

THE ADVISORY GROUP ON APEC FINANCIAL SYSTEM CAPACITY-BUILDING

A Public-Private Sector Initiative

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Final Report of the 6th Public-Private Dialogue for the Asia- Pacific Region Makati, Philippines, 15-16 June 2010

Office of the Advisory Group Chair

PURPOSE	For information.
ISSUE	Final full version of the report of the 2010 dialogue with financial regulators
BACKGROUND	The Advisory Group coordinated the preparation for the 15-16 June 2010 sixth annual dialogue between financial supervisory agencies and representatives of the Asia-Pacific region's financial industry. It was hosted by the Bangko Sentral ng Pilipinas (BSP) in Makati City, Philippines. This dialogue dealt with the theme "The Role of the Financial Sector in Sustaining Economic Growth and Stability." Participants discussed current global financial regulatory reform processes in the context of ongoing regional efforts to strengthen and develop the region's financial markets.
PROPOSAL	N.A. (The summary and recommendations of this report have already been considered at the Advisory Group meeting in Bangkok in August 2010 and incorporated in the 2010 Advisory Group Report.)
DECISION POINT	Endorse the report.



**THE 6TH SEACEN/ABAC/ABA/PECC
PUBLIC-PRIVATE DIALOGUE FOR THE
ASIA-PACIFIC REGION**
*THE ROLE OF THE FINANCIAL SECTOR IN
SUSTAINING ECONOMIC GROWTH AND STABILITY*

CONFERENCE REPORT

A DIALOGUE JOINTLY ORGANIZED BY
THE SOUTH EAST ASIAN CENTRAL BANKS' RESEARCH AND TRAINING CENTRE
THE APEC BUSINESS ADVISORY COUNCIL
THE ASIAN BANKERS' ASSOCIATION
THE PACIFIC ECONOMIC COOPERATION COUNCIL

15-16 June 2010
The InterContinental Manila
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Final Draft

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THE ROLE OF THE FINANCIAL SECTOR IN SUSTAINING ECONOMIC GROWTH AND STABILITY

CONFERENCE REPORT

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EXECUTIVE SUMMARY

On 15-16 June 2010, the Asian Bankers' Association (ABA), the APEC Business Advisory Council (ABAC), the Pacific Economic Cooperation Council (PECC) and the South East Asian Central Banks (SEACEN) Research and Training Centre jointly held the sixth annual dialogue between financial supervisory agencies and representatives of the Asia-Pacific region's financial industry. It was hosted by the Bangko Sentral ng Pilipinas (BSP) in Makati City, Philippines.

This year's dialogue dealt with the theme *The Role of the Financial Sector in Sustaining Economic Growth and Stability*. Participants discussed current global financial regulatory reform processes in the context of ongoing regional efforts to strengthen and develop the region's financial markets. Key messages from the discussions were as follows:

- *Risks to financial markets are growing again.* Risks to global financial markets are increasing as banks in developed economies come under stress due to rising sovereign risks and capital buffers for smaller banks in developed markets remain weak. Funding market strains are reappearing. Without recovery in inter-bank lending, the need for renewed liquidity support from central banks has increased. In developed economies, downside risks are rising due to growing fiscal vulnerabilities. Asian emerging markets will be impacted with respect to both funding and capital flows and asset prices.
- *Asian banks and regulators face increased economic, financial and regulatory challenges.* Asian banks are negatively affected by uncertain global recovery prospects, regulatory overreaction to the crisis and the tightening of capital requirements. Asian central bankers are confronted by challenges related to large capital inflows, currency appreciation, heightened exchange rate volatility, distortion of asset prices, the low interest rate environment, new financial stability mandates and international policy coordination and resolution mechanisms.
- *Growing fiscal imbalances present serious new risks and must be addressed.* Growing risk arises from the low interest rate environment that can encourage fiscal imbalances. Events in Europe indicate that markets are not very tolerant of high public debt levels that are seen as unsustainable.
- *Regulatory reforms must be handled with care.* While there is support for regulatory reforms within the region, three key principles need to be kept in mind.
(a) Regulators should guard against financial fragmentation and protectionism.
(b) The aggregate impact of global reform measures should be adequately assessed.
(c) Reforms should be undertaken with regulatory transparency through extensive consultation with industry, full impact analysis, a transition period for implementation, appropriate grandfathering terms and consistent compliance and enforcement.

- *Conditions in the region are not adequately reflected in current reform initiatives.* There is significant concern within the financial industry about the value to the region of certain reform initiatives. Negative impact of certain reforms in Asia would include significant reduction of liquidity in markets; putting Asian banks at a competitive disadvantage due to the lack of deep capital markets which limits the capacity of banks to tap into the markets to build their capital base; slowing the recapitalization of the banking sector; and extraterritorial impact of legislation in some North Atlantic economies.
- *Divergence between G20 and regional financial market development goals must be avoided.* There is concern that, due to strong domestic political pressures in some G20 economies, there is significant potential for divergence between the G20's direction and the direction of Asian regional efforts to promote liquid and efficient financial markets, which may end up damaging regional cohesion and solidarity. G20 member economies from within the region have a serious responsibility to ensure that the outcomes of this process are consistent with regional financial market development goals, and need to play an active role in shaping the G20's agenda.
- *Synergy between G20 and East Asian regional processes can be achieved.* The G20 is focusing on macro-economic policies and structural reforms to promote recovery and long-term growth, as well as on international financial regulatory reform. East Asian regional cooperation has been focusing on the development of a multilateral swap arrangement and local-currency bond markets. Synergies between these parallel global and regional processes could be achieved if members from the region ensure their voice is reflected in the development of policies at the global level and regional institutions work closely with their global counterparts.
- *Improvements to the revised Basel framework are needed to allow the region's emerging markets to benefit from reforms.* Responses to the package of proposals contained in the 2009 BCBS consultative document indicate that there is need for substantial improvement. Following are key issues regulators and policy makers should keep in mind: (a) Implementation of reforms should be coordinated globally and be internationally consistent, while sufficiently taking into account economic conditions, business models and tax and accounting systems particular to each economy. (b) The impact of new regulations on the cost of doing business and on capital markets should be reviewed and evaluated. (c) There should be close consultations and dialogue with the private sector to determine what constitutes an appropriate level of capital and liquidity in financial systems.
- *Basel reforms are likely to increase costs but provide long-term benefits.* It is expected that implementation of the new standards will result in a more stable banking system, lower risk premia and more efficient allocation of resources. However, it is also expected to increase the costs of funding, e.g., as a result of excessive capital-raising affecting banks' profitability and the costs being eventually passed on to the consumer. Basel reforms can lead to a more robust global banking system, but only if it is implemented at the right pace and time.
- *There is a need to minimize the use of top-down one-size-fits-all approaches.* It remains unclear how substantially Basel III will contribute to enhanced financial stability in Asian banking systems. It could penalize banks for taking excess deposits over loans and encourage banks to seek long-term funding from the market rather than through demand deposits. In Japan, a balanced reform package helped prevent major banking failures despite relatively low capital levels with lower quality capital components. These considerations indicate that

some issues may be better dealt with through Pillar 2 or through a balanced package of measures rather than through Pillar 1 and regulation of equity capital. It must also be kept in mind that more regulations will raise compliance costs and discriminate against regulated institutions vis-à-vis unregulated institutions, and encourage more regulatory arbitrage. In this context, authorities need to ensure that the regulatory perimeter is adequately assessed.

- *Focus on supervisory capacity is badly needed.* It is important that regulatory reforms are coordinated (to ensure level playing fields and avoid regulatory arbitrage). However, finding a proper balance between individual jurisdictions' discretion (amply needed) and consistency in implementation is a very difficult challenge. Implementation of agreed rules will also be meaningless unless complemented by strong supervision. There is therefore a real need in the region to address a perennial challenge facing supervisors worldwide – ensuring that they have adequate resources and authority as well as appropriate organizational frameworks and constructive relations with other agencies.
- *The Asia-Pacific region needs a regional architecture to effectively deal with regulatory reforms.* The crisis has led to major efforts toward regulatory reform at the global level and in North America and Europe. Regulators in the region need to carefully assess the value of various proposals, including higher taxes for the financial industry, and determine costs and benefits of adoption. It is important for Asia-Pacific economies to review the relevance and potential impact of such reforms on the region, and to develop an architecture for this purpose.
- *The region can benefit from further development of the Chiang Mai Initiative Multilateralization facility.* To strengthen the region's emerging markets against volatile short-term capital flows that can lead to capital account crises, policymakers should begin studies on converting the standby CMIM facility into a well-endowed and effectively managed international financial institution, such as an Asian Monetary Fund, when the time is ripe. An AMF that complements the existing global financial architecture could add value through its deeper understanding of Asian economies and help avoid repeating mistakes committed before and during the Asian financial crisis.
- *The Asia-Pacific region needs a regional financial forum of regulators and the financial industry.* Given the highly fragmented situation of the region's financial market infrastructure, it is important to complement regional surveillance with parallel regional efforts to ensure that global standards are developed taking into account market practices and market infrastructure in the region. There is a need for a regional financial forum to address regulatory and tax issues in the light of the region's needs, involving collaboration among regulators and the financial industry. Private sector input that can take into account both local and global perspectives should also be solicited in the process of designing regional structures.
- *There is a continuing need to develop financial sector safety nets in the region's emerging markets.* With the increasing complexity of financial products and growing inter-linkages among financial markets, maintaining domestic financial stability has become a shared responsibility among various institutions, thereby requiring a coordinated approach among regulators domestically and internationally and cooperation with the private sector. Efforts should focus on basic components, building robust frameworks for liquidity support, sound crisis management policies and procedures and good governance and sound strategies for deposit insurance.

- *Good corporate governance is crucial for stable growth.* In the face of globalization and an uncertain future of the global economy, the public sector has expanded its intervention and regulatory scope. However, the great diversity of economies precludes the success of a one-size-fits-all approach. Success in managing a return to prudent growth will require good corporate governance. Identifying milestones can help economies make steady progress in reforming corporate governance practices. Corporate governance scorecards, which have proven very effective, should be considered as a useful tool for checking on commitments.

The dialogue was a reminder to participants that the issues discussed are not entirely new but are instead the same policy concerns that regulators face on any given day and within which market players operate. The key difference however is that the same questions are now being raised in the context of recent and on-going financial market difficulties. The challenge is that stakeholders open themselves to a lot of questions for which the answers are neither obvious nor readily available. The value of this exercise is that we have come to understand that the old answers may no longer apply or that the old questions are no longer in step with current realities.

Moving forward, the dialogue highlighted the importance of a balanced approach to reforms in response to the crisis. International standards need to be recognized as the minimum threshold rather than the limits of regulation. There should be ample room above the threshold to allow for local conditions to be calibrated into governance standards. As financial markets gain their strength in the diversity they offer, which provides options to the public, managing the duality of a minimum threshold and accounting for localized conditions become increasingly important. This can be achieved by allowing idiosyncratic differences in the governance of markets while ensuring consistency with the broad intentions of minimum standards

The dialogue also pointed to the importance of financial inclusion as a key element that must be included in financial regulatory reform efforts. Sustained economic recovery can only be achieved if economies pursue balanced and inclusive growth agenda. Microfinance can play an effective role in expanding access to finance (particularly in the Asia-Pacific region's dynamic emerging markets), which is a crucial factor for attaining balanced and inclusive growth. In addition to ensuring proper regulatory and supervisory oversight of microfinance, this requires an enabling policy environment that financial regulators can help facilitate through their leadership.

APEC can play an important role in promoting capacity-building to assist emerging market regulators in the region in dealing with many of these issues. APEC Finance Ministers can support capacity-building measures involving public-private sector collaboration to help emerging markets in the region improve financial supervisory capacity, calibrate local conditions to global standards, promote the adoption of proven tools such as scorecards to strengthen corporate governance, strengthen financial sector safety nets (including frameworks for liquidity support, sound crisis management policies and procedures and deposit insurance firms' governance and strategies), and promote financial inclusion.

APEC can also support the development of a robust regional financial architecture, including a regional forum of financial regulatory authorities and the financial industry to address regulatory issues in light of the region's needs, review the relevance and impact of global reforms on the region, and ensure that development of global standards take into account market practices and market infrastructure in the region.



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INTRODUCTION

In 2005, the Asian Bankers' Association (ABA), the APEC Business Advisory Council (ABAC), the Pacific Economic Cooperation Council (PECC) and the South East Asian Central Banks (SEACEN) Research and Training Centre jointly held a dialogue between financial supervisory agencies and representatives of the Asia-Pacific region's financial industry. The success of this initial dialogue led to the holding of subsequent similar meetings in the years that followed. On 15-16 June 2010, the sixth annual dialogue was hosted by the Bangko Sentral ng Pilipinas (BSP) in Makati City, Philippines.

Past dialogues have focused on issues that are of great importance to the development and stability of the region's banking systems. These included the effective implementation of global financial regulatory frameworks and how collaboration between the public and private sectors could help in the achievement of this objective. This year's dialogue transpired in the midst of economic and financial uncertainty, as the world emerged from the devastation caused by the global financial crisis. It took place as policy makers and regulators debated on how best to respond to the need for financial regulatory reform in light of regulatory and market failures that have led to the crisis.

Within this context, the region's financial system faces important challenges. First is reconciling financial regulatory reforms being undertaken at the global level with the regional agenda for financial market development and growth. Second is implementing and adapting Basel III to local conditions. Third is strengthening governance of financial institutions. Fourth is strengthening financial sector safety nets. Fifth is strengthening frameworks for global regulatory cooperation. In addition, the region continues to face the challenge of achieving inclusive growth, which is becoming more important as the prospects for the revival of demand in traditional export markets in North America and Europe remain uncertain. These issues were dealt with in the course of the dialogue.

In setting the tone for the dialogue, the keynote address¹ highlighted the importance of preserving the value proposition of financial markets in the region. Among the issues cited were the following:

- There is renewed urgency as the difficulties arising from the crisis compel regulators to re-think the way they govern markets and instil change among practitioners. Rules of engagement are being modified. More market players are seeking more conservative ways of allocating funds while others seek to actively

¹ The keynote address was delivered by the Honorable Peter Favila, Monetary Board Member of the Bangko Sentral ng Pilipinas.

restructure balance sheets. Regulators are more explicitly concerned about financial stability and are taking a different look at regulatory intervention.

- The general public is increasingly concerned about the safety of their saving. With the crisis shaking confidence in markets and financial institutions, calls for stronger safety nets have grown. In response to this, various initiatives are underway to modify global standards, including those governing bank capital, accounting, auditing and corporate governance.
- A challenge arises from the tension between financial markets' dynamism and inherent ability to thrive on gaps on one hand, and market economies' inability to properly function if financial markets are in disarray, on the other. Regulators acknowledge the important role of private sector interests in the business of banking but remain fully cognizant of the general public's concern for the safety of savings. In responding to the need for reforms, regulators must walk the fine line between putting in place covenants that better protect the public and eliminating market dynamism as a result of the added controls.
- Nurturing the value proposition of financial markets requires stakeholders to work together toward responsible change, which balances key objectives and interests. For the real economy to thrive, change must ensure businesses' continued access to capital. For financial institutions, it should ensure sufficient leeway to create viable markets out of mobilized funds, transforming tenors and managing risks in the process. For regulators, it must define regulatory boundaries that enable them to take immediate and decisive action without micro-managing financial institutions. For the public, it must reaffirm and restore faith in financial markets, protecting savings within responsible limits while enabling people to take risks when the capacity to do so is in place.

