Maintaining financial stability: the experience of Thailand

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1. Introduction

An important lesson from the crisis of late 1990s is that the task of maintaining simultaneous economic and financial stability is a critical and complex one. It requires an in-depth understanding of the nature of risk and its propagation, an early warning system, effective risk management and a decision making process that ensures coordination and accountability on the part of all stakeholders - monetary authorities regulators and private agents.

The imbalances in economic and financial sectors are closely related, and the degree and nature of correlation can change significantly during abnormal market conditions, especially when speculative momentum and herd behaviour take hold, creating a vicious circle and eventually leading to a crisis. Nevertheless, imbalances and disequilibrium normally build up over time and are caused by unsustainable distortions and structural weaknesses in economic and financial structure. Such weaknesses are often manifested in current account imbalances, inflation, and massive increases in the indebtedness of the corporate and household sectors, as well as an asset price bubble. Such weaknesses then render the economy vulnerable to shocks. The effect of these shocks can be magnified by increased competition and integration of international trade and capital flows, as well as by technological advances and financial innovation.

This paper aims to address key issues in maintaining financial stability in Thailand under globalisation and structural change in the economic and financial sector. Section 2 discusses financial stability in the Thai context, and assesses the current conditions as well as the changing landscape of the Thai financial sector. Section 3 then analyses the risks posed to the financial sector, while the manner in which the financial institutions and authorities have managed and addressed these risks is presented in Section 4. Section 5 outlines the challenges ahead for the Thai financial sector.

2. Thai Financial Sector

2.1 Financial stability in the Thai context

The financial sector plays the key role in ensuring efficient allocation of resources and risks between savers and investors, and across time. Thus, among the key roles of the financial institutions and markets is facilitating the price discovery process of resources. A failure in the market can lead to resource misallocation, asset price bubbles, and a boom and bust cycle, the effect of which is transmitted to other economic sectors via the central role of the financial system. However, a well functioning financial system will contribute to the economy's increased efficiency, enhancing long-term growth potential through efficient choices of technology, capital formation and risk management.

In the case of Thailand, as a small open economy, the challenge of ensuring a dynamic and competitive real sector, especially with the growing competition, is a critical one. The external sector plays a key role in our economic development, as international trade/GDP is currently 126 per cent, while the degree of openness of the capital account is also significant.

Macroeconomic policy aims at sustainable growth, by ensuring internal and external stability. On the internal front, a key measure is inflation and its expectation. After the crisis, the framework of forward-looking inflation targeting was adopted in 2000, whereby the Bank of Thailand would ensure that core inflation would stay within a range of 0-3.5 per cent. This process has proven to be valuable in reinforcing credibility and transparency of monetary policy. Core inflation has remained well within the target, which has aided in the recovery process. On the external front, the current account has remained in surplus during the period of economic stabilisation and has only edged into small deficit during the recent oil price hike. Fiscal policy played an important role in propelling recovery while private sector demand was subdued by balance sheet constraints and risk aversion. But now, with the recovery of private demand, fiscal policy has shifted back to a balanced budget, while rather buoyant tax receipts with economic recovery have resulted in a cash surplus for the government, which should help ensure a sustainable investment-savings gap or current account position.

Vulnerability has also been reduced with the careful monitoring of public debt, which is currently below 50 per cent of GDP. External debt has declined to 31.1 per cent of GDP, 68.3 per cent of total external debt is long-term, and international reserves have risen to around 50 billion USD, which provides more than three times the necessary coverage for short-term external liabilities. The exchange rate regime has changed to a managed float since the late 1990s, thus removing the distortion and moral hazard from an inflexible exchange rate. The exchange rate has resumed a stable path, with monetary policy now shifting to inflation targeting, which in turn enhances the independence of monetary policy.

On the financial sector front, the Thai financial system is still bank-based, with Thai banks forming the dominant part. Prior to the crisis, there were also many finance companies which were similar to banks but had structural weaknesses mainly arising from restrictions on their activities. Such restrictions were partly the cause of their high risk and less flexibility to manage their portfolios, causing many to fail during the crisis. These structural weaknesses are tackled in the current Financial Sector Master Plan (FSMP) adopted early last year. The master plan seeks to ensure a financial landscape which is sound and free from such structural weakness, while providing a transition path to strengthen financial institutions, via merger and upgrading or orderly exit.

A root cause of the banking crisis was also poor corporate governance and risk management at the corporate level as well as in financial institutions. Lending practices in some institutions did not involve proper credit assessment and were dubious regarding lending or collateral-based lending. Collateral-based lending was also highly risky given the asset price bubble leading up to the crisis, particularly in property markets. At the same time, the corporate sector was involved in many inefficient investments, while its debt also rose significantly with greater access to funding. This was partly from financial liberalisation which led to greater shorter-term capital flows, propelled by the fixed exchange rate system and borrowing through the international banking facility set up in early 1990s. The crisis took a significant toll on the corporate sector and the banking system, exacerbated by the vicious circle between market risk, from the currency crisis and interest rate hikes, and credit default. This was an important lesson which led to a concerted effort on the part of banks, regulators and the corporate sector to improve corporate governance and risk management. The roles of the board of directors and various subcommittees, such as risk management and audit committees, have been strengthened. For banks, improvements in risk management have been noteworthy.

To date, substantial improvements have been made, including the introduction of risk management tools for banks and clients, the adoption of Basel market risk guidelines and capital allocation for market risk, and the planned adoption of Basel II by 2008. Moreover, the financial infrastructure will be strengthened by fortifying the capital market, foreign exchange market and money market; and legal reforms, including a move to introduce deposit insurance, which will pave the way for the removal of a blanket deposit guarantee, a legacy of the crisis.

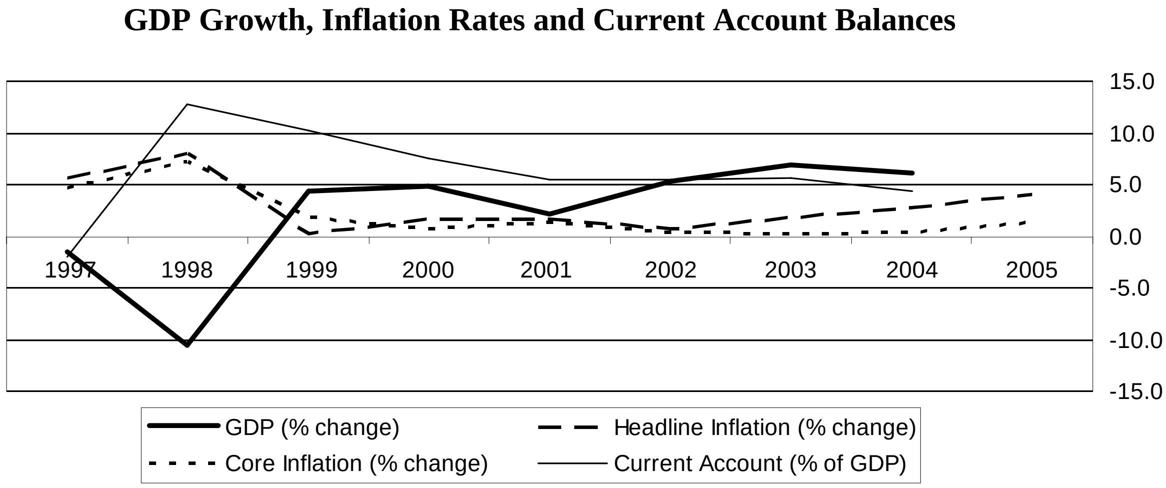
The Bank of Thailand occupies a central position in overseeing systemic risk due to its dual responsibility as banking regulator and monetary authority. The Bank's core strategy therefore seeks to manage both macroeconomic and prudential risk by creating an early warning system and in-depth analysis of risk, together with prompt corrective action. Regulatory authorities are now working to achieve compliance with international standards and codes, with a plan to undergo the comprehensive Financial Sector Assessment Program (FSAP) in 2007.

