BANKING SECTOR OUTLOOK SURVEY

FIRST SEMESTER 2022

Executive Summary

The overall outlook for the banking system remained buoyant amid the slowdown in global economic activity and commodity price increases mostly on account of the Russia-Ukraine war in the first half of 2022. Majority of surveyed banks shared a stable outlook of the banking system in the next two years. This optimism was coupled with expectations of double-digit growth in assets, loans, deposits, and net income. Banks informed that they intend to actively participate in the money and capital markets in the next two years as more than half of respondents expect double-digit growth in investments in securities. The Philippine Banking System (PBS) also plan to maintain risk-based capital, leverage, and liquidity ratios at levels higher than domestic and global standards to promote institutional stability.

With improving economic condition and recovery of credit activity, the loan quality is expected to be better in the next two years. The percentage of respondent banks that projected their non-performing loan (NPL) ratio to exceed 5.0 percent in the next two years went down to 52.4 percent from 58.9 percent in the first semester of 2021. By banking group, about 50.0 percent of universal and commercial banks (UKBs) estimated their NPL to settle within the range of greater than 2.0 percent to 3.0 percent, a shift from their projection of greater than 3.0 percent in the previous year. The percentage of respondent thrift banks (TBs) and rural and cooperative banks (RCBs) with more than 5.0 percent NPL projection went down to 50.0 percent and 67.2 percent, respectively, an improvement from the previous year's 72.7 percent and 75.9 percent, respectively. On loan loss provisions, about 50.4 percent of respondent banks (higher than the 42.7 percent in the last survey) anticipated NPL coverage ratio that Is higher than 51.0 percent.

On restructured loans, banks had varied projections with majority of foreign banks and RCBs indicating a more conservative restructured loan ratio of less than 1.0 percent and between 1.0 percent and 2.0 percent, respectively, from more than 5.0 percent restructured loan ratio in the previous year. UKBs' projections moved to a higher range of between 1.0 percent and 2.0 percent from less than 1.0 percent in the first half of 2021. Meanwhile, most TBs projected a restructured loan ratio of above 2.0 percent in the next two years.

In terms of products or services, majority of the respondents cited that corporate and retail banking would be their main priorities, followed by payments and settlement services, cross-selling, trade financing and treasury operations. The banks indicated that accommodation, wholesale and retail trade, and consumer loans were the sectors that were heavily affected by the COVID-19 pandemic. Banks revealed that wholesale and retail trade, and consumer loans will recover within a year while loans to the hotel and accommodation sector will require approximately two years to pull through.

Banks recognized the importance of pursuing digitalization as a strategic objective but are in varying stages of implementation. Based on the results of the survey for this semester, 2.8 percent of respondents revealed that their business was 100 percent digital while about 53.7 percent of the total respondents had already embarked on improving their digital capabilities to better serve their clientele. About 51.9 percent of respondents mentioned that they are right on schedule when it comes to being more digital while 1.9 percent of respondent banks were ahead of schedule in their digitalization efforts. Meanwhile, about 38.9 percent of respondent banks were still carefully mapping out their approach to ensure proper integration of digitalization with their existing operations and systems.

More than half of respondents were willing to partner with a fintech company with the objective of offering innovative digital financial products or services in the next two years. The products or services that banks intended to deliver in partnership with fintech players include, loans, payments, and mobile and online banking, among others.

Recognizing the risks and opportunities that emanate from climate change, along with the safety and soundness concern that it could pose on the financial system, the survey results revealed that there was a remarkable increase in organizational awareness towards sustainable financing as 70.0 percent of respondent banks viewed such mode of financing as highly important from 61.7 percent. Among those banks with plans of being involved in sustainable finance, most expressed willingness to finance projects in support of agriculture, solar power, transportation and water supply management and treatment.

Overall, asset quality and credit risk surfaced as the top-most risk to the banks' operations. The survey results also revealed that the other risks common to most of the respondent bank were macroeconomic risks, operational risk, and cybersecurity threats. Cognizant of these risks, banks have continuously strengthened various aspects of their risk governance to protect depositors, investors, and their institutions against internal and external shocks.

The PBS sustained its resilient and robust performance amid the lingering effects of the COVID-19 crisis alongside the tightening of global financial conditions. This was mainly due to the prudential and strategic reforms undertaken by the BSP over the years, as well as its swift, time-bound, and targeted relief measures to manage the impact of the pandemic. With the continued recovery in the economy, the BSP has started to scale back the temporary relief measures introduced during the COVID-19 crisis save for those that incentivize lending to micro, small and medium enterprises (MSMEs). Moving forward, the BSP will continue to adopt prudential measures that will strengthen corporate and risk governance in banks as well as promote responsible innovation and mainstream sustainable finance. All these are intended to foster a resilient, dynamic, and inclusive financial system that is supportive of sustainable economic growth.

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 financial system. The BSOS serves as a complementary tool to the conduct of supervision by gathering the sentiments of the Presidents/Chief Executive Officers/Country Managers of banks in the country for 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

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

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.

The BSOS reinforces the BSP's proactive and forward-looking approach to financial supervision. Market-driven and technological developments have allowed FIs to expand product offerings, diversify operations, and create new channels for the delivery of financial services. However, these changes have also given rise to risks that may rapidly evolve and adversely impact the stability of the financial system. Thus, it is important for the BSP to strengthen its financial surveillance capabilities and leverage on existing collaborative arrangements to obtain important information on the financial market and the financial system.

The BSOS complements the analysis of banks' business models. Reducing information asymmetry is crucial to supervisors for the prompt identification of vulnerabilities, closer monitoring of financial health, and comprehensive management of financial issues. Hence, the BSOS aims to provide the BSP with additional perspective on the continuing evolution of banks' business models that can eventually enhance prudential regulations and contribute to the resilience of the banking system. Moreover, it intends to provide supervisory and market perspective on emerging trends for timely and relevant prudential reporting and related analysis.

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

Section	This section seeks to ...
Banking System Growth Outlook	solicit the bank's projections on the performance of the banking system.
Business Strategy	understand the business model that the banks will adopt to implement their strategies over the next two years.
Risk Assessment	identify the risks that banks are most wary of and the existing mitigants for identified risks.
Digital Transformation and Cyber-resilience	obtain an idea of the banks' digital transformation roadmap, as well as the extent of fintech adoption and strategy, and the respondents' outlook on cybersecurity risks and threats.
Sustainable Finance	get the bank's views on sustainable finance as well as their plans with respect to financing sustainable projects.
Impact of Regulations/ Supervision on Bank Performance	solicit sentiments regarding challenges encountered on the implementation of BSP regulations and areas of regulation/supervision that the BSP needs to strengthen to promote the safety and soundness of the banking system.

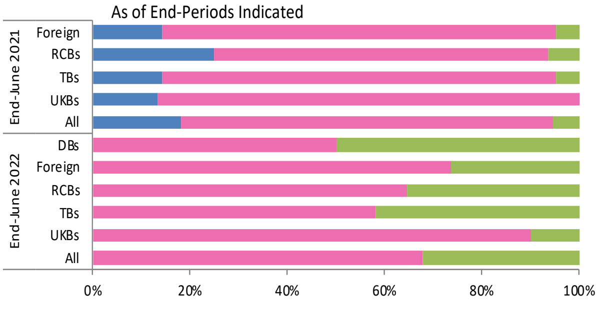
The BSOS Methodology. The conduct of BSOS for the first semester of 2022 covers all UKBs, TBs, 80 RCBs and two digital banks (DBs)[2,3] The survey was deployed to the Presidents/Chief Executive Officers/Country Managers of the covered banks using the digitalized survey form[4] in June 2022. The total assets of respondent banks accounted for 97.0 percent of the total assets of the PBS as of end-June 2022.

