The flow of funds in ASEAN

By Philip Zerrillo

In his novel, Memoirs of a Geisha, Arthur Golden wrote, "Water can carve its way even through stone. And when trapped, water makes a new path." Something similar seems to be happening with the flow of funds in ASEAN.

A strong, healthy and robust financial system is the backbone of any business ecosystem. In contrast, financial systems and their supporting regulatory structures in many emerging market economies are works in progress–still developing, often rudimentary, and mostly fragile. It is here that businesses tend to adapt and develop unique structures and odd fixes–much like the new paths forged by trapped water.

I grew up in the 'Silicon Hills' of the United States, and there we have what can be considered a very democratic financial system. Meaning, if you have an idea, or a solid credit history, you can generally gain access to some form of funding. Unsurprisingly, banks are assumed to be the first point of call for any new, expanding or ongoing business. We also have a plethora of private equity and venture capital firms available to support start-up entrepreneurs. It is easy to take these systems for granted.

To an outsider, it is sometimes difficult to understand why such models exist in Asia and how they function. Let me give you a taste of some of these highly innovative techniques and some of the shortcomings that I have come across during my work in the region.

In Thailand

Earlier this year, when I met the former Prime Minister of Thailand, Abhisit Vejjajiva, he talked about the lack of support for the nation's start-ups. According to the U.K.-based business networking group, Approved Index, Thailand ranks second worldwide for its entrepreneurship, with 16.7 percent of the country working for themselves (in contrast, only 4.3 percent of the U.S. adult population are entrepreneurs).[1] Although Thailand is a nation of entrepreneurs, it doesn't have the support of a financial system that really promotes start-ups.

Similarly, when I interviewed Krating Poonpol, a partner in the 500 TukTuks start-up and founder of Disrupt University in Thailand, he enumerated the limitations of the Thai start-up ecosystem. Unlike other countries that offer tax exemptions or direct financial support to start-ups, Thailand's tax system does not support or incentivise start-ups.

Moreover, Thailand does not have a framework that enables private companies to offer Employee Stock Ownership Plans (ESOPs). Krating explained, "ESOPs serve as both a strong retention mechanism for employees as well as a way to motivate employees and align their goals with those of the company...Additionally, the ESOP is a non-cash compensation scheme, which can assist start-ups in preserving their precious cash. Thailand also does not have convertible debt, a common type of security for start-ups the world over. The lack of these financial options means that entrepreneurs have to take on additional costs and are unable to share risks, and are thus discouraged from diving into disruptive initiatives...Start-ups in Thailand also face challenges in terms of lucrative exit options for investors. There are very few mature start-ups that can successfully list themselves on the Thai exchange as the premiums are insignificant. Acquisition hence becomes the only exit option available."[2]

In Vietnam

More and more Vietnamese companies are locating their operations in Singapore. When I enquired why, they said that, for accounting purposes, the tax structure in Vietnam does not differentiate between revenue and investment. For example, if a company receives two million dollars in funding, and it does not have concurrent expenses to offset it, it gets taxed at a 20 percent rate on the whole investment–so US$400,000 goes into paying taxes. As a result, businesses prefer to register their operations abroad to avoid such taxation. And for those businesses that do not have the luxury of relocating to another country, there exists a thriving market for receipts–people will actually sell you their expense receipts so you can show expenses against your investment!

Vietnam is a hard country to gain credit in. The country is almost entirely banking-financed and all land is owned by 'the people' of Vietnam. More directly stated, all land is state-owned, and the inhabitants are granted a land use right. Hence, there has been very little collateral value attributed to land use licenses in Vietnam, resulting in limited access to credit.

In Myanmar

Peninsula Plaza, a mall located close to Singapore's central business district, serves as a home away from home for the Myanmarese living and working in the island state. Here, as elsewhere in Myanmar, the informal money transfer 'hundi' system (called 'havala' in India) is still thriving, whereby cash given to an agent in one location allows a payment to be made by another agent in a distant location. This is the most rudimentary and traditional form of remittances, but it is still very important in such nations.

