

# FINANCIAL MONITORING IN THE NEW ASEAN-5 COUNTRIES

*Se Hee Lim and Noel G. Reyes*

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## Financial Monitoring in the New ASEAN-5 Countries

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## **Abstract**

This paper examines the issues surrounding the implementation of global regulatory reforms—spearheaded by the G20 and mainly under the aegis of the Financial Stability Board (FSB)—in Brunei Darussalam, Cambodia, the Lao People’s Democratic Republic (Lao PDR), Myanmar, and Viet Nam (BCLMV). These countries are the five newest members of the Association of Southeast Asian Nations (ASEAN). As such, there has been little consideration of the impact of global regulatory reforms on these countries. This paper contributes to the literature by providing an analysis of the capacity of the BCLMV countries to implement necessary financial regulatory reforms. Further, this analysis supplements ongoing efforts to establish the building blocks for the ASEAN Economic Community (AEC), which is scheduled to be implemented by 2015. Toward this end, the paper addresses five key development issues in the BCLMV countries: (i) financial regulatory and supervisory systems, (ii) compliance with capital adequacy and liquidity management guidelines under the Basel reforms, (iii) macroprudential surveillance systems, (iv) disclosure and transparency, and (v) capital flow management.

*Keywords:* financial regulatory systems; capital adequacy and liquidity management; Basel reforms; macroprudential surveillance; disclosure and transparency; capital flow; noncore liabilities; BCLMV and ASEAN-5 countries; and ASEAN Economic Community

*JEL Classification:* G28; K22; and O16

## 1. Introduction

Five years after its onset, the adverse effects of the global financial crisis (GFC) continue to be felt in the developed economies of the United States (US) and the eurozone. At the same time, the developing economies of Asia have remained relatively unscathed from the entire episode. The US economy's recovery remains anaemic and its unemployment rate, while down from its peak, remains stubbornly high even after the US government and Federal Reserve have instituted extraordinary measures and pumped hundreds of billions of dollars into the economy to stabilize financial markets and boost economic activity. In the eurozone, member economies have suffered recurrent bouts of recession characterized by sovereign debt defaults and steep credit downgrades, bank insolvencies, and record rates of joblessness.

The debilitating effects of the GFC and the overriding objective of preventing another similar crisis from occurring provided the impetus for the major economies to introduce a number of extensive regulatory reforms. These global reform measures—spearheaded by the Group of 20 Nations (G20), Financial Stability Board (FSB), International Monetary Fund (IMF), and Bank of International Settlements (BIS)—seek to bolster the resilience and stability of financial systems by addressing the vulnerabilities exposed by the crisis.

In addition, a new global financial architecture emerged in the wake of the GFC, with the FSB at its apex. Established after the G20 London summit in April 2009 as a successor to the Financial Stability Forum (FSF), the FSB coordinates the work of national financial authorities and international standard setting bodies. It also develops and promotes “the implementation of effective regulatory, supervisory, and other financial sector policies.” Its members include all of the major economies that comprise the G20, former FSF members, and the European Commission.

The FSB coordinates proposed global reform measures, which may be broadly categorized into two main areas of interest.

The first area concerns safety and soundness standards for financial firms, including bank capital and liquidity regulations, international accounting standards, and the resolution of financial firms. These standards cover the Basel III capital framework for banks, the overhaul of the international financial reporting standards under the auspices of the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB), and the mandatory establishment of the bank recovery and resolution regime in G20 member countries.

The second area of interest for global reform is the regulation of high-risk activities, including over-the-counter (OTC) derivatives trading, shadow banking, and high-frequency trading. These are to be covered by proposals for, respectively, central counterparty clearing for OTC derivatives, the strengthening of shadow banking oversight with focus on hedge fund activities, and the curtailment or ban of high-frequency trading.

Evident from this discussion is that policymakers in developed economies—the starting point of the crisis and home to most of the world's largest financial institutions—have been setting

the agenda for global regulatory reform. These proposed reforms understandably reflect their concerns and largely tackle the weaknesses and vulnerabilities of the developed economy financial systems that helped trigger the crisis. Yet, this focus on developed economy sources of weakness has left the proposed reform measures open to criticism that they fail to adequately address the distinctive risks and concerns of Asia's emerging economies.

In contrast to the developed economies, for instance, emerging economies mainly suffer from instability brought about by external shocks that upset trade flows and reverse capital flows, pummeling domestic currencies and the prices of local assets in the process and thereby stressing the economy. Furthermore, financial sector development in emerging economies remains in a nascent stage, in which the sector relies mainly on banks for financial intermediation. Placing a regulatory burden on Asia's financial sector, either prematurely or heavy-handedly, could constrain the growth of emerging economies at a crucial stage of their development.

There are those who argue that the reform agenda should be enlarged to accommodate the Asian view. Others argue that implementation of the proposed reforms, even as they relate largely to advanced economies and their sophisticated markets, will still benefit Asia's emerging economies and embryonic markets since these reforms serve the purpose of enhancing financial stability, preventing financial crises, and providing guidance to Asian policymakers with respect to best practices. The last point is especially relevant to the regional integration initiatives of the Association of Southeast Asian Nations (ASEAN), which require the harmonization of regulatory regimes across the region in order to avoid the risk of regulatory arbitrage. In addition, implementation of these reforms would help attract foreign investors who seek the presence of these measures to mitigate investment risks. The ultimate aim would be wean the region from relying too much on capital inflows by developing the region's capital markets and financial systems. However, the patent reality is that the region will remain reliant on these foreign inflows for the time being.

With these contentious points in mind, this paper seeks to study the impact of global regulatory reforms on the five newest members of ASEAN: Brunei Darussalam, Cambodia, the Lao People's Democratic Republic (Lao PDR), Myanmar, and Viet Nam (known collectively as the BCLMV countries). In assessing the impact of such reforms, this paper examines a number of key development issues in the BCLMV countries, including (i) the resilience of financial regulatory and supervisory systems, (ii) compliance with capital adequacy requirements and liquidity management guidelines under the Basel reforms, (iii) macroprudential surveillance systems, (iv) transparency and disclosure, and (v) capital flow management.

Face-to-face interviews were conducted with officials from the five countries' monetary authorities, market regulators, and stock exchanges. Interviewees were emailed a set of questions in advance along with a survey questionnaire based on the principles of corporate governance as determined by the Organisation for Economic Co-operation and Development (OECD) and the BIS.



Most research on financial development and reforms has focused on the more developed or larger ASEAN economies and has generally neglected the five newer members.<sup>1</sup> This study hopes to break new ground by focusing on the BCLMV countries and the status of their financial development and reform programs.

The relevance of the proposed global financial reform measures is particularly acute for these five developing economies, one of which, Brunei Darussalam, is also an oil-exporting country. Their financial sectors lag the rest of the region in terms of development, with banks functioning as the main financial intermediaries that generally offer only the traditional products and services of deposit-taking and lending. The looming global banking reforms, on the other hand, pertain to more advanced financial systems.

In addition to the relevance of global financial reform, another factor considered by this study is the impending economic integration of the ASEAN region by 2015.

The remainder of this paper is structured as follows. Section 2 discusses issues related to BCLMV countries and the ASEAN Economic Community (AEC). Section 3 analyzes issues related to the diversity of the BCLMV countries. Section 4 deals with various key development issues and indicators. Finally, section 5 summarizes and offers some recommendations.

## 2. BCLMV Countries and the ASEAN Economic Community

An overarching concern is the possibility that the BCLMV countries' financial development will continue to lag the rest of the region, which is currently gearing up for the accelerated establishment of the AEC by 2015. Upon its official launch, the 10-country integrated region will cover 4.46 million square kilometers, with a combined population of 600 million and a combined nominal gross domestic product (GDP) of more than \$2 trillion.

The official launch of the AEC has been moved forward from its original date. During the 13th ASEAN Summit on 20 November 2007 in Singapore, ASEAN leaders agreed to move from 2020 to 2015 the establishment of the AEC in the hope of accelerating the economic integration of the region. The ASEAN leaders adopted the *AEC Blueprint* in 2008 to serve as the master plan for the formation of the AEC.

The community's areas of cooperation include human resource development and capacity building, recognition of professional qualifications, closer consultation on macroeconomic and financial policies, trade financing measures, enhanced infrastructure and communication connectivity, development of electronic transactions through e-ASEAN, integrated industries across the region to promote regional sourcing, and enhanced private sector involvement in the establishment of the AEC.

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<sup>1</sup> ASEAN was formed on 8 August 1967 by Indonesia, Malaysia, the Philippines, Singapore, and Thailand. Since then, membership has expanded to include Brunei Darussalam, Myanmar, Cambodia, the Lao PDR, and Viet Nam.

The AEC will transform ASEAN into a region “with free movement of goods, services, investment, skilled labor, and freer flow of capital” (AEC Blueprint 2008). With regard to the “freer flow of capital,” the *AEC Blueprint* calls for strengthening ASEAN capital market development and integration, and allowing greater capital mobility in the region.

To achieve the goal of capital market integration, the planned policy actions include greater harmonization of standards for debt securities, disclosure requirements, and distribution rules; cross-recognition of market professionals; greater flexibility in language and the governing legal requirements for securities issuance; enhanced withholding tax structures to promote the broadening of the investor base in ASEAN debt issuance; and the establishment of exchange and debt market linkages.

To allow for greater capital mobility, the blueprint calls for removal or relaxation of restrictions on current account transactions to facilitate the flow of payments and transfers for current account transactions. With regard to capital flows, the blueprint supports foreign direct investment (FDI) and initiatives to promote capital market development.

Not all 10 of ASEAN’s members will be ready to implement these policy actions by 2015. The BCLMV countries, in particular, need to catch up with other ASEAN members in terms of financial sector and capital market development, as well as the adoption of global reform measures. ASEAN leaders recognize the different levels of development among its members, which “require[s] some flexibility as ASEAN moves towards a more integrated and interdependent future” (AEC Blueprint 2008). With this in mind, the *AEC Blueprint* intends to “address the development divide and accelerate integration of Cambodia, the Lao PDR, Myanmar, and Viet Nam (CLMV) through the Initiative for ASEAN Integration and other regional initiatives.”

The Initiative for ASEAN Integration, launched in November 2000, will be enhanced to serve as the platform for identifying and implementing technical assistance and capacity building programs for both the public and private sectors in ASEAN member countries, particularly in CLMV countries and among other sub-regional arrangements.

### **3. Diversity of the BCLMV Countries**

Any comparative discussion of the need for implementing economic reforms in the BCLMV countries must be cognizant of the extensive differences and diversity in terms of income, stage of development, political and economic structures, culture, and demographics, among other characteristics (Table 1). These five countries’ political frameworks, for example, range from an absolute monarchy to communist states to a parliamentary system. Their income levels range from as low as about \$120 to more than \$30,000 per capita. A number of commonalities also exist, such as the underdevelopment of the financial sector and undercapitalization of banks, less-developed to undeveloped capital markets, weak legal and regulatory enforcement, and wide gaps in human capital capacities.

