



Technical Assistance Report

Project Number: 50325-001
Knowledge and Support Technical Assistance (KSTA)
December 2017

Republic of the Philippines: Islamic Finance for the Philippines

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Asian Development Bank

CURRENCY EQUIVALENTS

(as of 5 December 2017)

Currency unit	–	peso/s (₱)
₱1.00	=	\$ 0.01977
\$1.00	=	₱50.55

ABBREVIATIONS

ADB	–	Asian Development Bank
ARMM	–	Autonomous Region of Muslim Mindanao
BIR	–	Bureau of Internal Revenue
BSP	–	Bangko Sentral ng Pilipinas (Central Bank of the Philippines)
BTr	–	Bureau of the Treasury
DOF	–	Department of Finance
FRSC	–	Financial Reporting Standards Council
IFSB	–	Islamic Financial Services Board
PDIC	–	Philippine Deposit Insurance Corporation
SEC	–	Securities and Exchange Commission
TA	–	technical assistance

NOTE

In this report, “\$” refers to United States dollars.

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KNOWLEDGE AND SUPPORT TECHNICAL ASSISTANCE AT A GLANCE

1. Basic Data		Project Number: 50325-001
Project Name	Islamic Finance for the Philippines	Department/Division OGC/OGC
Nature of Activity	Capacity Development	Executing Agency Bangko Sentral ng Pilipinas
Modality	Regular	
Country	Philippines	
2. Sector	Subsector(s)	ADB Financing (\$ million)
✓ Finance	Finance sector development	0.55
		Total <u>0.55</u>
3. Strategic Agenda	Subcomponents	Climate Change Information
Inclusive economic growth (IEG)	Pillar 2: Access to economic opportunities, including jobs, made more inclusive	Climate Change impact on the Project Low
4. Drivers of Change	Components	Gender Equity and Mainstreaming
Governance and capacity development (GCD)	Institutional systems and political economy	No gender elements (NGE) ✓
Knowledge solutions (KNS)	Public financial governance	
	Knowledge sharing activities	
5. Poverty and SDG Targeting		Location Impact
Geographic Targeting	Yes	Nation-wide High
Household Targeting	No	
SDG Targeting	Yes	
SDG Goals	SDG8	
6. Risk Categorization	Low	
7. Safeguard Categorization	Safeguard Policy Statement does not apply	
8. Financing		
Modality and Sources		Amount (\$ million)
ADB		0.55
Knowledge and Support technical assistance: Technical Assistance Special Fund		0.55
Cofinancing		0.00
None		0.00
Counterpart		0.00
None		0.00
Total		0.55

I. INTRODUCTION

1. The knowledge and support technical assistance (TA) will enable responsible growth of the Islamic finance industry as an additional vehicle for savings, infrastructure financing, portfolio diversification, and to promote financial inclusion in the Philippines. This will be achieved through the development of a regulatory framework appropriate for sustainable Islamic finance operations and capacity building activities for selected regulators and market participants in the country.

2. The TA was not included in the country operations business plan, 2017–2019 for the Philippines, but has been requested by the Government of the Philippines and is consistent with both (i) the Midterm Review of Strategy 2020, which recommends that the Asian Development Bank (ADB) deepen its support for financial inclusion; and (ii) the Review of the 2011 Financial Sector Operations Plan,¹ which recommends that ADB increase operational involvement in Islamic finance.² The TA is also aligned with the proposed Inclusive Finance Development Program,³ which will support government efforts to increase financial inclusion throughout the Philippines.

3. The TA builds on previous ADB TA for Islamic finance sector development, including Implementing Prudential Standards in Islamic Finance,⁴ and Development of Prudential and Supervision Standards for Islamic Financial Markets.⁵ Major lessons from the previous TA projects include the importance of country ownership and information sharing between countries at different stages of Islamic finance development. ADB began providing capacity building support to the Central Bank of the Philippines (BSP) under the Implementing Prudential Standards in Islamic Finance project (footnote 4).

