Supervisory Policy and Research Department

The Philippine

Banking Sector Outlook Survey

First Semester 2019

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Highlights of the Report

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Banks maintained their optimism on the country's economic prospect amid global uncertainties and market volatilities during the first semester of 2019 as majority of the Banking Sector Outlook Survey (BSOS) respondents projected the gross domestic product (GDP) to grow between 6 percent and 7 percent within the next two years. Similarly, the outlook on the Philippine banking system (PBS) remained stable as the banks' bullish projection on the economy and the banking system were expected to result in a double digit growth in assets, loans, deposits and net income.

Amid the headwinds, the banks intended to maintain risk-based capital and liquidity well beyond domestic and global standards. High-quality common equity tier 1 capital dominates the banks' capital. Meanwhile, the banks' projections on the Basel liquidity metrics of liquidity coverage ratio (LCR) and net stable funding ratio (NSFR) were expected to provide ample short-term and long-term funding to weather market volatilities while taking advantage of the opportunities presented by the growing economy.

In terms of financial products or services, majority of the respondent banks mentioned that corporate and retail banking will remain as their top-most priority followed by payments services. Meanwhile, the respondents revealed that their top two strategic priorities were: (1) to grow the bank; and (2) to optimize the available technology.

The BSOS noted the banks' increasing support to the use of technology-enabled solutions and strong interest in participating to the digital finance ecosystem. In particular, most of the banks planning or already employing technology in their operations find its most important application in areas of data security and privacy, know your customer (KYC) procedures and loan scoring. Moreover, most of the respondent banks revealed preparedness in managing cybersecurity risks.

Overall, institutional risk was considered as the top concern to the banks' operation. Nonetheless, respondents considered enhancing their risk management systems to strengthen the banks against headwinds. Likewise, they planned to strengthen client relationships, keep a high level of liquidity, upgrade personnel capabilities, and increase capital to protect their respective banks against internal and external shocks.

The survey results showed that inputs from audit, risk and compliance functions are always considered in the board/senior management business decisions and strategies. Moreover, majority of the respondents mentioned that their employees are bound by a code of ethics/conduct. Among the different aspects of business covered by their respective Codes of Ethics, customer dealings rank first, followed by personnel recruitment and termination as well as whistleblowing and grievance escalation policies.

I. Introduction

The adoption of a cohesive and pro-active supervisory approach to address the potential build-up of systemic risk is essential to achieve one of the BSP's Strategic Objectives which calls for a sound, stable and resilient banking and financial system. The Banking Sector Outlook Survey (BSOS) serves as a complementary tool in validating the assessments of banking supervisors. The conduct of the BSOS aims to gather the sentiments of the Presidents/Chief Executive Officers/Country Managers of banks in the country within a two-year horizon.[1] The practice of conducting a periodic banking sector outlook survey has been observed in some countries. However, the Philippine BSOS is insightful due to the following: (a) it is conducted by the central bank; (b) it gathers the sentiments/outlook of industry leaders; and (c) it forms part of the prudential surveillance and supervisory framework of the BSP. This is the third time the BSOS is conducted, with the maiden report released in October 2018.

II. What is the Banking Sector Outlook Survey (BSOS)?

The BSOS serves as a measure of proactive and forward-looking approach to surveillance and financial supervision. Banking sector risks have been historically concentrated in domestic traditional banking activities while the financial services industry has evolved in response to market-driven, technological, and geo-political developments. These changes have allowed financial institutions (FIs) to expand product offerings, geographic diversity, and delivery systems. However, these changes have also increased the complexity of the FIs' consolidated risk exposure. Said complexity necessitates the BSP's proactive and forward-looking approach to consider the outlook/sentiments of industry leaders in the conduct of regulatory risk surveillance and formulation of supervisory framework.

The BSOS can complement the analysis of banks' business models moving forward. Reducing information asymmetries is crucial to supervisors for the prompt identification of vulnerabilities, closer monitoring of financial health and comprehensive management of financial strains as they emerge. Hence, the BSOS aims to provide the BSP with additional perspective on the continuing evolution of banks' business models that can eventually help enhance prudential regulations and contribute to ensuring resilience of the banking system. Moreover, it intends to provide supervisory and market perspectives on emerging issues and trends for timely and relevant prudential reporting and related analysis. Lastly, it is also expected to promote financial innovation in the banking system.

[1] The Monetary Board Resolution No. 833 dated 17 May 2018 approved the conduct of BSOS.

Structure of the BSOS. The BSOS is currently composed of seven sections as shown in Table 1 below:

Table 1. The BSOS Structure

Section	Description
Growth Outlook	This section seeks to solicit the respondents' outlook on the country's gross domestic product (GDP) growth and projections on the performance of the Philippine banking system.
Business Strategy	This section seeks to understand the business model that the banks will adopt to implement their strategies over the next two years.
Operational Performance	This section seeks to understand banks' operational approach to maintain growth, address operational challenges and enhance profitability moving forward.
Fintech/Cybersecurity	This section seeks to identify the extent of fintech adoption and strategy as well as the respondents' outlook on cybersecurity risks and threats.
Impact of Supervision/ Regulation on Bank Performance	This section seeks to solicit sentiments on the concerns posed by BSP regulations to banks' operations, as well as to seek opinion in areas of regulation/supervision that the BSP needs to strengthen to promote the safety and soundness of the banking system.
Risk Assessment	This section seeks to identify the risks that banks are most wary of and the existing mitigants for identified risks.
Organizational Conduct and Risk Culture	This section seeks to categorize banks' internal assessments of the level and maturity of risk culture and risk governance frameworks.

An Enhanced Section on Fintech/Cybersecurity. For the first semester of 2019, a new section was introduced to have an insight on the extent of banks' fintech adoption and strategy as well as outlook on cybersecurity risks and threats. Specifically, respondents were asked whether they plan to use digital technology in the next two years and the use of technology in different aspects of the bank's operation. Moreover, this section also include questions on the most important technology area in the organization, the banks' level of preparedness in terms of managing cybersecurity risks, cybersecurity threats, and the impact of cybercrime events that banks are most concerned about.

The BSOS Methodology. The conduct of BSOS for the first semester of 2019 covers all universal/commercial (U/KBs), thrift banks (TBs) and the top 20 rural/cooperative banks (R/CBs) in terms of total loan portfolio. The updated survey questionnaire includes 24 questions (Annex A) and transmitted to the Presidents/Chief Executive Officers/Country Managers of the covered banks. Moreover, as an enhancement to the survey for the first semester of 2019, the respondents were requested to rank their responses for some of the questions.[2] The overall survey response rate for the first semester of 2019 improved to 73.5 percent from the previous semester's 69.0 percent, but lower as compared to the 96.6 percent during the maiden conduct of the BSOS. Meanwhile, banks which responded to the survey accounted for 90.9 percent of the total assets of the banking system as of end-June 2019.