Policy formulation and the decision making process at the Bank of Thailand have also been reformed. The reengineering process has led to an organisational structure which aims for effective decision making, transparency and accountability, while ensuring coordination with other relevant agencies. The monetary policy making process and financial sector supervision are now being conducted by a structure which has a well defined mandate and accountability, under the Monetary Policy Committee (MPC) and Financial Institutions Policy Board (FIPB), both of which include outside members. The Governor and Deputy Governors of the Bank of Thailand sit on both boards in order to ensure effective information sharing and promote synergy in decision making, while experts from the industry and academia are invited to join the boards in order to promote transparency and keep checks and balances in place, in addition to providing intellectual input.

2.2 Macroeconomic recovery

A closer examination of the economic data shows that the Thai economy has recovered from the financial crisis with positive GDP growth, stable price levels and a favourable current account position (Figure 1). The economic recovery is further strengthened by the more robust financial sector, largely as a result of successful debt restructuring and reforms. The Thai economy and financial sector are sufficiently strong to be able to adjust flexibly to adverse shocks such as oil price shocks, natural disasters and turning points in the global economic cycle and in interest rates.

Figure 1



2.3 Strengthening the financial sector

The financial sector continues to strengthen, with increasing stability and efficiency, as evidenced, for example, by declining NPL, rising profitability and ample provisioning, as well as the arrival of new financial products.

Regarding stability in the system, the NPL/total loan ratio has declined from 43 per cent in 1998 to 10.5 per cent in June 2005. The majority of the remaining NPLs are currently in the court process. Furthermore, the entire banking sector maintains excess loan loss provisioning, while indicators on banking efficiency also show continual improvements (Figures 2 and 3).

Efficiency in the financial sector is enhanced by the introduction of new sophisticated financial products and ongoing structural reform under the FSMP,[1] a medium-term policy framework formulated by Bank of Thailand in order to promote an efficient and stable financial sector that is responsive to consumers' needs.

[1] The FSMP will be discussed in detail in Section 4.

Figure 2

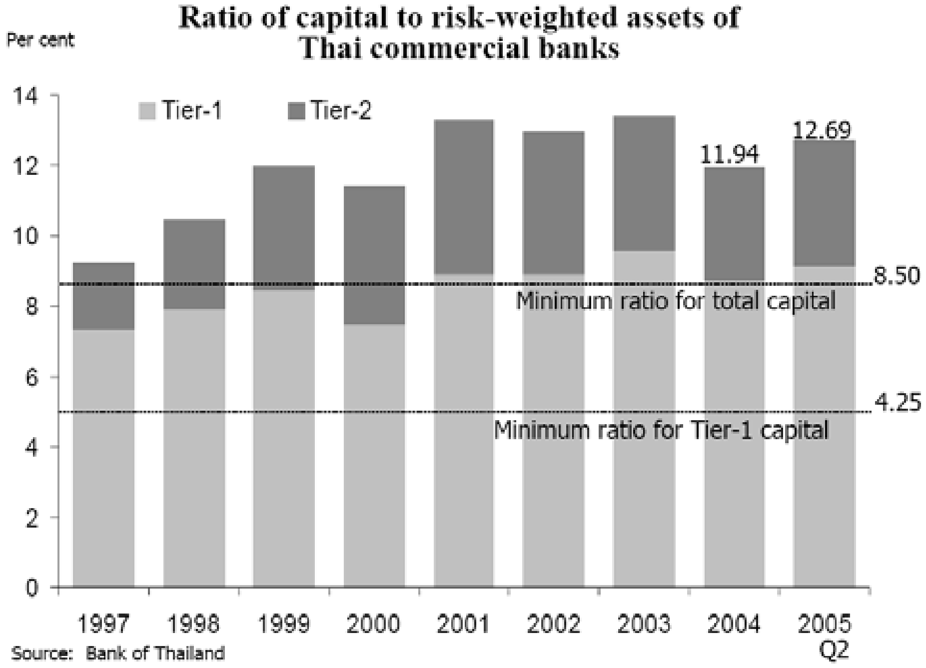
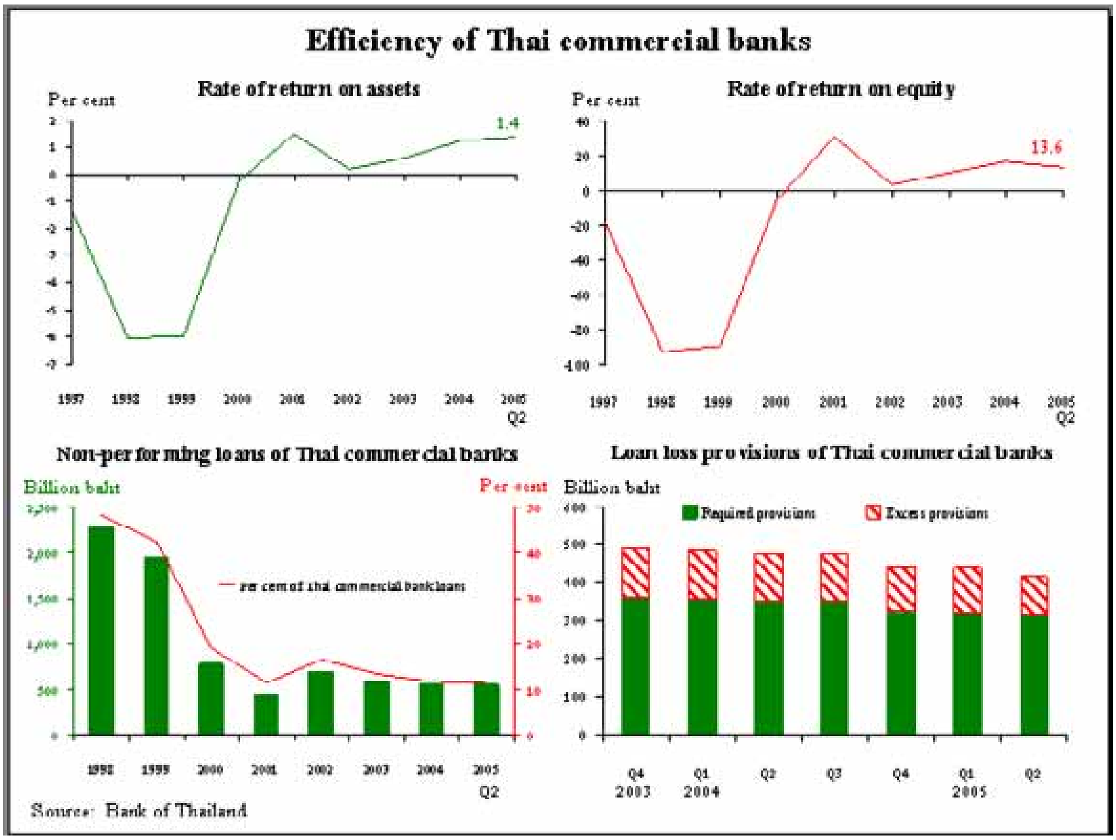


