The Financial Sector Master Plan Phase II

The Financial Sector Master Plan Phase II (FSMP Phase II) is a medium-term plan, to be implemented during 2010 – 2014. The FSMP Phase II has been designed to follow the FSMP Phase I (2004 – 2008), during which structural improvements to the financial institutions system were carried out in order to enhance its efficiency, strength, and access. Key measures under the FSMP Phase I included upgrading of financial institutions through voluntary mergers, widening of commercial bank business scope to "Universal Banking", enabling them to serve all client groups and perform almost all types of financial transactions. Moreover, new licenses were also granted, including new subsidiary license for foreign commercial bank, promoting financial access through new retail banking license, and introducing the "One Presence" policy to reduce duplication and increase economy of scale within the financial institutions system. Following the implementation of the FSMP Phase I, there has been a significant structural change in the Thai financial system. In particular, many small financial institutions merged, resulting in greater strength in terms of capital, operational and risk management. Financial conglomerates and retail banks were also formed.

The FSMP Phase I has now come into completion, while financial environment, both domestically and abroad, that has implication for business model of financial institutions, has also changed significantly. Such developments were a result of changes in business scope, risk management standards, technological advancement. Moreover, financial institutions face intensified competition--among peers, with the capital market, and with non-banks, both domestic and foreign,--and face challenges from increased globalization of the economic and financial system, as reflected by the global economic crisis in 2008.

The aforementioned developments in the financial environment brought about both opportunities and challenges, especially in maintaining financial and economic stability through safeguarding financial institution soundness and ensuring effective risk management. Thus, the Ministry of Finance (MOF) and the Bank of Thailand (BOT) have cooperated in developing the FSMP Phase II. In this regard, particular emphasis has been placed on the setting of goals and strategic direction for continuous financial institutions system development, to ensure that challenges arising from the aforementioned developments could be effectively managed. This would allow the financial system to function remain robust and resilient, supportive of sustainable economic development.

Development process of the FSMP Phase II

In developing the FSMP Phase II, the process emphasized stakeholders' involvement in sharing of ideas, information and feedback, to ensure that assessment of financial institutions system strengths and weaknesses, as well as development of related policies and measures are comprehensive, responsive to the needs of market players and users, and appropriate as well as acceptable in practice. Accordingly, the FSMP Phase II Committee was formed in July 2007. The Committee consisted of experts from relevant governmental agencies as well as outside experts, and was tasked with the responsibility to consider policy directions, strategies, and detailed measures prior to submission to the Financial Institutions Policy Committee and subsequently, the Minister of Finance and the Cabinet for approval.

Assessment of Thailand's financial institutions system and future challenges

The global economic crisis clearly demonstrated the importance of the financial system to the overall economy. A country with financial system that is strong and efficient would reap economic benefit, as resource allocation would be efficient and supportive of rapid economic development. Therefore, an assessment of stability and efficiency of the country's financial institutions system was deemed a necessary step in developing the FSMP Phase II.

Findings from strength, weakness, opportunity and challenge, or the SWOT analysis of Thailand's financial institutions system, which became inputs in developing the FSMP Phase II, can be summarized as follows.

1) <u>There has been an overall improvement in efficiency and soundness of the system.</u> This was a result of continuous development of the financial institutions system and improvement in risk-based supervision, which enabled financial institutions to remain quite resilient to the global economic crisis.

2) <u>Operating costs remained high.</u> This was partly due to the legacy non-performing loans and assets, and operating costs associated with investment in information technology, human resource, and branch network. Overall, Return-on-Asset (ROA) as of end-2008 stood at 1 percent, which was lower than most countries in Asia. As a result, efforts to lower costs arising from regulations that have become inconsistent with current business model of financial institutions, enhance economy of scale and scope, or increase competition, would provide an opportunity to strengthen financial institution efficiency.

3) <u>Range of services expanded, but access gaps remained</u>. This was particularly in the case of households and micro and small enterprises. Findings from the nation-wide survey, conducted jointly by the BOT and the National Statistics Office in 2006 revealed that commercial banks and Specialized Financial Institutions (SFIs) played an important role in providing financial services to Thai households. In particular, 80 percent of households were found to have deposits with commercial banks or SFIs, while only 31 percent of households were users of credits from these institutions. Reasons for non-usage could be due to inappropriately designed credit products, inability to access credits, due to factors such as having low income, being located in rural area, being unqualified or lacking collateral, or due to perceived lack of needs for credits. The FSMP Phase II would therefore pay particular attention to resolving these credit access issues.

