

EE460: Thailand's financial sector

Bhanupong

Lecture 23

ADB Review: The resilience of Thai banks

Mark Twain

- It ain't what you don't know that gets you into trouble.
- It's what you know for sure that just ain't so.

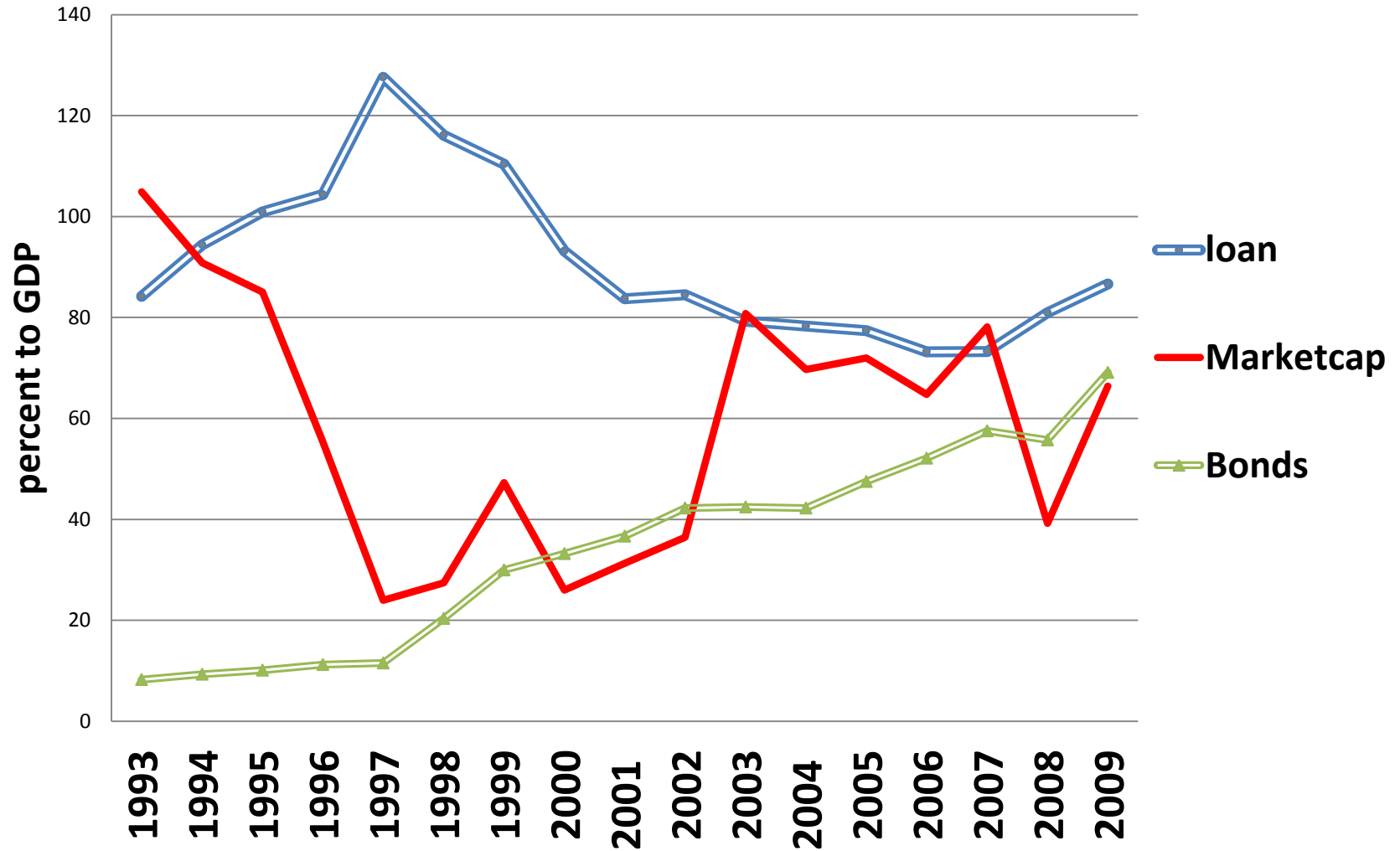
Outline

- Structural changes: domestic credit, market capitalization
- Good and bad bankers
- Profitability, efficiency, and solvency
- Foreign penetration
- GFC and the Thai financial sector

Article 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.

