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THAI CAPITAL MARKETS: CHALLENGES AND REFORMS

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I. INTRODUCTION: IMPACT OF THE CURRENCY CRISIS

The Asian financial crisis has come at a time when Thailand and other regional economies are progressing towards increased global financial market integration. The crisis has exposed a number of weaknesses in the operational as well as oversight spheres within the financial systems in the region, particularly in Thailand. The need for developing and strengthening alternative forms of financial intermediation is underscored by the maturity and currency mismatch problems that banks and Non-Bank Financial Institutions (NBFIs) in Thailand have been afflicted with in recent years. The alternative forms of intermediation have also been considerably weakened as a result of the decline in investor confidence in the creditworthiness of the entities that issue securities. As a reflection of this problem, the Thai SET index came to its lowest point in the last eight years at the end of 1997 and the domestic bond market has also slowed down considerably. Even prior to the crisis, liquidity has been constrained with a very small fraction of the population participating in the stock market, and now after the crisis it is likely to be further affected by the problems faced in the NBJ sector. This paper will address issues with regard to capital market reforms in Thailand, based on the recently approved ADB financial markets reform program loan and on the best practices for financial sector development as identified by IMF and G-10. Strengthening capital market institutions has a direct impact on enhancing competitiveness through providing alternative forms of long-term financial intermediation in place of traditional channels of funding that have led to currency and maturity mismatch problems in the recent crisis.

II. CAPITAL MARKETS IN THAILAND: A BRIEF BACKGROUND

A. Development Prior to the Crisis

Thai capital markets remained underdeveloped until the end of 1980s. At that time, commercial banks supplied most of the necessary funds to finance corporate growth. Since the early 1980s, the government has made an active effort to develop the bond market, but since 1988, demand for funds by the public sector has become minimal due to its budgetary surplus. In 1990, the government has started implementing a comprehensive liberalization and deregulation program on the financial sector. The liberalization of foreign exchange control took place in May 1990 when the government subscribed to Article VIII of the IMF status. Since the establishment of the Bangkok International Banking Facilities (BIBF) in August 1992, the private sector has dramatically increased its external borrowings.
Table 1 below presents three comparative indicators on financial sector development in Thailand and some other economies. While financial deepening and growth in market capitalization are comparable with that of the other economies, the absolute levels of equity and bond market capitalization are still low in Thailand, and market capitalization has declined significantly between 1995 and end-1997, from $141.5 billion (84 percent of GDP) to $23.5 billion (24 percent of GDP), due to capital outflow caused by the on-going financial crisis.

Table 1. Financial Market Development in Selected Asian Economies and the United States and Japan

<table>
<thead>
<tr>
<th>Economy</th>
<th>M2</th>
<th>Equities</th>
<th>Bonds</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1990</td>
<td>1996</td>
<td>1995</td>
</tr>
<tr>
<td>China, PR</td>
<td>79.2</td>
<td>66.23</td>
<td>22.9</td>
</tr>
<tr>
<td>Hong Kong, China</td>
<td>207.7</td>
<td>203.8</td>
<td>134.1</td>
</tr>
<tr>
<td>Indonesia</td>
<td>40.1</td>
<td>54.6</td>
<td>0.1</td>
</tr>
<tr>
<td>Republic of Korea</td>
<td>38.3</td>
<td>45.7</td>
<td>13.9</td>
</tr>
<tr>
<td>Malaysia</td>
<td>66.3</td>
<td>97.8</td>
<td>54.7</td>
</tr>
<tr>
<td>Philippines</td>
<td>34.1</td>
<td>54.0</td>
<td>6.6</td>
</tr>
<tr>
<td>Singapore</td>
<td>91.3</td>
<td>84.4</td>
<td>95.7</td>
</tr>
<tr>
<td>Taipei, China</td>
<td>144.7</td>
<td>181.5</td>
<td>19.1</td>
</tr>
<tr>
<td>Thailand</td>
<td>69.9</td>
<td>79.9</td>
<td>6.9</td>
</tr>
<tr>
<td>Japan</td>
<td>116.2</td>
<td>112.3</td>
<td>88.8</td>
</tr>
<tr>
<td>United States</td>
<td>68.2</td>
<td>59.5</td>
<td>63.2</td>
</tr>
</tbody>
</table>

Note: M2, Equities (Market Capitalization), and Bonds Outstanding as Percentage of GDP. Source: EDRC, Asian Development Bank, various issues.

