OUTLOOK SURVEY

1ST SEMESTER 2021

BANKING SECTOR

BANGKO SENTRAL NG PILIPINAS

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Main Message of the Survey

Following the resurgence of the COVID-19 outbreak, adoption of targeted quarantine measures, and delay in rollout of vaccination program, the banking industry leaders' expectations on economic prospects remain tempered. Majority of the Banking Sector Outlook Survey (BSOS) respondents project real gross domestic product (GDP) growth to be between 5.0 percent and 6.0 percent within the next two years. Respondents identified that economic sectors such as the accommodation (hospitality/tourism) and transportation would continue to be the hardest hit sectors. However, these sectors are expected to recover in the next six months to two years. Banks have also identified loans to consumers as vulnerable and prone to weakening.

Nevertheless, the outlook on the Philippine banking system (PBS) remains relatively stable with prospects of double-digit growth in assets, loans, investments, deposits and net income. Banks also remain positive about active participation in the money and capital markets in the next two years with expectations of double-digit growth in investments in financial assets by more than half of respondents.

Meanwhile, majority of the respondents continue to expect their non-performing loan ratio (NPL) to exceed five percent in the next two years. In particular, universal/commercial banks (UKBs) estimate their NPL to settle between 3.0 percent and 6.5 percent. Notwithstanding, more respondents (54.0 percent) intend to report a higher NPL coverage ratio of more than 50.0 percent to 100.0 percent, compared to 44.3 percent in the previous survey, demonstrating a more prudent stance on the part of banks. In particular, 75.0 percent of UKBs expect the NPL coverage ratio to fall between 76 percent and greater than 100.0 percent.

Banks have mixed projections regarding restructured loans. More banks anticipate that the ratio of their restructured loans to total loans to increase. Around 43.5 percent of banks, mostly thrift banks, foreign banks, and rural and cooperative banks estimate that the ratio of their restructured loans to total loans would be more than 5.0 percent (up to 15.0 percent of their loan portfolio for small banks) from an earlier projection of between 3.0 percent and 5.0 percent. By contrast, about 37.0 percent of respondents, skewed by UKBs, are expecting a more conservative restructured loan ratio of between 1.0 percent and 2.0 percent.

The PBS also intends to maintain the Basel ratios (e.g., risk-based capital, leverage, and liquidity ratios) at levels higher than domestic and global standards to promote institutional stability.

In line with the emerging market trends and evolving client needs, banks have recognized the need to integrate technology in achieving business objectives. Thus, respondent banks disclosed that they will continue to prioritize the digitalization of products and services for strategic efficiency in the next two years.

Following the issuance of Circular No. 1085 in April 2020 on Sustainable Finance Framework, majority of banks remain open to financing sustainable projects covering agriculture, transportation, water supply management, and solar power. Sustainable financing is consistently viewed by almost 61.7 percent of banks as a highly important strategic objective. In turn, around 71.3 percent of respondents are planning to finance sustainable projects in 2021 to 2022.

Overall, asset quality and credit risk emerged as the top-most risk to the banks' operations. The survey results revealed that the other risks common to most of the respondent banks are macroeconomic risks and operational risk. Enhancing risk management systems was considered by majority of the respondent banks as the primary tool to strengthen the bank against external headwinds. Likewise, strengthening client relationships, keeping a high level of liquid assets, and upgrading personnel capabilities were also deemed important by the respondents in order to protect their respective banks against internal and external shocks.

The impact of the pandemic on the overall condition and performance of the banking system, which remains the core of the domestic financial system, has been manageable. This was largely due to the BSP's implementation of targeted and time-bound regulatory relief packages that facilitated the uninterrupted flow of financial services in the country. The enactment of the Financial Institutions Strategic Transfer (FIST) Act as well as the issuance of its implementing rules and regulations in the first semester of 2021 will help keep the banking industry's NPLs in check. The FIST Act is expected to encourage BSP-supervised financial institutions (BSFIs) to transfer their non-performing assets (NPAs) to FIST Corporations and Special Purpose Vehicles through tax exemptions and privileges.

Moving forward, the Philippine banking system is projected to withstand the legacy risks and challenges of the COVID-19 pandemic within the next two years on account of its stable and sound capital, leverage and liquidity buffers, ample loan loss reserves, good earnings performance and prudent risk governance**.**

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 periodic outlook surveys has been observed in some countries. However, the Philippine BSOS is characterized by 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 sixth time the BSOS has been conducted, with the maiden report released in October 2018.

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

II. What is the Banking Sector Outlook Survey?

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 operations and 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, diversify operations geographically, and transform 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 PBS. Moreover, it intends to provide supervisory and market perspectives on emerging issues and trends for timely and relevant prudential reporting and related analysis.

Structure of the BSOS. The BSOS is currently composed of eight sections as shown below:

Section	Description
Macroeconomy and Banking System 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 PBS.
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 intends to understand banks' operational approach to maintain growth, address operational challenges and enhance profitability moving forward.
Fintech/ Cybersecurity	This section attempts to identify the extent of fintech adoption and strategy as well as the respondents' outlook on cybersecurity risks and threats.
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.

Section	Description
Sustainable Finance	This section strives to categorize the bank's view towards sustainable financing as well as their plans with respect to financing sustainable projects.
Impact of Supervision/ Regulation on Bank Performance	This section plans 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 PBS.
Risk Assessment	This section seeks to identify the risks that banks are most wary of and the existing mitigants for identified risks.

The BSOS Methodology. The conduct of BSOS for the first semester of 2021 covers all universal and commercial banks (UKBs), thrift banks (TBs) and 80 rural and cooperative banks (RCBs) to include top 20 RCBs in terms of total loan portfolio plus the 60 RCBs that were randomly selected. The updated survey questionnaire includes questions related to COVID-19 pandemic and transmitted to the Presidents/Chief Executive Officers/Country Managers of the covered banks. Meanwhile, banks which responded to the survey accounted for 71.9 percent of the total assets of the PBS as of end-March 2021.

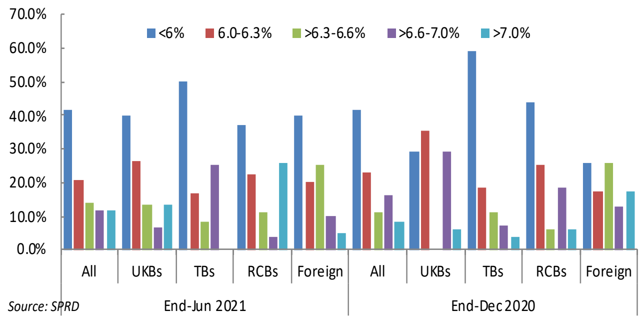
III. Results of the First Semester 2021 Banking Sector Outlook Survey

Macroeconomy and Banking System Growth Outlook

Banks report subdued optimism on the country's economic prospects due to uncertainties brought about by the resurgence of COVID-19 cases, reimposition of targeted lockdown measures and delay in the vaccination rollout in the first quarter of 2021. In the latest BSOS run, 41.9 percent of respondents expect GDP growth to range between 5.0 percent and 6.0 percent within the two-year horizon. Meanwhile, 20.9 percent of survey participants project GDP growth of between 6.0 percent and 6.3 percent.