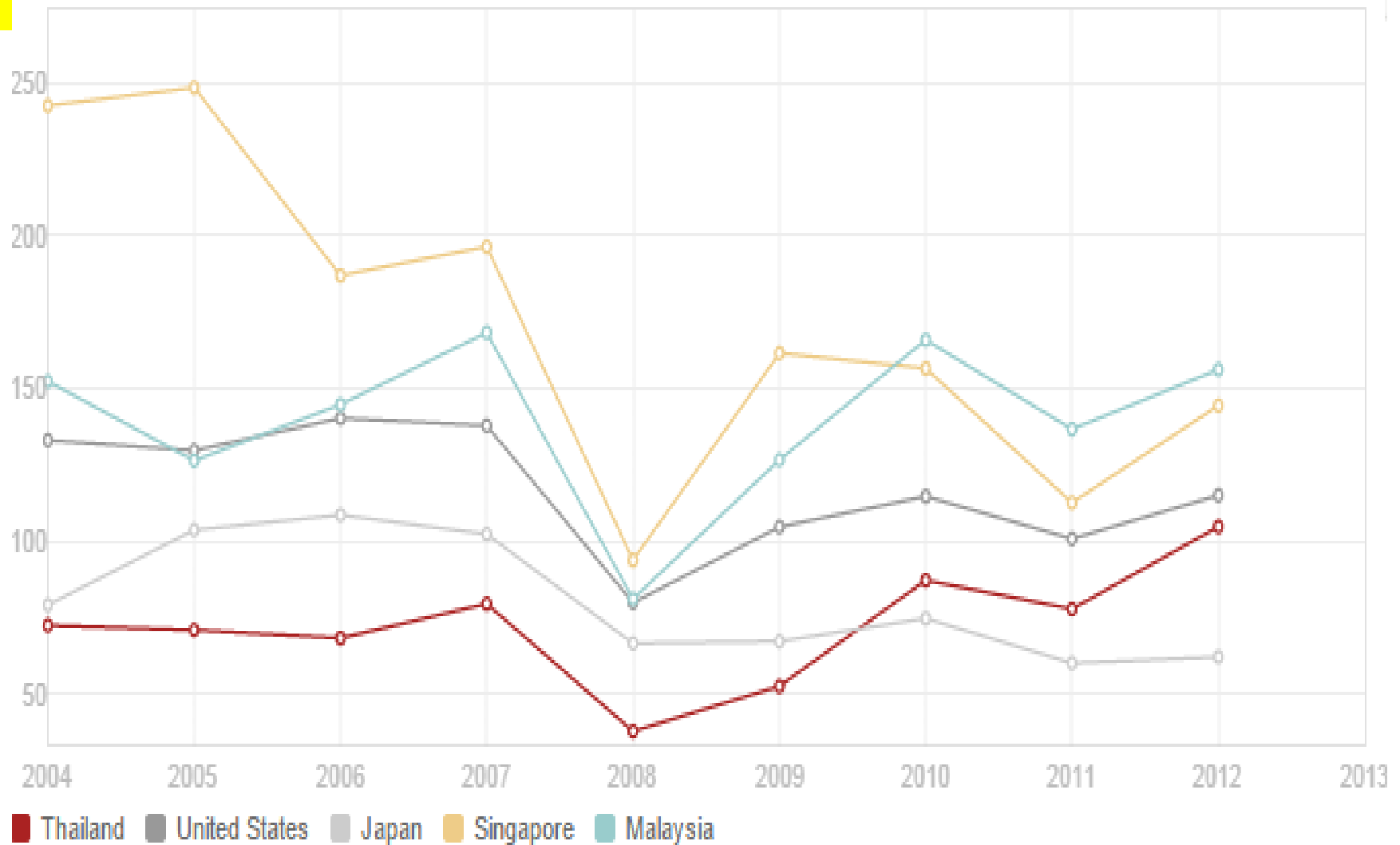
Structural Changes in the financial sector: Up to the GFC



Market Capitalization

- Market capitalization (also known as market value) is the share price times the number of shares outstanding.
- Listed domestic companies are the domestically incorporated companies listed on the country's stock exchanges at the end of the year.
- Listed companies does not include investment companies, mutual funds, or other collective investment

Market capitalization of listed companies (% of GDP)



Pre-1997 financial crisis

- 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 earnings.
- 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 recording 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.

Where are those bad bankers now?

Former BBC (Bangkok Bank of Commerce) boss was jailed for 155 years for fraudulent behaviors.

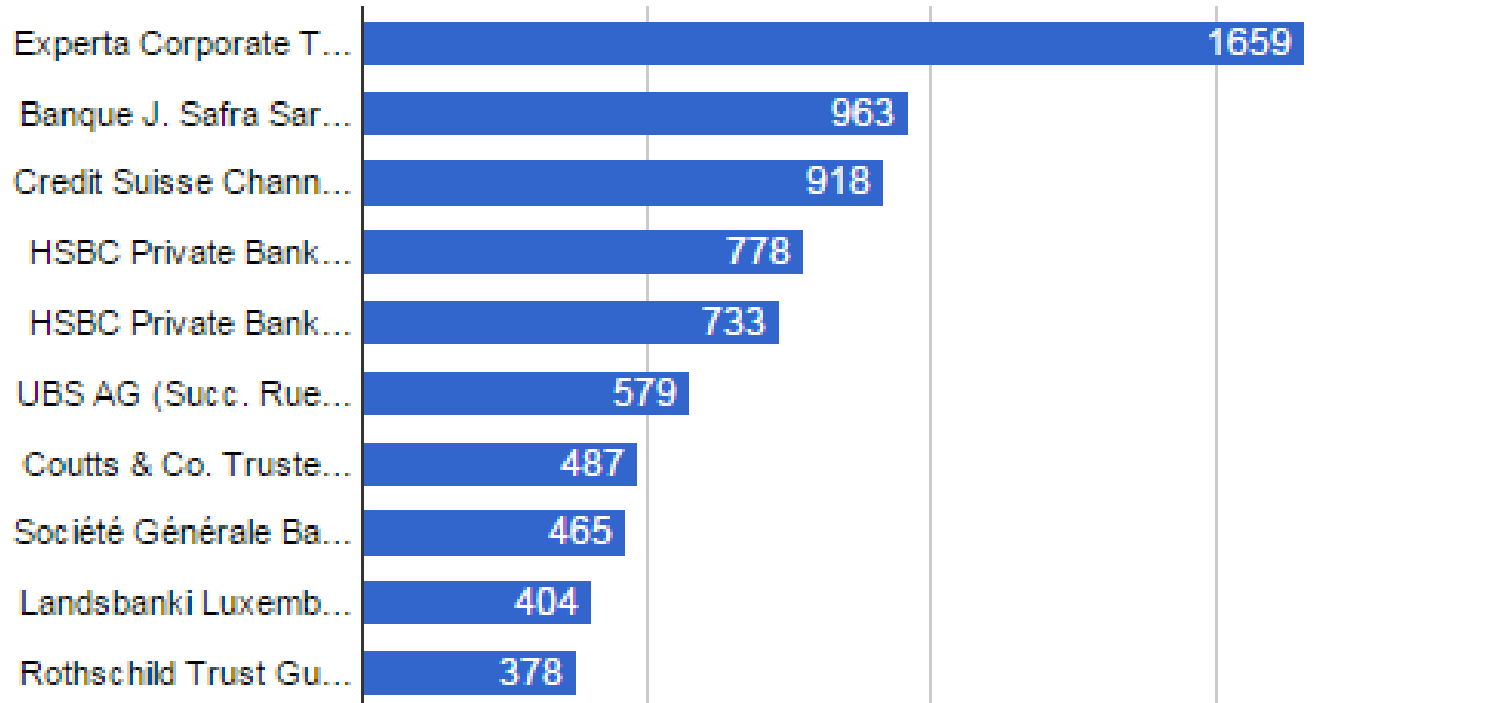
Former KTB executives and his staffs were put in jail for the crime committed more than ten years ago.

