

Financial Integration in ASEAN: Lessons from EU

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Presentation Outline

- ✦ EU financial services liberalization
 - Legal steps, salient features, current status
- ✦ Analysis of financial liberalization
 - Results of EU reforms :
 - ✦ Wholesale financial market,
 - ✦ Capital-market related banking activities
 - ✦ Retail
 - Remaining barriers
- ✦ Comparison with ASEAN and Lessons
 - Where we are now
 - Impediments
 - Lessons

EU financial liberalization: legal steps

◆ Major framework directives

- Banking Directives (1977, 1989)
 - ◆ 1st – freedom of establishment, national treatment for EC banks
 - ◆ 2nd – mutual recognition and single passport
- Insurance Directives (1988, 1990, 1992)
 - ◆ Freedom of establishment, then freedom of supply (single passport)
- Investment Services Directive (1994)

◆ Financial Sector Action Plan (FSAP, 1999)

- Timeline to 2005; address remaining barriers
- Harmonize rules and modernize prudential regulations

EU financial liberalization: features

✦ Pillars of reform

- Minimum harmonization
- Mutual recognition
- Home country control

Freedom of establishment
+ freedom of supply

- De-regulation + re-regulation

Existing conditions: sketch

	For EU Member States	Non-EU	GATS Commitments
Mode 1: Cross-border supply of services	No restrictions	No restrictions but only for subsidiaries established in a MS	Establishment requirement for specific financial services
Mode 2: Consumption abroad	No broad EU legislation	National legislation applies	
Mode 3: Commercial Presence	No restrictions; home country supervision; single passport	Subsidiaries established in a MS granted single passport while foreign branches no. Reciprocity condition	Establishment requirement to operate as unit trusts and investment companies, or as depositories of investment funds.
Mode 4: Movement of persons	Single Market Programme for free movement of labor applies		Unbound

EU financial liberalization: Results

◆ Wholesale (Price and quantity results)

- Convergence of EU- area prices: both short- and long-term interest rates
- Unsecured money market: cross-border trade increased
- Steady increase in cross-border interbank assets/ liabilities
- Overall: positive

EU financial liberalization: Results

- ✦ **Capital-market related banking activities**
 - Gross fees in securities issues in euro area has declined (for big transactions); not much for equity issuance;
 - **Bonds:** inroad of foreign (non-EU) firms: from almost zero presence in 1995 to 80% of transactions involving non-European intermediaries – for large transactions.

EU financial liberalization: Results

- ✦ **Equity:** more localized than bond markets
- ✦ **Syndicated loans:** non-euro area intermediaries increased presence in large transactions; asymmetry of information (costly for small transactions)
- ✦ **Asset management and trading –** increasing diversification within euro area
- ✦ **Overall: Positive**

EU financial liberalization: Results

✦ Retail Banking

- Least amount of liberalization seen – especially in mortgage
- Relatively little cross-border transactions within EU

Overview of integration in a selected number of retail products

	<i>Is Cross-border activity taking place?</i>	<i>Are prices converging?</i>	<i>What is the degree of integration?</i>	<i>Which are the main distribution channels?</i>
<i>Savings account</i>	Yes some	Yes	<u>Some signs</u> of integration	Local establishment/intermediaries; Phone; On line; ATM
<i>Home Loans</i>	No	Yes	Rather <u>fragmented</u>	Local establishment/intermediaries
<i>Investment in Securities (UCITS)</i>	Yes	No evidence	Increasingly <u>integrated</u> (but scope for progress)	Distribution through local networks; on-line
<i>Consumer Credit</i>	No evidence	No	Very fragmented	Local establishment/intermediaries/ retailers

Source: European Commission, Financial Integration Monitor, *Commission Staff Working Document*, 2005

