



PHILIPPINES

FINANCIAL SYSTEM STABILITY ASSESSMENT-PRESS RELEASE AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR THE PHILIPPINES

April 2021

In the context of the Philippine's Financial System Stability Assessment, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its March 5, 2021 consideration of the FSSA.
- The **Financial System Stability Assessment** (FSSA) for the Philippines, prepared by a staff team of the IMF for the Executive Board's consideration on March 5, 2021. This report is based on the work of an Joint IMF/WB Financial Sector Assessment Program (FSAP) mission to the Philippines during June 2019 and October 2020. The FSSA report was completed on February 11, 2021.
- A **Statement by the Executive Director** for the Philippines.

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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IMF Executive Board Concludes Financial System Stability Assessment with Philippines

FOR IMMEDIATE RELEASE

Washington, DC – April 9, 2021: The Executive Board of the International Monetary Fund (IMF) concluded the Financial System Stability Assessment¹ with the Philippines on March 5, 2021.

The work of the Financial Sector Assessment Program (FSAP) was conducted during the COVID-19 outbreak, with the virtual missions concluding on October 20, 2020, and adapted to include the immediate risks and vulnerabilities brought up by the pandemic.

The economy faces both COVID-related and structural risks. Real GDP contracted by 9.5 percent in 2020—a much steeper decline than during the Asian Financial Crisis. However, it is now recovering, and macroeconomic fundamentals at the onset of the COVID-19 were stronger than in the late 1990s. In addition, the Financial Action Task Force (FATF) may put the country on the so-called grey list in 2021 without significant reforms on the effectiveness of the Anti-Money Laundering and Counter Financing of Terrorism (AML/CFT) regime. However, significant legislative measures were enacted in early 2021 to address some of the FSAP recommendations. The Philippines is also vulnerable to increased typhoon risks from climate change owing to its geographical position.

Stress tests show that while banks can withstand the already severe baseline scenario, they could experience systemic solvency distress if the economic impact of COVID-19 turns out to be severer. The economic shock would weigh on corporate earnings and then spill over to banks. Bank stress could limit credit supply, reducing economic growth noticeably even more. Physical risks from climate change are relevant for financial stability, though the infrastructure destruction from typhoon wind alone is not systemic unless extreme tail events materialize. Higher median and estimated losses were used in the stress testing exercise for severer scenarios.

The Bangko Sentral ng Pilipinas (BSP) has modernized its oversight framework for banks since the 2010 FSAP and shows reasonably good compliance with the Basel Core Principles ([2020 BCP assessment](#)). The BSP also plays the central role in macroprudential policy framework given the dominance of banks in the financial system. The 2019 amendments to the BSP charter further strengthened the financial stability policy framework. Nonetheless, material gaps remain on BSP's legal powers related to conglomerate supervision, and bank secrecy laws are limiting the effectiveness of supervision, but also have wider financial sector implications. At the wake of the COVID-19 crisis, the BSP issued time-bound regulatory relief

¹ The Financial Sector Assessment Program (FSAP), established in 1999, is a comprehensive and in-depth assessment of a country's financial sector. FSAPs provide input for Article IV consultations and thus enhance Fund surveillance. FSAPs are mandatory for the 29 jurisdictions with systemically important financial sectors and otherwise conducted upon request from member countries. The key findings of an FSAP are summarized in a Financial System Stability Assessment (FSSA).

measures, including unusually strong forms of forbearance related to non-performing loan recognition and provisions, subject to prior notification to and approval of the BSP.

While there has been some progress with reforming financial safety net, a number of issues highlighted in the 2010 FSAP are still relevant. The resolution powers are provided to both Philippine Deposit Insurance Corporation (PDIC) and the BSP, making the resolution process relatively complex, while the prompt corrective action framework could be enhanced by including more specific escalation procedures. The resolution toolkit is largely limited to liquidation and resolution planning and resolvability assessments are not in place yet.



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FINANCIAL SYSTEM STABILITY ASSESSMENT

February 11, 2021

KEY ISSUES

Risks: GDP contracted by 9½ percent in 2020—a much steeper decline than during the Asian Financial Crisis (AFC)—but it is now recovering with the easing of containment measures and economic policy support. Banks are closely connected to the corporate sector through high credit exposures and conglomerate ownership linkages. The Financial Action Task Force (FATF) may list the Philippines as a jurisdiction with serious Anti-Money Laundering and Combatting the Financing of Terrorism (AML/CFT) deficiencies in 2021. The country is also vulnerable to climate change (physical) risks, especially the destruction of physical capital from typhoons.

Findings: The economic contraction is elevating credit risks, especially from the corporate sector. While banks can withstand the severe baseline scenario, they could experience systemic solvency distress in a much more severe adverse scenario. The second-round effects from such distress might reduce GDP even more. Regulatory forbearance that delays loss recognition could harm economic recovery by limiting credit growth, as observed after the AFC. However, prompt loss recognition and non-performing loan (NPL) restructuring can prevent sharp deleveraging and boost GDP. Physical risks from climate change are relevant for financial stability, though they are not systemic unless extreme tail events materialize.

Recommendations: Given the significant downside risks, the authorities should limit bank dividend distributions and be ready to take additional measures to strengthen banks' capital if downside risks materialize. The central bank should allow forbearance measures to lapse as scheduled and avoid introducing new measures, as delayed loss recognition and NPL restructuring could limit credit growth. The authorities should further enhance the effectiveness of the AML/CFT framework. The government should also amend the unusually stringent bank secrecy laws, which are limiting effective prudential supervision and impairing financial stability, financial integrity, and development. Given the downside risks to bank health, strengthening the resolution framework is urgent. While legislative changes will take time, the authorities should immediately start streamlining the prompt corrective action (PCA) framework and working on resolvability assessments and resolution planning. Over the medium-term, the authorities should expand their macroprudential toolkit, strengthen the supervision of financial conglomerates, and enhance the monitoring of climate change risks.

Approved by
**James Morsink and
Odd Per Brekk**
Prepared by
**Monetary and Capital
Markets Department**

This report is based on the work of the Financial Sector Assessment Program (FSAP) in person and virtual missions that were conducted between June 2019 and October 2020.

- The team was led by Hiroko Oura (IMF) and Ilias Skamnelos (WB), and included Dirk Jan Grolleman (IMF) and Valeriya Goffe (WB) as Deputy Mission Chiefs, Paola Morales-Acevedo, Peter Lohmus, Minsuk Kim, Jiri Podpiera, and Jonathan Pampolina (IMF staff), Geraldine Low, Adhi Nur, and Irman Robinson (IMF experts), Serap Oguz Gonulal, Karol Karpinski, Keith Alan Ligon, Nilima Chhabilal Ramteke, Martijn Gert Jan Regelink, and Luz Maria Salamina (WB staff), Alan Ball, Eddy Rodriguez Cespedes and Yavar Moini (WB experts).
- The mission met the Governor of the Bangko Sentral ng Pilipinas, the Secretary of the Department of Finance (Ministry of Finance), the Chairman of the Securities and Exchange Commission, the Commissioner of the Insurance Commission, the Executive Director of the Anti-Money Laundering Council, senior staff of Philippines Deposit Insurance Corporation, many staff in their agencies, and held many helpful meetings with other official agencies, financial sector representatives, and other stakeholders.
- FSAPs assess the stability of the financial system, not that of individual institutions. They are intended to help countries identify key sources of systemic risk in the financial sector and implement policies to enhance their resilience to shocks and contagion. Certain categories of risk affecting financial institutions, such as operational or legal risk, or risk related to fraud, are not covered in FSAPs.
- This report was prepared by Hiroko Oura and Dirk Jan Grolleman, with contributions from the members of the FSAP team.

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Glossary

AFC	Asian Financial Crisis
AG	Assistant Governor
AML/CFT	Anti-Money Laundering/Combating the Financing of Terrorism
AMLC	Anti-Money Laundering Council
BCP	Basel Core Principles
BIS	Bank for International Settlements
BSP	Bangko Sentral ng Pilipinas—Central Bank of the Philippines
CAR	Total Capital Adequacy Ratio
CCB	Capital Conservation Buffer
CCyB	Counter-Cyclical Capital Buffer
CET1R	Common Equity Tier 1 Ratio
CFT	Combating the Financing of Terrorism
CIC	Credit Information Corporation
DG	Deputy Governor
D-SIB	Domestic Systemically Important Bank
DSGE	Dynamic Stochastic General Equilibrium
DoF	Department of Finance
ELA	Emergency Liquidity Assistance
EM	Emerging Markets
ESG	Environmental, Social and Corporate Governance
FATF	Financial Action Task Force
FC	Financial Conglomerate
FSAP	Financial Sector Assessment Program
FSCC	Financial Stability Coordination Council
FSPC	Financial Stability Policy Committee
FSF	Financial Sector Forum
FSSA	Financial Sector Stability Assessment
FX	Foreign Exchange
GDP	Gross Domestic Product
GFC	Global Financial Crisis
G-SIB	Global Systemically Important Bank
HQLA	High-Quality Liquid Assets
IC	Insurance Commission
ICR	Interest Coverage Ratio
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
LCR	Liquidity Coverage Ratio
LGD	Loss Given Default
LTV	Loan-To-Value
LEA	Law Enforcement Agency
MB	Monetary Board
ML/TF	Money Laundering/Terrorism Financing

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MPM	Macroprudential Policy Measure
NCBA	New Central Bank Act
NFC	Nonfinancial Corporate
NGFS	Network for Greening the Financial System
NPL	Non-performing Loan
NSFR	Net Stable Funding Ratio
OSRM	Office of Systemic Risk Management
PAGCOR	Philippine Amusement and Gaming Corporation
P&A	Purchase and Assumption
PCA	Prompt Corrective Action
PD	Probability of Default
PDIC	Philippine Deposit Insurance Corporation
PSE	Philippine Stock Exchange
RAM	Risk Assessment Matrix
RCBs	Rural and Cooperative Banks
ROA	Return on Assets
RR	Reserve Requirement
RWA	Risk-Weighted Assets
SEC	Securities and Exchange Commission
SFF	Sustainable Finance Framework
SME	Small- and Medium-sized Enterprise
ST	Stress Test
STeM	Stress Testing Matrix
TBs	Thrift Banks
UKBs	Universal and Commercial Banks
USD	United States Dollar
VAR	Vector Autoregression
WB	World Bank
WEO	World Economic Outlook

EXECUTIVE SUMMARY

The financial system is dominated by banks. Banks are tightly interlinked with nonfinancial corporates (NFCs) through conglomerate ownerships and significant exposures.

The immediate risk to financial stability is from the impact of COVID-19. GDP contracted by 9½ percent in 2020—a much sharper decline than during the Asian Financial Crisis (AFC). The economy had solid macro-fundamentals before COVID-19 thanks to policy efforts, but the pandemic turned out to be an extreme tail shock. The authorities took various measures, including time-bound regulatory relief and forbearance measures, though the scale of loan moratoria and credit guarantees has been relatively limited. With policy support and easing of containment measures, the economy started to recover in the second half of 2020 and is expected to grow 6½ percent in 2021.

While banks can withstand the exceptionally severe shocks in the baseline, they could experience a systemic solvency impact if additional downside risks materialize. Distress to the corporate sector could be widespread even in the baseline and sharply rise in adverse scenarios, elevating credit risks to banks. In the baseline, banks' total capital adequacy ratio (CAR) falls from 15.6 percent to 11.7 percent by 2022, still above the ten percent minimum requirement even without sectoral policy effects. However, CAR falls to 9.3 percent in the adverse scenario, and 4.9 percent in the severe adverse scenarios. The second-round effects from such distress might reduce the real GDP level by an additional 4 to 9 percentage points in adverse scenarios. However, CARs start to recover in 2022 as the economy recovers. The results should be interpreted cautiously given the economic and model uncertainties. Moreover, conservative behavioral assumptions (e.g., deleveraging among others) in FSAPs tend to yield larger solvency impacts during a severe crisis.

Given the significant downside risks, the authorities should limit bank dividend distributions, and be ready to take additional measures to strengthen banks' capital if the risks materialize. Given the potential for large loan losses, the authorities should limit banks' dividend distributions as a precautionary measure. If downside risks materialize, banks should recognize NPLs and restructure them promptly with additional capital as needed. This is supported by a counterfactual policy analysis and the experience after the AFC, which suggest that such actions could improve GDP with sustained credit provision.

The BSP should allow the forbearance measures to lapse as scheduled and avoid introducing new measures. Forbearance does not address the underlying issues in weak banks and hampers banks' ability to continue providing credit and ultimately may even undermine financial stability. Instead, the authorities should continue to use the flexibility of the tools available in the accounting and Basel capital framework, and, looking at the future, further develop and use macroprudential tools and buffers.

The downside risks to the banking system also underscore the importance of further strengthening the bank resolution framework. The Philippine Deposit Insurance Corporation (PDIC) should be designated and given powers to act as the resolution authority. Also, the resolution toolkit should be broadened beyond liquidation and possibly with a statutory bail-in tool. Besides,

the purchase and assumption (P&A) tool should be expanded. While implementing these structural reforms requires amendments to laws and will take time, some action can be undertaken immediately. The Prompt Corrective Action (PCA) framework could be further streamlined and made more specific to prevent critically deficient banks from operating for prolonged periods. The authorities should also start working on resolvability assessments and resolution plans for individual banks, starting with D-SIBs. The cross-sectoral coordination mechanisms to manage the potential failure of a D-SIB should be enhanced and tested. Finally, the central bank should provide Emergency Liquidity Assistance (ELA) only against collateral.

While significant progress has already been made, further strengthening the macroprudential framework will be beneficial for dealing with future economic challenges. Within the Bangko Sentral ng Pilipinas (BSP)—the central bank and bank regulator—the sectors and units should collaborate to enhance essential financial stability exercises, including macro scenario stress tests of banks. The decision-making processes should reflect monetary policy, supervisory, and macroprudential perspectives given their interlinkages. The macroprudential toolkit should be expanded beyond the countercyclical capital buffer (CCyB), and the BSP should establish operational procedures in setting macroprudential policies, including introducing thresholds of relevant systemic risk indicators that trigger discussion to activate tools. The influence of the inter-agency Financial Stability Coordination Council (FSCC) could be elevated with a comply-or-explain mechanism and by providing financial stability objectives to supervisors of nonbank financial institutions.

Since the last FSAP, the BSP has modernized the oversight framework for banks, but material gaps in powers and conglomerate supervision remain. The government should amend the unusually stringent bank secrecy law as it limits BSP’s legal powers for effective prudential supervision and could impair financial stability and development. The BSP should strengthen conglomerate supervision with additional powers to obtain information from banks’ affiliates and to bring and supervise all related financial institutions under a regulated financial holding company. Regulatory powers and standards for transferring significant ownership, controlling interest, and assessing beneficial owners’ suitability should be enhanced. Financial conglomerates should be supervised with closer cross-agency collaboration, led by the BSP as the lead supervisor, and strengthened requirements and monitoring of large exposure and related party transactions.

The effectiveness of the Anti-Money Laundering and Counter Financing of Terrorism (AML/CFT) regime needs to be substantially enhanced. The 2019 Asia Pacific Group on Money Laundering (APG) assessment gave low/moderate grades to the regime. Without major reforms by June 2021, the country could again be included in the Financial Action Task Force (FATF) list of jurisdictions with serious AML/CFT deficiencies and expose the financial system to significant risks.

Analysis of climate change risks shows the importance of improving data and building capacity. The Philippines is highly exposed to physical (typhoon) risks. The FSAP developed an innovative tool that combines climate science and catastrophe risk models to build long-term bank solvency test scenarios. The analysis indicated the relevance of physical risks for financial stability, though they are not systemic unless extreme tail events—once in 250-500 years—materialize.

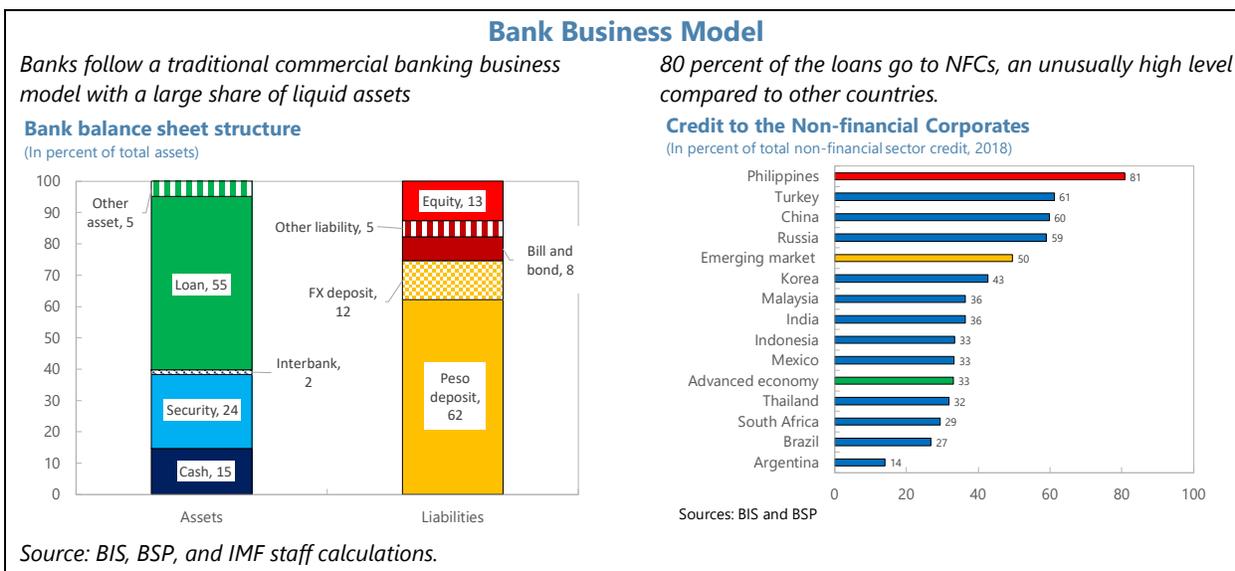
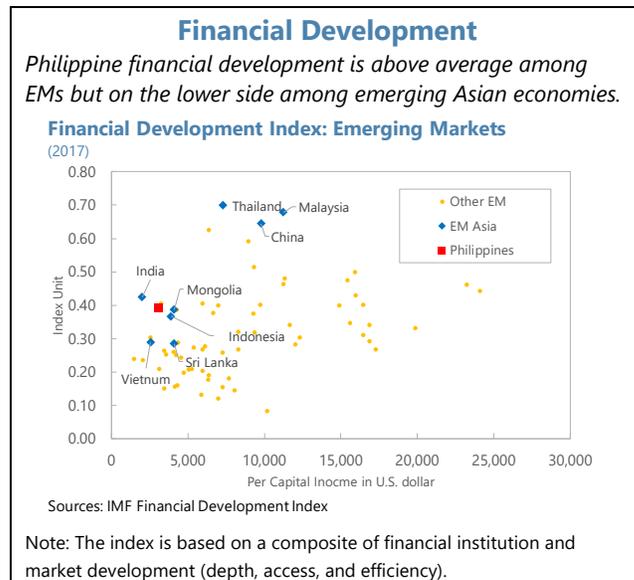
Table 1. Philippines: Key Recommendations	
Recommendation	Timing
Macprudential Policy and Systemic Risk Monitoring Framework	
Limit bank dividend distributions while downside risks remain high and be ready to take additional measures to strengthen banks' capital if the risks materialize to continue providing credit to the economy (FSCC members, BSP).	ST
Enhance collaboration within the BSP to conduct essential macroprudential risk analyses, including macro scenario stress tests, and assure a balanced decision-making process (BSP).	MT
Strengthen the influence of FSCC decisions by adding a comply-or-explain mechanism and providing sectoral regulators with a financial stability objective (FSCC members).	MT
Expand macroprudential policy toolkit and establish operational procedures to set them in a more systemic risk-based manner (BSP).	MT
Financial Sector Supervision	
Lapse or limit the use of issued regulatory forbearance measures (BSP).	ST
Enhance regulatory powers and standards regarding transfer of significant ownership or controlling interest and to assess the suitability of beneficial owners of banks (BSP, DoF).	ST
Strengthen sectoral supervision, appoint the BSP as the lead supervisor of financial conglomerates and conduct more frequent and comprehensive risk-assessment of FCs (BSP, IC, SEC, FSF).	ST
Update the large exposure requirements (to be applicable on a solo and consolidated level) and enhance large and related party exposure reporting requirements (BSP).	ST
Amend the bank secrecy laws to enhance supervision powers, strengthen AML/CFT effectiveness, and cooperation with foreign authorities (BSP, SEC, IC, AMLC and DoF).	MT
Provide the power to the BSP to insert a regulated Financial Holding Company into a mixed conglomerate and obtain information from the wider group (BSP, DoF).	MT
AML/CFT	
Make legislative amendments to (i) designate tax crimes as predicate ML offenses; and (ii) establish a comprehensive legal framework for targeted financial sanctions against proliferation financing (AMLC, DoF).	ST
Strengthen risk-based AML/CFT supervision (including sanctioning procedures) for high-risk sectors, such as banks, casinos, money value transfer service providers (BSP, AMLC, PAGCOR).	ST
Enhance the accuracy and availability of beneficial ownership information of companies (SEC).	MT
Crisis Management, Resolution, and Safety Net	
Ensure timely corrective actions and resolution of weak banks (BSP, PDIC).	ST
Implement resolvability assessments and resolution plans, starting with D-SIBs (PDIC, BSP).	ST
Make the legal framework for ELA more specific regarding the conditions under which it can be provided and avoid assistance without collateral (BSP).	ST
Designate and provide the PDIC with powers to act as resolution authority (PDIC, BSP, DoF).	MT
Expand and operationalize bank resolution tools (particularly P&A) beyond liquidation (PDIC).	MT
Climate Change, Environment Risks and Supervision	
Improve information collection, monitoring of risk metrics, and stress test capacity for climate change and environmental risks (BSP).	MT
Short-term (ST) = within one year; medium-term (MT) = one to three years	

BACKGROUND

A. Financial System Structure

1. The size of the financial system is broadly in line with the economy’s level of development (Figure 1). The total assets of the system amount to 126 percent of GDP (Table 2). The banking system holds about 94 percent of the system’s assets, but bank credit is just over 50 percent of GDP as banks hold substantial liquid assets. Access to finance for individuals is significantly lower than in other Asian emerging market economies (EMs), with only a third of adults having formal accounts.

2. The banking sector is dominated by several large domestic banks. Forty-six universal and commercial banks (UKBs) hold over 94 percent of bank assets, of which 60 percent are held by the top five banks (all domestic). Foreign bank subsidiaries and branches hold seven percent of bank assets. Also, there are about 500 small thrift banks (TBs) and rural and cooperative banks (RCBs).



3. Overall, banks follow a traditional commercial banking business model, relying on deposits and lending mostly to large NFCs (Figure 2). Eighty percent of the loans go to NFCs, which is unusually high, partly because of underdeveloped corporate bond markets. The exposure to real estate loans is relatively low under a regulatory limit of 20 percent of total loans applicable to UKBs (raised to 25 percent upon COVID-19). These loans are largely commercial. The exception is TBs, providing one-third of their loans to residential properties. TBs and RCBs are more exposed to household consumption and agriculture loans. A quarter of assets are securities (mostly sovereign

bonds). Overall, banks are liquid, with nearly 40 percent of their assets in securities and central bank reserves, the highest level among Asian EM peers.

4. The banking sector is subject to bank secrecy laws that undermine financial stability, financial integrity, and development and expose the banking system to reputational risk (Table 6).

The past two FSAPs, recent Article IVs, the 2020 Basel Core Principle (BCP) assessment, and the 2019 mutual evaluation report on AML/CFT by the APG—a FATF-style regional body—all emphasized challenges to supervisory effectiveness from these laws. Unlike most other countries with strict secrecy laws, the Philippine laws do not allow banks to share depositor information directly with supervisors for prudential purposes.¹ They reduce supervisors’ ability to monitor liquidity risk and make banks vulnerable to reputational risk. The secrecy laws also slow down the payouts by the Philippine Deposit Insurance Corporation (PDIC) and reduce the effectiveness of misconduct investigations by the Securities Exchange Commission (SEC). Furthermore, the laws prevent the Philippines from joining some regional capital market initiatives.

5. NFCs are deeply interconnected with the financial system through “mixed” conglomerate structures that include NFCs and financial institutions (Figure 3).

Seven out of the ten largest banks (holding about 60 percent of total bank assets) are related to local-family-owned mixed conglomerates. The network analysis by the BSP and the FSAP suggest that the primary source of contagion among banks is common exposures to large conglomerates.

6. The other segments of the financial system are underdeveloped. Nonbank financial institutions (NBFIs) are much smaller than several Asian peers. Informal financing among family members is more significant to households than retail bank loans. The domestic stock market capitalization and bond outstanding are roughly 90 percent and 30 percent of GDP, respectively, but government securities dominate the debt market.