Some of them left Thailand and enjoy life in London and Hong Kong, until the cases against them expire.

Mossack Fonseca

- Mossack Fonseca is a law firm that set up some 214,000 shell companies (otherwise known as "offshore companies" or "letterbox companies") on behalf of wealthy clients from every corner of the world.
- According to journalists investigating the leak, these companies facilitated the movement of funds related to drug dealing, human trafficking, financing terrorism, tax dodging, embezzlement, sanctions evasion and other crimes.

Mossack Fonseca's top 10 bank clients: offshore company requests



Source: ICIJ

Who's Been Implicated?

- Sigmundur Gunnlaugsson, Prime Minister of Iceland, was the Panama Papers' first casualty, resigning in response to massive protests two days after the leak.
- Gunnlaugsson and his wife owned a British Virgin Islands-based (BVI) shell company call Wintris Inc., which held close to \$4 million in bonds.
- Gunnlaugsson had previously stated in public that he did not own an offshore company.
- Mauricio Macri, President of Argentina;
- Petro Poroshenko, President of Ukraine;
- Salman bin Abdulazziz , King of Saudi Arabia.

Other world leaders directly implicated

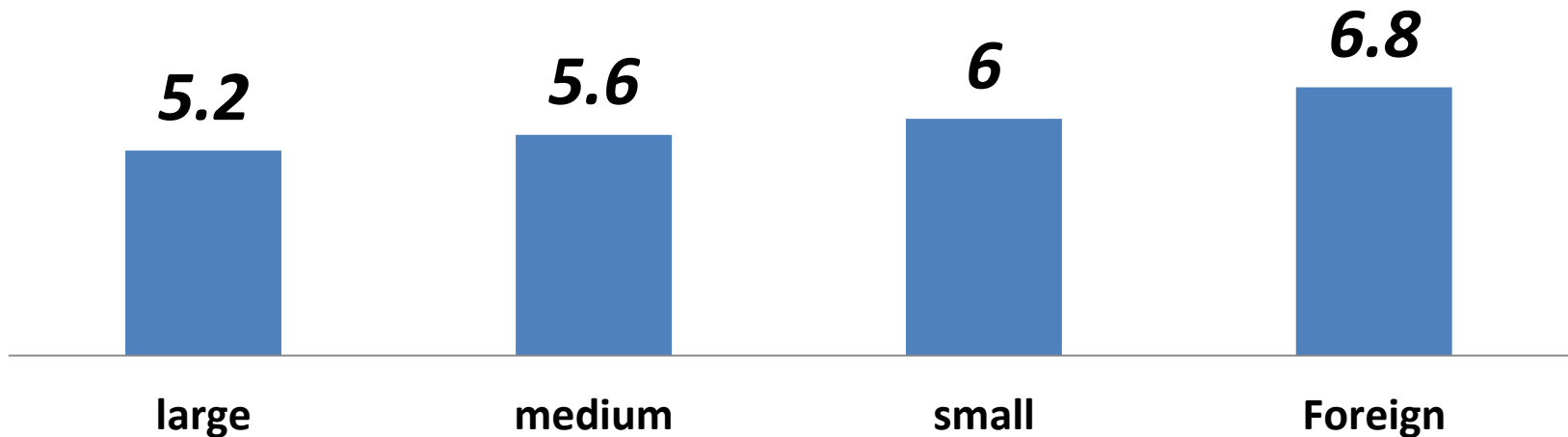
- A number of leaders are indirectly linked to Mossfon, through **friends, relatives or associates**. These include Xi Jinping, President of China, whose brother-in-law has at different times controlled three different BVI-based companies;
- Najib Razak, Prime Minister of Malaysia, whose son was a director of a BVI-based company;
- David Cameron, Prime Minister of Britain, whose father helped found an investment fund holding nearly \$20 million, much of it in bearer shares; and
- Vladimir Putin, President of Russia, whose close friends own a plethora of offshore companies connecting them to other Kremlin insiders.

