The international banking crisis: impact on Thailand's financial system and policy responses

Bank of Thailand

1. Impact on the banking system

The direct impact of the global financial crisis on the Thai banking system has been very small in terms of the decline in lending of foreign banks operating locally and cross-border lending. This is due to Thailand's very low reliance on foreign sources of funding as well as its low exposure to foreign assets. Foreign banks operating locally account for only 10% of the total assets of the banking system, while foreign funding accounts for only 3.5% of the total liabilities of the banking system. Stable domestic deposits form the core of the Thai banking system's funding source, at around 77% of total liabilities. Moreover, 95% of bank loans to households, corporations, and the government sector were in local currency, thus mitigating any risk of currency mismatch.

The lessons learned from the 1997 financial crisis, together with the strengthened risk-based supervision and risk management of banks, the countercyclical macroprudential measures in place since around 2003, and the removal of the fixed exchange rate regime in 1997, all contributed to reducing Thailand's vulnerability and exposure to contagion associated with the global financial crisis. As can be seen from Table A below, the external debt of the Thai banking system is very small, at USD 7.7 billion, and the external debt to asset ratio of the banking system has fallen significantly from 18.8% in 1996 to 2.5% currently. In addition, banks have few foreign investment holdings, accounting for only 1% of total assets, while loans to overseas financial institutions and non-residents account for around 2.4% of total assets.

The Thai banking model is not overly complex, comprising, predominantly, retail commercial banks, rather than the wholesale investment banking model, with a low leverage ratio and very low exposure to complex products or market risk. Most derivatives tend to be plain vanilla and are linked to underlyings such as international trade; thus, risk exposure is controlled through effective risk management.

Foreign bank branches operating in Thailand were also resilient to the effects of the global financial crisis, as their head offices were robust, or they received strong support from their home regulators and government. Nevertheless, from industry dialogue carried out with these branches in the context of a financial stability review, it appears that, at the height of the crisis, just after the collapse of Lehman Brothers, foreign bank branches became increasingly risk-averse as part of the growing trend manifested by their head offices towards reducing global risk in order to conserve capital. This increased caution tended to be in terms of reducing exposure to new clients as well as corporates which were not at the top credit tier. However, this did not have a noticeable impact on credit availability for the local economy since most of the clients of foreign bank branches were multinational corporations with a very strong credit standing (eg automobiles, electronics, ICs). Since foreign bank branches were not the major source of bank credit to local companies, the increased caution in lending had little impact on local firms.

Table A

Thailand's profile

	1996	2001	Q3/2009
L/D ratio of banks	129.0[1]	84.8	85.4
Corporate D/E ratio[2]	1.4[1]	0.8	0.8
External debt (bn USD)	108.7	67.5	65.9
Of which, short-term	47.7	13.4	24.1
Of which, banking system	41.9	9.4	7.7
(% total bank assets)	18.8	6.3	2.5
Of which, non-banking system	50.1	29.9	44.8
External debt (% GDP)	65.9	56.1	25.8
Reserve to short-term debt (times)	0.8	2.5	5.5

[1] Q2 1997. [2] The median of D/E ratios of non-financial institutions listed on the Stock Exchange of Thailand.

However, foreign banks are important players in the local over-the-counter (OTC) market for plain vanilla derivatives such as foreign exchange (FX) swaps and interest rate swaps, which were important for the risk management of local banks. Overall, however, derivatives contracts offered by foreign bank branches have not been significantly affected by the crisis, although the development of new products, ie structured products, has slowed down somewhat. However, structured products form only a very small part of Thai banks' business, which may be partly due to the Bank of Thailand's cautious policy with regard to the scope of permissible derivatives business even prior to the global crisis.

