

# The Road to ASEAN Financial Integration

A Combined Study on Assessing the  
Financial Landscape and Formulating Milestones  
for Monetary and Financial Integration in ASEAN



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# Preface

In January 2007, leaders of the Association of Southeast Asian Nations (ASEAN) affirmed their commitment to the creation of the ASEAN Economic Community (AEC) by 2015 and “to transform ASEAN into a region with free movement of goods, services, investment, skilled labor, and freer flow of capital.” To move the work program forward toward AEC 2015, the ASEAN central bank governors agreed to conduct a study to assess if ASEAN financial integration is on track and to recommend any further initiatives needed to achieve financial integration by 2015. In the same manner, the ASEAN finance ministers endorsed a study that comprehensively maps the current financial conditions in ASEAN and that makes relevant recommendations on the next steps needed to achieve integrated financial markets in ASEAN by 2015.

Recognizing the similarities of the scope as well as the possible overlaps and duplication of outputs, the two studies were combined into a *Combined Study on Assessing the Financial Landscape and Formulating Milestones for Monetary and Financial Integration in ASEAN* (Combined Study). The Combined Study aimed to critically and comprehensively assess financial sector regimes and the policy landscape in ASEAN, recommend a detailed financial integration milestones blueprint that shall lay out a comprehensive program to achieve ASEAN financial integration by 2015, and recommend institutional and policy reforms to be implemented in 2011–2020.

During the ASEAN Central Bank Governors’ Meeting held on 7 April 2011, the governors highlighted the imperative for financial integration to support regional economic integration to develop ASEAN into a leading growth region. Mindful of this, the governors accepted the results of the Combined Study as an important reference for ASEAN to further guide its financial integration process.

This summary report reflects the views of ASEAN on the state of financial integration in the region, with inputs from the respective studies drafted by a team of consultants led by Prof. Yung Chul Park and was funded and supported by the Asian Development Bank under the regional technical assistance on Assessing the Financial Landscape and Formulating Milestones for Monetary and Financial Integration in ASEAN, Phase 2.

# Abbreviations

AEC	–	ASEAN Economic Community
ACMF	–	ASEAN Capital Markets Forum
APN	–	ASEAN Payment Network
ASEAN	–	Association of Southeast Asian Nations
ASEAN 5	–	Indonesia, Malaysia, Philippines, Singapore, and Thailand (the original member states of ASEAN)
BCLMV	–	Brunei Darussalam, Cambodia, Lao People’s Democratic Republic, Myanmar, and Viet Nam (the five newer member states of ASEAN)
CAL	–	capital account liberalization
CMD	–	capital market development
EU	–	European Union
FSL	–	financial services liberalization
GDP	–	gross domestic product
IMF	–	International Monetary Fund
Lao PDR	–	Lao People’s Democratic Republic
PCA	–	prompt corrective action
PSS	–	payment and settlement system
QAB	–	qualified ASEAN bank
URR	–	unremunerated reserve requirement
WCCMD	–	ASEAN Working Committee on Capital Market Development
WCPSS	–	ASEAN Working Committee on Payment and Settlement Systems

# I. Introduction: Imperatives of Financial Integration

A new regional community is in the making in Southeast Asia. At the 12th Summit of the Association of Southeast Asian Nations (ASEAN) in January 2007, the member countries affirmed their commitment to create the ASEAN Economic Community (AEC) by 2015 and “to transform ASEAN into a region with free movement of goods, services, investment, and skilled labor, and freer flow of capital.” In creating the AEC, ASEAN will observe “the principles of an open, outward-looking, inclusive, and market-driven economy consistent with multilateral rules as well as adherence to rules-based systems for effective compliance and implementation of economic commitments.” The formation of such a community will benefit from the successful liberalization of the capital account and the domestic financial market in individual countries, and from the ASEAN-wide integration of financial markets and institutions supported by regulatory harmonization and the strengthening of policy coordination among the member states.

Over the past 2 decades, ASEAN member states have made great strides in improving the efficiency and soundness of their financial institutions and in developing money and capital markets. Yet, compared with their counterparts in advanced countries, ASEAN banks and other financial institutions are not large enough in asset size to compete effectively against global players in international financial markets. Small, segmented, and illiquid, various financial markets in ASEAN are vulnerable to shocks from outside the region. Stringent regulation of some cross-border financial transactions has also impeded ASEAN-wide financial integration. ASEAN must therefore place a high priority on speeding up and deepening regional financial integration to realize its continuing commitment to community building.

This study suggests plans for capital account liberalization (CAL) and financial services liberalization (FSL) in the ASEAN banking sector, together with institutional and policy reforms and an ASEAN framework for policy coordination and mutual assistance over 2011–2020. It proposes financial integration targets and directions consistent with the objectives of the ASEAN initiatives, identifies the required institutional and policy reforms, and describes the sequencing and time frame for the implementation of both CAL and FSL over the 10-year period.

The choice of target level and path of integration to be followed can be made from a wide range of options. This study considers full integration comparable to the level achieved by the core member countries of the European Union (EU) to be too ambitious for a 10-year period in view of the fact that it took the EU more than half a century to reach its current level of integration. The recent European financial crisis also provides important lessons on the challenges of such full integration. An alternative approach proposed in this study would be to allow financial integration in different member states to proceed at different speeds in order to build regional financial market infrastructure and harmonize institutions, market practices, and policies, and thus lay the foundation for regional financial integration.

In this study, planning for financial integration is guided by two reference frameworks for CAL and ASEAN-wide financial integration—one for the five original members (ASEAN 5) and another for the five newcomers (BCLMV).<sup>1</sup>

The plan proposes common objectives and a single end goal for all ASEAN member states, but with different timelines and milestones for each country

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<sup>1</sup> The countries that compose ASEAN 5 are Indonesia, Malaysia, the Philippines, Singapore, and Thailand. The BCLMV countries are Brunei Darussalam, Cambodia, the Lao People's Democratic Republic, Myanmar, and Viet Nam.

depending on its readiness in terms of the quality of its financial market infrastructure and financial standards of practice, the quality of its financial infrastructure, and its institutional capacity to implement reform. It also takes into account the gap between the ASEAN 5 and BCLMV states relative to the planned outcomes, and explores ways to narrow the gap over time.

In drawing up the plans for FSL and CAL, this study reviews and consolidates the following ASEAN-specific initiatives and plans:

- (i) those prepared by the ASEAN working committees on FSL, CAL, and CMD under the Roadmap for Monetary and Financial Integration of ASEAN;
- (ii) the strategic schedule of the AEC Blueprint 2015;
- (iii) the banking sector master plans of individual member states; and
- (iv) other official and private sector initiatives.



## II. Where the Region Stands

### A. Economic Growth and Structural Change

**D**iversity is one major characteristic of the member states of ASEAN. They differ significantly in size, stage of development, and industrial structure. For example, Indonesia, the largest economy in the region (with a nominal gross domestic product [GDP] of \$546.5 billion in 2009), is almost 100 times the size of the Lao People's Democratic Republic (Lao PDR), with a nominal GDP of \$5.6 billion. For the past 10 years, the ASEAN member states have sustained rapid growth averaging 6.6% in 2001–2009, almost twice the average GDP growth of the world economy. They have also managed reasonable price stability and accumulated sizable current account surpluses amounting to 6.8% of their combined GDP during the period.

Most ASEAN member states have chosen to pursue an export-oriented development strategy over the past several decades. This strategy has led to a large tradable sector: the ratio of total trade to GDP reached 103.6% in 2009. But despite the high degree of trade openness, the ASEAN member states do not trade among themselves as much as they do with other parts of the world.

For example, intra-regional trade in ASEAN is estimated to be only 24.5% of the region's total trade in 2009, compared with 49% in EU15.<sup>2</sup> With the rapid growth of the external sector and GDP, however, the share of intra-regional trade has increased, from 21.3% in 1994 to 24.5% in 2009. To a large extent, this increase reflects ASEAN's active promotion of freer trade with its

neighboring countries in recent years. ASEAN has concluded negotiations for five free trade agreements with the People's Republic of China (PRC), India, Japan, the Republic of Korea, and Australia plus New Zealand. These trade agreements may further increase ASEAN's intra-regional trade as a proportion of total trade.

### B. Financial Landscape

#### 1. Financial Markets and Institutions

Reflecting the diversity of their economies, some standard metrics of financial development—such as deposit money banks' assets, stock market capitalization, and the value of bonds outstanding as a proportion of GDP—show considerable differences across ASEAN. These differences are largely associated with differences in the size of stock and bond markets. Financial institutions in ASEAN are generally classified into (i) banks, including commercial banks and special-purpose banks (or specialized financial institutions); (ii) nonbank financial institutions; and (iii) capital market-related financial institutions. All three types of financial institutions are present in each of the ASEAN 5 states, but not in the BCLMV members.

