Philippine Credit Rating At A Glance

July 2012 | **AG-12-05**

Sovereign credit ratings are important for three reasons. First, they are the major determinants of a country's borrowing costs in the international capital market. Issuers with lower credit ratings pay higher interest rates representing larger risk premiums. Second, they affect private costs as they generally set the ceiling for the ratings assigned to domestic banks and companies. Lastly, they determine the eligibility of financial instruments for the portfolios of certain low-risk institutional investors.

The Philippines has been tagged as one of the most sophisticated[1] sovereign borrowers in Asia. The Philippines' credit rating however, remains below investment grade and lags behind its Asian neighbors. The government, hence, needs to double its efforts if it aims to be an investment grade issuer by the end of 2013.

The Credit Rating Agencies

The credit rating agencies' (CRAs) main task is to analyze and evaluate the creditworthiness of sovereign and corporate issuers and their debt instruments.[2] Moody's Investor Services (Moody's), Standard and Poor's (S&P), and Fitch Ratings (Fitch) are the three biggest CRAs in the industry. CRAs reduce information asymmetry between lenders and investors, on one hand and issuers on the other. This is an important factor in achieving market efficiency.

CRAs assess risks based on an analysis of a broad set of economic, social and political factors. Countries with a rating of BBB or above in the case of S&P and Fitch, and Baa or above in the case of Moody's, are considered to be investment grade; countries with ratings below that threshold are considered to be speculative grade.

According to a recent study published by the International Monetary Fund (IMF), attaining an investment grade status reduces sovereign financing spreads by 36 percent above and beyond what is implied by macroeconomic fundamentals, suggesting significant tangible benefits of reaching such status. An investment grade status also prompts inflows from institutional investors, whose covenants prevent them from investing in speculative grade assets, thus resulting in a broader and more diverse investor base.

Table 1. Sovereign Credit Ratings for Long Term Debt

Interpretation	Moody's	S&P	Fitch
Investment-grade ratings			
Highest credit quality	Aaa	AAA	AAA
High credit quality	Aa1 Aa2 Aa3	AA+ AA AA-	AA+ AA AA-
Strong payment capacity	A1 A2 A3	A+ A A-	A+ A A-
Adequate payment capacity	Baa1 Baa2	BBB+ BBB	BBB+ BBB
Last rating in investment-grade	Baa3	BBB-	BBB-
Speculative-grade ratings			
Speculative credit risk developing, due to economic changes	Ba1 Ba2 Ba3	BB+ BB BB-	BB+ BB BB-
Highly speculative, credit risk present, with limited margin safety	B1 B2 B3	B+ B B-	B+ B B-
High default risk, capacity depending on sustained, favorable conditions	Caa1 Caa2 Caa3	CCC+ CCC CCC-	CCC+ CCC CCC-
Default although prospect of partial recovery	Ca, C	C, D	C, D

Source: United Nations Conference on Trade and Development (UNCTAD). Credit Rating Agencies and their potential impact on developing countries, January 2008.

