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R106-17  
Addendum 1  
9 November 2017

Addendum to Document R106-17  
Proposed Policy-Based Loan for Subprogram 2  
and Technical Assistance Grant  
Encouraging Investment through Capital Market  
Reforms Program  
(Philippines)

A linked document has been added in the above document to complete the uploaded linked documents.

- |      |  |   |
|------|--|---|
| (i)  | Page 14, Appendix 2: List of Linked Documents                    | Delete "(to follow)" in reference to Linked Document 7: International Monetary Fund Assessment Letter |
| (ii) | Linked Document 7: International Monetary Fund Assessment Letter | Uploaded to the Board Document System   |

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(For consideration by the Board on or about 21 November 2017)

R106-17  
31 October 2017

## Proposed Policy-Based Loan for Subprogram 2 and Technical Assistance Grant Encouraging Investment through Capital Market Reforms Program (Philippines)

1. The Report and Recommendation of the President (RRP: PHI 48427-002) on the proposed policy-based loan for subprogram 2 and technical assistance grant to the Philippines for the Encouraging Investment through Capital Market Reforms Program is circulated herewith.
2. This Report and Recommendation should be read with (i) *Country Partnership Strategy: Philippines, 2011–2016 and Corrigendum 1*, which were circulated to the Board on 5 and 19 October 2011, respectively (DOCS.Sec.M55-11 and Corrigendum 1); and (ii) *Country Operations Business Plan: Philippines, 2017–2019*, which was circulated on 14 December 2016 (DOC.IN.489-16).

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# Report and Recommendation of the President to the Board of Directors

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Project Number: 48427-002  
October 2017

## Proposed Policy-Based Loan for Subprogram 2 and Technical Assistance Grant Republic of the Philippines: Encouraging Investment through Capital Market Reforms Program

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Asian Development Bank

## CURRENCY EQUIVALENTS

(as of 2 October 2017)

Currency unit	–	peso/s (P)
P1.00	=	\$0.01965
\$1.00	=	P50.89

## ABBREVIATIONS

ADB	–	Asian Development Bank
ASEAN	–	Association of Southeast Asian Nations
BTr	–	Bureau of the Treasury
DOF	–	Department of Finance
GDP	–	gross domestic product
GSED	–	government securities eligible dealer
IMF	–	International Monetary Fund
MMOU	–	multilateral memorandum of understanding
P3F	–	post-program partnership framework
PDP	–	Philippine Development Plan
PERA	–	Personal Equity and Retirement Account
PFM	–	public financial management
PPP	–	public–private partnership
SEC	–	Securities and Exchange Commission
TA	–	technical assistance

## 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; 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 “bellwether issues,” benchmark issues are typically used as the basis of yield curves.
bid–ask spread	–	The amount by which the asking 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.

- Bond Sinking Fund

  - In the Philippines, a legally mandated bond sinking fund holds approximately 20% of all outstanding government debt (Republic Act 1000 of 1954) and provides cash to offset temporary revenue gaps. This practice generates a substantial negative carry, or rate of return, discourages the development of robust cash management at the Bureau of the Treasury, and has led to a critical shortage of short-term treasury bills.
  
- Bureau of the Treasury

  - An agency of the Department of Finance which, under Executive Order No. 449, acts as the principal custodian of the 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](http://www.treasury.gov.ph/aboutbtr/mission_main.html).
  
- duration

  - In finance, the duration of a financial asset that consists of fixed cash flows (e.g., a bond) is the weighted average time until repayment. When an asset is considered as a function of yield, duration also measures the price sensitivity to yield, the rate of change of price with respect to yield, or the percentage change in price for a parallel shift in yields.
  
- treasury single account

  - An essential tool for government cash management, this 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 dealer

  - 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 exclusive access to primary auctions of government securities (sometimes coupled with a higher noncompetitive 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 (“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 repurchase interest. For the party selling the security (and agreeing to repurchase it in the future), it is a repurchase; 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.
  
- self-regulatory organization – A self-regulatory organization is a non-government organization that has the power to create and enforce industry regulations and standards. Its priority is to protect investors by establishing rules that promote ethics and equality. Some examples of self-regulatory organizations include stock exchanges, the Investment Dealers Association of Canada, and the National Association of Securities Dealers in the United States.
  
- 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 United States 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 United States dollars.

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## PROGRAM AT A GLANCE

<b>1. Basic Data</b>		<b>Project Number: 48427-002</b>	
<b>Project Name</b>	Encouraging Investment through Capital Market Reforms Program, Subprogram 2	<b>Department /Division</b>	SERD/SEPF
<b>Country Borrower</b>	Philippines Government of the Philippines	<b>Executing Agency</b>	Department of Finance
<b>2. Sector</b>	<b>Subsector(s)</b>	<b>ADB Financing (\$ million)</b>	
✓ <b>Finance</b>	Finance sector development		150.00
	Money and capital markets		150.00
		<b>Total</b>	<b>300.00</b>
<b>3. Strategic Agenda</b>	<b>Subcomponents</b>	<b>Climate Change Information</b>	
Inclusive economic growth (IEG)	Pillar 1: Economic opportunities, including jobs, created and expanded	Climate Change impact on the Project	Low
<b>4. Drivers of Change</b>	<b>Components</b>	<b>Gender Equity and Mainstreaming</b>	
Governance and capacity development (GCD)	Institutional development Public financial governance	No gender elements (NGE)	✓
<b>5. Poverty and SDG Targeting</b>		<b>Location Impact</b>	
Geographic Targeting	No	Nation-wide	High
Household Targeting	No		
SDG Targeting	Yes		
SDG Goals	SDG8, SDG9, SDG10		
<b>6. Risk Categorization:</b>	Complex		
<b>7. Safeguard Categorization</b>	Environment: C Involuntary Resettlement: C Indigenous Peoples: C		
<b>8. Financing</b>			
<b>Modality and Sources</b>		<b>Amount (\$ million)</b>	
<b>ADB</b>		<b>300.00</b>	
Sovereign Program (Regular Loan): Ordinary capital resources		300.00	
<b>Cofinancing</b>		<b>0.00</b>	
None		0.00	
<b>Counterpart</b>		<b>0.00</b>	
None		0.00	
<b>Total</b>		<b>300.00</b>	
Note: An attached technical assistance will be financed on a grant basis by the Technical Assistance Special Fund (TASF-OTHERS) in the amount of \$500,000.			

## I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on a proposed policy-based loan to the Republic of the Philippines for subprogram 2 of the Encouraging Investment through Capital Market Reforms Program.<sup>1</sup> The report also describes proposed technical assistance (TA) for Institutionalizing Capital Market Reforms, and if the Board approves the proposed loan, I, acting under the authority delegated to me by the Board, approve the TA.

2. The program supplements coordinated support provided by the Asian Development Bank (ADB) to accelerate investment by increasing the availability of long-term finance. The program will deepen the capital market through a series of sequenced reforms designed to (i) further develop the government bond market, (ii) encourage growth in domestic long-term savings, and (iii) ease barriers to entry to diversify and broaden available funding sources. Subprogram 2 is included in ADB's country operations business plan, 2017–2019 for the Philippines.<sup>2</sup>

## II. THE PROGRAM

### A. Rationale

3. **The programmatic approach and budget support.** ADB's Board of Directors approved the programmatic approach and loan for subprogram 1 on 26 November 2015. The program included two subprograms and focused on developing the domestic capital market to provide long-term finance to support the government's infrastructure agenda. Utilizing strong diagnostics as its base, the programmatic approach initially concentrated on improving efficiencies, strengthening capacity, and providing an enabling environment for the more complex and substantive reforms to come. Subprogram 2 implements these initiatives, thus providing a more stable and reliable yield curve, increased long-term savings and finance, and a greater diversity of participants in the domestic bond market. The inclusion of a post-program partnership framework (P3F), 2017–2021 continues ADB's engagement utilizing TA (para. 24). By addressing long-standing constraints in the wholesale finance market, ADB can now pivot its support toward increasing financial inclusion with a focus on improving poor households' access to finance, financial literacy, and consumer protection. The use of a programmatic approach with a policy-based loan and TA aligns ADB's support with the government's reform program while providing incentives and capacity to complete the reforms.

