The Promises of Bank Integration in ASEAN: Is There a Catch?

Maria Socorro Gochoco–Bautista

Professor of Economics, School of Economics
University of the Philippines

Eli M. Remolona

Chief Representative for Asia and the Pacific
Bank for International Settlements

In recent years, regional bank integration has been on the rise and is evidently the 'new normal'. The Association of Southeast Asian Nations (ASEAN) region, along with other regions such as Central America and the Commonwealth of Independent States, has seen banks headquartered in the region assume a stronger regional orientation, especially in the post Global Financial Crisis (GFC) period of 2008–2009. Given the historical dominance of bank-based finance in ASEAN, this seems to be the obvious next step in a natural progression of regional economic integration. What is perhaps less understandable is ASEAN's enthusiastic efforts to further accelerate the process of regional bank integration in light of the risks made apparent by a similar process in Europe.

The ASEAN Bank Integration Framework (ABIF) and its Guidelines were endorsed by the ASEAN Central Bank Governors in December 2014. Three months later, in March 2015, the ASEAN Finance Ministers signed the Protocol to implement the 6th Package of Commitments, which contains a provision to enable ABIF's implementation. Under ABIF, so-called 'Qualified ASEAN Banks', or QABs, in one member's jurisdiction are allowed to operate freely in others. Arrangements regarding QABs are currently being pursued amongst ASEAN members on a bilateral basis.

The underlying premise of ABIF is that banking integration in ASEAN will contribute to both economic growth and financial inclusion in the region. An integrated regional banking system is expected to confer greater efficiency through economies of scale, network externalities, and greater competition through the entry of foreign banks.

These would make possible lower costs and greater diversity in the types of services offered and expanded opportunities for risk sharing. These advantages would promote increased trade and investment via greater access to finance, especially by the currently 'unbanked' masses and small and medium-sized enterprises.

However, regional banking integration is a two-edged sword – it comes with risks as well as benefits. Remolona and Shim (2015: 130) identified: potential sources of risk to financial stability arising from the presence of common and concentrated lenders within the region, and through foreign branches and subsidiaries; liquidity risk arising from the preference for using foreign currency funding by regional banks; and the shortening of the tenor of foreign currency loans. Perhaps more importantly, the ASEAN initiative favours banks from within the region over banks from other regions and would thus increase the regional concentration of cross-border banking activity. The Asian Financial Crisis (AFC) of 1997–1998 shows that such concentration can be a source of contagion within the region. Van Rijckeghem and Weder (2003) found that when a bank is exposed to a crisis country, it reduces its lending to other countries. This is how a regional concentration of cross-border lending becomes a mechanism for contagion.

In the coming years, the expectation is that banking groups headquartered in ASEAN will continue to expand and to make their regional presence more strongly felt. They would increase their intra-regional share of foreign bank ownership and their share of portfolio investment in the region (CGFS, 2014: 1). As this process unfolds, it can also be expected that the risk profiles of these regionally based banking groups will change. The sheer size of their balance sheets gives them a capacity for expansion, and the business models they adopt will make them systemically more important, rivalling the large globally active banks headquartered in advanced economies that lend to the region currently.

In this chapter, we attempt to assess the current state of banking integration and examine the forces that propel as well as constrain banking integration in ASEAN. By understanding the evolution of integration and the implications of these forces for the calculus of potential benefits and potential costs of banking integration in ASEAN, we would be able to suggest ways in which authorities in ASEAN can improve the trade-offs between the benefits from banking integration in ASEAN and its risks.

The Importance of the Global Financial Cycle

To discuss how ASEAN has arrived where it now finds itself in terms of financial integration or, more specifically, banking integration, it helps to understand the global context in which this process has been taking place. This process in Asia represents the regional dimension of what Rey (2015) called the global financial cycle. In the boom part of the cycle, emerging markets, in general, and emerging Asia in particular, receive a flood of capital flows. In the bust part of the cycle, the flows recede and sometimes even reverse. What drives the cycle is a common global risk factor. What we see is not a tug-of-war between so-called push factors related to global developments and pull factors related to country-specific developments. Instead, as Amstad, Remolona, and Shek (2016) showed, we see a division of labour, in which the global risk factor drives what happens over time, while country-specific factors influence what happens in the cross-section in terms of the degree to which the global factor affects different countries.