##### a. Banking Institutions

Commercial banks are by far the most important type of financial institutions in ASEAN. Overall, they accounted for more than 82% of total financial assets in ASEAN in 2009. For the BCLMV, the share was even higher, at 98%. Commercial banks are supervised and regulated mainly by the central bank, whereas special-purpose banks

<sup>2</sup> The EU15 countries—the member countries of the EU before the accession of 10 other countries in 2004—were Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden, and the United Kingdom. See Organisation for Economic Co-operation and Development, <http://stats.oecd.org/glossary/detail.asp?ID=6805>

and nonbank financial institutions are regulated by different regulatory agencies. The average capital adequacy ratio of all ASEAN commercial banks was higher than 15% in 2009. The average nonperforming loan ratio of commercial banks in most of the member states was less than 5%. These ratios suggest that, on average, most ASEAN banks meet the international standards for soundness and safety.

Measured in terms of assets, ASEAN banks are, on average, rather small on an international scale. The average size of assets of these banks amounted to \$4.8 billion in 2009, far below the \$14 billion in total assets of the world's 500 largest commercial banks. There are large differences in the size of banks across ASEAN: the average size is higher than \$14 billion in Malaysia and Singapore, and almost \$10 billion in Thailand, but it is less than \$3 billion in other member states.

The list of the top 500 commercial bank brands, as selected by Brand Finance of the United Kingdom, includes 24 ASEAN commercial banks. Of these 24 banks, only one is among the top global 100 commercial banks. In terms of market capitalization, only three Singaporean banks and one Malaysian bank rank among the world's top 100 banks. Moreover, the market capitalization of all of the 24 ASEAN commercial banks combined is smaller than that of Industrial and Commercial Bank of China (ICBC), China Construction Bank, or Hongkong and Shanghai Banking Corporation (HSBC).

ASEAN needs to nurture globally competitive banks. The integration of ASEAN banking institutions will create an environment conducive to the emergence of such banks. It will build up a customer base large enough to support the growth of large competitive banks with a foothold in global banking through mergers and the acquisition of small banks.

#### **b. Nonbank Financial Institutions**

Nonbank and capital market-related financial institutions, except for insurance companies, are at an early stage of development, with limited intermediation capacity. Insurance companies are the only type of nonbank financial institution that is common across ASEAN, and even these differ in their main business activities from one member

country to the other. Life insurance has a relatively large market in ASEAN 5, whereas nonlife or general insurance dominates the insurance market in the BCLMV members.

Lending and borrowing by nonbank financial institutions, except for insurance companies, is often limited to a particular geographic area or a particular type of activity, such as financing for medium-sized companies. Their asset and liability management is subject to government regulations, and there are constraints on foreign competition. An exception is the insurance industry, which is substantially open to foreign investors. The average market share of foreign-owned and foreign-controlled insurance companies is as high as 40% in some ASEAN member states. Yet, because of their small size and the complexity involved in designing and marketing insurance products, local companies have been unable to compete against large Western companies that have long penetrated the regional market. For this reason, it is difficult to find a local insurance company that operates in other ASEAN member states.

## **2. Regional Financial Integration**

### **a. Commercial Banks**

ASEAN's banking market has so far seen little integration. Although the ASEAN 5 states have taken steps to open up their banking industry, cross-border banking and the cross-border penetration of ASEAN-based banks within ASEAN have been slow to develop. In 2010, not a single ASEAN-based commercial bank had either a branch or a subsidiary in all ASEAN member states. The three ASEAN banks with the widest regional presence (Maybank of Malaysia, Bangkok Bank of Thailand, and United Overseas Bank of Singapore) have operations in seven ASEAN member states. In contrast, global commercial banks have a large presence in the region. Standard Chartered Bank has subsidiaries in seven member states and representative offices in three. Citibank and HSBC also have subsidiaries in seven member states. To compete effectively, ASEAN banks must develop financial resources and managerial capacity, meet international standards, and achieve similar levels of regional penetration. Liberalization alone will not achieve the intended result of banking integration since some

ASEAN banks will still fall short of national regulatory standards compared with foreign banks.

**b. Portfolio Investment Flows among ASEAN Member States**

Reflecting the gradual pace of financial integration, intra-ASEAN portfolio investments as a proportion of the region's total investments have been relatively small. Among ASEAN 5, Singapore

and Malaysia are the two largest portfolio investors, with 84.2% and 12.1% of the total intra-ASEAN portfolio investments in 2009. Outward portfolio investments of ASEAN 5 within ASEAN more than tripled—from \$103.6 million to \$352.1 million—between 2001 and 2009. Inward investments of these countries more than quadrupled over the same period, to \$407.2 million.

### III. The ASEAN Vision

The AEC is “the realization of the end goal of economic integration” as envisaged in Vision 2020, declared in 1997. It is “a stable, prosperous and highly competitive ASEAN economic region in which there is a free flow of goods, services and investments, a freer flow of capital, equitable economic development and reduced poverty and socio-economic disparities.” In establishing the AEC, ASEAN has agreed to adopt “the principles of an open, outward-looking, inclusive, and market-driven economy consistent with multilateral rules as well as adherence to rules-based systems for effective compliance and implementation of economic commitments.”

The AEC would be built on an integrated financial sector with safeguards to enhance regional economic integration and to accelerate regional economic growth. ASEAN-wide financial integration would proceed with the orderly implementation of FSL and CAL, supported by ASEAN-wide regulatory arrangements, including mechanisms for crisis prevention, management, and resolution and for ASEAN-linked payment.

In recognition of the diversity in economic and social backgrounds, a well-prepared and

well-organized integration process would need to allow the member states to maintain orderly financial sector development as well as financial and socioeconomic stability.<sup>3</sup> In this spirit, the member states would be guided by the following principles in pacing their financial liberalization:

- (i) liberalization through the “ASEAN minus X” formula, where member states that are ready to liberalize can do so first and be joined by others later;
- (ii) respect for national policy objectives and differences in the level of economic and financial sector development among the member states;
- (iii) flexibility of member states in setting their own preconditions for liberalization and establishing their own timelines;
- (iv) adherence to internationally recognized standards of financial regulation; and
- (v) adoption of adequate safeguards against macroeconomic instability and systemic risk that could arise from the liberalization process, including the right to uphold the regulatory discretion of the national authorities of member states in taking the necessary measures.

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<sup>3</sup> ASEAN. 2007. *ASEAN Economic Community Blueprint*. November.

## IV. Preconditions for ASEAN Integration

### A. Threshold Conditions

Financial liberalization theories and experiences in other emerging economies suggest that the individual member states of ASEAN would be better able to minimize the adverse impact of external shocks on the economy if they were to develop broad and liquid domestic financial markets and improve their efficiency and stability before embarking in earnest on financial market integration. For example, Kose, Prasad, and Taylor (2009) argue that countries that meet a number of threshold conditions are better able to reap the benefits of financial market integration.<sup>4</sup>

Some of these conditions are well-developed financial markets, high-quality institutions, good governance, sound macroeconomic policies, and trade integration. This study finds prevailing conditions below the threshold levels in some ASEAN member states. But this does not mean that these member states should delay their participation in the integration process. On the contrary, meeting the threshold conditions is part of the integration process. This is because success in CAL and FSL is predicated on success in building institutions and improving financial efficiency and stability.

In preparing for FSL and CAL, this study follows the operational concept of financial integration and considers a financial market integrated if all potential participants face a single set of rules, have equal access to the market, and receive equal treatment when engaged in it. The most difficult and critical part of the integration process is getting the participating countries to agree on different timetables for different members and be prepared to implement liberalization measures at different stages.

### B. Crisis Prevention and Resolution Mechanism

The 2008–2009 global financial crisis underscored the potential pitfalls of unfettered deregulation and premature opening of financial markets in emerging economies. It led to many proposals on a wide range of reforms in financial markets, institutions, and regulatory systems, both regional and global. Compared with other regions, ASEAN has weathered the external financial shocks relatively well. Nevertheless, recent discussions at global forums, such as the G-20 and the Asia-Pacific Economic Cooperation, suggest that it would be in the interest of ASEAN policy makers to consider the following:

- (i) strengthening the ASEAN-wide safety net for liquidity support in addition to the Chiang Mai Initiative Multilateralization;
- (ii) reforming the financial sector to better meet the needs of members' economies;
- (iii) improving the system of evaluating and managing risk exposure at financial institutions;
- (iv) building an ASEAN-wide early-warning system;
- (v) harmonizing the regulatory systems of the individual member states; and
- (vi) developing a framework for cross-border resolution of regional financial institutions.

