

The Evolution of Thailand's Financial System: Future Trends

Pakorn Vichyanond*

Since 1990, the structure of the Thai financial system has undergone a remarkable shift: not only has the number of market participants risen markedly, but the volume of their market activities has grown exponentially. For instance, while the number of quoted companies in the Stock Exchange of Thailand jumped from 130 in the late 1980s to 295 in the early 1990s, the capital funds mobilized by these firms via issuance of securities more than tripled from 13.1 billion to 46.3 billion baht per annum in the same period. In addition, several policy measures allowing money market players to undertake some capital market activities and vice versa have further integrated the money market and capital market components of the Thai financial system.

This study analyzes these and other "liberalizing" changes in the Thai money and capital markets. Section 1 outlines the various steps toward financial liberalization permitted thus far by the Thai monetary authorities and presents the rationale behind such moves. Section 2 discusses the positive and negative effects of such policy actions from several different perspectives, namely, those of the general public, financial institutions, and the government. Section 3 presents probable scenarios for the future evolution of the Thai financial system and Section 4 addresses the effects of such changes on the above-mentioned parties.

LIBERALIZATION THUS FAR

Amid the growing wave of globalism in the mid-eighties, Thailand was fortunate in that its monetary authorities were far-sighted enough to begin progressive deregulation of the financial sector. The underlying rationale for deregulation was clear-cut: financial institutions had to be given more freedom to undertake market activities if they were to be competitive in the future. Keener competition, in turn, would benefit consumers through greater choice, at the same time, benefiting society in terms of better efficiency of resource utilization. Stronger market forces, of course, would also put pressure on dominant banks or finance companies to upgrade the caliber of their financial management. Given this compelling rationale, a series of financial liberalization measures undertaken over the past five years, as described below, thus came as no surprise.

Interest Rates

- Ceiling lifted on long-term time deposits (June 1989)
- Ceilings abolished on all time deposits (March 1990)
- Cap removed on savings deposits (January 1992)
- Ceilings terminated on all deposits and lending (June 1992)

Exchange Controls

- Phase I: Commercial banks process customers' applications for the purchase of foreign exchange without prior approval from the Central Bank (May 1990)
- Phase II: Greater flexibility for private businesses and the general public to purchase and sell foreign exchange covering current account transactions (April 1991); more convenience in processing trade payments (May 1992)
- Phase III: More investment or lending abroad and more baht notes carried into neighboring countries (February 1994)

Fewer Constraints on Commercial Banks' Portfolio Management

Obligated credits. Previously, commercial banks had to allocate credits to the agricultural sector in proportion to total bank deposits. In 1987, 1991, and 1992, this credit policy was modified to cover a wider scope of activities (e.g., regional small-scale industries, wholesale trading of agricultural produce, regional industrial estates, farmers' secondary occupations, and the exportation of farm products), extending beyond narrowly defined "agricultural activities."

Branch opening. Earlier, commercial banks were required to hold adequate government or eligible bonds before opening up branches, primarily because of the enormous government budget deficits that needed to be financed. Since 1987 the government's fiscal position has improved considerably and no government bonds have been issued since 1991. Consequently, the Central Bank progressively relaxed the bond requirement, lowering the ratio from 16 percent of total deposits to 9.5 percent (November 1990), 8 percent (September 1991), 7 percent (February 1992), 6.5 percent (October 1992), 5.5 percent (February 1993), and nil (May 1993). In addition, the Central Bank revamped regulations concerning compulsory credits. Formerly, each bank branch was required to lend a certain proportion of its total deposits to customers living within close proximity to it. The revised policy allows bank branches in each region to collectively extend credits to customers in their region, in proportion to their total deposits.

Reserve requirements. In June 1991, the Central Bank replaced its traditional reserve requirement ratio with the liquidity ratio, permitting commercial banks to substitute other securities for government securities in calculating their reserve balances. This allows commercial banks greater options in investment and asset management.

Capital adequacy. In 1993, the conventional capital risk asset ratio, which had been in use since 1962, was superseded by the Bank for International Settlements' (BIS) guidelines on capital adequacy, modified to fit local conditions. Commercial banks' capital funds are now divided into first tier (paid-up capital, retained earnings, reserves appropriated from net profits, and statutory reserves) and second tier (revaluation of land and buildings, hybrid debt instruments, and subordinated term debts) capital funds. Risk assets are weighted by the degree of their risks, in accordance with the BIS guidelines. Contingent liabilities or off-balance-sheet items are also weighted before being added to risk assets. Effective January 1993, Thai commercial banks were required to maintain a capital risk asset ratio of not less than 7 percent, within which at least 5 percent must be first-tier capital. These two ratios were adjusted upward to 8 percent and 5.5 percent respectively by the end of 1994.

