Bank of Thailand

Supervision Report

2001-2002

MESSAGE FROM THE GOVERNOR

In the past several years, the Bank of Thailand has implemented a comprehensive framework of policy measures to strengthen financial institutions, aiming at both market and regulatory reforms. In the earlier phase, the measures primarily aimed at ensuring recovery of financial institutions from the damages of the 1997 crisis, so that they can resume normal operations that support the economic growth. Thus far, these measures together with the commendable adjustments by the financial institutions themselves, aided by economic recovery, have met with considerable success. Since 2001, financial institutions have returned to profitability, showing improvement in business operations and risk management, corporate governance and management, and, importantly, fortified financial position with strengthened capital base.

Among the key forces of change is the market-oriented risk-based regulatory reform, which provides flexibility for financial institutions to adapt their business model to match their strategy and targeted niche, employing new financial technology, including information technology. Market adjustments have been served by such mechanisms as entry of strategic business partners, consolidation, business partnership on new niche market, out-sourcing and in-sourcing. These tools have allowed financial institutions to increase efficiency, rationalize operations, as well as increase revenue by expanding business scope. At the same time, the authorities have been instrumental in helping them deal with the problem of debt overhang, particularly with the setting up of the Thai Asset Management Corporation (TAMC). Importantly, the authorities' regulatory regime has shifted to risk-based supervision to cope with the evolving business and risk profiles of the institutions, while placing an ever-increasing responsibility and accountability on Board of directors of financial institutions.

Looking to the future, there are major challenges ahead. The Bank of Thailand aims at ensuring a sound and efficient financial system that can support sustainable economic development. This means the financial system should employ innovative market mechanisms and instruments to serve the needs of the entire economy, including the formerly disenfranchised population in the rural and poor areas. At the same time, the authorities intend to ensure that financial institutions are alert to face the dynamism of global forces of changes, such as the emergence of financial products, innovations, information technology, cross-border competitions, and regulatory changes such as the New BIS Capital Accord.

Towards this aim, the Bank of Thailand is drafting the Financial Sector Master Plan to ensure comprehensive and consistent market and regulatory reforms. In parallel, the critical regulatory reforms in the pipeline include the new Financial Institutions Businesses Act and the Deposit Insurance Agency Act. Moreover, we are improving early warning system, strengthening internal risk management, institutionalizing contingency planning of the Bank of Thailand, and further developing payments system with Payment System Master Plan 2004. These developments would ensure efficient risk-based supervision and financial infrastructure at par with international standards and best practice.

M.R. Pridiyathorn Devakula
Governor
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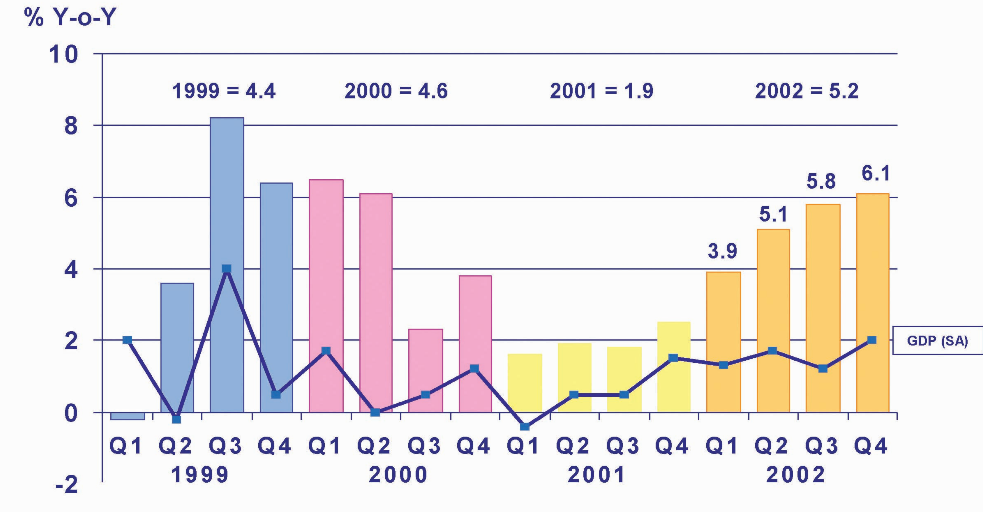
CHAPTER 1

HIGHLIGHTS OF MAJOR DEVELOPMENTS IN 2001-2002

1.1 Current situation: The environment faced by the financial system

The macroeconomic environment in 2001 and 2002 posed both positive and negative factors for the financial sector. The continued growth recovery helped enhance quality of loans and assets of financial institutions. However, growth of new investment and credit remained constrained. The major factors contributing to this are from the sides of both demand as well as supply for loans. These factors included continued excess capacity despite increasing utilization rate, and caution in lending due to non-performing loan (NPL) overhang. Despite the still small share, the step-up in growth of consumer loan warranted increased vigilance of credit risk management. Meanwhile, subdue inflation and external stability helped contain volatility in interest rate and exchange rate, which had in the past severely impacted both financial institutions and their clients in 1997-1998 when market risk escalated and compounded into credit risk, resulting in the current NPL overhang.

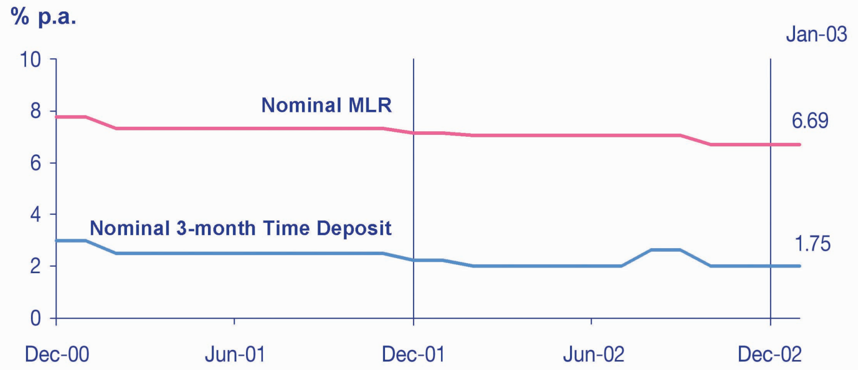
Chart 1 Gross Domestic Products (1988 price)



Source : NESDB

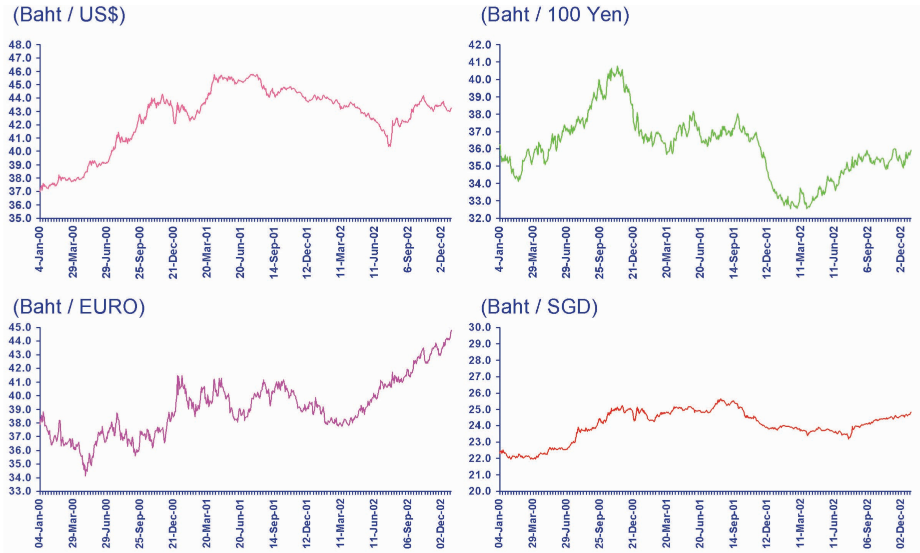
Chart 2 Nominal Interest Rates of Commercial Banks

End-month	Dec-00	Mar-01	Jun-01	Sep-01	Dec-01	Mar-02	Jun-02	Sep-02	Dec- 02	Jan-03
MLR	7.75	7.30	7.30	7.30	7.13	7.06	7.06	7.06	6.69	6.69
3-m dep.	3.00	2.50	2.50	2.50	2.25	2.00	2.00	2.00	1.75	1.75



Source : Interest rates quoted by 4 largest Thai banks

Chart 3 Movements of Exchange Rate (4 Jan. 2000 - 29 Dec. 2002)



On the other hand, market risk is also driven by market expectation on issues such as medium and long-term sustainability. The fiscal sustainability has received attention in view of the use of fiscal stimulus to propel recovery, and the increased supply of government bonds, for this purpose as well as in connection with the fiscalization of the financial reform cost. Much of this uncertainty has been resolved with the public announcement of the detailed plan of the fiscalization and the shared burden of the cost between the Ministry of Finance and the Bank of Thailand in June 2002.

Although the excess liquidity conditions curtailed the market impact of such bond issue, the increased exposure to market risk from holding of such bonds by financial institutions must be properly managed. The financial market itself has been active in developing risk management instrument, particularly for interest rate risk such as interest rate swap (IRS) and bond futures. In parallel, financial institutions have been enhancing internal risk management system using increasingly more sophisticated system developed in-house or with consultants and vendor's models, such as VaR type models. There were also efforts by the authorities to develop the bond market as well as the financial derivatives market. At the same time, prudential guideline on risk management has been strengthened to ensure proper management, especially of market risk in face of increasing complexity brought about by these new products and exposures. The authorities also emphasized the importance of building expertise, and thus organized the Market Risk Symposium in November 2001 for over 500 participants in the industry as well as regulators.

The details of developments in the real economy, the financial markets, and adjustments and reforms of the financial institutions are as follows:

1.1.1 Macroeconomic performance, fiscal and monetary conditions, performance and restructuring of corporate sector

Economic developments in 2001

In 2001, the Thai economic recovery was modest, with real GDP increasing by 1.9 percent. The potentially stronger recovery was restrained by unfavorable export conditions. This, in turn, was exacerbated by the US economic downturn and adverse impact on the consumer confidence after the September 11th attacks. Moreover, with excess capacity, demand for new investment in machinery and equipment was low, while financial institutions continued to be cautious in extending credits to major economic sectors.

Table 1 Gross Domestic Products at 1988 prices (Demand side)

% y-o-y	2001	2002	2002			
			Q1	Q2	Q3	Q4
GDP	**1.9**	**5.2**	**3.9**	**5.1**	**5.8**	**6.1**
Consumption	**3.6**	**4.1**	**4.3**	**3.1**	**3.9**	**5.0**
- Private	3.7	4.7	3.7	3.9	5.2	5.9
- Public	2.9	0.5	8.3	-1.6	-2.8	-1.1
Investment	**0.9**	**6.3**	**3.2**	**7.5**	**6.9**	**7.8**
- Private	4.7	13.3	8.3	9.9	18.8	16.8
- Public	-5.5	-6.8	-6.8	2.5	-8.0	-16.6
∆ in inventories	20.7	-19.4	-50.0	-34.4	-36.0	18.6
Domestic demand/1	**3.1**	**4.3**	**2.0**	**4.0**	**5.4**	**5.9**
Exports of G&S	**-4.1**	**10.9**	**5.1**	**12.2**	**13.8**	**12.2**
Imports of G&S	**-5.5**	**11.3**	**1.8**	**13.3**	**16.6**	**13.6**

Note /1 including change in inventories

Source : NESDB

Despite weak foreign demand, domestic demand was resilient as a result of accelerated government spending. Fiscal stimulus with accelerated disbursement at the beginning of FY 2002 helped mitigate the negative impact of the global economic slowdown. In addition, private spending was driven by several government measures, including the postponement of VAT rate hike. Meanwhile, private investment also showed clear signs of recovery towards the end of the year, especially in construction. The low interest rate environment and the pick-up of private demand for housing loan supported this development.

Internal and external stability strengthened in 2001. Headline inflation averaged 1.6 percent with core inflation at 1.3 percent, on account of lower oil prices, stable exchange rate, and absence of demand pressure. On external stability, there were substantial outflows of private capital in the first 5 months of 2001. However, following the Bank of Thailand's decision to reposition the 14-day repurchase rate to a slightly higher level from 1.5 to 2.5 percent on 8 June 2001 in order to correct the previous misalignment in the structure of Thailand's short-term interest rates, the outflows slowed down significantly. In the meantime, the stability of the Baht improved, and international reserves reached a comfortable level.

The decline in both inflation and external vulnerabilities during the latter half of the year facilitated monetary policy stance to become more accommodative to growth. As a result, the Bank of Thailand lowered the policy rate from 2.5 to 2.25 percent on 25 December 2001, but the impact of the move remained limited under prevailing excess liquidity in the banking system. Commercial bank credits[1] expanded by only 0.7 percent while commercial bank deposits rose at a higher rate of 4.0 percent.

Economic developments in 2002

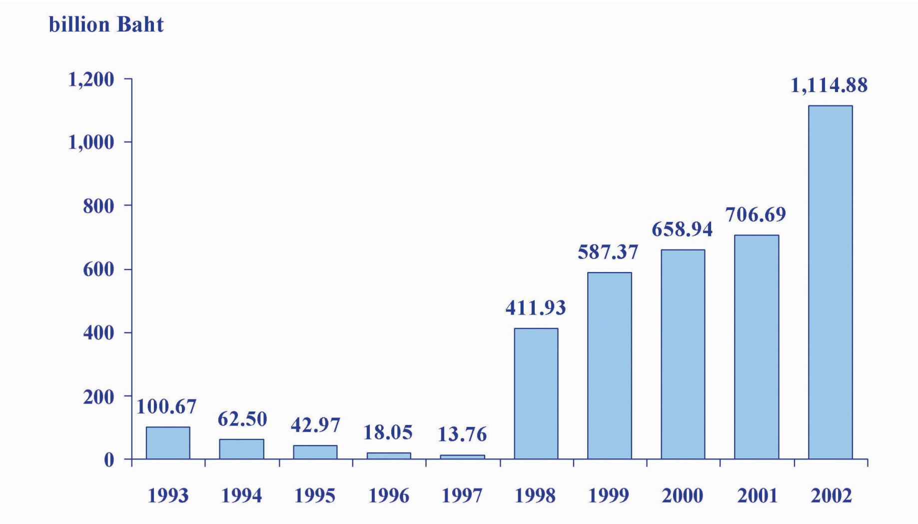
The year 2002 saw the Thai economy growing at a more solid pace, supported by stronger production and domestic spending as well as the pick-up in export growth. Real GDP expanded by 5.2 percent for the year.

Growth resilience was driven by private consumption and investment. Private consumption expanded by 4.7 percent boosted by government stimulus measures aimed at increasing employment in production, services and construction. Moreover, low commercial bank interest rates since early 2002 induced households to increase spending, particularly on durable goods. Private investment also continued to rebound, with growth accelerating to 13.3 percent with the especially strong pick-up in construction.

Fiscal expansion continued to support the economic recovery process, although less forcefully after frontloading at the beginning of the fiscal year 2002. However, the moderating stimulus was in fact a good sign as government revenue increased, reflecting in part continuous improvement in business performance. Despite the diminishing fiscal stimulus, accommodative monetary policy as well as private sector adjustment had contributed significantly to buoyant business sentiment, continued domestic demand growth, and business restructuring.

1 Adding back debt write-offs and loans transferred to AMCs but excluding credit extended to AMCs

Chart 4 Government Bonds

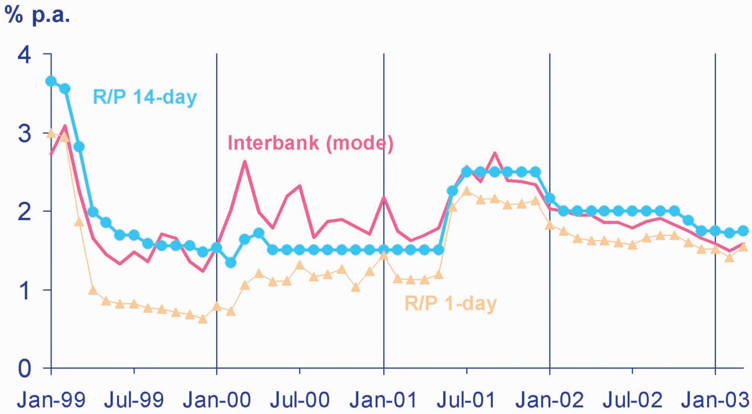


Despite the upward trend in world oil prices following tension in the Middle East, inflation remained low in 2002. Headline and core CPI rose by 0.7 and 0.4 percent, respectively. Meanwhile, external stability continued to improve. The balance of payments recorded a surplus of 4.2 billion USD, compared to 1.3 billion USD last year. This was a result of the large current account surplus, attributed to the expansion in tourism receipts. International reserves reached 38.9 billion USD at the end of 2002.

Liquidity in the financial system remained high especially during the payment period for the government bonds issued to fiscalize losses of the Financial Institutions Development Fund (FIDF). Thus, short-term money market interest rates continued to fall. Credit growth remained sluggish, but there were signs of improvements, especially in growth in credits for housing, personal consumption, and public utilities. While the amount of NPL in the system was steady, the risks posed to financial institutions decreased with clearer plans to resolve debt restructuring problems.

Chart 5 **Interest Rates in Money Market**

	Mar 02	Jun 02	Sep 02	Dec 02	Jan 03	Feb 03	3-27 Mar 03
R/P 1-day	1.65	1.60	1.69	1.52	1.52	1.41	1.54
Interbank (mode)	1.95	1.85	1.91	1.65	1.59	1.49	1.58
R/P 14-day	2.00	2.00	2.00	1.75	1.75	1.72	1.74



The Bank of Thailand lowered the policy rate twice from 2.25 to 1.75 percent in January and November 2002 to stimulate the economy. Nevertheless, the narrowing gap between domestic and foreign interest rates did not result in capital outflows. In the meantime, the exchange rate of the Thai Baht moved in line with regional currencies.

Table 2 **Corporate performance in 2001-2002**

Dupont Analysis of Listed Companies on SET

	1997	1998	1999	2000	2001	2002
D/E Ratio	4.9	3.5	4.0	4.5	3.4	2.3
Asset to Debt Ratio	1.2	1.3	1.2	1.2	1.3	1.4
Asset Turnover (%)	44	44	48	56	62	73
Profit Margin (%)	-44	7	-9	-6	5	8
ROA (%)	-19	3	-4	-3	3	6
ROE (%)	-115	15	-22	-17	14	20

In 2001, listed companies on SET posted combined profit of 205.9 billion Baht, a marked improvement from the 51.2 billion Baht loss in the previous year. From 1997 to 2002, the profitability and financial positions of listed companies improved substantially, as indicated by higher returns-on-asset (ROA) and returns-on-equity (ROE). A higher asset-turnover ratio also showed that companies had utilized assets more efficiently to generate revenue.

Meanwhile, the drop in the debt-to-equity ratio partly reflected the debt-to-equity swap resulting from debt restructuring process.

Improved profitability enabled internal source of funds to play a more important role for business financing. During 1995 to 2001, the ratio of financing from retained earnings increased from 14.6 percent to 24.4 percent, while equity financing increased from 7.5 percent to 11.1 percent. For debt financing, bank loans have gradually decreased in importance, while the share of issuing debt instruments rose from 1.9 percent to 5.6 percent during the same period.

Chart 6 SET Index

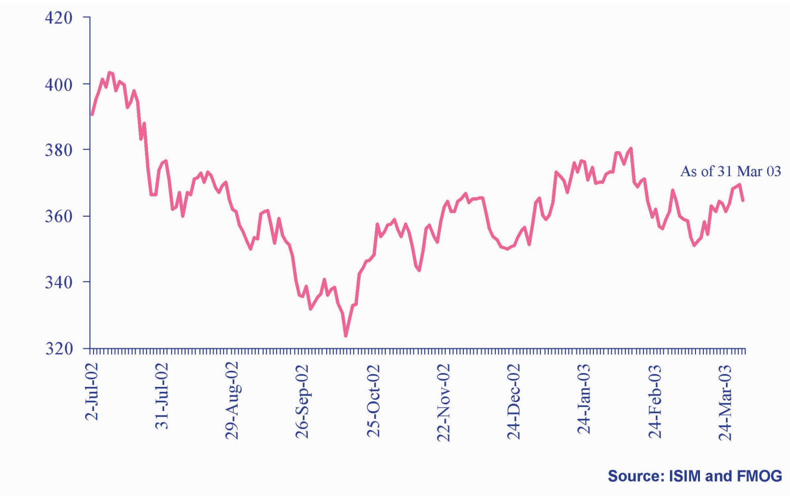


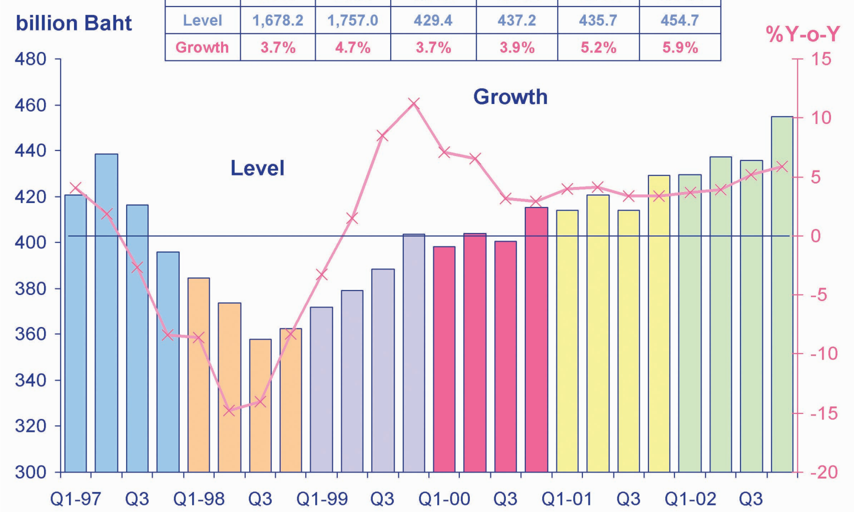
Chart 7 Indicators of Volume

1.1.2 Analysis of sources and uses of fund: Implications of consumption, investment, and capital market developments for financial institutions

The factors supporting the increase in private consumption included: (1) higher income for farmers and number of employed persons due partly to the Village Fund Project aimed at creating employment in rural areas; (2) the low interest rate environment; and, (3) the expansion in consumer credits for durable goods, particularly motorcycles and passenger cars.

