Thailand’s financial sector

Bhanupong

Lecture 23

Outline

- Domestic credit and market capitalization
- Stock bubbles
- Good and bad bankers
- Profitability, efficiency, and solvency
- Foreign penetration
- GFC and the Thai financial sector

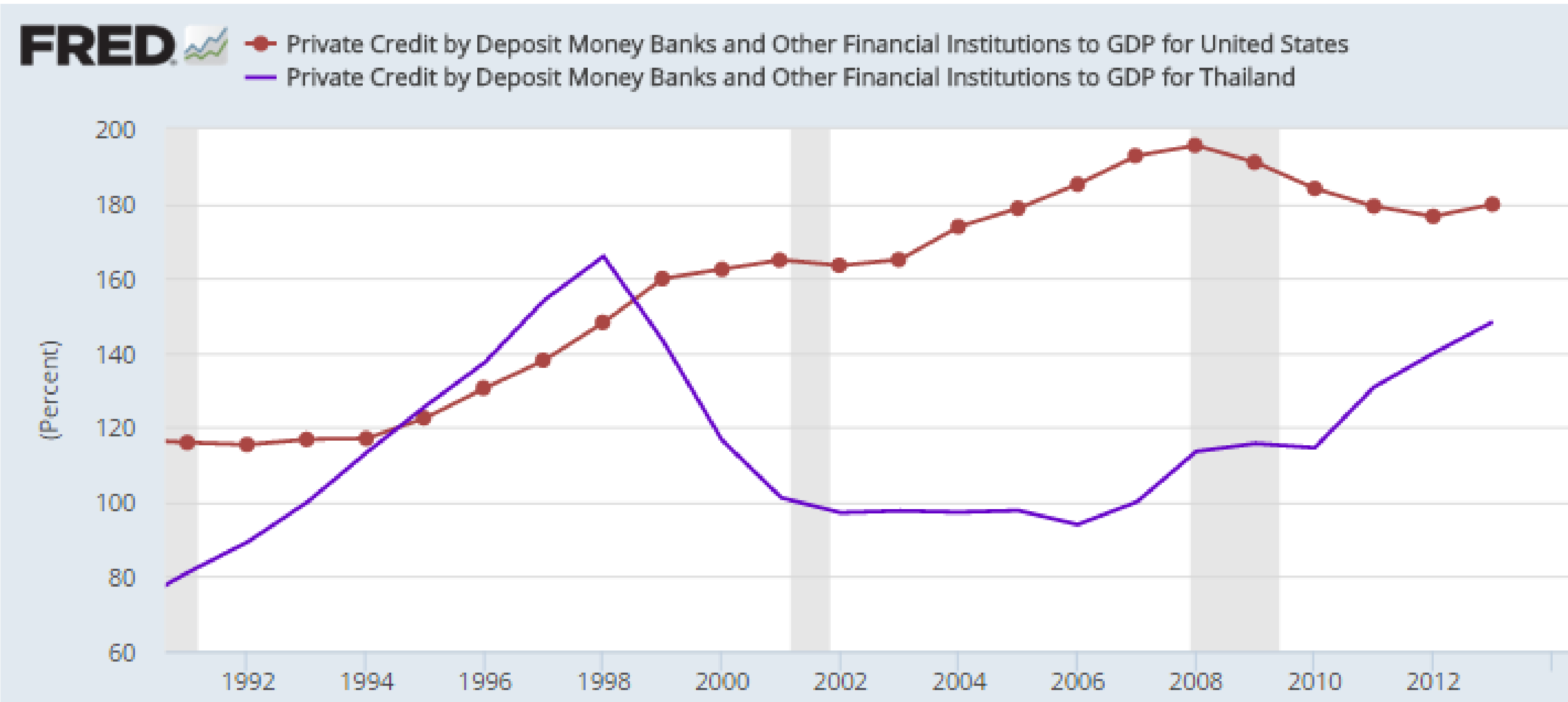
Domestic credit

- Domestic credit provided by the financial sector includes all credit to various sectors on a gross basis, **with the exception of credit to the central government**, which is net.
- The financial sector includes monetary authorities and deposit money banks, as well as other financial corporations where data are available (including corporations that do not accept transferable deposits but do incur such liabilities as time and savings deposits
- Examples of other financial corporations are finance and leasing companies, money lenders, insurance corporations, pension funds, and foreign exchange companies.

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, expansion of domestic credit, and subsequent financial turmoil.

Domestic credit provided by financial sector (% of GDP)



Source: Federal Reserve Economic Data (FRED)

Finance matters for economic activity

Direct vs. Indirect Finance

- Bank-based economy: banks perform the role of intermediaries, mobilizing savings and extending financial resources to investors
- Financial deepening process involves direct finance, where savers transfer financial savings directly to investors via stock and bond markets
- The value of stock markets rise faster as a percentage of GDP.

