ADB

Report and Recommendation of the President to the Board of Directors

Project Number: 48427-001
October 2015

Proposed Programmatic Approach and Policy-Based Loan for Subprogram 1 Republic of the Philippines: Encouraging Investment through Capital Market Reforms Program

Asian Development Bank

CURRENCY EQUIVALENTS
(as of 26 October 2015)

Currency unit	–	peso/s (P)
P1.00	=	$0.0214
$1.00	=	P46.600

ABBREVIATIONS

ADB	–	Asian Development Bank
ASEAN	–	Association of Southeast Asian Nations
BTr		Bureau of the Treasury
DOF	–	Department of Finance
GDP	–	gross domestic product
IOSCO	–	International Organization of Securities Commissions
MMOU	–	Multilateral Memorandum of Understanding
PDP	–	Philippine Development Plan
PERA	–	Personal Equity and Retirement Account
PPP	–	public–private partnership
PSE	–	Philippine Stock Exchange
SEC	–	Securities and Exchange Commission
TA	–	technical assistance

GLOSSARY

Association of Southeast Asian Nations (ASEAN)	–	A political and economic organization of 10 Southeast Asian countries, which was formed on 8 August 1967 by Indonesia, Malaysia, the Philippines, Singapore, and Thailand. Since then, membership has expanded to include Brunei Darussalam, Cambodia, the Lao People's Democratic Republic, Myanmar, and Viet Nam. Its aims include accelerating economic growth, social progress, and sociocultural evolution among its members; protecting regional peace and stability; and creating opportunities for member countries to discuss differences peacefully.
benchmark issue	–	A bond that provides a standard against which the performance of other bonds can be measured. Government bonds are almost always used as benchmark bonds. Also referred to as "benchmark issue" or "bellwether issue". Benchmark issues are typically used as the basis of yield curves.
bid–ask spreads	–	The amount by which the ask price exceeds the bid. This is essentially the difference in price between the highest price that a buyer is willing to pay for an asset and the lowest price

		for which a seller is willing to sell it. The wider the spread, the less "liquid" the market.
Bureau of the Treasury	–	An agency of the Ministry of Finance which, under Executive Order No. 449, acts as the principal custodian of financial assets of the Government of the Philippines and its agencies and instrumentalities. The Treasury's official duties can be found at http://www.treasury.gov.ph/aboutbtr/mission_main.html.
treasury single account	–	An essential tool for government cash management. It is critical for ensuring that (i) all tax and nontax revenues are collected, and payments are made correctly in a timely manner; and (ii) government cash balances are optimally managed to reduce borrowing costs (or to maximize returns on surplus cash). This is achieved by establishing a unified structure of government bank accounts via a treasury single account system.
market maker (market making)		A broker-dealer firm that accepts the risk of holding a certain number of shares of a particular security in order to facilitate trading in that security. Each market maker competes for customer order flow by displaying buy and sell quotations for a guaranteed number of shares. Once an order is received, the market maker immediately sells from its own inventory, or seeks an offsetting order. This process takes place in mere seconds.
primary dealers	–	A set of preapproved financial institutions which all bid for the right to participate in primary auctions of government securities. Primary dealers are responsible for purchasing the majority of government securities at auction and then redistributing them to their clients, creating the initial market in the process. These institutions must meet certain liquidity and quality requirements. Specific privileges typically include; actively participating in primary government issuance programs, providing liquidity by quoting effective two-way prices for government securities (sales and repurchase agreements) under all market conditions, providing market feedback to the monetary authorities and contributing to the development of the capital market. Privileges are often granted to both facilitate and compensate for these responsibilities and include; an exclusive access to primary auctions of government securities (sometimes coupled with higher non-competitive tender limit and overall allocation limit), exclusive access to financing facilities that are used to facilitate market-making, and close dialogue with monetary authorities on the conduct of market-related issues.

repurchase agreement or "repo"	–	A form of short-term borrowing for dealers in government securities. The dealer sells the government securities to investors, usually on an overnight basis, with an agreement to repurchase them at a set term for a set purchase price which includes repo interest. For the party selling the security (and agreeing to repurchase it in the future), it is a repo; for the party on the other end of the transaction (buying the security and agreeing to sell in the future), it is a reverse repurchase agreement.
yield curve	–	A line that plots the interest rates, at a set point in time, of bonds with equal credit quality but differing maturity dates. The most frequently reported yield curve compares the 3-month, 2-year, 5-year, and 30-year US Treasury debt. This yield curve is used as a benchmark for pricing all other debts in the market, such as mortgage rates or bank lending rates. The curve is also used to predict changes in economic output and growth.

NOTE

In this report, "$" refers to US dollars.

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CONTENTS

PROGRAM AT A GLANCE

1. Basic Data — **Project Number:** 48427-001

Project Name	Encouraging Investment through Capital Market Reforms Program, Subprogram 1	**Department /Division**	SERD/SEPF
Country	Philippines	**Executing Agency**	Department of Finance
Borrower	Republic of the Philippines		

2. Sector

Sector	Subsector(s)	ADB Financing ($ million)
✓ **Finance**	Finance sector development	100.00
	Infrastructure finance and investment funds	100.00
	Money and capital markets	100.00
	Total	**300.00**

3. Strategic Agenda

Strategic Agenda	Subcomponents
Inclusive economic growth (IEG)	Pillar 1: Economic opportunities, including jobs, created and expanded
Regional integration (RCI)	Pillar 2: Trade and investment Pillar 3: Money and finance

Climate Change Information

Climate Change impact on the Project	Low

4. Drivers of Change

Drivers of Change	Components
Governance and capacity development (GCD)	Institutional development Organizational development Public financial governance
Knowledge solutions (KNS)	Application and use of new knowledge solutions in key operational areas
Partnerships (PAR)	Bilateral institutions (not client government) Implementation International finance institutions (IFI) Private Sector
Private sector development (PSD)	Conducive policy and institutional environment Promotion of private sector investment

Gender Equity and Mainstreaming

No gender elements (NGE) ✓

5. Poverty Targeting

Project directly targets poverty	No

Location Impact

Nation-wide	High

6. Risk Categorization: Complex

7. Safeguard Categorization — **Environment:** C **Involuntary Resettlement:** C **Indigenous Peoples:** C

8. Financing

Modality and Sources	Amount ($ million)
ADB	**300.00**
Sovereign Program loan: Ordinary capital resources	300.00
Cofinancing	**0.00**
None	0.00
Counterpart	**0.00**
None	0.00
Total	**300.00**

9. Effective Development Cooperation

Use of country procurement systems	Yes
Use of country public financial management systems	Yes

Source: Asian Development Bank

I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on (i) a proposed programmatic approach for the Encouraging Investment through Capital Market Reforms Program, and (ii) a proposed policy-based loan to the Republic of the Philippines for subprogram 1 of the Encouraging Investment through Capital Market Reforms Program.[1]

2. The program will supplement coordinated support provided by the Asian Development Bank (ADB) to accelerate investment, including infrastructure through public–private partnerships (PPPs), by increasing the availability of long-term finance to fund these ventures. The program will apply sequenced reforms to (i) develop the government bond market as a precursor to further developing the corporate and/or project bond market, (ii) encourage growth in domestic long-term savings, and (iii) ease barriers to entry to diversify and broaden available sources of long-term finance. The program is consistent with ADB's country partnership strategy for 2011–2016 which focuses on supporting infrastructure development, and is included in ADB's country operations business plan, 2015–2017 for delivery in 2015.[2]

II. THE PROGRAM

A. Rationale

3. **The development problem.** The Philippine Development Plan (PDP), 2011–2016[3] calls for real gross domestic product (GDP) growth averaging 7.0%–8.0% per year, investment ratios reaching 22.0% by 2016 (2011–2013 average was 19.7%), and a corresponding reduction in extreme poverty to 17.0% (33% in 1991). In recognition of the key role played by investment in meeting the broader goals of inclusive economic growth and poverty reduction, the PDP targeted public infrastructure spending at 5.0% of GDP with private infrastructure spending exceeding 1.0% of GDP, all by 2016.[4] The government has achieved measured success in meeting these targets. As fiscal reforms initiated in 2010 began to take hold, public spending on infrastructure rose to 3.5% of GDP in 2014 from 2.2% of GDP in 2012, with private sector spending increasing to approximately 1.0% of GDP. However, infrastructure needs continue to balloon, with recent estimates calling for annual infrastructure spending of 6% of GDP.

