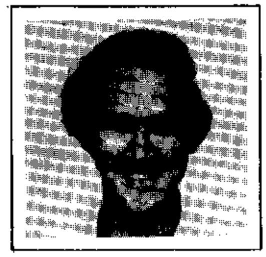

FEDERICO C. GONZALEZ

GUARANTEES AND INNOVATIVE INSTRUMENTATION IN REAL ESTATE DEVELOPMENT FINANCING

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Housing Requires the Combined Resources of Government and the Private Sector

In most developing countries such as the Philippines, the delivery of adequate housing is among the priority concerns of government. The demand for housing, however, is so great, especially from the lower income sectors, that it is imperative for government to harness and combine its resources with those of the private sector towards the national housing efforts, in all aspects of housing delivery, from production to finance to marketing.

Among these aspects of housing delivery, private sector expertise is acknowledged to be superior in production and marketing but, ironically, private funds generally shy away from the financial needs of housing, having a number of investment alternatives, including foreign currency trading and high-rate government securities which offer attractive returns. This has, therefore, been identified as the aspect of housing where government's role is most crucial. Consequently, the quality and substance of government's *intervention* in housing finance determine to a large extent the degree of private sector participation in the whole housing effort. This is not to say that funds should be sourced solely from government. Even in developing economies, the financial markets contain an array of funds, from risk-averse long-term savings to high-risk short-term floats which can be mobilized in various ways to support the housing program. Government is thus faced with the challenge, and duty, to devise creative means of unlocking these sources and to provide a stable and healthy financial environment for private funds to be invested in housing, traditionally a low-priority investment area.

The Components of Housing Finance

Housing finance in the context of a national housing program will always have two components: the financing; of production or construction and development financing, and the financing of home buyers, or long-term buyer mortgage financing.

Production involves the acquisition of raw lands, the development of these raw lands into buildable subdivided homelots, construction of utilities such as roads, drainage systems, water systems, power systems and construction of the housing units. It includes the marketing effort, the sales campaign, and the delivery of lots or units to buyers, and it ideally terminates in a cash sale made possible by buyer mortgage financing (sometimes in a high-rate short-term installment payment scheme).

Mortgage financing enables home buyers to acquire housing units under affordable long-term amortization or payment schemes, the key to transforming housing need into effective housing demand, ultimately allowing markets to expand.

There is a close linkage between the development and mortgage components of housing finance. Mortgage financing also ensures the viability of construction and development finance, which is dependent on the availability and stability of mortgage or "take-out" financing to facilitate the sale of housing inventories and enable developers to recycle funds towards additional

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development. By assigning the credit and collection burden to appropriate "carry" financial institutions, buyer financing liberates the developer and permits him to concentrate on the production-turnover business, his area of specific competence. Figure 1 illustrates this linkage.

Requirements for Development Financing

As in any commercial lending situation, the decision to lend funds for housing development hinges on the project's ability to repay the loan. This is determined from the following questions:

1. Are the proposed housing packages to be produced of the type required by the market?
2. Can the target market afford the proposed housing packages and the available mortgage financing facilities?
3. Will timely and adequate mortgage financing facilities be available to support the home buyers and liquefy developer's inventories?
4. Does the developer have the financial and management capability to undertake the completion of the project?

To be able to answer the first three questions in the affirmative, one must not only understand the housing market and the nuances of its needs; one must also depend on the credibility of the home mortgage financing institution.

The final question requires the usual project evaluation study and background check on the track record of the persons involved. It also includes an assessment of extraneous factors that influence project viability including cost of money, inflationary effects on cost of construction/development, bureaucratic processes, overall investment climate, and whether the developer/project are equipped to handle changes in these assumptions.

Requirements for Mortgage Financing

In the absence of accepted industry standards, banks and other intermediaries are most likely to adopt their respective sets of policies with respect to such items as tenor, interest rate, appraisals, loanable amounts, standards on credit, documentation, and other guidelines for mortgage financing. Moreover, it is natural for these banks to respond to changes in the quality of their fund sources with corresponding expansion or contraction of their mortgage loan portfolio. Such an unstable and unpredictable policy environment is not conducive to large scale housing development. However, the existence of a home mortgage financing institution facilitates the buyer's home-purchase decision and the developer's project start-up decision. For it is this financing institution's guidelines which define the housing packages and standards for mortgage financing. These guidelines also establish fund allocation targets among various population segments, and, when the demand for funds starts to strain limited resources, will have the final say on which market sectors will be favored. To the extent that these guidelines are clear, well-defined, stable, uniform, and non-discretionary, it becomes much easier to obtain commitments from both developers and buyers.

