Bank of Thailand

Supervision Report

2003

MESSAGE FROM THE GOVERNOR

The release of the Financial Sector Master Plan, a shared vision of medium- to long-term development strategies of all relevant stakeholders, marks an important milestone to the Thai financial system. The Master Plan envisions the financial system to become more balanced, resilient and competitive, and capable of providing financial services appropriate to the demand of all potential users, with sufficient consumer protection and fairness. Underpinned by the “One Presence” policy, whereby one financial group is allowed only one deposit-taking institution, the Master Plan has important implications on the structure of the financial system, especially as financial institutions are motivated to gain efficiency via rationalization and economies of scale.

With recognition of its impacts on the banking industry, the Master Plan was cultivated and is being implemented at the time when economic conditions and revitalized financial sector are conducive to changes. To date, all banking performance indicators point to resiliency, with solid capital base, continued profitability and increased lending activity, while the economy has returned to its steady growth path. Such favorable environment is particularly crucial for the initial stage of the reform: rationalizing the structure and roles of financial institutions. To ensure an orderly transition process, the authorities will closely monitor the impact of the changes. In parallel, the authorities will press on the reforms of key financial laws, especially the Deposit Insurance Act and new Financial Institutions Businesses Act, to strengthen the financial infrastructure necessary for the development of a sound and resilient banking sector.

Notwithstanding these positive developments, certain areas of concerns remain to be addressed. The authorities are working on new measures to comprehensively deal with the resolution of non-performing loans. For example, financial institutions will be allowed to transfer NPLs to the Asset Management Corporation after the amendment of the relevant legislation, while the Bank of Thailand is in the process of tightening the provisioning regulation for NPLs that have been long pending without proper restructuring or legal

actions. Meanwhile, the growth of consumer lending spurred by robust economic recovery is closely monitored in order to keep household debts in check. The Bank of Thailand's measure to tighten credit card lending to the lower end of the market indicates the authorities' intention to step in to curb excessive lending, if needed, in order to maintain financial system stability.

Looking to the future, the changing financial landscape, forces of globalization and liberalization, as well as advanced technology and financial innovation, will have major bearings on the Thai financial system. In this light, the Bank of Thailand will continue to strengthen risk-based supervision and place emphasis on corporate governance, with the aim of fostering competition and overall efficiency and safeguarding financial soundness. Banks also need to do their part to improve the overall risk management capacities in order to meet with these challenges and to prepare themselves for the implementation of the new Capital Accord. With these challenges, it is essential that we constantly assess our achievement in the area of supervisory policy and framework, as well as take stock of the system's strength and vulnerability, to prepare for any plausible adverse shocks. In so doing, benchmarking our financial system against international standards and codes is a means to identify areas for further improvement, taking into account the context of our institutional arrangements.

Thailand has already made enormous progress on financial and structural reforms, and we now have a road map toward a new era of a balanced and efficient financial system. All the stakeholders must work together to overcome the obstacles and achieve the objectives set out in the Financial Sector Master Plan. Daunting as these challenges may be, each step forward will be towards a meaningful and tangible result.

M.R. Pridiyathorn Devakula
Governor
Bank of Thailand

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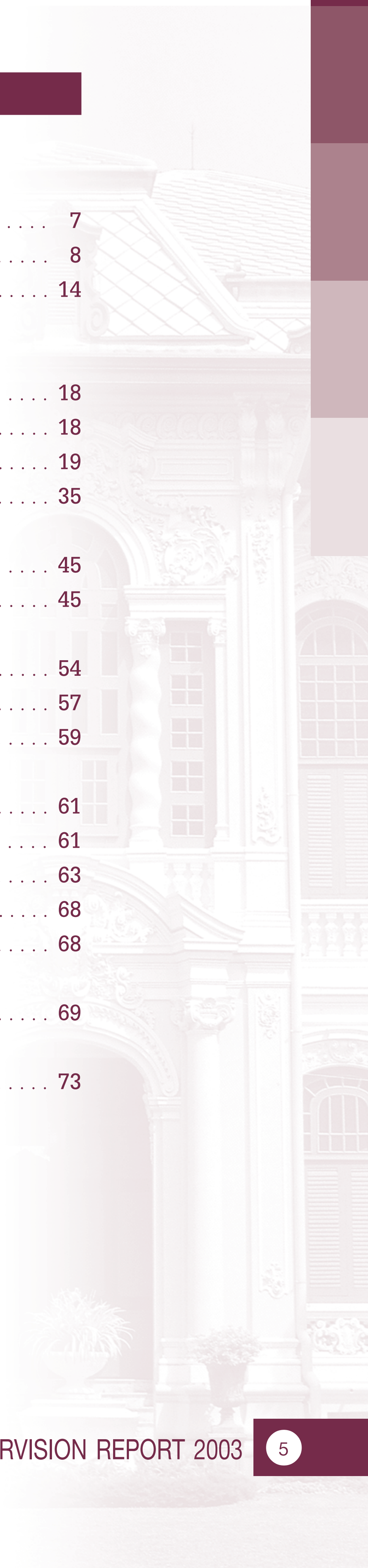

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CHAPTER 1

HIGHLIGHTS OF MAJOR DEVELOPMENT IN 2003

In 2003, the broad-based economic recovery as well as low interest rate environment played a supportive role for the financial sector. Both financial performance and stability improved notably throughout the year, with continued improved asset quality, reduction of debt overhang, and strengthened financial positions of financial institutions. In line with growth in consumption, investment, and exports, commercial bank credits picked up pace, especially consumer loans, on the back of rising income and favorable economic prospects. The growth of consumer credits warranted a close monitoring of household debt accumulation, although still benign so far, and the authorities would remain watchful over possible signs of overheating and emerging sectoral imbalances. Concrete plans to expedite NPL resolution have also been mapped out and are being implemented. Meanwhile, internal and external stability was maintained, with subdued inflationary pressure and lower external debt, which provided a foundation for a sustainable growth performance.

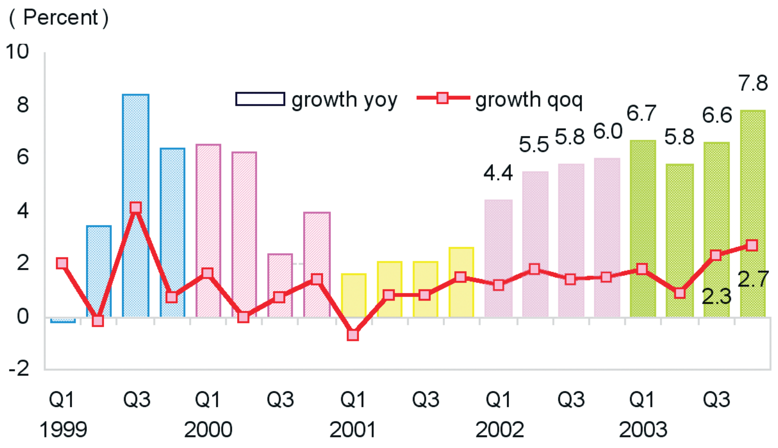
Against the background of solid economic recovery and strengthened positions of financial institutions, the Bank of Thailand continued to push forward its supervisory and structural reform agenda in order to safeguard financial system stability. Financial institutions have been working to make the necessary adjustments in line with the Bank of Thailand's guidelines on all key risk categories, with enhanced risk management and internal control systems, using more advanced tools and business models and adopting good corporate governance. Moreover, the changes in the structure and roles of financial institutions introduced by the Financial Sector Master Plan will bring about important challenges for financial institutions, as they strive towards a more efficient and balanced new financial system. To this end, the authorities will work to streamline rules and regulations and continue to strengthen financial and legal infrastructure, with the aim of ensuring a smooth transition process.

1.1 Economic Development

1.1.1 The overall economy

Despite the US-Iraqi war and the outbreak of Severe Acute Respiratory Syndrome (SARS) in Asia, which had some temporary impact in the first half of the year, the Thai economy maintained momentum and grew by 6.7 percent in 2003. This growth was propelled by a robust expansion of private consumption, a recovery of private investment, and buoyant export performance.

Chart 1 : Gross Domestic Product (1988 Prices)



Source : NESDB

Private consumption was supported by rising income, greater access to consumer financing, and strengthening consumer confidence. In particular, farm income expanded by over 25 percent this year, owing mainly to high prices of rice and natural rubber. Non-farm employment also expanded well at 5 percent due to demand for labour in the manufacturing, construction, and service sectors.

The low interest rate environment and expanding consumer credit channels allowed Thai consumers to borrow more, especially for durable goods such as passenger cars, the sales of which grew by 42 percent in 2003 compared with 21 percent in 2002. Although the recovery of consumer confidence was interrupted by concerns over the war and the spread of SARS, the impact was temporary. The Consumer Confidence Index (CCI) strengthened significantly in the latter half of the year.

Chart 2 : Private Consumption Index

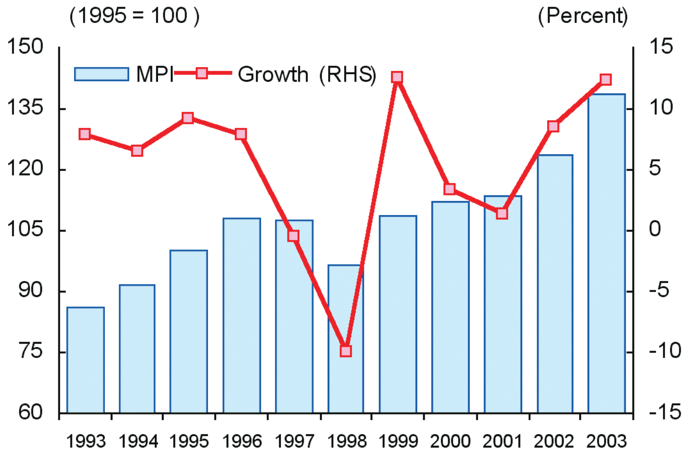
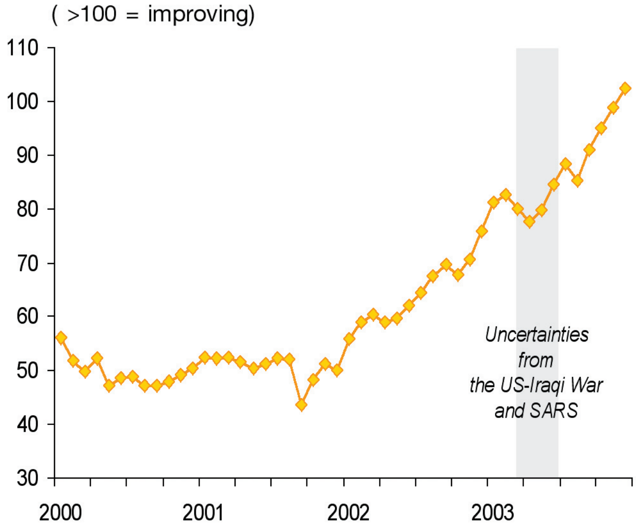


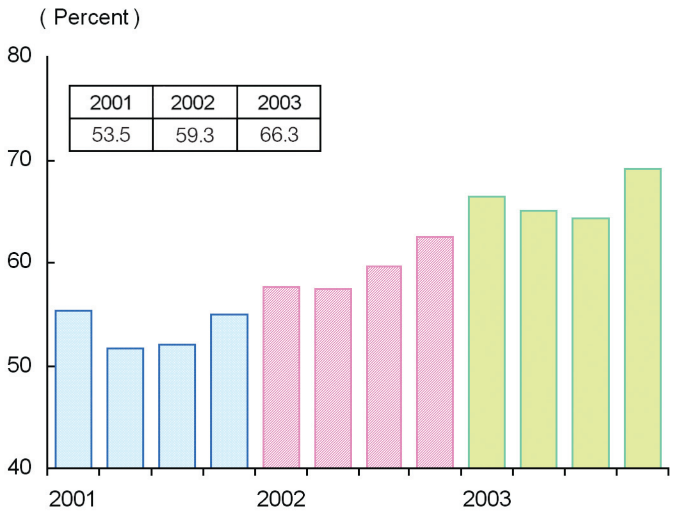
Chart 3 : Consumer Confidence Index



Source: The University of the Thai Chamber of Commerce

Private investment rose throughout the year but began to accelerate notably in the fourth quarter, with a strong pick-up in equipment investment. This came largely as a result of the continuous increase in industrial capacity utilization, which reached 73 percent in December 2003 and averaged at 66 percent for the whole year, compared with only 59 percent in 2002. In addition, with stronger balance sheets as shown by higher corporate profitability as well as a steady decline in the corporate leverage ratio, firms were in a better position to finance new investment projects through both internally generated funds and external financing. Hence, commercial bank credits to the manufacturing, trade, and export sectors grew all through the year for the first time since the financial crisis.

Chart 4 : Capacity Utilization Rate

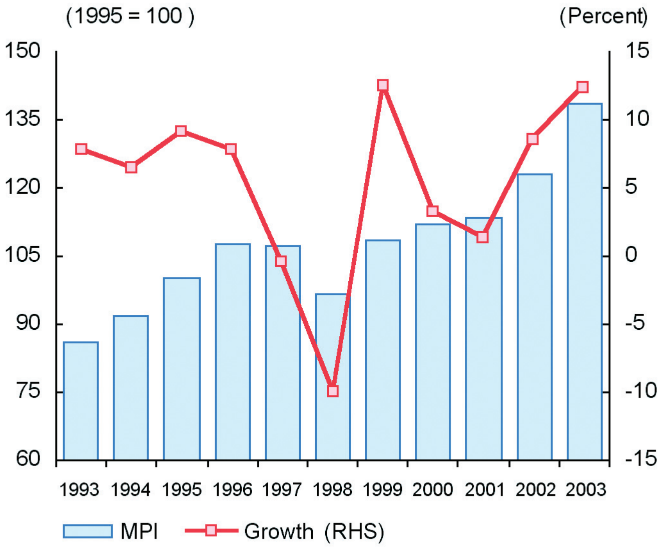


The **government** continued to support the economic momentum by adhering firmly to its Dual Track Policy which aimed at stimulating private domestic activities and strengthening ties with the global market. Government revenue expanded by nearly 14 percent and exceeded the revenue target by as much as 961 billion baht. Buoyant revenue was attributable to an improvement in tax administration as well as an expansion of private sector activities, both in terms of household spending and corporate performance. The budgetary surplus for the entire fiscal year stood at 22 billion baht, compared with the planned deficit of 175 billion baht.

Exports maintained favourable course, expanding by 19 percent for the entire year, while **imports** grew by 17 percent in value terms in 2003. The trade balance however continued to register a surplus of USD 4.2 billion. Meanwhile, the **tourism industry** proved highly resilient to adverse shocks like the outbreak of SARS, recording a year-on-year growth of 6 percent for the fourth quarter.

The **supply side** of the economy responded well to the increase in demand. In particular, the **Manufacturing Production Index** (MPI) expanded strongly by 12 percent, up from 8 percent in 2002, led by the production of vehicles for domestic use and the production of electronics and electrical appliances for export. Meanwhile, **agricultural production** benefited from favourable climate and thus grew by 8 percent this year compared with the zero growth rate in 2002. Higher farm income also allowed for a sustained increase in rural households' consumption.

Chart 5 : Manufacturing Production Index



Strong domestic demand and robust export growth translated into solid financial performances among non-financial listed firms. Increased operational efficiency, as reflected by rising asset turnover ratio, coupled with higher profit margin, led to an improvement in profitability. In addition, firms continued to de-leverage their balance sheets as seen by a steady decline in the D/E ratio.

With improved profitability among listed firms and a positive economic outlook, both local and foreign investors took interest in the Thai stock market. As a result, the SET Index rose markedly over the year and became one of the best performing equity markets in the world in 2003.

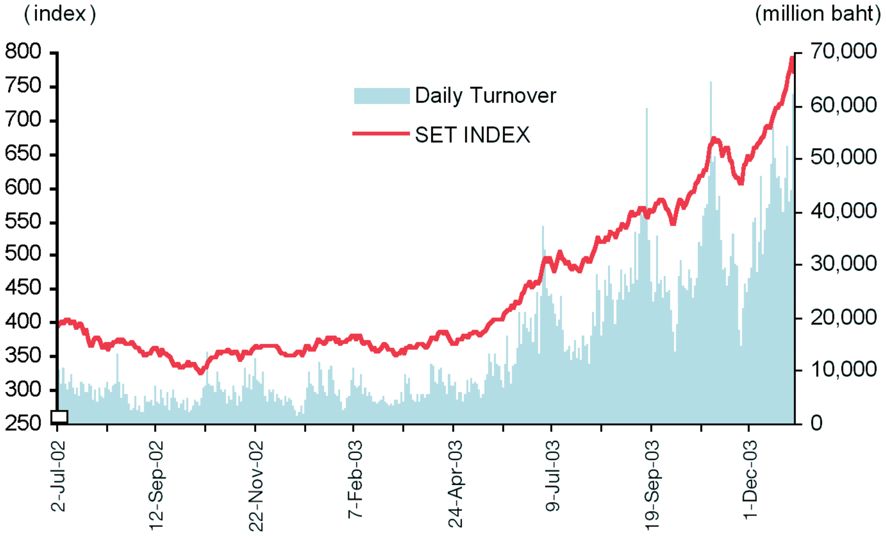
Table 1 : Corporate Performance of Non-Financial Listed Firms

(Key performance indicators based on the Dupont Analysis)

	1997	1998	1999	2000	2001	2002	2003
D/E Ratio	5.1	3.4	3.5	4.1	3.2	2.2	1.5
Asset Turnover (%)	45	44	47	54	58	73	79
Profit margin (%)	(44)	7	5	(11)	3	6	10
ROA (%)	(20)	3	(4)	(3)	3	5	8
ROE (%)	(85)	14	(18)	(15)	13	18	28.7

Sources: Stock Exchange of Thailand and BOT Staff's calculations

Chart 6 : SET Index

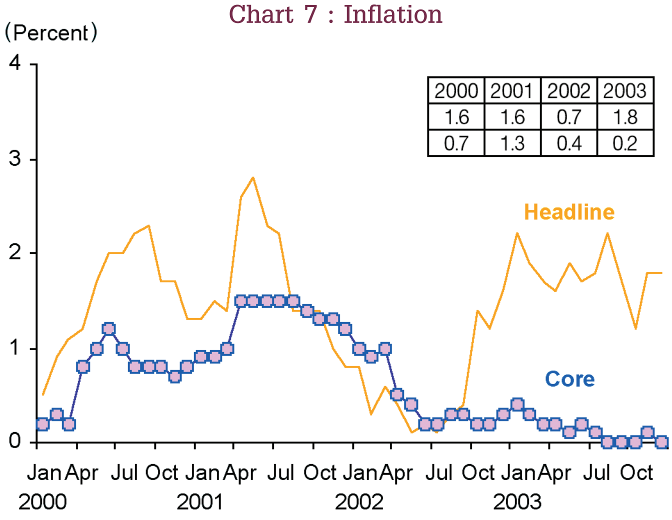


Source : Stock Exchange of Thailand

1.1.2 Economic stability in 2003

Favourable growth in 2003 was accompanied by **sound economic stability** both on the domestic and external fronts. Despite rising oil prices, **inflationary pressure** remained subdued. Headline and core inflation averaged at only 1.8 and 0.2 percent, respectively. Factors contributing to this low inflation environment included a persistent decline in housing rents, an appreciation of the baht, and a lower rate of increase of administered prices compared with earlier periods. Such absence of inflationary pressure and other overheating signs at the macroeconomic level allowed monetary policy to accommodate growth throughout the year.

Chart 7 : Inflation



2000	2001	2002	2003
1.6	1.6	0.7	1.8
0.7	1.3	0.4	0.2

Source : Ministry of Commerce

Unemployment fell to 2.2 percent, the lowest rate since 1998. Meanwhile, concerns over the issue of fiscal sustainability had mitigated substantially as the ratio of **public debt to GDP** declined from the peak of 57.6 percent in 2001 to only 49.0 percent at the end of 2003. This improvement in the fiscal position came largely from the higher-than-expected tax collection outturn coupled with the government's attempt to consolidate its fiscal stance as private spending gained strength.

On the external side, the **current account** registered a strong surplus of about USD 8 billion or approximately 5.6 percent of GDP. **External debt** level fell from USD 59 billion at end-2002 to USD 52 billion at end-2003, due in part to the repayment of the IMF loan package by the Bank of Thailand, which was completed nearly two years ahead of schedule. Despite this early loan repayment, Thailand's **international reserves** position continued to be strong, closing the year at USD 42 billion or roughly 3.9 times the country's short-term external obligations (by original maturity).

1.1.3 Economic outlook 2004

The Thai economy is expected to carry on favourable growth momentum in 2004, with the key growth drivers being private investment and exports. Private consumption is likely to continue to expand but perhaps at a moderate rate, and the government will help support growth with its supplementary budget of 135.5 billion baht. The increase in investment is likely to bring about accelerating imports, especially capital imports, leading to smaller trade and current account surpluses in the years to come.