Chart 8 Private Consumption at 1988 Prices

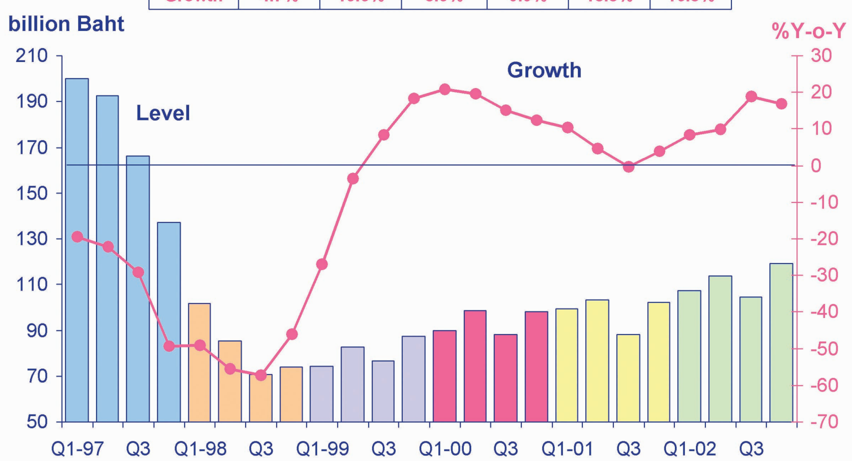
	2001	2002	Q1-02	Q2-02	Q3-02	Q4-02
Level	1,678.2	1,757.0	429.4	437.2	435.7	454.7
Growth	3.7%	4.7%	3.7%	3.9%	5.2%	5.9%



Source : NESDB

Chart 9 Private Investment at 1988 Prices

	2001	2002	Q1-02	Q2-02	Q3-02	Q4-02
Level	392.5	444.8	107.4	113.6	104.6	119.2
Growth	4.7%	13.3%	8.3%	9.9%	18.8%	16.8%

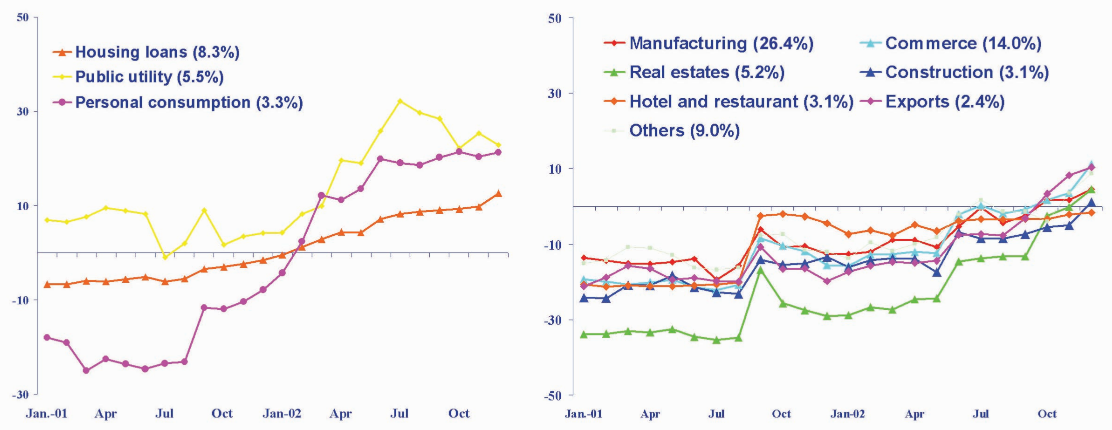


Source : NESDB

On private investment, signs of recovery in the last quarter of the year 2001, particularly in construction sector, reflected the pick-up in housing demand. This was supported by several government measures to revive the real estate sector. Other factors that contributed to the expansion in private investment included improved business sentiments, low interest rates, and strong growth of manufacturing production.

There were some signs of improvements in commercial bank credit since the beginning of 2002. This was seen mostly in credits to major economic sectors including manufacturing, commerce, real estate and construction. In addition, credits for housing, personal consumption, and public utilities had continued to expand rapidly since the beginning of the year.

Chart 10 Credits of Commerial Banks Classified by Sectors*
(Change from the same period last year)



* Please note that credit levels and growth rates are affected by the treatment of write-off and write-back. The Bank of Thailand ordered write-off for fully provisioned doubtful of loss loans in Sep 1999. Subsequently, in Feb 2002, Bank of Thailand allowed financial institutions to choose to write-back such loans. In Mar 2003, the Bank of Thailand mandated write-back on the written-off portions of loans which are collateralized, while there is a choice of write-back for the uncollateralized loans.

In this same period, especially when growth of commercial bank credits continued to slow in 2001, equity and private debentures played an increasing role in financing businesses. The new issuance of equity and private debentures increased steadily from the year 2000. Various measures were also implemented in 2001 to promote the development of capital market in terms of demand, supply, and market structure. These measures included tax and non-tax incentives to encourage listing on the Stock Exchange of Thailand, and the trading of fixed-income instruments. In addition, the Ministry of Finance set up a Steering Committee to develop a Master Plan for key capital market development. The plan focused on good corporate governance, quantity and quality of investment alternatives, investor base extension, quality of market intermediaries, market structure reform, and the efficiency of trading and clearing facilities.

1.2 Overview of financial institution conditions and reforms

During 1997-2002, Thailand undertook numerous policy measures to restore stability to the financial system. These included crisis management measures such as closing of nonviable banks and finance companies, recapitalization of the financial institutions by both private and public sector, and the consolidation of weak financial institutions with stronger ones. Subsequently, with improved stability and performance, there were privatizations of intervened institutions.

The cost of the dual economic and financial crisis in 1997 was very significant. There was indirect effect on businesses due to severe liquidity constraint resulting from closure of financial institutions, a hike in interest rate to support the currency, as well as the collapse of alternative sources of short-term financing such as market for short-term bill of exchange and trade credit. These further impacted the remaining viable businesses.

Table 3 Performance of Financial Institutions*

(billion Baht)

Items	1998	1999	2000	2001	2002
1. Interest Income	730.20	374.99	334.93	307.98	279.26
2. Interest Expense	663.39	312.87	226.86	182.74	149.03
3. Spread	**66.81**	**62.12**	**108.06**	**125.25**	**130.23**
4. Non-interest Income	58.69	58.17	71.24	73.04	88.12
5. Operating Expense	189.42	168.22	155.06	152.47	140.87
6. Operating Profit (Loss)	**(63.92)**	**(47.94)**	**24.25**	**45.82**	**77.47**
7. Provisions	370.90	366.38	130.38	53.07	50.16
8. Income Tax	(0.70)	7.03	5.21	4.63	3.11
9. Extraordinary Items**	0.52	13.62	105.82	99.42	0.08
10. Net Profit (Loss)	**(433.60)**	**(407.74)**	**(5.53)**	**87.54**	**24.28**
11. Yield on Loan	**9.70**	**5.16**	**4.99**	**5.40**	**4.68**
12. Yield on Deposit	**10.76**	**4.90**	**3.27**	**2.54**	**2.08**
13. Spread	**(1.06)**	**0.26**	**1.73**	**2.87**	**2.60**
14. ROA	**(5.74)**	**(6.00)**	**(0.08)**	**1.30**	**0.35**

* Financial institutions include commercial banks, finance companies, and credit foncier companies

** Extraordinary items between 2001-2002 are mostly reversed provisionings.

The reforms and adjustments of the financial institutions, after some time, succeeded in restoring stability and profitability to the financial system since 2001. This reflected the fact that substantial part of losses and provisioning expenses against impaired assets have been recognized and dealt with. This is partly aided by the Government's initiative to transfer NPL to the Thai Asset Management Corporation (TAMC). The operating results also improved as financial institutions made adjustments to reduce cost and enhance revenue.

1.2.1 Strengthening the financial institutions

The task of strengthening the financial institutions needs to be addressed both in the short and long-term perspectives. It needs to be tackled by both the financial institutions and regulators, with coordination playing a key role. In the long term, however, corporate sector must also be revived and restructured to ensure sustainability of overall recovery of real and financial sectors.

Although short-term stability has been restored, the sustainable development of the financial system over the long term requires further work in reducing NPL and returning the corporate and real sectors to full productivity. Moreover, since there are still risks—such as increased new NPL or NPL re-entry if the Thai or global economy slows down, or if the competition to expand credit leads to deteriorating risk culture among lenders and borrowers—prudential supervision must be reinforced to prepare the financial institutions to better meet these risks. In addition, we must also tackle the fundamental structural weaknesses of the financial institutions by re-drawing the architecture of the financial system. Thus, the Financial Sector Master Plan will aim at correcting these inherent weaknesses.

It is also important that financial institutions and regulators make a joint effort to improve infrastructure for the financial system. Among these is the development of the capital and financial derivatives markets which are robust, sound, and liquid in order to help players manage and trade risks.

Progress in resolving NPL and managing of cost of financial reform

As a result of debt restructuring efforts by both the private and public sector, and with the added benefit derived from economic recovery, NPL in the Thai financial system (commercial banks, finance companies, and foreign banks) has been steadily declining. From 2,729.4 billion Baht in June 1999, NPL declined to 772.6 billion Baht in December 2002, or approximately 15.77 percent of total loans outstanding. This figure corresponds to the new Bank of Thailand's definition of NPL. The Bank of Thailand's definition of NPL has been recently revised to reflect international standard which disallows the practice of writing-off from the NPL figures the portion of uncollateralised loan for which full provisioning has been made. Thus the current definition includes the entire amount of loans which are classified as substandard, doubtful, doubtful of loss, and loss. The criteria for loan classification are based on both aging and quality considerations as specified in Bank of Thailand's notification.[2]

The improvement in NPL is the result of the implementation of the debt restructuring efforts of financial institutions and government agencies, namely: the Financial Sector Restructuring Authority (FRA), Corporate Debt Restructuring Advisory Committee (CDRAC), and the creation of the Thai Asset Management Corporation (TAMC) in September 2001. The detail on evolution of NPL restructuring sponsored by these agencies is presented in Box 1.

Despite the progress made, remaining NPL continues to pose a challenge to the financial institutions due to its size as well as the effect it has in distracting the financial institutions from focusing on new lending. During 1998-2001, many private financial institutions set up their own asset management companies (AMCs) to focus on debt restructuring which allowed the parent bank to re-focus on new loans.

Moreover, the authorities give priority to a quick resolution of NPL in order to lower the risk of moral hazard, especially in light of the implication of the so-called strategic NPL—or the NPL which borrowers have ability to repay but prefer to become NPL for strategic reasons.

In addition, NPL raises the uncertainty regarding future cost of impairment. For NPL remaining at financial institutions, future impairment will lead to increased loan loss provision and raises question of capital increase. For NPL transferred to government-owned agencies, namely TAMC and AMCs of state owned banks which are guaranteed by Financial Institutions

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2 For example, substandard loans are based on loans which are overdue for over 3 months from the contractual period or where other evidences indicate that there are difficulties in the recovery of assets or claims, or where the assets or claims do not generate a normal return, as prescribed by the Bank of Thailand. Please see Bank of Thailand's Notification Regarding Worthless or Irrecoverable Assets and Doubtful Assets that may be Worthless or Irrecoverable.

BOX 1: An Evolution of Debt Restructuring Agencies in Thailand

Financial Sector Restructuring Authority (FRA)

The FRA was established in October 1997 as an independent organization under the Ministry of Finance responsible for the rehabilitation and liquidation of assets, and to safeguard the interests of depositors and creditors of the 58 finance companies whose operations were suspended. Of the 58 finance companies, only 2 companies, namely Bangkok Investment and Kiatnakin, were allowed to restructure their organizations, while the remaining 56 companies were ordered to have their assets with the total book value of 851 billion Baht liquidated. At the end of the FRA's mandate in June 2002, the FRA successfully recovered 271 billion Baht, or 36 percent of the total value from the liquidation of assets, interest income, and revenue sharing agreement of the 56 finance companies.

Corporate Debt Restructuring Advisory Committee (CDRAC)

CDRAC was established in June 1998 to facilitate and expedite private debt restructuring negotiations. CDRAC contributed substantially to the creation of debt restructuring standards of practice by reviewing and approving viable debt restructuring plans negotiated between debtors and creditors, and the development of a framework for voluntary out-of-court restructurings. Cumulatively, between 1998 and end of January 2003, CDRAC successfully restructured 10,322 cases with the total value of 1,382.9 billion Baht, while 1,683 additional cases with the total value of 420.3 billion Baht were sent to the courts for adjudication.

Thai Asset Management Corporation (TAMC)

The Thaksin government initiated the TAMC in September 2001 under the mandate of enhancing the stability of the financial sector and promoting the efficient management of non-performing assets. This would, in turn, serve to minimize economic losses, and to promote corporate restructuring consistent with goals of industrial and economic restructuring. Implemented under a special legislation, the TAMC has enhanced foreclosure powers needed to expedite debt restructuring and asset resolution. With initial funding from the FIDF, the TAMC was set up with the mandate to manage NPL transferred from state-owned banks and asset management corporations (AMCs), IFCT, and eligible NPL from private banks and AMCs with multiple creditors and full provisioning. By December 2002, TAMC acquired impaired assets covering 5,524 cases with the book value of 759.4 billion Baht, and was able to achieve its 500 billion Baht target in resolution. The total cases that reached conclusions were 2,206 cases, with gross book value of 501.2 billion Baht.

Development Fund (FIDF), further impairment could have implication for public sector debt. On the other hand, impact of the downside risk is mitigated by the fact that assets transferred to TAMC were made at net book value, thus with successful corporate restructuring, upside gains and profits may be anticipated. An example of this was in the case of its forerunner, the Asset Management Corporation—the government-owned AMC—which turned in a profit. Similar results can also be found overseas. Moreover, for the class of assets deemed eligible to be transferred to TAMC, private financial institutions have made full provision, in accordance with TAMC Law, regardless of whether or not they actually chose to transfer to TAMC. Thus, the quick and profitable resolution is deemed very important to the authorities. Management of cost of financial reform is of critical importance for confidence in the economic and financial sustainability. Consequently, the successful resolution in terms of announced plan for fiscalization of FIDF losses was crucial. (Please see Box 2)

Progress in strengthening risk-based supervision

The aftermath of the crisis brought a market-wide trend in reforms. The Bank of Thailand seized the opportunity to institute changes that will bring Thailand up to international banking standard, while also raising the level of competitiveness and efficiency of Thailand's financial institutions. The key to achieving this is ensuring appropriate risk-based and market-oriented prudential supervision. In parallel, there must be greater emphasis on good governance, increased role of market discipline and transparency. At the same time, there must be long-term contingency plan to deal with systemic risk as well as to safeguard against moral hazard.

Current policy objectives include the conclusion of such landmark initiatives as the Financial Institutions Businesses Act, Financial Sector Master Plan, further strengthening of the balance sheet of commercial banks to reduce NPL, and improvement of risk management techniques that meet BIS standards while preparing for the challenge of the New Basle Capital Accord. Many of these policy developments are already being pursued by the financial institutions themselves, indicating greater alertness to build capacity.

Part of the work being done in strengthening regulatory framework is in the area of electronic banking. The Bank of Thailand circulated a consultative paper on IT Outsourcing, and is in the process of drafting guidelines on E-Banking Risk Management, IT Business Continuity Plan, IT Security, and IT In-Sourcing. Such guidelines would facilitate financial

BOX 2: Managing Cost of Financial Reform:
Fiscalization of Financial Institutions Development Fund's (FIDF) Losses

The Ministry of Finance and the Bank of Thailand jointly agreed on the principles that the resolution must be transparent, in keeping with good governance, and has minimal adverse impact on the public finance and bond market. The losses have already been partially fiscalized by the issuance of 500 billion Baht worth of government guaranteed bonds in 1998 with total receipt of 513 billion Baht. The remaining losses were to be fiscalized with the 892 billion Baht issuance, comprising: (1) 112 billion Baht FIDF bonds guaranteed by the Ministry of Finance; and, (2) 780 billion Baht worth of Government borrowing or bond issuance.

Resolution Methodology:

(1) On 21 June 2002, the Government passed an Emergency Decree empowering the Ministry of Finance to issue bonds up to 780 billion Baht to fiscalize actual FIDF losses. The Ministry of Finance will be responsible for the interest expense to be paid for from the budget. As for the amortization of the principal, the Bank of Thailand will meet this obligation by using annual net profits from its Currency Reserve Account from 2002 onwards. A separate account will be set up within the Bank of Thailand's General Account to keep such profits in order to ensure transparency and accountability of this operation.

(2) As for the redemption of the 500 billion Baht bonds issued in 1998, the principal amortization of which was originally set to be funded by the privatization proceeds, and 90 percent of net profits of Bank of Thailand's General Account operations.

However, very small amount of proceeds have been received so far from the privatization program, while the Bank of Thailand's General Account continues to accumulate losses since 1997. Therefore to ensure that the Bank of Thailand has the capacity to remit profits to the government for this amortization, two Emergency Decrees were passed. The second of the set of 3 Emergency Decrees was issued to allow the one-time transfer of 165 billion Baht from Special Reserve Account under the Currency Reserve Account to the General Reserve Account. The third Emergency Decree then allowed the use of assets in the Special Reserve Account for backing issued banknotes. However, since both accounts are included in International Reserves, the transfer does not affect the total of International Reserves. (Additional details can be found in Chapter 4) institutions to utilize technology to reshape their business models and services. It is important that financial institutions manage the related risks which have the added complexity from new technology and cross-border aspects. These could affect their risk profile, especially for strategic, operational, reputational, legal, and cross-border risks.

Market-oriented regulatory reforms are also being made, namely measures to expand business scope of financial institutions to allow application of financial innovations including derivatives.

On financial derivatives, there has been significant interest in OTC derivatives products to manage market risks, as well as the emergence of credit derivatives in 2001-2002. The Office of the Securities and Exchange Commission (SEC) is working on the Draft Financial Derivatives Act, which would set the framework for the exchange traded financial derivatives.

Regarding the reform of business scope, this is aimed to facilitate market adoption of new business models, such as those involving outsourcing, as well as to allow banks to form business alliances with non-bank partners such as consumer finance, securities firms, and insurance companies. Moreover, criteria for permitting new business are now better aligned to risk-based supervision, e.g. criteria for approval of debt securities-related business which were initially based on size of financial institutions have been changed to one based on demonstrated ability to manage the risk and financial soundness. These measures have substantially helped boost financial institutions' revenue and competitiveness, and are better incentive alignment for improving risk management system.

1.2.2 Future strategies in supervision

Financial Sector Master Plan

Since January 2001, the Bank of Thailand began the process of establishing the medium to long-term strategy for Thailand's financial sector or the Financial Sector Master Plan. The main goals of the Financial Sector Master Plan include: (1) providing financial services for all potential, economically viable users; (2) fostering competitive, efficient, stable, and balanced financial system, capable of servicing the sophisticated and unsophisticated users; and, (3) ensuring fairness and protection for consumers. In this context, the Bank of Thailand has employed a Thai consulting firm to conduct a nationwide survey of financial needs, level of satisfaction on financial services, and future expectation of financial providers. Another consultant is also employed to conduct a research on global forces of change that will affect the Thai financial sector in the next 3-5 years.

The final outcome of the Financial Sector Master Plan will be vetted by a Steering Committee consisting of 9 distinguished financial experts from both the private and public sector. The Financial Sector Master Plan is scheduled to be completed by June 2003.

Draft Financial Institutions Businesses Act

The Bank of Thailand in conjunction with the Ministry of Finance drafted the Financial Institutions Businesses Act as a way to combine the financial institutions acts for commercial banks, finance companies, and credit foncier into one act. In keeping with international best practice, the Financial Institutions Businesses Act will empower the Bank of Thailand to oversee and supervise financial institutions based on consolidated supervision and with more stringent requirements for such issues as related party lending, risk-based capital requirement, resolution of distressed financial institutions, and consumer protection. Both the Senate and the Lower House of Parliament have already debated the Financial Institutions Businesses Act, but due to disagreements in the wording of the document, the Lower House has to wait until April 2003 before they can reconsider to pass one of the two versions of the Act. The Financial Institutions Businesses Act is expected to become effective within 6 months after promulgation.

CHAPTER 2

MAJOR DEVELOPMENTS AND PERFORMANCE OF FINANCIAL INSTITUTIONS IN 2001-2002

In 2001 and 2002, financial institutions underwent significant structural developments in response to the major forces of change and market conditions. The drive to strengthen performance and restore financial strength has resulted in shifts in business model and strategy. These are aimed primarily to increase competitiveness via reducing cost and enhancing revenue and to strengthen risk management. The improvements in performance with return to profitability and strengthening of capital and operation were seen in 2001 and continued onto 2002.

2.1 Overview of competition-driven structural developments

Table 4 Structure of Financial Institution System (as of December 2002)

(billion Baht)

	Locally - incorporated Banks	Branches of Foreign Banks	Stand-Alone IBFs	Finance Companies	Credit Foncier Companies	Total	Deposit-taking Specialised FIs*	Grand Total
Assets	**5,774.1**	**686.5**	**23.6**	**253.6**	**6.3**	**6,744.0**	**1,358.3**	**8,102.3**
Cash and deposits at financial institutions	478.2	53.2	0.6	2.3	0.6	534.9	25.0	559.9
Investments in securities (include R/P)	1,040.3	166.2	0.0	88.1	0.5	1,295.0	377.4	1,672.4
Credits (net)	3,835.4	437.8	21.7	147.4	4.6	4,446.9	859.4	5,306.3
Other assets	420.3	29.3	1.3	15.8	0.6	467.3	96.4	563.7
Liabilities	**5,454.3**	**404.9**	**0.1**	**197.7**	**5.4**	**6,062.5**	**1,175.0**	**7,237.5**
Deposits	4,985.8	293.7	0.0	178.6	0.0	5,458.1	1,049.0	6,507.1
Borrowing (include R/P)	319.0	73.9	0.0	14.5	5.4	412.8	50.1	462.9
Other liabilities	149.6	37.3	0.1	4.6	0.1	191.6	76.0	267.6
Equities	**319.8**	**281.6**	**23.5**	**55.9**	**0.8**	**681.6**	**183.1**	**864.6**
No. of banks	**13**	**18**	**7**	**19**	**6**	**63**	**3**	**66**

Note * Deposit-taking SFIs include Government Housing Bank, Government Savings Bank, and Bank for Agriculture and Agricultural Cooperatives.