4. Despite being relatively large and well-capitalized, the intermediation provided by banks to the economy is insufficient to close this widening investment funding gap (Figure 1a). At the same time, the central bank is implementing Basel III and will allow the exemption to the single borrower's limit for PPPs to lapse in 2016, which will further curtail the sector's ability to fund infrastructure development with short-term deposits. Local currency bonds represent a viable alternative and are still growing at a respectable pace despite a recent slowdown in regional local currency bond markets.[5] Nevertheless, the local currency bond market represents only 37% of GDP, is small relative to regional peers, and also provides limited intermediation to the economy. Malaysia and Thailand have local currency debt markets that exceed 75% of GDP, and their local currency corporate debt markets are 3–8 times the size of the Philippine market

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[1] The design and monitoring framework is in Appendix 1.

[2] ADB. 2011. *Country Partnership Strategy: Philippines, 2011–2016.* Manila; and ADB. 2014. *Country Operations Business Plan: Philippines, 2015–2017.* Manila.

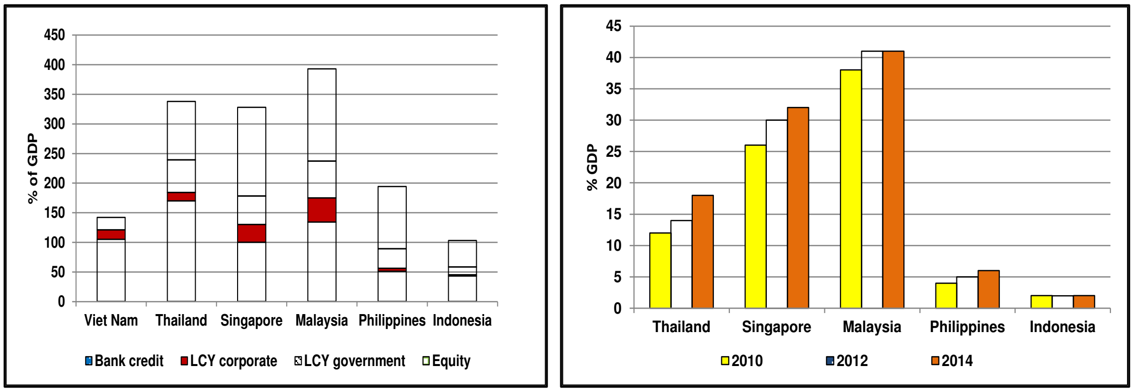
[3] Government of the Philippines. 2014. *Philippine Development Plan, 2011–2016.* Manila.

[4] The Global Competitiveness Report, 2013–2014 has identified the inadequate supply of infrastructure as the most problematic factor in doing business in the Philippines.

[5] Philippine local currency corporate bonds exhibited the fastest year-on-year growth through 2014 relative to regional peers at 27%, albeit from a very low base.

(Figure 1b). In the government bond market, liquidity is low with bid–ask spreads (a fundamental measure of liquidity) higher than in all regional peers except for Indonesia and Viet Nam. Trading activity has been depressed by an underdeveloped issuance process, fragmentation caused by too many outstanding issues, and high costs. As a result, reliance on low-volume issues produces a yield curve that does not provide a fully reliable pricing benchmark for corporate or infrastructure bonds.

Figure 1: Finance Sector – Regional Comparison
(a) Size of Finance Sector to GDP (2013) (b) LCY Corporate Bonds (2010–2014)



GDP = gross domestic product, LCY = local currency.
Sources: Asian Bonds Online; and Asian Development Bank. 2014. *Key Indicators 2014*. Manila.

5. **The binding constraints.** The government has recognized the set of challenges it needs to deal with to improve financial intermediation in the economy, including: (i) addressing the absence of a money market which discourages the wider development of the capital market, (ii) encouraging long term contractual savings and investment products, and (iii) diversifying the investor base. These binding constraints are elaborated in paragraphs 6 to 9 below.

6. The development of the local currency bond market has been constrained by the absence of a short-term money market. This market facilitates price discovery by setting short term market determined pricing benchmarks (interest rates) and supports the conduct of efficient and effective monetary policy. It is a key prerequisite to wider market development. In the Philippines, a legally mandated bond sinking fund holds approximately 20% of all outstanding government debt (about P980 billion as of September 2012) and provides cash to offset temporary revenue gaps.[6] This practice has discouraged the development of robust cash management at the Bureau of the Treasury (BTr) and has led to a critical shortage of short-term treasury bills. Without a ready supply of short-term bills, the central bank utilizes monetary interventions which do not produce market determined short term pricing benchmarks (e.g., deposit accounts with administered rates). Classic monetary policy, on the other hand, relies on buying and selling short-term government treasury bills. This provides for more efficient and effective monetary management. In addition, classic monetary policy provides an enabling environment for trading of liquidity between banks, and the establishment of the necessary market determined pricing benchmarks. Moreover, the use of the sinking fund produces a negative carry of approximate 2% per annum, or a cost to government of P20 billion per year.

7. Reforms in the government bond market need to encompass a variety of technical issues but fundamentally the government needs to encourage higher levels of trading, increase

[6] Republic Act 1000 of 1954.

liquidity, and provide a reliable yield curve so that the corporate bond market and other financial instruments can develop. First, the total number of outstanding government issues is too high, and so trading activity is spread too thinly among the issues.[7] In addition, primary dealers are not held to minimum obligations of participation in primary auctions, secondary market making, or information disclosure, and conversely do not enjoy any privileges. Further compounding this problem, primary dealers lack the risk management tools, such as repos and interest rate derivatives. Without these tools, primary dealers cannot act as market makers, which is a base requirement for increasing liquidity.[8] Moreover, the market suffers from a bifurcation between taxable and nontaxable investors, which effectively prohibits trading between the groups.

8. The domestic investor base does not provide sufficient demand. The contractual savings sector (insurance and pensions) in particular represents a potential engine of demand for long-tenor capital markets products.[9] Growth trends in this sector are positive and, unlike other regional peers, the focus of the industry still produces demand for long-term investments.[10] However, the development of the insurance sector has been constrained by financial literacy issues, as well as restrictive investment guidelines coupled with narrow distribution channels. Corporate and project bonds represent an especially challenging investment for the sector given the lack of reliable national credit rating agencies, as well as capacity and regulatory constraints. Moreover, investors have not been provided any incentives, such as a tax-deferred retirement savings plan, to defer consumption to a later date. Premium taxes are among the highest in the region and impede growth in the insurance industry.

9. The domestic investor base is not diversified. A historical restriction on the foreign ownership of domestic financial institutions has led to the development of a “one-way” market wherein most participants practice buy-and-hold strategies. As a result, more sophisticated trading strategies and business models, such as the resale of loans to end investors through securitization and project finance, have yet to emerge. Speculative trading must be encouraged so those seeking to hedge will find willing counterparties at reasonable cost. Finally, the limited adoption of international standards has exacerbated these constraints as the Philippines is the only country among the Association of Southeast Asia Nations (ASEAN) 6, which has not yet signed the Multilateral Memorandum of Understanding (MMOU) of the International Organization of Securities Commissions (IOSCO).[11] Bank secrecy laws complicate efforts to share information with foreign supervisors, although the authorities are devising mechanisms to address this impediment. Lacking this agreement, the Philippines has been unable to fully participate in the cross-border investment initiatives of the ASEAN Capital Markets Forum.

10. **The government’s sector strategy.** The government recognizes these binding constraints and has aligned its reform agenda to focus on promoting savings generation and developing an enabling environment for long-term investments. Within this framework, the government has adopted a capital market blueprint covering 2011–2016. Initiatives have been identified to improve cash management and forecasting, develop a money market, and increase liquidity in the government bond market. A primary dealer system will be established, fragmentation will be reduced, and pricing between participants will be harmonized. In addition, the government will launch an interdealer repo market and introduce securities lending. Savers

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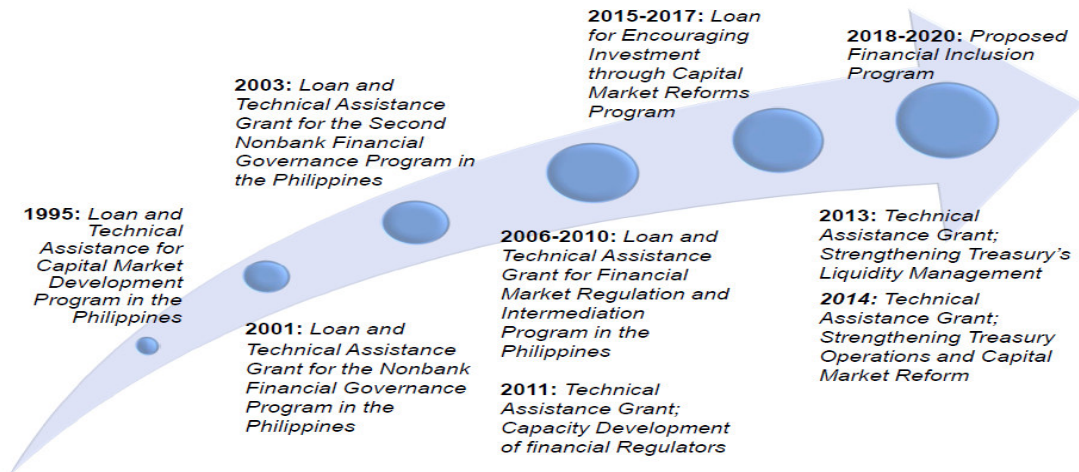
[7] Currently, only the 10- and 20-year benchmarks have achieved sufficient size to serve as reliable benchmarks.
[8] The inability of dealers to “short” bonds to offset long positions is considered a major impediment.
[9] For example, the investment holdings of this sector and the trust divisions of banks currently aggregate approximately $86 billion, representing 32% of GDP.
[10] The industry relies heavily on endowment products (whole life policies) which require investment in long-duration investments such as infrastructure bonds.
[11] Members of the ASEAN 6: Indonesia, Malaysia, Philippines, Singapore, Thailand and Viet Nam.

