

# Developing Islamic Finance in the Philippines



The report is prepared as part of the Islamic Finance and Financial Inclusion (P153163) project by Nataliya Mylenko (World Bank) and Zamir Iqbal (World Bank). The project received financial support from the Korean Trust Fund for Economic and Peace-building Transitions.

**Copyright Statement:**

The material in this publication is copyrighted. Copying and/or transmitting portions or all of this work without permission may be a violation of applicable law. The International Bank for Reconstruction and Development/ The World Bank encourages dissemination of its work and will normally grant permission to reproduce portions of the work promptly.

For permission to photocopy or reprint any part of this work, please send a request with complete information to the Copyright Clearance Center, Inc., 222 Rosewood Drive, Danvers, MA 01923, USA, telephone 978-750-8400, fax 978-750-4470, <http://www.copyright.com/>.

All other queries on rights and licenses, including subsidiary rights, should be addressed to the Office of the Publisher, The World Bank, 1818 H Street NW, Washington, DC 20433, USA, fax 202-522-2422, e-mail [pubrights@worldbank.org](mailto:pubrights@worldbank.org).

*This report was prepared as part of the World Bank engagement in the Philippines to support Islamic Finance and Financial Inclusion. It provides an overview on the context for the development of Islamic finance in the Philippines and is accompanied by two focused reports providing further detail and suggestions on enhancing financial inclusion in the Philippines through Islamic microfinance and assessment of the status of financial inclusion in ARMM and the proposed Bangsamoro territory.*

## I. Islamic finance: background and global trends

The term Islamic finance is used to refer to financial activities conforming to Islamic Law (*Shari'ah*). One of the main principles of the Islamic finance system is the prohibition of the payment and the receipt of *ribā* (interest) in a financial transaction. The term *ribā* covers all forms of interest and is not limited to usury or excessive interest only. The most critical and significant implication of banning interest is the indirect prohibition of a “pure” or unsecured debt security. This is based on Islamic law which doesn’t recognize money and money instruments as a commodity but merely as a medium of exchange. Hence any return on financing must be tied to an asset, or participation and risk-taking in a joint enterprise such as partnerships. A pure debt security is replaced with an “asset-based” security, direct financing of a real asset, and different forms of partnerships of which equity financing is the most desirable.

The following key principles guide Islamic Finance: i) Prohibition of interest on transactions (*ribā*); ii) Financing must be linked to assets (materiality); iii) Engagement in immoral or ethically problematic businesses not allowed (e.g., gambling or alcohol production); iv) Returns must be linked to risks. Table 1 provides a summary description of basic financial instruments.

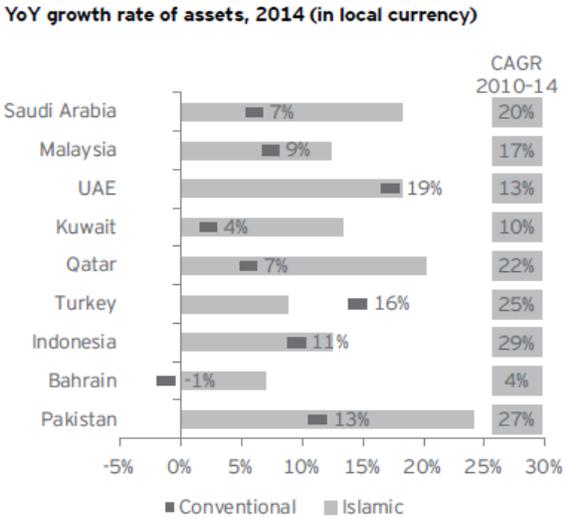
**Table 1. Key financial instruments of Islamic Finance**