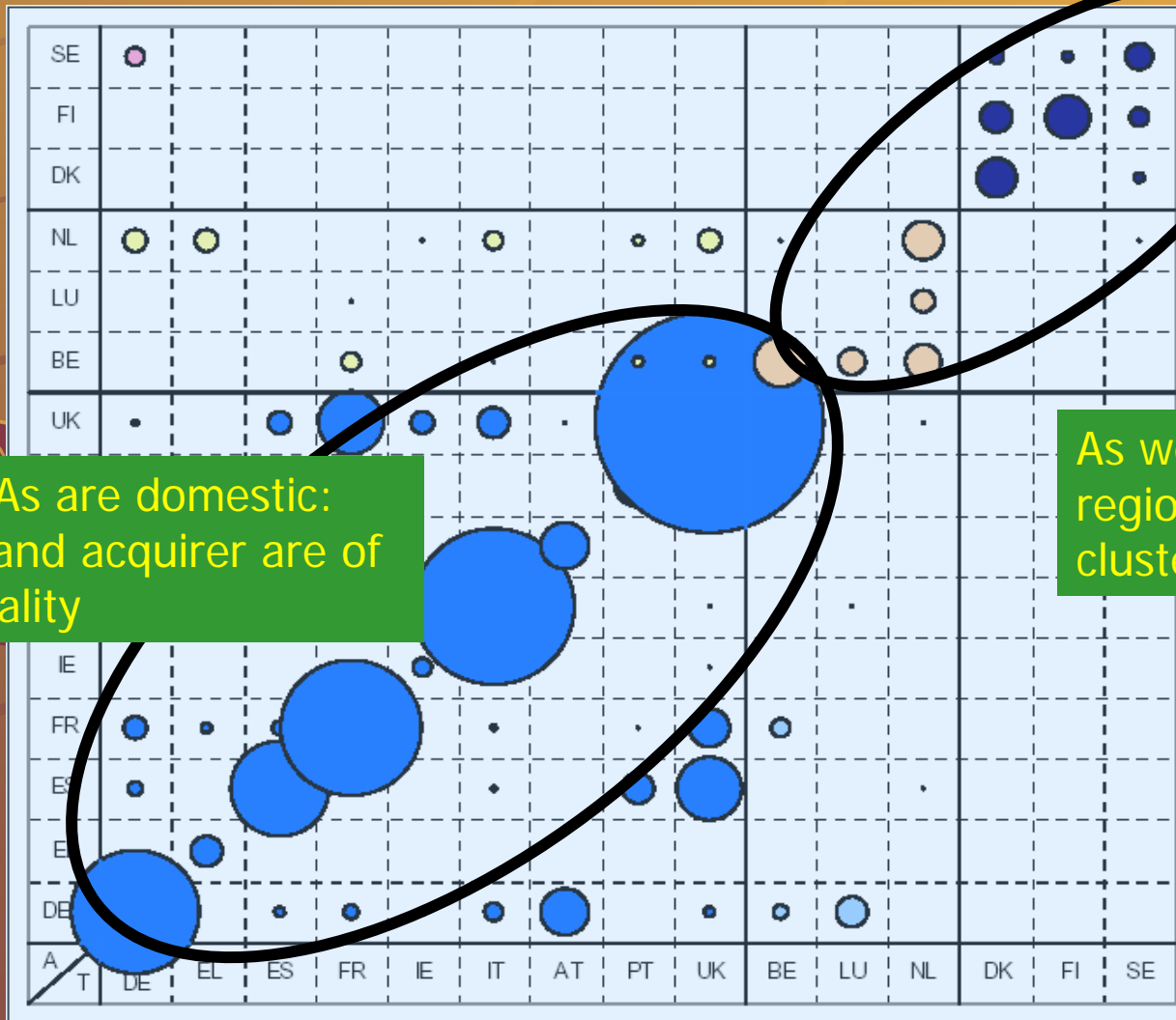
Mergers and acquisitions in financial services: trends

- ✦ **Mostly domestic M&As : 78%**
 - Of which: 60% within banking
 - Increasing domestic market concentration
- ✦ **But spikes in cross-border M&As can be noted:**
 - 1999-2000, cross-border M&As reached 42% of total value of M&A activity, also in 2004
 - Due to high-value M&A transactions e.g. B. Santander acquisition of Abbey National Bank (UK)
- ✦ **There are more cross-border M&As in non-financial services sector**
 - => pan-European companies (in manufacturing and others)
- ✦ **Regional clusters M&As:** Benelux, Nordic/Baltic, and in Southern, Central and Eastern Europe

EU financial liberalization: M&As lead to decreasing credit institutions due to consolidation

Country/Area	Number of Credit Institutions		
	2000	2002	2005
Germany	2742	2363	2089
Spain	368	359	348
France	1099	989	854
Italy	861	821	792
Netherlands	586	539	401
Austria	848	823	818
Great Britain	491	451	400
EU total	8368	7751	8616

EU financial liberalization: Domestic and Regional clustering from M&As



Majority M&As are domestic: both target and acquirer are of same nationality

As well as regionally clustered

EU financial liberalization: Pension, insurance, investment fund

◆ Insurance and pension fund

- Increasingly organized cross-border as well as cross-sector, e.g. Bancassurance
- Accessed through establishment ; largely domestic service
- Direct cross-border selling has been limited
- Consolidation – mostly within national borders
 - 85.5% of total activity => higher domestic concentration levels.