As part of the effort to meet the preconditions, this study also places emphasis on building a number of regional institutions required to promote orderly integration.

<sup>4</sup> M. Ayhan Kose, Eswar S. Prasad, and Ashley Taylor. 2009. Thresholds in the Process of International Financial Integration. *NBER Working Paper Series*. No. 14916. Cambridge, Massachusetts: National Bureau of Economic Research. April.

## V. Financial Services Liberalization: Milestones, Risks, and Challenges<sup>5</sup>

### A. Degree of Banking Market Integration in ASEAN

Despite ASEAN's commitment to accelerate capital market development, it would be reasonable to assume—given the experiences of advanced economies—that most member states will still have bank-based financial systems for some time. The ratio of bank assets to GDP is expected to rise steadily, but it is unlikely to reach the current levels in Europe by 2030 if ASEAN does not exert more effort to integrate the national banking markets.

The segmentation of banking markets in individual member states is part of the reason for the industry's slow pace of development. Several member states not only strictly regulate the entry of foreign banks but also impose restrictions on the operations of foreign banks in their domestic banking markets.

To assess the current state of banking market integration in ASEAN, this study has estimated the market shares of domestic and foreign-based banks—ASEAN-based and non-ASEAN-based banks—in three member states for which data are available (Malaysia, the Philippines, and Thailand). The statistics show that, in 2009, domestic banks in these countries accounted for 82% of the total commercial bank assets, on average, while the share of foreign banks was 18%. The share of ASEAN-based banks in Malaysia, at 8.5%, was the highest among the three member states; the share was 0.4% in the Philippines and 3.7% in Thailand.<sup>6</sup>

It is both natural and rational for ASEAN member states to prefer the entry into their domestic banking markets of large international banks with more advanced banking technology and a global network.

The experiences of other emerging economies, as well as advanced economies, show that the share of foreign banks tends to increase over time as the banks grow. A carefully planned market integration process can help more ASEAN-based banks develop faster than their non-ASEAN-based counterparts. According to the estimation, if the integration plan proposed in this study is successfully implemented, the share of ASEAN-based banks will begin to rise faster from 2015 in Malaysia, the Philippines, and Thailand—countries with rather high entry barriers—and will triple by 2025 or 2030.

### B. Barriers to ASEAN-Wide Banking Market Integration

In an integrated financial market, financial institutions and market participants operate under the same set of rules and regulations. ASEAN-wide integration of the banking market requires a substantial degree of regulatory harmonization among the member states, but instituting a uniform regulatory structure across a region with many sovereign states at different stages of development is a daunting task as it infringes on national sovereignty. To assess compatibility among the member states, this study divides regulatory systems into six categories, which have

<sup>5</sup> The recommendations on banking liberalization in this study are still under discussion by the Task Force on ASEAN Banking Integration Framework.

<sup>6</sup> In comparison, foreign banks made up more than 60% of total commercial bank assets in Eastern Europe at the end of 2009.

to do with (i) entry and licensing, (ii) capital stringency, (iii) supervision, (iv) empowerment of supervisors to take prompt corrective action, (v) restrictions on risk management procedures, and (vi) transparency. As expected, there are considerable differences not only between ASEAN 5 and BCLMV countries but also among the countries within each group. The differences among ASEAN 5, however, are not as large as those among the BCLMV countries.

Many bank applications are also turned down for failure to pass the convenience and needs test than for any other reason. This test and the licensing terms imposed by several member states, such as inclusion among the world's top 200 banks in asset size, require the possession of highly advanced banking technology. Large, well-known international banks based in Western countries are more likely to lead in the development of advanced banking technology, and ASEAN-based banks are less likely to have similar level of development in infrastructure or internal systems.

### C. Benefits and Risks of Banking Market Integration, and Safeguards

The integration of the banking market will substantially benefit ASEAN. First of all, an integrated banking market will enlarge the customer base and create opportunities to reduce banking cost by increasing competition, achieving economies of scale, and improving efficiency. ASEAN banks will then be able to mobilize more savings through their network and allocate these to more productive investment, thereby increasing total factor productivity and accelerating growth.

Second, banking market integration will improve the stability of the ASEAN banking industry, as the emergence of regionally competitive banks and improvements in financial infrastructure will undoubtedly make the banking sector more resilient and better able to respond efficiently to external shocks. Likewise, banking market integration

will promote closer cooperation among the individual member states in the fight against potential threats to their economic stability.

In pushing for banking market integration, however, ASEAN policy makers must guard against potential risks. The entry of foreign banks could expose the domestic banking market to the spillover effects of difficulties encountered by these banks in their home countries. To forestall such adverse effects of banking integration, prudential requirements and regulatory frameworks should first be harmonized and made compliant with international standards, and information shared between the supervisors in the home and host countries.

There is also the risk that the freedom to make cross-border transactions may embolden some of these new foreign entrants to engage in speculative activities that will increase the volatility of capital inflows into a specific member state, thereby destabilizing its economy. Hence, each member state must first set the necessary preconditions for CAL, as discussed in section VI, and the necessary safeguards. Cooperation among the national supervisors and the established common interests may help relieve stability concerns. Such cooperation may require the establishment of new regional arrangements that will perform surveillance and facilitation of information as collective responses to emergencies triggered by external shocks.

Finally, cross-border banking integration does not exclude the possibility that the domestic banking market will eventually be dominated by foreign banks. Many national supervisors may think that the stability of their domestic banking markets would be seriously threatened if domestic players were to be virtually replaced by foreign competition. This risk suggests that certain preconditions for entry liberalization may need to be put in place first and entry liberalized gradually as the preconditions are met. For example, a few member states with less developed banking institutions could be allowed to liberalize access of foreign banks to its domestic market at a slower pace.

## D. Strategy for Banking Industry Integration

### 1. Financial Services Liberalization Strategy

This study proposes an FSL strategy built on the two pillars of regional financial integration: (i) the liberalization of the domestic banking market, and (ii) the building of regional financial market infrastructure. More specifically, this study foresees a two-track liberalization of cross-border wholesale banking and of cross-border entry of ASEAN banks within the region, supported by the regional harmonization of regulations.

With respect to cross-border banking, this study proposes that the member states immediately start phasing out most of the remaining restrictions on wholesale banking as part of CAL. It may, however, be prudent for ASEAN 5 to delay the completion of the liberalization of cross-border retail banking (deposit taking).

The opening of domestic banking markets to foreign banks, which this study deals with at length, will be carried out in an “ASEAN banking framework,” which gives preference to ASEAN banks so that they can take the lead in ASEAN finance in the future.

Regulatory harmonization and infrastructure building are discussed in section F.

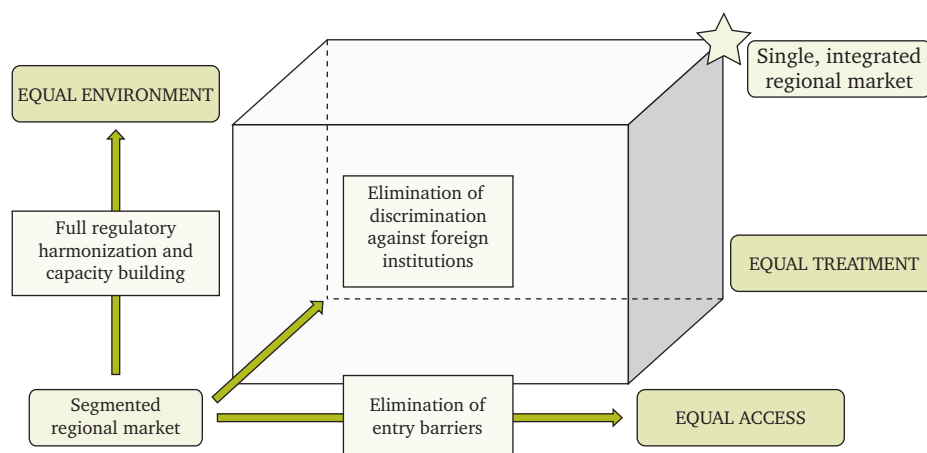
### E. Three Dimensions of the Single Market

This study has developed a three-dimensional framework to guide the long process of financial services liberalization in ASEAN. Figure 1 shows these dimensions (equal access, equal treatment, and equal environment) and their interrelationships.

