

Tarisa Watanagase: Asian banking – coping with risks and seizing opportunities

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Chairman of Asian Pacific Bankers Council,

Distinguished Speakers and Guests,

I would like to thank the Asian Pacific Bankers Council for inviting me to join this meeting today. With great uncertainty ahead, actions of each and everyone – banks, regulators, central bankers – can have significant impact at home and abroad. At this time, confidence and trust forged by candid and opened communication between key stakeholders is of paramount importance. Therefore, this meeting offers an immense opportunity for us to foster this dialogue.

Just over a month ago, the global economic and financial market condition was at a much different place from today. Since then, the magnitude of market adjustment, volatility, and contagion across markets, types of institutions, and countries have proven that risk diversification is easier said than done. This is especially as markets and institutions seem to correlate in a crisis as a result of risk-aversion and fear of counterparty risk.

Nevertheless, the positive factor that has emerged is that governments of major economies and financial centres are now addressing this with comprehensive package. The aims are chiefly to restore “main street’s” confidence by deposit guaranty; to shore up “Wall Street’s” confidence with adequate liquidity; and to mitigate counterparty risk through interbank guaranty. The rescue package also spans injecting capital into systemically important players, and neutralizing short-term market impact of valuation of toxic assets by underwriting those risks themselves.

Ladies and Gentlemen,

Up to now, banks in Asia have been less affected by the direct impact of the global financial turmoil. At this juncture, subprime-related losses have been lower in Asia than elsewhere. The estimated write down and credit loss, as recoded by Bloomberg on 28th October, is about 27 billion US dollars for Asia, compared with 430 billion US dollars in the U.S. and 221 billion US dollars in Europe.

While this may be the case, the impact on regional capital markets, including the prices of bank stocks and widening credit spread, signals a much deeper concern. Events in the recent weeks reflected market worries of the second round impact via expected slowdown in the global economy, trade, and exports. Of course, the last leg to all of this is the currency volatility experienced by regional currencies. In fact, we saw, for the first time in this past decade, intervention by some regional central banks that would have been quite unthinkable a year ago.

Looking ahead, significant downside risk to growth and upside risk to volatility remains. On the growth side, the October IMF World Economic Outlook sees the world economy entering a major downturn. Global growth is projected to slow substantially in 2008 and only a modest recovery would begin later in 2009. Against this background, key concerns of Asian central banks focus on the global economic slowdown, tightened global liquidity, and potential capital outflow. Indeed, slower export growth to major advanced economies, and adverse changes in equity market wealth on real consumption, investment, and income will certainly affect export-dependent Asian economies.

As for financial market volatility going forward, some of the growth projections that came out of various sources, including the degree of volatility in asset and currency markets, would quite easily exceed even the most conservative stress-test scenario that most banks would have carried out six months ago. However, if the experience of Asian crisis is anything to go by, one should remain alert to the possibility of a long period of correction and adjustment. Moreover, given the global contagion, economies and markets with less structural resiliency, and lacking width and depth and thus liquidity, may eventually encounter dislocations in their real sectors.

What does this combination of global slowdown and heightened market volatility mean for banks and financial regulators?

Ladies and Gentlemen,

In this scenario, **credit risk** management would be the priority for banks and regulators, to ensure that going forward, asset quality remains sound, and banks have adequate capital and provision to absorb this risk. Indeed, the underlying cause of the present global financial crisis is the lapse in credit culture and credit risk management, which has allowed excessive leveraging and indebtedness. Moreover, raising new private capital in this environment is a very tall order; while the option of public capital injection very costly for shareholders and tax payers. Therefore, it is imperative that banks need to be even more vigilant in managing not only their asset quality but also their internal capital, funding, expenditure including executive pay, and dividend policy.

Looking at banks in the Asian region, such as Thailand, despite rapid development of capital market in recent years, the core banking businesses remain traditional; largely deposit taking and loan extension. Meanwhile, treasury operation remains relative small. Moreover, with the financial market predominantly bank-based rather than market-based, there tends to be less risk and complication arising from the originate-to-distribute models of securitisation.