4. **The development problem.** The Philippine Development Plan (PDP), 2017–2022 continues the government's emphasis on inclusive growth. Under the PDP, the government has set a strategic target to reach upper-middle-income status by 2022.<sup>3</sup> It has also targeted gross domestic product (GDP) growth of 7%–8% per year, in real terms, with GDP per capita increasing from \$3,550 in 2015 to \$5,000 by 2022. In addition, the government has targeted a decline in the national poverty rate from 21.6% in 2015 to 14.0% in 2022, and from 30% to 20% in rural areas over the same timeframe. To accomplish these goals, a primary emphasis has again been placed on investment and infrastructure. However, the competitiveness of infrastructure in the Philippines still ranks very low worldwide—112th out of 138 in 2016–2017 compared to 98th out of 144 in 2012–2013—with inadequate infrastructure ranked as the second most problematic factor for

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<sup>1</sup> The design and monitoring framework is in Appendix 1.

<sup>2</sup> ADB. 2016. *Country Operations Business Plan: Philippines, 2017–2019*. Manila.

<sup>3</sup> Government of the Philippines, National Economic and Development Authority. 2017. *Philippine Development Plan, 2017–2022*. Manila. <http://pdp.neda.gov.ph/wp-content/uploads/2017/01/PDP-2017-2022-04-24-2017.pdf>.

doing business in the country.<sup>4</sup> To address this deficit, the government plans to increase expenditure on infrastructure significantly relative to the previous PDP. Public spending on infrastructure as a share of GDP is expected to increase from 5.1% in 2016 to 7.4% by 2022, or approximately \$14.5 billion annually. A diversified funding mix will be utilized, including government financing, private capital, and official development assistance.<sup>5</sup>

5. To achieve these goals, the financial sector must now absorb higher levels of long-tenor government debt and private sector debt capital without generating a significant increase in borrowing costs. In particular, the government recognizes the need to channel more private savings into bankable infrastructure investments through the domestic financial markets.<sup>6</sup> However, the capacity of the domestic financial market remains limited. The size of the Philippine bond market as a share of GDP remains small, at 27% relative to the average of 68% in emerging East Asia. The government bond market itself is underdeveloped and exhibits low liquidity, which reduces its attractiveness. Bid–offer spreads average 4.6 basis points, compared to the emerging East Asia average of 3.8 basis points. The nonbank finance sector represents an alternative source of private capital for infrastructure. Outstanding corporate bonds have reached an all-time high of 6.2% of GDP. The lapse of an exemption to the banking sector’s single-borrower limit for infrastructure at the end of 2016 has intensified interest in the capital market. Nevertheless, more needs to be done, as the size of the corporate bond market lags well behind regional averages. Insurance premiums are approaching 2% of GDP but are still less than half the level in more advanced markets such as Thailand (5.53%), Malaysia (4.30%), and Singapore (6.06%).

6. **Binding constraints.** The government recognizes the challenges it faces in improving financial intermediation in the economy, including the need to (i) strengthen the management of treasury operations and ensure increased participation in government bond auctions, (ii) encourage the development of long-term contractual savings and investment products to channel funds to infrastructure, and (iii) diversify the investor base in terms of participants and business models (paras. 7–9).

7. Increasing expectations for the Bureau of the Treasury (BTr) to fund infrastructure with government debt directly will be difficult to meet in the longer term. There are two primary constraints. First, the BTr has not yet institutionalized reforms to strengthen cash, investment, and risk management. Thus, a compensating bond sinking fund, consisting of government securities and liquid assets (see glossary), is still being maintained to ensure cash is adequate to meet maturing obligations. While the fund’s balance has declined, total holdings still exceed P700 billion and financing costs exceed revenue (negative carry) by approximately P17 billion per year. Supporting financial infrastructure must be modernized and inefficiencies arising from the bond sinking fund must be addressed. Second, the government must ensure significant and sustained participation in primary government bond auctions. The current Government Eligible Securities Dealers (GSED) system does not impose responsibilities and provides few incentives to participate. Efforts to defragment the government bond market by building a limited number of deep and liquid issues must continue, which will improve liquidity and increase the reliability of the yield curve as a price-setting tool. Dealers must be also provided with the tools to manage risks arising from market making.

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<sup>4</sup> World Economic Forum. 2012. *The Global Competitiveness Report, 2012–2013*. Geneva; World Economic Forum. 2016. *The Global Competitiveness Report, 2016–2017*. Geneva.

<sup>5</sup> Under the PDP, the national budget devoted to infrastructure expenditure is expected to increase from 3.5% to 5.7% of GDP by 2022, and resulting GDP growth is estimated to be 1.5–7.0 percentage points higher.

<sup>6</sup> An ADB staff “high-side” estimate indicates that untapped private capital could be sufficient to meet 4–5 years of infrastructure expenditure at an annual rate of 6% of GDP.

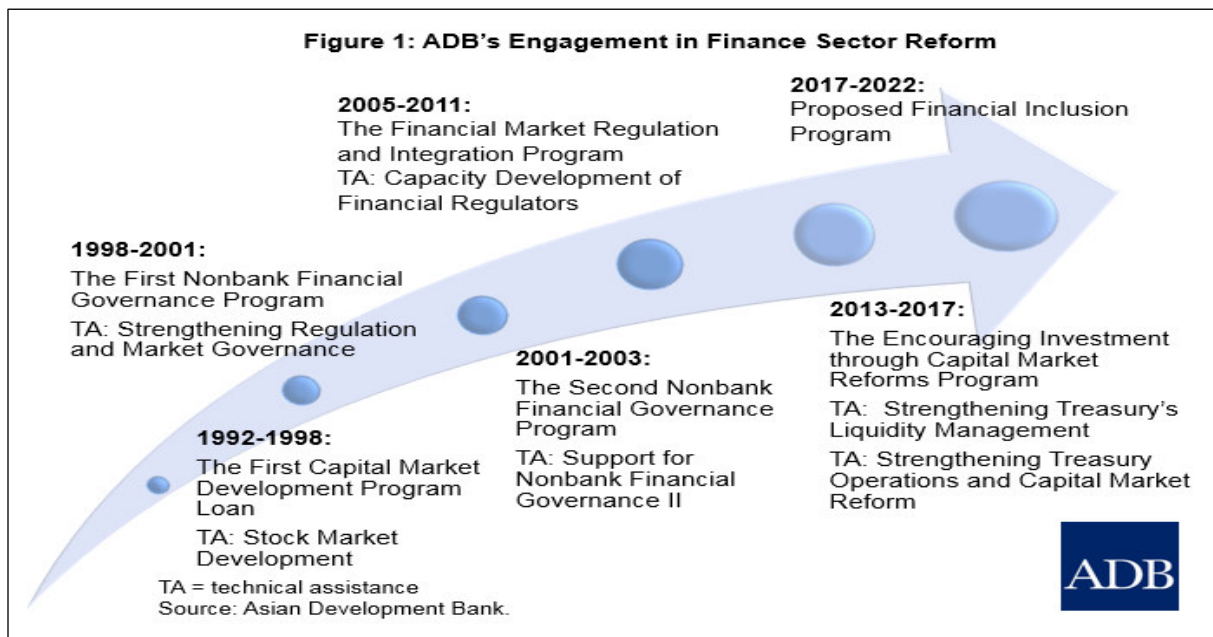
8. Legislative changes, financial infrastructure upgrades, and reduced friction costs have increased the availability of both long-term savings and finance. Nevertheless, development constraints remain. First, the government has not yet provided detailed implementation guidelines to support recent legislative initiatives (e.g., the revised insurance code and the law establishing the Personal Equity Retirement Account [PERA]). New products and services, while authorized, have not yet been provided with an enabling environment (e.g., repurchase agreements and project bonds). For example, the contractual savings sector exhibits elevated risk due to a significant mismatch between the duration of its liabilities and the far shorter duration of its assets. Providing incentives to close this mismatch will both reduce risk and increase the sector's appetite for long-term financial instruments, such as infrastructure bonds. Recent efforts to launch a tax-deferred long-term retirement savings account must be completed, and initiatives to authorize additional modalities of long-term finance must continue. Second, legal, operational, and cost distortions restrain the development of the nonbank finance sector and inhibit innovation. Foremost, taxation across subsectors has not been harmonized, regulatory constraints discourage alternative trading strategies, and associated costs are high.

