ADB

Concept Paper

Project Number: 48427-001
May 2015

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

Asian Development Bank

CURRENCY EQUIVALENTS
(as of 5 May 2015)

Currency unit	–	peso/s (P)
P1.00	=	$0.022
$1.00	=	P44.63

ABBREVIATIONS

ACMF	–	ASEAN Capital Markets Forum
ADB	–	Asian Development Bank
ASEAN	–	Association of Southeast Asian Nations
BSP	–	*Bangko Sentral ng Pilipinas*
BTr	–	Bureau of the Treasury
GDP	–	gross domestic product
IMF	–	International Monetary Fund
PERA	–	Personal Equity Retirement Account
PPP	–	public–private partnership
SEC	–	Securities and Exchange Commission
SCFP	–	Social Contract with the Filipino People

GLOSSARY

Association of Southeast Asian Nations	–	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; protection of regional peace and stability; and 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.
primary dealers	–	A set of pre-approved 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 and are expected to assist the government is ascertaining the state of local and global securities markets.
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.

NOTES

(i) The fiscal year of the Government of the Philippines ends on 31 December.

(ii) In this report, "$" refers to US dollars.

Vice-President	S. Groff, Operations 2
Director General	J. Nugent, Southeast Asia Department (SERD)
Director	K. Bird, Public Management, Financial Sector and Trade Division, SERD
Team leader	S. Schuster, Senior Financial Sector Specialist, SERD
Team members	S. Ismail, Financial Sector Specialist, SERD
	J. Mendez-Santos, Associate Project Analyst, SERD
	M. Parra, Operations Assistant, SERD
	A. Qadir, Senior Counsel, Office of the General Counsel
	S. Shrestha, Principal Country Economist. Philippines Country Office, SERD
	M. Varkay, Principal Private Sector Development Specialist, SERD
Peer reviewers	G. G. Giannetto, Senior Financial Sector Specialist, East Asia Department (EARD)
	S. M. Lee, Financial Sector Specialist, EARD

CONTENTS

PROGRAM AT A GLANCE

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

Project Name	Encouraging Investment Through Capital Market Reforms Program	**Department /Division**	SERD/SEPF
Country	Philippines	**Executing Agency**	Department of Finance
Borrower	Government of the Philippines		

2. 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	**Subcomponents**	**Climate Change Information**	
Inclusive economic growth (IEG)	Pillar 1: Economic opportunities, including jobs, created and expanded	Climate Change impact on the Project	Low
Regional integration (RCI)	Pillar 2: Trade and investment Pillar 3: Money and finance		

4. Drivers of Change	**Components**	**Gender Equity and Mainstreaming**	
Governance and capacity development (GCD)	Institutional development Organizational development Public financial governance	No gender elements (NGE)	✓
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		

5. Poverty Targeting		**Location Impact**	
Project directly targets poverty	No	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	**100.00**
Japan International Cooperation Agency	100.00
Counterpart	**0.00**
None	0.00
Total	**400.00**

9. Effective Development Cooperation

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

Source: Asian Development Bank

II. THE PROGRAM

A. Rationale

1. The economy of the Philippines will require increased investment to achieve the goals of the Philippine Development Plan, 2011–2016.[1] Infrastructure bottlenecks, limited budget space relative to projected infrastructure needs, and the inability of the finance sector to compensate with sufficient amounts of long-term financing have been identified as key constraints.[2] To tackle these challenges, the government is implementing several measures to increase investment in infrastructure. The proposed Encouraging Investment through Capital Market Reforms Program is part of coordinated support from the Asian Development Bank (ADB) to the Philippines designed to support these measures. The program will supplant ongoing efforts to strengthen the implementation of public–private partnerships (PPPs) by increasing the availability of long-term private 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.[3] The design and monitoring framework is in Appendix 1. The problem tree is in Appendix 2. The program is included in ADB's country operations business plan, 2015–2017.

2. **Robust reforms have produced sustained economic gains.** From 2010 to 2014, the economy of the Philippines enjoyed its fastest expansion since the 1970s with economic growth averaging 6.5% per annum. This growth has been supported by sound macroeconomic performance, including a large balance of payments surplus, and was recently rewarded with a sovereign credit investment grade rating.[4] The development of the capital market has likewise been positive. Regulatory oversight has been enhanced, the size of the nonbank finance sector has been increased, and participation levels have grown. Despite a recent slowdown in local currency bond markets throughout emerging East Asia, the Philippines still registered respectable year-on-year growth of 6.7% through the third quarter of 2014. Stock market capitalization now exceeds 100% of gross domestic product (GDP) (2013) and the total value of stock traded has effectively doubled to P2.5 trillion from P1.2 trillion in 2010. Insurance density has doubled to P1,592 per capita in 2012 from P859 per capita in 2008.

3. **Challenges to funding programmed infrastructure investment.** Against this backdrop, the government has targeted public infrastructure spending at 5.0% of GDP with private infrastructure spending exceeding 1.0% of GDP, all by 2016. Given the size of these needs relative to current budget deficits[5], improving the administration of PPPs and mobilizing private long-term financing is critical to achieving these targets. The capital markets should provide a viable and well-suited alternative to banks when financing long-term investment. However, the Philippines' local currency debt market currently represents only 39% of GDP. Many of its more advanced regional peers have local currency debt markets that exceed 70% of GDP, and their local currency corporate debt markets are 3–8 times the size of the Philippine market. The government bond market is the foundation on which wider capital market development is built, yet exhibits liquidity far below what would be expected in a country with an

