

Bandid Nijathaworn: National financial system and supervisory framework

Address by Dr Bandid Nijathaworn, Deputy Governor of Bank of Thailand, at the Thai Insurance Forum 2008, Bangkok, 20 October 2008.

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Good morning,

Ladies and gentlemen,

It is my pleasure to be here this morning to speak at the Thai Insurance Forum 2008, organized by the Asia Business Forum. I would like to thank the organizer for the invitation.

Today, my address will focus on two topics. The first is the global financial turmoil, and its implications for the Thai financial system, focusing on the regulatory framework and the banking sector. Next, I will talk about developments in phase II of the Bank of Thailand's Financial Sector Master Plan, and how this will help position the Thai financial sector going forward.

Let me start with the first topic, current developments in the global financial system and its implications.

In contemplating the key issues for my talk a few months ago, the main theme that came to mind was the rapid development and growth of the financial system in emerging markets in Asia. Despite the current global financial turmoil, this theme will remain the subtext for our region in the medium-term. Indeed, the turmoil seems to have highlighted the importance of these developments going forward. The key features of emerging markets in Asia are the rapid changes in the financial landscape, the disintermediation and growth of capital markets, globalisation and the increased linkages between financial markets and economies via cross-border activities, the proliferation of complex financial instruments and the increasing convergence of supervisory framework and standards such as Basel II, IOSCO, the Insurance Core Principles of the International Association of Insurance Supervisors (IAIS), and international accounting standards.

In this changing landscape, we see competition along with synergy between like-institutions as well as different kinds of institutions. In savings instruments and wealth management market, we see the rapid growth of interactions between commercial banks, investment banks, and insurance companies, domestic and overseas. Indeed, different types of financial institutions have different asset-liability structure, risk profile, and therefore together help enhance the completeness of the financial system. For instance, life insurance firms tend to have natural niche in the longer end of the market, and as such, offer opportunities for financing and providing hedging instruments for long-term investment, such as for infrastructure, which is a key driver of Asian economic growth. Many of the longer-term assets have become underlying assets upon which the market for financial engineering thrives-derivatives are used to engineer and structure complex products tailor-made for various market players with different risk-return preferences.

While this process brings benefit, it also brings inherent risks that need to be properly managed, as the current turmoil clearly demonstrates. On the benefit side, the market would become more efficient if buyers and sellers of financial products are offered product choices that better fit their risk-return preferences. Nonetheless, there are important risks, and the subprime and CDO problem have brought this to light. In short, the current global turmoil is a sharp reminder of the danger of overestimating one's own risk management ability. On the one hand, iconic investment banks, giant insurance firms, and market specialists such as rating agencies and bond insurers have, with hindsight, overestimated their ability to price

and manage complex derivatives. On the other hand, regulatory frameworks also need to be strengthened to ensure that financial institutions have adequate capital and liquidity.

Hence, there are calls for strengthening regulations, and I agree that there are many areas such as leveraging and capital requirements that needs to be strengthened. But, I also believe we would do well to approach this in a steady and thorough manner, as regulatory changes need to be considered carefully. Particularly, there needs to be domestic and international harmonization to avoid the sort of harmful arbitrage that has been associated with the current turmoil. Moreover, the current crisis also highlights the truly globalised nature of the financial market, as uncoordinated regulatory measures could cause major difficulty in crisis management. In short, we must ensure that regulations are truly risk-based and non-distortive, on both a domestic and international basis. This requires significant supervisory coordination going forward.

This, however, does not mean that we should be complacent. In the case of the Bank of Thailand, we have asked banks to carry-out stress-tests to ensure that bank's Board and management are fully alert to the increased risk, have the strategy to manage it, and have adequate capital and liquidity even in severe risk scenarios. The result of the stress-tests shows that the system remains resilient, but we will continue to monitor developments closely, and stand ready to take necessary actions to ensure financial stability.

Why have both financial institutions and regulators in mature economies and elsewhere not been fully prepared for such a challenge?

