THAILAND BANKING MARKET

HOW CAN BANKS NAVIGATE THROUGH THE PANDEMIC STORM?

December 2020 issue

WITH COVID-19 UPDATE

Roland Berger

Contents

Table of Figures

A Where we stood at the beginning of 2020 – Banks' digital transformation journeys

Roland Berger published a study "Thailand Banking Market: How can banks bridge the profitability gap while waiting for the digital dividend?" in February 2020, exploring the investment heavy situation of Thai banks amid their transformation journeys, especially their digital programs. The report shows that embarking on large digital transformation journeys has put significant investment burden on the banks and resulted in further deteriorating economics, evidenced by the increased Cost-to-Income ratios. Although the vast majority of the investment is being made in the current years, the expected results in terms of revenue growth, efficiency increase, and profitability will only fully materialize in the long term. Hence, banks are now in the middle of the transformation road – or the "valley of no return" – with even more hefty investments to be made to reach the end of the journey.

Roland Berger estimated, pre-COVID-19, that to maintain a Return on Equity (ROE) value in line with the average of previous years of about 8%, banks would have to cut total costs of approximately THB 100 billion in the medium term until 2024 (~USD 3.3 billion; equal to ~5% of the total cost base of Thailand banking sector over the same period of time). In a potential worst-case scenario where the digital dividend is significantly lower than expected, the Thai banking sector will be negatively impacted in the long term, with revenues stagnating without being compensated by a reduction of operating costs. In this context, the entire banking sector's profitability would gradually drop before platooning at ROE values of around 6.6%. Roland Berger estimates that a whopping THB 170-180 billion cost-savings would be required until 2024, to return to Return on Equity (ROE) values of approximately 8% which are in line with the average of previous years (~USD 5.7-6.0 billion; equivalent to ~8-9% of the total cost base of Thailand banking sector over the same period of time).

When COVID-19 storm hit hard – Increasingly challenging times for banks

Since the beginning of 2020, the COVID-19 outbreak has hit many economies worldwide, including Thailand's. Business activities have halted and the economy has been severely impacted. Thailand has successfully managed to contain and flatten COVID-19 infections in the country after the initial bleak months and the Thai Government has started the gradual opening of the economy through easing of mobility restricting as well as providing financial assistance to businesses. However, particular sectors such as tourism are still far from bouncing back to normal pre-pandemic levels, therefore slowing down the recovery of the overall economy.

The Thai banking sector is no exception in weathering the COVID-19's negative waves and has been severely impacted. The core revenue of banks, including interest income and fees income, has been declining especially in the second quarter of 2020. In the first half of 2020, interest income declined 4.9% compared to the same period in 2019. However, this was compensated by a 25% decline in interest expense between the two periods, following the policy rate reductions by the Bank of Thailand during the first half of 2020. Banking assets have grown with businesses accessing additional credit and loans under financial-aid programs amid the struggle of the pandemic.

Due to these uncertain and turbulent times, banks are in cautionary mode and the loan impairment levels have been significantly increasing to cover for potential low quality/ riskier loans. This is clearly shown by the increase in banks' H1 2020 loan impairments, which almost doubled (+80%) compared to H1 2019. Non-performing loans (NPLs) have been trending upward, reaching 3.2% of total loans in the second quarter of 2020, compared to 3.1% at 2019 year-end. NPL volume is expected to continue to grow towards the year-end with an increasing cost of risk to strongly hit the banks' bottom line.

On the brighter side, the pandemic has fostered a change in consumers' banking behaviors, paving the way for digital banking advancement. Due to countrywide lockdowns, restricted openings of business activities and social distancing practices, many customers have quickly switched from physical to online channels. The shift has also been observed in the banking sector with a significant surge of online banking activities and digital transactions. The number of ibanking transactions nearly doubled in Q2 2020 compared to last year. In line with this trend, the number of bank branches in Thailand have also reduced 3.8% from 6,508 to 6,260 from December 2019 to September 2020, and this reduction is projected to continue beyond the pandemic. For banks undergoing digital transformation journeys, this move will positively impact them as they can leverage on the changing behaviours of their customers, while refining their physical network.

Image: *Getty Images*

Impact of COVID-19 – Deeper "valley of no return"

The impact of COVID-19 will put a further burden on the banks' profitability in the short and medium term, translating into an even deeper "valley of no return" (Figure 1). Roland Berger estimates that the erosion of the Return on Equity (ROE) is expected to worsen in 2020 and 2021. A further decline of 1.1% in 2020 and 1.3% in 2021 of the ROE levels in the initial study's projections is still expected. This further erosion is mostly driven by an increased cost of risk. Impairments are reaching ~1.2% of the total assets in 2020 compared to the average value of ~0.8% of the previous years.