9. The finance sector is not adequately diversified. More needs to be done to encourage the entry of foreign financial institutions to stimulate additional demand for the increased issuance of local currency long-term debt. In addition, foreign financial institutions can (i) introduce different business models, which rely more heavily on investment banking as opposed to interest income; (ii) accelerate knowledge transfer (such as project finance); and (iii) provide counterparties for hedging transactions. Moreover, the government should strengthen governance within the financial markets to ensure competitive parity and guard against excesses, which often arise in high-growth scenarios coupled with increased debt issuance.

10. **The government's reform agenda.** Under the PDP, the government plans to increase public spending on infrastructure to as high as 7.4% of GDP by 2022 (para. 4). To finance this increase, the government will (i) increase public spending, (ii) promote public-private partnerships (PPPs), and (iii) develop the capital market to provide long-term finance. The government will also manage the debt portfolio and borrowing mix program proactively to increase fiscal space. To develop the capital market, the central bank will refine its interest rate corridor mechanism to align market and policy rates, establishing a foundation for the short end of the yield curve. The government will also implement an issuance program to maintain liquid benchmark securities, thereby establishing a reliable domestic yield curve. Complimentary reforms will strengthen the Government Securities Eligible Dealer (GSED) system to establish a market-making function to boost trading activity and liquidity. A repurchase agreement ("repo") for domestic securities will be launched, and upgrades to the financial market infrastructure will promote efficiency in the trading and settlement of securities.

11. **ADB experience.** ADB has supported finance sector reforms with five programmatic-approach, policy-based loans and substantial TA (Figure 1). ADB initially focused on the equity market and encouraged consolidation, self-regulation, and enhanced transparency. Responding to the 1997 financial crisis, ADB supported the government's efforts to strengthen governance, improve the Securities and Exchange Commission (SEC), implement investor protections, and develop an anti-money laundering function. Beginning in 2005, ADB launched an effort to support development of the fixed income market but these efforts were overtaken by the 2008 global financial crisis which necessitated a revised focus on financial stability. Nevertheless, reforms harmonized reporting and disclosure practices with international standards, improved settlement and payment systems, and strengthened regulatory capabilities. Based on lessons learned (para. 12), ADB has instituted a highly coordinated approach to guide its programmatic support. This program has re-emphasized the fundamentals of capital market development beginning with the

money and government debt markets. Concurrent with these efforts, ADB will continue to support the issuance of local currency project bonds. Recognizing that inclusive finance and finance sector development are mutually reinforcing, ADB will also launch a dedicated financial inclusion program in 2018 to supplement ADB's PPP and youth employment programs.<sup>7</sup>



12. **Lessons learned.** ADB's long-term engagement helped inform the program by highlighting key lessons learned. First, success in developing a local currency bond market depends on several factors, including (i) sound macroeconomic policies (e.g., a market-based monetary framework) and debt management strategies; (ii) a diversified investor base; (iii) a sound legal framework; and (iv) modern, reliable, and efficient infrastructure.<sup>8</sup> Seen through this framework, the credit rating upgrades and the recent launch of an interest rate corridor mechanism by the central bank have together provided a strong foundation for developing the domestic capital market. Second, finance sector reforms are complex, have a medium- to long-term gestation period, and require proper sequencing.<sup>9</sup> In retrospect, ADB's early engagement in the equity market delayed reforms to the fixed-income market that would have integrated and modernized the market in step with the wider financial market and international standards. Third, programs should exhibit sufficient flexibility to accommodate a medium- to long-term development horizon and changes in the addenda of reform champions. Fourth, capital market development is a prerequisite for expanding the financial inclusion of poor households beyond microcredit. As empirical evidence shows that financial exclusion of the poor contributes to persistently high income inequality, ADB's assistance will increasingly focus on financial inclusion.

13. **ADB's value addition to program design and implementation.** ADB's TA support to subprogram 2 has produced impressive results. To institutionalize reforms under subprogram 1, the BTr has reconstituted divisions covering cash, investment, and risk management. The

<sup>7</sup> ADB. 2015. *Report and Recommendation of the President to the Board of Directors: Proposed Programmatic Approach and Policy-Based Loan for Subprogram 1 to the Republic of the Philippines for Expanding Private Participation in Infrastructure Program*. Manila; ADB. 2017. *Report and Recommendation of the President to the Board of Directors: Proposed Programmatic Approach and Policy-Based Loan for Subprogram 1 to the Republic of the Philippines for Facilitating Youth School-to-Work Transition Program*. Manila.

<sup>8</sup> International Monetary Fund (IMF). 2013. *Local Currency Bond Markets, A Diagnostic Framework*. Washington, DC.

<sup>9</sup> IMF. 2003. *Managing Risks in Financial Market Development, The Role of Sequencing*. Washington, DC.

government then adopted formal operating procedures, risk manuals and limits, monitoring and reporting frameworks, and performance standards. Continuing efforts to scale back the size of the bond sinking fund, which ADB also supported under subprogram 1, and are now estimated to produce P5 billion–P7 billion in annual fiscal savings over the life of the reforms. ADB also provided direct support to upgrade the BTr’s infrastructure, including its registry of scripless securities. This is the first upgrade in over 20 years and will significantly modernize finance sector infrastructure in the Philippines.<sup>10</sup> In addition, ADB TA supported the adoption of risk-based capital by the insurance sector, providing a direct incentive for the purchase of four infrastructure bonds under subprogram 2.<sup>11</sup> ADB provided the infrastructure to launch the PERA, and is supporting the government’s efforts to reform the tax regime, including those applied to the finance sector.<sup>12</sup> Finally, ADB supported the SEC’s efforts to implement the corporate governance road map, and to strengthen the definition of an independent director.<sup>13</sup>

14. **Development partner coordination.** The government’s capital market reform agenda has strong development partner coordination.<sup>14</sup> The Government of Australia supported the Philippines–Australia Public Financial Management Program, which launched the treasury single account. ADB, the United States Treasury, and the International Monetary Fund (IMF) are currently facilitating an initiative to develop the Philippines’ first government-led capital market development strategy. Otherwise, the existing donor demarcation remains. The United States Treasury is providing resident advisors to strengthen the GSED system and develop an infrastructure bond market. ADB is providing support to modernize infrastructure, strengthen cash management, introduce a repurchase market, and develop capacity. The IMF is providing intermittent follow-up support and advice to strengthen the conduct of monetary policy.

15. **Economic impact of the program.** The program has several important impacts. First, the BTr’s more efficient management of liquid assets has yielded additional fiscal savings over subprogram 1. Second, reforms to treasury operations and the government bond market are expected to not only deepen the bond market but also produce efficiencies that will lower the overall cost of capital in the Philippines. Third, liberalized foreign entry into the banking system is expected to produce efficiencies and more competitive pricing (para. 28).

## B. Impact and Outcome

16. The program’s impact is meeting the government’s targeted investment rate. The outcome will be a deeper nonbank finance sector developed. At the program’s inception in 2015, the government agreed to accomplish nine prior expected actions and 13 policy milestones as the basis for subprogram 2.<sup>15</sup> All nine policy triggers have been fully accomplished. During the processing of subprogram 2, a new prior action reflecting the government’s commitment to liberalize foreign entry to the finance sector was added. Two policy milestones related to the development of unregistered bonds and the ongoing effort to harmonize finance sector taxes were shifted to the post-program partnership framework (P3F) at the government’s request. Two

<sup>10</sup> ADB. 2013. *Technical Assistance to the Republic of the Philippines for Strengthening Treasury’s Liquidity Management*. Manila; ADB. 2014. *Technical Assistance to the Republic of the Philippines for Strengthening Treasury Operations and Capital Market Reform*. Manila.

<sup>11</sup> ADB. 2013. *Technical Assistance to the Republic of the Philippines for Capacity Development to Support Regulation and Oversight at the Insurance Commission*. Manila.

<sup>12</sup> ADB. 2016. *Technical Assistance to the Republic of the Philippines for Strengthening Tax and Fiscal Policy Capacity for Inclusive Growth*. Manila.

<sup>13</sup> ADB. 2015. *Technical Assistance to the Republic of the Philippines for Enhancing ASEAN Capital Market Integration*. Manila.

