Topic: The changing nature of the financial system: implications for resilience and long-term growth in emerging market economies (EMEs)[1]

Bangko Sentral Ng Pilipinas

EME financial systems: what has changed?

1. How have EME financial systems changed in recent years? How is the relative importance of bank intermediation and capital markets shifting? How important are non-bank financial intermediaries (NBFIs) in EMEs and what is driving their expansion? What are the major changes in the domestic and foreign investor base? How did the Covid-19 pandemic shape these developments?

Significant changes in the Philippine financial system:

- **The Philippine financial system has been dominated by banks over the years.** As of end-September 2023, the banking system comprised 82.8% of the total resources of the Philippine financial system. The consolidation in the banking system has also paved the way for a leaner and stronger network amid digital transformation, supportive of the growing bank operations. Meanwhile, the liberalisation of the rules governing entry of foreign banks under Republic Act (RA) No 10641 in 2014 increased the number of foreign banks operating in the Philippines.
- **Banks remain the pillar of strength of the Philippine economy with their continued growth in assets and deposits, accompanied by a strong capital position, adequate liquidity buffers and ample loan loss reserves.** To promote institutional stability, banks have also maintained capital and liquidity buffers that were higher than Bangko Sentral ng Pilipinas (BSP) and international standards. The strong performance of the Philippine banking system has enabled it to remain supportive of the country's financing requirements.
- **The Philippine banking system is resilient and robust owing to the significant structural reforms implemented by the BSP over the years.** These reforms include passage of critical laws and implementation of a regulatory reform agenda that covers the adoption of Basel III standards, as well as enhanced corporate governance and risk management standards among BSP-supervised financial institutions (BSFIs).

[1] All the discussed data about the Philippine financial system are based on preliminary data as of September 2023, unless otherwise indicated.

The BSP also continues to pursue reforms aimed at promoting the safety and soundness of the financial system against the backdrop of rapid advancements in technological innovations, an evolving financial ecosystem and increasing attention to the attainment of environmental and social (E&S) goals as a means to ensure balanced, equitable and sustainable economic growth.

- **Innovation and evolution of financial services and products have led the BSP to welcome innovative market players into the financial system** with the entry of digital banks, electronic money issuers (EMIs), virtual asset service providers (VASPs) and other fintech players through the regulatory sandbox framework.

The Philippine financial landscape is rapidly evolving, especially with the digitalisation of financial services, which brings more opportunities to the unserved and underserved areas. It is in this light that the BSP has been committed to establishing a policy and regulatory environment that enables innovations to flourish while ensuring that controls and safeguards are in place. Recent policy issuances supporting this approach include the adoption of a digital banking framework (BSP Circular No 1105), issuance of guidelines for VASPs (BSP Circular No 1108), adoption of an Open Finance Framework (Circular No 1122) and issuance of a Regulatory Sandbox Framework (BSP Circular No 1153).

- The Sustainable Central Banking (SCB) programme was adopted as one of the BSP's strategic thrusts in 2020. The SCB programme features the BSP's role as enabler, mobiliser and doer in promoting the sustainability agenda in the financial system. Launched in December 2022, the 11-action-point programme was developed to reinforce these varying roles of the BSP.

As an enabler, the BSP has implemented a phased approach in issuing sustainability-related regulations to strengthen the banks' ability to manage environmental and social (E&S) risks and to promote integration of sustainability principles into their corporate governance and risk management frameworks as well as their business strategies and operations.

In April 2020 the BSP issued the Sustainable Finance Framework, which provides the overarching principles for embedding sustainability principles in banks. This was followed in October 2021 by the Environmental and Social Risk Management Framework, which requires banks to incorporate E&S risk factors into their credit and operational risk management systems. The BSP issued a third set of regulations on the Integration of Sustainability Principles in Investment Activities of Banks in August 2022.

- **Relatedly, the Securities and Exchange Commission (SEC) has adopted guidelines on the issuance of green, social, sustainability and sustainability-linked bonds**.[2] These regulatory issuances largely adopt the ASEAN Green, Social, Sustainability and Sustainability-Linked Bond Standards developed by the ASEAN Capital Markets Forum.

[2] www.sec.gov.ph/wp-content/uploads/2019/11/2018MCNo12.pdf
www.sec.gov.ph/wp-content/uploads/2019/10/2019MCNo09.pdf.%20
www.sec.gov.ph/wp-content/uploads/2019/10/2019MCNo08.pdf.
www.sec.gov.ph/mc-2023/sec-mc-no-03-series-of-2023/#gsc.tab=0.

As of 30 September 2023, the total ASEAN-labelled green, social and sustainability bonds issued amounted to USD 41.3 billion, of which USD 10.0 billion, or 24%, were issued by Philippine companies.[3] Since 2017, seven local banks have issued PHP 173.2 billion in peso-denominated and USD 1.5 billion in foreign currency-denominated green, social, sustainability and blue bonds.[4] Of these seven banks, two issued approximately PHP 49.3 billion[5] worth of social bonds to finance or refinance needs of eligible micro, small and medium-sized enterprises (MSMEs). A bank also issued USD 100 million worth of blue bonds in May 2022.[6]

- **The Philippines has also undertaken significant policy actions to solidify its track record of strengthening the Islamic banking ecosystem.** The enactment of Republic Act (RA) No 11439, or the Islamic Banking Act, in August 2019 has been a transformative step in opening up the Philippine financial system to greater depth and diversity. This law granted the BSP clear authority to issue a broader set of rules and regulations on Islamic banking, including the entry of other Islamic banking players into the country, consistent with the objective of providing an enabling regulatory environment that will allow Islamic banks to operate viably alongside the conventional banking system while considering the unique features of Islamic banking operations. The BSP's initiatives are complemented by reforms in takaful (Islamic insurance) and the Islamic capital market, which are part of the Islamic finance ecosystem that is progressively being developed under a whole-of-government approach.

The landmark maiden sukuk (Islamic bond) issuance by the Republic of the Philippines (ROP) on 6 December 2023 is part of the agenda to promote the development of Islamic banking and finance in the country. The sukuk issuance allows the ROP to diversify its global investor base and tap Islamic-focused investors and marks the establishment of an active, liquid reference curve for other Philippine issuers to access the sukuk market in the future. This milestone transaction illustrates the ROP's ability to leverage the stable market conditions and access the international capital markets.

Relative importance of bank intermediation and capital markets shifting:

- **The Philippine capital market has been gradually evolving, with consistent efforts to deepen and broaden the market.** Financial markets in the Philippines have developed considerably since the Asian financial crisis. Financial liberalisation, prudential supervision and regulatory reforms have significantly improved the stability, efficiency, depth and accessibility of the domestic financial

3 www.sec.gov.ph/cm-sustainable-2023/sustainable-finance-market-update-as-of-september-2023/#gsc.tab=0.

4 Proceeds are allocated to renewable energy and energy efficiency projects, green buildings, clean transportation, pollution prevention and control, sustainable water management, environmentally sustainable management of living natural resources and land use, affordable basic infrastructure, access to essential services, employment generation, affordable housing, and socioeconomic advancement and empowerment.

5 This includes the USD 150 million worth of social bonds issued by a bank on 23 July 2021. Converted using US dollar to Philippine peso rate as of issue date at PHP 50.235.

6 Proceeds of the said blue bonds will be allocated to financing for projects that help prevent marine pollution and preserve clean water resources, plastic recycling, wastewater treatment, sustainable tourism, fisheries and sustainable seafood processing.

markets and institutions. Although the financial system remains dominated by banks, there have been important changes in the structure of financial intermediation. Among the most striking changes are the expansion in the share of foreign funding and a rise in the external indebtedness of the non-financial sector, owing largely to the prolonged period of low global interest rates and ample global liquidity after the Global Financial Crisis (GFC). Strong capital inflows in the post-GFC period contributed to the weakening of the interest rate channel of monetary policy. This prompted a reassessment of monetary policy operations, which eventually led to the implementation of the interest rate corridor (IRC) system in 2016. The increasing reliance of the IRC on market-based instruments is expected to aid the development of the domestic money and capital markets in the country.

- **Capital market development can enhance domestic financial stability by providing new tools to not only raise funds, but also manage risks.** Financial market development increases market resilience and reduces risk concentration in the country's bank-centric financial system. Sources of funding will be diversified through the development of the capital market, including the local government bond market. Fostering capital market development involves encouraging the listing of qualified firms to enable them to raise funds in the equity market. Meanwhile, banks can encourage their medium-sized and large corporate clients to strengthen their capital structure by raising equity in the stock market, or corporates to leverage their balance sheets, raising long-term funding via bond issuances. Banks can also promote new equity and bond issues for investment through their retail and institutional clients, including small investors, who should be able to access these investment products through the banks' digital services.
- **The development of the capital markets, through progressive and innovative products and policies, will provide more investment opportunities to retail investors, broadening and deepening financial inclusion and at the same time improving the resiliency of the financial sector with a deeper capital market.** An efficient and secure national payment system (NPS) will enable and support the growth of financial transactions. Finally, the use of technology for reporting, supervision and compliance will facilitate financial inclusion and innovation and, more importantly, ensure a well functioning financial sector.

