THAILAND BANKING MARKET

HOW CAN BANKS BRIDGE THE PROFITABILITY GAP WHILE WAITING FOR THE DIGITAL DIVIDEND?

Roland Berger

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Roland Berger has been helping its clients to manage change for half a century. Looking forward to the next 50 years, we are committed to supporting our clients as they face the next frontier. To us, this means navigating the complexities that define our times. We help our clients devise and implement responsive strategies essential to lasting success.

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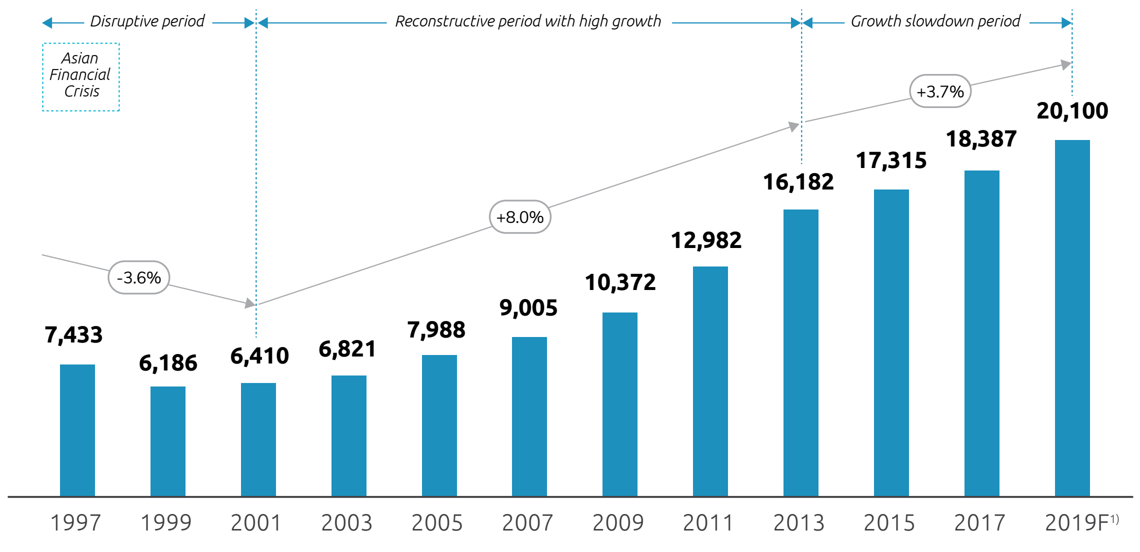
Headwinds for Thailand Banking Market

Banking is a sizeable and influential sector in Thailand, holding assets in total of THB 19.6 trillion as of August 2019. The sector is currently the third largest sector among all sectors in the Stock Exchange of Thailand. The banking sector is a maturing market with bank account penetration of 82% in 2017 – comparable to average bank account penetration in Europe and higher than the middle-income countries average (73%)[1]. After decades of sustained growth, the banking sector has been maturing fast and growth prospects rescinded. With the current economic slowdown of the Thai economy, the low interest rate environment and the necessary large investments into digital transformation programs, Thai banks should brace themselves for challenging years ahead.

To understand where the banking sector stands now, it is worth to look a few decades back. The Asian financial crisis of 1997 put a halt to years of fast expansion of banking assets with the sector verging on a complete meltdown. Under the rescue scheme, one-third of commercial banks were nationalized, and another one-third were either bankrupted or acquired by foreign banks. Assets of all commercial banks decreased by 3.6% y-o-y for 4 years (Figure 1). By 2001, the economy had recovered and entered a reconstructive period, with a high growth of 8.0% per year for commercial banks' assets observed between 2001 and 2013. In more recent years, the growth of the banking sector has slowed down, reaching a 3.7% y-o-y between 2013 and 2019.

