Limiting overdraft exposure: Implications for Myanmar’s banking sector

Private banks are required to gradually reduce overdraft loans to 20% of their respective loan portfolios by July 2020. This is a part of a regulatory and supervisory overhaul and efforts by the Central Bank of Myanmar (CBM) to clean up banks’ balance sheets. There is very little public data on this, but we estimate overdraft loans currently account for USD9.8bn or 70% of the total pool of private banks’ loan portfolio of USD14.1bn as of December 2018. Overdraft loans are normally rolled over indefinitely and never properly recognized in banks’ balance sheets. The market expects up to a third of those could be classified as bad loans under the new, more stringent regulations. Even if only half of what the market estimates is classified as NPLs, the private banking system would have insufficient capital buffers to absorb the loan loss, their balance sheets would be severely impaired, and there would be insolvency risk. This could destabilize Myanmar’s banking sector or trigger a banking crisis amid already-weak public confidence in the banking system. The situation could get worse with the absence of essential building blocks in the financial sector infrastructure and financial safety nets, including an effective banking resolution framework, a viable deposit insurance scheme, and emergency liquidity assistance. Hence, we see high risk of insolvency and instability in Myanmar’s private banking system in the transition to stricter regulations and banking standards, if capital adequacy is not addressed in a proper and timely manner.

Myanmar’s private commercial banks are transitioning to comply with new, improved and stricter regulatory standards to align with international best practices and strengthen the country’s banking sector. The new Financial Institution Law (FIL), together with other laws governing the financial sector, was launched in 2016 with the aim of modernizing and improving the stability of the banking system and the overall financial sector, to support sustainable economic growth (Figure 1). To enforce the FIL (2016), in July 2017, the CBM issued a set of new prudential measures and regulations to overhaul its regulatory and supervisory frameworks. One of those involves restructuring overdraft loans in private banks by transforming them into term loans with a maximum maturity of 3 years by July 2020 and limiting total outstanding overdraft loans at each bank to 20% of their respective loan portfolios. Overdraft Lending in Myanmar is discussed in Box 1 on Page 3.

However, it is challenging for private banks to comply with the new stricter regulations, with some considering them disruptive. Overdraft facilities offered by private banks have been heavily utilized and are popular among businesses to circumvent the CBM’s restrictive regulations, including limiting maturity of term loans to only one year. There is very limited data, but the market estimates overdraft loans account for USD9.8bn or up to 70% of the pool of private banks’ loans amounting to USD14.1bn (as of December 2018). They are normally rolled over indefinitely and have never been properly recognized by the lenders. As a result, it is hard to know exactly how much of these are non-performing loans (NPLs) especially amid the current backdrop of deteriorating debt servicing ability.

This development has undermined public confidence in the entire banking system. The mini bank-run in early September reflects this. While the CBM prohibits banks from converting non-performing overdrafts into loans1, there is growing public concern over instability and mounting NPLs in the private banking system in the run-up to the July 2020 deadline for banks to clear overdraft loans.

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1/ The mini bank-run in early September 2019 was reported by both local and international media, for example, Myanmar banks feel the heat.
In this paper, we explore whether Myanmar’s private banking system has sufficient capital to buffer shocks should a substantial part of overdraft loans be reclassified as NPLs. We took aggregate balance sheet data of private banks published in the CBM’s Quarterly Financial Statistics Bulletin for our analysis. Our analysis suggest it is challenging for private banks to comply with the new, stricter regulations, particularly the Implementation of Asset Classification and Provisioning Regulation (Directive No. 7/2017)\(^2\) which requires banks to cap total volume of overdrafts at 20% of their respective total loans outstanding by July 2020. The market estimates up to 70% of the private banks’ loans might be extended as overdraft loans with indefinite maturity dates, and a third of those could fall under NPLs under the CBM’s new regulations. While we are more optimistic and assume only 15% of the outstanding overdrafts would be NPLs, we find that this could still lead to a substantial drawdown of private banks’ capital buffers. Most of these banks are currently under-capitalized to cushion unexpected losses. And if this scenario materializes, it could destabilize the banking sector or trigger another banking crisis in Myanmar.