Across banking groups, around 40.0 percent of respective respondents from UKBs and foreign banks forecasted GDP growth of less than 6.0 percent (mostly between 5.0 percent and 6.0 percent). Meanwhile, 50.0 percent of respondent TBs and 37.0 percent of respondent RCBs projected real GDP growth of around 4.0 percent to 6.0 percent (Figure 1).

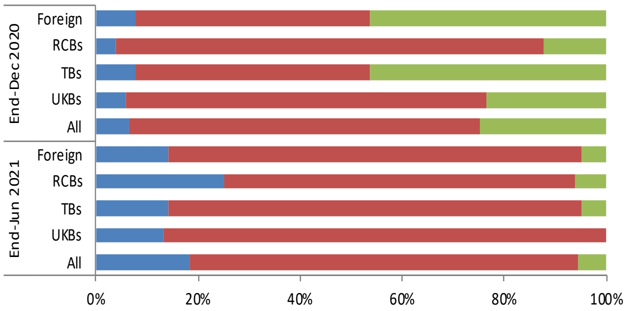
Figure 1. Real GDP Forecast by Type of Bank
As of End-Periods Indicated



Source: SPRD

On the whole, the banks' GDP growth outlook is consistent with that of the Asian Development Bank (ADB) which forecasts the Philippine economy to grow by 4.5 percent in 2021 and 5.5 percent in 2022. However, uncertainties over how the pandemic will unfold globally and domestically can pose risks to growth prospects.[2] Meanwhile, the International Monetary Fund (IMF) expects the country to grow by 5.4 percent this year and 7.0 percent in 2022.[3]

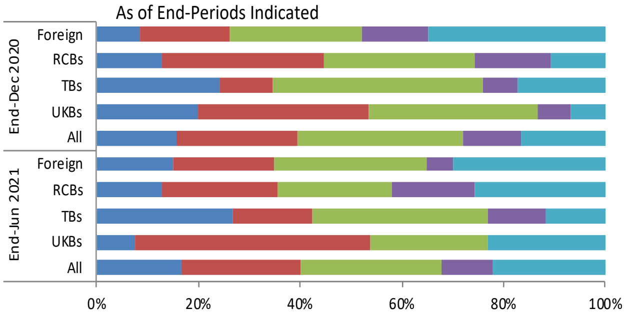
Figure 2. Banking System Growth Outlook
As of End-Periods Indicated



Source: SPRD

Amid the banks' subdued optimism on the country's economic prospects, the overall outlook in the banking system remains stable. This is evident as 76.3 percent of the banks projected a stable PBS in the next two years (Figure 2). This was higher than the PBS overall outlook for the second semester of 2020 wherein 68.8 percent of the industry leaders forecasted a stable PBS. The increase, however, was due to some banks tempering their optimistic view of a stronger banking system. However, 18.3 percent of respondents, largely rural and cooperative banks, expect a weaker banking system in 2022 to 2023.

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



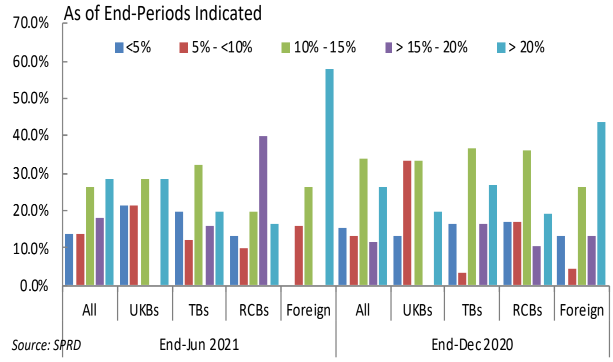
Source: SPRD

Expectations of improvement in economic growth and stable outlook on the PBS influenced 60.0 percent of the respondents to project double-digit growth in bank assets. This is almost the same as the 60.5 percent of respondents which projected double-digit asset growth in the BSOS for the second semester of 2020 but lower compared to the 70.7 percent projection during the second semester of 2019. It should be noted that the average projected asset growth rate of the top 10 large banks was below 10.0 percent.

[2] Asian Development Bank (ADB), *Asian Development Outlook 2021: Financing a Green and Inclusive Recovery*, April 2021.
[3] International Monetary Fund (IMF), "*IMF Staff Completes Virtual 2021 Article IV Mission to the Philippines*," Press Release No. 21/177 (15 June 2021).

The growth in assets is expected to be driven by credit expansion as more respondent banks (72.7 percent) estimated double-digit growth in their loan portfolio in the next two years. Majority of UKBs' and TBs' projection of credit growth hovered between 10.0 percent and 15.0 percent. About 57.9 percent of the foreign bank respondents (from 43.5 percent in the previous quarter) projected loan growth of more than 20.0 percent, while majority of RCBs' projection of credit growth shifted to the 15.0 percent to 20.0 percent range from 10.0 percent to 15.0 percent in the last semester (Figure 4). The progress in the country's vaccination rollout is expected to sustain loan growth due to consumer and business confidence and higher loan demand.

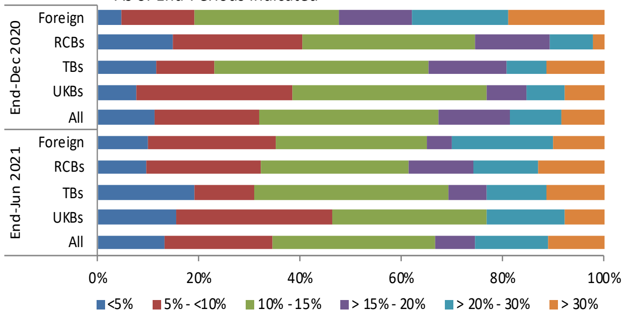
Figure 4. Projected Loan Growth
As of End-Periods Indicated



Source: SPRD

The BSOS results likewise revealed expectations on deposit growth to fund asset and loan expansion. About 65.6 percent of the current BSOS respondents projected double-digit deposit growth, though lower than that of second semester 2020 BSOS at 68.2 percent. In particular, majority of UKBs', TBs', and RCBs' projection of deposit growth were between 10.0 percent and 15.0 percent in 2022 to 2023 (Figure 5).

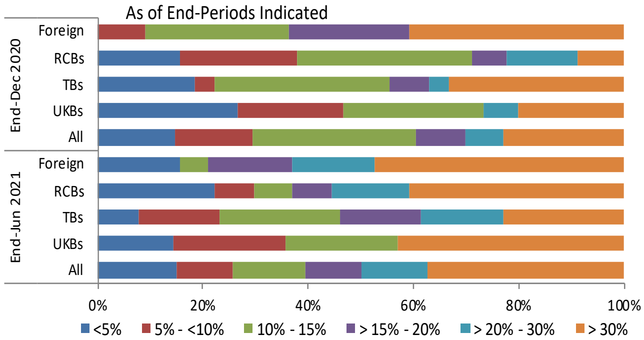
Figure 5. Projected Growth in Deposits
As of End-Periods Indicated



Source: SPRD

More banks set upbeat expectations on returns as 74.4 percent of the respondents for the first semester of 2021 forecasted double-digit net income growth for the next two years, slightly higher compared to the 70.6 percent of the respondents during the second semester of 2020. In particular, 42.9 percent of UKBs, 47.4 percent of foreign banks, and 40.7 percent of RCB respondents viewed growth in net income to be higher than 30.0 percent for the next two years (Figure 6).

