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Financial System Reform in Thailand

In 2004 Thailand began to implement the Financial Sector Master Plan (FSMP), a long-term reform program aimed at creating a more efficient, transparent, and internationally competitive financial sector that can serve a larger proportion of the Thai population. With the first phase of the FSMP completed in 2009, Thailand announced that a second phase of financial sector reforms will begin in 2010. This *Asia Focus* report provides an overview of the FSMP's development, highlights key reform measures completed under Phase I, and describes measures proposed under Phase II and some of the challenges regulatory authorities may face during implementation.

Development of the FSMP[1]

Regulators in Thailand began to consider the need for systemic reform after recognizing that weaknesses inherent in the financial system had intensified the 1997-98 Asian Financial Crisis, spawning a banking crisis in addition to the currency crisis. Regulators' immediate focus was on short-term emergency measures to contain the crisis and stabilize the financial system, including closing more than 50 insolvent financial institutions, recapitalizing viable institutions, and establishing debt restructuring mechanisms. By 2000, signs of stability had begun to return to the banking sector, and by the following year banks had begun to return to profitability. These developments allowed regulators to turn their attention to formulating a longer term, comprehensive reform program.

Initially, the focus of these reforms was broad and encompassed all financial markets and their governing supervisory framework. Regulators sought specifically to determine the types of financial services that the Thai economy required, the types of institutions that could best provide these services, and the appropriate regulatory structure to govern the institutions. However, recognizing the dominant role that commercial banks played in Thailand's financial system, and to avoid overlap with separate plans for capital market reform also under consideration, the Bank of Thailand (BOT) eventually narrowed the scope of the reforms to focus primarily on deposit-taking institutions under its supervision.[2] At the same time, the BOT expanded the reform's objectives to include the extension of financial services to financially underserved low-income households and small- and medium-sized enterprises (SMEs).[3]

In early 2002, the BOT formed a committee to formulate and finalize a master plan for reforms, the FSMP. The committee—including representatives from financial regulatory agencies, financial institutions, consumer groups, academia, and the general public—synthesized earlier reform proposals with the results of two surveys conducted by external consultants. The first survey measured the household and corporate sectors' level of satisfaction with financial services and sought to identify underserved customer groups. The second survey benchmarked Thailand's financial system with international best practices to determine reform options that would best suit Thailand's needs. These surveys yielded three key findings:

- Substantial inadequacies in the provision of financial services—notably credit, but also deposit services—to rural and urban low-income households and to SMEs.[4]
- Fragmentation of the financial sector amongst a number of smaller financial institutions and a few larger institutions unable to achieve benefits of scale, which resulted in relatively low productivity and weaker risk management.
- Structural elements of the financial system that appeared to adversely affect performance, such as weak information databases, inadequate creditor protection, and regulations that restricted competition.[5]

To address these findings, in 2003 the committee proposed three broad sets of reform measures for inclusion in the final FSMP that aimed to: (i) increase financial sector efficiency; (ii) broaden general access to financial services; and (iii) improve consumer protection and transparency. Because of the wide scope of these measures, regulators decided upon a three-phase implementation of the FSMP to begin in 2004. The FSMP's staged implementation is intended to create a dynamic reform process that allows for interim reviews of measures already implemented and revisions to measures yet to be implemented. Phase II is scheduled to begin during the second half of 2010, with Phase III sometime after 2014.

FSMP Phase I (2004-2009)

Increase Efficiency of the Financial Sector

At the heart of Phase I was a set of measures to increase the efficiency of the financial sector. Key to this effort was an overhaul of the commercial bank licensing system. Prior to the FSMP, regulators issued multiple types of licenses to a large number of financial institutions that provided many of the same services to customers. The BOT also restricted the operations of foreign banks and strictly limited the number of new domestic and foreign market entrants.[6] The BOT's recognition that this system restricted competition and allowed for regulatory arbitrage led to the need for increased efficiency.[7] The revised regime simplified the licensing system by reducing the number of license types to four, based on an institution's size and nationality (*Figure 1*). Financial institutions whose license types were eliminated were given the option to apply for a new stand-alone license or obtain a new license through a merger with another institution.