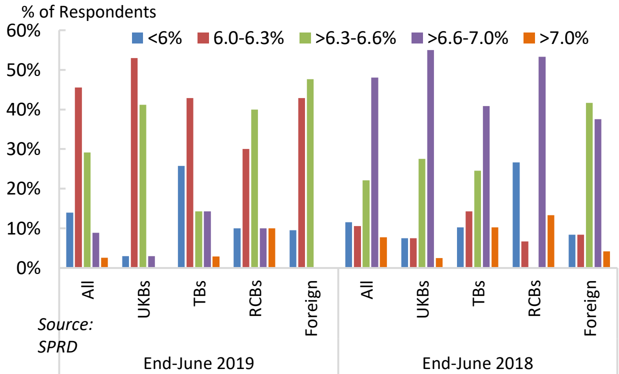
III. Results of the Banking Sector Outlook Survey as of the First Semester of 2019

Banks maintain their optimism on the country's economic prospect amid global uncertainties and market volatilities during the first semester of 2019 as 83.5 percent of the BSOS respondents projected that the gross domestic product (GDP) shall grow between 6 percent and 7 percent within the next two years.

Current projections converged at the lower end of the 6 percent to 7 percent range with 45.6 percent of respondents expecting the GDP growth between 6.0 percent and 6.3 percent, led by 52.9 percent of U/KBs. Meanwhile, 41.2 percent of respondent U/KBs were more optimistic, projecting the GDP growth at a range of 6.3 percent to 6.6 percent. By contrast, 48.1 percent of respondents during the maiden conduct of the BSOS projected the GDP growth between 6.6 percent and 7.0 percent.

Similarly, 42.9 percent of respondent TBs projected the GDP growth at a range of 6.0 percent to 6.3 percent while 40.0 percent and 30.0 percent of R/CB respondents projected the GDP growth at the range of 6.3 percent to 6.6 percent and 6.0 percent and 6.3 percent, respectively. Meanwhile, 90.5 percent of foreign bank respondents projected the GDP growth between 6.0 percent and 6.6 percent (Figure 1).

Figure 1. Real GDP Forecast by Type of Bank
As of End-Periods Indicated



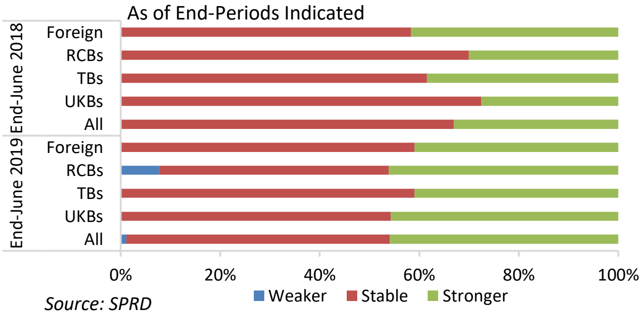
Source: SPRD

The general softening in the banks' projected domestic GDP growth was consistent with the Asian Development Bank's (ADB's) projection of slower GDP growth for the country from 6.4 percent in 2019 and 2020 to 6.0 percent in 2019 and 6.2 percent in 2020.[3] The revised ADB forecast was anchored on the weakening global economic outlook which also weighed down on external demand for Philippine exports.

[2] These include question numbers 5, 6, 12, 14, 16, 18, and 21.
[3] Asian Development Outlook 2019 Update, ADB, September 2019.

The banks' bullish economic outlook translated to continued confidence on the stability of the banking system. This is evident as 45.9 percent of the industry leaders projected stronger banks in the next two years while 52.9 percent of the respondents expected the banking system to remain stable (Figure 2). These compared favorably to the June 2018 BSOS where only 33.0 percent of the respondents have foreseen a stronger banking system.

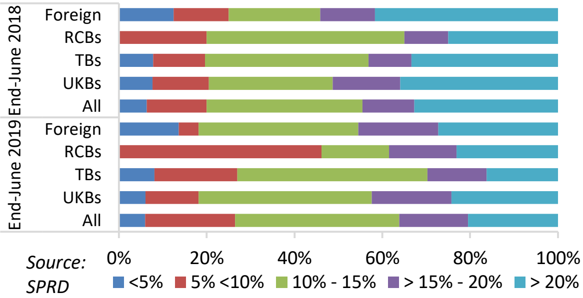
Figure 2. Banking System Growth Outlook
As of End-Periods Indicated



Source: SPRD

The projected economic growth and strength of the banking system influenced 73.5 percent of the survey respondents to forecast double-digit growth in the banks' assets. This was lower though, compared to the 80.0 percent projection of double-digit asset growth during the first semester of 2018. Interestingly, 81.8 percent of both U/KBs and foreign banks (most of which were U/KBs) projected double-digit asset expansion from last year's 79.5 percent and 75.0 percent, respectively. Meanwhile, R/CBs were least optimistic with only 53.8 percent of respondents projecting the same compared to last year's 80.0 percent (Figure 3).

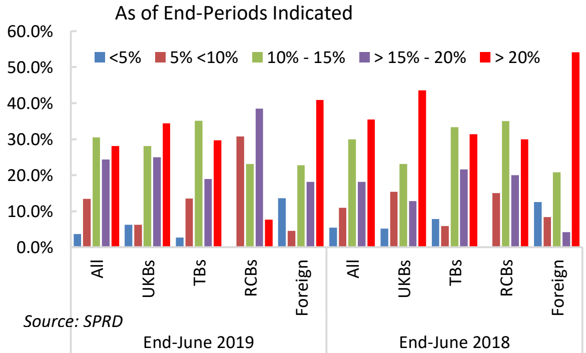
Figure 3. Asset Growth Projection
As of End-Periods Indicated



Source: SPRD

The growth in assets was expected to be driven by credit expansion as 82.9 percent of the banks projected double-digit growth in their loan portfolio for the current survey. This was relatively stable compared to the 83.6 percent of banks that projected double-digit loan growth in the BSOS for the first semester of 2018. The projected credit expansion was led by 87.5 percent of U/KBs, more bullish than the 79.5 percent U/KB respondents with the same projection last year. R/CBs, feeling the brunt of competitive pressures, had 69.2 percent of the respondents projecting double-digit loan growth, a significant decline from 85.0 percent in the June 2018 BSOS (Figure 4).

