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FOR AGENDA

SM/08/125
Correction 1

May 20, 2008

To: Members of the Executive Board

From: The Secretary

Subject: **Thailand—Financial System Stability Assessment**

The attached corrections to SM/08/125 (4/30/08) have been provided by the staff.

Factual Errors Not Affecting the Presentation of Staff's Analysis or Views

Page 6, para. 2, line 8: for "There are a few weaker banks, primarily state-owned, which the BOT has identified through its supervisory process. Several of these are now in the process of raising capital."
read "Two weaker banks, primarily state-owned, have been recapitalized, and one is now in the process of being privatized."

Page 10, Box 2, para. 1, line 2: for "The amended BOT Act, the Deposit Protection Agency Act (approved in February 2008), the Financial Institutions Business Act and the amended Securities and Exchange Commission Act will all go into effect August 2008. The Commission for Regulation and Promotion of Insurance Business Act was passed in August 2007."
read "The amended BOT Act (except sections related to the Deposit Protection Agency Act, which will be effective in August 2008) and the amended Securities and Exchange Act have come into effect since March 2008, while the Financial Institutions Business Act and the Deposit Protection Agency Act will go into effect August 2008. The Office of Insurance Commission Act was passed in August 2007."

Page 10, Box 2, para. 2, bullet 2, line 2: for "It can also provided uncollateralized borrowing and lending facilities."
read "It can also pay interest on banks' uncollateralized deposits held at the BOT."

para. 5, heading: for "Commission for Regulation and Promotion of Insurance Business Act"
read "The Office of Insurance Commission Act"

para. 6, heading: for "Securities and Exchange Commission Act"
read "Securities and Exchange Act"

para. 6, bullet 1: for "The Act gives the SEC investigative power"
read "The Act gives the SEC power to provide information/assistant upon request of foreign capital market regulators without its own interest in the matter."

Page 11, footnote 2, line 1: for "Thai commercial banks' total exposure to foreign securities and structured products amounted to less than 2 percent banks' total assets at end-2007."
read "Thai commercial banks' total exposure to foreign securities and structured investments such as CDO and structured notes amounted to less than 2 percent banks' total assets at end of June 2007."

Page 15, para. 4, line 3: for "Commercial banks account for 62 percent of financial sector assets."
read "Commercial banks account for 60 percent of financial sector assets."

line 6: for "Nonbank financial institutions hold the remaining 24 percent of financial assets"
read "Nonbank financial institutions hold the remaining 25 percent of financial assets."

Page 16, Table 1: Table replaced. Revisions made to footnote and 2007 data.

Page 17, para. 7, line 6: for "These banks accounted for 42 percent of total commercial banking sector assets at end-2006."
read "These banks accounted for 41 percent of total commercial banking sector assets at end-2006."

para. 8, line 8: for "Banks return on assets (ROA) fell to 0.3 percent in 2007 compared to 1.3 percent for 2005."
read "Banks return on assets (ROA) fell to 0.3 percent in 2007 compared to 1.4 percent for 2005."

Page 18, Table 3: Table replaced. Revisions to 2005 ROA data.

Page 19, Figure 4: Figure replaced. Revisions to net interest margin data.

Page 22, Figure 6: Figure replaced. Revisions to NPL data and replaced millions with billions in second chart.

Page 39, para. 58, line 6: for "In December 2007, the National Legislative Assembly has passed the new FIBA and DIA, and the amendment of the BOT Act."
read "In December 2007, the National Legislative Assembly has passed the new FIBA and Deposit Protection Agency (DPA), and the amendment of the BOT Act."

line 13: for "The new DIA will provide explicit, limited deposit guarantee to depositors as well as reduce moral hazard in the financial sector."
read "The new DPA will provide explicit, limited deposit guarantee to depositors as well as reduce moral hazard in the financial sector."

Page 53, Principle 3.2, line 14: for "High-frequency data on BOT open market intervention are posted continually on the website."
read "High-frequency data on BOT open market operations are posted continually on the website."

Questions may be referred to Ms. Gobat (ext. 39332) and Mr. Fiechter (ext. 35697) in MCM.

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

Att: (11)

Other Distribution:
Department Heads

PCA	Prompt corrective action
PDs	Probability of default
PSC	Payment Systems Committee
RTGS	Real time gross settlement
RTP	Royal Thai Police
SEA	Securities Exchange Act
SEC	Securities and Exchange Commission
SET	Stock Exchange of Thailand
SFIs	Specialized financial institutions
SMART	System for Managing Automated Retail Funds Transfer
SWIFT	Society for Worldwide Interbank Financial Telecommunication
TAMC	Thailand Asset Management Corporation
TF	Terrorist Financing
TSD	Thai Securities Depository Co., Ltd.
URR	Unremunerated reserve requirement
SMEs	Small- and medium-sized enterprises

EXECUTIVE SUMMARY

A great deal has been accomplished since the 1997 financial crisis to strengthen the soundness and resilience of the Thai financial sector (Appendix 1). Macroeconomic management has significantly improved through the implementation of a fiscal sustainability framework and adoption of a floating exchange rate regime and inflation targeting, along with enhanced monetary transparency. Major weaknesses revealed by the crisis in the regulatory and supervisory framework have largely been addressed. Thai corporations, which had been at the center of the crisis, have also significantly deleveraged and upgraded their governance practices. Domestic capital markets have developed over the past decade, in part in response to the large funding needs of the government and banks following the crisis. This has strengthened the resilience of the financial system.

Banking fundamentals have strengthened, with most Thai banks reporting high levels of capital and solid profitability. Thai banks have restructured and rebuilt their balance sheet following the huge losses suffered during the crisis. Banks' risk adjusted capital adequacy ratio averaged 15 percent at end-2007, well above the regulatory minimum of 8½ percent. Operating profitability has improved for most banks due to higher interest margins and strong loan growth. At the same time, better credit underwriting and efforts by the BOT to improve provisioning coverage against distressed assets has lowered the overall risk profile of the Thai banking sector. Two weaker banks, primarily state-owned, have been recapitalized, and one is now in the process of being privatized.

Banks and other financial institutions have also remained resilient in the face of the recent turmoil in mature credit markets and heightened market volatility. Standard market indicators suggest that default probabilities are low, reflecting the low direct exposure to structured products and to foreign funding. The Stock Exchange of Thailand (SET) rose strongly in 2007, recovering losses that resulted from investors pulling back at end-2006 and again mid-year.