The *AEC Blueprint* clearly recognizes these differences and makes the following concession: “Liberalization measures [in] the financial services sector should allow members to ensure orderly financial sector development and maintenance of financial and socio-economic stability.” Specifically, it sets guidelines for member countries in pacing their liberalization measures, providing the “ASEAN minus X formula, where countries that are ready to liberalize can proceed first and be joined by others later.” It added that the “process of liberalization should take place with due respect for national policy objectives and the level of economic and financial sector development of the individual members.”

In the same vein, a joint Asian Development Bank (ADB)–ASEAN publication in 2013 proposed an alternative approach that would “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.” The study sets two different frameworks for capital account liberalization and ASEAN-wide financial integration: one for the five original members (ASEAN-5) and another for the five newcomers (BCLMV).

### **Brunei Darussalam**

The oil and gas sector dominates Brunei Darussalam’s economy, with crude oil and natural gas production accounting for over half of GDP and more than 90% of exports, while employing less than 3% of the country’s workforce. Revenues from this sector also comprise most of the country’s GDP per capita of about \$31,000—one of the highest in Asia and the second-highest among ASEAN nations—and finances an extensive social welfare program under which the government provides for all medical services, offers free education through the university level, and subsidizes rice and housing for all of its citizens. The government is also the country’s largest employer. In early 2013, there were proposals at the Legislative Council to shorten the probationary period of service from 5 years to 3 years for civil servants being paid on a daily basis to become paid on a monthly basis. The government employs nearly 50,000 regular employees (excluding probationary workers), in comparison with private sector employment of about 121,000 in all industries. Another major recent proposal was the introduction of a minimum wage law.

Brunei Darussalam operates a currency board system with the Brunei Dollar (B\$) pegged to the Singapore Dollar (S\$) at the rate of 1:1. The country has a low tariff regime and no capital gains or personal income taxes. Under its Investment Incentives Order 2001, prospective investors enjoy a wide range of incentives, including up to 20 years exemption from corporate taxes; exemption from import duties on raw material, machinery, equipment, component parts, accessories and building structures; and adjustment of capital allowance and losses.

On the other hand, the rest of the domestic economy lags in terms of development and progress. Economic growth has also been a laggard, averaging around 0.2% over the past 5 years, which is well below the 1.8% average rate at which Brunei Darussalam’s population is growing. The country’s GDP growth took a hit during the GFC as the resulting drop in world crude prices and slump in oil demand pushed the economy into a long recession.

Excessive reliance on the oil and gas sector as well as the steady depletion of these natural resource reserves has become a major concern for Brunei Darussalam's leaders. *The Brunei Darussalam Long-Term Development Plan: Wawasan Brunei 2035* articulated the key development issue facing the country: "Although oil and gas resources have contributed much to the nation's prosperity, economic growth has, on the whole, not kept pace with population growth. The public sector that is the main employer of the majority of the citizens and residents can no longer adequately absorb the growing numbers of young people wishing to enter the work force each year. There is a widening gap between the expectations and capabilities of the nation's youth and the employment opportunities currently being created."

## **Cambodia**

Cambodia remains largely a dollarized economy, a system that came about as a result of historical circumstances rather than a conscious decision by the country's leaders.<sup>2</sup> The use of US dollars in Cambodia had its genesis during the Khmer Rouge era (1975–1979) when all barter, private commercial activity, private ownership, means of exchange, and stores of value were prohibited and punishable by death. During this period, Cambodia was without a monetary system and without money. In 1980, the riel was reintroduced but it did not receive wide acceptance by the public, which preferred other stores of value and means of payment such as the US dollar, gold, and even rice.

GDP growth has averaged more than 6% per year from 2010 to 2012, driven largely by garment manufacturing, construction, agriculture, and tourism. The garment industry employs more than 335,000 people and accounts for more than 75% of Cambodia's total exports. Oil deposits were discovered in 2005 but remain unexploited. Investors are also looking to exploit mining opportunities that include deposits of bauxite, gold, iron, and gems. Lastly, the tourism industry remains a growth sector, with foreign visitor arrivals surpassing 2 million per year.

Cambodia, however, remains one of the poorest countries in Asia, with GDP per capita below \$900 and with about 4 million people living on less than \$1.25 per day and 37% of Cambodian children under the age of 5 years old suffering from chronic malnutrition. More than 50% of the population is less than 25 years old. The population lacks education and productive skills, particularly in the impoverished countryside, which also lacks basic infrastructure.

More than half of the government budget comes from bilateral and multilateral donors, which have tied foreign aid to government passage of economic reform measures.

The country's economy was hit by the GFC, with its critically important garment industry suffering a 23% drop in exports to the US and Europe. GDP growth slumped to 0.1% in 2009 before recovering to more than 7% growth in 2011. It suffered no direct impact from the crisis in its financial sector and markets, however. The main lessons from the GFC, as far as the Government of Cambodia is concerned, include the need for less intervention in the markets and the need to bestow more power with the securities regulator.

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<sup>2</sup> A detailed history of Cambodia's currency may be found in G. Capannelli and J. Menon (2010).

## **Lao People's Democratic Republic**

Lao PDR is in a transition period where the government is in the process of modernizing the economy. This endeavor is being supported by the multilaterals, with experts reckoning the process might take 10–15 years.

Since the Communist party started decentralizing control and encouraging private enterprise, the country's GDP, while coming from a very low base, has grown an average of 6% from 1998 to 2008, and more than 7% from 2008 to 2012. The Lao PDR joined ASEAN in 1997 and the World Trade Organization (WTO) in 2013, and gained Normal Trade Relations status with the US in 2004.

Its economy continues to rely on subsistence agriculture, dominated by rice cultivation in lowland areas, which accounts for about 30% of GDP and 75% of total employment. Its landlocked economy also relies on investment from and trade with its neighbors: the People's Republic of China (PRC), Thailand, and Viet Nam. The country's water resources and mountainous terrain enable it to produce and export large quantities of hydroelectric energy to Thailand and Viet Nam. Tourism is the fastest-growing industry in the country.

Experts note complications in the Lao PDR's political economy given that the country is governed under a one-party system. The politburo, comprising the leadership of the Peoples' Revolutionary Party, sets policies, which the government bureaucracy then implements. The current hierarchical system also places the Ministry of Planning above the Ministry of Finance, which in turn supervises the Bank of Lao PDR (BOL).

## **Myanmar**

Myanmar remains a country in profound transition, in terms of its political economy and economic structure. The country embarked on a path of political and economic reforms in 2011, paving the way for developing its large potential. According to an ADB study in 2012, Myanmar could follow Asia's fast-growing economies and expand at 7%–8% per year, become a middle-income nation, and triple its per capita income by 2030 if it can surmount substantial development challenges by further implementing across-the-board reforms.

In August 2012, ADB stepped up its presence in Myanmar by assigning more staff to extended missions in the country. On 28 January 2013, ADB resumed its loan operations in Myanmar. The \$512 million loan, the first from ADB in almost 30 years, was made possible through bridge financing provided to the government by the Japan Bank for International Cooperation (JBIC). The loan will be used to finalize arrears clearance and sustain government efforts to revamp the national budget process and modernize tax administration. It will also support trade policy reforms and capacity development, and improve the investment climate and facilitate small and medium-sized enterprise (SME) development.

Myanmar's development and poverty reduction challenges remain substantial and require considerable external assistance. At the same time, Myanmar faces enormous development challenges following a long period without comprehensive assistance from the international

community. Strong and timely financial commitments are crucial to creating a foundation for inclusive economic development and maintaining the reform momentum in Myanmar.

Much still needs to be done, however, as the domestic economy continues to suffer from pervasive government controls, inefficient economic policies, corruption, and rural poverty. About 32% of the population lives in poverty and Myanmar is the poorest country in Southeast Asia, with GDP per capita of just over \$120.

Meanwhile, political parties have begun gearing up for the next round of general elections in 2015, potentially ushering in renewed political uncertainties.

## **Viet Nam**

Among the BCLMV countries, Viet Nam has the most developed financial sector, making it the model of transitional economic development among its less-developed neighbors. Since its *doi moi* (renovation) policy was launched in 1986, the country has been transitioning from a centrally planned economy to a socialist-oriented market economy.

Agriculture's share of economic output shrank from about 25% in 2000 to less than 22% in 2012, while industry's share increased from 36% to nearly 41% in the same period. State-owned enterprises (SOEs) account for roughly 40% of GDP.

The GFC hurt Viet Nam's export-oriented economy, with GDP in 2009–12 growing less per year than the 7% per annum average achieved in the prior decade. Between 2008 and 2011, Viet Nam's managed currency, the dong, was devalued by more than 20%.

Government economic policy in recent years has swung back and forth from a growth-oriented strategy to one that focuses on fostering macroeconomic stability. At the start of 2011, the government veered away from growth stimulation, which had stoked inflation to double-digit rates, and instead tightened monetary and fiscal control to stabilize the economy. The following year the government unveiled a broad "three pillar" economic reform program involving the restructuring of public investment, SOEs, and the banking sector. Viet Nam's economy continues to face challenges from an undercapitalized banking sector. Non-performing loans (NPLs) weigh heavily on banks and businesses. In September 2012, the official bad debt ratio climbed to 8.8%, though some financial analysts believe it could be as high as 15%.

## **4. The Key Development Issues**

### **4.1 Financial Regulatory and Supervisory System**

The financial system consists of institutions, markets, laws, regulations, and practices through which securities are traded, interest rates determined, and financial services produced and delivered. Markets—consisting of a market for short-term funds (money market) and another for long-term funds (capital market)—channel loanable and investible funds to those who

demand them and are willing to pay the cost. Institutions, on the other hand, consist of banks, insurers, finance and investment companies, and other financial intermediaries. Atop these markets and institutions are government regulators, whose main functions include preserving the safety of the public's funds, promoting public confidence in the financial system, and supporting the stability of markets and the economy, among others. The standard structure for government regulation calls for three independent agencies to oversee the banking system, the capital markets, and the insurance sector. A few developed economies have merged two or more of these functions under one agency. In the underdeveloped financial systems of the BCLMV countries, however, one or two of these essential agencies are either non-existent or only at their nascent stages as new laws are being enacted and new rules and regulations are being promulgated to create them as quickly as possible.

The table below summarizes the financial regulatory and supervisory systems of the BCLMV countries.