Myanmar banks are under-capitalized compared to those of regional peers

Private banks in Myanmar are complying to new, stricter measures and regulations. (The structure of Myanmar’s banking system is discussed in Box 2 on page 6). The CBM is empowered by the FIL (2016) to modernize and improve its regulatory and supervisory frameworks by moving away from a compliance-based framework to a risk-based framework. In 2017, with support from development partners, including the IMF and the World Bank, the CBM issued a set of prudential measures and new regulations with the objective of enhancing banking sector stability, including regulations on (1) capital adequacy, (2) large exposures, (3) asset classification and provisioning, and (4) liquidity requirements, in addition to a directive on credit risk management issued in March 2017. In November 2017, the CBM issued another directive to allow banks to restructure only the viable overdraft loans into term loans with maturities up to 3 years (some of the new regulations are presented in Box 3 on page 8).

Structurally, Myanmar’s private banking system has relatively thin capital compared to those of regional peers (Figure 2). Among ASEAN+3 peers, Myanmar’s banking system has among the lowest capital adequacy; however, this should not be a surprise as the banking sector has been highly regulated. And the interest cap policy introduced in 2011 partially explains this development as fixed lending and deposit rates at a maximum of 13% and minimum of 8% per annum\(^3\), respectively, have severely impeded local banks’ profitability and their ability to recapitalize. This development is also reflected in the declining trends of the capital-based Financial Soundness Indicators (FSIs) which is discussed in the following section. Given the weak capital position, we explore in the next sections if private banks would be able to withstand and comply with new, stricter requirements to cap outstanding overdrafts.

Myanmar’s banking sector: Some structural vulnerabilities

Myanmar has a bank-centric financial system and its banking sector is currently being modernized and developed to better support the growing economy. With the introduction of the Financial Institutions of Myanmar Law in 1990, the country embarked to develop and liberalize its financial sector, and banking activities had grown significantly until the banking crisis in 2003. Following the crisis, the banking sector had been severely constrained and bank credit to the economy (% of GDP) is the lowest among peers at 25.3% compared to that of Cambodia (99.4%) and that of Vietnam (133.3%). These two countries had concurrently embarked on economic liberalization in the 1980’s, the same period as Myanmar did.

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\(^2\) The Implementation of Asset Classification and Provisioning Regulation (Notification 7/2017)

\(^3\) In February 2019, Myanmar banks are permitted to extend unsecured loans with a maximum lending rate of 16%, and the annual credit card interest rate is raised to 20% in April 2019.
Box 1: Overdraft lending in Myanmar

Overdrafts are short-term loan arrangements, where banks allow clients to run a negative balance in current accounts up to an agreed limit. This agreed negative balance is called an overdraft and interest is charged only on the amount drawn. The maturity of overdraft facilities can vary from months to a year. Overdrafts are popular among businesses and bank clients because it gives the flexibility for clients to borrow up to the agreed limit without notifying the lenders.

Overdrafts are popular in Myanmar as the main vehicle for lending and borrowing between banks and clients due to regulatory arbitrage. Following the 2003 banking crisis, the CBM has turned extremely conservative in regulating local private banks. In 2005, the CBM’s Directive (No. 1/2005) set a maximum maturity of 12 months for term loans with strict collateral requirements, while banks accepted mainly short-term deposits. This impeded the banks’ ability to manage maturities to meet the businesses’ long-term financing needs. To circumvent the restrictions, banks and their clients switched to overdrafts which maturities could be rolled over indefinitely.

Figure 3: Aggregate balance sheet of private banks (billion USD as of December 2018)

This development has raised public concern about mounting NPLs in the banks’ books, which could destabilize the banking sector. Against a backdrop of deteriorating debt servicing ability, it is estimated current outstanding overdrafts could account for 70% - 80% of total private banks loan portfolio. Total overdrafts is estimated at between USD9.8bn and USD11.3bn compared to USD14.1bn in total private bank loans. And the market estimates about a third of the overdraft outstanding – mostly commercial loans - could be NPLs (Figure 3). To preserve financial stability, in 2017, the CBM issued prudential measures and regulations to revamp its regulatory and supervisory framework and to encourage banks to clean up their balance sheets. For overdraft loans, each bank is required to gradually reduce total overdraft loans to 20% of its total loan portfolio by July 2020. Further details are discussed in Box 3.

