OUTLOOK SURVEY

2ND SEMESTER 2021

BANKING SECTOR

Table of Contents

Executive Summary

Philippine banks shared optimistic views regarding the country's economic prospects in the second semester of 2021. Compared to the previous year, more bank respondents expect Gross Domestic Product (GDP) to improve to above 6.0 percent.[1]

The banks' level of optimism on the country's economic prospects is also seen in their overall outlook for the Philippine banking system (PBS) with expectations of double-digit growth in assets, loans, deposits and net income. Banks remain positive about active participation in the money and capital markets in the next two years as more than half of respondents foresee double-digit growth in investments in securities. The PBS also intends to maintain risk-based capital, leverage and liquidity ratios at levels higher than domestic and global standards to promote institutional stability.

In terms of loan quality, a lower number of respondents (around 57.3 percent from 63.5 percent in the previous BSOS) estimates a non-performing loan (NPL) ratio of above 5.0 percent in the next two years. By banking group, the topmost NPL ratio projection of universal and commercial banks (UKBs) shifted to between greater than 2.0 to 3.0 percent from the greater than 3.0 to 5.0 percent tier in the first semester of 2021. Meanwhile, majority of thrift banks (TBs) and rural and cooperative banks (RCBs) consistently expect elevated NPL ratios but with some marginal improvement in the latest roundup. On loan loss provisions, 42.7 percent of respondents project an NPL coverage ratio in the range of 51 percent to more than 100 percent, while 57.3 percent of respondents project an NPL coverage ratio of 50 percent and below.

Banks have mixed projections regarding restructured loans. About 30.1 percent (from 43.5 percent in the previous BSOS) of respondent banks, mostly niche marketers like foreign banks, TBs, and RCBs, estimate that their restructured loans to total loans will be more than 5.0 percent (mostly up to 10 percent of their loan portfolio for small banks). By contrast, about 23.0 percent of respondents, skewed by UKBs, predict a more conservative restructured loan ratio of between 1.0 and 2.0 percent.

Meanwhile, on products and services, majority of the heads of banks mentioned that corporate and retail banking will continue to be their main priorities, followed by payments and settlement services, cross-selling, and treasury operations. Respondents identified that wholesale and retail trade, consumer loans, and agriculture are the hardest hit sectors due to logistical disruptions. Banks indicated that wholesale and retail trade, and consumer loans will recover in the next twelve months while agriculture will take about two years to fully recover.

Respondent banks also disclosed that digitalization of products and services will be prioritized in in the next two years, as banks recognize the need to integrate technology in achieving business objectives. The mobility restrictions implemented due to the surge in COVID-19 cases, social distancing and other

[1] Excludes impact of the Russia-Ukraine War and inflation-related developments.

health and safety protocols pushed banks to modify their operations while maintaining proactive health and safety measures for the continued delivery of financial services. Banks deem it important to develop new capabilities, leverage on client relationship to maintain growth, and expand market reach digitally or through the offering of new products/services in the new economy arrangement.

Moreover, even prior to the pandemic, banks have been striving to better serve their clientele by making some of their products and services accessible through digital platforms. In line with this, majority of UKBs have already adopted programs on digitalization and implemented Initiatives to improve their capabilities in this area. Moreover, most of the banks identified that process/system improvement and investments in digital infrastructure are critical to their operations and achievement of business objectives.

Following the BSP's issuance of the first two phases of sustainability or Environmental, Social and Governance (ESG)-related guidelines, the survey results revealed that there was an increased organizational awareness towards sustainable financing as more respondent banks viewed such mode of financing as highly important. Majority of respondents indicated that they are planning to finance sustainable projects in the next two years.

Overall, asset quality and credit risk emerged as the top-most risk to the banks' operations. The other risks common to most of the respondent banks are macroeconomic and operational risks. Meanwhile, enhancing risk management systems, strengthening client relationships and upgrading of personnel capabilities are considered important by the respondents in order to protect their respective banks against internal and external shocks.

Amid the long tail of the COVID-19 pandemic, the PBS, as the core of the financial system, remains sound and stable. It also continued to support the financing requirements of the domestic economy, which exhibited signs of recovery in the second half of 2021.[2]

Moving forward, the strength and positive outlook of the banking system is complemented 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.[3] The BSP will also adopt prudential standards that will strengthen corporate and risk governance, promote responsible innovation and sustainable finance, and uphold financial integrity and operational resilience in its supervised financial institutions (FIs). All these are intended to foster a resilient, dynamic, and inclusive financial system that is supportive of sustainable economic growth.

[2] Based on National Economic and Development Authority (NEDA), the Philippine economy grew by 8.2 percent and 7.4 percent in the first and second quarter of 2022, respectively.

[3] Recognizing the need to sustain credit growth in the country, the BSP extended the effectivity of some of the prudential and operational relief measures until the end of 2022. This initiative likewise aims to ensure continued access to financial products and services by businesses and households, including vulnerable sectors of the economy.

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.[4] 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.

II. What is the BSOS?

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 …
Macroeconomy and Banking System Growth Outlook	solicit the respondents' outlook on the country's GDP growth and 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.
Operational Performance	understand the banks' operational approach to maintain growth, address operational challenges, and enhance profitability moving forward.

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

Section	This section seeks to …
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 Supervision/ Regulation 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.
Risk Assessment	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 second semester of 2021 covers all UKBs, TBs and 80 RCBs.[5,6] The updated survey questionnaire includes additional indicators to measure banks' outlook on profitability, loan and asset quality, liquidity, and capital adequacy. It also includes additional questions on digital transformation, cyber-resilience, and sustainable finance. The survey was deployed to the Presidents/Chief Executive Officers/Country Managers of the covered banks using the digitalized survey form. The total assets of respondent banks accounted for 94.4 percent of the total assets of the PBS as of end-December 2021.