### F. The ASEAN Banking Framework

The ASEAN Banking Framework is designed to enable ASEAN banks to enter and operate in banking markets in other ASEAN member states, to eliminate discrimination against foreign banks, and to create a more consistent banking environment throughout the region. The framework presents a plan for liberalization in each of the three dimensions of the single market presented in Figure 1. Figure 2 suggests that the target to be achieved by 2020 is not a fully integrated regional market but a semi-integrated one. To achieve significant progress by 2020, compromises must be made. First, only a small number of high-quality

**Figure 1: Three Dimensions of the Single Market**



Source: Asian Development Bank regional technical assistance project Combined Studies on Assessing the Financial Landscape and Formulating Milestones for Monetary and Financial Integration in the Association of Southeast Asian Nations (ASEAN).



banks that meet specific qualifications will gain access to the banking markets in all member states. Second, some within-market restrictions that may hinder free cross-border expansion will remain at the discretion of the host member state. Third, progress in the subdimension of regulatory harmonization will be slow, except in several key areas such as the criteria for prompt corrective action (PCA).

## 1. Equal Access

### a. Entry

To promote the active penetration of the regional banking market by ASEAN-based banks, the member states should first agree on the conditions that ASEAN-based banks must meet to qualify. The qualifications must be sufficiently stringent to relieve the prudential concerns of all the member states, and should include the following at a minimum: (i) capital adequacy requirements, (ii) consolidation requirements and authority for consolidated supervision, (iii) restrictions on large exposure, and (iv) accounting and transparency requirements. The ASEAN-based banks that satisfy all such qualifications are referred to in this study as qualified ASEAN banks (QABs). The member states should agree to facilitate QAB access to their respective domestic banking markets.

The qualifications set for QABs would serve as benchmarks for regulatory harmonization in the banking industry to accelerate the integration of banking markets in the region. The stated qualifications could also serve as operating targets for other banks within the region to increase their financial strength and operating efficiency, and thereby accelerate capacity building within the region's banking markets.

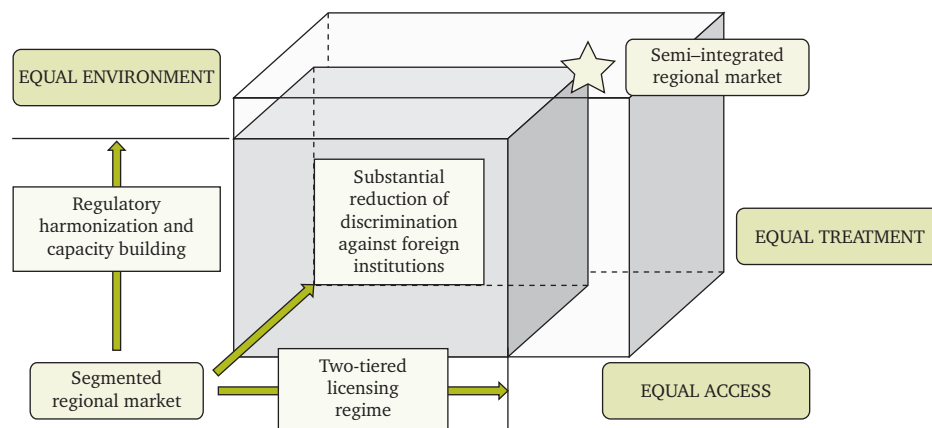
### b. Cross-Border Banking

The proposed entry liberalization plan is mainly centered on commercial banks. Given the differences in the nature of business between wholesale and retail banking, it is only reasonable to liberalize wholesale banking. The liberalization of market access should be implemented appropriately for market entry and cross-border banking activities. This means that QABs should be allowed to provide cross-border banking activities, which are subject to the relevant types of banking licensing category granted by the host country.

## 2. Equal Treatment

In allowing ASEAN-based banks to participate actively in domestic banking markets, regulators must take into account the intended activities of each bank and its capacity to manage the risks

**Figure 2: The ASEAN Banking Framework**



Source: Asian Development Bank regional technical assistance project Combined Studies on Assessing the Financial Landscape and Formulating Milestones for Monetary and Financial Integration in the Association of Southeast Asian Nations (ASEAN).

to which it is exposed. The process of granting equal treatment to all banks, specifically in the matter of regulatory supervision, should be based on their risk profile.

### 3. Equal Environment

#### a. Harmonization of Banking Regulations

While the harmonized licensing requirements during the initial stages of banking market integration could be based on the QAB qualifications, regional integration of the banking markets demands a consistent, if not uniform, regulatory environment throughout the region. Key areas of concern are the following: (i) bank accounting standards and disclosure requirements, (ii) minimum capital requirements, (iii) risk management, (iv) PCA and resolution methods for failed banks, (v) restrictions on large exposure, and (vi) anti-money-laundering and consumer protection regulations.

The prudential requirements for banks must be harmonized to prevent potential conflicts among national supervisors. Those requirements include (i) minimum PCA triggers (or a clear statement of PCA triggers in individual member states), (ii) accounting practices and disclosure requirements to ensure adequate transparency, (iii) asset and liability management restrictions to prevent regulatory arbitrage,<sup>7</sup> and (iv) risk management regulations.<sup>8</sup> However, national authorities are

not precluded from seeking higher standards that are appropriate to their national context.

#### b. Institution Building

In a few member states with less developed banking markets or inadequate financial infrastructure, priority should be given to capacity building. For example, national credit rating agencies, credit guarantee facilities, and interbank lending and borrowing markets must be established before a country can begin in earnest to ease entry barriers. This suggests that a uniform timeline cannot be imposed on all member states, and that the liberalization of banking services should depend on the progress made in the development of the individual countries' banking market and other financial infrastructure.

It is worth emphasizing the importance of joint efforts among the member states to create a consistent banking environment within the region. "Joint efforts" are not taken to mean that all member states are expected to contribute equally. Member states that lag behind in the development of domestic banking markets may find it difficult to establish critical infrastructure in time for the prompt integration of the regional banking market. In such cases, assistance and cooperation from other member states would significantly improve the prospects for timely integration.

<sup>7</sup> Key areas of concern are (i) restrictions on investments in corporate stocks, bonds, and real estate; (ii) deposit interest rates and types of deposit accounts; and (iii) restrictions on lending to specific sectors or industries.

<sup>8</sup> For example, national supervisors should discuss the feasibility of adopting uniform Basel III capital adequacy rules and of harmonizing leverage restrictions and liquidity provisions.

## VI. Capital Account Liberalization

### A. Need for Freer Capital Mobility in ASEAN

Capital account liberalization (CAL) is an essential aspect of any efforts to create an integrated economic region. Free capital mobility is a fundamental pillar of economic convergence, as it allows savings from the more developed economies to help support growth in developing economies by lowering the cost of capital. In the context of ASEAN, this means that an economic agent in any member state is allowed to invest in or borrow funds freely from any other member state according to economic considerations alone, and that no legal or administrative formalities are imposed on the movement of capital within ASEAN. Even if capital is substantially allowed to move across national borders, as is the case in many ASEAN countries, capital mobility is still considered not free if it is subject to control in the form of permission, ex ante reporting requirements, or quantity restrictions even if permission is generally granted. Capital is not freely mobile when there is a lag between the time a decision is made to transfer funds abroad and the time the transfer can be made. CAL is therefore defined as a process of dismantling legal and administrative impediments to the freedom with which economic agents can transfer ownership claims across national borders.

There is a compelling economic case for free capital mobility in ASEAN. First, it aids in the efficient allocation of the region's large savings across national borders, and therefore promotes economic growth and welfare. Though there is little conclusive empirical evidence to link free capital mobility with faster economic growth, recent academic research points to the importance of the quality of institutions in determining the growth-enhancing effect of international capital flows. In particular, recent evidence

suggests that financial depth and institutional quality are the two most important preconditions for a positive effect of foreign capital inflows on economic growth.

ASEAN is a highly open trading region, with most member states having made remarkable economic achievements in recent decades through an open-door policy. The literature generally considers trade openness, and trade liberalization that typically precedes it, to be an important threshold condition for CAL. The classical literature on the order of economic liberalization argues that if the capital account is liberalized before trade, foreign capital may come into a protected sector with no comparative advantage, and thus create a real distortion. Trade openness, moreover, helps reduce any negative costs of capital mobility. Economies that are more open to trade face less risk from sudden stops or reversals of capital inflows because they are in a better position to service external obligations through export revenues and are less likely to default. They will also require a more modest real exchange rate depreciation for a given current account adjustment in the event of a sudden stop. Given the background of trade openness, therefore, ASEAN as a region is well positioned to liberalize the capital account further and to gain from such measures to encourage greater financial integration.

Most critically, the freedom of capital to move across borders is a prerequisite for the creation of a single ASEAN market. The aim of the AEC is to transform ASEAN into a single market and production base, characterized by “free movement of goods, services, investment, skilled labor, and freer flow of capital.” This goal, which involves the free or freer movement of factors of production, cannot be achieved without substantial CAL. Capital mobility promotes further regional trade integration by facilitating payment for current transactions through cross-border lending and borrowing.