[1] | *Percentage of adult (+15 age) having an account, Global Findex 2017*

▶ Figure 1 *Total assets of alcommercial banks registered in Thailand [THB bn]* | *Source: BOT; Roland Berger*



1) Forecasted year-end value based on Nov 2019 figure

In this period of slow banking market growth, the key commercial banks in Thailand have been experiencing a period of stagnating profitability. The efficiency of the banks' operations, which was quite stable until 2017, has recently begun to decrease. The cost base has been increasing, significantly driven by the investments required for the launch of broad transformation programs, with particular focus on digital initiatives, to sustain the top-line growth and the increase of efficiency (Figure 2). In the short to medium term, this trend is likely expected to continue to negatively impact the bottom line of banks posing a concrete risk of further profitability deterioration until the dividend of those large transformation programs pays off.

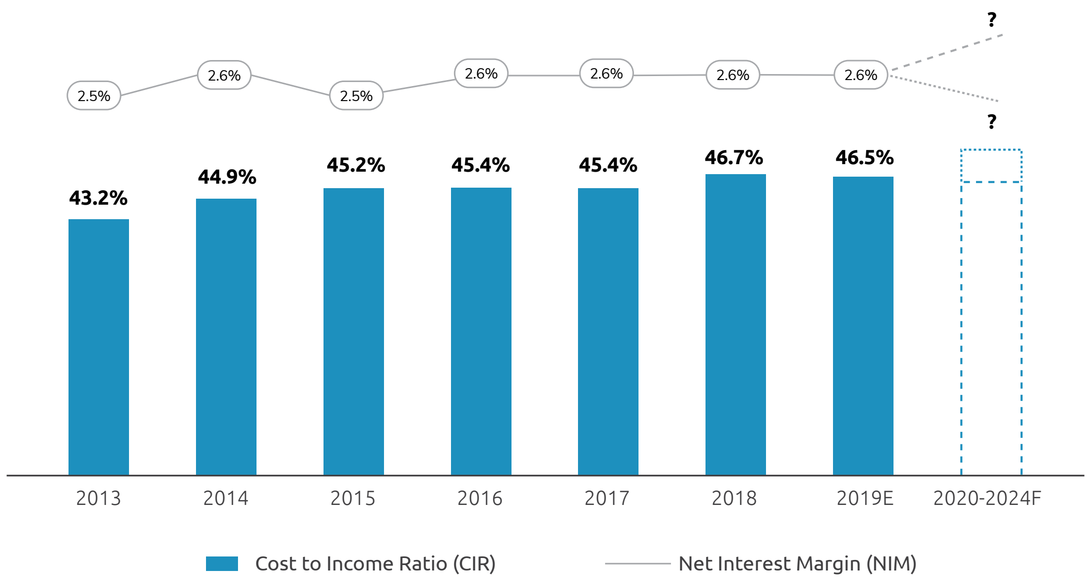


Figure 2 *Efficiency (CIR) and profitability (NIM) of all commercial banks registered in Thailand | Source: BOT, annual reports, SET, Roland Berger*

Beyond the digital disruption trends and the recent overall macroeconomic headwinds, Thailand banking sector will be strongly impacted by the demographic factor at plays in the coming years. Thailand is edging closer to becoming an aging society due to the rapid increase in the number of elderlies. It has been forecasted that the proportion of population aged 60 and above will account for one-fifth of the total population in 2021[2], causing Thailand to officially become an aged society. This indicates the shrinking of the working-age population who is the core customer group for banks with larger savings, higher spending power and higher lending activities posing a further threat to banks' profitability going forward.

In this changing banking environment, the vast majority of commercial banks have already started focusing their energies and investments on long term digital transformation journeys with the aim to significantly improve efficiency and profitability of their business models for the next decades. For these programs, banks have already invested and will be still required to invest large amounts.

[2] | *United Nations Population Division*

B

Storm amid Thai Banks' Digital Transformation Journey

Thailand is one of the most advanced countries undergoing a digital economy transformation in Southeast Asia. The digital industry has been identified as one of the new key industries to drive future new-growth for Thailand and will be fostered by national policies as indicated by the Thailand Economic Reform Plan[3]. The country's financial sector is expected to be one of the key drivers of this digital shift. The country's latest Financial Sector Master Plan 2016-2020 (FSMP III) promotes electronic financial payment and services (Digitization) while enhancing the efficiency of financial system (Efficiency) and aims to materialize Digital Banking by 2020. In line with this, it has also launched a national digital payment system in early 2017. Naturally, Thai banks are shifting their focus towards digitization and digital banking as a default strategy.

