The banking industry in Thailand: competition, consolidation and systemic stability

Tarisa Watanagase

1. Forces for change

In Thailand, the recent financial crisis was not only brought about by factors related to the economic cycle but also exacerbated by structural weaknesses in the system. A significant cause of the crisis was the massive capital inflows into the economy without effective management mechanisms. Some examples of the weak initial conditions are ineffective corporate governance, inadequate supervision and regulation, and insufficient or in some cases inaccurate disclosure which resulted in lax credit policies in banks and other financial institutions and misuse of funds in the corporate sector.

Thailand initiated its financial liberalisation efforts in the early 1990s. The first step was the acceptance of Article VIII of the International Monetary Fund's Articles of Agreement, followed by a series of deregulatory measures in the financial system. Market opening of the financial system ensued with the establishment of the Bangkok International Banking Facilities (BIBFs) in 1993, which coincided with the global trend of surges in capital flows to the emerging market economies. In July 1997, Thailand faced the worst economic and financial crisis in its recent history. In retrospect, the crisis was closely linked to the premature financial liberalisation and market opening.

Owing to the liberalisation policy and the swiftness of capital mobility in the integrated financial system, business has access to overseas funds at relatively low cost and allocated such funds for rapid expansion and other purposes; a process which was in general not subject to adequate monitoring and control. It cannot be denied that liberalisation at a time when the underlying economic strength and infrastructure were not yet well instituted posed threats to both the host country and the global market place because of the potential for contagion and systemic impacts. The following subsections list some major infrastructure components that were absent at the outbreak of the recent crisis and what has been done in order to prevent future crises.

1.1 Inadequate information system

While information on foreign borrowing through the banking system was monitored, inadequate information on non-bank private corporate foreign debt resulted in an incomplete aggregate picture of the country's foreign liabilities. Data on sectoral allocation of credits did not show any signs of over-extension to the property or real estate sectors, and in fact funds seemed to be properly allocated to the "productive" sectors. Direct lending to the property sector or real estate businesses was consistently below 5% of total lending.

However, it became apparent after the crisis that these so-called productive sectors, such as exporters, had used their BIBF proceeds to invest heavily in the property and real estate sectors, thus turning the entire business group into NPLs overnight as the baht depreciated.

Another area of information deficiency was demand and supply in the property market. During the bubble economy period, the real estate industry grew rapidly. However, developers were not fully aware until much later that supply was considerably outgrowing demand.

Systems for collecting necessary data are now in place. Thailand became the 21st country to meet the specifications of the Special Data Dissemination Standard, established in May 1996 by the International Monetary Fund to enhance the quality, integrity, availability and timeliness of comprehensive economic and financial statistics. Moreover, Thailand is in the process of enacting the Credit Bureau Act so that banks can disclose both personal and corporate loan information about borrowers without seeking the borrower's consent.

1.2 Inability to utilise policy instruments, particularly the exchange rate

Rigidity in the exchange rate system, and the lack of political will to tighten fiscal policy in the midst of an overheating economy, sent a warning signal worldwide of the unsustainability of the country's economic situation. Pressure was also put on monetary policy, which was further constrained by its inability to act autonomously. The high interest rate policy, in turn, encouraged further foreign capital inflows, exacerbating the already overheated economy.

Under a basket-peg exchange rate regime and volatile global capital flows, little room was available for independent monetary policy. Defending or abandoning the exchange rate peg was a difficult policy dilemma. In fact, before the float, the real effective exchange rate had appreciated in line with the US dollar. However, whether and to what extent it was overvalued was controversial, as it depends on the "equilibrium" real effective exchange rate. If one takes the period when the current account was in equilibrium, say in 1990, as the benchmark, there was an overvaluation of 8% at most at the time of the float. However, recognising the loss in competitiveness and structural changes since 1990, such a benchmark would have been too simplistic. Nevertheless, it was felt that tampering with the exchange rate system (eg band widening) under the circumstance of intense speculative pressure and ebbing domestic confidence would have resulted in a wholesale run on the baht and prompted an immediate currency crisis. The Bank of Thailand, even with substantial foreign reserves, would not have been able to stabilise the exchange rate, given the much larger unhedged foreign currency debts of Thai corporations, which would have rushed to close their exposure on the first signs of any weakening commitment to a stable exchange rate. The decision was made to protect the exchange rate system as long as possible in order to buy time for the authorities to tackle fundamental problems in the economy and the financial sector without having to face a simultaneous currency crisis.

