Tarisa Watanagase: Thai financial sector and the challenges ahead

Speech by Dr Tarisa Watanagase, Deputy Governor of the Bank of Thailand, at the conference on Asian Finance & Capital Markets 2004, Bangkok, 8 July 2004.

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Good morning,

Let me first begin by thanking Euro Events for inviting me to address this distinguished audience. I am delighted to be here to share with you some of my thoughts on the Thai financial sector and where it is heading, especially since a lot is happening at this juncture, with the Financial Sector Master Plan being implemented. I trust therefore that we will have much to learn from each other, given the diverse background of participants in this conference, ranging from banking and government officials to investment managers and business leaders.

Since you will engage in absorbing debates on practical issues on finance and capital markets, my presentation will deal with the broader issue of prospects and challenges for the financial market in the Thai perspective. While the discussion will be based on the experience of Thailand, some of the challenges will be commonly faced by other emerging economies. Thus, it is my sincere hope that the implication drawn from this presentation will also be applicable and useful for participants from other countries.

I will first touch on the structure of the Thai financial sector and the assessment of where the banking sector currently stands. This is then followed by a discussion on the authorities' major policies to further strengthen financial institutions' positions in view of more intensified competition and changing financial environment, including the implications of these policies. Finally, I will conclude this morning's talk by highlighting some challenges and benefits of capital market development for the banking sector.

The Thai financial system consists of four main institutional categories, in the order of their importance: the banking sector, the capital market, specialized financial institutions and non-bank financial intermediaries. The first two categories are the backbone of the Thai financial system, while the third provides funding for specific developmental purposes in accordance with the government policy, and the last supplements the others. Despite the stock exchange boom last year and the pick up of the bond market in recent years, the banking sector remains the primacy of our financial system in every sense. Not only does it provide the bulk of lending that amounted to about 5.5 trillion baht as of end-2003, or equivalent to 93 percent of GDP, the banking sector also mobilizes savings from the public and provides means of payment and settlements that sustain the well-functioning economy.

With the recapitalization effort and commendable operational improvement, the banking sector has emerged **much stronger** after the 1997 crisis, with all performance indicators pointing to the direction of resiliency. The banking sector's net profit has turned positive for the past three years; this figure more than doubled in 2003 from the previous year. Operating profit also rose at a higher rate in 2003, helped by both increasing interest- and non-interest incomes, and falling operating expense. Meanwhile, the growth of loan* portfolio maintained its momentum well at the rate of 5.6 percent at the end of 2003 compared with 4.9 percent a year earlier, in tandem with the robust economic recovery.

On the **stability** front, the banking sector's average provisioning was well above the required provision by about 35 percent, and capital to risk-weighted asset ratio remained comfortably above regulatory requirement in 2003, with a ratio of 13.7 percent for Thai banks and 20.5 percent for foreign banks. Moreover, the non-performing loans continued a declining trend with the ratio of 12.8 percent to total loans in 2003, compared to 15.7 percent in the previous year. The number is still high, admittedly; but one only needs to recall that we started with an NPL ratio of nearly 50 percent right after the crisis to realize that we have come a long way. The remaining NPLs do not pose a significant downside risk because of the over-provisioning and the continued robust performance of the economy. However, we will not be complacent. Regulations will be forthcoming to further expedite the resolution of the remaining NPLs - an issue that will be revisited later.

At the same time, banks have made substantial progress on **productivity**, with improvements on many fronts. Operating costs have been drastically cut by means of organizational restructuring and work process re-engineering. Moreover, capitalizing on their extensive network of over 3,000 branches, banks have widened the arrays of services to include distribution of corporate bonds or debentures, unit trusts, IPO shares and other debt instruments. Such efforts pay off with tangible result. Within four years, banks' ratio of net interest- and non-interest income to average number of employees rose from 0.8 to 2.6 million baht per person per year in 2003.

We also witness improvement in the area of customer **access**. Crowded customers at micro-branches speak volumes for the success of banks' strategy to approach customers outside their office hours. In response to more sophisticated demand, banks introduced new channels of services such as internet banking and tele-banking to satisfy the technology savvy demands of emerging new generation of customers.

These efficiency gains have been achieved without forsaking comprehensive **risk management**. On the contrary, banks have begun to move away from collateral-based lending to risk-based approach. At the same time, financial literate Board of Directors has bolstered its oversight function to ensure that banks are managed in a sound manner. In the area of credit risk management, credit scoring has been widely applied in the retail loan originating process, whereas internal credit rating models have been used for significant corporate loan portfolios. Moreover, banks also have in place security measures, contingency plans and auditing standards within their system of internal control to monitor reputational risk, strategic risk and other risks.