Figure 3



The current improved performance and soundness of the banking sector and prudent risk management practices mean that commercial banks are better able to identify risks and are in a position to adjust their portfolios accordingly. Increasing profitability and strong financial conditions, as evidenced by the high capital to risk-weighted assets ratio, which is above the minimum threshold set by the Bank of Thailand, provide Thai banks with a greater financial cushion to limit and absorb potential losses.

However, in light of the fast-changing financial environment, and increasing integration among markets both globally and domestically, there are factors that may challenge the risk management ability of the Thai financial system; for example, the close relationship between the economic business cycle and credit risks, the proliferation of new service suppliers (mainly non-deposit-taking credit companies, which are not under prudential supervision by the Bank of Thailand), and the introduction of new and more sophisticated financial products.

3. Macroprudential Analysis and Financial Sector Review

Since the maintenance of financial stability necessitates an understanding of the linkages between macroeconomic and financial risks, the Bank of Thailand carries out in-depth research and analysis of key variables determining instability. Moreover, the Bank also closely monitors developments in important macroprudential variables which can give early warning signals of risks to stability. In monitoring these key indicators, the Bank of Thailand also places importance on dialogue with market players at home and abroad. Such dialogue provides an important flow of information and feedback.

Moreover, when there are important changes such as an oil price hike or a change in the interest rate cycles, the Bank also carries out quantitative analysis of the risk and impact whose publication helps to strengthen the risk management of individual institutions as they can get better information on the aggregate picture. The effectiveness of the financial stability process is enhanced when all agents are well informed of the risk. Thus, transparent information and communication by the Bank is also viewed as key.

In such recent exercises, factors identified as potential risks that could trigger adverse effects in the Thai economy and financial sector were increases in oil prices and interest rates. Assessment, however, also shows adequate financial resilience in the corporate and household sectors to withstand the downside risks. In the medium term, there are risks from structural shifts in the financial and economic system, such as the changing monetary transmission mechanism or a shift in behavioural relationships such as propensity to save, which need to be carefully studied.

Nevertheless, the Bank of Thailand has taken measures to safeguard stability, including monetary tightening and stringent prudential measures on credit card and consumer loans.

3.1 Risk from oil shocks and interest rate hikes

3.1.1 Risk assessment for the corporate sector

Rising oil prices and interest rate trends would have a direct effect on the corporate sector through increases in production and borrowing costs. While these factors and corresponding economic uncertainty raise production costs and soften aggregate demand, the Bank of Thailand expects the impact of these factors to be moderate given the strong financial conditions in the corporate sector.

From simulations using the Corporate Sector Model linked to the Bank of Thailand's Macroeconomic Model[2] to test the corporate sector's ability to withstand the rising interest rate trend, it is shown that a rise in the policy interest rate could dampen the interest coverage ratio,[3] though it would still remain at a high level, while the debt-to-equity ratio would decline (Figure 4).

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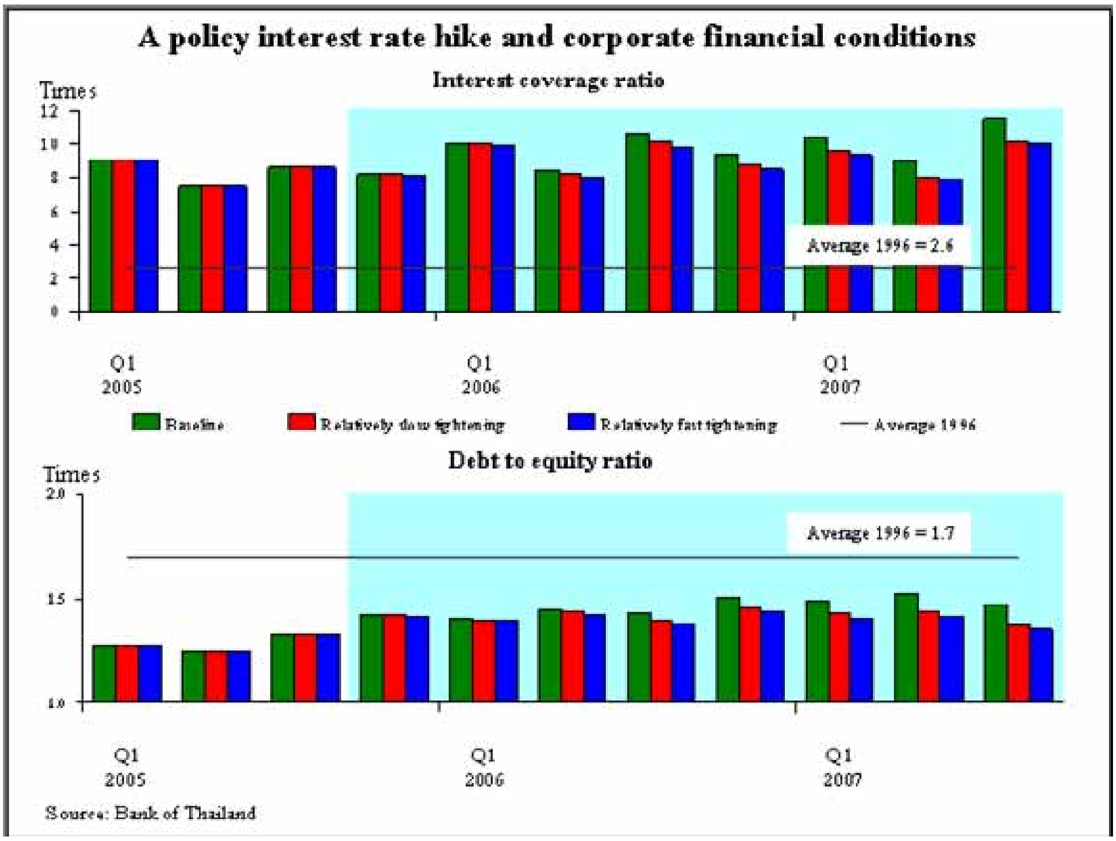
2 See the Bank of Thailand's Inflation Report October 2005 (Bank of Thailand, 2005).