First, there were many factors that caused the deterioration in the credit discipline, including financial innovation such as the originate-distribute model of securitisation which tends to lessen governance in credit process. The key lesson here is that financial innovation can be a mirage which misleads us into disbanding the fundamental discipline required for good risk management and governance. This lesson is not new; it re-emerges with different variants over the years. Therefore, going forward, we need to continue to be vigilant of this risk.

Secondly, as risk-profiles become more complex, so too must risk management and risk-based regulatory framework. Here, the lesson from CDOs is clear in that the regulatory framework, even at the level of international standards, have not properly converged, and there are regulatory arbitrage which resulted in excessive risk taking, to the detriment of the overall financial system.

And thirdly, the level and complexity of interconnectivity of various types of financial institutions have increased very rapidly, and with this, increased counterparty risk and systemic risk implications. Much of this is in the OTC derivatives markets which are hard to monitor, and presents huge problem in unwinding during a crisis, even with standard agreements such as the ISDA Agreements.

The overhaul of international regulatory framework is a major challenge, but as we all know, this process will not be immediate, as the regulators of major economies are still focused on solving the turmoil. In the meantime, it is up to all of us to be aware that conforming to minimum standard, even one prescribed by international best practices, may not be adequate if the risk profiles dictate a higher level of vigilance, risk management, and capital adequacy. In this regard, given the complex nature of financial conglomerates in emerging markets in Asia today, a robust framework of risk management and supervision on a consolidated basis is a must.

In the case of Thailand, we have undergone the Financial Sector Assessment Programme (FSAP) of the IMF and the World Bank in 2007. FSAP assessed the regulatory framework of banks, capital market, insurance, the payment system, against international best practices such as the Basel Core Principles for Effective Banking Supervision, as well as the Insurance Core Principles of IAIS. Overall, the FSAP team found the Thai financial system to be resilient and with the regulatory framework broadly conforming with international best practices.

Moreover, through the Financial Institutions Policy Committee, the Bank of Thailand is working closely with the Ministry of Finance, Office of the Securities and Exchange Commission (SEC), and the Office of Insurance Commissioner to ensure that the regulatory framework is consistent and conducive to financial stability. Where banks have securities companies or insurance companies as subsidiaries in financial conglomerates, the Bank of Thailand as lead supervisor currently supervises on a consolidated basis. It should also be emphasised that the Bank of Thailand is both the central bank as well as bank regulator, while also overseeing the payments system. Thus, we are at a vantage point to closely monitor any risks to financial and economic stability, while also, with coordination with the Ministry of Finance and other regulatory agencies, have the means to act to safeguard the system.

Ladies and gentlemen,

Let me now turn to the impact of the global turmoil on the Thai financial system, especially the banking system.

The global financial turmoil continues to pose a critical challenge as prospects for global growth, asset quality, and banks, capital remain under pressure. In emerging markets, the stock market has been under considerable pressure. As of the 13th of October, the MSCI Asia Pacific Index declined by 49 percent from its peak in November 2007, indicating the pressure of retreat to safe-haven, and lower liquidity in financial markets in emerging countries.

Most recently, the IMF, in its World Economic Outlook assessment of October 2008, forecasted that “The world economy is entering a major downturn in the face of the most dangerous financial shock in mature financial markets since the 1930s. Global growth is projected to slow substantially in 2008, and a modest recovery would only begin later in 2009. [...] The immediate policy challenge is to stabilize financial conditions, while nursing economies through a period of slow activity and keeping inflation under control.”

Nevertheless, there is also a positive development. Central banks and regulators around the world are now taking coordinated and concrete actions. Comprehensive measures aimed at restoring confidence in the banking systems include provision of liquidity, new capital injection, guarantee of interbank loans, blanket deposit guarantee, and government purchase of troubled assets.

As for Thailand, despite the magnitude of the turmoil in the global financial market and the decline in local stock market, the immediate impact of the turmoil on Thailand’s banking system thus far has been limited. This is because the direct first-round impact linked to investment exposure of the Thai banking system is small. The indirect second-round impact via the downside risks to economic growth and financial market volatility, however, will be a challenge and will require vigilance on macroeconomic policy, as well as prudential measures, to ensure continued economic growth and financial stability.

Let me cite some of the factors which have helped to keep the direct negative impacts limited.

First, Thai banks have low direct exposure to problem assets.