As of December 2002, there were 63 financial institutions under the supervision of the Bank of Thailand, which included, locally-incorporated banks (13), branches of foreign banks (18), international banking facilities (31, of which 7 are stand-alone IBFs), finance companies (19), and credit foncier companies (6). While Thai commercial banks continued to dominate the financial system, with market share both in terms of assets and credit extended at approximately 70 percent, growing role of specialized financial institutions (SFIs) has also been observed in recent years. This is particularly in the case of Government Housing Bank, Government Savings Bank, and Bank for Agriculture and Agricultural Cooperatives. This trend is partly the consequence of the crisis, which caused the retrenchment of the private financial institutions as they became very cautious in extending new loans. It was also partly a result of the policy to use the SFIs to serve development policy. Such development finance policy is quite innovative and is geared at giving wider access to financial services to the formerly disenfranchised population such as the urban and rural poor and SMEs. The SFIs increasingly employed new financial technology such as microfinance to provide products tailored to customers who are not served efficiently by the private financial institutions, thus bridging the gap left by imperfection of private market rather than competing where the private solution is already efficient.

2.1.1 Business consolidation and new strategies of the financial institutions

Major forces of change such as the crisis, increased competition, new technology and financial innovation have also propelled significant structural adjustments within the mainstream deposit-taking financial system.

Against the background of slow recovery in corporate sector, low interest rate environment, and high level of non-performing assets in the past few years, financial institutions were driven to increase operating efficiency, earning capacity, and risk management ability. There continued to be consolidation within the system, as well as closure of non-viable institutions. For instance, in 2002 there were two mergers in the financial system, one between 2 state-owned banks, and the other a market-driven merger among 6 finance companies and credit foncier companies to form a restricted-licensed bank.

There have also been moves to reshape business strategy in response to these forces of change. Among such moves observed are business rationalization and consolidation particularly among small and medium-size banks and finance companies, in order to re-focus on niche market, resulting in selling-off of interests in non-core subsidiaries. Such a strategy helped to improve risk management as well as reduce cost. In terms of major cost reduction measures, locally-incorporated banks widely reviewed their branch network strategy. Many non-viable domestic and foreign branches were closed, whereas a more cost-efficient form of delivery channels such as micro branches or electronic branches were introduced. Other means to raise operating efficiency included staff cost cutting through series of early retirement programs, and greater use of information technology.

On the other hand, some institutions, particularly larger banks and hybrid banks, opted for a strategy to provide comprehensive product range covering many new services. Such a strategy helped to enhance income, including fee-based income, and improved return-on-asset, particularly high cost fixed asset such as branch network and computer capacity. These products are provided either directly or through their subsidiaries—such as leasing companies, fund management companies, asset management companies, or IT service companies.

With a substantial decline in the number of potential customers due to the crisis, competition for existing prime customers intensified both in terms of pricing as well as quality of services. Financial institutions placed more emphasis on customer relationship management by increasing access, improving quality, and offering wider range of services.

Changes in business model, product, and delivery channel

Examples of such competition-driven changes included: extending branch operating hours, increasing the number of micro branches in areas of high potential such as shopping centers and university campuses, increasing other forms of access such as internet or mobile phone banking services, setting up of special units to take care of corporate and high net-worth customers. In terms of financial services offered, financial institutions have put more efforts on fee-based income businesses such as trade finance, debt underwriting, electronic banking, credit card, cash management, and custodian services. To support this development, the Bank of Thailand expanded business scope of financial institutions such as insurance brokerage and Internet banking. (More listing can be found in Chapter 3).

Business partnership formation has also become more prevalent. For example, financial institutions may agree to allow a retail financing company—such as consumer credit company, credit card company, or an insurance company—to use its branch network as a distributing channel of retail credit services and bancassurance services, in exchange for fee-based income.

Information technology

Advanced information technology and improved operating platform helped improve quality of services, thereby fostering growth in the fee-based income business as well. Some institutions have centralized back office operations. This helps to improve operating efficiency of the front office, as well as to improve the risk management system in tandem with the growing use of such tools as credit scoring system and centralized credit analysis and approval process.

2.1.2 Risk management and good governance

One very important and favorable development in the financial sector is greater awareness of risk management and corporate governance. This is evidenced by the increasing number of financial institutions setting up a risk management unit to oversee the institution's overall risk. More active Board of directors and management oversight is found in many institutions, via an establishment of Asset/Liabilities Committee (ALCO) or Risk Management Committee. There has also been a very visible trend of financial institutions adopting more advanced tool to measure, monitor and control risks such as credit and market risk, intensifying effort at promoting risk awareness through continuous training, and moving toward a risk-based internal audit function. The shift to risk-based supervision of the Bank of Thailand and the industry's awareness of the New Capital Accord, including concerted effort jointly with the Bank of Thailand to assess the impact of the New Capital Accord, played an important role in fostering this development. All this was in line with the Bank of Thailand's issuance of Financial Institution Directors' Handbook and announcement of a policy statement on corporate governance practices in 2002.

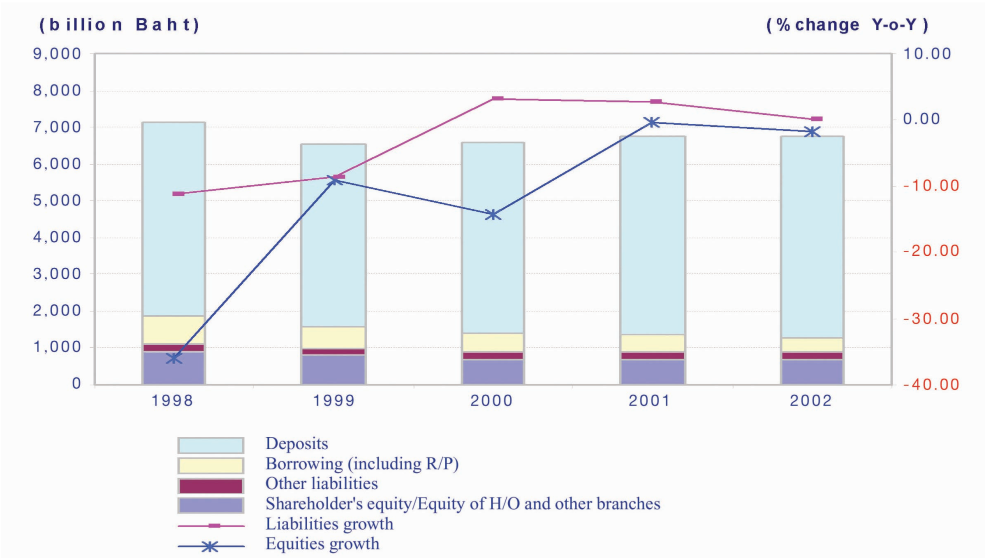
2.2 Performance and risk assessment

2.2.1 Performance of financial institutions

Balance sheet composition and loan portfolio

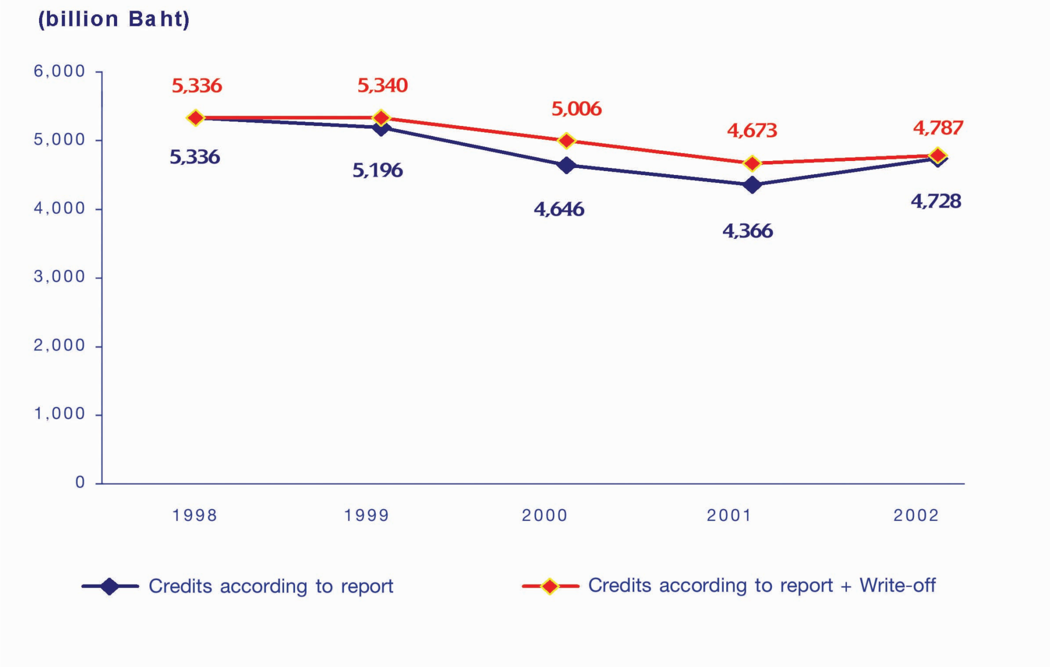
On the liability structure, financial institutions in Thailand turned increasingly towards domestic sources of fund since the crisis, with deposits remaining the major component for the locally-incorporated banks. Owing to continued low deposit rates in line with excess liquidity in the system, however, financial institutions began to experience some shift of household savings to other instruments such as debt securities or life insurance policies. The issuance of government saving bonds totaling 305 billion Baht during the third quarter of 2002 had slight impact on the growth of deposits. The role of borrowing, on the other hand, declined continuously. In the meantime, the low money market rates induced some institutions to shift their liability structure, increasing their short-term domestic borrowing, including borrowing through the repurchase market in 2002. There was not much movement in the long-term domestic borrowing. However, a major change is anticipated in 2004, when hybrid debt instruments and long-term subordinated debts issued by locally-incorporated banks which are eligible to be counted as capital can be redeemed.

Chart 11 Liabilities and Equities of Financial Institutions*



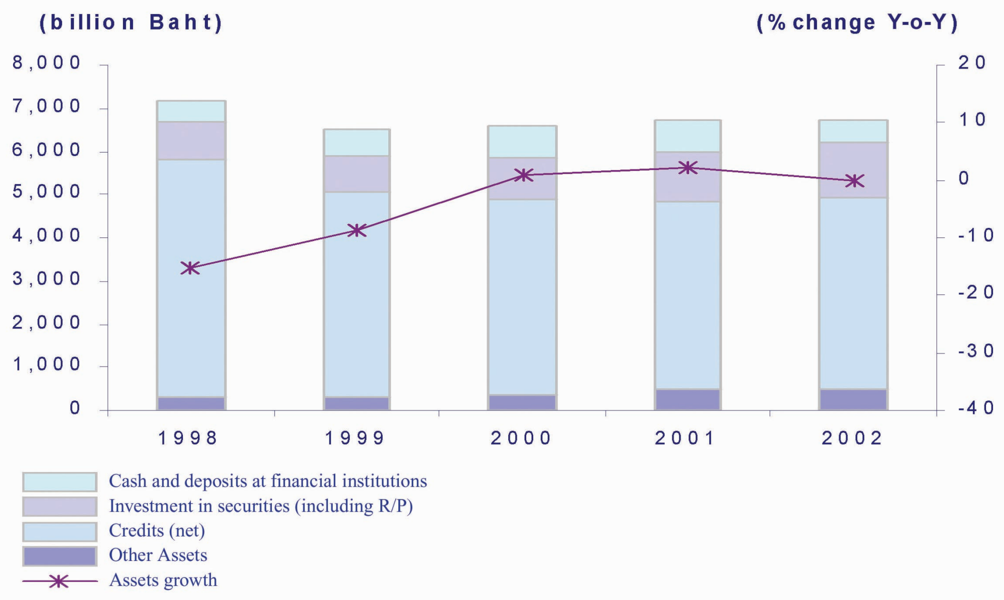
* Financial institutions include commercial banks, finance companies, and credit foncier companies.

Chart 12 **Credit Growth of Commercial Banks**



On the uses of funds, for the first time since the financial crisis, locally-incorporated banks' credit extension showed a more robust sign of improvement, with the approximate growth of 4 percent (after taking write-offs into account). This credit growth was recorded in almost all major economic sectors, including manufacturing, commerce, real estate, public utilities and personal consumption. Such movement reflected the recovery in private investment since the last quarter of the year 2001, when housing demand started to pick up, business sentiments improved, and there was strong growth in manufacturing production. Consumer loans of locally-incorporated banks, including housing loans, marked the highest growth rate compared to loans to other sectors; however, the share to total loans remained relatively small at 13 percent. Such trend resulted from low interest rate environment, improved consumer confidence, and increased efforts of all financial institutions to compete in the consumer market, especially housing loans, credit cards, and hire purchases. This, in turn, helped fuel recovery in retail trade, automobile and residential housing sectors.

Chart 13 Assets of Financial Institutions*



* Financial institutions include commercial banks, finance companies, and credit foncier companies.

Investment in securities continued to play an important role on banks' asset side. Since the aftermath of the crisis, there has been substantial growth in domestic bond market. This development was largely due to the government's fiscalization of the cost of financial sector restructuring and the authorities' efforts to promote debt securities as an alternative source of fund for the private sector. As of December 2002, the majority of securities investment of commercial banks remained government and state-enterprise bonds, with the overall growth rate of 16.4 percent. The increase was partly due to the notes received from transferring NPL to the Thai Asset Management Corporation (TAMC) as well.

Foreign currency interbank deposits (foreign exchange placement), which have had increasing role since 1999, on the other hand, declined substantially in 2002, corresponding to the declining foreign interest rates.

Profitability and capital adequacy

Performance of financial institutions continued to show improvements in 2001 and 2002, with profit being recorded across all types of institutions. This is attributed to economic recovery, adjustment of financial institutions, and the government's policy to transfer NPL to TAMC.

Table 5 Performance of Financial Institutions*

(billion Baht)

Items	1998	1999	2000	2001	2002
1. Interest Income	730.20	374.99	334.93	307.98	279.26
2. Interest Expense	663.39	312.87	226.86	182.74	149.03
3. Spread	**66.81**	**62.12**	**108.06**	**125.25**	**130.23**
4. Non-interest Income	58.69	58.17	71.24	73.04	88.12
5. Operating Expense	189.42	168.22	155.06	152.47	140.87
6. Operating Profit (Loss)	**(63.92)**	**(47.94)**	**24.25**	**45.82**	**77.47**
7. Provisions	370.90	366.38	130.38	53.07	50.16
8. Income Tax	(0.70)	7.03	5.21	4.63	3.11
9. Extraordinary Items**	0.52	13.62	105.82	99.42	0.08
10. Net Profit (Loss)	**(433.60)**	**(407.74)**	**(5.53)**	**87.54**	**24.28**
11. Yield on Loan	**9.70**	**5.16**	**4.99**	**5.40**	**4.68**
12. Yield on Deposit	**10.76**	**4.90**	**3.27**	**2.54**	**2.08**
13. Spread	**(1.06)**	**0.26**	**1.73**	**2.87**	**2.60**
14. ROA	**(5.74)**	**(6.00)**	**(0.08)**	**1.30**	**0.35**

* Financial institutions include commercial banks, finance companies, and credit foncier companies

** Extraordinary Items between 2001-2002 are mostly reversed provisionings.

Profitability of financial institutions, especially the locally-incorporated banks, has improved remarkably in 2002. Operating profits of financial institutions increased from 45.8 billion Baht in 2001 to 77.5 billion Baht in 2002. Improvements were found in all major components, including an increase in net interest income and non-interest income, and a decrease in operating expense.

Table 6 Performance by Type of Financial Institutions in 2002

(billion Baht)

Items Amount	Locally-incorporated Banks				Foreign Banks		Total Commercial Banks	Finance/CFs		Total Financial Institutions
	Majority-Owned by Thais	Majority-Owned by Foreigners	State-Owned	**Total**	Branches	Stand-alone IBF		Finance Cos.	Credit Foncier	
Net Interest Income	69.0	9.9	25.9	**104.8**	17.0	1.0	**122.8**	7.3	0.2	**130.3**
Non Interest Income	39.8	5.0	19.3	**64.0**	14.9	3.3	**82.2**	5.9	0.0	**88.1**
Non Interest Expense	72.8	11.3	28.9	**113.1**	21.6	0.1	**134.8**	6.0	0.1	**140.9**
Operation Profit	36.0	3.5	16.3	**55.8**	10.3	4.2	**70.3**	7.2	0.1	**77.5**
Allowance for Doubtful / Bad Debts	33.4	6.0	4.2	**43.6**	(1.9)	4.8	**46.5**	3.5	0.1	**50.2**
Income Tax	(0.1)	0.0	0.1	**0.0**	3.0	0.1	**3.1**	0.1	0.0	**3.2**
Extraordinary Items	0.0	0.0	0.0	**0.0**	0.0	0.0	**0.0**	0.1	0.0	**0.1**
Net Profit (Loss)	**2.6**	**(2.5)**	**12.0**	**12.1**	**9.2**	**(0.7)**	**20.6**	**3.6**	**(0.0)**	**24.2**
Yield on Loan	4.8	5.5	4.2	**4.6**	4.5	4.2	**4.6**	6.0	7.6	**4.7**
Yield on Deposit	1.9	2.1	2.4	**2.1**	1.4	-	**2.0**	3.4	5.0	**2.1**
Spread	2.9	3.4	1.8	**2.6**	3.1	-	**2.6**	2.6	2.6	**2.6**
ROA	0.1	(0.6)	0.7	**0.2**	1.2	(2.0)	**0.3**	1.4	(0.3)	**0.4**

Although the interest income of locally-incorporated banks decreased, mainly due to a significant decline in foreign currency interbank deposits, banks' interest expense went down even more from the continued low level of deposit rate. This resulted in an increase in banks' effective spread. The spread of foreign banks' full branches continued to be higher than that of Thai banks, as spread of state-owned banks remained low. However, a narrower gap has been observed as net interest income of foreign banks was on a decline.

Chart 14 **Intereat Rates and Spread**

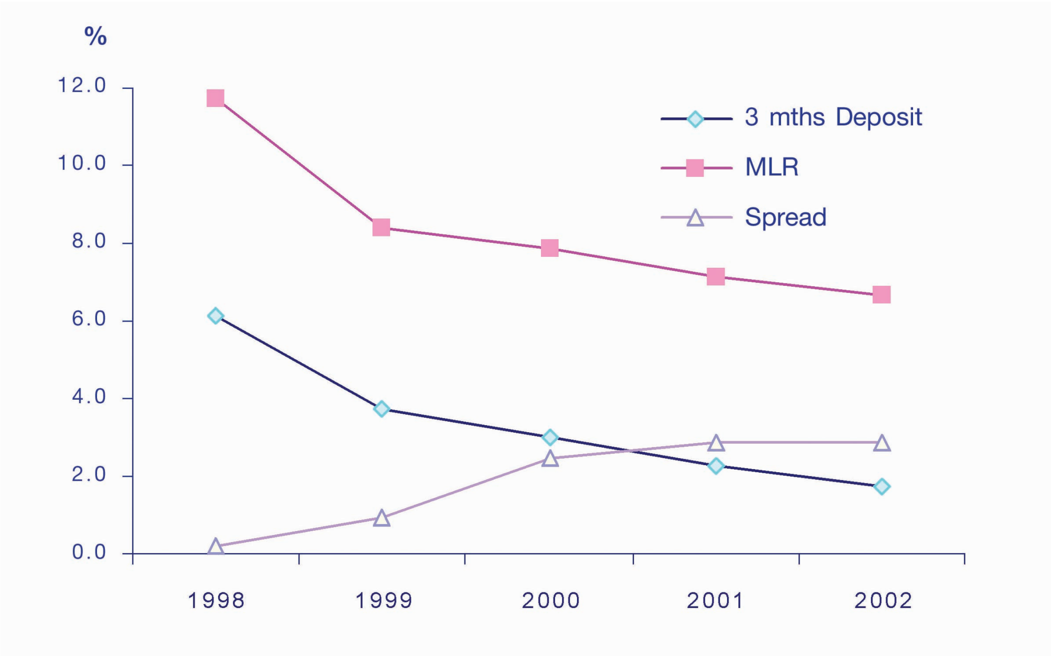
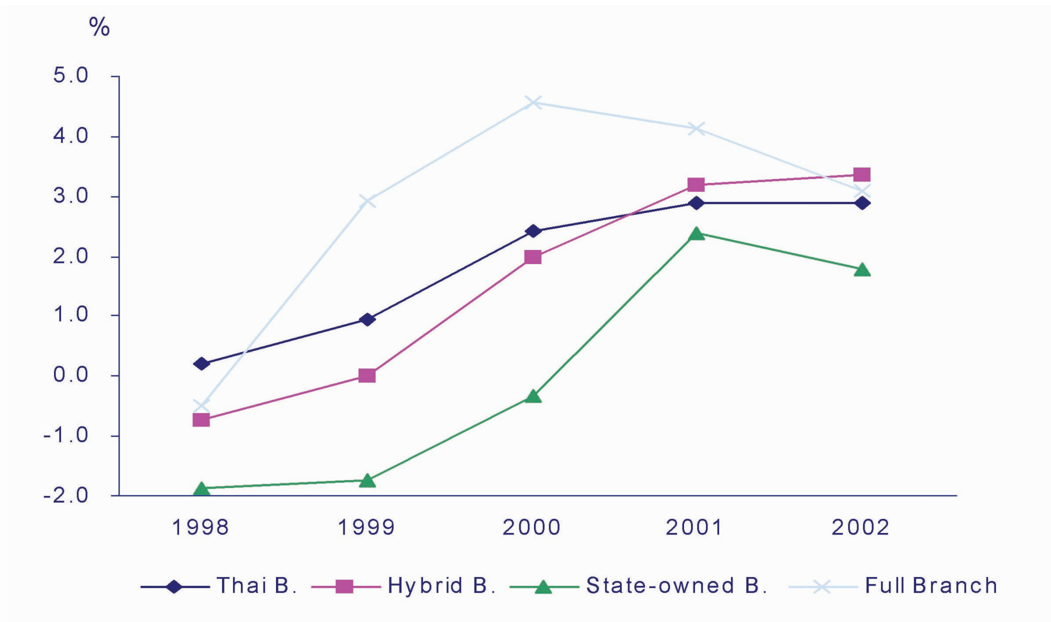
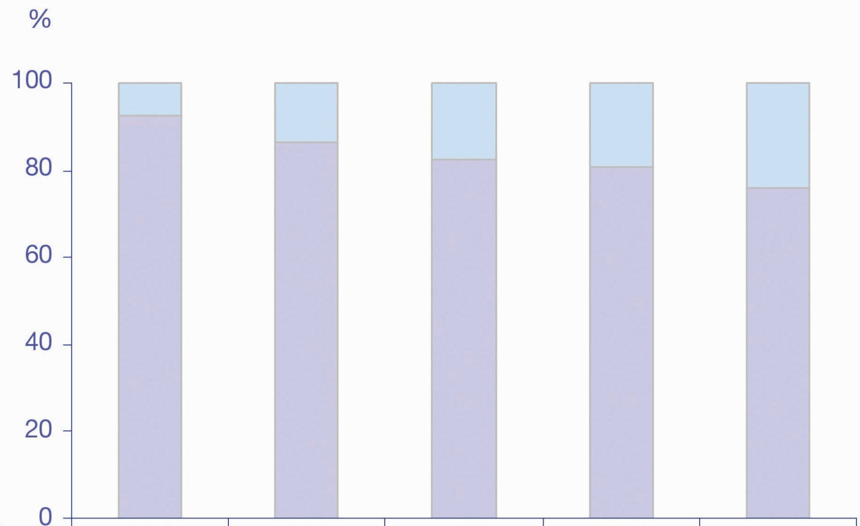


Chart 15 **Spread of Commercial Banks**



The trend of increasing importance of non-interest income continued. Non-interest income increased at the rate of 21 percent from previous year. As of December 2002, the share of non-interest income to total income was 24 percent as opposed to 7 percent in 1998. Fee-based income accounted for the highest share in non-interest income of locally-incorporated banks. The increase in non-interest income was attributed mainly to income from securities and foreign exchange transactions. One plausible explanation would be that the government bond yields across all maturities fell and that Baht depreciated against US dollar during the third quarter of 2002.