II. Results of the First Semester 2022 BSOS[5]

Banking System Growth Outlook

The overall outlook for the banking system remained buoyant amid the slowdown in global economic activity and increasing commodity prices in the first half of 2022, following tightening in global financial conditions and the ongoing geo-political tensions between Russia and Ukraine.[6] About 67.9 percent (from 76.3 percent) of respondent banks expected a stable banking system in the next two years while the remaining 32.1 percent (from 5.4 percent) projected a stronger banking system. Pessimism seemed to totally dissipate as none (from 18.3 percent) of the respondents forecasted a weaker banking system in the next two years (Figure 1).

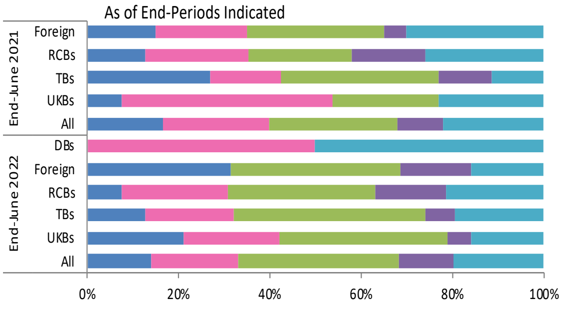
Figure 1. Banking System Growth Outlook
As of End-Periods Indicated



Source: SPRD

The industry sustained its double-digit growth projection in bank assets as the country continued its path towards economic recovery with the easing of quarantine restrictions and uptick in business activity. Most UKBs, TBs and RCBs expected their assets to grow at a rate between 10.0 percent and 15.0 percent. For DBs, asset growth projections diverged from 5.0 percent to 10.0 percent and up to more than 20.0 percent (Figure 2).

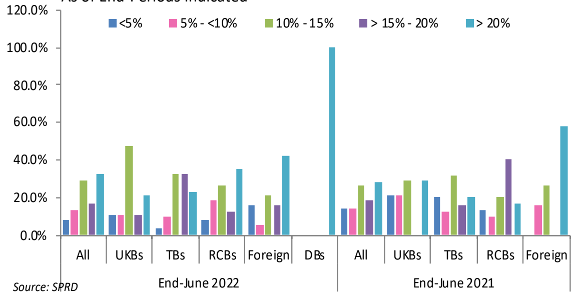
Figure 2. Asset Growth Projection
As of End-Periods Indicated



Source: SPRD

2 Covered RCBs include top 20 banks in terms of total loan portfolio plus 60 randomly selected banks.
3 Out of 171 banks surveyed, 141 banks or 82.0 percent participated in the BSOS for the First Semester of 2022.
4 The digitalized survey form started in S2 2021 BSOS.
5 The previous survey results pertain to the First Semester 2021 BSOS unless otherwise specified.
6 The analysis of the results of the BSOS focuses on the year-on-year (y-o-y, i.e., June 2021 versus June 2022) changes/movements in banks' projections on the performance of the banking system.

Figure 3. Projected Loan Growth
As of End-Periods Indicated



Source: SPRD

The expansion in bank assets was expected to be largely in the form of credit growth to further support the country's financing needs. Majority of respondent banks (78.9 percent) estimated double-digit growth in their loan portfolio in the next two years, higher compared to the previous 72.7 percent. On a per banking group, almost half of respondent UKBs projected loan growth of between 10.0 percent and 15.0 percent. RCBs, foreign banks, and DBs were more optimistic with credit growth projections exceeding 20.0 percent. Meanwhile, most TBs expected their loan portfolio to grow between 10.0 percent and 20.0 percent (Figure 3).

The top three (3) focus of lending by economic sector of domestic UKBs were manufacturing, wholesale and retail trade, and consumer finance for the next two years (Table 1). Foreign UKBs prefered to lend primarily to the manufacturing, financial and insurance, as well as information and communication and real estate. Consumer loans as well as wholesale and retail trade were the common sectors that subsidiary and stand-alone TBs intend to lend in the next two years. Meanwhile, the agriculture sector moved to the top spot for RCBs' loan portfolio, followed by wholesale and retail trade, and real estate activities. Meanwhile, the top three (3) sectors which DBs intend to extend credit to were consumer finance, information and communication/real estate activity, and wholesale and retail trade. Based on latest available data, the banking sector's lending activities were mainly channeled to real estate activities, wholesale and retail trade, household consumption (consumer finance), manufacturing, and electricity, gas, steam, and air-conditioning supply.

Table 1. Focus of Bank Lending by Economic Sector

Rank	First Semester 2022						First Semester 2021				
	Domestic UKBs	Foreign UKBs	Subsidiary TBs	Stand-alone TBs	RCBs	DBs	Domestic UKBs	Foreign UKBs	Subsidiary TBs	Stand-alone TBs	RCBs
1	Manufacturing	Manufacturing	Consumer Loans	Agriculture	Agriculture	Consumer Loans	Financial and Insurance Activities	Manufacturing	Consumer Loans	Consumer Loans	Wholesale and Retail Trade
2	Wholesale and Retail Trade	Financial and Insurance Activities	Wholesale and Retail Trade/ Real Estate Activities	Wholesale and Retail Trade	Wholesale and Retail Trade	Information and Communication/ Real Estate Activities	Wholesale and Retail Trade	Financial and Insurance Activities	Wholesale and Retail Trade	Agriculture	Agriculture
3	Consumer Loans	Information and Communication/ Real Estate Activities	Accomodation	Consumer Loans	Real Estate Activities	Wholesale and Retail Trade	Manufacturing	Information and Communication	Manufacturing	Manufacturing	Real Estate Activities

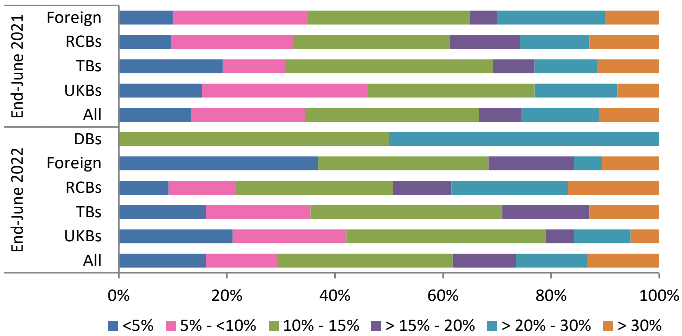
Source: SPRD

As part of the COVID-19 impact assessment, banks were also asked to identify the top three (3) industries that were severely affected by the pandemic based on evaluation of total loan portfolio. Similar with the previous BSOS, accommodation and consumer loans remained in the list of the top three (3) sectors that were hard hit by the pandemic. In order of ranking, accommodation, wholesale and retail trade, and consumer loans were the hardest hit sectors in the S1 2022 BSOS. By banking group, accommodation remained the hardest hit sector as disclosed by domestic UKBs, foreign UKBs and stand-alone TBs while RCBs indicated that wholesale and retail trade continued as the topmost hit sector. Meanwhile, subsidiary TBs revealed that wholesale and retail trade was severely affected by the

COVID-19 pandemic a shift from accommodation in the last BSOS. Further, the banks were asked to indicate the expected duration of recovery of these top three (3) industries from the pandemic. Similar with the results of S1 2021 BSOS, banks revealed that consumer loans will recover within a year while hotel and accommodation will take approximately two years to fully recover. Wholesale and retail trade which emerged as one of the hardest hit sectors this semester is expected to improve within a year.