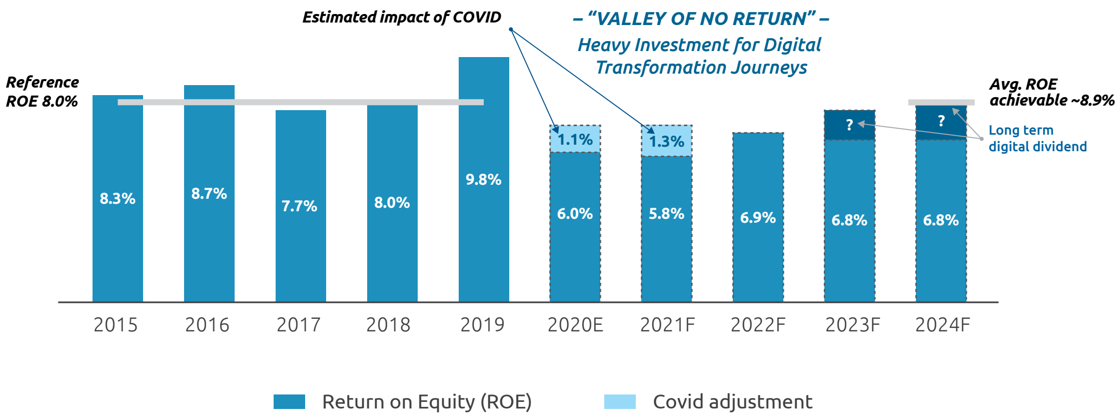


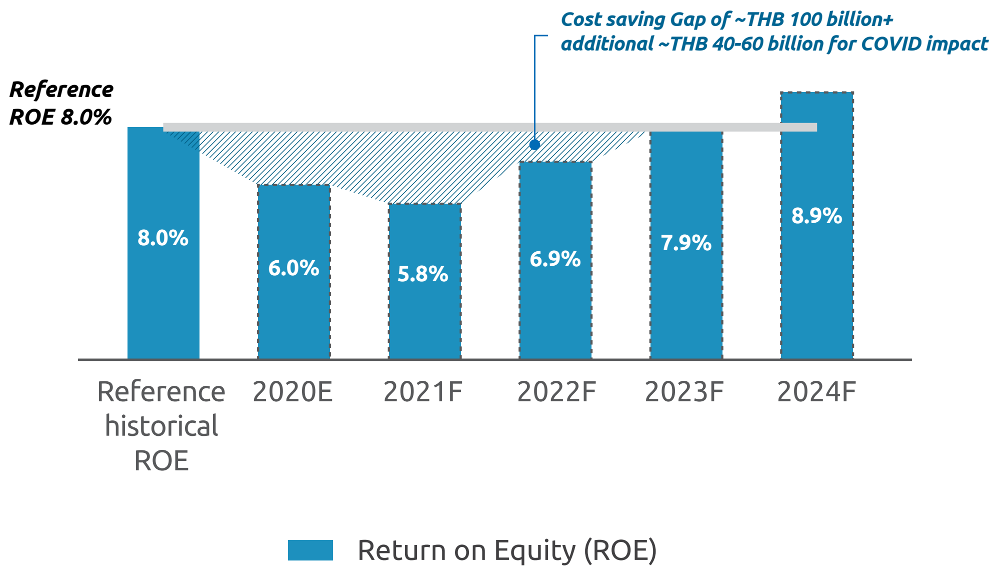
Figure 1 Projected Return on Equity of all commercial banks registered in Thailand

Businesses and individuals are expected to be more conservative with their liquidity, growth investments and spending over the next years, posing a great challenge for banks in revenue generation. Existing rigid investment structures, in particular for digital transformations, along with the higher uncertainty and the overall deterioration of debt quality, will directly impact the banks' bottom line. To tide through the pandemic and maintain the reference ROE of 8% over the next four years up to 2024, banks will need approximately THB 40-60 billion (USD 1.3-1.9 billion) of cumulative cost savings (Figure 2). This value is in addition to the cumulative cost savings already estimated for the digital transformation journeys (THB 100 billion for the optimistic scenario where digital dividend is realized in the year 2023 and

THB 170-180 billion for the worst-case scenario without any significant future digital dividend realized). The estimations assume a containment of the COVID-19 spread in the first half of 2021 and the continuation of the support from the Thai Government's financial aids until 2021.