Chart 16 Income Structure of Financial Institutions

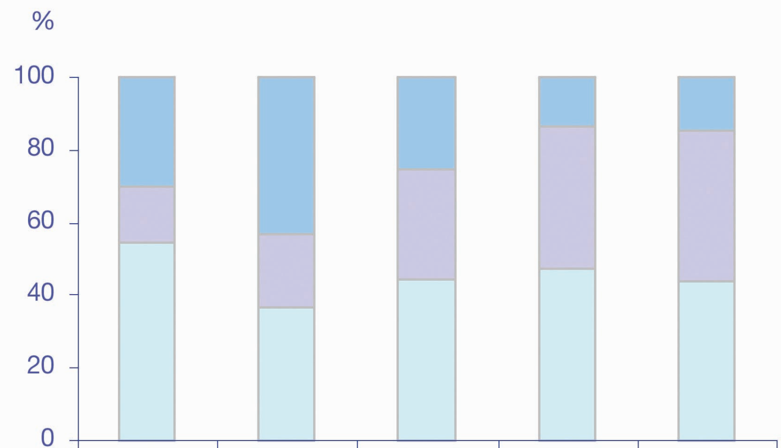


(billion Baht)	1998	1999	2000	2001	2002
Non Interest Income	58.7	58.2	71.2	73.0	88.1
Interest Income	730.2	375.0	334.9	308.0	279.3

Operating expense of locally-incorporated banks has been on a declining trend since 1998. Operating efficiency ratio[3], a measure of banks' ability to support net revenue stream with operating expense, of locally-incorporated banks improved markedly from 85 percent in 2001 to 67 percent in 2002. This is in line with the banks' stride to increase their operating efficiency.

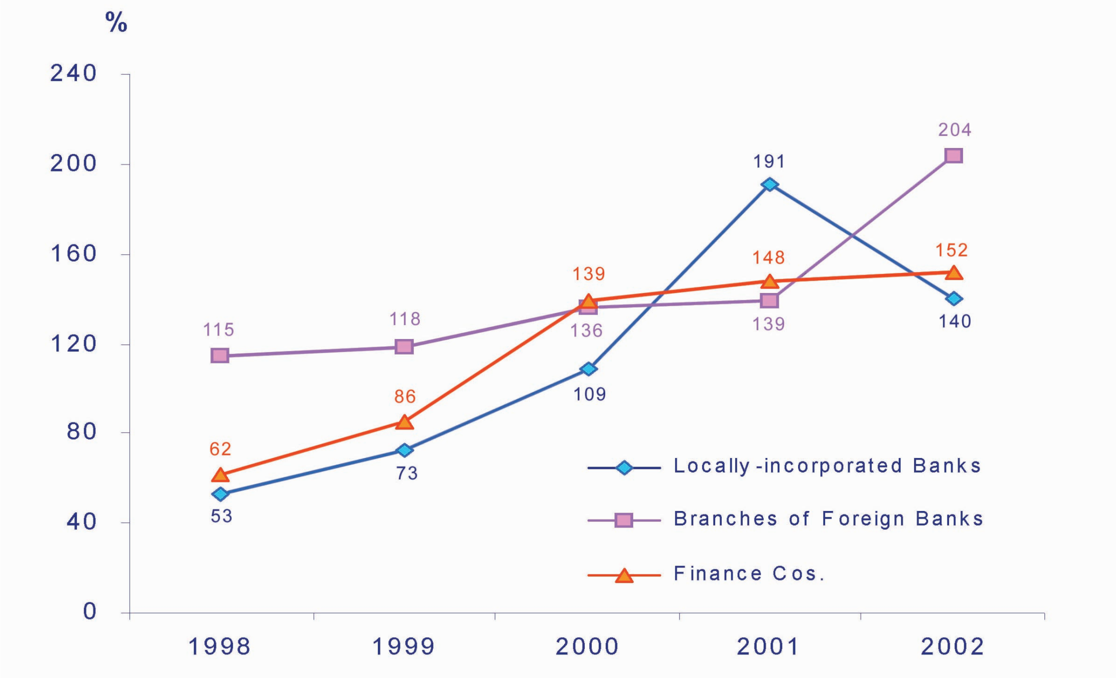
3 Operating efficiency ratio is defined as operating expense divided by the sum of net interest income and non-interest income.

Chart 17   Expense Structure of Financial Institutions



(billion Baht)	1998	1999	2000	2001	2002
Allowance for Doubtful/Bad debts	370.9	366.4	130.4	53.1	50.2
Operating Expense	189.4	168.2	155.1	152.5	140.9
Interest Expense	663.4	312.9	226.9	182.7	149.0

Chart 18   Existing Reserve : Required Reserve



For loan loss provisioning, the majority of financial institutions have set aside reserves more than the official requirement, though the extra reserves of locally-incorporated banks declined significantly, from 191 percent of required reserves to 140 percent. The principle behind the current reserve method is to ensure adequate capital to cover expected loss. Since collaterals act to minimize impact of loss if default occurs, deduction is allowed. Although deduction of physical collaterals is still allowed, the need to be conservative in valuation is recognized. Thus it is required that these collaterals' valuation meet set appraisal standards. In the future there is a plan to phase out such deduction.

Table 7 Capital Adequacy and Quality of Capital

Financial Institutions	Capital Fund (billion Baht)			BIS Ratio (%)		
	Tier – 1	Tier – 2	Total	Tier – 1	Tier – 2	Total
Locally-incorporated Banks	308.7	139.5	448.2	8.91	4.03	12.94
- Majority-owned by Thai	192.0	124.2	316.2	7.68	4.97	12.65
- Majority-owned by Foreign	25.5	8.4	33.9	9.78	3.21	12.98
- State-owned	91.2	6.8	98.1	12.97	0.97	13.95
Branches of Foreign Banks	74.4	-	74.4	20.37	-	20.37
Total Commercial Banks	**383.1**	**139.5**	**522.6**	**10.01**	**3.64**	**13.65**
Finance Companies	**43.7**	**2.9**	**46.6**	**22.25**	**1.48**	**23.73**
Credit Foncier Companies	**0.8**	**-**	**0.8**	**14.57**	**-**	**14.57**
Total	**427.7**	**142.4**	**570.0**	**10.61**	**3.53**	**14.14**

Overall, every institution maintained a higher capital-to-risk asset ratio (BIS ratio) than the minimum requirement.[4] As of December 2002, BIS ratio of locally-incorporated banks and finance companies were at 12.9 percent and 23.7 percent, with Tier-1 capital of 8.9 percent and 22.3 percent, respectively.

4 This is with the exception of Thanapat Credit Foncier Company which was taken under control of the Ministry of Finance on 23 December 2002.

There was not much recapitalization since 2000, as a significant amount had been completed during the 1998 to 2000 period. Capital increase from 2001 to 2002 amounted to 26.6 billion Baht as opposed to 959.2 billion Baht between 1998 and 2000. The ease of NPL pressure also helped reduce recapitalization need of financial institutions.

Chart 19 BIS Ratio of Commercial Banks

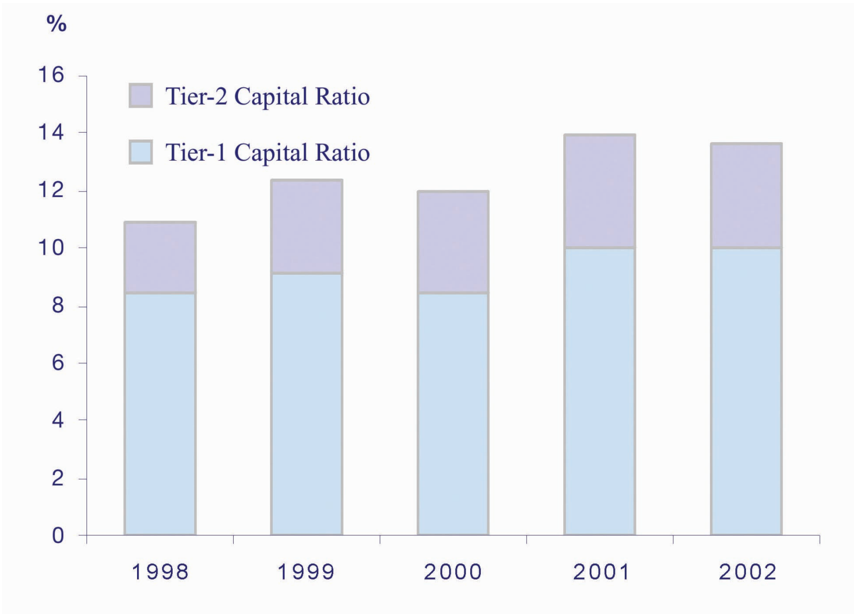
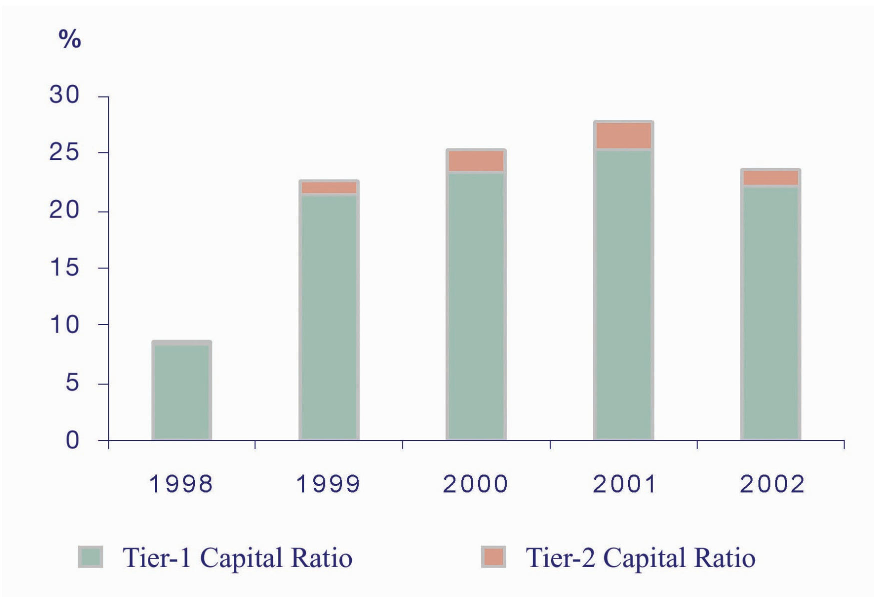


Chart 20 BIS Ratio of Finance Companies



2.2.2 Risk assessment

Credit Risk

Credit risk poses the biggest risk to financial institutions as credits make up the largest part of the asset, particularly as the financial crisis has left a substantial overhang of non-performing loans (NPL), although the system has most likely passed the worse phase of NPL. Nonetheless, there is continued need to remain prudent and to carefully monitor possibility of increased risk. Such possibility can come both from downside risk, if the interruption in economic recovery affects repayment ability, as well as from upside, if excess liquidity coupled with upsurge in consumer and business confidence leads to too fast credit expansion that could result in a bubble.

Table 8 Credit by Economic Sector of Commercial Banks

(billion Baht)

Economic Sector	1998	1999	2000	2001	2002
1. Agriculture & Forestry	147.17	136.65	115.25	106.94	109.31
2. Mining & Quarrying	32.73	31.42	22.51	15.11	23.08
3. Manufacturing	1,577.32	1,535.88	1,322.76	1,163.52	1,233.65
4. Construction	265.38	234.27	178.84	149.29	155.22
5. Retail and Wholesale Trade	895.03	801.02	658.34	579.08	650.21
6. Import	146.53	200.38	147.21	115.89	133.43
7. Export	150.25	151.96	120.39	101.87	113.19
8. Banking & Finance	318.89	436.60	687.96	868.93	876.65
9. Real Estate	507.03	521.37	349.64	248.61	260.42
10. Utilities	182.31	193.55	207.53	216.82	273.26
11. Services	439.75	412.27	330.43	293.13	316.74
12. Personal Consumption	673.25	541.09	505.31	506.93	582.97
Total	**5,335.64**	**5,196.46**	**4,646.17**	**4,366.12**	**4,728.13**

In terms of credit concentration, most of the credit outstanding concentrated in 5 major sectors, namely manufacturing, retail & wholesale trade, personal consumption, services, and real estate. About half of commercial banks' credits was extended to manufacturing, retail & wholesale, and real estate sector. Personal consumption took up about 12 percent of banks' total loan portfolio. A different picture was seen in lending of finance companies and credit foncier companies, where approximately half was concentrated in personal consumption and real estate loans.

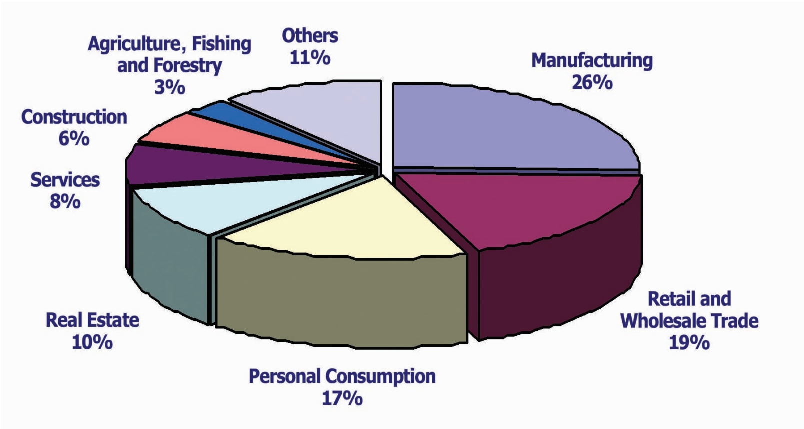
Table 9 Credit by Economic Sector of Finance Companies

(billion Baht)

Economic Sector	1998	1999	2000	2001	2002
1. Agriculture & Forestry	4.08	1.25	0.92	0.95	0.86
2. Mining & Quarrying	1.28	0.52	0.75	0.24	0.30
3. Manufacturing	97.54	35.23	24.11	22.93	19.74
4. Retail and Wholesale Trade	37.43	12.79	8.55	6.63	5.90
5. Import	7.25	3.31	2.10	2.76	1.39
6. Export	5.23	1.95	1.96	1.10	1.48
7. Banking & Finance	46.92	15.94	13.45	25.11	22.11
8. Construction	14.15	4.03	2.43	1.93	2.23
9. Real Estate	117.36	40.92	27.76	24.64	23.01
10. Utilities	19.35	11.85	11.82	10.14	8.95
11. Services	33.24	12.45	8.19	10.72	3.54
12. Leasing	9.91	1.22	1.77	0.94	0.46
13. Personal Consumption	67.61	41.65	38.11	54.75	83.86
Total	**461.35**	**183.11**	**141.92**	**162.84**	**173.83**

NPL in the Thai financial system (commercial banks and finance companies, including foreign banks) was at 772.6 billion Baht, or 15.77 percent of total loans, as at end-December 2002. The fact that over the past few years an increase in NPL was substantially due to NPL re-entry emphasized the need for close watch as this may imply the weakness in quality of debt restructuring. If restructuring is based on extension of period for principal repayment or interest reduction, without real corporate, operational or managerial restructuring, such restructured loans are more likely to become NPL again. For this reason, the authorities have given high priority to strengthening capital base, risk management, as well as accelerating debt restructuring. (For details of prudential measures to enhance credit risk management and debt restructuring, please refer to Chapter 3.)

Chart 21 NPL Sectoral Decomposition



On the sectoral decomposition of NPL, manufacturing, retail and wholesale trade, and personal consumption make up the 3 largest absolute amounts of NPL. The sectors with highest percentage of NPL-to-total loans in the sector were construction, leasing and real estate, respectively. The fact that the majority of NPL in housing loan was more than 12 months overdue suggested that debt restructuring in the housing loan sector has been slow. For credit card loan of commercial banks which had recorded high growth over the past two years, the percentage of NPL-to-total loan was 8.2 percent at the end of 2002. The relatively high rate emphasized the importance of close monitoring, although the overall amount of such loan remained quite low at 47.4 billion Baht. The setting up of the credit bureaus and the enactment of Credit Bureau Act would facilitate improvement in risk management in the future.

In addition to NPL, non-performing asset (NPA) such as foreclosed assets can impact financial institutions' financial position. Over the past few years, the amount of immovable properties in banks' book has been increasing. Banks continue to receive these assets through debt repayment or debt restructuring process. The fact that more than 50 percent of these assets are vacant land partly explains why the rate at which these assets can be successfully sold is rather low. To reduce further risk from these assets, the Bank of Thailand requires that the assets be appraised annually and 100 percent provisioning of the difference between the book value and appraised value (where book value is lower) be put aside.

Awareness in risk management has increased over the past few years. Several locally-incorporated banks and finance companies started to develop own credit rating model to assess risk in corporate sector. Many financial institutions made use of credit scoring model and information from the two private credit bureaus to assess risk in consumer lending. Members of the two credit bureaus include commercial banks, finance companies, leasing companies, as well as some non-bank consumer credit companies. We also see improvement in the underwriting standards and the loan origination system in several locally-incorporated banks. In all, the level of credit risk remained high while ability to manage the risk improved.

Market Risk

Exposure to market risk of locally-incorporated banks remained small because trading positions were small—with debt and equity securities amounting to 21.7 billion Baht or 0.4 percent of total assets in December 2002, and most of their derivatives transactions were customer-based and hedged. In 2002, a downward shift of yield curve and strong growth in the stock market helped increase the profits from trading portfolio in 2002. Unrealized gain from mark-to-market of available-for-sales securities also increased compared to the previous year.

The degree to which financial institutions will be affected by changes in interest rate depends on the level of re-pricing gap position and the direction of interest rate change. In using a re-pricing gap analysis model to assess interest rate risk in banking book activities, negative gaps are found in most financial institutions. This reflected the fact that majority of banks' source of fund was from saving and three-month deposits, whereas the re-pricing term of banks' use of fund was in a longer-term maturity. With current situation of high negative re-pricing gap in banking book activities, a rise in interest rate could have significant impact on the institutions' financial position. Note that the impact suggested from the gap analysis does not take into account financial institutions' discretion in re-pricing their assets and liabilities. Since the financial crisis, foreign exchange position of financial institutions was rather small. As of December 2002, the net foreign exchange open position was positive, with the net spot position positive and net forward position negative. Both foreign-currency denominated assets and liabilities have been on a decline since 1996, corresponding to a decreasing role of Bangkok International Banking Facilities (BIBFs) loans, foreign exchange placement (asset side) and foreign currency deposits and borrowing (liability side).

Table 10 Foreign Exchange Position of Commercial Banks*

(million USD)

(End of period)	1996	1997	1998	1999	2000	2001	2002
Spot Position							
Assets in Foreign Currencies							
Due from Banks Abroad	3,555	5,994	8,898	11,492	13,241	13,221	8,951
Foreign Bill Inward Negotiated	5,620	3,358	1,594	1,259	1,265	1,064	1,660
Bill Outward Negotiated	1,079	712	453	339	362	325	365
Loans and Advances	56,031	46,744	31,809	19,217	13,855	10,222	8,489
Foreign Investment	481	846	1,078	1,041	1,424	1,706	3,382
Others	806	808	676	690	555	387	346
Total Assets in Foreign Currencies	**67,572**	**58,462**	**44,508**	**34,038**	**30,702**	**26,925**	**23,193**
Liabilities in Foreign Currencies							
Deposits	810	1,502	1,821	2,225	1,923	1,775	1,504
Overdrafts	1,001	355	410	294	275	260	242
Borrowings	62,319	50,679	34,915	21,412	14,363	11,072	9,404
Trade Refinancing	563	232	151	42	13	0	1
Others	584	1,209	1,113	1,054	1,444	1,183	1,056
Total Liabilities in Foreign Currencies	**65,277**	**53,977**	**38,410**	**25,027**	**18,018**	**14,290**	**12,207**
Net Spot Position	**+2,295**	**+4,485**	**+6,098**	**+9,011**	**+12,684**	**+12,635**	**+10,986**
Forward Position							
Bought	79,961	45,706	36,518	33,706	40,895	38,161	38,539
Sold	81,084	48,625	41,010	40,982	52,256	49,847	48,460
Net Forward Position	**-1,123**	**-2,919**	**-4,492**	**-7,276**	**-11,361**	**-11,686**	**-9,921**
Net Foreign Exchange Position	**+1,172**	**+1,566**	**+1,606**	**+1,735**	**+1,323**	**+949**	**+1,065**

* Including IBF, EXIM Bank, IFCT and Asia Credit Finance Company transactions.