<sup>14</sup> Development Coordination Matrix (accessible from the list of linked documents in Appendix 2).

<sup>15</sup> Prior actions are considered loan disbursement conditions and policy milestones strengthen the program.

milestones were modified to reflect progress to date and one was completed but dropped. Subprogram 2 contains 21 reform actions (10 prior expected actions representing high impact reforms and 11 policy milestones), which have been accomplished. The changes in the policy matrix and DMF are reflected in the revised design and monitoring framework (Appendix 1).<sup>16</sup>

### C. Outputs

17. **Output 1: Liquidity in the government bond market enhanced.** This output will increase efficiencies to provide additional direct funding for infrastructure, and will provide a foundation for developing the government bond market, itself a foundation of wider capital market development. Accomplishments under subprogram 2 include the following: the BTr institutionalized improvements in cash management achieved under subprogram 1 by reconstituting a cash management committee and implementing enhanced reporting, formal policies and targets, and a standardized reporting template. The BTr also reconstituted a formal investment management process to improve the returns on its invested cash balances. Like the cash management committee, the investment management committee is now supported by a dedicated staff, operations manuals, performance targets, risk limits, and a standardized reporting protocol. Finally, the BTr further reduced the negative cost of carry associated with the bond sinking fund by reducing the fund's size to cover only 2 years of debt service, as opposed to the original 20% of all outstanding debt. All together, these reforms achieved or preserved approximately P5 billion–P7 billion in annual fiscal savings over the life of the reforms.

18. The rapid growth of the corporate bond market over the past 3 years is encouraging. However, much more needs to be done to develop the local currency government bond market to reduce the economy's dependence of bank-dominated financing and to match long-term finance with long-term funding. To support increased debt issuance, and to provide a term structure of interest rates, the government launched an initiative to ensure significant and consistent participation in primary auctions. An evaluation system will rank the participating GSED's (primary dealers) based on participation and activity levels. The BTr designed a "top-ranked dealer" program, which will include responsibilities and, more importantly, incentives, including exclusive market feedback discussions with the BTr and a government securities lending program. Moreover, the BTr continued to defragment the government securities market, and increase its liquidity by reducing the number of outstanding issues to 85 from 118 at the end of subprogram 1 and 204 at the inception of the program. To improve liquidity in the government bond market further, support market making, and encourage alternative trading strategies, the Money Market Association of the Philippines has formally applied to the SEC to establish a self-regulatory organization to govern the repurchase market.

19. To modernize its operations, the BTr institutionalized risk management by operationalizing four previously authorized divisions (e.g., the risk management, fund management, capital market strategy and planning, and debt strategy and planning divisions). Operations manuals, risk limits and structures, and exception reporting have been completed and implemented. In addition, internal treasury risk management systems and the registry of scripless securities were replaced with modern, off-the-shelf vendor products, representing the first such upgrade in approximately 20 years. The risk management system will facilitate the establishment and monitoring of fiscal risk limits. The new scripless registry will eliminate redundancies and foster greater efficiencies in the trading and settlement of securities, and will also lead to the more effective implementation of prior reforms such as trading across the tax and tax-exempt sectors.

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<sup>16</sup> Summary Assessment of Policy Actions under Subprogram 2 (accessible from the list of linked documents in Appendix 13).

20. **Output 2: Long-term savings and investment products encouraged.** This output will increase the supply and demand of long-term investment products. Accomplishments under subprogram 2 include the following. The Insurance Commission has encouraged insurance companies to consolidate through increased capital standards, which will strengthen the sector's financial footing and create economies of scale. The Insurance Commission has also adopted risk-based capital to provide economic incentives to the insurance sector to hold long-duration assets to match their long-duration liabilities. Moreover, the Insurance Commission has begun authorizing insurance companies to purchase infrastructure bonds and PPP-related debt under the revised Insurance Code (a reform under subprogram 1.) To date, insurance companies have been authorized to purchase debt issued by two separate projects supporting the construction of schools (PPP) and a power plant. The government launched the PERA to the public, and the SEC facilitated the introduction of additional fundraising channels by approving the listing rules for PPP companies of the Philippine Stock Exchange.

21. At the same time, the government has moved to reduce costs and improve the legal framework. The SEC submitted for congressional approval the revised Corporation Code, which includes provisions to provide corporations with perpetual existence and enable the creation of "one-person" corporations to extend the benefits and protections of the corporate legal structure to small businesses. To accommodate foreign strategic investors, the revised code has authorized board participation via remote access, and poll voting will be mandated at the request of shareholders. The legislation also strengthens protections against anticompetitive behavior, and allows the SEC to order the dissolution of any corporation found to be engaged in fraudulent practices, tax evasion, or corruption. The proposed code also authorizes the SEC to retain fees, fines, and other charges to fund modernization efforts and attract highly skilled technical staff by increasing staff salaries to mirror the private sector more closely.

22. **Output 3: Market depth and diversity increased.** This output will encourage the introduction of varied business models and products by liberalizing entry to the finance sector and strengthening its governance. Accomplishments under subprogram 2 include the following. Supported by legal reforms enacted under subprogram 1, the government has authorized foreign financial institutions (nine banks and one insurance company) to establish domestic subsidiaries in the Philippines. Unlike previously authorized branches, these banks will enjoy full access to the domestic market and can establish branches at will. The government also strengthened corporate governance by adopting a blueprint covering 2016–2020 that formally confirms the government's intent to adopt global corporate governance practices. The blueprint identifies gaps, communicates ongoing corrective measures, and establishes a phased implementation schedule. The blueprint also incorporates the recommendations of the Asian Roundtable 2003 White Paper on Corporate Governance which cover increased awareness, active enforcement, improved disclosures, capacity development, and protections for minority shareholders.<sup>17</sup>

23. Under the blueprint, the SEC promulgated a new Code of Corporate Governance based on the Organisation for Economic Co-operation and Development's principles. The code incorporates the concepts of "comply or explain" and proportionality, and covers board responsibility, transparency, internal controls, relationships, and duties to shareholders. The code also requires the following four committees: audit, corporate governance, risk oversight, and related party transactions. At least three directors must be independent. Independent directors are now limited to a maximum cumulative term of 9 years and can hold no more than five outside directorships. This change brings the Philippines in line with regional peers such as Malaysia and Singapore. By 2015, one quarter of the 609 independent directors of publicly listed companies in

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<sup>17</sup> Organisation for Economic Co-operation and Development. 2003. *White Paper on Corporate Governance*. Paris.

the Philippines had served more than 10 years, and 18 had served for 20 years consecutively. The government also identified specific revisions to the Securities Regulation Code needed to enable the government to join the International Organization of Securities Commissions' multilateral memorandum of understanding (MMOU). These changes include granting the SEC subpoena powers, and the power to respond directly to requests for information.

24. **Post-program partnership framework.** While nonbinding, the P3F provides for a structured dialogue over the medium term between ADB and the government, as well as a framework for continuing TA support. Under this framework, ADB will support the government's efforts to develop a capital market blueprint and to provide an enabling environment. The BTr will assume greater administrative control over the wholesale government bond market, improve its operations, and strengthen risk management. The "top-ranked dealer" program will be formalized and the development of a working repurchase market is anticipated within this timeframe. The SEC will continue pursuing legislative and regulatory changes, including amendments to the Securities Regulation Code and the possible adoption of a collective investment schemes law. The government will remove tax distortions that favor bank lending over capital markets, introduce additional long-term financing instruments, and launch the PERA to the wider market. Finally, the government will process revisions to the legal framework to join the International Organization of Securities Commissions' MMOU. Participation in the MMOU will increase cross-border investments and strengthen the quality of capital market supervision.

#### **D. Development Financing Needs**

25. The government has requested a regular loan of \$300 million from ADB's ordinary capital resources to help finance the program. The loan will have a 15-year term, including a 3-year grace period, 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 loan will be disbursed in accordance with ADB's *Loan Disbursement Handbook* (2015, as amended from time to time). The loan size is based on the Philippines' financing needs, the development impact of the policy reform package, and development spending arising from the reform. In 2017, the government's total gross borrowing requirement is estimated at \$12.6 billion, a fifth of which will be from foreign borrowing. The foreign borrowing will comprise government bonds estimated at \$477.1 million, and official development assistance in the form of program loans estimated at \$1.40 billion.