Government as Guarantor

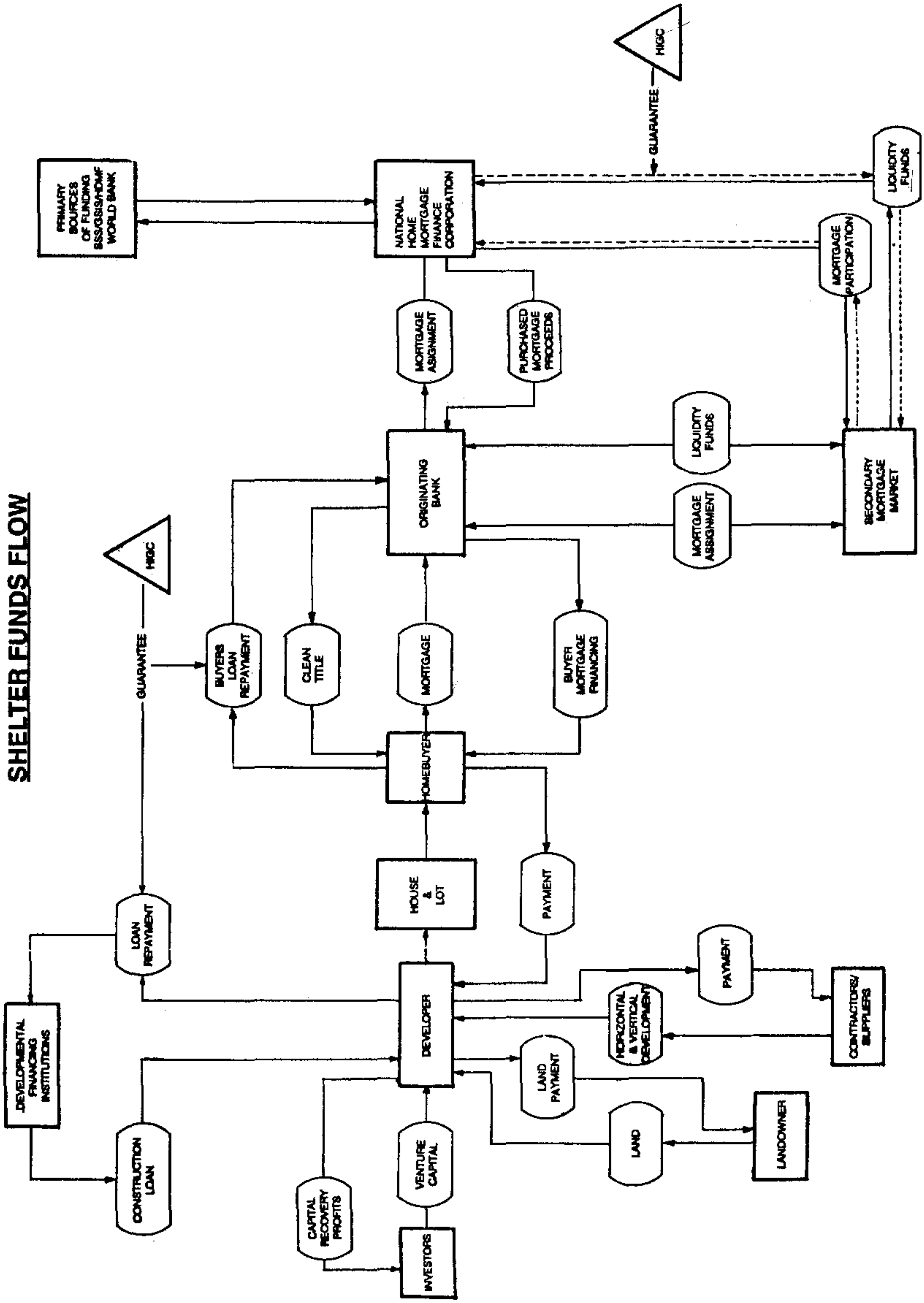
To mobilize private home developers, financial intermediaries and investors for a massive national shelter program which particularly addresses the lower segment of the market, it is basic that government provide the favorable investment climate necessary to encourage such participation and that it manifest its commitment and political will in clear and unconditional terms. The most effective manifestation of this is the provision of a guarantee mechanism for both mortgage financing and development financing. By enabling banks and other financial intermediaries to set aside their normal credit guidelines in favor of the standards recognized in their charters, the guarantee mechanism is instrumental in promoting and setting up industry standards. With industry standards come greater transparency and less discretion in loan processing, less bureaucratic red tape, simplified decision-making under uncertainty, and improved flow of funds to the housing sector.