Nonetheless, stress tests show that banks are vulnerable to a sharp domestic economic slowdown, primarily from credit risk. This reflects banks' large holdings of loans on their balance sheet. Liquidity risk was also found to be material for a few banks, notwithstanding the current high liquidity in the banking system. Market and contagion risks were more modest, largely reflecting banks' limited holdings of securities, use of hedging instruments, and low interbank and international exposure.

Moreover, the authorities face several critical challenges in enhancing financial soundness and efficiency. First, there is a need for continued and close supervisory attention to weaker banks. Second, it is important to address remaining legacy problems associated with the financial crisis, in particular reducing the high level of nonperforming loans and assets (NPLs and NPAs) in the financial system (in both banks and state-owned asset

Box 1. Thailand: Key FSAP Recommendations

	Prioritization
Supervisory regime	
• Passage of pending legal reforms to address weaknesses in the financial supervisory framework, including establishing legal independence of the heads of the supervisory agencies and provisions for objective and transparent standards for dismissal.	Immediate priority
• Strengthen the supervisory framework for insurance by establishing an independent supervisory board and moving to risk-based supervision and capital regimes.	Immediate priority
• Improve coordination among the supervisory agencies through regular consultations and greater sharing of drafts policies and regulations at the staff level. Improve process of consultations with market participants.	Medium-term priority
Financial safety net framework	
• Transition from a blanket guarantee to a limited deposit insurance system.	Medium-term priority
Central bank independence and transparency	
• Assure full legal and operational independence of the BOT in the conduct of monetary policy.	Immediate priority
• Clarify in the BOT Act the primary objectives of monetary policy.	Immediate priority
Role of the government in the banking sector	
• Gradually reduce the government's equity stakes in the private commercial banks.	Medium-term priority
• Re-evaluate the appropriateness of SFIs taking deposits in competition with commercial banks. If SFI take deposits, they should be regulated and supervised like commercial banks.	Medium-term priority
Distressed asset resolution	
• Reduce the large stock of NPLs and distressed assets in the Thai financial sector and state-owned asset management companies.	Medium-term priority
• Accurately identify and monitor the level and aging of NPLs in banks.	Immediate priority
• Address weaknesses in the legal infrastructure, including banks' ability to seize collateral of defaulted borrowers.	Immediate priority
• Provide tax incentives for writing off NPLs.	Medium-term priority
Financial Infrastructure and Integrity	
• Bring the AML/CFT framework in line with the international standard by amending the 1999 AMLA.	Immediate priority
• Amend the law to reduce the legal risk to the finality of the settlement of interbank transactions in the event of bankruptcy and reduce systemic risks in the securities settlement system.	Medium-term priority
• Legally separate the Central Securities Depository (CSD) and the Central Counterparty (CCP) functions.	Medium-term priority

Box 2. Thailand: Recent Reforms to the Financial Sector Institutional Framework

Since the FSAP discussions, Thailand has passed a number of critical legal financial sector reforms. The bulk of these were passed in December of 2007. The amended BOT Act (except sections related to the Deposit Protection Agency Act, which will be effective in August 2008) and the amended Securities and Exchange Act have come into effect since March 2008, while the Financial Institutions Business Act and the Deposit Protection Agency Act will go into effect August 2008. The Office of Insurance Commission Act was passed in August 2007. These reforms address most of the legal and regulatory shortcomings identified in the assessments of the standards. For instance, the formal inclusion of the Secretary Generals of the Office of Insurance Commission and Securities and Exchange Commission in the FIPC helps improve coordination among regulators with regard to critical matters affecting the financial system. Key benefits of these legal reforms:

Amendments to the BOT Act

- The objectives of the BOT to achieve monetary stability, payment system stability and financial stability, are now explicitly spelled out in the law.
- The BOT has full operational independence to achieve the monetary objectives. It no longer has to receive the Ministry of Finance approval for new issuance of its own bills for liquidity management. It can also pay interest on banks' uncollateralized deposits held at the BOT.
- Selection and dismissal of the BOT governor and the length of term of the Governor and Board Chairman have been defined. In addition, the terms, qualifications and responsibilities of policy committee members (Monetary Policy Committee, Financial Institution Policy Committee and Payment System Committee), the Governor and the Board of Directors have been defined.
- Financial transparency is enhanced by defining auditing and reporting requirements.

Financial Institutions Business Act

- The FIBA makes the BOT the sole regulator of commercial banks. The relationship between the MOF and the BOT has been clearly spelled out, improving transparency and accountability.
- While licensing power remains with the MOF, the BOT can now close an institution.
- The Act gives the BOT right to conduct consolidated supervision and explicitly anchors the prompt correction action framework in the law. Fit and proper criteria for bank managers and board members have been defined.

Deposit Protection Agency Act

- The blanket deposit guarantee will be replaced with a limited deposit insurance. The new scheme, which will go into effect August 11, 2008, will be phased in over 5 years. The first year will have full coverage and will then gradually be reduced to B 1 million (equivalent to about US$ 33,000 at current exchange rate).
- A premium will be collected by the Deposit Protection Agency (DPA) to fund the deposit insurance. The initial capital of B 1 billion will be funded by the government. The DPA will act as liquidator in the case of failed and closed financial institutions.

The Office of Insurance Commission Act

- Introduction of an independent regulator—the Office of the Insurance Commission.
- Movement toward risk-based capital regulatory framework for non-life and life insurance.
- Movement toward IAIS Insurance Core Principles and early warning systems, which offer rating-based approaches.

Securities and Exchange Act

- The Act gives the SEC power to provide information/assistance upon request of foreign capital market regulators without its own interest in the matter.
- The SEC and Thai Securities Deposit Corporation are given the authority to act in the event that a licensed broker fails.
- The MOF is no longer appointed Chairman of the Board of the SEC.