Wider Scope of Operations

In addition to the customary practice of receiving deposits and extending loans, the Central Bank allows commercial banks to conduct related business, such as loan syndication, insurance connection, conducting feasibility studies for projects or investment options, advisory services in mergers and acquisitions, and safekeeping or custodian services. In 1992, commercial banks were permitted to do more business related to financial instruments, including managing issuance, underwriting and distribution of securities, trading of debt instruments, acting as supervisors as well as selling agents for mutual funds, and securities registrars. Finance companies were also entitled to broaden their scope of activities. New services offered by finance companies include leasing, selling government bonds, providing economic/financial/investment information services, and foreign exchange transactions.

Bangkok International Banking Facilities (BIBF)

In the early 1990s, the Central Bank, spurred by Thailand's stable economic condition, liberal exchange controls, and high level of international credit transactions, took action to develop Bangkok into a regional financial center and in March, 1993, it inaugurated the Bangkok International Banking Facilities (BIBF). With BIBF licenses, commercial banks can pursue the following activities: acceptance of deposits in foreign currencies, lending in foreign currencies to both residents and non-residents, and (cross-currency) foreign exchange transactions, with relevant tax concessions.

Export-Import Bank

As another means of promoting Bangkok as a regional financial center, the EXIM Bank was established in February, 1994, to serve internationally trade-related sectors by offering various financial arrangements and risk sharing schemes. From a broader perspective, the EXIM Bank represents a new element of the Thai financial infrastructure and is proving essential amid current globalization and trade liberalization trends.

Capital Market

Although the Stock Exchange of Thailand (SET) was established under the Securities Exchange of Thailand Act of 1974, in its initial few years of operation, a variety of legal regulations kept it from taking off. For instance, the Public Company Act and the amendments to the Civil and Commercial Codes in 1973 did not allow limited companies to make any initial public offerings of their shares. Neither were public companies permitted to offer debentures to the public. New shares first had to be offered to existing shareholders. These provisions significantly retarded the mobilization of funds in the primary market and adversely affected the secondary market as well. In the 10 years following the enactment of the Public Company Act, for example, just 33 companies became public companies due to strict regulations and other stipulations in the Act. Among other things, the Act specified 1) severe criminal and civil liabilities for company directors who do not abide by the Act, 2) that directors be company shareholders and that they hold their posts on the board no more than one year, and 3) that a company with more than 99 shareholders be converted into a public company regardless of whether or not it intended to raise funds from the public.

In addition, the 1974 Securities Exchange of Thailand Act was primarily designed to regulate securities trading in the secondary, rather than the primary, market. In effect, there was no legal framework to supervise the primary market and yet there were too many supervisory agencies overseeing other aspects of the securities business.

Thus, the much awaited revised Securities and Exchange Act, passed by parliament in March 1992, came as a blessing. This Act helps not only to unravel the legal intricacies and correct the drawbacks of previous laws, but also to reinvigorate the local capital market so that the local money market is not too heavily relied upon. In other words, the 1992 Act supports the stock market as a means of strengthening competition in the financial market. Consequently, the Act puts pressure on powerful Thai commercial banks to scale down their degree of market control.

Along with the passage of the 1992 Act, several new institutions were established to streamline the operation and regulation of the capital market. The Act established the Securities and Exchange Commission (SEC), for example, which oversees the operation of the stock market. In addition, a credit rating agency was set up to link investors to borrowers in the capital market with respect to the disclosure and evaluation of pertinent financial information.

Later on, the SEC allowed operation of several mutual funds wherein small unit trusts are sold to investors and the receipts therefrom are collectively handled by means of a variety of investment possibilities in the local stock market. In this context, mutual funds act as channels to link small savers with the capital markets. Without mutual funds, these savers are unlikely to participate in capital market activities because of inadequate funds and a lack of expertise. Viewed from another perspective, mutual funds help strengthen market competition in the local financial market, since small depositors now have alternative channels, aside from typical bank deposits, through which to place their savings.

EFFECTS OF FINANCIAL LIBERALIZATION

The various financial liberalization measures described above have undoubtedly given rise to a more competitive Thai financial market. Theoretically, the general public should benefit the most from stronger market competition in the financial arena because competition should yield lower interest rate spreads and profit margins, smaller service charges, and greater access to credit lines. However, in the first few years of

liberalization, such gains to the general public did not materialize since the market mechanism was not completely adjusted. In fact, the effective profit margin earned by commercial banks in Thailand in those years moved to the contrary, i.e., growing from 1.3 percent in 1990 to 2.3 percent in 1993 because of full liberty in pricing in the absence of adequate competition. In the medium term, more participants as well as competition will certainly come into play, compelling banks to lower their interest rates or charges and expand their credit access to new and low-caliber clients. In this regard, it is likely that financial liberalization will bring about diminution of exorbitant lending in informal markets.

