Muhammad bin Ibrahim: ASEAN financial integration – outlook and implications

Keynote address by Mr Muhammad bin Ibrahim, Deputy Governor of the Central Bank of Malaysia (Bank Negara Malaysia), at the ASEAN Risk Conference: "ASEAN financial integration – outlook and implications", Kuala Lumpur, 14 May 2015.

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Thank you for giving me this opportunity to speak on the subject of ASEAN financial integration and its implications for the region. The theme is contemporary and relevant as ASEAN approaches an important milestone this year – the realisation of the vision to establish the ASEAN Economic Community. The path to economic integration is inherently challenging given that political and economic imperatives do not always converge. But at the same time there are enormous opportunities that can be realised for the good of member countries. For a region as diverse as ASEAN, where political systems, cultural backgrounds, stages of economic development and domestic priorities vary widely, the challenges are substantially greater, but not insurmountable.

It is worth noting that ASEAN leaders had adopted the ASEAN Economic Blueprint in November 2007 when the global financial crisis was upon us. It was a bold and visionary decision. The unfolding of the crisis, including the issues faced by the European financial and economic integration process, provided important lessons for the region in advancing its own integration journey.

Taking the primary lessons learnt, ASEAN has decided on an integration process that is flexible and pragmatic. This is fully supported by the commitment of its leaders to a shared vision to make meaningful progress in the implementation of the AEC Blueprint.

The vision for an economically and financially integrated ASEAN represents the aspiration of many policy makers, old and new. A recent take on this can be found in a document titled "The Road to ASEAN Financial Integration", a study on the financial landscape and formulating milestones on ASEAN monetary and financial integration. This document endorsed by the ASEAN Central Bank Governors and approved by the Finance Ministers presents a clear, ambitious and committed statement by the region to collectively embark on this journey. In this respect, ASEAN has made meaningful progress in the identification, articulation and implementation of principles to advance financial and economic integration among its members.

Work to craft the post-2015 plan is in progress, in line with the assessment of the current state of readiness in this region. As we enter the next phase, the principles that underpin ASEAN's integration model will continue to be tested, and whether ASEAN reaps fully the benefits of economic and financial integration, will be very much determined by the collective actions of governments, policymakers and economic and financial agents, including those of us in this room today.

In my remarks this morning, I will discuss the role of financial integration as both a key enabler and an outcome of the AEC. I will talk about where we are in this process and some of the priorities for policy frameworks as well as for the management of risks by financial institutions as we move forward. This, I hope, will provide useful inputs for your deliberation and discussion in this conference.

The case for greater financial integration

ASEAN is home to more than 600 million people and if considered as a single entity, would represent the sixth largest economy in the world with a combined GDP of USD2.5 trillion. According to the OECD, the region is projected to sustain an average annual growth of 5.6%

over the next four years and is expected to be the fourth largest trading bloc by 2050. Concurrently, the standards of living among the general populace will continue to improve. Household purchasing power has risen significantly over the last decade, transforming the region into a thriving hub of consumer demand. The size of ASEAN's consuming class is expected to double from 81 million to 163 million by 2030. By 2020, Asia is estimated to account for more than half of the total global middle class population, with ASEAN representing more than USD2 trillion of additional consumption within the region.

Also, as the sources of economic growth become increasingly domestic-based, this enables many economies to diversify their sources of growth. An important development is the significant increase in intra-regional trade. These developments augur well for the region and would expand domestic demand and further fuel greater intra-regional trade among ASEAN member countries.

The promise of higher living standards and employment is also drawing large numbers of people from the countryside to cities. Today, just over a third of ASEAN's population are living in urban areas. This is expected to rise to 45% by 2030.

Integrating national financial systems within the region is key to unlocking ASEAN's enormous economic growth potential. As a critical component of the AEC, financial integration will significantly enhance the efficiency and effectiveness of intermediation and allocation of resources. This is crucial as the region pursues greater economic prosperity that is both inclusive and sustainable. By allowing the region's financial resources to move more freely across borders, financial integration will open up new opportunities for businesses and trade, enhancing further financial linkages within the region.