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

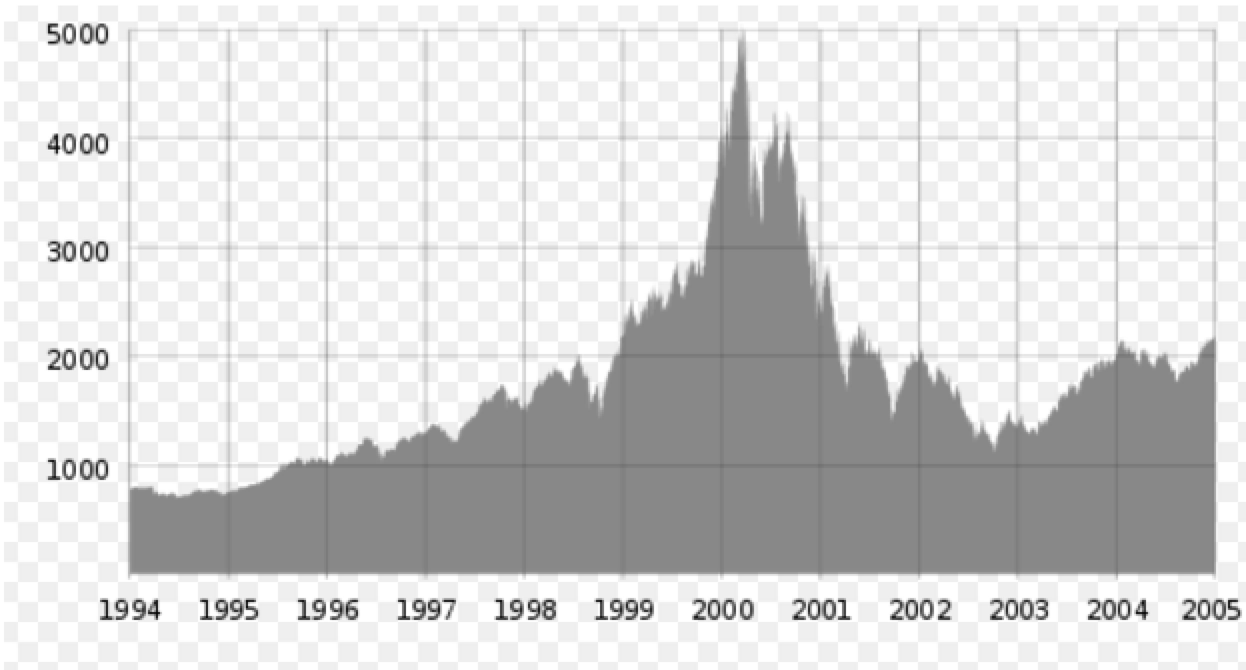
Stock bubbles

- Two famous early stock market bubbles were the Mississippi Scheme in France and the South Sea Bubble in England.
- Both bubbles came to an abrupt end in 1720, bankrupting thousands of unfortunate investors.
- Those stories, and many others, are recounted in Charles Mackay (1841) "Extraordinary Popular Delusions and the Madness of Crowds."

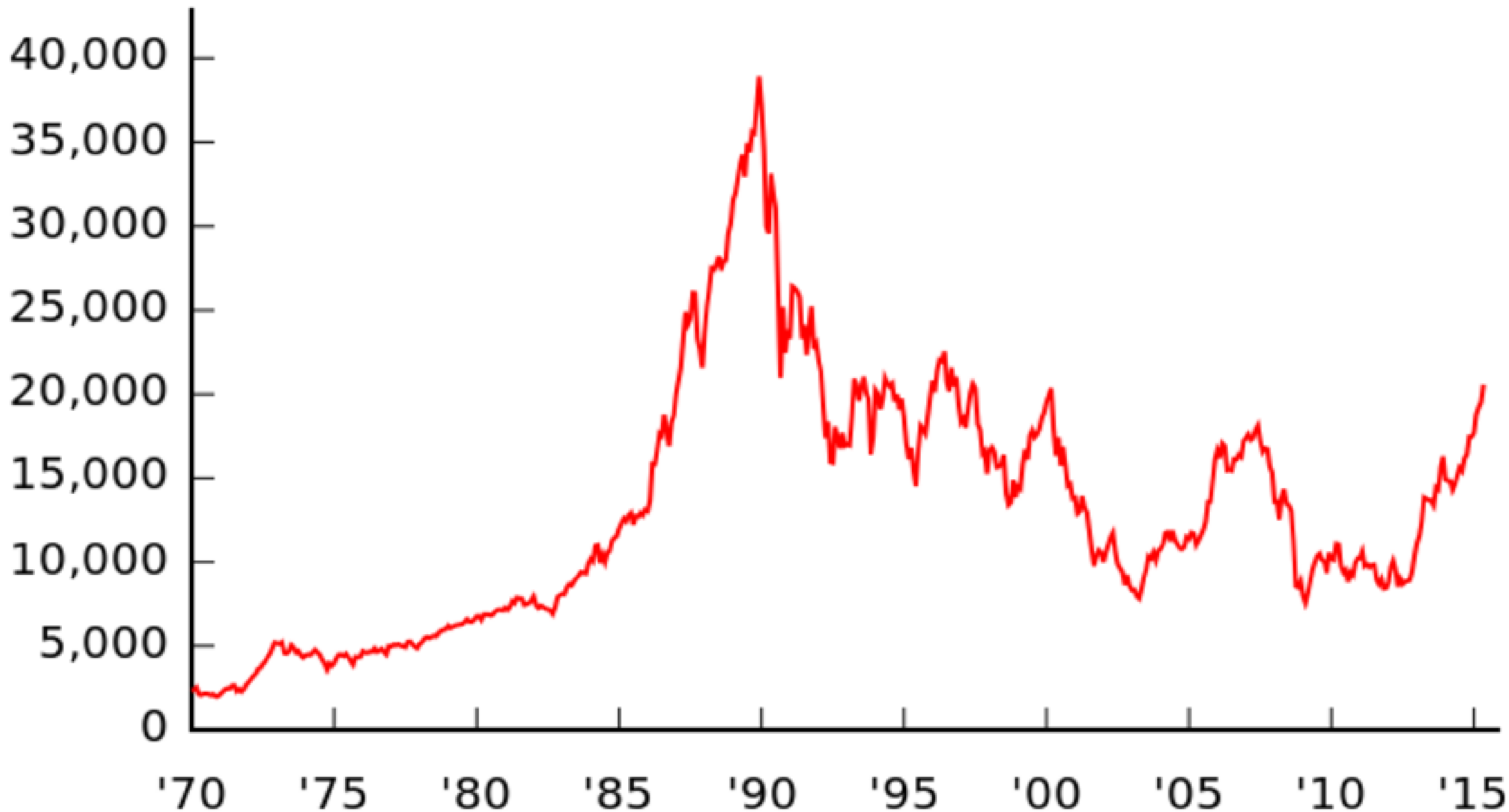
A stock market bubble

- A type of economic bubble taking place in stock markets when market participants drive stock prices above their value in relation to its intrinsic value determined by fundamental factors.
- Cognitive biases lead to groupthink and heard behavior.