will be provided the opportunity to become investors through an enabling environment that includes wider investment alternatives, appropriate prudential guidelines, and a national financial education program. A tax-deferred retirement savings account will be launched. Finally, efforts to enlarge and diversify domestic financial markets will be supported through faster integration of the financial system into ASEAN and the global financial markets.

Figure 2: ADB's Engagement in Finance Sector Development



ADB = Asian Development Bank
Source: Asian Development Bank

11. **ADB's experience.** ADB has supported reforms in the finance sector with four programmatic approach policy-based loans and substantial technical assistance (TA) between 1995 and 2010 (Figure 2). ADB's initial focus consolidated the markets, enhanced transparency and accountability, and supported capacity development. The Securities and Exchange Commission (SEC) was restructured and its enforcement capacity was strengthened. ADB's programs then focused on the nonbank finance subsector; governance of the Philippine Stock Exchange (PSE) was improved, market oversight was strengthened, and an anti-money-laundering regime was established. More recently, ADB promoted market liquidity, financial deepening, and stronger intermediaries. Reporting and disclosure practices were set to international standards, settlement and payment systems were improved, and regulatory capabilities were further strengthened. Going forward, ADB will utilize a highly coordinated approach to guide its programmatic support. Through the proposed program, ADB will continue to work with the government to enhance liquidity in the government bond market, encourage long-term savings and investments, and increase market depth and diversity. The proposed program supplements ADB's proposed Expanding Private Participation in Infrastructure Program (EPPIP) by addressing impediments to capital market financing of PPPs. Concurrent with these efforts, ADB's Private Sector Operations Department will encourage the local currency bond market to support infrastructure through selective support to local currency project bonds.[12] The program will also lay the foundations for a dedicated financial inclusion program planned for 2018.

12. **Lessons learned from the experience.** Several lessons have been learned during ADB's long-term engagement in the Philippines finance sector that have helped inform the program. First, sound public finances are a prerequisite for pursuing capital market development.

[12] ADB. 2015. *Report and Recommendation of the President to the Board of Directors: Proposed Partial Credit Guarantee and Loan for the Tiwi and MakBan Geothermal Power Green Bonds Project in the Philippines.* Manila.

The credit rating upgrades provide broad flexibility for reforms while enhanced cash management provides a key prerequisite for development of a money market. Second, a collaborative diagnostic[13] of the government bond market, completed in 2014, highlighted that previous interventions had accomplished much.[14] However, the diagnostic also illustrated that the reforms had not been integrated or modernized in step with the wider financial markets and advancements in international standards. In addition, the structure and technical capacity of the BTr did not receive sufficient attention. As a result, development of the government bond market lagged the banking sector and equity market. Third, ADB's wider experience, which is consistent with the diagnostic, underscores that finance sector development is hierarchical and that sequencing of reforms matters. Key foundation reforms must be successfully implemented before moving on to complex or higher-order reforms, and reform requires a continuous effort to keep pace with changes in global financial markets and new emerging risks to stability. Fourth, a published program completion report provided project-specific lessons which were incorporated into the design of the program, such as the need to focus on key reforms in key subsectors backed by demonstrated political will.[15] In addition, efforts to develop domestic capital markets are enhanced through a "one ADB" approach wherein all departments, such as ADB's Private Sector Operations Department, provide highly coordinated support.

13. **ADB's value added to the design and implementation of the program.** ADB's recent engagement began in 2011 with policy dialogue and supporting TA.[16] A comprehensive diagnostic of the SEC and subsequent engagements strengthened supervision, upgraded systems, and is currently providing assistance to facilitate the issuance of project bonds. The infrastructure to launch the Personal Equity and Retirement Account (PERA) was completed. This engagement was followed by a series of TA projects[17] which supported a reorganization of the BTr, improved its technical capacity, and provided the framework to launch a repo market. Support is being provided to institutionalize a middle office and risk management function, and to upgrade the treasury management system and registry of scripless securities.

14. **Development partner coordination.** There is strong development partner coordination behind the government's capital market reform agenda.[18] The Government of Australia has been supporting the Philippines–Australia Public Financial Management Program through which the treasury single account was launched. The government bond market diagnostic is also providing a template for donor coordination. The US Treasury is providing a resident advisor to strengthen the primary dealer system, while ADB is providing TA to modernize infrastructure, strengthen cash management, introduce a repo market, and develop capacity. The International Monetary Fund is providing intermittent follow-up support and advice to strengthen the conduct of monetary policy. The Japan International Cooperation Agency is considering parallel funding for the program and is providing assistance to the SEC to enhance reporting and surveillance and to better utilize credit information to increase financial inclusion.

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[13] Undertaken by the International Monetary Fund, the World Bank, ADB, and the United States Treasury.

[14] An automated debt auction processing system was established, a registry of scripless securities was introduced, a nascent primary dealer system was created, and straight-through processing was implemented.

[15] ADB. 2013. *Completion Report: Financial Market Regulation and Intermediation Program in the Philippines*. Manila.

[16] ADB. 2011. *Technical Assistance to the Republic of the Philippines for Strengthening the Capacity of Financial Regulators*. Manila.

[17] ADB. 2013. *Technical Assistance to the Republic of the Philippines for Strengthening Treasury's Liquidity Management*. Manila; and ADB. 2014. *Technical Assistance to the Republic of the Philippines for Strengthening Treasury Operations and Capital Market Reform.* Manila.

[18] Donor Coordination Matrix (accessible from the list of linked documents in Appendix 2).

15. **Policy-based loan and budget support**. The use of a programmatic approach with a policy-based loan providing budget support leverages a longer-term policy reform program. The programmatic approach begins with the recommendations of the government bond market diagnostic and will build on ADB's previous engagements to properly sequence reforms to increase access to long-term finance, complementing the medium-term PPP reform agenda. The program utilizes two subprograms concentrating initially on improving cash forecasting, reducing bond market fragmentation, and establishing an enabling environment for a money market to increase trading activity and provide reliable price discovery. Subsequent reforms in subprogram 2 will address the conditions necessary to establish a reliable yield curve by progressively introducing additive and more complex reforms, including a primary dealer system. Subprogram 2 will also increase the availability of long-term finance by launching a tax-deferred long-term retirement savings program, diversifying market participants, and expanding long-term funding models. A medium-term agenda and expected results framework will be used to continue ADB's engagement, assess program effectiveness, and provide an eventual pivot into wider financial inclusion efforts to supplement those of the central bank.

16. **Economic impact of the program**. The program achieves important impacts. The first is substantial fiscal savings from a more efficient management of liquid assets (para 18). Second, reforms to treasury operations and the government bond market are expected to not only deepen the bond market but also produce efficiencies. These efficiencies will be passed on through lower yields on corporate bonds, thereby lowering the cost of capital. The program is also expected to increase the wealth of individuals through better retirement incomes (para. 26).

B. Impact and Outcome

17. The program is aligned with the PDP and will contribute to meeting the government's targeted investment rate. The outcome will be a deeper nonbank finance sector. Subprogram 1 contains 20 policy actions, of which 10 are triggers, all of which have been accomplished. Subprogram 2 will deepen the reforms and contains 22 policy actions of which 9 are triggers.