II. ISSUES

4. Islamic financing is one of the fastest growing segments of international finance in the world. The Islamic finance industry's total worth across its three main sectors (banking, capital markets, and *takaful*)⁶ was estimated at \$1.89 trillion in 2016,⁷ and global Islamic finance assets are forecast to reach \$3.5 trillion by 2021.⁸ The volume of annual *sukuk* issuances reached \$75 billion in 2016,⁹ bringing the volume of outstanding *sukuk* to \$318.5 billion (footnote 7). As home to around 60% of the world's Muslims, Asia is in the midst of this development with a 22.5% share of the global Islamic finance assets (footnote 7).

5. Efforts by some Asian governments to support and develop their domestic Islamic financial services industries have helped drive Islamic finance growth in Asia. Through sound

¹ ADB. 2017. *Review of 2011 Financial Sector Operations Plan*. Manila.

² The TA first appeared in the business opportunities section of ADB's website on 7 December 2017.

³ Approval is expected in October 2018.

⁴ ADB. 2012. *Technical Assistance for Implementing Prudential Standards in Islamic Finance*. Manila (TA 8214-REG) sought to implement Islamic prudential standards developed by the Islamic Financial Services Board in Afghanistan, Bangladesh, Indonesia, and Pakistan.

⁵ ADB. 2009. *Technical Assistance for the Development of Prudential and Supervision Standards for Islamic Financial Markets*. Manila (TA 7246-REG) sought to harmonize Islamic prudential standards, data collection and risk measurement in selected common member countries of ADB and the Islamic Financial Services Board.

⁶ *Takaful* is a type of Islamic insurance, where members contribute money into a pooling system to guarantee each other against loss or damage.

⁷ Islamic Financial Services Board. 2017. *Islamic Financial Services Industry Stability Report 2017*. Kuala Lumpur.

⁸ Thomson Reuters. 2016. *State of the Global Islamic Economy Report 2016/2017*. Dubai.

⁹ A *sukuk* is an investment instrument (traded like a conventional bond) that provides the investor with undivided ownership of an underlying asset.

economic, financial, regulatory, and growth policies, Malaysia has established itself as Asia's principal Islamic finance market. Malaysia's Islamic financial institutions hold 23.8% of the country's total domestic banking assets, and the country accounts for 9.3% of Islamic banking assets globally (footnote 7). Malaysia similarly dominates in capital markets, accounting for 50.8% of total sovereign *sukuk* issuance and 50.2% of total corporate *sukuk* issuance in 2016 (footnote 7); it is the largest *takaful* market in Southeast Asia, with 62% of the market share in 2015.¹⁰

6. The Philippines was one of the first Muslim-minority countries to recognize the importance of Islamic finance. In 1973, the Philippine Amanah Bank was established to address the pressing need to expand the banking and credit system in Mindanao, where a majority of the country's Muslim population resides.¹¹ The bank's charter was revised in 1974 with the mandate that it operate "based on the Islamic Concept of Banking," to follow and respect the religious beliefs and practices of Muslim Filipinos.¹² In 1990, the Philippine Amanah Bank was transformed into the Al-Amanah Islamic Investment Bank of the Philippines (Amanah Bank) under a legislative charter mandating that it promote and accelerate the socioeconomic development of the Autonomous Region of Muslim Mindanao (ARMM) by performing banking, financing, and investment operations based on the concept of Islamic banking.¹³

7. Despite this early and promising start, the Philippines currently has an inadequate legal and regulatory framework for Islamic finance. The country's General Banking Law of 2000 recognizes "Islamic banks" as a category of banking institutions,¹⁴ and provides that "[t]he organization, ownership and capital requirements, powers, supervision and general conduct of business of Islamic banks shall be governed by special laws."¹⁵ However, Congress has yet to enact the general legislative framework for Islamic banking, capital markets, and insurance. More recently, bills providing for the regulation and organization of an expanded Islamic banking system in the Philippines have been filed in both the Philippine Senate and House of Representatives, but have not been enacted into law.¹⁶

