CHAPTER III

THE TRANSFORMATION OF THE BANKING INDUSTRY IN THAILAND

3.1. Introduction

After 10 years (1987-1996) of stable and rapid economic and financial development, in 1997 the Thai economy experienced a severe twin crisis, which was a simultaneous crisis in the balance of payments and in the banking system. There was a close link between a country's currency stability and the health of its banking sector. Devaluation had negative impacts on the balance sheets of financial intermediaries, which led to a tightening in credit market conditions and possibly to a contraction in output.

After the crisis, Thai commercial banks have seen significant improvements in profitability, asset quality, and risk management. Thailand has complied with most of the policy changes agreed with the IMF in the context of the 1997 rescue program. However, distressed assets of both the corporate sector and its financial sector counterpart have remained high. Because of the large debt overhang, the financial sector has not fully played its role as financial intermediary in facilitating sustained economic growth. Also, the credit channel of monetary policy transmission was impaired after the crisis. Hence, a close examination of bank performance, in particular in different groups of banks, is important for research and policy. This will contribute to handling and preventing further crisis and will be of use also for policy making relating to banking competition.

3.2. Industry structure

From a historical point of view, banking has been a heavily regulated industry in most countries. Consequently, the interest in studying bank efficiency and changes therein stems from a desire to know how deregulation and liberalization affects the industry. When considering total assets of Thailand's commercial banking sector at the end of 2007, the structure of the industry does not appear to have changed much. There are about the same number of both Thai and foreign commercial banks today as there were ten years ago foreign commercial banks accounted for about 13% of the sector's total assets at the end of 2007. Within the group of Thai commercial banks, the industry has become slightly more concentrated. This reflects post-crisis industry consolidation and a quest for scale economies by the large players. The significant change is the change in shareholding structures of Thai commercial banks. Although not as badly hit by the crisis as finance companies, the banking sector did suffer significant damage. From 1998 to 2000, Thai commercial banks were forced to raise equity to around 750,000 million baht in additional capital (see Table 1)

The year 2007 was a solid year for Thai commercial banks. Improved profitability contributed to further strengthening of the sector's financial position. Thai commercial banks' 2007 net profit dropped from 2006 bringing down the sector's return on assets. In terms of total income, the growth in income was supported by a strong increase in net interest and dividend income, which in turn benefited from improvement in net interest margin (NIM) and continued loan growth.

1992 was the year that commercial banks were fully liberalized. They were allowed to set up Bangkok International Banking Facility (BIBF) operation which enabled them to channel low-cost foreign funds to domestic borrowers and started the subsequent increase in lending. Meanwhile, the cost-to-income ratio of Thai commercial banks after the crisis had become higher, partly to the fact that most Thai commercial banks still carried a sizable amount of non-income generating assets (non-performing loans plus foreclosed properties) on their balance sheets.

In terms of asset quality, the ratio of non-performing loans (NPLs) to total loans of Thai commercial banks dropped further to 8.0%, the lowest level since 1997 (Table 2). The continued improvement in the NPL ratio reflected banks' effort to clean up their loan books in response to the Bank of Thailand (BOT)'s more stringent provisioning rules.

Foreign-owned banks had higher net interest margin (NIM) and net interest spread (the difference between yields on interest-earning assets and the funding costs) than Thai banks, but had higher operating costs and provisioning expenses which brought down their profitability.

Table 1 Commercial Banks' Performance [2000 - 2007]

(Unit : Millions of Baht)	2000	2001	2002	2003	2004	2005	2006	2007
1. Commercial Banks registered in Thailand								
Net interest income	76,808	94,587	104,036	122,150	159,280	197,972	233,898	254,035
Non-interest income	49,946	51,211	64,004	75,164	77,250	73,054	88,870	83,485
Total Income	126,754	145,798	168,040	197,314	236,530	271,026	322,768	337,520
Operating expenses	125,183	123,652	111,673	116,069	127,631	144,014	185,133	206,237
Net profit (loss)	- 13,343	85,188	11,008	39,535	77,998	92,911	54,538	6,697
Assets	5,497,031	5,665,019	5,779,883	6,122,122	6,424,612	7,006,370	7,537,895	7,815,228
Equity	235,550	283,196	319,760	433,678	494,669	628,431	673,293	741,486
No. of banks	13	13	13	13	12	16	17	18
2. Foreign Banks (full branch)								
Net interest income	23,879	22,414	16,981	13,032	13,958	21,483	25,451	27,479
Non-interest income	17,199	16,872	14,916	16,928	19,363	21,360	15,396	19,558
Total Income	41,078	39,286	31,897	29,960	33,321	42,843	40,847	47,037
Operating expenses	22,143	18,314	21,622	20,916	22,632	25,633	21,391	24,039
Net profit (loss)	11,579	- 1,090	9,227	10,838	18,150	10,507	14,296	13,718
Assets	766,867	744,545	686,268	699,187	847,129	981,254	1,109,331	1,189,844
Equity of Head Office and other branches of the same legal entity	338,135	302,152	281,215	220,874	245,592	255,617	213,383	208,122
No. of banks	21	21	18	18	18	18	17	17
3. Total Commercial Banks (1+2)								
Net interest income	100,687	117,001	121,017	135,182	173,238	219,455	259,349	281,514
Non-interest income	67,145	68,083	78,920	92,092	96,613	94,414	104,266	103,043
Total Income	167,832	185,084	199,937	227,274	269,851	313,869	363,615	384,557
Operating expenses	147,326	141,966	133,295	136,985	150,263	169,647	206,524	230,276
Net profit (loss)	- 1,764	84,098	20,235	50,373	96,148	103,418	68,834	20,415
Assets	6,263,898	6,409,564	6,466,151	6,821,309	7,271,741	7,987,624	8,647,226	9,005,072
Equity	235,550	283,196	319,759	433,678	494,669	628,431	673,293	741,486
No. of banks	34	34	31	31	30	34	34	35