4) <u>Necessary financial infrastructure to support risk management of financial institutions remained inadequate</u>. This constrained the ability of financial institutions to provide services more efficiently and widely. In particular, improvement would be desirable in the area of credit information and laws relating to risk management of financial institutions, for example, the secured transaction law and the bankruptcy law.

From these findings, it could be concluded that efficiency of the Thai financial institutions system has been substantially strengthened over the period. Nevertheless, further improvements could be carried out, and future challenges stemming from the global economic crisis remained. In this regard, future challenges that the Thai financial institutions system must take into account when designing a development framework for the next period include capital flows into Asia, the increasing role of domestic demand vis-à-vis exports as an economic driver, and the need to enhance competitiveness of the Thai economy.

Vision of the FSMP Phase II

In order to ensure that the Thai financial institutions system continues to gain strength, efficiency, and provides better financial access, as well as able to meet future challenges, the Thai financial institutions system in the future is envisioned to be:

1) A financial institutions system that is efficient, thus ensuring that financial services cost is supportive to economic growth.

2) A financial institutions system that is strong and resilient, able to withstand volatility in the global financial environment.

3) A financial institutions system that is diversified, thus able to provide financial intermediation for a wider group of the population.

4) A financial institutions system that provides financial services in a fair and transparent manner.

Expected benefits

The FSMP Phase II consists of measures to reduce system-wide operating cost, promote competition, and strengthen financial infrastructure. It is expected that households, businesses, the financial institutions system, and the country as a whole, would benefit from the followings.

1) An efficient financial institutions system, with good risk management and corporate governance, that is strong, not burdensome for the country, and supportive of economic development in both normal and crisis scenarios.

2) Reduction in costs of services, resulting in lower cost for businesses, thus leading to enhanced competitiveness of the economy and development potential of the population.

3) Greater access to diversified financial services appropriate to the demand, especially through the promotion of microfinance to help reduce problems in using informal market. This would also contribute towards building strength for local communities through sharing of knowledge from successful microfinance business experts with local grass-root micro institutions, which would help strengthen immunity for the society against economic uncertainties.

4) A legal framework that allows greater opportunity for qualified individual debtors and small business debtors to apply for a business restructuring process, enabling their businesses to continue as going-concern, and prevent value destruction for the overall economy.

5) A financial infrastructure that is supportive for risk management of the financial institutions system, allowing financial institutions to deal with legacy non-performing loans and assets more efficiently, leading to lower costs and greater efficiency and capacity in providing financial services.

Salient features of the FSMP Phase II

Main policies and measures of the FSMP Phase II can be grouped into 3 key pillars.

Pillar 1: Reduce system-wide operating cost

Operating cost of financial institutions reflects efficiency, translating to costs of consumers, while affecting international competitiveness. Important measures under this pillar focus on two operating costs, as follows.

1.1 Regulatory costs. The main objective of financial regulation is to ensure prudential standard and to safeguard the stability of the financial system as well as facilitate efficient and fair financial intermediation function. Financial intermediary functions range from savings to lending to other services, for example, transfers and payments. Nevertheless, regulations implemented could sometimes impose restrictions on financial institutions in terms of institutional set-up and business model, and represent operating costs or opportunity costs for financial institutions.

Measures: Improvement in financial institutions regulations would be based on the principle that such regulatory review would be in favour of higher efficiency and lower cost, without compromising stability and soundness of financial institutions and the economy as well as consumer rights.

Based on feedback from financial institutions, the BOT already responded to around 40 percent of the requested regulatory amendments, which came into effect in August 2008, together with the Financial Institutions Business Act. Presently, the BOT and MOF are in the process of reviewing the rest of the requests.

1.2 Cost of legacy NPL and NPA. These costs have been carried by the Thai financial institutions system since the crisis in 1997, and are now the focus for policy. During the first half of 2009, NPL in the banking system amounted to 402 billion baht, while NPA, which mostly consisted of foreclosed immovable properties, stood at 143 billion baht. At the same time, gross NPL stood at 5.4 percent of total loans.