With the new Securities and Exchange Act, the revision of the Companies Act in May 1992 and subsequent establishment of the Securities Exchange Commission (SEC), the development of capital markets has been accelerated. Simultaneously, a trading system, a settlement and clearing system and a central depository system were introduced, resulting in the development of a robust equity market. Meanwhile, the full liberalization of interest rates in June 1992 contributed to the development of the bond market. Thereafter, the private sector has been able to raise a substantial amount of funds from the equity and bond markets.

The main monetary instruments employed by the Bank of Thailand (BOT) prior to 1995 were (i) reserve requirements, (ii) liquidity requirements, and (iii) credit control. Rediscout facilities or open market operations were not often used by the BOT. With regard to the former, rediscout rates remained high to curb inflation, and the BOT extended credit against 90% of the assessed collateral. As for the open market operations, the depleting government securities - since 1990, the government stopped issuing new bonds due to the realization of consecutive budget surpluses - and a limited supply of eligible BOT or other securities, have acted as restraints on the use of this instrument. As a result, short-term interest rates have been determined in interbank markets, and long-term interest rates have been virtually non-existent.
B. Impact of the Crisis on Capital Markets

The Thai capital market has suffered seriously from the currency crisis. Before the crisis, trading at the equity market had been declining since the second half of 1996 due to the economic downturn and tight liquidity. When the crisis began, trading slowed down further. Similarly, the bond market was adversely affected by the increase in interest rates. The issuance of bonds increased by 75.8% in 1996, but its increase declined to 6.8% in 1997. In fact, the increase in 1996 and 1997 was due to a sharp increase in the BOT Bonds, the Financial Institutions Development Fund (FIDF) bonds and the Property Loan Management Organization (PLMO) bonds, the issuance of which was necessitated by banking and NBFI problems. With the reversal in capital flows following the crisis, the new bond issues have made the liquidity position extremely tight, causing additional distress to the banking and financial sectors. Corporate bonds have declined as well, from 36.2 billion baht in 1996 to 10.4 billion baht in 1997. The sudden change in the financial environment, in particular the decline in investor confidence, had an impact on the capital market and worsened its vulnerability during the crisis. The focus now should be on improving financial sector resilience and efficiency, particularly in equity and bond markets, and on strengthening the base of institutional investors in order to deepen the bond markets.

The following sections discuss in detail the market environment with regard to equities, bonds, derivatives, giving specific attention to institutional factors. Each section presents a brief analysis of the recent developments with a list of critical issues of relevance in the short-term as well as medium-term and some recommendations on how to deal with the issues.

III. STRENGTHENING THE EQUITY MARKET

The necessary basic framework for developing and regulating the equity market has been put in place with the establishment of the Thai SEC in 1992. Under this framework, SEC is in charge of the primary market, while SET and the Bangkok Stock Dealing Center (BSDC) are responsible for secondary markets, with the oversight authority vested in the SEC. With the basic framework established, there is now an urgent need to concentrate on the following short-term and medium-term issues to: (i) strengthen the regulatory framework and supervision; (ii) ensure adherence to prudential standards by stockbrokers; (iii) strengthen standards of disclosure; (iv) improve corporate governance by strengthening internal controls and defining rights and responsibilities of managers and directors. In addition, the Government should facilitate the expansion of the over-the-counter (OTC) market for small- and medium-sized firms, and privatization of state-owned enterprises in order to deepen the securities markets.