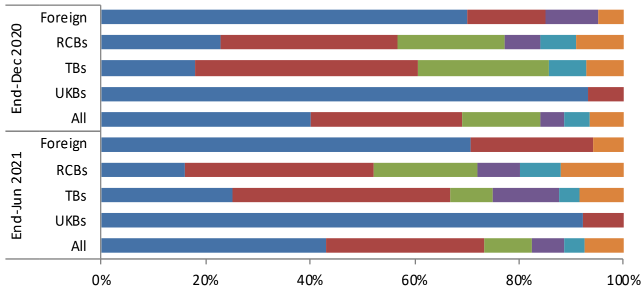
Figure 6. Projected Growth in Net Income
As of End-Periods Indicated



Source: SPRD

Banks report tight projections of net interest margin (NIM) of less than 3.0 percent (around 43.0 percent of respondents project NIM to range between 1.5 percent and 3.0 percent) and between 3.0 percent and 5.0 percent (30.4 percent of respondents). UKBs and foreign banks were the most conservative with 92.3 percent and 70.6 percent expecting an NIM of between 1.5 percent and 3.0 percent, respectively (Figure 7). TBs' and RCBs' NIM projections were tilted towards the 3.0 percent and 5.0 percent range.

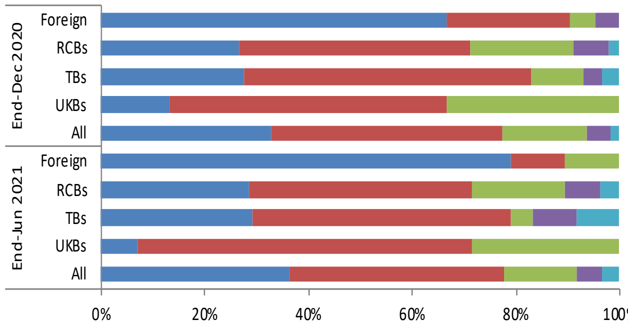
Figure 7. Projected Net Interest Margin
As of End-Periods Indicated



Source: SPRD

The projected return on equity (ROE) generally tightened, with higher number of respondents (36.5 percent) expecting it to be less than 5.0 percent (mostly between 2.0 percent and 5.0 percent) for the current BSOS compared to 32.7 percent and 11.3 percent of respondents during the second semester BSOS in 2020 and 2019, respectively. (Figure 8).

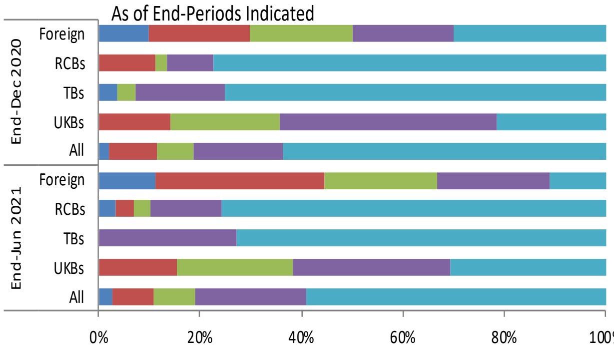
Figure 8. Projected Return on Equity
As of End-Periods Indicated



Source: SPRD

The slowdown in economic activities has exerted pressure on the quality of bank loan portfolio. All banks expect a downgrade in the quality of their loans with a non-performing loan (NPL) to total loan ratio of above 5.0 percent. UKBs, in particular, project their NPL ratio to range between 5.0 percent and 6.5 percent. The percentage of respondents which expect the NPL ratio to exceed 5.0 percent in the next two years stood at 58.9 percent from 63.5 percent during the second semester of 2020. Majority of TBs and RCBs also consistently expect elevated NPL ratios (Figure 9).

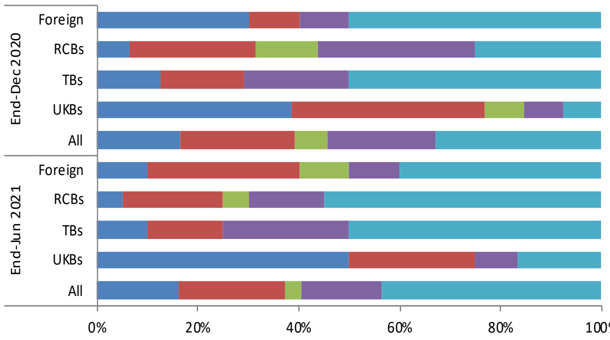
Figure 9. Projected NPL Ratio
As of End-Periods Indicated



Source: SPRD

The ratio of restructured loans to total loans demonstrates the propensity of banks to modify the terms of the loan when a borrower faces financial stress due to unforeseen events like the COVID-19 pandemic and natural disasters. About 43.5 percent of respondent banks, mostly niche marketers like foreign banks, TBs and RCBs, projected a restructured loan ratio of more than 5.0 percent (mostly up to 15 percent of their loan portfolio for small banks). By contrast, 37.1 percent of respondents, skewed by UKBs, predict a more conservative restructured loan ratio of 2.0 percent and below (Figure 10).

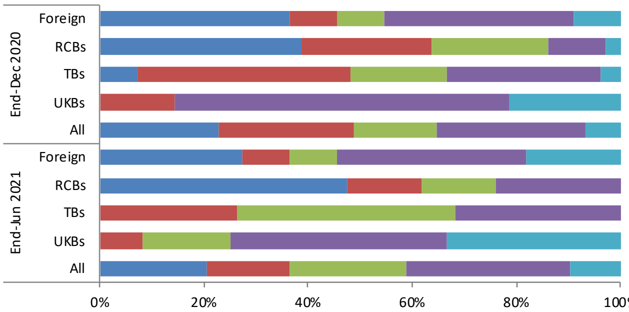
Figure 10. Projected Restructured Loans to Total Loans
As of End-Periods Indicated



Source: SPRD

The projected NPL coverage ratio, meanwhile, indicates the banks' (perceived) ability to absorb future losses. In the survey, 54.0 percent of the respondent banks projected an NPL coverage ratio in the range of 51.0 percent to 100.0 percent, while 36.5 percent of the respondents projected an NPL coverage ratio of below 50.0 percent (Figure 11). More UKBs, (33.3 percent from 21.4 percent of respondents) expect the NPL coverage ratio to be greater than 100 percent. Around 73.7 percent of TBs converged on the projected NPL coverage ratio of between 51.0 percent and 100.0 percent, while 47.6 percent of RCBs were tilted towards the NPL coverage ratio of 25.0 percent and below.

