Tarisa Watanagase: What do regulators really want - Thailand's perspective

Speech by Dr Tarisa Watanagase, Deputy Governor of the Bank of Thailand, at the Retail Finance Asia-Pacific 2004, Bangkok, 18 March 2004.

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Good afternoon. I thank the Lafferty Group for inviting me to speak at this Conference - an opportunity to engage in a discussion with practitioners in the banking industry. Therefore, it is with great pleasure that I accepted the invitation because I believe a gathering like this promotes interactive relationships between those in the industry and regulators so that, together, we can move with the industry trend. This year's Retail Finance Asia-Pacific Conference adopts the theme "Innovative Strategies For The New Consumer - Winning The Competitive Edge. I trust that you must have learned a great deal from yesterday discussions among leading experts on how to address the customers' needs with a wide array of new products and innovation.

This afternoon, you will hear from me on the same theme but from a different perspective - what might be the expectations of regulators on the industry with respect to the retail banking sector. In doing so, I would draw upon Thailand's experience by touching on, first, a quick overview of the retail banking sector; second, I will draw the link to its social aspects - focusing on what's moving and shaking in the Thai financial landscape; third, going through supervisory concerns and challenges - our policies to promote retail banking sector, while preserving financial stability, and concluding the session by attempting to answer "**What do Regulators Really Want?**" - from Thailand's perspective, some elements of which I hope would be true or applicable to other countries' experience as well.

1. Market developments of the retail banking sector in Thailand

The past few years have witnessed a steady increase in the share of retail credits to total credits of the Thai banking sector, climbing to 16.6 percent as of September 2003 from just slightly over 10 percent in 1998 - right after the Asian crisis. This remarkable trend can be explained by both push and pull factors. Laden with excessive liquidity and mired with sizeable unresolved NPL in the corporate sector within the banking system, commercial banks are under pressure to extend credit to the retail sector. In addition, lending to retail sector imposes lower possible loss in case of defaults given its much smaller average size of credits and greater diversity of portfolio than those of the corporate sector.

In terms of composition of banking retail credit, housing credit represents almost two-thirds, reflecting the household's holding of assets mainly in the form of housing real estate - a common feature prevalent in Asia. Credit cards and commercial credits take up 7.2 and 6 percent of total retail credit, respectively, while the remaining 21 percent are credit for other consumption purposes such as electrical appliance, education and so on.

Among all types of retail credit, there are three fast growing segments in the past few years that deserve our attention. First, housing credits with accelerating growth. Second, credit card advance with tapering growths close to 40 percent. And third, automobile hire purchase with record growths of well above 50 percent.

The booms in these segments commonly rest on the strong economic recovery, coupled with solid performance of the stock exchange - after all the Stock Exchange of Thailand recorded one of the best performing bourse in 2003.

The government spending programs such as the village fund has fuelled further consumption, especially at the grass-root level, to ensure firm recovery.

Moreover, against the backdrop of persistently low interest rate environment, consumers find it easier to part with their money acquired from liability assumption. This is particularly relevant for the build-up of debt in housing and automobile segments by households that simply mirrors an accumulation of assets on the other side of their balance sheet.

The tax and transfer fee incentives pertaining to purchase of real estate expired at the end of 2003 has helped encourage consumers to take up mortgage, adding extra boost to its growth.

As for the credit card segment, in addition to the factors cited above, some relaxed subscription conditions during the economic slump and early stage of recovery have contributed to high growth of credits in this segment.

Findings from studies on the financial services in the banking sector

Now, allow me to move on to the assessment of the services provided by the banking sector - what our customers have to say about their needs - what our customers really want. The assessments are based on the studies and surveys commissioned by the Bank of Thailand as part of the formulation of the Financial Sector Master Plan. In order to move forward, we need to have a clear grasp of what is needed and missing in the financial sector, and we found that the following issues are key:

- financial service availability;
- consumers' preference of channel of service distribution;
- expectations on financial services; and
- factors driving them away from using bank financial services.

Quantitative and qualitative gaps in both credit to personal sector and small enterprise sector

Quantitative gap: individual customer group

Allow me to elaborate a little further on these findings. Financing facility is the most dissatisfied aspect in terms of financial services provided by financial institutions. This is evident in the individual customer group, with almost 60 percent having no access to formal channels of credit, 37 percent of which are low-income consumers with annual income less than 100,000 baht. Access to deposit for the individual customer group is not as grave a problem as access to credit, although about one-eighth of this group still has no access to deposit.