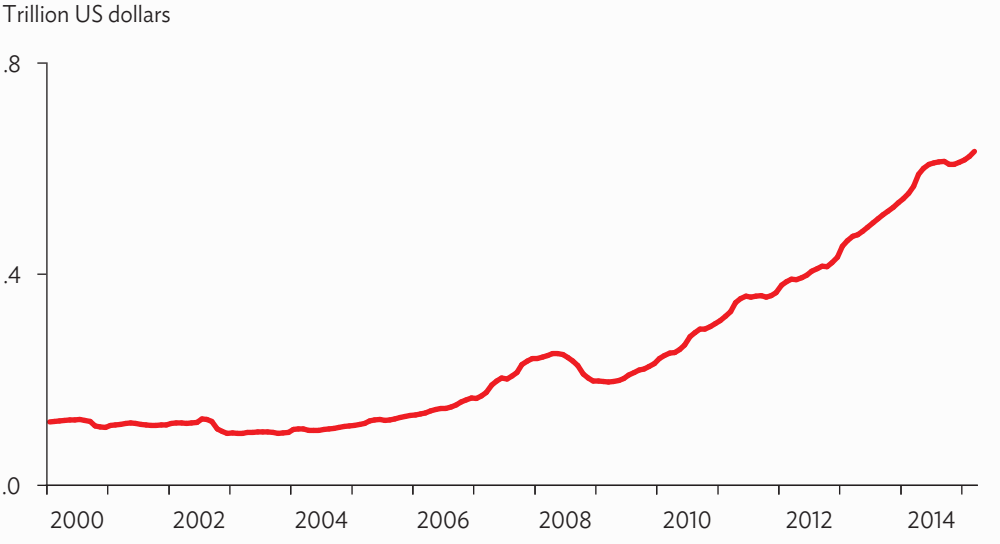
In the wake of the GFC, the central banks of the United States (US), Japan, and Europe attempted to avoid a depression by driving interest rates down to the zero lower bound and then by drastically expanding their balance sheets with massive asset purchases. All this led to a flood of global liquidity and a rise in global investors' risk appetites. These underlay a common factor that sent prodigious amounts of capital flows into emerging markets as whole.

It has become imperative for authorities in recipient countries to respond in a way to try to constructively deal with large cross-border flows and the attendant potential risks to financial stability. The existence of a common component in the global financial cycle amongst asset prices, risk appetite, and credit, implies that, to a large extent, global factors dictate the direction and pace of cross-border flows, the behaviour of global banks and investors, and the creation of credit and asset booms. That the global financial cycle responds mostly to global factors and is not necessarily synchronous with domestic business cycles is a problem for domestic monetary authorities who may want to use independent monetary policy to address them, but are constrained by their inability to counter the adverse effects of the global financial cycle on their individual economies' financial and real sectors.

Cross-border flows driven by global factors have been a fact of life for some time. However, the GFC of 2008–2009 was a particular watershed event that highlighted the vulnerability of banking systems in recipient or host countries such as those in emerging economies in Asia, including those in ASEAN. Using Bank for International Settlements (BIS) data, Figure 1 shows the rise in cross-border bank claims to the Asia–Pacific region

in US dollars between 2002 and 2007, particularly in the years immediately prior to the GFC. There was a pronounced decline in cross-border bank claims to the Asia–Pacific region during the GFC, from US$230 billion in September 2008 to US$190 billion in March 2009, and then a dramatic acceleration in cross-border bank claims after the GFC beginning in March 2010 at US$240 billion to US$620 billion as of March 2015. Cross-border bank flows into the Asia–Pacific region, including ASEAN, are many times larger today than they were at any time prior to the GFC.

Figure 1: Cross-border Claims (Asia–Pacific)



Source: Basic data from BIS.

The Role of Banks

The central role that global banks play as creditors to emerging market economies (EMEs) as well as the volatility of bank flows cannot be emphasised enough. In what Shin (2013) referred to as the 'first phase of global liquidity', global banks increased their leverage to provide cross-border lending primarily in US dollars. The sheer magnitude of these global banking flows, especially to non-residents outside the US, opened up opportunities for banks, as the flows required intermediation activities, even as the existence of such flows also presented challenges to monetary authorities particularly in EMEs with less-than-mature financial systems.