The gap between lending and deposit rates

Interest spreads

Minimum lending and fixed
(3 months) deposit rates

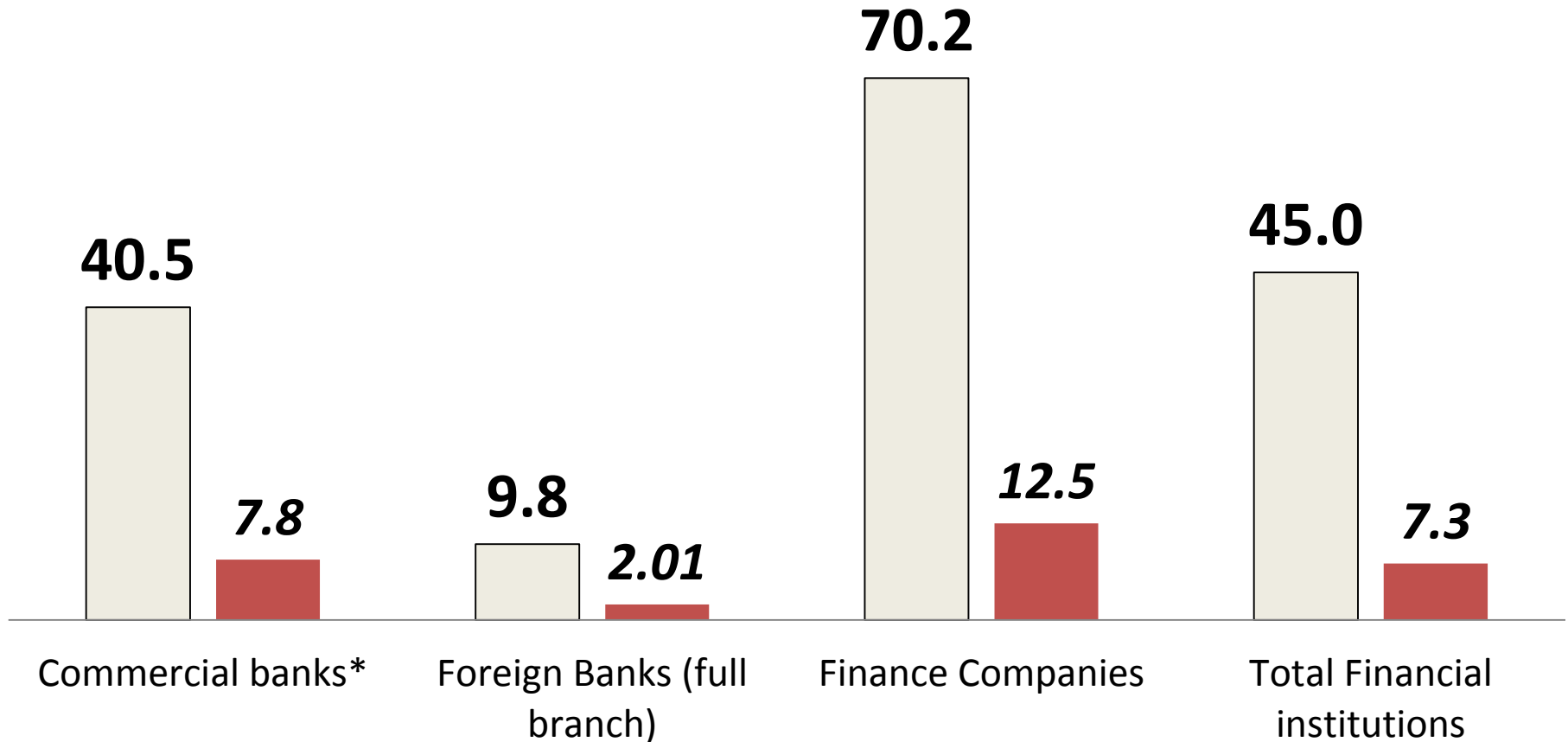
March 2010



The spread also measures bank efficiency

NPLs by types of financial institutions (% total lending)

1998 2007



If NPLs were written off in 1998, equity value of banks would be negative, and banks would be technically bankrupt.

A blessing in disguise

- Despite negative equity in 1998, some banks remained afloat because of liquidity injection by the central bank, capital injection by FIDF (Financial Institutions Development Fund of the BoT) and foreign banks' acquisitions of Thai shares.
- 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 in Southeast Asia

- 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.

Direct finance vs. Indirect finance (through financial intermediaries)

- With low exposure to export sector, Southeast Asian commercial banks invested little in collateral debt obligations backed by the US subprime loans.
- You should watch the movies “The Big Short” and “the margin call” to understand how greed interplay with financial engineering.
- Southeast Asian banks remain healthy and did not suffer from the GFC.
- Is Thailand still a bank-based economy?

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.
- Deposit insurance may encourage moral hazard.