III. Results of the Second Semester 2021 BSOS

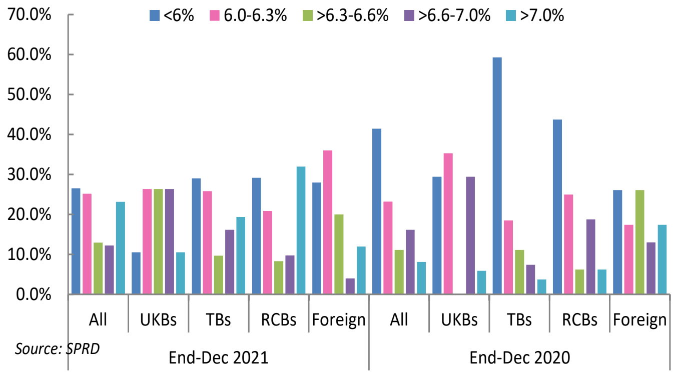
Macroeconomy and Banking System Growth Outlook

Banks shared more optimistic views regarding the country's economic prospects compared to last year. More bank respondents (48.3 percent of respondents vis-à-vis 35.4 percent in end-December 2020) expect GDP to improve to above 6.0 percent. Of these respondents, 25.2 percent project GDP growth of between 6.0 percent and 6.3 percent while 23.1 percent of the survey participants forecast GDP growth of more than 7.0 percent.[7]

On a per banking group, most UKBs estimate GDP to grow between 6.0 and 7.0 percent while respondents from TBs and RCBs continue to show subdued optimism with most banks forecasting GDP growth of less than 6.0 percent (a low of 4.3 percent and a high of 5.9 percent). Meanwhile, 36.0 percent of

5 Covered RCBs include top 20 banks in terms of total loan portfolio plus 60 randomly selected banks.
6 Out of 173 banks surveyed, 150 banks or 86.7 percent participated in the BSOS for the Second Semester of 2021.
7 Excludes impact of the Russia-Ukraine War and inflation-related developments

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

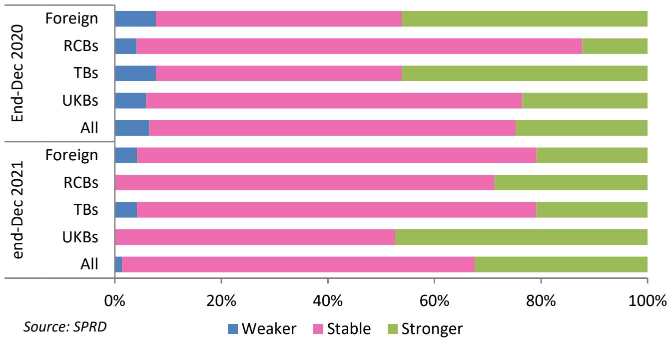


Source: SPRD

respondent foreign banks project real GDP growth of between 6.0 percent and 6.3 percent. (Figure 1).

On the whole, the respondent banks' GDP growth outlook Is consistent with that of the Asian Development Bank (ADB) which projects that the Philippine economy will grow by 6.5 percent in 2022 and 6.3 percent in 2023 on the back of strengthening domestic demand and reforms supporting investment.[8] Meanwhile, the International Monetary Fund (IMF) expects the country to grow by 6.7 percent in 2022 and 5.0 percent in 2023.[9] On the domestic front, the Development Budget Coordination Committee (DBCC) projects a GDP growth of between 6.5 and 7.5 percent for 2022 and 6.5 and 8.0 percent for 2023 to 2028.[10]

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

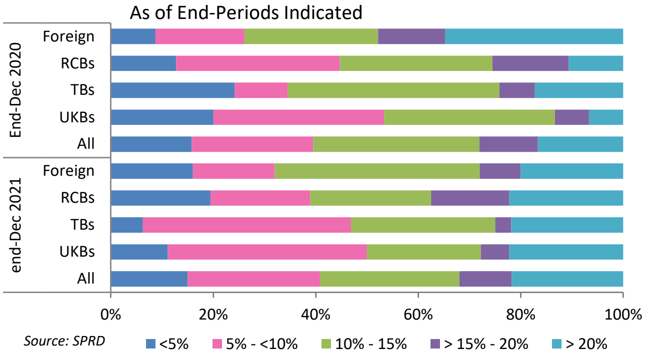


Source: SPRD

Amid the banks' mixed levels of optimism on the country's economic prospects, the overall outlook for the banking system remains stable. Respondents expect the banking system to be more resilient compared to last year. 66.2 percent of the banks project a stable banking system in the next two years while 32.4 percent expect the banking system to be stronger, up from 24.8 percent in the previous year, (Figure 2). Only a handful (1.4 percent) of respondents expect a weaker banking system in 2022 to 2023.

Expectations of improvement in the country's economic growth and stable outlook on the banking system supported the industry's continued projection of double-digit growth in bank assets (Figure 3). Most UKBs however anticipate their assets to grow at a rate of 5.0 percent to 10.0 percent.

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



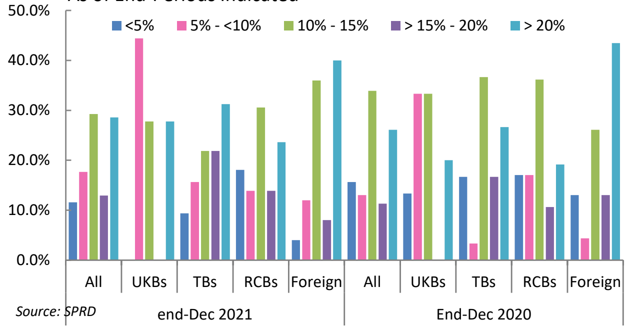
Source: SPRD

---

[8] Asian Development Bank (ADB), Asian Development Outlook (ADO) Supplement July 2022.
[9] International Monetary Fund (IMF), World Economic Outlook (WEO) Update July 2022.
[10] National Economic and Development Authority (NEDA), *Review of the Medium-Term Macroeconomic Assumptions and Fiscal Program for FY 2022 to 2028*, 8 July 2022.

The growth in bank assets will mostly be in the form of expansion in credit. More respondent banks this period (70.7 percent compared to 60.5 percent) estimate double-digit growth in their loan portfolio in the next two years. On a per banking group, most UKBs forecast modest loan growth of between 5.0 percent and 10.0 percent. RCBs project their loan growth to be between 10.0 percent and 15.0 percent. TBs and foreign banks are more optimistic and project their credit growth to go beyond 20.0 percent (Figure 4). The progress in the country's vaccination program and better growth prospects are expected to sustain loan growth as this would lead to consumer and business confidence and higher loan demand.

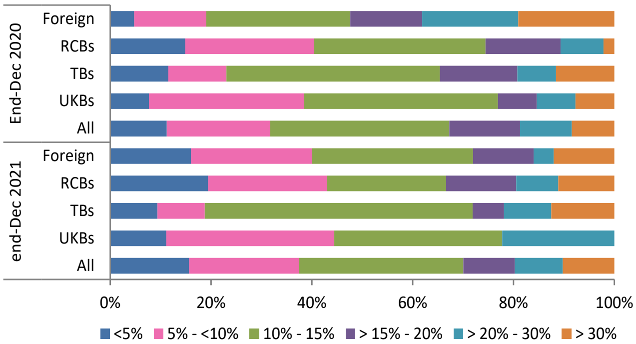
Figure 4. Projected Loan Growth
As of End-Periods Indicated



Source: SPRD

The BSOS results likewise reaffirmed expectations of deposit growth funding asset and loan expansion. About 62.6 percent of the current BSOS respondents project double-digit deposit growth, though lower than that of second semester 2020 BSOS of 68.2 percent. Across all banking subgroups, the top projection tier for deposit growth was between 10.0 percent and 15.0 percent in 2022-2023 (Figure 5).

