Ravi Menon: ASEAN financial integration – where are we, where next?

Keynote address by Mr Ravi Menon, Managing Director of the Monetary Authority of Singapore, at the ASEAN Banking Council Meeting, Singapore, 12 June 2015.

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Ladies and gentlemen, good morning.

ASEAN banks have performed well over the last two decades since the Asian Financial Crisis. Asia's economies and financial systems, including those in ASEAN, generally held up well during the Global Financial Crisis.

The near term economic outlook for ASEAN will be shaped by two themes: the ongoing recovery in the G3 economies and the slowdown in the Chinese economy. Barring shocks, overall growth in ASEAN should remain firm this year, at about 5%, not spectacular but very respectable considering the state of the global economy.

Macroeconomic conditions are therefore supportive of banks in ASEAN. There are, however, downside risks they need to watch.

- The divergence in monetary policy settings among the G3 economies could pose risks to financial stability that could also potentially hurt growth.
- The anticipated normalisation of interest rates in the US against continuing quantitative easing in the Eurozone and Japan is already causing sharp movements in exchange rates and bond yields.

The scenario of a "double whammy" posed by a rise in US interest rates and a strong US Dollar could expose vulnerabilities among some ASEAN borrowers.

- Banks in the region could face higher non-performing loans. They could also face reduced US Dollar funding if there are large capital outflows from ASEAN.
- But their liquidity and capital positions are generally sound and they should be able to weather this.

ASEAN growth story still good

Over the medium to long term, ASEAN is expected to remain among the fastest growing regions in the world.

Last year, the combined GDP of ASEAN was close to US$2.5 trillion – larger than India.

- The ASEAN-4 – Indonesia, Malaysia, Thailand and the Philippines – are projected to grow by at least 4% per annum on average over the next five years.
- It could be as high as 6% if ASEAN becomes more integrated and these countries successfully implement structural reforms to raise productivity and competitiveness.

For banks in ASEAN, it is not just the size and growth of the economies that matter. It is the composition of that growth and demand.

Rising incomes and the agglomeration effects of urbanisation will significantly expand the ranks of the middle class in ASEAN.

- In 2010, ASEAN had a population of 600 million, with around a quarter making up the middle class.

- In 2030, ASEAN will have a population of 700 million, with about two-thirds attaining middle class status.
- In other words, the size of the middle class will swell by as much as three times over two decades.

This rapid expansion of the middle class in ASEAN will spur demand for a wide range of goods and services.

- Services such as telecommunications, education, healthcare, and banking and finance, have a high income elasticity of demand.
- This means that as incomes rise and wealth accumulates, the demand for financial services – be it consumer credit, wealth management, or insurance – will rise more than proportionately.

This phenomenon is being demonstrated right now, as it has been over the last few years, and will continue to play out in the next few decades as ASEAN continues to grow.

Economic and financial integration to sustain growth

Besides domestic structural reforms, a key factor to sustain ASEAN's rate of growth closer to 6% than 4% is economic integration.

- A key vehicle to achieve this is the ASEAN Economic Community (AEC).
- The AEC, as you know, was adopted in 2007 by ASEAN Leaders as a blueprint to achieve a free flow of goods, services, investments, and skilled people within the region by 2015.

We have achieved substantial progress in implementing the AEC Blueprint.

- More than 90% of the key deliverables targeted for completion by 2015 have been implemented.
- Virtually all goods traded within ASEAN are at zero tariff.
- There are agreements in place to enhance protection for investors, liberalise sectors for investment, and provide greater transparency on investment rules.

Financial integration is a strong complement to trade integration and a critical component of the overall AEC project. Deeper financial integration will yield substantial benefits for ASEAN economies.

- It will support economic growth by helping to mobilise surplus savings more efficiently and channelling them to productive investment opportunities in the region.
- It will strengthen resilience to external shocks by helping to deepen and broaden capital markets.
- It will promote financial inclusion by helping to expand the reach of financial services to a wider community that is currently under-banked and under-insured.

The ASEAN Financial Integration Framework (AFIF), adopted by ASEAN Central Bank Governors and endorsed by ASEAN Finance Ministers in 2011, envisages a more integrated financial region by 2020.

AFIF sets out the following key thrusts:

- remove restrictions to the intra-ASEAN provision of financial services by ASEAN financial institutions;
- build capacity and infrastructure to develop and integrate the ASEAN capital markets

- liberalise the flow of capital across the ASEAN region
- harmonise payments and settlements systems
- strengthen capacity building, regional financing arrangements, and regional surveillance

The pace of financial integration has, however, lagged behind trade integration. In part, this is deliberate. In part, this is disappointing.

The slower pace is deliberate in the sense that financial integration is more complex than trade integration and requires more time.

- Liberalising access to financial services is not as straightforward as reducing numerical tariff rates on particular categories of merchandise.
- Financial liberalisation involves addressing issues of harmonising regulatory standards, market conduct practices, disclosure requirements, and conditions of licensing.

More so than in trade integration, financial integration requires a certain degree of convergence in the development of financial markets in the respective economies. The financial systems across ASEAN are at very different stages of development and sophistication.

Unlike the goods market and most services, financial liberalisation and integration must pay close heed to issues of systemic stability. A key lesson from past financial crises is that premature opening up of financial markets without strengthening domestic financial systems and establishing credible safety nets can have painful consequences.

While there are good reasons why financial integration has been slower than trade integration, one cannot help but think that progress could have been faster than what we have seen to-date. In that sense, the pace of financial integration is disappointing. ASEAN Finance Ministers and Central Bank Governors are therefore determined to make up for lost time and press ahead with liberalisation in the post-AEC phase leading up to 2020.