The various sessions that followed focused on a number of issues (for details, see the program of the dialogue, presented at the end of this report as Appendix A). Sessions 1 and 2 discussed the challenges and issues in the economic and financial environments. Sessions 3, 4, 5, 6 and 8 focused on different aspects of the post-crisis financial regulatory environment. Session 7 discussed the role of the financial sector in promoting inclusive growth. In reflecting the presentations and discussions in the dialogue, this report follows, in modified form, the outline of the program.

I. CHALLENGES OF THE POST-CRISIS ECONOMIC AND FINANCIAL ENVIRONMENT

A. The Post-Crisis Global and Regional Economic Outlook

The presentations in this session² focused on the economic outlook and the impact of current macroeconomic and monetary policies on Asia's economies. By the middle of 2010, global conditions have shown some improvement, with major industrial economies expected to post positive growth for the year after a 3.5% contraction in 2009. World trade was expected to post a 7.1% growth in 2010, recovering from a significant 12% contraction in the previous year. Annual inflation in G3 economies was predicted to average 1.4%, up from a 0.2% fall in 2009.

² Presentors in this session were Mr. Diwa Guinigundo (Deputy Governor, Bangko Sentral ng Pilipinas), who acted as chair and spoke on the global macroeconomic outlook in 2010 and beyond; Mr. Joseph E. Zveglich, Jr. (Assistant Chief Economist, Economics and Research Department of the Asian Development Bank), who discussed the economic outlook for Asia's economies; and Mr. Cheung Tai Hui (Regional Head of Research for Southeast Asia at Standard Chartered Bank), who provided an overview of the impact of current macroeconomic and monetary policies on Asian economies.

In Asia, recovery has been taking a firm hold, promoted by a variety of factors across economies that range from remittances-backed consumption in the Philippines to investment in China. Substantial fiscal stimulus, however, played a very important role, as reflected in the deterioration of fiscal balances throughout Asia. Growth in emerging markets, particularly in East Asia, has been able to partly offset slowdowns in developed economies. Inflation pressures are beginning to emerge, but remain manageable, while current account surpluses have been narrowing.

However, an uncertain global outlook and volatile capital flows pose risks to the recovery. Short-term, risks arise from the possibilities of a mistimed exit from policy stimulus, sharp rises in commodity prices, deterioration of fiscal positions and continued weakness in US mortgage markets. The Greek debt crisis raised fears of contagion. Until it erupted, Greece had remained relatively calm throughout the time of the Lehman shock, when Asian markets experienced significant volatility. Medium-term risks to the global outlook focus on a failure of international policy coordination and persistence of global payments imbalances.

For the Asian region, the major risks include rising food prices, poor international policy coordination, volatile capital flows and asset price bubbles. Capital flows to emerging Asian economies have been very volatile over the past three years, and the recovery of investors' risk appetites poses problems for Asian central banks as they contemplate exits from loose monetary policy. Risks of asset bubbles are particularly of significant concern in China and Hong Kong.

By the end of the first quarter of 2010, Asian recovery has been driven by fiscal stimulus, exports and consumption. China led this recovery, followed by India, Indonesia and Vietnam. Others, such as the Philippines, Singapore, Thailand, Korea, Malaysia and Chinese Taipei, were still approaching full recovery but have already surpassed pre-crisis levels. The decade has proven to be one of great volatility in economic growth in the region's emerging markets due to various factors. Among these were the crisis, price controls, inflation, and the large proportion of expenditures taken up by food and energy, which have experienced high price volatility.

While the region's exports have fully recovered and consumption, measured by indicators such as air traffic and retail sales data, has shown a clear upward trend, the outlook for investment has not been as encouraging. Most businesses have adopted a wait-and-see attitude in view of remaining excess capacity and concerns about the need to preserve working capital in the face of continued uncertainty. In this context, exports, government stimulus and consumption are expected to remain as the major drivers of growth in the region. Nevertheless, Asia remains vulnerable due to its continued dependence on the US and the EU, which still account for a large portion of the region's trade.

Asia continues to enjoy financial markets' confidence. Average credit default swap (CDS) spreads for four Southeast Asian economies (Indonesia, Malaysia, the Philippines and Thailand) have fallen by almost 650 basis points from post-Lehman peaks by mid-2010. Asian currencies have been appreciating vis-à-vis the dollar in spite of continuing risk aversion. Foreigners have been raising their stakes in several Asian government bonds, as reflected in bond yields. Behind these developments is investors' perception that, unlike their Eastern European counterparts, Asians in general borrow in order to invest rather than to consume.

Nevertheless, financial markets remain concerned about a number of issues surrounding the global financial system. One uncertainty arises from the massive expansion of public sector debt since the crisis and how eventual deleveraging will affect the economy. Another uncertainty relates to whether and how financial regulation can be coordinated across the world. A third focuses on the conflicting

impact of loose monetary policy, on one hand, and tighter financial regulation on the other.

The balance between growth and inflation has been another important concern. Fiscal and monetary policy options are more plentiful in Asia compared to the West. Governments and central banks are dealing with a number of difficult issues. One is the issue of timing, and the need to promote recovery while managing inflation and avoiding inflation volatility. Asian central banks are grappling with the issue of whether to use capital controls to mitigate the impact of loose monetary policy in the US and Europe. Another is the role of exchange rates, given their impact on export competitiveness and inflation.

The discussions that followed centered on whether the current US policy of fiscal stimulus coupled with loose monetary policy is the right solution to recovery. There are signs that this policy might be causing the crowding out of lending to the private sector, especially SMEs, which are major contributors to employment growth and, unlike large corporations, are in need of funds. If this analysis is correct, the US economy could enter a difficult period, possibly another recession, once the effects of current stimulus packages wear out.

B. Financial Market Conditions in the Aftermath of the Global Financial Crisis

Speakers from the IMF and the private sector³ updated participants on the state of current financial market conditions. As output recovered in early 2010, banks' losses have also moderated. However, risks to global financial markets have increased, with banks in developed economies coming under stress due to a number of factors. One is rising sovereign risks, which have started to pose a threat to recovery, as debt burdens affect several economies in Europe. Another factor is continued inadequacy of capital buffers for some smaller banks.

Funding market strains are reappearing and banks are not lending to each other, as reflected in the development of forward-overnight indexed swap spreads and basis swaps and the euro-US dollar 5-year basis swaps. This has increased the need for renewed liquidity support from central banks. In developed economies, downside risks have been rising due to growing fiscal vulnerabilities. Public debt relative to GDP has been rising in a number of key economies, with the required adjustments in primary fiscal balances increasing. Revenue loss has been the main contributor to the worsening fiscal situation in advanced economies, accounting for about half of the total debt increase in G20 advanced economies projected for the period 2008-2015.

Asia is not expected to be immune from the impact of these developments. It is true that, with respect to funding, Asian banks have limited exposure to European banks, broadly stable cost of capital and face only moderately higher US dollar funding pressures. However, bank de-leveraging in Europe could have adverse repercussions in Asia through its impact on corporate spreads.

With respect to capital flows and asset prices, compared to the Asian crisis, this time around domestic demand in Asia has remained resilient and capital inflows have returned quickly. With the shift of investors out of cash leading to increased portfolio

³ Presentors in this session were Dato' Ooi Sang Kuang (Deputy Governor, Bank Negara Malaysia), who acted as chair and spoke on the impact of global responses to the crisis on Asian emerging markets and challenges for monetary policy; Mr. Mahmood Pradhan (Senior Advisor of the IMF Asia-Pacific Department), who discussed post-crisis development and prospects of global financial markets; and Mr. Dilshan Rodrigo (Deputy General Manager for Risk of Hatton National Bank PLC of Sri Lanka), who gave a presentation on the outlook for emerging Asian banking and capital markets.

flows to emerging markets, the major risk lies in global equity market weakness and volatility and bubbles in certain sectors, although this is not a system-wide problem.

From an Asian banking industry perspective, concerns converge on a number of trends. One is the dampening impact on global recovery prospects of persistent uncertainties surrounding European financial institutions. A second trend is the politicized atmosphere in developed economies behind efforts to reform regulatory rules and financial industry practices. A third is the additional strain on global banks that is expected to come with new additional Basel requirements. These developments have created much uncertainty that has considerably slowed down the pace of globalization of the banking industry.

Important to consider are specific regional characteristics of the Asian banking sector that set Asian banks apart from their Western counterparts. First, governments have a large influence in the Asian banking sector due to the higher levels of state ownership of financial institutions. Second, Asian banks have healthier ratios of loans to deposits. Their excess of deposits over loans has remained positive and continued to grow after 2006 even as the figure for listed developed market banks turned negative during these years. Third, there is still much potential to improve financial inclusion in Asia, where banking assets as a percentage of GDP remain relatively low.

Given these trends and characteristics, Asian banks face specific challenges. Being dependent on manufactured exports, Asian economies are not likely to develop in the same direction as many other emerging markets, whose exports are dominated by commodities. There is higher dependence on cross-border trade compared to other emerging regions. Excess liquidity in local currencies has led to overheating markets in government bonds and equities.

Asian banks also face more unpredictable regulations as authorities begin to implement new global financial sector standards adopted in response to financial sector weaknesses in Western economies with significantly different local settings. Overheating markets have prompted regulators to impose new restrictions, such as on property ownership, expansion of branch networks and operations of foreign-owned banks. In the wake of the recent introduction of measures to rein in inflation and asset bubbles, there are concerns about a possible downturn in China, which plays an important role in the region's economy.

With all its difficulties, the current situation presents opportunities that have not been lost on both foreign and local banks that are moving to turn the crisis to their own advantage. Foreign banks are refocusing on wholesale banking and high net worth individual clients. They are expanding partnerships and alliances in order to draw more expertise for global markets. They are leveraging their expertise in treasury and capital markets and are shoring up their capital, e.g., through issuances in host markets.

Many local emerging market banks, on the other hand, are moving aggressively to penetrate the corporate and trade finance businesses. They are seizing opportunities in the presence of diasporas of home market customers overseas, e.g., by offering new deposit products. Local banks are leveraging on their competitive advantages in domestic markets, and are opening new channels for delivery of financial services such as mobile phone banking, which is being encouraged by governments to increase financial inclusion. Within Asia, large banks are beginning to resort to a "string of pearls" strategy, acquiring a number of smaller banks that are expected to add value to their operations and expand their geographical presence.

These trends and movements are leading Asia's banking sector toward greater consolidation. With their aggressive expansion, local banks are expected to increase their market share over foreign banks in their domestic markets. While government

banks are focused on domestic markets, private sector banks are expanding regionally. Financial inclusion is becoming an imperative that governments and regulators are likely to push in coming years. Regulators, on the other hand, will be under increasing pressure to open up markets, but will then face the challenge of how to deal with the risk of capital flight.

The discussions that followed stressed the various monetary policy challenges that now face Asian central banks. These include the management of capital inflows, in view of the large costs that could arise from sterilizing such inflows. Asian central banks also face the problem of appreciating currencies and how to smoothen exchange rate movements, which have been subject to excess volatility. Preventing asset price bubbles in the face of capital inflows is another issue, and some monetary authorities have been forced to adopt special measures for this purpose.

Asian central banks are also challenged by their economies' relatively rapid recovery from the crisis under a continuing low-interest rate global environment. Monetary policy frameworks that have been in place since the 1970s and 1980s, when inflation targeting was introduced, are undergoing a reassessment in view of the role that asset prices have played in the genesis of the recent crisis. Finally, there is now a greater need for global and regional policy coordination and resolution mechanisms.

Discussions also focused on the consequences of quantitative easing. In the US and the UK, quantitative easing has been applied with sufficient force in order to unfreeze markets and avert a much larger downturn. However, the question of how to unwind these measures in a way that ensures smooth adjustment has placed these economies in uncharted waters. Considering the large amount of mortgage-backed securities remaining in the Federal Reserve's balance sheet, it seems inevitable that US taxpayers will eventually have to bear the cost.

Further discussions ensued on how monetary authorities should deal with asset price bubbles. There was a strong sentiment that the pre-crisis approach that strictly focused on headline inflation while ignoring excessive credit growth, an important indicator of financial leverage and excess, was deeply flawed. There was acknowledgement of the need for monetary authorities to look at a broader range of indicators that include asset prices and to lean against the wind, even though it is never easy "to take away the punchbowl once the party has started to get wild."

II. CHALLENGES OF THE POST-CRISIS FINANCIAL REGULATORY ENVIRONMENT

A. Global Regulatory Reform and the East Asian Financial Agenda

Speakers provided perspectives from a multilateral development institution, a financial regulatory agency and the private sector⁴ discussed the work of the G20, the question of synergy between global and regional efforts and how current financial regulatory reforms could affect the financial industry.

⁴ Presentors in this session were Mr. Takashi Kihara (Director for Administration, Management and Coordination of the Asian Development Bank Institute), who acted as chair and discussed regional cooperation to develop, strengthen and integrate Asian financial markets; Mr Sjamsul Arifin (Advisor to Deputy Governor, Bank Indonesia), who discussed the future directions of the G20's agenda for strong, sustainable and balanced growth and for strengthening the international regulatory system; and Mr. Nicholas de Boursac (Managing Director, Asia Securities Industry and Financial Markets Association), who commented on the impact of global and regional financial sector reform initiatives on the financial industry.

1. Future Directions of Global Financial Regulatory Reform

Regulatory reform is currently being shaped by the need to respond to a combination of underlying factors that caused the recent crisis. The first set of factors relate to macro-policy drawbacks, which include several consecutive years of ultra-loose monetary policy in the US and Europe, overly optimistic investor assessments in the context of high global growth, the search for yield, persistent global imbalances and bubbles in the property and financial sectors.

The second set of factors relate to market drawbacks, which include an imprudently rapid pace of global financial integration, notional values of financial assets rising far above real asset values, inconsistent and opaque asset valuation, investors' overdependence on credit rating agencies (CRAs) and consequent lack of due diligence, and conflict of interest issues surrounding the operations of CRAs.

The third set of factors relate to supervisory drawbacks, which include the lack of effective supervision of the shadow banking system, narrow focus of firm-centric supervision on the soundness of individual financial institutions, failure of regulators to oversee systemic risks, and the lack of effective cross-border oversight of large and complex financial institutions.

The G20's response focused on three key initiatives.

First, the G20 adopted the *Framework for Strong, Sustainable and Balanced Growth* (FSSB) at the 2009 Pittsburgh Summit. This framework committed members to work together in adopting macro-economic policies that are consistent with price stability and promote adequate and balanced global demand, and in making decisive progress on structural reforms that can foster private domestic demand, narrow the global development gap and strengthen long-term growth potential.