7. The Fintech ecosystem is nascent. Digital payments are used much less than in Asian EM peers. The 2017 Global Findex results indicate that only a quarter of the adult population made or received at least one digital payment in the preceding year. Some of the constraints include expensive bank charges and barriers to establishing IT and communication infrastructure for the archipelago of over 7,000 islands.

8. The financial system is indirectly exposed to international spillovers (Figure 4). Banks’ direct cross-border exposure is low at about 10 percent of bank assets and liabilities, mostly to service overseas Philippine workers. Dollarization is also moderate (15 percent of deposits and 11 percent of loans are in Foreign Exchange, FX). Exposures to FX risks are tightly regulated, with separate licensing requirements to conduct FX transactions and strict limits to open FX positions. Most international spillovers are likely to stem indirectly from NFCs and market contagion effects. International remittance inflows are significant (about eight percent of GDP annually). However, they

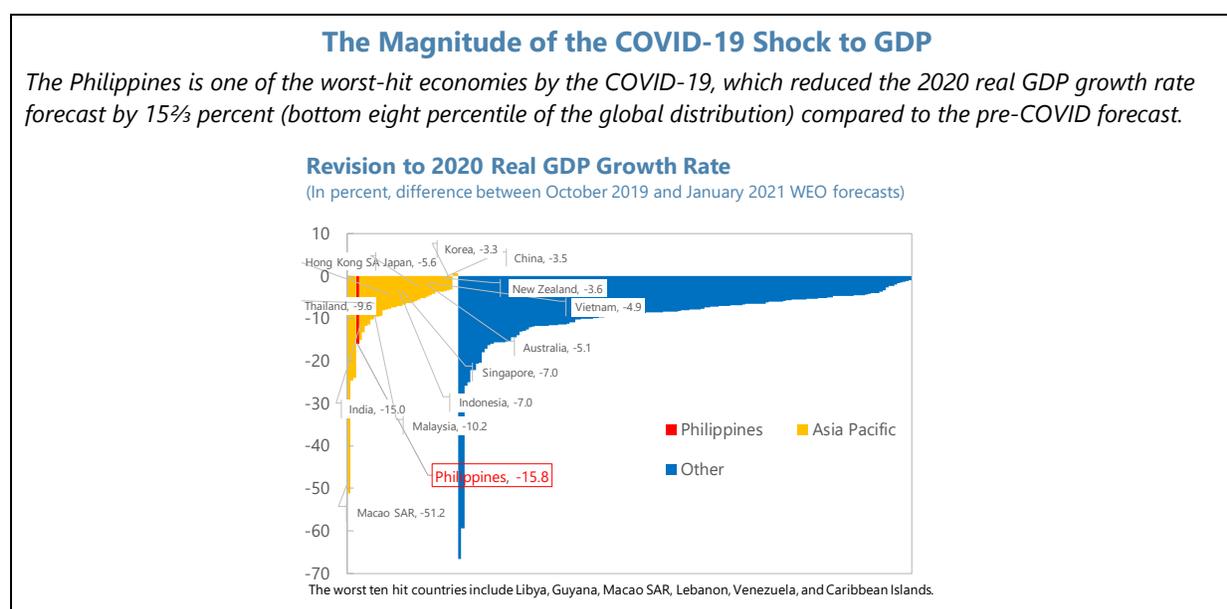
¹ Only the BSP can access depositor information for AML/CFT purposes during on-site examinations.

may have little impact on banks' FX deposits because they can be credited to banks only in pesos in most cases.²

9. The financial system faces risks from climate change. As indicated in the 2019 Article IV report, the Philippines is highly exposed to climate-related natural disasters (i.e., physical risks such as typhoons, landslides, floods, droughts). Transition risks for the Philippines appear to be closely related to the coal-based power generation industry.³ The BSP is building up capacity to assess climate risks and joined the Central Banks and Supervisors Network for Greening the Financial System (NGFS) in 2020.

B. Macrofinancial Developments

10. The Philippines was severely hit by COVID-19 (Figure 5 and Table 3) but is now recovering. Real 2020 GDP contracted by 9.5 percent. The government imposed stringent quarantine measures, resulting in 12 percent (H/H, s.a.) real GDP contraction in the first half of 2020. The recovery started in the third quarter, mainly driven by easing containment measures and economic policy support with real GDP increasing by 8.0 percent in the third quarter and 5.6 percent in the fourth quarter (q/q, s.a.). The Fund projects 2021 real GDP growth to be 6.6 percent (January 2021 World Economic Outlook, WEO).



11. However, the economy went into the pandemic with better macro-financial fundamentals than before the AFC, as a result of bold structural reforms and prudent macroeconomic policies (Figures 5–6). Annual economic growth has been over 6 percent during

² Major money transfer operators offer US\$ payments in cash.

³ As the government values energy security for a rapidly growing economy, the share of cheaper coal-based power generation increased from a negligible amount in the 1990s' to nearly 50 percent in 2016. The government recently announced the moratorium on the processing of applications for greenfield coal-fired power projects..

2013–19, with moderate inflation. Public debt steadily declined in the past 20 years, reducing the country's risk premiums. External debt and international reserves have improved. Pre-COVID financial indicators of NFCs were healthier than the pre-AFC time. While property prices doubled in the past ten years, they are broadly in line with income growth, and residential mortgages are only four percent of GDP.

12. Before the pandemic, banks' health appeared comparable to other EMs despite some deteriorations since the mid-2010s (Table 4 and Figure 7). By historical standards and among key EM comparators, the NPL ratio was low at end-2019. The CAR was stable at about 15 percent in the past ten years, and the quality of capital is high. Return on assets (ROA) has been about 1½ percent—at the median among EMs—supported by high interest margins. TBs and RCBs tend to have higher NPL ratios (around 6 and 11 percent, respectively) than UKBs (about 1½ percent), but they also have higher capital ratios and cure rates back to performing.

13. So far, the financial system has broadly withstood the COVID-19 shock (Figure 5 and Table 5).

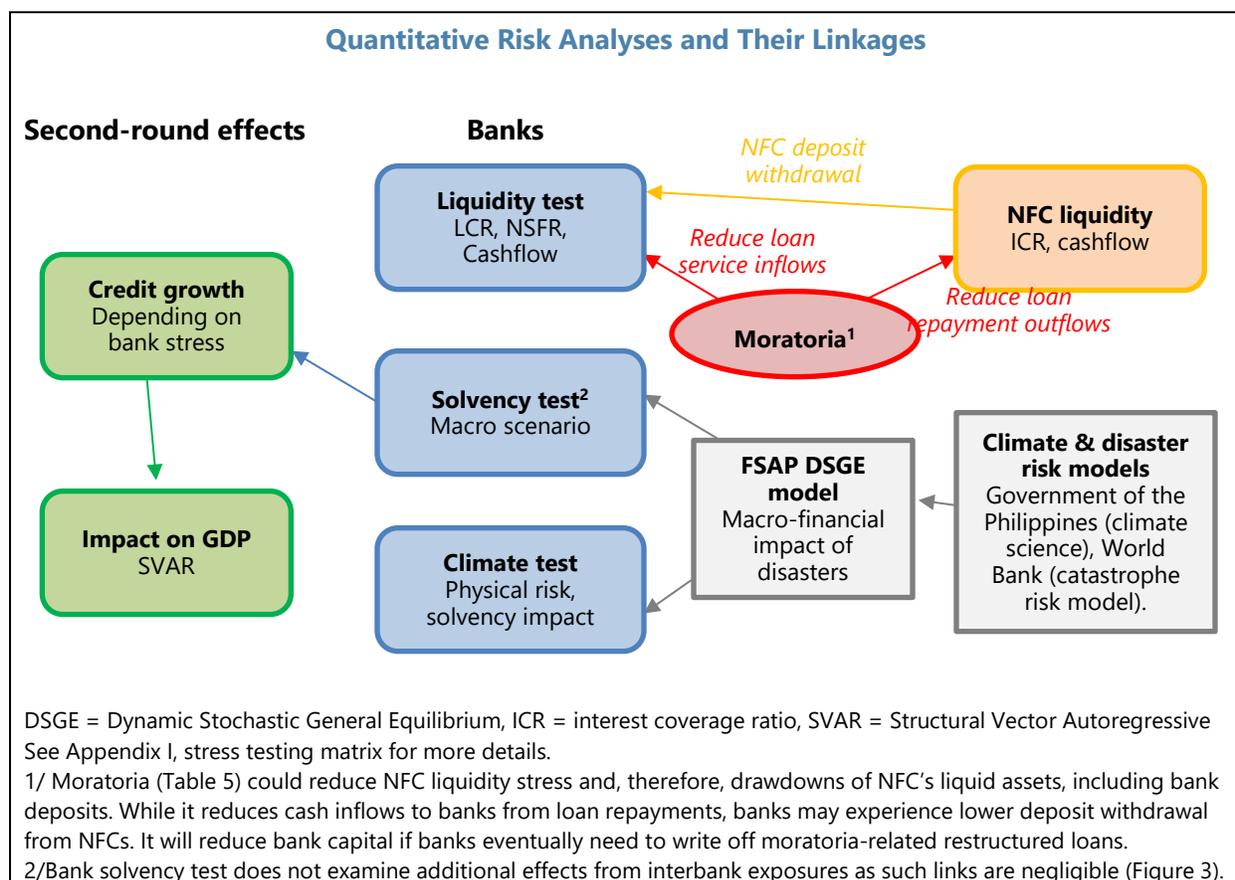
- **Financial markets:** Markets recovered well after a brief period of increased volatility in March 2020. The exchange rate appreciated slightly against the USD for 2020 as a whole, and gross international reserves recovered by nearly US\$20 billion to US\$110 billion between end-April and end-year (11 months of import coverage). The BSP cut policy rates and reserve requirements in contrast to the AFC.
- **NFCs:** Market analysts forecast significant earnings shocks, especially in retail, tourism, transportation, and construction industries. The authorities launched a small (0.6 percent of GDP) credit guarantee program for loans to small- and medium-sized enterprises (SMEs) and the agricultural sector. Moratoria (total of five months) expired at the end of 2020.
- **Banks:** Lending standards have tightened, and credit is contracting though the credit gap remains positive as GDP contracts. The NPL ratio rose from 2.1 at the end-2019 to 3.4 percent in September 2020, so has the share of past-due loans and restructured loans. However, the CAR rose over one percentage point since end-2019 (Table 4). However, these figures may have optimistic bias under moratoria and forbearance measures. At the same time, banks continued to receive new deposits, reducing the loan-to-deposit ratio noticeably.

14. The BSP also issued time-bound regulatory relief and forbearance measures (Appendix IV). Measures included unusually strong forms of forbearance to delay NPL recognition and allow banks to provision over a maximum period of five years subject to the BSP's approval. The uptake appears to be limited so far, given the BSP's tight approval criteria. We welcome BSP's effort to keep track of credit quality information without policy measures to maintain transparency.

SYSTEMIC RISK ASSESSMENT

A. Key Risks, Assessment Methods, and Scenarios

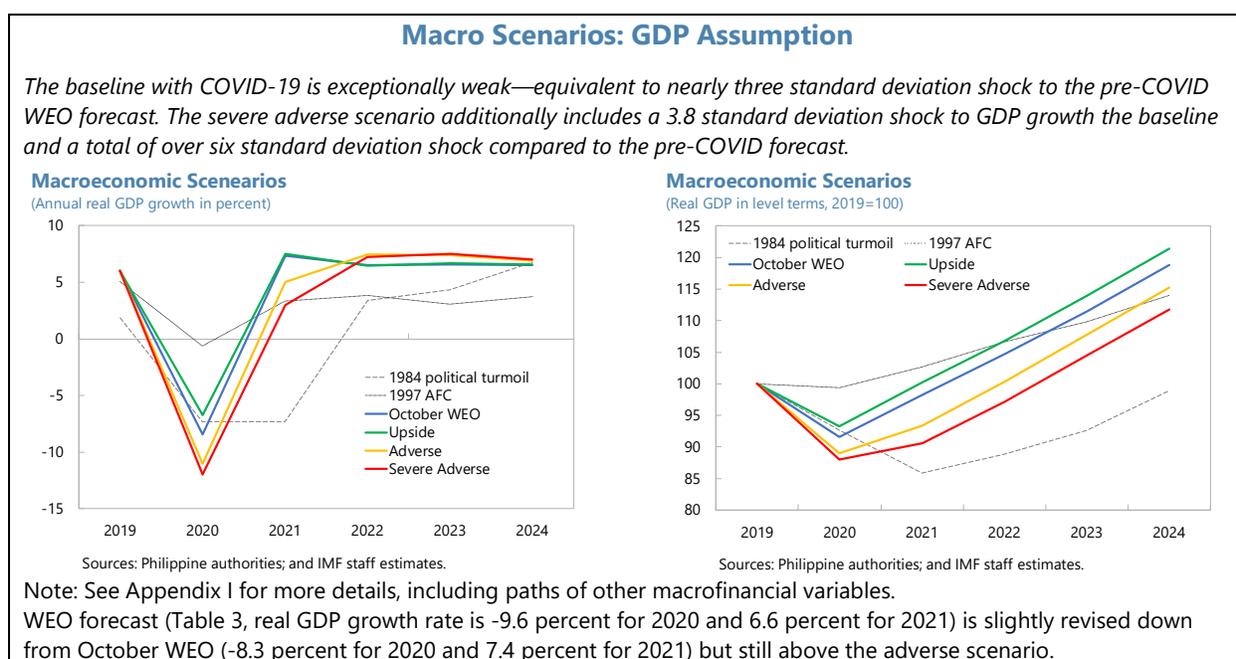
15. The key risks to financial stability stem from the COVID-19 crisis and bank-corporate linkages. The economic impact of COVID-19 is already much worse than the AFC. Uncertainty surrounding the growth outlook is larger than usual, mainly stemming from the uncertainty about the pandemic and the timing of the vaccine rollout. But the economy may recover faster, especially if reinforced with a quick vaccine rollout. Containment measures will depress NFC earnings, and they could spill over to bank health through direct exposures and ownership linkages of mixed conglomerates.



16. The FSAP mission conducted bank stress tests and applied new tools to better understand bank-NFC and bank-economic linkages (Appendix I). NFC tests assess the effects of earnings shocks on their capacity to repay bank loans. The bank solvency test covers all banks, and liquidity tests examine UKBs. Both use end-2019 data, as reported 2020 data are likely to be biased upward due to temporary policy effects. Solvency test results are then used to estimate the second-round effects on GDP through credit growth channels. The model is applied to analyze counterfactual policy to restructure NPLs promptly. Cashflow stress tests of banks and NFCs are linked to assess their liquidity contagion. The mission also developed a new approach to assessing

physical risk from climate change (Appendix I and VI). Except for bank-NFC liquidity linkage analysis, all exercises do not incorporate the effects of sectoral support measures. The guarantee program is limited to SMEs and the agricultural sector and small (0.6 percent of GDP). Moratoria expired at the end of 2020. Forbearance measures that are not compatible with Basel III should not be incorporated.

17. The macroeconomic scenarios assume different directions and degrees of risks from COVID-19. The real GDP paths of all four scenarios (baseline, upside, adverse, and severe adverse) are more severe than the AFC but less than the political turmoil experienced in the mid-1980s. The baseline is unusually weak, a nearly three standard deviation shock to GDP compared to the pre-COVID forecast. The unlikely severe adverse includes an additional 3.8 standard deviation shock to the baseline due to tighter containment measures and severer scarring effects. However, unlike the AFC, policy rates are assumed to remain low in all scenarios given the development. Still, financial conditions tighten slightly with higher risk premiums.



B. Nonfinancial Corporations

18. The mission assessed the NFC risks with a macro-scenario approach. The work in 2019 Article IV has been expanded to evaluate the impact of the COVID-19 pandemic on corporate earnings, interest coverage ratio (ICR), and cash positions. The sample is mostly limited to listed firms due to data availability, but it covers nearly half of bank loans.

19. Philippine firms are likely to experience substantial distress even in the baseline (Figure 8). The GDP shocks are expected to reduce corporate earnings across different sectors, especially in the energy, consumer discretionary, and industrial sectors. As a result, the debt weighted average ICR would decline from 4.9 percent at end-2019 to 1.3, below one, and 0.2 in the

baseline, adverse, and severe adverse scenarios, respectively. Debt-at-Risk (the share of debt issued by firms with ICR below one) would jump from five percent at end-2019 to about 45 percent even in the upside scenario and reach 80 percent in the severe adverse scenario. However, the contribution from other macroeconomic shocks, such as the exchange rate shock, appears to be relatively small.

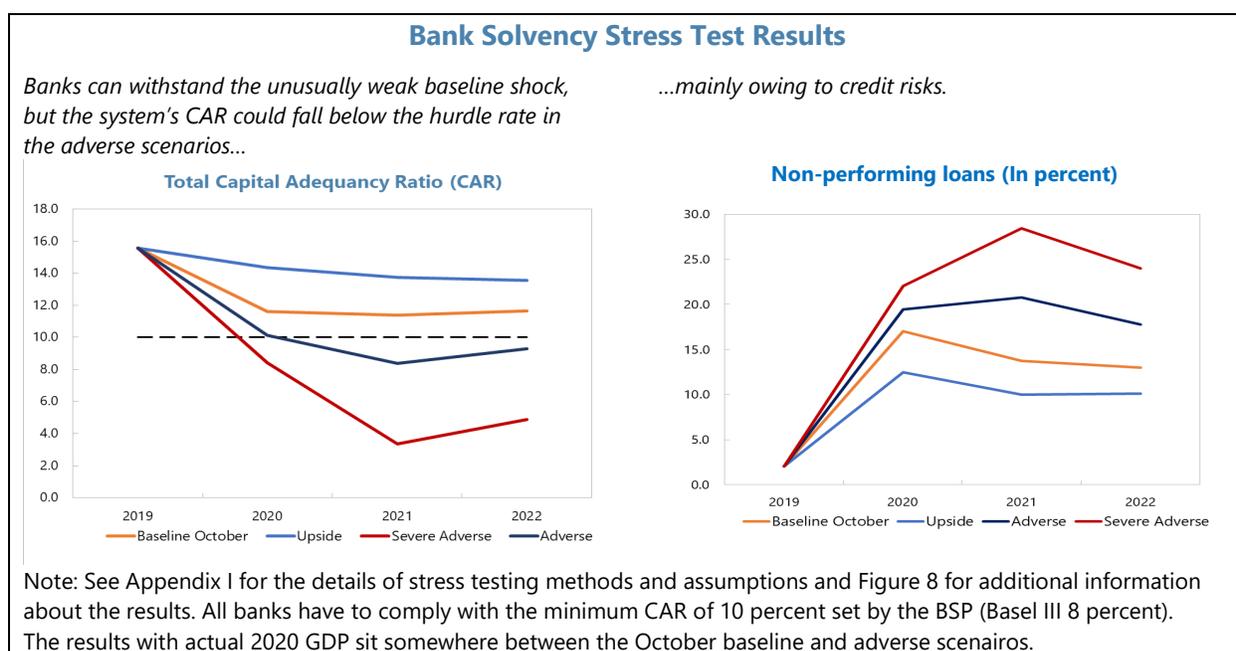
20. The NFC distress could significantly elevate credit risks to banks if the crisis persists.

Support from wealthy owner families of large conglomerates and policy support for SMEs could mitigate contagion from NFC distress to bank solvency. Loan moratoria, which do not automatically classify loans as NPL immediately, could help firms survive liquidity shocks. However, it might only delay eventual bankruptcy if the crisis incurs persistent impact.

C. Bank Solvency Stress Test and Second-Round Effects

Bank Solvency Stress Test

21. While banks can withstand the severe baseline scenario, they could experience systemic solvency stress in a much more severe adverse scenario. By 2022, the CAR falls from 15.6 percent to 11.7 percent in the baseline, 9.3 percent in the adverse scenario, and 4.9 percent in severe adverse scenarios compared to the 10 percent minimum CAR requirement. UKBs are more likely to meet the Common Equity Tier 1 Ratio (CET1) requirement (6 percent minimum requirement) as the quality of capital is high. Nonetheless, capital ratios start to recover in 2022 in adverse scenarios in line with the assumed economic turnaround.



22. The impact is particularly noticeable for UKBs and RCBs, but capital shortfalls vis-à-vis minimum requirements are moderate. Even in the baseline, 185 banks (mostly RCBs), which account for about a third of the system by assets, might not meet the 10 percent requirement. In the adverse scenario, 201 banks could have capital shortfalls. In the unlikely severe adverse scenario, 214

banks with three-quarters of the system's assets miss the minimum CAR requirement. Nonetheless, capital shortfalls appear moderate—below four percent of GDP even in the severe adverse scenario.

Bank Solvency Stress Tests: Key Results (2022)										
Scenarios	Capital ratios ¹ (In percent)					Capital shortfalls ^{1, 2} (in percent of GDP)				
	Total	UKB		TB	RCB	Total	UKB		TB	RCB
	CAR	CAR	CET1R	CAR	CAR	CAR	CAR	CET1R	CAR	CAR
Latest actual	15.6	15.3	12.7	17.5	19.4	0.0	0.0	0.0	0.0	0.0
Baseline October	11.7	11.0	8.9	18.2	14.2	1.0	0.9	0.5	0.0	0.0
Upside	13.5	13.1	10.8	18.5	14.3	0.5	0.5	0.1	0.0	0.0
Adverse	9.3	8.5	6.5	17.3	13.6	1.9	1.8	1.1	0.0	0.0
Severe Adverse	4.9	3.7	2.1	15.7	12.8	3.9	3.7	2.8	0.0	0.1
	Number of banks not meeting the minimum requirements ¹ (number)					Share of failed banks' assets in total ¹ (in percent of system's assets)				
	Total	UKB		TB	RCB	Total	UKB		TB	RCB
	CAR	CAR	CET1	CAR	CAR	CAR	CAR	CET1R	CAR	CAR
Baseline October	185	12	8	6	167	31.8	30.8	24.1	0.5	0.5
Upside	178	9	6	6	163	25.2	24.2	17.1	0.5	0.5
Adverse	201	18	12	9	174	59.9	58.7	32.1	0.6	0.6
Severe Adverse	214	21	20	12	181	76.4	75.0	64.3	0.8	0.6

1/ Figures at the end of the stress test horizon (2022).
2/ Amount of money needed to bring CAR and CET1 to respective regulatory minimums.
UKBs and TBs and RCBs that are subsidiaries of UKBs have to comply with the following minima (hurdle rate for the stress tests): CAR 10 percent (Basel III 8 percent), CET1 ratio 6 percent (Basel III 4.5 percent) and Tier 1 ratio 7.5 percent (Basel III 6 percent). Moreover, these banks are required to hold a 2.5 percent capital conservation buffer and, if applicable, a D-SIB buffer (of 1.5 or 2 percent). The minima for independent TBs and RCBs are: CAR 10 percent and Tier 1 ratio 6 percent. They are not subject to buffer and leverage ratio requirements either.

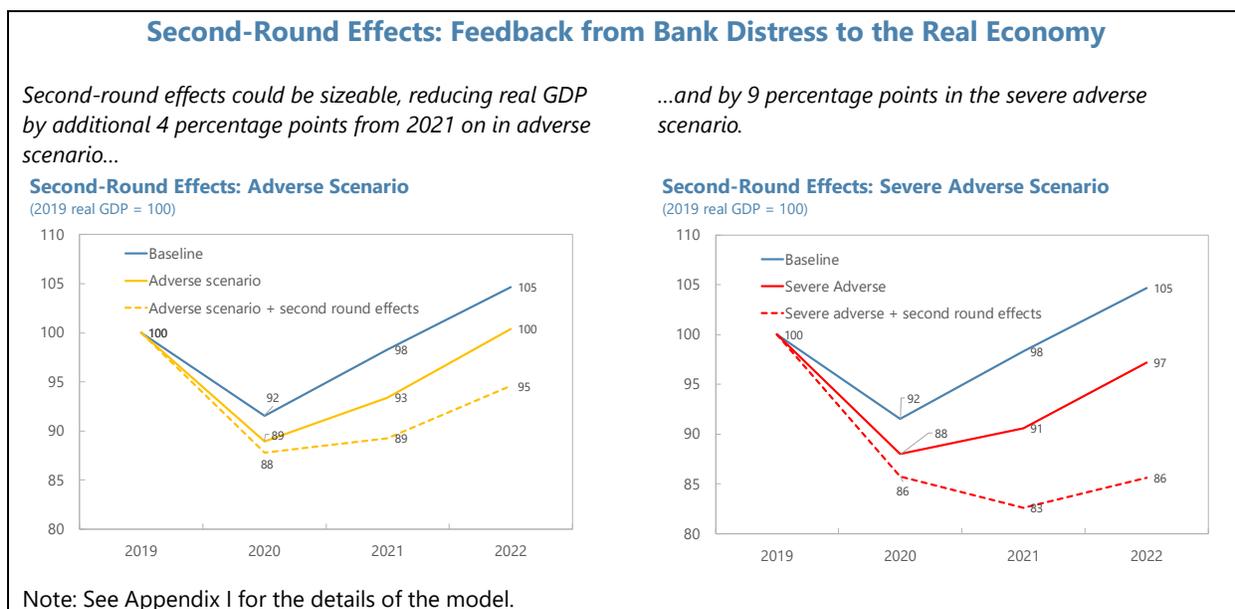
23. A jump in NPLs is the key driver of the results (Figure 9). PDs for UKBs jump to the level comparable to and higher than in the AFC episode in adverse and severe adverse scenarios. This increases NPLs sharply. As a result of the jump, loan-loss provisioning (LLP), lost interest income from NPLs, and lower margins drag capital ratios down.