EU financial liberalization: Pension, insurance, investment fund

◆ Investment Fund ('mutual funds')

- Level of cross-border consolidation (M&As) - low; mostly domestically domiciled funds
- But fund sales suggest high level of cross-border distribution and sales.
- Demand side: different demand preference for foreign domiciled UCITS: France - low; Germany and Belgium - high

EU financial liberalization: Summary

✦ Banks, insurance, and conglomerates

- cross-border M&A deals lower than financial sector average
- More **minority** acquisitions and larger domestic deals

✦ Securities activities

- More frequent cross-border M&A transactions
- Larger than domestic M&A transactions
- Often acquisition of **controlling** stakes

EU financial liberalization: Remaining barriers

- ✦ **Fragmented infrastructure** for cross-border clearing and settlement of securities transactions → higher costs than in US
- ✦ **Differences in technical requirements and market practices** → no economies of scale
 - Consumer protection, private law, differing consumer habits/ preferences, taxation regimes

EU financial liberalization: Remaining barriers

◆ Supervisory arrangements

- Multiple reporting requirements -> difficult for cross-border co's to unify back office operations

◆ Different taxation for dividends or exit taxes on capital gains

- hamper reorganization of head office functions (across sectors)
- Tax liabilities calculated using different rules – transfer pricing and losses in one MS cannot be offset against profits in another

EU financial liberalization: Remaining barriers

- ✦ Legal measures hampering acquisition
 - EU law allows MS to block mergers on prudential grounds, legitimate interests
 - Reporting requirements
- ✦ Direct and indirect political interference
- ✦ Employees' hostility and 'poison pill'

ASEAN Financial Liberalization: where are we now?

- ✦ Individual countries made autonomous liberalization in foreign investment and capital account in 1980s
- ✦ Signed ASEAN Framework Agreement in Services (AFAS) in 1994.
- ✦ Chiang-Mai Initiative Swap Plan
- ✦ Asian Bond Fund Initiative

ASEAN : where are we now?

✦ ASEAN Framework Agreement on Services

- Target: free flow of services by 2020
- Achieved 4 packages of schedule of commitments
- MRAs: Engineering*, Architecture, Accountancy, Nursing, Surveying, Tourism

ASEAN financial liberalization: AFAS

Member	Cross Border Supply		Consumption Abroad		Commercial Presence			
	Deposits	Lending	Deposits	Lending	Legal Form	Equity	# of Oper	\$ of Trans
GATS Commitments (1997)								
Indonesia	N	N	N					
Malaysia	U	LC	N					
Philippines	U	U	N					
Singapore	U	U	N					
Thailand	U	U	U					
AFAS Commitments								
Indonesia					LL		LN	
Malaysia								
Philippines	LC	LC	N	N	LL	LO1, if locally incorporated bank LO2 otherwise	LN	
Singapore								LC
Thailand					LL	LO2		

Still very far from the freedom of establishment and freedom of supply conditions.

GATS-plus but so tiny-weeny plus

N: None, U: Unbound, LC: Limited Commitments, LO1 limits on ownership < 50%, LO2: ownership limits > 50%, LL: limits on legal forms, LN: Limits on number of operations, LV: limits on value of transactions or asses; DL: Discretionary Licensing or Economic Needs Test

Summary of AFAS Commitments on Financial Services

- ✦ In sum, commitments to liberalize financial services on AFAS built and added on already existing commitments in the GATS
- ✦ **The most common restrictions include:**
 - Limitations on the number of branches and their locations
 - ✦ Indonesia: 3 cities more than that committed in the GATS
 - Limitations on the legal form of a company
 - ✦ Thailand only allows share acquisition of a company
 - Limitations on ownership
 - ✦ Thailand: up to 100%, but with limitation on operations and added stipulations
 - Limitations on amount of transactions
 - ✦ Singapore: offshore bank lending must not exceed S\$ 300 mn in aggregate

Where are we? Existing conditions in bonds and loan syndicates

- ◆ Hub and spoke characteristic: (from Asian to Asian)
 - Asian issuer chooses N.A or European firm as bookrunner (BR) -> BR assembles syndicate of underwriters -> Underwriters sell about half of the paper to Asian accounts
 - **Asian holdings** range from **36% (Korea and Singapore issues)** to **78% (Indonesian issues)** – based on distribution in the primary market
 - ◆ But most of the Asian holdings are also domestic i.e. Korean bonds held by Koreans

Following discussion on financial integration is based on McCauley, et.al (2002)

Where are we? Existing conditions in bonds and loan syndicates

- ✦ **Syndicated loans** – proxy for wholesale banking market integration. Data 1999-2002.
- ✦ **Banks with same nationality as borrower** provided approximately 20% of nominal amount; East Asian banks provided another 20% of funds. Total approx 40%.
 - Comparator: US banks to US issuers: 55%
 - Euro-area banks to Euro-area: 64%
- ✦ **But definition of Asia here is larger than just ASEAN;**
 - No data for cross-border loans within ASEAN

