Tarisa Watanagase: Strengthening the banking and financial sector – what needs to be done?

Speech by Dr Tarisa Watanagase, Governor of the Bank of Thailand, at Finance Thailand, a seminar organised by The Banker Magazine and Financial Times Business, Bangkok, 22 February 2010.

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Ladies and gentlemen,

First of all, I would like to thank The Banker Magazine and The Financial Times for the invitation. It is an honour, and indeed an opportunity, to join all of you here at this conference, and to share with you my thoughts at this very challenging juncture, not only for the global economy and financial system, but also at an important stage for development of Thailand's economic and financial sector.

The past three years have been one of the most turbulent periods in global economic development.

On the global economy front, despite the signs of green shoots in the global economy, we are constantly reminded of the remaining fragility and vulnerability of such recovery in various hot spots around the world, with emerging new paradigm of risk, namely sovereign risk.

For the global financial system, risk and challenges remain abound. The key challenge strikes at the heart of the global financial system – regaining trust.

Trust in market mechanism, as well as its regulator, has been severely tested. The task of setting a right balance in regulation, going forward, is still a global debate, in which the Bank of Thailand is closely engaged in our role in various working groups of the Basel Committee for Banking Supervision. On the one hand, it is critical that the global financial system re-establishes such trust, and ensures stability, integrity, and fair consumer treatment. On the other hand, the crisis has highlighted the complexity of the financial system, and the globalness of financial contagion. Thus, there is a critical need for the authorities and the financial market to work together to ensure that the emerging global standards and regulations can handle such complexity, and remain risk-focused at the economic and financial system, both in the national and global contexts. It is also important to avoid introducing distortion and risk of regulatory arbitrage between financial markets, products, and strategies, and most importantly, arbitrage between countries. Thus, the strong impetus on supervisory coordination, cross-border risk and coordination, as well as macro-prudential aspects are the new challenges.

Turning to the situation in Thailand, thus far, despite some set-back in terms of economic contraction in the past year, both the Thai economy and financial system have shown resiliency and robustness. This helps to stand us in good stead, and provide a strong grounding to forge our strategy to handle coming challenges.

Nevertheless, looking ahead into the longer term, Thailand's economic and growth potential is still not fully and efficiently harnessed. Economic efficiency, international competitiveness, and economic stability are keys to sustainable growth. A robust and stable financial system, that we have managed to ensure so far, is a necessary, but not sufficient condition for achieving sustainable growth. Financial system efficiency needs to be upgraded, so that it serves to lift economic efficiency, not least by harnessing the hitherto untapped strength of the grass-root economies, where the emerging organic social-economic network has increasingly highlighted the potential contribution to growth and welfare improvement. For the banking system, the strategy to harness this potential is set out in the Financial Sector Master Plan Phase 2, which is a continuation from Phase 1.

Ladies and gentlemen,

The challenges I have raised, together, pose a tall order. So in today's talk, let me set out our strategy and policy priority in three parts.

First, the SWOT analysis of the banking system and the challenges we face;

Second, the key strategies in the Financial Sector Master Plan Phase 2; and

Third, the key measures in risk-based supervision to ensure stability.

First, the strength of our banking system is evident in its continuous solid performance. During the toughest times, our banks remained strong and resilient against the backdrop of economic slowdown. Loan decelerated, partly due to contraction in corporate portfolio and deceleration in household portfolio, as a result of more cautious business undertaking and household spending, and partly due to tightened loan underwriting standard. The good news is the figures are already starting to pick up again. Meanwhile, NPL and delinquency have continued to decline, as the ratio of NPL, net of provisions, to total loans has declined further to 2.7 percent as banks attentively monitored their asset quality. Moreover, profit continued to be recorded for nine consecutive years, and the overall capital position of the banking system strengthened further, with BIS ratio at 16.1 percent, of which 12.6 percent is Tier 1 capital.

