

MOODY'S

INVESTORS SERVICE

BANKING SYSTEM OUTLOOK

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Thailand

Our outlook on Thailand's banking system remains stable¹. The outlook expresses our expectations for the fundamental credit conditions in this system over the next 12-18 months.

Summary Opinion

Our outlook for Thailand's banking system is stable, as it has been since October 2010. In coming to a stable outlook, we weighed the impact of the difficult operating environment -- resulting from the recent floods -- against the broadly more positive fundamentals in the economy and banking system.

The floods will have a significant negative impact on the economy over the initial period of our outlook. The latest estimates of flood-related damage have reached as high as 2.3 percentage points of GDP. We also take into consideration the absence of a robust global recovery and assume that the combined effect of these difficult conditions will lead to asset quality deterioration and higher non-performing loans (NPLs) formation in the coming six months, particularly in the agriculture, automobile and electronics sectors.

Nonetheless, we expect the impact from these negative developments to be temporary, and more importantly, without a lasting impact on Thai banks' credit standing.

Our outlook testifies to the strengths of the banks – including their strong capitalization and profit-generating capability – that will help the industry weather the current difficult period, and may even open up opportunities to grow earnings and profitability towards the second half of our 12-18-month horizon.

Our relative optimism, despite current circumstances, is based on three broad considerations.

First, there are strong economic and banking sector fundamentals. From a macro-perspective, while Thailand's trade-dependent economy will continue to face downside risks, posed by the demand weakness from the developed world, we now expect GDP growth to rebound to 4% in 2012 from a flood-hit 1.5% in 2011. Also, we anticipate loan growth to be sustained at an annualized pace of 5%-10% for the coming 12 to 18 months. This will be underpinned by reconstruction as well as calls for better infrastructure (e.g. drainage) following the floods.

¹ Outlooks for industries or sectors present Moody's view on the likely future direction of credit conditions in that sector. They do not represent our projection of rating upgrades versus downgrades.

Second, there is the issue of scale. Despite frequently-reported images of inundated rice fields and city streets, the direct impact of the floods on bank balance sheets is not major. We note that the banking system has an exposure of THB121 billion to firms in the directly-affected areas, and this figure represents just 1.5% of the total outstanding loans in the system. The Thai economy has been resilient to disruptions from multiple political incidents over the years.

Third, there are mitigating measures. Current events will pave the way for the new Pheu Thai Party-led government to push forward its spending policies, as well as more emergency assistance measures and flood rehabilitation packages. Furthermore, recent disasters also bias the Bank of Thailand (BoT) towards a more accommodative monetary stance – through signaled rate cuts -- to support private sector demands in 2012. This is notwithstanding our reservations towards some of the BoT's forbearance measures, which we think could lead to a wider discrepancy between reported NPLs and economic NPLs over the horizon of this outlook.

On balance, we thus expect a pickup in loan growth after an initial drop in lending, driven by stronger performances in the construction and infrastructure sectors. Nevertheless, under these circumstances, banks are likely to see some volatility in their asset quality, and which may test their capital positions. We assessed the probable outcomes in our scenario analysis.

Our initial estimates, based on information received from major Thai commercial banks, suggest that up to 1% of their outstanding loans would be directly affected, and another 5%-8% indirectly affected. There will likely be asset quality deteriorations and higher NPL formation in the coming six months as a result of flood-related disruptions and damages. However, we do not expect this will materially negate the improving asset quality trend of recent years.

Most importantly, we see Thai banks' current capitalization and profitability levels as strong enough to absorb potential credit losses, and maintain the trust of creditors. As at end-1H2011, Thai banks boasted an average Tier I ratio of 11.3%, well above the 4.25% threshold set by BoT. Our analysis shows that a jump in NPLs to 10% of total loans would reduce the Tier I ratio by up to 4.8 percentage points, but which would still leave capital levels well above the regulatory minimum, testifying to the system's high level of loss-absorption capacity.

Incidentally, all Thai commercial banks are currently operating under Basel II requirements. But while there is no timetable for Basel III implementation yet, we consider the banks as well-placed to adopt Basel III requirements in view of the quality of their core capital.

Also, we expect that most banks in Thailand will see pressure on their earnings for at least the next six months due to higher provisioning as well as repair costs to ATMs and other premises. Yet we expect the system to continue to display healthy profit-generating capabilities, driven by interest income, but also augmented by growing non-interest sources, with pre-provision earnings to average asset to reach 2.8% in 2011 and around 3.0% in 2012.

Having said that, we are aware of some areas of potential weakness that pose downside risks to our assessment. Worsening liquidity and structurally high single-party exposures are two concerns that counter our benign view on Thai banks' capital and profitability profiles.

Strong credit growth pushed loan-to-deposit ratios to near 105% at the end of June 2011, up from 100% at end-2010. At this point, liquid assets still amount to 28% of total assets, a level that compares well to their regional peers. However, we note that the Thai banks have started to turn to more

expensive and confidence-sensitive funding avenues to support credit growth, and which could become a risk factor if these methods of funding become a permanent feature of the system. During the timing horizon of our outlook, however, this risk remains low as customer deposits still constitute 80%-90% of banks' total funding.

Regarding single-party exposures, the system's top 20 loans amount to between 100% and 200% of its Tier I capital. We expect this level of concentration to remain unchanged, despite the floods, and as it has been over the past five years. But, in the longer term, it still raises concerns that micro-level shocks within a few commercial entities or industries may have an outsized impact on the banks' overall loan portfolio performance.

The banking system's stable outlook is in line with (i) the stable outlook on the standalone ratings of most of our rated Thai banks, and (ii) the stable outlook on their long-term local and foreign currency deposit ratings. The outlook on Thailand's government bond rating of Baa1 is also stable.

Definition of Outlook

Banking system outlook publications represent our view on the broad operating environment in which banks of a given system operate and, more specifically, on the influence that macroeconomic, competitive, and regulatory trends may have on banks' asset quality and capital and, ultimately, on their funding and profitability.

As such, a "stable" outlook is one that implies an environment that favours sustainable profitability and limited volatility for a period of at least four to six quarters (i.e., for the time horizon of our outlooks). A "negative" outlook is one that is characterized by volatility and uncertain conditions. A "positive" outlook is one in which we expect banks to rest on solid ground for the duration of our time horizon and in which we expect banks to grow steadily as a result of a favourable environment during that period. Outlooks for industries or sectors do not represent our projection of rating upgrades or rating downgrades.

Rating Universe

- » We rate 10 banks in Thailand, including 8 commercial banks and 2 policy banks. The 8 commercial banks accounted for approximately 87% of Thai commercial banking system assets at end-2010. The other 2 banks – EXIMT and GHB – are specialized financial institutions and policy banks, with 100% government ownership. Please refer to Figure 1.
- » Their asset-weighted average long-term bank deposit rating is Baa1, while their asset-weighted average BFSR is D+, reflecting two notches of uplift due to our assumptions about external support.