Globally, several characteristics of global credit to non-residents stand out, as shown in Figure 2, based on data from the BIS. First, bank credit is by far the most important source of credit to non-residents in the non-bank sector. Second, the amount of US dollar credit to non-residents in the non-bank sector dwarfs that of credit to the same sector in either euros or Japanese yen. Third, US dollar bank credit largely dictates the trend in total credit in any of the three currencies. Since the GFC, yen credit in debt securities has declined. Bank lending in each type of currency has generally followed a rising trend since the GFC, although in the case of euro credit, bank lending has been overtaken post-GFC by debt securities.

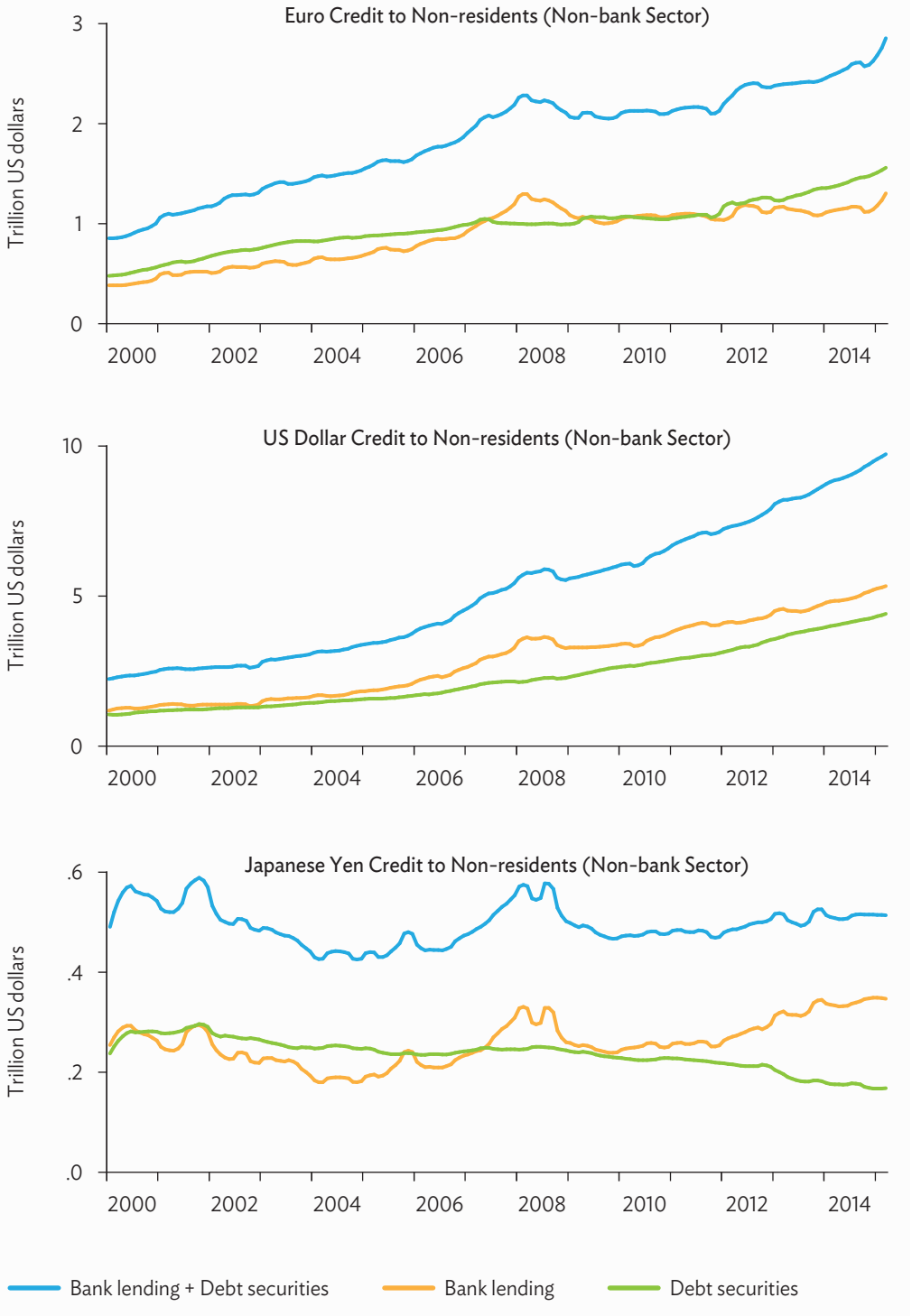
Van Rijckeghem and Weder (2003: 484) pointed out that banks constituted the single largest group of creditors to EMEs before the AFC of 1997–1998, but that bank lending, relative to other types of private capital flows, was also the most volatile component of capital flows during the crisis. According to the statistics they cite, roughly a third of all private inflows, amounting to US$120 billion into 29 EMEs in 1996 prior to the AFC, were net bank flows. However, these net bank flows dropped to only about 9% of total private inflows in 1997, and actually turned into net outflows of about US$30 billion by 1998, illustrating the large volatility of bank flows especially when a financial crisis occurs.