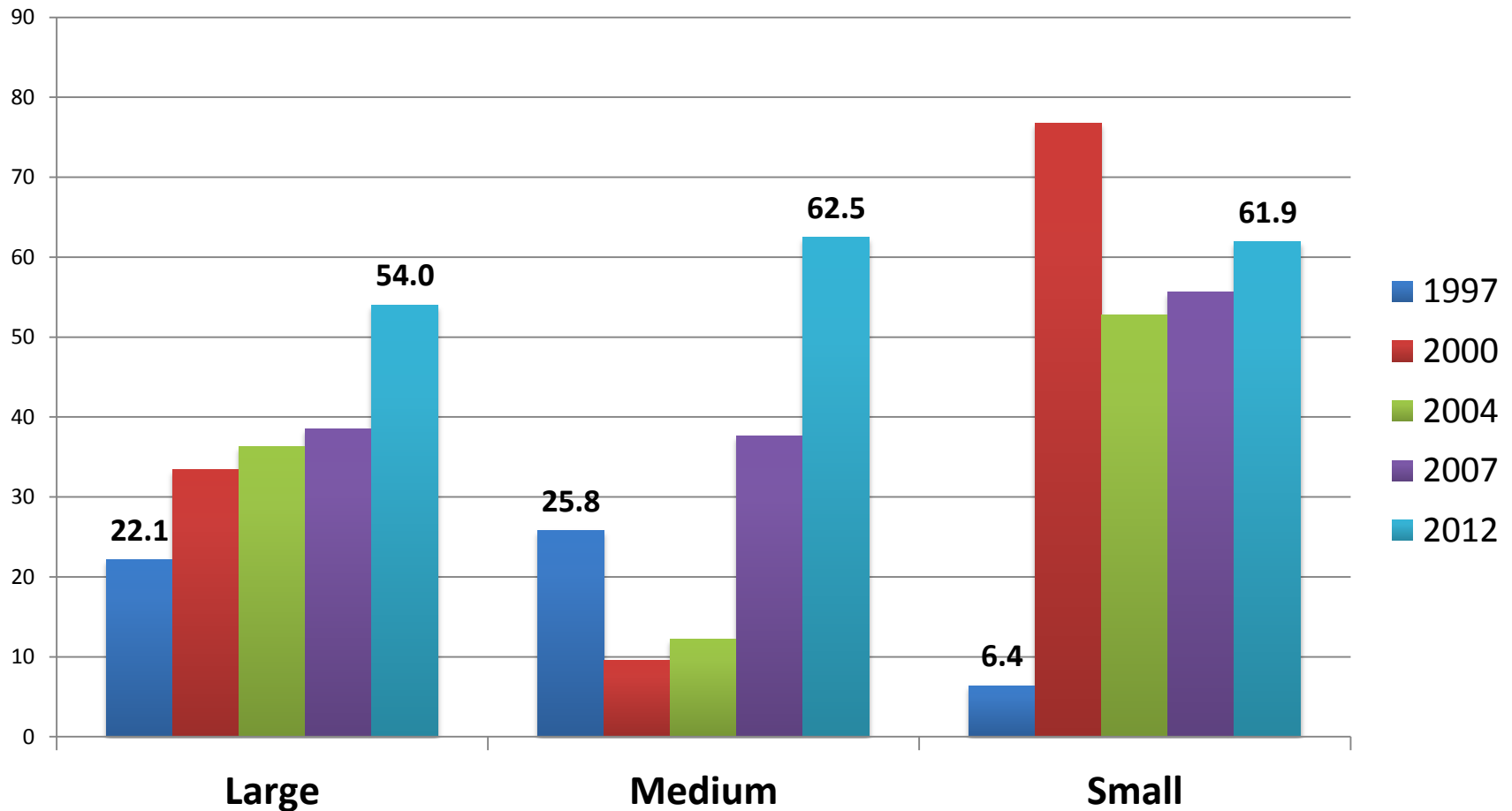
Foreign participation

- 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.

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.

Foreign ownership in Thai banks



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.

Benefits and costs of foreign participation

- 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 was the Thai financial sector?

- 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?

- 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.

