The changing nature of the financial system: implications for resilience and long-term growth in EMEs

Bank of Thailand

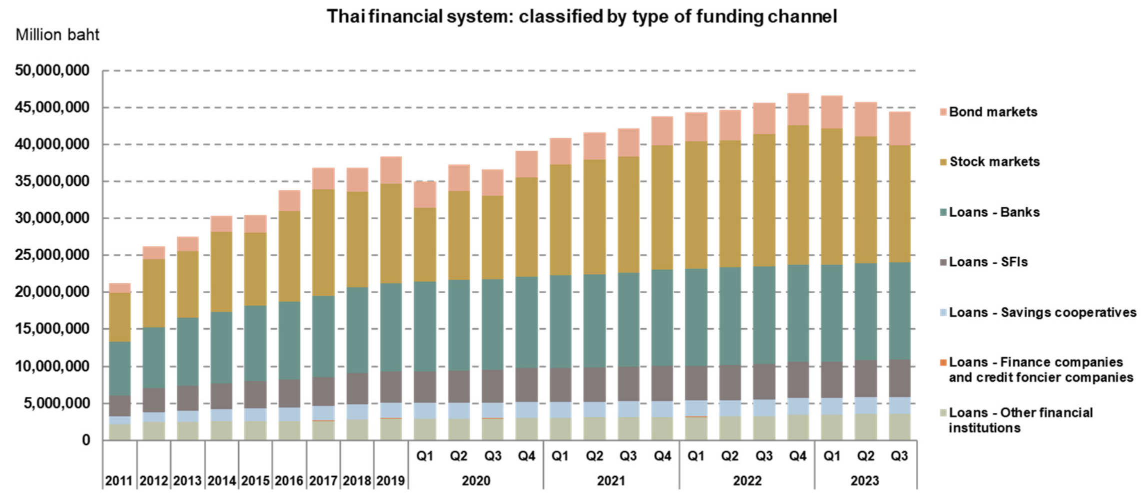
EME financial system: what has changed?

For the past decade, the main source of funds for the private sector was loans, which as of the third quarter of 2023 comprised approximately 54.0% of total funding, about 29.5% of which was from banks and 11.3% was from specialized financial institutions (SFIs). However, **the role of capital markets as financial intermediaries gradually became more important over time due to cheaper financing costs and less stringent conditions required to obtain funding compared with loans**. Capital markets comprised the rest of the funding (apart from loans), or 46.0% of total funds, 35.6% of which was from stock markets and 10.4% was from bond markets as of the third quarter of 2023. In addition, capital markets were very much domestic-based: 28.1% of total market capitalization of stock markets and only 0.3% of total outstanding corporate bonds were held by non-residents as of the third quarter of 2023.

However, the growth of capital markets was disrupted during the Covid-19 pandemic due to the low level of investor confidence. Hence, corporates switched to traditional lending channels such as banks to raise funds. Bank loans also increased during the pandemic with special measures, such as soft loans and rehabilitation credit schemes, implemented to provide liquidity to the most affected, notably small and medium-sized enterprises (SMEs). The total contract amount of rehabilitation loans stood at 255.8 billion baht as of November 2023.

After the pandemic, investors' confidence in capital markets was restored. Corporates then switched back to raising funds through bond markets, as can be seen by the strong annual growth rate of new bond issuance at 32.0% on average from 2020 to 2022. This was due to corporates trying to lock in lower funding costs during the higher interest rate environment.

The Thai financial system funding structure during the Covid-19 pandemic Graph 1



Source: Bank of Thailand

For the retail portfolio, SFIs shifted from extending personal loans to mortgage loans. The portion of personal loans in SFIs' portfolios declined to 13.0% as of the third quarter of 2023 from 33.5% in 2013. At the same time, the proportion of mortgage loans increased to 34.6% as of the third quarter of 2023 from 28.4% in 2013. This changing pattern could be attributed to the government's "One Million Home" program, which provided mortgage loans through SFIs to low-income debtors. In addition, non-bank financial institutions also entered the personal loan market, resulting in fewer SFIs on this front. **Non-banks are taking on a bigger role in the Thai financial landscape at present with an increase in both the amount of credit extended and number of players.** Loans extended by non-banks grew approximately 3.4 times from 2013 to the third quarter of 2023, and the number of players increased from 28 in 2013 to 111 by the third quarter of 2023 This spectacular growth could be attributed to non-banks' growth strategy, which concentrated on unserved and underserved customers – the majority of which are low-income debtors.