Much of the current strength and resiliency of our banking sector owes a great deal to the reform groundwork laid during the past decade. On prudential supervision, as apart from requiring banks to conform to international best practices on risk-based supervision under Basel I and now Basel II, the Bank of Thailand also moved to strengthen our supervisory function, utilising both on-site and off-site supervision as well as asking banks to carry out stress tests on a regular basis.

The key here was to strengthen banks' own risk management culture and system. Works on strengthening the financial infrastructure were started and are still on-going. In this regard, various initiatives were introduced, including the long-term effort to reshape the financial system, and address inherent structural weaknesses, that was the mission of the Financial Sector Master Plan Phase I. The establishment of the National Credit Bureau to improve credit information, and improvements in financial legislations, including the new Financial Institutions Business Act, the Bank of Thailand Act and the Deposit Protection Agency Act.

Today, our banking sector fundamentals continue to be strong, serving as a dependable pillar for our economy. Despite this advantage, the Bank of Thailand is not complacent and we will continue to prepare our banking sector for future challenges.

In this regard, a SWOT analysis of our current financial institutions system reveals that while there was overall improvement in efficiency and soundness, operating costs remained high and financial access gaps remained. Furthermore, there was still inadequate financial infrastructure to support risk management of financial institutions. Meanwhile, future challenges of the next five years would likely come from more intensified competition – not only among banks, but from capital market, both local and overseas. It would also come from more complex and varied needs for financial services, as a result of globalizations and aging population, the shift in resource allocation with greater role of domestic demand vis-à-vis external demand as engine of growth, and finally, capital inflows and external challenges from the global economic crisis. Taken together, these remaining areas of improvement and the need to tackle future challenges have led to the recent launch of the second phase of financial sector reform.

This brings me to the *second* part of my talk: key strategies in the ***Financial Sector Master Plan Phase 2***.

When thinking about characteristics that our future financial system is envisioned to have, several keywords come to mind: efficiency, strength and resiliency, diversification, fairness and transparency. With all of these keywords in mind, measures under the Financial Sector

Master Plan Phase 2 are grouped into three main pillars, aimed to tackle the following tasks: first, reducing system-wide operating costs, namely regulatory and legacy NPL and NPA costs; second, promoting competition and financial access; and third, strengthening financial infrastructure.

On the first pillar. In any business undertaking including banking business, operating cost reflects efficiency and while this translates to cost of consumers through pricing of services, it also affects competitiveness of the industry. The latter point is particularly true, given the trend toward further financial globalization and liberalization. As such, the first pillar would focus on reducing two important operating costs for the whole financial system, namely regulatory cost and legacy NPL and NPA cost.

Next, on *the second pillar*. It is envisaged that competition would be strengthened through new entries and expansion of existing service providers' business scope. In so doing, efficiency would be enhanced through more competitive pricing and service quality and greater opportunities for broader financial access would be introduced.

As for financial access, the idea is to encourage and facilitate the market mechanism by commercial service providers. To achieve this, we will help banks identify where the unmet demand is and encourage them to explore and adopt suitable microfinance business models.

For new service providers, we will consider providing opportunities for those with business model and expertise that can help further enhance market completeness, to enter the market under a restricted license. This may, for example, include microfinance bank, custodial or trust bank, Islamic bank, and investment bank. Such entry would depend on the value added generated for the economy, in terms of increased efficiency in services, and expanded access to underserved segments. In the last year of the Plan, 2014, we may also consider entry in terms of full commercial bank license, if this adds value to the economy, through serving Thailand's international trade and investment interest, including trends in regional integration.

We will also work on improving and developing necessary financial infrastructure to support banks and other microfinance service providers in reaching this untapped market. And for the still missing pieces of the jig-saw, SFIs will take the lead.

On *the third pillar*. There are five key areas of financial infrastructure improvement. First, in response to changes in customer needs that are becoming more complex, efforts would be made to enhance the capability and tools for risk management of financial institutions, including credit, market, liquidity, and settlement risks.