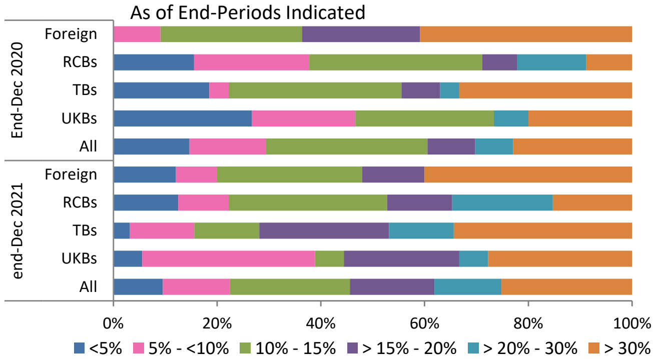
Figure 5. Projected Growth in Deposits
As of End-Periods Indicated



Source: SPRD

More banks set upbeat expectations on their profitability as 77.6 percent of the respondents for the second semester of 2021 forecast double-digit net income growth for the next two years, higher compared to the 70.6 percent of respondents in the second semester 2020 BSOS. In particular, 40.0 percent of foreign banks, 34.4 percent of TBs, and 27.8 percent of UKB respondents viewed growth in their net income to be higher than 30.0 percent for the next two years (Figure 6).

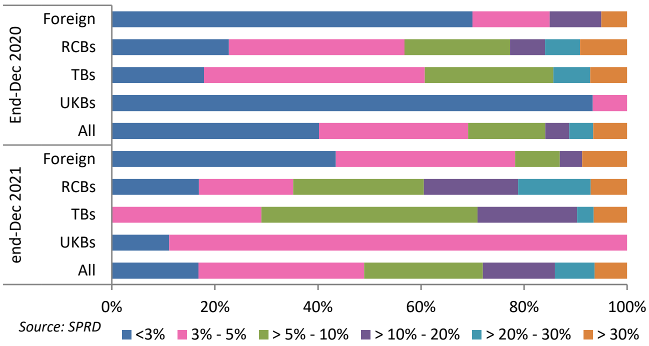
Figure 6. Projected Growth in Net Income
As of End-Periods Indicated



Source: SPRD

Banks reported slightly favorable projections of net interest margin (NIM) this year with more respondents (69.2 percent of respondents compared to 48.6 percent of respondents last year) estimating their NIM to go above 3.0 percent up to 20.0 percent. Respondents from UKBs and foreign banks were relatively conservative with most banks expecting NIM of up to 5.0 percent (Figure 7). The TB respondents' NIM projection tilted towards the 3.0 percent to 10.0 percent range, while RCB respondents' NIM projection practically spanned the whole gamut (from less than 3.0 percent to greater than 30.0 percent).

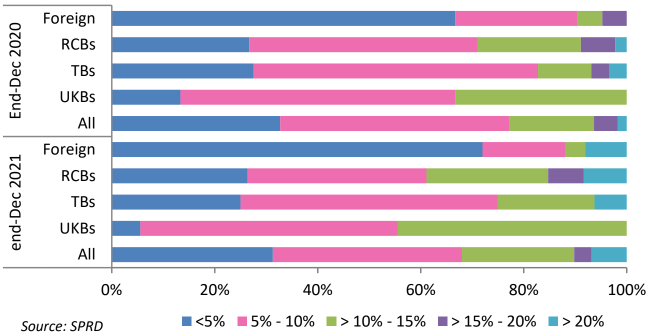
Figure 7. Projected Net Interest Margin
As of End-Periods Indicated



Source: SPRD

The projected return on equity (ROE) generally improved with the noticeable migration towards more robust ROEs, particularly in the greater than 10.0 to 15.0 percent range, and the greater than 20.0 percent tier. Nonetheless, majority of the ROE projections across banking groups remain partial to more modest tiers of less than 5.0 percent, and between 5.0 percent and 10.0 percent (Figure 8).

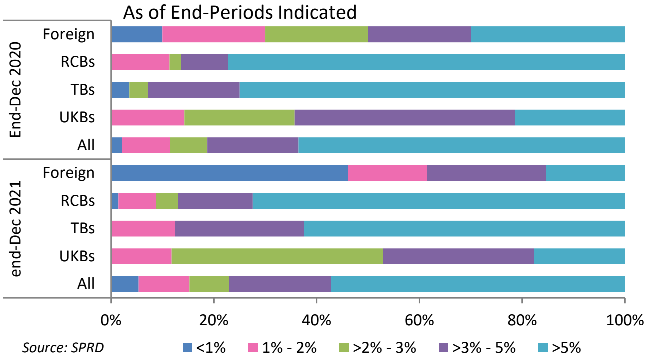
Figure 8. Projected Return on Equity
As of End-Periods Indicated



Source: SPRD

The uptick in economic activities has eased concerns regarding the quality of bank loan portfolio. The percentage of respondents that expect the NPL ratio to exceed 5.0 percent in the next two years went down to 57.3 percent from 63.5 percent in the second semester of 2020. Among UKBs, the topmost NPL ratio projection has shifted to the range of greater than 2.0 percent to 3.0 percent (41.2 percent of respondents, up from 21.4 percent in the comparative period) from the greater than 3.0 percent to 5.0 percent tier (29.4 percent, down from 42.9 percent). Majority of TBs and RCBs consistently expect elevated NPL ratios but with some marginal improvement in the latest round-up of the survey (Figure 9).

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

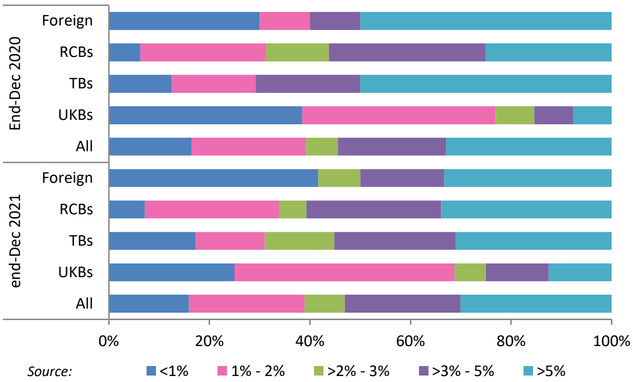


Source: SPRD

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 30.1 percent (from 43.5 percent in the previous BSOS) of respondent banks, mostly niche marketers like foreign banks, TBs and RCBs, project a restructured loan ratio of more than 5.0 percent (mostly up to 10 percent of their loan portfolio for small banks). By contrast, 23.0 percent of respondents, skewed by UKBs, predict a more conservative restructured loan ratio of between 1.0 percent and 2.0 percent (Figure 10).

