Bank lending in contemporary Thailand

by

Pati Buddhavibul, Ph.D.

Presentation outline

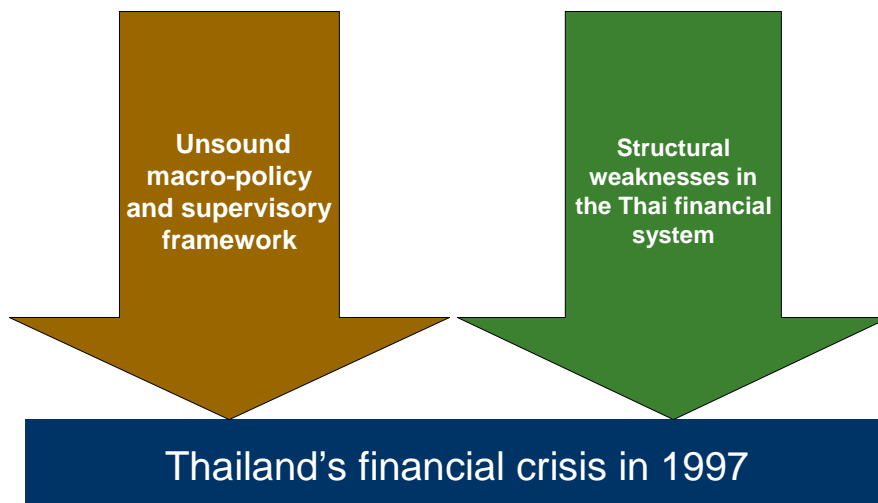1. Motives for the study

2. Research question and objectives

3. Theoretical framework
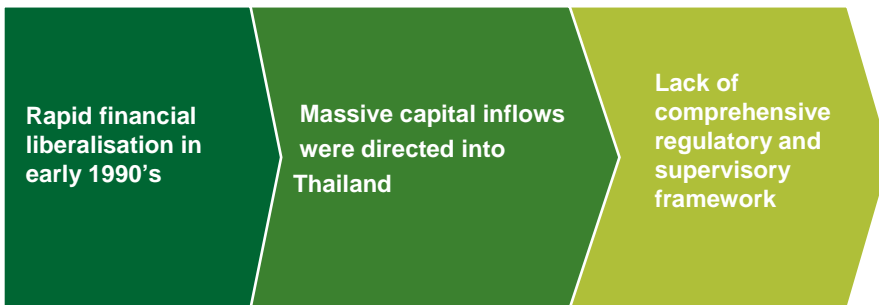
4. Research design

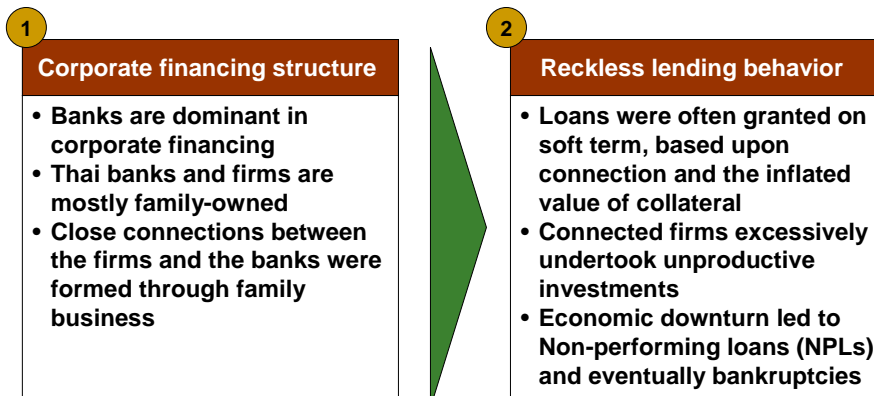5. Data interpretation and analysis

6. Key findings

Presentation outline

Motives for the study

Motives for the study

Unsound macro-policy and regulatory framework

Rapid financial liberalisation in early 1990's

Massive capital inflows were directed into Thailand

Lack of comprehensive regulatory and supervisory framework

Motives for the study

Structural weaknesses of Thai financial system

1

Corporate financing structure

- Banks are dominant in corporate financing
- Thai banks and firms are mostly family-owned
- Close connections between the firms and the banks were formed through family business