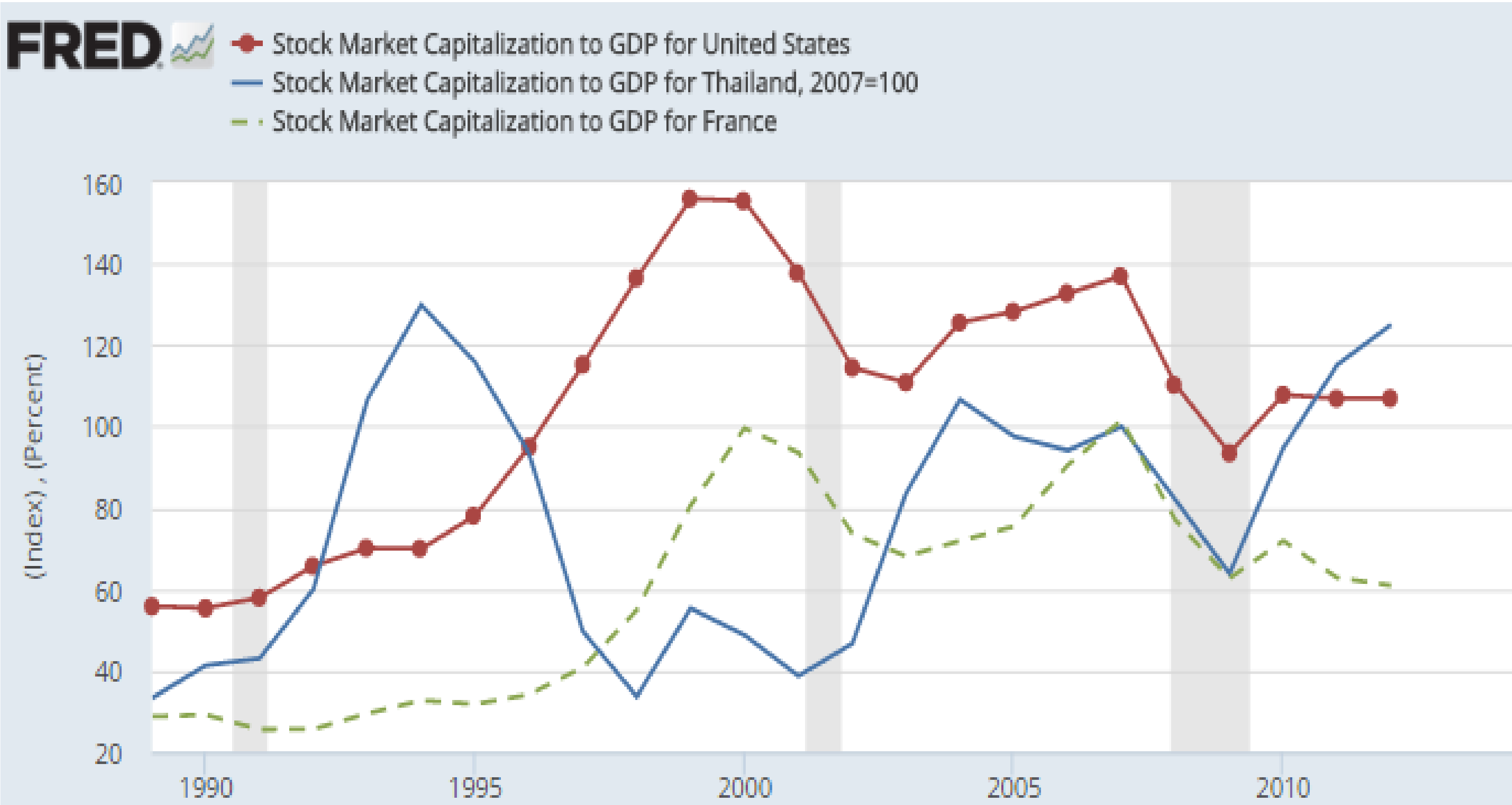
The NASDAQ Composite index spiked in the late 90s and then fell sharply as a result of the dot-com bubble.



