EE460: Thai financial sector

Bhanupong

Lecture 23

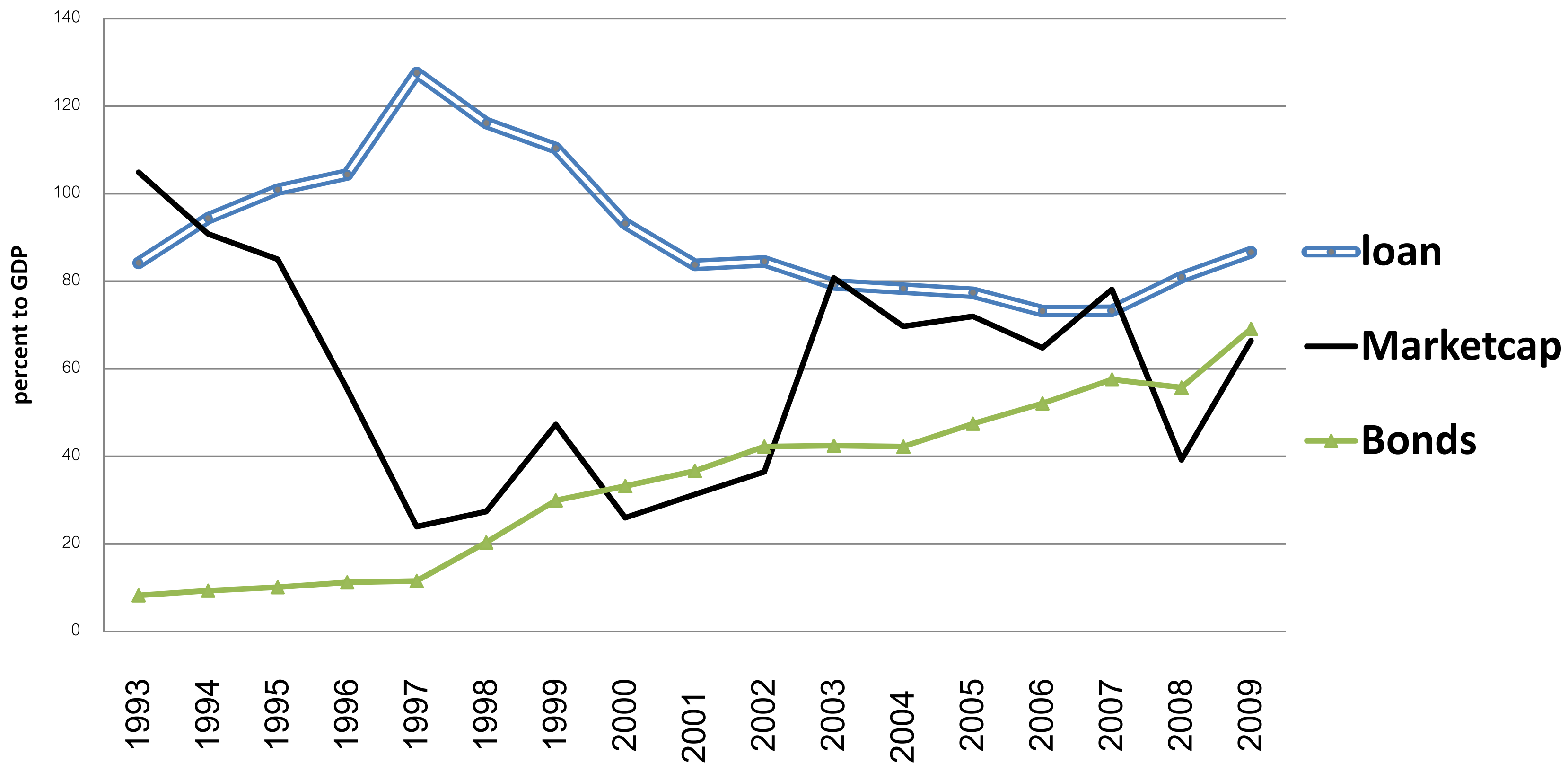
Outline

- Structural changes
- Good and bad banks
- Profitability, efficiency, and solvency
- Bond markets
- Foreign penetration
- GFC and the Thai financial sector
- Financial integration with Southeast Asian Economies

Abstract

- The Thai economy is vulnerable to external shocks because of its high exposure to trade and capital flows.
- Despite its adverse consequences on the real sector of the Thai economy in 2009, the global financial crisis had little impact on the Thai financial sector.
- The healthy performance and resilience of Thai financial institutions can be attributed to the financial reforms undertaken after the Asian financial crisis and the favorable macroeconomic environment.

Structural Change in the financial sector



- The Thai financial sector was vulnerable in the late 1990s.
- The lack of prudential regulations and sufficient loan loss provisions that prevailed before the liberalization of capital account led to huge capital inflows and subsequent financial turmoil.

When good banks become bad banks: Four stages

- The quality of management is an important difference between sound and unsound banks.
- The better-managed banks succeed in remaining solvent.
- Roots of financial distress can be grouped under three headings: **macroeconomic conditions, industrial and financial policy, and debtor and credit behavior**.
- Four types of mismanagement commonly occur in the absence of effective regulation and supervision:

1. Technical mismanagement

- Inadequate credit analysis
- Political pressures
- Excessive risk concentration
- Insider lending
- Mismatching assets and liabilities in terms of currencies, interest rates, or maturities

2. Cosmetic management

- Try to hide past and current losses:
- Bankers may keep dividends constant despite poor earrings.
- Retain smaller share of income for provisions against loss, thereby sacrificing capital adequacy.
- Resort to increase net profits on paper (even if more taxes must be paid)
- Classify bad loans as good so as to avoid making provisions.
- Recording income can be advanced and the recoding expenditure postponed.

3. Desperate management

When losses are too large to be concealed by accounting gimmicks.

- Lending to risky projects at higher loan rates
- Speculating in stock and real estate markets
- Greater risk may lead to further losses and cash flow problem.
- Offer high deposit rates to attract new deposits to avoid a liquidity crisis.
- The higher cost of funds eventually compounds the problems.

4. Fraud

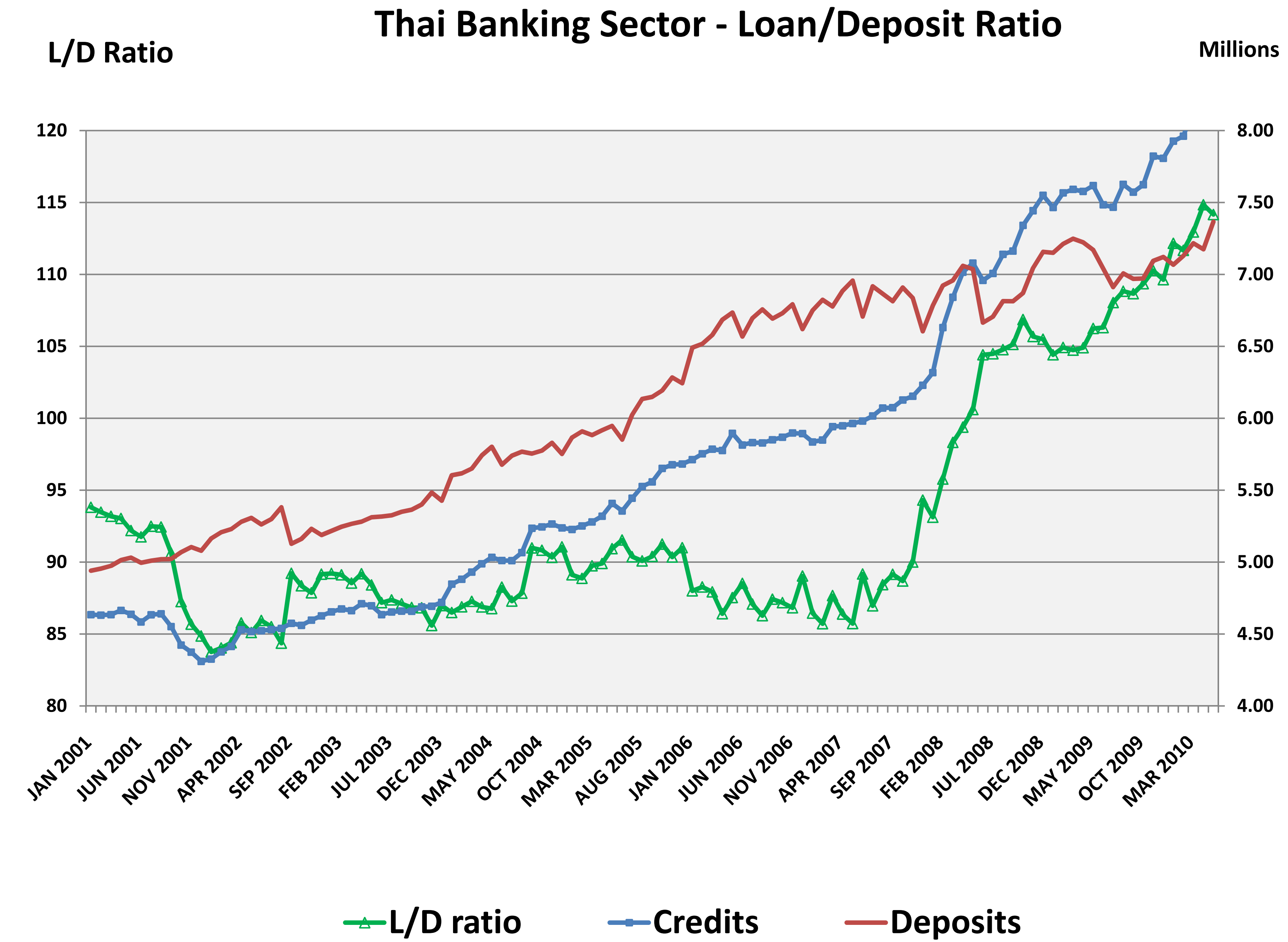
- Fraudulent behavior sometimes causes initial losses, but once illiquidity appears inevitable, fraud becomes common.
- As the end approaches, bankers grant themselves loans that they are unlikely to repay
- “Swinging ownership” of companies partly owned by banks or bankers.
- If a company is profitable, the bad banker will arrange to buy it from the bank at a low price, if the company is unprofitable, the banker will sell it to the bank at high price.