The BSOS results underscored optimistic projections on deposit growth to fund asset and loan expansion in the next two years. About 70.6 percent of the current BSOS respondents project double-digit deposit growth, higher than the 65.6 percent in the previous BSOS. Overall, the top projection tier for deposit growth ranged between 10.0 percent and 15.0 percent for all banking subgroups in 2023 to 2024 while one DB projected deposit growth of between 20.0 percent and 30.0 percent (Figure 4).

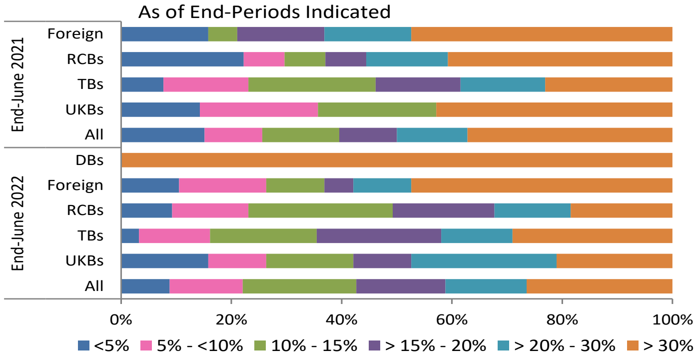
Figure 4. Projected Growth in Deposits
As of End-Periods Indicated



Source: SPRD

With the anticipation of improvement in the country's economic condition, more banks set upbeat expectations on their profitability as 77.9 percent of the respondents for the first semester of 2022 expected double-digit net income growth for the next two years, higher compared to the 74.4 percent of respondents in the previous BSOS. About 47.4 percent of foreign banks, 29.0 percent of TBs, and 100.0 percent of DB respondents viewed growth in their net income to be higher than 30.0 percent for the next two years. UKBs were more conservative in their estimates projecting deposit growth rate of higher than 20.0 percent (Figure 5).

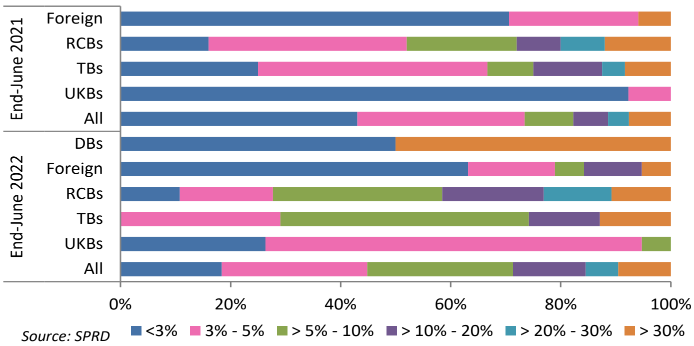
Figure 5. Projected Growth in Net Income
As of End-Periods Indicated



Source: SPRD

Projections of net interest margin (NIM) was more promising this period as 66.2 percent of respondents (from 45.6 percent of respondents in the previous year) estimated their NIM to fall between 3.0 percent and 20.0 percent in the next two years. UKBs and foreign banks were quite conservative with majority expecting NIM of 3.0 percent up to 5.0 percent and less than 3.0 percent, respectively (Figure 6). The TB and RCB respondents' NIM projection were tilted towards the greater than 5.0 percent to

Figure 6. Projected Net Interest Margin
As of End-Periods Indicated

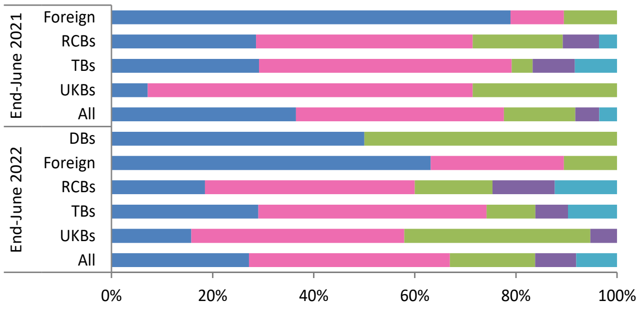


Source: SPRD

10.0 percent range. Meanwhile, the two DBs have extreme NIM projections with one expecting less than 3.0 percent and the other bank forecasting a bolder NIM of greater than 30.0 percent.

The projected return on equity (RoE) of the majority remained in modest tiers of less than 5.0 percent and between 5.0 percent and 10.0 percent. About 33.1 percent of respondent banks expected RoE of more than 10.0 percent, higher than 22.4 percent in the previous year (Figure 7). By banking group, more than 40.0 percent of UKBs, TBs and RCBs anticipated RoE between 5.0 percent and 10.0 percent in the next two years. Foreign banks were more conservative with 63.2 percent expecting their RoE at less than 5.0 percent. The two DBs reported contrasting results with one DB reporting estimated RoE of less than 5 percent and the other estimating RoE of 10.0 percent to 15.0 percent.

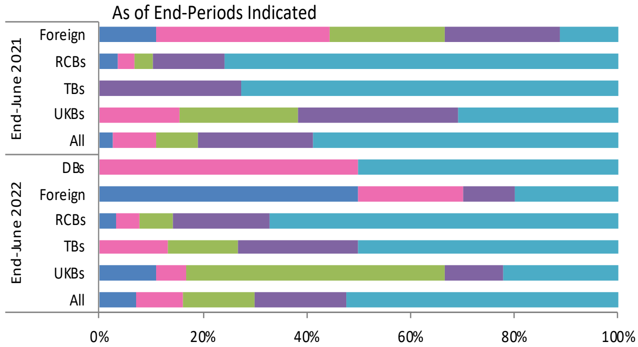
Figure 7. Projected Return on Equity
As of End-Periods Indicated



Source: SPRD

With improving economic condition and recovery of credit activity, the loan quality is expected to be better in the next two years. The percentage of respondent banks that expect their NPL ratio to exceed 5.0 percent in the next two years went down to 52.4 percent from 58.9 percent in the first semester of 2021 (Figure 8). About 50.0 percent of UKBs estimate their NPL to settle within the range of greater than 2.0 percent to 3.0 percent, a shift from their projection of greater than 3.0 percent in the previous year. The percentage of respondent TBs and RCBs with more than 5.0 percent NPL projection went down to 50.0 percent and 67.2 percent, respectively, an improvement from the previous year's 72.7 percent and 75.9 percent, respectively. The two (2) DBs varied in their estimates with one (1) DB projecting an NPL ratio of 1.0 percent to 2.0 percent and another projecting an NPL ratio of above 5.0 percent.