Second-Round Effects

24. The mission estimated the second-round effects focusing on the macro-financial linkage through credit growth. Bank-by-bank solvency test results are used as explanatory variables to project bank-level credit growth. After examining various model specifications, the final model includes changes of NPL ratios LLP ratio. Capital ratios were not significant in estimations, possibly because the past crisis-time regulatory responses reduced their risk-sensitivity. The

aggregated credit growth projection is then fed into a structural-VAR that produces a change in real GDP growth rate in response to reduced credit growth.

25. Second-round effects through weaker credit growth may double the initial shock to GDP in adverse scenarios. In the adverse (severe adverse) scenario, the banking sector CAR declines by nearly 8 (12) percentage points, which could reduce the real GDP level by additional 4 (9) percentage points by 2021. The effect might persist for several years.



Counterfactual Policy Effects

26. The second-round effect models can be used to investigate the effects of counterfactual policy measures. Since the empirical credit growth model indicates NPL ratios and LLP ratios as significant predictors, we consider the effects of a one-time write-off of NPL worth (an arbitrary) 30 percent of LLP stock in 2021—which we assume will be financed by available excess capital.

Cost-Benefit Analysis of Counterfactual Policy
(2019 real GDP = 100)

	Baseline	Adverse	Severe adverse
Benefit 1	1.62	2.23	2.86
Benefit 2	2.31	3.20	4.13
Cost	-1.56	-2.16	-2.88

Note:
Benefit 1: Maximum difference in the level of real GDP during 2020-22
Benefit 2: Sum of differences in the level of GDP from 2020 to 2022.
Cost: 30 percent of loan-loss provision stock as of 2021 (one time).

27. The estimates appear to suggest net positive effects of timely loss recognition and NPL restructuring (Figure 10). The counterfactual policy’s costs (the necessary excess capital) ranges from 1½ percent to nearly 3 percent of GDP. While the single year benefits are about the same as the costs, the benefits last for multiple years. The total benefits from 2021 to 2022 are significantly above the costs.

Limitation of the Analysis

28. The results should be interpreted with caution, given the uncertainties amid the COVID-19 shock, as they could bias the results to both directions. Stress test results are sensitive to assumptions over cure rates for NPL (back to performing), the extent of deleveraging, and loss-given-default (LGD), which could all show atypical patterns during a crisis. FSAPs usually assume conservative parameters that increase the negative impact. Credit risk during a deep economic crisis may evolve differently from what historical patterns imply. Also, our exercise did not incorporate the effects of policy measures because guarantees and moratoria are limited, and forbearance should not be incorporated (Appendix I). As for the second-round effects, other approaches may deliver different views.

D. Bank Liquidity Stress Test

29. Banks have sufficient buffers to withstand severe liquidity shocks (Figure 11). High-quality liquid assets (HQLA) for calculating the liquidity coverage ratio (LCR) are mostly reserves and sovereign securities. The high (12 percent) reserve requirement significantly contributes to the buffer, making its usability a critical factor for banks' survival. Banks rely mainly on retail and wholesale deposits. The system appears to be more resilient against FX liquidity shocks than local currency liquidity shocks. However, FX buffers are concentrated in a couple of Global-SIB branches. The net stable funding ratio and cash flow analysis show similar outcomes.

E. Loan Moratoria and Bank-NFC Liquidity Linkage

30. Liquidity stress to NFCs from lower earnings could spill over to banks, and loan moratoria could further complicate the linkages. As detailed in Figure 12, loan moratoria's direct effects are to improve NFC cash balance while reducing bank cash inflows and liquid assets. Without moratoria, NFC cash balance declines for debt service while increasing bank liquidity balance. However, liquidity-strapped NFCs may withdraw bank deposits, weakening banks' cash balance. Furthermore, if banks continue to roll over healthy maturing NFC loans, NFCs' liquidity balance recovers with or without moratoria.

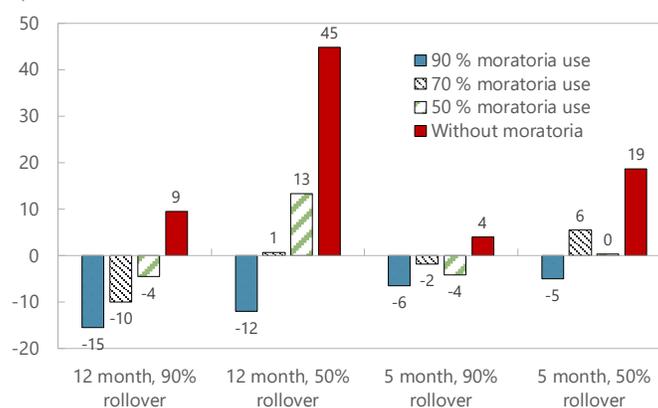
31. The results show that certain policies, such as moratoria, may not achieve their intended results depending on the behavior of banks and NFCs (Figure 13). For NFCs, moratoria can substantially improve their liquidity balance when banks' rollover rate is low but less so otherwise. So, the policy effectively support them with credit supply shocks but not much so without the shocks. For banks, overall moratoria effects on their liquidity balance critically depend on whether NFCs have alternative financing sources (e.g., liquidating other assets or issuing bonds). If NFCs withdraw deposits, banks might experience broadly the same cashflow effects irrespective of moratoria policy. The BSP could monitor banks and NFCs' contingent financing plans to gauge the systemwide effects better.

Bank-NFC Liquidity Linkage and Moratoria

Without moratoria, banks receive more loan repayment cash inflows but could lose substantial NFC deposits. Higher moratorium usage or rollover rates¹ mitigate NFC liquidity gaps and therefore reduce their deposit withdrawal. With some parameter combinations, NFC deposits could grow over the 2019 levels (shown as negative withdrawal rates).

NFC Deposit Withdrawal Rate

(In percent)



Source: IMF staff estimates.

1/ During normal times, banks' rollover rates for existing loans exceed 100 percent, reflecting normal time credit growth. Data shows they went down to about 90 percent during the past distress episodes across ASEAN.

Negative figures indicate deposit inflows.

F. Climate Change Risk Analysis

32. The mission developed an innovative approach for analyzing banks' solvency for physical risks from typhoons. We built climate change macroeconomic scenarios using climate science studies, a catastrophe (CAT) risk model, and a macro-financial model (Appendix I and VI).

33. The analysis indicated the relevance of typhoon risks, though they may not be necessarily systemic except for extreme tail events. Without other shocks, the destruction of physical capital from typhoons' wind alone would reduce bank capital ratio only by one percentage point even in the once-in-500-year event in the future. However, the joint shock with pandemic intensifies the effects of climate change for extremely intense typhoons. For once in a 500-year events, the difference between current and future scenarios with the pandemic rises to 4½ percentage points.

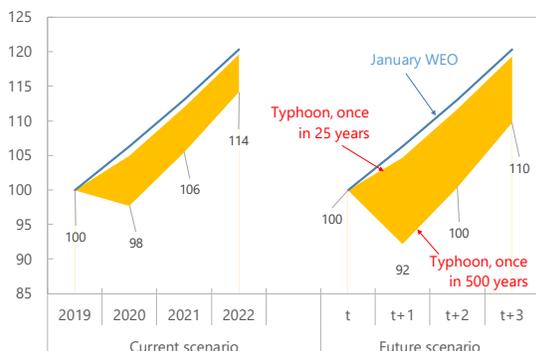
34. At this stage, the BSP should continue enhancing data and building capacity. The BSP has started to integrate green finance and Environmental, Social and Corporate Governance principles (ESG) principles into its investment policy, joined the NGFS, and has initiated studies on rainfalls and bank performance. It has issued the circular for banks on environmental risk management, governance, and disclosure, which should be followed-up by more granular regulations and guidance on risk management, stress testing, and reporting and disclosure. Supervisory capacity should be built to monitor uptake in on-site and off-site supervision.

Climate Change Stress Test

Macroeconomic assumptions: a severe typhoon is assumed to hit the country in Q3 2020

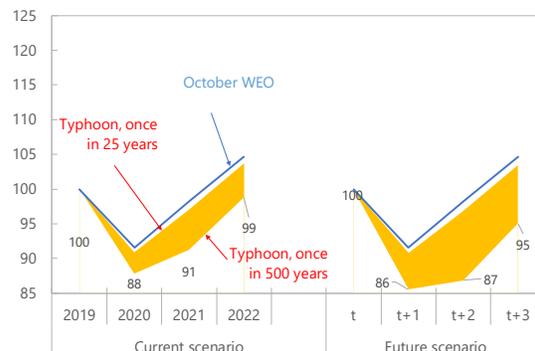
Macroeconomic Impact of Typhoons-Normal Time

(2019 real GDP = 100)



Macroeconomic Impact of Typhoons and Pandemic

(2019 real GDP = 100)



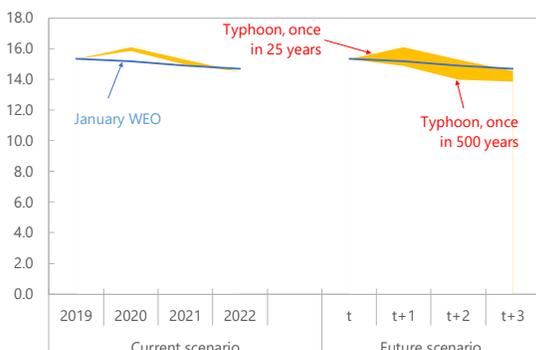
Impact on bank solvency¹

Climate change (the difference between current and future scenarios) has only a moderate impact on the effect of a severe typhoon to bank capital during normal time...

...but climate change increases the effects of a severe typhoon in an extreme tail event—a joint shock of a once in 500 years typhoon and pandemic.

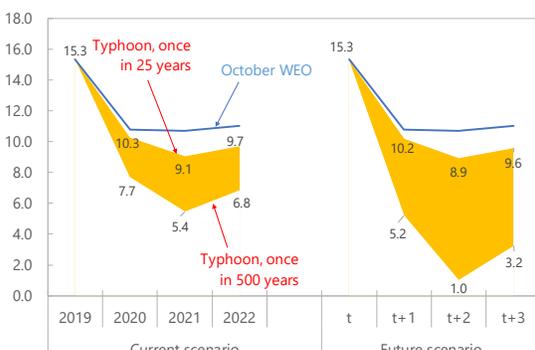
Impact of Typhoons on Bank Capital-Normal Time

(Total capital adequacy ratio in percent)



Impact of Typhoons and Pandemic on Bank Capital

(Total capital adequacy ratio in percent)



Notes: Bank capital ratio of UKB banks.

See Appendix I for methodological details.

1/ Bank capital rise in scenarios without pandemic over the short-period due to the valuation gains with securities (mostly sovereign) as the central bank cut policy rate.

MANAGING RISKS FROM COVID-19

35. Given the significant downside risks, the authorities should limit bank dividend distributions and be ready to take additional measures to strengthen bank capital if downside risks materialize.⁴ Given the potential for large loan losses, the authorities should limit dividend distributions as a precautionary measure. If downside risks materialize, the BSP should consider

⁴ The recommendation is in line with the Fund's position on dividend distribution during COVID-19 (see IMF Special Series on Covid-19: "[Restriction of Banks' Capital Distribution during the COVID-19 Pandemic](#)" and "[Main Operational Aspects for Macprudential Policy Relaxation](#).")

broader policy options (e.g., support measures facilitating the sale and recovery of bad assets, raising additional capital starting with conglomerate owner families and private sector funding, and public funding only as a last resort). This is supported by the counterfactual policy analysis, which suggests that timely NPL restructuring and loss recognition, financed by adequate capital, can improve GDP with sustained credit provision, while the benefits of such a policy are higher than its cost. The experience during the AFC (detailed in Appendix IV) also shows credit-to-GDP contraction from over 50 percent to 25 percent in the ten years since 1997 while NPLs are recognized and restructured only slowly, supports the recommendation.

36. The BSP should allow the forbearance measures to lapse as scheduled and avoid introducing new measures (Appendix IV). Forbearance does not address the underlying issues in weak banks and hampers banks' ability to continue to support the economy and ultimately may even undermine financial stability. Instead, the authorities should continue to use the flexibility in the accounting and Basel capital frameworks, and, looking at the future, further develop and use macroprudential tools and buffers. While the BSP used some of these micro and macro-prudential tools during the current crisis, the preceding forbearance measures could undermine their effectiveness by reducing bank capital's sensitivity to risks, as forbearance keeps bank capital at artificially high levels.

MACROPRUDENTIAL FRAMEWORK AND OVERSIGHT

A. Framework

37. The BSP plays a central role as the central bank, bank and payment system supervisor, macroprudential authority. The BSP is the only supervisor with financial stability mandate. The organization structure for macroprudential issues is different from that of monetary and supervision issues. A recently created financial stability "unit" (Office of Systemic Risk Management, OSRM) works on macroprudential issues, headed by an Assistant Governor (AG). In comparison, monetary policy and supervision are larger "sectors," each headed by a Deputy Governor (DG). BSP's Financial Stability Policy Committee (FSPC), a Monetary Board (MB) subcommittee comprising of all MB members, decides on macroprudential issues, while the MB makes monetary policy and supervision decisions.

38. The BSP should enhance collaboration and coordination within to conduct essential macroprudential analysis and assure a balanced decision-making process.

- **Financial stability analysis:** Currently, the supervision sector implements all bank-related analysis and sets prudential tools except for CCyB, and OSRM focuses on non-financial sectors and their link to banks and CCyB. No units/sectors conduct macro-scenario stress testing—one of the essential tools for financial stability analysis—despite the staff's strong capacity. The BSP should start such exercises. There is no single best practice about how to organize stress testing work. Several units and sectors could work jointly, or different sections could conduct distinct exercises depending on their objective.

- **Decision-making process:** Monetary and supervision sectors and OSRM should enhance their coordination at technical and senior levels so that the BSP decides monetary, micro-prudential, and macro-prudential policies incorporating all the three perspectives with a clear mechanism to resolve any conflicting views. Multiple institutional arrangements could facilitate cooperation. For instance, an advisory committee could be added to the FSPC to facilitate technical-level cooperation, similar to the arrangement for monetary policy. Also, OSRM's AG could be given the general right to attend MB meetings to participate in discussions on monetary policy and financial supervision (similar to the DGs, who are attending the FSPC meetings).

39. The Financial Stability Coordination Council (FSCC), a voluntary interagency body, is responsible for the cross-sectoral coordination of macroprudential policies and crisis management. It includes the BSP, SEC, Insurance Commission (IC), PDIC, and the Department of Finance (DoF) and is chaired by the BSP. The BSP also chairs the Financial Sector Forum (FSF) that coordinates microprudential policies and the supervision of financial conglomerates.

40. The influence of FSCC decisions should be enhanced. So far, the FSCC has been focusing on risk monitoring. To mitigate potential inaction bias, the FSCC should obtain powers (and a clear Charter or Terms of Reference) to make formal recommendations to its members with a comply-or-explain mechanism. Providing a financial stability objective to the IC, SEC, and PDIC could also strengthen the influence of FSCC's recommendations.

B. Policy and Oversight

41. The BSP should expand its macroprudential policy toolkit and establish operational procedures to set them in a more systemic risk-sensitive manner. So far, CCyB is the only prudential tool explicitly recognized as a macroprudential toolkit. Nonetheless, other jurisdictions use many other prudential tools explicitly for macroprudential purposes (Table 7). While the BSP has many of these instruments (e.g., loan-to-value (LTV), liquidity, FX positions), these are not explicitly calibrated to counter systemic structural (e.g., the concentration of exposures) or countercyclical risks. Indeed, operational procedures—including introducing thresholds of relevant systemic risk indicators that trigger discussion to activate tools—are missing for CCyB as well.

42. The data gap should be reduced to improve systemic risk monitoring and operationalize macroprudential tools. The quality of risk analysis is constrained by data gaps such as the lack of information on granular credit risk, including a comprehensive credit registry, LTV ratios, small and unlisted NFCs, and household indebtedness and survey, and detailed depositor information due to the bank secrecy. In this context, the new BSP power in the revised central bank charter to collect information from broader economic sectors for stability analysis and SEC's initiatives to digitalize NFC data are welcome progress.

MICROPRUDENTIAL SUPERVISION

A. Bank Supervision

43. The BSP has modernized its oversight framework since the previous FSAP and shows reasonably good compliance with the BCPs as an EM (2020 BCP assessment). The 2019 amendments to the BSP charter (NCBA) formalized its financial stability mandate, extended the scope of supervised entities, and granted the legal power to ask banks to hold capital beyond minimum regulatory requirements (Pillar 2). The BSP has been making progress in implementing the full Basel III framework. It introduced several core Basel III requirements (e.g., capital definition; capital buffers; Pillar 2; leverage ratio; LCR and NSFR, and the supervisory framework for D-SIBs); and amended core banking supervision legislation and numerous guidelines.

44. Nonetheless, material gaps remain with of BSP's legal powers related to conglomerate supervision. The BSP lacks powers to regulate, obtain information for prudential purposes, and examine the parent or other affiliate companies of banks. It cannot require mixed conglomerates to establish a regulated financial holding company that includes all group financial institutions. Finally, regulatory powers and standards on transferring significant ownership or controlling interest and assessing beneficial owners' suitability are not clear enough.

45. The BSP should strengthen conglomerate supervision by enhancing sectoral and group-wide supervision with closer cross-agency collaboration. At the group-level, the BSP should be appointed as the lead supervisor for FCs, given banks' systemic importance. Then it should conduct a more frequent and comprehensive risk assessment of FCs. The BSP should enhance the large exposure requirements and reporting on both solo and consolidated bases and enhance related party transaction reporting and monitoring. Capital ratios for FCs should be set based on their specific risk profile as part of the Pillar 2 process. To support more effective conglomerate supervision, the IC and SEC should adopt a risk-based approach with appropriate resources.

B. Financial Integrity

46. The FATF may include the Philippines in the list of jurisdictions with serious AML/CFT deficiencies in 2021. The 2019 APG assessment gave low/moderate grades to the AML/CFT regime's overall effectiveness, including supervision, preventive measures, and entity transparency. Absent sufficient progress by June 2021, the country could again be included in the FATF list and potentially face adverse effects on trade and remittances.

47. The authorities have started to take some actions. For example, the AMLC issued regulations expanding the definition of suspicious transaction reports and revised the reporting timelines. The BSP conducted thematic reviews and is enhancing its risk-based supervisory tools. Other AML/CFT supervisors (SEC, IC, and Philippine Amusement and Gaming Corporation,

PAGCOR)⁵ are in various stages of assessing their sector’s ML/TF risks and strengthening their supervisory approaches. While SEC-registered companies are now required to disclose their beneficial owners, the framework to access the information by competent authorities and reporting entities is being finalized.

48. Yet, additional reforms will be needed to enhance the AML/CFT regime’s effectiveness more fully. Legislative amendments should be promptly approved to (i) give BSP, SEC, and IC direct and full access to individual depositor information covered by bank secrecy laws (Appendix V); (ii) designate tax crimes as predicate ML offenses; and (iii) establish a comprehensive legal framework for targeted financial sanctions against proliferation financing.⁶ AML/CFT supervisors should continue to build their supervisory capacities and ensure high-risk reporting entities understand key risks and fulfill their obligations. The AMLC should work with AML/CFT supervisors to establish more efficient rules to apply administrative sanctions. Ensuring accuracy of and timely access to beneficial ownership information should be prioritized. PAGCOR should effectively apply risk mitigation and risk-based supervision measures (i.e., targeting casino junket operators). The authorities should resolve PAGCOR’s conflict of interest from its responsibilities for operating casinos and AML/CFT supervision.

FINANCIAL SAFETY NET, BANK RESOLUTION, AND CRISIS MANAGEMENT

49. The PDIC should be designated as and given comprehensive powers to act as resolution authority. The legislation in the Philippines does not explicitly single out the resolution authority. While banking institutions are subject to a blend of BSP and PDIC resolution powers, PDIC appears to serve as the de-facto principal resolution authority. Building on the existing framework, the logical next step would be to amend laws to formally designate the PDIC as the resolution authority.

50. Notwithstanding some progress in strengthening the resolution framework, the resolution toolkit should be further broadened. Bank resolution options are mainly limited to liquidation. In particular, the current P&A tool does not allow to leave uninsured creditors and bad assets behind. The law should provide for bridge banks and possibly for statutory bail-in tools along with increasing loss absorbing capacity requirements and strengthen the P&A tool to address potential D-SIB failures. The revised resolution framework should contain safeguards for bank stakeholders. In addition, the early intervention and remedial action framework could be further streamlined and include a clearer escalation process to avoid that severely deficient banks continue operating for long, as currently observed occasionally. The recent steps taken to clarify the preconditions for bank closures are welcome, but they could still leave weak banks operating for too long. Also, the PDIC should discontinue bailing out the shareholders of a weak bank by providing

⁵ PAGCOR is the licensing authority and AML/CFT supervisor for gaming entities.

⁶ Republic Act No. 11521 amending certain provisions of the AMLA was approved in January 2021.

open bank assistance. Finally, the authorities should consider establishing a dedicated backstop for the Deposit Insurance Fund from the government/Treasury to ensure prompt access to the funds.

51. The authorities should immediately start working on resolvability assessments and resolution plans for individual banks, starting with D-SIBs. The assessments of resolvability should be incorporated into the supervisory and resolution framework, especially for D-SIBs. To complement the bank resolution framework, the authorities' capacity and coordination need further attention. The authorities should consider establishing a platform that would bring together some of the competencies of the FSF and FSCC (for example, a joint committee) as both platforms have responsibilities for addressing the failure of D-SIB.

52. The legal framework for ELA should specify the conditions under which it can be provided more. Best practices suggest that a central bank should provide ELA only if a bank satisfies preconditions, such as exhausting all market-based and shareholder-sourced liquidity support and having adequate capital and sufficient collateral. The BSP should not provide uncollateralized loans. Nonetheless, for ELA to be effective, the BSP should consider taking a broader range of collateral. The BSP needs to establish internal guidance on determining bank's capital position and general viability for ELA purposes.

FINANCIAL INCLUSION

53. Promoting digital payments could increase access to formal finance deepen financial intermediation. Encouraging all financial institutions to participate in the core domestic retail transfer systems could encourage competition and reduce the cost of digital payments. As households shift to bank deposits from cash, the banking system could expand its credit provision.

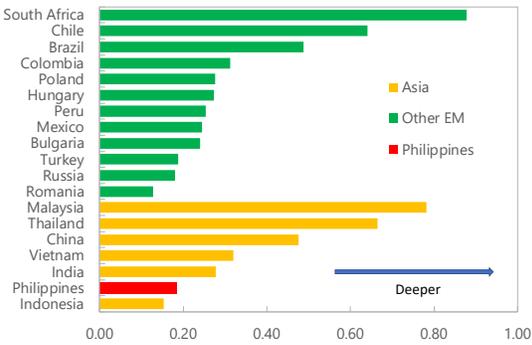
54. Improving capital markets and credit information could also advance inclusion. Simplifying the registration and approval process for the issuance of corporate debt could deepen the market. The national credit registry should increase funding to enhance its technology standards and resolve the technical issues to make the registry functional.

Figure 1. Financial Sector Development: Philippines and Selected Economies

Financial institutions' depth is on the lower side among Asian and other emerging markets.

Depth of Financial Institutions

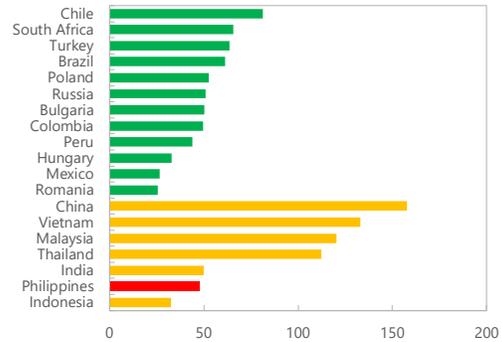
(Index based on bank credit, assets of pension and mutual funds, insurers' premiums in percent of GDP, IMF Financial Development Index)



Bank credits are on the smaller side among emerging markets.