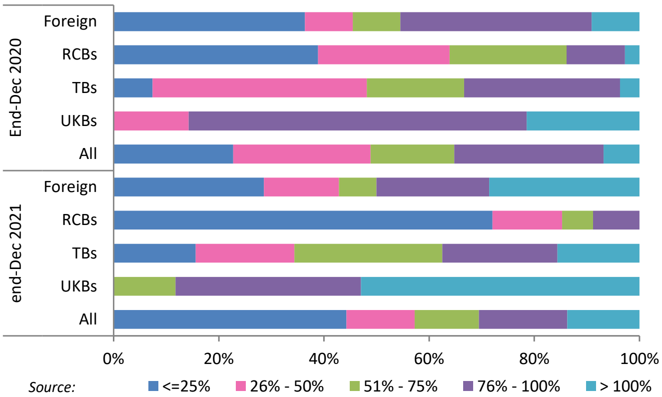
The projected NPL coverage ratio, meanwhile, indicates banks' management of their credit risk. In the survey, 42.7 percent (from 51.1 percent in second semester 2020) of the respondent banks project an NPL coverage ratio in the range of 51.0 percent to more than 100.0 percent, while 57.3 percent (from 48.9 percent in second semester 2020) of the respondents estimate an NPL coverage ratio of 50.0 percent and below (Figure 11). UKBs were more conservative in their outlook with 52.9 percent of respondents (from 21.4 percent) expecting the NPL coverage ratio to be greater than 100.0 percent. Around 72.1 percent of RCBs were tilted towards the NPL coverage ratio of 25 percent and below, while half of TBs converged on the projected NPL coverage ratio of between 51.0 percent and 100.0 percent.

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



Source: SPRD

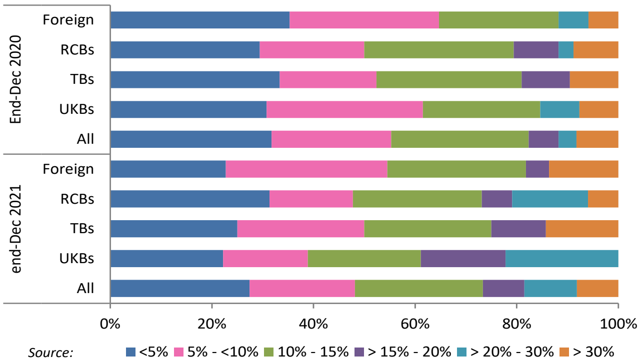
Figure 11. Projected NPL Coverage Ratio
As of End-Periods Indicated



Source: SPRD

Prior to the pandemic, income from investment in securities represented a material source of income apart from lending for banks. 51.9 percent of banks project double-digit growth in investments in securities for the next two years, higher than the 44.7 percent of respondents in the second semester 2020 BSOS (Figure 12).

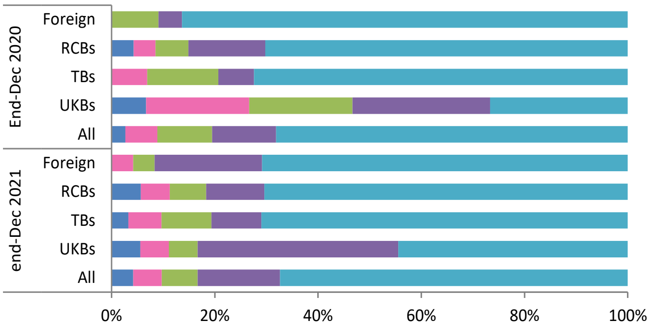
Figure 12. Projected Growth of Investments in Securities
As of End-Periods Indicated



Source: SPRD

Cognizant of the importance of capital in protecting banks from unexpected losses, the banking system has maintained risk-based capital 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 83.3 percent of the respondents expects their capital adequacy ratio (CAR) at more than 14.0 percent, higher compared to 80.5 percent of respondents in the second semester 2020 BSOS (Figure 13). Moreover, banks' CAR will mostly be comprised of high-quality common equity Tier 1 capital.

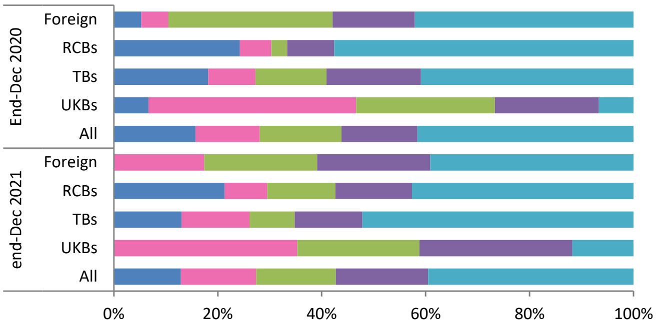
Figure 13. Projected CAR
As of End-Periods Indicated



Source: SPRD

As a backstop to their respective CAR, 87.1 percent of banks project their leverage ratio to exceed the BSP (5.0 percent) standard. Banks' projection of leverage ratio somewhat softened in line with growth in assets. Smaller banks, particularly 52.2 percent of TBs and 42.6 percent of RCBs project their leverage ratio to be above 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

Meanwhile, liquidity has been a key strength of the banking system. This is expected to be maintained up to 2023 as banks continue to project healthy liquidity metrics based on the Basel III liquidity coverage ratio (LCR)[11] and net stable funding ratio (NSFR)[12] for UKBs and their subsidiary banks and quasi-banks (QBs), and the minimum liquidity ratio (MLR)[13] for stand-alone TBs, RCBs and QBs. Liquidity buffer serves as a defense for banks to thrive amid a volatile market environment while enabling them to take advantage of business

---

[11] 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 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 short-term liquidity stress event.

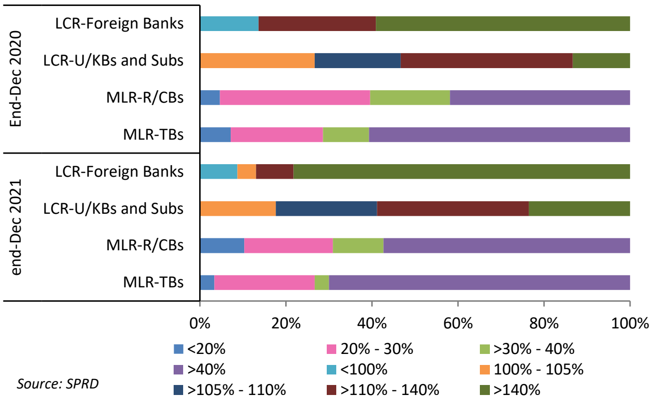
[12] The NSFR under Circular No. 1007 dated 6 June 2019, as amended, is a measure of the ability of a bank to fund its liquidity needs over one year. As a complement to the LCR, both ratios are aimed at strengthening the ability of banks to withstand liquidity stress and promote resilience of the banking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

[13] 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.

opportunities presented by the growing economy and the country's pursuit of better infrastructure to support domestic economic expansion.