C. Outputs

18. **Output 1: Liquidity in the government bond market enhanced.** Improved cash management will encourage trading of liquidity, develop a money market, and contribute to the development of short term pricing benchmarks. Accomplishments achieved under subprogram 1 include the following. To improve control over cash, the BTr has consolidated 603 government bank accounts into a treasury single account in line with international best practices. In addition, the BTr adopted a fee-based compensation scheme for its revenue collection banks which strengthened controls and reduced opportunity costs by approximately P1 billion per year. Further, the BTr reduced the cost of carry associated with maintaining the Bond Sinking Fund by reducing its size, yielding an estimated annual saving of P2 billion–P3 billion. These reforms will, in time, increase the ability of the BTr to issue short-term treasury bills. To provide a key prerequisite for a reliable yield curve, the government also adopted measures to increase liquidity and trading activity in the government bond market. First, the Department of Finance (DOF) reduced market bifurcation by enabling the taxable and tax-exempt sectors to trade freely with one another.[19] The BTr then reduced the number of outstanding government bond issues from 204 to 118 to increase trading volumes in the remaining outstanding benchmark issues. The BTr introduced the international-standard Global Master Repurchase Agreement which supports the development of a money market and the introduction of diversified trading

[19] The total outstanding reserves of two major government pension schemes are approximately $18.7 billion.

strategies, including hedging. Finally, the BTr has modernized its operations and established a Risk Management Division, Fund Management Division, Capital Market Strategy and Planning Division, and a Debt Strategy and Planning Division.

19. In subprogram 2, the government will build on these reforms by implementing additional measures to further improve cash management and forecasts, and to support the formation of a reliable yield curve. The government will continue to defragment the market by concentrating trading into key benchmark securities, and a primary dealer system will be launched with a basic set of responsibilities and privileges. To encourage market making, the BTr will sponsor a targeted repo program for selected dealers who will provide firm two-way price quotes (prices) for eligible government securities. The BTr will complete installation of the new treasury management system, institutionalize middle office risk management, and establish performance management and exception reporting.

20. **Output 2: Long-term savings and long-term investment products encouraged.** Accomplishments include measures to encourage savers to become investors, which will lead to an increase in the supply of long-term savings. In subprogram 1, the government encouraged more domestic participation in the finance sector, with an emphasis on contractual savings. The revised Insurance Code authorized a wider diversity of investments for the sector, including project bonds, and increased the range of permissible investment strategies. The infrastructure needed to support the introduction of a tax-deferred long-term retirement savings platform—the PERA—has been completed. The SEC, in conjunction with the PSE, encouraged professional management of collective investments by launching exchange-traded funds. Simultaneously, the government reduced the costs of financial transactions by introducing a bill to cut premium taxes on nonlife policies, removing the documentary stamp tax from repo transactions (policy action 13), and accelerating the processing of applications for business registration.

21. In subprogram 2, the government will continue to encourage the development of long-term savings and investment, and will establish an interagency memorandum of understanding to promote neutrality in capital market taxation. The PERA system will be launched and opened to public participation. The Insurance Commission will explore alternative investment schemes (e.g. structured finance), and encourage insurance companies to channel funds to PPPs. Similarly, the SEC, in conjunction with the PSE, will support the expansion of exchange-traded funds including both equity and fixed-income. Finally, the SEC will submit the revised Corporation Code to Congress to introduce one-man corporations, perpetual corporate existence and registration, XBRL-based electronic submission of financial statements, and strengthened anticorruption provisions.

22. **Output 3: Market depth and diversity increased.** The government has adopted reforms to increase competition, diversify participants and business models, and introduce new skill sets. Accomplishments under subprogram 1 include the following. The government authorized up to 100% foreign ownership in financial institutions.[20] An application for admittance to IOSCO's MMOU has been filed, which will position the government for deeper participation in ASEAN cross-border investment initiatives. Parallel efforts to strengthen governance and supervision in line with international standards have been enacted, including the issuance of guidelines covering the accreditation and operating standards of credit rating agencies. The SEC created a corporate governance and finance department and issued guidelines mandating all publicly listed companies to publish an annual corporate governance report. Incentives to

[20] Republic Act 10607, The Revised Insurance Code; Republic Act 10641, an act allowing the full entry of foreign banks into the Philippines; and BSP Circular No.858.

strengthen governance have been provided by completing the ASEAN corporate governance scorecard assessment for 2013–2014. Surveillance of the equities market has been improved and efforts made to strengthen surveillance of the fixed-income market.

23. In subprogram 2, the government will strengthen the insurance sector by encouraging consolidation through increased capitalization and the introduction of risk-based capital standards. The government will sign IOSCO's MMOU and will participate more fully in ASEAN cross-border investment initiatives. The SEC, in conjunction with the PSE, will promulgate a new code of corporate governance and a corporate governance road map. The SEC, through the Institute of Corporate Directors, will participate in the ASEAN corporate governance scorecard assessment and the SEC will establish surveillance of the fixed-income market.

D. Development Financing Needs

24. The government has requested a policy-based loan of $300 million from ADB's ordinary capital resources to help finance subprogram 1, with an equivalent amount programmed for subprogram 2. The loan will have a 15-year term, including a grace period of 3 years, annuity method with 30% discount, an annual interest rate determined in accordance with ADB's London interbank offered rate (LIBOR)-based lending facility, a commitment charge of 0.15% per year, and such other terms and conditions set forth in the draft loan agreement (the average maturity is 12.1 years). The Government of Japan, through the Japan International Cooperation Agency, is considering parallel financing for subprogram 1 in the amount of $100 million equivalent. The loan size is based on the financing needs of the Philippines, the development impact of the policy reform package, and development spending arising from the reform. The Philippines' gross financing needs remain high. In 2015, with a budget deficit target of 2% of GDP, the government will need to borrow $15.6 billion to close the budget gap, of which $1.65 billion will be obtained through official development assistance. The program impacts the budget through concessionary tax treatment of PERA accounts and incremental spending on the capital market reforms (para. 26).

E. Implementation Arrangements

25. The DOF will be the executing agency; the Bureau of the Treasury and the SEC will be implementing agencies. A steering committee, chaired by the Department of Finance with implementing agencies as members, will oversee the implementation of the program.[21] The steering committee will meet semiannually and, if needed, on an ad hoc basis to monitor progress in implementing reforms under the program and to provide guidance and direction to the DOF and the implementing agencies. The government will invite ADB and development partners to participate as observers. The implementation period is January 2013–June 2015 for subprogram 1 and July 2015–June 2017 for subprogram 2.

III. DUE DILIGENCE

A. Economic and Financial

26. A growing body of empirical research produces a remarkably consistent narrative: finance sector development exerts a first-order impact on long-run economic growth.[22] On a

[21] The Insurance Commission and the Bangko Sentral ng Pilipinas will be committee members, reflecting ADB's ongoing TA to each and the role of the Bangko Sentral ng Pilipinas in supporting financial inclusion and literacy.
[22] Sector Assessment (Summary): Finance (accessible from the list of linked documents in Appendix 2).

project-specific level, the program impact assessment[23] estimates that the recurrent quantifiable benefits of the program have a present value of $1.2 billion, under conservative discounting assumptions, and well exceed the program's estimated costs. Of this, approximately, $890 million flows to the government from more efficient use of liquid assets. A further $290 million is expected to flow to the corporate sector from improvements to the corporate bond market, and individuals are expected to benefit from a $50 million efficiency improvement in the insurance market. In addition to these recurrent benefits, better retirement incomes are expected to lift individual wealth by $143 million over 10 years. Significant, if unquantifiable, benefits are expected to flow from greater efficiency in the non-life-insurance sector and from initiatives to deepen the markets in investment vehicles, such as exchange-traded funds. The reforms will entail some costs, such as the concessionary tax treatment on PERA accounts estimated at $80 million. Other costs, while not insignificant, are small relative to the potential benefits.

B. Governance

27. The government's public financial management system has been strengthened with the implementation of the 2011 public financial management reform road map. On the basis of the 2014 update of the 2010 Public Expenditure and Financial Accountability assessment, the average scores for three of the six dimensions (comprehensiveness and transparency; policy-based budgeting; and accounting, recording, and reporting) have improved. Areas where no progress was observed since 2010 included budget credibility, predictability and control in budget execution, and external scrutiny and audit (e.g., legislative scrutiny of external audit reports). The government has adopted the unified account code structure which harmonizes budget classification and accounts codes, and the treasury single account which improves cash management and control. Other initiatives include adopting new accounting and auditing standards that are in line with international standards, involving civil society organizations in the national budget process, and carrying out citizen participatory audit. The remaining challenges include the need to strengthen the annual budget process, provide comparative accounting data, and strengthen revenue administration and internal controls.[24]

28. ADB's Anticorruption Policy (1998, as amended to date) was explained to and discussed with the government and the DOF. The Good Governance and Anti-Corruption Cabinet Cluster is developing a comprehensive and results-based anticorruption action plan, drawing on a review of the National Anti-Corruption Plan of Action. Initiatives are under way by various development partners to strengthen the capacity of the Office of the Ombudsman and the justice sector to perform their investigative and prosecutorial functions.