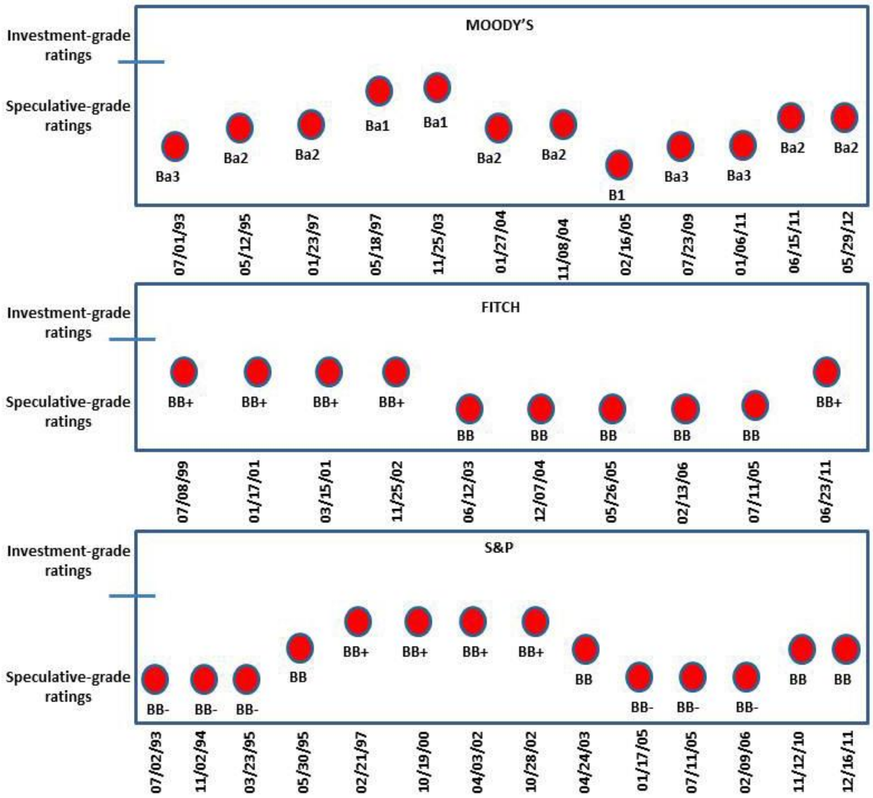
[1] Finance Asia Achievement Awards 2010: http://www.financeasia.com/News/231837,the-philippines-issues-a-ps441-billion-global-bond.aspx.

[2] For details on how CRAs assess sovereigns, please see Moody's Rating Methodology www.moodys.com, S&P's Sovereign Government Rating Methodology and Assumptions www.standardandpoors.com/ratingsdirect and Fitch's Sovereign Rating Methodology www.fitchratings.com.

The Philippines' Credit Rating History

The Philippines received its first credit rating from Moody's and S&P in 1993 and from Fitch in 1999. Since then, the country has never gotten a rating beyond the speculative grade. The best it has received so far is one notch below investment grade. While the CRAs recognize the improved economic and fiscal performance of the Philippines in recent years, they also note its shortcomings. S&P in July 2012 raised the country's credit rating from BB to BB+. In June of the same year, Fitch kept its BB+ credit rating outlook for the Philippines. Moody's rating, on the other hand, remains two notches below investment grade. This means that at least for 2012, the much coveted investment grade status will still remain elusive.

Figure 1. CRAs Credit Rating for the Philippines, 1993-2011



Source: Moody's, Fitch and S&P

Needs Improvement

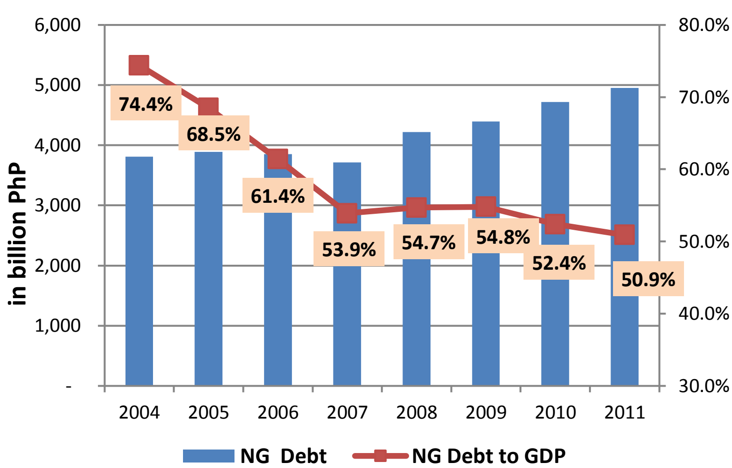
The country's credit profile has been weighed down by its long standing structural weaknesses including its low average income, poor revenue collection, subdued investment climate, as well as weak institutions and governance.

Low average income. The gross domestic product (GDP) per capita is a critical metric in evaluating a sovereign's creditworthiness. Moody's consider it as the single most important measure of a country's economic strength. The Philippines' GDP per capita in 2011 is recorded at US$2,223, slightly up from 2010's US$2,123. Indonesia, the country's closest peer in the region, had a GDP per capita of US$3,508 in 2011 from US$2,981 in 2010. Its credit rating was upgraded to investment grade in January 2012. According to studies conducted by Moody's and Fitch, it has been historically more difficult to reach investment grade status with a GDP per capita of under US$3,000.