Systems like the hundi continue to thrive because of tight capital controls restricting the movement of funds in and out of the country. The banking system in Myanmar is still so fragile that businesses are allowed to withdraw no more than US$10,000 at any given time and that too, no more than twice in one week. This makes it very difficult for businesses to operate–it can take up to three to four hours to withdraw cash, with numerous forms and approvals required. What this does is give rise to informal financial channels that circumvent the banking system. Speaking with owner operators across the country, it seems as though almost everyone keeps a safe full of money at home because of the unreliability of the banks.

Similar to Vietnam, start-ups in Myanmar also prefer to register their businesses in Singapore. When I visited the Phandeyar Incubator in Myanmar, its 16 to 20 start-ups were registered in Singapore. Reasons for doing so were also similar–favourable investment climate, better funding opportunities, the ability to move money easily and efficiently, and so on. Frankly, if the businesses need funding to get to the next level, it would be hard for international investors to want to commit their funds to a Myanmar-registered company: the restrictions on capital means the ability to liquidate their holdings and bring them back home would prove difficult.

Myanmar actively trades across the 6,522 km border that it shares with Thailand, China, India, Bangladesh and Laos. The Myanmar Kyat has limited appeal to foreign firms, thus driving an internal demand for hard currency. In popular tourist cities, currency changers own multiple outlets, and they will offer a premium ranging from two to three percent in order to get American dollars. In turn, these dollars are lent to traders and manufacturing or mining firms on the border. While the governmentsuggested interest rate is around eight percent, the informal lending rate is roughly four percent a month!

In the Philippines

The Philippines is largely a banking-based financial system. Access to credit information and histories is limited and much of the country is underbanked. Indeed, 86 percent of Filipinos do not have a bank account.[3] The country tends to be collateral based and hence it is difficult to move social classes in a single generation. Unlike the United States where good ideas find capital, the Filipino entrepreneur may often be forced into unregulated credit markets. Additionally, there are tax advantages to bank-based lending that make this the predominant source of funds for all businesses, including the SMEs.

Dark money

It is widely estimated that over US$200 billion of Indonesian assets are sitting in wealth management accounts in Singapore today.[4] The efforts of Indonesia to offer a tax amnesty, or one-time fee programmes, is part of initiatives to bring this money out of the shadows and repatriate it. How much of it will be 'whitened' is still a matter of great debate as many investors are uncomfortable with either the tax rate or the restrictions on the capital once they repatriate. This latter issue is one of great political will as governments attempt to put these funds to work in priority industries that often do not capture capital easily. Moreover, policymakers are trying to bring these newly legal funds permanently back home.

The long history and existence of dark money will have effects and legal consequences for years to come. Often, the deeds and real estate titles in these countries are difficult to determine and decipher as black money deals took place decades ago. Such purchases were often transacted without proper asset valuations, taxes or even the recording of transactions. The historical use of these practices throws another layer of complexity onto the already fragile banking systems of some emerging markets. This is especially true for financial systems where credit information is scarce and collateral is the coin of the realm.

One thing is for certain, the Foreign Account Tax Compliance Act, or FATCA movement begun by the U.S. is catching on, and more governments in the region are cracking down on informal economies and tax avoidance on accounts and other financial assets held offshore. The ability of governments to provide services, protect boundaries and educate their populations largely depends on the implementation of these policies. For instance, Bloomberg estimates that less than one million Indonesians pay the taxes they owe, and with a population of 255 million, the country has fewer than 27 million registered taxpayers.[5] Whether these efforts will be successful or not remains to be seen. Where these contested funds go and how they flow will impact the fortunes of many.

Making new pathways

The fragility and state of development of the financial systems in Asia often lead to seemingly unique workarounds. Despite business getting done, these are not the most optimal solution for businesses as they come at a major cost, frequently require relocation to other countries, and may lead to sprouting grey markets.

I have touched upon a few financial nuances that affect the nature of doing business in specific countries. It is by no means meant to be comprehensive or complete as we could write at length about the Shariah-based financial considerations in countries like Brunei or Indonesia. Topics such as the sophistication of the money transfers and wealth management in Singapore or even the priority lending sectors that various countries have deemed vital are some other areas that could be discussed at length.

As a 20-year veteran of Asia, I still look for insights that can help me to better understand and explain why things are as they are.

It is my hope that this note will stimulate thought and encourage our readers to share their ideas. Tell us what you think. We would love to hear from you.

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