

Financial Reforms in Thailand

Macroeconomic Policy Program

PATH TO CRISIS

At the beginning of the 1990s, it was envisioned that the Thai financial market would be better off if liberalization was pursued. Thailand's acceptance of the International Monetary Fund's (IMF) Article VIII in May 1990, which lifted foreign exchange controls on current account transactions, marked the beginning of a series of financial liberalization measures. On the exchange control front, the second round of liberalization abandoned most restrictions on capital account transactions in April 1991. The third round, in February 1994, gave more freedom to outward direct investment, travel expenditures, and additional channels of cross-border payments. In March 1993 the Bangkok International Banking Facilities (BIBF) were established to serve as a means to develop an international financial center. To enable BIBF to compete with other centers, BIBF transactions were granted some tax privileges (e.g., reduction of corporate income tax, exemption from special business tax and withholding tax on interest income). Furthermore, the government in January 1995 decided to allow BIBF to open up branches in upcountry provinces.

On the interest rate front, the authorities gradually removed interest rate ceilings in order to encourage savings mobilization and to make the financial system more dynamic. Interest rate ceilings on long-term time deposits were abolished in June 1989, on savings and short-term time deposits in January 1992, and on loan rates in June 1992. In addition, the central bank in 1992-93 gave commercial banks more flexibility by loosening the requirement of government bond holding as a prerequisite for opening up new branches. The obligations of commercial banks to extend credits to rural borrowers or those in the vicinity were also relaxed to cover more related occupations and wider geographical areas. Furthermore, the definition of "liquid reserves" was broadened to include Bank of Thailand and state enterprise bonds, as well as debt instruments issued by financial institutions or government agencies approved by the central bank.

Commercial banks were permitted to undertake new businesses, such as debt underwriting and dealing, acting as securities registrars and custodians, selling public sector debt instruments, mutual fund management, financial consulting, and feasibility studies. Finance and securities companies were on the same footing. Their new lines of operations included leasing, management of provident/private/mutual funds, custodial services, and foreign exchange businesses.

Meanwhile, a number of new frameworks and organizations were formulated. For example, the Securities and Exchange Act was passed in May 1992, giving qualified limited companies access to direct finance through issuing common stocks and debt instruments. The Act established the Securities and Exchange Commission (SEC) as an independent agency responsible for supervising capital market activities related to equities, bonds, and derivatives. In 1993 the government spearheaded the formation of a credit rating agency, Thai Rating and Information Services (TRIS), and in 1994 private parties organized a bond dealers' club to function as a secondary debt market, adding more liquidity to debt instruments. Regarding the payment systems, the central bank improved clearing and settlement, which helped lower transaction costs and facilitate business expansion. The BAHTNET and THAICLEAR networks were put into effect so as to better serve customers' needs. The latest development on this front was the introduction of electronic retail fund transfers through Media Clearing.

This financial liberalization was undertaken between 1988 and 1996 with the following purposes: to strengthen competition in the domestic financial system, to give more resilience to financial institutions, as preparation for the worldwide liberalization of trade and services, and to expand the role of Thailand to serve as a regional financial center.

In 1996 the Thai economy encountered a number of difficulties. Export growth abruptly came to a halt due to weak global demand while imports remained buoyant, resulting in surging current account deficits. Domestic inflation,

meanwhile, was rising, reducing the country's competitiveness in the world market. Unsurprisingly, traders and speculators had growing doubts about Thailand's debt servicing capacity or creditworthiness. In addition, deteriorating positions and increasing Non Performing Loans (NPL) in Thai financial institutions further weakened foreign investors' confidence. Waves of capital outflows, representing (p)repayments of external debts and exchange rate speculation, thus occurred in the first half of 1997 to such an extent that the Bank of Thailand found it impractical to continue defending its long held basket-peg exchange rate policy, even after it resorted to considerable external borrowing to support its foreign exchange reserves. The baht was therefore floated on July 2, 1997. Afterward, capital outflows continued to such an extent that the U.S. dollar reached a peak at 53.71 baht in January 1998 (from 25.75 baht in the first half of 1997). In 1998 Thailand's real GDP contracted by 10 percent. This severe financial crisis was not singular, as it spread to several of Thailand's neighboring countries, demonstrating the reverberating impact of weakening confidence.

ANALYTICAL SCRUTINY

Macro Perspective

It should be noted that though more freedom was given to cross-border capital flows, Thailand's exchange rate peg to a basket of currencies, adopted in 1984, remained in effect. Given the predominant weight of the U.S. dollar (85%) in the basket, the baht did not move much against the U.S. dollar, which did not correlate with the volume or direction of transactions in the Thai foreign exchange market. Instead, the central bank was the sole party which stipulated and defended the daily value of the baht against the U.S. dollar in line with the fluctuations of basket currencies' exchange rates in the world markets. Therefore, interest rate differentials between local and foreign currencies were not offset by exchange risks, so numerous private corporations, as well as financial institutions, took advantage by borrowing abroad at low interest rates without purchasing forward cover.

The financial liberalization measures mentioned above caused a flood of capital into the Thai market in 1990-96, fueling investment spending, speculation, and current account deficits. Meanwhile, excessive and imprudent credit extension engendered too much risk taking and deteriorated asset quality. Evidence of this is plentiful. Net capital inflows between 1990 and 1996 averaged 10 percent of GDP each year, thus expanding the outstanding external debt from US\$29 billion in 1990 to US\$94 billion in 1997, or from 34 percent of GDP to 59 percent of GDP, respectively. Within such mounting foreign debts, the private short-term portion surged from 22 percent to 50 percent, generating increased vulnerability. On the part of financial institutions, speculative and imprudent lending inflated several bubble sectors, not just real estate. For example, the automotive industry, private hospitals, steel, and the petrochemical industry were also inflated. Declining asset quality therefore came as no surprise, except for its speed and extent. Distressed by possible financial panic or bank runs, the central bank could not resist extending financial aid to ailing commercial banks and finance companies. This aid aggravated macroeconomic imbalances. For instance, current account deficits climbed from 5 percent of GDP in 1993 to 8 percent of GDP in 1995-96. Meanwhile, Thailand's excess inflation in comparison to the U.S.'s surged from 0.3 percent in 1993 to 3.0 percent in 1995-96. As a result, by mid-1997 investor confidence was critically shaken. Massive capital outflows, arising from fears of an upcoming devaluation, plus widespread bankruptcies, necessitated the floating of the baht, which triggered a series of financial crises region-wide.

