Thai Banking System and Implications for Financial Stability

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Using Thailand’s experiences with two different financial crises, namely the Thai financial crisis of 1997 – 1999 and the global financial and economic crisis of 2007 – 2009, this dissertation aims to draw some challenges and implications for financial stability for the Thai banking system by examining the impact of banking crisis on market discipline, exploring the potential role of contingent capital in restoring market discipline and as a countercyclical buffer to prevent future systemic crises, and providing a post-crisis reassessment of risk in Thailand’s banking system.

The first paper, entitled “Market discipline in banking: Evidence from Thailand during the 1997 crisis”, investigates the impact of banking crisis on deposit market discipline using evidence from Thailand. The empirical evidence suggests that depositors’ responsiveness to bank risk taking increases in the aftermath of the crisis. However, an explicit blanket guarantee provided by the government since the 1997 crisis weakens the extent of an increase in market discipline during the post-crisis period. The results have relevant implications on the implementation of an explicit deposit insurance scheme for Thailand.

The second paper, entitled “Contingent capital: A tool for restoring market discipline?” examines the potential role of contingent capital in restoring market discipline and as a countercyclical capital buffer. A well designed contingent capital would help improve incentives for banks’ risk management and enhance market monitoring which thereby restoring market discipline in banking. Moreover, the use of contingent capital to build up capital in good times when system-wide risks are growing markedly would help banks to absorb potential losses and
prevent a credit crunch in the economy in bad times. Using Thailand’s experience over two
different financial crises—the Thai financial crisis of 1997 – 1999 and the global financial crisis
of 2007 – 2009, this paper tests how a regulatory trigger or a market-based trigger would have
worked in the past, with a view to providing supporting empirical evidence and drawing some
policy implications for the design of contingent capital.

Thailand’s experience over two different financial crises provides empirical evidence
supporting the use of a market-value capital ratio as a trigger for conversion of contingent capital.
The market-value capital ratio could well identify Thai banks’ aggregate solvency problem and
distinguish between soundly-managed banks and weaker or distressed banks especially during the
Thai financial crisis in 1997. Moreover, Thailand’s experience particularly during the financial
crisis in 1997 also supports a potential benefit of contingent capital as a countercyclical capital
buffer add-on. If Thai banks issued contingent capital to build up their additional capital buffer
in periods when system-wide risks were growing markedly as signaled by a deviation of credit to
GDP ratio over trend, they would have been immediately recapitalized and had adequate capital
when the market-value capital ratio breached a pre-specified threshold trigger for conversion into
equity to protect them against potential losses and support their lending activities during the 1997
crisis. Thus, contingent capital instruments, if had been adopted earlier, might have helped
reduce the number of distressed banks, avoid a credit crunch in the economy, and mitigate the
Although the capital structures of Thai banks are comprised mainly of common equity and modest amounts of hybrid capital securities, Thailand’s experience over two different financial crises could provide support for the potential benefits of contingent capital instruments for achieving both micro-prudential and macro-prudential stability and be useful for the design of contingent capital. However, with some skepticism about the relative cost and the potential effects on market dynamics of contingent capital instruments which are still untested in a crisis, the Basel Committee requires banks to primarily use common shares and retained earnings to meet additional loss absorbency capital requirements. This paper not only agrees with the use of better quality capital to satisfy new capital requirements, but also supports the use of going-concern contingent capital instruments to build up capital on top of the Basel capital requirements to provide banks with an expedited but potentially lower-cost recapitalization mechanism while the market conditions are not supportive of bank recapitalization.

The third paper, entitled “Thailand’s banking system: Post-crisis reassessment of risk and implications for financial stability”, provides a post-crisis reassessment of risk in Thailand’s banking system and draw some challenges and implications for financial stability. A composite index, which is developed to quantify banking system vulnerability in one single measure, shows that the vulnerability in Thailand’s banking system has reduced significantly since the Thai financial crisis in 1997. The market-based indicators could better identify an increase in Thailand’s banking system vulnerability than the balance sheet indicators, particularly during the global financial crisis of 2007 – 2009. A cobweb-style diagram, which depicts various dimensions
of risks and vulnerabilities of the banking system in a single diagram, shows that the conditions in Thailand’s banking sector have improved significantly in various dimensions of bank risk or soundness since the 1997 crisis, covering capital adequacy and profitability, funding and liquidity, asset credit quality and financial risks of the banking sector as reflected from equity market. In addition, an historical analysis of each dimension of bank risks also shows that the bank’s market-value capital ratio could be a good indicator which enables a composite indicator to early identify distress buildup in the banking system.

Moreover, the results of the empirical relationship between the build-up of economic and financial imbalances and the banking sector distress during the period from 1997Q1 to 2011Q2 show that the build-up of imbalances and systemic risk has an influence on the Thai banking system vulnerability. In particular, credit growth and asset price growth are significant measures that could be used to detect early warning signals for bank distress in Thailand.

In safeguarding financial stability, Thailand is facing more challenges to enhance the capacity of the economy and banking system to absorb shocks and manage financial risks, specifically to enhance tools and capacity to early identify the build-up of imbalances and systemic risks, and continue to strengthen both micro- and macro-prudential regulation and supervision.