Bank Credit to the Private Sector

(In percent of GDP, 2018)

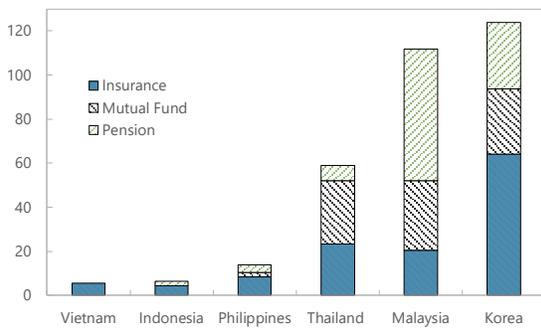


Sources: World Bank, World Development Indicators and IMF staff calculation.

NBFI sector is smaller than its peers

Non-bank Financial Institutions

(Assets in percent of GDP, latest available)

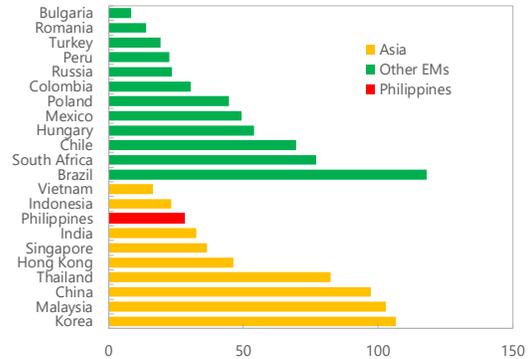


Sources: FinsStats, Financial Stability Board, and Fund staff estimates.

Bond markets are underdeveloped both in Asian and other EM peers.

Domestic bond market development

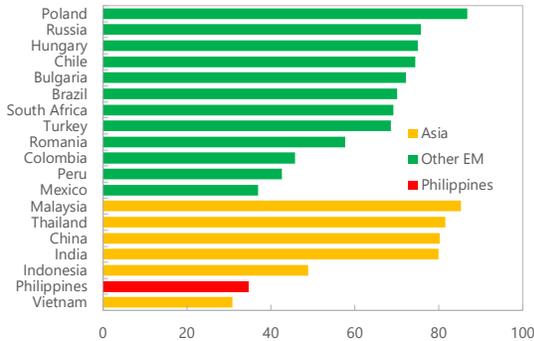
(Domestic bonds outstanding in percent of GDP)



Access to finance is much lower than EM peers, with only 34 percent of adults have formal accounts.

Adults with Financial Accounts

(In percent of survey respondents)

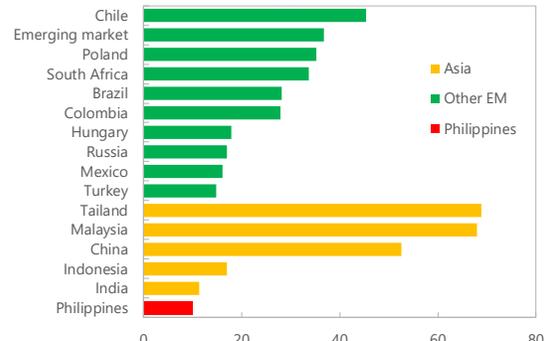


Sources: World Bank, Global Findex Data

Household debt from banks is the smallest among EM peers, and households borrow primarily from friends and families.

Household Credit

(In percent of GDP, 2018, consumer, mortgage, and household as employers)

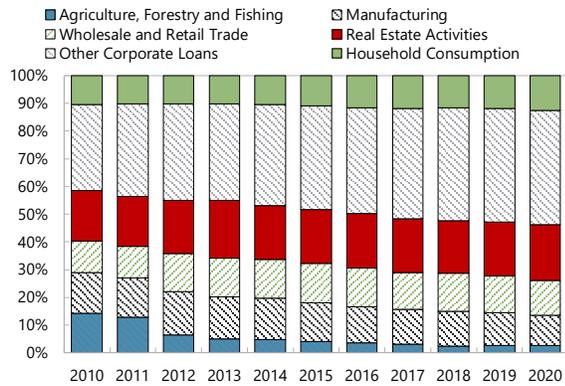


Sources: BIS, BSP, and IMF staff calculation

Figure 2. Business Model of the Banking System

Loans are largely given to the corporate sector.

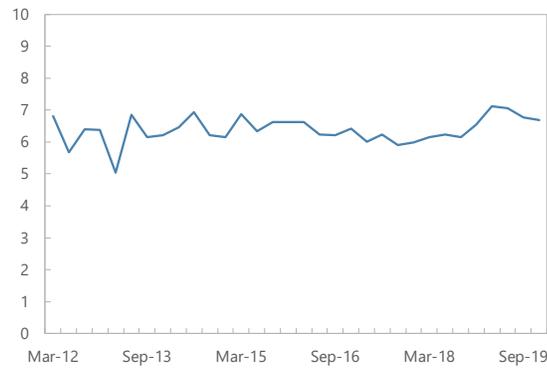
Loans by Sector



The share of directed loans to the agricultural sector under "Agri-Agra" law is about 7 percent of the total loans, even though banks are not fully compliant.¹

Directed Lending under the Agri-Agra Law

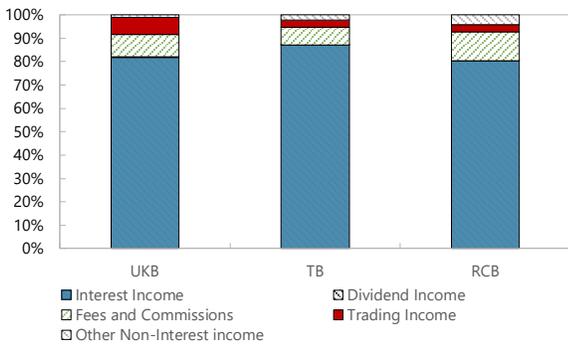
(In percent of total loans)



The main revenue source is interest income across all three types of banks.

Revenue Sources

(In percent of gross income, 2019)

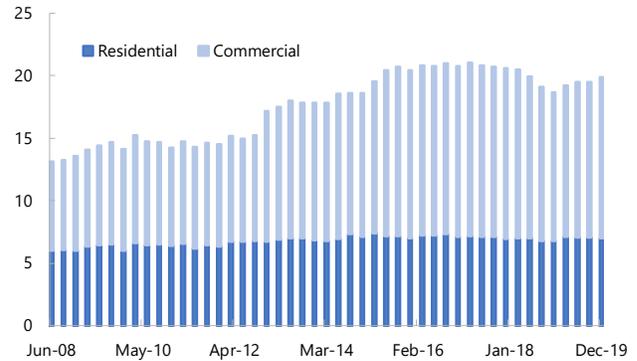


Sources: The BSP and IMF staff calculation.

Real estate loans are mainly commercial, and their share in total assets are capped at a relatively low 20 percent by the BSP.

Share of Real State Loans in Total Loans

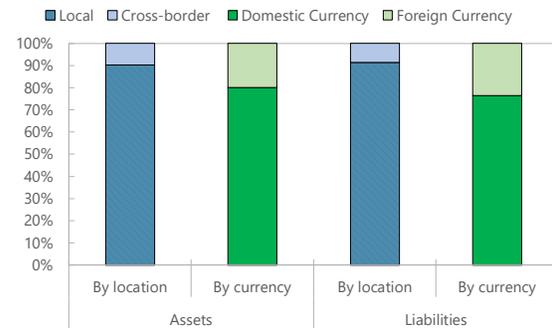
(In percent)



Banks have moderate levels of cross-border exposure and dollarization.

Bank asset and liability, by location and currency

(In percent of total)

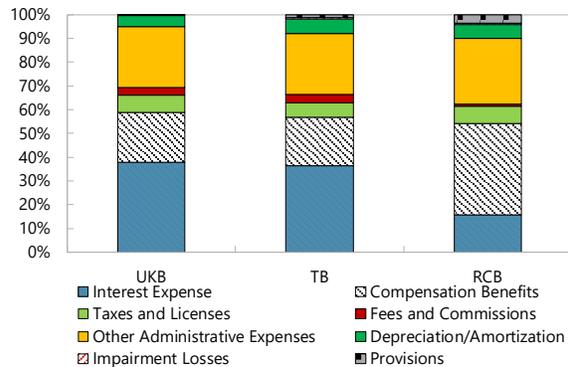


Sources: BIS Locational Cross-border data

Expenditures are mostly interest and administrative expenses, and salaries (especially for RCBs).

Expenditure Sources

(In percent of total 2019)



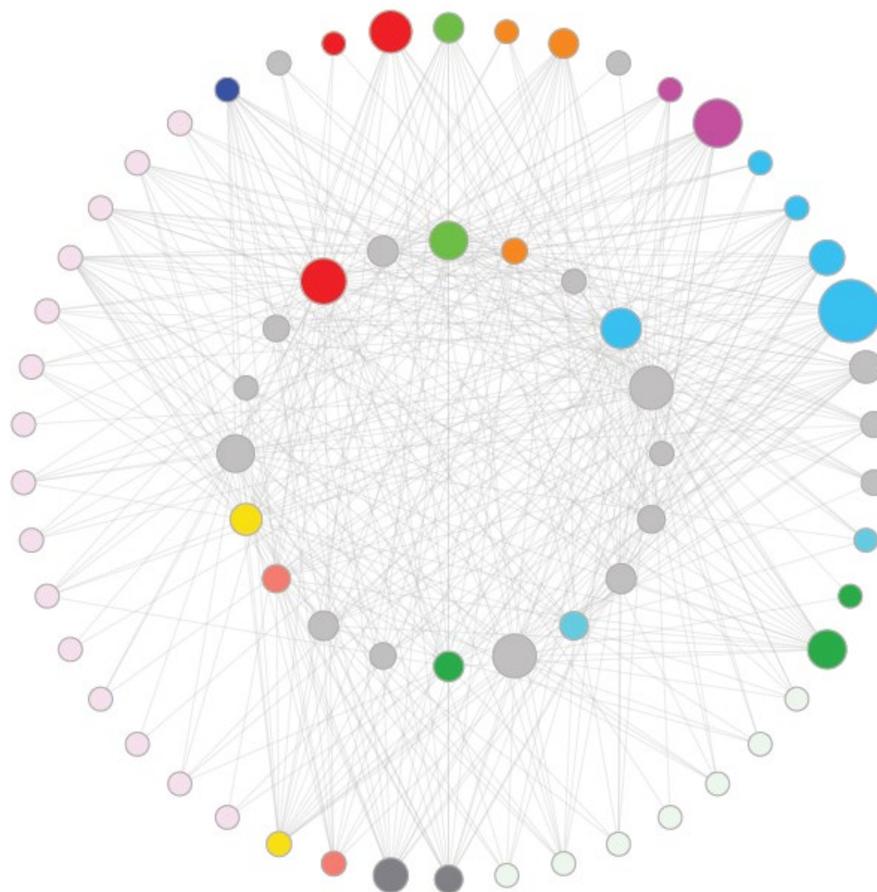
Sources: The BSP and IMF staff calculation.

1/ The law, introduced in 2009, requires banks to invest 25 percent of the increase of funding since 2009 (about 10 percent of UKB borrowing) to the broad agricultural sector (wider than the standard industry classification). At end-2019, UKBs provide about half of the required amounts and pay fines for shortfalls. The draft bill to expand the scope of qualifying investments is at the Senate.

Figure 3. Financial Linkage Among Banks and Conglomerates

(Inner circle = conglomerate groups, outer circle = banks)

The main source of interconnectedness is through bank lending to conglomerates (lines between outer and inner circles), rather than interbank exposures (among nodes on the outer circle). Large banks have significant exposures to a number of conglomerates, including their own. Each conglomerate also takes loans from various banks from within and outside of their own group. Contagion from common borrowers could be strong if any of the major conglomerates become distressed. The BSP study on network analysis shows that the failure of major conglomerates would have larger contagion effects on banks than banks' failure.



Sources: BSP and IMF staff visualization.

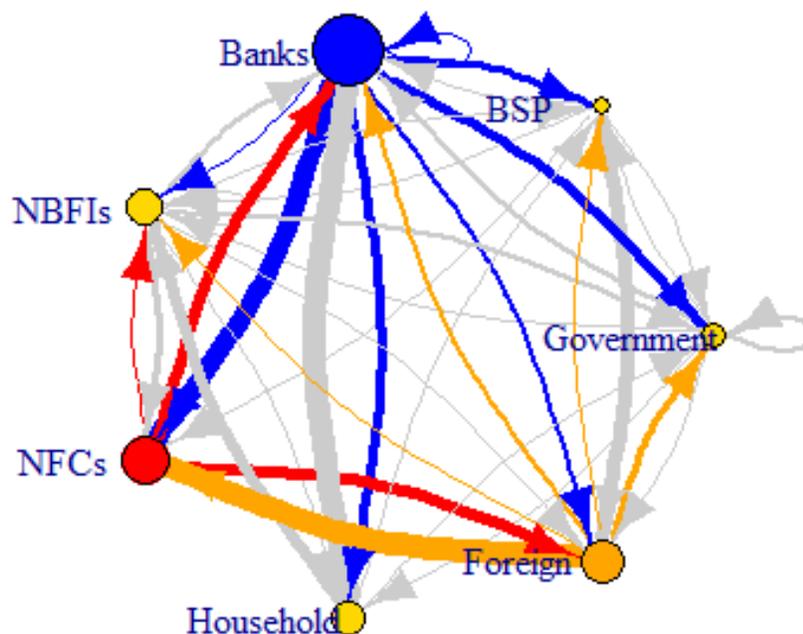
Note: The sample includes 20 large conglomerates. Out of all UKBs and thrift banks, those with more than one connection (lending counterparts among the 20 conglomerates) are included in the figure. Based on banks' large exposure data. Bank deposit data are not available due to the secrecy law.

Node size represents the degree of the network. Nodes color codes: light pink = thrift banks that are not part of any conglomerate; light green = foreign banks; dark grey = government-owned banks; light grey = conglomerates and banks in a conglomerate with a relatively smaller group total exposures; and other colors = other conglomerates—for instance, the three red nodes indicate a conglomerate groups and two banks that belong to the conglomerate.

Figure 4. Financial Linkage Map

(Network of Financial Claims, all instruments and currencies, March 2019)

Banks are at the center of financial linkage, followed by NFCs and foreigners. Banks fund themselves with mostly household deposits, followed by corporate deposits, while lend primarily to NFCs. They hold large liquidity buffer consisting of BSP reserve deposits and government securities. Foreign investment mostly goes to NFCs (including FDI, portfolio equity, and borrowing), followed by sovereign and banks. Banks' international liability is much smaller than their domestic liabilities and largely balanced with international assets amounting to over 80 percent of liabilities. However, the coverage is much lower for NFCs (about 20 percent) in part because NFC receives FDIs. NBFIs assets are mostly of institutions other than insurance and mutual funds (see Table 2).



Sources: BSP and IMF staff visualization.

NBFI = non-bank financial institutions, NFC = non-financial corporation.

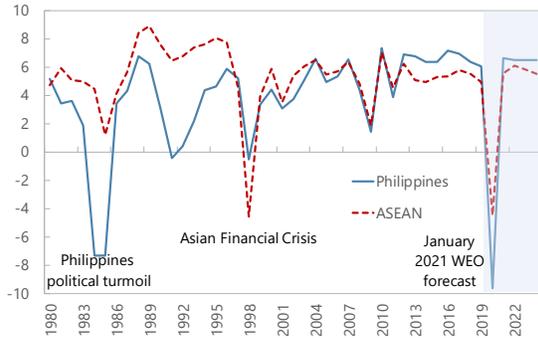
Yellow lines=liabilities to foreign investors, blue lines = bank assets, and red lines = NFC assets.

Bubble size represents relative financial footprint of the sector (sum of financial assets and liabilities). Financial exposure data among NFCs and between households and NFCs are missing.

Figure 5. Macro-Financial Indicators

The Philippines is more severely hit by COVID-19 than its Asian peers, with a weak growth forecast similar to the Asian Financial Crisis shock.

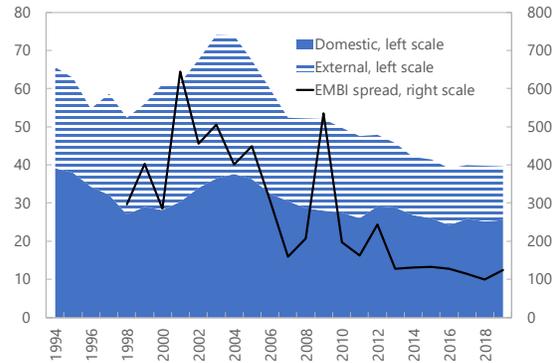
Real GDP Growth: The Philippines and ASEAN 5
(In percent)



But the economy went into COVID-19 crisis with generally stronger economic fundamentals with much lower sovereign debt and country risk premium...

Sovereign debt and risk premium

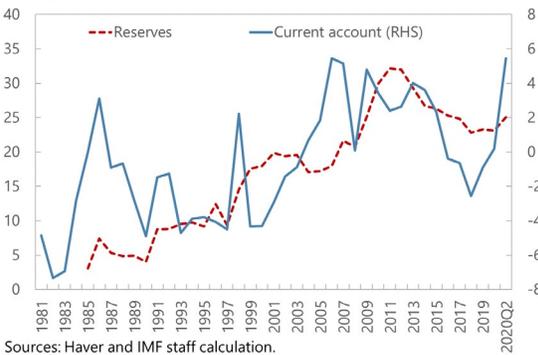
(Debt in percent of GDP, left scale; EMBI spreads in basis points, right scale)



...and higher international reserve buffers.

International Reserves and Current Account

(In percent of GDP)

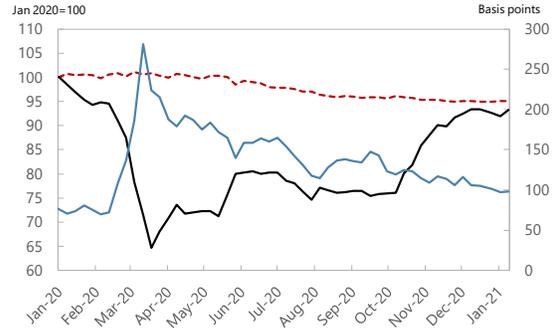


Sources: Haver and IMF staff calculation.

As a result, the exchange rate has appreciated by the end of the 2020, and the deterioration of EMBI spreads and equity prices in March moderated notably...

The Impact of COVID-19 on Filipino Asset Prices

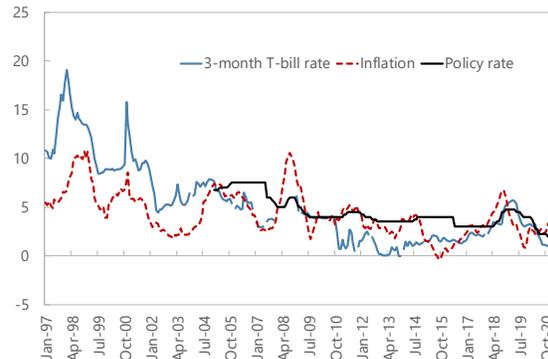
(Exchange rate, peso per USD (LHS) — Stock price (LHS) — EMBI spread (RHS))



...and the BSP managed to cut policy rate under stable broadly inflation, and T-bill rates declined, unlike AFC experience.

Interest Rates and Inflation

(In percent)



Sources: Haver Analytics, Moody's Analytics, Bloomberg, Datastream, national authorities, and IMF staff estimates.

The credit gap remains positive so far despite declining credit outstanding because of the contraction of GDP.

Credit gap

(In percent of GDP)

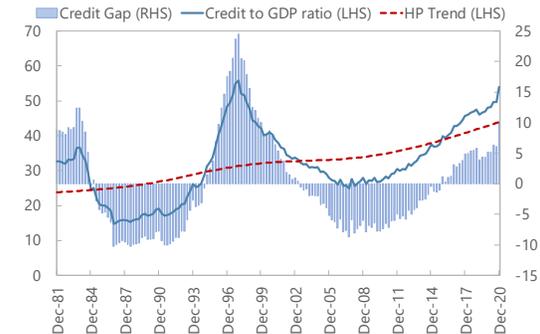
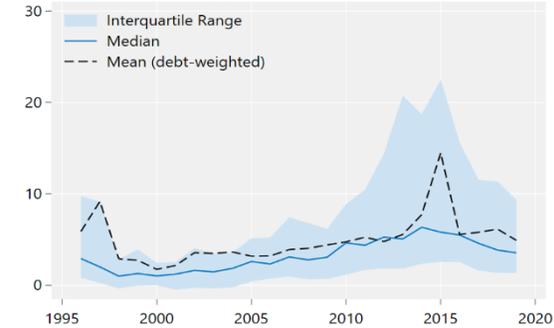


Figure 6. Risks from Non-Financial Sectors

The debt service capacity of NFCs is strong...

Interest Coverage Ratio

(In percent, EBIT/interest payment)

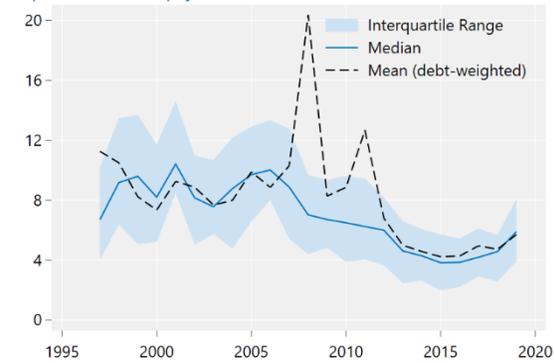


Sources: S&P Global Market Intelligence; and IMF staff estimates.

The slight declines of ICR in the past few years are mostly due to higher funding costs, as policy rates were tightened...

Effective Interest Rate

(In percent, Interest payment/total debt)

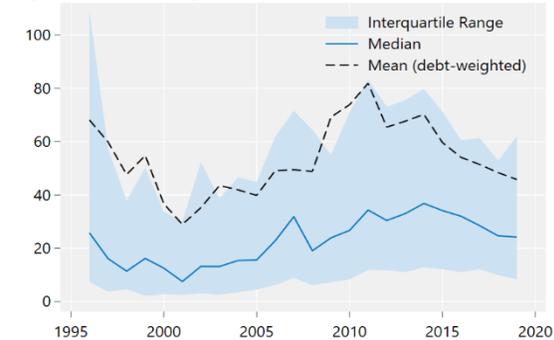


Sources: S&P Global Market Intelligence; and IMF staff estimates.

The cash buffer is also strong and provides additional resources to continue servicing debt upon earning shocks.

Cash Ratio

(In percent, cash and equivalents/total current liabilities)

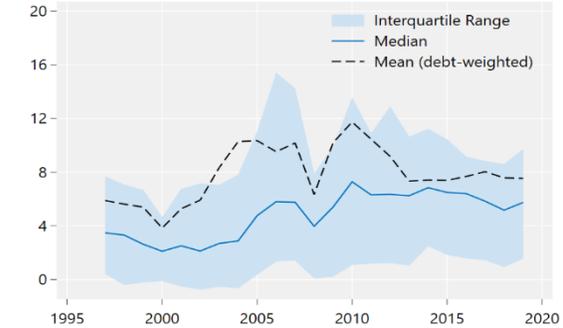


Sources: S&P Global Market Intelligence; and IMF staff estimates.

...supported by strong profitability.

Profitability: Return On Assets

(In percent, EBIT/assets)

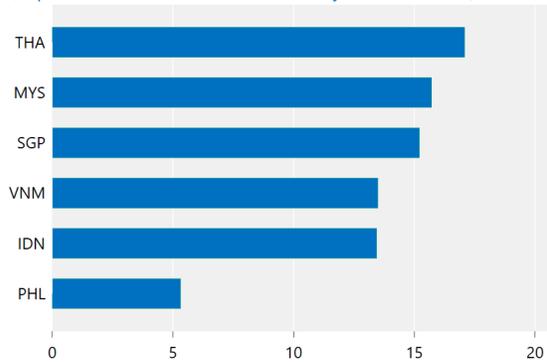


Sources: S&P Global Market Intelligence; and IMF staff estimates.

...still, the share of debt-at-risk is relatively low in the region.

Debt-at-Risk (ICR < 1)

(In percent of total debt in each economy, as of end-2019)

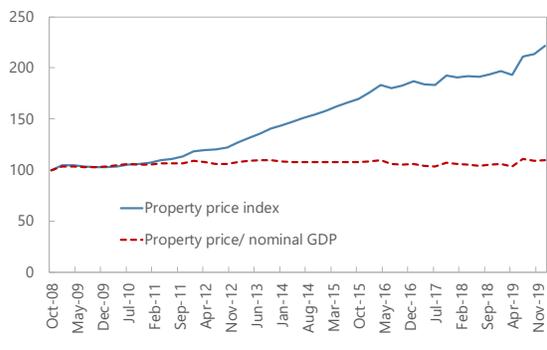


Sources: S&P Global Market Intelligence; and IMF staff estimates.

Real estate price has sharply increased since 2010, though reasonably in line with income growth...