ASEAN financial integration

Asian Participation in Asian Funding Needs

Percent share of total Asian issues by bookrunners/loan arrangers headquartered in:
(April 1999-August 2002)

Location-wise, most of cross-border credit to borrowers in emerging Asia is provided by banks located in Singapore and HK (although maybe headquartered in N.A. or Europe)

Syndicated
loans

12

23

63

Source: McCauley, Fung

Increasing lead role of Asian banks in loan syndication of Asian issues

But Asian participation (i.e. purchase of Asian issues) are higher when: issues are smaller, ratings are lower, maturities are shorter

Where are we now? Summary

- High financial integration of region with global financial system: ratio of foreign liabilities to GDP is 60%
- But regional integration is still at an early stage.
- **Banking**: predominance of banks in financial system
 - ◆ Regional cross-border activity appears limited although, perhaps, more integrated than commonly perceived, if indicator is Asian participation in syndicated loans (previous slide)
 - ◆ but maybe not ASEAN; most business from Korea, China, Taiwan
 - ◆ However, there is growing interest in cross-border bank acquisitions, especially by Singapore banks.

Where are we now? Summary

- **Equity markets:** In Thailand, Korea, Japan, almost 30% of turnover are by foreign shareholders, but few of these foreign shareholders are other Asians.
 - ✦ Limited cross-listing from foreign companies in Asian exchanges.
- **Bond:** foreign currency denominated bonds are more globally integrated; mostly held by US and EU, although there is evidence that Asian investors also hold large amounts
 - ✦ Local currency denominated bonds – little evidence of cross holding; largely domestically held.

Legal and Fiscal Impediments

✦ Too many national currencies, national rules and regulations, and different market standards

✦ **Restrictions** include:

- **Foreign firm participation** in local market (quota, share limits, ownership, type of operations)

- **Exchange controls** e.g. approval, limits in investments denominated in domestic currency, caps on amount of foreign borrowings

Legal and Fiscal Impediments: Restrictions and Omissions

- Differences in withholding **taxes**, stamp duties
- Inadequacies in **bankruptcy laws** and **property laws** that affect securitization
- Problems on **asset transfers**, especially to foreign asset holders
- Problem in **enforcement of court rights**, including against state-owned enterprises and sovereign governments

Legal and Fiscal Impediments: Restrictions and Omissions

- Lack of clarity in **settlement, custody, netting** and transfer arrangements
- Lack of clarity of master trading and repurchase agreements
- Differences in treatment: taxation, duties, refunds

Lessons from the EU

- ◆ Experience of EU shows key role of European Commission, ECJ, and European Parliament
 - MS agree to grand declarations but national legislation and practice still show protectionist bent, or conversely promote domestic advantage through regulatory laxity.
 - Supranational institutions can take them to task to practice the spirit of the treaties, or force convergence of regulatory regime.
 - Co > “ the existence of an institution to which sovereignty can be delegated, even partially, is an essential precondition for deep integration” (Wyplosz, C, 2006)

Yet, ASEAN desires an EU-like result but not EU-like institutions
Prefers inter-governmental structure over supranational

Lessons from the EU

- ✦ EU – result of political vision and economic defensive motivation;
 - ASEAN – economic: threat of irrelevance due to China and India; but political vision?

✦ Is it possible to achieve financial integration **without supra-national institutions?**

Lessons from the EU

- ◆ **Steps to take:** what legal steps would be worth copying and which do not require supranational institutions?
 - **Home country control, minimum harmonization and mutual recognition**
 - ◆ strengthening prudential regulation and harmonizing these rules with neighbors has universal validity. Pf: work on globally acceptable guidelines for supervision
 - **Inventory of national laws** that can put obstacles to financial integration in the areas of: M&As, distance marketing, transparency, accounting, bankruptcy laws, collateral arrangements, **competition policy**, etc.

Lessons from the EU

– Start developing infrastructure:

- ◆ linkages between jurisdiction for trading, payment, clearing, settlement and custodian systems for money and financial instruments to make cross-border transaction more efficient
- ◆ Existence of credible credit rating systems

Lessons from the EU

– Importance of preserving financial system resilience and stability during deregulation.

- ◆ supervisory agencies should ensure appropriate risk control measures are implemented in individual institutions;
- ◆ that capital adequately reflects the market, credit and operational risk exposure

Lessons from the EU

- ◆ **Credibility in the integrating plans** (in EU case: the SMP) – helps influence wider, permanent bank **expectation** of greater competition.
 - ◆ Helps national financial sector's **frame of reference away from protection and collusion** towards deregulation and greater competition
 - ◆ Integrating plans in financial services - **not shown in AFAS**: major restrictions on operation, establishment, ownership, value of transactions, ownership
 - ◆ ASEAN has **long way to go** in freedom of establishment. There are still many restrictions in cross-border investments

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