The new licensing system was codified under the 2008 *Financial Institutions Business Act* (FIBA), which replaced more than a dozen existing laws governing financial institutions' business and consolidated the governance of these institutions under a single law. As a result of these legal changes, the statutory ceiling on foreign investment in Thai commercial banks was raised to 49% from 25%, and the limit on foreign directors was increased to one-half from one-quarter of total directors.[8] The FIBA also clarified the BOT's responsibility as the sole regulator of financial institutions and empowered the central bank to conduct consolidated supervision over financial conglomerates.[9] The central bank's position was further strengthened by a 2008 revision to the *Bank of Thailand Act* which ensured the BOT's autonomy and independence from the government.

Reorganization under the new licensing regime and the FIBA was bolstered by the BOT's "one presence" policy, which limited financial conglomerates to a single licensed deposit taking entity and encouraged mergers.[10] To further encourage consolidation under the one presence policy, the Thai government also relaxed tax regulations that apply to financial institution mergers and reduced fees on land transfers that resulted from mergers. As a result of the new licensing regime and the one presence policy, the number of licensed financial institutions has fallen by more than half, to 38 as of March 2010 from 83 in December 2003 (*Figure 2*).[11] During roughly this same period, the average commercial bank asset size has grown by nearly 50%, to THB 324.3 billion (USD 10 billion) from THB 220 billion (USD 6.8 billion).[12] Foreign participation in Thailand's banking sector also increased, and a number of foreign banks have purchased substantial holdings in domestic commercial banks.[13] Foreign banks' share of total commercial bank assets has also grown, to 14.0% as of January 2010 from 10.8% as of January 2004 according to BOT data.

Broaden General Access to Financial Services

A second set of measures under Phase I of the FSMP focused on broadening access to financial services among underbanked households and small enterprises. Thai financial authorities considered microfinance to be one conduit for the provision of financial services to rural low-income communities, and in 2003 the Ministry of Finance (MOF) established a committee on Microfinance System Development to consider and promote options for grass-roots financing. Government-owned special financial institutions (SFIs) such as the Government Savings Bank and the Bank of Agriculture and Agricultural Cooperatives have also started to play a greater role in microfinance activities.

Figure 1: Thai Commercial Bank Licensing System

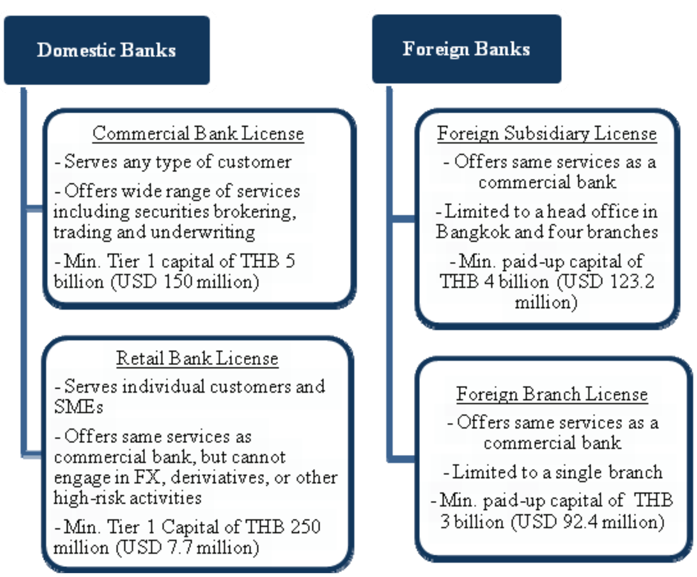

Figure 2: Financial Institution Consolidation (2003-2009)

Institution Type	Dec-03	Mar-10
Commercial Banks	**31**	**32**
-- Domestically Registered	13	16
-- Commercial Bank	n.a.	14
-- Retail Bank	n.a.	2
-- Foreign Bank Branch	18	15
-- Foreign Bank Subsidiary	n.a.	1
International Banking Facilities (IBFs)	**29**	**n.a.**
Finance Companies	**18**	**3**
Credit Foncier Companies	**5**	**3**
TOTAL FINANCIAL INSTITUTIONS	**83**	**38**

Source: Bank of Thailand and Economist Intelligence Unit

To further encourage the extension of credit to underserved sectors, in February 2006 the BOT incentivized lending to these sectors by amending guidance on banks' assignment of risk weights to certain types of loans. The revised guidance allowed banks to assign lower risk weights to fully collateralized mortgage loans of up to THB 3 million (USD 92,400), fully collateralized SME loans of up to THB 50 million (USD 1.5 million) and uncollateralized retail loans up to THB 100,000 (USD 3,000).[14] These revisions required banks to reserve less capital to protect against future losses on these loans, freeing funds for use in extending additional credit.