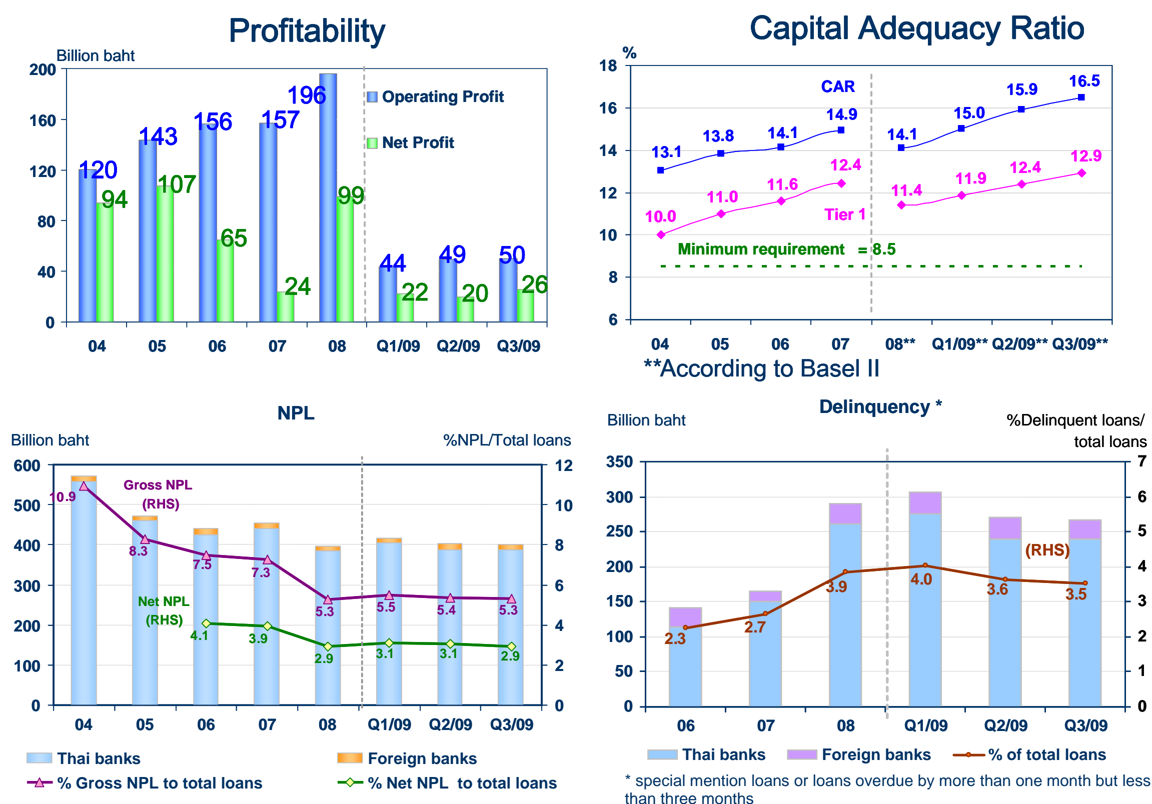
The outstanding volume of derivatives transactions across all banks in Thailand decreased slightly as of Q3 2009 compared to 2008, in line with both the contraction in key underlying transactions, namely the volume of exports and imports, and with international trade.

1.1 Oversight of the stability of financial institutions' systems and markets

To ensure market stability and integrity, the Bank of Thailand (BOT) engages in close monitoring of and dialogue with the banking industry, both from the perspective of the BOT's monetary policy and market operation conduct, as well as from the prudential supervision perspective. Its aim is to ensure that the market has adequate liquidity and capital, as well as the risk management ability to handle potential stress. The BOT also uses stress tests as an important tool to enhance the dialogue with the banking industry. This process, along with the adequate liquidity in the market, the robust condition of local banks and the fact that foreign banks operating in Thailand were resilient to the crisis either due to the robustness of their head offices, or because they were strongly supported by their home regulators and government, all contributed to the resilience of the local market. Of course, a key element of this resilience was the robust macroeconomic conditions prevailing in Thailand, particularly the current account surplus and strong international reserves position, which helped to underpin confidence in liquidity.

All these factors have contributed to a more resilient banking sector. The Thai banking system continues to record a profit with robust capital, a greater provisioning cushion in line with the adoption of IAS39 for the fair valuation of non-performing loans (NPLs), and stable asset quality, and, in addition, the NPL and delinquency loan ratios continue to decline, though at a slower rate.

Figure 1



1.2 Indirect impact via slowdown in global growth

The negative impact of the global financial crisis came from the contraction in global growth and world trade, which caused a contraction in the Thai economy and loan growth. The economic slowdown led to a contraction in banking credit growth; loan growth decreased from 11.4% at end-2008 to –3.1% at end-September 2009, on a year-on-year basis. Corporate loans, which constitute 73.1% of total loans, contracted by 6.5%, in tandem with the economic slowdown. In contrast, consumer loans continued to grow, although decelerated somewhat to 7.3%.

Given the global economic uncertainty, the BOT has asked banks to conduct stress testing to ensure that they are both alert to the potential impact of downside risks and are forward-looking in their risk management approach. Recent stress testing, which covers credit, market and liquidity risks linked to macroeconomic scenarios, has confirmed the resilience of the Thai banking sector.