Exacerbated by the sharp currency depreciation, falling asset prices, and a strong downturn of economic activities, financial institutions' NPL jumped from 8 percent of credit outstanding in mid-1997 to 20 percent in December 1997 and to 45 percent in December 1998. By the end of 1998, NPL totaled 2.7 trillion baht or 59 percent of GDP. Worse yet, an emerging moral hazard was fake or strategic NPL because, in spite of their strong debt servicing capacity, numerous debtors suspended remittances of their regular debt servicing. Fake NPL were estimated at one-third of reported NPL.

Thailand's economic meltdown in mid-1997 can largely be attributed to three policy errors:

- Liberalization of foreign capital flows while keeping the exchange rate rigid
- Premature liberalization of financial institutions
- Failure to prudently supervise financial institutions

These errors clearly demonstrate the importance of policy consistency. Should foreign exchange funds be allowed to move freely across borders, their prices or exchange rates ought to be liberalized as well so as to reflect market

conditions. Otherwise, an excess of inflows or outflows could easily materialize, depending upon market sentiment and expectations. The liberalization of financial institutions is an equally controversial issue. Given that domestic financial institutions are not adequately prepared or experienced, the question is whether they should be liberalized, since liberalization could bring about more risks. But once these immature entities are granted more freedom, there is no doubt that the central authority should closely monitor and carefully supervise them throughout the liberalization process, especially during the initial adjustment period.

Once the central bank recognized the danger of limited foreign exchange reserves, it did not aim for any exchange rate target. Rather, it only sought to lean against the wind or smooth exchange rate variations in order to avert a depreciation-inflation spiral. It also resorted to credit and interest rate policies, rather than direct foreign exchange interventions, as a means to restore exchange rate stability, since foreign exchange reserves were in short supply. In other words, exchange rate policy was reversed from an exchange rate target defended by reserves to stable reserves defended by the exchange rate.

Several parties called for another extreme—the creation of a currency board in which the money supply in circulation must be entirely backed by foreign exchange reserves. However, this would lead to a substantial loss of sovereignty over monetary policy, which is a highly precarious situation in the midst of financial havoc and mobile capital flows. The continuing banking crisis, the need for legal and institutional changes, and gathering political uncertainties all argued against a currency board.

Fortunately, the Thai government has emphasized the correction of underlying weaknesses in the country's economic fundamentals, since investor confidence and the country's credibility do not hinge solely on interest rates. According to a recent survey, the seven main factors that influence investor confidence are, in order of priority:

- Political stability
- Competence of the economic management team
- External accounts, including trade balance, current account, and balance of payments
- Efficiency and stability of the financial system
- Foreign exchange reserves
- Asset quality of financial institutions
- Policy consistency or rigidity

The efforts of the Thai government to reduce distortions in fundamentals were successful to some extent, as confirmed by the rising value of the baht, its growing stability ([Chart 1](#)), and improvements in the current account ([Chart 2](#)), even though baht interest rates decreased substantially. These results demonstrate some of the government's achievements in restoring investor confidence, which does not depend on only one or a few variables, such as interest rates or the trade balance. The crisis was rather a consequence of accumulated structural weaknesses. Lasting recovery is thus contingent on comprehensive structural reform. Attempting stabilization without explicit structural reforms, especially in the financial and corporate sectors, would be a costly exercise in treating symptoms without addressing the causes of the disease. In the financial sector, as foreign commercial banks' NPL (10%) were far smaller than those of Thai banks' (42%), it is worth examining details of structural differences.

Micro Perspective

Following international standards or adhering to principles prescribed by headquarters abroad, foreign commercial banks systematically evaluated project feasibility or the viability and debt servicing capability of prospective clients before extending credit. Their lending decisions were mostly cash flow based. Besides, they preferred not only to match maturities between sources and uses of funds, but also to cover their foreign exchange exposure. Most foreign banks are more efficient than their Thai rivals in collecting due debts and adopting advanced technology. Thai private commercial banks were at the opposite end. They paid strong attention to collateral and/or guarantees from reliable or familiar entities. Their lending decisions were asset-based, ignoring cash-flow analysis. Worse yet, they barely accounted for risks from maturity mismatching or foreign exchange exposure. Instead, nepotism and cronyism were of greater significance. Not only did their overdue debts far exceed those of their foreign rivals in proportion, but Thai

commercial banks often lagged behind in terms of technology.

A ranking of the problems that Thai banks and finance companies faced before the 1997 crisis clearly demonstrates the drawbacks in the Thai financial system. First was the lack of systematic credit risk assessment. Thai financial institutions resorted to collateral to an excessive extent, and there was no standard for pricing this collateral, so skewed pricing was prevalent. In other words, feasibility studies and risk appraisal received little attention. Second, extended credit tended to be linked with affiliated businesses, shareholders, and directors. Third, credit extension was speculatively oriented, so loans grew too much in particular periods of time and/or clustered in particular sectors engendering risky bubbles. The two principal factors underlying these problems are low-caliber staff and the fact that the Thai financial sector had been protected for too long, so it was too immature to compete with foreign units, such as foreign banks and BIBF.

At this point it should be noted that though Thai commercial banks may lag behind foreign ones in several respects (e.g., technology, management tactics), they command some advantages, especially in retail banking. Examples of their edges include local networks and familiarity or acquaintance with Thai culture and traditions. Their prospects for further competition with foreign rivals are therefore not negligible. Innovative adjustments (e.g., accommodating more small and medium enterprises, economical branching) could pave the way for firm competitive positions.