**Table 1: Financial Regulatory Systems of BCLMV Countries**

|                   | <b>Regulator / Supervisor</b>  | <b>Remarks</b>   |
|-------------------|--|--|
| Brunei Darussalam | Autoriti Monetari Brunei Darussalam (AMBD)   | Established 1 January 2011 under AMBD Order, 2010. AMBD administers and enforces: Banking Order, 2006; Islamic Banking Order, 2008; International Banking Order, 2000; Finance Companies Act, Chapter 89; Hire Purchase Order, 2006; Pawnbrokers Order, 2002; and Money-Changing and Remittance Businesses Act, Chapter 174.   |
|                   | No separate securities regulator   |  |
| Cambodia          | National Bank of Cambodia (NBC)<br><br>Securities and Exchange Commission of Cambodia (SECC) | Established in 1954 Manages monetary and exchange policies, regulates banks and financial institutions, and manages the national currency, the riel. Inaugurated in April 2009 under Issuance and Trading of Non-Government Securities (Preah Reach Kram No NS/RKM/1007/028) Regulator managing, supervising, and developing the securities sector in Cambodia. Minister of Economy and Finance serves as the SECC Chairman. |

**Table 1: Continued**

|                                  | <b>Regulator / Supervisor</b>                        | <b>Remarks</b>   |
|----------------------------------|--|--|
| Lao People's Democratic Republic | Bank of Lao P.D.R. (BOL)                             | Officially founded in 1988, the bank's charter was adopted by the law No. 05/NA, dated 14 October 1995, with the bank equivalent to a ministry in rank.  |
|                                  | Lao Securities and Exchange Commission Office (SECO) | Supervises the Lao Securities Exchange (LSX) SECO and LSX remain BOL units   |
| Myanmar                          | Central Bank of Myanmar                              | Created under the Central Bank of Myanmar Law (1990), which makes it responsible for financial stability and supervision of the financial sector in Myanmar. Currently under the Ministry of Finance and Revenue New law to grant CBM independence under parliament debate |
|                                  | No separate securities regulator                     | In the pipeline are new laws on financial institutions, foreign exchange management, and securities exchange.  |
| Viet Nam                         | State Bank of Vietnam (SBV)                          | Had its beginning in 1951. Law on the State Bank of Vietnam and the Law on Credit institutions, effective from January 1998.   |
|                                  | State Securities Commission (SSC)                    | Established in 1996, oversees and regulates securities trading on the country's two official exchanges Remains officially part of the MOF  |

Source: Authors' compilation.

**Brunei Darussalam.** Autoriti Monetari Brunei Darussalam (AMBD)—established on 1 January 2011 with the introduction of AMBD Order, 2010—is a corporate body acting as the central bank of Brunei Darussalam and undertaking core functions, including the formulation and implementation of monetary policy, the regulation and supervision of financial institutions, and currency management. The adoption of the currency board system, however, negated the monetary policy functions of the AMBD.

In its supervision and regulation of banks and finance companies, AMBD administers and enforces the following laws: Banking Order, 2006; Islamic Banking Order, 2008; International Banking Order, 2000; Finance Companies Act, Chapter 89; Hire Purchase Order, 2006; Pawnbrokers Order, 2002; and Money-Changing and Remittance Businesses Act, Chapter 174.



As part of its functions, in March 2013, AMBD imposed floors and ceilings on banks' deposit and lending rates (Autoriti Monetari Brunei Darussalam 2013). Banks cannot charge more than 4.5% on residential property loans, between 5.0% and 5.25% on consumer loans (excluding credit cards), 6.0% on corporate loans, 7.5% on salary and pension loans, and between 7.725% and 7.75% on new vehicle loans. The minimum rates on savings were set at 0.15% and between 0.20% and 0.75% for 1- and 12-month time deposits, respectively. The monetary authority reckoned that the market mechanism failed to reflect the costs of credit and funds because of the small number of players in the banking industry. Operating in the country are a total of nine banks, including the trust fund, six foreign banks (three regional and three international banks), two Islamic banks, and one private indigenous bank.

The banks' gross NPL ratio had previously averaged about 9% of total loans, with a higher ratio of 12.3% for domestic banks. More recently, AMBD officials disclosed that the banking industry's gross NPLs had exceeded 10%. After provisioning, net NPLs were placed below 2%, as AMBD mandated banks to fully write off their "legacy loans." NPLs primarily consist of personal loans (including credit cards), which account for roughly 40% of total banking industry loans.

The current priorities of the central bank are to enhance the national payments system, set up a trade information bureau, and establish a deposit insurance scheme under the Ministry of Finance.

**Cambodia.** The National Bank of Cambodia (NBC), established in 1954, is the country's central bank and, as such, manages monetary and exchange policies; regulates banks and financial institutions; and manages the national currency, the riel.

In 2009, NBC responded to the GFC by raising reserve requirements to 16% from 8% before the crisis, but it has since reduced this to 12.5%. Liquidity is maintained at 50% of net worth. Local banks have no access to investments; instead, the central bank "invests prudentially for them" using international reserves of \$3.4 billion.

To coordinate the functions of the fiscal and monetary authorities, the heads of the Ministry of Economy and Finance (MEF) and NBC sit as chair and vice-chair, respectively, of the Economic and Financial Policy Committee, which meets on an ad hoc basis. The Supreme National Economic Council, a think tank for the government under the office of the prime minister, aids the government in formulating public policies concerning macroeconomic and sectoral issues.

NBC's priority capacity building efforts focus on the following: ASEAN integration, mainly with respect to the 2015 deadline for implementation of the AEC; development of capital account monitoring; development of effective monetary policy (open market operations and benchmark interest rates); banking supervision and regulation (onsite and offsite); strengthened payments system; and a modern information system.

The Securities and Exchange Commission of Cambodia (SECC) was inaugurated in April 2009 under the law on the Issuance and Trading of Non-Government Securities (Preah Reach Kram

No NS/RKM/1007/028) as the regulator managing, supervising, and developing the securities sector in Cambodia. The MEF serves as the SECC Chairman.

The SECC, together with the MEF and NBC, comprise the crisis preparedness management team created in 2012. This team is now undertaking research on crisis response activities. Further, a private sector–government forum meets every 6 months.

The development priorities of the SECC include attracting more companies to list and preparing for financial integration in the region. It also seeks to build regulatory capacity in the areas of initial public offering (IPO) evaluation, processing, and procedure; listing promotion; corporate governance; market surveillance; and market investigation.

**The Lao People’s Democratic Republic.** Under the supervision of the Bank of Lao PDR (BOL) are 31 banks, of which 16 are foreign and three are subsidiaries of foreign banks. The regulator conducts offsite supervision and monitoring on a daily basis and comprehensive onsite evaluations annually, coordinating these activities with one another. Founded in 1988, the bank’s charter was adopted by law No. 05/NA, dated 14 October 1995, with the bank being given status equivalent to a ministry.

Banks in Lao PDR on average have NPLs of 2%, which is below the 3% threshold level monitored by the central bank given the country’s present stage of development. The BOL, furthermore, does not set limits on bank lending to specific sectors, but allows a single borrower limit of 25%. The BOL sets no loan-to-value (LTV) ratios and has no debt-to-income (DTI) rules.

There are some doubts over the official NPL figure of only 2% given that loan growth averages around 20% per annum. Furthermore, with regard to infrastructure lending, foreign and local contractors borrow from banks with an implicit sovereign guarantee.

Bank lending rates currently average 15% in US dollar terms, while rates on 1-year time deposits average 8%.

Although the country’s latest medium-term development plan lacks a financial sector plan, government officials have noted that the banking sector is subsumed under the plan’s “monetary policy and financial stability” section.

Priorities for the finance, banking, and capital market sectors under the *Seventh Five-Year National Socio-Economic Development Plan (2011–15)* include financial integration with the region, development of the securities market, and development of the capital market. The plan’s goals include raising the number of publicly listed companies to at least 10 by 2015, expanding the number of products traded in the stock market, and broadening the investor base (individuals and institutions).

The Lao Securities and Exchange Commission Office (SECO) and the Lao Securities Exchange (LSX) remain under BOL authority, even as government officials understand that the securities regulator should be independent. The PRC, Thailand, and Viet Nam act as models

for the SECO, which currently has over 40 people headed by an official of director general rank. It has partnered with the Thai and Vietnamese securities and exchange commissions, and forged an agreement with the SEC of Malaysia to train its staff on drafting a strategic plan for the development of the capital market.

In case of a financial crisis, the focal point would be the Ministry of Finance (MOF), which maintains a network of communications with the line ministries and the BOL. Every month, economic data is provided to the MOF, whose Fiscal Policy Department then analyzes the data. In addition, the deputy prime minister heads a high-level committee that includes the BOL Governor, the MOF, and the Prime Minister's Office.

The MOF, furthermore, administers the country's SOEs and has drafted a government decree on the transferring ownership of these SOEs to the public. The MOF also provided listing candidates during establishment of the SECO.

**Myanmar.** Following a series of political and economic reforms that led to a significant opening of the country and the lifting of international sanctions against it, Myanmar is now rushing to reform its financial system. It is currently rewriting its banking and financial laws under the auspices of the IMF and the World Bank.

A new law granting independence to the Central Bank of Myanmar (CBM), currently operated by the Ministry of Finance,<sup>3</sup> will be debated in Parliament. The CBM was created under the Central Bank of Myanmar Law (1990), which makes it responsible for financial stability and supervision of the country's financial sector. Also in the pipeline are new laws on financial institutions, foreign exchange management, and a securities exchange.

CBM currently oversees four SOE banks, 19 private banks, and 28 representative offices of foreign banks. It uses two main approaches for supervisory and regulation, and monitoring: on-site examination and off-site monitoring. On-site examination uses the CAMEL framework,<sup>4</sup> while off-site monitoring operations are based on the weekly, monthly, quarterly, and annual reports submitted by the banks. Banks are also required to submit audited financial statements once a year. CBM officials, however, admit that accounting and disclosure requirements remain weak. Furthermore, there is a need to upgrade the system so that it provides standard prudential regulation.

The adverse side effects of the financial sector's lack of development may be seen in the lack of convenience in banking transactions, high cost of intermediation, and basic payments system. Households use savings passbooks as "current deposits" mainly for transactions, while corporations use demand deposits. Time deposits, recently introduced into the market, remain unfamiliar to depositors. On the other hand, the country already has deposit insurance through state-owned Myanmar Insurance.

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<sup>3</sup> Formerly known as Ministry of Finance and Revenue until July 2013.

<sup>4</sup> This refers to the international bank-rating system where bank supervisory authorities rate institutions according to the following factors: capital adequacy, asset quality, management quality, earnings, and liquidity.

On top of the new laws being drafted, officials note that the country's economic culture needs to change as well, with institutional capacity building being the most important objective at this stage, especially since most of the people with institutional knowledge are retired or deceased.

**Viet Nam.** The State Bank of Viet Nam (SBV) supervises about 45 domestic banks in an industry that is dominated by five state-owned banks. Agriculture Bank is the largest in terms of total resources, followed by BIDV Bank, Vietin Bank, and Vietcom Bank. State-owned banks must follow the same regulations and abide by the same corporate governance rules as private banks.

The SBV has its beginnings in 1951 when President Ho Chi Minh signed decree 15/SL to establish the National Bank of Viet Nam, later renamed State Bank and merged with the National Bank of Viet Nam upon the country's reunification. The Law on the State Bank of Viet Nam and the Law on Credit Institutions were passed in December 1997 by the 10th National Assembly of the Socialist Republic of Viet Nam.

There are 100 foreign banks operating in Viet Nam, including branches, subsidiaries, and representative offices. The latter are required to maintain charter capital of at least \$15 million. In terms of foreign ownership, there is a 20% limit for a single investor and a 30% limit for total foreign ownership. There are five listed banks. In terms of disclosure, listed banks follow stock exchange rules, which include the submission and publication of annual audited financial statements and semi-annual statements.

The SBV does not have an overarching LTV policy, rather each bank has its own LTV policy. The SBV is now considering LTV regulations even as LTV ratios average a low of 60%.