The banking sector has remained a key provider of credit to the economy. Bank loans are broad-based and supportive of key productive sectors (eg real estate, wholesale and retail trade, electricity, gas, steam and air-conditioning supply, manufacturing), as well as households. Nonetheless, there is increasing attention on the development of the capital markets as an alternative source of funding for corporations. Capital market development is seen to strengthen the resilience of the financial system, with a broad set of potential investors with differing risk appetites that can support a more diverse range of borrowers. In recent years, there have been various regulatory reforms and enhancements to infrastructure with the aim of facilitating activity and enhancing the price transparency and liquidity of the market.

- **The higher post-pandemic interest rate environment has also brought new investors into the bond market.** Prior to the higher-for-longer environment, these investors might not have found the yields from bonds sufficiently appealing for them to be willing to have their funds locked in over the medium to long term. However, the yields offered by recent issuances have provided an incentive to breach the barrier. The hope is for these investors to consider reinvestment in the future and to remain in the market through changes in macroeconomic conditions, continuing to support market depth.

- **The digital transformation and greater use of technology is also evident in the area of capital markets.** Most recently, the Philippine national government has issued tokenised treasury bonds for the first time, with the objective of promoting greater financial inclusion and broader participation in the domestic bond market.

Importance of non-bank financial intermediaries and drivers of expansion:

- BSP-supervised non-bank financial intermediaries (NBFIs), such as non-stock savings and loan associations (NSSLAs), pawnshops (PS) and money service businesses (MSBs), play a crucial role in supporting the Philippine economy by:

    1. **Enhancing financial inclusion:** NBFIs serve as vital channels for providing financial services to segments of the population that are underserved by traditional banks. They help to increase financial access and inclusion by offering services such as small loans, remittances and basic banking facilities.

        Specifically, PS and MSBs are instrumental in promoting financial inclusion by serving as accessible financial touchpoints for sources of funds and provision of financial services, even in areas where banking services may be limited, given their wide presence across the country. As of 31 December 2023, there were 1,160 PS and 722 MSBs, with a combined total of 23,428 offices in the Philippines, surpassing the nationwide presence of banks by 80%.

        Their transactions/operating platforms are connected or deeply linked to the operations/transactions of other BSFIs and are widely used as alternative means to move funds in the financial system. For instance, they are used as cash agents by banks and EMIs have been tapped for the payout of government cash amelioration programmes. Large PS belong to group structures with other related corporate entities engaged in banking, MSB and EMI operations, among others.

        Meanwhile, the NSSLA industry has emerged as a crucial NBFI segment, playing an important role in fostering financial inclusion in the Philippines. Unlike banks, which serve and offer various financial instruments to the general public, NSSLAs cater to the needs of a welldefined group of members of a private company/conglomerate or department/branch/office of the government.

    2. **Increasing access to credit:** NBFIs often specialise in providing credit to individuals and small businesses that may have difficulty obtaining loans from traditional banks. This promotes entrepreneurship, supports innovation and stimulates economic growth in EMEs.

        For instance, NSSLAs provide access to a variety of loans and savings products. They have extended their services to millions of Filipinos across the archipelago (1.3 million as of 31 December 2023) and remain one of the more accessible and dependable sources of funding for Filipinos.

3. **Fostering capital market development:** NBFIs play a significant role in developing capital markets in EMEs. They provide alternative investment options beyond traditional bank deposits. This helps in mobilising savings, facilitating capital formation and attracting domestic and foreign investments.

4. **Diversifying sources of funding:** NBFIs offer an alternative source of funding for businesses and governments. By tapping into different funding channels, these intermediaries help diversify the overall funding structure of the economy and reduce reliance on traditional banking institutions.

5. **Fostering financial innovation:** NBFIs are often at the forefront of financial innovation. They develop new products, services and technologies that can improve the efficiency and effectiveness of financial markets. This innovation can lead to increased competition, better risk management and overall improvements in the financial system.

6. **Promoting financial stability:** NBFIs diversify the sources of funding and reduce reliance on the banking sector. This can enhance financial stability by reducing systemic risks and potential contagion effects. Additionally, these intermediaries can provide additional risk-sharing mechanisms against financial shocks, as they often have expertise and specialised knowledge in managing specific risks.

7. **Supporting economic growth:** By providing funding to diverse sectors of the economy, NBFIs contribute to economic growth and development. They can finance small and medium-sized enterprises (SMEs) that face challenges in accessing traditional bank loans. This supports entrepreneurship, job creation and overall economic expansion.

- Meanwhile, several factors are driving the expansion of NBFIs in EMEs like the Philippines, such as:

  1. **Unserved market segments:** NBFIs often target underserved or unserved market segments, including individuals and small businesses that have limited access to traditional banking services. By addressing the financial needs of these segments, NBFIs can fill market gaps and tap into new business opportunities;

  2. **Economic growth and investment opportunities:** EMEs offer substantial economic growth potential and investment opportunities. NBFIs are drawn to these markets because they can participate in the financing of infrastructure projects, provide capital for SMEs and contribute to the overall development of the economy;

  3. **Regulatory changes:** Regulatory reforms and changes in EMEs have created more favourable conditions for NBFIs. Governments have recognised the importance of fostering financial innovation and inclusion, leading to the implementation of regulatory frameworks that support the growth of these intermediaries while maintaining financial stability;

4. **Technological advancements:** The rapid advancement of technology has facilitated the growth of NBFIs. Digital platforms, mobile banking and financial technology (fintech) innovations have made it easier for these intermediaries to reach a wider customer base and offer a range of financial services efficiently and at lower costs;

5. **Search for higher yields:** NBFIs often seek higher investment returns compared to traditional banks. They may offer alternative investment products or engage in riskier activities, such as investing in emerging market assets. The search for higher yields drives their expansion as they cater to investors who are willing to take on more risk in pursuit of higher returns; and

6. **Changing consumer preferences:** Consumer preferences have shifted over time, with individuals and businesses becoming more open to utilising non-traditional financial services. NBFIs have capitalised on this trend by offering innovative and customer-centric financial products and services that align with evolving consumer needs and preferences.

- In the case of the Philippines, growth/expansion in the PS and MSB industries are driven by the ever-changing needs of consumers, fostering an inclusive financial system, along with technological/innovational changes and advancements, among others. In recent years, PS have expanded their range of products and services from simple pledge of jewellery to include high-value luxury goods and other personal items and have also utilised digital means in delivering their services to their clients. Furthermore, the scope of business is no longer limited to pawning but also includes corollary activities such as remittance, money changing and bills payment that provide Filipinos with accessible financial services. These evolutions have resulted in the need to expand the scope and reach of products and services by establishing additional branches/offices, among others. The number of PS and MSB offices has increased by 10% and 12%, respectively, based on end-December 2020 and end-December 2023 data.
- Meanwhile, the NSSLA industry has grown extensively in terms of asset size, with a pre-pandemic three-year[7] average growth rate of 13.21%. Meanwhile, similar to other sectors, the growth of the NSSLA industry was hampered by the challenges brought about by the Covid-19 pandemic. From 2020 to 2022, the average rate of increase in total assets was only 4.84%. This was a result of the low demand for credit as community quarantine restrictions were imposed on business operations.

Expansion in terms of the number of NSSLAs, however, has been non-existent in the past few years. No new authority to operate an NSSLA has been granted by the BSP for the last 10 years. While some letters of intention from government departments/branches/offices and private corporations to set up an NSSLA were received in the last five years, these applications were rejected due to lack of and/or deficiencies in the submitted documentary requirements.

[7] 2019 – 14.91%; 2018 – 16.97%; 2017 – 7.74%.

Major changes in the domestic and foreign investor base:

- While the liberalisation of the rules on entry of foreign banks under RA No 10641 increased the number of foreign banks operating in the Philippines, the banking system remains dominated by domestic banks. Out of the 483 banks operating in the Philippines as of end-October 2023,[8] 455 are domestic banks while 28 are foreign banks. Since the issuance of BSP Circular No 858 dated 21 November 2014 which implemented RA No 10641, the BSP Monetary Board has approved 12 foreign bank applications, from China [1], Japan [1], Malaysia [1], Singapore [1], South Korea [3] and Chinese Taipei [5]. The 28 foreign banks operating in the Philippines are comprised of 24 foreign bank branches and four foreign bank subsidiaries.[9]
- **PS and MSBs are consistently dominated by domestic investors, while NSSLAs have been purely comprised of domestic/Filipino capital contributors over the years.** Data for the years 2018 to 2023 show less than 1% average growth for both PS' domestic and foreign investor base, while for MSBs, the domestic and foreign investor bases have increased by an average of 6% and less than 1%, respectively. Growth is mostly driven by new entrants to the industry.

Developments in the Philippine financial system during and after the Covid-19 pandemic

- Please see discussions on the significant changes to the financial system above.
- At the onset of the pandemic, the BSP was swift in implementing operational and regulatory relief measures aimed at extending financial relief, boosting bank lending and promoting continued access to financial delivery and services. Philippine banks have shown resilience to the Covid-19 crisis, benefiting from risk management and other regulatory reforms of the past two decades. As economic conditions improved and Covid-19 restrictions eased, most of the relief measures expired but some were extended and adopted as permanent policy to sustain credit growth momentum and ensure continued access to financial services.
- In the case of NBFIs, the Covid-19 pandemic had a significant impact on their strategic initiatives, financial condition and overall operations.