FIGURE 1

Ratings Universe

Rated Thai Banks	Total Assets (THB Bn)	Market Share by Assets end 2010 (1)	Standalone Credit Strength and Outlook (2)	Foreign Currency Long-term Bank Deposit/(Issuer) Rating and Outlook	Notches of Uplift from Parental Support	Notches of Uplift from Systemic Support
Bangkok Bank PCL (BBL)	1,950	14.4%	C- / Baa2 ; Stable	Baa1 / P-2 ; Stable	0	1
Krung Thai Bank PCL (KTB)	1,762	13.1%	D- / Ba3 ; Positive	Baa1 / P-2 ; Negative	0	5
Kasikornbank PCL (KBank)	1,552	11.5%	D+ / Baa3 ; Stable	Baa1 / P-2 ; Stable	0	2
Siam Commercial Bank PCL (SCB)	1,477	10.9%	C- / Baa2 ; Stable	Baa1 / P-2 ; Stable	0	1
Bank of Ayudhya PCL (BAY)	870	6.4%	D+ / Ba1 ; Stable	Baa2 / P-2 ; Stable	0	2
Government Housing Bank of Thailand (GHB)	679	5.0%	E+ / B1 ; Stable	Baa1 / P-2 ; Stable	0	6
TMB Bank PCL (TMB)	590	4.4%	D- / Ba3 ; Stable	Baa3 / P-3 ; Stable	0	3
United Overseas Bank (Thai) PCL (UOBT)	248	1.8%	D / Ba2 ; Stable	Baa1 / P-2 ; Stable	4	0
Standard Chartered Bank (Thai) PCL (SCBT)	281	2.1%	D+ / Baa3 ; Stable	Baa1 / P-2 ; Stable	2	0
Export-Import Bank of Thailand (EXIMT) (3)	68	0.5%	-	(Baa1); Stable	-	-

Notes: (1) Market share is based on the sum of (a) Thai Commercial Banks registered in Thailand (exclude branch offices abroad), and (b) Depository Specialized Financial institutions comprising Government Savings Bank, Government Housing Bank, Bank For Agriculture And Agricultural Cooperatives, Export-Import Bank of Thailand, Small And Medium Enterprise Development Bank of Thailand and Islamic Bank of Thailand; (2) Bank Financial Strength (BFSR) ratings express a bank's standalone credit strength on a scale from A to E, without taking support considerations into account. Foreign currency (FC) Long-Term (LT) Bank Deposit Ratings reflect both a bank's stand-alone credit strength, support considerations and the country ceiling of Baa1; (3) EXIMT has a foreign currency issuer rating of Baa1 with a stable outlook. The principal methodology used in rating EXIMT, a government-related issuer ("GRI") and a government-controlled financial company with specific policy mandates, is "The Application of Joint-Default Analysis to Government Related Issuers".

Source: Company data and Bank of Thailand

Key Developments since Last Banking System Outlook

- » The economy suffered a worse-than-expected slowdown in 2011 due to general weakness in the global economy plus disruptions associated with the March 11 earthquake in Japan and more currently the escalation of the floods crisis at home. The latest estimates of flood-related damage have reached as high as 2.3 percentage points of GDP.
- » The National Economic and Social Development Board, which compiles Thailand's GDP data, expects the Thai economy to grow by 1.5% in 2011 and between 4.5% to 5.5% in 2012. Separately, the central bank also shifted away from its hawkish bias in its latest October monetary policy action, which saw it keep its policy rate at 3.5%, after seven consecutive 25-bps hikes since its December 2010 policy meeting. This is despite the fact that core inflation, at 2.9% in October 2011, remains at the high end of the BoT's target of 0.5%-3%.
- » The country's new Pheu Thai Party-led government took office in August 2011, and has since mooted a number of policy reforms. The floods will lend further support to its expansionary fiscal agenda.

- » At the end of 2010 and through 1H 2011, the BoT took steps to restructure and reduce the fees that Thai banks charge for various types of transactions. The overall objective of the BoT was to protect consumers from being charged unfairly high fees that result from a lack of domestic competition. The impact of the revamp has so far been muted.
- » Implementation of Deposit Protection Agency Act continues. The full deposit guarantee expired on 10 August 2011 and was replaced by a limited THB50million per account coverage until 10 August 2012. Thereafter, coverage will be further curtailed to THB1million per account.

Key Drivers

Strengths

- » Stable asset quality, driven by moderate loan growth in recent years and the industry's strong recovery record on problem loans.
- » Good capitalization buffers with most banks having sufficient capital to absorb losses expected under our base-case scenario.
- » Robust earnings-generating capabilities, supported by healthy interest margins, as well as banks' efforts to grow non-interest income sources such as fees and services, and bancassurance.

Weaknesses

- » Weakening liquidity positions as a result of higher loan growth and intense competition in the deposit market.
- » Credit risk remains high due to elevated single-party exposures, which raises concerns over the vulnerability of loan portfolios to the defaults of large borrowers, or to cyclical movements in certain industries.

Uncertainties

- » Uncertain state of the global recovery, which could directly impact Thailand's trade-dependent economy.
- » It remains to be seen whether the new government can bring lasting stabilization to the political environment, with recent criticism of its handling of the floods constituting a warning of the potential risks. The government's expansionary fiscal stance is another potential risk factor.

Key System Performance Measures

Operating Environment

ECONOMIC GROWTH, DRIVEN BY INCREASED GOVERNMENT SPENDING AND DOMESTIC DEMAND, WILL SUPPORT BANK LENDING AND REVENUE GROWTH

- » Our sovereign team estimates Thailand's real GDP growth to be 1.5% in 2011 and 4.0% in 2012. Growth in 2011 was weakened by the worsening in the European crisis and the disruptions from the floods.
- » Economic growth in 2012 will likely be driven by an increase in domestic investment, and accelerated government spending. While reconstruction will be a key theme, we also expect increased support from both monetary and fiscal policies. Against this backdrop, we expect bank lending to expand by 5%-10% in nominal annualized terms over the next 12-18 months.
- » Inflation continues to be at the high end of the central bank's target 0.5%-3% range, yet the floods may have softened its stance on monetary policy. The BoT had increased its policy rate from a record low of 1.25% to the current 3.5% through nine 25-bps hikes since July 2010, but decided to pause at its October 2011 meeting in view of the floods. We expect inflation to be around 3.6% for 2011 and 3.0% for 2012, compared to 3.0% in 2010.
- » The new government has shown an expansionary bias through fiscal policy initiatives. It has promised tax incentives for first-time home buyers and corporate tax reductions. While these steps may help to stimulate growth, they also raise the risk of a persistent fiscal deficit. Also, some of the proposed measures, like increased rice prices for farmers and higher minimum wages for civil servants, are likely to fuel cost pressures.
- » Total credit to GDP contracted sharply after the Asian financial crisis in 1997, and has been around 100% for the past decade, as illustrated in Figure 2. Such stability supports our assessment that there is no recent evidence of any credit bubble in Thailand. We believe that coming reconstruction demands, plus the pro-growth bias in both monetary and fiscal policies, will support bank lending growth at annualised 5%-10%, thus keeping pace with nominal GDP growth. We expect loan growth to span both the corporate and consumer sectors.

FIGURE 2

Credit/GDP has remained constant in last decade



Source: Bank of Thailand, IMF

Competitive Environment

- » The big four banks – Bangkok Bank, Krung Thai Bank, Kasikornbank and Siam Commercial Bank – still account for almost 60% of system assets, and continue to enjoy strong universal banking franchises. We see no material change in these broad parameters in the competitive landscape in the next 12-18 months.
- » However, amid an environment of tightening liquidity, we expect the banks to see stronger pressure to devise new products to attract and maintain customer deposits.
- » The BoT has over the past year tried to revamp the banks' fee structure – due to the lack of competition in the banking system -- where fees are considered too high, but the results have so far been muted. In the aftermath of the floods, many banks have heeded the central bank's call for relief and temporarily waived fees – a gesture that could push back the need for the BoT to push out other measures in this area.
- » Thailand's ongoing implementation of its Deposit Protection Agency Act could change the country's financial landscape, but we believe the impact will be gradual with no abrupt deposit migration.
- » 2011 saw the completion of the merger between Thanachart Bank (unrated) and Siam City Bank (ratings of Baa2 stable; D-/Ba2 stable have been withdrawn). We view large-scale consolidation, either domestic or overseas, to be unlikely in the coming 12-18 months, as we expect global financial uncertainty to remain and to force banks to focus on organic growth.