Banks' NPLs have grown as a result of the recent macroeconomic imbalances that include high inflation and slower growth. As a result, "enterprises have faced difficulties," with NPLs reaching a high of 9% of total loans in 2012.<sup>5</sup> In response, the government issued a master plan to restructure SOEs, the economy, and the banking system, including boosting economic growth and quickly resolving the real estate and NPL issue. The SBV also issued a directive for banks to set aside funds for socialized housing.

Prime Minister Nguyen Tan Dung approved the formation of an asset management company, effective 9 July 2013, to deal with the banking sectors' bad debts problem together with the

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<sup>5</sup> Private estimates put the banking sector's NPLs at a much higher rate of 15%. In 2012, the SBV conducted comprehensive supervision of some weak banks, which revealed that the small banks had bad loan ratios of up to 60%. The SBV has since then upgraded provisioning requirements for banks. Another source of complication is cross-shareholdings among banks. Also, small banks lend only to SOEs, making them de facto financial holding companies for these SOEs. Adding to the banking system's woes is that the real estate market has been either frozen or suffering from price declines for the past 2 years. CBRE, a private realty consultant, recorded declining trends in office rentals for the past 2 years due to oversupply and sees this trend continuing in the near-term. A lot of these office projects are funded by SOEs. Furthermore, borrowers usually use real estate as collateral. As a result, an estimated 60%–70% of NPLs are real-estate linked. Also under a cloud of doubt are the accounting standards being used. Viet Nam accounting standards (VAS), with the MOF acting as the national accounting body, still need to be aligned with international accounting standards (IAS). Further, the State Auditor is seen as problematic and weak.

existing Debt and Asset Trading Company (DATC). The Viet Nam Asset Management Corporation (VAMC), a wholly state-owned company managed by the SBV, will have initial capital of D500 billion (\$24 million). According to the SBV Governor Nguyen Van Binhand, VAMC will be tasked to resolve between D40 trillion and D70 trillion of NPLs this year out of total NPLs estimated at about D100 trillion by the chairman of the National Financial Supervisory Commission. The ultimate aim is to accelerate the country's banking restructuring process, restore the flow of credit to the business sector, and rejuvenate the country's economic growth. Credit growth has slowed as a direct consequence of the high rate of bad debts as banks have become more conservative in response.

Also, as part of the master plan, the SBV is seeking to merge five of the most financially sound banks in the country. SBV officials acknowledge that dealing with banks' bad debts also depend on what is happening in the real sector. The real estate sector remains a problem as property prices continued to soften in 1Q13 and the market remains frozen. An estimated 10%–12% of NPLs come from real estate lending.

With regard to crisis management protocols, the MOF, SBV, and State Securities Commission (SSC) have signed MOUs pledging cooperation with one another. Furthermore, the country has instituted safety nets, deposit insurance, and intensive supervision to counter any potential crisis.

The SSC, established in 1996, oversees and regulates securities trading on the country's two official exchanges: the Ho Chi Minh Stock Exchange and the Hanoi Stock Exchange. The SSC officially remains part of the MOF.

For capacity building, the SBV has its own training department and research institute, which also trains banking executives.

## **4.2 Capital Adequacy and Liquidity Management**

The GFC exposed a number of weaknesses in the global regulatory framework and in banks' own internal risk management systems. To prevent a recurrence of the negative impacts on the global economy, the Basel Committee on Banking Supervision agreed in 2010–2011 on the Third Basel Accord (Basel III), with the latest installment of the so-called Basel Accords developed to address the deficiencies in financial regulation revealed by crisis.

The key principles addressed by Basel III concern capital requirements, leverage ratios, and liquidity requirements. Specifically, Basel III requires banks to hold 4.5% of common equity (up from 2% under Basel II) and 6% of Tier 1 capital (up from 4% under Basel II) as a ratio of risk-weighted assets (RWAs). Tier 1 capital refers to a bank's core capital, consisting primarily of common stock and retained earnings, whereas the risk weights contain credit, market, and operational risk measures.

In addition to the minimum capital requirements, Basel III introduced a mandatory capital conservation buffer of 2.5% and a discretionary countercyclical buffer of between zero and 2.5% of common equity.

Since excessive leverage was seen as a major cause of the crisis and its consequent severity, Basel III introduced a minimum leverage ratio to prevent the build-up of too much leverage. This leverage ratio is calculated by dividing Tier 1 capital by the bank's (unweighted) average total consolidated assets, with banks required to maintain the leverage ratio at not less than 3%.

To address liquidity risk, which emanates from maturity mismatches as banks fund illiquid long-term assets with very short-term debt, Basel III introduced minimum liquidity requirements. These have two components: (i) the liquidity coverage ratio, in which banks need to hold sufficient high-quality liquid assets to cover total net cash outflows over 30 days; and (ii) the net stable funding ratio, in which banks' available amount of stable funding must exceed the required amount of stable funding over a 1-year period of extended stress.

Basel III rules were originally scheduled to be introduced between 2013 and 2015. Changes in the rules made effective on 7 January 2013 included extending the implementation period until 2019.

The complexity of the new Basel III regulations—in addition to disputes regarding liquidity requirements, added cost burden on banks, expected toll on economic growth, and lack of an Asian perspective—have put the reform measures under a cloud of controversy. The questions of Basel III's relevance to Asian conditions, practices, and rising funding needs for its regional rebalancing efforts have become especially acute, leading to widening calls for an “Asian voice” in global banking regulatory reforms.

Asia largely sees Basel III requirements as primarily designed to address the problems of the developed economies of the US and Europe, with Asian voices underrepresented in the decision-making forums leading to their adoption. The new rules aim to resolve the under-capitalization and over-leverage of the wholesale banking model prevalent in the advanced economies. This contrasts with the prevailing retail banking model in Asia, in which heavy reliance on equity capitalization allows Asian banks to readily meet Basel III capital requirements. Their continued compliance is not so clear going forward, however, as Asia's continuous growth would put increasing demand on the credit supplied by a bank-dominated financial system.

Furthermore, banking systems across Asia are at different stages of development and Asian countries have diverse national development objectives. As part of their national goals, for instance, Asian economies have responded to the post-crisis economic slowdown in their advanced trading partners by shifting toward domestic- and regionally-driven growth, which requires funding. The region's developing capital markets also make it difficult and costly for Asian banks to meet the liquidity standards of Basel III due to an insufficient or non-existent supply of local government bonds.

Another issue concerns the risk weights used to compute minimum capital. Asian banks are disadvantaged against their Western counterparts since the risk weights rely on sovereign credit ratings and most Asian countries have lower ratings. In addition, Asian banks use a less-sophisticated standard model for risk weighting while their Western counterparts rely on

internal risk-based models. As a result, Asian banks will have to set aside more capital to support the same amount of risky assets, such as loans and bonds.

In summary, the calls for an Asian voice in global financial reforms have been rising amid the perception that Basel III, among other initiatives, has become a “one-size-fits-all” solution that may not be suitable for many Asian economies, with their varied financial systems, stages of development, and banking industry practices. On the other hand, the strengths of Basel III include its notable attempt to standardize minimum capital and liquidity norms for global banking. Its main weakness is a heavy reliance on prescriptive measures that do not allow for flexibility and prudential discretion on the part of emerging economy banks and regulators in support of specific national development agendas.

**Table 2: Selected Policy Changes in Basel II and III**

| Indicators                         | Basel III   | Basel II |
|------------------------------------|---|----------|
| Minimum Tier 1 capital requirement | 6% of risk-weighted assets (RWA)  | 4% RWA   |
| Minimum common equity requirement  | 4.5%–7.0% RWA depending on countercyclical buffer   | 2% RWA   |
| Countercyclical buffer             | Zero to 2.5% RWA  | None     |
| Minimum capital adequacy ratio     | 10.5% (including the capital conservation buffer)   | 8% RWA   |
| Leverage ratio                     | Minimum ratio of common equity to exposures of 3%. This ratio will be tested before a mandatory leverage ratio is introduced in January 2018.             | None     |
| Liquidity ratio                    | There are two requirements – a liquidity coverage ratio (LCR, to be determined in 2015), and a net stable funding ratio (NSFR, to be determined in 2018). | None     |

Source: Liu and Moshirian (Forthcoming).

The table below summarizes the status of banking reform implementation in the five BCLMV countries. While most BCLMV countries have adopted Basel I regulations, none have fully adopted Basel II rules and none have started implementation of Basel III reforms.

**Table 3: Banking Reforms in BCLMV Countries**

|                                  | Basel Accords |                         |             |
|----------------------------------|---------------|-------------------------|-------------|
|                                  | Basel I       | Basel II                | Basel III   |
| Brunei Darussalam                | Adopted       | Deferred                | Not started |
| Cambodia                         | Adopted       | Modified solvency ratio | Not started |
| Lao People's Democratic Republic | Implementing  | Not started             | Not started |
| Myanmar                          | Not started   | Not started             | Not started |
| Viet Nam                         | Adopted       | Under consideration     | Not started |

Source: Authors' compilation.

**Brunei Darussalam.** Basel I core principles have been adopted but Basel II implementation has been deferred. All banks are Basel III compliant as far as the Tier 1 capital requirement is concerned since the capital funds of the banks in Brunei Darussalam consist solely of common equity. AMBD also closely observes the standards of the International Organization of Securities Commissions (IOSCO) in implementing its securities regulatory functions.

The capital adequacy of banks in September 2011 averaged 19.4% based on regulatory capital to RWA, and 20% based on Tier 1 capital to RWA.

**Cambodia.** The country's banking system dominates the economy with 32 commercial banks (including 10 foreign branches and 19 subsidiaries) empowered with universal banking functions but mainly doing traditional banking such as deposits, loans, and payment systems. Prudential regulations on liquidity and minimum capital have been tightened, with capital requirements raised from \$13 million to over \$35 million.

The implementation of Basel II rules are in a state of transition, whereby the NBC is using a "modified" 15% solvency ratio. It is also transitioning to a risk-based and forward-looking supervision model.

Banks are starting to comply with Basel II rules. The country has 32 commercial banks, including seven specialized banks that can only lend and do not have deposit-taking functions. Four or five of the largest banks account for about 70% of total loans and deposits. The government allows 100% foreign ownership of banks.

Banks have their own LTV policies and maintain a risk-management-based loan portfolio. Stress-testing is also conducted. Aside from mortgage lending, bank lending goes to the other leading sectors of the economy: tourism, agriculture (mainly rice), garments, and other manufacturing.

There is no insurance on deposits. The government regulates banks through loans, specifically by limiting access to financing and through collateral, which is based on the value of the asset



being financed (the assets should be 50% of the value of the collateral). Real estate values, the main form of collateral, declined in 2008–10 before recovering in 2011.

SMEs have no direct access to bank borrowings and instead resort to microfinance where interest rates can reach as high as 30% per annum.

**The Lao People’s Democratic Republic.** The country’s banking system is still implementing Basel I reform measures and is in the process of adopting Basel II reforms. The lagging pace of implementation is ascribed to the state of the supervision system itself, which needs to be developed since commercial banks are also unprepared in terms of expertise of staff and technical systems.

**Myanmar.** The banking system has not yet started implementing Basel I reforms and the capital adequacy ratio (CAR) in use does not meet international standards. The loan classification system in use also does not meet international standards and the rating system for banks is very basic.