NBFIs overhauled their strategic direction and key initiatives to cope with the challenges brought by the pandemic, mitigate the impact on operations and profit, and adapt to the new normal. They also revised their financial projections to come up with achievable and conservative short-term targets and adopted operational strategies to cut costs and mitigate the impact of the health crisis on profits.

Importantly, the pandemic highlighted the critical role of technology in NBFI operations. The adoption of digital means has dramatically increased, which has put immense pressure on technology infrastructure and information security,

[8] Source: Department of Supervisory Analytics (DSA) Financial Supervision Sector (FSS), BSP (latest preliminary).

[9] Twenty-six universal/commercial banks, or U/KBs (24 foreign bank branches, two subsidiaries) and two subsidiary thrift banks.

encompassing true tests of capacity planning and resilience. While varying in sophistication and extent of use of IT resources, NBFIs with digital channels have not encountered any system/resource disruption during the extended quarantine period. The pandemic also brought a new light to digital transformation. Digital platforms allowed customers to perform financial transactions with NBFIs during the community quarantine.

However, while most NSSLAs are digitally ready, PS and MSBs have appeared to lag behind as respondents spoke of roadblocks to digital reforms. To cushion the impact of the pandemic and prepare the institutions for the new operating environment, NBFI boards and management have adopted proactive measures and various initiatives. Revenue-generating and expense reduction measures were initiated to mitigate the pandemic's adverse impact on profitability. Other initiatives hinged on innovation, diversification and introduction of new products and services; intensified customer information campaigns; improved access point experience; and expanded networking to feasible and accessible locations. PS are also pursuing initiatives to increase client patronage by way of high appraisals, while NSSLAs have intensified loan collection activities.

2. How is lending by state-owned banks and development banks evolving? Which sectors are being financed? Did the pandemic affect the lending by these institutions and what is the outlook?

The evolution of lending by state-owned banks is influenced by various factors, such as general economic conditions, shifts in government policies/priorities, changing legal and regulatory requirements and global/domestic financial trends, among others. State-owned banks in the Philippines are at the forefront of implementing the various government lending programmes and initiatives. Changes in government priorities can impact the lending strategies of these banks, as the government may direct them to support and prioritise specific sectors such as agriculture, fisheries and rural development, and SMEs.

Based on data as of end-September 2023, government banks in the Philippines are mainly financing private corporations, loans to government, SME loans and salary-based general purpose consumption loans which are mostly part of the following industries: (i) electricity, gas, steam and air-conditioning supply; (ii) real estate activities; and (iii) public administration and defence, compulsory social security.

These banks provided financing and support during the Covid-19 pandemic, particularly to borrowers that were heavily affected. Though there was lower loan demand following business disruptions during the pandemic, their loans to assets started to increase with the resumption of business activities.

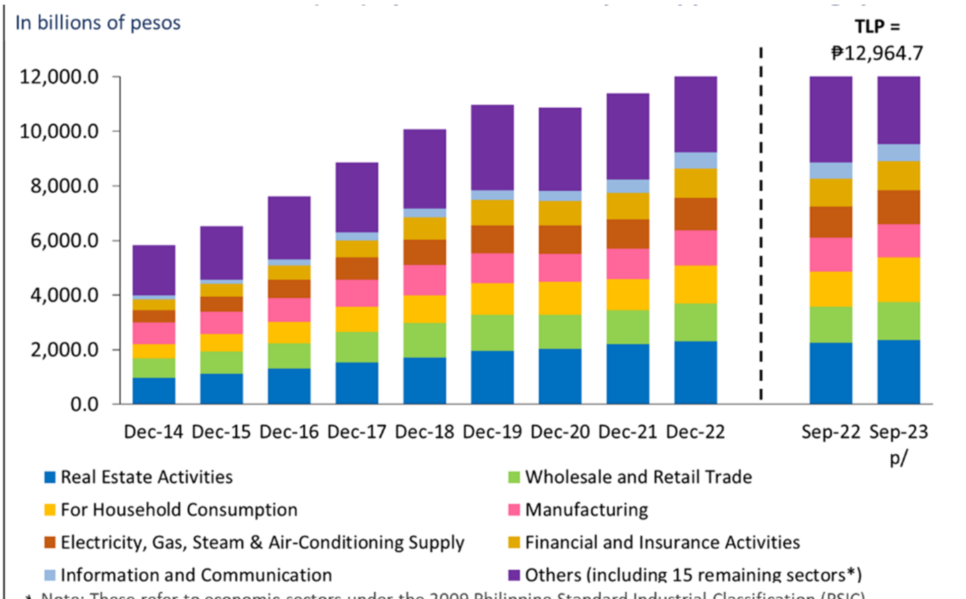
The boards and management of state-owned banks actively oversee their credit risk-taking activities and management of credit risk exposures.

Based on a survey conducted with Philippine banks in 2022, a majority of these banks, including government banks, shared a stable outlook on the banking system in the next few years. This optimism was coupled with expectations of growth in assets, loans, deposits and net income. Banks intend to actively participate in the money and capital markets in the next two years as more than half of respondents expect growth in securities investments. Banks also plan to maintain risk-based capital, leverage and liquidity ratios at levels higher than domestic and global standards to promote institutional stability.

3. How has the sectoral allocation of credit changed over time? Have there been major shifts in credit allocation between households and non-financial firms or within the non-financial corporate sector?

Philippine banks continue to extend credit mainly to the real estate sector. From 2014 to 2022, this sector was the biggest borrower in the banking system with an average loan share of 17.7%, followed by wholesale and retail trade (11.9%) and manufacturing (11.0 %). During this period, the share of economic sectors such as manufacturing and wholesale and retail trade gradually declined from 13.8% to 10.2% and from 12.4% to 10.9%, respectively. Meanwhile, sectors like households saw a considerable increase from 8.9% to 11.0%, as did electricity, gas and steam (from 7.5% to 9.6%), construction (from 2.1% to 3.7%) and information and communication (from 2.2% to 4.7%).

Gross total loan portfolio (TLP) by economic activity: Philippine banking system — Figure 1



* Note: These refer to economic sectors under the 2009 Philippine Standard Industrial Classification (PSIC)

Source: BSP

p/ preliminary

- Loans to the non-financial corporate sector and households in the Philippines have remained relatively stable over the years, as shown in Figure 1. Likewise, banks' lending has remained broad-based across various sectors. As of September 2023, the real estate sector remained the banking system's biggest borrower, with a loan share of 18.1% (PHP 2,357.5 billion) followed by households[10] (12.6%, PHP 1,641.1 billion), which registered 25.4% growth in the same period.[11] Except for manufacturing,[12] loans to all sectors expanded, albeit at a decelerated pace.[13] The slowdown in lending activity can be attributed to interest rate hikes and high inflation which dampened loan demand, particularly from business.

- Specifically for loans for household consumption, its share rose to 12.6% (from 10.8% in September 2022) due to faster growth recorded at 25.4%.[14] This is expected to continue amid growing demand from households and easing bank credit standards driven by improving economic conditions.[15]

The allocation of finance and long-term growth

4. What are the implications of recent shifts in the importance of bank intermediation and capital markets for financing long-run growth?

The BSP recognises the importance of bank intermediation and capital markets for financing long-run growth. The effectiveness of the intermediation function of the Philippine banking system is evident in its robust performance, with growing assets, loans, deposits and profits accompanied by sufficient capital and liquidity buffers and ample loan loss reserves. Funded mainly by domestic deposits, asset growth has enabled banks to remain supportive of the Philippine economy through lending activities whereby gross total loans went up by 7.8% to reach PHP 13.1 trillion in September 2023, marking 26 consecutive months of year-on-year growth since August 2021.

10 These borrowings were comprised of credit card receivables (CCRs) (40.3% share, PHP 662.0 billion), motor vehicle loans (30.3% share, PHP 496.5 billion), salary-based general purpose consumption loans (SBGPCLs) (26.6% share, PHP 436.0 billion) and other consumer loans (2.8% share, PHP 46.7 billion). Excluded are loans to individuals for housing purposes or residential real estate loans.

11 Other major sectors' shares are as follows: wholesale and retail trade (10.7%, PHP 1,390.8 billion), electricity, gas, steam and air-conditioning supply (9.5%, PHP 1,245.2 billion) and manufacturing (9.2%, PHP 1,198.2 billion).

12 Loans to manufacturing started to weaken from May 2023 (increasing by just 0.9% vis-à-vis the 9.5% growth in Q1 2023), followed by a contraction in July, August and September 2023 (down by 0.2%, 3.0% and 3.4% respectively). According to the Philippine Statistics Authority, manufacturing output recorded slower growth from Q1 2023 due to lower activity. Further, the Value and Volume of Production Index (VaPI) for the manufacture of food products registered an annual decline of 6.4%. This was primarily driven by the annual decline in the manufacture of dairy products industry group, which stood at 26.5% in September 2023 compared to the 3.8% annual decrement in the previous month.