Such a policy decision was premised on the rationale that a devaluation of the baht would have done more harm than good for the following reasons:

- High import content of Thai export products implied that there would be only limited gains in export competitiveness.
- Large losses on unhedged foreign currency debt would result in a high number of corporate bankruptcies, leading to unemployment and consequent social problems.
- Financial institutions' asset quality would be further impaired due to weakened corporate sector.
- Inflationary pressure would intensify through higher import costs and wage demands.
- Higher interest rates to contain inflation would make it even more difficult for weak financial institutions to recover.

On 2 July 1997, however, Thailand's exchange rate system was changed to a managed float, whereby the value of the baht is determined by market forces.

1.3 Outdated legal framework

Another factor contributing to the difficult pre-crisis environment was the outdated legal and regulatory framework. The foreclosure law involved lengthy procedures that did not allow financial institutions to sell, foreclose or dispose of bad debts to stop losses. This law, as well as the bankruptcy law, has now been amended to expedite legal procedures. The new laws, especially the bankruptcy law, also facilitate the settling of cases in court as well as provide opportunities for both creditors and debtors to rehabilitate the debts for mutual benefits.

At the same time, the new Financial Institutions Act has been drafted and is currently before parliament. It will pave the way for Thai supervisors to improve their approaches in response to the changing financial environment. The draft law broadens the scope of commercial banks' financial activities by allowing them to form financial conglomerates, empowers the Bank of Thailand to apply consolidated supervision and encourages the practice of good governance. Not only can market discipline impose strong incentives on banks to conduct their business in a safe, sound and efficient manner, but it can also encourage them to allocate efficiently resources and maintain a strong cushion against future losses. Since reliable and timely information enables all stakeholders to make effective assessments, the Bank of Thailand has required financial institutions to disclose specified information following the accounting standards, which are in line with international standards.

1.4 Inexperienced risk management and poor governance of financial institutions and corporations

Banks' lending practices were largely collateral-based. Less attention was paid to cash flow or analyses of project feasibility. With the property and stock price boom, financial institutions did not expend resources on valuing the underlying collateral. Banks were also under pressure from shareholders to take on risky investments in return for potential profits that would allow attractive dividend payments. This, in turn, made them less vigilant in monitoring and taking appropriate actions against borrowers once they showed signs of financial deterioration. Unfortunately, the real estate and stock market booms overshadowed the growing risks inherent in the system.

Before 1997, a number of Thai corporations had taken advantage of cheap foreign funds and the pegged exchange rate to borrow heavily from abroad. Many of them neither had foreign currency income, nor adequately hedged positions. When the exchange rate regime changed to the managed float system, many found their foreign liabilities had approximately doubled.

Risk management has become an essential component of the financial sector as financial institutions compete in an environment of increased risk and larger and more liquid financial markets. The Bank of Thailand organised a risk management symposium to promote a broader understanding of the risks involved in the finance and banking sector as well as stimulate concerted action to develop and strengthen prudential standards towards risk management for the stability of the Thai financial system.

1.5 Lax supervision

Prudential regulations, especially in the area of loan classification and provisioning, were inadequate. The skills required for on-site examination, and off-site supervision using a risk-based approach, were lacking. This, coupled with the absence of proper credit risk analysis, led to financial structures that were inherently fragile. To make matters worse, the weak standard of transparency and disclosure in private financial institutions also brought on a sense of mistrust. Banks did not have good internal control systems in place, while their managers had not been made more accountable.

As such, the component of market discipline can indirectly assist in reinforcing supervisory efforts in promoting risk management in banks and the financial system, since it adds pressure for financial institutions to manage themselves in a safe and sound manner. Effective market discipline requires reliable and timely information that enables all stakeholders to make effective assessments.

To address concerns about transparency and disclosure, the Bank of Thailand has required financial institutions to disclose necessary information along the same lines as the accounting standards. In addition, they must disclose their NPLs and related lending on a monthly basis. The Bank of Thailand has also changed the emphasis of its supervision to be more focused on risk and less on verification of transactions. Examiners are specialised through effective examination planning and scoping to suit the size and activities of financial institutions and to concentrate on areas that expose the financial institutions to the greatest degree of risk. An Examiners' School and examiner commissioning process have been established.

In addition, the Bank of Thailand has put forth various measures to improve governance, including:

- Limiting a bank's lending to related companies to no more than 50% of shareholders' equity or 25% of the company's total liabilities or 5% of the bank's Tier 1 capital, whichever is lowest.
- Restricting a bank's lending to related companies where cross-directorship exists. Where directors or senior executives of the bank also hold directorships and own shares exceeding 1% of paid-up capital of the related companies, lending to these companies is prohibited.
- Prohibiting senior executives and directors of a bank from holding directorships in more than three companies.
- Prescribing minimum requirements for procedures for granting credit, investing in securities, undertaking contingent liabilities for any person, and selling assets.