For financial institutions, liberalization can be a double-edged sword, resulting in both gains and losses, depending on how prudently commercial banks and finance companies exercise their new-found freedom in handling portfolios. Financial institutions must bear in mind at all times that greater liberty carries with it more risks which, if not well-managed, may backfire to outstrip any initial gains. Nevertheless, increased competition with respect to interest rates and credit availability pushes financial intermediaries to improve and professionalize their services. In Thailand, this is particularly true as several commercial banks and finance companies have made strenuous efforts to diversify their products and services. Many of them split themselves into various affiliated units specializing in different fields, such as financial consulting, leasing, factoring, and securities underwriting.

Although financial liberalization helps expand the size and role of the financial sector, for government and the economy as a whole it leads to some formidable dilemmas, namely: 1) increasingly volatile interest rates due to the fact that domestic liquidity is more vulnerable to external forces via capital flows, and 2) more difficulties in implementing economic policies to achieve macro-economic objectives (i.e., inflation control and savings mobilization measures). A clear example of the dilemmas is the recent surge of BIBF capital flows into Thailand. While these flows strengthened competition in credit extension, they lessened incentives for commercial banks to tap local deposits. In short, from the government's perspective, allowing market forces greater leeway is indeed a controversial issue.

FUTURE TRENDS

As Thailand moves along the waves of globalization and pursues further financial liberalization, three significant changes in the financial circuit seem unavoidable:

More exchange rate variations. At present, the Exchange Equalization Fund, attached to the Bank of Thailand, unilaterally fixes the daily exchange rates of the baht relative to foreign currencies by tying the baht value to the value of a basket of currencies, defined according to current exchange rates in the world markets. To keep the domestic financial market well-balanced amid waves of liberalization, however, greater exchange rate variations are likely. The magnitude and direction of the variations will depend not only on foreign exchange markets abroad but also on the local exchange market. One can easily recognize the reason for more exchange rate flexibility by comparing the foreign exchange market with the commodities market. For example, when the quantity demanded or supplied varies in the commodities market, commodity prices change accordingly. Similarly, as exchange control mechanisms are gradually dismantled and foreign exchange flows more freely through the BIBF, a strong case can be made for determining exchange rates based not only on exchange rates abroad but also the volume of foreign exchange traded in the domestic market. Furthermore, greater exchange rate variations will permit the government to effectively undertake desirable monetary policies without being disturbed too much by foreign capital inflows or outflows.

As is well known, an increased magnitude of exchange rate variations will affect the real sector, particularly exports and imports. If greater exchange rate variations are gradually pursued, however, the real sector will be able to adjust and cope with the change. In 1984, for example, Thai exports and imports responded well to the shift from a tightly fixed exchange rate scheme to a daily floating exchange rate system.

More capital market activities. It is likely that Thai capital markets will continue to develop, especially now that the necessary financial infrastructure (e.g., the Securities and Exchange Commission, credit rating agency, and secondary markets for debt instruments) is in place. Specifically, capital market activities or

"direct financing" will be indispensable in the near future, as the need for financing in a dynamic economy (like Thailand's) outstrips the resources available from domestic financial intermediaries, such as commercial banks and finance companies. Demand for funds will far exceed the capacity of commercial banks and finance companies, given their current capital base and the difficulties or limits they face in enlarging their capital. More direct financing via capital markets or "disintermediation," therefore, becomes inevitable.

More financial institutions. In the future, not only will the number of different kinds of financial institutions increase, but the number of financial institutions of each type will also grow. While some of this growth can be attributed to commitments and requests from both local and overseas units, some is due to domestic financial sector policies which favor stronger competition. Furthermore, financial institutions of the future may well be the outcomes of mergers, acquisitions, or "upgrading" (i.e., from finance companies to commercial banks). Upgrading, in particular, may also be used as incentives for certain policy objectives, such as separation of finance and securities business or rural credit extension.

LIKELY CONSEQUENCES OF FUTURE DEVELOPMENTS

Once realized, the three future trends outlined above (i.e., increases in exchange rate variations, capital market activities, and number of financial institutions) will profoundly affect the operations of existing banks, finance companies, and government.