Rising Bank Integration in ASEAN

One of the factors propelling cross-border expansion by banks in ASEAN appears to be the reduced opportunities for expansion that ASEAN banks face in increasingly saturated domestic markets. Banks in ASEAN are also operating within a more competitive environment in which the focus continues to be on retail banking and deposit funding, but with higher capitalisation ratios even prior to the GFC and which made them resilient to the crisis. All these provide a rationale for and the ability of overseas expansion by regional banks.

Another important factor is the retreat of European banks after the GFC. Prior to the GFC, European banks were the largest creditors in all regions during the AFC. Most of the cross-border bank lending activity in the Asia–Pacific region then was in US dollars and intermediated by European banks (Remolona and Shim, 2015: 119). From 2001–2007, European banks intermediated mostly US dollar flows coming from the US to Europe and then to Asia–Pacific.

Figure 2: Credit to Non-residents (Non-bank Sector)



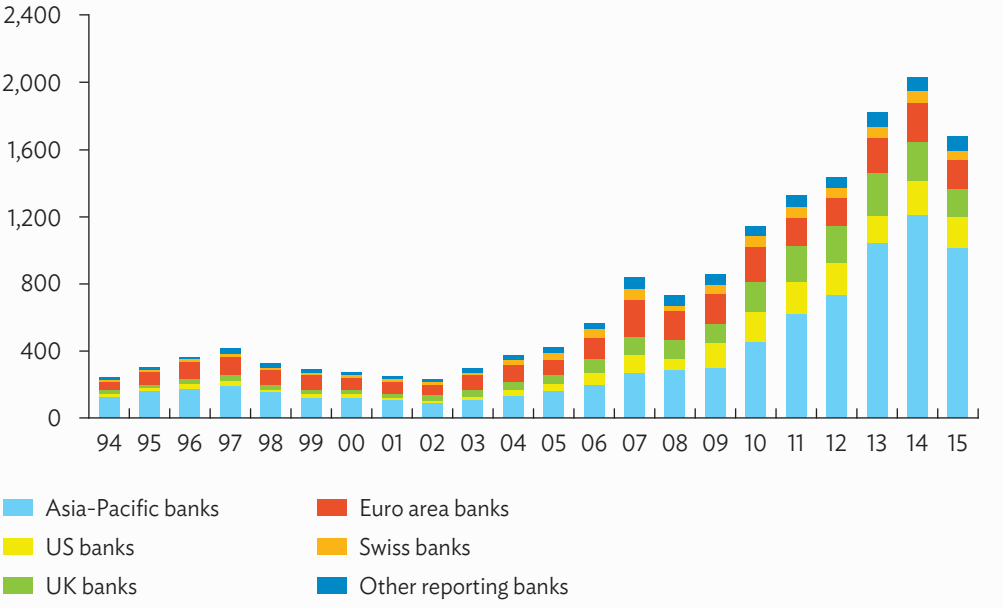
Source: Basic data from BIS.

The subprime crisis that began in the US and culminated in the GFC hit European financial institutions hard, as 40% of the securities backed by US subprime mortgages were held by European financial institutions (Litan, 2011). With the GFC and the retreat of European banks, a good opportunity arose for banks headquartered in the region to take their place and expand within the region. Not only did banks from within the region come in, they soon dominated cross-border activity. The pattern of financial intermediation in cross-border banking activity in the Asia–Pacific region has changed in the post GFC period as the bulk of financial intermediation now occurs within the region.