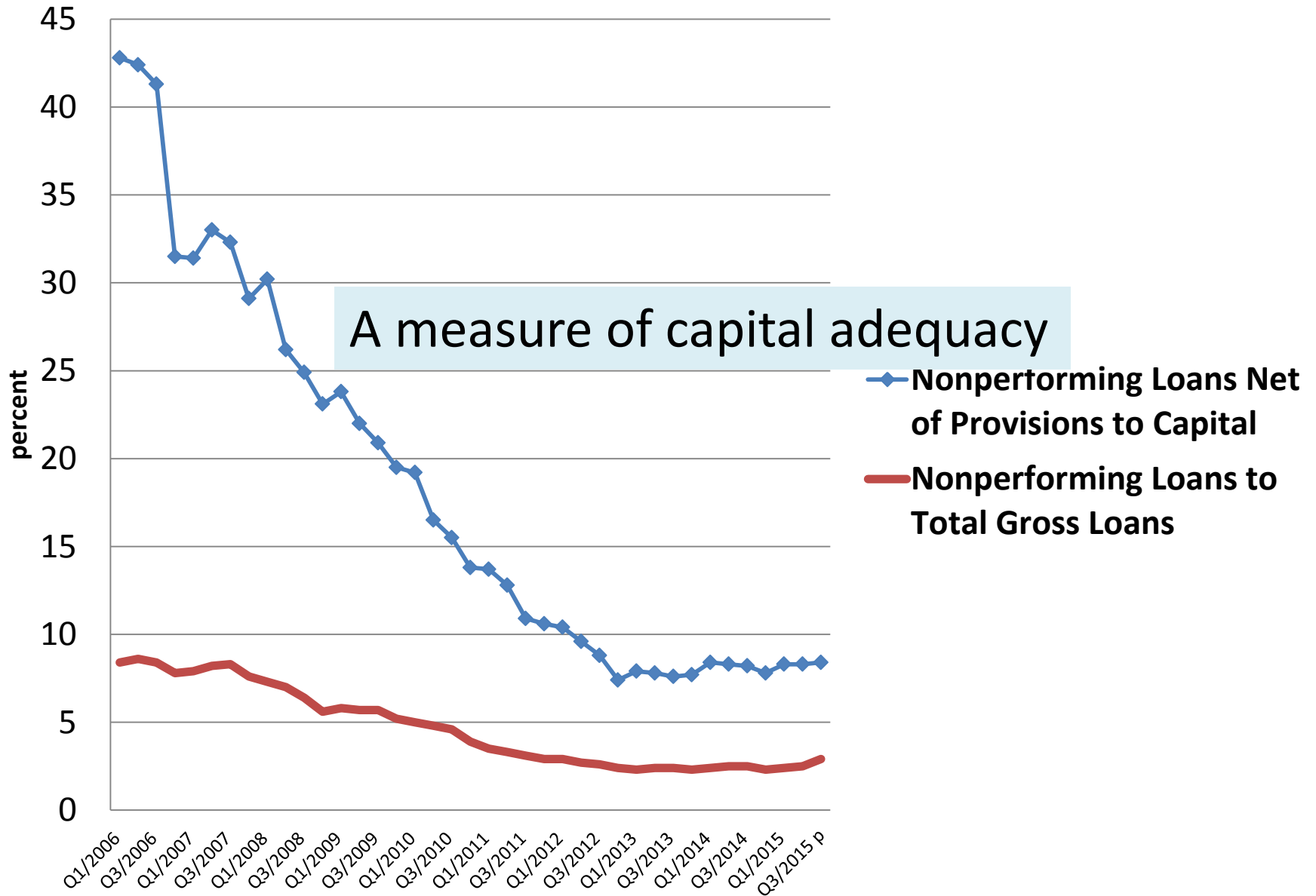
Reform leads to efficiency

- 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.