Table 2 : Bank of Thailand Forecasts

	2002	2003	2004	2005
GDP Growth	5.4	6.7	6.8-7.8	6.3-7.8
Headline inflation	0.7	1.8	1.5-2.5	1-2

Note : estimated in April 2004

The authorities will continue to maintain sound macroeconomic management to foster economic stability and growth sustainability. Careful monitoring of asset price developments, especially in the equity and real estate markets, and the accumulation of household debt is crucial in safeguarding against possible bubbles and economic overheating. Should signs of asset price bubble, economic overheating, or excessive household debt increase emerge, pre-emptive measures will be implemented in a timely manner to prevent these economic imbalances from undermining the prospect of sustainable growth. Recent measure by the Bank of Thailand to address concerns over market speculation in certain real estate sectors was a good example of the authorities' prudent approach to economic management.

1.2 Financial Sector Development

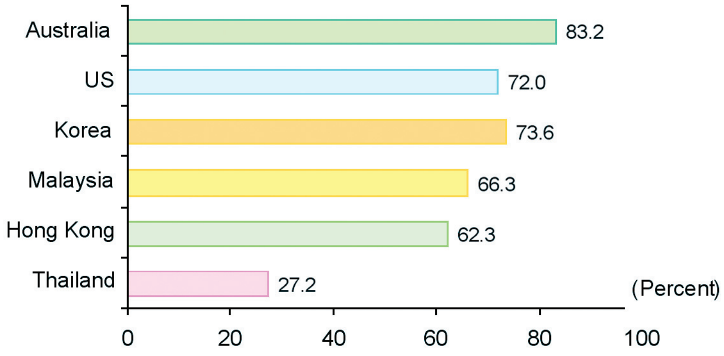
1.2.1 Financial institutions conditions

As the authorities maintained an accommodative stance to strengthen the growth process, with the policy rate cut in June from 1.75 to 1.25 percent per annum, **money market interest rates** stayed on a declining trend, against the backdrop of high liquidity in the banking system. Likewise, average **deposit and lending rates of commercial banks** declined, each by about 100 basis points over the year 2003.

Low interest rates and the recovery of economic activities in general brought about an improvement in **commercial bank credit growth**, albeit at a modest pace. Overall credits extended by financial institutions (excluding interbank loans, but adding back NPL transferred to AMC, fully provisioned NPL and losses from debt restructuring) grew by about 6 percent in 2003. This recovery was led mainly by credits to households in the forms of consumer and housing loans as well as credits to the manufacturing and commercial sectors.

The growth of consumer credits extended by both banks and non-banks has raised some concern over the pace of household debt accumulation. However, the degree of household leverage in Thailand, standing at 27 percent of GDP or 51 percent of household disposable income as of end-2002, was low by regional and international comparison. Moreover, much of this debt accumulation was to finance the purchases of owner-occupied houses and cars, the acquisition of which had decelerated markedly during the years following the 1997 financial crisis and picked up just recently as a result of better household earning prospects.

Chart 8 : Household Debt to GDP as of 2002



Sources : CEIC and BOT

This year, **profitability of financial institutions** improved markedly, with net profits more than doubling those of last year. Net interest income and non-interest income increased whereas provisioning burden reduced. Interest rate spread and net interest margin improved. The level of capital funds and provisioning was comfortably above the minimum requirements (detail on financial institutions performance is in Chapter 2).

Improved economic conditions as well as efforts by both the private and public sectors to accelerate the corporate debt restructuring process resulted in a steady decline of NPL. In particular, the ratio of NPL to total outstanding loans in the financial system fell from 15.7 percent as of end-2002 to 12.7 percent as of end-2003.

Chart 9 : Commercial Bank Interest Rates

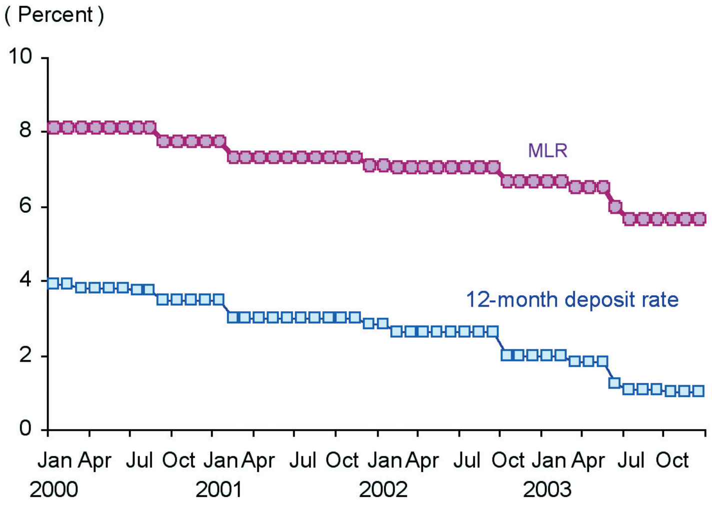
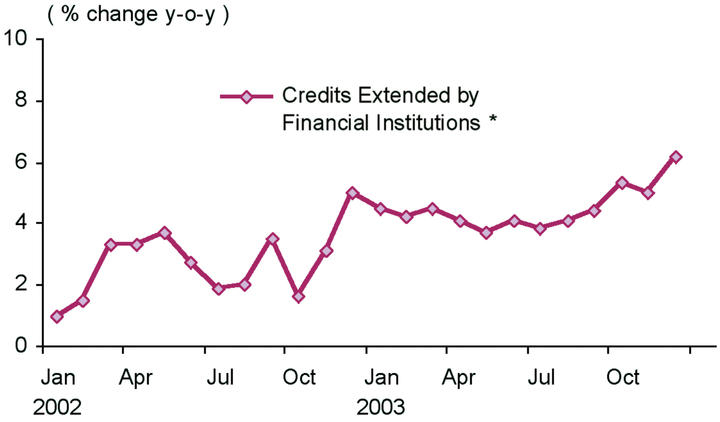


Chart 10 : Credits Extended by Financial Institutions



* Excluding interbank loans, but adding back NPLs which were transferred to AMCs, fully provisioned NPLs and losses from debt restructuring.

1.2.2 Supervisory and structural reforms

The Bank of Thailand continues to step up efforts to strengthen supervision, improve financial system infrastructure, and accommodate operations of financial institutions, with the aim to foster sustainable growth and prudent business undertaking of financial institutions and maintain financial system stability. Some of the key reforms in 2003 are summarized as follows (please see more details in Chapter 3).

The issuance of Market Risk Supervision Policy represented an important step in the aspect of prudential regulation. Formerly, market risk was supervised with net foreign exchange position limit and restriction of complex, leveraged derivatives products. The Market Risk Supervision Policy offers comprehensive supervisory guidelines for all elements of market risk: interest rate, equity price, exchange rate, and commodity price, and incorporates both quantitative measure, with respect to capital charge, and qualitative measure, with respect to internal control and trading book policy guidelines. Active financial institutions are differentiated from non-active institutions by the amount of trading book transactions, whereby the former must comply with all aspects of the guidelines and the latter only certain aspects of the guidelines. The Policy is implemented in transitional periods, allowing time for adjustment, with its final stage when financial institutions must maintain capital funds against market risk at the end of June 2005.

As part of the measures to accommodate financial institutions operations, the Bank of Thailand has allowed commercial banks to form business alliance with Thailand Post Co. Ltd. and to provide support services to other entities in addition to their related companies as previously permitted. The maximum rental period for the business of renting immovable properties was removed to increase flexibility in property management of commercial banks, and regulation on exposure to a business group of which some of the subsidiaries' incomes are less correlated was relaxed.

The implementation of the Data Management System Project, which has gone live since October 2003, will enhance financial surveillance system at the Bank of Thailand. The Project aims at improving the overall data management process by utilizing advanced information technology such as data warehouse and electronic data dissemination. The new system creates a single data center and single point of service for all the data. It helps manage, store, and utilize the data in a more timely and efficient manner.

The release of the Financial Sector Master Plan marked a milestone in the development of a medium- to long-term strategy for Thailand's financial sector. The Plan aims to provide financial services for all viable users, foster efficient, competitive, and stable financial sector, and ensure fairness and protection for consumers. The goals translate into three sets of measures. The first set of measures aims at broadening access to financial services, particularly for those previously underserved. The second set aims at improving efficiency and competitiveness in the financial sector as well as streamlining rules and regulations pertaining to financial institutions, while the last set seeks to instill consumer protection mechanism.

The structure and roles of financial institutions will be greatly affected by the second set of measures since it focuses on restructuring Thai deposit-taking financial institutions into two forms, namely commercial banks and retail banks, where retail banks are allowed to offer retail customers and SMEs virtually the same business scope as commercial banks, except businesses related to foreign exchange and derivatives products. At the same time, there will be two types of foreign-owned financial institutions, namely, subsidiaries and full branches, where both types can also undertake the same scope of business as commercial banks. Full branches are to have single office operations whereas subsidiaries are allowed to open one branch in Bangkok, in addition to the head office, and 3 branches outside Bangkok and its vicinity. A qualified finance company and credit foncier company can seek to become a commercial bank or retail bank, a full branch to become a subsidiary, and a stand-alone IBF to become a full branch or subsidiary. Any financial conglomerates with more than one form of deposit-taking institutions will have to comply with the Bank of Thailand's "one presence" policy, which ensures benefits from economies of scale and elimination of duplicate functions. As a result, there can be a number of mergers and acquisitions among the existing players, which should lead to greater operating efficiency in the future.

In parallel, the authorities have been working to strengthen the financial infrastructure to safeguard financial system stability. The enactment of the new Credit Bureau Act, with the pending new Financial Institutions Businesses Act and Deposit Insurance Act, will further solidify the foundation of the Thai financial system in the periods ahead.

CHAPTER 2

FINANCIAL INSTITUTIONS PERFORMANCE AND DEBT RESTRUCTURING PROGRESS

2.1 Structure of Financial Sector

Table 3 : Structure of Financial Institution System (as of December 2003)

(billion baht)

	Locally-incorporated Banks	Branches of Foreign Banks	Stand-alone I B Fs	Finance Companies	Credit foncier Companies	Total	Deposit-taking Specialized Fis*	Grand Total
Assets	**6,119.7**	**699.2**	**19.4**	**309.6**	**2.3**	**7,150.2**	**1,474.0**	**8,624.2**
Cash and deposits at financial institutions	434.1	42.6	0.2	2.9	0.2	480.0	23.5	**503.5**
Investments in securities (include R/P)	1,277.3	203.0	0.0	93.4	0.4	1,574.1	410.1	**1,984.2**
Credit (net) [1/]	3,973.8	407.3	19.0	195.9	1.2	4,597.2	953.9	**5,551.1**
Other assets	434.5	46.3	0.2	17.4	0.5	499.0	86.5	**585.5**
Liabilities	**5,688.4**	**478.3**	**0.0**	**245.3**	**1.7**	**6,413.7**	**1,255.8**	**7,669.5**
Deposits [2/]	5,197.3	312.6	0.0	217.5	0.0	5,727.4	1,159.6	**6,887.0**
Borrowing (include R/P) [3/]	336.4	116.3	0.0	21.7	1.7	476.1	42.9	**519**
Other liabilities	154.7	49.4	0.0	6.1	0.0	210.2	53.3	**263.5**
Equities	**431.3**	**220.9**	**19.4**	**64.3**	**0.6**	**736.5**	**218.2**	**954.7**
No. of banks	**13**	**18**	**5**	**18**	**5**	**59**	**4**	**63**

* Deposit-taking SFIs include Government Housing Bank,Government Savings Bank,Bank for Agriculture and Agricultural Cooperatives and Islamic Bank of Thailand

[1/] including Interbank Credit , Accrued Interest Receivable less Allowance for Possible Loan Losses

[2/] including Interbank Deposits

[3/] including Interbank Borrowing

As of December 2003, there were 59 financial institutions under the supervision of the Bank of Thailand, which included locally-incorporated banks (13), branches of foreign banks (18), international banking facilities (29, of which five were stand-alone IBFs), finance companies (18), and credit foncier companies (5). During the year, four financial institutions, namely, one finance company, one credit foncier company, and two stand-alone IBFs exited the financial system.

Locally-incorporated commercial banks still played a major role in the financial system, with the share of assets exceeding 70 percent. The four largest banks alone accounted for more than 60 percent of loans and deposits. On the contrary, we see a diminishing role of foreign banks' branches and IBFs, with their share of loans and deposits of only 7 percent and 4 percent, respectively. This was due mainly to the winding down of some stand-alone IBFs as well as declining transactions of the overall IBF businesses, in anticipation of termination of out-in tax privileges.

As the government policy in recent years was to promote financial access to low-income customers and small- and medium-sized enterprises (SMEs), the business of the specialized financial institutions (SFIs) that focused on this segment of customers grew considerably. These SFIs included the Government Savings Bank, the Government Housing Bank, the Bank for Agriculture and Agricultural Cooperatives, and the Islamic Bank of Thailand (Box 1 summarizes the history and role of the Islamic Bank of Thailand).

In the next few years, we will see changes in the structure of the Thai financial system following the implementation of the Financial Sector Master Plan in 2004. Finance companies and credit foncier companies have an option to apply to be upgraded to a commercial bank or retail bank, whereas stand-alone IBFs and branches of foreign banks to a full branch or subsidiary. Furthermore, financial conglomerates will have to choose only one form of existence to be in line with the "one presence" policy of the Master Plan (Detail of the Financial Sector Master Plan can be found in Chapter 4).

2.2 Performance of Financial Institutions

2.2.1 Balance Sheet Composition

Deposits continued to be the main source of funds of financial institutions, with the proportion of 92.3 percent. Against the continuous decline in deposit rates, deposits had grown at no less than 4 percent per annum since 2000 (except for 2002, when the growth rate was at 1.3 percent as depositors shifted to higher yield government bonds). Possible explanation for such behavior was that after the crisis depositors were left with fewer choices of good investments; at the same time, investors of other instruments shifted to a safer saving channel like deposits. However, in the next few years, this trend may be affected by some factors such as more investment opportunities in line with the economic recovery and future interest rates.

Extension of credits still played a major role on the uses of fund side. The majority of credit growth in 2003 was attributed to consumer loans. With rising income, strengthening confidence, competitive sales promotions, and low interest rate environment, personal consumption increased rapidly. At the same time, more financial institutions had resorted to investment in securities and repurchase markets, with the combined growth rate of 20 percent per annum. Most of the securities investments were in government and state-enterprise bonds and foreign debt securities. In the meantime, the role of interbank deposits decreased continuously as a result of declining interbank interest rates.

Box 1 : The Islamic Bank of Thailand

The idea of establishing the Islamic Bank of Thailand was initiated in 1994 when the Thai government signed Indonesia-Malaysia-Thailand Growth Triangle (IMT-GT Project) with a view to promoting banking services specific to the needs of Muslim consumers, in particular those in the four southern provinces. The window of Islamic banking services in accordance with Islamic precept (Shariah) was first provided by one commercial bank in late 1997, but brought to an end after the closure of this bank as a result of the financial crisis. In preparation for subsequent establishment of an Islamic banking institution, a few specialized financial institutions implemented pilot schemes to provide these services as a separate unit from the regular banking services. Not until October 2002 was the Islamic Bank of Thailand (ISBT) established under the Islamic Bank of Thailand Act B.E. 2545, following the studies by the National Economic and Social Development Council and the Fiscal Policy Office.

The ISBT is under the supervision of the Ministry of Finance. The Islamic Bank of Thailand's paid-up capital currently stands at 696.86 million baht, against the registered capital of one billion baht. The Ministry of Finance and a few state-owned financial institutions hold the majority of the ISBT shares, while the remaining shares were held by private funds, individuals and foreign interests. The foreign holding represents a mere 15 percent of total shares, which is less than half of the proportion allowed by the ISBT regulation (33 percent). The ISBT currently has seven branches, two in Bangkok and the rest in five southern provinces where there are considerable Islamic business activities.

The ISBT offers banking services that conform to Islamic precept to both Muslim and non-Muslim consumers, and thus operates its business in a way that does not involve profit making from interest margin, with part of the profit set aside for charitable social work. The ISBT provides roughly the same basic financial services as other commercial banks such as deposit taking, corporate and consumer lending, trade financing and simple foreign exchange transaction. Deposits with the ISBT are guaranteed in full under the blanket guarantee scheme by the government, and come into two main forms. One, comprising savings account and current account (Al Wadiah), is interest free. The other is investment account (Al Mudharabah) whereby depositors receive dividend based on prior agreement of profit sharing that depends on maturity and amount of deposits, among other factors, when opening such account.

In addition to restriction on lending to economic activity that is against Islamic precept, the conduct of Islamic banking is different from commercial banking business in terms of lending practices. Unlike commercial banks, the ISBT does not extend credit directly to clients and charge interest on such lending. Informed of clients' purpose of borrowing, the Bank will purchase the goods or services on behalf of its clients who will repay the Bank by means of installment repayments or hire purchase at the price inclusive of profit.

(Further information on the Islamic Bank of Thailand can be found in the website: www.isbt.co.th)

Chart 11 : Assets of Financial Institutions*

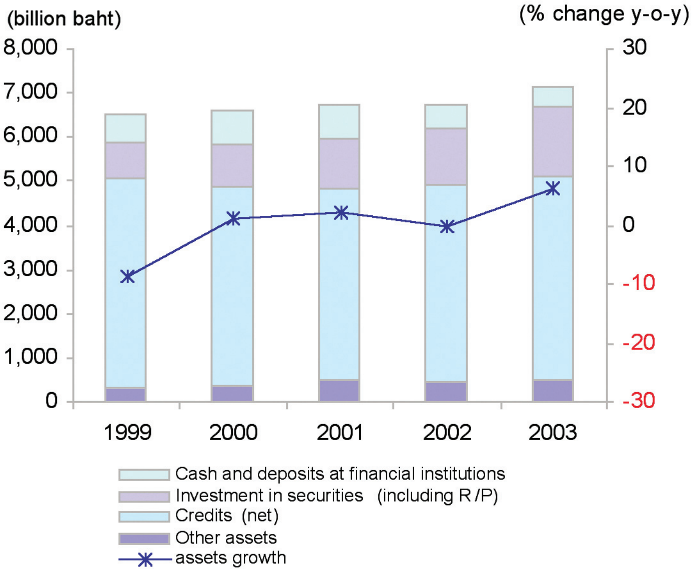
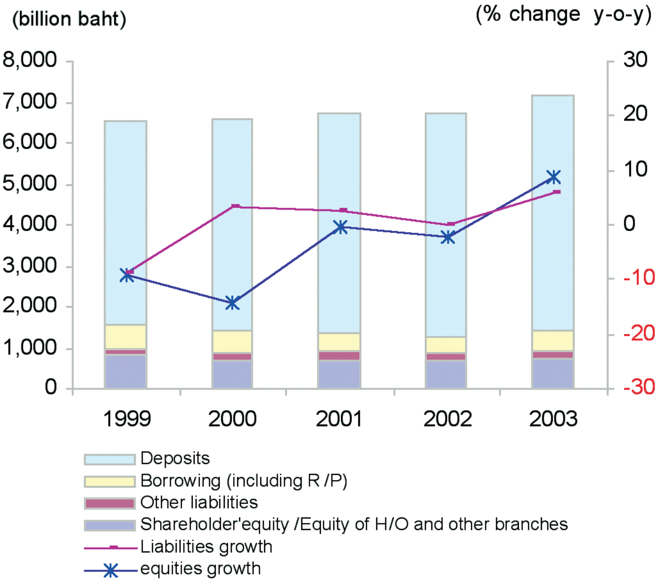


Chart 12 : Liabilities and Equities of Financial Institutions*



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

Table 4 : Change in Use & Source of Funds of Financial Institutions

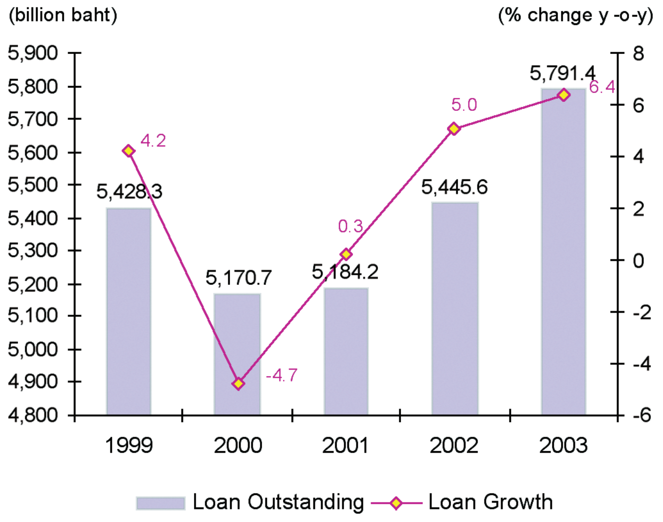
(% change y-o-y)

Main Items	1999	2000	2001	2002	2003
Use of Fund					
Cash and deposits at financial institutions	42.2	18.3	(0.2)	(30.6)	(10.1)
Investments in securities (include R/P)	(6.8)	18.0	20.1	13.5	21.6
Credits	(10.5)	(10.8)	(5.3)	6.6	2.7
Source of Fund					
Deposits	(6.2)	4.6	4.0	1.3	4.9
Borrowing (including R/P)	(14.6)	(11.8)	(16.8)	(7.3)	15.3

2.2.2 Loan Portfolio and Provisioning

Since the recovery of the Thai economy in 2000, loan portfolio has expanded at an accelerated pace from 0.3 percent in 2001 to 5 percent and 6.4 percent in 2002 and 2003, respectively. At the end of 2003, adjusted loans outstanding* was 5,791.4 billion baht, increasing from the previous year by 345.8 billion baht, of which 294.1 billion baht were the loans extended by commercial banks.