Almost all the banks are actively investing in new technologies and committing to digitalization effort. Some commercial banks have developed technology roadmaps/ transformation roadmaps and prioritized digital initiatives in accordance with their digital vision. Typically, these roadmaps are based on a three- to five-year time horizon. Based on the typical investment budget and prior investments by the banks, the total digital investment of the commercial banks is estimated to be approximately 30-35 billion Baht (~USD 1-1.2 bn) per year for the next 5 years.

These large digital transformation programs introduce a broad set of initiatives, spanning from enhancing specific activities such as Onboarding process (eKYC), Advisory (Robo advisors), Customer service (chatbots), and Lending (online credit assessment) to broader redesigning of customer journeys and revamping of Internet/ Mobile banking experiences. In addition, internal digitization initiatives are also being introduced such as the enhancement of Cloud adoption, Cyber security, Data analytics and AI. These digital initiatives have been mostly driven by Retail banking. Only more recently, digital programs are gradually including also SME, Wealth and, to a certain extent, Corporate banking.

[3] | *Thailand Economic Reform Plan, National Economic Reform Committee, December 2018*

Embarking on large digital transformation journeys has put significant investment burden on the banks as well as 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 therefore of profitability will only fully materialize in the long term (Figure 3). Hence, there is a long way on the roadmap for the banks to truly create a cohesive digital banking ecosystem. 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.

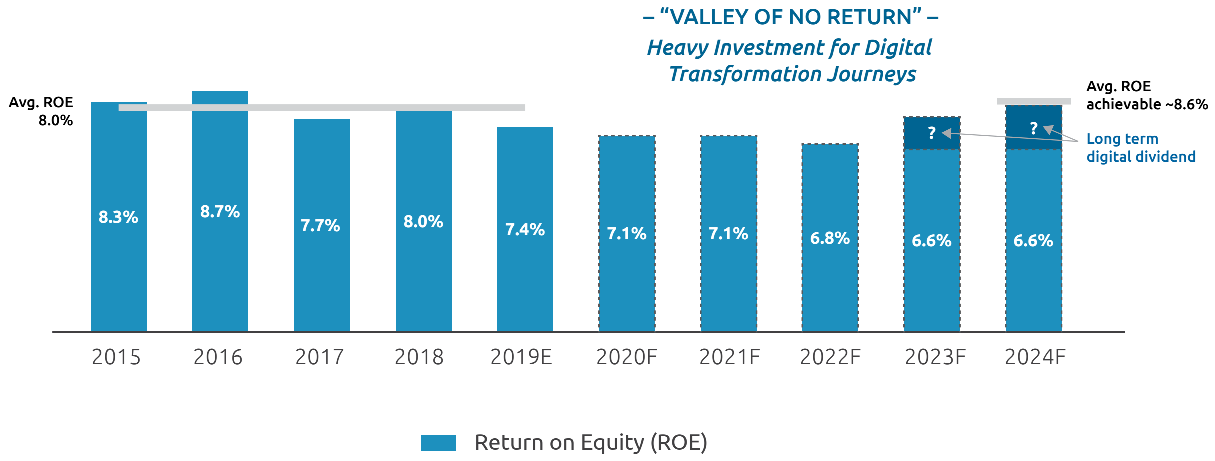


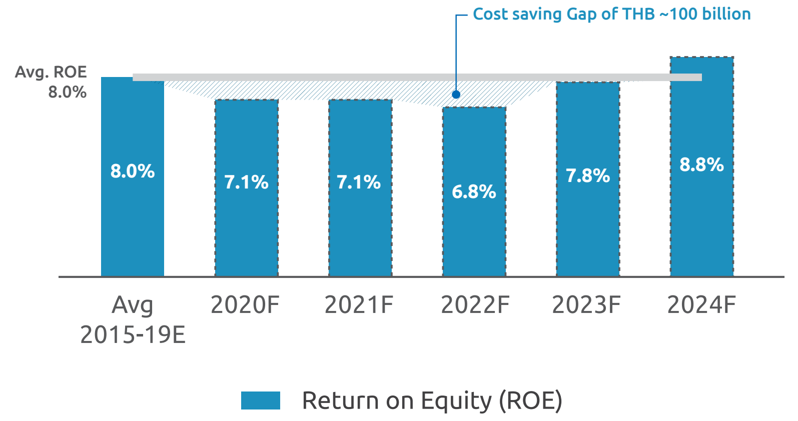
Figure 3 Projected Return on Equity (ROE) of all commercial banks registered in Thailand | Source: BOT; Roland Berger