C. Poverty and Social

29. Finance sector development helps reduce poverty through at least three channels: higher economic growth, finance sector inclusiveness, and finance sector stability. The program contributes to poverty reduction by encouraging the nonbank finance sector to support infrastructure development through the provision of long-term peso-denominated financing. Increased investments in infrastructure will lead to increased employment and, in turn, government tax revenues. While the program does not directly focus on financial inclusion, reforms to retirement income policies and policy improvements in the insurance industry lay down foundations for ADB's future engagement in this area.

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[23] Program Impact Assessment (accessible from the list of linked documents in Appendix 2).
[24] Assessment of Public Financial Management (accessible from the list of linked documents in Appendix 2).

D. Safeguards

30. The program will not entail any involuntary resettlement or affect indigenous people or the environment. It is assigned category C for all safeguards categories (involuntary resettlement, impact on indigenous people, and environmental impact).

E. Risks and Mitigating Measures

31. The program is exposed to broad national and macroeconomic risks and risks associated with public financial management and corruption. ADB is actively coordinating with other development partners to mitigate these risks. A macroeconomic and debt sustainability assessment has been prepared and documents these risks as *low*.[25] Strong economic performance over the past 4 years has produced one of the fastest growth rates in Southeast Asia with a corresponding decline in the level of public debt relative to GDP. However, risks arising out of the public financial management and procurement systems, as well as corruption, are considered high. To mitigate these risks, ADB is providing high-level leadership to facilitate interagency coordination to implement the government's whole of government approach to the entire public financial management cycle. ADB will support the revision of legislation supporting procurement to enable the participation of a wider range of bidders, including the direct participation of foreign firms, and is working to strengthen the bid and evaluation process. In addition, ADB will participate in the government's efforts to develop a comprehensive and results-based anticorruption action plan, drawing on a review of the National Anti-Corruption Plan of Action. Program-specific risks, including specific risks and corresponding mitigating measures, are described in detail in the risk assessment and risk management plan.[26]

IV. ASSURANCES

32. The government and the DOF have assured ADB that implementation of the program shall conform to all applicable ADB policies including those concerning anticorruption measures, safeguards, gender, procurement, consulting services, and disbursement as described in detail in the loan documents.

V. RECOMMENDATION

33. I am satisfied that the proposed programmatic approach and policy-based loan would comply with the Articles of Agreement of the Asian Development Bank (ADB) and recommend that the Board approve

(i) the programmatic approach for the Encouraging Investment through Capital Market Reforms Program; and

(ii) the loan of $300,000,000 to the Republic of the Philippines for subprogram 1 of the Encouraging Investment through Capital Market Reforms Program, from ADB's ordinary capital resources, with interest to be determined in accordance with ADB's London interbank offered rate (LIBOR)-based lending facility; for a term of 15 years, including a grace period of 3 years; and such other terms and conditions as are substantially in accordance with those set forth in the draft loan agreement presented to the Board.

Takehiko Nakao
President

27 October 2015

[25] Macroeconomic and Debt Sustainability Assessment (accessible from the list of linked documents in Appendix 2).
[26] Risk Assessment and Risk Management Plan (accessible from the list of linked documents in Appendix 2).

DESIGN AND MONITORING FRAMEWORK

Impacts of the program are aligned with: The Philippine Development Plan, 2011–2016 and will contribute to meeting the government's targeted investment rate.[a]

Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting Mechanisms	Risks
Outcome A deeper nonbank finance sector	**By 2018** Corporate bonds increase to at least 8.0% of gross domestic product. (2012 baseline: 4.9%) At least one domestic currency project bond is issued. (2012 baseline: 0) Annual trading volume of government bonds increases by at least 25%, and at least one government benchmark security is supported by two-way firm quotes. (2012 baseline: $156 billion and none supported by firm two-way quotes) Number of PERA accounts opened exceeds 100,000, with aggregate balances in excess of P14 trillion. (2012 baseline: 0 and 0) Foreign-owned domestic financial institutions account for at least 10% of the banking sector's total assets (2012 baseline: 0%)	AsianBondsOnline and public news releases AsianBondsOnline and public news releases AsianBondsOnline, public news releases, Bureau of the Treasury website, and consultant reports Financial Sector Forum reports Bangko Sentral ng Pilipinas website	Global monetary and regulatory actions undermine the development of the domestic capital market. Continuity of capital market development is not maintained. ASEAN integration is disrupted by uneven progress or national priorities.
Outputs 1. Liquidity in the government bond market enhanced	**By 2015** At least 500 Bureau of the Treasury cash accounts closed and consolidated into the treasury single account (2012 baseline: 0 accounts consolidated) At least one trade of government securities occurs between a tax and tax-exempt counterparty[b] (2012 baseline: 0 trades) Risk management and fund management divisions created with at least 40 Bureau of the Treasury staff trained in advanced bond math and trading strategies (2012 baseline: Not created and 0 staff trained)	Bureau of the Treasury internal reports Bureau of the Treasury internal reports, press releases Certification and test results from certified financial analysts' society	Technical capacity of regulators is insufficient to support the reform agenda. Budget is inadequate to fund capital market infrastructure upgrades and regulatory action plans. The government is unable to meet the prerequisites for ASEAN integration.

Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting Mechanisms	Risks
	By 2017 Primary dealer system is established with formal privileges and responsibilities. (2012 baseline: Not established)	Bureau of the Treasury website, consultant reports	Market development efforts outstrip financial inclusion and education programs.
	The number of government bond issues declines by at least 20%. (2012 baseline: 118)	Bureau of the Treasury internal reports	
	Hedging mechanisms established with the number of repurchase transactions, based on the GMRA, increasing to at least 100 per year. (2012 baseline: 0)	Bureau of the Treasury internal reports, Bloomberg	
2. Long-term savings and long-term investment products encouraged	**By 2015** User acceptance testing for PERA support system completed and accepted by Bangko Sentral ng Pilipinas. (2012 baseline: Not completed)	Consultant reports	
	Documentary stamp tax on GMRA-based repos reduced to zero. (2012 baseline: P0.30 for every P200.00, equivalent to the rate of 0.15%)	Bureau of the Treasury website	
	By 2017 Number of professionally managed exchange-traded funds listed on the Philippine Stock Exchange increases to three, of which at least one is a fixed-income exchange-traded fund (including project bonds) (2012 baseline: 1 and 0)	Philippine Stock Exchange website and annual report	
	PERA is declared operational with the approval of a cash custodian and a securities custodian bank(s). (2012 baseline: No custodians approved)	Financial Sector Forum reports and consultant reports	
	The insurance commissioner authorizes at least one alternative investment modality to support project finance or public–private partnerships. (2012 baseline: Not authorized)	Website and annual report of the insurance commissioner	
3. Market depth and diversity increased	**By 2015** IOSCO begins formal review of the government’s application to become a signatory to Annex A.	Securities and Exchange Commission	

Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting Mechanisms	Risks
	(2012 baseline: not submitted)	internal reports	
	At least one application received supporting the entry of a foreign financial institution into the Philippines (2012 baseline: No applications)	Press releases and regulatory websites	
	By 2017 Philippines joins IOSCO's Annex A as a signatory and participates in at least one ACMF cross-border initiative. (2012 baseline: Not joined and not participating in ACMF initiatives)	Published news reports, IOSCO website, Securities and Exchange Commission website, and ACMF website	
	Philippines places at least five publicly listed companies in the top 50 ASEAN Corporate Governance Scorecard rankings (2012 baseline: 0)	ACMF website	
	The insurance commissioner approves at least three mergers of life and/or nonlife insurance companies within the insurance sector. (2012 baseline: Not approved)	Website and annual report of the insurance commissioner	
Key Activities with Milestones: Not applicable. Please refer to the Policy Matrix in Appendix 4.			
Inputs **Asian Development Bank:** Subprogram 1 $300,000,000[c] Subprogram 2 $300,000,000[c]			
Assumptions for Partner Financing: **Japan International Cooperation Agency:** Subprogram 1 $100,000,000[c]			

ACMF = ASEAN Capital Markets Forum, ASEAN = Association of Southeast Asian Nations, GMRA = Global Master Repurchase Agreement, IOSCO = International Organization of Securities Commissions, PERA = Personal Equity and Retirement Account.

[a] Government of the Philippines. 2014. *Philippine Development Plan, 2011–2016*. Manila.

[b] This performance indicator confirms the effectiveness of government initiatives to allow pension funds to trade with the commercial sector by negating pricing differentials that have arisen over time because of the tax-exempt status of pension funds.

[c] Numbers are indicative and are subject to the government's request, and approval by the Asian Development Bank and the Government of Japan/Japan International Cooperation Agency.

Source: Asian Development Bank.