[1] Government of the Philippines. 2014. *Philippine Development Plan, 2011–2016.* Manila. The plan calls for inclusive growth, targeting real GDP growth averaging 7%–8% per year, through investment in infrastructure with investment ratios (including infrastructure) reaching 22% of GDP in real terms by 2016.
[2] The Global Competitiveness Report 2013–2014 has identified the inadequate supply of infrastructure as the most problematic factor in doing business in the Philippines.
[3] ADB. 2014. *Country Operations Business Plan: Philippines, 2015–2017*. Manila.
[4] Public debt as a share of GDP is now below 50.0%, down from 70.0% in 2005.
[5] While improved, the budget deficit has averaged 2.0% of GDP since 2010.

investment grade rating. For example, the average bid–ask spreads for government securities, a fundamental measure of liquidity, are higher in the Philippine market than in all regional peers except for Viet Nam and Indonesia. This is caused by too many auction participants spreading trading activity over a usually large number of government bond issues, utilizing a high cost infrastructure. As a result, price discovery is limited and market participants lack a reliable benchmark yield curve which can be used to price private sector debt. On the demand side, the contractual savings sector still emphasizes sales of endowment products and thus has a need to purchase long-tenor capital market products. However, insurance premiums represent only 1.5% of GDP, well below that of more developed markets. Growth has been restrained by legal, regulatory, and tax issues. Restrictions on foreign ownership of domestic financial institutions coupled with lagging compliance with international standards have isolated the Philippines and led to the development of a small, one-way market, practicing “buy and hold” strategies.

4. **The reform agenda.** The government needs to encourage higher levels of trading in the government bond market to support the development of reliable reference interest rates.[6] The Bureau of the Treasury (BTr) must strengthen cash-flow forecasting and management systems to align auctions with funding needs, including the issuance of short-term treasury revenue anticipation notes. A smaller number of auction participants must competitively purchase a smaller number of government bond issues, aided by hedging instruments, which are then resold to secondary market participants to force higher transaction volumes. The volume of secondary market participants must also be increased by allowing market segments (e.g. taxable and tax-exempt) to trade with each other. Domestic savers must be encouraged to become domestic investors. A more accommodating regulatory framework must be provided, long-term savings vehicles must be encouraged, costs and administrative burdens reduced and financial literacy concurrently strengthened to influence individual investor behavior. Finally, barriers to entry must be eased to encourage foreign financial institutions to enter the Philippines to supplement the domestic savings pool and to introduce varied business models and required skill sets such as originating and distributing infrastructure loans.

5. **Program design.** ADB has supported capital market development since 2010 as guided by the Philippines Capital Market Blueprint, 2011–2016. Specific initiatives include (i) support to strengthen BTr and the government debt market,[7] (ii) efforts to increase and broaden the investor base,[8] and (iii) promotion of regional integration.[9] The program builds on these initiatives and is part of ADB’s coordinated policy-based support to help overcome major developmental hurdles. The proposed Expanding Private Participation in Infrastructure Program will strengthen the government’s ability to identify and implement a pipeline of “bankable” PPP projects. The program recognizes that finance sector development is hierarchically ordered and utilizes a programmatic approach to implement sequenced reforms to increase access to long-term finance, complementing the medium-term PPP reform agenda (Appendix 4).

B. Impact, Outcome, and Outputs

6. 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

[6] A recent collaborative effort by the International Monetary Fund, ADB, the World Bank, and the United States Treasury provided a diagnostic which has been used to set the reform agenda.

[7] ADB 2014. *Technical Assistance to the Republic of the Philippines for Strengthening Treasury Operations and Capital Market Reform*. Manila.

[8] ADB. 2010. *Technical Assistance to the Republic of the Philippines for Capacity Development to Support Regulation and Oversight at the Insurance Commission*. Manila.

[9] ADB. 2010. *Technical Assistance to the Republic of the Philippines for Promoting an Interlinked ASEAN Capital Market*. Manila.

targeted investment rate, including public and private spending on infrastructure. 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.

7. **Output 1: Liquidity in the Government bond market enhanced.** In subprogram 1, the government will implement fundamental reforms to lay the groundwork for increased trading volumes and liquidity in the government debt market. BTr will improve cash flow forecasts by consolidating cash into a single account. This will enable the issuance of short-term money market treasury notes, and lower costs of issuance overall. Outstanding bond issues will be selectively consolidated, hedging instruments introduced, and trading between taxable and tax-exempt segments enabled leading to an increase in trading volumes around key bond tenors. BTr's technical and operational capacity will also be strengthened. In subprogram 2, the government will build on these reforms to transform higher trading volumes into a risk-free government yield curve. The number of auction participants will be reduced and a primary dealer system will be launched, further increasing secondary trading volumes. Cash-flow forecasting will be further enhanced, and hedging mechanisms will be institutionalized, allowing the development of two-way markets.

8. **Output 2: Long-term savings and investments encouraged.** In subprogram 1, the government will implement measures to encourage more domestic participation in the finance sector, with an emphasis on contractual savings. Legal and regulatory changes will authorize a wider diversity of investments and increase the range of investment strategies. A tax-deferred long-term retirement savings platform—Personal Equity and Retirement Account (PERA)—will be introduced. The government will also selectively reduce the cost of key financial transactions such as repurchase agreements. In subprogram 2, the government will continue to operationalize these reforms through the regulatory framework and will launch products (e.g., PERA and fixed-income exchange-traded funds) that are designed to encourage long-term savings and investment. Efforts to reduce the financial costs of capital market transactions will continue.

9. **Output 3: Market depth and diversity increased.** In subprogram 1, the government will introduce reforms to encourage greater investment from a more diversified group of investors. Under the ASEAN Economic Blueprint, the government will reduce barriers to entry by allowing foreign participation in all financial market subsectors. An application for admittance to the International Organization of Securities Commissions' Annex A will position the government for deeper participation in ASEAN cross-border investment initiatives while corporate governance of publically listed companies is concurrently strengthened. In subprogram 2, compliance with the International Organization of Securities Commissions' principles will enable direct participation in ASEAN cross-border investment initiatives, buttressed by a corporate governance blueprint.