Profitability of Thai banks

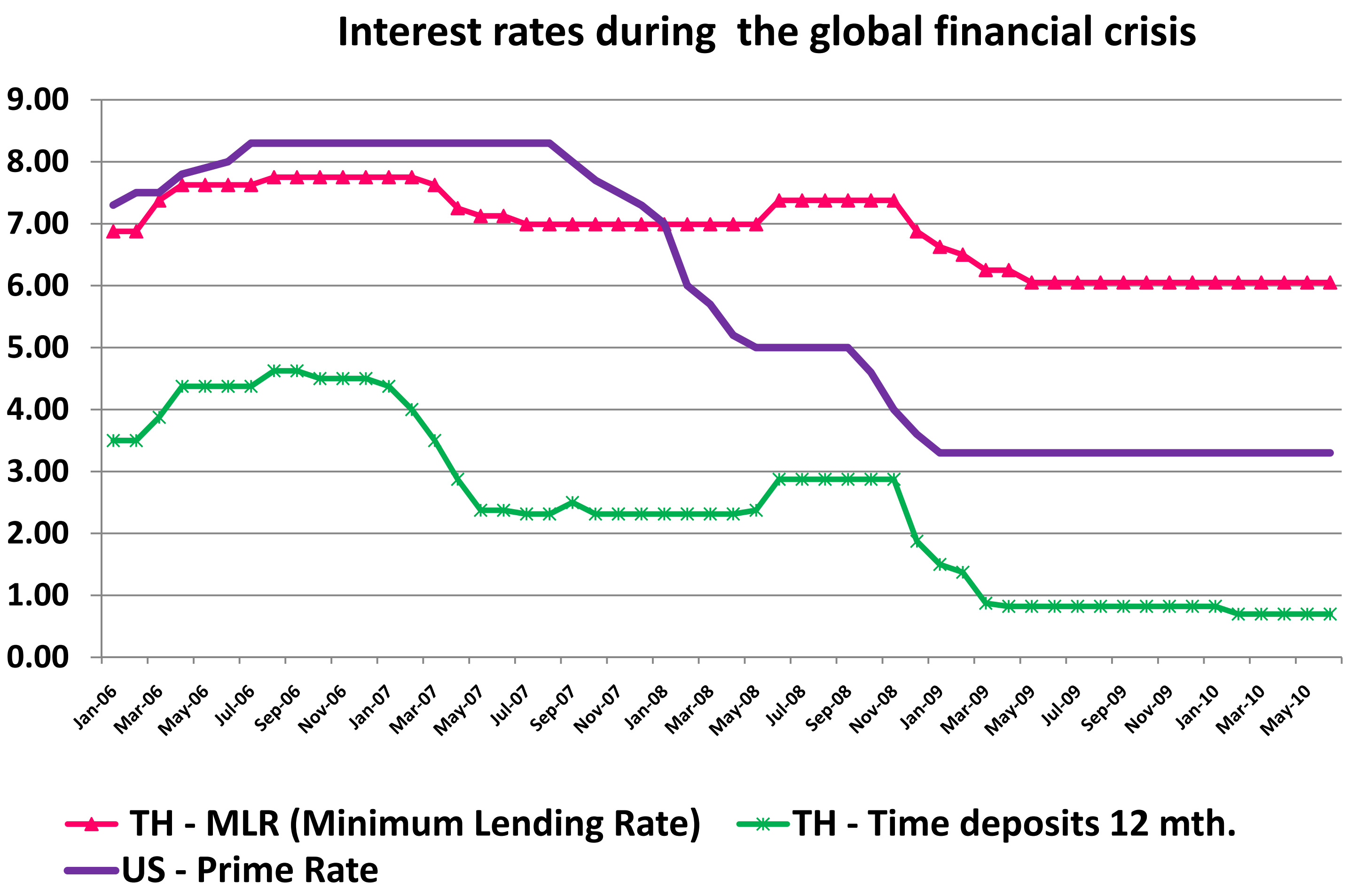
	Large		Medium		Small	
	2004	2009	2004	2009	2004	2009
Interest income and dividend/Average net assets	3.7	4.06	3.35	4.38	4.36	4.76
Net interest income and dividend/Average net assets (NIM)	2.64	3.08	2.05	2.88	3.17	3.25
Non-interest income/Average net assets	1.35	1.46	0.78	1.04	1.39	1.29
Operating expenses/Average net assets	2.08	2.44	1.63	2.54	3.1	2.7
Profit from operation/Average net assets	1.92	2.1	1.21	1.38	1.45	1.84
Net profit/Average net assets (ROA)	1.39	1.14	0.93	0.58	0.64	0.63

Efficiency

	Large		Medium		Small	
	2004	2009	2004	2009	2004	2009
Non-interest income/Total income	26.83	26.44	18.99	19.19	24.12	21.32
Gain (loss) on investments in securities/Non-interest income	20.43	3.97	21.57	-6.07	8.93	7.99
Gain on foreign exchanges/Non-interest income	11.42	14.62	8.12	10.56	10.57	20.53
Fee and services income/Non-interest income	55.8	77.35	54.47	65.43	56.31	41.82
Average net assets/Number of bank's employees	72	79.81	75	64.34	58	73.86
Net profit /Number of bank's employees	1	0.91	0.69	0.38	0.37	0.47
Salaries and employee benefits/Number of bank's employees	0.51	0.70	0.41	0.63	0.63	0.72