LIST OF LINKED DOCUMENTS

http://adb.org/Documents/RRPs/?id=48427-001-3

1. Loan Agreement
2. Sector Assessment (Summary): Finance
3. Contribution to the ADB Results Framework
4. Development Coordination
5. Country Economic Indicators
6. International Monetary Fund Assessment Letter
7. Summary Poverty Reduction and Social Strategy
8. Risk Assessment and Risk Management Plan
9. List of Ineligible Items

Supplementary Documents

10. Program Impact Assessment
11. Macroeconomic and Debt Sustainability Assessment
12. Public Financial Management Assessment

Republic of the Philippines
DEPARTMENT OF FINANCE
Roxas Boulevard Corner Pablo Ocampo, Sr. Street
Manila 1004

LETTER OF DEVELOPMENT POLICY

2 October 2015

Mr. TAKEHIKO NAKAO
President of the Asian Development Bank
6 ADB Avenue, Mandaluyong City

SUBJECT: Encouraging Investment through Capital Market Reforms Program (EICMR)

Dear **Mr. Nakao:**

We would like to express our appreciation for the continuing support of the Asian Development Bank (ADB), and your own keen interest in enhancing the resiliency of the regional capital markets, including those in Philippines.

The economy of the Philippines will require increased investment to achieve the goals of the Philippine Development Plan (PDP) 2011-2016. Given the escalating needs, mobilizing additional long-term financing from the financial sector will be critical to achieving the government's infrastructure investment targets, as well as its broader goals for inclusive economic growth and poverty reduction. This letter highlights the Philippine Government's policy for further capital market reforms aimed at increasing the availability of long-term finance to fund infrastructure projects through Public-Private Partnerships (PPP). We remain confident of having high prospects for further policy and regulatory changes with continuing major economic initiatives as there is broad consensus on the objectives of these. The Philippines is also committed to regional integration as that would allow the domestic market to expand its reach.

Much has been accomplished over the past 4 years. Growth in our Gross Domestic Product has accelerated, averaging nearly 6 percent from 2010-2014 compared with 4.8 percent over the previous decade. In fact, our average growth rate over the period 2010-2014 represents the highest 5-year average growth rate since the mid-1970s. This growth has been supported by sound macroeconomic performance. Fiscal space has widened with debt consolidation, expenditure reforms and more determined revenue collection efforts. As a consequence, the Philippines was awarded investment grade status from all 3 of the major global credit rating agencies.

Nevertheless, we acknowledge that inadequate infrastructure represents one of, if not the most important, critical constraints to the continuing economic development of the Philippines. Infrastructure bottlenecks, a historic lack of fiscal space, and the inability of the finance sector to compensate with sufficient amounts of long-term financing are considered critical impediments to adequate infrastructure development. The government is therefore initiating a rapid increase in spending that targets a doubling the ratio of public infrastructure investments to GDP from 2.5 percent in 2013 to 5 percent by 2016. To support this effort, we are also working to roll out and award more projects under our PPP infrastructure program, which is also being supported by the ADB. Ongoing reforms will improve the investment climate by removing administrative hurdles, ensure policy clarity, quicken project clearances and ease foreign ownership norms.

Alongside the fiscal consolidation that began in 2010, public spending on infrastructure has increased from 2.2% of GDP in 2012 to 3.5% in 2014. Likewise, we have seen private sector spending on infrastructure increase to approximately 1% of GDP. However, we are still short of the targeted investment ratio for 2016, and we expect required infrastructure spending to increase to 10% of GDP in the next decade, and to reach a total of $27 billion a year by 2025.

Given these skyrocketing needs, the government recognizes that parallel efforts are needed to channel more private savings into bankable infrastructure investments through the domestic financial markets, and in particular the bond market. The recent rapid growth of the corporate bond market is indeed an encouraging sign. However, much more needs to be done to develop the local currency government bond market to reduce the dependence of bank-dominated financing and to properly match long-term projects with long-term funding. As the development of financial markets is hierarchical, the government bond market is the foundation on which all wider capital market development is built. Yet Philippine government bond market is built on infrastructure, and exhibits liquidity far below what would be expected in a country with an investment grade rating.

There is also need to develop a domestic base of institutional investors as they can play a decisive role in national growth and enhance domestic capability to address infrastructure needs. To transform savers into investors, the government will need to ensure that appropriate incentives are in place and that the public has a variety of suitable investment products. We recognize that the growth of the insurance industry has been constrained by the restrictive investment guidelines coupled with narrow distribution channels. Impediments to investment in corporate and project bonds by the sector need to be addressed. In addition, we must accelerate the integration of our financial system into ASEAN, and the wider global economic community. Increased exposure to the Asian financial markets will encourage the rapid growth of the country's economy by increasing competition, diversifying participants and business models, and introducing new skill sets and avenues of financing.

The Government's sector strategy is anchored in the PDP and seeks to provide an enabling environment, progressive adoption of international standards and best practices, and good governance and transparency. Within this framework, the Government has adopted a revised and updated Capital Market Blueprint covering 2011–2016. Initiatives have been identified to increase liquidity in the government bond market by establishing a primary dealer system, reducing fragmentation of issuances, and harmonizing pricing between participants. In addition, the Government will launch an inter-dealer repo market and introduce securities lending. Issuance of corporate debt will be encouraged by streamlining the registration process and by authorizing securitizations and exchange traded funds. Savers will be provided the opportunity to become investors through an enabling environment that includes wider investment alternatives, appropriate prudential guidelines, infrastructure support, and a national financial literacy program. Efforts will focus on broadening the mix of collective investment schemes to provide additional alternatives for lower and middle-income investors including a tax-deferred retirement savings account. Finally, efforts to enlarge, deepen and diversify domestic financial markets will be supported through faster integration of the financial system into Association of Southeast Asian Nations (ASEAN) and the global financial markets.

To support the implementation of capital market reforms, the Government of the Philippines has established a medium term partnership with ADB which has been articulated into the program. Geared towards a deeper nonbank finance sector, the program is structured around three-policy outputs, enhancing the liquidity in the government bond market, encouraging long-term savings and investments, and increasing market depth and diversity.

Government Bond Market Depth and Liquidity

The Government provided the groundwork for increased trading volumes and liquidity in the government debt market. A treasury single account has been created through the consolidation of 561 government bank accounts in line with international best practices. By reducing the size of the Bond Sinking Fund, the Bureau of the Treasury (BTr) was able to reduce the cost of carry generating an estimated annual savings of P2 to P3 billion a year. These reforms will, in time, enhance the BTr's cash forecasting and provide an incentive begin regular issuance of short-term treasury bills. In addition, the BTr has strengthened its control of cash by replacing the free float based compensation for its revenue collection banks with a fee-based compensation scheme. Measures have been adopted to increase liquidity and trading activity in the government bond market that will lead to a reliable yield curve, based on which the corporate and project bonds can be issued. To begin, the BTr has reduced the number of outstanding government bond issues from 204 to 118 which will increase trading volume in the remaining benchmarks. By enabling trading between taxable and tax exempt sectors, the Department of Finance has reduced market bifurcation. This will now allow government securities held by the tax-exempt sector to be traded freely in the secondary market. To support prospective market makers, and the development of a money market, the BTr has introduced the international standard Global Master Repurchase Agreement. In order to complement the aforementioned bond market developments, the BTr has also undertaken necessary steps to upgrade in its internal process including the awarding of a contract to modernize its core operations and to improve data availability, and reorganization and establishment of specialized divisions focusing on risk management, capital market strategy and planning, and debt strategy and planning.

Long-term Savings and Investments

The government has also implemented measures to encourage more domestic participation in the finance sector, with an emphasis on contractual savings. The revised Insurance Code allows prudent-man management, authorizes a wider diversity of investments for the sector, including project bonds, and increases the range of investment alternatives. The physical infrastructure needed to support the introduction of a tax-deferred long-term retirement savings platform, the Personal Equity and Retirement Account (PERA), has been completed.

Exchange Traded Funds have been launched. Simultaneously, the costs of financial transactions have been reduced by introducing a bill to cut premium taxes on nonlife insurance policies. The documentary stamp tax from repo transactions has been removed, and the processing of applications for certificates of business registration has been accelerated.

ASEAN Capital Market Integration

Finally, the government introduced reforms to encourage greater investment from a more diversified group of investors. As agreed under the ASEAN Economic Blueprint, foreign participation in all financial market subsectors has been permitted subject to an aggregate cap as required by the constitution. An application for admittance to the International Organization ofSecurities Commissions' Annex A has been filed which will position the government for deeper participation in ASEAN cross-border investment initiatives. Corporate governance has been strengthened and the Securities and Exchange Commission issued guidelines to strengthen the operations of credit rating agencies in line with international standards. The SEC has enhanced its market surveillance in the equities market and has launched efforts to strengthen surveillance of the fixed income market.