Secondly, there needs to be improvement in the information system for risk management of financial institutions to help them in strategic planning and service expansion, while of course, ensuring appropriate protection of client confidentiality.

Thirdly, financial laws that support risk management of financial institutions in dealing with credit risk and NPL and NPA management would be reviewed.

Fourthly, the information technology infrastructure and capacity of financial institutions would be strengthened, thus allowing more efficient utilization of technology to serve increasing customer needs, while supervisory standards would focus on ensuring security of services.

Finally, there is the need to enhance the capacity of human resource in the banking sector.

Ladies and gentlemen,

In any financial system development and reform, regulation must be able to keep up. Let's now turn to the *third* and final part of my talk: key measures in risk-based supervision to ensure stability.

In this regard, the Bank of Thailand continues to work closely with the Basel Committee, through our participation as member of the Standard Implementation Group, or the SIG, and Basel Consultative Group, or the BCG, as well as work with other regulators in the EMEAP region to reform the global financial system. Through these forums, we participate in key reform areas such as refining of risk measurement, formulating measures in handling systemically important institutions, calibrating regulations, such as Basel II capital requirements, stress-testing, and accounting rules to alleviate such problems.

Our role in these forums helps us to steer much reform in ways that are consistent with our own national context, and would be key to ensure proper matching of risk profile in our system with emerging regulations.

At home, empowered with the recent improvement in the legal framework, namely the Financial Institutions Business Act, we will remain committed to performing risk-based supervision and ensuring proper governance within individual financial institutions.

There has also been increasing recognition of the need for macro-prudential policy in dealing with the problem of systemic risk as well as coordination between monetary policy and financial system policy, given that such measures could likely have a macroeconomic impact. The idea is not new to us as you may recall our prior uses of loan-to-value ratios and tightening of credit card rule to prevent the build-up of vulnerabilities in the real estate and household sectors.

Ladies and gentlemen,

When all things considered, though regulatory weakness was partly to be blamed for the recent global financial crisis, it is not that the tenet of risk-based supervision is flawed, but rather failures occurred where there was complacency in overestimating the ability to understand and manage such risks.

Therefore, I believe one of the key lessons to be drawn from this global crisis is that ***we must put great focus and vigilance on supervisory process, rather than just redrafting the written regulation***.

Finally, there is pressing call for stronger international cooperation and dialogue among supervisors. This is so because the complexity and cross-border linkages of financial systems will continue to increase and while we are still grappling with the appropriate supervisory structure to handle cross-border issues, information flows, at this time, continue to be limited. Thus, without effective communication and cooperation, it will be difficult to prevent or contain future financial crisis spillovers effectively.

While we welcomed greater engagement of emerging economies in the global regulatory reform process, such as in Basel Committee and various working groups, the key success factors are these: First, our inclusiveness at the policy development stage rather than just implementation stage, and secondly, on the inclusiveness in the supervisory colleges of global banks which are systemically important to our domestic financial system.

Ladies and gentlemen,

In closing, I would like to iterate that, the success in meeting these challenges, rests as much with us, as with the banking sector. Thus far, we are pleased with their efforts in strengthening risk management, not only in the process, but more importantly, the culture. Often, we are asked why our banking system has managed to remain resilient, while those with more sophisticated risk management system have suffered. I believe the key is, first of all, there is no gap between the risk profile of our banks and their risk management system, as well as our risk-based supervision. Our banks business model is less complex, mobilizing local and stable deposit, for on lending to domestic borrowers, with small investment portfolios, mostly in plain vanilla Thai government bond. They have very little exposure to less familiar risk such as overseas assets and complex products.

But looking ahead, things will not stay this safe if both banks and the Bank of Thailand do not work closely to continuously strengthen risk management. This is because the banking system must serve the need of the real economy, which will become more complex with economic globalizations, aging population, and increasing demand from corporate and households.

Thus, our banking system is interdependent with the real sector, and must evolve with this awareness, recognition, and impending responsibility.

Thank you for your attention.