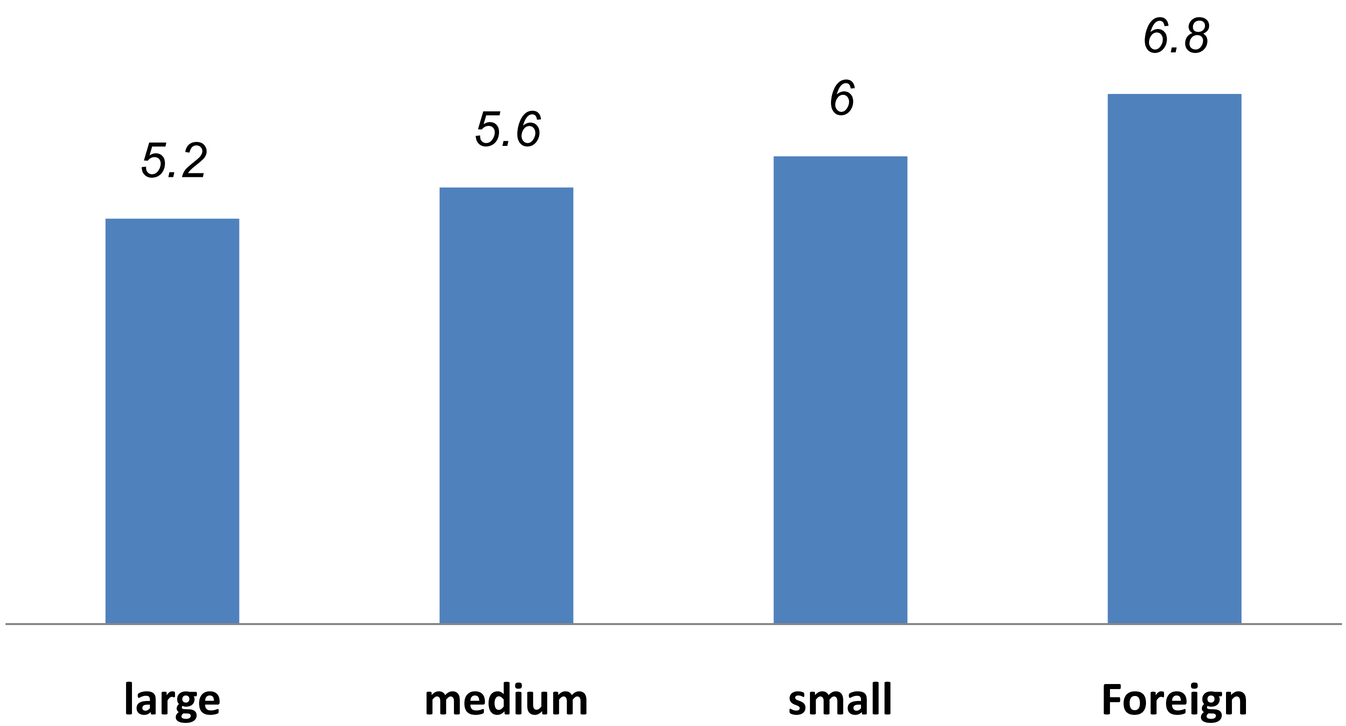


Thai Banking Sector - Loan/Deposit Ratio
L/D Ratio
Millions
120
115
110
105
100
95
90
85
80
8.00
7.50
7.00
6.50
6.00
5.50
5.00
4.50
4.00
JAN 2001
JUN 2001
NOV 2001
APR 2002
SEP 2002
FEB 2003
JUL 2003
DEC 2003
MAY 2004
OCT 2004
MAR 2005
AUG 2005
JAN 2006
JUN 2006
NOV 2006
APR 2007
SEP 2007
FEB 2008
JUL 2008
DEC 2008
MAY 2009
OCT 2009
MAR 2010
L/D ratio
Credits
Deposits



Interest rates during the global financial crisis
9.00
8.00
7.00
6.00
5.00
4.00
3.00
2.00
1.00
0.00
Jan-06
Mar-06
May-06
Jul-06
Sep-06
Nov-06
Jan-07
Mar-07
May-07
Jul-07
Sep-07
Nov-07
Jan-08
Mar-08
May-08
Jul-08
Sep-08
Nov-08
Jan-09
Mar-09
May-09
Jul-09
Sep-09
Nov-09
Jan-10
Mar-10
May-10
TH - MLR (Minimum Lending Rate)
TH - Time deposits 12 mth.
US - Prime Rate

Interest spreads
Minimum lending and fixed
(3 months) **deposit rates**
March 2010



Profit in 2010

- **The banking sector posted record high earnings of more than Bt100 billion for last year, against Bt86.46 billion in 2009, on outstanding loan growth and fee income.**
- Siam Commercial Bank and TMB Bank leading the way SCB's profit in 2010 rose sharply by 16.6 per cent to Bt24.21 billion, while TMB Bank's net earnings soared to Bt3.2 billion from Bt1.94 billion in 2009.
- Kasikornbank announced a 2010 net profit of Bt20.04 billion, surging 36.07 per cent year on year from Bt14.73 billion.

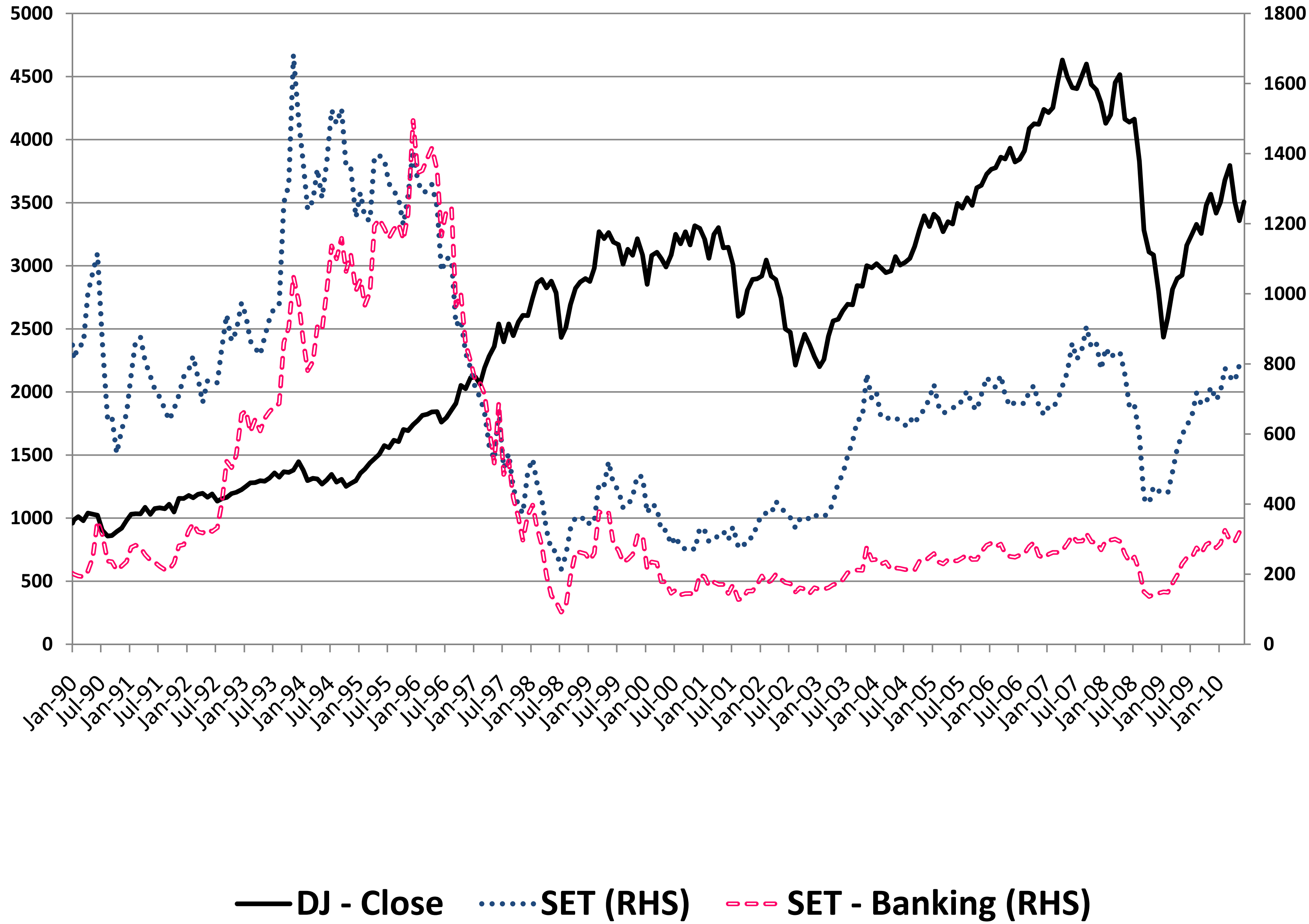
- **Macroeconomic condition and bank performance**

Capital adequacy of Thai commercial banks

	Large		Medium		Small	
	2004	2009	2004	2009	2004	2009
Capital funds/Risk assets	11.85	15.73	10.91	14.90	17.02	18.33
Tier 1 Capital/Risk assets	8.5	11.30	7.93	11.01	14.75	16.22
Loan to related parties/Loans	6.98	2.65	17.53	13.71	10.36	1.91
Non - performing loan/Loans	13.34	4.75	6.71	7.01	10.58	4.36
Actual allowance/Required allowance	131.95	137.01	174.7	120.68	135.84	116.35
Problem assets/Assets plus allowance	10.27	4.14	8.53	6.45	10.96	4.26
Loans/Deposits	88.96	99.54	81.52	108.17	92.9	137.21