In 2002, the Bank of Thailand revised the regulation on net foreign exchange position, using the standard BIS shorthand method.

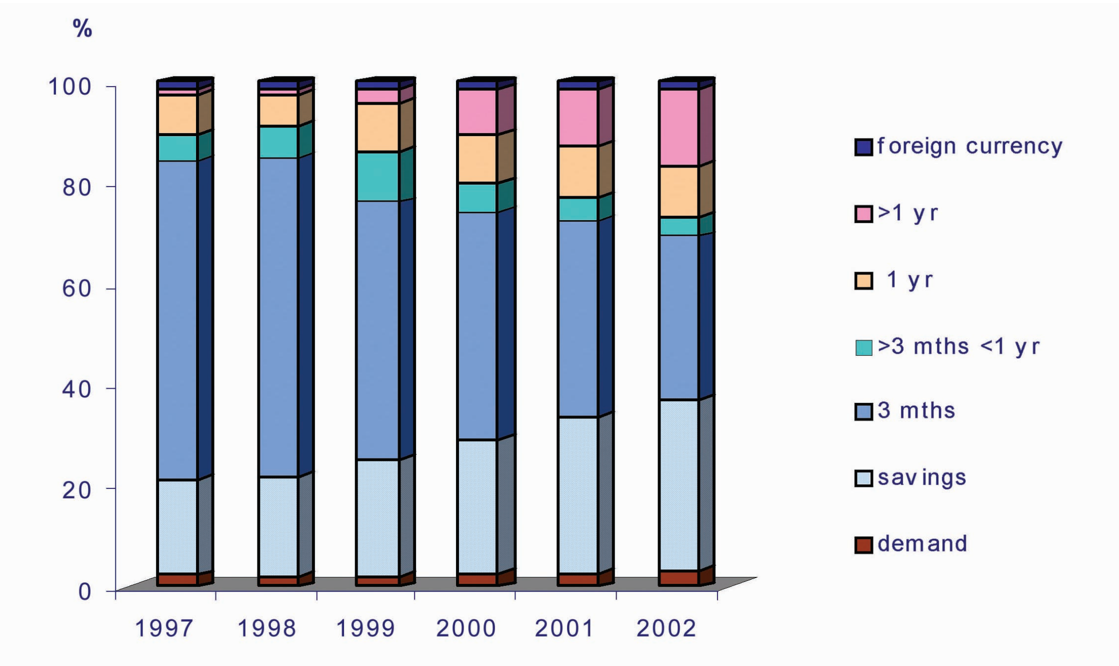
Under this new rule, financial institutions are required to maintain a net foreign exchange position of an individual currency not exceeding 15 percent of total capital, and the aggregate position not exceeding 20 percent of total capital. As of 27 December 2002, financial institutions maintained the net foreign exchange position of an individual currency and the aggregate position at the level far below the legal limit, with the highest exposure in US dollars, followed by Hong Kong dollar and Euro, respectively.

As with credit risk management, market risk management of locally-incorporated banks has improved over the past few years. Many have adopted the Value at Risk (VaR) model to assess market risk in trading book. Securities portfolio is marked-to-market at least monthly. Various trading limits are set and monitored by banks' management.

Liquidity Risk

Liquidity risk is not of a prime concern to the financial system. Since September 2002, the Bank of Thailand required that financial institutions have measures to deal with potential liquidity mismatching between assets and liabilities across different currencies.

Chart 22 Deposit Structure of Commercial Banks



Over the past few years, the financial sector has been faced with excess liquidity. The moderate, though accelerating, economic recovery and banks' reluctance to extend new loans due to high NPL were major contributing factors. Loan-to-deposit ratio of locally-incorporated banks has been under 100 percent since 1999, despite an increase in 2002 when the loan growth picked up. Banks maintained relatively high liquid assets, including cash, deposits at financial institutions, and tradable securities. Liquid asset ratio was kept significantly above the minimum level. Although the majority of source of fund was from short-term deposits whereas the use of fund was in a longer-term maturity, a gradual shift to longer maturity funding was also seen. Given the restored confidence in the financial institutions and continued economic recovery, liquidity risk should not yet be a prime concern to the financial system.

Chart 23 Borrowing of Commercial Banks

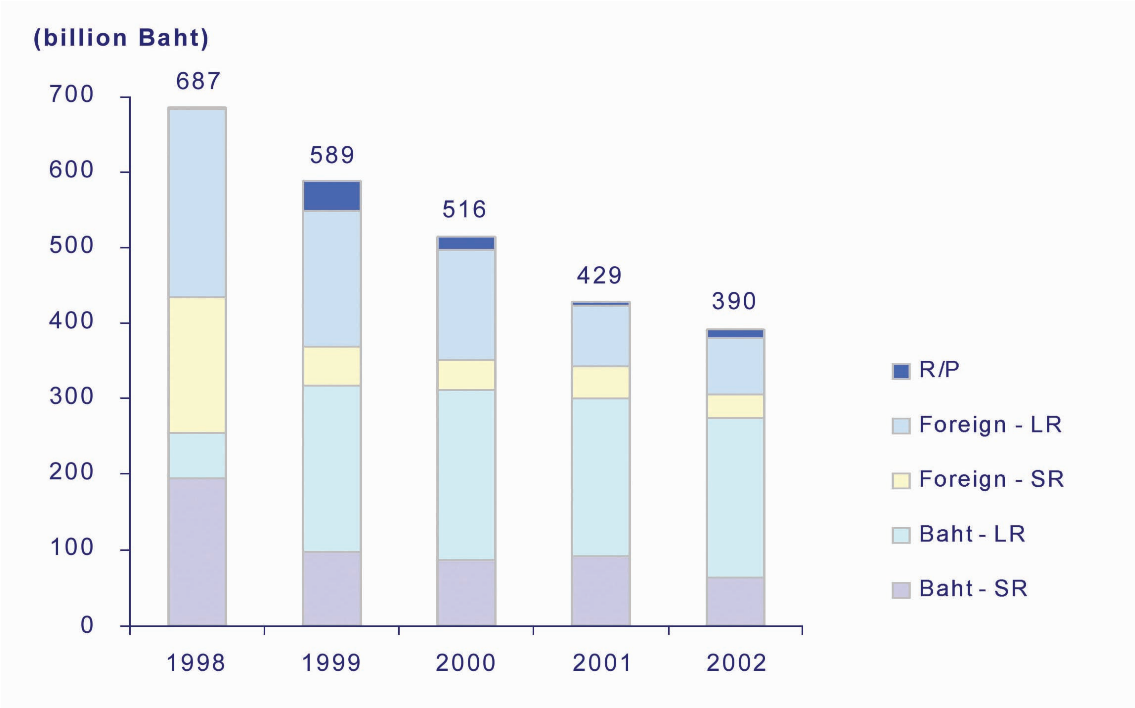
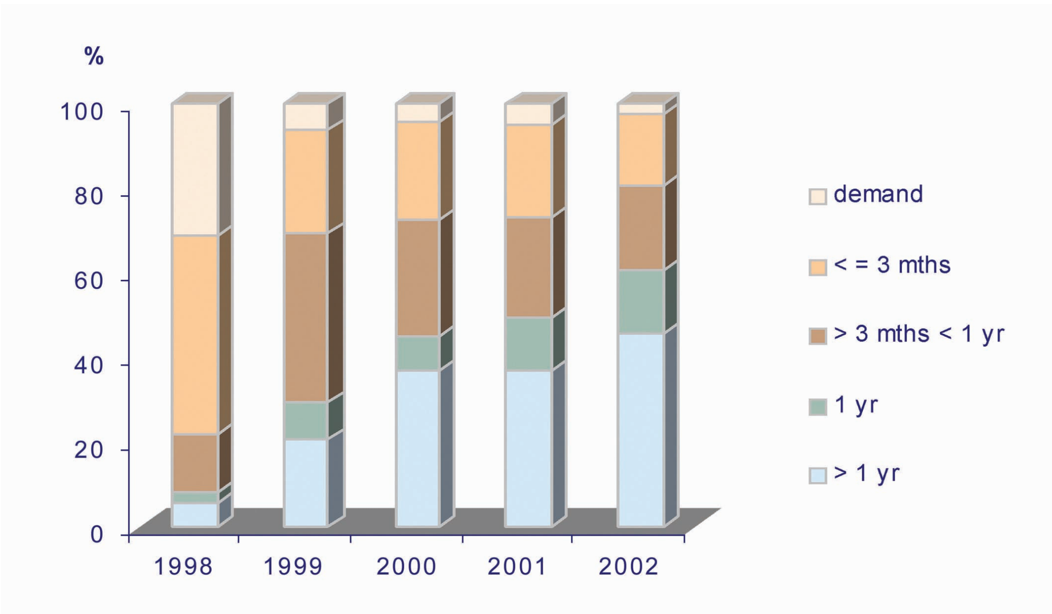


Chart 24 Borrowing of Finance Companies



Operational Risk

Since the onset of the crisis, several financial institutions have undergone extensive organizational restructuring which would have impact on operational risk. They have made significant changes in their product line, business model such as through out-sourcing and in-sourcing, work process, staffing, as well as key infrastructure such as IT system. Such changes expose the institutions to possible loss resulting from inadequate or failed internal processes, people, systems, or from external events, especially during transition period. Therefore vigilant management of operational risk and improvement of internal control system are very important since major failure can cause loss of reputation, which may lead to other financial damages. Thus far, no significant loss has arisen from such developments. Nonetheless, the authorities have asked these institutions to put great emphasis on internal controls and corporate governance, especially during this transitional period.

2.3 Assessment of financial system stability

Looking ahead, risk from consumer loan may rise if growth rate continued to be high, but will be marginal as its share in loan portfolio is still low, and the nature of the loan does have risk diversification in itself. The continued recovery of the economy and the authorities' continued efforts to reduce NPL should help reduce the overall level of NPL further. Moreover, as long as financial institutions keep prudent underwriting process and adequate internal controls, new NPL should not pose too much additional risk to the system. Less pressure from NPL re-entry is expected, as the overall economic recovery will improve financial positions of borrowers. Brighter prospect in earning capacity and the continued low interest rate should improve financial institutions' ability to raise capital, should a future need for capital arise. This, and the improved corporate governance and risk management, should help maintain the overall financial institution stability.

CHAPTER 3

SUPERVISORY REFORMS

3.1 Major regulatory and supervisory reforms

Since 1997 the Bank of Thailand has initiated many reform measures to rectify existing weaknesses and strengthen the supervisory framework in a market-oriented manner. These reforms were aimed primarily at strengthening the financial institutions' internal ability to monitor and control material risks inherent in their operations. With a sound risk management practice, financial institutions would be better placed to meet the challenge posed by: growing demand for new and more complex products; intensifying competition; as well as the overall economic and financial risk, as the economic recovery began to pick up pace, though corporate restructuring in the real sector was still on-going. These supervisory reforms as well as the adjustments by the financial institutions should help ensure that the financial sector will not impede sustainable economic recovery and growth.

The comprehensive re-orientation of the supervisory framework away from solo-basis transaction-testing analysis, towards risk-based consolidated supervision with emphasis on contingency planning and Board of director's oversight responsibility, will serve to prevent against future crisis. Presently, the Bank of Thailand has already implemented policies and guidelines for all key risk categories in addition to measures to improve corporate governance standards. It is important to note that the Bank of Thailand too has undertaken internal reforms and capacity strengthening to ensure that the supervisors and procedures effectively complement the new measures imposed on financial institutions.

3.1.1 Consolidated and risk-based supervision

Consolidated supervision

In 1999 the World Bank conducted an assessment of Thailand's banking supervisory regime's compliance with the Bank for International Settlements' (BIS) 25 Core Principles of Effective Banking Supervision and concluded that Thailand did not comply with the core principle concerning consolidated supervision. The underlying reason behind the non-compliance is due to the fact that the current laws governing financial institutions under the supervision of the Bank of Thailand do not grant power to the Bank of Thailand to supervise financial institutions on a consolidated basis.[5] In order to bring Thailand's banking supervisory regime up to international standard, the Bank of Thailand collaborated with the Ministry of Finance to draft the Financial Institutions Businesses Act which will empower the Bank of Thailand to oversee and supervise financial institutions based on consolidated supervision and with more stringent requirements for such issues as related party lending, risk-based capital requirement, resolution of distressed financial institutions, and consumer protection.[6]

The Bank of Thailand is also in the process of developing a policy statement on financial conglomerates and consolidated supervision, which is expected to be completed within the second quarter of 2003. The policy statement will concentrate on establishing scope of business and structure of the conglomerates, and the prudential framework for conglomerates i.e. capital adequacy, risk concentrations, intra-group transactions, and fit and proper test. At the same time, the Bank of Thailand has collaborated with other regulators, namely the Ministry of Finance, Ministry of Commerce, and Securities and Exchange Commission to enhance coordination and information sharing among regulators in order to standardize supervision of the financial conglomerates.

New Basel Capital Accord

The New Basel Capital Accord provides more risk sensitive approach to calculate regulatory capital compared to the current 1988 accord. Besides market and credit risk concerns of the 1988 accord, the New Basel Capital Accord in its 3 pillars introduces methodologies to deal with operational risk, supervisory review process, and market discipline issues. Thailand's banking industry is already aware of the regulatory capital requirement for credit risk and operational risk under the New Basel Capital Accord implementation. From preliminary results of surveys and studies on the effects of the New Basel Capital Accord on the commercial banks' capital base, the Standardized Approach (STD) will be the approach most commonly adopted by the Thai banking system. However, a final decision concerning which approach would be taken by each bank will depend on such factors as implementation cost, availability of data and system, and overall readiness of that particular bank. While the Bank of Thailand

5 Commercial Banking Act B.E. 2535 and the Act on Undertaking of Finance Business, Securities Business and Credit Foncier Business B.E. 2522

6 Detail of the Financial Institutions Businesses Act is in Chapter 1.

will not specify the approach commercial banks must use, there is a clear directive that the New Basel Capital Accord will be adopted, but at a time period when banks are ready.

The commercial banks are already well aware of the upcoming regulatory changes and have appropriately begun to prepare: 1) data warehouse; 2) strategic plan to implement New Basel Capital Accord with direct involvement from senior managers; and, 3) the testing of New Basel Capital Accord requirements on the banks' capital in order to determine if there are any operational obstacles. The Bank of Thailand has been in close cooperation with the commercial banks to evaluate and quantify the effects of the New Basel Capital Accord on the commercial banks' capital base.

In preparation for compliance, the Bank of Thailand has already adopted a number of measures in line with the New Basel Capital Accord. For instance, the Bank of Thailand has changed the supervision and examination approach from transaction testing toward risk-based approach, and has also issued the good corporate governance policy statement on the structure of the Board of directors and its sub-committees in December 2002. The Bank of Thailand also intends to issue a policy statement on sound practices of operational risk management that will serve as a guideline for financial institutions.

Risk-based Supervision

Credit risk

Amendments in loan classification

To encourage and support the debt restructuring efforts of financial institutions, and to align loan classification standards with improvements in the operating environment, the Bank of Thailand amended rules on asset classification and provisioning between January and February 2002. The major changes implemented by the Bank of Thailand include:

1) Financial institutions are now allowed to set provisioning for assets classified as "pass" and "special mention" at 1 and 2 percent, respectively, or at the average actual rate of migration into NPLs of previous 4 quarters, if the rate is lower. The amendment is to encourage financial institutions to continue their good performance on loan management and monitoring given that well-performing financial institutions will directly enjoy lower provisioning.

2) Classification rule of businesses based on 2 and 3-year consecutive losses was revoked. The previous classification standard was based on losses during the abnormal, crisis period and therefore penalized the improved forward-looking prospects of viable firms and acted as disincentive for lending to viable firms as well as to corporate restructuring.

3) Classification by accounts replaced classification by debtors, thereby allowing viable multi-credit line debtors to continue to have access to funding.

Market risk

The Bank of Thailand plans to issue policy statements on market risk supervision in accordance with the 1996 BIS Capital Accord for market risks in 2003. Transition period, however, will be given before the market risk capital charge is imposed.

In the process of drafting policy statements, the Bank of Thailand has drafted two consultative papers covering trading book policy and the standardized approach in measuring market risks. Two industry hearings were organized in November 2002 and February 2003 to discuss and receive feedback on these two papers. The Bank of Thailand is currently working on the third consultative paper on the internal model approach, the last component of the market risk policy statements. In conjunction with the Bank of Thailand's plan, financial institutions are urged to prepare the financial database necessary for the successful implementation of market risk guidelines.

Foreign exchange risk:

Maintenance of net foreign exchange position

In June 2002, the Bank of Thailand issued a policy statement revising the regulation on maintenance of net foreign exchange position to be in line with standards set by the BIS shorthand method, and expanding the coverage to strengthen the efficiency and effectiveness of supervision of foreign exchange risk. The guideline requires financial institutions to comply with these new changes no later than 20 December 2002. The details changes of the regulation include:

1) Individual currency limit: Financial institutions are required to maintain net foreign exchange position in a single currency of not exceeding 15 percent of total capital by the end of business day.

2) Aggregate currency limit: The Bank of Thailand has changed the calculation method of aggregate position to BIS shorthand method and requires financial institutions to maintain aggregate position of not exceeding 20 percent of total capital by the end of business day.

3) Thai commercial banks must include the foreign exchange positions of their foreign branches in the calculation of net foreign exchange position.

4) The Bank of Thailand allows, with prior approval, financial institutions with appropriate system, to use present value method to calculate their forward positions.

Liquidity risk

In September 2002 the Bank of Thailand issued policy statements, effective by January 2003, on liquidity risk management for financial institutions in accordance with international best practice as well as BIS standards. This policy aims to ensure that financial institutions establish a sound system for liquidity risk management in normal as well as stressful situations such as named-crisis, and ensure ability to maintain adequate liquidity for sustaining a short period of stressful situation.

The details of the guideline include:

1) Board of directors is responsible for authorizing the policy and action plan on liquidity management, and to monitor the implementation.

2) Both the policy and action plans should be reviewed periodically and when there are changes in the business strategy. There must also be an internal control system that can track and monitor the liquidity risk management system.

3) The liquidity risk management system must monitor exposures in domestic and foreign currencies under relevant scenarios. Furthermore, an effective and efficient reporting system that generates sufficient information for management to make a decision in a timely manner must be set up.

4) Financial institutions should have in place reports concerning internal liquidity risk management, and are required to keep all reports available for examiners. In case where financial institutions already have internal reports in line with the crux of Bank of Thailand's required reports, they are permitted to continue using their internal reports.

Operational risk

The Bank of Thailand has issued policy statements to strengthen operational risk management of financial institutions, especially with emphasis on internal control. These are particularly important during the period where financial institutions are undergoing restructuring and adapting new business models. Many are changing branch operation and out-sourcing to reduce costs; expanding into new businesses and in-sourcing services; or merging with other institutions as part of the consolidation process.

Internal and external auditors

The Bank of Thailand has issued a policy statement regarding the responsibilities of internal auditors, scope of audit work, and reporting requirement to the Bank of Thailand. This policy statement can also be used by a group-wide internal auditor or auditors outsourced by the bank. Apart from the policy statement, the Bank of Thailand also encourages internal auditors to apply other internal control guidelines issued by related organizations, such as the Institute of Internal Auditors (IIA), COSO, the Stock Exchange of Thailand, and the Institute of Certified Accountants and Auditors of Thailand.

As for external auditors, the Commercial Banking Act requires that financial statement of commercial banks be certified by an auditor approved by the Bank of Thailand who should not be a director, an officer, or an employee of the commercial bank. Qualifications of an external auditor, approval criteria, and scope of audit work are also specified by the Bank of Thailand. The material requirement in this notification is a five-year rotation period for commercial banks' external auditor.

In-sourcing and out-sourcing of supporting services

In order to allow financial institutions to optimize on their assets by out-sourcing and in-sourcing activities while remaining in keeping with good risk management practice, the Bank of Thailand issued notification on out-sourcing and in-sourcing of supporting services in October 2001. This requires financial institutions to have in place the Board of directors' approved policy on this matter which must contain objective, risk management procedures, contingent plan, and internal control procedures. In providing supporting services to other companies, the financial institution must ensure appropriate scope and avoid straying too far outside its core banking business, bearing in mind that the in-sourcing is meant to optimize existing assets and avoid idle resources. It must also ensure that third parties can clearly distinguish the bank's own activity and activities the banks are conducting on behalf of another party merely as service provider.

Concurrently, efforts are made to promote corporate accountability and prevent conflicts of interest. The Bank of Thailand implemented several initiatives aimed towards the promoting of good corporate governance and self-regulation within financial institutions. Such policy initiatives encompass guidelines for the structure of financial institution's Board of directors, information disclosure, related party lending, and the qualifications of internal and external auditors. The issues pertaining to these operational risk measures will be further discussed in detail in section 3.1.3 of this chapter.

3.1.2 New risk: E-banking

In light of innovation associated with information technology (IT) and e-banking, the structure of financial sector is evolving, giving rise to new businesses, delivery channels, forms of partnership and association (especially out-sourcing). Moreover, there are new forms of competition, such as those between financial and non-financial firms, particularly IT firms. To support market-driven development, the Bank of Thailand has focused on putting in place regulatory infrastructure that is market-oriented but serves to ensure safety and consumer protection.

IT out-sourcing

IT out-sourcing, while beneficial, exposes the financial institution to new operational, strategic, reputational, legal, and possibly cross-border risks. As such, the Bank of Thailand has developed a guideline for IT out-sourcing that requires financial institutions to develop IT policy that clearly states the reason and objective for IT out-sourcing, risk management procedures, qualifications of the IT service provider, the key features of the contract signed between financial institutions and the IT service provider, the monitoring and performance evaluation of the IT service provider, as well as consistency between related parties' IT contingency plans.

