TDRI Quarterly Review
Published in *TDRI Quarterly Review*
Vol. 10 No. 1 March 1995, pp. 8-11
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Thailand's Financial Institutions: Structure and Liberalization*

Executive Summary

INSTITUTIONS

The Thai financial sector comprises a variety of institutions. In most respects, such as the volume of deposits or credits and the number of branches or services, commercial banks dominate. In the past decade, they commanded a 73 percentage share in household savings captured by all financial institutions. The same share was also applicable to credits. Nevertheless, the structure of the commercial banking sector remains strongly biased. Though the banking culture was initiated by a foreign bank, 15 Thai banks within the full 29-bank circuit now control a 97 percentage share. This is largely due to continual government protection. Among all Thai banks, the largest three command one-half of credits and deposits in the entire banking system.

Finance and securities companies represent the second largest type of financial institution in Thailand, handling a 14 percentage share in all financial institutions' assets. Finance companies obtain funds mostly through issuing promissory notes and through borrowing from domestic and overseas banks. Securities companies, on the other hand, engage primarily in securities issuance and trading. At the end of 1992, Thailand had 92 finance and securities companies. Credit foncier companies specialize in immovable properties. They tap funds by issuing medium-term notes (with maturities longer than one year). As of December 1992, there were 18 credit foncier companies in Thailand.

An important rival in long-term financing is life insurance. Although most of the life insurance companies in Thailand (11 out of 12) are of local origin, the market is largely controlled by a foreign company, because of extensive networks, advanced technology, and know-how. Among the three types of insurance policies (ordinary, industrial, and group), ordinary policies account for three-quarters of all insurance sold.

Cooperatives are also operative in Thailand. By the end of 1992, the country had 1,797 agricultural cooperatives and 878 savings cooperatives. Agricultural cooperatives are organized by farmers to facilitate efforts in farming activities and to make low interest credits available to members. Savings cooperatives, on the other hand, are formed mostly on an occupational basis, such as those organized by schoolteachers, policemen, and public employees. Pawnshops, either privately run or government owned, are units which lend money against personal articles. By December 1992, Thailand had 367 pawnshops.

Among government-owned financial institutions, the Government Savings Bank (GSB) outranks all others in numerous respects, for instance, by the number of branches and the volume of deposits. Traditionally, GSB's main function was to tap funds in order to finance government deficits. In recent years, however, the government's perpetual fiscal surplus has enabled GSB to interact with the private sector to a greater extent.

The Bank for Agriculture and Agricultural Cooperatives (BAAC) provides low interest credits to farmers and cooperatives. A considerable portion of BAAC's resources are drawn from commercial banks on a compulsory basis. On some occasions, the Central Bank supplies BAAC with additional credit facilities. The Government Housing Bank (GHB), on the other hand, helps people of moderate income to buy their own homes. Both BAAC and GHB accept time and savings deposits from the general public.

Two other specialized financial institutions are the Industrial Finance Corporation of Thailand (IFCT) and the Small Industrial Finance Corporation of Thailand (SIFCT). IFCT operates along the lines of a private development bank, extending medium- and long-term loans to different private industries. SIFCT is the IFCT's counterpart for small-scale industrial undertakings, including cottage and handicraft industries.

REGULATIONS

The Thai monetary authorities have placed strong emphasis on preserving financial stability. Various stringent rules are therefore imposed on the two influential groups of financial institutions—commercial banks and finance companies. Shareholding, for instance, has to be adequately divested. Each bank or finance company must continually maintain liquid assets amounting to at least 7 percent of its total deposits. In addition, the minimum capital funds to risk assets ratio has to be abided by, and this ratio must comply with an international guideline (or that of the Bank for International Settlements) within a specific time frame.

To maintain financial stability, commercial banks and finance companies are required to diversify their customer profiles. Each is not allowed to extend credits of more than a certain percentage of its capital funds to any individual client. A similar rule also applies to off-balance-sheet obligations, such as avals and guarantees. Banks and finance companies are prohibited from concentrating their equity holding in any one enterprise, regardless of the prospects.

As commercial banks have been heavily engaged in foreign exchange transactions—especially in recent years when more funds moved liberally across borders and exchange rate fluctuations occurred to an unanticipated extent—the monetary authorities have imposed ceilings on commercial banks' foreign exchange positions (covering both spot and forward status). Commercial banks' net foreign exchange assets cannot exceed 25 percent, while net foreign exchange liabilities cannot exceed 20 percent, of their capital funds. These limits are meant to prevent commercial banks from suffering unexpected and/or sizeable exchange losses.

Once new bank branches are established, they have to extend credits to community clients amounting to at least 60 percent of their outstanding deposits. For small districts, one-third of these community credits must be agriculturally related. In contrast to compulsory credits, the Commercial Banking Act prohibits commercial banks from extending credits or obligations to their executives, executives' family members, and affiliated firms. Furthermore, the Act stipulates that persons to be employed as bank executives must not come from the allegedly liable category list.