Chart 13 : Growth of Financial Institutions' Adjusted Domestic Loans



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* Reported loans deducted interbank items, added back net write-offs, NPL transfer to AMCs and TAMC, and losses from debt restructuring

As mentioned earlier, rising income, strengthening confidence, sales promotions, and low interest rate environment had contributed to the rapid growth of consumer loans during the past few years, especially housing and credit card loans. Toward the end of the year, there was a sharp increase in housing loans as many home transfers were expedited to reap benefit from tax and fee incentives that were scheduled to expire in 2003 (More detail on real estate industry can be found in Box 2).

Table 5 : Adjusted Domestic Loans*

(billion baht)

Financial Institutions	1999	2000	2001	2002	2003
Commercial Banks	5,299.6	4,991.7	4,981.1	5,223.2	5,517.4
(% change y-o-y)	3.6	(5.8)	(0.2)	4.9	5.6
Finance Companies and Credit Foncier Companies	128.7	179.0	203.1	222.3	274.0
(% change y-o-y)	38.2	39.0	13.5	9.5	23.2
Total	**5,428.3**	**5,170.7**	**5,184.2**	**5,445.6**	**5,791.4**
(% change y-o-y)	**4.2**	**(4.7)**	**0.3**	**5.0**	**6.4**

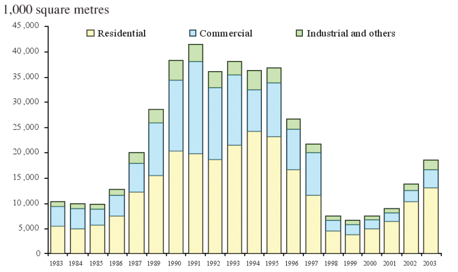
* Loans According to Report – Interbank Transactions + Net Write-offs, NPL Transfer to AMCs and TAMC, and Losses from Debt Restructuring

Most of the loans to economic sectors were in manufacturing, retail & wholesale trade, services, and real estate. Although loans to economic sectors started to increase since 2002, the pace was lower than those for personal consumption as major corporate enterprises increasingly turned to other sources of financing such as issuance of debentures and stocks.

Box 2 : Real Estate Market

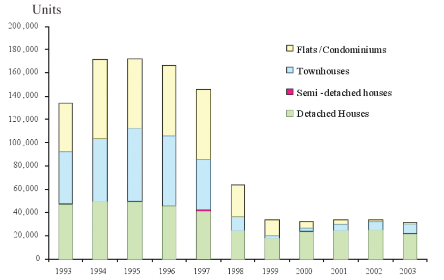
Real estate activities accelerated strongly in 2003, after the market had bottomed out in 2000, with housing demand being a major driving force. The value of land transactions for the entire kingdom totaled 437.0 billion baht, up by 64.4 percent from the previous year, with 25 percent of the transactions occurring in December alone. This was due to the approaching expiration of transfer fee reduction at the end of the year as well as the rush to transfer property before the reappraisal of land by the Treasury Department and the new city plan for Bangkok take effect, which would raise land and housing prices in 2004. However, other real estate indicators, such as permitted construction areas and new housing registrations, were still lower than that of the pre-crisis period despite strong growth in recent years.

Permitted Construction Areas



Sources: Bangkok District Office and Municipalities

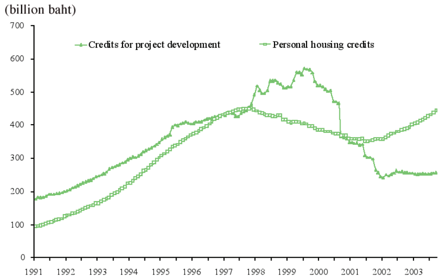
New Housing Registrations



Sources: Government Housing Bank

Major factors supporting buoyant real estate activities in 2003 include the low interest rate environment and high growth of housing credits extended by commercial banks, both of which made home-owning much more affordable. As of end-December 2003, the outstanding level of personal housing credits was 475.7 billion baht, growing by 18.7 percent year-on-year.*

Real Estate Credits Extended by Commercial Banks



Sources: Bank of Thailand

The increase in real estate demand which exceeded that of supply led to some upward pressure on real estate prices in 2003. Overall, housing prices increased roughly by 10 percent year-on-year, while land prices in certain locations also rose. Construction cost adjusted upward with higher prices of raw materials such as steel and cement. At the same time, the rise in the condominium rental index for the central business district encouraged greater demand for investment in condominiums.

Real estate activities are expected to slow down somewhat in 2004, partly because of the expiration of the transfer fee reduction and measures. Nevertheless, the trend for the rest of the year should remain quite strong, with genuine demand for housing and accommodating interest rates. The partial slowdown in real estate demand coupled with greater supply, partly due to the government's housing program for low-income families, is likely to help relieve some real estate price pressure in 2004.

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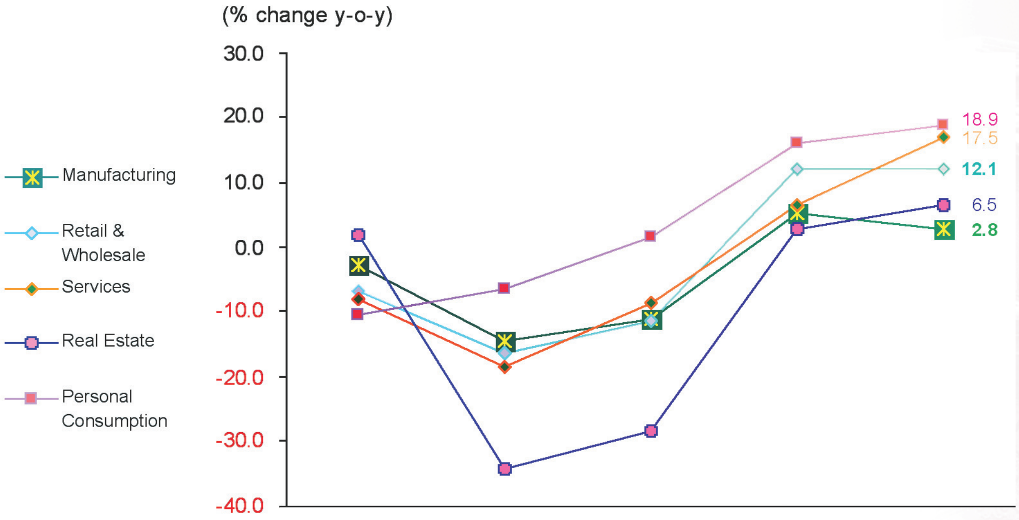
* Preliminary data

Chart 14 : Loans by Economic Sector of Commercial Banks



(billion baht)

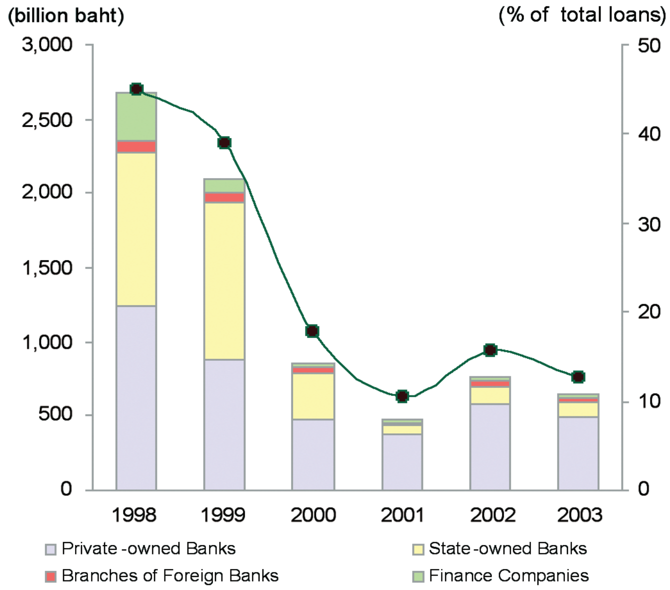
	Economic Sector	1999	2000	2001	2002	2003*
1.	Manufacturing	1,495.7	1,279.6	1,137.4	1,198.5	1,232.1
2.	Retail & Wholesale Trade	777.6	650.2	576.2	645.8	723.8
3.	Services	382.3	311.5	284.8	303.8	356.0
4.	Real Estate	513.8	338.9	243.0	249.6	265.9
5.	Personal Consumption	533.6	500.2	508.1	589.8	701.1

* Preliminary

Non-Performing Loan (NPL)

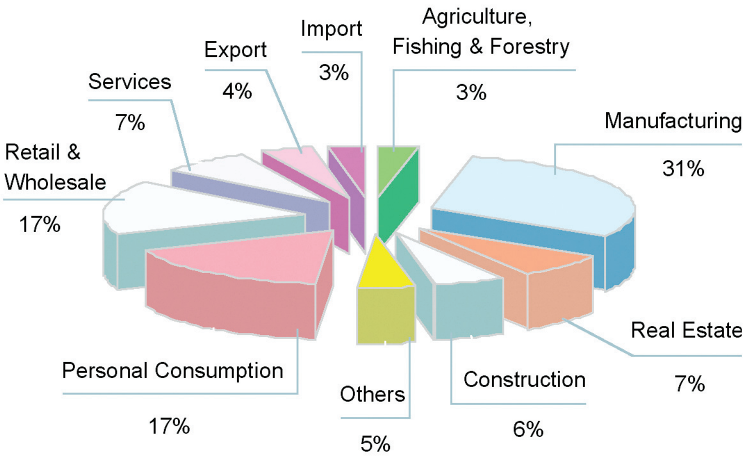
The NPL of commercial banks and finance companies has shown a downward trend since 1998, with a slight increase at the end of 2002 when the definition of NPL changed. As of December 2003, the amount of NPL reduced further to 641.4 billion baht (12.7% of total loans) compared to 776.6 billion baht (15.67% of total loans) in December 2002. This was due mainly to increased level of debt restructuring, debt repayment, and NPL write-off. The environment of low interest rate, together with tax incentives, also expedited debt restructuring and repayment progress. The economic recovery also played some role in reducing the level of new NPL and NPL re-entry (Details on NPL resolution strategies are in Section 2.3).

Chart 15 : Non-Performing Loan Outstanding



The decline of NPL outstanding was noted in almost all economic sectors. NPL in manufacturing, retail and wholesale trade, and personal consumption sectors accounted for over 60 percent of total NPL. Of the NPL in personal consumption sector, NPL in housing loans took up approximately 80 percent, most of which were with past-due period of over one year. Although the level of housing NPL declined from 102.2 billion baht in 2002 to 94.6 billion baht in 2003, expansion of housing loans in 2004 combined with the increase in government projects for low-income customers may give rise to NPL in this sector in the future. In view of such risk, several measures were implemented to curb the excessive growth in the high-end real estate market (please see detail in Chapter 3, Section 3.1).

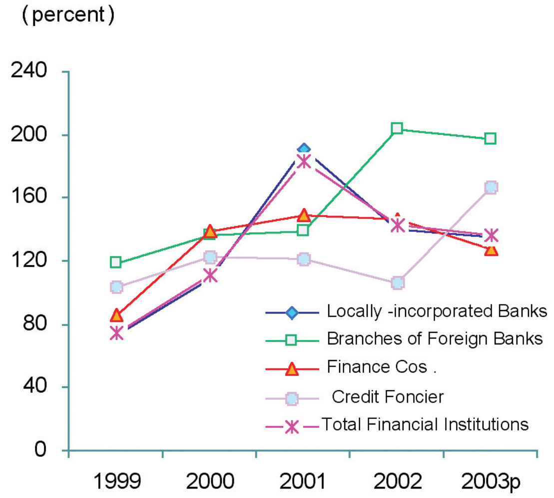
Chart 16 : Non-Performing Loan Outstanding Classified by Business Sector



Provisioning

In 2003, every financial institution provisioned for classified assets at the level higher than the regulatory requirement. The average provisioning was 136.1 percent of required provisions, compared to the ratio of 142.1 percent last year. This resulted from the increase in the provisions that were required for potential NPL of some financial institutions. Most of the potential NPL were loans under a debt restructuring plan classified as pass, but the Bank of Thailand's examiners adopted a precautionary measure by requiring financial institutions to set aside extra provisions to ensure against possible relapse. In addition to the extra provisioning, the value of collaterals evaluated in accordance with the Bank of Thailand's guideline was almost as high as 55 percent of the NPL outstanding. These two cushions should therefore give a reasonable comfort for financial institutions. Given that all NPL became bad debts, the value of existing collaterals would still cover the net loss.

Chart 17 : Actual Provisioning : Required Provisioning



2.2.3 Performance of Financial Institutions

Profits from operations

The year 2003 was the third consecutive year that financial institutions in Thailand were able to earn net profits, which increased more than one fold from the previous year. There was an increase in both net interest income (+10.2%) and non-interest income (+4.2%), and a decrease in both operating expense (-3.0%) and provisioning burden (-19.7%). Locally-incorporated commercial banks showed quite strong operating performance, contributing more than half of the increase in net profits of the financial institutions system. It should be noted that this year was the first year that most financial institutions were able to manage net interest income to cover operating expense, owing to low interest rate environment, financial institutions' ability to better control their expense, recovery of most economic sectors, increasing household expenditure, and continued progress of debt restructuring.

Table 6 : Performance of Financial Institutions [1/]

(billion baht)

Items	1999	2000	2001	2002	2003	Δ (2003-2002)	
						Amount	% y-o-y
1. Interest Income	375.28	334.14	304.97	281.65	262.78	(18.87)	(6.70)
2. Interest Expense	313.11	226.39	181.36	149.54	117.14	(32.40)	(21.67)
3. Net Interest Income (Item 1-2)	**62.17**	**107.75**	**123.61**	**132.11**	**145.64**	**13.53**	**10.24**
4. Non-interest Income	58.31	70.89	71.74	96.60	100.66	4.06	4.20
5. Operating Expense	168.45	154.63	152.40	150.76	146.21	(4.55)	(3.02)
6. Operating Profit (Loss) (Item 3+4-5)	**(47.97)**	**24.01**	**42.95**	**77.95**	**100.09**	**22.14**	**28.40**
7. Provisions [2/]	366.38	129.70	53.27	51.60	41.45	(10.15)	(19.67)
8. Income Tax	7.03	5.19	4.45	3.18	2.79	(0.39)	(12.26)
9. Extraordinary Items [3/]	13.62	105.82	99.42	0.08	0.34	0.26	325.00
10. Net Profit (Loss) (Item 6-7-8+9)	(407.76)	(5.06)	84.65	23.25	56.19	32.94	141.68
11. Yield on Loan (%)	5.16	4.95	5.32	4.69	4.32	(0.37)	(7.89)
12. Yield on Deposit (%)	4.90	3.26	2.53	2.07	1.52	(0.55)	(26.57)
13. Spread (Item11-12) (%)	**0.26**	**1.69**	**2.79**	**2.61**	**2.80**	**0.19**	**7.28**
14. Net Interest Margin (Item3/Avg Asset) (%)	**0.90**	**1.63**	**1.81**	**1.92**	**2.09**	**0.17**	**8.85**
15. ROA (Item 10/Avg Asset) (%)	**(5.90)**	**(0.08)**	**1.24**	**0.34**	**0.81**	**0.47**	**138.24**
16. Operating Efficiency Ratio [4/] (%)	**139.81**	**86.56**	**78.01**	**65.92**	**59.36**	**(6.56)**	**(9.95)**

[1/] Financial institutions include commercial banks, finance companies, and credit foncier companies

[2/] High provisioning in 1998-2000 partly reflected the acceleration in provisioning in order to meet the regulation mandating full provisioning by the end of year 2000

[3/] Extraordinary Items between 2000-2001 are mostly reversed provisioning.

[4/] Operating efficiency ratio is defined as operating expense divided by the sum of net interest income and non-interest income

Table 7 : Performance by Type of Financial Institutions in 2003

(billion baht)

Items Amount	Locally-incorporated Banks				Branches of Foreign Banks	Stand-alone IBFs	Total Commercial Banks	Finance / CFs		Total Financial Institutions
	Majority-Owned by Thais	Majority-Owned by Foreigners	State-Owned	Total				Finance Cos.	Credit Foncier Cos.	
Net Interest Income	77.56	11.09	33.50	**122.15**	13.08	0.38	**135.61**	10.08	(0.05)	**145.64**
Non-interest Income	55.32	5.07	14.66	**75.05**	16.94	0.43	**92.42**	8.21	0.03	**100.66**
Operating Expense	76.74	11.27	29.81	**117.82**	21.19	0.18	**139.19**	6.91	0.11	**146.21**
Operating Profit (Loss)	56.14	4.89	18.35	**79.38**	8.83	0.63	**88.84**	11.38	(0.13)	**100.09**
Allowance for Doubtful/ Bad Debts	28.10	4.25	9.76	**42.11**	(4.43)	(0.03)	**37.65**	3.17	0.63	**41.45**
Income Tax	(0.01)	0.02	0.19	**0.20**	3.17	0.05	**3.42**	(0.63)	0.00	**2.79**
Extraordinary Items	0.00	0.00	0.00	**0.00**	0.00	0.00	**0.00**	0.34	0.00	**0.34**
Net profit (Loss)	28.05	0.62	8.40	**37.07**	10.09	0.61	**47.77**	9.18	(0.76)	**56.19**
Yield on Loan (%)	4.33	5.12	4.10	**4.31**	3.50	2.49	**4.23**	6.39	2.40	**4.32**
Yield on Deposit (%)	1.31	1.53	1.86	**1.50**	0.92	-	**1.47**	2.70	4.26	**1.52**
Spread (%)	**3.02**	**3.59**	**2.24**	**2.81**	**2.58**	**-**	**2.76**	**3.68**	(1.86)	**2.80**
Net Interest Margin (%)	**2.09**	**2.86**	**1.82**	**2.06**	**1.82**	**1.85**	**2.03**	**3.48**	(1.21)	**2.09**
ROA (%)	**0.76**	**0.16**	**0.46**	**0.62**	**1.40**	**2.98**	**0.72**	**3.17**	(17.78)	**0.81**
Operating Efficiency Ratio (%)	**57.75**	**69.74**	**61.90**	**59.75**	**70.59**	**22.22**	**61.04**	**37.78**	(550.00)	**59.36**

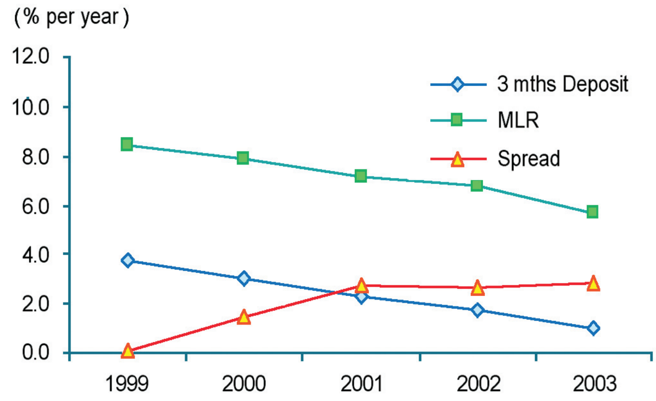
● Interest spread and margin

Although the market interest rates continued to decline, with three reductions of both deposit and loan rates in 2003, the overall interest spread improved from 2.6 percent in 2002 to 2.8 percent in 2003 as interest expense decreased at a higher rate than interest income.

Note that the spread of locally-incorporated banks showed improvement since 2001. This resulted from NPL transfers to TAMC, progress in debt restructuring, and increase in credit extension, particularly those in a high-margin loan segment such as consumer credits. At the same time, the spread of foreign banks which started to decline since 2001 dropped to the lowest level compared to the whole banking system. This was attributed to the decrease in lending as the share of IBF loans to total loans reduced from 90 percent before the crisis to less than 40 percent in 2003.

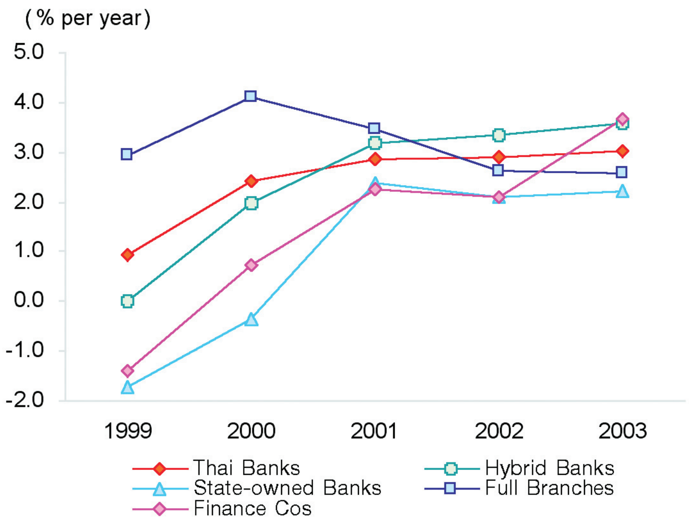
Along with the interest spread, net interest margin increased from 1.9 percent in 2002 to 2.1 percent in 2003.