The logical question to ask here is how do we ensure that these positive developments will maintain their momentum and that the banking sector will remain strong and sound amidst a more liberalized environment, fierce domestic and external competition, and the advent of more advanced technology and financial innovation? We can wait passively for external forces to inflict changes on us, or we can chart our own path of development in anticipation of any change. The Asian crisis brought it to the fore that complacency when met with abrupt and radical reforms as a result of external forces could entail enormous output loss and social cost. Thus, we must do what we can to ensure that the banking system is up to meeting any challenge. This brings us to the second point I want to make - what the authorities intend to do to enhance the financial system's competitiveness and its capability to withstand forces of change in this age of globalization.

The authorities are quick to grasp the opportunity of healthy economic and banking conditions conducive to embarking on a structural reform, with the announcement of the **Financial Sector Master Plan**. Thorough discussion on the Master Plan will require a separate session of its own. So, let me just pick some of its key features that will have the most significant impacts on the structure and efficiency of the banking industry.

First and foremost, under the "**One Presence**" principle, existing financial institutions must choose one form of deposit-taking financial institutions; be it a commercial bank, retail bank, foreign bank subsidiary or foreign bank full branch. This principle will foster a new structure that is clear, competitive and efficient. Specifically, the structure whereby many types of financial institutions offer essentially the same services to the same pools of customers and whereby a financial group has more than one type of deposit-taking institutions must go. Financial institutions will therefore have to address the issue of redundancy resulting from this principle.

Moreover, the Master Plan has introduced additional competitive pressure to the banking industry. Qualified foreign banks that opt to upgrade to subsidiaries will be able to open some branches, adding healthy competitive pressure to the market.

On the part of regulators, we will streamline regulations to ensure a smooth transition process and to provide adequate flexibility for banks to conduct their businesses. For instance, the authorities are working to resolve tax impediments to mergers. Moreover, banks have been allowed to outsource their administrative works and cut cost on redundant operations by back-office sharing.

While the structural reform is under way, we continue to forge ahead with our **prudential supervision** to maintain banking system soundness. In this regard, there are a few key regulations in the pipeline, some aiming at expediting the NPL resolution and others at strengthening the risk-based supervision.

The Bank of Thailand is rolling out a new measure in the second half of this year with a view to giving banks a nudge to deal with **NPLs** head on. For NPLs that have long been pending without proper restructuring or legal actions, financial institutions will be required to set aside provisions for the collateral at an increasing rate, depending on the overdue period. Essentially, banks will be required to make provision in full, regardless of the collateral value, for loans that have been non-performing for over four years. Also, the Asset Management Corporation, set up exclusively to buy NPLs from the finance companies that were closed down during the crisis, will be enabled to buy NPLs of banks. We are now in the process of amending the Corporation's charter.

On risk-based supervision, the Bank of Thailand has issued a Market Risk Supervision Policy framework at the end of last year - a timely move given a possible upward trend of interest rates. This measure will ensure that financial institutions instill mechanism to manage market risk commensurate with their risk-taking activities, especially in the trading book. Recognizing the need for financial institutions to adjust, the Bank of Thailand will implement the measure in transitional phases. By June 2005, banks will be required, for the first time, to maintain capital fund against market risk. Prior to that, they will have to comply with guidelines on internal control and trading book policy, as well as submit call reports on the calculation of the volume of trading book transactions and the calculation of the capital charge against market risk.

Ladies and Gentlemen,

Another factor which will have crucial implications for the banking sector is the **Basel II** implementation. With the recent release of the Basel II framework, it is inevitable that we get ourselves ready for this international standard of capital adequacy. We all would agree that the New Capital Accord is for the betterment of banking system soundness for it signifies a move away from the one-size-fits-all approach to credit risk assessment in accommodation of evolving more sophisticated risk management of modern banking. Specifically, under the New Accord, it provides more comprehensive and risk sensitive approach to calculate regulatory capital, augmented by supervisory review process of Pillar II and market discipline enforcement of Pillar III.

Despite the novel complexity of capital calculation under Pillar I, if a bank adopts the standardized approach, its calculated regulatory capital is only a proxy of the actual risks. I suspect that standardized approach is the one that most banks in emerging markets will adopt before they can meet the preconditions of IRB, or the internal-rating-based approach, especially in the areas of data quality and risk management practices. Therefore, **only** through proper Pillar II supervisory review can we understand the true risk profile of banks, so that capital requirement is set in line with the risks assumed by banks. To carry out this task, the authorities need to have the right **prudential rules** in place, as well as the **supervisory capability and capacity**. At the Bank of Thailand, we are developing prudential standards and risk-focused on- and off-site examination practices and manuals so that each supervisor can work on a common structured approach to risk analysis. Moreover, a lot of resources have gone into supervisory training to equip our supervisors with the necessary tools and build up their sound judgment for the implementation.

In parallel, the Bank of Thailand has proposed the New Financial Institutions Businesses Law to the Parliament to give us the necessary legal basis to implement both effective banking supervision and Basel II. To foster Pillar III market discipline enforcement, the authorities are working on an appropriate safety net to replace the blanket guarantee that undermines the functioning of the Pillar III. It's obvious that without lifting the blanket guarantee, market discipline will not work no matter how much disclosure is required. At present, the Ministry of Finance is in the process of reviewing the draft legislation on Deposit Insurance Agency before submitting it to the Parliament.

