12-1-1998

A false sense of recovery

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2,932 words
1 December 1998
Asian Business
ASBZ
30
Volume 34, Issue 12; ISSN: 0254-3729
English

The financial crisis might have provided the push that Thailand needed to get its house in order. But just because the Thai economy was the first to fall does not

mean it will be the first to recover

THE FIRST THING you notice when you arrive in Bangkok is the way Thai people smile. The second thing that grabs your attention is the concrete highways that stop in mid-air and the brick carcasses of half finished buildings. Underneath the smile which fools you into a false sense of recovery, lurks a country still struggling to find a way out of its economic crisis.

Thailand's party days during the boom years, when its economy grew rapidly between 1988 and 1995, have turned into an astronomical hangover since the currency crisis, which began last July and subsequently rollercoastered across neighbouring tiger economies.

However the Ministry of Finance and the Bank of Thailand think the worst is over, with the economy bottoming out towards the end of this year and rising again early next year.

Thai Farmers Bank predicts a growth rate of 0.5% in 1999, a significant turnaround from -8% in 1998, and a drop in the inflation rate, from 9% this year to 7.5% next year.

The government has been working hand in hand with the International Monetary Fund and its US$17.2 billion bail-out, of which financial reform is a key element. With IMF approval, the government plans to raise Thailand's public sector deficit to 3.5% of gross domestic product next year -1 percentage point higher than had previously been agreed with the IME

However, Goldman Sachs in its October report lowered its growth forecast for 1999 from -1% to -2.5%. Its 1998 GDP growth forecast remains unchanged at -8%. The rational behind their gloomy forecasts relates to the `pace and comprehensiveness of financial sector reform.'

And it is the financial sector where the recent optimism about Thailand's recovery - first into the frying pan, therefore first out theory-falls down. The country is still deep in recession, with the IMF warning that Thailand's economy will contract 7% this year and unemployment will rise from 3.5% to 6%. But its stumbling block is the banking sector, which has been crippled by Thailand's worst economic crisis in decades. The banks need US$13 billion to US$17 billion of new capital to survive, and as a crucial part of capital flows within Thailand, recovery of the banks is key to a general economic revival.

Recapitalisation and problem loans are on the tip of every Thai banker's tongue, that is every banker whose bank survived the crash.

So how successful have the bigger players been in their bid to recapitalise and reduce non-performing loans (NPLs)?

`So far, we've only seen two real private sector recapitalisations and those are the big banks, Bangkok Bank (BBL), which raised 43 billion baht (about US$1.2 billion) and Thai Farmers Bank (TFB), which increased its foreign shareholding to 49% and raised about 33 billion baht from foreign investors,' says Kenneth Ng, senior investment analyst at ING Barings.

On a long-term outlook ING Barings prefers TFB to BBL because of its higher assets, cost controls and restructuring programme. BBL is almost twice the size of TFB and is likely to take longer to reduce its problem loans.

However, Russell Kopp, banking analyst at Dresdner Kleinwort Benson says that both banks still need more funding, as does Bank of Ayudhya, which Kopp predicts needs an estimated US$575 million to recapitalise.

SMALL STEPS FORWARD

The third bank to recapitalise is the stateowned bank Krung Thai Bank (KTB), which will receive a 185 billion baht boost from the Bank of Thailand, the central bank. KTB will also absorb the ailing First Bangkok City Bank and the assets of Bangkok Bank of Commerce.

One of the barriers to reform and recapitalisation has been the reluctance of family shareholders to relinquish control of their banks. Many have refused or been unable to make a deal with a foreign partner and, as a result, many of the small- to medium-sized banks have been nationalised by the government. They have subsequently merged with larger institutions - Laem Thong Bank with Radhanasin Bank, and Union Banks with Krung Thai Thanakit. Others, such as Siam City Bank and Bangkok Metropolitan Bank are up for grabs.

Before the crisis broke, Thailand had 15 commercial banks. Krung Thai bank was government controlled, Siam Commercial was controlled by the Crown Property Bureau, essentially the royal family, and the Thai military was controlled by the armed forces. All other banks were controlled by businesses.

However, some formerly family controlled institutions have swallowed their pride and struck a deal for survival with new foreign owners.

Two of the local banks, Bank of Asia and Thai Danu Bank have been bought over by foreign banks, and market sources say Nakornthon Bank is set to do a deal with the Canadian Bank of Nova Scotia, which will recapitalise its acquisition by the end of this year.

Thai Danu Bank was the first to be bought by a foreign bank. Development Bank of Singapore took a 53% stake, while the Dutch financial group ABN-Amro took a 75% stake in the Bank of Asia.