<b><i>Murābahah</i></b> Trade with markup or cost-plus sale.	The purchase of an asset is financed for a profit margin, with the asset purchased on behalf of client and resold at a pre-determined price. Payment could be in lump sum or in installments and ownership of the asset remains with bank till full payments are made.
<b><i>Ijārah</i></b> Operational or financial leasing contracts.	Bank purchases asset on behalf of client and allows usage of asset for a fixed rental payment. Ownership of the asset remains with the financier but may gradually transfer to the client who eventually becomes the owner ( <i>ijārah wa-iqtina'</i> ).
<b><i>Muḍārabah</i></b> Trustee financing contract	One party contributes capital while the other contributes effort or expertise. Profits are shared according to a predetermined ratio and the investor is not guaranteed a return and bears any financial loss.
<b><i>Mushārahah</i></b> Equity participation contract	Different parties contribute capital and profits are shared according to a pre-determined ratio, not necessarily in relation to contributions, but losses are shared in proportion to capital contributions. The equity partners share and control how the investment is managed and each partner is liable for the actions of the others.
<b><i>Bay' mu'ajjal</i> and <i>bay' al-salam</i></b> Sales contracts	Deferred-payment sale ( <i>bay' mu'ajjal</i> ) and deferred-delivery sale ( <i>bay' al-salam</i> ) contracts, in addition to spot sales, are used for conducting credit sales. In a deferred-payment sale, delivery of the product is taken on the spot, but delivery of the payment is delayed for an agreed period. Payment can be made in a lump sum or in installments, provided there is no extra charge for the delay. A deferred-delivery sale is similar to a forward contract where delivery of the product is in the future in exchange for payment on the spot market.
<b><i>Sukūk</i></b> Certificates of Ownership	<b><i>Sukūk</i></b> are certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services, or (in the ownership of) the assets of particular

	projects. The returns on the certificates are directly linked to the returns generated by the underlying assets.
--	--

The Islamic finance industry has expanded rapidly over the past decade, growing at 10-12% annually. In many Muslim majority countries, Islamic banking assets have been growing faster than conventional banking assets (figure 1). There has also been a surge of interest in Islamic finance from non-Muslim countries such as the UK, Luxembourg, South Africa, and Hong Kong. Today, Sharia-compliant financial assets are estimated at roughly US\$2 trillion, covering bank and non-bank financial institutions, capital markets, money markets and insurance (“*Takāful*”). As seen in figure 2, *Sukūk* issuances increased steadily until 2011 and peaked in 2012 at approximately US\$130 bn. It is important to note that government issuances have driven the high growth as sovereign *Sukūk* dominate the market. In 2015 *Sukūk* issuances declined due to the slowdown in economies and the reduction in oil prices. The World Bank, recognizing the importance of Islamic finance, has been engaged in the development of the *Sukūk* market, issuing its first *Sukūk* in 2005 in Malaysia. Recently in 2015, the World Bank issued a \$500 million *Sukūk* to help fund an immunization program.

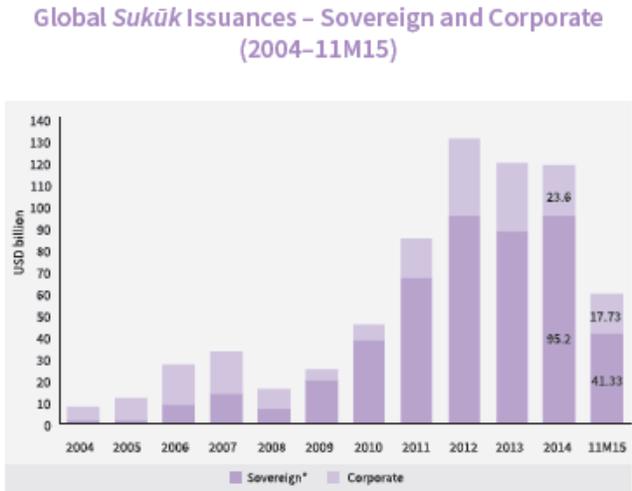
**Figure 1. Growth rates of banking assets of Islamic banks surpass those of conventional banks**



Length of bars represents YoY growth rate of assets in 2014 (in local currency)

Source: EY World Islamic Banking Competitiveness Report 2016

**Figure 2. Total *Sukūk* issuance have increased dramatically**



\*Includes all GRES, multilateral development banks (MDBs) and international organisations (IOs).  
Source: Zawya, Bloomberg, IFSB.