8. The lack of an appropriate legal and regulatory framework for Islamic finance has slowed development of Islamic finance in the country. The Amanah Bank, which is currently the only Islamic bank operating in the Philippines, has faced severe operational challenges because of the inadequate legal and regulatory framework, and Islamic finance-related capacity constraints (e.g., lack of technical capability, undercapitalization, and lack of Islamic liquidity management and investment avenues). Amanah Bank has reported net losses for several years, which totaled ₱23,538,265 in 2015, and ₱51,506,827 in 2016.¹⁷ Although Amanah Bank has its own legislative charter (footnote 13), the absence of an appropriate enabling regulatory framework for Islamic finance (which includes tax neutrality for Islamic finance transactions) means that Amanah Bank has continued to struggle to operate as a viable banking institution.

9. In addition to an inadequate legal and regulatory framework, the Philippines also lacks exposure to and experience with Islamic finance transactions, and thus has insufficient

¹⁰ Milliman Research Report. 2017. *Global Takaful Report 2017*. Dubai.

¹¹ Presidential Decree No. 264 dated 2 August 1973.

¹² Presidential Decree No. 542 dated 20 August 1974.

¹³ Republic Act No. 6848, otherwise known as the Charter of Al-Amanah Islamic Investment Bank of the Philippines.

¹⁴ Republic Act No. 8791, Section 3.

¹⁵ Republic Act No. 8791, Section 71.

¹⁶ Senate Bill No. 668 introduced by Senator Paolo Benigno A. Aquino IV, and House Bill No. 492 introduced by Hon. Sitti Djalia A. Turabin-Hataman of Anak Mindanao Party-List.

¹⁷ Annual Audit Report on the Al-Amanah Islamic Investment Bank of the Philippines for the years ending 31 December 2015 and 31 December 2016.

understanding of and expertise in Islamic finance transactions. Access to training and education on Islamic finance is limited, constraining development of talent and capacity. Both the capacity and competence to deliver Islamic finance services is lacking, and regulators are not equipped with the expertise to operationalize and supervise Islamic finance transactions.

10. Development of Islamic finance in the Philippines would promote financial inclusion, especially among those who choose to remain unbanked for religious reasons. Conventional banking has been slow to expand in the ARMM, where a majority of the country's Muslim population resides. As of 2015, there were only 21 banks and 33 automated teller machines—and no microbanking offices—serving all of the ARMM, which has a population of 3,781,387.¹⁸ In 2015 the ARMM made the smallest contribution (.7%) to national gross domestic product of any region in the country.¹⁹ The potential for conventional and Islamic banking to cater to the needs of Muslim Filipinos and boost economic development in Mindanao is evident. Islamic finance may also attract increased infrastructure investment from Islamic finance investors. In particular, *sukuk* has been increasingly used to fund infrastructure development projects. In 2016, infrastructure-linked *sukuk* issuers (predominantly in Malaysia) involved in the power and utilities, transportation and telecommunication sectors collectively accounted for \$12.5 billion (16.7%) of total *sukuk* issuances (footnote 7). Islamic finance would complement and support the government's goal of accelerating the country's infrastructure development to account for 5% of gross domestic product, and may provide a viable additional and/or alternative source of private capital and investments for public-private infrastructure projects.²⁰ The Bureau of the Treasury (BTr) is exploring issuing the first sovereign *sukuk* for the Philippines.

11. The challenge for the Philippine government will be to (i) develop an Islamic finance industry in a measured, inclusive, and sustainable manner; (ii) build adequate capacity in Islamic finance within the public and private sector for solid service delivery; and (iii) raise awareness of Islamic finance as a viable alternative to conventional finance, both for Muslims and those seeking to diversify their financial services options.