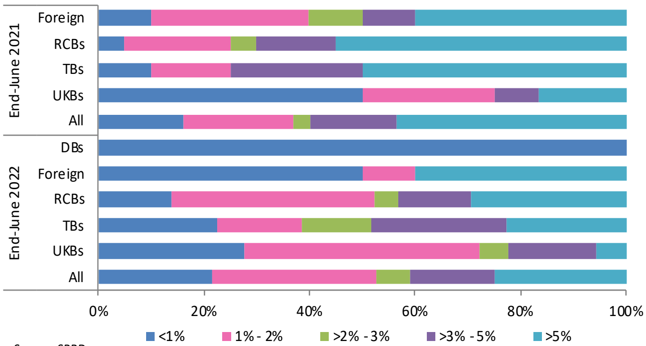
Figure 8. Projected NPL Ratio
As of End-Periods Indicated



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 encounters financial stress due to unexpected events like the COVID-19 pandemic and natural catastrophes. A shift in the projection was observed as respondent banks (31.2 percent) anticipated a restructured loan ratio of 1.0 percent to 2.0 percent from 43.5 percent of respondents which indicated more than 5.0 percent ratio in the previous year. Majority of foreign banks and RCBs predicted a more conservative restructured loan ratio of less than 1.0 percent and between 1.0 percent and 2.0 percent, respectively from more than 5.0 percent restructured loan ratio in the previous BSOS. Most of UKBs' projections moved to a higher range of between 1.0 percent and 2.0 percent from less than 1.0 percent in the previous BSOS. Meanwhile, most TBs continued to project restructured loan ratio of above 2.0 percent in the next two years. The two (2) DBs estimated their restructured loan ratio to fall below 1.0 percent (Figure 9).

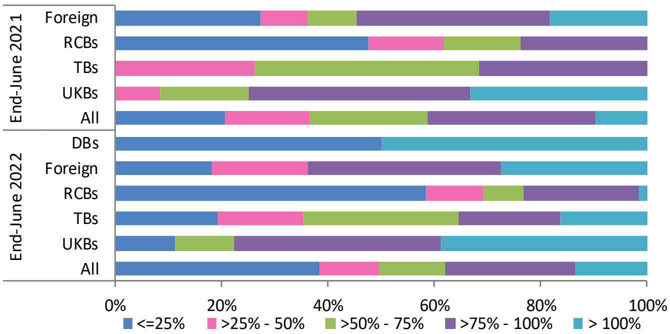
Figure 9. Projected Restructured Loans to Total Loans
As of End-Periods Indicated



Source: SPRD

Alongside the banks' low and manageable expectations of non-performing loan (NPL) ratio, about 50.4 percent of respondent banks (from 63.5 percent in the previous BSOS) anticipated an NPL coverage ratio in the range of 51.0 percent to more than 100.0 percent in the next two years while 49.6 percent of the respondents estimated an NPL coverage ratio of 50.0 percent and below (Figure 10). UKBs were conservative in their outlook with 38.9 percent of respondents (from 33.3 percent in the previous year) expecting the NPL coverage ratio to be greater than 100.0 percent. About 58.5 percent of RCBs were tilted towards the NPL coverage ratio of 25 percent and below, while more than 50.0 percent of TBs converged on the projected NPL coverage ratio of between 51.0 percent and 100.0 percent. In addition, 16.1 percent of TBs now project NPL coverage ratio of more than 100 percent. One (1) DB conservatively projected their NPL coverage ratio to fall above 100.0 percent while one (1) DB estimated an NPL coverage ratio of below 25.0 percent.

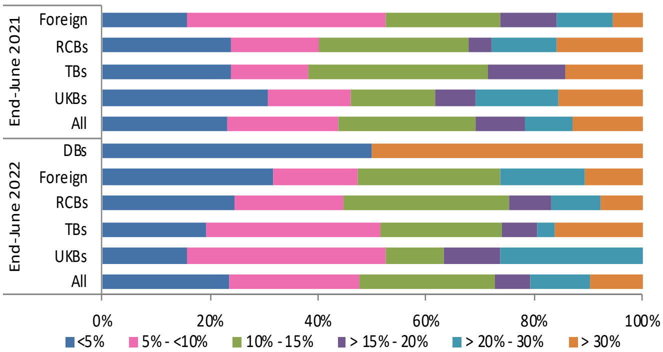
Figure 10. Projected NPL Coverage Ratio
As of End-Periods Indicated



Source: SPRD

Revenue from investment in securities has been a significant source of income aside from lending for banks even before the pandemic. Majority of bank respondents (52.2 percent) projected double-digit growth in investments in securities for the next two years, although lower than the 56.4 percent of respondents in the first semester 2021 BSOS (Figure 11). Most of the banks expected growth in investments of above 5.0 percent in 2023 to 2024.

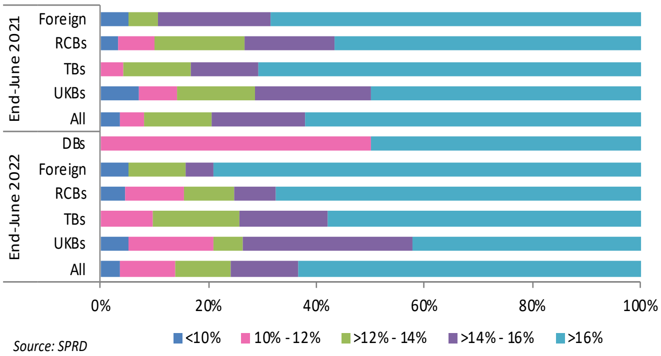
Figure 11. Projected Growth of Investment in Securities
As of End-Periods Indicated



Source: SPRD

The banking system intends to maintain risk-based capital levels higher than domestic (10.0 percent) and BIS global (8.0 percent) standards in the next two years. The percentage of respondents that expected capital adequacy ratio (CAR) of more than 14.0 percent remained high at 75.7 percent, albeit lower from the 79.3 percent of respondents in the first semester 2021 BSOS (Figure 12). By banking group, majority of UKBs, TBs, RCBs, and foreign banks projected CAR of greater than 16.0 percent in 2023 to 2024. The two DBs expected their CAR to be above 10.0 percent. Moreover, banks' CAR will mostly be comprised of high-quality common equity Tier 1 capital.

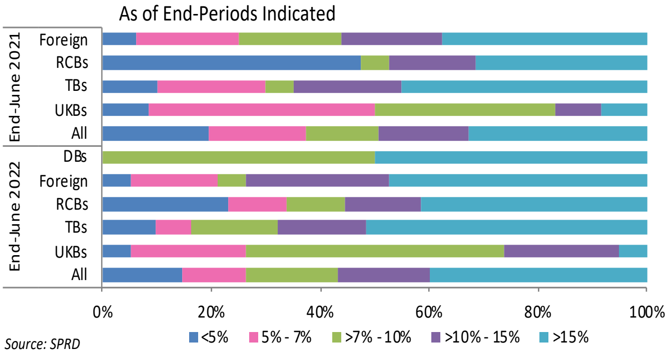
Figure 12. Projected CAR
As of End-Periods Indicated



Source: SPRD

As a backstop to their respective CAR, 85.3 percent of banks projected their leverage ratio to surpass the 5.0 percent BSP standard. UKBs' projection of leverage ratio was skewed to between 7.0 percent and 10.0 percent. Meanwhile, majority of TBs, RCBs and foreign banks forecasted their leverage ratio to be above 15.0 percent. The DBs estimated their leverage ratio to be above 7.0 percent (Figure 13). This level of gearing will provide banks with flexibility to expand their loan portfolio to support the financing needs of the economy.