C. Program Costs and Financing

10. Subprograms 1 and 2 are envisaged as single-tranche policy-based loans reflecting the development financing needs and indicative costs of reforms. The government's financing needs for 2015 are budgeted at $6.5 billion, of which programmed official external borrowing amounts to $2.2 billion. The government has requested a loan of $300 million from ADB's ordinary capital resources to help finance subprogram 1. The Government of Japan, through the Japan International Cooperation Agency, is considering cofinancing the program.

D. Indicative Implementation Arrangements

11. The Department of Finance will be the executing agency. The BTr and the Securities and Exchange Commission (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.[10] The implementation period is January 2013–June 2015 for subprogram 1, and July 2015–June 2017 for subprogram 2.

III. DUE DILIGENCE REQUIRED

12. The sector assessment will be supplemented by an assessment of risks to reforms arising from the political economy and a public financial management assessment describing risks as well as the government's medium-term expenditure framework. A program impact assessment will be completed and will describe the link between the program's reforms and benefits arising from finance sector development, as well as a description of the costs of the reforms. The initial poverty and social analysis is in Appendix 3. The program is expected to be classified as category C for all safeguard aspects. Program design has benefited from the explicit commitment of the government, and incorporates knowledge gained from sustained ADB and development partner policy dialogue. The program also incorporates the lessons from a recently published program completion report.[11]

IV. PROCESSING PLAN

A. Risk Categorization

13. The program is considered complex due to its loan size.

B. Resource Requirements

14. The aggregate estimated internal resource requirements are: mission leader, 8 months; finance sector economist, 3 months; principle country economist, 3 months; legal counsel, 6 weeks; national officers and analysts, 2 months; and operations assistant, 5 months.

C. Processing Schedule

Proposed Processing Schedule

Milestones	Expected Completion Date
Loan fact-finding mission	May 2015
Management review meeting	June 2015
Loan negotiations	July 2015
Board circulation of RRP	September 2015
Board consideration	September 2015

RRP = report and recommendation of the President.
Source: Asian Development Bank.

V. KEY ISSUES

15. Continuity of reforms through the election cycle in mid-2016 represents a specific risk. However, infrastructure, access to long-term finance, and integration with ASEAN will continue as priorities to overcome development constraints. ADB will coordinate closely with government agencies and private sector stakeholders to further mitigate this risk.

[10] The Insurance Commission and the *Bangko Sentral ng Pilipinas* (BSP) will be committee members reflecting ADB's ongoing technical assistance to each and the role of BSP in supporting financial inclusion and literacy.
[11] ADB. 2013. *Program Completion Report: Financial Market Regulation and Intermediation Program in the Philippines.* Manila.

DESIGN AND MONITORING FRAMEWORK

Impacts the program is aligned with. The government's targeted investment rate, including public and private spending on infrastructure met (The Philippines Development Plan, 2011–2016)[1].

Project Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting Mechanisms	Risks
Outcome A deeper nonbank finance sector	**Subprogram 1: by 2016** PERA system completed and opened to public participation. (2012 baseline: not applicable) At least one wholly-owned foreign financial institution establishes domestic operations in the Philippines. (2012 baseline: 0) **Subprogram 2: by 2018** Corporate bonds increase to at least 8.0% of GDP, and at least one domestic currency project bond is issued. (2012 baseline: 4.9% and 0) Annual trading volume of Government bonds increases by at least 25%. (2012 baseline = $156 billion) 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	Regulator websites, consultant reports and news releases Press releases and regulatory websites AsianBondsOnline and public news releases AsianBondsOnline and public news releases FSF reports BSP website	Global fiscal 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	**Subprogram 1: by 2015** Cash forecasting improved as the number of BTr cash accounts is reduced to less than 100. (2012 baseline: 400) At least one trade of government securities between a tax and tax-exempt counterparty.[2] (2012 baseline: not applicable)	BTr internal reports BTr internal reports Press releases	Technical capacity of regulators is insufficient to support the reform agenda. Budget is inadequate to fund capital market infrastructure upgrades and regulatory action plans.

	Capacity of BTr strengthened with at least 40 staff trained in advanced bond math and trading strategies. (2012 baseline: 0) **Subprogram 2: by 2017** Primary dealer system established with formal privileges and responsibilities. (2012 baseline: not applicable) The number of government bond issues declines to 90. (2012 baseline: 106) Hedging mechanisms enabled with the number of repurchase transactions, based on the GMRA, increasing to at least 100 per year. (2012 baseline: 0)	Certification and test results from certified financial analysts' society BTr website Consultant reports BTr internal reports BTr internal reports Bloomberg	The government is unable to meet the prerequisites to ASEAN integration. Market development efforts outstrip financial inclusion and education programs.
2. Long-term savings and investments encouraged	**Subprogram 1: by 2015** Inter-regulatory training provided to at least 30 staff to support launch of PERA. (2012 baseline: 0) Cost of financial transactions reduced by a formal inter-agency memorandum of understanding reducing the documentary stamp tax on GMRA-based repos to zero. (2012 baseline: P0.30 for every P200.00, equivalent to the rate of 0.15%) **Subprogram 2: by 2017** Number of professionally managed ETF's listed on the PSE increases to 3, and at least one is a fixed-income (including project bonds) ETF. (2012 baseline: 1 and 0) At least 5 PERA administrators approved to support investment management through PERA. (2012 baseline: 0) Insurance commissioner implements the revised insurance code by streamlining investment approvals and introducing a risk-based capital regime. (2012 baseline: not applicable)	Consultant reports BTr website PSE website and annual report FSF reports and consultant reports 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. (2012 baseline: not applicable) At least one application received supporting the entry of a foreign financial institution into the Philippines. (2012 baseline: not applicable) **By 2017** The government signs and participates in at least one ACMF cross-border initiative. (2012 baseline: none) Philippines places at least 3 publicly listed companies in the top 50 ASEAN Corporate Governance Scorecard rankings. (2012 baseline: 0) Philippines joins IOSCO's Annex A as a signatory. (2012 baseline: not applicable)	SEC internal reports Press releases and regulatory websites Published news reports, SEC website, and ACMF website ACMF website IOSCO website SEC website	
Key Activities with Milestones: Not applicable.			
Inputs **Asian Development Bank: $300,000,000**			
Assumptions for Partner Financing: not applicable			