#### **E. Implementation Arrangements**

26. The Department of Finance (DOF) is the executing agency, and the BTr and SEC are the implementing agencies. The implementation period is July 2015–June 2017. A steering committee chaired by the DOF with the implementing agencies as members will oversee the program's implementation.<sup>18</sup> The steering committee will meet semiannually and, if needed, on an ad hoc basis to monitor the continuing implementation of reforms under the P3F.

### **III. TECHNICAL ASSISTANCE**

27. The government asked ADB to provide transaction TA to support reforms specified under the program's P3F. The TA will have the same impact and outcome, and will contain two outputs. The first will prepare the government's first detailed implementation plan covering 2017–2022 to

<sup>18</sup> 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.

guide the stakeholders' reform priorities, and the second will provide support to complete specific key technical reforms called for in the P3F and necessary to develop a well-functioning domestic currency bond market. The BTr will be the executing agency, and the BTr and SEC will be the implementing agencies. The TA is estimated to cost \$550,000, of which \$500,000 will be financed on a grant basis by ADB's Technical Assistance Special Fund (TASF-other sources). The TA will be implemented from November 2017 to November 2020, and will include a total of 20 person-months of consulting services. ADB will engage the consultants in accordance with ADB Procurement Policy and Procurement Regulations for ADB Borrowers (2017).<sup>19</sup>

#### IV. DUE DILIGENCE

##### A. Economic and Financial

28. A growing body of empirical research produces a remarkably consistent narrative, namely, that finance sector development exerts a first-order impact on long-run economic growth.<sup>20</sup> On a project-specific level, the program generates recurrent quantifiable benefits with a net present value of \$437 million, supplementing the \$1.2 billion in net benefits achieved under subprogram 1. These benefits reflect the continuity of reforms through the programmatic approach, but still far exceed the program's estimated costs. The present value of gross benefits is \$653 million accrued primarily from enhancements to the primary and secondary government bond markets. In addition, foreign entry into the banking sector is expected to produce significant efficiencies through increased competition, more competitive pricing, and a wider array of business models. The present value of costs is approximately \$216 million, representing forgone tax revenue, an increase in the SEC's budget, and administrative and compliance expenses.<sup>21</sup>

##### B. Governance

29. The government continues to strengthen its public financial management (PFM). The 2017 Public Expenditure and Financial Accountability assessment confirmed that three of the seven core areas (transparency, policy-based budgeting, and asset-liability management) have improved and are now considered strong.<sup>22</sup> Areas of weakness identified in the assessment—budget credibility, predictability and control in budget execution, and external scrutiny and audit—are being actively addressed. Moreover, the proposed Public Financial Accountability Act will help to enforce accountability in PFM by strengthening congressional control and oversight, requiring an integrated PFM system, and increasing budget transparency and participation. The government continues to pursue a comprehensive, results-based anticorruption plan, and to increase the capacity of the Office of the Ombudsman and the justice sector. ADB's Anticorruption Policy (1998, as amended to date) was explained to and discussed with the government.

##### C. Poverty and Social

30. 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 increasing fiscal space for social expenditures, and by encouraging the provision of long-term, peso-denominated financing to support infrastructure development. Increased infrastructure investment will lead to increased employment and, in turn,

<sup>19</sup> Attached Technical Assistance Report (accessible from the list of linked documents in Appendix 2).

<sup>20</sup> Ross Levine, Sara Zervos, *The American Economic Review*, Volume 88, No. 3 (June 1998) pp. 637-558, and Marco Arena 2008. *The Journal of Risk and Insurance*, Volume 75. No. 4, pp. 921-946.

<sup>21</sup> Program Impact Assessment (accessible from the list of linked documents in Appendix 2).

<sup>22</sup> Public Financial Management Assessment (accessible from the list of linked documents in Appendix 2).

increased government tax revenues. While the program does not focus directly on financial inclusion, reforms to encourage retirement savings and policy improvements in the insurance sector provide an entry point for ADB's planned future engagement in this area.<sup>23</sup>

#### **D. Safeguards**

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

#### **E. Risks and Mitigating Measures**

32. The program has four substantial risks.<sup>24</sup> National risks include weaknesses in the PFM system and corruption. To mitigate these risks, the government, with the support of ADB and other development partners in the Philippines Development Forum, has strengthened the budget review process, reduced the number and size of special purpose funds, and mandated increased transparency as a precondition to accessing public funds. To reduce corruption risks, the Good Governance and Anti-Corruption Cabinet Cluster of the Philippines implemented a comprehensive and results-based anticorruption action plan. In terms of contextual risks, an inadequate budget to upgrade financial infrastructure and strengthen regulatory capabilities is a substantial risk. The Association of Southeast Asian Nations (ASEAN) integration efforts might be disrupted by uneven reform progress across ASEAN member states. Mitigation measures have been adopted and the government has shown commitment to ASEAN integration through the liberalization of foreign entry into the financial services.

### **V. ASSURANCES**

33. The government and the DOF have assured ADB that implementation of the project 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 project administration manual and loan documents.

### **VI. RECOMMENDATION**

34. I am satisfied that the proposed policy-based loan would comply with the Articles of Agreement of the Asian Development Bank (ADB) and recommend that the Board approve the loan of \$300,000,000 to the Republic of the Philippines for subprogram 2 of the Encouraging Investment through Capital Market Reforms Program, from ADB's ordinary capital resources, in regular terms, 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

31 October 2017

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<sup>23</sup> Summary Poverty Reduction and Social Strategy (accessible from the list of linked documents in Appendix 2).

<sup>24</sup> Risk Assessment and Risk Management Plan (accessible from the list of linked documents in Appendix 2).

## DESIGN AND MONITORING FRAMEWORK

<b>Impact the program is aligned with:</b> The Government of the Philippines' targeted investment rate achieved. (Philippine Development Plan, 2017–2022) <sup>a</sup>			
<b>Results Chain</b>	<b>Performance Indicators with Targets and Baselines</b>	<b>Data Sources and Reporting Mechanisms</b>	<b>Risks</b>
<p><b>Outcome</b> A deeper nonbank finance sector developed</p>	<p>By 2018:</p> <p>a. Corporate bonds have increased to at least 8.0% of gross domestic product. (2012 baseline: 4.9%)</p> <p>b. At least one domestic currency project bond has been issued. (2012 baseline: 0 [a project bond had not yet been issued])</p> <p>c. Annual trading volume of government bonds has increased by at least 25%, and at least one government benchmark security has been supported by two-way firm quotes. (2012 baseline: annual trading volume = \$156 billion, and 0 [no securities were supported by two-way quotes])</p> <p>d. The number of PERA accounts opened has exceeded 100,000, with aggregate balances greater than P14 billion. (2012 baseline: NA [the PERA had not yet been launched])</p> <p>e. Foreign-owned domestic financial institutions accounted for at least 10% of the banking sector's total assets. (2012 baseline: 0%)</p>	<p>a. AsianBondsOnline and public news releases</p> <p>b. AsianBondsOnline and public news releases</p> <p>c. AsianBondsOnline, public news releases, Bureau of the Treasury website, and consultant reports</p> <p>d. Financial Sector Forum reports</p> <p>e. Bangko Sentral ng Pilipinas website</p>	<p>Corruption derails the implementation of reforms.</p> <p>Public financial management weakens.</p> <p>ASEAN integration is disrupted by uneven progress or national priorities.</p>
<p><b>Outputs</b> 1. Liquidity in the government bond market enhanced</p>	<p><b>By 2017: Subprogram 2</b></p> <p>1a. Primary dealer system with formal privileges and responsibilities has been established. 2012 baseline: NA [primary dealer system not established])</p> <p>1b. The number of government bonds issued declined by at least 20%. (2012 baseline: 118)</p> <p>1c. The number of repurchase transactions, based on the GMRA, increased to at least 100 per year. (2012 baseline: NA [GMRA repurchase transactions</p>	<p>1a. Bureau of the Treasury website and consultant reports</p> <p>1b. Bureau of the Treasury internal reports</p> <p>1c. Bureau of the Treasury internal reports and Bloomberg</p>	<p>The budget is inadequate to fund capital market infrastructure upgrades and regulatory action plans.</p>

Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting Mechanisms	Risks
<p>2. Long-term savings and long-term investment products encouraged</p> <p>3. Market depth and diversity increased</p>	<p>do not yet exist])</p> <p><b>By 2020: P3F-TA</b>  1d. Capital market development plan released and adopted. (2017 baseline: NA [no plan completed or adopted])</p> <p>1e. SRO for the OTC government bond market established. (2017 baseline: (NA [no SRP established])</p> <p><b>By 2017: Subprogram 2</b>  2a. Number of professionally managed exchange-traded funds listed on the Philippine Stock Exchange increased to three, of which at least one was a fixed-income exchange-traded fund (including project bonds) (2012 baseline: 1 professionally managed exchange-traded fund, and 0 fixed-income exchange-traded funds)</p> <p>2b. The PERA was declared operational with the approval of a cash custodian and a securities custodian bank(s). (2012 baseline: NA [no custodians approved])</p> <p>2c. The insurance commissioner authorized at least one alternative investment modality to support project finance or public-private partnerships. (2012 baseline: NA [no alternative investment modalities authorized])</p> <p><b>By 2017: Subprogram 2</b>  3a. The Philippines identifies impediments to joining IOSCO's Annex A and proposes a legislative solution. (2012 baseline: NA [The Philippines has not identified or proposed specific legislative solutions to join Annex A])</p>	<p>1d. Press release and consultant reports</p> <p>1e. SEC approval memorandum, press release, and consultant reports</p> <p>2a. Philippine Stock Exchange website and annual report</p> <p>2b. Financial Sector Forum reports and consultant reports</p> <p>2c. Website and annual report of the insurance commissioner</p> <p>3a. Published news reports, IOSCO website, SEC website, and ACMF website</p>	

Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting Mechanisms	Risks
	<p>3b. The Philippines placed at least five publicly listed companies in the top 50 ASEAN Corporate Governance Scorecard rankings. (2012 baseline: 0)</p> <p>3c. The insurance commissioner approved at least three mergers of life and/or nonlife insurance companies within the insurance sector. (2012 baseline: NA [no mergers approved])</p>	<p>3b. ACMF website</p> <p>3c. Website and annual report of the insurance commissioner</p>	
<p><b>Key Activities with Milestones:</b> Please refer to the Policy Matrix in Appendix 4.</p>			
<p><b>Inputs</b> <b>Asian Development Bank:</b> Subprogram 2: \$300,000,000 (ordinary capital resources) Technical Assistance: \$500,000 (grant) (TASF-other sources)</p>			
<p><b>Assumptions for Partner Financing:</b> Not applicable.</p>			

ACMF = ASEAN Capital Markets Forum, ASEAN = Association of Southeast Asian Nations, GMRA = Global Master Repurchase Agreement, IOSCO = International Organization of Securities Commissions, NA = not applicable, OTC = over-the-counter, P3F = post-program partnership framework, PERA = Personal Equity and Retirement Account, SRO = self-regulatory organization, SEC = Securities and Exchange Commission, TA = technical assistance, TASF = technical assistance special funds.

<sup>a</sup> Government of the Philippines, National Economic and Development Authority. 2017. *Philippine Development Plan, 2017–2022*. Manila. <http://www.neda.gov.ph/2017/07/26/philippine-development-plan-2017-2022/>.

### **LIST OF LINKED DOCUMENTS**

<http://www.adb.org/Documents/RRPs/?id=48427-002-3>

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

### **Supplementary Documents**

11. Program Impact Assessment
12. Public Financial Management Assessment
13. Summary Assessment of Policy Actions under Subprogram 2

## DEVELOPMENT POLICY LETTER



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

### DEVELOPMENT POLICY LETTER

October 18, 2017

**Mr. TAKEHIKO NAKAO**  
 President  
 Asian Development Bank  
 Manila, Philippines

**SUBJECT: Encouraging Investment through Capital Market Reforms Program,  
 Subprogram 2 (EICMR2)**

Dear **Mr. NAKAO**:

On behalf of the Government of the Philippines (Government), 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.

This development policy letter outlines our reform program, and our interest in obtaining financial assistance from ADB. It highlights the Government's efforts to strengthen the domestic capital market and increase the availability of long-term finance thereby accelerating investment in infrastructure. The Government embarked on reform actions that would enhance government bond market depth and liquidity, encourage long-term savings and long-term investment products, and increase market depth and diversity.

In the attached policy matrix, we have identified specific reform initiatives which we sought support from the ADB through the Encouraging Investment through Capital Market Reforms (EICMR) Program. The first subprogram (EICMR1) approved by the ADB in November 2015 achieved significant milestones and laid the foundation for the seamless progression of reforms towards EICMR Subprogram 2 (EICMR2) implemented from July 2015 to June 2017. EICMR2 is consistent with the thrusts and strategies under the Philippine Development Plan (PDP) 2017-2022 specifically on accelerating infrastructure development to address the country's huge infrastructure gap.

Through the first subprogram of the EICMR, the Government provided the groundwork for increased trading volumes and liquidity in the government debt market. The Bureau of the Treasury (BTr) strengthened its control of cash and adopted measures to build a reliable yield curve which became the basis for corporate and project bonds issuance. The size of the Bond Sinking Fund was also reduced to increase fiscal space. In addition, the Government implemented measures to encourage more domestic participation in the finance sector, with an emphasis on contractual savings. The Personal Equity and Retirement Account (PERA), which is the physical infrastructure needed to support the introduction of a tax-deferred long-term retirement savings platform, was completed. Finally, the Government introduced reforms to encourage greater investment from a more diversified group of investors, including actions taken under the ASEAN Economic Blueprint to increase foreign participation in all domestic financial market subsectors.

Under subprogram 2, the Government continued and deepened these reforms by institutionalizing cash and investment management. The size of the BSF was further reduced resulting to additional savings. The BTr also developed a primary dealer system identifying a basic set of responsibilities and privileges in order to encourage significant and sustained participation in primary auctions. Moreover, the Government provided a framework for an active repurchase market to encourage market-making and 2-way price quotes. Further, the BTr installed a new treasury management system and registry of scripless securities to upgrade and modernize internal operations. These systems will significantly improve the efficiency and reliability of clearing and settlement systems.

To encourage the development of long-term savings and investment, PERA system was launched and opened to the public. The issuance and subsequent purchase of alternative instruments to fund infrastructure was also authorized by the Government. A group within the Department of Finance (DOF) was also created to develop a comprehensive tax reform program that will include the harmonization of taxes across financial subsectors. Furthermore, efforts to reduce financial costs of capital market transactions have continued and the Securities and Exchange Commission (SEC) submitted the revised Corporation Code to Congress. The revised Code introduces perpetual corporate existence and registration; electronic submission of articles of incorporation including amendments thereto, financial statements, and other corporate disclosures; and strengthened anti-corruption provisions.

Finally, subprogram 2 included efforts by the Insurance Commission to encourage consolidation through increased required minimum capitalization and introduction of risk-based capital standards. Adoption of risk-based capital will provide a financial incentive for insurance companies to purchase long-duration assets to reduce mismatch between the present value of their asset and liability cash flows. Substantial progress is also already achieved in terms of identifying specific legislative actions required to begin participating more fully in ASEAN cross-border investment initiatives. A corporate governance roadmap was issued along with a new code of corporate governance for publicly-listed companies to bring Philippine standards in line with those of the OECD.

In order to assist in the implementation of continuing capital market reforms, the Government of the Philippines is requesting financing in an amount of USD300 million for EICMR2. Loan proceeds is expected to fill the Government's budget deficit which will fund operations and priority reforms of the Government including improvement of the investment climate and further development of infrastructure consistent with the objectives of EICMR.

In closing, the Government reiterates its commitment to enhance the social fabric, reduce inequality, and increase potential growth through accelerated infrastructure development. The Government will continue to work in coordination with the ADB and other development partners to pursue reforms necessary towards this endeavor. To assist continuation of recent, successful efforts on capital market development, we look forward to sustained policy dialogue with the ADB through the Post-Program Partnership Framework.