Currently, the maturity of commercial term loans and overdrafts for businesses is capped at 3 years and 1 year, respectively, by CBM regulations. However, since 2015, private banks have been allowed to structure maturities of consumer loans and retail products including education loans, home loans, auto loans, and personal hire purchase loans based on the borrower’s needs and demands. For example, some private banks offer home loans with maturity up to 15 years for apartments, and 25 years for land, buildings and condominiums, at an interest rate of 13% including all fees, which is the lending rate ceiling set by the CBM.
Figure 4: Myanmar’s banking development parameters

Domestic credit to private sector by banks (% of GDP) (as of 2018)

Commercial bank branches (per 100,000 adults) (as of 2018)

Automated teller machines (ATMs) (per 100,000 adults) (as of 2018)

Borrowers with commercial banks (per 1,000 adults) (as of 2018)

Depositors with commercial banks (per 1,000 adults) (as of 2018)

Financial Development Index*

Note: BRN = Brunei, KHM = Cambodia, IDN = Indonesia, LAO = Lao PDR, MYS = Malaysia, MMR = Myanmar, PHL = the Philippines, SGP = Singapore, THA = Thailand, TLS = Timor-Leste, VNM = Vietnam


Note: *the higher the Financial Development Index, the more financial development sector of a country.
In addition, access to credit is one of the most challenging areas in doing business in Myanmar, based on the Ease of Doing Business (DB) index by the World Bank. Out of 190 countries, Myanmar ranks 181st in terms of access to credit and 165th in the overall 2020 DB index. Banking system assets as a percentage of GDP has been rising, from 53.2% in 2015 to 79.2% in 2018. The number of commercial bank branches per 100,000 adults has increased from 1.5 in 2010 to 5.1 in 2018, while the number of ATM machines per 100,000 adults has risen from almost zero in 2010 to 5.6 in 2018. The number of depositors and borrowers at commercial banks (per 1,000 adults) remains low. The overall financial sector needs to be developed further to move up the Financial Development Index (Figure 4).

However, loan growth at private banks has been rising following the gradual liberalization of the sector and relaxation of policies by the CBM since 2011. This includes allowing more types of collateral options for bank loans, deregulating of depository in banks from 10 to 16 times of capital, operating ATMs, issuing L/C for foreign trade, and engaging in foreign currency exchange.

In Myanmar, corporates and businesses prefer overdraft facilities to conventional term loans. This emerged primarily because of the restrictive regulations by the CBM. Banks and businesses have relied on overdraft loans secured mostly by real estate and fixed assets, mostly land and buildings (Figure 5). These overdraft loans are rolled over indefinitely, a practice which has triggered several undesirable policy side-effects and distortions. They include making it more challenging for small and medium-size enterprises (SMEs) to access credit as loans are required to be strictly collateralized by real estate or other immovable assets, credit quality would fluctuate with the value of real estate and encourage related-party lending or limit the pool of bank clients. Therefore, the banking system in Myanmar is not conducive to economic growth and is structurally weak.

As a result, in November 2017, the CBM issued a directive directing private banks to clear their overdrafts at least two weeks every year and facilities that cannot be cleared should be classified as NPL. Banks are prohibited from converting non-performing overdrafts into term loans, leading to speculation several creditors would not be able to clear their overdraft loans, which would lead to mounting NPLs in the private banking system. In addition, CBM requirements also put pressure on private banks to deleverage at least to maintain credit quality. Latest data show loans extended by private banks have contracted to most sectors following strong loan growth periods prior to 2017. If this trend continues, it could lead to a severe contraction of bank credit to the economy, and subsequently, derail Myanmar’s economic growth (Figure 6).
Box 2: Structure of Private Banks in Myanmar

The banking sector represents a sizeable share of the total assets of Myanmar’s financial sector, and the country has a bank-centric financial system like its regional peers. Currently, there are 4 state-owned banks (SOBs), 27 private banks, 13 licensed foreign bank branches, and almost 50 representative offices of foreign financial institutions. While roles of SOBs are declining, reflected by the smaller share of total assets, private banks are playing an increasingly important role against the backdrop of a conservative regulatory environment.

The private banking sector is structurally dominated by a single largest bank. Based on the share of total assets of the private banking system (Figure 7), the sector can be classified into 3 groups: one largest bank, 5 medium-size banks, and 19 small-size banks. Among these, the single largest bank, KBZ, represents about 33% of total system assets, and the remaining 26 banks represent 67%. While financial inclusion remains low in Myanmar especially in terms of access to credit, the large number of small private banks could signal that Myanmar is overbanked.