The allocation of finance and long-term growth

Structurally, approximately 60.0% of credit goes to the key business sectors driving economic growth, such as manufacturing and trade (which account for almost half of the 60%). However, over the past decade, credit extended to these sectors declined from 28.5% of total outstanding loans in 2013 to 21.0% as of the third quarter of 2023. Part of the funding was allocated to the agricultural sector where SFIs served as the main creditors. This is because banks deem this sector too risky to extend credit to due to its volatile cash flow and SFIs' mandate is to respond to government policies to support debtors who are unable to access a source of funds. The rest of the funding goes to the public utilities, transportation and services sectors.

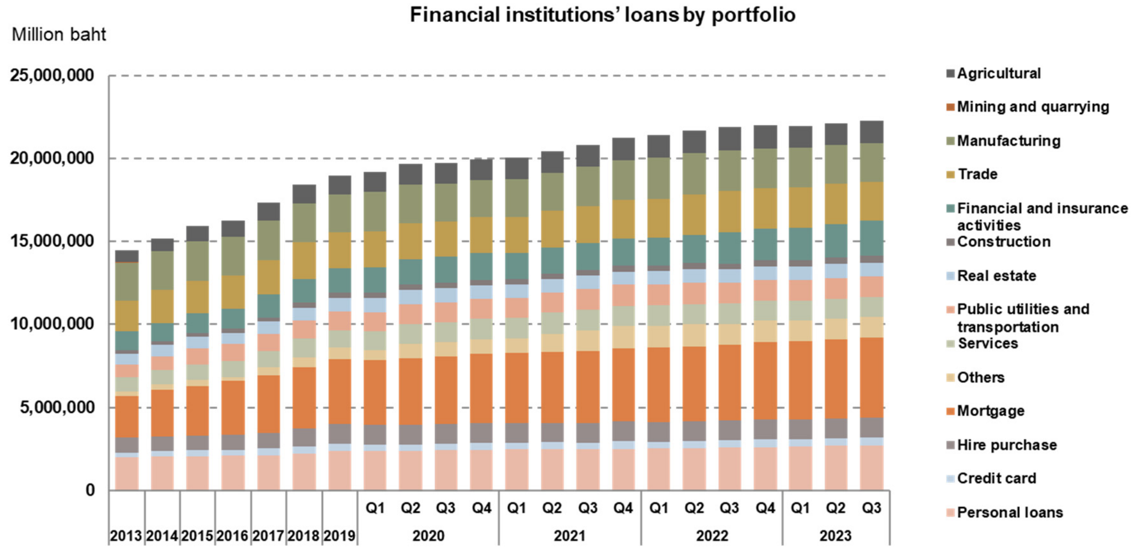
Loans to SMEs gradually declined because SMEs posed higher risks compared with large corporates and had a slower pace of recovery after the pandemic. SME loans declined to 21.3% as of the third quarter of 2023 from 31.4% in 2015, and the non-performing loan (NPL) ratio of SME loans of commercial banks stood at 5.9% on average, which was higher than the NPL ratio of corporate loans (1.4% on average from 2015 to the third quarter of 2023). Furthermore, the share of zombie firms in micro companies and SMEs was 18.5% and 7.7%, respectively, as of 2022 (Siam Commercial Bank Economic Intelligence Center), compared with the share of zombie medium and large firms, at less than 5%. Hence, creditors became cautious when it came to granting loans to SMEs. However, with SMEs contributing to over 35% of gross domestic product (GDP) and employment from SMEs contributing to 71% of total employment as of 2022, further development is under way to ensure that sufficient funds from conventional channels, such as bank loans and financial markets, are available to these borrowers to promote long-term growth and employment in the Thai economy.