3 Interest coverage ratio = $\dfrac{\text{Profit (loss) before interest and income tax expenses (billion baht)}}{\text{Interest expenses (billion baht)}}$

Figure 4



3.1.2 Risk assessment for the household sector

Analysis of the household sector also reveals conditions that moderate possible adverse effects from interest rate increases.

First, despite the average of 16 per cent per annum growth of household debt from 2002 to 2004, the ratio of household debt to GDP still stands at a manageable 30 per cent. Moreover, the effect from consumer loans including credit card lending may not significantly impact the stability of the financial sector as they account for a small portion of the financial sector. The latest figures show that in the second quarter of 2005 consumer loans accounted for 16.5 per cent, with credit card lending standing at 1.9 per cent, of total loans. The situation therefore does not pose a threat to the stability of the financial system, especially with the corresponding NPLs standing at 9 and 3.2 per cent, respectively**.**

Second, based on the forecast from the Bank of Thailand's Household Sector Model,[4] using different scenarios of interest rate hikes, the rise in the cost of borrowing following the rate hikes would induce households to adjust their financial behaviour and slow down their borrowing. This would consequently help reduce households' financial vulnerability (Figure 5).

Nevertheless, the Bank of Thailand realises that while the level of household debt is still manageable, the debtservicing ability of the household sector amidst rising interest rates warrants close monitoring.

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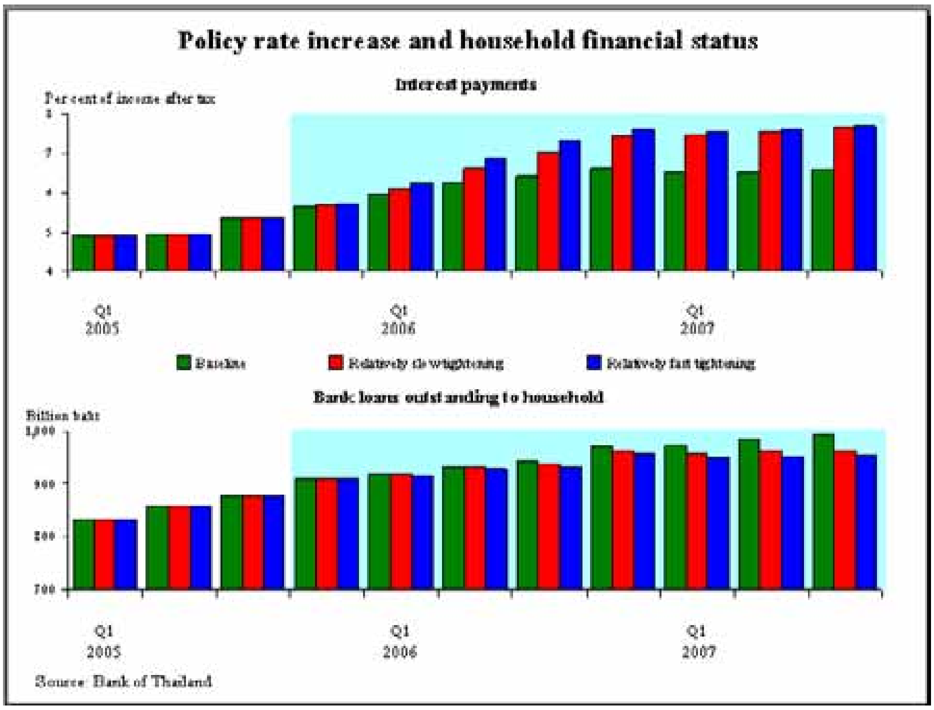
4 See the Bank of Thailand's Inflation Report October 2005 (Bank of Thailand, 2005).

Figure 5



While the analysis in 3.1.1 and 3.1.2 regarding domestic conditions does not present any immediate concern for the stability of the Thai financial sector, it is crucial to stay vigilant of market conditions. The global environment has been witnessing a period of very low long-term global interest rates. This could potentially change. Therefore, the credit and market risk environment faces uncertainty for which an emerging economy such as Thailand, and financial institutions, must be prepared. Accordingly, both the industry and regulators need to be sufficiently agile in conducting and overseeing risk management in the financial sector.

Under a forward-looking risk-based supervisory framework, financial institutions are encouraged to be proactive in assessing and managing their own risks, relying largely on their own analysis, auditing skills and risk management tools, while authorities are responsible for overseeing systematic risks and maintaining the stability of the whole financial sector and the economy. In this regard, the authorities have implemented measures to improve the risk management capability of the financial sector as well as initiating reform and structural change in order to address the weaknesses in the system.

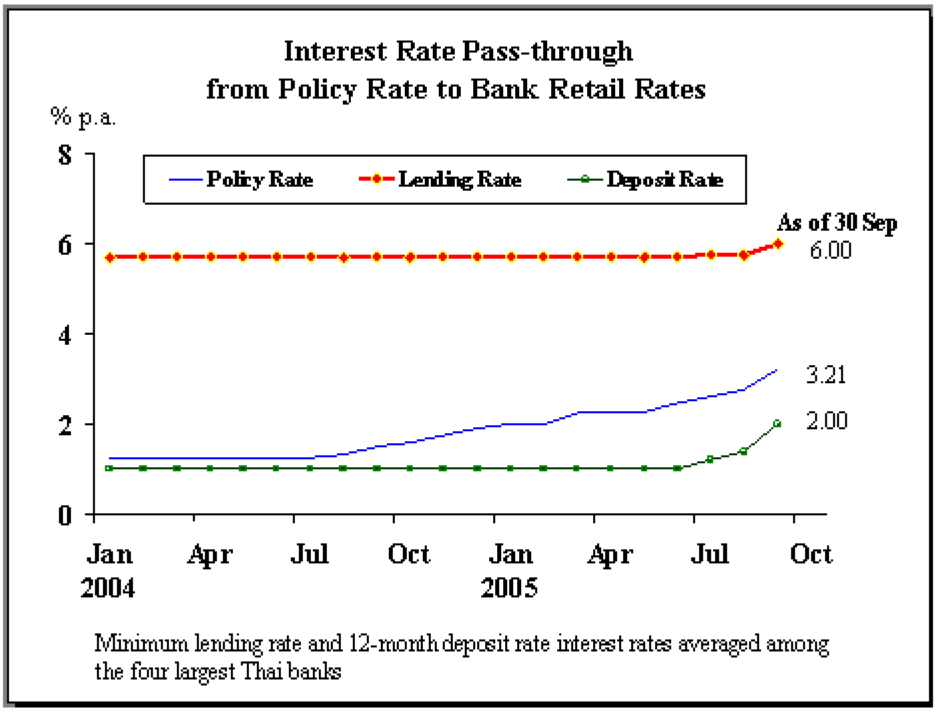
3.2 Medium-term risk from structural shift

3.2.1 Transmission mechanism of monetary policy

Until recently, the pass-through from policy and money market rates to commercial bank retail rates was sluggish in Thailand. Although the policy rate started to move upward in August 2004, retail rates only began to adjust in May 2005 (Figure 6). This slow pass-through is a consequence of excess liquidity in the banking system.