Free movement of investment presupposes the ability to transfer funds across borders. Free movement of skilled labor also necessitates ease in transferring funds from one country to another for a range of purposes, as the sphere of economic activities becomes increasingly regional. Freer movement of capital must therefore accompany the concurrent efforts to allow the free movement of goods, services, investment, and skilled labor.

CAL has a critical role in ASEAN financial integration, as it complements financial services liberalization. First, CAL promotes financial sector development, as well as capital market development, by increasing the volume of gross cross-border capital flows. Volume—promoted by two-way capital flows made possible by lower transaction costs—is a critical element of deeper and more liquid national and regional markets. Second, CAL facilitates the integration of ASEAN banking markets. The freedom of banks to operate in another national market in ASEAN is only one dimension of FSL. In fact, allowing greater freedom for banks to borrow and lend across borders can also facilitate FSL. For example, a liberalized capital account regime would allow residents to hold foreign currency deposits with banks located in foreign countries. From the point of view of the banks, this is a way of funding their operations from foreign sources. An integrated banking market allows greater freedom for cross-border banking flows, which in turn enhances their ability to engage in various financial transactions freely across all member states. Thus, FSL and CAL are two sides of the creation of an integrated financial market.

## B. Pace and Sequencing of Capital Account Liberalization

The first step in building an implementation plan for CAL is assessing the capital account regime of individual ASEAN member states. The assessment done for this study suggests several important observations. First, though a few member states are highly open, there still remain some restrictions on capital flows for macro-prudential reasons. Second, most of the controls are on outflows than on inflows. Third, although

all member states except one have accepted the obligations under Article VIII of the International Monetary Fund (IMF) Articles of Agreement, many still maintain current account-related payment restrictions, such as repatriation or surrender requirements for export proceeds and the verification procedures for service payments. Fourth, almost all member states have some restrictions on the offshore use of their currencies. Fifth, many member states place restrictions on external borrowing than on portfolio inflows, and many place some restrictions on external lending, especially in their national currencies. Sixth, many member states limit the ability of investors to hedge foreign currency risks, including the use of derivative transactions. Finally, a few member states impose withholding tax on interest income and capital gains from certain types of securities.

To be sure, CAL entails risks, especially given the volatile nature of global capital flows. Although how the risks of capital inflows is measured is a complex issue, this study proposes that the following three types of risks be considered, at least conceptually:

- (i) **Macroeconomic risks.** Capital inflows could accelerate the growth of credit, cause the real exchange rate to appreciate, create inflationary pressure, expand domestic demand, and affect other macroeconomic variables in a way inconsistent or incompatible with the immediate domestic policy objectives, such as price stability, exchange rate stability, and export. If fiscal policy positively responds to the increase in revenue, it could result in an overheating of the economy.
- (ii) **Financial stability risk.** Capital inflows could push up equity, real estate, and other asset prices, reduce the quality of assets (e.g., increase nonperforming loans on the balance sheets of banks), and adversely affect the maturity and currency composition of the balance sheets of the private sector, thereby contributing to greater financial fragility. Recent experience suggests that the impact of capital inflows on asset prices has been particularly significant.
- (iii) **Risk of capital flow reversal.** Capital inflows could reverse themselves suddenly, with the potential for the depletion of reserves or sharp

currency depreciation. It is mainly to mitigate this crisis risk that many countries in Asia have accumulated foreign exchange reserves as a form of self-insurance in recent years.

The idea that CAL must be managed properly to minimize these risks while maximizing the benefits forms the basis of the new orthodoxy that emerged in the aftermath of the financial crises of the late 1990s. The policy-oriented literature that has largely been developed at the IMF stresses the importance of an “integrated” approach, which considers CAL as part of a more comprehensive program of economic reform and coordinates it with appropriate macroeconomic and exchange rate policies, as well as with policies to strengthen the financial system. In this approach, emphasis is placed on the sequence in which the necessary preconditions—including the system of prudential supervision—are to be established and the various components of the capital account are to be liberalized.

Keeping in mind the existing ASEAN frameworks, including the AEC Strategic Schedule (through 2015), the ASEAN Capital Markets Forum (ACMF) Implementation Plan (through 2015), and the Working Committee on CAL Work Plan (through 2015), this study proposes the following building blocks for creating CAL implementation plans for individual member states:

- (i) Current account and foreign direct investment (FDI)-related measures should be liberalized as quickly as is practical, in accordance with the AEC Strategic Schedule on Freer Flows of Capital. Note that some of the existing current account and FDI-related restrictions, repatriation requirements in particular, while macro-prudential in nature, can also be viewed as a form of control on capital outflows.
- (ii) Restrictions on capital inflows should be removed. Given the already high degree of de facto openness in several countries (usually through purchases of domestic securities by nonresidents), removing impediments to inflows in these countries should not create additional risks.
- (iii) Restrictions on outflows should also be removed at the early stage of the

process—first with respect to other ASEAN countries, through the mutual recognition principle, and eventually to all countries. A distinction can be made in the process between non-retail and retail investors in specific instances. While the liberalization of outflows can be a gradual process for lower-income countries, it should receive high priority for higher-income countries, especially ASEAN 5.

- (iv) Enabling environment, including ease of use of currency, ease of hedging, removal of withholding tax, and freedom of personal transactions, can be created at a later stage. Restrictions for some or all of these categories may be retained as a safeguard measure. This study does not propose that these restrictions be removed totally, even in 2020.

It should be noted that this approach differs from conventional wisdom, which suggests that the liberalization of outflows should come after the liberalization of inflows. But this conventional wisdom would not work in the case of ASEAN because regional financial integration is a two-way process. Outflows must therefore be liberalized early in the process, along with inflows, to facilitate financial integration. In promoting capital outflows in an orderly manner, the principle of mutual recognition can be invoked to promote outflows within the region without violating the global rule of nondiscrimination while containing the associated risks, especially (at this stage) with respect to equity flows.

### C. Management of Capital Flows through Sound Policies and Safeguard Measures

Once the capital account is substantially open, the ability of countries to use conventional macroeconomic and structural policies to deal with surges in capital inflows becomes limited, short of allowing the currency to appreciate or depreciate when there are reversals. Given these limitations, policy makers may want to retain more direct instruments to influence the volatility of capital

inflows or to have devices to intervene in the free flow of capital when necessary. These instruments can broadly be referred to as safeguard measures. However, it is critical to remember that any safeguard measures, if adopted, should not interfere with the free flow of capital during normal times. Safeguard measures, broadly defined, could include (i) sound and consistent macroeconomic policies, including exchange rate policy; (ii) routine administrative mechanisms, including macro-prudential measures; and (iii) capital controls.

### 1. Sound and Consistent Macroeconomic Policies

The best strategy for living with an open capital account is to pursue sound macroeconomic policies. Such policies, characterized by price stability and fiscal discipline, are the proven way to minimize vulnerability to sudden reversals of capital flows. Countries pursuing sound macroeconomic policies would be better able to prevent an asset bubble from occurring when there is a surge in capital inflow. Such countries are less likely to be subject to (but are not completely immune to) a speculative attack when investor sentiment creates vulnerability to crisis. When the economic fundamentals are strong, the adverse impact of a sudden flight of capital can be more manageable. Fiscal discipline is especially critical. Equally important is following a *consistent* macroeconomic policy. Given the binding constraints of the so-called “impossible trinity,” the commitment to freer capital mobility within the region may increasingly mean that the government of an ASEAN member state must choose between a stable exchange rate and an independent monetary policy. The policy mix of a stable exchange rate and independent monetary policy will become increasingly difficult to maintain.

**Administrative mechanisms.** Until domestic financial markets become sufficiently deep and risk management skills fully developed, there could be routine administrative mechanisms, including prudential regulations, to safeguard the financial system from the potential adverse impact of capital flow volatility. Many of these measures are different from capital controls, to the extent that they do not discriminate between

residents and nonresidents, apply according to the currency of the flow or the type of institutions, or are placed only for monitoring purposes. Some are forms of capital control, intended to regulate some types of flows that are considered not intrinsic to productive economic activities. The CAL implementation plans that this study proposes incorporate safeguard measures. One is the retention of restrictions on the cross-border trading of forwards and derivatives, as well as on offshore currency use. Although lifting these restrictions would help increase the depth of cross-border transactions, the removal of these restrictions is not considered essential to achieving the aim of AEC, at least over the medium term. The other safeguard measures for the implementation plans is the application of the mutual recognition principle to the liberalization, in particular of capital outflows. This is intended to manage the volume of outflows, at least initially, by making it easier to purchase foreign assets issued by an ASEAN entity.