Improve Depositor and Consumer Protection and Transparency

The most significant measure to improve consumer protection under Phase I of the FSMP was the replacement of Thailand's blanket deposit guarantee system with a limited deposit guarantee. The new system is overseen by a newly created Deposit Protection Agency (DPA), which all commercial banks are required to join as members.[15] Beginning August 2011, the blanket deposit guarantee will be phased out over a five-year period, and the insured amount will be reduced incrementally each year through August 2015, when the amount will be limited to one million baht (USD 30,800).[16] The new system aims to remove an element of moral hazard introduced by the blanket guarantee, increase market discipline on banks, and minimize the public cost of the deposit insurance system.

The BOT also implemented measures to increase the transparency of products and services by requiring banks to post on their websites the daily deposit rates paid on savings and time deposits as well as interest rates charged on common types of loans. Banks must also submit this information to the BOT, which releases the rates and fees on its website in a format that allows consumers to compare prices across institutions.[17] To ensure consumer protection in banks' consumer lending business, the BOT limited to an aggregate rate of 28% the total interest, fines, service charges, and other fees banks could charge on consumer loans. Banks were also required to openly post on their website and in all branches the details of any such rates, fines, charges, and fees and respond promptly to consumer complaints regarding commercial loans.[18]

FSMP Phase II (2010-2014)[19]

Planning for Phase II of the FSMP began in 2007, when the BOT formed a committee of government and private sector representatives to conduct an interim review of Phase I. The committee concluded that financial institution consolidation had resulted in enhanced risk management practices, contributed to efficiency gains, and created a more resilient financial system that offered a wider range of services. However, it found that operating costs remained high, with Thailand's average return on assets from 2004-2008 at 0.7%, lower than banking sectors in other regional economies.[20] The committee also identified gaps that remained in the provision of certain financial services, despite measures taken under Phase I. A BOT survey noted, for example, that 20% of households continued to lack access to a bank account, 71% lacked access to bank lending, and nearly 10% of households lacked access to any type of financial service.[21] The committee further concluded that additional infrastructure developments were necessary to support stronger risk management at banks. Recommendations for Phase II therefore focused on addressing these ongoing weaknesses by (i) reducing operating costs, (ii) continuing to promote competition and financial access, and (iii) strengthening financial infrastructure.

Reduce System-Wide Operating Costs

One type of cost targeted for reduction under the second phase of the FSMP stems from outdated regulation that is no longer consistent with financial institutions' current business models. Although the BOT has yet to publicly identify specific regulatory reforms of this nature, it has sought the input of financial institutions and is working with the MOF to consider requests to amend certain regulations perceived to impose unnecessary costs. Any reforms would necessarily keep the safety and soundness of the financial system as a high priority.

A second source of costs derives from distressed assets that continue to weigh on Thailand's financial system more than a decade after the 1997 Asian financial crisis. Commercial banks have made significant progress in the resolution of non-performing loans (NPLs), reducing the aggregate ratio of gross NPLs to total loans to 5.26% as of end-2008 from 42.90% a decade earlier.[22] The BOT's implementation of stricter provisioning requirements under IAS 39 has also assisted in the resolution process by introducing greater transparency to bank balance sheets. However, a variety of factors, including legal and tax disincentives, continue to discourage banks from resolving remaining NPLs.[23] To address legacy distressed assets, the BOT has stated that it will encourage banks to more aggressively write off loans for which they have adequately provisioned and will permit banks to work with private firms to create markets for the trading of non-performing assets such as foreclosed real estate. The BOT will also address some of the legal barriers to NPL resolution through measures to strengthen the financial infrastructure (*see below*).