After the Stock Exchange of Thailand (SET) was established in 1975, several laws controlled the securities business, but in a piecemeal fashion. The Securities Exchange of Thailand Act, B.E. 2517, governed SET activities; the Act on the Undertaking of Finance Business, Securities Business and Credit Foncier Business, B.E. 2522, governed the securities companies' business; the Public Company Act, B.E. 2521, governed the public offering of shares and debentures; and the Civil and Commercial Codes governed such civil and commercial practices as the setting up of limited companies. Other than these confusing regulations, there was no single supervisory agency overlooking all facets of the securities business.

In 1992, the enactment of the Securities and Exchange Act and the establishment of the Securities and Exchange Commission (SEC) completely rectified the above shortcomings. Under the SEC Act, an issuer of shares and equity-related securities is restricted to a public limited company, while an issuer of debt instruments can be both a public limited company and a limited company. Issuers have to disclose reliable and adequate information to provide greater investor protection. Different types of securities business require different licenses. These include: securities brokerage, securities dealing, investment advisory services, securities underwriting, mutual fund management, and private fund management.

The SEC Act also provides for setting up an over-the-counter (OTC) center to facilitate the trading of unlisted securities. Ordinarily, public offering of securities must be processed through SEC. If the securities cannot be listed in SET, they can be traded OTC. SEC retains the power to investigate all unfair securities trading practices and to impose appropriate penalties.

MARKETS

Financial markets in Thailand comprise money markets, the foreign exchange market, government securities and commercial paper markets, and the stock market.

Money Markets. There is a wide range of money markets in the Thai financial system, including the ones for interbank, government bond repurchases, Treasury bills, and Bank of Thailand bonds. Among these, the interbank is not only the oldest but also the most popular one, despite its inherent partiality. Because of their widespread branches and abundant deposits tapped therefrom, few large Thai banks have conventionally been influential lenders in the interbank market, while small Thai banks, foreign banks, and finance companies often act as perpetual borrowers. Transactions are normally unsecured. Interbank rates tend to be volatile and more variable than Eurodollar rates, reflecting both seasonalities and the thinness of the market.

The government bond repurchase (RP) market, established in 1979, serves as a counterbalance to the oligopolistic and personal features of the interbank market. The RP market also helps increase the liquidity of government bonds and functions as another channel for the Central Bank's monetary policy. The Treasury bill market, which recently ceased to operate due to the government's persistent fiscal surplus, was largely captive and heavily dominated by the Central Bank. Bills were auctioned and purchased mainly by financial institutions to satisfy certain requirements.

The Bank of Thailand bonds were issued on an occasional basis so as to absorb excess liquidity from the financial system. In 1987, 1988, and 1990, these bonds, mostly short-dated and meant for particular purposes, were sold to commercial banks. These infrequent issuances did not facilitate the establishment of the secondary market.

Foreign Exchange Market. The two primary actors in this field are commercial banks and the Central Bank-affiliated Exchange Equalization Fund. The former serves exporters, importers, and borrowers, while the latter accommodates the former as the country's foreign exchange bufferstock. Several recent steps to deregulate exchange controls have led to more international movements of funds and more transactions between the baht and foreign currencies. Residents can now maintain foreign currency accounts domestically, whereas non-residents can hold baht accounts locally. Additionally, out-in and out-out flows of Bangkok International Banking Facilities (BIBF), established in 1993, have augmented to a record level the transaction volume in the foreign exchange market.

What should be noted in this regard is that exchange rates in Thailand are still unilaterally specified by the monetary authorities. And the value of the baht has not fluctuated much relative to the U.S. dollar, the major constituent of the currency basket utilized in the current exchange rate policy.

Government Bond Market. This market has been rather dormant, because the authorities often require the bond holding for specific purposes, e.g., liquidity reserves ratio. Consequently, the coupon rates have not reflected the market condition and thin market status has hindered the development of secondary market trading. Further, the government's recurrent fiscal surplus since 1988 has dampened the prospect for the government bond market.

Commercial Papers. These debt instruments have lately attracted strong attention in the financial arena as alternative means to tap funds, especially after the new securities law and SEC came into play. Commercial papers are normally issued by financial institutions or large and well-recognized corporations without any guarantee. Such issuance is encouraged by the authorities and it will help develop secondary market trading.

Stock Market. The Stock Exchange of Thailand (SET) started operation in April 1975. Its initial period did not see much trading. The atmosphere in the subsequent period deteriorated markedly as a result of the second oil price crisis and the worldwide surge of interest rates. The Black Monday event on October 19, 1987 and the Persian Gulf War (August 2, 1990) represented other clear-cut evidence that SET is highly susceptible to external factors. Meanwhile, the authorities did not hesitate to implement policy actions or to amend pertinent regulations to correct the problematic situation. A number of common funds, for instance, were pooled from the Government Savings Bank, the Thai Bankers Association, the Central Bank, and SET brokers as a means to prop up stock prices and rescue investors. At times, finance and securities companies were allowed to invest more in stocks, and borrowing margins were loosened.