Quantitative gap: corporate customer group

In terms of quantitative gap, it displays a similar pattern of deficiency in the corporate customer group to that of the previous group, but to a much lesser extent, with less than a quarter of corporate customers lacking access to credit and a mere half percent to deposit.

Qualitative gap: the urban low income group and the rural low income group

The survey reveals qualitative gaps among low-income customers that bear the brunt of inadequate financial services. Low-income customers in urban and rural areas face common problem of limited access to distribution channels of formal financial service providers, forcing some urban low-income customers to resort to loan sharks as the main source of financing. The rural low-income group in both agricultural and non-agricultural sectors also encounters the problem of limited choices of financial services, while the low-income customers in agricultural sector face additional problem of high funding cost.

Preference of traditional channels of service provision over e-banking

In terms of service distribution channel, brick banks still have competitive edge over click banks as consumers still prefer to conduct banking transaction with human contact at bank branches or sub-branches. E-banking is not yet well-accepted by consumers on account of:

- uncertainty surrounding accuracy of the services;
- lack of transaction evidence that might be useful in case of dispute settlement; and
- lack of knowledge among some retail customers.

The use of automated teller machines is quite well-spread while the use of phone banking and Internet banking is still limited to a small fraction of customers. According to the survey, high-income retail customers tend to make use of phone banking and Internet banking more often than do low income customers. Usage of phone banking and Internet banking by corporate customers is still low, though large and medium corporate tend to use phone banking and Internet banking more often than do small corporate.

Financial service needs expected in the next few years

Due to the current low return on savings with commercial banks, both individual and corporate consumers revealed preference towards alternative saving instruments such as saving bonds and government bonds. As for financing, the needs expected by individual customers are those for the purposes of working capital, residential, education and business expansion, while those of corporate customers remain financing for long-term investment for business expansion and short-term working capital requirements. Other financial service needs expected by individual customers to be on the rise are the use of ATM and life assurance, while more uses of phone banking and Internet banking, provident fund management and cash management are expected by corporate customers.

Unattractive aspects of financial institutions that drive customers away from using their financial services

Although financial institutions, especially banks, are still the main financial service providers to consumers in Thailand, there are some aspects of their services considered not so user-friendly, such as:

- complicated procedures and long period of time for getting credit approved;
- inconvenient access to the services;
- inflexibility in the terms and conditions of repayment; and
- the emphasis of banks on collateral instead of repayment ability.

2. Social aspects of retail banking sector

As you can see, these findings show that there are some gaps of the underserved to be filled in the financial sector, and retail banking is an area of potential growth. Moreover, we regulators believe that the consideration in retail banking sector extends *above and beyond profit making* for service providers and systemic stability because excess in this sector not only exacerbates a boom and bust cycle of credit, but also causes financial distress to over-leveraged consumers, triggering more social problems. Therefore, with profit-making comes responsibility - banks should be responsible for consumer education programs as well, disclosing information such as interest charges and fees of financial services. Let me go over quickly these points:

In order to fulfill this inadequate **access to financial services by under-served consumers**, the Bank of Thailand initiated a pilot project on micro finance in collaboration with commercial banks. Against misconception that micro finance is an unprofitable segment, this project aims to demonstrate that the coexistence of profitability and satisfied customers is possible with a right business model. Late last year, we invited foreign speakers to share with senior management of Thai commercial banks their experience in successful conduct of retail business in their countries. Following this seminar, a number of banks already expressed their interests to participate in this pilot project.

One social aspect that has clear benefits to all parties concerned is **consumer education**. It has two major dimensions, one on the cultivation of responsible use of credits and the other the introduction of new financial products and channels of distribution. While the former can improve the overall risk profile of financial institutions' retail portfolio, and thus lower the lending rates, the latter can potentially stimulate more demands and lower the cost of service provision. It is therefore the responsibility of lending institutions to convey clearly the message of 'no free lunch'. In other words, prudent lenders must ensure that borrowers are fully aware of the financial obligation of their debt burdens and legal consequence of default. Failure of either party could tarnish the healthy usage of retail credit.

