

## **M R Pridiyathorn Devakula: The strengths and weaknesses of the Thai financial system**

Address by Mr M R Pridiyathorn Devakula, Governor of the Bank of Thailand, at the Annual Dinner organised by the Thai Bankers Association, Bangkok, 18 February 2005.

\* \* \*

Distinguished members of the  
Thai Bankers Association  
Distinguished Guests,  
Ladies and Gentlemen,

Thirty years ago, when I first started to work at a commercial bank, I well remembered that every year there would be an evening of informal gathering among top management of commercial banks and the Bank of Thailand. The event provided an occasion for us to get together after one full year of hard work. The gathering is not one where supervisors meet the regulated. It is a gathering of people in the financial sector, bonded in fellowship, for they have shared the fruits of their success and their labour. It is therefore natural that in a gathering such as this, the central bank Governor who has been given the leadership role to steer the herd, would use the occasion to discuss the future direction of our financial system, including the strength and weaknesses, and prospects for improvement.

I once had an opportunity to join such an event when Dr. Snoh Unakul was Governor of the Bank of Thailand. I still hold fond memories of that event till this day.

I am very pleased that the Thai Bankers Association has once again revived this noble tradition. And, wearing the headmask of a central bank Governor, I will avail myself of this forum to share with you some thoughts and suggestions coming from one who has followed and spearheaded the developments of our financial system. I will be frank and candid in my remarks. I will share with you my perspectives on the strength and weaknesses, which we all have a responsibility to overcome.

First of all, I would like to express my sincere thanks to all the bankers for the wonderful cooperation we have been receiving these past few years. Since I assumed office, I received your cooperation on the sale of 300 billion baht in government bonds to finance the historical losses of the FIDF. It was probably the biggest launch ever and one that received tremendous success.

And in response to the Tsunami tragedy, which affected the 6 provinces in the South, commercial banks threw their support by extending loans at concessionary rates to those who were affected in the areas. So far, more than 43 billion baht have been approved. In addition, commercial banks have also reduced the interest burden on the customers affected by the outbreak of violence in the 3 southern border provinces. The banking community has willingly stepped in to help without undue regard for their balance sheet.

On business operations, commercial banks have given their full cooperation in the setting up of the nationwide Banknote Operations Centres, which enabled the completion of the new system within a short period of 1 year. Other than that you have also rendered your support to the Data Management System (DMS), a large and important project that is currently making progress and will significantly reduce the burden of reporting and eliminating duplication and the wasteful use of resources.

Lastly, I wish to thank you for your commitment and cooperation to develop the Interbank Transaction Management and Exchange System (ITMX), which is an important infrastructure of our modern payment system. The system provides a standard linkage to serve customers and to support interbank transactions such as E-clearing. This will boost the efficiency of the payment system in line with international best practices. More importantly, it is a significant move from a government-owned payment system to a privately run system owned and operated by all commercial banks. This development, in turn, will provide a basis for the system to respond more efficiently to the changing environment and where commercial banks can set appropriate fees consistent with their costs.

I am truly delighted to see such cooperation being worked out in the spirit of fair and collective responsibility, which will help enhance the efficiency and stability of our financial system.

Distinguished members

It is well recognized today that the Thai economy is on the recovery path after years of sluggish performance. Economic indicators point to firm and clear signs of improvement, albeit not to the extent of skyrocketing performance, but one of continuous recovery at a steady pace. The credit standing of our country has also improved where reputable credit rating agency such as Moody's has upgraded Thailand's sovereign rating from Baa3 to Baa1; whilst S & P, from BBB to BBB+.

I have to especially congratulate financial institutions, especially on your last year financial performances. Banking sector operations was more profitable than the previous year as reflected in the average Return on Asset (ROA) of 1.33% for the industry. Such an achievement is no doubt the product of your hard work and perseverance.

I recall, back in 2001, when I assumed office, I was disheartened by the earnings results of the banking system. In the year 2000, the banking system incurred losses of **more than one hundred billion baht** (-106.49 billion baht) or an average ROA of negative 1.7% of total assets. The first question that came to my mind was to return the banking industry to profitability or else the system would not survive.