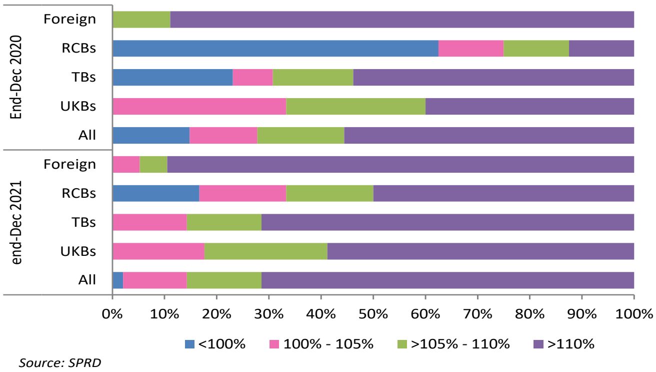
In the survey, the respondents disclosed that all banks intend to maintain an adequate level of liquidity buffer, supporting expansion in their lending and investment activities in line with the country's recovery. All domestic UKBs and their subsidiary banks intend to maintain LCR above the minimum 100.0 percent threshold, with 82.4 percent of domestic UKBs and their subsidiary banks reporting LCR at more than 105.0 percent. This was higher than the 73.3 percent recorded during the second semester 2020 BSOS. Majority of foreign bank respondents (about 78.3 percent) projected their LCR at more than 140.0 percent. In a similar manner, almost all stand-alone TBs (96.7 percent) plan to maintain their MLR above the minimum threshold with at least 73.3 percent of them planning to maintain MLR above 30 percent. Majority of stand-alone RCBs (69.1 percent) intend to maintain their MLR above 30 percent (Figure 15).

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



71.4 percent of respondents expect NSFR to be maintained at more than 110.0 percent for the next two years. 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



In terms of products or services, majority of the respondents mentioned that corporate and retail banking will be their main priorities, followed by payments and settlement services, cross-selling, and treasury operations. By type of bank, the respondents revealed that majority of domestic UKBs will focus on corporate banking, retail banking, payments and settlement services, and cross-selling, while foreign UKBs will mainly concentrate on corporate banking, trade financing, and treasury operations. Retail and business loans remain as the top two priorities of TBs and RCBs, which indicate that these banks are committed to their niche market.

The top three focus of lending by economic sector of domestic UKBs are manufacturing, wholesale and retail trade, and consumer finance for the next two years (Table 1). Foreign UKBs prefer to lend primarily to the manufacturing, financial and insurance, as well as wholesale and retail trade sectors. Subsidiary and stand-alone TBs shared that consumer loans, wholesale and retail trade, and real estate activities will have the largest portion of their lending portfolio in the next two years. Meanwhile, the agriculture sector will return as the top market for RCBs' loan window, followed by wholesale and retail trade, and consumer loans. 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	Second 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	Manufacturing	Manufacturing	Consumer Loans	Wholesale and Retail Trade	Agriculture	Consumer Loans	Information and Communication	Consumer Loans	Consumer Loans	Agriculture
2	Wholesale and Retail Trade	Financial and Insurance Activities	Real Estate Activities	Real Estate Activities	Wholesale and Retail Trade	Wholesale and Retail Trade	Financial and Insurance Activities	Wholesale and Retail Trade	Real Estate Activities	Wholesale and Retail Trade
3	Consumer Loans	Wholesale and Retail Trade	Wholesale and Retail Trade	Consumer Loans	Consumer Loans	Manufacturing	Manufacturing	Transportation	Wholesale and Retail Trade	Consumer Loans

Source: SPRD

As part of the COVID-19 impact assessment, banks were asked to name the top three industries that were heavily affected by the pandemic based on evaluation of total loan portfolio. The banks revealed, in order of ranking, that wholesale and retail trade, consumer loans, and agriculture were the hardest hit sectors due to logistical disruptions. Further, the banks were asked to indicate the expected duration of recovery of these top three industries from the pandemic. Banks observed that wholesale and retail trade, and consumer loans will recover relatively faster or within the next twelve months. Agriculture will take about two years to pull through.

Business Strategy

In line with emerging market trends and evolving client needs, banks continued to recognize the importance of integrating technology in their operations to achieve business objectives. Thus, respondent banks disclosed that they will prioritize the digitalization of products and services for strategic efficiency as well as prioritize the expansion of their target market in the next two years.

The top two strategic priorities by banking group are shown in Table 2. Survey results showed that digitalization of products and services is the topmost strategic priority of UKBs and TBs while RCBs shared that they need to prioritize expanding their target market.

Table 2. Top Two Strategic Priorities per Type of Bank

Type of Bank/ Period	UKBs	TBs	RCBs
Second Semester 2021	Digitalization of products and services	Digitalization of products and services	Expand the target market

Type of Bank/ Period	UKBs	TBs	RCBs
	Expand the target market	Expand the target market	Focus on sustainable finance business strategies
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

Meanwhile, foreign UKBs will concentrate in becoming a leader in sustainable financing as their top strategic business direction in 2022 to 2023.

Risk Assessment

Overall, asset quality and credit risk emerged as the top-most risk to the banks' operations in the second semester 2021 BSOS as compared with institutional risk in the second semester 2020 BSOS (Table 3). The survey results revealed that the risks common to most of the respondent banks are asset quality and credit risk, macroeconomic and operational risks.

Table 3. Top Three Risks to Banks' Operation

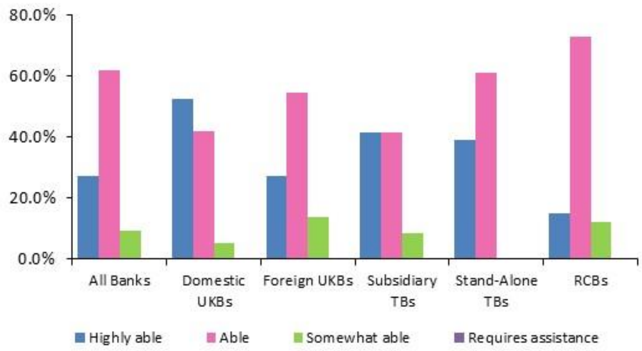
Rank	Second Semester 2021			Second Semester 2020		
	UKBs	TBs	RCBs	UKBs	TBs	RCBs
1	Asset quality/ Credit risk	Asset quality/ Credit risk	Asset quality/ Credit risk	Institutional risk	Institutional risk	Institutional risk
2	Macroeconomic risks/ Cybersecurity threats	Operational risk	Operational risk	Macroeconomic risks	Technology risk/Financial market risks	Financial market risks
3	Operational risk	Macroeconomic risks	Climate and environmental and social risks	Global risk and/or Domestic Geopolitical risks	Possible downturn in the real estate market	Over-regulation

Source: SPRD

Operational Performance

The banking system remains on stable footing as shown by the growth in assets, loans and deposits, profitable operations, as well as stable capital and liquidity buffers, amid the challenging environment brought about by the COVID-19 pandemic. The mobility restrictions implemented due to the surge in COVID-19 cases, social distancing and other health and safety protocols pushed banks to modify their operations while maintaining health and safety 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 expectations, and non-traditional market entrants. **The results of the BSOS revealed that 62.0 percent and 27.3 percent of respondent banks are able and highly able, respectively, to manage the effects of COVID-19 pandemic** (Figure 17).