The number of private banks have surged in the past 3 years. Their share of system assets has increased from 44.1% in 2015 to 58% in 2018. The roles of the 13 current licensed foreign bank branches are also increasing as the CBM has been relaxing regulations and allowing them to engage in a wider scope of business, their share of system assets has expanded from 4.8% in 2015 to 11.2% in 2018. On the other hand, SOBs are playing a smaller role, as reflected by the large drop in deposits, total assets and total liabilities (Table 1). However, based on international experience, the presence of too many small banks might pose a risk to financial stability in the entire system amid weak compliance by local banks and the authorities’ stretched regulatory and supervisory capacity.

Table 1: Structure of Myanmar’s banking sector

<table>
<thead>
<tr>
<th>Number</th>
<th>Branch</th>
<th>Total Deposits (% of system)</th>
<th>Total Assets (% of system)</th>
<th>Total liabilities (% of system)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2015</td>
<td>2018</td>
<td>2015</td>
<td>2018</td>
<td>2015</td>
</tr>
<tr>
<td>State Owned Banks (SOBs)</td>
<td>4</td>
<td>4</td>
<td>515</td>
<td>533</td>
</tr>
<tr>
<td>Private Banks</td>
<td>24</td>
<td>27</td>
<td>1,306</td>
<td>1,844</td>
</tr>
<tr>
<td>Foreign Bank Branch</td>
<td>13</td>
<td>13</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

% of GDP

Source: CBM’s Annual Report for FY2018 (April to September), Transition Period Report

Source: CBM Quarterly Financial Statistics Bulletins, Krungsri Research
Box 2: Structure of Private Banks in Myanmar (Con’t)

Private banks in Myanmar mostly depend on retail deposits - mainly savings and time deposit accounts (CASA) – as the source of funds. CASA represent about 91% of total deposits in non-financial institutions (Figure 8), and the total deposits represent 92% of their total liabilities. The significant reliance on CASA as the main source of funds means there is intense competition among banks, and they may be incentivized to offer higher deposit rates than the 8% annual rate set by the CBM. This would increase cost of funds for those banks. The expansion of deposits as a source of funds may be supported by increasing the number of branches after CBM relaxed restrictions on private banks’ activities, including removing the capital-to-deposit ratio and requirement for additional capital to expand their branch networks. **On the uses of funds, private banks channel deposits mainly into commercial loans, which is about 64% of their total loans** (Figure 9). With the loan-to-deposit ratio legally restricted at the maximum of 80%, some view that this cap coupled with narrow sources of funding has put pressure on credit expansion in Myanmar.

Growth of deposit-taking institutions’ claims on private sector, mainly loans, has recently slowed down in line with the gradual drop in liabilities driven by other deposits (Figure 10 and 11). The slowdown in the growth of both assets and liabilities was noticeable in 1Q 2018 following the implementation of prudential measures and stricter banking regulations by the CBM.

**Figure 8: Sources of funds in private banks (% as of 2018)**

**Figure 9: Uses of funds in private banks (% as of 2018)**

**Figure 10: Contribution to growth of assets side of the Other Depository Corporations (ODCs) Survey**

**Figure 11: Contribution to growth of liabilities side of the Other Depository Corporations (ODCs) Survey**

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Note: 4/ According to the IMF, “the Other Depository Corporations (ODCs) sector represents depository institutions, excluding the central bank, that issue liabilities included in the national definition of broad money. The institutional coverage of the ODC sector varies per country, but at the broadest level may include commercial banks, credit unions, savings institutions and money market mutual funds”.