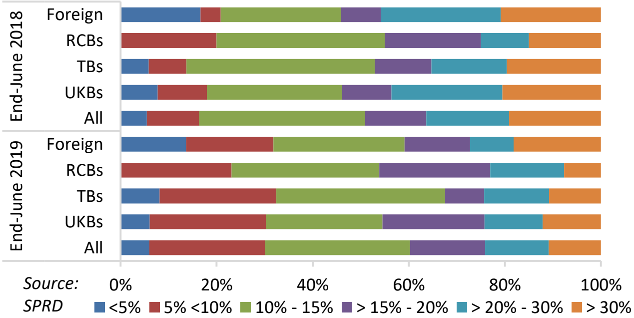
Figure 4. Projected Loan Growth
As of End-Periods Indicated



Source: SPRD

The BSOS results were likewise consistent with banks' expectations for deposits to fund asset and loan growth. In fact, 69.9 percent of the current survey respondents projected double-digit deposit growth, albeit muted compared to 83.6 percent of the respondents during the same period last year. A slightly lower percentage from the average is noted for U/KB, TB and foreign bank respondents while R/CBs were most optimistic with 76.9 percent of respondents with similar growth projection (Figure 5). The bigger banks' foray into the bond market to ensure a more stable funding for their operations may have influenced the decrease in the percentage of respondents expecting double-digit deposit growth.

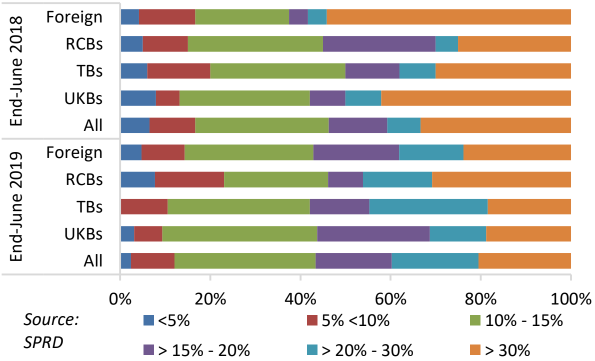
Figure 5. Projected Growth in Deposits
As of End-Periods Indicated



Source: SPRD

The banks' optimism on the economy and the bullish operational projections likewise elicited upbeat expectations on returns as 88.0 percent of the respondents for the first semester of 2019 forecasted double-digit net income growth for the next two years compared to 83.3 percent of the respondents during the first semester of 2018. As of the first semester of 2019, around 90 percent of U/KB and TB respondents projected double-digit net income growth while "only" 76.9 percent of R/CBs forecasted double-digit net income growth. More specifically, around 30 percent of U/KBs, TBs and foreign banks projected net income to grow between 10 percent and 15 percent. Foreign banks' projections were fairly distributed during the current survey compared to the maiden BSOS when 54.2 percent of foreign bank respondents projected net income to grow by more than 30 percent (Figure 6).

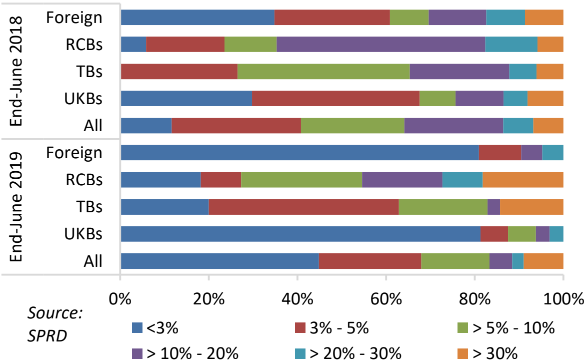
Figure 6. Projected Growth in Net Income
As of End-Periods Indicated



Source: SPRD

Evidently, the improved net income projections were not affected by the tighter projections for the banks' net interest margin (NIM) as 44.9 percent and 23.1 percent of the current respondents expected the NIM at less than 3 percent and between 3 percent and 5 percent, respectively. Respondent U/KBs and foreign banks were most conservative with around 81 percent of both banking groups expecting the NIM at less than 3 percent (Figure 7). By contrast, 74.8 percent of the banks' projections during the maiden conduct of the BSOS were fairly distributed across three NIM ranges[4]. R/CBs, which have the biggest NIMs in view of their niche markets, likewise tightened the NIM forecast from 47.1 percent respondents expecting the NIM at 10 percent to 20 percent to the current fragmented forecast, the biggest group of which (27.3 percent) projected the NIM between 5 percent and 10 percent. The current projections reflected an increasingly competitive banking environment.

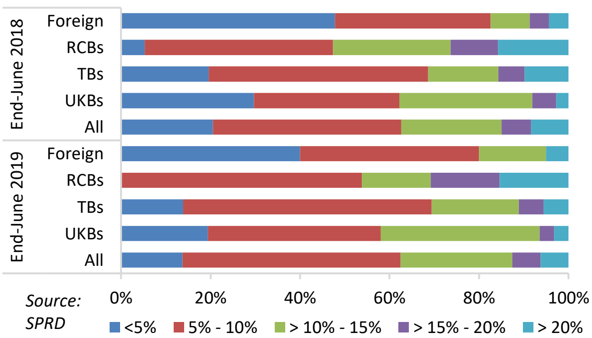
Figure 7. Projected Net Interest Margin
As of End-Periods Indicated



Source: SPRD

Amid the optimism, **the projected return on equity (ROE) generally improved** with only 13.8 percent of respondent banks expecting the ROE at less than 5 percent for the current BSOS compared to 20.6 percent during the previous year. The number of less optimistic respondents apparently upgraded their projections as 48.8 percent of respondents expected the ROE between 5 percent and 10 percent compared to 42.1 percent in the previous year (Figure 8).

Figure 8. Projected Return on Equity
As of End-Periods Indicated

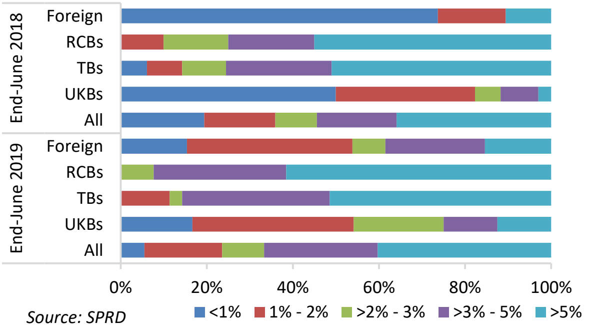


Source: SPRD

[4] NIM ranges from 3 percent to 5 percent; more than 5 percent to 10 percent; and more than 10 percent to 20 percent.