Viewed from a broader perspective, managing a financial system is an intricate issue. Protection is needed if a country wishes to develop its own financial institutions and staff. But protection also generates costs, e.g., moral hazard or malpractice. After a while, liberalization consequently deserves consideration. Nevertheless, such a move can be double-edged, depending on how ready domestic financial institutions are to compete and how good the central authorities are to monitor or supervise. The crucial elements are timing and intensity. Too long a protection period or too strong a liberalization drive could easily lead to excessive inefficiency or economic bubbles, respectively.

A similar financial structure and culture is applicable to typical Thai non-bank businesses. One is thus tempted to doubt whether any attempt at rehabilitation will have quick success. Thai corporations have a strong preference toward debt, instead of equity, financing. This is true of business enterprises of all sizes. There are two underlying reasons. First, most Thai companies are family-run and they want to retain control, so they prefer debt to equity. Second, they are further induced by the tax allowances given to debt servicing but not to dividend payments. Consequently, typical Thai business enterprises are not concerned about fixed obligations or the burden of debt financing. They also ignore the susceptibility to liquidity shortages that debts can easily bring when roll-over is needed.

Thai businesses, especially small ones, tend to be shortsighted in terms of their financing. They resort to short-term funding first. For example, overdraft facilities are widely used, even for long-term projects. In other words, to them maturity mismatching is not threatening, although frequent roll-overs or refinancing occasionally lead to financial strains. Worse yet, some modern entities that resort to external funds often leave their net foreign exchange positions uncovered or unhedged, especially at times of stable exchange rates. This is in sharp contrast to foreign firms or their affiliates.

On the part of the central authorities, the main shortcomings lay in the areas of supervision and examination. These duties were carried out by two separate departments at the central bank. Regulations before 1997 explicitly stated that before any preventive or corrective actions could be undertaken, the results from an examination had to be disclosed, and be affirmative. However, due to inadequate or inefficient staff, the examination department's normal procedures took so long that by the time any action was permitted, the situation at ailing financial institutions was beyond rescue. In other words, remedial actions were made useless by regulations and inefficiency in the examination process. Moreover, the regulations contained an excessive degree of subjectivity or too much discretion was involved. For instance, the clause "in accordance with discreet standards" was often referred to.

In contrast, some bank examiners argued that the problem was not the process itself, but in what happened afterward. In other words, they knew what problems existed at which local banks, but they were asked to "tone down" the language used in official reports. That means that political interference, fears of fueling public panic or a systemic crisis, or conflict of interest led to poor coordination among regulators themselves and the inefficient resolution of banking problems.

ALREADY DONE

In 1997 the Thai government promulgated several emergency decrees to undertake a financial restructuring package. It contained the following essential elements:

- In cases of urgent need, the Bank of Thailand has the authority to order a commercial bank or finance company, without having to go through a shareholders' meeting, to write down its capital below the value stipulated by law and to allocate share increases. In addition, the Bank of Thailand, with the approval of the Minister of Finance, has the power to remove directors or executives of such commercial banks or finance companies and appoint replacements. The purpose of this additional authority is to allow for timely intervention in inefficient financial intermediaries that experience large losses endangering the public interest.
- The Bank of Thailand Act was amended to reaffirm the government's commitment to have the Financial Institutions Development Fund (FIDF) guarantee depositors and creditors, with full financial support from the government.
- Battered by the 1996 economic downturn, the sluggish property sector in Thailand led to considerable deterioration in the quality of asset and collateral at commercial banks, generating a continuous rise in NPL. The tension was exacerbated by the baht's depreciation. The Property Loan Management Organization (PLMO), set up in 1997 and upgraded in 1998, was to provide liquidity to financial institutions by purchasing their impaired property loans and to facilitate the completion of concerned projects. The PLMO's scope of business was later expanded to include securitization, operation of property mutual funds, turnover of real estate projects and property collaterals. In this context, the authority also permitted financial institutions to set up their own property loan management companies to operate in a similar fashion to the PLMO.
- The Secondary Mortgage Corporation (SMC) was established in 1997 to provide liquidity for financial institutions by purchasing retail mortgage loans, to reduce interest burdens, and to securitize purchased mortgage loans. These functions should encourage the extension of housing credits, enabling the poor to afford their own accommodation. Another underlying objective was to develop a benchmark yield curve for the bond market.
- The Financial Sector Restructuring Authority (FRA) was set up as an independent entity with the following objectives:
 - To review the rehabilitation plans of suspended finance companies
 - To assist *bona fide* depositors and creditors of suspended finance companies
 - To administer the liquidation of finance companies which the FRA considers unable to be rehabilitated.
- The Asset Management Corporation (AMC) was established to bid for or to purchase the impaired assets of finance companies that the FRA deemed no longer viable. The AMC was also empowered to enter a bid for good assets to support a competitive bidding process. The AMC manages the purchased assets in order to enhance their value, or it can foreclose the collateral and resell it as soon as possible. The AMC is entitled to receive some privileges, such as exemption of Value Added Tax (VAT) and special business taxes.
- Ratanasin Bank (RB) was set up as a "good bank" to purchase and manage the good assets of the suspended finance companies. Later, RB was assigned to merge with the ailing Laem Thong Bank as one means of financial renovation.
- The limit on the foreign ownership of shares in commercial banks and finance companies was lifted from 25 percent to 49 percent (and later to 100%), effective for up to 10 years. This was done to enlarge financial institutions' capital base and strengthen their management tactics.

The FRA's strategy for financial sector reform involved:

- Identifying and resolving nonviable institutions
- Protecting viable institutions
- Dealing resolutely with nonviable institutions
- Distributing the burden: Shareholders must bear losses first, pursue cases of fraud and gross negligence, not allow willful loan defaults, minimize public sector costs

- Protecting depositors

The FRA laid down the following guidelines for the rehabilitation of suspended financial institutions:

- Only the strong may reopen
- Strict asset classification and provisioning
- Adequate capital cushioning
- Suitable ownership and management
- Maturity of borrowing from the FIDF lengthened
- Conversion of FIDF debt to equity only after the write-down of existing shareholders' capital

On December 8, 1997 after examining the detailed status and proposed rehabilitation plans of all 58 suspended finance companies, the FRA decided to permanently shut down all but two. The FRA based its decision on the following criteria:

- Capital adequacy and sources of additional capital funds
- Capability in liquidity management
- Ability to repay debts to the FIDF
- Reliability or trustworthiness of executives

Both the depositors and the creditors of the 56 defunct finance companies were provided with government guarantees, while shareholders could claim the excess of assets over liabilities. The monetary authority aimed to separate “good” and “bad” assets of the defunct finance companies. The “good” ones were handled by RB, while the “bad” ones were to be sold to and managed by the AMC.