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



Source: SPRD

Digital Transformation and Cyber-resilience

Even prior to the pandemic, banks have been striving to better serve their clientele by making some of their products and services accessible through digital platforms. The World Bank emphasized that digital reforms can also help the country become more resilient to external and natural shocks like the COVID-19 pandemic.[14] The BSP also underscored the importance of digitalization as part of its efforts to realize its vision for a strong "post-COVID-19" Philippine economy.

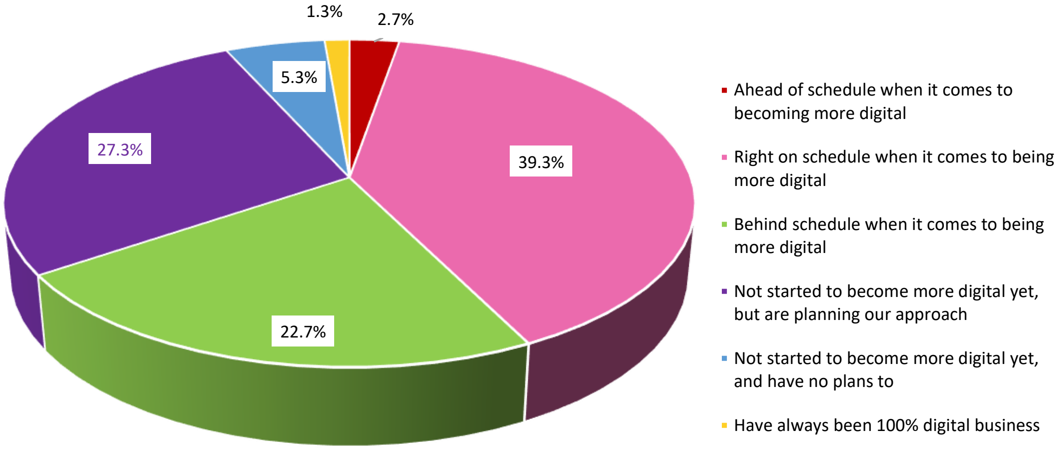
As a result of the community quarantine restrictions in the country, the digital transformation of the banking system was accelerated with the significant increase in the use of digital payments and electronic money platforms. Majority of UKBs had already adopted programs on digitalization prior to the COVID-19 pandemic and have embarked on improving their digital capabilities. Respondents were asked on the banks' roadmap on how to integrate digital technologies in achieving their business objectives. Relative to this, most of the banks recognize the need to integrate digital technologies to meet their

[14] The World Bank, *A Better Normal Under COVID-19: Digitalizing the Philippine Economy Now. Philippines Digital Economy Report,* September 2020.

objectives through process/system improvement and investment in digital infrastructure.

The survey results also revealed that about 39.3 percent of respondent are right on schedule when it comes to being more digital while 27.3 percent of respondents have not yet started to become more digital but are in the planning stage (Figure 18). Meanwhile, only 2.7 percent of the respondents are ahead of schedule in terms of being more digital. By banking group, 63.4 percent of UKBs and 42.9 percent of TBs are right on schedule when it comes to being more digital while 47.3 percent of RCBs are still planning their approach but have not started to become more digital.

Figure 18. Status of Digital Transformation



Source: SPRD

Overall, the top five challenges that banks have encountered in undertaking digital transformation are as follows: (1) insufficient in-house skills; (2) lack of the right technology/tools; (3) over-reliance on legacy technology; (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 legacy technology, lack of budget, and insufficient in-house skills are the topmost challenges encountered by UKBs, TBs, and RCBs, respectively. Most of the respondent banks believe 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.

The survey results revealed that 70.7 percent of respondents use technology and operating models[15] to ensure business continuity. Meanwhile, banks which are currently not using technology were asked if they have plans to use technology in the next two years. The survey results indicated that more than 50.0 percent of banks have plans to use technology in the next two years for purposes of enhancing operational performance, compliance, risk

[15] 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).

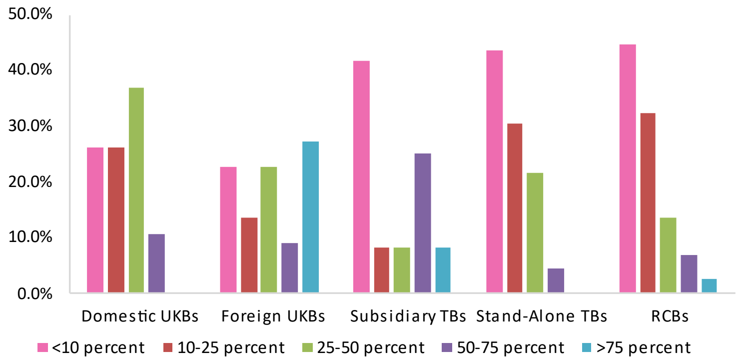
management, customer experience, expansion of client base, business continuity, and internal controls.

Cognizant of 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, 43.3 percent of respondent banks indicated that between 25.0 percent and 75.0 percent of their client-oriented activities (i.e., account opening, deposit, transfers, placements, among others) will be performed through digital means/remote processing in the next two years. In the same manner, about 48.0 percent of respondents revealed that between 25.0 percent and 75.0 percent of internal business processes (i.e., approvals, underwriting, among others) will be executed through digital means.

By banking group, majority (89.5 percent) of domestic UKBs indicated that between 10.0 percent and 75.0 percent of client-oriented activities will be conducted through digital technology. Foreign UKBs (40.9 percent) mentioned that they will use digital means in performing at least 50.0 percent of client-oriented activities. Meanwhile, subsidiary TBs, stand-alone TBs, and RCBs revealed that between 10.0 percent and 50.0 percent of their client-oriented activities will be performed through digital means.

Most respondents (skewed by small banks) mentioned that less than 25.0 percent of their customers are actively using digital channels. About 36.8 percent of domestic UKBs and 27.3 percent of foreign UKBs revealed that more than 75.0 percent of their respective customers actively use digital streams (Figure 19). Meanwhile, majority of subsidiary TBs, stand-alone TBs, and RCBs' shared that less than 10.0 percent of their customers access banking services/products through digital means.