Measures:

1) Encourage write-offs of loans classified as doubtful of loss that have been fully provisioned for in line with related accounting standards

2) Enhance demand for NPA by allowing banks to partner with private firms to work on enhancing attractiveness of foreclosed immovable properties. In the longer-term, when investors and financial system is more ready, measures to encourage introduction of a greater range of products to support trading of NPA could be implemented.

3) Increase the efficiency in trading of NPA by establishing an NPA information centre, and fostering an effective mechanism for foreclosure and subrogation.

Pillar 2: Promote competition and financial access

Strengthened competition is the key mechanism to enhance efficiency of financial institutions. Competition would be fostered through entry of new service providers, as well as expanding business scope of existing service providers. This will help induce competition in price and service quality, as well as increase the opportunity for broader financial access.

2.1 Promote competition in the financial institutions system. Measures to promote competition are stipulated under 5 key principles as follows.

2.1.1 Foster a financial institutions system that provides strong and resilient support for the economy under all scenarios. In view of Thailand being a small, open-economy, where the financial institutions system continues to play a major role, it is important that the functioning financial institutions system is resilient and able to support economic activities, in both normal and stress scenarios. The key features of the system that will contribute to this will be the locally incorporated commercial banks, which are well rooted in the long-term developments of the Thai economy, that are strong and efficient.

2.1.2 Encourage financial institutions to become larger in order to reap the benefits of economy of scale and scope, thereby enhancing competitiveness of the system. In this regard, voluntary mergers would be encouraged, and tax measures similar to ones introduced under the FSMP Phase I could be considered to eliminate constraints and additional burden from merger on financial institutions. All financial institutions may request for merger, and criteria of approval would be based on such considerations as impact on degree of competition in the market, as well as efficiency and fair consumer treatment, as merger should not result in anti-competitive market power that could negatively impact future development and stability of the financial institutions system. Moreover, there would be Prompt Corrective Actions regime to enable the authority to resolve any problem at individual institutions in a quick and timely manner, to prevent systemic risk and safeguard financial stability.

2.1.3 Promote competition by enabling financial institutions to gain greater flexibility in managing their branch network and business scope, thus enhancing the role of existing service providers. Moreover, new service providers would be introduced in order to further increase competition, thereby raising the efficiency of the financial system by:

1) Increase options in the following areas to allow financial institutions greater flexibility in their management.

(A) <u>Liberalization of branch network</u>. The BOT would consider liberalizing the opening of branches of Thai commercial and retail banks to allow them the flexibility in managing branch network. In this regard, qualified institutions must be Thai commercial or retail banks that are strong and sound, that is, they must have good ratings according to the BOT's rating assessment, as well as demonstrating good management.

(B) Expansion of business scope to allow commercial banks (not including retail banks) to conduct businesses that are presently undertaken by their subsidiaries, including mutual fund management and venture capital fund management. This would allow banks the flexibility to expand services, and reap benefits of economy of scale and scope, as well as allowing them greater flexibility in managing business models.

2) Enhance existing service providers' role by increasing the opportunity for existing retail banks to upgrade and foreign banks to compete by allowing greater service delivery channels.

(A) Retail banks would be allowed to request an upgrade to commercial banking license after the FSMP Phase II becomes effective and related conditions and rules are announced by the MOF. Criteria for eligibility are that the applicant retail banks should demonstrate good management and capability, have at least 10 billion baht of Tier 1 capital, good risk management system, and with viable business prospect so as not to pose systemic risk to the financial system.

(B) Existing foreign bank branches and subsidiaries. Existing foreign bank branches would be permitted to request opening of up to 2 additional branches, in accordance with conditions and rules stipulated by the authority. On the other hand, existing foreign bank branches may also choose to apply for a change in their status and convert to become a subsidiary, where the authority would consider permitting subsidiaries, both newly converted and existing, additional branches and off-premise ATMs to the maximum of 20 branches and 20 off-premise ATMs, in accordance with conditions and rules set by the MOF. Amongst such rules, would be the requirement for a minimum Tier 1 capital of 10 billion baht, good rating in accordance with the BOT's rating assessment, and good risk management system. This measure aims to foster greater competition from existing foreign service providers, while in parallel, fostering level playing-field with Thai commercial banks in the same market, by allowing foreign bank branches a choice between remaining in a branch status or to become subsidiary that is locally incorporated and have greater distributional network.