A sluggish global growth[5] may be exerting pressure to the quality of bank loan portfolio. This may be seen from the increase of respondents expecting the ratio of non-performing loans (NPL) to total loans to exceed 3 percent from the 54.4 percent during the maiden conduct of the BSOS to 66.7 percent for the current survey. TBs and R/CBs consistently expected elevated NPL ratios, but foreign bank respondents, 10.5 percent of which projected NPL ratio at more than 3 percent last year, currently have 38.5 percent of respondents with similar projection (Figure 9). The sluggish global growth, coupled with trade tensions among the world's biggest economies, may adversely impact the domestic manufacturing sector which exports a significant portion of its output. This, in turn, may have led to the banks' forecast of an uptick in the NPL ratios.

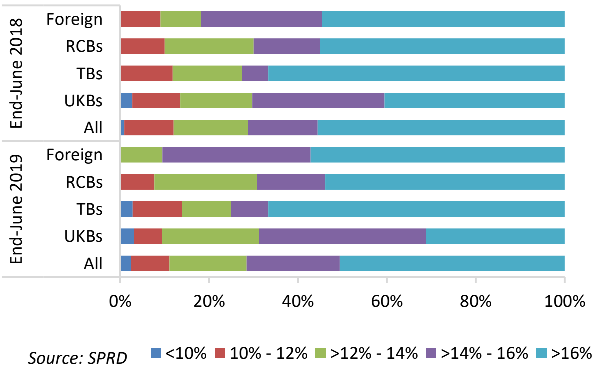
Figure 9. Projected NPL Ratio
As of End-Periods Indicated



Source: SPRD

Cognizant of the importance of capital to protect the banks from unexpected losses, the banking system has been maintaining risk-based capital at levels higher than domestic (10 percent) and global (8 percent) standards, and intends to do so for the next two years. Projection of capital adequacy ratio (CAR) was stable for the current and last year's BSOS with 71.6 percent of the current respondents expecting CAR at more than 14 percent compared to 71.3 percent last year (Figure 10). Moreover, industry data showed that banks' CAR was comprised mostly of high-quality common equity tier 1 (CET 1) capital.

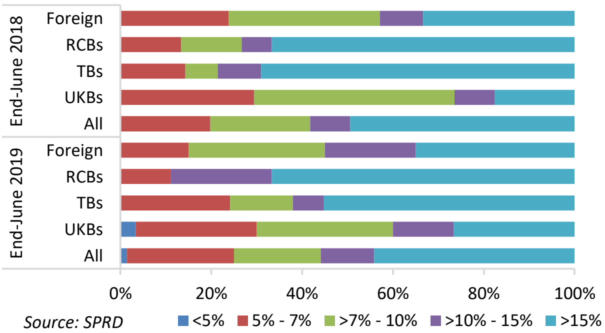
Figure 10. Projected CAR
As of End-Periods Indicated



Source: SPRD

Banks aptly projected a backstop to their respective CAR with expected leverage ratio generally exceeding the BSP (5 percent) and Basel (3 percent) standards. This constrains the potential build-up of excessive leverage in the banks and promote financial stability. Meanwhile, smaller TBs and R/CBs are more reliant on capital for their businesses with

Figure 11. Projected Leverage Ratio
As of End-Periods Indicated



Source: SPRD

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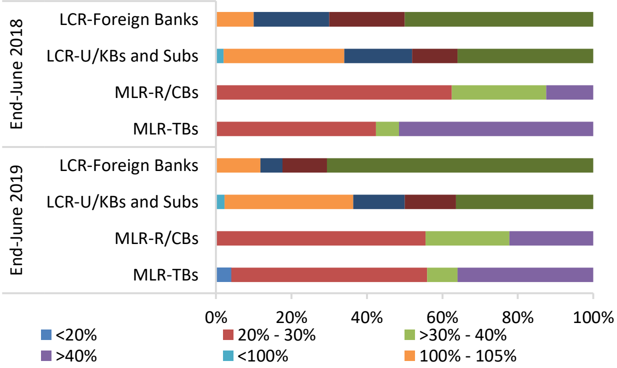
[5] International Monetary Fund, World Economic Outlook Update, 23 July 2019.

55.2 percent and 66.7 percent respectively, projecting leverage ratios at more than 15 percent (Figure 11).

Liquidity has been a key strength of the Philippine banking system. This is expected to be maintained in the medium term as banks continue to project healthy liquidity metrics under the Basel III liquidity coverage ratio (LCR)[6] and net stable funding ratio (NSFR)[7] for U/KBs and their subsidiary banks and quasi-banks (QBs), and the minimum liquidity ratio (MLR)[8] for stand-alone TBs, R/CBs and QBs. Liquidity serves as buffer for banks to thrive amid a volatile market environment while enabling them to take advantage of business opportunities presented by the growing economy and the country's pursuit of better infrastructure to support domestic economic expansion.

Figure 12. Projected LCR/MLR
As of End-Periods Indicated



Source: SPRD

For instance, the respondents disclosed that 63.6 percent of U/KBs and their subsidiary banks intended to maintain LCR at more than 105 percent, slightly lower from the 66.0 percent recorded during the maiden conduct of the BSOS. The biggest portion of U/KB and subsidiary (36.4 percent) and foreign bank (66.7 percent) respondents projected the LCR at more than 140 percent. Meanwhile, 52.0 percent and 55.6 percent of stand-alone TBs and R/CBs projected their respective MLRs between 20 percent and 30 percent (Figure 12).

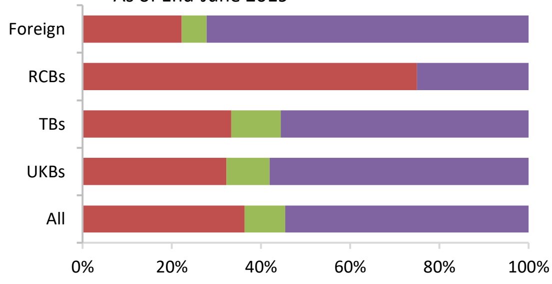
[6] Circular No. 905 dated 10 March 2016, as amended, requires the U/KBs to hold sufficient High Quality Liquid Assets (HQLAs) that can be easily converted into cash to service liquidity requirements over a 30-day stress period. This provides banks with a minimum liquidity buffer to be able to take corrective action to address a liquidity stress event.