A more integrated regional financial system would also allow a larger share of the region's surplus savings to be deployed within the region towards productive ends, such as in physical infrastructure projects. According to the Asian Development Bank, ASEAN will require approximately USD1 trillion 1[1] over the next 10 years in infrastructure investments across the region. This includes for the provision of sufficient housing, efficient public transportation and access to clean water and electricity. While the numbers seem staggering, the ability to recycle the huge savings within ASEAN will substantially enhance the region's prospects to fund and sustain such investments.

With one of the highest savings rate in the world, at approximately 30% of GDP which currently amounts to USD750 billion, a well-integrated regional financial system would provide a more comprehensive eco-system for an efficient and competitive intermediation and investment.

An important component of ASEAN growth is the critical role of SMEs in all economies. The AEC recognise this and calls for SMEs to play a greater role in contributing to the overall economic growth and development of ASEAN as a region. Access to financing, however, remains a key challenge for many businesses. Despite various national level efforts, more needs to be done for SMEs to obtain access to financing, including the funding required to grow their business beyond national borders. The credit gap for SMEs in East Asia is estimated to be more than USD250 billion.[2] The difficulties in access to financing are compounded by underdeveloped financial systems, the need to manage multiple banking relationships across different markets, and a lack of coordinated financial advisory support to help businesses navigate the regulatory and business environment in different jurisdictions. A larger presence of regional financial institutions can significantly reduce these challenges.

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1 Speech by David Lipton, First Deputy Managing Director, IMF on 19 March 2015 entitled "ASEAN – The Challenges of Convergence and Integration".

2 Sources: International Finance Corporation and McKinsey & Company, "Two trillion and counting – Assessing the credit gap for micro, small, and medium-size enterprises in the developing world", October 2010.

Banks with wide regional networks would possess the intimate knowledge of each economy and understands the unique requirements of SMEs. Such banks are well placed to serve and harness SMEs' capability to participate more meaningfully in the region's production networks.

For ASEAN financial institutions, the prospect of regional financial integration will also serve to raise industry standards across the region. This includes enhancing the breadth and quality of financial products and services as a result of more efficient markets and the transfer of knowledge and technology. Financial institutions will also need to meet higher standards in how they manage risk and govern their operations. To some extent, this will be driven by regulatory efforts to elevate prudential and business conduct standards – a point which I will return to in a few moments. But aside from regulation, greater economies of scale and scope will also make it more feasible for financial institutions to invest in talent and more advanced technology and systems, to support business development and risk management.

These benefits accrue not only to those individual financial institutions which are regionally oriented, but also more broadly to national financial systems. Greater market integration can contribute to the deepening of domestic financial markets which is important to encourage the more efficient allocation of capital and dispersion of risk more broadly, thereby strengthening the economy and financial system against external shocks. Best practices and innovative products from one part of the region can also be deployed to other parts of the region, to tackle a common need or challenge.

An area that has considerable potential, both to support, not only greater regional financial integration but also for the development of national financial systems, is the establishment of credit reporting infrastructure. For example, the implementation of the Central Credit Reporting Information System in Malaysia, one of the most comprehensive in the world, has had a profound impact in transforming the credit landscape in Malaysia by improving efficiency and productivity, enhancing access to financing, strengthening risk management and encouraging responsible borrowing. These benefits can be extended more broadly by establishing and linking up similar systems across the region through collaborative efforts. The potential also exists for similar infrastructure to be developed in the insurance sector which can serve to strengthen underwriting assessments, and allow loss data such as for catastrophes to be shared more efficiently. Importantly, developments in this area will greatly advance financial inclusion and contribute towards narrowing the development gap among and within ASEAN economies.

Key achievements in financial integration

Let me now turn to where we are in the financial integration process. Consistent with a flexible and pragmatic approach which has been adopted for ASEAN, implementing the integration process within ASEAN is grounded on the state of readiness of each member country. Member countries are given flexibility to ensure that the integration process is sustainable and meet national policy objectives. It is an important criteria, as the level of economic and financial development of member countries are very diverse.

More importantly, member countries are given sufficient timeframe to fulfil the preconditions for a successful integration, so that when markets become more accessible, domestic and regional financial stability is maintained.