The regional banking framework adopted by ASEAN is expected to give further impetus to this growing intra-regional banking trend. Asian economies excluding Japan appear to be more regionally integrated than other regions as they obtain financing from other economies within the region. While these funds may actually originate from outside the region, they are in large part intermediated through two banking centres in Asia – Hong Kong and Singapore. In other words, the presence of regional banking centres facilitates cross-border bank financing in Asia. Singapore-based banks, for example, which used to source funds from within the region for lending outside the region, became net borrowers from advanced economies in the post GFC period from June 2012 to September 2014. In this period, Singapore-based banks lent an average of US$163 billion a month to emerging economies in Asia (Remolona and Shim, 2015).

The role of the composition of lenders may be an important factor in explaining spillovers through banking centres, according to Van Rijckeghem and Weder (2003). They found that international bank lending flows are predicted by banks' exposures to a crisis country following the Mexican and Asian financial crises. They cite the fact that, unlike North American banks, which merely shifted their lending from Asia to Latin America and Europe during the AFC, or European banks, which continued to lend to Asia and other regions and only shifted their lending to Latin America and Europe in the first half of 1998, Japanese banks withdrew from Asia and reduced their claims from US$124 billion in mid-1997 to US$86 billion by end 1998, with average flows being smallest for Japanese banks during the AFC (Van Rijckeghem and Weder, 2003). This is because Japanese banks suffered the more significant losses on account of their large exposure to the region during the AFC, with exposures of 70% of capital in four crisis countries – the Republic of Korea, Indonesia, Malaysia, and Thailand (Van Rijckeghem and Weder, 2003).

Figure 3: International Claims on Emerging Asia
(by home region or creditor bank, in US$ billion)



UK = United Kingdom; US = United States.
Source: BIS.

Figure 3 shows the international bank claims on Emerging Asia in billions of US dollars by home region of the creditor bank, based on BIS data. The data show that on the eve of the AFC, banks from within the region accounted for US$171.6 billion or 47% of exposures to Emerging Asia while euro area banks accounted for US$117 billion or 32%. Six years after the AFC, banks from the region still accounted for only US$105.7 billion or 35% of exposures while euro area banks accounted for US$107.9 billion or 36% of exposures. This suggests the presence of lingering supply effects of the crisis, which hit Asian banks harder than euro area banks. By contrast, on the eve of the 2008 crisis, banks from within the region and banks from the euro area both accounted for 31% of exposures to Emerging Asia at US$264.0 billion and US$263.2 billion, respectively. Six years after the GFC, in 2014, banks from within the region accounted for US$1,207.3 billion or 59% of exposures to the region, while euro area banks accounted for a mere US$269.1 billion or 13% of exposures, again reflecting supply shocks in which euro area banks were hit harder by the GFC. In terms of market concentration, Ehlers and Wooldridge (2015) found that exposure to the three largest creditor banking systems in the Asia–Pacific has increased since 2007, with New Zealand, Thailand, and Malaysia experiencing especially large increases in concentration.

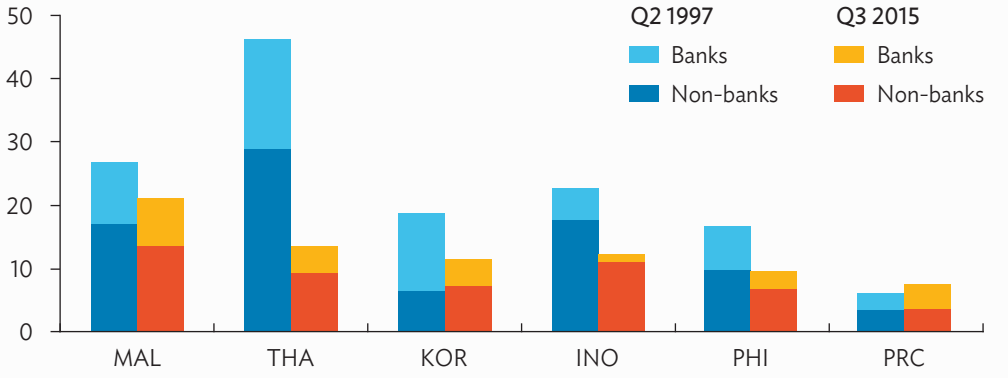
Not only do banks from the region account for more than half of total exposures to the region, some Asia-based banks also joined the ranks of global systemically important banks (GSIBs) as of November 2015. Using a 5-indicator-based measurement approach consisting of different equally weighted categories – cross-jurisdictional activity, size, interconnectedness, substitutability/financial institution infrastructure, and complexity – seven banks in Asia of 30 globally have been identified as GSIBs, according to Remolona (2016). These seven banks are Mitsubishi UFJ, Agricultural Bank of China, Bank of China, China Construction Bank, ICBC, Mizuho, and Sumitomo Mitsui. Of the seven Asian-based GSIBs, three are Japanese banks and four are Chinese banks. Japan has long been a regional creditor, but Chinese banks are a new major regional creditor. Surprisingly, despite the roles of Hong Kong and Singapore in intermediating flows in ASEAN, none of the regional SIBs are based in ASEAN. In any case, the large concentration of international bank lending in the region in these Japanese and Chinese GSIBs may lead to financial contagion and a drying up of bank flows to countries in the region were there to be a crisis in any of the countries in the region or in either Japan or China that would drive these regional and global SIBs to withdraw from the region, as Japanese banks did during the AFC.