Figure 19. Percentage of Customers Actively using Digital Channels
As of End-December 2021



Source: SPRD

Likewise, banks that have plans to use digital technology were also asked on the most important application of technology in their respective organizations. **Overall, deposit services emerged as the most important area of technology application for the second semester of 2021.** This was followed by payment systems which may be attributed to the increased use of digital payments and electronic money platforms as individuals and businesses shift to digital channels given the limited mobility and the necessity of avoiding face-to-face transactions. The top three most important technology application areas by banking group are shown in Table 4.

Table 4. Top Three Most Important Technology Application Areas

Rank	Second Semester 2021				
	Domestic UKBs	**Foreign UKBs**	**Subsidiary TBs**	**Stand-alone TBs**	**RCBs**
1	Deposit Services	Payment System	Deposit Services	Deposit Services	Deposit Services
2	Payment System	Treasury and Investment Activity	Collection/ Payment System/ Know your customer (KYC)	Know your customer (KYC)	Collection
3	Loan Scoring	Know your customer (KYC)/Customer Service/Collection	Customer Service	Payment System	Payment System

Source: SPRD

Fund transfer, loan payments/repayments, and bills payment were considered by most of the banks as the top three financial services offered through digital channels that can be completed without requiring the physical presence or visits of customers in branches or offices. Furthermore, banks were asked if they are willing to collaborate with a fintech company. Survey results revealed a mix of responses. 48.7 percent are 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, the remaining 50.0 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, mobile and online banking, payments, digital/e-wallets, loans, and deposits, among others**.

Metrics that are commonly used by banks to assess the change in consumer behavior towards digital alternatives include growth in digital channel enrollments/registrations as well as value and volume of digital transactions. Meanwhile, banks underscored the need for further guidance from the BSP regarding digital banking and constant engagements/collaboration through seminars and trainings to further help them through their digital journey.

The lockdown and remote working arrangements have accelerated the shift of financial transactions towards digital platforms which has resulted in an upsurge in cyberthreats and attacks targeting financial institutions and customers. Relative to this, the results of the BSOS showed that **48.0 percent of banks were 'prepared' to handle and manage cyberthreats**. This was lower than the 58.3 percent of banks reported in the end-December 2020 BSOS. Moreover, a higher proportion of respondents mentioned that they were 'somewhat prepared' in managing cybersecurity risks, respectively. This reflects the increasing challenge faced by banks in terms of managing cyberthreats.

The top three cybersecurity threats that are of concern to banks are listed in Table 5. In general, **cyberattacks (i.e., to disrupt, to steal money and intellectual property) topped the list of cybersecurity threats that respondent banks are most worried about**. Malware, direct hacking/advanced persistent threats (APTs) and phishing are the specific types of cybersecurity threats common to UKBs, TBs and RCBs.

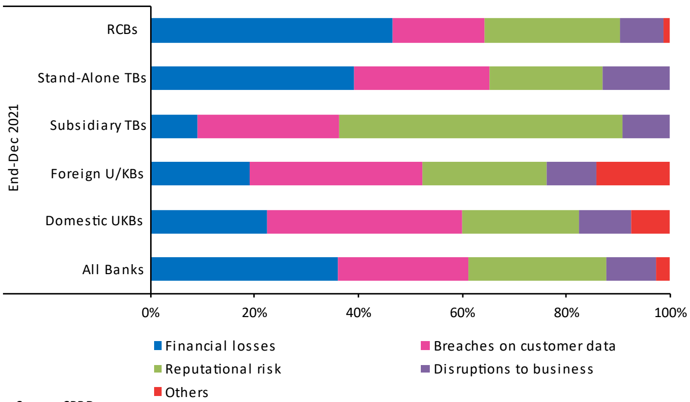
Table 5. Top Three Cybersecurity Threats

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

Source: SPRD

Overall, **35.3 percent of surveyed banks indicated financial losses as the most worrisome impact of cybercrime events followed by reputational risk and breaches in customer data**. By banking group, breaches in customer data were viewed by 42.1 percent of domestic UKBs and 31.8 percent of foreign UKBs as the most troublesome impact of cybercrimes. Financial losses were considered by 39.1 percent of stand-alone TBs and 45.9 percent of RCBs as the most disturbing effect of cybercrime events. About 50.0 percent of subsidiary TBs viewed reputational risk as the most worrisome impact of cybercrimes (Figure 20).

Figure 20. Impact of cybercrime events
As of End-December 2021



Source: SPRD

Sustainable Finance

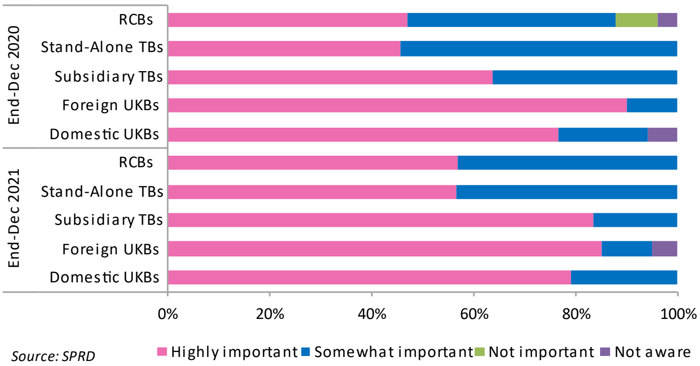
With the global move towards sustainable development, a growing demand for sustainable investments has been noted in recent years.

Cognizant of the risks posed by climate change to the FIs, the BSP issued the first phase of the sustainability or SG related guidelines in April 2020 under Circular No. 1085 or the Sustainable Finance Framework. This provides broad supervisory expectations on the integration of sustainability principles, including ESG considerations in the corporate and risk governance frameworks as well as in the business strategies and operations of banks.

The second phase of ESG-related regulations was issued under Circular No. 1128 in October 2021. The regulation provides granular expectations on the management of environmental and social (E&S) risks with respect to credit and operational risk management frameworks of banks. The third phase of ESG-related regulations with target issuance in the third and fourth quarter of 2022 includes the issuance of guidelines on the management of E&S risks in relation to the investment activities of banks, conduct of climate stress testing, and potential regulatory incentives that may be granted to banks which adhere to sustainability principles.

The survey results showed that there was a notable increase in organizational awareness towards sustainable financing as 64.7 percent of respondent banks viewed such mode of financing as highly important from 59.2 percent in the second semester 2020 BSOS. Most UKBs (78.0 percent), TBs (65.7 percent) and RCBs (56.8 percent) reported that sustainable financing as highly important. The views by banking group towards sustainable financing is shown in Figure 21.