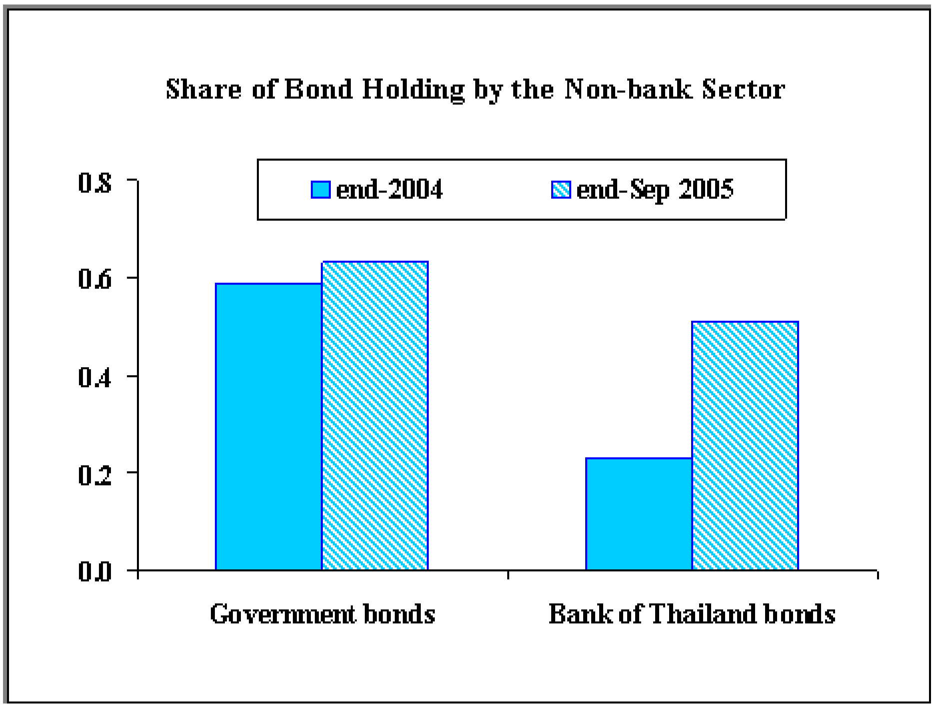
However, there are indications that the interest rate channel is beginning to improve. With deposit rates staying low in nominal terms and negative in real terms for a prolonged period of time, households and firms have moved away from bank deposits towards alternative saving instruments with higher rates of return. At the same time, the demand for loans continues to grow and is likely to accelerate from both the private and the public sector. The acceleration in private demand for loans is supported by a high and rising rate of capacity utilisation, which implies an increasing need for investment to expand production capacity. As for the public sector, large-scale investment projects are being planned for the next few years. Given these developments, banks are anticipating a relatively fast reduction of excess liquidity going forward.

Figure 6



Over the longer term, as the capital market, particularly the bond market, gains a bigger role in financial intermediation and the economy becomes less dependent on the banking sector, the chance of monetary transmission being stalled by the breakdown of the banking system's intermediation process should diminish. At the same time, transmission through other channels such as expectations and asset prices may become more important, rendering the overall transmission process more balanced and perhaps more potent.

Figure 7

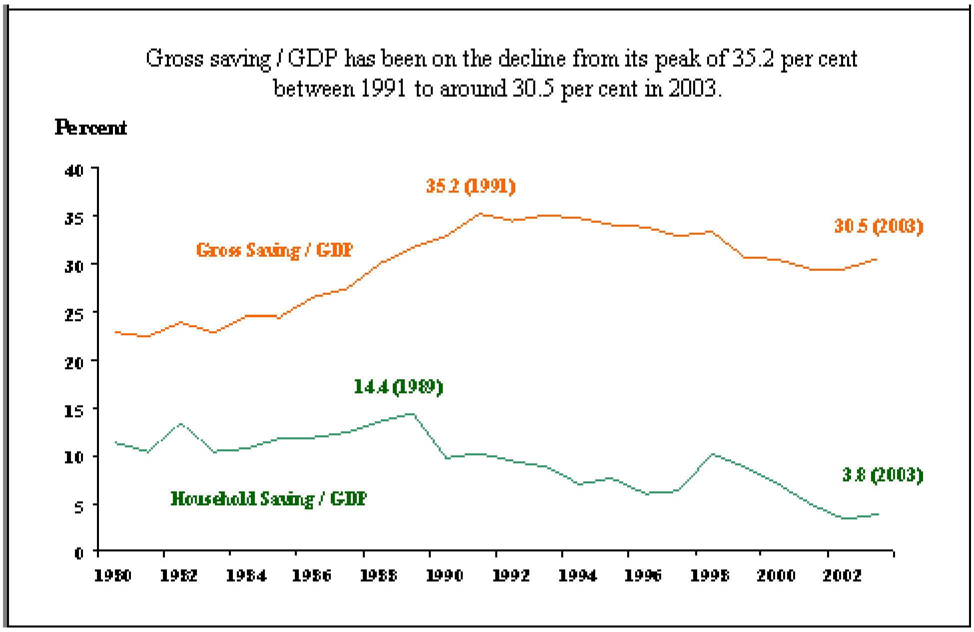


Since a developed and efficient bond market would enhance the effectiveness of the conduct of monetary policy in addition to promoting stability and efficiency in the financial system, in January 2005, a high-level Domestic Bond Market Development Steering Committee was set up by the government with the aim to promote the development of the domestic bond market. In relation to this, the Bank of Thailand is responsible for developing an active secondary market.

3.2.2 Declining domestic savings

The gross savings-to-GDP ratio has been gradually declining since 1991, particularly in the private sector (Figure 8). Possible medium-term adverse impact from declining domestic savings, as the result of the consumption boom post-crisis, includes a potential increase in current account deficit and higher pressure on financing for future retirement. Once private investment gains momentum and the government mega-projects[5] are launched, the pressure on the current account may increase, potentially leading to higher vulnerabilities in the foreign exchange rate.

Figure 8



Although the manner in which the projects are financed could have an adverse impact on Thailand's current account, mega-projects also offer favourable investment opportunities for domestic financial institutions and the capital market. In all, given prudent financing and project implementation plans, mega-projects provide both economic stimuli and social welfare benefits.

Current demographic trends in Thailand show that there will be an increase in the number of people of working and family age. This represents the expansion of potential borrowers as well as savers. Consequently, the challenge for financial institutions will be to tailor and market competitively priced financial products that respond to the needs of this segment of the population.

