

Benjamin E Diokno: Strengthening banking sector resilience through good governance

Speech by Mr Benjamin E Diokno, Governor of Bangko Sentral ng Pilipinas (BSP, the central bank of the Philippines), at the 1st General Membership Meeting of BAIPHIL (Bankers Institute of the Philippines) “BAIPHIL@80: Building Resilience through Strong Governance”, 17 August 2021.

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To the officers and members of the Bankers Institute of the Philippines, Inc. (BAIPHIL) under the leadership of BAIPHIL President Romel D. Meniado, colleagues from the banking industry, ladies and gentlemen, good morning!

First of all, thank you for inviting the Bangko Sentral ng Pilipinas (BSP) to be part of the 1st General Membership Meeting of BAIPHIL.

Good governance has underpinned BAIPHIL’s leadership through the years. It is for this reason that we are celebrating 80 years of excellence in the delivery of your mandate of continuing education, information sharing and research.

While the BSP wears many hats, today I will focus on the important role of the BSP as regulator and supervisor in the financial industry.

I will begin by sharing some highlights on the macro economy and the banking system, and then move on to the results of the Banking Sector Outlook Survey (BSOS). This will be followed by the KEY strategic supervisory thrusts of the Bangko Sentral which are: (1) strengthening risk governance; (2) promoting responsible and responsive innovation; and (3) advancing the sustainability agenda in the financial system.

I will discuss our continuing commitment and support to financial sector reform through the passage of key legislations. I’ll close by stating what we expect from BAIPHIL.

Let me begin with good news. Based on the recent Philippine Statistics Authority’s data, the country is officially out of the pandemic-induced recession. The economy grew by 11.8 percent in the second quarter of 2021.

Likewise, inflation rate decelerated in July 2021 to 4.0 percent. This is the first time this year that the inflation rate returned within the 2-4 percent target band.

As of end-July 2021, the country’s gross international reserves stood at USD106.6 billion. Once again, remittances coming from overseas Filipino workers continues to provide strong support to the economy as money transfers coursed through banks grew by 13.1 percent to USD2.6 billion in June 2021 from a 2.4 billion in May 2021.

Meanwhile, unemployment remained unchanged, at 7.7 percent in June 2021.

While we have taken a step back because of the recent implementation of ECQ in response to the more transmissible Delta variant, I am confident that we will be able to get back on track with the adoption of a whole-of-nation approach in addressing the challenges brought about by this pandemic.

What is key, however, is our vaccination rollout.

Let’s now look at the Philippine banking system. Banks’ total resources continued to expand, albeit at a much slower pace relative to pre-pandemic period.

Year-on-year growth of banking system assets was posted at 6.4 percent as of end-June 2021.

The expansion was mainly funded through deposit generation.

Deposits grew by 7.6 percent year-on-year to P15.3 trillion as of end-June 2021. These deposits were mostly peso-denominated and sourced from domestic households and enterprises. These developments are testament to the public's continued trust and confidence in the banking system.

Gross total loan portfolio (TLP) declined year-on-year by 0.4 percent to P10.8 trillion as of end-June 2021. This is both a supply and demand issue as banks continue to be risk averse while businesses defer their expansion plans given the uncertainty in the economic environment.

Nonetheless, banks have continued to restructure and grant new loans to the micro, small and medium enterprises or MSMEs.

As of the reserve week ending 29 July 2021, loans to MSMEs that were utilized as alternative compliance with the BSP's reserve requirements amounted to P188.7 billion, up from the P8.7 billion recorded as of end-April 2020.

Overall, loan quality remains manageable. Gross non-performing loan (NPL) ratio rose to 4.5 percent as of end-June 2021, but this was accompanied by a high NPL coverage ratio of 82.4 percent as of the same period.

The recent passage of the Financial Institutions Strategic Transfer (FIST) Act provides banks with a stand-by facility to offload their non-performing assets in case these post a sharp increase.

Banks remained well-capitalized. As of end-March 2021, the capital adequacy ratios of the universal and commercial bank industry stood at 16.8 percent and 17.4 percent on solo and consolidated bases, respectively, from the previous year's 15.3 percent and 15.8 percent.

Moreover, banks maintained sufficient buffers to meet liquidity and funding requirements. Liquidity of banks was ample as the liquidity coverage ratio (LCR) of the UKB industry reached 198.0 percent as of end-May 2021 on solo basis, almost double the regulatory minimum of 100 percent.

Similarly, as of end-May 2021, UKBs' net stable funding ratio (NSFR) stood at 143.6 percent on solo basis, well-above the BSP regulatory threshold of 100 percent. This indicates availability of more stable funding to serve bank customers in the medium term.

For smaller banks, the minimum liquidity ratios (MLRs) of stand-alone thrift banks (TBs), rural and cooperative banks (RCBs) surpassed the 20 percent minimum as of end-March 2021 data.

We owe the sustained safety and soundness and continued resilience of the banking system on the reforms implemented both by the BSP and the banking industry over the years.