Systemic Support

- » We assess Thailand as a high-support environment, as no bank has been allowed to fail on its obligations, at least in the previous three decades. The central bank's resolve to support the system is also evident from the massive liquidity support, measured in trillions of THB, that it provided to financial institutions in the aftermath of the Asian financial crisis.
- » The government has the resources, and has demonstrated its willingness, to extend support to the banking sector, as needed (systemic support uplift reflected in our senior ratings for Thai banks).
- » The authorities' capacity to support the system is based on (i) the government's financial strength, underpinned by a low debt-to-GDP ratio of around 30% at end-2010; and (ii) the country's flexible exchange rate regime, which allows the central bank full monetary autonomy.
- » Separately, prior to the Deposit Protection Agency Act – implemented in August 2008 -- the deposits of commercial banks were 100% protected by the government, in case a bank's license was cancelled, or if the bank went bankrupt. From August 2012, this protection will decrease to THB 1 million per person per bank, from the current THB 50 million. State-owned Specialized Financial Institutions (SFIs), such as GHB (Baa1 stable; E+/B1 stable), do not come under the Act. The phasing out of the Deposit Protection Agency Act may imply a gradual reduction in systemic support towards the end of our outlook.

Asset Quality and Capital

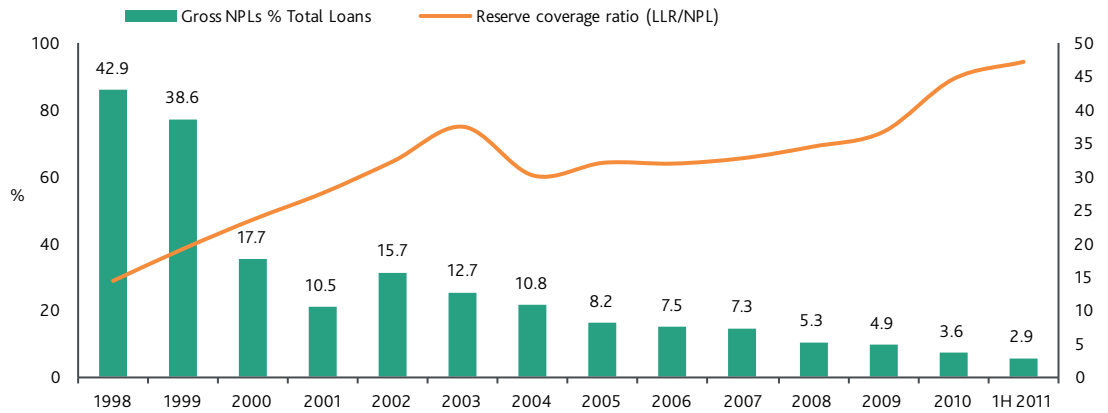
Asset quality

Asset quality indicators have improved, though the floods may prompt a temporary deterioration

- » Asset quality has improved in recent years, driven by credit growth (the denominator effect), recoveries on problem loans exceeding allocated provisions, and a low new NPL formation rate.
- » Data received from the BoT up to end-June 2011 indicates that asset quality has improved across the commercial banking industry, as illustrated in Figures 3 and 4. NPL ratios fell to 3.3% at end-June 2011 from 3.9% at end-2010 and 5.3% at end-2009. In addition, new NPL formation rates have remained low at under 0.5%, thanks to banks' stringent underwriting practices and central bank incentives that encourage prompt NPL write-offs.
- » For the coming six months at least, we expect NPLs to rise as disruptions from the floods have led many commercial and industrial borrowers to delay debt servicing. While no government data has been published, initial estimates from the major Thai commercial banks suggest that up to 1% of their outstanding loans would be directly affected, and another 5%-8% indirectly affected.
- » Also, the BoT has requested that banks assist affected customers through measures such as principal and interest grace periods, and tenor extensions, lower instalments, reconstruction financing, and selected fee and charge waivers. The BoT has also indicated that it will not classify flood-hit accounts as impaired for one year. This signals a higher level of policymaker forbearance, and which could lead to reported NPLs coming below economic NPLs in 2012.
- » Nevertheless, we expect this flood-related deterioration in asset quality to be temporary. Our stable outlook is underpinned by our view that the banking system remains capable of managing, through more stringent underwriting standards, coming incremental losses without compromising its capitalization.
- » While it is an imperfect proxy (since no long-term damage to property resulted), Thai banks' asset quality demonstrated resilience to temporary disruptions to production and transportation facilities during several political events from 2006 to 2010.
- » The government has approved several emergency assistance measures, such as a THB325 billion flood rehabilitation package announced in October, that we believe will mitigate pressure on asset quality.
- » In addition, Thailand's loan growth has been tepid in recent years, with credit relative to GDP displaying none of the strong rises seen in the years preceding the 1997 Asian crisis. This situation helps to isolate Thailand from those of its neighbours subject to rising concerns over credit-driven asset bubbles.
- » Partly offsetting these positive factors, credit risk remains vulnerable to elevated single-party exposures. The system's top 20 loans amount to between 100% and 200% of its Tier I capital. This level of concentration raises concerns that micro-level shocks within a few commercial entities or industries may have an outsized impact on banks' overall loan portfolio performance.

FIGURE 3

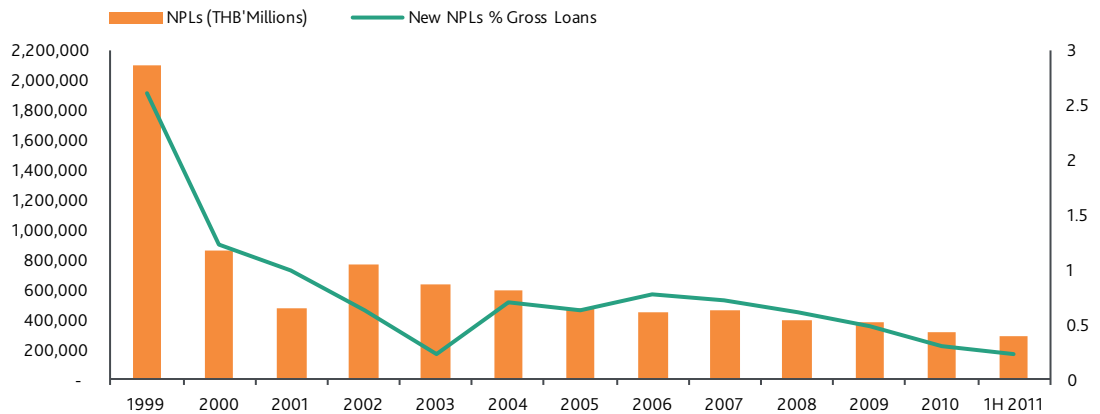
Asset Quality Indicators for the Thai Banking Industry



Source: Bank of Thailand

FIGURE 4

NPL Trends for the Thai Banking Industry



Source: Bank of Thailand

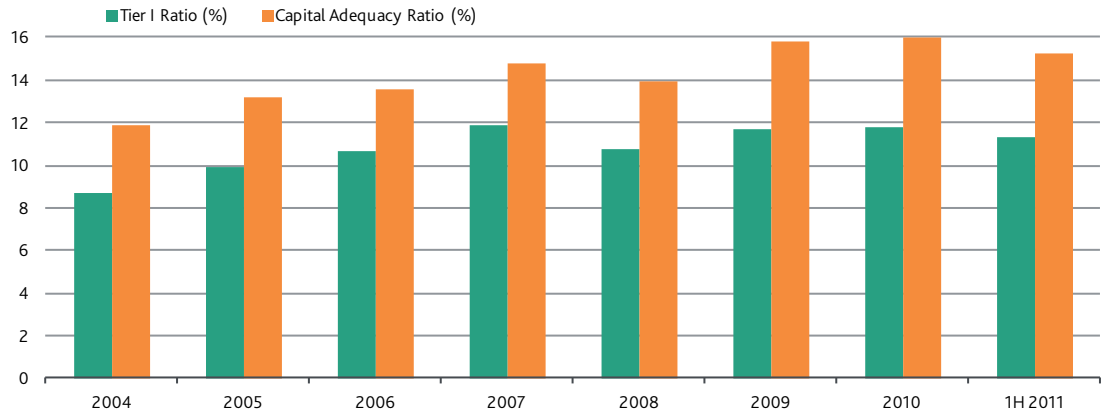
Capital

Bank capitalization is sufficient to absorb expected losses and support future growth