2. Impact on local money and debt markets

As the Thai banking system had become more prudent following the 1997 financial and economic crisis, the recent global financial turmoil did not directly adversely affect the health of the banking system. There was no obvious direct negative effect on the domestic money market either. Thai baht (THB) liquidity remained abundant and short-term interest rates continued to stabilise around the policy rate (Figure 2).

Figure 2

Money market rates

Despite the limited impact on THB liquidity, there were some spillover effects on the FX swap market related to tightened USD liquidity conditions overseas. Reluctance to lend USD to other financial institutions due to credit risk concerns resulted in remarkably low implied THB swap rates during the first half of October 2008 (Figure 3). This unusual situation was temporary and did not destabilise the local FX market as the Thai private sector did not rely mainly on external debt financing (Figure 4).

As for the unsecured lending market, during the peak of the crisis period, interbank transactions dropped slightly owing to heightened credit risk concerns among market participants. The daily average interbank volume decreased from THB 24 billion during the first half of 2008 to THB 13 billion in the second half. However, given the structural liquidity surplus in the Thai financial system, there were no difficulties in raising funds in the uncollateralised market and since January 2009 the daily average interbank volume has increased to THB 19 billion (Figure 5).

Figure 3

Three-month implied THB rate

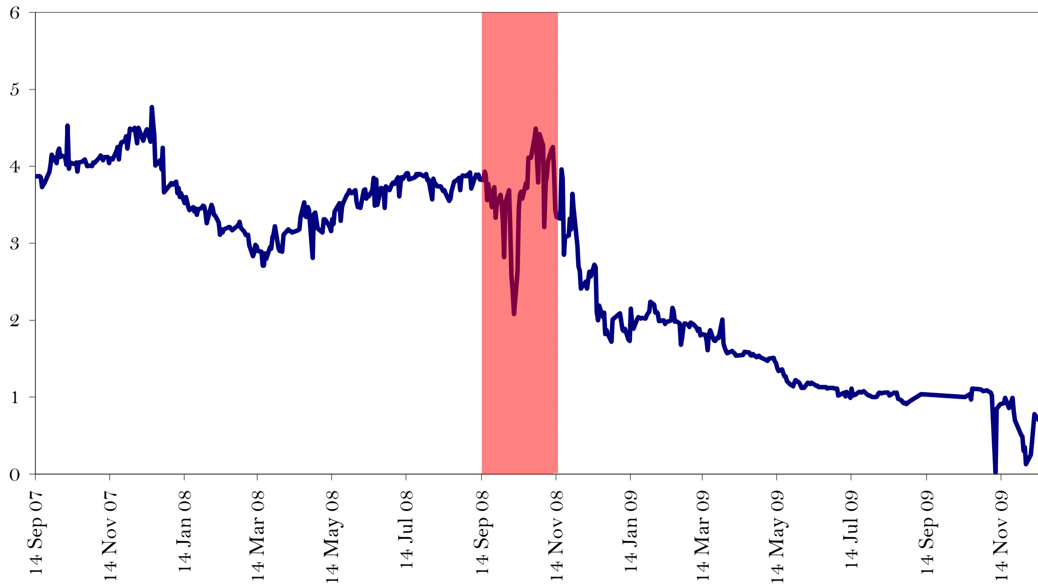


Figure 4

Foreign investment in Thailand

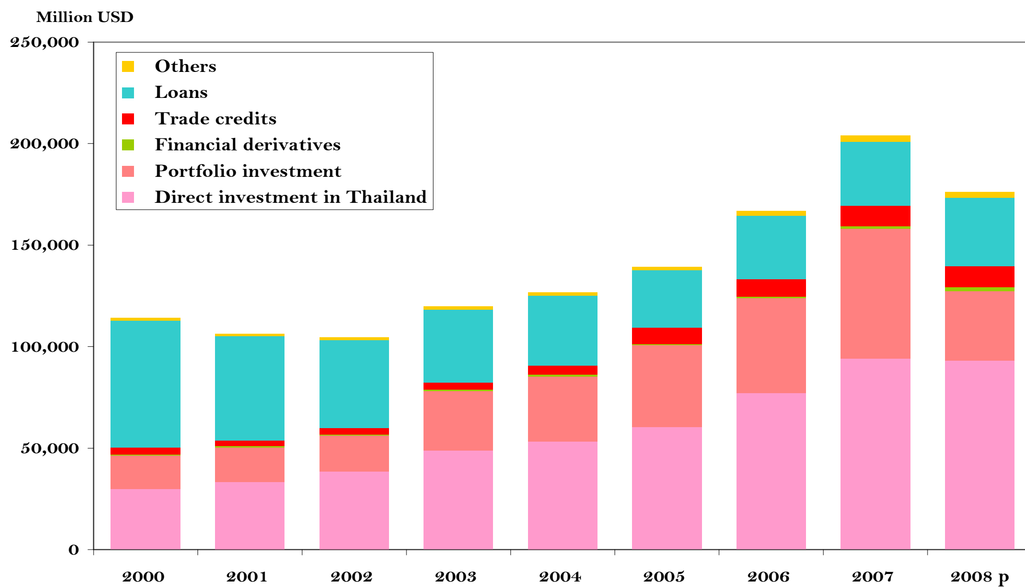
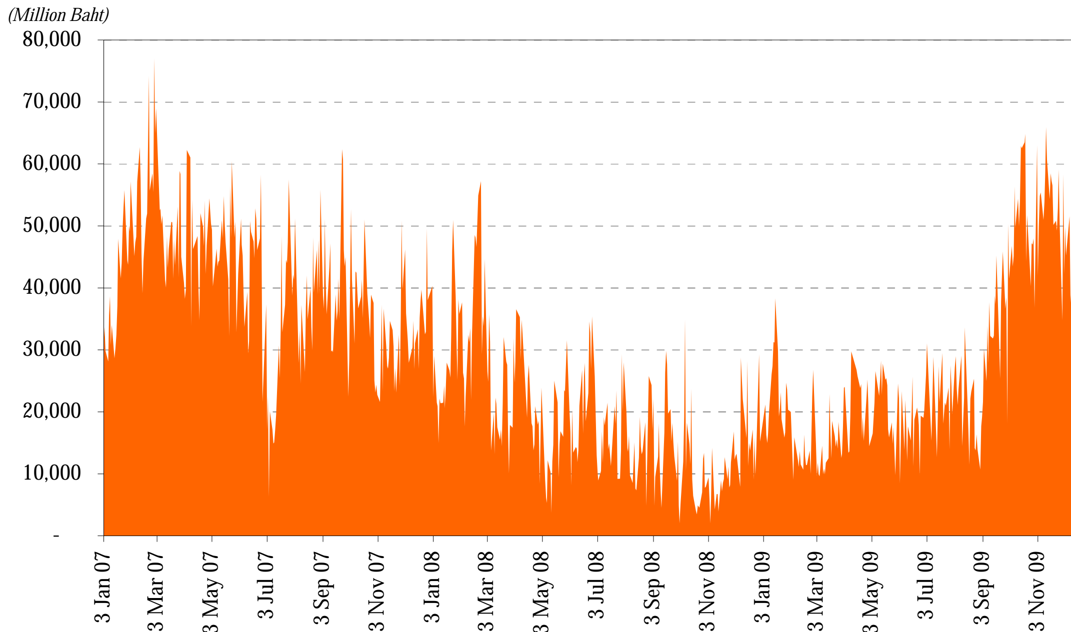