Nevertheless, in the past few years, banks have expanded business scope, operating as universal banks or financial conglomerate, with securities and insurance arms. Therefore, organisational structure and risk profile, of even the more traditional banks, have become much more complex. This, in turn, demands that bank's risk management, Board's oversight, and supervisory framework can match the increasing complexity and ensure adequacy of capital and risk management system on a consolidated basis.

On **market risk**, some banks in Asia and Pacific countries have been exposed to the subprime related assets such as CDOs as well as assets of failed institutions. The losses so far have been limited to foreign assets and are addressed by private and government assistance. On hindsight, this crisis highlights the fact that it is easy to overestimate one's risk management ability. The same applies to banks, rating agencies, specialist players such as bond insurers, hedge funds, and regulators. Mistakes brought down even highly sophisticated market makers and specialist players such as Lehman, Bear Sterns, and AIG.

The CDOs and structured products were very complex, and their valuation and risk management required sophisticated quantitative skill. When mark-to-market failed, mark-to-model becomes complicated by absence of in-house capacity. And, the option of turning to external expert valuer such as arrangers is very expensive, due to the lack of liquidity and captive nature of such market. Thus, the knowledge required to properly manage these risks goes well beyond the quantitative skill and the usual front-office ability to value, price, and trade in normal market period.

During abnormal periods, the Board must understand the context of each market, especially its market structure, to be in a better position to gauge erratic market behaviour and liquidity. Board members need to have a clear view, for example, whether the market would likely become a captive one, and the degree of counterparty risk in such OTC derivatives market. In the crisis environment, the strength of capacity of mid-and back-office becomes critical for minimizing losses, such as by reducing counterparty risk, and dealing with settlement risks.

As this crisis develops, financial markets have witnessed, in an unprecedented manner, the unwinding of many contracts, even those backed by standard agreements like ISDA.

On this note, I must stress that under-investment in human capacity and system of mid- and back-offices, as opposed to fronts, could prove costly. Building the capacity of mid- and back-offices may require in-house investment, as recruitment from market may not be as easy as front-office, but possibly more important, a change in management culture, which can only come from leadership of top management.

Ladies and gentlemen,

For those more conservative banks or financial markets, not affected in this first round hit, I also say that they cannot afford to be complacent. As in risk rating framework, it is neither the risk exposure nor risk management ability that determines bank's riskiness, but the danger lies in the gap between the two. Therefore, banks, though engaged in less complex products would still be at risk if their ability to manage such risk is lagging behind their products.

Indeed, the gap between risk exposure and management capacity becomes more important in a very volatile macroeconomic and financial environment. This is since such a gap may possibly emerge or expand undetected, given the dynamics of market events. Even with plain vanilla products, the exposure can become complex due to the number of positions used for different hedges and at different strikes. This is not to mention the complex layers of counterparty, with counterparty risk and concentration risk.

At such time as this, caution is vital, because even conservative banks could be exposed to market risk from domestic assets as well as currency risk. Even if not directly, risks could come indirectly via the exposure of their clients, especially in the case of interlinked market and credit risks.

The present environment also raises concerns of the close link between financial and reputation risks. Banks or their affiliates, be they fund management or insurance arms, may have sold inappropriate products to clients without doing proper due customer diligence or education. As a result, clients' losses could lead to either bad assets and credit risk, counterparty risk, or reputation risk for banks if dissatisfied customers generate queue and protest in front of the banks, or even legal risk. In this environment of tight liquidity, and depositors have bargaining power, reputation risk and customer queue and loss of confidence could translate into liquidity risk.