Chart 18 : Interest Rates* and Spread**



*the average of interest rates of 5 largest locally-incorportated banks
**the spread of all locally-incorporated banks

Chart 19 : Interest Spread

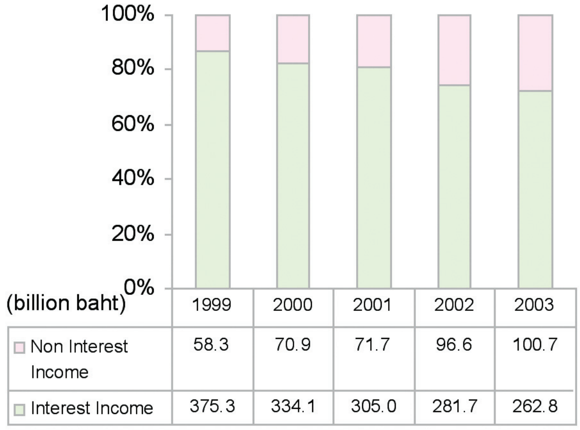


● Income and expense structure

Non-interest income of financial institutions continued to gain importance. The share of non-interest income to total income has increased since 1999, with the ratio of 27.7 percent in 2003. This year, non-interest income increased by 4.1 billion baht from the previous year (+4.2%), mainly due to the increase in profits from securities investment (+115.5%) and appropriations of profits from affiliates and subsidiary companies of locally-incorporated banks. Fee-based income, which accounted for more than 40 percent of non-interest income, increased slightly (+3.2%).

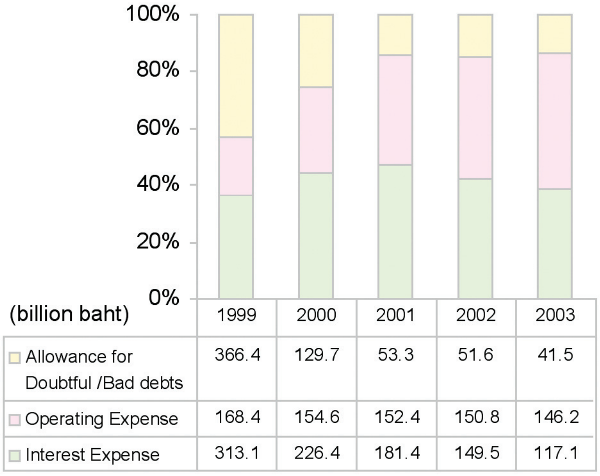
The declining interest environment reduced the burden of interest expense, which was the major expense of financial institutions since 2000, to the point where operating expense surpassed interest expense in 2002. The share of operating expense to total expense increased from 30.3 percent in 2000 to 48.0 percent in 2003. Most of the operating expense was employee expenditure and contributions to Financial Institutions Development Fund (FIDF).

Chart 20 : Income Structure of Financial Institutions



(billion baht)	1999	2000	2001	2002	2003
Non Interest Income	58.3	70.9	71.7	96.6	100.7
Interest Income	375.3	334.1	305.0	281.7	262.8

Chart 21 : Expense Structure of Financial Institutions



(billion baht)	1999	2000	2001	2002	2003
Allowance for Doubtful /Bad debts	366.4	129.7	53.3	51.6	41.5
Operating Expense	168.4	154.6	152.4	150.8	146.2
Interest Expense	313.1	226.4	181.4	149.5	117.1

Operating efficiency of employees

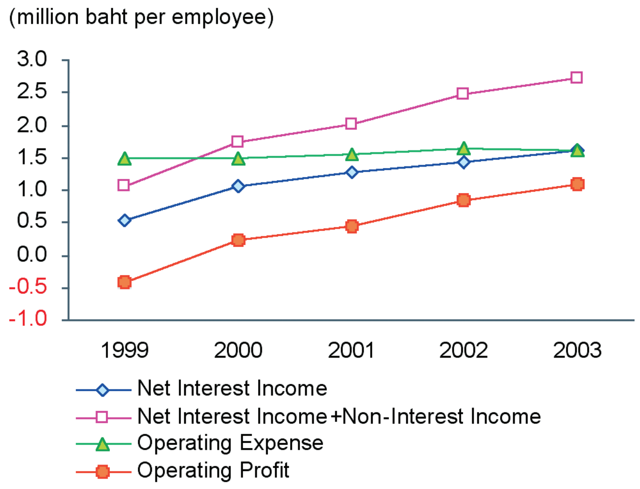
The overall operating efficiency of financial institutions has also been improving. The ratio of net interest income to average number of employees and the ratio of net interest income and non-interest income to average number of employees increased from 0.6 million baht and 1.1 million baht in 1999, to 1.6 and 2.7 million baht per person per annum in 2003. The ratio of operating expense to average number of employees during this period, however, stayed relatively constant at 1.6 million baht per person per year. This resulted from better management of both net interest income and non-interest income and financial institutions' efforts to improve the efficiency of individual employee. For example, locally-incorporated banks had reduced the number of employees as well as extended the branches of a lower cost form such as micro branches. However, the operating efficiency of locally-incorporated banks was still lower than that of foreign branches.

Table 8 : Employees' Efficiency by Type of Financial Institutions in 2003

(million baht per employee)

Financial Institutions	Net Interest income	Net Interest income & Non-Interest income	Operating expense	Operating profit
Total Locally-incorporated Banks	1.47	2.37	1.42	0.95
- Majority-owned by Thais	1.47	2.52	1.46	1.06
- Majority-owned by Foreigners	1.51	2.19	1.53	0.66
- State-owned	1.45	2.08	1.29	0.79
Branches of Foreign Banks	3.43	7.87	5.56	2.31
Stand alone IBFs	5.16	11.08	2.51	8.57
Total Commercial Banks	**1.56**	**2.62**	**1.60**	**1.02**
Finance Companies	**2.80**	**5.08**	**1.92**	**3.16**
Credit Foncier Companies	**(0.64)**	**(0.34)**	**1.37**	**(1.71)**
Total Financial Institutions	**1.60**	**2.71**	**1.61**	**1.10**

Chart 22 : Employees' Efficiency of Financial Institutions



2.2.4 Capital Funds

All financial institutions maintained capital funds higher than the minimum requirement, at the average of 14.6 percent of risk-weighted assets*, compared to the ratio of 14.1 percent in 2002. This was attributed to the continued improvement in operations of financial institutions as well as the recapitalization of three locally-incorporated banks and two finance companies in the amount of 70.7 billion baht to accommodate their business expansion. Hybrid capital funds in the forms of SLIPS/CAPS, which were issued by five locally-incorporated banks and bore extremely high cost of interest expense, started to be redeemed by some of the issuing banks. This redemption did not have an effect on the overall capital because these banks had already raised new funds to accommodate the redemption. It is expected that the remaining SLIPS/CAPS will be redeemed in 2004 and that the operating performance of these banks will improve as they were rid of these high cost items.

On average, finance companies maintained a much higher BIS ratio than the minimum requirement of 8 percent. Nevertheless, the acceleration of hire-purchase loans, which in turn increased the risk-weighted assets, brought the ratio down significantly from 27.9 percent in 2001 to 20.3 percent in 2003.

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* The capital requirement of risk-weighted assets for locally-incorporated banks, branches of foreign banks, finance companies, and credit foncier companies is 8.5 %, 7.5 %, 8 %, and 6 %, respectively.

Chart 23 : BIS Ratio of Commercial Banks

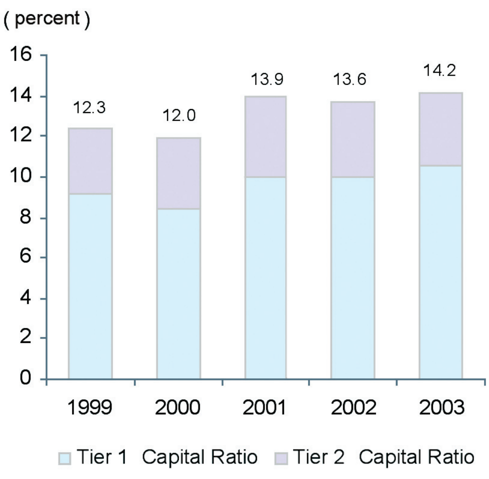


Chart 24 : BIS Ratio of Finance Companies

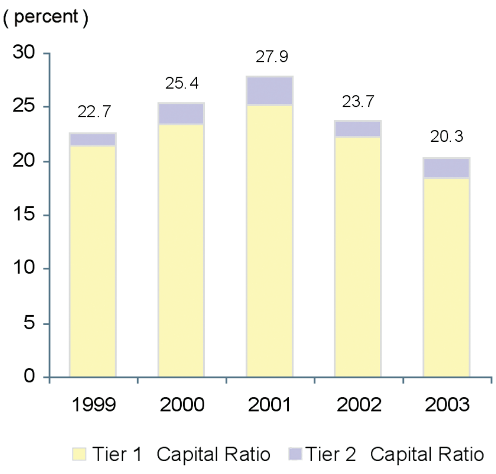


Table 9 : Capital Adequacy and Quality of Capital

Financial Institutions	**Capital Fund (billion baht)**			**BIS Ratio (%)**		
	Tier - 1	**Tier - 2**	**Total**	**Tier - 1**	**Tier - 2**	**Total**
Locally-incorporated Banks	378.0	152.1	530.1	9.7	3.9	13.6
- Majority-owned by Thais	263.8	134.1	398.0	9.9	5.0	14.9
- Majority-owned by Foreigners	25.1	8.0	33.2	9.5	3.0	12.5
- State-owned	89.0	10.0	99.0	9.4	1.0	10.4
Branches of Foreign Banks	74.1	-	74.1	20.4	-	20.4
Total Commercial Banks	**452.1**	**152.1**	**604.2**	**10.6**	**3.6**	**14.2**
Finance Companies	**47.8**	**4.5**	**52.2**	**18.5**	**1.7**	**20.3**
Credit Foncier Companies	**0.6**	**-**	**0.6**	**32.5**	**-**	**32.5**
Total Financial Institutions	**500.4**	**156.6**	**657.0**	**11.0**	**3.5**	**14.6**

2.2.5 Liquidity

Although the Thai economy has been recovering since 2000 when credit extension started to pick up pace, liquidity in the financial system remained excessive. Possible explanations are as follows:

1. Financial institutions continued to be conservative on their lending policy for fear of additional NPL;

2. More and more companies opted for lower-cost funding sources such as debt securities issuance, instead of borrowing from financial institutions. In 2003 alone, total issuance of new debentures were at 195.8 billion baht, almost twice the amount in 2002 ; and

3. Industry sector continued to have excess capacity, even though the averaged capacity utilization ratio has increased from 53.5 percent in 2001 to 66.3 percent in 2003.

2.3 Debt Restructuring Progress

Along with the private sector, the government agencies, namely, the Corporate Debt Restructuring Advisory Committee (CDRAC) and the Thai Asset Management Corporation (TAMC) continued their efforts on NPL resolution. Since its inception in June 1998, CDRAC has facilitated and expedited private debt restructuring negotiations. The Bank of Thailand's Corporate Debt Restructuring Group (CRG) has been acting as the secretariat to CDRAC to coordinate and facilitate debt restructuring between parties concerned and to operate in accordance with the resolutions of CDRAC. TAMC was initiated in September 2001 with the mandate to manage the impaired assets transferred from both state-owned and private banks as well as state-owned and private AMCs.

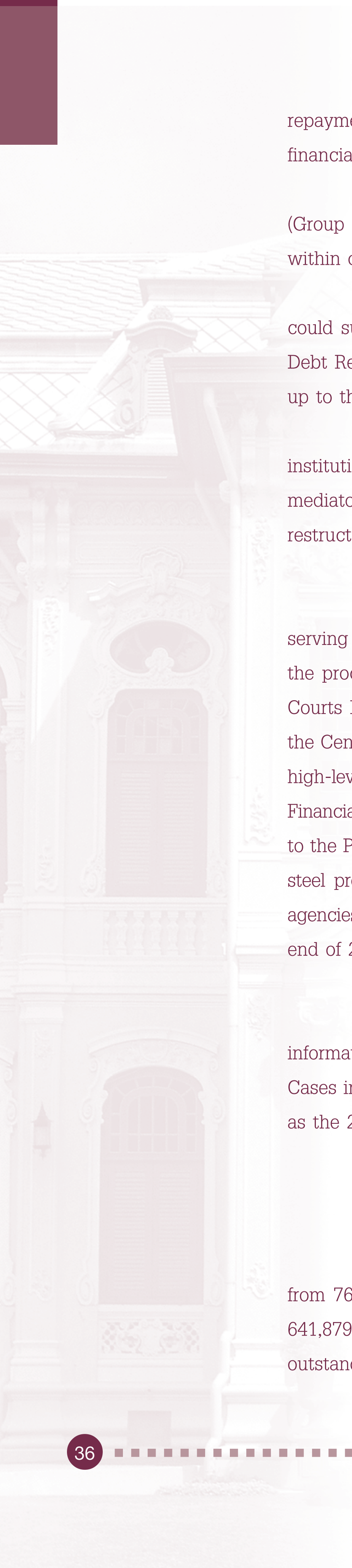
2.3.1 Corporate Debt Restructuring Advisory Committee

Result of Operations

Over 2003, a large number of debtors successfully negotiated debt restructuring with financial institutions, under the framework of the Corporate Debt Restructuring Advisory Committee (CDRAC). However, most of the restructured debts were small- and medium-sized companies, and there were NPL re-entry of some large debtors as well as new NPL. The proportion of NPL to total loans in the system was successfully reduced from 15.67 percent at the end of December 2002 to 12.74 percent at the end of December 2003.

- **Strategies for NPL resolution in 2003**

The strategies for NPL resolution were initiated during the joint meeting between the Bank of Thailand and top executives of 13 Thai commercial banks on 27 November 2002, with an aim to expedite resolution of NPL by category of debtors as follows:



1. Debtors that had already been restructured and were in the process of debt repayment (Group 1): such debtors were to be re-classified as performing-loan, where financial institutions were committed to complete the reclassification within 4 months;
2. Debtors that were in the restructuring process with financial institutions (Group 2): financial institutions were committed to complete the restructuring process within one year, and the new NPL and NPL re-entry should be resolved within one year;
3. Debtors that were in the legal process (Group 3): financial institutions could submit the list of cases for which they would like the Bank of Thailand's Corporate Debt Restructuring Group (CDG) to serve as mediator/facilitator. The CDG would facilitate up to three times in order to settle the restructuring cases outside of court; and
4. Debtors that were in the legal execution process (Group 4): financial institutions could also submit the list of cases for which they would like the CDG to serve as mediator/facilitator. The CDG would facilitate for up to two times in order to settle the restructuring cases outside of court.

In addition to specifying the procedures and timeframe for negotiations and serving as the mediator in 2003, the CDG also coordinated with various agencies to speed up the process of debt restructuring, for example, the Office of the Court of Justice, the Civil Courts Region 1-9, the Financial Dispute Resolution Office, the Legal Execution Office and the Central Bankruptcy Court for cases in the legal process. Furthermore, the CDG has sent high-level executives to work with other relevant support agencies such as the SMEs & P Financial Advisory Center and the Subcommittee on National Non-Performance Loan Policy to the Prime Minister, as well as the Ministry of Industry, regarding restructuring of the long steel products cases. The CDG has also coordinated with officials of relevant government agencies to extend the benefits and incentives of debt restructuring for one more year to the end of 2004.

In disseminating information, the CDG continued to organize seminars and information sessions as well as publishing three new hand-outs, namely "Negotiation of Cases in the Legal Process", "Negotiation of Cases in the Legal Execution Process", as well as the 2002 Annual Report.

● Result of NPL resolution by category of debtors

The implementation of the above strategies resulted in the reduction of NPL from 766,646 million baht or 15.67 percent of total loan outstanding in December 2002 to 641,879 million baht or 12.74 percent of total loan outstanding in December 2003. Debt outstanding of Group 1 debtors increased, whereas that of Group 2, 3, and 4 declined.

Table 10 : Resolution of NPLs under CDRAC in 2003

(million baht)

	as at December 2002	as at December 2003
Debts that had been successfully restructured and in the process of repayment (Group 1)	52,828	103,205
Debts that were in the negotiation (Group 2)	287,881	281,629
Debts that were in the legal process and legal execution process (Group 3 & 4)	428,388	257,045

The most significant obstacles to the debt restructuring process were that representatives on the creditors' side did not have the authority to make decision and that debtors did not have the ability to repay. In addition, financial creditors had proposed fewer debtors to enter into the restructuring process than expected. Moreover, since there was no timeframe for the CDG to serve as mediator for Group 2 debtors with only one creditor, the progress has been slow. The changes in the legal process and legal execution process, as well as the delay in payment received, also contributed to the delay in debt restructuring.

Strategy for Resolving NPL in 2004 - 2005

On 26 November 2003, the Bank of Thailand together with top executives of Thai commercial banks reached the following agreement for NPL resolution in 2004-2005:

A. Resolution by category of debtors

Group 1 Debtors that have been restructured and are in the process of repayment

Thai commercial banks jointly agreed to expedite these debtors to comply with the debt restructuring agreements. Banks will report the loans that are successfully restructured and become performing to the Bank of Thailand at the end of every month.

Group 2 Debtors that are in the process of debt restructuring

Thai commercial banks jointly agreed to expedite debt restructuring (to be completed by 2006) and report the successfully restructured cases to the Bank of Thailand at the end of every month.

For both Group 1 and 2, banks agreed to comply with the Bank of Thailand's future provisioning policies that will further expedite debt restructuring of debtors that have not been taken legal action by creditors.

Group 3 & 4 Debtors that are in the Legal Process and Legal Execution Process

Financial creditors will propose additional debtors of this group to enter into the process.

B. Measures to support debt restructuring in 2004

In addition to enhancing the supervision of financial institutions and expediting the resolution of debtors in Group 1 and Group 2, the Bank of Thailand, in cooperation with the relevant authorities, has extended tax and land transfer-fee benefits for another year. Furthermore, an amendment in the Emergency Decree on Asset Management Corporation (AMC) will allow the AMC, a public agency that had been set up with a limited task of acquiring only assets of the 56 finance companies as a last resort buyer, to purchase or acquire another round of non-performing assets (NPA) from financial institutions. The civil and bankruptcy laws will also be amended to support the debt restructuring efforts. All these measures should help speed up the process of debt restructuring in the periods ahead.

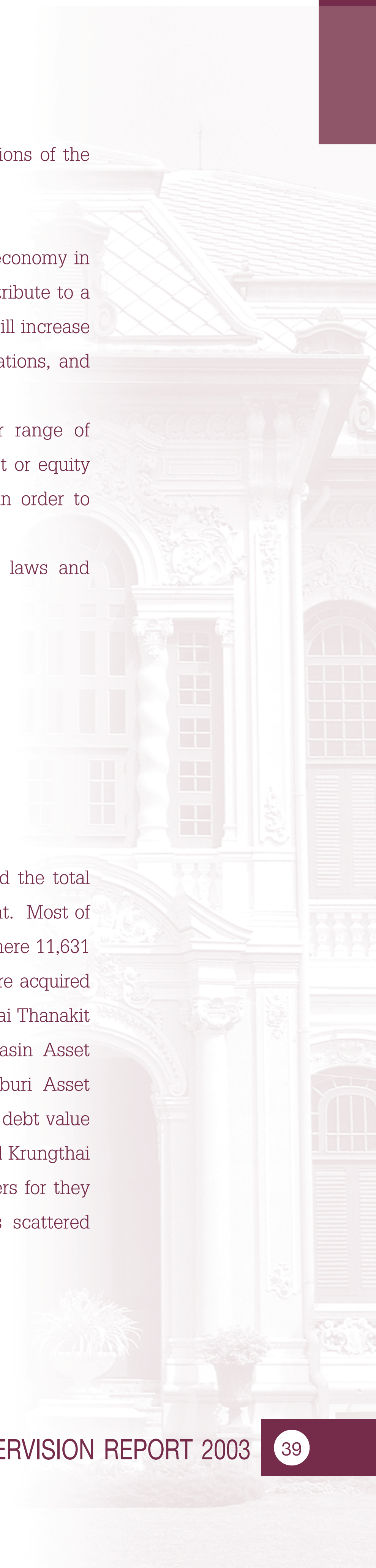
NPL Trends in 2004 and 2005

The level of NPL is likely to decline continuously. It is expected that by the end of 2004, the level of NPL will not exceed 10 percent, and by the end of 2005, the level will further reduce to 3-5 percent of total loans outstanding. Such is a result of continuous efforts and other supportive factors. Nonetheless, there are risks that could delay the reduction process. The key risk and success factors are as follows:

A. Risk factors

Factors that may adversely affect NPL include:

1. Deceleration of production and market activities that may affect cash flows and ability to repay debts by business sectors that face high competition, or deceleration of businesses that have high proportion of NPL or are in the rehabilitation process.
2. Factors that affect the foreign exchange rate and interest rates as these may cause certain business sectors to bear too much debt burden.
3. Revocation of tax benefits and fee exemptions in support of debt restructuring in 2005 and beyond as debt restructuring process would have to bear greater costs.