The G20 aimed to achieve durable recovery through the FSSB. Strong growth would involve closing the current output and employment gap, converging to the growth rate of potential output and increasing long-term potential output through structural reform. Sustainable growth would be based on sustainable public finance, price and financial stability, resilient to external shock, determined by competitive market forces and consistent with social and environmental policy goals. Balanced growth would ensure that growth is broadly based across all G20 economies and regions, will not generate persistent and destabilizing internal or external imbalances, and is consistent with broad development goals.

The G20 agreed on a process to ensure that policies fit together and are collectively consistent with more sustainable and balanced growth. This process involves a mutual assessment process based on an IMF report containing three alternative scenarios. The base case scenario was the projected outcome of the global economic outlook based on data and information provided by G20 members. The upside scenario assessed the impact of taking additional collective action beyond what members were currently pursuing. The downside scenario explored the implications of key risks for the G20 if they were to materialize.

Developments in 2010 highlighted the urgency for credible actions in order to improve the economic outlook. Renewed turbulence, particularly arising in Europe, has sharply increased the downside risks. Announced policy measures in response to this turbulence failed to calm the markets, with risk aversion growing in view of market perceptions that measures are not adequately coordinated and unclear, and that policy decisions are ill-timed. It has become more important than ever to prevent more recent financial shocks from further dampening future growth by aiming for policies that produce maximum global benefits. These policies include fiscal consolidation and financial sector repair and reform in advanced economies and structural reforms in both advanced and emerging surplus economies.

Second, the G20 adopted the *Agenda for Strengthening the International Financial Regulatory System*, focusing on reforms grounded in a commitment to free market principles and based on five principles, which are (a) strengthening transparency and accountability, (b) enhancing sound regulation, (c) promoting integrity in financial markets, (d) reinforcing international cooperation, and (e) reforming international financial institutions. The financial sector reform agenda consisted of two parts: reforming financial regulation and strengthening market integrity and transparency.

The reform of financial regulation focused on regulatory capital and liquidity reform and accounting standards convergence.

- Regulatory capital and liquidity reform is needed to ensure that banks hold sufficient amounts of high-quality capital in good times to enable them to better withstand crises. Reforms center on the quality, consistency and transparency of capital; the risk coverage of the capital framework (e.g., counterparty credit risk); the leverage ratio as a supplementary risk-based capital; countercyclical capital framework; forward-looking provisioning framework and new liquidity standards for internationally active banks. A major challenge in this area is how to lessen the risk of unintended consequences, particularly the possibility of economic and financial recovery becoming derailed.
- The need for accounting standards convergence has increased as the expansion of cross-border investment and capital flows has led to the growing demand for a single set of high-quality global accounting standards. Key to progress is the collaboration between the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) in converging accounting standards, particularly with respect to financial instruments (e.g., the use of fair value) and to expected loss provisioning (e.g., impairment standards based on an expected loss model as part of the effort to mitigate procyclicality). However, the risk remains that IASB and FASB may end up with large divergences in accounting for financial instruments.

Work on strengthening market integrity and transparency has focused on compensation reform; over-the-counter (OTC) derivatives regulation and market infrastructure; systemically important financial institutions (SIFI) and crisis resolution; and other reforms including those related to hedge funds, credit rating agencies and securitization.

- The need for compensation reform arose from the widespread concern that remuneration practices in the financial industry have encouraged excessive risk-taking and too much focus on short-term gains, factors that have led to the global financial crisis. In response, the Financial Stability Board (FSB) has established the Principles for Sound Compensation Practices, which covered corporate governance, compensation and capital, pay structure and risk alignment and disclosure and transparency. However, full implementation by domestic regulatory bodies remains far from complete and more efforts are needed to maintain the momentum of reforms through 2010 and beyond.
- Improvements to the infrastructure of OTC derivatives and credit default swaps (CDS) markets are seen as necessary in light of the recent crisis. G20 leaders agreed that standardized OTC derivatives should be traded on exchanges or electronic trading platforms and cleared through central counterparties (CCPs), and that OTC derivatives should be reported to trade repositories. The International Organization of Securities Commissions (IOSCO) recommended that the industry undertake measures to stabilize CDS markets and initiated work on revised standards for payment, clearing and settlement systems. The Basel Committee on Banking Supervision (BCBS) proposed to raise capital

requirements for OTC derivatives and began work on creating stronger capital incentives to move such contracts to CCPs.

- With the recent financial crisis highlighting the social and financial costs to the taxpayer and the wider economy of a collapse of SIFIs, the G20 and FSB started to consider special regulations for these institutions. Proposals included the raising of prudential standards for SIFIs commensurate to the potential costs of failure and policy reforms to reduce moral hazard on the part of SIFIs. These reforms aim to reduce the probability and impact of failure, improve capacity to resolve cross-border firms in times of crisis and reduce interconnectedness and the risks of contagion. However, significant issues remain to be resolved at the political level, including whether taxpayers or shareholders should ultimately bear the losses.

In sum, the G20 has recognized the urgency of taking concerted policy responses to accelerate economic recovery and of reforming the regulation of the financial sector and announced commitments to address these issues. However, it remains to be seen as to whether such commitments will be fully implemented and can deliver the intended outcome.

2. Achieving Synergy Between Global and Regional Efforts

The crisis has given impetus to global efforts to repair and reform global financial systems, with the G20 playing a central role in these efforts. The meeting of G20 finance ministers in Busan, Korea in June 2010 produced a number of agreements on where these efforts will focus, which will be in the following areas:

- Transparency, strengthening of banks' balance sheets and corporate governance of financial firms;
- Stronger capital and liquidity standards, to be embodied in new internationally agreed rules developed by the Basel Committee on Banking Supervision (BCBS) that will improve both the quality and quantity of bank capital and discourage excessive leverage and risk taking;
- Phasing in of new rules as financial conditions improve and economic recovery is assured;
- Use of quantitative and macroeconomic impact studies to inform the calibration and phasing in of measures; and
- Stronger supervision to complement the implementation of new rules.

Parallel to these efforts, there have been ongoing major initiatives in East Asia to strengthen and develop the region's financial markets, dating back to the years immediate following the 1997-98 Asian financial crisis. One of these grew out of the Chiang Mai Initiative (CMI), which was launched to address balance of payments and short-term liquidity problems in the region and to supplement existing international financial arrangements. Under the CMI, the 13 economies comprising the ASEAN+3 established a network of bilateral swap arrangements (BSAs) with a total value of US\$64 billion among them.

In March 2010, a new multilateralized version of the CMI, now called CMIM, came into effect. The multilateralized CMI consolidated the bilateral arrangements into a single contract and expanded the total size to US\$120 billion. Under this arrangement, the central bank of any participating economy may swap their local currencies with US dollars up to the amount corresponding to their respective

contributions multiplied by the agreed upon purchasing multiples.⁵ Liquidity support drawn through a bilateral currency swap matures in 90 days and may be rolled over for a maximum of seven times.

On the CMIM's institutional structure, the two economies co-chairing ASEAN+3 at the time when a request for drawing is made will coordinate the swap activation process. Fundamental issues, including the total size of CMIM and contributions, are determined by consensus at the ministerial level. Executive level issues, such as the initial execution of drawing, renewal, default events, are decided by a two-thirds majority of an executive-level decision-making body.

To complement this structure, a regional macroeconomic surveillance unit called the ASEAN+3 Macroeconomic Research Office (AMRO) has been created. To be based in Singapore, the AMRO will have the task of monitoring and analyzing developments in member economies for the purpose of early detection of risks, swift implementation of remedial actions and effective decision-making.

This enables CMIM to ensure that parties requesting for drawing meets conditions before voting for a swap request, particularly the completion of the review of the party's economic and financial situation. CMIM parties are also expected to comply with covenants such as submission of periodic surveillance reports and participation in regular economic review and policy dialogues.

Another ongoing initiative to develop the region's financial markets is the Asian Bond Markets Initiative (ABMI), which was launched to address the double mismatch problem in many economies that has given rise to the Asian financial crisis. In launching the ABMI in 2003, ASEAN+3 intended to develop local currency bond markets with a view to facilitating the use of the region's private savings for regional development.

These efforts have helped to significantly expand the size of emerging East Asia's bond markets. Work is now focused on increasing the size of the corporate bond markets, which have grown but are still far too small relative to government bond markets. A new roadmap for ABMI was recently created, focusing on four key areas:

- Promoting issuance of local currency bonds. This includes work on a credit guarantee and investment mechanism, promotion of a medium-term note program, debt instruments for infrastructure financing and development of derivatives and swap markets.
- Facilitating the demand for local currency bonds. This includes work on the development of a favourable investment environment for institutional investors through development of repo markets, enhancing cross-border transactions by improving regulations on capital movement and non-resident taxation, and dissemination of efforts under ABMI to institutional investors in the region.
- Improving regulatory frameworks. This includes work to facilitate collaboration among securities dealers' associations and promoting the application of accounting and auditing standards that are broadly consistent with international standards.
- Improving market infrastructure. This includes work to facilitate discussions by private sector participants on regional settlement systems, increasing the liquidity of bond markets, such as through the development and maintenance of

⁵ The financial contributions in US\$ billion (and purchasing multiples, in parenthesis) are as follows: (a) Japan – 38.4 (0.5); (b) China – 34.2 (0.5); (c) Hong Kong, China – 4.2 (2.5); (d) Korea – 19.2 (1); (e) Indonesia, Malaysia, Philippines, Singapore and Thailand – 4.552 each (2.5 each); and (f) Vietnam – 1 (5); (g) Cambodia – 0.12 (5); (h) Myanmar – 0.06 (5); and (i) Brunei and Lao PDR – 0.03 (5).

benchmark yield curves, and fostering a credit culture, such as through the development of a credit risk database.

At their 13th meeting in Tashkent, Uzbekistan in May 2010, the ASEAN+3 Finance Ministers announced the establishment of the Credit Guarantee and Investment Facility (CGIF), a trust fund of ADB with an initial capital of US\$700 million that aims to support corporate bond issuance in the region starting in late 2010. They also endorsed the establishment of a technical working group to discuss a regional settlement intermediary and of the ASEAN+3 Bond Market Forum, which aims to foster standardization of market practices and harmonization of regulations related to cross-border bond transactions.

The development of local currency bond markets is of particular importance for Asia for several reasons. One, the region's ageing population requires the financial sector to be able to respond to shifting asset demand, channel the region's currently ample savings into investment and efficiently utilize savings, which are expected to eventually decline. Two, there is a need to address the scarcity of long-dated government bonds in ASEAN and even in G10 economies, relative to the size of pension fund balances. Three, a more balanced financial structure is needed to reduce overdependence of some economies on the banking sector and thus to strengthen financial system stability.

Major efforts now being undertaken to overhaul financial regulation at the global level both necessitate and provide opportunities to develop synergies between global and regional financial reform, development and integration processes. A joint ADB-ADB Institute flagship study⁶ suggests three areas where such synergies can be developed:

- Crisis prevention. At the domestic level, a comprehensive structure bringing together key supervisory authorities should be established with clear objectives and responsibilities for monitoring private institutions' prudential behaviour. This could be implemented by establishing a framework for effective macro-financial surveillance and action, preferably involving a high-level systemic stability regulator empowered with a legal mandate and equipped with policy tools separate from monetary policy. Steps should also be taken to reduce procyclicality through positive incentives to promote adoption of countercyclical buffers and similar mechanisms, in addition to the removal of perverse incentives in capital requirements, capital buffers and accounting valuations. At the regional level, the surveillance process should be strengthened and made more effective by being supported by the ASEAN+3 Macroeconomic Research Office (AMRO) of the CMIM, and by unifying the Finance Ministers' process through the ASEAN+3 and the central banks' process through the EMEAP. Surveillance also needs to be extended outside the region, in light of Asia's dependence on exports and exposure to capital flows.
- Crisis management. Financial authorities should enhance coordination to cover all possible phases of a crisis, ensuring that there are credible ex-ante means of handling failures in all financial institutions (in particular those that operate across borders) and that there are effective deposit insurance systems. Substantially enhanced regional mechanisms, such as the CMIM and an Asian Financial Stability Dialogue (AFSD), could help improve resilience against shocks.
- Further efforts to develop bond markets. These would include encouraging more international participation in local currency bond markets; improving government debt management particularly through maintenance of a reliable set of risk-free

⁶ Masahiro Kawai and Jong-Hwa Lee (eds.), *Rebalancing for Sustainable Growth: Asia's Post-Crisis Challenge* (ADB/ADB Institute 2010).

benchmarks and adequate liquidity; improving market infrastructure to allow issuers to hedge maturity and currency risk; encouraging expanded coverage of private issues by credit rating agencies; strengthening domestic credit rating agencies and harmonizing rating practices across the region; and regional integration of markets, including development of a market for bonds denominated in an Asian Currency Unit (ACU).

The ADB-ADBI study argues that, within the region, greater efforts are needed to promote rebalancing for sustainable growth, focused on a number of key areas. First, a region-wide economic partnership agreement would promote intra-regional trade in goods and services and investment. Second, strengthening the CMIM through the establishment of an effective independent surveillance unit could lead to the eventual development of an Asian Monetary Fund (AMF) and the establishment of an AFSD to foster financial sector policy coordination. Third, the region should promote increased infrastructure investment and the development of bond markets through an Asian Infrastructure Investment Fund, the ABMI, Asian Bond Funds and issuance of ACU-denominated bonds. Finally, exchange rate policy coordination could help promote orderly movements of Asian currencies against the US dollar to enhance macroeconomic and financial stability and facilitate global rebalancing.

With the G20 emerging as a leading global forum for economic policy cooperation and coordination, it is important for Asia to ensure that its voice is reflected in major global dialogues and policy development. The region should consider developing regional institutions that can work with and strengthen the functioning of their global counterparts in the following areas, with the aim of promoting growth and financial stability:

- Macroeconomic cooperation. An AMF, evolving from the CMIM, could be responsible for regional surveillance, stability and crisis lending to complement the IMF's global surveillance, stability and crisis lending roles.
- Development finance. The ADB could enhance its work on open regional priorities and infrastructure to complement the World Bank's role with respect to global public goods, poverty and the environment.
- Trade liberalization. A Comprehensive Economic Partnership Agreement for East Asia that could emerge from the consolidation of existing FTAs and RTAs into deeper and wider agreements would complement WTO mechanisms for global disciplines, dispute resolution and Article XXIV implementation.
- Financial system stability. An Asian Financial Stability Dialogue can be created to focus on region-specific regulatory initiatives to complement the work of the Financial Stability Board in promoting global standards and regulatory colleges.

3. Regional Private Sector Perspectives on Current Regulatory Reform Efforts

From the standpoint of securities industries in Asia, in general, while there is support for regulatory reforms in principle, three key principles need to be kept in mind. (a) Regulators should guard against financial fragmentation and protectionism. (b) The aggregate impact of global reform measures should be adequately assessed, particularly the merits of individual initiatives, their aggregate impact on investors, capital flows and loan growth, economic growth and job creation, and their impact under low growth scenarios. (c) Reforms should be undertaken with regulatory transparency through extensive consultation with industry, full impact analysis, a transition period for implementation, appropriate grandfathering terms and consistent compliance and enforcement.