Examples of other safeguard mechanisms that ASEAN policy makers could consider adopting include (i) requiring routine *ex post* reporting, (ii) requiring cross-border flows to be effected through authorized domestic intermediaries, (iii) requiring transactions to be registered with the central bank, (iv) placing limits on the open foreign exchange positions of banks and corporations, and (v) allowing differential reserve requirements on foreign currency deposits. Prudential regulations aimed at domestic institutions, such as tighter loan-loss provisions and capital requirements (e.g., with respect to external lending), could also serve as a safeguard measure. Some of these measures are already in place in many of the ASEAN countries. The ASEAN member states must understand that these and possibly other measures are legitimate tools of prudential capital flow management and should not be considered a restriction on capital flows even when their outcome is similar to that of capital controls.

Those administrative measures need to be timely and targeted for them to be effective. This requires good and timely understanding of the nature of the capital flows. Thus, building a capacity to effectively monitor capital flows is a precondition in liberalizing the capital account. The critical yardstick is whether a particular measure

interferes with the freedom of economic agents to transfer funds across national borders according to economic considerations alone. It bears emphasizing that routine *ex post* reporting requirements are not the same as *ex ante* reporting requirements. One is not a restriction on the freedom of capital flows, but the other is. Economic agents should be allowed to make capital transactions freely without being required to report them at the same time or in advance of the transactions they are making. In this respect, to be required to report them after the fact—say, within 30 days of the time such transactions take place—is not a restriction on their freedom to make the transactions. However, to be required to obtain permission is a restriction on free capital mobility even when there is a presumption that such permission is routinely granted. These considerations should guide the choice of such safeguard measures.

## 2. Capital Controls

In emergency situations, countries with an otherwise open capital account have experimented with the use of direct controls on inflows. Most recently, Thailand (in December 2006) and Brazil (in 2009) have introduced capital controls to stem the tide of capital inflows and the resulting appreciation pressure on the currency. These recent controls have typically taken the form of unremunerated reserve requirements (URRs) that mandate a certain percentage of inflows to be deposited with the central bank for a given period of time. These measures also tend to be temporary, as the countries have previously been the beneficiaries of substantial capital inflows and do not have the option of permanently withdrawing from integration to the international financial system. The controls are lifted when the triggering situation ceases to exist.

URRs are different from conventional controls in at least three respects. First, URRs are designed for a country with an otherwise open capital account, to manage—not prevent—capital inflows. Second, they work on capital inflows not through administrative means but through the price incentives of international investors.

Third, the amount of “tax” on capital inflows is negatively related to the length of the investment. Hence, URRs are more effective on short-term and presumably on more speculative flows, than on long-term flows that are believed to be driven more by fundamental economic factors. For these reasons, URRs are considered to be less distortionary and abrasive, and have received support even from some advocates of freer capital mobility.

There is a large body of empirical literature on the effectiveness of URRs based on the experience of Chile in the 1990s. The results remain inconclusive, not only because they are sensitive to the choice of methodology, as in any empirical work, but more importantly because URRs were endogenous to the volume of capital flows. Broad consensus, however, seems to be that URRs (i) reduced the volume of capital inflows in the short run, but lost effectiveness over time; (ii) lengthened the maturity of inflows; (iii) were effective in raising relative domestic interest rates but not in preventing real exchange rate appreciation; and (iv) had greater (adverse) impact on small and medium-sized firms (which rely on bank borrowing) than on large firms with access to a wider range of financing instruments.

Despite the lack of empirical support for the effectiveness of capital controls, there is no reason to exclude their use *a priori* as an option. Economic theory suggests that the demand for a good falls when the price rises. Because capital controls raise the cost of making a transaction, the volume of transactions would fall unless the controls are not enforced. A recent IMF study provides arguments to support the use of capital controls if the economy is operating near potential, the level of reserves is adequate, the exchange rate is not undervalued, and the flows are likely to be transitory.<sup>9</sup> For capital controls to be effective as a safeguard measure, it is important to enhance the central bank’s administrative capacity. Empirical evidence suggests that capital controls tend to be more effective in industrial countries than in developing countries, presumably reflecting the difference in administrative capacity. Some of the safeguard measures proposed above can enhance

<sup>9</sup> Jonathan D. Ostry, Atish R. Ghosh, Karl Habermeier, Marcos Chamon, Mahvash S. Qureshi, and Dennis B. S. Reinhart. 2010. Capital Inflows: The Role of Controls. *IMF Staff Position Note*. SPN/10/04. Washington, DC: International Monetary Fund.

the ability of governments to introduce capital controls with some effectiveness in an emergency situation.

### 3. Regional Cooperation

Regional cooperation per se is not a safeguard measure, but it can enhance the effectiveness of a safeguard measure adopted by individual countries. After all, ASEAN CAL is a regional initiative and therefore requires regional cooperation to succeed. First and foremost, ASEAN could agree on the definition of what is and what is not a restriction. It is reasonable to consider in this respect any measures that require official intervention (be it permission, reporting, or notification) ahead of a planned transaction to be a restriction. Second, ASEAN could agree that a member state has the right to introduce an

emergency measure in extraordinary conditions. Emergency measures could include an administrative suspension of (certain types of) normal capital flows, temporary capital inflow controls (e.g., URRs), and exit levies. Third, to make this agreement operational, ASEAN could also agree as to what constitutes an extraordinary condition.

Regional cooperation makes it possible to manage capital flows more effectively. A regional system of surveillance (including an early warning system) and mutual financial support (such as the ASEAN Swap Arrangement, the Chiang Mai Initiative Multilateralization, or the network of bilateral swap arrangements) would allow individual countries to proceed with CAL with greater confidence. It is possible that the ASEAN CAL process could lead to greater macroeconomic policy cooperation among ASEAN member countries.



## VII. Financial Infrastructure Building

### A. Capacity Building

If financial integration is to succeed, the ASEAN financial regulatory agencies must be adequately equipped with relevant software and hardware. By software is meant the human resource capacity to monitor and manage domestic financial market deregulation under the new environment of an integrated ASEAN financial market. By hardware is meant the legal, tax, and regulatory systems that are required to support the financial market infrastructure.

ASEAN member states have two options in building human resource capacity. The first is to build a new institution. The second option is to use existing regional training and research institutes such as the South East Asian Central Banks Research and Training Centre (SEACEN Centre) and the ASEAN Insurance Training and Research Institute (AITRI), both in Kuala Lumpur, Malaysia. It is more cost-effective to use the training services of these agencies.

With respect to the hardware side of capacity building, it must be borne in mind that developing countries often do not have sufficient resources to build their own infrastructure. Thus, there must be an organized program of development assistance, first from the more developed member states of ASEAN, such as Indonesia, Malaysia, Singapore, and Thailand. In addition, ASEAN should request systematic assistance from the Plus-3 countries of the People's Republic of China, Japan, and the Republic of Korea, and from regional and international institutions, such as the Asian Development Bank (ADB) and the World Bank.

### B. Consumer Protection

Consumer protection systems for financial services are not well developed in a few ASEAN

countries. According to a recent World Bank report, *Financial Access 2010: the State of Financial Inclusion through the Crisis*, ASEAN ranks lower than other neighboring regions of South Asia or Central Asia in consumer protection systems, such as the legal framework, institutional structure, and dispute resolution mechanisms. ASEAN should make a concerted effort to build a well-developed consumer protection system. To this end, ASEAN should adopt and enforce standardized and harmonized laws and regulations on consumer protection applicable to all member states.

### C. Mechanism for Monitoring Financial Market Integration

If financial integration is to succeed, careful attention needs to be paid to (i) how the integration process is designed and (ii) how the agreed integration plan is actually implemented. A mechanism should be created to monitor the progress of financial integration in ASEAN—that is, an agency responsible for monitoring the progress in ASEAN financial market integration and for reporting its assessment to the regulatory authorities of the ASEAN member states, such as the central banks and finance ministries.

Three options are available for building such a mechanism: (i) the ASEAN Secretariat could take up this work; (ii) existing ASEAN mechanisms, such as a working group or committee, could be expanded; or (iii) an entirely new organization could be built. This study recommends a combination of the first and third options. For example, one possibility might be to create a division or department within the ASEAN Secretariat. This is cost-effective compared with the alternative of building an entirely new organization. At the same time, additional financial experts should be hired for the ASEAN Secretariat.

The work of the monitoring unit for financial integration can also be expected to benefit from the buildup of experience within the ASEAN Secretariat

in monitoring the progress of integration in the general services sector.