2

Reckless lending behavior

- Loans were often granted on soft term, based upon connection and the inflated value of collateral
- Connected firms excessively undertook unproductive investments
- Economic downturn led to Non-performing loans (NPLs) and eventually bankruptcies
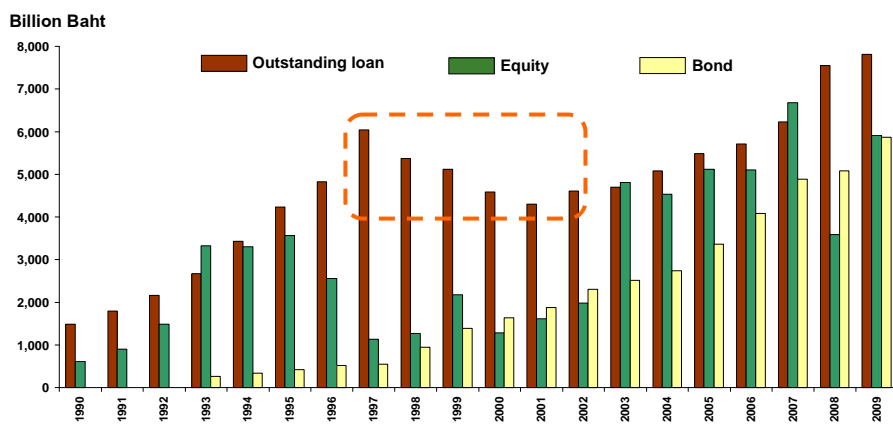
Motives for the study

Due to the crisis, controlling families have lost control over their own banks to foreign investors.

Percent of total number of banks classifies by their largest shareholder

■ Family ■ Crown Property Bureau ■ State ■ Foreign investors
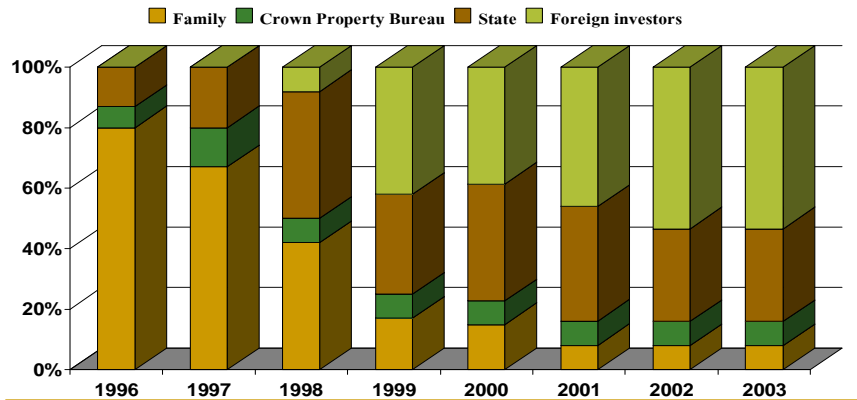
Motives for the study

Thai businesses still depended mostly on banks for credit and the liquidity in the Thai financial system was driven mainly by bank loans.

Billion Baht

■ Outstanding loan ■ Equity ■ Bond

Source: Bank of Thailand, The stock Exchange of Thailand, and ThaiBMA

4

Motives for the study

Due to a structural change in Thai banking industry, lending behavior of Thai banks was a topic of interest.

Prior studies in the Thai context		
1 *Chalumilind et al. (2003), Connected Lending: Thailand before the Financial Crisis.*	They examined whether business connections are a good predictor of preferential access to long term loans by using firms data prior to the crisis.	Connections were the most important factor determining access to long term bank loans.
2 *MENKHOFF, L., NEUBERGER, D. & SUWANAPORN, C. (2003) Collateral-Based Lending in Emerging Markets: Evidence from Thailand*	They examined the role and determinants of collateral in Thailand compared to mature economies.	Collateralization are higher there than in developed markets. Thai banks use collateral primarily to reduce the higher credit risks of small and relatively young firms.
3 *Menkhoff and Suwanaporn (2007), The Rationale of Bank Lending in Pre-Crisis Thailand*	They studied the lending behaviour of Thai banks before the crisis by directly analysing several hundred credit files of Thai commercial banks.	Close relations between banks and borrowers did not necessarily signal misbehavior. Rather, Thai banks failed to recognize risk factors.