This brings me to the third risk implication from this global crisis, which is the **liquidity risk**. Indeed, tightened global liquidity will be more pronounced for economies that rely on external short-term debt. For other economies, the shift of external funding toward domestic sources and the effect on trading partners' economies could cause a widespread contraction in credit supply. Furthermore, re-pricing of risks by investors and deleveraging has increased the risks and volatilities in global financial markets, which could in turn lead to greater risk-aversion in emerging markets. As a consequence, there could potentially be more reversals of capital flows from emerging markets, including Asia, thereby denting growth in countries heavily dependent on capital inflows.

Having said this, there is a sense of comfort that the capital base of banks in this region remains relatively sound. But going forward, banks, regulators, and central banks would benefit from undergoing stress-test and crisis management exercise to assess their strategy and make necessary adjustment to their risk management and capital policy. The close dialogue forged by such an exercise will be very useful in helping to instigate coordinated actions including information sharing.

In terms of financial stability surveillance, candid on-going dialogue and market communication between key stakeholders is at the heart of an early identification of emerging trends and risk in the system. We all know that most indicators, risk models, and early warning models are built based on the structure of the past crisis, but no two crises are identical. For the Thai banks, you are already familiar with the stress-test, both top-down and

bottom-up, that has started last year when we successfully completed the assessment of the Financial Sector Assessment Programme of the IMF and the World Bank, or the FSAP.

Ladies and Gentlemen,

The present global financial crisis highlights the importance of supervisory coordination. While this has been especially critical for crisis management in affected countries, a step-up in coordination would also be critical for currently unaffected countries as well. Importantly, this coordination should include both domestic and cross-border dimensions. And, it should encompass key regulators and central banks, for information sharing and elimination of regulatory arbitrage, which has been one of the underlying causes of this crisis.

While the crisis management may lead to rapid changes in regulatory framework, such as the much discussed mark-to-market rule, it is important to remember two things. First, investors would form their own opinion of valuation. Second, differences in such treatment could, if not carefully managed, cause regulatory arbitrage, moral hazard, deterioration in risk management culture, and difficulty in exit-policy.

There is of course no simple rulebook on how to deal with a crisis. Each country has to take into account its own institutional context. But, the mantra of a good and sensible risk management, especially at its core principle level, should not be violated. Again, I cannot overemphasize that the internal risk management system of banks should match its risk profile, as deemed appropriate by the Board. Simply observing minimum regulatory standards or international standards may not be adequate. Should the nature of its underlying risk indicate otherwise, attempts to ignore it would likely be tested by markets, and with real consequences. For this reason, the key principle of Basel II makes a very good sense, and even more so with the dynamic changes in risk emerging from the current crisis.

On the issue of cooperation, I am pleased to say that central banks and regulators of the Asia Pacific region have forged a very close cooperation over the years, under fora including ASEAN, EMEAP, SEACEN, and SEANZA. These fora, where finance ministers, central bank governors, and financial regulators meet regularly with each other and with their private sector counterparts, have achieved an important voice in the global financial community in recent years.

In the area of banking supervision, EMEAP – comprising ASEAN 5, China, Japan, Korea, Hong Kong, plus Australia and New Zealand – has representatives in the various BIS committees and working group, which set the international standards for financial regulations. In fact, Thailand currently represents the EMEAP group in the Accord Implementation Group. Through such avenues, the authorities in Asia Pacific region have and will continue to influence the evolution of the global standards. The goal is to ensure that these standards are suitable to the context of our economies and financial systems, based on feedbacks and dialogues with our regional banks.

Ladies and Gentlemen,

We all agree that the challenges for Asian economies and Asian banks are higher going forward. To ensure financial and economic stability to support long-term growth, the authorities need to foster closer policy coordination among regulators, domestically and internationally, as well as having continuous dialogue with market participants. Where possible, closer regional cooperation in the areas of surveillance and financing should be promoted further. Domestically, greater macroeconomic policy flexibility hinges on augmenting monetary and fiscal policies with financial policies that mitigate contagion risks in financial markets. In any case, a policy should be implemented carefully, avoiding overreaction that could increase distortion and instability in the economic and financial systems.