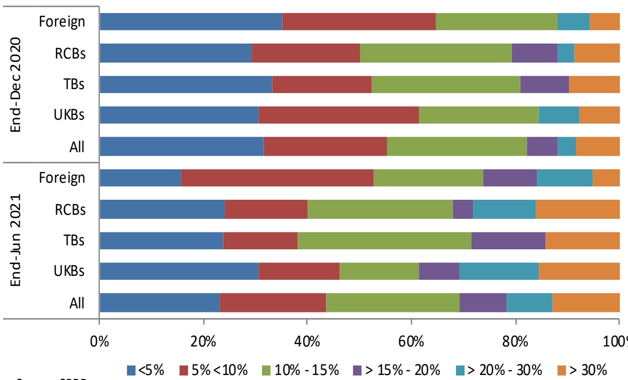
Figure 11. Projected NPL Coverage Ratio
As of End-Periods Indicated



Source: SPRD

Prior to the pandemic, income from financial assets (excluding loans) represented a material source of income for banks that have ready and active market access. Thus, banks were asked to report initial forecasts of investment growth in the next two years to indicate their risk appetite towards this business segment. About 43.6 percent forecasted an investment portfolio growth of less than 10.0 percent, while 56.4 percent of the banks projected double-digit growth in financial assets for the next two years (Figure 12).

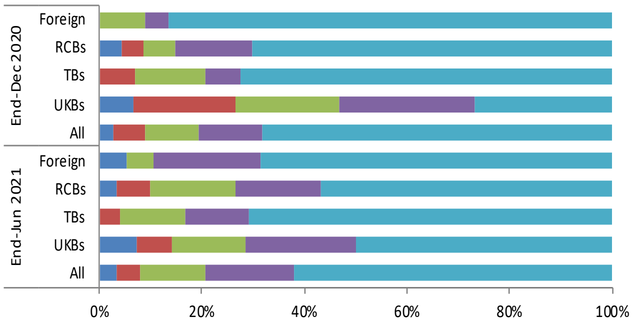
Figure 12. Projected Growth of Financial Assets
As of End-Periods Indicated



Source: SPRD

Cognizant of the importance of capital to protect the banks from unexpected losses, the PBS has been maintaining risk-based capital at levels higher than domestic (10.0 percent) and BIS global (8.0 percent) standards, and intends to do so in the next two years. About 79.3 percent of the respondents expect their capital adequacy ratio (CAR) at more than 14.0 percent, slightly higher compared to 78.0 percent of respondents in 2019 but lower than the 80.5 percent in the 2020 BSOS (Figure 13). Moreover, industry data showed that banks' CAR will mostly be comprised of high-quality common equity Tier 1 capital.

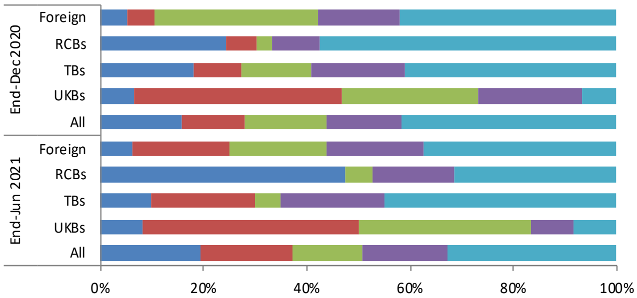
Figure 13. Projected CAR
As of End-Periods Indicated



Source: SPRD

As a backstop to their respective CAR, 80.6 percent of banks projected leverage ratio to exceed the BSP (5.0 percent) standard. This standard constrains the potential build-up of excessive leverage in banks and promote financial stability. Bank projections of leverage ratio somewhat softened in line with growth in assets. Smaller banks, particularly 45.0 percent of TBs and 31.6 percent of RCBs would be reliant on capital with projected leverage ratio of more than 15.0 percent (Figure 14). This level of gearing will provide banks with flexibility to expand their loan portfolio to support the financing needs of the economy.

Figure 14. Projected Leverage Ratio
As of End-Periods Indicated



Source: SPRD

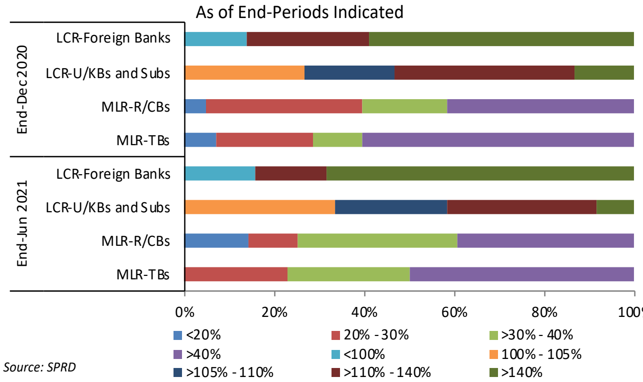
Liquidity has been a key strength of the PBS. This is expected to be maintained up to 2022 as banks continue to project healthy liquidity metrics under the Basel III liquidity coverage ratio (LCR)[4] and net stable funding ratio

[4] Circular No. 905 dated 10 March 2016, as amended, requires the UKBs to hold sufficient High Quality Liquid Assets (HQLAs) that can be easily converted into cash to service liquidity

(NSFR)[5] for UKBs and their subsidiary banks and quasi-banks (QBs), and the minimum liquidity ratio (MLR)[6] for stand-alone TBs, RCBs and QBs. Liquidity buffer serves as defense 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.

In the current survey, the respondents disclosed that all banks intend to maintain adequate level of liquidity buffer, notwithstanding expansion in their lending activities. All domestic UKBs and their subsidiary banks intend to maintain LCR above the minimum 100.0 percent threshold, with 66.7 percent of domestic UKBs and their subsidiary banks reporting LCR at more than 105.0 percent. This was lower than the 73.3 percent recorded during the second semester 2020 BSOS. More foreign bank respondents (about 68.4 percent) projected their LCR at more than 140.0 percent. In a similar manner, all TBs plan to maintain their MLR above the minimum threshold with 77.3 percent of TBs planning to maintain MLR above 30 percent. More RCBs (75.0 percent) intend to maintain their MLR above 30 percent (Figure 15).

Figure 15. Projected LCR/MLR
As of End-Periods Indicated



Source: SPRD

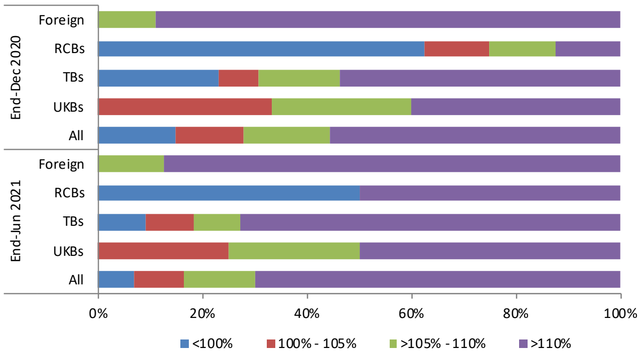
requirements over a 30-day stress period. This provides banks with a minimum liquidity buffer to be able to take corrective action to address a liquidity stress event.

[5] 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.

[6] Circular No. 996 dated 8 February 2018 requires stand-alone TBs, RCBs, 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. As a temporary relief measure, the BSP reduced the MLR requirement to 16 percent until 31 December 2021.

Implemented on 1 January 2019 for UKBs, the NSFR is projected to be maintained at more than 110.0 percent for the next two years by 69.8 percent of respondents. The strong commitment to long term stable funding is evident for all bank categories, with a sizeable portion of respondents planning to maintain their NSFR at more than 110.0 percent (Figure 16).