Source: Myanmar CSO, CBM, Krungsri Research
Box 3: CBM’s New Prudential Measures and Banking Regulations

The CBM has been revamping its regulatory and supervisory framework by moving from a compliance-based supervisory framework towards a risk-based approach. Following the enactment of the FIL (2016), in July 2017, it introduced a series of regulations and directives to bring domestic banking practice standards closer to those accepted by the international community, and to promote stability in the banking sector. The key elements are summarized in Table 2:

<table>
<thead>
<tr>
<th>Key Prudential Measures and Regulations</th>
<th>Main Elements</th>
<th>Effective Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital Adequacy Ratio (CAR) Regulation (Notification No. 16/2017)</td>
<td>• Adopting Basel I standards with a regulatory CAR ratio of 8% (Tier 1: core capital of minimum 4%, and Tier-2 (supplementary capital) of not more than 4%.</td>
<td>January 2018</td>
</tr>
<tr>
<td>Liquidity Ratio Requirement Regulation (Notification No. 19/2017)</td>
<td>• A bank is required to maintain a minimum liquidity ratio of 20%.</td>
<td>July 2017</td>
</tr>
</tbody>
</table>
| Large Exposures Regulation (Notification No. 18/2017) | • A bank is required to limit lending to an individual or a single borrower or group of connected parties to maximum 20% of its core capital.  
• Unsecured transactions are limited to 100% of its core capital  
• The total of all large exposures of a bank should not exceed 8 times its core capital. | July 2017 |
| Asset Classification and Provisioning Regulation (Notification No. 17/2017) | • A bank is required to maintain adequate provision for impairment of loans, advances and other assets. They should be made against all outstanding loans and advances (principal and interest), not just the overdue portions.  
• Specific Provision for loans and advances is as follows:  
  1. Standard: 30 days past due, 0% provision on shortfall in security value  
  2. Watch: 31-60 days past due, 5% provision on shortfall in security value  
  3. Sub-standard: 61-90 days past due, 25% provision on shortfall in security value  
  4. Doubtful: 91-180 days past due, 50% provision on shortfall in security value  
  5. Loss: over 180 days past due, 100% provision on shortfall in security value  
• A bank is required to maintain a general provision of up to 2% of total outstanding loans and advances.  
• Interest earned on loans and advances classified as doubtful or loss should be recognized as income once the interest has been collected by the bank. | July 2017 |
| Implementation of Asset Classification and Provisioning Regulation (Directive No. 7/2017) | • Bank can extend overdrafts and loans with maximum maturity of 1 year and 3 years, respectively  
• Banks are encouraged to develop new loan products to meet the business cycles and cash patterns of the borrowers.  
• Banks are permitted to convert only viable outstanding overdraft loans to term loans with a maximum maturity of 3 years (They are prohibited from converting non-performing overdrafts).  
• Banks’ exposure to overdrafts shall be reduced as follows:  
  1. 50% of total loan outstanding as of 6 July 2018  
  2. 30% of total loan outstanding as of 6 July 2019  
  3. 20% of total loan outstanding as of 6 July 2020 | November 2017 |
| Term Loan Conversion Plan (Directive No. 1/2018) | • Loan interest is required to be paid on a quarterly basis, and for principal repayment, up to 1-year grace period may be set. | January 2018 |


In the periods ahead, to enforce the FIL (2016), the CBM is drafting several measures and regulations to improve domestic banking standards. They include regulations on corporate governance, related-party lending, fit and proper criteria, bank directorships, and acquisition of substantial interests with the assistance of international development partners such as the World Bank. Therefore, we will witness several round of regulatory transformation in Myanmar’s private banks. However, these would be positive changes to the overall industry and the economy.
The market estimates a third of private banks’ overdraft loans would be classified as NPLs under the CBM (Directive No. 7/2017) - Implementation of Asset Classification and Provisioning Regulation. Currently, only a few private banks properly classify and distinguish between term loans and overdraft loans, while many do not\(^5\). In addition, the overdraft facility is the only lending channel for borrowers at several private banks. There is no publicly available data and statistics on overdraft loans either reported by individual banks or reported as aggregate data. However, the market estimates overdraft loans account for 70%-80% of the private banks’ total loan portfolio, or USD9.8bn - USD11.3bn of total loans of USD14.1bn (as of December 2018). If that is correct, the regulation could severely undermine the stability of Myanmar’s banking system and lead to a substantial drawdown of private banks’ equity capital. Given the structural weaknesses, in the next section, we assess the private banks’ stability as they attempt to restructure their overdraft loans.

**Private banks have a vulnerable balance sheet structure and carry risk of insolvency**

A bank’s equity capital plays crucial roles in ensuring its viability as a financial intermediary to support and nurture economic activities. A bank’s capital (or net worth) is the difference between assets and liabilities, or the residual after liquidating all assets at their accounting value. Capital also cushions against unforeseen losses or insolvency, a situation where the value of liabilities exceeds the value of assets, for a bank. This is illustrated in a simple balance sheet structure in Figure 12. Hence, capital provides a buffer against insolvency in a bank, and incentivizes bank managers to manage risks prudently under a sufficiently large and positive level of capital buffer.