For existing commercial banks and finance companies, the number of their high-caliber and creditworthy customers will decline as some of these customers will move to rival institutions, such as capital markets, BIBF, and newcomers to the financial market. Consequently, banks and finance companies will have to handle relatively more risks than ever before. Furthermore, existing commercial banks and finance companies will not be able to resort to as much foreign borrowing as before due to greater exchange rate fluctuations between the baht and foreign currencies.

In short, existing financial institutions cannot afford to stick fast to their conventional practices. To prepare for future changes, banks and finance companies are likely to try to improve financial management efficiency, as well as devise and offer new financial services to match clients' demand. Yet they must be aware of growing risks, since they will be dealing with customers of lower credibility.

As for government, the problems lie in the difficulties of monitoring and supervising financial institutions to maintain stability in the financial system as a whole. Arguably, the government already senses the difficulty of this task as it grapples with the present situation. Currently, financial markets are heavily influenced by the forces of dynamic competition arising from widespread liberalization and global linkages. Not only are there more financial institutions to deal with, but the institutions are now equipped with more innovations—and saddled with more risks—than ever before. As the market continues to expand, it is anticipated that government will resort to relying upon market forces to help it in monitoring and supervising financial institutions, as it did in the past in liberalizing interest rates and cross-border capital flows.

More specifically, the "market-oriented method" of monitoring and supervising financial institutions refers to the following:

Transparency. All relevant data and information will be openly disclosed to keep the public well-informed and alert about how "risky" or how "well-managed" financial institutions are. In this respect, the authorities will probably have to devise a set of easy-to-understand but meaningful indicators to inform the general public.

No automatic or immediate safety guarantee. Given the range of innovations and risks with which financial institutions have great liberty to make commitments, government cannot guarantee all financial institutions. To do so would be equivalent of endorsing a vicious circle for both financial institutions and depositors. That is to say if government were to offer a blanket safety guarantee, financial institutions might be tempted by moral hazard to make unreasonable commitments and, likewise, depositors may be

enticed to make commitments which are adverse selections. In other words, if government were to intervene to preserve the stability of all financial institutions, the plan might easily backfire and generate more costs than benefits.

Commercial deposit insurance. The Thai government may also revise the role of the current Financial Institution Development Fund to make it more market-oriented. The current FDIC could become a "commercial" FDIC or "C-FDIC." The C-FDIC would be assigned the task of aiding monetary authorities to monitor the positions of financial institutions. In addition, the C-FDIC would charge different deposit-insurance premiums depending upon the actual risks carried by particular financial institutions.

As mentioned earlier, this "market-oriented method" of monitoring and supervising financial institutions and activities is driven by the same underlying principles as past methods employed during deregulation and liberalization periods. In publicly declaring that it will not provide total deposit insurance to all financial institutions and depositors (as it has done before) but rather will keep the public well-informed about the status of each financial institution, government is alerting depositors to act in a rational and responsible way.

Thus, individual depositors have two choices: 1) invest according to their own judgment regarding safety ("play the market"), based on information or indicators released by monitoring agencies, or 2) deposit funds only with C-FDIC subscribers ("play it safe"), and rely upon the judgment of the C-FDIC. Either way, choice engenders market forces and, in turn, market forces impel financial institutions to control risks and improve financial management efficiency. If any institution does not do so, the informed depositors will turn to safer financial institutions, mutual funds, or other reliable securities in the stock market. In short, the principle of "buyers beware" or, in this case, it is "depositors beware," will motivate and sustain cautious management of financial institutions.

In addition, transparent monitoring and supervision of financial institutions as suggested above will help restrain them from committing errors or creating problems in the first place. In declaring the appearance of problems at an early stage, monitoring agencies will put pressure on financial institutions to remedy the situation as early as possible, rather than let the problems linger and worsen. In other words, the market-oriented mode of monitoring and supervising financial institutions represents a means of improving the efficiency of one conventional method.

As would be expected, some people may be skeptical as to whether transparency—"no automatic safety guarantee"—and the creation of a C-FDIC are compatible with the "financial culture" that prevails in Thailand, especially among the general public. Similar doubts about the "flexibility" of the public, however, were raised when the exchange rate system was revamped in 1984. Prior to that, the baht-dollar relationship was fixed and people had great faith in the firm parity. Nonetheless, after a short period of adjustment, the concepts of daily flexibility and linking the baht to a basket of currencies were accepted and embraced by the financial community, as well as the general public. Should a new system of monitoring and supervising financial institutions be gradually and prudently introduced, before long the general public will accept that the principle of "entries and exits" is applicable to financial institutions as well.