Reimagining ASEAN: The Philippines reports on ASEAN’s banking and capital market landscape

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As part of our “Reimagining ASEAN” series, we asked the Philippines’ Bangko Sentral Ng Pilipinas (BSP) and the Department of Finance for their input into the past, present and future of ASEAN.

Here they share their thoughts on ASEAN’s banking and capital market landscape.

Why is greater financial and capital markets integration one of the key aspects of the 2025 vision?

Ensuring the financial sector is inclusive and stable remains a key goal of regional economic integration and a key element under the ASEAN Economic Community’s (AEC) 2025 vision.

Financial integration can help facilitate the seamless movement of goods, services, investment, capital, and skilled labour across borders – it can help enhance ASEAN’s trade and production networks, as well as help create a more unified market for ASEAN’s firms and consumers. It can also stimulate competitiveness and efficiency in ASEAN’s financial institutions and in turn boost growth and employment – including in the poorer regions of higher-income ASEAN members.

Lastly, financial integration helps to facilitate the development of larger, deeper, and more liquid markets. This, in turn, can lower the cost of capital, improve resource allocation, enhance diversification of risks, lengthen the maturity of financing, and improve trading and settlement practices. It could also impose greater discipline on governments, banks, and non-bank corporations, and make the economy more resilient to shocks.

What are the costs of falling short of the goals outlined in the 2025 vision?

Falling short of the 2025 vision will have an underlying impact on the success of the whole regional integration agenda. Should financial integration get stalled, banks and other financial institutions may remain regionally limited in size and sophistication – in turn, restricting their ability to compete against global players in the international financial markets.

Small, segmented and illiquid domestic financial markets will be more vulnerable to shocks emanating from outside the region (if they intend to engage in international markets). At a time when flows of capital into Asia are already unstable, there is a growing need to reduce reliance on capital flows from outside ASEAN and to improve the region’s capacity to withstand external shocks.

In addition, failure to develop larger, deeper, and more liquid markets may deprive ASEAN of a source of alternative funding for domestic markets.

Delays in achieving the regional financial integration agenda could also affect another of the AEC’s goals – to make better use of the region’s resources. Funds need to be allocated to productive purposes, and a particular priority of the AEC’s is the development of infrastructure finance.

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Contrarily, does BSP feel there are risks to increased financial integration? Could greater openness lead to greater volatility?

Theory and experience from other geographic regions suggests that greater financial openness could lead to increased volatility in the region. More closely integrated markets mean a crisis in one jurisdiction has a bigger chance of spreading to others. This risk is heightened by the varying levels of economic development within ASEAN.³

In addition, while the global economic outlook is generally positive, uncertainties remain. The region deals with risks relating to currency depreciation pressures, capital flow volatility, and geopolitical risks, external vulnerabilities which both complicate macroeconomic management, and may also affect the integration process. To ensure regional resiliency and financial stability in the face of these risks, greater cooperation in regional surveillance, enhancement of safety nets, and continued information exchange is required.

Zeroing in on banking integration, the benefits are clear.

An integrated banking sector would create more competition and drive improvements in the quality of banking services – in turn helping to spur more trade and investment in ASEAN. Small and medium enterprises (SMEs), and the currently un-banked, in particular, would gain better access to financing – integration could help improve the lending capacity of ASEAN banks, and the stronger regional banks would be encouraged to utilise modern technology to reach out to a wider segment of the population.

However, banking integration also creates new risks. Identified risks may include: the possibility of the banking system being dominated by foreign banks, the challenge of managing complex regional bank operations that can strain supervisory infrastructures; and additional risks attendant to cross-border transactions.

To mitigate such risks, the ASEAN government and banking sector are already instituting measures to enhance its competitiveness i.e., scaling up of operations through capital expansion and domestic merger and acquisition, enhancing risk management, and preserving competitive advantage in local operations such as in remittance.

The BSP views that the benefits of banking integration outweigh the potential risks. To prepare the Philippines for integration, the BSP has committed to:

a. Careful monitoring and responsive regulation (to ensure the Philippines banking sector remains competitive in a more integrated regional network).

b. The implementation of appropriate safeguards to manage potential risks of integration.

c. Crafting new initiatives to ensure that the benefits of integration are realised and well managed.

d. Raising public awareness of the AEC – specifically the ASEAN Banking Integration Framework.