Source: IFSB Islamic Financial Services Industry Stability Report 2016

Indonesia and Malaysia - ASEAN’s first and third largest economies respectively have been actively developing Islamic finance. Malaysia is the largest Islamic finance market in the world with Islamic assets

amounting to US\$415.4bn<sup>1</sup>, and is the world's *Sukūk* leader in terms of number of issuances and value of *Sukūk* issued (US\$72.2), as well as value of *Sukūk* outstanding (US\$167.2).<sup>2</sup> Malaysia is also a host of over 300 Islamic funds. The Islamic finance sector in Indonesia is gaining momentum with a market size of US\$22bn in Islamic banking assets and *Sukūk* issuances worth US\$18bn in 2014. Brunei – another Muslim majority country in ASEAN has a market of US\$6.3 billion in Islamic banking assets. There are also Islamic finance activities in Thailand catering to Muslim populations in the south and in Singapore where focus is on issuances of *Sukūk*, including cross-border issuances.

Over the past decade Islamic finance has emerged as an effective tool for financing development worldwide, including in non-Muslim majority countries. Discussion and interest in Islamic finance has also appeared on G20 discussions. Major financial markets are discovering solid evidence that Islamic finance has already been mainstreamed within the global financial system – and that it has the potential to help address the challenges of ending extreme poverty and boosting shared prosperity.

In summary, Islamic finance is equity-based, asset-backed, ethical, sustainable, environmentally- and socially-responsible finance. It promotes risk sharing, connects the financial sector with the real economy, and emphasizes financial inclusion and social welfare.

## II. Philippines context

**The Philippines Development Plan 2011-2016 identified the development of Islamic finance framework as one of priorities.** Interest in developing Islamic finance in the Philippines demonstrated in recent years by Government, legislators and the private sector is driven by four main factors. The first is the desire to address the needs of the Philippines Muslim population. The second is ASEAN integration. As a member of ASEAN and a neighbor to Indonesia and Malaysia, Philippines looks to expand economic links with neighboring countries and sees regional and global Halal market and linked financing as an important component of its ASEAN integration strategy. The third is the opportunity to tap international financial markets for both resource mobilization and investment diversification through *Sukūk* and equity markets. And the fourth is the need to find a solution for Al Amanah Bank – an existing Islamic bank with a record of poor performance.

Islamic finance, or to be precise Islamic banking, in the Philippines is presently defined by the law adopted in 1990 establishing Al-Amanah Islamic Investment Bank of the Philippines. Al-Amanah bank is a sole Islamic bank, state owned, and in its present form not financially viable. The existing framework for Islamic banking in the Philippines must be understood in the context of the history of conflict in Mindanao. Ongoing peace process, ASEAN integration, and globalization of Islamic financial markets offer an opportunity to change course, move forward and develop effective Islamic finance in the Philippines.

---

<sup>1</sup> Data for 2014, from “ICD – Thomson Reuters Islamic Finance Development Report 2015”

<sup>2</sup> Data for 2014, from INDUSTRY AT CROSSROADS Thomson Reuters Barwa Sukuk Perceptions & Forecast 2016

## *Historical context*

Presently Muslim population in the Philippines accounts for 5-11%<sup>3</sup> of the total population of about 100 million<sup>4</sup>. Approximately 60 percent of Muslims reside in Mindanao and nearby islands<sup>5</sup>. The Autonomous Region in Muslim Mindanao (ARMM), with a population of 3.3million<sup>6</sup>, is a majority Muslim area.

Islam was an established religion in what is now Philippines prior to Spanish colonization in 1571 co-existing with other belief systems<sup>7</sup>. Over 300 years under the Spanish rule Christianity spread through Luzon and Visayas. At the time of transfer of the Philippines to American control in early 20<sup>th</sup> century Mindanao remained majority non-Christian<sup>8</sup>. Rapid population growth and increase in migration over the first half of the 20<sup>th</sup> century changed the demographics of Mindanao. With Philippines Independence in 1946 migration to Mindanao supported by national government policies continued eventually leading to conflicts over land ownership which progressively escalated and contributed to the emergence of organized political forces and armed groups. The Moro National Liberation Front (MNLF) emerged as a leading force for the separatist movement against Philippines government. Fighting erupted in 1972 after President Marcos declared martial law. In 1976 Tripoli peace agreement was signed providing for the principles of Muslim autonomy but the agreement was not fully implemented. After the overthrow of the Marcos regime, In 1989 the Autonomous Region in Muslim Mindanao (ARMM) region was created through Republic Act No. 6734 providing for an autonomous area in Muslim Mindanao. But the conflict was not resolved. In the past forty years Mindanao conflict has claimed over 120,000 lives and has displaced 2 million people with estimated economic loss of US\$10 billion between 1975 and 2002.