On March 31, 1998 the Bank of Thailand tightened regulations on loan classification, provisioning, and reporting standards, aiming to upgrade local financial institutions to international levels by the year 2000. Effective July 1, 1998, the definition of non-performing assets was changed to cover loans three or more months in arrears, instead of the previous six (or 12) or more months. Two new loan categories, pass and special mention, require 1 percent and 2 percent provisioning, respectively. Meanwhile, commercial banks as well as finance companies had to increase provisions for substandard loans from 15 percent to 20 percent ([Table 1](#)). Doubtful loans required a 50 percent provision rather than the previous 100 percent, but loss loans continued to necessitate 100 percent coverage. These new standards forced local banks to increase their capital by as much as 80 billion baht by the end of 1998, on top of the 129 billion baht previously added. Finance companies needed 42 billion baht of new capital on top of the 20 billion baht recently added. Banks have to set aside up to 100 billion baht in new provisions for loan losses, while the set asides by finance companies totaled 43 billion baht.

The system adopted in March 1998 also called for quarterly, instead of annual, audits and credit reports to be submitted to the central bank. Loan portfolio reviews have to cover at least 70 percent of credit outstanding, including the top 100 clients and credits or commitments to related parties. The measures also demand that financial institutions tighten their lending practices and credit analysis procedures, focusing more on borrowers' cash flow and debt servicing ability, rather than on loan collateral. Debt restructuring or renegotiations must be subject to realistic assessments of financial viability of clients or their projects.

On August 14, 1998 the government decided to nationalize six commercial banks and five finance companies. Some of these were merged with government banks or finance companies, while some were to be sold to interested parties later on. In addition, the government offered assistance to other financial institutions undergoing recapitalization as follows. If financial institutions commit themselves to comply with new loan loss provisioning immediately or earlier than the previously targeted year of 2000, they are entitled to enlarge their first-tier capital by issuing preferred shares to the government in exchange for tradable government bonds. Furthermore, as a means to motivate debt restructuring or reconciliation with problem clients, the government put forward an option to financial institutions to increase their

second-tier capital by exchanging non-tradable bonds with banks' newly issued debentures, equaling the losses suffered by financial institutions in their debt restructuring.

The underlying dual objective of the August 14 package was to reform the financial system so that new asset classification and loan loss provisioning could come into effect as soon as possible while reinvigorating the economy at the same time. If financial institutions were left by themselves, they could hardly extend credit because their huge existing NPL have to be backed up by capital funds, which were rather scarce and whose enlargement was very difficult in the midst of the prevailing economic depression. At this point, it is worth clarifying that the credit crunch is not due to liquidity shortages, as interbank interest rates dropped from 24 percent to only 1.5 percent ([Chart 1](#)). The problem was essentially caused by the inadequacy of financial institutions' back-up capital funds as demanded by the above-mentioned new loan classification and provisioning standards. Financial institutions could hardly extend credit or lower interest rates (so as to revive spending and combat the economic downturn) because NPL raise costs by compulsory provisioning. In other words, interest rates on credit do not depend only on deposit or interbank interest rates. They rely heavily on asset quality as well.

In retrospect, high domestic interest rates in the first half of 1998 were largely the consequence of substantial borrowing by the FIDF (or the rescue arm of the central bank) from short-term money markets to fund long term bail-out operations. In order to both obliterate this market distortion and provide funding channels for the August capital support facilities as stated above, the government authorized in August 1998 an emergency decree enabling the issuance of special government bonds worth 300 billion baht. This restructuring of the FIDF's liabilities certainly ameliorated the market scenario, as evidenced by the considerable decreases in the interbank interest rates. Meanwhile, better current account balances induced investor confidence to recuperate to such an extent that the baht recovered markedly, from 47 baht/US\$ in June 1998 to 36 baht/US\$ in December 1998, despite plunging interest rates ([Charts 1 and 2](#)).

What should be noted is that the August 14 capital augmentation measure is voluntary, depending on the discretion of financial institutions. It turns out that few banks resorted to the capital enlargement opportunities offered by the government, particularly the Tier 1 option. This indicates that banks have been reluctant to write down their capital in return for public money and accept the dilution of ownership that would ensue. Instead, they raised capital through the issuance of preferred stocks linked with subordinated debentures, or the so-called SLIPS (Stapled Limited Interest Preferred Shares) and CAPS (Capital Augmented Preferred Shares). Though these new instruments are appealing to some savers in the presence of low deposit interest rates, they still contain some inherent risks, as concerned principals receive no government guarantee and some returns are performance-based.

Other than adjusting the positions or status of the financial institutions, restructuring corporate debt is definitely another crucial element for both financial sector reform and economic recovery, because successful debt restructuring will help resolve the NPL problems of financial institutions and resuscitate economic activities simultaneously. The government therefore set up a corporate debt restructuring advisory committee to coordinate negotiations among debtors, their potential new partners, bankers, and finance company managers. Frameworks of corporate debt work-outs are based on the "London Approach" under which creditors: work together, share all information about debtors, recognize the seniority of claims, seek out-of-court solutions, and agree to keep credit facilities in place.

Examples of resolutions are interest rate reductions, maturity stretching, partial write-offs, and debt-equity conversion. However, debt negotiation is not an easy task. It involves not only strong pressures from several parties (e.g., debtors, their potential new partners, local and foreign creditors, central bankers, internal revenue officers) but also legal and regulatory constraints. In this context, the government tried to help by amending bankruptcy and foreclosure laws. Meanwhile, the government removed tax disincentives in order to encourage debt renegotiations. Nevertheless, corporate debt restructuring remains a lengthy and difficult process and represents a major stumbling block to economic recovery.