Figure 16. Projected NSFR
As of End-Period Indicated



Source: SPRD

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

By type of bank, the respondents revealed that majority of domestic UKBs will focus on corporate banking, retail banking, cross-selling, and payments and settlement services while foreign UKBs will mainly concentrate on corporate banking, trade financing, and treasury operations. Meanwhile, retail loans remained as the main priority of TBs and RCBs, which indicates that these banks are committed to their niche market.

Table 1. Focus of Bank Lending by Economic Sector

Rank	First Semester 2021					Second Semester 2020				
	Domestic UKBs	Foreign UKBs	Subsidiary TBs	Stand-alone TBs	RCBs	Domestic UKBs	Foreign UKBs	Subsidiary TBs	Stand-alone TBs	RCBs
1	Financial and Insurance Activities	Manufacturing	Consumer Loans	Consumer Loans	Wholesale and Retail Trade	Consumer Loans	Information and Communication	Consumer Loans	Consumer Loans	Agriculture
2	Wholesale and Retail Trade	Financial and Insurance Activities	Wholesale and Retail Trade	Agriculture	Agriculture	Wholesale and Retail Trade	Financial and Insurance Activities	Wholesale and Retail Trade	Real Estate Activities	Wholesale and Retail Trade
3	Manufacturing	Information and Communication	Manufacturing	Manufacturing	Real Estate Activities	Manufacturing	Manufacturing	Transportation	Wholesale and Retail Trade	Consumer Loans

Source: SPRD

The top three focus of lending by economic sector of domestic UKBs are financial and insurance activities, wholesale and retail trade, and manufacturing for the next two years (Table 1). Moreover, foreign UKBs prefer to lend primarily to the manufacturing, financial and insurance as well as information and communication sectors. Subsidiary and stand-alone TBs underscored that consumer loans will have the largest share in their lending portfolio in the next two years followed by loans to the agriculture, wholesale and retail trade, and manufacturing sectors. Meanwhile, the agriculture remains in the top three market of the RCBs' loan portfolio but with higher priority towards loans to the wholesale and retail trade sector. Based on latest available data, banks' lending activities were mainly channeled to real estate activities, household consumption (consumer finance), wholesale and retail trade, electricity, gas, steam and air-conditioning supply, and manufacturing.

As part of the COVID-19 impact assessment, banks were asked to name the top three industries that are heavily affected by the pandemic based on evaluation of total loan portfolio. The banks revealed, in order of ranking, that accommodation (hospitality/tourism), transportation, and consumer loans are the hardest hit sectors due to the strict quarantine measures. Further, the banks were asked to indicate the expected duration of recovery of these top three industries from the pandemic. Banks observed that transportation sector will be the fastest to recover in the next six months. Consumer loans will take around one year to fully recover while the accommodation sector will take the longest time of about two years.

Business Strategy

Overall, the respondents revealed that the top two strategic priorities[7] of the bank executives surveyed are: (1) digitalization of products and services; and (2) expansion in their target market. In line with the emerging market trends and evolving client needs especially during the lockdown period due to COVID-19, banks have recognized the need to integrate technology in achieving business objectives. Thus, respondent banks disclosed that they will prioritize the digitalization of products and services for strategic efficiency in the next two years.

The top two strategic priorities by banking group are shown in Table 2. For the BSOS this semester, the topmost strategic priority of UKBs and TBs is the digitalization of products and services while RCBs shared that they need to focus on sustainable finance business strategies.

Table 2. Top Two Strategic Priorities per Type of Bank

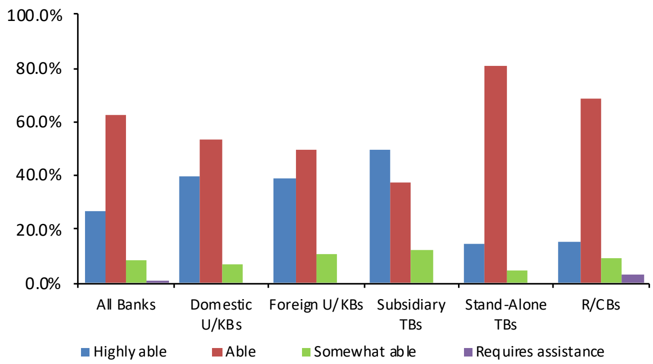
Type of Bank/ Period	UKBs	TBs	RCBs
First Semester 2021	Digitalization of products and services	Digitalization of products and services	Focus on sustainable finance business strategies
	Expand the target market	Streamline operational costs	Digitalization of products and services
Second Semester 2020	Grow the business	Grow the business	Protect the bank
	Optimize technology	Optimize technology	Optimize technology

Source: SPRD

[7] For this semester, choices for strategic priorities of the banks were revised.

Operational Performance

Figure 17. Banks' Level of Performance in Managing Covid-19



Source: SPRD

Amid global and domestic economic growth slowdown brought about by the COVID-19 pandemic, **the PBS remains on relatively stable footing as shown by growth in assets, loans, and deposits, profitable operations, as well as stable capital and liquidity buffers.** However, the restrictive lockdowns, social distancing, as well as other health and safety protocols pushed the banks to adjust their operations while maintaining proactive control measures for the continued delivery of financial services. In the survey, banks were asked about their preparedness in handling the COVID-19 pressures and how they will maintain growth in an era of intense competition, heightened customer expectation, and non-traditional market entrants. The result of the BSOS revealed that 62.8 percent and 26.6 percent of respondent banks are able and highly able, respectively, in managing the effects of COVID-19 pandemic (Figure 17).

Meanwhile, the top three plans of banks for the six consecutive editions of the BSOS remain the same. **Banks have deemed it important to develop new capabilities, leverage on client relationship to maintain growth, and expand market reach digitally or through new products/services** in the new economy arrangement as shown in Figure 18.

Figure 18. Top 3 Plans to Maintain Growth in the Presence of Intense Competition and Other Factors

Source: SPRD

About **53.2 percent of the respondents believed that efficient operations is important in maintaining profitability amid market and COVID-19 pandemic pressures.** The respondents also underscored that the ability to leverage on technology is also important for purposes of compliance with regulatory requirements. By banking group, maintaining efficient operations was ranked by UKBs, stand-alone TBs and RCBs as the most important. Meanwhile, foreign banks and subsidiary TBs regarded the pursuit of organic growth as the most important to maintain profit.

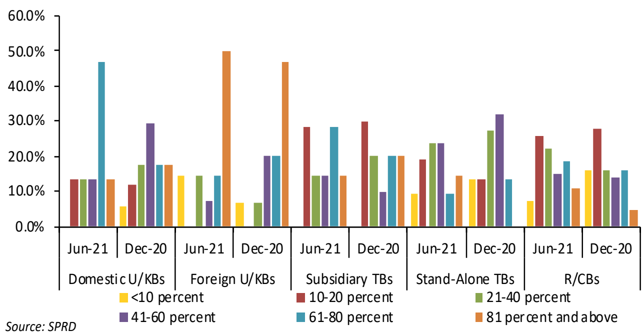
Fintech/Cybersecurity Plans

The COVID-19 pandemic highlighted the significant role of technology in banking operations. The enhanced community quarantine (ECQ) in the country expedited the digital transformation of the banking system with the significant increase in the use of digital payments and electronic money platforms. The survey results revealed **that 76.6 percent of respondents use technology and operating models[8] to address operational performance.** Likewise, technology and operating models are also deemed useful in enhancing business continuity, internal controls, risk management, and compliance.