In October 2012, the Government of the Philippines signed a Framework Agreement with the Moro Islamic Liberation Front (MILF), with the hope that the Agreement would meet the demands of the Muslim population for genuine autonomy and contribute to improved security. The Agreement lays out a process to establish “the Bangsamoro”<sup>9</sup>, a new autonomous political entity to replace the ARMM, and finalize a peace agreement with the MILF. The Comprehensive Agreement on the Bangsamoro was then signed on March 27, 2014. Two steps remain on the roadmap to establishing the Bangsamoro entity: the passing of the new Bangsamoro Basic Law (BBL) and its ratification in a plebiscite. While Congress did not pass the BBL before it adjourned (next session will be in July 2016, after the May 2016 elections), there is an understanding that the Government of the Philippines-MILF peace process continues. The government and the MILF also remain committed to implementing commitments in the Comprehensive Agreement

---

<sup>3</sup> Official statistics from 2000 census put Muslim population at 5%. 2012 estimate by the National Commission on Muslim Filipinos (NCMF) states that there are 10.7 million Muslims. Difference is due to methodology used in 2000 census assigning religion based on ethnic characteristics.

<sup>4</sup> Estimates based on 2010 census and population growth. <http://worldpopulationreview.com/countries/philippines-population/>

<sup>5</sup> <http://www.state.gov/j/drl/rls/irf/2013/eap/222161.htm>.

<sup>6</sup> 2010 Census

<sup>7</sup> This paragraph draws on analysis summarized in Thamas McKenna “Governing Muslims in the Philippines” [http://www.hcs.harvard.edu/~hapr/winter07\\_gov/mckenna.pdf](http://www.hcs.harvard.edu/~hapr/winter07_gov/mckenna.pdf)

<sup>8</sup> Non-Christian includes Muslim and indogenous peoples following own belief systems

<sup>9</sup> The area will be determined based on the Bangsamoro Basic Law (BBL) ratification. For the purposes of the project preparation and pending the approval and ratification of the BBL, the Bangsamoro area is preliminary defined as: the present geographical area of the Autonomous Region in Muslim Mindanao (consisting of Basilan, Lanao del Sur, Maguindanao, Sulu, Tawi-Tawi, and the City of Marawi); the Municipalities of Baloi, Munai, Nunungan, Pantar, Tagoloan and Tangkal in the province of Lanao del Norte and all other barangays in the Municipalities of Kabacan, Carmen, Aleosan, Pigkawayan, Pikit and Midsayap that voted for inclusion in the ARMM during the 2001 plebiscite; the cities of Cotabato and Isabela. The existing ARMM constitutes about 90% of the proposed Bangsamoro region in terms of geographical territory and population.

such as opening up access to Islamic finance. The ongoing peace process provides an opportunity to promote investment, economic development, and poverty reduction in Muslim Mindanao<sup>10</sup>.

### *Amanah Bank*

The roots of Al-Amanah bank go back to the early days of martial law and escalation of conflict in Mindanao in early 1970s. In 1972 Presidential Decree (PD) 264 established the Philippine Amanah Bank (PAB) “to promote and accelerate the socio-economic growth and development of Mindanao, particularly, the economically depressed provinces of Cotabato, Lanao del Sur, Lanao del Norte, Zamboanga del Sur, Zamboanga del Norte, and Sulu”. It is important to note that PD 264 did not make explicit references to serving the Muslim population or applying Islamic finance practices in its operations. A year later, in 1974 PD542 revised the earlier statute stating that “it is necessary that the religious beliefs and practices of the Muslim citizens of the Philippines, be followed and respected, unless otherwise it is contrary to law, good morals and public policy” and formulating that “The Philippine Amanah Bank shall be based on the Islamic Concept of Banking, following the no-interest and partnership principles”. Largely a political creation and operating with poor governance and management characteristic of the period, PAB failed.