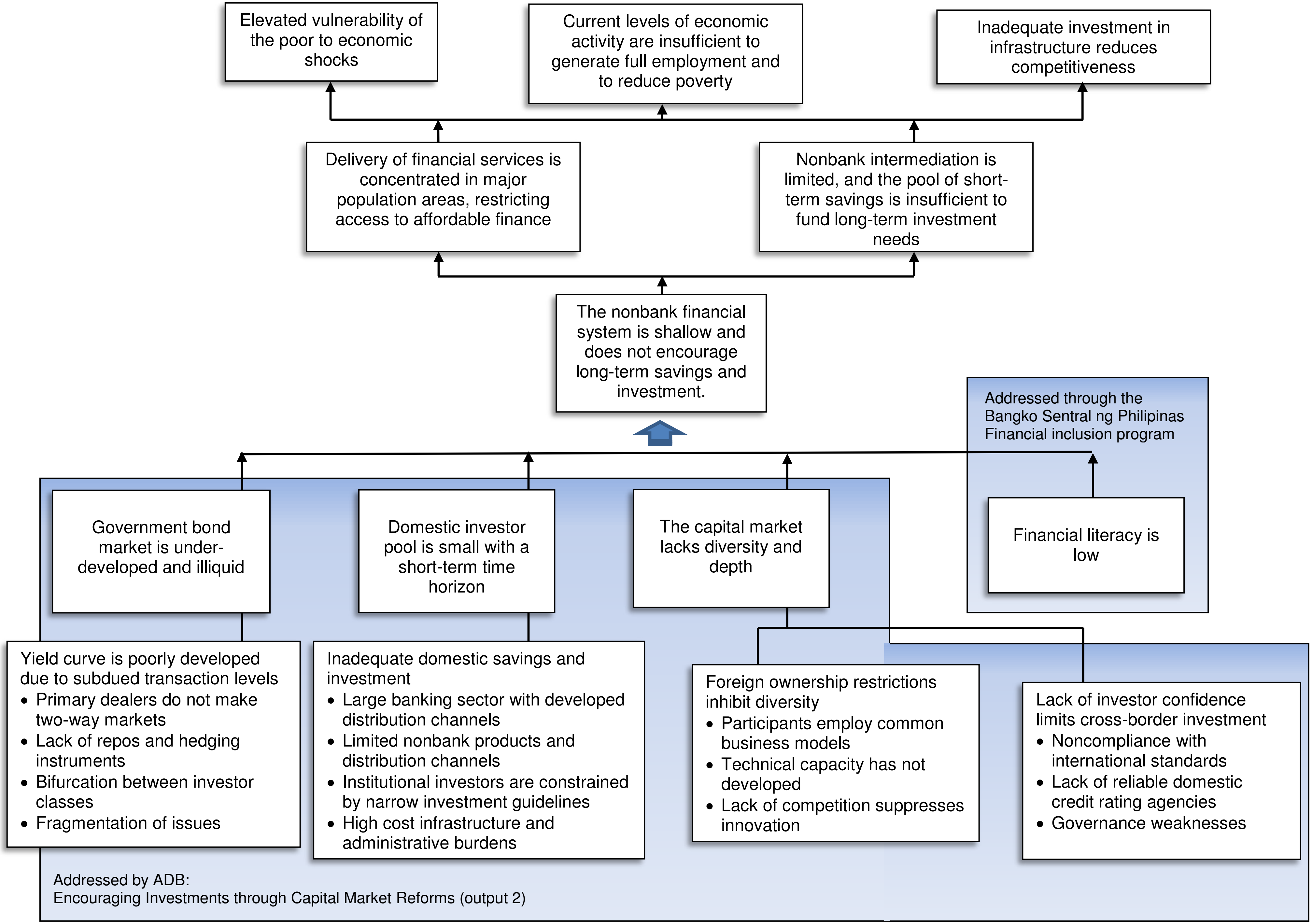
ACMF = ASEAN Capital Markets Forum, ASEAN = Association of Southeast Asian Nations, BSP = Bangko Sentral ng Pilipinas, BTr = Bureau of the Treasury, ETF = exchange traded fund, FSF = Financial Sector forum, GDP = gross domestic product, GMRA = Global Master Repurchase Agreement, IOSCO = International Organization of Securities Commissions, PERA = Personal Equity and Retirement Account, PSE = Philippine Stock Exchange, SEC = Securities and Exchange Commission.

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

[2] 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 due to the tax-exempt status of pension funds.

Source: Asian Development Bank.

PROBLEM TREE



Source: Asian Development Bank.