Estimations including COVID impact

Short to medium term cost optimization required – With digital dividend



Short to medium term cost optimization required – Without digital dividend

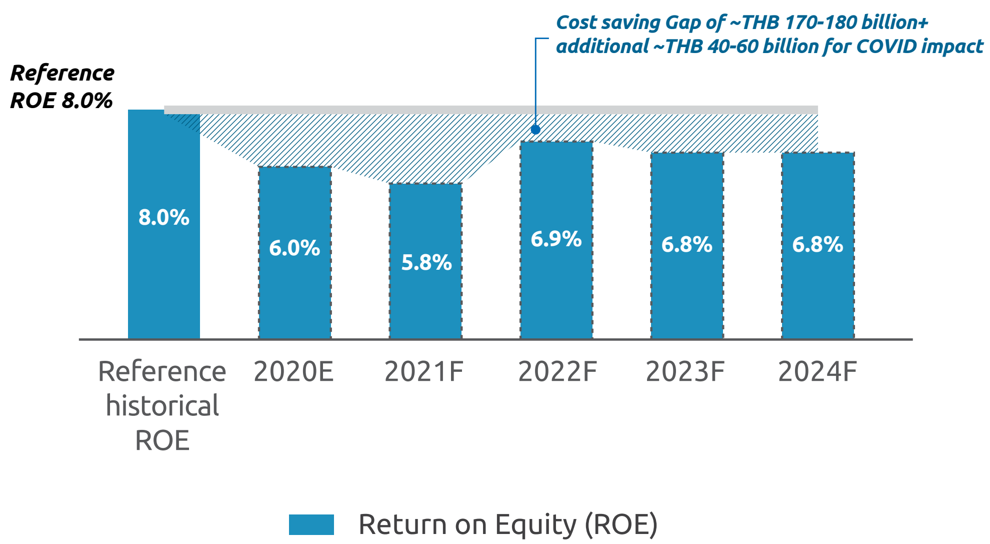


Figure 2 *Cost-saving Gaps and ROE projections of all commercial banks registered in Thailand*

Moving ahead - Tightening the ship and steering through the storm

Besides the significant digital transformation investments, banks are also facing a worsening of the overall financials due to the pandemic situation. Going through the "valley of no return" until the digital dividend pays off poses even more challenges now. During these years, Roland Berger believes that banks need to rely on proven short-to-medium term cost containment initiatives to bridge the gap until the end of their journeys. Banks should further accelerate the ongoing transition from physical to digital channels, capitalizing on changing customer behaviors and rethinking the overall footprint and the servicing models.

As part of the study published in February 2020, Roland Berger introduced three key cost-efficiency optimization programs to support banks in achieving significant efficiency gains in the short term.

Accelerated Zero-Based Budgeting (AZBB)

is a tailored cost management solution for companies who wish to not only run leaner and more efficient operations, but also identify hard savings that can be re-invested in growth. The program reviews all activities from the bottom-up in light of changing market conditions and identifies where to trim or expand. Typical savings are in the range of 10 to 20% of the in-scope cost base cost reduction with average AZBB programs self-funded with recurring savings in the region of 5 to 10 times of the one-off cost of the program.

Procurement Excellence

is a cross-functional procurement cost optimization program that enhances the bank's procurement activities while incorporating procurement best practices. The approach closely looks at the existing purchasing practices and procurement process, runs a purchasing optimization program on the bank's existing spend categories, and identifies best practices to improve procurement organization/tools. Procurement Excellence adoption can potentially bring up to a 15 to 20% reduction in procurement expenses. In addition to monetary benefits, it creates higher efficiency and faster time-to-market.

Frugal IT

strategically challenges every item of an IT/ digital investment to optimize investment decisions based on a structured analysis of Costs vs. Value. The approach acts on both hard and soft levers to design innovative solutions that captures the core project value while simplifying solutions. Estimated savings are reductions of 15 to 25% of investment costs, typically with an immediate pay-back, while optimizing the created value and securing the implementation schedule.

Image: *Getty Images*

In addition to these cost containment programs, banks should also increase their focus on optimizing their distribution channels and servicing models, in line with the acceleration of behavioral shift towards digital banking. Roland Berger recommends two well-proven and complementary key optimization programs that can further support banks in their journeys.