Continuing Capital Market Reform

In subprogram 2, the government will continue and deepen these reforms by completing a sequenced set of reforms additional measures to further improve cash management and forecasts. Defragmentation of the market will continue as the government continues to funnel trading into benchmark securities with key tenors. A primary dealer system will be launched with a basic set of responsibilities and privileges. To encourage market-making and 2-way price quotes, based. To begin, the BTr will sponsor a Specials Repo Program for selected dealers, who will provide firm two-way quotes for eligible government securities. In combination, these reforms will provide the basis of a more reliable yield curve on which the corporate and project bonds can be issued. To provide a more modern infrastructure, the BTr will complete installation of the new treasury management system, and will institutionalize middle office risk management.

Building on reforms implemented in subprogram 1, the government will continue to encourage the development of long-term savings and investment. The PERA system will be launched and opened to public participation and the government will make available a wider variety of exchange-traded funds, including fixed-income, that are designed to encourage long-term savings and investment. An interagency MOU will be established through the Capital Market Development Tax Group to promote neutrality in capital market taxation. An Investment Advisory Council will be established by the Insurance Commission to explore unique investment schemes and to encourage insurance companies to channel funds to public-private partnership projects. Efforts to reduce the financial costs of capital market transactions will continue. The Securities and Exchange Commission will submit the revised Corporation Code to Congress, introducing perpetual corporate existence and registration, XBRL based electronic submission of financial statements and other corporate disclosures, and strengthened anti-corruption provisions.

Subprogram 2 will also bring about consolidation in the financial sector through increased minimum capitalization and the introduction of risk based capital standards. The government will sign IOSCO's MMOU and will begin participating more fully in ASEAN cross-border investment initiatives including collective investment schemes and cross-border public offerings of debt and equity. A new code of corporate governance will be promulgated and a corporate governance road map will be issued. We continue to encourage advancements in corporate governance and will participate in the ASEAN corporate governance scorecard assessment.

Conclusion

In closing, the Government will continue to implement proactive measures to ensure Philippines is able to sustain economic growth and reduce poverty. The Government is committed to implement the agreed policy reforms and to continue with further measures over the medium and long term to improve the investment climate and further develop infrastructure to enhance competitiveness and increase productivity. The Government acknowledges and appreciates the support provided by ADB over the years and appreciates the commitment to work with the Government to deepen, enlarge and modernize the domestic capital market. We would appreciate the prompt consideration of proposed program with a loan of US$300 million, including an additional US$100 million parallel co-financing from the Government of Japan.

Thank you.

Very truly yours,

CESAR V. PURISIMA
Secretary
028470

POLICY MATRIX
Encouraging Investment through Capital Market Reforms Program

Highlights of Background	Objective: The Encouraging Investment through Capital Market Reforms Program will complement the proposed Expanding Private Participation in Infrastructure Program by increasing the availability of long-term finance. In doing so, the program will establish a framework through which private funding can be channeled to boost private investment in infrastructure. To accomplish this objective, the program will address fundamental constraints to bond market development, encourage growth in long-term savings, and diversify the investor base. Impact: The Encouraging Investment through Capital Market Reforms Program is aligned with the Philippine Development Plan, 2011–2016 and will contribute to meeting the government's targeted investment rate, including public and private spending on infrastructure. Outcome: The outcome will be a deeper nonbank finance sector, measured by an increase in corporate bonds relative to GDP, participation in the Association of Southeast Asian Nations (ASEAN) cross-border initiatives, and growth in contractual and long-term retirement savings. ➢ The program will build on ADB's comprehensive engagement with the Philippine financial sector, which dates from 2010, and will seek to increase the supply of long-term investable fundsavailable through the private sector. ✧ The program will address development constraints in the government bond market, which is a fundamental building block of financial market development, to facilitate the eventual issuance of corporate and project bonds. ✧ The program will increase the size of the domestic capital market by building up the contractual savings sector, eliminating costs on financial transactions, and easing administrative burdens. At the same time, the program will increase demand for capital market products by encouraging short-term savers to become long-term investors. ✧ Finally, the program will increase the diversity of participants and business models, and increase the available pool of savings, by encouraging deeper regulatory harmonization within Association of South East Asian Nations (ASEAN) through the ASEAN Capital Market Forum.

Outputs	Subprogram 1 Accomplishments (Policy triggers in bold) June 2013 to June 2015	Subprogram 2 (Policy triggers In bold) July 2015 to June 2017	Medium-term directions and expected results 2013 to 2021
Output 1: Government Bond Market Depth and Liquidity Enhanced			
1.1 *Money market developed through improved cash management.* ○ Government of Australia, Philippines-Australia Public Financial Management Program ○ ADB TA, Strengthening Treasury's Liquidity Management (TA8495)	*The Government of the Philippines (government) (through the Bureau of the Treasury (BTr)) implemented measures to stimulate the development of the short term money market by improving cash management and forecasts. Accomplishments included:* 1. **The BTr improved cash management by consolidating 603 government bank accounts aggregating approximately P30 billion into a Treasury Single Account (TSA) in line with international best practices.** 2. The BTr switched from a float to a fee based compensation scheme for its revenue collection banks, which strengthened BTr's monitoring and control and reduced opportunity costs by approximately P1 billion a year. 3. **The BTr reduced the cost of carry associated with maintaining the Bond Sinking Fund (BSF) by reducing its size by P127 billion yielding an estimated annual savings of P2 to P3 billion a year.**	*The BTr continues to improve cash management and forecasts. These measures will include:* 1. **The Btr establishes a cash management committee to improve the reliability of cash management and forecasts, enabling more efficient fund raising.** 2. The BTr continues to improve cash and investment management processes. **3. The BTr continues to restructure the BSF to further reduce cost of carry.**	*The Btr further consolidates major accounts into the TSA and sets investment performance standards.* Medium-term Results: • Cash flow forecasts are incorporated into the auction process, curtailing over-issuance of bonds and enabling issuance of treasury bills. Longer-term Results: • Administration of the wholesale government bond market returned to the BTr.

Outputs	Subprogram 1 Accomplishments (Policy triggers in bold) June 2013 to June 2015	Subprogram 2 (Policy triggers In bold) July 2015 to June 2017	Medium-term directions and expected results 2013 to 2021
1.2 *Trading volumes of government debt increased.* ○ IMF/World bank, diagnostic of the government bond market ○ ADB TA, Strengthening Treasury's Liquidity Management (TA8495) ○ ADB TA, Strengthening Treasury Operations and Capital Market Reform (TA8718) ○ U.S. Treasury Resident Advisor program	*The government adopted measures to increase trading activity within key government securities to increase liquidity. Increased liquidity and trading activity represent key prerequisites to developing a reliable yield curve which will support the issuance of corporate and project bonds. Accomplishments included:* 4. The BTr reduced the number of outstanding government bond issues from 204 to 118 by focusing on identified "benchmark" issues thereby increasing trading volumes in the remaining outstanding issues. 5. **The Department of Finance (DOF) reduced market bifurcation by lifting the restriction to trading between taxable and tax exempt sectors which allowed the 20% of outstanding government securities held by the tax exempt sector to be traded in the secondary market.**	*The BTr continues reforms to further increase the trading volume of government securities, including structural changes, to accelerate the formation of a more reliable yield curve.* 4. The BTr increases trading volumes by further consolidating outstanding issues by 20%. 5. **The BTr implements a basic set of responsibilities and privileges for government eligible securities dealers and market makers.**	*The BTr achieves increased liquidity in the government bond market which supports a yield curve based reported trades of highly liquid benchmark securities.* Medium-term Results: • Number of primary dealers rationalized in line with international best practices. Longer-term Results: • Number of outstanding government bond issues declines by at least 30%. • An active repo market utilizing both financing and GMRA-based repurchase agreements. • Bid/ask spreads decline by at least 10%.