Before examining why the debt restructuring process is difficult and lengthy, it is useful to notice some major differences between the four types of financial institutions in Thailand: the eight surviving private Thai commercial banks, the state-run commercial banks (including the ones taken over after the crisis), foreign commercial banks, and the 35 surviving finance companies ([Table 2](#)). Of the total credit outstanding as of December 1998, private Thai commercial banks commanded the largest share (51%), while finance companies had the smallest (8%). However, with regard to asset quality, the picture is almost the opposite, as finance companies' NPL were the highest at 70 percent, while private Thai commercial banks' NPL were 42 percent. The high NPL of state commercial banks (62%) should not be misinterpreted. The primary reason for this is that the government took over six ailing private commercial banks after the crisis, so their NPL raised the average of state commercial banks. Foreign commercial

banks were at the other extreme, holding the lowest NPL (10%).

On the part of foreign banks, their systematic approach yielded satisfactory results or low NPL. But given their limited share in the Thai financial market (due to legal constraints on branching and new establishments), their low NPL were of little consequence to the market as a whole. And because they had extended credit on an unsecured basis (no collateral or guarantees), foreign banks were more willing than Thai banks to renegotiate with debtors after the crisis. But their small market share made this willingness less meaningful in the overall context.

Thai commercial banks, on the other hand, hesitated to pursue rescue packages for ailing debtors. The collateral and/or guarantees that they commanded tempted them to try to foreclose the concerned assets or to sue guarantors instead of petitioning for rescues. Worse yet, even though the Thai bankruptcy law was amended in June 1998 with the addition of the possibilities of rehabilitation or rescue packages (like Chapter 11 of the U.S. law), the rescue option requires consensus among creditors (or at least 75% of creditors' voting rights covering at least 50% of outstanding debts). This makes the Thai banks' hesitation to renegotiate debts more influential. It is thus unsurprising that 90 percent of the debt restructuring cases that experienced serious difficulties involved Thai commercial banks.

In many cases creditors tried to foreclose collateral. But in Thailand the foreclosure procedure is very lengthy. Although the foreclosure law has recently been revised, the protracted period of time involved does not make this option attractive to creditors, especially when the concerned asset prices do not appreciate much. Both secured and unsecured creditors are therefore trapped in the horns of a dilemma. Although the final outcomes of legal prosecution (foreclosure or bankruptcy) are likely to be favorable to creditors, the procedure is time-consuming and costly due to the income foregone from and the requirements of NPL. On the other hand, debt restructuring, in a genuine sense, may yield quicker results and help avert NPL-related difficulties. But relaxing the terms of loan contracts means a reduction of creditors' income as well. Given that Thai banks typically commanded collateral and/or guarantees, they prefer extending repayment schedules to accepting any loss. In other words, Thai banks are rather tough as they often insist that debtors repay 100 percent of the principal together with interest, which is drastically different from debt concessions abroad where only 50-70 percent in returns is deemed excellent.

Debtors also face a quandary. Because of their excessive borrowing in the past and excess capacity at present, they are overwhelmed by an intolerably heavy debt burden. Long acquaintances and good relationships with particular creditors often tempted debtors to favor some creditors over others in the debt restructuring process. But such bias can hardly be accepted without inter-creditor agreements. If debtors resort to new partners to share debt servicing, the new partners have to be ones whose creditworthiness is acceptable to creditors. Meanwhile, new partners are tempted to demand several conditions or methods of protection before making capital investments or in sharing debt obligations. Without new partners, either debtors could go bankrupt when sued by unsecured (foreign) creditors, or debtors' assets could be lost to foreclosure when sued by secured (Thai) creditors. Besides, inter-creditor agreements are often difficult to reach since different creditors have different conditions or back-up securities (guarantees or collateral), depending upon their loan contracts.

One resolution to debt restructuring is swapping debts to equities or shares in debtors' companies. However, some debtors are reluctant to do this as they would like to retain the family-run nature of their companies. The unwillingness of others to adopt debt-to-equity conversion as a means to rehabilitate their businesses is due to the fact that such a route would require disclosure of relevant information, some of which is deemed confidential in their family circle. Another resolution is partial or total write-off, or the so-called hair cut. Some foreign banks (such as Japanese ones) prefer to avoid this route in accordance with their headquarters' guidelines. Other banks also hesitate, as some of them hold collateral and a hair cut necessitates a capital reduction while new capital funds are now extremely difficult to tap.

Even if financial institutions allow for some write-offs, tax problems arise. For instance, commercial banks have to pay taxes on accrued interest and principal even though they have yet to collect them. In the midst of debt restructuring efforts, banks thus request tax credits or refunds on the irrecoverable portion of accumulated debt service. But the tax law demands official prosecution if the money involved exceeds 500,000 baht. As for debtors, forgiven debts are treated as income subject to the 30 percent business tax. This requirement decreases the incentives for debtors to restructure their debts. Moreover, since the Revenue Department has priority over other creditors when claiming debtors' income or assets, such priority makes creditors less willing to write off parts or all of their overdue debts.

But creditors' hesitation to restructure debts could be costly as well because, according to the new requirements on loan classification and provisioning, the longer the debts are overdue, the larger provisions or capital supports become

necessary (see [Table 1](#)). And abiding by such a rule is now very painful, as financial institutions are finding capital funds scarce in their pockets and tapping them from the market represents a formidable task.

Another vicious circle of NPL occurs when Thai commercial banks hesitate to roll over maturing debts of even good clients, as the precarious environment drives banks to retrieve most credit as soon as possible. This hesitation creates pressure on banks' clients, and they could consequently become new NPL, either out of necessity or voluntarily.

Overall, the fact that Thai commercial banks tend to resist both hair cuts as well as extending new credit makes large scale debt restructuring unsuccessful, and economic recovery delayed, if it takes place at all. Interpreted in a broader sense, commercial banks and finance companies are not earnest enough in restructuring loans. This is in sharp contrast with the American situation in the 1990s, where U.S. banks were willing to accept massive loan write-offs, which helped reverse the economic downturn, and revive property prices.