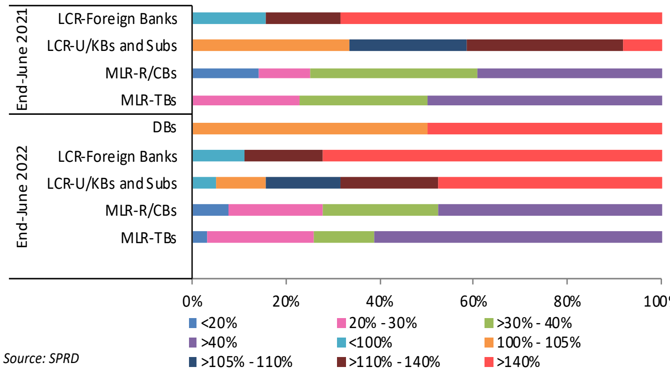
Figure 13. Projected Leverage Ratio
As of End-Periods Indicated



Source: SPRD

Liquidity buffer serves as a safeguard for banks to thrive amid a volatile market environment while enabling them to take advantage of business opportunities presented by the growing economy in the first half of 2022. The respondent banks also indicated that they intend to maintain adequate level of liquidity buffer which would support expansion of lending and investment activities. Around 94.7 percent of UKBs and their subsidiary banks intend to maintain their liquidity coverage ratio (LCR) above the minimum 100.0 percent threshold, slightly lower from the 100.0 percent in the previous BSOS. All DBs also reported projected LCR of above 100.0 percent. About 72.2 percent of foreign banks projected LCR of more than 140.0 percent, higher than the 68.4 percent in the last BSOS. Likewise, 96.8 percent of stand-alone TBs intend to maintain their minimum liquidity ratio (MLR)[7] above the minimum threshold while 72.3 percent of stand-alone RCBs plan to keep their MLR above 30 percent (Figure 14).

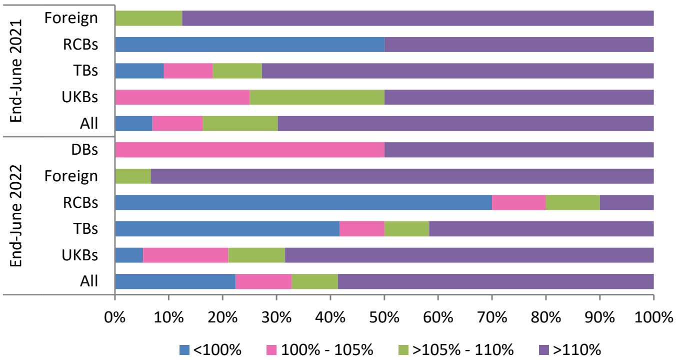
Figure 14. Projected LCR/MLR
As of End-Periods Indicated



Source: SPRD

The projected net stable funding ratio (NSFR)[8] of respondent banks remained well-above the BSP requirement of 100 percent. Overall, 77.6 percent of respondents expected NSFR of 100.0 percent and above for the next two years, lower than the 93.0 percent reported in the last BSOS. The strong commitment to long term stable funding is evident for all bank categories, with majority of respondents intending to maintain NSFR above 110.0 percent (Figure 15).

Figure 15. Projected NSFR
As of End-Period Indicated



Source: SPRD

In terms of products or services, majority of the respondents cited that corporate and retail banking will be their main priorities, followed by payments and settlement services, cross-selling, trade financing and treasury operations. Most of the banks cited MSME lending and sustainable finance as the top two (2) corporate banking products while real estate loans and salary loans under retail banking product. By type of bank, majority of UKBs will focus on corporate banking and payments and settlement services while foreign banks will mainly concentrate

[7] Circular No. 996 dated 8 February 2018, as amended, 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 end-December 2022.

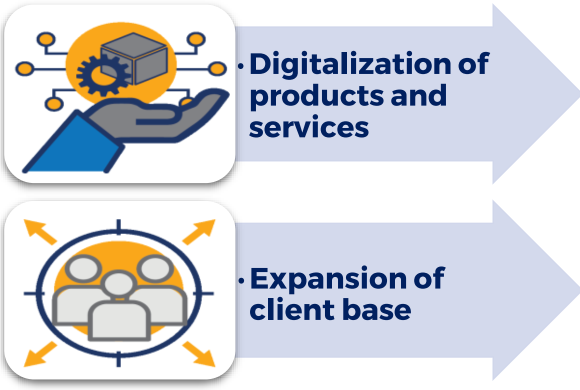
[8] The NSFR under Circular No. 1007 dated 6 June 2019, as amended, is a measure of the ability of a bank to fund its liquidity needs over one year. As a complement to the LCR, both ratios are aimed at strengthening the ability of banks to withstand liquidity stress and promote resilience of the banking sector. The BSP requires UKBs, and their subsidiary banks, to comply with a minimum NSFR of 100.0 percent. Stand-alone TBs and RCBs are not required to comply with the NSFR requirement.

on sustainable financing, trade financing, cross-selling and treasury operations. Meanwhile, retail and business loans remained as the top two (2) priorities of TBs and RCBs, which indicate that these banks are committed to their niche market.

Business Strategy

Banks have noted the importance of accelerating their digital transformation journey to achieve business objective, ensure business continuity, and improve competitiveness following the increase in digital payment transactions during the COVID-19 pandemic, Thus, **majority of respondent banks disclosed that digitalization of products and services for strategic efficiency will be their top priority followed by expansion of target market in the next two years** (Figure 16).

Figure 16. Top 2 Strategic Priorities



There was no change in the top priority of UKBs and TBs while RCBs' priority shifted to digitalization as their top strategic priority from sustainable finance (Table 2). Survey results showed that digitalization of products and services is the topmost strategic priority of UKBs and TBs. Meanwhile, RCBs shared that they need to prioritize expanding their target market as well as digitalization of products and services. The two DBs that participated in the survey mentioned that they will prioritize digitalization of products and services as well as focus on reaching unserved and underserved market in 2023 to 2024.

Table 2. Top 2 Strategic Priorities per Type of Bank

Type of Bank/ Period	UKBs	TBs	RCBs	DBs
First Semester 2022	Digitalization of products and services	Digitalization of products and services	Digitalization of products and services /Expand the target market	Pursue digitalization initiatives/Focus on reaching unserved and underserved market
	Expand the target market	Expand the target market	Focus on sustainable finance business strategies	Focus on sustainable finance business strategies/Streamline operational costs
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	

Source: SPRD

In terms of strategic business direction, domestic UKBs, subsidiary TBs, stand-alone TBs, and RCBs will target retail and business customers. Meanwhile, foreign banks will concentrate in becoming a leader in sustainable finance and a provider of innovative digital products and services as their top strategic business direction in the next two years. DBs will focus on becoming a provider of innovative digital products and services as well as leader in reaching the unserved and underserved market.

Risk Assessment

Overall, banks found **asset quality and credit risk as the top-most risk to their operations** (Table 3). Across banking groups, the top two (2) risks faced by respondent banks remained the same from the previous year. Furthermore, the survey results revealed that the other risks common to most of the respondent bank were macroeconomic risks, operational risk, and cybersecurity threats.

Table 3. Top 3 Risks to Banks' Operations

Rank	First Semester 2022				First Semester 2021		
	UKBs	TBs	RCBs	DBs	UKBs	TBs	RCBs
1	Macroeconomic risks	Asset quality/ Credit risk	Asset quality/ Credit risk	Global risks/ Cybersecurity threats	Macroeconomic risks	Asset quality/ Credit risk	Asset quality/ Credit risk
2	Asset quality/ Credit risk	Macroeconomic risks	Operational risk	Macroeconomic risks/ Asset quality/Credit risk	Asset quality/Credit risk/ Cybersecurity threats	Macroeconomic risks	Operational risk
3	Cybersecurity threats	Operational risk	Macroeconomic risks	Operational risk	Operational risk	Operational risk	Financial market risks

Source: SPRD

Meanwhile, DBs cited global risks and cybersecurity threats as their top-most risk to operations, which is expected considering the nature of the banking group's operations.