This may be a legitimate cause for concern regarding Chinese banks especially, as there are indications that the bulk of bank lending by outside banks has gone to borrowers in China, as suggested by the increase in the total assets of Chinese banks' foreign offices in Asia (Remolona and Shim, 2015). Of the US$2.5 trillion cross-border bank claims on EMEs as of 2012, half of these went to the Asia–Pacific region, with the majority of the increase accounted for by lending to China, Brazil, and Russia (CGFS, 2014).

Figure 4 shows international bank claims on selected Asian countries as a percentage of gross domestic product in two periods – Q2 1997 and Q3 2015. China is the only country where bank lending to banks and non-banks in Q3 2015 was larger than in Q2 1997, although Figure 4 also shows that this ratio is lowest in China relative to the other Asian economies.

In terms of the share of short-term claims in all international claims on emerging Asia–Pacific, Figure 5 shows that Asia–Pacific banks, alongside US banks, have been lending increasingly short-term within the region. In 2014, the share of short-term loans of Asia–Pacific banks amounted to 70% (Remolona and Shim, 2015). Figure 5 also shows that China's share of short-term borrowing has been on a sharp rising trend since around 1999, declining only during the GFC, but China's share of short-term borrowing rose to almost 80% as of 2014 from about 30% to 60% in the period between the AFC and the GFC (Remolona and Shim, 2015). This share is much higher than those of Indonesia, Malaysia, the Philippines, Thailand, and the Republic of Korea, although their shares of short-term debt rose slightly in the same period.

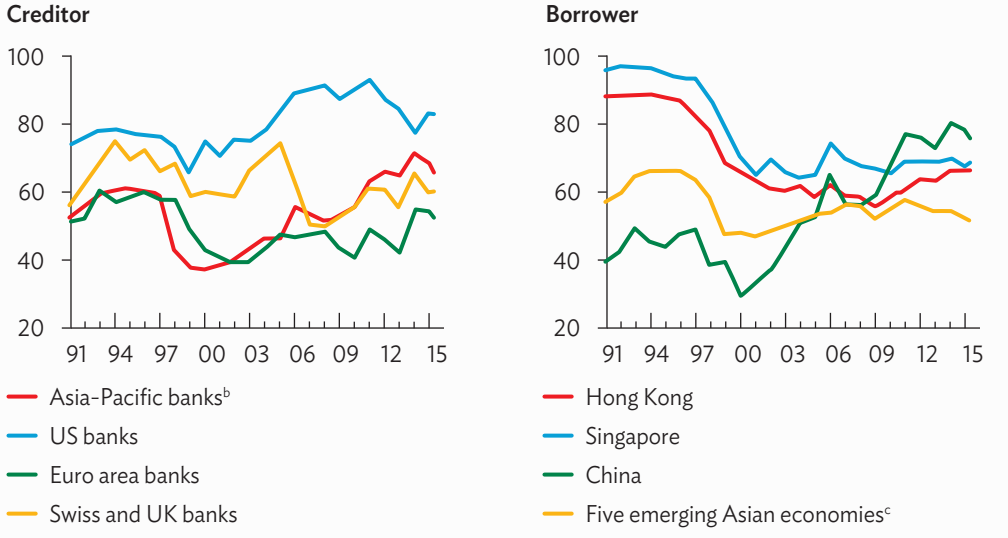
Figure 4: International Bank Claims on Selected Asian Countries (as % of GDP)



GDP = gross domestic product; MAL = Malaysia; THA = Thailand; KOR = Republic of Korea; INO = Indonesia; PHI = Philippines; PRC = People's Republic of China.