Although such decline in savings does not pose any immediate and serious concern for the stability of Thai financial sector or the economy as a whole, in order to support the rise in domestic investment, curb the possible rise in the current account deficit and ensure sufficient funding for future retirement given the current demographic trend, domestic savings will need to increase and play a greater role in assisting the development of the economy (Figure 9).

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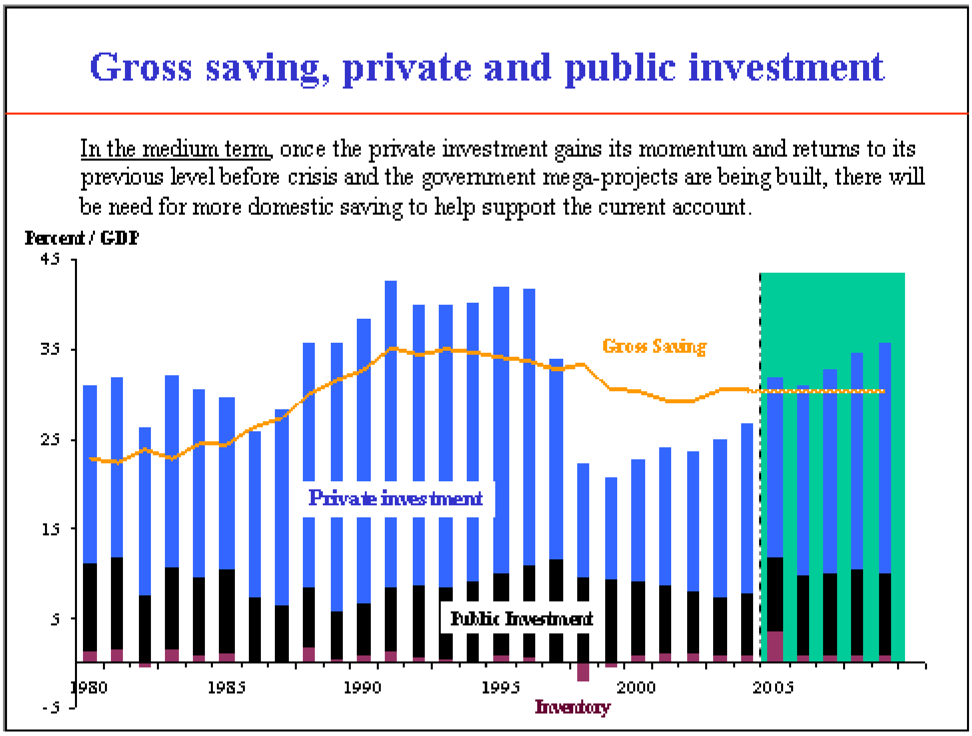
5 The government's mega-project initiative concerns 1.7 trillion baht in new infrastructure spending over 2005-09. Such initiatives have been on the decline since 1997 given the government's preoccupation with economic stabilisation.

Figure 9



Furthermore, in relation to the socioeconomic concern over the prevalence of low-income households, the current limited opportunities for low-income groups in accessing and utilising financial services for saving and borrowing purposes may limit Thailand's long-term development. Equal opportunity is important not only for better resource allocation but for social equity as well. Therefore, it is crucial to increase the coverage of financial institutions and services in rural areas and promote financial literacy, as well as raising income levels, especially among low-income households in order to encourage saving and more informed borrowing and lending decisions

Correspondingly, Thai authorities have implemented the FSMP whose aims are to improve access to financial services and the consolidation of the banking sector, among others. Earnest efforts in strengthening financial infrastructure and promoting financial literacy among consumers should continue to be priorities for Thai policymakers in order to ensure sustainable development of Thai financial sector.

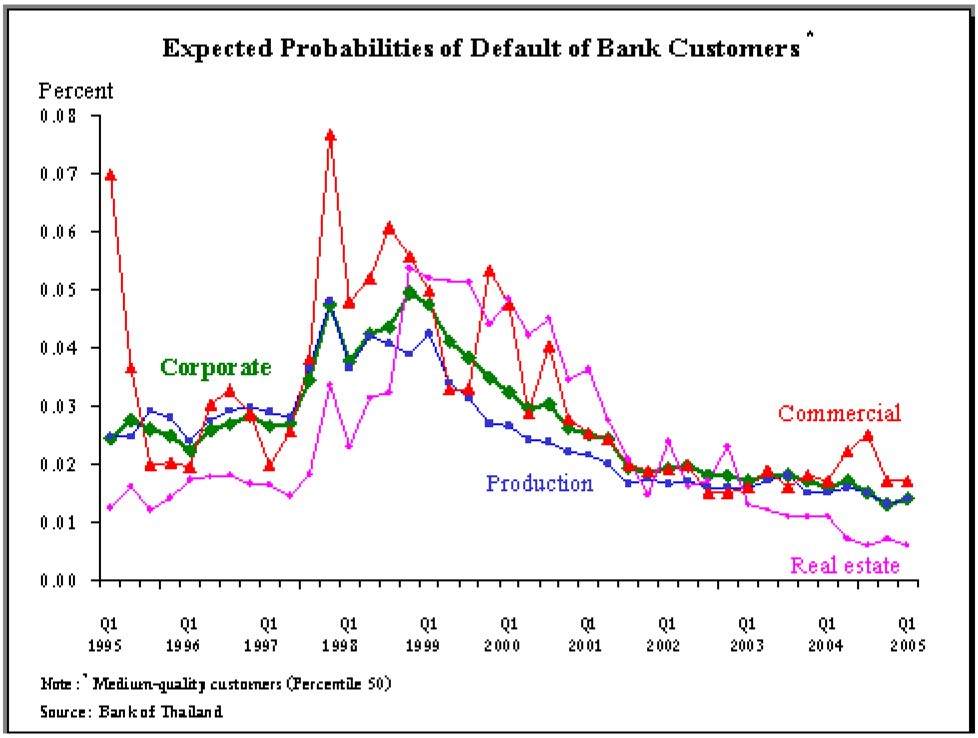
3.3 Implications for the financial sector

Adverse macroeconomic developments such as oil price and interest rate hikes, apart from the direct impact of reducing demand, may put further pressure on the debt service and loan repayment abilities of corporate and household sectors in the longer term. The financial strength and risk management capability of the financial sector are therefore important in ensuring that the sector will be able to withstand potential difficulties.

However, this is helped by the fact that credit risks related to asset quality of the whole banking system, in particular concentration risk, have declined following enhanced credit diversification into different economic sectors in addition to the low, and still declining, expected probability of default of bank customers (Figure 10).

Having begun to move away from collateral-based lending to a risked-based approach, commercial banks have improved credit analysis and risk management. There is increasing use of credit scoring and credit rating, application of value-at-risk, sensitivity and gap analyses, and fair accounting value that facilitate enhanced risk awareness and comprehensive management oversight.[6] All banks have internal rating systems, and loan applications go through a risk assessment model. Commercial banks are also in the process of developing a stress testing model. In support of this move, the Bank of Thailand has established the scenario for banks to perform stress tests and is currently waiting for the first round of results.

