

Presence of an Islamic Bond Market

A. Current Status

In recent years, the interest in the Philippines in Sharia-compliant banking products, Islamic finance and, particularly, the issuance of *sukuk* (Islamic bonds) has been growing.

Sukuk are certificates of investment in underlying assets, services, or investment activities that generate fixed or floating returns in accordance with Sharia principles. As opposed to conventional bonds, which confer ownership of a debt, *sukuk* grant the investor a share of an asset along with the commensurate cash flows and risk.

One of the most important aspects of *sukuk* issuance is that it should be backed by real underlying assets. The *Sukuk Standard* issued by the Accounting and Auditing Organization for Islamic Finance Institutions distinguishes *sukuk* from equity, notes, and bonds. It emphasizes that *sukuk* are not debts of the issuer but rather are fractional or proportional interests in underlying assets, usufructs, services, projects, or investment activities. The underlying business or activity and the underlying transactional structures, such as the underlying leases, must be Sharia-compliant.⁵⁴

The Government of the Philippines has launched initiatives to explore the possibilities of issuing *sukuk* to finance government funding needs (e.g., an inter-agency forum to discuss the potential for issuing *sukuk* in the country and exploratory engagements by government financial institutions on *sukuk*). The government may consider using its existing framework for the issuance of government securities.

B. Regulations Specific to *Sukuk*

While the option for government financing through *sukuk* issuance appears to be feasible, there has to be a clear regulatory framework to govern the secondary trading of *sukuk* in the Philippines. Considering that there is only one recognized bank with the authority to engage in Islamic financing structures and schemes, the following issues need to be considered and resolved first for the *sukuk* market to grow:

- (i) **Tax neutrality.** There is a need for a friendly and neutral taxation system that makes Sharia-compliant products at par and competitive with conventional ones. The tax consequences for structures required under Islamic finance are more onerous than their counterpart interest-based transactions because several structure or transactions are needed to achieve the equivalent interest-based transaction. The unfavorable tax regime reduces the possible return on investments and sets back Islamic finance in terms of attractiveness.

⁵⁴ Islamic Financial Services Board. 2008. *Islamic Finance: Global Legal Issues and Challenges*. Kuala Lumpur.

Supportive legislation, such as those harmonizing tax laws and adopting international regulatory standards, will be necessary to encourage investor confidence and promote industry growth.⁵⁵

- (ii) **Awareness of Islamic finance.** There is very little awareness of Islamic finance in the Philippines. Moreover, there is a misconception that Islamic finance caters only to Muslim investors and depositors. While Islamic finance adheres to Sharia principles, it does not preclude the participation of non-Muslim investors and depositors. Increased awareness will be an important factor in the success of an issuance of *sukuk* in the domestic market.
- (iii) **Well-defined legal and regulatory framework for Islamic finance, particularly *sukuk* issuance.** There is a need for a comprehensive review of pertinent Philippine laws such as the SRC law governing insolvency, taking into consideration the requirement for a *sukuk* issuance to comply with Sharia principles.
- (iv) **Support Infrastructure.** There is a need to establish the support infrastructures necessary for Islamic finance to prosper. For instance, national accounting standards may have to be expanded to accommodate Islamic finance transactions. Human resource development needs in this area should also be addressed. Furthermore, other non-fiscal incentives may have to be granted to promote the value proposition and competitiveness of Islamic financing.

The following environmental factors are needed to establish a responsive Islamic finance system in the Philippines:

- (i) a critical mass of market players under a competitive but regulated environment,
- (ii) appropriate linkages that cater to the peculiarities of Islamic finance,
- (iii) a regulatory and supervisory framework that encourages a level playing field for Islamic finance,
- (iv) a regulatory environment that encourages the provision of innovative products and services for Islamic finance, and
- (v) a broader customer and asset base through increased investor awareness and acceptance.

⁵⁵ Islamic Finance Global Legal Issues and Challenges, Islamic Financial Services Board, p. 32.