Very truly yours,

  
CARLOS G. DOMINGUEZ  
Secretary of Finance



## POLICY MATRIX

Outputs	Subprogram 1 Accomplishments (Policy triggers in bold) June 2013 to June 2015	Subprogram 2 (Policy triggers in bold) July 2015 to June 2017	Post-program Partnership Framework 2017 to 2020
<b>Output 1: Government Bond Market Depth and Liquidity Enhanced</b>			
<p><b>1.1 Money market developed through improved cash management.</b></p> <ul style="list-style-type: none"> <li>○ Government of Australia, Philippines-Australia Public Financial Management Program</li> <li>○ ADB TA, Strengthening Treasury's Liquidity Management (TA 8495)</li> </ul>	<p><i>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:</i></p> <ol style="list-style-type: none"> <li>1. <b>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.</b></li> <li>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.</li> <li>3. <b>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.</b></li> </ol>	<p><i>The BTr continues to improve cash management and forecasts. These measures will include:</i></p> <ol style="list-style-type: none"> <li>1. <b>The BTr reconstituted and formalized a formal cash flow committee, and improved the reliability of cash management and forecasts which enabled more efficient fund raising.</b></li> <li>2. To institutionalize improved cash management, the BTr operationalized the investment committee by adopting a formal investment policy manual and risk limits and a regular reporting protocol.</li> <li>3. <b>The BTr continued to restructure and reduce the size of the BSF to cover the larger of a rolling 2 years of debt service or 10% of outstanding debt, yielding additional savings of P2 to P3</b></li> </ol>	<p><i>The BTr further consolidates major accounts into the TSA and sets investment performance standards.</i></p> <p>Medium-term results:</p> <ul style="list-style-type: none"> <li>• Cash flow forecasts are incorporated into the auction process, curtailing over-issuance of bonds and enabling issuance of treasury bills.</li> </ul> <p>Longer-term results:</p> <ul style="list-style-type: none"> <li>• Organized OTC government bond market is implemented</li> </ul>

Outputs	Subprogram 1 Accomplishments (Policy triggers in bold) June 2013 to June 2015	Subprogram 2 (Policy triggers in bold) July 2015 to June 2017	Post-program Partnership Framework 2017 to 2020
		billion a year in associated negative cost of carry, and lowering the government's overall debt financing requirements by P252 billion over 3 years.	
<p><b>1.2 Trading volumes of government debt increased.</b></p> <ul style="list-style-type: none"> <li>○ IMF/World bank, diagnostic of the government bond market</li> <li>○ ADB TA, Strengthening Treasury's Liquidity Management (TA 8495)</li> <li>○ ADB TA, Strengthening Treasury Operations and Capital Market Reform (TA 8718)</li> <li>○ U.S. Treasury Resident Advisor program</li> </ul>	<p><i>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:</i></p> <p>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.</p> <p>5. <b>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.</b></p>	<p><i>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.</i></p> <p>4. The BTr encouraged increased trading volumes by further reducing and consolidating outstanding government bond issues to 85 from 118 in subprogram 1.</p> <p>5. <b>To encourage significant and sustained participation in primary auctions, the BTr designed an evaluation system for top-ranked dealers with a set of responsibilities and privileges, including market soundings, participation in a web-based auction system and the ability to administer sponsor accounts.</b></p>	<p><i>The BTr achieves increased liquidity in the government bond market which supports a yield curve based reported trades of highly liquid benchmark securities.</i></p> <p>Medium-term results:</p> <ul style="list-style-type: none"> <li>• Number of primary dealers rationalized in line with international best practices.</li> </ul> <p>Longer-term results:</p> <ul style="list-style-type: none"> <li>• Continuous buildup of sizeable benchmarks.</li> <li>• An active repo market utilizing GMRA-based repurchase agreements.</li> <li>• Two-way prices are available.</li> </ul>

Outputs	Subprogram 1 Accomplishments (Policy triggers in bold) June 2013 to June 2015	Subprogram 2 (Policy triggers in bold) July 2015 to June 2017	Post-program Partnership Framework 2017 to 2020
	<p>6. <b>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.</b></p>	<p>6. <b>To improve liquidity in the government bond market, support market-making, and encourage alternative trading strategies, the Money Market Association of the Philippines applied to the SEC to form a self-regulatory organization to support the introduction of a GMRA based repo market for the inter-dealer market.</b></p>	
<p><b>1.3 Treasury operations enhanced.</b></p> <ul style="list-style-type: none"> <li>○ ADB TA, Strengthening Treasury's Liquidity Management (TA 8495)</li> <li>○ ADB TA, Strengthening Treasury Operations and Capital Market Reform (TA 8718)</li> <li>○ Philippines CFA Society</li> </ul>	<p><i>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:</i></p> <p>7. <b>The BTr reorganized and established: Risk Management Division; Fund Management Division; Capital Market Strategy and Planning Division; and Debt Strategy and Planning Division.</b></p>	<p><i>The BTr continues to upgrade its internal operations to further reduce costs, enhance risk management and strengthen relationships with investors and stakeholders.</i></p> <p>7. <b>The BTr institutionalized risk management by operationalizing four divisions (e.g., risk management division, fund management division, capital market strategy and planning division, and debt strategy and planning division) by completing and distributing operations manuals, risk limits and structures, and exception reporting.</b></p>	<p><i>The BTr fully upgrades infrastructure and capacity, achieving operational and fiscal efficiencies.</i></p> <p>Medium-term results:</p> <ul style="list-style-type: none"> <li>• Stronger risk management with enhanced public disclosures regarding treasury operations.</li> </ul>

Outputs	Subprogram 1 Accomplishments (Policy triggers in bold) June 2013 to June 2015	Subprogram 2 (Policy triggers in bold) July 2015 to June 2017	Post-program Partnership Framework 2017 to 2020
<ul style="list-style-type: none"> <li>○ Govt of Australia, Philippines-Australia Public Financial Management Program</li> <li>○ U.S. Treasury Resident Advisor program</li> <li>○ JICA TA, Capacity Building for Capital Market Initiatives</li> </ul>	<p>8. The BTr awarded a contract to modernize its core operations, and to improve data availability.</p>	<p>8. The BTr further strengthened middle office risk management by installing a modern, vendor supplied treasury management system (Trasset International).</p> <p>9. <b>The BTr increased market efficiency by replacing its Windows 95-based ROSS with a modern, off-the-shelf Montran registry of scripless securities (NRoss).</b></p> <p>10. To strengthen capacity, the BTr has formalized the use of the Treasury Certification Program for new staff to provide a structured introduction to treasury operations.</p>	<p>Longer-term results:</p> <ul style="list-style-type: none"> <li>• Organized OTC government bond market is implemented</li> </ul>
<b>Output 2 –Long Term Savings and Long Term Investment Products Encouraged.</b>			
<p><b>2.1 Enabling regulatory environment provided.</b></p> <ul style="list-style-type: none"> <li>○ ADB TA, Capacity Development of Financial Regulators (TA8038)</li> </ul>	<p><i>The government has implemented legal and regulatory measures to foster the development of long-term savings and investments. Accomplishments included:</i></p> <p>9. <b>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.</b></p>	<p><i>The government will continue to encourage the development of long-term savings and investment.</i></p> <p>11. To increase the supply of long-term financing, the Insurance Commission (IC) has authorized insurance companies to purchase infrastructure bonds with two deals approved to</p>	<p><i>The contractual savings sector demonstrates intermediation of long-term savings.</i></p> <p>Medium-term results:</p> <ul style="list-style-type: none"> <li>• Outstanding corporate debt increases to 8% of GDP and the SEC</li> </ul>