Figure 10



With regard to market risk, the impact analysis on the rise in interest rates is estimated to be around 0.1 percentage point of the capital ratio of Thai commercial banks. This, given the potential uncertainty of persistent increases in oil prices and interest rates in the global market, warrants further close monitoring.

Moreover, financial institutions have benefited from information facilitated by the Bank of Thailand as well as from the market. The interest rate increases are necessary to maintain macroeconomic stability and send signals to the market, inducing market-oriented adjustment and triggering management of the changing risk environment. The market structure has also become more complete, allowing better pricing and trading of risk as evidenced, for example, by a more developed bond market with an almost complete yield curve, as compared to the situation before the crisis.

4. Maintaining Financial Stability

4.1 Risk-based supervision

As already mentioned, Thailand's supervisory system is moving towards risk-based supervision. In keeping with this new supervisory approach, Thailand still faces a number of key challenges, which include the following.

6 The most successful risk assessment tool used in the commercial banks thus far is credit scoring.

Availability and timeliness of data

One of the key policy lessons learnt from the financial crisis is the importance of the accuracy, availability and timeliness of data in the financial sector. The difficulties faced by financial institutions in building the capacity for better risk management (for example, formulation of stress testing models, value-at-risk and credit rating systems) as well as adopting international standards and best practices are the lack of sufficient data following the period of high NPL. Such limitations need to be addressed in a timely manner. This is especially important for the development of risk management models. The Bank of Thailand continues to work with financial institutions in addressing these limitations, for example by improving credit bureaus and providing training programmes for staff.

Timely information underpins the ability of commercial banks to make appropriate and prompt decisions. Third-party information on borrowers' credit history is particularly important in this regard. The centralisation of credit bureaus, from two to only one credit bureau, also helps to create a more complete database. However, the use of information up until now has been limited by the rigidity of the Credit Bureau Act. For example, currently financial institutions can use credit information only for originating credit, but not for renewing credit. To overcome the legal obstacles, the Credit Bureau Act is currently under review by the senate. Another third-party source of credit information is available from the domestic credit rating agency in Thailand, the Thailand Rating and Information Service (TRIS). TRIS's role thus far has been quite limited and less visible compared with that of international credit rating agencies. However, it is recognised that the domestic rating system needs to be further developed, particularly with the Basel II implementation and the development of the bond market.

Human resources

A commonly shared problem among emerging economies is the inadequate number of qualified staff both in the public and private sectors. Public sector officials need to have a broader and deeper understanding of macroeconomics, finance and accounting, as well as quantitative analysis, while personnel in financial institutions need to be more analytical, both quantitatively and qualitatively, in monitoring, assessing and managing risks.

In the meantime, much progress has been made to safeguard financial stability.

Market risk

The Bank of Thailand introduced a market risk supervision policy in line with the Basel standard in December 2003, giving commercial banks a one and a half year adjustment period. Starting from June 2005, commercial banks have maintained capital against the market-specific and general risks according to 1996 Basel market risk guidelines. This policy ensures that movements in interest rates, in addition to foreign exchange and equity, are taken into account in commercial banks' trading books when assessing their net positions in line with conservative accounting.

Corporate governance

Good corporate governance, not only in the financial sector, has been a key policy focus since the financial crisis. Moreover, in the context of risk-based supervision, corporate governance entails a high level of accountability by boards of directors for the performance and operations of the financial institutions under their oversight.

In this light, the Bank of Thailand has issued a handbook for the directors of financial institutions and has requested commercial banks to create subcommittees, including auditing and risk management subcommittees, as well as imposing stricter rules and regulations on related lending in financial institutions. Furthermore, the Bank of Thailand requires commercial banks to disclose their related transaction activities, such as special payment to directors or senior management in the form of cash or in kind. Such requirements are also in line with those set by Thai Accounting Standards (TAS).

New Basel Capital Accord

The Bank of Thailand and the financial sector have been working closely to prepare for the adoption of Basel II, which is set for 2008. Commercial banks are required to assess the impact of Basel II on their capital adequacy, and to demonstrate the readiness of their new databases, IT systems, risk management processes and human resources. Financial institutions are free to choose alternative approaches that suit them best. The standardised approach and foundation internal ratings-based (FIRB) approach will be implemented at the end of 2008, while the more sophisticated advanced internal ratings-based (AIRB) will be implemented a year later.

In implementing Basel II, both supervisors and financial institutions face the key challenge of building capability for handling the more quantitatively oriented risk management systems under Basel II's more advanced approaches to favour retail lending.

Consolidated supervision

In recognition of the presence of financial conglomerates, whose risk profiles and complex organisational structures call for a more inclusive supervisory mechanism than solo supervision, the Bank of Thailand has initiated consolidated supervision. In support of this, the existing law is being revised, empowering the Bank of Thailand to act as a lead supervisor of financial conglomerates. In the meantime, the Bank of Thailand has issued a consultative paper on consolidated supervision for comments from the banking community, before enforcement. Moreover, in order to ensure effective supervision, closer communication and cooperation among supervisory agencies, the Bank of Thailand has also formalised information exchange with Department of Insurance and the Office of the Securities and Exchange Commission.

Legal reform

Importantly, in order to carry out effective risk-based and consolidated supervision as well as implementation of Basel II, the role and responsibility of the Bank of Thailand need to be clearly defined with adequate legal authority. The current Commercial Banking Act of 1962, however, does not adequately address these points. Therefore, authorities are now working on a new Financial Institution Business Act that will specify the duties and authorities of the Bank of Thailand and is expected to reach the parliament for approval in 2006.

In addressing moral hazard and promoting risk management in the financial sector, the Deposit Insurance Act, which allows for a one million baht per person per bank guarantee limit, has been drafted. This guarantee is expected to cover 98 per cent of depositors. The draft Act has been approved by the cabinet, and is currently waiting approval of the parliament.