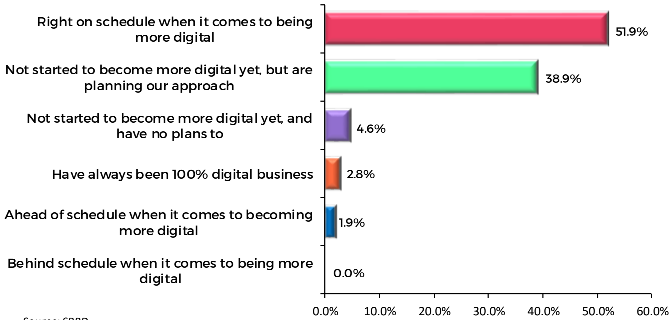
Cognizant of these risks, banks have continuously strengthened various aspects of their risk governance to protect depositors, investors, and institutions. Respondent banks disclosed the top three (3) strengths of their banks' risk governance framework, with board of director and senior management oversight topping the list, followed by comprehensive risk management policies, and appropriate risk appetite for the bank's business, resources, and capital.

Digital Transformation and Cyber-resilience

The ever-changing customer demands together with the pressure to improve operational efficiency especially during the COVID-19 pandemic have led banks to improve their service to clients. Due to community quarantine restrictions during the COVID-19 pandemic, bank clients have shifted from traditional banking to online or mobile banking which resulted in the accelerated use of digital technology.

According to the World Bank, promoting digital transformation brings an opportunity to boost economic recovery and position the country for long term growth. While the benefits of using digital technology have been evident especially during this pandemic, the Philippines still has room to fully leverage on its expected benefits.[9] This is consistent with the vision of the BSP for a strong "post-COVID-19" Philippine economy which emphasized the importance of digitalization to achieve such goal. Banks recognized the importance of pursuing digitalization as a strategic objective but are in varying stages of implementation. Based on the results of the survey for this semester, about 53.7 percent of the total respondents have already embarked on improving their digital capabilities to better serve their clientele. About 51.9 percent of respondents mentioned that they are right on schedule when it comes to being more digital while 1.9 percent of respondent banks are ahead of schedule in their digitalization efforts (Figure 17). Meanwhile, about 38.9 percent of respondent banks are still carefully mapping out their approach to ensure proper integration of digitalization with their existing operations and systems while 2.8 percent of respondents revealed that their business was 100 percent digital[10].

Figure 17. Status of Digital Transformation
As of end-June 2022



Source: SPRD

By banking group, 62.2 percent of UKBs, 42.4 percent of TBs, and 28.4 percent of RCBs were on schedule when it comes to being more digital. Meanwhile, 43.3 percent of RCBs are still planning their approach and have not started their digital transformation process.

The top five (5) challenges encountered by respondent banks that have already embarked on digital transformation are as follows: (1) over-reliance on legacy technology; (2) lack of the right technology/tools; (3) insufficient in-house skills; (4) tendency towards short-term thinking over long-term planning; and (5) lack of budget/lack of appropriate data governance. By banking group, over-reliance on

[9] The World Bank, *Strengthening the Digital Economy to Boost Domestic Recovery. Philippine Economic Update*, June 2022 Edition.
[10] This is comprised of 1 foreign bank and 2 DBs.

legacy technology were the topmost challenges encountered by UKBs and TBs while insufficient in-house skills were considered by TBs and RCBs as the most challenging in terms of digital transformation.

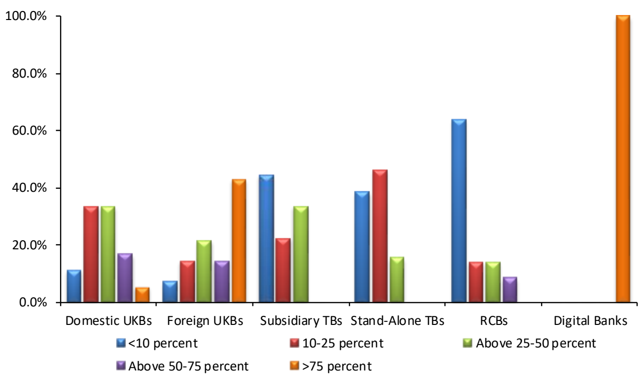
Of the total number of banks that have started improving their digital capabilities, majority of banks know that there is a need to invest in the right technology and tools, involve all departments in developing strategy, and invest in staff training to achieve a successful digital transformation.

Most of the banks that are still in the planning stage of digital transformation anticipated an increase in revenue and market share, as well as reduction in operating cost of 30.0 percent and below. Likewise, majority of respondents projected an improvement of between 31.0 percent and 60.0 percent in the following: (i) business speed and agility; (ii) customer satisfaction; (iii) number of better talents hired and retained; and (iv) development time of new products/services.

Fund transfer, loan payments/repayments, and bills payment remained as the top three (3) financial services that can be offered through digital channels and can be completed without the need for physical presence or visits of customers in branches or offices.

Most domestic UKBs mentioned that between 10.0 percent and 50.0 percent of their customers were actively using digital channels.[11] About 42.9 percent of foreign UKBs revealed that more than 75.0 percent of their respective customers actively use digital means (Figure 18). Meanwhile, a smaller proportion of clients of small banks access banking services/ products through digital means.

Figure 18. Percentage of Customers Actively Using Digital Channels
As of end-June 2022



Source: SPRD

The banking industry supports the use of technology-enabled solutions and expressed strong interest in participating in the digital finance ecosystem. Around 66.3 percent and 71.7 percent of respondent banks[12] indicated that between 10.0 percent and 75.0 percent of their client-oriented activities (i.e., account opening, deposit, transfers, placements, among others) and internal business processes (i.e., approvals, underwriting, among others) will be executed through digital means/remote processing in the next two (2) years, respectively.

Banks were also asked on their willingness to work in partnership with a fintech company. Survey results revealed a mix of responses as 53.7 percent of respondents were willing to partner with a fintech company with the objective of offering innovative digital financial products or services in the next two years. In contrast,

[11] There were 92 banks, comprising of 32 UKBs, 22 TBs, 36 RCBs and 2 DBs, which indicated the active use of digital channels by their customers.
[12] Ibid.

the remaining 46.3 percent of respondents had no plans to partner with a fintech company in the next two-year horizon. **The products or services that banks intend to deliver in partnership with fintech players include, loans, payments, and mobile and online banking, among others**. However, more than 50.0 percent of foreign UKBs and RCBS were not yet open to team up with a fintech company in the next two years.

Banks that have plans to use digital technology were asked on the most important application of technology in their respective organizations.[13] **Overall, deposit services remained as the most important area of technology application for the first semester of 2022.** Meanwhile, payment systems ranked second as the most important area of technology from first rank in the previous BSOS. The top three (3) most important technology application areas by banking group are shown in Table 4.

Table 4. Top 3 Most Important Technology Application Areas

Period	Rank	Banks				
		Domestic UKBs	Foreign UKBs	Subsidiary TBs	Stand-alone TBs	RCBs
First Semester 2022	1	Deposit Services	Payment System	Deposit Services	Deposit Services	Deposit Services
	2	Payment System/Loan Scoring	Loan Scoring	Payment System	Payment System/Loan Scoring	Collection
	3	Treasury and Investment Activity/Customer Service	Treasury and Investment Activity	Customer Service	Marketing/ Collection	Marketing/Know your customer (KYC)
First Semester 2021	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 survey results revealed that more than 50.0 percent of respondents use technology and operating models[14] to enhance the following: (1) operational performance; (2) customer experience; (3) coverage of client base; (4) compliance; (5) risk management; (6) internal controls; and (7) business continuity.