Outputs	Subprogram 1 Accomplishments (Policy triggers in bold) June 2013 to June 2015	Subprogram 2 (Policy triggers In bold) July 2015 to June 2017	Medium-term directions and expected results 2013 to 2021
	6. **The BTr introduced standard internationally accepted Global Master Repurchase Agreement (GMRA) which allows for an increased diversity of trading strategies including short positions, which will support two-way market making.**	6. **The BTr sponsors Specials Repo Program for selected market makers, who will provide firm two-way quotes (prices) for eligible government securities.**	
1.3 *Treasury operations enhanced.* ○ ADB TA, Strengthening Treasury's Liquidity Management (TA8495) ○ ADB TA, Strengthening Treasury Operations and Capital Market Reform(TA8718) ○ Philippines CFA Society ○ Govt of Australia, Philippines-Australia Public Financial Management Program ○ U.S. Treasury Resident Advisor program	*To support the development of the government bond market, the BTr upgraded its internal operations to reduce costs, enhance risk management, and strengthen relationships with investors and stakeholders. Accomplishments included:* 7. **The BTr reorganized and established: Risk Management Division; Fund Management Division; Capital Market Strategy and Planning Division; and Debt Strategy and Planning Division.** 8. The BTr awarded a contract to modernize its core operations, and to improve data availability.	*The BTr continues to upgrade its internal operations to further reduce costs, enhance risk management and strengthen relationships with investors and stakeholders.* 7. **The BTr institutionalizes middle office risk management, and establishes performance management, and exception reporting.** 8. The BTr completes installation of the new treasury management system. 9. **The BTr prepares to modernize the registry of scriptless securities (ROSS).**	*The BTr fully upgrades infrastructure and capacity, achieving operational and fiscal efficiencies.* Medium-term Results: • Stronger risk management with enhanced public disclosures regarding treasury operations. Longer-term Results: • Administration of the wholesale government bond market returned to the BTr.

Outputs	Subprogram 1 Accomplishments (Policy triggers in bold) June 2013 to June 2015	Subprogram 2 (Policy triggers In bold) July 2015 to June 2017	Medium-term directions and expected results 2013 to 2021
○ JICA TA, Capacity Building for Capital Market Initiatives		10. BTr identifies capacity development needs utilizing training and diagnostics.	
Output 2 –Long Term Savings and Long Term Investment Products Encouraged.			
2.1 Enabling regulatory environment provided. ○ ADB TA, Capacity Development of Financial Regulators (TA8038) ○ ADB TA, Capacity Development to Support Regulation and Oversight at the Insurance Commission (TA8608) ○ ADB TA, Strengthening Treasury Operations and Capital Market Reform(TA8718)	*The government has implemented legal and regulatory measures to foster the development of long-term savings and investments. Accomplishments included:* 9. **The revised Insurance Code became effective in September 2013, which encourages long-term savings by expanding the types of allowable investments (e.g. project bonds), investment strategies (e.g. prudent man), and delivery channels (e.g. banc-assurance).** 10. **The government further encouraged long-term savings by installing the physical infrastructure to support the launch of tax-deferred personal retirement accounts (PERA).** 11. The Securities and Exchange Commission (SEC), in conjunction with the Philippine Stock Exchange (PSE), encouraged professional management of collective investments by launching Exchange	*The government will continue to encourage the development of long-term savings and investment.* 11. The Insurance Commission (IC) creates an Investment Advisory Council to explore unique investment schemes and encourages insurance companies to channel funds to public-private partnership projects. 12. **The government launches PERA.** 13. The SEC, in conjunction with PSE, issues regulatory standards to govern market-making activities for ETFs to improve liquidity.	*The contractual savings sector demonstrates intermediation of long-term savings.* Medium-term Results: • Outstanding corporate debt increases to 8% of GDP and the SEC authorizes a public issuance of a project bond. • Additional Exchange Traded Funds introduced including at least one fixed income ETF. • Implementation of PERA generates at least 100,000 retirement accounts. Longer-term Results: • The SEC supports the passage of the

Outputs	Subprogram 1 Accomplishments (Policy triggers in bold) June 2013 to June 2015	Subprogram 2 (Policy triggers In bold) July 2015 to June 2017	Medium-term directions and expected results 2013 to 2021
	Traded Funds (ETFs).	14. The SEC authorizes unregistered bonds utilizing Section 144A of the United States' Securities Act of 1933 as a guide.	"Collective Investment Schemes Law".
2.2 Costs of financial transactions reduced. o ADB TA, Capacity Development of Financial Regulators (TA8038) o ADB TA, Capacity Development to Support Regulation and Oversight at the Insurance Commission (TA8608) o ADB TA, Strengthening Treasury Operations and Capital Market Reform(TA8718) o U.S. Treasury Resident Advisor program o JICA TA Capacity Support Study for the Introduction of XBRL in the Securities Exchange Commission (SEC) in the Philippines	*The government encouraged capital market development by reducing transaction costs. Accomplishments included:* 12. **A bill is tabled in Congress which replaces the Value-added Tax (VAT) of 12.00% with a Premium Tax (PT) of 2.00%, and changes the Documentary Stamp Tax (DST) from 12.50% to a graduated scale rates from Php 10.00 to P100.00 (effectively less than 1%) depending on the sum insured.** 13. **The government exempts DST of 1 Peso for every 200 pesos of face value on GMRA based repos to encourage growth in the market.** 14. SEC reduced regulatory costs by processing 70% of the total initial applications for the certificates of business registration in one day	*The government continues to rationalize and reduce transaction costs.* 15. The government, through the Capital Market Development Tax Group, establishes an interagency MOU and begins to promote neutrality in capital market taxation. 16. The SEC adopts XBRL based electronic submission of financial statements and other corporate disclosures. 17. **SEC submits the revised Corporation Code to Congress, and explores the potential to abolish the preferential broker**	The government achieves measurable results in easing business and capital market constraints. Medium-term Results: • The SEC issues regulations to implement the revised Corporation Code and continues to streamline business licensing. Longer-term Results: • The SEC supports enactment of the revised Securities Regulation Code • The government issues a master plan to achieve tax neutrality in the financial markets.

Outputs	Subprogram 1 Accomplishments (Policy triggers in bold) June 2013 to June 2015	Subprogram 2 (Policy triggers In bold) July 2015 to June 2017	Medium-term directions and expected results 2013 to 2021
	through the green lane.	**allocation.**	
Output 3 – *Market depth and diversity increased.*			
3.1 Barriers to entry eased. ○ ADB TA, Capacity Development of Financial Regulators (TA8038) ○ ADB TA, Promoting an interlinked ASEAN Capital Market (TA7576)	*Under the ASEAN Community Blueprint, the government reduced barriers to encourage diversified business models and cross-border investment flows. Accomplishments included:* 15. **The government allows foreign control of financial institutions in all sub-sectors which increases competition, capacity, and the diversity of market participants.** 16. The government (through the SEC) submits an application, and addresses requests for clarifications to join the International Organization of Securities Commission's (IOSCO) Annex A. 17. The SEC issued Guidelines on the Accreditation, Operations and Reporting of Credit Rating Agencies to increase transparency and improve the integrity of credit ratings.	*The government continues to encourage diversified business models and cross-border investment flows.* 18. The government encourages consolidation of the insurance sector through increased capitalization and the introduction of risk based capital standards. 19. The government is approved as a signatory to IOSCO's Annex A and begins to participate more fully in ASEAN Capital Market Forum initiatives covering collective investment schemes and cross-border public offerings of debt and equity.	*The government achieves substantial progress in meeting the financial sector related goals of the ASEAN Community Blueprint.* Medium-term Results: • The government approves entry of at least 1 foreign, ASEAN domiciled financial institution. Longer-term Results: • The government receives increased investment flows through the ASEAN via collective investment schemes and cross-border public offerings of debt and equity.

Outputs	Subprogram 1 Accomplishments (Policy triggers in bold) June 2013 to June 2015	Subprogram 2 (Policy triggers In bold) July 2015 to June 2017	Medium-term directions and expected results 2013 to 2021
3.2 Corporate governance strengthened.	*The government strengthened corporate governance to increase investor confidence thereby attracting a wider and more diversified group of investors.*	*The government continues to strengthen corporate governance to increase investor confidence thereby attracting a wider and more diversified group of investors.*	*The government achieves measurable success in strengthening investor confidence.*
	18. The SEC: (i) creates Corporate Governance & Finance Department; (ii) issues Template for Publically-Listed Companies' Websites; and (iii) issues Guidelines mandating all listed companies to submit Annual Corporate Governance Reports.	20. **The SEC strengthens corporate governance standards by promulgating a new Code of Corporate Governance and, in conjunction with the PSE, issues a corporate governance road map.**	Medium-term Results: • Philippines achieves parity with regional peers as measured through the ASEAN corporate governance scorecard.
○ ADB TA, Promoting an interlinked ASEAN Capital Market (TA7576)	19. The SEC through the Institute of Corporate Directors (ICD) completed the ASEAN corporate governance scorecard assessment for 2013-2014, which provides a benchmark of performance and incentivizes ASEAN member states to collectively strengthen corporate governance.	21. The SEC through the ICD completes the ASEAN corporate governance scorecard assessment for 2014-2015.	Longer-term Results: • Quality of capital market supervision improves as measured by independent evaluations.
	20. The SEC introduced an automated market surveillance system for the equities market and begins to strengthen surveillance of the fixed income market.	22. The SEC establishes surveillance of the fixed income market.	