B. Success Factors

Key factors that support reduction of NPL are the improved conditions of the capital market and the overall economy, and the various supportive measures.

1. The sustainable recovery of the capital market and the overall economy in 2003, together with the positive trends in the years ahead, will undoubtedly contribute to a lower level of NPL. Higher production growth and improved market conditions will increase cash flows for debt repayment, increase the chances of successful debt negotiations, and reduce the likelihood that restructured debtors will default again.
2. Further development in capital market will provide a wider range of funding alternatives for working capital and business expansion, either from debt or equity instruments. It will also provide the opportunity for businesses to refinance in order to improve their financial positions and repayment ability.
3. Supportive measures with respect to amendment of relevant laws and regulations in order to expedite and support the resolution of NPL and NPA.

2.3.2 Thai Asset Management Corporation (TAMC)

TAMC's Performance

- ### Management of impaired assets

From its inception in 2001 to the end of 2003, TAMC has acquired the total number of 17,151 cases with the book value of approximately 781,005 million baht. Most of the impaired asset transfers in 2003 occurred between May to December 2003, where 11,631 individual cases with the total book value of approximately 24,303 million baht were acquired from state-owned financial institutions, namely Krungthai Bank, Bankthai, Krungthai Thanakit Finance Company, Bangkok Commerce Asset Management Company, Radhanasin Asset Management Company, Sukhumvit Asset Management Company, and Petchaburi Asset Management Company. As these newly transferred cases were retail loans, with debt value per case between 200,000 baht - 20 million baht, TAMC has assigned and/or hired Krungthai Bank and Bangkok Commerce Asset Management Company to be asset managers for they have the nationwide networks and resources to manage these small debtors scattered throughout the country.

Table 11 : Cumulative Acquisition of Impaired Assets (as of December 2003)*

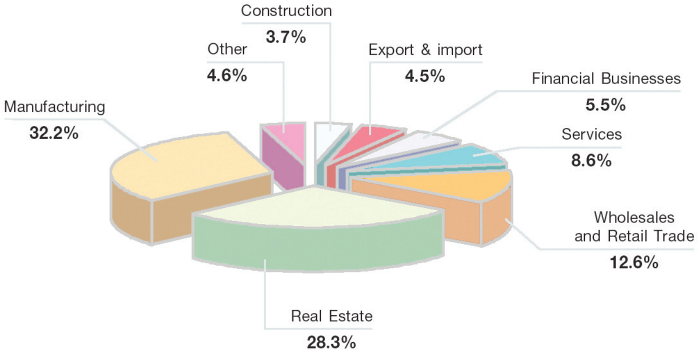
Transferring institutions	# Cases	Book value	
		million baht	%
State-owned	16,533	632,854	81.03
Private	1,079	148,152	18.97
Total	**17,151** [1/]	**781,005**	**100.00**
Transfer price (% of Book Value)			**34%**

* Preliminary data

[1/] Excluding case redundancies among financial institutions

Of all the impaired assets transferred to TAMC, two major sectors, namely, real estate and manufacturing, accounted for more than 62 percent of the total book value. Since they have significant impact on economic recovery, TAMC aims at expediting the NPL resolution in these two sectors, which is in accordance with the government policy framework.

Chart 25 : Sectoral Decomposition of TAMC Debt Under Restructuring



As at the end of December 2003, TAMC reached management conclusion of 4,888 cases with the book value of 732,332 million baht, an increase from the previous year of 121.58 percent in terms of the number of cases and 46.12 percent in terms of book value amount. Of the 4,888 cases, 59 percent (of the book value) was deemed viable and thus gained approval to proceed with debt or business restructuring (Debt restructuring conclusion cases). The overall recovery rate of these viable assets was expected to be at 47.04 percent of the book value, assuming that the debtors comply with the terms and conditions stipulated in the restructuring agreements. The remaining debtors were those who lacked viability, had ceased their business operations, refused to cooperate, or lacked expertise and operational funds. Such debtors were subject to foreclosure of collateral and final receivership of properties, as stipulated under section 58 and 74 of the Emergency Decree on the Thai Asset Management Corporation B.E. 2544 (Non-conclusion cases).

Table 12 : Impaired Assets Management (as of December 2003)*

Procedure	# cases	Book value	
		million baht	%
Debt Restructuring Conclusion Cases	**2,216**	**433,237**	**59.16**
1. Debt Restructuring	2,113	323,295	44.15
2. Business Restructuring	4	2,046	0.28
3. Rehabilitation in the Central Bankruptcy Court	99	107,896	14.73
a. Plans approved by Court	62	53,287	
b. Plans awaiting Court's approval	37	54,609	
Expected recovery rate	**47.04%**		
Non-Conclusion Cases	**2,672**	**299,095**	**40.84**
1. Foreclosure of collateral, final receivership of property	2,668	296,734	40.52
2. Civil Court's verdict	3	1,940	0.26
3. Write-offs	1	421	0.26
Total	**4,888**	**732,332**	**100.00**

* Preliminary data

Restructuring methods and execution progress

Debt restructuring conclusion cases

To successfully restructure impaired assets, TAMC employed 5 methods, namely, upfront payment, sale of non-core assets, installment payments, payment by transfer of assets, and debt to equity conversion. The installment payment method was utilized the most as it offered more flexibility to debtors. Payment by transfer of assets and debt to equity conversion methods were also used in conjunction with installment payment. In addition, TAMC has granted debtors some debt reduction so that their restructuring plans would truly reflect the ability to pay. The average haircut for all restructured cases stood at approximately 38.00 percent of the book value.

The signing of debt restructuring agreements usually takes place approximately 1-2 months after the cases are approved by the Executive Committee. As at the end of 2003, approximately 78 percent of debtors already signed an agreement with TAMC. As for the cases approved in December 2003, the signing of debt restructuring agreements is expected in the first quarter of 2004.

Regarding the payment record, debtors were able to service their debts without unreasonable delay. The accumulated cash received, as at the end of 2003, was 25,861 million baht, an increase of 5,091 million baht from 2002.

Table 13 : Debt Restructuring Progress (as of December 2003)*

(million baht)

Method	(1) Approved New contract Value	%	(2) Signed Agreement-Contract Value	(3) Accumulated Collection progress	% (3)/ (2)
1. Cash paid upfront	22,503	8.38	5,691	25,861	27.73
2. Sale of non-core assets	20,335	7.57	9,795		
3. Installment Payments	105,692	39.35	77,768		
4. Transfer of assets for payment	60,732	22.61	41,420	17,062	41.19
5. Debt to equity conversion and others	59,342	22.09	35,107	16,820	47.91
Total	**268,604**	**100.00**	**169,781**	**59,743**	**35.19**

*Preliminary Data

Non-conclusion cases

Of the 2,668 non-conclusion cases (foreclosure of collateral and final receivership of property), TAMC has provided support to the debtors who lacked expertise and operational funds by hiring four independent asset managers well equipped with solid financial restructuring expertise and funding sources to renegotiate with the debtors. The main objectives are to speed up the resolution of NPL and help revive their businesses, contributing to the overall economic recovery.

Asset liquidations and enhancement of asset values

For assets received from payment by asset transfer, foreclosure of collateral or enforcement of final receivership of property, TAMC placed its priority in preventing these assets from deterioration by providing security and insurance. At the same time, development alternatives were explored in order to increase their value before sale. The assets received comprised various kinds of real estate, including land, land and building, residential housing, office buildings, condominiums, and industrial factories, scattered throughout the country.

To expedite liquidation of such assets, TAMC established two strategies, according to the asset types:

1. Complete and saleable projects were sold to the public through TAMC's website, public auctions, or in conjunction with other asset sales conducted by financial institutions or other organizations.
2. Incomplete projects, generally real estate projects, were developed in cooperation with state-owned financial institutions, major real estate developers, the Real Estate Business Association, to name a few. This type of assets would be developed in the following fashion:
   - 2.1 Unfinished real estate projects with high potential will be developed in cooperation with the private sector so that they can be completed, marketed, and sold. Such cooperation can be in the form of joint ventures, property funds or special purpose vehicle (SPV).
   - 2.2 Low-income housing projects will be developed in cooperation with government agencies such as the National Housing Authority.

● Transparency and corporate governance

TAMC strongly adheres to the principles of transparency and corporate governance. It has strengthened its disclosure policy by setting up the Committee on Information Disclosure to encourage more information dissemination. In addition to disseminating general information on progress of its performance via press releases, quarterly and annual reports, and its website, TAMC discloses other information, such as assets for sale and auction announcements in newspapers and its website and enhances its mainframe to be able to accommodate more visitors.

With respect to corporate governance, TAMC's Board of Directors approved the Corporate Governance Practice during the third quarter of 2003. The Practice specifies roles and responsibilities of the Board of Directors, Executive Committee, management, and other committees, with emphasis on TAMC's responsibility to work assignment and the country, accountability, equitable treatment, transparency, clear vision and strategy, and code of conduct.

Operational Plan for 2004

TAMC has established the 2004 operational plan as a guideline for its activities. The plan includes:

1. Continuing plans

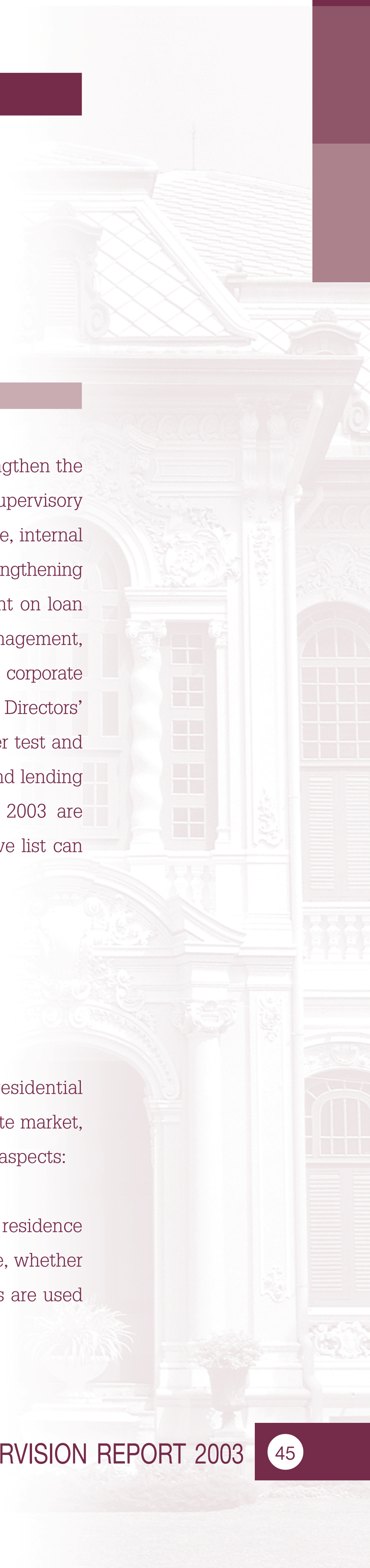
- Expediting foreclosure of collateral and enforcement of final receivership of properties.
- Expediting asset liquidation: TAMC will quickly and effectively dispose the acquired assets both from transfer of assets for payment and foreclosure of collateral in order to prevent asset deterioration and obtain the maximum returns possible.
- Prepayment of debt owed to the transferring financial institutions and redemption of TAMC's promissory notes, which are issued to the transferring institutions and guaranteed by the FIDF.
- Disclosure of proper information to the public in a transparent manner: TAMC will continue to disclose accurate and timely information regarding its performance, assets for sale and other relevant information to the public.
- Enhancement of corporate governance: TAMC will comply with the approved Principles of Corporate Governance.
- Enhancement of operation supporting systems: TAMC will continue to improve its database and other supporting systems in order to ensure accuracy, efficiency and effectiveness of impaired asset management and the follow-up processes.
- Enhancement of personal skills: Realizing the importance of improving its staff's skills and knowledge, TAMC will continue to organize trainings and workshops in various areas of interest.

2. New plans

- Completion of the remaining impaired asset management: TAMC will find resolution for the impaired assets of approximately 25,000 million baht by the first quarter of 2004. As for the assets to be managed by Krungthai Bank and Bangkok Commerce Asset Management Company, in the amount of 24,000 million baht, the resolution timeframe is set for the second quarter of 2004.
- Downsizing of assets both the restructured NPL and NPA: TAMC will effectively dispose these assets so as to prevent deterioration and to obtain the maximum benefits. Several alternatives, such as property fund, property company, and special purpose vehicle (SPV), are being explored.
- Enhancement of internal control and risk management: TAMC will improve its internal control and implement risk management system in order to detect, minimize, as well as prevent the risks.

CHAPTER 3

SUPERVISORY REFORMS



3.1 Supervisory Guidelines

Since the 1997 financial crisis, the Bank of Thailand has continued to strengthen the supervisory framework and improve the financial system infrastructure. The supervisory framework has become more market-oriented with a focus on corporate governance, internal control and risk management. Prominent supervisory guidelines implemented are strengthening of the asset classification and asset valuation, and the issuance of policy statement on loan review process, maintenance of net foreign exchange position, liquidity risk management, and operational risk management. Various initiatives have been taken to strengthen corporate governance of financial institutions. For example, the issuance of Financial Institution Directors' Handbook, policy guidelines on structure of banks' board of directors, fit and proper test and limitation on outside directorships of directors and senior management of banks, and lending to or investing in related parties. Key supervisory guidelines implemented in 2003 are described in detail below by their associated risk categories (a more comprehensive list can be found in the Appendix).

Credit Risk

● Prevention against speculation in the real estate sector

To encourage financial institutions to be more cautious about residential credits, and to avert speculations in certain asset markets, particularly the real estate market, the Bank of Thailand issued a guideline for financial institutions in the following aspects:

1. Demand side The amount of credits granted to any person for residence valued 10 million baht or more should not exceed 70 percent of the purchased price, whether the purpose is to purchase lands, condominiums, or houses, where such properties are used as collateral.

2. Supply side Financial institutions should submit a quarterly report on approvals of real estate loans whose credit lines are equal to or more than 100 million baht. Such report will help the Bank of Thailand in monitoring the current condition of the real estate business.

Policy on non-performing assets (NPA)

In an effort to solve the problem of NPA and expedite reduction of non-performing loans (NPLs), the Bank of Thailand is in the process of revising the provisioning regulation in connection with debt restructuring for financial institutions which have yet to take legal action against debtors. Such institutions will be required to gradually reduce the proportion of collateral which was deducted from the amount of debt before provisioning, thereby increasing their provisioning requirement. The proportion size will depend on the overdue period.

Moreover, to further promote the debt restructuring process, the period of debt restructuring privileges has been extended for one more year, ending on 31 December 2004. In this respect, financial Institutions are allowed to hold shares of any limited company acquired through debt restructuring in the amount exceeding the legal limit, as well as to hold immovable properties transferred between 1997 and 2004 in the holding period exceeding the legal limit.

Relaxation on the supervision of large exposure

As prior regulation on large exposure had constrained banks' transactions with all business groups, the Bank of Thailand issued a guideline to relax the large exposure limit for those with potential or stable financial standing. Under this guideline, commercial banks are allowed to grant credit to, make investment in, and undertake contingent liabilities with any juristic person in a business group with potential or stable financial standing, in the amount exceeding the legal limit. Such relaxation is granted on a case-by-case basis under the criteria set by the Bank of Thailand as follows:

1. Of the amount to apply for a relaxation on large exposure to a single group, 50 percent or more must be credit granted, investment made, and contingent liabilities undertaken with juristic persons that are rated at least BBB+ or have made profits from operation for at least two consecutive years, based on the latest audited financial statement;

2. Such juristic persons must have income from other companies within the group in the amount not exceeding 50 percent of the total income of the group, based on the latest audited financial statement; and

3. Such juristic persons must have income from the same business line in the amount not exceeding 50 percent of the total income of the companies in the group that the banks have granted credits to, made investment in, or undertaken contingent liabilities with, based on the latest audited financial statement.

Market Risk

● Market risk supervision policy

To ensure that financial institutions have in place a risk management system that is sound, adequate, and in line with the volume and complexity of financial institutions' transactions, and to ensure that financial institutions maintain adequate capital funds against market risk, the Bank of Thailand issued the Market Risk Supervision Policy in December 2003. This is the first time that financial institutions are required to maintain capital funds for market risk.

The policy, which comprises elements of interest rate and equity price risks in a trading book as well as exchange rate and commodity price risks, prescribes the prudential guidelines in the following 8 areas:

1. Calculation of the volume of trading book transactions
2. Internal control for market risk management
3. Trading book policy
4. Capital requirement against market risk
5. Measuring market risk under standardized approach
6. Measuring market risk under internal model approach
7. Measuring market risk under mixed approach
8. Compilation of data and submission of related call reports.

The policy will be implemented in transitional periods where

- Financial institutions must comply with the prudential guidelines on internal control for market risk management and trading book policy starting from April 2004;
- Financial institutions must calculate the volume of their trading book transactions starting from the end of July 2004 and submit the related call reports;

- Financial institutions must calculate the capital charge against market risk starting from the end of March 2005 and submit the related call reports; and
- Financial institutions must maintain capital funds against market risk starting from the end of June 2005.

The essence of the guidelines are summarized as follows:

1. Calculation of the volume of trading book transactions

All financial institutions must calculate the volume of trading book transactions every month and compare the calculated amount with the transaction level specified by the Bank of Thailand as **"significant"*** in order to ensure that they comply with the policy in one of the following manners:

- Financial institutions with the trading book volume at the "significant" level must comply with all the guidelines (i.e. guideline 1 to 8).
- Financial institutions with the trading book volume below the "significant" level must comply with guideline 1 to 3 and maintain capital funds against commodity price risk according to guideline 4 to 8.

2. Internal control for market risk management

Financial institutions' board of directors and senior management must implement an internal control system for market risk management, covering at least the following issues:

- Roles and responsibilities of the board of directors and senior management
- Guideline for risk measurement and monitoring system
- Risk control procedure and segregation of duties
- Guideline for data compilation and internal communication
- Internal audit system and corrective action.

3. Trading book policy

Financial institutions must prepare a trading book policy commensurate with the volume and complexity of their transactions and in line with the guideline set by the Bank of Thailand as follows:

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* The "significant" level is defined as the cumulative amount of trading book transactions averaged over the last 6 months at 3,000 million baht or more, or the proportion of trading book transactions to total assets, liabilities, and derivatives averaged over the last 6 months at 5 percent or more.

- Trading book must include debt and equity positions held for trading or hedging of other instruments in the trading book, and all derivatives not held for hedging of positions in the banking book.
- Trading book policy must be prepared in writing and be readily available for the Bank of Thailand's examiners.
- Trading book policy must be approved by the board of directors or other delegated committees, and must be communicated to officers involved throughout the institutions.
- Trading book policy must be periodically reviewed and adjusted to changes in the business environment. Adjustment of any major issues must be approved by the board of directors or other delegated committees.

4. Capital requirement against market risk

Financial institutions with trading book volume at the "significant" level must maintain capital funds against all elements of market risk, namely, interest rate and equity price risks associated with positions in trading book, and exchange rate risk and commodity price risk associated with all positions. Those with the trading book volume below the "significant" level must maintain capital funds against commodity price risk associated with all positions.

The Bank of Thailand may require financial institutions with trading book volume below the "significant" level to maintain additional capital funds against other elements of market risk, in addition to commodity price risk, if it is deemed appropriate. Capital requirement can be calculated by one of the three approaches: standardised approach, internal model approach, or a mixed approach between standardised and internal model approaches.

5. Measuring market risk under the standardized approach

Under the standardized approach, capital requirement is calculated based on each financial institution's position and risk weight of each market risk element set by the Bank of Thailand, namely, interest rate, exchange rate, equity price, and commodity price risks. The risk weight of general market risk is derived from the estimation of sensitivity of positions to changing risk factors, without taking into consideration the correlation between risk factors.

6. Measuring market risk under the internal model approach

Under the internal model approach, financial institutions can use their internal model to calculate the capital requirement only after the model has been approved by the Bank of Thailand. Financial institutions choosing the internal model approach have to comply with the following criteria:

- Qualitative Standards
- Specification of Market Risk Factors
- Quantitative Standards
- Stress Testing
- Back Testing and determination of Plus Factor
- Additional criteria for using Internal model to calculate specific risk.

7. Measuring market risk under the mixed approach

Financial institutions are allowed to use a combination of the internal model approach and the standardized approach to measure their overall market risk. However, a combination of two approaches for the same risk element is not permitted, except for option products. For risk element that applies internal model approach, financial institutions will not be allowed to revert to the standardized approach.