Of those banks which are currently not using technology, majority revealed that they have no plans to use technology and operating models in the next two (2) years. Nonetheless, banks highlighted the need for further guidance from the BSP regarding digital banking as well as relaxation of regulatory requirements to further help them in their digital journey.

The accelerated shift of financial transactions towards digital platforms has resulted in higher incidences of fraudulent behavior and cybersecurity threats which pose challenges to the stability of the financial system. The results of the

[13] Comprised of banks that are in still in the planning stage of digital transformation.
[14] 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).

BSOS showed that **47.5 percent of banks were 'prepared' to handle and manage cyberthreats**, lower than the 53.2 percent of banks reported in the end-June 2021 BSOS. Moreover, about 29.5 percent of respondent banks mentioned that they were 'somewhat prepared' in managing cybersecurity risks, higher than 23.4 percent reported in the same period in 2021. By banking group, more than 50 percent of respondent UKBs and TBs revealed that they are 'prepared' to handle cyberthreats. Relative to this, the BSP enjoins the BSP-supervised financial institutions (BSFIs) to adopt strong control measures against cyber fraud and attacks. Likewise, the BSP also encourages collaboration among BSFIs and other institutions to expedite fraud investigations and resolve cybercrimes.

Table 5. Top 3 Cybersecurity Threats

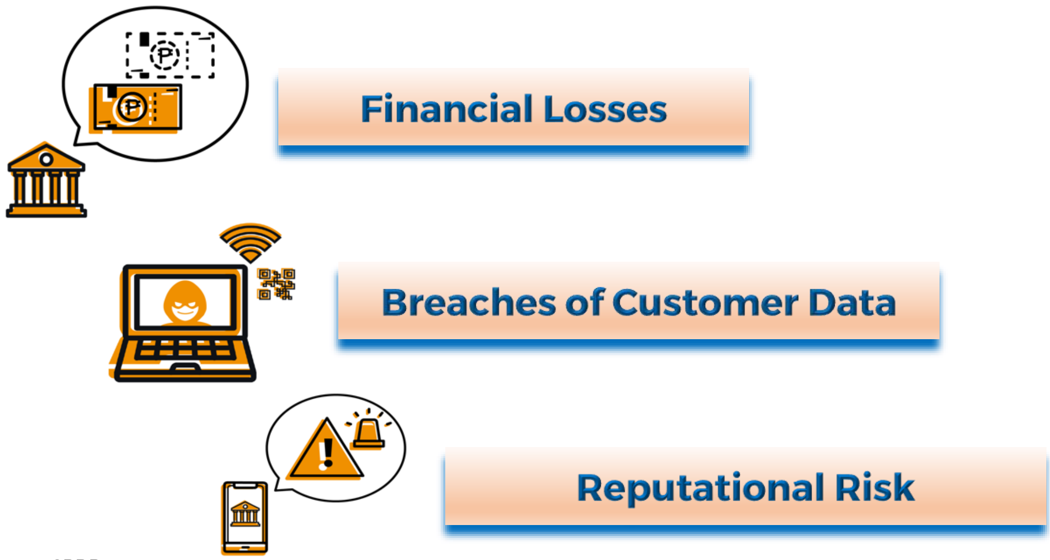
Period	Rank	Domestic UKBs	Foreign UKBs	Subsidiary TBs	Stand-alone TBs	RCBs	DBs
First Semester 2022	1	Phishing	Phishing	Cyberattacks	Phishing	Cyberattacks	Phishing/ Cyberattacks
	2	Malware	Malware	Malware	Malware	Malware	Malware/ Denial of Service Attacks
	3	Cyberattacks/ Direct Hacking/ APTs	Cyberattacks	Phishing	Fraud	Fraud	Fraud
First Semester 2021	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, respondent banks mentioned that **phishing/cyberattacks remained in the top list of cybersecurity threats that they are most worried about, followed by malware and fraud**. Meanwhile, phishing which ranked third in the previous BSOS currently topped the domestic UKBs' list of cybersecurity threats. The top three (3) cybersecurity threats that are of concern per banking group are listed in Table 5.

On the whole, **31.7 percent of surveyed banks indicated financial losses as the most worrisome impact of cybercrime events followed by breaches in customer data and reputational risk**. (Figure 19). By banking group, financial losses were viewed as the most troublesome impact of cybercrimes by 35.0 percent of domestic UKBs, 29.4 percent of foreign UKBs, 40.9 percent of stand-alone TBs and 31.3 percent of RCBs. Meanwhile, DBs considered reputational risk and disruptions to business as the most worrisome effect of cybercrime events.

Figure 19. Top 3 Most Worrisome Impact of Cybercrime Events



Source: SPRD

Measures taken by the bank to identify and protect vulnerable systems, detect, respond, and recover from cyber-attacks include investments in updated security tools, constant vulnerability assessments, and enhancement of security framework, among others. Moreover, most of the respondent banks underscored the importance of continuous monitoring and surveillance, and a reliable information technology (IT) department to ensure a quick and appropriate response to IT and/or security incidents.

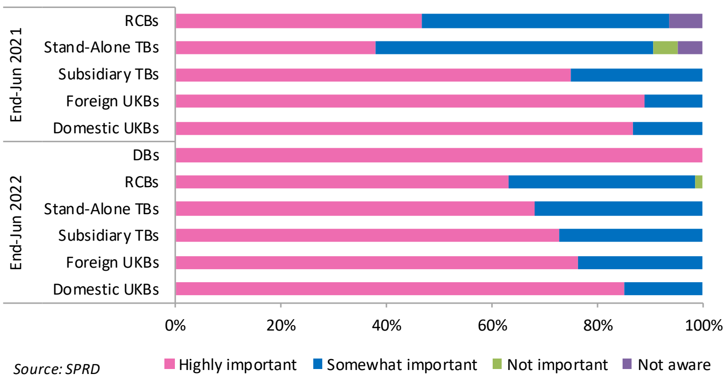
Sustainable Finance

The global move towards sustainable development has led to a growing demand for sustainable investments in the past few years. Most of the financial activities were previously concentrated in the advanced economies, but in the more recent years, emerging markets have enjoyed notable rapid growth in sustainable finance.[15]

[15] International Monetary Fund, *Sustainable Finance in Emerging Markets is Enjoying Rapid Growth, But May Bring Risks*, 1 March 2022.

Based on the survey results, there was a **remarkable increase in organizational awareness towards sustainable financing** as 70.0 percent of respondent banks viewed such mode of financing as highly important from 61.7 percent in the first semester 2021 BSOS. Most UKBs (81.1 percent), TBs (69.7 percent), RCBs (63.2 percent) and DBs (100.0 percent) considered sustainable financing as highly important, as shown in Figure 20.

Figure 20. Organization's View on Sustainable Financing
As of End-Periods Indicated



Source: SPRD

The results of the survey also revealed that 85.0 percent of respondents were planning to finance sustainable projects, and they intend to issue green, social and sustainability bonds and grant sustainable loans. This was an improvement from the 79.3 percent that signified having plans a year ago. Meanwhile 15.0 percent of banks have no plans of doing so in the next two years[16].

Among those banks with plans of being involved in sustainable finance, most expressed willingness to finance projects in support of agriculture, solar power, transportation and water supply management and treatment.

However, taking into consideration that sustainable finance is a relatively new field in the financial system, there are challenges for banks in integrating the new regulations and framework into their existing ones. Majority of the UKBs, TBs and RCBs indicated the lack of expertise or skill as their foremost barrier from pursuing sustainable financing. This was followed by the lack of demand for these types of projects and financial products (Figure 21).