With the important role of technology in banking operations, the banking industry supports the use of technology-enabled solutions and exhibits strong interest in participating in the digital finance ecosystem. In particular, the responses for the first semester of 2021 indicated that 89.4 percent of respondent banks (from 89.2 percent) have plans to use technology in the banking transactions for the next two years.

For the first semester of 2021, 46.7 percent of domestic UKBs that have plans to use technology revealed that between 61.0 percent and 80.0 percent of their banking transactions will be conducted through the use of digital technology for the next two years (Figure 19). Likewise, 50.0 percent of foreign UKBs stated that more than 80.0 percent of their banking transactions will utilize digital means. About 85.7 percent of subsidiary TBs will use digital means between 10.0 percent and 80.0 percent of their banking transactions. Almost half of the stand-alone TBs mentioned that between 21.0 percent and 60.0 percent of their banking transactions will

Figure 19. Percentage of bank transactions that will use technology
As of End-Periods Indicated



Source: SPRD

[8] This refers to 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).

be conducted through the use of digital technology. Meanwhile, 48.1 percent of respondents from RCBs revealed that between 10.0 percent and 40.0 percent of their banking transactions will utilize the internet, mobile phones or other digital means.

Likewise, banks that have plans to use digital technology were also asked on the most important application of technology in their respective organizations. **Overall, payment systems emerged as the most important application of technology**. This may be attributed to the increase in the use of digital payments and electronic money platforms as individuals and businesses shifted to digital channels given the limited mobility and the necessity of avoiding face-to-face transactions. Meanwhile, 51.1 percent of respondents have plans to partner with a fintech company with the objective of offering innovative digital financial products or services in the next two years. The top three most important technology application areas by banking group are shown in Table 3.

Table 3. Top Three Most Important Technology Application Areas

Rank	First Semester 2021				
	Domestic UKBs	Foreign UKBs	Subsidiary TBs	Stand-alone TBs	RCBs
1	Payment system	Payment system	Deposit Services	Payment system	Deposit Services
2	Know your customer (KYC)	Know your customer (KYC)	Loan Scoring	Loan Scoring	Payment system
3	Loan Scoring	Deposit Services/Customer Service	Payment system	Marketing	Loan Scoring

Source: SPRD

The disruption caused by the lockdown and remote working arrangements led to cyberthreats and attacks. Relative to this, the result of the BSOS showed that **53.2 percent of banks are 'prepared' to handle and manage cyberthreats**, lower from 58.3 percent of banks in the end-December 2020 BSOS. Meanwhile, 19.1 percent and 23.4 percent of the respondents expressed that they are 'highly prepared' and 'somewhat prepared' in managing cybersecurity risks, respectively.

The top five cybersecurity threats that are of concern to banks are 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, direct hacking/advanced persistent threats (APTs) and phishing are the other types of cybersecurity threats common to UKBs, TBs and RCBs.

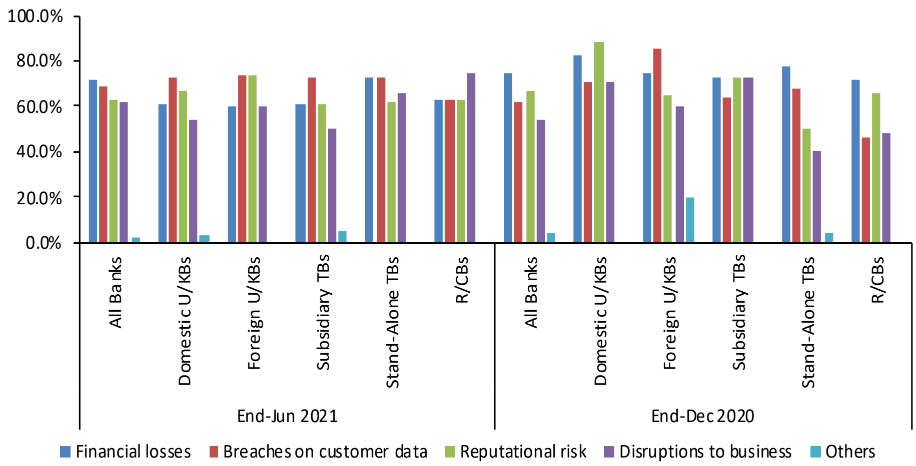
Table 4. Top Three Cybersecurity Threats

Rank	First Semester 2021				
	Domestic UKBs	Foreign UKBs	Subsidiary TBs	Stand-alone TBs	RCBs
1	Cyberattacks	Phishing	Cyberattacks	Phishing	Cyberattacks
2	Direct Hacking/APTs	Direct Hacking/APTs	Malware	Direct Hacking/APTs/Fraud	Fraud
3	Phishing/Card Skimming Attacks	Cyberattacks/Malware	Cyberattacks/Fraud	Malware	Phishing

Source: SPRD

Overall, **71.3 percent of surveyed banks indicated financial losses as the most worrisome in terms of the impact of cybercrime events followed by breaches in customer data and reputational risk**. By banking group, breaches in customer data and reputational risk were viewed by 72.7 percent of domestic UKBs and 73.3 percent of foreign UKBs as the most concerning impact of cybercrimes, respectively. Disruptions to business were viewed by 75.0 percent of RCBs as the most disturbing effect of cybercrime events (Figure 20).

Figure 20. Impact of cybercrime events*
As of End-Periods Indicated



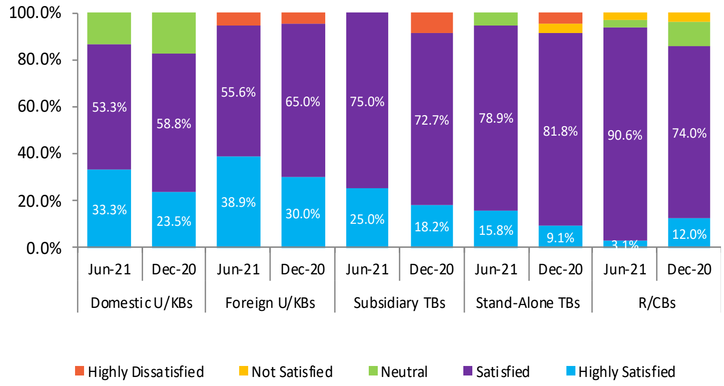
Source: SPRD
** Multiple response allowed*

Organizational Conduct and Risk Culture

The banking environment has been constantly driven by changes in technology, competition, and the evolving regulations and international standards. **Banks recognize the need to protect their depositors, investors and institutions from undue risks through strong risk governance standards**. These have been underscored in the results of the survey in which majority of the respondents are satisfied with the level and maturity of risk culture in their respective banks.

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. **On the whole, 72.3 percent of respondents revealed that they were satisfied with the risk culture in their respective banks while 19.1 percent of respondents disclosed that they are highly satisfied**. (Figure 21).

Figure 21. Banks' Risk Culture Satisfaction
As of End-Periods Indicated



Source: SPRD

The respondents identified the top three strengths of their banks' risk governance framework. The board of director and senior management oversight topped the list among the strengths of banks' risk governance framework followed by strong risk culture and values within the bank, and highly effective control functions. **The need for highly effective models/system for risk management, and comprehensive risk management policies** were the two areas that need to be improved in the next two years as indicated by 44.7 percent and 26.6 percent of the respondents, respectively.