You may recall that at the end of year 2001, we had a discussion at the BOT. Following that meeting, banks started to gradually reduce the deposit rate and stop competing for deposit through high deposit rates. These were important steps that helped reduce banks costs and gradually turn in profits.

You should take pride in the way we have overcome the tough times following the economic crisis. We started with the massive bank recapitalization at very high costs; we dealt with tough debt restructurings in amount and volume unknown in Thai history; we moved to reduce costs by re-engineering our work process and downsizing our work force; we improved services to find alternative source of income, we ceased to compete for deposit through offering high interest rate; and we succeeded in recapitalizing for the second round at lower costs than the initial round. These events combined to show up in better carving results and the potential to grow profitably. Today, I can say with confidence that our banking industry no longer has a weak spot that would pose systemic risk on the economy.

Although many analysts still considered the NPLs number high, in my view, the current situation is much better. Banks have been putting a lot of efforts to solve the NPLs problem. Recently NPLs of the banking system came down to 11.03 %. A closer look at the remaining NPLs of 576.8 billion baht, shows that 84.6 billion baht are loans which have been restructured and awaiting the signing of the agreement or the fulfillment of the 3 months obligation after which they will be reclassified as normal loans. Another 241.6 billion baht is awaiting foreclosure and will eventually become the assets of the banks. The Government is planning to amend the Asset Management Company (AMC), to enable the AMC to buy these NPLs from commercial banks at a fair value. Meanwhile, the remaining 250.6 billion baht are under the restructuring process of banks. I trust that with your efforts the 250.6 billion baht can be brought down to less than 100,000 million baht or to 2% of total loan portfolios in the year 2006. By that time we will be able to announce to the world that our banking system is as strong and competitive as any leading institutions in the region.

Other than the challenges of the resolution of NPLs, the Bank of Thailand has also entrusted upon you the responsibility to develop our financial system in line with the international best practices, namely the adoption of the Basel II framework. The Basel II emphasizes the adequacy of capital in accordance with the underlying risks. Its main objective is to build confidence of international investors and to ensure that Thai commercial banks can increase their access to and compete in a level playing field in international capital markets. I recognize that working towards the adoption of the Basel II framework has been burdensome, complicated, and difficult, but, once we have pointed out its benefits, every bank has been very forthcoming to meet this new international standard. I would like to record our thanks and appreciation for your positive response on this issue.

In addition to moving towards such guidelines, an important element to achieve sound banking with public acceptance, both domestically and internationally, is to have "**Ethical Management**", a term I prefer to the term "Good Governance". This is where Board members and senior management of banks have a duty to play role models to others.

Banking failures in the past have often been associated with unethical mismanagement through lending to related parties, lending to affiliated companies or those of families and friends, or lending to inconspicuous groups upon request of influential powers. In some cases, senior management have also benefited from return favours in the forms of share ownership in the debtor company. The board

of directors of the bank has a duty to prevent these abuses. This must start from the process of selection of bank management who must have high moral grounds and integrity.

I do not wish to use the term "professional" because I have seen many professionals who have taken advantage of their organizations. I would like to see banks select competent management of high moral standing and integrity to manage the institution.

The board of directors must also conduct themselves as role model by exercising restraint and minimizing their exposure to potential conflicts of interest. They must not give special treatment to their relatives and friends, which could potentially lead to losses to the bank. The board of directors must provide the leadership and protection to the management when faced with request from influential powers.

Thai society places virtue on kindness; people in influential position are often approached for special help and favours. Often time such requests are being entertained without prejudice and without the knowledge that such actions can result in the bank's financial losses later on. The duty of the management is to exercise diligence and care in considering such requests. If the loan application meets the bank's criteria, the bank could extend the loans as the case with ordinary customers. Otherwise, management should make an effort to explain the case to the influential party. Such communication will avoid problems and promote mutual understanding. I have done this before when I was working at the EXIM Bank and the requesting party also understood our point.