Banks with inadequate capital buffers may be harmful to the real sector and the rest of the economy. These zombie banks, banks which liabilities exceed their asset value, also known as insolvent banks, could be a risk to the stability of the country’s financial system. They could undermine public confidence, and consequently, trigger bank runs. In addition, through macro-financial linkages, under-capitalized banks are incapable of providing credit to borrowers; instead, these weak banks may opt to lend to zombie firms and add unpaid interest to the principal loan amount to avoid booking losses. This could undermine their already-weak capital buffers. If there is a widespread capital shortfall, the banking system would become more vulnerable to bank runs, and ultimately, a banking crisis.

Myanmar private banking system however is officially reported sound and stable. Based on the reported official statistics, the ratios of regulatory capital to risk-weighted assets and regulatory tier-1 capital to risk-weighted assets are at 12.8% and 10.8%, respectively, as of 1Q 2019, higher than that required by the CBM. According to the CBM Notification (No. 16/2017) dated 7 July 2017, the minimum regulatory capital adequacy ratio is 8%, and minimum tier-1 capital adequacy ratio is 4%. In addition, asset quality remains sound as reflected by the low NPL ratio, at below 5% as reported by the CBM in its annual report. However, the IMF has voiced through its annual country surveillance reports that Myanmar’s banking system is under-capitalized under current NPL classifications which are not in line with international standards, and there are differences in definitions, standards, and methods of classifying NPLs.

The ratio of capital to risk-weighted assets of banks in advanced economies range from 15% to 23%. Based on previous banking crises, this is sufficient buffer to absorb losses from shocks, according a study by the IMF\(^6\).

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5/ Frontier Myanmar: Tough money: Central Bank steers painful reforms
6/ Dagher, Jihad et al., IMF SDN: Benefits and Costs of Bank Capital

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While there is no conclusive and appropriate capital ratio for banks, banks with larger equity capital or buffers are less likely to take excessive risks. It also means those banks can weather larger losses in a crisis. In our view, the floor for capital to risk-weighted assets ratio could be lowered for frontier and developing economies, including Myanmar, where there are less complex banking activities and banks offer mostly conventional banking services. Nevertheless, with the appropriate recognition and classification of overdraft loans and the current level of capital buffers, substantial loan loss could cause a large drawdown in small banks’ equity capital, which would expose them to smaller buffers than required by the CBM, and possibly destabilize the banking sector.

Currently, on the asset side of private banks’ balance sheets, loans to NFIs and other clients account for about 60% (USD14.1bn) of total assets. The remaining 40% (USD9.5bn) are other assets. On the liabilities and equity side, the sources of funds are primarily retail deposits which represent about 87% (USD20.3bn) of total liabilities, and equity capital account for 5.6% or USD1.3bn (Figure 13).

To explore whether the private banking system in Myanmar has sufficient equity capital to cushion against loan loss when they are required to clear overdraft loans by July 2020, we (optimistically) assumed only 15% - rather than market estimate of one-third - of current outstanding overdrafts would be NPLs. In the absence of official data, we applied market estimate that 70% of total loans outstanding is overdraft loans.

In our simple simulation (Figure 14), NPLs could reach USD1.5bn of total outstanding overdraft loans (USD9.8bn) and 6.3% of total assets in the system. Loan loss provision and total equity capital are only USD0.01bn and USD1.3bn, respectively. Even in our more optimistic scenario than the market’s, our analysis shows capital buffers in the private banking system would be insufficient to absorb the loss.
Private banks in Myanmar have vulnerable balance sheet structures, which can expose them to insolvency risk. Limited data has prevented the full assessment of potential NPLs and recapitalization needs. However, uneven loan loss recognition and inadequate provisions, large exposures, and low capital adequacy, have raised concerns of systemic risks. Low capital adequacy may be reflected by some of the capital-based FSIs (Figure 15). Some small vulnerable banks may need urgent recapitalization to meet the new regulatory requirement to pre-empt systemic risks triggered by insolvency and instability, which could ultimately fuel a bank run. The CBM may encourage small banks to merge and consolidate to meet the capital requirements, to reap the advantages of economies of scale, and to increase competitiveness to compete with foreign lenders as the domestic banking sector is gradually liberalized. In addition, small viable banks could be recapitalized through foreign minority equity investments up to 35% stake, the limit set by the Myanmar Companies Act (2017). However, the CBM is authorized to approve larger foreign equity participation in local banks on a case-by-case basis.\(^7\)