³ International Monetary Fund, “ASEAN marches to a slow beat toward becoming a powerhouse”, Philippine Daily Inquirer, 20 January 2016”
Zeroing in on banking integration – what progress has been made by ASEAN since the establishment of the AEC in 2015, and what are the areas to look out for in the road to 2025?

ASEAN’s banking integration efforts are one of the key areas to watch out for in the road to AEC 2025.

The Banking Integration Framework (ABIF), signed by the finance ministry representatives of the Association of Southeast Asian Nations in March 2015, has already set guidelines for the banking sector to achieve further integration – providing market access and operational flexibility to banks accredited with the status Qualified ASEAN Banks (QAB).

Moreover, recognising the potential risks of integration, the ASEAN Member States have also committed to developing stronger regulatory and supervisory cooperation arrangements between the home and host ASEAN countries – which, it is hoped, will ensure more effective surveillance and supervision of the QABs.

A closer look at capital market developments

In what areas does BSP see ACMF (ASEAN Capital Markets Forum) Action Plan to be supporting the AEC 2025 goals?

The ACMF has been instrumental in the achievement of capital market development initiatives under the AEC, including the establishment of the ASEAN Trading Link. In view of supporting the AEC 2025 goals, the ACMF came up with a two-phased strategy/approach toward achieving the three strategic objectives set forth under the ACMF Vision 2025:

1. enhance and facilitate growth and connectivity;  
2. promote and sustain inclusiveness;  
3. strengthen and maintain orderliness and resilience of the ASEAN capital markets.

The first phase, Action Plan 2016-2020, aims to establish the fundamental building blocks for regional capital market connectivity over the next five years. This includes: achieving better linkages between ASEAN stock exchanges; increasing the cross-border offering for basic capital market products such as equity and bonds; reviewing and enhancing current arrangements used by signatories for the collective investment scheme (CIS) framework; promoting more exchange traded funds (ETF) and other new products; and reducing the developmental gap among members.

What has been achieved to date?

With the lessons learned from the Asian Financial Crisis, ASEAN has focused on laying the long-term infrastructure to achieve integration of capital markets in ASEAN. This is being implemented through the harmonisation of domestic laws and regulations, and the creation of new linkages. The following have been accomplished to date:

A timeline of developments to date:

- 2009: The initiative for ASEAN financial integration was first adopted in the Roadmap for Monetary and Financial Integration for ASEAN (RIA-fin).
- 2011: The ASEAN Financial Integration Framework (AFIF) was endorsed and the Task Force on ASEAN Banking Integration Framework (TF ABIF) created.
- December 2014: ASEAN Central Banks’ Governors signed ABIF guidelines.
- March 2015: ASEAN Finance Ministers’ Meeting (AFMM) endorsed ABIF as part of ASEAN Framework Agreement on Services (AFAS) 6th Package Protocol.

Banks based in all ASEAN countries will have the opportunity to achieve Qualified ASEAN Bank (QAB) status. The criteria for QAB status will be determined by the two central banks involved in the bilateral agreement. On achieving QAB-status, a bank will then be allowed to operate in both countries.4
– Linkage of three ASEAN Exchanges (Malaysia, Singapore and Thailand) via a single trading platform with a combined market capitalisation of US$1.4 trillion from more than 2,300 companies. The ASEAN Linkage is expected to enhance the region’s profile and visibility to investors by providing convenient access to all ASEAN markets through an electronic gateway.

– Harmonisation of prospectuses for cross-border primary offerings of securities under the ASEAN Disclosure Standards (incorporating the ASEAN Equity Disclosure Standards and the ASEAN Debt Disclosure Standards). Issuers offering equity and plain debt securities in multiple jurisdictions within ASEAN will now only need to comply with ASEAN Disclosure Standards. Malaysia, Singapore and Thailand will be the first group of ASEAN Member States (AMS) to officially adopt the ASEAN Disclosure Standards.5

– Completion of framework to reduce the review timeframe of secondary listing application.

– Launching of the ASEAN corporate governance scorecard, which aims to raise corporate governance standards and practices of ASEAN public-listed companies via the assessment and ranking of the companies using a universal scorecard.6

– The development of the Bond Market Development Scorecard, which measures the state of ASEAN’s bond market development, openness and liquidity, and provides a basis to identify market gaps and track the removal of such gaps over time.

