29th Asian Shadow Financial Regulatory Committee Statement

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ASEAN Bank Integration: Benefits, Risks, and Opportunities

Overview

Banks headquartered in ASEAN have assumed a stronger regional orientation, especially in the post Global Financial Crisis (GFC) period. According to the BIS, in 2014, six years after the GFC, banks from the Asia-Pacific region accounted for 59 percent of exposures to the region, equivalent to USD 1207.3B, compared to the exposure of euro-area banks which accounted for only 13 percent or USD 269.1B. Prior to the GFC, which began in 2008, banks from within the Asia-Pacific region and the euro area had similar exposures of roughly 31 percent to the region at USD 264B and USD 263.2B, respectively.

The regional bank integration process is expected to intensify in the coming years. One reason is the endorsement of the ASEAN Bank Integration Framework (ABIF) and its Guidelines by the Central Bank Governors in December 2014 and the signing of the Protocol to implement the 6th Package of Commitments by the ASEAN Finance Ministers in March 2015. Under ABIF, Qualified ASEAN Banks or QABs allows countries in ASEAN to negotiate bilaterally in order for their qualified banks to operate freely in other jurisdictions and be treated as local banks in these jurisdictions. These developments are part of the overall aim of achieving a high level of economic integration, including bank integration within ASEAN by 2020.

In addition to ASEAN economies themselves, other non-ASEAN economies in the region view ASEAN as a high-growth region with much potential. Banks from Taiwan, for example, are actively seeking to expand their operations in ASEAN economies, primarily to provide financing to firms and investors from Taiwan in ASEAN. Under the "Southbound Policy" for banks in 2015, the Taiwanese Regulatory Authority encouraged banks to operate in Southeast Asia in order to diversify risk especially since the Taiwanese economy has seen low growth in the last decade. The main source of bank profit growth in the last five years has been from overseas lending. During these years more than 40 percent of Taiwanese banks' profits from overseas have come from mainland China and 10 percent from ASEAN. With the moderation of growth in mainland China last year, most Taiwanese banks experienced declining profitability or even losses in their mainland China operations, encouraging even greater focus on ASEAN with economies like the Philippines, Vietnam and others exhibiting impressive growth rates.

In this statement we discuss the potential benefits, risks, and opportunities arising from ASEAN bank integration and provide policy implications and recommendations.

Benefits

Bank integration in ASEAN is expected to confer benefits such as greater efficiency through economies of scale, network externalities, and greater competition in the domestic banking sector from the entry of regional banks. In turn, these would lower costs and increase the variety of products and services offered as well as expand the opportunities for risk sharing. These benefits from regional bank integration is also expected to promote increased trade and investment and thereby enhance financial inclusion through the process of allowing greater access to finance by the currently “unbanked” masses and small and medium enterprises.

Aside from helping sustain and enhance growth in ASEAN economies, the entry of banks into ASEAN countries could promote financial inclusion. Many Taiwanese banks, for example, have extensive experience in lending to small and medium enterprises which they can attempt to replicate in ASEAN countries.

Potential Risks

Greater regional bank integration leading to a concentration of common lenders within a region can create its own potential risks to financial stability. These include: 1) liquidity risk arising from the preference for foreign currency funding by regional banks, particularly in US dollars; 2) the increased regional concentration of cross-border lending activity increasing the probability of contagion within the region; 3) the changing risk profiles of regionally-based banking groups with an increased intra-regional share of bank ownership and portfolio investment which could expand their balance sheets as well as their capacity to expand their activities within the region and make them more systemically important. More concentrated regional sources of lending and larger and systemically-more important banks within the region also present additional challenges to regulatory authorities to better detect and recognize systemic risk as well as undertake the appropriate supervisory and regulatory measures. Monetary policy actions could be undermined by the presence of alternative sources of credit which could, in turn, induce the formation of asset bubbles in housing and equity markets and compromise macroeconomic and financial sector stability in host countries.

Policy Implications and Recommendations

1. The risk of contagion and heightened systemic risk arising from having concentrated and common lenders can be mitigated by improving the regulatory environment. Regulatory authorities in the region should cooperate by monitoring banks, sharing information, and better recognizing the presence of systemic risk in order to prevent the failure of regionally-active banks. Their actions should be prompt, decisive and coordinated. Such efforts could be undertaken within the Executives’ Meeting of East Asia Pacific Central Banks (EMEAP), for example. Other more formal and informal methods of regional regulatory cooperation/coordination could be considered. The recent experience in the Eurozone illustrates the difficulties and the complexity of allowing banks to operate

freely in a region while having national authorities regulate the operations of regional banks within national jurisdictions and offers lessons on the need for attention to be paid to the regulatory aspect of regional bank integration.

2 Liquidity risk can be mitigated by having policies that are not exclusive to ASEAN but that allow banks from other economies to enter and provide additional US dollar liquidity. This would help diversify the region's sources of funding and reduce the risk of contagion due to a "common lender" effect. In addition, ASEAN economies should wean themselves away from dependence on the US dollar. This can be done by developing a regional repo market in regional currencies to reduce borrowing in US dollars from regional banks as well as increasing the amount of high-quality assets denominated in regional currencies to provide stable sources of local-currency funding for regional banks. For example, regional central banks could agree to accept cross-border collateral in the form of government and corporate bonds from within ASEAN+3 to have a facility that provides a daily source of local currency liquidity. Local currency capital market development could also be promoted by developing a system of currency swaps in regional currencies to provide a safety net against US dollar liquidity shortages and the risks associated with short-term borrowing within the region.

3 The challenges to the effectiveness of monetary policy and macroeconomic stability in host countries given alternative and additional sources of credit may encourage monetary authorities in these countries to use macro-prudential measures to try and restore some degree of independence to monetary policy as well as safeguard macroeconomic and financial stability by helping protect bank balance sheets.

4 ASEAN bank integration should pave the way for greater financial internationalization. For example the experience of Taiwanese banks in lending to small and medium enterprises can benefit countries like the Philippines by making the banking system more inclusive. ASEAN bank integration can be viewed as a first step towards greater financial internationalization by allowing ASEAN banks to gain experience in operating in a more competitive cross-border environment.

Reference: The Promises of Bank Integration in ASEAN: Is There a Catch? Maria Socorro Gochoco-Bautista and Eli Remolona forthcoming in book volume "ASEAN at 50" volume 3 as part of ERIA's book volume project on ASEAN.