Figure 21. Barriers from Pursuing Sustainable Financing

Source: SPRD

In view of this, most of the UKBs and TBs suggested that the BSP could further help them in their sustainability journey through capacity building, training, and

[16] Of the banks that did not signify their intent, majority of the UKB respondents have no definite plans yet, while most TBs and RCBs cited that they are not engaged in high-level financing and that most sustainable finance offerings are not applicable to their target market.

continuous guidance through detailed, relevant, and timely policy issuances, while RCBs predominantly requested for guidance in the form of trainings and seminars to further their knowledge on sustainable financing, as well as provide more flexibility in the regulatory requirements.

Impact of Supervision on Bank Performance

To evaluate the impact of BSP regulations, banks were also asked to rank five areas which they find challenging in terms of regulatory compliance. Except for the newly established digital banking group, all banking groups found the **mandatory credit to agri-agra as the most challenging to comply with** as the strategic objectives of most banks are not in line with the compliance requirements under the Agri-Agra Law[17]. As of end-June 2022, the banking system's 9.5 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 0.8 percent, was likewise below the 10.0 percent requirement. Penalties are collected from banks which fail to fully comply with the mandatory agri-agra credit allocation. Meanwhile, **DBs indicated reportorial requirements as the most challenging to comply with** among BSP regulations.

Apart from these, respondent banks also cited regulations on anti-money laundering, IT risk management, internal capital adequacy assessment process, operational risk management, credit risk management, related party transaction requirements as other challenging areas in terms of compliance with the BSP's regulatory framework.

Table 6. Most Challenging Areas in Terms of Compliance

Rank	Domestic UKBs	Foreign UKBs	Subsidiary TBs	Stand-Alone TBs	RCBs	DBs
1	Mandatory Credits to agri-agra	Mandatory Credits to agri-agra	Mandatory Credits to agri-agra	Mandatory Credits to agri-agra	Mandatory Credits to agri-agra	Reportorial requirements
2	Anti-money laundering	Reportorial requirements	Anti-money laundering	Credit risk management/ **Anti-money laundering**	IT risk management	Internal capital adequacy assessment process/ Forex regulations
3	RPT requirements/ **Reportorial requirements**	Internal capital adequacy assessment process	Internal capital adequacy assessment process/ **Operational risk management**/ IT risk management	IT risk management	Operational risk management	Mandatory Credits to agri-agra/ Anti-money laundering
4	IT risk management	Anti-money laundering	**Liquidity risk management**/ Reportorial requirements	Operational risk management	Credit risk management	Corporate governance requirements

[17] The Agri-Agra Law was repealed by R.A. No. 11901. Under the Agri-Agra Law, banks were 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 agricultural sector.

Table 6. Most Challenging Areas in Terms of Compliance

Rank	Domestic UKBs	Foreign UKBs	Subsidiary TBs	Stand-Alone TBs	RCBs	DBs
5	Corporate governance requirements/ Credit risk management	RPT requirements/ Liquidity risk management/ **Stress testing**/ Forex regulations	Credit risk management/ Stress testing	Liquidity risk management/ **Reportorial requirements**	Anti-money laundering	Basel III capital requirements/ RPT requirements

Source: SPRD
Note: For tied rankings, color legend pertains to regulation in bold font.

No Change in Ranking from BSOS First Semester 2021
Increase in Ranking from BSOS First Semester 2021
Decrease in Ranking from BSOS First Semester 2021

Table 6 presents the five (5) most challenging areas by banking group. Most banking groups' difficulty with compliance to the mandatory credits to agri-agra was likewise observed during the previous editions of BSOS.

BSP Policy Reform Agenda

The strength and positive outlook of the banking system was reinforced by the prudential and strategic reforms undertaken by the BSP over the years, as well as its swift, time-bound, and targeted relief measures, many of which remain in place.[18]

A number of policies to strengthen risk governance and ensure continued resilience and soundness of the financial system were issued during the first semester of 2022. These issuances aim to set out BSP's expectations on the management of information technology (IT)/cybersecurity risk as well as the governance of rural banks.

The BSP has been steadfastly working to institutionalize cyber-resilience in the financial services industry. This is embodied in BSP's Cybersecurity Roadmap covering three important areas on capacity building, collaborative engagements and continuing policy framework, and supervisory enhancements. As such, the BSP adopted crucial two-part amendments to regulations on IT risk management to better guide supervised entities in managing potential and emerging cyberthreats.

First, the regulations on outsourcing and IT risk management were revised.[19] To promote a risk-based supervisory approach on outsourcing, consistent with recent

[18] With the continued recovery in the economy, the BSP has started to scale back the temporary relief measures introduced during the COVID-19 crisis save for those that incentivize lending to micro, small and medium enterprises (MSMEs). The relief measures that were extended in 2022 until end-June 2023 include the reduced credit risk weight of loans granted to MSMEs and the utilization of loans to MSMEs as alternative compliance with the reserve requirements. The extension of these relief measures will encourage banks to continue to support financing requirements of creditworthy MSMEs.
[19] Circular No. 1137 dated 18 February 2022.

industry developments and international practices, the Circular includes the following key amendments: (1) adoption of risk-based supervisory approach; (2) expansion of classification of service providers from Cloud Service Providers to Technology Service Providers; and (3) relaxation of regulatory requirements for cloud outsourcing of core systems.

Second, modifications to the regulations on IT risk management were also set in motion.[20] These include the requirement for BSFIs to adopt a robust fraud management system as well as a reinforced consumer education and awareness program. These amendments aim to strengthen the financial system's cybersecurity posture[21] as well as minimize losses arising from fraud and cyber-criminal activities.

Within the BSOS survey period, the BSP also launched the Rural Bank Strengthening Program (RBSP),[22] which was developed through an inter-agency collaboration. The RBSP aims to enhance the operations, capacity, and competitiveness of RBs in view of their vital role in promoting countryside development and inclusive economic growth. This will reinforce the RBs' resiliency and enable them to respond to the evolving socio-economic conditions and regulatory environment with the increasing digitalization across economic sectors.

Another notable development was the enactment of Republic Act (R.A.) No. 11901[23] on 28 July 2022, which introduced comprehensive amendments to R.A. 10000 (Agri-Agra Law) by recommending a financing approach that considers the requirements of the broader agricultural ecosystem. The amendments are envisioned to strengthen rural development and improve the well-being of agricultural and rural community beneficiaries. The Implementing Rules and Regulations (IRR)[24] of R.A. No. 11901 was released in November 2022. As a form of scaling up sustainable finance, the BSP, through the issuance of said IRR, recognized sustainable finance as a form of compliance with the mandatory agriculture, fisheries, and rural development financing.

Overall, the BSP will continue to adopt prudential standards that will strengthen corporate and risk governance, promote responsible innovation and mainstream sustainable finance. All these are intended to foster a resilient, dynamic, and inclusive financial system that is supportive of sustainable economic growth.

[20] Circular No. 1140 dated 24 March 2022.
[21] Cybersecurity posture refers to technologies, processes, and practices designed to protect a BSFI's information assets and consumers by preventing, detecting, and responding to cyber-attacks.
[22] Memorandum No. M-2022-024 dated 5 May 2022.
[23] The Agriculture, Fisheries and Rural Development Financing Enhancement Act of 2022.
[24] Circular No. 1159 dated 4 November 2022.

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