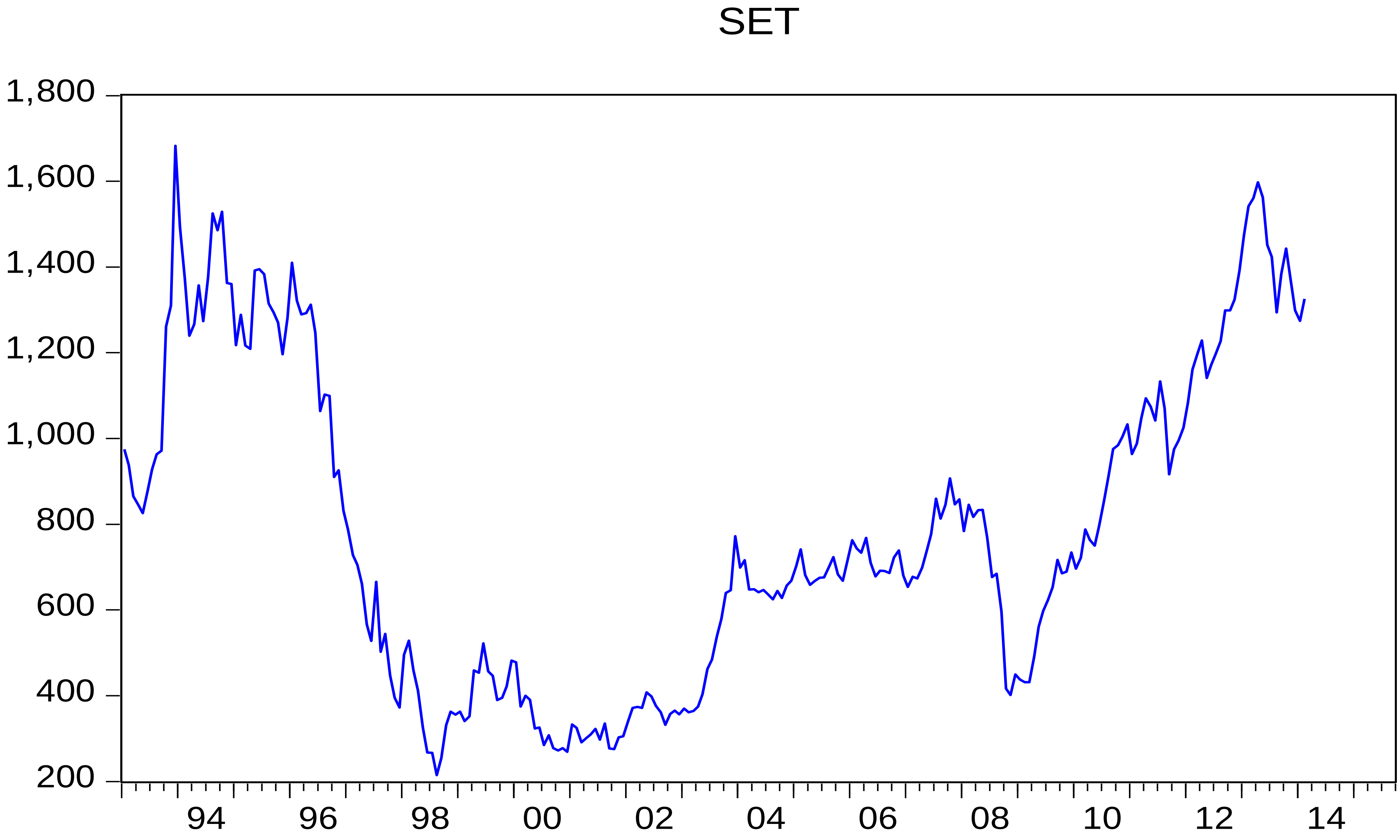
The Nikkei 225



Size of Stock Market Relative to GDP



Stock bubbles burst


SET
1,800
1,600
1,400
1,200
1,000
800
600
400
200
94
96
98
00
02
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06
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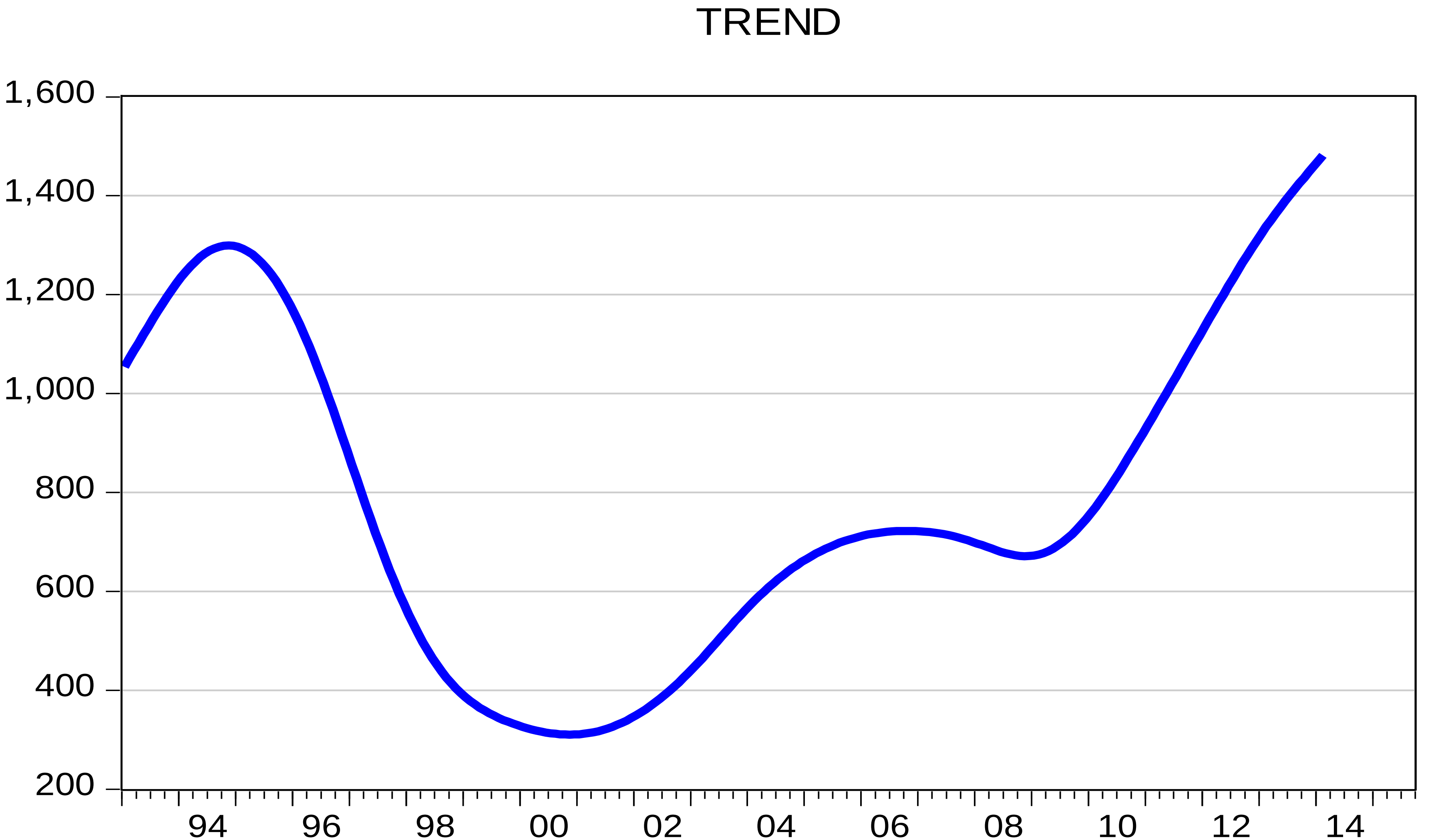
10
12
14

How far can we push the SET further?



When good banks become bad banks

- 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 stages 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.

Rogue trader

- A rogue trader is a trader at a financial institution who engages in unauthorized trading to recoup the loss he incurred in earlier trades. Out of fear and desperation, he manipulates the internal controls to circumvent detection to buy more time.
- The size of the loss is a reflection of the laxity in controls instituted at the firm and not the trader's greed. Contrary to the public perception, rogue traders do not have criminal intent to defraud his employer to enrich himself; he is merely trying to recoup the loss to make his firm whole and salvage his employment.