INITIAL POVERTY AND SOCIAL ANALYSIS

Country:	Philippines	Program Title:	Encouraging Investment through Capital Market Reforms Program
Lending/Financing Modality:	Policy-based loan	Department/ Division:	Southeast Asia Department/ Public Management, Financial Sector and Trade Division

I. POVERTY IMPACT AND SOCIAL DIMENSIONS

A. Links to the National Poverty Reduction Strategy and Country Partnership Strategy

Reducing poverty and eliminating the vulnerabilities of large sections of the population remain one of the government's principal challenges. In the late 1980s, poverty rates in the Philippines were about half the levels seen in other Southeast Asian countries. Since then, progress on poverty reduction has been achieved, but at a slower rate than in other countries, resulting in an estimated poverty rate (headcount index) of 26.5% in 2009 (up from 24.9% in 2003), while 45% of the population is vulnerable to falling into poverty.

Sustaining high economic growth is the government's overarching strategy to achieve inclusive growth and thereby reduce poverty. To support this initiative, the Philippine Development Plan, 2011–2016 translates the Social Contract with the Filipino People (SCFP) into three broad strategies.[a] These strategies are (i) attaining high, sustained economic growth through a stable macroeconomic environment, rapid growth of industry, investments in infrastructure, and curbing corruption and enforcing the rule of law; (ii) providing equal access to development opportunities by investing in human capital, especially in education, health, and other basic social services; and by ensuring equal treatment through better access to infrastructure, credit, land, technology, and other productive inputs; and (iii) formulating effective social safety nets to ensure both the protection and the promotion of extremely vulnerable groups.

The country partnership strategy (CPS), 2011–2016 of the Asian Development Bank (ADB) for the Philippines is based on the intersection of the Philippine Development Plan priorities with Strategy 2020, consistent with the needs of a lower middle-income country.[b] To support the government's objective of high, inclusive, and sustainable growth, ADB will focus on three core operational areas: infrastructure, environment, and education. To increase investments in infrastructure, ADB will implement a coordinated program to increase employment, and in turn government tax revenues, and to strengthen the government's capacity to utilize the public–private partnership modality. At the same time, efforts are needed to ensure that the private sector has a ready supply of long-term savings that can be deployed to finance infrastructure development. The Encouraging Investment through Capital Market Reforms Program (EICMR) will remove key development constraints beginning with initiatives to improve efficiencies in the government bond market. This market serves as the foundation of all capital market development by providing transparency, pricing benchmarks, and market standards.[c] The program will then build on existing ADB capital market development programs to increase the domestic investor base and encourage a greater diversity of market participants with the intent of transforming savers into investors, thereby increasing intermediation in the contractual savings sector.[d]

B. Poverty Targeting:

General Intervention ☒Individual or Household (TI-H) ☐Geographic (TI-G) ☐Non-Income MDGs (TI-M1, M2, etc.)

The overall design of EICMR is pro-poor. The program provides direct support to the government's efforts to achieve the goals set out under the SCFP by encouraging the nonbank finance sector to support infrastructure development through the provision of long-term peso-denominated financing. The program also provides indirect support by increasing the efficiency of the government debt market and freeing up fiscal resources to support increased expenditures on education, health, and other basic social services. Overall, finance sector development has been found to provide direct benefits to the poor. An International Monetary Fund working paper estimated the quantitative impact of finance sector development on poverty in 65 developing countries and found that it directly reduces poverty by raising the investment and interest incomes of the poorest 20% of the population.[e] Further, instability in the finance sector directly reduces the incomes of the poor, thereby raising poverty. Therefore, finance sector reforms that aim to mitigate risks of finance sector instability help reduce the vulnerability of the poor or the likelihood that the near poor will fall into poverty as a result of finance sector crises.

C. Poverty and Social Analysis

1. **Key issues and potential beneficiaries**. Poorly managed and inefficient execution of the government's borrowing strategy compromises its ability to deliver on its SCFP. Reduced expenditures on human capital (e.g., health,

education, and social services) disproportionately affect the poor through diminished productivity, as they do not have alternative income to compensate. Inadequate spending on infrastructure diminishes competitiveness overall, but likewise has a disproportionate impact on the poor because low-income regions lack the connectivity to participate in wealthier urban markets. Finally, an inability to access affordable insurance increases the vulnerability of the poor and near-poor.

2. **Impact channels and expected systemic changes**. By reducing the cost of issuance and the negative carry on the bond sinking fund, among others, EICMR will free up significant scarce resources that could be redirected to support implementation of the government's SCFP. Increasing expenditures on human capital and infrastructure can also ensure equal opportunities, thereby achieving more equal economic growth and a corresponding reduction in poverty.

3. **Focus of (and resources allocated in) program preparatory technical assistance or due diligence**. Not applicable. EICMR targets development constraints identified through the work of other development partners as well as past and ongoing ADB engagements.

4. **Specific analysis for policy-based lending**. The EICMR has a high-level impact, leading to finance sector development, which increases economic growth and incomes.[f] However, the impact from these reforms will only be felt over the medium (4–10 years) to long term. In the short term, reforms to strengthen public financial management and to increase the efficiency of BTr's operations will provide more immediate benefits through increased spending on human capital, especially in education, health, and other basic social services (1–3 years).

II. GENDER AND DEVELOPMENT

1. What are the key gender issues in the sector/subsector that are likely to be relevant to this project or program? – Not applicable. The program does not incorporate any gender specific elements.

2. Does the program have the potential to make a contribution to the promotion of gender equity and/or empowerment of women by providing women's access to and use of opportunities, services, resources, assets, and participation in decision making?
☐ Yes ☒ No EICMR will increase fiscal space and lead to greater expenditures on human capital, especially in education, health, and other basic social services. Intuitively, it is reasonable to assume that these expenditures will accrue more to women. However, the program does not seek to directly influence the funding decisions proposed and authorized by the government.