Source: Bank of Thailand

Table 2 Gross NPLs and Net NPLs Outstanding

(Unit: Millions of Baht)	2000	2001	2002	2003	2004	2005	2006	2007
1. Commercial Banks registered in Thailand								
Gross NPLs	784,413	441,948	699,781	591,028	556,998	461,438	426,196	441,598
Net NPLs	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	228,212	232,467
2. Foreign Banks (full branch)								
Gross NPLs	38,176	16,590	42,843	28,132	13,390	9,284	13,842	11,813
Net NPLs	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	5,932	3,346
3. Total Commercial Banks (1+2)								
Gross NPLs	822,589	458,538	742,624	619,160	570,387	470,722	440,038	453,411
Net NPLs	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	234,144	235,813
% to Total Loans								
1. Commercial Banks registered in Thailand								
Gross NPLs	19.27	11.49	16.50	13.52	12.54	9.05	8.03	7.81
Net NPLs	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	4.47	4.27
2. Foreign Banks (full branch)								
Gross NPLs	6.60	3.20	8.91	6.39	2.63	1.60	2.36	2.04
Net NPLs	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	1.03	0.61
3. Total Commercial Banks (1+2)								
Gross NPLs	17.70	10.50	15.73	12.87	10.92	8.29	7.46	7.28
Net NPLs	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	4.12	3.94

Source: Bank of Thailand

3.3. The industry environment

As with the Thai commercial banking players, the environment in which they operate continues to evolve along with their implications for Thai commercial banks. After the robust growth during 2002 and 2004, the Thai economy slowed down moderately from 2005 to 2007. It was buffeted by a number of negative shocks, such as political uncertainties and high oil prices. As a result, domestic demand softened markedly. In fact, there is a possibility that 2007 could be a short-term peak in Thai banks' performance. There have been four major changes in Thai commercial banks' industry environment since 1997. The four changes are disintermediation by the capital markets; the increased role of specialized financial institutions (SFIs), the rise of non-bank financial institutions, and heightened competition from foreign banks.

The major element of Thai banks' industry environment is the structure of the financial system. Thailand's financial system is bank-based, with commercial banks, providing funds for the domestic economy. Nevertheless, since the 1997 crisis there has been a gradual shift towards greater capital market financing. The decline in the significance of financial institutions in the Thai economy seen is due partly to the problems facing these institutions in the aftermath of the 1997 crisis and partly to the authorities' effort to promote the development of capital markets, targeting the corporate bond market as well as the equity one. In the case of commercial banks, a huge pile of NPLs and balance sheet weakness have led to a contraction in bank loan supply, making capital market an attractive financing alternative, or in some cases the only choice, for certain firms.

The capital market development provides banks with several income-generating opportunities, where Thai banks are the major players. In addition, Thai banks are also occasional issuers of corporate bonds. As a result, Thai banks will gain as the bond market grows.

Another development is on how "universal" a particular bank is. Although Thai banks are prohibited to directly participate in equity securities business, many own securities and asset management companies. Securities and asset management company subsidiaries of the banks are among leaders in their respective industries. Thus, as a result on a consolidated perspective, there is more on a shift in revenues from interest income to fees and services income. Wealth management for high-net worth customers is the fastest growing business segment for banks.

After the 1997 crisis, the role of SFIs in the Thai financial system increased significantly. The government has used SFIs to fill the gap voided by troubled banks and finance companies as well as to stimulate the battered economy, especially at the grass root level.

Competition in the consumer finance market is expected to become fiercer as the softened economy slows down the now crowded market. The amount of loans is extended by "non-banks" or non-deposit-taking consumer finance specialists. Some banks, however, have managed to avoid direct competition with non-banks in this market by launching their own non-banks or by forming strategic alliances with Non-banks themselves.