Property Price

(Index, 2008Q4 = 100)



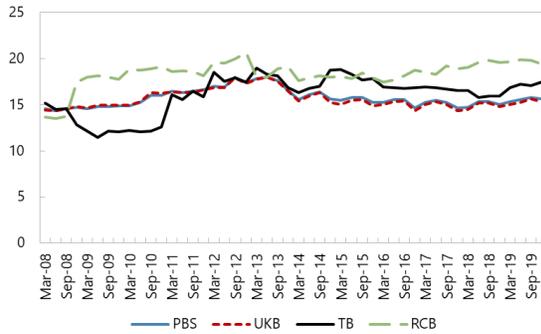
Sources: BIS and IFS, IMF staff calculation.

IDN = Indonesia, MYS = Malaysia, PHL = Philippines, SGP = Singapore, THA = Thailand, and VNM = Vietnam.

Figure 7. Financial Soundness Indicators

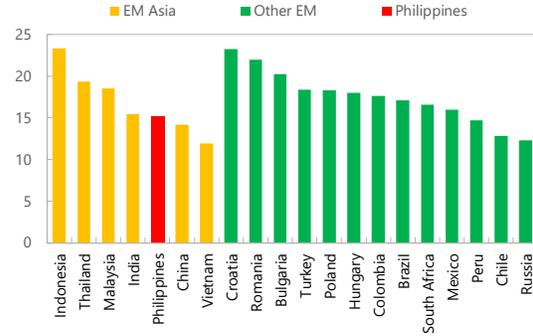
Bank capital ratios have been stable at about 15 percent in the past decade...

Capital Adequacy Ratio (CAR)
(Percent)



...at the lower side among EMs as others improved the capital ratio for the same period.

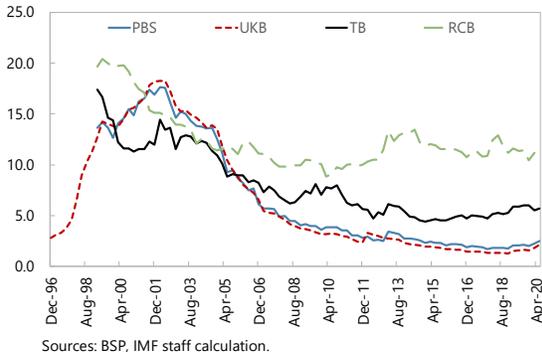
Total Capital to Risk Weighted Asset
(In percent, 2019 or latest)



Sources: IMF, Financial Soundness Indicator.

NPL ratio has declined substantially since the Asian Crisis. Smaller banks tend to have higher NPL ratios.

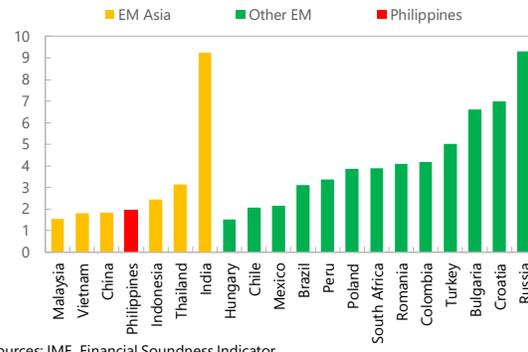
Non-performing Loans (NPLs)
(In percent)



Sources: BSP, IMF staff calculation.

The level of NPL ratio is lower than many EM peers.

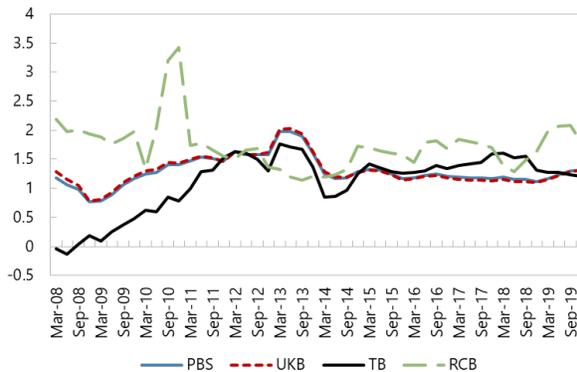
Non-Performing Loan to Gross Loan
(In percent, 2019 or latest)



Sources: IMF, Financial Soundness Indicator.

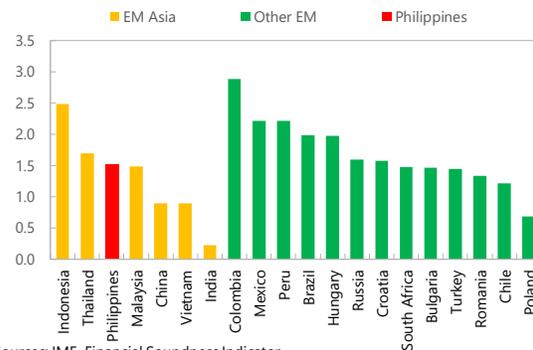
ROA has been stable in the past several years, and RCBs tend to show higher profitability.

Return on Assets (ROA)
(Percent)



The system-wide level of ROA is at about the median among EM peers.

Return on Assets
(In percent, 2019 or latest)



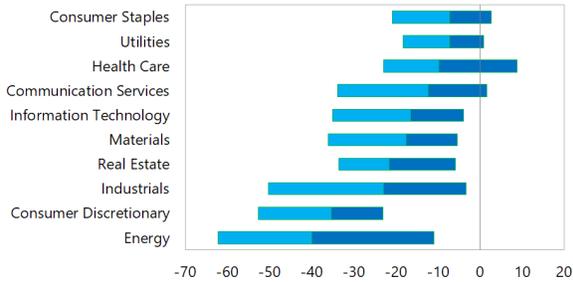
Sources: IMF, Financial Soundness Indicator.

PBS = Philippines banking system.

Figure 8. Non-financial Corporate Stress Test Results

Market analysts forecast considerable earning shock in 2020, especially for the industrials, consumer discretionary, and energy sectors.

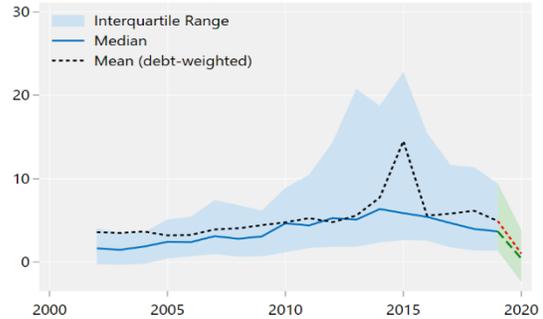
Expected Corporate Earning Shock by Industry 1/
(In percent, interquartile range)



Sources: S&P Capital IQ; and IMF staff estimates.
1/ Interquartile range of changes in analysts' 12-month-ahead company earning forecasts for each industry between January 2 and June 30.

Under these forecasts and the October WEO baseline, ICR deteriorates noticeably...

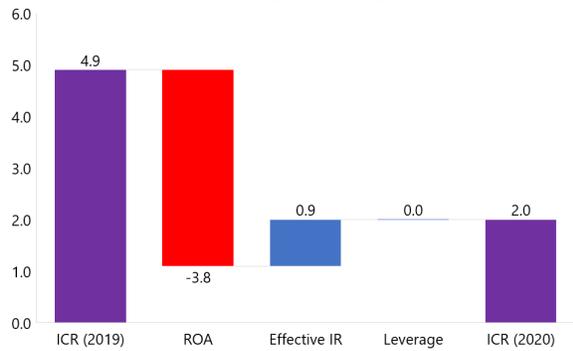
Philippines: Interest Coverage Ratio
(In percent, EBIT/interest payment)



Sources: S&P Global Market Intelligence; and IMF staff estimates.

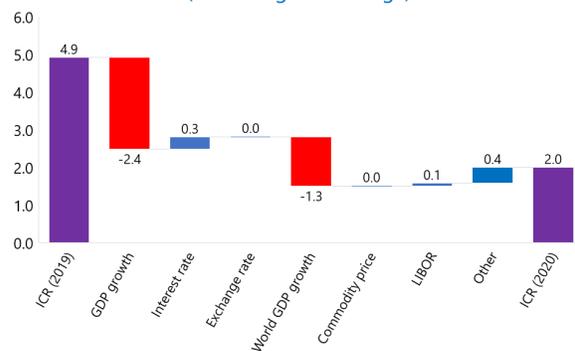
...mainly because of earning shocks...

Contribution to Change in ICR: 2019–2020
(Debt-weighted average)



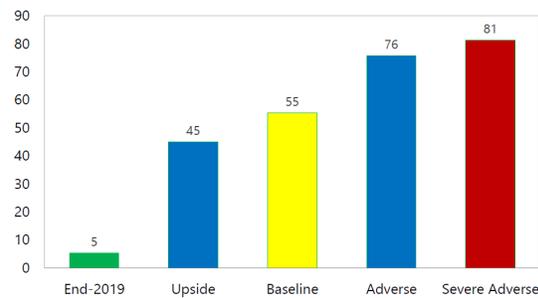
...as economic growth in the Philippines and the world drops rather than tighter financial conditions...

Contribution to Change In ICR: 2019–2020
(Debt-weighted average)



...and ICR deteriorates even more in adverse scenarios, causing systemic stress to the NFC sector...

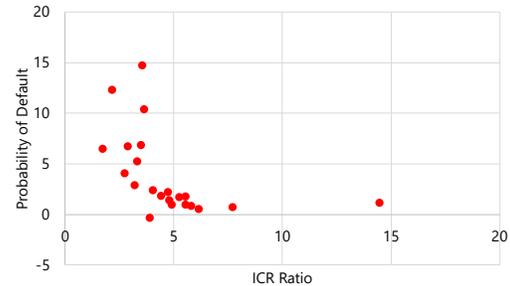
Philippines: Debt-at-Risk (ICR < 1)
(In percent of total debt, end-2020)



Sources: S&P Capital IQ; and IMF staff estimates.

...which is likely to increase the NPLs of banks.

Correlation: ICR And Probability of Default 1/
(ICR: debt-weighted average, 1997–2019)

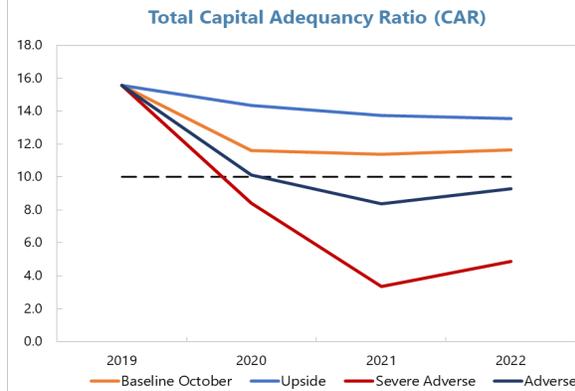


Sources: Bangko Sentral Ng Pilipinas; S&P Capital IQ; and IMF staff estimates.
1/ Defined as new flow into NPL/performing loans.

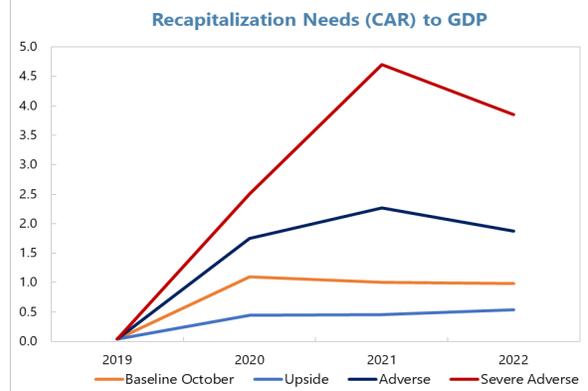
IDN = Indonesia, MYS = Malaysia, PHL = Philippines, SGP = Singapore, THA = Thailand, and VNM = Vietnam.

Figure 9. Bank Solvency Stress Test Results

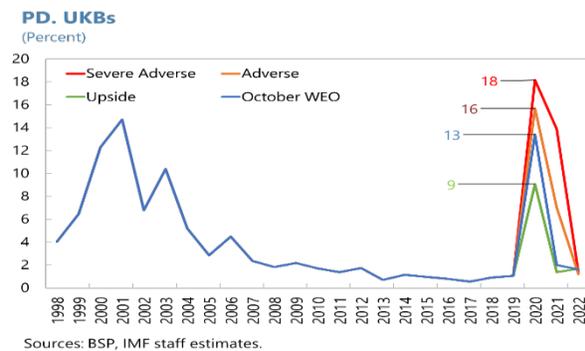
While banks can withstand the baseline shock, the system's CAR declines to below hurdle rate with some lags in the severe adverse scenario...



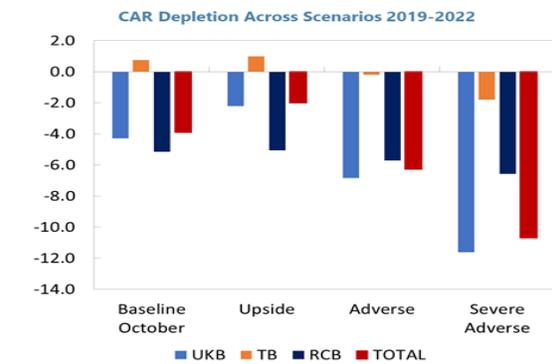
...and capital shortfalls vary between 1 and 4.7 percent across scenarios.



...as the probability of default of large banks (UKBs) responds to a sharp deterioration of GDP and unemployment rates.

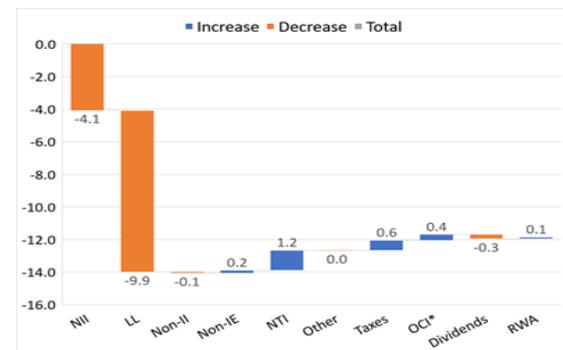


CAR of RCBs declines, the most except for the severe adverse case where UKBs are the most affected.



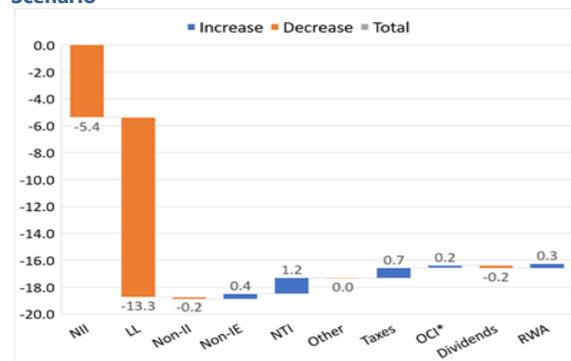
Provisions are the largest contributor to the decline followed by interest income in the adverse scenario...

Contribution to the Changes of CAR: Adverse Scenario¹



...as well as in the severe adverse scenario.

Contribution to the Changes of CAR: Severe Adverse Scenario¹



1/ Contribution is measured as the 2019 profit and loss multiplied by three minus 2020-22 cumulative profit and loss projection in each scenario.

NII = net interest income; LL = loan loss (provision); Non-II = non-interest income; Non-IE = non-interest expense; NTI = net trading income; and OCI = other comprehensive income (valuation change of available-for-sales securities).

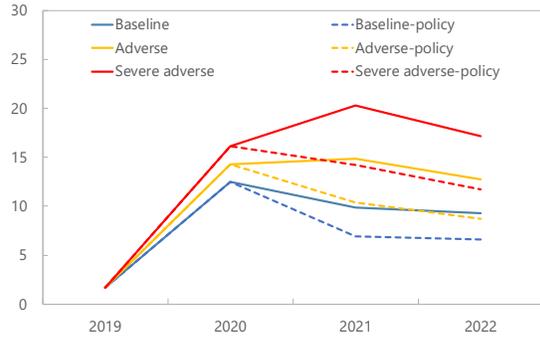
Figure 10. Second-Round Effects and Policy Effects Simulation

Counterfactual policy simulation considers the effect of a one-time cash injection to banks, reducing the 2021 stock of LLP by 30 percent.

The policy might be able to improve national income for several years over the cost of implementing the measure in baseline...

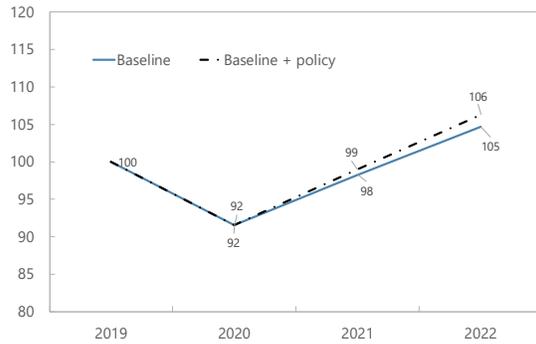
Counter-factual Policy Simulation

(Loan loss provision in percent of total loans)



Counter-factual Policy Simulation: Baseline

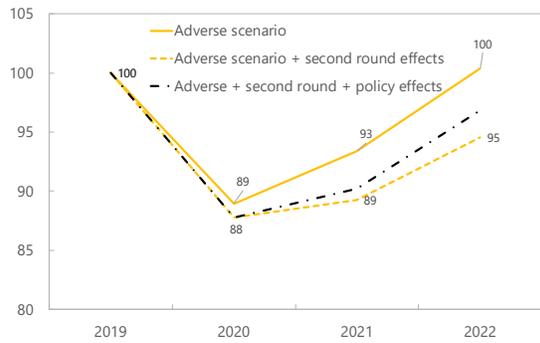
(2019 real GDP = 100)



...in adverse scenario...

Counter-factual Policy Simulation: Adverse Scenario

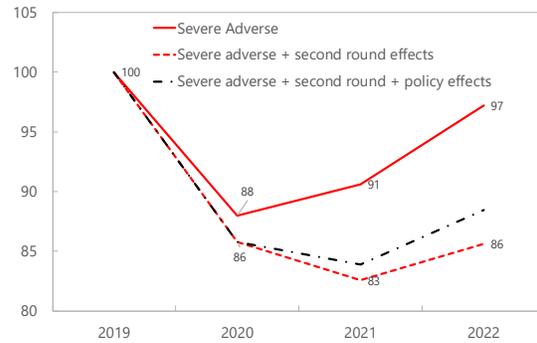
(2019 real GDP = 100)



...and in severe adverse scenarios.

Second-Round Effects: Severe Adverse Scenario

(2019 real GDP = 100)

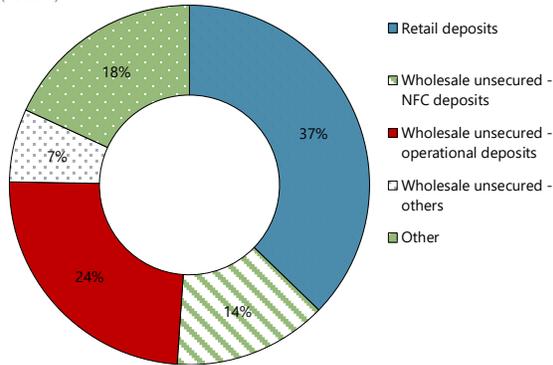


Note: See Appendix I for the details of counterfactual policy design.

Figure 11. UKBs Liquidity Analysis
(Data as of end-2019)

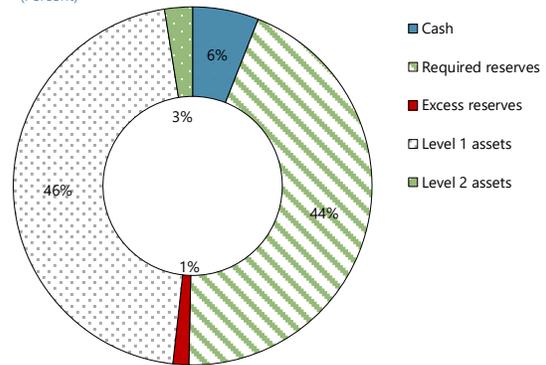
Banks rely mostly on retail and wholesale deposits.

Funding structure
(Percent)



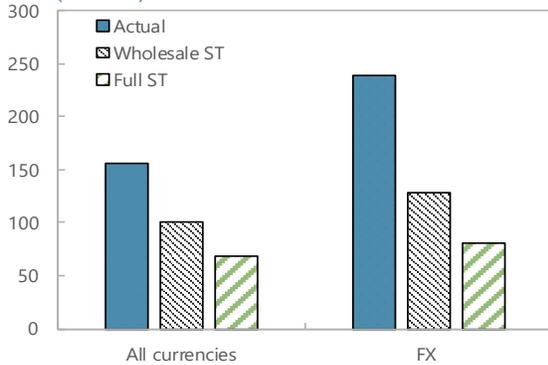
HQLA is mostly reserves and sovereign securities (Level 1 assets)

HQLA Structure
(Percent)



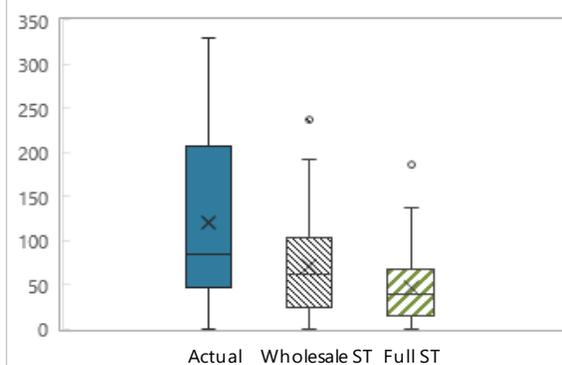
The whole system has sufficient liquid assets to absorb severe funding shocks, especially in FX.

Liquidity Coverage Ratio (LCR)
(Percent)



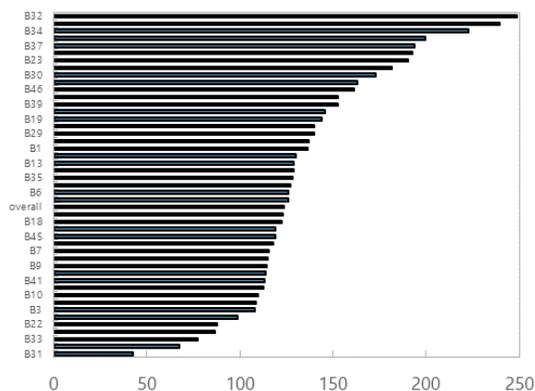
But FX-liquidity is concentrated in a few G-SIB branches.

LCR-FX: Distribution Across Banks
(Percent)



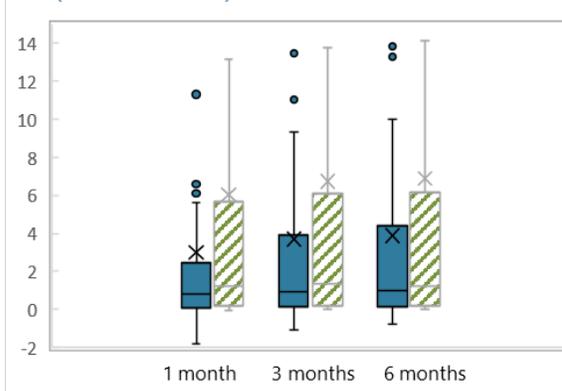
The long-term funding also appears mostly stable, except for a handful of branches of foreign banks.

Net Stable Funding Ratio (NSFR)
(Percent)



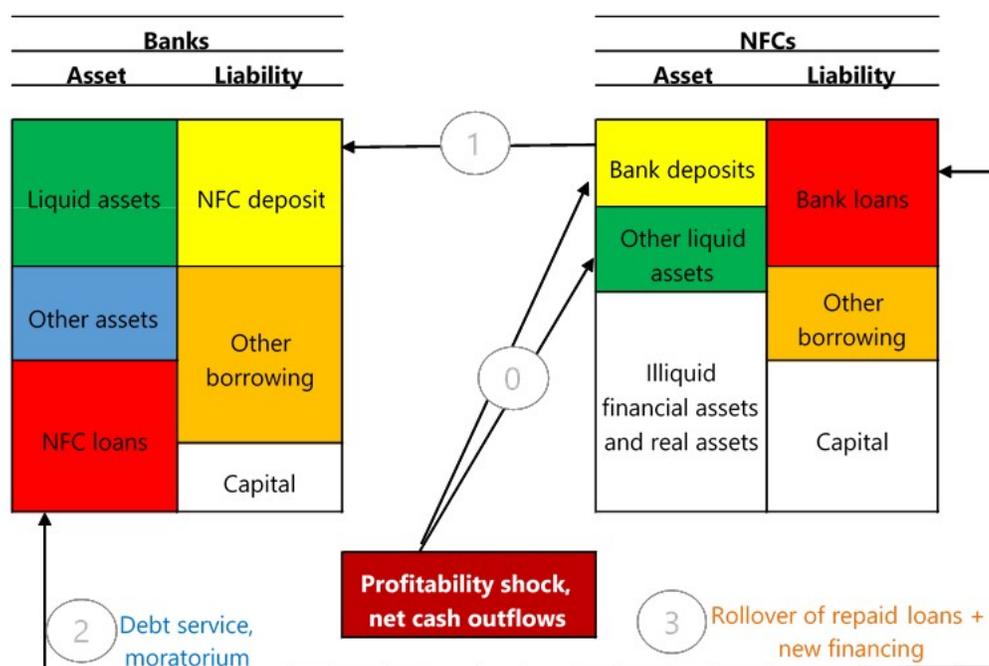
Liquidity buffers beyond 30 days also appear adequate for all banks, especially when all reserves are included.