[7] The NSFR under Circular No. 1007 dated 6 June 2019 is a measure of the ability of a bank to fund its liquidity needs over one year and complements the LCR. Both ratios are aimed at strengthening the ability of banks to withstand liquidity stress and promote resilience of the banking sector.

[8] Circular No. 996 dated 8 February 2018 requires stand-alone TBs, R/CBs, and QBs to maintain liquid assets at 20 percent of their liabilities to promote short-term resilience to liquidity shocks. It illustrates the BSP's commitment to the application of proportionality in its approach to supervision.

The NSFR, which started implementation on 1 January 2019 for U/KBs, was projected by 54.5 percent of covered respondent banks to be maintained at more than 110 percent for the next two years. The strong commitment to longer term stable funding was more evident for U/KBs and foreign banks, with 58.1 percent and 72.2 percent of respective respondents projecting NSFR at more than 110 percent (Figure 13).

Figure 13. Projected NSFR
As of End-June 2019



Source: SPRD

In terms of products or services, majority of the heads of banks mentioned that corporate and retail banking will remain as their top-most priority, followed by payments services. Under corporate banking, the respondents identified Micro, Small and Medium Enterprise (MSME) lending, other corporate loans, and real estate loans as primary services for the next two years. Meanwhile, real estate loans, salary loans and motor vehicle loans remained as the priority products under retail banking.

By type of bank, the respondents revealed that majority of domestic U/KBs will focus on corporate banking, retail banking, trust products, cross-selling, and trade financing while foreign U/KBs will mainly concentrate on corporate banking, trade financing, payments and treasury operations. Meanwhile, retail loans remained as the main priority of TBs and R/CBs, which indicates that these banks were committed to their niche market.

The top three focus of lending by economic sector of domestic U/KBs were agriculture, wholesale and retail trade, and consumer loans for the next two years (Table 1). Meanwhile, the results of the conduct of BSOS in 2018 showed that consumer lending was the top priority. Moreover, foreign U/KBs preferred to lend mainly to the manufacturing sector as revealed in the results of the survey for three semesters. Both subsidiary TBs and stand-alone TBs underscored that consumer loans will have the largest share in their lending portfolio in the next two years. Meanwhile, agriculture, real estate activities, and consumers loans were projected to be the top three credit markets in the R/CBs' loan portfolio as revealed in the BSOS for the first semester of 2019. Based on latest available data, banks' lending activities were mainly channeled to real estate activities, wholesale and retail trade, household consumption and manufacturing sector.

Table 1. Focus of Bank Lending by Economic Sector

Rank	First Semester 2019				
	Domestic UKBs	Foreign UKBs	Subsidiary TBs	Stand-alone TBs	RCBs
1	Agriculture	Manufacturing	Consumer Loans	Consumer Loans	Agriculture
2	Wholesale and Retail Trade	Wholesale and Retail Trade	Wholesale and Retail Trade	Wholesale and Retail Trade	Real Estate Activities
3	Consumer Loans	Financial and Insurance Activities	Real Estate Activities	Agriculture	Consumer Loans

Source: SPRD

Business Strategy. The top two strategic priorities by banking group for the two semesters are shown in Table 2. **Overall, the respondents revealed that the top two strategic priorities of the bank executives surveyed were: (1) to grow the bank; and (2) to optimize the available technology for growth and efficient banking operations**. Majority of the respondents believed that there is a need to grow the bank by expanding client base, by deepening customer relationships, and by developing new products. In line with the emerging market trends and evolving client needs, the rapid pace of digital technology is considerably reshaping the financial services landscape. Thus, most of domestic U/KBs, and R/CBs disclosed that they will prioritize the optimization of available technology through digital operations and customer service as well as leverage on financial technology for strategic efficiency in the next two years.

Table 2. Top Two Strategic Priorities per Type of Bank

Type of Bank/ Period	U/KBs	TBs	R/CBs
First Semester 2019	Grow the business	Grow the business	Grow the business
	Optimize technology	Reinforce the bank	Optimize technology
First Semester 2018	Grow the business	Grow the business	Grow the business
	Optimize technology	Protect operations	Protect operations

Source: SPRD

Meanwhile, 73.3 percent of the respondents disclosed their preferred strategic direction as domestic banks engaged in target retail and business customers, underscoring the overall inward-looking nature of the Philippine banking system. This finding is consistent with the results of the BSOS in 2018 when 75.4 percent of respondents revealed similar strategic direction. Surprisingly, among foreign bank respondents, only 36.8 percent aimed to be global banks providing specialized products and services to global clients while 26.3 percent intended to focus on the domestic market and engage with target retail and business clients.

Operational Performance. The strong macroeconomic fundamentals of the country and the steady growth of the banking system encourage foreign banks to establish presence in the Philippines. The number is expected to increase due to the ongoing ASEAN Banking Integration Framework (ABIF). Thus, banks are facing new aspects of competition and will benefit from a good competitive strategy. In the survey, banks were asked how they will maintain growth in an era of intense competition, heightened customer expectation and non-traditional market entrants. The top three plans of banks for the three semesters of the conduct of BSOS remained the same. **The banks have deemed it important to develop new capabilities, expand market reach and leverage on client relationship to maintain growth** in the presence of intense competition as shown in Figure 14.

Figure 14. Top 3 Plans to Maintain Growth in the Presence of Intense Competition and Other Factors

Source: SPRD

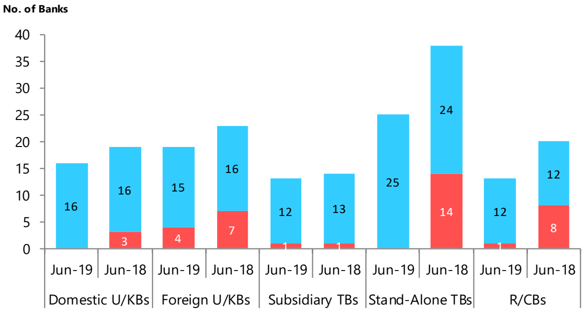
Meanwhile, about **88.4 percent of the respondents believed that efficient operation is important to sustain profitability**. Likewise, the respondents also viewed that pursuing organic growth, leveraging on technology, and hiring or retaining key talents were equally important to maintain banks' profitability amid market and regulatory pressures.