Source: Bank of Thailand

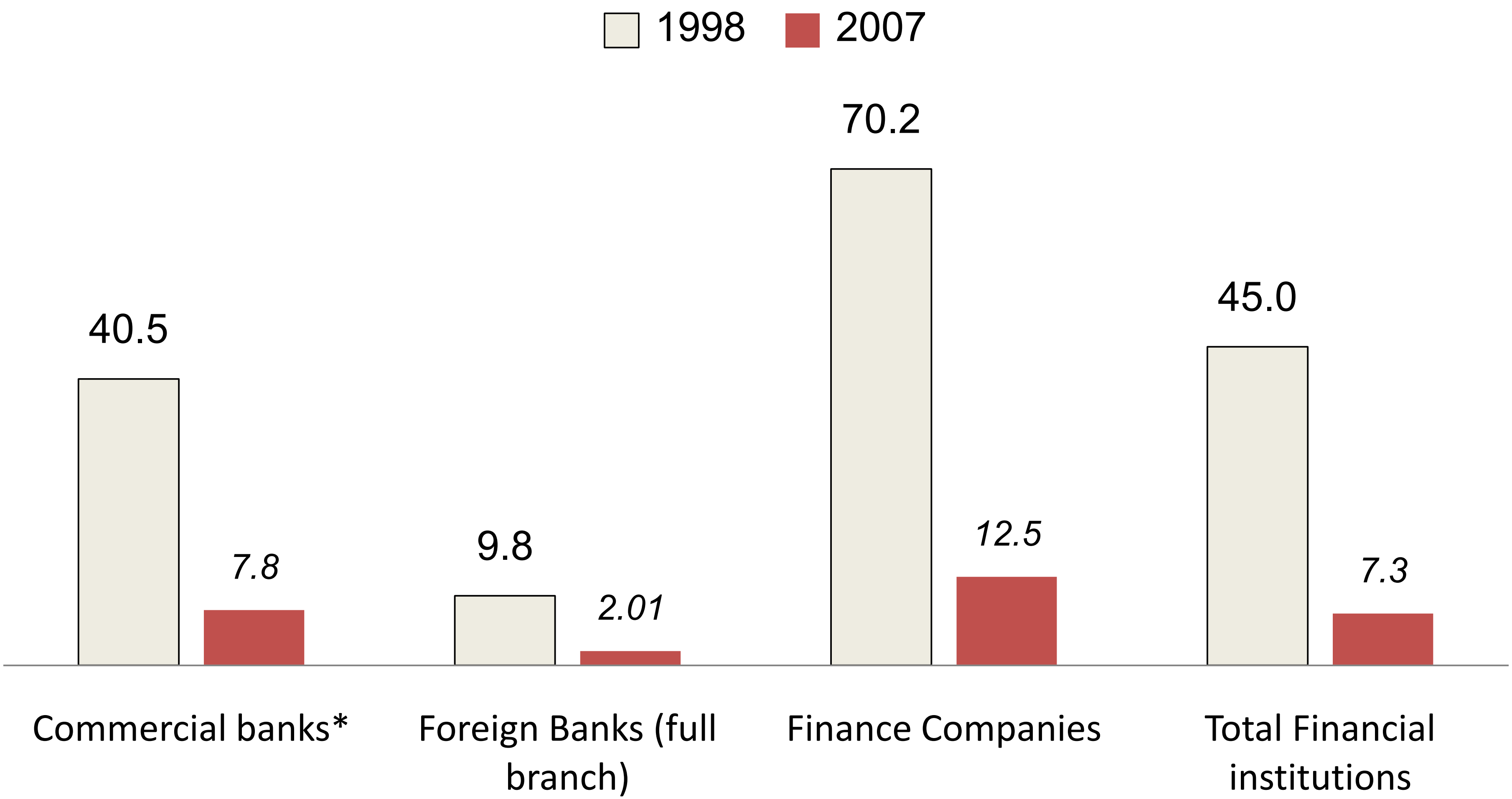
Dow Jones vs. SET Composite Index - Monthly Average



SET-listed firms' interim dividend payout ratio reaches a record high

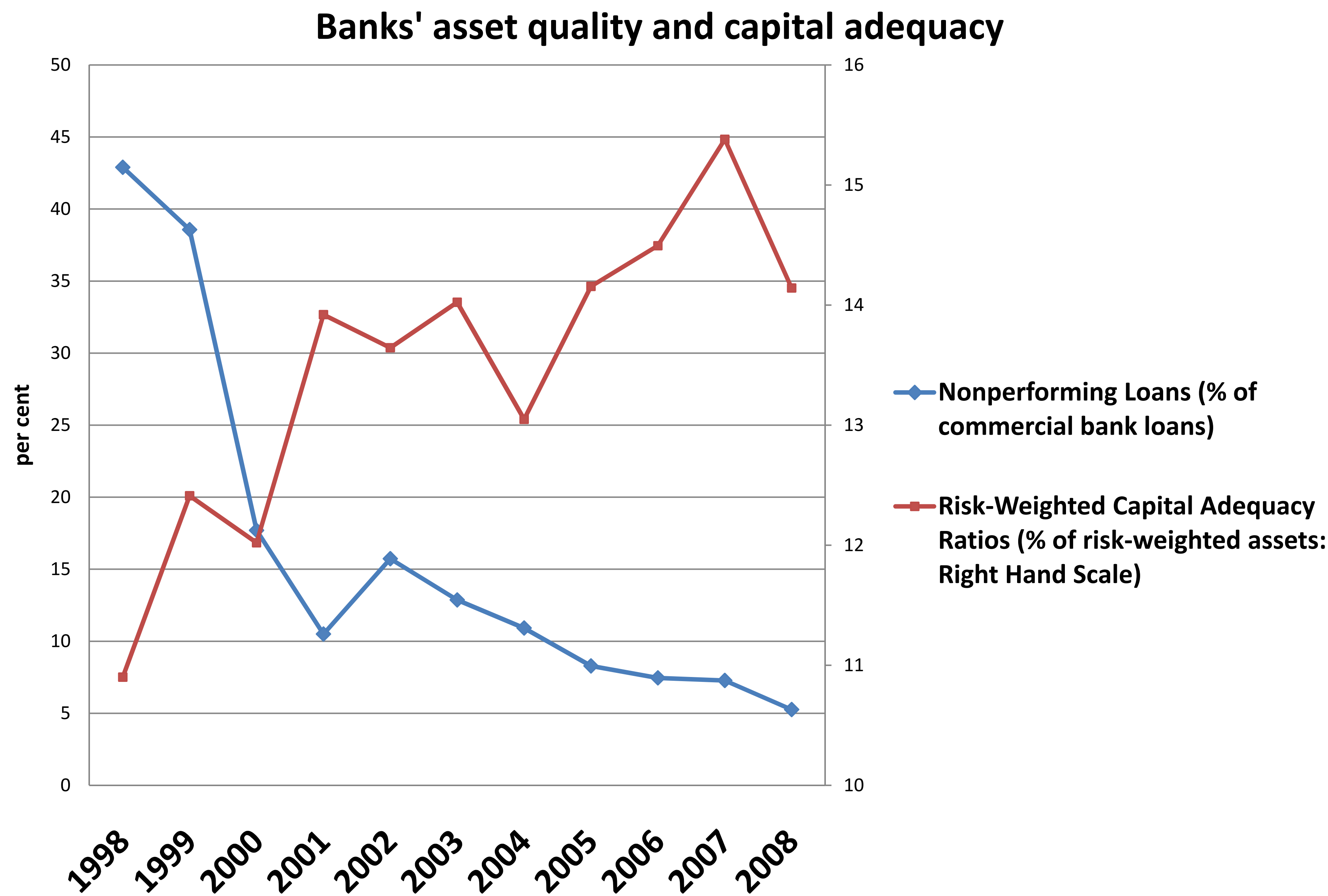
- The rise in the number of firms announcing interim dividend payments and ability to payout dividend resulted from the company's growth and a better operating performance, as shown from a 34.03 growth in net profits over the same period last year.
- The top five SET-listed firms paying the highest interim dividends were Shin Corporation Plc, PTT Plc, Advanced Info Service Plc, PTT Exploration and Production, and Siam Cement, accounting for 56.03 of total interim dividends of SET-listed firms.

NPLs by types of financial institutions (% total lending)