13 Loans to non-financial corporate sectors continued to expand at a decelerated pace. As of September 2023, loans to businesses engaged in real estate, electricity, gas, steam and air-conditioning supply, and wholesale and retail trade sectors recorded growth rates of 5.0% (up by PHP 112.2 billion), 9.0% (up by PHP 103.3 billion) and 6.1% (up by PHP 79.4 billion), respectively.

14 Loans to households grew by 16.9% before the pandemic. The pre-pandemic period covers the years from 2015 to 2019. Loans to households as of September 2023 and September 2022 rose by 25.4% and 16.1%, respectively.

15 Based on Q2 2023 Senior Loan Officers' Survey (SLOS).

The capital markets are seen to address critical funding gaps that cannot be fully met by bank credit or government spending. They serve to complement the banking industry, providing additional funding at longer maturities than banks may be willing to offer. Bond markets also allow for funding to be channelled to a wider variety of economic activities, including those that may be outside the risk tolerances of banks. The diversification afforded by the capital markets increases financial system resilience and ensures that stresses on a single creditor (eg the banking sector) are not propagated throughout the economy. Active domestic capital markets also allow borrowers to obtain funding onshore, in local currency. This prevents domestic agents from relying excessively on foreign funding sources, which may expose them to foreign exchange (FX) risk.

Capital markets make a broad range of financial products available to both borrowers and creditors, helping increase financial inclusion. Startups and SMEs may gain access to credit from investors with higher risk appetites, who in turn receive opportunities for enhanced returns.

While there has not been a marked shift in the importance of bank intermediation vis-à-vis the capital markets for financing long-run growth in the Philippines in recent years, there has been greater focus among both banks and capital market investors on financing long-run growth. Companies are increasingly expected to consider long-term risks such as climate risk in their strategic decision-making, and those that do can expect to benefit from being able to tap more potential sources of funding.

The BSP has supported this paradigm shift by collaborating on the promotion of sustainable finance. The sustainability/sustainable finance-related regulations for banks are being issued in phases. This began with the Sustainable Finance Framework, which provides high-level principles and broad expectations on the integration of sustainability principles into corporate and risk governance frameworks, as well as into banks' business strategies and operations. This was followed by the Environmental and Social Risk Management (ESRM) Framework, which requires banks to incorporate environmental and social (E&S) risk factors into their credit and operational risk management systems. The ESRM Framework also includes expectations of a bank's board in setting strategic E&S objectives, considering material E&S risks in the bank's capital planning process, institutionalising a capacity-building programme to equip all personnel to manage such risks, and adopting an effective communication strategy.

Moreover, the BSP has issued Guidelines on the integration of sustainability principles into the investment activities of banks. Under this regulation, banks are expected to assess if the investment and the issuing company are exposed to material E&S risks, and to analyse potential exit strategies if the said investment is found to have high E&S risks, among others. Proposed guidelines for integrating sustainability principles into unit investment trust funds are also under development.

Meanwhile, banks issuing green,[16] social[17] or sustainability[18] bonds are expected to refer to the pertinent guidelines issued by the SEC.

The BSP, the SEC and the Insurance Commission (IC), under the auspices of the Financial Sector Forum (FSF), have also jointly developed Sustainable Finance Taxonomy Guidelines. The local taxonomy will initially focus on climate change mitigation and adaptation and will later cover biodiversity, circular economy and other social aspects. The taxonomy is seen to establish a common understanding among various key players to identify which economic activities can be considered as environmentally and socially sustainable.

The consultation draft[19] was released for comments from supervised entities and other stakeholders or interested parties until 6 October 2023. The FSF member agencies also conducted a series of in-person consultations with relevant government agencies and supervised entities of the BSP, SEC and IC in October–November 2023 to further refine the proposed guidelines. The BSP and SEC issued their respective regulations adopting the Philippine Sustainable Finance Taxonomy Guidelines in February 2024.[20]

Sources:

(1) F Dakila, "The development of financial markets in the Philippines and its interaction with monetary policy and financial stability", in "Financial market development, monetary policy and financial stability in emerging market economies", BIS Papers, no 113, December 2020.

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5. How has the various markets' (equity/bond/bank loans) ability to promote growth evolved over time? How efficient are they in financing high growth firms? Are there concerns about financing zombie firms?

On equity/bond/bank loans markets and growth:

Bank loans can play a crucial role in fostering economic growth by providing businesses and individuals with the financial resources they need to invest, expand and engage in economic activities. This is particularly true for bank-dominated economies such as the Philippines, where gross total loans of the banking system reached PHP 13.1 trillion as of September 2023.

While banks still dominate, the bond and equity markets have become an increasingly important component of capital market development in the country. Outstanding local debt securities rose by 9.6% year on year to PHP 11.7 trillion as of June 2023. Treasury and other government bonds remained dominant in the local currency bond market, accounting for 82.4% of the total debt stock at the end of June 2023 after posting 2.3% quarter-on-quarter growth. Corporate bonds had a 13.6% share, while the securities issued by the BSP represented another 4.0%.

On the other hand, the Philippine corporate bond market grew by 4.4% year on year due to large-volume issuances from select firms. Banking, property and holding companies are the dominant issuers, accounting for an aggregate 81.0% of all corporate bonds outstanding as of end-June 2023.

However, local currency bond issuance contracted by 19.2% quarter on quarter in the second quarter of 2023. This was mainly driven by a reduced issuance of treasury bonds. Government securities saw a 39.0% quarter-on-quarter contraction in terms of new issuances, largely attributed to the high base resulting from the sale of retail treasury bonds amounting to PHP 283.7 billion in February.

Since 2017, seven local banks have issued PHP 173.2 billion peso-denominated and USD 1.5 billion foreign currency-denominated green, social, sustainability and blue bonds.[21] Meanwhile, two banks have issued approximately PHP49.3 billion in social bonds to finance or refinance the needs of eligible MSMEs.

Moreover, the landmark maiden issuance of the Philippines' sovereign sukuk marks the country's debut in the global Islamic financial markets, which is a leap towards further promoting the development of the Islamic banking and finance ecosystem. On 29 November 2023[22] the Philippines successfully priced its sukuk issuance ("sukuk"), utilising real estate assets under Ijara and Wakala structures, together with a Commodity Murabaha aspect. The sukuk, with an issuance size of USD 1 billion and a tenor of 5.5 years, marks the first time the country has tapped the

[21] Proceeds are allocated for renewable energy and energy efficiency projects, green buildings, clean transportation, pollution prevention and control, sustainable water management, environmentally sustainable management of living natural resources and land use, affordable basic infrastructure, access to essential services, employment generation, affordable housing, and socioeconomic advancement and empowerment.

[22] Please see press release www.treasury.gov.ph/wp-content/uploads/2023/11/ROP-Sukuk-2023-Press-Release-30-November-2023.pdf.

global Islamic financial markets in this structure. The sukuk issuance allows the Philippines to diversify its global investor base and tap Islamic-focused investors across the Middle East, and marks the establishment of an active, liquid reference curve for other Philippine issuers to access the sukuk market in the future.

Meanwhile, the opening of the Credit Information Corporation (CIC) database in 2019 enhanced the ability of banks to properly identify the capability of potential borrowers to repay loans. This is likely to further facilitate banks' lending to borrowers, including high-growth/high-growth-potential firms.

Technology is also increasingly being utilised to extend funding to clients in the different markets. For instance, the establishment of digital banks now enables banks to extend loans to borrowers via purely digital means. Bonds may also now be bought online through various digital channels.

On financing zombie firms

In the Philippine market, the key challenge lies in increasing activity in the capital market. Banks must continue to uphold and strengthen their credit risk management standards and practices to better screen and avoid financing "zombie firms" – companies that do not generate enough cash to pay the interest on their debts – so that they cease acting as a drag on the economy by using up scarce resources that could be better allocated to a more prolific undertaking. While the concern regarding zombie firms may not be as significant as before owing to the current economic environment with high interest rates which may shorten their lifespan, emerging risks may come from them slowly dying off in numbers as debts become due. This could mean layoffs and major losses for investors, which could usher in recession. Nevertheless, as zombie firms start selling off their assets, this could create new opportunities for healthier firms.

Sources:

(1) F Dakila, "The development of financial markets in the Philippines and its interaction with monetary policy and financial stability", in "Financial market development, monetary policy and financial stability in emerging market economies", BIS Papers, no 113, December 2020.

(2) J Armas and N De Guzman, "Introducing a multi-dimensional financial development index for the Philippines", BSP Working Paper Series, no 2022-05, July 2022.

(3) T Didier, R Levine, R Montanes and S Schmukler, "Capital market financing and firm growth", World Bank Policy Research Working Papers, no 9337, July 2020.

(4) W Frick, "Can zombie firms survive rising interest rates?", Harvard Business Review, September 2022.

6. How important is foreign capital for long-term growth? Does the composition of investment by type of investor and currency matter?

Foreign direct investment (FDI) is an important source of external financing for developing countries. Given its long-term nature, it provides a stable source of funding for host or receiving economies; thus, it is generally preferred over other types of external funding. The expected benefits of FDI to host economies include, among others, increased employment, technology spillovers, transfer of managerial practices and increased integration with international markets. These, in turn, are expected to ultimately contribute to a host country's economic growth and development. Due to the expected benefits of FDI, countries, especially developing and emerging market economies, implement various measures or offer incentives in an effort to make themselves more attractive to foreign investors.