- » The system capitalization level is comfortable. As at end-1H2011, Thai banks boasted an average Tier I ratio of 11% and total capital adequacy ratio (CAR) of 15% (Figure 5), the former well above the 4.25% threshold set by BoT.
- » For 2012, we expect system capitalization to remain broadly at current levels, as the banks continue to generate enough earnings to keep internal capital steady.
- » All Thai commercial banks meet Basel II requirements. There is no timetable for Basel III implementation yet, even though we consider that the banks are well-placed to adopt Basel III requirements in view of their sufficient capital buffers.
- » The current capitalization level ranks Thai banks as average among Asian economies, below the advanced economies of Hong Kong and Singapore but ahead of the Philippines and India (see

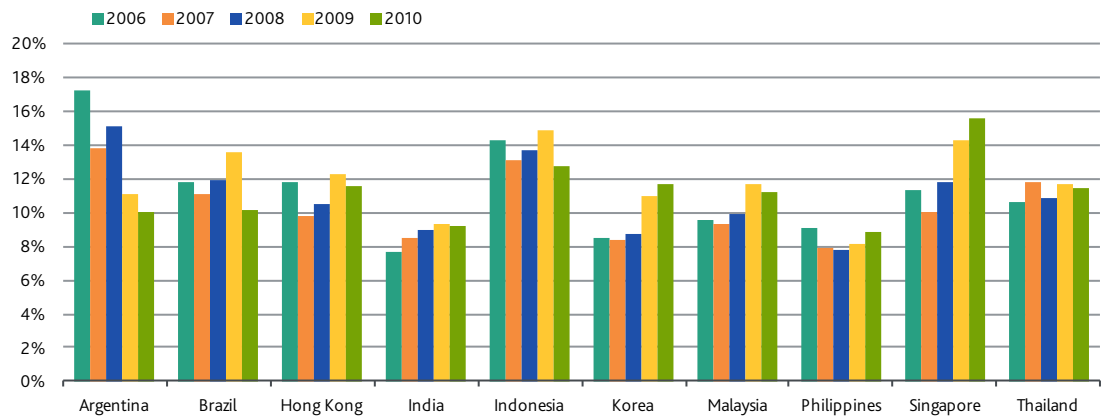
Figure 6). Current capitalization is also slightly ahead of major non-Asia emerging markets like Argentina and Brazil, both with lower credit-to-GDP, but higher GDP per capita than Thailand.

FIGURE 5
Capital Adequacy for the Thai Banking Industry



Source: Bank of Thailand

FIGURE 6
Average Tier I Ratios – Comparison with Emerging and Regional Markets



Source: Moody's Banking Financial Metrics

FIGURE 7

Rated Thai Commercial Banks: Scenario Analysis -- NPL Ratios Rise to 10%

All figures in THB million	BBL	KTB	KBank	SCB	BAY	TMB	UOBT	SCBT
Tier 1: end-2011 estimated (including 100% of 2010 PPP)	209,884	142,267	143,073	161,215	103,230	49,665	29,517	34,685
Loan loss reserves in 2010	72,452	45,126	36,832	41,595	33,953	20,546	6,147	3,262
Capital + Provisions (A)	282,336	187,393	179,904	202,810	137,183	70,211	35,664	37,947
Gross loans: end-2011 estimated -- 10% loan growth	1,384,677	1,376,975	1,189,023	1,166,438	715,753	400,115	179,476	106,424
NPLs: end-2011 estimate -- 10% NPL ratio	138,468	137,697	118,902	116,644	71,575	40,012	17,948	10,642
70% loan loss reserve coverage of NPLs	96,927	96,388	83,232	81,651	50,103	28,008	12,563	7,450
1% general provision on performing loans	12,462	12,393	10,701	10,498	6,442	3,601	1,615	958
Potential loss (B)	109,390	108,781	93,933	92,149	56,544	31,609	14,179	8,408
Tier 1: end 2011 estimated -- (A)-(B)	172,947	78,612	85,971	110,661	80,639	38,602	21,485	29,539
RWA: end-2011 estimated -- 10% credit growth	1,471,907	1,293,814	1,239,311	1,160,498	757,451	439,445	165,056	212,317
Tier 1 ratio: end 2011 estimated	11.7%	6.1%	6.9%	9.5%	10.6%	8.8%	13.0%	13.9%
Tier 1 ratio (%): end 2010	12.51	9.90	9.37	11.60	11.50	11.30	17.80	15.10

Source: Audited Financial Statements of Thai Banks, Moody's assumptions

- » In our scenario analysis, where the NPL ratio rises to 10% of total loans, the estimated Tier I ratio falls by up to 4.8 percentage points (see Figure 7). We have made the following assumptions: (i) 10% loan growth in 2011 from 2010, (ii) 2011 pre-provision profits (PPP) at 100% of 2010 level, taking into account higher loan growth, but also higher funding costs, (iii) 70% loan loss reserve coverage for NPLs, and (iv) an additional 1% general provision for performing loans.
- » Even under this extreme distressed scenario, our results still show Thai bank capitalization with a high level of loss absorption capacity.

Funding and Liquidity

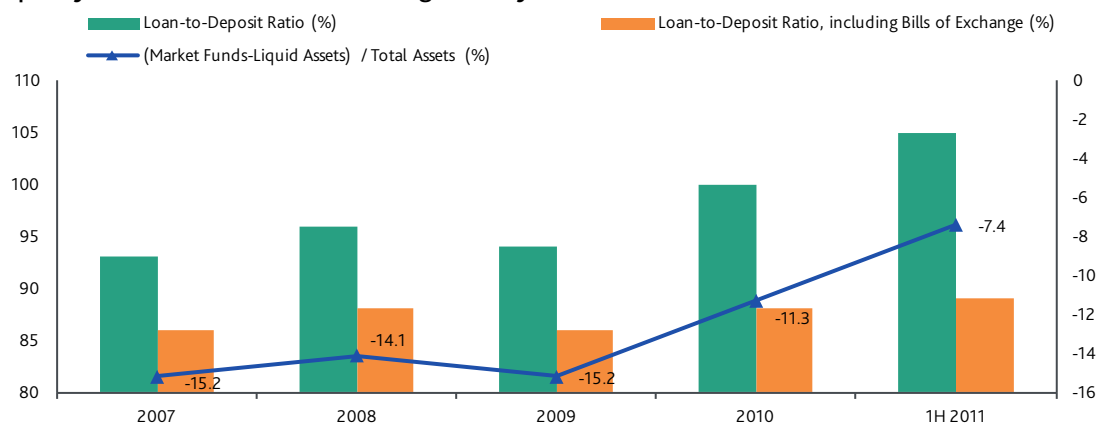
Liquidity to weaken; banks turning to more expensive funding sources

- » Over the next 12-18 months, we expect bank liquidity to tighten, with deposit growth to come below loan growth of 5%-10%.
- » For the six months to end-June 2011, loan growth of 7.1% outpaced deposit growth of 1.7%. This resulted in a jump in the loan-to-customer deposit ratio to 105%, as illustrated in Figure 8.