Furthermore, the Bank of Thailand has established a working group, with the participation of the banking industry, to map out guidelines for the Thai financial sector on the practice of good governance in line with international best practices. Preliminary recommendations include:

- Encouraging or requiring financial institutions to establish committees such as an audit committee, nomination committee and compensation committee.
- Encouraging or requiring financial institutions to have independent directors as the key component of the board and committees to form independent views on business policy issues and monitoring of the institution.

2. State banks: privatisation

2.1 Current development

The economic crisis in Asia in 1997 was the starting point for many countries in this region to lay down measures to solve financial sector problems. Giving foreign financial institutions an opportunity to invest in this region by, for example, forming business alliances with domestic financial institutions or buying financial institutions intervened by the government allows major international financial institutions to play an essential role in Asia.

During the crisis, seven Thai banks were intervened and taken into state ownership. In 1998, one bank was closed, and bad assets were transferred to an asset management company (AMC), due to the large losses. One was fully acquired by a state-owned bank. One was merged with a bank while another was merged with another financial institution. The main purpose of intervention is to strengthen financial institutions by merging them or selling them to the private sector through open competitive bidding processes to ensure fair competition and transparency. Consequently, two intervened banks were privatised in 1999 while the resolution of the other two banks was expected to be completed by the end of 2000. In addition, the authority aims to decrease gradually its stake in the remaining two banks in the medium term.

2.2 Deposit guarantee

While a deposit insurance scheme has not been implemented in Thailand, the Financial Institution Development Fund (FIDF) has provided blanket insurance to depositors and creditors of the closed banks, finance companies and credit fonciers in full amount.

For purchasers of state-owned banks, the FIDF guaranteed to compensate losses from NPLs through yield maintenance and gain-/loss-sharing schemes.

2.3 Transaction structure

In most cases, the FIDF is offering two distinct support packages to potential buyers:

(a) Loss sharing

Under this structure, the FIDF will enter into a Loss Sharing Agreement with the bank. The FIDF will thereby agree to reimburse the bank for a specified percentage of losses on covered NPLs and for the cost of holding covered NPLs on its balance sheet. Loss sharing will cover only loans above a certain size which are NPLs as of the date of closure and no more than 15% of remaining loans which become NPLs within six months of the date of closure. The loss-sharing agreement will establish two loss-sharing percentages, two loss-sharing thresholds and the initial reserve (representing the proportion of the specified losses to be borne by the FIDF).

Under the loss-sharing agreement, the FIDF will only share the losses above the first threshold. Bidders must specify the first and second loss-sharing percentages as part of the bids.

(b) AMC with loss sharing

This option is similar to pure loss sharing as described above. The key difference is that specified NPLs will be transferred to an AMC, which is owned by the FIDF. There will then be a loss sharing agreement between the Bank and the AMC.

3. Domestic mergers

In a number of countries, mergers take place in order to create synergy, reduce costs and increase the competitive edge of the merged institutions. In the case of Thailand, recent mergers were the consequences of problem bank resolution and the policy to reduce the number of smaller financial institutions. Any five or more finance companies, finance and securities companies and credit foncier companies can merge to form a restricted-licence bank, which will be further upgraded to a fully-fledged bank at a later stage.

4. Entry of foreign banks

From 1993 the Bank of Thailand authorised the establishment of the Bangkok International Banking Facilities (BIBFs) which allowed greater diversification of service providers through new international entrants. In addition, it enabled domestic banks to diversify their business towards international banking intermediation by obtaining offshore funds to lend to either the domestic market (out-in) or to the international market (out-out).

Since BIBFs are not allowed to take domestic deposits, they are subject to fewer regulations than commercial banks. For instance, BIBFs are not required to observe a minimum capital adequacy ratio. BIBFs also carry a lower corporate tax rate of 10%, as opposed to 30% in the case of banks. However, current policy does not allow new entry of foreign banks through BIBFs or full-licensed branches. Rather, foreign investors that have sound financial standing and high potential to help strengthen local financial institutions are allowed to hold more than 49% of the shares. With the relaxation of the regulation on foreign participation, five local banks out of a total of 13 banks are now majority-owned by foreign institutions.

Before the 1997 financial crisis, the domestic banks dominated the retail market through their extensive branch networks and their close relationship with local customers. Foreign banks, on the other hand, focused their businesses on wholesale customers. Nevertheless, the role of foreign banks will change significantly now that they have acquired majority shares in domestic banks. Access to retail customers is now possible. These foreign-owned banks are offering diversified financial services to their retail customers. With their experience and know-how, their shares in the retail market are expected to rise. However, this is hard to confirm, as reform of the Thai banking system is still at an early stage.