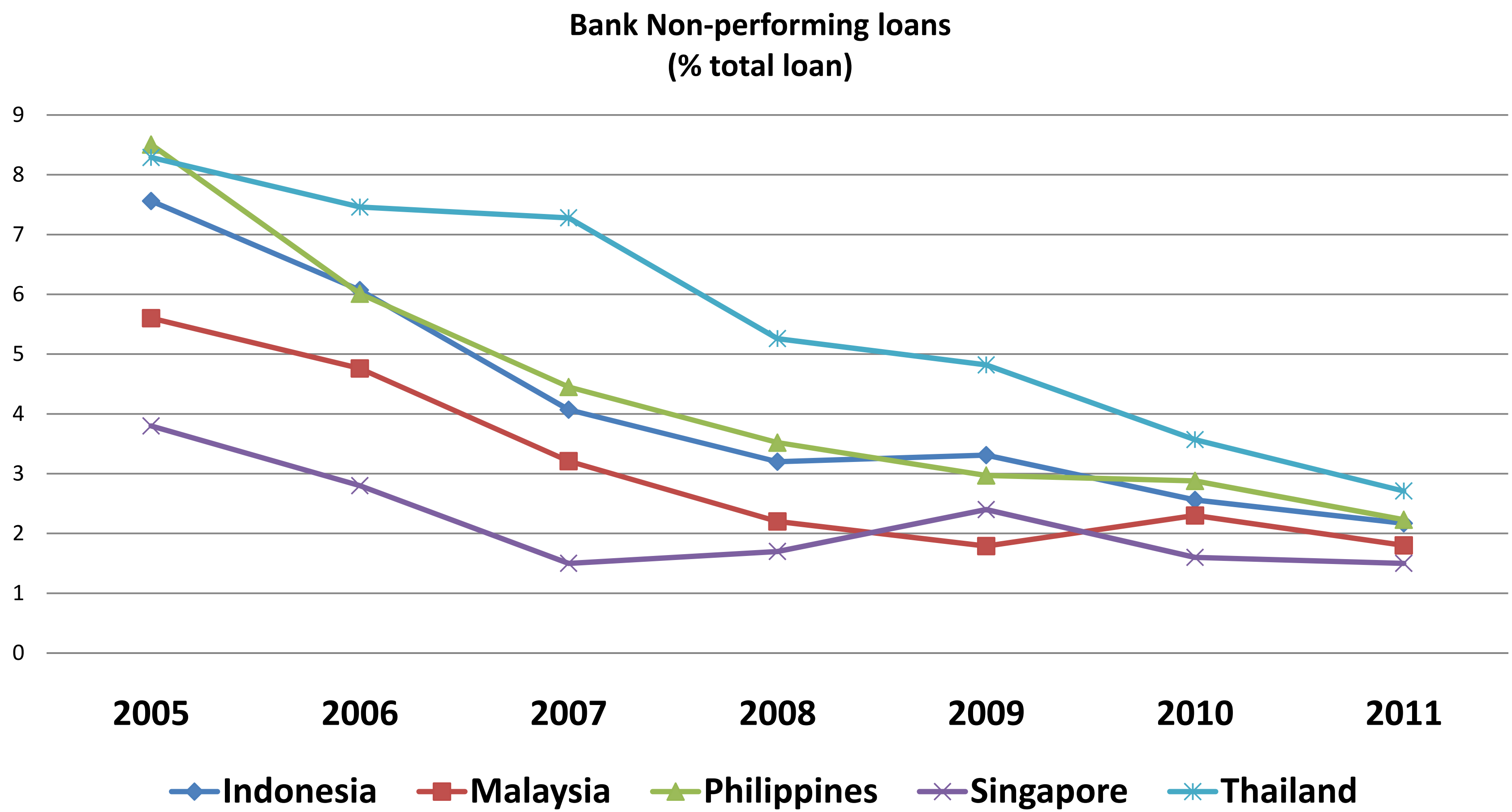


A blessing in disguise

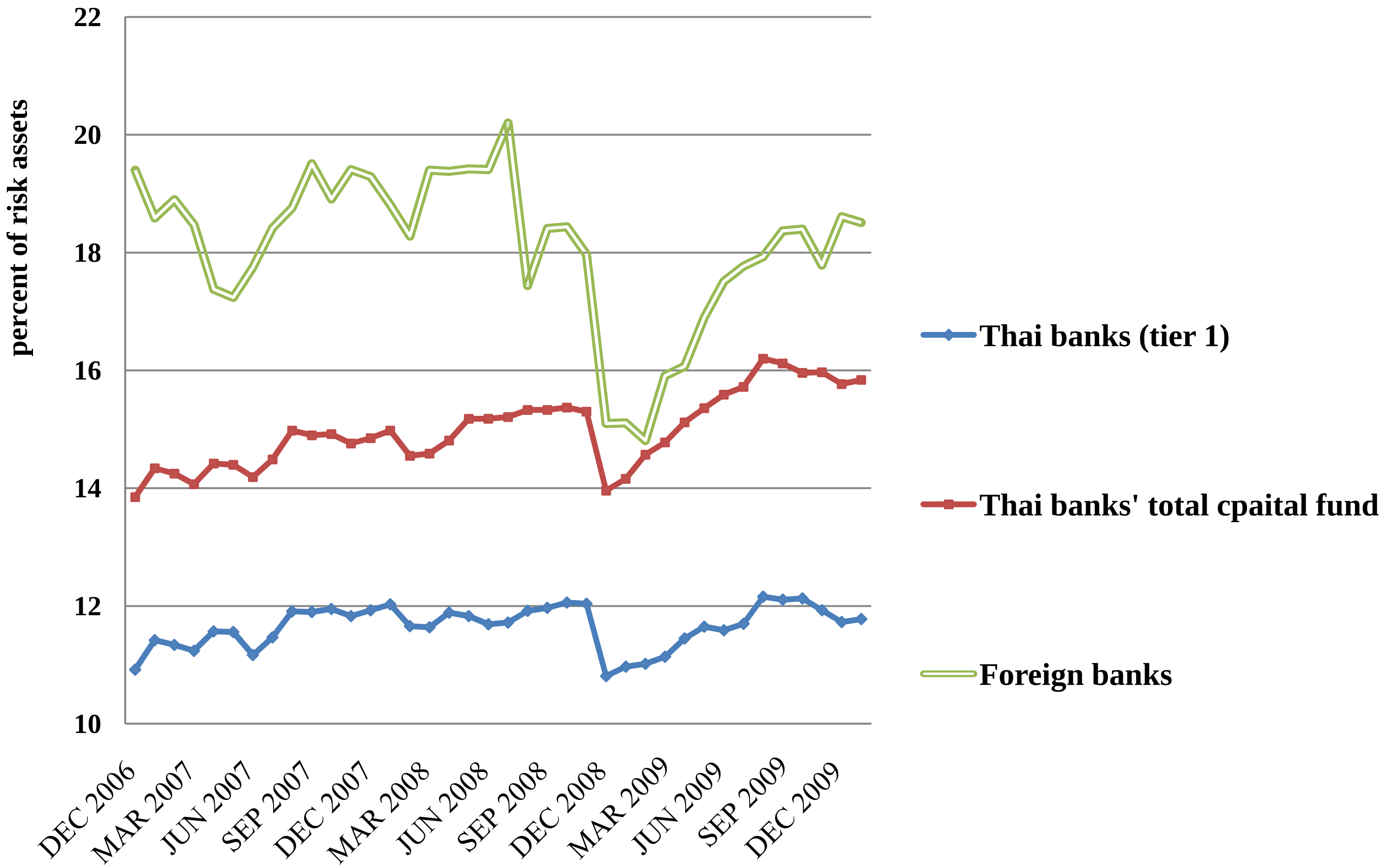
- The Thai financial sector has emerged from the 1998 crisis and become stronger and more resilient, thanks to foreign capital injection, good governance, strengthened financial rules, and economic recovery.


Banks' asset quality and capital adequacy
per cent
50
45
40
35
30
25
20
15
10
5
0
16
15
14
13
12
11
10
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
Nonperforming Loans (% of commercial bank loans)
Risk-Weighted Capital Adequacy Ratios (% of risk-weighted assets: Right Hand Scale)

Getting healthier



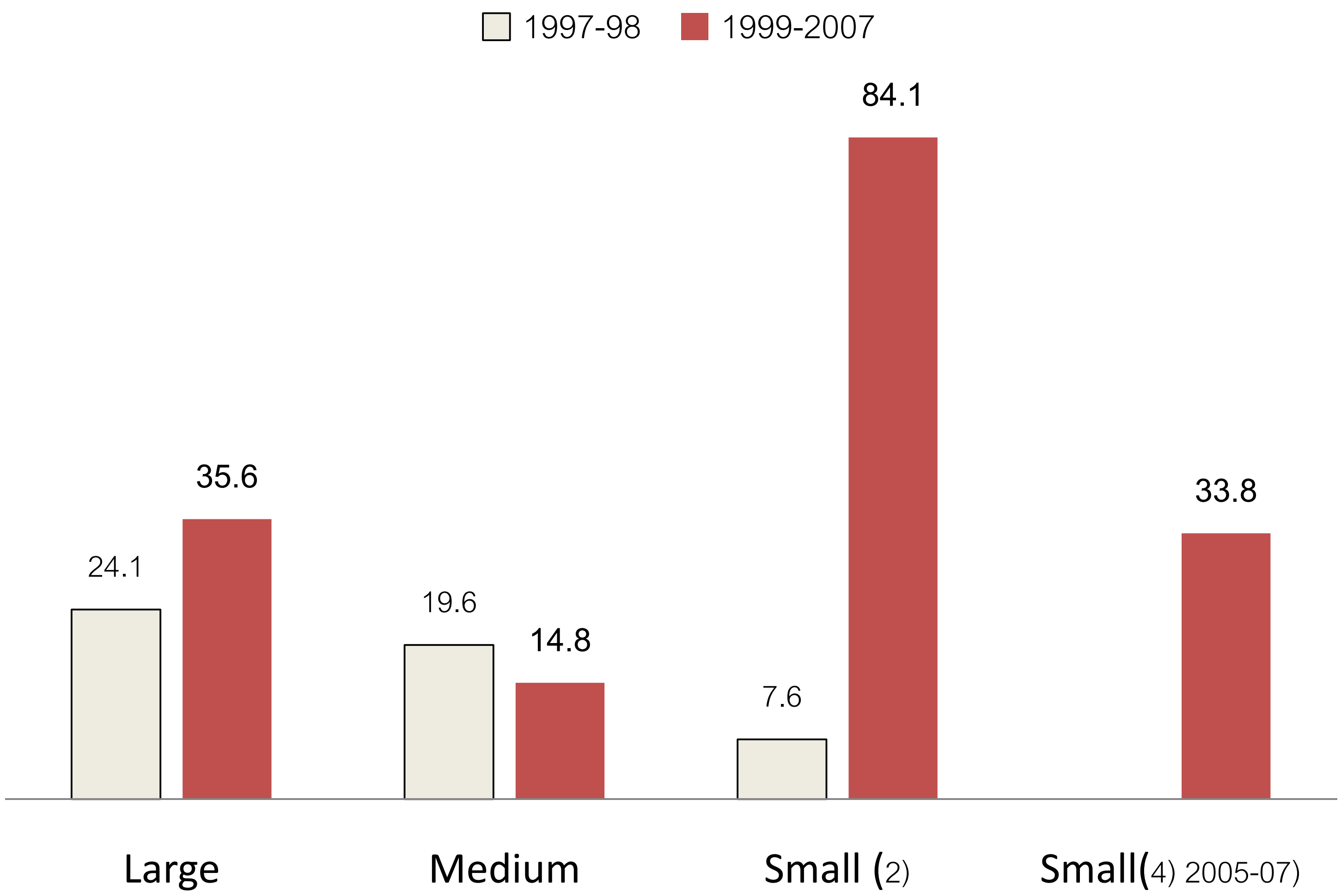
Capital Adequacy during the global financial crisis