12. In light of these challenges, the government has requested ADB to provide assistance in (i) formulating and drafting the implementing rules and regulations needed to operationalize Islamic finance; and (ii) enhancing the competence and capacity of regulators to implement and supervise Islamic finance operations.

III. THE TECHNICAL ASSISTANCE

A. Impact and Outcome

13. The TA will be aligned with the following impact: the socioeconomic development of the Philippines promoted and accelerated through the creation of Islamic banks and designated Islamic banking units.²¹

14. The TA will have the following outcome: Islamic financial services in the Philippines expanded under a suitable legal and regulatory environment.²²

¹⁸ Government of the Philippines, Bangko Sentral ng Pilipinas. 2015. *Report on the State of Financial Inclusion in the Philippines*. Manila.

¹⁹ Philippine Statistics Authority. Gross Regional Domestic Product Tables as of May 2017. <https://psa.gov.ph/regional-accounts/grdp/data-and-charts> (accessed 22 December 2017).

²⁰ Government of the Philippines, Public-Private Partnership Center. 2017. *Investment Opportunities*. Quezon City.

²¹ This impact is aligned with the intent of House Bill No. 492 and Senate Bill No. 668 (footnote 16).

²² The design and monitoring framework is in Appendix 1.

B. Outputs, Methods, and Activities

15. **Output 1: Regulatory framework for Islamic finance of acceptable quality developed.** A gap analysis will be conducted to determine the ideal legislative framework and the implementing rules and regulations required to support a robust Islamic finance market. The analysis will examine the country's tax framework to determine what rules and regulations are needed to promote tax neutrality (tax neutrality measures are intended to ensure equal tax treatment for Islamic finance products and services).²³ The relevant implementing rules and regulations required will be developed, drafted, and finalized. The preparation of the legislative and regulatory framework will serve as the foundation for the development of the Islamic finance industry in the Philippines.

16. **Output 2: Regulatory and market capacity to deliver Islamic financial services strengthened.** Capacity building activities—for BSP, BTr, the Bureau of Internal Revenue (BIR), Department of Finance (DOF), Financial Reporting Standards Council (FRSC), Insurance Commission, Philippine Deposit Insurance Corporation (PDIC), Securities and Exchange Commission (SEC), and other selected regulators and market participants, including the Amanah Bank and private sector banks intending to provide Islamic financial services—will be undertaken to enable these entities to develop, regulate and supervise, and provide Islamic finance services in the Philippines. Public and private sector participants from the Muslim community in the Philippines (including governmental officials and regulators from ARMM, academia, and business) will be included. The Philippines may benefit from the partnership between ADB and the Islamic Financial Services Board (IFSB), a Kuala Lumpur-based international standard-setting body that promotes development of a prudent and transparent Islamic financial services industry and has a structural capacity building approach suitable for output 2. BSP is a member of IFSB, and capacity building on prudential standards can be undertaken in partnership with IFSB. Training will be provided using various methods (e.g., conferences, intensive workshops, and training courses developed by expert consultants). ADB staff and consultants may also conduct general training on Islamic finance to raise public awareness. Major lessons under previous TA projects (para. 3) were the importance of country ownership and information sharing between countries at different stages of Islamic finance development. The TA aims to facilitate such cross-border dialogue between the Philippines and countries where Islamic finance development is at a more advanced stage.

C. Cost and Financing

17. The TA is estimated to cost \$600,000, of which \$550,000 will be financed on a grant basis by ADB's Technical Assistance Special Fund (TASF-other sources). The key expenditure items are listed in Appendix 2.