Ladies and Gentlemen,

Now let me turn to the issues that directly impact the banking industry: what might be the implications for financial institutions as a result of the measures discussed earlier, and what are the **challenges** ahead for the banking sector? I would like to point out a few:

First, in the new financial landscape following the implementation of the Master Plan, we anticipate a structural change in the banking sector with more industry **consolidation** and emergence of **financial conglomerates**, embraced by the "One Presence" principle. Such processes should lead to larger size and falling number of financial institutions. Although not a sure ticket to success, size will allow the working of economies of scale and scope - to eliminate redundancies in administrative and operational functions, reduce costs from more diversified portfolio of clients and enhance income from provision of wider range of services. For the first time ever in the Thai banking history, banks will have the opportunity to do all these and grow through consolidation and/or forming a financial group. Up until now cost cutting and income enhancement, for example, were possible only through reorganization and re-engineering within the same organization. Of course, there were cases of mergers in the history, but they were mainly out of necessity to solve the problem of some weak banks, not as a calculated move for growth. Therefore, in my opinion, the first major challenge in the next couple of years for banks is to reap the benefits from such an opportunity offered by the Master Plan. In doing so, a bank's **Board and senior management** must give its full attention and be fully committed to articulating a strategic plan, successfully integrating their operations, streamlining various business processes, as well as finding their niche markets or areas of comparative advantage.

Second, banks must prepare themselves for the **new Basel Accord**. Most banks in Thailand will start with the standardized approach in the calculation of their regulatory capital, because of the reasons I talked about earlier. Adopting the standardized approach does not require much preparation, since it is quite similar to the existing Accord, with only some differences in the risk weights of some assets. However, if banks stay on the standardized approach for too long, they will not be as risk sensitive as those which adopt the IRB approach, resulting in higher risk and higher need for capital, which means that they will not be able to compete well as internationally active banks. Therefore, the ultimate goal for those who wish to compete internationally would be to move to the IRB approach, after some extensive preparations. These preparations, in particular those on improving **data quality and risk management**, are in fact something that banks would like to do any way to be safe and sound, with or without moving to the IRB approach. Hence, the second major challenge for banks is to put in place a good data base and systems to identify, measure and manage all banking risks to optimize their use of capital and price their products according to risks. In addition, when taking into account the risk associated with business cycle, banks must be prepared to **beef up financial strength** during favorable economic conditions so that they could weather vulnerability during the downturns. These are daunting tasks and again require the full attention and commitment of the Board.

Banking is all about customer relation; this is particularly true for personal banking segment. The needs for financial institutions to properly take care of customer complaints are occasionally highlighted by a few high profile cases in the media. This type of issue will gain more importance, given the growing retail banking sector. To remain competitive and maintain customers' trust, banks must be **fair and transparent** about their provision of financial services, a challenge which is very much in line with the Basel II's Pillar 3.

Ladies and Gentlemen,

I have not forgotten the capital market, another integral part of the financial market, which makes it vibrant and offers diversification in terms of channels of financial intermediation. Deeper and broader capital market can avert or at the very least lessen the liquidity crunch effect on corporations in the event of a banking crisis. Efforts, therefore, have been made to develop the capital market to curtail dependence on the banking sector. In the past years, the private sector has raised financing more and more from the capital market. In particular, the bond market's outstanding corporate debt instruments more than doubled in five years, surging from 180 billion baht or 4 percent of GDP at the end of 1998 to 556 billion baht or 9.4 percent of GDP at the end of 2003. When combining the market capitalization of the equity market to the bond market, the capital market's outstanding financial instruments stood at 5.4 trillion baht or 91 percent of GDP at the end of 2003, nearly equal lending from the banking sector.

With its growing share in the financial market, the capital market offers both **opportunities and challenges** to the banking sector. Through their extensive branch networks, banks can further enhance fee-based income by increasing their roles as arranger, underwriter, facilitator and custodian. In direct competition with the capital market for corporate clients, banks must sharpen their competitive edge by being cost efficient without compromising quality of services, so that they can offer corporate loans at competitive pricing at par with the capital market. This again underscores the critical importance of risk management-banks with more advanced tools in risk management are likely to have an edge over those without, since the former can better price risk and use their capital more efficiently. Moreover, instead of competing for corporate loans at fine margin, banks can also explore other niche sectors that may have been somewhat neglected such as SMEs.

In summary, I would like to conclude that so far, the Thai financial system has shown signs of resilience with promising prospects for the future. But we will continue to press on with the structural reforms to achieve sustainable growth and soundness of the banking industry. The Master Plan provides us with a road map to a more balanced and efficient financial system. While the Bank of Thailand will continue to strengthen risk-based supervision and foster observance of corporate governance for financial system stability, financial institutions will need to continuously and vigorously improve their risk management capacity for the upcoming formidable challenges in order to thrive in the new financial landscape.