- Some of the largest unauthorized trading losses were discovered at Barings Bank (Nick Leeson), Daiwa Bank (Toshihide Iguchi),Sumitomo Corporation (Yasuo Hamanaka), Allfirst Bank (John Rusnak), Société Générale (Jérôme Kerviel), UBS (Kweku Adoboli), andJPMorgan Chase (Bruno Iksil).

Goals of Financial Institutions

- Profitability (differences between interest, non-interest income and cost of funds and operating cost)
- Profitability reflects monopoly power and degree of bank concentration)
- Efficiency (related to competition)
- Solvency (equity capital and liquidity)

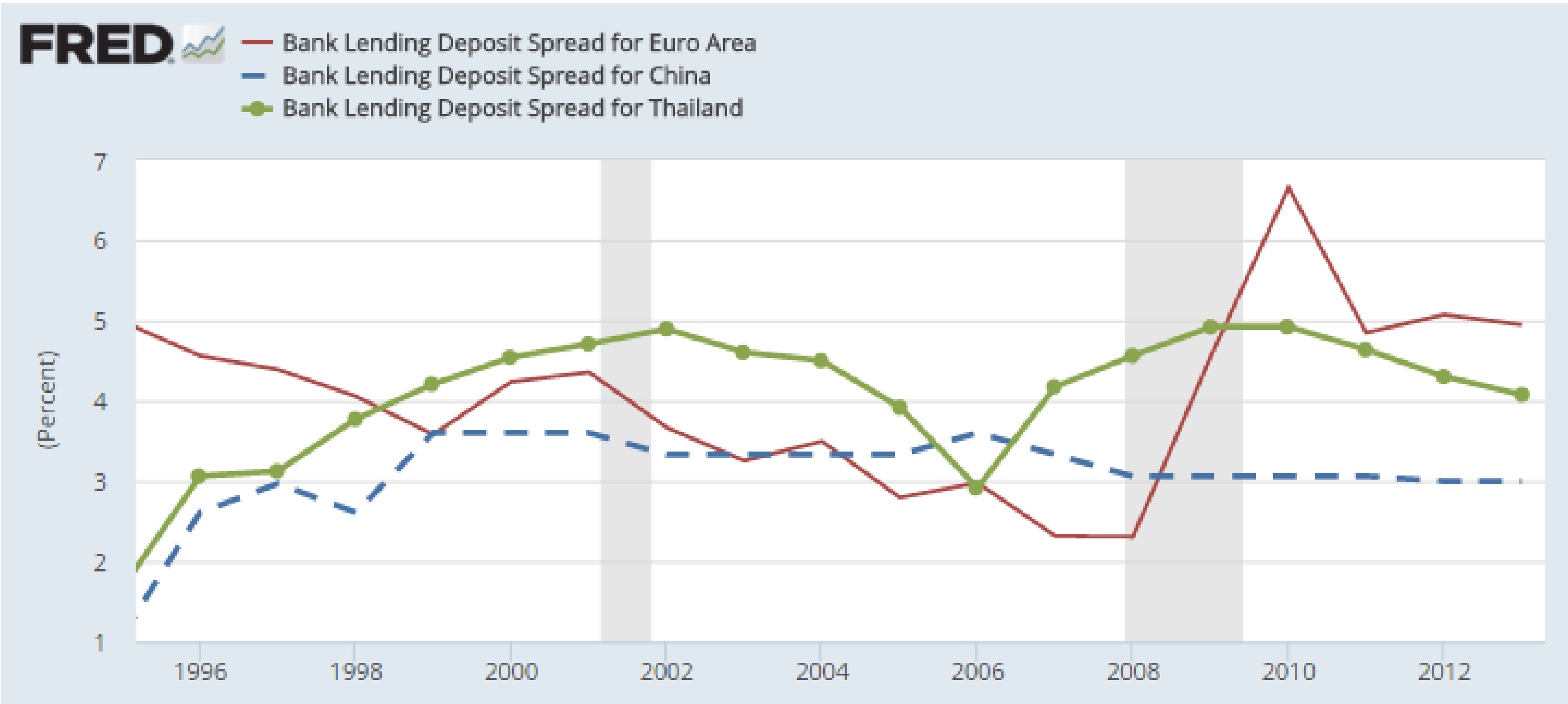
Determinants of bank profits

- Interest spread (lending and deposit)
- Loan growth volume
- Bad debt and non-performing loans (loan loss provision)
- Operation cost (wages)

Lending rates

- Lending rate is the bank rate that usually meets the short- and medium-term financing needs of the private sector.
- This rate is normally differentiated according to creditworthiness of borrowers and objectives of financing.
- High default risk implies high lending rates (risk premium)
- The terms and conditions attached to these rates differ by country, however, limiting their comparability (next slide)