By 2025 does BSP believe more ASEAN capital markets will have reached similar levels of maturity?

Capital market developments in ASEAN follow a multi-paced and multi-stage approach. The readiness of individual ASEAN members must be considered and the diversity of ASEAN member states – in terms of economic development, capital market maturity, regulatory frameworks (that impact the level of liberalisation commitments) – must be acknowledged.

Harmonisation by 2025 will be challenging. However, ASEAN is showing a strong commitment to addressing the remaining gaps.

Moreover, as ASEAN develops technologically, arguably the problems of fragmentation can be reduced. Technology can help enhance capital market operating models and service delivery, and help lower the barriers to entry for ASEAN market players.

5 Philippine corporations will be covered by the ASEAN Disclosure Standards once adopted by ASEAN member states.
6 The Philippines officially launched its participation in the ASEAN Corporate Governance Scorecard on 11 September 2012. Said scorecard was initially implemented among publicly-listed companies. It will eventually be implemented by all Philippine corporations.
Managing FX, cross-border cash, inter-company loans and lending:

What are the complexities/restrictions of managing FX, cross-border cash, inter-company loans and lending, etc. at the ASEAN level that BSP believes need to be tackled?

There are two major challenges to realising a form of financial integration which incorporates both FX management and other cross-border financial transactions:

1. the regulatory challenges of financial integration; and
2. the impact of financial integration on fiscal and monetary policy regimes

Regulatory challenges
Currently, ASEAN countries have diverse financial sector characteristics. Huge gaps exist in the areas of macro-prudential policies, crisis management protocol, and to some extent deposit insurance. This makes harmonisation difficult: standards must not be set so high that they prove irrelevant, even adverse to countries. Equally, ASEAN must ensure regional standards are not lowered in a manner that threatens financial stability.

Policy challenges
An integrated financial system could act as a transmission mechanism for monetary policy (impacting asset prices and economic conditions in individual ASEAN nations). It could increase the likelihood of cases of spill-overs and contagion in the region, and complicate the conduct of domestic monetary policy in member countries.

For example, financial integration could act as a transmission mechanism through consequential interest rate adjustments, capital flow dynamics, exchange-rate adjustments, as well as through increased cross-border lending. In particular, cross-border lending has the potential to fuel domestic credit expansion and inflationary pressures on domestic assets.

In terms of fiscal policy, interconnected banks increase the channel for external fiscal financing. They also facilitate foreign investors’ holding of local sovereign bonds. Moreover, flows of capital through interconnected banks could also affect the yield of sovereign bonds.

Free movement of goods and people as envisaged by AEC 2025 can mean greater cross-border usage of local currencies. Please share views on using local currency settlement for cross-border trade and direct investments. What is needed to facilitate greater adoption of local currency for settlement?

In Asia, there are countries that are actively using the US dollar for regional and international transactions – making them potentially more vulnerable to market risks (particularly as Asia’s role in the global economy continues to expand).

During periods of market stress, demand for safe haven assets such as the US dollar rises, increasing the need for dollar liquidity. This, in turn, can significantly impact the cost of settlements.

The use of local currency in the settlement of cross-border trade is one way of reducing the inherent risk from a potential US dollar tightening during periods of financial market stress. It provides a means of improving the funding efficiency of financial institutions in ASEAN.

Demand for the US dollar will also be alleviated as a medium of exchange and as a store of value. With regional currencies used as trade settlement
currencies, Asia can also contribute to the diversification of international settlement currencies.

The use of local currency settlement provides other benefits:

– The cost of hedging exchange risk can be lower, promoting efficiency in trade and enhancing export competitiveness
– The use of local currencies could also help to enhance and deepen regional financial integration.

However, to truly reap the benefits of local currency usage in cross-border trade and investments, an appropriate financial infrastructure is required. In Asia, establishing a regional settlement infrastructure for regional currencies can be considered. By providing proper infrastructure, the use of Asian currencies for regional trade and investment could be gradually promoted well before these currencies become international reserve currencies with full convertibility.