Figure 5

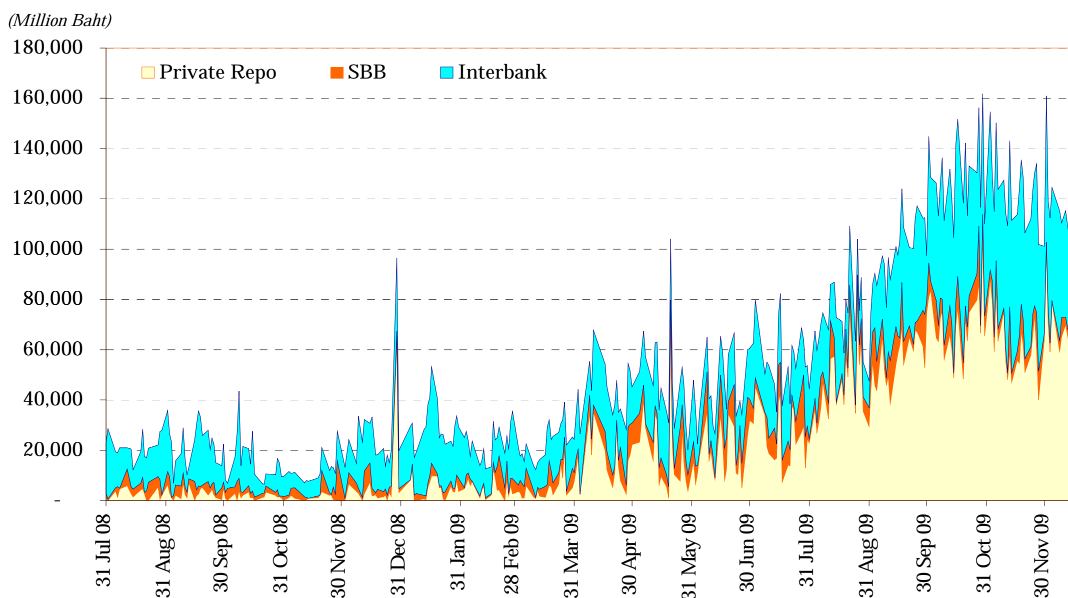
Daily interbank transactions



Conversely, secured lending transactions (private repo and sell–buyback), increased moderately towards the end of 2008. They have continued to grow significantly since mid-2009 onwards, mainly due to the BOT's plans to enhance the development of the private repo market (Figure 6).

Figure 6

Daily secured and unsecured lending transactions



Regarding the local debt market, the Thai Government had no difficulty in raising funds through the domestic bond market. However, heightened credit risk concerns led to higher risk premia, as evidenced by the rising credit default swap (CDS) spreads. Nonetheless, regional countries' sovereign bond spreads subsequently stabilised and retreated back to the normal range in mid-2009 (Figure 7).

Figure 7

CDS spreads – sovereign bonds

3. The central bank's policy responses to the recent crisis

3.1 Central bank instruments to deal with the crisis

During the recent crisis, the BOT did not implement additional monetary measures to inject THB liquidity into the financial system. Thailand's open market operations and end-of-day standing facility under the existing framework functioned rather effectively in managing money market liquidity, as reflected by short-term money market rates moving in line with the policy rate.

As regards the end-of-day standing facility under the existing framework, this liquidity adjustment window was designed to meet frictional funding needs both for normal and stressed market conditions. It is accessible to a wide range of counterparties, virtually all of which are deposit-taking institutions. The BOT has emphasised to market participants that there is no stigma attached to the use of the facility.

In addition, the BOT has prepared the contingency liquidity provision plan to ensure that there is sufficient liquidity for financial institutions.

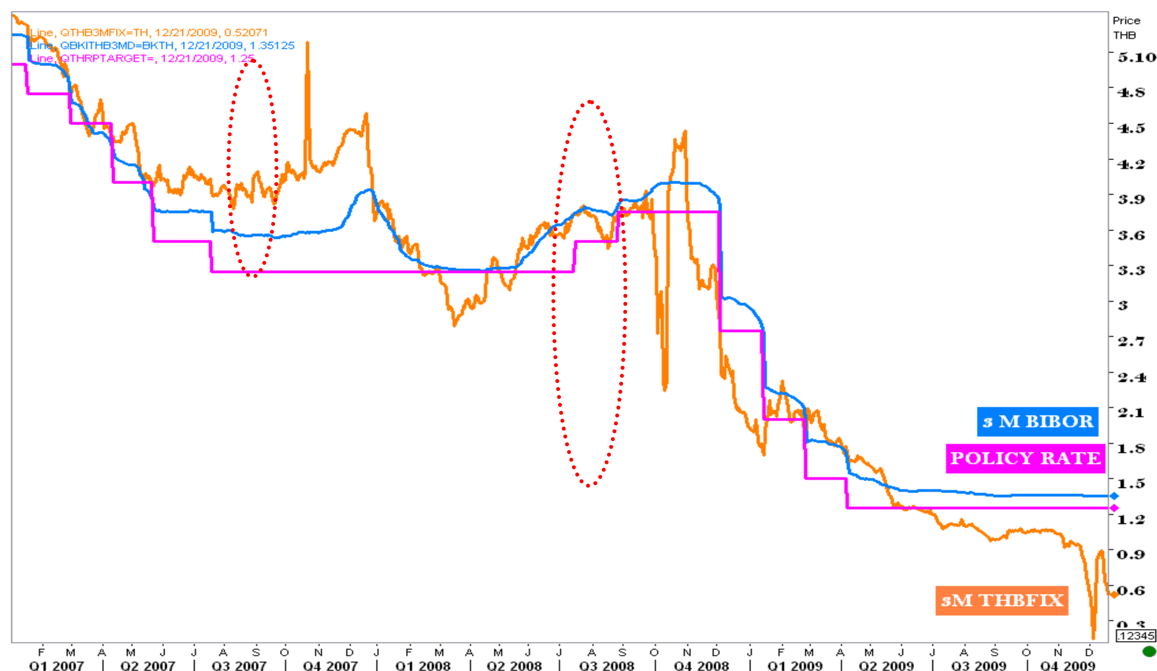
3.2 Measures taken to support interbank lending in local currency and/or to support foreign currency refinancing of banks/corporations