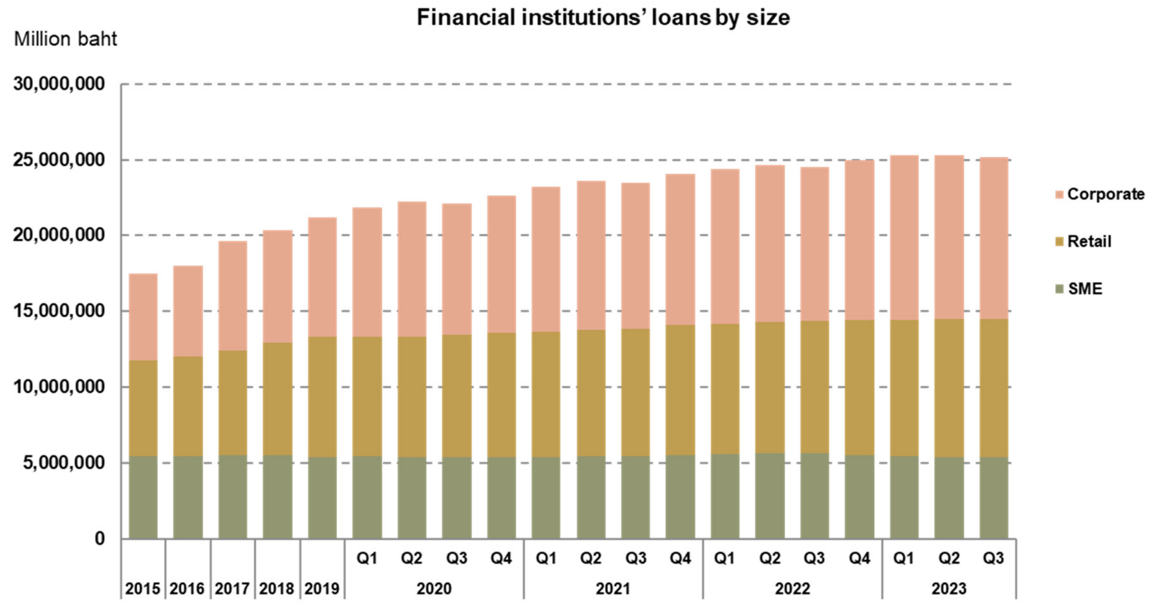
Digital innovation is playing an increasingly important role in reducing credit constraints and the use of informal lending channels for SMEs. Since 2020, the Bank of Thailand (BOT) introduced the new digital personal loan as a way to help SMEs gain more access to credit. It allows lenders to use alternative data, such as utility and mobile phone bill payment records and spending behaviours on e-commerce platforms, to assess the ability and willingness of borrowers to make payments. This has paved the way for service providers to leverage machine learning to help serve retail and SME customers by consolidating and expanding various types of data sources to assess the creditworthiness of SMEs as well as to automate the underwriting process for SME loans.

Among other things, in 2023, BOT also launched the PromptBiz system, which is a unified infrastructure for trade and payment data with the ISO 20022 international message standard. The aim of the system is to overcome the well-known problem of excessive paperwork, which usually leads to time-consuming follow-up and document review as well as possible errors and eventually higher costs. PromptBiz will help increase efficiency and reduce these costs. Trade transactions such as invoice disclosure and e-Tax invoice issuance will be linked to payments, which contain trade information, and will connect to the e-Receipt service. In the next phase, development will focus on building a mechanism to support business lending, particularly to SMEs, by utilizing trade and payment data.

BOT is also exploring ways to better utilize data and data-sharing mechanisms among service providers. The open data initiative aims to give data owners the ability to easily transfer their own data from one service provider to another at reasonable costs, with no barriers to choosing or switching their service providers. A successful open data scheme requires developing data exchange mechanisms under specified consent from customers. It also requires setting standards for application programming interfaces (APIs), data collection and security regarding the transfer of data between service providers. BOT plans to implement the open data initiative gradually. Once the specified target is achieved, BOT may consider expanding the scope of open data to include non-financial providers as well as a wider range of data types.