With political transformation of the Philippines following overthrow of the Marcos Regime, Al-Amanah Islamic Investment Bank of the Philippines (AAIIBP) was created in 1989 by the Republic Act No. 6848, repealing PD264 and PD542. AAIIBP was established as the sole Islamic bank in the country, with a primary purpose to promote and accelerate the socio-economic development of the Autonomous Region by performing banking, financing and investment operations based on the Islamic concept of banking. With a license of a universal bank, Amanah Bank was capitalized with PhP 50 million which were held mostly by the National Government, Social Security System (SSS), Government Service Insurance System (GSIS), and the Development Bank of the Philippines (DBP).

AAIIBP performed poorly (see Annex 1). From 1990 to 2006, the bank showed cumulative operating losses of PhP 554million, bringing down its total capital base to negative PhP 510 million by 2006. During those years the bank was losing an annual average of PhP 33 million from its operations or 64% of its initial capital per year. Given these annual losses, the bank relied on advances from the National Government for expenditures. A total of PhP 458 million was advanced to Amanah Bank by the Bureau of Treasury from 1990 to 2007. These advances were booked as special deposits, and ballooned the liabilities beyond total assets of the bank.

In 2008 AAIIBP started a new chapter when it was acquired by the Development Bank of the Philippines (DBP) – a state owned bank - and recapitalized through an additional capital infusion of PhP 1.0 billion. A five-year rehabilitation plan for the bank was put in place but the legal framework for Islamic bank operations was not revised. Under this plan, it was envisaged that the bank will continue performing Islamic and conventional banking dealings before converting to a full Islamic Bank by end of 2014. From incurring staggering losses in the previous decade, losses were expected to decrease during the rehabilitation with the reintroduction of its financing services under the stewardship of DBP.

The DBP infusion of additional capital reversed the negative capital of the bank upon its acquisition. However, net losses persisted in the operations of Amanah Bank until the current years. Even with revenues steadily increasing during its rehabilitation period of 2010 to 2014, operating costs remained in excess of earnings. With both loan portfolio and deposit base stagnant, revenues of Amanah Bank

---

<sup>10</sup> Please see World Bank (2016) “Financial Inclusion in ARMM and proposed Bangsamoro region” for the assessment of the status of financial inclusion in ARMM and proposed Bangsamoro region.

remained insufficient to reach positive net earnings. Consequently, capital base continues to decline every year. From 2007 to 2014, total net losses amounted to PHP 436 million, or an annual average net loss of PHP 45 million.

Presently Amanah Bank predominantly provides conventional financial services. In 2014 Islamic deposits accounted for 25% of total deposits or about US\$1.5 million. The Bank provides no Islamic financing services. The challenges facing Amanah Bank reflect fundamental regulatory and institutional weaknesses for Islamic finance in the Philippines and make a strong case for reforming the overall regulatory framework and approach:

*Legal and regulatory:* the charter of AAIIBP is the only piece of legislation guiding Islamic banking in the Philippines. The Charter does not address key issues such as tax neutrality for Islamic and conventional products, resulting in higher cost for Islamic products. In addition, the unavailability of deposit guarantee/insurance by the Philippine Deposit Insurance Corporation has raised apprehensions over Islamic deposit accounts offered by the bank.

*Market instruments:* the absence of Islamic trading accounts either for liquidity management or investment instruments affects the ability of Amanah Bank to attract Islamic funds. The BSP does not have a lending or repurchase facility for Islamic investments in the Philippines, regardless of tenor. This means that even if Amanah Bank attracts Islamic deposits or funds, there is no avenue to earn from basic Shari'ah-compliant securities that are otherwise available to conventional banks. Amanah Bank can opt to invest these funds outside the country, but the required volume of foreign investments is beyond the level that the bank can afford. There is also no clear framework on the treatment of *Sukūk*.