- » Retail deposits account for 85% of customer deposits and are a major funding source. Most of the banks' short-term deposits are sticky and typically roll over, assuring them a relatively cheap and stable source of funding.
- » Thai banks also maintain solid levels of liquid assets in their books, which provide them with a large cushion to cover short-term liabilities. These liquid assets – which comprise cash, placements with banks, certificates of deposits and other liquid assets – accounted for approximately 28% of total assets at end-June 2011, compared with a low of 16% during the Asian crisis year of 1997.
- » Nonetheless, amid tightening liquidity, the overall system's reliance on market funding remains low, but increasing; take for example the recent rapid increase in the number of bills of exchange (B/E) being issued. B/E's are deposit substitutes – with features close to those of time deposits -- that pay higher interest rates because they are currently exempt from reserve requirements and deposit insurance. Local banks have been popularising the use of B/E as a financial instrument to increase their funding and secure a wider customer base. At present, the ratio of B/E to deposits is 14%-15%, up from only 7% in 2007. Aside from B/E, banks have also turned to new innovative savings products and local currency subordinated debt issuance to secure new funds.
- » While these developments are only at a nascent stage and do not warrant immediate concern, we do recognize that these non-traditional funding resources are typically more expensive to secure and maintain. More importantly, they are also more volatile than customer deposits, susceptible to disruptions in periods of market distress. A lasting and growing dependence on these funding could weaken the banks' deposit franchises, pressure their interest margins, and weaken their structural resilience to liquidity shocks.
- » Recognising the potential risk of banks' accelerated pace of B/E issuance, the BoT has indicated that it may start subjecting B/E to the same insurance and reserving rules as traditional deposit products, and require banks to pay a 0.4% insurance premium on B/E issuance and hold 6% of their issuance proceeds in reserve. In the meantime, the banks are continuing their push to attract more retail customers to invest in their B/E products, with the minimum investment amount coming down to as low as THB100,000. In addition, for this group of investors, their preferred tenor and stickiness are similar to fixed-term depositors with a rollover rate of 80%-90%.

FIGURE 8

Liquidity Indicators for the Thai Banking Industry



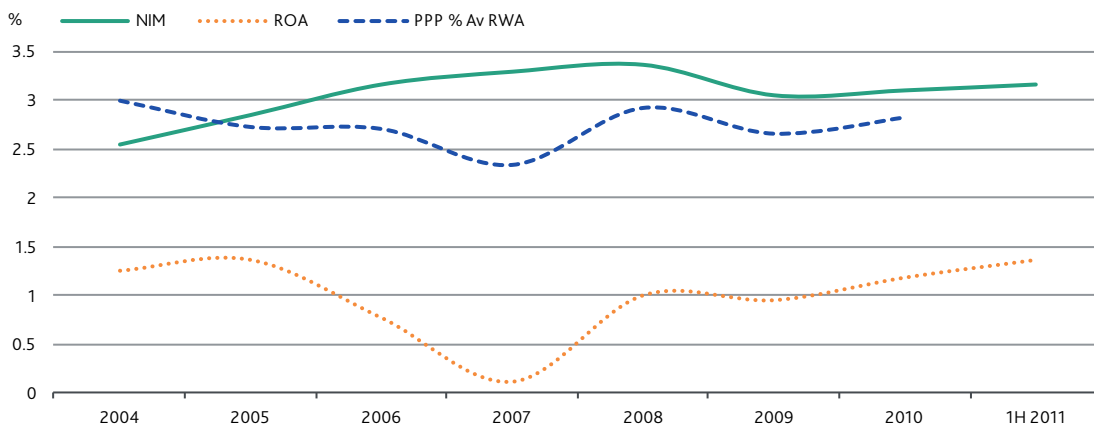
Source: Bank of Thailand

Profitability and Efficiency

Profitability to come under pressure from narrowing margins and higher provisioning costs

- » The banking system enjoyed a recovery in profits in 2010 (see Figure 9), when a rebound in economic growth fuelled stronger loan growth while lowering provision expenses. While the improving trend continued into 1H2011, the worse-than-expected economic slowdown plus the floods point to some deterioration for the rest of the year.
- » For the next 12 to 18 months, we expect profitability to remain under modest pressure, due to (i) narrower interest margins because of tighter liquidity and (ii) higher provisioning costs related to the floods. We expect pre-provision earnings to fall within their historic range of 2.5%-3% of average assets, which still compares well with its peers in the region.
- » Historically, Thai banks have maintained net interest margins (NIM) in the 3%-3.5% range. We expect current tight liquidity and rising deposit competition to translate into NIM pressure, but still see the banks as being able to defend their margins by pursuing improvements in loan pricing, such as by shifting their loan mix to higher-yield assets – for example, small-size SME and retail loans -- and by increasing their penetration of the high-yield low-end market segment.
- » As mentioned, initial estimates suggest that up to 1% of outstanding loans could be directly affected by the floods crisis. Nevertheless, we do not expect related credit charges to start deteriorating. Tepid credit growth in recent years testifies to strong discipline in the underwriting practices of Thai banks. This should keep NPL formation at manageable levels in our base-case scenario.
- » Fee and commission income will likely increase if and when the government's stimulus spending kicks in, supporting lending. Non-interest income has increased in recent years, accounting for 32% of banks' total operating income in 2010, up from 25% in 2007. We believe that fee and insurance income will be a major driver for the banking sector's profitability in the next few years. At the moment, net interest income still constitutes a significant share of operating income, but the banks are starting to push for cross-selling opportunities to both retail and corporate clients in areas like bancassurance and unit trusts. We also believe that sales of insurance products through bancassurance will continue to accelerate as the banks continue to gain market share from agent-base insurers.
- » While the central bank's overhaul of the banks' fee structure has resulted in some permanent loss in earnings, the banks have so far been able to offset the negative impact by broadening the scope on their value-added services, including bancassurance and other investment domains.

FIGURE 9
Profitability Indicators for the Thai Banking Industry

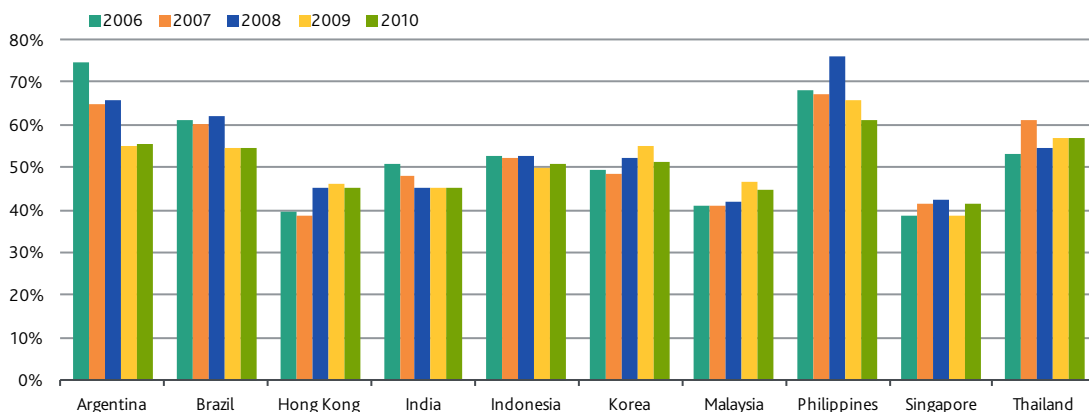


Source: Bank of Thailand

Efficiency

- » Cost-to-income ratios of rated Thai banks are high when compared to regional and developing market peers (except for the Philippines), as illustrated in Figure 10. These costs are mainly related to IT system upgrades, new branch openings, and follow-on costs from large investments in the past few years.
- » Looking ahead, costs may rise further in the immediate aftermath of the floods as the banks pay for the repair and replacement of their infrastructure. Aside from this one-time disturbance, we also expect overhead costs to stay high in coming years as the banks continue to invest to stay ahead in an increasingly competitive market.

FIGURE 10
Efficiency Indicators for the Thai Banking Industry



Source: Moody's Banking Financial Metrics

Moody's Related Research

Credit Opinion:

- » [Thailand](#)

Country Statistics:

- » [Thailand](#)

Sector Comments:

- » [Flood Damage Spreads to Thailand's Banks, a Credit Negative, October 2011 \(137034\)](#)
- » [Margin of Victory in Thailand's National Elections Is Credit Positive, July 2011 \(134326\)](#)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

Appendices

Appendix 1: Sovereign Credit Opinion: Thailand

Credit Strengths

Support factors for Thailand include:

- » International reserve build up and external debt reduction
- » Export competitiveness
- » Track record of fiscal restraint

Credit Challenges

Areas of concern for Thailand include:

- » Political risks from polarization and regional insurrection
- » Sustaining public debt reduction
- » Improving governance

Rating Rationale

Thailand's Baa1 government ratings reflect medium economic and institutional strength, but receive support from a relatively high level of government financial strength as the post-1997 crisis debt overhang has eased. Vulnerability of the government's balance sheet to external shocks has been reduced by a steady repayment of external debt and accumulation of official foreign exchange reserves. External indicators are considerably stronger than the median values of not only Baa peers but also many A-rated countries. However, Thailand's government debt relative to government revenue is more elevated than its Baa-rated peers, although the debt trajectory at both the general government and public sector levels was on a steady downward trend prior to the global recession.