Given that the current turmoil will bring about changes in the financial landscape, both the policymakers and private sector have to adapt themselves in an effective manner. To increase financial system resiliency, including by improving the credit information system,

regulatory reform could possibly mean more stringent prudential guidelines during the upturn to help financial institutions achieve bigger cushions during the downturn period.

In this challenging time, the private sector has to be alert, yet prudent with the new opportunities available. The board of directors and senior management has to oversee the operations and risk profile of their organization closely and regularly.

Ladies and gentlemen,

Just before ending note, allow me to touch on the situation in Thailand and the impact of the global crisis.

The latest assessment of Monetary Policy Committee projected that growth is expected to moderate, to a range of 4.3 to 5 percent this year, and 3.8 to 5 percent next year. Inflation should subside next year, with headline CPI at around 3 to 4 percent. External position will remain strong with current account surplus for this year and next year, international reserves currently at around 104 billion US dollars, while external debt is 65 billion US dollars as of August, of which just over one-third is short-term. Overall, the economy does not have imbalances that could pose as vulnerability.

The Thai banking system remains resilient and profitable, due to strengthened risk management of banks as well as the continued stable macroeconomic conditions at home, and credit growth remains supportive of the economy. BIS capital ratio stood at 15.7 percent at end-September. NPL has continued to decline in third quarter by another 15.7 billion, gross ratio to total loans down to 6 percent, and Net NPL ratio down to 3.3 percent. NPL is fully provisioned for in according to IAS 39 since the end of last year. We will continue to encourage banks to focus on bringing this down further to strengthen the sector outlook.

Liquidity conditions in the banking system remains normal as Thai banks rely on local funding in the form of deposit with some small portion of bill of exchange, or B/E, for 86 percent of the total liability. Thus, the Thai banking system is quite unaffected by direct impact from global credit crunch. Overall, the liquidity indicator, the ratio of loan to deposit plus B/E, is stable at around 90 percent throughout the third quarter, with slight tightening at the end of second quarter as loan growth accelerated, reaching 13.2 percent in September.

The direct impact of the turmoil so far on the Thai banking sector has been limited. This is because the Thai banking sector has low direct exposure to CDOs and other problem assets. Thai banks' exposure to CDOs including sub-prime CDOs is now less than 0.1 percent of total asset. Banks with CDO exposure have already made full provisioning and recognized losses in line with IAS 39, and presently all sub-prime related CDOs have been unwound. Thai banks also have very low exposure to investment banks like Lehman Brothers and have no investment in US GSE securities. In all, total exposure of Thai banks to foreign investment is about 1.2 percent of total assets, about half of which are sovereign assets.

Having said this, we are very mindful of the risk from second round effect of slowdown in global growth and domestic growth, which can affect credit, market, as well as liquidity risk. To handle this, the Bank of Thailand has been holding dialogue with top managements of banks to discuss financial stability outlook, and have conducted stress-test to ensure that banks are alert to these risks and are able to manage them to ensure adequate capital and liquidity. We will continue to hold candid and two-ways dialogues with all the banks operating here to ensure that we can manage these challenges and dynamics of the global turmoil.

Ladies and gentlemen,

I would like to conclude with some lessons learned so far to increase our immune system going forward. First, growth must be based on strong macroeconomic foundation, with prudent fiscal and monetary policy, flexible policy options, and strong external positions. Second, sound system of financial institutions, with adequate capital fund, good risk management, corporate governance, and systematic and effective system of financial and market information disclosure that promotes market discipline is important for economic

stability. Finally, the private sector should increase competitiveness and the ability to adapt, with emphasis on human resource development and key infrastructure.

Ladies and Gentlemen,

With increased globalisation and financial integration, emerging market economies has become more synchronized with advanced countries. As the turmoil is unfolding, we must work even more closely together to ensure smooth adjustment and safeguard economic and financial stability.

Thank you for your attention.