8. Compilation of data and submission of related call reports

All financial institutions are required to prepare data and reports on the trading book volume. Institutions with trading volume at the “significant” level must prepare additional reports on market risk capital charge.

● Maintenance of net foreign exchange position

The Bank of Thailand revised the policy statement on maintenance of net foreign exchange open positions and related reports to enhance flexibility in foreign exchange risk management by the overseas branches of locally-incorporated banks. Under this new policy guideline, banks shall include foreign currency loans classified as doubtful of loss in the calculation of net foreign exchange position of their overseas branches. The amount to be incorporated is the net outstanding after deduction of loan loss provision according to the regulation of the country in which the branch is located. Moreover, banks are allowed to exclude from the calculation investment in foreign branches that is considered to be fund allocation, the amount of which is limited to the value of fixed asset after depreciation.

Furthermore, banks may apply to use the present value method in the calculation of foreign exchange forward positions if they are deemed ready and efficient in accordance with the criteria set by the Bank of Thailand.

Liquidity Risk

Prescription on maintenance of liquid assets

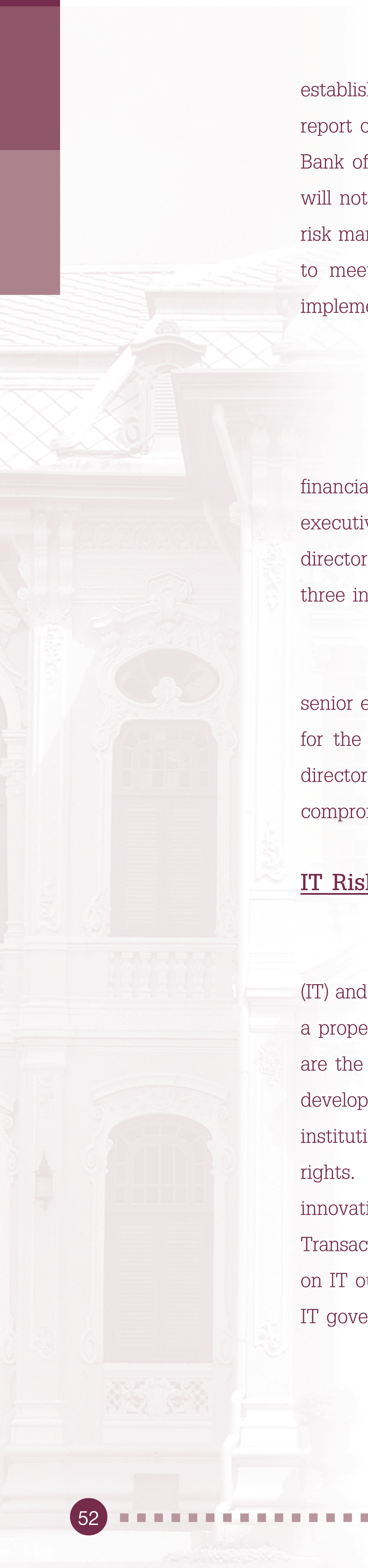
There were a few minor modifications in the prescription on maintenance of liquid assets to be in line with the expanded scope of business and the new accounting standard. Firstly, the new form of deposits or borrowings, whose return is linked to other variables, was to be included in the calculation of liquid asset ratio. Secondly, the valuation method of securities to be counted as liquid assets was revised to be in line with the Thai Accounting Standard No. 40 Re: Accounting for Investment in Debt and Equity Instruments. The amended rule was on valuation of securities associated with a reverse repurchase agreement (REPO) with the Bank of Thailand or a private REPO. The rule requires that such securities be deducted from liquid assets by using the book value, based on one of the following calculation methods: weighted average, first-in first-out, or last-in first-out. Finally, the list of liquid assets was expanded to include bonds, debentures or debt instruments issued by the Small and Medium Enterprise Development Bank of Thailand (SME Bank).

Operational Risk

Sound practice for management and supervision of operational risk

The growing trend towards mergers among financial institutions, along with the increasing use of information technology in the banking business, reinforces the need for financial institutions to have in place an effective operational risk management framework. To enhance financial institutions' awareness and understanding of the key issues, the Bank of Thailand has circulated to all commercial banks the Sound Practice for the Management and Supervision of Operational Risk issued by the Basel Committee on Banking Supervision.

Furthermore, the Bank of Thailand is in the process of issuing a guideline to provide further details on such issues as loss data collection, operational risk reporting, and development of contingency plans. This guideline aims to ensure that directors and senior executives of commercial banks recognize the significance of operational risk as one of the major risks that should be systematically managed as part of the overall risk management. Accordingly, commercial banks are required to formulate appropriate operational risk policy,



establish processes and procedures to identify, assess, monitor, mitigate/control, collect and report operational risks. The guideline, together with the policies previously issued by the Bank of Thailand on such areas as the board structure, and internal and external auditors, will not only contribute to improving banks' efficiency, but also strengthening their overall risk management as well. Essentially, it will help enhance the ability of financial institutions to meet the challenges posed by the rapidly changing financial environment and the implementation of the New Basel Capital Accord.

- Corporate governance

In recognition of the fact that conglomerates will have an increasing role in the financial sector, the Bank of Thailand amended the regulation to allow directors and senior executives of commercial banks to assume positions of the chairman, executive directors, or directors with full signatory authority in no more than three business groups, instead of just three individual companies as previously prescribed.

However, the Bank of Thailand still maintains the principle that directors and senior executives must devote sufficient time and effort to discharging their responsibilities for the banks. Thus, the Bank of Thailand may disallow them from assuming too many directorships even within three business groups, if it is clear that such undertakings would compromise their duties to the banks.

IT Risk

As more and more financial products and services involve information technology (IT) and electronic banking (e-banking), either as distribution channels or operational platforms, a proper risk management framework and IT security to ensure safe and sound operations are the primary concern of the Bank of Thailand. In this regard, the Bank of Thailand has developed policy framework on IT and e-banking issues that aims to encourage financial institutions to be prudent in conducting such businesses as well as to protect consumer rights. The framework is to keep up with demand from the financial community, market innovation, international best practices, and to be consistent with Thailand's Electronic Transaction Act, which has been effective since April 2002. During this year, policy guidelines on IT outsourcing and e-banking security were issued, while policy statement on e-money, IT governance, and IT contingency plan are in the pipeline.

● IT outsourcing

By the advent of rapid change in technology and competition amongst financial institutions, financial institutions tend to reduce costs and to improve their services by outsourcing some technology-related functions (e.g. data processing and system development) to the third parties both within and across the borders. Such outsourcing can be beneficial, and at the same time, impose risks to financial institutions and their clients.

To provide financial institutions with best practices in IT outsourcing, the Bank of Thailand issued the guideline which emphasizes that IT outsourcing does not absolve financial institutions from the obligation to ensure safe and efficient services to clients, and comply with the regulatory framework. Moreover, financial institutions are required to develop an IT policy that clearly states the reason and objective of IT outsourcing, risk management procedures, service provider selection procedures, key features of the contract between financial institutions and IT service providers, monitoring and evaluation process, as well as consistency of the IT contingency plans between the parties involved.

● Security of electronic financial services

As transactional e-banking services offered by financial institutions are subject to security threats from a wide range of sources, there is a need to strengthen the management of IT security in general as well as transactional e-banking services. In this regard, the Bank of Thailand issued the guideline on security of electronic financial services, which aims to provide financial institutions with a practical framework to formulate and implement their security policies and procedures.

The key features of the guideline cover provision of services that customers can directly initiate a transaction, such as internet banking services carried over open networks, which are subject to operational risks and computer crimes. Such services can significantly affect the financial institution and the system-wide reputational risk as well as the clients' confidence.

The guideline requires that financial institutions carefully consider the strategy for e-banking business and draw up the board of directors' approved security policy. The policy should address a comprehensive set of issues, covering risk scenario and assessment, risk management procedure, and suggestions on how to improve the environment to enhance security. The guideline also covers supplemental procedures to ensure effective compliance with the security policy and procedures, such as personnel training and education, consumer education, and appropriate internal controls.

● Electronic money

Introduction of electronic money services has raised concerns over the risks and impacts associated with these services, especially the impacts on customers. The Bank of Thailand has, therefore, planned to issue a policy statement on e-money to ensure that these services are developed in harmony with the development of the financial system and payment system. In addition, the Bank of Thailand and the Ministry of Finance have worked together to lay down the legal framework for e-money business, focusing on risk management, float management, security controls, and consumer protection such as exposure limits, audit trail, technology, etc. The framework will be congruent to the evolution of the market and international practices.

3.2 Supervision Reforms to Accommodate Financial Institutions Operations

Along with strengthening of the supervisory framework, the Bank of Thailand has implemented supervisory guidelines to accommodate financial institutions operations by broadening their business scope, increasing flexibility in business operations, easing report requirement, as well as expediting an approval procedure.

Postal Bank

In an effort to broaden access to basic banking services, especially among people in remote, rural areas, the Bank of Thailand has permitted commercial banks to appoint Thailand Post Co., Ltd., or to establish a joint venture company with Thailand Post Co., Ltd., as a deposit agent, thus utilizing the already existing nation-wide postal office network. The agent may provide only the basic banking services, namely deposit taking and withdrawal on customer's existing accounts, third-party fund transfer, and document delivery between the banks and their customers. The agent is not permitted to open new accounts or originate loans.

Increased Efficiency in Resource Utilization

To encourage commercial banks to optimize usage of existing resources, the Bank of Thailand has broaden the scope of in-sourcing services by allowing banks to provide supporting services to additional parties, namely, other financial institutions and their related companies that undertake financial business or support function business, specialized financial institutions, and the Bank of Thailand. The definition of financial business is expanded to include financial holding business, leasing, finance and investment advisory, securitization, credit card, payment and settlement business.

In providing supporting services to others, commercial banks must strictly comply with the prudential guidelines specified by the Bank of Thailand, and ensure that provision of these services will not damage or obstruct their normal business and that the extent of the supporting business does not exceed the commercial banking business.

Increased Flexibility in Business Operations

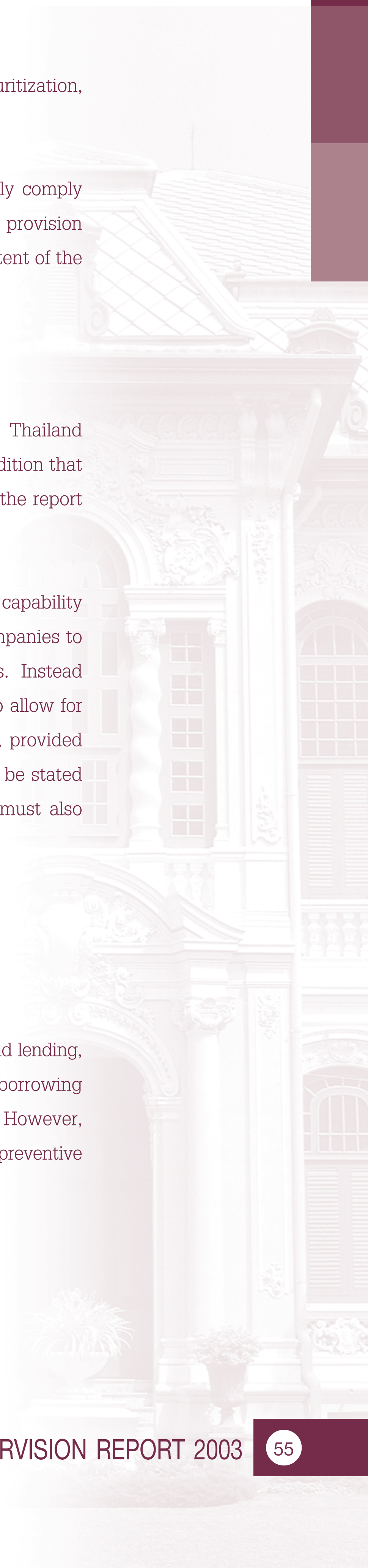
To increase flexibility in property management of banks, the Bank of Thailand amended the regulation on the business of renting immovable properties. The condition that required the rental period to be less than or equal to 3 years was terminated, and the report requirement on rental transactions was relaxed.

To further develop the debt markets and enhance liquidity management capability of finance companies, the Minister of Finance amended the criteria for finance companies to engage in the business of arranging, underwriting, and dealing of debt instruments. Instead of size, risk management capacity and financial stability are used as the criteria to allow for such activities. Finance companies can act as an arranger for debt instruments, provided that they show readiness in terms of personnel and operating system, which must be stated in the business plan and ratified by the board of directors. The business plan must also incorporate appropriate risk management systems and internal controls.

Expansion of Business Scope

● Commercial banks

Commercial banks' scope of business regarding securities borrowing and lending, and short selling has been expanded. Banks are allowed to undertake securities borrowing and lending, and short selling of equity securities in addition to debt securities. However, lending of securities to non-resident counterparts is prohibited to be in line with the preventive measure on baht speculation.



● Finance companies

Provided that the Bank of Thailand's prudential requirements are met and finance companies have shown readiness in terms of human resource and business operations, finance companies are allowed to engage in the business of investment advisory services and to introduce the services of securities companies to customers*. For the business of investment advisory services, they must also obtain a license from the Office of the Securities and Exchange Commission.

In addition, finance companies are allowed to engage in the business of escrow account**, except for the activity that involves dispute settlement or technical inspection to evaluate fulfillment of contract. To protect consumers and reduce operational and reputational risk, the list of minimum items in a contract and the proper internal control system are specified. There is also a requirement on disclosure of fee and other related expenses to ensure transparency and fair treatment to consumers.

Encouraging the Development of New Products

To encourage the development of Thailand's derivatives market and increase investment and hedging instrument alternatives, commercial banks that have effective risk management system and sound risk management policies in place, as well as comply with the Bank of Thailand's regulations on capital adequacy and large exposure, are allowed to engage in the following sets of derivatives transactions:

- forward bond, bond options or equity index-linked swap transactions within the specified scope of reference securities, counterparties, and currency denominations.
- deposits or borrowing transactions whose returns are linked to variables (embedded derivatives) which include domestic and foreign stock indices, average price of a basket of securities listed on the Stock Exchange of Thailand or other exchanges, domestic and foreign interest rates, and foreign exchange rates. The scope of transaction includes deposits or borrowings that give the commercial banks the right to (1) pay back the principal in cash or bond, (2) extend the maturity of deposits or borrowings, or (3) make an early redemption.
- credit default swap (CDS) transactions with the specified scope of business, counterparties and currency denominations.

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* Commercial banks have been allowed to engage in these businesses since 2002.

** Commercial banks have been allowed to engage in these businesses since 2001.

3.3 Other Reforms

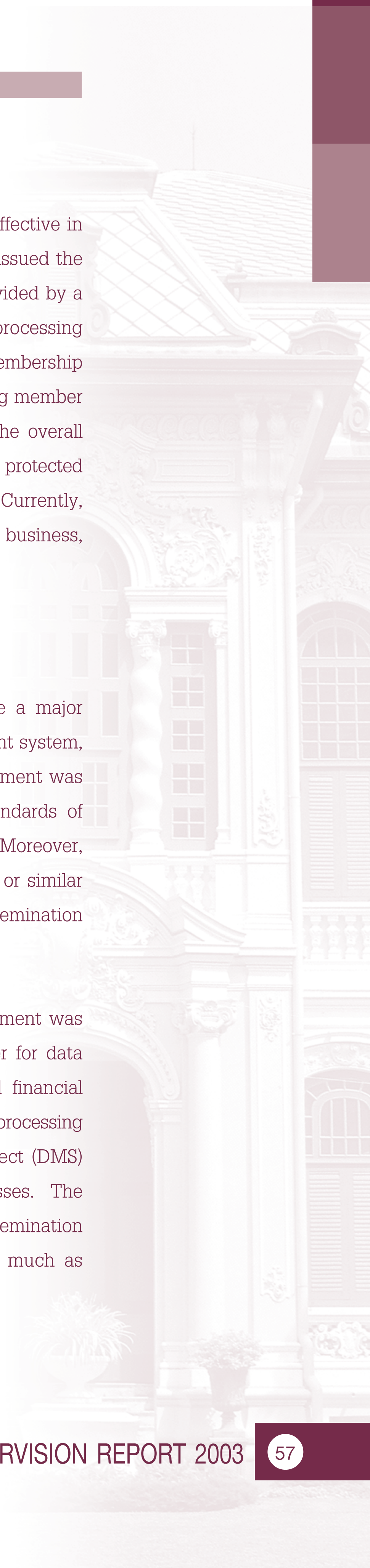
Credit Bureau Act

The Credit Bureau Act that was passed in November 2002 has become effective in March 2003. The Committee to Protect Credit Information set up under this Act issued the necessary regulations, for instance, the regulation on credit information to be provided by a member to a credit bureau company, consent letter requirements, and data processing guidelines. Leasing and hire purchase companies are also allowed to apply for membership of a credit bureau company. The Act aims at enhancing information sharing among member financial institutions for the purpose of loan analysis, which will help improve the overall credit risk management. At the same time, the Act outlines the owners' right to be protected and treated fairly with regards to accuracy and disclosure of their information. Currently, two licenses have been granted for two companies to operate the credit bureau business, namely, the Central Credit Information Service and the Thai Credit Bureau.

Data Management System

After the financial crisis in 1997, the Bank of Thailand has undergone a major re-organization in various aspects. One of the reforms was on the data management system, which had been found to contain several weaknesses. For example, data management was under too many departments in the Bank of Thailand, each with different standards of compilation, making it difficult to analyze the data in one comprehensive picture. Moreover, data compilations were redundant, with some data providers preparing the same or similar data for different departments of the Bank of Thailand. At the same time, data dissemination or usage across departments was complicated and too time-consuming.

Hence, the policy to improve data efficiency and centralize data management was laid out. The Data Management Group (DMG) was established to be the center for data compilation, encompassing financial institution data (FI), foreign exchange and financial market data (FM), and economic data (ECON). DMG's responsibilities include data processing as well as data dissemination. Concurrently, the Data Management System Project (DMS) was approved with an objective to improve the overall data management processes. The DMS project utilizes advanced information technology such as electronic data dissemination and data warehousing, aiming at automating the data management system as much as possible.



Box 3 : Data Management System Work Flow

1. Data Acquisition

Data acquisition is a process that brings data from different sources into a temporary data storage or ‘Staging Area’. There are two channels for data submission provided by the Data Management System (DMS) service: the On-line Web Submission Application and the Computer-to-Computer (C2C) method. The On-line Web Submission Application requires human controlling submission via the On-line Submission Service, whereas in the C2C method, a computer system sends the data automatically.

Data to enter the DMS must be in the XML format (Extensible Markup Language) and can be prepared in two ways: keying in the FI Data Entry Program developed by the Bank of Thailand or using the program designed to extract data into the required XML format. Financial institutions with low-volume transactions may choose the first method, while those with high-volume benefit more from the second method since there is no need to manually key in the data while validation rules and conditions can be built directly into the program.

Once the data is submitted to the DMS, Basic Validation, a process to validate simple features, such as data type, length of data, and possible value, will be performed. The data that passes Basic Validation will be stored in the Staging Area, otherwise the data providers have to correct and re-submit the data.

2. Data Storing

Data storing is a process that transfers the data from the Staging Area to the Central Data Warehouse. During this process, Complex Validation, a process to check for data reconciliation and relationships within the same data set in accordance with the business rules and pre-specified conditions, will be performed on the data. DMS will perform Complex Validation at the end of every business day. The data that passes Complex Validation will be transferred to the data warehouse.

The data stored in the warehouse will be performed Cross Validation between data sets. Data set that does not pass the Cross Validation needs to be corrected and re-submitted via the Adjustment Request Channel (see notes below).

3. Data Provision

Data provision is a process that distributes data into various formats to both the Bank of Thailand (BOT) and non-BOT data users.

BOT data users retrieve reports in the following formats:

- Fixed report designed according to the pre-specified conditions and formats, for example, report for specific policies such as supervisory or economic policy.
- Tailor-made report designed according to the user’s format and dimension. The Business Object program is used to retrieve the data from the warehouse, where users only need to choose the desired data elements in ordinary business terms.

Non-BOT users

- Members of the DMS Service receive the data dissemination service and news updates relating to the DMS Service through Extranet (Online Web Submission Service) and Internet (BOT Website).
- General users receive financial and economic data service via Internet (BOT website), email, telephone and automatic fax.

Notes: Adjustment Request Channel

In general, there are two cases where the data stored in the warehouse get adjusted. The first case is when the data pass Basic Validation and Complex Validation but fail Cross Validation. The second case is when the data pass all validations, but the data providers find an error and submit an adjustment request afterwards. In this respect, the BOT only allows adjustment for the data that are not more than one year old. In both cases, the data providers must submit an adjustment request, along with the corrected data file. After the new data file passes Basic Validation, the Data Approver will consider and approve the request. Once approved, the file will be processed for other validations, as in the normal submission process. When the file passes every validation step, the new data will be stored in the warehouse as the latest version.