**Viet Nam.** The central bank has already adopted Basel I reform and is considering Basel II reforms. The SBV intends to “do it step by step, depending on banks’ and the market conditions.” It is considering Basel III principles, electing to “pick up some of these principles, such as liquidity ratio.” It has designed a roadmap for implementing Basel II reforms and is now in discussions with banks, which consider the proposed requirements to be costly. An informal group of 20 persons is in charge of the roadmap, whose development was funded through technical assistance from the Japan International Cooperation Agency (JICA).

### 4.3 Macroprudential Surveillance

One core function of central banks is to maintain the stability and soundness of the financial system. This macroprudential responsibility stands in contrast to their role as bank supervisors, which is more microprudential in scope. It is understood that financial stability requires stable banks and a sound banking system. The experience of recent financial crises, however, has provided the lesson that the soundness of individual banks is not enough to maintain the financial stability of the entire system.

According to the BIS: “[The GFC] has prompted a careful review of a wide range of policy areas. In many cases, microprudential supervision failed to ensure that financial institutions had sufficient capital and liquidity to cope with the shock. The efficacy of monetary policy in responding to system-wide financial risk in an environment of stable inflation was, and still is, under debate. The issue of how to define and develop the macroprudential element of financial stability policy has attracted particular attention. Policymakers broadly agree that the purpose of macroprudential policy is to reduce systemic risk, strengthening the financial system against shocks and helping it to continue functioning stably without emergency support on the scale that was extended in the crisis” (BIS 2010). The BIS further defines systemic risk as “a risk of disruption to financial services that is caused by an impairment of all or parts of the financial system and has the potential to have serious negative consequences for the real economy.”

Davis (1999) defines macroprudential surveillance as the “monitoring of conjunctural and structural trends in financial markets so as to give warning of the approach of financial instability...” Meanwhile, the FSB, IMF, and BIS (2011) define macroprudential policy as “a policy that uses primarily prudential tools to limit systemic or system-wide financial risk, thereby limiting the incidence of disruptions in the provision of key financial services that can have serious consequences for the real economy...”

Practitioners utilize “the theory of financial instability and the experience of financial crises in the past... to enable meaningful use to be made of financial and macroeconomic data in macroprudential surveillance,” according to Davis (1999). The research data include econometric forecasts and current information. Macroprudential surveillance is not mechanistic, as “detailed knowledge of the sequence of events in past crises, both directly and as encapsulated in theory, is a sine qua non to interpreting the data. In addition, there is a need for development of broad information on what constitutes normal conditions in an economy, as well as the patterns that have often preceded financial crises in the past both domestically and internationally.”

Adding impetus to the progress in macroprudential surveillance, the IMF (2001) helped develop and distribute so-called macroprudential indicators (MPIs), which are “indicators of the health and stability of financial systems.” These MPIs “will be critical in producing reliable assessments of the strengths and vulnerabilities of financial systems as part of IMF surveillance, and to enhancing disclosure of key financial information to markets.” The lack of consensus on a core set of MPIs has been a major difficulty in this endeavor. Furthermore, “[the] ability to monitor financial soundness presupposes the existence of indicators that can be used as a basis for analyzing the current health and stability of the financial system.”

These indicators comprise both aggregated microprudential indicators of the health of individual financial institutions and macroeconomic variables associated with financial system soundness. A set of indicators that the IMF has identified through its financial sector surveillance, technical assistance, and program work over the years is enumerated in the table below.

**Table 4: Summary of Macroprudential Indicators**

| <b>Aggregated Microprudential Indicators</b>   | <b>Macroeconomic Indicators</b>  |
|--|--|
| Capital adequacy<br>Aggregate capital ratios<br>Frequency distribution of capital ratios | Economic growth<br>Aggregate growth rates<br>Sectoral slumps                           |
| Asset quality<br><i>Lending institution</i><br>Sectoral credit concentration             | Balance of payments<br>Current account deficit<br>Foreign exchange reserve<br>adequacy |
| Foreign currency-denominated lending   | External debt (including maturity<br>structure)  |

Table 4: *Continued*

| Aggregated Microprudential Indicators                              | Macroeconomic Indicators                  |
|--|---|
| NPLs and provisions  | Terms of trade                            |
| Loans to loss-making public sector entities                        | Composition and maturity of capital flows |
| Risk profile of assets   | Inflation                                 |
| Connected lending  | Volatility in inflation                   |
| Leverage ratios  | Interest and exchange rates               |
| <i>Borrowing entity</i>  | Volatility in interest and exchange rates |
| Debt-to-equity ratios  | Level of domestic real interest rates     |
| Corporate profitability  | Exchange rate sustainability              |
| Other indicators of corporate conditions                           | Exchange rate guarantees                  |
| Household indebtedness   | Lending and asset price booms             |
| Management soundness   | Lending booms                             |
| Expense ratios   | Asset price booms                         |
| Earnings per employee  | Contagion effects                         |
| Growth in the number of financial institutions                     | Trade spillovers                          |
| Earnings and profitability   | Financial market correlation              |
| Return on assets   | Other factors                             |
| Return on equity   | Directed lending and investment           |
| Income and expense ratios  | Government recourse to the banking system |
| Structural profitability indicators                                | Arrears in the economy                    |
| Liquidity  |   |
| Central bank credit to financial institutions                      |   |
| Segmentation of interbank rates                                    |   |
| Deposits in relation to monetary aggregates                        |   |
| Loans-to-deposits ratios   |   |
| Maturity structure of assets and liabilities (liquid asset ratios) |   |
| Measures of secondary market liquidity                             |   |
| Sensitivity to market risk   |   |
| Foreign exchange risk  |   |
| Interest rate risk   |   |
| Equity price risk  |   |
| Commodity price risk   |   |
| Market-based indicators  |   |
| Market prices of financial instruments, including equity           |   |
| Indicators of excess yields  |   |
| Credit ratings   |   |
| Sovereign yield spreads  |   |

Source: IMF (2001).

In an alternative approach, Hahm, Shin, and Shin (2012) proposed using the growth in banks' noncore liabilities as a predictor of crises. Banks, as the main financial intermediaries in developing economies, source their funding from retail deposits of households. However, retail deposits grow in line with the economy's expansion, so when credit is growing faster than deposits, banks turn to other sources of funding. By classifying retail deposits as banks' core liabilities and the remaining components of bank funding as noncore liabilities, the ratio of noncore to core liabilities reflects the pace of credit growth relative to trend. A rising ratio would indicate the economy's rising risk premia. The authors further observed that foreign liabilities of banks in emerging economies comprise a major component of their noncore liabilities, as the underdeveloped domestic wholesale funding market cannot support the rapid growth in bank lending.

According to Hahm, Shin, and Shin (2012), measures of the noncore bank liability ratio "have significant predictive power for currency crises and credit crises," based on the information contained in the banking sector's liabilities to the foreign sector. In addition, "the noncore bank liability ratio has independent predictive power over the much better-known and debated credit-to-GDP ratio."

They contend, that their "findings suggest that, at least in emerging and developing economies, noncore bank liabilities may be usefully monitored as a complementary measure to the credit to GDP ratio in gauging the stage of financial cycles and the build-up of financial risk."

Meanwhile, most developing economies, including the BCLMV countries, suffer from a dearth of available data that precludes effective macroprudential surveillance as well as the proposed monitoring of noncore bank liabilities.

In response, ADB's Office of Regional Economic Integration (OREI) has embarked on a project to build a database on banks' noncore liabilities in the BCLMV countries, while a similar database is also being built for Indonesia, Malaysia, the Philippines, Thailand, and Singapore. In this database, core liabilities refer to liabilities of the financial intermediary sector to non-bank domestic creditors, while noncore liabilities include foreign exchange liabilities of the financial intermediary sector, and claims held by intermediaries on other intermediaries.

As studies have shown, an alarming accumulation of noncore liabilities could signal mounting vulnerability to both liquidity and currency crises, and therefore, it is important to monitor the movements and size of the financial intermediary sector's noncore liabilities.

These core and noncore liabilities should be further classified by type of holder to determine whether the holders of the liabilities are the ultimate domestic creditors. Examples of core and noncore liabilities, classified further in terms of degree of liquidity, are given in the table below.

**Table 5: Core vs. Noncore Liabilities** (by degree of liquidity)

|                  | <b>Core Liability</b>                                       | <b>Intermediate</b>  | <b>Noncore Liability</b>  |
|------------------|---|--|---|
| Highly<br>Liquid | Cash  | Demand deposits  | Repos   |
|                  | Demand deposits<br>(households)                             | (non-financial<br>corporates)  | Call loans<br>Short-term FX bank<br>debt  |
| Intermediate     | Time deposit and<br>Certificates of Deposit<br>(households) | Time deposit and<br>Certificates of Deposit<br>(non-financial<br>corporates) | Time deposit and<br>Certificates of<br>Deposit<br>(banks and securities<br>firms) |
|                  | Trust accounts<br>(households)                              | Trust accounts<br>(non-financial<br>corporates)                              | Long-term bank debt<br>securities<br>(banks and securities<br>firms)              |
| Illiquid         | Covered bonds<br>(households)                               |  | ABSs and MBSs   |

ABSs = asset-backed securities, MBSs = mortgage-backed securities.

Source: Shin and Shin (2011).

It is important that data are disaggregated by type of holder, such as households and non-financial corporates. For each of these holders, wherever appropriate, the relevant indicators include cash, demand deposits, time deposits, certificates of deposit, trust accounts, covered bonds, repurchase agreements, call loans, short-term foreign exchange bank debt, long-term bank debt securities, and asset-backed securities and mortgage-backed securities.

ADB researchers surveyed the central bank websites of the BCLMV countries to collect publicly available data on noncore liabilities. As summarized in the table below, most of the data being sought were not publicly available. Building and regularly updating a database of these indicators for the BCLMV countries would be a useful exercise as these countries gradually emerge as important players in global financial markets. Monitoring the noncore liabilities of their financial intermediary sectors can help detect emerging liquidity and currency risks before they turn into a full-blown financial crisis.

**Table 6: Availability of Data on Core and Noncore Liabilities of the Financial Intermediary Sector in BCLMV Countries**

|  | Brunei Darussalam | Cambodia | Lao People's Democratic Republic | Myanmar | Viet Nam |
|--|-------------------|----------|----------------------------------|---------|----------|
| <b>Core Liabilities</b>                    |                   |          |                                  |         |          |
| Cash                                       | X                 |          | X                                | X       | X        |
| Demand deposits (households)               | X                 | X        | X                                | X       | X        |
| Time deposits (households)                 | X                 | X        | X                                | X       | X        |
| CDs (households)                           | X                 | X        | X                                | X       | X        |
| Trust accounts (households)                | X                 | X        | X                                | X       | X        |
| Covered bonds (households)                 | X                 | X        | X                                | X       | X        |
| <b>Intermediate</b>                        |                   |          |                                  |         |          |
| Demand deposits (non-financial corporates) | X                 | X        | X                                | X       | X        |
| Time deposit (non-financial corporates)    | X                 | X        | X                                | X       | X        |
| CDs (non-financial corporates)             | X                 | X        | X                                | X       | X        |
| Trust accounts (non-financial corporates)  | X                 | X        | X                                | X       | X        |
| <b>Noncore Liabilities</b>                 |                   |          |                                  |         |          |
| Repos                                      | X                 | X        | X                                | X       | X        |
| Call loans                                 | X                 | X        | X                                | X       | X        |
| Short-term FX bank debt                    | X                 | X        | X                                | X       | X        |
| Time deposits (banks and securities firms) | X                 | X        | X                                | X       | X        |
| CDs (banks and securities firms)           | X                 | X        | X                                | X       | X        |
| Long-term bank debt                        |                   |          |                                  |         |          |
| Securities (banks and securities firms)    | X                 | X        | X                                | X       | X        |
| ABSs and MBSs                              | X                 | X        | X                                | X       | X        |

ABSs = asset-backed securities, BCLMV = (Brunei Darussalam, Cambodia, the Lao People's Democratic Republic, Myanmar and Viet Nam), CDs = certificates of deposit, FX = foreign exchange, MBSs = mortgage-backed securities.