Susceptibility to event risk is low, despite deep political polarization. The intrinsic strength of the Thai financial system is also weaker than the global norm, but was not destabilized from the global financial crisis. Thailand's income level is also lower than its peers, but this is offset by economic diversity, a high level of national savings, and favorable economic growth prospects.

Rating Outlook

The outlook was changed from negative to stable in October 2010, prompted by the continued robustness of the economic recovery and the post-crisis stabilization of government finances. Despite the lack of a definitive resolution to the underlying tensions between government and anti-government factions, the current administration capably steered the economy through a major external economic shock, as well as a potentially destabilizing domestic political crisis. In 2010, the central government's fiscal position has consolidated largely due to a strong rebound in revenues, while a persistent current account surplus has combined with large capital inflows to result in record levels of foreign exchange reserves.

The foreign currency bond ceiling was also raised to A2 from A3 in October 2010, based on a lower assessment of moratorium risk, taking into account the following factors: the Thai economy's high degree of trade and investment integration into the global system, recent policies aimed at the liberalization of capital outflows, and the government's low reliance on external financing.

What Could Change the Rating - Up

Maintenance of the strong external payments position. Continued progress in strengthening public sector finances, which includes limiting contingent fiscal liabilities from social welfare programs and minimizing the long-term effect on government debt from stimulus measures adopted, and not yet wound down, to counteract the global recession.

What Could Change the Rating - Down

Political instability that leads to a deep weakening of credit fundamentals and competitiveness.

Recent Developments

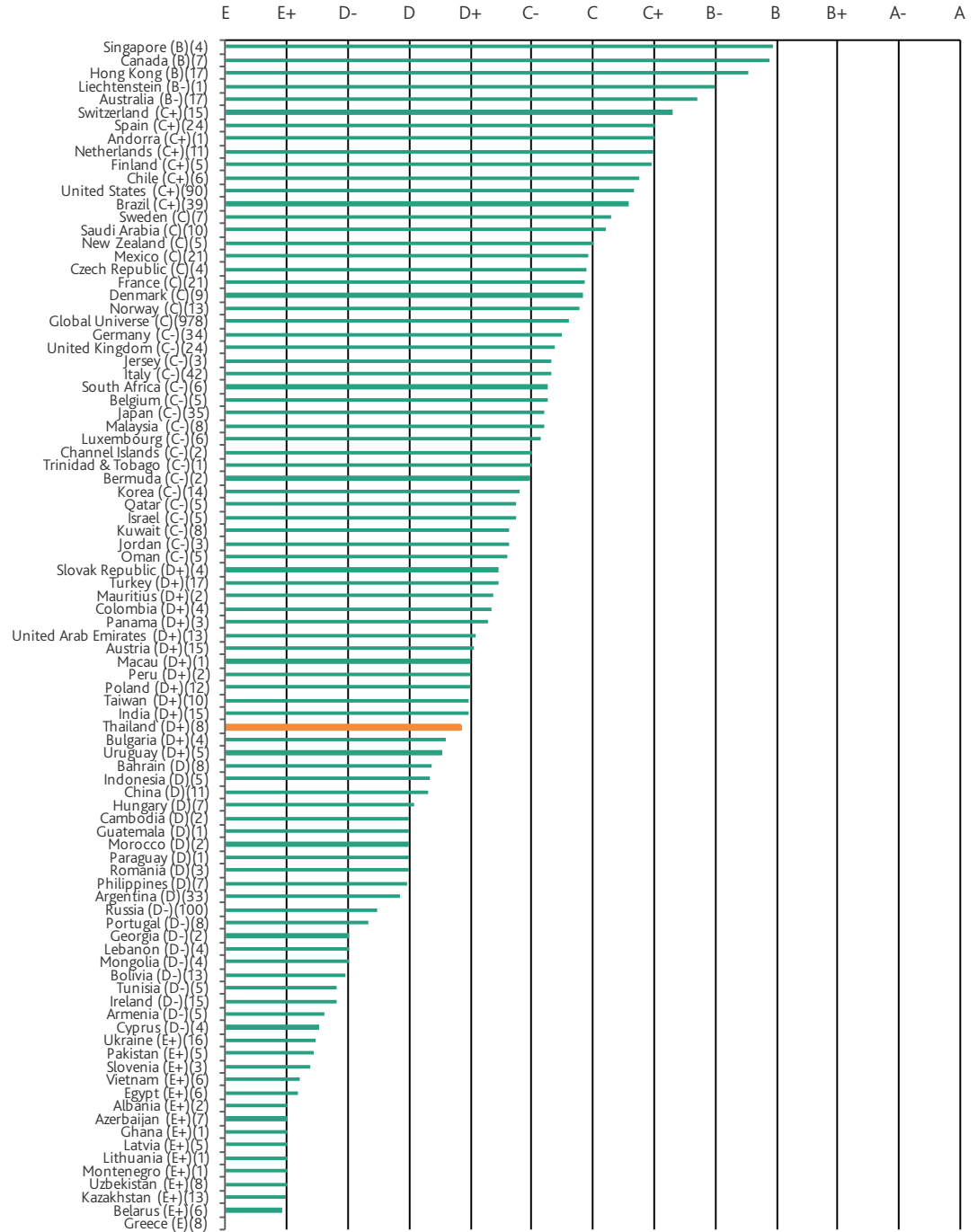
Massive flooding is set to significantly affect agricultural and manufacturing production. Supply chains have been disrupted, notably among automobile manufacturers, while rice crops will be adversely affected. As of mid-October, estimates of damage have reached as high as THB100 bn, or around 1% of GDP; however, the potential for flooding to spread to Bangkok poses upside risk to these projections. Combined with the deterioration in the outlook for external demand, real GDP growth in the second half is likely to slow significantly.

The new Pheu Thai Party-led government passed its FY2012 budget in September, projecting a deficit of THB350 bn (around 3% of GDP) that incorporates many of the ruling party's campaign promises. These include a hike in civil servant wages, a fuel tax cut, subsidies for first-time buyers of cars, and price support scheme for rice. Subsequently, the Cabinet approved a plan to cut corporate tax rates to 23% from the current rate of 30%. More recently, the government maintained its budget projections in the wake of the floods, but has stated that a supplementary mid-year budget that directly provides for aid and reconstruction efforts is likely. In the meantime, the government has directed state agencies to set aside 10% of their investment and operating budgets for recovery efforts.

Since the new government took office in August, a number of policy reforms have been mooted, including the proposed establishment of a sovereign wealth fund and a shift from a core inflation targeting regime to that which focuses on headline inflation. Since the Asian Financial Crisis, macroeconomic management has been relatively successful in anchoring inflation expectations and guarding against external vulnerabilities. As such, it is unclear as to how the proposed reforms can significantly improve upon Thailand's recent track record in these areas.