Source: Remolona (2016).

Figure 5: Share of Short-term Claims[a] in All International Claims on Emerging Asia–Pacific (%)



UK = United Kingdom; US = United States.

[a] Maturity equal to or less than one year.

[b] Includes outside area banks, i.e. those that do not report to BIS consolidated banking statistics at a given point in time, on the assumption that outside area banks lending to emerging Asia-Pacific economies are headquartered in Asia-Pacific. Also includes: Japanese banks (from Q2 1990); Taiwan and Singaporean banks (from Q4 2000); Indian banks (from Q4 2001); Australian banks (from Q4 2003); Hong Kong banks (from Q2 2005); Republic of Korea banks (from Q4 2011).

[c] Indonesia, Republic of Korea, Malaysia, the Philippines, and Thailand.

Sources: Remolona and Shim (2015: 129); BIS consolidated banking statistics (immediate borrower basis); authors' calculations.

In summary, the exposure of Asia-based banks to the region accounts for more than half of total exposures; several Japanese and Chinese banks have become regional and global SIBs; China has become the top borrower or destination of international bank claims in the region; and the bulk of this borrowing, some 80% in China's case, is short-term. The phenomenon of having a large share of short-term borrowing appears to be largely confined to China as there are differences in the degree to which the different Asian economies rely on short-term foreign currency liabilities.

Potential Risks

One potential risk to bank integration is the risk to financial stability arising from contagion. Banking centres may become conduits for financial contagion at the system and institutional levels. There are two possible reasons for this: a 'common lender' effect and a 'wake up call' effect (Van Rijckghem and Weder, 2003: 484).

Under a 'common lender' effect, when a home bank's balance sheet is adversely affected, it spills over to a host country or many host countries as losses incurred in a host country leads the home bank to reduce exposures elsewhere. Contagion occurs as a bank creditor withdraws from one country in which it holds a position to restore capital adequacy ratios, meet margin calls, acts according to the dictates of its Value-at-Risk model, etc., when it experiences a loss in another country. Under a 'wake-up call' effect, the withdrawal of a bank creditor from a country is due to a change in perceptions for an entire class of assets following a crisis, or to a general rise in risk aversion.

Given the previous discussion of the findings in Van Rijckghem and Weder's (2003) study, there is historical evidence of contagion through a 'common lender' effect in the case of Japanese banks' lending to Asia during the AFC given their large exposure to at least four crisis-hit Asian countries. They found a statistically significant 'common lender' effect in which for each additional dollar of exposure to Thailand, on average, flows per Emerging Market fell by four cents (Van Rijckghem and Weder, 2003; Ehlers and Wooldridge, 2015). In addition, we have presented evidence that indicates that regional lending has become more concentrated in that over half of total exposure of Asia–Pacific banks is to the Asia–Pacific region, and that seven Japanese and Chinese banks have become not only regional SIBs but GSIBs as well. It may also be the case that bank operations of foreign-based banks account for a large share of host country banking system assets, in which case the foreign-based bank may have a systemic role in the host country even if relative to the size of its global operations, operations in the host country are not large.

Thus, the risk of contagion through spillover effects arising from potential losses of these important regional bank lenders were there to be a crisis somewhere that would cause them to withdraw from the region is a real one.

A second source of potential risk from bank integration is liquidity risk related to foreign currency funding in US dollars, given the limited depth of local markets to provide local currency liquidity and to distribute such liquidity more evenly across domestic banks. Much of the US dollar funding of regional banks is obtained from global wholesale markets and derivatives markets and lent through cross-border flows. Cross-border flows are a less stable source of foreign currency financing than are foreign claims extended through affiliates of foreign banks (CGFS, 2014; Ehlers and Wooldridge, 2015). The foreign currency loan-to-deposit ratio of regional banks is typically in excess of 100% and in some cases has been declining recently. In time of stress, foreign currency funding is less stable than local currency funding, most of which comes from core deposits (Remolona and Shim, 2015). The lack of local currency funding by foreign banks in a host jurisdiction is seen in their having a local currency funding gap, i.e. their local currency liabilities are less than their local currency assets. Banks could convert US dollars into local currency to fill this gap, but then they would also face exchange rate risk, also given the limited opportunities for hedging such risk in light of the relative underdevelopment of capital markets in the region.