*Institutional:* At the level of operations of the bank, difficulties are identified on several fronts – undercapitalization, technical capacity, and Shari'ah oversight. Amanah Bank is considered a universal bank, with core capital of PHP 200 million (post acquisition by DBP) where prescribed minimum capitalization for universal banks by the Monetary Board is PHP 6.0 billion. After cumulative losses consumed Amanah Bank's capital in the last decade, the infusion made by DBP remained inadequate for rehabilitation efforts such as hiring technical personnel, as well as setting up of basic banking services such as automated teller machines, and strategic partnerships for foreign exchange remittance services. In the effort to control risk, lending is constrained and the bank is slowly draining its capital on operating expenses.

*Expertise:* the management of Amanah Bank lacks technical Islamic finance expertise. DBP as a parent bank does not have experience in Islamic banking, and the workforce employed by Amanah Bank does not have the requisite proficiency to purposely promote, manage and develop Shari'ah-based financial transactions. In addition, supervision and Shari'ah oversight of the bank's operations has remained weak. Since the start of its rehabilitation in 2010, the chairmanship of Amanah Bank Board had four turnovers. The prescribed Shari'ah advisory board in its charter continue to be inapplicable, with only one advisor currently providing Shari'ah compliance approval. Annual reports of Amanah Bank provided by Commission on Audit (COA) do not mention any Shari'ah audit or contain clearance from the Shari'ah advisor(s).

*Market:* Amanah bank is tasked to operate in the poorest and least banked region of the Philippines where persistent conflict severely constrains economic activity. Due to history of implementation

of Islamic finance in the Philippines there is minimal public awareness and financial literacy for Islamic finance, even among the Muslim population.

In the effort to resolve some of these challenges, the government considered privatization including sale to a qualified international Islamic finance bank. However interest has been limited, not the least in the face of fundamental constraint for future operations that inadequate legal framework poses. Recognizing these challenges and in line with the objectives identified in the Philippines Development Plan the government embarked on an effort to transform Islamic finance landscape in the Philippines.

### **III. Considerations for Developing Islamic Finance in the Philippines**

Although, Philippines is one of the earliest countries who introduced an Islamic banking institution as early as in 1973, no supporting infrastructure was developed since then. A renewal of interest in Islamic finance is motivated by changing realities in the country as well as in the region given rapid growth and advancement in Malaysia, Indonesia, and Brunei.

Due to growth over the last three decades, Islamic finance has grown beyond basic banking services and now includes well-developed investment banking, capital markets, insurance, and non-banking financial institutions. This growth has been accompanied by development of eco-system and necessary regulatory and supervisory framework and institutions. Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI) and Islamic Financial Services Board (IFSB) are responsible for accounting, Shari'ah governance, regulatory, and supervisory standards.

Introduction of Islamic finance in a non-Muslim majority country and without any prior infrastructure is a challenge which requires effort and political will which needs to be evaluated against potential benefits and demand for the services. It is difficult to make good assessment of the potential demand and potential size of the market. Discussions with stakeholders have indicated demand and interest in bank deposits/investments and micro-finance lending which is leading the policy makers to consider making Islamic finance available to achieve financial deepening and financial inclusion. There is also potential demand for developing Islamic finance instruments for attracting investments to the Philippines through Shari'ah compliant securities or banking sector.

In absence of a clear indication of solid and sustainable demand for Islamic banking services, it is suggested that a phased approach is taken allowing for experimentation and incorporating learnings into the formal framework as market develops.

#### *Phase 1 - Introduction*

In this phase basic Islamic banking transactions are introduced and institutions are enabled to begin offering Islamic finance products and services.

- I. Pave the way for establishing Islamic banks and windows through necessary legal changes.
- II. Review regulatory and supervisory framework to make necessary adjustments to issue licenses and to supervise activities of the banks providing Islamic financial services.
- III. Build capacity of the regulators and stakeholders on products and risks of Islamic banks.
- IV. Enhance financial awareness and literacy of Islamic financial products.

### *Phase 2 – Expansion*

Given the response and demand from the market after introduction of Islamic banking, an expansion phase can begin consisting of the following activities:

- I. Full development of legal, regulatory, and supervisory framework based on best practices and recommendations of international standard setting bodies including IFSB and AAOIFI.
- II. Development of Shari’ah governance and compliance framework.
- III. Development of Lending of Last Resort (LOLR) framework compliant with Shari’ah.
- IV. Capacity building of stakeholders.
- V. Introduction of Islamic capital markets and insurance (*Takaful*) services.