Outputs	Subprogram 1 Accomplishments (Policy triggers in bold) June 2013 to June 2015	Subprogram 2 (Policy triggers in bold) July 2015 to June 2017	Post-program Partnership Framework 2017 to 2020
<ul style="list-style-type: none"> <li>○ ADB TA, Capacity Development to Support Regulation and Oversight at the Insurance Commission (TA 8608)</li> <li>○ ADB TA, Strengthening Treasury Operations and Capital Market Reform (TA 8718)</li> </ul>	<p><b>prudent man), and delivery channels (e.g. banc-assurance).</b></p> <p>10. <b>The government further encouraged long-term savings by installing the physical infrastructure to support the launch of tax-deferred personal retirement accounts (PERA).</b></p> <p>11. The Securities and Exchange Commission (SEC), in conjunction with the Philippine Stock Exchange (PSE), encouraged professional management of collective investments by launching Exchange Traded Funds (ETFs).</p>	<p>date covering a school project (PPP) and a power plant.</p> <p>12. <b>To encourage long-term savings, the government launched PERA supported by vetted and licensed account administrators.</b></p> <p>13. To encourage additional financing of infrastructure projects, the SEC published listing rules for PPP companies and extended the effectivity of financial statements to 180 days in line with the harmonized ASEAN disclosure standards.</p>	<p>authorizes a public issuance of a project bond.</p> <ul style="list-style-type: none"> <li>• Additional Exchange Traded Funds introduced including at least one fixed income ETF.</li> <li>• Implementation of PERA generates at least 100,000 retirement accounts.</li> </ul> <p>Longer-term results:</p> <ul style="list-style-type: none"> <li>• The SEC supports the passage of the “Collective Investment Schemes Law”.</li> </ul>
<p><b>2.2 Costs of financial transactions reduced.</b></p> <ul style="list-style-type: none"> <li>○ ADB TA, Capacity Development of Financial Regulators (TA 8038)</li> </ul>	<p><i>The government encouraged capital market development by reducing transaction costs. Accomplishments included:</i></p> <p>12. <b>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</b></p>	<p><i>The government continues to rationalize and reduce transaction costs.</i></p>	<p>The government achieves measurable results in easing business and capital market constraints.</p> <p>Medium-term results:</p> <ul style="list-style-type: none"> <li>• The SEC issues regulations to implement the revised Corporation Code and continues</li> </ul>

Outputs	Subprogram 1 Accomplishments (Policy triggers in bold) June 2013 to June 2015	Subprogram 2 (Policy triggers in bold) July 2015 to June 2017	Post-program Partnership Framework 2017 to 2020
<ul style="list-style-type: none"> <li>○ ADB TA, Capacity Development to Support Regulation and Oversight at the Insurance Commission (TA 8608)</li> <li>○ ADB TA, Strengthening Treasury Operations and Capital Market Reform (TA 8718)</li> <li>○ U.S. Treasury Resident Advisor program</li> <li>○ JICA TA Capacity Support Study for the Introduction of XBRL in the Securities Exchange Commission (SEC) in the Philippines</li> </ul>	<p><b>(effectively less than 1%) depending on the sum insured.</b></p> <p>13. <b>The government exempts DST of 1 peso for every 200 pesos of face value on GMRA based repos to encourage growth in the market.</b></p> <p>14. SEC reduced regulatory costs by processing 70% of the total initial applications for the certificates of business registration in one day through the green lane.</p>	<p>14. The SEC commenced procurement of the XBRL based electronic submission of financial statements and other corporate disclosures.</p> <p>15. <b>SEC submitted the revised Corporation Code to Congress with provisions to reduce friction costs, strengthen supervision and improve the SEC's funding.</b></p>	<p>to streamline business licensing.</p> <ul style="list-style-type: none"> <li>• The government enacts reforms to promote tax neutrality between financial sub-sectors.</li> </ul> <p>Longer-term results:</p> <ul style="list-style-type: none"> <li>• The SEC supports enactment of the revised Securities Regulation Code</li> <li>• The government issues a master plan to achieve tax neutrality in the financial markets.</li> </ul>
<b>Output 3 – Market depth and diversity increased.</b>			
<p><b>3.1 Barriers to entry eased.</b></p> <ul style="list-style-type: none"> <li>○ ADB TA, Capacity Development of Financial Regulators (TA 8038)</li> </ul>	<p><i>Under the ASEAN Community Blueprint, the government reduced barriers to encourage diversified business models and cross-border investment flows. Accomplishments included:</i></p> <p>15. <b>The government allows foreign control of financial institutions in all sub-sectors which increases competition, capacity, and the diversity of market participants.</b></p>	<p><i>The government continues to encourage diversified business models and cross-border investment flows.</i></p> <p>16. <b>The government implements Republic Act 10641, and BSP Circular No.858 by authorizing private foreign financial</b></p>	<p><i>The government achieves substantial progress in meeting the financial sector related goals of the ASEAN Community Blueprint.</i></p> <p>Medium-term results:</p> <ul style="list-style-type: none"> <li>• The government approves entry of at</li> </ul>

Outputs	Subprogram 1 Accomplishments (Policy triggers in bold) June 2013 to June 2015	Subprogram 2 (Policy triggers in bold) July 2015 to June 2017	Post-program Partnership Framework 2017 to 2020
<ul style="list-style-type: none"> <li>○ ADB TA, Promoting an interlinked ASEAN Capital Market (TA 7576)</li> <li>○ ADB TA, Enhancing Association of Southeast Asian Nations Capital Market Integration (TA 8905)</li> </ul>	<p>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.</p> <p>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.</p>	<p><b>institutions to enter the domestic market.</b></p> <p>17. The government encouraged the consolidation in the insurance sector by increasing the required minimum capitalization and introduced the risk based capital standards.</p> <p>18. SEC and IOSCO identified and agreed on the specific legislative provisions needed to become a signatory of the IOSCO multilateral memorandum of understanding concerning consultation and cooperation and the exchange of information.</p>	<p>least 1 foreign, ASEAN domiciled financial institution.</p> <p>Longer-term results:</p> <ul style="list-style-type: none"> <li>• The government receives increased investment flows through the ASEAN via collective investment schemes and cross-border public offerings of debt and equity.</li> </ul>
<p><b>3.2 Corporate governance strengthened.</b></p>	<p><i>The government strengthened corporate governance to increase investor confidence thereby attracting a wider and more diversified group of investors.</i></p> <p>18. The SEC: (i) creates Corporate Governance &amp; Finance Department;</p>	<p><i>The government continues to strengthen corporate governance to increase investor confidence thereby attracting a wider and more diversified group of investors.</i></p> <p>19. <b>The SEC strengthened corporate governance standards and encouraged foreign investment by</b></p>	<p><i>The government achieves measurable success in strengthening investor confidence.</i></p> <p>Medium-term results:</p> <ul style="list-style-type: none"> <li>• Philippines achieves parity with regional</li> </ul>

Outputs	Subprogram 1 Accomplishments (Policy triggers in bold) June 2013 to June 2015	Subprogram 2 (Policy triggers in bold) July 2015 to June 2017	Post-program Partnership Framework 2017 to 2020
<ul style="list-style-type: none"> <li>○ ADB TA, Promoting an interlinked ASEAN Capital Market (TA 7576)</li> <li>○ ADB TA, Enhancing Association of Southeast Asian Nations Capital Market Integration (TA 8905)</li> </ul>	<p>(ii) issues Template for Publically-Listed Companies' Websites; and (iii) issues Guidelines mandating all listed companies to submit Annual Corporate Governance Reports.</p> <p>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.</p> <p>20. The SEC introduced an automated market surveillance system for the equities market and begins to strengthen surveillance of the fixed income market.</p>	<p><b>issuing, in conjunction with the PSE, a corporate governance roadmap covering 2016–2020 and subsequently issuing a Code of Corporate Governance for publicly listed companies.</b></p> <p>20. The SEC through the ICD completed the ASEAN corporate governance scorecard assessment for 2014-2015.</p> <p>21. To build market confidence, the SEC established surveillance of the fixed income market.</p>	<p>peers as measured through the ASEAN corporate governance scorecard.</p> <p>Longer-term results:</p> <ul style="list-style-type: none"> <li>• Quality of capital market supervision improves as measured by independent evaluations.</li> </ul>

ADB = Asian Development Bank, ASEAN = Association of Southeast Asian Nations, BSF = bond sinking fund, BSP = Bangko Sentral ng Pilipinas, BTr = Bureau of the Treasury, DST = documentary stamp tax, ETF = exchange trade funds, GMRA = Global Master Repurchase Agreement, IC = Insurance Commission, IOSCO = International Organization of Securities Commissions, ICD = Institute of Corporate Directors, JICA = Japan International Cooperation Agency, MMOU = multilateral memorandum of understanding, PERA = Personal Equity and Retirement Account, PPP = public-private partnership, PSE = Philippine Stock Exchange, PT = premium tax, SEC = Securities and Exchange Commission, SRO = self-regulatory organization, TA = technical assistance, XBRL = eXtensible business reporting language.