Fundamental to an effective housing finance system, therefore, is a solid government guarantee institution. This institution, by charter and practice, must have the unwavering faith and credit backing of the government not only in fair weather, but most especially during foul weather. To be accessible, this institution must adopt simple systems. Yet, to be credible, it must have adequate capital, inherent and actual financial viability, and sufficient powers and the capability to design and issue innovative, tradeable housing finance instruments.

The Home Insurance and Guaranty Corporation (HIGC) plays precisely this role in our national shelter program. Our new government has supported the HIGC, helping it maintain its operations and honor all guarantees it has extended, even during the recent difficulties that the financial system underwent following the economic crisis of the 1983-1985. As the economy is nurtured back to health, the HIGC is thus in the forefront of mobilizing the private sector to redeploy its resources in the housing program.

Figure 1.

SHELTER FUNDS FLOW



The features of the HIGC guarantee essentially include:

- By way of security, corporate and Republic of the Philippines guarantee over principal and interest up to 8.5% p.a.
- By way of incentive:
  - 8.5% interest is tax free;
  - The loan is considered risk-free, thus exempt from the setting up of reserves; and
  - The loan is exempt from the single borrower's limit and the 70% loan which is collateral requirement of the General Banking Act.

The Role of Guarantees in Development Financing

To satisfy the gargantuan needs of the housing market, the guarantee institution must grow beyond being a mere provider of the comfort, security, and incentives of the guarantee. It must define itself as a major intermediator seeking to remove obstacles to the umhampered flow of funds from all likely sources into all likely needs in the construction/development cycle.

There are many credit needs in the production cycle which, due to lack of financial engineering diligence by both borrowers and traditional lenders, are subsumed under the general heading of development financing: between developer and landowner, manager and venture capitalist(s), developer and contractor, supplier and contractor. In most of these bilateral transactions, detailed, extensive, time-consuming negotiations and, ultimately, a certain degree of personal chemistry are needed to arrive at suitable arrangements. An absence of credit agreement generally results in a cash-and-carry transaction which is eventually funded by the bank.

On the other side of the coin, there exist many non-traditional sources of financing other than banks. These include insurance companies, trusts, pension funds, the mass investor and savers markets. But while these non-traditional sources retain a basic trust and confidence in the inherent security and viability of real estate, they are generally not organized for project financing or have no professional management.

The challenges for the serious intermediator in the production cycle would therefore come from the creation of more purposive solutions to the developer's credit needs, and this should go beyond simply providing more cash. Or the serious intermediator's tasks may be provoked by the challenge to mobilize all those passive funds waiting to be packaged into specific applications. Success in either case will be reflected in an expansion of supply.

A generic solution that HIGC is seriously investigating, and experimenting with in one case that will be described later, is creative instrumentation and securitization backed by the HIGC guarantee.

Instrumentation should make possible and expedite the flow of funds in the production cycle. Properly documented, such transactions could be made the object of secondary trade. In one instance in the past, a depersonalized developer-landowner deferred payment scheme cum profit bonus, with HIGC guaranteeing the basic returns, had been documented in an instrument which was subsequently traded in the secondary market. The developer obtained a deferral of his cash payment for land, the landowner his liquidity, the investors a new security to trade. HIGC stood by to ensure that the trade was not open-ended and had a mandatory term.

Securitization widens the variety of distribution networks that may be employed, and expands the reach of fund sourcing into non-traditional areas and even the mass investor market.

Naturally, instruments and securities are only as good as the promised performance of the developer or debtor, or of the project, as safe as the business climate in which it operates, or as risky as any number of uncertainties that threaten the industry and the economy. How then will non-traditional funds lacking in competence in real estate project evaluation and monitoring be attracted?