Take the example of the Renminbi (RMB) trade settlement scheme piloted between the People’s Republic of China, and the region of Hong Kong, and Macao. The existence of an efficient securities trading and settlement centre in both Hong Kong and China (infrastructure was available for payment vs. payment, and for delivery vs. payment for RMB securities), was largely responsible for the expansion of offshore RMB trading. This in turn, helped reduce the relatively larger costs of bilateral currency transactions (compared with “triangular” transactions through the United States dollar).

To facilitate greater adoption of local currency for settlement, there is a need to build an efficient payments and securities settlements to promote more bilateral trade settlement systems or a multilateral trade settlement system in Asia. Trade settlements using local currency can be combined with government securities settlement infrastructure (for which central banks are the main depositories). Combining trade and government securities settlement could keep costs of infrastructure developments low, while helping promote the development of local currency bond markets in Asia.

**What are the areas in payment regulations and market standards that are noticeably different between ASEAN countries? And what are the challenges and potentials to realise?**

**Retail payment regulations:** Some ASEAN countries differ on their retail payment system regulations; for instance on payment card issues such as disclosure of interchange fees and merchant discount rates, treatment of bank-issued Amex companion cards, and surcharging standards; while other economies leave such concerns to the agreements between financial institutions and payment card-issuing entities.

**Instant Payment Schemes:** Some ASEAN countries are driving ahead with the development of Fast Retail Payment Systems – they plan to adopt payment systems that allow for the real-time settlement in central bank funds, and to make such payment systems work on a 24/7 basis.

While most ASEAN Central Banks operate their respective Real Time Gross Settlement Systems (RTGS) for high-value payments, others have their mandates to operate retail payment systems as well.

**The challenges and potentials to realise:** Given the dynamic evolution of electronic payments, monetary regulators (central banks) must act proactively.

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8 The scheme had allowed the settlement in RMB of trade transactions between five cities in the PRC and selected trade partners. It also permitted banks in PRC partner locations to provide RMB services, such as deposit-taking, currency exchange, remittance, trade finance, and check issuance, to enterprises choosing to settle trade transactions in RMB.
9 Ibid.
They must play a strong, active role in performing supervisory and regulatory functions. They must ensure retail and high-value payments are operationally safe, reliable, and efficient. Moreover, they need to ensure that financial inclusion and consumer protection remain a top priority.

The key challenge, at least for some emerging countries in ASEAN, will be the establishment of legal frameworks that govern and support the supervisory role of regulators across the entire payment systems.

Does the BSP see currency volatility as a long-term feature of the ASEAN economy? What are the possible solutions? How can ASEAN strengthen its defences in the run-up to 2025?

Some degree of volatility may be expected as a consequence of increasing integration and the commitment of most ASEAN economies to capital account openness.

In addition, external events (such as Brexit and the US Fed rate hikes) may also be expected to heighten currency volatility across the region in the short-term.

What are the possible solutions?
Amidst these expected fluctuations, authorities in ASEAN need to be able to manage currency risks and safeguard macroeconomic stability.

The majority of ASEAN economies, particularly the Philippines, Indonesia and Thailand have adhered to freely-floating exchange rate regimes compatible with inflation targeting framework for monetary policy. Over the years since the Asian Financial Crisis, a flexible exchange rate regime has proven to be effective as a first line of defence in shielding against sharp gyrations and global headwinds. (The IMF Working Paper in 2016 also noted that this exchange rate regime is not incompatible with the economies’ respective objectives of domestic macroeconomic stability.)

In addition to exchange rate flexibility, the BSP believes ASEAN central banks can add to its arsenal of currency risk management by: maintaining an ample level of foreign exchange reserves to stabilise the convertibility of the currency and contain wild swings in the market; employing a variety of hedging tools (non-deliverable forwards, forwards, options and swaps); and utilising a mix of policy tools that help to temper exchange rate pressures amid capital flow volatility.

Some examples of the policy tools which the BSP have used previously include:

a. Macro-prudential measures to reduce speculation and volatility in the foreign exchange market, including:
   i. limiting local banks’ NDF exposure to 20% of capital;
   ii. limiting local branches of foreign banks’ NDF exposure to 100% of capital; and
   iii. forbidding pre-termination of NDF contracts.

b. The deployment of various liquidity-enhancing tools in case the domestic liquidity situation becomes unexpectedly tight or disorderly, including actions adopted during the 2008-2009 global financial crisis (see Annex).

