# Program Information Document (PID)

Concept Stage | Date Prepared/Updated: 18-May-2022| Report No: PIDC33983

## BASIC INFORMATION

### A. Basic Project Data

| Country | Project ID | Project Name | Parent Project ID (if any) |
|---|---|---|---|
| Philippines | P175360 | Philippines Second Financial Sector Reform Development Policy Financing (P175360) | P175008 |
| **Region** | **Estimated Board Date** | **Practice Area (Lead)** | **Financing Instrument** |
| EAST ASIA AND PACIFIC | Dec 20, 2022 | Finance, Competitiveness and Innovation | Development Policy Financing |
| **Borrower(s)** | **Implementing Agency** | | |
| Republic of the Philippines | Department of Finance | | |

**Proposed Development Objective(s)**

The program development objective of this programmatic operation is to support financial sector reforms that will assist the Government of the Philippines in achieving a resilient, inclusive and sustainable financial sector.

**Financing (in US$, Millions)**

**SUMMARY**

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| **Total Financing** | 200.00 |

**DETAILS**

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| **Total World Bank Group Financing** | 200.00 |
| World Bank Lending | 200.00 |

Decision

The review did authorize the preparation to continue

### B. Introduction and Context

Country Context

1. **This Program Document proposes a Second Development Policy Loan (DPL) for the Government of the Philippines (GOP) for US$ 200 million.** The proposed operation is the second of a programmatic loan series of two operations supporting the GOP in achieving a resilient, inclusive, and sustainable financial sector.

2. **This operation builds on the reform agenda initiated under the first financial sector DPL and focuses on continuity of reform implementation that will span across the forthcoming political transition.** The three pillars of the program aim to support the GOP in i) strengthening financial sector stability, integrity, and resilience, ii) expanding financial inclusion for individuals and firms, and iii) catalyzing disaster risk and sustainable finance. Overall strong implementation progress has been achieved to date across these reform pillars. These include progress on the implementation of amendments to the Anti-Money-Laundering Act to address deficiencies in the Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT) regime based on the Financial Action Task Force recommendations; approval of the Financial Consumer Protection Act by the Senate and the House of Representatives aimed at building consumer trust in the financial sector; and approval of digital banking licenses for six financial institutions following the adoption of a conducive regulatory framework. Moreover, universal and commercial banks are progressing well on integration of climate risks and transition plans to adopt the Bangko Sentral ng Pilipinas (BSP) Sustainable Finance Framework.

3. **The impact of COVID-19 continues to weigh heavily on medium-term inclusive growth prospects.** It has led to deterioration in macroeconomic buffers amid the worst recession in the country's post-war history, dampening the prospect of additional policy support. The crisis has eroded human capital, causing potential long-term economic scarring through loss of lives, disruption in education, and hunger and malnutrition, especially among the poor. Without mitigating measures, the country will face weaker long-term growth potential at 5.7 percent between 2020 and 2029, from more than 6.0 percent in the preceding decade. In 2021, the economy expanded by 5.6 percent year-on-year from a contraction of 9.6 percent in 2020 and is projected to grow by 5.7 percent in 2022. Recovery, however, hinges on the return of domestic demand with declining COVID-19 cases and wider reopening. This would compensate for the weak external environment, reeling from a global growth deceleration, higher inflation, and geopolitical turmoil. The poverty rate is estimated to have increased by around 2.6 percentage points between 2018 and 2021[1] due to income loss and smaller inflows of remittances. With the rebound of economic growth in 2021-2024, poverty is estimated to start a steady, though slow decline and will remain much higher than its pre-pandemic level.

4. **The financial system, while smaller than the financial systems of Asian peers, has broadly withstood the impact of COVID-19, but it faces downside risks due to high interconnectedness with nonfinancial corporates and volatile external conditions.** In terms of financial depth, access, and efficiency, the Philippines' financial development is above average among emerging markets but on the lower side among emerging Asian economies. The banking sector's overall capital adequacy ratio remains stable at about 17 percent. On asset quality, the banking system's gross non-performing loan (NPL) ratio rose to 4.1 percent in end-January 2022 from 2.0 percent at the end of 2019. The key risks to financial stability arise from significant interlinkages between banks and nonfinancial corporates. Mixed conglomerate ownership structures and large lending exposures could be negatively impacted due to the impact of the COVID-19 pandemic. These inherent risks are heightened due to stringent bank secrecy laws that inhibit BSP's legal powers to undertake effective supervision. Certain forbearance measures are still active in 2022 and may continue to mask the true extent of vulnerabilities such as the potential deterioration of bank asset quality. The Russia-Ukraine war is likely to have a limited impact on the Philippines' economy and its financial sector because of limited trade linkages and financial sector exposures. However, the impact may be felt through indirect channels such as a more abrupt monetary policy tightening in advanced economies due to heightened inflationary pressures, and global financial tightening due to waning risk appetite and contagion.