### *Phase 3 – Maturity*

After successful expansion and market size reaching a certain threshold, i.e. 5-7%, advance steps can be taken to provide full support and infrastructure for advance products and services. This could include:

- I. Development of Shari’ah-compliant money market instruments for liquidity facility and monetary policy interventions.
- II. Development of capital markets to support risk-sharing and securitized products.
- III. Development of advance supervisory and compliance frameworks.
- IV. Development of regulatory and supervisory frameworks for Islamic capital markets and insurance.

The more detailed considerations for actions envisaged in Stage 1 are outlined below

#### **Legal and regulatory framework and supervision**

A draft bill amending RA 6848, known as the Charter of Al-Amanah Islamic Investment Bank of the Philippines and providing for the regulation and organization of an expanded Islamic banking system in the Philippines with a short title of “The Philippines Islamic Finance Act” was submitted to Congress in August 2015 (HB5989) and Senate in January 2016 (SB3150).

The Bill seeks to strengthen Al-Amanah Bank to service a broader market, while enabling both the establishment of other Islamic banks and engagement in Islamic banking arrangements by conventional banks under the supervision and regulation of BSP.

The proposed bill also mandates government to provide programs for increased consumer awareness and capacity building.

The bill provides BSP with the authority to authorize the establishment of Islamic banks or authorize banks providing conventional services to offer Islamic financial products and services through an Islamic banking unit or “window” within a bank. The BSP may also authorize Islamic banking operations by foreign banks in line with existing legislation on foreign banks operation in the Philippines. The bill envisages the establishment of Islamic banks with a range of functions and capitalization requirements in line with those of universal banks. BSP is tasked to issue implementing rules and regulations and provide necessary regulatory guidance for the establishment and operation of Islamic banks and windows.

The bill includes an important provision on tax neutrality requiring the Government to ensure neutral tax treatment between Islamic banking transactions and equivalent conventional banking transactions. The bill empowers BIR to issue policies and guidelines to ensure tax neutrality.

The bill provides a basis for deposit insurance for Islamic banks through the establishment of an insurance mechanism on *takaful* principles.

The drafting of the bill included active consultations among BSP, NCMF, Amanah Bank, DBP, PDIC, BIR and other key agencies. The drafting was informed by international practice, including from the World Bank. There is generally a broad-based support for the bill among the regulators and business community and it is expected to be passed into a law. The effective implementation of the law will depend on the issuance of appropriate implementing regulations and guidance by BSP, BIR and other concerned agencies as well as the establishment of the necessary institutional support through bank supervision and bank resolution processes, Shari'ah Councils and accounting and auditing.

BSP is working on identifying specific steps to enable effective implementation of the provisions of the proposed bill if passed into a law. BSP has already initiated work on drafting supervisory guidance within the existing legal framework for minimum prudential standards and expectations relative to Shari'ah-compliant debt-type *Sukūk* investments of universal and commercial banks. The authorities intend to build on the international experience available to inform the development of regulatory framework and supervisory standards for Islamic finance in the Philippines. The BSP also plans to strengthen the capacity of the supervisory staff in terms of their understanding of Islamic finance concepts and supervisory practices to design and implement appropriate supervisory process for Islamic banking in the Philippines. Such capacity building efforts would potentially involve engaging qualified international experts to work with BSP supervisory staff to develop implementing regulations, principles and supervision manual, attending training courses on Islamic finance supervision, and working with qualified experts to fine-tune supervisory practices once Islamic banks or windows are authorized to operate in the Philippines.

### **Education and capacity building**

The successful introduction of Islamic banking and finance in the Philippines requires a substantial capacity building, financial education and awareness effort. Broadly there are three core audiences for capacity building and education each requiring a different approach: (1) Policymakers, regulators and supervisors (2) Providers of financial services, and (3) Clients of Islamic finance.