The new system of data warehouse whose service conforms to the international standard helps improve the management of data in many ways. Now, data collection from financial institutions is in one standard format and acquired by electronic methods. The collected data are then categorized and stored in an integrated system, creating a single data center and a single point of service. The system also embodies a more systematic validation procedure and makes use of new technologies and tools to help manage, store, and utilize data more efficiently. The detail of the Data Management System workflow is presented in Box 3.

At present, the BOT is in the process of implementing the DMS project. Both FI and FM data have been deployed (FI data in since October 2003; FM data in April 2004), while ECON data is scheduled to be launched in 2005.

3.4 Update on Financial Sector Liberalization

The Bank of Thailand recognizes globalization and liberalization as ubiquitous forces of change that, with sufficient supervisory framework and expertise, can be harnessed to increase efficiency, and stimulate technological advances and financial innovations within Thailand's financial sector. Nonetheless, Thailand's past liberalization exercises, combined with other developing countries' liberalization experiences, reveal clearly liberalization's potential harmful effects when undertaken without careful phasing and plans or when undertaken during periods of economic instability and duress.

The costs and benefits of liberalization have long been two sides of the same coin. Every international trade literature expounds on the fact that there will naturally be winners and losers as a consequence of cross-border trade. This premise implies that well-prepared countries are ones that can spread market-opening benefits to the general economy, while sufficiently mitigating the downside risks arising from liberalization. As a small, opened market economy with a developing financial sector, Thailand is sensitive to rapid cross-border movement of capital and changes in investment sentiment. Thus, it is vital for Thailand to improve financial structure and develop mechanisms and procedures to monitor the impacts of progressive liberalization, while implementing measures to moderate potential losses and impacts to the general economy.

Financial Sector Liberalization Initiatives

The Bank of Thailand's dual commitments toward liberalization and maintenance of the safety and soundness of the financial sector were one of the key motivations underlying the formulation of the Financial Sector Master Plan. One of the main goals of the Financial Sector Master Plan is to foster competitive, efficient, stable, and balanced financial system, capable of servicing both sophisticated and unsophisticated users. Within this context, financial sector liberalization is not an end in itself, but is one of the tools to motivate financial institutions to reform, diversify and strengthen operations in preparation for heightened competition. As a member of the World Trade Organization (WTO), Thailand has continuously liberalized the financial sector in line with its neighbors and trading partners. As a result, foreign financial institutions have the same rights and obligations as Thai financial institutions.

With negotiations currently underway, the Bank of Thailand plans to further liberalize the financial sector in line with the reforms envisioned within the Financial Sector Master Plan, which received acknowledgement from the Council of Ministers in January 2004. In the first phase, the Financial Sector Master Plan proposes a reorganization of existing players within the market including foreign financial institutions. As mentioned in Chapter 4 -- the Financial Sector Master Plan, foreign financial institutions will be allowed to expand their role in the Thai financial sector, with two types of licenses, instead of merely one:

(1) Full branches: enjoying the same scope of business as Thai commercial banks, yet not permitted to open any branch; and

(2) Subsidiaries: enjoying the same scope of business as Thai commercial banks and allowed to open additional branches in phases.

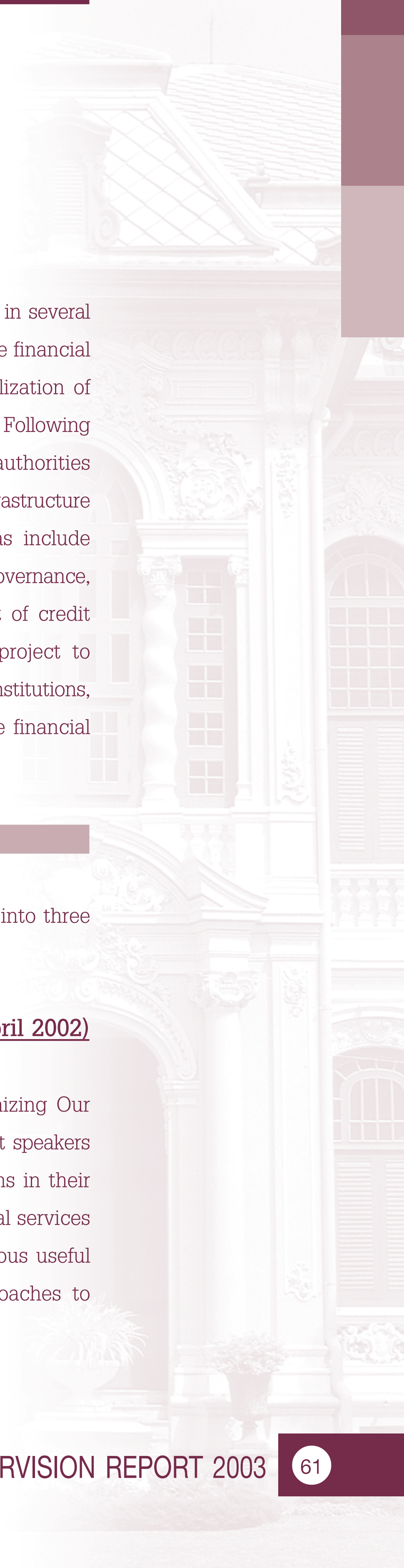
The Bank of Thailand will closely monitor the impacts of phase-one reforms in order to ensure safety and soundness, and gauge readiness of the financial sector to face challenges brought by new players that can be expected to enter the market starting in the second phase of the Financial Sector Master Plan.

Efforts to Promote Financial Sector Liberalization

Thailand's current financial sector liberalization involves negotiations within the multilateral Doha Development Agenda (DDA) in the WTO, regionally through ASEAN and BIMSTEC (Bangladesh, India, Myanmar, Sri Lanka, and Thailand Economic Cooperation), and bilaterally through negotiations with more than seven trading partners. Although conclusion of multilateral negotiations within the WTO has been delayed by disagreements over agricultural issues, the Thai government believes that successful negotiations in the bilateral and regional forums can reinvigorate and help restart multilateral negotiations. As such, Thailand has already concluded bilateral negotiations with several key trading partners, and is in the process of entering into further negotiations with remaining targeted economies.

CHAPTER 4

FINANCIAL SECTOR MASTER PLAN



Since the 1997 crisis, Thailand has undergone progressive financial reforms in several areas. Past efforts were centered on resolving more urgent problems brought by the financial crisis, with such measures as closure of nonviable financial institutions, recapitalization of viable institutions, and establishment of necessary framework for debt restructuring. Following financial institutions' return to profitability with stronger financial positions, the authorities have placed more emphasis on addressing structural weaknesses and inadequate infrastructure in the Thai financial system. Examples of the continued efforts in these areas include measures to strengthen asset classification, asset valuation, loan review, corporate governance, and risk management, introduction of risk-based supervision, and establishment of credit bureaus. Complementary to these measures, the authorities embarked on a project to formulate medium- to long-term strategies to increase competitiveness of financial institutions, improve access to financial services and correct the remaining weaknesses in the financial system.

4.1 Formulation of the Financial Sector Master Plan

The process of formulating the Financial Sector Master Plan was divided into three stages:

Stage 1: Problem identification and vision setting (January-April 2002)

In January 2002, the Bank of Thailand organized a seminar on "Modernizing Our Financial System" for the benefits of financial institutions and related parties. Guest speakers included those who had been involved in formulating financial sector master plans in their own countries (i.e., Canada and Australia), financial experts, and experts in financial services to low-income households. In the process, the Bank of Thailand received numerous useful comments regarding problems in the financial sector as well as possible approaches to improve the financial sector.

Following the seminar, the Bank of Thailand established the Financial Sector Master Plan Committee (Committee) in February 2002, comprising representatives from government sector, regulatory agencies (i.e. Bank of Thailand, the Office of the Securities and Exchange Commission, and the Department of Insurance), financial sector, consumer groups, the general public, and a number of recognized experts to assist in formulating the vision and framework for the Master Plan. From February to April, the Committee held several meetings to analyze fundamental problems within the financial system, including its inadequacy in providing financial services for certain public segments. In the end, the Committee surmised the vision of the Financial Sector Master Plan as follows:

1. Comprehensive financial services for all potential users, with no significant differences in the level and quality of services between rural and urban areas.
2. Efficient, stable, and competitive financial sector, with a balanced composition of available sources of financing, namely, financial institutions, debt instruments and equity market; and
3. Fairness and protection for consumers.

Stage 2: Problem analysis (May 2002-January 2003)

To conduct a more thorough review of existing problems in the financial system, the Bank of Thailand commissioned (1) a research company to conduct a nation-wide survey on households and business sectors' demand for financial services, to ascertain which population groups are not adequately served by financial institutions and the reasons behind such shortcomings; and (2) a consulting firm to assess the current status and structure of the financial system, in addition to performing a cross-country comparative study, and analyze the impact of global financial trends on the overall system to determine the way forward.

(1) The results of the nation-wide survey revealed both quantitative and qualitative gaps in the manner with which the financial institutions service their customers. Noticeably, gaps in access to credit were much more prevalent than those of deposit services, and gaps in both areas were found mostly among population with smaller income as well as small- and medium-sized enterprises (SMEs). For example, in terms of individual customers, the survey showed that 57.7 percent of the people surveyed did not have access to credits, with 36.7 percent from the low-income group (people with household income less than 100,000 baht per year). In terms of the gaps in access to deposit services, the result showed 12.9 percent of the people surveyed, with 9.9 percent from the low-income group. These findings clearly exposed the inadequacy of the financial services to the low-income sector both in urban and rural areas, thereby leaving this sector to seek financing from the informal economy.

On the corporate segment, the survey revealed that 23.4 percent of the corporations surveyed did not have access to credits, where 21.8 percent constituted SMEs. Similarly, whilst 0.5 percent of the corporations surveyed did not have access to deposit services, 0.4 percent represented those of SMEs.

In terms of qualitative gaps, individual customers and corporations with access to the financial system would like to see improvement in the aspects of pricing, fees, returns, convenience and efficiency.

(2) The result of the benchmarking exercise characterized the Thai financial system as fragmented with relatively uncompetitive, small and undifferentiated players. For example, the findings found that there were too many uncompetitive small players, while some bigger players could not fully reap the scale benefits, resulting in low productivity and skill gaps in risk management. A deeper analysis further identified certain elements of the financial system infrastructure that undermined the performance of the industry and players. Such elements included specific regulations that weakened competition, inadequate creditor protection under the existing legal system, weaknesses in the information database, and insufficient depth of the pool of debt market issuers and investors.

The result of these studies provided useful input for the drafting of policy recommendations in the Financial Sector Master Plan.

Step 3: Draft of policy recommendations (January-June 2003)

To achieve the objectives set out by the Committee, the Bank of Thailand formulated three sets of measures based on the findings of the survey, focus groups, and benchmarking results. They are measures to (1) broaden general access to financial services, (2) increase efficiency of the financial sector, and (3) improve consumer protection. Subsequent to the Committee's deliberations, the policy proposals were submitted to the Ministry of Finance for further deliberation in June 2003. By January 2004, the Financial Sector Master Plan received acknowledgement from the Council of Ministers.

4.2 Measures under the Financial Sector Master Plan

A. Measures to broaden access to financial services

1. Promoting grass-root financial services to close the gaps in financial services for low-income households. The Committee for Grass-Root Financial Services has been set

up to promote efficient and sustainable grass-root financial services, where an appropriate agency will be designated to assume a developmental role to provide support for community financial organizations.

2. Transforming the Bank for Agriculture and Agricultural Cooperatives (BAAC) to a rural development bank to provide financial services to individuals and communities in the rural areas as well as cooperatives, local administrative bodies, village funds, and community enterprises. The Bill to transform the BAAC into a rural development bank has been approved by the Cabinet and is currently under legal review by Office of the Council of State.

3. Encouraging existing financial institutions to increase access to financial services for low-income households. A seminar was organized in November 2003 to promote awareness and understanding of financial institutions on the commercial viability of financial services to low-income households. Moreover, the Bank of Thailand initiated a pilot project in cooperation with interested commercial banks to improve capacity and infrastructure specifically for promotion of financial services to low-income households.

B. Measures to increase efficiency of the financial sector

1. Rationalizing the structure and roles of financial institutions to better meet customer demand

As the current financial system comprises different types of institutions offering essentially the same types of services to the same pools of customers, it is necessary that such duplication of functions be eliminated in order to foster competitiveness and efficiency. Three tasks are set forth to obtain this objective.

1.1 <u>Restructuring the Thai financial institutions</u> to create a level-playing field for all financial institutions. Henceforth, only two types of bank licenses will be issued for Thai deposit-taking financial institutions.

A. Commercial banks (for qualified and well-capitalized financial institutions) Such banks may provide financial services to all groups of customers and carry out virtually all types of financial transactions, except insurance underwriting and equity securities brokering, trading and underwriting. The minimum tier 1 capital fund for a financial institution seeking a new license to operate this type of bank is 5 billion baht.

B. Retail banks (for qualified financial institutions with smaller capital fund) Such banks may offer financial services to retail customers and SMEs subject to lending limit per customer and other conditions specified by the Bank of Thailand. Retail banks can undertake virtually the same business scope as commercial banks, except businesses related to foreign exchange and derivatives. The minimum tier 1 capital fund is 250 million baht.

During the first 1-3 years, existing finance companies and credit foncier companies may apply for commercial or retail bank licenses, provided that they satisfy both qualitative and quantitative pre-requisites (e.g. management competency, asset quality, capital to risk asset ratio, and percentage of impaired assets). The application to establish a commercial bank must include a plan to merge with at least one finance company or credit foncier company.

After three years, depending upon the economic conditions, a retail bank may apply for an upgrade to a commercial bank. In addition, after the authorities have thoroughly assessed the impact of the first phase of the Financial Sector Master Plan, an opportunity may open for new investors to apply for commercial bank licenses. This should further enhance competition and efficiency in the financial sector.

1.2 <u>Restructuring foreign-owned financial institutions</u> to enable them to play a greater role in the economic and financial development of Thailand. Therefore, two types of bank licenses will be issued for foreign-owned financial institutions.

A. Subsidiaries: can undertake the same scope of business as commercial banks and are allowed to open one branch in Bangkok and its vicinity, in addition to the head office, and 3 branches outside. Registered and paid-up capital must be maintained at the minimum of 4 billion baht.

B. Full branches: can undertake the same scope of business as commercial banks but are to have single office operation. The minimum capital requirement for an existing IBF seeking an upgrade to a full branch is 3 billion baht.

During the first 1-3 years the emphasis will be placed on restructuring foreign-owned financial institutions currently operating in Thailand by

- Encouraging qualified stand-alone BIBFs to upgrade to full branches or subsidiaries. Since the tax benefits for IBF Out-In transactions will be discontinued in an attempt to solve tax distortions, whereas Out-Out transactions can be carried out by a financial institution, the IBF license will no longer be necessary.

- A foreign-owned stand-alone BIBF intending to upgrade to a subsidiary must enter into a merger or acquisition, or transfer of assets and liabilities, with at least one financial institution. Likewise, if a full branch having been upgraded from BIBF subsequently intends to establish itself as a subsidiary, it must have adequate capital as well as a plan to merge with at least one financial institution.
- Existing full branches may apply to be upgraded to subsidiaries.

After 3-5 years, depending upon the economic conditions and thorough assessment of the impact of the Master Plan, new commercial banking licenses may be issued to new foreign investors.

1.3 "One Presence" Policy Prior to the implementation of the Master Plan, a financial conglomerate can have more than one form of financial institutions, each mobilizing savings from the public, reflecting the current regulatory distinction between commercial banks, finance companies, and credit foncier companies. The new system of bank licensing will remove the distinction with respect to the scope of business, making it redundant for financial institutions in the same group to have different kinds of presence. Indeed, to reap full benefits from economies of scale and elimination of duplicate functions, the Master Plan requires that a financial conglomerate have only one form of deposit-taking institution.

1.4 Incentives for lending to retail customers and SMEs Loans to retail customers and SMEs that meet both small size test and non-concentration test as specified by the Bank of Thailand will, for capital adequacy purposes, be assessed at lower risk weights consistent with those proposed in the draft Basel II.

2. Streamlining rules and regulations

2.1 Improving basic infrastructure of the financial sector Measures include promoting increased cooperation amongst supervisory agencies, resolving data issues and problems of credit bureau companies, and reviewing problems relating to the Foreclosure Law and Bankruptcy Law.

2.2 Resolving tax impediments for mergers by relaxing tax regulations to facilitate mergers between financial institutions.

2.3 Removing regulations that impede financial sector efficiency Measures include

- Removing the rule that requires commercial banks to open a branch in the rural areas if they wish to open a branch in dense and well-serviced areas
- Relaxing conditions on closure of the last bank branch in a given sub-district
- Removing the rule that requires a provincial bank branch to lend at least 60 percent of the total amount of deposits in the operating region
- Revising and expediting the process to authorize financial institutions' request for new types of financial products/transactions (Permission will be granted by product groups rather than by individual products.)

2.4 Strengthening financial institutions by enhancing the development of risk management capability, promoting good governance, promoting alternative business models to help improve operational efficiency and effectiveness (e.g. outsourcing and back-office sharing), and increasing flexibility in the conduct of financial businesses, whereby financial institutions may choose to organize in a Bank-parent or holding-company structure while enjoying a wider scope of business activities.

2.5 Enhancing market mechanism by establishing a clear exit procedure to ensure prompt and timely intervention in problem financial institutions and further promoting the development of capital market as an alternative source of finance in tandem with financial institutions.

C. Measures to protect consumers

1. Requiring financial institutions to establish a clear procedure to handle customer complaints
2. Promoting information disclosure with respect to terms and conditions of financial services in a more comprehensible manner
3. Ensuring that disclosure of information on the financial position and operating performance complies with international standards
4. Replacing the existing blanket guarantee with a deposit insurance scheme in a timely manner and in transitional stages

4.3 Implementation of the Financial Sector Master Plan

Since the formal approval of the Financial Sector Master Plan, considerable progress has been made by government agencies involved, particularly the Ministry of Finance and the Bank of Thailand.

The first meeting of the Committee for Grass-Root Financial Services was held in February 2004, where a subcommittee was appointed to take charge of drafting a master plan for grass-root financial services scheduled to be completed by 2005.

Regarding the measures to increase efficiency of the financial sector through rationalizing the structure and roles of financial institutions, the Ministry of Finance issued three notifications in January 2004, detailing the rules, procedures and conditions for financial institutions to apply for new commercial bank licenses, namely commercial banks, retail banks, full branches and subsidiaries. Subsequently, the Bank of Thailand issued three notifications and three circular letters elaborating on key aspects of the Financial Sector Master Plan such as the rules on merger, acquisition, or transfer of assets, the qualitative criteria on management assessment for financial institutions seeking a commercial bank license or a retail bank license, and the definition of SMEs.

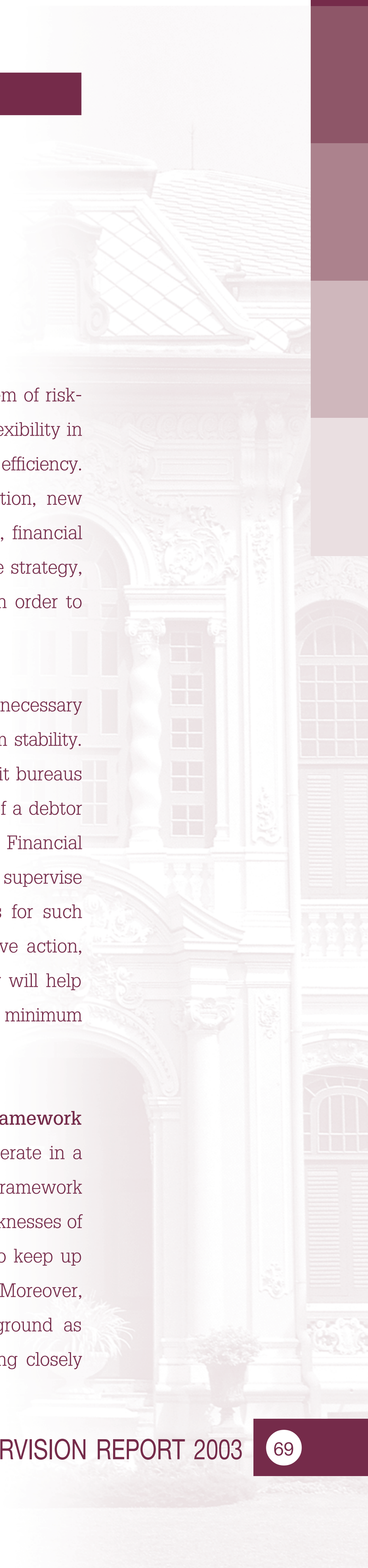
4.4 The New Financial Landscape

The gaps of financial services identified at the outset of the Master Plan reflect untapped opportunities awaiting financial institutions with the capabilities to capitalize on these opportunities. Those with the right business models and comprehensive strategy, effective oversight of various risks, good corporate governance practices, and an able team of staff to achieve operational efficiency will likely be able to flourish in the new financial landscape. On the contrary, those unable to adapt will be threatened by more intense competition from existing banks and non-bank players. In the end, they may have to confine their operation to lending within a credit institution framework.