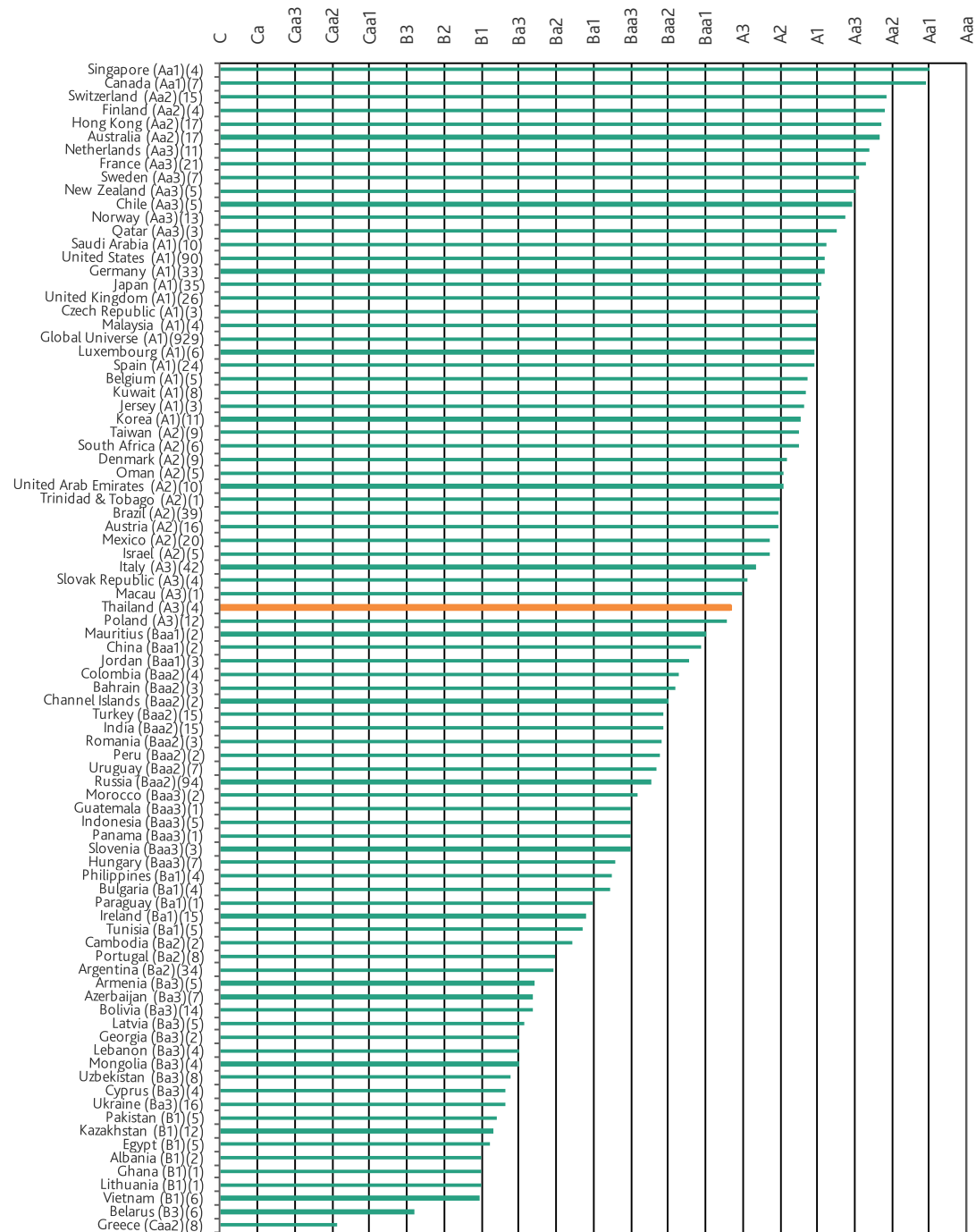
Appendix 2: Global Comparison Charts

Average* Bank Financial Strength Ratings by Country (as of 1 November 2011)



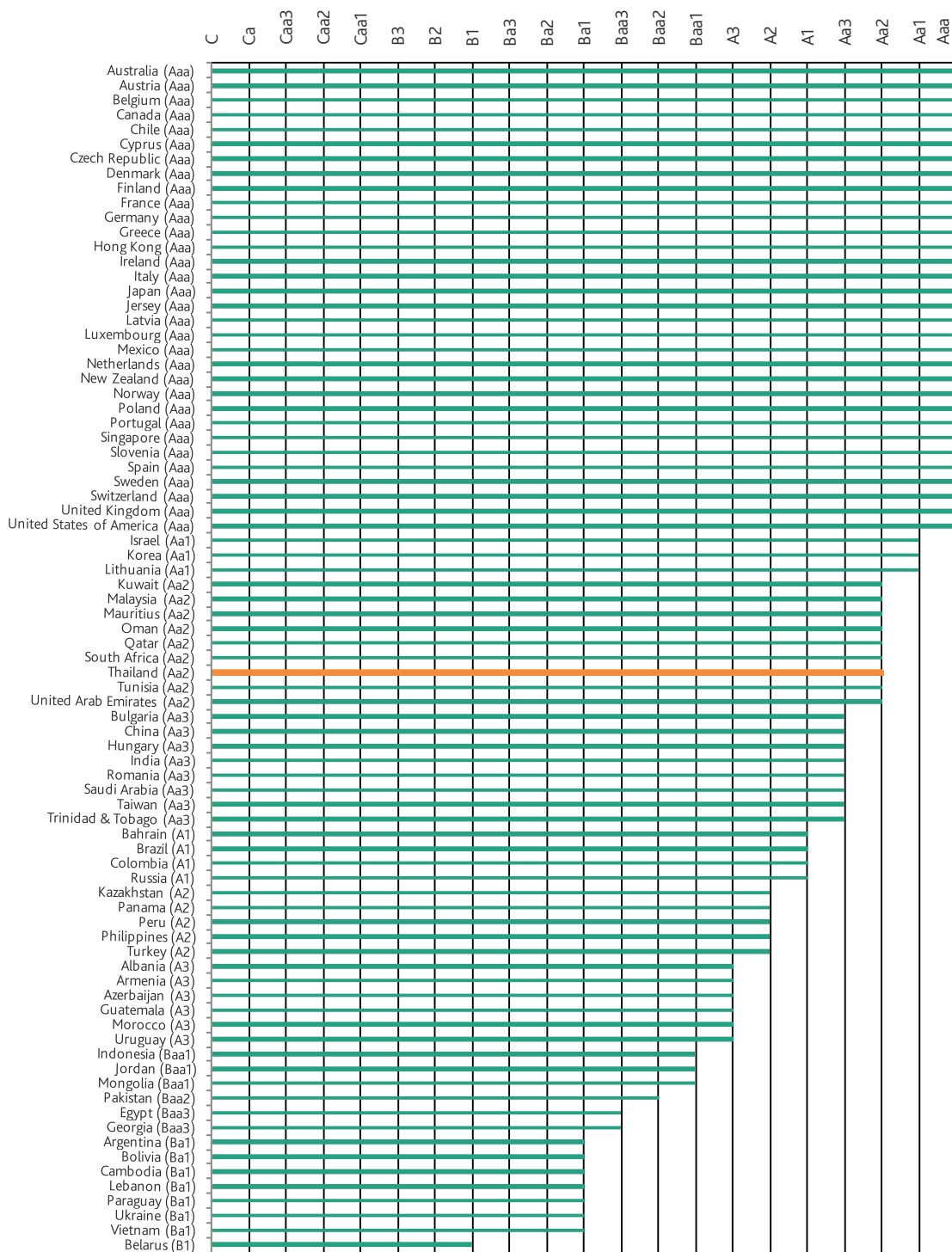
Average* Long-Term Bank Deposit Ratings by Country (as of 1 November 2011)