Under those assumptions, to bridge the gap until the end of the journeys, in a market situation where competition intensified, services are commoditizing, fee revenues are shrinking, and Non-Performing Loans (NPL) are potentially increasing, banks must take a tactical hard look at their current cost base. Roland Berger estimates 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).

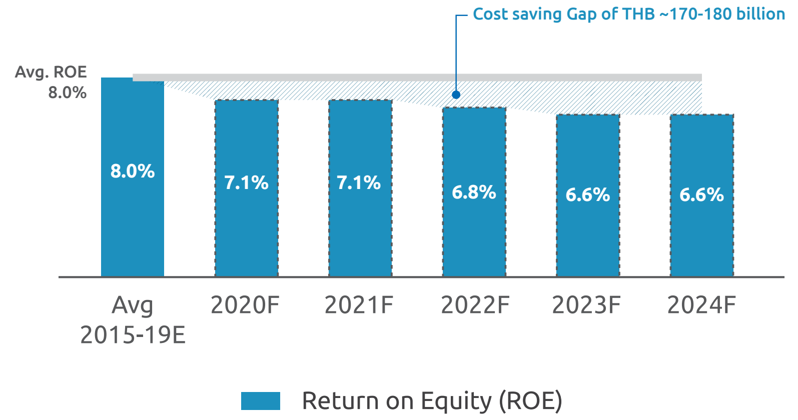
In a potential worst-case scenario where digital dividend is not paid off as expected, the Thai banking sector will have to face a very negative impact in the long term, with revenues stagnating without being compensated by a reduction of operating costs. In this context, the profitability of the entire banking sector would gradually drop before platooning at ROE values of around 6.6%. Roland Berger estimates that to reach back values of Return on Equity (ROE) in line with the average of previous years of about 8% (Figure 4), a whopping THB 170-180 billion cost-saving would be required until 2024 (~USD 5.7-6.0 billion; equal to ~8-9% of the total cost base of Thailand banking sector over the same period of time).

Figure 4 Cost-saving Gaps and ROE projections of all commercial banks registered in Thailand

Short to medium term cost optimization required – With digital dividend



Short to medium term cost optimization required – Without digital dividend



Two major cost areas can contribute to the significant cost reduction required in either case: i) operating expense (main driver) and ii) impairments with a better NPL management (secondary driver). All and all, banks are in dire need to react fast and strategize for short to medium term cost optimization/ efficiency.

Overall, 5 to 10% in cost base reduction might not seem too difficult to reach however these numbers apply to the entire cost base. Part of the bank's cost base is immovable in the short term and achieving such a cost reduction across the board will require trimming 10%, 15%, 20% or even more in other parts of the bank. This will require a systematic approach, strong top management impetus and decisive arbitrage on projects and activities.

Tightening the ship – Decisive cost containment measures needed in the short term

A major lever to improve the efficiency of the Thai banking sector and (re)gain operational efficiency requires banks to critically review their way of doing business with particular focus on how costs are generated and what are their key drivers. Based on our extensive experience in cost containment to achieve significant efficiency gains in the short term, three major cost-efficiency optimization programs should be considered: 1) Accelerated Zero-Based Budgeting (AZBB), 2) Procurement Excellence, and 3) IT Frugal (Figure 5). These are all well-proven proprietary programs that Roland Berger has already successfully implemented in dozens of banks, financial institutions and other leading companies operating globally, regionally, or at country level.