The total foreign investment of Thai banks amounts to only around 1.2 percent of their total asset, and a small part of this is the investment by Thai banks on CDOs. Banks that have CDO investments have mostly sold them off, and all have made full provision and recognized losses in line with IAS 39.

Secondly, Thai banks rely predominantly on local deposits for funding, as opposed to the international wholesale market. This helps make the domestic financial conditions more stable and not affected by the global credit crunch.

Liquidity conditions in the Thai system have remained more or less stable, though liquidity tightened marginally due to acceleration in credit growth. The ratio of loan to deposits,

including bills of exchange, has been stable at around 90 percent, indicating no shortfall in liquidity.

Thirdly, the fundamentals of the Thai banking system have strengthened markedly, with robust capital and improved risk management.

Banks have had solid profit since 2001, with gross NPL ratio to total loans declining to 6.4 percent and the NPL ratio net of provisioning declining to 3.4 percent as of the end of the second quarter of this year. NPLs are fully provisioned for in accordance with IAS 39. In August, the BIS capital ratio of the banking system increased to 15.5 percent due to higher profit and capital increase. Credit growth accelerated to 11.3 percent, supportive of economic growth, while banks, fund mobilization via deposits and bills of exchange accelerated to 3.6 percent in August, allowing the ratio of loan to deposits, including bills of exchange, to remain stable. In sum, over the years, better risk management, improved asset quality, greater provisioning coverage, and enhanced regulatory and supervisory framework have significantly improved the overall risk profile of the Thai banking sector.

Fourthly, despite much weaker global outlook, Thailand's economic conditions are expected to be well-supported.

GDP growth for the first half of this year stood at 5.7 percent, with inflation contained through appropriate monetary policy and aided by the fiscal package which delayed some utility price increase for around six months. While the expected slower global growth would pose downside risk to domestic growth via a slowdown in exports, Thailand has a considerable policy room, especially fiscal policy, which helps to cushion the impact, by employing macroeconomic and prudential measures to support growth and maintain financial stability.

Nevertheless, we cannot afford to be complacent given the severity of the global turmoil. The Bank of Thailand has asked banks to conduct stress-testing to ensure banks are alert to potential impact of downside risks. Recent stress-testing, which covers credit market, and liquidity risks, linked to a macroeconomic impact scenario, confirms the resiliency of the Thai banking sector.

On the regulatory front, considerable progress has been made to increase the efficiency, adhere to international best practices, strengthen banks, capital position and enhance risk management practices. The Bank of Thailand continues to place great emphasis on strengthening the regulatory framework and our surveillance capability in order to carry out prompt actions to adequately assess and deal with emerging risks in the financial system. We also have regular dialogues with top management of banks to discuss financial and business conditions, risk management, and issues relating to broader economic and financial stability.

In terms of international standards, Thailand is on track to adopting the Basel II framework starting end of this year. For the move to Basel II, banks are aligning their risk management practices to prepare for the increase in requirements. In addition, the new Financial Institutions Businesses Act, which came into effect this past August, has also empowered the Bank of Thailand to fully enforce consolidated supervision, carry out prompt corrective action, and strengthen the governance of boards and top management.

Ladies and gentlemen,

Let me now turn to my second topic today, that is the medium-term plan to strengthen the efficiency and financial infrastructure for the banking system under the ***Financial Sector Master Plan Phase II***.

During the past five years, and under Phase I of the Financial Sector Master Plan, considerable progress has been made in strengthening the banking system, through consolidation of financial institutions, under the "One Presence" policy. There has been voluntary merger and acquisitions, among local institutions as well as with foreign partnerships, leading to fewer but stronger players, enhanced capital base, improved risk

management and operational efficiency. The enhanced strength and increased competition has fostered continued profitability as well as expansion of economies of scale and scope in the banking system, with wider range of products to serve the public.