# VIII. ASEAN Payment and Settlement System

## A. Introduction

An efficient payment system is vital in strengthening the link among ASEAN members and supporting integration objectives under the AEC Blueprint 2015 and beyond. ASEAN coordinates its efforts in payment and settlement system (PSS) development by focusing on five key elements: (i) policy, (ii) legal framework, (iii) instrument, (iv) institution, and (v) infrastructure.<sup>10</sup> With these elements in mind, studies were conducted on five specific areas of PSS to determine areas for future enhancement, development, and harmonization. The five areas were (i) cross-border trade settlement, (ii) cross-border money remittance, (iii) cross-border retail payment systems, (iv) cross-border capital market settlement, and (v) standardization. These initiatives are aimed at improving the domestic payment infrastructure, promoting cross-border payment services that are more efficient than existing arrangements, and ultimately achieve the integration of systems in the region.

## B. Key Findings

For each of the five PSS areas, a study was carried out to understand the current and expected conditions, identify gaps, and propose recommendations for dealing with the gaps. The following key findings from each study represent areas where improvements could be made:

- (i) **Trade settlement.** The existing correspondent banking mechanism is adequate to accommodate demand. However, there are

opportunities for improvements that would raise the efficiency of cross-border trade settlement in ASEAN by reducing foreign exchange spread and bank charges, and develop integrated regional payment infrastructure to support faster availability of funds.

- (ii) **Money remittance.** Nonstandardized remittance channels exist and efficiency levels vary. Further, informal nonregulated channels make consumer protection difficult.
- (iii) **Retail payment systems.** Domestic retail payment systems in some countries are still fragmented, resulting in non-interoperability among different providers. Inefficiency in payment systems and opaque pricing mechanisms make cross-border payments costly.
- (iv) **Capital market settlement.** Varying market practices exist, and they hinder the cross-border settlement of capital market transactions.
- (v) **Standardization.** Many ASEAN members have adopted various standards, which might make PSS non-interoperable and inter-linkage more costly. Therefore, central banks would play a central role in promoting standardization to enable interoperability and inter-linkage among PSS. Also, there is a need for greater sharing of expertise among members.

## C. Categories of Goals

To overcome the challenges presented in the above findings, each of the five studies recommended solutions that the ASEAN member

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<sup>10</sup> In April 2010, the ASEAN Central Bank Governors Meeting endorsed the establishment of the ASEAN Working Committee on Payment and Settlement Systems with the broad aim of identifying areas of improvement in ASEAN countries that require the development of payment and settlement systems and drawing up recommendations for the member countries, where relevant.

countries could undertake, either individually or as a group. A common theme across the studies was the need to promote the adoption of common standards that would enable interoperability and inter-linkage among the various payment instruments and infrastructure, and would in turn improve cross-border payment and settlement. Three broad categories of goals were therefore identified to be prioritized as follows:

- (i) **Standardizing systems.** It was recognized in all studies that a variety of standards and systems are in place within each member state. To facilitate efficient cross-border payment and settlement, the first step would be to adopt common best practices and standards across systems. Such standards could be technical standards, market practices, or regulatory standards. Regulatory standards, such as adequate legislation and policy, may be easier to achieve and hence would be classed as short-term goals, while other standards, such as electronic messaging, might have to follow medium-term infrastructure development. The key short-term goal, therefore, would be identifying common standards for ASEAN to adopt. Standardization will form the foundation for all future PSS development and is thus the foremost goal.
- (ii) **Improving existing infrastructure and payments environment.** The studies also recognized the fact that PSS in member countries are at different stages of development and thus have different requirements. It is acknowledged that the development of new systems could be potentially costly for some members. To minimize costs, the studies recommended that members, particularly those with less developed domestic PSS, should focus on improving their PSS to meet their economic needs. In doing so, members could take the opportunity to standardize their systems and be ready for the long-term goal of regional integration. It follows that a needs analysis, possibly in the form of a scorecard, to determine what best fits the needs of individual members should be conducted immediately for each of the five study areas.
- (iii) **Exploring the option of PSS linkages within ASEAN.** In the long term (beyond 2015), ASEAN would reach a state where common

standards are in place and members' PSS would be fairly developed. In such an environment, the ASEAN countries could seek to link their PSS and even connect to international systems. Full integration across the region would be the long-term goal. In the meantime, the member countries could study the feasibility of smaller-scale pilot initiatives that could form the basis for reaching that long-term goal.

To achieve these goals, ASEAN members should strive to support each other's development through capacity building or technical assistance. Also, ASEAN is cognizant of the fact that PSS play a supportive role to other developments in the economy, particularly under the AEC Blueprint 2015. Hence, rather than being rushed by arbitrary timelines, the ASEAN has deliberately taken a longer-term view of developments (beyond 2015) to ensure that initiatives are carefully aligned with real economic needs. The timelines indicated in this study are therefore guidelines rather than hard targets that must be met.

## D. Road Map

### 1. Short-Term to Midterm Recommendations (2012–2013): Standardization

Individual studies have identified many areas of PSS that require greater standardization, formalization, and harmonization. International standards exist for some areas, while in other areas, it would fall upon the ASEAN members to identify best practices as a benchmark for services in the region. One key outcome of the standardization study is the recommendation that ASEAN should look to adopt ISO 20022 for PSS, for financial services to allow more seamless integration in the future. The other recommendations for the short term to midterm are as follows:

#### a. Cross-Border Trade Settlement

The standardization study proposed more transparency in the disclosure of bank charges (such as foreign exchange spread and handling fees) for cross-border banking. Greater disclosure of charges will reduce the cost of intra-ASEAN trade,

particularly when transactions are done in foreign exchange. The region would benefit from lower local-currency transaction costs as a result of the availability of more information and greater competition among banks.

#### **b. Money Remittances**

The standardization study also proposed the adoption of policies to promote the use of formal, regulated channels, as well as greater transparency of remittance charges, to strengthen consumer protection. Central banks could encourage the participation of regulated nonbank remittance service providers, which could enter into unbanked rural areas.

#### **c. Retail Payments**

The standardization study highlighted the need for central banks to promote the adoption of common (international) standards in retail payment systems as the foundation for interoperability between retail payment systems in the region. Moreover, to increase efficiency and to widen the use of payment instruments, central banks might facilitate the development of commonly used instruments under a regional scheme for retail payment systems. To ensure the effectiveness of the initiative, joint research among central banks could be useful.

#### **d. Capital Market Settlement**

The standardization study proposed the adoption of international standards for straight-through processing in domestic and cross-border settlements, and the introduction of risk-mitigating measures such as delivery-versus-payment and payment-versus-payment settlement if these are absent in certain domestic markets.

As mentioned in an earlier section, the immediate short-term goal should be to conduct a needs analysis that takes into account the varying states of the existing standards, infrastructure, and environment in each member's country. Members can then align their needs to the foregoing recommendations, and work toward achieving the longer-term goals without incurring excessive

costs. The needs analysis should be done for each member across the five study areas.

## **2. Midterm to Long-Term Recommendations (2014–2015): Infrastructure and Environment Improvement**

In the medium term, when ASEAN has achieved some degree of standardization in the various areas, the member countries could work toward further improvements in PSS and market practices, in alignment with their needs, based on the outcome of the needs analysis. Specific initiatives include moving toward T+1 receipt of funds and improving infrastructure by establishing or expanding links in existing payment systems (e.g., the ASEAN Payment Network [APN]). The midterm to long-term recommendations for each study area are as follows:

#### **a. Cross-Border Trade Settlement**

It was recommended that ASEAN study possible mechanisms for achieving T+1 receipt of funds for cross-border payments. Also recommended was the promotion of local-currency settlement of trade through bilateral linkages among ASEAN 5 countries, in line with the relaxation by member states of access to domestic currencies.

#### **b. Money Remittances**

ASEAN should explore the feasibility of using existing regional networks (e.g., APN) for money remittances and expanding their reach to other member countries.

#### **c. Retail Payment Systems**

ASEAN should continue facilitating the expansion of products for retail payment, including not only ATM cards but also debit and credit cards, as well as money remittance and other services provided by the existing regional network.

#### **d. Capital Market Settlement**

ASEAN should assist the ACMF and the Working Committee on Capital Market Development with

their implementation plans. ASEAN may have to help study various options for establishing regional infrastructure for capital market settlement.