Nevertheless, strenuous efforts at financial reform in Thailand have achieved some results. These include:

- Viable financial institutions were segregated from unviable ones. Fifty-six finance companies were closed down and their assets were liquidated through the FRA's auctions. Six ailing commercial banks were handled on a case-by-case basis, i.e., integrated with state banks (FBCB, LTB, UB), their good assets transferred (BBC), recapitalized by the government for subsequent privatization (BMB, SCIB).
- The remaining financial institutions were strengthened by improvement in supervision, upgrading of loan classification and provisioning, greater foreign ownership, and recapitalization. Foreign financial institutions acquired substantial shareholding in small banks (TDB, BOA, NTB, RB) and thereby enlarged their capital base. Large Thai banks were successful in recapitalization by issuing a new hybrid between preferred shares and subordinate debentures. The so-called SLIPS and CAPS offered buyers a combination of preferred shares and debts with guaranteed minimum returns. They therefore attracted strong interest from general investors in the midst of the low-interest-rate scenario of 1999. It is thus unsurprising that large private commercial banks succeeded in augmenting their capital base to a considerable extent. As for the ones that could not do so, the FIDF stepped in and assisted. Between 14 August 1998 and 12 May 1999, financial institutions in Thailand attained the following amounts of recapitalization, either through the August capital support measure or their own efforts: private commercial banks—190.148 billion baht, state commercial banks—254.137 billion baht, finance companies—3.119 billion baht, grand total—447.404 billion baht.
- More foreign participants or shareholders in commercial banks will help upgrade the management strategy of these banks. In other words, more objective systems and a stronger cash flow will be adopted, which should result in fewer and more manageable risks.
- The process of corporate debt restructuring was successful to a certain extent. The accumulated number of successful debt restructuring cases went from 9,016 in December 1998 to 17,667 in February 1999, and to 30,763 cases in March 1999, covering 155.566 billion baht, 215.863 billion baht, and 280.936 billion baht, respectively. (Nevertheless, 2.7 trillion baht worth of NPL remains to be worked out.)
- Enhanced bankruptcy and foreclosure laws were passed. In addition, a bankruptcy court was established. These reforms will help facilitate debt restructuring, and thereby consolidate the financial system.
- In September 1999, a credit bureau was officially organized. Spearheaded by the Government Housing Bank, the bureau helps interchange debtor data among creditors. This is expected to favor creditors in reducing credit risks and in raising efficiency levels in risk assessment and management. Practically, the credit bureau is an enlargement of the central credit registration previously administered by the central bank.
- The Bank of Thailand on September 24, 1999 stipulated the limit on credit that commercial banks could offer to companies where bank executives sit in the administration. The limit is a minimum of 50 percent of client's equity, 25 percent of the client's total liabilities, and 5 percent of the creditor bank's first tier capital. Senior executives of commercial banks cannot hold more than 1 percent of subscribed stocks of a limited company. Furthermore, senior bank executives are not allowed to serve as directors in more than three limited companies. These restrictions are meant to build up good governance and transparency, which will serve to prevent NPL from occurring as a result of connected lending.

These changes, however, did not come free of charge. In fact, their costs were substantial, and they took several forms:

- The first parties to bear the cost (of writing off bad debts) were existing shareholders of financial institutions. The government utilized this channel as a prerequisite for injecting new capital support in the August measures.
- The issuance of FIDF bonds places a heavy burden on the government. By January 1999 the FIDF had issued roughly 400 billion baht of bonds, the proceeds of which were used to lend to or recapitalize ailing financial institutions. Whether they are recoverable depends on the future status or privatization of these units.
- Upgrading regulations on financial institutions (i.e., loan classification, provisioning, capital adequacy) in a short timeframe caused a vicious downward spiral on the real sector because tighter rules meant more NPL, which in turn required further provisioning and capital increases, which made banks more reluctant to lend to the real sector. This in turn led to a credit crunch in the real sector, more recession, and more NPL in the business sector. Unsurprisingly, Thailand's real GDP contracted by 10 percent in 1998, generating a myriad adverse socio-economic impacts.
- Closing down some commercial banks and finance companies meant not only laying off staff but also discontinuing credit lines to some companies. The latter led to production cuts or downsizing, which worsened the employment environment. The situation was aggravated by corporate debt restructuring since new terms of debts often necessitated adjustment of debtors' financial operations and streamlining of relevant costs, which inevitably raised unemployment. Labor ministry's statistics demonstrate the plight of workers, as the unemployment rate rose from 4.8 percent in February 1998 to 5.47 percent in February 1999. The number of laid-off employees surged from 5,015 in 1996 to 38,217 in 1997 and 51,498 in 1998. These figures are consistent with decreasing capacity utilization (72.4% in 1996, 65.0% in 1997 and 52.1% in 1998). This clearly indicates the costs of correcting the economy's external balance and in restructuring the country's financial system.
- Though successful financial reforms will lead to sustainable economic growth, the process, which involves more information disclosure, could weaken market confidence and country's credibility in the short run. Whether such confidence and credibility will be restored depends on the achievements of financial reforms in the long run.

Among all the above-mentioned costs, those that most capture the attention of the public are the ones borne by the government. This is because the government's fiscal attempts to encourage financial sector restructuring (through capital injections) and to accelerate spending (through tax cuts and increased expenditures) sharply increase the government's outlays and indebtedness. According to World Bank projections, the pace of public debt buildup is alarming in the four crisis-hit Asian countries, particularly Indonesia and Thailand.

REMAINING TASKS

The financial sector crisis in Thailand has proved to be systemic, requiring major restructuring, which takes many forms, i.e., separation of good and bad assets, capital enlargement, adjustment of debt overhangs, more qualified staff, improvement of management strategies (e.g., credit risk assessment, standard valuation criteria for collateral, systematic databases), legal amendments, better ethics, good governance, adoption of international standards, and upgrading of clients' financial status or viability. These components deserve equal, immediate, and simultaneous attention. It is thus understandable that the pace of financial sector restructuring in Thailand has proceeded slower than envisaged.