A study on "Foreign direct investment and economic growth: some empirical evidence from the Philippines"[23] shows that foreign capital is important for long-term growth. It was cited that the possible reason for this is that those firms with significant foreign investors enjoy lower cost of production and higher productive efficiency. This is primarily driven by the incentives being given to encourage foreign investments and the expertise these foreign investors bring into the Philippines.

According to the same study, there are institutional and scale factors that contribute to foreign investment influencing growth.[24] These factors include the recipient economy's trade regime, legislation, political stability, balance of payment constraints and the size of the domestic market for goods and services produced through the investment. On the other hand, the study was not able to identify the composition of investment by type and currency as factors that could have an impact on foreign investment influencing growth.

One downside of reliance on foreign capital is that the flow of such capital may become volatile due to foreseen and unforeseen circumstances. Liberalised rules on foreign investment may result in increased inflow of capital. At the same time, however, the country's exposure to the threat of capital flight may increase. The concentration of foreign investments from a specific type of investor can also contribute to the volatility of capital flows. This can potentially pose a significant threat to long-term growth if capital is withdrawn in unison by foreign investors.

In recent years, the Philippines has been attracting more FDI amid domestic and global developments. Even with healthy FDI recorded to date, policymakers are on the lookout for a better macroeconomic enabling environment to sustain and maximise the benefits from FDI; offer reasonable incentives, clarity and continuity of reforms; and enhance promotion of the Philippines as a prime FDI destination.

The Philippines is undergoing economic structural shifts and implementing policies that are responsive to global challenges, and could unlock the potential

[23] esacentral.org.au/images/Agbola.pdf.

[24] However, according to the study, the effect on long-term growth of these factors still depends on the absorptive capacity of the Philippines, as created through increased domestic private investment and infrastructure development.

benefits of even more FDI, with foreign investors able to differentiate the Philippine economy from others.

Furthermore, engagement of stakeholders for better investor perception and improvement in competitiveness, ease of doing business and institutional and governance reforms cannot be underestimated and may very well complement the sufficient external buffers and domestic liquidity provisions in place.

Sources:

(1) H Parcon-Santos, M Amador and M Romarate, "Understanding country disparities in foreign direct investments", BSP Research Blog, 26 September 2023.

(2) M Bartolazo, "Sustaining foreign direct investments (FDIs) in the Philippines", BSP Economic Newsletter, no 18-01, August 2018.

7. How have changes in the sectoral allocation of credit affected the economy's growth potential?

The BSP is of the view that allocation of credit as discussed above has been broadly in line with the growth of economic sectors, with banks cognisant of each sector's opportunities and risks. It is worth noting that economic activities contributing to capital formation activities and fostering technology adaptation have seen their share increase during the period 2014 to 2022. For instance, electricity, gas and steam saw a sizeable increase from 7.5% to 9.6%, as did construction (from 2.1% to 3.7%) and information and communication (from 2.2% to 4.7%). Increased lending to these sectors can help bring down the cost of doing business, increase productivity and, in turn, attract FDI that can lead to job creation and sustained growth.

The BSP deems that the current sectoral allocation of credit is conducive to the economy's growth potential as a huge portion of lending is invested in the productive sectors of the economy.

Given the Philippines' market-led economy, financing needs of various industries are demand-driven. Banks mainly provide financing support by granting loans and levying interest to borrowers according to their corresponding risk profiles and the prevailing cost of capital, albeit influenced by the policy rate set by the BSP. Aligned with its role as regulator and financial supervisor, the BSP focuses on ensuring that banks take on risks while remaining in compliance with prudential and regulatory standards.

Aside from monetary policy and prudential regulations, the BSP's recent initiatives to influence the allocation of credit have mainly involved shepherding the banking sector to mainstream green projects and to align its operations on sustainability principles and practices towards a more inclusive and resilient economy. Incentives for banks funding green or sustainable projects are also in place in the form of a separate single borrower's limit (SBL) for project finance, exclusion from some prudential limits and treatment of sustainable finance as an eligible mode of compliance with mandatory credit to agriculture, fisheries and rural development, among others. Recently, the BSP released guidelines providing temporary incentive measures to accelerate financing of green or sustainable projects, including transition activities. These are in the form of an increased SBL (by 15%) and a gradual reduction in the reserve requirement rate against sustainable bonds issued by banks.[25]

Since 2014, the Philippine economy has been driven by the services sector, accounting for close to 60% of GDP.[26] Multilateral institutions and economic policymakers advise that in order for the Philippines to escape the "middle-income trap"[27] and to increase the economy's growth potential, more investments in physical capital, particularly infrastructure that will improve economic productivity, as well as investments in technology, innovation and human capital (ie health and skills upgrading) are paramount.[28]

8. How important is lending by state-owned and/or development banks from the perspective of long-term growth and employment?

State-owned or government banks or government financial institutions (GFIs) are considered partners of the national government in carrying out its initiatives by providing finance and support to projects/programmes that cater to their respective mandated sectors for the benefit of the rest of the economy. They also provide countercyclical lending, which is lending more when the economy is weak. This became evident during the Covid-19 pandemic, when GFIs increased their lending to sectors or industries that were deeply hit by the pandemic.

In particular, the lending programmes of government banks are crafted to finance development to stimulate economic activities across the nation. Further, their pivotal role as development financing institutions is to drive resiliency and empowerment for various industries and sectors of society through transformative banking that fosters inclusive growth and sustainability.

Meanwhile, government banks have created and implemented new and responsive lending programmes that have significantly aided the whole-of-government approach by assisting the country's various economic sectors. Various credit assistance programmes which offer low interest rates and flexible terms and conditions have been offered to mitigate the pandemic's negative effects and aid in the revival of businesses, particularly small-scale enterprises and other vulnerable sectors. At the core of their operations is their role as a catalyst for sustainable development, responding to the financing requirements not only of small farmers and fishers, but also of local government units, MSMEs, private corporations in strategically important industries, government-owned and controlled corporations, financial institutions and other sectors that create employment and propel robust economic growth. These banks are also aggressive in accelerating financial inclusion,

25 www.bsp.gov.ph/Regulations/Issuances/2023/1185.pdf

26 Annual average from 2014 to 2022 is 59.8 percent.

27 A situation in which countries have failed to grow further into a high-income level despite attaining middle income status for certain periods. There are three known approaches on the cause and resolution of middle-income trap, namely: (i) getting education and institutions right; (ii) changing export composition through comparative advantage; and (iii) industrial upgrading through state intervention. Source: unctad.org/system/files/official-document/gdsmdp20151kanchoochat_en.pdf

28 www.pids.gov.ph/details/news/in-the-news/health-energy-key-to-exiting-lower-middle-income-trap

bringing the previously unbanked into the formal banking system, thereby promoting a more equitable participation of Filipinos in the growth of the nation.

Are there concerns about lending to the public sector and to state-owned enterprises crowding out lending to the private sector over the long term? How has the pandemic affected these trends?

The BSP has no current concerns that lending of Philippine banks to the public sector and to state-owned enterprises is crowding out lending to the private sector. Notwithstanding the banks' social mission as mandated by their respective charters, more than half of the loan portfolio of government banks is composed of loans to the private sector, while loans to the public sector/state-owned enterprises account for less than a fifth to a third of the total loan portfolio. These figures have remained steady pre- and post-pandemic.

It may be worth noting that mechanisms are in place to ensure that government borrowings are not excessive and are consistent with the state's overall financial goals. Pursuant to Section 123 of Republic Act (RA) No 7653, or the New Central Bank Act, as amended by RA 11211, whenever the government, or any of its political subdivisions or instrumentalities, contemplates borrowing within the Philippines, the prior opinion of the Monetary Board (MB) shall be requested in order that the MB may render an opinion on the probable effects of the proposed operation on monetary aggregates, the price level and the balance of payments.

9. How important is digital innovation (eg fintech or big tech platforms, machine learning) for reducing credit constraints, including for SMEs?

Digitalising financial services is an excellent opportunity to improve financial inclusion as it could expand financial access for traditionally unserved and underserved consumers. Fintech firms have introduced game-changing innovations that have widened the accessibility of financial services tailored to many people. They promote the use of technological developments such as biometrics, digital identity, artificial intelligence (AI) and machine learning (ML). In particular, ML can be used to enhance credit scoring, client interface and insurance risk management activities. ML algorithms help provide a data-driven assessment of a client's credit risk and subsequent loan pricing.

The BSP continues to nurture the growth of digital innovations in the financial sector as it is seen to enable financial products and services to be accessible to all. This is embedded in the adoption of the country's National Strategy for Financial Inclusion (NSFI) 2022–2028.[29]

More specifically, the BSP gives priority attention to innovative and sustainable financing approaches that are instrumental in reducing credit constraints and improving access to finance. These include:

- The Credit Risk Database (CRD) Project, a joint initiative of the BSP and Japan International Cooperation Agency (JICA) which involves creating a large-scale

[29] www.bsp.gov.ph/Pages/InclusiveFinance/NSFI-2022-2028.pdf

database of MSMEs and developing a robust credit scoring model as a credit evaluation tool for risk-based lending. This is envisioned to enable financial institutions to lend to collateral-strapped SMEs with greater confidence. The CRD scoring model was launched on 25 April 2023.