Figure 5
Overview of cost-efficiency optimization programs

	Accelerated Zero-Based Budgeting (AZBB) 1	**Procurement Excellence** 2	**Frugal IT** 3
What?	**Capture dormant cost reduction potential with sustainable saving realization goals**	**Examine existing procurement process incorporating procurement best practices**	**Optimize investment decisions based on a structured analysis of Costs vs. Value**
Approach	Primary application on supports **functions, branch activities and client coverage** A systematic **3-step approach for a tailored cost management solution**	**Cross-functional procurement cost optimization** within an organization **3-step** process **for closing procurement gaps**	**Challenging every item of an IT investment** from multiple perspectives **5-step approach** supported by **comprehensive off-the shelf tools**
Result	**10 to 20%** cost reduction on in-scope cost base	**15 to 20%** cost reduction on in-scope cost base	**15 to 25%** cost reduction on in-scope cost base

1

Accelerated Zero-Based Budgeting (AZBB)

A manager's toolkit is full of methodologies and frameworks that propose to help identify savings and increase efficiency. But while many programs like Six Sigma and Lean have been adapted, with varying success, from their production-line roots to other areas of a company, AZBB was designed from the ground up to provide a tailored cost management solution for companies who wish not only to run leaner and more efficient operations but also identify hard savings that can be re-invested in growth. By reviewing all activities from the bottom-up in light of changing market conditions, companies can see where they need to trim and where to expand.

A typical AZBB project unfolds three key stages. The first stage is the "diagnostic" where a thorough understanding of each business unit is performed. The "savings Identification" is the next stage where a critical assessment is done at each activity performed. The last and third stage is "budget inscription and rigorous program governance". Roland Berger has designed the AZBB not only as a results-driven program to identify and quantify efficiency levers, but also to provide companies with a clear path to turn budgeted savings into concrete and actionable re-investment plans. RB's project management tool, 'RBPoint' accompanies to ensure agreed-upon savings are ultimately achieved.

AZBB is different from traditional cost management methodologies. Not only it can generate between 10 to 20% cost reduction on average, but also it gives ownership of cost bases to line managers, to build the rationale and consensus for reductions on the knowledge and experience only the front-lines of business can provide. With a focus on achieving cost discipline through consensus, AZBB guarantees initiatives are developed in partnership with the managers who will implement them. Key areas of application are support functions from IT to Marketing to HR or Finance, branch activities, business lines activities. This methodology also helps create a cost-conscious culture at all levels of the organization and ultimately linked savings into revised budget at division/department levels that Finance can monitor.

AZBB programs are self-funded with recurring savings in the region of 5 to 10 times the one-off cost of the program

AZBB Success Story : A leading corporate and investment bank

A top global bank approached Roland Berger to help instill a more cost-conscious culture to weather the muted market outlook. In addition to this cultural shift, they wanted help to identify savings of 15-20% on their multi-billion dollar cost base.

Working closely with the client's top management, Roland Berger designed a year-long program, articulated around 70 individual projects across the globe. Roland Berger has assembled a global view on how the bank functions and examined how individual businesses could be re-aligned to better meet the market of today and tomorrow.

Covering businesses as diverse as back-office IT operations (e.g., Systems & Architecture, Telecoms & Network), key support functions (e.g., Finance, Marketing, HR) and client-facing business lines (e.g., Capital markets, Structured finance, Corporate finance), Roland Berger teams helped build the case for significant changes to the organization. AZBB has helped the client meet – or exceed – savings targets, systematically improving key activities and management structures.

2 Procurement Excellence

Procurement is a strategic function in a company and more than just the purchasing of goods and services. It has a notable impact on the financial performance of banks as the financial services sector is characterized by a material "Purchasing volume to Sales ratio" of ~24% as well as impacted by tough regulatory compliance requirements. Well-structured procurement practices could create value through cross-functional cost optimization within an organization. To close procurement gaps, Roland Berger has developed the Procurement Excellence approach.

Procurement Excellence approach closely looks at the existing purchasing practices and procurement process, runs a purchasing optimization program on the bank's existing spend categories, identifies best practices to improve procurement organization and tools. The first step is to "create transparency". In this step, not only products and services purchased are reviewed but also the status quo of procurement process (including cost structure, processes/procedures, main suppliers and main KPIs) is detailed. Secondly, the approach "evaluates procurement optimization programs and defines targets". Here, purchasing optimization activities are considered across the bank's purchasing practices and improvement targets are set.