The survey results also showed that inputs from audit, risk and compliance functions are always considered in the board/senior management business decisions and strategies. Meanwhile, 98.9 percent of the respondents mentioned that their employees are bound by a code of ethics/conduct majority of which were formulated by the banks. The survey results also revealed that customer dealings, personnel recruitment and discipline, and whistleblowing and grievance escalation policies are the top three aspects of business covered by their respective codes of ethics.

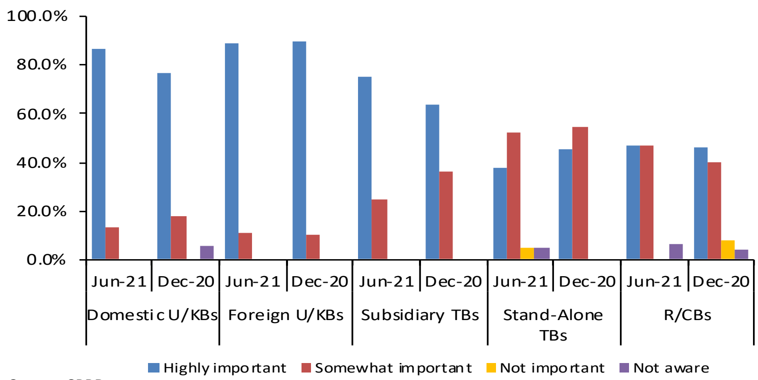
Sustainable Finance

With the global move towards sustainable development and the growing demand for sustainable investments, the rise in interest from global investors and fund managers to direct funds toward sustainable projects and activities has been noted. Following the issuance by the BSP in April 2020 of Circular No. 1085 on the Sustainable Finance Framework, the increase in demand has been complemented by the development of various financing mechanisms for sustainable projects. Circular No. 1085 provides high-level expectations on the integration of sustainability principles in the corporate governance, risk management systems, business objectives and operations of banks.

The survey results showed a distinct shift in organizational focus towards sustainable financing. More respondent UKBs and subsidiary TBs viewed such mode of financing as highly important. Most of the stand-alone TBs

(52.4 percent) reported that sustainable financing as somewhat important. Meanwhile, RCBs (46.9 percent of respondents) view sustainable financing as highly important. The views by banking group towards sustainable financing is shown in Figure 22.

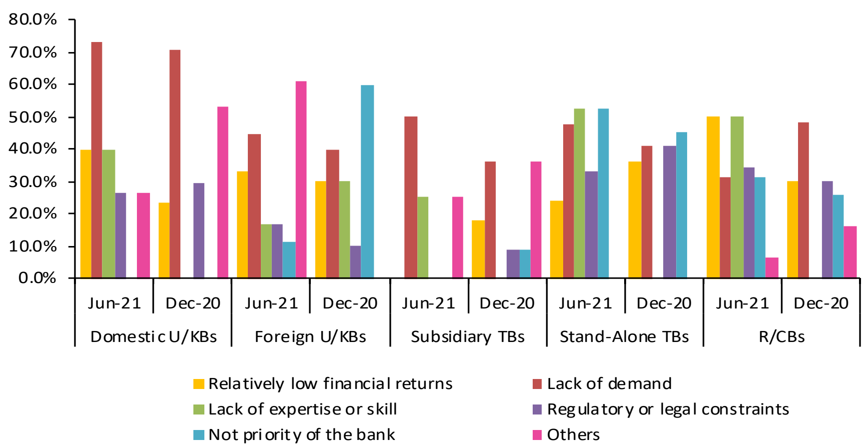
Figure 22. Organization's view on sustainable financing
As of End-Periods Indicated



Source: SPRD

BSOS results also revealed that 71.3 percent of respondents are planning to finance sustainable projects while only 27.7 percent of banks have no plans to finance these types of projects. Meanwhile, banks expressed willingness to finance sustainable projects in support of agriculture, solar power, water supply management and treatment, and transportation. Majority of the UKBs and TBs indicated that lack of demand for these projects topped the list among the barriers from pursuing sustainable financing. For simple banks, they identified lack of expertise or skill followed by relatively low financial returns as the barriers. Other barriers mentioned by foreign UKBs include lack of government support, lack of regulatory incentive, and lack of information campaign, among others. The barriers identified by banks in pursuing sustainable financing are shown in Figure 23.

Figure 23. Barriers in pursuing sustainable financing
As of End-Periods Indicated



Source: SPRD

The BSP has taken a two-pronged approach to sustainable finance: first is undertaking capacity building and awareness campaigns, and second is mainstreaming environmental and social governance through the issuance of enabling regulations that will encourage the growth of the market while maintaining the soundness and stability of the PBS. The BSP has recently issued a draft guidance which aims to further integrate climate change and other environmental and social risks in the enterprise risk management frameworks of banks, particularly on credit and operational risks.

Impact of Supervision on Bank Performance

In order to evaluate the impact of the BSP regulations, banks were also asked to rank five areas which they find challenging in terms of regulatory compliance. Except for RCBs, **compliance with mandatory credits to Agri-Agra remains as the most challenging** since the complex business models of bigger banks may not be suited to lend to the agri-agra sector.[9] As of end-December 2020, the PBS' 9.0 percent compliance for other agricultural credit, for instance, was below the 15.0 percent statutory credit requirement under the Agri-Agra Law. Moreover, the compliance ratio for agrarian reform credit, which stood at 1.0 percent was way below the required 10.0 percent. Penalties have been collected from banks which have failed to fully comply with the mandatory agri-agra credit allocation.

The BSP, the Department of Agriculture (DA) and the Department of Agrarian Reform (DAR) approved the amendments to the Implementing Rules and Regulations (IRR) of R.A. No. 10000. These amendments broaden the access of the agrarian reform sector to bank financing, streamline banks' process of investing in agri-agra eligible securities, and promote innovative financing solutions, within the legal ambit of R.A. No. 10000. The IRR amendments are only an interim measure pending the passage of the proposed amendments to Agri-Agra Law. The BSP is currently pushing for the enactment of comprehensive amendments to R.A. No. 10000, which recommends a holistic financing approach that considers the requirements of the broader agricultural ecosystem.

Banks also cited regulations on anti-money laundering, IT risk management, operational risk management, and reportorial requirements as the 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 issuances of BSOS.

[9] 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.

Table 5. Most Challenging Areas in Terms of Compliance

Rank	Domestic UKBs	Foreign UKBs	Subsidiary TBs	Stand-alone TBs	RCBs
1	Mandatory credits to agri-agra	Mandatory credits to agri-agra	Mandatory credits to agri-agra	Mandatory credits to agri-agra	IT risk management
2	Anti-money laundering	Reportorial requirements	Anti-money laundering	Credit risk management	Operational risk management
3	IT risk management	Anti-money laundering	IT risk management	Anti-money laundering	Credit risk management
4	Liquidity risk management	Operational risk management	Liquidity risk management	IT risk management / Stress testing	Stress testing
5	Reportorial requirements	Credit risk management / Stress testing	Operational risk management	Corporate governance requirements / Reportorial requirements	Mandatory credits to agri-agra

Source: SPRD

Increase in Ranking from BSOS Second Semester 2020

Decrease in Ranking from BSOS Second Semester 2020

Further, domestic UKBs and subsidiary TBs consider compliance with anti-money laundering as second among the most challenging areas in terms of compliance, while foreign UKBs consider compliance with reportorial requirements as the second most burdensome. Notably, most of respondent RCBs found it challenging to comply with the areas of IT risk management as well as operational risk management.