The changing landscape will present important challenges for the authorities as well. The Bank of Thailand will need to closely monitor the impact brought about by the consolidation of financial institutions to ensure financial system stability throughout the process. Moreover, all the relevant regulatory bodies will have to work closely together in the periods ahead to strengthen risk-based consolidated supervision in line with more complex products and organizations, and to successfully achieve the objectives set out in the Financial Sector Master Plan.

CHAPTER 5

SUPERVISION OUTLOOK



Looking ahead, the Bank of Thailand will continue to build a robust system of risk-based supervision, with an aim to streamline rules and regulations and increase flexibility in business scope and business model to foster development, competition, and overall efficiency. In view of the forces of globalization and liberalization, more intense competition, new technology and financial innovation, as well as the changing financial landscape, financial institutions in Thailand will have to find their niche markets, adopt comprehensive strategy, achieve operational efficiency, and conduct adequate oversight of various risks in order to thrive in a new financial environment.

In this respect, the authorities have placed emphasis on improving the necessary **legal and financial infrastructure** that will provide a firm basis for financial system stability. The enactment of the Credit Bureau Act as well as the establishment of two credit bureaus have helped financial institutions to assess the risk profile and repayment ability of a debtor more accurately, thereby reducing their overall credit risk. Once enacted, the Financial Institutions Businesses Act will empower the Bank of Thailand to oversee and supervise financial institutions on a consolidated basis, with more stringent requirements for such aspects as related party lending, risk-based capital requirement, prompt corrective action, and consumer protection. The establishment of the **Deposit Insurance Agency** will help lessen moral hazard, increase market discipline, and provide social safety nets at the minimum costs to the public in the event of a bank failure.

In parallel, the authorities will continue to strengthen **the supervisory framework** to keep abreast of market developments and ensure that financial institutions operate in a safe and sound manner. This process involves benchmarking the supervisory framework against international practices in order to adequately assess the strengths and weaknesses of the overall financial system. Works on **consolidated supervision** is advancing to keep up with the more sophisticated business undertakings of financial conglomerates. Moreover, preparation for the implementation of the **New Capital Accord** has gained ground as financial institutions are improving their risk assessment capabilities and following closely

Basel II development, while work on improved market discipline is also ongoing. Lastly, to bolster its surveillance capacity, the Bank of Thailand intends to systematically and comprehensively assess risks and vulnerabilities of the financial system by participating in the **Financial Sector Assessment Program** in the near future.

Against this background, the authorities will also have to enhance supervisory capacity commensurate with these new demands and challenges. The introduction of new complex products, supervision of financial conglomerates and cross-border banking, including impact of the Basel II on banks and policy framework, will have important implications on the work of supervisory authorities. As such, technical capacity building is being strengthened so as to ensure a smooth transition process to a new era of sound and resilient financial system.

Deposit Insurance Agency

The purpose of a deposit insurance agency is to help increase market discipline, reduce moral hazard in the financial sector, and lessen the impacts of deposit runs that may destabilize the financial system in time of an individual bank failure or a financial crisis. In the case of Thailand, an explicit deposit insurance scheme did not exist prior to 1997. The extent and urgency of the 1997 financial crisis prompted the Thai authorities to resort to a temporary blanket guarantee to regain confidence in the financial institution system. Although the blanket guarantee proved to be effective in curtailing deposit runs and restoring public confidence, it has incurred a substantial cost to the government. The guarantee is therefore set to be replaced by a limited deposit guarantee when the economic and financial conditions are deemed appropriate.

In preparation to lift the blanket guarantee and establish a deposit insurance agency (DIA), the Bank of Thailand, the Financial Institutions Development Fund (FIDF) and the Ministry of Finance have worked on the design and implementation of the scheme. The deposit insurance agency will take over the task of administering deposit insurance from the FIDF and provide a limited deposit guarantee. The DIA will constitute a juristic person with the mandate of insuring small depositors against losses and maintaining confidence and stability in the financial institution system.

One important consideration in establishing a deposit insurance system with a limited guarantee in place of a blanket guarantee is the timing. Critical success factors for removing the blanket guarantee suggested by many studies are stability of the financial institution system, health of the economy, effectiveness of supervision and public understanding of the deposit insurance system. A gradual reduction of insurance coverage is deemed to be the best approach for Thailand as it gives depositors and financial institutions time to adjust and forestall public's adverse reaction to the removal of the blanket guarantee. As the first step of the phasing-out plan, the government announced the removal of its full guarantee on the creditors of financial institutions in November 2003. At present, the Ministry of Finance is in the process of reviewing the draft legislation before submitting it to the Parliament.

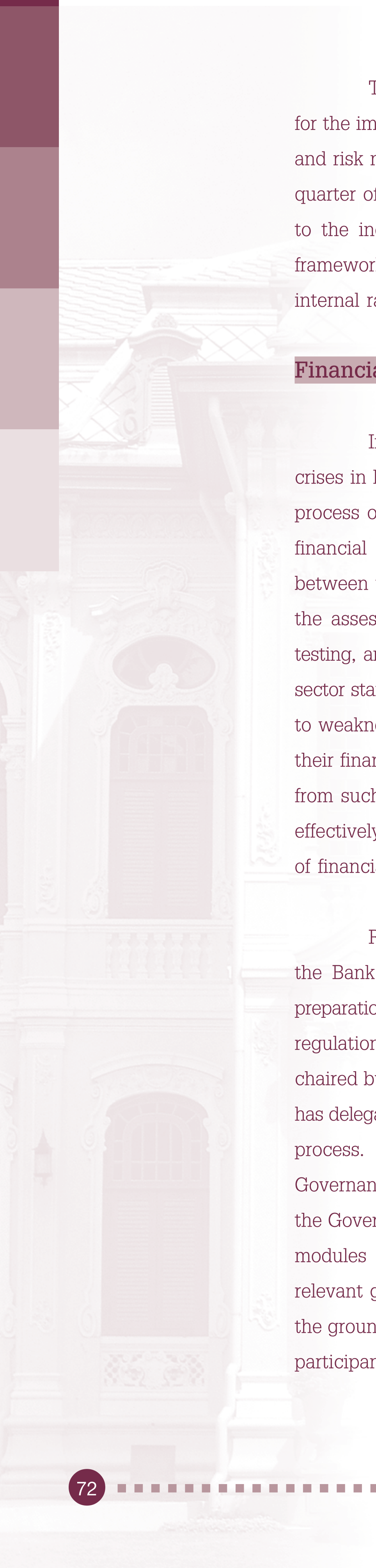
Consolidated Supervision

As more financial institutions conduct new financial but conventional non-bank businesses such as leasing, insurance and securities business through subsidiaries and affiliates, the supervisory framework needs to respond to the complexity of the organization as well as financial innovation. As such, consolidated supervision, where financial standing and risks of a financial conglomerate are assessed comprehensively, becomes an indispensable tool for effective supervision.

The Bank of Thailand is in the process of developing a framework and policy statement on consolidated supervision, which will be applicable to financial institutions after the new Financial Institutions Businesses Act is enacted. The statement will concentrate on establishing the structure, scope of business, and prudential framework for conglomerates i.e. capital adequacy, risk concentration, 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, Department of Insurance, and the Office of the Securities and Exchange Commission to enhance coordination and information sharing among regulators to ensure that all relevant risks arising from financial conglomerates are taken into account, and to avoid regulatory arbitrage across banking, securities, and insurance industries.

New Basel Capital Accord

Since the release of the first consultative paper by the Basel Committee, the Bank of Thailand has been monitoring the development of the New Basel Capital Accord (Basel II). Recognizing the improved framework—with the more comprehensive and risk-sensitive minimum capital requirement, a supervisory review process and market discipline—the Bank of Thailand will further encourage banks to improve their risk assessment capabilities to remain prudent and competitive. An extensive dialogue with the banking community has been made, and a Basel II working group comprising representatives from the Thai banking industry and the Bank of Thailand was established to study and comment on the consultative papers.



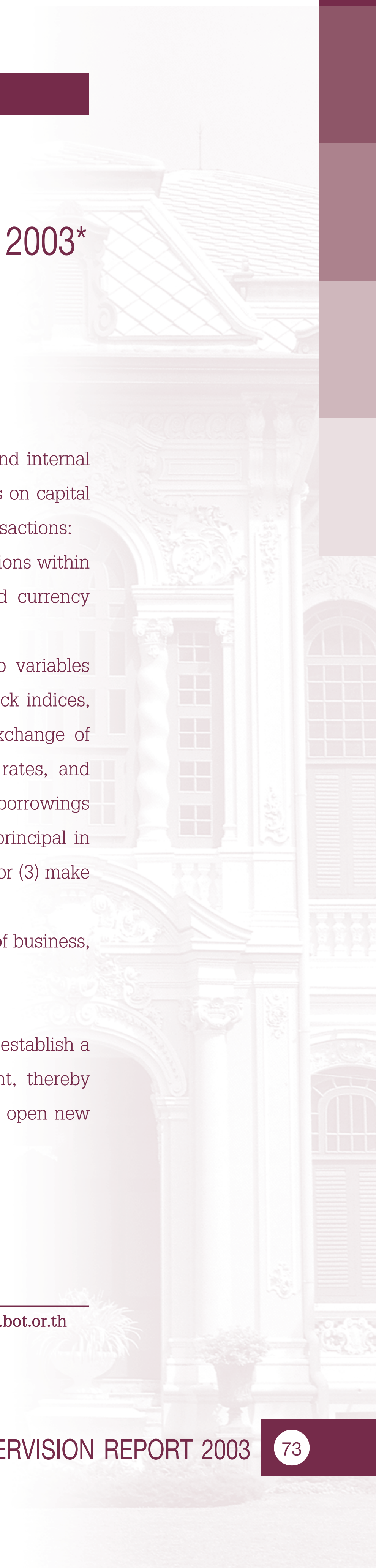
The Bank of Thailand will continue to work closely with the industry in preparation for the implementation of Basel II, including the required infrastructure, the adequacy of data and risk management system. An impact assessment will also be undertaken. By the third quarter of 2004, the Bank of Thailand expects to provide a detailed guideline and timetable to the industry on the implementation of Basel II. Work on various aspects of Basel II framework are already in the pipeline, including development of guidelines on credit scoring, internal rating system, stress testing, loan portfolio management and model validation.

Financial Sector Assessment Program

Introduced in May 1999 by the IMF and the World Bank in response to the financial crises in late 1990s, the Financial Sector Assessment Program (FSAP) aims at bolstering the process of financial system monitoring. The program entails comprehensive assessment of financial system strengths, risks and vulnerabilities, taking into account interconnection between the financial sector and macro economy. The comprehensive nature and scope of the assessment calls for various analytical tools such as macro-prudential analysis, stress testing, and assessments of observance and implementation of relevant international financial sector standards, codes and sound practices. The FSAP exercises help alert assessed countries to weaknesses in the financial sector and prepare for capacity building to safeguard against their financial instability, thereby boosting resilience to crises. At the same time, the results from such program guide the IMF, the World Bank and other international organizations to effectively designing technical assistance and reform policy that appropriately address areas of financial sector vulnerability.

Recognizing these potential benefits which are broadly in line with its work program, the Bank of Thailand is planning to participate in the FSAP in the next few years. In preparation for the assessment of standards and codes, such as banking supervision, insurance regulation, and payment system, the National Corporate Governance Committee (NCGC), chaired by the Prime Minister with prominent members from both public and private sectors, has delegated four relevant subcommittees to oversee the self-assessment and other preparation process. Among these subcommittees, the Subcommittee on Improvement of Corporate Governance of Commercial Banks, Finance Companies and Insurance Companies chaired by the Governor of the Bank of Thailand is responsible for overseeing assessment of major FSAP modules such as Banking Supervision, Insurance Regulation, and Payment System. The relevant government agencies have therefore been working closely together to help prepare the groundwork of the program. The authorities will continue to raise the awareness of other participants in the financial sector and work closely with them in the assessment process.

APPENDIX



LIST OF MAJOR POLICY ANNOUNCEMENTS 2003*

1. Increase Flexibility in Business Scope and Business Model

1.1 Permitted commercial banks that have efficient risk management and internal control systems in place, as well as comply with the Bank of Thailand's regulations on capital adequacy and large exposure, to engage in the following sets of derivatives transactions:

- forward bond, bond options or equity index linked swap transactions within the specified scope of reference securities, counterparties, and currency denominations.
- deposit or borrowing transactions whose returns are linked to variables (embedded derivatives) which include domestic and foreign stock indices, average price of a basket of securities listed on the Stock Exchange of Thailand or other exchanges, domestic and foreign interest rates, and exchange rates. The scope of transaction includes deposits or borrowings that give the commercial banks the right to (1) pay back the principal in cash or bond, (2) extend the maturity of deposits or borrowings, or (3) make an early redemption.
- credit default swap (CDS) transactions with the specified scope of business, counterparties and currency denominations.

1.2 Permitted commercial banks to appoint Thailand Post Co., Ltd. or to establish a joint venture company with Thailand Post Co., Ltd. to act as a deposit agent, thereby broadening the public access to basic banking services. While not authorized to open new accounts or originate loans, the agent is allowed to:

- take deposits and make withdrawals
- transfer funds to third-party accounts
- deliver document between banks and their clients.

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

1.3 Expanded the scope of business of commercial banks in the areas of:

- foreign exchange offices so as to include debt payments collection, taking deposits for existing accounts, updating pass book by automatic machine and international money transfers.
- support services so as to add other financial institutions and their related companies, specialized financial institutions, and the Bank of Thailand to the list of permitted service recipients, in addition to commercial banks' own related companies as previously allowed.
- securities borrowing and lending and short selling business so as to cover equity securities, in addition to debt securities as previously allowed, although lending securities to non-resident is prohibited.

1.4 Amended the regulation concerning the permission for commercial banks to engage in credit linked notes (CLN) transactions. The list of counterparties is expanded to include securities companies registered in Thailand and domestic and foreign special purpose vehicles established for credit derivatives purpose. The form of transaction is also extended to include credit linked deposits (CLD). In addition, the requirement that CLN/CLD issuers own the referenced assets is removed, although the issuers are required to assume credit risks in the referenced assets.

1.5 Permitted finance companies to engage in the following business undertakings:

- distributing the advertisement leaflets of insurance companies to customers
- providing investment advisory services
- introducing the services of securities companies to customers
- undertaking the business of escrow account
- purchasing loans and assets from receiverships of 56 problem finance companies during 1997 crisis.

1.6 Amended the criteria for allowing finance companies to engage in arranging, underwriting, and dealing in debt securities by replacing the conditions based on size of finance companies with the companies' risk-management capacity, good corporate governance, and financial soundness and stability.

1.7 Relaxed the criteria for allowing commercial banks to conduct the business of renting immovable properties by repealing the condition regarding the rental period as well as changing the period which commercial banks have to submit related report to the Bank of Thailand.

2. Financial Institutions Supervision Policies

2.1 Issued the market risk supervision policy comprising elements of interest risk and equity price risk in trading book as well as exchange rate risk and commodity price risk. The policy prescribes 8 areas as follows:

(1) Calculation of the volume of trading book transactions
(2) Internal control for market risk management
(3) Trading book policy
(4) Capital requirement against market risk
(5) Measuring market risk under standardized approach
(6) Measuring market risk under internal model approach
(7) Measuring market risk under mixed approach
(8) Compilation of data and submission of related call reports.

The market risk supervision policy is implemented in transitional stages, allowing sufficient time for financial institutions to adjust, with the last stage at the end of June 2005 when financial institutions will be required to maintain capital funds against market risk.

2.2 Issued a guideline on security of electronic financial services, which aims to provide financial institutions with a practical framework to formulate and implement the security policies and procedures. Financial institutions are expected to provide highly secured and reliable electronic financial services to their customers, thereby enhancing consumers' confidence on financial services rendered to them electronically.

2.3 Issued a practical guideline for IT outsourcing in order to provide financial institutions with best practices in IT outsourcing. Financial institutions need to ensure continuity and reliability of the services outsourced as if the services were undertaken by themselves.

2.4 Circulated the Sound Practices for the Management and Supervision of Operational Risk issued by the Basel Committee on Banking Supervision to all financial institutions as a guideline for developing their operational risk management frameworks.

2.5 Revised the regulation on credit granted for residence to encourage financial institutions to be more cautious in extending property loans to the high-end segment. Financial institutions should not grant credit to any person who purchases condominiums, lands and houses for residence valued equal to or more than 10 million baht, exceeding 70 percent of purchased price, for which these properties are used as collateral. Moreover, financial institutions are required to submit a quarterly report on approvals of real estate lending of which credit lines are equal to or more than 100 million baht.

2.6 Relaxed the supervision of large exposure of a business group by allowing commercial banks to grant credit to, make investment in, and undertake contingent liabilities with a juristic person in any business groups in the amount exceeding the legal limit on a case-by-case basis under the criteria prescribed by the Bank of Thailand, in addition to revising the regulation on large exposure as follows:

(1) revised the calculation methods of foreign exchange contracts and interest rate contracts;
(2) added supervision of large exposure for credit linked notes and credit default swaps transactions; and
(3) exempted from the calculation of large exposure interbank Thai baht term loans with maturity not exceeding 12 months and foreign currency contingent liabilities with Thai residents undertaken by the head office of foreign banks in Thailand or other branches.

2.7 Revised the regulation on maintenance of capital funds for financial institutions to reflect the market value of capital funds by including the net value from the appraisal of equity securities available for sale, and investments in treasury stocks and debt instruments issued as tier-2 capital by other financial institutions. The regulation also prescribes computation methods, risk weight of assets and credit conversion factors of new business transactions such as credit linked notes (CLNs) and credit default swaps (CDS) transactions.

2.8 Revised the regulation on capital funds of foreign banks' branches to reflect the market value of capital by requiring the assets under Section 6 of the Commercial Banking Act to be marked-to-market in accordance with the accounting standards at the end of every accounting period. The definition of the net debit balance of the inter-office accounts is expanded to cover transactions with parent and all subsidiary companies of their head office in order to prevent capital remittance through the parent and subsidiary companies. In addition, to give foreign banks more flexibility, the Bank of Thailand allows deposits at specialized financial institutions to be counted as assets under Section 6.

2.9 Revised commercial banks' services, fees and disclosure regulations, with the view to enhancing banks' transparency and protecting retail customers. Banks are required to be more transparent about the terms and conditions pertaining to any contract and agreement, especially with regard to the service fees.

2.10 Relaxed the rule on loan reviews and related call reports by allowing random sampling via a reliable statistical method and explainable theory for two groups of debtors. The first is debtors with credit line or outstanding balance less than 20 million baht and the second is debtors classified by financial institutions under the same portfolio whose risk is managed as a group.

2.11 Relaxed the regulation on commercial banks' purchasing or holding of shares in any limited company above the legal limit if such investments are considered to be beneficial to the whole financial system.

2.12 Relaxed the regulation on the assumption of directorship in other companies by directors and senior executives of commercial banks to allow them to assume the position of chairman, executive director, or director with full signatory authority in no more than three business groups, instead of three individual companies. This is to provide due flexibility consistent with the current corporate practices where businesses are managed and supervised as groups, rather than as individual companies.

2.13 Clarified the qualifications of credit cardholders for both bank and non-bank card issuers to be in accordance with the rules, procedures, and conditions for credit card business of commercial banks, including clarification on loan collection fee, penalty fees for insufficient fund and returned cheque, credit card renewal, and information to be shown in debt collecting invoices.

2.14 Allowed promissory notes that financial institutions received from the Thai Asset Management Corporation (TAMC) as payment for non-performing loans to be recorded in financial statement as investment.

2.15 Prohibited dividend payment by financial institutions to be considered as unrealized profits.

2.16 Revised the rule on reclassifying purchased loans into investment in account receivables. Such investment must be measured at fair value as prescribed by the BOT, while gain or loss must be recognized in the income statement.

2.17 Revised the guidelines on information disclosure and reporting requirement in the summary statement of assets and liabilities as follows:

(1) revised the definition of NPL to exclude NPL that is subject to the Financial Institutions Development Fund's yield maintenance and gain/loss sharing agreement (Covered Asset Pool), where this excluded amount is to be disclosed separately under the remark section;

(2) added two more items in the disclosure list, namely, required provisioning (quarterly) and loan loss provisioning outstanding (monthly); and

(3) revised the definition of required provisioning to include additional provisioning as required by the Bank of Thailand's examiners.

2.18 Revised the regulation on asset classification and provision. The method of recognizing loss from debt restructuring of financial institutions was revised to be in line with the amended Thai Accounting Standard No. 34 on Accounting Standard for Troubled Debt Restructuring. The stipulation for financial institutions to write back collateralized debtors classified as doubtful of loss that financial institutions have already written off was also revised. Moreover, financial institutions have the option to re-record debtors classified as doubtful of loss with no collateral into their books.

2.19 Revised the principle pertaining to methods of measuring investment value of securities in accordance with the Thai Accounting Standards. Such methods are used in the calculation of the proportion of investment in securities to capital and the single lending limit.

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