Due to USD scarcity in the global market and unreliable indicators for USD funding costs, the market began to move away from using a FX swap rate; i.e. THBFIX reference rate. Instead,

major market participants began to use the Bangkok interbank offered rate (Bibor) more actively as a short-term benchmark because it was more stable and reliable (Figure 8).

Figure 8

Policy rate, three-month THBFIX and three-month Bibor



In addition, the BOT has continually encouraged the development of private repo markets as it deems that a collateralised repurchase transaction imposes better risk management on participants' financing activities in terms of credit, legal and market risk arrangements. It is also more consistent with international practice.

As for measures to support foreign currency funding, the BOT has established bilateral swap agreements with other regional central banks, namely the Bank of Japan, the Bank of Korea and the People's Bank of China, within the Chiang Mai Initiative (CMI), in order to help facilitate short-term liquidity management in case of an emergency among regional countries. The facilities have not yet been activated as Thai financial institutions are not highly dependent on foreign financing and hence were not severely impacted during the recent crisis. However, the financial turmoil has highlighted the importance of bilateral swap arrangements among central banks.

3.3 The BOT's monetary policy responses to an international financial crisis

The BOT has made it clear to the market that the monetary policy stance would be shifted should the turmoil impose threats on the real economy and the economic growth outlook. Therefore, when economic data in the third quarter of 2008 pointed towards a noted slowdown in economic activity and a much weaker economic outlook via a significant decline in exports, the Monetary Policy Committee (MPC) decided to lower the policy rate, initially by 100 basis points (bp) and altogether by 250 bp over a period of four months from December 2008 to April 2009.

Moreover, the crisis did not put notable depreciation pressure on the Thai baht. Incidentally, the Thai currency was relatively stable compared to major and other regional currencies

because capital outflows were only moderate. Thai banks and corporations were neither heavily leveraged nor significantly exposed to foreign liabilities. Consequently, there were no concerns over excessive THB depreciation, and the issue did not act as a constraint to interest rate cuts.

3.4 The BOT's view on the role of FX reserves and interventions

The BOT's view on the role of FX reserves and interventions remains unchanged. The response to FX market volatility is consistent with the managed floating exchange rate regime adopted under the inflation targeting framework. FX intervention, which resulted in excess domestic liquidity, is fully sterilised to avoid any inflationary effect. Thus far, despite prolonged excess liquidity conditions, inflation developments have been well contained and core inflation remains well within the target band.

Moreover, the recent crisis has shown that FX reserves played a vital role as the first line of defence to help ease the impact of an exchange rate shock.

3.5 Other government measures

The Thai Government also implemented various measures to support financing for both bank and non-bank corporations. For instance, in order to restore public confidence in the Thai banking system, the government decided on 28 October 2008 to extend the *blanket deposit guarantee scheme* to August 2011. Initially, the blanket deposit guarantee scheme that had been in place since February 2008 was to be gradually replaced by a partial guarantee scheme beginning in 2010.

On 17 February 2009, through the Small Business Credit Guarantee Corporation (SBCG), the government approved the *portfolio guarantee scheme* for small- and medium-sized enterprises (SMEs). Under this scheme, the SBCG partially guarantees commercial banks' SME loan portfolios. The credit guarantee limit is set at THB 40 billion for a period of five years with a fee of 1.75%, which is waived for the first year. The loss incurred by the SBCG will be compensated by the government within a limit of THB 2 billion.

Moreover, on 5 August 2009, the Cabinet approved the *credit fast track project*, the aim of which is to accelerate the credit approval procedures of seven state banks in order to offset the reduction in commercial banks' credit extension. Total credit for 2009 under this project is targeted at THB 927 billion. The government also set out its plans to recapitalise certain government specialised financial institutions (SFIs) in order to enhance their credit extension capacities.