In the immediate future, there is a need to pay attention to the development of secondary market activity, which has declined drastically since the onset of the crisis. Another issue has to do with the burden placed on many stockbrokers by the non-performing margin loans that led to the permanent closure of 56 finance companies, many of which had stockbroking firms, in December 1997. The government has recently announced that the government securities held by these closed companies will be auctioned off. However, the securities licenses held by these companies will not be sold in order to ease the competitive pressure on the already struggling securities industry.
A. Recommendations for Strengthening the Equity Market

1) Strengthening Prudential Regulation and Investor Protection

- The collapse of the finance companies and joint finance/securities companies suggests the need for strengthening prudential regulation by the SEC and BOT over NBFLs. Although the SEC enjoys a significant amount of independence and autonomy in its operations, a certain amount of political pressure has been imposed on the SEC during its investigation of insider trading charges. To ensure independence and autonomy of the SEC, the licensing authority of capital market institutions will be transferred from MOF to SEC and the number of full-time SEC commissioners will increase. The SEC Chairman will be a non-politician and private sector representatives will be appointed as SEC commissioners.

- With regard to licensing of different types of securities businesses, the current system of shared responsibility between the SEC and the BOT creates unnecessary complications. The existence of finance and securities companies which are subject to regulatory oversight of both these agencies obscures the final responsibility of the two market regulators.

- The concept of self-regulation is yet to be clearly defined for better coordination between the SEC and the SET and BSDC. There is a need for strict enforcement of self-regulation by the latter two institutions over their respective member companies. Market surveillance and investor protection are two major areas which are yet to be strengthened to improve market confidence.

2) Strengthening Equity Market Infrastructure

- As Thai investors have experienced an unprecedented downturn and extreme volatility in the equity market, the need to strengthen equity market infrastructure becomes critically important in a number of areas, including securities borrowing and lending (SBL), capital adequacy of SET-member firms, streamlining of licensing for securities businesses, market transparency and surveillance systems, risk management systems, and daily price limits.

- A legal framework is being formulated for short-selling in Thailand, while margin purchase is allowed already now. In the absence of equity index derivative instruments (such as index futures and options) and short-selling mechanisms, local institutional investors do not have appropriate hedging tools for their equity investments when the market experiences a declining trend as in recent months. It is essential to make SBL operational as soon as possible to allow for short-selling.

- With almost one half of SET members’ operations suspended, the capital adequacy of securities companies emerges as an important policy issue for the SEC as well as the SET as a self-regulatory organization. Many SET member firms suffer from nonperforming margin loans. During the drastic market decline following the onset of the financial crisis, maintenance margins and margin calls were not properly enforced. The supervisory function of the SEC and the monitoring function of the SET over the securities companies’ margin loan activities appear to be very inadequate, and there is an urgent need to strengthen the surveillance system in this respect.

- Risk management in extremely volatile environments will be another key issue to focus on at present. The overall risk management associated with clearing and settlement built around the Thailand Securities Depository Company (a subsidiary of the SET) must be carefully examined to ascertain its adequacy in coping with extreme market volatility. The SET recently introduced a new set of circuit breaker mechanisms to contain extreme price
volatility. The impact of these mechanisms must be carefully studied using the SET intraday transaction data.

3) **Strengthening Disclosure Standards**

- There is a need to strengthen accounting, auditing and disclosure standards. Although in principle, all business entities are required by the Institute of Certified Accountants and Auditors to adhere to the Generally Accepted Accounting Principles, it is essential in practice for the supervisory and regulatory authorities to pay attention to laxities and loopholes in the accounting and auditing systems. Strengthening internal controls and corporate governance will be another important challenge facing the regulatory authorities. Disclosure of ownership is a good example. At present, ownership of listed companies is not fully disclosed in Thailand as several large family business groups own shares through various private companies. This practice is observed in several listed commercial banks as well, and increases inter-connected lending despite the existence of prudential standards limiting the same.

4) **Expansion of the Over-the-Counter (OTC) Securities Market**

- With the current liquidity crisis in the Thai financial system, small and medium-sized firms have suffered most. Since these firms are major contributors to Thai export activities, it is critically important for them to have ready access to capital markets to raise funds. Recognizing the importance of this issue, the Thai government Action Plan for Fiscal and Monetary Policies (1997-1998) has called for the listing of small and medium-sized firms on the BSIDC.