### 3. Long-Term Recommendations (Beyond 2015): Exploring ASEAN Payment and Settlement System (PSS) Linkages

A midterm goal identified by ASEAN is the achievement of T+1 for the receipt of funds across PSS within the region. In the longer term, the goal might be to achieve same-day funds transfer within the region. This long-term goal would ultimately require linkages to be formed between the various payment systems, be they for retail payments, trade settlement, or money remittances. At that point, the region is expected to have enhanced or developed systems that are interoperable since they adopt similar standards. What remains to be done is to determine the

form of linkages within ASEAN for each PSS area; this would constitute the long-term work goal of the ASEAN Working Committee on Payment and Settlement Systems (WC-PSS). An example identified in the studies is the region's eventual participation in continuous linked settlement, which would reduce foreign exchange settlement risk. Other linkages could be between automated clearinghouses, real-time gross settlement systems, or other systems.

**Capacity building.** Members are aware that different conditions exist in each country. The harmonization and the development of interoperability and inter-linkage among various PSS may require strategic and gradual planning based on the readiness of each individual country. ASEAN has thus identified capacity building as a parallel track to the above recommendations that should cut across all five study areas. ASEAN will act as coordinator to find suitable solutions such as workshops and attachment programs based on identified needs.

## IX. Capital Market Development

The AEC Blueprint 2015 pertaining to capital markets seeks to achieve significant progress in building a regionally integrated market, where within the region (i) there is freer movement of capital, (ii) issuers are freer to raise capital anywhere, and (iii) investors are freer to invest anywhere. In such a market, anyone would be able to trade in ASEAN capital market products freely in any ASEAN market at a competitive fee from a single access point, with capital market intermediaries being able to provide services throughout ASEAN based on home country approval.

Work plans have been outlined by the Working Committee on Capital Market Development (WCCMD) and the ACMF to further capital market integration. These form a ready framework for integration in the capital markets. The ACMF is overseeing specific initiatives to promote capital market development, including (i) establishment of an expedited review framework for secondary listing applications, (ii) the launching of an ASEAN Corporate Governance Scorecard for assessing corporate governance practices of ASEAN listed companies, (iii) the development of ASEAN disclosure standards that will

facilitate more efficient cross-border securities offerings within the region, and (iv) the work of ASEAN exchanges to launch the ASEAN Trading Linkage and develop a model for the integration of post-trade services.

Key initiatives under the WCCMD work plan include (i) the development of an ASEAN Bond Market Development Scorecard, which is a “living document” to track the state of ASEAN’s bond market development, openness and liquidity; (ii) facilitating the implementation of targeted and focused capacity-building programs to help members address market gaps identified in the scorecard; and (iii) further close cooperation and coordination with other ASEAN capital market initiatives at WCPSS or ACMF, for example, including an independent study with the ASEAN Secretariat and ACMF to pinpoint key gaps hindering market development, and develop policy recommendations for individual member countries. Such new initiatives and joint efforts will ensure that WCCMD and other related capital market work streams will play their roles in helping to comprehensively address gaps in ASEAN’s capital market development.

## X. Beyond Integration: What Is Next for the ASEAN Community?

Financial integration is essentially a market-driven process, which can be set in motion by domestic financial market liberalization and CAL. In this market-driven process the role of ASEAN governments is essentially to develop regional financial market infrastructure in addition to removing restrictions and reforming policies that obstruct cross-border movements of capital. It should also be emphasized that CAL will eventually lead in the long run to the unification of the domestic financial markets of ASEAN with those of countries outside the region because the fungibility of money and finance would make it difficult to discriminate against non-ASEAN borrowers and lenders even if it were possible under multilateral rules.

The proposed plan for creating the AEC is expected to be carried out simultaneously in the areas of trade and finance, though there has been more emphasis on trade integration. In theory, causal relations between trade and financial liberalization could run either way. In reality, they seem to vary from country to country and from region to region. In a regional setting, freer trade could produce pressure for regional financial market integration and intra-regional exchange rate stability. Monetary and financial integration therefore generates incentives for and facilitates trade expansion and integration. But, in a few member states, the simultaneous pursuit of trade and financial liberalization may overstretch their limited capacity for reform, and hence those states may have to proceed first with trade liberalization. This ordering does not necessarily mean that there is no scope for financial reform. It only means that the plan for financial market opening may need to be adjusted, taking into account the administrative capacity of each member state.

The current global financial crisis has raised a new set of questions in the emerging world regarding the desirability of global financial integration and

the means of achieving it. Countries with an open capital market have suffered relatively more from the crisis than others, as they have been unable to shield themselves fully from external shocks irrespective of the foreign exchange regime in place. Without a global lender of last resort and regulatory institution, the globalized financial system is susceptible to a breakdown as a result of market overreaction, panic, and mania. In opening up the financial markets, therefore, ASEAN policy makers will need to take precautionary measures to mitigate the impact of external shocks. This precaution calls for regulatory reform in the individual member states in line with the global reform under way and highlights the need to consolidate regulatory cooperation at the regional level.

According to a forecast by the IMF, ASEAN will grow at 5.5% per year in 2011–2015, raising its average per capita income to \$10,603 by 2015. Extending the horizon further, we believe that ASEAN has the potential to sustain the rapid growth beyond 2015. Combined with rapid growth, a successful completion of the plans for FSL and CAL will allow ASEAN to construct an integrated ASEAN-wide financial system that is highly sophisticated, diversified, and open to foreign savers and investors.

However, the success of ASEAN integration is not a foregone conclusion. For a long time, the ASEAN member state authorities' overriding concern with financial stability—which may well be legitimate, in view of what was experienced at the time of the global financial crisis—has necessitated an uneven and prolonged approach to capital account and financial services liberalization. The aims of CAL, as envisioned in the implementation plans for individual countries, are modest at best, with adequate safeguards; unlike the EU, ASEAN does not envision the complete elimination of all restrictions, prudential or otherwise, on cross-border capital flows, even by 2020 or 2025.



Likewise, the implementation plans for FSL have deliberately been based on a two-pronged, two-tiered approach. They reflect the realism that *some* financial services liberalization should move forward while the existing domestic financial institutions and systems are developed and strengthened, and this has necessarily created two separate tracks—one for “regional champions”, and the other for all other institutions mainly serving the interests of domestic customers.

The need to pursue a consistent macroeconomic policy mix as the countries liberalize their cross-border capital flows was noted earlier. Initially, this means that the member states must allow their exchange rates to become more flexible if they are to retain monetary independence. As financial integration proceeds, with the expected liberalization of trade, investment, and movement of skilled labor, there will be greater pressure for intra-regional exchange rate stability. It will be challenging to create a single market and production base with widely fluctuating exchange rates.

If financial integration proves successful, the ASEAN member states must accept the inevitable possibility of region-wide consolidation in the financial landscape. Indeed, consolidation is a fact of life in the financial world. For example, some of the world’s leading stock exchanges are discussing potential mergers. Leading global banking institutions are either being consolidated or purchasing smaller institutions to increase size. As the ASEAN member states further liberalize and become part of the global economy, they cannot expect to avoid the wave of consolidation that will inevitably follow. As the experience of

the EU shows, this is unlikely to mean that many existing domestic institutions and markets will disappear. More likely, there will be a two- or three-tier market structure in which some domestic institutions serve strictly local needs while others compete with their global or regional peers across national borders. Likewise, the boundaries between national markets may increasingly blur for regionally or globally known institutions, but national markets may still remain viable for local institutions.

Some of these outcomes may sound daunting to ASEAN policy makers. But the process of integration and consolidation will continue to be an inescapable reality as long as member states wish to remain part of the global economy. In this environment, small economies must specialize in a few things they do best to survive. They cannot expect to offer all services to all people in all market segments. Indeed, this is the very reason the ASEAN leaders have embarked on the process of creating a single market and production base as a means of joining forces together. So as not to be left out, the ASEAN member states must commit anew to creating a single market and production base. Full and complete capital account and financial services liberalization is ultimately key to the success of the AEC. Though a gradual and judicious approach is the only pragmatic and feasible option at the present, this must be considered as a step toward the eventual elimination of all restrictions on cross-border capital flows and financial services. To make this safe and possible, the ASEAN member states must start creating and strengthening the requisite regional institutions.

## **The Road to ASEAN Financial Integration**

A Combined Study on Assessing the Financial Landscape and Formulating Milestones for Monetary and Financial Integration in ASEAN

This paper provides a summary assessment of the Association of Southeast Asian Nations (ASEAN) on the state of financial integration in the region, with inputs from the Asian Development Bank regional technical assistance project *Combined Studies on Assessing the Financial Landscape and Formulating Milestones for Monetary and Financial Integration in ASEAN*. Information on the financial integration milestones blueprint that will lay out a comprehensive program to achieve ASEAN financial integration by 2015, as well as the recommended institutional and policy reforms to be implemented in 2011–2020 are discussed here.

## **About the Asian Development Bank**

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