Domestic Currency



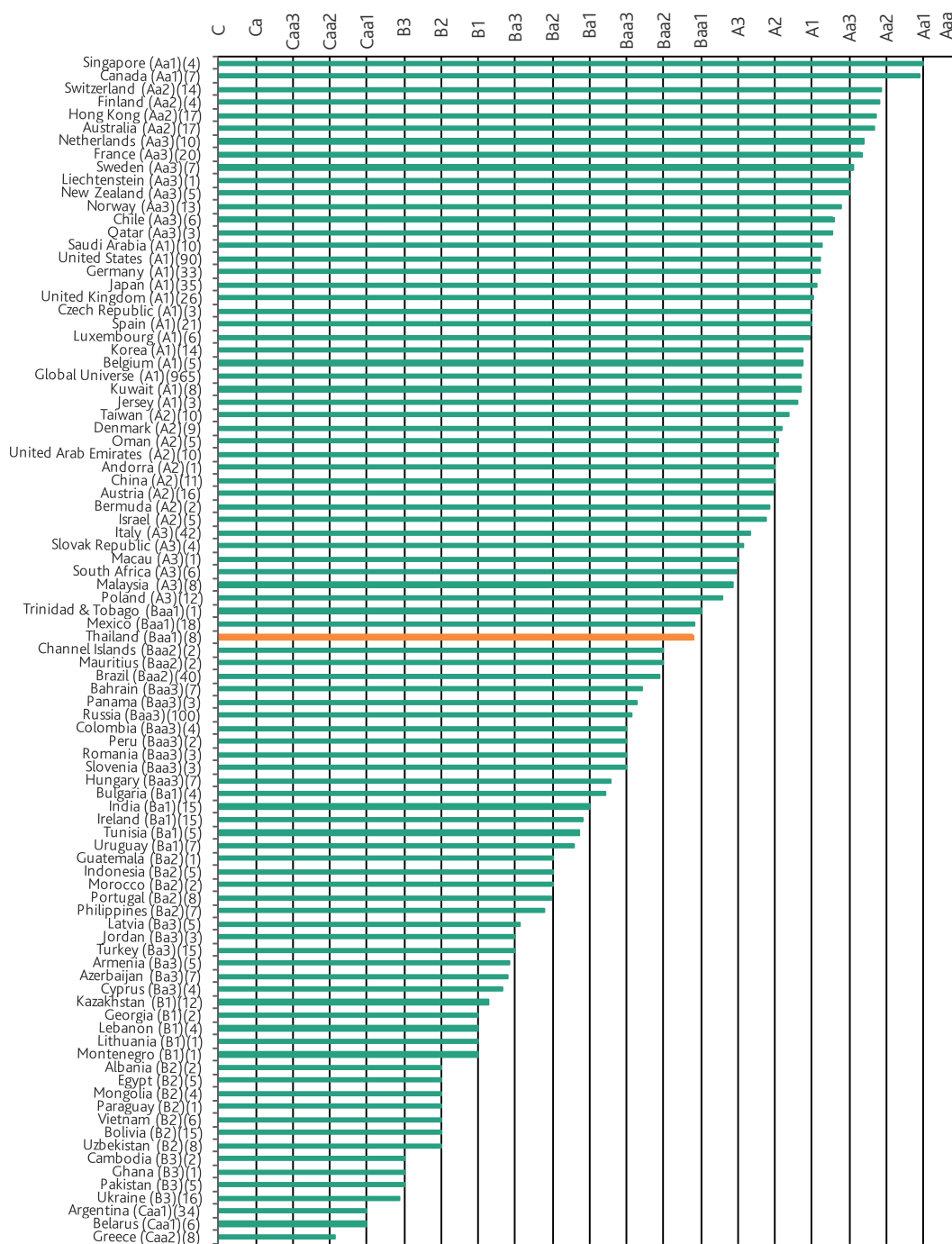
Country Ceilings for Long-Term Bank Deposit Ratings (as of 9 November 2011)

Domestic Currency



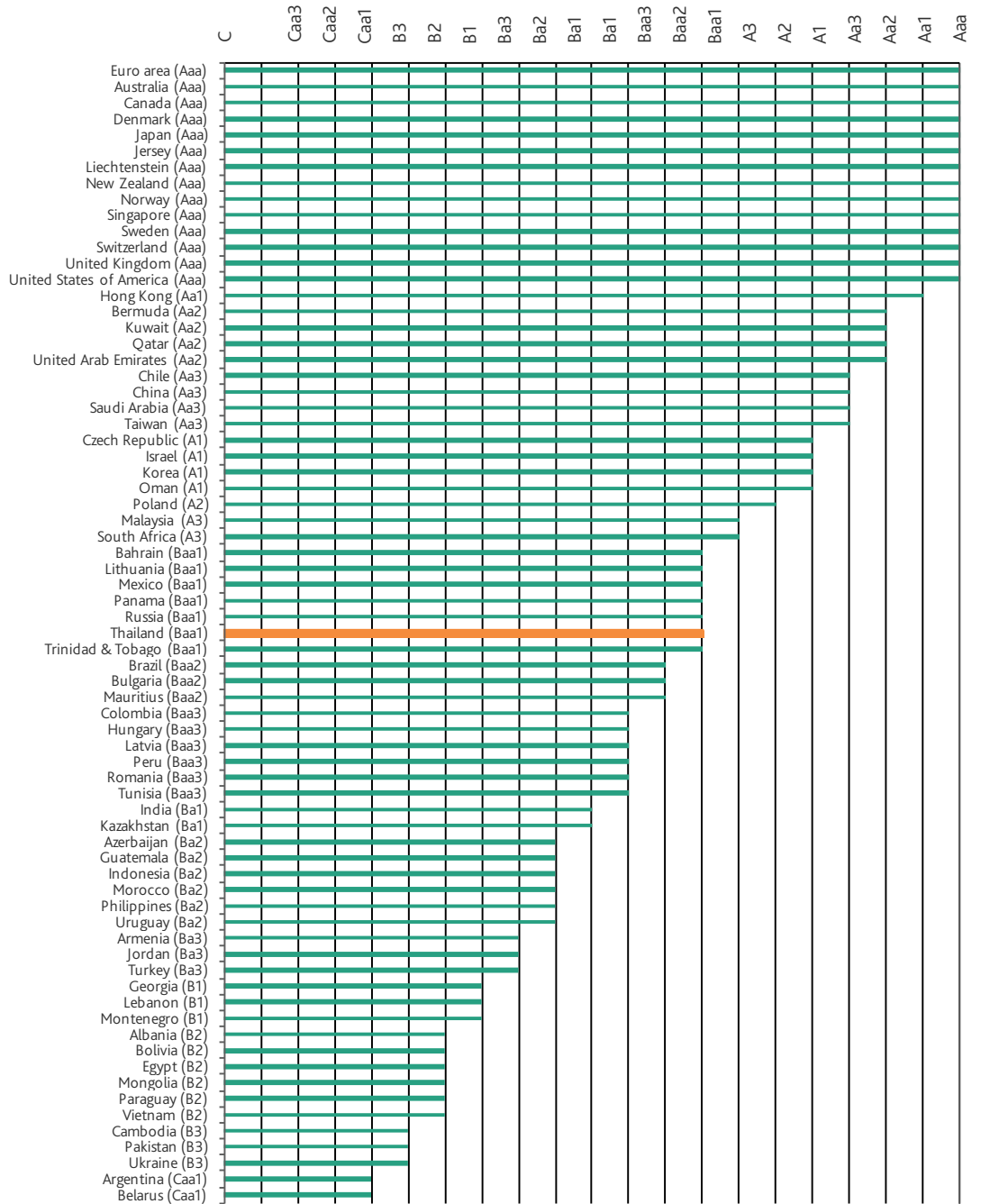
Average* Long-Term Bank Deposit Ratings by Country (as of 1 November 2011)

Foreign Currency



Country Ceilings for Long-Term Bank Deposit Ratings (as of 9 November 2011)

Foreign Currency



Appendix 3: BFSR / BCA Mapping Table

BFSR/Baseline Risk Assessment Mapping Table	
BFSR	Baseline Credit Assessment (BCA)
A	Aaa
A-	Aa1
B+	Aa2
B	Aa3
B-	A1
C+	A2
C	A3
C-	Baa1
C-	Baa2
D+	Baa3
D+	Ba1
D	Ba2
D-	Ba3
E+	B1
E+	B2
E+	B3
E	Caa1
E	Caa2
E	Caa3

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