*1) Policymakers, regulators and supervisors.* As discussed in the section on the legal and regulatory framework there is an interest and a need to improve the understanding of the key policy makers, regulators, supervisors and staff of involved government agencies on the issues of Islamic finance. The work in this respect has started. BSP and NCMF and organized a number of learning events, including with experts from the World Bank, Islamic Development Bank, and a number of others as part of the effort to draft legal amendments. The next step is to continue focused and targeted training and capacity building to help relevant agencies prepare for the implementation of the Islamic Finance Act if passed. There may also be a need to provide technical briefings for legislators on Islamic finance drawing on international and regional experience.

*2) Providers of financial services.* Providers of Islamic finance products and services would need to build capacity to develop and deliver products relevant for the Philippines market. In the banking sector in the short term the learning is likely to take several forms including through entry of

foreign banks with experience in Islamic banking, bank staff attending training courses available internationally, banks engaging advisors to help develop Islamic banking and deliver training. In parallel and with the view to medium to long term there is a need to develop training programs and courses on Islamic banking and finance by universities and professional financial learning institutions in the Philippines. NCMF already plays an important role as a promoter and facilitator of Islamic finance through the organization of industry conferences and promotional events. Scaling up such efforts and continuing encouraging collaboration between banks, training institutions and other key stakeholders is important. This could include for example (1) partnership between NCMF, BSP and Department of Education on encouraging learning institutions to offer Islamic finance courses, (2) partnerships between Philippines and foreign universities for student and faculty exchange programs, (3) scholarships for researchers and students to access international programs and build knowledge base for the Philippines.

Beyond banking, it is expected that Islamic microfinance can play an important role to improve financial inclusion. The accompanying paper “Enhancing Financial Inclusion in the Philippines through Islamic Microfinance” provides detailed discussion on the opportunities for the Philippines. Unlike banking, the capacity building for Islamic microfinance requires support to NGOs, community organizations and relevant government agencies to integrate Islamic microfinance training with other community support programs.

*3) Clients of Islamic finance.* The National Strategy for Financial Inclusion (NSFI) identifies improving financial education and awareness as one of the priority areas to support financial inclusion the Philippines. Interviews with various stakeholders show that there is lack of understanding and awareness of Islamic finance concepts, even among Muslim communities. The successful introduction of Islamic finance requires improving awareness of the potential clients of Islamic finance products. This could be achieved through a range of public awareness and targeted financial education and training initiatives. There is a broad range of financial education and awareness programs in the Philippines implemented by various government agencies, financial service providers and NGOs. The experience from these programs can help design effective delivery models for Islamic finance education and awareness. Available research suggests that financial education programs are more effective when delivered at “teachable moments” and combined with the use of financial products and services. The implementation of such initiatives would require collaboration of government agencies including NCMF, BSP, Department of Education, CDA and financial service providers, NGOs and community organizations and leaders.

### **Targeted solutions - Islamic microfinance.**

While the lack of legal framework currently limits banks in providing Islamic finance products, there is an opportunity to offer Shari’ah compliant microfinance products by non-banks such as NGOs or cooperatives. Accompanying papers<sup>11</sup> provide an assessment of the status of financial inclusion in ARMM and proposed Bangsamoro region and an outline for a potential Islamic microfinance pilot program drawing on international experience. The Islamic microfinance is practiced globally in varied models, which may be broadly divided into two broad categories – (i) replicating commercial conventional microfinance with Islamic financial instruments; and (ii) based on Islam’s redistributive instruments built on the principles of solidarity, benevolence, and philanthropy. In addition, there are hybrid models which

---

<sup>11</sup> World Bank (2016) “Enhancing Financial Inclusion in Bangsamoro through Islamic Finance” and World Bank (2016) “Financial Inclusion in ARMM and proposed Bangsamoro region”

are primarily based on commercial operations but supplemented by one or more of redistributive instruments.

The accompanying paper elaborates a proposed set of interventions designed to: (i) introduce Islamic micro-finance to support economic activity; (ii) enhance capacity of public and private sector to understand and provide enabling environment for Islamic micro-finance; and (iii) lay the foundations for enhancing inclusion through use of Islamic instruments of redistribution. Implementation of such pilot projects would define product characteristics suitable in the Philippines context and help validate feasibility of applying various models. Moreover, piloting Shari'ah compliant microfinance in parallel with capacity building and financial education and awareness would help prepare the ground for broader adoption and integration of market based and social models of Islamic microfinance.