemes that have impeded their growth in the Philippines, but rather the heavy tax costs bearing on the securities and transactions supporting such schemes.

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[1] Reyes, *Random Walker,* 12 November 2003 issue of the BUSINESSWORLD.

The question may then be asked is whether it is better to change the thrust of the Securitization Act from an institutional-building legislation, to a simpler tax measure to reflect the Government's favorable endorsement of the ABS and SMI systems in the Philippines. To a great extent, ABS should be market led development in a country, rather than government-spearheaded. Government efforts should be limited to providing for the correct tax and fiscal incentives for such types of securities to evolve and providing for reasonable safeguards by which the interests of the investing public are covered.

Therefore, evaluation of the proposed Securitization Act should be viewed with one eye firmly on the issue on whether what Congress should pass is a bill that properly evaluates the tax breaks or incentives that would cover the secondary market on ABS and other securities; essentially a tax measure, rather than an over-reaching law that would dictate the form of such transactions.

After all, there is already a general law that governs the issuance of all types of securities, including ABS the institutions that issues them, and provides for punishments for fraudulent transactions pertaining to such securities, *i.e.*, the Securities Regulation Code.

2. Overhaul of the Law on Documentary Stamp Taxes

Recently, the Philippine Congress approved a bill essentially removing the documentary stamp tax (DST) on secondary sale of stocks and debts. The bill, which is expected to be signed into law by the Philippine President who has previously certified it as an urgent legislation, is intended to revive the stock market activities by breaking investment barriers and removing distortions in the domestic capital market, particularly the cascading impact of the DST on financial transactions.

Flaws in the documentary stamp taxes regime has been perceived as impeding the ability of the Philippine capital market to general a faster velocity. It has been observed that government securities have become the dominant financial instruments in the Philippine financial sector when compared to miniscule share of private-sector debt issues.

The bill haste a uniform rate of 0.5% on instruments such as time deposits, special savings account bonds, loan agreements, and government securities. A range of lower rates of tax has been set for other instrument such as insurance and pre-need plans, mortgages, deeds of trust, lease agreements, and acceptance of bills of exchange. The bill removes also the DST on transfer of land to a merged corporation.

3. Effective Removal of Redemption Rights for Foreclosure of Mortgages of Corporate Mortgagor

In a related front, under the General Banking Law of 2000 (GBL) has not only sought to strengthen the supervision and control of the Philippine Central Bank over the banking industry, provided for higher measures on corporate governance, but likewise provides measures to assure realization by banks of their loan exposures.

Prior to the GBL, the foreclosure of banks on real estate mortgages, whether effected judicially or extra-judicially, always accorded to the mortgagee a one-year redemption period. Under Section 47 of the GBL, when the mortgagee is a juridical entity, and the mortgage is foreclosed extra-judicially (which is the preferred mode by banks), although there is a reduced redemption period of three (3) months for the mortgagor within which to redeem, nevertheless, when the certificate of sale is registered with the Registry of Deeds, that would extinguish any right of redemption. In practical terms, since banks do usually register with dispatch the certificate of sale, then the mode of extra-judicially foreclosure has afforded the banking institutions a cheaper and quicker mode of realizing on their defaulted loans.

Epilogue

The Philippine approach towards addressing the NPAs of its financial sectors may be marked as being below average; rather than having a definitive national approach, the remedies resorted by the Executive Department at times have been rather *ad hoc* or patchy, in the light the slowness by which the Legislative Department has been enacting the legislations certified to it for urgent passage. It seems rather odd, that the Philippine Supreme Court, in the exercise of its power under the Philippine Constitution to promulgate rules of procedure, has done its share of promulgating rules of procedure that embody provisions that seem to provide a bridge for what sometimes is lacking in substantive law.

Political will and national discipline seem to be the necessary ingredients to gent the Philippine engine going on full throttle.