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Research question and objectives

Question: How do Thai banks deal with informational and incentive problems in practice after the 1997 financial crisis?
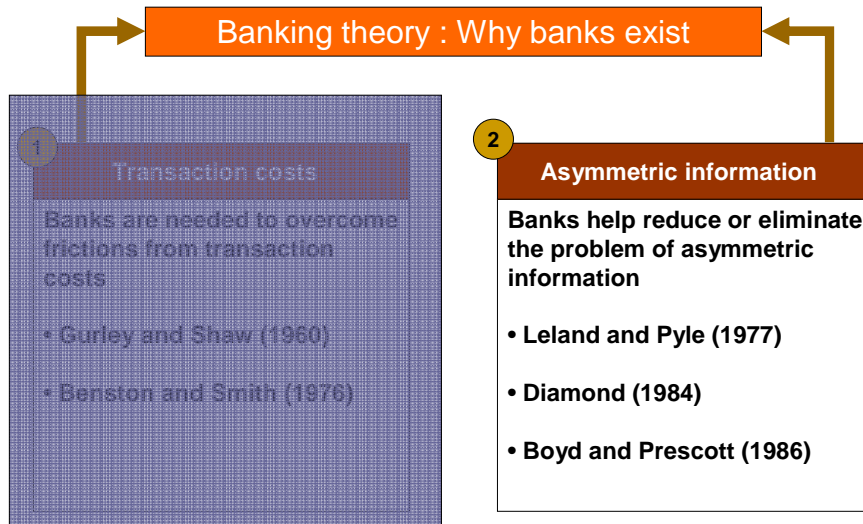
Objectives

- Seeking to discover what are in Thai bankers' minds concerning imperfect information and incentive problems
- Seeking to understand how Thai bankers cope with the problems in reality
- Seeking to address the differences between pre-crisis and contemporary lending and monitoring practices
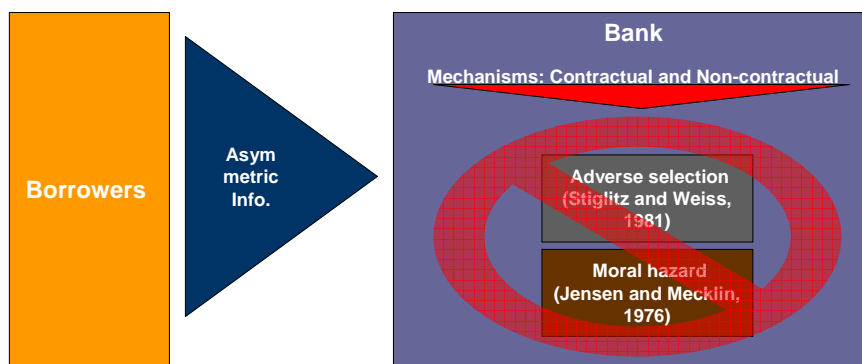
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Theoretical framework

Banking theory : Why banks exist

1

Transaction costs

Banks are needed to overcome frictions from transaction costs

• Gurley and Shaw (1960)

• Benston and Smith (1976)

2

Asymmetric information

Banks help reduce or eliminate the problem of asymmetric information

• Leland and Pyle (1977)

• Diamond (1984)

• Boyd and Prescott (1986)

Theoretical framework

From micro-perspective, information asymmetry is well suited to explaining the methods and mechanisms exploited by banks in lending and monitoring of loans.

Borrowers

Asym metric Info.

Bank

Mechanisms: Contractual and Non-contractual

Adverse selection (Stiglitz and Weiss, 1981)

Moral hazard (Jensen and Mecklin, 1976)