Poor revenue collection. Sustained progress and improving prospects in the fiscal and external fronts are critical to achieving an initial upgrade to investment grade.

Against the backdrop of a slow US economic recovery and the escalation of the debt crisis in Europe, the Philippines still managed to gain significant ground towards a more favorable debt position. The country's national government (NG) debt stood at PhP4.95 trillion, which is equivalent to 50.9 percent of the GDP in 2011, down from 52.4 percent in 2010. Of the total NG debt, 42.0 percent is owed to foreign creditors, a decline from 42.4 percent in 2010. The downtrend was largely on account of the government's fiscal consolidation efforts, the modest economic growth and the strengthening of the peso.

Figure 2. NG Debt and NG Debt to GDP, 2004-2011



Source: Department of Finance

The Philippines has lower fiscal deficit-to-GDP and debt-to-GDP ratios than many investment grade countries. However, it continues to suffer from weak revenue collection. As of end 2010, the country's government revenue is merely 13.4 percent of its GDP, among the lowest in Asia and in the world. Its debt to-revenue ratio is 364 percent in 2011, more than double the average ratio for similarly rated countries. Low revenues limit the government's ability to meet its public investment and social spending plans, consequently affecting the overall GDP growth in the medium term. If the government does decide to increase spending, then it is likely that government debt would increase as well. The insufficient revenue generation is thus, a preeminent factor that must be improved if the country were to reach an investment grade status.

Table 2. Government Revenue (as a % of GDP)

Country	2009	2010
Indonesia	15.4	15.1
Malaysia	15.7	14.3
Philippines	14.0	13.4
Singapore	13.7	13.8
Thailand	18.6	20.3

Source: World Bank. Government Revenue Excludes Grants.

Subdued investment climate. Overall investment is likewise soft in the Philippines relative to other countries in the region. As of September 2011, it stood at only 21.8 percent of the GDP. Investment in infrastructure has been low, particularly in the electricity and in the transport network. This has led to the high cost of doing business in the country, thereby quelling investor appetite. The lack of investments has severely constrained growth and resulted in the failure to generate adequate employment opportunities for the people.

Table 3. Investment (as a % of GDP)

Country	2009	2010	2011
Indonesia	31.0	32.6	32.8
Malaysia	14.4	21.4	22.2
Philippines	16.6	20.5	21.8
Singapore	25.5	22.1	22.4
Thailand	21.2	25.9	26.6

Source: IMF

Governance. CRAs consider governance as part of their overall review of a country's creditworthiness. The Philippines is relatively strong in the area of financial governance with the continually rising resources of the banking sector and growing bank lending. The latest Bangko Sentral ng Pilipinas (BSP) data show that the banks' capital adequacy ratio (CAR) which measures their capability to meet liabilities and other credit exposures and risks, remained healthy at 16.44 percent on solo basis and 17.43 percent on consolidated basis as of end-September 2011. This is double the international standard of 8 percent. The BSP has also announced that to further improve their ability to absorb losses and have stronger firewalls against periods of stress, banks starting January 2014 will be required to adopt the capital adequacy standards under Basel III.[3]

The Philippines, however, still needs to make significant improvements in other dimensions of governance. For instance, out of the six indicators in the 2010 World Governance Indicators (WGI) of the World Bank, the country only managed to score above the 50th percentile rank[4] in government effectiveness (51.7 percent). It scored poorly in the five other governance indicators which are voice and accountability (46.9 percent), regulatory quality (44.0 percent), rule of law (34.6 percent), control of corruption (22.5 percent), and political stability and absence of violence or terrorism (6.6 percent). The WGI has in recent years become among the most widely-used indicators of governance by policymakers and academics, including the CRAs. CRAs note that the Philippines' lower sovereign credit rating is consistent with its poor governance score.

[3] Basel III is an international regulatory framework that aims to improve regulation, supervision and risk management, in the banking sector. Basel III strengthens bank capital requirements and introduces new regulatory requirements on bank liquidity and bank leverage.

[4] Percentile ranks indicate the percentage of countries worldwide that rate below the selected country. Higher values thus indicate better governance ratings.