While the pace of financial integration has not been as fast as we would have liked, it is important that we recognise the progress that has been made and the opportunities that have been created. Let me now touch on the progress and prospects for integration in banking, insurance, and the capital markets respectively.

Banking integration

In banking, the key achievement is the establishment of the ASEAN Banking Integration Framework (ABIF).

- ABIF provides a platform for Qualified ASEAN Banks to enjoy greater market access and operational flexibility.
- Banking liberalisation under the ABIF can be done on a bilateral basis and customised accordingly.
- Two ASEAN countries can agree on specific areas to be liberalised based on the Qualified ASEAN Banks' commercial interests.

ABIF will complement the broader economic integration of ASEAN.

- As ASEAN economies develop further, their corporates will expand their operations into the region.
- The banks who have been servicing these corporates in their home markets are well placed to follow their customers and support them as they regionalise.

- ABIF will provide them an enhanced vehicle to do so.

More importantly, ABIF will be a vehicle to help grow a group of strong pan-ASEAN regional banks with the scale and the capability to compete alongside the global banks. As ASEAN becomes an economic powerhouse, so must our ASEAN banks.

Looking ahead, a key priority for banking integration will be to help banking groups with operations in several ASEAN countries to share and transmit information across borders.

- For banks with pan-ASEAN operations, the segregation of data and systems in multiple countries due to data on-shoring requirements may hinder effective group risk management and raise data security concerns.
- We should harness technology to support the pooling of data in regional and global data centres.
- Data aggregation will help enhance consolidated risk management and ensure better protection of customer data.

Insurance integration

In insurance, ASEAN member states have agreed on an ASEAN Insurance Integration Framework.

- ASEAN members have agreed in-principle to liberalise the cross-border supply of Marine, Aviation and Goods in International Transit (MAT) insurance in the seventh package of financial sector commitments of the AFAS.
- When this agreement is signed and ratified in 2016, insurance companies will be able to offer MAT insurance across ASEAN's borders.
- This move will help to lower the cost of insuring cross-border business risks and help to spur intra-ASEAN trade.

The next key steps will be to liberalise the catastrophe insurance and reinsurance markets.

- ASEAN's insurance penetration rate is barely half the global average, even as the incidence and severity of natural catastrophes in ASEAN continue to increase.
- This large and widening gap in insurance coverage leaves ASEAN countries vulnerable to economic loss and production disruptions from natural catastrophes.
- As risk exposures grow in scale, size and complexity, they will exceed the capacity of individual states to underwrite the risks confronting their communities and economies.

Liberalising ASEAN's insurance markets will reduce the cost of insurance protection to governments, to businesses as well as to consumers.

- The insurance business is premised on the law of large numbers and risk pooling – the wider the distribution of risks, the more cost-effective the cover.
- It is therefore important to allow cross-border provision of insurance services.

Capital market integration

In capital markets, ASEAN has made good progress in integration, starting with Thailand, Malaysia and Singapore. Concrete measures have been put in place to harmonise disclosure requirements and broaden market linkages.

For investors, the ASEAN Trading Link among Thailand, Malaysia and Singapore provides a single gateway to all three exchanges.

- This means an investor in one country can buy shares in the other two markets through his local stockbroker.

For issuers, Thailand, Malaysia and Singapore have adopted fully harmonised prospectus disclosure requirements, known as the ASEAN Disclosure Standards.

- This means an issuer can tap all three markets with a single set of prospectus, yielding greater efficiency and cost savings.
- A Streamlined Review Framework for such prospectuses is targeted to be implemented later this year. This will shorten the time taken for the issuer to obtain approval for a multi-jurisdictional offering and provide greater certainty on the time-to-market.

For fund managers, Thailand, Malaysia and Singapore have launched the ASEAN Collective Investment Scheme Framework, which is a mutual recognition framework providing fund managers with a streamlined authorisation process for the cross-border offering of funds.

- This means that a fund manager authorised to manage a fund in one country can market the same fund in the other ASEAN countries.

These are significant steps towards achieving an integrated ASEAN capital market. But they are not enough. In fact, it is like a bridge three-quarters completed. It marks good progress but is not quite useful until it is end-to-end. And end-to-end integration is what we need to fully realise the benefits of our efforts on the capital market front.

ASEAN needs to continue enhancing linkages across its markets.

- We should build on the ASEAN Trading Link among Thailand, Malaysia and Singapore by further broadening and deepening post-trade linkages.
- Establishing clearing, settlement, and custody links will make the ASEAN Trading Link a full-fledged end-to-end platform across the three ASEAN markets.

And with the progressive participation of the other ASEAN exchanges, we would have created a truly integrated ASEAN capital market – one that will:

- enhance trading volumes;
- lower the cost of corporate fund raising;
- provide investors with more choice and ease of access; and
- enhance liquidity and stability in the market.

Conclusion

To achieve its potential, ASEAN must integrate further.

Economic integration is a win-win proposition. By exploiting economies of scale and strategic complementarities, every country in ASEAN stands to gain.

Economic and financial integration in ASEAN owes at least as much, if not more, to the natural functioning of market forces as it does to official initiatives like free trade agreements. Integration in ASEAN, more so than it has been in the European context, is a bottom-up, organic process driven by:

- trade and investment flows arising from the production networks of global MNCs spanning the ASEAN region; and
- cross-border capital flows arising from the operations of global and regional banks.

The success of ASEAN financial integration therefore requires active industry collaboration and participation. The industry has an important role to play in working with regulators and governments to identify and clear roadblocks to growing their business across borders.

The ASEAN Bankers Association, representing the banking associations across all ASEAN members, is well placed to play this role.

- Coming from the industry, you know what makes commercial sense, where the specific obstacles are, and you know how to persuade your governments and regulators to press on with economic and financial integration.
- I wish you fruitful discussions and look forward to your ideas.

Thank you.