Avoiding financial fragmentation and protectionism would require coordinated efforts to ensure a level playing field and to avoid imposing new barriers to market entry,

avoid distortion to competition and avoid the creation of opportunities for regulatory arbitrage. Timing will need to be coordinated. Reform measures across the globe being undertaken by such bodies as the G20, FSB, IOSCO and others should be monitored. However, there is much concern in the private sector on the inability of various authorities to adhere to their governments' commitment at the G20 Pittsburgh Summit to refrain from uncoordinated policy decisions, in view of different challenges they are facing.

More specifically from a regional perspective, there is significant doubt within the securities industry whether a number of reform initiatives being considered in the US and Europe would be seen by Asian economies as beneficial and urgent. As the recent financial crisis originated principally from the North Atlantic region, and many Asian economies have already learned from the Asian crisis and undertaken a number of reforms, it is expected that Asian regulators will adopt a wait-and-see attitude to certain key reform initiatives, monitor their implementation in the US and Europe and evaluate the impact of North Atlantic reforms on Asian markets.

Negative impact of certain reforms in Asia would include significant reduction of liquidity in markets (e.g., through curtailment of short selling); putting Asian banks at a competitive disadvantage due to the lack of deep long-term capital markets to tap in beefing up capital; slowing the recapitalization of the banking sector; reducing the trading of government bonds (e.g., through the Volcker Rule); and extraterritorial impact of North Atlantic legislation on Asian market players.⁷

In Asia, it is especially important for authorities to consider the impact of regulatory reforms on the liquidity of government bond markets. These markets play crucial roles as shock absorbers, as well as in facilitating cost-effective risk management, supporting the development of a sound corporate debt capital market, maintaining a source of liquidity supporting the banking system and reducing systemic risk. Authorities should avoid measures that can inhibit the development of these markets, including withholding and transaction taxes, prohibition of shorting, liquidity requirements, incentives to hold-to-maturity and capital controls.

In this context, authorities should ensure that regulatory reforms serve to strengthen major factors underlying liquid government bond markets. These are disciplined issuance programs involving reopening issues and benchmark issues; a classic repo market; the government bond futures market; quality electronic platforms, price discovery, trading, clearing and settlement; enabling regulatory and tax regimes; and promotion of a broad investor base that includes domestic institutional and retail and international investors.

Sentiments expressed by representatives of the Asian banking industry also reflect the perception that acute public concern in the US and Europe over the crisis has generated very strong domestic political pressures in these economies. These are seen as shaping the G20's agenda in ways that are not always consistent with Asia's interests, and in ways that could penalize Asia's economies, consumers, businesses, and financial institutions for excesses that have occurred in other parts of the world.

There is concern that this poses significant potential for divergence between the G20's direction and the direction of Asian regional efforts, which may also end up damaging regional cohesion and solidarity. As a consequence, it is felt that Asian members of G20 have a very great responsibility to ensure that the outcomes of this

⁷ Two examples are as follows. First, in the case of hedge funds, it will become more difficult for Asia-based fund managers to sell funds in Europe. Second, Asian structured products not subject to US securities laws but rated by credit rating agencies under US regulation (NRSROs) being subjected to disclosure requirements as a result of amendments to US SEC Rule 17g-5(a)(3) that would require NRSROs to make the information available to other NRSROs.

process are consistent with Asian efforts to develop liquid and efficient financial markets, by carefully scrutinizing proposals from other regions and playing a very active role in shaping the G20's agenda.

B. Basel III and its Implications for Asian Emerging Markets

Speakers expressed views from regulatory and banking industry perspectives.⁸ Discussions focused on the BCBS reform program and its impact on banking regulation and supervision and the banking industry in Asian emerging markets; raising the quality, consistency and transparency of the capital base; enhancing risk coverage; supplementing the risk-based capital requirement with a leverage ratio; reducing pro-cyclicality and promoting countercyclical buffers; and addressing systemic risk and interconnectedness.

Responses to the package of proposals contained in the BCBS consultative document approved in December 2009 indicate that there is need for substantial improvement. Among the comments are the following:

- Proposals can result in more appropriate capital and liquidity requirements and lower leverage levels, provided they are adequately implemented.
- The combined effects of proposed capital requirements and buffers are overly conservative and lack transparency; there is no discussion of what constitutes an appropriate level of capital and liquidity in the financial system; macroeconomic consequences need to be carefully evaluated; there is too much focus on mechanical capital regime and formulaic liquidity requirements and not enough consideration of systemic factors and developing a balanced range of regulatory tools.
- Proposals will lead to higher cost of capital, potentially reduced capital supply, increased demand for liquid assets that are not adequately available in the region, reduced availability of credit and increased disintermediation.
- Combined effect of proposals may be inadequate to address underlying cause of the crisis; BCBS should evaluate impact on areas such as availability and cost of credit, availability and demand for liquid securities, competition for deposits, lending capacity, demand for capital and impact on equity markets, and how all these will affect the real economy.
- Proposals could significantly impair efficiency and financial intermediation; stronger capital surcharges on financial institutions alone will not ensure financial system stability; what is needed is an entire package of regulation and supervision; proposals should reflect differences in business models and organizational structures, such as Asian banks' stable base of retail deposits.
- Proposals will increase cost of financial intermediation, especially in the case of banking systems where high quality liquid assets are insufficient to meet new requirements; proposals will also reduce capacity of markets to provide liquidity needed for banking sector's resilience; proposals would impose unnecessary

⁸ Presentors in this session were Mr. Rizalino Navarro (Senior Adviser, Director and Chairman of the Risk Management Committee of the Rizal Commercial Banking Corporation), who acted as chair and discussed the reform of Basel II and its implications for banks in Asian emerging markets; Mr Jason George (Senior Financial Sector Specialist, Financial Stability Institute, Bank for International Settlements Representative Office for the Asia-Pacific), who discussed the reform of Basel II and its impact on Asian regulatory practices; Mr. Hideaki Tanaka (Chief Manager, Basel II Implementation Office, Corporate Risk Management Division, Mitsubishi UFJ Financial Group), who discussed the reform of Basel II from the perspective of an Asian global bank; and Mr. Antonio Paner (Head of Treasury, Bank of the Philippine Islands), who discussed the reform of Basel II and its impact on Southeast Asia.

penalties on banking systems in certain economies that have relatively low debt levels.

Key proposals coming out of the Asian financial industry are as follows: (a) Implementation of reforms should be coordinated globally and be internationally consistent, while taking into account economic conditions, business models and tax and accounting systems particular to each economy. (b) The impact of new regulations on the cost of doing business and on capital markets should be reviewed and evaluated. (c) There should be close consultations and dialogue with the private sector to determine what constitutes an appropriate level of capital and liquidity in financial systems.

The 2008 Washington DC G20 Leaders Declaration clearly placed responsibility for the crisis not just on banks, but also on policymakers, regulators and supervisors in some advanced economies, who “did not adequately appreciate and address the risks building up in financial markets, keep pace with financial innovation or take into account the systemic ramifications of domestic regulatory actions.”

Key elements of the BCBS reform program under discussion are (a) capturing all significant risks in the capital framework; (b) raising the quality of the capital base; (c) introducing a leverage ratio as a backstop to the risk-based requirement; (d) building buffers to withstand shocks; and (e) better supervision and risk management. From the BIS standpoint, it is important that regulatory reforms are coordinated (to ensure level playing fields and avoid regulatory arbitrage).

However, finding the proper balance between national discretion (which is amply needed) and consistency in implementation is a very difficult challenge. Implementation of agreed rules will also be meaningless unless complemented by strong supervision. There is therefore a real need in the region to address a perennial challenge facing supervisors worldwide – ensuring that they have adequate resources and authority as well as appropriate organizational frameworks and constructive relations with other agencies.⁹

In a June 2010 interim report on the cumulative impact on the global economy of the proposed changes in the banking regulatory framework, the Institute of International Finance (IIF) noted that the impact of specific changes on growth would be uneven across emerging markets, with Emerging Europe (where Western European banks play very significant roles) and Latin America suffering the most. Africa and the Middle East are expected to be the least affected (mainly by liquidity measures); while Asia will be mainly affected by higher capital ratios (although in this case more than any other developing region) and liquidity measures.

It is understandable that there is resistance in Asia to certain measures being implemented, although Asian financial institutions are already moving to increase their capital. The BIS currently expects that implementation of the new standards will result in a more stable banking system, lower risk premia and more efficient allocation of resources. However, it is also expected to lead to increased costs of funding. Overall, it is expected to have a mild negative impact on GDP growth (between 50 and 100 basis points), which, it is argued, would be a small price to pay for the added financial benefits.

⁹ In this context, five key documents are important: (a) Good Practice Principles on Supervisory Colleges (Consultative Document, March 2010); (b) Report on Cross-Border Bank Resolution (March 2010); (c) Principles for Enhancing Corporate Governance (Consultative Document, March 2010); (d) Compensation Principles and Standards Methodology (January 2010); and (e) Pillar Two Enhancements (July 2009). Unresolved questions include (a) how much national discretion and how much consistency; (b) cumulative impact assessment; (c) implementation and timing; (d) capital composition; (e) leverage ratio; and (f) countercyclical measures.

From a commercial banking perspective, regulatory reforms being contemplated will have significant impacts on large internationally active Asian banks. The leverage ratio could penalize commercial banks for taking excess deposits over loans. The net stable funding ratio (NSFR) would encourage long-term funding from the market rather than funding through demand deposits. Measures to address pro-cyclicality such as capital buffers and forward-looking provisioning mainly focus on lending activities of commercial banks. In this context, it is seen as more desirable to address leverage and cover the NSFR within Pillar 2 rather than Pillar 1.

Reforms related to the definition of capital also need to be seen in light of certain issues. One is the loss absorbency of Hybrid Tier 1 and Tier 2 capital. During the recent financial crisis, such regulatory capital failed to bear their share of the burden in the case of banks that have effectively failed and started to rely on injections of public funds. It is also necessary to improve systems for dealing with bank failures and to clarify shareholders' responsibilities. In the US and Europe, some banks received public funds without any reduction in common equity. In Japan, the Deposit Insurance Law allows for injection of public funds during crises, where banks can be requested to undergo capital reductions.

Japanese banks' experiences since the 1990s imply that a new framework should not depend excessively on the regulation of equity capital. After the "lost decade" of the 1990s, the Japanese financial regulator launched various counter-measures to revive the financial sector, which included accelerated separation of non-performing loans from balance sheet based on risk assessment; introduction of a deposit insurance safety net; introduction of a resolution framework; and injection of public funds into the major Japanese banks.

Although Japanese banks had relatively low capital levels with low-quality capital components, compared to their Western counterparts, there were no major banking failures in Japan during the recent crisis. This experience highlights the importance of a balanced reform package that incorporates various measures for strengthening the resilience of the banking sector, instead of an excessive dependence on the regulation of equity capital.

Efforts to reform supervisory regulation should also take into account that more regulation usually opens up more opportunities for regulatory arbitrage. Because it is impossible to regulate all finance-related activities, regulation can never prevent arbitrage. In the meantime, more regulation increases compliance costs that regulated institutions need to bear, especially vis-à-vis unregulated institutions. In this context, authorities need to ensure that the regulatory perimeter is adequately assessed.

Basel II implementation in Asia is mostly in the final phases, with most Asian banks adopting the standardized approach for credit risk measurement. It is expected that in general, reforms to the Basel Framework (Basel III) will result in (a) banks needing to hold more equity capital; (b) banks needing to be more liquid; (c) bank earnings becoming less cyclical (due to shift from incurred loss to expected loss provisioning); and (d) banks being subject to greater regulatory intervention (with regulators having to impose capital distribution constraints).

All in all, banks are expected to be subject to less cyclicity but will have lower return on equity. Impact on emerging Asian local banks is not expected to be severe.

- Current Tier 1 ratios (average: 10.7%) are higher than the required minimum of 4%.
- They have a reasonable amount of liquid assets (greater reliance on deposits, which are more stable than wholesale borrowing) and in this respect are better placed than their counterparts in Europe and America.

- Banking in Asia is still focused on basic services without much complex derivative, structured and off-balance sheet activities.
- The adjusted average Tier 1 ratio of 9% is sufficient to clear future requirements.

In the case of Philippine banks, for example, requirements are already higher than Basel (10% CAR vs. 8% under Basel; 6% Tier 1 ratio minimum vs. 4% under Basel), and actual ratios of the banking sector are even much higher (on consolidated basis, 15.68% CAR and 12.28% Tier 1 ratio). Asset quality has been improving, with NPL ratio at 3.37%. Liquidity positions are comfortable and there is a high level of vigilance on the part of the regulator.

Nevertheless, Asian banks will face some challenges with new regulatory reforms, among which will be (a) added costs from the shift in provisioning methodology; (b) need by some banks to raise additional capital; (c) increased authority of regulators to constrain banks' capital distribution; (d) possibility of new liquidity standards increasing demand among Asian banks for high quality assets, which will increase intermediation costs; and (e) implementation challenges (enhancing internal management systems, addressing data issues, building internal and external expertise and risks of unintended consequences).

Overall, costs of banking services are expected to increase, e.g., as a result of excessive capital-raising affecting banks' profitability and the costs being eventually passed on to the consumer. Basel III can lead to a more robust global banking system, but only if it is implemented at the right pace and time.

The discussions underscored the importance of Pillar 2 (effective supervision), which is indispensable. It was pointed out that especially in Asian emerging markets, where a certain preference for Pillar 1 and a reluctance to exercise supervision have been observed, it is important to build supervisory capacity. A number of bankers agreed that relying on rules alone more than the quality of supervision is the wrong approach, as this will only lead to a growing body of complex but ineffective rules.

C. Strengthening Governance of Financial Institutions: Lessons from the Financial Crisis

Speakers¹⁰ focused on the major causes of governance failures leading to the global financial crisis and the role of bank directors in strengthening firm-wide risk management. In the face of globalization and an uncertain future of the global economy, the public sector has expanded its intervention and regulatory scope. However, the great diversity of economies precludes the success of a one-size-fits-all approach. Success in managing a return to prudent growth will require good corporate governance.

In the wake of the recent crisis, closer scrutiny of corporate behaviour has underscored the importance of good corporate governance. There is sharper focus of attention on board composition and the timeliness of data and analysis has become more important. Firms must now have a clearer focus on their target market, closer monitoring of competitors, clearer understanding of business drivers, greater appreciation of legal compliance issues and more attention to the bottom line.

These entail greater demands on corporate directors. Boards are expected to review policies, including employment strategies, and tighten procedures. They must be

¹⁰ Presentors in this session were Ms. Juliet McKee (Advisor on Corporate Governance and Member of New Zealand PECC), who acted as chair and discussed promoting good corporate governance in the region's financial institutions; and Dr. Jesus Estanislao (Chairman of the Institute of Corporate Directors in the Philippines), who discussed challenges and solutions to implementing good corporate governance principles in Asian banks.

capable of exploiting technology and determining true business drivers. They are expected to more diligently identify key performance indicators and monitor performance. They are under pressure to rationalize, and if necessary restructure, operations. These all require better understanding of wider contexts, setting clear strategic directions and communicating these to all stakeholders, who are now demanding greater transparency.