3. Could the program have an adverse impact on women and/or girls or widen gender inequality?
☐ Yes ☒ No EICMR supports high-level finance sector development, including reforms to increase the flow of long-term finance to fund infrastructure development. These reforms are unlikely to widen gender inequality or to have a negative impact on women.

4. Indicate the intended gender mainstreaming category:
☐ GEN (gender equity) ☐ EGM (effective gender mainstreaming)
☐ SGE (some gender elements) ☒ NGE (no gender elements)

III. PARTICIPATION AND EMPOWERMENT

1. Who are the main stakeholders of the program, including beneficiaries and negatively affected people? Identify how they will participate in the program design. – Key immediate stakeholders include the government, through BTr, the direct participants in BTr's debt issuance and cash management programs, and the recipients of the government's social programs. On a wider basis, the Philippines will benefit from the resultant increase in infrastructure development. Participation was facilitated through missions and policy dialogue with the government, donor partners, and the private sector. The ability of the industry to provide long-term financing to infrastructure will enable an expanded sale of whole-life products through an expended bancassurance framework, which also provide a buffer for income loss associated with the death of a principal wage earner.

2. How can the program contribute (in a systemic way) to engaging and empowering stakeholders and beneficiaries, particularly the poor, vulnerable, and excluded groups? What issues in the program design require participation of the poor and excluded? – Reforms are currently high-level and focused on providing an enabling environment that is consistent with international sound practice. Nevertheless, ADB will continue its policy dialogue with the government to ensure that related initiatives consider access to finance, and will consider outreach to civil society should the need arise.

3. What are the key, active, and relevant civil society organizations in the project area? What is the level of civil society organization participation in the project design? – Not applicable.
☐ Information generation and sharing ☐ Consultation ☐ Collaboration ☐ Partnership

4. Are there issues during program design for which participation of the poor and excluded is important? What are they and how shall they be addressed? ☐ Yes ☒ No Given EICMR's high-level focus, and initial emphasis

on the development of an enabling environment, direct participation by the poor is considered premature.

IV. SOCIAL SAFEGUARDS

A. Involuntary Resettlement Category ☐ A ☐ B ☒ C ☐ FI

1. Does the program have the potential to involve involuntary land acquisition resulting in physical and economic displacement? ☐ Yes ☒ No The program supports high-level finance sector development and will not involve any land acquisition and will not generate any resettlement issues.
2. What action plan is required to address involuntary resettlement as part of project preparatory technical assistance (PPTA) or due diligence process? – Not applicable.
   ☐ Resettlement plan ☐ Resettlement framework ☐ Social impact matrix
   ☐ Environmental and social management system arrangement ☒ None

B. Indigenous Peoples Category ☐ A ☐ B ☒ C ☐ FI

1. Does the program have the potential to directly or indirectly affect the dignity, human rights, livelihood systems, or culture of indigenous peoples? ☐ Yes ☒ No
2. Does it affect the territories or natural and cultural resources indigenous peoples own, use, occupy, or claim, as their ancestral domain? ☐ Yes ☒ No The program supports high-level finance sector development and will not affect, directly or indirectly, the territories or natural and cultural resources that indigenous peoples own, use, occupy, or claim as their ancestral domain.
3. Will the program require broad community support of affected indigenous communities? ☐ Yes ☒ – Not applicable.
4. What action plan is required to address risks to indigenous peoples as part of the PPTA or due diligence process?
   ☐ Indigenous peoples plan ☐ Indigenous peoples planning framework ☐ Social Impact matrix
   ☐ Environmental and social management system arrangement ☒ None

V. OTHER SOCIAL ISSUES AND RISKS

1. What other social issues and risks should be considered in the program design? – None.

☐ Creating decent jobs and employment ☐ Adhering to core labor standards ☐ Labor retrenchment
☐ Spread of communicable diseases, including HIV/AIDS ☐ Increase in human trafficking ☐ Affordability
☐ Increase in unplanned migration ☐ Increase in vulnerability to natural disasters ☐ Creating political instability
☐ Creating internal social conflicts ☐ Others, please specify __________________

2. How are these additional social issues and risks going to be addressed in the program design? – Not applicable.

VI. PPTA OR DUE DILIGENCE RESOURCE REQUIREMENT

1. Do the terms of reference for PPTA (or other due diligence) contain key information needed to be gathered during the process to better analyze (i) poverty and social impact, (ii) gender impact, (iii) participation dimensions, (iv) social safeguards, and (v) other social risks. Are the relevant specialists identified?
   ☐ Yes ☒ No EICMR targets development constraints identified through the work of other development partners as well as past and ongoing ADB engagements.

2. What resources (e.g., consultants, survey budget, and workshop) are allocated for conducting poverty, social, and/or gender analysis, and participation plan during the PPTA or due diligence? – None. Not applicable.

[a] Government of the Philippines, National Economic and Development Authority. 2011. *Philippine Development Plan, 2011–2016.* Manila (publicly released on 27 May). http://www.neda.gov.ph/PDP/2011-2016/default.asp

[b] ADB. 2008. *Strategy 2020: The Long-Term Strategic Framework of the Asian Development Bank, 2008–2010*. Manila.

[c] As an ancillary benefit, these efficiencies will provide fiscal savings, which are potentially significant and can be redirected to support the SCFP's emphasis on human capital.

[d] ADB. 2010. *Report and Recommendation of the President to the Board of Directors: Proposed Loan for Subprogram 2 to the Republic of the Philippines for the Financial Market Regulation and Intermediation Program*, Manila; ADB. 2011. *Technical Assistance to the Republic of the Philippines for Capacity Development of Financial Regulators*. Manila; and ADB. 2013. *Technical Assistance to the Republic of the Philippines for Strengthening Treasury's Liquidity Management*. Manila.