By offering its own competence in project selection and evaluation and instrument design, and its own integrity and credibility as the investor's final recourse, the guarantee institution transforms a transaction or project financing decision into a security-investment decision, replacing investor concern for project-related issues with assessment of more familiar investment features such as:

- Repayment terms
- Yield
- Liquidity and tradeability
- Substitutability for government securities
- Coupon rates
- Tax aspects, etc.

The Asset Participation Certificate

A major task of HIGC in the revival of housing activities is the rehabilitation of projects that suffered the pressures of very high interest rates experienced 1984-1985. These projects which are now mired in legal entanglements among owners and creditors are actually locking up huge inventories of real estate that are needed to implement the national housing program. In line with its role to provide innovative housing finance instruments, HIGC helped develop the *asset participation certificate* as an unlocking mechanism to release the huge real estate inventories in stalled projects. Generically, an asset

Figure 2. ASSET PARTICIPATION CERTIFICATE SPECIMEN (Front Page)

CERTIFICATE

No.

For ______________ Unit(s)

Issued to

____

____

____

Dated ______________ 19__

FROM WHOM TRANSFERRED

____

Dated ______________ 19__

NO. ORIGINAL CERTIFICATE	NO. ORIGINAL SHARES	NO. OF Units TRANSFERRED

Received Certificate No. ______________

For ______________ Units

this ______ day of ______ 19__

____

____

P 5,000.00

SERIAL NO. 30531

Asset Pool No. 1
P600,000,000.00
Aggregate Value:

BF HOMES, INC.

Participation Units
120,000

ASSET PARTICIPATION CERTIFICATE

VALUE DATE: May 15, 1988

ISSUED BY THE REHABILITATION RECEIVER
by authority of the Securities & Exchange Commission
per Order in SEC Case No. 2693 dated Feb. 2, 1988

MATURITY DATE: May 16, 1993

THIS CERTIFIES that the Holder is the owner of participation unit(s), as below stated, in the pool of real estate properties managed for optimum return by the Rehabilitation Receiver under the trusteeship of the Philippine National Bank.

HOLDER:

NO. OF UNITS: 1 PAR VALUE: P5,000.00

The Holder participates pro-rata in the asset pool, its proceeds and profit distribution upon its full liquidation. When the buy-back option is exercised by the Receiver, however, the Holder shall be paid, in lieu of the regular profit entitlement, and on top of the par value hereof, a special fixed return equivalent to twelve per cent (12%) per annum, compounded annually. The Holder's withdrawal option is stipulated at the back hereof.

IN WITNESS WHEREOF, the Receiver affixes hereon his signature and seal this 15th day of May 1988 in Paranaque, Metro Manila.

SPECIMEN

COUNTERSIGNED AND ATTESTED:

Philippine National Bank
Trustee

By: ______________

____

FLORENCIO B. ORENDAIN
Rehabilitation Receiver

This Certificate is insured for its face value and return by the Home Insurance and Guaranty Corporation as authorized under Board Resolution No. 32-1988.

FEDERICO C. GONZALEZ
President
Home Insurance & Guaranty Corporation

Figure 3. ASSET PARTICIPATION CERTIFICATE SPECIMEN (Back Page)

INTRINSIC NATURE

An Asset Participation Certificate (APC) represents an undivided, pro-rata interest in a pool of real estate properties managed by the Rehabilitation Receiver under the trusteeship of the Philippine National Bank (PNB).

ASSET POOL

Asset Pool No. 1 consists of prime urban properties, programmed for maximized value and profit generation, with starting aggregate value of P600,000,000.00 per concurrence by the major lien-holders, the Home Insurance and Guaranty Corporation (HIGC) the PNB and the Receiver.

PARTICIPATION UNITS

The aggregate value of Asset Pool No. 1 is divided into 120,000 Participation Units. One unit is equivalent to P5,000.00 in the starting value of the pool, per records of the PNB and HIGC, and from which value is derived the par value of an APC.

SPECIAL FIXED RETURN TO HOLDER

In lieu of the regular profit entitlement, the Holder shall be paid, on top of the full par value hereof, a special fixed return of 12% per annum, compounded annually, up to 8.5% of which is HIGC-guaranteed, when any of the following events occur:

* BUY-BACK. When the Receiver exercises his option to buy back this Certificate at any time.

* WITHDRAWAL. When the Holder exercises the option to withdraw from the asset pool and instead receive the fixed return in lieu of profit entitlement after the end of five years from issue date hereof and within the investment-review period of six months thereafter. Additionally, when the Receiver is unable to make the stipulated payment, the Holder shall have the right of recourse against the HIGC insurance and cash payments within a period of six months after call.