I. Current Macroeconomic and Financial Environment

A. Macroeconomy

1. **Economic developments were broadly favorable for the financial sector over the past two years (Figure 1).** GDP growth averaged 5 percent in 2006 and 2007, supported by strong net exports. Domestic demand weakened reflecting the negative impact of political developments and higher oil prices. Inflation declined steadily from its peak in May 2006 to well within BOT's target band. Property prices also continued to rise, helping to support collateral values and spur demand for housing-related credit. Corporate profitability strengthened further on the back of rising profit margins and sales (Figure 2). The household sector's financial position also improved, despite higher debt acquired largely to finance housing, due to positive real wage growth and rising housing prices (Figure 3). Household debt at about 30 percent of GDP at end-2005 is moderate compared to regional averages.[1]

2. **Macroeconomic policy management faced the challenge in 2006 and through 2007 of high capital inflows, a rising baht, and weak domestic demand**. Faced with a rapid appreciation of the baht and surging external inflows, the authorities in late 2006 introduced wide-ranging capital controls (i.e., a 30 percent unremunerated reserve requirement (URR). Investors reacted negatively. The Stock Exchange of Thailand (SET) fell 15 percent the day after the announcement and bond yields increased sharply. Financial institutions were not significantly impacted by this market reaction nor subsequent ones, such as the mid-2007 repricing of risks in the mature markets, because of their low exposure to structured products and market risks.[2] The BOT has since removed the URR and the SET index has gained 26 percent in value during 2007. In response to weaker domestic demand and declining inflation, the BOT cut its main policy rate by 175 basis points since early 2007 while fiscal policy provided a small stimulus.

3. **The near-term macroeconomic outlook remains favorable to the financial sector, although slower growth could pose challenges.** Owing to their large exposure to corporate loans and slow progress made in addressing outstanding legacy issues, stress tests show that Thai banks are vulnerable to a sharp slowdown in growth. The main channel of macroeconomic risks for the Thai economy and financial sector are: (i) a significant deterioration in global economic growth, with exports accounting for over two-thirds of GDP; and (ii) domestically, political uncertainties and delayed implementation of major public investment projects continuing to act as drag on domestic demand and the investment climate. A protracted slowdown would also hurt Thai banks' ability to lower their non-performing assets.

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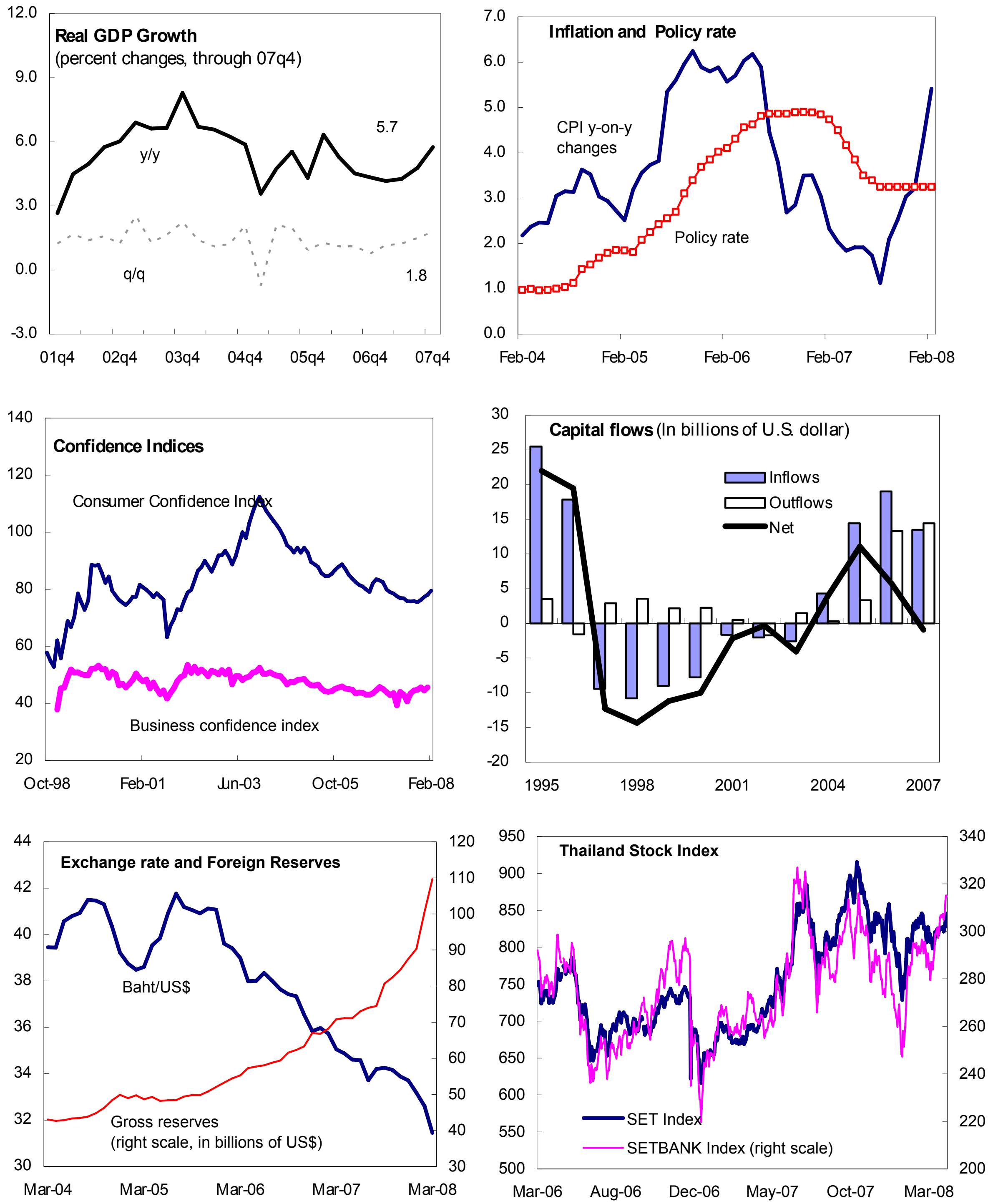
[1] Derived from the national household socioeconomic survey data which are conducted every two years.

[2] Thai commercial banks' total exposure to foreign securities and structured investments such as CDO and structured notes amounted to less than 2 percent banks' total assets at end of June 2007. One bank with a moderate trading book exposure in CDOs is under BOT's supervisory watch.

Figure 1. Thailand: Economic Indicators



Source: Bank of Thailand.

B. Financial Sector

4. **The Thai financial sector is relatively large, with assets close to 180 percent of GDP. It is bank centered, although capital markets and nonbank financial institutions are assuming a more prominent role** (Table 1). Commercial banks account for 60 percent of financial sector assets. Specialized Financial Institutions (SFIs)—which are government-owned, in most cases are deposit-taking, and are intended to promote the government's social and economic development—account for another 14 percent. Nonbank financial institutions hold the remaining 25 percent of financial assets. Many of them (e.g., leasing, asset management, insurance, and securities companies) are subsidiaries of local banking groups.