- The Paleng-QR Ph Plus programme, a collaboration framework to promote cashless payments in public markets and local transport across the country. This is a joint initiative of the BSP and the Department of the Interior and Local Government (DILG)[30] in support of the NSFI's priority initiative to promote digital payments. The programme capitalises on the BSP's QR Ph initiative and seeks to promote financial inclusion and cashless transactions in public markets, community shops and local transport hubs in all cities and municipalities in the country. It aims to build a digital ecosystem following the basic payment patterns of Filipinos, bolster the value of transaction accounts and aid in the promotion and adoption of these accounts.
- Agriculture value chain financing (AVCF). The adoption of AVCF encourages the linking of various actors/players in an agricultural value chain to help reduce the credit risk of participating smallholder farmers/fisherfolk. Participation in strong value chains allows farmers and agri-based microentrepreneurs to leverage on better technologies and sustainable high-value markets, which can increase their productivity and income potential, thereby improving their risk profile from the perspective of the banks.

Relatedly, the SEC promotes crowdfunding as another option for MSMEs and startups to gain access to the capital market for their financial needs. Crowdfunding is a viable alternative to traditional loans that uses the fundraising approach where an individual or group solicits money from the public through an online platform. Such a platform allows users to access, evaluate and process a wide range of data sources to create accurate risk models, improving the quality of risk assessments and decision-making for financing applicants. In 2023, the SEC gave crowdfunding portals the authority to act as registrars of qualified institutional and individual buyers, as it ramps up efforts to boost the capital market.[31]

How important is digital innovation for reducing informality? What promising projects and/or developments are ongoing in your jurisdiction?

Digitalisation expands the policy options in addressing informality and related issues. Digital solutions have been particularly helpful in facilitating the formalisation and delivery of public services, improving access to financial services and expanding market reach to the unbanked and underbanked segments.

Digital innovations can improve financial inclusion in the informal sector by offering access to mobile banking and payment solutions, enabling informal businesses to conduct financial transactions more efficiently and with less cost, and to access formal financing. The informal business sector will be able to access new

[30] www.bsp.gov.ph/Media_And_Research/Public_Advisories/Joint_Memorandum_Circular_No.1_Series_of_2022_Paleng-QR_Ph.pdf

[31] www.sec.gov.ph/wp-content/uploads/2023/09/2023PR-SEC-empowers-crowdfunding-portals-to-boost-capital-market-09122023.pdf

markets and customers beyond their borders through e-commerce platforms, social media and digital marketplaces.

The BSP is cognisant of its crucial role in facilitating an enabling regulatory environment that promotes inclusive digital finance and risk resilient financial systems and infrastructures. Strengthening financial systems and infrastructures is central to increasing cost efficiencies and managing risks to enable new means of innovative financial services delivery capable of reaching the vulnerable sectors of the economy.

In 2020, the BSP launched its Digital Payments Transformation Roadmap 2020–2023, one of its key strategic initiatives towards digitalisation. The establishment of the roadmap aims to promote digitisation of payments that is strategically geared towards the development of a secure, profitable and interoperable payment system that caters to the welfare of consumers. Targeted outcomes of this roadmap included shifting at least 50% of the total volume of retail payments into digital form and having at least 70% of Filipino adults onboarded to the financial system through the ownership and use of a transaction account by 2023.[32]

- **Guidelines on the establishment of digital banks (Circular no 1105)**

Digital banks are well positioned to serve as key enablers towards greater digital transformation and financial inclusion in the country. These banks are at the forefront of digitalisation as they leverage on emerging and innovative technologies to operate efficiently and conduct their business more effectively.

Digital banks can help advance financial inclusion by helping address long-standing demand and supply constraints to delivering financial services that are appropriate to the needs and capacity especially of the marginalised. Some of the challenges/barriers that were noted and used as a basis in formulating the digital banking framework are informality and lack of documentation, low and unpredictable income, geographical barriers, and literacy and trust. Digital banks offer innovative products and services that attract a wide range of financial consumers. The banks' offerings have primarily focused on the retail segment, spanning from high interest earning deposit accounts to more accessible consumer loans (including quick/salary loans) facilitated via alternative credit scoring models.

- **Guidelines for the adoption of an Open Finance Framework (Circular no 1122)**

As a landmark initiative, the BSP recognises the benefits of moving towards an open finance ecosystem as it enables the development of bespoke financial products and services responsive to the needs of customers through responsible sharing of information. The Open Finance Framework under Circular no 1122 aims to empower customers by giving them better control over their personal and financial data, catalysing the development of products and services that are responsive to their needs.

[32] With the share of digital transactions in total retail payments having increased from 1% in 2013 to 42.1% in 2022, the BSP is optimistic that the 50% by end-2023 target has been reached. The BSP is already charting the next phase of the country's digital journey under the Digital Payments Transformation Roadmap 2024–2026.

Open finance is expected to help reduce credit constraints in the economy and further expand access to credit. Customers who have limited or no access to traditional bank credit can use open banking/finance to share their alternative data sources, such as digital footprints, with other financial market players who can use them to assess their creditworthiness and offer them loans. Meanwhile, customers who have access to traditional bank credit can also use open banking/finance to compare and switch between different loan offers from various providers, such as banks, fintech lenders or peer-to-peer platforms.

Other ongoing digitalisation initiatives include: (i) open finance pilot activities; and (ii) development of digital financial marketplace model regulation.

Excessive finance, resilience and long-run growth

10. At what point or under what circumstances does finance become "excessive", eg by generating higher volatility of output growth and/or becoming a drag on long-term growth? What channels are relevant?

- A number of studies have focused on determining whether a threshold or an inflection point exists in the relationship between debt and growth. This relationship can be analysed using an extended growth regression model from Cecchetti et al (2011).[33] In this model, real per capita GDP growth is considered as a function of a set of regressors, which include national gross saving to GDP, change in population, schooling, log of real per capita GDP, trade openness, inflation rate, age dependency ratio, liquid domestic liabilities to GDP, total non-financial debt, government debt, private debt, corporate debt and household debt.
- At moderate levels, debt improves welfare and enhances growth. But high levels can be damaging. Results of the study support the view that, beyond a certain level, debt is a drag on growth. For government debt, the threshold is around 85% of GDP. Examination of other types of debt yields similar conclusions. When corporate debt goes beyond 90% of GDP, it becomes a drag on growth. And for household debt, we report a threshold around 85% of GDP, although the impact is very imprecisely estimated.
- The credit channel and how this affects inflation and output or economic growth should be monitored in times when there is excessive finance.

[33] See S Cechetti, M Mohanty and F Zampolli, "The real effects of debt", BIS Working Papers, no 352, September 2011.

11. When does exposure to international finance increase macroeconomic volatility and reduce long-run growth? What economic channels and institutional factors are relevant? (See eg recent evidence by Abhijit Banerjee and Atif Mian here.)

- **Traditional literature on the link between financial globalisation and economic growth suggests that financial openness contributes to economic growth in the long run**.[34]
- **International finance integration is believed to improve the global allocation of capital and reduce consumption volatility.** In theory, better access to global capital boosts economic activities, especially the more productive types of flows. However, the impact of financial integration on macroeconomic volatility and economic growth varies over time across different groups of countries (Kose et al (2003)).[35]
- **Along with greater financial openness, however, come the appurtenant risks of capital flow surges and sudden stops which could impact the exchange rate, lead to financial crisis contagion and technological disruptions arising from rapid and unregulated financial innovations.**
  - o Newer literature such as the paper by Banerjee and Mian (2023) posits that unbridled access to global finance may endanger the growth of EMEs.[36]
  - o The risk of sudden stops or reversals of global capital flows to developing countries has increased in importance, since many developing countries now rely heavily on borrowing from foreign banks or portfolio investment by foreign investors. These capital flows are sensitive not just to domestic conditions in the recipient countries but also to macroeconomic conditions in industrial countries. For instance, Mody and Taylor (2002), using an explicit disequilibrium econometric framework, detect instances of "international capital crunch" – where capital flows to developing countries are curtailed by supply side rationing that reflects industrial country conditions.[37] These financial linkages, in addition to the real linkages described in earlier sections, represent an additional channel through which business cycles and other shocks that hit industrial countries can affect developing countries.
  - o Kapingura et al (2022) investigate the relationship between financial sector development and macroeconomic volatility in the Southern African Development Community (SADC) region. Findings show that financial openness, as measured by the Chinn-Ito Financial Openness Index, has

[34] See M Obstfeld and A Taylor, "Globalization and capital markets", NBER Working Papers, no 8846, March 2002.

[35] See M Kose, E Prasad and M Terrones, "Financial integration and macroeconomic volatility", IMF Working Papers, no WP/03/50, March 2003.

[36] See A Banerjee and A Mian, "Global finance and growth", slide presentation, 30 August 2003, https://www.resbank.co.za/content/dam/sarb/what-we-do/research/biennial-conference/updated/presentations/2a.%20Session%202%20-%20Atif%20Mian.pdf.