- According to the Ministry of Commerce statistics, a total of 181,729 companies were registered at the end of 1995, 457 of which are listed on the SET and three of which are listed on the BSIDC at present. The BSIDC suggests that at least 3,000 companies are qualified to be listed on the BSIDC, and half of them could be listed immediately. Capital gains tax treatment represents the single most critical impediment to the growth of the BSIDC. Currently, BSIDC-listed stocks are not exempt from capital gains taxes while the SET-listed stocks enjoy the benefits of tax exemption. Also, there is no tax incentive provided to listed companies either on the SET or the BSIDC. This policy with regard to capital gains tax exemption for BSIDC listings needs to be reviewed. The government should also undertake a comprehensive study on the OTC market development program.

5) **Privatization and Listing of Government-owned Enterprises**

- Privatization is one of the medium-term policy measures recommended by the IMF to improve the Thai government's fiscal balance. Also, the depth of the Thai equity market can be improved by the privatization of government-owned entities and their eventual listing on the Stock Exchange of Thailand (SET). The listing of a number of blue-chip companies is expected to stabilize the local market and reduce market volatility. Privatization could also improve operational efficiency of the respective entities. According to the Thai Ministry of Finance (MOF), the privatization program will be implemented over a three-year period. In view of this timetable, it is essential to enhance the capacity of the Comptroller

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41 At present, there are 66 government-owned entities. These entities are classified into three categories: (i) entities to be fully privatized, (ii) entities to be partially privatized, and (iii) entities to be liquidated or sold to private sectors. Expected privatization revenues amount to B 50.18 billion (or US$ 1.43 billion) for the first category entities and B 842.55 billion (or US$ 24.07 billion) for the second category entities. Accurate statistical information is not available from the Thai MOF for the last category entities.
General’s Office in reviewing the privatization project proposals before they are forwarded to the Privatization Policy Commission.

IV. **STRENGTHENING BOND AND DERIVATIVES MARKETS & PROMOTING THE ROLE OF INSTITUTIONAL INVESTORS**

As the bond market is an interest-oriented market, a risk-free benchmark yield curve is critically important. The government is now seriously considering the issuance of government bonds for providing such a yield curve. It should also focus on: (i) developing bond market infrastructure; (ii) promoting securitization, in particular of developing mortgage-backed securities (MBS); and (iii) reviewing private placement and rating requirements. The development of an MBS market will play a significant role in the banking industry. As commercial banks are suffering from a maturity mismatch and tight liquidity, sale of mortgage loans to the Secondary Mortgage Corporation or a special purpose vehicle will help solve these constraints.

While the government has taken various steps in developing the capital market, there is still not more than a handful of institutional investors. For the government to be successful in developing and deepening bond markets, it is essential to have a broad investors’ base. For this reason, it has introduced some contractual savings schemes. It is also essential that an appropriate supervisory and regulatory framework for the pension funds and provident funds is put in place.

A. **Recommendations for Strengthening the Bond Market**

1) **Establishing a Yield Curve**

   - The most critical impediment to the development of a deep and liquid bond market has been the lack of a risk-free benchmark yield curve to facilitate bond pricing. The government has not issued bonds, since it has maintained a budget surplus. In the post-crisis environment, it is expected that the government will have to run budget deficits, at least temporarily. Historically, government bond issues have not followed market conditions, as bonds were placed with “captive” investors that were required to hold such instruments under statutory reserve requirements. If the government does not repeal such restrictions on institutional investors and others, then any efforts to establish a benchmark yield curve will be futile. Thus, it is recommended that a government borrowing program is established along with the continued issuance of government-guaranteed state enterprise bonds. Such a measure would have to be preceded by a thorough review of the objectives of issuing such bonds, that is, reviewing the government’s fiscal management and the appropriateness of the expenditures to be financed by bond issues. The terms should be market-oriented and the borrowing program should aim at establishing a yield curve by offering a range of maturities on a regular and consistent basis.