While the government was successful in overhauling the bankruptcy and foreclosure laws, which help to expedite debt restructuring, it encountered difficulties in speeding up capital enlargement. This is understandable as investor appetite for bank equity diminished rapidly once the financial crisis emerged. Although the government decided to provide direct assistance through capital injection, capital funds alone can neither reform nor revive financial institutions. Other aspects of financial reform, as mentioned above, are also essential.

Recent experience has clearly indicated that strong foreign financial institutions will assume growing influence in the Thai financial market in all regards. They are holding larger stakes and taking greater management control in the previously protected banking circuit in Thailand. Consequently, if Thai banks are to survive, the following is likely to happen.

1. Family banking will gradually disappear, and so will connected lending.

2. The introduction of professional management will gather momentum, as will the role of technological adjustment.

The chances of survival will increase if Thai commercial banks resort more to mergers and acquisitions, because these will yield benefits from economy of scale and the increased ability to compete with foreign rivals. In the medium term, mergers and acquisitions will also help in resolving NPL, recapitalization, and technological advancement.

All of the fundamentals of Thai financial institutions need to be improved, especially the caliber of staff, management tactics, and ethics, if financial reform is to have long-lasting positive effects. This warning is applicable to all means of restructuring in the financial system in Thailand. For example, separating good and bad assets through private AMC, mergers, takeovers, or even foreign participation, may not mean much if fundamental weaknesses are not remedied. Imprudent credit extension, further NPL, and another financial crisis may recur. On the other hand, better staff, efficient management, and improved ethics can permanently upgrade and consolidate the financial system.

Specifically, recommendations for the future course of banking and finance in Thailand can be divided into two groups: involuntary and voluntary. The first is to be achieved by implementing new rules and regulations, while the second represents a gradual process of adjustment which depends upon several factors, such as government incentives, new foreign shareholders, and the banks' own discretion.

The involuntary course consists of the following.

1. Pertinent rules and regulations need overhauling. Currently, financial institutions are controlled by types (e.g., commercial banks, life insurance, and cooperatives). But financial liberalization has allowed financial institutions to pursue the businesses that they had never before handled. Therefore, financial institutions should rather be regulated by functions. Otherwise, regulations can easily become ineffective because of leakage or inefficiency. For instance, overlapping between banking and insurance or banking and cooperatives can make rules for each type of financial institution ineffective. Function-wise rules have already been adopted by some advanced countries, such as the United Kingdom and New Zealand, covering functions such as brokerage, commercial banking, and investment banking.
2. The basis of laying down rules and regulations should be re-oriented toward more objectivity. Less subjective judgement will help avoid loopholes and biases. Nevertheless, in some areas, regulators should distinguish assets of more and less risks depending upon their underlying qualities. For example, assets or debtors within the same business category may receive different weights depending upon inherent status or debt servicing capacity. This new risk weighting system corresponds to the new Bank for International Settlement (BIS) system, which is a refinement of the previous one.
3. Both examiners and supervisors should focus more on forward looking analysis rather than just monitoring bank accounts. This is essential since financial institutions have to manage volatile cash flows over a period of time. Forward looking regulators will therefore help detect whether problems may recur in the system, and if so, when and where.
4. More accountability should be required from bank executives or operators, since their actions or decisions have a strong bearing on their banks' performances. These executives should be held liable to criminal charges, or they should have to put up some of their own stake as contingent liabilities for excessive NPL. This will help motivate bank executives or operators to take more care over the efficiency and asset quality of their banks.
5. The standards on accounting, detailed information, and transparency need to be upgraded so that the financial system will be underpinned by the following qualities: sustainability, checks and balances, and effective internal controls.
6. Once urgent problems in the Thai financial system are resolved, a deposit insurance agency should be established as a means to impose more market mechanisms on financial institutions. Otherwise, excessive risk taking or moral hazard and financial crisis could easily reappear.

The voluntary part has two components that largely depend on each financial institution's administration: human resources and good corporate governance. Development of these two items will help improve the core of the financial system. And once these two items are achieved, together with the above-mentioned accountability, accounting

standards, detailed information, and transparency, regulating financial institutions will not be difficult, and examination will become unnecessary. In other words, when these six conditions hold, regulations specified by the central authorities will be continually abided by, and thus automatically prevent problems. Such a situation is certainly possible, e.g., as in New Zealand. Therefore, the central authorities should press for an improvement of human resources and corporate governance in financial institutions.

Together with the above-recommended policy actions, governments in developing countries may adopt some early warnings of banking crises. As suggested by Gonzalez-Hermosillo (1999), the ratio of capital equity plus loan reserves minus NPL to total assets, or the so-called coverage ratio, serves as one good indicator of bank fragility. However, other indicators pinpointing market risk and liquidity risk should also be considered. In short, an appropriate early warning system ought to take into account both relevant microeconomic and macroeconomic factors.

The central authorities ought to prepare local financial institutions to cope with the upcoming changes in the global financial arena. For instance, at present the Bank of Thailand requires financial institutions to maintain a capital-to-risk-asset ratio of 8.5 percent in accordance with the BIS's 1988 Capital Accord. At least half of the capital base must be in the form of tier-one capital, defined as equity (common and preferred stocks) and retained earnings. The rest, or tier-two capital, consists of subordinate debts and revaluation of assets.

In June 1998, the Basel Committee on Banking Supervision of BIS released a draft framework to replace the 1988 Accord. The new framework focuses on three areas.

- *Minimum capital requirements:* the broad, five-step risk weight system will be replaced with a credit assessment system that will more finely determine the risk of loans and other assets. Assessments will be made through external sources, such as credit agencies, or through internal bank risk models. Other types of risk, such as operational and interest rate risks, will be factored into calculating minimum capital requirements.
- *Supervisory review process:* the framework encourages early supervisory intervention to ensure that capital is sufficient for an institution's risk profile. Regulators could require different institutions to raise capital beyond minimum requirements. Internal risk management systems at banks will be regularly reviewed.
- *Effective use of market discipline:* banks will be required to disclose information about their capital structure, accounting practices, and key risk exposures.