Mindful of the importance of **consumer protection**, the Bank of Thailand already issued a regulation requiring financial institutions to disclose information, especially on effective interest rate and fee charged, financial position and operating results, so that customers can make well-informed decisions. Additionally, financial institutions will be required to have in place clear procedures for handling customer complaints. On a system-wide scale, the authorities will introduce a deposit insurance scheme in place of the existing blanket guarantee to ensure protection of retail consumers.

3. Supervisory concerns and challenges

I have already touched on regulators' concerns that directly affect consumer benefits. Now allow me to go through the concerns and challenges of retail banking from a wider perspective. First, we are concerned for those considering jumping onto the booming retail credit bandwagon without having sufficient skills and resources to capitalize on the key drivers of this market segment. Second, the risks inherent in credit extension, which have to be adequately monitored and managed. Third, the one that directly concerns us, regulators, - how to achieve a balanced objective of financial institution stability and fostering development, competition and level playing field.

Drivers of retail banking business

The gaps of financial services provided by financial institutions in Thailand reflect untapped opportunities in the retail sector awaiting those having the capability to fill in these gaps. The opportunities are open to banks with the right business models for the identified niche markets. However, it takes more than that to be successful in this competitive segment - banks must be capable of accurately charging the right price commensurate to the risk profiles of customers and their own operating cost. To this end, it is important that banks know their pool of customers in this sector, as well as have in place an efficient network of service distribution and able team of staff to achieve extensive outreach and operation efficiency.

Adequate oversight of various risks

The profitability of banks hinges on their ability to manage various risks arising from their conduct of banking businesses. Retail banking is no exception.

Therefore, it is the interest of banks to have in place effective tools and internal control system to manage all types of risks. Stringent credit scoring is the centerpiece of **credit risk** management in the retail sector so as to minimize potential write-offs. The model must be based on analysis of accurate data of debtors on their credit exposure and pattern of repayment to gauge their risk profiles properly. As part of bank normal course of business, the credit grading process should be regularly reviewed so that banks can adjust credit exposure appropriate with the repayment ability of individual debtors. This boils down to a basic concept of '**know your customers**'. The increasing use of sophisticated financial technology to manage portfolio of retail customers with more complex demand at least costs can pose significant **operational risk** such as internal and external fraud. This calls for bank management to establish adequate security measures, contingent plans and auditing standards within their system of internal control that should serve to monitor reputational risk, strategic risk and other risks.

Balanced objective of financial institution stability and the needs for development, competition and level playing field

Recognizing the needs for a salient financial system with sound and strong financial institutions on the one hand, and the benefits of competition unleashed by innovation and evolving development on the other, regulators are faced with the challenge to achieve the latter without stifling the former. It is therefore our duties to create a regulatory environment that offers a level playing field in which innovation is nurtured and financial institutions are encouraged to operate their businesses in a safe and sound manner.

To foster innovation:

Mindful of the needs to keep up with the development of the market, we regularly communicate with market participants and practitioners - this Conference is an example. In addition, at the Bank of Thailand, we develop a policy issuance process that is methodological and is a product of consultation with all stakeholders. We often seek the view of our fellow regulators to ensure that our policies are in line with market and international best practices - in addition to helping us anticipate problems that we might face during implementation phase. In addition, the Bank of Thailand's senior and middle management regularly exchange views with those from other central banks and regulatory bodies in both regional and international forums. Prior to issuing a policy, its final draft is sent out for comments from stakeholders both in and outside the Bank of Thailand, especially the industry, to avoid the problem of impracticality and minimize the cost of compliance on the part of financial institutions. Regulation and guidelines are also subject to regular review and revision to make sure that they are up to date and in tune with technological changes and market developments. To ensure that our supervisors competently meet these challenges, we have undertaken steps to enhance their supervisory capacity. The School for Examiners was established to provide training programs ranging from basic concepts of bank supervision to how to lead a team in bank examination based on risk-based supervision. Specifically, we are working to enhance quantitative skills necessary for comprehensive implementation of Basel II and financial engineering skills to keep pace with the developments of new financial products and package risks.

To maintain stability:

The prime concern shared by regulators of financial institutions is a stable financial system that is resilient to shocks and supports efficient allocation of resources in the real economy. One of the pitfalls of the retail banking market in Thailand before the Asian crisis was **information asymmetry** whereby creditors only had partial knowledge of their debtors' financial indebtedness, including history of repayment. To address this weakness, two **credit bureaus** were set up so that banks can accurately assess the risk profile and repayment ability of a debtor. This in turn enables banks to differentiate good debtors from more risky ones, and charge them commensurate to their risk profiles.