After the FSMP Phase I, the authority does not have a policy to upgrade finance companies and credit fonciers to retail or commercial banks. However, they are allowed to choose to become credit companies with no deposit taking activities.

3) Entry of new service providers. The initial phase of the FSMP Phase II would not include entry of new service providers, so as to allow financial institutions time at this stage to carry out adjustments to meet challenges, including intensifying competition, changes in regulatory landscape, as well as challenges posed by the global financial market.

2.1.4 Entry of new service providers into the financial institutions system. The entry would be subjected to assessment of remaining gap in the system, and emphasis would be given to service providers with the ability to address such gaps. In so doing, the financial institutions system would be able to provide a comprehensive range of services, in line with the trend in Thailand's international trade and investment, particularly given the regional trade and investment liberalization. Approval would be on a case-by-case basis and consideration by the BOT and MOF would be based on appropriateness for the financial institutions system.

2.1.5 Support the role of SFIs in focusing on providing financial services to the low-income population and micro businesses that do not as yet have access to services provided by commercial banks. Government ownership in the commercial banking system, resulting from the crisis in 1997, would also be reduced.

Under the umbrella of aforementioned principles, competition would be promoted in 3 phases as follows.

Phase 1 (2010 – 2011) would emphasize strengthening and enhancing efficiency of current financial institutions. This would be achieved by promoting mergers, expansion of business scope, reducing system-wide operating cost, facilitating qualified retail banks to upgrade to commercial banks, and increasing the number of branches for foreign bank branches.

Phase 2 (2012 – 2013) would step up competition in the system by gradually relaxing rules and regulations pertaining to business conduct of foreign financial institutions. In this regard, existing foreign bank branches and subsidiaries would be able to apply for new subsidiary status with more branches. Moreover, new service providers would be introduced under a restricted license. These new providers could be Thai, foreign, or in partnership, to bring about necessary expertise that is still lacking locally, to help further enhance efficiency, while helping to fill the gaps in the financial services. The types of financial institutions that fall under this category of licenses might include microfinance, trust banks, investment banks and Islamic banks.

Phase 3 (2014) Following the implementation of measures under Phases 1 and 2, the financial institutions system should be well prepared to meet intensified competition. In this final phase, there may be another round of assessment of efficiency of the system in meeting the trends and developments in international trade and investment of the country, especially in line with the trends in regional integration, prior to consideration of further new licenses for Thai or foreign financial institutions. These new licenses could be in a form of restricted or full commercial banking licenses.

2.2 Promote financial access for various groups of the population in order to increase the opportunity for micro businesses and low-income individuals to access financial services that are appropriate to their needs at a reasonable price. To achieve this, the following measures are introduced.

2.2.1 Encourage existing commercial banks to adopt business models that are suitable in reaching the group of population that currently lacks the opportunity to access financial services. This would be achieved by relaxing regulatory requirements on commercial banks, to allow greater flexibility in managing services to meet this objective. In addition, existing commercial banks would be encouraged to explore business models that would allow them to better service micro businesses and low-income individuals. Such business models could include:

1) Commercial banks could set up an internal unit to provide financial services, especially credits, to the aforementioned groups of customers. Such

account may be separated from that of normal banking operations to facilitate clarity in business goals, flexibility in business operation, low cost, and appropriate risk management system.

2) Commercial banks could partner with other microfinance operators that are more familiar with the local conditions, for example, cooperatives and credit unions. Business undertakings can be in a form of wholesale finance to microfinance operators for on-lending to customers or outsourcing some functions in the credit process to microfinance operators in return for service fees.

3) Commercial banks could appoint qualified service providers with strength in customer networking to act as an agent in providing microfinance services. This model could be supplemented with uses of various technologies such as mobile phone.

2.2.2 Provide opportunities for new microfinance service providers with expertise and good management to enter the market in order to serve customers who are unable to access financial services from the formal sector. The BOT and MOF would consider new licenses on a case-by-case basis, subjected to applicants' qualifications and the guidelines set. The main principle is that qualified applicants would operate under restricted licenses to fill remaining gaps in the system. They should have clearly targeted business goals and special expertise in serving the target groups on which existing commercial banks do not focus. In this regard, policy and regulations would remain risk-based, focusing on soundness, but would also have appropriate flexibility to meet the business model.