First improvement activities cover key saving areas such as volume bundling, supplier selection and negotiation, and changes in sourcing models. Then evaluation metrics are set up and the procurement organization enhanced, also improving procurement process and tools with particular focus on procurement digitization. The last step of the approach is to "estimate the potential and prioritize". In this phase, potential savings for each improvement activity are estimated and a clear roadmap is defined. The Procurement Excellence approach comes together with the Roland Berger procurement toolkit that combines value levers with highly innovative approaches.

Procurement Excellence adoption can potentially bring up to a 15-20% reduction in procurement expenses. In addition to monetary benefits, it creates higher efficiency and faster time-to-market.

Procurement Excellence Success Story : Procurement transformation at a Swiss bank

A Swiss bank was developing procurement transformation program with the objective of pushing to a new level the cost-saving.

Roland Berger implemented the Procurement Excellence program at the bank and conducted in-depth analysis of IT and non-IT commodities. Cross-functional definition of savings measures was identified, an action plan for procurement organization defined, and processes restructured as part of the transformation project.

The project resulted in savings of more than USD 200 million (THB 6 billion) equivalent based on a clear procurement organization excellence roadmap and a structured procurement model including strategy, processes, roles, and responsibilities.

3 Frugal IT

As companies, including banks, face growing investment needs in a context of high-cost pressure, Roland Berger has developed a unique IT Frugal approach to optimize investment decisions based on a structured analysis of Costs vs. Value and investment scenarios definition.

Frugal IT approach challenges every item of an IT/ digital investment from multiple perspectives while assessing value vs. cost respective contribution in order to explicit trade-offs and enlightened decision making. It acts on both hard and soft levers to design innovative solutions that capture the core project value while simplifying solutions. On a given investment objective, Frugal IT is constructed on a standard intuitive 5-step approach (Project scope breakdown, Cost deconstruction, Business value reconstruction, Alternative options creation, and Value/ Cost reconciliation) and supported by a comprehensive toolbox.

This approach generates on average 15 to 25% reduction of investment costs, typically with an immediate pay-back, while optimizing the created value and securing the implementation schedule. Moreover, beyond the economic gains, the approach fosters collaboration between IT and business teams, increasing transparency and generating a more shared vision. It also improves the time-to-market of projects, provides better risk analysis, and offers the ability to adjust scope quicker.

Frugal IT Success Story : National marketing campaign tool development

The client was embarking on a project to create a national marketing campaign tool distributed to the network of sales branches. However, IT was not able to develop the solution within the budget of ~USD 10 million (~THB 300 million), as expensive adjustments of a commercial software were required to adapt it to the required workflow. There was no other alternative identified besides IT solutions. The organization had no shared view of what drove value vs. what was ancillary.

Under dual sponsorship from the Head of IT and the CFO, Roland Berger conducted an 8-week IT Frugal project involving relevant stakeholders including but not limited to the Marketing team, the Distribution team (agent network), the IT teams (developments & integration), and the Procurement function (vendor solution selection). Several workshops and ad-hoc interactions were conducted along the 5 key steps of the IT Frugal approach.

The implementation of the Frugal IT approach enabled 25% investment reduction (~USD 2.5 million or THB 76 million) on the project. On top of monetary savings, it helped identify what was the value created by the project and uncovered potential alternatives.

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After a couple of decades of uninterrupted growth for the Thai banking sector and strong focus by managers on business expansion, banks are now confronted with a changing landscape requiring significant investments in transformative technology while facing at the same time margin contraction and an overall challenging macro-economic environment. The transition from a fast-growing sector to a more mature and sophisticated one is weighing on the profitability. The longer-term growth prospect for the Financial Service sector in Thailand and the region is still solid. Banks need to brace themselves for the transition years ahead.

In that context, launching material tactical cost containment programs will be key for the success of their long-term strategy and successfully travel through the "Valley of no return" in the years to come.

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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

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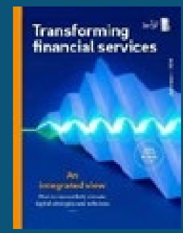

Digital transformation for financial service providers

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

Plan D – Digital all the way

Banks and insurers have some of the greatest digitization potential of all, given that they have been collecting, processing and connecting data on clients and transactions since the year dot.

Locations in Southeast Asia

Indonesia

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