The other element of Thai banks' industry environment is the heightened competition from foreign banks. It was a foreign bank which jumpstarted commercial banking in Thailand in 1888, foreign banks have played limited roles in Thailand's modern banking era. The main reason for the limited presence of foreign banks in Thailand has to do with the Bank of Thailand's regulations on foreign bank entry and branching. The foreign banks are registered as subsidiaries, confining to having one branch only. A few foreign bank branches have opted for organic growth during the past ten years by building a retail operation, particularly in credit cards, despite having only one branch each. Although business models of foreign bank branches are diverse, most of them focus on corporate banking. The typical businesses of foreign bank branches are lending to large and medium-sized firms, offering structured products, and providing foreign exchange and money market activities. But even foreign wholly-owned Thai banks are a relatively new phenomenon. In an effort to stabilize the Thai banking system after the 1997 crisis, the Bank of Thailand relaxed the 25%-ceiling on foreign ownership in Thai banks. Following this process, four commercial banks were sold during 1998 and 1999. More recently, the Bank of Thailand allowed the foreigners to take a majority stake in some other Thai banks.

3.4 The regulatory environment

An important milestone in Thailand's post-crisis banking regulatory reform was the initiation of the first phase of the Financial Sector Master Plan (FSMP) in January 2004. Bank of Thailand (2006) provided background, rationales, and details of the plan. The FSMP is a 10-year, medium-term development plan for financial institution under the supervision of the Bank of Thailand.

The outcome under the first phase (2004-2007) of the FSMP was the rationalization of the structure and roles of financial institutions. One of the strategic objectives of the FSMP was to correct this structural weakness. This had been accomplished by the removal of the regulatory boundary line between commercial banks' and finance companies' businesses. Finance companies were then asked to merge with their parent bands, or to merge with other finance companies to become commercial banks or retail banks, or return their licenses.

It was International Banking Facilities (IBFs) that fueled the pre-crisis lending boom in Thailand. IBFs attached to commercial bank were asked to merge with their parents and stand-alone IBFs had to upgrade to foreign full branch or subsidiary or to return their license at the same time.

The establishment of foreign subsidiary is a new concept in Thailand and represents the Bank of Thailand's response to pressures for further financial liberalization. Under the FSMP, foreign banks can operate as a full branch or a subsidiary. Both full branch and subsidiary can do the same scope of business as Thai commercial banks. They can have four branches in addition to one head Office as opposed to the former which (by definition) has only one branch.

The FSMP Phase II in 2008 will aim at increasing efficiency of the financial institution system so as to strengthen its competitiveness and resiliency. An important element of the FSMP Phase II will be the "orderly but meaningful" introduction of more competition into the system between existing institutions and new entrants, domestic and/or foreign ones

3.5. The changing business model

The 1997 crisis made it necessary for Thai commercial banks to adapt and develop in nearly every dimension of their operations, resulting in changes in Thai banks' business structure, sales and services, distribution channels, and risk management. Before the crisis, Thai banks earned most of their income from lending business. Interest income accounted for nearly 60% of banks' total income in 2000. Within the loan portfolios, the focus of most banks was on large corporations. Such dependency made banks' profit sensitive to an economic downturn. Defaults by a few large borrowers meant huge damages to income and capital base.

To achieve greater portfolio diversification, Thai banks have given more importance to consumer loans and loans to small and medium enterprises (SMEs). The emphasis has shifted to non-interest income, especially fees and commissions to reduce the dependency on interest income. In terms of sales and services, cross-selling and customer segmentation was generally rare before the crisis. The need to increase the bottom line amidst increased competition after the crisis motivated Thai banks to cross-sell and move to a customer-centric architecture where customer needs come first. Several banks have adopted a customer relationship management (CRM) platform to serve specific needs of different customer segments.

With regards to distribution channels, the most visible change is probably branch rationalization. Even the state-owned banks have fewer people in their branches before the crisis. At the same time, Thai banks have aggressively used ATMs and sub-branches to increase points of service and lower cost-to-serve. Use Of mobile and internet banking also has an impressive growth albeit still small in total volume.

The other significant change is the change in Thai banks' risk management, which has become more systematic. After the crisis, most banks adopted a system where transparency in the credit process as well as the system of check and balance and specialization among different departments occur. In all banks, there is now a risk management committee that sets credit risk policy and monitor banks' own risks. Also, an attempt to move towards risk-based pricing using RAROC (Risk-Adjusted Return on Capital) or similar tools has been progressively implemented.

3.7. Conclusion

Since 1997 the banking sector has more or less returned to stability by strong economic growth, consolidation and recapitalization efforts, improved risk management, operational restructuring, and regulatory reforms. The most important things from the financial stability perspective are the thinner bottom line and increased credit risks. Nevertheless, the outlook for the sector could change if the future macroeconomic and financial environment significantly diverges. The introduction of greater competition under the second phase of the Financial Sector Master Plan would test Thai banks. These banks will have to work competitively in terms of efficiency and create more value-added products to ensure their long-term place in the Thai economy.