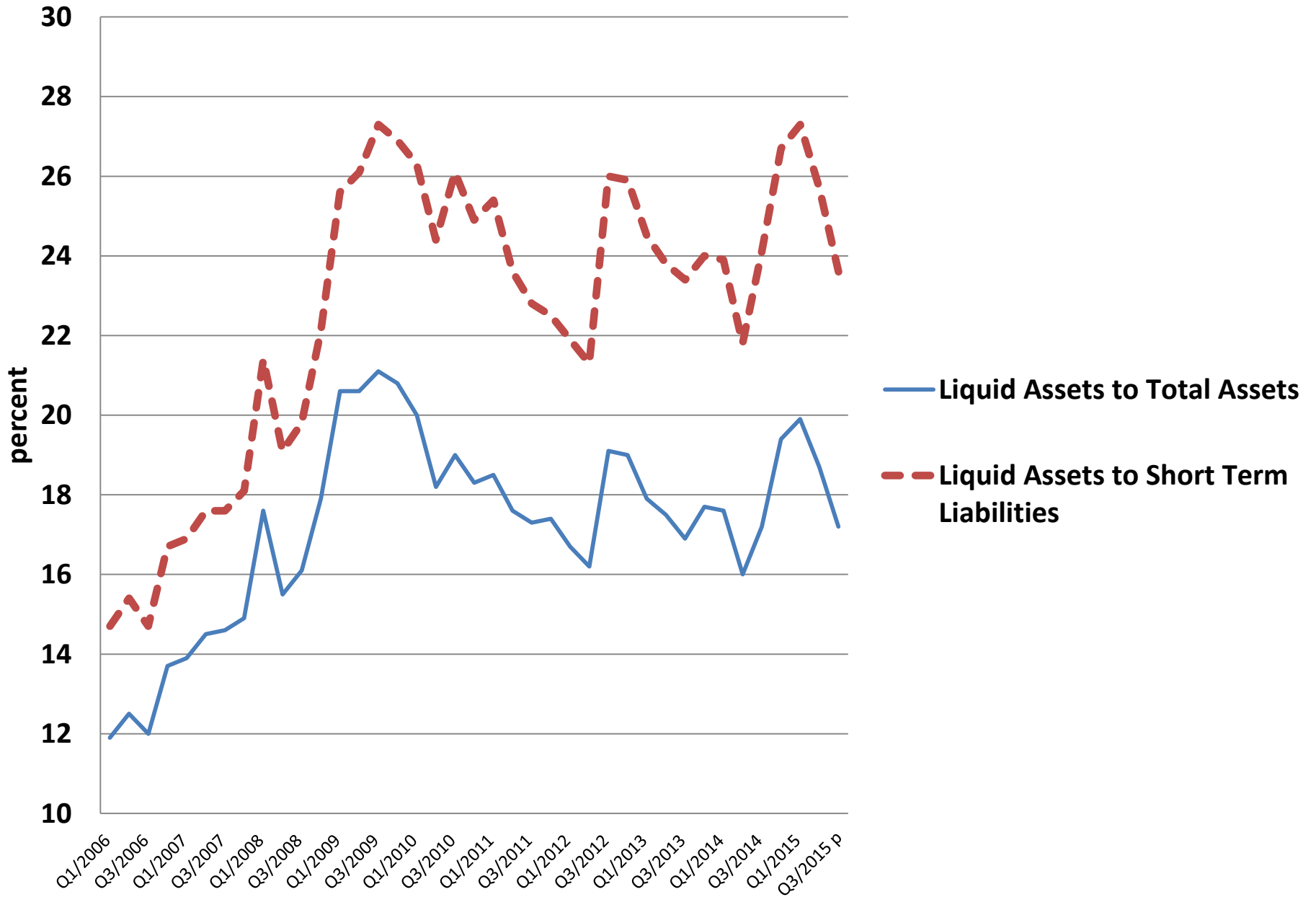
How to measure financial soundness

- Capital adequacy
- Liquidity
- Profitability
- What are factors determining bank profitability?
- Why banks need liquidity?
- What does excess liquidity means for bank operations?
- How large should banks hold capital (equity)?

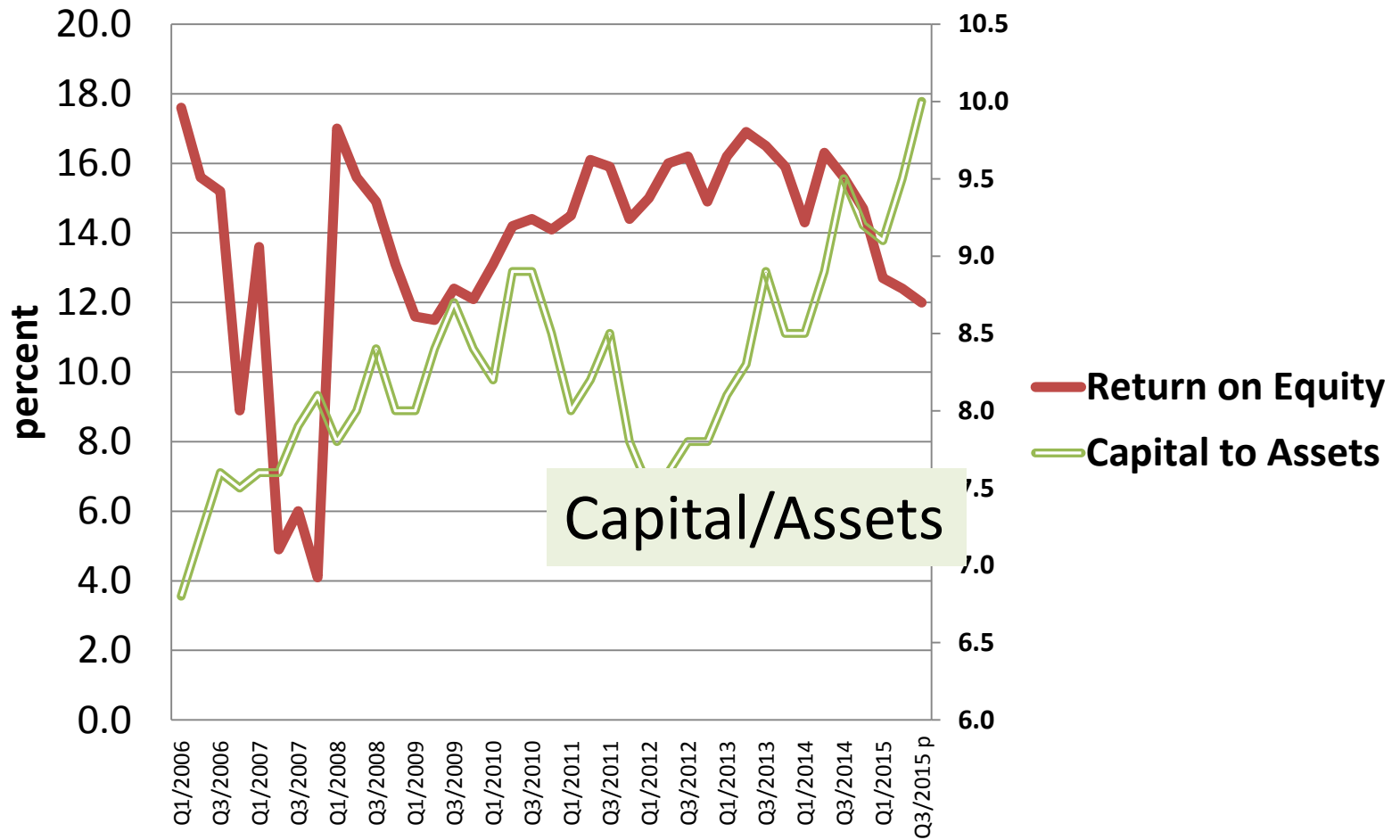
Nonperforming Loans



Liquidity



Return on Equity and Capital (Equity) as % of total Asset (right scale)