While corporate governance principles are global and universal, their application and implementation need to be adapted to specific local circumstances. It is useful to identify milestones to make progress on the path to reform of corporate governance practices. Such milestones could include: (a) building awareness; (b) commitment to act; (c) checking on commitments; (d) recognition of successes; (e) commitment from the top; (f) enlisting allies; (g) corporate strategy map; (h) cascading up and down; (i) governance scorecards; and (j) governance culture.

A useful tool for checking on commitments is the corporate governance scorecard. An example, which is used in the Philippines, assigns weights to particular areas (based on OECD principles) where the performance of universal and commercial banks are given scores: 15% for rights of shareholders; 10% for equitable treatment of shareholders; 10% for the role of stakeholders in corporate governance; 20% for control environment and processes; 20% for disclosure and transparency; and 25% for board responsibility. The Securities and Exchange Commission and the domestic stock exchange require all publicly listed companies to submit to the questionnaire, while the financial regulator (the central bank) encourages banks to comply.

Applying the scorecard to universal and commercial banks in the Philippines, the banking sector scored highly (84 out of a perfect score of 100), especially in terms of control environment and processes (89) and equitable treatment of shareholders (86). The average score for the banking sector has been higher than that for publicly listed companies (84 against 72). With these achievements, the Philippines has been able to cover the first four milestones in the process of reforming corporate governance practices, and is now working on the next set of milestones.

The use of the corporate governance framework by businesses and local government units has been proven to deliver high-quality performance. Using the assessment methodology has enabled the detection of variations in corporate governance practices among firms within each economy. It has also allowed firms to identify strengths and weaknesses. In the case of business, studies have established a positive relation between the quality of corporate governance practice and market valuation. An overwhelming majority (86%) of local government heads who used the corporate governance scorecard were re-elected.

Governance scorecards are also important in the formulation of long-term strategy. They are being used for the evaluation of performance and assessment of contributions to the corporate strategy map, which in turn should be cascaded and used as effective tools for alignment and monitoring of actual performance. The use of these scorecards facilitates the establishment and nurturing of a governance culture on a sustained basis, in a way that stresses professionalism, ethics and social responsibility.

Because of their special role, banks are subject to higher standards compared to other publicly-listed corporations. The scorecard designated for commercial banks includes special features that focus on risk management practices. Regular stress-testing of universal and commercial banks provide an opportunity for the regulator to invite bank directors of underperforming banks to have a dialogue on capital adequacy, risk profile and governance culture.

D. Strengthening Frameworks for Global Regulatory Cooperation

Speakers¹¹ focused on various issues, including early warning and economic and financial surveillance under the IMF and CMIM frameworks; cross-border crisis management for major cross-border firms and legal frameworks for crisis intervention; resolution tools and frameworks to mitigate failures of major financial institutions and reduce moral hazard; development of an international framework for cross-border bank resolution arrangements; and establishment of supervisory colleges for significant internationally active financial institutions.

As mentioned earlier, Asian regional financial cooperation significantly expanded after the Asian financial crisis. Through the CMIM and AMRO, new regional mechanisms for promoting financial stability have been introduced to play a role alongside existing institutions like the ADB, which is also promoting regional surveillance and financial cooperation, and EMEAP, which undertakes important functions through its monetary stability committee. How to minimize overlaps among these institutions as well as with global institutions like the IMF, more efficiently use resources, and ensure greater complementarity among institutions and processes and their accountabilities are key issues that need to be addressed.

The crisis has led to intensive global efforts to reform regulatory frameworks, particularly under the G20, the FSB, the BCBS and other institutions. Efforts have been focused on a number of issues, which include: (a) additional capital charges for banks; (b) increased regulation for non-bank financial institutions; (c) stress-testing and macro-prudential measures; (d) additional regulations for SIFIs; (e) risk-based compensation policies; (f) capital charges to safeguard against liquidity risk; (g) enhanced disclosure requirements; and (h) closer cooperation among domestic regulators in cross-border supervision.

The crisis has also led to an expansion of regulatory intervention in financial markets in the US and Europe. In the US, the legislature has vastly increased the scope and sophistication of regulation, increased regulatory authorities' resources and authority, and created a consumer protection agency. While retaining key elements of previous deregulation measures and resisting calls for breaking up conglomerates and imposing limits on size of financial institutions, legislators agreed to curb speculative trading activities, proprietary trading by banks and derivatives trading.

In Europe, a plethora of proposals have been considered with the aim of reducing risks in banking and in taming excesses that contributed to the crisis and exacted a toll on taxpayers. Regulators have focused on the issue of additional taxes on banks to finance resolution funds designed to manage future lender failures and to limit contagion. To placate taxpayers, affected governments have been seeking to recover the costs incurred in bail-outs and to take preventive measures to curtail future excesses.

Because increased regulatory intervention and proposed new taxes on financial institutions will involve higher costs, Asian regulators will need to assess the value of specific prudential recommendations of standard-setting bodies and determine costs and benefits of their adoption. Asian economies are also expected to exercise great care in responding to proposals for increasing taxes on the financial industry, considering whether they would see any reason to implement such measures to

¹¹ Presentors in this session were Dato' Ooi Sang Kuang (Deputy Governor, Bank Negara Malaysia), who acted as chair and discussed issues related to financial surveillance under global and regional frameworks, Dr. Olarn Chaipravat (Honorary Advisor, Fiscal Policy Research Institute of Thailand), who commented on the CMIM framework and its impact and contribution to regulatory cooperation, and Mr. Kenneth Waller (Director of the Australian APEC Study Centre at RMIT University), who made a presentation on developing a regional framework to support global regulatory cooperation.

guard against future systemic failure. It is important for Asian economies to review the relevance and potential impact of such reforms on the region.

It is also important for Asian economies to develop an architecture for this purpose and for the purpose of obtaining a better understanding of changing financial conditions affecting systemic stability in the region. Ideally, this architecture should be determined by financial policy makers, regulators and the business sector. It should be guided by principles fundamental to the region's stability – open markets, commitment to open trade and investment, sound financial regulation, structure reform and regional economic integration. It should complement the work of global bodies such as the IMF and international standard setting bodies by developing Asian perspectives on major financial developments and on regulatory reforms. Finally, it should reflect differences in approaches to governance, influenced by the way financial institutions in the region have evolved.

A new regional mechanism or architecture with the objective of minimizing turbulence in financial systems could consider a number of key issues. These include (a) minimizing the impact on the region of changes in investor sentiment due to rising concerns on sovereign debt in Western economies; (b) maintaining trade credit and investment flows during times of constrained global liquidity; (c) sustaining demand and investment in the region in the case of protracted weakness in advanced economies; (d) assessing the suitability of compensation and governance arrangements proposed by the BCBS and others to institutional practices and standards in the region; (e) ameliorating any outbreak of trade and financial protectionism; (f) evaluating the relevance of proposed capital charges to regional financial institutions; and (g) developments in exchange rates.

Asian economies need to enhance cooperation in dealing with these substantive policy issues, so that confidence in the region could evolve to place regional economies as equal and substantial partners of major Western economies and other regional groupings in the formulation and determination of financial policies and regulations that have global and regional impact. They need to establish an architecture to safeguard financial stability in the region and to make fundamental assessments of the long-term costs and benefits and regulatory reforms initiated by international standard-setting bodies. This regional mechanism should also focus on major longer-term issues that will have major repercussions for budgets and fiscal policies and for the development of the region's financial markets and systems.

With the conclusion of the CMIM agreement and in light of most East Asian economies adopting or being likely to adopt either flexible or managed floating foreign exchange rate regimes, they are less likely to suffer from current account crises in the future. However, they still face significant risk of capital account crises resulting from massive outflows of short-term capital as a result of either a sudden loss of confidence in the creditworthiness of one of the economies in the region or a financial panic in other regions (e.g., impact of the Lehman Brothers crisis on Korea), that could result in massive sell-off of shares and government bonds and bring down the value of the region's currencies.

To strengthen the region against such an eventuality, it was suggested that policy makers consider converting the standby CMIM facility into a well-endowed and effectively managed international financial institution, such as an Asian Monetary Fund. This could be accomplished through a number of steps:

- Ensure that the already established ASEAN+3 Monitoring and Surveillance Organization (AMRO) is adequately staffed with high-quality personnel, including experienced technical personnel from existing international institutions outside the region such as the IMF and the World Bank.

- Convert AMRO into AMF as soon as China is ready to shift its currency regime from a managed float to a market-oriented one. Two recent developments signal the growing internationalization of the RMB and the enhanced prospects for its convertibility. One is the recent flotation of RMB bonds in Hong Kong for non-Chinese residents and market-making activities by Hong Kong-based financial institutions for secondary market liquidity. The other is the recent announcement of plans for issuance of RMB-denominated bonds by a major Japanese corporation in Hong Kong, with support from the Hong Kong and Chinese authorities.
- Convert the CMIM standby facility into capital subscription by members, with China (including Hong Kong) and Japan contributing 32% each (in their own currencies) and the rest contributing the remaining 36% (in US dollars) as agreed at the 13th ASEAN+3 Finance Ministers' Meeting, with these assets invested in JPY, CNY and USD government bonds in the proportion 32:32:36 expected to yield an average of 3-4% per annum.
- In case of a crisis in a member economy, upon recommendation of the AMF staff and approval by the AMF Governing Board, that member economy can put in its own currency and swap for any combination of the three convertible currencies. AMF can add value through its deeper understanding of Asian economies and help avoid mistakes committed during the Asian financial crisis.

The discussions highlighted the highly fragmented situation of Asia's financial market infrastructure, compared to Europe and the US. While regional surveillance efforts are very welcome, it is important to have parallel regional efforts to ensure that global standards are developed taking into account market practices and market infrastructure in the region. There is a need for a regional financial forum in Asia to address regulatory issues in the light of the region's needs. Collaboration between regulators and the private sector is very important, as demonstrated by the experience of Europe, where private sector input is solicited in the process of designing regional structures.

Discussions also emphasized the importance of collaboration between regulators and the private sector in ensuring that regional surveillance is effective in providing systemic stability. A lesson learned from the disconnect between regulators and markets in developed economies that led to the crisis is that there should be intense exchanges between regulators and the financial industry.

E. Strengthening Financial Sector Safety Nets

Speakers¹² focused on major elements of financial sector safety nets, including liquidity support, crisis management policies and deposit insurance. With the increasing complexity of financial products and growing inter-linkages among financial markets, maintaining domestic financial stability has become a shared responsibility among various institutions. This requires a coordinated approach

¹² Presentors in this session were Ms. Cristina Que Orbeta (Executive Vice President of the Philippine Deposit Insurance Corporation), who acted as chair and discussed issues related to strengthening financial sector safety nets; Mr. Masaru Tanaka (Deputy Director General of the Bank of Japan's International Department and Chief of the Center for Monetary Cooperation in Asia), who spoke on good practices in maintaining robust financial safety nets, focusing on liquidity support and crisis management policies; Mr. Mahmood Pradhan (Senior Advisor, Asia and Pacific Department, of the IMF), who focused on deposit insurance and investor and policyholder protection schemes; and Mr. Jean-Pierre Sabourin (Chief Executive Officer of the Malaysia Deposit Insurance Corporation), who made a presentation on challenges and solutions to developing financial safety nets in Asian emerging markets.

among regulators domestically and internationally and cooperation with the private sector.

Basic components of financial safety nets include (a) prudential regulation and supervision, (b) lender of last resort, (c) deposit insurance, and (d) bank failure resolution mechanisms. However, financial safety net structures vary across economies, with different institutions (e.g., central banks, deposit insurance agencies, finance ministries) playing the key roles. In Asia, financial sector safety nets were significantly enhanced after the Asian crisis, which enabled Asian economies to quickly recover from the recent crisis. Nevertheless, the threat of contagion as demonstrated by the Greek crisis underscores the need to continue strengthening financial systems.

Within the region, financial systems have remained largely stable during the recent global financial crisis. Reforms undertaken in the wake of the 1997 Asian crisis contributed to strengthening the region against global financial shocks. These reforms included (a) implementation of Basel II; (b) adoption of international accounting standards; (c) enhancement of corporate governance structures, particularly oversight capacity and accountability of boards of directors to promote proper risk management environments; (d) improved disclosure requirements; (e) harmonization of corporate governance standards with other financial regulators; and (f) implementation of risk-based supervision and continuous capacity building.

In addition, most economies in the region began to set up and enhance their deposit insurance systems in order to help prevent a repetition of the Asian crisis. They became more responsive to the need for harmonized and coordinated supervisory and regulatory methods and policies, which are required by increasingly complex financial systems. Even as these reforms continued, most economies in the region responded quickly to the global financial crisis, taking such pre-emptive measures as providing temporary blanket guarantees or access to liquidity facilities to the banking sector and increasing deposit insurance coverage.

The Philippines provides an example of how Asian authorities have responded to financial crises. To strengthen coordination among supervisors after the Asian crisis, the central bank, the Philippine Deposit Insurance Corporation (PDIC), the Insurance Commission and the Securities and Exchange Commission jointly established a Financial Sector Forum in 2004. In response to the sub-prime crisis, the PDIC proposed the doubling of the maximum deposit insurance coverage and institutional measures to reduce moral hazard, including authority to determine deposit accounts covered by insurance, to conduct special examination of banks and to examine the deposit accounts of banks that are found engaging in unsafe and unsound practices as an exception to the Deposit Secrecy Law.

Asian economies' success in weathering the impact of the global financial crisis notwithstanding, regulators in the region remain wary of future dangers to their financial systems, particularly in the wake of recent developments in Europe. As a result, they continue to seek ways to further strengthen their abilities to withstand such future threats and to effectively respond to new emerging threats. Three key issues for Asian economies are (a) how to promote robust frameworks for liquidity support; (b) sound crisis management policies and procedures in providing deposit insurance; and (c) development of deposit insurance through good governance practices.

1. Promoting Robust Frameworks for Liquidity Support

Maintaining robust financial safety nets involves robust frameworks for liquidity support and sound crisis management policies and procedures. Japan's experience following the burst of the bubble in the early 1990s provides an example of how a

central bank, in this case the Bank of Japan (BOJ), carried out innovative monetary policy measures on a large scale and offer lessons on liquidity and financial crisis detection, frameworks for liquidity support and crisis management.

After the burst of the bubble, Japan experienced its “lost decade,” going through two business cycle expansions and three contractions until 2003. This period of decline is now attributed not just to the bursting of the bubble, but more particularly to a decline in population and productivity. The BOJ responded to the situation through continued reduction of the overnight interest rate until it reached virtually zero in the latter half of 1995.