## Capital Flows and Noncore Liabilities

Banks in emerging Asian economies, including those in BCLMV countries, intermediate not only internal funds available domestically but, just as importantly, they intermediate a large amount of cross-border capital flows. Due to their procyclical nature, these capital flows have important implications for emerging Asian economies' financial stability. Their high volatility, furthermore, adds a dimension of challenge to regulatory, political, and economic policymaking.

The volatile feature of these flows was underscored in the paper of Cho and Rhee (2013) that compared trends in capital flows in 10 Asian economies before and after the GFC.<sup>6</sup> The trend analysis indicated a sharp rise in inflows to over \$1.4 trillion in 2007 and a sharp plunge to less than \$200 billion during the worst of the GFC in both 2008 and 2009. As the US Federal Reserve launched its large-scale asset purchases, otherwise known as quantitative easing, the capital flows into Asia sharply rebounded to pre-crisis levels in 2010 and 2011, before easing again in late 2011 in the wake of the worsening European sovereign debt crisis. In terms of the composition of capital inflows, bank loans exceeded their pre-crisis levels and became the main source of capital inflows after the GFC.

On the other hand, most of the BCLMV countries were spared these volatile capital flows due to their serendipitous low degree of financial integration with the region and the rest of the world, lack of capital account openness, and relatively undeveloped capital markets and financial sectors. Relative exceptions would be Cambodia, whose dollarized economy suffered credit outflows in 2009, and Viet Nam, which alone among the five BCLMV countries is included in the “frontier markets” indices of major market data aggregators.

While these five countries under study have yet to gain the capacity and develop the institutions required to absorb and benefit from the inflow of capital from abroad, it would be instructional to thresh out the linkages between noncore liabilities and capital flow management.

The banking sector, in particular, traditionally intermediates the wholesale funding variety of capital flows, which are highly procyclical and tend to quickly reverse when adverse conditions emerge. These debt-type inflows can thus become significant transmitters of instability.

The impacts of bank-related capital flows are determined by a number of factors, including how domestic banks manage their balance sheets and source out funds, and how multinational banks organize themselves.<sup>7</sup>

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<sup>6</sup> The 10 Asian economies are the PRC; Hong Kong, China; India; Indonesia; Japan; the Republic of Korea; the Philippines; Singapore; Taipei, China; and Thailand.

<sup>7</sup> A fuller discussion of these issues may be seen in Committee on International Economic Policy and Reform. 2012. *Banks and Cross-Border Capital Flows: Policy Challenges and Regulatory Responses*. Washington, DC: Brookings Institution.

Bank lending is highly procyclical and this procyclicality is further amplified by the slack in banks' balance sheets, which refers to banks' ability to take on additional risks. When the pool of available retail deposits becomes exhausted during a credit boom, banks will turn to alternative sources such as wholesale lending banks, whose support typically comes in the form of cross-border funding. Short-term wholesale funding from foreign creditor banks, which become the noncore liabilities of domestic banks, are more volatile than retail funding and would typically fall in the boxes of Tables 6 and 7 that encompasses repos, call loans, and short-term foreign exchange bank debt, as well as time deposits and certificates of deposit (upper rightmost boxes in Table 6 and lowermost boxes in Table 7).

How large banks organize their international operations also has implications for capital flows and financial stability. In particular, international banks with a decision-making process that remains centered at the home country headquarters, and with funding pooled from each country source and redistributed from the headquarters, can transmit shocks more directly and quickly through changes in affiliates' funding. Foreign banks, operating either as affiliates or branches, can easily migrate to cross-border, noncore funding for their credit expansion needs. Another source of funding would be inter-office funding channeled by the parent bank through its subsidiaries.

Capital flows, in addition, can affect the balance sheet of custodian banks in a distinctive way. A custodian refers to a bank or financial institution that holds securities on behalf of investors. Custodian banks' basic tasks include safekeeping securities, accepting or rejecting traded securities, asset servicing (processing of rights, collecting principal, interest, or dividend payments), and cash management and foreign exchange services. Global custodians whose customers invest in foreign securities contract with custodians in foreign countries, known as "sub-custodians," to provide local custody services. Providing custodian services can affect banks' cash flows and liquidity.<sup>8</sup> Gross inflows and outflows from customers' payment traffic can be very large and volatile. The impact of custodian services on a bank's balance sheet would be felt more on the core liabilities such as cash and demand deposits (upper leftmost box in Table 6 and uppermost boxes of Table 7).

**Brunei Darussalam.** A macroprudential surveillance system is still being set up. A financial stability committee exists as an ad hoc group. AMBD does not specify LTV ratios or DTI rules, nor does it mandate collateral values for mortgages, preferring to merely monitor these matters. Onsite and offsite monitoring is done on a regular basis; a complete onsite examination, lasting 3–6 months has just been completed. It uses the CAMEL framework to evaluate banks.

**Cambodia.** NBC is just starting to implement macroprudential surveillance. No specific department or task force has been designated for this purpose. For disclosure and transparency purposes, banks are required to report and publish in June of every year their audited financial statements on their websites and in newspapers of general circulation. NBC is developing an offsite inspection manual that is scheduled to be implemented in the middle of

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<sup>8</sup> These issues are discussed in BIS (2008).



2013. NBC branches conduct onsite inspection in all provinces on a sample basis, using the CAMEL methodology in its bank examinations.

As part of macroprudential surveillance, the Supreme National Economic Council and the MEF look at the monetary survey. Over 95% of deposits in the country, consisting of savings and demand and time deposits, are in US dollars, which creates a problem with intermediation and the resulting non-securitized intervention by economic managers.

With an open economy and a liberal exchange rate system, the US dollar has effectively become a second national currency existing alongside the national currency, the riel, which was introduced in 1955. The dollar's dominant use over the riel, however, has presented a number of challenges to Cambodia's monetary authorities. Capannelli and Menon (2010) pointed out that as a result of dollarization, Cambodia's monetary authorities cannot directly influence the money supply and cannot conduct exchange rate policy effectively. Consequently, the burden for macroeconomic adjustments in Cambodia falls mainly on fiscal policy.

Signs of financial deepening, based on the ratio of the M2 money supply to GDP, are evident. In particular, the M2 money supply has been growing on the back of increasing foreign currency deposits and credit growth, and with the entry of new banks. However, banks have been limited to short-term lending. Rates on deposits are at 6% per annum, while lending rates range from 10% to 15%.

**Lao People's Democratic Republic.** A BOL unit has been set up to work on the planned macroprudential surveillance system, which is expected to be set up by 2015. The BOL is learning from the experiences of the Bank of Thailand and Bank Indonesia in this endeavor.

**Myanmar.** The CBM's priority plans for capacity building include macroprudential and crisis prevention and resolution, risk management systems (since credit risk is no longer the sole risk in an evolving financial system), and risk-based supervision. In general, the plan is to follow the ASEAN framework plan for economic integration by 2015.

**Viet Nam.** The SBV already has an early warning system and uses macroprudential indicators. A financial sector assessment program being conducted by the IMF is expected to be launched by the end of 2013, with a specific unit in the SBV in charge of this effort. (There is no specific SBV department in charge of macro surveillance, however.) The SBV also has a credit bureau, the Credit Information Center, which was established in 2008.

#### 4.4 Disclosure and Transparency

Disclosure and transparency form one of the six major principles of corporate governance of the OECD and one of the BIS' six principles for enhancing corporate governance.

“The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company,” according to the OECD (2004).

“A strong disclosure regime that promotes real transparency is a pivotal feature of market-based monitoring of companies and is central to shareholders’ ability to exercise their ownership rights on an informed basis,” the OECD (2004) further states. “A strong disclosure regime can help to attract capital and maintain confidence in the capital markets. By contrast, weak disclosure and non-transparent practices can contribute to unethical behaviour and to a loss of market integrity at great cost, not just to the company and its shareholders but also to the economy as a whole.” OECD (2004)

For its part, the BIS (2010) notes “Transparency is one tool to help emphasise and implement the main principles for good corporate governance.” Principle 14 for enhancing corporate governance states: “The governance of the bank should be adequately transparent to its shareholders, depositors, other relevant stakeholders, and market participants... The objective of transparency in the area of corporate governance is therefore to provide these parties, consistent with national law and supervisory practice, with key information necessary to enable them to assess the effectiveness of the board and senior management in governing the bank... Such disclosure should be proportionate to the size, complexity, structure, economic significance, and risk profile of the bank.”

Empirical studies tend to support the importance of disclosure and transparency to investors and, consequently, to the flow of capital. The IMF (2001) commented: “A lack of transparency was a feature of the build-up to the Mexican crisis of 1994–95 and of the emerging market crises of 1997–98. In these crises, markets were kept in the dark about important developments and became first uncertain and then unnerved as a host of interrelated problems became known. Inadequate economic data, hidden weaknesses in financial systems, and a lack of clarity about government policies and policy formulation contributed to a loss of confidence that ultimately threatened to undermine global stability... Transparency and candor are particularly important in today’s environment of substantially increased private capital movements and countries’ growing integration with international capital markets.”

In a study, Gelos and Wei (2002) investigated the effect of transparency in developing countries on the level of investment by international institutional investors. They enumerated several noteworthy findings. “First, we find relatively clear evidence that international funds prefer to hold more assets in more transparent markets. Second, on the other hand, herding among funds is more prevalent in less transparent countries. Third, there is some modest evidence that during a crisis, international investors tend to flee more opaque markets.” Here, “herding” is defined as “funds taking investment decisions which they would not take if they did not observe other funds taking them.” Their findings suggest that improved transparency can reduce the sudden reversal of capital flows during a crisis and thus enhance the stability of domestic financial markets in a developing country.

**Box 1: Organisation for Economic Co-operation and Development  
Principle on Disclosure and Transparency**

The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.

A. Disclosure should include, but not be limited to, material information on:

1. The financial and operating results of the company
2. Company objectives
3. Major share ownership and voting rights
4. Remuneration policy for members of the board and key executives, and information about board members, including their qualifications, the selection process, other company directorships, and whether they are regarded as independent by the board
5. Related party transactions
6. Foreseeable risk factors
7. Issues regarding employees and other stakeholders
8. Governance structures and policies, in particular, the content of any corporate governance code or policy and the process by which it is implemented.