Fintech/Cybersecurity Plans. This new section consisting of six questions was introduced to have an insight on the extent of the banks' fintech adoption and their outlook on cybersecurity risks and threats. The survery results showed **that technology and operating models[9] are most applicable in addressing margin pressure and brand management.** Likewise, technology and operating models were also deemed useful in expanding client base and enhancing customer experience.

[9] How the bank runs its operations (e.g., decentralizing operations or introducing more cost efficient processes and technologies) or delivers value to customers (e.g., moving low-value transactions to self-service channels such as ATMs and online and/or mobile banking).

The banking industry supports the use of technology-enabled solutions and exhibits strong interest in participating in the digital finance ecosystem (Figure 15). The responses for the first semester of 2019 showed that **93.0 percent of respondent banks have plans to use technology in the banking transactions**, higher than the 71.1 percent and 73.5 percent of banks which reported the same for the first and second semesters of 2018, respectively.

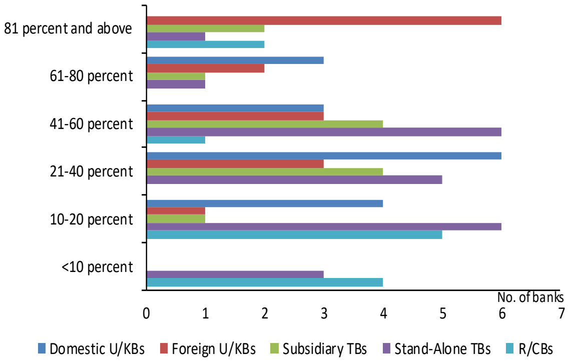
Figure 15. Number of Banks Engaged in Mobile and Electronic Banking
As of End-Periods Indicated



Source: SPRD

For the first semester of 2019, 37.5 percent of respondents from domestic U/KBs that have plans to use technology revealed that 21 percent to 40 percent of their banking transactions will be conducted through the use of digital technology in the next two years (Figure 16). Moreover, 40.0 percent foreign U/KBs stated that more than 80 percent of their banking transactions will utilize digital means. Meanwhile, 66.7 percent of subsidiary TBs mentioned that 21 percent to 60 percent of their banking transactions will be conducted through the use of digital technology. Also, 41.7 percent of respondents from R/CBs revealed that 10 percent to 20 percent of the transaction will utilize the internet, mobile phones or other electronic means.

Figure 16. Percentage of Technology-Enabled Bank Transactions



Source: SPRD

The banks that have plans to use digital technology were also asked on the most important application of technology in their respective organizations. **In general, data security and privacy were considered as the most important applications of technology**, followed by know your customer (KYC) procedures and loan scoring. The top five most important technology application areas by banking group is shown in Table 3.

Table 3. Top 5 Most Important Techonology Application Areas

Rank	First Semester 2019				
	Domestic UKBs	**Foreign UKBs**	**Subsidiary TBs**	**Stand-alone TBs**	**RCBs**
1	Data security and privacy	Data security and privacy	Data security and privacy	Data security and privacy	Data security and privacy
2	Know your customer (KYC)	Know your customer (KYC)	Know your customer (KYC)	Know your customer (KYC)	Deposit services
3	Loan scoring	Deposit services	Loan scoring	Loan scoring	Loan scoring/Collection
4	Payment system	Marketing/Loan scoring	Collection	Collection	Know your customer (KYC)
5	Customer service	Payment system	Deposit/Marketing/Payment system	Deposit/Marketing/ Payment system	Payment system

Source: SPRD

With the firm grasp of the risks and economic costs posed by cyberthreats, **65.1 percent of banks disclosed that they are 'prepared' to handle and manage these cyberthreats, while 15.1 percent expressed that they are 'very prepared' in managing cybersecurity risks**. Meanwhile, 47.4 of foreign U/KBs disclosed that they are 'very prepared'. This was the same percentage of foreign U/KBs that expressed that they are 'prepared' in dealing with cybersecurity risks and threats.

The top five cybersecurity threats that are of concern to banks is listed in Table 4. **In general, cyberattacks (i.e. to disrupt, to steal money, to steal IP) topped the list of cybersecurity threats that respondent banks were most worried about**. Moreover, 70.9 percent of surveyed banks indicated breaches on customer data as the most worrisome in terms of the impact of cybercrime events followed by reputational risk and financial losses.

Table 4. Top 5 Cybersecurity Threats

Rank	First Semester 2019				
	Domestic UKBs	**Foreign UKBs**	**Subsidiary TBs**	**Stand-alone TBs**	**RCBs**
1	Cyberattacks	Cyberattacks	Cyberattacks	Fraud	Cyberattacks
2	Direct Hacking/APTs	Phishing	Malware	Cyberattacks	Direct Hacking/APTs
3	Insider Attack	Malware	Card Skimming Attacks	Denial of Service Attacks	Phishing/Fraud
4	Malware	Phishing	Phishing	Malware	Insider Attack/Malware
5	Denial of Service Attacks	Fraud	Insider Attack/Fraud	Insider Attack/Direct Hacking/APTs	Denial of Service Attacks

Source: SPRD

Impact of Supervision on Bank Performance. Banks were also asked to rank five areas which they find challenging in terms of regulatory compliance. This is intended to evaluate the impact of BSP regulations. Except for R/CBs, **compliance with mandatory credits to Agri-Agra remained as the most challenging** as many banks' business models may not be suited to lend to the agri-agra sector. The results of the survey showed that 34.9 percent of respondent banks found it difficult to comply with the Agri-Agra Law (Republic Act No. 10000).[10] As of end-June 2019, the banking system's 13.2 percent compliance for other agricultural credit, for instance, was below the 15.0 percent statutory credit requirement under the Agri-Agra Law. Moreover, compliance ratio for agrarian reform credit, which stood at 1.2 percent, was way below the required 10 percent.

Banks also cited regulations on credit risk management, anti-money laundering and operational risk management as most challenging areas in terms of compliance with the BSP's regulatory framework.

Table 5 presents the five most challenging areas by banking group. Most banking groups' difficulty with compliance to the mandatory credits to Agri-Agra was noted during the previous conducts of BSOS.