* OFF-MARK WIND-UP. In the remote possibility that the Receiver declares an off mark wind-up and liquidation of the asset pool and proceeds, in which case the Holder may also call upon the HIGC insurance; provided, however, that when the off-mark wind-up is made before the end of five years from issue date, HIGC will have the option to pay the Holder either in cash or in HIGC bonds with maturities not later than one year after the maturity date of the APC.

HIGC INSURANCE

This Certificate is insured by the HIGC, for a period of five years and six months, for the full par value hereof and earnings up to 8.5% per annum which is tax exempt for holders who qualify under Sec. 25 of R.A. 590 in relation to Sec. 2 (e) of Executive Order No. 535.

PNB TRUSTEESHIP

The administration of Asset Pool No. 1 and all its proceeds is covered and directed by a Trust Agreement between the Receiver and the PNB as the Trustee Bank performing the following functions: Trust custody of all certificates of title and documents pertaining to the pooled assets, custody and management of the resulting trust funds, as well as issuance, transfer and servicing agents for the APC's.

TRANSFERABILITY

This Certificate is fully and freely transferable but only upon the books of the Trustee, by assignment hereof by the Holder or his Attorney duly authorized in writing, and surrender of this Certificate to the Trustee duly assigned/endorsed and witnessed.

NO EVIDENCE OF RECOURSE

This Certificate does not constitute any evidence of recourse against the Receiver or the Trustee, since it is a holding directly against the assets of the pool.

HOLDER'S RIGHT TO INSPECT THE BOOKS OF THE TRUSTEE

Upon prior notice to the Trustee, the Holder shall have the right at reasonable hours of any business day, to inspect the records of the Trustee relating to the assets constituting the pool, as well as other reports, documents or instruments relating thereto.

ANNUAL STATEMENT OF CONDITION

The Receiver, jointly with the Trustee, shall make an annual audited statement of financial condition of the pool, for the benefit of the Holders.

ASSIGNMENT FOR TRANSFER

FOR VALUE RECEIVED, I/WE HEREBY SELL, ASSIGN AND TRANSFER TO

____

MY/OUR RIGHTS, TITLE AND INTEREST IN THIS CERTIFICATE, TOGETHER WITH ACCRUED SHARE IN EARNING OF THE ASSET POOL, IF ANY, AND I/WE HEREBY AUTHORIZE THE ISSUER TO TRANSFER THIS CERTIFICATE IN ITS BOOKS

____
ASSIGNOR

BY: ______________________________
ATTORNEY

DATE ______________________, 19____

SIGNED AND ACKNOWLEDGED IN THE PRESENCE OF

______________________________ ______________________________

Figure 4.
BFHI REHAB/ APC REDEMPTION OPTIONS

End of Period	0	1	2	3	4	5
1. Projected APC redemption by Receiver with		100	100	100	100	200
12% interest payment		12	25	40	57	152