Deposit-taking financial institutions

5. **The deposit-taking financial system underwent a major restructuring over the past decade.** This includes: (i) the closure and mergers of a number of finance companies; (ii) the implementation of the government's Financial Sector Master Plan, resulting in new entrants, mergers, and the formation of new banking conglomerates; and (iii) ownership changes from private bank recapitalizations, government intervention in banks, and the sale of two banks to foreign investors.

6. **Foreign-owned banks play an important but limited role.** Foreign banks accounted for about 18 percent of total banking assets at end-March 2007—in line with many emerging market countries.[3] In accordance with BOT rules, they operate mostly as single branches, with only two full-service foreign-owned commercial banks. While a one branch policy restricts the size and scope of their retail banking activities, some have used outsourced distribution channels with support from internet banking and telemarketing to penetrate the retail market. Most foreign banks are focused on the wholesale market. Domestic banks do not have a major presence abroad. Despite some entry restrictions, the banking sector does not appear concentrated, with the Herfindahl index at 910.[4]

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[3] This includes the shares of fully foreign owned Standard Chartered Thailand (SCT) and United Oversees Bank Thailand (UOBT) as well as the market shares of the foreign branches.

[4] Based on end-March 2007 data for all individual banks' market share (local banks and foreign branches). When the Herfindahl index is between 1000–1800, the market structured is viewed as somewhat concentrated. If above 1800, highly concentrated, and if below 1000 not concentrated.

Table 1. Thailand: Structure of the Financial System
(In billions of baht)

	1996	In percent of total financial assets	2006	In percent of total financial assets	2007	In percent of total financial assets
Financial Sector Assets	10,004		13,965		14,924	
In percent of GDP	217.0		178.7		175.9	
Deposit-taking financial institutions						
Banks	5,537	55	8,653	62	9,006	60
Private banks	3,859	39	5,691	41	5,981	40
3 largest private banks	2,343	23	3,407	24	3,680	25
Others privately owned	1,516	15	2,284	16	2,301	15
State-owned	1,206	12	1,835	13	1,823	12
Foreign-majority owned	472	5	1,127	8	1,202	8
Subsidiaries	0	0	12	0	12	0
Branches of foreign banks	472	5	1,115	8	1,190	8
Specialized Financial Institutions (excluding state AMCs) 1/	718	7	2,015	14	2,075	14
(in percent of total financial sector assets)	7.2	0	14.4			
of which deposit-taking SFIs (4 + SME Bank)	683	7	1,947	14	2,075	14
- Taking deposit currently	683	7	1,891	14	1,961	13
- Non deposit taking	0	0	56	0	114	1
Finance Companies	1,767	18	81	1	47	0
Credit Fonciers	9	0	2	0	0	0
Non-Bank Financial Instiutions						
Insurance companies	235	2	833	6	953	6
Life	146	1	700	5	816	5
Mixed	0	0	0	0	0	0
Nonlife	89	1	133	1	137	1
of which: state-owned	0	0	0	0	0	0
Mutual Funds 2/	247	2	1,050	8	1,437	10
Securities dealers (brokers)	1,491	15	123	1	142	1
Pension Funds 3/	n.a.	n.a.	667	5	755	5
of which: state-owned	0	0	276	2	313	2
Leasing Companies	n.a.	...	n.a.	...	n.a.	...
Venture Capital Companies	n.a.	...	1	0	n.a.	...
Asset Management Companies (AMCs)	n.a.	...	540	4	509	3
State-owned	n.a.	...	461	3	437	3
Privately-owned	n.a.	...	79	1	72	0
Number of Insitutions						
Commercial Banks	29		34		34	
SFIs	4		6		6	
of which deposit-taking SFIs	4		4		4	
Finance Companies	91		6		5	
Credit foncier	12		4		3	
Insurance companies	76		99		98	
Mutual Funds 2/	205		726		830	
Securities dealers (brokers)	83		41		43	
Pension Funds 3/	n.a.		526		514	
Leasing Companies	n.a.		n.a.		n.a.	
Venture Capital Companies	0		2		2	
AMCs	0		15		15	
Memorandum items:						
Nominal GDP	4,611		7,813		8,485	

Sources: Thai Authorities.

1/ Including deposit and non-deposit taking SFIs

2/ Including Property Funds for public but excluding special funds.

3/ Including provident funds and government pension fund.

7. **Despite considerable divestiture since the crisis, the government continues to maintain a significant equity stake in the commercial banking sector (Table 2).** This equity stake resulted from the 1997 financial crisis, and while the government has since reduced its participation in these banks, the pace of divestiture has slowed in recent years. It currently has controlling interests in three banks and significant shares in three other large local banks as well as a number of smaller banks. These banks accounted for 41percent of total commercial banking sector assets at end-2006.

Table 2. Thailand: Developments in the Government's Equity Stake of Thai Banks 1/
(In percent of total)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007 2/
Bank Thai	7.4	100.0	100.0	100.0	96.3	49.0	49.0	49.0	49.0	49.0	32.9
KTB 3/	57.3	99.1	90.9	90.9	90.9	90.9	90.9	60.1	56.4	56.3	55.5
TMB	0	0	0	0	10.3	10.3	10.3	10.3	31.2	31.2	31.2
SCIB	8.5	100.0	100.0	100.0	100.0	100.0	100.0	79.0	47.6	47.6	47.6
SCBT	0	0	25.0	25.0	25.0	25.0	25.0	25.0	-	-	-
SCB 4/	4.0	2.6	2.6	2.4	2.1	1.7	1.3	1.0	0.9	0.8	0.8

Source: Thai Authorities.
1/ Data reflects developments in the government's equity stake in large Thai banks, a number of which received government support during the 1997 financial crisis. The government also has equity holdings in other smaller banks, including Tbank and ACL.
2/ Latest data observation August 2007.
3/ The government intervened in KTB in the 1980s.
4/ 2007 data reflects the common shares held by the Ministry of Finance of Siam Commercial Bank. The government via Vajupuk Funds also holds preferred shares of SBC. The government's shareholdings of SBC amounted to 19 percent at end-August 2007.

8. **Banking fundamentals continue to strengthen, with most banks reporting high capital levels and solid operating profitability (Table 3, Figure 4).** The average risk weighted capital adequacy ratio (CAR) for Thai banks was 15 percent at end-2007, well above the regulatory minimum (8½ percent), supported by a high level of Tier 1 capital and a strong leverage ratio. While banks have reported strong operating profits since 2004, driven by higher margins and moderate loan growth, net profits fell in 2006 and 2007 due to large provisioning requirements arising from the phased introduction of International Accounting Standards (IAS 39). Banks' return on assets (ROA) fell to 0.3 percent in 2007 compared to 1.4 percent for 2005. The three largest private banks achieved full compliance with IAS 39 at end-2006. Other banks, some which raised additional capital including through new foreign strategic partners, phased in their compliance during 2007. Two state-banks with low capitalization are being closely supervised by the BOT.