Table 5. Most Challenging Areas in Terms of Compliance

Rank	Domestic U/KBs	Foreign U/KBs	Subsidiary TBs	Stand-alone TBs	R/CBs
1	Mandatory credits to agri-agra	Mandatory credits to agri-agra	Mandatory credits to agri-agra	Mandatory credits to agri-agra	Credit risk management
2	Anti-money laundering	Single Borrowers' Limit	Credit risk management	Credit risk management	IT risk management
3	Operational risk management	Anti-money laundering	Operational risk management	Operational risk management	Operational risk management
4	IT risk management	Internal Capital Adequacy Assessment Process (ICAAP)	IT risk management	Corporate governance requirements	Other areas of risk management
5	Electronic banking services and operations	Reportorial requirements	Liquidity risk management/ ICAAP/ Corporate governance requirements	Liquidity risk management	Anti-money laundering

Source: SPRD

Increase in Ranking from BSOS Second Semester 2018

Decrease in Ranking from BSOS Second Semester 2018

[10] Under the Agri-Agra Law, banks are required to set aside 25 percent of their loanable funds (10 percent for agrarian reform beneficiaries and 15 percent for other agricultural credit) to the agriculture sector.

Meanwhile, all the banking groups except for foreign U/KBs considered operational risk management in the third rank among the most challenging areas in terms of compliance. Notably, there was a shift in the ranking of the most challenging areas by some banking groups. For instance, reportorial requirements ranked number three for foreign U/KBs in the second semester of 2018, but ranked last in the first semester 2019.

Risk Assessment. Table 6 presents the top five risks to the banks' operation. **Overall, institutional risk was considered as the top-most risk to the banks' operation**. Domestic U/KBs and foreign U/KBs considered cybersecurity threat and regulatory/ compliance risk as the main risk under institutional risks, respectively. Subsidiary TBs considered cybersecurity threat, credit risk and market competition as the leading risks under institutional risk while market competition topped the list of institutional risk for stand-alone TBs and R/CBs. Moreover, technology risk and financial market risk were the other type of risks common to U/KBs, TBs and R/CBs.

Table 6. Top Five Risks to Banks' Operation

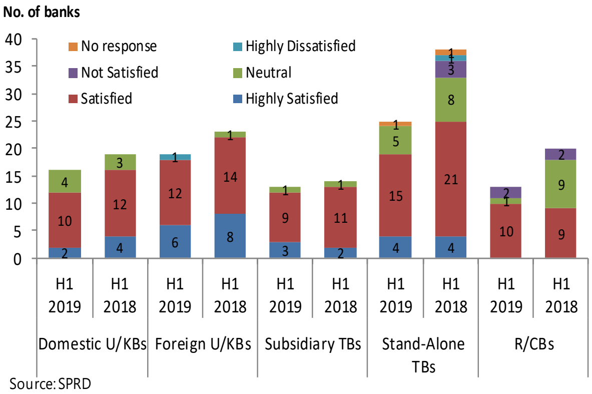
Rank	First Semester 2019			First Semester 2018		
	UKBs	TBs	RCBs	UKBs	TBs	RCBs
1	Institutional Risk	Institutional Risk	Institutional Risk	Institutional Risk	Institutional Risk	Institutional Risk
2	Technology Risk	Financial Market Risk	Technology Risk	Financial Market Risk	Financial Market Risk	Financial Market Risk
3	Financial Market Risk	Technology Risk	Financial Market Risk	Macroeconomic Risk	Macroeconomic Risk	Over-regulation
4	Macroeconomic Risk	Possible downturn in the domestic real estate market	Macroeconomic Risk	Technology Risk	Technology Risk	Technology Risk
5	Global and/or domestic geopolitical Risk	Over-regulation	General Risk	Global and/or domestic geopolitical Risk	Over-regulation	Macroeconomic Risk

Source: SPRD

Meanwhile, **enhancing their risk management systems was considered by banks as the primary tool to strengthen the bank against external headwinds**. Likewise, strengthening client relationships, keeping a high level of liquid assets, upgrading of personnel capabilities, and increasing capitalization were also deemed important by the respondents in order to protect their respective banks against internal and external shocks.

Organizational Conduct and Risk Culture. The survey disclosed the extent of satisfaction in terms of the level and maturity of banks' risk culture, as well as the strength of risk governance standards. **Overall, 65.1 percent of respondents revealed that they were satisfied with the risk culture in their respective banks while 17.4 percent of respondents disclosed that they were highly satisfied**. Two respondents from R/CBs were not satisfied with their banks' risk culture while one respondent from a foreign U/KB was dissatisfied with the level and maturity of the bank's risk culture (Figure 17).

Figure 17. Banks' Risk Culture
As of End-Periods Indicated



Source: SPRD

The banking environment has been constantly affected by changes in technology, competition, and the evolving regulations and international standards. **As new risks emerge due to these factors, it is necessary that banks protect their depositors, investors and institutions from these undue risks**. These have been reaffirmed in the results of the survey.

In order to mitigate risks, the respondents viewed the importance of: (a) board of director and senior management oversight; (b) appropriate risk appetite for the bank's business, resources and capital; (c) strong risk culture and values within the bank; and (d) highly effective control functions (i.e. risk management, compliance and internal audit. The top three areas that the banks need to strengthen in the next two years were presented in Annex B. **Overall, 44.2 percent of respondents highlighted the need for a highly effective models/system for risk management as one of the areas for improvement**.

The survey results showed that inputs from audit, risk and compliance functions were always considered in the board/senior management business decisions and strategies. Likewise, about 94.2 percent of the respondents mentioned that their employees were bound by a code of ethics/conduct in which majority was formulated by the bank. The survey results also revealed that customer dealings topped the list among the different aspects of business covered by their respective Codes of Ethics. This was followed by personnel recruitment and termination as well as whistleblowing and grievance escalation policies.

IV. Conclusion

The domestic and global economic uncertainties and geo-political tensions slowed the country's economic growth for the first half of 2019. **The slowdown resulted in the moderation of the banking industry leaders' bullish expectations on economic growth and banking system prospects**. Nonetheless, outlook on the economy and the banking system were still optimistic, with most of the BSOS respondents projecting double-digit growth in assets, loans, deposits and net income. Meanwhile, the highly competitive banking environment may have led to a narrower projections of net interest margin.

Nevertheless, **prudence remains** as banks intended to keep a high level of risk-based capital and liquidity; to enhance their risk management systems; and to strengthen organizational conduct and risk culture in order to thrive amid the volatility and complexity of the operating environment. Moreover, the banks intended to solidify their respective shares in the domestic market leveraging on their existing client relationships while harnessing technology to expand the banking business and achieve strategic and operational efficiencies.

Meanwhile, a number of policy reforms to enhance the resilience of individual banks and to strengthen risk governance in the financial system have been issued or will be adopted.