[1] Based on recent poverty estimates released by the government for the first semester of 2021 show an increase in poverty from 21.1 percent to 23.7 percent between the first semesters of 2018 and of 2021.

Relationship to CPF

5. **The reforms supported by this DPL series are fully aligned with the Country Partnership Framework (CPF).** The 2019-2023 CPF focuses on three development objectives: i) job creation, ii) improving human capital, and iii) building resilience to conflict and natural disasters, which remain relevant in the current context. Crosscutting themes include governance and digital transformation. Financial sector reforms contribute to these objectives across pillars by improving access to finance for individuals and firms, bridging the gaps in human capital development with accessible and affordable financial services (e.g., digital payments, insurance), and strengthening resilience through disaster risk finance, climate change and green finance.

## C. Proposed Development Objective(s)

The development objective of this programmatic operation is to support financial sector reforms that will assist the Government of the Philippines in achieving a resilient, inclusive and sustainable financial sector.

This programmatic DPL series is structured around the following three pillars:

i. **Pillar A**: Strengthening Financial Sector Stability and Resilience. Pillar objectives: to support reforms aimed at improving financial sector resilience to withstand the risks arising from the COVID-19 crisis while accelerating structural reforms to support economic recovery.
ii. **Pillar B**: Expanding Financial Inclusion for Individuals and Firms. Pillar objectives: to support reforms to expand financial inclusion for individuals and firms by harnessing digital technologies, building consumer trust, and addressing the MSME's financial needs for recovery and innovation.
iii. **Pillar C**: Catalyzing Climate and Disaster Risk and Sustainable Finance. Pillar objectives: to support reforms aimed at improving the management of disaster risk and greening the financial sector to support sustainable economic recovery from the COVID-19 crisis.

Key Results

6. **The expected outcomes of the program's policy actions include** strengthening financial sector stability, integrity, and resilience, expanding financial inclusion for individuals and firms, and catalyzing disaster risk and sustainable finance.

7. **For Pillar A** the reforms are expected to i) strengthen prudential supervision of banks and conglomerates; ii) enhance the effectiveness of the AML/CFT regime to reduce reputational risks; iii) align the insurance framework with international standards and increase the adoption by large non-life insurance companies of the new Own Risk and Solvency Assessment (ORSA) like tools and disclosure requirements to implement effective risk management systems based on international standards, iii) strengthen BSP's capacity to undertake timely preventive and prompt corrective actions to ensure risks arising in banks are detected and addressed at an early stage for a better response and increased resilience, and iv) broaden the issuer and investor base for the corporate debt securities market by enhancing the efficiency of the private placement and public offer regime for corporate bonds and rationalizing the tax regime to encourage broader participation of domestic and foreign investors in the capital markets.

8. **For Pillar B** the reforms are expected to i) expand digital and innovative financial services through digital banks. This will facilitate cost-effective and convenient digital financial services for retail clients and MSMEs and help increase the number of players who are better able to tap into unbanked/underserved segments given lower costs to serve and given simpler, more transparent and convenient banking solutions; and, improve financial infrastructure by

introducing open banking which will promote interoperability and facilitate digital financial services, ii) develop a coherent financial consumer protection framework in the financial sector which will provide the authorities with the power to undertake market supervision, and iii) strengthen the credit reporting ecosystem, where banks will have access to improved credit information of firms, data of risk modeling and the standardized loan application form, which will make credit analysis and loan processing more efficient.

9. **For Pillar C** the reforms are expected to i) support the establishment of the Philippines Catastrophe Risk Insurance Facility (PCIF) to act as a catalyst in enforcing revised rates and to help improve market sustainability, and ii) adoption of BSP requirements on climate risk management and governance by Domestic Systemically Important Banks (D-SIBs) to systematically assess the impact of climate change on their portfolios, develop policies to address these risks, and provide transparent disclosures based on international practices. Moreover, the green finance taxonomy would help provide a common standard and classification of green assets to facilitate private sector investments in green assets through capital markets and by financial institutions.

## D. Concept Description

10. **This DPL supports policy reforms aimed at the government's efforts to strengthen the resilience of the financial sector due to rising risks while accelerating key structural reforms to support the government's medium- to long-term vision.** The DPL continues to build on the nation's long-term vision articulated in "AmBisyon Natin 2040" and the Philippine Development Plan 2017-2022 which envisions a key role for the financial sector in achieving inclusive growth. The proposed policy actions under the DPL series are informed by the 2020 Joint International Monetary Fund-World Bank (IMF-WB) FSAP Update and by the World Bank's analytical and advisory services supporting a range of financial sector reforms. All pillars of the DPL series, as described below, are aimed at fostering inclusive growth.