Foreign ownership in Thai banks

	1997	2000	2004	2007
Large	**22.1**	**33.4**	**36.3**	**38.5**
Medium	**25.8**	**9.5**	**12.2**	**37.6**
Small	**6.4**	**76.7**	**52.8**	**55.6**

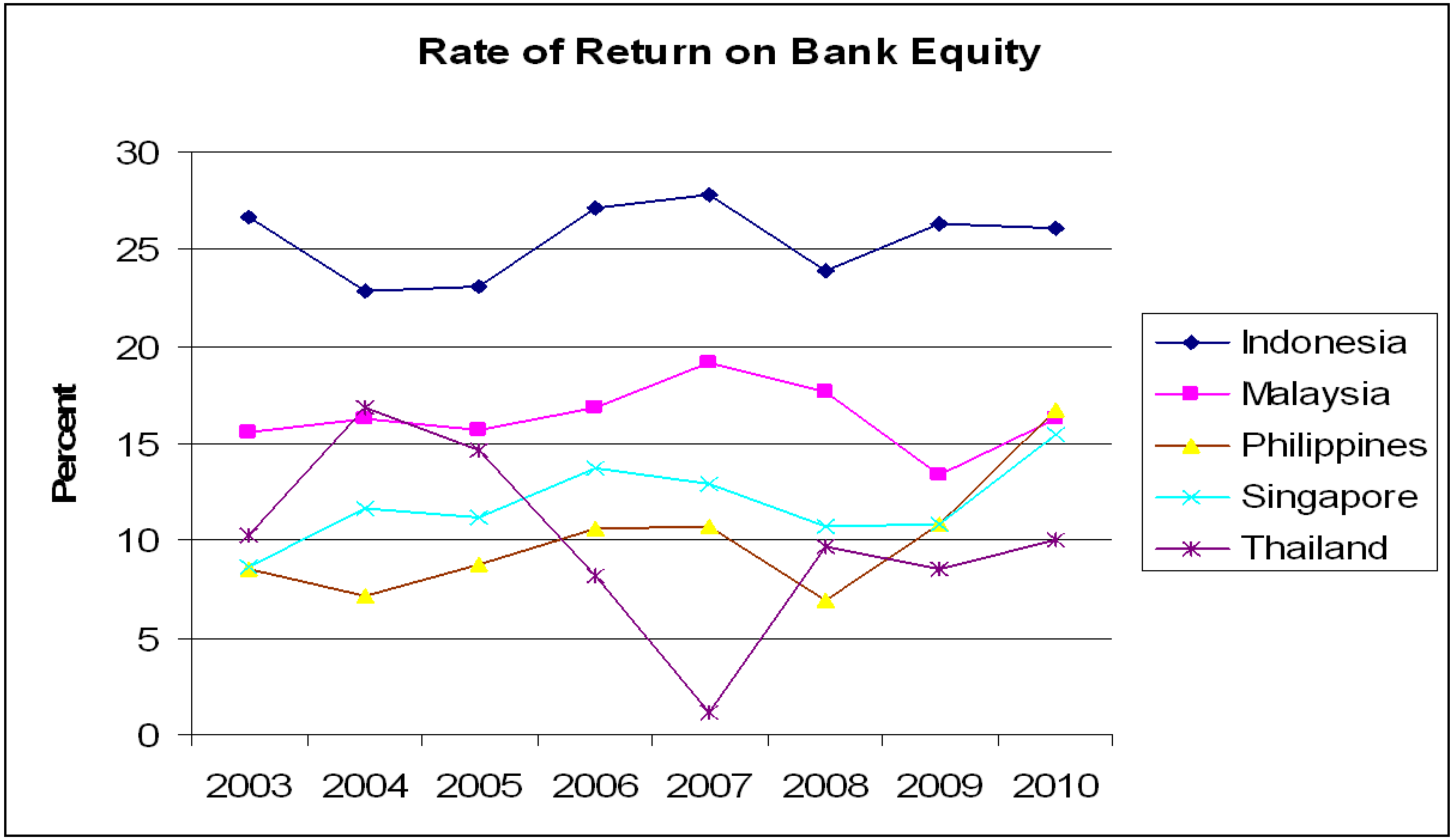
Foreign ownerships in Thai banks



Foreign penetration

- By opening up the financial sector to foreign participation, the financial sector has become more efficient, taking the benefit from competition effect and technology adaptation.
- The large interest margin between lending and deposit rates bodes well for the monopoly rent of commercial banks.
- The transfer of wealth from consumers to banks can be reduced via allowing foreign entry in line with liberalization of the service sectors.