[37] See A Mody and M Taylor, "International capital crunches: the time-varying role of informational asymmetries", IMF Working Papers, no 2002/043, February 2002.

contributed significantly to greater macroeconomic volatility through increased exposure to external shocks. The paper further notes that structural characteristics, ie the depth of the financial system, the size, and the trade openness of the economy affected, may exacerbate the impact of these shocks on the economic cycle.[38]

- o Eslamloueyan and Fatemifar (2021) provide evidence on the financial integration-growth volatility nexus. Using panel data consisting of 30 Asian countries, it was found that financial integration without coordinated monetary and fiscal policy among participating countries may lead to greater macroeconomic volatility.[39] The paper also underscores the importance of balancing the trade-offs of achieving monetary and fiscal policy objectives among countries aiming to strengthen integration. Results of the models simulated suggest that financial integration in the presence of monetary policy results in financial stability through the credit and exchange rate markets, but may contribute to inflation volatility. Similarly, in the presence of fiscal policy in the model, financial integration promotes interest rate stability but contributes to output growth volatility and inflation uncertainty.

- As much as financial openness can support financial stability, it can also amplify the impact of its attendant risks to other institutional sectors of the economy, including the fiscal and external sectors. Hence, there is a need to:
  - o Sequence financial liberalisation properly depending on financial and regulatory systems' level of development;
  - o Put in place rapid monitoring systems that track capital flows, especially the more volatile ones, and introduce capital flow management and liberalisation efforts to blunt the adverse impacts; and[40]
  - o Adequately regulate the debt- and leverage-creating institutional sectors;

    Some financial innovations may indeed be initially disruptive, hence regulation, including "sandboxing" approaches and oversight, are key, without unduly stifling the growth of these sectors.

- **With the ongoing high interest environment due to elevated inflation, financial institutions (eg banks) are most immediately and directly affected.** While this can improve banks' margins, an extended period of high rates can also be associated with more loan losses at banks as their corporate and household

38 See F Kapingura, N Mkosana and S Kusairi, "Financial sector development and macroeconomic volatility: case of the Southern African Development Community region", Cogent Economics & Finance, vol 10, no 1, February 2022, 2038861, DOI: 10.1080/23322039.2022.2038861.

39 See K Eslamloueyan and N Fatemifar, "Does deeper financial integration lead to macroeconomic and financial instability in Asia?", Economic Analysis and Policy, vol 70, June 2021, 10.1016/j.eap.2021.03.012.

40 For example, Bartolazo (2015) proposes a timely and simpler composite capital flow index that may be updated readily and tracks inward capital flows especially of the types that may impact the stock of foreign liabilities. See M Bartolazo, "Developing a Philippine composite capital flow indicator (CCF)", Bangko Sentral Review 2015, BS2015_04.pdf (bsp.gov.ph).

borrowers face heavier debt servicing burdens which may adversely affect economic growth.[41]

- o Based on the IMF's Global Financial Stability Report from October 2023, the ongoing high global interest rates are affecting the cost of financing in emerging market and developing economies. Nonetheless, financial markets of major emerging markets had been resilient up to that point in 2023. Meanwhile, a significant number of frontier and low-income countries continue to face financing challenges due to high debt vulnerabilities.

12. Is there an optimal financial structure that minimises output volatility and maximises long-run growth? How have recent changes in the structure of financial intermediation affected your economy's ability to withstand domestic and external shocks as well as support growth?

- **The financial system is still the most efficient sector to intermediate resources among savers, borrowers and investors.** However, there are information asymmetries between these actors, putting constraints on their budgets, objectives and motives and efficiencies. Therefore, an effective oversight of the financial sector and the other sectors of the economy, as well as macroeconomic discipline and policy coordination (ie with fiscal authorities) are essential. Ensuring well supervised and capitalised banks is key to minimising the volatilities within this sector and preventing spillovers to the broader economy, while allowing and maximising profitability.
- **The BSP is of the view that a well functioning financial system supports productive expansionary business activities and consumption spending, and hence is crucial to promoting economic growth**. The BSP's pursuit of banking and financial reforms in the areas of supervisory policy, banking supervision, financial surveillance and systemic risk stabilises and strengthens the domestic financial system and helps grow financial institutions into regionally competitive and economically viable players.
- **Furthermore, the BSP ensures that the financial system is able to perform its financial intermediation role despite economic shocks**. Financial stability is essential for monetary policy to be effective since fragility of the financial sector can affect the transmission of monetary policy to the real economy.
- **The BSP continues to monitor newer concerns like sustainable financing. The rise of alternative payment systems is still within the ambit of the financial regulators.** While a well functioning financial architecture is deemed a global public good by some, policy coordination and international cooperation on a cross-border level is also essential to minimise disruptive policies of other

[41] See IMF, Global Financial Stability Report, October 2023.

economies and hence financial shocks, as NBFIs have also significantly increased.[42]

- Some studies show that developed financial markets act as a catalyst in promoting economic growth (Setiawan et al (2021)).[43] In the Philippines, **the resilience of the country's banking system is mirrored by promising developments in the domestic capital market, which has continuously supported the financing needs of our country's growing economy.**

  The BSP has actively supported the development of the capital markets. Some of the policies it has implemented include:

  - **Incentivising bond issuers** by providing banks and quasi-banks with greater flexibility to finance their liquidity requirements through the capital market and by lowering the reserve requirement rate for bonds.
  - **Supporting price discovery and use of reliable benchmarks**, such as the exclusion of market-making positions from the SBL to encourage the fulfilment of market-makers' commitment to provide prices of debt securities in the secondary market; the relaxation of requirements for banks to invest in readily marketable bonds and securities; and the supervisory expectations set on the selection of benchmarks for the performance measurement and reporting of unit investment trust funds (UITFs).
  - **Measures promoting investor access and protection**, such as reducing the minimum size for an investment management activities (IMA) account and expanding the securities eligible as investment outlets for co-mingled funds; streamlining the requirements for securities custodians and securities registry; and allowing the pre-termination of non-deliverable FX forwards.
  - **Promoting environmental sustainability**, for example by developing and adopting a sustainable finance framework and sustainable finance taxonomy, as well as issuing and financing green, social and sustainability-linked bonds and loans.
  - **Crafting policies that improve the operational efficiency** of the Personal Equity and Retirement Account, institutionalising a regulatory sandbox framework and fostering partnerships between financial institutions that have digital platforms.

42 See F Allen and A Walther, "Financial architecture and financial stability", Annual Review of Financial Economics, vol 13, August 2021, pp 129–51, Financial Architecture and Financial Stability (annualreviews.org).

43 See B Setiawan, A Saleem, R Nathan, Z Zeman, R Magda and J Barczi, "Financial market development and economic growth: evidence from ASEAN and CEE region", Polish Journal of Management Studies, vol 23, no 2, 2021, pp 481–94, 10.17512/pjms.2021.23.2.29.

Policy measures

13. What structural policy measures are needed in your jurisdiction to support the allocation of finance for long-term growth, including by further developing capital markets? In which markets is there most scope for development? What is the role of the central bank?

Over the years, the BSP has rolled out various regulatory measures to bolster the strength of the financial system and implemented a systematic agenda of policy reforms focused on promoting good corporate governance and effective risk management. This has helped ensure banking stability. **Beyond this, the BSP has worked to support the expansion of the range of products and services made available to the public and the growth of the domestic capital market.**

To this end, reforms pursued by the BSP in coordination with related government entities have been focused towards: (i) incentivising capital market issuers; (ii) supporting price discovery and the use of reliable benchmarks; (iii) promoting investor access to the capital markets and investor protection; (iv) promoting the issuance of Islamic and sustainable bonds; and (v) digital innovation initiatives.

The further development of the Philippine capital markets may be facilitated by reforms to improve: (i) the supply side of capital; (ii) the demand side of capital; and (iii) market infrastructure.

For example, to support the allocation of finance for long-term growth, the government can offer incentives for companies to go public and encourage more company listings on the Philippine Stock Exchange (PSE). In line with this, it may enhance the regulatory environment to encourage more potential investors to participate in the capital market, for instance by improving disclosure requirements and further strengthening corporate governance standards.

Promoting financial literacy is also necessary to increase the public's awareness and understanding of the capital market, which in turn has the potential to increase participation in the market.

In addition, to deepen the capital markets the government may develop new financial instruments that will cater to a wide range of investors.

The government can also implement policies that will encourage foreign investors to participate in the Philippine capital market. Policy reforms such as reducing restrictions on foreign ownership, providing tax incentives and streamlining investment processes are seen to encourage foreign investment. Linking the PSE with other stock exchanges may also increase the foreign investor base in the Philippines.

One of the responsibilities of the BSP as a central bank is to create an enabling environment for the further development of the capital markets. Over the years, the BSP has rolled out various regulatory policies and measures to support the expansion and growth of the domestic markets.

In addition to policies promoting sustainable finance, the BSP has issued regulations to incentivise bond issuers, support price discovery and the use of reliable benchmarks, and promote investor access and protection.