`We are in a better position than most to take advantage of an economic recovery when it occurs,' says Chulakorn Singhakowin, president and CEO of the Bank of Asia.

To save his sinking ship Chulakorn suggests severing ties from the Phatraprasit family, who had owned most of the bank, and to replace family members in management with professionals.

Liberated from the daunting task of searching for capital in a difficult market, Bank of Asia is concentrating on loan recovery and believes its strategy gives it an edge on the competition. `ABN-Amro expects this bank to be one of the leading banks, if not the leading bank, in the country in the future,' says Chulakorn.

`Our boat is slightly more watertight than others. There is still a storm, but we aren't leaking, one or two banks are.'

One such bank which found itself sinking under the strain of trying to raise 20 billion baht in new equity funding is Siam Commercial Bank. Thailand's oldest and its fourth largest bank, Siam Commercial is the first to apply to the government's capital support scheme by asking Thailand's central bank for 1.7 billion baht.

Unveiled on August 14 by Thailand's finance minister Tarrin Nimmanahaeminda and the country's central bank, the offer was not taken up by any of the banks until after 11 weeks passed. The scheme's provisions mean banks must first show signs of having helped themselves before they can apply for assistance.

The package, which basically gives banks a breather, does not appeal to familyrun banks, which are trying to save face while resisting change. However, the longer they delay taking action, the less chance they have of improving their capital base and their ability to make new loans. So what is actually on offer?

The package is split into the Tier 1 and the Tier 2 scheme. The simpler Tier 2 scheme, which Siam Commercial has opted for, provides a pool of cheap capital put up by the government. However, banks must first demonstrate that they have made progress in restructuring their debts or increased lending to the corporate sector.

'I would expect most banks to use the Tier 2 scheme,' says Alastair Macdonald, banking analyst at Paribas Asia Equity. `The Tier 1 scheme is really a last-gasp option, and there's been a lot of debate whether it will be used at all.'

Under the Tier 1 scheme the bank has to provision fully for all its bad debts, which will probably wipe out all existing capital. If it does that, the government will recapitalise the bank up to 2.5% of Tier 1 capital adequacy.

`In addition you have to find a new private sector investor to inject new money, which the government hopes will incentivise new private money to recapitalise a bank,' says Macdonald.

However, this procedure requires share holders to voluntarily write down their existing interests in the bank. So far nobody has applied for Tier 1 help.

`Too little attention has been given to the government's recapitalisation package,' says James Mitchell, a vice president of Salomon Smith Barney, but he also points out the unattractive consequences of the Tier 1 scheme. `If banks issue their shares to the government, it raises the risk that they lose management control, but they might lose that anyway if they are forced to sell so many shares to foreigners.'

However, as Ng of ING Barings notes, the severity of NPLs means that without raising Tier 1 by a substantial amount you cannot fully recapitalise the banks. Given the market conditions most banks are unable to raise Tier 1 capital without having to resort to the government scheme, which effectively writes down existing shareholders' holdings before injecting new capital.

So most banks will eventually have to knock on the government's door for help. `If they want the banking system to recover quickly, they have to come up with something that takes NPLs off their balance sheets to relieve the banks from having to make large provisions, and that would probably be through an NPL purchase scheme, similar to what's happening in South Korea,' says Ng.

Debt restructuring is proceeding slowly with only about 11 billion baht worth of debt restructured so far. And with estimates of NPLs currently running at two trillion baht (US$sS billion), the government still has a long way to go.

NPLs are increasing by up to US$1 billion a month. The increase in NPLs will only slow down if interest rates fall, according to Mitchell.

`Thailand's minimum lending rate (MLR) was as low as 10% in 1994, it reached 1213% in 1995 and hit 16% in 1997 when NPLs skyrocketed. So if we can get it back down to 12%, then we'll see some stabilisation on the NPL front,' he says.

Bangkok Bank has the lowest MLR now (at about 13.25%) and `the rates are falling at a rate of 25 basis points to 50 basis points a month, so stabilisation may be as early as the first half of next year', says Mitchell.

Kopp of Dresdner Kleinwort Benson also sees no slowing `in the NPL deterioration at least into the first half of 1999'. In an August report, he wrote: `If [the interest rate environment] develops as we expect, interest rates may fall dramatically [as inflation drops] without massive depreciation to the baht. Lower rates would also do wonders for the ability to restructure NPLs and for companies to actually begin repaying some of their debts.' But predicting realistic figures, he says, could still be as much as 12 months away.

For now, however, the banking system is in no condition to start providing any new loans and may not even have the ability to restructure existing loans given their capital inadequacy. It is entering a state of limbo where the banks that haven't recapitalised cannot restructure their debts because that will result in bad write downs and a further reduction in their capital, but neither can they go forward until they recapitalise.