[e] G. Jeannwney, S. Kpodar, and K. Kpodar. 2008. Financial Development and Poverty Reduction: Can there be a benefit without a cost? *IMF Working Paper # 62.* Washington, DC.

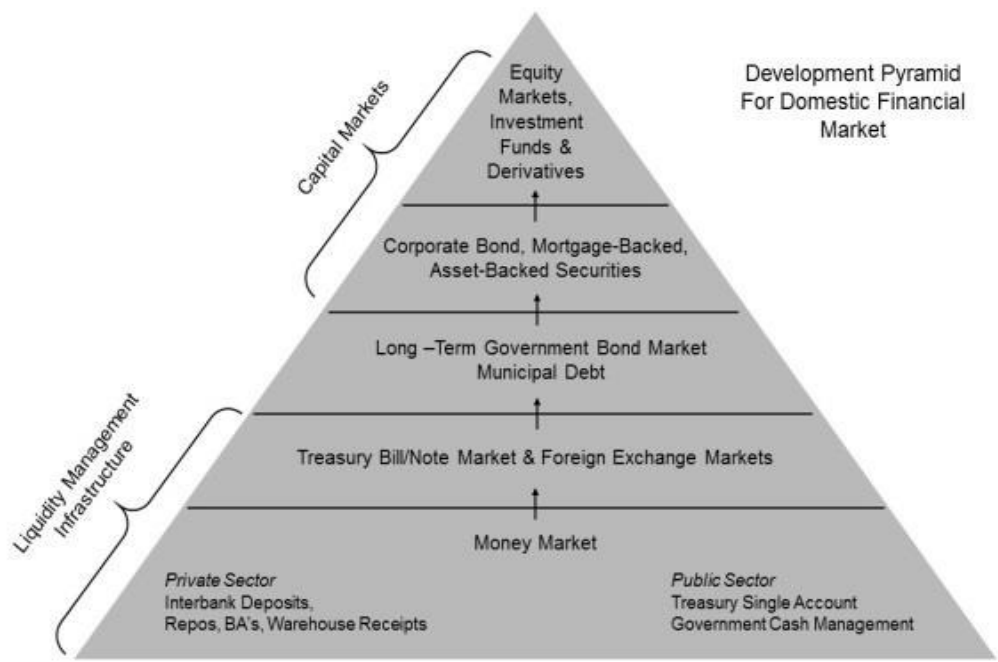
[f] R. Levine and S. Zervos. 1998. Stock Markets, Banks, and Economic Growth. *The American Economic Review*. Pittsburgh.

Source: Asian Development Bank.

SEQUENCED FINANCE SECTOR DEVELOPMENT, AND THE MEDIUM-TO-LONG TERM DEVELOPMENT FRAMEWORK FOR THE PHILIPPINES

1. **The need for sequencing.** An International Monetary Fund (IMF) working paper published in 2003 undertook a study of the reforms necessary to develop a domestic capital market.[12] The objective of the paper was to provide a framework for financial liberalization, focused on domestic financial market development, as opposed to well-discussed capital account issues.[13] In summary, the working paper established a position that financial markets are hierarchically ordered, as shown in the figure below. In effect, a well-functioning money market is the first step in market development and represents a necessary precondition to the development of a government bond market. The government bond market then serves as a necessary precondition to the development of a corporate debt market. In time, the corporate debt market, with the support of derivatives, provides additional channels of intermediation as more focused products such as securitizations, project finance, and structured products are introduced. Further, financial markets are highly interdependent, which means that development policies must be applied with appropriate sequencing to take advantage of their cumulative and interdependent nature.[14]

The Finance Sector Development Pyramid



[12] C. Karacadag, V. Sundararajan, and J. Elliot. 2003. Managing Risks in Financial Sector Development: The Role of Sequencing. *IMF Working Paper (WP/03/116)*. Washington, DC.

[13] Domestic capital markets are a fundamental pillar of a market-based economy and serve to intermediate savings, allocate risk, mitigate external financial shocks, and provide a catalyst for better governance. Moreover, the development of capital markets can alleviate the concentration and maturity mismatch risk that is inherent to bank lending, and can provide the matched tenor funding necessary to support long-term investments in infrastructure.

[14] The development of a government bond market depends on a liquid money market. Money markets also gain liquidity from a deep and active government bond market.

2. Money markets should be established first because they are the basic foundation of all capital and financial market development. Money markets provide central banks with the ability to assure a stable monetary and economic environment, which is necessary to develop financial markets, as well as fundamental price discovery and a tool for liquidity management. Repurchase agreements are an important instrument in developing the money market. They (i) provide a key tool for indirect monetary policy, (ii) support the development of credit and liquidity risk management skills, and (iii) enable securities dealers to create two-way markets.

3. Government bond markets contribute to and underpin capital market development in several ways and should be established next. A developed government bond market provides a market-determined term structure of interest rates along a variety of maturity points, forming a yield curve. This term structure, or yield curve, is an essential building block without which a corporate, derivative, and structured finance market could not develop.[15] To develop a robust government bond market, a government must be willing to finance its operations at market-determined interest rates, issue debt instruments with highly standardized terms and conditions, and utilize a small number of benchmark issues to encourage secondary trading.

4. Corporate bonds and equities represent the next stage of market development and provide additional channels of intermediation apt to diversify risk and reduce reliance on short-term bank lending. Corporate bonds and equities can provide matched-term financing to support the development and operation of capital-intensive projects such as infrastructure. However, the introduction of equities and corporate bonds should be coordinated to avoid over-leverage in the corporate sector, and require a sound regulatory system along with a well-established corporate governance framework.

