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Financial Integration Challenges in ASEAN Beyond 2015

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Financial integration has many potential economic benefits. However, it also carries potential risks. In ASEAN, since its financial sector is generally bank-dominated, the banking sector is a key driver in the financial integration process. The ASEAN Banking Integration Framework (ABIF) aims to provide financial stability in the region and achieve multilateral liberalization in the banking sector by 2020 for ASEAN commercial banks. Given the diversity of financial market development, economic structure, and priorities among ASEAN members, the implementation process of ABIF is very challenging, particularly in terms of establishing the necessary preconditions. The biggest technical challenges concern the harmonization of the principles of prudential regulations and the building of financial stability infrastructure. Political challenges, meanwhile, stem from varying political commitments to ABIF between countries, with the ABIF process experiencing numerous domestic political backlashes.

ASEAN countries can learn lessons from European Union (EU) banking integration, especially in light of the recent European sovereign and banking crisis, but it must be emphasized that the ABIF will not be the same as that of the EU banking integration. Ultimately, ABIF will continue to progress in the "ASEAN way" marked by small incremental changes, pragmatism and countries retaining much of their sovereignty.

Key Issues :

- *Technical challenges to achieving ABIF*
  - *Harmonization of principles of prudential regulations*
  - *Building of financial stability infrastructure*
- *Political challenges to achieving ABIF*
  - *Dominance of domestic political backlashes in the ABIF process*
  - *Wide spectrum of political commitments to ABIF*

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Introduction

Although financial integration in Asia has lagged behind trade integration, financial linkages in the region may nevertheless be seen to be deepening as shown in the growth of the Asian bond market from USD600 billion in 2000[1] to USD6.5 trillion at the end of 2012[2] and in the increasingly important presence of contractual savings institutions like pension funds and insurance companies in the emerging East Asian bond market in recent years. Financial integration has many potential economic benefits. It helps global rebalancing, induces more competition, and provides financial access to underserved households and firms, thereby reducing financing constraints that hamper consumption and investment. Cross-border banking also tends to improve overall economic performance by ensuring that productive capital is channeled towards the most efficient firms, thereby reducing the risk of crises caused by the mispricing of investment risk[3].

Despite its potential benefits, however, financial integration also carries potential risks. The recent global financial crisis has brought to light the risks of financial sector development without sufficient regulatory structures in place. There is therefore the need for better regulations, supervision, transparency, and a less risky business model.

Towards Banking Integration: the ASEAN Banking Integration Framework (ABIF)

The Association of Southeast Asian Nations (ASEAN) envisages integrated financial and capital markets under the ASEAN Economic Community (AEC) Blueprint. It is expected that an integrated regional financial system with more liberalized financial services, capital account regimes and interlinked capital markets will facilitate greater trade and investment flows in the region.

As the ASEAN financial sector is generally bank-dominated, the banking sector is a key driver in the financial integration process. Banking integration in ASEAN has been proceeding slowly but surely. In April 2011, ASEAN Central Bank Governors endorsed the ASEAN Banking Integration Framework (ABIF), which aims to provide financial stability in the region and achieve multilateral liberalization in the banking sector by 2020 for ASEAN commercial banks.

Given the diversity of financial market development, economic structure, and priorities among ASEAN members, however, the implementation process of ABIF is very challenging, particularly in terms of establishing the necessary preconditions. To ensure a successful implementation of ABIF, four pre-conditions have been agreed upon: (1) harmonization of principles of prudential regulations; (2) building of financial stability infrastructure; (3) provision of capacity building for Brunei Darussalam, Cambodia, Lao PDR, Myanmar, and Viet Nam (BCLMV); and (4) setting up of agreed criteria for Qualified ASEAN Banks (QAB) to operate in any ASEAN country with a single "passport".