In addition to the Zero-Interest Rate Policy (ZIRP), the BOJ significantly expanded the size of its balance sheet, embarking on a policy of “credit easing,” a policy that has been widely adopted by other central banks after the recent crisis in the form of quantitative easing (QE). This was achieved through the purchase of asset-backed securities, asset-backed commercial papers and stocks held by financial institutions. After exiting ZIRP and resuming a Targeted Interest Rate Policy (TIRP) in the third quarter of 2000, the BOJ introduced the Lombard-type lending facility in early 2001, with the aim of creating a ceiling over the TIRP and capping any abrupt rise in interest rates.

QE emerged as a new monetary policy option once the ability of ZIRP to prevent further economic downturns or deflation reached its limit, and the central bank needed to convince the public of its determination to prevent an economic freefall and a deflationary spiral. The implementation of QE has required an “extra-ZIRP,” or provision of redundant liquidity on top of the existing ZIRP. As QE inflates the central bank’s balance sheet both in quantitative and qualitative terms, the central bank faces the question of whether a numerical target for expanding the balance sheet as well as the expansion of eligible assets for credit easing would be credible.

The initiation of QE has spurred expectations by the public and the government of visible effects on the economy and on prices, making it crucial for the central bank to effectively communicate to the public and the government regarding the measurement of QE and its effects. The BOJ undertook a clear commitment to the public and the government that it would maintain QE until the year-on-year change in the Consumer Price Index (CPI) has turned positive on a sustainable basis.

The BOJ injected ample liquidity to financial institutions through open market operations that resulted in the accumulation of unremunerated current deposit balances (CDBs) at the BOJ. As the economy deteriorated further, the BOJ increased the target levels of CDBs it held in order to convince the public and the government of its resolve. The BOJ’s provision of ample liquidity was effective in maintaining financial system stability, while the commitment to maintain QE until the CPI target was reached proved even more effective in supporting the economy through its effect of flattening the yield curve.

Upon exiting QE and resuming ZIRP in early 2006, the BOJ adopted a “two-perspective approach” to monetary policy. This consisted of examining whether the BOJ’s base scenario follows a path of sustainable growth with price stability within a semi-annual forecast period (first perspective) and assessing various risks, including tail risks that can seriously damage the economy beyond the forecast time horizon (second perspective). This represented the introduction of a forecast-based policy, which is inherently a forward-looking risk management approach, which has helped mitigate the spillovers from the global financial crisis for Japan to a certain extent. In providing liquidity support, the BOJ relied on a system for quick diagnosis of domestic financial market developments in monitoring and reacting to capital flows.

Market intelligence is a crucial element in this framework. Well-developed and diverse domestic financial markets provide good conditions for this, by providing the central bank access to a wide source of market information. In addition to a central bank's trading counterparties – commercial and investment banks – the central bank can also exchange views with other entities such as hedge funds and non-financial firms in order to obtain broad market information covering money, structured debt, currency, corporate bond, property and derivatives markets. This enables the central bank to diagnose arbitrage flows among various markets and forecast reversal risks for asset prices.

Japan's experience and various financial crises since 1997 have helped identify key indicators that are useful in anticipating liquidity and financial crises detection. Among these are domestic demand, exports, real GDP growth, prices of consumer goods and key commodities, land prices, equity share prices, current accounts, unemployment and foreign exchange rates. In the wake of massive fiscal and monetary stimulus undertaken since the recent crisis, the size of public debt outstanding relative to nominal GDP, reliance on foreign investors, yields of key sovereign bonds, policy rates of key economies and growth of bank lending also bear watching.

2. Sound Crisis Management Policies and Procedures in Providing Deposit Insurance

Deposit insurance played an important part in economies' response to the recent crisis across the globe. A total of 46 economies introduced enhanced depositor protection in the wake of the crisis, with the majority (28) increasing coverage levels and 19 introducing full depositor guarantees. However, none introduced blanket guarantees protecting all creditors.

- Among the 28 economies increasing the coverage, the size of coverage varied significantly from 75 to 400 percent; 21 economies permanently increased deposit insurance coverage and seven increased coverage on a temporary basis.
- Of those that introduced full depositor guarantees, five relied on public commitments (instead of legal protection); four offered unlimited coverage for banks operating in their respective jurisdictions; and most offered guarantees only to household (as opposed to corporate) deposits.

The primary motivation for these responses has been the large systemic shock to banking systems that resulted from the crisis. In addition, deposit insurance was seen as part of the broader policy response, which included large scale liquidity support, unconventional monetary policy accommodation, recapitalization initiatives and public sector guarantees offered to shadow banking systems. The absence of resolution frameworks was also an important consideration.

The unwinding of enhanced temporary protection presents a challenge. Most (18) of the economies that increased coverage have announced termination dates. Economies that have not done so are mainly those where deposit insurance was enhanced through a public statement. There is a marked absence of phased withdrawals or discussions with stakeholders. With coordination becoming a major concern, a number of economies in the EU and Asia have started actively engaging in international discussions, with a growing interest in regional collaboration.

Deposit insurance aims to protect small depositors when banks fail and protect financial system stability. Its coverage is limited to specific bank liabilities (personal deposits) and excludes other debt instruments and wholesale deposits. Design issues include coverage (involving the trade-off between depositor discipline and financial stability); moral hazard (involving low-coverage, risk-based premiums and capital requirements on banks); and payment of claims (involving the promptness of

payments needed to maintain public confidence, which can vary between 3 months as indicated by the EU directive and 30 days as proposed by the IMF).

Guidelines for extraordinary measures in times of crisis include the following:

- Blanket guarantees are useful in stabilizing depositor expectations while policy adjustments are being undertaken and a resolution strategy is being implemented.
- Measures will not be credible if the public sector fiscal position is weak.
- Moral hazard increases if the guarantee is prolonged.
- Extraordinary measures should be accompanied by a comprehensive banking strategy.

Lessons from the recent crisis underscore the need for deposit insurance to be explicit, compulsory and to acknowledge the trade-off between coverage and risk-taking behavior; the difficulty of addressing cross-border resolution frameworks and agreements; and the need for deposit insurance to be widely understood and for timely payments to be made. These lessons also underscore the primary importance of a robust supervisory regime as a necessary foundation for building an effective deposit insurance scheme.

3. Development of Deposit Insurance through Good Governance Practices

Building institutional reputation and capacity to deliver on mandates is an important element of strengthening financial safety nets. Public confidence in the integrity of deposit insurers and in their ability to meet their mandates is a critical factor in maintaining public confidence in financial systems. Governance is a key issue for a number of reasons.

- The mandate of deposit insurers is to promote and maintain public confidence in financial system stability, which depends on trust, transparency and prudence. If depositors trust the organization that protects their savings, they will also have more confidence that their interests are well protected and that they would be reimbursed promptly and accurately when a bank failure occurs. It is therefore important for a deposit insurer to be credible by demonstrating that it is well governed and well managed.
- Being well-governed is important for governing well. It is therefore important to demonstrate good governance to those that deposit insurers regulate, as well as to the general public.
- With sound governance comes integrity and effectiveness of operations, which are important for stakeholders to have confidence in the deposit insurer's capacity to effectively fulfil its mandate.

The experience of Malaysia Deposit Insurance Corporation (MDIC) provides useful lessons in this regard. MDIC is a government statutory body, established under legislation as an operationally independent government agency. Being operationally independent allows MDIC to have authority to promptly carry out its duties without undue political or bureaucratic intervention. Specific legislative authority enables it to operate effectively as an instrument of public policy, dedicate sufficient time, resources and expertise to promoting sound risk management of banks, and fulfilling its mandate of intervening and resolving a troubled bank in the best interests of depositors and the financial system. Independence also makes MDIC clearly accountable to depositors and the authorities from which its mandate originates.

MDIC's governance structure mirrors that of private sector corporations, with a Board of Directors led by a Chair and a management led by the CEO. The board has full

responsibility for setting the vision, mission, strategic direction and corporate policies governing the institution's business and affairs. It has responsibility for oversight and assessment of management's performance against approved performance indicators and expected behaviour.

There is clear separation between the board and the management, and the CEO, who is responsible for day-to-day management, is not a member of the board. The CEO is recommended by the board, appointed by the Minister of Finance and accountable to the board for implementing the vision and directions within approved strategic parameters. Management is required to provide the board with timely, relevant, accurate and complete information and recommendations.

MDIC is accountable to parliament, and publishes an annual Corporate Plan, which is disseminated to all key stakeholders. The plan provides a list of initiatives that MDIC will undertake during the year. It is also required to produce an annual report to the parliament within three months after the end of its fiscal year.

Three principles – accountability, openness and integrity – form the cornerstone of MDIC's corporate governance. They are implemented in the following way:

- MDIC undertakes an annual strategic planning process where the board approves strategic directions, key initiatives and budgets as part of a three-year rolling corporate plan. The process commences with an assessment of risks in the operating environment and the risks facing the corporation. Key performance indicators are also designed and approved by the board, against which the performance of management is assessed at the end of the year.
- The board assesses and monitors its performance against defined roles and responsibilities set out in its Board Governance Policy. The policy includes 15 standards covering independence of the board, board effectiveness and governance responsibilities, roles and responsibilities of committees, board composition and succession, role and responsibilities of the CEO, appointment of officers, compensation of officers, succession planning, standards of behavior and ethics, significant risks to the corporation, control environment and internal audit, corporation "in control", strategic management process, effective communication and review of board governance policy.
- As part of accountability, MDIC established specific job descriptions defining in detail the roles of the board, its members, the Chairman and the CEO. The board assesses its own performance collectively and annually by filling out a questionnaire. Responses are consolidated and reported at the board meeting.
- In relation to transparency, the board publicly discloses the following information: (a) state of MDIC's governance practices against international benchmarks; (b) performance against each of the standards in the Governance Policy; (c) the work of the board and each of the board committees; (d) statements of internal controls and descriptions of implementation of risk management systems and activities attested to by corporate officers; (e) financial statements attested to by the CEO and Chief Financial Officer (CFO) and validated by the Chief Internal Auditor (CIA).
- MDIC carries out public consultations on key policy and regulatory matters, holds roadshows and briefings, outreach programs and annual dialogues with key stakeholders related to the public release of the annual report.
- To promote high standards of conduct and behavior among employees and board members, MDIC put in place a Code of Conflict of Interest, ethical behaviour standards, and a Code of Business Conduct. Board members and

employees report annually in writing their compliance with these codes. Briefings are held from time to time to remind employees of their responsibilities.

- To maintain a strong and independent internal audit function, the CIA, who reports directly to the board through the Audit Committee, prepares each year a risk-based annual audit plan for board approval. The internal audit function covers the state of internal controls, reports on audits undertaken in accordance with the board-approved annual internal audit plan, and tracks management performance against any recommended action plans arising from the audit.
- Under MDIC's enterprise-wide risk management function, the CRO reports directly and continuously to the board through audit committee and board meetings on the organization's risks and their identification, management and mitigation. The board is required to ensure that policies are sound, current and relevant and are being complied with. The independence of the CRO enables the flow of information to the board without undue control or interference from management, and provides an independent assessment of management's performance in the areas of internal controls and risk management.
- In line with internal checks and balances, the Audit Committee Chairman holds regular sessions individually with the CFO, CIA and CRO to provide them an opportunity to discuss issues of concern without the presence of the CEO. The board also holds regular sessions and may call any senior officer to discuss issues without the CEO being present. External auditors are invited to all Audit Committee meetings and receive relevant materials and reports in advance of these meetings.

In addition to its efforts to maintain good corporate governance, MDIC also fulfils its statutory mandate to promote sound risk management in the financial system in two ways:

- MDIC assesses annual premiums based on a differential premium system, with each bank paying premiums corresponding to its risk profile (the higher the risk profile, the higher the risk premium).
- MDIC collaborated with the central bank in establishing the Financial Institutions Directors' Education Program (FIDE), which is designed to enhance the quality of corporate governance in financial institutions.

III. PROMOTING INCLUSIVE GROWTH IN THE REGION

Speakers¹³ focused on issues ranging from innovative policies to promote greater financial inclusion, including the development of mobile phone banking and agent banking to expand access to finance, the promotion of financial identity and improvement of credit reporting systems for increased and more equitable access to credit, to the improvement of lending infrastructure to facilitate lending technologies for SMEs.

¹³ Presentors in this session were Dr. Julius Caesar Parreñas (Advisor on International Affairs at the Bank of Tokyo-Mitsubishi UFJ, Ltd.), who acted as chair and presented an overview of the development of microfinance as a tool for inclusive growth; Ms. Pia Roman-Tayag (Bank Officer V and Head of the Philippine central bank's Inclusive Finance Advocacy Staff), who spoke on innovative policies to promote financial inclusion; Mr. Thomas Tan Koon Peng (Deputy Director of the Malaysian central bank's Development Finance & Enterprise Department), who focused on Malaysia's experience in SME and micro-financing; and Mr. Anthony Hadley (Vice President for International Policy in Experian), who proposed a regional agenda for promoting financial inclusion and SME lending.

A. Overview of Financial Inclusion

In recent years, microfinance has grown to become a potentially powerful tool for promoting financial inclusion, with the growing profitability of MFIs and the expanding scope of their operations. Microfinance is attracting increasing interest from financial institutions and investors all over the world. The key factor has been the introduction of technology and innovation, such as mobile banking, point-of-sale technology and biometrics, among others. Microfinance has taken off in economies where policies and regulations have been put in place to enable the use of these technologies.

In its 2009 report, ABAC recommended that policy makers and regulators consider undertaking measures in six areas identified in a recent ground-breaking study, where policies can have the most impact. These are mobile phone banking, agent banking, channel and product diversification, public bank reform, financial identity and consumer protection. There are already many existing best practices in providing an enabling environment for the introduction and use of new technologies and innovations. Many of these can be easily made available through various institutions.

There is also a need to recognize the potential of the public sector, especially government banks, in promoting financial inclusion, especially given the magnitude of the challenges to expand coverage of microfinance. Capacity-building measures to assist developing economies in effectively harnessing public sector resources and in promoting public-private sector partnerships are needed.

There is much commonality between the G-20's approach and the approaches currently being discussed in APEC and there is great potential for APEC to undertake an initiative that complements the work of the G-20. Finally, there are ample resources, including expertise, funding and networks that private, international and bilateral institutions are willing to share in support of an APEC financial inclusion initiative.

B. Innovative Policies to Promote Financial Inclusion: The Philippine Experience

The Philippine experience provides valuable lessons for promoting financial inclusion. Access to finance currently remains a major challenge for the Philippines. Of all municipalities, 37% are not served by banks as of the end of 2009. Financial services have been concentrated in higher income urban areas, resulting in low-income areas being significantly underserved. With its archipelagic geography, the Philippines faces the challenge of bringing more people into the financial system, particularly those who remain unserved and unbanked.

Financial inclusion involves the delivery of a wide range of financial services, including savings, credit, insurance, payments and remittances, which need to be appropriately designed and priced for the particular market. The Philippine experience demonstrates that bank and non-bank delivery channels can be combined to more effectively achieve greater financial inclusion. It shows that market-based solutions to address financial access issues are feasible with an appropriately supportive regulatory environment. Finally, it underscores the importance of proper and proportionate regulation of all financial service providers in order to uphold consumer protection and financial system integrity.