Promote Competition and Financial Access

Measures to improve financial sector competitiveness primarily focus on allowing existing institutions to expand business activities by relaxing restrictions on the operation and scope of commercial and retail banks as well as foreign branches and subsidiaries. Indeed, the BOT has already begun moving in this direction by allowing commercial banks to gradually expand their product offerings to include leasing and hire-purchasing services, certain commodity-linked derivatives and hedging instruments, and other derivatives-related activities.[24] Proposed measures going forward include allowing commercial banks to expand into business lines—such as mutual fund and venture capital fund management—currently offered by their subsidiaries. Retail banks may also be permitted to upgrade to a commercial bank license if they meet certain requirements, including a minimum of THB 10 billion (USD 308 million) of Tier 1 capital, and if financial regulators determine they possess strong management, good risk management systems and viable business prospects that will not pose future systemic risks.

Secondarily, the measures aim eventually to allow new market entrants. Foreign branches may be permitted to upgrade to a foreign subsidiary license, and starting in 2012 new and existing foreign subsidiaries will become eligible to open up to 20 new branches and 20 off-site ATMs.[25] To qualify for an expansion, subsidiaries would need to have at least THB 10 billion (USD 308 million) in Tier 1 capital, good exam ratings from the BOT and a good risk management system. Regulators hope that further expanding foreign banks' presence will strengthen the competitiveness of domestic commercial banks. Foreign branches will be permitted to open two additional branches starting in 2012, including currency exchange counters and automated teller machines ATMs.[26] After assessing the effects of these proposed reforms, Thailand will also consider permitting the entry of new financial services providers to fill any remaining gaps in service.

The BOT has also issued proposals to expand financial access to segments of the population that remain underserved after Phase I of the FSMP. In addition to providing greater support to SFIs that already offer microfinance and other financial services to rural, low-income households and small businesses, the BOT will encourage commercial banks to engage in microfinance activities and consider new business lines that will facilitate these activities. This could include establishing internal business units to specialize in lending to underserved customers, or partnerships with existing microfinance lenders to provide funds for lending. The BOT and MOF will also consider on a case-by-case basis granting new, restricted, licenses to financial institutions such as microfinance service providers with expertise in the provision of financial services required to fill the gaps left by SFIs and commercial banks.[27]

Strengthen Financial Infrastructure

The BOT has identified areas of Thailand's financial infrastructure that need improvement, primarily through directly or indirectly strengthening risk management practices. To address these areas, it has announced five sets of measures designed to:

- Encourage banks to develop products and tools to enhance the management of credit, market, liquidity, and settlement risks.
- Improve risk management information systems through a proposed expansion of information collection and distribution through the National Credit Bureau and its own distribution channels.
- Improve banks' credit risk and management of non-performing assets. Initially, the BOT will review laws governing secured transactions, foreclosure and bankruptcy to ease the process for pledging collateral, streamline the foreclosure process, and ease access to the restructuring process for small businesses.
- Encourage financial institutions to employ new technologies to better serve customer needs and reduce the cost of providing services.
- Emphasize the need for financial institutions to attract and develop knowledgeable staff capable of strengthening corporate governance and risk management.[28]

Conclusion

Although it is somewhat difficult to evaluate the FSMP's ultimate impact giving its ongoing nature, the recent completion of Phase I has improved the architecture of Thailand's financial sector. Legal reforms, including those under the FIBA, have strengthened the country's regulatory and supervisory framework and addressed a number of deficiencies identified by the International Monetary Fund (IMF) in its recent Financial System Stability Assessment.[29] Phase I has also strengthened the competitiveness of domestic financial institutions by allowing greater foreign participation, a development welcomed by many domestic and foreign observers.

The FSMP's second phase aims to continue these positive developments. A number of the proposed measures, such as accelerated resolution of legacy NPLs, target areas identified by the IMF as immediate or medium-term priorities in its stability assessment. Nevertheless, regulators in Thailand could face challenges going forward. Some market participants have pointed out, for example, the potential difficulty of reconciling the push for new market entrants to fill service gaps or improve competition under Phase II with the efficiency gains achieved through consolidation under Phase I. Concern has also been expressed that a growing international consensus on the need for stricter global bank regulation could make it difficult for Thai banks to reduce operating costs.[30] Thai banks may also face additional difficulties given the country's ongoing political uncertainty. Thus, while the latter phases of the FSMP are clearly aimed at further improving financial market infrastructure, these issues and the dynamic and ever changing global financial landscape will continue to challenge their implementation.

<u>Endnotes</u>

1. This section references the Bank of Thailand's *Financial Sector Master Plan Handbook* (August 24, 2009).

2. According to the BOT Monetary Policy Group, commercial banks provided more than three-quarters of external funding to Thai companies between 1988 and 1998.