Republic Act No. 11211, which amended the BSP Charter, expanded and enhanced the BSP's existing regulatory and supervisory powers. It embodied a package of reforms that will further align the BSP's operations with global best practices and will enhancethe regulator's capacity for crafting proactive policies amid rising interlinkages in the financial markets and the broader economy.

In particular, the law strengthened the BSP's supervision over money service businesses, credit granting businesses and payment system operators. **This placed the BSP in a strategic position to address potential risks arising from the interconnection of banks and these financial entities**. It also put payment and settlement systems under BSP supervision including the critical market infrastructures that are vital components of the country's financial system.

Governance and risk management standards were enhanced to promote a sound risk culture. In strengthening risk governance, the BSP is guided by the concept of proportionality towards achieving an enhanced risk management system and sound capital position of BSP-supervised financial institutions (BSFIs). This objective is complemented by the deployment of prompt and calibrated enforcement actions as well as dynamic and forward-looking assessment framework.

The BSP issued the guidelines on investment activities of BSFIs which set out the regulatory expectations in managing risks arising from investment activities of banks/quasi-banks (QBs) to a wide range of instruments. This includes bonds issued by emerging economies, complex structured products, and other tradable assets.[11] Likewise, the guidelines on the management of interest rate risk in the banking book (IRRBB) and the amendment of the guidelines on market risk management aim to provide clear expectations on how a bank/QB should manage IRRBB and align the same with the BSP's supervisory framework on interest rate risk with international standards.[12]

The BSP enhanced the guidelines on LCR and MLR in response to feedback received from the BSP's continuing dialogue with the industry. At the same time, the BSP delayed the implementation of the LCR and NSFR for subsidiary banks/QBs to allow further build up of their liquidity positions given the combined impact of these measures. Moreover, the BSP shall introduce intraday liquidity reporting guidelines which aims to enable banking supervisors to better monitor a bank's management of intraday liquidity risk and its ability to meet payment and settlement obligations on a timely basis under both normal and stressed conditions.

Use of technology will continue to define the future landscape of the Philippine banking system. Fintech or technology-driven innovations in financial services has become a leading driving force in reshaping the landscape of the Philippine financial system. The BSP remains proactive in its approach to the rapid development and reach of fintech innovation considering its potential to promote financial inclusion and improve efficiency in banking operations.

The BSP pursues the effective implementation of its cybersecurity roadmap through capacity building, collaborative engagements, as well as policy framework and supervisory enhancements. As systems, customers, and institutions become more interconnected and accessible, the cyber threats have magnified as well. Meanwhile, the BSP is currently crafting supervisory tools aimed to assess cybersecurity maturity and security posture, both on supervised institution and industry-wide bases, including gaps in regulatory compliance. This will improve the BSP's supervisory responses as well as guide the future policy direction on cyber-resilience. In response to the growing concerns over cyber-attacks and threats, the BSP reiterates the need to have a collective, coordinated and strategic cyber response through information sharing and collaboration within the financial services industry.

[11] Circular No. 1042 dated 25 July 2019.
[12] Circular No. 1044 dated 06 August 2019.

Initiatives were likewise implemented to allow the use of technology to streamline the conduct of banking activities and to migitate and/or address technology-related risks, including anti-money laundering (AML) and other concerns with respect to fintech. In 2019, the BSP issued the guidelines on the streamlining of licensing requirements for BSFIs that intend to offer electronic payment and financial services (EPFS).[13] The BSP also issued the rules and regulations on the registration of payment systems operators[14] as part of the implementation of Republic Act No. 11127 or the National Payment Systems Act.

The BSP also issued the amendments to the framework for dealing with domestic systemically important banks (D-SIBs).[15] The assessment methodology of D-SIBs was enhanced and the existing framework was aligned with the recent policy measures issued by the Basel Committee on Banking Supervision (BCBS). The amendments to the D-SIBs framework include: (1) revision in the differential weights of categories/ indicators and the composition of indicators including adoption of threshold level; and (2) calibration of the level of additional capital requirement.

Meanwhile, **the BSP recognizes that the financial system is an important stakeholder in driving investments to activities that promote climate-resilient, green, and sustainable growth**. The BSP's proposed policy framework on sustainable finance provides high level principles and broad expectations on the integration of environmental and social governance and sustainability principles in the corporate and risk governance framework as well as business strategies and operations of banks.

The BSP, together with the other financial regulators participated in the joint IMF-World Bank Financial Sector Assessment Program (FSAP).[16] The FSAP mission generally assess the country's compliance with internationally-recognized standards considering the reforms implemented in the Philippine financial system since the last mission in 2009. The results of the FSAP mission provided meaningful inputs in building a strategic financial sector development roadmap and accorded credibility to the country's overall financial stability.

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[13] Circular No. 1033 dated 22 February 2019.
[14] Circular No. 1049 dated September 2019.
[15] Circular No. 1051 dated 27 September 2019.
[16] The FSAP main mission was held last 3-19 June 2019.

Moreover, collaboration with BSP stakeholders through conduct of regular dialogues will be strengthened. This includes the regular conduct of Bank Supervision Policy Committee (BSPC)[17] meetings with financial industry associations, cooperation with co-regulators under the Financial Sector Forum (FSF)[18] and Financial Stability Coordination Council (FSCC)[19], participation in forums organized by industry organizations, bilateral discussions and written queries with banks.

[17] The BSPC is comprised of the heads of the Financial Supervision Sector (FSS) and its Subsectors, the Reserves Management Departments I and II, the Department of Economic Research, the Center for Monetary and Financial Policy and the Department of Economic Statistics. It is at the forefront of the BSP's initiatives to enhance strategic partnership with the financial community. Through the BSPC, the BSP is apprised of financial industry developments which ensure the continued relevance and responsiveness of supervisory policy. The platform is an interactive venue in informing the industry of the BSP's policy direction, supervisory approach and stakeholder expectations.

[18] The FSF is a voluntary cooperative endeavor of domestic financial regulators (i.e. the BSP, the Securities and Exchange Commission [SEC], the Insurance Commission [IC], and the Philippine Deposit Insurance Corporation [PDIC]) to provide an institutionalized framework for coordinating the supervision and regulation of the financial system, while preserving each agency's mandate.

[19] The FSCC is a voluntary interagency council composed of the Department of Finance (DOF), the SEC, the IC, the PDIC, the Bureau of the Treasury (BTr) and the BSP. The FSCC's main task is to identify, manage and mitigate the buildup of systemic risks consistent with the overall prudential objective of financial stability.

BANKING SECTOR OUTLOOK SURVEY

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