Financing allocation by financial institutions during the Covid-19 pandemic Graph 2





Note: Financial institutions include banks, specialized financial institutions (SFIs) and non-banks

Source: Bank of Thailand

Excessive finance, resilience and long-run growth

The Thai financial system is becoming more resilient with increasing numbers and types of service providers supplying credit and supporting growth to all

segments in the economy. New players such as non-banks and a new type of loan such as the digital personal loan create more diversification of creditors. This prevents disintermediation and provides a cushion for the impact of shocks by containing them to only a certain part of the system. However, having many players in the system poses some challenges such as having well-balanced supervision as well as a level playing field. BOT is in the process of developing a standard to deal with such challenges.

The challenge for long-term growth for Thailand is household debt overhang. During the Covid-19 pandemic, the ratio of household debt to GDP peaked at 95.5% in the first quarter of 2021 then gradually declined in line with economic recovery to 90.7% as of the second quarter of 2023. This excessive credit could cause a drag in consumption, investment and ultimately long-term growth. In response to this problem, BOT planned to implement new household debt measures that are more targeted and offer a more sustainable solution to this debt overhang problem. These measures would offer new solutions for debtors throughout their debt journey by (1) providing debt solutions for NPLs, (2) offering options for debtors with persistent debts to fully repay their loans, (3) ensuring new debt is of good credit quality and will not undergo debt distress in the future, and (4) increasing opportunities for borrowers with informal debt to obtain credit from formal channels.

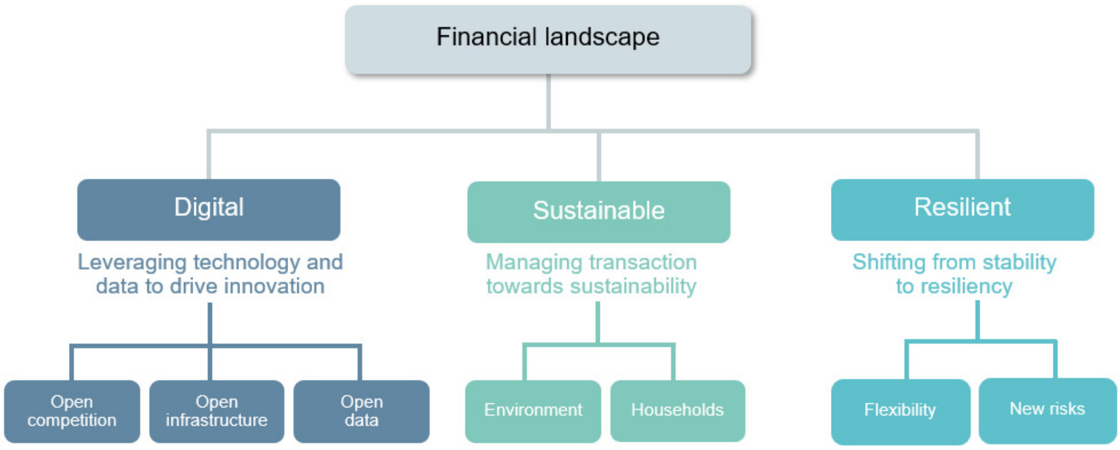
Policy measures

In the period ahead, we see three key forces shaping Thailand's economy and financial sector. These forces are technological advancement, a movement towards more sustainability in response to climate change and addressing household debt overhang. In response to these factors, BOT set three strategic directions to facilitate a smooth transition of Thailand's financial sector towards a sustainable and digital economy.

The first direction is to leverage technology and data to drive innovation. In addition to the digital personal loan, BOT is allowing both new and incumbent players to establish a virtual bank to foster competition in developing financial services, promote innovations that meet consumer needs, and improve access for retail and SME customers. Applications for virtual bank license are being accepted from 20 March 2024 to 19 September 2024. The introduction of virtual banks in Thailand is expected to promote open competition among players and to encourage players who possess expertise in technology, digital services and data analytics to offer financial services in a more efficient way through digital channels while saving costs by having a small number of staff and bank branches. This should result in better services that are tailor-made to each customer segment, particularly the unserved and underserved segments of retail and SME customers.