D. Implementation Arrangements

18. The executing agency for the TA will be BSP; in that capacity, BSP will be the main counterpart agency for the TA. BSP will be responsible for TA implementation, including coordinating with other regulatory entities, including BIR, BTr, DOF, FRSC, the Insurance Commission, PDIC and SEC. A working group will be established with senior representatives

²³ Several Islamic financial products require multiple transactions (more than their conventional counterparts) to achieve functional equivalence, and face additional tax burdens under most existing legal and taxation systems. Countries developing indigenous Islamic financial markets need to consider taxation and regulatory changes.

from ADB, ARMM, BIR, BSP, BTr, DOF, FRSC, the Insurance Commission, PDIC, SEC, and other key agencies and participants to guide and supervise TA implementation.

19. ADB's Office of the General Counsel will be responsible for the administration and supervision of the implementation of the TA in close coordination with the Public Management, Financial Sector, and Trade Division, Southeast Asia Department. ADB will engage individual consultants in accordance with ADB's Procurement Policy (2017, as amended from time to time) and the associated project administration instructions and TA staff instructions.²⁴ To reduce the administrative burden and improve economy, efficiency, and value for money, lump-sum payments and/or output-based contracts will be considered for consulting services under the TA. All disbursements under the TA will be made in accordance with ADB's *Technical Assistance Disbursement Handbook* (2010, as amended from time to time).

20. BSP officials, government officials, and investors and/or bankers will make time available to participate in regulatory reform and capacity building activities. BSP will also provide office space, venues for training sessions, and assist with logistical arrangements. It is envisaged that some training sessions will be undertaken within Malaysia to leverage its knowledge and experience as Asia's principal Islamic finance market. More developed institutions—such as Bank Negara Malaysia, State Bank of Pakistan, and the Islamic Development Bank—with experience in establishing and developing adequate legal and regulatory frameworks for Islamic finance will help provide training.

Implementation Arrangements

Aspects	Arrangements		
Indicative implementation period	January 2018–December 2019		
Executing agency	Bangko Sentral ng Pilipinas (BSP)		
Implementing agency	BSP		
Consultants	To be selected and engaged by ADB		
	Individual Consultant Recruitment	International: 10 person-months National: 16 person-months	\$355,000.00
Disbursement	The TA resources will be disbursed following ADB's <i>Technical Assistance Disbursement Handbook</i> (2010, as amended from time to time).		

Source: Asian Development Bank.

IV. THE PRESIDENT'S DECISION

21. The President, acting under the authority delegated by the Board, has approved the provision of technical assistance not exceeding the equivalent of \$550,000 on a grant basis to the Government of the Philippines for Islamic Finance for the Philippines, and hereby reports this action to the Board.

²⁴ Terms of Reference for Consultants (accessible from the list of linked documents in Appendix 3).

DESIGN AND MONITORING FRAMEWORK

Impact the TA is Aligned with The socioeconomic development of the Philippines promoted and accelerated through the creation of Islamic banks and designated Islamic banking units. ^a			
Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting	Risks
Outcome Islamic financial services in the Philippines expanded under a suitable legal and regulatory environment	Numbers of Islamic finance products increased by April 2020 (2017 Baseline: 1)	BSP annual reports Data and annual reports from banks providing Islamic financial services	Limited expansion of Islamic finance products provided by financial institutions once legal and regulatory environment is established.
Outputs 1. Regulatory framework for Islamic finance of acceptable quality developed	1a. Gap analysis completed by August 2018 (2017 Baseline: 0) 1b. Necessary implementing rules and regulations finalized by December 2019 (2017 Baseline: 0)	1a. TA reports 1b. Government gazettes, TA reports, and reports from regulators, including BSP DOF, BTr, BIR, SEC, the Insurance Commission, FRSC and PDIC	Legislators do not approve the necessary legislative enactments. Regulatory bodies do not issue the implementing rules and regulations.
2. Regulatory and market capacity to deliver Islamic financial services strengthened	2.a. At least 40 governmental, regulatory, and private sector participants trained in regulatory and market issues by September 2019, at least 20% of whom are women (2017 Baseline: 0)	2.a. DOF, BTr, and BSP annual reports and TA reports	Financial institutions do not dedicate sufficient resources to expand their personnel and change their internal systems.