Cashflow Stress Test
(Percent of GDP)



ER = excess reserve; FX = foreign exchange; HQLA = high-quality liquid asset; LCR = liquidity coverage ratio; RR = required reserve; ST = stress test.

Figure 12. Bank-NFC Liquidity Linkages—Framework



The tool is based on the cash-flow analysis of banks and NFCs (see Appendix I for details). It incorporates three channels of liquidity contagion between banks and NFCs upon NFC earning shocks (step "0" in the figure) that reduce corporate liquid asset balance.

1. **NFCs may cash their liquid assets, including bank deposits**, when their cash inflows from earnings are not enough to finance their operational expenditures and debt service obligation (indirect effect of moratoria). NFC deposit withdrawal rate is measured by $(\text{change of NFC cash balance between end-2020 and end-2019}) / (\text{end-2019 cash balance})$, assuming NFCs liquidate all types of liquid assets proportionally. If they cash in assets other than bank deposits and find alternative financing (e.g., bonds), the withdrawal rate stays low.
2. **Loan moratoria** help NFCs retain liquidity but reduce cash inflows to banks (direct effect of moratoria).
3. **Additional bank lending**—rollover of repaid loans and new financing—also shifts liquidity from banks to NFCs.

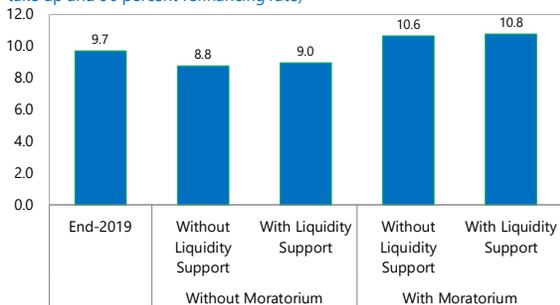
Figure 13. Bank-NFC Liquidity Linkage—Results

12-month moratoria and stress test period, 70 percent moratoria take up by NFCs, and high rollover rate (90 percent)

Moratoria improve NFCs' cash balance above the pre-stress level, but a high rollover rate limits the deterioration of cash position even without moratoria.

NFC Cash-to-Assets Ratio

(In percent of end-2019 total assets, 12 month, 70 percent moratorium take up and 90 percent refinancing rate)

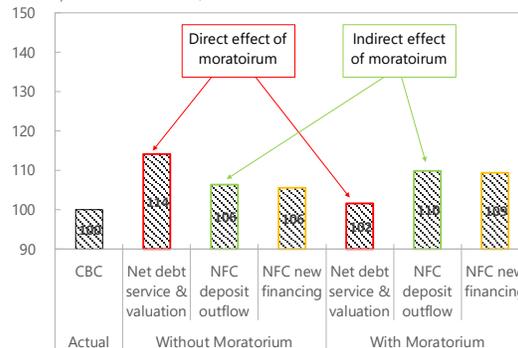


Sources: S&P Capital IQ; and IMF staff estimates.

While moratoria's direct effect reduces banks' liquidity buffer noticeably, the policy effects decline once the indirect effects from deposit withdrawal are accounted for.

Bank Counter-Balancing Capacity (CBC)

(12 month moratorium and test horizon; rollover rate = 90%, moratorium take up = 70%; in percent of initial CBC)

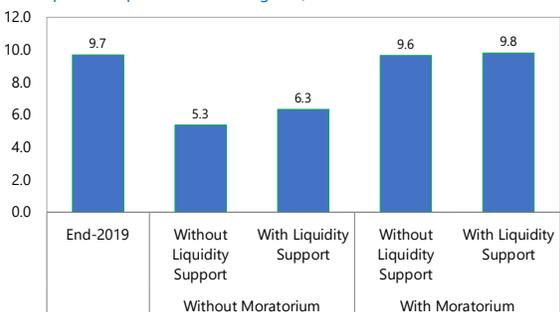


12-month moratoria and stress test period, 70 percent moratoria take up by NFCs, and low rollover rate (50 percent)

Moratoria improve NFCs' cash balance substantially compared to the levels without the measure.

NFC Cash-to-Assets Ratio

(In percent of end-2019 total assets, 12-month, 70 percent moratorium take up and 50 percent refinancing rate)

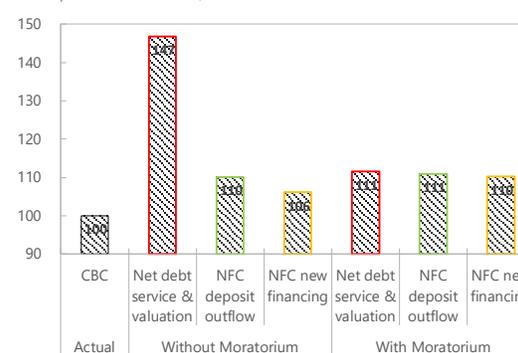


Sources: S&P Capital IQ; and IMF staff estimates.

With a lower rollover rate, the direct effect of moratoria on bank liquidity increase substantially. However, the policy effects become muted once the indirect effects from deposit withdrawal are accounted for.

Bank Counter-Balancing Capacity (CBC)

(12 month moratorium and test horizon; rollover rate = 50%, moratorium take up = 70%; in percent of initial CBC)



Note: The rollover rates of 90 percent are comparable to the distressed level observed during the past crises. During normal time, the rollover rates usually exceed 100 percent. Fifty percent is the assumption from Basel III LCR.

Table 2. Philippines: Financial System Structure

Type of Institution	Number of Institutions	Assets December 2019			Asset December 2009		
		Billion PHP	Percent of total	Percent of GDP	Billion PHP	Percent of total	Percent of GDP
Bank	547	18,338	76	94	6,512	74	81
Universal and Commercial Banks	46	16,919	70	87	5,779	66	72
of which, Government Banks	3						
Thrift Banks	50	1,153	5	6	555	6	4
Rural and Cooperative Banks	451	267	1	1	178	2	2
Non Bank Financial Institutions (NBFI)		5,700	24	29	2,303	26	29
Insurance ¹		1,716	7	9	554	6	7
Mutual Funds		285	1	1	59	1	1
Other NBFIs ^{1,2,3}		3,699	15	19	1,690	19	21
Total		24,039	100	126	8,815	100	110

Sources: National authorities

1/ Number of institutions is as of end-June 2019.

2/ Data on NBFIs is end-March 2019, except insurers and mutual funds, which is end-June 2019.

3/ Including investment houses, finance companies, investment companies, securities dealers/brokers, pawnshops, lending investors, non-stock savings and loan associations, venture capital corporations., and credit card companies, which are under BSP's supervision. The line also includes private and government insurance companies. Data is end-March 2019.

Table 3. Philippines: Selected Economic Indicators

Demographic: Population (2020): 108.8 million; Life expectancy at birth (2018): 71
 Poverty (2015, percent of population): Below \$1.90 a day: 6.1; Below the national poverty line: 21.6
 Inequality (2015, income shares): Top 10 percent: 34.8; Bottom 20 percent: 5.7
 Business environment (2019 country ranking): Ease of doing business: 95 (out of 190); Starting a business: 171 (out of 190)
 IMF quota: SDR 2,042.9 million
 Main products and exports: electronics, agriculture products, and business process outsourcing

	2016	2017	2018	2019	2020 Proj.	2021 Proj.
(Annual percentage change, unless otherwise indicated)						
National account						
Real GDP	7.1	6.9	6.3	6.0	-9.6	6.6
Consumption	7.4	6.0	6.8	6.4	-4.9	7.7
Private	7.1	6.0	5.8	5.9	-7.4	7.3
Public	9.4	6.5	13.4	9.6	9.6	9.2
Gross fixed capital formation	20.9	10.6	12.9	3.9	-27.9	8.2
Domestic demand	10.2	7.1	8.2	5.8	-10.4	7.8
Net exports (contribution to growth)	-3.8	-0.9	-2.3	-0.1	3.6	-2.4
Real GDP per capita	5.4	5.2	4.7	4.5	-10.9	5.0
Output gap (percent, +=above potential)	0.1	0.4	0.2	-0.1	-2.4	-0.5
Labor market						
Unemployment rate (percent of labor force)	5.5	5.7	5.3	5.1	10.4	7.4
Underemployment rate (percent of employed persons)	18.3	16.1	16.4	13.8	16.2	...
Employment (percent change)	4.7	-1.6	2.0	1.9	-6.1	5.2
Non-agriculture daily wages (Q4/Q4) 1/	2.1	4.3	4.9	0.0
Price						
Consumer prices (period average, 2012 basket)	1.3	2.9	5.2	2.5	2.6	3.2
Consumer prices (end of period, 2012 basket)	2.2	2.9	5.1	2.5	3.5	3.1
Core consumer prices (period average, 2012 basket)	1.5	2.5	4.1	3.2	3.1	...
Residential real estate (Q4/Q4) 2/	3.3	5.7	0.6	10.2
Money and credit						
3-month PHIREF rate (percent, end of period) 3/	2.0	3.3	6.5	3.1	1.3	...
Claims on private sector (percent of GDP)	42.9	45.6	47.6	48.0	53.7	52.9
Claims on private sector (percent change)	16.6	16.4	15.1	7.8	3.1	8.7
Public finances (in percent of GDP)						
National government overall balance 4/	-2.3	-2.1	-3.1	-3.4	-7.7	-9.1
Revenue and grants	14.5	14.9	15.5	16.1	15.9	14.5
Total expenditure and net lending	16.8	17.1	18.7	19.5	23.5	23.6
General government gross debt	37.3	38.1	37.1	37.0	47.0	52.3
Balance of payments (in percent of GDP)						
Current account balance	-0.4	-0.7	-2.6	-0.9	2.6	-1.2
FDI, net	-1.8	-2.1	-1.7	-1.2	-1.6	-1.0
Gross reserves (US\$ billions)	80.7	81.6	79.2	87.8	109.8	109.0
Gross reserves (percent of short-term debt, remaining maturity)	418.2	419.3	369.0	387.0	440.9	418.0
Total external debt	23.5	22.3	22.8	22.2	25.4	24.8
Memorandum items:						
Nominal GDP (US\$ billions)	318.6	328.5	346.8	376.8	362.7	391.7
Nominal GDP per capita (US\$)	3,108	3,153	3,280	3,512	3,334	3,547
GDP (in billions of pesos)	15,132	16,557	18,265	19,516	17,997	19,860
Real effective exchange rate (2005=100)	108.2	103.4	100.5	105.3
Peso per U.S. dollar (period average)	47.5	50.4	52.7	51.8	49.6	...

Sources: Philippine authorities; World Bank; and IMF staff estimates and projections.

1/ In National Capital Region.

2/ Latest observation as of 2019:Q4.

3/ Benchmark rate for the peso floating leg of a 3-month interest rate swap.

4/ IMF definition. Excludes privatization receipts and includes deficit from restructuring of the previous Central Bank-Board of Liquidators.

Table 4. Philippines: Financial Soundness Indicators
(In percent)

	2015	2016	2017	2018	2019	2020*
Capital adequacy						
Regulatory capital to risk-weighted assets	15.3	14.5	14.4	14.9	15.2	15.0
Regulatory tier 1 capital to risk-weighted assets	12.8	12.6	12.7	13.3	14.0	13.9
Capital to total assets	10.5	10.4	10.6	11.3	11.5	11.0
Non-performing loans net of provisions to capital	3.1	3.0	3.1	3.5	4.6	5.1
Net open position in foreign exchange to capital	2.4	2.0	7.9	4.7	5.8	3.5
Gross asset position in financial derivatives to capital	1.7	1.8	1.6	1.8	1.2	1.6
Gross liability position in financial derivatives to capital	0.0	0.0	0.0	0.1	0.4	0.6
Asset quality						
Nonperforming loan to gross loans	1.9	1.7	1.6	1.7	2.0	2.2
Specific provisions to nonperforming loans	70.1	69.7	66.9	63.2	58.0	57.6
Earnings and profitability						
Return on assets	1.4	1.4	1.3	1.3	1.5	1.4
Return on equity	13.8	13.7	13.6	12.7	13.9	13.0
Interest margin to gross income	70.7	69.2	73.9	75.2	74.0	76.3
Trading income to total income	5.7	8.3	4.3	3.2	7.8	9.4
Noninterest expenses to gross income	61.3	60.8	60.9	62.2	58.7	53.9
Personnel expenses to non-interest expenses	37.6	36.7	36.6	35.4	34.5	33.6
Liquidity and funding						
Liquid assets to total assets	38.8	35.6	32.9	32.6	32.1	30.6
Liquidity assets to short-term liabilities	60.6	54.6	51.8	50.7	48.8	46.9
Non-interbank loans to customer deposits	76.9	76.3	79.6	82.7	85.2	83.6
Sensitivity						
Foreign currency denominated loans to total loans	11.9	11.9	11.1	10.9	10.7	11.1
Foreign currency denominated liabilities to total liabilities	20.3	20.7	20.2	20.1	19.6	19.2
Real estate markets						
Residential real estate loans to total loans	7.2	7.3	7.2	7.1	7.3	7.4
Commercial real estate loans to total loans	13.9	14.3	14.1	12.3	13.2	13.7
Household Indebtedness						
Loans to households to total loans	17.4	17.8	17.9	17.6	18.3	19.3
Consumer loans to total loans	9.5	9.9	10.0	9.8	10.4	10.9
Mortgage loans to total loans	6.8	6.8	6.8	6.7	6.9	7.6
Loans to households as employers to total loans	1.1	1.1	1.1	1.1	0.9	0.8

Source: Philippines authorities; IMF, *Financial Soundness Indicators*; and IMF staff estimates.

*As of September 2020.

Table 5. Philippines: Main Policy Measures to Mitigate the Impact of COVID-19
(as of October 2020)

Monetary	
1	Reduction of the policy rate four times in 2020 by a cumulative 175 bps to 2.25 percent
2	Lowering of the reserve requirement ratio for banks by 200 bps to 12 percent
3	Relaxation of requirements for accessing the rediscount window
4	Purchase of PHP 300 billion worth of government securities (about 1.5 percent of 2019 GDP) through a repurchase agreement with the government and secondary market transactions
5	Distribution of PHP 20 billion as dividend to the government
6	Inclusion of peso loans to micro and SME (MSME) and certain large enterprises and certain large enterprises to calculate the compliance with reserve requirements (unusual measure to encourage banks to maintain MSME loans). In end-August 2020, loans to MSME and large enterprises accounted for about 8 and 1 percent of required reserves respectively
Regulatory	
7	A 90-day moratorium (ending May 2020) on all bank loan repayments during the Enhanced Community Quarantine period (part of the Bayanihan Act, March 2020). The BSP estimates that the uptake of the moratorium covered about 70 percent of total loans. In August 2020, Congress approved another 60-day moratorium taking effect mid-September (part of the Bayanihan Act II).
8	Relaxation of asset classification and provisioning requirements: (i) exclusion from the past due loan ratio of loans to affected borrowers until December 2021, (ii) staggered booking of allowance for credit losses over a maximum period of five (5) years, subject to prior approval of the BSP (strong form of regulatory forbearance).
9	The temporary relaxation of some reporting requirements and penalties on required reserves and single borrower limits (subject to review March 2021, possible regulatory forbearance measure).
10	The temporary relaxation of prudential regulations that allow banks to reclassify available-for-sale securities subject to mark-to-market valuation to held-to-maturity securities that are valued at their book value, which expires September 30, 2020 (regulatory forbearance).
11	The temporary reduction of micro and SME credit risk weights to 50 percent (below the Basel III minimum of 75 percent), subject to review end 2021 (regulatory forbearance).
12	Increase in the limit on banks' real estate loan share from 20 percent of their total loan portfolio (net of interbank loans) to 25 percent.
Exchange Rate and Balance of Payments	
13	The BSP has relaxed documentary and reporting rules for FX operations.
Fiscal	
14	The public response (part of the Bayanihan Act, March 2020) has four pillars: (1) PHP 205 billion cash aid program (1.1 percent of 2019 GDP) for 18 million low-income households for a period of two months (2) PHP 56 billion social protection measures for vulnerable workers, including for displaced and overseas Philippine workers (0.3 percent of 2019 GDP); (3) PHP 54 billion on COVID-19-related medical response (0.3 percent of 2019 GDP); (4) PHP 120 billion (0.6 percent of 2019 GDP) credit guarantee for small businesses and support to the agriculture sector.
15	Further fiscal support (part of the Bayanihan II Act, September 2020) will be provided to vulnerable households and to workers and businesses in hard-hit industries, such as agriculture, transportation, and tourism (0.8 percent of 2019 GDP).

Table 6. Philippines: Risk Assessment Matrix

Sources of risks	Relative likelihood	Impact and transmission channels
Unexpected shift in the Covid-19 pandemic. The disease proves harder to eradicate, requiring costly containment efforts and promoting persistent behavioral changes rendering many activities unviable.	Medium	High <ul style="list-style-type: none"> • A long-lasting pandemic with new strains prolongs containment measures and prevents fast recovery. It also increases corporate bankruptcies and longer-term unemployment, causing persistent scarring effects. • While risk assets are sold-off, strong fiscal and external positions before the COVID shock contains depreciation pressures. The central bank manages to maintain low policy rates, keeping funding costs at low levels. • NPLs will increase as macroeconomic shocks increase bankruptcies and reduce the repayment capacity of corporate borrowers. Higher unemployment could affect the repayment capacity of the household as well. • Bank capital declines substantially and, in turn, depresses economic recovery with weaker credit growth for a prolonged period (second-round effects). • While issued regulatory forbearance measures may optically help banks to maintain capital adequacy, these measures may create moral hazard and reputation risk and reduce the effectiveness of Basel III and macroprudential framework based on buffers (capital conservation, D-SIB, and CCyB).
Higher severity of natural disasters related to climate change causes severe economic damage.	Medium	High for extreme tail events. Moderate otherwise. <ul style="list-style-type: none"> • The Philippines has high exposure to the physical risk of climate change with natural disasters such as typhoons, landslides, floods, droughts, and sea-level rise. • Country-specific climate science models show that climate change could increase typhoons' intensity but reduce their frequency under the high global greenhouse gas emission and temperature increase scenario. • Physical capital losses reduce GDP directly and indirectly by reducing productivity for a prolonged period. • Such events could have a systemic impact on banks due to higher credit risk from macroeconomic shocks and operational risk. Certain industries (e.g., agriculture, real estate) and regions could be affected more, though large banks have little exposure to typhoon-prone regions and the agricultural sector. • Climate change is likely to increase the impact of extreme tail events on banks (especially when typhoon risk materializes with other disasters like pandemic). In contrast, the impact of less intense and more frequent events remains more or less the same and moderate. • Additional effects from sea-level rise, floods, and drought, among others, are likely to increase the impact of climate change even more. • Transition risk is concentrated in the coal-based power generation sector and the sectors with high fuel/electricity inputs.
The reputation risk to the country's frameworks for financial stability and AML/CFT from major financial crime events and limited actions to amend the bank secrecy law.	Medium	Medium <ul style="list-style-type: none"> • International confidence could diminish from insufficient supervision and monitoring of casinos, the gaming industry, and cryptocurrency exchanges, which could be abused for financial crimes. • The strict bank secrecy laws that limit financial supervisors' access to individual depositors could encourage criminals to misuse Philippine banks for fraud, money laundering, terrorism financing, and other financial crimes. • The reputational risk could pressure correspondent banking relationships, limit Philippine banks' access to global markets, and affect the flow of international remittances, resulting in depreciation pressure on the Philippine Peso.

Table 7. Philippines: Key Macroprudential Policy Measures (MPMs): Selected Asian Economies

	Philippines	Korea	Indonesia	Thailand	Malaysia
Broad-based tools 1/					
Countercyclical capital buffer (above 0%)	No	No	No	No	No
Capital conservation buffer	Yes	Yes	Yes	Yes	Yes
Limit on leverage ratio	Yes	Yes	Yes	No	Yes
Household sector tools					
Household sector capital requirement	No	No	No	Yes	Yes
Cap on loan-to-value ratio	Yes	Yes	Yes	Yes	Yes
Cap on debt-service to income ratio	No	Yes	No	No	No
Cap on household credit growth	No	No	No	No	No
Fiscal measures to contain systemic risks	No	No	No	No	Yes
Corporate sector tools					
Corporate sector capital requirement	No	No	No	No	N.A.
Loan/eligibility restrictions	Yes	No	Yes	N.A.	N.A.
Exposure caps on corporate credit	Yes	No	No	No	N.A.
Liquidity tools (banking sector)					
Liquidity buffer requirements	Yes	Yes	Yes	Yes	Yes
Stable funding requirements	Yes	Yes	Yes	Yes	Yes
Limits on foreign exchange positions	Yes	Yes	Yes	Yes	No
Tools for systemic liquidity risk and nonbank sector					
Asset management industry	No	Yes	No	Yes	No
Pension funds	No	Yes	No	N.A.	No
Insurance companies	No	Yes	No	N.A.	No
Tools for SIIIs and interconnectedness					
Capital surcharges for SIIIs	Yes	Yes	Yes	Yes	No
Exposure limits/additional risk weights between financial institutions	No	Yes	Yes	No	No

Source: IMF Macroprudential Policy Database.

1/ These broad-based tools are only applicable to the banking sector and, in some cases, to investment firms.

Note: In addition to these MPMs, the Philippines has extensive capital flow management (CFM) measures on FX transactions and borrowings—mostly to banks. For instance, banks have to obtain a separate license to handle FX transactions, and their access to non-deliverable forwards (NDFs) are constrained. However, many of the CFM measures do not apply for NBFIs and non-financial corporations as well as transactions in cash or foreign soil (that are not repatriated), which led to developing substantial and efficient informal FX and derivatives markets that are even larger than formal markets.

Domain		Assumptions
		Top-down by FSAP Team
BANKING SECTOR: SOLVENCY RISK		
1. Institutional Perimeter	Institutions included	<ul style="list-style-type: none"> • 542 banks: 46 UKBs (21 universal banks, 25 commercial banks), 49 TBs, 447 RCBs) for macro scenario tests.
	Market share	<ul style="list-style-type: none"> • Nearly 100% of total banking sector assets (92.3 percent UKBs, 6.3 percent TBs, and 1.4 percent RCBs)
	Data and baseline date	<ul style="list-style-type: none"> • Supervisory data (balance sheet and income statements) • Started position: December 2019 • Data on a 'solo basis.'
2. Channels of Risk Propagation	Methodology	<ul style="list-style-type: none"> • IMF Solvency Stress Test Workbox (Balance-sheet model)
	Satellite Models for Macro-Financial linkages	<ul style="list-style-type: none"> • Credit Risk: Satellite models per bank type to estimate loan losses. Regression model for logit transformed PDs. Regressors include the lagged dependent variable and contemporaneous and lagged macroeconomic variables: GDP growth, short term rates, term spread, unemployment, stock price, and exchange rate. • Market risk: valuation losses for HfT and AfS securities are calculated using a Mark to Market (MtM) approach. Valuation losses for held-to-maturity (HtM) securities are calculated using a credit risk approach. As a sensitivity analysis, an MtM approach is used for the HtM securities. • Net interest income: A gap analysis is conducted based on granular data on asset/liability structure of individual banks broken into types of funding sources and time to re-pricing buckets. Interest margin shocks vary per scenario. • Pre-impairment income for banks: Income in the absence of shocks is assumed to stay at the level observed for 2019 with the additional feature that non-performing loans will not generate any income. • No effects from sector-specific mitigation policies are incorporated. The scale of government credit guarantee is small (0.6 percent of GDP and given only to SMEs and the agricultural sector), and moratoria (introduced twice) already expired at the end- 2020. While the effects of forbearance to delay NPL recognition and loan-loss provisions continues over the five years, such measures are not consistent with Basel III and, therefore, should not be reflected in stress tests. We use end-2019 data instead of 2020 data because 2020 data are likely to be influenced by temporary or Basel III inconsistent measures. Starting with 2019 data allow us to estimate the potential 2020 figure without policy measures.
	Stress test horizon	<ul style="list-style-type: none"> • 3 years (2020-2022)

Domain		Assumptions
		Top-down by FSAP Team
3. Tail shocks	Scenario analysis	<ul style="list-style-type: none"> • Three macro scenarios, baseline, adverse, and severe adverse scenarios with varying degrees of COVID-19 impact, are considered. Across all scenarios, shocks affect mostly real economic activities. Financial conditions remain relatively benign: pressures on exchange rates are limited, and the central bank can cut policy rates supported by fairly strong economic fundamentals and ample global liquidity. • The baseline scenario follows October 2020 WEO, which factors in the tight containment effects in the first half of 2020 and a slow recovery path in the second half as the measures are relaxed and exhibit a sharp V-shaped recovery in 2021. The scenario shows a sharper GDP contraction in 2020 than the AFC but is followed by stronger medium-term growth in line with the potential growth rate of about 6½ percent. Compared to January 2020 WEO, the two-year cumulative growth in 2021 is 14.8 percentage points lower, corresponding to a three standard deviation shock using data from 1990-2019. Unemployment remains high at 11.3 percent at the end-2020 but returns to pre-COVID levels by 2021. • The upside scenario is similar to the baseline scenario but assumes a faster recovery in the second half of 2020. The real GDP contracts by -6.7 percent in 2020, compared to a contraction of -8.4 percent for the same period under the baseline. The unemployment rate shows a fast recovery, returning to pre-COVID levels by the end-2020. • The adverse scenario assumes prolonged containment measures throughout 2020 and some scarring effects (prolonged demand shock and rise in corporate bankruptcies and credit spreads) in 2021. The BSP manages to cut policy rates, reducing short term interest rates 290 basis points in 2020. However, stock prices decline by over 14 percent in 2020-21, and corporate credit spreads rise. As observed during the AFC, the net interest margin also declines by 15 percent at the worst point in the three years. Unemployment remains elevated at 14.8 percent by 2020 and 8.6 percent by 2021, returning to pre-COVID levels by 2022. • The severe adverse scenario assumes prolonged and even more stringent containment in 2020 with much severer and longer scarring effects in 2021 than the adverse scenario equivalent to a 3.8 standard deviation shock to the two-year cumulative growth. Still, the scarring effects are temporary, and the medium-term growth rate stabilizes at the same potential as the baseline by 2024. The BSP manages to cut policy rates subject to zero lower bound, reducing short term interest rates 290 basis points in 2020. However, stock prices decline by over 14 percent in 2020-21, and corporate credit spreads rise. The net interest margin also declines by 20 percent at the worst point in the three years. Unemployment remains elevated at 18.4 percent by 2020 and 11.9 percent by 2021, returning to pre-COVID levels by 2022. • Adverse macro scenarios are constructed using the DSGE model developed for the climate scenario.