Three strategic directions

Graph 3



Source: Bank of Thailand

In addition to open competition, an ecosystem for responsible innovation requires an open data ecosystem for consumer empowerment – an efficient data-sharing mechanism that allows consumers to conveniently and securely request or send their information from one service provider to another, when requested and with consumers' consent. This will empower consumers, as data owners, to fully utilize their own data kept by various service providers, ranging from financial service providers, social media, e-commerce platforms and telcos. In addition, service providers would be able to access key digital infrastructures at lower costs, making it easier for players to enter the market. We also need to ensure open access to key infrastructures for all types of players, thereby reducing the risk of a few players monopolizing key digital infrastructures.

Building reliable and safe digital infrastructures and ecosystems is not a one-man job. It requires all stakeholders to collaborate and turn policy visions into actions. We want to take a more collaborative approach to new technology by exploring new use cases with the industry under an appropriate risk framework (such as tokenisation, programmability and artificial intelligence). BOT currently has a regulatory sandbox, which allows testing of regulated activities that employ new technologies. We are planning to have an additional channel, the "New Sandbox", which is more flexible, to support the testing of unregulated financial activities that apply new technologies for use cases that benefit customers (eg tokenisation that helps improve access to credit for SMEs and programmability that helps enhance the efficiency of payment services).

The second direction is to manage the transition towards sustainability by steering financial entities to incorporate environmental risk assessment into their business operations and to support the transition of businesses from environmentally unsustainable activities to more sustainable ones. This should be done without disrupting the economy while minimizing the unintended consequences and helping households or vulnerable groups such as SMEs to survive and adapt sustainably to the new global trends. One of the key policies is promoting the development of a national green taxonomy in collaboration with relevant agencies. This taxonomy should be appropriate for Thailand and should be aligned with international standards. Furthermore, to facilitate households' transition towards digital finance and to help over-indebted households manage their debts sustainably, BOT has proposed the following key policies: promoting financial literacy and digital financial literacy, ensuring responsible retail lending practices that account for borrowers' repayment ability to prevent over-indebtedness, promoting holistic mechanisms for resolving debt so households can adjust and recover over the longer term without returning to insolvency, and promoting comprehensive data collection on household debt.

The last direction is to shift towards a more flexible regulatory framework that allows financial service providers to capitalize on the digital trends while ensuring their appropriate and timely responses to significant and emerging risks. Examples of key policies designed to provide greater flexibility for financial and banking supervision include applying a risk-proportionality approach to the supervision of increasingly diverse service providers as well as reviewing regulations that are currently limiting service providers' abilities to adapt, compete, innovate or serve customers better. Both incumbent and new players should compete on a level playing field to improve both the depth and breadth of the financial system with greater access and better services. The resulting financial innovations and services will better meet the needs of consumers and contribute to a more efficient allocation of capital overall. Another dimension of this direction is to enhance supervision and management of significant risks, including the risks from systematically important financial service providers in the new financial era. A couple of key approaches are applying activity-based supervision to major retail lenders to protect consumers and implementing macroprudential policies to cope with household debt overhang and to put unregulated non-bank retail lending under the same regulatory framework as commercial banks and non-bank retail lenders, which have already been regulated.

In summary, the financial system has seen various changes over the past decade, ranging from a shift in financial intermediation, an increase in the number of players, to a shift in sectoral allocation of credit. Going forward with the new challenges and the strategic directions that we set for a smooth transition towards a digital and sustainable economy, we expect to see the Thai financial sector leverage technology to offer better financial services and facilitate the smooth transition to a digital economy, and to help support transitions amid rapidly emerging digital and sustainability trends. Finally, financial intermediaries should continue to innovate, provide better financial services and manage key and emerging risks in a timely manner while keeping pace with the rapidly changing environment.