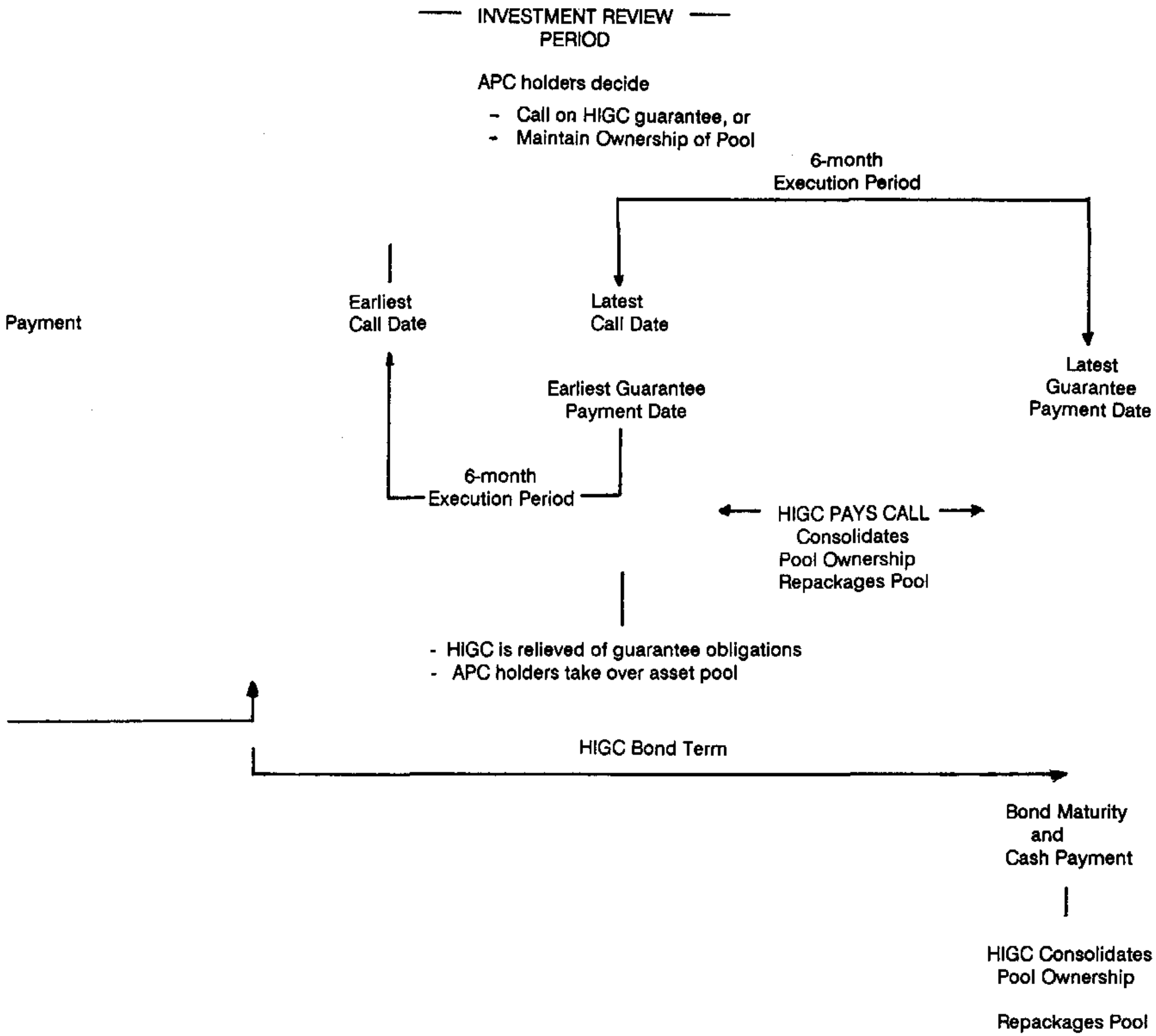
2. In the Event of Non-Redemption

2a. In the Event of Call and HIGC Cash Payment

2b. In the Event of NO CALL

3. Off-Mark Wind-Up within 5 yrs.

HIGC Issues bond in payment of APC's



participation certificate represents an undivided pro-rata share in a pool of real estate assets which is held under trust management by a receiver and/or trustee.

The first issue of the asset participation certificate was authorized by the Securities and Exchange Commission for BF Homes Inc., a pioneer in the business and one of the biggest housing developers in Metro Manila, which was stalled by the very high interest rates during the economic crisis of 1984-85. As designed, the BF Homes Asset Participation Certificate is issued by the SEC-appointed rehabilitation receiver. The certificates pertain to an asset pool consisting of several prime properties of more than 300 hectares within Metro Manila which are in various stages of development. These properties were previously mortgaged to various creditors and were liable to foreclosure or sale.

As a backgrounder, BF Homes Inc. was an active developer catering to middle- and low-income families. It had a tie-up with Banco Filipino Savings and Mortgage Bank, which provided the bulk of the long-term mortgage financing for its buyers. The closure of Banco Filipino, the lack of buyer financing, and the rapidly deteriorating economic situation resulted in the collapse of the BF Homes market. Unable to sell its inventories, BF Homes was also pressed for accelerated payments by its creditors. As its assets were mostly in real estate inventories, it sought relief from the SEC, the major government regulatory institution with jurisdiction over corporations, which granted its request for a suspension of payments and ordered the drawing up of a rehabilitation program.

It took two years to draw up the rehabilitation program and obtain approval of most of the creditors and the SEC. The main feature was the issuance of the asset participation certificate to creditors in exchange for their original notes and liens on the BF Homes properties.