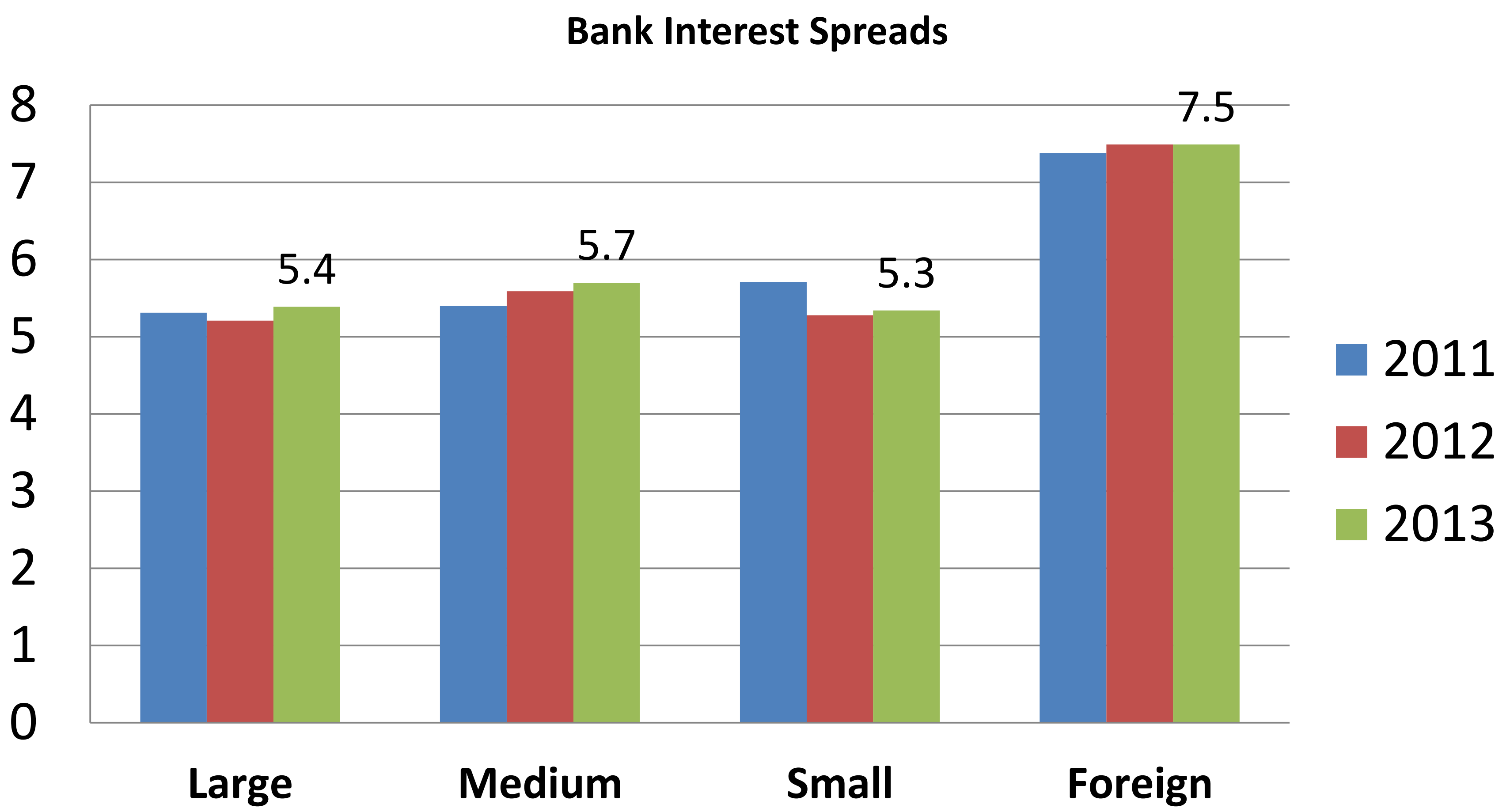
Lending and deposit interest Spread

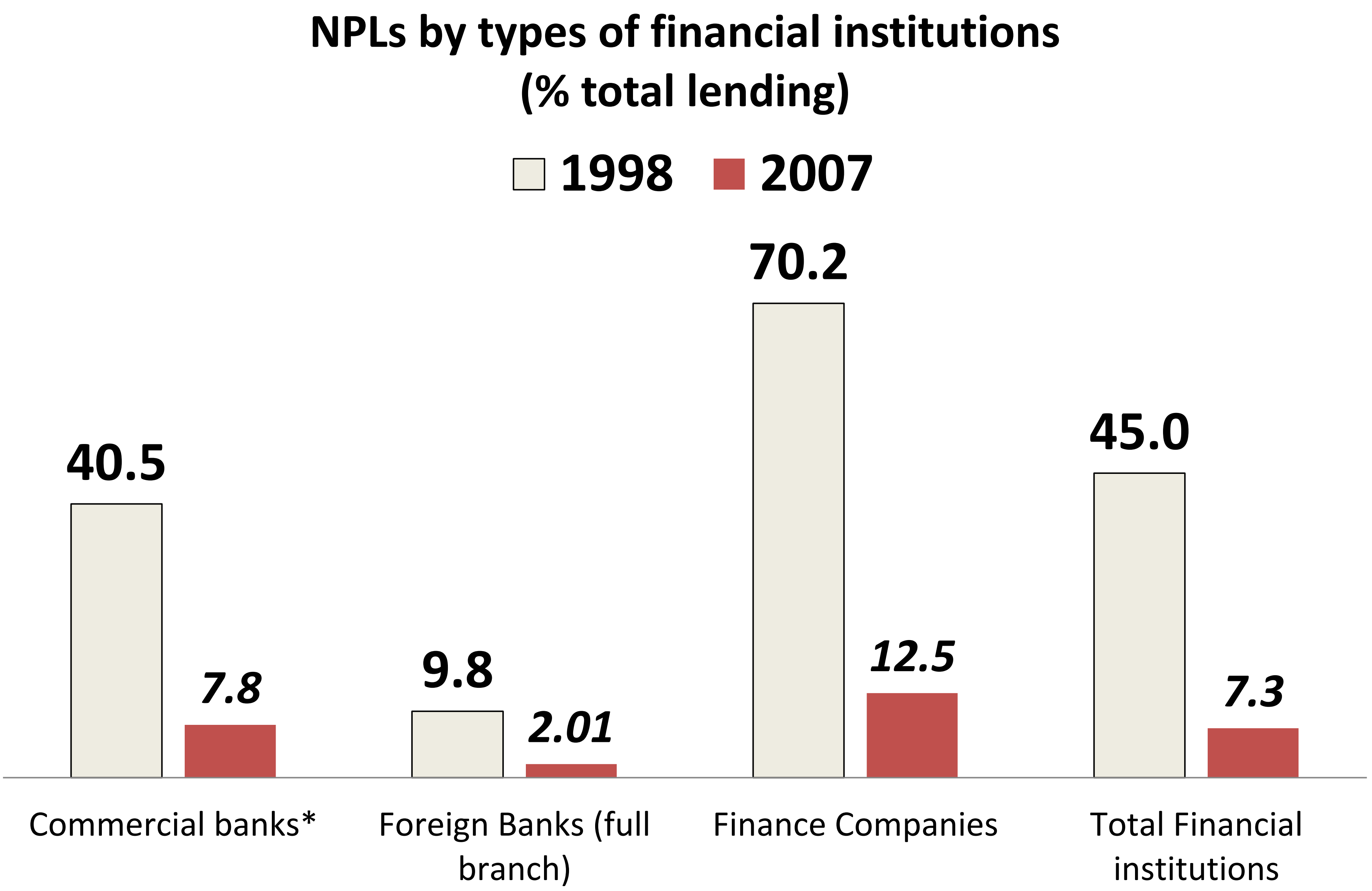


Interest Spread: A measurement of efficiency

- 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.