Domain		Assumptions
		Top-down by FSAP Team
4.Risks and Buffers	Risks/factors assessed (How each element is derived, assumptions).	<ul style="list-style-type: none"> • Credit risk (provision costs) • Market risk, including FX risk • Stress on pre-provision profits, including interest margin
	Behavioral adjustments	<ul style="list-style-type: none"> • Balance sheet growth assumption: Quasi-Static—balance sheet size/GDP remains constant. • Balance sheet composition remaining constant over the stress test horizon. • Banks can only accumulate capital through the retained earnings. • Banks pay dividends only if net income after taxes is positive, with the dividend payout ratio consistent with individual banks' 2019 ratios for UKBs and individual banks' historical experience during 2014-2019 for TBs and RCBs. Out of the 542 banks, only 45 banks (11 UKBs, 2 TBs, and 32 RCBs) paid dividends with an average payout ratio of 13 percent for UKBs, 0.8 percent for TBs, and 0.9 percent for RCBs. • Tax rate: 30% (corporate tax rate).
5. Regulatory and Market-Based Standards and Parameters	Calibration of risk parameters	<ul style="list-style-type: none"> • PDs: proxies based on actual and estimated new NPL flows over performing loans. PDs for banks with limited credit information is taken as the weighted average PD of the rest of the institutions. • LGDs: 68 percent for UKBs, 35 percent for TBs, and 66 percent for RCBs, based on average historical provision coverage ratio (provisions/NPLs) that appear consistent with cross-bank type variation over collection and cure rates of NPLs. • Cure rates with respect to NPL(t-1): 10 percent for UKBs, 22 percent for TBs, and 24 percent for RCBs per year, equivalent to a quarter of historical averages to be conservative but more realistic than typical FSAPs that assume zero cure rates. In addition, an extra annual cure rate of 18 percent on New NPLs (t-1) is assumed for UKBs in 2021. This, given the concentration of their loan portfolio to the Manila area that has been the focus of the containment measures. This means that some of the loan defaults of 2020 are driven by shortage in liquidity rather than solvency issues.
	Regulatory/Accounting and Market-Based Standards	<ul style="list-style-type: none"> • Basel II standardized approach. • The hurdle rates are based on minimum capital requirements: 6 percent for Common Equity Tier 1 (applies only to UKBs), 7.5 percent for Tier 1, and 10 percent for total capital (T1+T2). • RWAs evolve with credit growth, net of increases in provisions. RWAs are further adjusted by the new NPLs that are not provisioned (to reach the weight of 150% required by regulation).

Domain		Assumptions
		Top-down by FSAP Team
6. Reporting Format for Results	Output presentation	<ul style="list-style-type: none"> • Capital shortfalls per bank type • Number of banks and percentage of assets that fail to meet the hurdle rates per bank type • Evolution of capital ratios under the scenario horizon per bank type\and for various bank classifications. • Decomposition of the drivers of changes in capital ratios per bank type • Distribution of capital ratios per bank type over the scenario horizon
BANKING SECTOR: SECOND ROUND (BANK-MACRO TRANSMISSION)		
1. Institutional Perimeter	Institutions included	<ul style="list-style-type: none"> • 46 UKBs (21 universal banks, 25 commercial banks)
	Market share	<ul style="list-style-type: none"> • 90.8% of total banking sector (gross) loan.
	Data and baseline date	<ul style="list-style-type: none"> • Solvency stress test results for Baseline (October WEO), Adverse and Severe Adverse scenarios • Started position: End of 2019 data
2. Channels of Risk Propagation	Methodology	<ul style="list-style-type: none"> • A simplified application of Catalan and Hoffmaister (2020) • Elasticities of (individual) bank loan growth to macroeconomic variables and bank-specific characteristics • Elasticities of macroeconomic variables to aggregate bank loan
	Satellite Models for Macro-Financial linkages (Bank-Macro transmission)	<ul style="list-style-type: none"> • Credit Growth Model (to estimate bank loan growth response to changes in macroeconomic variables and bank-specific characteristics): Panel model of UKB's bank with individual bank's credit growth as the dependent variable. After examining models with various regressors, the final model's regressors include lags of real credit growth, both contemporaneous and lags of macroeconomic variables (real GDP and the change in policy rate), and bank-specific factors (the change in NPL ratio and loan loss reserve ratio). Estimation period: 2008Q1-2019Q3. In contrast with the standard theoretical prediction, CAR and the difference between actual CAR and regulatory minimum requirements did not play significant roles. Therefore, they are excluded from the final model. This may reflect historical reliance on forbearance measures to delay NPL recognition and builds loan loss provisions (LLPs) only slowly (see Appendix IV). • SVAR (Structural Vector Auto Regression) macro-financial model: Five equations capture the interactions of key macroeconomic variables, including real credit, real GDP, inflation, real policy rate, and nominal exchange rate. The Cholesky decomposition is used to characterize the contemporaneous relations among the variables. Real credit is modeled as an autoregressive process and enters as the first variable in the model so that the other variables can react contemporaneously to changes in bank credit, but the reverse is not true. Estimation period: 200Q4-2019Q3.

Domain		Assumptions
		Top-down by FSAP Team
2. Channels of Risk Propagation (continued)	Satellite Models for Macro-Financial linkages (Bank-Macro transmission)	<ul style="list-style-type: none"> • Counterfactual policy experiment: Given that NPL ratio and loan-loss reserve models are the only two bank-specific explanatory variables significant in the final credit growth model, we considered the effect of reducing LLP stock by 30 percent (only) in 2021. The measure could be interpreted as using bank capital and income to write off NPLs by closing the gap between NPL and LLP (1-LGD).
	Adjustments and Assumptions	<ul style="list-style-type: none"> • UKBs' aggregate loan growth is used as an approximation of the overall banking sector's loan growth • Baseline real credit growth is assumed to be equal to baseline's real GDP growth • Real credit growth in adverse scenarios is calculated based on the baseline's real credit growth and the changes in real credit growth due to deviation of macroeconomic and bank-specific variables between non-baseline and baseline scenarios.
	Horizon	<ul style="list-style-type: none"> • 3 years (2020-2022)
3. Reporting Format for Results	Output presentation	<ul style="list-style-type: none"> • Second Round (bank-macro transmission) output: GDP growth path and GDP level path (relative to 2019 GDP). • Policy Simulation output: benefit and cost. Benefit is calculated as: (1) maximum difference in the level of GDP (based on cumulative GDP growth), and (2) sum of differences in the level of GDP (based on cumulative GDP growth). Cost is calculated as the amount of funds injected into the banking sector to implement the policy.
BANKING SECTOR: LIQUIDITY RISK		
1. Institutional Perimeter	Institutions included and their share	<ul style="list-style-type: none"> • 40 UKBs for modified LCR tests (90 percent of the banking system) • 46 UKBs for cashflow tests and NSFR (92 percent of the banking system)
	Data and baseline date	<ul style="list-style-type: none"> • Supervisory data on a solo basis • September 2019 (to be updated using March 2020 data)
2. Channels of Risk Propagation	Methodology	<ul style="list-style-type: none"> • LCR (one month) • Cashflow test (one, three, and six months) • NSFR (one year)
3. Risks and Buffers	Risks	<ul style="list-style-type: none"> • Funding liquidity • Market liquidity • Moratoria effects
	Buffers	<ul style="list-style-type: none"> • LCR: (stressed) cash inflows and HQLA • Cashflow: (stressed) cash inflows and counterbalancing capacity • N.A.

Domain		Assumptions
		Top-down by FSAP Team
4. Tail shocks	Size of the shock	<p><u>LCR</u></p> <ul style="list-style-type: none"> Run-off rates: Household deposits-highest historical cash withdrawals at bank levels—20 percent for less stable deposits and 10 percent for stable deposits. Institutional deposits: 60 percent for corporate deposits, 35 percent for operational deposits, and 20 percent for less stable, and 10 percent for stable retail deposits. Haircuts: 50 percent haircut to Level 2a assets (corporate bonds) <p><u>Cashflow</u></p> <ul style="list-style-type: none"> Run-off rates: 1 month—50 percent on institutional deposits and 20 percent on household funding; and roll-off rate of 50 percent on cash inflows. These rates gradually decline over 1-3 months and 3-6 months to reach 30, 10, and 10 percent. Haircuts: 20 percent on unencumbered eligible collateral and 50 percent on equities. <p><u>NSFR</u></p> <ul style="list-style-type: none"> Same as Basel III
	Regulatory standards	<ul style="list-style-type: none"> LCR: 100 percent, liquidity shortfall by bank Cashflow: net funding gap (shortfall) by bank NSFR: 100 percent
NON-FINANCIAL CORPORATE SECTOR		
1. Institutional Perimeter	Institutions included	<ul style="list-style-type: none"> 151 non-financial firms (147 listed and 4 non-listed)
	Market share	<ul style="list-style-type: none"> 44 percent of total NFC debt 70 percent of total market capitalization 46 percent of total bank loans
	Data and baseline date	<ul style="list-style-type: none"> Capital IQ, S&P Global Market Intelligence Consolidated balance sheets Balance sheet data as of end-2019
2. Channels of Risk Propagation	Methodology	<ul style="list-style-type: none"> Debt service capacity: ICR (one-year) Cash flow: cash ratio = cash and cash equivalent / current liabilities (one-year)
	Test horizon	<ul style="list-style-type: none"> 2020
3. Tail shocks	Size of the shock	<ul style="list-style-type: none"> ICR <ul style="list-style-type: none"> Macroeconomic shocks: <ul style="list-style-type: none"> Interest payment shock: 0 percent

Domain		Assumptions
		Top-down by FSAP Team
3. Tail shocks (continued)		<ul style="list-style-type: none"> ▪ Exchange rate shock: 4 percent appreciation against the USD - Operating income shock (in percent of operating income in 2019, varying across industries): <ul style="list-style-type: none"> ▪ Baseline: between -35 percent and -137 percent ▪ Upside: between -26 percent and -103 percent ▪ Adverse: between -39 percent and -151 percent ▪ Severe Adverse: between -47 percent and -185 percent ▪ In all scenarios, the least affected industry is utilities, and the most affected is consumer discretionary. • Cash flow analysis <ul style="list-style-type: none"> - $Capex_{2020} = \text{minimum of } 0.25 * Capex_{2019} \text{ and } 0.5 * depreciation_{2019}$ - Debt rollover ratio = 0.9 of maturing debt - Dividend payments = 0
4. Reporting Format for Results	Output presentation	<ul style="list-style-type: none"> • Distribution of ICR (median and interquartile range) • Debt-at-risk share by industry • Firm-at-risk share by industry • Cash ratio by industry
BANK-NFC LIQUIDITY LINKAGE		
1. Institutional Perimeter	Institutions included	<ul style="list-style-type: none"> • 151 non-financial firms (147 listed and 4 non-listed) and 40 UKBs
	Market share	<ul style="list-style-type: none"> • 44 percent of total NFC debt • 70 percent of total market capitalization • 46 percent of total bank loans • 90 percent of the banking system (UKBs)
	Data and baseline date	<ul style="list-style-type: none"> • Capital IQ, S&P Global Market Intelligence, the BSP (UKB data) • Consolidated balance sheets for NFCs, solo-based balance sheet for UKBs • Balance sheet data as of end-2019 for both UKBs and NFCs
2. Channels of Risk Propagation	Methodology	<ul style="list-style-type: none"> • Based on the 2020 IMF COVID-19 note in "system-wide FX liquidity stress test." • Cash-flow based liquidity stress tests for banks and NFCs and link assumption parameters (see Figure 16) • For banks, the analysis only considers shocks to transactions with NFCs. • Aggregate results of the NFC liquidity stress test (e.g., deposit withdrawal rate and new financing need) are applied to bank-by-bank liquidity stress tests (uniform assumption across banks). • NFC cash flow calculation formula <i>Cash balance</i> (x months in 2020)

Domain		Assumptions
		Top-down by FSAP Team
		<p>= Cash balance 2019 + earnings shock × net cash flows from operations × (x/12) - stressed capital expenditure × (x/12) - debt repayment with moratorium (= original debt repayment × (1-moratorium utilization) × (x/12)) + rollover of repaid debt (= debt repayment with moratorium × rollover rate) + interest income × (x/12) – interest expense × (1-moratorium utilization) × (x/12) - dividend payment × (x/12) + new financing (to bring cash balance(x, 2020) to zero for each firm)</p> <ul style="list-style-type: none"> - In the case with 5-month moratorium, debt payments (principal and interest) are set at about 40 (=5/12) percent of the original amounts in the baseline. - Capex₂₀₂₀ = minimum of 0.25 × Capex₂₀₁₉ and 0.5 × depreciation₂₀₁₉ - Dividend payments = 0 <p>• Bank cash flow calculation formula <i>Counterbalancing capacity (CBC) at month x in 2020</i> = CBC at end 2019 + net cash flows from operation within x (excl. loans and interests) + debt service receipt (= bank loan principal repayment in x months × (1-moratorium utilization)) – rollover rate × debt service receipt + interest income in x months × (1-moratorium utilization) – interest expense in x months - matured bank debt repayment within x + refinancing rate for banks (90 percent) × banks' repaid borrowing - deposit runoff rate × stock of deposits (NFC deposit runoff rate = Δcash by x month in 2020/cash at end 2019) - new financing to NFCs (to bring NFC cash position to 0 or above for each firms) - dividend payment within x + new financing inflows into banks + valuation change of CBC (i.e., haircut)</p> <ul style="list-style-type: none"> - Note: Moratoria and loan rollovers affect all loans (including household credit) but we only consider deposit withdrawal of NFCs.
	Test horizon	<ul style="list-style-type: none"> • 5 and 12 months (moratorium period = stress testing horizon)

Domain		Assumptions
		Top-down by FSAP Team
3. Tail shocks	Size of the shock	<ul style="list-style-type: none"> • Moratorium utilization rate = {0 (no moratorium), 50, 70, 90} percent • NFC loans rollover rate = {50, 90} percent • New financing to NFCs = {yes, no} • Refinancing rate of repaid loans by banks = 90 percent • Liquid asset haircuts 0% for cash, 2% for high-quality sovereign securities, 8% for low-quality sovereign securities, 11% for corporate bond, 10% for covered bond.
4. Reporting Format for Results	Output presentation	<ul style="list-style-type: none"> • NFC: change in cash balance in month x, 2020/ cash balance at end 2019 • Bank: change in CBC by month x, 2020/ CBC at end 2019
CLIMATE CHANGE STRESS TEST OF BANK SOLVENCY		
1. Institutional Perimeter	Institutions included	<ul style="list-style-type: none"> • 46 UKBs
	Market share	<ul style="list-style-type: none"> • 92 percent of the banking system by assets.
	Data and baseline date	<ul style="list-style-type: none"> • Supervisory data (balance sheet and income statements) • Started position: December 2019 • Data on a 'solo basis.'
2. Channels of Risk Propagation	Methodology	<ul style="list-style-type: none"> • Solvency stress test—the same as macro scenario stress tests, including risk factors, satellite models, and various micro and behavioral assumptions (such as LGD) following IMF solvency stress test workbox • Climate scenario—constructed by combining climate science, catastrophe risk, and macro-financial models
	Risk factors	<ul style="list-style-type: none"> • Physical risks—extreme weather events (typhoons) affecting bank solvency through their macro-financial impact • Credit risk, market risk, net interest income, and pre-impairment income shock follows the same approach as bank solvency stress test.
	Test horizon	<ul style="list-style-type: none"> • Three years upon an intense disaster. • <i>Current scenario</i>: A typhoon shock materializes in 2020, using end-2019 balance sheet data and hazard rate of typhoons (frequency and severity) as of 2020. • <i>Future scenario</i>: A typhoon shock materializes sometime in the mid-21st century, using end-2019 balance sheet data and the hazard rate of typhoons as of the mid-21st century.
3. Climate scenario	Scenario formulation method	<ul style="list-style-type: none"> • Scenarios consist of climate science, disaster, and macrofinancial scenarios. <ul style="list-style-type: none"> ○ <i>Climate scenario</i> provides the future distribution of typhoon severity and frequencies for the Philippines using climate science models, based on a given global climate scenario. FSAP scenarios are based on the

Domain		Assumptions
		Top-down by FSAP Team
3. Climate scenario (continued)	Scenario formulation method (continued)	<p>2018 exercise by the Philippines Atmospheric, Geophysical, and Astronomical Services Administration. It shows the impact of an internationally-accepted global scenario from IPCC (RCP 8.5—a high greenhouse gas emission scenario with little global-scale mitigation policies and technological advancement) for the mid-21st century. The global temperature would increase by 1.4-2.6°C above the 1986-2005 levels. For the Philippines, such climate change is likely to increase the intensity (windspeed) of severe typhoons but reduce their frequency.</p> <ul style="list-style-type: none"> ○ <i>Disaster scenario</i> provides the estimate of physical capital losses in percent of existing stock for a given likelihood (25-500 return period, namely, once in 25-500-year probability). For a given climate scenario, ten thousand possible losses from disasters are simulated using the catastrophe-risk model developed under the World Bank disaster risk financing and insurance program with the Government of the Philippines. While it considers direct destruction from typhoons, the additional effects from sea-level rise are not included. For each return period, the mission uses the losses at the 90th percentile of the ten thousand simulation results for the future scenario (the losses under the current scenario roughly correspond to the 25th percentile of the simulation results.) ○ <i>Macro-financial scenario</i> is constructed by a staff-developed Dynamic Stochastic General Equilibrium (DSGE) model calibrated for the Philippines. The physical damage is modeled as a capital depreciation shock, which also causes correlated productivity shocks in line with empirical findings in disaster/infrastructure economics (1/3 of the impact comes from short-lived capital depreciation and 2/3 from persistent productivity shocks). The model also includes adjustment costs with investment, slowing capital accumulation and, therefore, recovery.
4. Tail shocks	Size of the shock	<ul style="list-style-type: none"> • Two baseline economic scenarios before applying typhoon shocks <ul style="list-style-type: none"> ○ <i>Normal time</i>: January 2020 WEO forecast (before COVID-19 shock), in line with the potential growth rate of 6½ percent. ○ <i>Pandemic</i>: October 2020 WEO forecast that includes the impact of COVID-19. These scenarios consider the realization of two extreme events—pandemic and severe typhoons. • The severity of typhoons is measured by the value of destroyed physical capital in percent of existing capital (for both current and future scenarios), for 25-500 return periods (i.e., once in 25-500-years event). In the insurance industry, insurers price disaster insurance aiming at the losses under a 100-year return period. They examine the adequacy of their reserves for tail events (250-500 years return period).

Domain		Assumptions
		Top-down by FSAP Team
5. Risks and buffers	Risks/factors assessed (How each element is derived, assumptions.)	Same as bank solvency stress test
	Behavioral adjustments	Same as bank solvency stress test
6. Regulatory and market-based standards and parameters	Calibration of risk parameters	Same as bank solvency stress test
	Regulatory and accounting and market-based standards	Same as bank solvency stress test
7. Reporting Format for Results	Output presentation	<ul style="list-style-type: none"> The level of real GDP and aggregate CAR chart for three years for current and future scenarios showing the range of potential outcomes of the baselines (without disaster shocks) and stress scenarios (with typhoon shock ranging from once in 25-500-year severity.)

Appendix II. Implementation of 2010 FSAP Recommendations

Recommendations	Progress
Access to Finance	
Establish a credit bureau with positive and negative credit information that includes the whole banking system and information about utility payments.	Implemented
Expand access points for mobile services provision.	Implemented
Financial Sector Supervision—all sectors	
Expand legal protection for all supervisory staff (in line with proposed amendments to NCBA).	Implemented
Allow full access to individual deposit and investment accounts to all financial sector supervisory agencies (in line with proposed amendments to NCBA).	Partially implemented
Banking	
Enact proposed amendments to NCBA.	Partially implemented
Amend GBL and NCBA to give power to the BSP to set prudential rules without changing laws.	Implemented
Amend NCBA to allow BSP to set additional required capital and other limits according to a bank's risk profile.	Implemented
Update the definition of connected counterparties in the GBL in line with that in the proposed amendments to the NCBA.	Implemented
Amend the single borrower limit to and the definition of large exposures to apply on a solo and consolidated basis and include all on- and off-balance sheet exposures.	Implementation in process
Capital Markets	
Start onsite examinations for mutual funds and other SEC registered entities.	Implementation in process but implemented for mutual funds since 2015.
Amend SEC law to increase maximum penalties and have civil enforcement authority.	Changes filed with Congress
Enforce requirements on PSE ownership and create an autonomous and self-funded SRO for both stock and debt markets, reporting to the SEC.	On-going
Comply with existing law for SEC staff salaries.	Pending approval
Enact revised Investment Company Act.	Changes filed with Congress
Housing Finance	
Rationalize housing credit subsidy policy and role of public housing finance institutions.	Implemented
Apply BSP rules on loan provisioning to public housing loans.	Implemented
Reduce foreclosure "redemption" period for individual borrowers.	Not implemented
Insurance	
Harmonize minimum capital requirement to eliminate the distinction based on domestic or foreign ownership.	Partially implemented
Adjust risk-based capital rule to reflect local risks, while increasing intervention thresholds and rationalizing asset and investment requirements.	Implemented
Strengthen and enhance minimum liability valuation rules for life insurance.	Implemented
Start risk assessment, internal ratings, risk-focused interventions and targeted inspections.	Partially implemented
Safety Nets	
Amend PCA regulation to make it more proportional and timelier.	Partially implemented
Involve PDIC early on in dealing with PCA failure banks.	Implemented
Allow conservator /receiver to take full control to restructure a bank without shareholder approval once capital adequacy breaches a regulatory threshold.	Implemented
Amend law for a bridge bank resolution mechanism	Not implemented

Note: Based on both IMF and World Bank staff assessment.