In general commerce or businesses, the practice of giving special favours or treatment to influential people from time to time through special discounts or complimentary offers do not pose unnecessary risk. But in the business of financial institutions, the losses that ensue are far too great and may lead to the collapse of the financial institutions or the financial system at large. Therefore, it is imperative that board members exercise great care and prudence. In some instances, board members might consider it a minor issue, but as a board member, one cannot afford to undermine one's integrity and reputation. If board members overlook small matters, then management may take the opportunity to do the same but this time with bigger cases, and other finance officers may also do the same until the practice becomes widespread and pose a risk to the bank.

Board members should therefore recognize the critical importance of their office. Board members of banks are not merely board members of a company. They are board members of a financial institution that is part of the financial system of the country. Their responsibility is far-reaching. The bank is responsible for the efficient allocation of resources or the scarce public savings for investment in economically viable projects to enhance the country's potential growth and development. The board should ensure adequate oversight on the allocation of funds to unproductive projects. This is especially so if the board member is the board of a bank which is owned by the state.

More important than their oversight role on management, the Board member must not put themselves in a position that would compromise their integrity by accommodating the requests of friends and families, or by cultivating the favours of influential powers. If board members are in it themselves, there is not stopping others from doing the same.

Unethical behaviour in the management of a bank, also touches on issues other than lending activities, there is also the issue of excessive expenses. Here the management of some banks has been practicing without undue regard for what I would call decent practices. If left unchecked, this practice could be widespread throughout the bank and ultimately affect bank's cost and profitability. Here too, the board must also exercise oversight to safeguard the interests of the organization.

To do this effectively, the boards must exercise restraint not to reap undue benefits from the bank even in small matters. For if board members are tempted by the benefits from the institutions, they would immediately undermine their authority to manage their subordinates.

Let me give an example of what I see as taking undue benefits. Lately, I noticed that the remuneration of Board members in **some banks** have been set at a unreasonably high level. Some banks pay meeting allowances at a relatively fair rate and pay no bonus (which seems appropriate). Some banks pay relatively less meeting allowances but also pay fixed bonus for the heavy responsibilities (which is still considered acceptable). Some banks both pay high meeting allowances and high bonus. And, interestingly the bonus is also paid out at a flexible rate based on yearly profit, which is inherently risky as a scheme of compensation payment.

The point here is that if the remuneration of board members varies with the profits of the bank, then this could create a disincentive for board members to exercise their oversight responsibility to ensure

the prudence and soundness of the bank through adequate provisioning, or prevent management from undertaking excessive risks for greater prospects of profits. Typically, a bank that runs its operations in a normal course of business without special efforts is already expected to generate returns on their business or normal profits. If the entire profit is taken as base to calculate bonus for their board members, would that seem fair to the institution? Furthermore, how would board members explain to their employees that the basis of computation of their bonus is the individual employees' salary, while that used for board members are calculated based on total profits?

I am bringing up this topic today with no intention of being disrespectful to the many senior board of directors of our financial community. I merely noticed the rapid escalation of certain benefits of board members of some banks rising to the point of "excessive". My only concern is that such practices may be brought up by your subordinates, which may undermine your authorities to lead, and to supervise a business that is so vital to the financial system of the country.

However, I do not intend to issue guidelines on this matter. But, I believe that what has been brought up today will lead to significant improvements at your own initiatives. There is a saying from Venerable Phra Dhammapitaka (a highly respected venerable, the master of "Buddhist Economics") that "the righteous path for a business is one which it does right for its customers, its employees, its social and environment, its shareholders, its owners and itself". I subscribe to this principle that an honourable executive is one who does what is right for his employees, his organization (by not excessively taking benefits from the organization), and for himself (by not reducing the benefits he deserves to receive from the organization).

In conclusion, I would like to extend my sincere appreciation to the Thai Bankers Association and all its members for bringing back this traditional gathering. I truly hope that my frank and candid remarks will not lead to cancellation of next year's event!!

I would like to emphasize that I have no ill intentions other than to see our financial system progress and develop with a sound management and ethical standard. There is a deeper meaning to this than the sense of "Good Governance" of the Western world. Above all, the country would then have a financial system that is sound and robust for years to come.

Thank you for your attention.