Size and spreads




NPLs by types of financial institutions
(% total lending)
1998
2007
40.5
7.8
9.8
2.01
70.2
12.5
45.0
7.3
Commercial banks*
Foreign Banks (full branch)
Finance Companies
Total Financial institutions

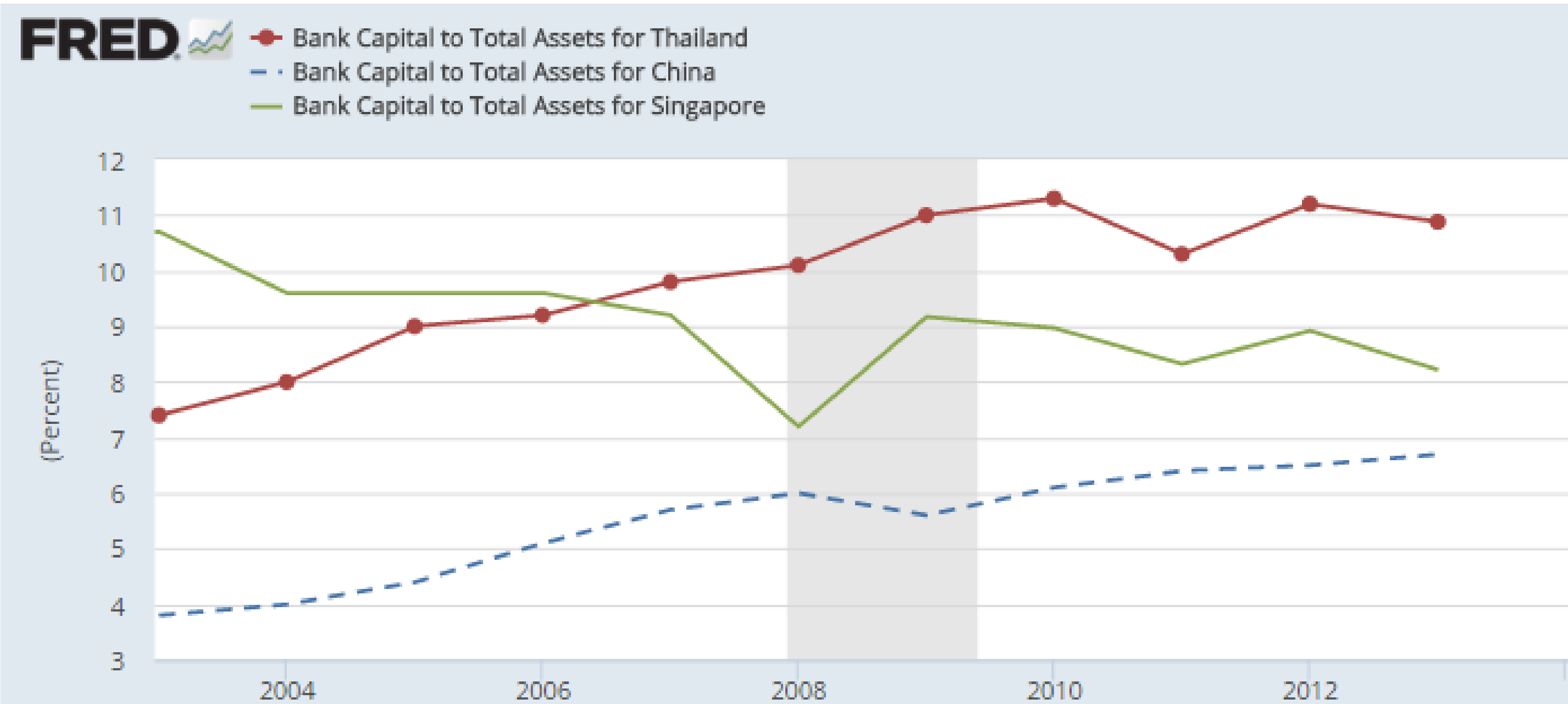
Bank solvency

- Writing off bad debts means reducing equity
- The size of equity relative to risk assets
- The importance of liquidity
- Public confidence
- The central bank’s role of lending of the last resort