Appendix III. Recommendations from Article IV Reports

Financial Sector Policy Recommendations 2019	
1	A strategy for proactive macroprudential intervention, including the introduction of borrower-based measures such as loan-to-value ratio and debt-service-to-income ratio, will help to address systemic financial risks, given risks of high credit growth resuming.
2	Bolder implementation efforts are needed for the strong structural reform momentum to bear fruit. The policy agenda could be reinforced by mobilizing more resources for climate change adaptation and mitigation and easing the bank secrecy law among others.
Policy Recommendations 2018	
Related Policy Actions	
1	<p>Introduce the countercyclical capital buffer (CCyB) for banks at above zero, while clearly communicating with market participants regarding the methodology and the set of indicators that will be used to calibrate the CCyB.</p> <p>Collect more granular data on real estate and project finance.</p>
	<p>The framework for CCyB was introduced in December 2018. The uniformly applicable rate of the CCyB is set at zero. CCyB decisions will be based on a set of indicators including, but not limited to, the credit-to-GDP gap as well as the growth quality of credit.</p> <p>From June-2018, all banks need to report information on their real estate loans to mid- and high-end housing units and submit a report on project financing exposures including the type of the infrastructure project and project phase.</p>
4	Promote financial inclusion.
	Several initiatives were implemented in 2018 to foster financial inclusion, including the approval of a framework for banks to offer Basic Deposit Accounts - which features simplified customer identify requirements and no minimum maintaining balance, and the passage of the Personal Property Security law – which allows the use of accounts receivables, inventory, crops, livestock, and other movable assets as collateral.
Policy Recommendations 2017	
Related Policy Actions	
1	Stand ready to tighten the policy stance in response to faster-than-expected credit growth with inflationary pressures, or a stronger-than expected impact of the fiscal expansion inflation.
	In June 2016, the BSP introduced a new interest rate corridor with a term deposit auction facility to manage liquidity. This has resulted in a de facto monetary tightening of about 60 basis points.
2	Monitor emerging systemic risks (especially in the real estate sector) and stand ready to respond with targeted macroprudential measures.
	The BSP set up a new financial stability department (December 2016) to enhance risk monitoring, and strengthened its in-house supervisory training.
	Allow the additional Single Borrower Limit (SBL) for PPP to lapse in December 2016.
	Implemented as recommended.
	Assign an explicit financial stability mandate to the BSP through amendments to its charter.
	An amendment to the BSP charter was submitted to Congress, which would expand the BSP's regulatory perimeter to the less regulated nonbank sector.
3	Develop capital market instruments to support infrastructure financing.
	The authorities are drawing up a comprehensive capital market development strategy, including enhancing the primary market issuance policy and introducing an interdealer repo market.

Appendix IV. Regulatory Forbearance Upon COVID-19 Crisis

The BSP issued several regulatory forbearance measures (Table 5) at an early stage of the crisis before exercising the Basel III and accounting frameworks' flexibility. In particular, the measure allowing banks to delay NPL recognition (upon the BSP's approval) until end-2021 and credit loss recognition gradually over five years—an unusually strong form of forbearance compared to other EMs—could significantly undermine banks' economic capital for an extended period. We welcome close monitoring of affected loans and the strict approval process, which have limited the uptake so far. But the measure, when used widely, risks creating weak banks that are not able to support the economy without additional capital.¹

The experiences of the AFC suggests that regulatory forbearance may slow economic recovery by suppressing credit growth. The BSP took similar measures upon the AFC, which limited the impact on reported capital, which declined only by a couple of percentage points over several years (with some recapitalization). With some delays, the NPL ratio rose from about 2 percent to 18 percent end-2001 and took ten years before declining back to the pre-crisis level. In the meantime, the credit-to-GDP ratio declined from over 50 percent in 1997 to about 25 percent in 2007 (Figure 5). This may point to that banks need to restructure NPLs before being able to support the real economy. These observations are consistent with the “credit-less recovery,” implying potentially significant lost opportunities from lower credit growth.

¹ See joint IMF-WB Staff Position Note, COVID-19: The Regulatory and Supervisory Implications for the Banking Sector (May 2020).

Appendix V. Bank Secrecy and Financial Integrity

The current arrangement to access information protected by bank secrecy laws could reduce the AML/CFT regime's effectiveness. The AMLC, as the financial intelligence unit and lead ML/TF investigative agency, is the primary agency that can access bank secrecy information. While the Philippines received a largely compliant rating on financial institution secrecy in Recommendation 9 under the FATF standards, such concentration of access potentially weakens the ability of AML/CFT supervisors and law enforcement agencies (LEAs) in performing their functions. For example, the BSP's ability to timely assess emerging ML/TF risks is constrained since it can only access protected information either through a request to the AMLC or during an onsite inspection. Meanwhile, the capacity of the AMLC to respond quickly to the requests for the protected information could affect the LEAs' ability to use financial intelligence for investigating predicate offenses. Thus, direct and full access to bank secrecy information should be extended to competent authorities (including the BSP, SEC, and IC). However, the recent resource increase in the AMLC and efforts to build capacity in LEAs are welcome as these can help facilitate more timely access to bank secrecy information and strengthen overall financial investigation for predicate offenses.

Appendix VI. Climate Change, Environment Risks, and Supervision

The mission examined climate change macroeconomic scenarios, building on the following three steps (Appendix I).¹

- **Climate scenario** is taken from existing climate science research by the government of the Philippines. It estimated the changes of typhoon frequency and intensity for the Philippines (windspeed) under the high-emission global scenario.
- **Disaster scenario**: The impact of extreme typhoons, measured by the value of lost physical capital over the existing capital (i.e., damage rate), is simulated using the CAT risk model developed by the World Bank. The damage rate is calculated following the current typhoon hazard risk (“current scenario”) and the future risk under the above climate scenario (“future scenario”). Following the practice in the catastrophe insurance industry, the mission considered several tail events (once in 25–500 years).
- **Macro-financial scenario**: The disaster impact is translated into macro-financial indicators with the staff developed DSGE model. The damage rate is modeled as a capital depreciation shock, which also causes correlated productivity shocks in line with empirical findings in the literature. The mission used two baseline scenarios: one using January 2020 WEO without pandemic before COVID-19 and the other using October WEO with the pandemic.

The exercise and results should be interpreted with caution. Climate change stress tests face significant model and scenario uncertainties. Moreover, the FSAP exercise covered only a small component of the risks due to climate science and CAT risk models’ limitations. It covered only the effects of building/infrastructure destructions by typhoon wind without incorporating the effects of sea-level rise and floods. Other types of risks—drought, flood, and transition risks—could increase the impact in less extreme events. Also, additional channels could amplify the impact of disasters, such as the impact of fiscal expansion for reconstruction on sovereign risks and their spillovers to banks. Given the early stage of the literature and various uncertainties, it is premature to discuss prudential policy measures based on one stress test results.

¹ The approach is developed by Fabian Lipinski, Paola Morales, Hiroko Oura (all IMF), Stephane Hallegatte, Martijn Gert Jan Regelink, Nicola Ranger, Henk Jan Reinders, and Brian Walsh (all World Bank).

**Statement by Ms. Mahasandana, Executive Director for the Philippines, and
Mr. Bautista, Advisor to the Executive Director
March 5, 2021**

Introduction

1. The Philippine authorities thank the IMF FSAP team for the insightful dialogue and meaningful exchange of views during the mission. Our authorities recognize the prompt adjustments made by the mission team to consider the impact of the COVID-19 pandemic in the assessments and to complete the mission using fully virtual platform.
2. Our authorities appreciate and broadly agree with the staff's assessments and policy recommendations. While our authorities may hold different views on certain issues covered, the analyses, observations, and recommendations in the report provide them with useful inputs in their shared interest in making the Philippine financial system more resilient to future disruptions.

Risk Assessment and Stress Testing

3. The COVID-19 pandemic continues to pose shocks to the global economy and the Philippines is not insulated from the adverse effects.
4. The long track record of structural reforms in the financial system has resulted in the build-up of ample capital and liquidity buffers. The Philippine Banking System (PBS) continues to post comfortable margin over the prescribed minimum capital ratio of 10 percent (10%) amid the pandemic. Banks have also increased their provisions for credit losses since the onset of the crisis. Based on the authorities' internal stress testing exercises, capital levels will only be affected in extremely severe scenarios. The authorities are highly confident that risks to the banking sector will be well-contained under the baseline scenario and stand ready to provide more targeted support if the worst-case scenario materializes.
5. As the spread of COVID-19 is being contained progressively— along with the availability of vaccines – normalization should ensue. One important development is the signing into law by the President a bill that will hasten the procurement of vaccines and create an indemnity fund to cover compensation for individuals who may experience adverse side effects. This will help facilitate the normalization process and economic recovery. Amid strong headwinds, our authorities reiterate the continuing need for sustained policy support. Adequate monetary accommodation was provided to complement crucial fiscal policy measures in supporting private demand and market confidence. In the meantime, our authorities note the resilience of the financial system despite the contraction in the GDP and in other economic activities.
6. The Philippine Government has ample fiscal policy space to support priority expenditures in rebuilding the economy. It has allocated funds to address the pandemic and its economic impact, such as (i) the 2021 national budget which prioritizes health-related programs and infrastructure projects, (ii) the *Bayanihan 2* which was extended under Republic Act (RA) No. 11519 until 30 June 2021, and (iii) the 2020 national budget which was extended under RA No. 11520 until 31 December 2021. The Bangko Sentral ng Pilipinas (BSP) also extended provisional advances to the government in support of its measures to deal with the

health crisis.¹ Moreover, the government has room for fiscal policy response and to borrow funds for priority projects. The country's outstanding debt-to-GDP ratio remains manageable and relatively low at 54.5 percent as of the last quarter of 2020. The bulk of the debt is denominated in local currency at about 70 percent. Overall, the country's fiscal position remains sound and favorable, providing enough fiscal policy leeway for the government to respond to crisis.

7. On the recommendation to limit dividend distribution, the BSP may limit or prohibit dividend declaration as provided in the law and the regulations governing dividends, as necessary. Dividend prohibition is handled on a case-by-case basis considering the bank's varied internal capital targets, stress testing results, risk profile, among other factors. Banks applying for relief measures may be restricted from making dividend or other forms of profit distributions. This restriction applies automatically to banks that utilize their capital conservation buffers and may be imposed on banks that have reached their internal capital targets.
8. We agree with staff's view that the results of the bank solvency test and the second-round effects should be interpreted with caution due to possible bias in the results which are sensitive to the assumptions. In addition, the conservative parameters in the FSAP assumption increase the negative impact while credit risk during a deep economic crisis may evolve differently from what historical patterns imply. Meanwhile, our authorities understand that the IMF's solvency stress test did not consider the effects of regulatory response and statutory loan moratoria. The BSP strongly considers the **time-bound** relief measures implemented as crucial in supporting banks to weather the crisis and in promoting the overall stability of the financial system. The BSP is currently assessing the appropriate timing to reduce or scale back the COVID-19 relief measures to ensure smooth transition post-pandemic. The BSP underscores that while there are regulatory reliefs implemented such as staggered booking of allowance for credit losses and delayed classification of past due or non-performing loans, the banking industry statistics published on the BSP website reflect the actual level of soured loans and do not consider said relief measures.
9. More extensive measures are also underway to moderate the spillover effects of the pandemic on the real economy. The recent enactment of Republic Act No. 11523 or the Financial Institutions Strategic Transfer (FIST)² Act will facilitate the mobilization of savings and investments in the financial system to support the country's economic recovery and sustained growth. It will also ease banking system stress through the removal of soured loans and other non-performing assets (NPAs) by banks. This could serve to free up capital to augment the banking system's liquidity and capacity to expand investment and lending activities. Moreover, the proposed Government Financial Institutions Unified Initiatives to Distressed Enterprises for Economic Recovery (GUIDE)³ bill aims to reinforce the capacity of government financial institutions to give financial assistance necessary for the continued operations of micro, small, and medium enterprises (MSMEs) and other strategically important industries. Finally, the Corporate Recovery and Tax Incentives for Enterprises (CREATE)⁴ bill aims to reduce corporate income tax and rationalize fiscal incentives.

¹ This is temporary and subject to the limits provided for under the law.

² FIST Act was signed into law by President Rodrigo Duterte on 16 February 2021.

³ GUIDE bill was approved on the third and final reading at the House of Representatives on 9 February 2021.

⁴ CREATE bill was ratified at both Houses of Congress on 4 February 2021 and for signature by the President.

10. On climate change stress testing, our authorities agree on improving data collection to enhance analysis of climate risks, particularly physical risks and its impact on individual financial institutions and the overall financial system. Our authorities are conducting several awareness campaigns and capacity building activities in the areas of climate change and sustainable finance, which cover environmental and social risk management, among others, to equip regulators and supervisors as well as supervised entities.
11. To further improve climate stress testing, estimation of shocks and policy advice, staff may want to take into consideration the various features of the laws that have been enacted. For example, the Climate Change Act of 2009 created the Climate Change Commission to oversee the programs and action plans relating to climate change. The National Climate Change Action Plan 2011-2028 prioritizes food security, water sufficiency, ecological and environmental stability, human security, climate-smart industries and services, sustainable energy and knowledge and capacity development as the strategic themes and direction.
12. In addition, the Philippine Disaster Risk Reduction and Management Act formed the various levels of disaster risk reduction and management (DRRM) councils. This facilitates the coordination of responses to natural calamities at all levels – national, regional, provincial, and local governments units. The Philippine Disaster Risk Reduction and Management Act also established the local DRRM fund, setting aside 5% of estimated revenues for prevention, mitigation, and responses. Moreover, the national government issued catastrophe bonds to sustain the growth momentum while climate-proofing the country by providing protection against earthquake and tropical cyclone risks through the issuance of insurance-linked securities. This demonstrates the ability of the government to tap various financing mechanisms to deal with natural disasters and to ensure that ample fiscal space remains in place. That said, the authorities remain fully committed to fiscal discipline and consolidation over the medium-term, consistent with its monetary and financial sector stability objectives.

Macprudential Policy Framework and Oversight

13. The establishment of the Financial Stability Coordination Council (FSCC)⁵ in 2011, the conferment of the BSP's financial stability mandate in 2019, the creation of an *en-banc* Board-level Financial Stability Policy Committee at the BSP in 2020, and the release of the country's Macprudential Policy Strategy Framework also in 2020 are the milestone developments in macroprudential policy. Consistent with the amended BSP Charter, our authorities maintain that the financial stability policy objective requires a whole-of-market perspective, and thus a collaborative and holistic effort among the authorities. To further strengthen the FSCC and to institutionalize its legal standing, an Executive Order has been submitted for signature by the President.
14. With its legal mandate on financial stability, the BSP is fully cognizant of the need to continuously sharpen its macroprudential policy toolkit as well as its operating procedures. This reflects the authorities' recognition of the unique challenges posed by an environment of changing risks and evolving uncertainties for macroprudential policy and is also in line with the FSAP recommendation. There are ongoing initiatives to execute the provision in

⁵ An interagency body comprised of the Securities and Exchange Commission (SEC), Insurance Commission (IC), Philippine Deposit Insurance Corporation (PDIC), and Department of Finance (DOF).

the amended BSP Charter that gives the BSP authority to gather data for policy and statistical purposes to enhance its quality and breadth.

15. Meanwhile, the BSP assures that it upholds strong collaboration and coordination within the organization so as to foster a balanced decision-making process to carry out its price stability and financial stability mandate effectively and to ensure effective supervision of financial institutions and management of systemic risks. There are board-level committees and mechanisms in place to ensure that interrelated issues and concerns are considered in the decision-making process. Financial stability and financial supervision implications are considered and discussed during the meetings of the Advisory Committee to the Monetary Board. Meanwhile, financial supervision related matters with financial stability implications are discussed during preparatory board meetings attended by Monetary Board members and heads of relevant units in the BSP. Discussions from these committees form the bases for appropriate policy decisions and implementation, that provide a balance between macroeconomic and financial stability objectives.

Banking Sector Supervision and the Regulation and Supervision of Financial Conglomerates

16. Our authorities welcome the recommendation and assessment on the observance of the Basel Core Principles (BCPs) for effective banking supervision, as well as the regulation and supervision of financial conglomerates. This will provide valuable inputs in crafting the financial sector strategy roadmap and in further strengthening the conduct of effective banking supervision in the Philippines.
17. In particular, the financial sector regulators affirm the views of the FSAP mission team on the critical benefits of lifting the bank deposit secrecy laws. The legislative amendments will empower the BSP and other financial sector regulators in executing their supervisory mandates towards the promotion of the safety and soundness of the financial system and protection of the depositing public.
18. With respect to conglomerate supervision, the Financial Sector Forum (FSF)⁶ had contemplated the idea of designating a lead coordinating regulator for particular groups of conglomerates. However, since conglomerates have mixed interest in both financial and non-financial sectors, this raises a fundamental issue that challenged the effective implementation of said approach. It is in this light that the FSF member-agencies decided to adopt common standards across the financial sector. Cross cutting issues are being discussed in the Forum while specific enforcement actions in relation to said issues are being referred to relevant supervisors for appropriate action. Moreover, the FSF has drafted, following the IMF Technical Assistance on Conglomerate Supervision, the Memorandum of Agreement on the establishment of a supervisory college as a regulatory platform for the effective supervision of financial conglomerates, particularly in conducting a group-wide risk assessment and discussing cross-cutting issues.
19. On the recommendation to establish regulatory powers on the transfer of significant ownership or controlling interest, our authorities wish to emphasize that the amended BSP Charter has authorized the BSP to disapprove transfer of shares to parties who are deemed unfit and improper to hold or own shares of banks. The BSP is well able to assess the fitness

⁶ An interagency body comprised of the BSP, SEC, IC and PDIC.

and propriety of the ultimate beneficial owners even though existing BSP regulations do not explicitly include the term ‘ultimate beneficial ownership’ in the ‘control’ or ‘significant controlling interest’ definitions. There have been instances where the BSP rejected applications for transfer of bank shares to parties who were unable to meet the fitness and propriety criteria.

20. It is also worth mentioning that the BSP recently amended its regulations to require ultimate beneficial owners to provide documents for the BSP to better assess the ownership and control structure for the establishment of new banks or in cases of transfer of bank shares.
21. The SEC has also issued the Beneficial Ownership Transparency Guidelines⁷ in January 2021 which will enhance the accuracy and availability of beneficial ownership information of companies. The guidelines include prohibition of bearer shares and requires mandatory disclosure of the identity of beneficial owners.
22. Building on the ongoing policy initiatives and the FSAP recommendations, the BSP will continue to pursue risk-based, relevant, and responsive regulatory reforms to further improve the effectiveness of banking supervision. The BSP, along with relevant financial sector authorities, is working closely with both Houses of Congress for the approval to amend the Bank Deposit Secrecy Laws, expand the BSP’s authority on conglomerate supervision and pass other critical legislative reforms necessary to reinforce the strengthened nexus of banking supervision and financial system resilience.

Anti-Money Laundering and Countering the Financing of Terrorism (AML/CFT) and Bank Secrecy

23. In November 2018, the Philippines formally adopted a “one-nation approach” in combating money laundering and terrorism financing through Executive Order No. 68, adopting the National AML/CFT Strategy (NACS). The NACS is a strategic and collective response in the form of action plan to address the risks, gaps, and problem areas identified in the National Risk Assessment (NRA) on Money Laundering and Terrorism Financing (ML/TF) exercise. Under the NACS, relevant government agencies are required to implement action plans that would contribute to the effectiveness of the AML/CFT system. One of the key action plans under the NACS is the enhancement of financial intelligence sharing. In particular, the Anti-Money Laundering Council (AMLC) can share bank account information, among others, to support supervisory actions, including for prudential supervision, when requested by the relevant agencies.
24. Our authorities wish to emphasize that the bank deposit secrecy laws do not impede the implementation of the AML/CFT framework. Section 24 of the Anti-Money Laundering Act, as amended, has expressly repealed the existing bank deposit secrecy laws (i.e., Republic Act Nos. 1405 and 6426) by providing the AMLC with unimpeded access to bank account information. The Asia Pacific Group on Money Laundering (APG) rated the Philippines “Largely Compliant” and “Compliant” on Recommendations 9 and 29. This recognized that the bank secrecy law does not inhibit the implementation of the FATF Recommendations and does not impede the AMLC’s ability to obtain information from banks as needed to perform its analyses properly.

⁷ SEC Memorandum Circular No. 1 Series of 2021 on the Guidelines in Preventing the Misuse of Corporations for Illicit Activities through Measures Designed to Promote Transparency of Beneficial Ownership <https://www.sec.gov.ph/mc-2021/mc-no-01-s-2021/>

25. In addition, there are defined circumstances that allow the BSP to examine bank accounts in compliance with the AML Act and in cases of unsafe and unsound banking. Our authorities strongly view that analysis of available information, market surveillance, and intelligence gathered from collaborative engagements with other agencies enable them to effectively assess and monitor any institutional and sectoral money laundering and terrorist financing risks.
26. Moreover, the recent passage of Republic Act No. (RA) 11521 or An Act Further Strengthening the Anti-Money Laundering Law has already addressed the recommendations to (i) designate tax crimes as predicate money laundering offenses; and (ii) establish a comprehensive legal framework for targeted financial sanctions against proliferation financing. The related implementing rules and regulations, particularly on the implementation of the targeted financial sanctions, was also published on 31 January 2021.

Financial Safety Net, Bank Resolution and Crisis Management

27. The resolution authorities, the BSP and the PDIC, appreciate the staff's recognition of the significant progress on crisis management, resolution, and safety nets since the 2010 FSAP. This includes amendments to the legal framework on resolution enshrined under the PDIC and BSP Charters, strengthened collaboration with the establishment of the FSCC, introduction of the recovery plan for Domestic Systemically Important Banks (D-SIBs), enhanced legal protection of BSP and PDIC personnel, streamlining of the BSP's early intervention measures and prompt corrective action framework, and establishment of the banks for resolution (BRes) framework. Moreover, the BSP revised its guidelines in October 2020 to tighten the implementation of Section 30(c) of Republic Act No. 7653, as amended, allowing the BSP to resolve banks concerned more promptly.
28. The resolution authorities welcome the observations and recommendations as these are essential in strengthening the country's resolution regime. In particular, they acknowledge the need to conduct resolvability assessments and to formulate resolution plans for individual banks to ensure timely and orderly resolution in case of bank failure.
29. On the recommendation to designate the PDIC as a resolution authority, our authorities, however, wish to highlight that the legal framework already vests the resolution authority to both the BSP and the PDIC. The laws are also clear on where the power and responsibilities of the BSP on banks end and at what point the power of the PDIC begins with respect to resolution. The resolution power ultimately resides with the BSP with respect to operating financial institutions under its jurisdiction while the PDIC's resolution authority comes into play when the BSP cannot act due to conflict of interest or because it is beyond the BSP's mandate. Meanwhile, after a bank is closed/prohibited from doing business in the Philippines, the legal framework is clear that PDIC shall be designated as receiver and it shall proceed with the takeover and liquidation of the closed bank.
30. We believe that the present set-up where the BSP exercises both supervisory and resolution authorities, promotes efficiency and evenhanded action as the BSP has the necessary information to support the resolution of a bank. Moreover, the PDIC is onboarded early on in the resolution process through the conduct of joint BSP-PDIC examinations, regular meetings to discuss banks under PCA or BRes frameworks and information sharing arrangement. This effectively addresses the perceived conflict of interest. In addition, the

BSP processes in resolving banks are covered by Quality Management System subject to internal and third-party assessments.

31. Meanwhile, although there are certain processes or coordination mechanisms not found in the law, the same can be found in the respective regulations of the authorities and bilateral arrangements. Our authorities thus believe that the current resolution structure is working well in the Philippine context.
32. The concept of a bridge bank authority has been proposed in the past, but legislation was unsuccessful. Our authorities recognize that a bail-in framework is yet to be formalized but the BSP requires loss absorption features in Additional Tier 1 and Tier 2 capital instruments issued by banks which can be tapped as a bail-in tool for the meantime. Moving forward, our authorities will continue to push for initiatives that will further improve our resolution toolkit.
33. With respect to the recommendation to ensure timely corrective action and resolution of weak banks, the BSP is already in the process of revising and streamlining its early intervention and remedial framework (i.e., Prompt Corrective Action Framework, Letter of Commitment). The BSP has also tightened the basis of prohibiting a bank from doing business under Section 30 of the amended BSP Charter to further improve timely resolution of banks. Our authorities wish to emphasize that its continuous effort in enhancing supervisory policies and implementation has resulted in a significant decline in the portfolio of problem banks since the 2010 FSAP. Moreover, it is also worth noting that entities currently under the PCA framework do not pose systemic risk to the Philippine financial system.
34. Lastly, our authorities deem that the legal framework on Emergency Liquidity Assistance (ELA) is already sufficient as it explicitly provides the specific conditions for availing ELA and the broad range of acceptable ELA collaterals. While Section 84 of the amended BSP Charter specifies the acceptable prime collaterals, the BSP is also provided with the flexibility to accept other kinds of collaterals as may be authorized by the Monetary Board in accordance with sound risk management principles. Nonetheless, issuance of more specific guidelines on the conditions/collaterals for the grant of ELA may be considered. Meanwhile, our authorities wish to emphasize that the BSP has not provided uncollateralized loans under Section 83 of the amended BSP Charter, as it is not operational up to this time. All availments under the ELA are secured by first class collaterals as required under Section 84 of the amended BSP Charter. The BSP will consider the mission team's insights in the ongoing study covering Section 83 of the amended BSP Charter.