\(^7\) On 7 November 2019, the CBM issued the announcement of New Round of Foreign Bank of Licensing in the Republic of the Union of Myanmar by allowing foreign bank ownership into a Myanmar domestic bank exceeding 35% of the capital of the domestic bank on a case-by-case basis. In addition, foreign banks may apply for either a branch license – allowing a range of wholesale banking activities – or a subsidiary license allowing wholesale services and, starting from January 2021, allowing onshore retail banking services: [https://www.cbm.gov.mm/content/5240](https://www.cbm.gov.mm/content/5240)
In addition to weak capital buffers, other structural weaknesses in the balance sheets could destabilize private banks despite the fact that loans are sufficiently secured by collateral (Table 3). Myanmar’s private banks are prone to concentration risks, by sector and geography.

- **Concentration in commercial loans**: By sector, private banks’ loans to the trading, construction, services, production sectors and general lending account for 88.5% total loans outstanding. Other sectors such as SMEs, transportation, and hire purchase, account for 4.7%, 2.3%, 2.1%, while housing loans account for 0.4% of the total loan portfolio (Figure 16).

- **Concentration in Yangon**: Private banks’ loans are geographically concentrated in Yangon, the former capital city and business center (Figure 17). Approximately 80% of loans (as of December 2018) are extended in Yangon Region and about 12% in Mandalay Region. Private banks rarely extend loans in Rakhine State, Kachin State, Chin State, which collectively account for only 0.6% of private banks’ total loans outstanding.

- **Highly secured loans**: Strict collateral requirements cause private banks’ to focus on lending to a small group of clients who have immovable assets such as land and buildings. Although the CBM has gradually expanded the list of eligible collateral for bank loans (Table 4), about 80% of private banks’ loans are still secured by land and buildings (Figure 9). This exposes the banks’ assets to fluctuations in real estate prices. Recently, banks have been required to conduct fixed asset revaluation after real estate prices fell by around 30%\(^8\). This could further weaken banks’ balance sheet positions.

Table 3: Some prudential measures of the CBM

<table>
<thead>
<tr>
<th>Types of collateral</th>
<th>Collateral Details</th>
<th>Instruction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land &amp; Building</td>
<td>Maximum 50% of forced sale value</td>
<td></td>
</tr>
<tr>
<td>Treasury bonds</td>
<td>Maximum 80% of the assessed value</td>
<td>Directive No. 27/2012</td>
</tr>
<tr>
<td>Saving and fixed deposits</td>
<td>Maximum 80% of outstanding savings</td>
<td>Directive No. 24/2011</td>
</tr>
<tr>
<td>Gold</td>
<td>Maximum 75% of assessed value for only 1-year term</td>
<td>Directive No. 22/2011</td>
</tr>
<tr>
<td>Machines and crops</td>
<td>Maximum 60% of the assessed value</td>
<td>Directive No. 25/2011</td>
</tr>
</tbody>
</table>


Table 4: List of eligible collateral (CBM)

<table>
<thead>
<tr>
<th>Date of Issue</th>
<th>Instruction</th>
<th>Collateral</th>
</tr>
</thead>
<tbody>
<tr>
<td>25 May 2005</td>
<td>Instruction No 1/2005</td>
<td>Strong Collateral</td>
</tr>
<tr>
<td>8 September 2011</td>
<td>Instruction No 22/2011</td>
<td>Gold, Accessories made of gold</td>
</tr>
<tr>
<td>27 December 2011</td>
<td>Instruction No 24/2011</td>
<td>Bank deposits</td>
</tr>
<tr>
<td>25 January 2012</td>
<td>Instruction No 25/2012</td>
<td>Machinery, Goods, Crops</td>
</tr>
<tr>
<td>8 June 2012</td>
<td>Instruction No 27/2012</td>
<td>Treasury bonds</td>
</tr>
</tbody>
</table>

Source: CBM, JICA

\(^8\) Myanmar Financial Services Report (2018)
Under-developed financial sector infrastructure and financial safety nets could exacerbate any instability in the banking sector

There should be some essential building blocks in place in the financial or banking system to allow financial institutions, including banks, to perform their functions effectively. Coupled with a strong legal and supervisory framework, the ecosystem in which banks operate should have the following key elements and building blocks (Figure 18):

1) **Development in the real sector**: Economic conditions play crucial roles in determining the banks’ overall performance, including asset quality and loan growth.