9. **Since the financial crisis, banks have diversified their revenue base, which has helped improve their risk profile**. Banks have focused on expanding their services to retail customers and small- and medium-sized enterprises (SMEs). This has helped them diversify their loan and revenue base, reduced earnings volatility and lowered the concentration risk associated with lending to larger corporates. Concerned over the rapid pace of consumer lending, starting in 2004 the BOT introduced a series of prudential measures to strengthen

lending standards.[5] These measures have contributed to a reduction in the pace of lending over the past two years and there was no evidence that the rapid growth had resulted in rising consumer nonperforming loans (NPLs).

Table 3. Thailand: Banks' Profitability and Solvency Indicators [1]
(In percent)

	2005	2006	2007	Avg 2000-07
Return on Assets (ROA), all banks	1.4	0.8	0.3	0.7
Private banks 1/	1.4	0.7	0.2	0.3
State-owned banks	1.1	0.8	-0.1	1.5
Foreign branches	1.4	0.9	1.4	1.2
Return on Equity (ROE), all banks	12.1	7.1	7.1	8.1
Private banks 1/	15.8	7.7	7.7	1.5
State-owned banks	16.3	10.4	10.4	30.3
Foreign branches	4.8	4.2	4.2	3.6
Capital Adequacy Ratio (in % of RWA) 2/	13.0	13.6	14.6	13.1
Private banks 1/	13.5	13.9	14.9	13.3
State-owned banks	11.7	12.7	13.5	12.4
Regulatory Tier 1 Capital (in % of RWA) 2/	9.8	10.7	11.7	9.5
Private banks 1/	10.1	10.9	12.0	9.3
State-owned banks	8.9	10.2	10.5	10.4
Leverage ratio (capital in percent of assets) 2/	7.6	7.6	8.4	10.6
Private banks 1/	8.5	8.4	9.4	12.1
State-owned banks	5.0	5.2	5.0	7.0

Source: Bank of Thailand, and staff estimates.
1/ Includes Thai Military Bank in which the government has a large stake.
2/ RWA stands for risk weighted assets. Data excludes foreign branches.

10. **Considerable efforts have also been made to strengthen banks' capital position and enhance their risk management practices.** Recent regulatory measures include revisions to loan loss provisioning guidelines to comply fully with IAS by end-2007. This has led to higher provisioning charges for the banking system as a whole (Figure 5), although a few large and mid-sized banks still have low loan loss coverage. The BOT has also adopted a conservative approach to Basel II implementation, now expected at the end of 2008. Banks are aligning their risk management practices and IT systems for the move to Basel II and all but one bank have indicated they intend to adopt the standardized approach.

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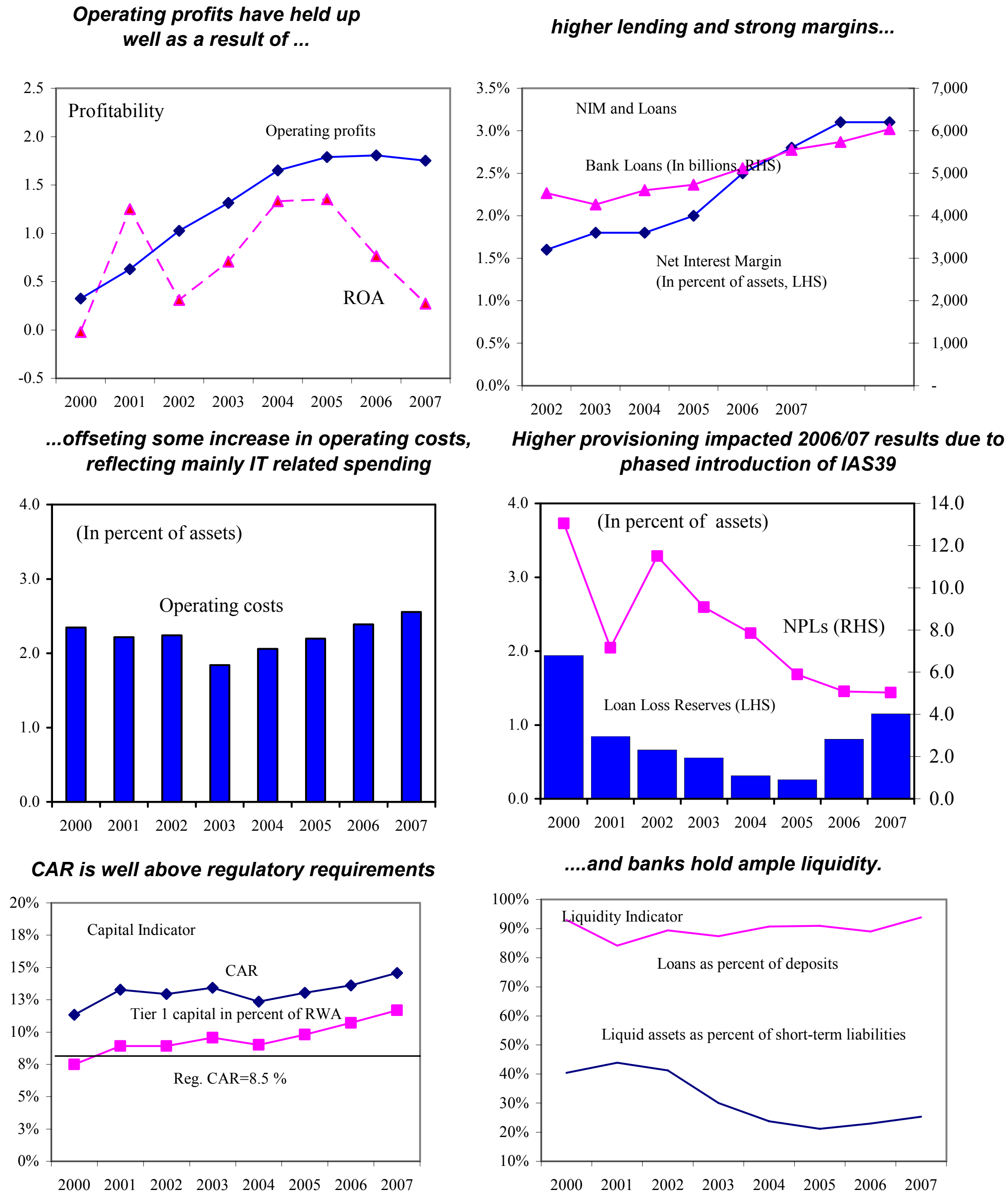
[5] These include: (i) increasing minimum installment repayments on credit card debt outstanding; (ii) minimum qualifying income for credit cards and interest rate ceilings on credit card charges; (iii) imposing stricter credit line limits for personal loans; and (iv) setting the maximum loan-to-value ratio at 70 percent for mortgage loans exceeding B 10 million.