A third potential source of risk to financial stability from bank integration is the shortening of the tenor of foreign, mostly US dollar, loans extended to non-banks intra-regionally by Asia–Pacific banks largely due to the reliance on inter-bank markets as a funding source. Any breakdown in inter-bank market operations would jeopardise the ability to continue to secure funding even on such short-term tenor or roll over existing debt. In the case of a potential 'wake up call' kind of contagion effect in which protection from contagion entails lengthening the maturity structure of debt and reducing the reliance on debt, this is a potentially serious problem ex ante. As was the case during the AFC, it is also possible for there to be maturity structure mismatches in foreign currency borrowing and lending.

There are other important potential sources of financial instability from bank integration. The current system of national regulation of foreign bank branches may not be optimal with rising regional bank integration. A regulatory framework reliant on home country regulation of foreign bank branches may not be conducive to the recognition of systemic risk in home countries. Ehlers and Wooldridge (2015) pointed out that in many countries, bank branches, unlike domestic banks and foreign subsidiaries, face a different set of capital and liquidity requirements. There may thus be an incentive for regulatory arbitrage by foreign bank branches. And foreign bank branching is typically the preferred mode of expansion as is it less costly to set up relative to setting up a foreign subsidiary.

Measures to Address Potential Risks

There is a need to improve the regulatory environment in the region through greater cooperative efforts and action. It is important for regulatory authorities in the region to cooperate with each other to better recognise the presence of systemic risk, take steps to mitigate such risk, prevent the failure of regionally active banks, and act promptly, decisively, and in a cooperative and coordinated way to allocate losses and deal with the failure of regionally active banks. Perhaps it is time to consider the benefits of a regional and coordinated approach to recognising and dealing with systemic risks given more concentrated and common lender banks based in the region and the regulatory trade-off with respect to supervisory independence now accorded national authorities in dealing with regional banks active in the region. These efforts could be undertaken and cooperation and information sharing could be enhanced within the Executives' Meeting of East Asia Pacific Central Banks (EMEAP).

Regional authorities must learn to better decipher potential channels of systemic risk and financial contagion. Given the increased concentration of lenders in the region, the possibility of a 'common lender' effect is heightened. One way to reduce this type of potential risk to financial stability is to diversify the region's sources of funding and assess the vulnerability of the different regional economies by monitoring the region's vulnerability to shared bank creditors and to certain banks that have large exposures to countries in the region, and taking prompt collective action. The good news is that we know who the regional and global SIBs from Asia–Pacific are, that the amount of exposure of Asia–Pacific banks in the region is large, and that the bulk of lending is short-term, sourced from inter-bank markets and delivered through cross-border bank flows by regionally active banks. These are good starting points for monitoring purposes. That said, countries also need to be willing to share data and information more readily to enhance their and the region's ability to deal with systemic risk.

Even in the absence of 'wake-up call' effects of potential contagion, it would be prudent to try and reduce the amount of short-term borrowing from regional banks, especially in US dollars. Since the source of funds lent short-term tend to be inter-bank markets, ways must be found to increase the amount of high-quality assets in the region and reduce the risk of dysfunction in inter-bank markets and to provide stable sources of local-currency funding for regional banks. This can be promoted by deepening local financial and capital markets, especially local currency bond markets. Gochoco–Bautista and Remolona (2012) proposed, amongst others, extending the Chiang Mai Initiative Multilateralization (CMIM) into a regional repo market in which central banks agree to accept cross-border collateral in the form of government and corporate bonds from within ASEAN+3. It would turn CMIM into a facility that provides a daily source of local-currency liquidity rather than one that operates only during a crisis.

Monetary authorities in the region should also learn lessons from dealing with previous crises in which there was a drying up of liquidity (in US dollars). Developing a system of currency swaps in regional currencies may be a more effective safety net that will have the added benefit of promoting the development of local currency capital markets.

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