2) **Sound internal management systems**: Banks’ management frameworks, including good governance, well-developed strategies, and risk management, should help to safeguard operations as well as to sustain public confidence.

3) **Resilient financial sector infrastructure**: This includes an effective resolution regime, viable deposit insurance scheme, and emergency liquidity assistance.

4) **Public trust and client confidence in the banking system**: This may be supported by several factors, including the central bank functioning as the lender of last resort, an effective financial safety net such as a deposit insurance scheme, and a resolution framework.

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**Figure 17**: Geographical distribution of private banks’ loans by region and state (% share, as of December 2018)

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**Figure 18**: Analysis Framework - Banking System Stability

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Source: CBM Quarterly Financial Statistics Bulletins, Krungsri Research

Source: Krirk Vanikkul, Phrasiam Magazine Vol.4 2013, Bank of Thailand, Krungsri Research
The absence of such essential building blocks for the financial sector means higher instability risk in Myanmar’s banking sector. While Myanmar has been working to upgrade its regulatory and supervisory frameworks, some of the fundamental infrastructure - both soft and hard - in the financial sector are still not in place or are being developed. The main infrastructure includes an effective bank resolution and contingency plan, a viable deposit insurance scheme, and emergency liquidity assistance. These play important roles in ensuring public confidence in the banking system and could prevent banks from failing. Based on international experience, a country that does not have a strong financial safety net in place faces financial instability risks. In addition, frontier and developing economies (FDEs) have experienced instability in their respective banking sectors, with 38 of the 54 FDEs experiencing full-blown banking crises since 1976. This had resulted in considerable economic and fiscal costs estimated at 10% of GDP. Hence, the lack of essential building blocks for financial sector infrastructure and key financial sector safety net could exacerbate any banking sector instability by putting constraints on the authorities to address failing or insolvent banks in a timely manner to avoid financial instability.

Krungsri Research’s view: Myanmar’s banking sector stability could be fragile

Private banks in Myanmar are under considerable pressure to clean up their balance sheets following the CBM’s directive to gradually reduce overdraft loans to 20% of their respective total loan portfolios by July 2020. The banks have been dependent on overdraft lending facilities to circumvent the CBM’s restrictive regulations. This corresponds with the fact that most of the loans extended by private banks are commercial loans. It is estimated that outstanding overdrafts account for 70%-80% of the total loan portfolio, and these loans are normally rolled over indefinitely without being properly recognized in the banks’ books. This has created concerns over mounting NPLs on banks’ balance sheets as the deadline for compliance approaches. The market estimates non-performing overdrafts could reach a third of current outstanding overdraft loans.

Current capital buffers and loan loss provision in private banks are inadequate to absorb the losses, even only a half of what market expects which is about a third of the outstanding overdrafts becomes NPLs. This means private banks are prone to insolvency risk. With the current loan portfolio at USD14.1bn and assuming outstanding overdrafts is 70% of that, NPLs could amount to USD1.5bn, surpassing the system’s current loan loss provisions (USD0.01bn) and banks’ capital buffer (USD1.3bn). This may lead several private banks, especially small banks, into insolvency, and increase instability risk in the system. And, the banking sector instability could be exacerbated by the lack of effective financial sector infrastructure and efficient financial safety net, such as a banking resolution platform, a viable deposit insurance scheme, and emergency liquidity assistance framework to address failing or insolvent banks in a timely manner, against a backdrop of weak public confidence in the banking system and correction in real estate prices.

To conclude, the private banking system in Myanmar is prone to insolvency and instability risks as they transition to stricter regulations and banking standards, if the issue of capital adequacy is not addressed in a properly and timely manner.

9/ Luc Laeven and Fabian Valencia: Systemic Banking Crises Revisited, IMF Working Paper No. WP/206/18
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