The Philippines undertook a major step toward financial inclusion in 2000, when the General Banking Law was passed, mandating the central bank, the Bangko Sentral ng Pilipinas (BSP), to recognize microfinance as a legitimate banking activity. Since then, the BSP's policy approach has been to mainstream microfinance in the banking sector and enable a wider scale and scope of banking operations while maintaining prudential standards. With a shift from directed credit to a market approach, bank-based microfinance has proven to be profitable and viable. The BSP has also

institutionalized the means by which non-government organizations (NGOs) can transform themselves into formal financial institutions.

The Philippine central bank as financial regulator adopted an open and flexible but cautious approach to mobile banking regulation designed to allow different pioneer models to flourish. This approach has enabled the development of two successful initiatives -- Smart Money (bank-based model) and G-Cash (non-bank-based model).

Smart Money is a partnership between a telecommunications company and a bank, where the bank uses the former's mobile technology platform and distribution outlets as delivery channels, in addition to their branches and ATM network. The bank issues and owns Smart Money, which is accessed via a Mastercard-powered card. In this model, the bank is the e-money issuer while the telecommunications company is the e-money technology provider.

G-Cash, on the other hand, is issued by a subsidiary of the telecommunications company, and is accessed via the mobile device's virtual wallet. Delivery channels are the telephone firms technology platform for distribution outlets and individually authorized agents. Banks may partner with the provider and use G-Cash for their mobile banking applications. In this case, the company is a non-bank entity licensed as an "e-money issuer," an entity regulated by the central bank.

Enabling mobile banking involved key adjustments to bank supervision, including targeted regulations governing technology risk management, consumer protection, registration of remittance and transfer agents, know-your-customer (KYC) rules, general regulation for e-money business, and e-money outsourcing. It also involved supervisory capacity-building, including close interaction with industry players.

These efforts have yielded measurable results. To date, there are now around 8 million users of e-money and g-cash. An increasing number of banks are offering mobile banking for microfinance operations, which at present include 49 rural banks, where there was none in 2005. Some banks have lowered interest rates (50 bps on monthly rates) on microfinance loans for clients that use the text-a-payment platform. Domestic remittance costs fell from 6-7% of the amount of remittance to 1%.

The Philippines' experience provides lessons on general principles that can be shared with other regulatory bodies in the region. These include the following:

- Financial inclusion is a worthy policy objective that should be pursued alongside the development of stable and efficient financial systems, contributes to social cohesion and helps share more broadly the fruits of economic development.
- E-banking and e-money are powerful tools to promote greater financial inclusion, but require appropriate regulation and supervision to ensure integrity of financial systems and protection of vulnerable consumers.
- There should be clear delineation between deposit-taking transactions and the receipt of funds for fund transfer purposes, which should consequently be regulated proportionately.
- Retail deposit taking should be limited to banks and other similarly regulated institutions, including cooperatives.
- Financial inclusion of the unbanked and underbanked can be initiated and deepened through simple and convenient deposit and fund transfer products that can mature into more value-generating relationships.
- A combination of a liberalized branching regime, mobile banking technology and optimization of strategic partnerships with third-party non-bank agent networks can help significantly in extending the reach of banking services.

- Sound internal governance arrangements are an essential pre-condition to complement proportionate regulation and to maintain order and discipline in potentially large ecosystems.

Moving forward, the BSP continues to closely and continuously monitor market developments and the appropriateness and responsiveness of regulations. It is undertaking reviews of various issues, which include enhancement of e-money platform and operations through the recognition of e-money technology providers; policies on objecting beneficial owners, definition of microfinance and microfinance loans, and consumer protection regulations including price transparency and fair treatment. The BSP also continues its advocacy efforts for personal finance and financial literacy, while promptly responding to emergent risks, including financial crimes, abuse of financial services and over-indebtedness.

C. Enabling Inclusive Growth through SME and Micro-Financing: Malaysia's Experience

Malaysia has ranked high in terms of financial access, having been ranked first for "Getting Credit" by the World Bank's Doing Business Reports for the past three years. For SMEs' access to credit, key factors have been the following:

- The National SME Development Council. Chaired by the Prime Minister and administered by the SME Corporation, it formulates broad policies and strategies and provides direction for comprehensive development of SMEs across all sectors. It also oversees coordination of and ensures effectiveness of policy implementation. The NSDC is focused on three strategic thrusts: strengthening infrastructure, building SME capacity and enhancing access to finance.
- The Central Credit Reference Information System. The CCRIS is managed by the central bank. It collects information from banks and regulated financial institutions. It provides a comprehensive credit database for financial institutions on the financial standing of customers and suppliers to facilitate a more efficient and effective credit process. The CCRIS also provides useful information that helps the central bank in analysis, regulation and supervision. It benefits the public by serving as a conduit to inculcate a good credit culture.
- The SME Credit Bureau. The bureau serves as a one-stop central database of credit-related information on SMEs that provide consolidated credit information, including credit ratings. It helps SMEs access financing on more favourable terms and obtain prompt decisions on their financing applications, which could be evaluated on a more balanced and objective basis. It identifies areas of improvement. Commencing operations in July 2008, the bureau now has more than 28,000 SMEs and 38 financial institutions as registered members.
- The Credit Guarantee Corporation. The CGC offers a wide range of products and services. Its key achievements include (a) the introduction of a risk adjusted pricing structure, a guarantee scheme for start-ups and equity financing through joint venture with global fund management companies; (b) participation in the securitization of SME loans as credit enhancer; and (c) expansion in the scope of beneficiaries to include Islamic banks and development financial institutions. It has yielded positive results, guaranteeing over 400,000 SME accounts totalling RM45.6 billion since 1972. Outstanding guarantees at of the end April 2010 involve slightly over 100,000 accounts and RM16.9 billion.
- Financing schemes that include the central bank's SME Funds, an export-import Overseas Guarantee Facility and Century Capital Funds for Agriculture. To these may be added recent stimulus measures, including RM 1.2 billion facilities for SME assistance and modernization; SME Assistance Guarantee Scheme

amounting to RM2 billion and the Working Capital Guarantee Scheme and Industry Restructuring Financing Guarantee Scheme.

With respect to microfinance, a comprehensive framework was introduced in 2006 to replace the previous framework that relied mainly on government-sponsored schemes. The new framework was based on key principles (commercially driven with market-based lending rates; self-sustaining funding; and need for well-defined business model). The microfinance development strategy was pursued in three stages.

- First, the central bank encouraged financial institutions to provide microfinance by organizing senior management visits to successful MFIs abroad, providing global case studies and information and holding frequent discussions with financial institutions.
- Second, the central bank jointly designed with local moneylenders, formal financial institutions providing microfinance and traditional banks the right products to meet the needs of micro-enterprises for easy, fast and convenient service. This included the creation of the Micro Enterprise Fund to lower the financing costs for micro-enterprises while encouraging responsible credit approval and monitoring practices.
- Third, the central bank undertook various initiatives to promote awareness of the availability and benefits of microfinance. These included an official microfinance logo, distribution of microfinance flyers, advertisements and mass media interviews, information booths at exhibitions and roadshows, posters and financial institutions' own sales and marketing.

Regarding consumer education and protection, the key elements of Malaysia's strategy are (a) avenues for seeking help and redress (including the central bank's financial advisory services via an integrated contact center, complaint and advisory units at financial institutions, the Small Debt Restructuring Scheme, the ABMConnect Toll Free Channel, the Credit Counselling and Debt Management Agency, the Financial Mediation Bureau and advisory services through the SMEInfo Portal); (b) the Malaysian Deposit Insurance Corporation; (c) enhanced disclosure through transparency and disclosure requirements for banking and insurance products; (d) fair market practices through market conduct requirements for market players; and (e) enhancing financial awareness through structured consumer education programs, exhibitions and roadshows, promotional materials and mass media advertisements.

D. Promoting Financial Inclusion and SME Lending through Financial Identity

Extensive investigation and studies have demonstrated that full-file, comprehensive credit reporting increases lending to the private sector, especially among lower income segments, and results in better loan performance. Based on these results, four key general principles for credit reporting are being proposed:

- First, positive and negative payment data should be reported to private credit bureaus.
- Second, bank, non-bank and non-financial payment data should be reported to private credit bureaus comprehensively and not segmented.
- Third, consumer rights and protections are paramount, and the OECD Fair Information Principles – including notice, access, choice, correction and redress – should serve as the foundation for any regional standard.
- Fourth, data use should be limited to well-defined permissible purposes.

The rationale for adopting and implementing these standards is derived from extensive investigations and studies, which have demonstrated that full-file and comprehensive credit reporting increases lending to the private sector, especially among lower social segments, and results in better loan performance than segmented and negative-only reporting.¹⁴

Credit reporting forms a critical part of the financial infrastructure. It provides rapid access to accurate and reliable standardized information on potential borrowers, enables lenders to evaluate credit risk more accurately, reduces loan processing time and costs, and promotes increased lending while reducing the level of bad debts. Credit reporting also contributes to enhanced borrower discipline. It is therefore important to establish robust credit reporting systems that enable credit bureaus – both public and private – to effectively perform their proper roles in the economy.

Such robust systems greatly contribute to financial inclusion. The use of full-file reporting and broad participation by data furnishers have been shown to significantly increase private sector lending and access to mainstream credit. They have also proven effective in promoting more equitable lending, particularly benefiting underserved communities including low-income groups, women and young people, who experience greater increases in their acceptance rates compared to currently served demographics.

Effective and efficient credit reporting systems also lead to smarter lending, with lenders experiencing fewer defaults by borrowers and improved portfolio performance. For borrowers and the economy as a whole, risk-based pricing enabled by credit reporting can contribute to lowering the cost of credit, by reducing the de facto subsidization of higher-risk borrowers by lower-risk borrowers and thus reduce average interest rates charged by lenders.

Broadening information sharing beyond the financial sector helps in expanding lending to lower income segments. This would need to involve the collection of data from such sources as utilities and telecommunications payments, rentals, remittances and informal SME trade credit and payment data.

Establishing financial identities involves blending data with analytics to allow lenders to establish identity verification and authentication throughout the customer life cycle, while also preventing fraud. This involves establishing ID for initial screening, account opening, account monitoring, collections and KYC compliance. Complexities associated with establishing financial identity include common surnames, common first names, use of nicknames or initials instead of full first name and use of multiple valid addresses.

The inventory of unique identifiers that can help in establishing financial identities include national identity numbers, social security numbers, names, addresses, wireless or land telephone numbers, date of birth, driver's license number and account numbers. Shared information is key to establishing financial identity, and this can be obtained by facilitating information from multiple third-party sources.

Discussions focused on the need to further expand microfinance activities in rural areas, and the current lack of data that could serve as useful indicators of progress in this respect. Participants also noted the importance of promoting financial literacy and the sharing of successful experience in this area, including the harnessing of

¹⁴ These variations in the structure of credit reporting are defined as follows: (a) **Full-file reporting** is the reporting of both positive payment information and negative information, late and on time payments are reported. (b) **Negative-only reporting** is the reporting of only negative information such as delinquencies and defaults. (c) In **segmented reporting**, only data from one sector, e.g., retail or banking, are contained in reports. (d) In **comprehensive reporting**, the system contains information from multiple sectors, often even extending to non-financials.

rural banks and the mass media. The discussions also emphasized the need for financial regulators to take the leadership, in order to encourage market players to share data and move toward a robust and inclusive credit reporting system and to put in place the appropriate frameworks for the protection of consumer rights and data.

CONCLUSIONS AND RECOMMENDATIONS

Through the discussions on current global financial regulatory reform processes in the context of ongoing regional efforts to strengthen and develop the region's financial markets, the dialogue provided valuable perspectives on the situation of financial systems in the region and how they may be strengthened. Key messages from the discussions were as follows:

- Risks to financial markets are growing again.
- Asian banks and regulators face increased economic, financial and regulatory challenges.
- Growing fiscal imbalances present serious new risks and must be addressed.
- Regulatory reforms must be handled with care.
- Conditions in the region are not adequately reflected in current reform initiatives.
- Divergence between G20 and regional financial market development goals must be avoided.
- Synergy between G20 and East Asian regional processes can be achieved.
- Improvements to the revised Basel framework are needed to allow the region's emerging markets to benefit from reforms.
- Basel reforms are likely to increase costs but provide long-term benefits.
- There is a need to minimize the use of top-down one-size-fits-all approaches.
- Focus on supervisory capacity is badly needed.
- The Asia-Pacific region needs a regional architecture to effectively deal with regulatory reforms.
- The region can benefit from further development of the Chiang Mai Initiative Multilateralization facility
- The Asia-Pacific region needs a regional financial forum of regulators and the financial industry.
- There is a continuing need to develop financial sector safety nets in the region's emerging markets.
- Good corporate governance is crucial for stable growth, and corporate governance scorecards should be considered as a useful tool.

The dialogue was a reminder to participants that the issues discussed are not entirely new but are instead the same policy concerns that regulators face on any given day and within which market players operate. The key difference however is that the same questions are now being raised in the context of recent and on-going financial market difficulties. The challenge is that stakeholders open themselves to a lot of questions for which the answers are neither obvious nor readily available. The value of this exercise is that we have come to understand that the old answers may no longer apply or that the old questions are no longer in step with current realities.

Moving forward, the dialogue highlighted the importance of a balanced approach to reforms in response to the crisis. International standards need to be recognized as the minimum threshold rather than the limits of regulation. There should be ample room above the threshold to allow for local conditions to be calibrated into governance standards. As financial markets gain their strength in the diversity they offer, which provides options to the public, managing the duality of a minimum threshold and accounting for localized conditions become increasingly important.

This can be achieved by allowing idiosyncratic differences in the governance of markets while ensuring consistency with the broad intentions of minimum standards.

The dialogue also pointed to the importance of financial inclusion as a key element that must be included in financial regulatory reform efforts. Sustained economic recovery can only be achieved if economies pursue balanced and inclusive growth agenda. Microfinance can play an effective role in expanding access to finance (particularly in the Asia-Pacific region's dynamic emerging markets), which is a crucial factor for attaining balanced and inclusive growth. In addition to ensuring proper regulatory and supervisory oversight of microfinance, this requires an enabling policy environment that financial regulators can help facilitate through their leadership.

APEC can play an important role in promoting capacity-building to assist emerging market regulators in the region in dealing with many of these issues. APEC Finance Ministers can support capacity-building measures involving public-private sector collaboration to help emerging markets in the region improve financial supervisory capacity, calibrate local conditions to global standards, promote the adoption of proven tools such as scorecards to strengthen corporate governance, strengthen financial sector safety nets (including frameworks for liquidity support, sound crisis management policies and procedures and deposit insurance firms' governance and strategies), and promote financial inclusion.

APEC can also support the development of a robust regional financial architecture, including a regional forum of financial regulatory authorities and the financial industry to address regulatory issues in light of the region's needs, review the relevance and impact of global reforms on the region, and ensure that development of global standards take into account market practices and market infrastructure in the region.