4.2 Structural changes

Financial Sector Master Plan

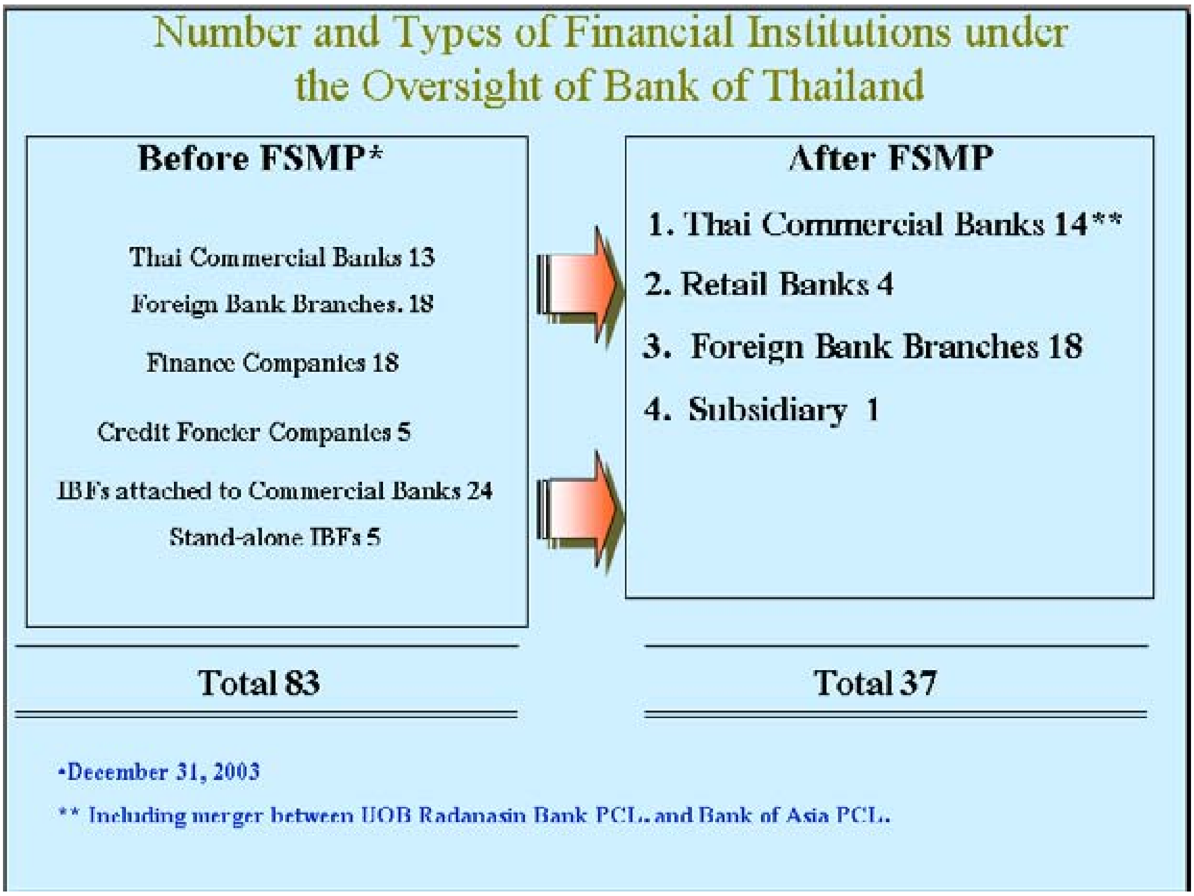
In order to further address structural weaknesses and develop a stable and efficient financial sector that is also accommodative to Thailand's dual economy, the Bank of Thailand developed the Financial Sector Master Plan (FSMP) as the medium-term (5-10 years) development plan for the Thai financial sector. The plan was drafted with emphasis on meeting the needs of all financial service users, given that there is a need to promote greater access to financial services to cover low-income households and SMEs and expand the range of financial products for the corporate sector.

The key measures to increase efficiency in the financial sector, by reducing the number of small players and eliminating regulatory arbitrage, are the licensing rationalisation scheme and the "one presence" policy. Licensing rationalisation created a new deposit-taking regime occupied by only four types of financial institutions, namely commercial banks, retail banks, foreign bank branches and subsidiaries of foreign banks. Licenses for International Banking Facilities (IBFs) have been discontinued to eliminate tax distortion. Qualified finance companies, credit fonciers, and stand-alone IBFs are allowed to be upgraded to either commercial or retail banks. With the new licensing scheme, authorities have removed the overlapping scopes of business that posed regulatory arbitrage problems. Commercial banks will be able to better take advantage of the economy of scope and scale, leaving retail banks as niche players in the retail and SME markets, while the expansion of foreign banks' role will contribute to greater competition in the financial sector.

The "one presence" policy requires financial conglomerates with more than one type of deposit-taking financial institution within their group to merge their holdings and maintain only one type of deposit-taking institution. This measure corresponds well with the new licensing scheme in that it reduces the number of licenses and increases the scope of commercial banks, thereby reducing regulatory arbitrage in the system.

The FSMP began to be implemented at the beginning of 2004. Following the merging and upgrading of the finance companies and credit fonciers to commercial or retail bank status, discontinuation of IBFs and consolidation under the “one presence” policy, the number of financial institutions under the supervision of the Bank of Thailand is expected to decline from 83 to about 37 (Figure 11).

Figure 11



5. Challenges Ahead

The key long-term challenges are how to ensure that the economic and financial system can adjust flexibly to the key drivers of change (namely increased globalisation and technological innovation in both goods and the financial market), and to underlying changes in economic and financial structure such as demographic changes.

Recent years have witnessed growing global competition and integration of goods and financial markets, especially from dynamic emerging markets such as China and India, as well as rapid and volatile capital flows. Thailand’s long-term growth and stability depends on upgrading competitiveness along with ensuring an agile and innovative private sector. The financial system, both the financial institutions which are still the key intermediary in Thai system as well as the rapidly growing capital market, play an important role in this process of resource allocation and risk management. Failure to make efficient investments and manage risk properly could have consequences for growth potential, with long-term impact on stability, as was the case in the last crisis.

The impact of globalisation and competition will also increase due to numerous multilateral, regional and bilateral trade and investment agreements such as those of the WTO, APEC and the various free trade agreements (FTA). Thus, regulators also face the challenge of balancing costs and benefits of increasing market access to foreign competition. While increased competition enhances efficiency, the precondition and sequencing must be appropriate in light of the risk of instability and the remaining weakness in domestic system.

The reforms in the private and public sectors after the crisis have also done much to enhance risk awareness, including increasing demand for transparency, information dissemination and strengthened corporate governance. Such trends are observed in both the public and private sectors. As the Bank of Thailand moves to risk-based supervision, therefore, in parallel, greater emphasis and expectation must be placed on the internal risk management of financial institutions. Consistent with this, the Bank of Thailand has placed greater importance on involving financial institutions in the process of setting risk-based principles. Thus, the policy consultative process has been well institutionalised for most key policies, such as those on provisioning, new derivative products and market risk guidelines. The benefit of this is to ensure understanding of the principles and to allow close regular dialogue between regulators and financial institutions. This is truly helping to move regulation from a focus on black-letter law to a focus on the process of risk, which is critical in the face of the complexity of financial innovation. The consultative process and close cooperation have also been key in preparation for Basel II as the Bank of Thailand and financial institutions come together to review and draft comments on various consultative papers as well as in the process of finalising the Quantitative Impact Study.

Managing the challenges ahead requires efficient risk monitoring and management, as well as redressing of structural weaknesses, including new architecture such as the FSMP and fortifying and modernising key infrastructure such as market and legal systems, and strengthening knowledge and technology in the financial system.

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