B. Information should be prepared and disclosed in accordance with high-quality standards of accounting and financial and non-financial disclosure.

C. An annual audit should be conducted by an independent, competent, and qualified auditor in order to provide external and objective assurances to the board and shareholders that the financial statements fairly represent the financial position and performance of the company in all material respects.

D. External auditors should be accountable to the shareholders and owe a duty to the company to exercise due professional care in the conduct of the audit.

E. Channels for disseminating information should provide for equal, timely, and cost-efficient access to relevant information by users.

F. The corporate governance framework should be complemented by an effective approach that addresses and promotes the provision of analysis or advice by analysts, brokers, rating agencies and others that is relevant to decisions by investors and free from material conflicts of interest that might compromise the integrity of their analysis or advice.

**Brunei Darussalam.** Aware of the merits of public listing, the government is in the process of establishing a stock exchange under its capital markets development plan. Senior AMBD management is in charge of this plan. No timetable has been set.

AMBD has issued up to \$100 million of *sukuk* (Islamic bonds), with maturities of up to 1 year, mainly to set benchmarks and contribute to capital market development.

**Cambodia.** The development of the securities sector had been laid out in the *Financial Sector Development Strategy 2006–15* and the *Rectangular Strategy, Stage II*. Under these plans, the government considers the securities sector as an essential dimension of the financial system, providing the mechanism for mobilizing all sorts of financial resources for investment projects and to diversify the sources of economic growth. Moreover, the existence of the securities market will promote accountability, transparency, good corporate governance, and efficiency in the operations of firms, especially those engaging in public offers.

These objectives have been carried over into the newer *Financial Development Strategy 2011–20*. Capital market development is seen as a catalyst in promoting good corporate governance in the public sector, as companies are required to have 3 years of audited financial statements prior to listing. Market development will be conducted in three overlapping stages, with the first stage (2011–14) focused on bond market development, the middle stage (2014–17) focused on equities, and the last stage (2017–20) focused on the introduction of derivatives.

The SECC, which supervises the securities sector in the country, has six operating departments: Securities Market Supervision; Securities Intermediaries Supervision; Legal Affairs; Securities Issuance Supervision; Research, Training, Securities, Market Development and International Relations; and Administration and Finance. It has the power to arrest without the prosecutor’s opinion, and to hold the suspect for 48 hours. It has recorded one case in 2010 for an illegal security offering. It uses criminal laws to prosecute. The sanctions it imposes fall under two major categories: administrative and criminal.

The SECC further supervises 13 securities companies, consisting of seven underwriters (five of which are foreign), two dealers (one foreign), and four brokers (zero foreign).

It has a 30-investor rule as the threshold: companies with more than 30 investors are required to engage in a public offering of shares.

Under the law, listed public companies are differentiated from listed private companies in terms of corporate governance rules. Public companies cannot have more than seven directors, at least one of which must be independent, while private companies can have between seven and 15 directors, of which 20% must be independent.

The SECC foresees the local market being integrated with the ASEAN Exchanges, an existing collaboration among four national exchanges (Malaysia, the Philippines, Singapore, and Thailand). The SECC’s top priorities are listing promotion; IPO evaluation, processing, and procedures; corporate governance; market surveillance systems; and market investigation. A team has been set up to spearhead these efforts.

**The Lao People’s Democratic Republic.** Disclosure requirements consist of the publication of annual audited financial statements within the first quarter each year, in addition to the submission of monthly statements.

A new securities bill passed in December 2012 waits to be signed into law. Under the law, the LSX, with status as a self-regulatory organization, will be in charge of monitoring and regulating

corporate disclosure, with the SEC in charge of enforcing irregular disclosures. The LSX currently only trades the stocks of two companies: a bank (BCEL) and a power utility (EDL). An SEC committee has drafted a long-term development plan for the domestic capital market to be released and implemented by end of 2013. The Lao PDR's accession to the WTO in 2012 is seen as a plus for the country's capital market development.

The government permits 100% foreign-owned banks to operate in the country and sets a 20% foreign ownership limit for industrial nonbank companies. The 5% threshold rule is enforced.

The MOF is in charge of the government bond market. Auctions are conducted once a year, although the government desires to eventually conduct one auction every month. Investors hold these treasuries to maturity as a secondary market for treasuries is still under study. The legal framework for this secondary market is lacking and policymakers are still looking for a model to follow and are open to receiving technical assistance on this matter. Clearing is done by the BOL.

The government issues Treasury securities: Treasury bills are issued to cover the fiscal deficit while bonds with maturities of up to 5 years have also been issued. There are no corporate bonds. Under discussion is whether the LSX will handle the secondary market for bonds. The MOF previously considered the issuance of cross-currency asset-backed securities to fund its hydro project. However, this funding alternative did not progress because of issues regarding the transfer of royalties as collateral for the securities.

Tax incentives are provided to develop the capital market, mainly consisting of a 5-year exemption from the 24% capital gains rate. Additional fiscal incentives are not possible at present due to the government's primary goal of reducing poverty, which entails financing social programs, subsidies for SOEs, and bank lending to certain strategic sectors.

**Myanmar.** The country has no functioning capital market, a situation that is to be addressed by the proposed Security Exchange Law, which is now awaiting passage in Parliament. This law will also set up a Securities and Exchange Commission.

This process has been years in the making. A steering committee was created in 1996 to set up a stock exchange, with the CBM taking the lead. In June of that year, the Myanmar Securities Exchange Center Co., Ltd (MSEC) was established as a 50:50 joint venture between the state-owned Myanmar Economic Bank (MEB), the country's largest bank, and Japan's Daiwa Institute of Research Ltd. MSEC's business activities include brokering, dealing, underwriting, and distributing securities, as well as research and consultancy services. It also sells Myanmar Treasury bonds as an agent for the CBM.

In May 2012, the CBM, Daiwa Research Institute, and Tokyo Stock Exchange signed a technical aid agreement to develop the country's stock exchange by 2015. Daiwa will help train the stock exchange's workforce and advise on the set-up of the necessary IT systems, while the TSE will help establish the stock exchange's rules and operating standards.

**Viet Nam.** Public disclosure requirements compel companies to report to the SSC and Hanoi Stock Exchange (HSX), and also to provide their disclosure reports on their websites. As the SSC issues new guidelines on filing rules, it is implementing a system for the electronic transmission of disclosure reports. However, as some companies have limited access to the internet, almost all listed companies still either send hard copies or scanned copies. Authentic verification remains an issue for electronic filing. The new system, the Information Disclosure System (IDS), was set-up with the help of the Luxembourg Agency for Development Cooperation and the FPT Information System. It is slated to be operational by the end of 2013. The initial stage of implementation will be for public companies. FPT Information System is a local IT solutions provider that is listed on the Ho Chi Minh Stock Exchange.

The fine for late or inaccurate disclosure is D20 million, an offense that occurs very often, with around 15 companies investigated every year. Circular 52 classifies disclosures into three main groupings: regular (about 10 items, including audited financial statements, annual reports, corporate governance certifications, and BOD resolutions); unusual; and as required by the regulator. These groupings adhere to international standards on disclosure.

Decree 58 covers foreign enterprises' issuance of shares, mandating that foreign companies can list only those shares issued in Viet Nam. To date, no foreign enterprise has availed of this listing rule.

Foreign ownership is limited to 49% for listed non-banking companies and 30% for banks. A 5% ownership threshold is mandated for foreign and local investors, whereby the investor or group must file a disclosure report. Each 5% increment thereafter, up to 25%, requires a corresponding disclosure. Ownership above 25% requires approval from the SSC.

A two-tier market surveillance system is maintained; the primary tier covers surveillance at the stock exchange level and the second tier at the SSC level. The parameters for market surveillance have been developed by the stock exchange. For its part, the SSC administers compliance requirements over the stock exchange and monitors transactions conducted on the exchange. Illegal trades fall under criminal proceedings and carry penalties plus a prison sentence. Administrative cases currently carry a fine of up to D2 billion.<sup>9</sup>

In its investigations, the SSC can access an investor's ID from security brokers and documents from the settlement bank, but it has no direct access to investor communications (e.g., e-mails, phone records). The investigation department then refers the case to the inspection department, which forms an examination group, which if needed then refers the case either to prosecutors for a criminal case or the relevant SSC department for an administrative case. It takes a maximum 10 days for a case to be elevated from the stock exchange to the SSC, where the surveillance department may process the case over a few months or even years for complex cases. For its part, the Ho Chi Minh Stock Exchange interviews, investigates, and asks listed companies for an explanation within 24 hours.

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<sup>9</sup> Decree No 108/2013/ND-CP, which took effect on 15 November 2013, raised maximum fines up to D2 billion (\$95,238) for institutions and D1 billion (\$47,619) for individuals—quadruple the prior rates.

Circular 183, which covers the establishment of mutual funds, was instituted in 2012. In the early part of 2013, the local financial industry had 23 closed-end funds and 2 open-end funds.

#### 4.5 Capital Flow Management

Capital flows can be a double-edged sword for developing economies. On one hand, capital inflows into a developing economy can be a great boon to growth, financing developmental requirements, smoothing consumption patterns, diversifying risks, and expanding economic opportunities. On the other hand, capital flows can also create a host of problems.

“Although few deny the benefits of capital inflows for recipient economies, they often create problems especially if they are substantial and volatile,” stated Kawai and Lamberte (2010). “Massive capital inflows,” they continued, “can create too much bank lending, excessive investment, and speculative activities, which can lead to goods price inflation, asset market bubbles, and potential vulnerabilities in bank, household, and corporate balance sheets. Moreover, sudden stops or reversals in capital inflows could lead to a currency crisis, the bursting of asset price bubbles, investment collapse, banking sector stress, and economic difficulties.”

Since recovering from the 1997–1998 Asian financial crisis, the region’s developing economies have seen the return of capital inflows and a string of current account surpluses over a number of years. The more recent GFC that started with the collapse of the US subprime mortgage housing market left most Asian economies relatively unscathed, although their foreign trade inflows suffered due to the downturn in demand from developed economies.

These Asian economies have proved to be resilient, expanding in the post-crisis years while developed economies continue to either recover at a snail’s pace or remain in a slump.

“There are signs that capital of a largely short-term nature is returning to Asia in a significant way, raising serious concern among policymakers in the region who are trying to prevent rapid appreciation of their currencies against the US dollar and to contain inflation and increases in asset prices to stabilize their economies and sustain the recovery,” stated Kawai and Lamberte (2010). They added: “These recent developments suggest that managing capital inflows remains an important policy issue for many emerging market economies that needs to be studied rigorously and debated openly. Policymakers in the region are faced with questions on best policy responses and regional cooperation initiatives to utilize capital inflows while maintaining macroeconomic stability.”

**Brunei Darussalam.** The combination of a healthy level of international reserves—a major necessity for a currency board system—as well as a perennially positive trade balance, a huge current account surplus that exceeds 40% of GDP, fiscal surpluses, no foreign debt, and the presence of flexible markets for goods and labor have rendered moot the management of capital flows in Brunei Darussalam.