The key point emphasized is that IT out-sourcing does not absolve the financial institution from its obligation to ensure safe and efficient services to clients, and to comply with the regulatory framework, as if it has not outsourced the services. To foster accountability, both the financial institution's IT policies and risk management procedures must be deliberated and approved by the financial institution's Board of directors. The Bank of Thailand's IT out-sourcing guideline was circulated for comment from the industry, and announced in second quarter of 2003.

E-banking security

The Bank of Thailand has drafted policy statement governing e-banking security which has been sent to the industry for comment. The key feature of the guideline covers provision of services whereby transaction can be directly initiated by the customers, most typically internet banking services, which are carried over open network subject to operational risk and computer crime. Therefore, these can significantly affect the financial institution and the system-wide reputational risk and client's confidence.

The guideline requires the financial institution to draw up a Board of directors' approved plan that addresses a comprehensive set of issues, beginning with business strategy consider-ation for providing e-banking business, risk scenario and assessment, policy objective on security risk management which weighs risk against cost. The risk management procedures should cover key process/issues such as: access control; authentication and non-repudiation, system and data integrity; data confidentiality; system availability and contingency plan; system detection of intrusion and vulnerabilities such as audit log; and procedures for incident response and reporting.

It also covers suggestion on how to improve the environment to enhance security, such as via employee education and training, and consumer education, since consumers are usually the weak link in security chain that is susceptible to hacker as well as social engineering technique; and issues of out-sourcing and internal control.

IT business continuity plan (IT BCP)

Financial institutions will be required to develop and implement an IT business continuity plan that could ensure that when IT risk occurs, the financial institution has a plan to ensure all key businesses can function so as to reduce expected loss from this operational risk. The essence is that the plan generated by the institution, such as planned back-up facility and recovery, must be commensurate with the level of risk of the institution. The Bank of Thailand is formulating a policy guideline that will address the key issues to be included in the financial institution's IT business continuity plan, which may include: integrating IT business continuity plan into overall risk management plan; requirement on data and system recovery; assignment of responsibility and accountability; and test procedures of the plan.

3.1.3 Corporate governance

The need to improve corporate governance, not only within the Thai financial sector, but also throughout the economy, has been widely recognized since the financial crisis in 1997. Good corporate governance underpins the improvement of efficiency, transparency, and trust-worthiness of banks, which will increase their long-term competitiveness and shareholder value. The new Financial Institutions Businesses Act, which is currently under consideration by the government, will encourage banks to become more self-regulated. In the meantime, the Bank of Thailand has restructured its own organization and improved supervisory policy framework by placing greater emphasis on risk-based supervision instead of the usual transaction testing, which now relies more on banks' own auditing function. In recognition of the critical role of good corporate governance in the new financial environment, the Bank of Thailand has taken various initiatives to strengthen corporate governance in addition to those already required by the Commercial Banking Act. The following sections summarize these initiatives, guidelines and regulations that promote corporate governance in the Thai financial sector.

Financial Institution Directors' Handbook

The Bank of Thailand, with the support of the World Bank and cooperation from the Thai Bankers' Association, the Foreign Banks' Association, the Association of Finance Companies, and other respected experts, issued Financial Institution Directors' Handbook in March 2002. This Handbook advocates the practice of good corporate governance at all levels in each financial organization and provides corresponding guidelines for directors of financial institutions in performing their roles and responsibilities.

The Handbook spells out the fiduciary duties of directors as the leader of an institution and the expectations of the company's stakeholders such as shareholders and depositors. It also elaborates on the Board of directors' role in strategy and policy formulation as well as monitoring and supervision of management, and the Bank of Thailand's supervisory and regulatory roles and its expectations of the Board of directors.

Structure of commercial banks' Board of directors

In December 2002, the Bank of Thailand announced a policy statement to further strengthen financial institutions' corporate governance practices. This policy statement builds on the previously issued Financial Institution Directors' Handbook and is designed to provide guidelines and rules for the improvement of the composition, qualifications and responsibilities of the Board of directors and its sub-committees.

Under the new guidelines, the Board of directors of a commercial bank shall consist of executive directors not exceeding one-third of the board. The Board of directors shall also have at least 3 independent directors, or at a proportion of 1 independent director to 4 directors, whichever is higher. The policy statement specifies that an independent director, who plays an important role in maintaining a proper balance among board members in exercising the Board of directors' roles and responsibilities, is a person: (1) who is neither an officer nor an employee of the bank; (2) who does not have a familial relationship with top executives or major shareholders of the bank; (3) whose direct and indirect shareholdings of the bank is not more than 0.5 percent; and (4) who does not retain direct or indirect interest in related entities of the bank or that of its major shareholders. The Bank of Thailand issued these standards in order to better assess the Board of directors' independence and to provide greater transparency for the general public.

In line with the intentions of the policy statement, commercial banks must establish an audit committee comprising at least 3 directors, 2 of whom must be independent, to oversee the internal audit and compliance functions. Moreover, a risk management committee comprising at least 5 members from the Board of directors and/or executives to manage the overall risks of the institution and report to the audit committee must be established by commercial banks. The policy statement further specifies that the chief executive officer should also chair the risk management committee.

Two other sub-committees, the nominating committee and remuneration committee, should also be established based on institution-specific needs and resources. Whereas the nominating committee oversees the selection of directors, members of various committees and top executives of the bank, the remuneration committee reviews compensation programs of bank executives, directors, and members of various committees. These committees shall not consist of executive directors whereas the chairperson should be an independent director.

Fit and Proper Test: Qualification of directors and senior management

In December 2002 the Bank of Thailand issued a policy statement outlining the characteristics deemed undesirable and improper for directors and senior management of banks, in addition to those already stated in the Commercial Banking Act. The main characteristics stated were:

1) Person having been a director, manager, deputy manager, assistant manager of a commercial bank whose license has been withdrawn.

2) Person removed from a position in a commercial bank on recommendation of the Minister.

3) Government official with duty to control the operations of commercial banks or an official of the Bank of Thailand.

Limitation on outside directorships of directors and senior management of commercial banks

To ensure that directors of banks can devote sufficient time to effectively perform their duties at a bank, directors and senior management of commercial banks can be chairpersons of the Board of directors, executive directors, or directors with signatory authority, in no more than 3 other companies.

Lending to/or investing in related parties

Commercial banks are prohibited by law from lending to directors, their immediate family, and the enterprises where they, individually or in aggregate, hold more than a 30 percent stake. This prohibition also covers exposure arising from guarantee on any debt, accept, provide aval to, or intervene for honor of any bills that the director is a drawer, a maker or an endorser.

Moreover, for:

- lending to/ or investing in enterprises related to the bank, or its directors, or senior management (where the stake is more than 10 percent), and;
- for lending to the bank's shareholders with substantial or controlling interest; or its senior management,

These transactions are permitted, but must not exceed the limits and must conform to normal lending practices, with no special terms and conditions.

The limits are: 5 percent of the bank's tier 1 capital; 25 percent of total liability of the such enterprise; or 50 percent of such enterprise's equity, whichever is the smallest.

Information disclosure

In order to increase transparency and promote market discipline, commercial banks must disclose details of the following information in addition to those required by Thailand's accounting standards:

1) Transactions relating to senior management of the commercial bank or enterprise in which its directors or senior management have interest equal to or more than 10 percent of the enterprise's paid-up capital.

2) Compensation or other benefits, both cash and non-cash, paid to directors, or senior management apart from their usual compensation.

Anti-money laundering

In August 2001, the Bank of Thailand issued a notification regarding the procedures for the acceptance of deposits in order to prevent financial institutions from becoming a conduit for illegal money laundering and terrorism. The material condition in the notification concerns the requirement that potential clients must present certified proof of identification before opening an account in order to ensure that an account will not be opened under an assumed name or an alias.

3.2 Measures to support corporate and debt restructuring

The Bank of Thailand amended regulatory framework to better facilitate debt and corporate restructuring. These include, abovementioned, amendment of rules on loan classification to align loan classification standards with improvements in the operating environment. The key changes that are the heart of the reforms center around the revocation of the classification rule of businesses based on 2 and 3-year consecutive losses classification, thereby focusing on the loan repayment record of the debtor, and the classification by accounts instead of by debtors. These should help remove obstacles for viable borrowers by ensuring their continued access to funding.

Moreover, to facilitate efficient asset management and debt restructuring, regulation has been amended to allow financial institutions to purchase loans from a wider set of loan sellers. The Bank of Thailand has also amended the International Banking Facilities (IBFs) regulation to allow off-shore loan repayment by resident guarantor.

3.2.1 Permission for commercial banks and finance companies to purchase loans

In order to allow financial institutions to manage assets effectively and facilitate debt restructuring, the Bank of Thailand has expanded the scope of the loan sellers from which the financial institutions can purchase the loans. These sellers may now include the Thai Asset Management Corporation, asset management companies (privately-owned), and receiverships of 56 suspended finance companies. These are in addition to loans from financial institutions and the Asset Management Corporation (state-owned) already permitted.

3.2.2 Off-shore loan repayment by resident guarantor

The Bank of Thailand amended regulation to allow domestic guarantors to repay off-shore loans, if such loan has already undergone debt restructuring in accordance with the Bank of Thailand's debt restructuring guidelines. The latter condition helps ensure that financial institutions will receive loan repayments from genuine domestic guarantor of off-shore loans, and not from domestic borrowers attempting to take advantage of the amendment.

3.3 Regulatory reform to accommodate financial institution operations

The Bank of Thailand realizes that the current reporting and approval regime places a substantial burden on the financial institutions and the regulators in terms of time, cost, and resource allocation. As such, regulatory framework is reviewed in order to enhance the operational flexibility of financial institutions, ease reporting and approval procedures, and assist in the innovation of new business models and delivery channels.

3.3.1 Relocation of commercial bank branches and acquisition of real estate by commercial banks

In October 2002, the Bank of Thailand amended the regulation on branch relocation and acquisition of real estate in order to enhance operational flexibility and efficiency. Banks are now allowed to relocate their branches without the Bank of Thailand's prior approval, in cases where:

1) The relocation occurs within the same district.

2) The closure of existing branch and opening of new branch occurs on the same day.

3) The commercial bank discloses the date for the closure of existing branch and opening of the new branch to the Bank of Thailand and customers no less than 45 days before the effective date.

Banks may also expand branch size and operating hours without prior approval. The Bank of Thailand has also allowed banks to acquire real estate for operational purposes, and not for development or profit taking purposes, under the condition that they have in place the Board of directors' approved policy on real estate acquisition that clearly states objective and acquisition procedures.

3.3.2 New delivery channels: electronic branches

Given the growing adoption of technology, financial institutions in Thailand are turning increasingly to the new technological tools to develop delivery channels for their products. The Bank of Thailand has issued guidelines on the use of internet network for commercial banking business since 2000, and is in the process of deliberating guidelines on ATM and electronic branches. The latter are branches staffed by minimal number of employees but fitted with automated machines for cash and check deposits, passbook updates, computer stations for office banking, and equipments for video conference. In the meantime, the Bank of Thailand's draft guideline on e-banking security, currently being circulated for industry's comment, would cover the risk related to these operations.

3.4 Bank of Thailand Modernization

Given the dramatic shift in the regulatory regime towards the adoption of consolidated and risk-based supervision, the Bank of Thailand recognized that the organizational structure and internal operations of the Financial Institutions Policy Group (FIPG) and Supervision Group (SG) will also have to be reengineered in order to best fulfill the new regulatory demands brought about by risk-based and subsequently consolidated supervision. In other words, the reorganizations realigned the organizational structure and policy implementation to support risk-based supervision.

3.4.1 Restructuring of the Financial Institutions Policy Group (FIPG)

The Bank of Thailand initiated a reengineering project of the Financial Institutions Policy Group (FIPG) between February 2001 and June 2002. The material changes involved reforms to FIPG's organizational structure and policy deliberation process. Key changes and outcome can be summarized as follows:

Objective of reorganization: enhance the clarity of roles, reduce work duplication, respond to the demands of consolidated and risk-based supervision, and install new department to handle the group's long-term strategy planning and new financial innovation and financial sector liberalization.

Organizational structure: FIPG is divided into 3 departments: Risk Supervision Policy, Capital Policy, and Financial Institutions Strategy. This comprises 3 functional groups that correspond with key risks within risk-based supervision and future strategy on financial institution system.

Work process : Policy development objective:

- Enhance transparency of the FIPG's policy deliberation process.
- Ensure that policy and regulations are principle-based, risk-based, market-oriented, and in keeping with international standards.
- Enhance staff's capability via intensive training.
- Improve participation of relevant internal and external stakeholders in policy-making process and the clarity of regulations.

Outcome:

- FIPG has improved policy deliberation process by adopting the policy statement concept. This does more than just outlining the regulatory framework for compliance, but also emphasizes the essence and rationale of risk management. The new generation of policy statement achieves this by stating the best practice in risk management, and accountability and responsibility of the financial institutions' Board of directors to adopt appropriate internal risk management system. This emphasis should help motivate financial institutions and regulators to aim for conformity with substance rather than forms, that is to comply to the principle and spirit of regulatory guideline rather than the 'black-letter laws' and check-list.
- FIPG implemented internal guidelines to standardize procedure for policy deliberation and implementation. Through the standardization of industrial hearing, consultative paper, circulation, creation of the sub-committee chaired by outside experts to deliberate new policy initiatives, external stakeholders have opportunities to participate and influence the development of new policies prior to their enactment.
- FIPG has also standardized the policy's post-implementation phase by having internal guidelines on policy review. Self-assessment against international standards on policy-making process is now mandated.
- There is enhanced transparency by system of public disclosure via press release, direct mail to financial institutions, and postings on the Bank of Thailand's website.

3.4.2 Restructuring of the Supervision Group (SG)

Organizational structure: The Bank of Thailand restructured the Supervision Group (SG), effective from 1 January 2001. Under the new structure, supervision and examination work are divided into 6 departments to enhance the risk-focused examination process: Development Department, Financial Institution Applications and Special Examination Department, Risk Management and Information System Examination Department, Financial Institutions Monitoring and Analysis Department and 2 departments of Onsite Examination.

Work process: To optimize resource utilization, as well as ensure consistency in the work of risk-based supervision, the following concepts are used:

- Continuous supervision relies on both the on-site and off-site examination process to assess the safety and soundness and risk management of financial institutions on an on-going basis.
- Each financial institution is subject to an on-site examination at least once a year. For institutions with poor risk management, more frequent visits are required.
- Targeted or limited-scope examination may also be conducted on an as-needed basis.
- The examination, analysis, and assessment of financial institutions' risk management system include strategic risk, credit risk, market risk, liquidity risk and operational risk. The procedures follow the BIS guideline and international best practice of risk management framework.
- To maintain a continuous relationship with the senior management of financial institutions, directors and senior executives of the Supervision Group will pay regular visit and communicate with senior management of financial institutions as well as external auditors and other institution-affiliated parties.

3.5 Legal Reforms

3.5.1 Deposit Insurance Agency

Experience of 1997 crisis triggered the move to set up deposit insurance agency to prevent the problem of moral hazard. The Cabinet at the time approved in principle the establishment of a Deposit Insurance Agency covering all financial institutions. With the problem of moral hazard, depositors tended not to distinguish between weak and strong financial institutions, seeking only the highest rates of return. Financial institutions, on the other hand, were not subject to adequate market pressure to improve their operations. When the crisis broke out, the authorities were forced to provide blanket guarantee to all creditors and depositors to stop bank runs, resulting in substantial fiscal cost.

In the future, deposit insurance will protect only small depositors, without excessive costs to the government, and is thus deemed appropriate. The proposed institution will be assigned to:

1) Protect small depositors which account for 90 percent of all depositors in the financial system. These marginal depositors are usually incapable of evaluating risks of each financial institution. Large depositors and creditors to a failed financial institution, on the other hand, will not be protected.

2) Strengthen and prevent instability in the financial institution system that could arise from liquidity shortages when a large number of small depositors withdraw funds at the same time.

3) Start operations immediately when an insolvent financial institution is closed down in order to minimize costs of redeeming deposits, and deal with problem financial institutions to limit the amount of repayments to depositors.

The Ministry of Finance has set up a committee to consider the establishment of the Deposit Insurance Agency, the draft the legislation, and promotion of public understanding on this issue. The two key phases to the process are:

First phase: Issues include (i) conditions and timing for permanently lifting the blanket guarantee by FIDF; (ii) preparation of the necessary transitional steps; (iii) studies of depositors' behavior in order to identify the appropriate environment for changes. The preconditions are: economic stability, strong financial institutions, effective rules and regulations, and depositor confidence in financial institutions are indispensable.

Second phase: This involves the designing of work processes of the Deposit Insurance Agency, including criteria for closing a problem financial institution.

3.5.2 Credit Bureau

Information provided by credit bureaus help reduce lending risk, thereby lowering the likelihood of NPL occurrence and raising the confidence of commercial banks. In due course, this should facilitate the return to normal functioning of the financial sector and promote sound credit culture in the longer term.

There are two credit bureaus in Thailand:

1) The Central Credit Information Service (CIS) was set up in December 1999 under the auspices of the Bank of Thailand. Its shareholders are exclusively private institutions, with 13 Thai commercial banks holding altogether 50 percent of the shares and two other companies, Trans Union International and Business On-line, each holding 25 percent. With 22 current members, CIS has expanded its services from initially providing information on large customers only to providing information on retail customers as well.

2) The Thai Credit Bureau (TCB) was set up in September 1999 under the auspices of the Ministry of Finance, with the Government Housing Bank and Processing Center Co. Ltd (PCC) holding 49 and 51 percent of its shares, respectively. The company specializes in personal data, providing information on each debtor's total liabilities, loan purposes, loan classifications, as well as debt restructuring history.

Essence of the Credit Bureau Act

The Credit Bureau Act, passed in November 2002, carries the following key features:

1) Credit bureau business must be set up in the form of a company, under a license granted by the Ministry of Finance.

2) A credit bureau must be owned in the majority by Thai shareholders, and the number of Thai directors must be no less than half of the total number of directors.

3) Except by consent of the Credit Information Protection Committee, any action that would interfere with the provision of information to a credit bureau, or the use of credit information on any company, as well as any action that would lead to a monopoly in this business, is prohibited.

4) Financial institutions may supply credit information to a credit bureau without the debtor's consent. Information that may reveal the identity of a debtor, however, must not be disclosed by a credit bureau without the concerned debtor's written consent.

5) A credit bureau may share information with its members for the purpose of loan analysis only when written consent is given by the owner of the information (except when the information is requested by court order or is to be used for an investigation or asset appraisal for the purpose of conversion into securities, or receipt of transferred assets, in accordance with the credit information protection code). The use of information for other purposes is subject to a written consent of the owner of the information on a case-by-case basis.

6) Owners of information must be protected and treated fairly. The owners have both the right to know what information on them has been gathered by a credit bureau, and the right to examine and contest the accuracy of such information. The right to know the reason for credit refusal is also protected in the case where credit is denied on the basis of information provided by a credit bureau.

CHAPTER 4

DEBT RESTRUCTURING

4.1 Resolution of non-performing loan (NPL)

4.1.1 Trends in NPL

Non-Performing Loan (NPL) in the Thai financial system has been steadily declining from 2,729.3 billion Baht in June of 1999 to 843.3 billion Baht in June 2002, and 772.6 billion Baht in December 2002, or around 15.77 percent of total credit outstanding in the financial system. The strategy to tackle NPL in 2003 will specifically target four categories, namely: 1) Restructured and Repaying to Creditors, 2) In the Negotiation Process, 3) In the Court Process, and 4) In Legal Execution Proceedings. NPL debtors in the first two categories are expected to be resolved within one year of entry into the respective statuses. For the latter two categories of debtors in the court process and legal execution process, the Corporate Debt Restructuring Advisory Committee (CDRAC) and the staff of the Bank of Thailand will play an even more active role in facilitating the cases in order to expedite the process. The authorities have the objective of reducing NPL ratio in the system to a single-digit by end of 2004, provided that the economic recovery progresses sustainably.

4.1.2 Assessment of NPL

The economic crisis that erupted in 1997 resulted in record number of corporate failures and NPL in the financial system. At its highest, NPL reached 47 percent of total credits in the system in 1999. The resolution of the debts was difficult and time-consuming due to various factors including the inadequate infrastructures, legal and administrative, to facilitate the process.

To address the NPL problems, the informal workout process has been founded, and the formal process in the court has been amended. To support the informal workout process, Thailand has instituted guidelines for debt restructuring, the Bangkok Framework, Inter-Creditor Agreement, Debtor-Creditor Agreement, Court Mediation Center guidelines, and incentives such as relief on land transfer fees. In addition, the government has also amended the Bankruptcy Law to allow the qualified debtors to restructure their bad debts through the court process.

A number of informal workout mechanisms have been established to tackle the distressed asset problem. They include the Central Bankruptcy Court, Financial Sector Restructuring Authority (FRA), state-owned Asset Management Corporation (AMC), privately-owned asset management companies, Thai Asset Management Corporation (TAMC), Corporate Debt Restructuring Advisory Committee (CDRAC), Provincial Sub-committee for Debt Restructuring, Court Mediation Center, and SMEs & P Financial Advisory Center (SFAC).

4.2 Corporate Debt Restructuring Advisory Committee (CDRAC)

4.2.1 Framework and key agreements

The Joint Public-Private Consultative Committee (JPPCC) Resolution dated 22 June 1998 established the Corporate Debt Restructuring Advisory Committee (CDRAC) to encourage and accelerate informal workouts. CDRAC's key role is to act as a facilitator or an independent intermediary in the restructuring process in order to facilitate and expedite the negotiation among all parties concerned. The Governor of the Bank of Thailand is the Chairman of CDRAC, while its members are represented by the chairpersons from both the creditor and debtor associations, namely, the Thai Bankers' Association (TBA), the Foreign Banks' Association (FBA), the Association of Finance Companies (AFC), the Federation of Thai Industries, and the Board of Trade of Thailand. The Bank of Thailand provides a Corporate Debt Restructuring Group (CDG), formerly known as the Office of the Corporate Debt Restructuring Advisory Committee, as the secretariat to coordinate and facilitate the debt restructuring between parties concerned and operate in accordance with the resolutions of CDRAC. The Director of CDG is also a CDRAC member and secretariat.