Cognizant of the challenges faced by banks, the BSP issued guidance, which rationalizes reportorial requirements of banks to help ease their compliance burden and focus attention on the generation of reports that are supportive of the BSP's surveillance efforts.

Risk Assessment

Overall, asset quality and credit risk emerged as the top-most risk to the banks' operations (Table 6). The survey results revealed that the risks common to most of the respondent banks were macroeconomic risks and operational risk.

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

Table 6. Top Three Risks to Banks' Operation

Rank	First Semester 2021			Second Semester 2020		
	U/KBs	TBs	R/CBs	U/KBs	TBs	R/CBs
1	Macroeconomic Risks	Asset Quality/Credit Risk	Asset Quality/Credit Risk	Institutional Risk	Institutional Risk	Institutional Risk
2	Asset Quality/Credit Risk/Cybersecurity Threats	Macroeconomic Risks	Operational Risk	Macroeconomic Risks	Technology Risk/Financial Market Risks	Financial Market Risks
3	Operational Risk	Operational Risk	Financial Market Risks	Global Risk and/or Domestic Geopolitical Risks	Possible Downturn in the Real Estate Market	Over-regulation

Source: SPRD

Conclusion

The impact of the COVID-19 pandemic on the domestic economy resulted in banks' subdued optimism on the country's economic prospects. Nonetheless, the overall outlook in the banking system remains stable as banks intend to maintain risk-based capital and liquidity buffers; enhance their risk management systems to safeguard financial system stability; and strengthen organizational conduct and risk culture in order to thrive amid the volatility and complexity of the operating environment.

Strengthening risk governance

Enhancing risk management systems was considered by majority of respondent banks as the primary tool to strengthen the bank against external headwinds. Moreover, the banking environment has been constantly driven by changes in technology, competition, and the evolving regulations and international standards. Banks recognize the need to protect their depositors, investors, and institutions from undue risks through strong risk governance standards. Toward this end, the BSP has issued relevant regulations aimed at strengthening risk governance in the financial industry.

Reputational risk management. The guidelines expect BSFIs to adopt a framework to manage reputational risk holistically and actively across the organization and within the conglomerate or group to which they belong. Having a fully integrated risk management approach that is mandated by the bank's Board of Directors and adopted consistently across the organization is key to maintaining and strengthening the bank's reputation and confidence in the banking system.

Operational risk management. Guidelines that strengthen Know-Your-Employee (KYE) policies and practices were issued as part of the overall operational risk management system of BSFIs. The regulation highlights the importance of continuing assessment of employees' fitness and propriety in performing the responsibilities required of their position.

Recovery plan of a domestic systemically important bank or D-SIB. The circular requires D-SIBs to separately submit their Internal Capital Adequacy

Assessment Process (ICAAP) document and recovery plan to better embed the recovery planning work in the broader crisis preparedness framework of the bank. While a recovery plan is separate and distinct from the ICAAP document, D-SIBs are expected to ensure coherence in the approaches set forth in both documents. The ICAAP outcome and potential measures to address capital needs should feed without delay into the recovery plan, and vice versa, to ensure that the processes and information included in the said documents are consistent and up to date.

Improving asset quality

The enactment of the FIST Act and its implementing guidelines provides banks with a permanent resolution mechanism to dispose of their NPAs. This will further improve the system's risk-bearing capacity and ability to expand investment and lending activities.

Promoting digital innovation

The COVID-19 pandemic highlighted the significant role of technology in banking operations. The ECQ in the country expedited the digital transformation of the banking system with the significant increase in the use of digital payments and electronic money platforms. The survey results revealed that majority of respondents use technology and operating models to address operational performance. Likewise, technology and operating models were also deemed useful in enhancing business continuity, internal controls, risk management, and compliance.

In line with the BSP's efforts to foster an enabling regulatory environment that promotes adoption of beneficial and responsible technology, the BSP issued rules and regulations governing the operations of Virtual Asset Service Providers (VASP) or entities that facilitate financial services through the conduct of virtual asset (VA) activities, to cover new business models and activities. The guidelines expand the scope of activities that are considered as VA, which would be subject to licensing requirements, regulatory expectations for money service businesses as well as anti-money laundering, countering the financing of terrorism and proliferation financing obligations.

Promoting sustainable finance

With the global move towards sustainable development and the growing demand for sustainable investments, the rise in interest from global investors and fund managers to direct funds toward sustainable projects and activities has been noted. Following the issuance by the BSP in April 2020 of Circular No. 1085 on the Sustainable Finance Framework, banks have developed various financing mechanisms in support of sustainable projects. The BSP will subsequently issue detailed guidance aimed at further integrating sustainability principles in the corporate governance and risk management frameworks, as well as in the strategic objectives and operations, of banks.

Deepening domestic capital markets

The BSP recognizes the need to collaborate with concerned agencies for purposes of introducing programs that will help deepen domestic capital markets, promote access to such markets and strengthen investor protection. A domestic capital market that is deep and efficient facilitates the allocation of funds and is crucial to ensuring the stability of the financial system.

In partnership with the Department of Finance, the Bureau of the Treasury and the Securities and Exchange Commission, the BSP supported the establishment of a local currency debt market development roadmap to ensure synergy of regulatory approaches as well as facilitate the smooth execution of needed reforms.

Consistent with this objective, the BSP has issued regulations which aim to promote access and protection of investors in relation to their capital market activities.

Regulations on securities custodianship and securities registry operations. The regulations aim to expand the client base as well as the number of financial institutions offering said services. It provides for a simplified licensing process for securities custodianship and securities registry. It also provides for an option for a securities seller to perform self-managed securities custodianship arrangement where securities sold to or managed on behalf of clients may be maintained under a BSFI's own securities custodian unit, subject to compliance with minimum prudential controls.

Amendments to the Regulations on Investment Management Activities (IMA). The regulations reduce the minimum account opening amount for IMA from P1 million to any lower amount, subject to a floor of P100,000. The policy amendment aims to expand the investment opportunities of the public by reaching markets that may not have been able to open IMAs due to the high entry requirement. The Circular also reduces the required investment of each IMA in a commingled fund from P1 million to P100,00 in order to increase the participation of retail investors in the securities markets through IMAs. Moreover, commingled IMAs can now invest in a wider range of financial assets, which includes exchange-traded equities and fixed income securities and commercial papers registered with the Securities and Exchange Commission. Likewise, corporate accounts can now participate in commingled funds.

The BSP will continue to pursue reforms aimed at promoting the safety and soundness of the financial system to adapt with the rapid advancements in technological innovations and evolving financial ecosystem to ensure balanced, equitable and sustainable economic growth.

The BSP will further strengthen partnerships and collaborative engagements with other financial authorities to maintain the integrity, safety, and soundness of the financial system, , contribute to the deepening of the domestic capital market, and advance the financial inclusion agenda in the country.

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SURVEY

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