Unsurprisingly, the banking industry's leaders remain optimistic of banking system prospects in the next two years.

Highlights of the results of the Banking Sector Outlook Survey (BSOS) for the First Semester of 2021 reveal the following:

- ♦ First, banks continue to view the Philippine banking system as stable with prospects of double-digit growth in assets, loans, investments, deposits and net income.
- ♦ Second, all banks continue to expect a downgrade in the quality of their loans with a non-performing loan (NPL) to total loan ratio of above 5 percent. In particular, Universal/Commercial banks (UKBs) estimate their NPL to settle between 3.0 percent and 6.5 percent. More banks also intend to report higher NPL coverage ratio at more than 50.0

percent to 100.0 percent.

- ♦ Third, banks will continue to report tight net interest margin (NIM) at 1.5 percent to 3.0 percent. Respondents expect return on equity of 2.0 percent to 5.0 percent.
- ♦ Fourth, asset quality and credit risk emerged as the top-most risk to the banks' operations while macroeconomic and operational risks are the risks common to most of the respondent banks.
- ♦ Fifth, there is a distinct shift in organizational focus towards sustainable financing. More respondent banks view such mode of financing as highly important.
- ♦ Finally, banks intend to maintain capital and liquidity buffers at levels higher than domestic and global standards to promote institutional stability.

The BSP will continue to push for major reforms to ensure the soundness, stability, resilience and inclusivity of the banking system amid the ongoing health crisis.

The BSP's strategic regulatory and supervisory thrusts focus on three key areas, namely: (1) strengthening risk governance; (2) promoting responsible and responsive innovation; and (3) advancing the sustainability agenda in the financial system.

The pandemic triggered a strategic review of business models and business priorities due to the changing business landscape. This highlights the importance of having strong risk governance.

The BSP will continue to raise the bar in managing risk to ensure that the financial industry remains resilient to threats to financial stability.

In this respect, we expect three things from banks:

1. We expect banks to build buffers and adopt robust stress testing methodologies so that they will be able to timely identify emerging risks, anticipate the occurrence of new risk triggers and prepare for their occurrence.
2. We expect banks to adopt more resilient systems to fend off the increase in cyber threat actors as the industry becomes largely digitalized.
3. Finally, we also expect banks to continuously adhere to the tenets of good governance and protect the interest of the public even with the reduced face to face interaction with their clients.

Recent issuances of the Bangko Sentral are all directed toward this end. For instance, the BSP recognizes that building and sustaining a good reputation is a critical element in promoting a bank's safety and soundness. Since reputational risk is inextricably linked to other risk exposures such as credit, market, liquidity, and operational risks, it can be triggered by any risk such as for instance an unfavorable feedback from a client.

Circular No. 1114 or the guidelines on reputational risk management recognizes that everyone in the organization has a role to play in the management of reputational risk.

Said guidelines highlight the importance of shared accountability and has set out the roles and responsibilities of the board of directors and officers, consistent with the principle that the tone of good governance should come from the top.

In the same vein, the BSP issued Circular No. 1112 requiring banks to observe due diligence in the recruitment of their personnel. The "Know your employee" rule will not only improve the operational risk managements of banks but also foster confidence in the banking system.

On another note, I would like to take this opportunity to remind everyone that while the delivery platforms for products and financial services may have changed, the banking industry is exposed

to the same risks credit, liquidity, market, and operational, among others.

As such, as we put more resources on information technology systems and infrastructure.

An important part of risk governance is having the effective policies, practice, and systems in place to combat money laundering and terrorist and proliferation financing. Please allow me to briefly discuss the Philippines's recent inclusion the Financial Action Task Force's grey list.

The Financial Action Task Force (FATF) included Philippines in its latest "grey list" of countries, which means that the Philippines will be under increased monitoring as we prove our progress against money-laundering and terrorist financing. If we as a nation fail to institute the recommended measures, this may potentially increase the cost of doing business with Filipinos, as regulators and financial institutions add another layer of scrutiny on our transactions.

While we have not yet received any report on changes in the cost of transactions, we continue to engage different stakeholders to inform them of the actions taken by the country to address the remaining issues identified in the Mutual Evaluation Report.

Indeed, the Philippines swiftly acted on the concerns raised in the report and took a whole of government approach in addressing the issues. We have completed our key commitments and continue to do so in the midst of our fight against the ill effects of the pandemic.

On our part, the BSP remains steadfast and committed to implement initiatives aimed at further strengthening banking system's framework and defenses against money laundering, terrorist financing and proliferation financing risks.

We will continue with our strategic initiatives to promote awareness and enhance the capabilities of our supervised financial institutions against these risks.

Moving on, the BSP believes that digitalization and financial inclusion are mutually reinforcing goals. It is in this light that the BSP is espousing an enabling environment to promote responsible and responsive innovation while at the same time ensuring that attendant risks are prudently managed.