3. Bank of Thailand. *Supervision Report, 2000*.

4. Nearly 60% of households surveyed reported a lack of access to formal credit channels, and 36.7% of these households were identified as low-income, earning less than THB 100,000 (USD 3,000) per year. Nearly 25% of businesses, mostly SMEs, also reported inadequate access to credit products. A majority of households reported a lack of access to adequate information regarding financial products and services.

5. Bank of Thailand. *Supervision Report, 2003*.

6. Foreign commercial banks were limited to a single branch with no ATMs and focused primarily on trade financing, with little emphasis on retail banking. Foreign banks could operate in a more limited capacity under an off-shore license as an International Banking Facility. Regarding new entrants, in 1996 Thailand issued the first new licenses for domestic and foreign commercial banks in nearly two decades.

7. Tarisa Watanagase. "Maintaining financial stability: the experience of Thailand." BIS Papers No. 28. August 7, 2006.

8. In practice, the BOT granted exceptions to the 25% ceiling.

9. Bank of Thailand. *Supervision Report, 2007*. The BOT had already begun consolidated supervision of commercial banks.

10. Bank of Thailand. *Supervision Report, 2005.*

11. The number of banks has fallen even more significantly compared with January 1997, when Thailand had a total of 176 financial institutions. The decline in the number of banks between 1997 and 2003 is accounted for by the closure of a large number of insolvent institutions following the crisis.

12. Interbank rate as of May 1, 2010 (USD 1.00=THB 32.4624).

13. In 2007 and 2008 GE Capital acquired 33% ownership of Bank of Ayudhya, Thailand's fifth largest domestic commercial bank by asset size. ING owns 30% of TMB Bank, Thailand's sixth largest commercial bank, and reportedly plans to increase its ownership through the purchase of additional shares from the Ministry of Finance. In February 2009 Bank of Nova Scotia increased to 49% its stake in Thanachart Bank, Thailand's eighth largest commercial bank.

14. Economist Intelligence Unit. *Thailand Country Finance Report, 2010.* April 10, 2010.

15. The BOT had imposed the blanket deposit guarantee in 1997 as an emergency measure to help restore confidence in the Thai financial system during the Asian financial crisis. Prior to 1997 Thailand lacked any type of deposit insurance.

16. *Deposit Protection Agency Act*. The gradual reduction in the deposit insurance cap was set to begin in August 2008, but was postponed until 2011 due to BOT concerns over confidence in the banking system during the global financial crisis.

17. Banks must notify the Bank of Thailand of any changes to these fees and rates within three days of their announcement or within three days of their taking effect, whichever is sooner. (BOT *Notification No. 1482-2548*, August 16, 2005.)

18. Bank of Thailand. *Notification No. 51-2548*. June 30, 2005.

19. This section references the BOT's November 2009 "Executive Summary on the Financial Sector Master Plan Phase II."

20. International Monetary Fund. *Global Financial Stability Report: Meeting New Challenges to Stability and Building a Safer System*. April 2010.

21. Bank of Thailand press release on the Financial Sector Master Plan Phase II. (November 4, 2009.)

22. Data are from the BOT and include domestic and foreign commercial banks.

23. International Monetary Fund. *Thailand: Financial System Stability Assessment*. May 2009.

24. Economist Intelligence Unit. *Thailand Country Finance Report, 2010*. April 10, 2010.

25.Under existing regulations off-site ATMs are considered equivalent to a branch. Because foreign subsidiaries are permitted to open no more than three branches in addition to their head office in Bangkok, their off-site ATM operations are limited.

26. Bank of Thailand Notification No. NorSorSor. 1/2553.

27. "Strengthening the banking and financial sector – what needs to be done?" Speech by Bank of Thailand Governor Tarisa Watangase. February 22, 2010.

28. Bank of Thailand press release (No. 54/2552) on the Financial Sector Master Plan Phase II.

29. International Monetary Fund. *Thailand: Financial System Stability Assessment*. May 2009.

30. Michelle Price. "Thai Government Effects Reform." *The Banker*. February 1, 2010.

<u>Contacts</u>: Walter Yao (walter.yao@sf.frb.org) and Nkechi Carroll (nkechi.carroll@sf.frb.org)

<u>Written by</u>: R. Ashle Baxter