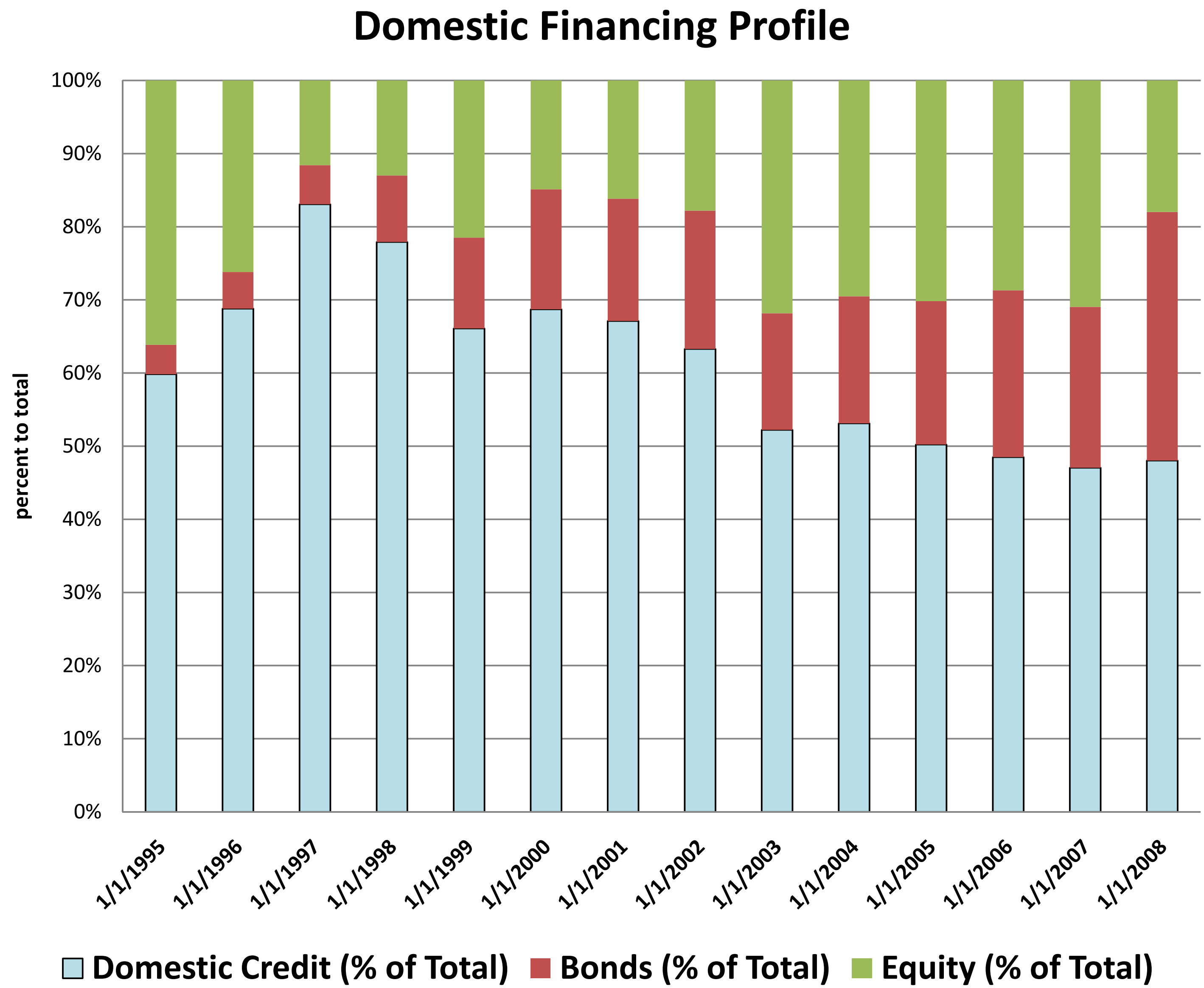
ROE


Rate of Return on Bank Equity
Percent
30
25
20
15
10
5
0
2003
2004
2005
2006
2007
2008
2009
2010
Indonesia
Malaysia
Philippines
Singapore
Thailand

Southeast Asian Banks

- Southeast Asian countries were well prepared as they underwent financial reform after the 1997 crisis.
- Prudential rules and regulations have been established before the eruption of the GFC.

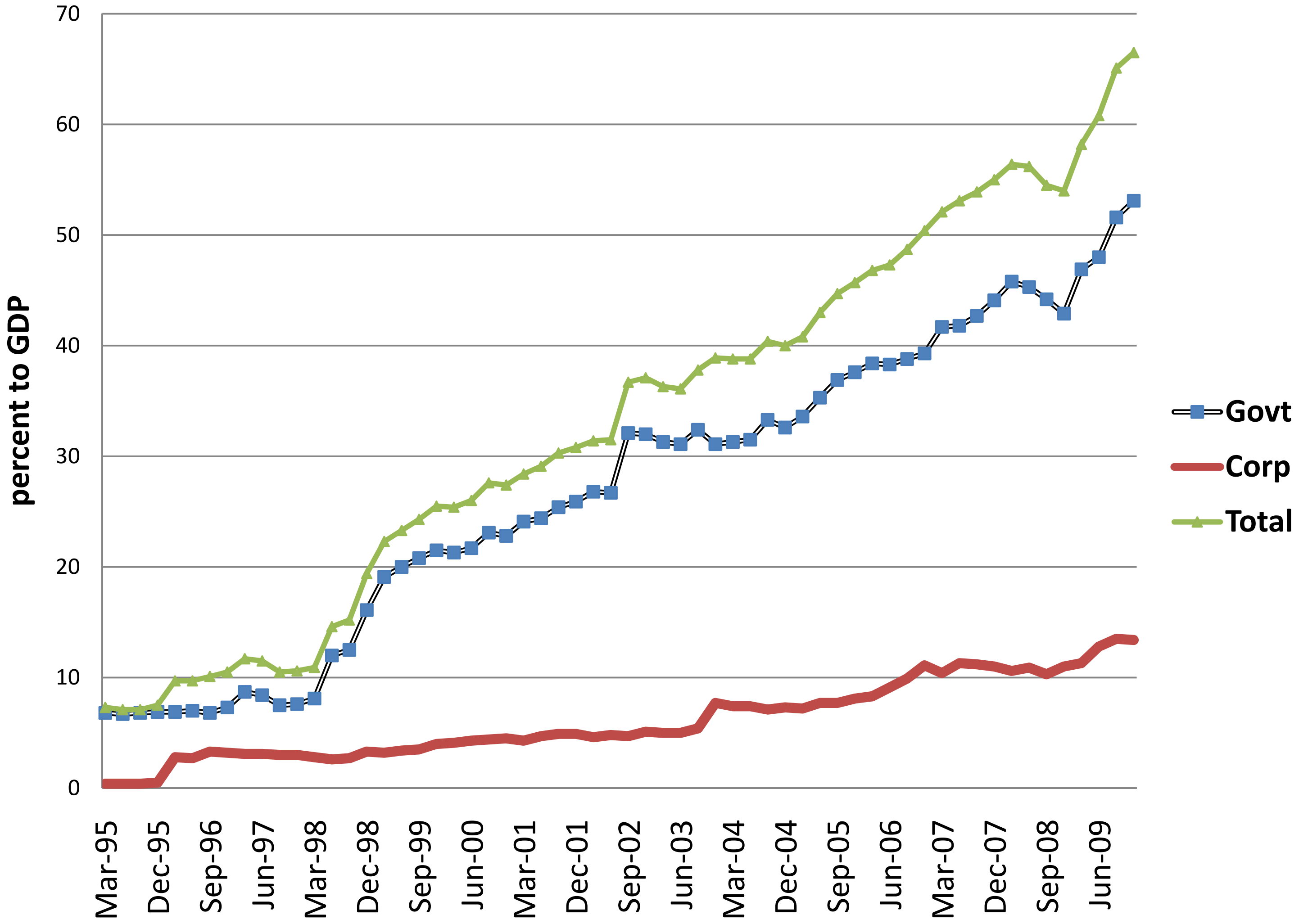
- With low exposure to export sector, Southeast Asian commercial banks invested little in collateral debt obligations backed by the US subprime loans.
- Southeast Asian banks remain healthy and did not suffer from the GFC.
- Is Thailand still a bank-based economy?


Domestic Financing Profile
100%
90%
80%
70%
60%
50%
40%
30%
20%
10%
0%
percent to total
1/1/1995
1/1/1996
1/1/1997
1/1/1998
1/1/1999
1/1/2000
1/1/2001
1/1/2002
1/1/2003
1/1/2004
1/1/2005
1/1/2006
1/1/2007
1/1/2008
Domestic Credit (% of Total)
Bonds (% of Total)
Equity (% of Total)