5. Institutional investors, including insurance companies and pension funds, represent a key component of capital market development. First, they provide a source of demand for long-term debt and equity securities. They also introduce competition to bank-denominated financial systems and drive modernization and efficiencies. As institutional investors have a long-term investment horizon, they also support efforts to strengthen corporate governance and to increase management accountability. Integration with the Association of Southeast Asian Nations (ASEAN) can also help support the development of a domestic capital market. Foreign investors can supplement the role of domestic institutional investors by providing a source of demand for domestic securities. Foreign investors also diversify the investor base through the introduction of varied business models, and can contribute to the enhancement of transparency and governance. The first pillar of the ASEAN Economic Community Blueprint lays the groundwork for achieving greater diversity of market participants by calling for the removal of ownership restrictions on financial institutions across ASEAN by 2015.[16] Within this framework, the ASEAN Capital Markets Forum has established a detailed agenda to integrate the region's capital markets. Initial reforms will focus on cross-border fund raising[17] and investments within ASEAN, enhancing corporate governance and establishing cross-border trading links.

6. **The diagnostic.** The IMF, with the support of the Asian Development Bank (ADB), the World Bank, and the United States Treasury, completed a diagnostic of the government bond market in 2014. It confirmed that many prerequisites for further development of the government bond market were already in place. An automated debt auction system was installed in 2006,

---

[15] The government bond market even affects the development of the equities market because it provides the information used to value the projected earnings of listed companies.
[16] The first pillar of the ASEAN Economic Community Blueprint is a single market and production base.
[17] This involves reform and standardization of issuance, listing, and distribution of debt and equity.

and a scriptless registry was established the following year. A rudimentary primary dealer system was launched in 2004, and was followed shortly thereafter by the issuance of over-the-counter trading rules and the formation of a self-regulatory organization for the bond market, along with straight-through processing (2006). Building on these achievements, the diagnostic proposed that a well-planned and gradual introduction of a more advanced primary dealer system would likely accelerate capital market development. Three preconditions were identified to ensure proper sequencing: (i) a well-functioning money market, including a master repo agreement, (ii) enhanced tradability between the taxable and tax-exempt members of the investor base,[18] and (iii) active securities lending and borrowing through a secure securities depository. Over the longer term, the diagnostic identified a need to broaden and increase the diversity of the investor base. In supporting finance sector development, the government and ADB have agreed on the following framework, which incorporates the findings of the diagnostic along with the Capital Market Blueprint, 2011–2016. The framework incorporates sequencing as described in the IMF working paper, as well as the proposed timing of the government's reform agenda as detailed in the Capital Market Blueprint.

The Reform Framework

Encouraging Investment through Capital Market Reforms Program, 2013–2016	**Medium-Term Framework**
Subprogram 1 Cash-flow forecasting improved through the single treasury account. Key constraints to increasing government bond market liquidity resolved.[a] Domestic investors enabled through revisions to the legal framework for contractual savings, provisions for a long-term savings product, and incentives to encourage professional management of collective investments. Prerequisites for increased diversity of market participants through integration with the Association of Southeast Asian Nations attained. **Subprogram 2** Primary dealer system launched, treasury operations strengthened, and capacity improved. A more reliable yield curve established to guide pricing of capital market products.	**2017 to 2019** Cash management further strengthened, leading to a deeper money market and more predictable and efficient government bond auctions. Treasury systems upgraded, and primary dealer performance targets enforced. Regulatory enhancements processed to ease business costs and processes. Project and longer-tenor bonds approved by the Securities and Exchange Commission on an exception basis. Domestic investor base increased through sustained technical assistance support to the insurance commissioner. Government progresses on harmonization initiatives under ACMF. **Beyond 2019** Securities Regulation Code revised to provide a permanent foundation for cross-border investments and project bonds.

[18] Trading between pension funds and the rest of the market is impractical due to the difficulty that the existing withholding-tax system creates in calculating the tax liability of non-tax-exempt investors who hold tax-exempt securities.

Legal framework improved to reduce barriers to business formation. New investment products introduced, including a long-term savings vehicle and a precursor to project bonds. Government begins active involvement in ACMF capital market harmonization initiatives.	Insurance commissioner continues to expand range of permissible products and investment strategies. Government completes harmonization initiatives under ACMF leading to cross-border investments.

ACMF = ASEAN Capital Markets Forum.
[a] These include adoption of the single-price methodology, increased benchmark size, taxation of repos, and bond sinking fund operations
Source: ADB staff, Securities and Exchange Commission, Bureau of the Treasury, and Insurance Commission

7. **ADB engagement and development partner coordination.** ADB has been continuously supporting finance sector reforms since 2011. Initial efforts focused on developing the capacity of nonbank regulators and introduced a long-term savings product.[19] Subsequent efforts supported public financial management reforms under the Philippine Public Financial Management Roadmap[20] and included ancillary support to the launch of a treasury single account, as well as direct support to provide the Bureau of the Treasury with organizational and capacity development. Currently, ADB is participating in a collaborative project with the United States Treasury to strengthen the primary dealer system and, subsequently, improve liquidity in the government bond market.[21] Concurrent support is being provided to the Office of the Insurance Commissioner to introduce risk-based capital and implement the revised insurance code.[22]

[19] ADB. 2011. *Technical Assistance to the Republic of the Philippines for Capacity Development of Financial Regulators*. Manila.
[20] This project will be supported by the Philippines–Australia Public Financial Management Program, which is being funded by the Government of Australia.
[21] ADB. 2014. *Technical Assistance to the Republic of the Philippines for Strengthening Treasury Operations and Capital Market Reform*. Manila.
[22] ADB. 2014. *Technical Assistance to the Republic of the Philippines for Capacity Development to Support Regulation and Oversight at the Insurance Commission*. Manila.