Figure 4. Thailand: Banking Sector Financial Soundness Indicators



Source: Bank of Thailand, and staff calculations.

II. Banking Stability

11. **Despite considerable efforts to improve banking soundness and lower NPLs, Thai banks remain exposed to large holdings of NPAs and restructured loans.** Total NPLs among banks amounted to 7.3 percent of total loans at end-2007, a modest improvement from 8.3 percent in 2005. This was driven primarily by lower NPLs among private banks. Most of the NPLs are loans that were previously restructured and have fallen back to NPL status or assets acquired through foreclosure. This figure may underestimate the problem given the high re-entry rate of previously restructured loans to NPL status and, until recently, lax guidelines governing classification of restructured loans.[6] The magnitude of the problem is also higher if loans and foreclosed assets warehoused with the state-owned AMCs are included. The gross level of distressed assets in banks and AMCs amounted to B 1.5 trillion at end-2007, or 17.5 percent of GDP.

Table 4. Thailand: 2007 Ratings of Six Largest Commercial Banks

	Moody's		Fitch	S&P	
	Long term deposits	BSFR	Individual	Long term Foreign Issuer	Outlook
Bangkok Bank (BBL)	Baa1	D+	C	BBB+	Stable
Krung Thai Bank (KTB)	Baa1	D-	C/D	BBB	Stable
Siam Commercial bank (SCB)	Baa1	D+	C	BBB	Stable
Kasikornbank (Kbank)	Baa1	D+	C	BBB	Stable
TMB 1/	Baa2	D-	C/D	BB+	Negative
Bank of Ayudhya (BAY) 1/	Baa3	D-	C/D	BBB-	Positive

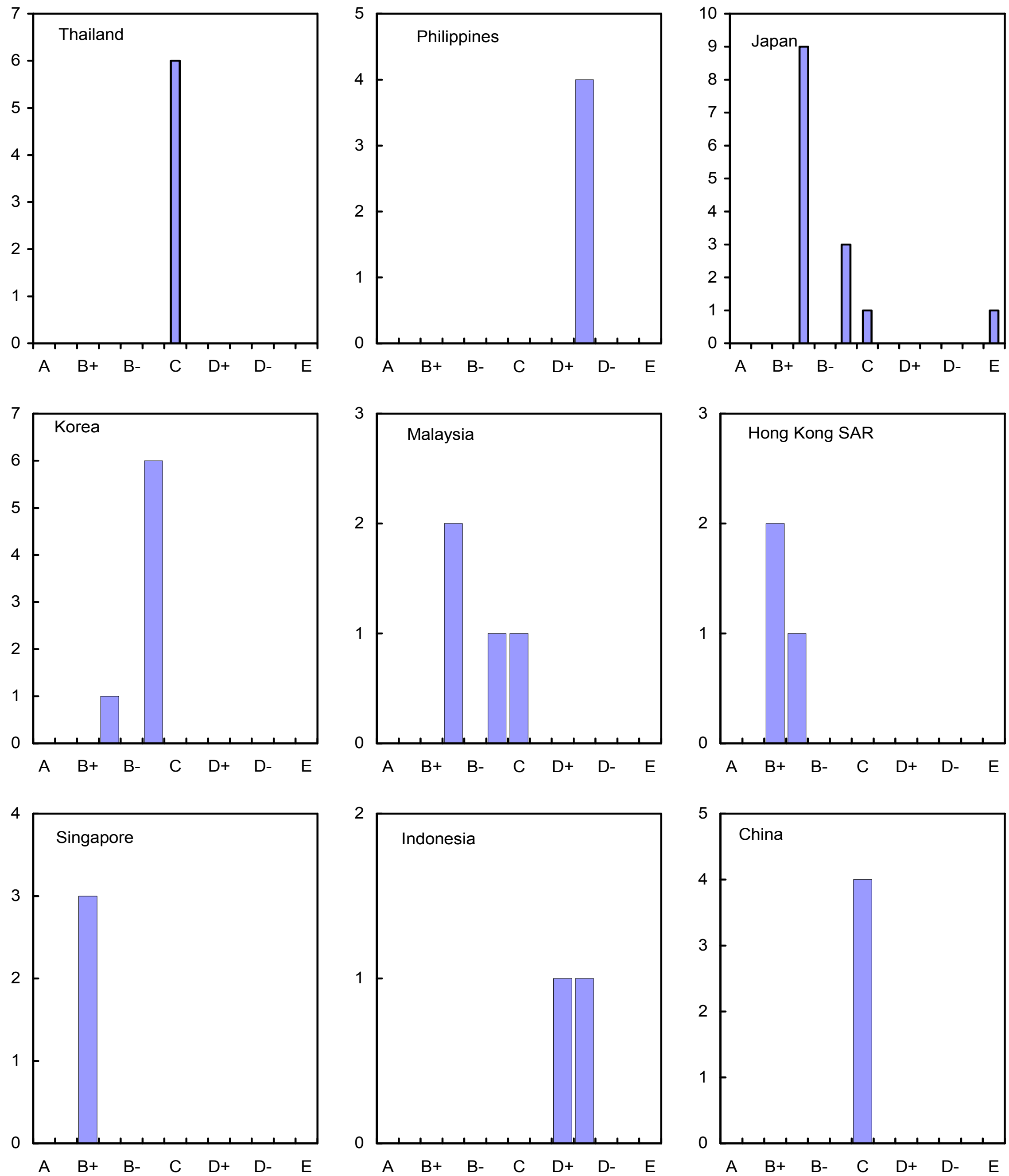
Source: Moody's, Fitch, Standards and Poors (S&P), and Bloomberg.
1/ Individual ratings for TMB and BAY were upgraded in 2007 due to capital raising efforts and the emergence of a major foreign strategic shareholder.