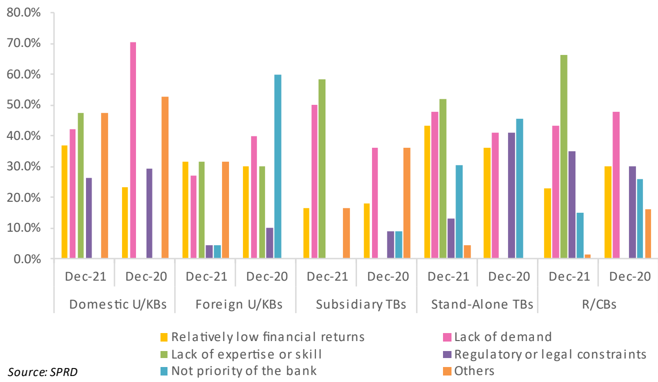
Figure21. Organization's View on Sustainable Financing
As of End-Periods Indicated



Source: SPRD

BSOS results also revealed that 79.3 percent of respondents are planning to finance sustainable projects while 19.3 percent of banks have no plans to finance these types of projects in the next two years. Meanwhile, banks expressed willingness to finance sustainable projects in support of agriculture, solar power, transportation, and waste management. Majority of the UKBs, TBs and RCBs indicated that lack of expertise or skill ranked first on the list among the barriers from pursuing sustainable financing. This was followed by the lack of demand for these types of projects as indicated by all banking groups (Figure 22).

Figure 22. Barriers from Pursuing Sustainable Financing
As of Ends-Period Indicated



Source: SPRD

Majority of UKBs and TBs shared that the BSP can further help them in their sustainability journey through capacity building/training followed by provision of incentives to the banks which include lower risk weights for sustainable loans, tax incentives, subsidies, among others. Most RCBs revealed that they need trainings/seminars to enhance their knowledge on sustainable financing.

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. All in all, **compliance with mandatory credit to agri-agra remains as the most challenging** since the strategic objectives of most banks may not be attuned to the funding requirements of the agri-agra sector.[16] As of end-December 2021, the PBS' 9.7 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 0.9 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.

Banks also cited regulations on anti-money laundering, credit risk management, reportorial requirements, information technology (IT) risk management, and operational risk management as other challenging areas in terms of compliance with the BSP's regulatory framework.

Table 6 presents the five 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.

Table 6. Most Challenging Areas in Terms of Compliance

Rank	Domestic UKBs	Foreign UKBs	Subsidiary TBs	Stand-alone TBs	RCBs
1	Anti-money laundering	Mandatory credits to agri-agra	Mandatory credits to agri-agra	Mandatory credits to agri-agra	Credit risk management
2	IT risk management	Reportorial requirements	Anti-money laundering	Credit risk management	Mandatory credits to agri-agra
3	Mandatory credits to agri-agra	Anti-money laundering/	Operational risk management	Operational risk management	IT risk management
4	Reportorial requirements	Foreign exchange regulations	Reportorial requirements	Anti-money laundering	Anti-money laundering
5	Internal Capital Adequacy Assessment Process	Stress Testing	Credit risk management	IT risk management	Reportorial requirements/ Operational risk management

Source: SPRD

Increase in Ranking from BSOS First Semester 2021   Decrease in Ranking from BSOS First Semester 2021

As a feedback mechanism, banks were asked to identify areas of supervision and/or regulation that the BSP should strengthen to promote the stability of

16 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.

the banking system. Cybersecurity and IT risk management emerged as common areas of concern across all banks, while credit risk management and liquidity risk management were identified by respondents from UKBs and RCBs.

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.

A number of policies to strengthen risk governance and ensure continued resilience and soundness of the financial system were issued during the second semester of 2021. These issuances aim to set out BSP's expectations in the management of reputational risk,[17] operational risk, as well as E&S risks.

The BSP enhanced the risk management and internal control measures in the area of operational risk.[18] The said amendments recognize "people risk" as an inherent source of operational risk of banks. As such, BSFIs are required to put in place adequate policies and risk management and control measures in the area of human resource management, including recruitment and selection, and performance management.

The BSP also issued the second package of regulations on ESG, which provides granular expectations on the management of E&S risks in relation to credit and operational risk exposures of banks.[19]

The Agriculture, Fisheries and Rural Development Financing Enhancement Act lapsed into law on 28 July 2022. Said Law recognizes sustainable finance as among the eligible forms of compliance with the mandatory credit requirement. The new law also provides banks with flexibility in allocating the 25 percent mandatory credit requirement to a range of borrowers and eligible activities.

In addition, the BSP, in collaboration with industry associations, development partners, and other interest groups, has been conducting capacity-building activities for banks to deepen their understanding of sustainable finance concepts, including disclosure and reporting requirements, and promote adoption of sustainable practices. Some banks have also initiated related events to increase awareness of their clients or have provided technical assistance in relation to the grant of loans, for instance, to finance projects on renewable energy or energy efficiency solutions.

---

[17] Circular No. 1114 dated 16 April 2021. Guidelines on Reputational Risk Management.

[18] Circular No. 1112 dated 8 April 2021. Amendments to Operational Risk Management and Internal Control Measures.

[19] Circular No. 1128 dated 26 October 2021. Environmental and Social Risk Management Framework; Circular No. 1085 dated 29 April 2020. Sustainable Finance Framework.

To provide clarity on other challenging areas cited by respondent banks, the BSP released guidance for BSFIs in the areas of credit, money laundering (ML)/terrorist and proliferation financing (TF/PF), and IT/cybersecurity. For instance, under credit risk, the BSP adopted prudential parameters for a loan that has been modified to be classified according to status.

As for the ML/TF/PF risks, the ML/TF Risk Assessment System (MRAS) serves as the platform for assessing the level of inherent risk and the quality of risk management and self-assessment systems of BSFIs, to arrive at their net ML/TF/PF risk profile. In addition, guidelines on correspondent banking relationships were issued to have improved understanding and management of ML/TF/PF risks associated with correspondent banking relationships.

Further, to counter the evolving IT/cybersecurity threats and foster responsible digital innovation, the BSP has developed a Cybersecurity Roadmap covering three key areas on capacity building, collaborative engagements, and continuing policy framework and supervisory enhancements to institutionalize cyber-resilience in the financial services industry. Likewise, the BSP constantly engages with BSFIs to ensure that cyber resilience strategies remain effective vis-à-vis evolving threats.

On the whole, the BSP will continue to adopt prudential standards that will strengthen corporate and risk governance, promote responsible innovation and sustainable finance, and uphold financial integrity and operational resilience in its supervised financial institutions. All these are intended to foster a resilient, dynamic, and inclusive financial system that is supportive of sustainable economic growth.

OUTLOOK SURVEY

2ND SEMESTER 2021

BANKING SECTOR

Published by
Supervisory Policy Research Department
Financial Supervision Sector
Bangko Sentral ng Pilipinas