Key Activities with Milestones**1. Regulatory framework for Islamic finance of acceptable quality developed**

- 1.1 Establish working group with ADB, ARMM, BIR, BSP, BTr, DOF, FRSC, the Insurance Commission, PDIC, SEC, and other key agencies and participants by April 2018.
- 1.2 Establish baselines for measurements, including finalizing any surveys, by May 2018.
- 1.3 Undertake consultations with representatives of the Muslim population from the public and private sector, including those in ARMM, by July 2018.
- 1.4 Conduct gap analysis, review drafts, undertake extensive consultations with stakeholders, and finalize with working group and other interested stakeholders by August 2018.
- 1.5 Present findings to government and support drafting of implementing rules and regulations from January 2019 through to December 2019.

2. Regulatory and market capacity to deliver Islamic financial services strengthened

- 2.1 Conduct needs assessment of (i) financial regulatory agencies, (ii) financial services providers, and (iii) other participants with respect to Islamic financial services by August 2018.
- 2.2 Conduct capacity development trainings on a multi-regulatory and individual basis to address selected needs identified in 2.1 above, through September 2019.
- 2.3 Assessments of training results and further needs completed by December 2019.

Inputs

ADB: \$550,000

Note: Participating regulators will provide counterpart support in the form of: counterpart staff, office space for meetings and trainings, logistical support to facilitate meetings and discussions with relevant stakeholders at all levels, and other in-kind contributions.

Assumptions for Partner Financing

Not Applicable

ADB = Asian Development Bank, ARMM = Autonomous Region of Muslim Mindanao, BIR = Bureau of Internal Revenue, BSP = Bangko Sentral ng Pilipinas (Central Bank of the Philippines), BTr = Bureau of the Treasury, DOF = Department of Finance, FRSC = Financial Reporting Standards Council, PDIC = Philippine Deposit Insurance Corporation, SEC = Securities and Exchange Commission, TA = technical assistance.

^a This impact is aligned with the intent of Senate Bill No. 668, introduced by Senator Paolo Benigno A. Aquino IV, and House Bill No. 492 introduced by Hon. Sitti Djalila A. Turabin-Hataman of Anak Mindanao Party-List.

Source: Asian Development Bank.

COST ESTIMATES AND FINANCING PLAN
(\$'000)

Item	Amount
Asian Development Bank^a	
1. Consultants	
a. Remuneration and per diem	
i. International consultants	275.0
ii. National consultants	80.0
b. International and local travel	30.0
c. Reports and communications	15.0
2. Training, seminars, and conferences ^b	
a. Facilitators	30.0
b. Training programs	80.0
3. Miscellaneous administration and support costs ^c	10.0
4. Contingencies	30.0
Total	550.0

Note: The technical assistance (TA) is estimated to cost \$600,000, of which contributions from the Asian Development Bank are presented in the table above. The government will provide counterpart support in the form of counterpart staff, office space for meetings and training, logistical support to facilitate meetings and discussions with relevant stakeholders at all levels, and other in-kind contributions. The value of government contribution is estimated to account for 8.3% of the total TA cost.

^a Financed by the Asian Development Bank's Technical Assistance Special Fund (TASF-other sources).

^b Includes ADB staff travel as resource persons and engagement of external resource persons. This will also include representation expenses in accordance with ADB (Budget, Personnel, and Management Systems Department; and Strategy, Policy and Review Department). 2013. Use of Bank Resources: Regional Technical Assistance and Technical Assistance vs. Internal Administrative Expenses Budget. Memorandum. 26 June (internal).

^c Includes expenses for office operations, administrative and/or technical staff and local transportation. Source: Asian Development Bank estimates.

LIST OF LINKED DOCUMENTS

<http://www.adb.org/Documents/LinkedDocs/?id=50325-001-TARreport>

1. Terms of Reference for Consultants