**Cambodia.** As a dollarized economy, there are no restrictions on international capital flows, but local banks are not allowed to invest abroad. NBC admits this is not a good system of

capital flow surveillance from the point of view of financial stability. This also makes monetary policy inutile and achieving price stability difficult. The government does not issue either Treasury bills or bonds, as it remains cheaper to borrow abroad at concessional rates. Debt management capacity thus has to be developed. The government also hopes to develop an early warning system under its 2020 financial sector development plan.

**The Lao People's Democratic Republic.** Total international reserves have surged in recent years, surpassing \$700 million in 2010, more than double the amount 5 years earlier. This has been fueled by the financial account balance—mainly consisting of direct investments and other investments from abroad. Experts note that investors from Viet Nam have been shifting funds to Lao PDR banks in anticipation of the depreciation of the Vietnamese dong. Capital flow management in the Lao PDR remains rudimentary.

**Myanmar.** The country is still in the process of attracting foreign investment and does not yet have a capital flow management system. Its funding has come mainly from concessional loans. However, attracted by Myanmar's ongoing reform and liberalization policies, as well as the lowest labor wages in the region, foreign firms have been rushing to search for investment opportunities.

**Viet Nam.** Although Viet Nam restricts capital inflows and outflows, the country enjoys robust inflows of capital, consisting mainly of FDI. The Ministry of Planning and Investment has the authority to grant foreign investment licenses for projects over \$1 million, while provincial authorities approve projects under \$1 million. Foreign individuals and organizations are allowed to purchase local securities, but any issuance or sale of securities by non-residents requires SBV approval. Furthermore, enterprises operating in the country are subject to annual overall ceilings on foreign borrowings.

From 1988 to 2011, registered FDI summed to almost \$230 billion. These capital flows once largely funded the country's current account deficit, but since 2005 remittances and portfolio inflows have played an increasing role in financing the trade deficit. With overseas remittances estimated at \$9 billion in 2012, the country ranks ninth among the world's largest remittance-receiving countries and territories. The current account surplus surged to over \$9 billion in 2012, in part due to low imports. With this, gross international reserves rose at end-February 2013 to more than 2.5 months of prospective imports of goods and nonfactor services. Based on official data, Viet Nam's international reserves stood at \$13.5 billion at the end of 2011, up from a low of \$12.5 billion in 2010, but still down from the recent high of almost \$24 billion in 2008.

## 5. Summary Findings and Recommendations

In sharp contrast to the 1997–1998 Asian financial crisis, the contagion effects of the recent GFC did not spill over into the financial sectors of ASEAN countries and left their economies relatively unharmed as well. The pain inflicted by the earlier Asian crisis, in terms of lost economic momentum, currency collapse, social unrest, and bank insolvencies, provided the impetus for countries in the region to embark on a series of economic, banking, and capital



market reform initiatives. The 1997–1998 Asian financial crisis drove the region’s developing economies to see the globalization handwriting on the wall, and they opted to benefit from this trend by instituting the necessary reforms and pushing for greater regional cooperation.

This sense of urgency is sadly lacking in the aftermath of the recent GFC, which engulfed the developed economies and left Asia’s developing economies in a relatively robust and resilient position. This larger crisis, however, affected the weakened advanced economies’ demand for Asian exports. Asian economies, led by the PRC, turned inward with development programs aimed at re-balancing their economies by bolstering domestic consumption. The search for alternative markets is also pushing the agenda for greater regional integration in the form of the AEC. This, however, may prove to be too weak of an incentive for the BCLMV countries to accelerate economic and financial reforms.

As has been stated, the BCLMV countries differ widely in terms of political systems, stages of economic development, and cultures, among other characteristics. The major implication of this heterogeneity is that there is no one-size-fits-all solution for each country’s response to the banking reform measures emanating from developed economies. Each of the BCLMV countries has its own national banking development agenda and timeframe for achieving its goals. A broad description of the priorities for financial sector development in the BCLMV countries is provided in the table below.

## **Box 2: Financial Sector Development Priorities in the BCLMV Countries**

### **Brunei Darussalam**

- Enhance national payments system
- Set up a trade information bureau
- Establish a deposit insurance scheme under the MOF

### **Cambodia**

- Capacity building efforts focusing on the following:
- prepare for ASEAN integration (2015 deadline for the AEC)
  - develop capital account monitoring system
  - develop effective monetary policy (open market operation and benchmark interest rates)
  - enhance banking supervision and regulation (onsite and offsite)
  - strengthen payments system
  - institute a modern information system

### **Lao People's Democratic Republic**

- Priorities under the 2010–15 plan:
- develop the securities market
  - institute a capital market strategy plan
  - prepare for ASEAN financial integration in line with sustainable Basel II reforms

Also, transfer ownership of SOEs to the public (based on a MOF-drafted government decree)

### **Myanmar**

- Reform financial system (rewrite banking and financial laws)
- Grant independence to the Central Bank of Myanmar (CBM)
- New laws on financial institutions, foreign exchange management, and securities exchange
- Reform accounting and disclosures

### **Viet Nam**

- The government has issued two resolutions to boost economic growth and quickly resolve the real estate and NPL issue
- Set up Viet Nam Asset Management Company (VAMC) and merge "five strong banks"

AEC = ASEAN Economic Community, ASEAN = Association of Southeast Asian Nations, BCLMV = (Brunei Darussalam, Cambodia, the Lao People's Democratic Republic, Myanmar and Viet Nam), MOF = Ministry of Finance, NPL = non-performing loan, SOEs = state-owned enterprises.

Source: Authors' compilation.

The main objective of the Basel reforms to fortify global financial stability clearly cannot take precedence over the BCLMV countries' national economic development aspirations. Adoption of these reforms will entail costs in terms of constraining economic progress. With the exception of Brunei Darussalam, the CLMV countries are in their catch-up phase of economic development marked by rapid growth. As these countries continue to grow, their financing requirements for infrastructure development will be substantial and continuously increasing.

Global financial reforms, especially the Basel reforms, may constrain the capacity of banking sectors in the BCLMV countries to provide their portion of the required funding.

Ultimately, however, the relevant dictum is that the financial sector must serve the needs of the real economy. But for it to do so effectively, financial sector development must go hand-in-hand with the economy's overall development. Financial development, including the advancement of the banking system, is a powerful determinant of economic growth. Part of this development is the regulatory regime and certain reforms are essential to enhancing its structure, such as establishing an independent regulatory and supervisory system, and ensuring compliance with international standards for bank supervision.

Given the underlying dissimilarities among the five BCLMV countries, the sequencing of financial reform measures should likewise diverge among them. Being at different stages of financial development, each country will have to set its own pace for opening up and reforming its financial sector. Brunei Darussalam, for example, presents a special case due to its oil-fueled high per capita income and lagging financial sector. While it has issued a small amount of *sukuk*, it has yet to establish a market for publicly traded securities, including stocks and bonds. In contrast, Cambodia, the Lao PDR, and Viet Nam have made strides in launching their own national stock exchanges.

The sequencing of which laws and regulations should be revised or enacted, and which institutional capacities need to be strengthened, is best decided by each country's set of policymakers. At the same time, this does not mean there is no need for the synchronization of implementation timeframes. It is crucial for the other five member countries of ASEAN, as well as for multilateral funding agencies, to push the BCLMV countries to accelerate their financial sector development programs. It would be risky, for example, for the AEC to be in general compliance with global regulatory reforms while allowing peripheral zones of non-compliance. There is the real danger that the BCLMV countries' continued rapid growth and development might outpace their regulatory capabilities, thus risking financial instability and planting the seeds of financial contagion in the region. Prolonged non-compliance would also unlock opportunities for regulatory arbitrage, which could become another source of instability within the region.

**Table 7: Summary: Financial Monitoring of BCLMV Countries**

|  | <b>Brunei Darussalam</b>                                 | <b>Kingdom of Cambodia</b>   | <b>Lao People's Democratic Republic</b>                     | <b>Republic of the Union of Myanmar</b>                         | <b>Socialist Republic of Viet Nam</b>  |
|--|--|--|---|---|--|
| Financial regulatory & supervisory system (independenc/resiliency) | No securities regulator                                  | SECC under MEF   | SECO and LSX are BOL units                                  | CBM under MFR; no securities regulator                          | SSC under MOF  |
| Capital adequacy & liquidity management                            | Adopted Basel I, deferred Basel II                       | Adopted Basel I, modified solvency ratio of Basel II   | Implementing Basel I  | Not started on Basel I  | Adopted Basel I, mulling Basel II  |
| Corporate governance & risk management                             | No CG for banks; limited disclosure for registered firms | Banks required to have independent board member and special committees for audit and risk management | CG contained in the Commercial Bank Law (c. 2006–2007)      | CG rules to be addressed by proposed Financial Institutions Law | CG contained in Law on Enterprises, Banking Law 2010, Circular 121, and Decision 12      |
| Macroprudential surveillance                                       | System being set up                                      | NBC just starting on it  | BOL unit working on it                                      | Included in CBM priorities                                      | Already in operation   |
| Transparency & disclosure  | Plans to put up stock exchange                           | Plans laid out in Financial Sector Development Strategy 20062015                                     | Securities Law, passed in December 2012, waits to be signed | Security Exchange Law, now waiting for parliament for approval  | Two-tier market surveillance system is maintained; rules under Circular 52 and Decree 58 |
| Capital flows management   | Oil sales receipts main source of funding                | Dollarized economy, no restrictions on capital flows   | Rudimentary system  | No formal system  | MPI and SBV regulate flows   |

BOL = Bank of Lao PDR, BCLMV = (Brunei Darussalam, Cambodia, the Lao People's Democratic Republic, Myanmar and Viet Nam), CBM = Central Bank of Myanmar, CG = corporate governance, LSX = Lao Securities Exchange, MEF = Cambodian Ministry of Economy and Finance, MFR = Ministry of Finance and Revenue, MOF = Ministry of Finance, MPI = Ministry of Planning and Investment, NBC = , SBV = State Bank of Viet Nam, SECC = Securities and Exchange Commission of Cambodia, SECO = Securities and Exchange Commission Office, SSC = State Securities Commission.

Source: Authors' compilation.

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## **Financial Monitoring in the New ASEAN-5 Countries**

The five newest members of the Association of Southeast Asian Nations (ASEAN)—Brunei Darussalam, Cambodia, the Lao People’s Democratic Republic, Myanmar, and Viet Nam—continue to develop their financial sectors and catch up with the rest of southeast Asia prior to the launch of ASEAN Economic Community in 2015. This paper examines the status and concerns regarding the five nation’s financial sector development and the impact of global financial reforms after the crisis.

### **About the Asian Development Bank**

ADB’s vision is an Asia and Pacific region free of poverty. Its mission is to help its developing member countries reduce poverty and improve the quality of life of their people. Despite the region’s many successes, it remains home to approximately two-thirds of the world’s poor: 1.6 billion people who live on less than \$2 a day, with 733 million struggling on less than \$1.25 a day. ADB is committed to reducing poverty through inclusive economic growth, environmentally sustainable growth, and regional integration.

Based in Manila, ADB is owned by 67 members, including 48 from the region. Its main instruments for helping its developing member countries are policy dialogue, loans, equity investments, guarantees, grants, and technical assistance.