RB BranchOptimizer™

The program aims to extract maximum value from the physical network. Identifying the optimal presence on the ground is key and banks need to balance the geographical revenue potential vs. the overall cost efficiency. Roland Berger has crafted this analytical tool to supports banks in this critical trade-off, with the final objective to maximize both dimensions. The tool creates transparency on the branches' performance, assesses the geographical potential of a specific granular, level of competition, and other key factors to identify potential branches to close or be relocated to more attractive areas.

The tool also identifies the ideal branch format mix and branch model for each specific location. The tool is very comprehensive and considers a wide array of data to derive its suggestions (e.g., detailed P&L indicators, customer-related data, performance clustering based on selected peer groups, more than 50 macro and microeconomic indicators, detailed competitors data and branch-related real estate data). This ensures high robustness of the results and offers the opportunity for the bank to model different scenarios (e.g., prioritization of revenues vs. efficiency).

***Image:** tostphoto/iStockphoto*

Branch of the future

This is a comprehensive transformation program that enhances the bank's operations efficiency and customer satisfaction through defining a seamless omnichannel integration between its physical and digital channels. While digital banking is gaining traction driven by the pandemic and the availability of more use cases online, physical branches remain essential as a key engagement channel, especially for more critical and complex financial services. The program focuses on optimizing the bank's physical and digital channels. For instance, digital channels should not only serve as a direct sales channel but also as a mechanism to generate leads to be converted in sales by the branch. In addition, branches should be equipped with self-service counters and terminals to cater to digitally-savvy customers requiring little staff interaction for standard transactions and services, such as cash deposits/ withdrawals and inquiries. The servicing model should also be transformed to provide personalized face-to-face interaction for value-added services of sales and advisory services including credit cards, loans, wealth management advisory, and high-volume business customers. As the branch service model gradually evolves, the future physical bank visits are envisioned to be in the form of an appointment where customers require dedicated personnel, time and place for necessary services. The program defines all the key transformation initiatives and integrates them into a holistic implementation roadmap with the final aim to better serve customers and to further increase cost efficiency across the physical network.

Image: *Getty Images*

Image: Getty Images

In this radically changing context, in addition to the short to medium term challenges posed by the hefty investment in transformative technology in an environment of progressive margin contraction, banks now have to further "tighten the ship' to cope with the sudden impact of the COVID-19. Launching material tactical cost containment programs as well as anticipating the shift of customers' channel/ servicing preferences will be key for the success of banks' long-term strategy, allowing them to successfully travel through the "valley of no return" in the years to come.

We welcome your questions, comments and suggestions

Note: Reference exchange rate between THB and USD used in this report is equal to 1 USD = 30.2 THB

Authors

PHILIPPE CHASSAT
Senior Partner
co-Head of Financial Services Competence Center APAC
Singapore Office, Southeast Asia

philippe.chassat@rolandberger.com
+65 9487 4845

UDOMKIAT BUNWORASATE
Partner
Financial Services Competence Center
Bangkok Office, Southeast Asia

udomkiat.bunworasate@rolandberger.com
+66 952 062 064

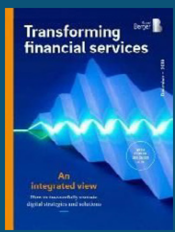
LUCA TURBA
Principal
Financial Services Competence Center
Singapore Office, Southeast Asia

luca.turba@rolandberger.com
+65 8198 4032

Explore other insights by Roland Berger

Thailand Banking Market:
How to bridge the profitability gap

Research on Thailand Banking Market and the profitability gap that commercial banks must mitigate through cost restructuring while waiting for dividends from digital transformation projects.



Digital transformation for financial service providers

Integrated digital change management is the key to survival of organizations. How can financial service providers capitalize on the digital transformation?

Locations in Southeast Asia

Indonesia

The Plaza Office Tower,
40th Floor
Unit 40 B-C
Jl. M.H. Thamrin 28-30
10350 Jakarta

+62-21-5084-8100

Malaysia

Menara AIA Sentral,
Penthouse

30 Jalan Sultan Ismail
50250 Kuala Lumpur

+603 2203-8600

Singapore

3 Church Street
Samsung Hub #10-02
049483 Singapore
Singapore

+65 6597-4530

Thailand

Sathorn Square,
17th Floor
Unit 1701
98 North Sathorn Road
10500 Bangkok

+662-050-2325

Myanmar

Mimosa Building,
1st Floor
Unit 1 D-E
196 Shwe Gon Daing
11201 Yangon

+95 989 550-1413

Roland Berger

THAILAND BANKING MARKET

HOW CAN BANKS NAVIGATE THROUGH THE PANDEMIC STORM?

December 2020 issue