Guided by these principles of pragmatism and flexibility, ASEAN has made significant strides on several fronts. A key milestone in 2015 will be the implementation of the ASEAN Banking Integration Framework, or ABIF, which will provide for an expanded presence of Qualified ASEAN Banks in the region. Given the dominant role of the banking system in financial intermediation within the region's economies, the successful implementation of ABIF represents a key catalyst to drive deeper integration and enhance the region's growth potential.

While the specific qualifying criteria for Qualified ASEAN Banks, or QABs, will be agreed mutually on a bilateral basis, by and large, these will focus on the financial capacity, governance quality and track record and business plan of the prospective candidate bank. With the QAB status, indigenous ASEAN banks will be accorded full operational flexibilities akin to privileges accorded to domestic banks. Of course this would be subjected to prudential safeguards and requirements and agreed based on reciprocal arrangements. Amongst the attractive propositions for QABs are a more flexible operating environment such as branching requirements and employment of expatriates. Under this new operating scenario, QABs ought to operate more competitively and enjoy greater economies of scale.

With the conclusion of ABIF, ASEAN members are now pursuing reciprocal bilateral agreements, which will detail measures on market access and operational flexibilities for QABs in the respective countries. The future looks bright. Last December, Malaysia and Indonesia signed a Heads of Agreement which will provide opportunities for banks from both economies to expand their scope of operations and businesses in each other's markets. As such, we should witness an expanding network of bilateral agreements in the coming years.

In line with its focus on the principles of inclusiveness, reciprocity and mutual benefit, ABIF allows member countries to manage systematically the integration process, while taking into consideration, national development objectives and financial stability. Countries which are ready to proceed will be able to start the integration process early and at their own pace. Other countries will aspire to meet the preconditions and will be supported by the region's collective commitment to capacity building efforts, so that they can progress steadily towards achieving a state of readiness to enable full participation in the integration process.

In the insurance sector, continuing progress is being made to strengthen insurance regulatory and supervisory frameworks in the region through observance of the Insurance Core Principles as an important precondition for more integrated insurance markets. This process has been supported by the ASEAN Insurance Regulators forum and its training arm. Going forward, progressive liberalisation of the insurance sector in the region will be guided by the ASEAN Insurance Integration Framework.

In this regard, ASEAN members have agreed to prioritise efforts to liberalise the cross-border supply of Marine, Aviation and Goods in International Transit (MAT) insurance and to support the establishment of an ASEAN Disaster Risk Financing and Insurance (DRFI) mechanism. Progress in these areas will enable ASEAN members to increase capacity for such risks which are growing in scale and complexity, and achieve broader diversification of risks across the region, leading to lower costs of insurance. It will also enhance the protection of ASEAN communities and economies against increasing exposures to catastrophes.

Significant progress has also been made in promoting freer flow of capital and greater connectivity between the ASEAN capital markets through the various initiatives and measures by the ASEAN Capital Markets Forum. Market participants can look forward to more seamless cross-border investments with reduced costs and greater access to ASEAN investments.

Financial integration initiatives are also focusing on harmonising further the operating environments for payment systems within ASEAN countries. A key outcome is to create an efficient, reliable and secure payment and settlement system which is able to operate smoothly across ASEAN. Consumer transactions such as cash withdrawals and payments for goods and services will be further simplified, contributing towards the growth of retail businesses in ASEAN economies. The development of more convenient and cost effective retail payment systems can also help realise the full potential for e-commerce in ASEAN. Efforts are also underway to promote the use of ASEAN currencies for trade settlement. This will diversify the use of currencies by importers and exporters.

The use of domestic currency for settlement of trade reduces the exposures to currency risk and costs associated with the need to hedge against such risks. Collectively, these initiatives are expected to contribute towards further deepening trade and financial integration in the region.

Priorities going forward

With the developments described just now, in moving forward, we can expect the financial integration process to continue to gather momentum. To my own mind, an important question for policymakers and financial institutions is where should we focus our attention and efforts to adapt to the changes ahead?