Going forward, Phase II of the Financial Sector Master Plan seeks to build further on this process, and ensure that the Thai banking system can meet future challenges. These challenges include globalisation and technological development which will increase competition in retail banking. The Thai economy will become more open, with increasing intra-regional trade and investment, due to the growing importance of regional economies in the world economy as well as various trade and investment treaties. Hence, financial institutions need to not only build resiliency and ability to adjust to these changes, but also build capacity to serve clients which will have growing needs for international businesses and risk management. Moreover, demographic factors point to an aging-society in the future, thus increasing demand for wealth management. The regulatory framework will continue to evolve with due regard to international standards and local needs. Indeed, with the current global financial turmoil, each of these challenges will become even more poignant in the future.

The implication of these challenges to Thai financial institutions is that they must enhance their operating efficiency and risk management, while also becoming more responsive to clients, with fair and transparent treatment.

Given these challenges, what do we envisage are the key features of the future landscape?

We would like to see the banking system that is efficient, competitive, robust, and resilient at all times; the banking system that is able to support continued economic growth, while providing better access to the underserved segments. Different types of banks will operate in each market niche to provide better service via improved access, choice, and pricing. These banks will have enhanced efficiency via increased economies of scale and scope through voluntary mergers as well as expansion of business scope and deregulation, under a modernised legal framework. With this improvement, the local banking system will be better placed to meet the future challenges of market innovation and international competition.

Ladies and gentlemen,

The policy framework to achieve these objectives under the Financial Sector Master Plan Phase II comprises three key pillars. Firstly, improving the regulatory environment and reducing regulatory and legacy costs. Secondly, enhancing efficiency by injection of competition in an orderly manner, and thirdly, by improving financial market infrastructure such as the legal system and information, key to effective risk management.

Let me turn to these three Pillars in more detail.

Pillar I focuses on the assessment of the regulatory framework and streamlining regulations in order to minimize the burden of banks without compromising prudential imperatives. This will be done by shifting more to a principle-based approach focusing on risk, lowering operating costs stemming from regulation, as well as tackling remaining legacy NPLs.

Under ***Pillar II***, the objective is to enhance efficiency by an orderly increase of competition and promotion of financial access. Pillar II is based on five key principles. The first principle is to ensure a robust banking system that is resilient, committed and able to provide a strong foundation to support the Thai economy at all times. In the second principle, banks will be encouraged to reap the economy of scale by promoting voluntary consolidation to promote competitiveness. At the same time, proper competition policy will also be put in place to ensure fair consumer treatment. The third principle aims to promote competition via the liberalization of branch network and business scope and to enhance the roles of existing players, including banks and niche banks, while the fourth principle will consider new entries based on the value added to the economy. Lastly, the fifth principle will focus on enhancing the role of specialised financial institutions in providing increasing access to financial

services for the low-income and small business groups and reducing the role of the state in commercial banking.

Pillar III, on the other hand, will focus on laying down the foundation for a strong and supportive infrastructure for the medium term development of the financial system. This will be done through further enhancing the market and products which will facilitate banks, own risk management, promoting an effective information system and pushing for the amendments of necessary laws to facilitate risk management.

Ladies and Gentlemen,

The Thai banking system will continue to face new challenges going forward, both from external developments and domestic factors. In addition, the financial landscape is changing due to various factors including increasing competition, changing market demand, more complex risk and innovation in business models and financial products. Meeting these challenges will require efficient risk management, improved financial infrastructure as well as enhanced regulatory and supervisory framework to keep abreast of the changing environment. The ultimate goal would be a resilient financial system that is capable enough of withstanding external instabilities.

Ladies and Gentlemen,

In conclusion, let me just say that the underlying cause of financial turmoil, be it the Asian crisis over ten years ago or the current one, bears important lessons for the global economy as well as for Thailand. As the forces of innovation, globalisation, and increasing integration continues to steer the course of our financial system, meeting the increasing challenges will not only require an effective risk monitoring and management system, but also the concerted efforts of industry players to adopt and apply best practices.

As for the current situation, while it is yet uncertain how the current financial situation will unwind, the regulatory and supervisory management will have to keep abreast of the game. For us, as the Thai economy enters this more challenging period, we as bank regulators will have to continue to be vigilant to ensure a safe and sound banking system that is capable of weathering the storm, without adverse impact on its crucial role of supporting the real economy.

On that note, I would like to wish all of you a very productive and successful forum.

Thank you for your attention.