Technical Challenges to Achieving ABIF

In all areas of the ABIF, gaps were identified among ASEAN countries, particularly between ASEAN-5 (Singapore, Malaysia, Thailand, Philippines, and Indonesia) and BCLMV (Brunei Darussalam, Cambodia, Lao PDR, Myanmar and Viet Nam), including in terms of domestic banking regulations and financial stability infrastructure. The biggest challenges concern (a) harmonizing principles of prudential regulations, and (b) closing the gaps in financial stability infrastructure between ASEAN-5 and BCLMV, especially with regard to macroprudential policies and crisis management protocol.

(a) Harmonization of Principles of Prudential Regulations

Harmonization of principles of prudential regulations among ASEAN members is needed to create a level playing field, as big differences remain between countries. For example, Singapore is far ahead of some of its BCLMV counterparts. The city-state has adopted the strictest prudential regulations, including the adoption of Basel II.5 and has the highest paid-up capital for conventional foreign bank branches. Difficulties in harmonization also arise due to the diversity of ASEAN countries in terms of their financial sector depths and systemic risks, which therefore calls for different levels of macroeconomic prudence.

Among the areas identified for harmonization in the prudential regulation measures are: (1) bank accounting standards and disclosure requirements, (2) minimum capital requirements, (3) prompt corrective action (PCA) and methodologies for the resolution of failed banks, (4) restrictions on large exposure, and (5) anti-money laundering and consumer protection regulations.

The question now is how to harmonize the principles of prudential regulations without lowering the prudential standards which may put a threat to regional financial stability, and at the same time, without making the prudential standards so high that they become irrelevant or even adverse to other countries that have adopted lower standards.

(b) Financial Stability Infrastructure

Building financial stability infrastructure as a pre-condition for ABIF is a necessary measure to prevent crises. Macroprudential policy has not been comprehensive, fully integrated or even adopted in most of the BCLMV countries. For example, unlike their ASEAN-5 counterparts, BCLMV countries have not yet integrated crisis management in the definition of macroprudential policy.

Financial stability infrastructure may thus start from the establishment of such infrastructure in each country; but eventually, there will have to be some regional financial stability infrastructure such as a regional macro-prudential monitoring and surveillance system (which is under the ASEAN+3 Macroeconomic Research Office or AMRO now), regional crisis management protocol, regional payment and settlement system, and regional financial safety net (which is under the Chiang Mai Initiative Multilateralisation or CMIM now).

Political Challenges to Achieving ABIF

Thus far, the ABIF process has been dominated by domestic political backlashes, which has slowed the process and caused the ever-present risk of the process becoming deadlocked. As such, progress on fulfilling some of the preconditions has been slow, notably regarding harmonization of prudential regulations to create a level playing field, and building financial stability infrastructure to ensure that adequate crisis-prevention and crisis-management measures are set up. Greater progress, on the other hand, has been achieved by the working groups on capacity building and QAB.

There is a wide spectrum of political commitments to ABIF. At one end of the spectrum, in Malaysia, for example, ABIF has been integrated as a national blueprint. At the other end of the spectrum, in Indonesia, there is still an internal debate among the central bank officials about whether or not the benefits of ABIF outweigh the costs. Because each country will be impacted differently by ABIF, differing political commitments to the process are therefore not surprising. For example, Indonesia with a large market and unsaturated demand for banking services will take a more cautious, protectionist approach to banking liberalization than Malaysia which has a saturated market and is likely to take a more aggressive approach to liberalization.

Given the above, it needs to be emphasized that the ABIF process is as important as the achievement of the end goal of ABIF itself. It is therefore critical that *ASEAN countries do not push too fast nor too far if individual countries do not yet have strong commitments to integration, because banking integration carries risks that require strong political commitments to minimize them.*

ASEAN Banking Integration Framework: Beyond 2015

Measuring Banking Integration

There has been some controversy about measuring banking integration. The ABIF concept of integration is commercial presence of QAB, which is used as the benchmark for ASEAN banking integration by 2020. However, it is difficult to see how commercial banks' presence can be deployed as a measure of banking integration to indicate to what extent ABIF has brought about economic benefits and financial stability.