CDRAC's restructuring process is based on the Inter-Creditor Agreement on Restructure Plan Votes and Executive Decision Panel Procedures (ICA) and the Debtor-Creditor Agreement on Debt Restructuring Process (DCA) that are used for large and multi-creditor debtors, and the Simplified Agreement (SA) that is used for small- and medium-sized debtors. These agreements were modified from the Bangkok Framework, approved by CDRAC and signed by financial institutions in Thailand in March 1999 as part of the operation of the structured informal workout process through the CDRAC.[7]

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7 Initially, these agreements were signed by commercial banks, finance companies, EXIM Bank, and the Industrial Finance Corporation of Thailand. In 2001 and 2002, asset management companies also signed into these agreements.

The ICA provides the basic conditions under which the creditor parties to a workout will endeavor to reach consensus on proposed plans for corporate restructuring. It lays out the policies on voting on plans, time limits for decisions, mediation of inter-creditor disputes, and the appointment of an executive decision panel to review and approve or reject a proposed plan. The decision of the executive panel is final and binding on the creditors who have executed the inter-creditor agreement.

The DCA is required to be signed into the Agreements by a debtor corporation that seeks to invoke the CDRAC informal workout process. The debtor must be first approved as a target debtor by the CDRAC. In essence, this Agreement is made with the banks and other financial institutions that have agreed to the Inter-Creditor Agreement. The DCA binds the parties to the Inter-Creditor Agreement. The policy areas covered by the DCA include convening of meetings, lead creditor, steering committee, provision of information, promises by the debtor while the negotiation process is under way, mediation of disputes, debt trading, voting and approval of plan, and implementation of plan. The agreement contains detailed schedules for the commencement and advancement of the workout process and of information that the debtor is required to provide.

4.2.2 Negotiation process under the framework

The negotiation of debt restructuring is processed under the tight schedule set by the DCA. If the negotiation is carried according to the schedule and can be settled by the first vote, it would take only between 4 - 5 months. The conditions for a Sufficient Plan Approval status are that no less than 50 percent of the creditors *and* no less than 75 percent of the credits outstanding of voting creditors vote in favor of the plan. If the plan is not approved in the first vote, the debtor has the opportunity to amend the plan in accordance with the comments of the disapproving creditors and re-submit for a second vote.

If, in the second vote of the creditors, a proposed plan is approved by creditors holding no less than 50 percent of the total credits owed to voting creditors or no less than 50 percent of the number of voting creditors, but does not achieve Sufficient Plan Approval status, the Steering Committee, lead institution or any creditor shall submit the proposed plan to CDRAC within 10 business days from the date of such second vote, with a request for CDRAC to appoint an Executive Decision Panel.

If, after completion of the second vote of the Process Schedule, the proposed plan is not approved by creditors holding at least 50 percent of the total credits of all voting creditors or being at least 50 percent of the number of voting creditors, the creditors under this Agreement shall immediately file a joint petition with a court having jurisdiction for collection of all their credits and/or the reorganization under new management or the liquidation of the debtor.

4.2.3 Results of operations

In 2002, the CDRAC turned its focus to facilitating the restructuring efforts of small and medium-sized debtors, especially viable SMEs, as most large debtors have already been transferred to asset management companies and the Thai Asset Management Corporation (TAMC).

Since mid-1998 up to 31 January 2003, CDRAC has approved 15,386 cases with credit outstanding of 2,841,749 million Baht. Of these, 14,850 cases with total credit outstanding of 2,625,223 million Baht are 1998-2001 target debtors, and 536 cases with total credits outstanding of 216,526 million Baht are 2002 target debtors. Details of the progress in restructuring these cases are as follows:

Table 11 CDRAC Debt Restructuring Progress

	Cumulative from 1998 to end of January 2003	
	Cases	million Baht
1. Successfully Restructured Debtors	10,322	1,382,945
2. Unsuccessfully Restructured Debtors (Financial institutions take legal action)	1,683	420,253
3. Debtors under Restructuring Process	178	81,048

Of the 10,322 successfully restructured debtors, a total of 10,149 cases with total credit outstanding of 1,308,056 million Baht are 1998-2001 target debtors. A total of 173 cases with total credit outstanding of 74,889 million Baht are 2002 target debtors. The majority of the successfully restructured cases is represented by the wholesale and retail trade sector with 2,619 cases, followed by the personal consumption sector with 2,438 cases, and the industrial sector with 1,638 cases. Most debtors are based in Bangkok and the Central Region.

The relatively small increase in the number of cases in 2002 is a direct result of the smaller number of targeted debtors, due in part to the transfer of large debtors undergoing debt restructuring negotiations to asset management companies and the TAMC.

For 1,683 debtors for whom restructuring under CDRAC was unsuccessful, and 3,110 debtors (credit outstanding of 774,176 million Baht) who did not enter into the CDRAC process, civil cases have been filed against them in the court by financial institutions.

Furthermore, an additional 28 debtors with credit outstanding of 23,163 million Baht have been transferred to the TAMC, and 60 cases with credit outstanding of 159,662 million Baht have become performing loans.

On the division of responsibility between CDRAC and TAMC, the roles of the two institutions are for the most part mutually exclusive. While the financial institutions transfer some of the outstanding debt obligations to the TAMC for management and resolution, CDRAC continues to facilitate the debt restructuring for those debtors that remain in financial institutions.

4.3 Thai Asset Management Corporation (TAMC)

4.3.1 Result of operations of TAMC

Acquisition of impaired assets

In the year 2002, the Thai Asset Management Corporation (TAMC) continued to acquire additional impaired assets to be brought under its management. The first acquisition took place in the third quarter when TAMC acquired impaired assets with the amount of less than 50 million Baht, belonging to single creditor, from both state-owned financial institutions and asset management companies. In addition, after the Minister of Finance announced that the Industrial Finance Corporation of Thailand (IFCT) was eligible to transfer impaired assets to TAMC, 23 cases of debtors with the book value of 8,682 million Baht were transferred to TAMC on 31 December 2002.

Table 12 Cumulative Acquisition of Impaired Assets (as of December 2002)

(million Baht)

Transferring Institution	Cases	Book Value
State-owned FIs and AMCs	4,937	611,100
Private FIs and AMCs	1,043	148,260
Total	**5,524**	**759,360**
Transfer Price (% of Book Value)		34%

Management of impaired assets

At the end of 2002, TAMC was able to achieve its target of 500,000 million Baht in resolving the impaired assets acquired from financial institutions and asset management companies. This was due to the fact that negotiations on many major cases reached conclusions, and subsequently their debt/business restructuring plans were approved by the Executive Committee. The total number of cases that reached conclusions was 2,206, with gross book value of 501,195 million Baht. This represents a notable acceleration in the last quarter of 2002, as can be seen from comparison that this figure rose from those at the end of September 2002 by 1,133 cases, and book value of 151,134 million Baht. Since approximately half of the total approved cases involved businesses that were either viable or had potential to continue to grow, the cases were approved by the TAMC's Executive Committee to proceed with debt/ business restructuring or rehabilitation in the Central Bankruptcy Court. The rest were considered non-viable or non-cooperative in restructuring with TAMC's authorities. As a result, TAMC exercised its authorized power to foreclose on and/or to enforce final receiverships of the debtors' properties.

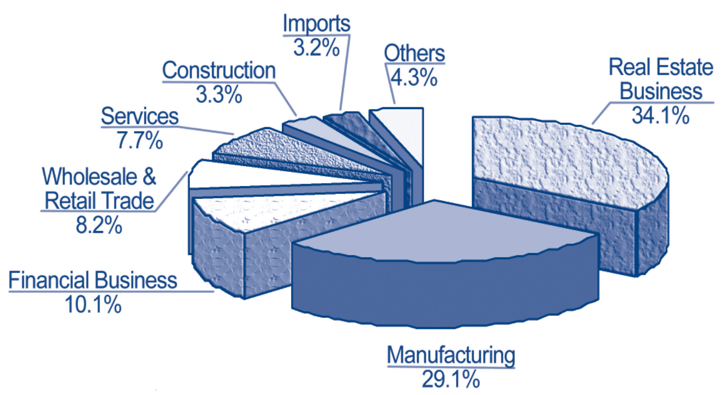
Table 13 Cumulative Progress in Restructured Cases (as of December 2002)

(million Baht)

	Procedure	Cases	Book Value	% of Book Value
1.	Debt Restructuring	611	200,661	40.04%
2.	Business Restructuring	4	2,046	0.41%
3.	Rehabilitation in the Central Bankruptcy Court	61	47,570	9.49%
	a. Approved	51	43,015	8.58%
	b. Awaiting Approval	10	4,555	0.91%
4.	Foreclosure/Final Receivership of Properties/Verdict by the Civil Court	1,530	250,918	50.06%
	Total	**2,206**	**501,195**	**100.00%**

Classified by industrial sector, approximately 34.1 percent of the total amount of debt approved for restructuring was real estate-related, while 29.1 percent was in the manufacturing field.

Chart 25 Sectoral Decomposition of TAMC Debt Under Restructuring (as of December 2002)



The Executive Committee assesses the viability of each debt/business restructuring plan based on cash flows and economic values of debtors' businesses in order to determine their abilities to service debts and to evaluate their business potentials. For viable and cooperative debtors, the strategies used include the amendments of terms and conditions, payment rescheduling, debt-to-equity conversion, transfer of properties for payment, and sales of non-core assets. Furthermore, TAMC may grant debtors certain financial assistances once they have fulfilled required terms and conditions specified in their debt restructuring plans and have demonstrated certain responsibilities, such as write-down of their equities, provision of additional cash and/or non-collateralized properties.

According to the restructuring plans of 676 debtors, whose cases were approved for debt/business restructuring and rehabilitation in the Central Bankruptcy Court, these are expected to recover with expected recovery rate[8] of 47.96 percent. This rate is considered acceptable, based on the ground that TAMC is a non-profit governmental organization. Moreover, when the transfer prices are taken into consideration, TAMC's management of the impaired asset does not cause any further losses or damages to the nation.

4.3.2 Business restructurings in major industries

One of TAMC's main aim is the facilitation of business restructuring. In this regard, TAMC has appointed the Sub-committee on Sectoral Restructuring, consisting of prominent persons from both public and private sectors, to provide advices and recommendations on business restructurings and to assist the arrangements of funding sources in accordance with debt/business restructuring plans. Furthermore, TAMC encourages financial institutions, investors, and other relevant agencies to provide assistance, in terms of funding, expertise, and technologies in order to improve debtors' competitiveness while supporting restructuring of the real sectors. TAMC also adheres to the principle that the restructuring of the impaired assets in each sector must not cause distortion against other performing firms in order to avoid unfair competition.

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8 Assumptions for the calculation of expected recovery rate of debtors approved for debt/business restructuring and rehabilitation in the Central Bankruptcy Court:

1. Calculate net present value of restructuring plan by using MLR as a discount rate. This does not factor in the risk of default that may arise if debtors cannot comply with the terms and conditions specified in their debt restructuring plans.
2. Debt-to-equity conversion
   - For listed companies, use the 30-day average closing price prior to the date of calculation or the latest closing price, whichever is lower.
   - For non-listed companies, assess value from their cash flows or gross values. If the assessment is not possible, the value is determined to be zero.

Real estate business

To support the government's policy to revive the real estate sector and to support viable debtors in the sector, TAMC has liaised with the National Housing Authority (NHA) and financial institutions to find the best possible solutions. In this context, NHA conducted researches on real estate projects and selected those with potential for successful completion for consideration of new funding from financial institutions. As of the end of 2002, two such housing projects were launched with the value of approximately 110 million Baht.

As for the progress in restructuring the real estate business, 548 cases, with the book value of 170,305 million Baht, were concluded by the end of 2002. Of these cases, 198 cases with the book value of 85,211 million Baht were approved for debt restructuring and/or rehabilitation in the Central Bankruptcy Court. The rest of the cases were to proceed with foreclosure and final receivership of properties.

Manufacturing

The sectors that TAMC focuses on are those that are not only fundamentals to the economy, but also have significant impact on employment. In accordance with the government's policy, 13 industries are included, namely iron and steel, food, textile, automobile and parts, electrical appliances, ceramics and glasses, rubber, footwear and leatherwear, chemical products, jewelries, wooden products, plastic, as well as petrochemical.

Among the aforementioned industries, TAMC has made an important move towards the restructuring of the iron and steel industry. In this regard, it has collaborated with the Iron and Steel Institute of Thailand to find the solutions to effectively solve problems of the industry. Also, TAMC encourages consolidation between companies in this industry so as to improve efficiency and to utilize advanced technology to manufacture high-quality products. TAMC also works closely with the Thailand Textile Institute to identify strengths and weaknesses of the textile industry and find ways to enhance productivity and quality of the players to meet the world standard.

On the overall progress in restructuring the manufacturing sector, 415 cases, with the book value of 145,806 million Baht, were concluded at the end of 2002. Out of these, 151 cases with the book value of 95,724 million Baht were approved for debt restructuring, business restructuring, and/or rehabilitation in the Central Bankruptcy Court, while the rest of the cases were to be proceeded with foreclosure and final receivership of properties.

4.3.3 Transparency and good governance

TAMC adheres to the principles of transparency and good governance. This is to enhance the confidence of the debtors, creditors, and public that TAMC is independent, transparent, accountable and non-discriminating. Such principle also strengthens TAMC's management efficiency and, at the same time, mitigates its potential operational risks.

TAMC has successfully implemented a check-and-balance control system for its policy and decision-making processes. Both the Board of directors and the Executive Committee comprise the authorities from state agencies and representatives from private organizations, acting on behalf of debtors and creditors. While the Executive Committee has the authority to carry out activities related to the management of impaired assets and to establish management framework and guidelines, it has to act in accordance with the policies, set forth by the Board of directors. Also, the approved cases with the book value of more than one billion Baht must be presented to the Board of directors for their recommendations and comments as these cases are usually sensitive and have significant impact on the economy. Furthermore, the original creditors and asset managers are involved in the restructuring process. To assure that the management of impaired assets is in compliance with applicable laws, regulations, and guidelines, TAMC has established both internal and external auditing procedures.

As for the disclosure of information, TAMC disseminates information on its performances on a monthly basis. In addition, it releases information on debt restructuring plans of individual debtors, with their consents. As at the end of 2002, TAMC released the details of three individual cases. To enhance its transparency, TAMC is now convincing debtors, whose debts are more than one billion Baht and those who have the attention of the public, to agree to disclose their restructuring plans.

4.3.4 Policy on TAMC

Management strategies

TAMC has established the following key management strategies as the guideline for its operations:

- Rehabilitate viable debtors' businesses to assist them in resuming their normal operations and growth path.

- Focus on sectoral restructuring with emphasis on key sectors.

- Establish exit strategies for restructured debts and properties acquired from foreclosure or transfer of properties for payment.

- Enhance value of assets acquired, by cooperating with relevant parties that have expertise and by utilizing various instruments in the financial and equity markets.

- Encourage financial institutions, investors, and other relevant agencies to provide funding, technologies, and expertise to viable debtors.

- Operate in a transparent manner by disclosing necessary information to the public.

- Enhance efficiency of management information system as well as cooperate with financial institutions and debtors.

Future acquisition of impaired assets

To achieve its main objective of solving NPL problem in a rapid and efficient manner, TAMC concurrently supervises both large and small cases. It aims to transfer the remaining impaired assets, with the amount of less than 20 million Baht, from the state-owned financial institutions and asset management companies by the first quarter of 2003.

CHAPTER 5

SUPERVISION OUTLOOK

Encompassing the Bank of Thailand's development strategy for the Thai financial system is the impact from the forces of change currently sweeping through financial services worldwide. Because Thailand is a small, market-oriented, open economy with financial linkages to the international financial markets, it is of utmost importance for domestic financial institutions to be alert to the global changes and incorporate the lessons learned in their competitive strategies to create value added. The global forces of change bring both opportunity and challenges, and the key to a successful strategy is to harness these forces to create products, services, and business model that increase value added to the financial sector. The financial institutions should then have the capability to adapt to changing international norms and act as stable conduits for allocating financial resources and risk among various sectors vital to Thailand's overall economic and social development strategy.

5.1 Forces of change

By researching the past experience of other countries such as Canada, South Africa, Malaysia and Australia that have already undergone the process of developing a financial sector master plan, and from the Bank of Thailand's conference on "Modernizing our Financial System: Challenges for the New Millennium" held in January 2002, four key forces of change can be summarized.[9]

1) Technology: Rapid advances in information technology enable new delivery mechanism and a new class of competitors to come into play. However, a service provider with low skill workers and lacking in ability to adopt their organization flexibility may find it difficult to benefit from technology.

2) Consumer Trends: By looking at changing demographics and consumption trends, it was found that customers are becoming increasingly sophisticated and demanding with new preferences which raise service hurdles and shorten product life cycles.

9 "The Changing Landscape for Canadian Financial Services: New Forces, new competitors, new choices," by McKinsey & Company, September 1998

3) Regulatory Reforms: Reforms act as a force of its own by breaking down barriers between products and countries, and facilitate the emergence of truly global providers. Most major markets are undergoing a period of reforms.

4) Globalization: Globalization has taken many financial services beyond the realm of domestic competition and onto a global playing field where international financial services giants have redefined both the competitive and regulatory landscapes.

The four main forces of change have in effect increased competition from non-traditional players, encouraged intra-industry consolidation, and increased performance pressures on financial institutions to innovate due to falling profit margins. Some examples of the material impact from the forces of change are as follows:

1) Disintermediation and Securitization: Commercial banks are being bypassed as the traditional providers of credit and savings products either by the market or other non-intermediary institutions. Some new players do not provide financial products but rather serve as information channels between customers and a variety of financial service providers, thereby becoming a new type of intermediary.

2) Disaggregation and Reaggregation: Global forces are breaking up and reassembling companies in ways that enable new entrants to serve bank customers often more effectively and efficiently than traditional providers. They are able to do this because they design their business systems around specific customer and market needs rather than around regulatory or geographic barriers. In essence, global forces are enabling new entrants to pool together parts of the business system and create new types of intermediation, i.e., electronic marketplaces/intermediaries.

3) Intra-industry Consolidation and Convergence: Institutions have found it easier to grow and meet stock market expectations through these external means rather than through slow organic growth.

5.2 Impacts of the forces of change on Thailand's financial sector

Being a small, open economy, Thailand is not immune from the evolution occurring within the international financial markets. Although such forces of change may not have immediate impact on the structure of Thailand's financial system, they do influence the deliberation process of Thailand's Financial Sector Master Plan, supervisory reforms, and the subsequent liberalization of financial services within the World Trade Organization (WTO), ASEAN Framework Agreement on Services (AFAS), and various bilateral agreements with which Thailand is an active participant.

The evolutionary changes occurring among developed countries help signify the coming trends within financial services that both domestic financial service providers and regulators must recognize in order to formulate financial policies that can accommodate new financial innovations. For example, the design of the Financial Sector Master Plan takes into account the impact from the aforementioned forces of change.

Beyond the Financial Sector Master Plan, discussions about the forces of change was also one factor that helped usher in the period of self-introspection that questioned the adequacy of the Bank of Thailand's supervisory regime. Such questions concerning the adequacy of existing supervisory regime, supervision of financial conglomerates and cross-border banking in light of the forces of change are examples of policy deliberations that culminated in such major legal reforms undertaken by the Bank of Thailand as the Financial Institutions Businesses Act.

Additionally, these discussions have also motivated the Bank of Thailand to perform qualitative self-assessments measuring how Thailand's financial supervisory regime complies with internationally accepted standards, and monitoring the strengths and weaknesses of the entire financial system. Through this exhaustive process, the Bank of Thailand will be able to pinpoint current infrastructural weaknesses and promptly devise an appropriate action plan capable of remedying such conditions.

APPENDIX 1

LIST OF MAJOR POLICY ANNOUNCEMENTS 2001*

1. Policies to Encourage Debt Restructuring

1.1 Issued circulation to inform financial institutions of the Revenue Department's decision on granting tax and duty privileges for financial institutions' debt restructuring.

1.2 Expanded the types of equity commercial banks can possess, in excess of the legal limit, following debt restructuring in accordance with the Bank of Thailand's guidelines. The regulation was amended so that, in addition to equity from debt-equity swap, the permission is extended to equity obtained as foreclosed assets.

2. Expanding Scope of Businesses of Financial Institutions

2.1 Escrow account agent: Permitted commercial banks to accept deposits in the form of escrow account where depositors have entered into purchase/sale agreement with the sellers. In performing such activity, commercial banks have to oversee that the withdrawal will be done when the purchaser and seller have fulfilled the conditions agreed upon opening the account.

2.2 Expanding counter party in Private Repo Market: Permitted commercial banks to borrow from institutional investors in the form of private repurchase transactions. The institutional investors are as follows: 1) funds under the Office of the Securities and Exchange Commission (SEC) supervision such as mutual funds, provident funds, private funds, and any funds which may be formed in the future; 2) Government Pension Fund; 3) Social Security Fund; 4) Specialized financial institutions; 5) Life insurance companies; and, 6) Insurance companies.

* For a complete list of policies, please visit the Bank of Thailand's website at www.bot.or.th

2.3 Measures to Enhance Operational Effectiveness of Asset Management Companies (AMCs)

(1) Allowed AMCs to buy real estate that has already gone through the legal foreclosure process and debt restructuring.

(2) The Ministry of Finance issued an Emergency Decree classifying AMCs as financial institutions, thereby allowing AMCs to purchase assets from other AMCs.

2.4 Allowed financial institutions to provide back office services to other institutions within the group so as to help reduce operating cost and optimize on the value of resources. Financial institutions are required to have in place a detailed policy on provision of such services.

2.5 Expanded the scope of custodian service of finance companies to include documents designating ownership that are related to the sale, transfer, and asset appraisal such as land titles, purchase agreements, and appraisal documents.

2.6 Allowed International Banking Facilities (IBFs) to hedge interest rate risk for themselves and for others such as non-resident customers, resident customers who borrowed in foreign currencies, other IBFs, Ministry of Finance, and the Bank of Thailand.

3. Financial Institutions Supervision Policies

3.1 Clarification on asset classification rules

The Bank of Thailand issued the clarification on asset classification rules in May 2001 to clarify the following:

(1) <u>Asset classification in case where the debtor has been operating his business at a loss for two or three consecutive years</u>

The regulation on asset classification stated that for debtor whose business recorded a loss for two or three consecutive years, the debtor must be classified as substandard or doubtful, respectively, unless there are evidences that the debtor has an opportunity to make profit to compensate for the loss. In this case, the Bank of Thailand has clarified that the debtor who made such loss, but is not yet overdue by more than 3 months, need not be so classified.