APPENDIX A: FORUM PROGRAMME

The 6th SEACEN/ABAC/ABA/PECC Public-private Dialogue for the Asia-Pacific Region

Makati, Philippines, 15-16 June 2010

*Theme: The Role of the Financial Sector in Sustaining Economic Growth and
Stability*

Program Agenda

Tuesday, 15 June 2010

(Venue: Ballroom B, 2nd Floor, Intercontinental Hotel)

08:30 – 09:30 **Registration and Networking**

09:30 – 10:30 **Opening Ceremony and Introduction**

Opening Remarks

Dr. A. G. Karunasena,
Executive Director
The SEACEN Centre

Welcome Remarks on behalf of ABAC

Mr. Gary Judd QC,
Co-Chair, Advisory Group on APEC Financial System
Capacity-Building and Chairman, ASB Bank

Keynote Address

Mr Peter B. Favila
Monetary Board Member
Bangko Sentral ng Pilipinas

Group Photograph

Tea Reception

10:30 – 11:45

SESSION 1:

Recent Economic Developments and Prospects

- Current economic situation in major markets and the macroeconomic and monetary policy responses being undertaken by their governments and central banks
- Short- and medium-term outlook for the global economy and the impact of global developments on emerging markets in Asia

Session chair:

Mr. Diwa Guinigundo, Deputy Governor, Bangko Sentral ng Pilipinas, "The Global Macroeconomic Outlook In 2010 And Beyond"

Panelists:

- Mr. Cheung Tai Hui, Regional Head of Economic Research, SE Asia, Standard Chartered Bank, “Impact Of Current Macroeconomic And Monetary Policies On Asian Economies From A Private Sector Perspective”
- Mr. Joseph E. Zveglich, Jr., Assistant Chief Economist, Economics and Research Department, Asian Development Bank, “The Economic Outlook For Asia’s Economies”

Open Forum

Closing remarks by Session Chair

11:45 – 13:15

SESSION 2:

Update on Current Financial Market Conditions: The Aftermath of the Global Financial Crisis

- Prospects for recovery of global financial markets
- The outlook for emerging Asian banking and capital markets
- Implications of the transfer of financial risks to sovereign balance sheets and higher public debt levels on financial markets
- Prospects for capital inflows to emerging markets and implications for the development of asset prices and exchange rates
- Exit strategies and financial markets

Session chair:

Dato’ Ooi Sang Kuang, Deputy Governor, Bank Negara Malaysia, “The Impact Of Global Responses To The Crisis On Asian Emerging Markets And Challenges For Monetary Policy”

Panelist:

- Mr. Mahmood Pradhan, Senior Advisor, Asia and Pacific Department, International Monetary Fund (IMF), “Post-Crisis Development And Prospects Of Global Financial Markets”
- Mr Dilshan Rodrigo, Deputy General Manager (Risk), Hatton National Bank PLC, “Outlook For Emerging Asian Banking And Capital Markets”

Open Forum

Closing remarks by Session Chair

13:15 – 14:00

Lunch

14:00 – 15:30

SESSION 3:

The Role of the Financial Sector in Economic Recovery and Stability

- Progress and future directions of the G-20 agenda for promoting growth and financial stability
- Priority issues for financial regulatory reform in East Asia
- Asia-Pacific and East Asian regional financial integration and cooperation

- How to develop synergies between global and regional financial reform, development and integration processes

Session chair:

Mr. Takashi Kihara, Director, Administration, Management and Coordination, Asian Development Bank Institute
 “Regional Cooperation To Develop, Strengthen And Integrate Asian Financial Markets”

Panelists:

- Mr Sjamsul Arifin, Advisor to Deputy Governor, Bank Indonesia, “Future Directions Of The G-20’s Agenda For Strong, Sustainable And Balanced Growth And For Strengthening The International Financial Regulatory System”
- Mr. Nicholas de Boursac, Managing Director, Asia Securities Industry & Financial Markets Association (ASIFMA), “Comments On The Global And Regional Financial Sector Reform Initiatives”

Open Forum

Closing remarks by Session Chair

15:30 – 15:45

Tea Break

15:45 – 17:15

SESSION 4:

The Reform of Basel II: Implications for Asian Emerging Markets

- The Basel Committee’s reform program and its impact on banking regulation and supervision and the banking industry in Asian emerging markets
- Raising the quality, consistency and transparency of the capital base
- Enhancing risk coverage
- Supplementing the risk-based capital requirement with a leverage ratio
- Reducing procyclicality and promoting countercyclical buffers
- Addressing systemic risk and interconnectedness

Session chair:

Mr. Rizalino Navarro, Senior Adviser, Director and Chairman of Risk Management Committee, Rizal Commercial Banking Corporation, “The Reform Of Basel II And Its Implications For Banks In Asian Emerging Markets”

Panelists:

- Mr Jason George, Senior Financial Sector Specialist, Financial Stability Institute, Bank for International Settlements, Representative Office for Asia Pacific, “The Reform Of Basel II And Its Impact On Asian Regulatory Practices”
- Mr. Hideaki Tanaka, Chief Manager, Basel II Implementation Office, Corporate Risk Management Division, Mitsubishi UFJ

- Financial Group (MUFG), “The Reform Of Basel II From The Perspective Of An Asian Global Bank”
- Antonio Paner, Head of Treasury, Bank of the Philippine Islands, “The Reform Of Basel II And Its Impact On The South-East Asian Region”

Open Forum
Closing remarks by Session Chair

17:15 – 18:30

SESSION 5:

**Strengthening Governance of Financial Institutions:
 Lessons from the Financial Crisis**

- Major causes of governance failures leading to the global financial crisis
- The role of bank directors in strengthening firm-wide risk management
- The FSB Principles for Sound Compensation Practices: Issues and progress of implementation

Session chair:

Ms. Juliet McKee, Advisor on Corporate Governance and Member of New Zealand PECC, “Promoting Good Corporate Governance In The Region’s Financial Institutions”

Panelist:

- Dr. Jesus P. Estanislao, Chairman, Institute of Corporate Directors, “Challenges And Solutions To Implementing Good Corporate Governance Principles In Asian Banks”

Open Forum
Closing remarks by Session Chair

18:30 – 20:00

Welcome Reception Hosted by The SEACEN Centre
(Venue: Bahia, Hotel Intercontinental)
(Attire: Business)

Wednesday, 16 June 2010

(Venue: Ballroom B, 2nd Floor, Intercontinental Hotel)

09:00 – 10:30

SESSION 6:

**Strengthening Frameworks for Global Regulatory
 Cooperation**

- Early warning and economic and financial surveillance under the IMF and Chiang Mai Initiative Multilateralization (CMIM) frameworks
- Cross-border crisis management for major cross-border firms and legal framework for crisis intervention
- Resolution tools and frameworks to mitigate failures of major financial institutions and reduce moral hazard
- Development of an international framework for cross-border bank resolution arrangements

- Establishment of supervisory colleges for significant internationally active financial institutions

Session chair:

Dato' Ooi Sang Kuang, Deputy Governor, Bank Negara Malaysia, "Issues In Implementing Early Warning And Economic And Financial Surveillance Under Global (IMF) And Regional (CMIM) Frameworks"

Panelists:

- Mr. Kenneth Waller, Australian APEC Study Centre at RMIT University, "Developing A Regional Framework To Support Global Regulatory Cooperation"
- Dr. Olarn Chaipravat, FPRI Advisory Co., Ltd, Thailand, "Comments on CMIM Framework: Impact and Contribution to Regulatory Cooperation"

10:30 – 11:00

Tea Break

11:00 – 13:00

SESSION 7:

Promoting Inclusive Growth in the Region

- Innovative policies to promote greater financial inclusion
- Development of mobile phone banking and agent banking to expand access to finance
- Promoting financial identity and improving credit reporting systems for increased and more equitable access to credit
- Improvement of lending infrastructure to facilitate lending technologies for small and medium enterprises

Session chair:

Dr. J.C. Parrenas, Advisor on International Affairs, The Bank of Tokyo-Mitsubishi UFJ, Ltd. "Global And Regional Efforts To Promote Financial Inclusion"

Panelists:

- Ms. Pia Roman-Tayag, Bank Officer V and Head of IFAS, Bangko Sentral ng Pilipinas, "Innovative Policies To Promote Financial Inclusion"
- Mr. Thomas Tan Koon Peng, Deputy Director, Development Finance & Enterprise Department, Bank Negara Malaysia, "SME and Micro Financing: Malaysia's Experience"
- Mr. Tony Hadley, Vice President, International Policy, Experian (and representing the Asia-Pacific Credit Coalition), "A Regional Agenda For Promoting Financial Inclusion And SME Lending"

Open Forum

Closing remarks by Session Chair

13:00 – 14:00

Lunch

14:00 – 15:30

SESSION 8:

Strengthening Financial Sector Safety Nets

- Promoting robust frameworks for liquidity support, including lender-of-last-resort facilities and central bank emergency lending
- The development of deposit insurance as well as investor and policyholder protection schemes.
- Promoting sound crisis management policies and procedures
- Challenges and solutions

Session chair:

Ms. Cristina Q. Orbeta, Executive Vice President,
Philippines Deposit Insurance Corporation

Panelists:

- Mr. Masaru Tanaka, Deputy Director General and Chief of Center for Monetary Cooperation in Asia (CeMCoA) International Department, Bank of Japan, “Good Practices In Maintaining Robust Financial Safety Nets: Liquidity Support And Crisis Management Policies”
- Mr. Mahmood Pradhan, Senior Advisor, Asia and Pacific Department, International Monetary Fund (IMF), “Good Practices In Maintaining Robust Financial Safety Nets: Deposit Insurance, Investor And Policyholder Protection Schemes”
- Mr. Jean Pierre Sabourin, Chief Executive Officer, Malaysia Deposit Insurance Corporation, “Challenges And Solutions To Developing Financial Safety Nets In Asian Emerging Markets”

Open Forum

Closing remarks by Session Chair

15:30 – 16:15

CLOSING COMMENTS

On behalf of ABA

Dr. Shing-Shiang Ou
Chairman,
Asian Bankers’ Association Policy Advocacy Committee

On behalf of PECC

Ambassador Antonio Basilio
Chairman,
Philippine Pacific Economic Cooperation Committee

Closing Remarks

Dr. A. G. Karunasena,
Executive Director
The SEACEN Centre

Closing Remarks

Mr. Nestor A. Espenilla, Jr.
Deputy Governor
Bangko Sentral ng Pilipinas

Presentation of tokens of appreciation to the host bank

APPENDIX B: LIST OF ABBREVIATIONS

ABA	Asian Bankers' Association
ABAC	APEC Business Advisory Council
ABMI	Asian Bond Markets Initiative
ACU	Asian Currency Unit
ADB	Asian Development Bank
AFSD	Asian Financial Stability Dialogue
AMF	Asian Monetary Fund
AMRO	ASEAN+3 Macroeconomic Research Office
APEC	Asia-Pacific Economic Cooperation
ASEAN	Association of Southeast Asian Nations
BCBS	Basel Committee on Banking Supervision
BIS	Bank for International Settlements
BOJ	Bank of Japan
BSP	Bangko Sentral ng Pilipinas (Central Bank of the Philippines)
CAR	Capital adequacy ratio
CCP	Central counterparty
CCRIS	Central Credit Reference Information System
CDB	Current deposit balance
CDS	Credit default swap
CEO	Chief executive officer
CFO	Chief financial officer
CGC	Credit Guarantee Corporation
CGIF	Credit Guarantee and Investment Facility
CIA	Chief internal auditor
CMI	Chiang Mai Initiative
CMIM	Chiang Mai Initiative Multilateralization
CPI	Consumer price index
CRA	Credit rating agency
EMEAP	Executives' Meeting of East Asia Pacific Central Banks
EU	European Union
FASB	Financial Accounting Standards Board
FIDE	Financial Institutions Directors' Education Program
FSB	Financial Stability Board
FSSB	Framework for Strong, Sustainable and Balanced Growth

FTA	Free trade agreement
IASB	International Accounting Standards Board
IIF	Institute of International Finance
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
KYC	Know-your-customer
MDIC	Malaysia Deposit Insurance Corporation
NSDC	National SME Development Council
NSFR	Net stable funding ratio
OECD	Organisation for Economic Co-operation and Development
OTC	Over-the-counter
PECC	Pacific Economic Cooperation Council
QE	Quantitative easing
RTA	Regional trade agreement
SEACEN	South East Asian Central Banks
SIFI	Systemically Important Financial Institution
SME	Small and medium enterprise
TIRP	Targeted interest rate policy
WTO	World Trade Organization
ZIRP	Zero interest rate policy

APPENDIX C: ABOUT THE CO-ORGANIZING INSTITUTIONS

The Asian Bankers Association (ABA) serves as a forum for advancing the cause of the banking industry and promoting regional economic cooperation. It provides a venue for an exchange of views and information on banking opportunities in the region; facilitates networking among bankers; and encourages joint activities that would enhance its members' role in servicing the financial needs of their respective economies and in promoting regional development. With 100 members from 25 Asian economies, the ABA holds annual meetings and conferences on issues of concern to the banking sector, with a view to broadening its members' perspectives on the situation and opportunities in the region. Other activities include policy advocacy, an information exchange program; and a professional development program. For more details, visit <http://www.aba.org.tw>.

The Pacific Economic Cooperation Council (PECC) aims to serve as a regional forum for cooperation and policy coordination to promote economic development in the Asia-Pacific region. Since its foundation in 1980 it has been a policy innovator in trade, finance, information technology, human capacity building, urban development, and mining amongst many others. PECC brings together leading thinkers and decision makers from government and business in an informal setting to discuss and formulate ideas on the most significant issues facing the Asia Pacific. It regularly develops and advocates regional policy initiatives to aid in the stable economic development of the region. PECC is the only non-government official observer of the APEC process. For more details, visit <http://www.pecc.org>.

The Asia-Pacific Economic Cooperation (APEC) Business Advisory Council (ABAC) was created by the APEC leaders in 1995 to advise APEC on the implementation of its agenda and to provide the business perspective on specific areas of cooperation. ABAC is comprised of up to three members from each of APEC's 21 member economies, representing a range of business sectors. ABAC holds an annual dialogue with the APEC leaders and engages in regular discussions with APEC ministers in charge of trade, finance, and other economic matters. Through the *Advisory Group on APEC Financial System Capacity Building*, ABAC collaborates with other international and regional public and private sector organizations and development agencies on financial capacity building issues. For more details, visit <https://www.abaconline.org>.

The South East Asian Central Banks (SEACEN) Research and Training Centre reviews and analyses financial, monetary, banking and economic developments in its 16 constituent member economies and in the region as a whole. Established in 1982 and located in Kuala Lumpur, Malaysia, it initiates and facilitates co-operation in research and training relating to the policy and operational aspects of central banking. Since 2001, training has become its principal activity, focusing on areas that have practical applications in central banking, i.e., monetary policy, banking supervision and payments and settlement systems. Research plays supporting functions. Research papers are presented and used as course materials at appropriate training events. For more details, visit <http://www.seacen.org>.