While further financial integration process has captured the imagination of many, because of the numerous benefits and opportunities, at the same time, policymakers in the region remain focused on ensuring strong and resilient financial systems which are critical to buffer against greater exposures to contagion in a more open and competitive market environment. Efforts continue to be taken to strengthen financial stability frameworks. This includes continuing to develop arrangements, both formal and informal, for cooperation in monitoring risks and to support the effective supervision and resolution of financial institutions with a significant cross-border presence. Greater consistency in the implementation of minimum regulatory standards will also be as important, to reduce distortions arising from unfettered competition, regulatory arbitrage and transactional compliance costs incurred when operating across borders. In implementing the minimum regulatory standards, the objective is not to achieve a single set of uniform rules, but rather to focus on implementing rules in the respective ASEAN member countries that are consistent with an agreed set of sound *principles* of regulation and supervision.

This will entail efforts at the national level to align existing regulatory and supervisory regimes with international standards such as the Basel and Insurance Core Principles. In addition, the implementation of well-designed financial safety nets such as deposit insurance systems will further support the successful management and transition during the financial integration process.

Surveillance mechanisms also need to be enhanced to be able to take into account the implications of cross-border transactions and the diversity of the market structures across the region which will affect the way risks are measured and managed. Traditional risk metrics may not be able to fully capture more layered risk complexions. As financial systems develop at an uneven pace across the region, and as regional exposures become more significant, more granular and broader risk metrics will need to be developed to capture differences in market structures and different business profiles in local markets which reflect prevailing economic and financial conditions. As an example, loan-to-deposit ratios vary considerably across the region, partly reflecting differences in the depth and sophistication of financial systems and to some the extent whether savers and borrowers have alternative avenues for investment and financing.

Financial institutions – and in particular those with regional aspirations – must develop the capacity and capability to manage risks arising from cross-border operations. Given the greater complexity of business, boards and management will be confronted with more difficult and multi-dimensional challenges in driving strategy and in overseeing operations. This calls for greater emphasis on board and management composition and diversity in terms of skills and experience.

Board members with experience in the areas of international banking and finance for instance, would be critical to help the institution in managing the new operating environment including new business models, while guarding against the attendant risks.

The growth of the regional financial markets will also accompany such financial integration and cross border banking and investment activity. This could open up new sources of revenues for the financial sector, at the same time, new risks that may require upgraded skills and infrastructure to manage. Policymakers will try to harness the economic and financial benefits these bring while ensuring that risks will be well managed. For financial institutions, there will be a need to enhance capacity in operations and connectivity – developing the necessary infrastructure, systems, counterparty lines and settlement capability across the region. Risk management also needs to be enhanced correspondingly, capability of assessing market and credit risks which could be challenged by different liquidity conditions and market environments.

Financial institutions must also be ready and able to comply with diverse legal and regulatory expectations in each country of operation. In this respect, the implementation of robust and consistent group-wide risk management, and a strong risk culture, is critical to mitigate risks of group contagion.

Another critical element is the investment in talent development – both in industry and in the regulatory community – to provide a strong pipeline of skilled individuals required for the management of a more integrated financial sector. Sufficient resources and attention is needed to develop and implement strategies to attract and retain the right talent. The demand for talent particularly in the area of risk management and compliance continues to rise in the aftermath of the global financial crisis as financial institutions adjust to implement regulatory reform measures. Similarly, training and development programmes must be continuously enhanced to ensure that skill sets within the financial institution are kept current and relevant. Regional training institutions such as the Asian Institute of Chartered Bankers and the Asian Banking School and the South East Asian Central Banks Research and Training Centre, or SEACEN, amongst others, will play an essential role in meeting the demand for new talent with the necessary skill sets and experience.

Concluding remarks

The success of financial integration in ASEAN will be critical to support the on-going transformation of ASEAN economies in the coming decades. No doubt there are risks, challenges and setbacks even. But benefits and risks are two sides of the same coin. We should be confident enough, ASEAN is more than 40 years old now, as we chart our progress towards a more integrated economy as a group. Our ability to realise these benefits in future will largely depend on the investments and priorities that we make today.

Our priorities should work to improve our ability to effectively manage financial stability in a more integrated financial system, and to build stronger, more resilient and dynamic institutions that will effectively serve the economic needs of the people in this region.

On that note, let me conclude my remarks and wish all of you a productive and fruitful conference.