Presentation outline

8

Research design

Methodologically

Scant prior study on bank-lending in post-1997 crisis Thailand

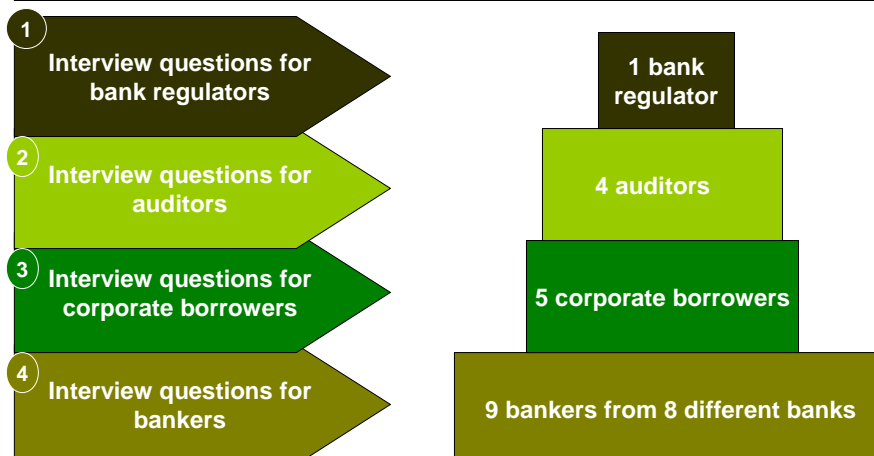**Exploratory research**

Qualitative method adopted

8

Research design

Qualitative method

- Open-ended interview technique is employed to study the selected issue in depth and detail and to explore what actually are in interviewees' minds
- No attempt has been made to
  - undertake a statistical survey of banking practices
  - focus on setting up detailed hypotheses for subsequent testing
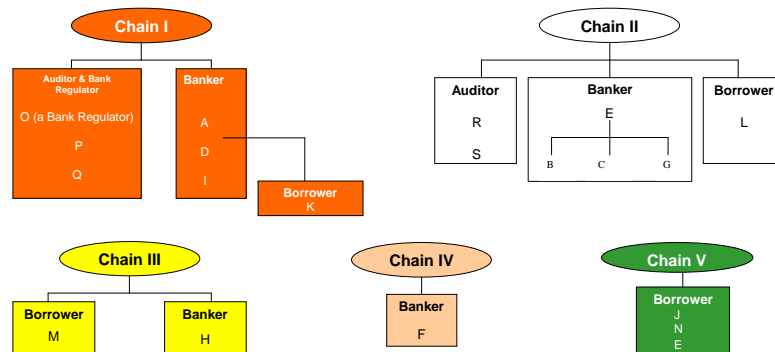- Doesn't claim to be a representative study of the entire banking sector in Thailand

Research design

Interview questions were based upon literatures on financial systems, agency theory, financial intermediations, and corporate finance.

1 Interview questions for bank regulators

1 bank regulator

2 Interview questions for auditors

4 auditors

3 Interview questions for corporate borrowers

5 corporate borrowers

4 Interview questions for bankers

9 bankers from 8 different banks

Research design

■ **The number of participants depends heavily on the well-established connection and a snowball strategy.**

■ **Selection bias was minimized by initiating links in multiple referral chain.**

Chain I

Auditor & Bank Regulator	Banker
O (a Bank Regulator)	A
P	D
Q	I

Borrower
K

Chain II

Auditor	Banker	Borrower
R	E	L
S	B C G	

Chain III

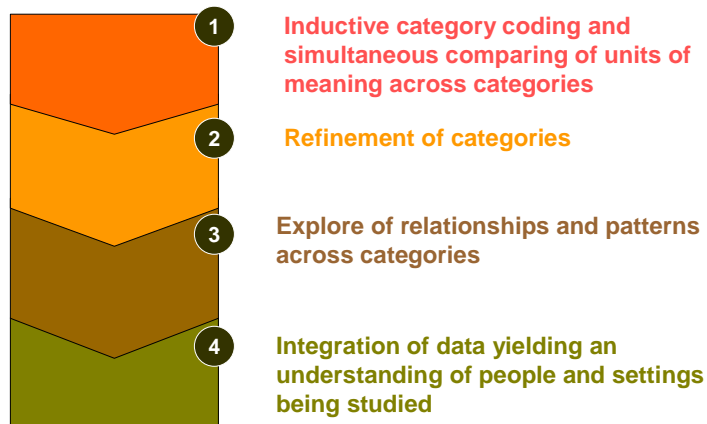| Borrower	Banker
M	H

Chain IV

Banker
F

Chain V

Borrower
J
N
E

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Data interus and analysis

A constant comparative method (Glaser and Strauss, 1967; Maykut and Morehouse, 1994) was used to analyze the interview data.