To encourage banks and quasi-banks to issue instruments in the capital markets, in 2018 the BSP amended the regulations to allow a bank or quasi-bank to issue bonds or commercial papers without prior BSP approval, provided that the entity meets the prudential criteria, enrols and/or trades the bond in an organised market in accordance with the SEC rules and regulations, and submits certain documentary requirements within a prescribed timeline. In 2019, the BSP also reduced the reserve requirement rate for bonds issued by banks and quasi-banks from 6.0% to 3.0%. More recently, the BSP has issued guidelines that gradually reduce the reserve requirement rate to 0% (from 3.0%) against sustainable bonds issued by banks.[44]

Meanwhile, to increase the liquidity in the capital markets, the BSP has excluded certain debt securities holdings resulting from market-making activity for the purpose of determining a bank's compliance with the SBL. The BSP has also loosened the requirements for rural and cooperative banks to invest in readily marketable bonds and other securities without prior BSP approval.

Recently, the BSP adopted a variable rate auction format to facilitate price discovery. This format consists of a predetermined volume for the overnight repurchase facility and a market-determined interest rate. The resulting rate conveys the prevailing cost of and demand for overnight funds in the financial system.

To promote investor access and protection, the BSP also issued amendments to regulations on the investment management activities of BSFIs. The amendment reduced the minimum opening amount for an investment management account (IMA) from PHP 1 million to PHP 100,000 to increase the participation of retail investors. Commingled IMAs are also allowed to invest in a wider range of financial assets, including exchange-traded equities, fixed income securities and commercial papers registered with the SEC.

Moving forward, regulations on non-deliverable FX forward (NDF) contracts involving the Philippine peso shall be amended to allow the pre-termination of these contracts in line with global best practices and risk management. At the same time, the BSP's ability to monitor the extent and nature of cancellations shall be strengthened, as banks will be required to report transactional information on cancelled or rolled-over NDFs to the regulator. The increased flexibility is expected to improve liquidity in the FX market, enhancing price discovery. This in turn will help reduce friction costs for investors.

The derivatives regulations have been amended[45] to include, as generally authorised derivatives activities for universal and commercial banks, derivatives traded in an organised market where the banks are recognised as participants. This will support the bond forward transactions of BSFIs. The guidelines likewise further rationalise the notification process for derivatives activities and allow for an expanded use of derivatives for unit investment trust funds, subject to guidance and limits that are broadly aligned with international standards. The recent and forthcoming amendment of the derivatives and FX regulations, respectively, support not only trading but hedging activity, which are seen to boost both domestic and foreign investor participation.

44 www.bsp.gov.ph/Regulations/Issuances/2023/1185.pdf.

45 www.bsp.gov.ph/Regulations/Issuances/2024/1194.pdf

Finally, to widen the reach of financial service providers, the BSP has issued a formal regulatory sandbox framework. A digital financial marketplace framework is also under development. Moving forward, the BSP will likewise study the potential of decentralised finance to support transactions in the domestic capital market.

In addition to the aforementioned policy reforms, as provided for under its mandates, the central bank may also consider supporting bond market liquidity by providing the system with government securities as part of its market operations.

14. How can central banks and other authorities best encourage digital innovations to finance long-term growth while mitigating emerging risks?

With the growing demand for digital financial services, central banks should take a proactive stance in guiding the market towards fulfilling the promises of digital innovations, while ensuring that the financial system remains secure and resilient. Fraudulent activities and cyber security issues should be on the radar given the increased interconnectivity and interoperability of systems. Lastly, through their current and upcoming regulations central banks will further ensure that appropriate measures are in place to provide safety and security among consumers and providers, thereby translating to a safe and secure financial system.

In line with this, the BSP adheres to the following principles, which we refer to as the three Cs, to foster responsible digital innovation:

Commensurate regulations: we strive to enforce commensurate regulations to maintain a forward-looking approach to ensure that regulatory and supervisory frameworks are in tune with emerging trends and developments;

Collaborative engagement: we maintain active collaboration across multiple stakeholders from the public and private sectors; and

Consumer-centric culture: we ensure that innovations work for the benefit of consumers. To do so, we work hard to develop a culture among market players that focuses on customers and gives them the best protection as financial consumers.

With these principles in mind, central banks and other financial authorities can take the following strategic measures to encourage responsible digital innovation:

First, uphold security of data at all stages. It is imperative that central banks adopt an organisational policy on a data governance framework and ethical use of data. They need to make sure that data are protected from unauthorised access, breaches, fraud and misuse, both when they are stored and when they are shared with others. Ways of pursuing this include the use of strong encryption, authentication and monitoring tools to safeguard our data. How market players use and share data to develop and deliver their financial products must be underpinned by sound digital governance standards that safeguard the security and privacy of consumer data. It goes without saying that the framework that institutions adopt should extend to their partners for outsourced and in-house data processes.

Second, espouse technical interoperability. Future-proofing synergies between technology and financial services will require central banks to embrace an ecosystem mindset. This means that data and services can be easily and securely integrated with other providers, both locally and globally. To do so, central banks need to use common standards, protocols and frameworks to enable seamless connectivity and compatibility.

Lastly, promote digital literacy. It is critical that regulators, in partnership with the private sector, place strategic importance on helping consumers understand the power and value of their personal information, especially in the digital world, so as to achieve and maintain a secure, sustainable and inclusive financial system.

15. What policy actions could further enhance the depth and diversity of the financial system and thus improve the efficient allocation of capital?

Cognisant of the need to improve the depth and diversity of the Philippine financial system, the BSP pursues reforms and landmark regulations that will promote the safety and soundness of the financial system on the back of rapid advancements in technological innovations, an evolving financial ecosystem including advancing Islamic capital markets, and increasing attention towards the attainment of environmental and social (E&S) goals to achieve balanced, equitable and sustainable economic growth.

On sustainable finance, the BSP actively collaborates with development partners to conduct climate stress testing exercises and develop a sustainable finance taxonomy[46] that is initially focusing on climate change mitigation and adaptation but will later cover biodiversity, circular economy and other social aspects. Furthermore, the BSP will update its disclosure requirements on sustainable finance in line with the IFRS Sustainability Disclosure Standards and amendments to the Basel Pillar 3 disclosure framework.

The initiatives related to green finance ensure that environmentally sustainable initiatives are accessible to all, including the underserved populations.

Meanwhile, a well developed capital market facilitates access to capital for businesses and individuals. This can enhance financial inclusion by offering alternative avenues for funding and investment. Consumer protection measures, such as transparent disclosures and fair trading practices, contribute to the overall integrity and stability of the capital market.

Information asymmetry, especially adverse selection, can likewise hamper the efficient allocation of capital. Creating institutions that reduce information asymmetries, such as a credit information agency, or implementing credit risk databases, as well as increasing the availability of collateral can help deepen the financial system. Reducing information asymmetry can lead to better pricing of loans and access to finance.

The BSP also remains committed to championing Islamic banking and finance through ongoing policy initiatives, including the study of the policy framework on profit-sharing investment accounts, the licensing framework on sukuk issuance, and

[46] The Philippine Sustainable Finance Taxonomy Guidelines were adopted by the BSP and the SEC in their respective regulatory issuances in February 2024.

the capital adequacy ratio for Islamic banks and Islamic banking units of conventional banks. The BSP is also looking to formulate tailored rules for extending financial facilities to Islamic banks. The BSP will continue to forge synergies with domestic and international stakeholders in fostering regulatory reforms and infrastructures that encourage the entry of more Islamic finance players into the country. The inter-agency collaboration is expected to advance other prudential reforms in the field of takaful and the Islamic capital market.

The BSP has also taken a proactive stance in guiding the market towards the fulfilment of the digital transformation, while ensuring that the financial system remains secure and resilient. In this regard, the BSP will be issuing regulations on a digital financial marketplace model[47] where banks and other qualified BSP-regulated/-supervised entities may forge strategic and meaningful partnerships with other financial service providers to enable them to access a range of select financial products and services through a one-stop-shop digital platform. The BSP will also assess the effectiveness of the digital banking framework as part of its supervisory policy review.

As financial services increasingly rely on technology, ensuring cyber security is essential for maintaining trust in digital financial systems. Cyber security measures contribute to the reliability and security of digital financial services, promoting financial inclusion by encouraging trust in online transactions. Therefore, it is important that robust cyber security measures are in place to maintain consumer trust in digital financial services.

Beyond the policy actions on the part of the central bank, other government agencies can also undertake initiatives to promote the depth and diversity of the financial system.

- For example, programmes on increasing financial literacy, which can be undertaken by a wide variety of entities, can promote increased investor participation in the financial markets. Broader consumer protection initiatives can also further build investor confidence.
- Meanwhile, the Bureau of the Treasury (BTr) has continued to introduce new products such as sovereign sukuk and tokenised treasury bonds and has promoted the increasing digitalisation of the issuance of government debt.
- Finally, the Department of Finance is pushing for the passage of the Passive Income and Financial Intermediaries Taxation Act (PIFITA), which aims to boost capital market development efforts. The bill contains measures to simplify and rationalise the tax regime for passive income, financial services and financial transactions.

[47] The BSP is exploring the potential adoption of a digital marketplace banking model by U/KBs, digital banks and EMIs. Anchoring on the implementation of the Open Finance Framework, the BSP anticipates the emergence of new business models and arrangements which will further drive innovation and bring more value to customers. The adoption of a digital marketplace banking model will be underpinned by a sound governance and risk management system, including an effective information-sharing arrangement to ensure that attendant risks are adequately managed and consumer interests are protected.

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