However, the debtor must be qualified in one of the following criteria:

1. The debtor is in the beginning period of business or project and has a good record of operating according to project plan;
2. The loss of the debtor was a consequence of the adverse general economic situation, and debtor is expected to recover with the economy;
3. The financial institution has analyzed that the business plan is viable; or
4. In case the SME debtor has positive EBITDA, if the financial institution has considered that the approved credit line is necessary for the debtor's operation, the debtor's account can be classified as pass.

These do not constitute supervisory forbearance since the de-classified debtor must not become overdue by no more than 3 months; otherwise they are reclassified.

(2) <u>Asset classification based on each debtor</u>

The regulation states that in case the debtor has several types of loans, if one of these loans is classified, the financial institution must classify all of debtor's loans in the lowest class. This is with the exception of the case where the credit line of each loan can be separated from each project, the financial institution can then classify the assets on loan-by-loan basis. In this case, the Bank of Thailand has clarified that if the debtor's working capital account is active or O/D account is active and not fully used, the financial institution can classify this debt as pass.

(3) <u>Asset classification based on quality of guarantor</u>

In case where there are concerns over the credit standing of the guarantor, as long as the debtor is not more than 3 months overdue, the classification process need not consider the credit standing of the guarantor. Where the debtor becomes more than 3 months overdue, classification should still emphasize the credit standing of the debtor himself.

(4) <u>Asset classification on group of loan</u>

The Bank of Thailand does not have rule and regulation on this matter.

(5) <u>The regulation in case where the financial institution is uncertain on the qualification of debtor as mentioned above</u>

1. An independent external auditor and financial consultant, unrelated to the financial institution or Bank of Thailand, will determine the qualification of the debtor.

2. The Bank of Thailand will approve the debtor's qualification in the first 2 years.

3.2. Use of Standby Letter of Credit (SBLC) and Letter of Guarantee (LG) as collaterals

The Bank of Thailand has allowed Standby Letter of Credit (SBLC) and Letter of Guarantee (LG) to be used as collaterals for deduction from the book value of the debt before calculating the provisioning; the amounts eligible for deduction are:

(1) 100% for SBLC collateral.

(2) 95% for LG collateral.

3.3. Collateral appraisals in case of pass and special mentioned loans:

If the appraisal is made within 36 months, 90% of the value can be used for deduction from required reserves calculation, but only 50% of the appraised values can be used when the last appraisal exceeds 36 months period.

3.4 Appraisals for immovable properties acquired as a result of debt settlement

(1) Properties with book value equal to or in excess of 50 million baht are required to be valued by an independent appraiser. For properties with lower book value, financial institutions can use either an independent appraiser or a financial institution's internal appraiser for collateral valuation.

(2) For properties of which the appraisal has not been made within 12 months, only 50% of the appraised value can be used for deduction from required reserve calculation.

3.5 Collateral appraisals

(1) In case that an independent appraisal is required and the Appraisal Committee does not agree with appraised value determined by the independent appraiser, the Committee can arrange to have the collateral appraised by another independent appraiser and choose any amount ranging between these two appraised values as the collateral value.

(2) For financial institutions with capital less than 8,000 million baht, independent appraisal is required if the book value of the loan exceeds 25 million baht. In case of larger financial institutions, independent appraisal is required if the book value of loan exceeds 50 million baht.

3.6 Credit risk and credit policy

(1) The Bank of Thailand issued further guidelines on related lending. Financial institutions are not allowed to grant credit or invest in the business in which the financial institutions, their directors or senior management, have the related interests in excess of the prescribed limits.

(2) The Bank of Thailand issued guidelines which permitted finance companies to grant credit, aval, acceptance, guarantee, or undertake contingent liabilities for government entities in excess of the prescribed limits without the Bank of Thailand's permission.

(3) The Bank of Thailand issued the guidelines for financial institutions on the collection of data or documents to enhance efficiency and effectiveness in analyzing and monitoring the debtors' performance.

(4) The Bank of Thailand issued guidelines defining the meanings of private repurchase transaction, the conditions for lenders and borrowers engaging in the private repurchase transaction, and specifying the way to measure the collateral value in excess of the amount of loan received for calculating the limit of large exposure.

3.7 Ceiling on lending interest rate

To encourage level playing field between Thai and foreign commercial banks, the Bank of Thailand removed the ceiling on lending interest rate of not exceeding MLR + 4%, previously set up during the period of relatively high market interest rates.

3.8 Valuation of securities for liquid asset maintenance

In order to ensure that the value of liquid assets reflects the true value and is in line with the Thai Accounting Standard, the Bank of Thailand amended the valuation guidelines on liquid assets from the par value to fair market value according to the accounting standard mentioned.

3.9 Framework on good governance

(1) Outside directorship: The Bank of Thailand amended related guidelines on the following issues: Limit a director and senior management of a commercial bank to be a chairman, executive director, or director with signatory authority in no more than 3 other companies.

(2) Sales of properties to directors: Allowed financial institutions to give or sell property to a director without permission from the Bank of Thailand if and only if its value does not exceed 50,000 baht per year. Financial institutions can further sell properties beyond this limit to their directors if these sales comply with the criteria set by financial institutions according to the Bank of Thailand's regulations.

(3) Established procedure involving paying cash or other assets as remuneration to employees.

3.10 Financial Institution Directors' Handbook

The Bank of Thailand published Financial Institution Directors' Handbook in 2002 to foster improved corporate governance of financial institutions by emphasizing duties and responsibility of the Board of directors as well as touching on related prudential guidelines to help the Board of directors perform its function.

3.11 Internal audit and internal control

The guidelines cover the key areas of internal audit, internal control, as well as requirement for external auditors to submit special audit report to the Bank of Thailand regarding the processes in receiving, paying and lending money; creating contingent liability; investing in securities; and selling assets.

3.12 Accounting and financial statement

(1) The Bank of Thailand amended the financial statements in reporting form to be in line with the Thai Accounting Standard and set the guidelines for financial institutions to compare their current financial statements with the previous year, starting from the accounting period after 31 December 2001.

(2) The Bank of Thailand clarified that income recognition in the case of the debts previously written off as lost and later restructured are to be in line with accounting standards' principles regarding income recognition in the profit and loss account.

(3) Financial institutions are required to account for investments in debt instruments in accordance with the Thai Accounting Standard Number 40 that includes guidelines on valuation of debt instruments that are traded in the market and with no tradable market.

3.13 International Banking Facilities (IBF) fees

To ease the financial burden caused by Thailand's current economic slowdown, the Bank of Thailand reduced the annual fee charged to Bangkok International Banking Facilities (BIBF) from 500,000 baht to 100,000 baht, effective from 2002.

3.14 Set up of restricted-license bank

The Bank of Thailand proposed to the Minister of Finance that a group of financial institutions led by National Finance PCL has a sound and proper business plan for setting up a restricted-license bank. Subsequently, banking license was granted to the group on 3 January 2002, and the new bank is called Thanachart Bank PLC.

3.15 Usage of Internet network to undertake finance companies and credit foncier companies business

The guidelines permitting finance companies and credit foncier companies to use Internet network to conduct their business were issued in 2001. The guidelines required finance companies and credit foncier companies to seek approval from the Bank of Thailand prior to the use of the Internet to conduct business to ensure adequate risk management.

3.16 Seminar on "Market Risk Management Techniques for the BIS Capital Regime"

The Bank of Thailand jointly with the World Bank organized the seminar on Market Risk Management Techniques for the BIS Capital Regime on 12 October 2001. The main objectives of this seminar were to stimulate improvements in market risk management techniques among financial institutions and regulators. The topics included Market Risk Management in

Volatile Market, Market Risk Modeling, and Development and Implementation of Market Risk Modeling by Commercial Banks. Furthermore, the seminar embodies the topics of Model Approval and Stress Test/Back Test, Risk Behavior of Thailand Trading Asset, and Future Supervisory Direction. The seminar had been structured as a seminar, with discussion panel by market risk experts from frontline international financial institutions and expert risk supervisors from Financial Stability Institute of the BIS. The Bank of Thailand also unveiled the outcome of the market risk project that has been conducted internally with the expert consultant who is the risk expert from Thamasart University.

APPENDIX 2

LIST OF MAJOR POLICY ANNOUNCEMENTS 2002*

1. Financial Institutions Policies

1.1 Debt Restructuring

1.1.1 Extended permission period for debt restructuring privileges for one more year ending 31 December 2003, for the following activities:

(1) Allow financial institutions to hold shares in companies acquired through debt restructuring, in excess of the legal limit.

(2) Permit financial institutions to conduct hire purchase and leasing business for assets derived from debt restructuring.

(3) Extend the period allowed for holding immovable properties, transferred between 1997 to 2003, in excess of the legal limit.

1.1.2 Revised regulation on debt restructuring to be in line with Accounting Standard No. 34 on Accounting Standard for Troubled Debt Restructuring.

1.1.3 Allowed the international banking facilities for off-shore lending to accept the repayment of principal and the payment of interest from domestic residents guarantor in the case of debt restructuring in accordance with rules prescribed by the Bank of Thailand.

1.1.4 Expanded the list of approved loan sellers to allow commercial banks to purchase loans from asset management companies (AMCs), the Thai Asset Management Corporation (TAMC), and receivership of the 56 closed finance companies, in order to enhance the effectiveness in the commercial banks' asset management and increase the number of players in the market. However, the loans purchased from AMCs must be loans that have already been restructured and are classified within pass or special mention category.

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* For a complete list of policies, please visit the Bank of Thailand's website at www.bot.or.th

1.2 Increased Flexibility in Business Scope and Business Model

1.2.1 Amended the conditions for commercial banks to engage in arranging, underwriting, and dealing in debt securities by changing the criteria from those based on the size of such financial institutions to one based on risk management ability, good corporate governance, and financial soundness and stability of interested financial institutions.

1.2.2 Allowed commercial banks to act as an introducing agent for services of securities companies to customers.

1.2.3 Allowed commercial banks to engage in investment advisory services.

1.2.4 Expanded the scope of finance companies' hire purchase business to include hire-purchase agreement on automobile for which the ownership has been transferred from general public rather than car dealership.

1.2.5 Permitted finance companies to borrow from institutional investors through Private Repo market.

1.2.6 Permitted commercial banks to be a broker of general and life insurance business. In performing such activity, commercial banks have to receive permission from, and comply with, the regulations of the Department of Insurance.

1.2.7 Permitted commercial banks to distribute brochures of insurance companies to their customers.

1.2.8 Out-sourcing: Permitted commercial banks to appoint other commercial banks, specialized financial institutions, or other finance companies to be a deposit-taking agent, loan and credit card payment collection agent. Commercial banks may appoint the Communications Authority of Thailand (CAT) or money transfer service-provider to be the loan and credit card payment collection agent.

1.2.9 Out-sourcing: Permitted finance companies to appoint commercial banks, specialized financial institutions, or other finance companies to be a deposit-taking agent for fixed deposit with passbook. Finance companies may appoint commercial banks, specialized financial institutions, CAT, or money transfer service-provider to be the loan payment collection agent.

1.2.10 In-sourcing: Permitted commercial banks to provide back office and support functions for their parent companies, subsidiaries, and affiliates that perform financial services.

1.3 Risk Supervision Policies

1.3.1 Asset classification and provisioning

(1) Financial institutions are allowed to set provisioning for assets classified as pass and special mention at either specifically 1 and 2 percent, respectively, or at the average actual rate of migration into NPL of the previous 4 quarters, if the rate is lower.

(2) Revision of regulations governing accounting methodology for doubtful debtors, with 100 percent provisioning, that commercial banks have already written off, to allow commercial banks to re-record debtors with collateral back into their accounts. Nevertheless, decisions concerning debtors without collateral are left to the discretion of the commercial banks.

1.3.2 Revision of regulations on single lending limit of commercial banks by extending the definition of Tier I to be applicable to capital of foreign bank branches and permitting some additional transactions not to be included in single lending limit.

1.3.3 Revision of regulations on credit extensions for securities trading purposes, and credit extensions that have securities as collateral. Financial institutions are allowed to grant credits to public limited companies for the purpose of buying back shares from their shareholders (Treasury Stock). The financial institutions are allowed to pledge securities deposited with Thailand Securities Depository Company Limited either through using physical certificate or Scripless system.

1.3.4 Revision of regulations on net foreign exchange position to be in line with international standards and to strengthen the efficiency and effectiveness of supervision of foreign exchange risk. The revised regulations can be summarized as follows:

(1) Financial Institutions are required to maintain net foreign exchange position by the end of business day in single currency not exceeding 15 percent of total capital (Individual currency limit), and financial institutions are required to maintain aggregate position by the end of business day not exceeding 20 percent of total capital (Aggregate currency limit).

(2) The calculation method of aggregate position has been changed to BIS shorthand method.

(3) Thai commercial banks must include the foreign exchange positions of their foreign branches in the calculation of net foreign exchange position.

1.3.5 Maintenance of liquid assets by commercial banks. The Bank of Thailand expanded the list of eligible liquid assets to include debt securities issued by approved government agencies or state enterprises, including the Asset Management Corporation (AMC) and amended the composition and computation method of the liquid assets ratio for greater clarity in its application.

1.3.6 Issuance of policy statements on liquidity risk management in financial institutions. This policy aims to ensure that financial institutions establish a sound system for liquidity risk management in accordance with international best practice. The system must address their liquidity management in normal as well as in stressful situations such as named-crisis, ensuring ability to maintain adequate liquidity for sustaining a short period of stressful situation. The Bank of Thailand prescribed essential guidelines covering roles of Board of directors or senior executives in liquidity management, minimum requirements on a liquidity policy and associated action plans including contingency plan, and a minimum data system requirement for liquidity management.

1.3.7 Issuance of policy guideline permitting commercial banks to engage in Credit Linked Note transactions in order to provide commercial banks with a new alternative to hedge their credit risks, enhance returns, and improve their efficiency. The transaction is subject to the risk-based guidelines covering the transaction description, types of counterparties, currency denomination, types of reference assets, and the application of capital adequacy requirement and large exposure limits.

1.3.8 Issuance of regulations on credit card businesses conducted by banks and non-bank credit card issuers. The regulation covers qualification of credit card applicants, interest rate, penalty fees, other service charges and fees related to credit card usage, information disclosure, guidelines for minimum debt repayment, credit card risk management system, database system for collecting applicants' information, transfer of credit card debt, and reporting requirements. The regulation is aimed at fostering consumer protection and level playing field primarily by increasing disclosure and transparency of fees and charges.

1.3.9 Revision of regulations concerning loan reviews and contingent liabilities to help reduce costs and burden of financial institutions, and to encourage them to put in place adequate internal risk management system. The revisions on the regulations on loan review are as follows:

(1) Financial institutions must submit loan review and contingent liability reports to the Bank of Thailand every quarter.

(2) Loan review plan approved by the Board of Directors must be submitted to the Bank of Thailand within January of each year, while report on loan review must be reported to the Board of Directors on a quarterly basis.

(3) Every loan and contingent liability related to each debtor must be reviewed at least once a year. However, for small debtors, financial institutions have the option of reviewing credits by random sampling via the reliable statistical method.

(4) When reviewing the loans of a particular debtor, the contingent liability related to that debtor must also be reviewed. Furthermore, financial institutions must review the contingent liabilities of the 20 largest debtors that have no outstanding balance on their loan accounts.

(5) Financial institutions must perform loan review via an independent review process that is separate from the credit approval process. The Bank of Thailand may relax this requirement for financial institutions that have human resource limitations. Such financial institutions would not have to set up an independent review process until the Bank of Thailand instructs them to act in accordance with the policy of inde pendence process.

1.3.10 Revision of rules and procedures regarding compensation for losses incurred by depositors due to branch closure, in order to ensure fairness to consumers.

1.3.11 Revision of regulations on relocation of branches, temporary closing and opening of commercial bank branch offices under emergency circumstances, broadening their zone of new operations to nearby vicinity, extension of grace period on permitted establishment of branch offices, in addition to prescribing rules on authorizing banking operations within and beyond banking premises and office hours.

1.3.12 Issuance of guideline requiring commercial banks, finance companies, and credit foncier companies to submit their half-year financial reports to the Bank of Thailand within 90 days of the end of the accounting period.

1.3.13 Revision of regulations on the accounting methodology concerning the transfer and purchase of loans for financial institutions to comply with the Guideline on Accounting for a Transfer of Financial Assets, which was issued by the Institute of Certified Accountants and Auditors of Thailand.

1.3.14 Issuance of the guideline requiring financial institutions to use the accounting methodology prescribed by the Thai Accounting Standard on accounting for investments in debt and equity securities. The guideline also determines the standardized methodology for calculating fair value of various types of securities to be used by financial institutions.

1.3.15 Issuance of guidelines concerning information disclosure and reporting requirements of financial institutions.

(1) Revision on the financial report forms required to be submitted by financial institutions, such as financial position and revenue and expense reports to conform with the new Balance Sheet and Profits and Losses formats in accordance with accounting standards issued by the Ministry of Commerce under the new Accounting Act.

(2) Revision on the definition of Non-Performing Loans (NPLs) and the preparation of reports required to be submitted by financial institutions accordingly.

First revision: Effective as of end-February 2002 to end-November 2002, the exclusion of the following items from NPLs:

- O/D loans with un-drawn amount and/or remaining period.
- Doubtful of loss loans of which full provisioning has been made.

Second revision: Effective from end-December 2002. The essentials are:

- Revision on the definition of NPLs to include all loans classified as substandard and under, as well as doubtful of loss loans for which full provisioning has been made for uncollateralized portion, which were previously written off.
- Changing the reporting frequency, from monthly to quarterly periods.

1.3.16 Issuance of policy statement on qualification requirement and approval criteria for selection of external auditors of financial institutions, as well as scope of work to be performed by the external auditor.

1.3.17 Issuance of policy statement on structure of the Board of Directors, sub-committees such as audit, risk management, nominating, and remuneration committees of commercial banks, to enhance corporate governance within financial institutions.

1.3.18 Revision of regulations on capital adequacy concerning 1) the gain from property revaluation to be counted as the Tier-2 capital, 2) the redemption criteria on innovative capital instruments or subordinated debts, and 3) risk weighted specification of assets and contingent liabilities.

1.3.19 Amendment of methodology for valuing investments of financial institutions by allowing them to mark-to-market the value of securities.

1.3.20 Circulation of Risk Management Principles for Electronic Banking. The Bank of Thailand circulated the Risk Management Principles for Electronic Banking issued by the Bank for International Settlements (BIS) as a guideline for financial institutions to manage risks associated with electronic banking activities. Applying the Principles to the electronic banking systems will improve the confidence in electronic banking transactions and will bring the electronic banking processes and systems closer to international standard.

1.3.21 Circulation of the Electronic Transactions Act. The Bank of Thailand circulated the Electronic Transactions Act to inform financial institutions of its promulgation on 3 April 2002. The essence of the Act is to ensure the legal effect and enforceability of an electronic data message.

1.3.20 SMEs Credit Extension Target. The Bank of Thailand requested commercial banks to submit their SMEs credit extension target for 2002 and report the progress on semi-annual basis to the Bank of Thailand. In 2002, commercial banks set their total SMEs credit extension target at 27,491 million baht, reflecting a 10.14% decline from the 2001 target of 30,594 million baht. Within the first half of the year 2002, 87.60% of the annual target was achieved.

2. Landmarks in Financial Sector Reform

2.1 The Draft Financial Institutions Businesses Act

Background:

The Bank of Thailand together with the Ministry of Finance drafted the Financial Institutions Businesses Act to replace the existing Commercial Banking Act B.E. 2505 and the Act on the Undertaking of Finance Business, Securities Business and Credit Foncier Business B.E. 2522. The main rationale of the draft is to adopt international best practices. The major changes of prudential regulations from the existing laws are authority to conduct consolidated supervision, recognition of financial conglomerate, strict limitation on loans to related party, improvement of good governance, enhancing the financial institutions' flexibility to determine the capital requirement for any special risk assessment, clarity in the procedures for rectifying problem financial institutions and prompt corrective action, and roles of the Bank of Thailand in consumer protection.

Developments of the draft Financial Institutions Businesses Act:

As the Senate and the Lower House did not agree in the entirety on the act drafted by the Lower House and amended by the Senate, the Parliament had set up the Joint Committee between the Senate and the Lower House to revise the draft. On 9 September 2002, the Senate voted against the draft law, which had been revised by the Joint Committee while the Lower House voted for the draft law on 23 September 2002.

As a result, the Lower House has to wait for at least 180 days after 9 September 2002 before they could reconsider if they wish to pass one of the two versions of the law: (1) the original draft that was submitted by the Lower House or (2) the new draft that was revised by the Joint Committee but rejected by the Senate. If one of the drafts is passed, the Financial Institutions Businesses Act would become effective 6 months afterwards.

2.2 Financial Sector Master Plan

The recent East Asian financial crises underscored the importance of a sound and well-functioning banking sector to the overall health of the economy. Consequently, since the beginning of 2002 the Bank of Thailand has embarked on a yearlong project to outline medium-term strategies to further modernize and enhance efficiency of the Thai financial institutions. To be implemented in the next 5-10 years, this market-based reform intends to increase financial institutions' roles in the economic development process. It also aims to provide more accessible and affordable services to potential financial services users in all market segments, in urban and rural areas. The project consists of these key work areas:

- In February 2002, the Bank of Thailand established a Steering Committee (hereafter called "the Committee") to oversee the drafting of the financial sector master plan, articulate a vision, and recommend short-term and long-term strategies for the future development of Thai financial institutions. The Committee supervises and provides necessary guidance to the Working Team in conducting consumer surveys, background studies, in-depth research, as well as soliciting comments from relevant stakeholders until the completion and implementation of the plan.

- The Bank of Thailand commissioned two separate studies, with internal funding. The first study entails a nationwide survey designed to analyze consumers and businesses' financial service needs in all market segments, both in urban and rural areas. Meanwhile, the second study provides the necessary background analysis on the global, regional, and domestic financial services trends, and provides specific policy recommendations for the financial sector master plan. These studies, together with directives from the Committee, will be the core materials for the write-up of the draft of the Financial Sector Master Plan.

- The Bank of Thailand will announce the Financial Sector Master Plan and its implementation plan during the period between June and year-end 2003.

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