1 — **Inductive category coding and simultaneous comparing of units of meaning across categories**

2 — **Refinement of categories**

3 — **Explore of relationships and patterns across categories**

4 — **Integration of data yielding an understanding of people and settings being studied**
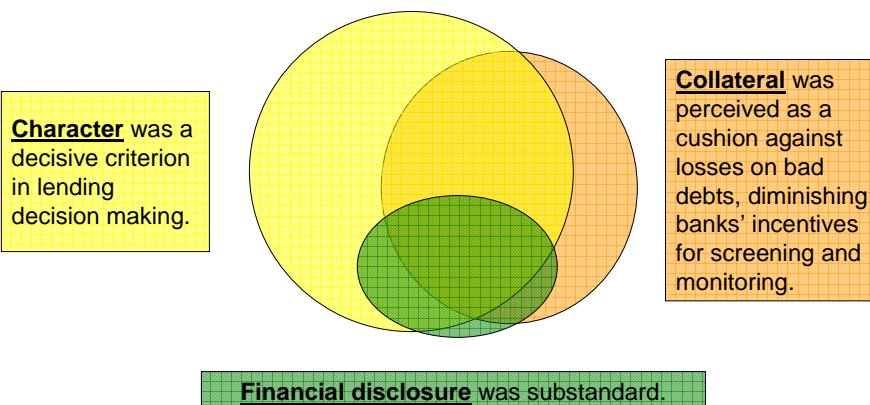
Presentation outline

Key findings

There are 3 (interrelated) elements which are crucial to lending decision making, namely character, collateral and financial disclosure.

Financial disclosure
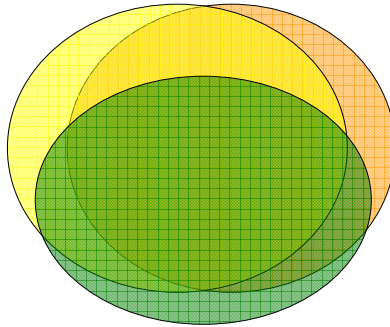
Collateral
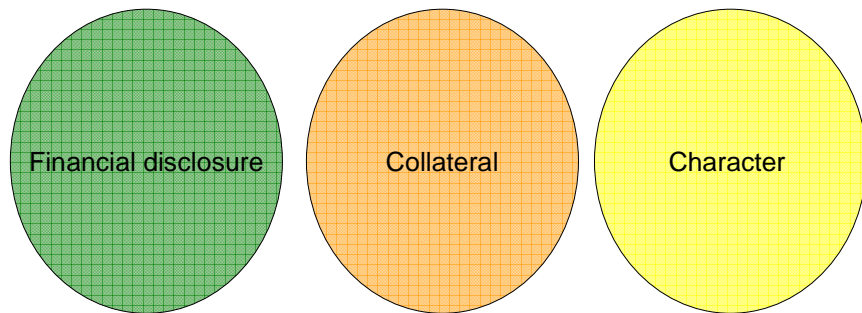
Character

Key findings

Before 1997, intense information asymmetry due to the inadequacy of financial disclosure among Thai firms caused Thai banks to rely on customers' character and value of collateral as an alternative means of resolving the problems.

Character was a decisive criterion in lending decision making.

Collateral was perceived as a cushion against losses on bad debts, diminishing banks' incentives for screening and monitoring.

Financial disclosure was substandard.

Key findings

After 1997, information has become less asymmetric due to improvements in financial reporting and increased recognition of the importance of project-based analysis.

Character is no longer a decisive criterion in lending decision making, but is a prerequisite factor.

Collateral is a prominent factor complementing other factors in project-based analysis.

A significant improvement **financial disclosure** standard, especially among Thai listed companies.

Key findings

After 1997, crony lending still exists but in a much lesser extent due to:

- A dramatic change in ownership structure of banks

- A stronger governing body (The Bank of Thailand)

- Bankers' mentalities towards their profession (lessons learned)

Key findings

Key main concerns

- Government intervention in state-owned banks

- Intense information asymmetry in the SMEs sector due to sub-standard financial reporting

- Stronger regulation *but* still-weak enforcement

- Pre-crisis lending practices still exist among certain groups of bankers

Key findings

Suggested future research topics

- Bank governance as
  - Strong information asymmetry in banks' portfolio
  - Banks' vulnerability to shock
  - Agency problem arising from deposit insurance
- Thai state-owned bank governance as
  - Agency problem between bureaucrats/politicians and taxpayers
- The provision of bank finance to SMEs as
  - SMEs are vital to the Thai economy, representing over 99% of registered companies in Thailand with their revenue account for 38% of Thailand's GDP