Until this crucial recapitalisation is achieved, 70% of the banking system is frozen, it cannot move forward and until the banks start lending again the recovery cannot happen.

The slump has also shaken Thailand's legal foundation by forcing the government to introduce a new foreclosure and bankruptcy law - one of the conditions of the IMF rescue package. `Critical to recovery is legislation concerning foreclosure and bankruptcy,' says Chulakorn of Bank of Asia. `Without the weapon of law as a marketing chip in relation to delinquent customers, the market for assets will not clear.'

In Thailand, bankruptcy and foreclosure proceedings are so ineffectual, that one of the first things a struggling company does is stop paying interest.

`In many ways the crisis has been the catalyst for change,' says Macdonald of Paribas Asia Equity. `Before the crisis broke everyone was making so much money, there was perceived to be less urgency in reforming the bankruptcy law and the whole approach to credit management which has been a great weakness underlying all of this.'

CATALYST FOR CHANGE

Lessons have been learnt but somebody somewhere is still not doing their homework as the IMF's deadline for introducing the new foreclosure law, on October 31, came and went unobserved, a delay which Macdonald sees as cause for concern. `The longer the delay, the more time there is for an increase in strategic NPLs, where customers who probably can pay have decided not to,' he says.

In theory the foreclosure law will give increased powers to creditors against errant customers, but the flip side is the implication it has for Thailand's farmers who may lose their livelihood as a result of being forced to pay off their debts at a time when they can't afford it. Echoes of social unrest are not what new investors want to hear. Political stability is an essential ingredient for building confidence and attracting new investors. For now, the rich/poor debate has been swept under the carpet, but it may be the crucial stumbling block in building a new Thailand with solid foundations. `People need certainty when they invest,' says Ng of ING Barings.

As for the effectiveness of any amendments, Kopp predicts that bankruptcies are likely to be far higher next year: '1999 is likely to be an Armageddon compared to what we have seen to date.' And with a backlog of paper- work, he predicts that the courts may not resolve any case before 2000.

However, the Bank of Asia's Chulakorn remains optimistic. `Most Thais are looking beyond economic recovery to a more equitable, a more modern economy,' he says. `Thais are far more demanding than they have ever been. Public sentiment is towards a high degree of transparency in government, in the private sector and political system.'

In touch with this new momentum is central bank governor Chatu Mongol Sonakul, who has introduced greater transparency and increased disclosure, starting with regular press conferences.

In this new wave of openness the stock market requires listed companies to have not only independent directors, but also an audit committee to supervise the work of the board. The Securities and Exchange Commission has suspended three auditors for improper accounting standards or insufficient disclosure, and the Bank of Thailand has prosecuted managers and directors of eight different financial institutions for inappropriate behaviour.

Poor management systems have been blamed for doing damage to financial institutions, and Bank of Thailand is not without blame.

NEW POWERS

Chatu is to restructure the Bank of Thailand, giving it a bite to its bark. Criticised for igniting the crisis through its defence of the baht in 1997 and its lax supervision of financial institutions, the central bank can now intervene in an errant bank and has a greater supervisory role.

However, Thailand still has a long way to go in its bid for increased disclosure - analysts complain that quarterly GDP figures are still not published by government agencies.

`Thailand's problem is not purely or even mainly financial,' said Chatu in an address to the Asia Society in October. `The problem was a failure of democracy, a failure of government, and a failure of civil society. One thing leading into another and all interlinked.'

Thailand has badly needed to change its ways. The long-term outlook for a more structured, professional and open banking sector shows a system that will do business the right way, rather than the Thai way.

`The Thai way of doing business is cutting corners and circumventing controls,' says Robert McMillen, managing director of Seamico Securities. He is positive about Thailand's future, and his confidence is bolstered by a long list of completed international transactions since July 1997. `There's no going back now. The system can never go back. The whole control system is going to be put in place by the major shareholder. Thai Danu for example will now have Singaporean banking controls.'

Thailand is moving away from an era of family-run businesses and into a more professional climate. Increased credit control procedures mean lending will veer towards the more productive area of the economy and, as a result, a more stable and sustainable economic growth rate will emerge.

`It's still a difficult aspect to change but certainly we're seeing the boulder starting to move,' says Ng of ING Barings. 'A more professional code of conduct to replace the traditional code of honour is clearly the goal of the government,' says Macdonald from Paribas Asia Equity. `That is also the goal that the leading private sector banks like Bangkok Bank and Thai Farmers Bank will be pursuing. It's in their interest, it's their way to move forward.'

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