2.2.3 Improve and develop infrastructure conducive for the financial institutions system to enhance financial access for those presently underserved or excluded from services such as credit products. Such development could include, amongst others, improvement in the credit information system, efficiency enhancement of the credit guarantee mechanism, and a study to develop microfinance service provider rating system for Thailand.

2.2.4 Support the role of SFIs in addressing gaps left by commercial service providers. This would be achieved by enhancing the efficiency of SFIs, and developing clear business plans that are consistent with their long-term goals.

Pillar 3: Strengthen financial infrastructure

To promote financial institutions system efficiency, key supporting financial infrastructure must be efficient and complete, especially those relating to credit extension, the core business of financial institutions. Under the FSMP Phase II, there are five areas of financial infrastructure improvement.

3.1 Enhance the capability and tools for risk management of financial institutions, including credit, market, liquidity, and settlement risks. In response to changes in customer needs that are becoming more complex, financial institutions have to ensure that appropriate risk management system and tools are in place. Examples of policy measures are promoting the use of trade credit insurance as an instrument in risk management and supporting the payment-versus-payment system that connects

Thailand's payment system with the global systems to allow dual currency settlement in real-time, which would potentially mitigate time-zone risk.

3.2 Improve the information system for risk management of financial institutions. The enhancement would benefit financial institutions in strategic planning and service expansion, and the key components could include expanding the National Credit Bureau's information system capacity and service in terms of type and scope of data collection and services. In this connection, revisions of related laws could be needed if deemed necessary and appropriate. Moreover, data dissemination format that would allow financial institutions quicker and cheaper access could be developed. Other improvements could include development of a data pooling system, and better data dissemination system to ensure that financial institutions have adequate information for risk management and business planning. However, due consideration would be given to ensuring appropriate protection of client confidentiality.

3.3 Reviewing financial laws that support risk management of financial institutions in dealing with credit risk and NPL and NPA management, including:

1) Secured transaction law. The review aims at creating a secured transaction system for business agreements to allow borrowers to pledge collaterals without physical delivery. Currently, the Draft Secured Transaction Act has already been approved by the Cabinet and is being reviewed by the Office of the Council of State, before being submitted to the Parliament.

2) Foreclosure law. The review aims at increasing efficiency in the foreclosure process. Examples of points under review include setting the minimum amount and time limit for payment of expense relating to enforcement procedure and document, setting a higher deposit to prevent bidders from cancelling bids, and separating processing of secured from unsecured debt cases.

3) Bankruptcy law. The review aims to promote the ability of natural persons and small businesses to have access to the restructuring process, and the use of the "Ability to Pay" principle together with financial strength from financial statement in determining whether a borrower should be declared bankrupted.

3.4 Strengthen the information technology (IT) infrastructure and capacity. The objective is to promote efficiency, to reduce cost of providing financial services, and to prepare financial institutions for competition with foreign peers. In particular, more efficient utilization of technology to serve increasing customer needs would be encouraged while supervisory standards would be reviewed to ensure security of all services, thereby enhancing user confidence.

3.5 Enhance the capacity of human resource in the financial institutions system. The objective is to promote efficiency of financial institutions by enhancing the skills and expertise of staff as well as promoting required knowledge and corporate governance of high-level management. This could include enhancing the role of the Thai Institute of Banking and Finance Association, increasing attractiveness for knowledgeable and capable new graduates to enter the financial sector, and encouraging financial institutions to set clear policies on developing and retaining human resource.

Implementation of the FSMP Phase II

After the principles stipulated in the FSMP Phase II have been approved, to ensure that implementation would meet its objectives, the FSMP Phase II Implementation Committee, chaired by the Minister of Finance, would be formed. The Committee would be responsible for the overall implementation of the FSMP Phase II. Moreover, the Committee would form 4 Sub-Committees to oversee implementation of the Action Plan in various areas including tax, legal, data, and human resource development. Meanwhile, the Financial Institutions Policy Committee would oversee implementation of policies on competition and financial access. In this regard, the BOT would be in charge of policies to reduce regulatory cost, NPL and NPA resolution, and enhancement of financial infrastructure to facilitate strengthened risk management and information technology capacity and utilization. All related agencies and Committees would coordinate and work together to determine an implementation timeline.

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