More appropriately, in the language of the ASEAN Framework Agreement on Services (AFAS), banking integration can be measured by cross-border bank flows (Mode 1 of AFAS), consumption abroad (Mode 2 of AFAS), commercial bank presence (Mode 3 of AFAS), and movement of natural persons (Mode 4 of AFAS).

The four preconditions in ABIF mentioned earlier may seem to contradict AFAS, which promotes services liberalization, since ABIF may increase regulatory and prudential barriers instead of promoting banking liberalization. However, it is best to view ABIF as 'AFAS+'. While AFAS promotes banking liberalization via the four abovementioned modes, ABIF provides the "soft infrastructure" (harmonized regulation) and "hard infrastructure" (financial stability infrastructure).

Lessons from Europe

ASEAN countries can draw some lessons from the European Union (EU) banking integration, especially in light of the recent European sovereign and banking crisis, and the proposals concerning greater banking, fiscal and political union in the wake of the crisis.

Two key lessons that can be considered are:

- *For a regional ASEAN banking system, banking resolution, cross-border banking supervision and deposit guarantee system are needed.* Banking integration will need funds in case of a bank restructuring, which must otherwise be paid by national governments and taxpayers' money. ASEAN countries must decide whether the host or home country should pay for a bank's restructuring and for what types of banks (branches, subsidiaries, etc.). This will impact on fiscal policies in either the home or host countries. For banking integration to be achieved, independent central banks that are able to enforce prudential financial regulations are needed.

- *Banking integration will necessitate a central, integrated, single banking supervision, and a central or federal deposit insurance mechanism.* Preventing sovereign problems from spreading to banks (e.g., the case of Greece) and preventing banking problems from spreading to sovereigns (e.g. Ireland, Cyprus) are of key importance. Given the cross-border networks of banks, any bailout program must be coordinated across the border. An important hurdle of the bailout program in the European economies is the absence of a cross-border integrated supervisory capacity to fully assess the extent of the bailouts needed. ASEAN must therefore realize that building trust through deepening cooperation among supervisors across the borders is of vital importance for the successful management of an increasingly interconnected banking system.

Conclusion

Although there is no need to re-invent regional banking standards to be adopted at ABIF, since banking standards are regulated globally, ABIF could make sure that given ASEAN's more conservative and traditional banking sector than those of the United States and Europe, global banking standards remain relevant to the different banking sector development in the region and do not impede development and growth that are still very much needed by most of the ASEAN countries. ABIF will not be like that of the EU banking integration initiative, especially since ASEAN is not and does not need to have a supranational body like that of the EU. ABIF will continue to progress in the "ASEAN way" marked by small incremental changes, pragmatism and countries retaining much of their sovereignty.

Finally, financial integration is a complex and difficult process which involves a number of requisites and challenges. For ASEAN, banking integration, in particular, faces a lot of challenges not only in terms of technical aspects but also, and more so, of political issues. Since ASEAN member countries (i.e., ASEAN-5 and BCLMV) have different economic, political, institutional and technical levels of capacity in meeting said challenges, it is best that ASEAN countries, especially the less developed ones, do not push the process too fast nor too far. At the very least, capacity building is very much needed for BCLMV and perhaps even for some of the ASEAN-5 countries.

On the whole, what is important to note is that financial integration in ASEAN will be a long-term process and concern.■

[1]People's Republic of China, Hong Kong, South Korea, Thailand and Viet Nam.

[2]People's Republic of China, Hong Kong, Indonesia, South Korea, Malaysia, the Philippines, Singapore, Thailand and Viet Nam.

[3]Gonzales-Paramo and Jose Manuel, "Globalization, international financial integration and the financial crisis: the future of European and international financial market regulation and supervision," speech delivered in Dublin, Ireland, 19 February 2010.

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