The year 1992 saw several significant developments in the Thai capital markets. The new Securities and Exchange Act was enacted, while the governing body or the Securities and Exchange Commission (SEC) was established. The Act paves the way for further development of both primary and secondary markets for debt and stock instruments, e.g., warrants, mutual funds, and convertible debentures. These changes represent a major renovation, since the previous rules and regulations—which were either too stringent or intricate—were properly relaxed. Moreover, various regulators or supervisors were unified into a single unit, or SEC, which not only screens and approves stock/debt issuance but also oversees SET's patterns of trading.

PREDICAMENTS

The stock market was not the only financial institution which suffered disturbances from the world markets. Finance and securities companies and commercial banks in Thailand also underwent several rounds of stresses and strains, partly due to fluctuations on the external frontier.

Prior to 1979, the growth of finance and securities companies was very rapid, but the quality of their performances was questionable. Given that these financial firms emerged in the late 1960s, their mismanagement and/or immaturity were understandable.

From 1978 to 1979, liquidity shortages were exacerbated by excessive speculation and stock price manipulation. The difficulties were further compounded by high interest rates around the world. Fearing repercussions affecting the overall financial stability of the country, the monetary authorities finally intervened and offered assistance to the market.

Despite this intervention, a number of finance companies still suffered from the aftermath of the first crisis. The economy during that period (1981 to 1983) was weakened by major changes in the world economy: a slackening global demand, an increase in foreign interest rates relative to domestic rates, and a larger extent of exchange rate volatility. Some finance companies tried to compensate the sluggish atmosphere by extending voluminous credits, but without sufficient care. Frauds and mismanagement were rampant in many other finance companies. These factors led to a second crisis in 1983.

The magnitude and severity of the second crisis were far greater than those of the first, resulting in numerous revocations of licenses and mergers as well as acquisitions of finance companies. The number of firms decreased—from 127 in 1982 to 107 in 1987. In addition, the central authorities amended the pertinent laws and set up in 1984 the "April 4 Lifeboat Scheme" to rehabilitate troubled companies while offering rescue to their depositors.

In spite of the fact that commercial banks had more experience in the financial arena than finance companies, they still encountered difficulties which arose from frauds, mismanagement, and exchange and interest rate fluctuations. One small bank, for instance, suffered from imprudent portfolio management caused by maturity mismatching and excessive exchange risks. In these cases, the Thai monetary authorities did not hesitate to step in to preserve financial stability in the market. Examples of rescue measures included: the reorganization of management teams, the enlargement of capital bases, and the provision of soft loans.

In addition, the Commercial Banking Act was amended to enable the authorities to deal with troubled banks in a more flexible, effective, and timely fashion. The Financial Institutions Development Fund was also established as a separate legal entity to rehabilitate ailing financial institutions and to safeguard depositors.

LIBERALIZATION

The above-mentioned measures to restore economic and financial stability typically characterize the persistent attitude among most economic policymakers in Thailand. This was the prime reason why between 1980 and 1987 financial liberalization received little attention from the Thai authorities, despite the rapid advancement of telecommunications technology and a growing volatility in interest rate and exchange rate movements in world markets. The central authorities gave top priority to resolving fundamental macroeco-nomic problems (e.g., economic slackening, current account deficit or savings gap, and inflation) and micro-economic plights (e.g., ailing finance companies, problematic banks, and chit funds). When all these entanglements were under control in the late 1980s, Thailand began to experience impressive economic expansion and recurrent surpluses on the fiscal balance and the balance of payments. Enhancing the competitiveness of domestic financial institutions and restructuring the financial system then became more pressing issues.

Amid waves of deregulation and stronger competition worldwide in both trade and finance, the Thai monetary authorities believed that, though financial liberalization had not been imposed by any country or agency, it seemed to be the only viable choice for the Thai financial system to cope with rapid market fluctuations. It came as no surprise, then, that after 1988, a number of market-oriented policies were implemented. These included the dilution of exchange controls, the liberalization of interest rates, and a wider scope to the financial institutions' operations. Furthermore, the basic financial infrastructure was upgraded in several respects. The Bank for International Settlements' guideline on capital adequacy was adopted, for example, while offshore Bangkok International Banking Facilities (BIBF) were initiated. The following crucial agencies were also established: the Securities Exchange Commission, more mutual fund companies, a credit rating agency, and the Export-Import Bank.

Because the monetary authorities gradually relaxed certain regulations, broadened the scope of financial institutions' operations, and allowed branches of financial institutions in both metropolitan and rural areas more room to function, Thai financial institutions are expected to be improved and upgraded via takeovers or mergers and acquisitions, and via entries of new members for each type of financial institution.

Overall, the government may seem to have forgone some of its previous directive control over the temperature of the economy. Valuable benefits from financial liberalization have, however, emerged, though gradually and implicitly via automatic adjustments of prices and quantities. The central authorities have not lost all their discretion. They can still utilize indirect means to influence the market, such as intervention in the repurchase market and moral suasion. These means have thus far proven effective in creating the conditions for a smooth transition to a dynamic and efficient financial system.