The BF Homes Asset Participation Certificate resolved the legal stalemate of state of suspension of payments on one hand and threatened foreclosures on the other, a stalled condition which benefitted neither owners nor creditors. Through issuance of the APC, the unhampered disposition of the properties at market determined values has been made possible while assuring APC holders adequate returns on their values. The assurance emanates not only from the HIGC insurance cover, which is a major feature of the APC, but also from the credibility of the institutional framework for its implementation. The APC specimen may be seen in Figures 2 and 3.

The BF Homes APC Institutional Framework

The BF Homes APC is issued by an SEC-appointed Rehabilitaion Receiver who is mandated to implement the SEC-approved rehabilitation program, of which the APC is a component.

The Philippine National Bank was appointed as the trustee bank for the asset pool and all proceeds from the disposition of such asset pool. It is also the trustee for the APC, performing the role of transfer agent and servicing agent. One of its tasks is to control the issuance of the APC, ensuring the matching of APC values with those of the asset pool. In essence, it is the trustee which protects and makes good creditors' interests in the rehabilitation program.

The HIGC provides the insurance cover for the APC, assuring holders minimum guaranteed returns on their holdings. In the event of project failure, or inability of the receiver to develop and/or dispose of the assets within the target time and values, APC holders may seek recourse from the HIGC, which is then committed to pay the holders on the due date stated on the certificate its face value and guaranteed earnings.

The Planters Development Bank was appointed as the convenyancing agent responsible for receiving payments and collections from sale of lots, and for transfers of certificates of titles from the trustee to buyers, thereby protecting buyers' rights.

Features of the APC

As a direct participant in an asset pool, the APC holder shares pro-rata in its earnings. But as an added assurance and in exchange for the receiver's option to buy back the certificate anytime before the five and one half year maturity, the receiver guarantees a 12% return per annum to holders of the APC.

As earlier mentioned, the APC is covered by HIGC insurance, by virtue of which certain qualified holders may enjoy tax-free incomes to the extent of 8.5% per annum, as well as the HIGC-guaranteed return.

The APCs are issued in denominations of P1 million, P500,000, P100,000, P50,000, P20,000, P10,000, and P5,000. The certificates are assignable and transferable upon proper endorsement and notice to the trustee, features which, on top of its yield, make the APC a very tradeable issue.

The Redemption Features of the APC

The redemption features of the APC (as illustrated in Figure 4) derive from internal project payment capabilities and recourse to the HIGC guarantee.

1. At any time during the approved five-year term of the rehabilitation program, the Receiver may exercise the option to redeem or buy back the

certificates with a mandatory 12% p.a. return, compounded annually.

2. Any certificate which the Receiver fails to redeem within the five-year period enters a 6-month "investment review period"--actually the first semester of the sixth year--during which period the Holder must decide to exercise either of two options:

   a. To call on the HIGC guarantee, which HIGC undertakes to pay in cash in the amount of the principal plus interest at 8.5% p.a., compounded annually, after a maximum "execution period" of six months; under this option, HIGC's payment period would be the second half of the sixth year;
   b. To maintain his pro-data share in the pool of assets (at this stage diminished to the extent of sales and APC redemptions but most likely representing a proportionately larger collateral: to APC ratio due to real estate price inflation) and enter into an asset liquidation or partitioning arrangement under SEC guidelines.

3. A third eventuality exists: the declaration by the Receiver of an off-mark wind-up at any time during the five-year rehabilitation term to signify his opinion that the rehabilitation program is unworkable under existing conditions. Should this event occur, all APC holders will be automatic beneficiaries of the HIGC guarantee, which undertakes to pay the guaranteed obligations in 8.5% tax-free HIGC bonds maturing at the end of the sixth year, which is incidentally also the latest cash payment for any call made after the five-year term of the plan.

Prospects for the APC

As can be gleaned from these discussions, the APC promises to be more than just an unlocking tool for releasing inventories in stalled projects. The APC could very well be the new instrument for facilitating the organization and packaging of development projects to meet the ever-growing demand for housing.

The institutional framework of the APC depersonalizes the relationships between landowner and developer, developer and venture capitalists, creditors, and bankers. The institutional back-up is also a source of credibility, which makes it possible to attract new and non-traditional investors into housing projects. The unitization of asset pool and issuance of various denominations of APC would make project investments accessible even to small investors. The tradeability features give investors enough liquidity fallback in the secondary markets.