12. **Banks' large holdings of NPLs, the poor performance of restructured loans, questions regarding adequacy of provisioning levels, and unfinished legal reforms weigh on banks' credit ratings and risk perception** (Table 4, Figure 5). This is visible in the C/D rating in Fitch's Banking System Index, in the individual D ratings in Moody's Bank Financial Strength Rating (BFSR) and the Group 6 (scale of 1–10 with 1 the highest) Banking Industry Country Risk Assessment (BICRA) ranking by Standard and Poor's.[7]

[6] As of end-2006, restructured loans amounted to 5.7 percent of total bank loans. On average, about 14 percent of such loans reenter into nonperforming status. There is no updated data on restructured loans for 2007.

[7] Fitch and Moody's industry ratings measure the strength of the banking system, based on individual ratings of the core banks in the system while abstracting from potential government support. Standard and Poor's looks at the strengths and weakness of the overall economy and banking industry, while also accounting for the government's history in intervening in the banking system.

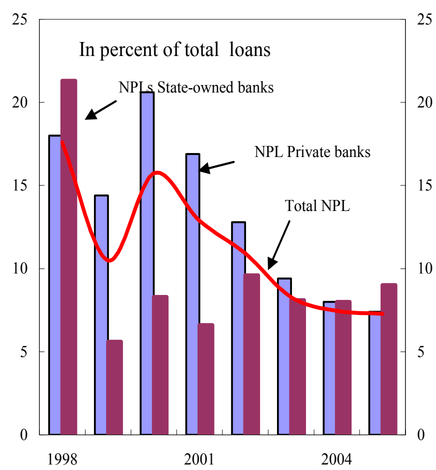
Figure 5. Thailand: Standard & Poors' Distribution of BFSR Ratings for Systemically Important Banks in Asia (2007) [1]



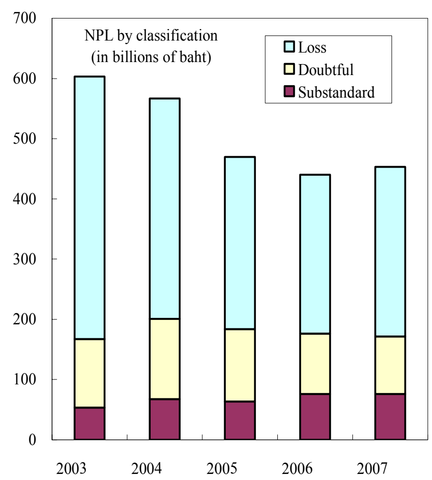
Source: Standards & Poors
1/ Left hand side reflects the number of systemically important banks. The ratings reflect S&P's bank's stand-alone credit ratings, represented by the Bank Fundamental Strength Rating (BFSR). BFSR is based on an asssessment of a bank's fundamental strengths. 'A' reflects very strong and 'E' significant weaknesses.

Figure 6. Thailand: Distressed Assets and Loan Loss Provisions

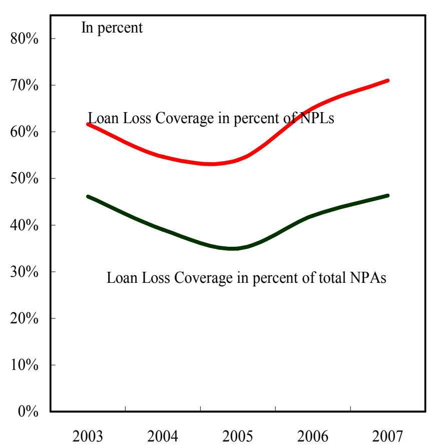
NPLs have declined since the crisis.



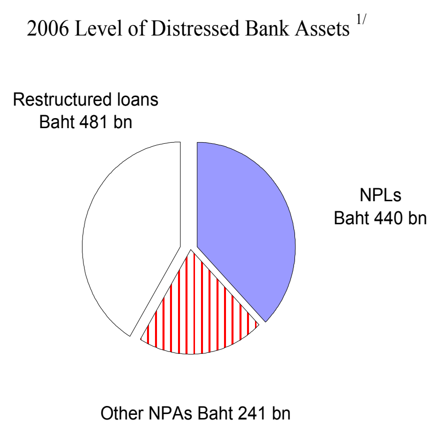
NPLs reflect mainly bad debts not written off for legal and tax reasons.



Loan loss provisioning has increased...



...but exposure to non-earning assets and restructured loans remains high.



Sources: Bank of Thailand, and staff calculations.
1/ The BOT does not collect or monitor the stock of restructured loans on a regular basis. Information for 2006 was collected as a result of a BOT survey. Restructured loans tend to have a relative high reentry to NPL status.

regulation. Where there are gaps, without due delay, the authorities have already taken steps to implement some of the recommendations and are carefully considering the others to develop the policy agenda for further enhancing effective supervision. As banking activities are changing rapidly around the world, and the internationally accepted regulatory environments are swiftly evolving, our policy objectives in the coming years are to continue to work towards achieving optimal compliance with the existing BCPs and the revised BCPs, and equally ensuring the strength of our system for continued growth, stability, and the protection of consumers and market integrity.

57. **As reported in the Detailed Assessment (DA), Thailand fares satisfactorily well in both essential and additional criteria in banking regulation system measuring against international best practices.** The authorities would like to highlight some of those elements mentioned in the DA and those discussed during both missions so as to provide complete and balanced information in our response associated with this summary report.

58. **We agree with the FSAP mission's findings that the laws had not kept pace with what we needed to perform our job in the past.** While the explicit legal powers are to be preferred, the FSAP mission confirmed that they did not find interference and we have continued to press ahead to achieve the high quality outcomes. However, the legal infrastructure going forward will be greatly strengthened in line with international best practices. In December 2007, the National Legislative Assembly has passed the new FIBA and Deposit Protection Agency (DPA), and the amendment of the BOT Act. Under the new FIBA, the BOT will have broad explicit supervisory power, including the authority to conduct consolidated supervision and take prompt corrective actions. The BOT will have sole responsibility for virtually all ongoing supervisory tasks, while the Minister retains the formal authority to grant or revoke licenses, but only on BOT's recommendation. The amended BOT Act will further enhance operational independence of the BOT as the Governor will be appointed on a fixed term basis (5 years), with conditions for premature dismissal explicitly specified in the law. The new DPA will provide explicit, limited deposit guarantee to depositors as well as reduce moral hazard in the financial sector.