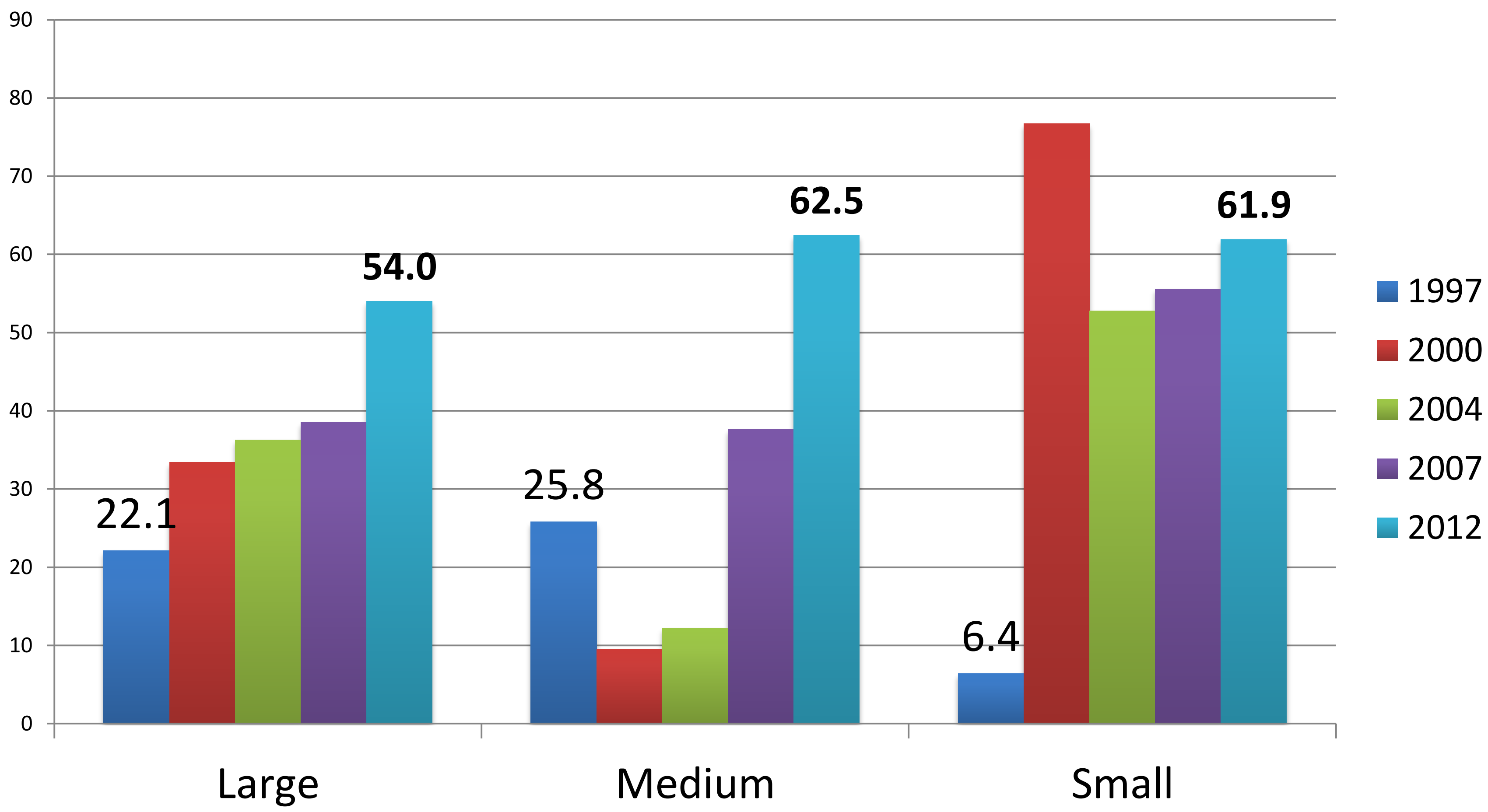
When are banks too big to fail?

- 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.

Bank Capital to Total Assets



Foreign ownership 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.

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.

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.

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.
- 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.

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.

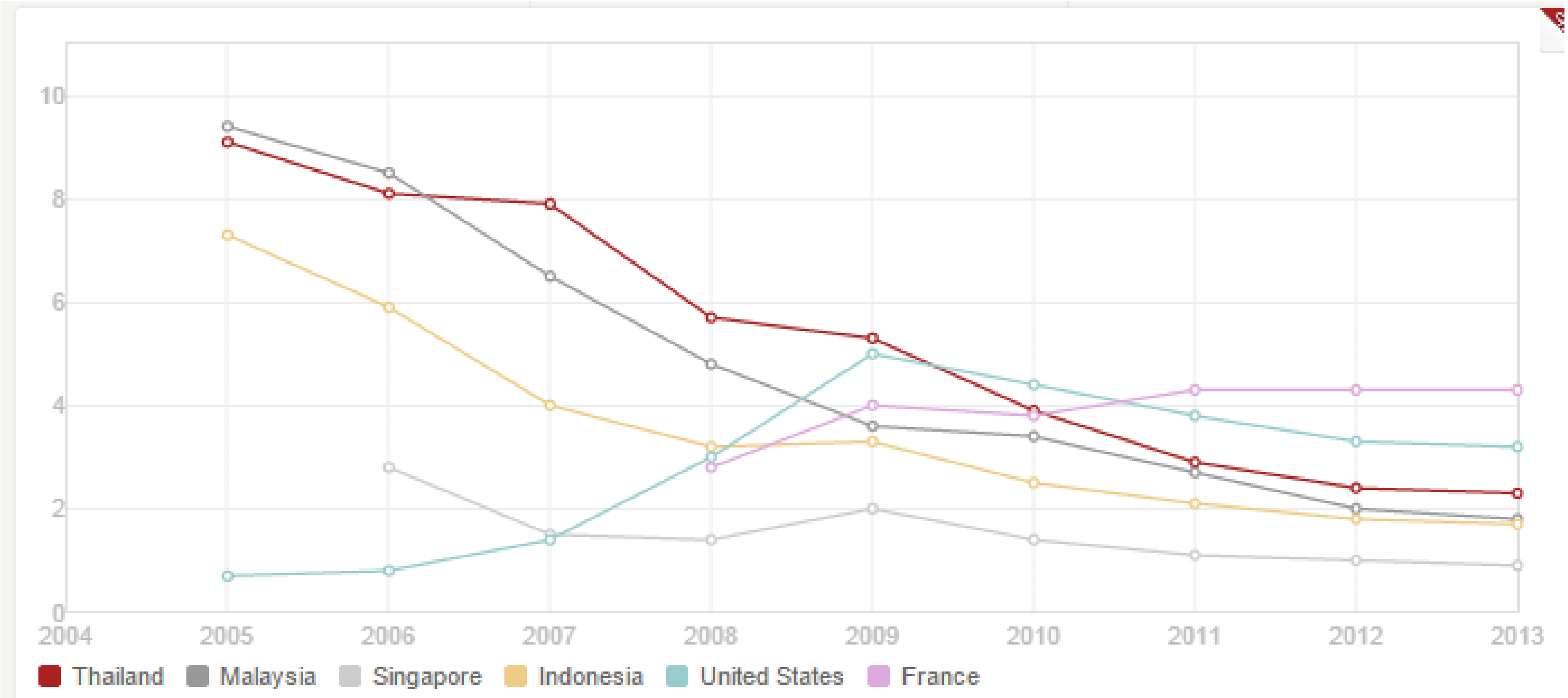
GFC and Thai banks

- 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.**

Bank nonperforming loans (% total loans)



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?

- 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.

Lessons learned

- 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.

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?

Abstract from ADB Review Article
The Resilience of Thai Banks

- 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.