Moreover, more generally, it is imperative for authorities to stay on top of regulatory changes and keep abreast of macro risks to determine the direction of FX/liquidity policy.

Lastly, to be able to manage currency volatility, ASEAN economies can also continue to work towards:

Reimagining ASEAN

– Maintaining robust intra-ASEAN growth through policies to enhance resilience and protect trade integration amid a more complicated external environment;
– Promoting the use of local currency to facilitate intra-ASEAN trade and investments and the ASEAN payment and settlement systems; and
– Building capacity and laying the long-term infrastructure to achieve greater integration of capital markets in ASEAN.

In what ways might financial technology help promote financial growth and integration in the region?

Financial technology opens up huge opportunities for the growth of financial services in the region.

Banks, recognising the value of technology as a means of improving operational efficiency, lowering

Annex: BSP liquidity enhancing tools

A. Dollar liquidity measures
– Continue the US dollar repo facility\(^\text{11}\) to assist banks having US dollar liquidity needs
– Promote the use of banks’ hedging facilities to help domestic firms manage FX risks
– Increase the budget for Exporters’ Dollar and Yen Rediscounting Facility (EDYRF)

B. Peso liquidity measures
– Adjust the terms of access to the BSP rediscounting facilities\(^\text{12}\)
– Reduce the BSP’s reserve requirement, conditional on the inflation outlook
– Lengthen the maturity of BSP lending instruments
– Lower the margin between RP and RRP rate to encourage use of the RP facility

C. Regulatory forbearance in the event of excessive capital outflows (time-bound)
– Allow financial institutions to reclassify financial assets from categories measured at fair value to those measured at amortised cost\(^\text{13}\)
– Permit banks to not deduct unrealised mark-to-market losses in computing for the 100 percent asset cover. This will reduce the need for banks to source dollars from the foreign exchange market\(^\text{14}\)

D. Communication program
– Ensure timely and clear communication with financial institutions and market participants

E. Careful surveillance of risks
– Enhance network analysis to test vulnerabilities in terms of interconnectedness of banks and corporates
– Cooperate with other central banks or international financial institutions for information sharing and surveillance

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\(^{11}\) In 2008, when the facility was introduced, a total of US$43 million was availed of at a rate of 4.79 percent. In 2009, only US$34 million was availed of at 4.5 percent.

\(^{12}\) The rediscounting budget was increased to P60 billion during the 2008-2009 global financial crisis.

\(^{13}\) BSP Circular No. 628 dated 31 October 2008 allowed a financial asset to be reclassified from Held for Trading (HFT) to Available for Sale (AFS), Held to Maturity (HTM) or Unquoted Debt Securities Classified as Loans (UDSCL) only in rare circumstances and if there is a change in intention (i.e., the financial asset is no longer held for the purpose of selling or repurchasing it in the near term). A financial institution (FI) was allowed to reclassify all or a portion of its financial assets from HFT to AFS/HTM/UDSCL as of the same date from 1 July 2008 to 14 November 2008.

\(^{14}\) During the 2008 global financial crisis, banks were allowed until 30 September 2009 not to deduct unrealized mark-to-market losses in computing for the 100 percent asset cover.
operating costs, and enhancing customer experiences, are increasingly investing in technological initiatives.

In particular, the development of partnerships between banks and fintech companies could create valuable synergies – banks have the client relationship, credibility, and trust, while fintech companies can offer the innovative technologies and new products and services, which may, in turn, lead to the further expansion of market coverage and penetration.

However, the rise of financial technology also carries with it cyber security and operational risks. Risks may present themselves in various forms. Personal information of customers, for example, may be lost or stolen. When the IT system of a financial service provider is attacked, large-scale loss of personal data may occur. IT systems may also be accessed and manipulated to effect criminal payments. Given the increasing interconnectedness in the region, this could have systematic implications.

The challenge is about creating an environment that encourages innovation, without compromising investors’ trust and confidence and the fair and efficient operations of the markets. Regulators need to be aware of the challenges and risk these developments could pose.

ASEAN recognises the concerns relating to rapid innovations and the ASEAN members are committed to cooperate to monitor and address these risks.

There is much potential, much activity, and much enthusiasm in the region about the development of financial technology.

Thank you.

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