The new framework aims at correcting longstanding weaknesses in the existing accord. For instance, interbank loans to institutions in countries within the Organization for Economic Cooperation and Development (OECD) were assigned a 20 percent risk weight, despite the fact that the actual default rate might be far higher. For non-OECD countries such as Thailand, the existing accord encourages banks to lend short-term, as loans of up to one-year maturity carry a risk weight of only 20 percent while long-term claims carry a 100 percent weight. This was one of the reasons that led to excessive short-term borrowing, the crucial element that triggered the Asian financial crisis in 1997 when investor confidence was critically shaken.

The revised capital framework could be implemented in Thailand as early as 2001, introducing tier-three capital (subordinate debts with maturities of up to five years) to supplement the existing tier-one and tier-two capital. Capital requirements would become more finely tuned to the risks taken by different banks. Calculations would factor in not just credit and market risks, but also liquidity positions, maturity structures, and operational risks taken by financial institutions.

Though the five-step risk weight system will certainly be replaced by a credit assessment system, it remains debatable as to who should be responsible for the risk assessment: external sources such as credit rating agencies, or banks themselves. Using external sources will result in ratings that are comparable worldwide. However, obtaining such ratings will certainly take more time and money, raising overall costs to borrowers. In any case, local bankers have expressed concern as to whether the timing is right to introduce new capital requirements.

Another challenging issue that the Thai monetary authorities have to cope with in the near future is the stronger momentum toward financial liberalization. The U.S., for example, has already passed the Financial Services Act of 1999 that supersedes the Glass-Steagall Act of 1933. The 1999 Act overhauls the U.S. financial system by allowing financial institutions to undertake functions that they were not previously permitted, i.e., an overlap among commercial banks, securities firms, and insurance companies. This is likely to result in more competition, efficiency and cost reductions, innovations, and diversity of financial services. It will also raise the number of mergers and

acquisitions around the world. Even though consumers will certainly benefit from this move, small developing countries (like Thailand) have to be cautious. Lessons from the 1997 financial crisis indicate that several ingredients (e.g., maturity of financial institutions and their supervisors) have to be in place for financial liberalization to be successful. Therefore, the Thai monetary authorities should be wary in coping with further liberalization in the global arena. Gradualism is typically a safe route toward successful and stable adjustment.

Equally challenging is the course of capital market development in Thailand. In order to assure general investors of the honesty and reliability of the performances of listed companies, the Stock Exchange of Thailand (SET) stipulates detailed prerequisites for new entrants, e.g., minimum profits for a certain number of consecutive years, a minimum number of shareholders, etc. But these requirements are seldom met by small and medium-sized enterprises (SME) in Thailand. Most SME, therefore, have to rely on debt financing from commercial banks plus finance companies, and funds from informal money markets or crony connections. What is more worrisome is the number of these SME. Unit-wise, SME total about 90 percent of all Thai private enterprises. Even though their final output has not reached a sizable share of GDP, their future prospects are important in terms of economic development, income distribution, and social welfare. At present, although there are a few specialized financial institutions designed specifically for SME, i.e., the Small Industry Finance Corporation and the Small Industry Credit Guarantee Corporation, due to their limited capital funds and branches, they have not been able to satisfy the financial needs of the majority of SME.

Two possible solutions to the SME plight are the following. First, developing domestic debt markets will help reduce the excessive reliance on banks and finance companies as the principal vehicles for term financing. More developed domestic debt markets would also lower the risks of maturity mismatching. Second, special purpose vehicles (SPV), such as those in Japan, may be set up to issue asset backed bonds directly marketed to savers. These SPV may need guarantees from the central authorities in order to gain enough confidence of savers. Once in operation, SPV can immediately serve SME effectively, as SPV should be able to pool risks and develop expertise in efficiently handling SME. SPV will help reduce the NPL of both commercial banks and finance companies, while invigorating the economy. Similar to SPV is the Debtor Rehabilitation Fund (DRF). Its main objective is to revive ailing firms or almost bankrupt debtors who have strong or promising economic prospects, or whose projects will benefit the community at large. The DRF is meant to restructure the debt profiles of potential corporations or entrepreneurs who do not receive adequate attention or credit from private financial institutions.

As regards other facets of capital market development, listed firms on the SET ought to be continually and closely monitored to ensure the continued efficiency of their management. Trustworthiness and reliable internal controls will help ensure that the stock market function as a competent rival to commercial banks and finance companies in serving savers, investors, and the development of the financial system. However, a study by the World Bank shows that 16 percent of the firms listed on the SET are controlled by single-family shareholders. Five large family groups dominate up to 50-60 percent of listed firms. This lack of diversity in shareholding often impedes sound internal controls and risk management. Corporate restructuring is thus an immediate task since building up good corporate governance normally takes a long time.

Another reason to develop local capital markets is that bank loans are intrinsically volatile. Before 1997, about 70-80 percent of all financial intermediation in Asia was bank credit-based, compared to 40-50 percent in Latin America. Bank lending has also been blamed for corporate over-leveraging during periods of growth in asset prices. The bulk of the US\$125 billion of funds withdrawn from Asia during the region's crisis comprised bank lending, particularly short term. In other words, the herd was in banks, not in the capital markets, so a shift from bank-led to market-based intermediation will result in less volatility and greater focus on profits, as well as healthier economic growth.

According to the IMF's 172-page report entitled "Financial Sector Crisis and Restructuring: Lessons from Asia," the following items deserve strong attention from monetary authorities, especially those in developing countries.

- Take prompt and decisive action to deal with banking problems, including pre-emptive restructuring action.
- National authorities should have full ownership of all aspects of the financial restructuring effort.
- Transparency in government action is needed to make restructuring credible and successful.
- Valuation of bank assets in the absence of clear market values and fluctuating economic conditions is difficult but necessary.
- Solving banking and corporate sector crises must go hand-in-hand.

- In good times, financial institutions should build up a “cushion” of capital.

While the economy is recuperating, one clear-cut lesson from the crisis is that the central authorities should closely monitor the operations and status of financial institutions, corporate financing, SME, and capital flows, as these items have grave consequences for the country as a whole. In addition, the authorities should maintain consistent policies in order to achieve proper targets and restore confidence.

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