2) **Improving Primary and Secondary Market Activity**

   - The Thai corporate bond market has witnessed a number of positive developments in recent years, including: (i) the relaxation by the Thai SEC of statutory

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42 Under the recently approved Financial Sector Reform Program Loan of the ADB, the Government has committed itself to establishing a program and timetable for the issuance of long-term Government bonds to develop a market for long-term securities.
limitations imposed on the issue of corporate bonds and debentures; (ii) the creation of a bond rating agency, the Thai Rating and Information Services (TRIS) in 1993; and (iii) the opening of secondary bond market in 1994 through the establishment of the BSDDC. However, due to the recent financial crisis in Thailand, both primary and secondary markets have experienced a significant setback. In 1997 new issues in the primary bond market in Thailand were limited to Bank of Thailand (BOT) bonds, state enterprise bonds, FIDF bonds, and PLMO bonds. Only a small portion of the BOT and FIDF bonds have maturities longer than one-year, while new issues of corporate instruments have been severely limited in 1997. The PLMO effectively stopped issuing new bonds due to the lack of demand even though the PLMO bonds are guaranteed by the BOT.

- To promote long-term primary and secondary markets, a comprehensive review of legal and institutional constraints and market infrastructure must be conducted. The following areas need to be studied: (i) tax treatment of interest income and capital gains related to bond investment, (ii) introduction of write full word (SBL) in the secondary market trading, (iii) mandatory bond rating schemes, (iv) launching of mortgage-backed securities, (v) creation of a repurchase market for corporate bonds, (vi) an enhanced role for contractual savings institutes, (vii) upgrading of the current clearing and settlement systems for bond instruments, and (viii) regional cooperation among organized bond exchanges.

3) **Promoting the Role of Credit Rating Services**

- At present, TRIS, being the sole credit rating agency (CRA), is vested with monopoly power over issuers. It is essential to encourage competition in this sector. However, before doing so, the regulatory framework with regard to credit ratings needs to be strengthened. The SEC Act, which requires debentures offered to the public to be rated by a CRA, exempts those issuers who sell debentures to specific groups from this requirement. Private placements, defined as issues sold to a limited number of investors (not exceeding 35) or to special groups, such as the BOT, commercial banks or finance companies, are exempted from the mandatory requirement for rating. However many of these private placements are eventually sold to the public at large. Such practice constitutes a violation of the spirit of the regulation, and it is essential to solve this problem for practices in this market to be in line with standard practices in comparable markets.

4) **Promoting Asset Securitization**

- In recognition of the limited supply of high quality debt instruments in primary markets and severe liquidity problems in secondary markets in the Asian and Pacific Region, asset securitization is one of major initiatives approved by the Fourth Asia-Pacific Economic Cooperation Finance Ministers Meeting in April 1997. The Thai government is creating the legal framework for asset securitization, in particular for MBS. The Securitization Act and the Secondary Mortgage Company Act were passed by the Thai Legislature on 28 June 1997, and the Secondary Mortgage Corporation (SMC) was established in January 1998, with the initial capital of one billion baht fully paid-in by the Bank of Thailand. There is a need to strengthen the capacity of SMC both in terms of credit enhancement and human resources.

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43 The ADB has been reinforcing its catalytic role in developing domestic bond markets as an effective vehicle for savings mobilization in its developing member countries (DMCs) to meet financing needs for massive infrastructure projects.
B. Recommendations for Developing a Derivatives Market

- The Thai SEC has taken the initiative to create a financial derivatives market. In preparation for the establishment of a derivatives exchange, the SEC has allowed derivatives business to be conducted on OTC-basis as an effort to estimate the local demand for derivative products. The draft Derivative Market Act, which was submitted to the MOF in May 1997, stipulates that: (i) securities companies will be allowed to execute OTC derivative contracts; (ii) the underlying products will initially be equity indexes, interest rate...