59. **As Basel II will be fully implemented in Thailand in 2008, BOT is committed to sound regulation and is actively considering the recommendations contained within the report for future policy outcomes.** Under the current laws, BOT has implemented various regulations. The major regulation now in place includes the consolidated supervisory framework, which gives the broad range of powers to review the banking structure, its related parties and nominees. We also have developed an early warning system and bank resolution methodologies to enable BOT to take necessary, prompt corrective and preventive actions. In line with Pillar II, our continuous, supervisory review process has been strengthened and well-integrated into our system since 2001. The BOT examiners have been enforcing the minimum standards as set out by the current banking law. In addition, where necessary, they have been able to utilize qualitative judgment to gather and independently verify information, and applied a range of penalties when prudential requirements are not met or risks deemed to be material and concentrated. For this vigorous review, coupled with other global forces of change, market participants have responded positively by upgrading their systems and operational structures with more sophisticated risk management and more improved

governance practices. As a result, the system reflects a level of strengthened capital adequacy with a low rate of new NPLs and reentry of restructured loans.

60. **As mentioned in the DA, we have employed various channels of communication and cooperation, ranging from formalized MOU to making informal contacts.** Such system of interagency cooperation and sharing of relevant information has been used for both domestic and foreign regulators. In the domestic context, through the functioning and membership of Financial Institutions Policy Committee (including representatives from MOF, SEC, DOI, the Council of State, FAP, and the Agricultural Futures Exchange), it provides an effective channel for co-ordination, especially in minimizing regulatory arbitrage and conducting problem bank resolution. At the technical level, we are also actively pursuing cooperation as recommended by the FSAP mission. This additional channel will be useful for system-wide policy implementations; first of which may include suitable measures to resolve the problem of legacy NPLs.

61. **With respect to the role of Government in the banking system, particularly SFIs supervision, the economic and social objectives of SFIs, fitting in Thai economic and social development context, should continue to be maintained in SFIs' operations in a foreseeable future.** The international standard practices as recommended by the FSAP mission would help policymakers to come up with the most appropriate reform, design, fitting particular circumstances, for example the need of comprehensive, medium term strategy for the SFIs and a systematic process to evaluate the outcomes and cost effectiveness of government policy intervention. However, the MOF has to be cautious that the assessment is set as a prescriptive norm without certain flexibilities. Then, the application may be difficult to implement in Thailand.

Role of SFIs

62. SFIs are important and vital to provide financial services to specific groups such as the low–income households, farmers and infant SMEs. These groups are the backbone and blood line of the country and do not have access to normal financial markets.

63. **The partial functions of SFIs may be the same as private commercial banks in providing banking services to the people.** However the overlapping of the market segment between commercial banks and SFIs is insignificant. Most of SFIs customers are low and medium income people and in the provincial areas. SFIs provide loans with concessional terms and conditions. The amount of loans is very small compared with commercial banks. It inevitably confirms that Government Housing Bank (GHB) does not increasingly compete with commercial banks. 90 percent of the GHB lending portfolio is loans that are less than 1 million baht.

64. Moreover, the operation of SFIs in the overlapped market segment does not undermine the role of the private financial sector, but it is considered as a benchmark for commercial banks to improve their operation.

Principle	Grading	Description
3.2 The central bank should publicly disclose its balance sheet on a preannounced schedule and, after a predetermined interval, publicly disclose selected information on its aggregate market transactions	O	The Royal Decree requires that the BOT submit to the MOF within three months after the end of each financial year the balance sheet and the income statement along with the report of the CoD on the operations of the BOT throughout the year. There are no other legal balance-sheet publishing requirements. However, in practice, publishing standards by the BOT have been very high. The BOT publishes its assets and liabilities every Friday with a one-week lag on the BOT website. In addition, the BOT publishes its annual balance sheet in the Annual Economic Report by July following the end of each financial year. High-frequency data on BOT open market operations are posted continually on the BOT website. Aggregated data on selected items on market transactions are published on the BOT website, the Quarterly Bulletin and Annual Economic Report.
3.3 The central bank should establish and maintain public information services.	O	The BOT has established the Communications and Relations Office to maintain the relationship with external parties and oversee BOT's publication program. In addition, the BOT has established additional public information services including the Public Information Room and the Interactive Voice Response to provide the public with financial and economic data. Finally, the BOT provides copies of speeches, seminars, research papers and has a publications program.
3.4 Texts of regulations issued by the central bank should be readily available to the public	O	Regulations of the BOT and the summary of important policies and measures are readily available to the public--through BOT website and the Annual Economic Report.
4.1 Officials of the central bank should be available to appear before a designated public authority to report on the conduct of monetary policy, explain the policy objective(s) of their institution, describe their performance in achieving their objective(s), and, as appropriate, exchange views on the state of the economy and the financial system	O	The BOT officials regularly brief the Cabinet on economic conditions and monetary developments. Upon request, the BOT officials appear before the relevant committees at the Senate and the House of Representatives to report on the conduct of monetary policy and exchange views on the state of the economy and the financial system. The BOT also appears before market participants and the broader public to explain the monetary policy and exchange rate objectives, describe performance under the inflation target framework, as well as BOT's view of economic and financial sector developments.
4.2 The central bank should publicly disclose audited financial statements of its operations on a preannounced schedule	BO	The BOT publishes its annual financial statements reviewed by the Audit Committee and audited by the Office of Auditor General of Thailand by July following the end of the financial year. The financial statements are included in the Annual Economic Report.

4.3 Information on the expenses and revenues in operating the central bank should be publicly disclosed annually	O	Information on the expenses and revenues of the BOT is publicly disclosed in its audited annual financial statements in the Annual Economic Report.
4.4 Standards for the conduct of personal financial affairs of officials and staff of the central bank and rules to prevent exploitation of conflicts of interest, including any general fiduciary obligation, should be publicly disclosed	BO	The BOT has code of conduct rules governing personal financial affairs of BOT officials and staff; rules to prevent exploitation of conflicts of interest; and code of conduct rules for the MPC members and BOT staff involved in the preparation of MPC meetings. There is also an internal regulation requiring BOT staff to report the purchase/sale of securities by themselves or their spouse to the BOT within 15 days after the transaction date. Violations of these rules are subject to sanctions. Directors of the CoD are also required to report and disclose their personal assets and liabilities to the National Counter Corruption Commission. The code of conduct rules do not include disclosure for personal assets and liabilities for BOT senior officials. The disclosure rule applies only to Directors of the CoD. There are also no rules requiring the declaration of interest by directors, requirement for directors to refrain from voting if they have interest in a decision and the notation of such declaration in the minutes of the BOT.

Aggregate: Observed (O), broadly observed (BO), partly observed (PO), not observed (NO), not applicable (N/A).