- **Pillar A of the DPL focuses on "Strengthening Financial Sector Stability, Integrity, and Resilience."** This first pillar supports the authorities in addressing significant legal, regulatory, and supervisory gaps to i) allow effective prudential supervision of banks, including conglomerate supervision, enhance the effectiveness of the AML/CFT regime, and bring the insurance sector regulatory framework in line with international standards; ii) enhance crisis management through the strengthening of the early-intervention regime, and iii) introduce a conducive tax regime for capital markets to crowd in domestic and foreign investors and accelerate the development of the corporate debt securities market by enhancing market efficiency.
- **Pillar B of the DPL focuses on "Expanding Financial Inclusion for Individuals and Firms."** This pillar supports the authorities in accelerating reforms aimed at promoting innovative financial services by harnessing digital technologies to expand the reach of financial services to the underserved segments of the population, strengthening frameworks for responsible finance to build consumer trust in the financial sector, and increasing the quality of the credit information infrastructure to support MSME access to finance during recovery.
- **Pillar C of the DPL focuses on "Catalyzing Climate and Disaster Risk and Sustainable Finance."** This pillar supports the authorities in implementing reforms aimed at enhancing public-private partnership-based financial instruments for disaster risk finance and greening the financial sector to support sustainable economic recovery from the COVID-19 crisis. The key reforms include establishing public-private risk-pooling mechanisms for catastrophe insurance to support the sustainable development of the market and allow inclusive access to catastrophe insurance, building financial sector resilience to climate-related shocks by integrating climate and environment risks in financial institutions' risk management frameworks, and mobilizing green finance by introducing green finance taxonomy.

11. **The reform program is consistent with the WBG crisis response framework for supporting green, resilient, inclusive development (GRID) and Maximizing Finance for Development (MFD).** Aligned with the GRID framework, this operation supports reforms that address immediate and long-term barriers to a growth path that will deliver broad-based inclusive recovery. Moreover, several policy measures aim to increase climate resilience and reduce GHG emissions and would contribute to substantial climate co-benefits. A detailed climate change and disaster risk screening will be undertaken during preparation, and the outcomes will inform the design of the policy actions. The operation supports "MFD-enabling" policy reforms, such as rationalizing the tax regime to reduce capital market issuance costs, which would encourage the participation of domestic and foreign investors. To help mobilize private sector financing for sustainable recovery, the operation supports the sustainable development of the catastrophe risk insurance market including putting into operation the Philippine Catastrophe Insurance Facility (PCIF) and issuance of green finance taxonomy.

## E. Poverty and Social Impacts, and Environmental, Forests, and Other Natural Resource Aspects

### Poverty and Social Impacts

12. **The proposed DPL's prior actions associated with the reform action pose no adverse poverty and social impacts.** Rather, the direct and indirect impact of these actions are likely to be positive. While poverty levels in the Philippines have declined over the years, they remain high and the government's socio-economic policy agenda – which focuses on infrastructure, education, and health – seeks to address these challenges. The proposed operation will enable the financial sector to play an effective role in reducing inequalities and supporting green and inclusive economic recovery from the pandemic. This will be achieved by strengthening the resilience of the financial sector to withstand the effects of COVID-19, expanding financial inclusion for individuals and MSMEs, increasing access to catastrophe risk insurance, and greening the financial sector.

### Environmental, Forests, and Other Natural Resource Aspects

13. **The second DPL continues to support reforms towards a stable, inclusive, and sustainable financial sector that can have an overall positive impact on the natural environment and contribute to the overall resilience of the financial sector.** The policy actions under the second DPL further strengthen the engagement of the Philippine government in embedding the sustainability agenda in the financial system and the mitigation by the banking and insurance industry of future systemic risks, including addressing the impacts of climate change.

14. **The financial sector has been playing an increasing role in addressing climate change and contributing to sustainable investments and finance.** The Prior Actions (PA) under the second DPF are responsive to this role of the sector and account for the different levels of readiness and capacity of the stakeholders to comply and manage their risks. Awareness on climate risks, as promoted by the different PAs, can have positive environmental effects if investments are directed towards sustainability and environmental integrity assessment is enhanced. The green finance taxonomy is envisioned as a principles-based classification and would support not only green projects but also sustainable economic activities required to facilitate capital flows.

## CONTACT POINT

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## APPROVAL

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### Approved By

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|---|---|---|
| Country Director: | Ndiame Diop | 29-May-2022 |