In view of bank oversight, the Bank of Thailand has reoriented its focus on supervisory framework away from solo-basis transaction-testing analysis, towards risk-based supervision on consolidated basis. To fulfill this objective, we have already issued guidelines on all key risk categories and undertaken internal reform and capacity building to meet the challenge posed by comprehensive risk-based supervision. An example in this area is the development of examiners' manuals that are regularly revised to ensure consistently high standards of supervision.

4. Going forward

Ladies and gentlemen, in the next few years, Thailand anticipates both opportunities and threats in the retail banking sector for existing banks in the light of the implementation of the Financial Sector Master Plan. As regards the focus of regulators, more attention will be given to watchful monitoring of the use of credit cards, monitoring of non-bank credit institutions, and observance of governance by market participants.

The changing landscape of financial system to be brought about by the Financial Sector Master Plan will create **opportunities** for present market participants that have the courage to explore the niche and capability to satisfy the specialized needs of this group of customers. They come in the form of a new type of bank license - retail bank and other incentives. The tier1 capital requirement of 250 million baht for retail banks will be conducive to their specialized lending to retail customers. In order to enhance delivery channels of retail banking, the Bank of Thailand will allow and encourage commercial banks to use customer contact points other than their own branches and sub-branches by means of alliance with post office branches and telecom companies' service points, for instance. Moreover, banks can capitalize on lower capital charge for performing retail loan portfolios if they pass both small size test and non-concentration test, with risk weight of 75 percent for loans to retail customers or SMEs and only 35 percent for fully collateralized housing loans. These are the risk weights proposed by the draft Basel II Accord.

However, for those who fail to adapt, these forces of change may inflict **threats** raised by more intense competition from non-bank players and existing foreign banks. The competition is particularly intense in consumer credit segment with mushrooming non-bank credit institutions that offer more relaxed lending conditions for consumer credits, with faster services - some applications are approved within half an hour. Moreover, if qualified existing foreign bank branches or office of international banking facilities choose to upgrade their status to subsidiary, they will be allowed to have some branches, inserting more competitive pressure on the existing players.

Despite low household debt of less than 30 percent of GDP in Thailand, the rapid growths of personal credit and credit card advances, in particular, are a potential source of our concern, especially for low-income customers. Due to consumption-orientated feature of this type of credit, this group of customers might develop a habit of living beyond their means, causing their debts compounding faster than income. Therefore, we will be on a careful watch of this segment of retail banking. Currently, the Bank of Thailand, in consultation with the industry, is in the process of issuing additional measures to ensure the integrity and soundness of personal credit sector.

Another area that alerts our attention is intense competition among non-bank credit institutions for credit card advances. Outside the purview of the current supervisory scope of the Bank of Thailand, they are part and parcel of the retail credit market. Their relaxed lending practices may attract irresponsible borrowing by undisciplined consumers who may bring themselves and their family to financial distress. It is in the interest of consumers that these credit institutions are prudently managed and sufficiently supervised - the role that will be better served by the Bank of Thailand empowered by the new Financial Institutions Businesses Act currently in legislative process.

It is my belief that good corporate governance is key to safe and strong financial system because prudent and capable bank management that adheres to its professionalism overseen by independent and financial literate Board of Directors will be responsible to not only its shareholders but also depositors and consumers in all aspects of its business, including retail banking. In order to put such belief into a concrete form, the Bank of Thailand has announced guidelines supporting the practice of good corporate governance of banks' Board and management.

5. Conclusion

The discussion thus far has covered various aspects of the question posed to me - what do regulators really want? - By now you will have already known my answers to this question. In essence, it is our hope that industry participants will make their best effort to do their job as well as we do ours to meet the challenges set out in the Financial Sector Master Plan:

- Providing financial services for all potential users indiscriminately to those in urban and rural areas, whereby viable users with simple needs and those with more sophisticated needs have access to financial products and services commensurate to their depth of financial literacy and risk appetite at reasonable price.
- Developing a competitive, efficient, stable, and balanced financial system
- Fostering fairness and protection for customers whereby financial institutions follow good corporate governance principles and consumers receive adequate information and advice from various financial institutions to make informed investment decisions.

Thank you.