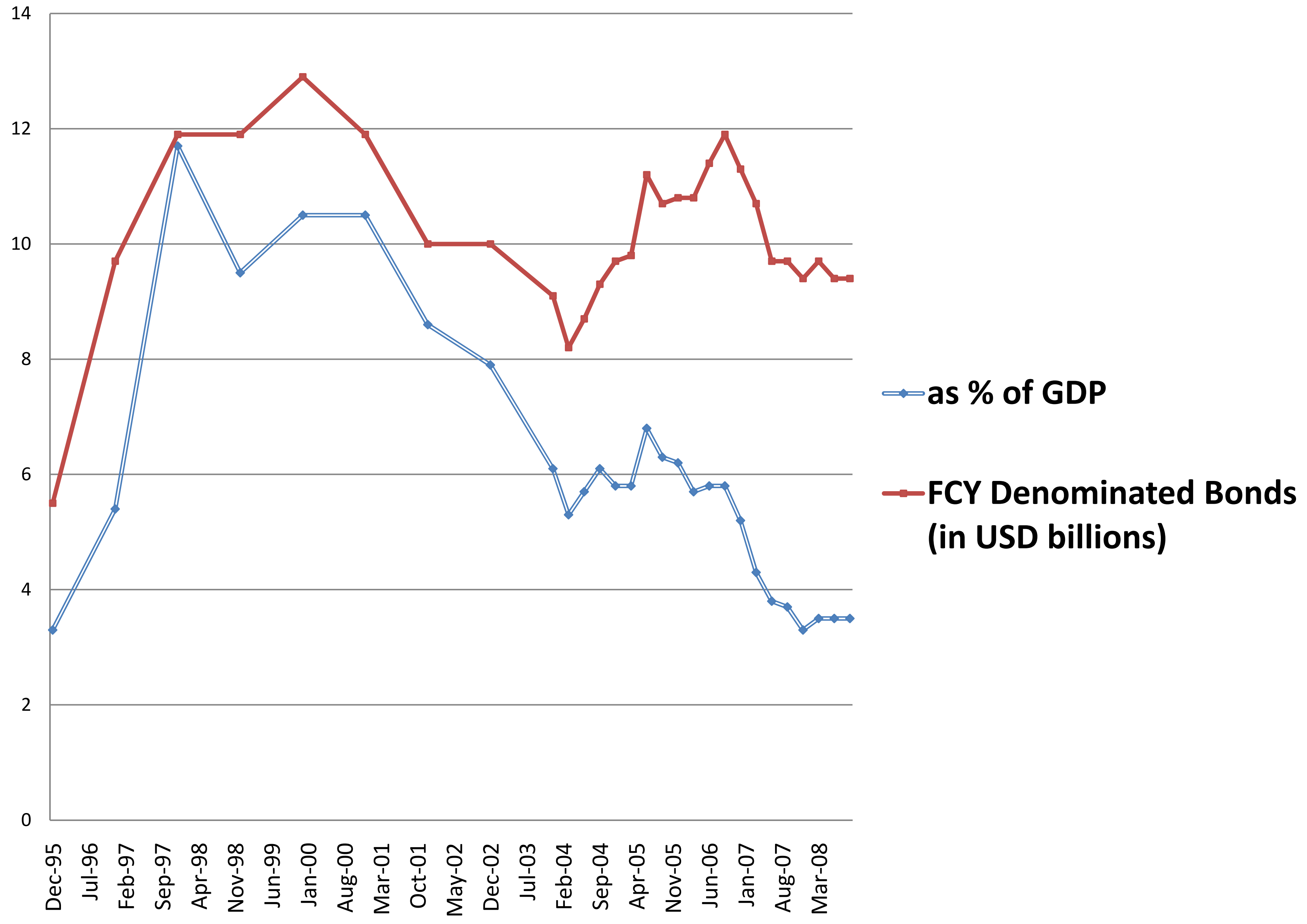
Bond markets

- According to the Securities and Exchange Commission, in the past eight months inflows to the bond market had reached US$3 billion (Bt92 billion).
- The central bank earlier said that during August 3-9, $468 million were pumped into the market. In the first half of this year, Thailand's bond market experienced a net outflow of $44 million, compared to $407 million at the stock market.
- Foreign investors tend to gain from the differential in bond yields, plus foreign exchange gains. If the investment is shifted to the stock market during a bull run, it could benefit more from capital gains.

Emerging local bonds market



Foreign currency (FCY) denominated bonds



Foreign banks' participation or invasion?

- With foreign capital injection, the monetary authorities can maintain system solvency while lessening the burden on financial bailouts.
- Financial restructuring cannot be achieved without allowing foreign participation or acquiring shares of less efficient public-owned financial institutions.

When are banks too big to fail?

- In the future, there would always be some banks that fail because of the vulnerable nature of financial firms; the monetary authorities must distance themselves from the too-big-to-fail syndrome.
- It takes time for depositors to learn to protect themselves and realize that deposit insurance program does not prevent them from any losses caused by future failure of financial institutions.
- What has happened to banks in Cyprus?
- Is there any similarity to Thai banks in 1997?

GFC and Thai banks

- The Thai financial sector was vulnerable and weak in the late 1990s. The lack of prudential regulations and sufficient capital funds made capital control relaxation in the early 1990s premature liberalization.
- The ensuing fast and large capital inflows led to subsequent financial turmoil.

GFC and Thai banks

- The Thai financial sector since then has emerged from the 1998 crisis and become stronger and resilient, thanks to foreign capital injection, good governance, and strengthened financial rules.
- The rapid economic recovery, despite the political turmoil in 2010, provided opportunities for banks to expand their credit and enjoy the benefits from rising interest rates.
- In addition, strong performance of the corporate sector enabled banks to reduce nonperforming loans further.

A measurement of efficiency

- The large interest margin between lending and deposit rates bodes well for the monopoly rent of commercial banks.
- The transfer of wealth from consumers to banks can be reduced by allowing foreign entry in line with liberalization of the services sector.

What foreign banks are coming to town?

- Financial institutions and their regulators cannot resist the global trend of foreign penetration.
- By opening up the financial sector to foreign participation, the financial sector has become more efficient, benefiting from competition and technology adaptation.
- With foreign capital injection, monetary authorities can maintain system solvency while lessening the burden of financial bailouts.

How vulnerable?

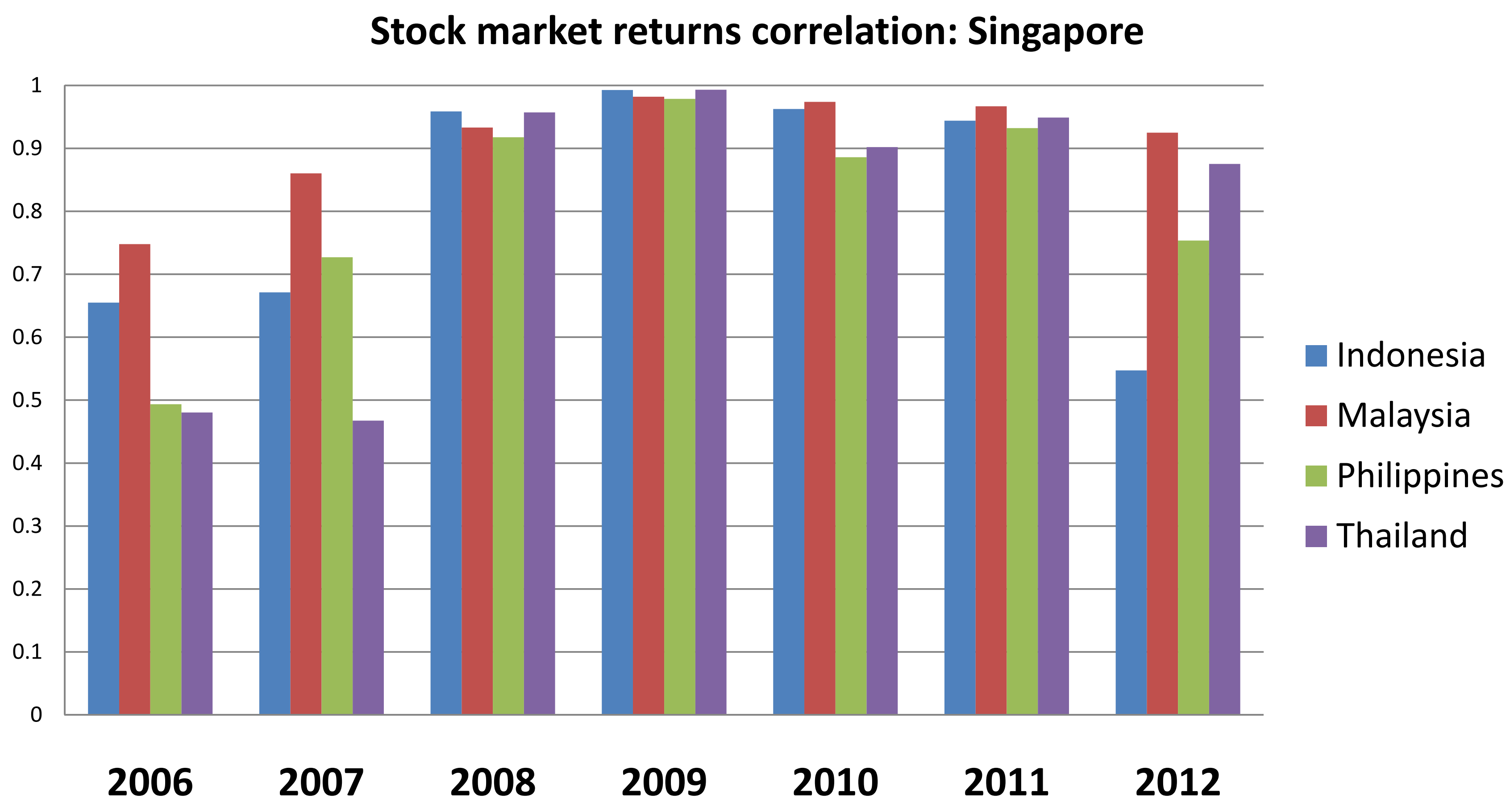
- Since the 1997 financial crisis, the Thai economy has been closely integrated to the world economy through international trade and capital flows.
- As such, it cannot completely shield itself from external shocks. The global financial crisis during 2007–2009 led to export collapse and output contraction in 2009.
- The debacle of the world's financial institutions and stock market crashes in 2008 had a negative impact on the Thai stock market.

How resilient?

- However, the adverse consequence on the Thai banking sector was minimal. Thai banks were able to make profits during difficult times.
- Most of them did not invest in CDOs nor focus mainly on property lending. The level of NPLs continued to decline, while banks enhanced capital strength and provided sufficient loan-loss provisions.
- The exploitation of economies of scale and scope improved efficiency in their operation.
- All of these factors are the result of financial reforms undertaken after experiencing the financial crisis in 1997.

- Thai banks have been well prepared for the global financial crisis as they have learned a valuable lesson on being conservative and observing stringent prudential rules and regulations.
- It remains to be seen how vulnerable and resilient the Thai banking system is in the face of the Eurozone problems and fears of a US double-dip recession.

Singapore as a benchmark



The shape of things to come

- Financial and real sectors in Southeast Asia have become increasingly integrated.
- The danger of capital market integration is that shocks can be transmitted easily in time of boom and bust.