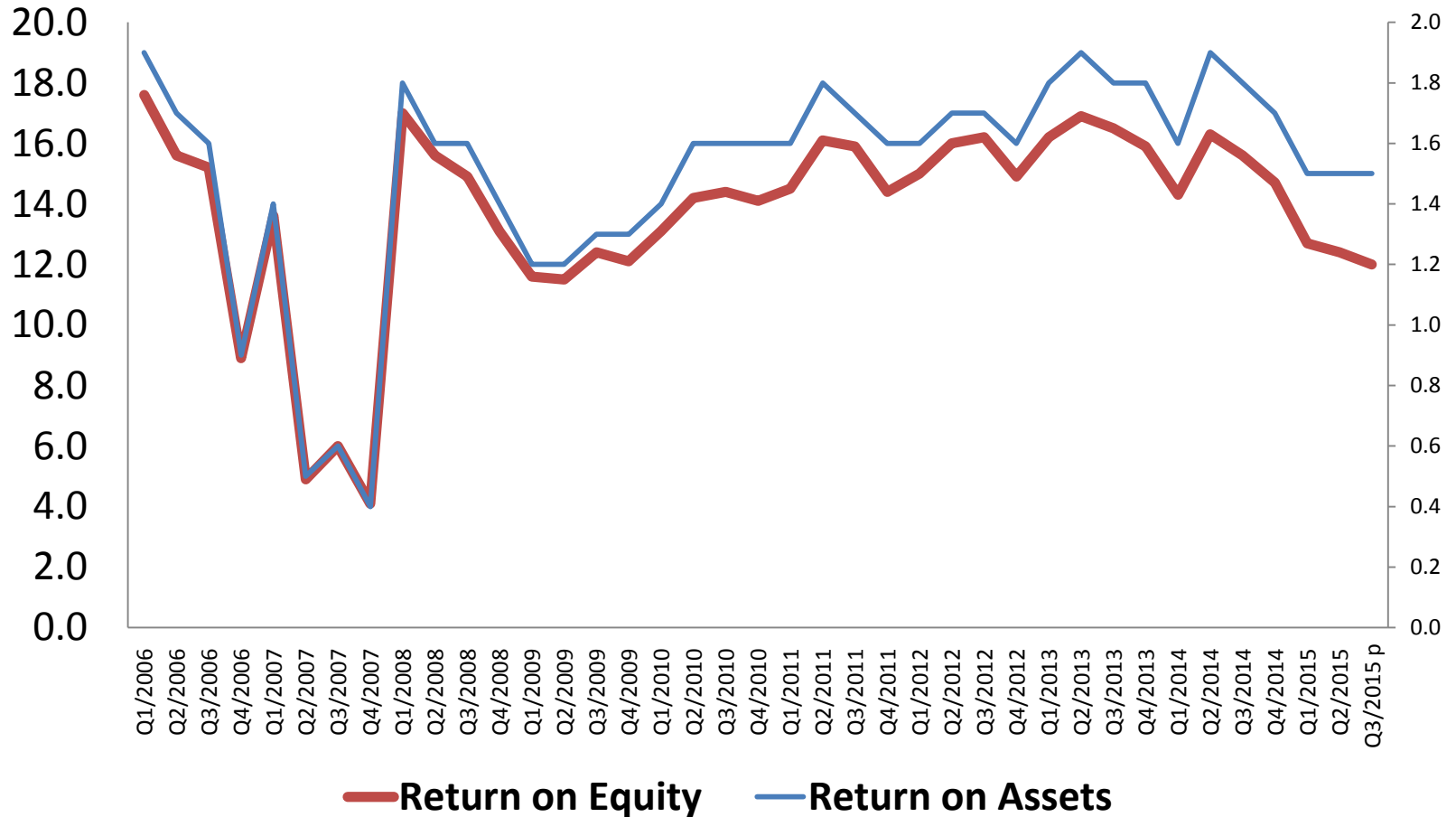


$$ROE = \frac{\textit{profit}}{\textit{Equity}} = \frac{\textit{profit / Assets}}{\textit{Equity / Assets}}$$

$$ROE = \frac{\text{Return to Assets}}{\textit{Capital / Assets}}$$

$$ROE = \frac{ROA}{\textit{Capital / Assets}}$$

A positive relation between ROA (left scale) and ROE (right scale)



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.
- How would Thai banks cope with the slowdown of economic activity and the risk of property bubble burst?
- It is not the questions of if there will be a Minsky meltdown, rather it is the question of when.

News Analysis

Krung Thai Bank

Big provisions to squeeze 1Q16 profit

- KTB management provided guidance on its rather conservative lending growth target of 3%, amid its grave concerns over NPLs.
- Given the fragile economy, the bank intimated that it was exercising a more prudent policy in FY16, **loan-loss provisioning (LLP)** at Bt21bn in FY16, reflecting KTB's objective to bring its loan loss-coverage ratio to 130 percent from 113% in 4Q15.

LLP, NIM, and Profitability

- Loan-loss provision is an expense which lowers bank profit
- Bank profit depends on NIM (Net Interest Margin) loan growth rate, and non-interest income (fees, foreign exchange transactions, other incomes)
- $NIM = (\text{interest receivables}/\text{loan}) - (\text{interest payables}/\text{deposit and loan})$
- Economies of scale and economies of scope can save per unit cost per output of banks.

Poor earnings to emerge in first quarter on greater LLP

- KTB anticipates 1Q16 loans to be flat YTD, with expected **NIM** of 2.9-3.0%.
- Given the sustainable NIM and good fee income growth of 10%, its 1Q16 **cost/income ratio** may dip to 48.6percent from the 53.2% it recorded in the same period last year.
- Management reiterated a very prudent FY16 loan growth rate of 3%, driven by medium SME and corporate sectors (both lending yields are higher than the government and SOE sectors).
- The bank's 1Q16 loan view is flat on slow economic conditions and the bank sets its NIM target close to 3%, as it did for FY15.
- ***Discuss how macroeconomic conditions affect bank performance in 2016***