Promoting the growth of the digital financial ecosystem is a win-win proposition for the industry and the public. On one hand, digitalization will allow financial institutions to broaden their client base, tap other revenue sources, and improve operational efficiency.

On the other hand, financial consumers will benefit in terms of convenience in completing transactions, lower costs, and access to specialized financial products and services.

These are the main drivers that led to the development of the BSP's three-year Digital Payments Transformation Roadmap. The Roadmap aims to shift at least 50 percent of total retail payment transactions to digital, and to have 70 percent of adult Filipinos with transaction accounts by year 2023. These goals are anchored on the implementation of key digital rails namely: (i) the Philippine Identification System; (ii) next generation payment system; and (iii) open finance ecosystem.

We see open finance as a means to foster digital financial inclusiveness since individual consumers and small businesses would be empowered to choose the financial service provider that could offer products and services suited to their needs at reasonable costs. This is made possible through "permission based" access to consumer data that will enable banks and other financial institutions to develop products and services that address the needs of the customers.

In line with the BSP's thrust to promote effective risk management systems without stifling innovation, the BSP will institutionalize its regulatory sandbox or test and learn approach to provide guidance and encourage FinTech companies to propose solutions that will address gaps

and improve products and services in the digital financial ecosystem.

The BSP is also currently working on an issuance which will explicitly set out our expectations on the fraud management systems of our supervised financial institutions.

In view of the increasing number and evolving forms of cyberthreat attacks, supervised financial institutions are expected to adopt more robust systems to protect their data and systems and ensure delivery of uninterrupted services.

We hope that this issuance will further strengthen industry partnerships and collaboration keeping in mind that the fight against cyberthreats is not a battle faced by one bank alone. It is a battle that should be fought collectively by the entire financial industry.

Finally, the BSP recognizes that environment and climate change related risks may translate to financial losses and pose threats to financial stability in the long run.

In this regard, the BSP issued the Sustainable Finance Framework under Circular No. 1085 to mainstream the adoption of the sustainability agenda in the financial industry.

This will be followed by more granular expectations in managing climate change and other environment-related risks in relation to key financial risks such as credit and operational risks.

Our team is already completing the assessment of comments received on the draft guidance and we are targeting to publish the issuance by the fourth quarter of this year.

Parallel to this, the BSP, in partnership with the World Wildlife Fund (WWF) Philippines, The World Bank, and industry associations will conduct vulnerability assessments and stress testing exercises with volunteer banks.

The BSP will leverage on the results of said exercise in the issuance of supplemental stress testing guidelines, and enhancement to the prudential reportorial requirements. These exercise will enable the BSP to gather more data and information for financial surveillance analysis and policy development.

Within the BSP, we have also embraced sustainability principles with the formal launch of our Sustainable Central Banking Program. We have taken significant strides in this space as a recognized champion of the sustainability agenda.

First, the BSP has invested USD 550 million in the green bond fund of the Bank for International Settlements. Second, we are conducting a vulnerability assessment of the BSP branches in the region to determine our potential losses in case of severe hazards.

Along this line, we launched a design competition for the New BSP Complex to be built in New Clark City. The BSP Complex is envisioned to become a global benchmark for a smart, green, and modern facility that promotes environmental sustainability and efficiency.

Finally, we continue to strengthen engagement with varied stakeholders in the domestic and international fronts to intensify our campaign for the adoption of sustainability principles.

To further strengthen financial stability, the BSP is supporting key legislations. These include the Deposit Secrecy Bill, Financial Consumer Protection Act, and the Amendments to the Agri-Agra Mandatory Credit Allocation.

The BSP is pushing for the Amendment of the Bank Secrecy Laws to ensure the conduct of effective supervision of banks. We believe that BSP should be granted unimpaired access to information on depositors to fulfill its supervision mandate and protect the interests of depositors.

The Financial Consumer Protection Bill will provide a comprehensive financial consumer protection regime that consolidates financial inclusion, financial education, good governance, and effective supervision for the purpose of consumer protection.

Meanwhile, the amendments to the Agri-Agra Law recommends a financing approach that considers the requirements of the broader agricultural ecosystem. The proposed amendments to the Law are envisioned to strengthen rural development and improve well-being of agricultural and rural community beneficiaries.

In closing, we look forward to BAIPHIL's utmost support and commitment as we pursue our financial sector stability and resiliency agenda.

Aside from further training and conduct of fora, BAIPHIL may consider sponsoring or conducting studies to contribute to the growing literature on the Philippine banking system.

We will be happy to be your partner in this endeavor as we also recently created a BSP Research Academy.

The BSP looks forward to our continued partnership in retooling, reskilling, and shaping the professional development of our colleagues in the banking industry.

I would also like to recognize the officers and committee chairpersons of the BAIPHIL in the past year under the leadership of our very own Assistant Governor Resty Cruz. Under their leadership BAIPHIL remained strong and productive despite the ongoing crisis.

Maraming salamat at Mabuhay po tayong lahat!